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THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for 2002/2003

Overview

By the end of the third quarter of FY03, it is clear that the acceleration in economic growth promised by early indicators has indeed materialized. Provisional estimates based on July-March figures show that the FY03 GDP growth is comfortably ahead of the target, and that, this improvement is remarkably broad based, with strong participation from major segments of the economy. Specifically, the recovery by agriculture has complemented by a very strong showing by the manufacturing sector, both of which, in turn, supported a much-improved performance by the services sector (see **Table 1.1**).

Table 1.1: Real GDP Growth
percent

	FY02 (P)	FY02 (R)	FY03 (P)	Adjusted[1] base FY03 (P)
GDP	3.6	3.4	5.1	4.6
of which				
Agriculture	1.4	-0.1	4.2	3.4
Manufacturing	4.4	5.0	7.7	5.8
Services	5.1	4.1	5.3	5.0

[1] Percent change in FY03 (P) over FY02 (P); (P): Provisional
Source: Economic Survey, 2002-2003 (R): Revised

Notwithstanding the impressive performance of the economy, the estimated 5.1 percent growth in real GDP (against the 4.5 percent annual growth target) requires some explanation. It appears that a *part* of the above-target growth is simply a function of prior year adjustments that altered[1] the base for the FY03 growth. Adjusting for these, the estimated real GDP growth for FY03 comes down to approximately 4.6 percent – in line with SBP projections and still above the FY03 growth target (reflecting the actual improvement in the economy).

The July-March FY03 performance of the economy is even more creditable considering that it was achieved despite a negative shock in Q3-FY03, in the form of the conflict in Iraq that pushed up the country's oil bill and increased energy and transportation costs.

Clearly, the macroeconomic stabilization program initiated in December 1999 is finally paying dividends in the form of an increasingly robust and resilient economy, which appears set on an upward growth trajectory towards a trend growth of 6 percent (or higher) by FY06. This positive outlook is well captured in

[1] The growth rates in FY02 altered not only due to data revision in FY02, FY01 was also revised downwards.

the performance of key economic indicators for July-March FY03 (see **Table 1.2**), all of which depict substantial improvement.

Table 1.2: Economic Indicators

percent

	Jul-Mar		
Growth rates	**FY01**	**FY02**	**FY03**
Large-scale manufacturing[1]	8.6	1.5	8.5
Exports	8.4	-2.7	20.2
Imports	7.2	-8.5	22.8
Home remittances[2]	15.1	125.3	101.4
Tax revenues (CBR)	14.9	-2.5	15.0
CPI (Q3 over Q3)	4.6	3.3	3.4
Private sector credit (CBs)	14.1	8.7	15.3
Money supply (M2)	4.7	9.3	13.0
Total liquid reserves[3]	2,275	5,236	10,312
Foreign private investment[4]	104.0	285.0	664.7
As percent of GDP[5]			
Fiscal deficit	4.2	3.2	2.1
Trade deficit	-2.3	-1.4	-1.7
Current account balance	-0.1	3.8	6.4

[1] Based on 91 items.
[2] Excluding receipts on account of Kuwait war affectees & Hajj.
[3] With SBP & with banks. End-March, in million US$.
[4] Net flows, in million US$.
[5] Based on full year GDP.

While both domestic and external demand contributed to the July-March FY03 LSM growth, it is noteworthy that most of the segments reporting higher (above 10 percent) growth are dependent primarily on the former. This is quite encouraging, given that the factors contributing to domestic demand (e.g. access to cheap credit) are likely to persist into Q4-FY03 and beyond.

As pointed out in earlier reports of the SBP, there are serious gaps in the coverage of data included in the manufacturing sector. Some of the fast growing emerging exports such as value added textiles are largely missing from the reported data on LSM, while the small scale manufacturing is assumed to grow at a constant rate (based on past sample survey). Thus the analysts looking at the domestic output and export volume data are unable to reconcile the two. Some of them jump to their cynical conclusions about the veracity of export data, indulging in speculative conjectures and distract from a serious debate on the improvement in the coverage of statistical series.

Similarly, export demand has been remarkably stable through July-March FY03 driven, in addition to improved market access, by a fall in exporters' cost of funds and the relative stability in the exchange rate (due to the heavy forex purchases by SBP). As these factors likely to persist, it seems reasonable to assume that the exports will continue propelling the aggregate demand in the economy.

The SBP's policy to only partially sterilize its heavy forex market purchases and leave ample rupee liquidity in the market with a view to bring lending rates down has started paying dividends. Lending rates have declined from 10.7 percent in November 2002 to 8.3 percent by March 2003; export finance rates from 6.5 percent to 3.5 percent during the same period. The lower interest rates stimulated

demand for credit by the private sector, which jumped to Rs 107.2 billion during July-March 2003 from Rs 54 billion extended in the corresponding period of FY02. The excess liquidity also forced banks to aggressively market credit and develop new products. The pickup in credit to agriculture, SMEs and consumer durables reflects this trend.

Despite strong (11.7 percent) growth in reserve money, the inflation rate has been benign. Low inflation was a key comfort point for the SBP while lowering the sterilization of forex purchases, in a successful bid to drive down lending rates. While the low lending rates contributed to the increase in aggregate demand, they also helped raising the profitability of businesses. It appears that the decline in inflationary pressure stems primarily from a combination of good agri-harvests (lower food price inflation) and imported deflation (due to the stronger rupee).[2] SBP projections indicate that the annualized FY03 inflation is likely to be contained in the 3.1 to 3.3 percent range.

Going forward, the SBP is likely to continue moderating the appreciation of the rupee through forex purchases, but a confluence of additional factors may help *stabilize* interests rates. Firstly, the premature retirement of expensive external debt could help drain liquidity from the market. Moreover, it is likely that, the government will increase its budgetary borrowings from the banking system (unlike the retirement seen in July-March FY03). All of these factors are expected to neutralize the impact of continuing external account surpluses. Finally, the SBP is likely retaining a neutral monetary stance unless interest rates rise abnormally.

Another determinant of the expansion in private sector credit and the simultaneous lowering of lending rates was the lower dependence of the government on the banking system. Strong revenue growth together with sustained fiscal discipline, helped contained the fiscal deficit for July-March FY03 to 2.1 percent of GDP, well in line with the 4.6 percent of GDP revised FY03 annual target. In particular, the 15 percent growth in CBR tax collections during July-March FY03 was underpinned by a 22.6 percent increase in sales tax (which directly proxies increasing consumption of goods and services in the economy). It should be noted that the strong growth in CBR tax receipts, despite the unexpectedly large refunds,[3] was complemented by notable increases in both, surcharges (up 19.8

[2] In fact, it is now clear that even the upsurge in WPI inflation during July-March FY03 (which was in contrast to the deceleration in CPI inflation), was primarily due to the impact of rising oil prices.
[3] July-March FY02 saw very large refund payments, totaling Rs 62.9 billion, as the government paid off accumulated refund arrears. It has therefore been expected that the corresponding July-March FY03 would be *significantly* lower. However, the actual July-March FY03 refunds of Rs 60.4 billion were only *marginally* lower.

percent YoY) and non-tax receipts (up 11.7 percent YoY) during July-March FY03, pushing aggregate revenues for the period to Rs 505 billion, a rise of 15.7 percent compared to the corresponding period of FY02.

While the growth in current expenditures of the Federal government has been contained, the corresponding growth in current expenditures of provincial governments, although declining, remains very high. Similarly, the YoY *decline* in July-March FY03 development expenditures, despite the increased fiscal space due to a Rs 26.4 billion YoY reduction in debt servicing charges, is potentially a source of concern (if current trends continue). It must be clearly recognized that a reduction in the budgetary deficit achieved at the cost of lower development expenditures is not desirable.

Although the financial sector, textiles, oil & gas sectors have witnessed increased investment over the past two years following the improvement in the macroeconomy, the pace of overall investment is moderate, the rate of accumulation in relation to the requirements is unspectacular, and the sectoral penetration remains limited. A sharp rise in public sector development spending is imperative if the economy is to observe the acceleration and spread of investment required to sustain high growth rates which is necessary if the economy is to see a rise in employment and lower poverty.

Outlook for FY04

The budget announced for FY04 sets the course for transition from macroeconomic stabilization to higher growth trajectory. While incentives have been provided and irritants removed to stimulate production and investment in the private sector, the main emphasis is on higher development outlays by the public sector. The PSDP has been allocated 30 percent higher resources and public sector investment is expected to increase from 4.5 percent to 5.5 percent of GDP, but the continuing worry is the slow implementation and lack of utilization of these resources.

It appears that there will be a shortfall of 1 percentage point of GDP in the current fiscal year in public sector investment, arising mainly due to large non-utilization of PSDP allocations. As the crowding-in effect of public investment is quite strong in Pakistan, it is imperative that the institutions responsible for carrying out major projects are monitored regularly at the highest policy level to ensure that the impediments are removed, the results are achieved and the benefits are realized. This has become even more important due to arrival of a new player on the scene i.e., the local governments, whose impact on the poverty related expenditures is likely to be much sharper than other tiers of the government.

The second generation of reforms should therefore focus on institutions, as good policies, good governance and good luck, will not translate automatically into better living standards for the population at large, unless the delivery of services, easy access to justice, police and executives, uniform application of the rule of law, strengthening of local governments, and reform of key economic organizations, are not ensured in the next few years. Macroeconomic policies and management are easy to improve; given the political will, microeconomic incentives can also be sharpened for private sector; but the majority of the population will not derive the economic benefits unless the existing institutions are revamped and restructured. This is a difficult challenge that requires strong leadership, which can oversee the design, monitor the implementation, remove the bottlenecks and ensure the results. The inertia and apathy around institutional reforms in the past have to give way to a more pro-active outcome-oriented approach.

Executive Summary

Agriculture

During FY03, agriculture sector posted an impressive recovery by witnessing an estimated 4.2 percent growth compared to a 0.1 percent decline in FY02. The momentum to the growth came from major crops, which rose by 5.8 percent during the year as against a decline of 1.8 percent in FY02.

Canal water availability during FY03 was higher both in *kharif* (by 14.9 percent) and in *rabi* (by 31.7 percent). This, coupled with the timely rainfalls, encouraged farmers to bring larger area under cultivation for sugarcane, rice and maize. However, due to the fall in area under cotton crop in the Punjab (mainly caused by the delayed water availability in the region), the total area under cultivation during FY03 was almost unchanged compared to FY02.

The entire growth in the major crops seems to stem from the improvement in the yields. In particular, per hectare yield of gram rose by the unprecedented 58.5 percent, followed by rice (9.6 percent), cotton (7.3 percent), wheat (5.4 percent) and maize (2.6 percent).

During entire FY03, the market prices of rice, cotton, maize and wheat during post-harvest period, remained higher compared to FY02. This helped to improve the financial position of the farmers during FY03, and may lead to increased focus on these crops in the next season.

Large-scale Manufacturing

The Large-scale Manufacturing (LSM) recorded a remarkable growth of 8.5 percent during July-March FY03 compared with a mere 1.5 percent growth in the corresponding period of the preceding year. The growth in LSM was broad based; all LSM sub-sectors, except leather products, witnessed an increase in output during July-March FY03.

However, tremendous growth in the production of automobile, electronics and construction related industries on the back of robust domestic demand, has been the highlight of LSM growth during July-March FY03. The increasing availability of consumer financing, sustained growth in remittances, robust growth in agriculture accompanied by increase in productivity etc., have been the major factors boosting domestic demand.

As a result, the production of the allied industries such as tyres & tubes, paper and board, cement, steel and chemicals also saw increases. The textile industry too, performed well on the back of rising exports of textile products.

Fiscal

The government was successful in containing the budgetary deficit in line with the full year target during July-March FY03. This was achieved on the back of strong growth in total revenues (15.7 percent) and disciplined expenditures (6.8 percent). The end-Q3 figures suggest that it is likely that government will be able to meet the budget deficit target of 4.6[4] percent of GDP.

An improvement in the fiscal position of the government is the result of a good performance of both tax and non-tax components of revenues. Within tax revenues, CBR tax receipts, which constitute 81.9 percent of tax revenue, recorded a strong growth (15.0 percent) for a third successive quarter of FY03, predominantly helped by a recovering economy, broadening of the tax base, and reform of the taxation system. These developments are in sharp contrast to the FY02 poor performance.

During July-March FY03, total expenditures grew at a lower rate than the nominal GDP growth, but accelerated marginally over the corresponding period of the previous year. The major impetus came from higher current expenditures by the provincial governments, defense and subsidies, while a sharp reduction in debt servicing (Rs 26.4 billion) and *shortfall* in development expenditures (Rs 9.9 billion) partially offset these increases.

Money and Credit

A host of factors including (1) substantial rupee liquidity injections through SBP forex purchases, (2) strong deposit growth, and (3) lower net requirement from the government sector, kept the interest rates under pressure during Q3-FY03. The resultant decline in lending rates and rising aggregate demand in the economy led to an exceptional rise in net private sector credit during Q3-FY03. Although, the increase in aggregate demand had been apparent even prior to the November 2002 discount rate cut, credit off-take only accelerated thereafter.

Since the November 2002 discount rate cut was in response to the apparent weakness in net credit expansion, once net private sector credit began rising strongly, SBP signaled its neutral stance by keeping the discount rate unchanged,

[4] Modified budget estimate, Economic Survey 2002-03. Preliminary target was 4.0 percent.

even as interest rates declined over Q3-FY03 amidst high market liquidity and the expectation of a further discount rate cut

These expectations of a discount rate cut together with the ample liquidity in the market created a self-perpetuating cycle – heavy bids in auctions (as banks strove aggressively to book assets) led to lower auction cut-offs which, in turn, spurred heavier bids, at lower rates, in the succeeding auctions. This trend culminated in bids of over Rs 100 billion in both of the March 2003 auctions, and as a result, the benchmark 6-month T-bill yield fell to an all time low of 2.1 percent.[5] Significantly, the weighted average lending rates slipped into single digits, reaching 8.3 percent by end Q3-FY03.

Thus, during Q3-FY03, the government continued to benefit from lower interest rates, substantial foreign assistance and inflows from the non-bank sources. This allowed the government to retire its borrowings from the banking system as a whole. However, within the banking sector, there was a shift of government debt from SBP towards the commercial banks, reflecting the continuing SBP efforts to sterilize a part of the heavy growth in Net Foreign Assets (NFA). There was also an exceptionally heavy retirement in commodity operation loans, which is indeed a welcome development. This exceptional retirement is apparently a result of improved financial position of relevant federal agencies and the provincial governments, and the government policy of transferring this activity to the private sector.

In contrast to substantial retirement in the government sector, the non-government sector credit recorded an impressive Rs 95.4 billion expansion, during July-March FY03. The major contributor to this was net private sector credit, which recorded an expansion of Rs 107.2 billion; almost twice the expansion seen in the corresponding period of FY02.

Banking

Deposits of the banking sector registered a strong growth of 4.1 percent during Q3-FY03, making a cumulative rise of 11.6 percent during July-March FY03. This unprecedented growth stemmed entirely from the rupee deposits, as forex deposits continued to decline. An exceptional rise in remittances as well as increase in PSE's and the government deposits led this impressive growth.

[5] In the auction dated March 6, 2003, this yield went further down before bottoming out at a new all time low of 1.6 percent in the auction dated April 3, 2003.

Low lending rates along with the strengthening economy, led to exceptionally strong credit disbursement, which recorded a Rs 210.9 billion increase during July-March FY03 compared to the same period of FY02. This unusual rise in overall credit was headed by a surge in the private sector credit.

Other significant developments are the decline in banking sector spread and improvement in NPLs. While the former saw a decline of 126 basis points during Q3-FY03, the latter declined to Rs 242.2 billion with a contraction of Rs 2.0 billion during the quarter under review.

Prices

Inflationary trends further subdued in Q3-FY03. The Consumer Price Index and Sensitive Price Indicator continue to decelerate and registered annualized increases of 3.1 percent and 2.8 percent compared with 3.5 percent and 4.1 percent respectively in the corresponding period last year. Although both the food and non-food components of CPI recorded lower price increases, the contribution of food inflation in aggregate CPI inflation continued to decline. By contrast, WPI posted higher increases from 0.4 percent last year to 8.6 percent. The higher WPI inflation was mainly driven by non-food prices. However, WPI inflation in March 2003 has also edged down, indicating that inflation is likely to be subdued in the remaining months of FY03.

Capital Market

Unlike the previous quarter, Q3-FY03 was marked with considerable volatility. During this quarter, the benchmark KSE-100 index assumed a new high, reaching 2955.52 points on January 16, 2003. The downturn persisted during the entire month of February 2003, which saw the market bottom out around the 2350-point levels. Encouragingly, the March 2003 rally was more robust and less speculative than the earlier one.

As regards the badla market, the badla rates reached as high as 48 percent during the January speculative rally, but for most of the remaining quarter, they were around the 8 percent level due to ample liquidity prevailing in the market.

The corporate bond market remained active during Q3-FY03. As compared to Q2-FY03, when three new issues worth Rs 2.2 billion were issued, seven new issues worth Rs 2.7 billion were listed in Q3-FY03. However, the debt market is still very small compared to the equity market.

External

Pakistan's external account continued with the trends set in previous quarters by posting yet another large surplus of US$ 2.1 billion during Q3-FY03 despite a rising trade deficit and services outflows. The main drivers of the surpluses were the continued buoyant growth in workers' remittances, logistic support receipts, declining interest payments on external debt & liabilities and higher official transfers mainly due to US$ 1.0 billion *write-off* from US. This helped the SBP in maintaining its heavy interbank forex purchases during Q3-FY03, raising the SBP forex reserves to US$ 9.5 billion and moderating the rupee appreciation. The Pak rupee appreciated by only 0.88 percent during Q3-FY03.

Exceptional inflows such as the debt write-off, logistic support and grants by the US and Saudi Oil Facility (SOF) contributed US$ 1.7 billion during Q3-FY03 to the balance of payments. After adjusting for such inflows, while there is a gradual narrowing of the quarterly current account surpluses, the capital account witnesses a roughly parallel offsetting improvement.

Cumulatively, current account surplus rose to US$ 4.4 billion during July-March FY03, registering growth of 96.5 percent over the corresponding period last year. Exceptional inflows contributed US$ 2.4 billion to this gain, while the remaining improvement mainly came from continued surge in workers' remittances and lower interest payments on external debt & liabilities.

Notwithstanding the 20.2 percent growth in exports, the trade deficit rose by 43.9 percent in July-March 2003 mainly on the back of 27 percent higher POL imports. This increase in the oil bill was due to both a sharp rise in international oil prices and an increase in quantum to maintain oil reserves in the wake of US-Iraq war. This led to a 22.8 percent increase in the total import bill in this period. Although international oil prices impose a significant burden on Pakistan's import bill (US$ 2.4 billion, or 26.8 percent of the total import bill), the offsetting export growth kept the July-March FY03 trade deficit from rising even further.

Other groups such as machinery and food, also contributed in the rising imports. As a matter of fact, machinery imports were the second largest claimant on the import bill, having 8 percent contribution in the total import growth. Within machinery imports, the highest share was captured by textile machinery, which was followed by imports of road motor vehicles. The broad based growth pattern in imports can be gauged from the fact that non-oil and non-food imports also showed a similar robust increase, as did overall imports.

In terms of exports, the highest contribution in overall growth was made by the textile sector (68 percent), which grew by 21.4 percent during July-March FY03. All the major value-added textile categories contributed in this growth with significant increases in volumes and unit values. Among the major non-textile exports the performance of rice remained impressive, which witnessed 20.8 percent growth mainly on the back of higher unit values.

The capital account posted a deficit of US$ 1.0 billion, during Q3-FY03, despite higher FDI, rising FE-25 trade financing and increased assistance on account of project financing. This was primarily due to the treatment of debt write-off as an outflow in the long-term capital (official). Excluding the US debt write-off and FE-25 trade financing, the capital account deficit declined to US$ 187 million during Q3-FY03 down US$ 617 million from Q3-FY02.

2 Real Sector

2.1 Agriculture

With the completion of the two cropping seasons[1] i.e., *kharif* and *rabi*, it is now evident that the crops sub-sector, will indeed record strong growth in FY03, in contrast to the contraction in output witnessed during the previous two years. The improvement is primarily due to higher per hectare yields, for *most* of the important crops.[2] The rise in yields, in turn appears based on an improvement in water availability (especially through timely rains), and relatively higher prices of preceding crops, both of which encouraged the increased use of agri-inputs during FY03.

This strong performance by the crops sub-sector is particularly encouraging given that the production of wheat has been below target (which was more than offset by a substantial improvement in rice and sugarcane harvests). However, while the latest wheat crop estimate of 19.3 million tonnes is below the FY03 target, it remains 5.6 percent higher than the FY02 output.

Thus, the FY03 growth in major crops[3] has further strengthened. This, together with the reasonable growth in livestock and the recovery in minor crops[4], has pushed the annual agricultural sector growth to an estimated 4.2 percent for FY03. This is in sharp contrast to a marginal decline of 0.1 percent recorded in FY02, as well as above the 2.5 percent revised target for FY03.

It is worth noting that while availability of water through canals improved significantly over FY02, it remained well below normal,[5] and the timely rainfalls in both, *rabi* and *kharif*, were therefore important contributors to the recovery in the crops sub-sector during FY03. However, despite the delay in canal-water supply at the sowing-time for cotton in the Punjab, no *severe* crop-specific water shortage was seen throughout the year.

Higher productivity in the case of rice, cotton and wheat coupled with their better market prices during FY03 resulted in a significant financial gain to a majority of

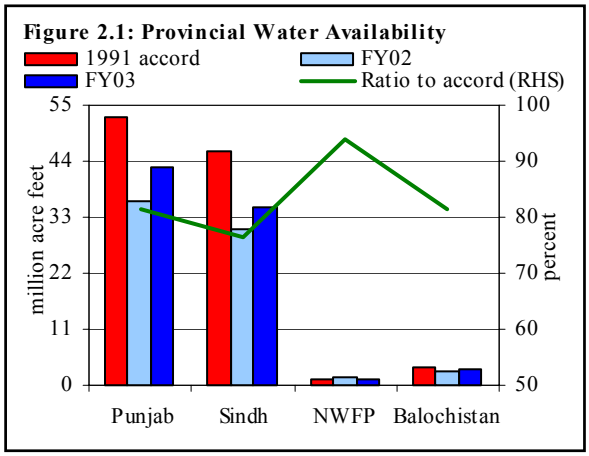
[1] *kharif*: April to September and *rabi:* October to March.
[2] The cotton crops saw a drop in the area under cultivations but this was offset by a sharp jump in yields.
[3] Include: rice, wheat, barley, jowar (sorghum), bajra (millet) maize, gram, cotton, sugarcane, rapeseed & mustard, sesamum and tobacco.
[4] Include: vegetables, fruits, condiments, oil-seeds, pulses (except gram) and fodder.
[5] Normal water availability refers to the average water supply during 1996-2000. It equals the water availability mentioned in the 1991 Water Accord.

the farmers.

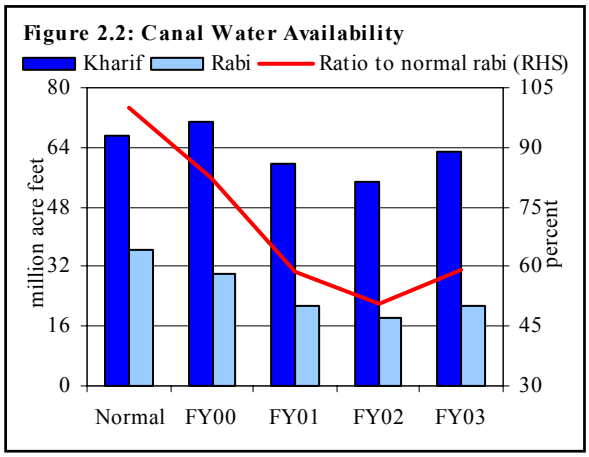
2.1.1 Water Availability

The unexpectedly good rainfalls during the crop year FY03 (April 2002 to March 2003) helped push water availability above the rather conservative estimates fixed early in the crop year amidst fears of a continuing drought-like situation in the country. In particular, the heavy down pours in February 2003, brought 1.1 Million-Acre Feet (MAF) to Mangla and 0.35 MAF additional water to Tarbela. Canal head water supplies during current r*abi* crop thus increased to 23.7 MAF from October 1 to March 20, FY03 compared to 18.0 MAF during the same period of FY02.

The improvement in the release of canal water was seen in both Sindh and the Punjab, the two provinces with the heaviest share in agriculture. However, in NWFP, the release of water was marginally less than in FY02, primarily because of higher rainfalls that reduced the need of canal water during FY03 (see **Figure 2.1**).



It is worth stressing here that despite the improvement, the *rabi* canal water availability in FY03 remained well below normal. The deterioration in canal water supply that began in *rabi* FY00, was at the worst during FY02 when overall water availability was 29.1 percent less than the average water availability and the hardest-hit cropping season was r*abi FY02* when the water supply was 50.5 percent lower than normal (see **Figure 2.2**).



The impact of the continuing (though lower) shortfall in canal water availability during FY03,

was mitigated only by the *timings* of the rainfalls during the period. This only serves to highlight the continuing vulnerability of the sector, stemming from inadequate development of water resources.

The canal water situation in the *kharif* FY04, however, is expected to improve further compared to FY03 because the snowfall over the mountains has been close to normal levels during this winter. The snowmelt would be expected to augment the relatively higher leftover level in reservoirs after *rabi* FY03.

2.1.2 Crops Sub-sector

With the widespread recovery by most of the major and minor crops during FY03 the crops sub-sector seems set to regain it customary leading position in the agricultural growth profile.

Area Under Cultivation

Other than cotton and maize, the aggregate area under all other major crops increased by 1.4 percent to 13.6 million hectares during FY03 compared to the area sown in the preceding year. However, the decline in acreage of cotton was so great, that the overall growth in cultivated area under all major crops rose only marginally (see **Table 2.1**).

Table 2.1: Area Under Important Major Crops

thousand hectares

		FY03		% change over	
Crops[1]	**FY02**	**Target**	**Actual**	**FY02**	**Target**
Cotton	3,116	2,860	2,753	-11.6	-3.7
Sugarcane	1,000	991	1,100	10.0	10.9
Rice	2,114	2,114	2,225	5.3	5.3
Gram	934	979	960	2.8	-2.0
Maize	942	958	935	-0.7	-2.4
Wheat	8,058	8,080	8,090	0.4	0.1
Total	16,163	15,982	16,063	-0.6	0.5

[1] These constitute around 96 percent share in all major crops.

Source: Ministry of Food, Agriculture and Livestock

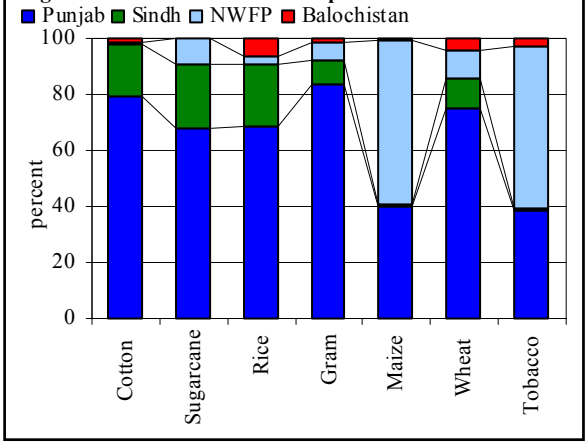
The decline in the area under cotton came entirely from the Punjab, where a shortage of canal irrigation water at sowing time led farmers to decrease the cultivated area even below the FY02 crop levels.

The situation was altogether different for sugarcane, as rainfalls at the sowing and growing period in the Punjab helped to increase the area under the crop. The Punjab alone contributed more than 78.0 percent increase in the area under sugarcane during FY03.

Similarly, the higher availability of canal-head water in all rice-growing regions caused the area under cultivation to increase by 111 thousand hectares. Of this increase, 42.5 percent was contributed by *Balochistan*, followed by 32.8 percent by the *Punjab,* and 24.5 percent by *Sindh*, while; the area in *NWFP* almost remained unchanged.

The area under wheat during FY03 showed a very marginal improvement over the preceding year, almost all of which emerged from *NWFP*. The province-wise shares indicate that with the exception of maize and tobacco (with higher share of *NWFP*), the *Punjab* accounted for the highest share in each of other important major crops (see **Figure 2.3**).

Figure 2.3: Provincial Breakup of Area



During FY03, the area under cultivation of some important minor crops also showed a significant improvement over FY02. In particular, pulses were grown on an area higher than in FY02. In case of vegetables, the area under potato during FY03 decreased while, the area under onion and chilies, increased compared to the preceding year (see **Table 2.2**).

Table 2.2 Area Under Important Minor Crops

thousand hectares

		FY03		% change over	
Crops	**FY02**	**Target**	**Actual**	**FY02**	**Target**
Mung	239	235	261	9.2	11.1
Lentil	45	55	46	2.2	-17.2
Mash	55	46	58	6.0	25.6
Potato	105	107	100	-5.2	-6.8
Onion	104	106	106	2.6	0.7
Chillies	43	93	47	11.0	-49.0
Total	590	642	619	4.8	-3.7

Source: Ministry of Food, Agriculture and Livestock

Interestingly, the aggregate area under minor crops, at around 26 percent of the total cropped area, is almost equal to its share of value addition in the crops sub-sector.

The expansion in minor crops is limited by a number of factors; the dominant of these being the proximity of cultivable land to markets because these are relatively perishable commodities. Other factors include the type of cultivable land available, farmers' preferences and the farm to market roads. The correlation between market access and growth in marketing high value added minor crops suggests that an improvement in farm to market roads, and investments in storage facilities offer the possibility of significantly enhancing value added in the sector.

Production of the Crops

FY03 was clearly a very good year for the crops sub-sector as most important major and minor crops saw a rise in harvests (see **Table 2.3**). Amongst the major

crops, only the wheat crop was below target (but even this relatively disappointing harvest represented a 5.6 percent YoY increase in output).

Similarly, amongst the important minor crops, only lentils and chillies suffered below-target harvests. However, even these crops saw a YoY increase in the FY03 production.

Encouragingly, the improvement in the output of the crops sub-sector owed mainly to jumps in the yields of most important crops. Only chillies saw a drop in yields (see **Figure 2.4**).

Table 2.3: Production of Important Crops
thousand tonnes

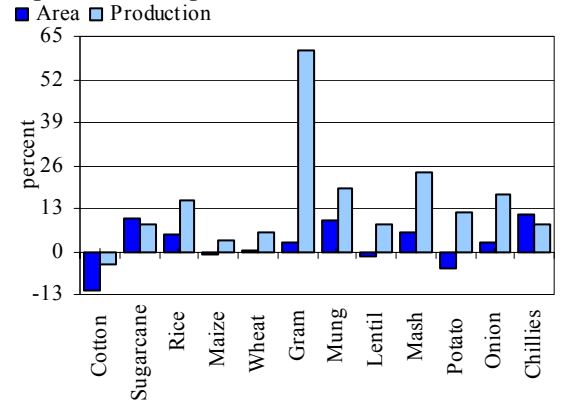
		FY03		% change over	
Crops	**FY02**	**Target**	**Prel.**	**FY02**	**Target**
Major crops					
Cotton (million bales)	10.6	10.1	10.2	-3.9	1.3
Sugarcane	48,042	46,000	52,049	8.3	13.1
Rice	3,882	4,000	4,478	15.4	12.0
Maize	1,664	1,700	1,758	5.6	3.4
Wheat	18,227	19,754	19,235	5.5	-2.6
Gram	362	389	582	60.8	49.7
Minor crops					
Mung	115	121	134	19.3	10.8
Lentil	26	35	28	8.0	-19.6
Mash	28	27	34	24.1	25.5
Onion	1,385	1,542	1,622	17.1	5.2
Potato	1,722	1,679	1,925	11.8	14.7
Chillies	93	145.8	105	8.1	-29.6

Sources: i) Ministry of Food, Agriculture and Livestock
ii) Economic Survey, 2002-2003

2.1.3 Use of Inputs

Amidst hopes of an improvement in weather conditions and the presence of other supporting factors such as higher market prices of preceding crops, and cheaper (and improved) availability of credit, farmers used higher inputs for crops during FY03, particularly on certified seeds and fertilizers.

Figure 2.4: Change in Area & Production



Use of Certified Seeds

The distribution of certified seeds of the important major crops increased in FY03. The highest rise was seen in gram, and the lowest in cotton crop (see **Table 2.4**). The possible reasons for the lower enthusiasm in cotton might be (1) depressed prices during FY02 and (2) unclear prospects of the global cotton market for FY03 crop at sowing time.

For other crops, particularly, paddy and gram, in addition to higher availability of seeds ensured by the respective departments, the higher prices of those commodities during FY02 spurred use of certified seeds. In particular, for gram, farmers' ability to use certified seeds was augmented by the financial gains on the good cotton crops for FY03.

Table 2.4: Distribution of Certified Seeds
tonnes

	FY02	FY03	percent change over FY02
Cotton	28,975	29,038	0.2
Paddy	2,062	3,608	75.0
Maize	2,447	2,478	1.3
Gram	315	1,509	378.6
Wheat	119,299	128,983	8.1

Source: Working papers of Federal Committee on Agriculture

Use of Fertilizers

Use of fertilizers during FY03 posted an increase of 5.8 percent over FY02 (see **Table 2.5**). The entire increase was witnessed in *rabi*; the season for two important crops i.e., wheat and gram.

In *kharif FY03*, although there had been an increase in the use of urea, the abrupt decline in the use of DAP lowered the use of fertilizers in that season.

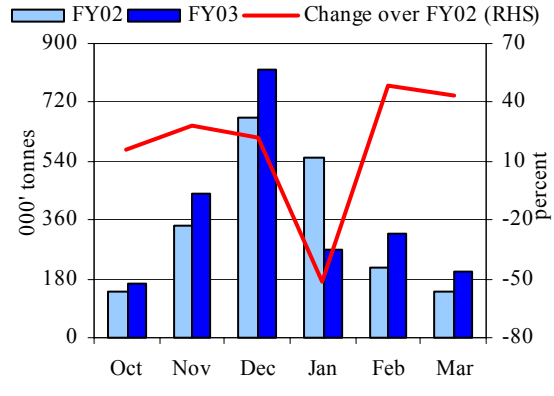
Table 2.5: Use of Fertilizers
thousand tonnes

	FY02	FY03	percent change over FY02
Kharif season			
Urea	1,857	2,035	9.6
DAP	622	428	-31.2
Total	2,479	2,463	-0.7
Rabi season			
Urea	2,064	2,215	7.3
DAP	528	685	29.8
Total	2,592	2,900	11.9
Grand Total	5,071	5,363	5.8

Sources: i) National Fertilizer Development Center
ii) Working papers of Federal Committee on Agriculture

The monthly distribution of fertilizer application to wheat showed that higher use of fertilizer was made during first three months of the FY03 crop compared to the usage in the corresponding months last year. After slackness in the month of January 2003, when the farmers were undecided over further application of fertilizers (due to delay in rainfall), usage surged again in the months of February and March 2003 when adequate

Figure 2.5: Monthly Use of Urea



rainfalls has improved the prospects of the wheat crop (see **Figure 2.5**).

2.1.4 Agriculture Produce Markets

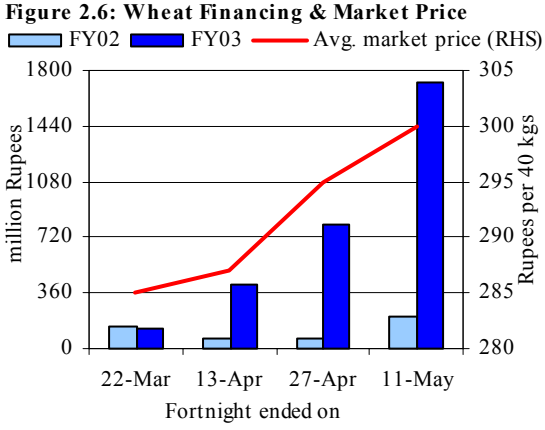
Crops

Financially, FY03 proved an especially good year for farmers. For most of the kharif crops (i.e., cotton, rice maize and bajra), wholesale prices at harvest-time were higher than in the corresponding period of FY02.

Encouragingly, prices received by the farmers for wheat in the post-harvest period have remained steady at the support price of Rs 300 per 40 kgs although the harvest was bigger than in FY02.

The strength in prices for the FY03 wheat crop appears driven mainly by higher purchases by the private sector. The lower cost and greater accessibility of credit to the private sector for purchase of wheat helped traders raise purchases in the harvest season. In fact, data from commercial banks shows that the steps taken by SBP as early as in February 2003[6], to facilitate private sector credit for wheat purchases, have proved very successful.

Figure 2.6: Wheat Financing & Market Price



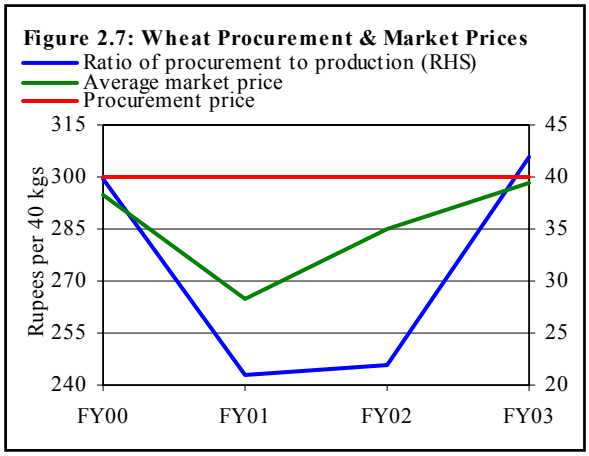
During March 10 to May 10, 2003 the private sector availed wheat financing of Rs 3,069.5 million, phenomenally higher than the Rs 473.6 million during the same period of FY02 (see **Figure 2.6**).

Moreover, the wider coverage of government procurement agencies in the markets kept the market sentiments in favor of the wheat growers. For the FY03 crop, the government procurement target for wheat, which was earlier set at 5.1 million tonnes, in view of the size of the crop, was revised upward to 8.1 million tonnes. This target is very close to the procurement of wheat at 8.4

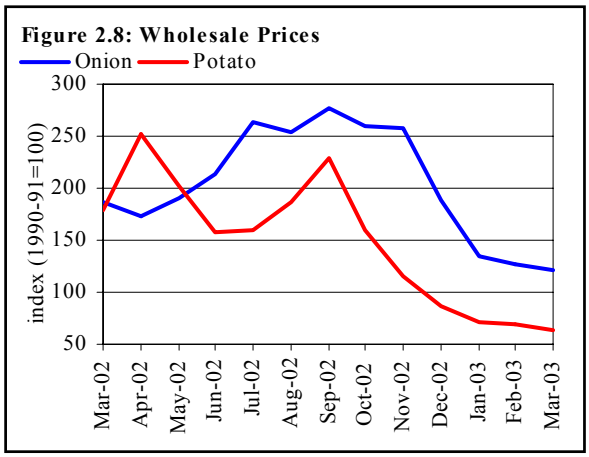
[6] To facilitate wheat purchases in the private sector, the SBP has issued a circular to all commercial banks to provide finance to individual borrowers on a market-based markup (linked with the 6-month weighted average T-bill rates).

million tonnes made during FY00 when the crop size was at around 21.1 million tonnes compared to over 19.3 million tonnes for the FY03 crop.

Historical data strongly suggests that the ratio of the quantity of wheat procurement to total production during any year has a significant impact on the market price. The higher the procurement quantity, closer the market prices around the support price (see **Figure 2.7**).



However, farmers fared less well on a number of minor crops, especially potatoes and onions (see **Figure 2.8**). The steep fall in prices of these two crops was not only a function of good production but was also fuelled by the lower exports of these two commodities as compared to the previous year. The H1-FY03 potato exports of Rs 8.9 million were only 20.2 percent of the of the Rs 44.0 million FY02 exports. Similarly, onion exports during H1-FY03 were only 13.4 percent of the total exports during FY02. The drop in exports of onions is mainly attributed to decline in export unit values; during FY03 it fell by 41.9 percent over FY02.



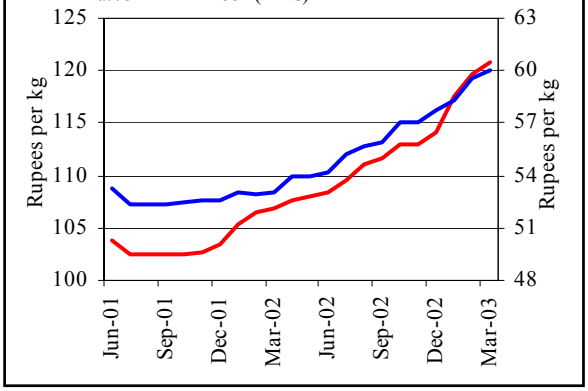
Livestock

The price of meat, particularly mutton increased sharply during Q3-FY03 (see **Figure 2.9**).[7] In major city centers, the average price of mutton rose from Rs 120 per kilogram to Rs 150 per kilogram since January 2003. In the absence of any

[7] **Figure 2.9** is based on CPI data compiled by FBS.

major reason for a contraction in the domestic livestock population, this hike seems to reflect the increased exports of live goats and sheep to Gulf countries.

Figure 2.9: Consumer Prices



During H1-FY03, export receipts from live animals reached Rs 418 million compared with full year receipts of Rs 254.8 million during FY02. Similarly, exports of meat during H1-FY03 at Rs 257.2 million also exceeded the full year export of Rs 218.2 million during FY02. Data on exports of goats and sheep revealed that 18,365 animals were exported during July-December FY03 compared to FY02 (full year) exports of only 2,800 animals.

2.1.5 Agricultural Credit

Disbursement

The agri-production and development credit disbursed during July-March FY03, was sharply higher than in the corresponding period year of FY02; despite a larger indicative target for FY03, the actual July-March disbursements as share of the annual target was higher compared to FY02 (see **Table 2.6**).

Table 2.6: Agricultural Credit Disbursement (Jul-Mar)

billion Rupees

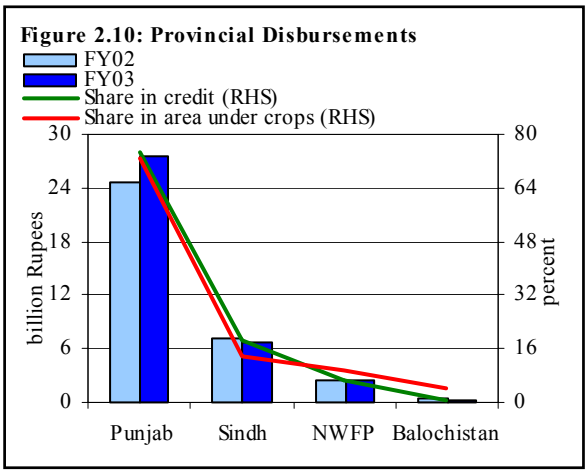
	FY02	FY03	percent change
Annual target	60.0	62.7	4.4
Disbursements	35.0	37.6	7.4
Percentage share of target	58.3	60.0	2.9

Source: Agriculture Credit Department, SBP

This performance is expected to improve further in the coming months because of the strong seasonal increase in disbursement of credit generally witnessed during the fourth quarter of a fiscal year.

The provincial distribution of total credit showed that during first nine months of FY03, higher credit was availed in the Punjab while in other provinces it remained marginally lower than the corresponding period last year. The provincial distribution of credit when compared with the provincial breakup of area under the important crops reveals that there is a close proximity between the two (see

Figure 2.10), i.e., the provinces are getting the share in credit in proportionate to the area under cultivation.



However, contrary to trends for the total credit, financing for purchase of tractor declined by 5.6 percent during July-March 2003 compared to the corresponding period last year. This is in contrast to the production of tractors, which increased to 17,870 in July-March 2003 from 15,112 thousand during the corresponding period last year.

Commercial Banks[8]

The institutional break up of credit reveals that the five major commercial banks continued to lead the growth in agri-credit disbursements during Q3-FY03, registered phenomenal 40.8 percent YoY quarterly growth. As a result, corresponding July-March FY03 figure saw a 27.2 percent YoY growth (see **Table 2.7**), thus increasing their share in total agri-credit disbursement from 32.3 percent in July-March FY02 to 38.2 in July-March FY03. It may be recalled that

Table 2.7: Credit to Agriculture Sector (Jul-Mar)
million Rupees

	Disbursement			Recovery			Net credit[1]	
	FY02	FY03	percent change	FY02	FY03	percent change	FY02	FY03
ZTBL	20,162	19,347	-4.0	22,190	21,332	-3.9	-2,029	-1,986
Commercial banks[2]	11,299	14,376	27.2	9,657	13,158	36.3	1,641	1,218
New private CBs[3]	435	679	56.3	408	382	-6.2	27	297
PPCBL	3,107	3,218	3.6	2,779	2,985	7.4	329	233
Total	**35,002**	**37,620**	**7.5**	**34,626**	**37,858**	**9.3**	**-32**	**-238**

[1] Net credit = disbursement minus recovery
[2] Includes: NBP, HBL, MCB, UBL, and ABL
[3] New private commercial banks started lending in FY02
Source: Agricultural Credit Department, SBP

[8] Include: i) Allied Bank of Pakistan, ii) Habib Bank Limited, iii) Muslim Commercial Bank Limited, iv) National Bank of Pakistan, and v) United Bank Limited.

their share started improving since FY01.[9] Earlier, in FY00 it was close to 23 percent of the total credit disbursement.

The apparent advantages, which the commercial banks exploited aggressively to enhance their exposure to agricultural credit include:

- availability of ample funds to finance credit activities in agriculture sector.
- longer prevalence of relatively higher lending rates in agricultural lending.
- concentration of branches in rural areas.
- larger access to fresh borrowers.

Zarai Taraqiati Bank Limited

Although vigorously pursued by the five major commercial banks, the Zarai Taraqiati Bank Limited (ZTBL) still emerged as the single largest lender to agriculture with a market share of 51.5 percent during Q3-FY03. Nonetheless, the aggregate disbursements for July-March FY03 were 4.0 percent lower than in the corresponding period of FY02.

Even after meeting the credit needs of all applicants, ZTBL could not match the credit disbursement made during the same quarter of the previous year. This clearly suggests a shortfall in credit demand for ZTBL, which may be a result of number of factors:

(1) disqualification of a majority of potential borrowers (due to non-payment);
(2) unattractive credit package compared to commercial banks;
(3) belated decision of downward revision of lending rates for credit to agriculture sector.

This was probably augmented by constraints on ZTBL's ability to extend credit, including:

(4) preoccupation of the higher management with restructuring of the Bank, and
(5) liquidity problem caused by a shortfall of 16.1 percent in the recovery of credit during January-March FY-03 (in the absence of significant fresh credit lines this remains the sole source of funding available for fresh disbursements).

[9] Financing to agriculture sector became a commercially viable business for the commercial banks, after the various policy changes announced by the SBP during FY01 including the discontinuation of all concessionary credit facilities to the then ADBP and the FBC. Further, the methodology for credit disbursement was also revised during that year.

To improve upon the situation and to restore the lost credit demand, ZTBL has announced on April 30, 2003 various incentives to its borrowers including 3.0 percent rebate on mark up rate applicable on loans taken w.e.f. January 1, 2003. This will be available to all new borrowers and also on subsequent loan/ installments if the previous loan/installments is repaid on or before the due date. Moreover, the equity rate in case of loans for tractors and the allied equipments has also been reduced in favor of borrowers.

Recovery

The overall amount of loans recovered during July-March FY03 increased by 9.3 percent, with all the improvement emanating from commercial banks; loan recoveries by commercial banks stood 36.3 percent higher than the corresponding figure for FY02. Recovery on the part of ZTBL on the other hand, declined by 3.9 percent compared to that in corresponding period of FY02.

The higher ratio of *past-due* loans in its recovery portfolio and the concentration of borrowers in area declared by the government as calamity hit areas[10] were the major factors responsible for the decline in loan recovery by ZTBL. By contrast, the portfolio of recoverable amount of commercial banks have a lower ratio of past dues as well as a lesser number of borrowers belonging to the calamity-hit areas.

2.2 Large-scale Manufacturing

The evident recovery in large-scale manufacturing (LSM) during H1-FY03, gained further momentum during Q3-FY03 with the sector recording 11.9 percent growth over Q3-FY02.[11] As a result of this strong quarterly performance, the cumulative LSM growth for July-March FY03 rose sharply; the Quantum Index of Manufacturing (QIM), showed a 8.5 percent growth during July-March FY03, against a mere 1.5 percent increase in the corresponding period of FY02 (see

Table 2.8: Large-scale Manufacturing: Growth Rates

percent

	Jul-Mar	
	FY02	**FY03**
Overall	1.5	8.5
excluding sugar	1.4	7.6
excluding automobile	2.6	6.7

Source: Federal Bureau of Statistics

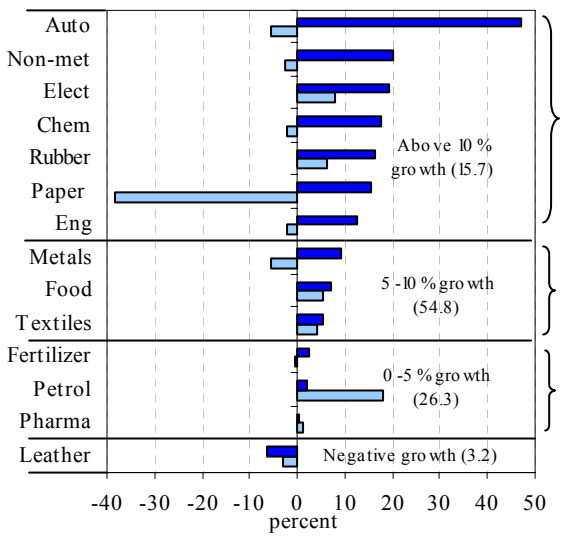
[10] In some cases the recovery is deferred for certain period where sometimes the markup on loans is also waived, depending upon the severity of calamity.

[11] The quarterly growth is based on 90 LSM items, as the production data on solid paints & varnishes was has some reconciliation problem. The fact that the weight of this item is only 0.206, its inclusion is not likely to change the quarterly growth trends.

Table 2.8).[12]

During July-March FY03, the growth was remarkably broad-based. Even excluding the significant improvement in sugar production during July-March FY03, the overall LSM growth remains a robust 7.6 percent. Similarly, excluding the exceptional performance of the auto sector also leaves LSM growth impressively high (see **Table 2.8**).

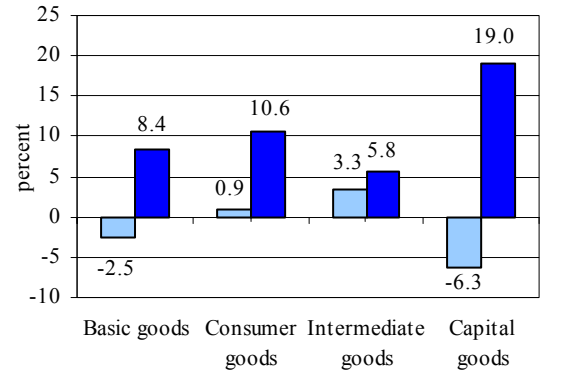
Figure 2.11: Growth in Selected LSM Groups



Figures in parenthesis show respective group's share in reported LSM.

During July-March FY03, all LSM sub-sectors except leather products saw an increase in output, and 11 of the 14 LSM groups registered *acceleration* in the growth rates (see **Figure 2.11**).

Figure 2.12: LSM Production by End-use (Jul-Mar)



In terms of the end-use classification, growth in all groups accelerated during July-March FY03 (see **Figure 2.12**). Within the consumer goods sector, the major contribution was made by consumer durables with a substantial 42.6 percent growth.

Encouragingly, the capital goods industries also recorded a sharp recovery, showing a 19.0 percent growth during July-March FY03 in contrast to declines in the preceding two years.

[12] The QIM for the period July-March FY03 has been constructed on the basis of 91 LSM items as the data on the missing items as in the case of quarterly index was available on cumulative basis for the period.

Table 2.9: Growth in Production of Selected Large-scale Manufacturing Items
percent

		Jul-Mar				Jul-Mar	
	Weights	**FY02**	**FY03**		**Weights**	**FY02**	**FY03**
Textile	**19.069**	**4.3**	**5.2**	**Chemicals**	**2.335**	**-2.3**	**17.5**
Cotton yarn	8.850	4.5	8.1	Caustic soda	0.621	4.4	5.8
Cotton cloth	4.881	16.2	1.5	Soda ash	0.320	13.8	12.9
Cotton ginned	3.893	-1.2	-4.7	Other six items	1.394	-11.5	30.0
Other five items	1.445	-16.0	10.8	**Electronics**	**2.230**	**31.8**	**19.3**
Food, beverages & tobacco	**17.336**	**5.4**	**7.2**	Electric transformers	0.577	45.2	34.3
Sugar	8.630	6.4	12.3	TV sets	0.363	-27.3	59.1
Vegetable ghee	3.004	-4.8	-7.0	Air conditioners	0.120	-71.5	69.1
Cigarettes	2.505	-5.1	-7.1	Refrigerators	0.015	10.3	23.1
Tea	1.785	13.3	2.8	Other five items	1.155	8.0	-1.6
Beverages	0.964	-1.9	-18.3	**Automobile**	**2.348**	**-5.7**	**46.9**
Cooking oil	0.448	17.0	6.8	Trucks	0.698	-8.0	118.1
Petroleum products	**7.824**	**17.9**	**2.2**	Tractors	0.593	-29.2	16.5
Fertilizers	**5.871**	**-0.6**	**2.4**	LCVs	0.369	9.1	57.6
Nitrogenous	5.441	4.6	4.2	Cars & jeeps	0.309	0.9	51.6
Phosphatic	0.430	-46.8	-27.8	Motorcycles	0.249	5.4	33.5
Pharmaceuticals	**5.284**	**1.2**	**0.4**	Buses	0.130	-30.3	42.3
Tablets	2.705	6.0	-0.5	**Non metallic minerals**	**1.915**	**-2.7**	**20.0**
Syrup	1.602	-6.8	4.8	Cement	1.846	-2.2	20.5
Injections	0.466	5.2	-13.3	Glass sheets	0.069	-17.2	2.8
Capsules	0.228	-2.5	-0.6	**Paper & board**	**1.359**	**-38.2**	**15.7**
Other two items	0.283	20.7	8.6	**Engineering items**	**0.712**	**-2.3**	**12.4**
Metal industries	**3.194**	**-5.7**	**9.1**	Bicycles	0.348	-7.6	16.9
Pig iron	1.477	-4.4	4.9	Safety razor blades	0.109	9.3	5.1
Coke	1.319	-3.6	7.2	Diesel engines	0.065	-37.6	-9.2
Billets	0.311	-8.5	14.0	Sewing machines	0.052	-6.6	19.0
H.R/coils and plates	0.074	-9.6	29.2	Power looms	0.051	89.6	19.5
C.R coils/plates/sheets	0.013	-16.9	14.1	Other five items	0.087	-18.6	-4.8
Leather products	**2.333**	**-3.2**	**-6.6**	**Tyres & tubes**	**0.452**	**6.1**	**16.2**

Source: Federal Bureau of Statistics

Similarly, the production of basic goods, which had witnessed a 2.5 percent fall in July-March FY02, reversed direction by recording a substantial increase of 8.4 percent during July-March FY03. Likewise, growth in the production of intermediate goods also increased over FY02, indicating rising demand of inputs by the manufacturing, construction and other sectors.

The performance of LSM can also be examined on the basis of allied indicators such as gross disbursement of credit to private sector, import of raw materials, electricity consumption by industry, sales tax collections and exports of

manufactured goods. The behavior of all these indicators was well aligned with LSM performance during July-March FY03 (see **Table 2.10**).

Table 2.10: Growth Rates in Allied Indicators
percent

	Jul-Mar	
	FY02	**FY03**
Gross credit disbursement to private sector	25.3	21.0
Import of raw materials	-7.6	21.8
Import of machinery including transport equipment	-5.4	38.3
Export of manufactured goods	0.8	24.1
Electricity consumption by industry[1]	6.7	6.6
Sales tax collections (domestic sales)	4.7	22.6

[1] This figure corresponds to supplies from WAPDA only.

The impressive LSM performance during July-March FY03 was attributable primarily to (1) growing consumer demand for durables (automobile, electronics), (2) improvement in construction activities and, (3) expansion in exports of manufactured goods.

Continued increase in remittances, higher farm incomes due to good prices of the major crops, improvement in productivity, and growing availability of consumer financing coupled with lower interest rates, have been the major factors boosting domestic demand. The *automobile, electronics* and *construction* related industries, in particular, have benefited from the rising domestic demand.

The demand-driven increase in production of automobile was the highlight of manufacturing growth during FY03, as the sub-sector grew by 46.9 percent during July-March FY03.[13] The sale of all automobile categories increased during this period (see **Table 2.11**).

Table 2.11: Automobile Sales
numbers

	Jul-Mar		
	FY01	**FY02**	**FY03**
Cars	23,961	23,561	36,298
Jeeps	5,562	5,636	8,899
Motorcycles	82,377	86,544	112,848
Trucks	668	702	1,256
Buses	1,086	735	1,077
Tractors	24,672	14,793	17,484

Source: All Pakistan Automotive Association

Aggressive marketing of attractive loan schemes by commercial banks and leasing companies remains the major contributor to strong sales of cars and motorcycles.[14] Therefore, to meet the growing demand, manufacturers also raised production during July-March FY03,

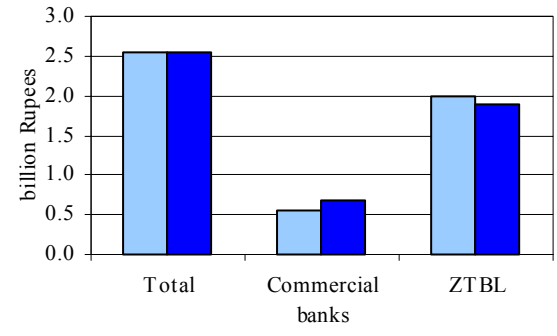
[13] Growth excluding automobile, declines by 1.7 percentage points.
[14] The lending rates on the advances for the purchase of cars fell below 9 percent during July-March FY03, compared to 15-24 percent prevalent during FY02.

e.g. Indus Motors began production on a double shift basis in March 2003.[15]

An additional factor behind the higher growth in the motorcycle production was the entry of Chinese manufacturers during FY03. The new entrants offered their products at significantly lower prices, forcing price cuts by the established competitors.[16]

By contrast, the high growth in the production of trucks and buses not only reflects the increasing economic activity (higher transportation of goods and induction of new buses in intercity routes), but also a low-base effect. Finally, growth in the production of tractors, other than low base effect, was also supported by higher sales on the back of a recovery in agriculture after a three-year drought cycle. This is reflected from the fact that although total financing remained stagnant, sale of tractors increased during July-March FY03 (see **Figure 2.13**).

Figure 2.13: Financing for Purchase of Tractors (Jul-Mar)



In the *electronics* sub-sector, there was a significant increase in production of electric transformers, air conditioners, refrigerators and televisions. Other than robust domestic demand, the increase in the production of the first three was also supported by exports, mainly destined to Afghanistan and the Middle East (see **Table 2.12**).

Table 2.12: Trends in Exports of Electronics

numbers

	FY00	FY01	FY02	FY03[1]
Refrigerators	0	106	1368	3765
Air conditioners	251	287	1054	577
Transformers	1422	700	2828	2810

[1] July-April

Source: Federal Bureau of Statistics

[15] Not only has the market for domestically manufactured cars expanded, imports of cars also rose during the H1-FY03. Imports during the period totaled 28,549 units against imports of 39,609 units for whole of FY02.

[16] The difference in the prices of motorcycles by Chinese manufacturers and that of the already popular brands (Honda and Yamaha) ranged from Rs 20,000 to Rs 25,000. Honda Atlas reduced prices by approximately Rs 15,000 in May 2003.

However, increase in the production of TV sets was mainly driven by domestic demand, primarily due to the spread of cable network and availability of credit. Credit for the increased domestic *production*, however, also goes to a policy change. The government relaxed the deletion requirements (for the next five years) and the import of components in CKD condition was allowed at 5 percent custom duty under Emerging Electronic Products Assembly Scheme FY02. Since then, the assembling-cum-manufacturing of electronics especially TV sets has been increasing.[17] As a result, the prices of TV sets have also declined significantly over the last two years due to increasing competition.

The *textile* industry, despite higher cotton prices in FY03 (see **Figure 2.14**), grew by 5.2 percent during July-March FY03 compared to a 4.3 percent increase in the corresponding period last year. This increase in production was mainly due to continued expansion in exports of textile products, which have been rising since Q4-FY02 due to increased access to key markets since January 2002 (see **Figure 2.15**).

Accordingly, the production of both cotton yarn and cloth increased during July-March FY03. However, growth in the production of cotton cloth remained lower at 1.5 percent compared to 16.2 percent increase in July-March FY02. However, this figure is

Figure 2.14: Lint Cotton Prices

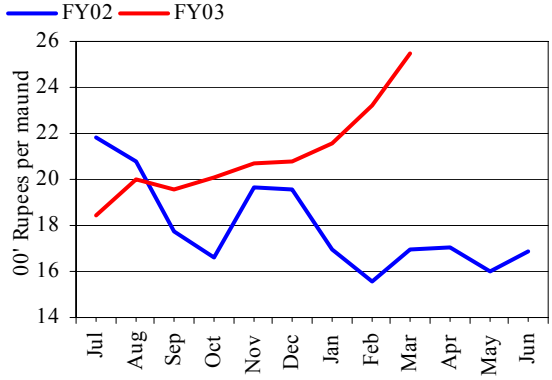
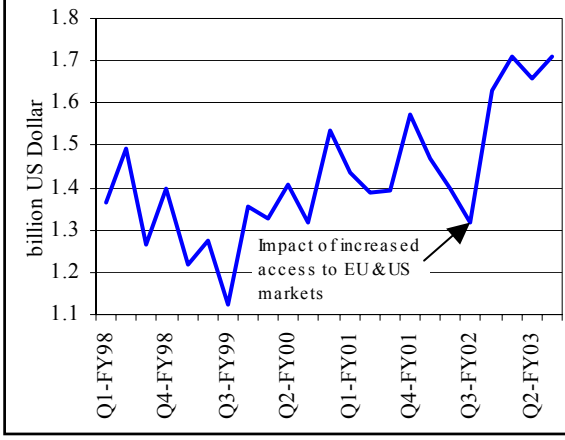


Figure 2.15: Export of Textile Manufactures



[17] During July-March FY03, the FBS used information on production of TV sets as provided by the Electronics Association. According to the Electronics Association, the previously reported numbers understated the production of TV sets. However, the comparable production numbers are not yet available for FY01. Therefore, growth for FY02 is based on old numbers that showed decline in TV sets manufacturing.

deceptive, as it reflects the substitution of production to undocumented non-mill sector.[18]

In fact, it is estimated that cloth production by the non-mill sector actually increased by 14.6 percent.[19] Therefore, incorporating the estimated non-mill production, the aggregate growth in cloth production rises to 13.1 percent. This number is consistent with the visible growth in exports of cotton cloth and related items.

Along with improved performance of the textile industry in terms of production and exports, the textile manufacturers also continued concentrating on investment for Balancing, Modernization and Replacement (BMR). The manufacturers availed a total of Rs 24.7 billion during July-March FY03 compared to Rs 22.6 billion in the corresponding period last year. Moreover, the textile industry also attracted a higher (US$ 23.1 million) foreign direct investment during July-March FY03 compared to a mere US$ 10.5 million in the corresponding period of FY02.

Here, it is important to highlight the issue of non-availability of production data on a range of value added textile items, which have a major share in exports. To illustrate, the currently reported production data on two major items (yarn and cloth) is just 30 percent of the total textile manufactures, and thus information is missing on the larger part (such as hosiery, towels, ready made garments etc.) of this vital sector of the economy. In the wake of expanding exports of the value added items and growing policy attention towards this sector, there is a need to increase the coverage in LSM.

Despite decline in the production of vegetable ghee, cigarettes and beverages, overall growth in the production of *food, beverages & tobacco* sub-sector increased by 7.2 percent during July-March FY03 compared to 5.4 percent increase in July-March FY02. This was mainly supported by higher production of sugar and cooking oil. Increase in sugarcane produce (8.3 percent) was the key reason behind the higher refined sugar production during July-March FY03.

[18] However, the reported FBS data corresponds to mills sector only, which represents only 11 percent of the estimated total cloth production.

[19] These estimates were worked out by the Textile Commissioner of Pakistan and published by Ministry of Industries & Production in "Industrial Production Data of 39 Selected Industrial Items" for July-March FY03. However, the FBS did not include it while calculating the overall LSM growth.

As result of higher production during FY03, Pakistan ended up with surplus sugar by the end of crushing season FY03 (see **Table 2.13**).[20] Unfortunately, higher world sugar production has resulted in depressed prices during FY03: the world sugar prices are hovering around US$ 221.4 per ton (Rs 12,788 per ton), which is Rs 4,972 per ton less than the prevalent price in domestic market.

Table 2.13: Sugar Scenario

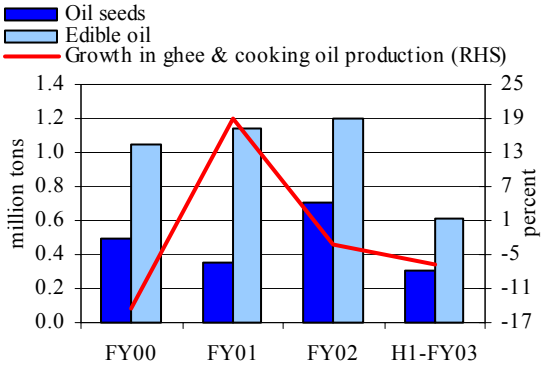
million tons	
Carryover stock (start of season)	0.634
Production	3.600
Imports (till March 2003)	0.004
Export (till March 2003)	0.002
Total availability	**4.236**
Estimated consumption	3.100
Surplus	**1.136**

Source: All Pakistan Sugar Mills Association

Although, the government has purchased around 12,000 tons of sugar through Trading Corporation of Pakistan (TCP), this is a very small quantity compared to the excess stock after accounting for the projected consumption during the year and buffer stocks.

On the other hand, production of vegetable ghee has been persistently declining (even as the production of cooking oil increased) over the last couple of years, despite increasing imports of edible oil (palm oil and soyabean oil) and oilseeds (see **Figure 2.16**).[21] The combined growth in the production of ghee and cooking oil does not match the availability of raw material. The major reason behind this puzzle, as mentioned in the previous quarterly reports, has been the shifting of production from formal to informal sector.

Figure 2.16: Import of Raw Material and Production of Ghee & Cooking Oil



[20] On the basis of figures provided by All Pakistan Sugar Mills Association, sugar production stood at 3.6 million tons by the end of crushing season FY03. This is the highest level of production ever achieved. Previously, the highest production level of 3.5 million tons was achieved during FY98 and FY99.

[21] More than 50 percent of the imported oilseeds are crushed to extract oil (and remaining is meant for sowing). The import of oilseeds has been increasing since FY99, when import duty on edible oil was increased (now it is 60-65 percent) and on oilseed was just 11 percent. In addition to this, the commercial import of oilseeds was also exempted from GST. The main objective was to enhance value addition in the country and reduce import bill on this account.

In fact, imports by the manufacturing units established in Provincially Administered Tribal Areas (PATA) and Federally Administered Tribal Areas (FATA) are exempted from GST. Therefore, these units (mostly unregistered) are importing raw edible oil and producing ghee at comparatively lower cost (by 20 percent of the price of the branded ghee). As a result, many registered large-scale manufacturing units have been closed.[22]

During July-March FY03, growth in the production of *petroleum products* moderated to 2.2 percent compared to 17.9 percent in the same period last year. The key factor behind the moderate growth was the normalization of base; during the last two years, growth had been boosted by capacity increases following the commencement of production by the Pak Arab Refinery (PARCO) in September 2000.

Table 2.14: Construction Indicators

		Jul-Mar	
	Unit	**FY02**	**FY03**
Cement sale (local & export)	000 tons	7066.4	8556.4
Sale of steel products	000 tons	599.3	906.0
HBFC financing[1]	million Rupees	4.4	491.7

[1]Out of total financing for construction and purchase of houses, around 76 percent goes in the construction of new houses.

During the past two years, a number of steps have been taken to revive the construction industry.[23] Although the data on construction sector value added is not available yet, factors such as sale of steel products and cement, increasing HBFC financing for the construction of houses and entry of commercial banks in this area during FY03, indicate improvement in labor-intensive construction activities during July-March FY03 (see **Table 2.14**). The HBFC, after one year's suspension due to a shifting to Islamic modes of financing, restarted disbursement of loans for the construction, purchase and repair of the houses, in early 2002.

As a result of an improvement in demand, the production of basic metals recorded a 9.1 percent increase during July-March FY03 against a decline of 5.7 percent in the same period of FY02. As Pakistan Steel Mills Corporation (PSMC) had already drawn down inventories, the production started to pick up in Q3-FY03. Although the production by PSMC is usually budgeted (the Pakistan Steel has to achieve the budgeted production targets by the year-end), the fact that its output is used as raw material in downstream industries, means that higher PSMC sales are a fair indicator of improvement in the overall activity in the metal industry.

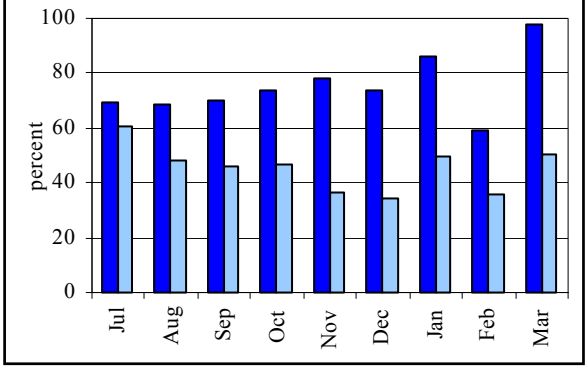
[22] According to Pakistan Vanaspati Manufacture's Association (PVMA), 33 units have been closed down over the last three years, which were the members of PVMA.

[23] These include tax incentive to homeowners on home loans, foreclosure laws and revitalization of HBFC etc. Above all, the SBP encouraged banks to finance housing construction and organized a conference on housing finance.

During July-March FY03, the *non-metallic minerals* sub-sector showed marked improvement over last year. The production of cement increased by 20.5 percent compared to a decline of 2.2 percent in July-March FY02. Other than improvement in construction activities, the failure to reach agreement regarding sale quotas spurred competition among cement manufacturers. This was particularly true for the North Zone, which saw prices fall by approximately Rs 50 per bag. However, in the South Zone, where competition was relatively lower, prices initially remained unchanged. It was only when North Zone producers entered into the South Zone that prices came under pressure in this region as well.[24]

This phenomenon is reflected in capacity utilization statistics. The average capacity utilization in North Zone rose to 75.2 percent during July-March FY03 compared to 45.3 percent in South Zone. This in turn, helped the overall average capacity utilization of the industry to increase significantly (to 66.9 percent) during July-March FY03, compared to 43.0 percent in the same period of FY02 (see **Figure 2.17**).

Figure 2.17: Capacity Utilization - FY03



The production of *chemicals* also increased sharply (17.5 percent increase) during July-March FY03 against a 2.3 percent decline recorded in the same period of FY02. The major items that showed higher growth include caustic soda, soda ash and paints & varnishes. The former two are used as raw materials in the production of a number of products such as textile processing, plastic manufacturing, glass products etc; their production usually follows the trends in allied industries.

Higher production of soda ash was also due to increase in the production of glass sheets; soda ash is one of the major raw material used in the production of glass sheets and glass products. Similarly, the higher production of paints & varnishes

[24] The price decline also boosted cement sales as traders expecting the imminent revival of the cartel, built up stocks.

can be linked to the performance of automobile and construction related industries.

The sharp increase in the production of *paper & paperboard* was mainly driven by higher production of manufacturing in general and electronics in particular.

In the *engineering* sub-sectors, the production of bicycles, power looms, shuttles, bobbins and sewing machines recorded robust growth during July-March FY03, pushing the overall growth to 12.4 percent compared to a decline of 2.3 percent last year. Higher production of power looms, shuttles and bobbins was mainly due to BMR in the textile industry.

3 Fiscal Developments

3.1 Consolidated Position

The government was successful in containing the fiscal deficit during July-March FY03 to 2.1 percent of GDP, leaving it comfortably placed to meet the 4.6 percent of GDP revised FY03 target.[1] This was achieved on the back of strong growth in revenues (see **Table 3.1**).

Table 3.1: Consolidated Government Fiscal Operations
billion Rupees

	Jul-Mar		YoY growth	
	FY02	FY03[1]	absolute	percent
Total revenue	436.4	505.0	68.6	15.7
Tax revenue (net)	324.6	380.0	55.5	17.1
Non-tax revenue	111.9	125.0	13.1	11.7
Total expenditures	553.5	591.4	37.9	6.8
Current expenditures	466.1	528.8	62.7	13.5
Development expenditures	91.5	82.4	-9.1	-9.9
Net lending	5.0	4.3	-0.7	-13.5
Unidentified expenditures	-9.1	-24.2	-15.1	164.8
Budget deficit	117.1	86.4	30.7	-26.2
	as percent of GDP			
Budget deficit	3.2	2.1	-1.1	-33.1

[1] Provisional
Source: Ministry of Finance

The improvement in revenues is the result of robust growth in taxes as well as exceptional non-tax receipts (which rose despite a substantial shortfall in receipts of SBP profits).

Although the total government expenditures during July-March FY03 were marginally higher over July-March FY02, their share in GDP declined. Most of the growth in expenditure is accounted for by defense, subsidies (particularly to KESC and WAPDA) and a rise in current expenditures of provincial governments. However, the aggregate impact of these was partially offset by a sharp decline in debt servicing and lower-than-budgeted development expenditures. The latter, in particular, is a source of concern, since current trends suggest that the budget outlays will not be met; the development expenditure level in the first three quarters of the current FY03 was lower than the previous year despite a much higher target.

3.1.1 Revenue Receipts

The healthy performance in revenue collection is attributable primarily to the impressive growth in CBR taxes (see **section 3.2** for details), although non-tax revenues too saw reasonably good growth (see **Table 3.2**).

This increase in non-tax revenues is despite a large decline in SBP profits (Rs 14.0 billion), lower interest income (Rs 7.3 billion) and drop in sales proceeds and royalties during July-March FY03 over the corresponding period of FY02; these

[1] Modified budget estimate, Economic Survey 2002-03. Preliminary target was 4.0 percent.

lower collections were more than offset by receipts on account of the logistic support to coalition forces operating in Afghanistan (recorded under *other civil administration*), as well as higher miscellaneous receipts, post office profits, and dividend income (mainly from PTCL and OGDC). Adjusting for the receipts for logistic support from US (Rs 39.6 billion in July-March FY03 compared to Rs 8.1 billion in the corresponding period of FY02), non-tax revenues witnessed a fall of 17.7 percent.[2]

Table 3.2: Consolidated Revenue Receipts
billion Rupees

	Jul-Mar		YoY growth	
	FY02	FY03[1]	absolute	percent
Total revenue (a+b)	436.4	505.0	68.6	15.7
a. Tax (net)	324.6	380.0	55.5	17.1
Taxes (consolidated)	283.9	331.4	47.5	16.7
Surcharges	40.6	48.7	8.0	19.8
Gas (net)	12.6	15.9	3.3	25.8
Petroleum	28.0	32.8	4.8	17.0
b. Non-tax revenues	111.9	125.0	13.1	11.7
Interest	15.0	7.7	-7.3	-48.6
Dividend	25.2	25.2	0.0	0.1
Profit of post offices	0.0	0.4	0.4	-
SBP profits	20.0	6.0	-14.0	-70.0
Sales proceeds/royalties	11.3	9.6	-1.7	-15.1
Other civil admin.	20.5	52.8	32.3	157.4
Defense receipts[2]	9.8	45.1	35.3	361.3
Non-defense receipts[2]	10.7	7.7	-3.0	-28.1
Miscellaneous	19.8	23.3	3.4	17.3

[1] Provisional
[2] Estimated on the basis of its share in FY03 revised figures
Source: Ministry of Finance

3.1.2 Expenditures

The consolidated July-March FY03 expenditures growth (6.8 percent) is in line with the annual FY03 targets, but a breakup of the total expenditures reveals that current expenditures rose sharply while developmental expenditures suffered due to lower utilization.

The substantial increase in current expenditures was led by higher expenditures by the provincial governments (up 43.1 percent), while the federal government expenditures recorded a modest 4.0 percent growth during July-March FY03 over the corresponding period of last year (see **Table 3.3**).

Table 3.3: Composition of Current Expenditures
billion Rupees

	Jul-Mar		YoY Growth		Share	
	FY02	FY03[1]	absolute	percent	FY02	FY03
Current expenditure	466.1	528.8	62.7	13.5	100.0	100.0
a. Federal	353.6	367.9	14.3	4.0	75.9	69.6
Interest payments	175.2	148.8	-26.4	-15.1	37.6	28.1
Domestic	137.1	121.9	-15.2	-11.1	29.4	23.0
External	38.1	26.9	-11.2	-29.4	8.2	5.1
Defense	94.5	115.8	21.2	22.5	20.3	21.9
General admin.	54.6	65.0	10.4	19.0	11.7	12.3
Grants to non govt	14.6	14.5	-0.1	-0.7	3.1	2.7
Subsidies	14.4	23.5	9.1	63.1	3.1	4.5
Other/unallocable	0.21	0.28	0.1	33.3	0.0	0.1
b. Provincial	112.5	160.9	48.4	43.0	24.1	30.4

[1] Provisional
Source: Ministry of Finance

[2] The US logistic support receipts during July-March, are estimated on the basis of its share in annual revised figures of FY03.

The lower growth in Federal current expenditures largely reflects the sharp decline in interest payments on external and domestic debt. This, in turn, is a result of the re-profiling, and restructuring of external debt, repayments of expensive debt and liabilities, as well as the sharp decline in the domestic and international interest rates.

On the other hand, defense expenditures and general administration increased by Rs 21.2 billion and Rs 10.4 billion, respectively during July-March FY03 over the corresponding period of FY02. The increase in the defense expenditures is ascribed to demobilization of troops from the eastern border.

Subsidies too saw strong YoY growth during July-March FY03, primarily due to higher payments to WAPDA and KESC.[3]

3.1.3 Financing of the Budget Deficit

The Rs 86.4 billion budget deficit for July-March FY03 was financed mostly through (net) external sources (see **Table 3.4**), which totaled Rs 64.2 billion during the period, 15.3 percent higher than for the corresponding period of FY02. A break up of the net external flows shows that the YoY change was dominated by sharply lower external repayments (down Rs 75 billion), as well as higher external receipts under non-food commodity aid (up Rs 17 billion) and an increase in the value of the Saudi Oil Facility (up Rs 6.9 billion). Receipts under most other heads declined.

Table 3.4: Financing of Budget Deficit
billion Rupees

	Jul-Mar		
	FY01	**FY02**	**FY03[1]**
External	59.0	55.7	64.2
Domestic	83.2	61.4	13.7
Bank	13.0	-52.5	-52.5
Non-bank	70.1	66.6	66.2
Privatization receipts	0.0	0.0	8.5
Total financing	142.1	117.1	86.4
Shares in total financing			
percent			
External	41.5	47.6	74.3
Domestic	58.5	52.4	15.8
Bank	9.2	-4.5	-60.8
Non bank	49.3	56.9	76.6
Privatization receipts	0.0	0.0	9.9
Total financing	100.0	100.0	100.0

[1] Provisional
Source: Ministry of Finance

[3] It is estimated that the annual FY03 subsidy to these two institutions will reach Rs 36.4 billion, substantially higher than the Rs 6.9 billion originally budgeted for the year, and the Rs 14.4 billion paid in FY02.

Only 15.8 percent (Rs 13.7 billion), of the July-March FY03 budget deficit, was financed by domestic sources, primarily through the privatization proceeds[4] and non-bank borrowings.

As a result of higher availability of external financing and domestic non-bank financing (both are non-discretionary sources) the government retired bank borrowings of Rs 52.5 during July-March FY03.

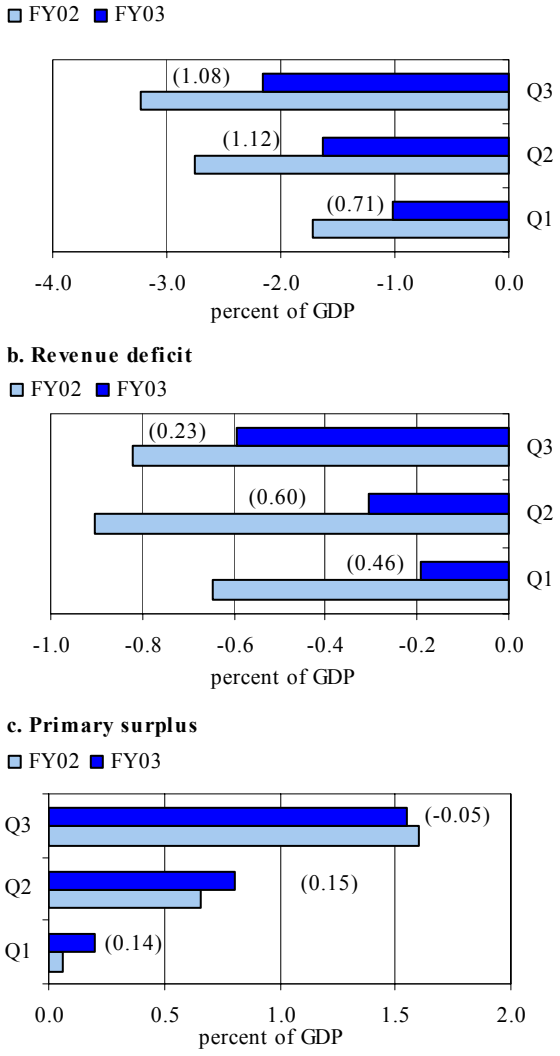
Within the July-March FY03 non-bank financing, a sizeable amount was collected from NSS (Rs 62.1 billion) and prize bonds (Rs 18.0 billion) while relatively smaller amounts were retired on account of FIBs (Rs 5.9 billion) and foreign bonds/bearer certificates (Rs 16.1 billion).

3.1.4 Deficit Indicators

The comparison of the fiscal indicators for July-March FY03 clearly points to an improvement compared to the corresponding FY02 picture (see **Figure 3.1**). The growth in revenues was stronger than that in expenditures during July-March FY03 and, as a result, the fiscal deficit for the period was lower relative to the corresponding of FY02 (see **Figure 3.1.a**).

Similarly, revenue budget also saw an improvement in the

Figure 3.1: Comparison of Deficit Indicators



Note: The values in parenthesis represent the difference of FY03 over the corresponding period of FY02.

[4] The Privatization Commission during the first nine months of FY03 has sold 51 percent GoP stake in UBL, 28 percent shares of Bank Alfalah, additional 10 percent shares of Pak Saudi Fertilizer Limited. Moreover, government also sold its stake in National Bank and MCB.

period under review (see **Figure 3.1.b**).

The primary surplus during July-March FY03 was almost unchanged from that in July-March FY02. In the initial quarters of FY03, the comparison had been more favorable, but the lower interest payments during Q3-FY03 resulted in a lower primary surplus (see **Figure 3.1.c**).[5]

3.2 CBR Tax Collections

Helped by a recovering economy, a broadening of the tax base, and reform of the taxation system,[6] CBR tax receipts recorded strong growth for a third successive quarter of FY03, in sharp contrast to the FY02 performance (see **Table 3.5**).

Table 3.5: Net Tax Collections during Jul-Mar

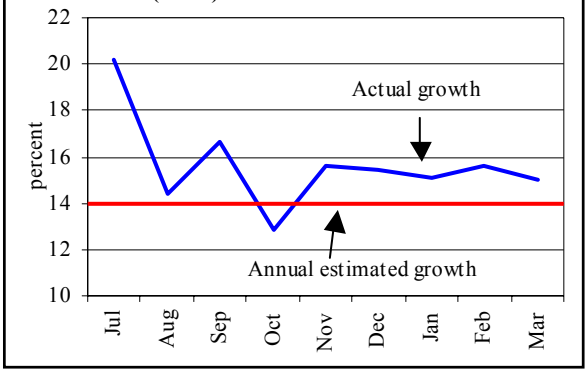
billion Rupees

	Net receipts		YoY growth rates	
	FY02	**FY03**	**FY02**	**FY03**
Q1	77.5	90.4	-3.1	16.6
Q2	97.1	111.1	-4.9	14.4
Q3	95.3	108.9	0.6	14.2
January	32.8	37.2	5.5	13.5
February	27.6	33.1	-10.2	19.8
March	34.9	38.6	6.1	10.6
End-Q3	**269.8**	**310.3**	**-2.5**	**15**

Note: Growth rates are in percent and figures may not tally due to separate rounding off to one decimal point.

As a result, growth in cumulative net tax collections during July-March FY03 remained above the budgeted target of 14.0 percent during most of the first nine months of FY03 (see **Figure 3.2**). Thus, the trend in aggregate net tax receipts suggests that if the traditional surge in Q4 tax collections, is also visible in FY03 (as expected), it is likely that the FY03 receipts will be very close to the Rs 460.6 billion annual target.

Figure 3.2: Growth Pattern of Net Tax Collections - Cumulative (FY03)



[5] The accumulated past obligations are major constraint on government operations, accounting all these things, the government comes in surplus.

[6] On-going CBR reforms include its restructuring, introduction of modern/ model tax payer units e.g. (Large Taxpayers Unit and Medium Taxpayers Units), automation of sales tax refund system, expansion of GST to retail and wholesale level, on-going work on automation of customs clearance system (CARE) and a human resource management strategy etc. The benefit of these reforms will remain accruing in coming time period.

While the FY03 tax receipts have indeed been helped by the unexpected jump in international oil prices as well an exceptional performance by the auto sector, it should be noted that these windfall gains were largely offset by an equally unanticipated appreciation of the rupee[7] (lowering import taxes), below-target inflation (depressing ad-valorem taxes), as well as a greater-than-expected slide in domestic interest rates (depressing withholding tax receipts). This suggests that the strong growth in taxes probably reflects a revival in the economy.

3.2.1 Targets and Collections

A cursory look at the figures for the past five years shows that the CBR tax targets have traditionally proved ambitious; not only were the budgetary targets repeatedly revised, even these amended targets generally proved unachievable.[8] However, FY03 may prove to be an exception to this trend (see **Table 3.6**).

Table 3.6: CBR Targets Revision
billion Rupees

	Budgeted	Revised	Actual
FY98	324.0	297.6	293.6
FY99	325.0	308.0	308.5
FY00	362.5	351.7	347.1
FY01	430.0	406.5	392.3
FY02	443.7	414.2	404.1
FY03 (Jul-Mar)	310.2	Not Revised	310.3

Note: Figures may not tally due to separate rounding off to one decimal point.
Source: CBR Year Book

The growth rate of actual tax collection during July-March, FY03 i.e., 15 percent is the highest among last three years.

Although the overall CBR tax performance is creditable, it should be noted that it owes much to the above-target July-March FY03 GST and customs duty receipts that have offset the underperformance of direct taxes and of central excise duties (see **Table 3.7**). On face value, the discordance in the trends of direct and indirect taxes is a little puzzling. However this is explained by a number of factors,[9] as detailed in **section on Direct Taxes**.

[7] As at the time of estimation of the annual targets, the average exchange rate was assumed at Rs 60 per US Dollar, but the average Rs/US$ exchange rate prevailing during July-March FY03 stood at Rs 58.5 per Dollar. However, despite the resulting lower rupee value of imports (and takes thereon), the CBR collections have remained on target. The rupee appreciation led to an estimated loss of Rs 3.0 billion on sales tax and customs receipts.
[8] The revised targets were achieved only once, in FY99.
[9] The shortfall in the direct taxes is mainly attributed to the fall in withholding taxes on government securities and interest on deposits and overall interest income, extending a loss of Rs 0.8 billion over the corresponding period of last year.

Table 3.7: Federal Tax Collections
billion Rupees

	Targets for		Actual tax (Jul-Mar)				Actual as % of target for		absolute	percent
	FY03	Q3	FY00	FY01	FY02	FY03	FY03	Q3	Excess/ shortfall over Q3	Change over FY02
Direct taxes	148.4	101.1	74.4	86.9	96.2	94.7	63.8	93.6	-6.4	-1.6
Indirect taxes	312.2	209.1	166.5	189.8	173.7	215.6	69.1	103.1	6.5	24.2
Sales tax	205.7	138.9	80.7	108.3	113.4	139.1	67.6	100.1	0.2	22.6
Central excise	47.5	37.0	39.5	35.2	31.2	31.3	65.9	84.6	-5.7	0.3
Customs	59.0	33.2	46.3	46.3	29.0	45.2	76.7	136.2	12.0	55.9
Total collections	460.6	310.2	240.9	276.7	269.8	310.3	67.4	100.0	0.1	15.0

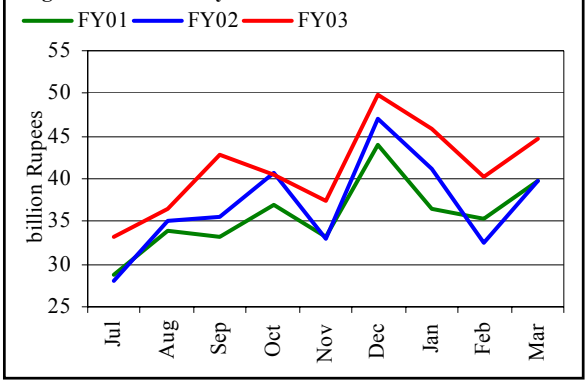
Note: The figures may not tally due to separate rounding off to one decimal point.
Source: Central Board of Revenue

3.2.2 Gross Collections and Refunds

In order to assess if the FY03 tax performance has been obtained by simply withholding the release of accrued tax refunds, both the pattern of gross tax collections and the level of tax refunds distributed over the year were analyzed.

The structure of gross tax receipts does not appear to differ significantly from that in the preceding two years (see **Figure 3.3**), and the monthly receipts for July-March FY03 are uniformly higher than the corresponding collections in previous years.

Figure 3.3: Monthly Gross Collections - FY03



As a result, cumulative gross receipts recorded an year-on-year increase of 11.4 percent (Rs 37.9 billion) during July-March FY03 (see **Table 3.8**), which is substantially higher than a 3.6 percent corresponding increase in July-March FY02. Clearly, the increase in *gross* taxes is consistent with the higher net CBR tax receipts.

Table 3.8: Quarterly Gross Collections
billion Rupees

	Gross collections			YoY FY03 growth rates over	
	FY01	FY02	FY03	FY01	FY02
Q1	95.6	98.5	112.5	17.7	14.2
Q2	114.1	120.6	127.5	11.8	5.7
Q3	111.5	113.6	130.7	17.2	15.0
End-Q3	**321.2**	**332.7**	**370.7**	**15.4**	**11.4**

Note: Growth rates are in percent, and figures may not tally due to separate rounding off to one decimal point.

Similarly, there is a healthy quarterly growth in the disbursement of refunds (see **Table 3.9**). The refunds of Rs 60.4 billion, are 16.3 percent of the total gross collections for the period (see **Figure 3.4**). Moreover, these refunds are only a little below the admittedly exceptional refunds disbursed in the corresponding period of FY02. In fact, the GST refund during July-March FY03 *exceeds*[10] the amount disbursed in the corresponding period of FY02 (see **Table 3.15**).

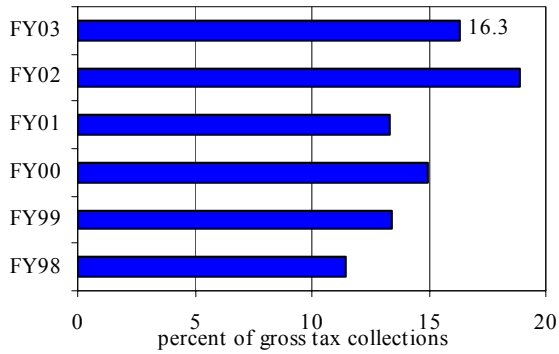
These observations suggest that the rise in net tax receipts is probably not mainly due to withheld tax refunds.

Table 3.9: Quarterly Refunds by CBR
billion Rupees

	Actual			YoY growth rates	
	FY01	**FY02**	**FY03**	**FY02**	**FY03**
Q1	15.7	21.1	22.2	34.3	5.2
Q2	12.0	23.5	16.4	95.3	-30.2
Q3	16.8	18.3	21.8	9.1	18.9
End-Q3	**44.6**	**62.9**	**60.4**	**41.2**	**-4.0**

Note: Growth rates are in percent, and figures may not tally due to separate rounding off to one decimal point.

Figure 3.4: Refunds (Jul-Mar)



3.2.3 Analysis by Tax Components

In the previous quarter, indirect tax receipts during Q3-FY03 were substantially higher than target, but unlike the preceding two quarters, the Q3-FY03 out-performance did not compensate for the continuing shortfall in direct tax collections in the period (see **Table 3.10**).

Table 3.10: Variation in FY03 Tax Receipts from Target
billion Rupees

	Direct	**Indirect**	**Total**
Q1	0.4	0.0	0.4
Q2	-4.7	5.3	0.6
Q3	-2.2	1.3	-0.8
End-Q3	**-6.4**	**6.5**	**0.1**

Figures may not tally due to separate rounding off to one decimal point.

As a result, although by end-Q3-FY03 the growth in indirect tax collections was an impressive 24.2 percent (vs. a 8.4 percent fall in the corresponding period of FY02), the shortfall in aggregate direct tax receipts meant that the *overall* tax

[10] The overall growth in sales tax refund is consistent with the higher exports during July-March FY03.

collections remained only marginally above the Rs 310.2 billion *target* for the period.

The growth in indirect taxes also meant that their share in aggregate taxes increased (see **Table 3.11**)

Table 3.11: Share in Total Taxes in Q3
percent

	FY00	FY01	FY02	FY03
Direct taxes	30.9	31.4	35.6	30.5
Indirect taxes	69.1	68.6	64.4	69.5
Sales tax	33.5	39.2	42.0	44.8
Central excise	16.4	12.7	11.6	10.1
Customs	19.2	16.7	10.8	14.6

Note: Figures may not tally due to separate rounding off to one decimal point.

Direct Taxes

Direct tax receipts remained below target for the second successive quarter in Q3-FY03 as a result of which the cumulative July-March FY03 figure fell 6.4 percent short of the target for the period (see **Table 3.12**).

Table 3.12: Performance of Direct Taxes
billion Rupees

			Shortfall	
	Target	Achievement	absolute	percent
Q1	23.2	23.6	0.4	1.7
Q2	42.8	38.1	-4.7	-10.9
Q3	35.1	32.9	-2.2	-6.2
End-Q3	**101.1**	**94.7**	**-6.4**	**-6.4**

Note: Figures may not tally due to separate rounding off to one decimal point.

The FY03 direct tax performance is thus significantly weaker than in the corresponding FY02 picture, when direct tax receipts grew 10.7 percent despite the relatively sluggish economic activities amidst geo-political concerns.

A break-up of income tax receipts (which account for 96 percent of direct taxes) reveals that a precipitous drop in *normal returns* underpins the poor direct tax performance in FY03, offsetting the gains under other heads (see **Table 3.13**). It should be noted here that the annual FY03 direct tax target growth of 4.8 percent was set lower than the FY02 growth to account for changes in tax policy introduced in the budget.[11] In particular, the sharp fall in receipts under normal returns was to be expected following the reduction in institutional tax rates, but the extent of the decline suggests that the realized tax losses may have been greater than envisaged.

[11] In the last year budget, the income tax rates on banks and corporations were reduced from 50 & 45 percent to 47 & 43 percent, respectively. While withholding taxes on outstation checks, commission on petroleum products was abolished while the withholding taxes on processed poultry meat, commission & brokerage and interest on securities was reduced to encourage the business activity. Tax rates on the commission & brokerage and interest on securities was brought down to 5 & 20 percent from 10 & 30 percent, respectively. A fall in withholding taxes on government securities and interest on deposits was also announced in the budget.

Another factor that could explain the fall in receipts under *normal returns* is the introduction of a Universal Self-Assessment Scheme for individual and corporate income tax payers. Given the weak tax culture in Pakistan, it is not unusual to witness a sharp fall in receipts until the tax authorities can establish a strong audit and enforcement machinery.

Table 3.13: Income Tax Collections (Jul-Mar)
billion Rupees

	Actual		YoY growth		Share	
	FY02	FY03	absolute	percent	FY02	FY03
Normal returns[1]	15.0	6.7	-8.3	-55.4	15.0	6.5
Current year u/s 53 collection	21.5	26.4	4.9	22.8	21.6	25.7
Collection on demand	7.8	9.6	1.8	23.6	7.8	9.4
Withholding tax	54.8	59.2	4.4	8.0	55.0	57.8
Miscellaneous	0.6	0.6	0.1	11.3	0.6	0.6
Total gross	99.6	102.5	2.9	2.9	100.0	100.0
Less refunds	8.6	10.8	2.2	25.8	8.6	10.5
Net	91.1	91.7	0.7	0.7	91.4	89.5

[1] Returns u/s 54
Note: Figures may not tally due to separate rounding off to one decimal point.

The weakness in receipts through *normal returns* was aggravated by below-target collections of withholding taxes on securities, bank interest and interest income. The receipts under all three heads were likely impacted by the unexpectedly large decline in domestic interest rates. In fact, total net receipts under the sub-heads declined by Rs 0.8 billion during July-March FY03 relative to the corresponding period of FY02. However, other than these three sub-heads, growth in withholding tax receipts is consistent with increasing economic activity. Healthy growth is visible in withholding tax on contracts, imports, salaries, exports, electricity and telephone bills (see **Table 3.14**).

Table 3.14: Withholding Tax Collections (Jul-Mar)
billion Rupees

	Actual		YoY growth		Share
	FY02	FY03	absolute	percent	in FY03
Salaries	5.7	6.5	0.8	14.6	11.0
Securities	4.0	3.8	-0.3	-6.7	6.4
Bank interest	4.9	4.4	-0.4	-8.9	7.5
Non-residents	0.8	1.0	0.2	23.5	1.7
Contracts	12.8	15.2	2.3	18.1	25.6
Commission	0.6	0.6	0.0	4.8	1.0
Imports	14.3	15.4	1.2	8.1	26.1
Exports	3.9	4.1	0.2	4.4	7.0
Transport	0.7	0.7	0.1	8.4	1.2
Dividends	1.0	1.1	0.1	11.6	1.9
Interest	0.5	0.5	-0.1	-13.7	0.8
Elect. Bills	2.2	2.9	0.6	27.3	4.8
Telephones	1.1	1.7	0.6	50.8	2.9
Miscellaneous	2.2	1.3	-0.9	-41.0	2.2
Total	**54.8**	**59.2**	**4.4**	**8.0**	**100.0**

Note: Figures may not tally due to separate rounding off to one decimal point.

Yet another factor depressing net direct tax receipts is the jump in refunds paid during FY03 (see **Table 3.13)**. This is particularly surprising given that FY02 saw an exceptional rise in the disbursement of tax refunds.

The rise in collections on demand is primarily driven by the better performance of Large Taxpayer Unit (LTU), particularly the improved performance of its audit staff.

Indirect Taxes

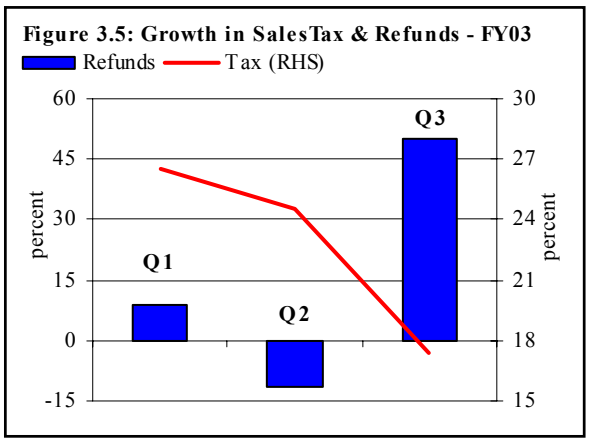
The relatively high growth in indirect taxes, which was led by sales tax and customs duty collections, took the share of indirect taxes in overall collections to a new high during the last three years (see **Table 3.11**). Moreover, within indirect taxes, it was the GST that accounted for an increasing share of collections. This is simply a reflection of the on-going policy to focus on the sales tax as the primary revenue generator for the exchequer, by broadening the tax base as well as substituting for the CED (which is gradually being phased out).

However, the trend-reversing rise in the share of the customs duty is worth noting, particularly given the appreciating rupee (which, *ceteris paribus*, would have led to lower receipts) as well as a drop in the effective tax rate to 14.3 percent (estimated) during July-March FY03.

Sales Tax[12]

Aided by the removal of exemptions, a larger tax base, and more importantly, a revival in domestic demand, sales tax receipts during July-March FY03 exceeded the target for the period (see **Table 3.7**).

However, the Q3-FY03 GST figures are at least potentially a source of concern. Although 17.4 percent higher than the Q3-FY02 receipts, these are nonetheless Rs 2 billion short of target. Moreover the growth in quarterly receipts is decelerating.



A possible explanation lies in the exceptional rise in sales tax refunds in Q3-FY03, possibly on the back of a sharp jump in exports (see **Figure 3.5** and **Figure 3.6**). This would account for both, the lower

[12] There are two components of sales tax i.e. import related and domestic component. The former is levied on taxable imports while the latter represents the receipts from the taxable commodities levied at the consumption stage, both of these can be proxied for the domestic economic activity.

growth as well as the shortfall in net receipts.

Incidentally, the sharp growth in the disbursement of GST refunds, even over the admittedly exceptional refunds seen in FY02, lends some support to the CBR contention that accruing refunds are generally not being withheld to pad the FY03 CBR net tax receipts.

In fact, the double-digit rise in total net GST receipts, despite the high refunds (which, to an extent, net out the impact of export demand), points to rising domestic demand (see **Table 3.15** and **Figure 3.7**). However, this does not mean that the import related sales tax was lower; in fact, it also recorded a double-digit growth during July-March FY03 as against a decline in the corresponding period last year.

The break up of gross domestic sales taxes reveals that a third (Rs 30.7 billion) of the July-March FY03 collections were contributed by energy charges (POL, electricity and natural gas), (see **Table 3.16** and **Table 3.17**).[13] Substantially

Figure 3.6: Annual Exports and Sales Tax Refunds

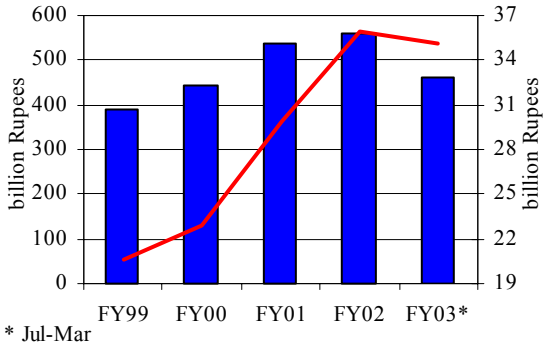


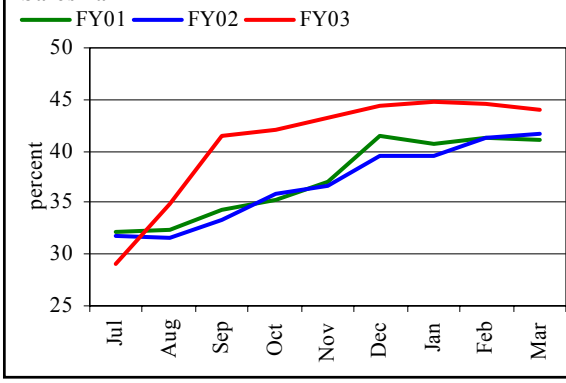
Table 3.15: Sales Tax Collections (Jul-Mar)

billion Rupees

	Net collection		Refunds		YoY growth in net collections	
	FY02	FY03	FY02	FY03	absolute	percent
Sales tax	113.4	139.1	30.6	35.1	25.7	22.6
Import related	66.1	77.9	0.2	0.2	11.9	18.0
Domestic	47.4	61.2	30.4	34.9	13.8	29.1

Note: Figures may not tally due to separate rounding off to one decimal point.

Figure 3.7: Share of Domestic Component in Total Sales Tax



[13] The overall incidence of energy taxes is also very high as these are 35.2 percent of total taxes and 3.3 percent of GDP during July-March FY03.

higher increase under POL is mainly attributed to the higher unit prices of oil in international markets, while the electrical energy revenues increased due to the higher consumption and adjustment of a Rs 2.9 billion recovery from WAPDA.[14]

Cigarettes, fertilizers, mild steel re-rolled products, motorcars, aerated waters/beverages, all contribute only 11.2 percent in domestic sales tax but it is interesting to note that these items posted the higher growth rates over the corresponding period of FY02. The production of the cigarettes although have declined (7.1 percent) but the revenue increased due to a rise in tax rates.

A sizeable increase (Rs 1.4 billion) observed in revenue from steel re-rolled products, which are surging on account of increased iron and steel supply (12.3 percent), (possibly) increased documentation, and a boost in construction activity. Motorcars & other vehicles sale and production rose sharply by 34.8 percent and 46.9 percent respectively mainly due to more leasing facilities, entry of the banks into leasing business, larger remittances and lower

Table 3.16: Incidence of Energy Taxes

billion Rupees

	Prov. Actual		YoY growth	
	FY02	FY03	absolute	percent
Domestic sales tax	22.6	30.7	8.1	35.9
Gas	6.0	6.1	0.0	0.8
Electricity	5.5	9.9	4.3	78.5
POL	11.1	14.8	3.7	33.8
Surcharges	40.6	48.7	8.0	19.8
POL	28.0	32.8	4.8	17.0
GAS	12.6	15.9	3.3	25.8
CED	3.7	2.7	-1.0	-27.4
CD[1]	0.4	3.2	2.8	657.1
Total	**107.9**	**133.9**	**25.9**	**24.0**
As percent of tax revenue	33.3	35.2	2.0	5.9
As percent of GDP	2.9	3.3	0.4	12.5

[1] Mineral fuels oil and its products thereof (Jul-Feb).

Note: The data on import related energy taxes are not available.

Table 3.17: Major Gross Domestic Sales Tax Items Collection (Jul-Mar)

billion Rupees

			YoY growth	
	FY02	FY03	absolute	percent
POL products	11.1	14.8	3.7	33.8
Cotton not corded or combed	9.1	9.9	0.8	8.7
Electrical energy	5.5	9.9	4.3	78.5
Services	7.1	9.3	2.2	30.9
Natural gas	6.0	6.1	0.0	0.8
Sugar	5.7	5.9	0.2	3.3
Cigarettes	3.1	3.3	0.3	9.0
Cement	2.7	2.7	0.0	-1.6
Fertilizer/Urea	1.0	2.4	1.4	147.8
Mild steel re-rolled products	0.4	2.1	1.7	446.9
Cotton yarn	1.9	1.6	-0.4	-18.6
Motorcars & other vehicles	0.5	1.5	1.0	202.4
Aerated waters/beverages	1.2	1.4	0.2	17.3
Others	12.0	13.5	1.5	12.1
Sub total	67.3	84.3	17.0	25.2
Other sectors	10.7	11.4	0.7	6.5
Gross total	78.0	95.6	17.7	22.7

Note: Figures may not tally due to separate rounding off to one decimal point.

[14] This is a matter of some concern, given that approximately 46 percent of the *growth* in gross domestic GST collections was from this segment alone.

interest rates. The government's efforts to bring the services into the tax net are also showing considerable progress (with a 30.9 percent YoY growth in gross collections).

Of the major traditional GST contributors, only cement and cotton yarn exhibited a negative growth. The production of cement increased (20.5 percent) however fall in its prices by 24.2 percent (see **section 2.2** for details), during most of the period under review, resulted in lower collections. Similarly, the collections from the cotton yarn fell due to a decline of 5.8 percent in its prices during the first half of the current fiscal year.[15]

Central Excise Duty (CED)
The share of CED in total federal taxes has been consistently falling over the years; it contracted from 16.4 percent in FY00 to 10.1 percent by end Q3-FY03 (see **Table 3.11**). This was largely caused by the government's policy of substituting the CED with the GST and customs duty.[16]

Table 3.18: Major CED Contributing Items (Jul-Mar)
billion Rupees

	Actual		YoY	Share
	FY02	FY03	growth	in net
Beverages (total)	1.74	1.46	-16.1	4.7
Cigarettes & tobacco (total)	10.52	11.05	5.1	35.5
Cement	7.05	8.29	17.5	26.6
Natural gas	3.10	3.27	5.5	10.5
POL products (total)	3.65	2.65	-27.4	8.5
Others	3.79	3.38	-10.8	10.9
Imported goods	1.47	1.20	-18.3	3.9
Gross total	31.32	31.30	-0.1	100.6
Refunds	0.02	0.18	1,083.2	0.6
Total (net)	31.30	31.12	-0.6	100.0

Note: (1) Growth and shares are in percentage terms.
(2) Totals in this table may not tally with CED figures in Table 3.7 due to reconciliation problem.

The CED on cigarettes, cement and natural gas contributes the bulk of total collections (see **Table 3.18**). Although, the receipts from cigarettes and cement saw reasonably good growth during July-March FY03, aggregate receipts were held down by a fall in collections on other items. As a result, the July-March FY03 receipts were 15.4 percent below the target for the period (see **Table 3.7**).

[15] The production of cotton yarn has increased (8.1 percent), while exports of cotton yarn witnessed a surge of 1.8 percent both in value and quantum during July-March FY03. It is basically domestic consumption, which is leading this decline due to low prices in the first two quarters of FY03.
[16] The CED on POL products was transformed into a custom duty during FY03. If adjusted for this Rs 1.9 billion shift, the CED would depict a 6.3 percent increase relative to the corresponding FY02 figure.

Customs[17]

In broader terms, the share of custom duties in overall tax collections is on the decline, due to a gradual reduction in the average tariff rate since the beginning of the 1990s (see **Table 3.11** and **Figure 3.8**). This step is consistent with the government strategy of trade liberalization through reforms in tariffs and lowering the high rates of effective protection. Despite further reduction in tariff rates announced in FY03 budget and an appreciation of the rupee, the actual growth in collection of custom duties has been exceptional. During July-March FY03 the growth under this head was 55.9 percent over the preceding year (see **Table 3.7**).

Higher imports, specifically in capital goods, and higher duty items (such as automobile CKD kits, POL products, animal & vegetable fats and oil) seem to be the major factors of this upswing.

The break up of the customs duty during July-February FY03

Figure 3.8: Trends in Average Tariff

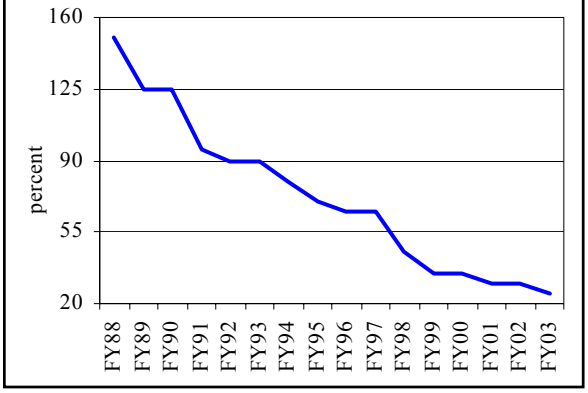


Table 3.19: Major Custom Duty Contributing Items (Jul-Feb)

billion Rupees

Heads	Actual		YoY growth	Share	
	FY02	FY03		FY02	FY03
Coffee, tea & spices	2.2	1.8	-18.3	4.8	3.6
Animal, vegetable fats & oil	6.4	8.2	27.7	13.7	15.9
Mineral fuel oil & products	0.4	3.2	657.1	0.9	6.2
Chemicals & chemical products	2.8	3.9	39.0	6.1	7.6
Iron & steel manufacturers	2.4	2.2	-7.6	5.1	4.3
Machinery & mechanical appliances	2.3	3.2	37.0	5.0	6.1
Electric machinery & equipments	1.5	2.7	82.9	3.1	5.2
Motor & other vehicles	3.1	5.6	78.2	6.7	10.8
Others	9.9	11.0	11.6	21.2	21.4
Sub total	31.0	41.7	34.5	66.7	81.0
All other articles	13.3	7.7	-42.3	28.5	14.9
Total import duty	44.2	49.3	11.5	95.3	95.9
Gross total[1]	46.4	51.4	10.7	100.0	100.0

[1] Includes miscellaneous charges

Note: Growth rates are in percent and figures may not tally due to separate rounding off to one decimal point.

[17] The total imports recorded an increase of 22.8 percent during July-March FY03; the major imports recorded increases were machinery (37.8 percent), petroleum products (23.5 percent) and food group (21.0 percent). The surge in the imports of the food group is attributed to edible oil and pulses, both in the quantum and value terms. All these are major revenue contributors. The POL products have witnessed the higher unit prices over the corresponding period, accordingly more than expected revenue generated on CD and sales tax. It should be looked with caveat, as next year the oil prices are likely to be moderated and less volatile.

(the latest available data) indicates that the share of POL and its products recorded an extraordinary increase over the corresponding FY02 figures, mainly due to shifting of POL from CED to customs (see **Table 3.19**).

Higher imports of animal, vegetable fats & oil, chemical & chemical products, machinery & mechanical appliances, electrical machinery & equipments and motor & other vehicles resulted in corresponding increases in custom duties and contributed significantly to the overall tax growth.

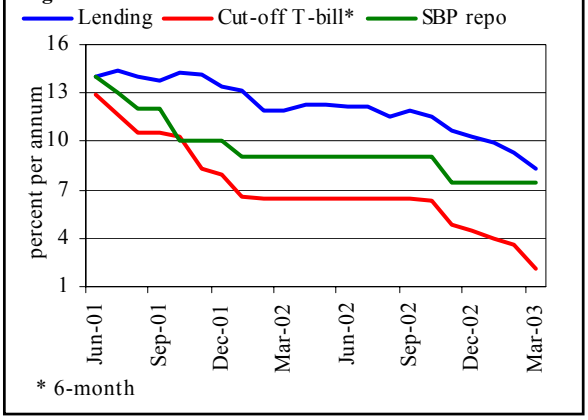
4 Money and Credit

The substantial rupee liquidity injections through SBP forex purchases continued into the third quarter of FY03. While the government's borrowings from scheduled banks were a sizeable Rs 56.5 billion,[1] these were much lower than the injections, and the quarter also saw an unusually strong retirement of commodity operation loans. As a result, despite an unseasonal surge in net private sector credit, interest rates remained under pressure during Q3-FY03.

In fact, there is evidence to support that the exceptionally strong rebound in private sector credit is, at least in part, driven by an unusual decline in lending rates as much as rising aggregate demand in the economy.

The increase in aggregate demand had been apparent even prior to the November 2002 discount rate cut, through indicators such as growth in large scale manufacturing, rising sales tax receipts, etc., but credit off-take remained relatively weak until the discount rate cut that *accelerated* the decline in lending rates (see **Figure 4.1**). Thereafter, as lending rates paralleled the fall in T-bill auction yields, private sector credit demand surged strongly (see **Figure 4.2**).[2] This trend continued in Q3-FY03.

Figure 4.1: Movements in Interest Rates



In particular, the post-November 2002 pressure on interest rates intensified in Q3-FY03 as strong unseasonal[3] deposit growth coincided with the usual retirement of commodity operation loans during the third quarter of a fiscal year.

[1] This figure refers to the net of the maturities amount *actually* mopped up from the scheduled banks through auctions of government securities during Q3-FY03. This gives an indication of the market demand for liquidity. The computed figure therefore does not incorporate the impact of the government deposits with scheduled banks as in the *net borrowings* figure reported in the monetary survey.

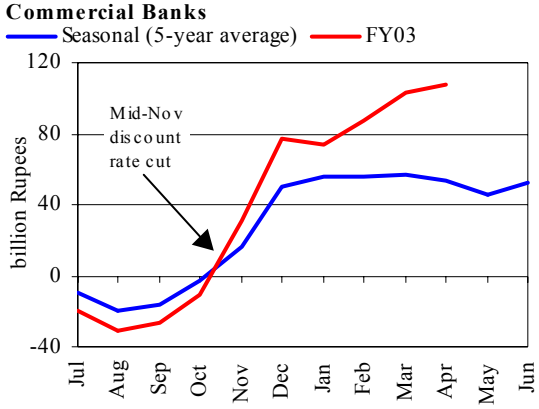
[2] The rising demand may have also been supported by perceptions of (1) political stability and (2) continuity of economic policies following the formation of the PML-Q government.

[3] Banking sector deposits typically either stagnate or weaken during the third quarter of a fiscal year.

Fueled by increased remittances, and an improvement in the government's financial position, banking sector deposits grew strongly for yet another quarter, rising by Rs 61.9 billion, during Q3-FY03. Not only was this a 39.1 percent increase over the Q2-FY03 deposit growth (i.e. the deposit growth accelerated), it also represented a *net addition* to the already exceptionally strong Rs 102.1 billion increase in aggregate deposits during the preceding two quarters.

On the other hand, net credit demand weakened substantially during January 2003, in accordance with normal seasonal trends (see **Figure 4.2**), and even the subsequent, unusual rise in credit demand during February-March 2003 failed to quell the pressure on rupee interest rates.

Figure 4.2: Net Credit to Private Sector by Commercial Banks



The latter also explains the immobility of the SBP discount rate during the quarter. As detailed in the *SBP State of the Economy Report for Q2-FY03*, SBP is now using the discount rate as an indicator of its monetary *stance*. In other words, the November 2002 discount rate cut was primarily used simply to *signal* an easing of the monetary stance of the SBP in response to the apparent weakness in net credit expansion, at the time. Correspondingly, once net private sector credit began rising strongly, SBP signaled its neutral stance by keeping the discount rate unchanged even as interest rates declined during Q3-FY03.

4.1 Monetary Survey

A striking development visible in the monetary survey for July-March FY03 (see **Table 4.1**) was the substantial retirement of the government sector borrowings from the banking system on account of the retirement of net budgetary borrowings as well as commodity operation loans.

The retirement in the first is not surprising; as mentioned in the *SBP State of the Economy Report for Q2-FY03*, this was simply the result of the substantial net foreign assistance and the continuing demand for NSS instruments, which forced the government to retire its T-bill holdings (see **section on Fiscal Developments** for details). Moreover, even within the stock of budgetary borrowings from the

Table 4.1: Monetary Survey (Jul-Mar)
billion Rupees

	FY02	FY03	
	Actual	IMF proj.	Actual
A. Government sector borrowing (net)	**-23.4**	**-58.2**	**-89.4**
1 Net budgetary borrowing	-1.0	-38.6	-52.5
from State Bank of Pakistan	*-71.5*	*-21.2*	*-224.2*
from scheduled banks	*70.5*	*-17.4*	*171.7*
2 Commodity operations	-22.6	-20.0	-39.4
3 Net effect of zakat fund/privatization proceeds	0.2	0.5	2.5
B. Non-government sector borrowing	**39.5**	**85.2**	**95.4**
1 *Private sector*	*54.0*	*68.8*	*107.2*
Commercial banks	*47.8*		*103.1*
of which export finance	*-14.9*		*-8.9*
Specialized banks	6.2		4.1
2 Public sector enterprises	0.0	*16.3*	-6.4
Autonomous bodies[1]	3.3		5.8
Other PSEs	*-1.9*		*-9.1*
PSEs special account-debt repayment with SBP	-1.5		-3.2
3 Other financial institutions	-14.4		-5.3
C. Other items (net)	**15.7**	**0.0**	**-64.7**
D. Net domestic assets of the banking system	**31.8**	**27.0**	**-58.7**
E. Net foreign assets of the banking system	**110.7**	**79.7**	**278.6**
F. Monetary assets (M2)	**142.5**	**106.7**	**219.9**
M2 growth (percent)	9.3	6.1	12.5

[1] WAPDA, OGDC, PTCL, KESC, PSMIC & PIA.
Note: Figures may not tally due to separate rounding off.
Source: Economic Policy Department, SBP

banking system, there was also a continuing substitution of government debt with SBP by borrowings from commercial banks, reflecting the SBP efforts to sterilize a part of the heavy NFA growth during the period.

However, the exceptionally heavy retirement of commodity operation loans is a welcome development, as it (1) indicates the improved financial position of relevant federal agencies as well as the provincial governments, and (2) the success of the government policy of transferring this activity to the private sector.

In contrast to the government sector, the expansion in non-government sector credit by end-March 2003 was a spectacular Rs 95.4 billion, more than twice the net credit expansion in the corresponding period of FY02; this improvement stemmed primarily from an exceptional Rs 107.2 billion increase in net credit to the private sector.

Other items (net) of the banking system shrank in July-March FY03 compared to an expansion in the same period of FY02 mainly because of a contraction in scheduled banks' other items (net) (see **section 4.4** for details).

In aggregate, the Net Domestic Assets (NDA) of the banking system contracted. However, this was substantially offset by the growth in the Net Foreign Assets of the banking system stemming from the large surpluses in Pakistan's external account (see **section on Balance of Payments**). As a result, monetary assets grew by 12.5 percent during July-March FY03 whereas reserve money growth was contained to 11.7 percent.[4]

The high growth in reserve money (RM) can be a source of concern given the possible future implications on inflationary pressures. In view of this, and the fact that the RM growth is driven by net forex inflows into the country, the planned early retirement of expensive external debt offers the possibility of multiple gains – lowering the external debt servicing outflows, creating fiscal space (by replacing expensive forex debt with cheaper rupee debt) and constraining inflationary pressures (by containing RM growth).

4.2 Government Sector

4.2.1 Government Borrowings for Budgetary Support

Strict financial discipline held the government's financing requirements for July-March FY03 to Rs 86.4 billion, (down 26.2 percent YoY). Moreover, since non-discretionary financing inflow[5] and privatization proceeds exceeded the government's relatively modest requirements, (see **Table 4.2**), net borrowings from the banking system totaling Rs 52.5 billion were retired during the period. As a result, the net retirement of credit for budgetary support from the banking system during July-March FY03 was 36.0 percent higher than the Rs 38.6 billion target for the period.

Table 4.2: Deficit Financing[1]
billion Rupees

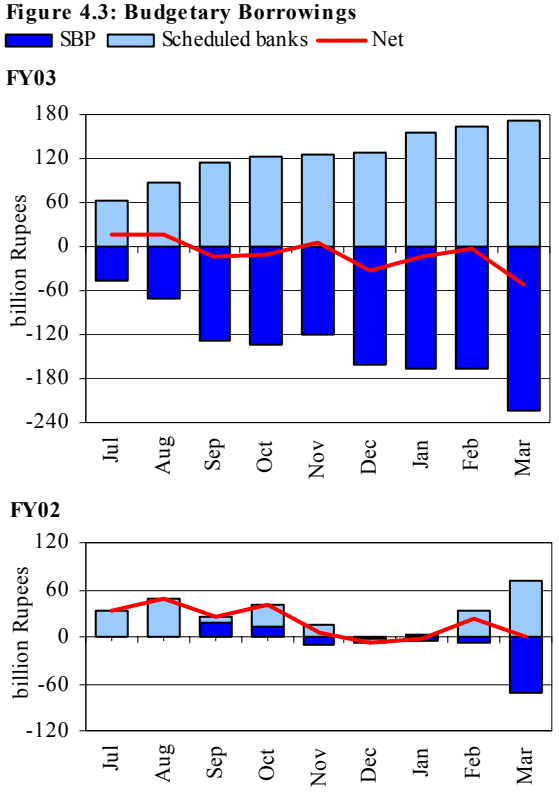
	Jul-Mar		Jan-Mar	
	FY02	**FY03**	**FY02**	**FY03**
External	55.7	64.2	-16.3	15.9
Non-bank	66.6	66.2	27.8	23.6
Privatization proceeds	0.0	8.5	0.0	0.0
Sub-total	*122.3*	*138.9*	*11.5*	*39.5*
Total financing	**117.1**	**86.4**	**-32.5**	**21.0**
Banking system	-5.2	-52.5	-44.0	-18.5

[1]The MoF and SBP numbers may slightly differ due to mismatching of timings and definitions.
Source: Ministry of Finance

[4] Had SBP not sterilized, the reserve money growth would have been 50.1 percent.
[5] External + Non-bank.

A breakup of July-March FY03 net retirement shows that budgetary borrowings from the banking system, in turn, incorporates a Rs 171.7 billion increase in net borrowings from scheduled banks, which was more than offset by a Rs 224.2 billion retirement of the government debt with the SBP (see **Figure 4.3**).

Figure 4.3: Budgetary Borrowings



This shift in the government's borrowings from the SBP to scheduled banks represents the sterilization of a large part of SBP's interventions in the forex market during the quarter.

Significantly, as in earlier quarters of FY03, despite the substantial increase in market (scheduled banks) borrowings, interest rates on government papers continued to decline throughout FY03, particularly during post-November 2002 period. This is explained by a Rs 254.9 billion liquidity injection through SBP forex purchases which, was substantially higher than even the larger absorptions from the scheduled banks (Rs 190.9 billion).

4.2.2 Commodity Operations

In accordance with seasonal pattern, July-March FY03 witnessed a net retirement of commodity operations loans.[6] However, Rs 39.4 billion net retirement during the period was substantially higher than the net retirement of Rs 22.6 billion during July-March FY02.

The larger decline in the stocks was due to:

(1) the improved financial position, particularly of provincial governments and federal government agencies. The provincial governments alone retired loans

[6] The bulk of these loans are for the procurement of wheat.

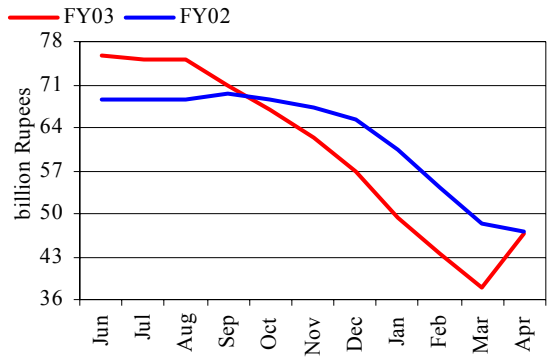
totaling Rs 29.8 billion during July-March FY03, as compared to the retirement of Rs 16.5 billion during the corresponding period of FY02;

(2) an increase in wheat exports that helped in retiring the commodity operation loans. This also explains the earlier retirement of these loans in FY03 (see **Figure 4.4**);

(3) the increased availability of credit to private sector for wheat purchases. The resulting increase in the procurement of wheat by the private sector reduced the commodity operations of the government sector; and

(4) finally, in anticipation of a bumper wheat crop, government increased the sales of its wheat stock.

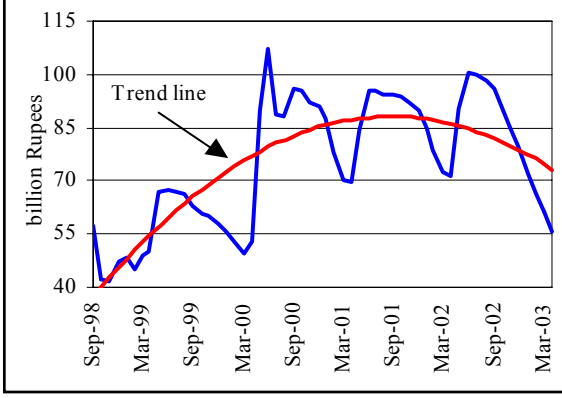
Figure 4.4: Credit to Government for Wheat Procurement



Similarly, among the federal agencies, PASSCO, which predominantly procures wheat, retired Rs 7.5 billion during July-March FY03.

As a result, the governments *stock* of commodity finance loans saw significant reduction, contrary to the trends in previous years (see **Figure 4.5**).

Figure 4.5: Commodity Operations - Outstanding Credit



4.3 Non-government Sector

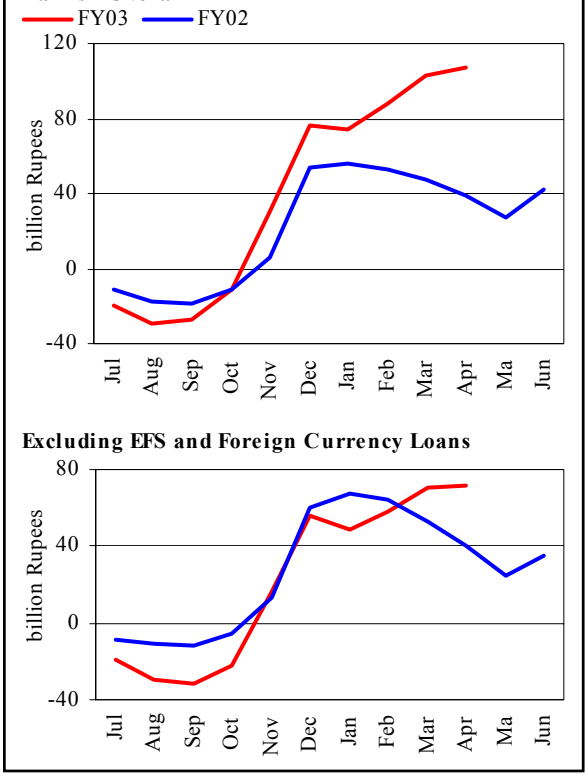
4.3.1 Private Sector Credit

Both gross[7] and net credit disbursements to the private sector rose strongly in Q3-FY03, in sharp contrast to the usual seasonal trends. As a result, the July-March FY03 net credit to the private sector rose by Rs 107.2 billion, nearly twice the Rs 54.0 billion expansion recorded in the corresponding period of FY02.

[7] The gross disbursement data does not include foreign currency loans disbursement whereas net credit includes both rupee and foreign currency loans.

Interestingly, if the net change in EFS loans and FCY loans (which are primarily to exporters) are excluded from the quarterly net credit expansion, the adjusted net credit expansion falls a little below the corresponding FY02 figure (see **Figure 4.6**) until March 2003. Clearly, the unseasonal surge in Q3-FY03 net credit appears entirely related to the export sector.[8,9]

Figure 4.6: Credit to Private Sector by Commercial Banks - Overall



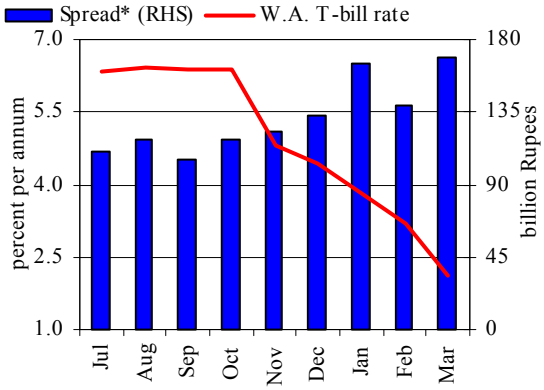
While the strong credit expansion during July-March FY03 is clearly well aligned with indicators of economic recovery, there is evidence that higher prices of some key inputs have also contributed to the rise in net credit extension. In particular, the sharp jump in the credit requirements of the textile sector probably stemmed from a rise in cotton prices as well as higher prices of petroleum products. The latter would not only push up transportation costs, but production costs as well, through higher power charges and the use of petroleum derivatives (e.g. dyes, polyester etc.).

It has also been argued that a large proportion of the net credit expansion simply reflects the re-pricing of earlier loans, and has no bearing on current economic activity. This is misleading. Since the re-pricing of loans represents the *substitution* of expensive loans with cheaper loans, this would not lead to an increase in net credit. In other words, the net credit expansion represents an actual increase in the demand for credit.

[8] In fact, even the post-January 2003 up trend in the *adjusted* net credit is primarily due to increased cotton financing, which is probably correlated with strong export demand for textile products.
[9] The exceptional Q3-FY03 growth in export-driven net credit is even more credible given that this was *despite* the dampening influence of the conflict in Iraq.

However, this is not to suggest that there is no evidence for the re-pricing of loans. Since the difference between the gross and net expansion in rupee credit[10] represents the stock of loans that could *possibly* have been re-priced, the fact that this difference increased sharply even as interest rates began to decline is an indication that re-pricing of loans has indeed taken place (see **Figure 4.7**). In other words, businesses have probably benefited significantly from the declining interest rates in the economy through cheap fresh loans, as well as the re-pricing of earlier ones.

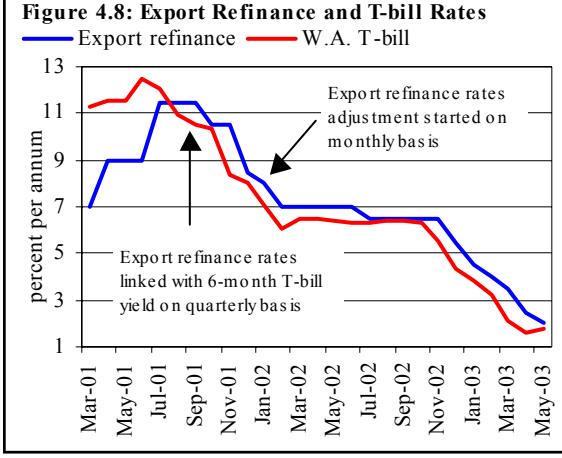
Figure 4.7: Repricing of Private Sector Loans



*Between gross disbursement and net Rupee credit

It is important to note here that sharp jump in the July-March FY03 net credit expansion is to be seen in the overall context of other complementary indicators to make any judgment about the recovery in economic activity. In particular, corporate profitability appears to be rising (which could *potentially* have lowered borrowing requirements),[11] and remittances grew strongly during FY03 (a portion of which could *potentially* be available to businesses). Finally, there is a visible increase in the net credit disbursement of NBFIs, from a net retirement of Rs 35.3 billion in July-March FY02 to a net expansion of Rs 8.3 billion in July-March FY03. All these indicators (reinforcing each other) suggest that there has been a strong recovery in FY03 compared to the previous years.

Figure 4.8: Export Refinance and T-bill Rates



Export Finance Scheme (EFS)

The export refinance rates declined by 200 basis points through Q3-FY03, bringing the cumulative July-March FY03 fall to 350 basis points.

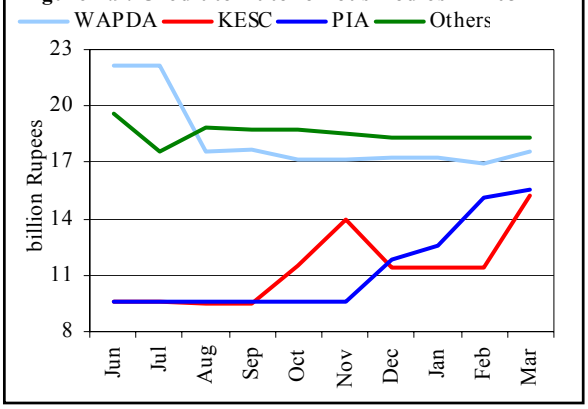
[10] As the interest rates on foreign currency loan have not changed, these loans have been excluded.
[11] This is particularly evident for the automobile and oil marketing sectors.

However, despite the reduction in the export refinance rate, interest in EFS loans remained low as exporters preferred to substitute these with foreign currency borrowings, as the latter were cheaper and required less documentation (see **Figure 4.8**).

4.3.2 Public Sector Enterprises (PSEs)

Credit to autonomous bodies saw a net expansion of Rs 7.9 billion during Q3-FY03 compared to Rs 1.2 billion increase recorded in the corresponding quarter of FY02. Two institutions account for the bulk of this rise (see **Figure 4.9)**.

Figure 4.9: Credit to Autonomous Bodies - FY03



KESC continued its borrowing to meet its working capital requirements in March 2003 it borrowed Rs.3.9 billion under financial improvement program (FIP).

Furthermore PIA's bank borrowings continued to rise in Q3-FY03. In February 2003 PIA launched a Rs 15.4 billion TFCs, of which Rs 10.7 billion were purchased by banks. As a result, PIA's overall borrowing from the commercial banks almost remained at the same level.[12] The rest of the PSEs did not show any noteworthy movement during the period under review.

4.4 Other Items (net)

Other items net of the banking system showed a contraction of Rs 64.7 billion during July-March of FY03 compared to an expansion of Rs 15.7 billion during the same period of FY02. This massive contraction was on account of changes in the figure for scheduled banks' account, which shrank by Rs 89.7 billion (see **Table 4.3**).

[12] At one hand, the purchase of PIA TFCs increased banks claims on PIA whereas on the other hand, PIA paid back its borrowing from the banks that resulted in almost no change in PIA's overall borrowings from the banks.

The adoption of International Accounting Standards by the SBP with effect from July 1, 2003 resulted in some changes in other item net. The *other liabilities* of the SBP fell as the capital requirements of foreign banks (FBs) were shifted to *reserve money* (banks deposits with SBP).

There was also a discrepancy between the data sets of SBP and scheduled banks. Another major change in other items was due to increased paid up capital and reserves. Finally, the privatization of UBL reduced *other assets of scheduled banks* as SBP disinvested its share capital in UBL.

Table 4.3: Major Changes in Other Items Net: Jul-Mar FY03[1]
billion Rupees

On SBP accounts	**25.0**
Net change in other assets and other liabilities	24.8
of which: capital requirement of FBs	*21.0*
On scheduled banks accounts	**-89.7**
Capital paid up & reserves	-12.5
Investment in shares of scheduled banks	-12.8
Discrepancy	-37.1
Of which: capital requirement of FBs	*-21.0*
Discrepancy on account of HBL	*-13.0*
Net change in other assets and other liabilities	-31.8
of which: on account of NBP	*-15.1*
ZTBL	*-13.6*
ABL	*-6.8*
UBL	*5.0*
Bank Al-Falah	*2.0*
Banking system	**-64.7**

[1] The signs indicate monetary impact

4.5 Net Domestic Assets (NDA)

NDA of the banking system shrank by Rs 58.7 billion during the first nine-months of FY03 compared to an expansion of Rs 31.8 billion in the corresponding period of FY02. More importantly SBP NDA contracted by Rs 205.2 billion, primarily because of the retirement of SBP holdings of government debt, which curtailed reserve money growth caused by SBP forex purchases. By contrast, scheduled banks' NDA swelled by Rs 146.5 billion mainly because of increased government bank borrowings as well as an expansion in net credit to the private sector, which outpaced the contraction of other items (net) and net retirement of commodity operation loans.

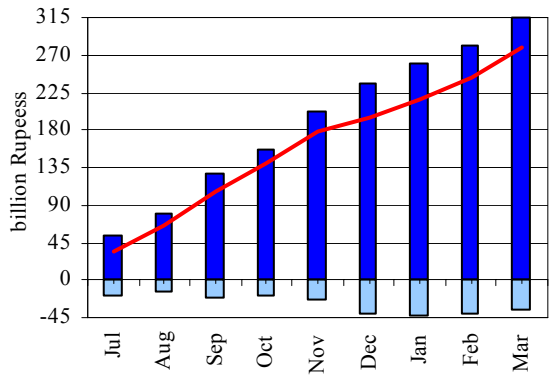
4.6 Net Foreign Assets (NFA)

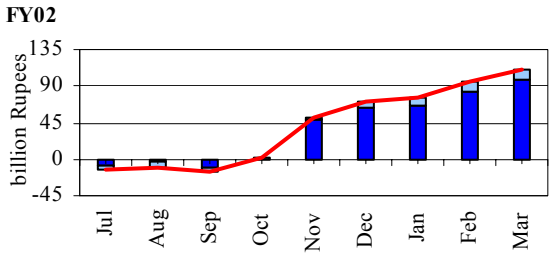
NFA of the banking system recorded a Rs 278.6 billion increase in July-March FY03, compared to a Rs 110.7 billion increase in the corresponding period of FY02.

The stronger increase during FY03 is entirely attributable to the continual up trend in the NFA of SBP (see **Figure 4.10**) due to rising SBP forex purchases, as well as loans from IFIs, receipts of US logistic support payments, and other external financing.

Scheduled banks NFA declined primarily because of their foreign currency lending. This is due to a definitional quirk. Although the loans are re-payable in foreign currency, the loan assets are classified as part of the NDA of the scheduled banks.

Figure 4.10: Net Foreign Assets



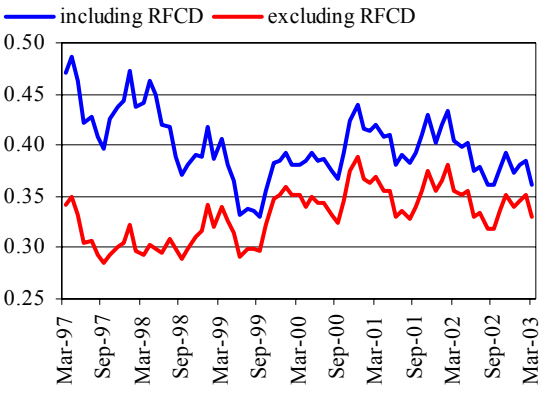


4.7 Components of Money Supply

Overall increase in money supply of Rs 219.9 billion came from both deposits of banking system and currency in circulation; both grew by almost same rates (marginally over 13 percent). Moreover, January-February 2003 witnessed a seasonal hike in currency in circulation, which then started declining in March 2003.

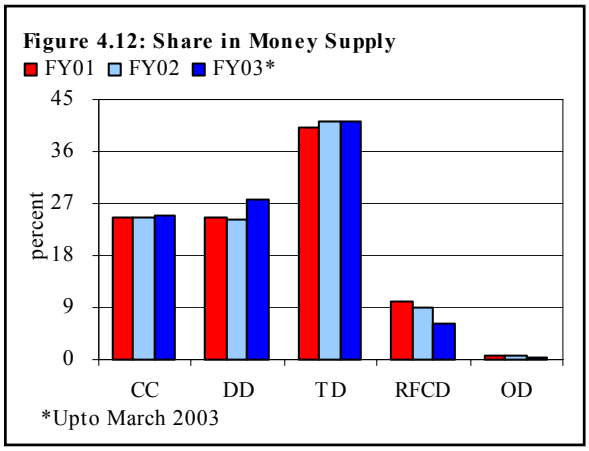
Consequently, the currency deposit ratio (CDR), which rose to 0.35 in January and February 2003, fell back to 0.33 in March 2003, as it was in June 2002 (see **Figure 4.11**). The key development in CDR is its declining level, which reflects increasing intermediation by banks.

Figure 4.11: Currency Deposit Ratio

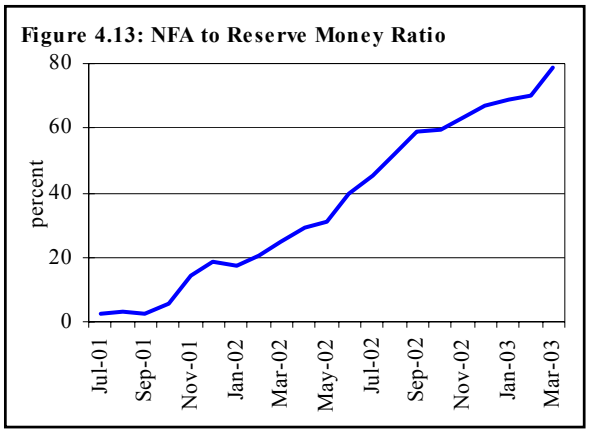


As shown in **Figure 4.12**, the share of both time deposits and currency in circulation remained almost unchanged during FY03 (upto March 2003) over FY01 and FY02. On the other hand, the falling share of RFCDs was offset by a rise in the share of demand deposits.

While continual conversion of foreign currency deposits explains their falling share in M2, the preference for demand deposits is in contrast to earlier trends, when declining RFCDs were substituted by time deposits. An apparent reason might be very low interest rates on fresh time deposits. Also, a relatively sharper decline in CDR (excluding RFCDs) is a reflection of declining stock of RFCDs as against stable share of currency in M2 (see **Figures 4.11** and **4.12**).



An interesting observation is the proportionately lower growth of reserve money compared with hefty increase in NFA, because of which the NFA/RM ratio rose sharply from Q1-FY02 onwards, indicating expanded coverage of the domestic monetary base by the foreign currency denominated assets (see **Figure 4.13**).



5 Money Market

Interest rates declined throughout Q3-FY03, continuing the downtrend initiated by the mid-November 2002 discount rate cut, amidst a substantial availability of liquidity in the market; primarily due to:

(1) rupee injection in the interbank market by SBP (Rs 81.5 billion against US dollar purchases and Rs 8.5 billion through swaps), and
(2) the retirement of commodity operation loans (Rs 18.4 billion).

The high market liquidity together with the expectations of interest rate decline created a self-perpetuating cycle – heavy bids in auctions (as banks strove to aggressively book assets) led to lower auction cut-offs which, in turn, spurred heavier bids, at lower rates, in the succeeding auctions. This trend culminated in bids of over Rs 100 billion in both of the March 2003 auctions.

Thus, although the SBP held acceptances in auctions to targets that were consistently higher than maturities, interest rates fell in each successive auction, with the benchmark six-month T-bill yield falling to a historical low of 2.1 percent[1] by the end of the quarter (see **Table 5.1**).

Table 5.1: Auction Analysis
basis points

		Decline in rate (6m T-bill)	Accepted less maturity (billion Rupees)	Discount rate cut
FY02	Q1	206	31.0	200
	Q2	257	-27.2	200
	Q3	148	65.1	100
	Q4	16	36.6	0
Cumulative		**627**	**105.5**	**500**
FY03	Q1	-8	106.1	0
	Q2	192	49.0	150
	Q3	236	43.8	0
Cumulative		**419**	**199.0**	**150**

The fact that T-bill auction targets were consistently higher than maturities reflects the SBP's policy of sterilizing a *part* of the liquidity injections stemming from its forex purchases.[2] It is also worth underlining that this *partial* sterilization stemmed from a deliberate policy to pressure lending rates.[3]

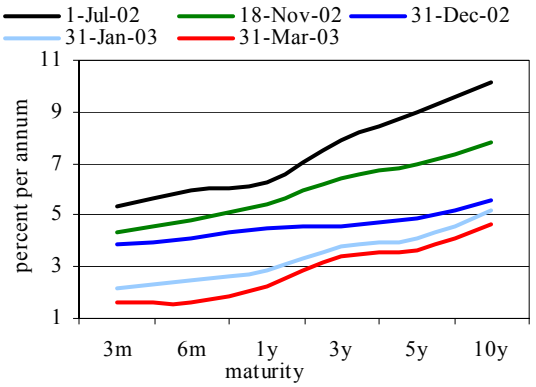
Interestingly, even at the beginning of Q3-FY03, there were indications of a bottoming out of PIB yields, as investors were clearly uncomfortable with the sharp decline in real returns.

[1] In fact, February 2003 real returns on T-bills of all tenors had dropped below zero.
[2] The difference between the maturities and acceptances effectively reflects a shift of T-bill holdings from the SBP to scheduled banks.
[3] In fact, the substantial liquidity in the market forced banking institutions to market aggressively, which contributed to a slide in lending rates (see **section 4.2**).

Despite a sharply reduced supply of PIBs, the market yields on these instruments rose above the auction cut-off, in sharp contrast to the behavior in previous quarters. This pushed up the term premium[4] (see **Figure 5.1**), reflecting market expectations of a rise in interest rates in the medium term. The resulting steepening of the yield curve was aggravated by the continuing fall in short-term rates during the quarter due to the *prevailing* market liquidity (see **Figure 5.2**).

Figure 5.1: Term Premium - FY03

Figure 5.2: Yield Curves



However, the key point in the sustainability of the emerging change in market expectations is the hope that the continuing liquidity injections in the market will be offset by a combination of higher government expenditures in FY04, as well as a partial sterilization of forex flows through the pre-mature repayments of external debt.

5.1 SBP Market Support and Rupee Interventions

The third quarter of the fiscal year is normally characterized by retirement on account of commodity operations and a decline in credit to private sector after it peaks in January.[5] However, the Q3-FY03 liquidity was exceptionally high with only two episodes of discounting (see **Table 5.2**).

[4] The term premium is taken as the difference between market yields of 3-month and 10-year government paper.

[5] Credit to private sector saw an un-seasonal high demand in February-March 2003.

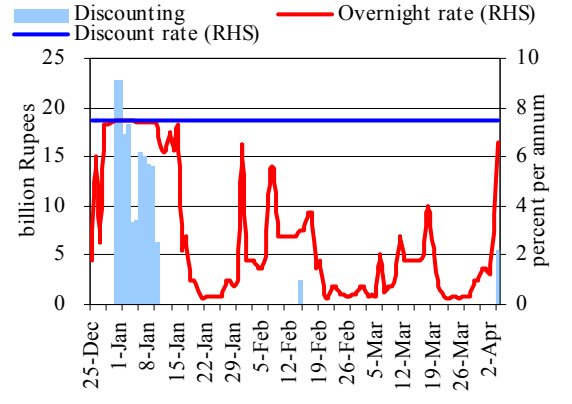
Table 5.2: Activities at Discount Window
billion Rupees

	Visits to discount window (No. of days)			Total amount of discounting			Average per visit		
	FY01	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**
January	19	5	10	309.4	17.4	140.2	16.3	3.5	14.0
February	8	8	1	16.2	102.0	2.5	2.0	12.7	2.5
March	9	1	0	33.9	10.4	0.0	3.8	10.4	0.0
Quarterly	**36**	**14**	**11**	**359.5**	**129.7**	**142.7**	**10.0**	**9.3**	**13.0**

Source: State Bank of Pakistan

The first was a 10-day episode due to: (1) end-December 2002 payments of taxes and dividends by PSEs, and (2) settlement of PIB auction of December 31, 2002. The second episode, in February 2002 was caused by a single bank, which faced line and exposure limits; the aggregate market was, in fact, liquid (see **Figure 5.3**).

Figure 5.3: Discounting and Overnight Rates - FY03



Also atypical was the absence of OMOs during Q3-FY03 (see **Table 5.3**). This was primarily because SBP continually injected liquidity into the market through its forex purchases as well as through its swap window.

Table 5.3: Open Market Operations
billion Rupees

	Injection			Absorption		
	FY01	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**
January	13.6	-	-	-	17.6	-
February	-	23.9	-	27.9	5.2	-
March	-	-	-	22.4	-	-
Total	**13.6**	**23.9**	**-**	**50.3**	**22.8**	**-**

Source: Exchange & Debt Management Department, SBP

Interestingly, banks' increased preference for government paper may have been augmented not only by the prevalent market liquidity, but also the expectations of continuing liquidity injections.

5.2 Treasury Bills Auctions

Commercial banks' appetite for government papers remained intact during Q3-FY03. In overall terms, banks offered Rs 490.6 billion during Q3-FY03 as

compared to Rs 180.4 billion in the corresponding period last year, while SBP accepted Rs 188.7 billion and Rs 98.3 billion respectively. As a result of the exceptional demand, the benchmark six-month yield dropped drastically by 236 basis points during the quarter to reach 2.1 percent.

Significantly, although T-bill auction acceptances during Q3-FY03 rose by Rs 90.4 billion compared to the figure for Q3-FY02, however the bid-to-acceptance ratio declined by more than 16 percentage points compared to the corresponding period for FY02. This not only reflects the higher liquidity in Q3-FY03, but probably also indicates heavy over bidding by banks amidst expectations of a continued decline in short-term interest rates (**Figure 5.4** [6]).

This expectation is evident in the continued lack of interest in shorter-tenor T-bills; 3-month T-bills accounted for only 8.5 percent of the total bids in all T-bills auctioned during Q3-FY03.[7]

Not surprisingly, given the movement in interest rates

Figure 5.4: Summary of T-bill Auctions

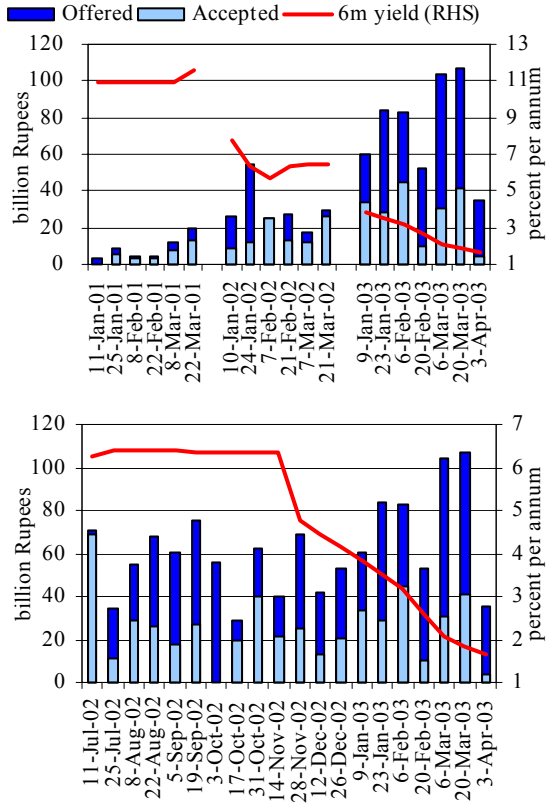
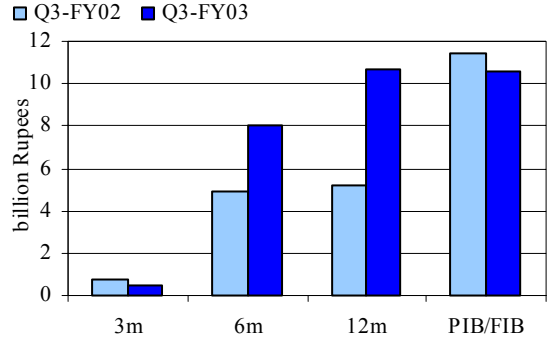


Figure 5.5: Average Trading Volume per Day



[6] The six-month weighted average yield series is smoothed out by taking averages of preceding and following auction yields where the auction held is not for six-month paper.

[7] While 50.4 percent and 41.2 percent of the total offered amount during Q3-FY03 represented 6 and 12-month T-bills respectively.

during the quarter, the trading of T-bills in the interbank money market increased. In particular, there was a sizeable increase in average daily trading volume for six- and twelve-month T-bills. Similarly, there was also substantial trading in PIBs (see **Figure 5.5**).

5.3 Pakistan Investment Bonds Auctions

In accordance with lower government demand for long-term debt only one auction for sale of PIBs was held during Q3-FY03 (see **Table 5.4**), in contrast to the larger (and more frequent) auctions in Q3-FY02. The acceptances in both years remained in line with the target amount.

Table 5.4: PIB Auctions - Summary of Results

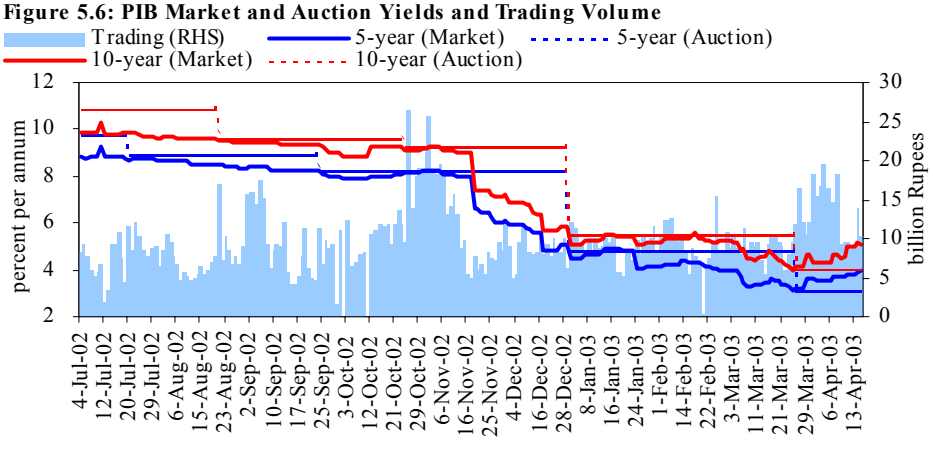
billion Rupees

Auction	Tenor	Target	Coupon (percent)	Amount offered	Range of price offered/Rs 100	Amount accepted	W. A. (percent p.a.)	Tenor wise acceptance (percent)
Q3-FY02		**24.0**	**-**	**78.2**	**-**	**23.3**	**-**	**-**
28-Mar	3-year	1.0	7.0	3.8	109.8--112.5	1.0	2.8	31.3
	5-year	1.0	8.0	3.7	119.0--123.1	1.1	3.1	32.8
	10-year	1.0	9.0	5.7	132.1--140.9	1.2	4.0	35.9
Q3-FY03		**3.0**	**-**	**13.2**	**-**	**3.2**	**-**	**100.0**

Source: Exchange & Debt Management Department, SBP

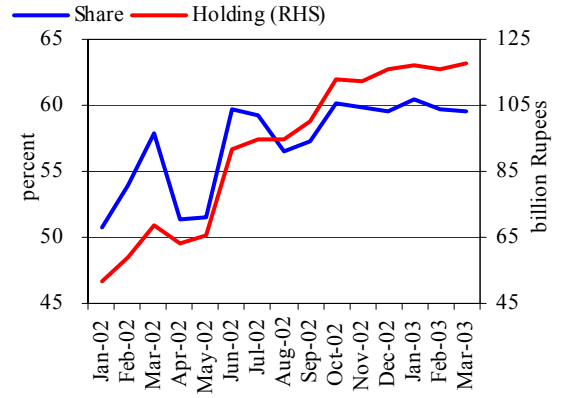
As shown in **Figure 5.6**, the daily trading activity in PIBs remained low as compared to the activity of H1-FY03 until end-March 2003. The increased trading interest in PIB by end-March 2003 is probably due to profit taking amidst rising expectations of an interest rate reversal.

Figure 5.6: PIB Market and Auction Yields and Trading Volume



It is important to note that despite repeated expressions of concern, banks holdings of PIB remain large (see **Figure 5.7**). This implies that if long-term interest rates do indeed witness a reversal, the aggregate banking system could face substantial capital losses on their bond holdings.

Figure 5.7: Banks' Holdings of PIBs



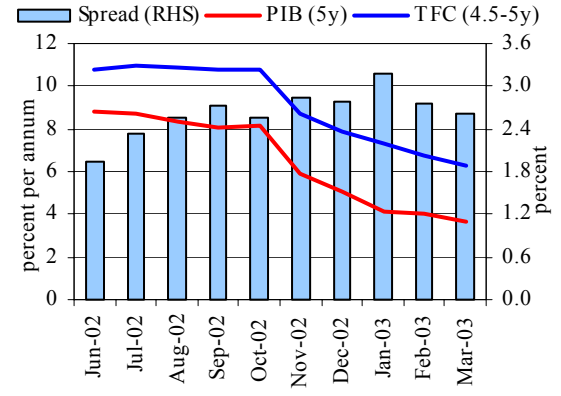
5.4 Trading in TFCs

The historic low interest rates scenario has resulted in an enormous growth in issuance of corporate debt. In specific terms, the listed TFCs issued during July-March FY03 increased by 28.6 percent as compared to the same period last year.

The secondary market data on corporate debt (TFCs) is not robust due to the shallowness of the market. Nonetheless, some analysis can be made on the basis of the spread between the corporate debt and the similar maturity government paper by taking the indicative secondary market quotes.

As shown in **Figure 5.8**, the spread hovered within the range of 2.5 to 3.0 percent during June-March FY03, and the secondary market rates of TFCs have also fell in line with the declining PIB rates. The average spread of 2.6 percent during the same period reflects the risk premium required to make the corporate debt attractive vis-à-vis the government paper (zero risk security) of 5-year maturity.

Figure 5.8: Secondary Market (PIB & TFCs)



6 Banking Sector Developments

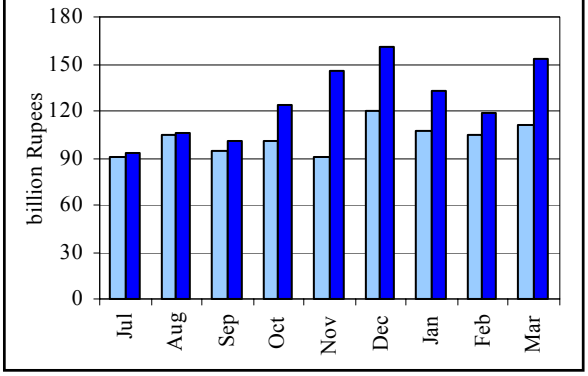
Strong growth in banking sector deposits, a partial sterilization of the SBP forex purchases, together with relatively weak public sector demand (in the absence of net budgetary borrowings,[1] and exceptionally strong seasonal retirements of commodity operation loans), kept rupee lending rates under pressure through Q3-FY03.

The aggregate deposits of banks continued to grow strongly for the third successive quarter of FY03, registering a 4.1 percent increase even though the real rate on deposits turned negative. This strong deposit growth along with the net retirement of government credit (excluding sterilization) led to excess liquidity in the banking sector, and increased competition as banks strove to book assets.

As a consequence, the weighted average lending rates on *fresh* loans and advances of the banks during the quarter slipped into single digits, reaching 8.3 percent by the end of Q3-FY03. The combination of low lending rates and strong deposit growth also meant that banks remained under pressure to aggressively market credit, and to create new products. Banks' increased focus on consumer financing is a case in point.[2]

The steep slide of 205 basis points in the weighted average lending rate during Q3-FY03, took the cumulative July-March FY03 decline to 386 basis points. This unprecedented fall in lending rates was probably a key driver, together with the strengthening economy, of the exceptionally strong credit disbursement (Rs 210.9 billion higher than the last year) recorded during July-March FY03 (see **Figure 6.1**).

Figure 6.1: Credit Disbursement



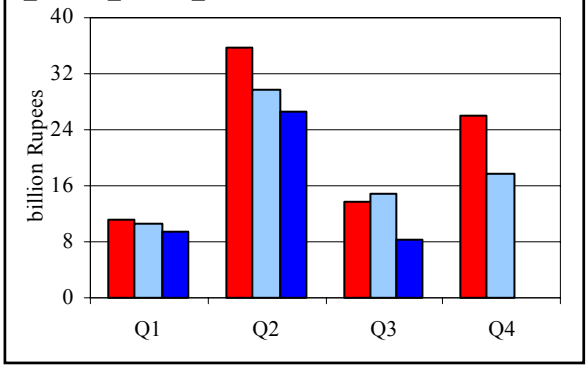
[1] There is a constraint on the sale of government securities in terms of budget deficit target. Furthermore, the net budgetary borrowings remained substantially below the target due to improved fiscal position of the government, and availability of non-discretionary funds (external financing).
[2] A large number of banks have recently entered in the area of housing finance, started various schemes for personal loans and consumer durables.

As a consequence, net credit saw an expansion of Rs 64.5 billion during July-March FY03, up Rs 32.8 billion from the corresponding figure for FY02, led primarily by a doubling of net credit extension to the private sector.[3]

Although both lending and deposit rates declined, the fall in the former was more pronounced, which helped in narrowing the banking spread.[4] Specifically, the banking spread went down by 126 basis points during Q3-FY03, forming a total decline in banking spread of 250 basis points during all three-quarters of the fiscal year.

A factor, which should help in lowering banking spread, is a considerable improvement in NPLs of the banking sector. Fresh NPLs of the banking sector were substantially lower (by Rs 10.8 billion) during July-March FY03 as compared to the same period of FY02 (see **Figure 6.2**). Furthermore, the outstanding level of NPLs declined to Rs 242.2 billion by the end of Q3-FY03, with a contraction of Rs 2.0 billion during the quarter under review.

Figure 6.2: Quarterly Fresh NPLs



6.1 Deposit Mobilization

Despite negative real deposit rates, banking sector deposits registered a healthy growth of 4.1 percent during Q3-FY03, which is not only higher than the Q2-FY03 growth of 3.0 percent, but also well above the 1.8 percent recorded during the same quarter of FY02 (see **Table 6.1**). The growth stemmed entirely from rupee deposits, as

Table 6.1: Deposit Growth

percent

	FY02			FY03		
	Overall	Local	Foreign	Overall	Local	Foreign
Q1	-0.6	-0.6	-0.7	4.1	4.8	-0.7
Q2	5.8	8.6	-7.7	3.0	4.3	-6.4
Q3	1.8	2.1	0.2	4.1	6.2	-11.9
Upto Q3	7.1	10.2	-8.2	11.6	16.1	-18.2

[3] Particularly interesting is a Rs 9.0 billion *expansion* in total net credit during Q3-FY03; this is in contrast to the *retirement* of net credit witnessed in the third quarter of the preceding two years.

[4] The weighted average deposit rate is available only on the entire *stock* of deposits, and the fall in rates offered on *incremental* deposits of Q3-FY03 would not be fully visible. The apparent squeeze in the banking spread is thus probably overstated.

forex deposits continued to decline (see **Box 1**).

This impressive growth in deposits is largely underpinned by: (1) an exceptional rise in remittances,[5] (2) unusual net credit expansion, (3) relatively lower disintermediation of NSS instruments,[6] (4) increase in government deposits, and (5) rise in deposits of the public sector enterprises because of the improved financial health of these institutions.[7]

A striking feature of Q3-FY03 is the participation of all groups in the deposit growth (see **Table 6.2**). The turnaround in the deposits growth of nationalized banks, relative to the previous quarter is explainable by (1) the absence of large withdrawals seen in Q2-FY03 and (2) the relative improvement in the financial health of government as well as PSEs (both of which typically bank with this group). Interestingly, while deposit growth of private banks remains strong, it is weaker than that in the previous quarter.[8] Finally, the continuing withdrawal of foreign currency deposits remained a major drag on deposit growth of foreign banks during the quarter.

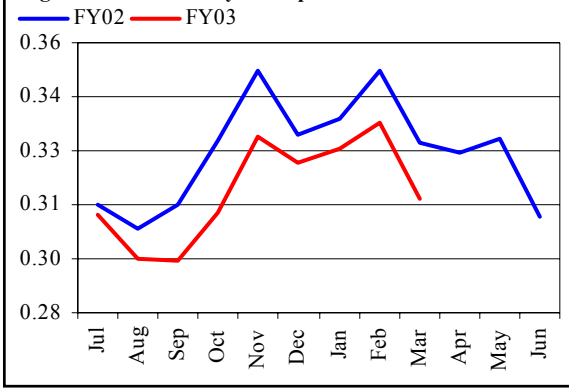
Table 6.2: Changes in Deposits during FY03

billion Rupees

	Q1	Q2	Q3	Total
Nationalized	24.9	-3.8	24.3	45.4
Privatized	1.1	19.4	18.0	38.5
Private	37.0	31.0	17.9	85.9
Foreign	-5.1	-3.3	0.8	-7.6
Specialized	-0.3	1.2	0.9	1.8
All banks	57.6	44.5	61.9	164.0

Note: For meaningful comparison, deposits of UBL are included in privatized banks for Q1 and Q2.

Figure 6.3: Currency to Deposit Ratio



Finally, although currency in

[5] Remittance during July-March FY03 reached at US$ 3.2 billion as compared to US$ 1.6 billion in the corresponding period last year. Moreover, the cash-to-deposit ratio for FY03 was lower than the FY02, indicating greater intermediation of monetary assets by the banking system.

[6] During Q3-FY03, net mobilization from NSS was Rs 16.8 billion as compared to Rs 22.3 billion during the previous quarter.

[7] Specifically, deposits of PIA and PTCL substantially increased during Q3-FY03. While issuance of TFCs and improving financial health explained the rise in PIA deposits, relatively higher profits during Q3-FY03 increased deposits of PTCL.

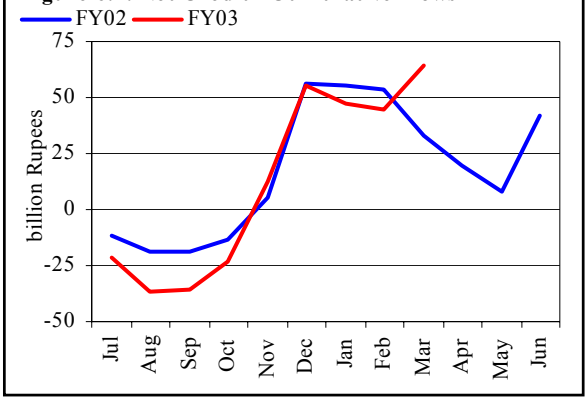
[8] The substantial rise in deposits of private banks during H1-FY03 also takes into account the impact of *one time* adjustment for the merger of Emirates Bank with Union Bank Limited.

circulation has slightly increased (Rs 4.1 billion) during Q3-FY03, the higher deposit growth of the banking sector resulted in a decline of currency to deposit ratio (see **Figure 6.3**). Furthermore, the ratio remained consistently lower as compared to the previous year, suggesting higher intermediation by the banking sector (increasing use of ATM and credit cards may also have contributed to the low ratio[9]).

6.2 Credit Activities

In sharp contrast to the net retirement of Rs 23.7 billion during Q3-FY02, net credit registered an expansion of Rs 9.0 billion during the quarter under review (see **Figure 6.4**).

Figure 6.4: Net Credit - Cumulative Flows



A quick glance at **Table 6.3** shows that within the banking sector, both, private and foreign banks witnessed a net credit expansion during Q3-FY03, mainly on account of (1) relatively lower lending rates on fresh loans and advances; (2) greater exposure toward trade related activities; (3) greater involvement in consumer financing; and (4) better marketing capabilities.[10]

Table 6.3: Net Credit Expansion during Q3

billion Rupees

	FY01	FY02	FY03
Nationalized	-9.7	-29.3	-5.9
Privatized	-13.0	-15.5	-10.3
Private	7.3	24.5	24.5
Foreign	0.7	-5.5	1.6
Specialized	0.7	2.1	-0.9
All banks	-14.0	-23.7	9.0

Note: For meaningful comparison, net credit amount of UBL is included in privatized banks for FY01 and FY02.

Compared to these banks, nationalized and privatized banks witnessed a net credit retirement during the quarter.[11] This was primarily attributed to: (1) the seasonal net credit retirement of commodity operation loans;[12] and (2) improving financial health of public sector enterprises.[13]

[9] ATM network continued to expand during Q3 FY03. Specifically, 18 new ATMs were installed during Q3 FY03, bringing the total number of ATMs in the country to 417.

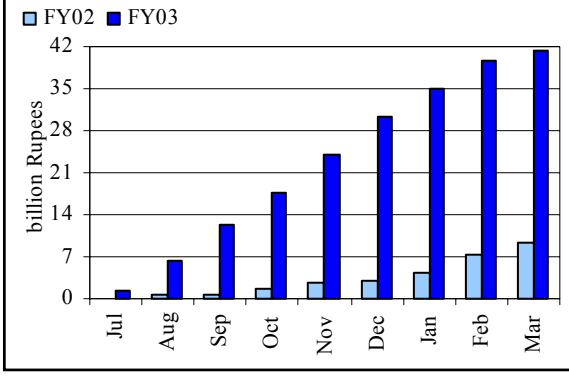
[10] Foreign banks largely deal with corporate clients, especially multinational corporations, and high net worth individuals. Private banks mainly focus on the middle tier market.

[11] Nationalized and Privatized Commercial Banks mainly deal with the government, public sector enterprises (PSEs) and large corporations.

However, net credit retirement to nationalized and privatized banks in Q3-FY03 was substantially (Rs 23.4 billion) lower than the corresponding net retirement in Q3-FY02. This difference is due to higher net credit expansion in the former period. This upsurge in the net credit is probably attributable to (1) investment in TFCs, particularly issued by PIA, (2) greater participation in foreign currency lending, (3) higher credit requirement of textile sector, and (4) changing focus toward consumer financing.[14]

Within advances, it was net foreign currency lending (against FE-25 deposits)[15] that continued to rise during Q3-FY03. Specifically, cumulative net foreign currency lending during July-March FY03 reached Rs 41.3 billion, as compared to Rs 9.4 billion during the same period last year (see **Figure 6.5**). The appreciation of the rupee, and the consequent reversal in expectations regarding exchange rate movements, along with foreign exchange liberalization measures[16] led to massive demand for these loans. This higher demand was also supported by (1) a fall in international interest rates; and (2) increased trade activities. Exporters, in particular, substituted export finance credit with foreign currency loans as the latter were cheaper and required less documentation.

Figure 6.5: Net Foreign Currency Lending - Cumulative Flows



[12] Only nationalized and privatized banks provide credit for commodity operations.
[13] Financial health of major PSEs, such as PIA, PTCL, etc. have considerably improved, this may result in less credit expansion from these banks.
[14] For example, NBP has stated marketing wholesale lease of consumer durables and personal loans, while HBL has launched an Auto-Finance Scheme.
[15] The banks are also allowed to lend foreign currency with the help of foreign exchange SWAP, but the above figure includes loans only against FE-25.
[16] Although banks were allowed to utilize their FE-25 deposits for lending/ investment with effect from April 2, 2001 (BSD Circular No 18, dated March 31, 2001), the demand for these loans remained limited. However, reversal of devaluation expectations and foreign exchange liberalization measures (also allowed to use from the financing of exports and imports: F.E. Circular No 5, dated August 23, 2002) played a major role in the sharp rise in the demand for foreign currency loans.

The influence of the exports sector is visible also in the sectoral distribution of total net credit. A substantial turnaround is visible in Q3-FY03 credit demanded by the manufacturing sector relative to Q3-FY02, and the greater share of this is claimed by the textile and textile products sector (see **Table 6.4**). Similarly, net credit to commerce has seen a lower seasonal retirement.

Table 6.4: Net Credit Expansion during Q3 by Sector
billion Rupees

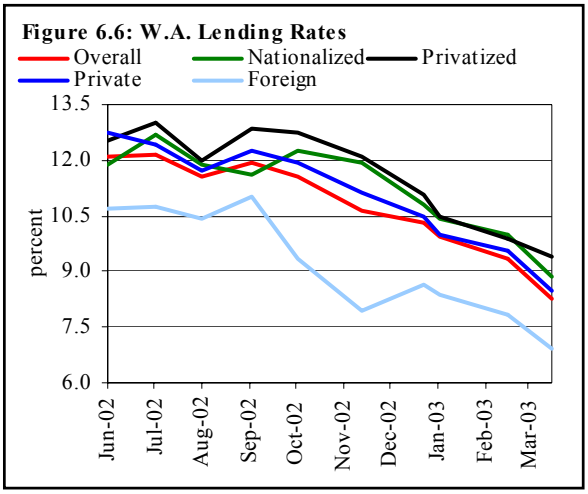
Selected sectors	FY02	FY03
Agriculture	-3.1	0.3
Manufacturing	-21.5	20.7
of which:		
Food	3.5	4.4
Textile	-8.9	4.7
Textile products	-12.5	7.1
Leather and products	-0.3	2.3
Commerce	-16.2	-2.6

Net credit to agriculture sector also increased during Q3-FY03, as compared to the same period a year before reflecting a significant improvement in the sector.

6.3 Lending and Deposit Rates: Banking Spread

Q3-FY03 saw a remarkable development with the weighted average lending rates on *fresh* loans and advances dropping to single digits for the first time since 1974. Specifically, the rate plunged to 8.3 percent by end-March 2003; a very substantial 205 basis points lower than the corresponding end-December 2002 figure. Within the banking sector, all groups, except specialized banks, witnessed a decline of over 170 basis points in their weighted average lending rates during the quarter under review (see **Figure 6.6**).[17]

Figure 6.6: W.A. Lending Rates



A striking feature of the FY03 downtrend in lending rates is the leading role of foreign banks. While other banking groups began substantially reducing their lending rates after November 2002 discount rate cut by SBP, foreign banks had

[17] During Q3-FY03, weighted average lending rates of nationalized commercial banks declined by 194 basis points; privatized banks by 170, private by 198 and foreign banks by 176 basis points. While the specialized banks saw a decline of only 3 basis points during the quarter.

clearly anticipated the reduction.[18] All other banking groups (which account for a larger share of the market), not only delayed the rate cuts, but the pace of the reduction was clearly slower.

While the difference between the lending rates of foreign banks and the other groups can be at least partially explained by greater intermediation costs of the latter, the alacrity with which foreign banks responded to the changing banking environment appears primarily a reflection of better management (and the pricing pressures of a blue-chip client base).

Following decline in lending rates, weighted average deposits rates also witnessed a decrease of 79 basis points during the quarter. The unprecedented decline in weighted average lending rates and relatively lower fall in deposit rates helped narrow the banking spread by 126 basis points during Q3-FY03. On a cumulative basis, the banking spread saw a visible squeeze of 250 basis points during July-March FY03. Interestingly, within the banking sector, the nationalized commercial banks witnessed the maximum squeeze of 146 basis points in their spread during Q3-FY03 (see **Table 6.5**).

Table 6.5: Change in Banking Spread during FY03

basis points

	Q1	Q2	Q3	Cumulative
Nationalized	8	49	146	203
Privatized	-8	182	83	185
Private	5	117	92	214
Foreign	-46	176	61	191
Specialized	10	-36	-238	-264
All banks	-8	132	126	250

Note: (1) Negative sign means increase in banking spread.
(2) To remain consistent for comparison, UBL has been reclassified in privatized banks for Q1 and Q2 also.

The *apparent* sharp decline in banking spread suggests that (1) the profitability of banks may come under pressure in future, or (2) that the intermediary efficiency of the banking sector may be improving, due to competitive pressures.

Neither of these prepositions may be true.

(1) The profitability of the banking sector may not record any substantial change as: (a) the banking spread does not include all interest bearing assets and liabilities of the banks; (b) a sharp decline in weighted average lending rate in Q3-FY03 also includes the impact a of 300 basis point reduction in interest rate on export finance credit (July-March FY03), on which banks earn a predetermined spread; (c) although the decline in

[18] Another reason for drastic decline in lending rates of foreign banks could be the pressure from their weak credit performance during first half of the fiscal year.

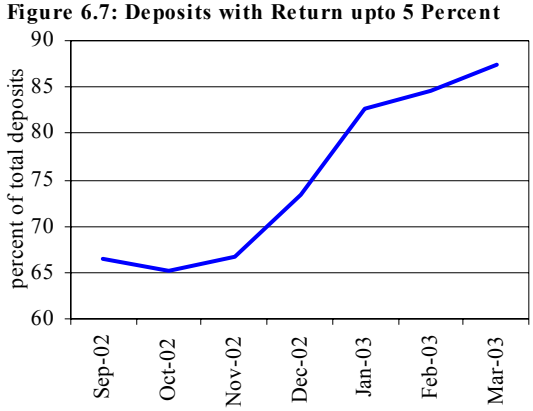
deposit rates is lower than the lending rates, the former is applied to larger base while the latter deals with a smaller base; (d) banks profitability would be helped by lower stock of non-provisioned NPLs, a fall in the tax rates, etc., and (e) non-interest income would have increased due to capital gains amidst declining interest rates.

However, a greater threat to the profitability of the banking sector could, paradoxically, emerge from a possible reversal in the interest rates scenario. Over the past few quarters, the profitability of banks had been bolstered by the capital gains on bond portfolios as interest rates declined. Thus, as interest rates stabilize these gains would end (or indeed reverse, if interest rate climb).

(2) Even the efficiency gains could be illusory. As defined currently, the weighted average deposit rate is computed on the basis of the entire stock of outstanding deposits. Since, in any given year, fresh deposits typically represent only a fraction of the outstanding deposits, and rates on the larger part of the remaining stock of (older) deposits too are not adjusted very frequently.[19] Therefore, it is likely that a decline in the rates on fresh deposits would be masked by the relatively high rates of the existing stock of deposits. The fact that the weighted average deposit rate on the entire stock is trending downwards could suggest a *very sharp* reduction on fresh deposits.[20]

This is supported by **Figure 6.7,** which shows that share of deposits carrying rate of return upto 5 percent[21] in total deposits have sharply increased from 66.5 percent in September 2002 to 87.4 percent in March 2003.

Figure 6.7: Deposits with Return upto 5 Percent



6.4 Non-performing Loans[22]

In sharp contrast to Q2-FY03, which saw a considerable rise of Rs 11.6 billion,[23] NPLs of the

[19] e.g. on PLS deposit rates are adjusted semi-annually.
[20] In other words, it is possible that when marginal lending rates are correctly compared with the marginal deposit rate, the banking spread may actually depict an increase.
[21] Cut off at upto 5 percent is due to data constraint.
[22] NPLs net of restructured loans.

banking sector witnessed a contraction of Rs 2.0 billion from the outstanding level of Rs 244.2 billion at end-December 2002 to Rs 242.2 billion by the end-March 2003 (see **Table 6.6**). Within the banking sector, the specialized banks took a lead with a reduction of Rs 7.5 billion in the stock of their NPLs during Q3-FY03.[24] While foreign and private banks did not record any significant movement in the level of their NPLs, nationalized and privatized banks appeared to offset a major portion of above reduction in NPLs, and recorded an increase of Rs 5.3 billion in the NPLs during the quarter.[25]

Table 6.6: NPLs of the Banking Sector (end-period)

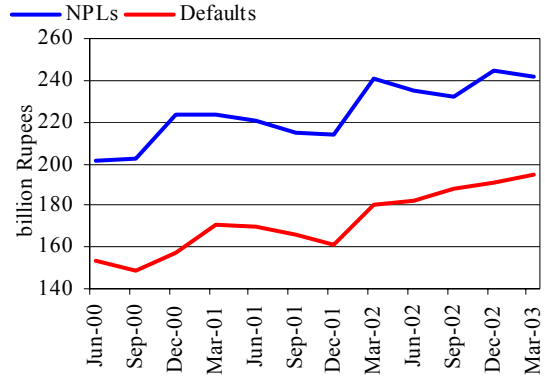
billion Rupees

	Q2-FY02	Q3-FY03	Change
Nationalized	90.8	94.0	3.2
Privatized	47.8	49.9	2.1
Private	19.8	20.2	0.4
Foreign	7.1	6.9	-0.2
Specialized	78.8	71.3	-7.5
All banks	244.2	242.2	-2.0

Note: Due to privatization, category of UBL has been changed from nationalized to privatized banks.

Within the NPLs, the defaulted loans continued to rise during Q3-FY03 (see **Figure 6.8**). This rising share of defaulted loans in the NPLs reflects that (1) the fresh loans and advances of the banking sector are of relatively better quality,[26] and (2) it is the old infected portfolio of the banking sector, which is eclipsing the present good performance of the sector.[27] The first point is reinforced, as increase in fresh NPLs during Q3-FY03 is significantly lower than in the previous quarter.

Figure 6.8: NPLs and Defaults



[23] This was the upshot of Rs 12.6 billion increase in net NPLs of Zarai Taraqiati Bank Limited (ZTBL).

[24] This reduction is mainly attributed to Rs 3.4 billion deletions from net NPLs of the ZTBL, and improvement in their cash recovery.

[25] Rise in net NPLs of nationalized and privatized banks is largely on account of fresh NPLs and relative slowdown in cash recovery of these institutions. However, one institution from each category is mainly responsible for the poor performance, which overshadowed the good performance of other institutions.

[26] Classified loans under Other Assets Especially Mentioned (OAEM) are only 5.4 percent of gross NPLs of the banking sector. This clearly suggests that the fresh loans are of better quality.

[27] Composition of classified loans also confirms this point, as 60.7 percent of NPLs fall in loss category.

Although a comparison of stocks of NPLs at two points of time is useful in determining changes in the aggregate position, it is more meaningful to view the NPLs relative to advances.

Table 6.7: Intensity of NPLs
percent

	Net NPLs/Net Adv.	Coverage ratio
Mar-02	13.8	56.7
Jun-02	12.8	61.6
Sep-02	12.2	62.7
Dec-02	11.7	63.1
Mar-03	11.4	63.2

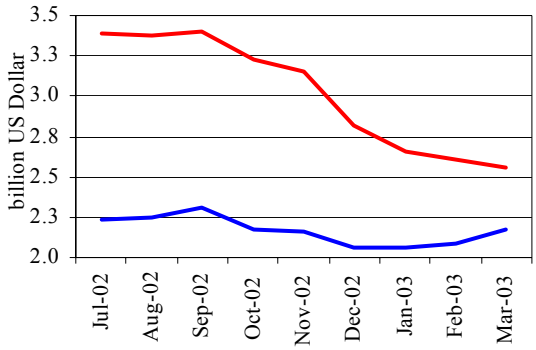
The gross NPLs to gross advances ratio has declined from 27.6 percent as on end-December 2002 to 27.2 percent by the end-March 2003. Moreover, (1) provisions created by the banking sector back a notable portion of these loans, and (2) markup in suspense accounts is around 20 percent of gross NPLs.[28] Taking these two components into account, *net NPLs to net advances ratio* of the baking sector declined to 11.4 percent by end-March 2003 from 11.7 percent by end-December 2002 (see **Table 6.7**). This is a positive development for the banking sector, as the burden of NPLs is on a decline. Finally, the coverage ratio (provisions to NPLs) increased to 63.2 percent by the end of Q3-FY03, witnessed a marginal improvement of 10 basis points over the previous quarter.

[28] Interest accrued on NPLs is credited to suspense accounts.

Box 1: Decline in Foreign Currency Deposits

Foreign currency deposits (FCDs) declined to US$ 2.6 billion by end Q3-FY03, showing an outflow of US$ 0.8 billion during July-March FY03 (see **Figure 1**). This erosion in FCDs is largely attributed to: (1) conversion of old foreign currency deposits, (2) maturing *institutional* FCAs, that have now been completely repatriated, (3) declining effective rate of return on forex deposits due to strengthening of rupee, and (4) *one-time* transfer of privatization proceeds.

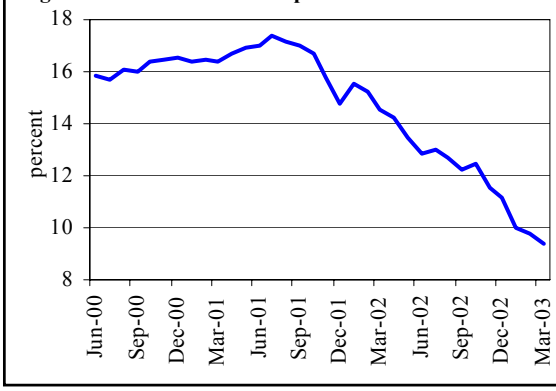
Figure 1: Foreign Currency Deposits



In this context, a *rise* in the FE-25 deposits in Q3-FY03 is surprising, but this apparently anomalous change is largely accounted for by temporary build-up of forex holdings by a local bank for investment abroad. Another contribution to FE-25 deposit growth was through the conversion of the other forex deposits.[29]

The currency composition of new FCAs showed that both dollar and Euro denominated deposits have increased, but rise in the latter is more pronounced. Having said this, overall declining trend in foreign currency deposits suggests that phenomenal increase in rupee deposits also contain a substitution effect, as the account holders receive payments in rupees on maturity of old FCAs.[30] Consequently, the share of foreign currency deposits has significantly declined to 9.4 percent by end-March 2003 from 17 percent in September 2001 (see **Figure 2**).

Figure 2: FCDs to Total Deposits Ratio



[29] The holders of FE-31 deposits were given the option to withdraw their deposits by the end of December 2002, otherwise these deposits will be treated under FE-25 deposits rules. On the expiry date, outstanding amount in these accounts was transferred to FE-25 deposits.

[30] During July-March FY03, over 95 percent of maturing old FCAs (excluding institutional deposits) held by the residents and other non-residents were converted into rupees.

Box 2: Corporate and Industrial Restructuring Corporation

The government of Pakistan established Corporate and Industrial Restructuring Corporation (CIRC) under the CIRC Ordinance 2000 dated September 22, 2000 to clean up the infected portfolios of the financial institutions, to assist the business sector and to promote rehabilitation of the national economy. To achieve these objectives, the corporation was authorized to make provisions for the acquisition, restructuring, rehabilitation, and realization of non-performing loans and assets.

According to the CIRC Ordinance, the corporation can deal with only those NPLs which are: (1) held as assets on the books of the financial institutions, (2) the principal or interest is overdue by 365 days, and (3) outstanding amount is equal to or over Rs 30 million. Furthermore, the CIRC is authorized to deal with NPLs of those financial institutions wherein the government's share in equity is in excess of 85 percent.

Since its inception, the corporation has acquired 191 cases, with an outstanding amount of Rs 31.3 billion,[31] from the banks/DFIs by end-March 2003 (see **Table 2.1**). The institution-wise data indicates that the CIRC acquired 62 cases from the UBL and 57 cases from NDFC. This heavy bias toward UBL may be due to its privatization schedule, as it was essential to clean its balance sheet before privatization. Similarly, the merger of NDFC with NBP may explain the higher number of accounts transferred to CIRC from this institution.

Table 2.1: NPLs Acquired by CIRC

billion Rupees

	No of Accounts	Amount
United Bank Limited	62	12.53
National Development Finance Corporation	57	11.56
National Bank of Pakistan	14	1.55
Habib Bank Limited	22	1.42
Industrial Development Bank of Pakistan	27	2.51
Zarai Taraqiaiti Bank	9	1.71
Total	191	31.28

According to the CIRC, it has rehabilitated 74 units upto March 2003. Provincial breakup shows that out of 74 units, 38 were from the Punjab, 22 from Sindh, 10 from NWFP and 4 from Balochistan. It is further stated that around 30,000 people from all over Pakistan have directly or indirectly benefited from this rehabilitation drive.

Transfer of NPLs to CIRC has direct bearing on the NPLs of the banks/DFIs. However, this impact is not directly visible from the outstanding level of NPLs, which continues to rise. This is due to the fact that NPLs consists of the principal amount and unrealized mark up (this will continue to increase with the passage of time, until the case is settled). Another technical reason could be the exchange rate fluctuations, as the rupee counterpart of foreign currency denominated non-performing loans will take into account the impact of depreciation and appreciation of the Rs/US$ parity. In addition, the stock of NPLs at one point of time also takes into account the impact of fresh non-performing loans.

Stepping back, at present, CIRC can acquire NPLs only from 3 institutions (HBL, IDBP and ZTBL), as the remaining three institutions do not fall under the preview of the corporation. This is due to the fact that the UBL has been privatized, NDFC has been merged with NBP, and NBP itself is no longer eligible for transferring NPLs to CIRC. Eligibility of NBP has been changed due to decline in the government share in its equity.

[31] This amount must be seen with caveat, as CIRC claims that it has acquired NPLs worth of Rs 44.3 billion. However, banks reporting the transfer of Rs 31.3 billion over the same period.

7 Prices

Inflation remained subdued in Q3-FY03, with the *Consumer Price Index* (CPI) and *Sensitive Price Indicator* (SPI) registering annualized increases of 3.1 percent and 2.8 percent respectively, lower than the corresponding figures of FY02 (see **Table 7.1**).

Table 7.1: **Annualized Inflation Trends**

percent

	March		Jan-Mar		Jul-Mar	
	FY02	**FY03**	**FY02**	**FY03**	**FY02**	**FY03**
CPI	4.2	2.2	3.5	3.1	3.3	3.4
Food	3.8	0.5	2.8	1.9	1.9	3.3
Non-food	4.4	3.4	3.9	3.8	4.3	3.5
WPI	1.5	8.5	0.4	8.6	2.1	6.0
Food	2.8	2.4	2.3	2.6	1.8	3.0
Non-food	0.5	13.8	-1.2	13.7	2.5	8.5
SPI	5.1	2.0	4.1	2.8	3.1	3.8

Source: Federal Bureau of Statistics

While the *Wholesale Price Index* (WPI), by contrast, rose sharply during the period, here too inflationary pressures appear to have peaked, as the marginal (year-on-year) inflation in March 2003 is sharply lower than in the preceding month. In fact, all three price indices have moved down *in unison* in March 2003, after peaking in Q3-FY03.

Thus, given that the marginal inflation rates for CPI and SPI have remained below their corresponding 12-month moving averages (see **Figure 7.2**), that the marginal rates may be trending downwards, and that inflationary pressures traditionally weaken in the April-June quarter, inflation seems set to reach the lowest levels for the past three decades.

The downward pressure on inflation stems primarily from a deceleration in food price inflation. This phenomenon, that is visible in all three indices, seems a result of increased *availability* of essential commodities and increased quantum of cheap imports (imported deflation).

The relatively high WPI inflation during July-March FY03 is a function of: (1) a rise in the prices of some WPI-specific items such as *raw materials and building materials* (see **Figure 7.1**); and (2) a larger impact of energy prices on this index compared to the CPI. While the weight of energy -related elements in the CPI (14.6 percent) is practically

Figure 7.1: WPI Inflation (weighted)

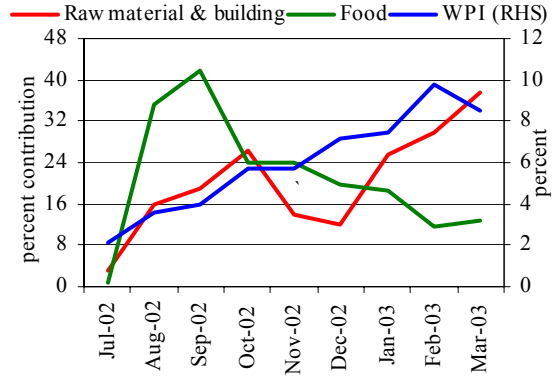
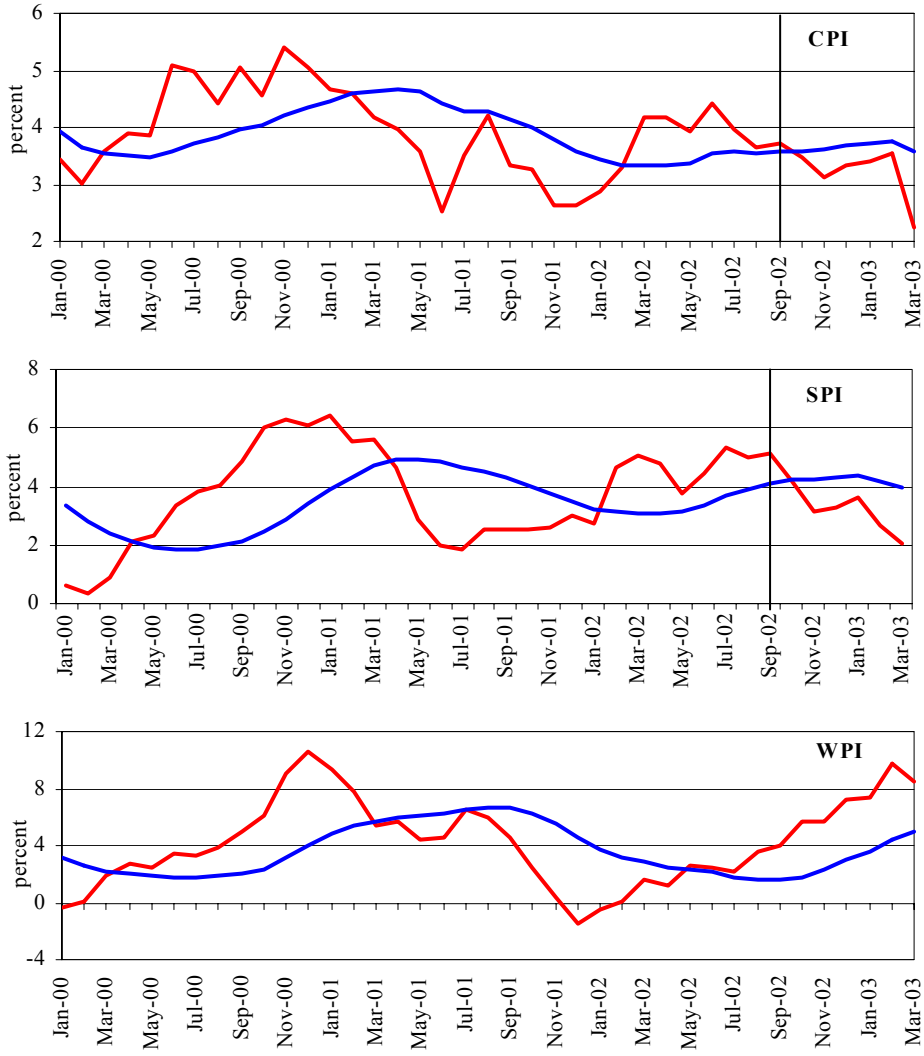


Figure 7.2: 12-monthly Changes in Price Indices



equal to that in the WPI (15.3 percent), the impact on the CPI is muted by the index's broader exposure to non-food elements (some of which witnessed a deceleration in prices).

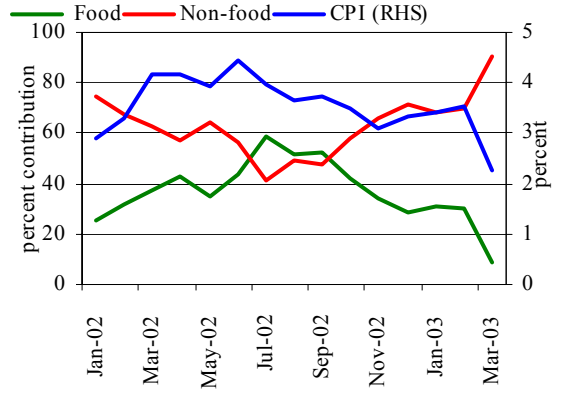
Finally, it is instructive to note that the weakness in non-food CPI inflation does *not* reflect a higher exposure to regulated prices. In fact, it is the non-food WPI that has a relatively larger regulated component.

7.1 Consumer Price Index

With the gradual deceleration in marginal inflation over the past six months, the annualized CPI inflation moderated to 3.4 percent during July-March FY03.[1] However, the sharp drop in March 2003 suggests that annualized CPI inflation, which had remained confined within a narrow band of 3.5 to 3.7 percent through the first three quarters of FY03, now seems set for a decisive downwards move during Q4-FY03, towards the 3.1 to 3.3 percent range.[2]

The key element of the deceleration in the CPI was the *declining* share of food inflation (see **Figure 7.3**). In fact, deflationary trends in a rising proportion of the CPI food components helped largely offset the rise in prices of others, holding down the aggregate increase in the food sub-group of the CPI.

Figure 7.3: Inflationary Trends



The disinflationary trend largely appears to reflect supply factors:

(1) the rise in production witnessed in agriculture (see **Section 2.1**);
(2) larger (and cheaper) imports of some key food commodities,[3] and
(3) a fall in the quantum of some food exports during July-March FY03 (e.g., fruits by 4.1 percent and vegetables by 16.3 percent).

7.1.1 Food Component of CPI

Food inflation registered a further slowdown in Q3-FY03, rising by a mere 1.9 percent compared to a 2.8 percent increase in the corresponding period of FY02. Prices of some essential food items (e.g., potato, onion, gram, sugar, green chilies, etc.) continued the Q2-FY03 decline, and this trend was reinforced by falls in the prices of additional commodities during Q3-FY03 (e.g. tea, *besan*, rice basmati & irri, powder milk, garlic, eggs, etc.). However, increases in the prices of livestock – derived commodities such as milk (having the highest weight as an individual

[1] It came down gradually from 3.8 percent during Q1-FY03 and 3.6 percent during H1-FY03.
[2] SBP Research forecast.
[3] e.g., milk & cream, dry fruits and pulses saw decline in the import unit values.

item in the CPI basket), curd, mutton, chicken and beef, as well as edible oil derivatives (cooking oil, ghee) more than offset these deflationary pressures.

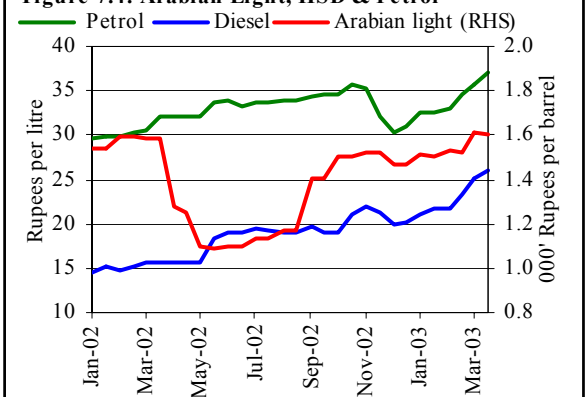
As a result of slowdown in *food inflation*, the contribution of food group in overall CPI declined from its peak level of 60 percent in July 2002 to 9 percent in March 2003 (see **Figure 7.3**).

7.1.2 Non-food Component of CPI

In contrast to the slowdown of inflationary pressures in food items, the *non-food sub-component*, rose by 3.8 percent in Q3-FY03; this was slightly lower than 3.9 percent rise seen during the corresponding period last year. As a result, the contribution of non-food items to inflation rose from almost 40 percent in July 2002 to over 90 percent in March 2003 (see **Figure 7.3**).

A component-wise break up of non-food inflation during Q3-FY03 reveals that *transport & communication* contributed a 28 percent share, followed by *fuel & lightening* (24.7 percent) mainly due to higher oil prices. Other significant contributions were from *cleaning, laundry & personal appearance* (14.6 percent) and *apparel textiles & footwear (*11.6 percent).

Figure 7.4: Arabian Light, HSD & Petrol



Transport costs rose primarily in Q3-FY03, on the back of the continued upward adjustment in most POL product prices during Q3-FY03 (see **Figure 7.4**).

7.2 Wholesale Price Index

Through most of FY03 the trend of the WPI was altogether different than the movement of the CPI. Not only was WPI inflation higher since Q1-FY03, it was *accelerating* throughout this period, even as the CPI *decelerated*. During July-March FY03 the WPI inflation rose by 6.0 percent as against a 2.1 percent rise in the comparable period of FY02. Although the rise in WPI was visible in all components, the major push came from higher increases recorded in the sub-indices of (1) *fuel, lightening & lubricants*, (2) *raw materials,* and (3) *manufactures*.

The *fuel, lighting & lubricant* sub-group, which had declined by 1.6 percent in Q3-FY02 recorded a massive 24.1 percent rise during Q3-FY03. Similarly, the sub-index of *raw materials* also jumped a sharp 14.3 percent in contrast to a *decline* of 3.6.percent in the corresponding period of FY02. Thus, although the *food* component of WPI recorded higher increase in Q3-FY03 compared to Q3-FY02, its contribution in the overall WPI inflation during the quarter declined.

7.2.1 Food Component of WPI

Although food prices recorded an increase of 2.6 percent during Q3-FY03 compared to a 2.3 percent rise recorded in Q3-FY02, the marginal (year-on-year) food inflation declined. A closer look at the components of the food group (see **Table 7.2**) reveals that over half of the food index saw either negligible or negative price increases, i.e. deflationary pressures gained strength in Q3-FY03. Moreover, market conditions suggest that even components currently contributing the bulk of existing food inflation will see a deceleration in price growth during Q4-FY03.

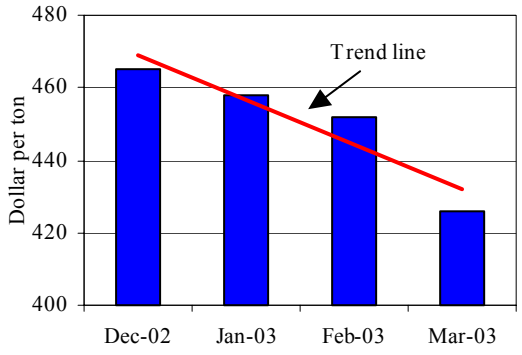
Table 7.2: WPI-Food Inflation

Q3-FY03 over Q3-FY02			Q3-FY03 over Q2-FY03		
No. of items	weights	percent growth	No. of items	weights	percent growth
17	10.68	< 0	22	13.45	< 0
6	12.68	0 to 1	7	16.28	0 to 1
6	5.58	1 to 5	5	6.90	1 to 5
10	16.85	> 5	5	9.17	> 5
39	45.79	2.6	39	45.79	-0.02

Source: Federal Bureau of Statistics

The arrival of the FY03 crops, together with lower exports seems likely to keep wheat and rice prices in check. Similarly, as the price of palm oil in the world market had decreased on average from $ 465 per ton in December 2002 to $ 426 per ton in March 2003, local cooking oil and vegetable ghee prices may also decline (see **Figure 7.5**).

Figure 7.5: World Palm Oil Prices



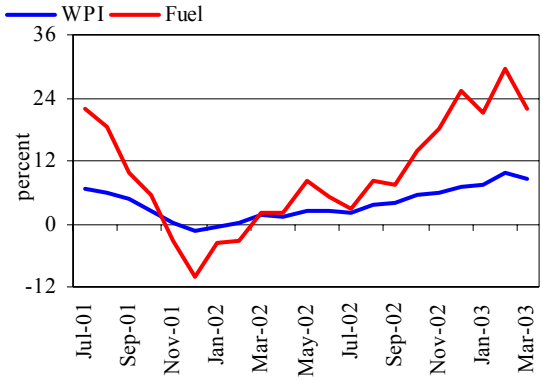
Source: Commodity price data, World Bank

7.2.2 Non-food Component of WPI

Non-food prices increased at a relatively high rate of 8.5 per cent during July-March FY03 as against 2.5 per cent in the corresponding period of FY02. The increases were more pronounced in Q3-FY03 and March 2003 as non-food WPI rose by 13.7 and 13.8 percent respectively.

Among the sub indices *fuel, lightening & lubricants* has recorded a massive increase during Q3-FY03. The movement of this sub-component largely accounts for the asymmetric movement of the WPI inflation (see **Figure 7.6**). It is instructive to note that the direction of the WPI is very strongly correlated with the sub-component, and that the March 2003 dip in WPI inflation, in particular, appears to be caused by a fall in this sub-index.

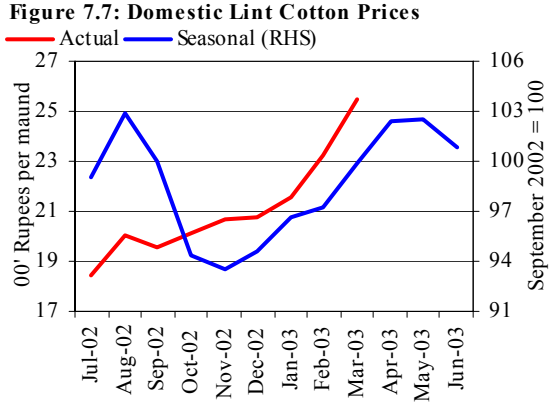
Figure 7.6: WPI & Fuel Inflation



The rise in the sub-component since CY02 appears to be driven primarily by international oil prices (see **Figure 7.4**), and should be reversed as these weaken. However, it should be noted that the sharp increases in international oil prices were partially offset by strengthening of the rupee against the US dollar, and this may continue to be a factor in Q4-FY03.

Prices of the *manufactures*[4] sub-group also recorded an increase of 5.3 percent during Q3-FY03 as against a decline of 0.1 percent in the corresponding period of FY02. Within this sub-group, the highest increase was recorded in the prices of cotton yarn (16.6 percent), followed by soap (7.6 percent), fertilizer (5.7 percent) and transport capital equipment (5.7 percent).

Figure 7.7: Domestic Lint Cotton Prices



Raw material prices continued to rise due mainly to the higher than the seasonal pattern of cotton prices in the domestic market (see **Figure 7.7**).

[4] It includes leather, cotton yarn, blended yarn, nylon yarn, cotton textiles, hosiery, silk & rayon textiles, woolen textiles, jute manufactures, readymade garments, utensils, chemicals, dyeing materials, soap, fertilizer and cosmetics, etc.

Domestic lint prices continue to receive higher prices mainly on account of higher export of raw cotton (which increased by 5.8 percent), cotton yarn and the developments in the world cotton market.

During July-March FY03 the increases in the prices of *building materials* by 1.7 percent compared with 0.9 percent in the corresponding period last year, indicates acceleration in the pace of construction activity during the current fiscal year. The highest increase of 16.5 percent was recorded in the prices of wires and cables, followed by paints & varnishes (4.9 percent), bricks/block (2.3 percent), cement (1.7 percent), which pushed up the overall index of building materials. The higher demand and lower domestic production of paints & varnishes and chemicals seem to have contributed to the higher prices of these items.

Similarly, rising prices of fertilizers during Q3-FY03 also contributed to the non-food WPI inflation. Not did fertilizer demand rise due to improved prospects for agriculture, import prices were also higher (25.8 percent) during the period.

7.3 Sensitive Price Indicator (SPI)

In line with CPI, the SPI during January-March FY03 also recorded slower growth of 2.8 percent compared with 4.1 percent last year. The SPI is based on price movements of 51 essential items including 5 items of utilities. During the period under review, average prices of 16 items decreased and those of 31 increased while prices of 4 items remained unchanged. A significant aspect of the price situation was the continued downward trend in the prices of some of the important kitchen items during Q3-FY03.

The major items responsible for 3.8 percent SPI inflation during July-March FY03 over the corresponding period last year were: vegetable ghee tin (25.4 percent), rice basmati *tota* (*broken*) (18.9 percent), cooking oil (17.3 percent), mutton (12.4 percent), beef (11.8 percent) and chicken farm broiler live (2.9 percent).

However, the above increases have eased somewhat by the decline in prices registered in the case of onions (45.9 percent), garlic (32.3 percent), potatoes (27.5 percent), powder milk (24.1 percent), tomatoes (20.9 percent), tea (20.0 percent), pulses (9.2 to 16.4 percent), sugar (8.2 percent), gur (7.1 percent), and eggs (0.4 percent).

8 Capital Market

Unlike the previous quarters that saw a fairly steady upward progression, the KSE-100 index exhibited considerable volatility during Q3-FY03, although it closed the period up marginally over the end-December 2002 level.

The market initially continued its Q2-FY03 rise based on ample market liquidity and improved economic fundamentals, registering a new all-time high of 2955.52 on January 16, 2003. However the vulnerability to unfavorable shocks was clearly visible in the rising share of speculative holdings in the market (see **Figure 8.1**).

Table 8.1: Highlights of KSE (end-period)
shares in billion

	Q3-FY02	Q3-FY03
Listed companies at KSE (numbers)	757	706
KSE-100 index (1990-91=100)	1868.11	2715.70
Change since start of FY (percent)	36.71	53.42
Change since last quarter (percent)	46.74	0.53
Year-on-year change (percent)	41.05	45.37
Listed capital at KSE (billion Rupees)	235.68	293.12
Market capitalization (billion Rupees)	427.95	580.70
Shares traded at KSE during the quarter	11.86	13.86

The rising speculation in the equity market was evident not only in the *badla* volumes, but also in the high cost of this financing. In fact, the *badla* rate, which was already at 21 percent at the beginning of the year, more than doubled to approximately 48 percent by mid-January 2003 as brokers faced capital adequacy limits (see **Figure 8.1**). This spike in the financing cost, together with a souring of investor sentiment,[1] punctured the speculative bubble.

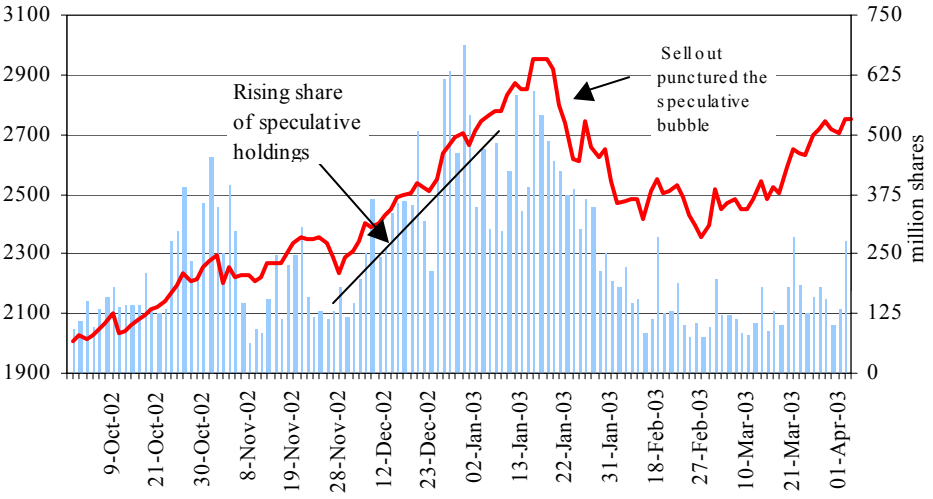
The ensuing sellout forced the KSE-100 index down a stunning 337 points from its January 16, 2003 peak - a 11.4 percent decline in mere 5 days. Thereafter the market continued to weaken gradually, and eventually bottomed out by the end of February, around 2350-point levels.

However, market fundamentals pointed to a recovery. Firstly, the already attractive end-December 2002 market valuations (see **Figure 8.2**) looked even better following the January 2003 sell off.

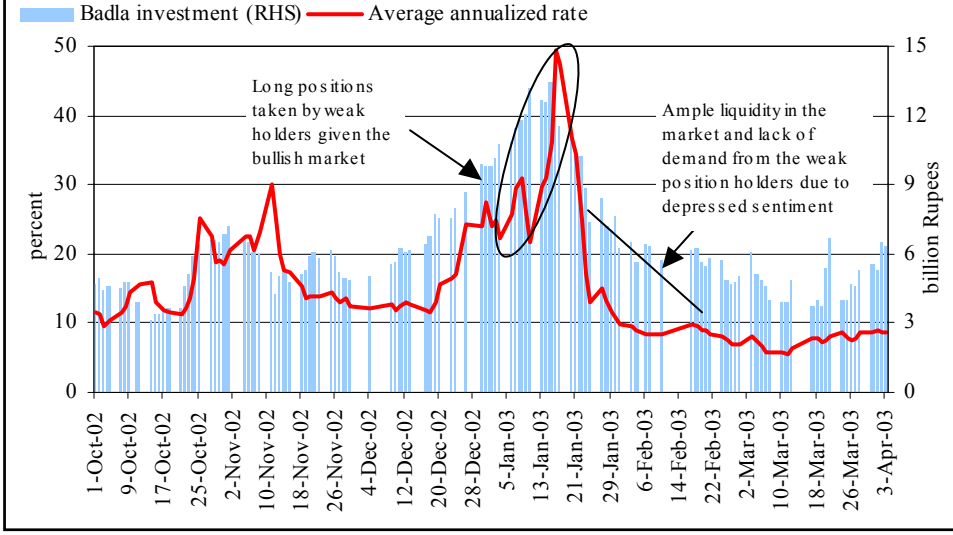
Furthermore, investor interest in the equity market was reinforced by the continued liquidity injections into the economy (see **Section on Money and Credit** for details) and the consequent decline in rupee interest rates. The latter not only contributed to an improvement in corporate earnings, it also increased the *relative* attraction of the equity market vis-à-vis alternative investments.

[1] Due to factors such as emerging concerns over the timing of PSO privatization and looming fears of the impact of a possible conflict in Iraq, etc.

Figure 8.1: KSE-100 Index and Turnover of Shares



Badla Rates and Investment



It is worth noting that, in recent years, the profitability of domestic corporates[2] has risen steadily. In particular, FY02 profits appear to have accelerated on account of low interest rates and a drop in the cost of goods sold (see **Figure 8.3**). The Q3-FY03 quarterly earnings[3] data suggests that this acceleration has not lost momentum as yet. The results of a sample survey of 50 registered companies shows highly exceptional growth during the quarter under review, albeit dominated by auto and financial sectors. But even excluding these two outliers, the average growth was 47.3 percent (see **Table 8.2**).

Figure 8.2: Market Valuation of KSE

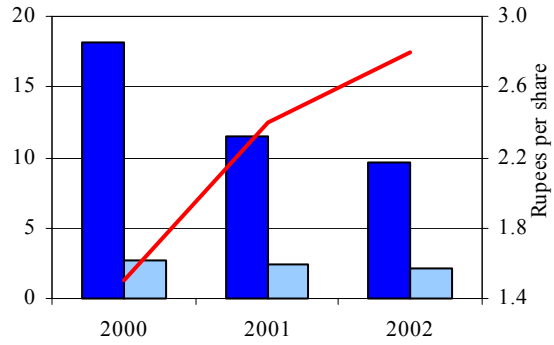
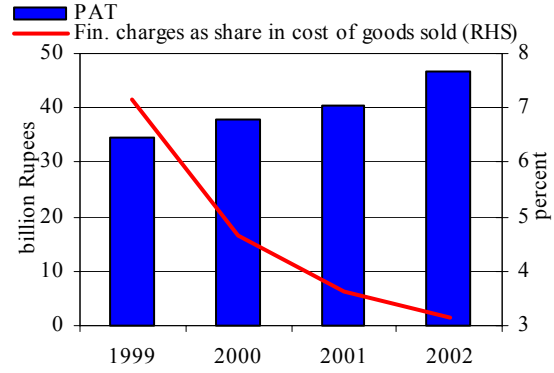


Figure 8.3: Performance of Corporate Sector



Not surprisingly therefore, March 2003 saw a renewed market rally, which recovered all ground lost in the earlier sell-off. As a result, the KSE-100 index registered an improvement of 359.24 points from the Q3-FY03 low of 2356.47 points on February 27, 2003 to reach 2715.71 by end-March 2003 i.e. marginally above end-December 2002 close.

A distinguishing characteristic of this second rally was the substantial reduction in badla volumes. The average daily badla volume of 133.5 million shares during March 2003 was approximately half of that in January 2003.[4] It can be argued

[2] As proxied by the profitability of corporates (other than financial institutions) that are constituents of the KSE-100.
[3] It could be noted, however, that the quarterly results are un-audited. Therefore, these are only indicative of full year performance.
[4] This was despite the reported decision of the Karachi Stock Exchange on March 8, 2003 to cap badla rates at 18 percent, on the 30 most-traded scrips at the local bourse, down from the previous

that in light of the relative absence of heavy speculative activity, the March 2003 rally was relatively robust.

Table 8.2: Quarterly Earnings of Corporates
million Rupees

	No. of companies	Jan-Mar 2002	Jan-Mar 2003	Growth
Auto	5	459	1,136	147.5
Financial	11	1,184	2,383	101.3
Chemical	5	(1,369)	856	--
Energy	10	5,222	6,659	27.5
Communication	1	4,584	5,553	21.1
Others	18	1,773	1,971	11.2
Total	**50**	**11,854**	**18,559**	**56.6**
excl. finance	39	10,670	16,176	51.6
excl. finance & auto	34	10,211	15,040	47.3

8.1 Corporate Bond Market

The listed corporate bond market was relatively more active during Q3-FY03 as compared to the preceding quarter as well as the corresponding period of FY02. The quarter saw seven new issues worth Rs.2.7 billion[5] as compared to just three issues worth Rs.2.2 billion in the previous quarter (see **Table 8.3 & 8.4**). With the issuance of these new instruments the total amount of outstanding listed TFCs has reached Rs 27.4 billion—still only 4.7 percent of equity market capitalization.

Table 8.4: TFC Outstanding Amount during Q3
billion Rupees

	New issues		Total outstanding issues at end-March 2003
	FY02	FY03	
Number	1	7	51
Amount	0.2	2.7	27.4

Not surprisingly, given the continuing decline in interest rates all of the fresh issues were floating rate instruments (see **Table 8.5**). Also noteworthy is the issuers apparent reluctance to use PIBs as the benchmark issue; seven of the last ten TFC issues have been based on the discount rate. This probably is a result of the scarcity premium being attached to PIBs following scanty fresh issues.

Table 8.5: Overall Composition of TFCs

	since FY95	FY02	FY03
Total issued	60	17	20
Fixed	23	4	0
Floating	37	13	20
Anchored to discount rate	23	8	12
Anchored to PIBs	14	5	8

As customary, the bulk of each TFC issue was privately placed, ahead of a limited IPO. As a group, commercial banks were the most active participants in the pre-

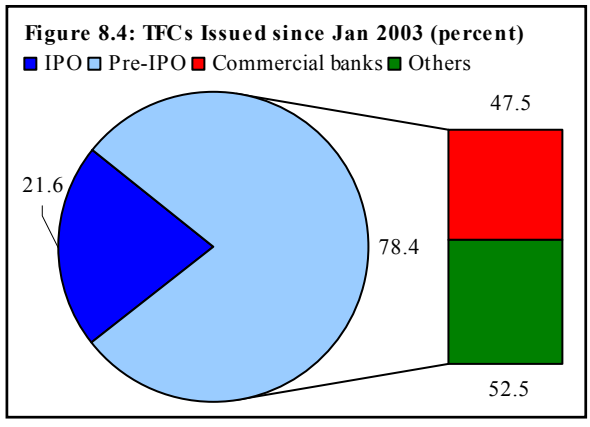
cap of 24 percent. On other securities, the badla rates were capped at 24 percent from the earlier cap of 50 percent.

[5] In addition to the listed issues, Pakistan International Airlines floated a Rs.15.4 billion TFC (unlisted) as a private placement. The PIA certificate has been oversubscribed by 40 percent and it is the largest Term Finance Certificates issued by a corporate entity in Pakistan.

Table 8.3: TFC issues since January 2003
million Rupees

Company	Issue date	Maturity	Coupon rate	Rating		Issue amount		Total
				PACRA	JCR	Pre-IPO	IPO	
Security Leasing 2nd tranch	9-Jan-03	9-Jan-06	SBP Dis Rate +2.25, 1st Year Floor:11.50%, Cap15.50%, 2-4 years Floor11.00%, Cap 15.50%		A	239	60	299
KASB Leasing (Pak Apex Lease)	14-Jan-03	13-Jan-08	W.A. of last 3 cutt-off of 5 years PIB+2.25, Floor 11.50%, Cap 14.50%	A-		160	40	200
Gulistan Textile Mills Ltd	29-Jan-03	28-Jan-08	SBP Dis Rate + 2.25%, Floor 11.00% , Cap 17.00%		A	320	80	400
Gulshan Spinning Mills	29-Jan-03	28-Jan-08	SBP Dis Rate + 2.25%, Floor 11.00% , Cap 17.00%		A	320	80	400
Paramount Spinning Mills	29-Jan-03	28-Jan-08	SBP Dis Rate + 2.00%, Floor 10.90% , Cap 17.00%		A+	160	40	200
Paramount Leasing Ltd.2	7-Feb-03	6-Feb-07	SBP Dis Rate + 2.50%, Floor 11.50% , Cap 14.50%		A	250	75	325
Paktel	27-Mar-03	26-Mar-06	SBP Discount rate +2.0%, For 1st Year, floor of 12% and a cap of 16% ,For 2-3 Years, floor of 11.50% and a cap of 16%		A	640	200	840

IPO market (see **Figure 8.4**).



Of the total amount of TFCs issued during the quarter, only 22 percent (Rs 0.58 billion) were offered in the IPOs. Again, not surprisingly these meager IPO offerings attracted bids amounting to Rs 1.34 billion. This has given rise to the suspicion that issue (advisors) probably underestimated the demand for TFCs i.e. the issues were under priced (offered higher yield).

9 External Sector

Balance of Payments[1,2]

Despite a larger trade deficit and increased services account outflows, Pakistan's external account continued the trends set in previous quarters (see **Table 9.1**) by recording yet another large surplus in Q3-FY03 based on strong transfer payments.[3] As a result, the SBP maintained its heavy interbank forex purchases, raising the SBP forex reserves to US$ 9.5 billion by the end of the quarter (see **Table 9.2**).

Table 9.1: Current & Capital Accounts
million US Dollar

	Q3		Jul-Mar	
	FY02	**FY03**	**FY02**	**FY03**
Current account balance	939	2,125	2,227	4,375
Capital account balance	-695	-987	-1,207	-997
Total	244	1,138	1,020	3,378
Adjusted for transitory factors				
Current account balance[1]	89	425	910	1,962
Capital account balance[2]	-804	-187	-1,364	-724
Total	-715	613	731	1,843

[1] Excluding non-structural inflows: US debt write-off, logistic receipts, Saudi oil facility and US grant.
[2] Excluding US debt write-off & FE-25 trade financing.

A question arises as to how much improvement in the balance of payments has taken place due to exceptional one-time inflows such as the US debt write-off, logistic support and grants from the US and Saudi Oil Facility (SOF). These exceptional one-time inflows pushed the current account surplus by US$ 2.4 billion to US$ 4.4 billion during July-March FY03. A more revealing picture of the quarterly performance emerges after adjusting for these *non-structural* components[4] of the current and capital accounts. Two distinct trends that emerge in FY03 are: (1) a gradual narrowing of the quarterly current account surpluses, and (2) a roughly parallel offsetting improvement in the quarterly capital account.

A year-on-year comparison of the cumulative July-March figures is even more interesting. The growth in the "headline" current account surplus (96.5 percent) is weaker than that in the adjusted figure (115.6 percent). This relatively better

[1] This section is analyzed on the basis of exchange records compiled by SBP that do not tally with more detailed trade data (based on customs records compiled by FBS) used in **section 9.2**.
[2] The figures of the current account and the capital account may not tally with the ones reported in earlier Quarterly Reports due to revision in the BOP data.
[3] It should be noted however that the Q3-FY03 numbers incorporate the impact of the US$ 1 billion debt write-off by the US. In Pakistan's balance of payments statistics, this is treated as an inflow in official transfers while, on the other hand, it is also recorded as an outflow in capital account (long-term capital: official) as the country's debt liability is reduced by an equivalent amount.
[4] This includes irregular, potentially non-recurring inflows such as US grants, SBP kerb purchases, debt *write-off*, and receipts for logistics support as well as the Saudi oil facility.

Table 9.2: Balance of Payments - Summary
million US Dollar

	Q3		Jul-Mar		
	FY02	**FY03**	**FY02**	**FY03**	**absolute**
1. Trade balance	**-97**	**-145**	**-206**	**-610**	**-404**
Exports (fob)	2,137	2,589	6,658	7,761	1,103
Imports (fob)	2,234	2,734	6,864	8,371	1,507
2. Services (net)	**-361**	**-182**	**-1,788**	**-1,043**	**745**
Shipment	-175	-215	-541	-641	-100
Other transportation	47	56	48	178	130
Travel	-73	-92	-117	-148	-31
Investment income	-529	-499	-1,615	-1,544	71
Interest payments	-315	-265	-1,016	-779	237
Profit and dividend	-214	-234	-599	-765	-166
Other goods, services & income	369	568	437	1,112	675
3. Current transfers (net)	**1,397**	**2,452**	**4,221**	**6,028**	**1,807**
a) Private transfers (net)	1,175	1,220	3,008	4,215	1,207
of which: Workers' remittances	645	1,083	1,630	3,231	1,601
FCA (residents)	47	-24	185	-86	-271
Outright purchases	432	0	1,069	0	-1,069
b) Official transfers	222	1,232	1,213	1,813	600
of which: Saudi oil facility	117	170	417	566	149
4. Current account balance (1+2+3)	**939**	**2,125**	**2,227**	**4,375**	**2,148**
Current account balance (excl. debt write-off)	939	1,125	2,227	3,375	1,148
5. Capital account (net)	**-695**	**-987**	**-1,207**	**-997**	**210**
6. Errors & omissions	306	158	740	271	-469
7. Overall balance	**550**	**1,296**	**1,760**	**3,649**	**1,889**
8. Financing	**-550**	**-1,296**	**-1,760**	**-3,649**	**-1,889**
I. Changes in reserves (-Inc/+Dec)	**-416**	**-1,353**	**-1,748**	**-4,039**	**-2,291**
Assets	-379	-1,354	-2,001	-4,107	-2,106
SDRs	-1	-126	0	-120	-120
Forex (State Bank of Pakistan)	-400	-1,326	-1,859	-4,594	-2,735
Forex (commercial banks)	22	98	-142	607	749
Liabilities	-37	1	253	68	-185
Use of Fund credit	-37	1	253	68	-185
Repurchases	0	118	377	348	-29
Purchases/drawings	-37	-117	-124	-280	-156
II. Exceptional financing	-133	57	-11	389	400
SBP reserves (end-period)	3,945	9,527	3,945	9,527	5,582

Source: Statistics Department, SBP

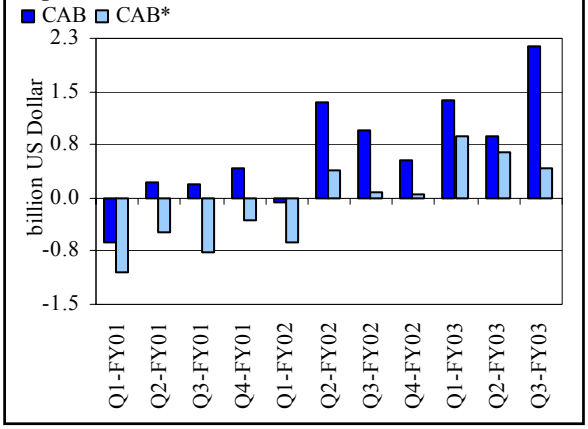
showing of the secular current account[5] reveals the structural improvements in the form of rising exports, strong remittances as well as falling interest payments on external debt and liabilities in the current account balance.

It suggests that the current account surpluses are likely to persist even if potentially non-recurring current account gains are unavailable in future. The capital account shows a similar picture.

9.1 Current Account

The current account posted a surplus of US$ 2.1 billion during Q3-FY03 that includes US$ 1 billion notional inflow on the account of debt write-off by the US. However, excluding this one-off element, the current account surplus is still a very healthy US$ 1.1 billion, up 19.8 percent from the corresponding period last year, and 30.2 percent higher than that in the immediately preceding quarter.

Figure 9.1: Current Account Balance



More importantly, even after excluding other non-structural inflows, the adjusted current account balance (CAB*) though declining, it was still significantly positive relative to Q2-FY03 (see **Figure 9.1**) mainly due to higher transfers. This decline in CAB* reflects widening trade deficit (stemming largely from higher oil prices) (see **Table 9.3**).

Table 9.3: Adjusted Current Account Balance (CAB*)
million US Dollar

	Q3		Change		Share in change
	FY02	FY03	absolute	percent	
Trade	-97	-145	-48	49.9	-14.3
Services (net)	-661	-712	-51	7.7	-15.2
Transfers	847	1,282	435	51.4	129.5
CAB*	89	425	336	377.5	100

9.1.1 Trade Balance

According to exchange data, the trade deficit during Q3-FY03 widened by US$ 48 million over the same period last year to reach US$ 145 million. Although

[5] Secular current account adjusted for transiting or cyclical factors, represents the past and potential trend.

exports continued their impressive growth over the quarter, rising 21.2 percent over Q3-FY02, these gains were offset by an even stronger increase in imports (for more details, see **section 9.2**).

9.1.2 Services (Net)

The Q3-FY03 services account (deficit) narrowed by US$ 179 million, over the corresponding period of FY02, to reach US$ 182 million.

Net outflows increased under most heads, including *shipment* (due to higher imports), *travel,* and repatriation of *profit & dividend* (primarily by multinational companies). However, this was more than offset by massive inflows in *other goods & services* mainly representing payments for logistic support to international forces in Afghanistan, as well as communication charges (see **Table 9.2**).

A notable feature of the Q3-FY03 services account was the continuing decline in *net interest payments* on external debt and liabilities. In fact, this was primarily because the payments have declined by US$ 207 million during the first three quarters of the current fiscal year relative to the corresponding FY02 figure (see **Table 9.4**).

The fall in the interest on external debt was realized despite the increase in the stock of external debt by US$ 79 million during July-March 2003.[6] This reflects the increasing focus on substituting expensive debt with soft loans, as well as the impact of lower international interest rates.

Table 9.4: Details of Interest Payments and Receipts
million US Dollar

	Jul-Mar		Saving
	FY02	FY03	
Payments (I+II)	**1,094**	**887**	**207**
I. External debt	890	783	107
Public & publicly guaranteed	687	624	63
Long-term	583	556	27
Military	18	16	2
Eurobonds	33	37	-4
Commercial loans/credits	37	11	26
IDB	16	4	12
Private loans/credits	161	129	32
IMF	42	30	12
II. External liabilities	204	104	100
Foreign currency deposits	70	26	44
Special US Dollar Bonds	51	25	26
NHA bonds	15	7	8
Central bank deposits	42	22	20
Others	26	24	2
Receipts	**78**	**108**	30
Interest on reserves	71	97	26
Others	7	11	4
Net interest payments	**-1,016**	**-779**	**-237**

Source: State Bank of Pakistan

[6] The stock of external debt was US$ 33,479 million by end-March 2003 as compared to end-June 2002 stock of US$ 33,400 million.

On the other hand, the fall in interest paid on external liabilities is mainly on account of their declining stock (Special US Dollar Bonds, FCAs and commercial & private loans/credit, NBP deposits and Rs/US$ swaps).

Finally, the net interest outflows have also decreased by US$ 26 million during July-March FY03 over the corresponding period in FY02 due to the higher interest *earnings* on the country's rising stock of forex reserves.

The decline in Q3-FY03 net interest payments was, however, offset by rising *profit & dividend* outflows (see **Table 9.5**). These increased to US$ 234 million during Q3-FY03, up 9.3 percent (US$ 20 million) over Q3-FY02, reflecting the rising outward remittances on the purchase of crude oil[7] by oil extracting companies, and profit repatriation by foreign companies.

Table 9.5: Details of Profit and Dividend
million US Dollar

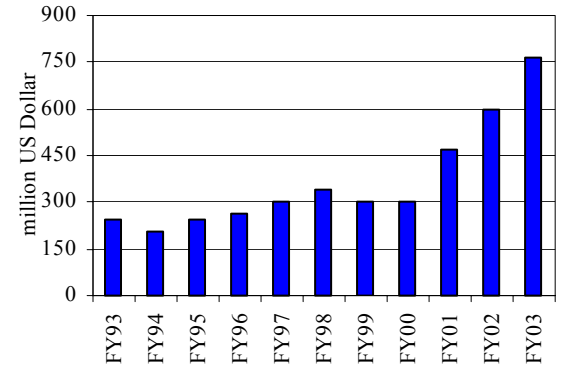
	Q3		Jul-Mar	
	FY02	**FY03**	**FY02**	**FY03**
Total	**214**	**234**	**599**	**765**
Profit	2.4	26	18	52
Dividend	96.9	64	228	281
Purchase of crude oil	87.4	124	282	352
Export of crude oil	*8*	*9*	*48*	*36*
Remittances	*79.4*	*115*	*234*	*316*
Reinvested earnings	27.3	20	71	80

Source: Statistics Department, SBP

Cumulatively, the profit and dividend (excluding purchase of crude oil and reinvested income) increased by US$ 87 million during July-March 2003 to US$ 333 million over the corresponding period of FY02.

The rising outflows under profit & dividend during the last three years (see **Figure 9.2**) reflects the impact of the settlement of dispute with IPPs as well as higher investment in the lucrative oil & gas sector.

Figure 9.2: Outflow of Profit & Dividend (Jul-Mar)



The energy sector has captured most of the FDI in Pakistan in recent years. While the increase in investment by itself is

[7] This shows the amount paid by the government against the purchase of crude oil from the foreign oil extracting companies.

welcome, and should be encouraged, it must be noted that investments in the energy sector often have long gestations periods and, at least in the short term, would probably have low spillover impacts on the economy. Thus, there is a need to supplement such enclave-type investments with FDI in other areas as well.

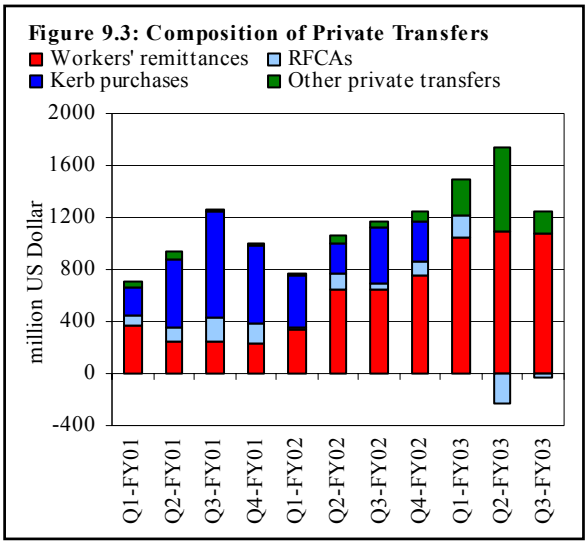
9.1.3 Transfers

Although the net current transfers increased by US$ 1,055 million during Q3-FY03 over the corresponding period of FY02, this was mainly due to US$ 1 billion debt write-off by the US. Adjusting for this, it is clear, that (1) transfers increased marginally by US$ 55 million during Q3-FY03 and (2) remittances dominated the transfers profile during the quarter.

Private Transfers

Private transfers decreased by US$ 0.3 billion during Q3-FY03 over preceding quarter to reach US$ 1.2 billion. This was because the structure of private transfers saw a significant change compared to the preceding quarter.[8] While remittances remained almost at the same level, other private transfers saw a sharp decline; this was on account of lower *export of currency,* which was partially offset by lower withdrawals from resident FCAs (see **Figure 9.3**).[9] Incidentally, when compared with Q3-FY02, the YoY increment in remittances (US$ 438 million) during Q3-FY03 is

Figure 9.3: Composition of Private Transfers



[8] With effect from mid-February 2003, the SBP disallowed moneychangers to export currencies, leaving this function only to the recently established Foreign Exchange Companies (FECs). Earlier, the moneychangers were required to surrender the remittances against the export of currencies to SBP through selected Authorized Dealers (ADs) and the amounts were recorded as other private transfers in the BOP. By contrast, the aggregate amounts collected by FECs (including remittances for export of currencies etc.) are used for their permissible transactions (e.g., remittances of profits, travel etc.). Only the remaining net aggregate amounts as retained in the FCAs of FECs, or the amounts sold to ADs (as remittances) are recorded under private transfers.

[9] The relatively higher draw down of FCAs during Q2-FY03 stems from the payments made to the Privatization Commission by investors purchasing a large public sector bank (UBL), as well as the conversion of frozen FCAs into rupees.

almost equal to the kerb purchases of US$ 432 million in Q3-FY02 (see **Table 9.2**).

Workers' Remittances

The workers remittances crossed US$ 1.0 billion for the third successive quarter in Q3-FY03, and are projected to cross the US$ 4 billion mark by end-FY03. In terms of volume, Q3-FY03 remittances from USA declined 12 percent compared to the preceding quarter, but was offset by a sharp 28 percent rise in remittances from Kuwait (see **Table 9.6**). The latter is probably a reflection of increased insecurity of Pakistani nationals in Kuwait due to its vicinity to the conflict in Iraq.

Table 9.6: Region-Wise Workers' Remittances
million US Dollar

	Q3		Jul-Mar		percent change over	
	FY02	FY03	FY02	FY03	Q3	Jul-Mar
I. Gulf region	**279.6**	**480.9**	**761.5**	**1462.4**	**72.0**	**92.0**
Bahrain	12.8	19.5	27.4	53.3	52.2	94.7
Kuwait	25.7	77.3	60.3	184.4	200.9	205.8
Qatar	8.9	26.0	22.3	66.8	192.2	199.5
Saudi Arabia	89.0	139.4	259.0	422.8	56.6	63.2
Sultanat-e-Oman	17.2	24.8	44.7	69.2	44.6	54.9
UAE	126.1	194.0	347.9	665.9	53.8	91.4
II. USA	**209.9**	**286.1**	**483.8**	**943.2**	**36.3**	**95.0**
III. Other than Gulf & USA	**145.9**	**304.0**	**341.4**	**795.1**	**108.4**	**132.9**
Canada	7.8	3.9	17.3	11.2	-50.2	-35.3
Germany	2.7	5.3	8.2	18.0	94.8	120.5
Japan	1.3	2.0	3.7	6.4	63.2	71.6
Norway	1.6	2.4	4.8	6.5	48.4	35.4
UK	42.4	67.5	103.5	197.5	59.2	90.8
Others	90.1	222.9	203.9	555.6	147.4	172.4
Total	**635.4**	**1,071.0**	**1,586.7**	**3,200.6**	**68.6**	**101.7**
Encashment FEBCs & FCBCs	**9.0**	**11.4**	**39.9**	**29.5**	**27.8**	**-26.3**
Grand total	**644.3**	**1,082.4**	**1,626.6**	**3,230.1**	**68.0**	**98.6**

Source: Statistics Department, SBP

Resident FCAs

Resident FCAs (comprising old FCAs and the FE-25 deposits) saw an outflow of US$ 24 million during Q3-FY03 as compared to inflow of US$ 47 million during Q3-FY02. The continued conversion of old FCAs into rupees was more than offset by an increase in the stock of FE-25 deposits (partly, due to the new

deposits of foreign exchange companies) (see **Figure 9.4**).[10]

Official Transfers

As explained earlier, the ballooning official transfers during Q3-FY03 incorporate a US$ 1 billion debt *write-off* by the US. Excluding this one-time inflow, the official transfers totaled US$ 0.8 billion during July-March FY03. This was relatively less than the transfers realized in the corresponding period of FY02.[11]

Also, the Saudi Oil Facility (SOF), which has been one of the major components of official transfers,[12] increased by US$ 53 million during Q3-FY03, cumulated to US$ 566 million in July-March FY03. The rise in the SOF was due to higher international crude oil prices (see **Figure 9.5**).[13]

Figure 9.4: Stock of Old FCAs & FE-25 Deposits

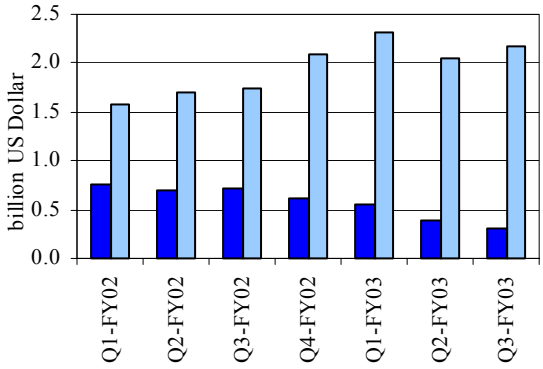
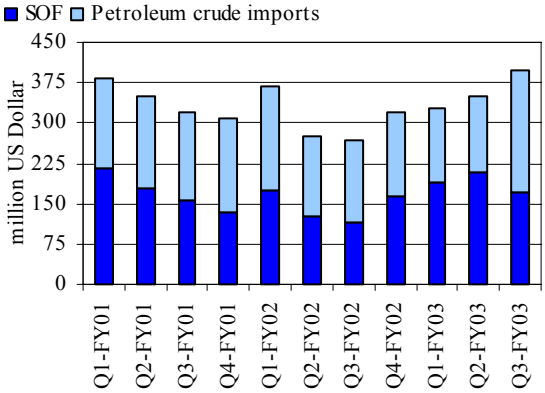


Figure 9.5: SOF and Petroleum Crude Imports



9.2 Trade Account

Q3-FY03 witnessed the continuation of rising activity in both, exports and imports, with growth in the latter outstripping that in the former (**Table 9.7**). The trade deficit for this quarter

Table 9.7: Trade Deficit - Q3

million US Dollar

	FY02	FY03	percent change
Exports	2,080	2,662	28.0
Imports	2,479	3,244	30.8
Trade deficit	399	582	45.8

[10] The foreign exchange companies use FCAs for their foreign exchange transactions, as their Nostro accounts are not yet operational.

[11] July-March FY02 official transfers also included US$ 600 million cash grant by the US.

[12] Since FY99 the SOF has contributed significantly in the financing of Pakistan's huge oil import bill as it covers, on average, 50 percent of the crude oil imports during a quarter.

[13] In Q3-FY03, the unit prices of the imported crude oil increased by US$ 63.2 per metric ton to US$ 218.3 over Q3-FY02.

therefore jumped by 45.8 percent. As a result, the cumulative trade deficit for July-March FY03 reached US$ 1,173.5 million, which was 43.7 percent higher than the deficit during the same period last year, and 67.7 percent greater than the overall trade deficit target (US$ 700 million) set in the trade policy for FY03.

It should be noted that the sharp jump in the FY03 trade deficit reflects both, a supply shock (high oil prices) as well as the influence of an economic recovery.

A sharp increase in international oil prices (see **Figure 9.6**) as well as a decision to increase the country's oil reserves[14] added US$ 463.8 million in the country's oil bill during July-March FY03 (see **Figure 9.7**).

Figure 9.6: International Oil Prices (Brent)

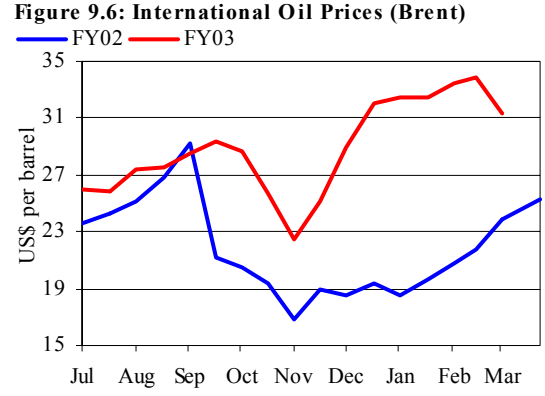
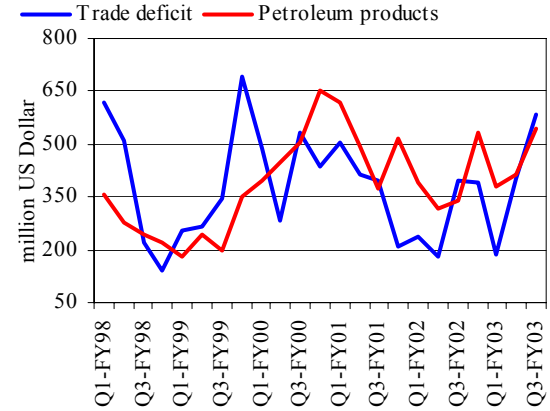


Figure 9.7: Trade Deficit and Oil Imports



9.2.1 Exports

A spectacular 28 percent Q3-FY03 year-on-year surge in textile-led exports helped push the cumulative exports to an impressive US$ 7.86 billion, a 20.2 percent growth during July-March FY03 over the corresponding period last year (see **Table 9.8**).

The monthly exports have also been remarkably consistent. Only in February 2003 were exports below US$ 800 million, and only in three months did they fall below the monthly target (see **Figure 9.8**). As a result, the July-March FY03 exports accounted for 75.5 percent of the annual target, raising expectations that the US$ 10.4 billion overall FY03 export target will be exceeded.

[14] In anticipation of the US-Iraq war oil reserves were increased as a part of contingency plan developed in January 2003.

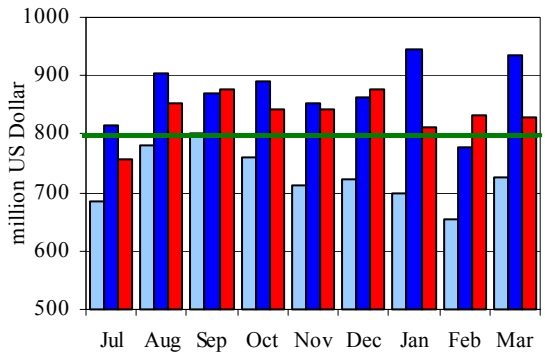
Table 9.8: Major Exports
Value: million US Dollar; Unit value: US Dollar

		Jul-Mar 2002		Jul-Mar 2003		absolute	Change (percent)		
	Unit	Value	Unit value	Value	Unit value	Δ in value	Qty	Value	Unit value
A Primary commodities		**783.5**	---	**933.1**	---	**149.6**	---	**19.1**	---
Rice	MT	332.2	257.8	401.3	295.9	69.1	5.2	20.8	14.8
Raw cotton	MT	13.1	770.6	44.3	869.9	31.2	198.6	237.1	12.9
Raw wool (excl. wool tops)	MT	0.8	901.8	0.7	837.1	-0.1	-2.3	-9.3	-7.2
Fish and fish preparations	MT	96.1	1,532.3	96.2	1,530.6	0.0	0.2	0.1	-0.1
Leather	SqM	168.9	13.8	170.2	15.0	1.3	-6.9	0.8	8.2
Guar and guar products	MT	12.5	710.5	17.7	924.1	5.3	9.4	42.3	30.1
Fruits	MT	64.1	297.1	64.1	303.7	-0.1	-2.3	-0.1	2.2
Vegetables	MT	22.7	195.9	17.9	160.2	-4.8	-3.7	-21.2	-18.2
Crude animal material	MT	9.5	554.9	9.2	736.3	-0.3	-26.6	-2.7	32.7
Oil seeds & nuts etc.	MT	15.7	433.2	5.6	482.8	-10.1	-68.1	-64.5	11.5
Wheat	MT	47.9	108.6	105.9	111.3	58.0	115.8	121.3	2.5
B Textile manufactures		**4,178.6**	---	**5,074.8**	---	**896.2**	---	**21.4**	---
Cotton yarn	MT	682.3	1,744.0	694.5	1,743.4	12.2	1.8	1.8	0.0
Cotton fabrics (woven)	SqM	805.9	0.6	948.7	0.6	142.8	7.6	17.7	9.4
Hosiery (knitwear)	Doz	602.3	24.0	791.5	21.8	189.2	44.2	31.4	-8.9
Bed wear	MT	659.4	4,983.4	896.2	5,458.2	236.8	24.1	35.9	9.5
Towels	MT	189.4	3,395.9	239.9	3,609.0	50.5	19.2	26.7	6.3
Cotton bags and sacks	MT	11.8	3,926.8	12.8	4,079.4	1.0	4.7	8.7	3.9
Readymade garments	Doz	636.2	20.5	794.8	29.2	158.6	-12.3	24.9	42.4
Tarpaulin & other canvas goods	MT	37.7	2,234.3	50.4	2,291.7	12.7	30.5	33.8	2.6
Tule, lace embroidery etc.	(-)	7.1	---	7.3	---	0.2	---	3.1	---
Synthetic textiles	SqM	294.5	0.6	376.0	0.7	81.5	15.1	27.7	11.0
Other textile made-up	(-)	247.3	---	254.6	---	7.3	---	3.0	---
Waste material of tex. fibers/fabrics	MT	4.8	586.3	8.0	661.4	3.2	46.8	65.6	12.8
C Other manufactures		**1,084.8**	---	**1,212.0**	---	**128.4**	---	**11.8**	---
Carpets, carpeting rugs & mats	SqM	174.5	48.3	163.0	51.3	-11.5	-12.2	-6.6	6.3
Petroleum and its products	MT	130.1	180.1	174.1	251.6	43.9	-4.3	33.7	39.7
Sports goods	(-)	200.3	---	225.8	---	25.5	---	12.7	---
Leather manufactures	(-)	294.7	---	288.4	---	-6.3	---	-2.2	---
Surgical and medical instruments	No	106.5	---	105.6	---	-0.9	---	-0.8	---
Cutlery	Gr	17.8	32.0	21.0	30.6	3.2	23.3	17.7	-4.5
Onyx manufactured	MT	7.3	1,526.8	8.8	1,823.4	1.5	1.2	20.9	19.4
Chemicals and pharmaceuticals	(-)	102.1	---	191.7	---	89.6	---	87.7	---
Molasses	MT	50.3	39.5	33.7	37.3	-16.6	-29.0	-33.0	-5.5
Sugar	MT	1.2	333.8	0.7	340.8	-0.5	---	-41.7	2.1
D Others		**491.2**	**---**	**635.5**	---	144.3	**---**	**29.4**	---
Total exports		**6,538.1**	**---**	**7,856.0**	---	**1,317.9**	---	**20.2**	---
excl. major food items and raw cotton		*5,754.6*		*6,922.9*		*1,168.4*		*20.3*	
excl. major food items, raw cotton and yarn		*5,072.3*		*6,228.5*		*1,156.2*		*22.8*	

Source: Federal Bureau of Statistics

The *textile sector* remained the major performer, contributing 68 percent of the overall exports growth, while the remainder was shared almost equally by other groups (see **Table 9.9**).

Figure 9.8: Monthly Exports



The impressive export performance was also supported by certain favorable policy changes, including greater availability of funds to exporters on lower lending rates[15] and accelerated pace of sales tax refunds by CBR.[16] These developments probably helped in neutralizing the impact of the appreciation of the rupee.

Table 9.9: Contribution in Growth by Major Exports

percent

	FY01		FY02		FY03	
	Growth	Contribution in growth	Growth	Contribution in growth	Growth	Contribution in growth
Primary commodities	13.5	1.8	-14.3	-1.9	19.1	2.3
Textile manufactures	4.1	2.7	-0.9	-0.6	21.4	13.7
Other manufactures	22.2	3.3	-4.4	-0.7	11.8	1.9
Other exports	10.3	0.7	7.8	0.5	29.4	2.2
Total	**8.4**	**8.4**	**-2.7**	**-2.7**	**20.2**	**20.2**

Primary Exports

Rice, wheat and leather remained the leading primary exports during Q3-FY03; however, the exports of finished leather fell marginally over the same period last year.

Rice export, which is the largest foreign exchange earner for Pakistan outside the *textile sector*, witnessed an impressive 20.8 percent growth during July-March FY03 over the same period last year, reaching US$ 401.3 million, i.e., 87.2 percent of the annual target (US$ 460 million).

[15] EFS rates have been reduced from 13 percent in June 2001 to 3.5 percent by end-March 2003. During the period July-March FY03 alone, rates have been reduced by 400 basis points.

[16] In the period of July-March FY03, the amount of sales tax refunds stood at Rs 60.4 billion, while in the corresponding period of FY01 and FY02, it was Rs 44.5 billion and Rs 62.9 billion respectively.

The higher receipts were a result not only of the substitution of *non-basmati* rice with higher valued-added *basmati* rice, but also the rising export prices of the latter. Despite lower growth in production during FY03, the exports quantum of *basmati* rice rose sharply during July-March FY03. In contrast, the *non-basmati* exports quantum declined despite a relatively sharper increase in production (see **Table 9.10**). This suggests that the domestic availability of *basmati* rice is declining. This is also evident in the 8.9 percent rise in the domestic price of *basmati* rice.

Table 9.10: Rice Production & Exports (Jul-Mar FY03)
percent change over corresponding period

	Production	Exports quantum	Unit values
Basmati	5.7	22.1	12.7
Non-basmati	10.3	-4.8	5.2

Further, the higher unit values also materialized due to the following factors:

1. Within the *basmati* varieties, the share of high value *super-basmati* exceeded the *basmati-385* variety; and
2. The adoption of new rice polishing and processing techniques helped value addition.

Table 9.11: Rice Exports
million US Dollar

	FY01	FY02	H1-FY03
Total rice	525.5	448.2	240.2
Non-basmati	288.9	190.1	81.1
Basmati	236.7	258.1	159.1
Share of major basmati markets (percent)			
Dubai	33.0	36.6	39.6
Oman	7.2	8.2	6.5
Saudi Arabia	9.4	7.9	4.8
UK	5.9	5.9	5.6
Qatar	5.2	5.3	4.0
Bahrain	4.8	5.1	4.7
Yemen	4.6	5.0	4.1
Kuwait	4.2	3.5	3.3
Mauritius	3.1	3.5	3.8
USA	3.0	3.2	2.9
Others	19.7	15.7	20.7

Basmati rice is mostly exported to the Middle East with Dubai being the largest market (see **Table 9.11**).

Wheat exports experienced a sharp decline during Q3-FY03 (see **Figure 9.9**). The overall exports, during July-March FY03, however remained substantially higher than the

Figure 9.9: Wheat Exports - FY03

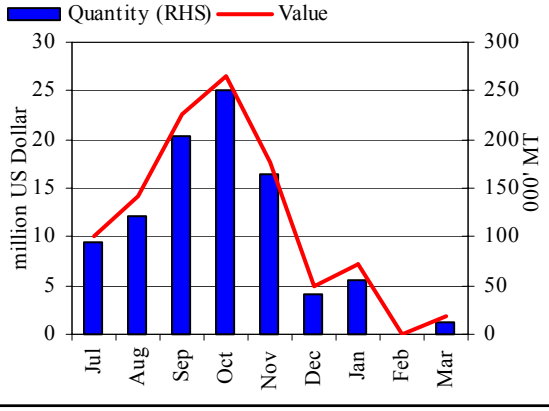
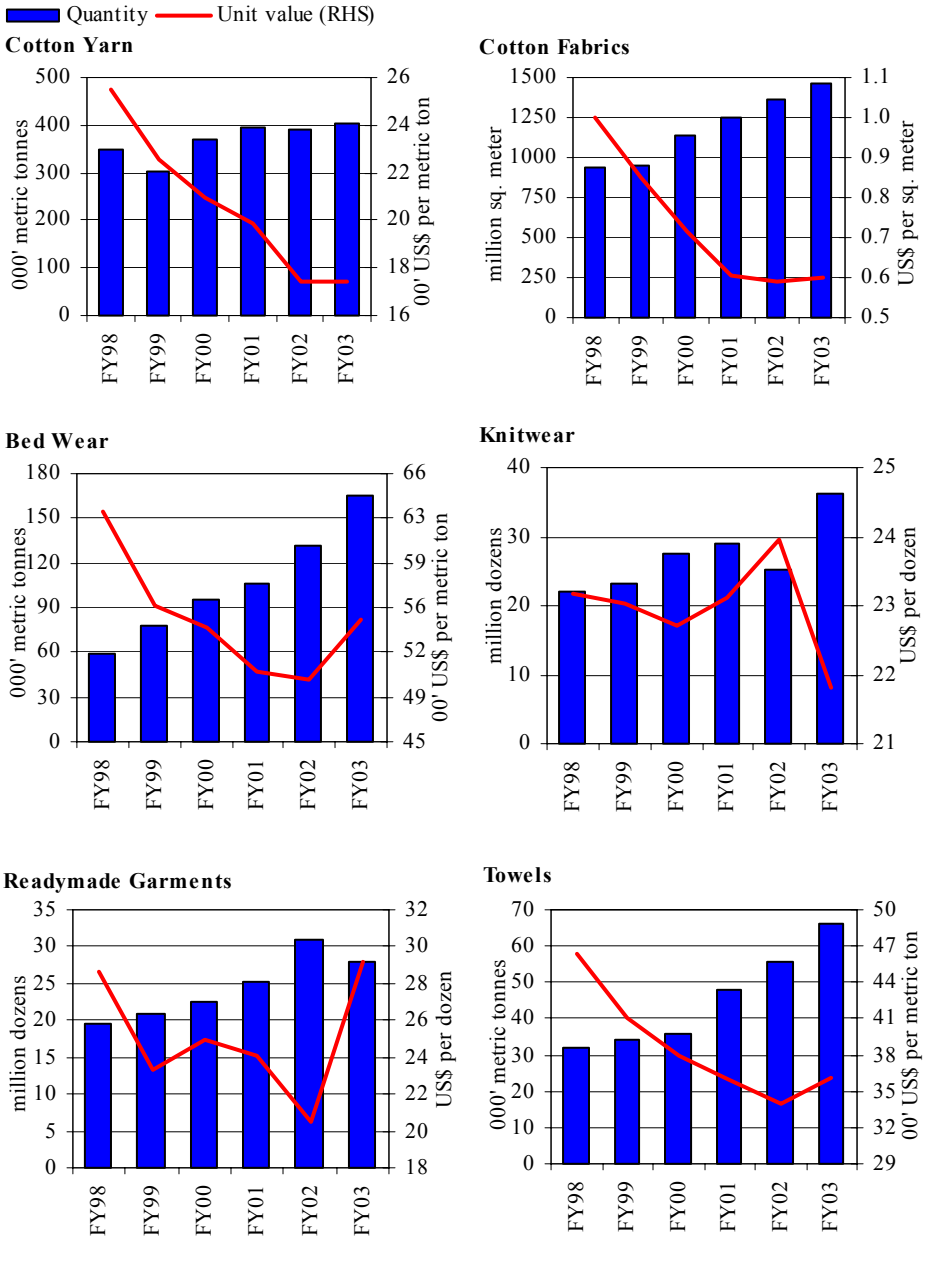


Figure 9.10: Textile Manufactures - Quantitative Exports and Unit Prices (Jul-Mar)



same period last year (see **Table 9.7**).

The fall in exports was the result of concerns over the FY03 wheat crop. PASSCO, which purchases wheat from the farmers for subsequent sale, stopped supplies to the private sector exporters by end-November 2002. However, it kept providing wheat to TCP for exports.

Textile exports

Textile exports staged a strong growth in July-March FY03 — 21.4 percent over the same period last year. All the major value added textile categories contributed in this growth (see **Table 9.12**), with significant increase in export volumes recorded in most categories (see **Table 9.8 and Figure 9.10**). **Figure 9.10** shows that (1) except for readymade garments, all the other major categories registered higher volumes, and (2) other than Knitwear, the unit values for all other major categories are either stable or rising.

Table 9.12: Contribution in Textile Growth of Major Textile Exports (Jul-Mar)

percent

	FY01		FY02		FY03	
	Growth	Contribution in growth	Growth	Contribution in growth	Growth	Contribution in growth
Bed wear	4	0.5	23	2.9	35.9	5.7
Hosiery (knitwear)	6.5	1	-9.8	-1.6	31.4	4.5
Readymade garments	7.8	1.1	4.9	0.7	24.9	3.8
Cotton fabrics (woven)	-7.8	-1.6	7.4	1.3	17.7	3.4
Synthetic textiles	22	1.8	-26.1	-2.5	27.7	2
Towels	27	0.9	10	0.4	26.7	1.2
Cotton yarn	0.8	0.1	-12.8	-2.4	1.8	0.3
Other categories	3	0.2	2.1	0.2	7.9	0.6
Total	**4.1**	**4.1**	**-0.9**	**-0.9**	**21.4**	**21.4**

9.2.2 Imports

Looking at the quarterly imports for the last five years, Q3-FY03 imports (US$ 3.2 billion) are the highest in any quarter (imports have been on the rise since Q3-FY02). Although the relatively high imports in Q3-FY03 were mainly due to the higher oil imports, other groups such as machinery and food have also contributed significantly. It should be noted that even excluding POL products, imports have been on the rise since Q3-FY02 (see **Figure 9.11** and **Table 9.13**). The broad based growth pattern in imports can be gauged from the fact that non-oil and non-food imports also showed a similar robust increase as the overall imports.

Despite a sharp increase in oil imports and a slight decline in *machinery group* imports during Q3-FY03, the contribution of the latter in the overall increase in

Table 9.13: Major Imports
Value: million US Dollar; Unit value: US Dollar

		Jul-Mar 2002		Jul-Mar 2003		absolute	Change (percent)		
	Unit	Value	Unit value	Value	Unit value	Δ in value	Qty	Value	Unit value
A. Food group	**---**	**607.1**	**---**	**744.0**	**---**	**136.9**	**---**	**22.5**	**---**
Milk, cream incl. milk food for infants	MT	11.3	2,279.3	14.6	1,938.1	3.4	52.8	29.9	-15.0
Wheat unmilled	MT	43.7	189.1	28.7	194.2	-15.0	-36.0	-34.3	2.7
Dry fruits	MT	22.8	362.4	17.9	308.8	-4.9	-8.0	-21.6	-14.8
Tea	MT	124.5	1,570.1	132.4	1,594.7	7.9	4.7	6.3	1.6
Spices	MT	12.6	889.8	15.0	923.2	2.4	15.0	19.3	3.8
Edible oil	MT	279.4	316.1	439.9	449.9	160.5	10.6	57.4	42.3
Soya bean	MT	7.7	351.7	38.5	571.1	30.7	206.6	397.9	62.4
Palm oil	MT	271.7	315.2	401.5	440.9	129.8	5.6	47.8	39.9
Sugar	MT	22.8	272.3	1.4	312.2	-21.4	-94.9	-93.9	14.7
Pulses	MT	90.0	305.1	94.1	296.9	4.1	7.4	4.5	-2.7
B. Machinery group	**---**	**1,457.2**	**---**	**2,045.6**	**---**	**588.4**	**---**	**40.4**	**---**
Power generating machinery	---	138.6	---	203.3	---	64.7	---	46.7	---
Office machinery	---	154.7	---	143.6	---	-11.1	---	-7.2	---
Textile machinery	---	309.6	---	379.5	---	69.9	---	22.6	---
Construction & mining machinery	---	82.8	---	70.8	---	-12.0	---	-14.5	---
Electrical machinery & apparatus	---	89.2	---	156.7	---	67.5	---	75.7	---
Railway vehicles	---	22.7	---	35.8	---	13.1	---	57.9	---
Road motor vehicles	---	219.1	---	354.8	---	135.7	---	62.0	---
Aircraft, ships and boats	---	45.3	---	57.3	---	12.0	---	26.5	---
Agricultural machinery & implements	---	9.9	---	25.8	---	15.9	---	161.1	---
Other machinery	---	385.4	---	618.0	---	232.6	---	60.4	---
C. Petroleum group	**MT**	**1,954.8**	**1,65.1**	**2,418.6**	**202.2**	**463.8**	**1.1**	**23.7**	**22.4**
Petroleum products	MT	1,045.0	162.9	1,342.7	202.4	297.7	3.4	28.5	24.2
Petroleum crude	MT	909.8	167.7	1,075.9	201.9	166.1	-1.8	18.3	20.4
D. Textile group	**---**	**139.3**	**---**	**169.0**	**---**	**29.7**	**---**	**21.3**	**---**
Synthetic fiber	MT	56.3	1,252.0	69.1	1,291.4	12.9	19.2	22.9	3.1
Synthetic & artificial silk yarn	MT	61.8	1,518.3	71.7	1,509.5	9.9	16.7	16.0	-0.6
Worn clothing	MT	21.3	309.5	28.2	319.9	6.9	28.2	32.5	3.4
E. Agricultural & other chemicals	**---**	**1,356.7**	**---**	**1,505.6**	**---**	**171.5**	**---**	**12.6**	**---**
Fertilizer	MT	155.7	145.5	211.8	183.0	56.0	8.1	36.0	25.8
Insecticides	MT	55.0	2,867.5	44.5	2,633.0	-10.5	-11.8	-19.0	-8.2
Plastic materials	MT	261.2	760.0	309.3	801.5	48.1	12.3	18.4	5.5
Medicinal products	MT	164.7	22,242.4	156.4	24,654.1	-8.3	-14.3	-5.0	10.8
Others	---	720.0	---	783.6	---	86.1	---	12.0	---
F. Metal group	**---**	**322.5**	**---**	**361.0**	**---**	**38.5**	**---**	**11.9**	**---**
Iron and steel scrap	MT	39.6	121.5	30.6	130.9	-9.1	-28.5	-22.9	7.7
Iron and steel	MT	248.8	292.8	291.0	360.1	42.2	-6.5	17.0	25.0
Aluminum wrought & worked	---	34.0	---	39.5	---	5.4	---	16.0	---
G. Miscellaneous group	**---**	**206.2**	**---**	**221.5**	**---**	**15.3**	**---**	**7.4**	**---**
Rubber crude	MT	31.4	629.5	35.2	741.8	3.8	-4.9	12.1	17.8
Rubber tyres & tubes	Nos	47.3	21.3	57.4	21.2	10.1	22.0	21.4	-0.5
Wood & cork	---	8.9	---	20.0	---	11.1	---	125.2	---
Jute	MT	19.2	288.6	15.6	238.2	-3.6	-1.5	-18.7	-17.5
Paper, paper board & manufactures	MT	99.3	709.1	93.2	594.2	-6.2	11.8	-6.2	-16.1
H. Others	**---**	**1.311.0**	**---**	**1.564.4**	**---**	**231.0**	**---**	**17.6**	**---**
Total imports:		**7,354.8**		**9,029.7**		**1,675.0**		**22.8**	
excl. Food group		*6,747.7*		*8,285.7*		*1,538.0*		*22.8*	
excl. POL group		*5,400.0*		*6,611.1*		*1,211.1*		*22.4*	
excl. Food & POL group		*4,792.9*		*5,867.1*		*1,074.2*		*22.4*	

Source: Federal Bureau of Statistics

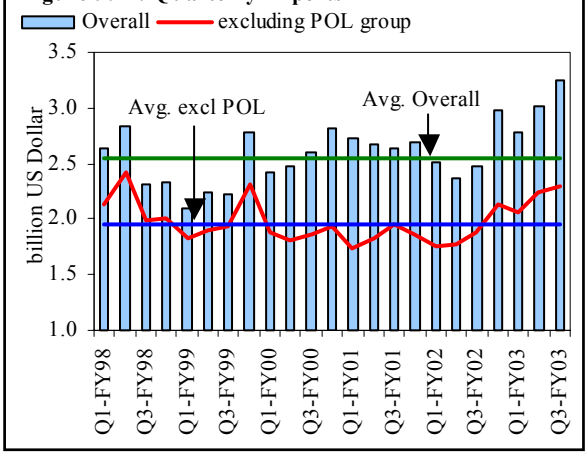
Table 9.14: Contribution in Growth by Major Import Groups (Jul-Mar)

percent

	FY01		FY02		FY03	
	Growth	Contribution in growth	Growth	Contribution in growth	Growth	Contribution in growth
Food	-9.5	-1.1	-23.7	-2.4	22.5	1.9
Machinery	5.4	1.0	-3.4	-0.6	40.4	8.0
Petroleum	30.7	7.9	-22.9	-7.2	23.7	6.3
Textile	8.2	0.1	14.1	0.2	21.3	0.4
Agriculture/other chemical	-2.5	-0.5	-5.5	-1.0	12.6	2.3
Metal	-6.1	-0.2	25	0.8	11.9	0.5
Miscellaneous	-0.6	0.0	9.7	0.2	7.4	0.2
Others	-0.4	-0.1	9.5	1.4	17.6	3.1
Total	**7.2**	**7.2**	**-8.5**	**-8.5**	**22.8**	**22.8**

imports during July-March FY03 is still the highest. *Machinery group* has contributed 35percent of the growth in imports, as compared to the 28 percent by the *petroleum group*, during the said period (see **Table 9.14**).

Figure 9.11: Quarterly Imports



Petroleum Group import bill recorded a 23.9 percent increase in Q3-FY03 over Q3-FY02, raising its share in the overall imports to 29.2 percent, which is well above the quarterly average of 23.1 percent (during the last five years) and 24.5 percent in the Q3-FY02. Although both prices and volumes increased, the price impact was dominant, despite the rising quantum of imports due to the decision to increase the country's strategic oil reserves (see **Table 9.15**).

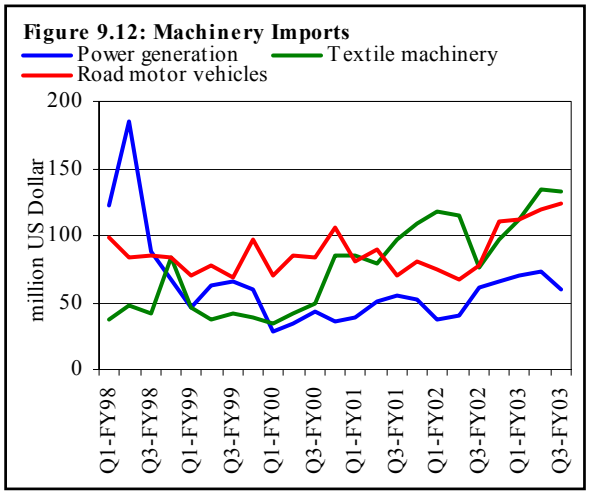
Table 9.15: Quantum and Price Impact of Oil Imports

	Overall change	Quantum impact	Price impact
	US$ million	percent	percent
	Q3-FY03 over Q3-FY02		
Petroleum group	340.0	14.8	85.2
Petroleum products	131.2	12.2	87.8
Crude oil	208.8	16.2	83.8
	Jul-Mar FY03 over Jul-Mar FY02		
Petroleum group	463.8	4.4	95.6
Petroleum products	297.7	12.1	87.9
Crude oil	166.1	-9.7	109.7

The overall imports of the petroleum group increased by 23.7 percent during July-March FY03 over the same

period in FY02. As visible in **Table 9.15** the price impact in the case of petroleum products is reinforced by a significant contribution of quantum increase, whereas the price impact is solely responsible for the increase in crude oil import bill.

Machinery imports registered 40.4 percent growth during July-March FY03 over the same period in FY02 and had the highest contribution (8 percentage points) in the overall imports growth (see **Figure 9.12**).



- Among the machinery imports, *road motor vehicles* had the highest share in overall import growth (7.4 percent) during July-March FY03 largely on the back of higher imports of cars and buses and their spare parts, owing to rising demand.
- *Power generating machinery* also had a substantial share (3.6 percent) in total imports growth, which is reportedly due to increasing trend of self power generation by industrial units to lower costs and improve reliability of supply.
- The rise in the imports of *electric machinery and apparatus* is attributable to two factors: (1) an increase in manufacturing activities of electronic goods sector; and (2) reduction in customs duties on inputs as a result of the Emerging Electronics Products Assembly Scheme, announced in FY02, under which the manufacturers were allowed to use imported inputs.

9.3 Capital Account

The capital account deficit increased by US$ 292 million during Q3-FY03 to reach US$ 987 million, despite the higher FDI, rising FE-25 trade financing, and increased assistance on account of project financing (see **Table 9.16**).[17] The main

[17] Foreign exchange trade financing to exporters & importers is included in the capital account as "short-term capital (others)". The main reason for including this trade financing in the capital account is that this lending is in foreign exchange and it shifts the forex reserves from commercial banks to SBP in the case of lending to exporters, while lending to importers affect their Nostro balances.

Table 9.16: Capital Account
million US Dollar

	Q3		Jul-Mar	
	FY02	**FY03**	**FY02**	**FY03**
Capital account (1 through 9)	**-695**	**-987**	**-1,207**	**-997**
Inflows	**504**	**683**	**2,019**	**2,761**
Outflows	**1,199**	**1,670**	**3,226**	**3,758**
1. Direct investment abroad	1	2	-4	-29
2. Direct investment in Pakistan	83	114	287	657
3. Portfolio investment	-159	-77	-280	-272
of which :Stock markets	55	-23	-2	7
Special US Dollar Bonds	-206	-45	-253	-253
4. LT Capital (official)	-213	-1,133	-466	-1,134
of which:Project assistance	95	207	375	455
Food aid	0	0	0	0
Non-food aid	2	10	247	515
Amortization	-345	-1,357	-1,149	-2,105
5. LT capital (DMBs)	0	-4	-1	-4
6. LT capital (Others)	-205	-76	-593	-559
of which: Suppliers' credits/MNCs (net)	-125	-120	-327	-253
7. ST capital (official)	-263	2	-274	-201
of which: Commerial banks(net)	-91	-15	-216	-169
IDB (net)	-38	24	-23	74
Others liabilities (NBP deposits)	-86	0	-86	-52
8. ST capital (DMBs)	13	63	-6	101
of which: Outstanding export bills	72	10	64	50
FCAs (Non-residents)	-9	50	-24	45
9. ST capital (Others)	46	122	130	444
of which: Outstanding export bills	57	-11	141	-142
FCAs (Non-residents)	-54	-27	-92	-66
Other liabilities	56	182	121	596

Source: State Bank of Pakistan
Note: LT= Long-term, ST= Short-term, DMBs= Deposit Money Banks.

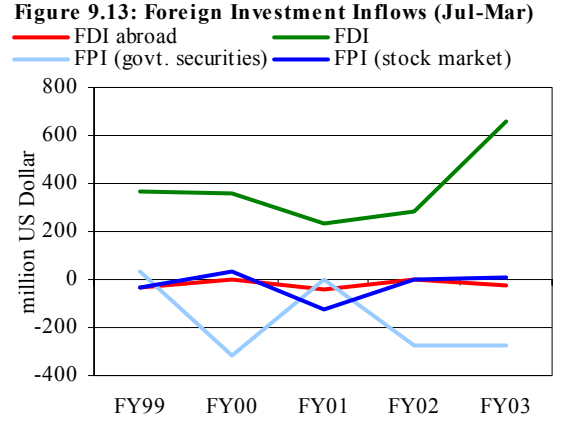
reason for this increased outflow is the *write-off* by the US, which is recorded as an outflow in long-term capital (official). Excluding debt write-off and FE-25 trade financing, the adjusted capital account outflow of US$ 804 million in Q3-FY02 has decreased to US$ 187 million during Q3-FY03, posting an improvement of US$ 617 million over the corresponding quarter of FY02. This improvement was mainly driven by the following factors: (1) lower repayments of Special US Dollar Bonds and short-term commercial banks & IDB loans, (2) increased disbursements for project financing from IFIs and bilateral countries, and (3) higher inflows under FDI. At the same time, exceptional financing showed an inflow of US$ 57 million in Q3-FY03 against an outflow of US$ 133 million in

Q3-FY02 due to the first principal repayment on the sovereign Eurobond (see **Table 9.2**).[18]

9.3.1 Net Foreign Investment (NFI)

The overall net foreign investment showed a reversal from an outflow of US$ 75 million during Q3-FY02 to an inflow of US$ 39 million during Q3-FY03, mainly due to lower maturity of Special US Dollar Bonds and higher foreign direct investment. The repayments of US Dollar Bonds are relatively low when compared with Q3-FY02, which saw maturities of the 5-year US Dollar Bonds (see **Table 9.16**). Cumulatively, the net foreign investment increased by US$ 353 million to US$ 356 million during the first three quarters of the current fiscal year over the corresponding period of FY02 (see **Figure 9.13**).

Figure 9.13: Foreign Investment Inflows (Jul-Mar)



Within the NFI, the FDI posted a growth of 128.9 percent during July-March FY03, mainly due to the privatization of UBL and some oil and gas fields. Excluding privatization receipts, the FDI registered a growth of 24.7 percent during first three quarters of the current fiscal year over July-March FY02

As usual, investors from USA, UK and UAE accounted for the bulk of the FDI, concentrating mainly in a few preferred sectors (see **Table 9.17**). Overall, the bulk of FDI was realized from UAE and UK during H1-FY03. In addition, Saudi Arabian business groups have invested in the transport sector. Similarly foreign investment in textiles also increased during Q3-FY03 (see **Table 9.17**).

Foreign investment in the stock market registered an outflow of US$ 23 million during Q3-FY03 against an inflow of US$ 55 million in Q3-FY02.

[18] Since rescheduled/rollover loans/liabilities were earlier recorded as an inflow under exceptional financing, their repayments are treated as an outflow in the same account.

Table 9.17: Foreign Direct Investment (Jul-Mar)
million US Dollar

	USA		UK		UAE		Saudi Arabia		Others		Total	
	FY02	FY03	FY02	FY03	FY02	FY03	FY02	FY03	FY02	FY03	FY02	FY03
Food	3.4	1.1	0.2	0.0	0.0	0.8	0.0	0.0	1.3	2.8	4.9	4.6
Textiles	1.8	11.9	0.8	1.7	1.8	6.6	1.3	0.0	4.6	2.8	10.3	23.1
Chemicals	1.8	1.6	0.3	75.4	0.0	0.2	0.0	0.0	2.1	3.3	4.2	80.4
Oil & gas exploration	92.3	84.6	3.5	27.9	0.1	0.0	0.0	0.0	3.3	23.3	99.2	136.0
Pharma. & OTC products	3.5	3.0	0.2	0.3	0.1	0.2	0.0	0.0	2.4	1.6	6.2	5.2
Electrical machinery	0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0	5.6	8.9	6.1	9.0
Power	3.4	0.1	0.1	7.3	0.0	0.0	0.0	0.0	13.4	20.7	16.9	28.1
Construction	1.8	8.0	2.1	0.8	1.3	0.2	0.2	0.8	3.7	1.2	9.1	11.1
Trade	9.6	10.4	0.6	2.5	0.3	4.9	0.2	0.2	14.0	14.1	24.9	32.1
Transport	0.4	0.5	0.0	5.3	0.2	5.5	0.0	31.2	12.8	23.8	13.4	66.2
Communications	6.1	17.4	0.6	1.0	0.2	0.4	0.0	0.0	1.2	1.8	8.1	20.6
Financial business	2.2	9.2	0.3	75.7	1.7	88.8	0.0	0.0	9.7	28.1	13.8	201.8
Others	11.1	15.6	8.1	4.8	4.2	5.1	0.4	0.3	46.2	14.2	69.9	40.0
Total	**138.0**	**163.5**	**16.8**	**202.7**	**10.0**	**112.7**	**2.1**	**32.6**	**120.1**	**146.7**	**287.0**	**658.2**

Source: Statistics Department, SBP

9.3.2 Long-term Capital (official)

As explained at the onset, the US debt waiver was recorded as a notional outflow in the capital account under this head. Adjusting for this one time outflow, long-term capital (official) registered a lower outflow of US$ 133 million during Q3-FY03 as compared to US$ 213 million in the same period of FY02. This decline in net outflows was primarily due to the higher disbursements on soft terms for project assistance from ADB, World Bank and other donor countries.

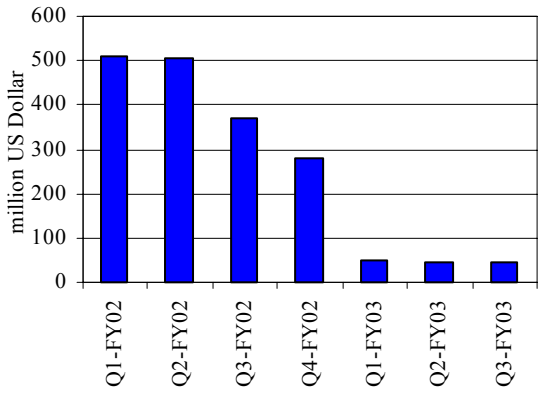
9.3.3 Long-term Capital (others)

Long-term capital (others), which comprises of suppliers' credit and swaps, showed a substantial decrease in the net outflows to US$ 76 million during Q3-FY03 as compared a net outflow of US$ 205 million in Q3-FY02. A US$ 30 million suppliers' credit inflow to a textile unit, was more than offset by substantial repayment of supplier's credit (US$ 150 million) during Q3-FY03.[19]

[19] The total outflow in long-term capital (others) (US$ 106 million) is lower than the repayments of supplier's credit (US$ 150 million) during Q3-FY03 mainly due to inflow of US$ 44 million to MNCs operating in Pakistan from its parent companies.

Further, the outflow on account of swaps was also absent in Q3-FY03 as against a US$133 million outflow in Q3-FY02 (see **Figure 9.14**).

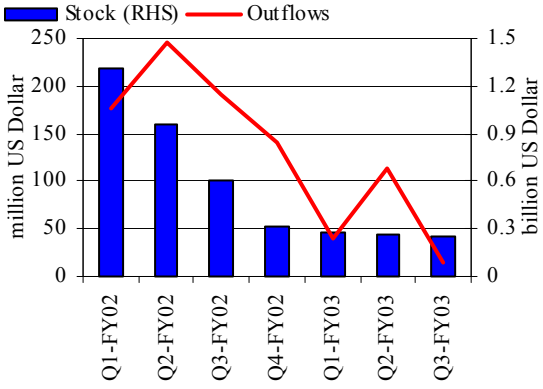
Figure 9.14: Outstanding Stock of Swaps



9.3.4 Short-term Capital (official)

Short-term capital exhibited a sharp reversal from an outflow of US$ 263 million during Q3-FY02 to an inflow of US$ 2 million during Q3-FY03. Within the short-term capital (official), the inflows were realized from IDB for oil import financing to PSO, while the commercial borrowings were discontinued due to the country's ample forex reserves. The outstanding stock of commercial loans & credits declined by US$ 857 million to US$ 246 million at end-March as compared to end-June 2001 stock of US$ 1,103 million. Therefore, the corresponding principal payments on these loans also declined significantly during last four preceding quarters (see **Figure 9.15**). Similarly, net flows to IDB improved as financing needs for oil imports declined on the face of higher forex reserves.

Figure 9.15: Outflow of Commercial Loans (Official Short-term)



9.3.5 Short-term Capital (deposit money banks & others)

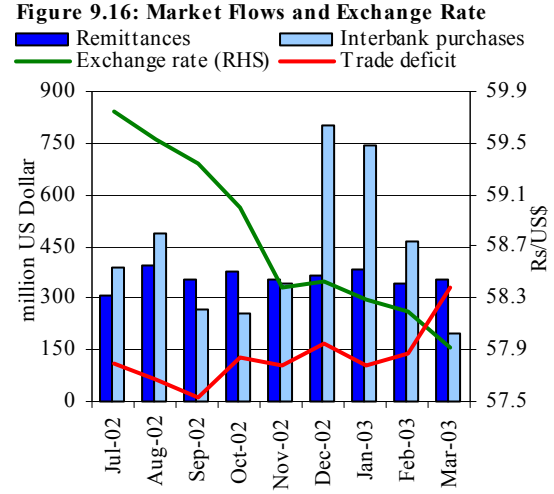
This mainly constitutes Outstanding Export Bills (OEBs) held by commercial banks and exporters, foreign currency denominated loans and non-resident FCAs mobilized by commercial banks and NBFIs. Aggregate inflows during Q3-FY03 totaled US$ 185 million as compared to US$ 59 million over the corresponding quarter of FY02 as the commercial banks provided increasing volume of trade financing against FE-25 deposits during Q3-FY03. The net lending against FE-25 deposits rose to US$ 182 million during Q3-FY03 as compared to US$ 56 million

during Q3-FY02. The preference of exporters and importers for such loans is due to: (1) lower effective lending rates, (2) easy documentation and (3) continued appreciation of the rupee.[20] Moreover, outstanding export bills merely increase by US$ 1 million during Q3-FY03 reflecting the impact of continued appreciation of the rupee.

9.4 Exchange Rate Policy

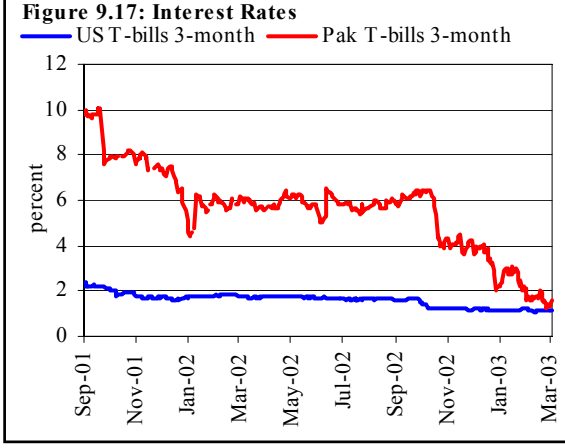
The Rs/US$ parity continued its downward trend during Q3-FY03, although the rate of its descent moderated relative to the earlier two quarters; the rupee appreciated by only 0.9 percent in Q3-FY03 compared to appreciations of 1.5 and 1.6 percent in Q1 and Q2 of FY03, respectively. This relative stability of the Rs/US$ parity, in the face of an extended quarterly external account surplus (see **Section 9.1**), was once again attributable to the SBP's heavy market purchases (see **Figure 9.16**).

Figure 9.16: Market Flows and Exchange Rate



During January-February 2003, the SBP mopped up the excess forex liquidity in the interbank market. Subsequently, however, it was the sharp increase in trade deficit (see **Section 9.2** for details), which helped absorb the forex inflows, thus reducing the need for SBP interventions in March 2003.

Figure 9.17: Interest Rates

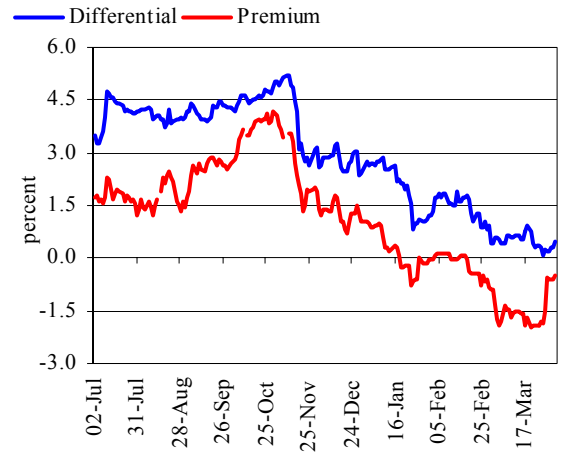


Interestingly, while the spot rate declined moderately during Q3-

[20] During March 2003, the weighted average lending rate was 8.2 percent and the export refinance rate was 4.0 percent while trade-related loans against FE-25 deposits were available at an average of 2.5 percent.

FY03, the fall in the forward rate was greater in this period, primarily because the differential between rupee and US$ *interest* rates (which determines the theoretical forward exchange rate), dropped by 197 basis points during the quarter. However, the market forward premium fell by 154 basis points as rupee interest rates plunged (see **Figure 9.17**). This differential between the theoretical forward exchange rate and the market premium largely reflects expectations of a rupee appreciation in the market.

Figure 9.18: Interest Rate Differential (3-month US & Pak T-bills) and Forward Premium - FY03



The combination of a fall in the interest rate differential, the market expectations of the future appreciation of the rupee and, very importantly, a short-term pressure on the aggregate Nostro position of commercial banks, ultimately pushed the forward rate below the spot rate (see **Figure 9.18**). The forward premium improved subsequently following SBP intervention.

The *market* expectations of a strengthening rupee, in turn, were probably driven by a number of factors, including:

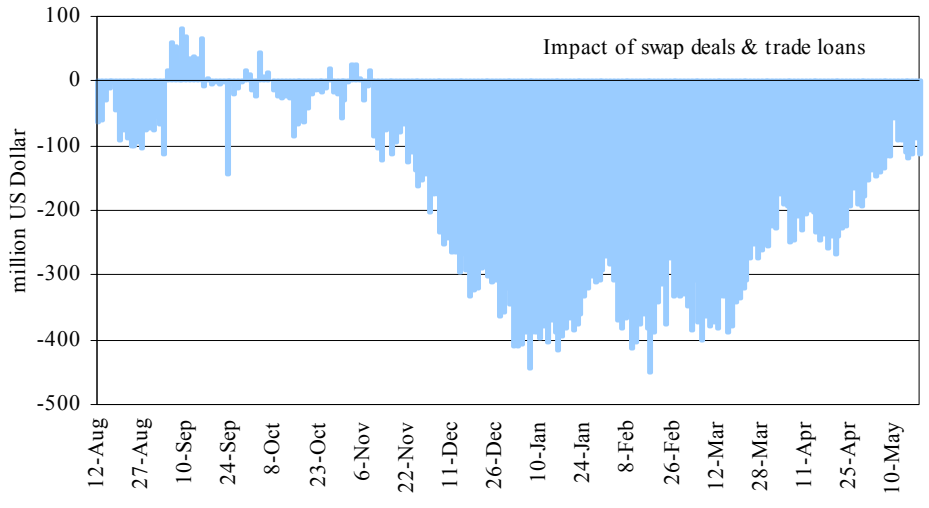
1. Inflows of workers' remittances, which had been growing robustly during the past several months (see **Figure 9.16**) were likely to accelerate ahead of the expected conflict in Iraq.[21]

2. The weakening of the US dollar against major currencies, especially the euro.

However, since the rupee remained relatively stable until mid-February 2003, these market expectations moderated somewhat. The pressure on the aggregate Nostro positions of commercial banks also eased (see **Figure 9.19**) due to a

[21] There is some evidence that this did indeed take place (see section on **Balance of Payments** for details).

Figure 9.19: Market Nostro (Trade) - FY03

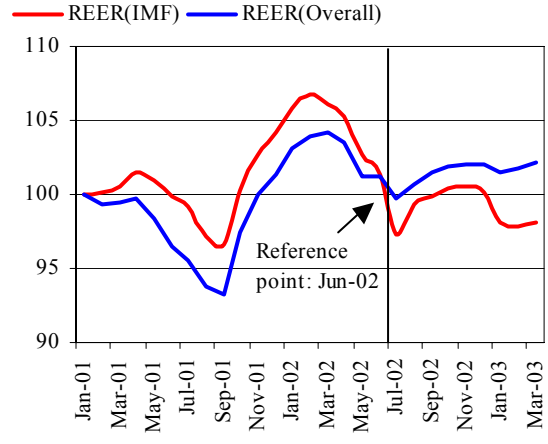


relative decline in demand for outward payments, and continued interventions[22] by the SBP in the forward market. As a result, the forward premium moved up, nearing the theoretical cover interest parity.

9.4.1 Real Effective Exchange Rate

The movement in the two variants of the REER index, since the beginning of FY03, shows an interesting picture of the exchange rate in real terms. While the REER (overall) shows that the rupee has appreciated by 0.95 percent since end-June 2002, the REER (IMF) tells a contrasting story of a 3.2 percent depreciation (see **Figure 9.20**).

Figure 9.20: Real Effective Exchange Rate Indices (Jan 2001=100)



- For the REER (overall), the loss in competitiveness due to the relatively higher

[22] The SBP not only conducted sell/buy swaps, it also "talked up" the forward rate.

inflation in Pakistan, compared to inflation in the *basket* countries, dominated the marginal depreciation of Pak rupee against the *basket* currencies (reflected by a change in NEER). As a result, the REER index inched up showing an appreciation of the Pak rupee.

- The REER (IMF), on the other hand, fell significantly as the fall in the relative price index furthered the depreciation of rupee against the basket currencies leading to an overall depreciation of the rupee in real terms.
- The depreciation of the Pak rupee against the *basket* currencies is much stronger in the case of REER (IMF) than the REER (overall) as the former has relatively much higher weight for the European countries against which the US dollar depreciated sharply (see **Table 9.18**).

Table 9.18: Effective Exchange Rates (Jul-Mar FY03)
percentage change

	Overall	IMF
REER	0.95	-3.15
NEER	-0.05	-2.65
RPI	1	-0.52

9.5 Foreign Exchange Reserves

The sustained foreign exchange inflows in Q3-FY03 helped Pakistan's total liquid foreign exchange reserves cross the US$ 10 billion mark, reaching US$ 10.3 billion by end-March 2003. Though the increase in reserves during Q3-FY03 was lower than in the last quarter, it was twice that of the corresponding period of FY02 (see **Table 9.19)**. While workers' remittances remained the major source of inflows, staying almost at the same level as in Q2-FY03, the reserve accumulation still decelerated during Q3-FY03 mainly due to lower inflows on account of FDI and loans from IFIs.

Table 9.19: Quarterly Changes in Total Liquid Reserves
million US Dollar

	Q3-FY02	Q2-FY03	Q3-FY03
Overall increase	428	1,092	976
major contributors factors[1]*:*			
Trade balance	-97	-275	-145
Services (excl. interest payments)	-46	-476	83
Workers' remittances	645	1,095	1,083
FDI	83	371	114
Loans from IFIs	27	361	151
Debt servicing	342	270	374
Eurobonds	0	-187	0
Interest payments on deposits	-261	-19	-14
Swaps	-136	0	0
PTMA	-159	0	0

[1] Figures are based on exchange records from SBP

A comparison of reserves accumulation during Q3-FY03 with the corresponding period last year reveals a noticeable absence of PTMA payments and substantially lower interest payments on deposits & US Dollar Bonds (see **Table 9.20**).

Table 9.20: Foreign Exchange Reserves with SBP
million US Dollar

	Q3		Jul-Mar	
	FY02	**FY03**	**FY02**	**FY03**
Opening balance	***3,538.0***	***8,068.0***	***2,076.0***	***4,804.9***
Receipts	**1,722.4**	**2,205.7**	**4,515.0**	**6,833.0**
Purchases	**1,238.3**	**1,434.8**	**2,595.0**	**4,372.3**
Kerb market	431.6	0.0	1,068.6	0.0
Interbank (net)	806.7	1,402.0	1,526.4	3,943.0
Export of currency	0.0	32.5	0.0	429.0
Loans	**26.5**	**151.1**	**699.3**	**982.6**
IBRD/IDA	17.5	11.6	146.6	226.7
ADB	9.0	10.3	173.1	349.2
IMF	0.0	120.8	376.9	352.3
IDB (for PSO)	0.0	8.4	0.0	54.4
JBIC (OECF)	0.0	0.0	2.7	0.0
Grants	**42.1**	**31.3**	**642.1**	**133.9**
UK	0.0	31.3	42.1	31.3
USA	42.1	0.0	600.0	0.0
European Commission	0.0	0.0	0.0	15.1
SAMA	0.0	0.0	0.0	87.5
Other receipts	**415.5**	**588.5**	**578.6**	**1,344.2**
Logistic support	300.0	530.2	300.0	847.2
UBL privatization proceeds	0.0	0.0	0.0	299.6
UN troops	31.5	12.3	59.3	66.9
Interest on deposit/discount	60.2	26.2	60.2	83.2
Miscellaneous receipts	23.8	19.8	159.1	47.3
Payments	**1,323.4**	**750.6**	**2,658.0**	**2,114.8**
Debt servicing to donors	**341.5**	**374.3**	**854.2**	**920.7**
IMF	47.5	125.5	163.1	311.5
IDA	24.2	36.2	74.4	96.4
IBRD	78.8	69.8	188.2	178.7
ADB	52.4	47.0	109.8	190.2
IDB	133.0	78.4	304.6	126.5
Miscellaneous payments[1]	5.6	17.4	14.1	17.4
Other Payments	**981.9**	**376.3**	**1,803.8**	**1,194.1**
Swaps	136.0	0.0	136.0	110.0
Interest on deposits/profit on $ bonds	260.7	14.3	485.4	60.0
Eurobonds	0.0	0.0	31.2	186.6
FE-45	244.9	194.0	393.0	238.1
Payment for Hajj	107.0	73.0	107.0	113.5
ACU settlement	38.1	69.4	108.8	120.3
PTMA	159.3	0.0	368.1	0.0
Miscellaneous payments[2]	35.9	25.6	174.3	365.6
Closing balance	***3,937.0***	***9,523.1***	***3,937.0***	***9,523.1***

[1] Includes IFAD (US$ 8.2 million), OPEC (US$ 5.3 million) and JBIC (OECF) (US$ 3.9 million) for FY03.
[2] Includes FCY Loan Bonds (US$ 29.1 million), US Aid (US$ 30.0 million), US$ Bond Encashment (US$ 53.5 million), PL-480 (US$ 10.8 million), NDRP (US$ 61.1 million), SAINDAK Bonds (US$ 13.0 million), Catic China (US$ 10.0 million), Uch Power Project (US$ 7.1 million) and FE-25 (CRR) (US$ 49.9 million) for FY03.
Source: State Bank of Pakistan

This increase in total reserves boosted the *import coverage* further enabling the reserves to cover 48 weeks of import (see **Figure 9.21**). While the reserves to short-term debt ratio improved considerably during FY02 (as repayment of short-term debt was reinforced by reserve accumulation), the marginal improvement in the ratio during Q3-FY03 is mainly on account of the reserve build-up (see **Figure 9.22**).

Figure 9.21: Reserves in Weeks of Imports

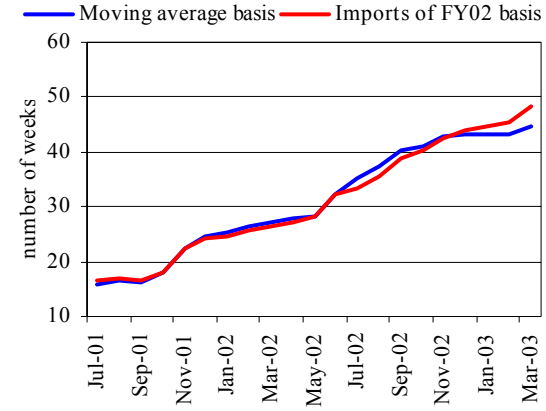
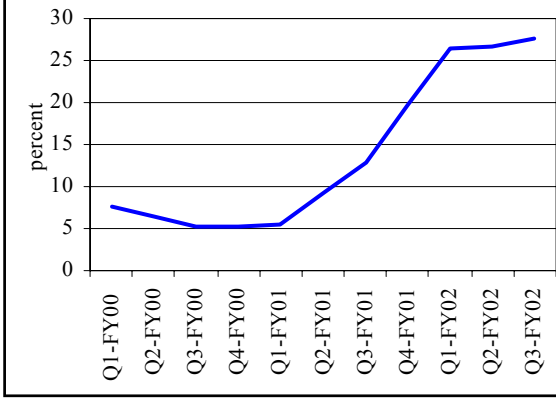


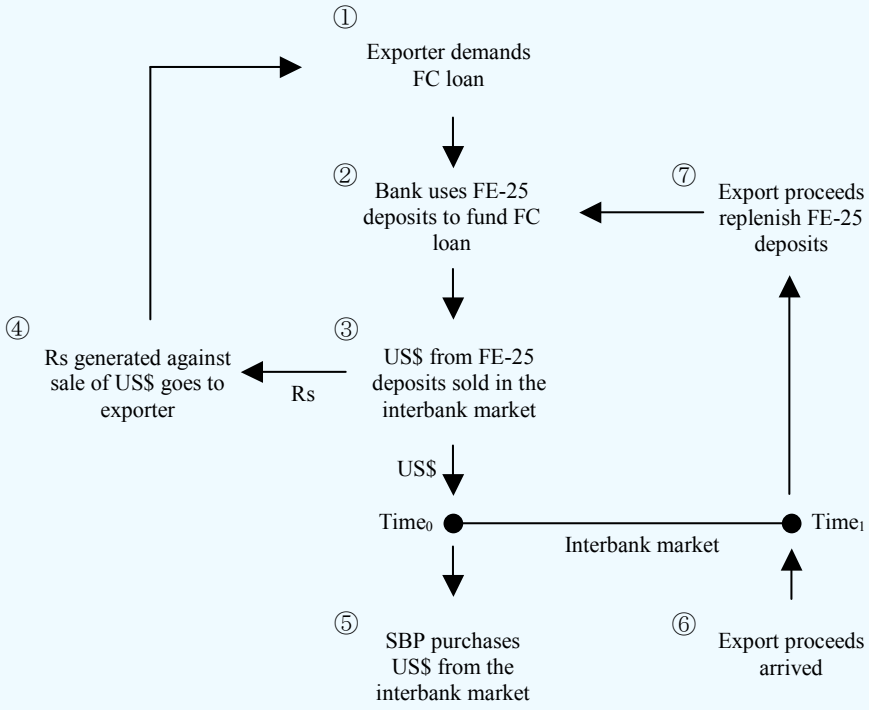
Figure 9.22: Reserves as percent of Short-term Debt



An important development in the context of foreign exchange reserves is the adjustment in commercial banks' reserves December 2002 onwards. It was necessary to adjust the foreign currency lending by commercial banks using FE-25 deposits.[23] Specifically, when a commercial bank extends a foreign currency loan (against FE-25 deposits) to an exporter, the foreign currency amount lent is sold in the interbank market, and it is presumably purchased by the SBP (since it is the largest buyer in the market). Thus, in effect, the loan extended from commercial bank's reserves (against FE-25 deposits) also becomes a part of SBP reserve balance (see **Chart 9.1**). Given the fact that the FE-25 deposits are a part of commercial banks' reserves, an extension of loan would result in an

[23] Although the foreign currency loans against FE-25 deposits were allowed in April 2001, the sharp appreciation of the rupee in the interbank market in October 2001 onwards made these loans attractive for exporters. The real impetus came after August 2002 when SBP issued guidelines for such loans.

Chart 9.1: Mechanism for Foreign Currency Lending



overstatement of overall liquid reserves of the country (if not adjusted).[24]

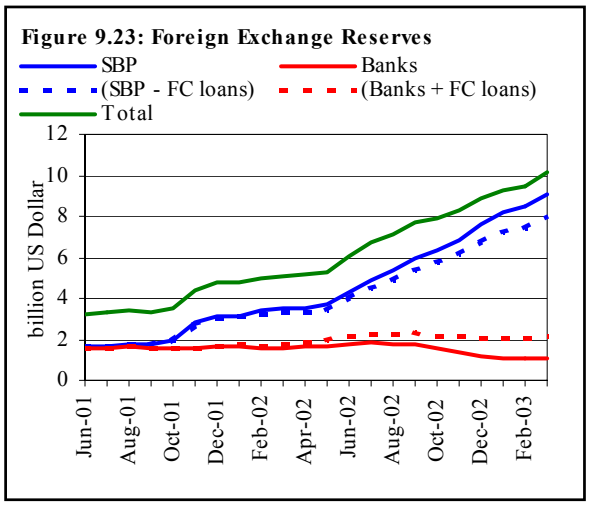
In order to correct this anomaly, SBP began adjusting commercial banks' reserves by the amount of outstanding foreign currency loans.

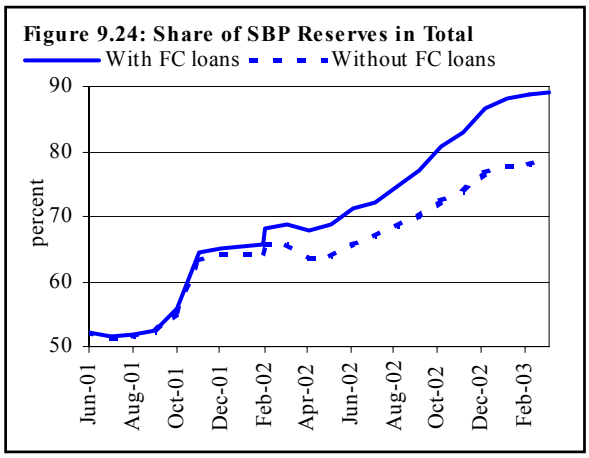
The impact of the forex lending on key market participants is as follows:

(1) It allowed SBP to purchase those dollars from the interbank market, which otherwise would have realized in the future (i.e., when export bill payments materialized). The resulting shift in SBP reserves is shown in **Figure 9.23**. Also, since forex loans were deducted from the reserves of commercial banks, the share of SBP holdings in total reserves has increased markedly (see **Figure 9.24**).

[24] Overall forex exchange reserves are the sum of SBP reserves and commercial banks' reserves.

(2) Due to persistent market expectations of a rupee appreciation, and the falling interest rates in the international market, the foreign currency lending against FE-25 deposits are available at rates that are even lower than the lending rates on the export finance scheme. Consequently, these loans are increasingly substituting the credit under the export finance scheme (see details section on **Money and Credit**).





(3) Commercial banks also have incentive in extending foreign currency loans as it provides them relatively higher returns (greater than Libor) on their FE-25 based portfolio.

(4) Surprisingly, banks seem reluctant in sharing gains from forex loans with depositors. FE-25 depositors still receive meager returns (Libor minus) on their balances.