Contents ***Page Nos.***

The Team

Leaders

Mohammad Mansoor Ali	mohammad.mansoor@sbp.org.pk
Syed Sajid Ali	sajid.ali@sbp.org.pk

Researchers

Fida Hussain (Manufacturing)	fida.hussain@sbp.org.pk
Mahmood-ul-Hasan Khan (Fiscal)	mahmood.khan@sbp.org.pk
Mohib Kamal (Money & Credit)	mohib.kamal@sbp.org.pk
Muhammad Amin Khan Lodhi (Banking)	amin.lodhi@sbp.org.pk
Muhammad Mazhar Khan (Money Market)	mazhar.khan@sbp.org.pk
Muhammad Mazherul Haq (Agriculture)	mazharul.haq@sbp.org.pk
Muhammad Waheed (Capital Market)	muhammad.waheed@sbp.org.pk
Sardar Shah (Prices)	sardar.shah@sbp.org.pk
Syed Muhammad Tariq (Trade)	syed.tariq@sbp.org.pk
Zulfiqar Hyder (Balance of Payments)	zulfiqar.hyder@sbp.org.pk

Research Assistance

Adil Mahboob	adil.mahboob@sbp.org.pk
Asma Khalid	asma.khalid@sbp.org.pk
Ghazi Rahman	ghazi.rahman@sbp.org.pk
Iffat Mustafa	iffat.mustafa@sbp.org.pk
Misbah Manzoor	misbah.manzoor@sbp.org.pk
Shahbaz Nasir	shahbaz.nasir@sbp.org.pk
Syeda Sabina Batool Kazmi	sabina.kazmi@sbp.org.pk
Waheed Akram	waheed.akram@sbp.org.pk

Data Support

Abdul Faheem	abdul.faheem@sbp.org.pk
Mazhar Hussain	mazhar.hussain@sbp.org.pk
Salman Ahmed	salman.ahmed@sbp.org.pk
Tasneem Alam	tasneem.alam@sbp.org.pk

THE STATE OF PAKISTAN'S ECONOMY

Third Quarterly Report for 2001/2002

Overview

The most noteworthy development during the third quarter of FY2002 was the continued improvement in the country's external account. This improvement was broad-based – a reduced trade deficit, substantial decline in the services account and a large rise in the current transfers, all contributed to this positive outturn. Worker remittances, in particular, remained at approximately twice the corresponding levels of the previous year. In fact, the net inflows were sufficient to warrant a further substantial appreciation of the Rupee, were it not for the SBP's conscious decision to purchase heavily in the inter-bank market in order to boost reserves, and to protect exporters.

Table 1.1: Quarterly Economic Indicators

percent

Growth rates	Jul-Mar		
	FY00	FY01	FY02
Large-scale manufacturing	0.3	7.6	3.2
Exports	8.9	8.4	-2.7
Imports	13.1	7.2	-8.5
Home remittances[1]	-16.0	15.1	126.0
Tax revenues	18.2	14.9	-2.5
CPI (Q3 over Q3)	3.4	4.8	3.0
Private sector credit (CBs)	5.3	14.1	5.7
Money supply (M2)	2.8	4.7	9.3
Total liquid reserves[2]	2,073	2,275	5,234
Foreign private investment[3]	393	104	285
As percent of GDP[4]			
Fiscal deficit	6.4	5.3	5.7
Trade deficit	2.8	2.6	817*
Current a/c balance	-0.4	0.6	2095*

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

[2] With SBP & with banks. End March, in million US$.

[3] Net flows in million US$.

[4] Numbers relate to full year.

[*] Numbers correspondence to end-March in million US$.

With just three months remaining to the end of fiscal year 2002, it seems that the timely interventions by the authorities (increased tax refunds, monetary easing, etc.), timely rains, the continuing impact of structural improvements in the external account, and a modicum of luck may have rescued the domestic economy from a very poor showing in FY02. As a result, real GDP growth could comfortably cross the three percent mark, supported equally by a reasonable, under the circumstances, performance by large-scale manufacturing and a small revival in agricultural output (if positive expectations from the wheat crop and the non-crop sector, are realized).

The external account improvement also provided an enabling environment for the SBP's looser monetary stance in FY02, allowing the central bank to accelerate the downtrend in domestic interest rates in response to the shocks to the economy due to Q2-FY02 events.

This said, it must be pointed out that the situation of the economy is far from satisfactory. Water shortages once again bedeviled the agricultural sector, pulling down a potentially more impressive recovery in the sector. It is no coincidence that the large portion of the agricultural recovery FY02 is attributable to the kharif crop – it requires 50 percent more water than the rabi crop and it was the early rains in the kharif that averted a *fall* in agriculture output.

Despite the perceptible shifts towards diversification, agriculture will likely remain at the heart of the domestic economy for the foreseeable future. Therefore, if the economy is to sustain substantial growth in future, urgent attention is required to improve the infrastructure for the agricultural sector, including, but not limited to, better water storage & supply facilities, enhanced access to credit, increased capacities for storage of food grains, crop insurance, etc.

In view of the improving macroeconomic fundamentals, large scale manufacturing (LSM) growth too has been a little disappointing. It appears that despite the supportive policies of the government and the SBP, many sub-sectors could not shrug off the impact of the Q2-FY02 turmoil in the domestic and export markets.

The weakness in the broader economy had obvious negative repercussions for government revenues, with net tax collections falling 5 percent short of even the thrice-adjusted Rs 414.2 billion target for FY02[1]. It must be noted that a part of the lower net collections stemmed from enhanced payments of tax refunds – since a large part of these comprised arrears, this implies that a similar drag on FY03 collections should not repeat itself. Nonetheless, given that (1) even gross collection rose only 3.5 percent in year-on-year terms during Jul-Mar 2002, and that (2) the value in dutiable imports may remain low in coming months[2], it is clear that the restructuring of the CBR, to broaden the tax base and enhance revenue, is imperative. The failure to do so will contribute either to the continuation of high fiscal deficits, eroding the macroeconomic gains directly, or

[1] By end-March 2002, the net receipts target for FY02 has been reduced by a cumulative Rs 43.5 billion.
[2] Weak custom duty receipts have been the primary cause of the tax shortfall in FY02.

if controlled by lower development expenditure, lead to the general deterioration of the infrastructure necessary for economic growth.

In the external sector, the current account rose another US$ 820 million during Q3-FY02 to take the cumulative surplus to an unprecedented US$ 2095 million. While very welcome, this "improvement" has to be viewed with a degree of caution, and without invoking a sense of complacency or self-congratulation. The challenges ahead are difficult. The lower trade deficit is quite narrowly based on lower imports of sugar and a considerable decline in oil prices, both of which depend on exogenous factors, i.e. one bad sugarcane crop and a sharp jump in international oil prices could easily leave the trade balance in the red again. This vulnerability can also be discerned in other components of the current account. The services account is bolstered by payments of US$ 300 million on account of the basing charges paid by the international forces policing Afghanistan, while higher current transfers benefit from a US$ 600 million non-repeating grant paid by the US government. Adjusted for the one-time gains, as well as the uncertain benefits of the trade account, the FY02 current account improvement falls to approximately US$ 420 million (less than the US$ 783 million FY02 *growth* in worker's remittances).

So far, the more impressive and somewhat durable gain appears to be on account of remittances, which have roughly doubled as the kerb market premium plummeted and the informal money transfers drew greater regulatory scrutiny internationally. The above discussion thus only suggests the need for urgent policy changes to consolidate the real improvement in the current account by subsuming the informal foreign currency markets into the formal system. The SBP intends to take the first step to this end by bringing foreign exchange companies into existence in FY03 to capture a larger portion of the potential remittances that currently flow into the informal market[3].

The other noteworthy development was the continued rise in the quantum of exports particularly given the adverse trading environment. In fact, it is the decline in unit values of textile exports that has not allowed higher earnings. While the resumption of higher growth in the OECD countries holds a better promise for value added textile exports in the coming years, the trend also underlines the urgency for moving away from commodity exports.

[3] In essence, the worker's remittances represent the 'export' of Pakistani services. Thus, the funds sent through the informal markets represent leakages that should correctly accrue to the formal economy. Plugging of these leakages through the FECs could thus lead to a sustained improvement in Pakistan's current account.

The imponderables about the current account taken together with the CBR's poor revenue generation record serves to underline the fragility of monetary sector improvements as well. Firstly, a key element in the SBP's ability to sharply lower interest rates during FY02 was the high liquidity in the banking sector. As detailed in **Section 5,** this ultimately derived from the liquidity injections due to the SBP's foreign currency purchases (from both, the formal and informal markets) and allowed a significant fall in the government's budgetary borrowings away from the SBP without crowding out private sector demand. The magnitude of these flows for FY03 is obviously still uncertain.

The most unambiguous positive for the economy is the *fall* in Pakistan's External Debt and Liabilities (ED&L) by end-FY02 - this is the first visible sign of the country progress in moving out of its debt trap. The ED&L are projected to fall by approximately US$ 2 billion compared to the FY00 figure of US$ 37.9 billion (see **Table 1.2**). Although the debt component has actually risen by US$ 768 million due to positive net inflows from international financial institutions, this has been offset by a much larger (US$ 2.8 billion) fall in foreign currency liabilities. Interestingly, even the *rise* in the debt is part of SBP strategy to *lower* the country's external debt servicing burden, by substituting very expensive debts with soft loans.

The agenda for economic revival remains the same as spelled out in the preceding Quarterly Reports, with fiscal discipline and an aggressive strategy to consolidate the gains on external front remaining the essential elements for the necessary macroeconomic environment. Early reform of the CBR, privatization of key state owned enterprises (public sector banks, KESC, PTCL, etc.), curtailment of losses in the public sector and increased development expenditures, particularly in water storage and conservation, are the priority elements of this agenda.

The forthcoming budget should aim to accelerate the pace of public investment in the coming year to strengthen the foundation for growth and to stimulate the economy. It is quite obvious by now that for a variety of reasons the private sector remains shy as far as new investment is concerned. Given the fiscal space freed by debt re-profiling and reduction in the government's domestic borrowing costs due to lower interest rates it is now possible to raise the level of public investment by at least 20 percent compared to the current year's actual utilization. Most of this investment should be in infrastructure and the social services sectors, with particular attention to the district and municipal levels.

Table 1.2: Pakistan External Debt and Liabilities

million US$

	End-June 2000	End-June 2001	End-March 2002	Inflow	Repayment Principal	Rescheduled interest	Projected stock at end Jun-02	Change 30-06-02/ 30-06-00
1. Public & publicly guaranteed debt	**27,862**	**28,145**	**28,469**	**1,066**	**581**	**324**	**29,278**	**1,416**
Medium and long-term debt (> 1 year)	27,732	27,888	28,235	921	467	324	29,013	1,281
Paris Club	12,428	11,822	12,489	88	-	317	12,894	466
Multilateral	12,292	13,343	13,353	733	168	-	13,918	1,626
Other bilateral	639	421	463	-	-	1	464	-175
Euro bonds/ Saindak bonds	620	645	643	-	-	-	643	23
Military debt	653	554	778	-	2	6	782	129
Commercial loans/credit	1,100	1,103	509	100	297	-	312	-788
Short-term (< 1 year)	130	257	234	145	114	-	265	135
IDB	130	257	234	145	114	-	265	135
2. Private non-guaranteed debt (M&LT: > 1yr)	**2,842**	**2,450**	**2,014**	**25**	**106**	**-**	**1,933**	**-909**
3. IMF	**1,550**	**1,529**	**1,778**	**110**	**77**	**-**	**1,811**	**261**
Total external debt	**32,254**	**32,124**	**32,261**	**1,201**	**764**	**324**	**33,022**	**768**
4. Foreign exchange liabilities	**5,664**	**5,015**	**3,787**	**-**	**898**	**-**	**2,889**	**-2,775**
Foreign currency accounts	1,733	1,100	687	-	369	-	318	-1,415
FE-45	1,072	774	368	-	50	-	318	-754
FE-31 (incremental deposits)	300	326	319	-	319	-	-	-300
FE-25	361	-	-	-	-	-	-	-361
Special US$ Bonds	1,297	1,376	1,102	-	220	-	882	-415
Foreign currency bonds (NHA)	241	219	198	-	-	-	198	-43
National Debt Retirement Program	156	150	111	-	40	-	71	-85
Central bank deposits	700	700	750	-	-	-	750	50
NBP/BOC deposits	781	749	568	-	68	-	500	-281
Other liabilities (Swaps)	756	721	371	-	201	-	170	-586
FEBCs/FCBCs & DBCs	148	90	70	-	7	-	65	-83
Total external liabilities[1]	**37,918**	**37,139**	**36,048**	**1,201**	**1,662**	**324**	**35,911**	**-2,007**

[1] Excluding FEBCs/FCBCs and DBCs

Executive Summary

Real Sector

GDP growth in FY02 is likely to range between 3 to 3.5 percent – still lower than the long-term trend growth rate but higher than the previous year.

The shortage of irrigation water, which has worsened over the last two years, dampened the growth of agriculture for the second successive year in FY02. While the rice crop suffered fall, other major crops (e.g., cotton and sugarcane) were able to do better due to rains in early part of kharif that alleviated the water shortage from an anticipated 48 percent to 18 percent, as well as an increase in the area under cultivation.

The 22 percent fall in rice production is markedly higher than the 14.1 percent decline in the area under rice cultivation. This is explained by the replacement of a low-value variety of IRRI rice (high yielding) with a refined but low-yielding variety of basmati rice.

Notwithstanding the better harvests of cotton, sugarcane and wheat, much of the benefit to farmers is expected to be lost to lower prices. As a result, despite higher growth in the sector, farm incomes will not improve commensurately. The continuous fall in farm incomes since FY01 is aggravating rural poverty, reducing agricultural investment and raising agricultural credit requirements (see **Figure 2.3**).

Thus, the FY02 entry of private sector commercial banks into the agricultural credit market is a very welcome new development. Together with NCBs, these banks can play an important role by extending developmental credit e.g. for the construction of godowns/silos. Investment in storage capacity, in particular, would help food grain losses and also protect farmers against large seasonal variation in the prices of agriculture produce (the latter has positive connotations for rural poverty alleviation as well).

Unfortunately, despite the improvement in the country's macroeconomic fundamentals during the current year, the overall growth in large-scale manufacturing (LSM) was very narrowly based and remained much lower than the last year's 7.6 percent increase. In addition to the high-base effect, weak demand (both in domestic and international markets) and uncertainty following September 11 events affected industrial activities.

However, the textile sub-sector picked up in January with greater market access from the EU. This improvement is also reflected in the large quantum increase in the export of value added items during Jul-Mar FY02. In addition, the production of petroleum products remained strong on account of full-year impact of the establishment of PARCO. On the other hand, fertilizer output declined due to the closure of Fauji Jordan's DAP plant. Construction and engineering activities remained depressed, causing declines in the production of the related industries like steel, cement etc.

Surprisingly, the automobile sector output declined significantly. The production of trucks, buses and tractors sagged for the second successive year, but unlike FY01, the production of cars & jeeps in FY02 increased by only 0.9 percent. This was despite the favorable environment of robust demand, the appreciation of the Rupee (lowering cost of imported components) and lower interest rates.

Fiscal Deficit

Federal government revenue remained under stress, as CBR tax collections were 4.8 percent short of the thrice-revised Jul-Mar FY02 targets. Net collections witnessed a 2.5 percent decline over the same period last year. A compositional break down shows that direct tax receipts were largely in line with the 14.2 percent target for period, suggesting that the government's effort to broaden tax base are paying dividends. However, the indirect taxes undermined this improvement.

The shortfall in overall tax collections was attributed to the following factors: (1) exceptionally high tax refunds totaled Rs 62.9 billion, a stunning Rs 18.4 billion (41.2 percent) higher than for the corresponding period last year; (2) lower than expected growth of imports, GDP, and manufacturing; and (3) subdued inflation. Looking ahead, the target for tax collections remains challenging, as CBR has to collect over Rs 48 billion per month on the average to meet the set target of Rs 414.3 billion.

Monetary Developments

As in the past, developments in the external sector continued to have an important bearing on monetary aggregates and policy. The extraordinary growth in foreign currency inflows & foreign currency reserves, and the resulting strength of the Rupee, allowed the SBP to ease monetary policy. It initially reduced the discount rate by 200 basis points, and then slashed it another 300 basis points post-September 11, bringing it down to a record low 9 percent to offset the shocks to the economy.

A slowdown in private sector *credit* was not unexpected given the uncertainties emanating from global recession, border tensions and cancellation of export orders. However, a closer reading of the data suggests that the actual availability of *funding* for the private sector fell by a much lower amount (see **Table 4.3**).

Despite SBP's proactive monetary management, SBP purchases, lower than the usual demand for credit by the private sector from commercial banks, and continued retirement of export finance credit and government (commodity operation) the banks remained flush with liquidity. The inability of banks to expand their lending base to cope with this liquidity rush, led to larger interest in government securities. Coupled with high NSS receipts and improved external financing, this helped the government draw down its SBP debt, allowing it to comfortably meet IMF mandated limits of NDA growth.

Although, the monetary base increased by 6.3 percent during Q3-FY02 as against a contraction of 2 percent during Q3-FY01, lower interest rates kept the inflation in check at around 3 percent.

The money multiplier for Jul-Mar FY02 was 2.9 against the 3.0 for the last year. However, due to large increase in monetary base, money supply shot up to 9.34 percent, which was more than double the last year's growth of 4.3 percent and marginally higher than the full year target of 9.1 percent.

As explained above, the interbank money market remained liquid in the third quarter of the fiscal year, with SBP smoothing out any temporary shortages through OMOs. Banks piled into the T-bill and PIB auctions, in order to lock-in assets at higher yields.

Banking Sector

Banks were unable to keep the momentum in the deposit growth during Q3-FY02. Specifically, banks ended with a nominal increase of Rs 10 billon during the current quarter against a massive surge of Rs 72.2 billion in Q2-FY02 and the Rs 23.4 billion in the third quarter of FY01. This subdued performance was mainly attributed to decline in the foreign currency deposits, amidst the expectations of a stable Rupee and low interests. The decline in the expected return on FCAs made the NSS instrument more attractive, as seen in the continuously rising net mobilization in the NSS.[4]

[4] During Q3-FY02, net mobilization under NSS were Rs 23.4 billion against Rs 12.4 billion recorded in the last quarter.

The higher deposit growth of the Q2-FY02, seasonal retirement against commodity operations, decline in net credit demanded by the private sector, and SBP foreign currency purchases (especially, from the interbank market), left the banks with excess liquidity. A liquid interbank market, decline in tax rates (w.e.f. 1st July 2001), and a slight reduction in NPLs and defaulted loans during Jul-Mar this year, enabled the banks to operate at a relatively lower banking spread. It is encouraging to note that overall weighed average lending rates recorded a decline by 145 basis points during Q3-FY02 against 45 basis point downward adjustments in deposit rates.

Prices

All the three price indices recorded lower increases in Q3-FY02. However, the deceleration was sharper in terms of WPI, which increased by only 0.4 percent compared with 7.5 percent last year. This was due to the relative comfortable supplies of agriculture produce (except rice), the appreciation of the Rupee as well as decline in unit value of some imported items. However, the higher monetary expansion during the quarter coupled with increasing energy prices, may contribute to inflationary pressures in coming months.

External Sector

The most noteworthy change in the external sector is the current account surplus of US$ 2.1 billion during Jul-Mar FY02 against the deficit of US$ 82 million in corresponding period last year. This surplus was achieved despite the lower kerb purchases, primarily on the basis of a reduced trade deficit (mainly due to lower international oil prices), a broad-based improvement in the services account, a surge in workers' remittances and a heavy official transfers (see **Table 9.1**).

Notwithstanding the 2.7 percent fall in export revenues, the trade balance improved by 38.1 percent on the back of a marked reduction in the import bill to the tune of US$ 685.6 million (8.5 percent), primarily on account of lower import quantum of POL and their falling price in international market. In addition, sufficient stocks of refined sugar due to excessive imports of both raw and refined sugar last year coupled with better domestic production this season, almost eliminated the need for the import of this essential commodity (net saving of US$ 195.3 million).

Exports, on the other hand, received a serious setback by the events of September 11 and subsequent hostilities in the region.[5] The textile sector, the major

[5] This is in addition to impact of continued global recession and falling unit export prices of Pakistan's major export items.

contributor to export earnings, declined by 0.9 percent over the same period last year. Nonetheless, despite lower prices, the rise in the quantum of textile exports is encouraging, particularly for value-added exports such as cotton fabrics, bed-ware, towels, readymade garments, tarpaulin and other canvas goods. The exports of knitwear, synthetic textiles, cotton bags & sacks and cotton yarn, on the other hand, declined markedly both in volume and value. Among the food items, rice exports suffered the most serious shortfall (17.1 percent) and earned US$ 332.2 million compared to US$ 400.6 million last year (mainly due to lower export volumes).

As far as the capital account is concerned, the higher outflows during the period under review were primarily driven by the repayment of maturing 3-year Special US Dollar Bonds, the lower project aid from bilateral countries, the higher repayments of commercial loans/credit contracted in last year, accelerated repayments of institutional FE-45 deposits and the closure of swaps with various commercial banks. The more encouraging sign is the acceleration in foreign investment. This reflects the renewed interest of foreign investors due to the higher foreign exchange reserves and their confidence in the government's commitment to the ongoing reforms agenda.

In terms of the exchange rate, the Rupee remained stable during Q3-FY02. This stability was the upshot of SBP purchases from the interbank market that increased to US$ 902 million during Q3-FY02 against US$ 705.2 million in the previous quarter. This solicited cushion was provided in order to protect Pakistani exporters that had already suffered on account of the appreciating Rupee (6.54 percent to date) and cancellation of export orders.

This huge current account surplus[6], together with increased inflows from IFIs helped in building up foreign exchange reserves to unprecedented level of US $ 5,233.5 million by end-March FY02. Although the donors' support to Pakistan to compensate for the negative economic impact imposed by Afghan war is prominent in this build up, the reversal of capital flight and the stronger inflows of workers' remittances cannot be overlooked.

In turn, with wider pool of reserves, SBP capitalized on this opportunity by settling short-term liabilities under swaps, short-term deposits and PTMA, which will ease the future cash flows for Pakistan.

[6] The current account surplus allowed the SBP to increase the SBP reserves.

The comfortable reserve position and the narrowing of kerb premium have also provided an opportunity to consolidate the gains in remittances by enfolding the informal market into the official system. The first step in this regard will take place in July 2002, when exchange companies are to come into existence.

This page has been left blank intentionally

2. Real Sector

2.1 Agriculture

Water shortages had once again raised serious concerns on the performance of agricultural sector in FY02. In fact, it was only the rains in early part of the kharif season that prevented another dismal year for agriculture in Pakistan. The latest estimates on area under cultivation and the production of the key major crops, i.e., cotton, sugarcane, wheat, maize and gram[7] indicate a reversal of the 2.5 percent negative growth witnessed during FY01.

Table 2.1: Area and Production of Major Crops

	Share in Major Crops (percent)#	Area			Production		
		FY01	FY02*	Percent change	FY01	FY02*	Percent change
Cotton	30.6	2,928	3,123	6.7	10.7	10.9	1.9
Rice	11.7	2,375	2,032	-14.4	4,810	3,747	-22.1
Sugarcane	15.4	960	1,037	8.0	43,590	49,207	12.9
Maize	4.1	900	932	3.5	1,433	1,514	5.6
Gram	2.4	905	987	9.1	397	440	10.8
Wheat	32.1	8,181	8,070	-1.4	19,019	19,157	0.7

*= Preliminary estimates # = Estimated share in major crops during FY02.
Production: Cotton = million bales; others 000'tonnes
Area: thousand hectares
Sources: i) Federal Committee on Agriculture ii) Press Reports

The FY02 improvement is emerging on the back of good cotton and sugarcane crops, supported by good (expected) wheat and gram production. These greatly offset the disappointing rice harvest (see **Table 2.1**). In fact, agri-sector growth would have been at least a percentage point higher if the rice crop had even reached FY01 level.

Preliminary estimates on various minor crops[8] show a mixed picture, with no signs of strong growth. Production of potato and mung has been estimated higher than the last year by 1.2 percent and 9.8 percent respectively. On the other hand, production of onion, mash and masoor registered decline by 0.9 percent, 0.4 percent and 5.6 percent, respectively over last year.

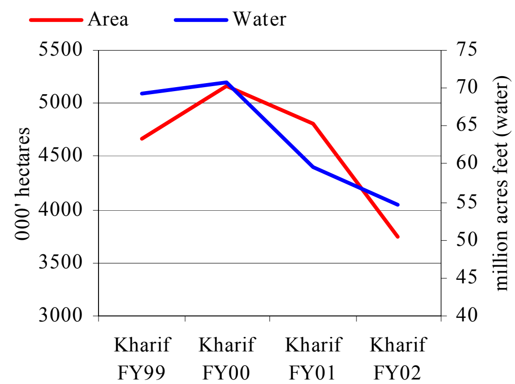
[7] These account for a 40 percent share in overall agriculture.
[8] These include fruits, pulses (except gram), vegetables, condiments, oil seeds and fodders and jointly constitute 17 percent share in agriculture.

Lack of data on current developments in non-crop sector i.e. livestock, forestry and fishing make it difficult to arrive at any projected growth rate of agriculture sector as a whole. Nonetheless, if we assume that livestock[9] would maintain the FY01 growth rate of 4.8 percent and the minor crops, fishing and forestry[10] finish-the year on a positive note, the agriculture sector should grow by 2.0-2.5 percent during FY02. This estimate, however, is particularly vulnerable to the final outcomes of major crops.

2.1.1 Water shortage

The summer rains during FY02 were 10 to 12 percent higher than normal, but still could not fill all major reservoirs to their maximum capacity. Consequently, later part of the kharif and the full season of rabi was characterized by lower canal water availability. Canal water shortage while affecting all crops, puts a severe impact particularly on rice because of its greater vulnerability to canal irrigation (see **Figure 2.1**), and this is reflected in the 14.1 percent decline in the FY02 area under rice cultivation.

Figure 2.1: Availability of Water & Area Under Rice



However, the disproportionately higher (22 percent) fall in output is also due to the replacement of a low-value variety of irri (high yielding) with a refined but low- yielding variety of basmati rice. According to the latest estimates, the area under basmati increased by 7 percent and production by 10 percent while, area under irri and other varieties declined by 40.3 percent and production fell by 44.0 percent. The above changes probably also reflect the Government's policy to encourage (1) the production of quality (high value) rice; as well as (2) the substitution with cotton on the left bank of the Sukkur barrage.

The stronger focus by farmers on cotton and sugarcane largely mirrors the favorable market prices prevalent in the previous season. The prices of sugarcane in FY01 were, on average, 40 percent higher than that of last year. Similarly, market price of seed-cotton (*phutti*) stayed higher than the minimum support price

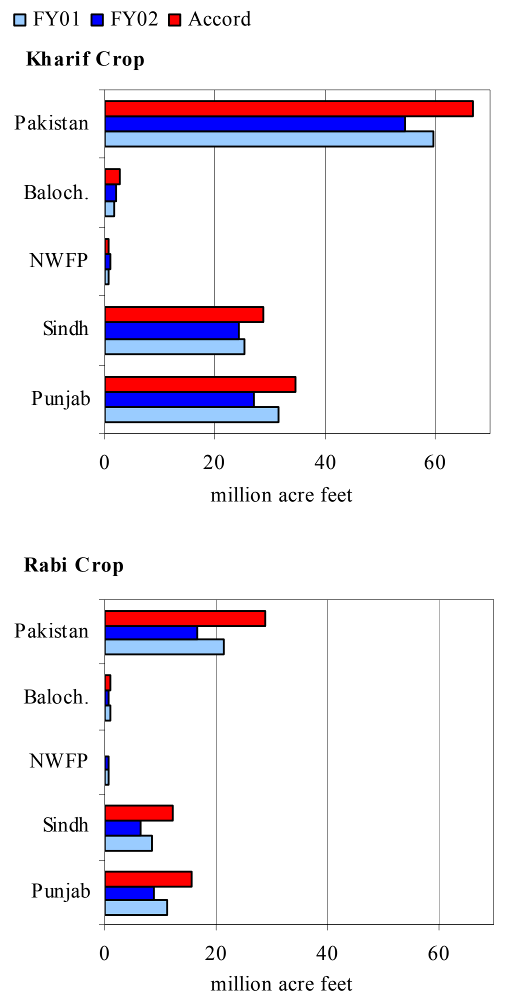
[9] With almost 37 percent share in agriculture, it is the second highest contributor to agriculture, after crops (major + minor), which jointly contributes around 59 percent.
[10] Fishing and forestry both constitute around 4 percent share in agriculture sector.

of Rs 725 per 40 kg fixed during the FY01 harvesting season. This resulted into increase in area under cotton by 6.7 percent and sugarcane by 8.0 percent. However, the good FY02 harvest for both crops also reflects the impact of timely rains.[11]

On the whole, the shortage of irrigation water has worsened over the last two years, and lowered growth of agriculture for the second successive year in FY02. In fact, had it not been for timely and ample rains in the early part of kharif FY02, which reduced the water shortage from an anticipated 48 to 18 percent, agricultural output would have suffered serious reverses.

As seen in **Figure 2.2**, the kharif water availability is a higher proportion of requirement than that of rabi as defined in the 1991 water Accord. In rabi (Oct – Apr) FY02, the water availability in the country was 10 percent lower than in FY01, and is expected to remain 42 percent below the 1991 Accord.

Figure 2.2: Water Availability



It is interesting to note that the rabi crops traditionally require approximately 50 percent less water compared to the kharif crops, as farmer choose crops in line with the seasonality of rainfalls, and availability of water storage capacity in the

[11] Sugarcane in particular is vulnerable to water shortages, and the absence of rains could have seriously jeopardized the crop.

country. However, the actual water availability in FY02 fell well below even this lower requirement.

A key element of lower availability of water for the FY02 rabi crops was the lack of rain in catchment areas, which in turn meant that major water reservoir were not replenished to adequate capacity. The government has responded with a project for installation of 10,000 tube wells, to be funded partially by Federal government. As a long-term strategy, in addition to building large dams, priority is being given to construct small rainwater reservoirs.

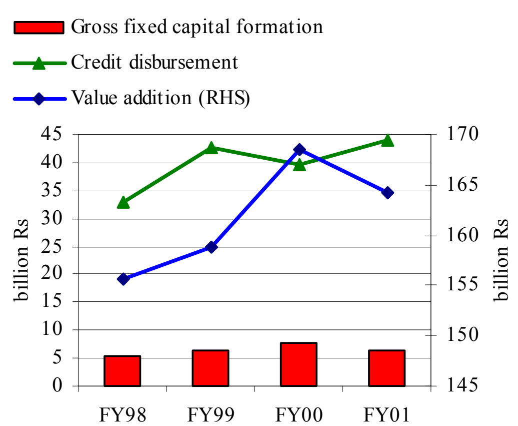
2.1.2 Farm Incomes

During FY01, lower agricultural growth due to water shortages correspondingly reduced farmers' incomes. Wheat producers were particularly vulnerable as a fall in prices exacerbated the impact of productivity declines.[12]

Although some improvement is expected in FY02 due to better harvests, much of the benefit of good crops of cotton, sugarcane and wheat is expected to be lost to price declines. As a result, despite higher growth in the sector, farm incomes will not improve commensurately.

In FY00 when value addition by agriculture GDP was at the highest in the wake of bumper crops of wheat, rice and cotton, less credit was disbursed and higher investment was made by the private sector in agriculture. The relatively low farm incomes in FY01 and FY02 are aggravating rural poverty; agricultural investment is falling and the requirement for agricultural credit is rising (see **Figure 2.3**).

Figure 2.3: Growth in Agriculture, Credit & GFCF

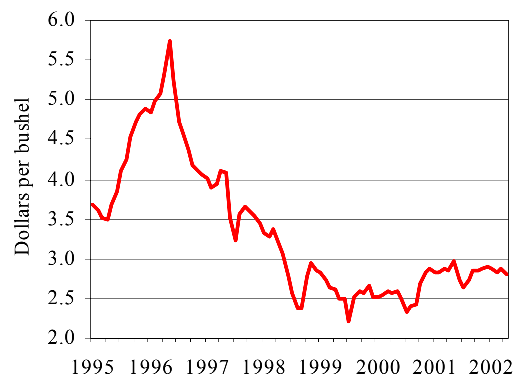


[12] During the peak of the FY01 harvesting season farmers sold the produce as low as Rs 225 per 40 kilograms. This is considerably lower than the support price of Rs 300 and the average price of more than Rs 300 they received during FY00. Per hectare yield also declined by around 7 percent in FY01as compared to last year.

2.1.3 Market Prospects for the FY02 Wheat Crop

FY00 remains the best year for wheat growers in recent memory. The support price was hiked by 25 percent and despite a record crop of 21 million tonnes, prices remained high on the back of an unusually large government procurement (8.4 million tonnes[13] against the usual average of 4 million tonnes).

Figure 2.4: Prices Received by Wheat Farmers in US



Unfortunately, the FY00 price dynamics were non-repeatable. Thus, while the FY01 crop was a reasonable 19 million tonnes, the "normal" government procurement of approximately 4 million tonnes proved insufficient to sustain the market price of wheat around the support price.

However, it must be recognized that this phenomenon, though painful, is not uncommon; almost all countries see sharp variations in prices of agricultural commodities from year to year and from season to season.

Table 2.2: Cost of Production and Support Price
per 40 kgs

	Cost of production		Support price	Support price over cost of production	
	Punjab	Sindh		Punjab	Sindh
FY96	172	175	173	(+) 0.6	(-) 1.1
FY97	196	198	240	(+) 22.4	(+) 21.2
FY98	252	249	240	(-) 4.8	(-) 3.6
FY99	263	256	240	(-) 8.7	(-) 6.3
FY00	279	271	300	(+) 7.5	(+) 10.7

Source: Pakistan Journal of Agricultural Economics, No. 4, July 2000

For example, a look at the behavior of prices of wheat in USA over the past nine years shows considerable variation in prices (see **Figure 2.4**) from year to year. Such volatility is unlikely in Pakistan because wheat prices are generally very much close to the cost of production.

[13] Taking advantage of the unusually large crop, the Government had replenished its depleted strategic buffer stocks (typically 3-4 million tonnes) in FY00, through a one-off purchase.

Moreover, the benefit of increases in procurement prices have been short lived, generally persisting only for an year or two before being offset by the rising cost of production (see **Table 2.2**).

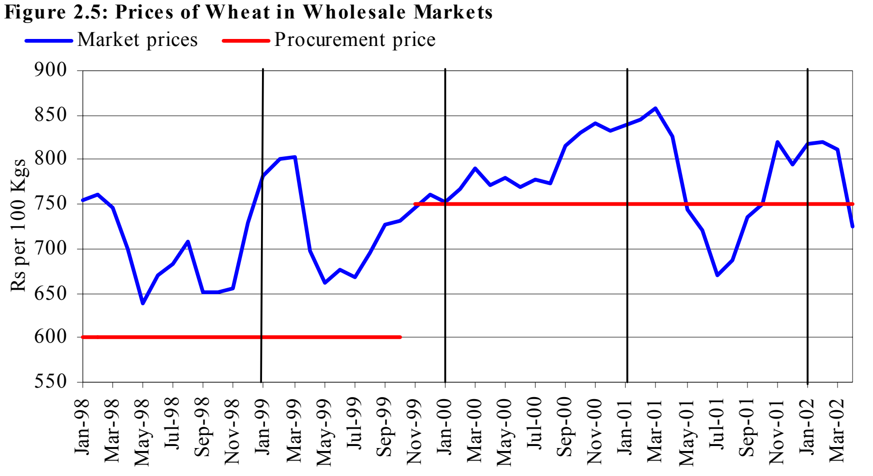
Further, in Pakistan, there exists no protection plan for the farmers in case of any crash in commodity prices e.g. in the US farmers are compensated when the price of wheat fall below the floor price. Thus, the lack of crop insurance schemes together with the thin margin between the cost of production and farm gate prices means that any untoward decline in prices turns the production of wheat uneconomical.

Seasonal variations in prices

The monthly movement of domestic prices of wheat in the wholesale markets contains considerable seasonality. Prices remain depressed during the peak harvest season i.e., from April to May, (see **Figure 2.5**), Being always highest in March, prices start declining with the very first arrival of crop in Sindh province mostly in first week of April, i.e., the time when the crop size can be estimated with a degree of accuracy. The fall accelerates through the subsequent months, before troughing by the close of May each year.

The critical months for wheat growers are April and May when they are left with no option but just to bring their produce to the markets on farm-gate prices[14] set by the commission agents.

Figure 2.5: Prices of Wheat in Wholesale Markets



The market prices, after settling marginally in June, begin to move upwards again in July, before peaking in March. The benefit of these higher prices therefore accrues largely to stockiest, commission agents and flour mill-owners. This trend is common in the marketing of almost all the cereals produced in Pakistan. The wheat crop differs only because of the sheer size of the crop, which creates financing and storage pressures.

Financing arrangements

The financing requirements are generally eased by the State Bank of Pakistan, which annually makes special arrangements to ensure easy and instant availability of credit to wheat buyers. In 2001, margin requirement for wheat purchases was reduced from 25 percent to 10 percent and, banks were allowed to lend to flourmills on their installed capacity, using the wheat stock as collateral.

These measures were well conceived, and helped stabilize market prices from July onward in 2001. Unfortunately, they were announced too late to be of major benefit to the wheat growers in FY01; moreover, practically all of the benefit accrued to middlemen.

Storage Issues

The standard storage facility for wheat is currently estimated at 4.8 million tonnes, largely with the federal and provincial governments. A large portion of this is dedicated to the strategic stocks, and the remainder is therefore not even enough to store the additional wheat procured by the government annually.

A greater part of the produce is therefore stored in inadequate shelter, often quite vulnerable to rodents and the vagaries of nature. It has been variously estimated that up to 10-15 percent of the wheat crop is lost due to inadequate storage.

Moreover, the availability of adequate storage could be an important anti-poverty measure, giving farmers the ability to vary the supply of wheat in accordance with demand patterns, and avoiding the harvest gluts that reduce prices and the effective returns to farmers. The resulting price stability would also benefit the farmers and consumers throughout the year.

Realizing the fact, State Bank of Pakistan attempted to facilitate the creation of storage facilities, directing the banks to provide loans to the farmers/flour mills

[14] Farm-gate prices are generally 3 to 5 percent lower than the prices in wholesale markets during harvesting season.

for construction of godowns/silos. This has been reinforced through April 2002 circular to the banks reminding them of the facility and asking to expedite disbursements.

Price Outlook

Table 2.3 summarizes the expected wheat stock available for FY02. While, the FY02 harvest and purchases are almost identical to the FY01 levels, the FY02 carry-over stock is estimated to be considerably larger. This would imply that FY02 prices will remain weak.

Table 2.3: Wheat Availability During FY02

million tones

	FY01	**FY02**
Wheat production	19.0	19.2
Wheat procurement	4.0	4.0

Source: Federal Committee on Agriculture

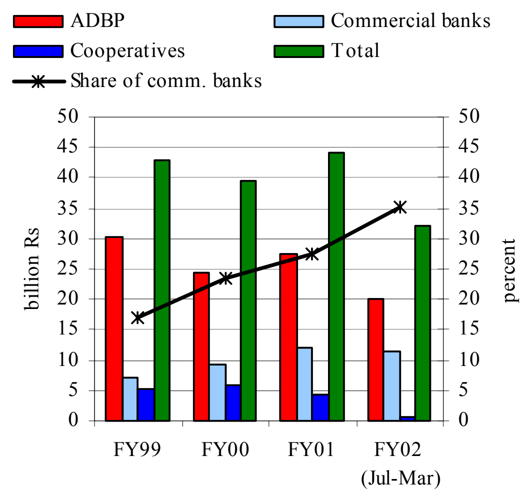
While the SBP measures to improve credit availability for wheat purchases (that was announced late in FY01) should arrest (or at least help ease) the decline, the larger stock of wheat available means that the market price is likely to fall below the procurement price in FY02 as well.

The key factors that could help farmers in FY02 could be an increase in government purchases and/or substantial exports of Pakistani wheat. Export contracts for 1.4 million tonnes have been negotiated, and 0.87 million tonnes of wheat have been exported so far.

2.1.4 Agricultural Credit

During Jul-Mar FY02 a gross disbursement of Rs 35.0 billion was made to the agriculture sector, up by 20.3 percent from Rs 29.1 billion during the corresponding period last year (see **Table 2.4**). More interestingly, contrary to past practice, it is commercial banks that have taken the lead by advancing 60.3 percent more credit (year-on-year) during first nine months of FY02. This is a clear reflection of the success of the changes made

Figure 2.6: Bank-wise Disbursement of Credit



by SBP [15] during FY01 in broadening the scope of agricultural credit and liberalizing the regulations governing the delivery system.

As a result, the share of commercial banks in agricultural credit reached 34.7 percent in the first three quarters of FY02, up from a mere 16.8 percent in FY99 (see **Figure 2.6**). For the first time, private commercial banks have also entered the field of agriculture credit.

Table 2.4: Credit to Agriculture Sector (Jul-Mar)

million Rupees

	Disbursement			Recovery			Net Credit#	
	FY01	**FY02**	**Percent change**	**FY01**	**FY02**	**Percent change**	**FY01**	**FY02**
ADBP	18,859	20,161	6.9	21,163	22,190	4.9	-2,304	-2,029
5 Commercial Banks@	7,049	11,299	60.3	7,325	9,657	31.8	-276	1,641
New Private CBs*	--	435	--	--	408	--	--	27
Cooperatives	3,194	3,114	-2.5	3,858	3,479	-9.8	-664	-365
Total	29,101	35,009	20.3	32,345	35,735	10.5	-3,244	-726

Sources: Agricultural Credit Department, SBP ii) Punjab Provincial Cooperative Bank
= Disbursement minus recovery
@ = Includes: NBP, HBL, MCB, UBL, and ABL
*= New Private Commercial Banks started lending in FY02

Following the liquidation of the Federal Bank of Cooperatives (FBC), Punjab Provincial Cooperative Bank (PPCB) would be the only bank providing finance to cooperative societies for onward distribution among the farmer members. Therefore, the SBP has started extending credit lines directly to PPCB. During FY02, a credit line of Rs 4,775 million has been provided to PPCB to carry out its lending independently of FBC. This is in addition to Rs 1,225 million given to FBC early in FY02.

Of the total disbursement, the higher growth of 17.4 was seen in seasonal (input) credit. Credit for development purposes, on the other hand, declined by 13.9 percent.

The higher priority attached to input credit by lending institutions and a concurrent deterioration in farm incomes over the past years may be the major factors responsible for negative growth in credit for development purposes.[16]

[15] For more details, see page 24 of SBP Annual Report 2000-2001.

During Jul-Mar FY02, 58.3 percent of the total gross disbursement, planned at Rs 60.0 billion for the full year, has been realized. Being highly seasonal activity, disbursement will get a boost in the last quarter of the year, as sowing of most of the kharif crops concentrates in the April to June period. Outstanding credit to agriculture during of FY02 increased by Rs 8.3 billion over the first nine month period by reaching Rs 98.7 billion as on March 31, 2002. The SBP has formed a committee of experts to examine the whole issue of rural financing and come up with recommendations for improving access by rural population to financial services including credit.

2.2 Large-scale Manufacturing

Large-scale manufacturing (LSM) growth in FY02 has been weaker and more narrowly based relative to the previous year. As evident from **Table 2.5**, growth in Jul-Mar FY02 dropped to 3.2 percent, despite the support offered by the sugar production, which rose 6.0 percent during the period. The 'trimmed growth' statistic paints an even bleaker picture.[17]

Table 2.5: Summary of Growth Rates
percent

	Jul-Mar	
	FY01	**FY02**
Overall	7.6	3.2
Excluding sugar	7.8	2.7
Trimmed	8.7	1.5

Source: Federal Bureau of Statistics

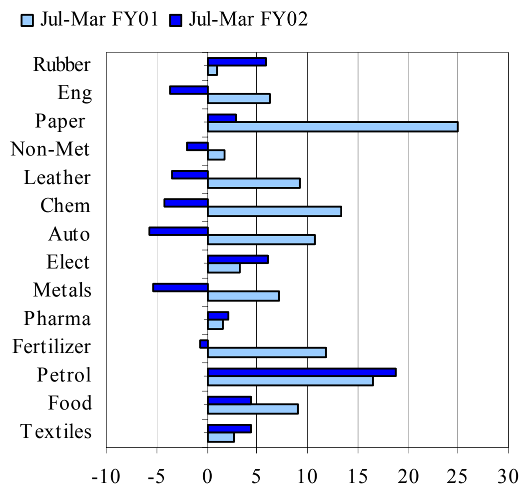
Also, while none of the 14 sub-categories of LSM had seen output declines in Jul-Mar FY01, as many as 7 sub-categories, with a combined weight of 18.87 percent in LSM, witnessed a fall in production during Jul-Mar FY02 (see **Figure 2.7**).

Moreover, output in only 3 categories (11.25 percent weight) saw growth of over 5 percent by end Q3-FY02, compared to the 9 such categories (43.48 percent weight) during the corresponding period of FY01.

[16] For example, during the first nine months of FY02, Rs 2,555 million was disbursed to farmers for financing the purchase of 9,191 tractors, as compared to Rs 3,647 million disbursed in FY01 for the purchase of 13,439 tractors.

[17] The trimmed growth rate is calculated after excluding 5 percent outliers each for the best and worst performers (on the basis of their weighted growth). The trimmed growth rate is based on the statistical concept of 'trimmed mean', which is a robust measure of the central tendency. Simple arithmetic average or even weighted average does not properly reflect the underlying "average" behavior, when data contains large variations as in the case of LSM. In such cases, the trimmed mean or weighted trimmed mean is more useful.

Figure 2.7: Growth in Seclected Industrial Groups



The loss of growth momentum appears to be quite disappointing, particularly when seen in the backdrop of the clearly visible improvement in the country's macroeconomic fundamentals during the current year. However, while the evidence of a slowdown in LSM up to the end of Q3-FY02 is quite unambiguous, prospects for FY02 and beyond appear less discouraging.

It is also important to note that the impressive performance of FY01 had already raised the bar for FY02 through a high-base effect, and this was implicitly recognized in the lower FY02 LSM target growth of 5.0 percent. In fact, growth in Q1-FY02 LSM was a very creditable 5.3 percent over Q1-FY01, with all but one sub-sector (metals) participating in the rise.

The Q2-FY02 shock then played a critical role in lowering economic activity; the domestic economy as well as key Pakistani export markets were in turmoil, and business confidence was extremely shaky amidst reports of large-scale cancellation of export orders (this is particularly evident in the high-value added knitwear industry).[18]

The uncertainty in the domestic economy was also fueled during the October to December 2001 period, first by the consequent military action in neighboring Afghanistan, and towards the end of December 2001, by the border tensions with India. Not surprisingly, it appears that decline in LSM activity during most of

[18] Knitware was particularly vulnerable as a large share of exports was to the US market. In fact, it is possible that a broader weakening in Pakistan's textile industry, which generates approximately 60 percent of the country's annual exports, was averted largely due to the orders already in the pipeline as well as prompt government support (expediting tax refunds, lobbying for market access, etc.). The SBP too, responded pro-actively with a number of measures. It slashed benchmark discount rate by 300 basis points over the next few months, and reinstated its export finance credit to grey cloth subject to the minimum export price of US$ 3 per square meter.

FY02 was largely a post-September 11 phenomenon, which simultaneously hurt exports as well as domestic demand.

As the impact of shock fades, the extensive improvement in Pakistan's external sector, and the consequent sustainability of the easier monetary stance can be expected to drive a gradual recovery possibly led by domestic consumption provided the economy is not again exposed to other unanticipated exogenous shocks.

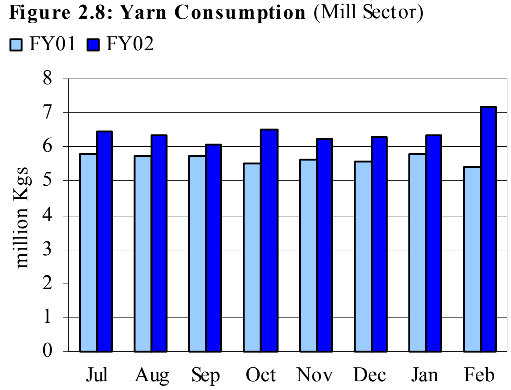
2.2.1 LSM sub-groups

The major groups that showed increase in production during Jul-Mar FY02 include textiles, food, beverages & tobacco, petroleum products, pharmaceuticals, electronics and tyres & tubes, *while* fertilizer, metal industries, automobile, non-metallic minerals and engineering industries showed declines (see **Table 2.6**).

In terms of positively contributing sectors, the improved performance of *textiles*, during Q3-FY02 was most significant. Despite the depressed market conditions prevailing in the global economy during this period, this sub-sector showed 4.4 percent growth compared to 2.7 percent growth in the last year.

This might have received some support from the EU decision to improve Pakistan market access.[19] The importance of this to Pakistan can be best substantiated in terms of quantum increase in export of value added items during Jul-Mar FY02 (see **Table 9.3 in Trade Section**). It is largely the value added exports that have seen an increase in CY2002; while the exports data is not yet available segregated by commodity and markets, it can be argued that the boost has been on account of the

Figure 2.8: Yarn Consumption (Mill Sector)



Source: Textile Commissioner's Organization

[19] The European Union, despite an outcry from its own industry, lifted tariffs on *value-added* Pakistani textile products and increased the existing quota by 15 percent (with effect from January 1, 2002). Items that will be zero-rated in terms of import duty include readymade garments, finished cloth, knitwear, tarpaulin and towels; while cotton yarn, grey and printed cloth would continue to attract duty.

extended access to the EU market.

It is also encouraging to note the rising value addition in textiles as evident in the higher domestic consumption of cotton yarn. The consumption of cotton yarn (mills sector) has been on a rising trend since the beginning of the current fiscal year, and saw a large jump, particularly in February 2002 (see **Figure 2.8**).

Table 2.6: Growth in the Production of Selected Large-scale Manufacturing Items
Percent

		Jul-Mar				Jul-Mar	
Items	**Weights**	**FY01**	**FY02**	**Items**	**Weights**	**FY01**	**FY02**
Textile	**19.069**	**2.73**	**4.37**	**Electronics**	**2.976**	**3.31**	**6.09**
Cotton yarn	8.85	2.70	4.78	Electric transformers	0.577	-27.62	45.21
Cotton cloth	4.881	11.28	15.17	Storage batteries	0.451	4.43	8.10
Cotton ginned	3.893	-4.52	-1.12	TV sets	0.363	-20.01	-27.30
Other five items	1.445	11.98	-16.05	Air conditioners	0.12	462.05	-76.94
Food, bev & tobacco	**17.336**	**9.04**	**4.38**	Refrigerators	0.015	30.78	13.81
Sugar	8.630	6.43	6.01	Other five items	1.45	-0.75	1.58
Vegetable ghee	3.004	20.11	-6.14	**Automobile**	**2.413**	**10.76**	**-5.72**
Cigarettes	2.505	27.58	-3.10	Trucks	0.698	-2.97	-8.16
Tea	1.785	-13.73	1.26	Tractors	0.593	-18.20	-29.18
Beverages	0.964	13.35	-0.83	LCVs	0.369	10.13	9.10
Cooking oil	0.448	14.60	12.92	Cars & jeeps	0.309	24.16	0.88
Petroleum products	**7.824**	**16.62**	**18.71**	Motorcycles	0.249	35.24	5.39
Fertilizer	**5.871**	**11.83**	**-0.63**	Buses	0.13	-14.88	-30.43
Nitrogenous	5.441	5.79	4.59	Diesel engines	0.065	5.37	-37.58
Phosphatic	0.430	125.91	-46.83	**Chemicals**	**2.335**	**13.38**	**-4.13**
Pharmaceuticals	**5.798**	**1.61**	**2.23**	Caustic soda	0.621	3.03	4.42
Tablets	2.705	-3.15	5.79	Soda ash	0.32	-13.07	-4.20
Syrup	1.602	2.58	-6.86	Other six items	1.394	33.92	-11.00
Injections	0.466	4.12	5.82	**Non metal minerals**	**1.915**	**1.78**	**-2.03**
Capsules	0.228	-3.38	-2.56	Cement	1.846	2.32	-1.52
Other five items	0.471	13.17	9.49	Glass sheets	0.069	-11.96	-17.23
Metal industries	**3.317**	**7.20**	**-5.34**	**Paper & board**	**1.359**	**25.02**	**2.84**
Pig iron	1.477	-1.09	-4.41	**Engineering items**	**0.691**	**6.23**	**-3.62**
Coke	1.319	11.72	-3.61	Bicycles	0.348	12.15	-7.62
Billets	0.311	18.73	-8.50	Metal containers	0.153	6.72	4.19
Safety razor blades	0.109	31.98	9.33	Sewing machines	0.052	-4.05	-6.53
H.R/coils and plates	0.074	-11.50	-9.58	Power looms	0.051	-53.75	89.61
C.R coils/plates/sheets	0.013	-14.02	-16.93	Other five items	0.087	-35.99	-18.62
Leather products	**2.333**	**9.30**	**-3.51**	**Tyres & tubes**	**0.452**	**1.01**	**5.88**

Source: Federal Bureau of Statistics

On the supply-side, due to low world commodity prices and falling exports of raw cotton, domestic lint prices remained under pressure in FY02. This was a boon to the domestic textile sub-sector.

The production of food, beverages and tobacco group also showed positive growth, but much lower than the last year. The overall growth was only 4.4 percent for the sub-sector during Jul-Mar FY02, compared with 9.0 percent recorded last year. Although, the production of sugar increased despite the fact that crushing started late this year, a sharp decline in the production of vegetable ghee during Jul-Mar FY02, resulted in an overall slowdown in the sub-sector. The production of sugar increased by 6.0 percent during Jul-Mar FY02 compared to a decline of 6.4 percent in the same period last year.

As mentioned in the *Second Quarterly Report for FY02*, the prices of refined sugar declined during the crushing season, mainly due to continued import of raw, and refined sugar that was allowed at lower rate of import duty. In fact, the decision to import was made on the basis of an expected shortfall in sugar cane production due to persistent water shortages. However, the timely rainfall rescued the crop in the Punjab, laying the foundations for a supply glut.

As a result, although sugarcane prices were fixed by the government at Rs 42 and Rs 43 per maund in Punjab and Sindh respectively, market prices diverged. Due to the larger sugarcane harvest in Punjab and a slight shortfall in Sindh, market prices remained lower in Punjab and higher than the fixed prices in Sindh. Consequently, the lower cost Punjab sugar made inroads into the traditional markets of the Sindh mills.

Vegetable ghee, another major item in *food, beverages & tobacco* group, however, declined by 6.1 percent during Jul-Mar FY02 compared to strong growth of 20.1 percent in the last year. Since, the domestic industry mostly processes imported palm oil, the prices of palm oil increased (by more than 20 percent) during Jul-Mar FY02 over the last year. The impact of increase in prices is clearly reflected in terms of decline in import of edible oil by 1.3 percent during this period.

Although, the Trading Corporation of Pakistan (TCP), put up for auction 75,000 tons of Soya bean oil received from U.S. under 416 (b) program, it appears as it was mainly used for the production of cooking oil. This is clearly reflected in 12.9 percent increase in the production of cooking oil during Jul-Mar FY02.

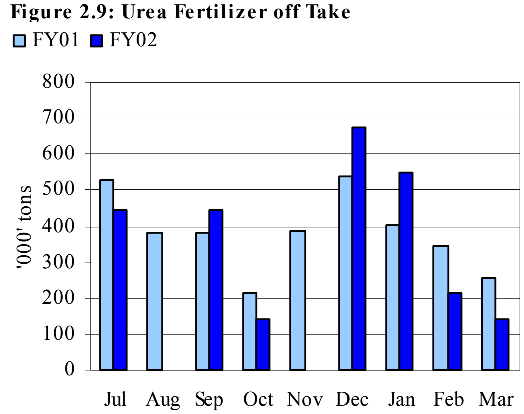
Another major industry, with respect to its weight in the overall manufacturing sector, is *petroleum refining*. The production of refined petroleum products increased by 18.7 percent during Jul-Mar FY02, compared to a 16.6 percent rise in the same period last year. Since the establishment of Pak-Arab Refinery Company (PARCO) in September 2000, the production of petroleum products has risen significantly and the FY02 output jump simply reflects the full year of operations for the refinery which came on-line mid-way through FY01.

The demand for petroleum products during the current fiscal year appears mainly driven by the power sector (which has a share of over 35 percent in overall consumption). The dependence on thermal power generation has increased during the last two years due to persistent water shortages in the country, but the impact on the trade account has been mitigated by lower oil prices. Another factor driving FY02 demand was the move to increase the strategic reserves (from a 2-week supply to a 3-4 week supply) post-September 11, as a precautionary measure.

The production of *fertilizer* practically unchanged during Jul-Mar FY02 compared to a significant increase of 11.8 percent recorded in the same period last year. This difference stemmed essentially from the closure of Fauji Jordan's DAP facility in October 2001, as no additional capacity was brought on-line in FY02.[20]

Fertilizer *off-take* has fallen a little during FY02 due to persistent water shortages and a hike in prices. A further increase in prices with the increase in the nominal value of the sales tax in February 2002, may aggravate the weak demand (see **Figure 2.9**). It may be noted that the sharp increase in off-take during December and January, was mainly in anticipation of the imposition of GST, when dealers

Figure 2.9: Urea Fertilizer off Take



[20] Reasons for the closure of Fauji Jordan's DAP plant have already been explained in the *Second Quarterly Report for the Year 2001-02*. The plant's urea production was unaffected.

stockpiled to earn higher margins.

The production of *steel products* contracted by 5.3 percent compared to 7.2 percent last year. Although, the major reason behind this contraction is slackness in construction and engineering industries, factors such as a reduction in import duties on various steel products and availability of cheap products from the domestic ship breaking industry cannot be ruled out.[21]

World steel product prices, which firmed in January 2002, are expected to decline again due to the high tariff imposed in the US market, which will divert supply to the world market. This suggests domestic production too, will remain under pressure.

The production of the automobile sector also showed a significant decline of 5.7 percent during Jul-Mar FY02, against an increase of 10.8 percent in the same period last year. Sharp drops in the production of trucks, buses and tractors, which continued for the second successive year, dragged down the overall growth, as unlike FY01, the production of cars & jeeps too, was not strong enough to offset this decline.[22]

Interestingly, during Jul-Mar FY02, robust demand (evident in the over-booking of vehicles), the appreciation of the Rupee and lower interest rates, appeared to present a high growth scenario for the sector.[23] Surprisingly, however, the production of cars & jeeps increased by only 0.9 percent, compared with a 24.2 percent increase in the last year.[24]

In fact, due to transitional delays and a massive increase in bookings of the new Toyota model, the price as well as the premium on the prompt delivery out of the dealer's stock, increased. This profitable turn in the market may have induced

[21] The ship breaking activities picked up with the announcement of certain incentives in the last budget. Furthermore, the prices of ships for breaking purposes fell significantly in the world market. Also, the import of iron & steel increased 43.8 percent during Jul-Mar FY02.

[22] As discussed in the *Second Quarterly Report for the year 2001-02*, the manufacturing of trucks, buses and tractors fell in the wake of smuggling of trucks, absence of new Urban Transport Schemes, less financing by ADBP and absence of any concessional facility for the purchase of tractors, respectively.

[23] Demand for cars, over the past couple of years, has been showing a healthy trend mainly due to the introduction of attractive models, sales through hire purchase and shift from dollarization towards purchase of durables and real estate etc.

[24] The introduction of a new model by Toyota Motors contributed to this slowdown, but that for the lower production by other manufacturers remains troubling.

other manufacturers to change their business strategies, as well.[25] As a result, the premium on the older models also increased. Thus, instead of passing on the benefit of reduced production costs to costumers, the manufacturers used the opportunity to improve profitability.[26]

The *construction related industries* continued to suffer during Jul-Mar FY02, mainly due to depressed construction activities in the country. During Q3-FY02, production of cement declined by 1.5 percent compared to 2.3 percent increase in the last year. While, the production of glass sheets further declined by 17.2 over 12.0 percent decline in the previous year.

The price of a key input, furnace oil, remained lower during Jul-Mar FY02 (and a number of plants have started substituting furnace oil with the low cost coal), but cement prices remained unchanged and demand remained depressed; during Jul-Mar FY02, cement dispatches fell by 6.0 percent.[27] Since the proposed reconstruction package for Afghanistan has not materialized yet, export of cement remained negligible.

3. Fiscal Developments

Despite weak federal tax collections, the consolidated budgetary position of federal and provincial governments was quite encouraging, as the overall budget deficit of Rs 117.1 billion for Jul-Mar FY02 was well below the Rs 160.4 billion target (see **Table 3.1**). The lower deficit was driven by both, declining expenditures and higher revenue receipts, with the former accounting for the bulk

Table 3.1:Summary of Public Finance

billion Rupees

	Jul-Mar FY02		Difference
	Target	Pro. actual	
1 Revenue receipts (a+b)	**427.2**	**436.4**	**9.2**
a) Tax revenue	328.8	324.5	-4.3
b) Non-tax receipts	98.4	111.9	13.5
2 Total expenditure (a+b)	**587.7**	**553.5**	**-34.2**
a) Current	492.1	466.1	-26.0
b) Development	88.6	91.5	2.9
c) Net lending to PSEs etc.	7.0	5.0	-2.0
d) Unidentified	0.0	-9.1	-9.1
3 Revenue surplus/deficit	**-64.9**	**-29.7**	**35.2**
4 Overall deficit (1-2)	**-160.4**	**-117.1**	**43.4**

Sources: Ministry of Finance; and IMF staff estimates

[25] It has been alleged that some manufacturers kept production below orders and delayed deliveries, creating an artificial shortage.

[26] The auto industry heavily depends on the imported completely knocked-down (CKD) kits and other precision-engineered parts. Therefore, appreciation of Pak rupee resulted in a lower rupee cost of imports and thereby, lower import duty collections.

[27] The cement industry is high energy intensive and the consumption of furnace oil alone constitutes above 35 percent of the total cost of production. Because the prices of furnace oil had increased alarmingly over the last five years, some manufacturers started substituting it with low cost fuels such as coal (for details, see **Box 2.1,** *Second Quarterly Report forFY02)*.

of the improvement. A detailed analysis of total expenditures and revenue receipts is presented in the following sections.

3.1 Expenditures

The fall in expenditure is very creditable, as it is broad-based, derives primarily from below-target current expenditure, *and* incorporates *higher*-than-target development expenditure.

With respect to the current expenditures, lower debt servicing and defense costs accounted for approximately half of the savings during the period, with further savings accruing from below-target general administration spending as well as an improved fiscal performance by provincial governments.

3.1.1 Current Expenditure

Expenditure on interest payments, the biggest component of current expenditures, remained below than the targeted level of Rs 184.8 billion, largely on account of lower T-bill rates during the period under consideration (see **Table 3.2**). Another important contributor was the closure of the special debt repayment account with the SBP against rescheduled debt. This helped the government to retire Rs 193.0 billion of outstanding debt, correspondingly lowering interest payments on domestic debt. Interest payments on external debt were also slightly lower than the target, mainly due to re-profiling of bilateral foreign debt.

Table 3.2: Consolidated Governments Expenditures

billion Rupees

	Target	Actual	Difference
Total expenditure	**587.6**	**553.5**	**34.1**
Current expenditure	**492.0**	**466.1**	**25.9**
Federal	375.9	353.6	22.3
Interest payments	184.8	175.2	9.6
Domestic	146.1	137.1	9.0
External	38.7	38.1	0.6
Defense	102.2	94.5	7.7
General administration	57.0	54.6	2.4
Grants	14.4	14.6	-0.2
Subsidies	10.0	14.4	-4.4
Others	7.5	0.2	7.3
Provincial	116.1	112.5	3.6
Development expenditures	**95.6**	**96.5**	**-0.9**
PSDP	88.6	91.5	-2.9
Net lending	7.0	5.0	2.0
Unidentified	0.0	-9.1	9.1

Sources: Ministry of Finance; and IMF staff estimates

Aggregate defense expenditure was also lower than the targeted level of Rs 102.2 billion, although a clear upward trend is visible in the quarterly FY02 data. Given the prevailing borders tensions the surplus implies the efficient use of defense resources.

Other significant contributions came from the non-disbursal of a budgeted amount for a one-time bank restructuring charge, as well as fall in general administration spending.

The exceptions to the trend were the subsidies, which crossed the mark set for Jul-Mar FY02, and were Rs 4.4 billion higher than the target.

3.1.2 Development Expenditure

Expenditure on the public sector development program (PSDP) crossed the set target of Rs 88.6 billion for the period under review (see **Table 3.1**). However, the Jul-Mar FY02 PSDP expenditures also include two one-time expenditures; Rs 10 billion for drought related spending and a Rs 3.0 billion charge for fiscal devolution.

3.2 Revenue Receipts

As can be seen from **Table 3.1**, the consolidated revenue receipts of federal and provincial governments were Rs 9.2 billion higher than the targeted level of Rs 427.2 billion. This was entirely due to higher non-tax revenues; tax revenues were Rs 4.3 billion short of the target, whilst non-tax receipts surpassed the target by 13.5 billion, more than offsetting the shortfall in tax revenue.

Lower CBR tax collections during Jul-Mar FY02 were the prime source of the shortfall (see **Section 3.3**). Although petroleum and gas surcharges contributed Rs 5.23 billion *more* than the targeted amount, this was insufficient to cover the shortfall stemmed from lower tax collections. The rise in surcharges was largely driven by a 0.75 Rupee per litre increase in the petroleum development levy and a 0.25 Rupee per litre increase in the tax on other petroleum products.

The high non-tax receipts were largely driven by higher dividend income, SBP profit, sale proceeds from oil and gas, and other civil administration receipts (including economic and social services receipts). The higher dividends paid by PTCL and OGDC were primarily responsible for the rise in dividend income, while gains on foreign exchange deals due to the appreciation of the Pak Rupee against US Dollar enabled SBP to transfer more profit to the government.

Although government was able to cross the set target by Rs 9.2 billion, the situation is far from satisfactory as the entire increase came from the non-tax revenue, which is not a dependable source of income. The major and consistent source of government exchequer (CBR tax revenues) remained significantly lower than the targeted level.

3.3 CBR Tax Collections

Federal government tax revenues remained under stress as Jul-Mar FY02 CBR tax collections witnessed a marginal (2.5 percent) *decline* to Rs 269.8 billion, against the revised target *growth* of 2.4 percent for the same period and the 14.9 percent growth recorded in the corresponding period last year (see **Table 3.3**).

Table 3.3: Federal Tax Collections

billion Rupees

	Targets for		Tax collection Up to Q3			As percent of		Excess/ shortfall over Q3	Percent change over FY01
	FY02	Q3	FY00	FY01	FY02	FY02	Q3		
Direct taxes	**146.5**	**99.2**	**74.4**	**86.9**	**96.2**	**65.6**	**96.9**	**-3.0**	**10.7**
Indirect taxes	**267.7**	**184.2**	**166.5**	**189.8**	**173.7**	**64.9**	**94.3**	**-10.5**	**-8.5**
Sales tax	170.1	119.7	80.7	108.3	113.4	18.2	94.8	-6.3	4.7
Central excise	47.1	34.1	39.5	35.2	31.2	66.3	91.6	-2.9	-11.2
Customs	50.5	30.4	46.3	46.3	29.0	57.4	95.4	-1.4	-37.3
Total collections	**414.3**	**283.4**	**240.9**	**276.7**	**269.8**	**65.1**	**95.2**	**-13.6**	**-2.5**

Source: Central Board of Revenue

Encouragingly, direct tax receipts were roughly in line with the 14.2 percent growth target for the period, suggesting that the government's efforts to broaden the tax base are finally paying dividends. Unfortunately, this improvement was undermined by large shortfalls in indirect tax receipts.

The role of exceptionally high tax refunds in depressing Jul-Mar FY02 net collections is particularly noteworthy. By end of Q3-FY02, tax refunds totaled Rs 62.9 billion, a stunning Rs 18.4 billion (41.2 percent) higher than for the corresponding period last year.[28] The underlying growth in gross tax collections was 3.6 percent.

3.3.1 Revisions of Targets

The CBR tax revenue target witnessed three downward revisions up to Q3-FY02 (see **Table 3.4**). Initially, CBR tax receipts were budgeted at Rs 457.7 billion, which was revised downwards in August 2001 to account for the shortfall realized in actual tax collections during FY01.[29]

[28] For details see **Table 3.5**.

[29] For each new financial year, the budget targets for CBR tax collections are generally computed towards the end of the preceding financial year, on the basis cumulative (11 month) current collections and the estimated June collection. Thus, any significant shortfall realized in the receipts of the earlier year has to be incorporated into the budgetary target for the new year.

However, the shortfall realized on the new targets during Q1-FY02 and the expected losses to the economy (in terms of revenue) following the events of September 11 forced the CBR to re-visit the revenue targets in October 2001. Based on the preliminary estimates of these losses, the revenue target was once again adjusted downwards from Rs 444.7 billion to Rs 429.9 billion.

Table 3.4: CBR Revenue Targets

billion Rupees

	Budget	Revisions		
	target	1st	2nd	3rd
Direct taxes	**149.8**	**143.1**	**142.4**	**146.5**
Indirect taxes	**307.9**	**301.6**	**287.5**	**267.7**
Sales tax	185.2	183.1	176.8	170.1
Excise	53.1	49.6	49.4	47.1
Customs	69.6	68.9	61.3	50.5
Total	**457.7**	**444.7**	**429.9**	**414.2**

Source: Central Board of Revenue

Unfortunately, mid-year collections remained Rs 8.9 billion short of even this revised figure, as the economic assumptions made at the time of the earlier revision proved optimistic. Thus, the accumulated shortfall by December 2001 coupled with below target January 2002 receipts, forced a third revision of the FY02 target.[30] This time, the yearly target was revised to Rs 414.2 billion, which was only 5.2 percent higher than the actual collections in FY01.[31]

Even in terms of the new targets, receipts up to Q3-FY02 proved inadequate; the actual collections were only 95.2 and 65.1 percent of quarterly and annual targets, respectively (see **Table 3.3**). The shortfall was attributed to a variety of factors *of which* lower than projected growth of GDP, low inflation and fall in rupee imports are the most relevant. Furthermore, as stated earlier, the higher amount of refund/rebate was a large dampener to net tax collections.

The outlook for the current tax targets remains discouraging as the CBR has to collect over Rs 48 billion per month on average during the last quarter of the year to reach the FY02 billion target. Given the average collection of Rs 30 billion per month up to Q3-FY02 and adjusting for the usual trends in tax collections, this target clearly looks ambitious. Thus, the government will likely be forced to revisit its revenue targets for the fourth time in FY02.

---

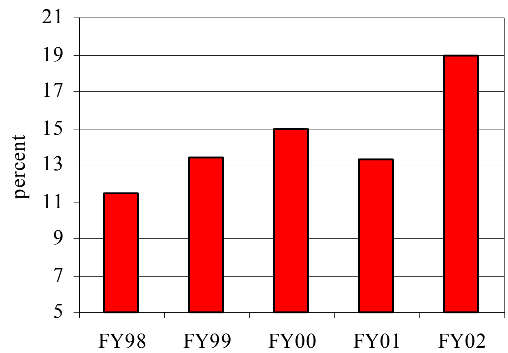
[30] This required the government to seek an IMF waiver for the non-observance of the earlier-set performance target under the PRGF.

[31] However, by the time the new targets based on the Dec-Jan collections were published, the new end-March collections were already looking difficult, due to the continued weakness in tax receipts.

3.3.2 Refund/Rebate Issues

Tax refunds as a percentage of total gross collections had held between 11-15 percent in recent years, but in FY02 a policy decision to eliminate backlog of unpaid refunds received additional impetus from the need to support local businesses in the aftermath of the September 11 economic shock (see **Figure 3.1**).[32]

Figure 3.1: Jul-Mar Tax Refunds as % of Tax Collection



Consequently, Q2-FY02 refunds surged to Rs 23.5 billion, i.e. a quarter of the gross collections for the period, and a 95 percent increase over the corresponding period of FY01. By the end of Q3-FY02, the total refunds accumulated to Rs 62.9 billion[33] against Rs 44.6 billion over a year ago (see **Table 3.5**).

Table 3.5: Quarterly Collections and Refunds by CBR
billion Rupees

	Gross collections		Refunds		Growth rates (percent)	
	FY01	FY02	FY01	FY02	Collections	Refunds
Q1	95.6	98.5	15.7	21.1	3.0	34.3
Q2	114.1	120.6	12.0	23.5	5.7	95.3
Q3	111.5	113.6	16.8	18.3	1.9	9.1
Total	**321.2**	**332.7**	**44.6**	**62.9**	**3.6**	**41.2**

Source: Central Board of Revenue

The high refund paid during FY02 may have resolved a long-standing issue between the CBR and exporters; the latter have been of the view that CBR authorities held refunds at quarter ends to meet their net revenue targets, and had built up a huge backlog of unpaid refunds. The exporters therefore faced a liquidity shortage in meeting their overseas contracts. President of Pakistan had to personally intervene for liquidating this backlog of refunds. This is not a

[32] This point is reinforced when seen in the context of credit utilized under Export Finance Scheme (EFS). See section on **Money and Credit** for details.
[33] However, not all of the FY02 increase is attributable to the elimination of the backlog. The increased reliance on the cascading sales tax (GST) regime would be expected to drive up refunds in proportion to rising gross collections.

viable situation and therefore the CBR has to make procedural improvements to avoid further build up in future.

The CBR has now made considerable progress in curtailing the time lag in meeting refund claims as well as in shrinking the backlog of such claims. More importantly, it is expected that this improvement would avoid an increase in these arrears.

3.3.3 Direct Taxes

In sharp contrast to the trend in overall CBR tax receipts, direct tax collections recorded buoyant growth up to Q3-FY02. The 10.7 percent year-on-year growth for the period was driven by higher income tax receipts through *normal returns* as well as *on demand* collections (see **Table 3.6**). [34]

Table 3.6: Income Tax Collections up to Q3-FY02
billion Rupees

	Actual		Shares (percent)		Change over FY01	
	FY01	FY02	FY01	FY02	Absolute	Growth
Collections with normal returns	11.6	16.1	13.0	16.0	4.6	39.3
Collections on demands	6.5	7.7	7.3	7.6	1.2	18.0
Current collections	13.4	21.5	15.0	21.3	8.0	59.9
Withholding taxes	57.1	55.2	63.9	54.7	-1.9	-3.3
Others	0.8	0.4	0.9	0.4	-0.4	-48.9
Total	**89.4**	**100.9**	**100.0**	**100.0**	**11.5**	**12.9**

Source: Central Board of Revenue

Withholdings taxes, that are generally strong contributors to income tax receipts, have declined in FY02. Other than the generally lower activity in the economy, the fall in the receipts of withholding taxes is mainly attributed to lower collections on income from (1) interest on government securities, (2) on import proceeds in terms of value,[35] (3) on the supply of goods and, (4) execution of contracts. Furthermore, the abolition of five types of withholding taxes, the

[34] Collections with normal returns include amounts received from periodic returns filed by the businesses, while the 'on demand' collections include receipts from outstanding arrears and amount deducted by the auditors of the CBR. A rise in the former generally implies an increasing tax base of income tax, while the later reflects the CBR efforts to collect arrears as well as improving audit capabilities.
[35] Not only are imports lower, but the impact is more pronounced in Pak-Rupee terms due to the appreciation of Pak-Rupee against the US$. During FY02, rupee imports fell by approximately Rs 30 billion, which has obvious negative repercussions for import tax collections (e.g. GST and customs duty, etc.)

reduction in tax rates on banking companies in federal budget for FY02, contributed to lower collections from withholding taxes. In this context, the strong income tax receipts are even more encouraging.

Direct tax collections reached 96.9 percent of quarterly and 65.6 percent of annual targets (see **Table 3.3**). The underperformance of only 3.1 percent of the quarterly target can be overlooked given that (1) the FY02 target was actually revised *upwards* even as the targets for other taxes were brought downward, and (2) the receipts collection are net of unusually large refunds. The figures thus suggest that the government efforts to broaden the tax base are indeed bearing fruit.

3.3.4 Indirect Taxes

Indirect tax collections up to Q3-FY02 were quite disappointing, contributing 77.2 percent of the shortfall in the end-March 2002 net tax collection target.

Sales Tax

As can be seen from **Table 3.3**, the sales tax (GST) is the only component of indirect taxes that recorded any increase in FY02. In fact, the net sales tax collections maintained a marginally positive growth for both, domestic and import related items, through most of the FY02. However, the growth was lower than targeted, leading to the Rs 6.3 billion shortfall.

The sales tax on imports, declined continually post-September 2001, until strong March 2002 imports (up 20% year-on-year) halted the slide. Overall receipts were boosted by strong receipts from domestic production, i.e. the cement, sugar, fertilizer, natural gas, electricity and petroleum products.[36]

However, in assessing the FY02 sales tax collections, it is important to consider two factors:

1) The one-time distortion caused by exceptional GST refunds (**Table 3.5**) mean that FY02 net collections figures are not easily comparable to net FY01 receipts. In fact, net sales tax collections would have surpassed the March 2002 quarterly target, if the refund amount remained the same as for Jul-Mar FY01.

[36] These 5 elements contributed incremental receipts of Rs 2.7 billion during Jul-Mar FY02. The rise in GST from cement stems from (a) a relative price stability, and (b) the expiry of the time-bound exemptions earlier available to some units. Interestingly, the latter would also eliminate the threat to the cement cartel earlier posed by the hitherto GST-exempt units.

2) Also, the increasing reliance on the GST (a VAT) in total revenue collections will correspondingly feed some growth in tax refunds in future (albeit not at FY02 levels).

Central Excise Duty

Up to Q3-FY02, central excise duty (CED) collections slipped down by 11.2 percent over the comparable period last year. The fall is not surprising given that the government is seeking to substitute the CED with the GST, but the extent of the drop in FY02 is much larger than projected. In fact, in proportion to its 12 percent share in the Jul-Mar 2002 target, the contribution of the CED shortfall in the aggregate deficit is disproportionately large at 21.1 percent.

The driving force behind this massive decline is the lower CED collections on cement, beverages and on services, as well as sagging collections on import-related goods also added a dampener.

Customs

Custom duty collections were the hardest hit in the post-September 11 environment, with gross receipts dropping 13.3 percent year-on-year to reach Rs 52.8 billion by end-March 2002, mirroring the fall in imports and the appreciating rupee, and a reduction in the average applicable rate.[37]

During Jul-Mar FY02, imports were 8.5 percent lower (in US$) when compared to the same period last year.[38] Similarly, while Jul-Mar FY01 collections were aided by a 14.4 percent depreciation of the rupee, collections this year faced a 6.7 percent *appreciation* that worsened the custom duty collections.[39]

Finally, even these relatively weak gross receipts were further reduced to Rs 29.0 billion, by the government decision to expedite the payment of tax refund arrears. During Jul-Mar FY02, these payments rose by Rs 9.1 billion over the corresponding period last year adding to the divergence in collections during the respective periods. To put the scale of these refunds in perspective, the total customs duty refunds in the period constituted 45.1 percent of the gross receipts for the period and, 62.3 percent higher than the amount refunded over the corresponding period last year.

[37] The FY02 budget saw a broad reduction in the customs duty rates, with the maximum rate being reduced from 35 percent to 30 percent. Moreover, the number of slabs was also reduced from the earlier 5 to only 4 (i.e. 30 percent, 20 percent, 10 percent and 5 percent).
[38] For a detailed discussion on imports, please see section on **External Sector**.
[39] Please, see **footnote 35**.

3.4 Financing of Budget Deficit

The overall budget deficit of Rs 117.1 billion was financed through external and domestic resources. As can be seen from **Table 3.7**, the financing from domestic resources was higher than the net external resources. Lower net external financing was the upshot of higher repayments of both long term and short term loans, which amounted to Rs 120.5 billion up to Jul-Mar FY02. Higher gross disbursement on account of special budgetary support grant and debt rescheduled amount coupled with lower than projected financing needs of the government (lower budget deficit) facilitated the above repayments of loans.

Table 3.7: Financing of Budget Deficit
billion Rupees

	Jul-Mar FY02	
	Target	**Pro. actual**
Financing through:	160.4	117.1
a) External resources (Net)	83.9	55.7
b) Internal resources (i+ii)	76.5	61.4
i) Domestic non-bank	81.3	66.6
ii) Banking system	-4.8	-5.2

Sources: Ministry of Finance; and IMF staff estimates

Within the domestic resources, government retired Rs 5.2 billion to the banking sector, slightly higher than the targeted level of Rs 4.8 billion to the banking system. However, the government borrowed Rs 66.6 billion from non-banking system during the course of time, which was also less than the targeted level.

4. Money and Credit

As in the previous quarter, rising Net Foreign Assets (NFA) of the SBP continued to propel strong growth in money supply (M2) in Q3-FY02, even though the net domestic assets (NDA) *fell* by Rs 20.9 billion in the same period. As a result, M2 jumped Rs 18.5 billion during the quarter, pushing the year-to-date FY02 increase to Rs 142.5 billion (9.3 percent). This is more than twice the Rs 66.1 billion increase in the corresponding period last year (see **Table 4.1**), marginally higher than the full year FY02 target.

Typically, the third quarter of the financial year is a period of relative calm in the credit cycle of the economy, and FY02 was no exception. In fact, by end-December 2001, when the seasonal private sector net credit off-take tapered off, the commercial bank credit to the private sector was already rather low at Rs 52.6[40] billion - against the corresponding FY01 figure of Rs 80.6– and it declined by another Rs 9.5 billion by end-Q3-FY02.

[40] Data was revised on account of reclassification of some of the public sector enterprises (PSEs) as private concerns. Without this adjustment the net credit to private sector is Rs 39.4 billion.

Table 4.1: Monetary Survey

billion Rupees

	Actual up to Mar-FY02	Actual up to Mar-FY01
A. Government sector borrowing (net)	**-28.1**	**-26.2**
1. Net budgetary borrowing	-5.9	13.0
From State Bank of Pakistan	-76.6	-0.8
From scheduled banks	70.7	13.8
2. Commodity operations	-22.6	-37.1
3. Net effect of zakat fund/privatization proceeds	0.2	-2.4
4. Others (credit to NHA & CAA)	-0.5	0.4
B. Non-government sector borrowing	**39.8**	**76.8**
1. Autonomous bodies[1]	6.2	-13.9
2. Net credit to private sector and PSCEs	33.7	90.7
Commercial banks	43.3	92.2
i. PSCEs other than B(1)	0.3	11.0
ii. Private sector	43.0	81.2
of which export refinance	*-14.9*	*4.8*
Specialized banks	6.2	1.8
Other financial institutions	-14.4	-0.2
PSCEs special account debt-repayment with SBP	-1.4	-3.1
C. Other items (net)	**20.8**	**-6.1**
D. Net domestic assets of the banking system	**31.8**	**44.6**
	(2.12 %)	(3.08 %)
E. Net foreign assets of the banking system	**110.7**	**21.6**
F. Monetary assets (M2)	**142.5**	**66.1**
	(9.34 %)	(4.72 %)

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

Source: Economic Policy Department, State Bank of Pakistan

The normal retirement of FY01 commodity operations credit in Q3-FY02 further depressed the net domestic credit figures, and this trend was reinforced by the continuing net retirement of the government's budgetary borrowings from the banking sector during the period.

The weak growth in private sector credit, the extraordinary rise in NFA in post September 11 period, and the continuing fall in government borrowings, left the banking system flush with liquidity during Q3-FY02. From the banks' perspective, this problem was aggravated by the easing monetary stance (lowering yields in auctions). In fact, the expectations of a continuing slide in interest rates led banks to bid very aggressively in the auctions for government paper until the SBP very clearly signaled an end to the downward trend in T-bill yields.[41]

Interestingly, while exceptional NFA growth in FY02 has contributed Rs 98.5 billion towards reserve money growth, this was partially offset by a Rs 76.6 billion retirement of government debt held by the SBP. The FY02 growth in reserve money by end-March 2002 was thus held to Rs 33.6 billion, as compared to a reduction of Rs 10.2 billion during the corresponding period last year.

4.1 Growth in Monetary Assets

4.1.1 Government Borrowings

The impact of various economic policy measures can also be seen in the pattern of government borrowings from the banking system. Government traditionally leaned heavily on SBP to meet financing requirements, which raised a conflict with end-quarter targets agreed with the IMF.[42] The FY02 behavior was thus refreshingly different (see **Figure 4.1**).[43] Despite relatively more binding IMF targets, the hectic activity usually associated with the end quarters was absent,[44] with government borrowings concentrated almost entirely with the commercial banks.

By the end of Q3-FY02 the government had retired Rs 76.6 billion of its SBP borrowings (during the same period last year government could only manage to retire Rs 0.8 billion).

Government borrowings from the scheduled banks during the period, by contrast, increased by Rs 70.7 billion as against only Rs 13.8 billion last year. Nonetheless, the government was able to raise its funding from the commercial banks, without pushing up interest rates due to high banking sector liquidity.

[41] Amidst market expectations of a continuing fall in interest rates, banks over-bid massively in the auctions for government paper. In response, the SBP finally acted to end these self-fulfilling expectations by accepting all bids in the February 7, 2002 auction, leaving the market short of liquidity. Thereafter, it refrained, for a week, from conducting an OMO to re-inject liquidity into the system.

[42] The SBP NDA is a key target. NDA=Claims on government + claims on non-government+ other items net. An increase in government borrowing increases the claims on government and in turn NDA.

[43] Since the FY02 NDA target had been met with a positive margin of Rs 103.3 billion, high SBP retirement and matching scheduled bank borrowing in March 2002 are not prompted by NDA considerations.

[44] End March target of government borrowing from the banking system was Rs 19.9 billion for FY01 and Rs -4 .0 billion for FY02.

This, in turn, stemmed from a combination of unusual low demand for credit by the private sector, liquidity injections via SBP purchases of foreign currency and increased remittances.

In aggregate terms, the government retired Rs 5.9 billion to the banking system during Jul-Mar FY02 as against borrowings of Rs13.0 billion in the corresponding period last year. It is also important to note here that the government could hold down its FY02 borrowings from the banking sector only because of enhanced availability of external and non-bank financing (see **Table 4.2**).

4.1.2 Commodity Operations

During Jul-Mar FY02 the retirement in commodity operations credit was Rs 22.6 billion, which was about the same as disbursed for this purpose in FY01 (see **Figure 4.2**). By contrast, the retirement in commodity operation credit during the same period last year was Rs 37 billion – substantially lower than the peak credit off-take of Rs 57.6 billion in

Figure 4.1: Budgetary Borrowings

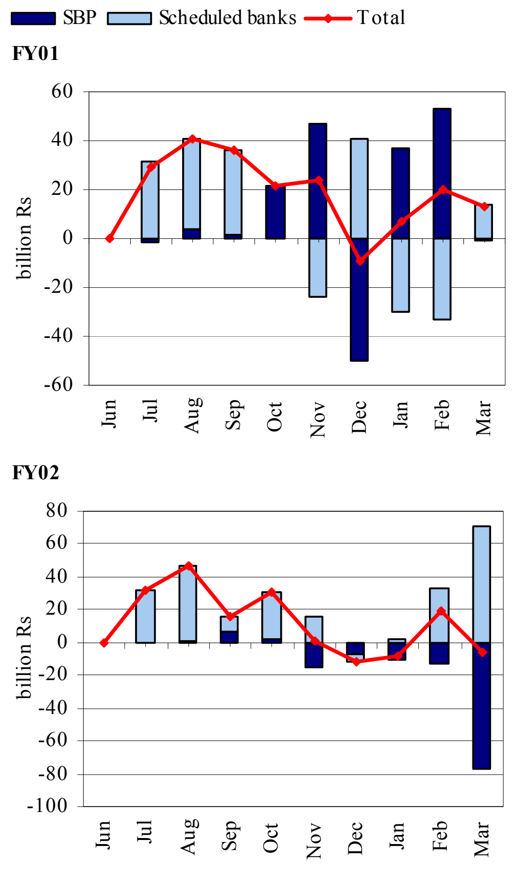


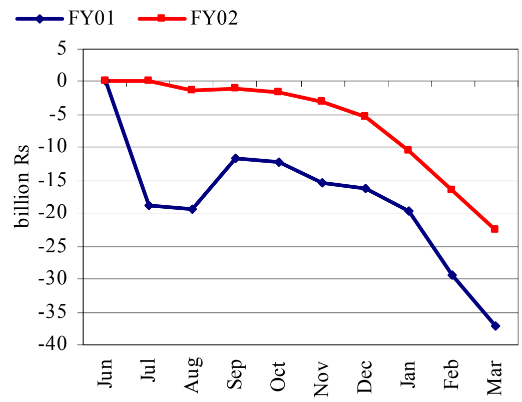
Table 4.2: Non-Bank and External Sources of Financing

	Up to Mar-FY02	Up to Mar-FY01
PIB (billion Rupees)	66	29.7
NSS (billion Rupees)	44	19.4
External financing and grants (million US$)	663	567

Source: IMF, MOF and SBP

FY00.[45] Thus, the retirement figures of the current year are a welcome indication of the government's move to instill financial discipline in its commodity operations.

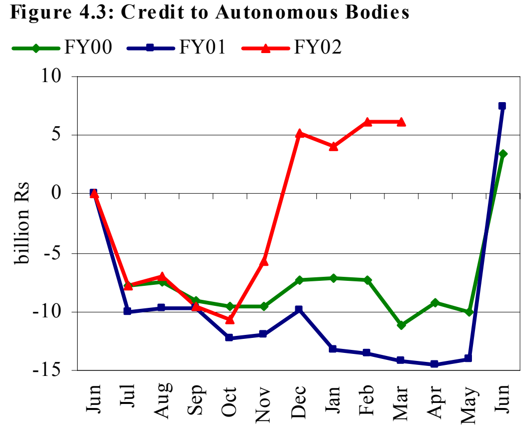
Figure 4.2: Commodity Operations



4.1.3 Autonomous Bodies

A significant shift is also visible in the borrowing pattern of the autonomous bodies during Jul-Mar FY02 as compared to last years (see **Figure 4.3**). It is usual for the autonomous bodies to utilize their allocated ceilings at (or around) the close of the fiscal year. This is then gradually retired throughout the next financial year.

Figure 4.3: Credit to Autonomous Bodies



However, in FY02 the autonomous bodies[46] utilized the bulk of their annual ceiling in the 2nd quarter. As a result, their borrowings during Jul-Mar FY02 soared to Rs 6.2 billion against a retirement of Rs 13.9 billion in the corresponding period last year.

The major borrowers by end-March 2002 were KESC (Rs 11.7 billion), followed by WAPDA (Rs 1.5 billion) and PIA (Rs 1.2 billion). On the other hand, Pakistan Telecommunication Corporation continued its retirement pattern, returning Rs 7.7 billion to the banking system.

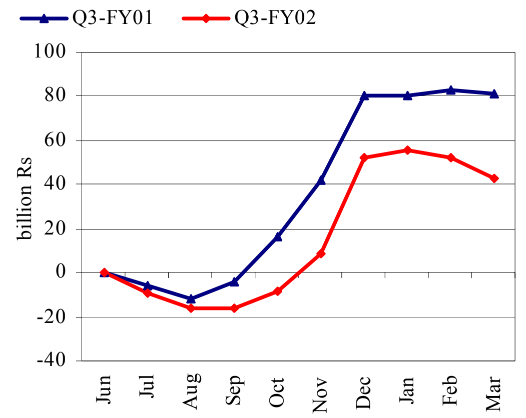
[45] The concern over growth in the outstanding *stock* of credit for commodity operations has been highlighted in SBP's previous quarterly reports.

[46] With effect from June 2001 Pakistan International Airlines (PIA) and Pakistan Steel Mill Corporation are both defined as autonomous bodies for credit purposes (and are now subject to credit ceilings). However, the credit limits for the Autonomous bodies has been adjusted to incorporate their planned requirements.

4.1.4 Credit to Private Sector

Q3-FY02 saw a worsening of the relative decline in net credit that was already visible in the preceding quarter (see **Figure 4.4**). Jul-Mar FY02, recorded Rs 43.1 billion growth in net credit to the private sector, representing a stunning 47 percent fall compared to the Rs 81.2 billion extended during Jul-Mar FY01. If adjustment made for changes in export finance, the decline is 24 percent. The fall in private sector credit is most commonly linked to a decline in business confidence, weakening economic activity in the aftermath of the September 11 shock, the uncertainty over the conflict in Afghanistan and, the later border tensions with India.

Figure 4.4: Credit to Private Sector



However, while these have probably been important factors behind the fall in net credit growth, data suggests that more prosaic reasons (not all negative) have also contributed to the lower funding demanded from the banking sector.

Firstly, input costs for a number of major credit intensive sectors have declined sharply. These industries include textiles (average cotton prices fell by 16.3 percent), sugar (sugarcane prices were lower), automobiles (appreciating Rupee and higher advance payments), cement (lower fuel costs) as well as IPPs (lower fuel costs would lead to a fall in their revolving credit requirement).

Another important contribution to self financing (and therefore lower credit from the banking sector) would be from the Rs 18.4 billion *increase* in tax refunds paid out by the CBR during FY02.

Also, the volume of credit retirement in a year is generally proportional to the volume of disbursements made in the preceding year. Thus the relatively high net credit expansion in FY01 (Rs 81.2 billion by March 2001 vs. Rs 29.9 billion in March 2000) would also result in comparatively higher retirements by March

2002, deflating the net credit figures in this period. Thus, it is important that we also take into account the gross disbursement figures.

Gross loan disbursement up to Q3-FY02 exceeded that in Q3-FY01 by Rs 129.4 billion. It must be acknowledged that a significant portion of this incremental gross lending may simply reflect a re-pricing of outstanding loans in the wake of interest rate cuts. Nonetheless, when taken together with the high net credit in FY01, it becomes clear that higher retirements probably did indeed depress the FY02 statistic.

Yet another strong deflator of the net credit figure for Jul-Mar FY02 is the Rs 25.6 billion in loan deletions and write-offs (as against Rs 6.4 billion in Jul-Mar FY01). This reduced the outstanding volume of advances and thereby the net credit figures.

Similarly, higher corporate bond issues in FY02 too would have eaten into commercial credit demand relative to the previous year.
On the other hand, the FY02 net credit growth would be artificially *inflated* by Rs 20.7 billion on account of the merger of some non-banking institutions with commercial banks.[47]

Table 4.3 provides an indicative picture of the net credit availability to the private sector after adjusting for most of the factors discussed above. It thus provides a clearer picture about credit availability. Economic activity during FY02 is probably better than reflected in a bare reading of the net credit figures.

Table 4.3: Adjusted Credit to Private Sector (Jul-Mar)
billion Rupees

	FY01	FY02
Credit to private sector (Monetary Survey)	81.2	43.1
Adjusting for CBR refunds	45.5	63.9
Adjusting for deletion and write-offs	6.4	25.6
Adjusting for merger of NDFC and Faisal Investment bank	-	-20.7
Credit to private sector after adjustments excluding export finance	**133.1**	**111.9**
Adjusting for export finance	-4.8	14.9
Credit to private sector after adjustments including export finance	**128.3**	**126.8**

Export Finance

The export finance profile in FY02 differs distinctly from that in earlier years for the following reasons:

[47] The National Development Finance Corporation merged into National Bank Limited, while Al Faysal Investment Bank was merged into Faysal Commercial Bank.

(1) Exclusion of re-finance for yarn & gray cloth in Q1-FY02
The July 2001 exclusion of this major export category is estimated to have caused a Rs 12.1 billion reduction in credit under this head during Q1-FY02. However, the funding was restored for gray cloth in January 2002, contributing to an unseasonal increase in export finance for these categories in Q3-FY02.

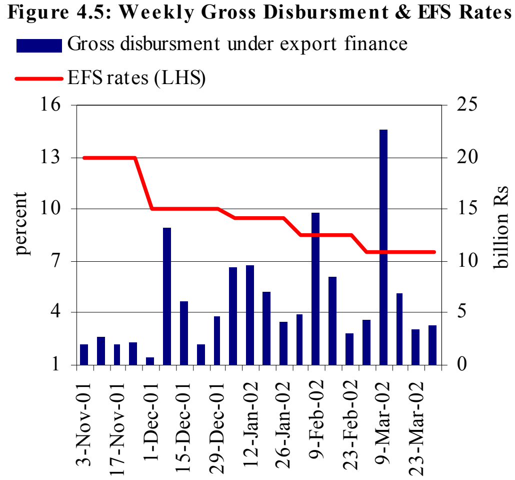
(2) Unusual net retirement of export finance in Q2-FY02
For once, despite gross disbursements of Rs 55.6 billion during Q2-FY02 (against Rs 40.3 billion in Q2-FY01), net export financing actually fell by Rs 6.1 billion, due to exceptionally heavy retirements of Rs 64.8 billion during the period (the corresponding FY01 retirements totaled Rs 35.6 billion).

The unusually heavy retirements in Q2-FY02, almost certainly reflect the impact of the appreciating Rupee[48] as is evidenced by the Rs 9.8 billion decline in export receivables outstanding (see **Figure 9.13** in 'Capital Account') since October 2001, as well as a fall in export orders.

(3) Exceptional jump in gross disbursements in Q3-FY02
The retirements continuing into Q3-FY02, totaling Rs 96.7 billion for the quarter vs. Rs 57.2 billion for Q3-FY01, but in this quarter the gross disbursements Rs 103 billion marginally topped the retirements.

Data suggests that a large portion of the simultaneous jump in retirements and disbursements simply reflects a re-pricing activity as exporters moved to take advantage of falling interest rates. **Figure 4.5** depicts this behavior, with a jump in gross disbursements in the week following each reduction in the export finance rate.

Figure 4.5: Weekly Gross Disbursment & EFS Rates



[48] The Rupee appreciated 6.6 percent during Q2-FY02 before stabilizing in Q3-FY02. The retirement of export finance follows this trend, being considerably higher in Q2-FY02 relative to Q3-FY02.

4.1.5 Net Domestic Assets (NDA)

Net domestic assets of the banking system grew by Rs 31.8 billion during Jul-Mar FY02 against a Rs 44.6 billion expansion in the corresponding period last year.

A break-up of NDA into the SBP and scheduled banks sub-components reveals that while the NDA of scheduled banks expanded by Rs 94.3 billion that of the SBP fell Rs 62.5 billion. *In effect*, during FY02, the government substantially increased its commercial bank borrowings while simultaneously reducing its borrowings from the SBP.

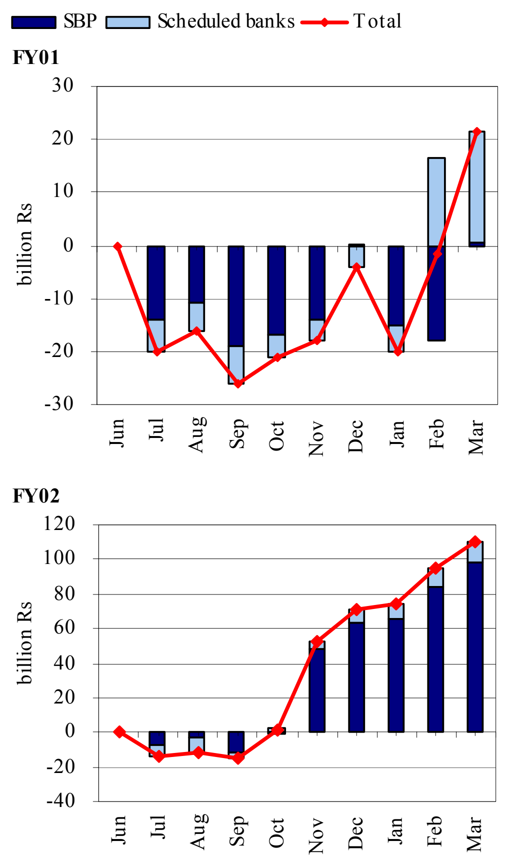
The extent to which this is an effective switch of borrowings from the SBP to commercial bank borrowings, it also represents an equivalent sterilization of the monetary base growth stemming from the SBP's higher foreign currency purchases.

The huge retirement of SBP debt also explains the SBP's over-achievement of its end-March FY02 NDA target by a wide margin of Rs 103.3 billion.[49]

4.1.6 Net Foreign Assets (NFA)

Net foreign assets (NFA) of the banking system increased by Rs 110.7 billion during Jul-Mar, 2002, over five times the Rs 21.6 billion rise seen in Jul-Mar FY01. Thus, SBP not only easily met the end-March 2002 NFA target of Rs 6.0 billion, but has also already surpassed the full year FY02

Figure 4.6: Net Foreign Assets



[49] SBP's end-March FY02 NDA target was Rs 28.5 billion.

target of Rs 46.4 billion.

Another striking difference in NFAs of the two periods is its composition (see **Figure 4.6)**. While growth in NFA in FY01 (up to March) was mainly due to increase in the NFA of the scheduled banks which contributed Rs 21.0 billion. This year it is the NFA of SBP, which is driving the growth in NFA of the banking system. Its contribution in overall expansion is Rs 98.5 billion whereas that of scheduled banks is only Rs 12.2 billion. While the rise in the NFA of SBP was due to increase in its assets (SBP reserves), the upsurge in NFA of scheduled banks was due to decrease in their foreign currency liabilities.

The major component of these foreign currency liabilities of the scheduled banks is the non-resident foreign currency deposits, which are essentially institutional deposits that were rescheduled following the May 98 nuclear tests. These are now being withdrawn, thereby reducing the liability of the scheduled banks.

4.1.7 Components of Money Supply

Money supply recorded a robust growth during Jul-Mar FY02. Rupee deposits registered an increase of 8.9 percent while currency in circulation increased by 15.6 percent. In the corresponding period last year Rupee deposits grew by 1.2 percent while currency in circulation increased by 8.5 percent. The trend in growth of resident foreign currency (RFCD) deposits was predictably in the opposite direction.

During Jul-Mar FY01, RFCDs increased by 22.1 percent, but declined by 2.2 percent in Jul-Mar FY02. The growth in RFCDs last year was fueled by continuing weakness of the Rupee, since the rate of return on RFCD was well below that on Rupee deposits.

By contrast, in post September 11, the Rupee has appreciated 6.5 percent and seems set to rise even further, but for the intervention of the SBP, which is seeking to hold the exchange rate stable to protect exports (and build up its foreign currency reserves). This clearly reduces the economic incentive for RFCD holdings.

The resulting decline in RFCDs since September 2001 may also, at least, partially explain the extraordinary growth in currency in circulation and Rupee deposits in Q2-FY02.

The currency in circulation usually begins to rise with the disbursement of credit to private sector, continues to grow till Eid before tapering off in January.

However, in FY02 it continued to grow until February, possibly because of a lack of an obvious investment avenue and/or a wait-and-see attitude over the behavior of the Rupee.

Interestingly, although the currency in circulation increased sharply in Q3-FY02 the average currency to deposit ratio was slightly lower than last year's 2.7 percent. This means that increase in currency in circulation was equally matched with the growth in deposits and, as such, is not a cause of concern as in previous years.

5. Money Market

As is customary, the seasonal retirement of commodity operations credit kept the market liquid in the third quarter of the fiscal year, with pro-active liquidity management by the SBP, through OMOs, smoothing out any temporary shortages. As a result, pushed by unexpectedly weak net credit off-take and sustained market expectations of further interest rate cuts, banks piled into the T-bill and PIB auctions, in order to lock-in assets at higher yields.

By mid-January, in view of the continuing weakness in credit growth despite the earlier loosening of the monetary policy, the SBP further reduced the discount rate by a percentage point. This brought the total reduction in the discount rate post September 11, to 500 basis points. But, rather than calming the market, this only served to incite a bidding frenzy, with the 25th January T-bill auction attracting bids totaling over Rs 54 billion against a maturity of just Rs 6.1 billion.

This trend continued into the next auction, in which the SBP was finally forced to quash expectations of further interest rate cuts by accepting all bids. The fact that despite this drastic measure the weighted average rates in all three tenors dropped by over 43 basis points (i.e. the bulk of the bids were well below the previous cut-off rate) is a telling insight into the degree of the market panic.

Interestingly, the SBP's proactive monetary management, which reduced volatility in short-term rates by ensuring liquidity, may have actually helped banks to bid aggressively in the auctions. Although the SBP's intention was to facilitate banks' liquidity to expedite private sector activity, there is some evidence that this encouraged banks to invest in government securities and fund it from the repo market (albeit, at higher risk levels).

Another effect of the declining interest rates and weak credit growth was an undesirable shift in the ownership structure of outstanding PIBs. While the non-bank institutions that are the primary targets for PIB issues, show no change in their investment patterns, banks invested heavily in the relatively high-yield instruments. In fact, during the Sep-Mar FY02, the outstanding PIB issues doubled, with banks' holding accounting for a stunning 87 percent of this increase. This prompted the central bank to caution the banks against holding these instruments, as the target group was non-bank institutions, which are able to match their liabilities with PIBs.

In fact, the share of banks' holding of PIBs shifted from a 25.8 percent in June 2001 to a whopping 57.9 percent in March 2002. This shift has two major adverse implications; the risk of potential capital losses if the interest rates increase in future[50], and a threat to the limits on GOP borrowing from the banking system.

5.1 Discounting

During Q3-FY02, the amount of discounting as well as the number of visits to the discount window showed a considerable decline as compared to Q3-FY01 (see **Table 5.1**).

This relative liquidity ease during the period resulted mainly from:(1) the seasonal retirement of credit on account of commodity operations, (2) strong deposit growth in the previous quarter, (3) weak credit demand from the private sector and, (4) forex purchases by SBP. Additionally, State Bank ensured smooth flow of liquidity through its open market operations.

As shown in **Figure 5.1**, overnight rates were mostly subdued, fluctuating within the range of 1 to 4 percent. This is in sharp contrast to the 7.6 percent levels prevailing in Q3-FY01. In fact, the inter-bank market was short for a few days in just three episodes; on the first two occasions this was due to the acceptance of excessive bids in T-bill auctions (a deliberate step to quash the speculative expectations) and in the third episode the crunch was due to the seasonal Eid outflows.

5.2 Open Market Operations

During the quarter SBP conducted six open market operations (see **Table 5.2**). Sequencing of open market operations in terms of injections and absorptions was managed through continual monitoring of available market liquidity, overall direction of monetary policy and prevailing credit situation. This ensured an even

[50] Especially for smaller banks, that cannot bear heavy losses. This happened to certain banks with larger holding of FIBs in FY97, when T-bill rates were rising and actually overtaken the coupon rates on FIBs of all tenors.

Figure 5.1: Discounting and Over Night Rates

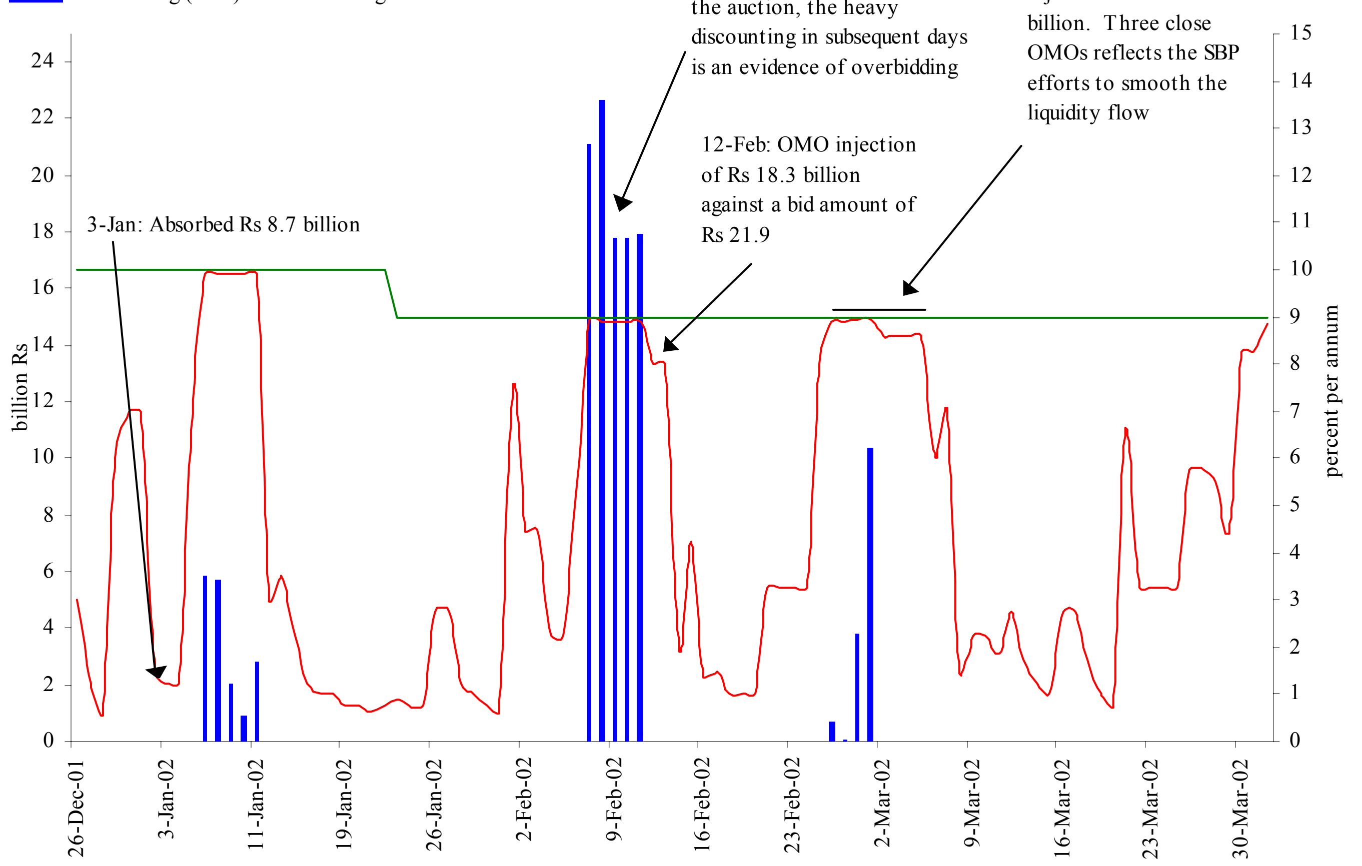


Table 5.1: Activities at Discount Window
billion Rupees

	Visit to the discount window (no. of days)			Total amount of discounting			Average discounting per visit		
	FY00	FY01	FY02	FY00	FY01	FY02	FY00	FY01	FY02
January	10	19	5	106.9	309.4	17.4	10.7	16.3	3.5
February	4	8	8	12.7	16.2	102.0	3.2	2.0	12.7
March	14	9	1	42.6	33.9	10.4	3.0	3.8	10.4
Quarterly	**28**	**36**	**14**	**162.1**	**359.5**	**129.7**	**5.8**	**10.0**	**9.3**

Source: Exchange and Debt Management Department, SBP

flow of liquidity for the most part of the quarter. This implies a lower cash management cost for banks (as liquidity provided through open market operations is cheaper than liquidity provided through the discount window). This effectively complemented the SBP's easy monetary stance.

As shown in **Table 5.3**, during the period there is a net injection of Rs 1.1 billion in contrast to the net absorption of Rs 36.7 billion in the corresponding period last year. The contrasting behavior of OMOs reflects the proactive monetary management in FY02, OMOs were used to lower short-term interest rates (and reduced volatility) in conjunction with the easing monetary stance with a relatively stable Rupee. By contrast, the higher absorptions last year reflect the use of monetary management in order to support the depreciating Rupee.

Table 5.2: Open Market Operations
billion Rupees

Day	Date	Offered	Absorbed	Bid	Injected
Thu	3-Jan-02	16.5	8.7	0.6	0.0
Wed	30-Jan-02	23.1	8.9	0.0	0.0
Tue	12-Feb-02	0.0	0.0	21.9	18.3
Mon	25-Feb-02	6.4	5.2	8.0	1.0
Tue	26-Feb-02	0.0	0.0	7.5	1.8
Thu	28-Feb-02	0.0	0.0	6.9	2.8
Q3-FY02		**45.9**	**22.8**	**44.8**	**23.9**

Source: Exchange and Debt Management Department, SBP

Table 5.3: Open Market Operations
billion Rupees

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

Source: Exchange and Debt Management Department, SBP

5.3 Primary Auctions

As discussed earlier, the declining trend in T-bill rates continued in the first three auctions held during the quarter, accelerating especially after a further one percent point cut in the discount rate prior to the second auction (see **Figure 5.2**). This signaled a further easing of monetary policy. However, the rates stabilized in the last four auctions.

Although, SBP successfully lowered the rates, the actual decline was beyond the desired level due to the self-fulfilling expectations of banks, which feared that interest rates would continue to fall in future auctions. In essence, banks wanted to book assets in current auctions anticipating further interest rate cuts.

This behavior also reflects the excessive monetary growth, fueled primarily by foreign currency inflows on account of increased aid inflows, increased remittances and heavy SBP kerb market purchases.[51]

In first auction of the quarter, banks offered Rs 25.6 billion. Given that the banks had been accessing the SBP discount window prior to the auction, and that the offered amount was more than Rs 19.6 billion in excess of the maturing T-bills (6.0 billion), it is clear that banks were over-bidding aggressively. This is mirrored also in the 16.2 basis point fall in the acceptance cut-off despite the rejection of two-thirds of the bids (see **Figure 5.2**).

The already evident anxiety over interest rate cuts, was further sharpened by the SBP's decision to signal a further reduction in interest rates through its 23rd January cut in the discount rate, ahead of the next auction, held on January 24, 2002. In this, banks offered a staggering Rs 54.8 billion, and despite the SBP decision to accept only a paltry 22.3 percent of the offered amount, the benchmark six-month yield declined by 141 basis points (i.e. 41 basis points more than the discount rate cut).

In the next (February 7) auction, although the amount offered declined considerably, the over-bidding component persisted. Specifically, Rs 25.6 billion were offered against a maturity of only Rs 1.7 billion. Moreover, the lowest priced bid for the six-month paper was at 5.1 percent (137 basis points less than the acceptance cut-off in the previous auction) and the spread between the highest and the lowest priced bid was around 146 basis points.[52] This suggested the persistence of banks' self-fulfilling interest rate expectations.

As a result, to strongly signal its desire for interest rate stability, the central bank accepted all the bids, and further emphasized its intentions by refusing to re-

[51] To put this in perspective, the bank deposit growth during FY02 has been the strongest since FY98.
[52] Usually the spread is lower than 30 basis points.

Figure 5.2: Auction Summary of MTBs

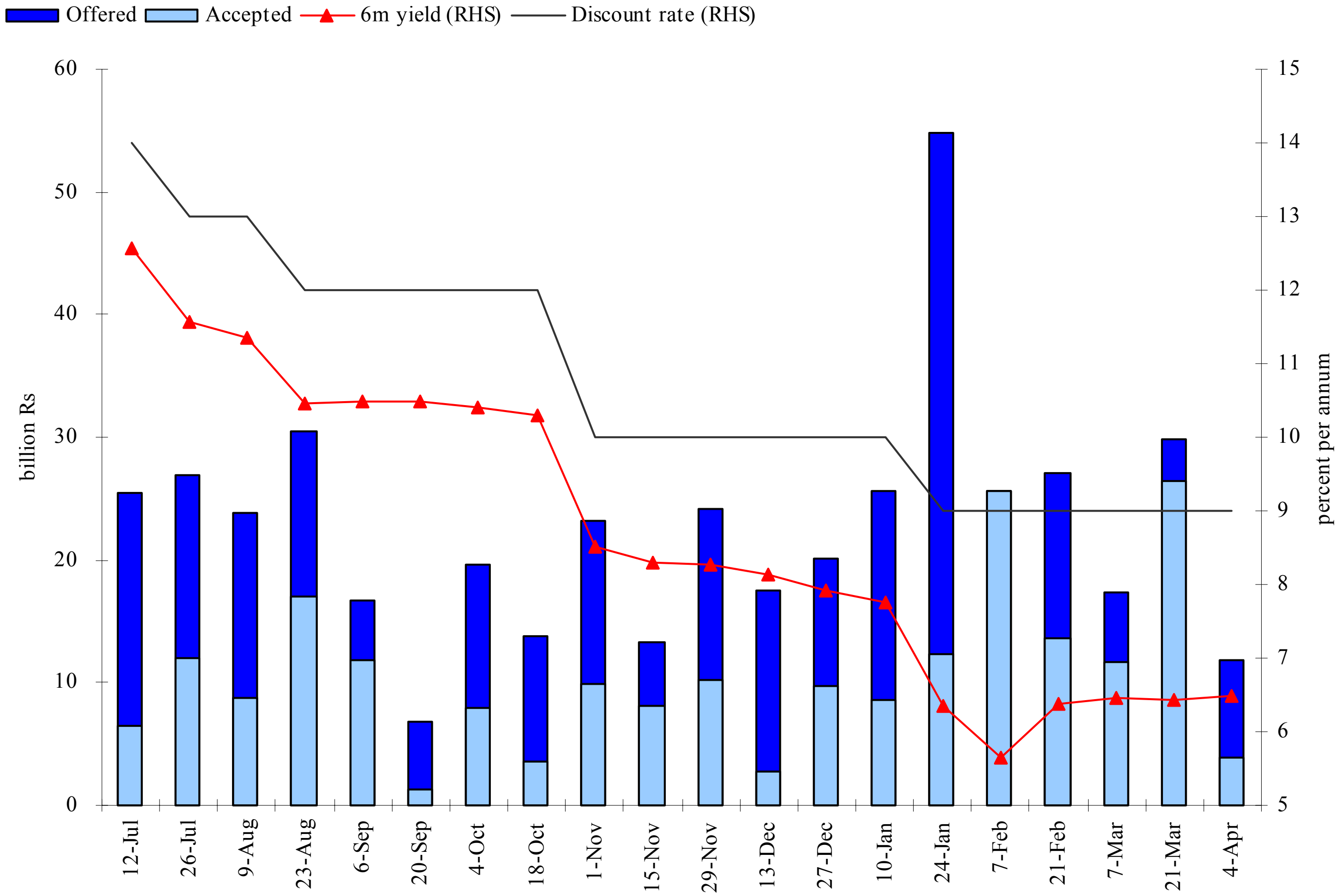
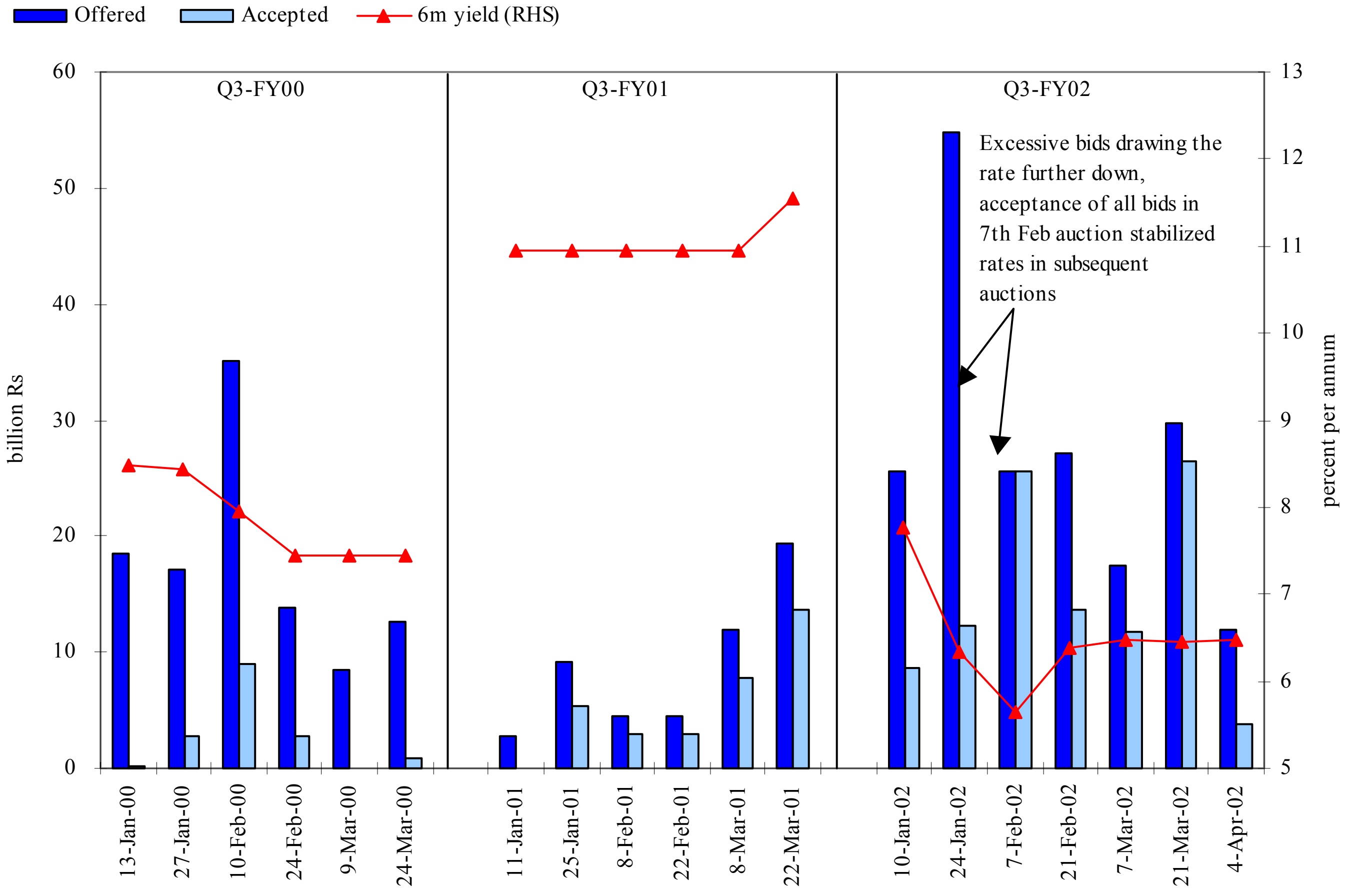


Figure 5.3: Auction Summary of MTBs



liquify the market through an OMO for a period, putting an implicit tax on the market participants who had over-bid.[53]

This strategy effectively quelled the expectations of further interest rate decline, as is evident in the subsequent auctions during the quarter. Not only did the rates stabilize (see **Figure 5.2**), but banks re-focused their auctions bids away from longer tenor (see **Table 5.4**).

Table 5.4: Share of Bid Amount in Different Tenors of T-bills

billion Rupees

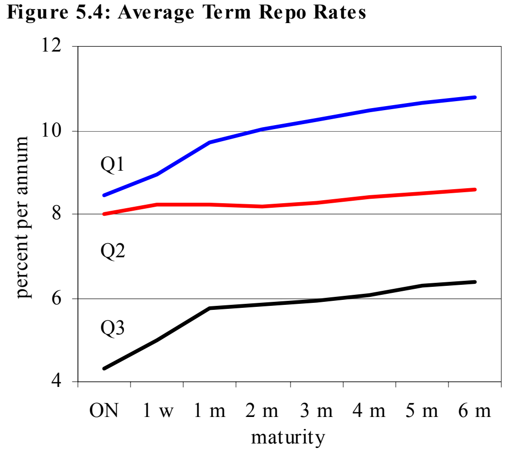
		3-month	6-month	12-month
Up to Feb. 7	Bid amount	12.9	44.7	48.3
	Share of total bids	12.2%	42.2%	45.6%
Post- Feb. 7	Bid amount	21.8	37.8	14.5
	Share of total bids	29.4%	51.0%	19.6%

Source: Exchange and Debt Management Department, SBP

In overall terms, banks offered Rs 180.4 billion against Rs 52.3 billion in the same quarter last year. Out of this offered amount SBP accepted 54.5 percent compared with 62.5 percent during the corresponding period of FY01. The higher bids during Q3-FY02 were due to the usual seasonal inflows of retirement on account of commodity operations plus the speculative over-bidding by banks (see **Figure 5.3**).

Another important issue during the quarter was the lower level of term repo rates, even after adjusting for discount rate cuts (see **Figure 5.4**). These lower repo rates, which were well below interest rates available on government paper, provided a profitable opportunity for banks. Anecdotal evidence suggests that banks were indeed investing in government securities and funding it from the short-term repo market. This is supported by the secondary market activity in PIBs. The number of transactions

Figure 5.4: Average Term Repo Rates



[53] Banks get the return on the basis of their respective bids yield and not at the cut-off /weighted average yield. This means that larger the differential between bid yield and the cut-off yield the lower the return for the bank relative to the return accrued to the other participants of the auction.

in secondary market for PIBs rose from 10.1 per day in June 2001 to 57.6 per day in February 2002, and similarly the trading volume is also very high, even as term repo rates declined.

It must be noted that such transactions increased banks' exposure to interest rate shocks. A sharp unexpected jump in interest rates would precipitate into heavy capital losses due to a mismatch in the maturities of investment and their funding.

While the central bank was primarily facilitating the banks in their cash management and credit extension to private sector by reducing volatility and level of short-term interest rates, and the banks were trying to make speculative gains.

5.3.1 Pakistan Investment Bonds

Since their inception in December 2000, PIBs have remained very attractive for the investors. As in previous quarters, the amount offered exceeded the combined target, for all the auctions held during Q3-FY02, by 235.6 percent. During the quarter three auctions were held, two for 3 and 5-year paper and one for the 10-year paper. Although SBP accepted funds strictly within the announced targets even then the weighted average yield on all papers and in all auctions was comfortably below the announced coupon rates (see **Table 5.5**). The market yields also remained below the coupon rates in days prior to the auctions. The coupon rates on PIBs of all tenors were also reduced by one percentage point, in conformity with the market perceptions and the reduction in the discount rate. Effectively the coupon rates have fallen by 3.5 and 3 percentage points, since inception, on 3-year and 5&10-year bonds, respectively.

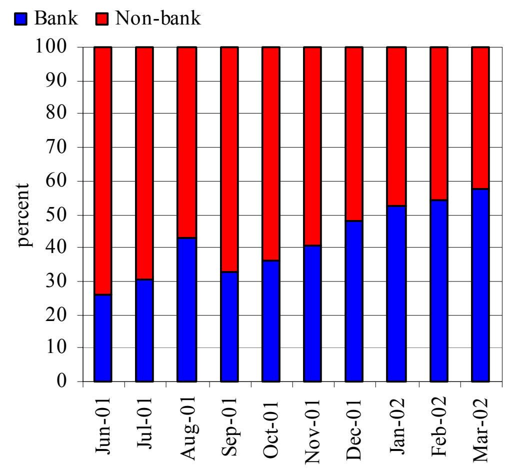
Table 5.5: PIB Auctions – Summary of Results
billion Rupees

Auction	Tenor	Target	Coupon (percent)	Amount offered	Range of price offered/Rs. 100	Amount accepted	W. A. % p.a.	% Accepted of total.
12th Jan 28, 02	3 Years		10.5	17.5	100.6--103.9	4.7	9.16	60.3
	5 Years		11.0	17.7	100.1--103.9	3.1	10.10	39.7
	10 Years		-	-	-	-	-	-
	Total	**8.0**	**-**	**35.2**	**-**	**7.8**	**-**	**100.0**
13th Feb 28, 02	3 Years		-	-	-	-	-	-
	5 Years		-	-	-	-	-	-
	10 Years		11.0	26.1	99.4--103.5	7.7	10.46	-
	Total	**8.0**	**-**	**26.1**	**-**	**7.7**	**-**	**-**
15th Mar 28, 02	3 Years		9.0	7	100.0--100.2	2.6	8.36	33.3
	5 Years		10.0	9.9	99.50--103.0	5.2	9.39	66.7
	10 Years		-	-	-	-	-	
	Total	**8.0**	**-**	**16.9**	**-**	**7.8**	**-**	**100.0**
Grand total		**24.0**	**-**	**78.2**	**-**	**23.3**	**-**	**-**

Source: Exchange and Debt Management Department, SBP

Figure 5.5 reveals the changing pattern of PIB holdings. Bank holdings of PIBs have increased from 25.8 percent in June 2001 to 57.9 percent in March 2002, primarily due to the declining interest rates and the increased term premium.[54]

Figure 5.5: Ownership Pattern of PIBs



The PIB was envisaged as a long-term instrument targeting the non-bank institutions such as pension funds, insurance companies, etc. Moreover, the increased appetite from the banking sector is not a healthy development either from the` banks' risk management perspective or for the GOP's limits on borrowings from the banking system.

It is important to note that bank liabilities are largely short-term in nature and should ideally be matched with short-term investment portfolio. Large long-term paper holdings are a potential risk for banks in case the coupon rates in future increases and/or the term premium diminishes. The problem is compounded if the long-term holdings are funded through a potentially volatile short-term market as indicated earlier.

From the government's perspective, PIB is a component of non-bank borrowings. Funds generated from these would give space on government borrowing from the banking system and also are a major source of long term funds for development expenditures (that often have long gestations periods). Excessive bank holdings of PIB will tend to undermine the non-bank sources besides breaching the borrowing limits.

In fact, State Bank has used moral suasion to try to minimize banks' PIB holdings and if it fails, other more stringent measure may be required.

---

[54] In the beginning of the year the term premium (respective PIB coupon rates – six month T-bill yield) was –37, 12 and 112 basis points for 3, 5,and 10-year bond, respectively. However, on March end, the respective term premium was 255, 355 and 455 basis points.

6. Banking

So far, FY02 has witnessed considerable variation in deposit growth in each of the three quarters. While the Q1 deposit growth ended marginally (Rs 8.6 billion) in the red, Q2 saw a spectacular trend reversal, recording the highest post-1998 quarterly deposit growth of Rs 72.2 billion.[55] The next quarter (Q3) differed again from both the preceding quarters, recording a growth of Rs 10.0 billion (see **Table 6.1**).[56]

Table 6.1: Total Deposits of Banks (Flows)

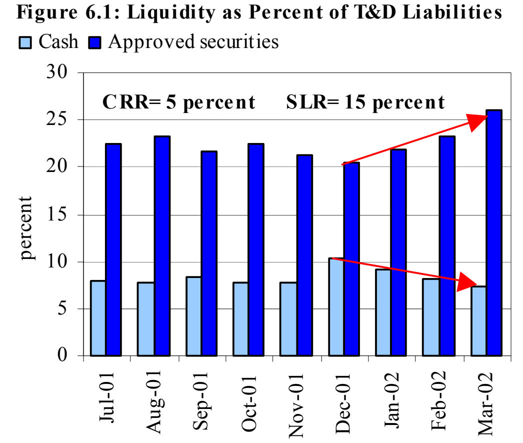
billion Rupees

	Q2		Q3		Jul-Mar	
	FY01	FY02	FY01	FY02	FY01	FY02
Nationalized	-20.6	36.4	6.0	0.9	-3.0	39.0
Privatized	5.0	2.4	1.6	5.2	2.2	3.5
Specialized	-1.6	2.4	-0.4	-0.7	-0.8	-0.1
Private	9.5	26.5	5.9	28.5	28.2	55.0
Foreign	6.2	4.5	10.4	-10.7	19.0	-10.5
All	**-1.5**	**72.2**	**23.4**	**23.2**	**45.5**	**86.8**
Adjusted for Faysal bank						
Private			5.9	15.2	28.2	41.7
All			**23.4**	**10.0**	**45.5**	**73.8**

Source: Banking Supervision Department

This extraordinary increase in the deposit base during Q2-FY02 also laid the base for an exceptionally liquid inter-bank market in Q3-FY02 as analyzed in **Section 4.1** above. Banks were, therefore, already looking to park excess cash holdings in government paper, and this turned into a virtual stampede when the SBP signaled yet another round of monetary easing through a one percentage point reduction in the discount rate (see **Figure 5.2 & 6.1**).[57]

Figure 6.1: Liquidity as Percent of T&D Liabilities



[55] This performance is more impressive considering that Rupee deposits grew by Rs 88 billion, and that the foreign currency deposits, in Rupee terms, fell by Rs 16.2 billion during the period.

[56] The actual deposit growth for the banking system was higher at Rs 23.2 billion. However, Rs 13.3 billion represented the addition to banking sector deposits through the merger of Al Faysal Investment Bank with Faysal Commercial Bank Ltd. We have netted-off this amount for the purposes of this discussion, to maintain a comparable profile over the quarters.

[57] W.e.f. January 23, 2002, discount rate has reduced to 9 percent per annum. This is the lowest ever discount rate.

Specifically, post-September 11, the country has consistently posted monthly current account surpluses, and taking advantage of this, SBP purchased a *net* US$ 1.6 billion from the inter-bank market, thereby converting the US$ liquidity into Rupee liquidity.[58]

Moreover, anecdotal evidence suggests that the demand for traveler's checks (TCs), which can be used conveniently as liquid bearer instruments, is rising sharply. The float available to banks on these funds, which do not attract reserve requirements, could provide significant amounts of cheap liquidity to the banking sector.[59]

Q3-FY02 was also very significant in the sense that it finally heralded a much-awaited fall in lending rates, especially by nationalized and privatized banks. Higher *gross* disbursements coupled with low *net* credit growth, had already been evident from Q2-FY02, suggest the likelihood of a re-pricing of existing loans in response to earlier interest rate reductions initiated by the SBP. The fact that phenomenon continued (and gathered pace) into Q3-FY02, to an extent, refute claims that the interest rates cuts enacted late into the credit cycle would not help borrowers that had already met their credit needs. Moreover, some large banks explicitly announced large reductions in their 'headline' lending rates.

6.1 Deposit Mobilization

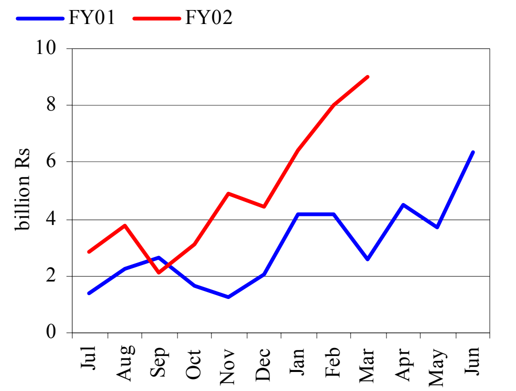
The extraordinary growth in the Rupee deposit base of the banking system during Q2-FY02 and the possible explanations were presented in the *Second Quarterly Report of SBP*. Although, most of the factors responsible for this massive increase were also present during Q3-FY02, banks failed to capture deposits commensurately. Reasons for this could be: (1) a declining net credit to the private sector and (2) sharply increased mobilization under the National Saving Schemes (NSS).

During Q2-FY02 net credit to the private sector *rose* by Rs 46.7 billion, but then in Q3-FY02 it *fell* by Rs 4.6 billion. Since the change in net credit

[58] The SBP purchases help in *current account* improvement. Also, net purchases either from the formal or the informal markets add to the Rupee liquidity in the economy. The interbank US$ purchases add to inter-bank Rupee liquidity directly, while the kerb purchases lead to higher banking system liquidity only to the extent that the Rupee counter part is deposited there.
[59] In fact, some of the banks not only charge no fee for issuing TCs, but also pay interest on the instruments. Data from the whole banking sector is not yet available, however, two of the five largest banks reported an average daily float of Rs 6.5 billion.

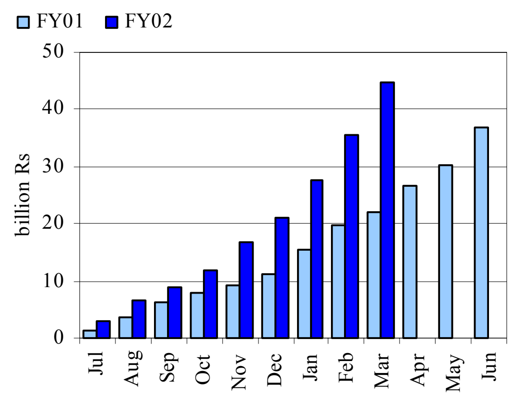
correspondingly affects deposits growth through the multiplier effect, the reversal in net credit would lower deposit growth.

Figure 6.2: NSS-Monthly Net Mobilization



Interest in the NSS instruments has grown steadily in direct proportion to the easing of the SBP's monetary posture, and in inverse proportion to the strengthening Rupee. Since July 2001, the return on NSS instruments has either been left unchanged or cut by one percent point (on Defence Saving Certificates), while the benchmark T-bills yield fall by more than 600 basis points.

Figure 6.3: NSS-Cumulative Net Mobilization



A ban on institutional investment in NSS instruments[60] weakens the linkage of these non-tradable long-term instruments with the government's tradable long-term debt (the yields which are determined by the market). Nonetheless, the large decline in benchmark interest rate inevitably did influence investment decisions.

This influence is compounded by the lower expected returns on foreign currency holdings through declining yields on FCAs, and an appreciating Rupee. Over the 1990s foreign currency holdings became a favored savings avenue due to a subsidized forward cover rate (until 1998) and substantial average depreciation of

[60] These are not tradable and their yields are only weakly affected by changes in the prevailing market yields through a formula-based six-monthly re-pricing of coupons on *fresh* issues.

the Rupee.[61] However, the post-September 11 improvements in Pakistan's external account, and the upward pressure on the Rupee led to the liquidation of substantial foreign currency holdings, especially in Q2-FY02.

The combination of both factors probably underpins the rising monthly net investments in the NSS for October 2001 and beyond (see **Figure 6.2**). In fact, Q3-FY02 net mobilization under NSS was Rs 23.4 billion against the Rs 12.4 billion recorded in the previous quarter and Rs 10.9 billion during Q3-FY01 (see **Figure 6.3**).

Given that the Q3 growth in NSS investments outstrips the growth in banking sector deposits by Rs 10 billion during the same period, a strong case can be made that the inadequate linkage between the NSS yields and those on market based instruments must be corrected to strengthen the banking system and to protect the role of the PIBs as a long-term interest benchmark.

6.1.1 Adjusted Deposits

On face value, it appears that the deposit mobilization by the banking industry during Q3-FY02 replicates that in the same period last year (see **Table 6.2**). However, deposit flows during the current quarter need to be adjusted for the merger of Al-Faysal Investment Bank with Faysal Commercial Banks Limited w.e.f. 1st January 2002 that added deposits of Rs 13.3 billion deposits to the banking sector total.

Adjusted for this one-time effect, the net deposit mobilization by banks during Q3-FY02 halves (almost) to only Rs 10.0 billion compared to Rs 23.4 billion in the same quarter last year. [62]

This subdued performance was primarily because of FCAs. Adjusting for the merger, bank's Rupee value of aggregate foreign currency deposits show a decline of Rs 10.8 billion during the quarter under study against a nominal increase in the same quarter a year earlier (see **Table 6.2**).[63] Excluding FCAs, the adjusted deposits growth is a more creditable Rs 20.8 billion during Q3-FY02 against Rs 21.6 billion in the same period last year.[64]

---

[61] Through the 1990's the depreciation of the Rupee against the US dollar averaged over 12 percent per annum.
[62] As the separate values of deposits of Faysal commercial bank and Al-Faysal Investment bank as on 31st March 2002 were not available, data of 31st December 2001 is used to get the adjusted figures of quarterly flows.
[63] The decline represents an outflow of the foreign currency deposits (US$ 250.5 million).
[64] Out of Rs 9.9 billion deposits of Al-Fayasal Investment bank, Rs 2.2 billion were local currency and Rs 7.7 billion were foreign currency denominated.

Another intriguing facet of the quarterly deposit performance is the switch in the traditional roles of the nationalized and private banks. Contrary to intuition, practically all of the Rupee deposits growth comes from private banks, while the foreign currency deposits growth has been booked entirely by the nationalized banks.

Table 6.2: Deposit Flows During Q3

billion Rupees

	LCD		FCA		Total	
	FY01	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**
Nationalized	4.6	-5.7	1.4	6.6	6.0	0.9
Privatized	0.1	6.4	1.5	-1.2	1.6	5.2
Specialized	-0.4	-0.7	0.0	0.0	-0.4	-0.7
Private	4.3	23.7	1.6	4.7	5.9	28.5
Foreign	13.0	-0.8	-2.6	-9.8	10.4	-10.7
All	**21.6**	**22.8**	**1.8**	**0.4**	**23.4**	**23.2**
Adjusted for Faysal bank						
Private	-	21.7	-	-6.5	-	15.2
All	**-**	**20.8**	**-**	**-10.8**	**-**	**10.0**

Source: Banking Supervision Department

The latter, while surprising, may be explainable by effort made by these banks, in response to government appeals, to increase remittances through official channels.[65] The success of these banks in improving their infrastructure for the timely transmission of remittances would be expected to help bolster a relative improvement in foreign currency deposits growth as well.

The deposit growth for private banks is more curious, especially in light of the declining trend in Rupee interest rates, and the excessive liquidity in the inter-bank market. These factors would have discouraged the raising of deposits by competing on deposit rates. It is interesting to note that some of the relatively small banks in this group that are showing higher deposit mobilization are also very aggressive in disbursement under the export finance scheme.

6.2 Spread between Lending and Deposit Rates

Lending rate declined further in Q3-FY02. The weighted average lending rates on new disbursements by the banking sector during March 2002 fell to 11.9 percent, from 13.1 percent in January 2002, marking a cumulative decrease of 200 basis points since the beginning of FY02 (see **Figure 6.4**). This fall coincides with period of excess liquidity in the inter-bank market.

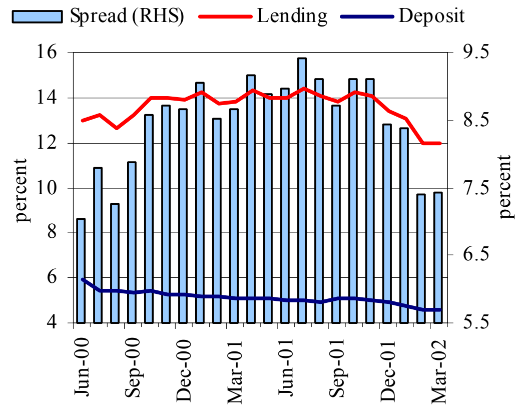
The rate offered on the export finance scheme was earlier linked to the quarterly weighted average yield on 6-month T-bills. Since December 2001, it is now revised on a monthly basis, declining yield on T-bills resulted in downward revision of EFS rates by 200 basis points during Q3-FY02. It is important to note

[65] Only that part of foreign currency inflows are considered as remittances, which are either being withdrawn (in Rupee) or deposited in the Rupee accounts. Part of these flows may go in foreign currency accounts and these are taken as part of FCAs and not remittances.

that 34.8 percent of total credit disbursed during the quarter was under the EFS; decrease in the EFS rates played a major role in pulling down the aggregate weighted average lending rate of banks.

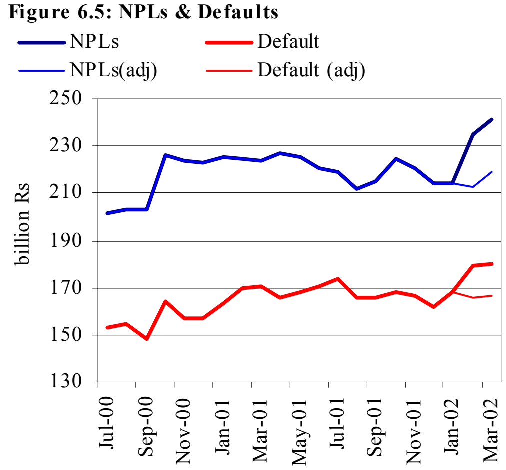
Interestingly, Q3 deposit rates have fallen only marginally by 41 basis points, which account for practically all of the fall in FY02. It is important to note that decrease in the *weighted average* deposits rates was probably driven by steeper falls in yields of marginal deposits.

Figure 6.4: W. A. Deposit & Lending Rates



In addition to this, the decline in the tax rate from 58 percent to 50 percent w.e.f. July 01, 2002 and improvement on the front of non-performing loans (especially for Nationalized banks) provide the opportunity for banks to pass on some relief to their client by operating at lower spreads[66].

Figure 6.5: NPLs & Defaults



6.3 Non-performing and Defaulted Loans

Data on the non-performing loan and advances depicts a spike in February 2002 (see **Figure 6.5**). However, this is more because of reclassification of data rather than real deterioration in the loan portfolio of the banking industry during the Q3-FY02. More specifically, non-performing loans of NDFC have been shown with that of National bank of Pakistan in the data of

[66] During first nine month of FY02, NPLs and default of banking sector declined by Rs 1.7 and Rs 3.8 billion respectively. For Nationalized banks decline were Rs 11.6 and Rs 10.4 billion in NPLs and default respectively.

February 2002.[67] This alone resulted in Rs 22.3 and Rs 13.7 billion increase respectively in NPLs and defaulted loans of banking industry. **Figure 6.5** also shows the adjusted series for both NPLs and default for NDFC data, whereby NPLs and default of the banking sector increase slightly during this quarter.

7. Prices[68]

During Jul-Mar FY02, the annual average rate of inflation was lower in terms of all three indices (i.e., CPI, WPI, and SPI) as compared to the same period last year (see **Table 7.1**). This was largely the result of improved agriculture output, continued appreciation of the Rupee, as well as a decline in unit values of some imported items. Although, the monetary growth is significantly higher during this period, its impact is yet to be felt on commodity prices.

Interestingly, the annualized inflation rate based on CPI and SPI during Jul-Mar FY02 is lower than the marginal increase during March 2002 (and the third quarter of the current fiscal year). This indicates the possibility of upward pressures on these indices during coming months due to the carryover effect of the increase in the prices of POL as well as gradual scaling down of subsidies on public utilities.

The ease in inflationary pressures during Jul-Mar FY02 is more notable for WPI. Also, the incremental rise in WPI is less than the annualized increase in three quarters. This was largely due to falling prices of raw materials (especially the raw cotton).

7.1 CPI

7.1.1 Food, beverages & tobacco

The food group witnessed a price increase of 2.8 percent during Q3-FY02 compared with 4.0 percent during the same period last year. The lower increase in the prices of *food, beverages & tobacco* was due to the high-base effect (some of the items that observed higher prices last year, either showed substantial

---

[67] It is important to note that assets and liabilities of the NDFC added in the banking sector as on 30th November 2001.

[68] The change in the base year for CPI from 1990-91 to 2000-01 has raised certain issues for comparative analysis. More importantly, CPI at new base is available only from 2000-01, and even in this base year, monthly CPI is assumed constant at 100 to arrive at an annual average of 100 for the whole year. Although, this practice renders absolute values of the new index incomparable with the old series, the problem is largely addressed when we instead compare percentage changes. In order to understand the difference between the two series, see **Section 7.4**.

declines or experienced stability during Q3-FY02); improved domestic production; and falling imports prices due to appreciating Rupee/US Dollar parity.

Table 7.1: Inflation Trends
percent

Indices[1]	Cumulative				Annualized Inflation					
	Jul-Mar		Jan-Mar		Mar		Jan-Mar		Jul-Mar	
	FY01	FY02	FY01	FY02	FY01	FY02	FY01	FY02	FY01	FY02
CPI	**2.6**	**4.7**	**0.2**	**1.8**	**4.2**	**4.7**	**4.5**	**3.6**	**4.8**	**3.0**
Food	*1.8*	*4.5*	*0.2*	*2.6*	*3.8*	*4.5*	*4.0*	*2.8*	*4.2*	*2.1*
Non-food	*1.8*	*4.8*	*0.3*	*1.1*	*4.6*	*4.8*	*4.9*	*4.3*	*5.4*	*3.8*
WPI	**4.1**	**1.1**	**-1.4**	**1.6**	**5.4**	**1.5**	**7.5**	**0.4**	**6.7**	**2.1**
Food	*2.2*	*4.8*	*-0.1*	*1.3*	*3.0*	*2.8*	*3.7*	*2.3*	*3.5*	*1.8*
Non-food	*5.8*	*-1.8*	*-2.4*	*1.9*	*7.5*	*0.5*	*10.8*	*-1.2*	*9.5*	*2.5*
SPI	**2.2**	**5.7**	**-0.1**	**2.0**	**5.6**	**5.7**	**5.9**	**4.8**	**5.4**	**3.7**

Note: Cumulative changes are based on end-period indices, whereas for annualized changes are calculated using indices based on period average.

[1] CPI and SPI figures for FY02 are based on index with new base of 2000-01, whereas figures for FY01 have a base of 1990-91. WPI figures are with base 1990-91.

Source: Federal Bureau of Statistics

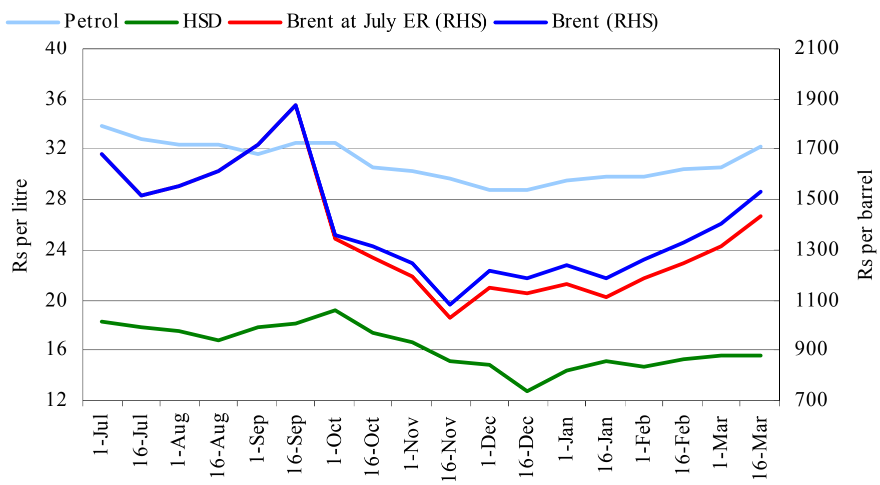
In particular, wheat prices remained stable due to a comfortable supply from last year's carryover stocks and new crop arrivals. Similarly, large inventories of sugar kept the retail price in the range of Rs 20-23 per Kg compared with Rs 25-27 last year. In the case of tea, relative stability in world prices kept the retail prices in the lower band.

On the other hand, prices of vegetable ghee/cooking oil, rice, gram, and tomato etc., recorded an increase during Q3-FY02. Vegetable ghee prices rose following the withdrawal of concessional pricing schemes announced in Ramadan, and this trend was reinforced by higher prices of palm oil in the international market. Anecdotal evidence also suggests that a large quantity of cooking oil and ghee is being exported to Afghanistan in order to capitalize on price differential. In the case of rice, a marginal increase in prices (particularly for basmati rice) was mainly on account of the shortfall recorded in the domestic production.

7.1.2 Non-food group

The prices of *non-food* group rose by 4.3 percent during Q3-FY02 compared with 4.9 percent recorded in the comparable period last year as the *non-food* group is slightly larger in terms of weight (55.87 percent), it contributed around two-thirds of the total CPI inflation. Since, domestic prices of POL products are now linked to the international prices, the initial reaction to the OPEC's decision to cut crude oil production by 1.5 million barrels on daily basis, growing world demand as economies are picking up, and tension in the Middle East are causing a surge in global oil prices. This in turn has pulled up the domestic prices of certain POL products (see **Figure 7.1**). Accordingly, prices of diesel and petrol recorded 21.9 and 12.0 percent increase respectively during Q3-FY02 following fortnightly review by Oil Companies Advisory Committee (OCAC).

Figure 7.1: Brent Crude, Petrol & Diesel Prices



1. January 1 (Petrol: ↑2.96%, HSD: ↑12.87%)
2. January 16 (Petrol: ↑0.68%, HSD: ↑4.42%)
3. February 1 (HSD: ↓2.45%)
4. February 16 (Petrol: ↑1.95%, HSD: ↑3.66%)
5. March 1 (Petrol: ↑0.46%, HSD: ↑2.29%)
6. March 16 (Petrol: ↑5.51%)

Source: OCAC/Energy Information Admininstration

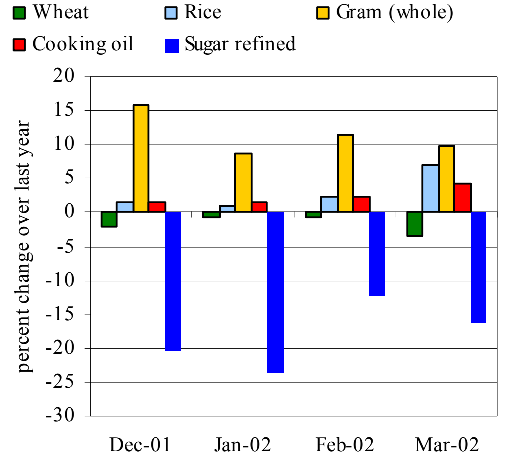
The increase in *apparel, textile & footwear* by 3.4 percent was on account of the high demand both due to the seasonal factors (i.e., Eid-ul-Azha) and improvements in export orders. Recent trade data indicates that there were more orders from Europe and a slight pick up in import demand from the USA. The price impact of the higher export demand was compounded by the decline in domestic production of leather.

7.2 WPI

7.2.1 Food group

As discussed earlier, the ease in inflationary pressures is more significant for WPI. In terms of sub-component, the *food* group recorded lower increases of 2.3 percent compared with 3.7 percent observed in the same period last year. Within the *food group*, the prices of wheat, wheat flour, sugar and gur were lower in the wholesale market mainly because of the large carryover stocks as well as fresh arrivals. On the contrary, items such as, rice, vegetable ghee, gram, potato, onion and tomato recorded an increase in prices (see **Figure 7.2**).

Figure 7.2: Wholesale Price of Major Food Items



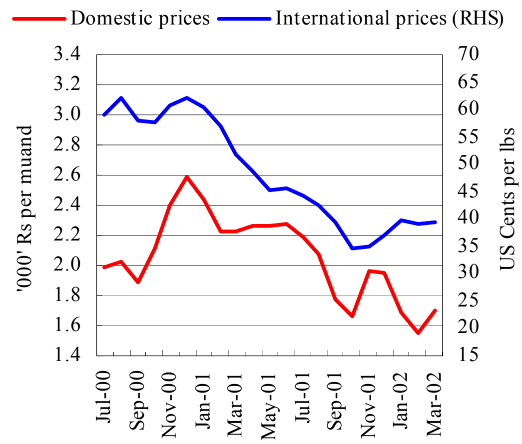
The developments in the Malaysian palm oil significantly influence wholesale prices of cooking oil and vegetable ghee in the domestic market. Recently, the Malaysian palm oil market has witnessed higher prices because of low stocks, falling production and active buying by certain countries. In view of these external pressures, domestic prices are expected to increase further in the coming months as stocks run down, thereby raising the need for imports.

7.2.2 Non-food group

This sub-group is showing a *deflation* of 1.2 percent during Q3-FY02 compared to 10.8 percent increase during same period last year. A considerable deceleration was recorded in the prices of *raw materials*, particularly in raw cotton prices. The realization of a good cotton crop this year, accumulating stock at gins, and higher estimates for the new crop further dampened price prospects in the domestic market. Moreover, the decline in yarn exports and falling unit value of raw cotton owing to depressed demand in world cotton market further influenced market sentiments (see **Figure 7.3**).

Since the world cotton production exceeded consumption by 1.3 million tones, the accumulated stock of cotton led to subdued cotton prices in the global market. The "B" index averaged at 39.4 cents per pound in March, which is 23.8 percent lower than the corresponding month of last year.[69] The impact of the continued recession in Asia, which is the biggest cotton yarn market, cannot be ruled out. Although the cotton prices have shown an upward movement in March 2002, this does not seem sustainable as the behavior of cotton buyers is largely influenced by the supply position.

Figure 7.3: Domestic & International Lint Prices



The cottonseed oil, however, observed pressures on prices due to ready demand from oil manufactures. Similarly, oil cakes also fetched higher prices because of the strong cottonseed market.

On the other hand, pig iron prices remained stable. While reduction in tariffs, new incentives to ship-breaking industry, and subsequent adjustment in prices by Steel Mills, have placed prices of steel products in the lower band, the demand for the commodity is yet to pick up momentum due to the slow pace of construction activities.

Manufactures index also declined by 0.1 percent during Q3-FY02. Since this largely depends on the prices of *raw materials*, their falling prices have contained the growth of *manufactures* prices. In addition, export prices of most of the manufactures (particularly cotton yarn, cotton textiles and synthetic textiles etc.) are showing a downward trend, resulting in larger supplies in the domestic market. On the other hand, fertilizer prices recorded an increase due to imposition of sales tax and the recent decline in its domestic production following closer of one of the fertilizer plants.

---

[69] The "B" Index is a representative of the offering prices in the international raw cotton market. It is an average of the cheapest 3 quotations from a selection of (at present numbering eight) of the principal upland cotton i.e. of short staple less than 25 mm, traded internationally.

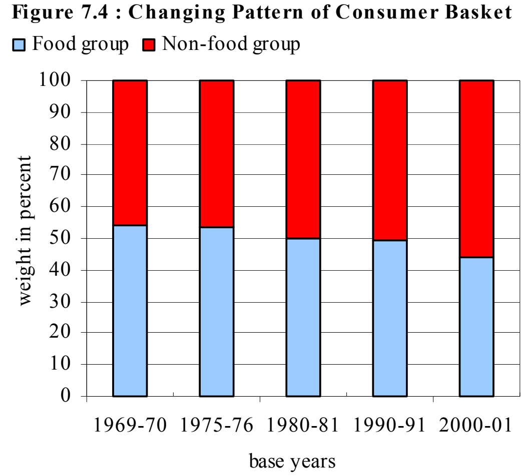
7.3 SPI

Sensitive Price Indicator (SPI) is also computed with revised base 2000-01, covering 35 cities with expanded basket of 51 items. Sensitive Price Indicator (SPI) registered an increase of 4.8 percent during Q3-FY02 compared with 5.9 percent increases last year. It is mainly attributed to the seasonal factors, high demand on the eve of Eid-ul-Azha and short fall in the production of some of the minor crops.

7.4 Consumer Price Index at the 2000-01 Base

The Consumer Price Index (CPI) is the most widely used measure of inflation. However, its effectiveness in terms of capturing the changes in expenditure and consumption patterns and structural shifts in the economy largely depends upon the coverage, the weights attached to various items and periodical shifting of the base in accordance with changes in the economy.

Figure 7.4 : Changing Pattern of Consumer Basket



In Pakistan, Federal Bureau of Statistics (FBS) is responsible for calculating monthly CPI, which is based on individual market prices of a fixed basket of goods and services both for food and non-food items. In March 1994, the base year for CPI was revised from 1980-81 to 1990-91. Since then, the economy has undergone some major structural shifts.

In the year 2000-01, FBS conducted a Family Budget Survey that covers all categories of consumers drawn from 52 cities with a sample of 40,806 households. The consumption pattern based on the new survey is shown in **Figure 7.4**. On the basis of this survey, a new CPI series was generated, which became effective from July 1, 2001. The profile of the CPI coverage in various base years is shown in **Table 7.2**. The revised index covers all urban areas and comprises of 10 commodity groups with 375 consumer items.

Table 7.2: CPI Coverage in Various Base Years

Base Year	Number of items in CPI basket	Number of commodity groups	Number of cities	Number of markets	Number of quotations	Percent of urban population	Occupation	Income groups
1948-49		4	4				Industrial	Up to Rs 68-130
1955-56		4	4				Industrial Clerical	1.Upto Rs 105-130 2.Rs 218-332
1969-70	202	4	12	28	22,624	57.0	Industrial Commercial Government	1.Upto Rs 300 2.Rs 301-500 3.Rs 501-1000 4.Above Rs 1000
1975-76	357	4	12	28	39,984	57.0	Industrial Commercial Government	1.Upto Rs 600 2.Rs 601-1500 3.Rs 1501-2500 4. Above Rs 2500
1980-81	464	9	25	65	116,928	63.0	Industrial Commercial Government	1.Upto Rs 1000 2.Rs 1001-2500 3.Rs 2501-4500 4. Above Rs 4500
1990-91	460	9	25	61	112,240	63.1	Industrial Commercial Government Self-employer & employed	1.Upto Rs 1500 2.Rs 1501-4000 3.Rs 4001-7000 4.Rs 7001-10000 5.Above Rs10000
2000-01	375	10	35	71	106,500	65.0	All categories combined	1.Upto Rs 3000 2.Rs 3001-5000 3.Rs 5001-12000 4.Above Rs 12000

Source: Federal Bureau of Statistics

More importantly, the earlier sub-index of recreation, entertainment & education has been split into two different indices: (1) recreation & entertainment; and (2) education. Furthermore, out of 460 items in previous basket, 141 have been dropped, and 56 new items were added. The number of cities have also been increased from 25 to 35, which are further divided into four groups: (1) large cities having population of half million and above; (2) medium cities having population in the range 100,000-500,000; (3) small cities with population range from 50,000 to 100,000; and (4) additional small cities with population of less than 50,000 (one from each province).

The revised group weights in the new CPI are given in **Table 7.3**. It is evident that weight of *fuel and lighting* group has increased from 6.1 to 8.0. This implies that any increase in the price of POL products would push up inflation rate by a much greater magnitude. Similarly, the increase in the weight of transport and communication not only depicts the increasing transportation cost but also reflects growing mobility by the people as well as more usage of internet facilities etc.

Table 7.3: Commodity Group Weights

	Base year		Absolute	Number of items		
	1990-91=100	2000-01=100	change	dropped	added	total
Food Group	**49.35**	**44.13**	-5.2	44	5	124
Non-food group	**50.65**	**55.87**	5.2	97	51	251
Apparel, textile & footwear	7.56	6.34	-1.2	29	2	42
House rent	18.98	21.69	2.7	-	-	1
Fuel & lighting	6.13	8.01	1.9	2	1	16
Household, furniture & equipment	2.00	2.57	0.6	14	5	44
Transport & communication	5.08	5.56	0.5	6	6	43
Recreation & entertainment	1.12	0.69	-0.4	9	6	16
Education	2.00	2.79	0.8	8	6	24
Cleaning, laundry & personal appear	5.40	6.01	0.6	16	7	36
Medicines/medicare	2.38	2.21	-0.2	13	18	29

Source: Federal Bureau of Statistics

Since the indices developed earlier for categories of employees did not show any significant variation over time, the recent family budget survey does not include breakdown in terms of occupation categories. However, the structure of income groups has been changed significantly (see **Table 7.2**). In addition, the new basket includes seasonal items during off-season when their prices normally go up. This is in contrast to past practice when such items were excluded in off-season.

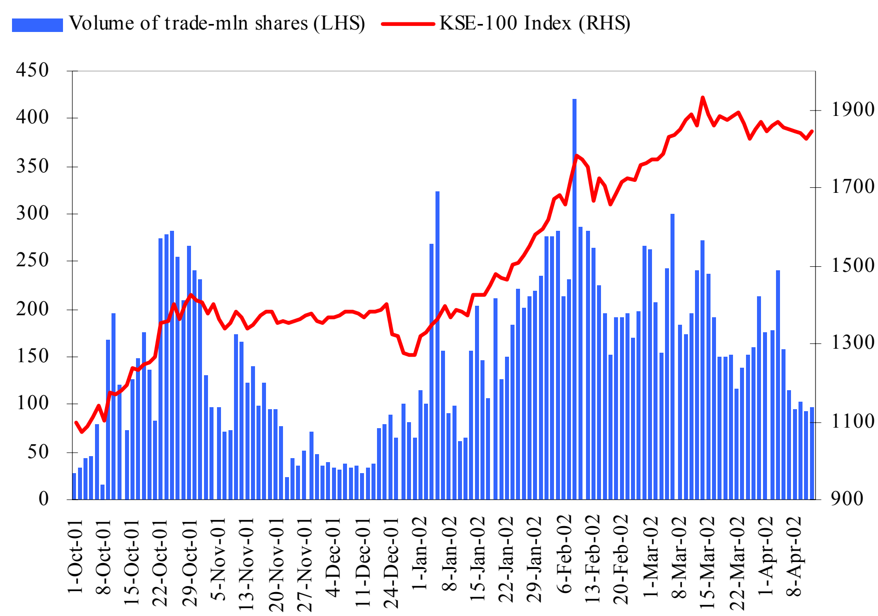
8. Capital Markets

The December 13, 2002 attack on the Indian Parliament and the ensuing border tensions had overshadowed the positive economic developments during FY02, with the KSE-100 index surrendering 130.95 points to close at the quarter on a negative note, at 1273.06. But when international diplomacy alleviated the immediate threat, market attention returned to the improvement in economic fundamentals and the emergence of Pakistan as a key United States ally, driving a strong broad-based rally in the first quarter of calendar year 2002.

The market's exceptional gains of January 2002, when the index gained 347 points (27.3 percent) were underlined by its ranking as the top performing emerging market for the month by MSCI[70] (see **Figure 8.1**). Unfortunately, the market momentum was broken in mid-February by the KSE circular prudently reminding members of the stringent minimum capital adequacy rules introduced recently.

As a result, the index fell by 119 points in three trading days before recovering on the back of strong performance reported by Hubco, MCB and Askari Bank. Thereafter, sentiment on oil marketing company (OMCs) stocks dominated the market, taking the market to its Q3-FY02 peak of 1930.46 on March 14, 2000 as the government announced a much awaited increase in their margins (this was also taken by the market as a prelude to the privatization of PSO). However, the KSE-100 index was unable to remain above 1900 level and consolidated around the 1850 levels.

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



[70] The MSCI Pakistan Index was up 31.24 percent for the month. The next best performing market was Indonesia with a 22 percent rise.

It finally closed the Q2-FY02 at 1868.12 having gained a net 46.7 percent during the current quarter (see **Table 8.1** for summary statistics).

The third quarter witnessed an increase in foreign portfolio investment in the stock exchange (see **Table 8.2**, **Figure 8.2**). During the first two months of this quarter, market has seen an inflow of US$ 50 million against an outflow of US$ 32 million during Q2-FY02.

This increase in foreign portfolio investment is in-line with the rise in KSE-100 index. This appears to reflect greater confidence of foreign fund managers in the Pakistani market's prospects due to its positive economic outlook, hefty reserves and stable exchange rate.

During FY02, the Karachi Stock Exchange has implemented several structural developments including the complete implementation of the T+3 system, rationalization of risk management measures (deposit requirements, capital adequacy & up tick/downtick fluctuation bands), changes in the carryover market and more recently the launching of the new trading system.

On regulation front, Securities

Table 8.1: Highlights of KSE (as on March 29, 2002)

Value and shares in billion

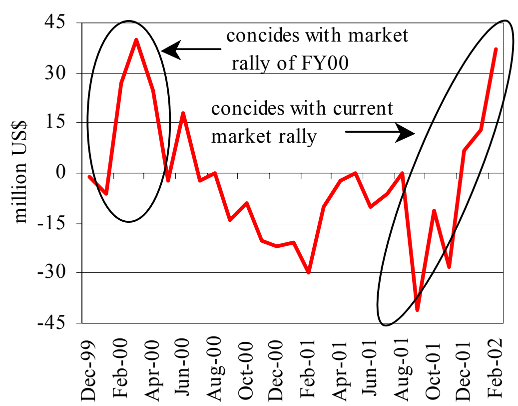
Listed companies at KSE	757
KSE-100 index	1868.11
Change since June 2001 (percent)	36.71
Change since last quarter (percent)	46.74
Year on year (percent)	41.05
Listed Capital at KSE	235.68
Market Capitalization	427.95
Shares traded at KSE during the quarter	11.86

Table 8.2: Foreign Portfolio Investment

million US$

Months	FY01	FY02
Jul	-2	-6
Aug	0	0
Sep	-14	-41
Oct	-9	-11
Nov	-20	-28
Dec	-22	7
Jan	-21	13
Feb	-30	37
Mar	-10	5

Figure 8.2: Portfolio Investment in Stock Market



and Exchange Commission of Pakistan, for the purpose of establishing a framework of good corporate governance whereby a listed company is managed in compliance with best practices, issued the "Code of Corporate Governance" on March 28, 2002. Accordingly, all stock exchanges included the code of conduct in their respective listing requirements.

This comprehensive law aims to enhance investor confidence by increasing transparency in the business practices of listed companies. It envelopes diverse areas of corporate governance including guidelines on the constitution of the Board of Directors of the company; a framework of internal control; guidelines on financial and accounting responsibilities of directors; directors' report; disclosure regarding pattern of shareholding; and scope of internal audit, etc.

Table 8.3: 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 LEASE	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%
UNION LEASING	9-Apr-02	Apr-05	250	SBP Discount Rate+2.25%, Floor 14.50%, Cap 16.75%

*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.

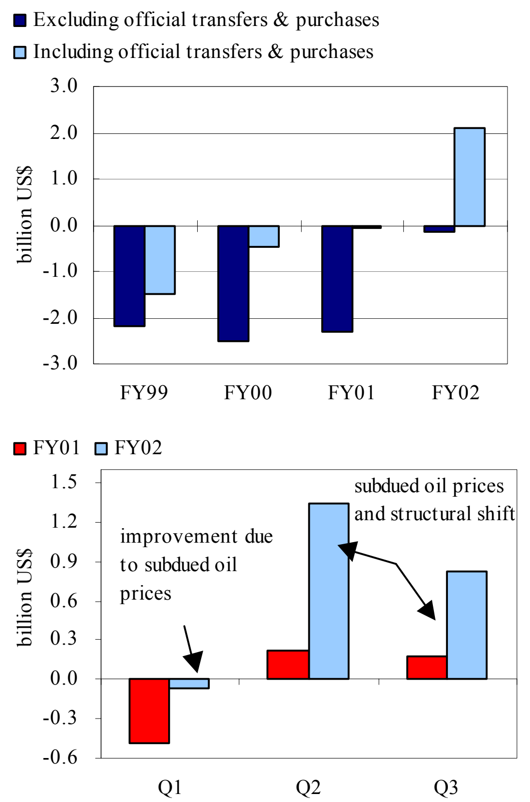
8.1 Debt Capital Market

Although private corporate debt market has seen brisk activity since the start of this fiscal year as thirteen issues are floated in the market during FY02. Only one TFC was launched during third quarter (see **Table 8.3)**, but the future outlook is positive as a number of large issues are in the pipeline.

9. External Sector[71]

As highlighted in the previous *Quarterly Report*, Pakistan experienced a positive structural shift in the external account following the September 11 incident. The most noteworthy changes emanating from this shock were the collapse of the kerb market premium and the appreciation of the Rupee. In addition, the government's cooperation with international anti-terrorist efforts allowed Pakistan to improve on the previously strained relations with major creditor countries that resulted in a generous restructuring offered by the Paris club creditors, and greater assistance from bilateral and multilateral sources.

Figure 9.1: Current Account Balance (Jul-Mar)



As a result, the current account posted a surplus of US$ 2.1 billion during Jul-Mar FY02 compared to a deficit of US$ 82 million in corresponding period last year (see **Table 9.1**). The

[71] This section will rely on exchange records from the SBP, which due to definitional differences do not tally with more detailed trade data (based on customs records) used in the subsection on **Trade Account**.

Table 9.1: Balance of Payments- Summary

million US$

	H1		Q3		July-March		
	FY01	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**	**Change over FY01**
1. Trade Balance	**-766**	**-48**	**-411**	**-238**	**-1,177**	**-286**	**891**
Exports (fob)	4,323	4,527	2,259	2,101	6,582	6,628	
Imports (fob)	5,089	4,575	2,670	2,339	7,759	6,914	
2. Services (Net)	**-1,621**	**-1,449**	**-848**	**-361**	**-2,469**	**-1,810**	**659**
Shipment	-405	-367	-213	-184	-618	-551	
Other transportation	30	-24	19	89	49	65	
Travel	-61	-44	-78	-73	-139	-117	
Investment income	-1,167	-1,088	-551	-550	-1,718	-1,638	
Interest payments	-851	-703	-399	-331	-1,250	-1,034	
Profit and dividend	-316	-385	-152	-219	-468	-604	
Other goods, services & income	-18	74	-25	357	-43	431	
3. Current Transfers (Net)	**2,125**	**2,773**	**1,439**	**1,418**	**3,564**	**4,191**	**627**
a) Private transfers (net)	1,643	1,832	1,257	1,177	2,900	3,009	
of which: Workers' remittances	609	983	246	646	855	1,629	
FCA (residents)	192	134	192	50	384	184	
Outright purchases	752	635	809	433	1,561	1,068	
b) Official transfers	482	941	182	241	664	1,182	
of which: Saudi oil facility	393	300	155	117	548	417	
4. Current Account Balance (1+2+3)	**-262**	**1,276**	**180**	**819**	**-82**	**2,095**	**2,177**
5. Capital Account (net)	**-764**	**-525**	**-231**	**-563**	**-995**	**-1,088**	**-93**
6. Errors & Omissions	**350**	**441**	**163**	**299**	**513**	**740**	
7. Overall Balance	**-676**	**1,192**	**112**	**555**	**-564**	**1,747**	
8. Financin	**676**	**-1,192**	**-112**	**-555**	**564**	**-1,747**	
I. Changes in Reserves (-Inc/+Dec)	**51**	**-1,332**	**-133**	**-448**	**-82**	**-1,780**	**-1,698**
Assets	4	-1,622	-210	-410	-206	-2,032	
SDRs	-9	1	-121	-1	-130	0	
Forex (State Bank of Pakistan)	-73	-1,459	124	-400	51	-1,859	
Forex (Commercial banks)	86	-164	-213	-9	-127	-173	
Liabilities	47	290	77	-37	124	253	
Use of Fund Credit	47	290	77	-37	124	253	
Purchases/drawings	191	377	133	0	324	377	
Repurchases	-144	-87	-56	-37	-200	-124	
II. Exceptional financing	**623**	**140**	**23**	**-107**	**646**	**33**	
SBP reserves	1,443	3,546	891	3,495	891	3,495	2,604

Source: Statistics Department

lower trade deficit was the major contributor to this surplus (mainly due to lower international oil prices), with the sizable support from the services account and transfers (both official as well as private – see **Table 9.3**).

The current account deficit has been declining continuously since FY99, essentially due to the kerb purchases and Saudi Oil Facility (SOF), but the FY02 improvement is far more broad-based. In fact, the current account balance is still showing an improvement of US$ 1.5 billion during Jul-Mar FY02 even after excluding the SOF and kerb purchases (see **Figure 9.1**).

This unprecedented current account surplus easily offset the US$ 1.1 billion capital account deficit (primarily due to notional payments of Special US$ Bonds), leaving the interbank market fairly liquid. This allowed SBP to increase its purchases from the interbank market, which has not only helped build up foreign exchange reserves to US$5.3 billion at end-March, but also stabilized the exchange rate.[72] Although the donors' support to Pakistan to compensate for the negative economic impact imposed by the Afghan war is prominent in this build up, the reversal of capital flight and the stronger inflows of workers' remittances cannot be overlooked. The comfortable reserve position and the narrowing of kerb premium also provide an opportunity to consolidate the gains in remittances by enfolding the informal market into the official system – one of the important conditions of the current PRGF. The first step in this regard will take place in early FY03, when exchange companies are to come into existence.

As far as the capital account is concerned, it witnessed a higher net outflow during Jul-Mar FY02 relative to the corresponding period last year due to the policy decision taken to liquidate expensive commercial debt and foreign exchange liabilities (see **Table 9.1**). Thus, the repayment of maturing 3-year Special US Dollar Bonds, accelerated repayments of FE-45 deposits to institutional investors, the higher repayments of commercial loans/credit contracted in last year, and the closure of swaps with various commercial banks, were the main contributory factors along with the lower project aid from IFIs and bilateral countries. The more encouraging sign is some modest pick up in foreign investment. This reflects the renewed interest of foreign investors due to the higher foreign exchange reserves and our commitments to ongoing reforms agenda.

[72] In fact, it is clear now that in the absence of SBP purchases from the interbank market, the Rupee/Dollar parity would have experienced substantial appreciation.

9.1 Current Account

Since major developments during the first-half of the current fiscal year have already been discussed in the previous *Quarterly Report*, this section will primarily focus on BOP position in Q3-FY02. The external position of Pakistan further consolidated during the third quarter as current account registered a surplus of US$ 819 million. On monthly basis, the current account balance showed a sharp improvement in March 2000 following the receipt on account of logistic support the country provided in the war against terrorism (see **Figure 9.2**).

9.1.1 Trade Balance

According to exchange data, the trade deficit during Q3-FY02 contracted by US$ 173 million over the same period last year to reach US$ 238 million. This improvement stems primarily from a sharp fall in the oil import bill (due to lower quantum and the subdued prices of POL in the international market) and reduction in food imports (for more details, see section on **Trade Account**).

9.1.2 Services (Net)

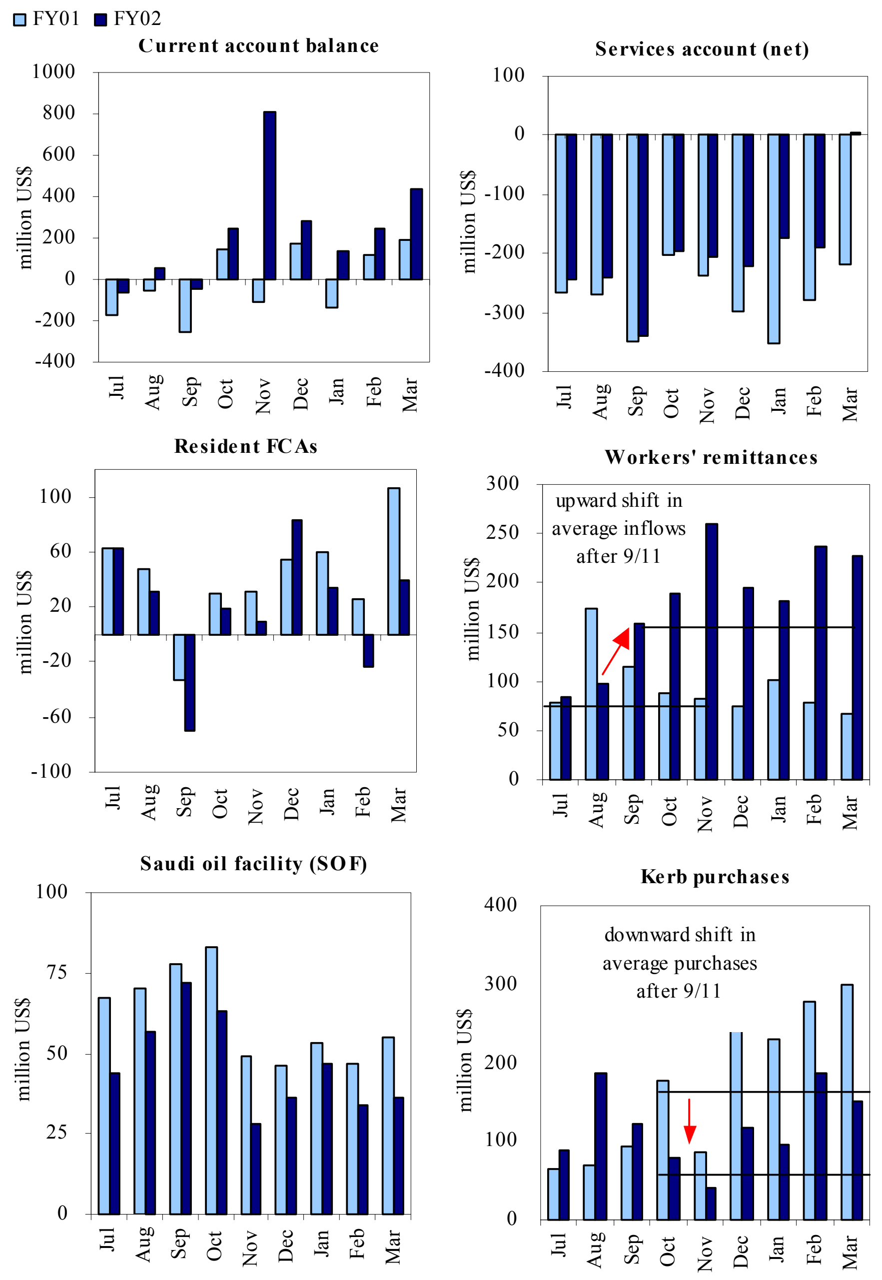
Looking at services account (net), despite the higher payments for profit and dividend, the deficit contracted by US$ 487 million during Q3-FY02 (down from outflows of US$ 848 million to US$ 361 million) over third quarter last year. This mainly reflects receipts from the USA in March 2002 against logistic support in Afghanistan (see **Figure 9.2**).[73] Furthermore, the falling stock of private loan/credit & FE-45 deposits, and to some extent the lower international interest rates (LIBOR) have led to the reduced interest payments on external debt and liabilities. In addition, due to low trade volumes, shipment payments fell by US$ 29 million over last year despite an increase in the war risk premium in October 2001.[74]

9.1.3 Transfers

Despite buoyant inflows of workers' remittances, the current transfers during Q3-FY02 have declined by US$ 21 million over the same period past year to US$ 1,418 million. However, the structure of current transfers has changed markedly during Sep-Mar FY02 period compared to the last year (see **Figure 9.2**). More specifically, Pakistan experienced both, a reversal of capital flight primarily from

[73] Interestingly, this resulted into a surplus of US$ 4 million under services (net) during March 2002 despite higher debt servicing at the end-quarter.
[74] Effective from October 1, 2001, Lloyds of London - insurance underwriter - included Pakistan in the list of ***War Excluded Areas*** due to war in Afghanistan (for more details, see **Box 9.1** in *Second Quarterly Report for FY02*).

Figure 9.2: Current Account Balance at Glance



the US and the UAE, and substitution of workers' remittances from the kerb market to the interbank market. This argument is supported by the fact that the incremental remittances during Sep-Mar FY02 period (US$ 843 million) are much higher than the fall in kerb purchases of US$ 636 million (see **Table 9.2**). This simply shows that the remittances received in this period are much higher than what SBP could have purchased from the kerb market in normal circumstances.

Table 9.2: Changes in Kerb Purchases & Remittances
million US$

	Sept-Mar		
	FY01	**FY02**	**Increment**
Workers' remittances	604	1447	843
Kerb purchases	1428	792	-636
Total	**2032**	**2239**	**207**

The hard currency purchases from the kerb market during the third quarter were only US$ 433 million against US$ 809 million during the same period last year. However, at this level, these purchases are much higher than the total procurement of US$ 238 million made during Q2-FY02 that incorporates the impact of the kerb market collapse (see **Figure 9.2**). In overall terms, the kerb purchases are still lower during Jul-Mar FY02 compared to the last year (see **Table 9.1**).

However, ample inflows of hard currency in formal channels not only financed lumpy oil payments, but also compelled SBP to increase its purchases from the interbank market in order to save the Rupee from appreciating.[75] [76] Had SBP not purchased net amount of US $ 797 million during the third quarter from the interbank market, the exchange rate would have been well below its current level.

Worker's remittances (cash) registered a phenomenal growth of 174 percent during Q3-FY02 compared to the corresponding quarter last year. Although, the growth is widespread in terms of major source-countries, the increase is more prominent from the USA and the UAE (see **Table 9.3**). These two countries accounted for 68 percent of the total increment during Q3-FY02 over the corresponding period last year. As discussed in the last *Quarterly Report*, this was mainly due to the scrutiny of *Hundi* & *Hawala* transactions in UAE and other

[75] This was necessary to protect exporters who were already coping with the loss of traditional markets due to war risk premium, cancellation of orders and the 6.6 percent year to date Rupee appreciation.
[76] Since, unlike kerb purchases, SBP purchases from the interbank market are made from a pool of hard currency already accounted as inflows in the current account, these do not form part of the current transfers.

Table 9.3: Region-wise Worker's Remittances
million US$

	H1		Q3		Jul-Mar		
	FY01	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**	**Growth**
Gulf Region:	415.7	481.9	143.9	279.6	559.6	761.5	36.1
Bahrain	12.9	14.6	5.4	12.8	18.2	27.4	50.3
Kuwait[1]	81.9	34.6	31.8	25.7	113.6	60.3	-46.9
Qatar	7.5	13.4	3.1	8.9	10.6	22.3	110.6
Saudi Arabia	167.8	170.0	63.1	89.0	230.9	259.0	12.1
Sultanat-e-Oman	19.8	27.5	9.1	17.2	28.8	44.7	55.0
U.A.E.	125.9	221.8	31.5	126.1	157.4	347.9	121.0
Other than Gulf Region:	156.5	469.5	87.8	355.7	244.3	825.2	237.8
Canada	2.2	9.5	1.3	7.8	3.5	17.3	393.1
Germany	4.9	5.5	2.3	2.7	7.2	8.2	12.9
Japan	1.7	2.5	1.1	1.3	2.8	3.7	34.1
Norway	3.2	3.2	1.4	1.6	4.6	4.8	4.1
U.K.	41.3	61.1	21.9	42.4	63.2	103.5	63.8
U.S.A.	62.6	274.0	32.6	209.9	95.3	483.8	407.9
Others[2]	40.6	113.8	27.2	90.1	67.8	203.9	201.0
Total	**572.1**	**951.3**	**231.8**	**635.4**	**803.9**	**1586.7**	**97.4**
Encashment FEBCs/FCBCs	37.0	31.0	13.7	9.0	50.7	39.9	-21.2
Total (including FEBC/ FCBCs)	**609.2**	**982.3**	**245.4**	**644.3**	**854.6**	**1626.6**	**90.3**
Growth rate excluding Iraq-Kuwait W A and Hajj Receipts (percent)							126.0

Source: Statistics Department

[1] The growth rate is negative due to the receipts of US$ 78 million on the account of Kuwait war affectee last year.

[2] Mainly reflects FCA conversions.

countries, coupled with the panic following September 11 event.[77] However, it remains unclear as to what extent these inflows reflect a one-time shift.

In terms of resident FCAs, it is evident from **Figure 9.2** that the appreciation of Rupee against the Dollar has quelled the incentives for domestic dollarization. As a result, resident FCAs declined sharply to US$ 50 million in the third quarter from US$ 192 million during Q3-FY01.

[77] A detailed analysis of regional remittances revealed that inflows from almost all major countries have experienced a shift after the crackdown on the *hundi* network in UAE. This suggests that informal flows that used to be routed through Dubai are probably flowing into Pakistan directly from the country of origin *and* through formal channels.

Similarly, inflows under Saudi Oil Facility (SOF) also fell by US$ 38 million over corresponding period last year, mainly due to the lower oil prices prevailing in the international market. **Figure 9.2** shows that the inflows under the SOF normally grow from July to October period in line with the seasonal oil import pattern, and then taper off in the remaining part of the fiscal year.

9.1.4 External Vulnerabilities

Due to the unprecedented improvement in the current account deficit, the enhanced vulnerability of the external sector has been contained, but many of the factors responsible for this upturn are still mired in uncertainty (see **Table 9.4**).

Table 9.4: External Sector Vulnerability
million US$

Vulnerabilities	FY02 Contribution
Oil saving	480
Workers' remittances	774
Kerb purchases	-493
Saudi oil facility	-131
US aid	600
Logistic support	300
Total	**1,530**

For example, the grants from the USA are unlikely to be available in the amounts received in FY02 and should be discounted from future projections. Second, the trajectory of oil prices is moving in an upward direction and therefore, the savings realized this year cannot be assumed for the coming year. Third, until the kerb market is integrated, the permanence of the improvement in workers' remittances flows would remain in question. This underlines the need to consolidate positive structural changes in the external sector by removing the segmentation of the foreign exchange market. Therefore, the planned introduction of FECs is an important step forward. Given Pakistan's established pool of expatriate workers' abroad, this would help to ensure more dependable flows to formal channels.

9.2 Trade Account[78]

By the end Q3-FY02, it was clear that Pakistan's exports (US$ 6.5 billion) have suffered due to the extraordinary conditions prevailing in the region as well as economic slowdown in key markets. As pointed out earlier, falling POL prices helped to reduce the total import bill to US$ 7.4 billion, and thus more than offset the negative impact of lower exports. As a result, the trade deficit declined by 38.1 percent to US$ 816.7 million over Jul-Mar FY01 (see **Figure 9.3**).

---

[78] This section is based on Customs data, which is different from exchange record used in the 'balance of payments' section. For details, see ***Special Section 3*** of SBP's first *Quarterly Report* for FY01.

9.2.1 Exports

In addition to difficulties associated with regional problems and the global recession, the sharp appreciation of 6.63 percent in the Rupee/Dollar parity during Jul-Mar FY02 also posed problems for exporters. The impact is reflected in a 2.7 percent fall in exports during Jul-Mar FY02 (see **Table 9.5** & **Figure 9.4**). Had the unit values of exports remained unchanged at their FY01 levels, Pakistan would not have recorded negative growth in exports. In fact, it would have shown a marginal increase over last year.

The fall of US$ 243.0 million in export earnings due to deteriorating unit prices, was far greater than the quantitative gains in major export items valuing at US$ 53.4 million.[79,80] As a result, the export target for FY02 has been revised downward to US$ 8.5 billion.

Although the cumulative performance strongly suggests the adverse impact of

Figure 9.3: Trade Account (July-March)

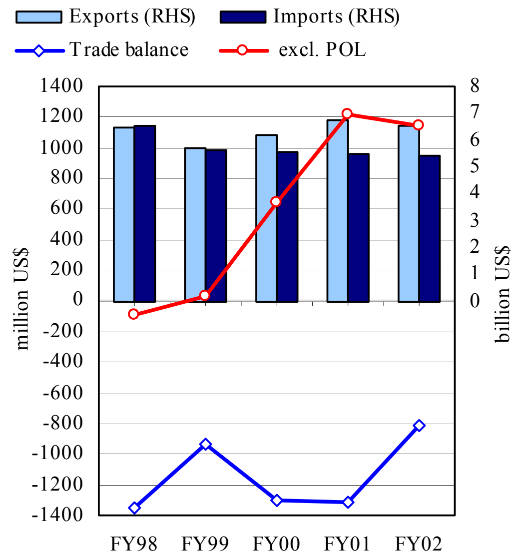
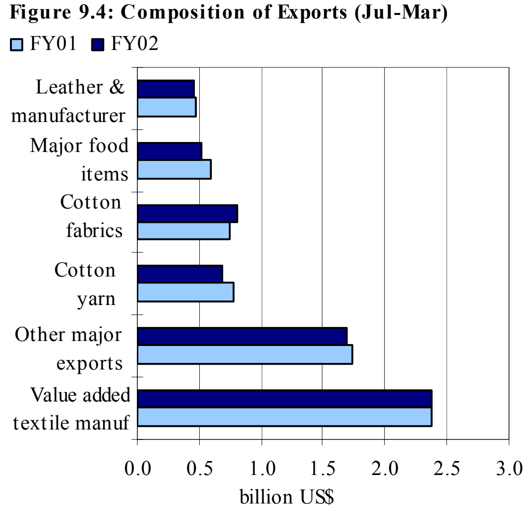


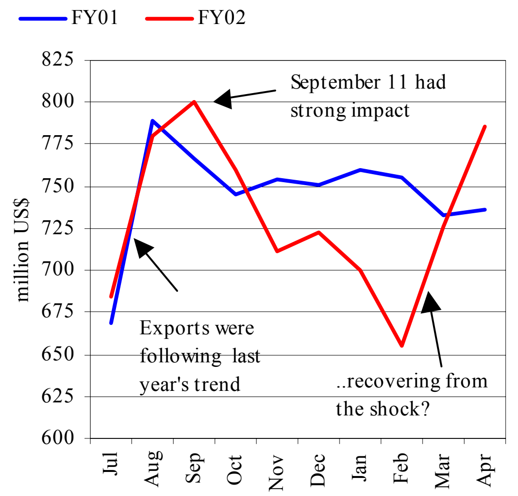
Figure 9.4: Composition of Exports (Jul-Mar)



[79] The quantity and price effect (on exports) is calculated on the basis of detailed data available on 27 items, covering 79.3 percent of total exports.

[80] Pakistan's major exports (including POL, leather, readymade garments, towels, tarpaulin & other canvas goods, bed-ware, surgical instruments, footwear, and cotton fabrics) were able to show quantitative increases during Jul-Mar FY02 over the same period last year.

Figure 9.5: Monthly Trends in Exports



September 11 on Pakistan's exports,[81] it can be argued that the impact of the lower export finance rate, the easier access to credit from banks, the swift tax refunds/duty drawbacks and commencement of the export credit guarantee agency will take time to translate into export growth. This is also reflected in monthly trends in exports, which clearly show that exports after falling continuously since September 2001, reached their bottom in February 2002. Since then, there is an upward trend on account of lagged impact of measures taken so far (see **Figure 9.5**).[82]

In view of a recovery in the global economies together with the improved access to the major markets, there is hope for improvement in FY03.[83, 84] However, this will require aggressive export marketing and its diversification. Also, with the return of peace and normalcy in Afghanistan, Pakistan is in a position to explore the Central Asian markets. Certainly, this would be in addition to potential export demand (for construction materials, food items and a number of services) for the rehabilitation and reconstruction of Afghanistan.

In analyzing Pakistan's export performance, very little attention is paid to considerable expansion in volume of exported goods. Too much emphasis is laid on nominal Dollar values without taking into account the phenomenal growth which has been occurring in the form of higher quantities of value added exports. **Table 9.5** presents the increase in volumes achieved by major exports on the top

[81] The quarterly growth rates for FY02 are as follows: Q1⇒↑ by 1.8 percent; Q2 ⇒↓ by 2.5 percent; and Q3 ⇒↓ by 7.4 percent.
[82] Export numbers for April 2002 are provisional.
[83] The recent estimates for USA put real GDP growth at 5.6 percent in the first quarter of 2002, while fourth quarter (2001) growth was also revised upward to 1.7 percent.
[84] The EU has increased textile quotas by 15 percent for all categories and withdrew duties on all imports from Pakistan, except five items (yarn, fabrics, leather and leather products and carpets) with effect from January 2002. The USA has also allowed 'selective' quota increases with no tariff suspensions after protracted negotiations.

of similar increases over last year. The unit values realized are set in the international market, and the Pakistani exporters cannot influence those prices; for them, the prices are given. Thus, to apportion the blame on exporters for poor performance is misplaced. Had the world prices behaved more normally in the last three years, the target of US$ 10 billion would have indeed been achieved.

Table 9.5: Export Items Showing Quantitative Increase
quantum impact: million US$

	Unit	Jul-Mar			Quantum
		FY01	**FY02**	**% Change**	**impact**
Readymade garments	(000 Doz)	25,173.6	31,007.6	23.2	140.5
Bed wear	(000 MT)	106.4	132.3	24.4	130.9
Cotton fabrics (woven)	(mln.SM)	1,245.0	1,365.6	9.7	72.7
Petroleum and petroleum products	(000 MT)	548.1	722.8	31.9	38.9
Surgical and medical instruments	(000 Nos)	67,908.5	91,453.7	34.7	30.6
Towels	(000 MT)	48.0	55.8	16.1	27.7
Molasses	(000 MT)	785.7	1,271.1	61.8	16.1
Basmati rice	(000 MT)	365.4	390.7	6.9	12.1
Oil seeds & nuts etc.	(000 MT)	15.8	36.3	130.6	10.5
Fruits	(000 MT)	192.5	215.9	12.2	7.4
Tarpaulin & other canvas goods	(000 MT)	14.4	16.9	16.8	5.4
Foot wear	000 Pairs	5,511.6	6,269.1	13.7	4.2
Leather	(000 SM)	11,905.4	12,200.4	2.5	3.9
Guar and guar products	(000 MT)	15.9	17.6	10.7	1.7
Fish and fish preparations	(000 MT)	62.3	62.7	0.6	0.7
Raw wool (excluding wool tops)	(000 MT)	0.4	0.9	121.7	0.6
Waste material of textile fibres/fabrics	(000 MT)	8.0	8.3	2.9	0.1
Impact of total quantum increase					**503.9**

Source: Federal Bureau of Statistics.

The following points highlights Pakistan's export performance during the first nine months of FY02:

Textile Manufactures

Over the last many years, export earnings from the ***textile manufactures*** remained stagnant at around US$ 5.5 billion, while their share in total exports stayed within a range of 63-65 percent.[85] During Jul-Mar FY02, export revenues from the textile manufactures amounted to US$ 4,178.6 million (↓ 0.9 percent

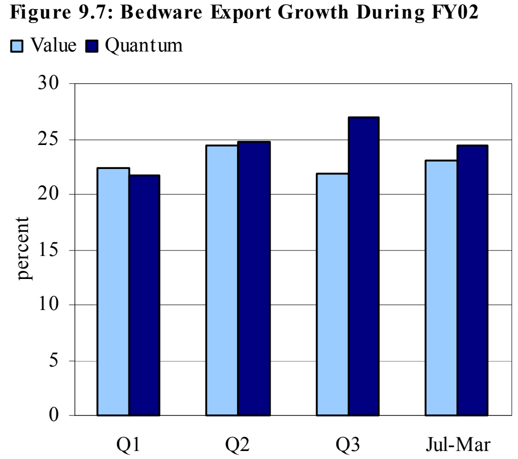
[85] The present textile quota regime seems to be mainly responsible for the stagnation of the domestic textile industry as the system has increased output concentration in low priced products in an effort to gain competitive edge over other countries.

over the same period last year – see **Table 9.6**). The negative price effect of US$ 236.4 million more than offset the additional earnings of US$ 195.9 million accrued from higher export volumes. The dismal performance is more serious for the third quarter this year as, despite the increased access to EU market, export earnings registered a marked decline of 5.6 percent over last year.

- During Jul-Mar FY02, ***cotton yarn*** exports at US$ 682.3 million were down by 12.8 percent over last year, due to prevailing recession in the world yarn market. While export receipts fell by US$ 95.7 million owing to the falling prices, the lower volumes also resulted in the additional loss of US$ 4.9 million (see **Figure 9.6**).

- ***Bed-ware*** exports showed a significant improvement during Jul-Mar FY02 by fetching US$ 659.4 million (↑ 23.0 percent over last year). The gains of US$ 130.9 million for higher export volumes were marginally reduced by the negative price effect of US$ 7.8 million. The withdrawal of 6.4 percent anti-dumping duty by the European Union (EU) has impacted positively on the quantum of bed-ware exports, which showed a 26.9 percent increase in Q3-FY02 over Q3-FY01 (see **Figure 9.7**).[86] The reported imposition of 9.8 percent anti-dumping duty on Indian bed-linen by the EU may further boost Pakistan's bed-ware exports.

Figure 9.7: Bedware Export Growth During FY02



- Within the textile manufactures, knitwear exports suffered seriously due to the downstream impact of September 11 events. Despite a 3.7 percent rise in the unit prices, the export of knitwear fetched US$ 602.3 million during Jul-

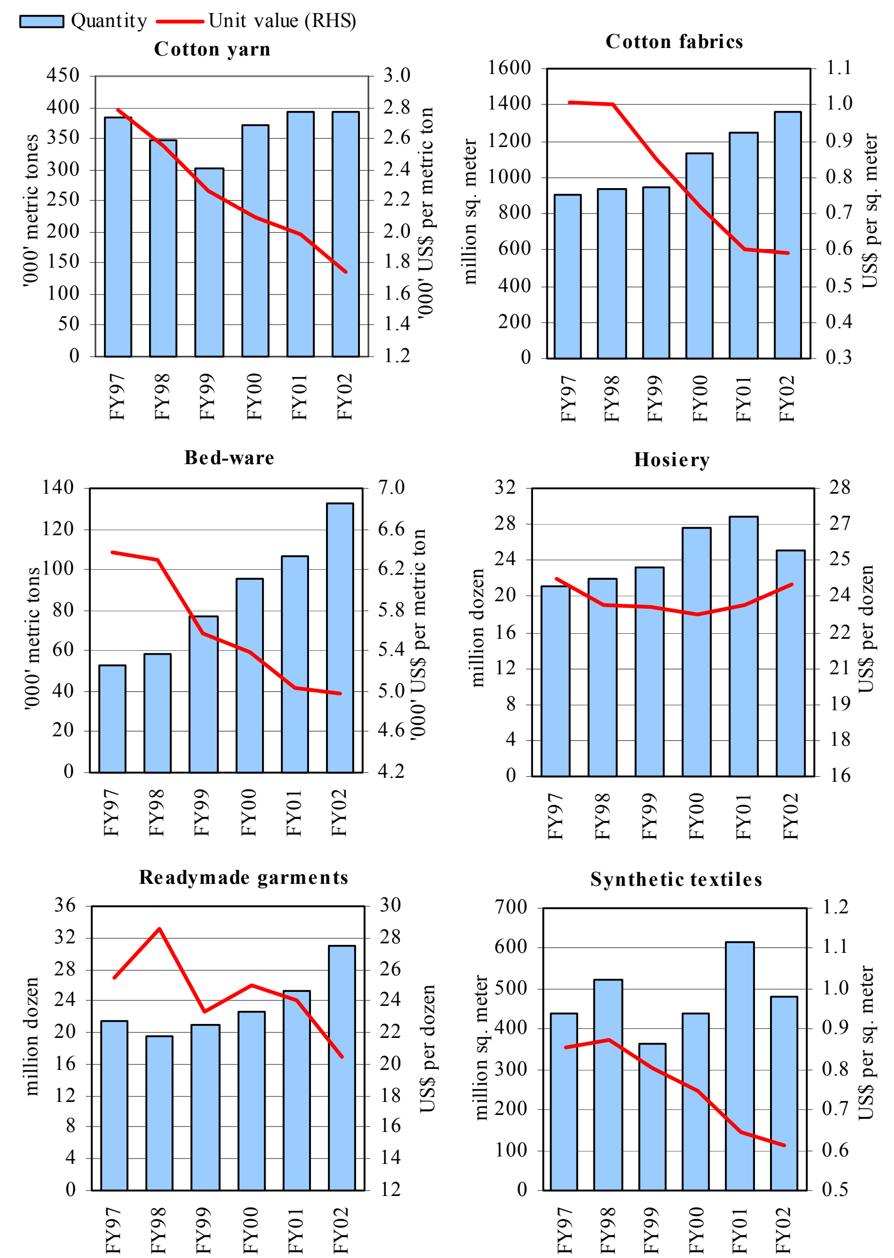
[86] The quality assurance committee on bed linen in consultation with the Quota Supervisory Council (QSC) has fixed the minimum export price of bed-linen at US$ 5 per kg to ward off the risk of anti-dumping by the EU authorities.

Table 9.6: Major Exports (Jul-Mar)
value: million US$; unit value: US$

Commodities	Unit	FY01		FY02		Abs. Δ in Value	percent Δ in FY02 over FY01		
		Value	Unit Value	Value	Unit Value		Qty.	Value	Unit Value
A. Primary Commodities		**914.3**		**735.7**		**-178.6**		**-19.5**	
Rice	MT	400.6	228.5	332.2	257.8	-68.3	-26.5	-17.1	12.8
Raw cotton	MT	127.0	1,031.1	13.1	770.6	-113.9	-86.2	-89.7	-25.3
Raw wool (*excl*. wool tops)	MT	0.5	1,270.8	0.8	901.8	0.3	121.7	57.3	-29.0
Fish and fish preparations	MT	109.2	1,751.6	96.1	1,532.3	-13.1	0.6	-12.0	-12.5
Leather	SQM	155.8	13.1	168.9	13.8	13.1	2.5	8.4	5.8
Guar and guar products	MT	15.5	978.0	12.5	710.5	-3.0	10.7	-19.6	-27.3
Fruits	MT	60.5	314.5	64.1	297.1	3.6	12.2	5.9	-5.5
Vegetables incl. roots and tubers	MT	25.6	195.6	22.7	195.9	-2.9	-11.6	-11.5	0.2
Crude animal material	MT	11.4	490.4	9.5	554.9	-2.0	-26.9	-17.3	13.2
Oil seeds & nuts etc.	MT	8.0	509.5	15.7	433.2	7.7	130.6	96.0	-15.0
B. Textile Manufactures		**4,216.9**		**4,178.6**		**-38.3**		**-0.9**	
Cotton yarn	MT	782.9	1,988.5	682.3	1,744.0	-100.6	-0.6	-12.8	-12.3
Cotton fabrics (woven)	SQM	750.7	0.6	805.9	0.6	55.2	9.7	7.4	-2.1
Hosiery (knitwear)	Doz.	667.7	23.1	602.3	24.0	-65.4	-13.0	-9.8	3.7
Bed-ware	MT	536.3	5,042.2	659.4	4,983.4	123.1	24.4	23.0	-1.2
Towels	MT	172.2	3,584.1	189.4	3,395.9	17.2	16.1	10.0	-5.3
Cotton bags and sacks	MT	13.8	4,101.5	11.8	3,926.8	-2.0	-10.6	-14.4	-4.3
Readymade garments	DOZ.	606.3	24.1	636.2	20.5	29.9	23.2	4.9	-14.8
Tarpaulin & other canvas goods	MT	32.1	2,222.0	37.7	2,234.3	5.6	16.8	17.5	0.6
Tule, lace embroidery etc.	---	7.5	---	7.1	---	-0.4		-5.2	
Synthetic textiles	SQM	398.6	0.6	294.5	0.6	-104.2	-22.1	-26.1	-5.1
Other textile made up	---	244.6	---	247.3	---	2.6		1.1	
Waste material of textile fibres/fabrics	MT	4.3	536.5	4.8	586.3	0.5	2.9	12.4	9.3
C. Other Manufactures		**1,125.8**		**1,121.7**		**-4.1**		**-0.4**	
Carpets, carpeting rugs & mats	SQM	199.5	45.9	174.5	48.3	-25.0	-16.8	-12.5	5.1
Petroleum and petroleum products	MT	122.2	222.9	130.1	180.1	8.0	31.9	6.5	-19.2
Sports goods	---	188.1	---	200.3	---	12.2		6.5	
Leather manufactures	---	323.8	---	294.7	---	-29.1		-9.0	
Foot wear	pairs	30.9	5.6	38.1	6.1	7.2	13.7	23.5	8.5
Surgical and medical instruments	NO	88.1	1.3	106.5	1.2	18.3	34.7	20.8	-10.3
Cutlery	GR	19.6	33.1	17.8	32.0	-1.7	-5.9	-8.9	-3.2
Onyx manufactured	MT	8.9	1,734.8	7.3	1,526.8	-1.7	-7.5	-18.6	-12.0
Chemicals and pharmaceuticals	---	118.7	---	102.1	---	-16.6		-14.0	
Molasses	MT	26.1	33.2	50.3	39.5	24.2	61.8	92.8	19.2
D. Others		**464.0**	**---**	**502.1**	**---**	**38.1**		**8.2**	
Total Exports		**6,720.9**		**6,538.1**		**-182.8**		**-2.7**	
excl. Major food items and raw cotton		5,989.8		5,994.0		4.2		0.1	
excl. Major food items and raw cotton and yarn		5,207.0		5,311.7		-182.8		2.0	

Source: Federal Bureau of Statistics.

Figure 9.6: Textile Manufactures-Quantitative Exports and Unit Prices (Jul-Mar)



Mar FY02 (↓ 9.8 percent over last year).[87] This mainly reflects a fall in export volume by 13.0 percent owing to the reported slowdown in export orders, which is more pronounced in the second and third quarter of FY02 when they registered declines of 15.6 percent and 24.7 percent respectively.[88]

- During Jul-Mar FY02, export earnings from ***towels*** increased by only 10.0 percent (US$ 17.2 million) compared to a sharp rise of 27.0 percent in the same period last year. The decline in per unit prices led to a loss of US$ 10.5 million that partially offset the gains of US$ 27.7 million resulting from higher export volumes (see **Figure 9.6**).[89] Although exports registered a substantial growth of 28.9 percent in Q1-FY02, the performance declined markedly in subsequent quarters (Q2-FY02: ↑ 8.1 percent; and Q3-FY02: ↓ 4.4 percent).

- Export of ***readymade garments*** earned US$ 636.2 million during July-March period (↑ 4.9 percent over last year). The US$ 110.6 million loss in export revenues due to fall in average export prices was more than neutralized by enhanced earnings of US$ 140.5 million from higher export volume. The quarterly exports show growth both in terms of volume and value.

Primary Commodities

- ***Rice*** exports during Jul-Mar FY02 declined sharply by 17.1 percent over last year to reach US$ 332.2 million, thus lowering its share in total exports to 5.1 percent from 6.0 percent last year. The depressed global demand, higher domestic prices resulting from lower rice production, and the sharp appreciation of the Rupee rendered Pakistani exporters un-competitive against India, Thailand, Vietnam, China and Myanmar.[90]

[87] The fall in export volume led to loss of US$ 86.9 million in export proceeds, which was marginally offset by additional revenues of US$ 21.5 million due to higher realized unit prices.
[88] The slowdown in export orders has led to reported closure of a substantial number of units in the knitwear sector.
[89] The Quality Assurance Committee (QAC) has fixed the minimum export price for towel at US$3.50 per kg (fob) with a flexibility of 15 percent reduction to pre-empt any potential risk of anti-dumping proceedings by the EU.
[90] Pakistani exporters are reportedly loosing markets in Indonesia, Saudi Arabia, Philippines, Bangladesh, etc. due to comparatively higher prices of both Irri-6 and Basmati and aggressive marketing by Indian rice exporters.

Interestingly, the export of basmati rice has increased both in terms of quantum and value (see **Table 9.7**). It is clear that the fall in export earnings is stemming mainly from a quantitative decline of 35.3 percent in low variety rice, leading to a net loss of US$ 68.3 million in export earnings.[91] This was due to the shortage of varieties like Irri-9 and 386 (non-basmati).[92]

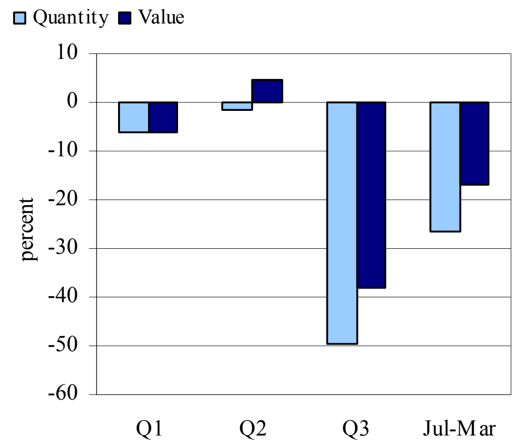
Table 9.7: Export of Rice (Jul-Mar)

value: million US$; quantity: '000' metric tons

	FY01		FY02		% change over FY01		
	Qty.	Value	Qty.	Value	Qty.	Value	Unit value
Basmati	365.4	174.0	390.7	183.1	6.9	5.2	-1.6
Other Varieties	1,387.9	226.5	898.1	149.1	-35.3	-34.2	1.7
Total	**1,753.3**	**400.6**	**1,288.8**	**332.2**	**-26.5**	**-17.1**	**12.8**

Source: Federal Bureau of Statistics

Figure 9.8: Rice Export Growth During FY02



The quarterly trends show that the rice exports were weak even in the first quarter, and the appreciation of the Rupee in Q2-FY02 may have simply accentuated the problem. (see **Figure 9.8**)

- During Jul-Mar FY02, ***raw cotton*** exports of US$ 13.1 million represents a significant decline of 89.7 percent over last year (US$ 109.5 million negative quantum effect and US$ 4.4 million negative price effect).[93] The price fall is attributed largely to overproduction. On the positive side, shipments have lately picked up and raw cotton valuing US$ 8.2 million was exported in Q3-FY02.

[91] On the other hand, the overall increase in the realized per unit prices reflects larger proportion of high quality basmati rice in total rice exports. This share increased to 30.3 percent during Jul-Mar FY02 from 20.8 percent last year.
[92] Last year, the government banned the cultivation of variety 386 (non-basmati), which was being primarily used for blending purposes. As a result, growers reportedly shifted to superior varieties.
[93] Pakistan's raw cotton fetches low prices due to high proportion of contamination.

- ***Fish and fish preparations*** exports showed a decline of 12.0 percent during the Jul-Mar FY02 over the same period last year and stood at US$ 96.1 million.[94] Despite a marginal increase in the quantum, the fall in per unit realized prices (equivalent to US$ 13.8 million) led to a loss of US$ 13.1 million in export earnings. Major export markets include the European Union (EU), Japan and USA. Fish is also exported to Sri Lanka in dried form.

- Following the availability of surplus ***wheat***, the government allowed its export by the private sector without any restriction on quantity, value and purchase.[95,96] During Jul-Mar FY02, 441.0 thousand metric tons of wheat valued at US$ 47.9 million was exported compared to only 28.8 thousand metric tons (valuing US$ 4.8 million) in the same period last year.[97] However, the absence of a grading system and lack of experience and reputation as a reliable supplier, are the main factors limiting wheat exports. Major buyers of Pakistani wheat are Afghanistan, UAE, Iraq, East Africa, Egypt, Sudan, Kenya and Yemen.

Other Manufactures

- Notwithstanding the improvement in unit prices, ***carpet*** exports fell by US$ 25 million (12.5 percent) on account of lower quantum during the first nine months of FY02 (positive price effect of US$ 8.5 million was more than offset by the negative quantum effect of US$ 33.5 million). Being one of the major markets for Pakistani carpets, the recession in the US economy had an adverse impact on the performance of this sector.

- Export of ***leather and leather manufactures*** (including leather footwear) declined to US $ 499.1 million (1.1 percent) during Jul-Mar FY02.[98] While leather (US$ 168.9 million), leather footwear (US$ 34.3 million) and leather gloves (US$ 35.3 million) showed improvement, the export of apparel &

---

[94] The detection of high level of chloramphenicol (an antibiotic) in a consignment of frozen shrimps exported by an EU approved processing plant, posed serious threats to seafood exports to this major market.

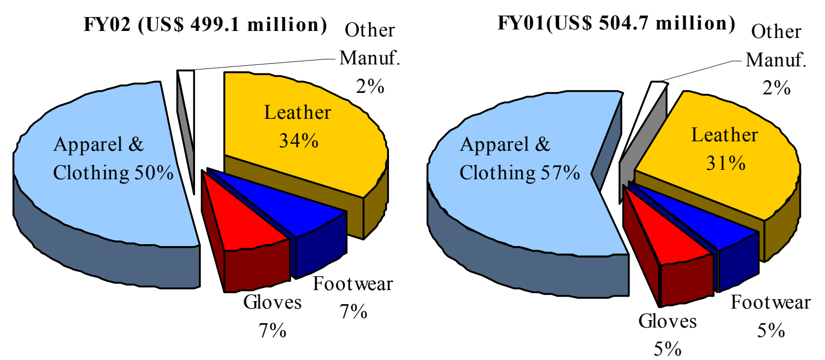
[95] On February 16, 2002, SBP allowed export finance facility to wheat exporters under part-I of the export finance scheme at post shipment stage.

[96] Despite severe water shortages, wheat crop in FY02 is estimated at 19.2 million metric tons, which is slightly higher than 19.0 million metric tons last year (see section on **Agriculture**).

[97] During Jul-Mar FY02, 231.2 thousand metric tons of wheat valuing US$ 43.7 million was also imported into Pakistan consisting solely of World Food Program (WFP) shipments and other donations destined for Afghanistan and Afghan refugees.

[98] The outbreak of foot & mouth disease in some western countries has significantly increased the demand for Pakistani leather/leather manufactures and country earned a record US$ 696.5 million through leather/leather manufactures export in FY01.

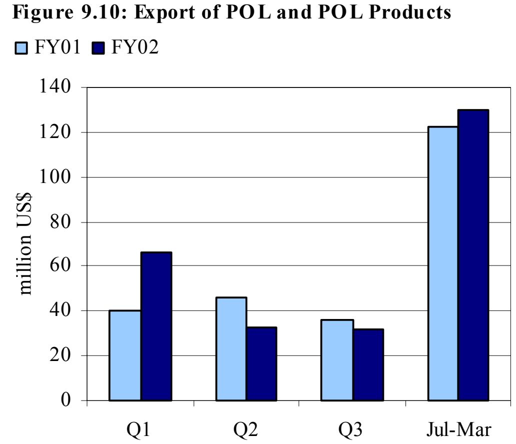
Figure 9.9: Export of Leather and Leather Manfactures (Jul-Mar)



clothing fell by 11.7 percent (see **Figure 9.9**). The European Union, particularly Germany, UK, Italy and France, is the main market.[99]

- Export earnings from ***POL*** at US$ 130.1 million during the Jul-Mar FY02, continued to register positive growth (6.5 percent) despite falling international oil prices. Bulk of the revenues (US$ 81.2 million) came from a 45.0 percent rise in exports of refined petroleum products mainly by Pak Arab Refinery Company (PARCO). In contrast, crude petroleum at US$ 39.3 million fell by 22.8 percent.[100] The quarterly performance is, however, not very encouraging as export receipts have declined in the second and third quarter over last year owing to fall in international prices (see **Figure 9.10**).

Figure 9.10: Export of POL and POL Products

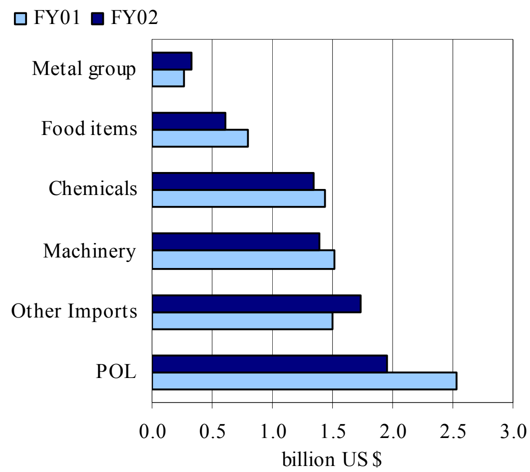


[99] European Union's decision to withdraw duties on all types of products exported from Pakistan with effect from January 2002 exclude leather and leather products.
[100] Export of crude oil is necessary since Pakistan lacks refining capacity for low-grade crude oil produced in the country.

9.2.2 Imports

As mentioned earlier, total imports at US$ 7.4 billion, registered a fall of 8.5 percent during Jul-Mar FY02 over last year (see **Table 9.8).** Lower imports of food items (-23.7 percent) and a reduction in the POL import bill (-22.9 percent) reduced the total import bill by US$ 685.6 million. Excluding POL, imports declined by only 1.9 percent, while non-food non-oil imports, showed a positive growth of 1.8 percent (see **Figure 9.11**).

Figure 9.11: Composition of of Imports (Jul-Mar)



The following points highlight the major developments in Pakistan's import during Jul-Mar FY02:

- The slowdown in the domestic economy and a significant decline in world oil prices reduced the ***POL*** import bill by US$ 580.2 million (22.9 percent).[101] The savings on account of lower POL price amounted to US$ 420.6, which were augmented by US$ 159.6 million due to a reduced quantum.[102] The falling import volume reflects the increased domestic production due to the commissioning of PARCO and the conversion of some of the power plants to gas.[103] The increased volume of crude oil imports (up by 3.7 percent), mirrors the higher consumption due to added refining capacity.

[101] The September 11 incident, subsequent military action in Afghanistan, and India-Pakistan standoff in December 2001 caused a slowdown in the economic activities, resulting in reduced domestic consumption of POL products.

[102] During the Jul-Mar FY02, the average Brent crude prices were US$ 22.07 per barrel, showing a cumulative decline of 23.1 percent over the same period last year. However, during the third quarter the Brent crude prices started to firm up and showed a smaller decline of 17.8 percent over last year.

[103] According to market sources, the industrial consumption of POL products fell by 5 percent during Jul-Feb FY02 over last year. However, demand for diesel is expected to pick up due to opening up of the Afghan Transit Trade. Similarly, the furnace oil demand by WAPDA for power generation is expected to rise in the coming months owing to the water shortage.

Table 9.8: Major Imports
value: million US$; unit value: US$

Commodities	Unit	FY01 (Jul-Mar)		FY02 (Jul-Mar)		Abs. Δ in Value	% Δ in Jul-Mar FY02 over Jul-Mar FY01		
		Value	Unit Value	Value	Unit Value		Qty.	Value	Unit Value
A. Food Group	**---**	**796.1**	**---**	**607.1**	**---**	**-189.0**	**---**	**-23.7**	**---**
Milk & cream *incl.* Infant milk food	MT	16.2	1,882.3	11.3	2,279.3	-4.9	-42.6	-30.5	21.1
Wheat un-milled	MT	9.5	203.4	43.7	189.1	34.3	396.8	361.8	-7.0
Dry fruits	MT	28.1	499.3	22.8	362.4	-5.2	12.1	-18.6	-27.4
Tea	MT	165.6	1,887.4	124.5	1,570.1	-41.1	-9.6	-24.8	-16.8
Spices	MT	13.2	1,388.3	12.6	889.8	-0.6	48.8	-4.6	-35.9
Edible oil	MT	261.9	292.5	279.4	316.1	17.6	-1.3	6.7	8.1
Soya bean oil	*MT*	*36.3*	*340.3*	*7.7*	*351.7*	*-28.6*	*-79.4*	*-78.7*	*3.4*
Palm oil	*MT*	*225.5*	*286.0*	*271.7*	*315.2*	*46.2*	*9.3*	*20.5*	*10.2*
Sugar	MT	218.1	271.5	22.8	272.3	-195.3	-89.6	-89.5	0.3
Pulses	MT	83.7	324.2	90.0	305.1	6.3	14.3	7.5	-5.9
B. Machinery Group	**---**	**1,509.1**	**---**	**1,398.0**	**---**	**-111.0**	**---**	**-7.4**	**---**
Power generating machinery	---	145.6	---	138.6	---	-7.0	---	-4.8	---
Office machinery	---	173.3	---	154.7	---	-18.6	---	-10.7	---
Textile machinery	---	261.6	---	309.6	---	48.0	---	18.3	---
Construction & mining machinery	---	50.4	---	82.8	---	32.4	---	64.3	---
Electrical machinery & apparatus	---	94.8	---	89.2	---	-5.6	---	-5.9	---
Railway vehicles	---	17.1	---	22.7	---	5.6	---	32.5	---
Road motor vehicles	---	240.2	---	219.1	---	-21.1	---	-8.8	---
Aircraft, ships and boats	---	57.7	---	45.3	---	-12.4	---	-21.4	---
Agriculture machinery & implements	---	16.9	---	9.9	---	-7.0	---	-41.5	---
Other machinery	---	451.4	---	326.2	---	-125.2	---	-27.7	---
C. Petroleum Group	**MT**	**2,535.0**	**200.7**	**1,954.8**	**165.1**	**-580.2**	**-6.3**	**-22.9**	**-17.7**
Petroleum products	MT	1,484.6	200.6	1,045.0	162.9	-439.6	-13.3	-29.6	-18.8
Petroleum crude	MT	1,050.4	200.7	909.8	167.7	-140.5	3.7	-13.4	-16.4
D. Textile Group	**---**	**122.1**	**---**	**139.3**	**---**	**17.2**	**---**	**14.1**	**---**
Synthetic fibre	MT	61.2	1,282.6	56.3	1,252.0	-4.9	-5.8	-8.1	-2.4
Synthetic & artificial silk yarn	MT	42.9	1,741.3	61.8	1,518.3	18.9	65.4	44.2	-12.8
Worn clothing	MT	18.1	305.2	21.3	309.5	3.2	16.0	17.7	1.4
E. Agricultural and Chemicals Group	**---**	**1,434.9**	**---**	**1,345.0**	**---**	**-90.0**	**---**	**-6.3**	**---**
Fertilizer	MT	168.8	178.9	155.7	145.5	-13.1	13.4	-7.8	-18.7
Insecticides	MT	50.7	3,100.5	55.0	2,867.5	4.2	17.1	8.3	-7.5
Plastic materials	MT	260.1	858.6	261.2	759.7	1.1	13.5	0.4	-11.5
Medicinal products	MT	178.0	23,040.6	164.7	22,242.4	-13.3	-4.1	-7.5	-3.5
Others	---	777.2	---	708.3	---	-68.9	---	-8.9	---
F. Metal Group	**---**	**258.0**	**---**	**322.5**	**---**	**64.5**	**---**	**25.0**	**---**
Iron and steel scrap	MT	27.5	116.0	39.6	121.5	12.1	37.7	44.1	4.7
Iron and steel	MT	202.3	336.8	248.8	288.0	46.5	43.8	23.0	-14.5
Aluminum wrought & worked	---	28.2	---	34.0	---	5.8	---	20.7	---
G. Miscellaneous Group	**---**	**188.0**	**---**	**206.2**	**---**	**18.2**	**---**	**9.7**	**---**
Rubber crude	MT	29.4	666.0	31.4	629.5	2.0	13.1	6.9	-5.5
Rubber tyres & tubes	NO	47.3	24.1	47.3	21.3	0.0	13.1	0.1	-11.5
Wood & cork	---	8.0	---	8.9	---	0.9	---	11.6	---
Jute	MT	16.8	258.1	19.2	288.6	2.5	2.5	14.6	11.8
Paper and paper board & manufactures	MT	86.6	770.7	99.3	708.5	12.8	24.8	14.7	-8.1
H. Others	**---**	**1,197.2**	**---**	**1,381.9**	**---**	**184.7**	**---**	**15.4**	**---**
Total Imports		**8,040.4**		**7,354.8**		**-685.6**		**-8.5**	
excl. Food group		*7,244.3*		*6,747.7*		*-496.6*		*-6.9*	
excl. POL group		*5,505.4*		*5,400.0*		*-105.4*		*-1.9*	
excl. Food and POL groups		*4,709.3*		*4,792.9*		*83.6*		*1.8*	

Source: Federal Bureau of Statistics.

- ***Machinery*** imports continued to fall as imports declined by 7.4 percent to US$ 1,398.0 million during Jul-Mar FY02.[104] However, textile sector persisted with their BMR drive, though not so vigorously, and imported machinery worth US$ 309.6 million (↑18.3 percent over last year).[105] Similarly, import of construction & mining machinery increased by significantly 64.3 percent during the first nine months of FY02. The return of normalcy in Afghanistan and the emerging views on potential opportunities in the reconstruction and rebuilding efforts are clearly reflected in a sharp increase of 87.2 percent in imports of construction machinery during Q3-FY02.

- This perception is also mirrored in imports of ***metal group*** during the first three quarters of FY02 that amounted to US$ 322.5 million (↑ 25.0 percent). The import of ***iron and steel scrap*** accounted for US$ 39.6 million (↑ 44.1 percent) owing to rising demand by steel re-rollers to cater for the needs of construction activity. Similarly, a 23.0 percent increase was recorded in the import of ***iron and steel*** at US$ 248.8 million.

- Import of ***manufactured fertilizer*** reached US$ 155.7 million during Jul-Mar FY02 (↓ 7.8 percent). Lower import unit prices resulted in net savings of US$ 35.8 million, which more than offset the higher expenditures of US$ 22.7 million due to a 13.4 percent rise in import volumes.

- ***Edible oil*** imports had been declining since FY99 due to: (1) the falling international prices of both soyabean and palm oils; (2) improved domestic production of edible oils like canola and sunflower; and (3) availability of soft oils from imported seeds. However, during Jul-Mar FY02, edible oil imports stood at US$ 279.4 million (↑ 6.7 percent). Higher international prices of both soyabean and palm oils resulted in greater outlay of US$ 20.8 millions, which was mitigated slightly due to savings of US$ 3.3 million from the lower quantitative imports. The quarterly data reveals that both volume and import prices of palm oil have recorded declines of 8.5 and 11.1 percent respectively during Q1-FY02, while the second and third quarters have witnessed increases.

---

[104] Since the pace of capital formation continues to be low, the import demand for machinery, spare parts and raw materials appears to have shrunk to a considerable extent.
[105] Textile machinery imports during the same period of FY01 recorded a sharp increase of 108.2 percent over the comparable period of FY00. The quarterly import data also supports the market belief that BMR drive in the textile sector is beginning to falter. After recording hefty increases of 38.6 and 46.3 percent in the first two quarters of FY02, textile machinery imports showed dismal negative growth of 21.9 percent over the corresponding quarter of last year.

- The insufficient domestic output over the last many years has led to more imports of ***pulses***. During Jul-Mar FY02, imports stood at US$ 90.0 million (↑ 7.5 percent). The higher import volumes during the period required additional expenditure to the tune of US$ 11.9 million, while depressed import prices provided relief equivalent to U$ 5.6 million.

9.3 Capital Account

The capital account deficit increased by US$ 93 million during Jul-Mar FY02 to US$ 1,088 million as total inflows improved by US$ 415 million, which were more than offset by larger payments of US $508 million (see **Table 9.9**). While the higher outflows were primarily due to the repayment of maturing Special US$ bonds and closure of swaps with various commercial banks, the lower inflows resulted mainly from commercial loans/credit and IDB trade related support. At the same time, exceptional financing declined to US$ 33 million in Jul-Mar FY02 from US$ 646 million (see **Table 9.1)**. This reflects the actual hard currency payments of previously rescheduled commercial loans (PTMA) and the repayments of FE-45 deposits.[106,107]

Focusing on the third quarter, the overall capital account further deteriorated as it registered a deficit of US$ 563 million against US$ 231 million during the same quarter last year (see **Table 9.9**).

9.3.1 Net Foreign Investment

The repayment of US$ 250 million of maturing Special US$ bonds led to US$ 127 million fall in the net foreign investment during Q3-FY02 over the same period last year (see **Table 9.9**).

Foreign investment in stock market registered an inflow of US$ 55 million in this quarter (reflecting positive trends in stocks) as compared to an outflow of US$ 61 million during the third quarter last year. The higher outflow last year was on account of the liquidation of the Morgan Stanley Fund operating in Pakistan. On the other hand, direct investment inflows fell to US$ 83 million during Q3-FY02 as compared to US$ 90 million last year.

---

[106] This refers to Pakistan Trade Maintenance Agreement, which is a credit from commercial banks for the financing primarily of oil imports and was rescheduled in December 1998.

[107] Since the BOP data is compiled on an accrual basis, the rollover and rescheduling of any loan is considered notional payment financed by equal inflows in the head of exceptional financing. However, any hard currency payment of these rescheduled loans is treated as actual reduction in the exceptional financing.

Table 9.9: Capital Account
million US$

	Q3		July-March	
	FY01	**FY02**	**FY01**	**FY02**
Capital Account (1 through 9)	**-231**	**-563**	**-995**	**-1088**
Credit	**443**	**623**	**1720**	**2135**
Debit	**674**	**1186**	**2715**	**3223**
1. Direct investment abroad	-28	1	-39	-4
2. Direct investment in Pakistan	90	83	234	290
3. Portfolio investment	-62	-211	-132	-282
Of which (Stock markets)	-61	55	-128	-2
Special US Dollar bonds	7	-253	26	-250
4. LT Capital (official)	-193	-112	-847	-344
Credit	237	260	795	825
of which: Project assistance	187	207	592	501
Food aid	0	0	0	0
Non-food aid	50	-27	203	244
Debit	430	372	1642	1169
of which: Amortization	430	372	1375	1150
Central bank deposits	0	0	-250	0
5. LT capital (DMBs)	0	0	-1	-1
Credit	0	0	0	0
Debit	0	0	1	1
6. LT capital (Others)	143	-202	-129	-595
Credit	182	26	255	81
of which: Suppliers credits/MNCs	94	26	167	81
Debit	39	228	384	676
Of which: Supplier credits repayments	144	147	384	396
others liabilities (Swaps etc.)	0	-81	0	-280
7. ST Capital (official)	77	-181	210	-280
Credit	98	127	375	707
of which: Commercial banks	70	100	108	396
IDB	31	91	245	267
Debit	21	308	165	987
of which: Commercial banks	12	94	74	612
IDB	7	128	82	289
Others liabilities (NBP deposits)	0	86	0	86
8. ST Capital (DMBs)	-8	8	-13	2
Credit	4	58	43	65
Debit	12	50	56	63
of which: Outstanding exports bills	4	61	43	64
FCAs (Non-residents)	-10	-3	-53	-16
NBP deposits	0	-46	0	-46
9. ST capital (Others)	-250	51	-278	127
Credit	-168	69	18	167
Debit	82	18	296	40
of which: Outstanding exports bills	2	68	-201	141
FCAs (Non-residents)	-14	-55	-36	-94
Other liabilities	-235	56	-45	120

Source: Statistics Department
Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

Looking ahead, the recent bomb blast in Karachi, which targeted foreign nationals, may setback the government efforts to encourage foreign investment in Pakistan.

The total repayment and reinvestment in Special US$ bonds is shown in **Table 9.10**. Despite the announcement of 5 percent redemption bonus in the Rupee, the reinvestment in these bonds was relatively more attractive till November 2001. However, as incentives to dollarize faded, people promptly availed the option of redemption in Rupees (which then came with 5 percent bonus).[108] Keeping in view the collapse of the kerb premium and increased foreign exchange reserves, SBP withdrew the redemption bonus in March 2002. As evident from **Figure 9.12**, bulk of the 3-year Special US$ bonds will mature in the next two quarters.

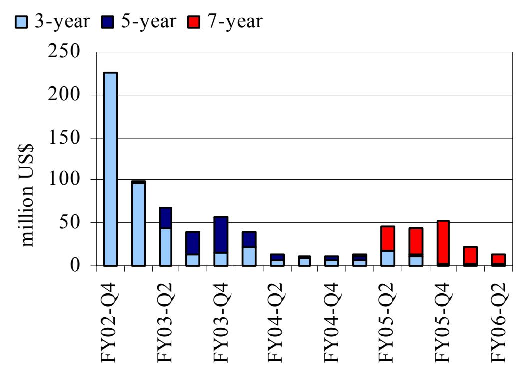
Table 9.10: Encashment and Reinvestment of Special US$ Bonds

million US$

	Maturity	Repayment			Reinvestment
		US$	Converted into Pak Rs	5 percent Bonus	
Aug-01	-	-		-	-
Sep-01	0.0	0.0		-	-
Oct-01	0.1	-	0.1	0.0	0.0
Nov-01	38.9	0.3	3.4	0.2	15.1
Dec-01	89.7	5.0	44.0	2.2	21.2
Jan-02	70.5	4.8	124.8	6.2	4.9
Feb-02	28.7	1.9	28.8	1.4	7.6
Mar-02	45.4	1.6	44.3	2.2	2.9
Apr-02	71.5	13.3	29.8	-	2.9
Total	**344.9**	**26.9**	**275.1**	**12.3**	**54.6**

Source: Karachi and Lahore offices of SBP.

Figure 9.12: Maturity Structure of Special US$ Bonds



9.3.2 Long-term capital (official)

This account registered a lower outflow of US$ 112 million during Q3-FY02 compared to US$ 193 million last year. This decline reflects falling repayment of long-term debt. In terms of inflows, the reimbursement of F-16 installment in soybean oil also contributed significantly this year. Although the inflows under project assistance increased by US$ 20 million, the non-food aid showed a reversal from an inflow of US$ 50

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

million to an outflow of US$ 27 million in this quarter. In view of the new commitments from donor countries and lag in their disbursements, a rise may be expected in future.

9.3.3 Long-term capital (others)

Long-term capital (others), which comprises of suppliers' credit, PAYE loans and swaps, exhibited a net outflow of US$ 202 million during Q3-FY02 in contrast to an inflow of US$ 143 million last year. While outflows increased due to closure of swaps with various moneychangers and the higher repayments of suppliers' credit, the inflows reduced significantly to US$ 26 million on account of lower suppliers' credit.[109]

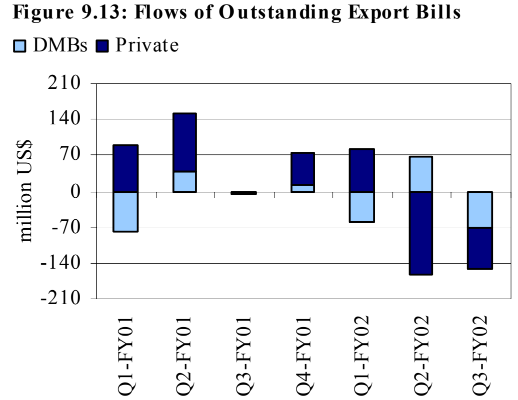
9.3.4 Short-term capital (official)

Short-term capital posted a sharp reversal from an inflow of US$ 77 million during Q3-FY01 to an outflow of US$ 181 million during the same period this year. In particular, the disbursements of short-term loans from commercial banks and IDB trade related financing were more than offset by repayments of short-term commercial swaps and IDB financing.[110]

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

Short-term capital comprises Outstanding Export Bills (OEBs) held by commercial banks and exporters, and non-resident FCAs mobilized by commercial banks and NBFIs. In aggregate terms, during Q3-FY02 this head posted a reversal from an outflow of US$ 258 million to an inflow of US$ 59 million over the corresponding period of this year. This change was mainly a response of exporters and banks to the appreciating Rupee, which reduced their stock of outstanding export bills (see **Figure 9.13**).

Figure 9.13: Flows of Outstanding Export Bills



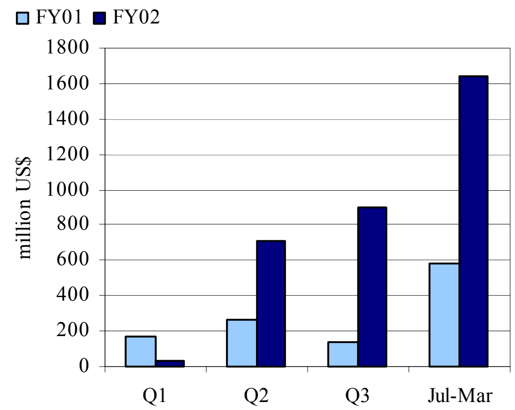
---

[109] The Rupee payment of these swaps is matched by inflows under errors and omissions to neutralize the notional currency repayments (see **Table 9.1**).

[110] SBP contracted a one month swaps with Shamil Bank in June 2001 to shore up foreign exchange reserves.

9.4 Exchange Rate Policy

Figure 9.14: SBP Purchases from the Interbank Market



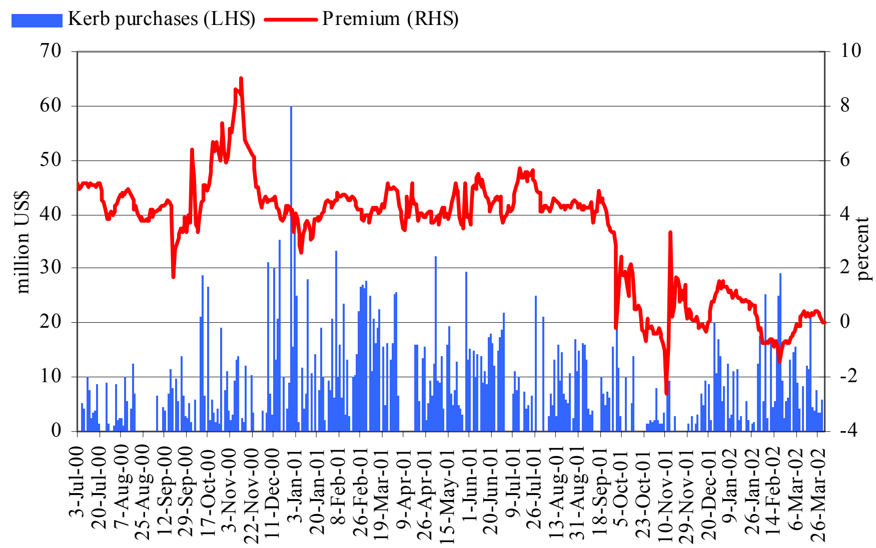
The upward pressures on the Rupee that developed in Q2 FY02, continued into Q3-FY02 as well, depressing the kerb market premium further. As a result, the hefty inflows are pouring into the forex market, whereas demand pressures are still subdued.[111] Nevertheless, exchange rate movements in this quarter were different in the sense that the exchange rate fluctuated within a narrow range of only 26 paisas in the interbank market. This is in sharp contrast to 6.6 percent *appreciation* observed during the second quarter this year, and 4.7 percent *depreciation* during the corresponding period last year. This stability in the exchange rate was the upshot of SBP purchases from the interbank market that increased to US$ 902 million during Q3-FY02 against US$ 705.2 million in the pervious quarter (see **Figures 9.14 & 9.15**).

The higher purchase from the interbank market reflects the desire to stabilize the exchange rate at around Rupees 60 /Dollar. This was necessary, as Pakistani exporters had already suffered on account of appreciating Rupee (6.6 percent during Jul-May FY02), loss of traditional markets, and the imposition of a war risk premium on transportation cost following September 11 incident, had the SBP not supported the Dollar, the parity would have appreciated further. The strength of the Rupee is underlined by the fact that not only the SBP purchased heavily from the interbank market; it has also drastically reduced injections (see **Table 9.11**).

The Rupee stability is also reflected in the movement of real effective exchange rate indices (REER) for Q3-FY02 (see **Figure 9.16**).[112] Although, major international currencies depreciated against the US Dollar, the relatively low rate of inflation in Pakistan helped in maintaining the purchasing power parity of the

[111] For details see SBP's first and second *Quarterly Reports* for FY02.
[112] For details on different REER indices, see SBP's first *Quarterly Report* for FY01.

Figure 9.15: Kerb Purchases, Premium and Market Support



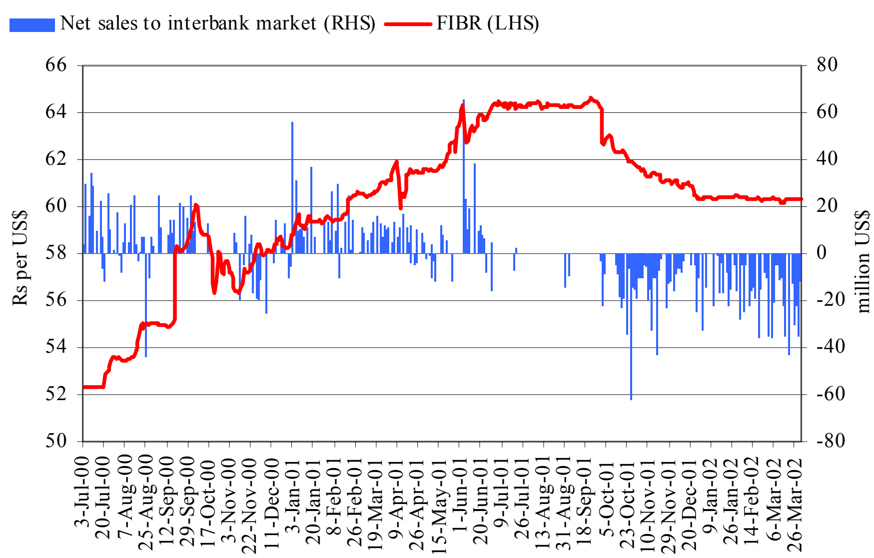
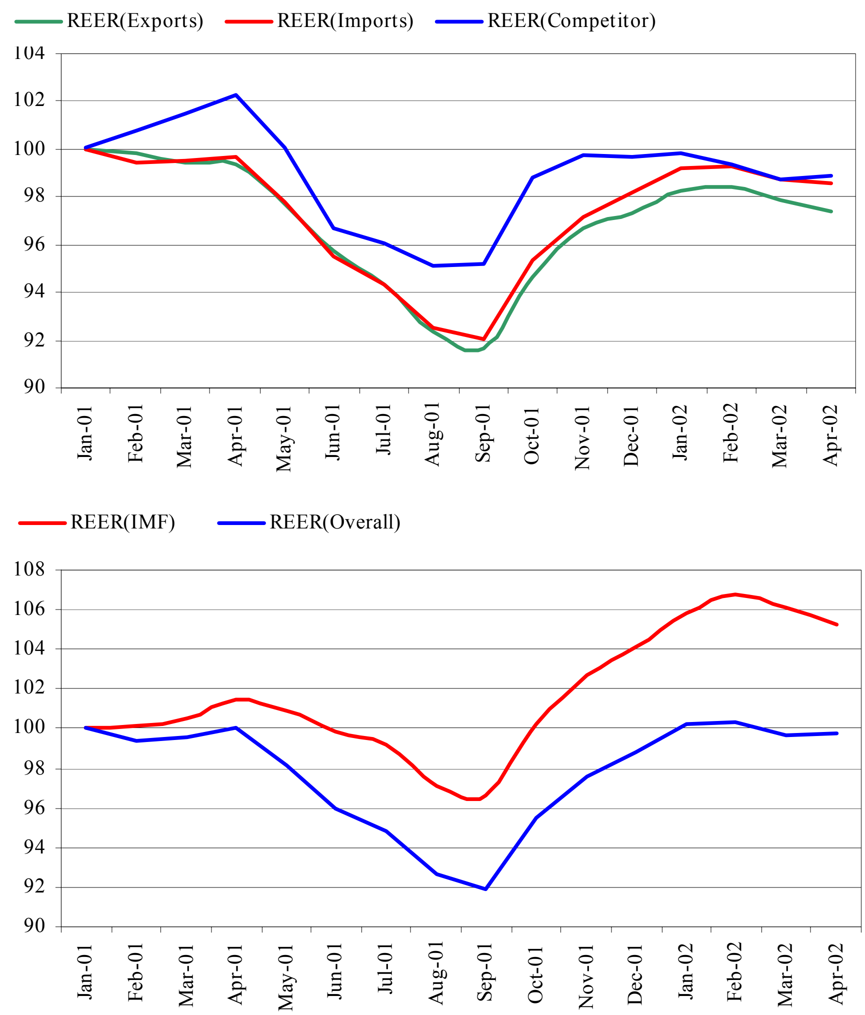


Figure 9.16: REER Indices (January 2001=100)



Rupee against the major trading partners and competitors.[113] Interestingly, since the basket of competitor countries include developing countries with high inflation, low prices in Pakistan are keeping the REER (competitor) down by a greater margin (see **Figure 9.16**). However, focusing on Jul-Apr FY02 period, the Rupee has appreciated considerably in real terms.

Table 9.11: Net Flows Through Purchases
million US$

	Q1		Q2		Q3		Jul-Mar	
	FY01	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**
Kerb purchases	226.7	397.9	528.30	239.10	806.00	431.6	1561.0	1069
Interbank Purchases	171	33	266.00	705.20	142.40	902.2	579.40	1640
Support	566.5	4.5	250.6	9.0	601.0	105.5	1418.1	119.0
Net sales	395.5	-28.5	-15.4	-696.2	458.56	-796.7	838.66	-1521

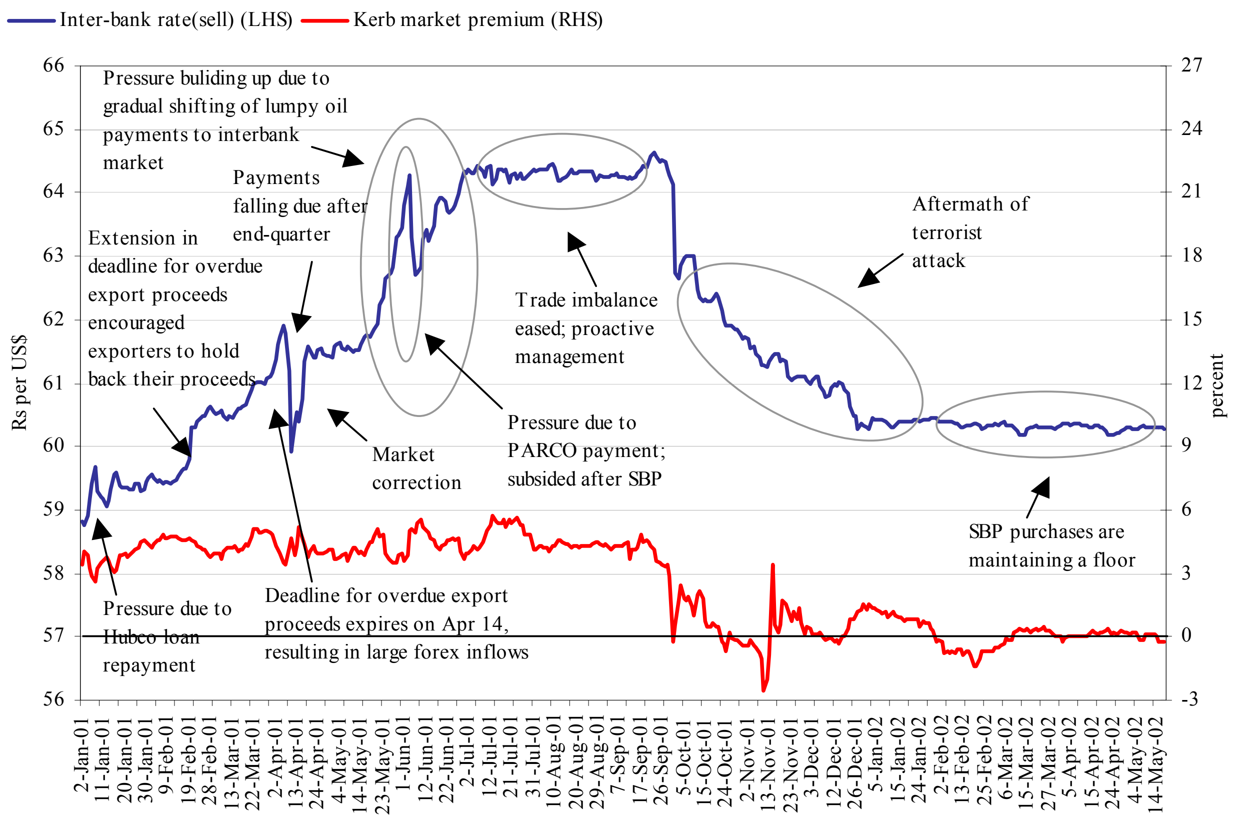
Source: Exchange and Debt Management Department, SBP

On the other hand, while the factors that were responsible for the positive structural shift in the forex market are still in play and putting upward pressure on the Rupee, which might prove to be unsteady in the longer-term. Therefore, in order to provide a continuing base to this structural change, there is a need to remove the segmentation in the foreign exchange market. In this regard, the launching of the foreign exchange companies (FECs) in July 2002 would be a major step.[114] As discussed in the previous *Quarterly Report,* these FECs may even lead to strengthening of the Rupee.[115] However, the final outcome would depend on how successfully the merger of the two markets takes place.

In the kerb market, following global crackdown on the hundi network, the premium has narrowed substantially.[116] This trend persisted even during the third quarter, when the market was working at around 1 percent premium.[117] In fact,

[113]On quarter-to-quarter basis, CPI Index growth rate dropped to 3.6 percent during Q3-FY02 (base 2000-01) compared to 4.5 percent in the corresponding period last year (base 1990-91).
[114] The higher foreign exchange reserves and the collapse of the kerb premium have already set a stage to unify the two foreign exchange markets.
[115] By capturing more inflows into the formal system, the setting up of these companies may result in a larger surplus in the current account.
[116] Prior to September 11 event, the kerb market premium used to vary in the range of 4-6 percent.
[117] The fall in smuggling (particularly from Afghanistan) along with movement of Pakistani troops on border induced drop in demand for Dollars in the kerb market. For further details, see first and second *Quarterly Reports* for FY02.

Figure 9.17: Interbank and Kerb Market Rate



the premium generally remained marginally in the negative during February 2002 (see **Figure 9.17**).

As a step towards liberalization of foreign exchange regime, SBP abolished the requirement on ADs to surrender foreign currency deposit mobilized under FE-31 scheme to SBP. From depositors' viewpoint, this would result into the integration of the two deposit schemes (i.e., FE-25 and FE-31), whereas from SBP's perspective, this would shift the foreign exchange liabilities to banks. As an immediate impact, this decision would affect the Rupee liquidity in the interbank market.[118] With the withdrawal of surrender requirement, the forward cover facility provided by SBP on FCAs also stands abolished. It may be mentioned here that in a scenario when the Rupee is appreciating, this facility could have been a major source of earning for SBP.

9.5 Foreign Exchange Reserves

The foreign exchange reserves continued to build up during the third quarter, but with lesser intensity, which reflects the greater emphasis by the SBP on settling expensive debt and short-term liabilities. The total outflow of US$ 511.3 million was witnessed under swaps, short-term deposits and PTMA, which will improve the country's future cash flows (see **Table 9.12**). Similarly, the accelerated payments of FE-45 deposits of US$ 393 million will also reduce the future external liabilities.

With the merging of FE-31 and FE-25 foreign currency deposit schemes, there will be a shift in reserves from SBP to commercial banks. In terms of inflows, logistics support by US, SBP purchases and long term loans marked an improvement in foreign exchange reserves (see **Figure 9.18**).

[118] Under FE-31 scheme, commercial banks were required to surrender the foreign exchange to the SBP against the Rupee equivalent. Following withdrawal of this restriction, banks have reclaimed the foreign exchange they have earlier surrendered after returning the Rupee counterpart.

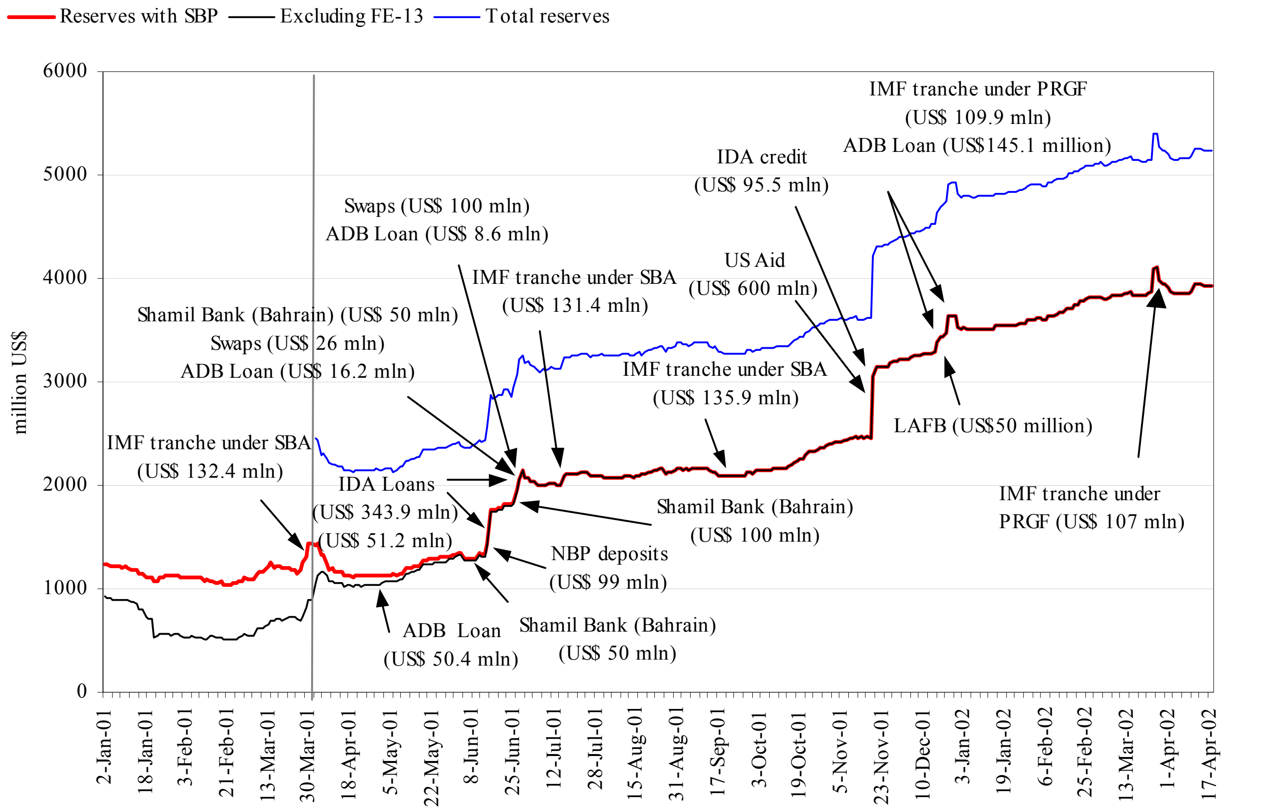
Table 9.12: Foreign Exchange Reserves With SBP (Jul-Mar 2002)
(million US$)

Opening balance as on July 1, 2001	2,075.8		
Closing balance as on March 31, 2001	3,940.3		
	1,864.5		
Details	**Inflows**	**Outflows**	**Net change**
FE-25 deposits placed with SBP as CRR	272.8	222.5	50.3
FE-31 incremental deposits	409.2	300.6	108.6
FE-45 repayments including interest		393.0	-393.0
Interbank purchases/sales	1640.4	124.0	1516.4
Kerb market purchases	1068.6		1068.6
US Grants	600.0		600.0
Logistics support by USA	300.0		300.0
ACU settlement[1]	139.1	247.9	-108.8
Debt servicing[2]		863.0	-863.0
Hajj Payments		107.0	-107.0
Long term loans[3]	320.2		320.2
Libyan deposits	50.0		50.0
Swaps		156.0	-156.0
Interest on Short term deposits/FE-25 deposits	60.2	55.9	4.3
Sale of Special US Dollar Bonds	14.6		14.6
Profit on Special US Dollar Bonds		43.4	-43.4
Short-term deposits[4]		381.0	-381.0
Pakistan Trade maintenance Agreement (PTMA)		368.1	-368.1
Receipts on serving as UN troops	48.5		48.5
IMF	376.9	163.1	213.8
Miscellaneous	66.8	77.3	10.5
Total	**5,367.3**	**3502.8**	**1864.5**

Source: Exchange and Debt Management Department, SBP

1. Settlement under Asian Clearing Union.
2. Debt servicing includes IDB (US$ 304.6 million), IBRD (US$ 188.2 million), ADB (US$ 109.8 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) and NBP (US$231 million.

Figure 9.18: Foreign Exchange Reserves



This page has been left blank intentionally

Appendix: Policy Measures During the Third Quarter FY02

1. Agriculture Sector

- **Enhancement of Grain Storage Capacity:** On January 19, 2002, the government decided to enhance grain storage capacity for rice and wheat by at least 500,000 tonnes with the help of private sector. Investors from the private sector would be encouraged to develop modern storage facilities near wheat growing areas and ports, particularly in Punjab and at Port Qasim. The Board of Investment invited bids from private sector to build modern storage facility on build-own-operate (BOO) basis.

- **Imposition of Cess:** On January 26, 2002, the government decided to impose cess on all crops, including wheat, rice, maize, onion, pulses, potato and tea etc., with a view to generate funds for agricultural-related research projects, besides providing better infrastructure to the farming community. Presently, cess is collected on sugarcane and tobacco crops. The mill-owners and cane growers share equal rate of cess, while in case of tobacco, cess is paid 100 percent by the industry, because there is no mechanism to check production and sale of the crop at growers' end.

- **Establishment of Agricultural Machinery Pool:** On February 09, 2002, Lahore District Government announced the establishment of an 'Agricultural Machinery Pool' for 11 Union Councils of the district. All kind of agricultural implements and machinery maintained in the Pool would be provided to the interested farmers on rent.

- **Laser Land Leveler:** On February 28, 2002, Pakistan Agricultural Research Council (PARC) demonstrated very encouraging results of the land-tilling machine known as laser land leveler. According to PARC it could increase production by as much as 80 percent through efficient utilization of water, like installation of sprinkling system. The locally manufactured laser land leveler costs US $ 2500 as compared to imported one price of US $ 10,000.

- **Closure of Sindh Seed Corporation:** On March 17, 2002, the government decided to wind up Sindh Seed Corporation (SSC). The corporation, under a special permission was allowed to purchase 15,000 mounds cottonseeds from PASCO, which were to be marketed before the end of the current fiscal year. The seeds multiplication farms would be handed over to Agriculture Research or Agriculture Extension while the fate of processing plant was not decided till that time. The Punjab Seed Corporation has been allowed to continue its operations till the private sector seed industry is fully developed and start meeting the seeds requirement of the growers.

2. Industrial Sector

- **SME Bank:** To cater the financial needs of small and medium enterprises, the SME Bank started operations from January 01, 2002. It was established by merging two specialized financial institutions, Small Business Finance Corporation (SBFC) and Regional Development Finance Corporation (RDFC).

- **Repayment of Custom Duty on Raw Materials:** In order to provide relieve to the textile industry, the Central Board of Revenues (CBR), with effect from February 01, 2002, announced repayment of custom duty on the import of raw material to be used in the manufacturing of finished products by textile mills and manufacturer of dyes.

- **Income Tax Relief to SIZs:** In order to expand the industrial base and revive the sick units, the CBR exempted special industrial zones (SIZs) from the levy of income tax with effect from February 10, 2002 till December 2002. This exemption of income tax would not be available to those units whose cases are under sub judice.

- **Increase in Custom Duty to Protect Domestic Sugar Industry:** In order to avoid the glut of sugar in the wake of good sugarcane crop, and to protect the domestic sugar industry, the government decided to increase custom duty from 20 percent to 30 percent on the import of both raw and refined sugar through an ordinance issued on February 27, 2002.

- **Relief to the Pharmaceutical Industry:** To provide relief to the pharmaceutical industry, the CBR, with immediate effect from March 22, 2002, exempted the import of raw materials from customs duty in excess of five percent ad valorem.

- **Micro Credit Bank:** To alleviate poverty and meet the credit needs of Small businesses and Agricultural tenants, Micro Credit Bank started its operation from March 11, 2002.

- **GST on the Import and Local Supply of, Castings for Automobiles:** The Central Board of Revenue (CBR) imposed 20 percent GST on the import and local supply of 'castings for automobiles and tractors', with effect from March 18, 2002.

3. Monetary Sector

Export Finance

- **Changes in Export Finance Rate:** On January 29, 2002, the State Bank of Pakistan decided to set export finance rate at 7 percent for February 2002, which was further reduced to 6 percent for the month of March. The rate was, however, increased by 50 basis points to 6.5 percent effective from April 01, 2002. The condition of maintaining the maximum margin/spread to 1.5 percent for providing financing facility to exporters to avail refinance facility was retained. The financing facilities under Part-B (Export Sales) of the Scheme for financing Locally Manufactured Machinery (LMM) shall also attract similar mark up rate structure.

- **Extension of EFS for Bleached/Unbleached Clothes:** Effective from January 30, 2002, exporters of the bleached/unbleached cloth were provided financing facilities under Part-I of the Export Finance Scheme. The provision of this facility was however, made conditional to maintaining the export price equivalent to or above US$ 3 per square meter.

- **Coverage of Export of Bones Under EFS:** Effective from February 16, 2002, Export Finance Facility was extended to export of bones under both parts of the Export Finance Scheme, and for the export of wheat under Part I of the Scheme at post shipment stage to the exporters of private sector only.

Cash Reserve Requirement for Deposits Raised under FE-Circular 25 of 1998

- The rate of remuneration on Special Cash Reserve Account (US$) maintained with the State Bank of Pakistan, was set at 1.35 percent for the month of February 2002, however subsequently increased to 1.37 percent, and 1.38 percent for the month of March and April respectively.

Discount Rate

- **Reduction in Discount Rate:** Effective from January 23, 2002, 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 FIBs was reduced from 10 percent to 9 percent per annum.

- **Extension of 3-Day Repo Facility to IBs & DFIs:** To meet liquidity requirements of the Investment Banks and Development Finance Institutions (DFIs) were allowed to access SBP 3-Day Repo facility on the same terms and conditions as applicable to the commercial banks.

Other Measures

- **Treatment of Subordinated Debt Instruments:** Effective from January 01, 2002, sub-ordinate debt will include rated and listed subordinated debt instruments (like TFCs/Bonds) raised in the capital market. To be eligible for inclusion in the supplementary capital, the instrument should be fully paid up, unsecured, subordinated as to payment of principal and profit to all other indebtedness of the bank, including deposits and should not be redeemable before maturity without prior approval of the SBP.

- **Amendment in Prudential Regulation Related to FE-25 Deposits:** Prudential Regulation pertaining to deposits mobilized under FE-25 1998, amended on January 01, 2002, stating that Foreign currency deposits mobilized under FE-25 schemes should not at any point exceed twenty 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 01, 2002, will ensure compliance by July 01, 2002.

- **Banks' Asset Requirement Against Their Time and Demand Liabilities:** Prudential regulation related to maintenance of assets by banks amended, under which, effective from March 02, 2002, all banks in Pakistan were required to maintain 80 percent (as against the present ratio of 85 percent) of the assets created by them against their time and demand liabilities in Pakistan and remaining 20 percent of its time and demand liabilities as specified in the said Form-X could be held abroad.

- **No Further Sale of Special US Dollar Bonds:** Effective from March 22, 2002, the Sale of Special US Dollar Bonds against payment of value in US dollars and payment of "Rupee Redemption Bonus of 5 percent", on maturity of three years Special US Dollar Bonds, for encashment in Pak Rupees was stopped by SBP, by amending Special US Dollar Bonds Rule of 1998.

4. Fiscal Measures

Taxation measures taken during the Q3-FY02 are summarized below:

Sales Tax

- **No Sales Tax on Computer Server Import:** Effective from January 17, 2002, the Central Board of Revenue (CBR) announced exemption of general sales tax (GST) on import and supply of computer servers. The net working equipment and data communication devices do not fall under this category.

- **20 Percent Increase in GST:** On February 02, 2002, GST rate was increased from 15 percent to 20 percent on local and imported steel products and ship-breaking items. A Central Board of Revenue note (No C.4/1-STB/2001-01) says that the five percent increase in GST rate would be effective through an amendment in the budget notification; where 190 items were put under 20 percent GST rate.

- **GST Relief on Computer Equipments:** Effective from February 11, 2002**,** various computer hardware components and parts including computer diskettes, tape cartridges, printer toner cartridges, ribbons and computer printers are exempted from General Sales Tax (GST). However, items of multiple use like speakers and blank CDs do not come under this law.

- **Sales Tax Refund on Courier Services:** On February 10, 2002, the Central Board of Revenue (CBR) permitted the registered exporters to demand refund of sales tax paid on courier services in lieu of exported goods.

- **No GST Exemption on Machinery Imports:** The Central Board of Revenue (CBR) announced on February 12, 2002, that all service providers, including mobile phone companies, are not allowed to avail exemption of general sales tax (GST) on the import of plant/machinery.

- **Re-Fixation of Urea Taxable Value:** The CBR through SRO 73, re-fixed the value of the taxable supply of locally produced urea fertilizer at the fixed rate of Rs 6,660 per tonne with effect from February 1, 2002.

- **GST on Supplies to Balochistan Tribal Areas:** On March 4, 2002, 15percent GST has been imposed on all the supplies to the tribal areas of Balochistan. Moreover, 3 percent further tax would also be applicable on the supply of unregistered sector of these areas.

- **General Sales Tax on Cell Phones in Swat:** On March 20, 2002, fifteen percent GST has been imposed on the connections of cellular phones operating in Swat, and calls made through this apparatus from other parts of the country.

- **15 Percent GST on All Kinds of Drugs:** From March 22, 2002, government imposed 15 percent general sales tax (GST) on all kind of medicines including Allopathic, Unani, Ayurvedic and Homeopathic medicines.

- **Withdrawal of Exemption to Fertilizer Dealer:** Government on March 30, 2002, announced withdrawal of all sales tax exemptions given to the local dealers of urea fertilizer.

- **Per Tonne Bagasse Value Fixed:** It is notified by the CBR authorities on March 30, 2002, that sales tax has been fixed at Rs 200 per tonne on the value of 'bagasse' used by the sugar industry.

Central Excise Duty

- **Withdrawal of Central Excise Duty on Local Supply of Bitumen:** From February 22, 2002, CBR announced withdrawal of central excise duty (CED) on the local supply of petroleum bitumen, natural bitumen and asphalt. Formerly, there was Rs 127.95 per tonne CED on these things.

Customs

- **One Installation Certificate for Duty, Tax-Free Machinery Import:** From January 1, 2002, importers of plant and machinery are no longer required to attain separate certificates for the exemption of the custom duty and sales tax on single import.

- **Duty Drawback Facility for ICI Raw Materials:** The Central Board of Revenue (CBR) decided to repay custom duty on the import of seven different raw materials used in production of goods produced by ICI Pakistan Limited, Karachi. The amount of repayment ranges from Rs 1.04 per kg to Rs 13.55 per kg on the export of goods during 1998-2000.

- **Withholding Tax Removal on Supply of Imported Goods:** On February 14, 2002**,** federal tax authorities announced withdrawal of withholding tax on supply of imported goods. A 6 percent levy had been applicable earlier at the input stage.

- **Oil Companies Allowed to Claim Input Tax Credit:** The tax authorities allowed the petroleum exploration companies to claim input tax credit and issue debit or credit note for adjustment against output tax in the sales tax returns from February 15, 2002.

5. External Sector

Foreign Trade

- **Abolition of Export Development Surcharge:** The Ministry of Commerce in consultation with Central Board of Revenue decided on January 16, 2002, to abolish Export Development Surcharge (EDS) on all exports up to June 30, 2002. This decision was taken to reduce extra financial burden on exporters.

- **Withdrawal of Anti-Dumping Duty:** European Union announced the withdrawal of 6.4 percent anti-dumping duty on imports of bed linen from Pakistan with immediate effect on January 28, 2002.

- **Exemption of Custom Duty and Sales Tax for Import of Raw Materials Used in Manufacturing of Finished Products:** In a move to encourage investment in export-oriented industries, Central Board of Revenue, on February 7, 2002, announced exemption of customs duty and sales tax for a specific period (3-5 years) on the import of raw materials used in the manufacturing of finished products from July 01, 2002. The decision covered thousands of industrial raw materials used by various sectors including high-tech industry and other zones, exclusively dealing in the raw materials cleared on payment of customs duty and sales tax.

- **Repayment of Customs Duty on Batteries Raw Material:** On February 12, 2002, CBR announced the repayment of custom duty on the import of raw materials used in the manufacturing of various kinds of batteries produced in the country.

- **Exemption of CED on Hydraulic Cement's Import:** The CBR announced the exemption of central excise duty (CED) on the import of 'hydraulic cement', used specifically in the construction of oil wells on February 13, 2002.

- **Exports to Afghanistan:** On February 21, 2002, the Economic Co-ordination Committee of the Cabinet (ECC) approved the negative list for export to Afghanistan and allowed the export of urea, high speed diesel, furnace oil and all other petroleum products, zero rated export from EPZ/Bonds except vegetable ghee and cooking oil.

- **Repayment of Custom Duty on Raw Material Import by Textile Industry:** The Central Board of Revenue (CBR) on March 04, 2002, decided to repay custom duty on the import of raw materials used in the manufacturing of 'core spun yarn' by the textile industry. The duty drawback facility would only be applicable on the import of 'lycra yarn or spandex yarn' used for producing 'core spun yarn with lycra', for export.

- **Withdrawal of Custom Duty Concession:** On March 07, 2002, CBR withdrew the concession in the rate of custom duty on the import of hot roll clad (HRC) sheets of all sizes, on the recommendations of the Engineering Development Board (EDB).

- **Extension of Duty Drawback Facility:** CBR announced the extension of duty draw back facility to 50 new raw materials, which included all man-made yarns used in the manufacturing of textile products to be re-exported by the commercial exporters as well manufacture-cum-exporters on March 17, 2002.

Foreign Exchange Market

- **No Further Deposits Under NDRP:** Having sufficient reserve buildup, it was decided not to accept further deposits under National Debt Retirement Program (NDRP III 'profit bearing') as well as rollover of existing deposits ceased with effect from January 31, 2001. Hence, all existing deposits under NDRP III were to be paid on maturity dates.

- **Issuance of Foreign Currency Travelers' Cheques by ADs:** In a move to further liberalize foreign exchange activities, effective from February 13, 2002, ADs were allowed to issue foreign currency travelers' cheques to foreign nationals and Pakistani nationals against surrendering of an equivalent amount of foreign exchange in cash.

- **Special Foreign Currency Accounts:** Effective from February 19, 2002, ADs were delegated the powers to allow shipping companies to open Special Foreign Currency Accounts in Pakistan and operations of such accounts are subject to fulfillment of certain conditions.

- **Treatment of FE-31 Deposits:** In respect of FE-31 deposits, it was decided on March 18, 2002, that ADs would not be required to surrender to SBP the foreign currency deposits mobilized by them. No fresh forward cover will be provided by the SBP and no rollover of forward cover will be allowed with effect from April 01, 2002. However ADs will be allowed to take up their forward covers, both for deposits and to the extent of accrued interest from SBP, by paying equivalent Pak Rupee at booked rates. Premature take up would also be permissible. Moreover, with effect from July 01, 2002, the same CRR and SLR will be applicable on FE-31 as is applicable to FE-25. Hence, effective from January 01, 2003, all deposits under FE-31 shall cease to exist and will be shifted to FE-25.