

1 An Overview, Prospects and Executive Summary

1.1 Overview

Pakistan's economic performance in FY01 can be characterized by government efforts to bring macroeconomic fundamentals back on-track. The fiscal deficit was contained within its targeted level, inflation was low, current account was in surplus, foreign exchange reserve accumulation was satisfactory and government borrowing from the banking system was within manageable limits. For the first time, Pakistan completed its Standby Arrangement (SBA) with the IMF and established credibility with the international financial institutions. However, restrained expenditures and efforts to increase tax revenues (Tax Survey, Self Assessment Scheme, extension of GST, etc.) lowered purchasing power – the corresponding need to reduce the element of subsidy in utility bills also added to this issue.

The policy steps required to address underlying structural problems altered the incentive structure for the existing private sector. Although this is to be expected given the nature of the stabilization program, poor agricultural growth compounded the problem since the country was unable to meet its aggregate growth target for the year. Private sector investment was also stagnant, since investors were looking for the outcome of reforms to develop a longer-term perspective, while interest rate spreads continued to increase. Furthermore, this did not allow the privatization drive to achieve the desired results. Under these conditions, it is not surprising that the desired level of economic activity and employment in the country was not achieved. Hence, Pakistan's aggregate growth was only 2.6 percent this year against a target of 5.0 percent.

In the real sector, persisting drought conditions did not allow the agriculture sector to even show positive growth. Although bumper crops in cotton and wheat last year created a strong base effect (which required conservative growth projections for this year), the impact on water-intensive crops like sugarcane and rice compounded the problem. Looking at Pakistan's major crops, FY01 witnessed negative growth of 10.5 percent against an increase of 15.1 percent last year. Risk diversification in the rural sector encouraged strong growth in livestock, but this was insufficient to shore up the agriculture sector. In aggregate terms, value added by agriculture declined by 2.5 percent against a target of positive 2.6 percent.

As shown in **Table 1.1**, the saving grace was large-scale manufacturing (LSM). With full year growth of 8.4 percent, this was broad based, but still spearheaded by sugar, vegetable ghee and cigarette production (which had all experienced negative growth during FY00). Petroleum refining, leather and automobiles also showed strong performances. However, Pakistan's major export item (textiles), which is also the heaviest in LSM, has not performed well this year as it had during FY00.

In the external sector, the two noteworthy outcomes were: (1) for the first time in its history, Pakistan was able to post a current account *surplus* of US\$ 331 million, and (2) the Rupee/Dollar parity depreciated by 18.6 percent, the largest adjustment since FY82 when the Rupee was moved to a managed float. In terms of the surplus, although the narrowing of the trade deficit helped, the swing factors were SBP's kerb purchases and the recognition of the Saudi Oil Facility (SOF) as an official transfer (grant). In view of the latter, Pakistan's BOP has experienced a windfall improvement for the past three years, with a surplus this year. However, this improvement in the external gap did not ease pressure on the Rupee, which was on account of the change in Pakistan's exchange rate regime. Inflows and outflows of hard currency are shown in **Table 1.2**.

Table 1.1: Selected Macroeconomic Indicators

	FY97	FY98	FY99	FY00	FY01		FY02
					Targets	Actual Prov.	
<i>Growth Rates</i>							
Real GDP (FC) ¹	1.9	4.3	4.2	3.9	5.0	2.6	4.0
Agriculture	0.1	3.5	2.0	6.1	3.9	-2.5	2.0
Major crops	-4.3	8.3	0.02	15.05	3.2	-10.5	-
Manufacturing	-0.1	6.9	4.1	1.4	5.9	7.1	-
Large-scale	-2.1	7.6	3.6	-0.2	6.2	7.8	6.5
Services sector	3.6	3.2	5.0	4.8	5.2	4.4	4.1
Consumer price index (FY91=100)	11.8	7.8	5.7	3.6	4.5	4.4	5.0
Sensitive price indicator (FY91=100)	12.5	7.4	6.4	1.8	-	4.8	-
Domestic credit	15.3	15.0	3.5	9.0	6.1	3.6	6.7
Monetary assets (M2)	12.2	14.5	6.2	9.4	10.3	9.0	9.5
Exports (f.o.b.)	-2.6	4.2	-10.7	8.8	11.1	9.0	7.6
Imports (f.o.b.)	-6.4	-8.4	-6.7	-0.1	3.6	5.9	6.8
Liquid foreign exchange reserves ² (US\$ million)	1,219.4	930.0	1,729.7	1,352.3	-	2,075.8	-
<i>As percent of GDP</i>							
Total investment	17.9	17.7	15.6	15.6	15.5	14.7	15.2
National savings	11.8	14.7	11.7	13.8	13.6	12.7	15.2
Tax revenue	13.2	13.2	13.3	12.7	14.2	13.3	13.9
Total revenue	15.6	16.0	15.9	17.0	17.3	16.3	17.3
Budgetary expenditure	22.0	23.7	22.0	23.4	22.0	21.7	22.3
Budgetary deficit	6.3	7.7	6.1	6.4	4.6	5.3	4.9
Current account deficit (Including official transfers)	-5.6	-2.7	-3.8	-0.4	-2.0	0.6	-
Domestic debt	42.2	43.9	46.8	49.0	-	49.2	-
Foreign debt	51.8	55.4	57.7	56.2	-	64.0	-
Total debt (Including external liabilities)	94.4	99.8	106.7	107.3	-	115.3	-

¹ During FY01, sectoral shares in GDP were as follows: agriculture (24.7 percent), industry (25.0 percent) and services (50.3 percent)

² Foreign exchange reserves for FY99 and FY00 include FE13 deposits with SBP, whereas for FY01, these includes CRR/SLR on FE-25 deposits.

Drought conditions that adversely impacted agriculture were also reflected in Pakistan's external sector. Additional oil imports were needed to compensate for reduced hydel power generation¹, sugar imports were required to ease domestic shortages, while rice exports did not show much growth during the year. Nevertheless, despite an unprecedented oil import bill of US\$ 3.4 billion, the *realized* trade deficit was brought down from US\$ 1.4 billion in FY00 to US\$ 1.2 billion this year. This clearly shows that non-oil imports had to be squeezed; except for oil and textile machinery, all other imports declined during the course of the year.

As part of the stabilization program, Pakistan's central bank allowed a free float for its currency and dismantled the Rupee band that had been in place during FY00. This, coupled with the emphasis on accumulating foreign exchange reserves, shifted SBP's thrust in managing the exchange rate. Instead of direct intervention and moving the Rupee/Dollar band, monetary policy was the main tool to quell

¹ As discussed in **Chapter 9**, crude oil imports were 53.9 percent higher than FY00, while an additional 10.1 million tons of petroleum products were imported into the country during the year.

episodes of speculation (in the foreign exchange market) and to smooth out volatility caused by lumpy payments.

However, Pakistan's monetary policy had to be tempered by conflicting goals. On the one hand, there was an urgent need to shift government borrowings from SBP to banks and to insulate the Rupee from excessive volatility – this placed upward pressure on T-bill rates. On the other hand, efforts to increase private sector investment, ease the government's debt burden, and contain the impact of our commitment to link export finance rates to T-bills, pushed in the opposite direction. In overall terms, however, SBP's monetary policy remained tight during the year.

In terms of monetary aggregates this year, the overall increase in domestic liquidity was driven by the sharp accumulation of net foreign assets (liquid reserves). As expected, with the stabilization program in place, the government retired its borrowing from the banking system, while private sector credit disbursed by commercial banks increased from Rs 15.4 billion last year to Rs 54.2 billion this year. The underlying reasons are simple: the uncertainty that existed last year dissipated while textile manufacturers were more forthcoming in terms of their credit needs. Although a significant volume of free liquidity was injected into the system in the latter half of the year (on account of closing certain foreign exchange swaps), domestic credit expansion was only 3.6 percent this year. Even with the increase in liquidity on account of the accumulation of net foreign assets, total M2 growth was Rs 125 billion, which is below the targets set in the original and revised Credit Plan.

As a result of the free float of the Rupee in July 2000, there was a sharp depreciation of the Rupee due to unanchored expectations of market participants. With the removal of the band (at Rs 51.90 per US Dollar) that had been put in place since June 1999, and low level of liquid foreign exchange reserves held by SBP, speculators began betting on a one-sided movement of the Rupee parity. If one were to make the distinction between market *intervention* (done at SBP's discretion to stabilize the rate) and one-sided market *support* (to meet lumpy payments), SBP support during the course of FY01 was higher but the rate still continued to depreciate. SBP intervened less in *net* terms to compensate for greater support, while market players were testing the central bank's resolve to determine when it would intervene to stabilize the Rupee. After the harsh monetary measures taken in October 2000, sentiments in the market became more subdued.

Table 1.2: Pakistan: External Cash Flow Position in FY01

million US\$	
Reserves at the beginning of the year ¹	997
Inflows	19,410
<i>of which</i>	
Exports	8,926
Services	1,464
Remittances	1,087
Purchases	2,157
Foreign investment	146
Disbursement	2,739
Exceptional financing	692
Outflows	18,719
<i>of which</i>	
Imports	10,195
Services	4,601
(interest payments)	1,660
(profit & dividend)	610
Amortization	2,887
Reserves at the end of the year ²	1,688

¹ Reserves excluding FE 13 with SBP

² Reserves excluding CRR/SLR with SBP

1.2 Medium-term Prospects

The medium term prospects for Pakistan under the heightened uncertainty following the September 11 attacks are highly tentative and mostly speculative. As subsequent events unfold, there will be greater certainty about the outcomes that should be analyzed. The implications of these developments on the economy of Pakistan are presented within two scenarios. The assumptions underlying these scenarios represent the current understanding of the situation and will be updated and revised as things become clearer. Needless to say, the probability associated with each of these scenarios will determine the likely outcome.

The common theme underlying these scenarios is that the government will remain fully committed in implementing the on-going reform process, irrespective of the optimistic scenario that includes higher external assistance, debt write-off, and increased market access to developed countries. The path of economic self-reliance and the corresponding exit from IMF programs will be adhered to. These scenarios will be developed after a brief backdrop.

Pakistan's economy was showing some signs of recovery, while the after effects of the drought were beginning to dissipate. The wheat crop during FY01 was much higher than expected, resulting in the resumption of wheat exports. The new cotton crop is also expected to be larger than what was realized in FY01 and preliminary indications show that sugar production should be adequate to meet the country's consumption needs. This positive turnaround in the agriculture sector and strong growth in manufacturing, would have improved the prospects of economic recovery this fiscal year (FY02).

The Standby Arrangement with the IMF was successfully completed and all targets (except one) were met on time. The likelihood of successfully negotiating a three-year Poverty Reduction and Growth Facility (PRGF) is therefore brighter.² This particular action should have a positive impact on restoring investor confidence, and will also give a clear signal that the comprehensive structural adjustment process initiated two years ago would continue.

These expectations have been put into doubt on account of two factors: the global recession and the consequences of the events of September 11. The global forecast for the next 9 months is likely to be much more severe than earlier projections. According to the latest IMF report, the synchronized slowdown in the global economy should result in growth of 2.6 percent this year, compared to 3.2 percent that was forecast earlier. US growth in the second quarter had slipped to an annual rate of only 0.2 percent, while industrial production has declined to an annualized rate of 4.8 percent – consumer spending in the US continues to slow. The European economy has not fared any better and gloom about the Japanese economy has been reinforced by recent data.

The September 11 attacks have further intensified the global recession, which are clearly shown in financial markets the world over. Stock indices in the US and Europe had fallen 7 to 15 percent, with the negative 'wealth effect' stalling consumer spending. High yield and emerging market bonds have witnessed a sharp rise in spreads. After an initial oil price hike immediately following the attacks, international prices have slumped on account of low demand. The response of the leading central banks in cutting interest rates and injecting liquidity, and the US government's appropriations for aviation and reconstruction, have moderated the adverse impact of this event.

What are the implications of these imported shocks on the outlook for Pakistan's economy? Global recession is likely to spread through international trade. Commodity prices are forecast to fall by 7 to 8 percent on average this year. More specifically, the price of cotton in world markets has declined to 35 ¢/lb, which has lowered lint prices in Pakistan by 25 to 30 percent compared to last year. Demand for Pakistani exports in the EU and US, which together account for 55 percent of total exports, has slackened and is likely to worsen.

Pakistan's decision to support the US-led coalition and its frontline status has significantly enhanced the country's vulnerabilities to additional risks and costs. In the short-run, a number of factors will come into play: (1) increase in freight rates and the imposition of war-risk insurance will increase the cost of imports and make Pakistani exports more expensive; (2) cancellation of air cargo flights by foreign airlines will disrupt trade flows; (3) manufacturing units will have to maintain higher inventories; and (4) the possible departure of expatriates from the country and the suspension of visits

² This will be accompanied with collaborative assistance from the World Bank and the Asian Development Bank.

by foreign buyers (in view of the media-hype about Pakistan being in the war-zone), will not allow the country to maintain normal trade relationships. Furthermore, revenue collection will also suffer due to lower imports, while the continuous influx of Afghan refugees will add further pressure on Pakistan's limited resources and infrastructure.

As stated earlier, it is difficult to conjecture how long these trends will persist, since a lot will depend on how the war against terrorism in Afghanistan plays itself out. A short and swift outcome will bring an end to these uncertainties and normalize Pakistan's trade patterns (more later). However, a more protracted and extended 'war' will exacerbate the situation causing severe and heavy losses to Pakistan's economy. Under this scenario, exports will decline significantly, foreign investment flows will dry up, capital flight will intensify, output losses will be severe and GDP growth will either be stagnant or negative depending on the intensity, duration and scope of the campaign.³ The World Bank estimates that growth in developing countries could be ½ or ¾ percentage points lower than projected. Applying this to Pakistan's frontline status implies that GDP growth in FY02 could be in the range of 2½ to 3¾ percent.

The positive effects on Pakistan's fiscal and balance of payments situation will follow with the lifting of economic sanctions by the US and other G-7 countries, resumption of economic assistance by bilateral governments (particularly the US), debt relief and better market access to Pakistani exports.⁴ However, these issues have yet to be discussed, negotiated and settled. The increased scrutiny of the Hundi system following the terrorist attacks, has narrowed the spread between the interbank and kerb market; if this persists, it will provide incentives to overseas Pakistanis to send their remittances through the banking system. Larger flows of hard currency will allow SBP to substitute away from kerb purchases, and in doing so, help meet the external gap using more conventional means.

Although it is too early to predict the cumulative impact of these measures in the short-term, to the extent that all the negative consequences outlined above are offset by these positive factors, the events of September 11 will have a neutral impact on Pakistan's economy. Having said this, the initial disruption to economic activity and sentiments should not be underestimated. If the law & order situation within the country is controlled and the resulting economic disruption minimized, it is likely that the positive factors will have a bigger say in Pakistan's medium-term prospects.

³ Despite the fact that IFI assistance should be forthcoming, if economic activity is severely disrupted, this will not help shore up investor confidence. Furthermore, the country will not be able to sustain the types of structural changes that are envisaged.

⁴ In terms of market access, although this may neutralize the negative implications following Pakistan's involvement in the war, it will segment our export strategy. This issue will have to be addressed once the war ends and the concessions given to Pakistan are abruptly withdrawn.

1.3 Executive Summary

Economic Growth, Savings & Investment

Although it was expected that agriculture would not be able to *lead* economic growth this year, worsening drought conditions in the country did not even allow this sector to meet the modest growth target that had been envisaged for the year. In fact, agricultural growth was *negative* 2.5 percent. If it had not been for the strong recovery posted by large-scale manufacturing (at 8.4 percent this year against negative 0.2 percent during FY00), economic growth in Pakistan would almost surely have been negative. As of end-FY01, provisional GDP growth for the year is estimated at 2.6 percent.

The main reason for this poor performance of the agriculture sector was the shortage of irrigated water. During the *kharif* season (May to September) water supply was 15.8 percent lower than FY00, while in the *rabi* season (October-April), flows this year were 28.8 percent lower. Although effective measures were taken to tap into groundwater where available, water intensive crops like sugarcane and rice were the hardest hit, as farmers intentionally reduced area under cultivation. As shown in **Table 2.2**, negative growth of wheat and cotton was expected given the bumper crops last year, but the decline posted by sugarcane and rice was the direct result of the drought. This also had negative implications for Pakistan's trade; sugar imports were required while rice exports were not as high as anticipated. In view of the resilience of the rural sector in terms of risk diversification, strong growth of livestock helped shore up the agricultural sector.

In terms of large-scale manufacturing (LSM), this was the first time in seven years that all industrial groups recorded positive growth. Unlike last year, LSM growth was broad based as shown by the trimmed growth of 7.7 percent.⁵ Nevertheless, the overall growth of 8.4 percent was spearheaded by sugar, petroleum refining, vegetable ghee and cigarette production, which together account for 25 percent of LSM. With growth of 14.0 percent exhibited by these sub-sectors during FY01, this was able to compensate for the slowdown in value added by the textile sector. Although fertilizer and pharmaceuticals slowed compared to FY00, strong growth in automobiles and complementary sectors created a sense of optimism as these products have a high public profile.

Value added by the leather sector was given a boost on account of the *mad cow* and *foot & mouth* diseases that hit Europe during FY01. With the mass incineration of cows and other farm animals, leather exports increased by US\$ 144.6 million during the year. Since leather *products* accounted for 60 percent of this increase, this helped create the demand that allowed value added (by the leather industry) to increase by 10.1 percent this year against growth of only 1.9 percent last year.

The services sector grew by 4.4 percent during the year compared to 4.8 percent in FY00. Despite the fall in growth by commodity producing sectors, this indicates that forward and backward linkages with services are weakening. *Retail and wholesale* trade showed some improvement over last year on account of higher industrial activity, while *finance and insurance* posted a sharp slowdown on account of structural adjustments in the banking system. Fiscal consolidation slowed government expenditures on civil and defence administration.

Price Developments

As mentioned in the last *Annual Report*, the record low inflation rates realized in FY00 could not be sustained. As of end-June 2001, the annualized average CPI inflation had risen from 3.6 percent last year to 4.4 percent. The sharpest increase was posted in WPI, which increased from 1.8 percent last year to 6.2 percent in FY01. This increase was driven by retail petroleum prices, utility charges, the depreciation of the Rupee and pre-emptive steps taken by suppliers to pass on the imposition of sales tax.

⁵ This involves a subset of LSM, which excludes the top five and five worst performers during the year.

Furthermore, the primary reason for low inflationary pressures last year (food items) reversed itself. The sharp increase in SPI during August to October indicates the pressure on basic food prices. Looking ahead, **Figure 3.1** indicates that inflationary pressure in the latter part of the year was again tapering off. In fact, an argument could be made that the low annualized rates posted in end-FY00, are underestimates, since the marginal pressure on prices was already on the rise. This situation seems to have reversed itself as FY01 ended with monthly rates pulling annualized rates lower. Retail prices of food items (which figure prominently in SPI), are stabilizing and some were even showing declines at the end of the year. With the downward trajectory of international oil prices at the end of the year, WPI should also start edging down. If this is the case, then inflationary pressures in FY02 may not be any higher than what was witnessed this year. The government's commitment to economic stabilization and a three-year IMF program (which will still focus on the fiscal imbalance), implies that inflationary pressures will not be stoked. This period may indicate a shift in price expectations that will allow the country to remain in a low inflationary regime.

Public Finance & Fiscal Policy

On the face of it, revenue slippages during the course of the stabilization program, suggests that fiscal reforms have not been successful. However, the targets were ambitious and even with slippages, realized revenues for the year are impressive. This is the second consecutive year that tax revenues have posted double digit growth, which signals an increase in real terms. The focus remains on sales tax, and despite the replacement of certain excise duties by sales tax, the combined growth of these two revenue heads was still 17.1 percent this year. Furthermore, direct taxes also showed strong growth (12.8 percent) compared to the mild increase of 2.5 percent last year. Given the difficulty of fiscal reforms, not just in terms of shifting tax incidence but also to change the mind-set of collectors and payers, these increases signal a credible change in Pakistan's fiscal stance. The reform of tax administration and the Central Board of Revenue (CBR), has become imperative if significant improvement in fiscal revenue is to be attained with a widening of the tax net.

In overall terms, the austerity of the stabilization program was able to contain the consolidated fiscal deficit to Rs 185.6 billion, which is Rs 18.5 billion less than last year. Although revenue collection has been impressive, this narrowing of the fiscal gap also required hard steps to contain expenditures. As shown in **Table 4.1**, total expenditures only edged up by Rs 1.4 billion, but the reprioritization allowed development spending to increase by Rs 14.4 billion during the year. Although this has increased its ratio to GDP from 2.8 to 2.9 percent, this at least shows a break from the past trend dating back 10 years. In this regard, FY01 should prove to be a turning point in terms of social/development spending.

Money & Credit

The simultaneous pursuit of macroeconomic stabilization and liberalization of the exchange rate regime, created a very strong link between the central bank's management of the foreign exchange market and its monetary policy. More specifically, the induced stability of the Rupee was dismantled, and given the urgent need to increase liquid reserves, SBP's ability to directly manage the foreign exchange market was severely curtailed. With the abrupt shift away from the Rupee/Dollar parity as the country's nominal anchor, SBP's monetary policy had to perform a totally new function – to signal, and in some cases, impose stability in the foreign exchange market. Owing to these prior actions, by end-September 2000, SBP was facing two challenges: (1) arrest the rapid depreciation of the Rupee, and (2) contain the growth of reserve money by shifting government borrowing from SBP's books to commercial banks.

In view of these fundamental changes, efforts to meet the challenges resulted in conflicting signals about the direction of SBP's monetary policy. For example, despite the peak off-take of private sector

credit in the second quarter of the year, the central bank had to increase both the discount rate and CRR in early October 2000, in an attempt to discipline speculative attacks on the Rupee. This led to severe liquidity shortages amongst the banks and pushed overnight call money rates to almost 100 percent in end-December. This meant that during the peak requirement for private sector credit, the market was squeezed to its limits. As a counterfactual exercise, it could be argued that although net disbursements of credit to the private sector was much higher compared to FY00, if conditions had been more *normal*, this could have been even higher.

In the second half of the year, as external financing from the IFIs started flowing in, and adjustment were made in subsequent end-quarter targets, some calm was restored in the markets. Although the Rupee continued to slide in the remaining part of FY01, it was less erratic and therefore less disruptive.

In aggregate terms, not only were money supply and inflation kept within their planned limits, the composition of monetary growth was an improvement over the set targets. In terms of figures, the Rs 125.4 billion growth in money supply was marginally higher than last year, but still below the Credit Plan target. More importantly, the composition of this growth was encouraging; 58 percent of the increase in domestic liquidity was on account of foreign assets, which corresponds to a build up in liquid reserves.

With lower lending to the government both in terms of budgetary support and commodity operations, net retirement of Rs 46.9 billion during the year facilitated private sector lending by commercial banks. This increased from Rs 15.4 billion last year to Rs 54.2 billion during FY01. The retirement of government debt exceeded what had been projected in the revised Credit Plan⁶, which allowed domestic credit expansion of only 3.6 percent during the year. This was possible on the strength of external and non-bank financing during the latter half of the year.

In terms of the composition of money supply, the growth of currency in circulation till the first half of FY01 (which was a cause of concern) has subsided somewhat. However, the increase in foreign currency accounts (FCAs) at the cost of Rupee deposits is a worrying development. Having said this, the growth in FCAs is a natural and combined result of the 18.6 percent Rupee depreciation and the failure of banks to attract Rupee deposits. This depreciation was able to over-compensate for the penal returns offered on FCAs.

The main increase in Rupee deposits (Rs 55 billion) was realized in the last two months of FY01. Although part of this increase is seasonal (window dressing for year ends), while the other factor was mandatory credit ratings of commercial banks starting end-June 2001, the back-to-back closure and start of fresh Dollar swaps in May/June played a role in this increase in deposits.⁷ This increase in domestic liquidity is reflected in *other items (net)*, while the remaining amount on account of SBP's reserves, is shown by the accumulation of the banking system's NFA (see **Table 5.1**).

Capital Markets

Pakistan's capital markets have shown mixed sentiments during the course of the year. In terms of the equity markets, the Karachi Stock Exchange (which is the leading indicator) posted no perceptible trend, while the bond market showed improvement. The floating of the Pakistan Investment Bond (PIB) posted lower long-term interest rates than the benchmark provided by NSS instruments, which encouraged local corporates and leasing companies to issue bonds. The need for long-term corporate

⁶ This incorporated the thrust of the stabilization program.

⁷ Closing swaps implies that Rupee liquidity is injected into the economy. If this increase is not held in the form of currency notes, it shows up in the banking system as deposits. However, such deposits are volatile and do not reflect a concerted effort on the part of banks to solicit Rupee deposits.

funding was spearheaded by the increasing popularity of leasing consumer durables (cars, motorcycles, kitchen appliances, etc.), which resulted in a large number of leasing companies issuing Term Finance Certificates (TFCs). As of now, of the 24 corporate bonds that currently exist in the market, 14 have been floated since July 2000.⁸

In terms of the equity market, initial optimism that a resolution of the Hubco issue was in the offing dissipated in early October, which started a gradual decline of the KSE-100 index. This bearish trend was reinforced by the poor results announced by PSO in mid-November, and the short selling of liquid scrips. This forced SECP to initially restrict such trades for Hubco, ICI, PTCL and PSO; this was extended to other scrips by early December. The signing of the SBA in November reversed this trend, but the underlying tension between SECP and the bourses, erupted in end-December when the Article of Association of KSE was amended to limit the discretionary power of board members of the stock exchanges. However, the most damaging development took place in February, when Merrill Lynch issued a warning that Pakistan would not be able to stay on-track with the IMF stabilization program. The resulting selling pressure from foreign fund managers, culminated in Morgan Stanley's decision to close its fund in the country. Such sentiments persisted for the rest of the year.

Balance of Payment & Exchange Rate Regime

For the first time in its history, Pakistan was able to show a current account *surplus* this year. However, this did not create easier conditions in the foreign exchange markets, as the Rupee experienced tremendous pressure during the course of the year. In fact, the surplus was generated by a statistical artifact – proceeds from the Saudi Oil Facility (SOF) were categorized as official transfers and therefore a current account receipt. The second contributing factor was purchases from the kerb market, which were US\$ 523 million higher compared to last year. Excluding the impact of the changing status of SOF and the volume of kerb purchases, the current account deficits for FY00 and FY01 were US\$ 2,641 and US\$ 2,509 million, respectively. Despite this marginal narrowing of the external gap, there was a great deal of pressure on the foreign exchange market; the main reason was the IMF stabilization program that was in place.

In broad terms, external financial conditions did improve somewhat compared to last year. Although international oil prices continued to impose a significant burden on Pakistan's oil bill (a record US\$ 3.4 billion, or 31.3 percent of the total import bill), the resumption of IFI assistance, an extension of the external debt rescheduling, and lower declines in export unit prices, allowed for a smaller *realized* trade deficit and easier financing. Given the import dependency of the country (not just for raw material but also for physical capital), the trade deficits posted since the mid-1990s are already constrained. With growing oil payments in the past three years, non-oil imports are being squeezed, which does not bode well for economic activity in the country.

While worker remittances have exceeded US\$ 1.0 billion this year, they are still below what was realized before June 1998. It is only when such inflows reach a significantly higher level (perhaps as much as US\$ 5 or 6 billion per annum) and export receipts show more than 10 percent annual growth over the next 3-5 years, will Pakistan be able to finance a larger trade deficit and *still* post a current account surplus.

Although the practice of kerb purchases is an unorthodox interim measure to shore up current transfers, it is far superior to the past practice of using FCAs or expensive commercial borrowing to finance the external deficit. To safeguard the interests of resident FCA holders, a number of steps have been taken. The placement option of these deposits with SBP has been withdrawn⁹, and an

⁸ Of this fourteen, six have been issued by leasing companies.

⁹ The stock of FE-25 lying with SBP has been returned to individual banks.

ordinance has been passed that will disable the government or SBP from freezing foreign currency accounts.

The narrowing of the trade deficit from US\$ 1.7 to US\$ 1.5 billion this year was driven by a 7.4 percent increase in the value of exports and a 4.1 percent increase in imports. In terms of inflows, the major sources of expansion were leather (hides and products) and non-traditional exports. The big gainers amongst non-traditional exports were chemicals & pharmaceuticals, petroleum, carpets and some smaller items. The mainstay of Pakistan's exports (yarn and fabrics) posted decline, while garments, bedware and towels showed higher revenues despite falling per-unit prices. Raw cotton experienced positive price and quantity effects, thereby increasing Pakistan's export revenues. Two consecutive bumper cotton crops have allowed Pakistan to increase the export quantum, but prices are still working against the country.

In terms of imports, excluding petroleum and industrial machinery (specifically textile), all other imports fell during the year. Other than the sharp depreciation of the Rupee, this also reflects the poor investment climate in the country. Despite the 14.3 percent increase in average oil prices compared to FY00, the quantum of crude imports increased by 53.9 percent, while 10.1 million tons of additional petroleum products were imported. This increase in demand was driven by the drought, which forced the country to substitute lost hydel generation of power with thermal units. With the oil bill increasing from US\$ 2.8 billion last year to US\$ 3.4 billion during FY01, non-oil imports were squeezed from US\$ 7.5 to US\$ 7.4 billion this year. As mentioned above, structural changes in the exchange rate regime, coupled with the need to increase liquid reserves, put upward pressure on the Rupee/Dollar parity, which may also have discouraged imports.

Although Pakistan's food import bill was almost stagnant in FY01, the savings realized from lower wheat imports (and to a lesser extent edible oil) allowed the country to increase sugar imports by US\$ 378.5 million to avert shortages following poor domestic production of sugarcane. The US\$ 159.2 million increase in textile machinery imports shown this year reflects the continuation of the BMR drive that started last year. The fall in imports of fertilizer and insecticides reflects substitution by domestic production (fertilizer) and the absence of any significant pest attack.

Pakistan's liquid reserves (excluding FE-25 deposits) increased from US\$ 991 million in end-June 2000 to US\$ 1,677 million at the end of FY01. This was achieved despite debt payments of over US\$ 4 billion that SBP made from its own resources during FY01. This accumulation of reserves was possible due to stepped up purchases from the kerb market and inflows from IFIs.

However, as discussed earlier, the most obvious development in Pakistan's external sector was the sharp depreciation of the Rupee/Dollar parity. The 18.6 percent depreciation during FY01 was the second largest since FY82, when the Rupee was moved to a managed float. In this regard, the loss of value was to be expected since SBP moved the exchange rate regime to a free float in July 2000. Nevertheless, the depreciation of the Rupee was not just on account of greater payments being directed into the interbank market, but the change in expectations of market participants. With the Rupee band dismantled, SBP actually increased its market *support* (one-sided injection to meet lumpy payments) compared to FY00, while its *intervention* (buy/sell on its discretion) was lower during FY01. Without the indicative price anchor that the band provided, market players attacked the Rupee several times during the year (especially in the first half), but then settled for a gradual but consistent depreciation.

The popular view that SBP purchases from the kerb market are responsible for the Rupee depreciation does not pass the test of rigorous analysis. The first point to realize is that SBP does not purchase from the interbank market, and therefore does not put pressure on this market. The second point to remember is that the kerb rate *follows* changes in the interbank rate. Third, SBP only purchases from

the kerb market when it is sure there are surplus funds in the market and this will not put pressure on the kerb premium. With an almost fixed Rupee wedge between the interbank and kerb rates, developments in the interbank market (more specifically the exchange rate regime) are responsible for this loss of the Rupee's value. After this difficult year for the interbank market, it is hoped that the stability witnessed in the first quarter of FY02, will remain.