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# THE STATE OF PAKISTAN'S ECONOMY

*Second Quarterly Report for FY02*

## 1. Overview

Pakistan was able to record a historical overall surplus of about US$ 1.2 billion on its balance of payments during the first six months of FY02 despite the shock and aftermath of September 11 event, deepening of the world recession and the tension with neighboring India. Although the US-led war against terrorism had created significant uncertainty in Pakistan's economy in terms of a potentially adverse political fallout, the stance taken by Pakistan and the fact that the Afghanistan campaign effectively ended in December, allowed the government to maintain domestic calm, reestablish its international status and also gain from certain windfalls. In terms of the latter, the sharp turnaround in domestic sentiments concerning the external sector is adequately reflected in the appreciation of the Rupee and the unprecedented increase in liquid foreign exchange reserves. Although the donor support to Pakistan for the war effort figures prominently in this build up, the reverse capital flight and stronger inflow of worker remittances also contributed significantly.

**Table 1.1: Quarterly Economic Indicators**

percent

| | July-December | | |
|---|---|---|---|
| **Growth rates** | **FY00** | **FY01** | **FY02** |
| Large-scale manufacturing | 8.0 | 2.0 | 2.9 |
| Exports | 8.1 | 8.4 | -0.4 |
| Imports | 11.7 | 10.2 | -9.6 |
| Home remittances[1] | -22.3 | 16.6 | 96.4 |
| Tax revenues | 20.8 | 13.5 | -4.1 |
| CPI (H1 over H1) | 3.4 | 4.9 | 2.3 |
| Private sector credit | 4.3 | 14.0 | 6.2 |
| Money supply (M2) | 2.8 | 5.4 | 8.1 |
| Liquid foreign exchange reserves* | 1466 | 1438 | 4814 |
| Foreign private investment[2] | 277 | 75 | 148 |
| *As % of GDP*[3] | | | |
| Fiscal deficit | 6.4 | 5.3 | 4.9 |
| Trade deficit | 2.8 | 2.6 | 418* |
| Current a/c balance | -0.4 | 0.6 | 1276* |

[1] Excluding compensation on a/c of Kuwait war affectees & Hajj receipts.
[2] Net flows in million US Dollar.
[3] Numbers relate to full year.
* Numbers correspond to end December amount in million US Dollar.

Despite the impressive balance of payments (BOP) outturn in the first six months, it is too premature to declare victory. More specifically, it is difficult to disentangle the temporary or transitory factors from the structural shifts as a number of underlying parameters have changed in the post September 11 period: global recession has worsened; Pakistan's trading relations were disrupted due to the war in Afghanistan; the exchange rate differential between the kerb and interbank market disappeared; world petroleum prices have declined; and smuggling to Afghanistan has dwindled. In effect, the continuation of these trends in future months will determine the balance of payments outcome for the fiscal year. Yet there are some structural shifts that can already be factored in. For example, in addition to commitments for external grants and concessional loans, Paris club creditors have approved the relief on debt servicing of about US$ 1 billion during the current fiscal year. Also, increase in quota and reduction in tariff by the European Union will lead to some modest improvement in exports.

While the setback in terms of fiscal revenues, exports, and to some extent, industrial production was significant, the mind-set change in the external sector allowed for an unprecedented surplus in the current account.[1] More specifically, the sharp fall in the import bill has actually reduced the trade deficit, despite a fall of 0.4 percent in exports during the first half of FY02. Falling international oil prices and lower quantitative imports of POL, have not only reduced Pakistan's import bill in Dollar terms, but still allowed for higher non-oil/non-food imports into the country, compared to the corresponding period last year. Furthermore, the gain in the external sector has paved the way to address the long-standing structural distortions created by the parallel foreign exchange market (Hundi). The first step towards merging the interbank and Hundi markets will take place in July 2002, as foreign exchange companies will come into existence.

The enhanced international stature of Pakistan also helped secure favorable terms in the restructuring of its bilateral external debt. For example, the recent US proposal to write off approximately US$ 1 billion of its bilateral loans to Pakistan, has resulted in better terms than had been negotiated with Paris Club members in the past.[2]

More broadly, prudent macroeconomic management allowed for the successful completion of the Stand-By Arrangement (SBA) in September 2001, which in turn helped Pakistan negotiate a Poverty Reduction and Growth Facility (PRGF)

[1] The robustness of the underlying current account surplus was tested by excluding the exceptional grant of US$ 600 million and the Saudi Oil facility of US$ 300 million. Despite these exclusions the current account surplus was still US$ 376 million.
[2] In fact, this write off proposed by the US is over and above the rescheduling agreement that had been secured in Pakistan's negotiations with the Paris Club in mid-December 2001.

with the IMF in November.[3] This attainment of macroeconomic stability and enforcement of fiscal and monetary discipline allowed the country to absorb the shock of September 11 smoothly and with ease. Unlike past episodes when Rupee came under severe pressure, the exchange rate in fact appreciated by almost 6.5 percent in the post September 11 period. This allowed SBP to continue relaxing monetary policy by reducing T-bill rates significantly during the course of Q2-FY02. Although exporters have benefited (export finance rates fell by 300 basis points to 10 percent by December 2001[4]), banks have not been able to pass on this saving to middle market borrowers.

The developments in the external sector have also improved the outlook for foreign direct and portfolio investment, which has been reflected in the upgrading of Pakistan's credit rating by Moody's. In fact, net foreign investment already increased by US$ 148.0 million during the first half of FY02, compared with an increase of US$ 74.7 million during the corresponding half of the previous year. Stock markets performed well during the second quarter of FY02, which attracted foreign portfolio investment.

Despite the increased foreign assistance and favorable external developments, the outlook on domestic growth, investment, budgetary revenues and employment still does not show perceptible signs of improvement. This reinforces our belief that the favorable external sector outcome should not lull us in a false sense of complacency. The improvement in creditworthiness following Paris Club agreement, on-going implementation of PRGF, and reserve accumulation should provide sufficient signals for expected turnaround in the real sector of the economy during H2-FY02. But this is still not obvious and cannot be taken for granted. There are still many unknowns and imponderables such as the performance of textile sector, the size of wheat crop, resumption of export business etc.

Exports are likely to decline further in the second half of FY02 because of the lagged impact of cancelled export orders and less than anticipated access to western markets (especially the US). Although growth in large-scale manufacturing during the second half of FY02 is likely to be shored up by stronger value addition in sugar, the extent of this rebound will also depend on the performance of the textile sector.

[3] A very strong argument can be made that had the events of September 11 not taken place, Pakistan was still on its way to secure the PRGF.
[4] As monetary policy has continued to ease in 2002, export finance rates have fallen further to 7.5 percent in March 2002.

Looking ahead, Pakistan should not deviate for a moment from the course of economic reforms and restructuring that aimed at enhancing the competitiveness of its real and financial sectors. In particular, it should continue the process of building its institutional strengths and improving economic fundamentals, and reduce the perceived country risk. This would require a three pronged approach: continued implementation of prudent macroeconomic policies; vigorous pursuit of sectoral reforms; and focused interventions for poverty alleviation.

Macroeconomic stability should be maintained by gradually reducing the fiscal and current account deficits, and keeping the inflation low. In this respect, the restructuring of CBR is of foremost importance to strengthen revenues and enhance tax bases. Sectoral and macroeconomic reforms should be intensified to make the economic structure more adaptive and responsive to changing domestic and external environment. Accordingly, the privatization process should be speeded up, especially by transferring UBL and KESC to the private sector in the short-term, and making other institutions ready for this exercise. Poverty alleviation agenda should be implemented through broad-based economic growth, investment in human development and targeted interventions.

More importantly, gains from improved economic governance, which are possible through provision of level playing field, transparency in decision-making, and predictability and continuity of economic policies should be institutionalized. This is a long and daunting agenda and temporary gains should not distract us from pursuing reforms vigorously.

## Executive Summary

Some of the most extraordinary results realized during the first half of FY02, took place in the external sector. Other important developments were largely an impact of changes in balance of payment on other sectors such as money and banking. Noticeable shifts also occurred in the trend and composition of total debt that resulted into important savings in terms of reduced future obligations.

## Real Sector

### *Agriculture*

Agriculture sector remained the most important determinant of overall growth for the economy. Preliminary estimates show that the major crops are likely to grow by only 1.2 percent if wheat crop results in targeted production of 20 million tons. This should enable the agriculture sector to attain the growth to around 2.5

percent for FY02, if minor crops and livestock sector maintain their last year growth and fishing and forestry do not show a decline. It may be recalled that the agriculture sector recorded a negative growth of 2.5 percent during FY01.

Looming specter of drought continued to haunt farming activities. Rice crop showed a decline of 21.2 percent, unprecedented since FY74, that reduced the crop size to just under 3.8 million tons, even lower than that attained in FY94. Severe infestation of bollworm in Punjab reduced the total cotton crop by 1.6 percent. Hopes for recovery in major crops now depend largely on wheat crop currently under critical growing stage and in need of timely rains.

***Large Scale Manufacturing***

Overall growth in large-scale manufacturing (LSM) sector increased marginally from 2.0 percent during H1-FY01 to 2.9 percent in the first half of current fiscal year. However, it would be premature to interpret it as a sign of improvement. Alternative indicators of growth that are more relevant for comparing the half-yearly growth of LSM seem to indicate marked deceleration in manufacturing activities.

Trimmed growth indicates a slowdown from 6.6 percent in H1-FY01 to only 1.0 percent during the same period this year. Similarly, growth excluding sugar decelerated from 6.7 percent to 3.8 percent in respective periods. However, the future prospects remain positive because of late crushing of sugarcane. Full year growth is, therefore, likely to go up. The extent of gain, however, will also depend on the performance of textiles that are export driven. Prospects of reconstruction in Afghanistan may spur production, especially of cement, in the second half of current fiscal year and onwards.

**External Sector**

The balance of payments registered a dramatic improvement during the first half of the current fiscal year, despite a marginal decline in exports. While the downstream implications of war against terrorism waged in Afghanistan proved negative for the exports, changes stemming from the heightened scrutiny of informal channels of foreign exchange payments were overwhelmingly positive. The current account recorded an unprecedented surplus that derived from distinct improvements in trade balance, services account and current transfers. Surplus on current account stood at US$ 1,276 million in H1-FY02 in contrast with a deficit of US$ 262 million in H1-FY01. The overall balance of payments showed a surplus of US $ 751 million, a feat that has rarely been achieved before.

These developments came about in the wake of significant behavioral shifts in the foreign exchange market that started in the aftermath of September 11 events. As discussed in the first *Quarterly Report* for FY02, the kerb market effectively collapsed at the beginning of second quarter due to tighter documentation requirements imposed by UAE central bank on capital flows. The fall in kerb premium not only constrained the flows through Hundi system, it also led to a complete reversal of devaluation expectations in the market during the second quarter. Kerb premium, in fact became negative during mid October to mid November and a greater part of December (see **Figure 9.14**). This led to a sharp appreciation of Pak Rupee against US Dollar in the interbank market. The magnitude and span of appreciation were unmatched among rare episodes of appreciation in the history of exchange rate movements in Pakistan.

Collapse of kerb premium not only resulted in shifting of remittance flows from Hundi to formal banking channels, it also arrested the trend of dollarization. While exporters hurriedly surrendered their proceeds to floating interbank market, importers held back their demand expecting further appreciation of Rupee. This mindset of the players added further strength to the Rupee. Complete reversal of expectations about the devaluation fully reversed the direction of causality from the interbank to kerb rate that emerged after the free float in July 2000.

Foreign exchange reserves began to accumulate dramatically during the second quarter of FY02, as a consequence of forex inflows due to above sentiments and supplemented handsomely by falling import bill, rescheduling of external debt and receipt of US aid. Foreign exchange reserves rose from US$ 3,295 million in the beginning of second quarter to a historic high of US$ 4,814 million at the end.[5] Contrary to popular beliefs, reserve build up was not based on kerb purchases, which were limited to only US$ 239 million during Q2-FY02 against US$ 528 million during the same period last year. In fact, due to the careful management of SBP, net purchases from the interbank market increased significantly to US$ 696 million during Q2-FY02 from a mere US$ 15.4 million in Q2-FY01. These net purchases represent mopping up of excess supply of foreign exchange in the interbank market after the private sector has met its demand for imports of goods and services.

These unprecedented positive developments in the foreign exchange market have also created a unique opportunity to remove the current segmentation of the foreign exchange market by merging the kerb and floating interbank markets.

[5] Foreign exchange reserves continued to accumulate in January 2002 and beyond. They stood at US$ 5,139.5 million as on March 09, 2002.

Accordingly, SBP is formulating operating rules for the proposed foreign exchange companies (FECs) that will start working from the beginning of coming fiscal year. Establishment of FECs will go a long way in improving the efficiency of foreign exchange market by not only addressing the problem of diversion of remittances to Hundi channel, but also increasing the effectiveness of SBP in monitoring of forex transactions.

**Money and Credit**

Behavior of money supply during the first half of FY02 was largely a reflection of developments that took place in the external sector. Monetary assets expanded at a brisk pace during H1-FY02 compared with the momentum observed in H1-FY01. As a result of sharp accumulation in net foreign assets, money supply recorded a growth of 8.1 percent in H1-FY02, whereas the contraction of foreign assets in H1-FY01 caused it to grow by only 5.4 percent then. However, the pace of private sector credit during H1-FY02 contrasted sharply with that of money supply.

A slower pace was recorded in terms of expansion of only Rs 39.4 billion in credit to the private sector, compared to Rs 80.0 billion in H1-FY01. If adjustment is made for export finance, private sector credit expanded to Rs 57.6 billion in H1-FY02 compared to 74.5 billion last year. However, the slower expansion was only partly reflective of decelerating economic activities. It was largely due to the lower prices of cotton that reduced the working capital requirement of textile sector to a great extent. Late start of crushing by sugar industry also applied a dampener to the credit growth. Brisker disbursements with relatively quicker retirements also came out as a slowdown in terms of net credit. Although credit started to expand relatively late in the financing season during Q2-FY02 by about five weeks, it also did not begin to taper after December 2001 as it usually does. In fact it continued to show an expansion of further Rs 8.3 billion up to second week of February over end December 01, in contrast with a contraction of Rs 2.3 billion during the same period of last year.

Government borrowing, owing to better availability of non-bank[2] and external resources[3] was better managed in H1-FY02. There was no compulsion on SBP this year, to take drastic measures such as increasing the CRR, which it had to take in October 2000 to stabilize the exchange rate. Thus the resultant abrupt shift in government borrowing which was the feature of H1-FY01 (see **Figure 4.1**) was not witnessed this year. In contrast government borrowing in H1-FY02

[2] Pakistan Investment Bonds.

[3] Besides other IFI assistance US grant of US$ 600 million was a major source of external finance.

was more rationally spread between SBP and commercial banks. As such IMF performance criteria for both the government borrowing and NDA of SBP were comfortably met.

Complete reversal of sentiments in the foreign exchange market, as stated earlier, not only helped SBP in implementing a policy of a gradual monetary ease, but also largely confounded the money market that fell into a perplexing and unending cycle of decreasing short-term rates. This cycle of self-fulfilling expectations was unwittingly caused by decreasing cut-off yields, although by only a few basis points, in successive auctions of November and December 2001. In fact, SBP had to quash these expectations by accepting the full and voluminous amount of Rs 25.6 billion in the T-bill auction of 6$^{th}$ February 2002. Bid patterns in later auctions and OMOs, started to reflect relatively saner expectations.

Due to the weaknesses in the transmission mechanism of monetary policy, the decrease in discount and T-bill rates during the first half of FY02 only started to impact the lending rates of scheduled banks towards the end of December 2001. Consequently, the weighted average lending rate of the banks only marginally declined from 14.0 percent at the beginning of July to 13.4 percent at the end of December 2001.

**External and Domestic Debt**

Trend and composition of total debt had also undergone a significant change during the first half of FY02 (see **Special Sections 1** & **2**). A deceleration in external debt and a marginal decline in total external liabilities were visible (see **Table 1**, **Special Section 1**). A marked decline occurred in the outstanding amount of domestic debt due to the retirement of treasury bills held by SBP (see **Figure 1**, **Special Section 2**). While the extraordinary restructuring of bilateral credits through the Paris Club will result in substantial reduction in foreign exchange payments during the grace period, the reduction in floating debt will relieve some pressure from the government in terms of reduced interest payments on domestic debt. Both of these developments augur well for the future course of economic development.

# 2. Real Sector

## 2.1 Agriculture

The drought specter looming over agriculture for almost past two years is undermining the growth of this sector and in turn causing slackness in overall economic growth. Although the summer rains in 2001 were 10-12 percent higher than the normal, and helped in recharging the ground water, these could not allow the major irrigation dams to fill to their capacity. The overall shortage of irrigation water, which was projected earlier at around 51 percent during FY02 (compared to 40 percent last year) had to be revised further down to 60 percent in the wake of shortfall of rains since September 01 onward. Under such circumstances, Punjab and Sindh are expected to face water shortage by 73.3 and 69.9 percent respectively during the remaining part of rabi season.

To mitigate its adverse effects, stakeholders are engaged in searching various alternatives including substitution among crops (from more water intensive to less, where feasible) and conserving water resources. At some places the severity is more intense and small farmers have been hit harder. In addition to allocate meager available production resources they have to spend a sizeable amount on purchasing water from tubewells. This has made farming uneconomical on scattered small pieces of land and consequently, restricted the market-based choices available to farmers for crop substitution.

In the current fiscal year, some shift has occurred from rice to cotton. Area under rice (more water intensive crop) during FY02 fell by 369 thousand hectare to 2.01 million hectares, while area under cotton (less water intensive) increased by 234 thousand hectares to 3.16 million hectares (see **Table 2.1**). Though this instant change in area reflects the farmers' enthusiasm to match the changing environment, it could not bring the matching impact on the size of the respective crops due to the decline in per hectare yield of the crops.

**Table 2.1: Area under Major Crops**
thousand hectares

| | FY00 | FY01 | FY02 | |
|---|---|---|---|---|
| | | | Target | Sown |
| Cotton | 2,983 | 2,928 | 2,560 | 3,162 |
| Sugarcane | 1,010 | 961 | 860 | 1,038 |
| Rice | 2,515 | 2,375 | 2,059 | 2,006 |
| Wheat | 8,463 | 8,269 | 8,410 | 8,340 |
| Maize | 962 | 970 | 958 | 932 |

Source: i) Federal Committee on Agriculture
ii) Ministry of Food, Agriculture & Livestock

Preliminary estimates of production remained unfavorable in both the cases i.e., 15.5 percent decline in area under rice triggered a larger decline of 21.2 percent in production, while 8.0 percent increase in area of cotton could not bring any increase in production, rather it declined by 2.4 percent compared to last year. Severe infestation of bollworm affected cotton crop in Punjab, while in Sindh, late sowing of the crop due to water shortage caused the decline in productivity. For rice, in addition to water shortage, replacement of area from low quality (high yielding) variety to refined variety (less yielding) may be one of the reasons for larger decline in the size of the crop.

**Table 2.2: Growth Prospects for Major Crops**

| | **Production** | | **%** | **Weighted** | |
|---|---|---|---|---|---|
| | **FY01** | **FY02*** | **Change** | **Shares#** | **Growth** |
| Cotton | 10.7 | 10.5 | -2.4 | 29.4% | -0.70% |
| Sugarcane | 43,606 | 46,516 | 6.7 | 14.6% | 0.97% |
| Rice | 4,802 | 3,782 | -21.2 | 11.8% | -2.50% |
| Wheat | 19,019 | 20,000 | 5.2 | 33.4% | 1.72% |
| Maize | 1,695 | 1,815 | 7.1 | 4.1% | 0.29% |
| Jowar | 219 | 224 | 2.7 | 0.6% | 0.02% |
| Bajra | 199 | 213 | 7.2 | 0.7% | 0.05% |
| Gram | 397 | 580 | 46.1 | 3.1% | 1.43% |
| **All crops above** | | | | **97.5%** | **1.28%** |

*= Preliminary estimates
# = Estimated shares in major crops for FY02 (1980-81, base)
Production: Cotton = million bales; while others are in 000 tonnes
Sources: i) Federal Committee on Agriculture, ii) FBS bulletin

Even with higher than the expected production of sugarcane, loss on account of shortfall in production of rice could not be compensated. It is expected to pull down growth of major crops by 2.5 percent while the gain on account of sugarcane is expected to be at around 1.0 percent (see **Table 2.2**). Customarily, sugarcane, cotton, rice and wheat, contribute around 89 percent of all the major crops[6], which in turn contribute almost 42 percent of the value added to agriculture sector.[7]

Customarily, among crops, the heaviest contribution in agriculture comes from wheat. As such, hopes for recovery in major crops now linger on the outcome of ensuing wheat and to some extent gram crops. Any addition above the targeted output of 20 million tonnes in case of wheat and 580 thousand tonnes in case of gram will pull up the growth of major crops. Based on the latest available estimates on area and production, growth prospects of major crops are consistent with the targeted growth of agriculture sector as a whole. Non-crop sector contributes 40.9 percent of agriculture sector. It is dominated by livestock (89.5 percent) followed by fishing (8.5 percent) and forestry (2.0 percent). Dairy farming, poultry farming and sheep and goat breeding are the major contributors to the livestock. Although data on non-crop sector is available only by the close of each fiscal year, proxies like government policies and opening up of new market opportunities may be a good

[6] It includes rice, wheat, barley, jowar (sorghum), bajra (millet), maize, gram, cotton, sugarcane, rapeseed and mustard, sesamum and tobacco.
[7] For further detail, please see **Box II.1** at page 20 of SBP Annual Report 1999-2000.

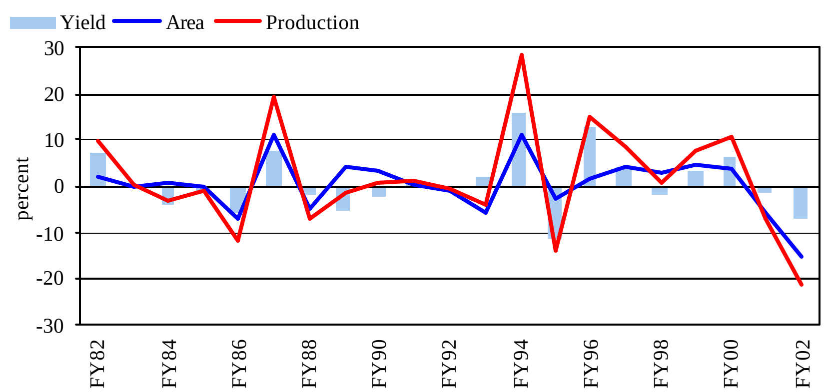
**Table 2.3: Growth Prospects for Agriculture**
billion Rupees at constant factor cost 1980-81

| | During | | | % Growth |
|---|---|---|---|---|
| | FY00R | FY01P | FY02 E | FY02 E |
| Agriculture | 168.5 | 164.3 | 168.4 | 2.5 |
| Crops | 101.7 | 94.2 | 95.3 | 1.2 |
| Major crops | 74.1 | 66.3 | 67.1 | 1.3 |
| Minor crops | 27.5 | 27.9 | 28.2 | 1.1 |
| Livestock | 59.2 | 62.0 | 65.0 | 4.8 |
| Fishing | 6.0 | 5.8 | 5.8 | 0.0 |
| Forestry | 1.6 | 2.3 | 2.3 | 0.0 |

R = Revised; P = Provisional; E = Estimated

guess for estimating the on-going progress in this sub-sector. The overwhelming interest of processing and marketing of milk and its by-products and the stable prices of milk and beef provide clues towards better growth prospects of livestock this year. Furthermore, the announcement of deep-see fishing policy by the Government may contribute to accelerated fishing during the current fiscal year. If the livestock sub-sector succeeded in maintaining its growth at last year's level, and fishing and forestry do not show a decline, then the growth in agriculture will be close to 2.5 percent during FY02 even after a record shortfall in rice crop (see **Table 2.3**).

**Figure 2.1: Growth in Area, Production and Yield of Rice Crop**




The heaviest ever fall in the area and production of rice by 15.5 percent and 21.2 percent respectively (mostly caused by the continued drought-like condition) was unprecedented since FY74. Earlier the maximum decline was 13.7 percent that reduced the rice crop in FY95 to 3.5 million tonnes (see **Figure 2.1**).

Due to shortfall in production, domestic price of rice is on rise since January this year. The rising trend in domestic prices will further deteriorate competitiveness of rice export already aggravated by the rupee appreciation. During the first six months of FY02, a total of 852.2 thousand tonnes of rice was exported compared to 884.3 thousand tonnes last year.

Among minor crops, production of mung and mash during FY02 were higher by 8.3 percent and 1.2 percent respectively. Future outlook of onion and potato crops remains optimistic as the prices of these commodities irrespective of seasonal variations has not shown any exceptional hike.[8]

### 2.1.1 Agricultural Credit

Gross disbursement of credit during H1-FY02 was 16.5 percent higher than the corresponding period last year. Purpose-wise breakup revealed that 19.4 percent increase was registered in production loans, while development loans, on the other hand, declined by 2.6 percent. This may be a reflection of the declining farm incomes that compelled the farmers to get more input loans and defer their capital expenditures. Commercial banks were more aggressive in loaning to the farmers during July-December 2001. Their total disbursement at Rs 8.1 billion was 68.8 percent higher than the same period last year. However, the disbursement by ADBP rose by only 8.7 percent apparently constrained by decline in loans for development purposes (see **Table 2.4**).

**Table 2.4: Credit to Agriculture Sector**

million Rupees

| | Disbursement | | | Recovery | | | Net Credit[#] | |
|---|---|---|---|---|---|---|---|---|
| | H1-FY01 | H1-FY02 | % Change | H1-FY01 | H1-FY02 | % Change | H1-FY01 | H1-FY02 |
| ADBP | 11,854 | 12,885 | 8.7 | 13,460 | 13,544 | 0.6 | -1,606 | -659 |
| Commercial Banks[@] | 4,816 | 8,127 | 68.8 | 4,653 | 5,685 | 22.2 | 163 | 2,442 |
| New Private CBs* | -- | 244 | -- | -- | -- | -- | -- | 244 |
| FBC | 2,190 | 708 | -67.7 | 2,362 | 1,435 | -39.3 | -172 | -727 |
| Total | 18,859 | 21,963 | 16.5 | 20,475 | 20,663 | 0.9 | -1,615 | 1,300 |

# = Net Credit = disbursement minus recovery

@ = Includes: NBP, HBL, MCB, UBL, and ABL

*= New Private Commercial Banks started lending in FY02

As the Federal Bank for Cooperatives (FBC) is under liquidation, no disbursement was made in Q2-FY02. The amount of Rs 708 million appearing in H1-FY02 is the remaining part of Rs 900 million disbursed by the FBC to Punjab Provincial Cooperative Bank (PPCB) during the first quarter minus the refund of Rs 191 million made by PPCB to FBC in October 01. Credit line by SBP earlier

[8] For detailed discussion, please see section on **Prices**.

being provided to FBC will now directly be given to PPCB and as such there will be no hit on availability of agriculture credit despite the winding up of FBC.

Entry of five new private commercial banks in the field of agriculture financing is a major breakthrough seen this year. Earlier, since 1974, only five major banks (NBP, HBL, MCB, UBL and ABL) were in this business. Initially new entrants have disbursed Rs 243.5 million among the farmers.[9] The amount does not matter at this stage. The main achievement is the change in attitude of the private commercial banks towards agricultural financing. Now, they have started taking it up as a commercially viable business. This became possible on account of the policy changes made by SBP during last couple of years, especially those relating to linking the agriculture refinance rate to T-bill yield and widening the coverage of agricultural financing through including new items in the admissible activities of agriculture financing.[10]

Net credit during first half of current fiscal year showed an expansion of Rs 1,300 million compared to a contraction of Rs 1,615 million during corresponding period last year. This is mostly because of higher disbursement of credit by five major commercial banks during H1-FY02. Consequently, the outstanding credit to agriculture sector increased by 5.4 percent and reached Rs 99.6 billion as on December 31, 2001.

#### 2.1.2 Financing Facility for Building Storage Capacity

In addition to failure of crops, failure of market to support the bumper crops is another major factor that hits the farmers' incomes. Even after realization of an excellent crop they can hardly make good money because of the depressed market prices. At peak harvest season, supply glut pushes the prices down to levels lower than those prevailing in pre-harvest season. This happens mainly due to lack of proper storage facilities, because after crop harvest farmers are left with no option but to dump it in the market at once. With average crop size of wheat at 18.7 million tonnes and rice 4.7 million tonnes, existing storage is available for keeping only 4.6 million tonnes of wheat and 0.8 million tonnes of rice. This storage capacity is insufficient to provide needed support to farmers.

Keeping in view the importance of storage facilities for farm produce, the foremost element in the value chain of agriculture, State Bank of Pakistan, as a first step, has recently issued instructions to all the commercial banks and ADBP

[9] Includes: Bank of Punjab (Rs 188.2 million), Askari Commercial Bank (Rs. 93.8 million), Bank of Khyber (Rs 12.3 million), Bolan Bank (Rs 9.6 million) and PICIC Commercial Bank (Rs 9.5 million).

[10] For further detail, please see page 24 of SBP Annual Report 2000-2001.

to provide priority financing to farmers and flour mill owners for construction of storage facilities particularly for wheat crop. In the beginning, adequate loans will be provided for a period of 5 to 7 years with a debt equity ratio of 60:40 (bank: borrower) with 12 percent markup rate. Later on, the lending rate will be made market based by linking it to the rate on T-Bills.

As this facility is likely to be commercially viable and provides comparative security than other modes of agriculture lending, bankers are likely to extend credit through this facility. Furthermore, bankers will also like to avail the advantage given to them of fulfilling mandatory target through this lending. Farmers will have a better opportunity to plan the marketing of their produce at the time of their choice, if they have their own storage capacity for grains. This is also likely to reduce the extent of post-harvest losses of grains that sometime soar up to 20 per cent. This in turn will reduce the intensity of seasonal variation in the prices of grains, thereby benefiting consumers as well.

## 2.2 Large-scale Manufacturing

During the first half of FY02, large-scale manufacturing sector registered an overall growth of 2.9 percent over the first half of FY01, up from 2.0 percent. However, this performance can hardly be interpreted as a sign of improvement. Here, the overall growth rate is a relatively poor indicator of the performance of large-scale manufacturing (LSM) because of two reasons. First, the LSM sector displays erratic variations across its 96 items. Second, period to period changes, like quarter over quarter, or six months over six months also show a high variability because of seasonal fluctuations. Therefore, it is better to have a collective look at alternative growth rates shown in **Table 2.5**.

**Table 2.5: Summary of Growth Rates**

percent

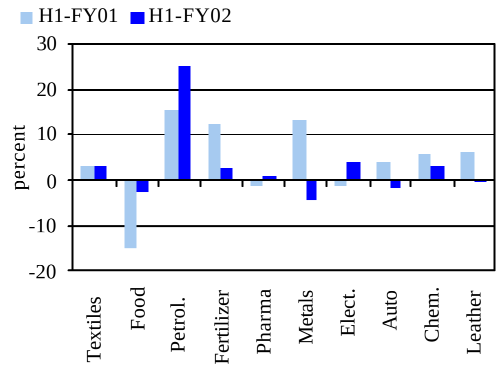
| | FY01 | FY02 |
|---|---|---|
| Overall | 2.0 | 2.9 |
| Excluding sugar | 6.7 | 3.8 |
| Trimmed | 6.6 | 1.0 |

Source: Federal Bureau of Statistics

Trimmed growth rate, a relatively better indicator in cases of large variations, shows a dismal performance. However, the deceleration reflected in trimmed growth was inevitable in the backdrop of slowdown in the global economy and the uncertainty following the events of September 11. Further, the domestic environment for growth was less conducive than last year, when production from the build up of new capacities was coming on line.[11]

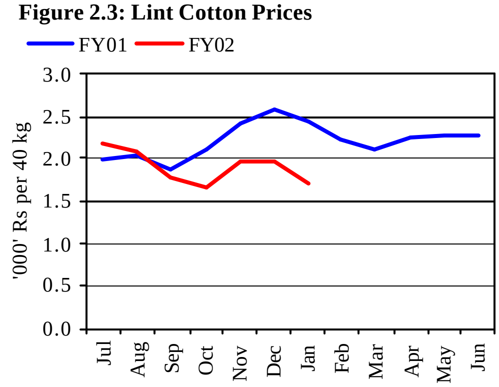
Growth excluding sugar, decelerated to 3.8 percent compared with 6.7 percent in H1-FY01.[12] This is also a reflection of slackening growth, further corroborated by trimmed growth of only 1.0 percent, down from 6.6 percent in the first half of last year. In addition, the majority of LSM groups showing positive growth, except a few, did not register any significant improvement over last year's performance (see **Figure 2.2 & Table 2.6**). The major sectors that showed increase in production include *textiles, petroleum refining, fertilizer, pharmaceuticals and electronics*, while *food, beverages & tobacco, metal industries, automobile, non-metallic minerals and engineering* showed declines.

**Figure 2.2: Growth in Selected Industrial Groups**




Contrary to earlier expectations, *textiles* showed only a slight loss of momentum. However, their level of performance last year was hardly commendable. During H1-FY02, production of textiles increased by 3.2 percent compared to 3.3 percent increase last year. The ongoing slowdown in the global economy, further aggravated by September 11 events and consequent

**Figure 2.3: Lint Cotton Prices**




[11] During last year, new units were established in petroleum refining, fertilizer and automobile sectors. While, during H1-FY02, DAP fertilizer plant established by Fauji Jordan Fertilizer Company (FJFC), closed its operation in October 2001.

[12] During H1-FY02, sugar production declined by only 10.1 percent compared to 35.2 percent fall in the same period last year.

**Table 2.6: Production of Selected Large-scale Manufacturing Items**

| Items | Weights | Percentage Change | | Items | Weights | Percentage Change | |
|---|---|---|---|---|---|---|---|
| | | FY01 | FY02 | | | FY01 | FY02 |
| **Textile** | **19.069** | **3.33** | **3.22** | **Electronics** | **2.976** | **-1.31** | **3.93** |
| Cotton yarn | 8.85 | 3.44 | 4.28 | Electric transformers | 0.577 | -16.45 | 19.50 |
| Cotton cloth | 4.881 | 13.20 | 12.87 | Storage batteries | 0.451 | 8.17 | 0.56 |
| Cotton ginned | 3.893 | -4.52 | -3.09 | TV sets | 0.363 | -24.31 | -21.20 |
| Other five items | 1.445 | 8.27 | -22.06 | Air conditioners | 0.12 | 719.73 | -78.22 |
| **Food, beverages & tobacco** | **17.336** | **-14.95** | **-2.79** | Refrigerators | 0.015 | 37.51 | 25.65 |
| Sugar | 8.630 | -35.24 | -10.06 | Other five items | 1.45 | -13.97 | -1.14 |
| Vegetable ghee | 3.004 | 20.19 | -7.74 | **Automobile** | **2.413** | **3.85** | **-1.83** |
| Cigarettes | 2.505 | 16.14 | -3.02 | Trucks | 0.698 | 4.84 | -27.88 |
| Tea | 1.785 | -10.64 | -3.24 | Tractors | 0.593 | -33.45 | -17.46 |
| Beverages | 0.964 | 5.21 | 7.14 | LCVs | 0.369 | 13.59 | 21.40 |
| Cooking oil | 0.448 | 17.34 | 17.02 | Cars & jeeps | 0.309 | 18.65 | 4.29 |
| **Petroleum products** | **7.824** | **15.43** | **25.08** | Motorcycles | 0.249 | 37.44 | 4.11 |
| **Fertilizer** | **5.871** | **12.07** | **2.71** | Buses | 0.13 | -3.75 | -45.91 |
| Nitrogenous | 5.441 | 4.32 | 7.15 | Diesel engines | 0.065 | 1.94 | -37.14 |
| Phosphatic | 0.430 | 218.97 | -36.05 | **Chemicals** | **2.335** | **5.56** | **3.18** |
| **Pharmaceuticals** | **5.798** | **-1.40** | **1.02** | Caustic soda | 0.621 | 2.72 | 3.40 |
| Tablets | 2.705 | -7.22 | 7.47 | Soda ash | 0.32 | -13.72 | 1.47 |
| Syrup | 1.602 | -0.19 | -8.48 | Other six items | 1.394 | 15.49 | 3.42 |
| Injections | 0.466 | 6.69 | -0.78 | **Non metallic minerals** | **1.915** | **-2.77** | **-2.72** |
| Capsules | 0.228 | -4.53 | -0.79 | Cement | 1.846 | -2.39 | -2.30 |
| Other five items | 0.471 | 10.70 | 4.76 | Glass sheets | 0.069 | -12.97 | -15.19 |
| **Metal industries** | **3.317** | **12.94** | **-4.23** | **Paper & board** | **1.359** | **24.54** | **6.65** |
| Pig iron | 1.477 | 4.33 | -5.88 | **Engineering items** | **0.691** | **1.03** | **-0.69** |
| Coke | 1.319 | 18.87 | -1.03 | Bicycles | 0.348 | 4.79 | -1.22 |
| Billets | 0.311 | 28.14 | -6.72 | Metal containers | 0.153 | 6.27 | 0.10 |
| Safety razor blades | 0.109 | 23.61 | 23.76 | Sewing machines | 0.052 | -9.43 | 2.97 |
| H.R/coils and plates | 0.074 | -18.50 | -2.52 | Power looms | 0.051 | -56.95 | 59.06 |
| C.R coils/plates/sheets | 0.013 | -17.72 | -16.98 | Other five items | 0.087 | -35.35 | -23.17 |
| **Leather products** | **2.333** | **5.97** | **-0.53** | **Tyres & tubes** | **0.452** | **-11.38** | **21.86** |

Source: Federal Bureau of Statistics

depressed demand, resulted in fall in prices of lint cotton in international as well as in domestic market (see **Figure 2.3**). This fall in price might have spurred production of textile products, as observed in FY00, but negative sentiments arising out of the developments taking place in the world market, forced the industry to maintain a modest production activity. Had the world market condition remained normal, production levels would have been higher than actually achieved.

If clouds of war clear from this region, then with increased access to markets in Europe and US and falling trend in cotton prices, the textile sector is expected to come up with strong growth in the second half of FY02. The ongoing up-gradation of textile machinery is also expected to help the sector to increase value addition. The recently announced export refinance facility, revived after an year of suspension with lower rates, may also boost export of yarn and gray cloth, and hence, their production.

The only industry that has shown not only a robust growth during the H1-FY02, but also a significant improvement over last year's performance, is *petroleum refining*. Its production increased by 25.1 percent during the H1-FY02, compared to 15.4 percent increase last year. Fall in world crude oil prices, coupled with the policy to allow domestic refineries to export surplus petrol, provided the major boost to petroleum refining. This is reflected in higher import of crude oil and higher export of petroleum products during H1-FY02 compared to last year (see section on **Trade Account**).

*Fertilizer* is another sector that has shown positive growth, though much lower than what was observed last year. Despite the closure of the only DAP fertilizer plant, the overall production recorded 2.7 percent increase during H1-FY02 compared to 12.1 percent increase last year. Falling prices of DAP and urea fertilizers in international market, resulted in increase in import of fertilizer during H1-FY02.[13] The imports lowered the local selling prices at the time domestic cost of production was rising on account of price hike in inputs like natural gas and imported phosphoric acid etc. The profits of fertilizer industry were thus squeezed.

More specifically, the profits on the production of DAP fertilizer was hit severely on account of imported basic raw materials. In addition, depreciation of Pak rupee in the first quarter, further enhanced costs. These factors, as a result, forced

[13] During H1-FY02, import of fertilizer increased by 43.8 percent over the same period last year.

the management of Fauji Jordan Fertilizer Company (FJF) to shut down operations of DAP unit in October 2001, while that of urea continued.

The overall growth of *electronics* sector increased by 3.9 percent in contrast with 1.3 percent decline recorded for the same period last year. Increase in the manufacturing of transformers by 19.5 percent, which has been showing sharp declines during the last couple of years, helped the electronics industry to improve its performance during H1-FY02. The increase in the installation of tubewells (for irrigation purposes) during the last fiscal year on account of higher financing made available by ADBP for the purpose coupled with increase in exports, created favorable conditions for the manufacturing of transformers.[14] During FY01, ADBP disbursed Rs 1,648.1 million for installation of tubewells, compared to a disbursement of Rs 830.9 million last year.

On the negative side, *food, beverages & tobacco* is the major sector that showed decline, though less than the last year. Sugar, being the largest item with respect to weight, also contributed in the declined by 10.1 percent. Like last year, row between sugarcane growers and mill owners over sugarcane price, delayed crushing season this year as well. However, contrary to last year, the root cause of fight over prices was not the quality of sugarcane, but the price of refined sugar that fell before the start of crushing season.

Despite higher than last year's estimates of sugarcane crop and mill owners' claim to have around 620,791 tons end September stock, the import of refined sugar continued in post July 2001 period, resulting in fall in prices of refined sugar.[15] This fall in prices of refined sugar was against the interests of mill owners, because they had already produced sugar at higher cost on account of higher prices of sugarcane (around Rs 55 per mound) during FY01, and the purchase of sugarcane at this price during FY02 was not viable with depressed sugar prices. In addition, early crushing (in October in Sindh and November in Punjab & NWFP) usually results in lower sugar recovery and does not cover cost, which was further aggravated by the falling prices of refined sugar. Hence, the mill owners intentionally delayed the crushing season to press farmers for reducing the price of sugarcane on the one hand, and let the sugar price go up, on the other hand.[16] Therefore, the crushing season is likely to be extended by one month, with higher sugar production expected during FY02.

[14] A transformer accompanies each tubewell installed.
[15] Sugar prices fell to Rs 19 to 21 per kg in December from Rs 26 to 28 per kg in July 2001.
[16] Most of the mills in the three provinces (Punjab, Sindh and NWFP) remained closed up to November 30.

Another major item included in the food group that has also performed poorly, is *vegetable ghee*. Its production declined by 7.7 percent during H1-FY02 compared to 20.2 percent increase last year. This is in sharp contrast to strong growth shown by the production of cooking oil, despite 1.4 percent decline in the import of edible oil (the raw material for both ghee and cooking oil).[17]

*Metal industries*, which have been showing sound performance for the last couple of years, showed a decline of 4.2 percent during H1-FY02. The major factor causing this decline was falling sale of domestic steel products, mainly due to contraction in construction activities and rising import substitution. Reduction in custom and regulatory duties on the import of various steel products in July 2001, resulted in higher imports that hurt the already dwindling sales of Pakistan Steel.[18] To arrest fall in sales, Pakistan Steel has frequently made downward adjustment in price of various steel products since July 2001. But due to subdued construction activities, sales could not pick up during H1-FY02. Accordingly, to avoid building up of further inventories, Pakistan steel reduced the budgeted production for FY02.

After achieving remarkable growth last year, *automobile* sector recorded 1.8 percent decline during H1-FY02. Sharp declines in the production of trucks, buses and tractors, more than offset the positive contribution made by LCVs, cars, Jeeps and motorcycles. Restricted market for domestically assembled trucks compared to smuggled ones, forced the producers to cut manufacturing of trucks during H1-FY02.[19] Furthermore, in the absence of new induction of buses under the Urban Transport Scheme, sales of buses fell by 47.6 percent. Owing to these conditions, Gandhara (Nissan) did not manufacture trucks in three months of H1-FY02. In the case of buses, the situation is even worse; during 4 out of 6 months, Gandhara did not produce a single unit and in the remaining two months, only 15 buses were manufactured. In the case of tractors, production declined on account of lower financing by ADBP and absence of any concessional facility.

The *non-metallic minerals*, consisting of *cement* and *glass* industries, continued showing dismal performance for, at least past three consecutive years. The output

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[17] During H1-FY02, production of cooking oil increased by 17.0 percent against 17.3 percent increase in the last year.

[18] During H1-FY02, import of iron & steel was 0.6 million tons compared to 0.4 million tons in the same period last year: showing 54.5 percent increase.

[19] Anecdotal evidence suggests that smuggling of trucks is taking place over the Chaman border with Afghanistan. These trucks are sold at lower prices than locally manufactured.

of both these industries is used as an input in the construction industry. Already in slump, and further hit by the situation emerging after the event of September 11, prospect for turnaround in the construction sector and hence, for these two industries remained unfulfilled during H1-FY02.[20] However, the realization of the proposed reconstruction of Afghanistan is expected to bring some relief to these, especially to cement industry in H2-FY02.

Though, the reconstruction of Afghanistan holds promising prospects for all sectors having linkages with construction, but the cement industry is likely to benefit the most. Anecdotal evidence suggests that on the basis of its quality, Pakistani cement is being sold on a premium in Afghanistan. For Pakistani manufacturers, it is an excellent opportunity to off-load the burden of excess capacity, which has been causing ailment to the industry for last five or six years. However, to do so, Pakistani manufacturers need to curtail their costs, by switching their production process to coal (see **Box 2.1**) and capture the market that carries the prospect of further access to big markets of Central Asian Republics (CARs).

[20] During the H1-FY02, cement dispatches declined by 7.7 percent compared to 0.6 percent decline in the same period last year.

**Box 2.1: Coal as Kiln-Fuel for Cement Production**

The process of cement production is energy intensive. Presently, cement industry in Pakistan is mostly using furnace oil as fuel, which alone constitutes around 35 percent of the total cost of production. The increasing price of furnace oil over the last few years is endangering the viability of the industry.

Substituting of furnace oil with other low cost fuels like natural gas and coal can solve the problem of rising cost. Natural gas is an ideal substitute for the industry, given its advantage of being *ready to use* and with the required equipments already installed in many plants. Unfortunately, the existing gas reserves do not allow the country to burn them at such a mass level. The other major reason for not switching over to gas is, frequent load shedding during winter that causes discontinuity in production process. Moreover, the pace at which gas prices are rising also inhibits switching over to gas.

Presently, major cement manufacturing countries, with proper environmental safety systems, are using coal as a kiln-fuel. Pakistan too, has large coal deposits, estimating to around 180 billion tons. These reserves are largely unexplored owing to lack of demand in the country. Though, domestic coal is not of very high quality, processing and blending with imported one can produce required heating content.

By switching to coal, the cost of production of cement is expected to come down. In addition, the country could save about US$ 69.3 million foreign exchange annually, on the import of furnace oil (see **Table**). This opinion is formed on the following assumptions.

1. Annual production of cement is 10 million tons;
2. Heat value of furnace oil is 9,600 K Cal/Kg;
3. The ratio of imported to local coal is 70:30, and;
4. Heating value of blended coal is 6,050 K Cal/Kg.

**Cost Comparison--Furnace oil v/s Coal**

| **Furnace Oil** | | **Coal** | |
|---|---|---|---|
| Furnace oil consumption (Kg per ton of clinker) | 85 | Coal consumed (Kg per ton) | 135 |
| Cost of furnace oil per ton of cement produced[1] | 842.4 | Average price of ready to use coal per ton[2] | 530.6 |
| Annual consumption of furnace oil (million Rs) | **8,424** | Power consumption of coal firing plant per ton of clinker | 22 |
| | | Total cost of using coal (per ton) | 552.6 |
| | | Annual consumption of coal (million Rs) | 5,526 |
| **Annual saving** (million Rs) | | **2,898** | |
| Saving per ton (Rs) | | 289.8 | |

[1] at Rs 9910 / ton equivalent to $165 per ton

[2] blending 70 percent imported with 30 percent indigenous at prices of 4500 and 2600 per ton, respectively and having 6050 K.Cal/Kg

Source: All Pakistan Cement Manufacturers Association (APCMA)

As a result, the price of cement per bag may go down, which in turn is likely to increase domestic demand. This reduction in cost will also result in lower dollar price of Pakistani cement in world market, which could make export of cement to countries like Sri Lanka, Bangladesh, Malaysia, Myanmar, Nepal, Vietnam, Singapore etc., feasible.

However, this process of conversion will initially cost a 2000 tons per day (tpd) plant around Rs 200 million, which can be covered within couple of years on account of savings from the use of coal and increase in capacity utilization.

Currently, Pakistan is producing around 3.3 million tons coal annually. If the whole cement sector is totally converted to coal, another 1.4 million tons will be required. Supposing a 70:30 ratio of imported to local coal, about 0.4 million tons domestic coal per annum will be enough to serve the purpose.

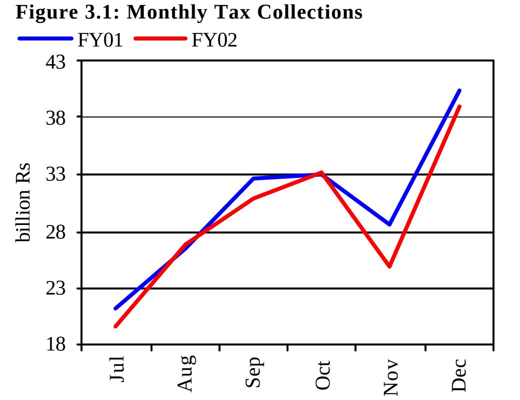
# 3. Fiscal Developments

## 3.1: Tax Revenue

Fiscal efforts of the government were severely affected in the aftermath of events of September 11. The impending shortfall in revenue from the target became all the more clearer by the close of second quarter. Compared to a targeted increase of 9.1 percent, the first half of the current fiscal year witnessed a decline of 4.1 percent over the corresponding period last year.[21] Decline stemmed entirely from indirect taxes as direct taxes grew by 7.6 percent. The severity of decline in indirect taxes (-9.6 percent) originating from custom (-37.3 percent) and excise (-16.5 percent) was arrested to considerable extent by a rise of 4.0 percent in sales taxes.

Tax collection was lower than projected in the second quarter of FY02 due to slowdown in economic activity. Lower imports and higher refunds/rebate to exporters also edged down the tax collection. Sharp appreciation of Pak Rupee against US dollar and higher freight charges on account of war-risk insurance dampened the envisaged growth in imports that constitute over 40 percent of our tax base.[22] Reduction in maximum tariff rate from 35 to 30 percent could not accelerate imports and only resulted in intensification of decline in customs duty collection. Although monthly tax collections were marginally higher in August and October 2001 compared to previous year, the cumulative tax collections remained constantly below the last year's collections (see **Figure 3.1**). In terms of revised targets, revenue collections constitute only

**Figure 3.1: Monthly Tax Collections**




[21] The CBR revenue targets have been revised twice during the first half of the year. The first revision was entirely on account of actual tax collections realized during FY01, which lagged behind the revised target by Rs12.8 billion. The budget target of Rs 457.7 billion for this year was adjusted downward to Rs 444.7 billion. The shortfall realized in Q1 coupled with the developments following September 11 forced CBR to further revise its tax collection targets. The revenue target, therefore, was revised downward to Rs 429.9 billion.

[22] For detailed discussion on these points, see **External Sector**.

40.6 percent of annual and 95.2 percent of half-yearly targets (see **Table 3.1**).

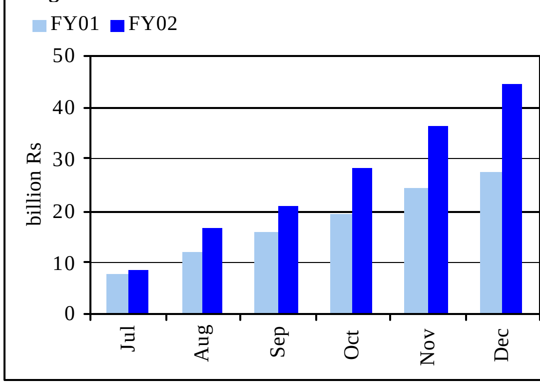
**Table 3.1: Federal Tax Collections up to H1-FY02**
billion Rupees

| Head | Target | | Collection in 1st Half | | | Percent of Target | |
|---|---|---|---|---|---|---|---|
| | FY02 | H1-FY02 | FY00 | FY01 | FY02 | FY02 | H1-FY02 |
| Direct taxes | 142.4 | 62.6 | 50.1 | 58.3 | 62.8 | 44.1 | 100.3 |
| Indirect taxes | 287.5 | 120.8 | 110.2 | 123.6 | 111.8 | 38.9 | 92.5 |
| Sales tax | 176.8 | 75.6 | 52.0 | 70.7 | 73.5 | 41.6 | 97.2 |
| Central excise | 49.4 | 22.3 | 26.8 | 24.2 | 20.2 | 40.8 | 90.5 |
| Customs | 61.3 | 22.9 | 31.4 | 28.8 | 18.1 | 29.5 | 78.9 |
| Total | 429.9 | 183.4 | 160.3 | 182.0 | 174.5 | 40.6 | 95.2 |

***Gross Vs Net Collections***

Gross collection of CBR registered an increase of 4.5 percent during the first half of the current fiscal year compared with previous year. Usually tax collections are reported net of refund/rebate amount. Issue of refund/rebate remains highly contentious between the CBR and taxpayers, with the former inclined to delay refunds in order to show increases in net collection. The accelerating refunds amounted to Rs 44.6 billion during H1-FY02 against Rs 27.7 billion in the same period a year before (see **Figure 3.2**). The CBR made a concerted effort to rapidly clear the backlog of refunds/rebates that were accumulated due to delays in the past. This also reflects the concern to reduce administrative discretion over refunds. In the VAT system, the importance of refund procedure is at its heart, as tax paid at the buying stage is deducted from the total tax collected at the selling stage. If the difference is positive, the government takes the entire amount and if this is not the case, the taxpayer receives the refund amount. As mentioned in our previous annual and quarterly reports, the government is extending the scope of VAT mode sales tax with

**Figure 3.2: Refund Amount**



increasingly greater zeal, which is pushing the refund amount to go up. The government should also revisit the list of exemptions, which are of vital concern for the smooth functioning of VAT mode taxation system and revenue generation for the government exchequer.

Given the position of overall revenue collections, the compositional breakdown will be more insightful, as one can trace out the roots of shortfall in great details.

***Direct Taxes***

Looking at **Table 3.1**, the direct taxes recorded an increase of 7.6 percent during H1-FY02 over the comparable period last year. The driving forces behind this increase were the higher collections both on *normal returns* as well as arrears (on demand collections). More specifically, collections with normal returns registered an increase of Rs 3.4 billion during the course of time. This increase would amount to Rs 6.3 billion, if the impact of one time tax amnesty scheme operative during H1-FY01, was excluded.

Despite reasonable growth in direct taxes, the compositional breakdown showed that the withholding taxes, constituting more than one-half of direct taxes, witnessed marginal decline during H1-FY02 over the same period last year. This decline was mainly attributed to the abolition of five types of withholding taxes in federal budget for FY02; lower collections from interest/profit income on securities, accounts and deposits; and decline in import related withholding taxes. Reduction in tax rate on banking companies from 58 percent to 50 percent in federal budget for FY02 along with retirement in government borrowing to banking sector during H1-FY02 and lower T-bill rates are mainly responsible for sagging tax collection on interest income on securities.

This changing composition of direct taxes, showing increasing collection with normal returns and decline in the withholding taxes, is in the right direction and should be encouraged and pursued vigorously. The future outlook for direct tax collection remains positive, as revenue from this head is on track, slightly higher than the half yearly targets and representing 44.1 percent of annual target.

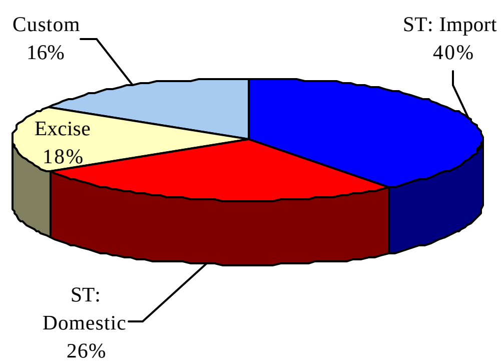
***Indirect Taxes***

In contrast with direct taxes, revenue collection from indirect taxes not only fell short of half yearly target, but also posted a negative growth of 9.6 percent over the comparable period a year ago. In terms of annual targets, only 38.9 percent of indirect taxes were realized during H1-FY02. The compositional breakdown of indirect taxes helps to trace out the factors responsible for shortfall (see **Table 3.1** & **Figure 3.3)**.

Sales Tax

Compared to negative growth of indirect taxes, revenues from sales taxes posted 4.0 percent increase during H1-FY02. However, this growth was lower than envisaged in revised estimates, as collections from sales tax were 97.2 percent of half yearly and 41.6 percent of annual targets (see **Table 3.1**). The shortfall was mainly on account of lower collection from textile related items, while sales tax on import related items posted reasonable increase of 7.5 percent. The fall in latter was largely driven by a significant decline in prices of cotton yarn, uncombed cotton, processed fabrics, man made fiber and yarn, etc., recorded double-digit decline during H1-FY02 over a year before. Moreover, dwindling sale of consumer durables largely on account of uncertain situation following the developments of September 11 and escalating border tensions with India added to this decline.

**Figure 3.3: Composition of Indirect Taxes**




Stepping back, higher collection from import related items, despite declining value of imports in rupee terms, could be explained by looking at sales tax rate on these items. As mentioned in our first quarterly report for the year that government has increased sales tax rate from 15 to 20 percent on more than hundred select items related to raw material. This measure continued to fetch much needed revenues to government exchequer during H1-FY02. In this backdrop, the outlook for sales tax collection remained unclear, as sales tax on import related items is recording positive growth but less than the target, while the sales tax on domestically produced goods and services is lagging behind the target and recording negative growth as well.

Central Excise Duty

Central excise duty, holding 18 percent share in indirect taxes, recorded double-digit decline during the period under consideration. Although target for FY02 is slightly lower than the actual collections of last year, the realized shortfall is even larger than what was envisaged in revised target for the whole year. In terms of targets, CED collections constitute 90.5 percent and 40.8 percent of half yearly and annual targets respectively. The shortfall is recorded on both locally produced good and imported items. The fall on domestic front was largely on account of lower collections on POL products, cement and domestic travel, while lesser imports are responsible for import related items.

Customs

Among the component of indirect taxes, custom duties bore the hardest hit; the collection witnessed steep decline of 37.3 percent during H1-FY02. Only 78.9 percent of half yearly target was realized, which was the lowest among all the components of indirect taxes. The decline in Rupee value of imports on account of the appreciation of Pak-Rupee following the development of September 11 frustrated government efforts to realize the targeted amount. In addition, higher freight charges forced economic agents to at least revise their import decisions in the short-run, if possible. The lower petroleum imports in terms of quantity also contributed to this decline.

The outlook for overall tax collections remains pessimistic, as the accumulated shortfall in indirect taxes during the first half of the year will be very difficult to recoup in the later half. This forced the government to resort to a third revision in tax revenue targets.[23] Since the direct taxes were on track and even marginally higher than the target, the indirect taxes bore the burden of adjustment. Within indirect taxes, the custom duties, sales tax and CED all were adjusted downward.

### 3.2: Surcharges

During H1-FY02, Rs 24.3 billion were collected from surcharges on gas and petroleum products. These were 51.8 percent of the annual budget target (Rs 47 billion). Marginally higher surcharges were entirely on account of higher collection on petroleum products. Compared to this, collection on gas was slightly lower than the half yearly target (50 percent of budget target).

### 3.3: Non-Tax Revenue

Compared to Rs 129.8 billion envisaged in the annual target for budget FY02, non-tax revenue contributed Rs 54.9 billion to government exchequer during first half of the year, which was only 42.3 percent of annual target. Looking at **Table 3.2**, only SBP profit was higher than 50 percent of annual target, while all other

[23] The CBR tax collection target was third time revised downward, in February 2002, to Rs 414.3 billion from 429.9 billion.

components were lower than half yearly target.[24] Receipts from civil administration were lower mainly on account of declining defense receipts. Furthermore, lower receipts from social and economic services also added a dampener to this decline. Steeping back, lower sale proceeds and royalty on oil and gas were largely responsible for the shortfall in miscellaneous receipts. This was might be due to sudden exit of foreign engineers from oil and gas sectors following Afghan war.

**Table 3.2: Non Tax Revenue**
billion Rupees

| Head | FY02[t] | H1-FY02 |
|---|---|---|
| Interest income and dividends | 53.2 | 24.0 |
| SBP profits | 23.0 | 12.0 |
| Receipts from civil administrations | 5.6 | 1.7 |
| Miscellaneous | 48.0 | 17.2 |
| Total | 129.8 | 54.9 |

t: Budget target

### 3.4: Budget Deficit

Consolidated budget deficit stood at Rs 99.9 billion during H1-FY02. This realized amount constitutes over 50 percent of annual budget target for the year. Looking at **Table 3.3,** the push towards higher deficit came from revenue side. The factors responsible for revenue shortfall are already identified in earlier sections. On expenditure side, the government succeeded to control its total expenditures during the course of time, which were just 43.1 percent of the annual budget target for the year. Despite developments along the Afghan boarder and escalating tension with India, only 41.2 percent of budgeted defense expenditures were utilized during H1-FY02.

Debt servicing, another important component of current expenditures, was 47.6 percent of the annual budget target. Partial relief on interest payment on external debt might have helped the government to curtail its interest payments. However, this little saving may remain unable to record signific ant impact on overall expenditures, as interest payment on external debt has little say compared to interest payments on domestic debt. The changing composition of domestic debt coupled with retirement of floating debt of around Rs 190 billion may help to realize savings on domestic front also.[25] Furthermore, lower T-bill rates may also contribute to this end.

In terms of the impact of budget deficit, the sources of financing are of vital importance. Looking at **Table 3.3**, the government has utilized 59.2 percent of its

[24] Since half yearly targets are not available, we are assuming that 50 percent of annual target should be realized during first half of the year.
[25] Please, see special section on **Debt**.

planned external resources. This is largely on account of improved track record with international financial institutions and higher bilateral receipts.[26] Stepping back, the composition of domestic financing also witnessed commendable changes during H1-FY02, as the government has retied Rs 10.9 billion to banking system against 10.5 billion budgeted borrowing from this source. Simple arithmetic suggests that government borrowed more from non-banking sector. Higher investment in Pakistan Investment Bonds contributed to this end.

**Table 3.3: Summary of Public Finance**
billion Rupees

| | FY02[t] | H1-FY02 |
|---|---|---|
| **1 Revenue receipts (a+b)** | **657.9** | **263.9** |
| a) Tax revenue | 528.2 | 209.0 |
| b) Non-tax receipts | 129.8 | 54.9 |
| **2 Total expenditure (a+b+c)** | **844.8** | **363.8** |
| a) Current | 714.6 | 296.7 |
| b) Development* | 130.0 | 60.3 |
| c) Net lending to PSEc etc. | 0.2 | 6.8 |
| **3 Revenue surplus/deficit (1-2.a)** | **-56.6** | **-32.7** |
| **4 Overall deficit (1-2)** | **-186.9** | **-99.9** |
| **5 Financing through:** | **186.9** | **99.9** |
| External resources (Net) | 121.6 | 72.0 |
| Internal resources (i+ii) | 65.3 | 27.9 |
| i) Domestic non-bank | 54.8 | 38.8 |
| ii) Banking system | 10.5 | -10.9 |

t: Budget Target, *: Include unidentified expenditures

In sum, although government succeeded to control its expenditures during H1-FY02, the outlook for overall fiscal operations remained pessimistic as the revenue side is lagging behind the target. Furthermore, expected higher defense expenditures due to tensions on boarder with India may cast a shadow on government outlay. Having said this, the government has to revisit its budget deficit target. In terms of GDP, the change in deficit might be more visible, as GDP at market prices may be lower than the target on account of lower inflation and slower overall economic activities.

## 4. Money and Credit

The behavior of monetary and credit aggregates during H1-FY02 contrasted sharply with the trends observed in the first half of FY01. Money supply rose noticeably during H1-FY02, mainly due to a sharp accumulation in the net foreign assets of the banking system. It may be recalled that the increase in money supply, during H1-FY01 was rather moderate due to the de-accumulation in net foreign assets. While the money supply increased perceptibly, the private sector credit expanded at a lower pace, in comparison with a faster pace observed in H1-FY01. Behavior of government borrowing from the banking system was

[26] For detail discussion on external resources, see section on **External Sector**.

also qualitatively different in H1-FY02: It was more rationally spread between SBP and scheduled banks, while it was extremely tilted towards SBP for most part of H1-FY01. Moreover, the short-term interest rates declined during H1-FY02, in contrast with an increase registered in H1-FY01

While H1-FY01 was characterized by hard decisions needed to bring back the fundamentals of the economy on track, H1-FY02 proved to be the period of consolidation on the progress made last year (FY01). One might recall that in H1-FY01, SBP was using the monetary policy to achieve stability in the exchange rate and at the same time trying to meet the hard performance criteria set by the IMF. It was the time when banks were facing unprecedented liquidity shortage and discounting heavily. The interest rates were going up and demand for private sector credit was high. Government was conducting expensive swaps to shore up its foreign exchange reserves, which even with its best efforts could not cross US $ 1.5 billion.

Contrary to this, in H1-FY02, there were no conflicting goals. Government was able to easily meet its performance criterion. There was no pressure on exchange rate whatsoever, in fact SBP had to intervene to stop rupee from appreciating. The money market was amply liquid especially in December 2001.[27] (See section on **Money Market**). Demand for credit by the private sector was low even in the face of falling interest rates.[28]

However, in terms of challenges H1-FY02 fared no less. Events of September 11 posed Pakistan with make or break kind of situation. Nevertheless, it seems that Pakistan has tackled the situation quite deftly. It has been successful, both in capitalizing on the opportunities and minimizing the losses. Having said this, the synchronized recession in the world economy, continuing drought, and border tensions with India have been a drag, which Pakistan could have done well without.

The expansion in H1-FY02 was 8.1 percent, which is almost as much as for the full year FY01 (8.9 percent) (see **Table 4.1**). As compared to H1-FY01 it was 63.2 percent higher. The growth in money supply in H1-FY02 was dominated by the foreign component, which recorded a phenomenal growth of 251.2 percent.

[27] As against Rs 138.9 billion discounting in December 2000, discounting in December 2001 was only Rs.17.3 billion.

[28] The return on 6 month T-bill as of 28th June 2001 was 12.9 percent, which declined to 7.9 percent as of 26th December 2001. Similarly discount rate was brought down from 14 percent to 10 percent

**Table 4.1: Monetary Survey**

billion Rupees

| | Actual H1-FY02 | Actual H1-FY01 |
|---|---|---|
| **A. Government Sector Borrowing (net)** | **-17.4** | **-27.6** |
| 1. Net Budgetary Borrowing | -10.9 | -9.4 |
| From State Bank of Pakistan | -7.6 | -50.4 |
| From Scheduled Banks | -3.3 | 41.0 |
| 2. Commodity Operations | -5.4 | -16.3 |
| 3. Net effect of Zakat Fund/Privatization Proceeds | -0.9 | -2.1 |
| 4. Others (Credit to NHA & CAA) | -0.2 | 0.2 |
| **B. Non-Government Sector Borrowing** | **52.1** | **81.8** |
| 1. Autonomous Bodies* | 5.3 | -9.1 |
| 2. Net Credit to Private sector and PSCEs | 46.8 | 90.8 |
| Commercial Banks | 51.8 | 90.6 |
| i. PSCEs other than B(1) | 12.3 | 10.0 |
| ii. Private Sector | 39.4 | 80.6 |
| *of which Export refinance* | *-18.2* | *6.1* |
| Specialized Banks | 7.3 | 2.5 |
| Other Financial Institutions | -11.4 | -0.1 |
| PSCEs Special Account-Debt Repayment with SBP | -0.9 | -2.2 |
| **C. Other Items (Net)** | **18.0** | **25.8** |
| **D. Net Domestic Assets of the Banking System** | **52.7** | **80.0** |
| | (3.52%) | (5.54%) |
| **E. Net Foreign Assets of the Banking System** | **71.3** | **-4.0** |
| **F. Monetary Assets (M2)** | **124.1** | **76.0** |
| | (8.13%) | (5.43%) |

P = Provisional

* WAPDA, OGDC, PTC, SSGC, SNGPL, KESC, PR, PS & PIA

Source: SBP

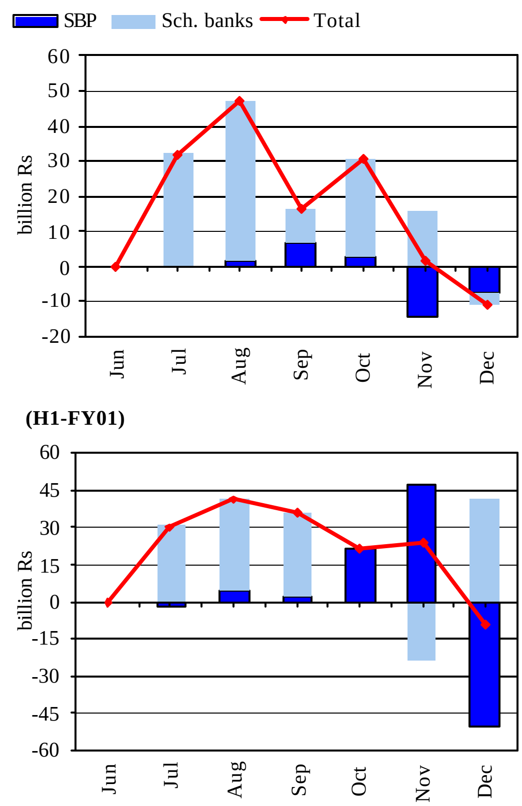
In contrast domestic credit expansion lagged behind. As against 5.5 percent growth in H1-FY01 it could only achieve 3.5 percent in H1-FY02. Credit to private sector was also not able to show the robust growth as it did in H1-FY01. Normally credit to private sector picks up in late August to peak in December-January. However, due to uncertain conditions this year private sector has been slow to pick up.[29]

[29] Data of credit to private sector beyond 31st December suggests that it has not leveled off as it usually does after December. Figures of 2nd week of February 2002 show an expansion of Rs 8.3 billion over December 2001, last year during the same period private sector recorded a contraction of Rs 2.3 billion.

### 4.1 Government Sector

As said earlier the conditions prevailing in the economy in H1-FY02 were vastly different from those of H1-FY01. The unprecedented liquidity crunch, following SBP's decision to increase CRR on October 7, 2000 to defend the exchange rate, resulted in shifting of almost entire government borrowings to SBP. Meeting end December 2000 (IMF performance criterion) NDA targets required transferring of almost 90 billion of government debt to commercial banks in little over two weeks. In H1-FY02 there was no such compulsion on SBP. Government borrowing till October 2001 was predominantly from commercial banks, and in later months too it was more evenly spread between State bank and commercial banks (see **Figure 4.1**).

**Figure 4.1: Budgetary Borrowings (H1-FY02)**

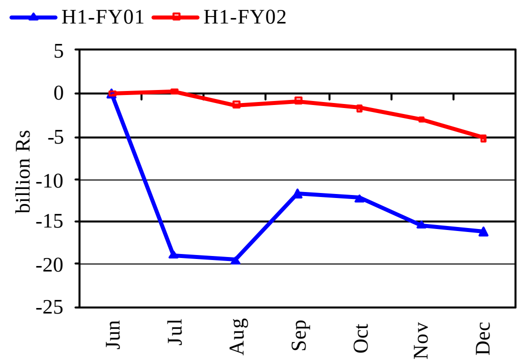



In this regard the behavior of the commercial banks during the 2nd quarter has been quite intriguing. Despite easing of rates, commercial banks were effectively throwing funds in primary auctions of T-bills (see section on **Money Market**). This could be due to number of reasons; (1) banks were expecting further cuts in the rates and trying to lock their funds at whatever rate they could get, (2) lower demand/higher retirement of credit by the private sector had left them with surplus funds, and (3) the recent surge in deposits of commercial banks has increased their liquidity, with little options to invest.

Although the target of government borrowing for H1-FY02[30] was tougher than that of H1-FY01, it was comfortably met. In H1-FY02 the government had at its disposal more of both external as well as non-bank resources. Its borrowing from PIBs (Rs 44.6 billion) and NSS (Rs 19.9 billion) was considerably higher than the corresponding period's Rs 14.2 billion (PIB) and Rs 10.9 billion (NSS). However the pivotal role in this relaxed position at end December 2001 was that of US $ 600 million grant received from the USA. Through this amount government retired almost Rs 36 billion of its debt to banking sector during November, December (see **Figure 4.1**).

Credit for commodity operations is mostly being utilized for the procurement of wheat, with the harvesting season starting in March and retirement taking place from July through April. In H1-FY02 retirement was Rs 5.4 billion as against Rs 16.3 billion in H1-FY01 (see **Figure 4.2**). The main reason for this, as explained in the earlier quarterly report was the record disbursement of Rs 40 billion in FY00, which resulted in abnormally high retirement throughout FY01. Therefore retirement in H1-FY02, although lower as compared to IH-FY01, was not abnormal.

**Figure 4.2: Commodity Operations**



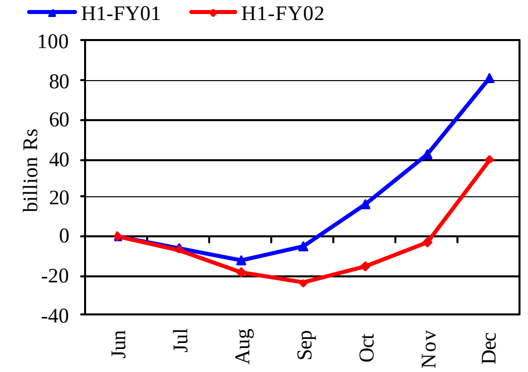

### 4.2 Non-Government Sector

Monetary Survey (see **Table 4.1**) shows that credit to private sector in H1-FY02 was Rs 39.4 billion against Rs 80.6 billion in H1-FY01. If we take into consideration the impact of merger of NDFC with NBP, actual credit expansion in H1-FY02 would be even lower. Excluding credit disbursed under export finance; credit expansion in H1-FY02 works out to Rs 57.6 billion compared to Rs 74.5 billion in H1-FY01. Accelerated retirement under export finance took place due to shift from administered and subsidized rate to market-linked rate.

[30] The target of government borrowing for H1-FY02 (under IMF PRGF) was Rs -9.6 billion, as compared to Rs 21.1 billion for H1-FY01 (under IMF SBA). It may be noted that this target of Rs 21.1 billion was initially Rs 6.4 billion and was revised upwards due to shortfall in external financing.

Apparently it seems that in H1-FY02 not only credit to private sector had been slower to pick-up but it was also significantly lower than H1-FY01 (see **Figure 4.3**). Since the figures of monetary survey are on net basis (gross disbursement less retirement) they could be misleading especially at times of quick or higher retirement. Thus, contrary to what these figures suggest, on the face of it, pace of private sector credit in H1-FY02 has not necessarily been slower. The grounds for this assessment are based on; (1) gross loans disbursement to private sector, (2) gross disbursement under export finance and (3) export data.

**Figure 4.3: Credit to Private Sector**




The data of commercial banks gross loan disbursements to private sector reveal that the amount disbursed increased from Rs264.6 billion during September-December 2000 to Rs 279.7 billion in the same period this year. Therefore the decrease in net credit as depicted in the monetary survey could also be the result of combination of the following factors; (1) relative lower credit requirement for cotton related activities in view of lower prices of raw and lint cotton, (2) effectiveness of loan recovery drive, (3) prudent lending by the banks and (4) timely repayment by the borrowers.[31] Similarly, export finance figures show that export finance provided during Q2-FY02 was Rs 55.6 billion and recoveries during the same period were Rs 64.8 billion. As against this, the amount of export finance disbursed and recoveries made during Q2-FY01 were Rs 40.3 billion and Rs 35.6 billion respectively.[32]

We have already discussed in the first quarterly report that in Q1-FY02 export finance was lower due to making of cotton yarn and cloth ineligible for export finance.[33] Timely repayments by exporters may have also been motivated by the

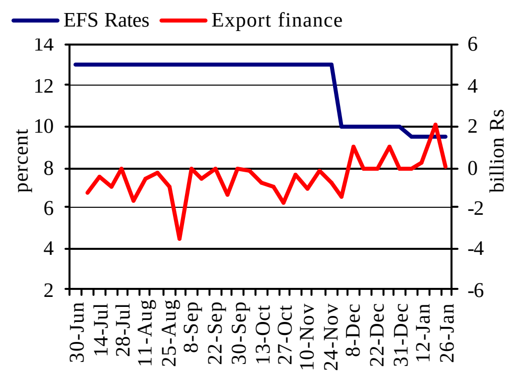
[31] Prior to appreciation of rupee, exporters used to delay repatriation of their export proceeds to gain from depreciation. Since this incentive is now gone the outstanding amount has drastically decreased.

[32] Note that the amount of recoveries in 2$^{nd}$ quarter of this year is higher than the amount disbursed under export finance.

[33] BID vide their circular No.5 dated: 30.1.02 has again made cotton yarn and cloth (bleached/unbleached) eligible for availing export finance.

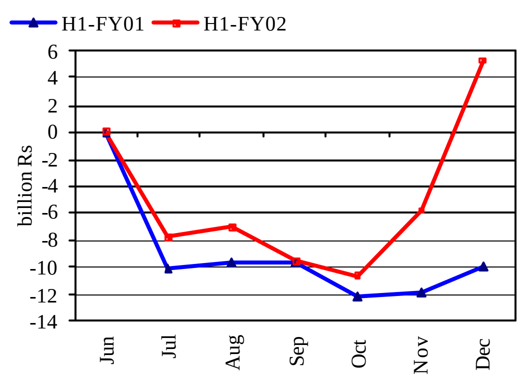
opportunity of getting new funds at lower rates. An inverse relationship between EFS rate and volume disbursed seems to have emerged. **Figure 4.4** shows increase in demand of credit under EFS after cuts in EFS rates. The trend suggests that demand in credit under EFS will increase with further 1 percent cut announced, effective from February 2002.

**Figure 4.4:Export Finance (Weekly ? ) and EFS Rates**




With regard to exports although growth in export has no doubt been hit by events of September 11 (see section on **Trade**). Quantity-wise, some products such as cotton yarn, cotton fabrics, bed wear, towels, fish and fish preparations and molasses have shown improvement in quantity exported over the corresponding period last year, which is encouraging.

**Figure 4.5: Credit to Autonomous Bodies**




Thus its seems that private sector has borne the brunt of September 11 events rather well. Having said this, private sector is not out of woods yet. There are indications that the real testing time for it will be the third quarter. Till December exporters were basically honoring their past commitments despite dwindling profits.[34] This condition is by no means sustainable. If the exporters do not get fresh orders and international prices remain depressed, there are chances that private sector may perform poorly. However, recent developments are encouraging. The EU has recently announced increase in textile quota and removal of anti-dumping duties on Pakistani textile imports. US is expected to follow suit in near future. Interest rates on EFS have

[34] The time lag involved in order received and actual shipment varies from product to product. In case of textiles it varies from 30 to 60 days.

been reduced significantly. Cotton cloth (bleached/unbleached) has again been made eligible for export finance. Construction work is likely to start in Afghanistan soon. Lower input prices this year is yet another reason for private sector, dominated by the textile to perform well.

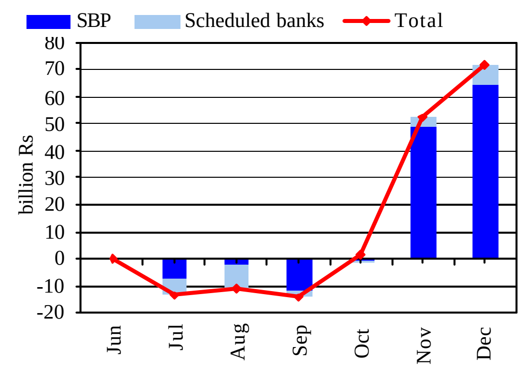
The significant development this year, with respect to autonomous bodies has been the inclusion of Pakistan Steel (PS) and Pakistan International Airlines (PIA) in the autonomous bodies. These were earlier classified as Public Sector Enterprises (PSEs). Credit to autonomous bodies is a performance criterion under PRGF while credit to PSEs is not. Since these organizations were drawing considerable sums, IMF has opted to categorize them as autonomous bodies. Normally autonomous bodies avail their credit ceilings in June and retire throughout the year. Till October 2001, autonomous bodies were following their normal retirement pattern (see **Figure 4.5**), however, this was changed in December with the borrowing of Rs 7.1 billion by PTC and Rs 2.1 billion by Pakistan Steel (PS). H1-FY02 figures thus show an expansion of Rs 5.3 billion against contraction of Rs 9.1 billion in the corresponding period last year.

In terms of lending by specialized banks, credit expansion was more pronounced in H1-FY02 as compared to H1-FY01. This expansion of Rs 7.3 billion was entirely on account of ADBP. As pointed out in the 1st quarterly report, due to better monsoon rains, prospects for agriculture sector were bright for FY02. As such ADBP had extended Rs 7.0 billion loans till September 2001. Since the nature of ADBP loans is six monthly, figures of H1-FY02 are only a slight improvement over 1st quarter figures and are likely to be liquidated by the end of next quarter.

### 4.3 Net Foreign Assets (NFA)

The growth in net foreign assets was no doubt the most significant development of the 2nd quarter (see **Figure 4.6**). Net foreign assets recorded an increase of Rs 71.3 billion in H1-FY02 against a decline of Rs 4.0 billion in H1-FY01. The increase in NFA was predominantly due to SBP's reserves build up, which continued to swell after

**Figure 4.6: NFA H1-FY02**



December 2001. Scheduled banks' NFA also showed an increase of Rs 7.7 billion but it was mainly due to decline in their liabilities. As can be seen from the figure, NFA of the banking system was negative till the end of September 2001. It showed some improvement in October; however the real boost to NFA came in November and afterwards with the inflow of US $ 600 million from USA, and around US $ 250 million from IDA and ADB. At the same time SBP, in order to both stabilize the appreciating rupee and build-up reserves purchased heavily from both the interbank and kerb markets. SBP's net purchases from the market in Q2-FY02 were US $ 935.3 million as against US $ 543.6 million in Q2-FY01. The advantage of this build-up is that SBP has already achieved its end-June 2002 target of reserves.

**4.4 Components of Money Supply**

Although money supply increased sharply in H1-FY02, there was no inflationary pressure. Lower inflation in the presence of high growth in money supply was probably due to the normal growth in domestic credit. This was further confirmed by the fact that reserve money showed no significant divergence from its seasonal growth pattern. Barring special circumstances prevailing as on 31 December 2000, the growth in reserve money in H1-FY02 and H1-FY01 was more or less the same i.e., around 9 percent.

Currency in circulation that was growing at a faster pace in Q1-FY02 than last year lost its momentum during Q2-FY02. It peaked in November 2001 and tapered off in December. Currency in circulation follows a seasonal pattern determined jointly with the interaction of calendar and Islamic Hijri months.[35] It starts to grow with the seasonal disbursement of credit to private sector (from September) and peaks usually in November or during the month in which Eid falls before tapering off. Due to this reason growth in currency in circulation peaked in December in H1-FY01 and in November in H1-FY02. In overall terms growth in currency in circulation was 14.4 percent in H1-FY02 against 15.4 percent in H1-FY01. The decrease in currency in circulation and increase in deposits has also helped bring down currency deposit ratio, which was 43.9 percent in H1-FY01 as compared to 40.2 percent in H1-FY02.

With regards to deposits, perhaps the main beneficiaries of the fallout of September 11 had been the banking institutions. Their rupee deposits that continued to dwindle in Q1-FY02 had amazingly increased by Rs 81.2 billion or a hefty 8.2 percent by end December. In contrast rupee, deposit growth in H1-

[35] See SBP Working Paper No.0102 for detailed analysis. SBP working papers are available at its website www.sbp.org.pk

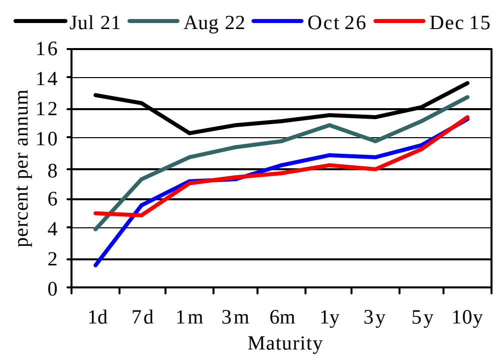
FY01 was a meager Rs 11.2 billion or 1.2 percent. The events of September 11 had led to a chain of events that eroded the opportunity cost of holding hard currency. It had not only stopped dollarization, but also effectively redirected the funds to rupee deposits. The factors responsible for this increase in deposits are discussed at length in the section on banking. Here it will be suffice to say that most of these factors are either a one time phenomenon or temporary in nature. There is a possibility that as things return to normal, people will find more profitable ways to manage their portfolios. As such this windfall increase in deposit can disappear as quickly as it has appeared. Already, stock market and real estate are showing signs of increased activity. Therefore, decrease in deposit of Rs 17 billion in January 2002 should be considered as a wake-up call.

The need of the hour hence is for the banks to capitalize on this unique opportunity. They should devise attractive incentives to retain these deposits and in the mean while also find ways to reduce their intermediation cost.

## 5. Money Market

The money market remained calm during second quarter of FY02, as compared to the same quarter of preceding year. It did not experience drastic upheavals in overnight rates as observed in end December 2000. Likewise, periods of extraordinary shortages of liquidity were also relatively absent during the quarter, in contrast with the last year. Government borrowing behavior was also much more balanced in its composition from SBP and scheduled banks. Rupee counterpart of US aid greatly helped in achieving that balance (see section on **Money and Credit**)

**Figure 5.1: Yield Curves (FY02)**




Above developments gave SBP a considerable leverage in successfully implementing its policy of gradual monetary ease, supported by injections for smoothing seasonal liquidity shortages. Three gradual cuts in the discount rate during first half of FY02 not only succeeded in bring down the short-term money market rates, but also shifted the yield curve steadily downwards (see **Figure 5.1**).[36]

However, the market participants largely misconstrued the signals of gradual monetary ease. The market, unfortunately, fell into a cycle of self-fulfilling expectations of decreasing rates in t-bill auctions, unwittingly started by decision of lowering cut-off yields in successive auctions of November and December 2001.[37]

### 5.1 Discounting

During the quarter as a whole, activities at the discount window highlighted the relative liquidity comfort as compared to Q2-FY01. Overall, banks discounted Rs 336.1 billion during the quarter against Rs 859.8 billion in corresponding period of last year. Both the frequency of visits and average discount per day showed a considerable decline. The only exception was the month of November, when banks faced a crunch similar to the one they faced during last November (see **Table 5.1**).

**Table 5.1: Activities at Discount Window**

billion Rupees

| | No. of visit to discount window (no. of days) | | | Total amount of discounting | | | Average per visit | | |
|---|---|---|---|---|---|---|---|---|---|
| | **FY00** | **FY01** | **FY02** | **FY00** | **FY01** | **FY02** | **FY00** | **FY01** | **FY02** |
| October | 13 | 28 | 25 | 29.5 | 438.2 | 107.4 | 2.3 | 15.6 | 4.3 |
| November | 2 | 30 | 26 | 28.2 | 282.7 | 211.5 | 14.1 | 9.4 | 8.1 |
| December | 12 | 22 | 6 | 62.3 | 138.9 | 17.3 | 5.2 | 6.3 | 2.9 |
| **Quarterly** | **27** | **80** | **57** | **120.0** | **859.8** | **336.1** | **4.4** | **10.7** | **5.9** |

The second quarter of the fiscal year is usually characterized by the private sector credit extension; therefore, liquidity squeeze on the banks was expected. In anticipation, SBP provided liquidity ease through injections in OMOs, and by accepting less than the maturing amounts in the t-bill auctions.[38] Specifically, against a maturity of Rs 79.4 billion only Rs 52.2 billion were accepted. However the banks felt the liquidity drain in November mainly due to increase in currency in circulation, on account of credit extension to private sector coupled with seasonal Eid outflows. However, market eased off in December

[36] The lower end of yield-curve inched-up in December 2001, not due to the actual liquidity crunch but market perception tainted by the negative experience of December 2000.
[37] These expectations were reinforced by the cut in discount rate to 9% in January 23, 2002.
[38] This is in contrast to Q1-FY02, moreover, this is expected in wake of declining T-bill rates.

considerably due to higher retirement, in anticipation of lowering interest rates (see section on **Money and Credit**).

Looking at **Figure 5.2**, overnight rates were very close to discount rate during November, and for the other two months the rates mostly remained lower, though fluctuated randomly. Interesting point to note here is the constant crest in November that started just after the discount rate decrease in October. Ordinarily, a cut in discount rate triggers a decrease in money market rates of all tenors. However, the overnight rates remained close to the new, albeit lower discount rate, indicating the seasonal liquidity shortage at that time. Nevertheless, other short-term rates declined unequivocally, clearly reflecting the change in SBP's monetary stance.

## 5.2 Open Market Operations

As stated earlier, the SBP facilitated banks in meeting the expected drain on liquidity, through injecting funds without resorting to any absorption during the whole quarter (see **Table 5.2**). Although, during the same quarter last year funds were not absorbed, the amount injected was much lower.

**Table 5.2: Open Market Operations**
billion Rupees

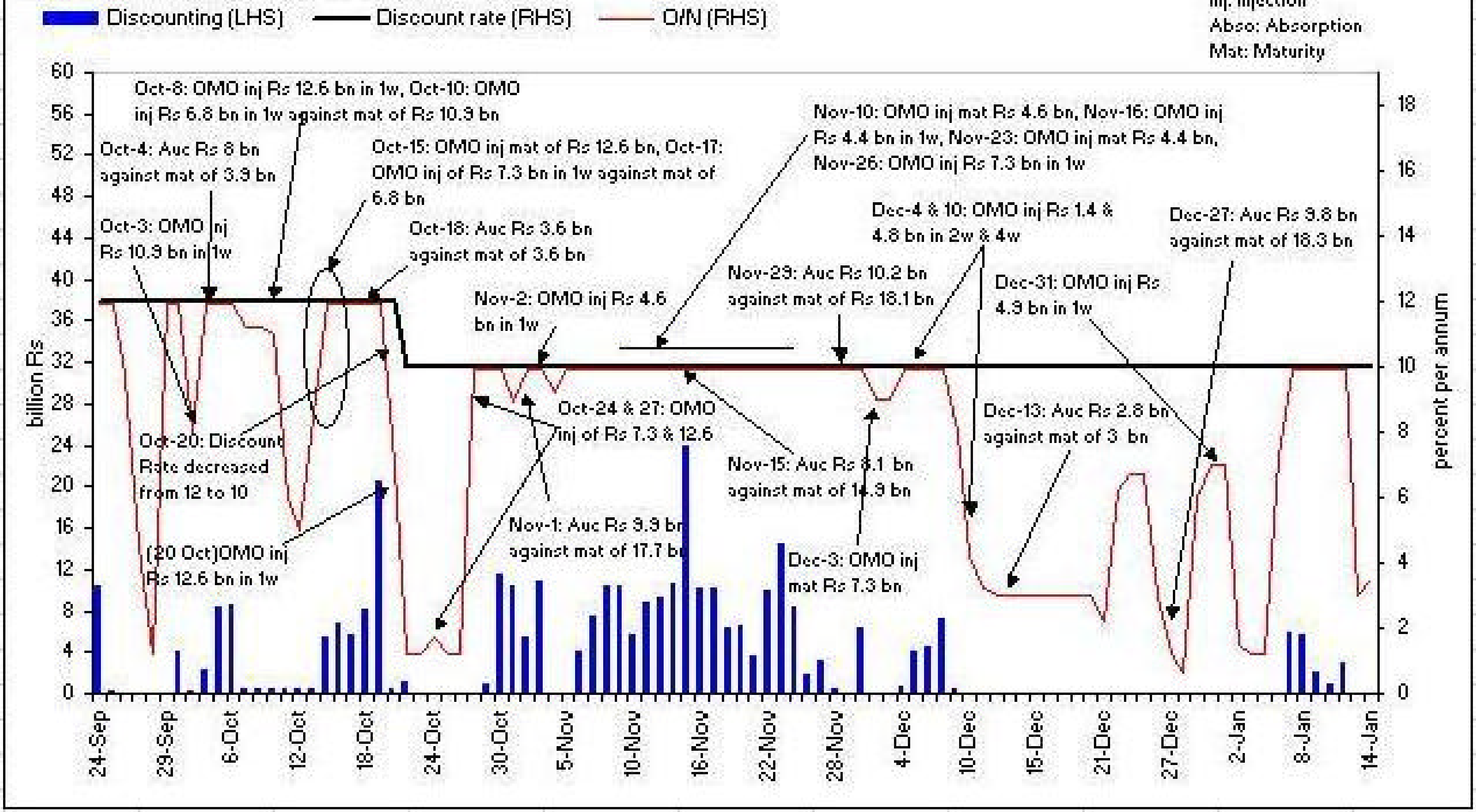
| | Injection | | | Absorption | | |
|---|---|---|---|---|---|---|
| | **FY00** | **FY01** | **FY02** | **FY00** | **FY01** | **FY02** |
| October | 18.2 | - | 50.1 | - | - | - |
| November | 4.4 | 9.4 | 16.2 | 5.5 | - | - |
| December | 24.5 | 22.4 | 11.1 | 5.0 | - | - |
| **Total** | **47.1** | **31.8** | **77.4** | **10.5** | **-** | **-** |

Since switching to proactive conduct of OMOs, the SBP continued to monitor market liquidity conditions and developments in exchange rate on daily basis.[39] In contrast to Q1-FY02, the pressure on exchange side was non-existent when financing season arrived. This had two significant implications: *firstly*, no urgent need to invert the short-end of yield curve; and, *secondly*, to keep the market liquid through intervention (see **Table 5.3**). It can be seen in **Figure 5.2**, the overnight rates remained mostly subdued, apart from periods of systemic liquidity crunch.

The most noteworthy event of the quarter, in terms of OMOs, was, the injection of Rs 4.9 billion on December 31, which was an unprecedented event and contrasted sharply with the same day of the preceding year. This shows the SBP's willingness to facilitate the market, barring any exceptional circumstances.[40]

[39] See section on **Money Market** in the first *Quarterly Report* FY02.
[40] For a complete discussion see section on **Money Market** in the *Second Quarterly*, FY01.

**Figure 5.2: Discounting and Over Night Rates**



## 5.3 Primary Auctions

**Table 5.3: OMO Summary of Results**

billion Rupees

| Day | Date | Offered | Absorbed | Bid | Injected |
|---|---|---|---|---|---|
| Wed | 3-Oct-01 | 0.0 | 0.0 | 15.8 | 10.9 |
| Mon | 8-Oct-01 | 0.0 | 0.0 | 18.3 | 12.6 |
| Wed | 10-Oct-01 | 0.0 | 0.0 | 13.0 | 6.8 |
| Wed | 17-Oct-01 | 0.0 | 0.0 | 18.6 | 7.3 |
| Sat | 20-Oct-01 | 0.0 | 0.0 | 16.6 | 12.6 |
| Fri | 2-Nov-01 | 0.0 | 0.0 | 8.4 | 4.6 |
| Fri | 16-Nov-01 | 0.0 | 0.0 | 18.6 | 4.4 |
| Mon | 26-Nov-01 | 0.0 | 0.0 | 11.7 | 7.3 |
| Tue | 4-Dec-01 | 0.0 | 0.0 | 4.7 | 1.4 |
| Mon | 10-Dec-01 | 0.0 | 0.0 | 11.5 | 4.8 |
| Mon | 31-Dec-01 | 0.0 | 0.0 | 4.9 | 4.9 |
| **Q2-FY02** | | **0.0** | **0.0** | **141.9** | **77.4** |

As shown in **Figure 5.3**, the t-bill rates have followed the declining trend of the previous quarter. Effectively, the six month T-bill yield have fallen from end-June level of 12.9 percent to 7.9 percent at end December 2001.[41] This decline is, primarily, due to three factors: recessionary impact generated by September 11 events on world economy as a whole and its negative brunt on Pakistan; the easing pressure on the exchange rate front; and, last but not the least, the better state of affairs with IFIs together with improvement in NFA of the country.

In overall terms, the government mobilized Rs. 52.2 billion from primary auctions, representing 39.6 percent of total bids in Q2-FY02. The fraction accepted, predictably, shows a decline vis-à-vis last year, however, in absolute terms, both the amount offered and accepted show a considerable hike.[42]

The **Figure 5.4** reveals some unusual bidding behavior by the banks. Although, the month of November faced liquidity problems in both FY01 and FY02, the bidding patterns were the opposite. Last year banks were offering nominal amounts even if the T-bill yields were largely stagnant, however, this year the banks were bidding heavy amounts, though the T-bill yields were declining.

This perplexing behavior suggests that banks have been overbidding in the hope of locking their funds at higher rates, as the interest rates were going down. As stated earlier, this was due to the self-fulfilling expectations of the market about decrease in interest rates. This behavior was triggered by the fact that SBP was accepting less in order to keep the market liquid. This effectively reduced the rates further and, consequently, banks resorted to overbidding in subsequent

[41] After one percent cut in discount rate effective from 23 January 2002, t-bill weighted average yield further declined to 6.3 percent in the auction held on the same date.

[42] Comparing Q2-FY01 and Q2-FY02, banks offered Rs 59.2 & 131.9 billion of which SBP accepted Rs 27.7 & 52.2 billion, respectively.

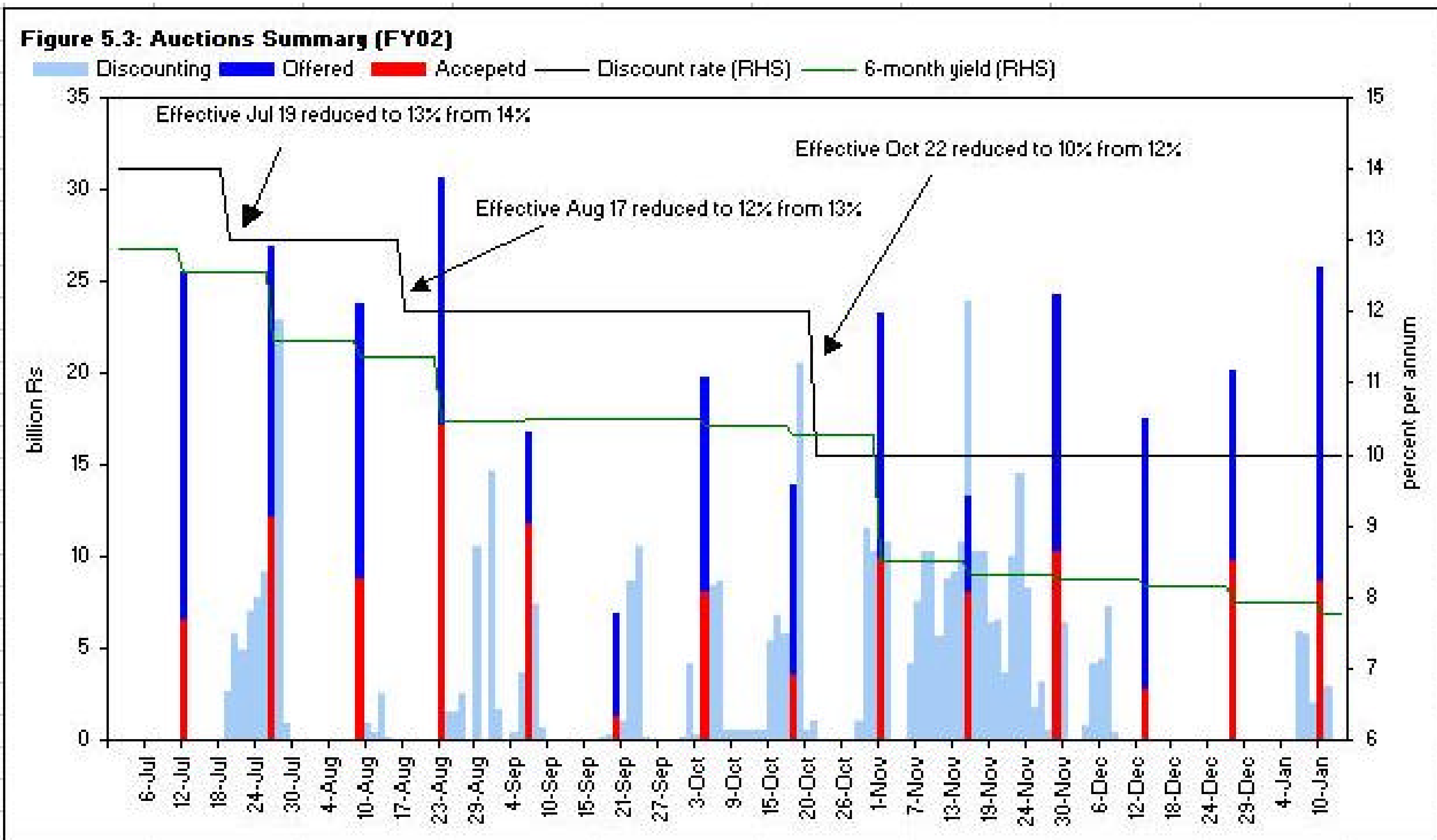
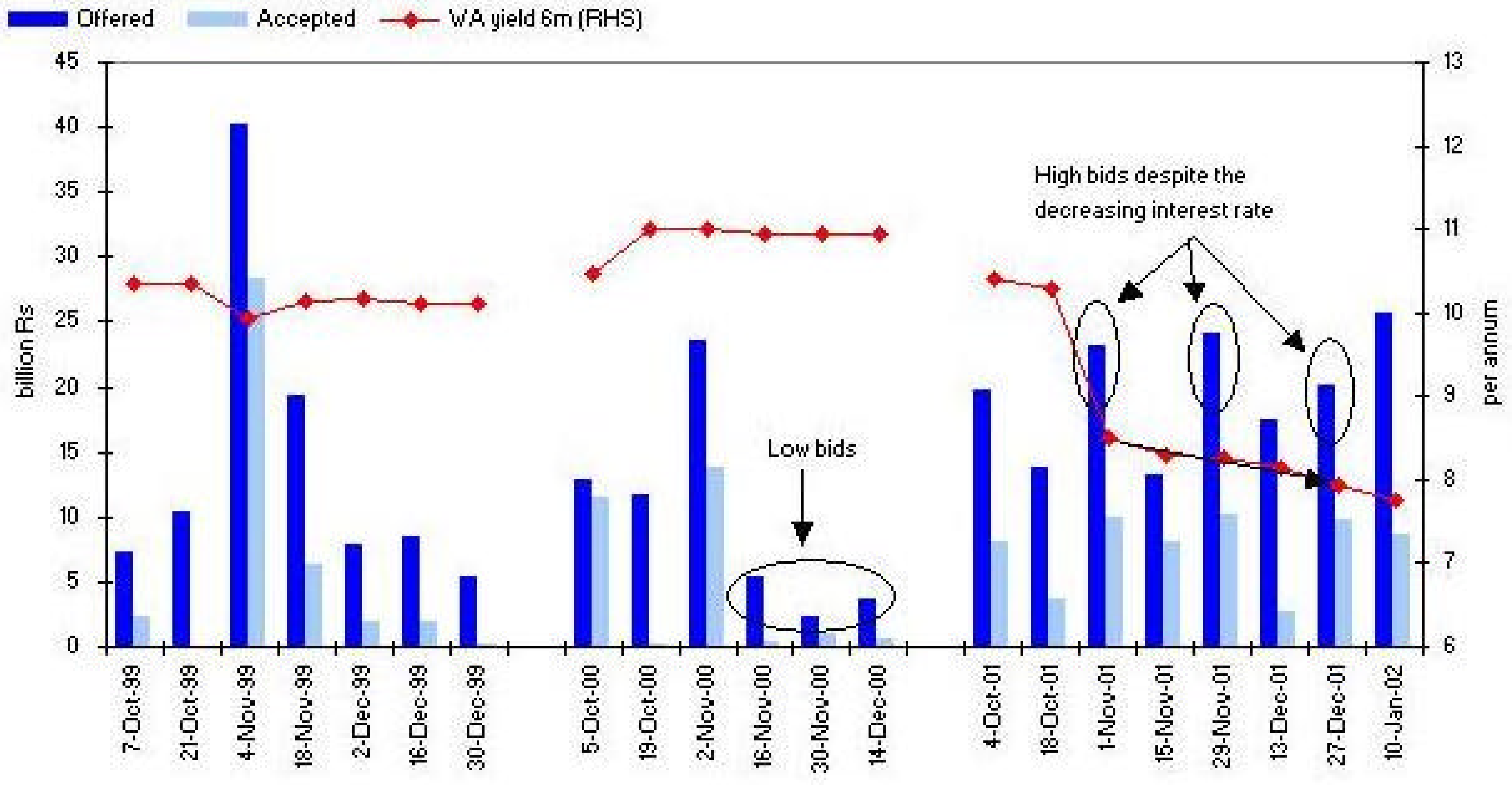


Figure 5.3: Auctions Summary (FY02)
Discounting
Offered
Accepetd
Discount rate (RHS)
6-month yield (RHS)
Effective Jul 19 reduced to 13% from 14%
Effective Aug 17 reduced to 12% from 13%
Effective Oct 22 reduced to 10% from 12%
billion Rs
percent per annum
0
5
10
15
20
25
30
35
6
7
8
9
10
11
12
13
14
15
6-Jul
12-Jul
18-Jul
24-Jul
30-Jul
4-Aug
10-Aug
17-Aug
23-Aug
29-Aug
4-Sep
10-Sep
15-Sep
21-Sep
27-Sep
3-Oct
9-Oct
15-Oct
20-Oct
26-Oct
1-Nov
7-Nov
13-Nov
19-Nov
24-Nov
30-Nov
6-Dec
12-Dec
18-Dec
24-Dec
29-Dec
4-Jan
10-Jan

**Figure 5.4: Auction Summary of MTBs**



auctions. In order to align the market expectations in the proper direction, the SBP accepted all bids in the auction of February 6, 2002, with a slight increase in 12-month cut-off yield. This gave market a sufficient signal that rates are unlikely to go down further, thereby preparing the participants to place bids in coming auctions on a more rational basis.

## 5.4 PIB Auctions

As shown in the **Table 5.4**, three PIB auctions were held during the quarter with a combined target of Rs 27 billion, SBP was able to meet the target comfortably in all auctions and in all tenors. This is in contrast to the last quarter where the target was not achieved, mainly due to several distinct factors.[43] PIB coupon rates were adjusted downwards on November 6, 2001, in accordance with the overall expansionary monetary stance. Additionally, the secondary market quotes for 3, 5 and 10-year tenors already declined in October, just after the decrease in discount rate.

**Table 5.4: PIB Auctions - Summary of Results**

billion Rupees

| Auction | Tenor | Target | Coupon rate | Amount Offered | Range of Price offered/Rs. | Amount Accepted | W. A. % p.a. | % Accepted of Total |
|---|---|---|---|---|---|---|---|---|
| 11th Oct 29, 01 | 3 Years | | - | - | - | - | - | - |
| | 5 Years | | - | - | - | - | - | - |
| | 10 Years | | 13.0% | 22.3 | 100.00–104.37 | 11.9 | 12.4534% | 100.0% |
| | **Total** | **12.0** | - | **22.3** | - | **11.9** | - | **100.0%** |
| 12th Nov 21, 01 | 3 Years | | 10.5% | 3.7 | 99.51—100.10 | 2.2 | 10.4933% | 44.1% |
| | 5 Years | | 11.0% | 4.0 | 99.50—100.10 | 2.8 | 10.9968% | 55.9% |
| | 10 Years | | - | - | - | - | - | - |
| | **Total** | **5.0** | - | **7.7** | - | **5.0** | - | **100.0%** |
| 13th Dec 22, 01 | 3 Years | | - | - | - | - | - | |
| | 5 Years | | - | - | - | - | - | |
| | 10 Years | | 12.0% | 26.5 | 99.90–100.80 | 10.4 | 11.9206% | 100.0% |
| | **Total** | **10.0** | - | **26.5** | - | **10.4** | - | **100.0%** |
| **Grand Total** | - | **27.0** | - | **56.4** | - | **27.4** | - | - |

Two auctions involving the sale of ten year PIB were held during the quarter. The factor of under-estimation of market demand by PDs was clearly reflected in the bid pattern. Had SBP selected the cut-off bid at par the amount accepted would have been roughly 120 percent more than the combined target. Nevertheless,

[43] See section on **Money Market** in the first *Quarterly Report*, FY02

SBP honored its commitment of not exceeding the target.[44] We have been highlighting, in our previous reports, the inherent behavior of PDs to undermine market demand. It is expected that PDs will increase their capability to judge the market more accurately in future in order to make 10 year PIB an even greater success. This bidding behavior has another aspect also, that is, the inability of institutional investors to properly price their bids. Mostly, the institutional investors want their bids to be placed at par. PDs can also play a meaningful role in educating their clients. All in all, ten year PIB is enjoying considerable success in the market even after the cut in coupon rates.

Only one auction involving the sale of three and five-year PIBs was held. Cut-off was drawn at par and target was met comfortably. Despite the decrease in coupon rates, bidding pattern suggests satisfactory market response. The market demand estimates of PDs also seem to be better in case of these papers.

## 6. Banking

The current fiscal year did not start with a positive note for the banking industry.[45] Increase in profit rates of National Saving Schemes (NSS) in July 2001, began to set a trend of dis-intermediation. This further accentuated in the aftermath of 11th September, leaving banks with an erosion of Rs 9.1 billion in their deposit base during Q1-FY02. Although during the first quarter of fiscal year, banking activities usually remain dormant with limited credit off-take and higher retirement; slackening of credit demand following the events of September further dampened the banking business. Later developments especially scrutiny of Hundi system, fortunately proved beneficial for banks despite slower pick-up of private sector credit and decrease in T-bill rates.[46]

More specifically, during Q2-FY02 deposits of banking sector grew by Rs 80.0 billion against Rs 8.5 billion in the same period last year and an actual decline in first quarter this year (see **Table 6.1**). This was possible due to extraordinary foreign exchange inflows that overshadowed the expected poor performance of the banking system. With the increased risk in keeping the foreign exchange holdings abroad and suspension of Hundi system (for reasons see first *Quarterly*

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[44] If cut-off was drawn at the amount accepted would have been Rs 48.3 billion out of total offered amount of Rs 48.8 billion, instead of the actual accepted amount of Rs 22.3 billion (combined target was Rs 22.0 billion).

[45] See first *Quarterly Report* for FY02 for an extended discussion.

[46] Though declining return on government papers affects the earning opportunities, banks were aggressively participating in auctions in anticipation that interest rates would further go down. However, this decline may help them in recording capital gains on securities purchased earlier at higher rates.

*Report*), these were diverted towards banking channels. Furthermore, low premium between kerb and interbank market, induced the overseas Pakistanis to use the official means for remitting foreign exchange.[47] In addition, money coming under Hajj Sponsorship Scheme also helped banks (especially Nationalized banks) in replenishing their deposit base.

**Table 6.1: Deposits of Banks (Flows)**

billion Rupees

| | Q1 | | Q2 | | H1 | |
|---|---|---|---|---|---|---|
| | **FY01** | **FY02** | **FY01** | **FY02** | **FY01** | **FY02** |
| NCBs | 10.2 | 0.4 | -20.3 | 38.5 | -10.1 | 38.9 |
| Prvtzd banks | -6.1 | -4.2 | 11.2 | 6.4 | 5.1 | 2.2 |
| Splzed banks | 1.3 | -1.3 | -3.9 | 3.3 | -2.6 | 2.0 |
| Private banks | 10.8 | -0.6 | 12.8 | 27.1 | 23.6 | 26.5 |
| Foreign banks | 0.1 | -3.4 | 8.7 | 4.7 | 8.7 | 1.3 |
| **All banks** | **16.3** | **-9.1** | **8.5** | **80.0** | **24.8** | **70.9** |

It is encouraging to note that this higher growth in deposit is mostly brought by Rupee banking. This is because of the fact that appreciation of domestic currency and declining LIBOR rates[48] depleted the effective return on FCAs and dollar holdings, leaving the holders with the option to convert these in to Rupee accounts.[49] **Table 6.2** shows the declining flows in rupee value of total FCAs in first half of FY02,[50] against a positive growth in Dollar term. The difference can be explained by appreciation of Rupee against greenback during second quarter this year. Point to make here is that if appreciation of local currency is adjusted, increase in the deposits during H1-FY02 was much higher than what is depicted from **Table 6.1**.[51] However, foreign currency *term deposits* have declined both in rupee and dollar term, which is understandable after decrease in expected return thereon.

**Table 6.2: Foreign Currency Deposits (flows during FY02)**

| | billion Rupees | | | million US$ | | |
|---|---|---|---|---|---|---|
| | **Q 1** | **Q 2** | **H1** | **Q 1** | **Q 2** | **H1** |
| Demand | 0.7 | 1.8 | 2.5 | 11.9 | 51.1 | 62.9 |
| Savings | 1.0 | -1.9 | -0.9 | 16.8 | 82.1 | 98.9 |
| Time | -3.2 | -9.3 | -12.4 | -48.5 | -75.8 | -124.3 |
| **Total** | **-1.4** | **-9.5** | **-10.8** | **-19.8** | **57.4** | **37.5** |

[47] During first half of FY02 US$ 982.3 million remittance from banks were recorded against US$ 609.2 million in the same period last year.
[48] LIBOR rate is the upper ceiling for the rates on foreign currency deposits.
[49] During H1-FY02, withdrawals of US$ 348.6 million were recorded from FE-45 & FE-31 deposits of banks and NBFIs, while in the same period FE-25 increased by US$ 162 million.
[50] Including both resident and non-resident FCAs of all categories.
[51] Rupee deposits of the banking system increased by Rs 89.5 billion during second quarter of FY02, as total deposits grew by Rs 80.0 billion while $ deposits in Rupee term declined by Rs 9.5 billion (see **Table 6.1 & 6.2**)

Notwithstanding these developments, possibility of window dressing at end financial year may not be excluded as a reason for this higher growth, as Rs 50.8 billion increase is observed during December alone.[52] Subsequent decline by Rs 17.1 billion in the first week of January further support this view.[53] However, even after adjusting this element, significantly higher growth is evident in banks' deposits.

When compared at group level, nationalized and private banks out performed the other groups. It is observed that private banks have been performing well in deposit generation; growth was higher this year especially during second quarter (see **Table 6.1**). With the increase in the opportunity cost of dollar holdings people started depositing in these banks as they are offering relatively better return. Much more important to note is the deposit growth for Nationalized banks. Large branch network and shifting focus on rupee banking provided them an advantage over other groups. It is a stylized fact that these banks are considered safer under uncertain conditions with the explicit government guarantee at the back. Furthermore, large share of money from Hajj Sponsorship Scheme came to these banks.

Data given in **Table 6.1** suggest that foreign banks failed to perform up to their standards. However, as these banks are more exposed towards foreign currency accounts, the conversion effect at lower exchange rate resulting in lower Rupee value is more prominent for this group.[54] In addition to this, anecdotal evidence suggests that restrictions on foreign currency deposits (under FE25) that limited their growth to just 20 percent of their rupee deposits hampered the growth of foreign banks.

### 6.1 Spread between Lending and Deposit Rates

Declining yield on government securities since the beginning of FY02 brought about by the downward adjustment of SBP repo rate, started to narrow the spread between weighted average lending and deposits rates at the end of second quarter

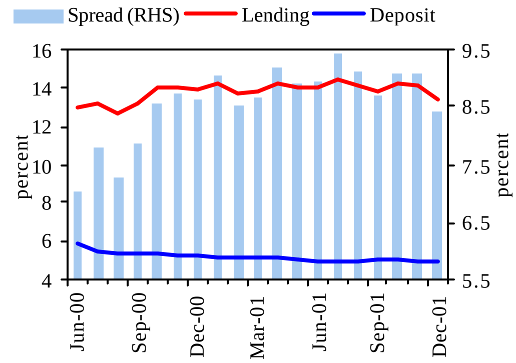
[52] The main motive behind this are (a) banks want to show a rosy picture in their half yearly and annual accounts which are made public and (b) branch manager's reward and bonuses depend on the amount of deposits they can manage at closing.

[53] It is generally observed that at end June and December, to show higher deposits growth, few banks shift EFS advances in saving deposits, which favors both banks and the customer. In addition, banks usually pursue the customers to delay the withdrawals during last week of June and December. However, it results in heavy withdrawals during following week.

[54] As on December 2000, 43 percent of foreign banks total deposits were foreign currency denominated.

(see **Figure 6.1**). This was possible due to decline in weighted average rate on lending during this period with almost same level of deposit rates. As discussed earlier in *Money & Credit* section, compared to last year, lower increase in advances despite higher disbursement during Q2-FY02 suggests that borrowers were retiring high interest loans in anticipation that they may borrow cheaply following the rates cut by SBP. This behavior is more apparent in case of Export Finance Scheme (EFS) as these are linked with weighted average yield on six month T-bills.[55] It is generally observed that EFS lending comprised large portion of private and foreign banks loan portfolio, hence higher decline in their lending rates was expected (see **Figure 6.2**). In addition, limited and relatively more informed clientele of foreign banks quickly readjusted their loan portfolio at lower rate.

**Figure 6.1: W. A. Deposit & Lending Rates**



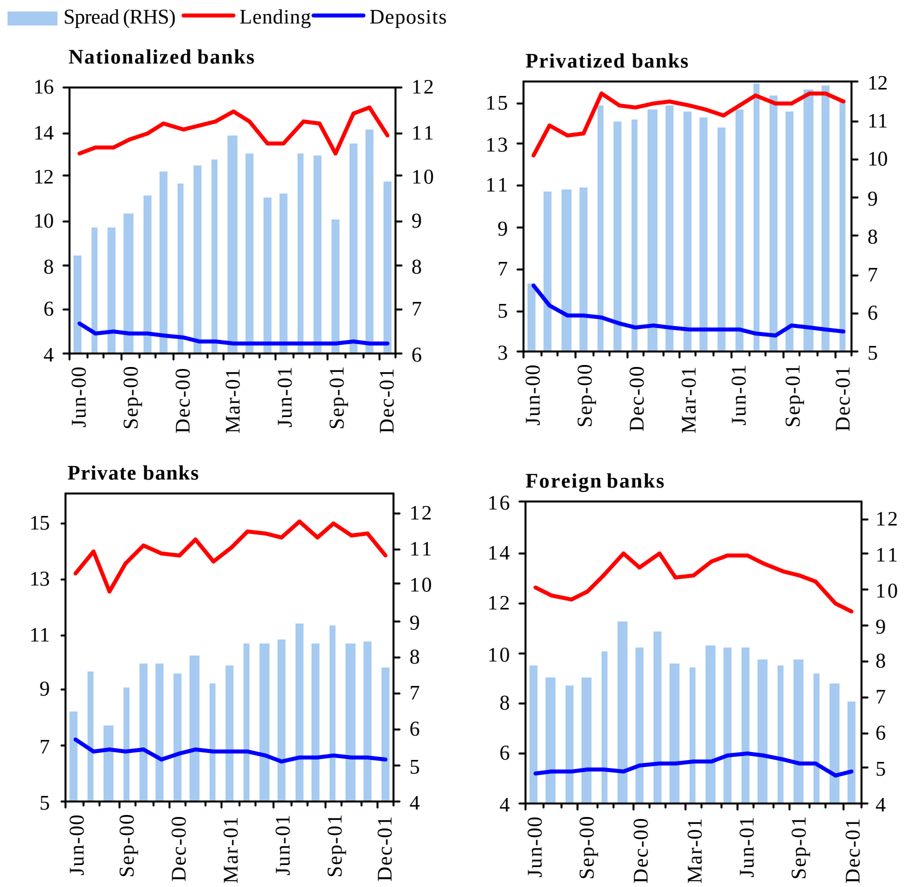

Large banks both in nationalized and privatized groups failed to show a decrease in their lending rates for most of the quarter. However, sharp cut in weighted average lending rates during December 2001 with almost same deposit rates at last month level narrowed the spread for these groups.[56] As they cater to the need of relatively longer maturity credit and consequently have a relatively small share of export financing in their total loan portfolio, lending rates of these banks are expected to decline a little further with a time lag.

### 6.2 Non-performing and Defaulted Loans

Non-performing loans of the banking system fell back at end of Q2-FY02 (see **Figure 6.3**). A visible declining trend is noticeable in the outstanding amount of

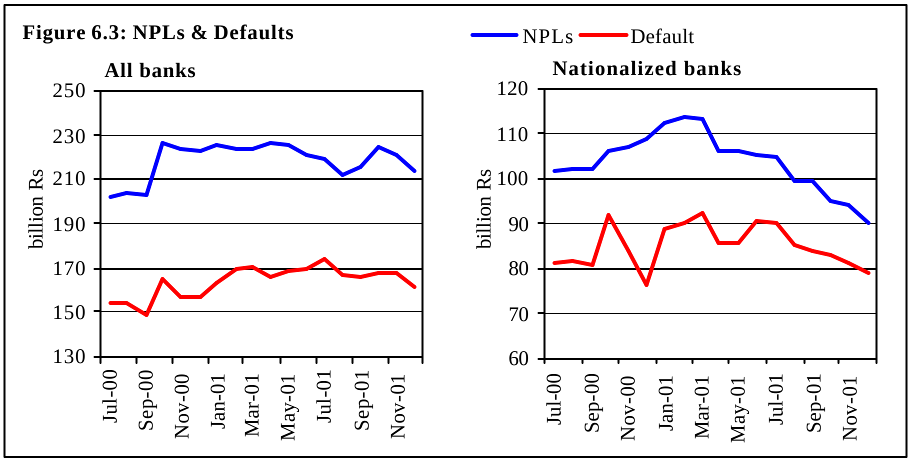
[55] During Q2-FY02, Rs 55.6 billion were disbursed in EFS while Rs 64.8 billion were repaid. In this same period last year these figures were Rs 40.3 and Rs 35.6 billion respectively.
[56] Weighted average lending rates of Nationalized and Privatized banks fell by 130 and 40 basis points respectively, during December 01.

**Figure 6.2: Group-wise W.A. Deposit and & Lending Rates** (percent)




both NPLs and defaulted loans. However, more encouraging is the declining gap between the two, as simultaneous downward movement is probably indicative of the fact that new loans are being disbursed more prudently.

As shown in **Figure 6.3**, declining trends in both NPLs and defaulted loans are more prominent in case of Nationalized banks. Accountability drive by the present government and increasing role of CIRC (established in Sep 2000) in acquiring bad loans, are helping these banks in improving the quality of their asset portfolio. As they are expected to be privatized, these developments will help government in getting a better price.



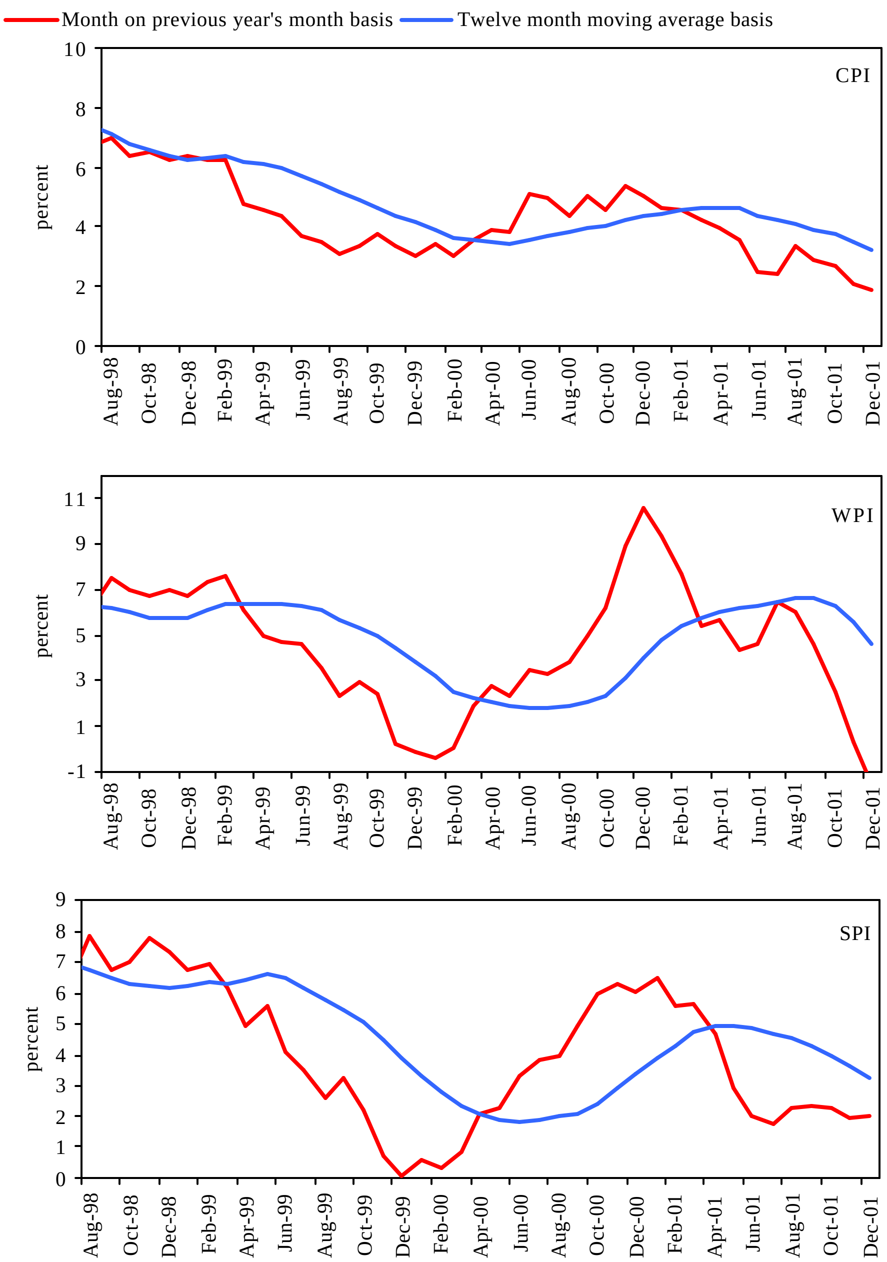

## 7. Prices

The rate of inflation continued on its declining trend during the second quarter of FY02 that started in the first quarter. The intensity of decline was visible not only in all the three price indices but across the various measures of annualized inflation reported in **Table 7.1**. Annualized inflation in terms of the Consumer Price Index (CPI), on quarter to quarter basis showed a decline from 5.0 to 2.2 percent. In terms of the Wholesale Price Index (WPI), the decline was very sharp, from 8.6 to 0.4 percent, and in terms of the Sensitive Price Indicator (SPI), from 6.1 to 2.1 percent. Moreover, all the three indices show a declining trend in terms of the twelve-month moving average rates of inflation (see **Figure 7.1**). This is an indication that the inflationary pressures are unlikely to develop in the current fiscal year.

**Table 7.1: Inflation Trends**
percent

| Indices | Quarterly Inflation | | Half yearly Inflation | | Annualized Inflation | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cumulative Oct to Dec | | Cumulative July to Dec | | Month to Month Basis | | Quarter to Quarter Basis | | Half Year to Half Year Basis | | 12-Month Moving Average Ending* | |
| | 2000 | 2001 | 2000 | 2001 | Dec-00 | Dec-01 | Q2-FY01 | Q2-FY02 | H1-FY01 | H1-FY02 | Dec-00 | Dec-01 |
| CPI | 0.9 | -0.1 | 2.4 | 1.8 | 5.1 | 1.9 | 5.0 | 2.2 | 4.9 | 2.3 | 4.4 | 3.2 |
| WPI | 3.3 | -2.7 | 5.6 | -0.5 | 10.6 | -1.5 | 8.6 | 0.4 | 6.3 | 3.0 | 4.0 | 4.6 |
| SPI | -0.1 | -0.5 | 2.3 | 2.3 | 6.1 | 2.0 | 6.1 | 2.1 | 5.2 | 2.1 | 3.4 | 3.3 |

**Figure 7.1: 12-Monthly Changes in Price Indices**



Declines in annualized rate of inflation, on month over month basis, were more pronounced. In fact, a deflation of 1.5 percent was registered in terms of WPI between December of 2000 and 2001. During this period, CPI increased by only 1.9 percent. Deflation in WPI was caused by the decline in prices of *raw materials and building materials* that are not covered in CPI.[57] This is, perhaps, also an indication of relative vulnerability of wholesale markets to domestic and external developments.

Across the board falling rates of inflation reflect lower food and non food prices resulting from buffer stock of food grains, improved supply of essential commodities like wheat flour, sugar, pulses and vegetables etc. The declining prices of POL products and unit value of some of the imported items further helped in pulling down the rate of inflation during the quarter. In addition, softening of inflationary expectations also played their part.

***CPI***

The inflation rate, as measured by the annual average change in CPI, by and large, moved in tandem with WPI. Looking at the average change in CPI, the rate of increase was 2.2 percent in second quarter of FY02 compared with 5.0 percent in the corresponding period last year. A decelerating trend was observed both in food and non-food groups. Decomposition of CPI basket revealed that during second quarter, *food, beverages & tobacco* registered relatively a much smaller increase than non-food group during Q2-FY02. *Food, beverages & tobacco* group increased only by 0.9 percent during Q2-FY02 compared with 4.9 percent in the same period last year. Non-food group recorded a subdued growth of 3.5 percent during Q2-FY02 compared with 5.1 percent in the corresponding period of last year.

The deceleration of the *food, beverages and tobacco* index during Q2-FY02 was mainly on account of the improved availability of essential items like wheat, wheat flour, rice, sugar, gur, tea, ghee, pulses and vegetables etc; coupled with higher imports of some of the food items as well as lower transportation cost. The sugar prices were also declining in the second quarter. It started declining from Rs.26.68 per Kg in July 2001 to Rs.20.93 per Kg in December FY01. The

[57] The sub-index of r*aw materials* declined by 0.5 percent compared with an increase of 8.3 percent in the corresponding period of last year. The pronounced drop in the index of raw materials was on account of the decline in cotton prices by 7 percent. Similarly, the sub index of b*uilding materials* declined by 0.6 percent as against rise of 4.4 percent last year. The fall in the prices of cement and bricks/blocks etc, mainly contributed to the deceleration of this sub index.

falling price of sugar was mainly on account of the huge stockpiling at the end of FY01 and additional fresh supply from the sugar mills during the ongoing season.

Prices of wheat and wheat flour showed a downward trend. Vegetable ghee and cooking oil prices also remained stable on account of reduction of retail prices in the month of Ramadan by the manufacturers and further due to falling import unit value of edible oil. Similarly, rice prices remained in the range of last year level as new crop arrivals gained momentum with relative slowdown on the export front, the appreciation of Pak Rupee has made exports less competitive. Tea also observed stability in its prices. The domestic price of tea largely depends upon the behavior of international prices and its import unit value. Because of the improved tea production in Kenya this year and a decline in the import unit value by 15.5 percent, prices of tea remained stable as compared to the corresponding period last year. A substantial deceleration was observed in the prices of onion and tomatoes during Q2-FY02 compared with the corresponding period of last year.

Non-food group registered an increase of 3.5 percent during Q2-FY02 as against 5.1 percent in the comparable period last year. The subdued growth in the non-food mainly resulted from reduced rates of increase observed in *apparel, textiles & footwear; fuel & lighting; transport & communication; recreation; entertainment* & *education*; *cleaning, laundry & personal appearance;* and *household furniture* as compared to the changes in the similar period of last year.

During Q2-FY02, the prices of petroleum products were revised six times. The five times downward revision in the prices of diesel by Oil Companies Advisory Committee had a bearing on the index of the *fuel & lighting* and *transport & communication* that led to smaller increase by 6.4 and 7.0 percent compared with 9.6 and 13.3 percent respectively in the corresponding period last year. The strength of deceleration in CPI was contained to some extent by the acceleratory impact of other indices i.e., *apparel, textiles & footwear* and *recreation, entertainment & education* that showed an increases of 3.0 and 4.5 percent during Q2-FY02 compared with 2.6 and 4.0 percent respectively in the same period last year. However, the increase in *apparel, textiles & footwear* was due to the seasonal effect.

***WPI***

The change in WPI depicts a much smaller increase of 0.4 percent in second quarter compared to an increase of 8.6 percent in the corresponding period last year. Both food and non-food group showed deceleration. The decline in WPI was primarily driven by non-food items, which posted negative growth of 0.4

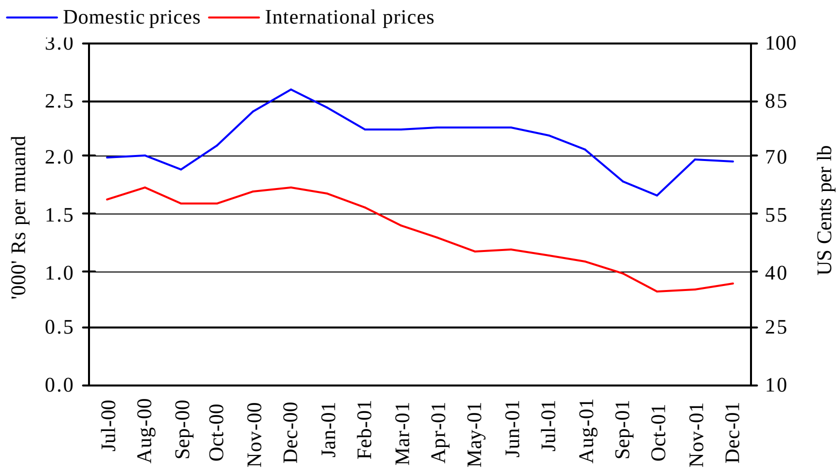
percent during the quarter while food items rose by 1.5 percent. More specifically, the decline in prices of *raw materials* by 0.5 percent, *fuel, lighting & lubricants* by 2.7 percent and *building materials* by 0.6 percent spearheaded the overall decline in WPI.

The large weight (28.68) attached to *raw materials; fuel, lighting & lubricants;* and *building materials* greatly contained the increasing pressure of prices stemming from *manufactures*. Considerable deceleration was observed in the prices of *raw materials* that recorded a negative growth of 0.5 percent during Q2-FY02 as against 18.3 percent rise in the same period last year. Decrease in cotton prices was the prime reason. The prices of cotton were quoted lower than the same period last year (see **Figure 7.2**).

Realization of good cotton crop last year, subsequent stockpiling by textile producers, and bearish trend in the world cotton market seemed to have caused the slump in the domestic cotton market. The international cotton prices continued to decline for most of the time in H1-FY02 due to the increasing world cotton production and lower demand.

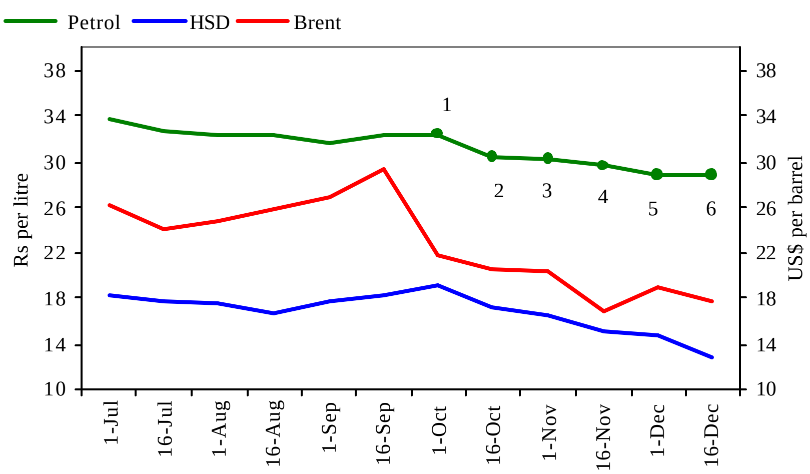
Another significant feature of the deceleration in the WPI was that the prices of *fuel, lighting & lubricants* recorded a negative growth of 2.7 percent during

**Figure 7.2: Domestic and International Lint Prices**




Source: www.cotcorp.com/current3 and KCA, Karachi second quarter compared with an increase of 26. 5 percent in the comparable period last year. As stated earlier, consequent to the falling international oil prices (see **Figure 7.3**), domestic POL prices were adjusted six times, with an increase in October. The most significant decline on cumulative basis was observed in the price of diesel by 29.5 percent compared with 19.6 percent increase observed in the corresponding period last year.

**Figure 7.3: Brent Crude, Petrol & Diesel Prices**




1) October 1, 2001 (5.50 % hike in High Speed Diesel prices)
2) October 16 (6.01 % decline in Petrol & 9.69 % in HSD prices)
3) November 1 (0.82 % decline in Petrol & 4.27 % in HSD prices)
4) November 16 (1.98 % decline in Petrol & 9.04 % in HSD prices)
5) December 1 (3.10 % decline in Petrol & 1.92 % in HSD prices)
6) December 16 (13.38 % decline in HSD prices)

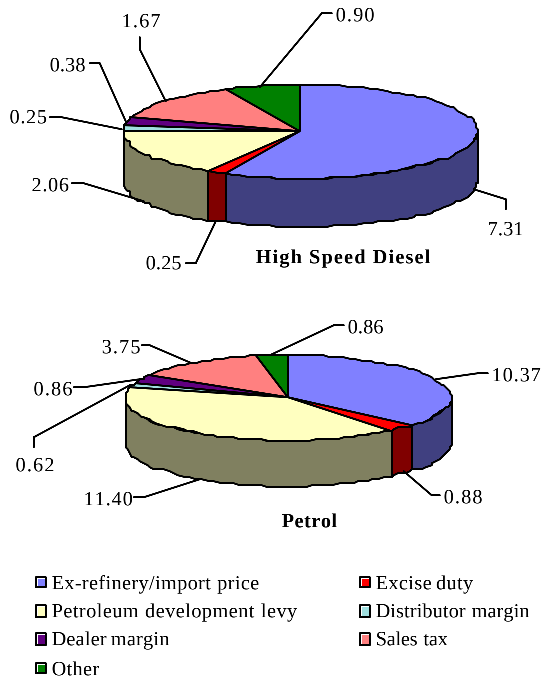
Under the present practice, Oil Companies Advisory Committee determine POL products prices keeping in view certain factors such as rate of excise duty, petroleum development levy, inland freight charges, dealer & distributors margins and sales tax etc. Per litre price structure of HSD and Petrol, as on end December 2001 is given in **Figure 7.4**. The reduction in international prices of petroleum products and appreciation of Pak rupees against the US dollar helped in revising the domestic oil prices downward.[58] There was a considerable fall in world oil

[58]The inverse relationship coming out on October 1, 2001 between the fall in Brent Crude prices and a rise of 5.5 percent in domestic Diesel prices was attributable to more than one factors. Under the present pricing mechanism, Oil Companies Advisory Committee (OCAC) determines POL products prices on the basis of its availability and demand/supply scenario that are not linked with

demand since September 11, mainly due to lower demand for jet fuel and reduced economic growth, combined with over production of oil that exceeded the last five-year average.

During Q2-FY02 the index of *manufactures* showed a rise of 1.9 percent as against 0.7 percent in the same period last year. The increases were mainly on account of the deceleration in the domestic production of chemicals and glass sheets etc, the sub important items, of *manufactures* group.

**Figure 7.4: Price Structure of Diesel and Petrol**[1]




[1]: Rs per Litre as on end December 2001

### *SPI*

Sensitive Price Indicator (SPI) recorded a lower increase of 2.1 percent in Q2-FY02 than 6.1 percent in the corresponding period last year. This trend in SPI was the result of the decline in the prices of food and non-food items: sugar, gur, wheat flour, beef, onion, tomatoe and kerosene oil etc. As discussed earlier prices of sugar and gur showed downward trend. Prices of kerosene, also fell by 29.5 percent from Rs.18.6 in September to Rs.13.1 per litre in December 2001. The decrease in oil prices had also an impact on the cost of transportation of consumer items. Supply side factors and government's efforts to ensure stability of prices of essentials items in Ramadan com bine with checking of speculative hoarding further helped in containing the growth of SPI during the quarter.

the international oil prices in the short run and there always remains a time lag. Second, the consignment imported pertains to the period when international prices were high. Third, the war risk surcharge on imports has also a marginal impact. Fourth, POL product prices are derived from Arab Gulf price quotations and these prices do not necessarily follow the same pattern as that of the crude oil.

# 8. Capital Market

As discussed in SBP's *Quarterly Report* for Q1-FY02, the KSE-100 index shed 116.3 points in just three trading days following the September 11 (see **Figure 8.1**). With sudden change in market sentiments, many players were caught off guard. Due to the decline in market value of investments financed by *badla*, these players were trapped in rising price of *badla* finance. However, the timely decision by Securities and Exchange Commission of Pakistan (SECP) to keep the bourses closed for a week (from September 17 to 21), and the bailing out of *Crescent Investment Bank* by five major commercial banks buoyed the market.[59]

As a result of these measures, and with the comfort that Pakistan had assumed an important role in US led coalition; market started the second quarter on a positive note. In addition, market was anticipating that Pakistan would reap significant economic benefits including debt rescheduling from this move. In the mean time, fear of crack down by USA on informal channels of money transfers, forced Hundi/Hawala dealers to sell dollars in open market, thus forcing an appreciation of Rupee. With interest rates falling (as a matter of policy by SBP) and the Dollar weakening against Rupee, investors had little choice but to enter in the equity market. This up trend continued till the KSE-100 reached at a level of 1406.05 on October 31.

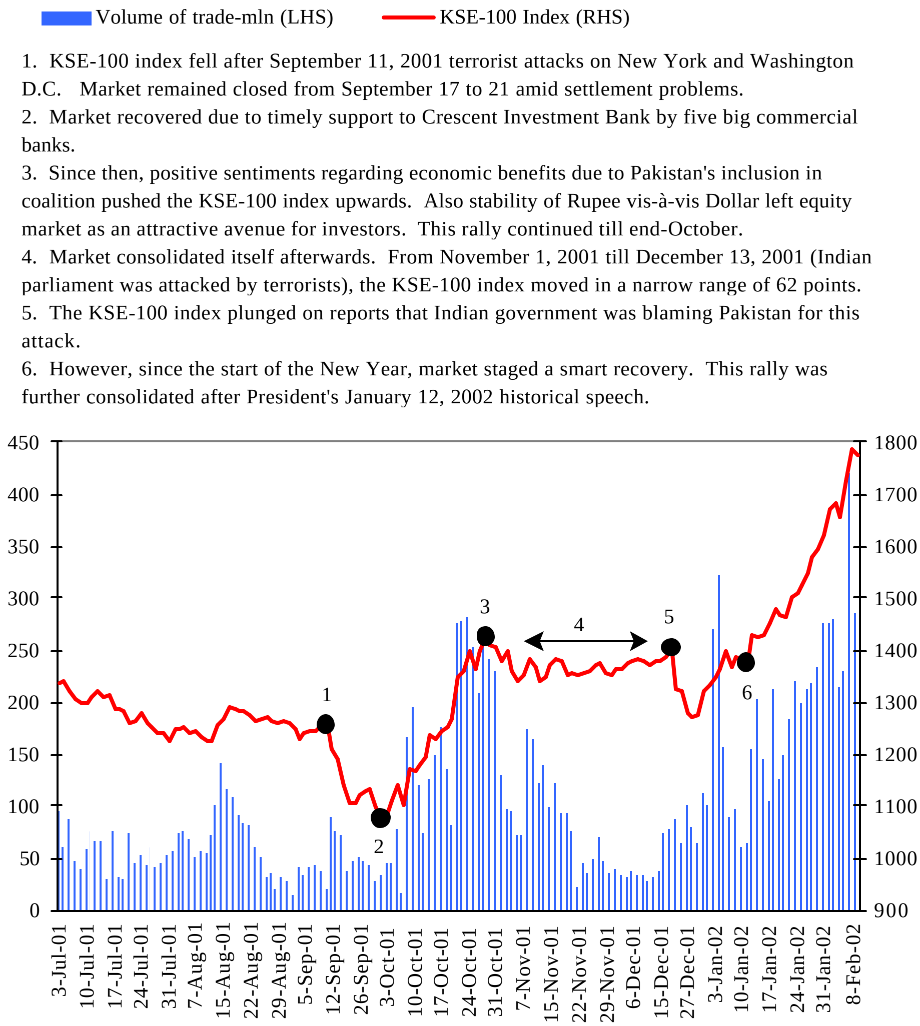
This bull run was, however, broken afterwards. The KSE-100 index consolidated itself, as it moved in a narrow range of 61.86 points (between 1399.81 and 1337.95) from November 1 to December 13, 2001. However, unfortunate, terrorist attack on Indian parliament on December 13, 2001 caused nervousness among investors—even though market stabilized initially. But it was after December 21, that Indian government raised the stakes by withdrawing its ambassador from Pakistan and deploying its troops on the borders. Resultantly, market went into a tailspin with the KSE-100 index shedding 130.95 points in last 10 days of the quarter. It closed the Q2-FY02 at 1273.06 on December 31, 2001. (For summary statistics, please see **Table 8.1**.)

Even though the Indian government continued with its rhetoric of blaming Pakistan together with its troop build up on border, market rebounded strongly by the start of January 2002. Two factors were instrumental in this recovery; firstly,

[59] The *Crescent Investment Bank* was one of the most affected players, as most of its stock holdings were financed by *badla*. With badla financers opting to stay away from the market after September 11, it became difficult for this institution to carry-over these trades. To avoid cross defaults and further collapse, market was closed for a week. Support was eventually provided by five big banks who bought the portfolio of *Crescent Investment Bank* at discount.

**Figure 8.1: Movement in KSE-100 Index and Volume Traded**

1. KSE-100 index fell after September 11, 2001 terrorist attacks on New York and Washington D.C. Market remained closed from September 17 to 21 amid settlement problems.
2. Market recovered due to timely support to Crescent Investment Bank by five big commercial banks.
3. Since then, positive sentiments regarding economic benefits due to Pakistan's inclusion in coalition pushed the KSE-100 index upwards. Also stability of Rupee vis-à-vis Dollar left equity market as an attractive avenue for investors. This rally continued till end-October.
4. Market consolidated itself afterwards. From November 1, 2001 till December 13, 2001 (Indian parliament was attacked by terrorists), the KSE-100 index moved in a narrow range of 62 points.
5. The KSE-100 index plunged on reports that Indian government was blaming Pakistan for this attack.
6. However, since the start of the New Year, market staged a smart recovery. This rally was further consolidated after President's January 12, 2002 historical speech.



it became clear that war with India was not on cards due to international diplomatic efforts; secondly, economic fundamentals remained strong during this period.[60] With foreign exchange reserves reaching as high as US$ 4.82 billion at end December 2001, there was a sense of stability vis-à-vis Rupee. As a result, effective rate of return on Dollar denominated assets became unattractive. Likewise, weighted average Rupee deposit rates were also low.[61] In this scenario, equity market proved to be an attractive avenue for investors.

**Table 8.1: Highlights of KSE (as on December 31, 2001)**

Rupees and shares in billion

| | |
|---|---|
| Listed companies at KSE | 757 |
| KSE-100 index | 1273.06 |
| Change since June 2001 (%) | (6.83) |
| Year on year (%) | (15.56) |
| Listed Capital at KSE | 235.68 |
| Market Capitalization | 294.01 |
| Shares traded at KSE during the quarter | 6.24 |

Although, these factors were instrumental in current rally (since the start of January 2002), role of investor confidence cannot be overlooked. In this regard, the part played by Securities and Exchange Commission of Pakistan (SECP) as regulator of the equity market is commendable. Since its inception, SECP has assumed a hands-on approach to improve transparency in the trade activities of the market. It successfully handled the sensitive issue like *conflict of interest* in management of bourses by enforcing change in the Article of Association of stock exchanges.[62] After these changes, SECP nominates about 40 percent *outside* members in the Board of Directors, thus making it more independent from the influence of the members of the bourses.[63] Previously, SECP could nominate only two members on Board. As a result, influence of brokers and members of stock exchanges has been diluted and there are more checks and balances in place now. While, this was a significant improvement, it is expected that in future, SECP will gradually shift this balance in favor of independent *outside* members.

Also, with the successful introduction of T+3 system, settlement risks are minimized. Besides, Karachi Stock Exchange adopted a risk management system to minimize speculative and over-trading beyond the financial capacity of the

[60] There was no rush on retail or wholesale markets for buying. Also, banks remained immune from large withdrawals.
[61] Weighted average deposit rates were at 6.1 percent on end-December.
[62] In addition to this, now SECP has final say on the appointment, removal/termination, and non-renewal of the Managing Director of KSE. Managing Director is also a member of the Board.
[63] However, purpose will only be served if these independent outside members take due responsibility.

brokers. These include imposition of minimum capital adequacy requirement and exposure/loss limits for members. Moreover, the imposition of circuit breakers has reduced the volatility in the KSE-100 index.[64]

**Table 8.2: TFCs issued since July 2001**
million Rupees

| Security | Issue Date | Maturity | Issuance Size | Coupon Rate |
|---|---|---|---|---|
| ICI/PTA | 2-Aug-01 | Aug-06 | 1600 | PIB 5 Yr + 300bps = 16.00 |
| ATLAS LEASE | 16-Aug-01 | Aug-06 | 100 | 15.0 |
| PACKAGES | 27-Aug-01 | Jan-05 | 700 | 13.50%-17% , three days repo rate +1.25% pa |
| GULISTAN | 5-Sep-01 | Sep-06 | 320.7 | 2% + DR. floor 14%, ceiling 17.5% |
| DAWOOD | 12-Sep-01 | Sep-06 | 253.8 | Perpetual with put and call option, yield 1.75 + DR, floor 13.5%, cap 17.5% |
| INTERBANK | 15-Sep-01 | Sep-06 | 500 | 13.75-16% , 3 yrs = 13.75% pa monthly 3 yrs 6 months = 16% |
| NISHAT | 19-Sep-01 | Sep-05 | 600 | 14.5% 1st year, 2-4 year 1.5% over DR, floor 13% ceiling 17% |
| ENGRO CHEMICAL | 27-Nov-01 | Nov-06 | 500 | Floating rate (weighted average cut off yield of last three auction of 5 year PIB Plus 1.15) Floor 13 %, Ceiling 17% |
| PARCO | 12-Dec-01 | Dec-04 | 2500 | Base rate* + 1.45 % (Floating rate profit) Floor 13% p.a, ceiling 15% p.a |
| CRESCENT LEASING | 26-Dec-01 | Dec-06 | 250 | Base rate** + 2 % (Floating rate profit) Floor 14.5% p.a, ceiling 18% p.a |
| SECURITY LEASING | 28-Dec-01 | Dec-05 | 200 | SBP Discount Rate+2.25%, 1st 2 years Floor 14.75%, Cap 17.50%, 3 & 4 Year Floor 14.0%, Cap 17.5% |
| RELIANCE WEAVING | 6-Feb-02 | Feb-07 | 150 | SBP Discount Rate+2.5%, Floor 15.25%, Cap 17.50% |

*Base rate is defined as the last cut-off yield on the last SBP's auction of 3-year PIB.

** Base rate is defined as the last cut-off yield on the last SBP's auction of 5-year PIB.

As a word of caution, there are still certain weaknesses that need to be addressed. For example, issue of poor disclosure by the companies is the foremost concern for investors. Recent fiasco of Enron in USA has once again brought the issue of poor accounting disclosures to surface. In many ways, this highlights the need to improve both internal and external auditing standards. The myth of self-regulation that is prevalent in accounting industry (in Pakistan as well) needs to be changed. It is easier said than done for the management body to regulate its members, who elected it. Also, there is a need to split auditing and consultation

[64] If there is 7.5 % change (plus or minus) in price of scrip from its last closing price, trading in such scrip is suspended.

business of accounting firms.[65] It is high time for concerned authorities to make changes in regulations that govern accounting profession in our country. This will make accounting disclosures more transparent and will provide comfort to domestic and foreign investors. Also, the issue of badla financing, which every now and then creates tremors in the market, needs some regulation. As a matter of fact, brokers simultaneously acting as intermediaries and badla financers present another conflict of interest situation.

An area of encouragement is the corporate debt market that showed immense progress since FY01. Twelve new issues were floated in the market since the start of this fiscal year (see **Table 8.2**). Future outlook is also encouraging as few more TFCs are in pipeline and will be floated in future. Also, State Bank of Pakistan allowed commercial banks to issue TFCs to augment their supplementary capital.[66] These issues will be unsecured, with a minimum maturity term of 5 years and must be rated "A" by credit rating agencies. This will allow banks to raise funds to match their medium term requirements. This decision is likely to accelerate the growth in corporate debt market as some banks are expected to launch their TFCs in near future.

## 9. External Sector[67]

Unlike rest of the World where the September 11 attacks further depressed the economic outlook, Pakistan experienced a positive structural change in the external account. This extraordinary shift even overshadowed successful completion of first IMF program in 10 years that not only increased Pakistan's credibility with the IFIs, but also paved the way for three-year PRGF. In fact, there is a high probability that even if September 11 incident had not happened, Pakistan would have nonetheless obtained the PRGF on similar terms. The terms of restructuring of external debt, however, may not have been as concessional as those eventually offered.

While trade and services are showing some signs of disruption from cancellation of export orders, slowdown in shipment of air cargo of foreign airlines, and higher war-risk freight and insurance surcharges; these losses seem limited and short-term in nature. In contrast, economic gains of September 11 attacks obviously have significant long-term implications. More specifically, the

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[65] Since Enron's auditing failure, world's leading accounting firms are splitting their auditing and consulting business. Among these are, the world's largest firms like *Deloitte Touche Tohmatsu*, *PricewaterhouseCoopers* and *Andersen*.

[66] BSD Circular No.1 dated January 1, 2002.

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

government's decision to support the US-led coalition against terrorism has revived previously strained relations with major bilateral creditors, particularly the United States. Consequently, sanctions imposed by the USA and Japan in response to May 1998 nuclear tests and military takeover in October 1999 have been withdrawn. Accordingly, in addition to payments for logistic support to US operations in Afghanistan and increased quota for Pakistani textile exports, USA also provided a US$ 600 million as grant and, resumed Pakistan's access to EXIM Bank and OPIC. Furthermore, the EU has increased quota for textile exports from Pakistan by 15 percent and removed tariffs.

Another positive development is the recent debt restructuring agreement with the Paris Club, which is more accommodating than previous two accords. Pakistan is the fourth country in the world along with Egypt, Poland and Yugoslavia, which was granted such generous terms leading to implied debt reduction without having a HIPC or IDA only status. With reduction in the net present value of bilateral debts between 27 to 43 percent, Pakistan is expected to save between US$ 2.7-3 billion in debt payments in the next three years (see **Special Section on external debt)**.

The agreement also provided the immediate support in terms of cash flows with the deferral of interest and principal payments (including interest payments due on restructured debt as well) for remaining part of current fiscal year. This is extraordinary as payments on loans contracted after the cut-off date of September 30, 1997 were also postponed (see **Special Section on external debt** for more details on rescheduling).[68]

The most significant development relating to September 11 event occurred in the foreign exchange market, where collapse of the kerb premium and sharp appreciation of the Rupee (following global efforts to starve terrorists of funds), has provided a window of opportunity to remove the market segmentation. In this regard, the proposed set up of foreign exchange companies will be a step towards resolving the most binding structural problem in the Pakistan's external sector.

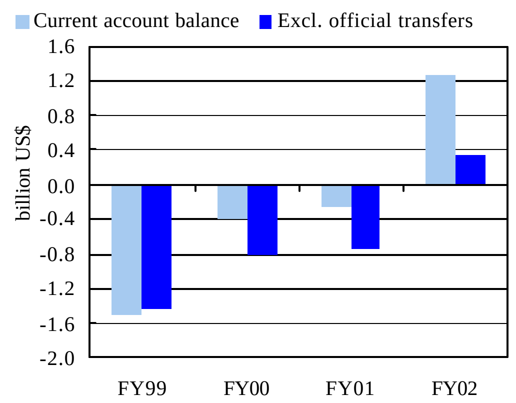
### 9.1 Current Account

The current account recorded an unprecedented surplus of US$ 1,276 million in H1-FY02 (see **Table 9.1**). Although Pakistan posted a surplus in FY01 as well,

[68] The cutoff date defined in the first rescheduling is important since it is not changed in subsequent Paris Club treatment. Furthermore, credits granted after this date, are generally not subject to future rescheduling.

this was primarily driven by purchases from the kerb market and change in the accounting treatment of Saudi Oil Facility (SOF) from non-food aid to official transfers. In contrast, the upturn during H1-FY02 is broad-based as all subcategories of the current account show a marked improvement. In effect, excluding inflows under official transfers (grant from the USA, SOF, etc.), the current account showed a *surplus* of US$ 335 million during H1-FY02 against a deficit of US$ 744 million during the same period last year (see **Figure 9.1**).

**Figure 9.1: Current Account Balance (Jul-Dec)**




Despite reported cancellation of export orders and levy of war risk premium on exports from Pakistan after September 11 attack, the trade deficit during H1-FY02 was only US$ 48 million, showing a contraction of US$ 718 million over corresponding period last year. Of that, US$ 514 million were savings in the import bill, largely on account of subdued oil prices and lower quantum of petroleum products. Although export earnings increased by US$ 204 million during H1-FY02 over last year, their performance in November and December is not very encouraging.[69]

The services account improved further following September 11 incident as net outflows in the second quarter fell by US$ 114 million over last year.[70] Looking at the first half of FY02, the deficit contracted by 10.6 percent over H1-FY01, despite higher payments in 'other transportation' and 'dividend and profit' (see **Table 9.1**). The reduced interest payments are the major source of contraction,

[69] Exports for Q2-FY02, on the basis of *custom record*, have declined by 2.5 percent, against a growth of 1.8 percent registered in Q1-FY02. This suggests that exports based on *exchange record* may fall in coming months unless compensated by increased market access from EU and the US. In particular, it is expected that EU decision to increase quotas for textile and clothing products by 15 percent and to reduce duties by about 7 percent effective from January 1, 2002 would provide much needed scope for Pakistani exports.

[70] During the first quarter, the services account deficit declined by US$ 58 million over same period last year.

**Table 9.1: Balance of Payments- Summary Table**
million US$

| Items | H1-FY01 | H1-FY02 | Q 1-FY02 | Q 2-FY02 | Q 1-FY01 | Q 2-FY01 |
|---|---|---|---|---|---|---|
| **1. Trade Balance** | **-766** | **-48** | **-194** | **146** | **-568** | **-198** |
| Exports(fob) | 4323 | 4527 | 2225 | 2302 | 2135 | 2188 |
| Imports (fob) | 5089 | 4575 | 2419 | 2156 | 2703 | 2386 |
| **2. Services (Net)** | **-1621** | **-1449** | **-826** | **-623** | **-884** | **-737** |
| Shipment | -405 | -367 | -197 | -170 | -213 | -192 |
| Other transportation | 30 | -24 | -15 | -9 | 18 | 12 |
| Travel | -61 | -44 | -35 | -9 | -28 | -33 |
| Investment Income | -1167 | -1088 | -570 | -518 | -653 | -514 |
| *Interest payments* | -851 | -703 | -373 | -330 | -483 | -368 |
| *Profit and Dividend* | -316 | -385 | -197 | -188 | -170 | -146 |
| Other goods, services,& Income | -18 | 74 | -9 | 83 | -8 | -10 |
| **3. Current Transfers (Net)** | **2125** | **2773** | **959** | **1814** | **971** | **1154** |
| a) Private Transfers -net | 1643 | 1832 | 775 | 1057 | 707 | 936 |
| i) Workers' Remittances | 609 | 983 | 340 | 643 | 366 | 243 |
| ii) FCA (Residents) | 192 | 134 | 23 | 111 | 76 | 116 |
| iii) Outright Purchases | 752 | 635 | 397 | 238 | 227 | 525 |
| b) Official Transfers | 482 | 941 | 184 | 757 | 264 | 218 |
| *of which: Saudi oil facility* | 393 | 300 | 173 | 127 | 215 | 178 |
| **4. Current Account Balance (1+2+3)** | **-262** | **1276** | **-61** | **1337** | **-481** | **219** |
| **5. Financing** | **262** | **-1276** | **61** | **-1337** | **481** | **-219** |
| **I. Capital Account(net)** | **-764** | **-525** | **-596** | **71** | **-441** | **-323** |
| a) Foreign Investment | 63 | 131 | 16 | 115 | 27 | 36 |
| i) Direct investment in Abroad (Net) | -11 | -5 | 0 | -5 | 0 | -11 |
| ii) Direct investment in Pakistan (Net) | 144 | 207 | 69 | 138 | 36 | 108 |
| iii) Portfolio investment in Pakistan (Net) | -70 | -71 | -53 | -18 | -9 | -61 |
| of which: stock markets | -67 | -57 | -47 | -10 | -16 | -51 |
| b) Foreign long-term loans/credit (Net) | -554 | -407 | -358 | -49 | -425 | -129 |
| i) Disbursements | 631 | 620 | 179 | 441 | 233 | 398 |
| Project Aid | 405 | 294 | 166 | 128 | 199 | 206 |
| Food Aid | 0 | 0 | 0 | 0 | 0 | 0 |
| Non Food | 153 | 271 | 0 | 271 | 0 | 153 |
| Others | 73 | 55 | 13 | 42 | 34 | 39 |
| ii) Amortization | 1185 | 1027 | 537 | 490 | 658 | 527 |
| Official | 945 | 778 | 396 | 382 | 513 | 432 |
| Others | 240 | 249 | 141 | 108 | 145 | 95 |
| c) Official Assistance (Net) | 200 | 455 | 5 | 450 | 168 | 32 |
| d) FCA (Non-residents) | -65 | -52 | -25 | -27 | -60 | -5 |
| e) Others | -408 | -652 | -234 | -418 | -151 | -257 |
| **II. Changes in Reserves (-Inc/+Dec)** | **51** | **-1332** | **84** | **-1416** | **303** | **-252** |
| Assets | 4 | -1622 | -136 | -1486 | 366 | -362 |
| SDRs | -9 | 1 | 2 | -1 | 0 | -9 |
| Forex (State Bank of Pakistan) | -73 | -1459 | -42 | -1417 | 320 | -393 |
| Forex (Commercial Banks) | 86 | -164 | -96 | -68 | 46 | 40 |
| Liabilities | 47 | 290 | 220 | 70 | -63 | 110 |
| Use of Fund Credit | 47 | 290 | 220 | 70 | -63 | 110 |
| Purchases/drawings | 191 | 377 | 267 | 110 | 0 | 191 |
| Repurchases | -144 | -87 | -47 | -40 | -63 | -81 |
| **III. Errors & Omissions** | **350** | **441** | **346** | **95** | **43** | **307** |
| **IV. Exceptional financing** | **623** | **140** | **231** | **-91** | **584** | **39** |
| SBP reserves | 1443 | 3546 | 2134 | 1412 | 1034 | 409 |

which largely reflect falling stock of private loan/credit and FE 45 deposits, and lower international interest rates (LIBOR) compared to the last year.

In addition, higher PTCL earnings in the second quarter that led to a reversal in 'other goods and services', suggest that Pakistan received more overseas calls in net terms during the period. These were probably from expatriate Pakistanis in United States making calls to their families back home, or international media providing extensive coverage to Pakistan. On the other hand, since a number of international airlines have either suspended or reduced their operations in Pakistan due to higher insurance premium (for being in the proximity of war zone), this adversely impacted earnings of Civil Aviation Authority (CAA) as reflected in 'other transportation'. Nevertheless, PIA made gains as its cargo operations went up to offset the reduced earnings from travel abroad. Looking ahead, the services account is likely to be benefited from the government's decision to provide logistic support to US operation in Afghanistan.

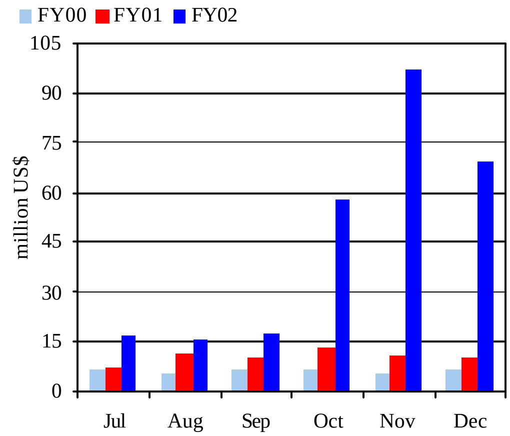
In terms of current transfers, these have posted a sharp increase of US$ 648 million (30.5 percent) during H1-FY02, mainly driven by official transfers and worker remittances. Official transfers include disbursement of US $600 million grants from the USA realized in November 2001. However, this was partly offset by reduced inflows under Saudi oil facility (SOF) on account of falling oil prices in international markets.

As far as worker remittances are concerned, the cash inflow registered a growth of 66.2 percent during the first half of FY02. This is outstanding in the sense that excluding *forced* remittances (compensation to Kuwait war affectees and receipts from Hajj Sponsorship Scheme), these inflows posted even larger increase of 96.4 percent over last year (see **Table 9.2**).

In terms of geographical sources, the upsurge in remittances was mainly from the USA and the UAE, particularly in the second quarter of FY02. More specifically, cash remittances from the USA increased sharply to US$ 223.9 million in Q2-FY02 from just US$ 50.1 million in the earlier quarter (see **Figure 9.2**). This probably reflects one-time reversal of capital flight from USA for fear of possible freeze following international scrutiny.

In case of the UAE, cash remittances increased from US$ 97.1 million in first quarter to US$ 124.7 million in Q2-FY02. Being hub of the hundi network in the Gulf region, this increase in remittances is largely the result of enhanced monitoring by the UAE central bank. It is therefore expected that with continuing efforts to clamp down the hundi network that led to collapse of the kerb premium,

Figure 9.2: Worker's Remittances from USA




these inflows would persist in coming months as well.[71] Also, with the launching of foreign exchange companies from July 1, 2002, it is expected that more remittances would flow through formal channels.

Looking at unfrozen FCAs, while large withdrawals were noticed in immediate response to September 11 attack, these experienced hefty inflows as fears of international investigations forced many individuals to bring their foreign currency accounts (held abroad) into Pakistan (see **Figure 9.12**). As a result, inflows under FCAs rose sharply from US$ 23 million in first quarter this year to US$ 111 million during Q2-FY02. However, the total inflow of US$ 134 million in H1-FY02 is still far lower than US$ 192 million during the same period last year. This suggests that the appreciation of Rs/Dollar parity has largely quelled incentives for Dollarization.

As far as SBP purchases from the kerb market are concerned, these fell sharply to US$ 238 million in Q2-FY02 from US$ 525 million during second quarter last year. This largely reflects contraction in transaction volumes through the kerb market following international efforts on tracking funds to terrorist organizations. However, the decline in kerb purchases was more than compensated by SBP buying from the interbank market that rose to US$ 696 million (net) in Q2-FY02 against only US$ 15.4 million during the same period last year (see **Figure 9.13**).[72]

[71] The UAE central bank has enforced proper documentation on outgoing transfers of more than US$ 500.

[72] SBP purchases from the interbank market are not reflected under 'Current Transfers'. The reason is simple: the hard currency in the interbank market (which are receipts from export of goods and services, or remittances) are already realized in banking channels; SBP purchases merely change their ownership from authorized dealers to the central bank. In contrast, SBP purchases from the kerb market *add* foreign exchange volumes into the formal channel.

**Table 9.2: Region-Wise Worker Remittances**

| Countries | H1-FY00 | H1-FY01 | H1-FY02 | Q1-FY02 | Q2-FY02 | Change in H1-FY02 over H1-FY01 | |
|---|---|---|---|---|---|---|---|
| | | | | | | Absolute | Percentage |
| **Gulf Region:** | **369.1** | **415.8** | **481.9** | **216.3** | **265.5** | **66.1** | **15.9** |
| Bahrain | 15.2 | 12.9 | 14.6 | 6.7 | 7.9 | 1.7 | 13.0 |
| Kuwait | 64.0 | 81.9 | 34.6 | 12.5 | 22.1 | -47.3 | -57.7 |
| Qatar | 7.5 | 7.5 | 13.4 | 3.7 | 9.7 | 5.9 | 78.8 |
| Saudi Arabia | 168.6 | 167.8 | 170.0 | 85.4 | 84.6 | 2.2 | 1.3 |
| Sultanat-e-Oman | 25.2 | 19.8 | 27.5 | 10.9 | 16.6 | 7.7 | 39.0 |
| U.A.E. | 88.6 | 125.9 | 221.8 | 97.1 | 124.7 | 95.9 | 76.1 |
| **Other than Gulf Region:** | **118.5** | **156.5** | **469.5** | **109.1** | **360.4** | **313.0** | **200.0** |
| Canada | 2.1 | 2.2 | 9.5 | 2.3 | 7.1 | 7.3 | 329.5 |
| Germany | 6.1 | 4.9 | 5.5 | 2.4 | 3.0 | 0.6 | 11.2 |
| Japan | 0.8 | 1.7 | 2.5 | 1.0 | 1.4 | 0.8 | 44.1 |
| Norway | 3.0 | 3.2 | 3.2 | 1.6 | 1.6 | 0.0 | 0.6 |
| U.K. | 38.0 | 41.3 | 61.1 | 22.7 | 38.4 | 19.8 | 47.9 |
| U.S.A. | 37.9 | 62.6 | 274.0 | 50.1 | 223.9 | 211.4 | 337.6 |
| Others | 30.6 | 40.6 | 113.8 | 29.0 | 84.9 | 73.2 | 180.4 |
| **Total** | **487.6** | **572.3** | **951.3** | **325.4** | **625.9** | **379.0** | **66.2** |
| Growth Rate (%) | | | | | | | |
| **Encashment FEBCs & FCBCs** | **30.1** | **37.0** | **31.0** | **14.6** | **16.4** | **-6.0** | **-16.2** |
| **TOTAL (including FEBC & FCBCs)** | **517.7** | **609.3** | **982.3** | **340.1** | **642.3** | **373.0** | **61.2** |
| Growth Rate (%) | | | | | | | *61.2* |
| Growth Rate excl Iraq-Kuwait W A and Hajj Receipts (%) | | | | | | | *96.4* |

## 9.2 Trade Account[73]

During the first half of FY02, Pakistan's external trade suffered the most serious short-term setbacks in the shape of imposition of War Risk Surcharge and reported cancellation of orders for exports that is likely to reduce exports in coming quarters, besides causing further slowdown in industrial activity (see **Box 9.1**). However, it is too early to assess the exact impact, as the long-term benefits

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

**Box 9.1: War Risk Surcharge**

Reacting to events of September 11 and subsequent war in Afghanistan by the US led coalition against international terrorism; Lloyds of London - insurance underwriter - included Pakistan in the list of ***War Excluded Areas*** effective from October 1, 2001. The ships calling on ports of the listed countries are required to pay an additional premium over and above the normal insurance charges. Besides Pakistan; Algeria, Angola, Democratic Republic of Congo, Egypt, Eritrea, Gulf of Aqaba and the Red Sea, Israel, Jordan, Lebanon, Liberia, Libya (incl. Gulf of Sidra/ Sirte), Oman, Persian or Arabian Gulf and adjacent waters including the Gulf of Oman North of 24° N, Sierra Leone, Somalia, Sri Lanka, Suez/Red Sea Transit, Syria, Yemen/ Peoples Republic of Yemen, and Federal Republic of Serbia and Montenegro are currently included in the exclusion list.

Responding to this, the India, Pakistan, Bangladesh, Ceylon Conference (IPBCC) lines imposed war risk surcharge (WRS) of $185 per TEU (equivalent to one 20 feet shipping container) from Oct 1, 2001 and a surcharge of $4 to $5 per ton on bulk cargos. Realizing the adverse impact of WRS on exports, government immediately started efforts for the removal of this surcharge and offered to provide sovereign guarantee to the Lloyds of London. A delegation of Lloyds of London and other insurance underwriters also visited Pakistan to assess the situation and expressed their satisfaction on the normal functioning of ports but the surcharge has not yet been withdrawn completely. Although, some shipping companies have reduced the WRS for Europe, no significant reduction is observed in WRS for cargos destined to US coasts (East and West), which is the largest trading partner of Pakistan. The WRS for Europe on all cargo destined to and from Pakistan charged by the IPBCC lines is presently US$ 53 per TEU, while for US destinations it currently stands at US$ 125 per TEU. War risk surcharge currently levied on Pakistan and some of the countries in the region are given in the following table:

**War Risk Surcharge[1] Charged by IPBCC Lines For Europe**

per TEU

| Effective from | Pakistan | India | Bangladesh | Sri Lanka |
|---|---|---|---|---|
| **1-Oct-01** | 185 | 10 | 10 | 160 |
| 30-Oct-01 | 149 | 10 | 10 | 160 |
| 26-Nov-01 | 149 | 10 | 10 | 110 |
| 15-Dec-01 | 139 | 10 | 10 | 110 |
| 22-Dec-01 | 130 | 10 | 10 | 110 |
| 15-Jan-02 | 120 | 0 | 0 | 100 |
| 19-Jan-02 | 100 | 0 | 0 | 100 |
| 2-Feb-02 | 100 | 0 | 0 | 70 |
| 9-Feb-02 | 82 | 0 | 0 | 70 |
| 16-Feb-02 | 82 | 0 | 0 | 52 |
| 26-Feb-02 | 53 | 0 | 0 | 52 |

[1] Including Suez transit extra risk premium of US$ 10 per TEU withdrawn w.e.f. January 15, 2002.

The imposition of WRS, though adversely affected the Pakistan's export competitiveness across the board, its effect is more severe in the case of low value added exports as this surcharge is levied on per container or on weight irrespective of the value. This fact reinforces the urgent need to shift towards the high value added exports, which government is emphasizing for the last many years. To lessen the impact of WRS on exporters, SBP also lowered export refinance rates to as low as 6.0 percent. Moreover, reported decline in the trade cargo after September 11 created surplus space in the vessels, and foreign shipping lines have reportedly reduced the freight rates towards the end of December 2001 to fill up space.

may outweigh the short-term costs.[74] Most importantly, Pakistan may benefit from the reconstruction and rebuilding of Afghanistan, also generating new trade activity in future.

In this backdrop, Pakistan's trade performance during the first half of FY02 was not so disappointing. Based on custom's data, Pakistan's trade deficit was US$ 417.6 million during H1-FY02, showing an improvement of 54.7 percent over the same period last year (see **Figure 9.3**). Despite a fall of 0.4 percent in export earnings, the lower trade deficit was mainly due to a 9.6 percent decline in imports in the first half of this year, which is in sharp contrast with positive growth of 10.2 percent in H1-FY00. As a result, the ratio of exports to imports also went up from 82.9 percent in H1-FY01 to 91.4 percent this year. Excluding POL import, which has been a continuous strain on Pakistan's balance of payment position, the trade account registered a surplus of US$ 930.3 million showing a decline of 1.2

**Figure 9.3: Trade Account**

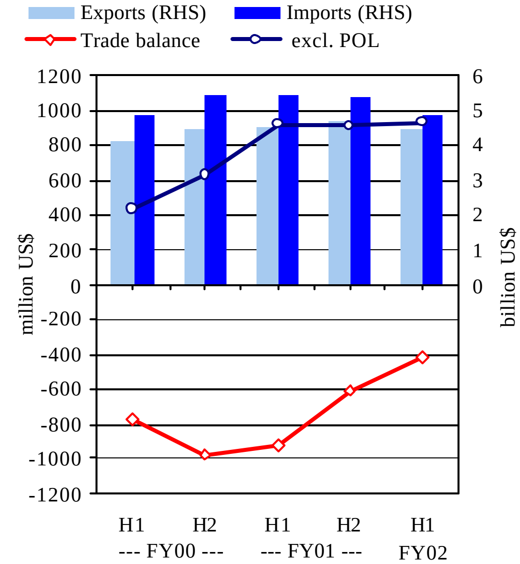
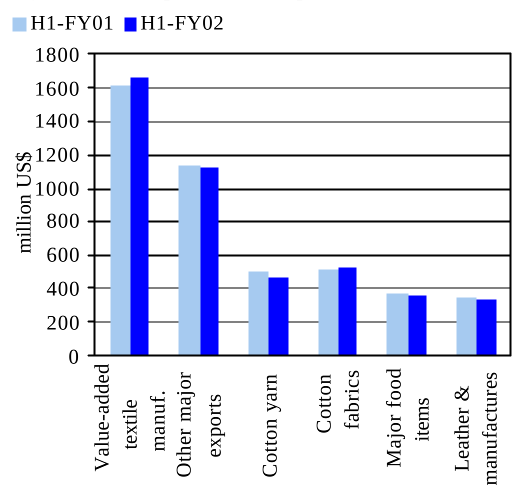



**Figure 9.4: Composition of Exports**




[74] Economic sanctions clamped on Pakistan in response to its nuclear tests on May 28, 1998 were lifted by USA, Japan and other industrialized countries thus paving the way for economic assistance.

percent over the same period last year.

### 9.2.1 Exports

Exports during the first half of FY02 stood at US$4.458 billion (see **Table 9.3** & **Figure 9.4**). This fell short of the trade policy target of US$ 5.05 billion for H1-FY02. The slowdown of economic activities across the globe, particularly in the major markets of the US and EU posed immense challenges to Pakistan's exports.[75] The appreciation of 6.74 percent in the value of Pak-Rupee during the second quarter of FY02 has also worked against the exporters.[76]

Under these circumstances, maintaining the last year's export level with just a small decline of 0.4 percent in exports during H1-FY02 is itself a significant achievement.[77] Pakistan's major exports, including POL, leather, readymade garments, towels, tarpaulin & other canvas goods, bed-ware, surgical instruments, footwear, cotton fabrics, and yarn were able to show moderate to impressive quantitative increases over H1-FY01. The total quantity effect for the period amounted to positive US$ 162.2 million.[78] However, unit prices continued to deteriorate over the period resulting in an overall loss of US$ 182.0 million in export earnings.

Quarterly analysis reveals that in the second quarter of FY02, export revenues declined by 2.5 percent, against a growth of 1.8 percent registered in Q1-FY02 reflecting the fact that the reported cancellation of export orders and imposition of War Risk Surcharge may have already started taking its toll on Pakistan's export

[75] The economic outlook in the US is still in doldrums, with GDP growth after declining by 1.3 percent in the third quarter of 2001, recovered in the fourth quarter and posted a growth of 1.4 percent. Though US economy is technically not in recession, the slowdown still persists. Industrial production fell by 0.1 percent in December, while capacity utilization was the lowest since 1983. The latest 25 bps cut in the US interest rates by the Fed, the 11th such cut since the beginning of the year, is yet another indication of the flagging US economy. However, Composite Index of Leading Economic Indicators rose by 1.2 percent in December, its largest gain in almost six years, boosting hopes of a speedy recovery in the economy. In the Euro area, there was more evidence of economic slowdown. In November, industrial output fell in Germany by 4.8 percent, Netherlands by 5.3 percent, and Belgium by 9.3 percent, and France by 0.9 percent.

[76] If viewed in the context of price-cost structure of exports especially textile, this appreciation has also led to lowering of manufacturing cost and to some extent mitigated the adverse impact on exporters. SBP's intervention (purchases) to prop up the value of US dollar has to be seen as a balancing act between the benefits realized and foregone. Realized benefits include build up of reserves, while the foregone benefits include potentially larger import of capital goods for BMR.

[77] More specifically, our exports to the US registered a negative growth of 0.8 percent, while exports to EU increased by 5.2 percent.

[78] The quantity and price effect (on exports) is calculated on the basis of detailed data available on 27 items, covering 78.8 percent of total exports.

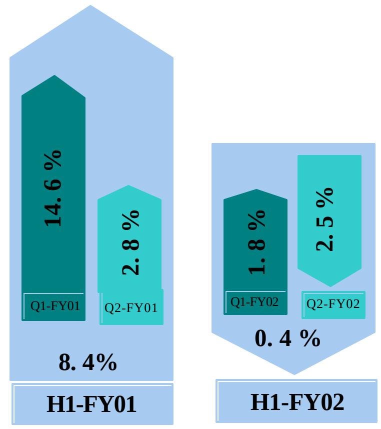
**Table 9.3: Major Exports**
value: million US$; unit value: US$

| Commodities | Unit | H1FY01 Value | H1FY01 Unit Value | H1FY02 Value | H1FY02 Unit Value | Abs. ? in Value | % ? in H1-FY02/ H1-FY01 Qty. | % ? Value | % ? Unit Value |
|---|---|---|---|---|---|---|---|---|---|
| **A. Primary Commodities** | | **577.4** | --- | **500.6** | --- | **-76.8** | — | **-13.3** | — |
| Rice | MT | 225.5 | 254.98 | 224.1 | 262.99 | -1.4 | -3.6 | -0.6 | 3.1 |
| Raw cotton | MT | 87.8 | 1,009.18 | 5.0 | 880.18 | -82.8 | -93.5 | -94.3 | -12.8 |
| Raw wool (excl. Wool tops) | MT | 0.4 | 1,257.66 | 0.6 | 912.37 | 0.2 | 95.9 | 42.1 | -27.5 |
| Fish and fish preparations | MT | 82.0 | 1,934.97 | 73.6 | 1,677.34 | -8.4 | 3.6 | -10.2 | -13.3 |
| Leather | SQM | 102.2 | 12.92 | 114.7 | 13.73 | 12.5 | 5.7 | 12.2 | 6.2 |
| Guar and guar products | MT | 9.3 | 1,089.45 | 8.4 | 720.84 | -0.8 | 37.8 | -8.8 | -33.8 |
| Fruits | MT | 42.0 | 396.23 | 38.6 | 364.22 | -3.4 | -0.1 | -8.2 | -8.1 |
| Vegetables incl. roots and tubers | MT | 16.9 | 219.16 | 16.8 | 195.92 | -0.1 | 11.0 | -0.7 | -10.6 |
| Crude animal material | MT | 8.3 | 490.62 | 6.6 | 525.72 | -1.7 | -25.5 | -20.1 | 7.2 |
| Oil seeds & nuts etc. | MT | 3.1 | 507.84 | 12.2 | 434.71 | 9.1 | 358.0 | 292.0 | -14.4 |
| **B. Textile Manufactures** | | **2,823.2** | --- | **2,862.5** | --- | **39.3** | — | **1.4** | — |
| Cotton yarn | MT | 504.5 | 1,991.11 | 469.3 | 1,778.47 | -35.2 | 4.1 | -7.0 | -10.7 |
| Cotton fabrics (woven) | SQM | 509.4 | 0.61 | 522.3 | 0.59 | 12.9 | 5.9 | 2.5 | -3.2 |
| Hosiery (knitwear) | Doz. | 455.5 | 23.14 | 435.8 | 23.94 | -19.7 | -7.5 | -4.3 | 3.5 |
| Bed ware | MT | 367.3 | 5,074.66 | 453.4 | 5,082.66 | 86.1 | 23.2 | 23.4 | 0.2 |
| Towels | MT | 111.9 | 3,583.58 | 131.8 | 3,414.64 | 19.9 | 23.6 | 17.8 | -4.7 |
| Cotton bags and sacks | MT | 8.5 | 4,133.58 | 7.7 | 4,104.01 | -0.8 | -9.2 | -9.8 | -0.7 |
| Readymade garments | DOZ | 411.9 | 25.34 | 433.3 | 20.75 | 21.5 | 28.5 | 5.2 | -18.1 |
| Tarpaulin & other canvas goods | MT | 18.0 | 2,277.73 | 21.8 | 2,233.19 | 3.8 | 23.3 | 20.9 | -2.0 |
| Tule, lace embroidery etc. | — | 4.4 | --- | 5.0 | --- | 0.6 | — | 12.5 | — |
| Synthetic textiles | SQM | 263.3 | 0.65 | 207.9 | 0.61 | -55.4 | -15.2 | -21.0 | -6.8 |
| Other textile made up | — | 165.8 | --- | 171.1 | --- | 5.2 | — | 3.2 | — |
| Waste material of textile fibres/fabrics | MT | 2.6 | 534.95 | 3.3 | 580.54 | 0.7 | 15.5 | 25.3 | 8.5 |
| **C. Other Manufactures** | | **760.9** | --- | **764.6** | --- | **3.7** | — | **9.8** | — |
| Carpets, carpeting rugs & mats | SQM | 133.8 | 46.92 | 110.8 | 47.52 | -23.0 | -18.2 | -17.2 | 1.3 |
| Petroleum and petroleum products | MT | 86.5 | 232.63 | 98.4 | 183.23 | 12.0 | 44.5 | 13.8 | -21.2 |
| Sports goods | — | 120.2 | --- | 126.2 | --- | 6.0 | — | 5.0 | — |
| Leather manufactures | — | 240.2 | --- | 221.1 | --- | -19.1 | — | -7.9 | — |
| Foot wear | PAIRS | 20.7 | 5.86 | 23.7 | 6.17 | 3.0 | 8.9 | 14.7 | 5.3 |
| Surgical and medical instruments | NO | 59.0 | 1.31 | 70.6 | 1.28 | 11.6 | 22.4 | 19.6 | -2.3 |
| Cutlery | GR | 13.8 | 32.13 | 12.3 | 33.35 | -1.5 | -14.0 | -10.7 | 3.8 |
| Onyx manufactured | MT | 6.6 | 1,737.78 | 5.1 | 1,508.82 | -1.4 | -9.9 | -21.8 | -13.2 |
| Chemicals and pharmaceuticals | — | 64.9 | --- | 66.2 | --- | 1.3 | — | 1.9 | — |
| Molasses | MT | 15.3 | 32.85 | 30.2 | 40.91 | 14.8 | 57.9 | 96.6 | 24.5 |
| **D.** Others | | **312.2** | --- | **330.1** | --- | **17.9** | — | **5.7** | — |
| **Total Exports** | | **4,473.8** | --- | **4,457.8** | --- | **-15.9** | — | **-0.4** | — |
| *excl. Major food items and Raw cotton* | | *4,016.5* | | *4,087.6* | | *71.1* | | *1.8* | |
| *excl. Major food items and Raw cotton and Yarn* | | *3,512.0* | | *3,618.3* | | *-15.9* | | *3.0* | |

Source: Federal Bureau of Statistics.

performance (see **Figure 9.5**). However, the actual impact of the crisis would not be known till the second half of the current year as the industry was so far engaged to accomplish the export orders, which were already in the pipeline. Keeping in view the present world economic scenario, Pakistan may have to revise downwards its exports target, as it seems unlikely to achieve the US$ 10.1 billion target set in the Trade Policy.

**Figure 9. 5: Export Growth (over corresponding period)**




The following highlight Pakistan's export performance during the first half of FY02:

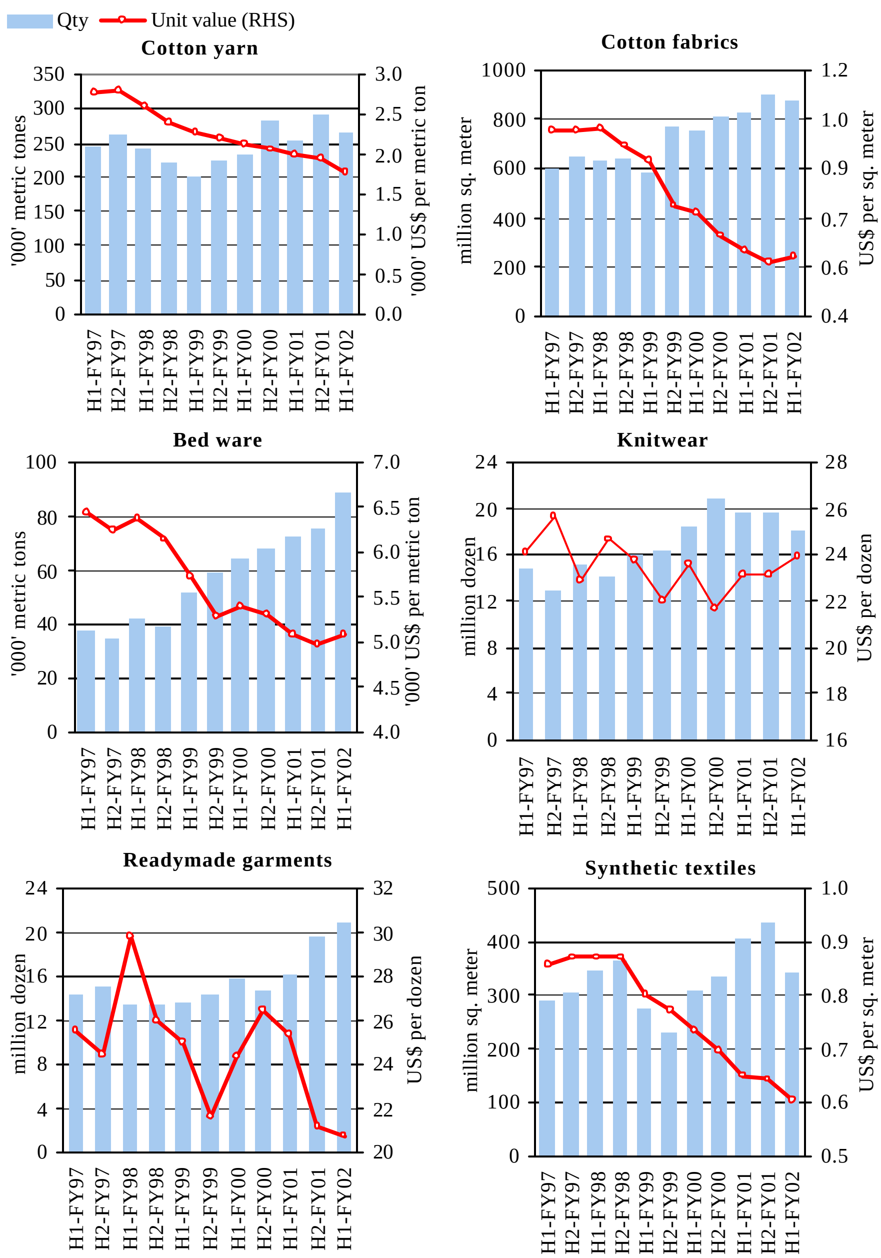
?? Exports of ***textile manufactures*** during the first half of this year amounted to US$ 2,862.5 million, recording a 1.4 percent improvement over H1-FY01. The exports of cotton fabrics, bed-ware, readymade garments, other textile made-ups, towels, tarpaulin & other canvas goods, tule, lace embroidery, and waste material of textile fabrics, showed increases; while cotton yarn, knitwear, synthetic textiles, and cotton bags recorded negative growth. Though higher textile quantitative exports contributed additional earnings of US$ 209.5 million, the negative price effect of US$ 175.9 million reduced this gain to just US$ 33.5 million (see **Figure 9.6**).

?? ***Cotton yarn*** exports stood at US$ 469.3 million in H1-FY02, showing a 7.0 percent decline over the same period last year. The, lower per unit export prices reduced total receipt by US$ 56.1 million, which completely wiped out the gain of US$ 20.9 million from the 4.1 percent increase in export quantities.

?? ***Bed-ware*** exports showed a marked improvement in terms of both value and export volume during the first half of FY02.[79] Their contribution towards export earnings increased by 23.4 percent to US$ 453.4 million on the back of

[79] The European Union (EU) has withdrawn anti-dumping duty of 6.4 percent on import of bed linen from Pakistan with immediate effect, which was imposed on June 12, 1997 along with Egypt, India.

Figure 9.6 : Textile Manufactures-Quantitative Exports and Unit Prices



higher export volumes and a slight improvement in the realized per unit export price. A 23.2 percent higher export volume accounted for a gain of US$ 85.4 million while 0.2 percent improvement in the per unit export price enhanced the total export proceeds by US$ 0.7 million.

?? During H1-FY02, 38,587 metric tons of ***towels*** were exported valuing US$ 131.8 million, registering a 17.8 percent increase compared to the corresponding period last year. The higher revenues from towel exports can be decomposed into a positive quantum effect of US$ 26.4 million and a negative price effect of US$ 6.5 million. Main buyers of Pakistani towels are the US, UK, Germany, the Netherlands, Italy, France, Canada, Australia, Spain and the UAE.

?? ***Readymade garments*** fetched US$ 433.3 million during H1-FY02, registering a 5.2 percent growth over the same period last year.[80] A 28.5 percent increase in export volume resulting in US$ 117.2 million enhanced earnings more than neutralized the loss of US$ 95.8 million caused by 18.1 percent fall in average export price. Readymade garments exporters were able to post a positive growth both in terms of volume and value during the Q2-FY02.

?? During the first half of current fiscal year, revenues from ***rice*** export stood at US$ 224.1 million as against US$ 225.0 million in the same period last year, showing a slight decline of 0.6 percent.[81] During the period, 275.7 thousand metric tons of basmati rice valued at US$ 129.3 million was exported, showing 18.5 percent increase in terms of volume and 14.8 percent in value over H1-FY01. On the other hand, export of 576.5 thousand metric tons of low quality rice earned US$ 94.9 million, registering a decline of 11.5 percent and 16.0 percent both in terms of volume and value respectively. Despite the improvement in per unit export price by 3.1 percent, the fall in export earnings resulted from an overall quantitative decline of 3.6 percent leading to a net loss of US$ 1.4 million in export earnings.[82] It is, however, worth mentioning that rice export earnings increased by 4.5 percent in Q2-FY02 compared to a fall of 6.0 percent in Q1-FY02 over the corresponding periods of last year

[80] Most of American buyers are reluctant to place fresh orders in fear of delay in shipments.

[81] Rice production had been estimated at 3.8 million tons this year as compared to 4.8 million tons in the last year because of irrigation water shortages during the growing season. The country's annual domestic rice consumption is around 2.3 million tons.

[82] A detailed analysis revealed that the increase in the realized per unit price resulted due to higher proportion of high quality basmati rice in total rice exports during H1-FY02 which increased to 32.3 percent from 27.3 percent in H1-FY01.

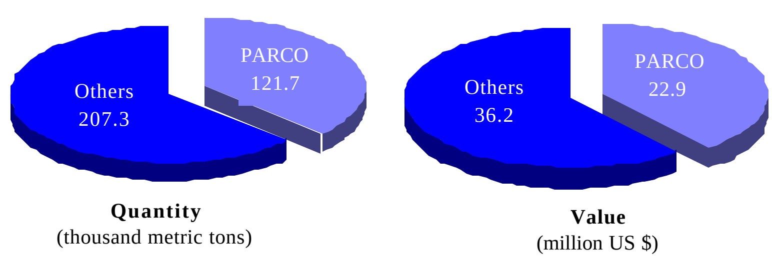
despite appreciation of rupee against the dollar, and stiff competition from India, Thailand, Vietnam, China and Myanmar.[83]

?? ***Carpet*** exports in H1-FY02 fell by 17.2 percent due to lower quantum despite improvement in unit prices. During the period, a total of 2,332.8 thousand square meters of carpets (worth US$ 110.8 million) were exported, showing a net reduction of US$ 23.0 million compared to the same period last year. Since the US is a major market for Pakistani carpets, continuing weakness in the US economy, had an adverse impact on the performance of this sector.

?? During the first half of FY02, ***Footwear*** exports rose by 14.7 percent due to both higher quantum and 5.3 percent improvement in the per unit price over the same period of last year. A total of 3.8 million pairs valuing US$ 23.7 million were exported registering a net gain of US$ 3.0 million.[84]

?? ***POL*** exports, despite falling international prices, registered a growth of 13.8 percent over H1-FY01 and earned US$ 98.4 million during the period under review. During the first half of current fiscal year, Pakistan exported 208.2 thousand metric tons of crude oil valued US$ 39.3 million showing a decline of 9.4 percent when compared with the corresponding period of FY01.[85] Bulk

**Figure 9.7 : Export of Petroleum Products during H1-FY02**




of the crude oil export was registered in Q1-FY02, while Q2-FY02 saw a significant decline of 48.5 percent over the same quarter last year. Export of

[83] Pakistani exporters were unable to quote lower prices being offered by India and other competitors.

[84] The European Union, especially Western Europe including Germany, UK, Italy and France, is the main importer of Pakistani footwear. The Middle East is the second buyer followed by Central Asia and Africa.

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

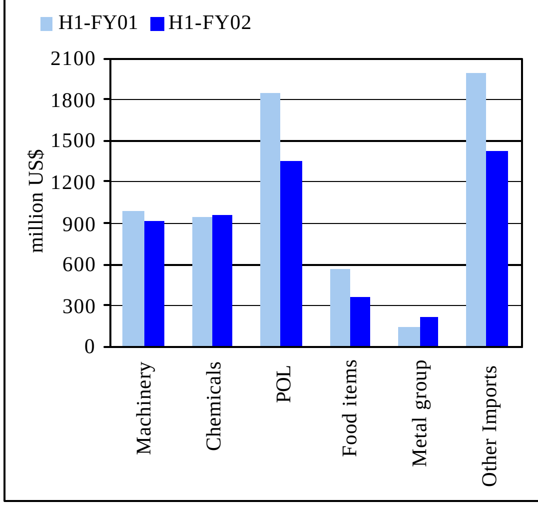
petroleum products, however, showed remarkable growth both in terms of quantity (131.8 percent) and value (66.1 percent).

During the period, Pak Arab Refinery Co Ltd (PARCO) exported 121.7 thousand metric tons of motor gasoline valuing US$ 22.936 million (see **Figure 9.7**).

### 9.2.2 Imports

Imports during the first half of FY02 amounted to US$ 4,875.4 million, registering a 9.6 percent decline over the corresponding period last year (see **Table 9.4** & **Figure 9.8**). Lower imports of food items (especially refined sugar) and a reduction in the POL import bill (resulting from lower international oil prices as well as reduced import quantum of petroleum products), were mainly responsible for this decline in Pakistan's total import bill.[86] Excluding POL, imports declined by a much smaller margin of 0.8 percent, while non-food non-oil imports, showed a significant growth of 5.9 percent (see **Figure 9.9**). The following points highlight the major developments in Pakistan's import performance during the first half of the current fiscal year.

**Figure 9.8: Composition of Imports**




?? Owing to a decline in world oil prices and fall in domestic consumption, ***POL*** import bill during the first half of current fiscal year showed a significant reduction of US$ 492.9 million over H1-FY01 and stood at US$ 1,347.9 million. The average POL import price during the period fell by 19.6 percent, resulting in a net saving of US$ 327.9 million. Notwithstanding the increase of 7.9 percent in the volume of crude imports due to the commissioning of PARCO, there was an appreciable 20.2 percent decline in the import volume

[86] International prices of crude oil continued their declining behavior observed in the first quarter of FY02 as Brent crude prices posted a cumulative decline of 25.4 percent for H1-FY02 over the same period last year.

**Table 9.4: Major Imports**

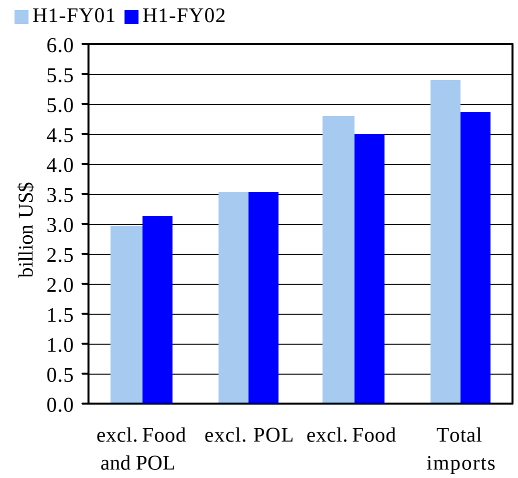
value: million US$; unit value US$

| Commodities | Unit | H1-FY01 | | H1-FY02 | | Abs. ? in Value | % ? in H1-FY02/ H1-FY01 | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Value | Unit Value | Value | Unit Value | | Qty. | Value | Unit Value |
| **A. Food Group** | --- | **572.8** | --- | **371.2** | — | **-201.6** | --- | **-35.2** | --- |
| Milk & cream incl. Infant milk food | MT | 11.2 | 1,759.6 | 7.0 | 2,475.4 | -4.2 | -55.7 | -37.7 | 40.7 |
| Wheat un-milled | MT | 9.4 | 203.2 | 20.6 | 178.9 | 11.2 | 149.1 | 119.3 | -12.0 |
| Dry fruits | MT | 18.5 | 543.2 | 13.7 | 362.5 | -4.8 | 11.1 | -25.9 | -33.3 |
| Tea | MT | 105.2 | 1,933.8 | 78.9 | 1,598.8 | -26.3 | -9.3 | -25.0 | -17.3 |
| Spices | MT | 7.4 | 1,178.8 | 7.7 | 917.1 | 0.3 | 32.9 | 3.4 | -22.2 |
| Edible oil | MT | 176.0 | 312.4 | **166.5** | 299.7 | -9.5 | -1.4 | -5.4 | -4.1 |
| *Soya bean* | *MT* | *26.6* | *344.6* | *7.0* | *346.5* | *-19.6* | -73.8 | -73.7 | 0.5 |
| *Palm oil* | *MT* | *149.4* | *307.3* | *159.5* | *297.9* | *10.1* | 10.1 | 6.7 | -3.1 |
| Sugar | MT | 187.9 | 271.1 | 22.4 | 271.3 | -165.6 | -88.1 | -88.1 | 0.1 |
| Pulses | MT | 57.1 | 328.7 | 54.4 | 302.5 | -2.7 | 3.4 | -4.8 | -8.0 |
| **B. Machinery Group** | --- | **977.1** | --- | **908.6** | — | **-68.5** | --- | **-7.0** | --- |
| Power generating machinery | --- | 90.7 | --- | 78.1 | — | -12.7 | --- | -14.0 | --- |
| Office machinery | --- | 111.0 | --- | 104.4 | — | -6.6 | --- | -5.9 | --- |
| Textile machinery | --- | 164.0 | --- | 233.4 | — | 69.4 | --- | 42.3 | --- |
| Construction & mining machinery | --- | 34.3 | --- | 52.7 | — | 18.4 | --- | 53.7 | --- |
| Electrical machinery & apparatus | --- | 64.0 | --- | 54.7 | — | -9.4 | --- | -14.6 | --- |
| Railway vehicles | --- | 5.4 | --- | 16.3 | — | 10.9 | --- | 204.2 | --- |
| Road motor vehicles | --- | 170.8 | --- | 141.9 | — | -28.9 | --- | -16.9 | --- |
| Aircraft, ships and boats | --- | 38.5 | --- | 26.6 | — | -11.9 | --- | -30.8 | --- |
| Agricultural machinery & implements | --- | 10.9 | --- | 5.8 | — | -5.1 | --- | -46.6 | --- |
| Other machinery | --- | 287.6 | --- | 194.7 | — | -92.8 | --- | -32.3 | --- |
| **C. Petroleum Group** | **MT** | **1,840.8** | **214.5** | **1,347.9** | **172.5** | **-492.9** | **-12.3** | **-26.8** | **-19.6** |
| Petroleum products | MT | 1,111.7 | 215.9 | 704.8 | 171.5 | -406.9 | -20.2 | -36.6 | -20.5 |
| Petroleum crude | MT | 729.1 | 212.3 | 643.1 | 173.6 | -86.0 | 7.9 | -11.8 | -18.2 |
| **D. Textile Group** | --- | **74.2** | --- | **87.2** | — | **13.0** | --- | **17.5** | --- |
| Synthetic fibre | MT | 38.2 | 1,294.5 | 35.4 | 1,272.5 | -2.8 | -5.7 | -7.3 | -1.7 |
| Synthetic & artificial silk yarn | MT | 23.6 | 1,803.4 | 37.5 | 1,499.0 | 13.9 | 91.1 | 58.8 | -16.9 |
| Worn clothing | MT | 12.4 | 305.8 | 14.3 | 311.7 | 1.9 | 13.1 | 15.3 | 1.9 |
| **E. Agricultural and Chemicals Group** | --- | **946.5** | --- | **954.7** | — | **8.2** | --- | **0.9** | --- |
| Fertilizer | MT | 125.1 | 185.2 | 141.1 | 145.3 | 16.1 | 43.8 | 12.8 | -21.5 |
| Insecticides | MT | 44.8 | 3,106.3 | 48.0 | 2,922.5 | 3.2 | 13.8 | 7.0 | -5.9 |
| Plastic materials | MT | 164.1 | 880.4 | 160.6 | 790.8 | -3.5 | 9.0 | -2.1 | -10.2 |
| Medicinal products | MT | 114.7 | 23,221.7 | 107.0 | 22,024.4 | -7.6 | -1.6 | -6.6 | -5.2 |
| Others | --- | 497.8 | --- | 497.9 | — | 0.1 | --- | 0.0 | --- |
| **F. Metal Group** | --- | **156.3** | --- | **213.3** | — | **56.9** | --- | **36.4** | |
| Iron and steel scrap | MT | 15.6 | 116.6 | 25.8 | 120.3 | 10.2 | 59.8 | 64.9 | 3.2 |
| Iron and steel | MT | 124.5 | 337.2 | 169.5 | 297.2 | 45.0 | 54.5 | 36.2 | -11.9 |
| Aluminum wrought & worked | --- | 9.8 | --- | 8.6 | — | -1.2 | --- | -12.4 | |
| **G. Miscellaneous Group** | --- | **123.2** | --- | **133.7** | — | **10.5** | --- | **8.5** | --- |
| Rubber crude | MT | 19.6 | 672.1 | 20.1 | 644.7 | 0.5 | 6.9 | 2.5 | -4.1 |
| Rubber tyres & tubes | Nos. | 32.8 | 24.9 | 30.3 | 21.4 | -2.5 | 7.2 | -7.6 | -13.8 |
| Wood & cork | --- | 5.6 | --- | 5.7 | — | 0.1 | --- | 2.5 | --- |
| Jute | MT | 12.8 | 261.7 | 10.8 | 287.6 | -2.0 | -23.3 | -15.7 | 9.9 |
| Paper and paper board & manufactures | MT | 52.4 | 763.0 | 66.7 | 723.3 | 14.4 | 34.4 | 27.4 | -5.2 |
| **H. Others** | --- | **704.6** | --- | **858.9** | — | **154.3** | | **21.9** | |
| **Total Imports** | | **5,395.5** | | **4,875.4** | | **-520.1** | | **-9.6** | |
| *excl. Food group* | | *4,822.6* | | *4,504.2* | | *-318.4* | | *-6.6* | |
| *excl. POL group* | | *3,554.7* | | *3,527.6* | | *-27.1* | | *-0.8* | |
| *excl. Food and POL groups* | | *2,981.9* | | *3,156.3* | | *174.5* | | *5.9* | |

Source: Federal Bureau of Statistics

of petroleum products, which led to a further saving of US$ 165.0 million.[87] A best part of this saving occurred in Q2-FY02 when POL import bill declined by 29.6 percent as against a smaller decline of 24.4 percent during Q1-FY02.[88]

**Figure 9.9: Imports excl. Food and POL**




In addition to the increased availability of petroleum products in the country, the economic slowdown especially after the September 11 events, conversion of some power and cement plants to gas, and conversion of cars and other vehicles to CNG from petrol resulted in lower import of petroleum products. Greater reliance on hydel power generation by WAPDA due to improved water situation (reservoir levels) in the first half of FY02, and suspension of operation by foreign airlines coupled with reduction of flights by PIA immediately after the September 11 events also resulted in the reduced demand of furnace oil and jet fuel respectively.[89]

?? Import of ***machinery*** (except textile machinery) has been declining over the years, indicating an industrial stagnation and poor investor confidence in the country. Despite the appreciation of 6.77 percent in the value of Rupee during the first half of FY02, the import of machinery has not yet picked up. In fact it has declined by 7.0 percent from US$ 977.1 million to US$ 908.6 million. However, reflecting the continuation of BMR drive, textile sector imported machinery worth US$ 233.4 million as compared to US$ 164.0 million in H1-

[87] In particular, the import volume of high-speed diesel and furnace oil declined by 13 and 26 percent respectively during H1-FY02 over same period last year.
[88] International prices of crude oil (Brent crude) fell by 34.1 percent in Q2-FY02 as compared to a decline of 17.1 percent in Q1-FY02.
[89] Furnace oil demand may increase in the later half of FY02 when water situation is expected to deteriorate and demand for power will increase due to start of summer. Moreover, majority of foreign airlines have since come back and resumed their normal operations from Pakistan thus increasing the demand of jet fuel by the aviation industry.

FY01, showing an increase of 42.3 percent.[90] Import of construction & mining machinery, the only other machinery item showing promising prospects, increased by 53.7 percent during H1-FY02 over the same period last year. All this improvement occurred in Q1-FY02 when import of construction & mining machinery increased by 124.7 percent, while it actually declined by 7.7 percent during Q2-FY02. Immense opportunities that are likely to emerge in the reconstruction and rebuilding of Afghanistan may turn this trend around in future.[91]

?? During H1-FY02, ***metal group*** imports cost US$ 213.3 million, registering a 36.4 percent increase over the corresponding period of last year showing some signs of activity in construction business. Within this group, import of ***iron and steel scrap*** accounted for US$ 25.8 million, a rise of 64.9 percent over H1-FY02 owing to rising demand by steel re-rollers to cater to the needs of construction activity. Similarly, a 36.2 percent rise was recorded in the import of ***iron and steel***, increasing from US$ 124.5 million in H1-FY01 to US$ 169.5 million in the first half of FY02.

?? ***Fertilizer*** accounted for US$ 141.1 million in the import bill for H1-Y02, which is 12.9 percent higher than H1-FY01. This is on account of an increase of 43.8 percent in imported quantity, which may be a direct consequence of the decision by FFC-Jordan Fertilizer Company to stop Di-Ammonium Phosphate (DAP) production due to heavy losses and dismal prospects. The US$ 54.8 million positive quantum effect was partially neutralized by the negative price effect of US$ 38.7 million resulting from lower import unit prices.

?? ***Edible oil*** imports during the first half of FY02, stood at US$ 166.5 million, showing a 5.4 percent fall over last year. Lower imported volume accounted for the saving of US$ 2.4 million, while weak international prices resulted in a gain of US$ 7.1 million. Bulk of the decline in import volume happened in Q1-FY02 (15.2 percent), while imports actually increased by 13.2 percent in

[90] The import of textile machinery and equipment is a part of the investment drive by the big business groups continuing for last couple of years to re-design and revamp industry with a focus on value-added sector and technology improvement in spinning, weaving, bleaching, and dyeing. However, market sources claim that this BMR drive is beginning to falter and no fresh import orders for textile machinery are being placed despite the appreciation of rupee against dollar and other currencies. Pakistan is also likely to buy second hand textile machinery worth $200 million from the United States.

[91] Pakistan's construction sector has many strategic advantages because of geographical proximity, established means of communication, common language and historic links with Afghan contractors.

the second quarter of FY02 owing to recovering exports to Afghanistan, especially of palm-based products and reduced cottonseed oil crop.[92]

?? ***Sugar*** imports during H1-FY02, declined by 88.1 percent owing to adequate availability from domestic production, and carryover stocks from the last season. Despite the delay in the start of current crushing season due to continuing price dispute between the growers and mill owners, total expected domestic availability will be more than sufficient for the overall requirements of 3.0 million tons and no further import of sugar will be required this fiscal year.[93]

### 9.3 Capital Account

The deficit in the capital account declined by US$ 239 million to US$ 525 million during H1-FY02 (see **Table 9.1** & **9.5**). This was realized despite falling project aid from IFIs and bilateral countries, higher repayments of commercial loans/credit, lower inflow of IDB trade related support, and the closing out of swaps with various commercial banks. On the contrary, the increased foreign direct investment and over realization of outstanding export bills (OEB) from exporters helped in reducing net outflows from the capital account. As far as the *inflows* in exceptional financing are concerned, the actual hard currency payments of rescheduled commercial loans (PTMA) and 25 percent repayment of remaining FE 45 deposit reduced inflows to US$ 140 million in H1-FY02 from US$ 623 million during the same period last year (see **Table 9.1**).

Net foreign investment

Foreign investment (net) increased by US$ 68 million during H1-FY02 over the same period last year. This is a reflection of Pakistan's enhanced international stature in recent political developments together with building up of foreign exchange reserves that improved the balance of payments viability.[94]

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[92] Purchases by the United Nations to help the Afghan refugees also increased the volume of edible oil imports during Q2-FY02.

[93] In fact there is a glut like situation in the domestic market and retail sugar prices have come down significantly. Allegedly, un-interrupted import of refined sugar during the last season is responsible for the accumulation of stocks with the sugar mills and they are asking for the permission to export at least 200,000 tons of refined sugar. To discourage the import of refined sugar, Government has decided to increase the import duty on sugar to 30 per cent from the existing 20 per cent.

[94] As a result, Moody's Investors Service recently upgraded rating for Pakistan's long-term foreign currency debt and bank deposits from Caa1 to B3.

**Table 9.5: Capital Account**
million US$

| Items | IH-FY00 | | | IH-FY01 | | | IH-FY02 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Cr. | Dr. | Net Credit | Cr. | Dr. | Net Credit | Cr. | Dr. | Net Credit |
| 1. Direct investment abroad | 0 | 0 | 0 | 0 | 11 | -11 | 0 | 5 | -5 |
| 2. Direct investment in Pakistan | 307 | 0 | 307 | 144 | 0 | 144 | 207 | 0 | 207 |
| 3. Portfolio investment | | 167 | -167 | | 70 | -70 | | 71 | -71 |
| (of which Stock market) | | 29 | -29 | | 67 | -67 | | 57 | -57 |
| 4. Other long-term capital-official sector | 665 | 1,044 | -379 | 558 | 1,212 | -654 | 565 | 797 | -232 |
| 4.1. Assets | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 4.2. Loans drawn | 665 | 1,022 | -357 | 558 | 945 | -387 | 565 | 778 | -213 |
| 4.3. Loans extended | | | 0 | | | 0 | | | 0 |
| 4.4. Other Liabilities | 0 | 22 | -22 | 0 | 267 | -267 | 0 | 19 | -19 |
| 5. Other long-term capital-Depost money banks | 0 | 0 | 0 | 0 | 1 | -1 | 0 | 1 | -1 |
| 5.1. Assets | | | 0 | | | 0 | | | 0 |
| 5.2. Loans | | | 0 | | | 0 | | | 0 |
| 5.3. Other Liabilities | | | 0 | | 1 | -1 | | 1 | -1 |
| 6. Other long-term capital-Other Sectors | 137 | 332 | -195 | 73 | 345 | -272 | 55 | 448 | -393 |
| 6.1. Assets | | | 0 | | | 0 | | | 0 |
| 6.2. Loans | 106 | 332 | -226 | 73 | 240 | -167 | 55 | 249 | -194 |
| 6.3. Other Liabilities | 31 | 0 | 31 | 0 | 105 | -105 | 0 | 199 | -199 |
| 7. Other short-term capital-Official Sector | 90 | 374 | -284 | 277 | 144 | 133 | 580 | 679 | -99 |
| 7.1. Assets | 0 | 8 | -8 | 0 | 7 | -7 | 61 | 0 | 61 |
| 7.2. Loans | 90 | 174 | -84 | 252 | 137 | 115 | 472 | 679 | -207 |
| 7.3. Other Liabilities | 0 | 192 | -192 | 25 | 0 | 25 | 47 | 0 | 47 |
| 8. Other short-term capital-Deposit Money Banks | 0 | 662 | -662 | 39 | 44 | -5 | 7 | 13 | -6 |
| 8.1. Assets | 0 | 70 | -70 | 39 | 0 | 39 | 3 | 0 | 3 |
| 8.2. Bilateral balances -assets | | | 0 | | | 0 | | | 0 |
| 8.3. Bilateral balances -liabilities | | | 0 | | | 0 | | | 0 |
| 8.4. Liabilities under NR A/cs | 0 | 7 | -7 | 0 | 1 | -1 | 4 | 0 | 4 |
| 8.5. Other Liabilities | 0 | 585 | -585 | 0 | 43 | -43 | 0 | 13 | -13 |
| 9. Other short-term capital - Other Sectors | 0 | 470 | -470 | 186 | 214 | -28 | 98 | 22 | 76 |
| 9.1. Assets | 0 | 103 | -103 | 0 | 203 | -203 | 73 | 0 | 73 |
| 9.2. Loans | | | 0 | 18 | 11 | 7 | 0 | 22 | -22 |
| 9.3. Other Liabilities | 0 | 367 | -367 | 168 | 0 | 168 | 25 | 0 | 25 |
| **Capital Account** | **1,199** | **3,051** | **-1,852** | **1,277** | **2,041** | **-764** | **1,512** | **2,037** | **-525** |

In terms of investment rating, although the Pakistan's Eurobond is presently traded at premium; its usefulness as a proxy for investment climate is limited due to narrow base of bondholders which restricts its trading in the secondary market.

Nevertheless, improved international position would be a source of comfort for foreign investors in Oil and Gas sector, as Pakistan would be able to meet external payments when commercial production begins.

<u>Long-term capital (official)</u>

This head posted significant fall in net outflows from US$ 645 million in H1-FY01 to US$ 232 million during the same period this year. This was possible due to following two reasons: (1) lower maturing repayments (see item 4.2 in **Table 9.5**), and (2) absence of rolling-over central bank deposits (see item 4.4 in **Table 9.5**). Although, inflows under this category increased marginally during H1-FY02, it is expected that new commitments by donors would result into higher receipts in future.

<u>Long-term capital (others)</u>

Long-term capital (others), which mainly comprises of suppliers' credit, PAYE loans and swaps, posted higher net outflows of US$ 393 million in H1-FY02 against US$ 272 million during the same period last year. This was largely due to higher payments in 'others liabilities' on account of closing out of swaps with various commercial banks (see item 6.3 in **Table 9.5**).[95] In addition, lower inflows under suppliers' credit and higher repayment of past contracted loans/credits during H1-FY02 (see item 6.2 in **Table 9.5**) also added to net outflows under this category.

<u>Short-term capital (official)</u>

This showed a sharp reversal from inflows of US$ 133 million during first half of FY01 to outflows of US$ 99 million in H1-FY02. More specifically, the inflows increased by US$ 222 million due to a higher disbursement of short-term loans from commercial banks like Shamil Bank and National Bank. However, these large inflows were more than offset by: (1) maturing of short-term commercial swaps contracted with various commercial banks in June, and (2) repayments of IDB financing for BOP support.

<u>Short-term capital (deposit money banks & others)</u>

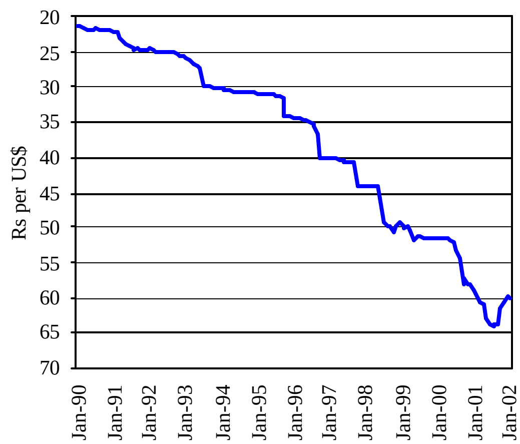
[95] These foreign currency swaps were contracted in June 2001 as an effort to meet NFA target. However, since their settlement was carried out in Rupees, this represents notional outflow that was matched by inflows under Errors and Omissions (see **Table 9.1**).

This includes outstanding export bills (OEBs) held by commercial banks and exporters, and non-resident FCAs. In overall terms, this category experienced a reversal from outflows of US$ 33 million during H1-FY01 to inflows of US$ 71 million during same period this year. This was mainly driven by over realization of OEBs as exporters promptly surrendered their outstanding proceeds to avoid losses from further appreciation of the Rupee/Dollar parity.

## 9.4 Exchange Rate Policy

The developments in the foreign exchange market during Q2-FY02 were dominated by downstream implications of September 11 attack. Although, these changes have already been discussed in the first *Quarterly Report* for FY02, this section would highlight some of the issues that emerged during the course of events.

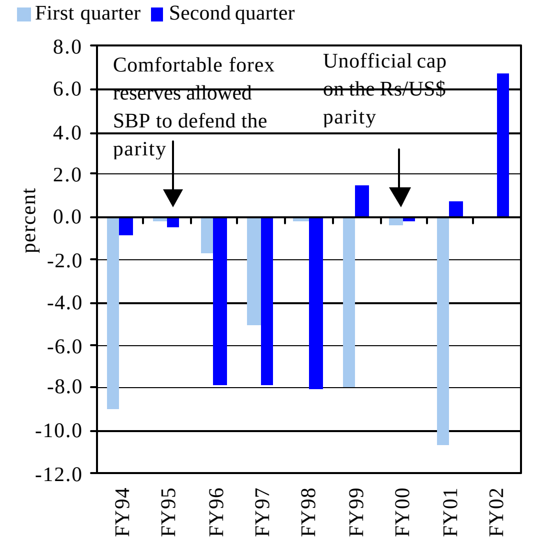
**Figure 9.10: Rupee Exchange Rate Since Jan' 1990**




Most importantly, this led to a complete reversal of devaluation expectations in the market, which are generally formed on the basis of typical history of exchange rate movement. Looking at historical trends, the exchange rate has two main features: (1) the movement has been mostly one-way (i.e., the Rupee depreciates overtime); and (2) this has stepwise pattern which suggests that the Rupee rate has witnessed long period of stability before being interrupted by sharp phases of depreciation (see **Figure 9.10**). Interestingly, due to payment pressures, often these phases were concentrated in the months of September and October, thereby inevitably leading to devaluation expectations in these two months every year.

This stepwise and uni-directional movement is also reflected in the behavior of market participants. More specifically, exporters who were accustomed to uni-directional movement of the Rupee, have incentives to hold on their proceeds instead of selling in forward. On the other hand, exchange rate stability induced a sense of complacency among importers who minimized their cost by running un-hedged positions.

**Figure 9.11: Quarterly Depreciation of Pak Rupee**




With this mindset of the market participants, the external shock of September 11 and subsequent collapse of the kerb premium that led to sharp appreciation of the Rupee in the interbank market, were a major blow to market expectations on exchange rate.[96] Although, this is not the first time that the Rupee/US$ parity showed appreciation, its magnitude and span are unparalleled. As evident from **Figure 9.11**, the Rupee also posted appreciation during the second quarter of FY99 and FY01. However, such episodes can simply be termed as correction in the parity as these were preceded by large Rupee depreciation.

This movement against trend has caught market participants by surprise. While exporters are finding it unrewarding to retain their proceeds, importers are holding back their foreign currency demand in improvement of further appreciation of the Rupee; this behavior is adding further strength to the Rupee.[97] Although, this appreciation of the Rs/US$ parity has neutralized the incentive to Dollarize, its impact on total FCAs was mitigated as fears of international scrutiny forced many individuals to bring back their foreign currency deposits illegally held abroad (see **Figure 9.12**).

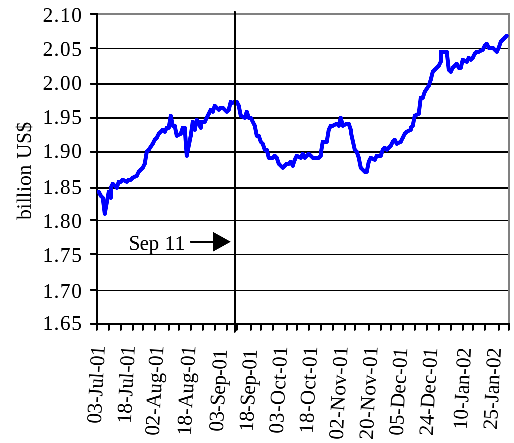
The resulting nervousness in the forex market has reversed the causal relationship between the kerb and interbank rates. As discussed in the second *Quarterly*

[96] While the Rupee started showing sign of strength in the last week of September, major gains were realized on October 1 when it appreciated by over 4 percent in the kerb market. In overall terms, as on February 15, 2002, the Rupee has shown an improvement of 12 percent over September 11; whereas in interbank market, it showed an appreciation of over 6.5 percent.

[97] The collapse of the kerb market premium has encouraged exporters not only to settle their outstanding export bills by purchasing Dollars from the kerb market, but also pay their premature proceeds from exports that would otherwise result in inflows in next few months.

*Report* for FY01, a clear causality had established between the kerb and the interbank rate after the free float on July 21, 2000; this implies that changes in the interbank rate were leading to changes in the kerb rate. However, events following September 11 have shown that the developments in the kerb market led to appreciation of the Rupee in the interbank market.

**Figure 9.12: FCAs (FE-25 & FE-31)**




In terms of the forex flows, falling oil import bill and rescheduling of interest and principal payments for remaining part of current fiscal year under Islamabad terms further appreciated the Rupee (see **Special Section on debt**). In addition, since the hundi network has become unfeasible with the collapse of the premium, remittance inflows have also started shifting to formal banking channels.[98]

The upturn in forex inflows (in both the kerb and foreign exchange markets) has marked impact on exchange management by SBP. More specifically, reliance on purchases from the kerb market reduced considerably as SBP bought US$ 239 million in the Q2-FY02 against US$ 528 million during the same period last year (see **Figure 9.13**). This largely reflects SBP's careful stance in view of lower volume of transactions through kerb channels. On the other hand, SBP net purchases from the interbank market increased significantly to US$ 696 million during Q2-FY02 from mere US$ 15.4 million in the same quarter last year (see **Figure 9.13**).

Besides adding to foreign exchange reserves, the higher purchases from the interbank market also provided a comfortable floor to the Rupee at around 60 per US Dollar (see **Figure 9.14**).[99] This is important for exporters as they are already

[98] This is reflected in cash remittances (excluding compensation for Kuwait war affectees and receipts from Hajj sponsorship scheme) that increased from US$ 190 million during Q2-FY01 to US$ 614 million in the same period this year.

[99] If SBP eased it's buying of hard currency, the Rupee would easily appreciate to Rs 58/Dollar, if not more (or lower in terms of the parity).

**Figure 9.13: Kerb Purchases, Premium and Market Support**

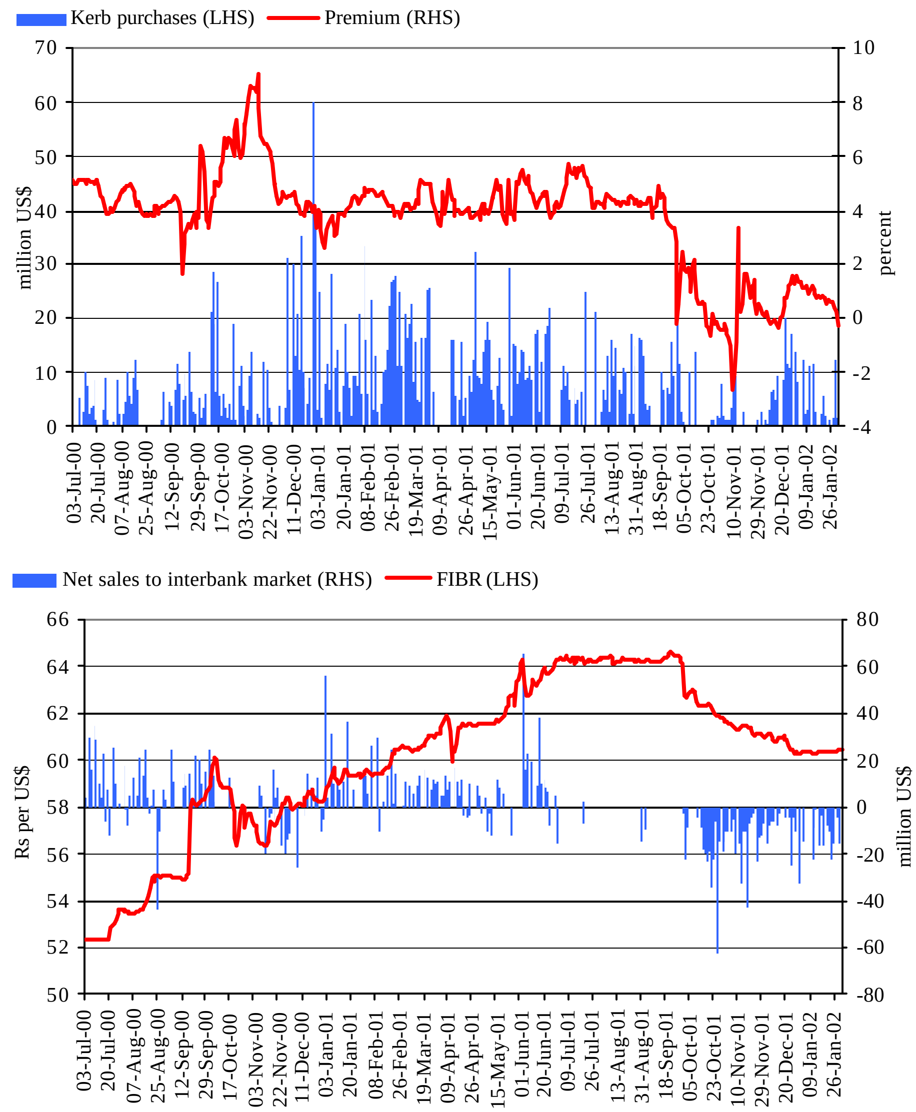
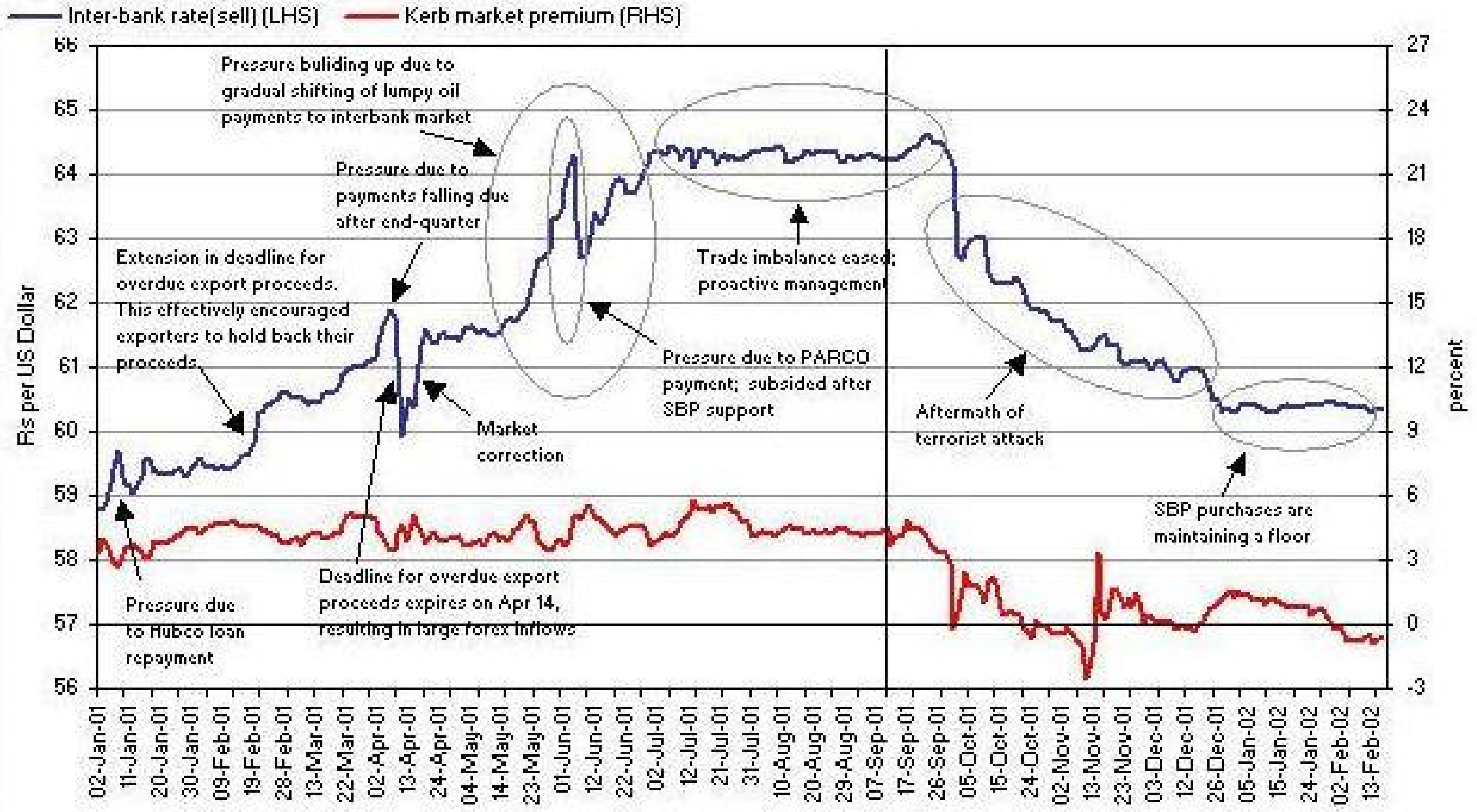


**Figure 9.14: Inter-bank and Kerb Market Rate**



facing loss of their traditional markets following Afghan war and, in some cases, are unable to meet their commitments. Despite these large purchases, the exchange rate in real terms is showing appreciation in the range of 5.1-9.6 percent during September-January period (see **Figure 9.15**).

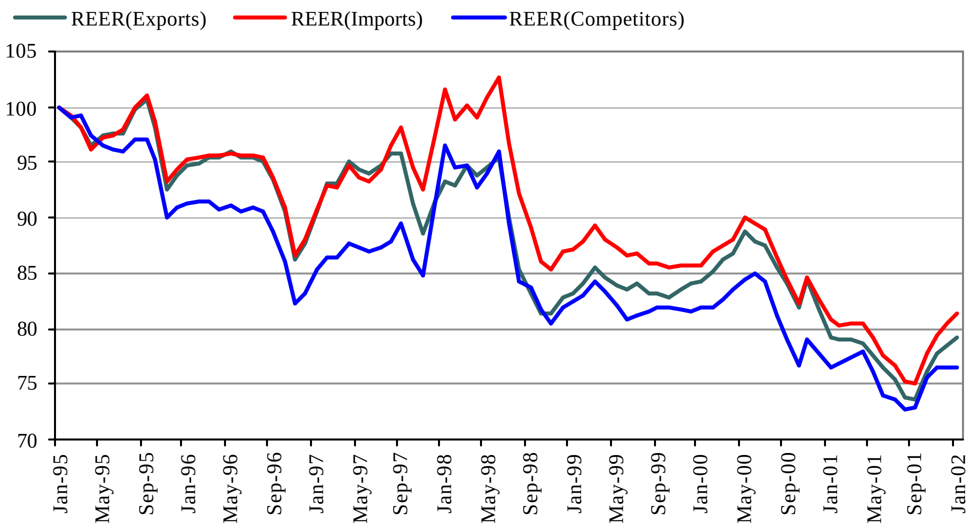
The increased inflows in the interbank forex market also allowed SBP to further liberalize the exchange rate regime. In particular, the requirement of approved commercial transactions for any interbank deal was abolished. Although, the condition was imposed to prevent speculative trading by ADs, this also restricted otherwise legitimate market transactions aimed at managing their risk. In another step, limits on foreign exchange payments relating to travel, education and health were done away with. Furthermore, the facility of back-to-back remittances was restored with effect from February 13, 2002 as ADs were allowed to issue travelers' checks against surrender of an equivalent amount of foreign exchange in cash.[100]

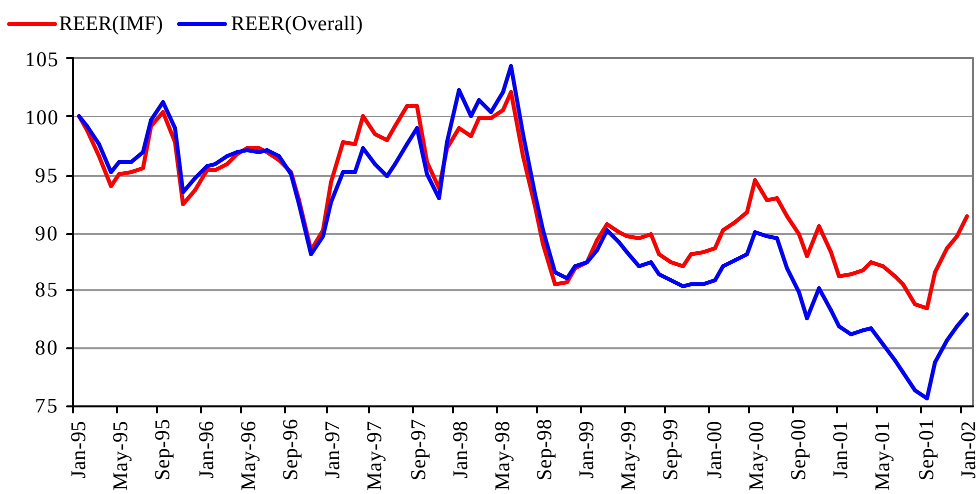
Looking ahead, the comfort in the interbank market (that allowed SBP to build up foreign exchange reserves to over US$ 3.2 billion) together with nervousness in the kerb market following crackdown on hundi network, have provided the best opportunity to remove the segmentation in the two markets which is also an important condition of the PRGF. In this regard, SBP is already in the process of formulating operating rules for foreign exchange companies (FECs) that will start working from July 1, 2002.

In this regard, the need for establishing FECs is clear: this will resolve the most damaging structural problem Pakistan's external sector has been facing since last two decades. More specifically, the hundi system (backbone to moneychangers) has been able to outperform the banking channels due to better exchange rates and more customized services to remitters abroad. Consequently, worker remittances, one of the most important sources of foreign exchange, were not being realized by the official sector. This in turn resulted in persistent deficit in Pakistan's external account, thereby necessitating foreign borrowings. Although the country has built up a significant foreign debt (especially short-term commercial debt), by merging the two markets the root cause for this build up will be addressed.

[100] Although, this condition was imposed to restrict capital flight in view of uncertainty following October 1999 military takeover, its usefulness was doubtful as individuals could transfer foreign exchange abroad by using hard currency balances in their FE-25 deposits.

**Figure 9.15: REER Indices (January 1995=100)**



While the hundi network has become commercially unviable with the collapse of kerb premium, their importance in terms of collecting remittances from individual workers cannot be underestimated. In view of this, the establishment of FECs would allow banks to explore this network for inward remittances. It may be mentioned here that in order to formalize SBP purchases from the kerb market, the central bank was empowered in 1999 to buy foreign exchange from any source within or outside Pakistan. Now as a next step towards liberalization, this mandate would be transferred to commercial banks, as they will be purchasing hard currency from FECs.

The creation of FECs is also necessary from regulatory point of view. Since, authorized moneychangers have grown to over 400 in numbers, this limits SBP's capacity to effectively regulate their businesses.[101] In contrast, commercial banks have extensive rules with well-defined monitoring procedure by SBP. In view of this, a limited number of FECs with sound monitoring framework would not only provide a corporate structure to currency exchange business but also help SBP in effectively regulating their activities.

The launching of FECs would also address concerns about the sustainability of developments on external sector. No doubt, it is difficult to judge whether Rupee appreciation is a short-lived event or a result of permanent shift in the market sentiments. But, since the forces that led to the collapse of the kerb premium are in place, and the interbank market is still experiencing large inflows, it is expected that upward pressure on the Rupee would continue. In fact, if most remittances are realized in the formal sector through FECs, it is likely that current account surplus realized during H1-FY02 may continue afterwards. Hence, the Rupee could appreciate after the introduction of FECs.

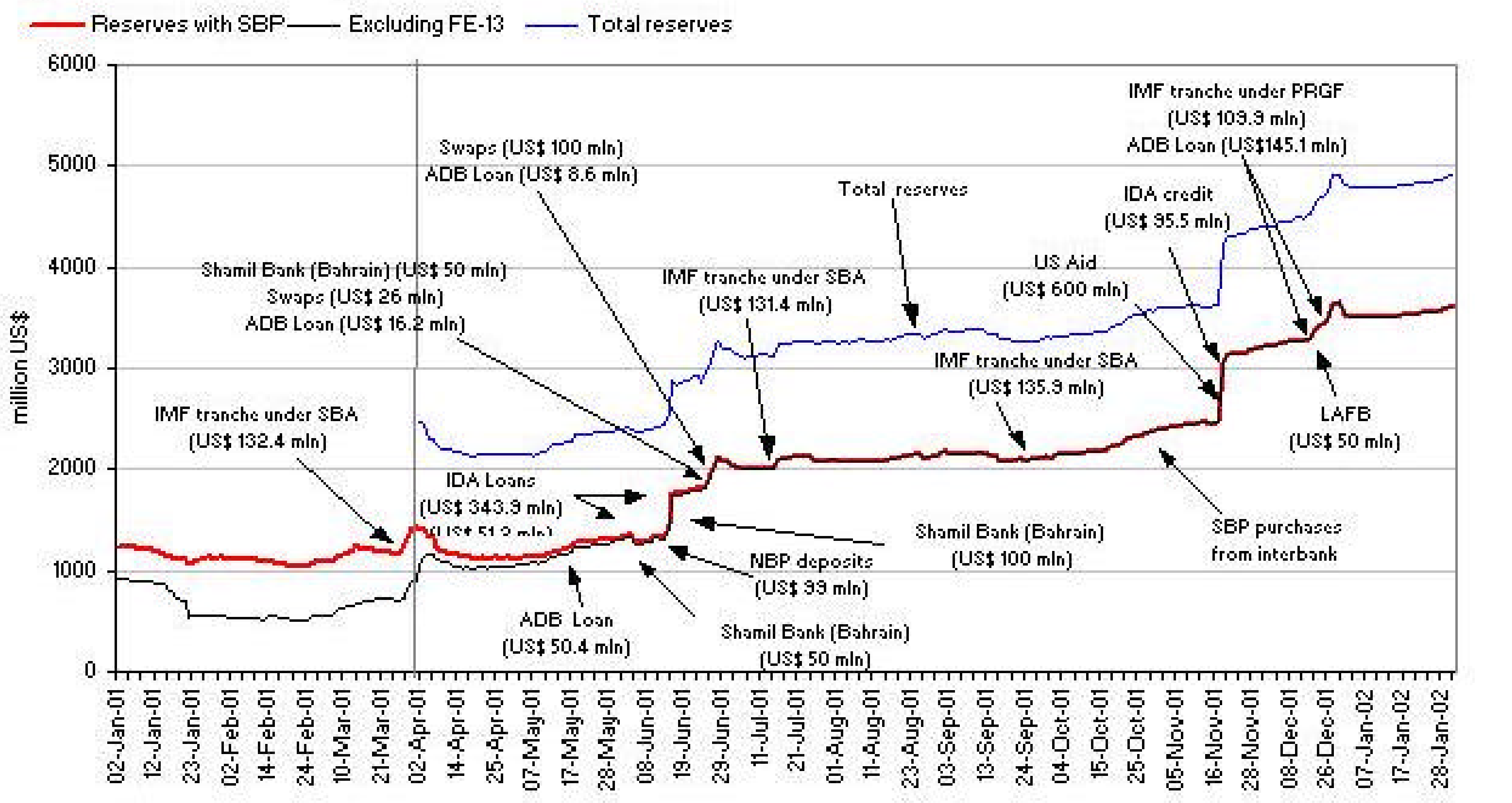
## 9.5 Foreign Exchange Reserves

As shown in **Figure 9.16**, the impact on SBP's liquid reserves has been exceptional. Although it would seem that lumpy inflows from bilateral aid agencies (USAID) and IFIs are largely responsible for the sharp increase, it is important to realize that the gradual increase since October 2001, are *non-debt* purchases from the foreign exchange markets (see **Table 9.5**).[102] Hence, while the lumpy inflows may taper off in the future, with higher remittances flowing in,

[101] According to code of conduct defined by SBP, activities of AMCs are restricted to purchase/sell of foreign currency notes and coins only. However, their interest in foreign exchange transfers is well recognized.

[102] SBP purchases from the kerb market also entail foreign exchange losses on account of kerb premium. In contrast, purchases from the interbank market do not involve this cost.

**Figure 9.16: Foreign Exchange Reserves**



purchases from the kerb and interbank markets should allow SBP to continue with its reserve build up.

**Table 9.5: Foreign Exchange Reserves (Jul-Dec 2001)**
million US $

| | | | |
|---|---|---|---|
| Opening balance as on July 1, 2001 | 2,075.8 | | |
| Closing balance as on December 31, 2001 | 3,536.0 | | |
| | 1,460.2 | | |
| **Details** | **Inflows** | **Outflows** | **Net change** |
| FE-25 deposits placed with SBP as CRR | 170.2 | 136.8 | 33.4 |
| FE-31 incremental deposits | 258.0 | 178.1 | 79.9 |
| FE-45 repayments including interest | | 164.1 | -164.1 |
| Interbank purchases/sales | 738.2 | 18.5 | 719.7 |
| Kerb market purchases | 637.0 | | 637.0 |
| US Grants | 600.0 | | 600.0 |
| ACU settlement[1] | 93.6 | 176.9 | -83.3 |
| Debt servicing[2] | | 553.6 | -553.6 |
| Long term loans[3] | 294.5 | | 294.5 |
| Libyan deposits | 50.0 | | 50.0 |
| Swaps | | 30.0 | -30.0 |
| Interest on Short term deposits/FE-25 deposits | 36.3 | 40.1 | -3.8 |
| Sale of Special US Dollar Bonds | 6.8 | | 6.8 |
| Profit on Special US Dollar Bonds | | 29.6 | -29.6 |
| Short-term deposits[4] | | 155.0 | -155.0 |
| Pakistan Trade maintenance Agreement (PTMA) | | 208.8 | -208.8 |
| Receipts on serving as UN troops | 17.0 | | 17.0 |
| IMF | 376.9 | 115.6 | 261.3 |
| Miscellaneous | 19.4 | 30.6 | -11.2 |
| | **3,297.9** | **1,837.7** | **1,460.2** |

1. Settlement under Asian Clearing Union.
2. Debt servicing includes IDB (US$ 151.5 million), IBRD (US$ 104.2 million), ADB (US$ 56.2 million) and foreign currency loan (US$ 37.7 million).
3. Includes loans from ADB (US$ 163 million) and IDA (US$ 125.3 million).
4. Repayment of short-term deposits to Shamil Bank Bahrain (US$ 150 million).

The impact of building liquid reserves cannot be underestimated. Other than easing market expectations that the Rupee will continue to lose value (like it has done in the past), higher reserves are a source of great comfort to foreign investors. An argument can be made that foreign investment in the Oil and Gas sector has not met with much of a response since these investors are often more concerned with Pakistan's ability to meet hard currency payments when commercial production of the wells begins. Hence, existing and projected reserves are critical in determining whether foreign investment will take place. In this regard, such investment will start once the external uncertainty concerning Afghanistan and India is resolved.

## Special Section 1: External Debt and Foreign Exchange Liabilities[103]

The purpose of this section is to highlight some issues relating to Pakistan's external debt burden. This is important for ordinary citizens of Pakistan, as it not only affects their purchasing power (through higher taxes to finance debt servicing), but also reduces government ability to properly cater for their social needs. On the other hand, this is relevant to SBP for its involvement in debt management.

Despite its significance, the external debt is entangled with a lot of confusion mainly due to: (1) use of various definitions and technical terms; (2) limited disclosure of information; and (3) data revisions and changes in reporting formats. Consequently, even persons familiar with the issue of Pakistan's external debt, find it difficult to follow important developments in this area. Although SBP is already providing a complete picture of Pakistan's external debt and liabilities in its Annual Reports, public confusion following the recent restructuring of external debt deserve a special section on this topic.

This section focuses on external debt and liabilities with particular emphasis on recent restructuring by Paris Club creditors. This section also tries to quantify the financial saving from the current debt restructuring. In addition, it also outlines some key points for future external debt management.

### 1. What is Pakistan's debt burden?

As of end-December 2001, Pakistan's total sovereign external debt and liabilities (EDL) were US$ 38 billion (external debt: US$ 33 billion; and foreign exchange liabilities: US$ 5.0 billion - see **Table 1**).

In terms of external debt, public and publicly guaranteed debt amounted to US$ 28.9 billion. This primarily represents project loans contracted by the government, as well as loans contracted by non-government entities (e.g. public utilities and other PSCEs) on the basis of federal government guarantees.[104] In addition, commercial and IDB credit (cash loans kept abroad that are used to finance imports and L/C based credits from IDB) amounted to US$ 0.6 and US$ 0.3 billion, respectively. On the other hand, private loans and credit amounted to US$ 2.3 billion. These loans are generally L/C based and include: (1) supplier credit, (2) buyer's credit (when the credit-providing agency buys the goods and

[103] Ownership of this section goes to Mr. Zulfiqar Hyder, Analyst, Research Department.

[104] While loans contracted by non-government do not represent a direct liability of the federal government; in case of cash flow difficulties, the federal government must make the hard currency payments.

**Table 1: Pakistan's External Debt and Liabilities**
million US$

| | FY90 | FY95 | FY00 AR | FY00 R | FY01 P | IH-FY02 |
|---|---|---|---|---|---|---|
| **1. Public and publicly guaranteed debt** | **18,600** | **25,772** | **26,632** | **28,167** | **29,021** | **28,855** |
| A. Medium and long term (> 1 year) | 18,477 | 25,643 | 26,502 | 28,037 | 28,745 | 28,564 |
| Paris Club^ | 8,089 | 11,005 | 12,428 | 12,428 | 12,090 | 12,403 |
| Multilateral^ | 5,787 | 10,125 | 10,767 | 12,292 | 13,527 | 13,468 |
| Other bilateral^ | 1,218 | 1,005 | 639 | 639 | 598 | 580 |
| Eurobonds | 0 | 150 | 610 | 620 | 620 | 645 |
| Military debt | 2,708 | 2,126 | 958 | 958 | 825 | 825 |
| Commercial loans/credits | 675 | 1,232 | 1,100 | 1,100 | 1,085 | 643 |
| B. Short-Term (= 1 year) | 123 | 129 | 130 | 130 | 276 | 291 |
| IDB | 123 | 129 | 130 | 130 | 276 | 291 |
| **2. Private non-guaranteed Debts (**M&LT: >1 yr) | **304** | **1,418** | **2,842** | **2,842** | **2,450** | **2,256** |
| **3. IMF** | **839** | **1,630** | **1,550** | **1,550** | **1,529** | **1,876** |
| **Total external debt (1 thru 3)** | **19,743** | **28,820** | **31,024** | **32,559** | **33,000** | **32,987** |
| | | | | | | |
| **4. Foreign exchange liabilities** | **3,156** | **8,343** | **5,664** | **5,664** | **5,414** | **5,024** |
| Foreign currency accounts | 2,116 | 6,575 | 1,733 | 1,733 | 1,499 | 1,358 |
| FCAs prior to freeze | 1,027 | 5,376 | | **Frozen** | | |
| FE-45 | 1,089 | 1,199 | 1,072 | 1,072 | 774 | 592 |
| FE 25 accounts * | 0 | 0 | 361 | 361 | 399 | 432 |
| FE 13/For FY01: FE 25 CRR w/SBP | 0 | 0 | 361 | 361 | 399 | 432 |
| FE-31 deposits (incremental) | 0 | 0 | 300 | 300 | 326 | 334 |
| Special US Dollar bonds | 0 | 0 | 1,297 | 1,297 | 1,376 | 1,318 |
| Foreign currency bonds (NHA) | 461 | 351 | 241 | 241 | 219 | 235 |
| National debt retirement program | 0 | 0 | 156 | 156 | 150 | 150 |
| Central Bank Deposits | 94 | 105 | 700 | 700 | 700 | 700 |
| NBP/BOC Deposits | 130 | 123 | 781 | 781 | 749 | 749 |
| Others liabilities | 0 | 600 | 756 | 756 | 721 | 514 |
| FEBCs | 355 | 434 | | | | |
| FCBCs | 0 | 132 | | **Frozen** | | |
| DBCs | 0 | 23 | | | | |
| **Total external liabilities (1 to 4)** | **22,899** | **37,163** | **36,688** | **38,223** | **38,414** | **38,011** |
| **External liabilities payable in Rupees** | | | **1,720** | **1,720** | **1,243** | **1,065** |
| Frozen FCAs | | | 1,572 | 1,572 | 1,153 | 977 |
| FEBC | | | 109 | 109 | 65 | 65 |
| FCBC | | | 36 | 36 | 22 | 20 |
| DBC | | | 3 | 3 | 3 | 3 |
| * FE 25 accounts (outside SBP) | | | 616 | 616 | 1,144 | 1,709 |

^: End September Stock; R: revised; P: provisional.

Source: State Bank of Pakistan

sends them to Pakistan). Another component of external debt is IMF loans; the stock of this item in end-December 2001 is US$ 1.9 billion.[105]

The country also owes US$ 5.0 billion as foreign exchange liabilities. These are different from external debt in the sense that repayments are not structured by any set schedule; it is not generally solicited; and is primarily held by residents. These liabilities mainly include foreign currency accounts, Special US Dollar Bonds, NHA Bonds, central bank deposits (primarily from Gulf countries), NBP/BOC deposits, swaps and deposits under NDRP.

Interestingly, the increase in total stock of EDL may not necessarily be due to borrowing alone. In fact, since Pakistan borrows in multiple currencies (which are then converted to US Dollar for reporting purpose), any appreciation in the currency of the creditor would have an adverse impact on debt obligations.[106] This valuation impact increased the debt stock by US$ 1.5 billion. However, this is more bunched in FY01 as it includes revaluation of past years as well.

## 2. Recent Restructuring of External Debt

The restructuring of external debt by Paris Club creditors is another issue of interest, but at the same time, mired with confusion due to technical jargon.

With historical perspective, Pakistan has benefited in the past from a number of debts rescheduling from the Paris Club (see **Table 2**). The first two rescheduling

**Table 2: Pakistan: History of Paris Club Debt Rescheduling**

| | Terms | Amounts Rescheduled million US$ | ODA credits | | Non-ODA credits | |
|---|---|---|---|---|---|---|
| | | | Maturity (yrs) | Grace Period (yrs) | Maturity (yrs) | Grace Period (yrs) |
| December 14, 2001 | Ad-Hoc | 12,500 | 38 | 15 | 23 | 5 |
| January 23, 2001 | Houston | 1,752 | 20 | 10 | 18 | 3 |
| January 30, 1999 | Houston | 3,254 | 15 | 8 | 15 | 3 |
| January 14, 1981 | Classic | 260 | | | | |
| June 28, 1974 | Ad-Hoc | 650 | | | | |
| May 26, 1972 | Ad-Hoc | 234 | | | | |

[105] Although, the federal government does not directly guarantee these loans, these usually carry assurance by SBP (foreign exchange convertibility guarantee), multilaterals, NCBs, and Export Credit Agencies belonging to OECD countries.

[106] The amount of US Dollars required to pay the same debt in multiple currencies will be higher than originally contracted.

agreements, which were concluded in 1972 and 1974, were based on adhoc terms. The first rescheduling that involved US$ 234 million was the result of payment difficulties following the separation of East Pakistan in 1971. Subsequently, the unprecedented increase in oil prices in 1974 compelled Pakistan to seek debt rescheduling of US$ 650 million. Following the second oil shock and the appreciation of US Dollar, Pakistan requested another rescheduling of US$ 260 million by January 1981. However, this concession was granted on Classic terms (for details, see **Box 1**).

Following the acute balance of payments difficulties after the nuclear detonations in May 1998, Pakistan again approached the Paris Club in January 1999. With the cut off date of September 1997[107], the Paris Club provided *cash flow* relief under "*Houston terms*" of US$ 3.3 billion against payments falling due between January 1999 and December 31, 2000 (see **Table 2** and **Box 1**). This also included arrears accumulated during the first half of 1999.

Since Pakistan was unable to build its repayment capacity even after the end of the consolidation period in December 2000, another round of rescheduling was sought from sovereign creditors in January 2001. The Paris Club agreed to restructure debt worth about US$ 1.8 billion under "*Houston terms*". This included arrears as on November 30, 2000, and payments falling due between December 1, 2000, and September 30, 2001 (the consolidation period).

Although Pakistan successfully completed the IMF's Standby Arrangement, the need for the third rescheduling in three years was obvious by the end of consolidation period in September 2001. However, it was Pakistan's enhanced international stature following September 11 that allowed for extraordinary terms from Paris Club creditors.[108]

[107] When a debtor country first meets with Paris Club creditors, the "cutoff date" is defined and is not to be changed in subsequent Paris Club treatments; this means that credits granted after cutoff date are not subject to future rescheduling, thereby protecting credits granted by Paris Club creditors after a rescheduling.

[108] Pakistan is the fourth country in world over along with Egypt, Poland and Yugoslavia, which was granted such generous terms.

**Box 1: Various Terms of Paris Club Rescheduling**

**Classic terms**
Classic terms are the standard terms applied to a debtor country coming to the Paris Club.
*Eligibility*
Any country that has an appropriate program with the IMF that shows the need for Paris Club debt relief may benefit from classic terms.
*Description*
Credits (whether ODA or non-ODA) are rescheduled at the appropriate market rate with a repayment profile negotiated on a case-by-case basis.

**Houston terms (September 1990; for the lower middle-income countries)**
Houston terms provide three substantial enhancements over Classic terms:
- Non-ODA repayment period = 15 years and ODA repayment period = 20 years with a maximum of 10-year grace;
- ODA credits are rescheduled at a concessional rate;
- Debt swaps can be conducted on a bilateral and voluntary basis. These swap operations may be carried out without limit on ODA loans, and up to 20 percent of the outstanding amount or 15-30 million SDR for non-ODA credits.

*Eligibility*
There are three criteria for eligibility for these terms (i) low level of income (GDP per capita smaller than US$2,995), (ii) high indebtedness (defined as reaching at least two of the following three criteria: debt/GDP higher than 50 percent, debt to exports higher than 275 percent, scheduled debt service over exports higher than 30 percent); (iii) have a stock of official bilateral debt of at least 150 percent of private debt.

**Naples terms (December 1994; for the poorest countries)**
*Eligibility*
Eligibility for the Naples terms is assessed on a case-by-case basis, taking into account the track record of the debtor country with the Paris Club and the IMF and of various criteria, including having a high level of indebtedness, being only eligible for IDA from the World Bank, and having a low GDP-per-capita (755 $ or less).
*Description*
- Naples terms provide the reduction to a 67 percent on Non-ODA to creditor. Creditors can choose from one of the two option:
  1) Debt Reduction option (DR): 67 percent of the claims treated are cancelled, the outstanding part being rescheduled at the appropriate market rate with 23 years repayment period with a 6-year grace and progressive payments.
  2) Debt Service Reduction option: the claims treated are rescheduled at a reduced interest rate with 33 years repayment period with progressive payments.
- Two other options were also designed, but have been very seldom used:
- Concerning ODA credit are rescheduled at an interest rate at least as favorable as the original concessional interest rate applying to these loans. This rescheduling results in a reduction of the net present value of the claims, as the original concessional rate is smaller than the appropriate market rate.
- Debt swaps can be conducted on a bilateral and voluntary basis. These swap operations may be carried out without limit on ODA loans, and up to 20 percent of the outstanding amount or 15-30 million SDR for non-ODA credits.

Source: **www.clubdeparis.org**

As a result, on December 13, 2001, Pakistan was granted debt *restructuring* with the following salient features:[109]

1. In contrast to the previous two rescheduling agreements that provided relief *only* in terms of debt flows (as per Houston terms), the existing arrangement is applicable to the entire stock of US$ 12.5 billion of Pakistan's bilateral debt by Paris Club creditors.[110] Consequently, this provided an implied debt reduction without having a HIPC or IDA only status, which are generally associated with *Naples terms* (see **Box 1**).[111]

2. This agreement granted a repayment period for 38 years (with 15 years as grace period) on ODA credit. This means that the first payment of the restructured amount will be made in May 2017 (end of the grace period) and the final payment is to be made in November 2039 (end of the repayment period). On the other hand, maturity period for non-ODA credit is 23 years, which includes a 5-year grace period.

3. In addition to relief in debt stocks, the agreement also provided support in terms of debt *flows* by deferring all repayments on *post* cutoff date (i.e., September 1997) debt maturing in the remaining part of the current fiscal year. Now these amounts will be paid in 4 equal and successive semi-annual installments starting from May 31, 2005.

4. In order to provide further support to Pakistan's balance of payments, all interest payments due on *restructured debt* between November 30, 2001 and June 30, 2002, have also been deferred. These amounts will also be paid in four equal and successive semi-annual installments starting from May 31, 2005.

5. This relief would also be available in the next two fiscal years, as 20 percent of the annual interest accrued on restructured debt was also deferred. However, this is subject to the annual IMF reviews of the existing PRGF.

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[109] Debt restructuring is different from rescheduling as: (1) it provides relief in the forms of reduction in NPV of external debt; (2) interest rate on the outstanding loans is on concessional terms; and (3) the consolidation period is much longer.
[110] This comprised ODA: US$ 8.8 billion, non-ODA: US$ 3.6 billion, and arrears of US$ 77 million. In this regard, "official development assistance (ODA)" are defined by the OECD as credits with a low interest rate and aimed at development.
[111] In a sense this is beneficial for Pakistan as HIPC or IDA only status restricts borrowings on normal terms from IBRD, ADB or market sources.

6. Furthermore, this agreement also allows debt to equity swaps for bilateral debt by creditor countries if the leeway provided is used for social sector development.

### 3. Financial Saving from the Current Restructuring of Paris Club Debt [112]

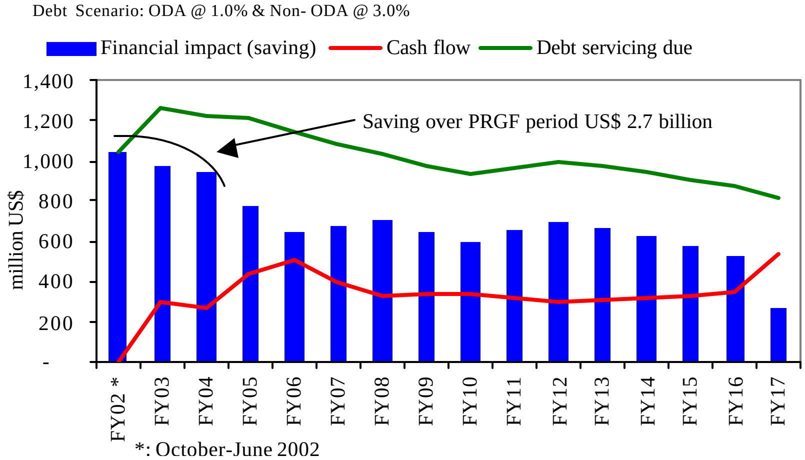
The financial saving from the current restructuring depends on the interest rate negotiated with individual creditor countries. However, on the basis of assumed interest rates both for ODA and non-ODA creditors, the financial impact during the course of the PRGF and the grace period provided in this rescheduling, and implied debt reduction have been worked out (see **Table 3**).

**Table 3: Financial Impact of Restructuring of Paris Club Debt**

| | Interest Rate | | Saving over | | Expected NPV Reduction |
|---|---|---|---|---|---|
| | ODA percent | Non-ODA percent | PRGF | Grace Period | percent |
| Scenario I | 1.0 | 3.0 | 2,971 | 11,060 | 43 |
| Scenario II | 1.5 | 3.5 | 2,848 | 9,880 | 36 |
| Scenario III | 2.3 | 4.0 | 2,711 | 8,541 | 27 |

As can be seen from **Table 3**, the highest saving and debt reduction is possible under scenario I (with 1 percent interest on ODA and 3 percent interest on non-ODA credit). If these interest rates are realized in the negotiation, this will entail savings of US$ 3.0 and US$ 11.1 billion over the PRGF and grace period, respectively. In addition, the NPV of external debt will also fall by 43 percent

**Figure 1: Financial Impact of Reorganisaton of Paris Club**
Debt Scenario: ODA @ 1.0% & Non- ODA @ 3.0%




*: October-June 2002

[112] The financial impact or saving is measured by comparing the cash flow with that of the same stock of debt prior to the restructuring exercise.

(see **Figure 1**).[113] In other words, for the restructured debt of US$ 12.5 billion, Pakistan will only have to pay US$ 7.1 billion.

### 4. Financial Saving from the Rupee's Appreciation

Following the collapse of the kerb (Hundi) market on October 1, 2001, the Rupee cost of servicing Pakistan's external debt has fallen substantially. As shown in **Table 4**, despite the rescheduling of Pakistan's external debt (which has reduced payments by US$ 1.3 billion), payments of US$ 2.7 billion will be required in FY02. Since the Rupee has appreciated from the start of the second quarter of this year, and assuming the current Rupee/US$ parity is to remain at Rs 60 for the remaining part of this year, Pakistan's Rupee cost of servicing these payments will be Rs 121.7 billion. Had the Rupee not appreciated, and maintained the level existing in the first quarter of this year, the Rupee cost of servicing would have been Rs 130.8 billion. This saving of Rs 9.1 billion is still an underestimate, since market expectations were that the Rupee would loose value against the US Dollar for the remaining part of this year. At the margin, this saving in debt servicing will provide tremendous leeway on the fiscal side.

**Table 4: Financial Savings During FY02 from the Rupee's Appreciation**

million US$ (otherwise specified)

| | Q1 | Q2 | Q3 | Q4 | Total |
|---|---|---|---|---|---|
| **Interest** | **249** | **195** | **249** | **398** | **1,091** |
| Official | 195 | 133 | 191 | 146 | 665 |
| Moratorium | 36 | 42 | 38 | 240 | 356 |
| Commercial + IDB | 18 | 20 | 20 | 12 | 70 |
| **Principal** | 696 | 765 | 765 | 640 | 2,866 |
| Official | 365 | 394 | 400 | 360 | 1,519 |
| Commercial + IDB | 331 | 371 | 365 | 280 | 1,347 |
| *of which IDB* | *45* | *116* | *116* | *83* | *360* |
| **Total Payments** | **945** | **960** | **1,014** | **1,038** | **3,957** |
| Rescheduled | 267 | 205 | 340 | 439 | 1,251 |
| **To be paid** | **678** | **755** | **674** | **599** | **2,706** |
| Payment in Rupees@ 64.5 per US$ | | 48,698 | 43,473 | 38,636 | 130,806 |
| Payment in Rupees@ 60.0 per US$ | | 45,300 | 40,440 | 35,940 | 121,680 |
| Savings in Rupees | | 3,398 | 3,033 | 2,696 | 9,126 |

[113] The net present value (NPV) of debt is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the appropriate market rate. The value of this estimate depends on the discount rate and maturity profile of debt. Since, the interest rate on restructured debt will be lower than the originally contracted, and repayment stream has been expanded, this would reduce the NPV of debt, thereby reflecting more concessions.

## 5. Future Debt Reduction Strategy

In addition to reduction in NPV, the write off of US$ 1 billion of bilateral debt from the US will also reduce the external debt burden.[114] This, together with the extraordinary increase in foreign exchange reserve, would not only improve Pakistan's international liquidity position, but also provide an opportunity to exit from IMF programs after the completion of the current PRGF. In addition, the resulting fiscal space would allow the government to increase development expenditures. With strong correlation between pubic and private investment, this increase in public investment should crowd-in investment from the private sector. Furthermore, the improved credit worthiness as evident from up gradation of Pakistan's rating from Caa1 to B3 by Moody's should attract more foreign investment. In effect, the debt relief would provide a much-needed impetus to economic growth, which is an essential element of the debt reduction strategy.

However, there is a need to further consolidate these gains. In this regard, since multilateral debt (from the IFIs) cannot be rescheduled or re-profiled, non-concessional loans from the World Bank, Asian Development Bank and IMF are being substituted by new loans on soft terms.[115] Besides that, the government is also refraining from contracting new commercial or short-term loans. In fact, unlike the recent past when reserve buildup was largely due to commercial borrowings, the present government is focusing more on retiring expensive short-term commercial debt.

With this backdrop, **Table 5** projects Pakistan's stock of external debt from FY02 to FY04.[116] As evident from this table, by June 2002, Pakistan's Trade Maintenance Facility (commercial debt largely used to finance oil payments) would come to an end; NBP deposits with Government and SBP would be fully repaid; 50 percent of Special US$ Bonds and FE-45 deposits will be paid; foreign exchange swaps will be closed; FE-31 deposits will be returned to banks; and NDRP deposits will mature and be paid.

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[114] Under the US laws, the congress has to appropriate US$ 200 million in the budget which is equivalent to NPV of US$ 1 billion over 20 years.

[115] In addition to the current PRGF from IMF (which is on concessional terms compared to the SBA), the World Bank is also providing credit on IDA terms (zero interest rate, 0.75 percent service charge, 10 year grace period and 30-35 years repayment period). Furthermore, ADB is not only increasing its annual assistance to Pakistan, but also shifting gradually from ordinary capital resources to concessional resources of Asian Development Fund.

[116] These estimates, which are based on the Report prepared by Debt Reduction and Management Committee, also includes other external debt and liabilities like NBP (Government) deposits, FE 31, FCL bonds, Swaps and NDRP.

**Table 5: Revised External Debt: Published in Debt Reduction & Management Strategy (Summary Report)**

million US$

| | Closing Stock As On | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | End June 2001 | | End June 2002 | | End June 2003 | | End June 2004 | |
| | Table-19 | Revised | Table-19 | Revised | Table-19 | Revised | Table-19 | Revised |
| Total External Debt | 31,791 | 32,862 | 32,672 | 33,470 | 34,534 | 34,106 | 34,674 | 34,563 |
| Medium & long-term EAD | 25,046 | 26,235 | 26,151 | 27,237 | 28,031 | 28,170 | 28,643 | 29,062 |
| IMF | 1,783 | 1,529 | 2,729 | 1,998 | 3,393 | 2,115 | 3,537 | 2,168 |
| Short-term Commercial/IDB | 1,180 | 1,449 | 521 | 905 | 433 | 940 | 438 | 837 |
| Euro & Saindak Bonds | 620 | 645 | 620 | 643 | 465 | 485 | 310 | 327 |
| Defense | 903 | 554 | 903 | 543 | 903 | 543 | 797 | 543 |
| Private Loans Un-guaranteed | 2,259 | 2,450 | 1,748 | 2,144 | 1,309 | 1,853 | 949 | 1,626 |
| Total External Liabilities | 3,636 | 5,015 | 3,198 | 2,790 | 2,785 | 1,562 | 2,768 | 710 |
| NBP (BOC) Deposits | 500 | 500 | 500 | 500 | 500 | 300 | 500 | - |
| NBP Deposits with SBP | 235 | 203 | 235 | - | 235 | - | 235 | - |
| NBP Deposits with GOP | - | 46 | - | - | - | - | - | - |
| Central Bank Deposits | 700 | 700 | 700 | 700 | 700 | 400 | 700 | - |
| Special US Dollar Bonds | 1,297 | 1,376 | 1,297 | 689 | 1,297 | 472 | 1,297 | 344 |
| FE-45 | 796 | 774 | 392 | 379 | - | - | - | |
| FE-31 | | 326 | | - | - | - | - | |
| Bearer Certificates | 108 | | 74 | | 53 | | 36 | |
| FCL Bonds | | 219 | | 235 | | 213 | | 191 |
| SWAP | | 721 | | 287 | | 177 | | 175 |
| NDRP | | 150 | | - | | - | | - |
| | **35,427** | **37,877** | **35,870** | **36,260** | **37,319** | **35,668** | **37,442** | **35,273** |

Notwithstanding the above repayments, credits from IMF will increase due to disbursements under the PRGF. Also, with greater emphasis on medium and long-term loans, this will help increase the maturity of Pakistan's external debt. However, since these loans are concessional, there is no harm in borrowing as long they are utilized for productive purposes and contribute to economic growth.

In overall terms, the total stock of Pakistan's external debt and liabilities should gradually decline. Although this seems difficult to believe, the current account surplus posted during the last year and half and substantial gains from recent developments in the external sector (price movement of petroleum products, higher worker remittances) can make this task within reach. Nevertheless, the importance of export growth, the need to remove the segmentation in the foreign exchange market, and the commitment to continue with the reform and adjustment program, cannot be emphasized enough.

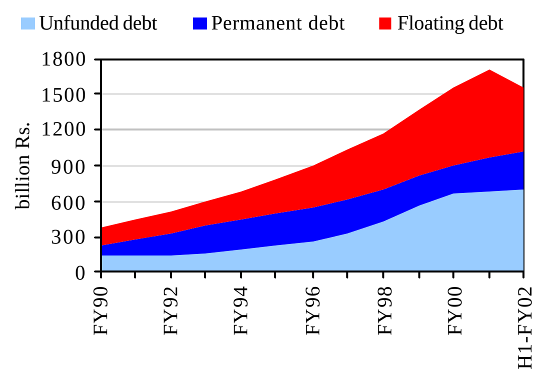
## Special Section 2: Domestic Debt[117]

In this section we make an attempt to analyze how the profile of domestic debt has changed since debt management reforms in FY90 with special focus on the recent changes in the size and composition of domestic debt resulting from external debt rescheduling.

### Backdrop

Domestic debt in Pakistan is categorized into permanent, floating and unfunded debt. Interestingly, though, there has not been a clear delineation of the different categories of domestic debt. Broadly speaking, however, permanent debt represents government borrowing using instruments of more than one-year maturity; floating debt is short term borrowing primarily through treasury bills at market rates of return, while unfunded debt refers to mobilizations through NSS instruments.[118]

**Figure 1: Domestic Debt Outstanding**




The size and composition of domestic debt, and the underlying interest rate structure have important implications not only for the fiscal policy of a country but for its monetary policy as well. Chronic imbalances in the fiscal operations of the government and limited access to external sources of financing during the decade of 1990s led to a continued accumulation of the stock of domestic debt (see **Figure 1**). The outstanding amount of domestic debt rose to 49.0 percent of GDP in FY00 compared with 43.7 percent in FY90. On the other hand, the composition of domestic debt has varied a great deal since debt management reforms in FY90. Frequent changes in yield structure of government securities, restrictions on financial institutions' access to high-yield debt instruments, and launching of instruments with market determined rates of return have played the dominant role in changing the structure of domestic debt (see **Table 1**).

[117] Ownership of this section goes to Mr. Tasneem Alam, Analyst, Research Department.
[118] Permanent debt can also be labeled as long-term debt; floating as short-term debt; and unfunded debt can also be labeled under another name. The word 'unfunded' seems superfluous, but used traditionally.

**Table 1: Changing Composition of Domestic Debt**

End period, million Rupees

| | FY90 | FY95 | FY00 | FY01 | H1-FY02 |
|---|---|---|---|---|---|
| **Permanent debt** | **95,019** | **275,671** | **259,599** | **281, 077** | **309,299** |
| | *25.4* | *35.0* | *16.6* | *16.4* | *19.7* |
| Market loans | 25,509 | 23,322 | 15,028 | 6,827 | 6,670 |
| | *26.8* | *8.5* | *5.8* | *2.4* | *2.2* |
| Federal Investment Bonds (FIBs) | - | 168,808 | 135,870 | 113,043 | 91,638 |
| | - | *61.2* | *52.3* | *40.2* | *29.6* |
| Pakistan Investment Bonds (PIBs) | - | - | - | 46,123 | 91,638 |
| | - | - | - | *16.4* | *29.6* |
| Others | 69,510 | 83,541 | 108,701 | 115,084 | 119,353 |
| | *73.2* | *30.3* | *41.9* | *41.0* | *38.6* |
| **Floating debt** | **144,979** | **294,233** | **647,428** | **737,776** | **548,725** |
| | *38.8* | *37.3* | *41.5* | *43.2* | *35.0* |
| Adhoc treasury bills | 69,595 | 61,456 | 90,074 | 125,302 | 125,316 |
| | *48.0* | *20.9* | *13.9* | *17.0* | *22.8* |
| Treasury bills (On-tap) | 58,714 | - | - | - | - |
| | *40.5* | - | - | - | - |
| Treasury bills/STFB/MTBs (Auction) | - | 57,172 | 90,009 | 104,096 | 110,565 |
| | - | *19.43* | *13.90* | *14.11* | *20.1* |
| Treasury bills/STFB/MTBs (SBP) | - | 175,592 | 467,332 | 508,364 | 312,831 |
| | - | *59.7* | *72.2* | *68.9* | *57.0* |
| Others | 16,670 | 13 | 13 | 13 | 13 |
| | *11.5* | *0.0* | *0.0* | *0.0* | *0.0* |
| **Unfunded debt** | **134,110** | **218,563** | **652,922** | **689,680** | **709,647** |
| | *35.8* | *27.7* | *41.9* | *40.4* | *45.3* |
| Defence saving certificates | 35,156 | 85,019 | 248,402 | 264,648 | 271,542 |
| | *26.2* | *38.9* | *38.0* | *38.4* | *38.3* |
| Khas deposit certificate | 79,023 | 1,377 | 705 | 655 | 650 |
| | *58.9* | *0.6* | *0.1* | *0.1* | *0.1* |
| Special saving certificates & accounts | 8,755 | 95,736 | 202,402 | 213,140 | 222,092 |
| | *6.5* | *43.8* | *31.0* | *30.9* | *31.3* |
| Regular income certificates | - | 9,387 | 170,211 | 178,649 | 184,156 |
| | - | *4.29* | *26.07* | *25.90* | *26.0* |
| Others | 11,176 | 27,044 | 31,202 | 32,588 | 31,207 |
| | *8.3* | *12.4* | *4.8* | *4.7* | *4.4* |
| **Total domestic debt** | **374,108** | **788,468** | **1,559,949** | **1,708,533** | **1,567,671** |

Figures in red represent percentage share in total domestic debt.

Figures in blue show share in percent of the instrument in its respective category.

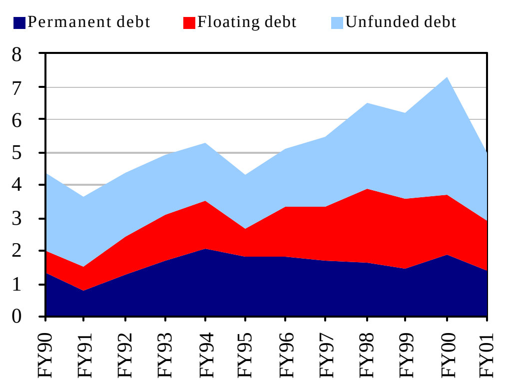
**Changing Profile of Domestic Debt**

Government's domestic borrowing needs are financed either from the banking system or the nonbank sector. Prior to FY90, bank and nonbank borrowings were largely dominated by instruments issued on tap and redeemable before maturity. Because of early redemption characteristic the cash flows of these instruments were uncertain and, thus, a larger proportion of domestic debt was, in effect, short-term in nature. Furthermore, the segmentation in government debt market, promoted through a highly differential interest rate structure, was leading to disintermediation besides adversely affecting the allocative efficiency of the financial sector.

Debt management reforms were initiated, in the early 1990s, to rationalize interest rate structure and to bring about a balance in the composition of debt vis-à-vis its three categories. Auctions of treasury bills and Federal Investment Bonds (FIBs), and discontinuation of Khas Deposit Certificates were the main steps that started to effectuate a welcome compositional shift in respective constituents of domestic debt. The share of permanent debt rose till FY93, while that of unfunded debt declined.

Unfortunately, later developments again effectively put the compositional dynamics of domestic debt on the pre-reform track. Upward revision in rates of return on NSS started to accelerate the growth in unfunded debt and, therefore, resulted in an increase in the servicing burden of unfunded debt. Suspension of auctions of FIBs in 1998 further accentuated the problem resulting in drastic decline in share of permanent debt and increase in share of unfunded debt. The fact that now the government was borrowing from banking system on market determined rates of return coupled with the increase in yield on NSS raised the servicing burden of domestic debt to unsustainable levels. In terms of GDP, interest payments on domestic debt increased to 7.2 percent as on end of FY00 from 4.3 percent as on end June 1990 (see **Figure 2**). The costs of servicing domestic debt, consequently, proved disastrous for public finance.

**Figure 2: Interest Payments on (as % of GDP)**

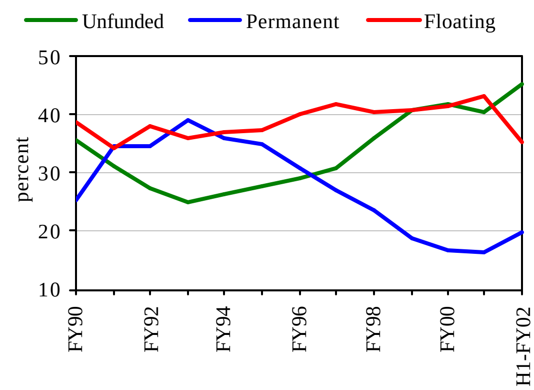


By the end of 1990s the government realized the apparent reversal of debt management reforms and, hence, concerted efforts were initiated to do away with the turnaround. Consequently, rates of return on NSS were gradually reduced beginning May 1999. Furthermore, a long-term debt instrument with fixed coupons (Pakistan Investment Bonds) was launched in December 2000.[119] Consequently, by end FY01, the share of NSS instruments declined while the continued decline in the share of long-term debt came to an end. Resultantly, interest expenditure on account of unfunded debt dropped significantly during FY01.

***Recent Changes in the Composition of Domestic Debt***

There have been significant changes in the size and composition of domestic debt during the first six months of FY02. The stock of domestic debt has actually declined by Rs 140 billion during H1-FY02 in sharp contrast to a rise of Rs 60 billion during the same period last year. Moreover, the declining trend in the share of permanent debt, beginning FY94 when the growth in floating and unfunded debt outpaced the growth in permanent debt, has now reversed (see **Figure 3**). The overwhelming response to Pakistan Investment Bonds (PIBs), owing to the absence of any other long-term paper with market rates of return and restricting institutional investors from investing in NSS, was primarily responsible for the change. In case of unfunded debt, increasing the yield on Defence Saving Certificates (DSCs) and other NSS instruments in July 2001 after linking the yield on DSCs to PIBs by January 2001 contributed towards the rise in its share during H1-FY02.

**Figure 3: Shares in Domestic Debt**

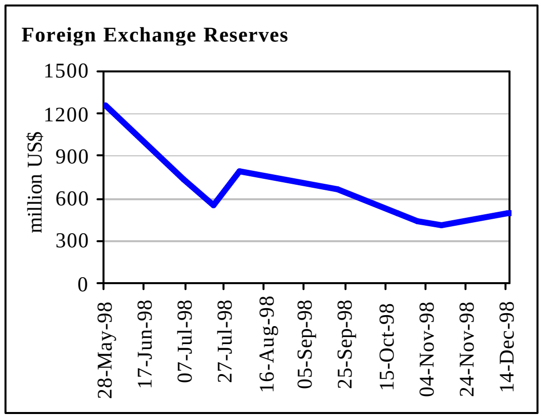



The most remarkable change, however, has occurred in the share of floating debt that declined from 43.1 percent to 35 percent during the first six months of

[119] Coupons are fixed but can vary for different issues, unlike those of FIBs.

FY02[120]. One must also notice the fact that the decline in total domestic debt has resulted entirely from this huge reduction in floating debt (see **Figure 1**). A closer look at the composition of floating debt reveals the fact that the decline is primarily due to the retirement of Market Related Treasury Bills (MRTBs)[121] during this period. More specifically, treasury bills held by SBP valuing Rs 193 billion were retired in July 2001 as the government decided to close Special Account (Debt Repayments) and adjust the amount therein against the repayment of MRTBs (see **Box** on next page).

**Box: Impact of External Debt Rescheduling on Domestic Debt**




Pakistan's decision to go nuclear in May 1998 led to immediate economic sanctions by G-8 countries. In addition, the decision to freeze all FCAs severely impaired government's credibility to honor its commitments and, thus, resulted in almost a complete halt to private foreign exchange inflows. Owing to these circumstances country's foreign exchange reserves more than halved in just less than two months (see **Figure** on Foreign Exchange Reserves). The abrupt decline in foreign exchange reserves to dangerous levels necessitated extraordinary measures. Hence, the government decided that with effect from July 17, 1998 all payments relating to external debt servicing shall be made in Pak rupees at the prevailing exchange rate. Consequent upon this decision, on July 21, 1998 SBP opened an account titled 'Special Account-Debt Repayments' under the main head 'Other Deposits' in its books with separate folio for each creditor. The creditors concerned were allowed to draw from the special rupee account, if they so desired. However, repayments to international financial institutions were allowed to be made in foreign exchange. These decisions effectively implied postponement of servicing Pakistan's bilateral foreign debt.

In December 1998 the government decided to open a separate account at SBP titled 'Special Account- Debt Repayments-II' on account of remittances in respect of Defence Services. Thus, rupee equivalent of payment authorities issued by Economic Affairs Division in respect of debt servicing of foreign debts and the authorities issued by Ministry of Defence relating to defence services were credited in 'Special Account-Debt Repayment I & II' maintained at Central Directorate, SBP per contra debit to respective Governments Account at SBP offices. The opening of these accounts had no net monetary impact as these merely reflected transfer of government funds from one head of account to another.

[120] For the last six years, floating debt's share in total domestic debt averaged more than 41%.
[121] MRTBs refer to six-month treasury bills that are purchased by SBP outside auctions but at market determined rates to replenish Government Non-Food Account.

With extensive rounds of negotiations with the IMF and Paris club creditors, Pakistan was finally able to secure agreements on Standby Arrangement (SBA) with the Fund and on rescheduling of her foreign debts amounting to about $3 billion in January 1999. It was, however, decided, after consultations with the Fund, that rupee equivalent of reschedulable debt would continue to be deposited in the special accounts maintained by SBP. The reason for deciding to continue with this procedure was to ensure availability of rupee funds when the payment finally falls due.

Though, at first, the decision seemed reasonable, it apparently failed to realize the fact that allocation for the deferred debt servicing would add to government expenditures resulting in higher than actual budget deficit. Besides, as the prospects of second rescheduling of foreign debt became obvious, further continuation of the special accounts seemed redundant for a couple of additional reasons. Firstly, credit to the special accounts were being made per contra debit to Central Government Account-I (Non-Food) and, thus, were directly contributing towards the creation of treasury bills for replenishment and increase in interest cost of the government. Secondly, with the continuous depreciation of rupee, the amount lying in these accounts was getting depleted in dollar terms. The government, therefore, decided, with the Fund's accord, to close down these accounts and adjust the amount therein with repayment of treasury bills held by SBP. Accordingly, balance amounting to Rs 194.6 billion in 'Special Accounts-Debt Repayments-I & II' as on July 21, 2001 was credited to Government's Non-Food account. Simultaneously, the Non-Food account was debited with the same amount and treasury bills valuing Rs 193.03 billion were retired (Rs 193.03 billion Principal + 1.64 billion on account of markup).

Due to this huge retirement, the outstanding amount of total domestic debt has declined by about Rs 140 billion during H1-FY02 against an actual increase of Rs 60 billion during the same period last year. As a result, the interest expenditure on domestic debt is, certainly, expected to go down during FY02. Furthermore, it has ended the process of an almost continuous increase in domestic debt through unnecessary enlargement of floating debt held by SBP.

## Appendix: Policy Measures During the Second Quarter FY02

### 1. Agriculture Sector

?? On November 1, 2001, the CBR exempted local suppliers of urea fertilizer (other than importers or manufacturers) from general sales tax (GST) with effect from April 1, 2001. GST exemption would also apply on local supplies of 50 different types of fertilizers, other than urea purchased by individuals on or after September 2, 2001.

?? In order to ensure that the transition to procurement of wheat by private sector is accomplished smoothly, following guidelines were issued by SBP to banks on December 3, 2001:

i. The banks will provide credit to private sector for wheat procurement under commodity operations at 12 percent mark up to the eligible flourmills for the initial year. The lending rates shall subsequently be made market based by linking with T-bill rates.

ii. In order to assess the credit risk, the banks would have a direct interaction with the borrowers, and the Flour Mill Association would ensure cooperation so that banks are able to complete their credit approval/appraisal process and legal documentation required for this purpose.

iii. For the purpose of improving wheat storage capacity in the private sector, banks will provide adequate funds for a maximum period up to 7 years for the construction of silos, and other structures that can serve as a storage area for wheat at a debt equity ratio of 60:40 at normal lending rates. The banks would ensure that the transactions are viable and their exposure is secured adequately. The banks may like to approach Ministry of Food Agriculture & Live Stock (MINFAL) who would prepare standardized models for construction of storage facilities (of various sizes/types).

### 2. Industrial Sector

?? The central excise duty (CED) on cigarettes was increased from Rs 1.77 per ten cigarettes to Rs 1.91 per ten cigarettes with effect from October 1, 2001. Furthermore, in the case of price exceeding Rs 10 per ten cigarettes, an additional 63 percent of the retail price will be charged.

?? In order to boost the sale of vehicles, the CBR on October 5, 2001, allowed the foreign diplomats to purchase locally assembled vehicles from recognized local manufacturers free of duty subject to the condition that such vehicles (including four wheelers) should not be sold to another party without prior permission of the customs authorities.

?? With a view to accelerate the domestic production, the CBR on October 7, 2001 withdrew 20 percent regulatory duty (RD) on the import of raw material and components required for production of chloro-fluro carbons (CFC) used in refrigerators, deep freezers and air conditioners.

?? General Sales Tax (GST) levied at a rate of 15 percent on the import of canola seed was withdrawn on October 11, 2001 to promote domestic crop of oil seeds.

?? In order to promote domestic production of synthetic staple fibre, 5 percent ad valorem regulatory duty (RD) was imposed on its import on October 14, 2001. The RD has been levied on a particular type of synthetic staple fibre not exceeding 2.22 decitex.

?? The CBR on October 25, 2001, exempted the import of selected raw materials used in the manufacturing of footwear from custom duty. Furthermore, duty drawback curtailed earlier for the manufacturers of synthetic and leather shoes were restored with effect from November 20, 2001. The CBR also revised the repayment of customs duty on the import of such raw materials used in the production of canvas or textile shoes.

?? To provide relief to pharmaceuticals, the federal cabinet on November 28, 2001 approved a 3 percent increase in the prices of essential drugs and a 4 percent rise for decontrolled category.

?? On December 28, 2001, the CBR allowed Sui Southern Gas Company Ltd (SSGCL) and Sui Northern Gas Company Ltd (SNGCL) duty-free import of items for infrastructure rehabilitation and expansion of their projects.

## 3. Monetary Sector

### Export Finance

?? Effective from October 1, 2001, the State Bank of Pakistan (SBP) made a few amendments under Part-I of Export Finance Scheme. These changes were aimed at simplifying the procedure, reducing the rate of mark up, extending coverage and setting up of a Pre-shipment Export Finance Guarantee (PEFG) agency. Furthermore, in order to promote financing for indirect exporters, the government will set up an Export Product Upgrading Matching Grants Fund (to be managed by Export Promotion Bureau), which would be available as an incentive to direct exporters (establishing inland letter of credit/issuing standardized purchase order), and for indirect exporters receiving it.

- In order to enable banks to have the confirmation of their certain eligible L/Cs at a reasonable rate, the government negotiated a facility with the Asian Development Bank (ADB). This facility notified on October 17, 2001 will be used to guarantee payments to international banks confirming eligible L/Cs (if the payment obligation under the L/C is not made by the issuing bank and this failure to pay is solely, directly and immediately caused by the occurrence of certain events which have been pre-agreed between ADB and the GOP). The guarantee so provided will effectively transfer Pakistan's country risk to ADB and would ensure continued willingness of international banks to confirm import L/Cs issued by Pakistani banks. The facility would be administered through Standard Chartered Bank in Dubai, which was appointed by ADB with concurrence of the government.

- It was decided on October 24, 2001 to relax the provision of EFS up to 270 days (both pre-shipment and post shipment) for availing export finance in respect of *carpets and rugs*. In case of fresh finances, banks will have to adjust the finance within a maximum period of 180 days, and allow refinance for an additional period of 90 days (provided shipment has been made by the exporters within a period of 180 days after the withdrawal of the finance). In case of export finance already availed of by exporters under Part-I, banks may allow an additional period up to 90 days for repayment of export finance.

- Banks were advised on October 30, 2001 to provide financing facility under Export Finance Scheme to consultancy services. Since, the government accorded "deemed export" status to foreign exchange receipts remitted into Pakistan against consultancy services, such earnings would also qualify for export finance facility under Part I for a period not exceeding 180 days. However, the facility would be available on case-by-case basis.

- Effective from December 1, 2001, the refinance rate applicable to banks on their disbursement to exporters under export Finance Scheme was reduced to 8.5 percent per annum (This rate was further reduced to 8 percent effective 1$^{st}$ January, to 7 percent effective 1$^{st}$ February, and to 6 percent effective from 1$^{st}$ March, 2002). The banks were asked to ensure that the maximum margin/spread on refinance does not exceed 1.5 percent per annum. The financing facilities under Part-B (Export Sales) of the Scheme for financing

Locally Manufactured Machinery shall also attract similar mark up rate structure.

?? Following September 11 event, and thereby cancellation of export orders for leather garments and leather product, SBP relaxed rules on December 21 for such exporters availing loans under export finance Part-I and II. Accordingly, exporters who had availed loan under Part-I for export prior to September 30, and had shipped goods with delay, a maximum period of 90 days will be available for which fine for delayed shipment will not be levied. However, exporters will be obliged to liquidate the finance/refinance within a period of 180 days. On the other hand, exporters under Part-II will be required to show matching performance for the year 2001-02 equal to at least 1.5 times instead of 2.0 times prescribed for all other eligible commodities under the scheme.

?? In order to provide a clear understanding to banks, SBP on December 27, 2001 defined 'Overdue Exports Proceeds' as those where an exporter is unable to repatriate the export proceeds within 180 days from the date of shipment or within such periods as may be determined for the purpose by the State Bank for a particular sector, as modified from time to time or on due date of the bill whichever is earlier. Accordingly, banks were instructed to ensure that the exporters who had overdue export bills against any finance availed by them under the scheme should not ordinarily be eligible to avail the facility. However, if an exporter is unable to repatriate export proceeds for reasons beyond his control, the bank concerned may allow the facility after recording reasons in writing.

?? SBP on January 30, 2002 reinstated the refinance facility under Part-1 of the Export Finance Scheme to the exporters of the bleached and unbleached cloth if exported at the price of above 3 US dollar (or equivalent) per square meter. The facility was earlier withdrawn as a part of the measures announced in the Trade Policy for 2000.

**Non-Performing Loans (NPLs)**

?? It has been decided to create a database of NPLs at the SBP so as to have a consolidated as well as individual borrower wise figures of NPLs on a uniform basis for the purposes of SBP monitoring and for sharing with others banks. Banks were advised to submit to the Credit Information Bureau, data of their non-performing loans of Rs.10 million and above as per revised format on monthly basis, starting from October 2001, within 15 days of the end of each month.

### Discount Rate

?? The minimum rate of return to be paid by recipients of financing facilities from SBP for temporary liquidity shortages and SBP 3-Day Repo facility against GOP Market Treasury Bills and Federal Investment Bonds was reduced from 12 percent to 10 percent on annual basis effective from October 20, 2001.

### Other Measures

?? According to prudential regulation amended on January 1, 2002, foreign currency deposits mobilized under FE-25 schemes (after netting-off the deposits utilized to finance trade related activities such as financing against Import and Export documents), should not at any point exceed 20 percent of the local currency deposits of the banks/NBFIs at the close of business on the last working day of the preceding quarter. However, banks/NBFIs who will still be in breach of this new requirement as on January 1, 2002 will ensure compliance by July 1,2002.

?? On January 1, 2002 the SBP instructed all banks/DFIs not to nominate as director (including nominee director) on the board of a bank/DFIs persons related with the business of moneychangers, members of the stock exchanges, brokerage houses or companies owned or controlled by them or persons directly or indirectly associated with the business of stock market/moneychanger. Banks having such persons on their board were asked to regularize their positions within 90 days.

## 4. External Sector

### Foreign Trade

?? The Central Board of Revenue on October 16 2001 announced the Zero-rating supplies of taxable goods made by registered persons against international tender to UNICEF, UNDP, WHO, WFP, UNHCR and IRC for Afghan refugees.

?? On November 28 2001, the federal government granted sales tax exemption to the supplies of hand-knotted carpets by registered persons to foreign nationals (against payment through a foreign credit card) for subsequent export as personal baggage.

?? According to earlier instructions, exporters were allowed to retain foreign exchange (maximum of 6 percent FOB value of goods realized) in their accounts with ADs in Pakistan, provided that the exporter is not required to pay commission or where he is required to pay to the foreign agent an amount less than the maximum permissible limits. However, with effect from December 3, 2001 exporters (who post at least 10 percent growth over the last year's export performance) were allowed to retain 50 percent of their additional export proceeds in their foreign currency account.

?? With effect from December 27, 2001, ADs were allowed to approve import payments up to US$ 5000 per person during a fiscal year in respect of cost of medicines, hearing aids, braille watches and small carts or parts of special gadgets for the disabled persons or life saving instruments imported by the applicants for their personal use. Previously this limit was Rs 5,000 per person during a fiscal year.

?? Effective from December 27, 2001, ADs were permitted to issue foreign currency demand draft up to US$ 15,000/- for import of spare parts/ machinery without opening of letter of credit provided such import is made by air or by courier. Previously this ceiling was US$ 7,000/- per fiscal year.

?? The European Union (EU) withdrew duty on many Pakistani value-added products, besides allowing 15 percent increase in quota with effect from January 2002. In return Pakistan would improve market access to EU clothing and other textile exports through reducing import duty by 5 percent.

?? Under the second phase of the WTO agreement, effective from January 1, 2001, several products exported by Pakistan to European Union (EU), Canada and the US, are declared quota-free which include Bar mopes (Cat-369-R); flat dish towels (Cat-369-FP); knitted gloves for the USA; bathrobes for the EU (Cat-18); and knitted blouse and boxers' shorts for Canada (Cat-8A-1).

**Foreign Exchange Market**

?? The requirement that all interbank foreign exchange deals must by backed by permissible commercial transaction, has been withdrawn with effect from November 21, 2001.

?? With a view to further liberalize foreign exchange activities, effective from November 22, 2001 ADs were allowed to approve payments in excess of limits specified for travel (private, government or business), education or medical treatment abroad or other purposes, subject to certain conditions.