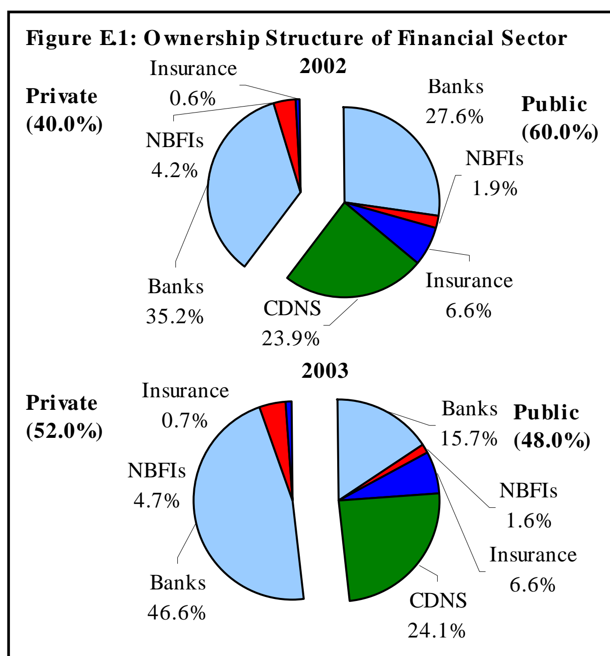
Executive Summary

Financial Sector and Regulatory Profile

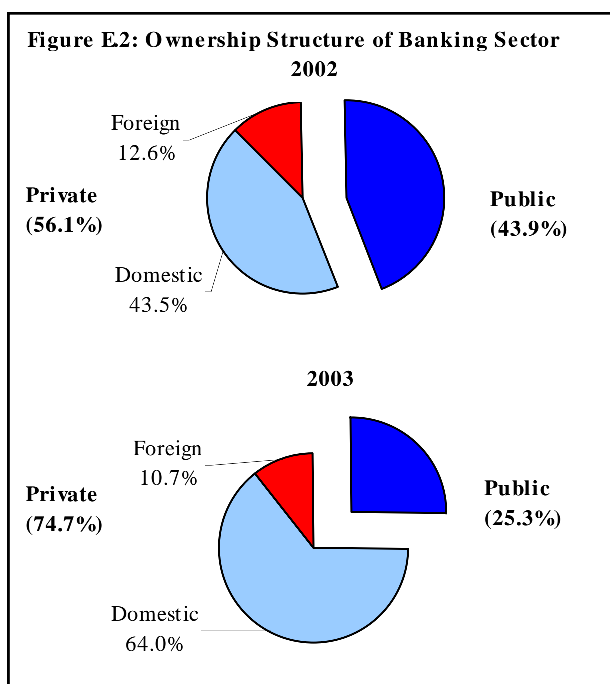
The private sector has become the dominant owner of the overall financial sector by the end of 2003 with an asset share of 52.0[1] percent up from 40.0[2] percent in 2002 (see **Figure E.1**)). Within the banking sector, the share of private domestic and foreign banks has grown to 74.7 percent (see **Figure E.2**). Not only has the ownership structure become more favorable for undertaking market-based financial activities, a competitive environment has also been firmly instilled in the financial landscape. Various financial indicators support this contention.

Figure E1: Ownership Structure of Financial Sector



The financial sector grew robustly during 2003 adding Rs 542.7 billion worth of assets which represent an increase of 15.3 percent over the asset base of 2002. Asset size at end-2003 was equivalent to 84.7 percent of the GDP of FY03 (at market prices). All the segments of the financial sector – banks, NBFIs, insurance industry and CDNS – simultaneously expanded their asset bases in relation to GDP. Deposits, advances and investments also experienced vigorous growth.

Figure E2: Ownership Structure of Banking Sector



Intermediation costs came down significantly during 2003 for the financial sector as a whole. Average spread for the financial sector declined to 4.4 percent in 2003 from 5.1 percent in 2002. Similarly, the net interest margin declined to 4.1 percent in 2003, from 4.4 percent a year earlier. Within the banking system, all six alternate measures[3] of spread not only declined in 2003 from their previous levels for different banking groups but there was a distinct trend of convergence towards a common level of spread as well. This is a very strong indication of an enhanced competitive environment within the banking system. Measures of banking concentration also depict an identical picture.

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[1] Including HBL that was privatized in February 2004.
[2] Excluding HBL.
[3] See chapter 3 for details.

Profitability of the financial sector also increased with the return on average assets (after tax) moving to 1.4 percent in 2003 compared with only 0.4 percent in 2002. Considering that the financial sector incurred a loss both in 2000 and 2001, the current performance is highly commendable. This assertion is also corroborated by the fact that the current level of return on average assets (after tax) is marginally higher than the generally accepted benchmark of 1.25 percent.

Capital adequacy of the financial sector has also strengthened during 2003 with the equity to liability ratio going up to 7.5 percent from 6.8 percent in 2002. Liquidity position of the financial sector also remained at a comfortable level, although the liquid assets to total assets ratio declined to 43.5 percent in 2003 from 44.9 percent a year earlier.

The flow of financial savings increased by Rs.381.7 billion during 2003 which represents 7.9 percent of GDP of FY03. Although the structure of financial savings remained almost the same as that of last year, except for the increase in share of banks' deposits from 48.5 to 50.9 percent and a decline in the share of government debt instruments by around 3 percentage points, there were signs of underlying qualitative changes, triggered by the high deposit growth together with the changing ownership of financial assets towards the private sector. Savers are increasingly exploring alternative instruments of savings. Decline in interest rates and the ban on institutional investment in NSS has contributed significantly to this change in investor preferences.

Payment system in 2003 remained in a transition phase. Automated and electronic means of financial transactions are gradually replacing the paper-based system. The use of credit, debit and ATM cards is growing rapidly. However, the value of transactions routed through ATMs is still very limited. Significant improvements in the payment system will only come about after the completion of the Real Time Gross Settlement System (RTGS) project, currently being implemented by SBP. Nevertheless, the Central Depository System (CDS) continued to make significant inroads in the trading and settlement of equities listed in the three stock exchanges of the country.

In short, not only did the overall financial sector improve significantly during 2003, its resilience to both internal and external shocks also became stronger. Moreover, an accommodative monetary policy stance with exchange rate stability equipped the financial system to adequately cater to the burgeoning credit needs of the economy. However, the easy availability of finance and the large investment portfolio of government securities has made the financial sector more vulnerable to credit and market risks.

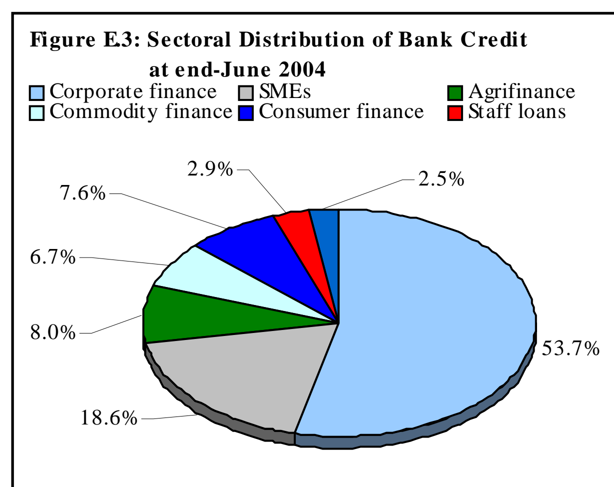
Nevertheless, the financial sector is currently much more sound and stable to successfully overcome these shocks. Both SBP and SECP are proactive in aligning their regulatory profile in a rapidly changing domestic and global financial environment. The process of refinement in prudential regulations is almost continuous and based on an actively-sought feedback from the financial sector stakeholders. Separate sets of regulations for corporate finance, SME finance, consumer finance, microfinance, NBFCs and insurance companies is a reflection of the changed mind-set of the supervisory authorities.

A new system of monitoring, surveillance and supervision, Institutional Risk Assessment Framework (IRAF) has been put in place by SBP in early 2004. This is aimed at ensuring a cohesive and proactive monitoring through preparation of risk profiles of individual institutions and taking prompt corrective action as and when called for. The risks associated with undertaking financial activities will always remain there, however the financial system in 2003 is adequately equipped to manage these risks.

Financial System Credit
There has been a tremendous growth of credit to the private sector during the last two years due to favorable demand and supply conditions in the credit market. SBP identified various relatively new sectors and provided requisite guidelines for banks' financing with the objective of giving a boost to the overall economy while maintaining prudential norms. Due to the historically low interest rates and a surge in the overall economic activities, credit demand from the traditional sectors also grew rapidly.

As shown in **Figure E.3**, the share of the corporate sector is now limited to only 53.7 percent of total credit. SME and consumer finance have a substantial share in overall credit at 18.6 percent and 7.6 percent respectively. The share of agriculture finance is 8.0 percent. Total agri-credit disbursement registered a remarkable improvement in volume, increasing to Rs 70.9 billion in FY04. Commercial banks have increased their share from 23.4 percent to 45.2 percent of total agri-credit while ZTBL's share shrank from 61.5 percent to 40.7 percent in the same period. Total disbursement by commercial banks was 46.2 percent higher than the target during FY04. The major shift is the enhanced role of commercial banks and PPCBL in agri financing, which resulted in gradual shifting of ZTBL's share to the commercial banks.

Figure E3: Sectoral Distribution of Bank Credit at end-June 2004



Moreover, consumer finance has grown sharply since June 2003, with an increase of 128 percent up to June 2004. Within consumer finance, the largest share belongs to personal loans which include financing for consumer durables. With respect to credit cards, currently two foreign banks hold the largest share of the market. Moreover, increasing demand for vehicles due to the availability of auto loans has been the driving force behind the strong growth of the automobile industry.

Given the longer tenors associated with housing finance, it is essential for the lending institutions to match the tenors of their liabilities and assets in order to avoid potential problems in case of default on these loans. Due to the lack of previous experience and relevant expertise in consumer credit analysis, banks also need to have adequate training facilities for their staff members responsible for managing the consumer finance portfolios. Well-managed consumerism is a healthy aspect of the economy, however banks need to be careful about devising and maintaining prudent risk management policies with respect to consumer loans.

In addition, the absence of a centralized credit information bureau, which maintains the credit history of all individuals availing such loans, continues to pose a problem for the further development of consumer finance. The risk here is that individuals can over-leverage themselves by taking several loans from various banks whereas each bank calculates the debt-burden profile based on its own loans. SBP has made it mandatory for all banks engaged in consumer finance to become a member of at least one consumer credit information bureau.

Scheduled banks largely cater to the working capital needs of the private sector; however they also extend fixed investment finance. The NBFIs in contrast, are an essential source of project financing albeit they also provide short-term finance. The overall credit extended by the scheduled banks increased from Rs 1,042.2 billion at the end of FY03 to Rs 1,350.9 billion at the end of FY04. The share of working capital and consumer finance provided by the scheduled banks in overall credit

increased during FY04. The SME sector has shown a tremendous growth in fixed investment finance during FY04. The aggregate of working capital and trade financing data reveals that the share of SME sector in the working capital finance grew from 29.1 percent at the end-June 2003 to 33.8 percent at the end-June 2004. Moreover, the share of agri credit, a part of which may be treated as working capital finance, declined during FY04.
Among NBFIs, DFIs have the largest share in overall advances and investments, followed by Mutual Funds and Leasing Companies in 2003.

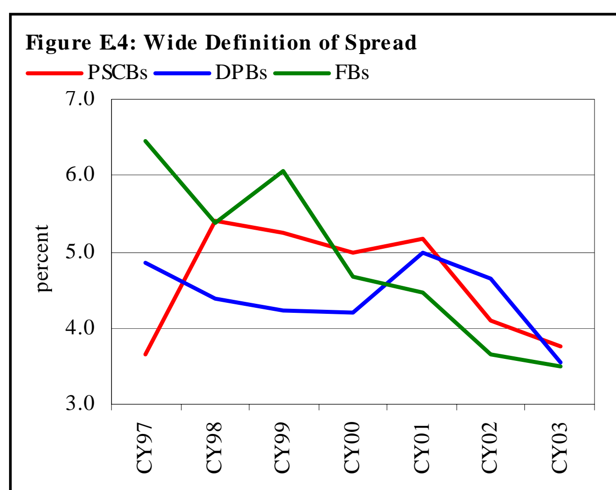
During the last two years, banks' lending to SMEs has increased substantially. Outstanding credit to SMEs has increased from Rs 145.5 billion in June 2003 to Rs 250.6 billion in June 2004. SBP, while closely monitoring the growing volume of SME finance and its associated risks, has also issued prudential regulations for SME finance. Micro finance is also gaining weight as an effective tool of social mobilization and poverty alleviation through market-oriented self-employment and income generation schemes. At present a variety of institutions are providing micro finance services, ranging from NGOs, to private and government sponsored rural support programs. Two commercial banks are also providing special lines of credit for the micro finance sector. Additionally, two specialized Micro Finance Institutions (MFIs) are operating in the country. MFIs have expanded their branch network to 56 by the end of CY03. Since their inception, these two MFIs have extended 207,120 micro loans, disbursing an amount of Rs 2,258 million to 145,000 borrowers. MFIs' advances increased by 49.3 percent during CY03. Interestingly, one-third of the total MFI clients are female, whereas the livestock sector has the major share in advances followed by micro enterprises and agri inputs.

The past few decades have witnessed a significant expansion of the Islamic financing industry on a global basis. In response to the three-pronged strategy defined by SBP, a number of banks have showed interest in setting up stand-alone branches and until end-May 2004, 9 branches have started operations, managed by four banks. As on June 30, 2004, licenses for 13 Islamic banking branches have been issued to 5 commercial banks. For financing purpose, Islamic banks are using a wide range of products including corporate Ijarah, consumer Ijarah, trade/project financing, export and import Morabaha financing etc. The assets of the Islamic banks and Islamic banking branches of conventional banks have almost doubled from Rs 33 billion in FY01 to Rs 68.4 billion during FY03.

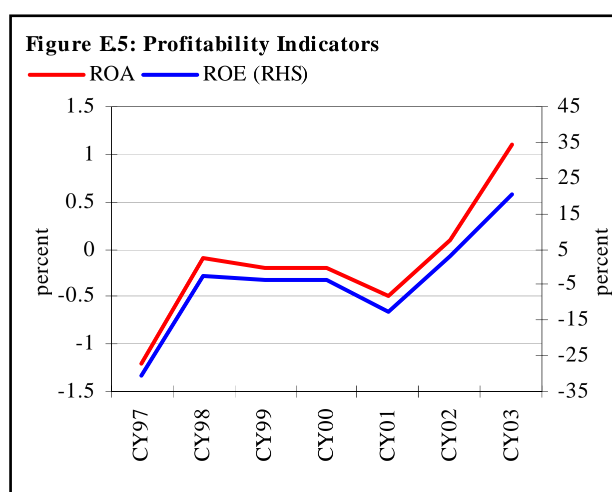
Ownership, Spreads And Profitability of Banking System

The structure of the banking system underwent significant changes after FY97 when the banking supervision process was aligned with international best practices. Privatization of public sector commercial banks and the ongoing process of mergers/consolidation brought visible changes in the ownership structure, and concentration within the sector. While analyzing a number of concentration indicators, i.e. Lorenz curve, Gini coefficient, M-concentration ratios, Herfindahl index and coefficient of variation of major banking variables, it is evident that market concentration in the banking sector has significantly declined from CY97 to CY03. This more equitable sharing has contributed to increased competition in the market and has provided a more level playing field for the participants. In the years to come, banking sector concentration is likely to decline further given the aggressive

Figure E4: Wide Definition of Spread



marketing strategy adopted by the private banks and the continued process of mergers and acquisition of relatively smaller banks with other institutions.
The cost of intermediation, which is an important indicator of efficiency of the banking sector, has declined significantly since CY97. Although the level of intermediation measured by alternative definitions available in finance literature differs, the resulting trend is seen to be declining in general. A significant variation among the banking groups is also visible while using different definitions of spreads, which reflects the differences in business strategies, clientele, response to policy changes, degree of competition, etc between banks. Furthermore, group-wise spreads also show a converging trend towards smaller and common numeric values. More specifically, the variation in spreads has come down from 280 basis points in CY 97 to only 30 basis points in CY03 (see **Figure E.4**).[4] which is a strong indication of increased competitiveness.



Profitability of the banks has also increased considerably, particularly during the last two years (see **Figure E.5**). This was due to a significant increase in the surplus on revaluation of assets resulting from declining interest rates, although increase in earnings from core business and decline in expenses on provisions also contributed to profitability increase. Nonetheless, it is important to mention that the exclusion of capital gains from the income of banks reduces the return on average assets by 0.8 percentage points for FY03. Although the high levels of profitability observed in the recent two years may not be sustained, the financial system is, nevertheless, expected to continue with positive profits in future.

Performance of Non-Bank Financial Institutions

FY03 has been a productive year for the NBFI sector given its significant performance with respect to assets (growth of 28.2 percent), deposits (growth of 23.1 percent) and advances (growth of 14.3 percent), over FY02. This is primarily due to the fact that during FY03, the NBFI sector has had a chance to build on the benefits of the restructuring and consolidation process initiated earlier. The consolidation process across the various sub-sectors continued during the year which saw the formalization of a few mergers and acquisitions among leasing companies, modarabas, mutual funds and investment banks.

The number of operative DFIs has reduced further in FY03, and their share in total NBFI assets reduced by 2.3 percentage points, however it continues to retain its dominant position in the sector with an almost 32 percent share of total assets. The key financial indicators of the DFI group reflect a healthy situation as at end-FY03. Assets have grown by 19.5 percent, the capital to liability ratio has strengthened, expenses have declined considerably and both the return on assets and equity has shown a remarkable improvement (see **Figure E 6**).

[4] Wide definition of spread is ((interest received/average interest bearing assets) – (interest paid/average interest bearing liabilities))*100

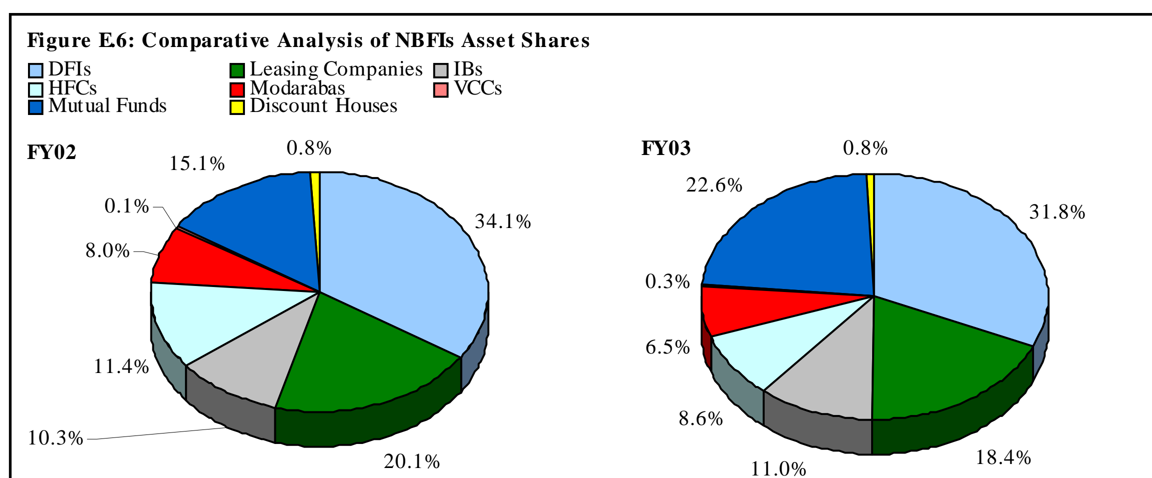


Figure E6: Comparative Analysis of NBFIs Asset Shares

Investment Banks, on the other hand, have registered an increase in the share of assets in FY03, despite the reduction in the total number of these institutions. Investment banks continued to be in a state of flux in FY03, with an increased focus on consolidation and expansion of business under the NBFC umbrella. Financial indicators of this group depict an improved performance in comparison to FY02.

A reason for concern in case of both DFIs and investment banks is the increasing proportion of investments in their total earning assets base. In case of DFIs, investments in equity and government securities now constitute over 60 percent of total earning assets, in comparison to the declining proportion of advances at 25.6 percent. The investments to earning assets ratio for investment banks was 67 percent in FY03.

Leasing companies continued to perform well in FY03, despite a difficult operating environment given the increased competition from commercial banks, which reflects their remarkable resilience to adverse developments. Their share in total assets has reduced marginally by 1.7 percentage points in FY03 with the share of lease finance at around 83 percent of earning assets.

The Modaraba sector has shown a declining share in total assets since FY90 and FY03 was no exception. This is despite the fact that modarabas constitute the largest group in the NBFI sector in terms of the numbers of functioning entities. As evidenced by the financial health indicators, expenses remained high and earning assets to total assets continued to decline in FY03. Moreover, the growth rate of both capital and assets has also visibly slowed down.

Housing Finance Companies faced an increasingly challenging environment in FY03 given the aggressive stance of commercial banks in mortgage financing, due to which the share of their assets declined by 2.8 percentage points. Moreover NPLs continue to be a problem for HBFC, the major player in this group of companies. However with the repayment / recovery incentives given in the federal budget 2004-05, in addition to the recently introduced housing finance schemes by HBFC, the future outlook for this sector is expected to improve.

Mutual Funds have registered a remarkable growth in FY03 and their share in total assets has increased to 22.6 percent, as compared to 15.1 percent in FY02. This was primarily due to the low interest rates and exceptional performance of the capital markets in the country. It is quite evident from their performance that mutual funds are gaining ground as a lucrative investment option by investors.

Whereas venture capital companies have shown slightly increased activity in FY03, discount houses did not show any improvement in terms of performance.

Review of Insurance Industry

The insurance industry plays a very significant role in the overall development of an economy by managing and indemnifying financial risk and by serving as a major institutional investor for capital and money market instruments. The concentration of insurance in the overall financial system depends on the demand and supply of insurance services. The demand for insurance depends on the macro-economic environment, cultural and religious aspects and the individual need for financial security. The supply of insurance of many financial products is primarily related to the availability of insurance services, and there is a more than adequate supply in the local market.

The insurance industry is classified into non-life and life insurance in terms of the types of products offered. The total number of companies operating in the market has decreased from 63 in CY00 to 54 in CY03, whereas the total assets of the industry have grown by 14.3 and 15.2 percent in CY02 and CY03 respectively. The asset structure is heavily skewed towards state owned insurance companies in both non-life and life insurance. The share of State Life Insurance Corporation (SLIC) was 74.0 percent in the total assets of the entire industry in CY01 which has reduced to 70.5 percent in CY03. Moreover, in non-life insurance, National Insurance Company (NICL) occupied a 10.3 percent share of total assets in CY01 which decreased to 9.6 percent in CY03. In addition to the insurance industry, the country also has one Reinsurance company, which exclusively acts as a reinsurer to the non-life insurance companies. The total assets of Pakistan Reinsurance Company have grown by an average rate of 37.2 percent over CY01-CY03.

The number of non-life insurance companies has decreased from 58 in CY00 to 49 in CY03 mainly due to the losses incurred by them. Furthermore, in line with regulatory requirements, it was mandatory for a non-life insurance company to have a minimum paid-up capital of Rs 50 million by the end of CY02 and to increase the minimum paid-up capital to Rs 80 million by the end of CY04. In this respect, some non-life insurance companies have merged to maintain the required paid-up capital level. The composition of non-life insurance industry has shown an increasing trend towards the private domestic and foreign companies in terms of the share of total assets, investments and net premiums, with a reduction in the share of NICL. The structure of the non-life industry may be regarded as highly oligopolistic with only ten companies accounting for almost 90 percent of total insurance business, in the form of net and gross premiums. The accumulation of total net premiums by the non-life insurance companies increased by 12.4 percent and 10.5 percent during CY02 and CY03 respectively. Moreover, the claim ratio declined from 56.2 percent in CY02 to 54.1 percent in CY03.

Profits declined by 12.3 percent in CY01 mainly because of high reinsurance cost subsequent to 9/11 and associated events. Profitability increased in CY02 to 80.4 percent but again fell by 3.3 percent in CY03 due to an increase in underwriting expenses and increased reinsurance cost.

In contrast to the non-life market, there are only 5 companies in the life insurance industry including the government owned State Life Insurance Corporation (SLIC), which enjoys a near monopoly status on account of its share in total assets, investments and insurance premiums in comparison with other companies. The share of SLIC in total equity has decreased from 66.4 percent in CY01 to 64.4 percent in CY03 whereas the share of private companies has significantly increased from 14.7 percent in CY01 to 28.5 percent in CY03.

The share of first year premium to gross premium, which serves as a benchmark for the development of life insurance in the economy, has increased by 17.1 percent during CY02 and 18.5 percent during CY03. Much of this growth has been led by private companies which have come up with new

product offerings and have diversified their businesses. The total gross premium of life insurance companies has been augmented by 23.8 percent in CY02 and 26.3 percent in CY03, whereas the claims ratio has improved from 72.7 percent in CY01 to 53.9 percent in CY02 and further to 52.8 percent in CY03.

As an institutional investor, the life insurance companies have accumulated investments at an average growth rate of 13.3 percent over CY01-CY03. Meanwhile, the return on investment has registered a decline of 9.7 percent in CY03 over CY02. This reduction severely affected the profitability of the life insurance companies which registered a negative growth in CY02 of 18.4 percent followed by a significant improvement of 60.2 percent in CY03 due to a decline in the net claims ratio along with a reduction in management and underwriting expenses as a percentage of gross premiums.

NSS and Social Protection Funds

The outstanding level of investments in NSS almost stagnated during FY04 at the preceding year level after showing an unabated increase over the past many years. Composition of investment in NSS has also shown a moderate change due to introduction of Pensioner's Benefit Account and Bahbood Saving Certificates[5] that started the process of shifting of funds from old schemes to newer ones (see **Table E.1**). This shift also aided the decline in NSS profit rates brought about by their alignment with PIB yields. There seems to be a prominent switch between Regular Income Certificates with Bahbood Saving Certificates and Pensioner's Benefit Account. Moreover, Prize bonds have also captured a larger share. Although the shares of the new schemes are small in percentage terms, they are likely to gain importance with time. Nevertheless, their share is unlikely to increase rapidly due to the targeted nature of these schemes.

Funds mobilized through NSS have also been an important source for the financing of budget deficit beside funds generated through external resources and from the banking system. Consequently, National Saving Schemes (NSS) have had an increasing share in the domestic debt which reached around 50 percent in FY03. This was due to the attractive rates of return on these schemes particularly during the 1990s as opposed to other investment opportunities. The outstanding amount as a proportion of GDP has also increased from 13.4 percent during FY93 to 21.8 during FY04 (upto May).

Table E.1: Composition of Outstanding NSS
shares in percent

	FY03	FY04
Defence Saving Certificates	31.5	31.8
Special Saving Cert.(Reg.)	29.9	28.6
Regular Income Certificates	17.8	12.8
Bahbood Saving Certificates	--	2.3
Special Saving Accounts	5.3	5.5
Pensioners' Benefit Account	1.0	2.4
National Prize Bonds	13.2	15.5
Others	1.3	1.1
Total	100.0	100.0
Amount Outstanding (billion Rs)	982.5	982.7

The Social Protection System in Pakistan covers old-age, invalidity and widow pensions and health care governed by the Employees' Old-Age Benefits Institution (EOBI). The other social protection measures include Workers' Welfare Fund (WWF) and Workers' Participation Fund (WPF) managed by the Ministry of Labor. The objective of the Workers' Welfare Fund is to allocate funds for development projects and other welfare measures. On the other hand, the objective of the Workers' Participation Fund is to distribute profit amongst low salaried workers and to provide funds for other welfare measures.

Benefits paid by EOBI in terms of pensions have increased from Rs 914.4 million in FY00 to Rs 1,591.7 million in FY03. This was enabled by the size of EOBI fund rising from Rs 41,514 million to Rs 69,419 million during the same period. However, the last actuarial valuation of the fund (carried

[5] Pensioner's Benefit Account and Bahbood Saving Certificates were started during January, FY03 and July, FY04 respectively.

out on June 30, 2002) showed that the existing EOBI scheme is not financially viable. Valuation indicated that the Fund would start depleting from the year 2024 and will become negative in 2035. Adequate amendments in the scheme are currently being explored by EOBI to make it viable.

Under the scheme of Workers' Welfare Fund (WWF) every industrial establishment in the private sector is required to deposit 2 percent of assessable income exceeding Rs 100,000 in an accounting year to the Ministry of Labor. The other source of income of WWF is the leftover amount of Workers' Participation Fund (WPF) and income from investment by WWF. The funds under WWF are utilized for development projects for welfare of workers at provincial level. The governing body of WWF allocates funds to provincial governments for the welfare of workers particularly for the establishment of labor colonies, schools and health facilities. **Table E.2** shows the amounts released to provincial governments from WWF during the past two fiscal years.

Table E.2: Amounts Released from WWF

million Rs

	FY03	FY04
Punjab	570.9	550.8
Sindh	366.2	600.6
NWFP	119.9	263.2
Balochistan	121.7	137.9
Total	1,178.70	1,552.40

Under the Companies Profits (Workers' Participation) Act, 1968 and Rules, 1971, every registered company, with 100 or more employees, is required by law to establish a Workers' Participation Fund by paying 5 percent of its net profit to this fund. Annual income of the fund, including capital gains, are distributed by the company each year to its workers in proportion to their unit of entitlement based on their average monthly wages. The leftover portion of these funds is deposited to the Ministry of Labor, which is then transferred to the Ministry of Finance for a further transfer to the Workers' Welfare Fund (WWF).

Table E.3 shows the utilization from WPF during FY03 and FY04. It is apparent that the leftover amounts are much larger, which are deposited to WWF. There seems to be a considerable room for improvement in the utilization efficiency of both Workers' Welfare Fund and the Workers' Participation Fund.

Table E.3: Amounts Utilized from WPF

million Rupees

	FY03	FY04
Allocated	5,726	4,989
Distributed	1,292	936
Leftover	4,434	4,053
Workers Benefited (thousand)	330.1	778.2

Activities of Financial Markets

The renewed expectations of rise in the interest rates, trend reversal of the exchange rates and credit off take were the distinct developments of money and forex market during FY04 as compared to the preceding two years. On the other hand, Capital market continued to show a remarkable growth, breaking all the previous highs of the index level as well as turnover of shares (see **Table E.4**).

The expectations of a hike in interest rates developed around September 2003 due to the reducing current account surplus. The growing need of bank borrowing by the government in early 2004 due to prepayment of expensive external debt and lower receipts of NSS strengthened the market views about the eventual rise in interest rates. Moreover, the mounting inflationary pressures, depreciation of Rupee, two episodes of unexpectedly large PIB auctions and rise in international rates also fuelled market expectations.

Despite being aware of these developments, SBP chose the path of a gradual tightening of monetary policy since May 2004 because: (1) a rapid upward adjustment in interest rates was likely to hamper the growth prospects, (2) the decline in the current account in FY04 was expected and more importantly it was still important for SBP to keep the policy stance unchanged, (3) SBP brought the

NDA within manageable limits through OMOs[6], and (4) the growing inflation was mainly driven by food supply, which generally is not impacted by monetary policy.

Table E 4: Key Fundamentals of Financial Markets		
	FY03	**FY04**
Forex Market		
Amount in US$ million		
Current Account Balance	4,070	1,806
Remittances	4,237	3,872
Trade Deficit	-1,060	-3,278
Exchange Rate end-June (Rs/US$)	57.80	58.17
Appreciation/Depreciation (in percent)	3.74	-0.65
Money Market		
All in percent		
6-month Yield	1.7	2.3
Discount Rate	7.5	7.5
EFS Rate	2.0	2.0
6- month LIBOR	1.12	1.9
CPI Inflation Rate	3.1	4.6
Capital Market		
	CY03	**H1-CY04**
No. of Listed Companies	701	666
KSE-100 Index- High	4,604.0	5,620.7
Market Capitalization (in billion Rs)	951.4	1,474.6
Average Volume per Day (Shares in milion)	308.8	414.8

Despite the sharp fall in the trading of the 6-month T-bills, the volumes in the secondary markets further increased in FY04 mainly due to PIB trading. The larger activity in long-term instruments was probably driven by the increase in the stock of PIB in FY04. Similarly, the decline in 6-month T-bills trading was primarily due to lesser issue of 6-month paper. The lower amount offered in T-bill auctions in FY04 was largely due to: (1) remarkable growth of credit to private sector, (2) market players in anticipation of higher rates in subsequent auctions bidding less, (3) large issues of long term bonds in the second half of 2003, and (4) lower SBP net purchases consequently reducing Rupee injections.

Despite a reasonable amount of inflows, external accounts aggravated in FY04 due to larger outflows resulting in pressures on exchange rate. As a result, the Rupee Dollar parity saw a reversal in November 2003 and Rupee depreciated by 1.68 percent in FY04. Moreover, the year ended on positive note as transition of moneychanger business into exchange companies was successfully completed. Specifically, since promulgation of ordinance on July 30, 2002 and later permission to form exchange company ‘B’ on June 7, 2004, a total of 18 exchange companies (EC) and 33 exchange companies (B) have been issued licenses. Out of these, 17 EC and 24 EC (B) were in operation as end of June 2004, with branches/booths across Pakistan for efficient and easy access to customers.

The pressures on the exchange rate are the consequence of exceptional trade deficit, higher shipment and travel expenses, prepayment of expensive debt, and retirement of forex loans. In effect, the drying up of external flows, coupled with rising inflation, fueled market sentiments and also accelerated Rupee depreciation expectations.

One encouraging aspect of the outflows which caused moderate exchange rate pressures was that they were mostly one-off in nature, for instance, the repayment of expensive loans. Another positive aspect was that the increased outflows were due to the higher imports of machinery and raw materials which supported a robust growth in the large-scale manufacturing sector.

The considerable growth in capital markets in 2003 carried through in early 2004. The growth of 59.9 percent in equity markets during CY03 was followed by a 55.0 percent growth in the first half of 2004. Other measures of the equity markets such as total turnover, average turnover and more importantly, new floatation[7], also indicate a positive picture of the capital market.

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[6] As against small net absorption of Rs.12.2 billion in FY03, FY04 witnessed larger net absorption of Rs.211.9 billion.

[7] FY04 witnessed 17 flotation (including IPOs) compared with 4 each in FY02 and FY03

In fact, considerable improvements were seen in the indicators of all the three stock exchanges in Pakistan during FY04. This largely resulted from: (1) good corporate earnings, (2) restoration of investors' confidence due to improvement in macro economic environment, (3) restoration of political ties with neighboring countries, and (4) the expectations of political stability and continuity of economic policies. In terms of size and liquidity, the oil and gas exploration sector ranked first followed by the cement sector.

However, in contrast to the previous years (FY01-FY03) new issues in the corporate debt market fell by 69.4 percent during FY04. This reversal in corporate debt market was probably attributable to the availability of cheaper finance from the commercial banks.

Financial Development, Economic Stability and Growth

Financial development is generally considered to be an important factor for the promotion and sustenance of economic growth. However, macroeconomic stability becomes a pre-requisite in order for the finance-growth nexus to become firmly established in the economy. This stability supports the financial services in expanding their depth and outreach to eventually boost and sustain real economic activities.

The year 2003 witnessed a broad-based recovery which helped real GDP to grow by 6.4 percent in FY04. Although the higher growth trajectory has resulted in inching up the average level of prices and the aggregate demand, the rate of inflation is still low as compared to historical levels. Despite the current pressures on prices, the outlook for inflation is lower than the estimated threshold level of inflation for developing countries[8]. This indicates that the actual GDP is still lower than our potential output. The relatively larger monetary expansion in the past two years also has to be seen in this context. A gradual deceleration of money supply is likely to sustain the macroeconomic stability that was achieved in the last few years while containing a further build-up of a monetary overhang.

The pace of growth of GDP is likely to continue in the medium term. Credit expansion in the private sector is now playing a much more important role in sustaining economic growth. In order to manage the credit risks in a booming economy, both SBP and SECP have already introduced new sets of prudential regulations for the various segments of financing, which provide substantial safeguards for the banks and NBFCs not to indulge in taking irrational exposures. Hence, the economy is now less vulnerable to various shocks emanating from the real sector.

Besides a good performance in real GDP growth and adequate expansion in monetary and credit aggregates (within the context of expanding economic activities), recent trends in other macroeconomic indicators have also contributed in strengthening the stable economic environment. Moreover, fiscal prudence is evident from declining budget deficits, adequate current account balances, reduced debt and debt servicing burden, stable exchange rate and rising reserves of hard currency. Differential between domestic and international interest rates has also come down in recent years and is quite stable presently. Vulnerability aspects of equity market are now being addressed vigorously by SECP; gradual phasing out of badla financing by December 2004 is a step in this direction.

With a stable macroeconomic environment it becomes easier for the financial services to quickly transmit their growth promoting impacts to the real sector. This works through both quantitative and qualitative channels. The former works through financial deepening and capital accumulation, while the latter through the distributive efficiency of capital and increases in productivity. Different indicators of financial sector development and depth have shown improvement in recent years; ratios

[8] Threshold level of inflation is the rate at which the rate of unemployment is minimum and growth rate of GDP is maximum for an economy. Estimated threshold average for developing countries is around 11 percent.

of M2, financial assets and stock market capitalization to GDP have increased. These indicators are also positively correlated with GDP growth, total factor productivity and incremental capital. This indicates that both the quantity and quality channels are functional in our economy. In fact the quality channel that works through the impact of financial development on increases in productivity and capital intensity is quite strong in our economy. This again shows that our potential GDP is much higher than the actual level and financial development will go a long way in realizing this potential.

A comparison with select peer countries (India, Bangladesh, Sri Lanka, Philippines, Thailand, Turkey, Malaysia and Korea) indicates that the financial sector still needs to be developed further not only in order to keep pace with other countries in the region but also to realize the potential gains from increasingly integrated financial markets in a globalized economy.