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THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY03

Overview

Prospects for Pakistan's economy brightened significantly in Q2-FY03 following a pick-up in both, domestic demand and export activity. Not only is there an increased likelihood that the agri-sector will indeed meet the 2.6 percent FY03 growth target, there is also a visible improvement in large scale manufacturing (the YoY sectoral growth rate nearly tripled to 5.2 percent in H1-FY03), and in trading activity (e.g., H1-FY03 exports are up 16.6 percent YoY). As a consequence, it looks increasingly likely that Pakistan will meet the 4.5 percent FY03 real GDP growth target.

Table 1.1: Economic Indicators

percent

	July-December		
Growth rates	**FY01**	**FY02**	**FY03**
Large-scale manufacturing	2.2	1.8	5.2
Exports	8.4	-0.4	16.6
Imports	10.2	-9.6	18.7
Home remittances[1]	16.6	96.1	124.7
Tax revenues (CBR)	13.5	-4.1	15.4
CPI (H1 over H1)	4.9	3.3	3.6
Private sector credit	14.0	8.5	11.4
Money supply (M2)	5.4	8.1	9.5
Liquid foreign exchange reserves[2]	2453	4807	9336
Foreign direct investment[3]	144	204	541
As % of GDP[4]			
Fiscal deficit	2.3	2.7	1.6
Trade deficit	1.6	0.7	0.9
Current a/c balance	-0.4	2.1	2.5

[1] Excluding receipts on a/c of Kuwait war affectees & Hajj.
[2] With SBP & scheduled banks, end-December, in million US$.
[3] in million US$.
[4] Based on full year GDP. GoP projections used for FY03 GDP.

The revival of growth in large-scale manufacturing (LSM) is a particularly noteworthy, and welcome, development of Q2-FY03 (see **Table 1.1**). The Q2-FY03 growth represents a significant improvement over the anemic 2.2 percent growth in LSM during Q1-FY03. Moreover, unlike the data used for Q1-FY03, which was partial in coverage, the data for the current quarter is more robust. The reliability of these numbers is confirmed by the concordance between this data and aligned indicators of domestic demand, i.e., imports of machinery and raw materials, strong inward remittances, improved manufactured exports and growth in private sector credit.

The latter, in particular, is one of the most encouraging developments of Q2-FY03. Private sector credit demand from banks jumped very sharply, reaching Rs

76.8 billion by end-December 2002. The increase probably reflects both, reduced political uncertainty and a sharp cut in domestic interest rates.

The rise in domestic demand is clearly evidenced by a number of factors including the rising domestic sales tax collections, higher cement dispatches, an exceptional showing by the auto sector, improved manufactured exports (which would require domestic inputs), etc.

Interestingly, despite the strong rise in demand, CPI inflationary pressures have remained subdued. This appears to stem from a deceleration in food inflation as a result of supply side improvements including, cheaper imports of some commodities (i.e., an element of imported deflation), strong harvests of important crops as well as lower exports of key agri-commodities (increasing domestic supply). While the annualized CPI inflation for H1-FY03 (3.6 percent) is certainly a little higher than in H1-FY02 (3.3 percent), the marginal (YoY) CPI inflation has *trended* downwards, after peaking in June 2002. This suggests that CPI inflation will remain around the 4 percent FY03 target. By contrast, the WPI, which has a lower weightage for food items, shows a steady upward trend[1] in both, annualized and marginal rates, which appears more, aligned with the perceived rising demand pressures.

Another bright spot for the economy appears to be the good fiscal out turn, with the H1-FY03 deficit held to 1.6 percent of GDP, comfortably within the annual target of 4 percent of GDP. However, a quarterly break-up of the consolidated federal and provincial fiscal performance depicts a decidedly mixed result. The revenue picture is quite exceptional, with sustained strong growth in tax revenues *and* non-tax revenues in each quarter of FY03. On the other hand, expenditures too have accelerated in Q2-FY03, with the 9.6 percent YoY increase being concentrated in current spending, rather than on development. It is worth noting, however, that the spurt in consolidated expenditures is due to a Rs 35.3 billion (50.5 percent YoY) rise in provincial spending; the Federal government, encouragingly, has maintained fiscal discipline. Clearly, if the macroeconomic stability is to be maintained, provincial governments will also need to shoulder greater responsibility in managing their budgets. Moreover, it is imperative, that spending increases be focused in pro-growth areas such as health, education, and infrastructure, which deliver sustained economic benefits in investment,

[1] This could be a point of concern since (1) historically, the movement of the CPI has seen a weak lagged correlation to the WPI and (2) rising energy prices are likely to contribute strongly to non-food inflation in months ahead.

employment and production. Improvements in the fiscal deficit generated through low development spending are *not* desirable for the economy in the long run.

In any case, the fall in the fiscal deficit and the relatively higher availability of non-bank credit allowed the government to significantly reduce its borrowings from the banking system. Specifically, the government's need for rupee borrowings declined sharply, as approximately 73.6 percent of the H1-FY03 fiscal deficit was funded by external inflows. As a result, the government's domestic funding requirement for the period was a mere Rs 8.8 billion. Given that the non-discretionary NSS inflows also increased, the government, perforce, retired Rs 34 billion of its bank borrowings. This is troubling. In effect, the government was using expensive funds to retire cheap borrowings. Clearly, the current practice of NSS instruments being continuously available on tap, needs to be reviewed.

Incidentally, the reduction in the government's bank borrowings is attributable entirely to the retirement of SBP holdings. In fact, during H1-FY03, SBP forex purchases increased the SBP NFA by Rs 172.9 billion, which was partially offset (sterilized), through retirement of SBP T-bill holdings and other NFA changes, resulting in a net Rs 55.9 billion growth in reserve money during H1-FY03.

Notably, the Q2-FY03 SBP purchases were underpinned by the current account *and* capital account surpluses. Remittances were again the most significant contributor to the build-up of current account surplus. In fact, it is the rising confidence in the sustainability of these flows that has (1) led SBP to initiate a gradual appreciation of the rupee in FY03, after a period of stability, and (2) increased interest in the premature retirement of the country's external debt.

Another key positive for the current account was the export performance. As exporters gradually adjust to the structural shifts in Pakistan's external account, it is probable that the SBP will slowly accelerate the exchange rate adjustments, in order to benefit the economy through cheaper imports and savings in external debt servicing. However, this may not be immediately possible. While Pakistan's 16.6 percent export growth for H1-FY03 is encouraging, it remains to be seen if this trend is sustainable or not. The export sector faces significant near-term threats, including:

(1) The potential loss of exports orders due to regional geo-political disturbances

This has two dimensions for Pakistan. In the short-term, the greater risk emanates from the threat of a US-led campaign against Iraq. The perceived risk to the fulfillment of export orders due to resulting regional disorders could

potentially lead to a substantial diversion of business away from Pakistan. Pakistan will need a very aggressive campaign by the private sector to counter these risk perceptions. The government should too play a part, by supporting such initiatives. Simultaneously, exports could be hit by the impact of high oil prices and higher transportation costs (e.g. due to a war risk premium, etc.)

(2) Anti-dumping proceedings
Some of Pakistan's key exports face the threat of anti-dumping actions. These too need to be aggressively countered through a partnership between the private sector and government.

The impending US-led war with Iraq will also have some financial consequences for Pakistan's economy depending on its intensity, duration and collateral damages (under the most likely scenario, the government estimates a loss of US$ 1 billion to the economy due to a higher oil import bill) which can be absorbed without much serious disruption. It is at times such as these that the benefits of accumulating large liquid foreign reserves become quite apparent.

In summary, the prospective FY03 is a watershed for Pakistan's economy. Structural adjustments of recent years appear to be slowly taking hold (see **Box 1:** *Macroeconomic Stabilization and Economic Growth*), laying the foundations for an acceleration of the economic growth in the medium term. However, it should be noted that such transitions are, by definition, fragile, and must be nurtured through continued adherence to the reform path.

The new government has remained committed, so far, to good governance and continuity of economic reforms. If this tendency persists, domestic investor uncertainties will be reduced to a large extent and help reinforce the economic revival process. At the same time, any indications about perceived political instability or, relaxation in the fiscal or monetary discipline, or a slowdown in either CBR reforms, or regulatory reforms, or restructuring of WAPDA, KESC or, privatization, will exacerbate these uncertainties and render the achievement of the above path unviable.

Box 1: Macroeconomic Stabilization and Accelerated Growth

After three years' consistent and focused efforts, Pakistan has successfully completed its macroeconomic stabilization program initiated in December 1999. This assessment is based on the observed changes in key indicators. Inflation has been brought under control (below 4 percent); debt dynamics are moving in the direction of sustainability (although the debt stock indicators are still relatively high); fiscal deficit reduction targets are on track (around 5 percent of GDP); the current account has recorded surplus for the last two years (even after excluding the one-time transfers from the US Government); the budgetary losses of public sector enterprises have been contained (e.g. Pakistan Steel, PIA have turned around financially); and foreign reserves are at a highly comfortable level to face unforeseen shocks.

How has this situation come about? A combination of structural changes (financial sector reforms, tax reforms, aligning agricultural producer prices to international prices), sound but tough policy decisions (removal of subsidies, deregulation of petroleum prices, free float of exchange rate), improved economic governance (reduced leakage in public expenditure) and good luck (remittances began to flow through banking channels, capital flight was partially reversed) have contributed to this outcome.

How durable is this stability? The two main sources of vulnerability for Pakistan's economy, in the past, have been persistent and large fiscal and current account deficits. The common thread between these twin deficits has been an extremely high debt burden – both external and domestic. In the last three years, the strategy aimed at reducing debt servicing burden in terms of foreign exchange earnings and the budgetary expenditure, has started to bear fruits. By re-profiling bilateral debt over a longer tenor (38 years), making early payments of expensive debt and liabilities (about US$ 6 billion), substituting soft-term loans for non-concessional loans from multilateral institutions and avoiding new commercial loans, the external debt servicing ratio (the ratio of debt servicing to foreign exchange earnings) will decline from 75 percent in FY01 to the 25-30 percent range by FY05. This will certainly be within manageable limits, which Pakistan can pay out of its own earnings, without seeking any exceptional balance of payments financing from the IMF.

On the public debt servicing reduction path, Pakistan is projected to run primary surpluses on its budget (it has been generating surpluses for the last 4 years) and nominal GDP growth rate is likely to exceed the implicit rate on public debt (assuming that the high cost of National Savings Scheme will continue to be brought in line).

Macroeconomic stabilization has taken somewhat longer than originally envisaged but four unanticipated major shocks (severe drought, global recession, September 11 and border tensions with India) prolonged the period of successful completion.

Moreover, uncertainty caused by domestic terrorist attacks did not help either, although the extra vigilance on Hundi and Hawala in the USA and UAE diverted the channeling of remittances from the open market to the inter-bank market.

The country has entered, in FY03, the transition phase for achieving accelerated growth. The outcomes for the current fiscal year will, by and large, determine whether Pakistan is indeed moving towards a 6 percent GDP growth trajectory targeted for FY05 onwards or not. If the growth rate of 4.5 percent is attained this year and the Iraq war or any other shock – domestic, regional or international – does not cause a major disruption, it is quite likely that Pakistan would be able to strike GDP growth of 5 to 5.5 percent range in FY04 and 6 percent in FY05. But Pakistan has been prone to a variety of shocks. Therefore, downside risks of a worsening geopolitical situation, domestic violence, stresses in the working of Parliament, etc., should always be kept in mind. In such events, these targets will be hard to achieve. Also, losses of WAPDA and KESC continue to pose a threat to government's fiscal deficit reduction objectives.

The main stimulus to the economy in the next two years should take place via larger public sector development expenditure (PSDP) and higher agricultural production. The monetary and credit policy will also play its role in boosting domestic and export demand while keeping inflation under control. The increase in PSDP expenditure has become feasible because of the fiscal space available due to reduced burden of debt servicing and growth in tax revenues. Agriculture had been hit hard by prolonged drought but it is expected that water availability will normalize and agriculture will resume its historical growth trend. Considerably low rates of lending, large liquidity with the banking system, fierce competition among the banks and lower remuneration on Government securities are pushing the financial institutions towards new avenues such as, consumer, mortgage, personal loans, SME and agriculture financing and targeting new customers particularly in middle class. This is likely to boost domestic demand while the continued decline in export finance rate, low cost dollar loans to exporters and stable exchange rate will help the export sector of the economy.

Nonetheless, there is no room for complacency. Pakistan has still a long way to go before the incidence of poverty is significantly reduced, employment generation takes place on a wide scale and the standard of living of the common man takes a turn for the better. But the route to achieve these objectives is not through ad-hoc short term temporary palliatives but by sticking to the course of reforms, good governance, political stability and hard work by Pakistanis.

Executive Summary

Agriculture

Good harvests of *kharif* crops along with improved prospects for the *rabi* crops are likely to result in a strong recovery by agriculture during FY03. Preliminary estimates on a majority of the important crops suggest that the crops sub-sector, which has a share of more than 57 percent in agricultural GDP, is set to lead the growth in agriculture sector during FY03.

Improved canal-water availability over the last year, particularly during the sowing season for rice and sugarcane, made it possible to bring a higher area under cultivation for these crops. Together with high yields, this allowed significant improvement in the production of the respective crops. By contrast, the fall in area under cotton was caused by the delayed water availability in *Punjab* and the poor market prices during the preceding season. Although the yield of cotton improved during FY03, this could not compensate for the lower area. As a result, the FY03 cotton production is provisionally estimated to be lower than in FY02.

During H1-FY03, the market prices of both rice and cotton remained higher than in the previous year. Although partly offset by lower prices of minor crops, this increase has helped arrest the deteriorating trend in farmers' income witnessed in the past two years. Consequently, the sales of consumer durables in rural economy remained higher during H1-FY03 compared to the same period last year.

Moreover, higher recovery of agri-loans during H1-FY03 was another reflection of stronger financial position of the farmers. Similarly, higher disbursements, with rise in ratio of development loans to production loans during H1-FY03 suggest that the farmers are more confident on the prospects of agriculture sector as a whole.

Large-scale Manufacturing

The overall growth in large-scale manufacturing (LSM), based on data for 91 items, showed remarkable growth of 5.2 percent during H1-FY03 compared to 1.8 percent increase in H1-FY02. The growth in manufacturing was generally broad-based, led by increase in textile exports and domestic demand for consumer durables.

While increase in textile exports was due to increased exports to the EU and USA, rising remittances, declining interest rates and increased access to consumer credit, (especially for the purchase of autos and home appliances) have been the major factors behind rising local consumer demand. Improvements in the production of

sugar (13.6 percent against a decline of almost same magnitude last year) cement, and paper & board also helped in pushing up the overall LSM growth up. However, the production of petroleum products, which had been rising in the preceding two years (since PARCO started production), declined during H1-FY03.

Fiscal Developments

Fiscal consolidation achieved during Q1-FY03 was further strengthened during Q2-FY03. The overall H1-FY03 budget deficit was down to only Rs 65.7 billion (1.6 percent of GDP) compared to Rs 99.9 billion (2.7 percent of GDP) for H1-FY02. This encouraging development was the upshot of a significant increase of Rs 68.9 billion in total revenues compared to preceding year. The surge in revenues was largely on account of an impressive growth in CBR tax collections, higher surcharges and dividend income, and payments received against logistics support to international forces operating in Afghanistan.

CBR H1-FY03 tax collections not only saw a 15.4 percent rise over the corresponding period last year, but also marginally crossed the Rs 200.5 billion target. A sharp rise in sales tax receipts on the back of higher dutiable imports as well as increased demand for domestic goods was the main factors behind this outcome.

A rise of Rs 34.7 billion in expenditures has been recorded in the Q2-FY03, with bulk of this increase coming from a sharp rise in current expenditures of provincial governments. It appears that there has been a pick-up in the activities of local government and the newly elected provincial governments.

Money and Credit

The external account improvements continued to heavily influence the SBP monetary policy during Q2-FY03, as it strove to reconcile the conflicting imperatives of preventing a too-abrupt rise of the rupee while simultaneously preventing a de-stabilizing growth in reserve money. Therefore, under the weight of the continuing external inflows, the SBP again chose to allow a gradual adjustment of the Rs/US$ parity by mopping up the liquidity from the inter-bank forex market, it also loosened its hold on the benchmark 6-month T-bill rates.

During H1-FY03, the marginal inflation rate continued to drop until November 2002, bottoming out below the 12 month moving average. The weakness in inflationary pressures and apparent weakness in net private sector credit growth prompted SBP to implement a 150 basis point discount rate cut on November 18, 2002. This had an immediate response on net credit to private sector, which

recorded an increase of Rs 103.7 billion during Q2-FY03 as against Rs 72.3 billion in the same period last year. Moreover, the acceleration in net credit expansion was not limited only to the banking sector. The Non-bank Financial Institutions (NBFIs), which saw only a nominal credit expansion of Rs 1.2 billion during H1-FY02, recorded a significant increase of Rs 14.0 billion in H1-FY03.[2]

In overall terms, the monetary survey indicates that the main policy objective i.e., providing a stimulus to the private sector, was achieved in H1-FY03, while keeping the broad money growth under control. Money supply grew by 9.5 percent in H1-FY03 (8.1 percent in H1-FY02), even though net domestic assets declined by 1.9 percent in this period (compared to an increase of 3.5 percent in the corresponding period last year). The phenomenal growth in NFA thus accounts for all of the growth in money supply during H1-FY03.

Despite healthy off take of credit by the private sector, SBP did not inject any liquidity into the market through OMOs during Q2-FY03. This was primarily due to the forex interventions of the central bank that were gradually injecting rupee liquidity in the money market. Although commercial banks were forced to the discount window on 32 days during Q2-FY03, this number was substantially lower than in past years. This suggests liquidity shortages were not a major concern for banks during the period.

In addition, the lack of rupee injections through OMOs was directed towards streamlining the bidding behavior of the commercial banks in the primary auctions and to minimize the probability of excessive bidding in auctions by banks in anticipation of liquidity support by the SBP.

Participation in auctions remained high during Q2-FY03 reflecting the sheer amount of rupee injections through SBP forex purchases. Accordingly, there was a downward pressure on the yields of government securities in the secondary market, shifting the yield curve downwards. The pronounced fall in yields of the long-term paper relative to the fall in the yields of the short-term paper, flattened the yield curve. The reason behind a larger fall in the yields of the long-term bond towards the end of H1-FY03 was the scarcity of PIBs created due to restricted supply by the government in the wake of earlier high mobilization vis-à-vis the budgetary target.

[2] Figure of net credit expansion for NBFIs has been calculated from their un-audited balance sheets and is the total of (a) advances and lease finance to private corporate sector, unincorporated entities and individuals (b) inland bills and (c) investment in private corporate bonds, shares and term finance certificates.

Banking

During Q2-FY03, the highlight of the banking sector developments was the remarkable growth in net credit[3] helped by lower political uncertainty and a 150 basis point cut in discount rate. There was a supply push as banks had ample liquidity and investment in government securities had become less attractive due to the historically low yields. Demand factors also played a part as lower lending rates attracted borrowers, who could utilize credit profitably at these rates.

Other than the nationalized banks, all the groups extended higher credit in Q2-FY03 compared to the second quarter of FY02. There were two prime factors behind the slow credit growth by nationalized banks: (1) the larger exposure towards credit to government (commodity operations), PSEs and autonomous bodies that saw net retirement in Q2-FY03; and (2), an inability to cut their high lending rates to the extent of the other groups. The weighted average lending rates of all banks fell by 165 basis points during the quarter; whereas NCBs dropped their lending rates by less than 100 basis points during the same period.

Larger seasonal increase in the demand for cash and higher mobilization of funds through NSS resulted in a relatively slow growth in deposits of scheduled banks during Q2-FY03. Finally, the outstanding level of scheduled banks' NPLs surged by Rs 11.6 billion in Q2-FY03, but this was entirely due to the contribution of one specialized banks.

Prices

The annualized rate of inflation, in terms of all three indices, was higher than in Q1-FY03. However, marginal rates for CPI and SPI declined in Q2-FY03. This deceleration in the rate of CPI and SPI inflation has largely been on the part of food group that has seen lower price increases. The improved availability of essential food items due to better production combined with the imported deflation amidst rupee appreciation probably helped eased inflationary pressures during the second quarter of FY03. However, the up trend in WPI inflation is a source of concern.

Capital Markets

During Q2-FY03, the KSE-100 index soared as high as 2701.4 registering a 33 percent gain over the previous quarter. The market capitalization also rose to Rs 588.4 billion, a 28.4 percent increase over Q1-FY03. The main reason behind this bullish trend was the ample rupee liquidity flowing into the capital market amidst depressed returns on alternative investment avenues. Factors such as improved

[3] Banks saw a credit growth of 9.4 percent against 8.0 percent in the preceding quarter of FY02.

economic fundamentals, relatively cheap market valuations and expectations of early privatizations also contributed to the upward rise. Speculative interest was indeed a significant contributor to this rise as badla financing volumes were 44.9 percent higher during Q2-FY03 relative to previous quarter.

The primary corporate debt market remained relatively inactive in Q2-FY03 witnessing just three new issues worth Rs 2.2 billion in the period, as against eight issues worth Rs 4.6 billion in Q1-FY03. Moreover, given the decline in the benchmark interest rates, practically all floating rate bonds hit their floors, providing ample opportunity for investors to book capital gains.

External Sector

Pakistan's external account picture remained significantly positive during Q2-FY03, despite a rising trade deficit and a fall in the services account inflows compared to Q1-FY03. Cumulatively, the current account posted a surplus of US$ 1.7 billion during first half of the current fiscal year relative to a surplus of US$ 1.3 billion in the corresponding period last year. Even, excluding Saudi Oil Facility (SOF), kerb purchases, US aid and receipts against logistic support, the current account balance (CAB*) improved substantially during HI-FY03 by registering a surplus of US$ 1.1 billion as against a deficit of US$ 0.3 billion during HI-FY02.

The noteworthy development during the first half of current fiscal year is the reversal in capital account from outflow of US$ 512.0 million during HI-FY02 to an inflow of US$ 106.0 million in H1-FY03. This was mainly driven by: (1) higher foreign direct investment inflows due to receipts of privatization proceeds; (2) higher inflows on account of project aid and balance of payments support from World Bank and ADB; (3) the increased inflows under suppliers' credit and (4) the sharp growth in disbursement of foreign currency denominated loans (mainly from FE-25 deposits) for export financing. Approximately US$ 413 million of the inflows represents a contra-entry against forex loans disbursed by banks. Adjusting for these flows, the capital account shows a deficit of US$ 307 million, but even this represents a 47 percent improvement over the corresponding figure for FY02.

The continued current account surplus, largely due to the increased remittances resulted in massive inflows in the inter-bank market. The SBP, by mopping up this excess liquidity through its inter-bank purchases, allowed only a gradual appreciation of 3.1 percent in the Rs/US$ parity during H1-FY03.

The large inter-bank purchases also helped the SBP in building up its reserves further to US$ 8.1 billion by end-December 2002. While the SBP reserves growth accelerated during H1-FY03 over H1-FY02, the commercial banks' reserves declined over the same period.

H1-FY03 witnessed an impressive trade performance, with exports rising by 16.6 percent over the corresponding period last year, and totaling US$ 5.2 billion (50 percent of the annual target i.e. US$ 10.4 billion) during the period. Textile sector continued to contribute a larger share (64.7 percent) in total exports, with high value added textiles capturing a 59.2 percent share. Among the major non-textile exports, rice exports performed well, recording a 7.2 percent growth over the corresponding period last year, while most other important categories displayed marginal growth. The export of carpets and leather manufactures continued to decline.

Imports also witnessed higher growth in H1-FY03 over H1-FY02 (18.7 percent). Encouragingly, this growth is contributed more by non-food and non-POL imports (machinery and other raw-materials for industrial and consumer goods), with the machinery imports providing the highest contribution in growth (36 per cent). The rising petroleum prices inflated the petroleum import bill, despite the lower quantity of POL product imports. Food group imports registered a 30.3 percent growth in H1-FY03, with edible oil being the major contributor to this category.

2. Real Sector

2.1 Agriculture

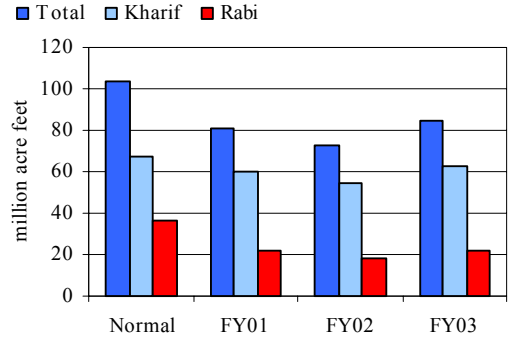
Supported by improved water availability and fewer incidences of pest and virus attacks, the agricultural sector has turned in a significantly better performance during H1-FY03 relative to H1-FY02. Not only did the production of important *kharif* crops[4] see an improvement over the preceding two years but also the market prices for these products were more attractive.[5] Initial data suggests that the important *rabi* crops are also likely to follow this trend in production. Thus, barring unforeseen problems, and assuming a reasonable performance by the livestock sector, the agricultural sector growth target (2.6 percent for FY03)[6] is likely to be exceeded.

The sugarcane crop for FY03 registered a significant rise of 7.5 percent, mainly on account of higher water availability and higher market prices last year. Despite preliminary estimates that the FY03 cotton crop would be slightly smaller than that in FY02, cotton markets witnessed robust activity; cotton arrivals in ginning factories during H1-FY03 were around 11.1 percent higher than in the corresponding period last year.

2.1.1 Water Availability

There was a distinct improvement in water availability during FY03 for both, the *kharif* and *rabi* seasons. The availability of irrigation water during *kharif* (April-September) was up by 15 percent (YoY), while it was higher by 17 percent (YoY) up to January 10, 2003 during *rabi* (October- March).

Figure 2.1: Availability of Irrigation Water



Although not yet at comfortable levels, when compared with the average for normal years of water supply (e.g., 1996-2000),[7] the total water availability at

[4] Higher productions were achieved in case of rice, sugarcane and maize, while the preliminary estimates place cotton slightly less than last year.
[5] Sugarcane prices were a distinct exception to this trend.
[6] As per the Annual Plan the growth for agriculture was projected at 2.4 percent for FY03.
[7] It was at 102.2 million acre feet (MAF), very close to the 103.5 MAF 1991 Water Accord.

canal heads during FY03 was higher than in the preceding two years[8] (see **Figure 2.1**). Water requirements are generally higher in *kharif* season (viz., 65 percent of the total water availability at canal heads) because most major crops are produced in this season[9] including the two most water intensive crops—rice and sugarcane.

In addition to availability, the timely release of canal-water is another prime determinant of the area under cultivation and yields. This relationship can clearly be observed in FY03 when the delayed supply of irrigation water in the *Punjab* caused a shortfall in the area under the cotton crop; it declined by 12.2 percent or 285 thousand hectares compared to the previous year. Later, however, improved water supply helped to achieve a 3.6 percent (YoY) increase in yields, offsetting some of the effects of the area contraction. Timely release of water also boosted the yield of sugarcane by 4.2 percent. Similarly, the extended winter rainfall spell, which started in January 2003, is expected to substantially boost the yield of wheat and other *rabi* crops.

2.1.2 Crops Sub-Sector

Better prospects for wheat, in particular, have raised the likelihood that the recovery in the crop sub-sector will accelerate in H2-FY03, building on the gains from the *kharif* crops.

Other salient features observed in the current fiscal year, so far, include:

i) Substitution of low value varieties with the high value varieties of rice i.e., from *irri* to *basmati;*
ii) Improved yield of rice. In addition to the rise in area under cultivation, rice yields also increased by 4.8 percent during the year; and
iii) The area under sugarcane rose, reversing a three-year decline, in response to the attractive prices offered in the preceding year.

Area under cultivation

Despite a considerable decline in the area under cotton, the total area under important crops surpassed the corresponding area cultivated last year and met the target for FY03 (see **Table 2.1**).

The relatively stronger increase in the area under sugarcane and rice was on account of higher rainfall and improved canal-water availability at sowing and

[8] FY03 estimates of water availability include projections for two months i.e., February and March 2003.
[9] *Kharif* crops (April to September) include: cotton, sugarcane, rice, and maize, contribute more than 63 percent of major crops and 24 percent of agricultural GDP.

growth periods for the crops. Although the area under *irri rice* increased in Sindh, this was more than offset by a decline in the area under *irri* crop in the *Punjab*.
The decline in the area under cotton stems from both, low water availability during sowing periods and poor prices in preceding year.

Table 2.1: Area Under Important *Kharif* Crops

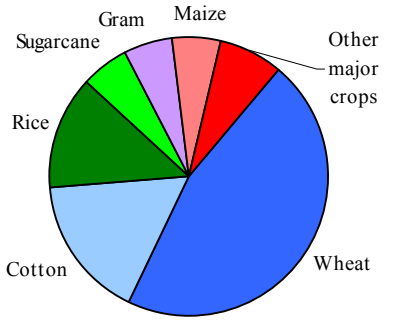
Crops	FY02	FY03 Target	FY03 Sown	% Change over FY02	% Change over Target
Cotton	2,862	2,900	2,718	-5.0	-6.3
Sugarcane	1,000	991	1,096	9.6	10.6
Rice	2,114	2,114	2,201	4.1	4.1
Maize	938	958	962	2.6	0.4
Wheat	8,057	8,080	8,141	1.0	0.8
Total	14,971	15,043	15,118	1.0	0.5

Area in thousand hectares

Source: Ministry of Food, Agriculture and Livestock

As usual, the wheat crop saw the highest area under cultivation, constituting approximately 46 per cent of the total area covered by all the major crops in both *rabi* and *kharif* seasons (see **Figure 2.2**).

Figure 2.2: Area Under Major Crops



Production of the crops

Other than cotton, all important crops have either already posted higher production or are expected to see a substantial improvement in output during FY03.

The optimism on projected harvests is fed by lead indicators such as better availability of water, higher input loans obtained during sowing period of *rabi* crops, and greater availability of fertilizers (through higher production of *urea* and rising import of *phosphatic* fertilizer).

Table 2.2: Production of Important *Kharif* Crops

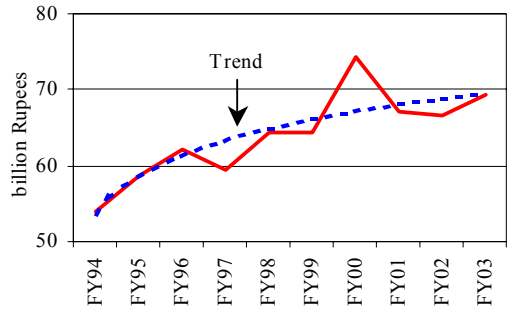
Crops	FY02	FY03 Target	FY03 Prel.	% Change over FY02	% Change over Target
Cotton	10.6	10.1	10.1	-4.8	0.0
Sugarcane	48,042	46,000	51,650	7.5	12.3
Rice	3,882	4,000	4,228	8.9	5.7
Maize	1,664	1,700	1,860	11.8	9.4
Wheat	18,226	19,754	-	-	-

Production: Cotton million bales; Other crops 000' tonnes

Sources: i) Ministry of Food, Agriculture and Livestock
ii) Economic Survey, 2001-2002

Thus, if the wheat and the gram harvests are in accordance with the FY03 target, the crops sub-sector would be expected to contribute substantially to a recovery by agriculture during FY03. However, it should be noted that while the value addition by major crops[10] would likely to be higher than in the last two years, it would remain considerably below the output seen in FY00 (see **Figure 2.3**).

Figure 2.3: Value Addition by Major Crops



Value addition for FY03 is based on projections.

2.1.3 Marketing of *Kharif* Crops

In H1-FY03 market conditions remained in favour of farmers for almost all the important *kharif* crops except sugarcane.

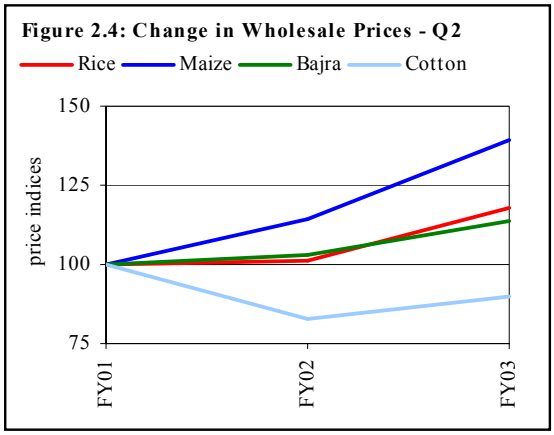
The price row between sugarcane growers and millers, which started in the beginning of the crushing season was resolved quickly in the *Punjab* and *NWFP*. Fortunately, the intensity of the price dispute in the *Punjab* was not grave and the market prices initially settled around the support price.[11] However, this dispute lingered on in *Sindh*, where the cane-crushing season started after a delay of one month, and that too without a resolution of the price controversy. Higher prices of sugarcane (between Rs 50 to Rs 60 per 40 kg) in *Sindh* last year, was the main factor in the price dispute - farmers had built the expectations for the higher prices for FY03 as well. But, millers having incurred losses in FY02 due to high prices, were insisting on prices that were lower than the indicative price determined by the provincial government[12] (i.e., Rs 43 per 40 kg).

[10] Includes: rice, wheat, barley, jowar, bajra, maize, gram, cotton, sugarcane, rapeseed, mustard, sesamum and Tobacco.

[11] Later, however, late payments by mills to the farmers became a problem. A provincial level parliamentary committee has been constituted to look into this issue.

[12] The indicative price of sugarcane for the FY02 was fixed by ECC at Rs 42 per 40 kg for the *Punjab* and *NWFP* and Rs 43 per 40 kg for *Sindh* and *Baluchistan*. For the current FY03, the matter of fixing minimum price has been referred to the provincial governments empowered under Sugar Factory Control Act 1950.

By contrast, other crops (i.e., cotton, rice and maize) fared much better, due to the availability of relatively higher prices vis-à-vis FY02 (see **Figure 2.4**).



Owing to high prices in the international markets and expectations of a fall in output, local prices for raw cotton for the FY03 crop remained higher than the prices prevalent last year as well as compared to the current support price.[13] (For detail see section on **Prices**).

Similarly, in the case of rice, farmers enjoyed the dual benefit of a rise in prices as well as the higher yields. The farmers would also have benefited from the production shift in rice from *irri* to *basmati*. The latter would not only add to the income of the concerned farmers, but would also bring higher value addition to GDP.

Mirroring the brisk activities in agriculture markets, agri-credit expansion in the private sector during H1-FY03, against the major crops, increased to Rs 4,268 million as compared to retirement of Rs 17.0 million during the corresponding period last year. Consequently, for the agriculture sector as a whole, the situation improved drastically and net credit to agricultural sector increased from Rs 903 million in H1-FY02 to Rs 3,598 million in H1-FY03.

2.1.4 Market Prospects for *Rabi* Crops

The expected improvement in major *rabi* crops, especially after the good winter rains, has increased the urgency for policy measures to safeguard growers from an *abrupt* fall in harvest prices, as witnessed for the cotton crop in FY02 and wheat crop in FY01. The liberalization of producer prices with free imports and exports of cotton created an element of uncertainty in the domestic market. The decline in the world cotton prices in FY02 resulted in decline in the returns to growers.

[13] Support price for seed cotton (phutti) was fixed at Rs 780 per 40 kg in FY03 and the TCP was nominated by the Government to act as the second buyer if the market prices fell below the support price.

In particular, the majority of farmers are exposed to fluctuations in the wheat price. Joint efforts are therefore required from the farmers and the government agencies to avert excessive pressure on wheat prices in the harvest period. Clearly, under the present market conditions, when sufficient stocks of wheat are already available, the expectations of an above-target harvest will depress wheat prices. Therefore, timely policy measures are needed to strengthen the market so as to soften this seasonal decline.

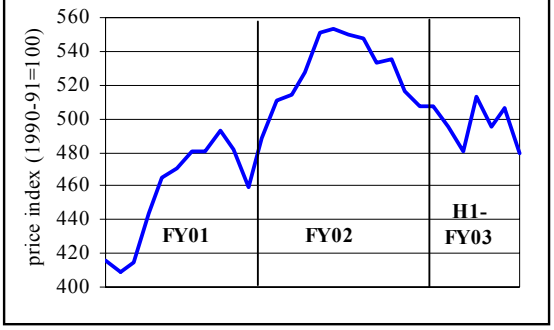
In this regard, the policy on wheat procurement would have a significant impact on market sentiment e.g., during FY00 although there was a record wheat production of 21 million tonnes, the government's purchases at 8.4 million tonnes kept the market prices of wheat above the procurement price of Rs 300 per 40 kgs throughout the harvesting season. Although the existing wheat stocks in the government's storages, storage capacity, impending import orders and short/medium-term government policy biases are all important considerations in deciding the procurement size, it is the higher procurement size that tends to bring stability in the market price of the wheat. An aggressive campaign to export Pakistani wheat (if the larger harvest materializes) would allow the government agencies and private sector exporters to increase room for higher purchases, protecting farmers from a large seasonal price fall.

To ensure sufficient liquidity in the market at harvest time, SBP has already issued a circular on February 15, 2003 lowering the rate of markup for commodity operations by 250 basis points. Banks have been advised to provide credit to Government and its concerned agencies, for commodity operations, at 9.5 percent markup rate against an earlier rate of 12.0 percent. Moreover, to facilitate wheat purchase in the private sector, the SBP has advised banks to provide finance on a market-based markup (linked with the 6-month weighted average T-bill rate). As the T-bill rate has fallen sharply compared to the preceding year (see section on **Money Market**), this suggests that private sector traders will correspondingly be receiving the credit at far cheaper rates.

The most crucial step that farmers can take, either individually or collectively, is to build storage capacity for wheat. This will help them plan the supply of wheat in the market, rather being forced to put it all in the market within a short period, creating a temporary supply glut at harvest time. As the activity is highly capital intensive, SBP has taken special measures and instructed the banks to provide the finance to private sector (i.e. to flour mills/farmers) for construction of silos/godowns. Unfortunately, data on disbursement of credit for building storage capacity shows that this activity has not yet picked up. During H1-FY03 only

Rs 114.9 million were disbursed among 152 borrowers. With average lending of Rs 0.8 million per borrower it can be concluded that no major project for construction of silos has so far been initiated in the private sector.

Figure 2.5: Trends in Gram Prices



Unlike wheat, the wholesale price of gram started to decline by the second half of FY02 after experiencing a sharp increase over one and a half years, (see **Figure 2.5**); it fell by 5.6 percent during the first six months of FY03. Although the production in FY02 was still less than that achieved in FY01, the higher imports of pulses pressured domestic prices. During H1-FY03 the import of pulses totaled US$ 83.0 million compared to US$ 54.4 million in H1-FY02. In this situation, there is little chance for any quick upturn in the domestic prices, particularly at the arrival of the new gram crop.

2.1.5 Agricultural Credit

Disbursement

After a slack Q1-FY03, the gross disbursement of agri-credit finally picked up by the end of Q2-FY03. Apparently, the post-election boost in economic activities and the onset of sowing periods for most *rabi* crops were the prominent factors behind this recovery.

In fact, an exceptionally higher growth in the disbursement of credit to agriculture was seen during Q2-FY03 with a 49.1 percent increase over the previous quarter and a 32.2 percent rise over the corresponding quarter of FY02. Consequently, by the close of H1-FY03, gross disbursements reached Rs 25.3 billion compared to Rs 22.7 billion during H1-FY02 (see **Table 2.3**).

The better performance by all banks engaged in agricultural lending during H1-FY03 suggests that a larger portion of the disbursement target (Rs 62.7 billion) would be achieved by the end of FY03. During H1-FY03, 40.4 percent of the annual target was achieved compared to 37.9 percent for the corresponding period last year.

Table 2.3: Credit to Agriculture Sector

million Rupees

	Disbursement			Recovery			Net credit[1]	
	H1-FY02	H1-FY03	Percent change	H1-FY02	H1-FY03	Percent change	H1-FY02	H1-FY03
ZTBL[2]	12,885	13,061	1.4	13,544	14,079	4.0	-659	-1,018
C.B[3]	8,127	9,911	22.0	5,685	8,012	40.9	2,442	1,900
D.P.Bs [4]	139	439	215.5	88	300	239.2	51	139
P.P.C.B	1,571	1,874	19.2	1,472	1,620	10.0	99	254
Total	22,722	25,284	11.3	20,789	24,010	15.5	1,933	1,274

[1] Net Credit = disbursement minus recovery
[2] Zarai Taraqiati Bank Limited, the new name of ADBP.
[3] Commercial Banks: Includes: NBP, HBL, MCB, UBL, and ABL
[4] Domestic Private Banks started lending in FY02

Of the total credit disbursed, 82.4 percent was advanced for the purchase of seasonal inputs (working capital) while the remainder was for development, (e.g., purchase of tractors, installation of tubewell, development of cultivable land, etc).

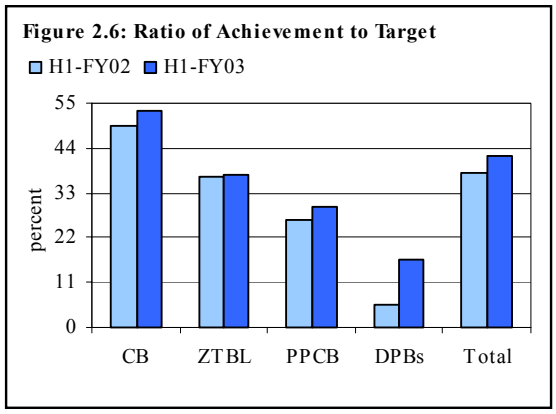
Consistent with the pattern of farm holdings, the highest amount of farm credit (72.1 percent) was disbursed among the farmers with subsistence holdings followed by economic (21.4 percent) and above-economic (6.5 percent) holdings of land.[14] According to the *Census of Agriculture-1990*, 80.6 percent of the total number of farms in Pakistan came under the definition of subsistence holdings, while 16.9 percent and 2.5 percent are classified respectively as *economic* and *above economic* holdings of land.

Finding agricultural lending attractive, commercial banks showed greater interest and their share in total agri-credit disbursement once again increased, to 39.2 percent in H1-FY03 compared to 35.8 percent in H1-FY02.[15]

While all banks raised disbursements to the agri-sector during H1-FY03 relative to H1-FY02, commercial banks achieved the highest actual-to-target disbursement ratio (see **Figure 2.6**). Their lending reached Rs 6.2 billion during Q2-FY03, very close to the lending by Zarai Taraqiati Bank Limited (ZTBL) (Rs 7.4 billion). Among domestic private banks, which started lending in agriculture very recently,

[14] Subsistence holding: up to 12.5 acre in Punjab and NWFP, 16 acres in Sindh and 32 acres in Balochistan. Economic holding: above 12.5 to 50 acres in Punjab and NWFP and from above 16 and 32 acres to 64 acres in Sindh and Balochistan. Above-Economic holding: above 50 acres in Punjab and NWFP and above 64 acres in Sindh and Balochistan.
[15] The rising trend started emerging in FY01, the time when the SBP expanded the scope and coverage of agricultural credit. It rose gradually from 23.5 percent in FY00 to 33.3 percent in FY02

the Bank of Punjab is emerging as the leader, accounting for 60.3 percent of the total lending by these banks, followed by Askari Commercial Bank Limited with a share of 35.3 percent. [16]



Net credit to agriculture showed an expansion of Rs 1.3 billion by end December 2002, compared to Rs. 1.9 billion by December last year (see **Table 2.3**). The decline in net credit is not a negative development. Gross disbursements during H1-FY03 were actually 11.3 percent higher than in corresponding period of FY02 suggesting that farmers received increased credit at sowing time, and the fall in the *net* credit represents a higher recovery of loans. This suggests that the credit delivery system is gaining strength over time, with a more responsible behavior by lenders and borrowers.

Another welcome development during H1-FY03 was the trickle-down impact of low interest rates on agri-credit e.g., rate for agri-financing.[17] However, there is insufficient data at this stage to meaningfully gauge the impact of this development on the sector.

Recovery

The aggressive recovery drive launched by the banks resulted into further improvement in the overall recovery of agricultural loans; the recoveries were 15.5 percent higher during H1-FY03 compared to the recoveries made during corresponding period last year (see **Table 2.3**).

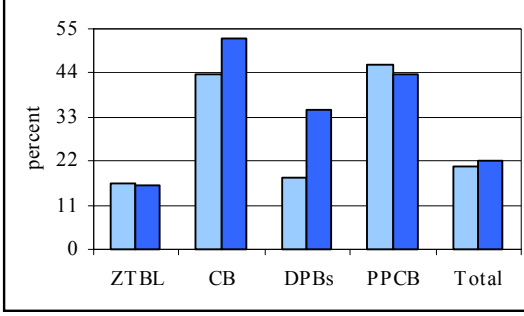
The loan recovery performance of the various institutions is summarized in **Figure 2.7**.

[16] This category of banks includes: 1) Askari Commercial Bank, 2) Bank of Al-Habib, 3) Bank Al-Falah, 4) Bolan Bank, 5) Faysal Bank, 6) Metropolitan Bank, 7) PICIC Commercial Bank, 8) KASB Commercial Bank, 9) Prime Commercial Bank, 10) Saudi Pak Commercial Bank, 11) Soneri Bank, 12) The Bank of Khyber, 13) The Bank of Punjab, 14) Union Bank.

[17] The Bank of Punjab has already announced various schemes for financing agriculture activities at rates as low as 9.0 percent per annum.

Although there had been an increase in the amount recovered by ZTBL during H1-FY03 compared to last year, it remained behind the level required to avoid an increase in ratio of recovery-to-outstanding loans. The deferment of loan recoveries in drought-affected areas may be a contributor to the weakness in ZTBL's recovery performance.

Figure 2.7: Ratio of Recovery to Outstanding Loans



2.2 Large-scale Manufacturing

Large-scale manufacturing (LSM) saw a marked improvement during H1-FY03[18], with many sectors reporting double-digit growth on the back of rising exports (*textiles*) and domestic demand (*automobile* and *electronics*) (see **Tables 2.4 and 2.5**).

While this robust improvement is quite welcome, particularly given the seeming weakness in LSM during Q1-FY03, it should be noted that the H1-FY03 growth rate is also inflated by a base effect, as the H1-FY02 output had been depressed by the September 11 shock to the domestic economy.[19]

Table 2.4: Summary of LSM Growth - First Half

percent

	FY02	FY03
Overall	1.8	5.2
Excluding sugar	2.9	4.6
Excluding automobile	2.0	3.5

Source: Federal Bureau of Statistics

A comparison of the sub-sectoral growth performance for the two periods reveals that eight of the sub-sectors showed significantly high growth rates in H1-FY03,

[18] The sharp jump in the overall LSM growth for H1-FY03 strongly supports the view that the provisional Q1-FY03 statistics were indeed understating the LSM performance for that period. The current data for H1-FY03 represents approximately 72.276 percent of total LSM. The Q1 data consisted of only 57.21 percent of the historical index, which represented 73.689 percent of LSM, i.e. the "missing" industries now constitute a mere 1.118 percentage points.

[19] As a result of the shock, LSM growth fell from 5.3 percent in Q1-FY02 to 1.8 percent for H1-FY02.

Table 2.5: Production of Selected Large-scale Manufacturing Items – First Half

		Percentage change				Percentage change	
Items	**Weights**	**FY02**	**FY03**	**Items**	**Weights**	**FY02**	**FY03**
Textile	**19.069**	**3.86**	**5.53**	**Chemicals**	**2.335**	**15.38**	**-6.07**
Cotton yarn	8.850	4.52	6.92	Caustic soda	0.621	3.40	2.96
Cotton cloth	4.881	14.16	7.47	Soda ash	0.320	1.47	7.76
Cotton ginned	3.893	-1.18	-4.72	Other six items	1.394	30.32	-15.66
Other five items	1.445	-21.93	19.97	**Electronics**	**2.230**	**12.99**	**12.47**
Food, beverages & tobacco	**17.336**	**-2.03**	**4.61**	Electric transformers	0.577	19.50	38.95
Sugar	8.630	-12.31	13.59	TV sets	0.363	-21.20	127.72
Vegetable ghee	3.004	-5.09	-9.81	Air conditioners	0.120	-78.22	-12.96
Cigarettes	2.505	-5.53	-9.61	Refrigerators	0.015	25.65	15.43
Tea	1.785	8.36	1.86	Other five items	1.155	10.97	-1.18
Beverages	0.964	21.54	-10.80	**Automobile**	**2.348**	**-2.26**	**39.49**
Cooking oil	0.448	17.22	13.48	Trucks	0.698	-27.88	138.95
Petroleum products	**7.824**	**25.94**	**-3.61**	Tractors	0.593	-17.46	9.09
Fertilizer	**5.871**	**2.71**	**-0.96**	LCVs	0.369	21.08	47.85
Nitrogenous	5.441	7.15	1.50	Cars & jeeps	0.309	3.62	41.27
Phosphatic	0.430	-36.05	-36.96	Motorcycles	0.249	4.11	38.33
Pharmaceuticals	**5.284**	**1.92**	**-0.19**	Buses	0.13	-45.91	92.33
Tablets	2.705	7.26	-1.35	**Non metallic minerals**	**1.915**	**-3.18**	**17.39**
Syrup	1.602	-5.91	2.20	Cement	1.846	-2.78	17.80
Injections	0.466	0.90	-3.27	Glass sheets	0.069	-15.19	3.32
Capsules	0.228	-1.91	-1.86	**Paper & board**	**1.359**	**-36.02**	**17.44**
Other two items	0.283	32.28	2.52	**Engineering items**	**0.712**	**5.44**	**9.99**
Metal industries	**3.194**	**-4.81**	**-1.09**	Bicycles	0.348	-1.22	13.67
Pig iron	1.477	-5.88	-2.23	Safety razor blades	0.109	23.76	3.42
Coke	1.319	-1.03	-3.52	Diesel engines	0.065	-37.14	-7.58
Billets	0.311	-6.72	0.58	Sewing machines	0.052	2.98	10.26
H.R/coils & plates	0.074	-2.52	13.94	Power looms	0.051	59.84	28.57
C.R coils/plates	0.013	-16.98	11.21	Other five items	0.087	-23.17	-5.82
Leather products	**2.333**	**-0.08**	**-4.45**	**Tyres & tubes**	**0.452**	**21.85**	**10.59**

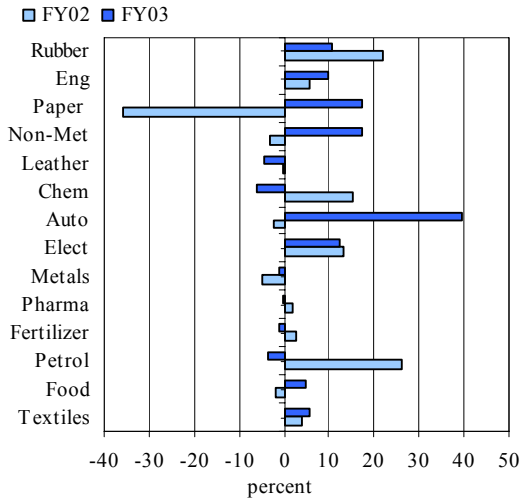
Source: Federal Bureau of Statistics

resulting in an overall improvement in the average performance of the LSM sector (see **Figure 2.8**).

The growth in the *textile industry* was boosted primarily by a sharp jump in exports. In line with higher imports of textile machinery and impressive export performance of most of textile products, the overall production of *textiles*

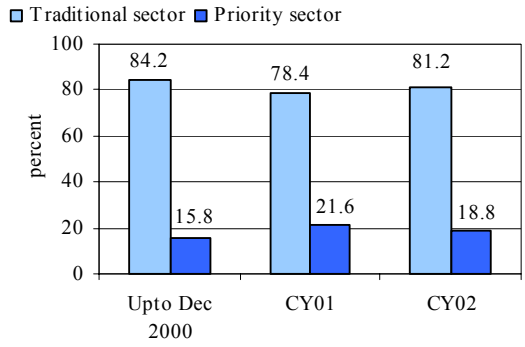
increased by 5.5 percent during H1-FY03, compared to a 3.9 percent increase in H1-FY02. Although raw material prices remained higher during H1-FY03, strong demand from the key EU and USA markets, helped sustain the up trend in production.

Figure 2.8: Growth in Selected Industrial Groups - First Half



The textile manufacturers have also been engaged in Balancing, Modernization and Replacement (BMR) for the last two years. Under 'Textile Vision 2005', banks have been directed to allocate credit for textile sector so as to meet the challenges of the new trading environment from January 2005. In this regard, between January 2001 and December 2002 a total investment of Rs 58.2 billion has been undertaken, which is fractionally higher than the Rs 57.9 billion target. Unfortunately, the bank credit has been flowing towards the traditional sub-sectors of textile such as spinning and weaving, while the identified priority sectors[20] received only 20.2 percent of the total credit, on average, during CY01 and CY02 (see **Figure 2.9**). Anecdotal evidence suggests that the low investment in these priority sectors is primarily a function of market entry-barriers (e.g., textile quotas). Investors are apparently reluctant to undertake the required substantial investments until

Figure 2.9: Credit Disbursement Under Textile Vision 2005



[20] These are stitching, knitting, and finishing.

such barriers are removed.

Auto and electronic industries have benefited mainly from a rising consumer demand. This rise appears to be fueled by the upsurge in remittances, supported by a sharp decline in interest rates and improved access to consumer credit;[21] banks and leasing companies have aggressively competed in the consumer finance market in recent years, and this has been complemented by other installment schemes (by middlemen, etc) (see **Table 2.6**).

Table 2.6: Financing for the Purchase of Vehicles by Commercial Banks

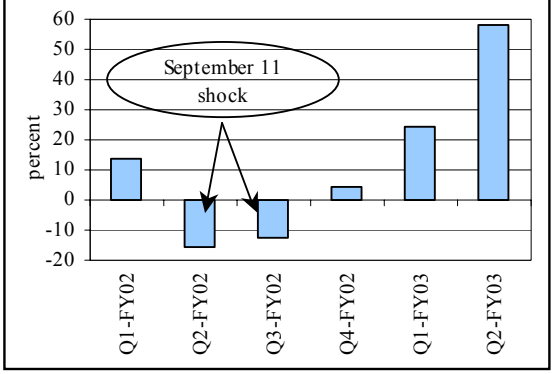
million Rupees

Year	Disbursement for vehicles
FY98	737
FY99	447
FY00	872
FY01	3487
FY02	4075
H1-FY03	3524

Source: State Bank of Pakistan

The impact of consumer financing is particularly reflected in the performance of the *auto* sub-sector, which recorded a phenomenal 39.5 percent growth during H1-FY03 over the corresponding period of FY02. In fact, the growth in the sector accelerated from 24.1 percent in Q1-FY03 to 57.9 percent in Q2-FY03 over the corresponding periods of FY02 (see **Figure 2.10**). The production of cars rose a stunning 41.3 percent on the back of rising credit availability and (probably) increased remittances.

Figure 2.10: Growth in Auto Production



Also, the manufacturing of *tractors*, *trucks* and *buses*, which showed sharp decline last year, witnessed a rebound during H1-FY03. Although, the low base is a contributing factor, the impressive growth rates in the production of trucks and buses, suggests a substantial improvement in demand, which should subsequently lead to higher value addition in the services sector (through the transport and communication

[21] Some of the banks have reduced consumer finance mark-up rates to as low as 8 percent compared to an average of 15 percent in the previous year.

sector). Similarly, the rise in the production of tractors appears to reflect increased credit availability to farmers.

As for other vehicles, the production of motorcycles (Honda, Suzuki, Yamaha and Sohrab) too, went up by 38.3 per cent to 84,523 units during H1-FY03 from 61,103 units in the same period last year. However, this data probably understates the true increase in production since the data is unavailable for some recently introduced brands of Chinese origin (Hero, Star, Pak Hero, Janan, etc).

The *tyres and tubes* industry, which is an ancillary industry of *autos*, recorded a growth of 10.6 percent during H1-FY03 as against 21.9 percent during H1-FY02. The deceleration in growth may be due to the high base and available cheaper imports in the wake of appreciating rupee.[22]

Within the *electronics* sub-sector, the double-digit increase in production owes to higher consumer demand (TVs and refrigerators) and the increasing use of tubewells (transformers).

The phenomenal increase in the demand for *TV sets* and *refrigerators* is the result of competitive prices of popular brands increased remittances, credit facilities extended by some commercial banks, and finally, the exclusion of these items from the Afghan Transit Trade.

The manufacture of *transformers* has been rising since July 2001. Its growth appears to be driven by installation of tube-wells and expansion in the electric distribution network under the public works program.

S*ugar* production increased by 13.6 percent during H1-FY03 as compared with a decline of 12.3 percent during H1-FY02, despite delays in crushing due to a controversy over sugarcane prices and large inventories of refined sugar with mills,. The higher growth reflects low base effect and higher sugarcane crop (up by 9.6 percent in H1-FY03). To protect sugar mills from an inventory build-up, government committed to purchase surplus sugar (the Trading Corporation of Pakistan has already floated tenders to purchase sugar).

The demand for *cement* was spurred by increased activities under the public works program, higher private construction (possibly another consequence of rising remittances), and reconstruction activities in Afghanistan, as well as lower prices.

[22] Imports under this category has increased about 32 percent during H1-FY03.

The price fall, despite rising demand during H1-FY03 was a function of increased competition in the cement industry. Firms that shifted from the relatively expensive oil-based processes to coal based processes used the resulting cost efficiencies to expand market share (see **Table 2.7** for cost savings).[23] As a result, the overall capacity utilization of the industry increased to 66.4 percent in H1-FY03 as compared with 57.0 percent in FY02.

Table 2.7: Cost Comparison--Furnace oil Vs Coal

Furnace Oil	
Furnace oil consumption (Kg per ton)	85.0
Cost of furnace oil per ton of cement produced[1]	1226.5
Coal	
Coal consumed (Kg per ton)	135.0
Average price of ready to use coal per ton[2]	530.6
Power cost of coal firing plant per ton of clinker	22.0
Total cost of using coal (per ton)	552.6
Saving per ton (Rs)	674.0
Saving per bag (Rs)	33.7

[1] @ Rs 1,4430 per ton

[2] Blending 70 percent imported with 30 percent indigenous coal at prices of 4,500 and 2,600 per ton, respectively and having 6,050 K.Cal/Kg

Source: All Pakistan Cement Manufacturing Association

By contrast, *chemical group* that recorded a substantial increase of 15.4 percent during H1-FY02 witnessed a sharp fall of 6.0 percent in H1-FY03. This was mainly due to decline in *paints & varnishes (solid)* by 57.5 percent, which more than offset the increases witnessed by *paints & varnishes (liquid), soda ash* and *caustic soda* in this group.

While *fertilizer* production also declined, this is attributable entirely to the lower production of phosphatic fertilizer, following the closure of the FFC Jordan DAP capacity. Urea production saw a marginal increase during H1-FY03.

The declining trend in the *leather industry* accelerated in H1-FY03; registering a fall of 4.5 percent, against a marginal contraction of 0.1 percent in H1-FY02. The explanation lies in the export performance of the industry, exports of finished leather recorded a marginal rise of 0.6 percent and leather manufactures fell by 1.1 percent in H1-FY03 over the same period of FY02. The downward adjustment in rebates on leather exports and the appreciating rupee probably depressed the performance in this sector.[24]

[23] Cement prices fell from over Rs 200 per bag to Rs 178 to 185 per bag during December 2002.
[24] For details see SBP's Annual Report for FY02 (Annexure).

3. Fiscal Developments

The consolidated budgetary position of the federal and provincial governments, which improved considerably during Q1-FY03, strengthened further during Q2-FY03. Therefore, the aggregate H1-FY03 budget deficit dropped to Rs 65.7 billion i.e., 1.6 percent of GDP vs. 2.7 percent of GDP for H1-FY02 (see **Table 3.1**). This improvement was on the back of an exceptional 26.1 percent increase in government revenues, which compensated for strong (9.6 percent) expenditure growth during the period.

Table 3.1: Fiscal Operation - First Half
billion Rupees

	FY02	FY03	Difference
Total revenues	263.9	332.9	68.9
Tax revenues	209.0	253.2	44.2
Non-tax revenues	54.9	79.7	24.7
Total expenditures	363.8	398.6	34.7
Current expenditures	296.7	345.1	48.5
Development expenditures	50.9	51.5	0.6
Net lending to PSEs	6.8	2.7	-4.1
Unidentified expenditures	9.4	-0.8	-10.2
Budget deficit	99.9	65.7	-34.2

Source: Ministry of Finance

3.1 Revenue Receipts

Both, tax and non-tax revenues contributed to the impressive revenue growth (see **Table 3.2**).

The strong 18.9 percent growth in consolidated tax collections and a 38.3 percent rise in surcharges (YoY) drove the rise in tax revenues. The consolidated tax receipts, in turn, increased on the back of a sharp jump in dutiable imports and higher domestic demand. The rise in surcharges probably reflects higher consumption of gas and petroleum products, as well as (in the case of gas) the greater share of sales to non-subsidized customers.

Table 3.2: Consolidated Revenue Receipts - First Half
billion Rupees

	FY02	FY03	Difference
Total revenue (a+b)	263.9	332.9	68.9
a. Tax revenue	209.0	253.2	44.2
Taxes (consolidated)	184.7	219.6	35.0
Surcharges	24.3	33.6	9.2
Gas (net)	7.1	11.6	4.5
Petroleum	17.2	21.9	4.7
b. Non tax revenue	54.9	79.7	24.7
Interest	8.8	4.6	-4.2
Dividends	15.2	24.3	9.1
SBP profits	12.0	6.0	-6.0
Sale Proceeds and royalties	6.6	7.7	1.1
Other civil administration	1.7	20.9	19.2
Miscellaneous	10.6	16.1	5.5

Source: Ministry of Finance
Note: Total may differ due to separate rounding off

The H1-FY03 increase in non-tax revenues was even more remarkable. A Rs 6.0 billion shortfall in receipts from the SBP and a Rs 4.2 billion decline in interest

income,[25] was largely offset by a jump in the government's dividend income.[26] Thus, the net increase in non-tax revenues hinged largely on the receipts against logistics support provided to international forces in Afghanistan.

3.2 Expenditures

The consolidated expenditures of the federal and provincial governments during H1-FY03 rose 9.6 percent over H1-FY02 (see **Table 3.1**). Interestingly, a bifurcation of current expenditures between federal and provincial governments reveals that rise in consolidated current expenditures is largely attributable to the provincial governments. This massive increase in provincial government expenditures is largely attributed to expanding economic and administrative activities of the district and the (newly elected) provincial governments.

Table 3.3: Position of Current Expenditures – First Half

billion Rupees

	FY02	FY03	Difference
a. Federal	226.7	240.0	13.2
Interest payments	123.7	98.1	-25.6
Domestic	95.7	79.8	-15.9
Foreign	28.0	18.3	-9.7
Defense	54.2	76.7	22.4
General admn. and services	32.9	39.9	6.9
Grants to non-government	9.4	8.5	-0.9
Subsidies	6.3	16.6	10.3
Others	0.2	0.2	0.0
b. Provincial	69.9	105.2	35.3
Total (a+b)	296.7	345.1	48.5

. Source: Ministry of Finance

Note: Total may differ due to separate rounding-off

As compared to a Rs 35.3 billion rise in current spending by provincial governments during H1-FY03, the current expenditures of the federal government saw a rise of only Rs 13.2 billion during the same period. A break-up of federal government expenditures reveals that a reduction of Rs 25.6 billion in interest payments on domestic and foreign debt created the fiscal space to absorb a jump in defense spending,[27] thereby containing the growth in federal current expenditures. All time low domestic interest rates, rescheduling of foreign debt during FY02 and the relatively low deficit contributed to the fall in interest payments during this period.

Development expenditures during H1-FY03 were only slightly higher than the corresponding period last year. Although it is little disappointing that the rise in overall expenditures was not primarily due to higher development expenditures,

[25] All time low interest rates and financial restructuring of major public sector DFIs are mainly responsible for lower interest income.

[26] The larger contribution comes from Pakistan Telecommunications Corporation Limited.

[27] This was probably attributed to return of the armed forces to their peacetime locations following de-escalation of tension on borders with India.

however, these are expected to increase in the following quarters on account of developmental plans of newly elected federal and provincial governments.

An encouraging development during H1-FY03 was the improvement shown by the public sector enterprises (PSEs). The government investment in these institutions was only Rs 2.7 billion as compared to Rs 6.8 billion during H1-FY02. This suggests that financial restructuring of major PSEs during FY02 has started paying dividends. The point is reinforced, by the fact that PSEs were able to pay Rs 24.3 billion in dividend to the government during H1-FY03, up 59.8 percent from the corresponding figure for FY02.

Financing of Budget Deficit

Table 3.4 shows that approximately three-forth of deficit was financed through external receipts (net),[29] while remainder was funded from non-bank borrowings. The government was able to retire Rs 34 billion to the banking sector in the presence of higher inflows in national savings schemes (a major source of non-bank borrowing).

Table 3.4: Financing of Deficit - First Half

billion Rupees

	FY02	FY03
Total financing	99.9	65.7
External (net)	72.0	48.3
Domestic	27.9	8.8
Bank	-10.9	-34.0
Non-bank[28]	38.8	42.9
Privatization proceeds	0.0	8.5

3.3 CBR Tax Collections

Although the exceptional growth in tax receipts witnessed in Q1-FY03 weakened somewhat during Q2-FY03, collections were nonetheless strong during the latter period, rising 14.4 percent over Q2-FY02, and helping push the cumulative tax collections for H1-FY03 marginally above the Rs 200.5 billion target for the period (see **Table 3.5**). Interestingly, the impressive tax performance for

Table 3.5: Net Tax Collections

billion Rupees

				Growth rates	
	FY01	FY02	FY03	FY02	FY03
Q1	79.9	77.5	90.4	-3.1	16.6
Q2	102.0	97.1	111.1	-4.9	14.4
H1-Total	**182.0**	**174.5**	**201.4**	**-4.1**	**15.4**

Note: (1) Growth rates are in percent.
. (2) Figures may not tally due to separate rounding off.
Source: Central Board of Revenue

[28] This figure is not equivalent to the NSS borrowings referred to in the following sections, as it is based on provisional data, and also incorporates the impact of net PIB/FIB holdings of non-banks.
[29] Gross external receipts showed that the government was able to pay-off its external debt of worth Rs 31.5 billion during H1-FY03.

H1-FY03 was not only underpinned by a sharp rise in dutiable imports, but also by increasing demand for domestic goods.

Also, comforting was the stability of the receipts, with monthly tax collections maintaining a double-digit growth through H1-FY03, except for the month of October 2002. The relatively low 4.1 percent rise in October appears to be a seasonal phenomenon, and even this was nonetheless sufficient to meet the revenue target for the month.

3.3.1 Revenue Collections Versus Targets

Unlike H1-FY02, which saw massive tax shortfalls and frequent revisions of targets, the aggregate CBR tax collections remained on track through the first half of FY03. However, the collections of individual taxes varied considerably from their respective targets (see **Table 3.6**). Direct tax collections and excise duties fell short of targets, but the resulting shortfalls were offset by above-target sales tax and customs duty collections.

Table 3.6: Targets Achieved

billion Rupees

	Targets		Actual	Actual as percent of target for	
Heads	**FY03**	**H1-FY03**	**H1-FY03**	**FY03**	**H1-FY03**
Direct taxes	148.4	66.0	61.7	41.6	93.5
Indirect taxes	312.2	134.5	139.7	44.8	103.9
Sales tax	205.7	90.0	92.2	44.8	102.5
Central excise	47.5	21.5	19.8	41.7	92.1
Customs	59.0	23.0	27.7	46.9	120.4
Total	460.6	200.5	201.4	43.7	100.5

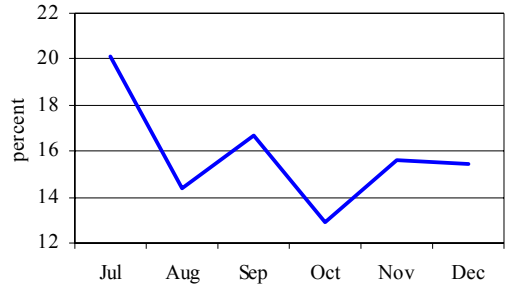
Source: Central Board of Revenue

As a result, revenue collections during H1-FY03 stood at 43.7 percent of the annual target for the year, which is slightly higher than the 43.2 percent recorded in H1-FY02. Furthermore, growth in cumulative monthly tax collections remained well above the targeted annual average increase of 14.0 percent (see **Figure 3.1**).[30] This suggests that the CBR is well placed to achieve Rs 460.6 billion budget target for the year.

[30] A growth target of 14.0 percent is calculated on the basis of actual tax collections of Rs 403.9 billion for FY02. While at the time of annual budget an increase of 11.2 percent was envisaged on the basis of revised figure of Rs 414.2 billion for FY02. Had CBR revised its target according to the actual tax collections, the H1-FY03 collections would have been more impressive.

Finally, a quick glance at **Figure 3.2** also clearly shows that the optimism is not simply a function of a conservative budgetary tax target. The average tax growth *budgeted* for FY03 is only slightly lower than that for each of the past 6 years, but the H1-FY03 performance is significantly better relative to almost all these years.

Figure 3.1: Growth in Cumulative Tax Collections - FY03

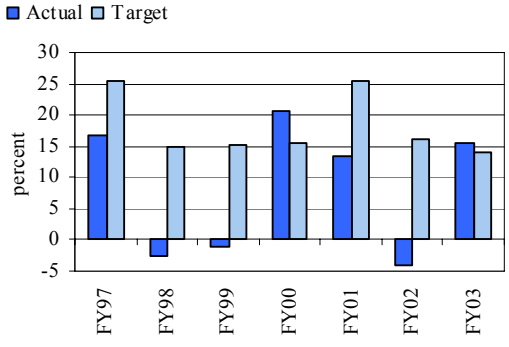


3.3.2 Refunds and Gross Collections

A more reasonable concern, however, could be that the growth in H1-FY03 net tax collections has been inflated by:

- The exceptional refunds in FY02 that lowered the base for FY03, and more importantly,
- Delays by tax authorities in payments of refunds and rebate amounts due in H1-FY03, to artificially boost net tax collections during the period.

Figure 3.2: Tax Growth Target Vs Performance - First Half



However, the latter concern does not appear to be supported by data. It should be noted that *gross* tax receipts during H1-FY03 grew at 9.5 percent, a little over twice the corresponding rate for FY02. Moreover, the monthly gross collections show no abrupt shifts and exhibit roughly the same seasonal structure as in previous years (see **Figure 3.3**). This suggests that the rise in net collections is not just due to lower refunds.

Over the last few years, the payments for refunds and rebates usually accounted for almost 15 percent of gross collections (see **Figure 3.4**). During H1-FY03 these payments totaled 16.1 percent of gross collections; slightly lower than the figure for FY02, which includes exceptional payments. At the very least, it seems logical to conclude that CBR is not withholding refunds/rebates at the same rate as prior to FY02.

Figure 3.3: Monthly Gross Collections

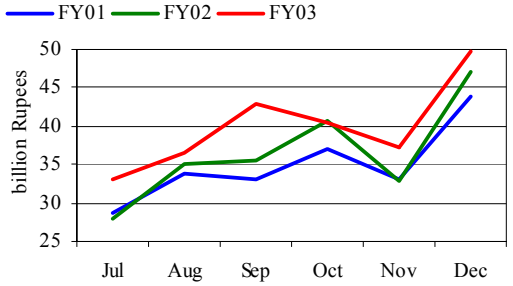
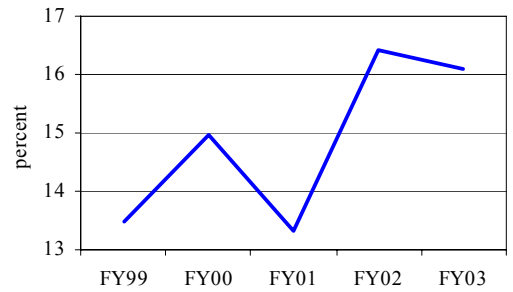


Figure 3.4: Refunds as Percent of Gross Collections



Note: Value for FY03 is based on H1- collections

While the H1-FY03 refund payments fell by Rs 6.0 billion (13.4 percent) than H1-FY02, this can be easily explained by the fact that the exceptional FY02 refund payments were largely due to the government's policy to repay the accumulated refund arrears in order to buffer exporters from post-September 11 shocks. Once the accumulated arrears had been paid off, the monthly refund payments were likely to decline during H1-FY03, as proved to be the case.

Table 3.7: Refunds - First Half

billion Rupees

	FY01	FY02	FY03
Direct taxes	4.5	6.9	6.6
Indirect taxes	23.2	37.7	32.0
Sales tax	12.5	21.3	21.2
Import related	0.0	0.1	0.2
Domestic	12.5	21.1	21.0
Central excise	0.1	0.0	0.1
Customs	10.7	16.4	10.7
Total	27.7	44.6	38.6

Source: Central Board of Revenue

It is also worth noting that a significant fall in refunds is visible only for customs duties (see **Table 3.7**). The lower refunds on custom duties in H1-FY03 is also understandable (1) in the absence of one-time payment of refund arrears, and (2) increase in those imports which are subject to the highest tariff rates and do not entail any refund amount (e.g. vehicles, edible oil, etc.).

Finally, the refunds to gross collections ratio remains quite high at 16.1 percent during H1-FY03. Although lower than the all time high of 20.4 percent for H1-FY02, this ratio is still significantly higher compared to the 13.2 percent for H1-FY01. This also suggests that CBR is disbursing the normal refunds.

3.3.3 Disaggregated Position

Direct Taxes

Direct taxes not only fell short of the H1-FY03 target, but also recorded a negative growth of 1.7 percent over the H1-FY02 collections (see **Table 3.8**). This setback is attributable entirely to the 6.4 percent year-on-year decline in Q2-FY03 receipts stemming from sharply lower voluntary payments and collections on-demand (down 22.3 percent YoY).

Table 3.8: Trends - First Half

Shares

	FY01	FY02	FY03
Direct taxes	32.1	36.0	30.6
Indirect taxes	67.9	64.0	69.4
Sales tax	38.8	42.1	45.8
Import related	22.7	25.5	25.4
Domestic	16.1	16.6	20.4
Central excise	13.3	11.6	9.8
Customs	15.8	10.3	13.7
Total	100.0	100.0	100.0
Growth rates			
Direct taxes	16.4	7.6	-1.7
Indirect taxes	12.2	-9.6	25.0
Sales tax	35.9	4.0	25.5
Import related	35.6	7.5	15.2
Domestic	36.4	-1.0	41.3
Central excise	-9.7	-16.5	-1.9
Customs	-8.4	-37.3	53.3
Total	13.5	-4.1	15.4

Source: Central Board of Revenue

Q2-FY03 *Voluntary Payments* witnessed a decline of 22.9 percent, in contrast to the remarkable increase of 40.3 percent during Q1-FY03. Consequently H1-FY03 *voluntary payments* registered a decline of 10.2 percent over the corresponding period last year. The decline was mainly attributed to lower payments by PTCL, which is one of the major sources of receipts under this head.

Collections from *withholding taxes* however, registered a growth of 8.5 percent during Q2-FY03, and as a result H1-FY03 collections were 6.9 percent higher over the H1-FY02. Key contributions to this growth were from the impressive growth of 25.0 percent on *contract income* on account of higher government development spending; 15.4 percent rise on *salaries income* mainly due to changes in tax slabs and removal of exemptions on perquisites; and 10.7 percent increase in withholding tax on imports as the result of surge in dutiable imports. However, a negative growth of 29.2 percent on *government securities and interest*

on deposits, due to the very low interest rates and lower government borrowings, were the major offsetting factors.

Sales Tax

Over the last two years, the sales tax has emerged as the prime contributor to the exchequer; its share in H1 collections has risen from 32.4 in FY00 to 45.8 percent during FY03, reflecting the government's increasing focus on this VAT for revenue growth.[31]

During H1-FY03, sales tax collections played a considerable role in meeting the overall target of Rs 200.5 billion by partially offsetting the shortfall in direct taxes and excise duties. The noteworthy growth of 25.5 percent (increase of Rs 18.7 billion) in sales tax collections in this period was mainly driven by the surge in sales tax on domestic items (see **Table 3.8**), reflecting an upturn in domestic economic activity, and extension of GST to various items and services.

The growth in H1-FY03 import-related sales tax collections doubled to 15.2 percent from 7.5 percent during H1-FY02 (see **Table 3.8**). This was largely attributed to higher imports, which recorded an increase of 11.7 percent (in rupee value) during the first half of the year. The increase in GST rate from 15 to 20 percent on some selected items was also a contributing factor.

Although gross collections from domestic sales tax did not repeat the extraordinary growth (over 30 percent) observed during the first quarter of FY03, Q2-FY03 nonetheless witnessed a healthy rise of 15.8 percent YoY. This slowdown in the growth rate during the second quarter was largely attributed to lower sales tax collections from the services sector, natural gas, cement and cotton yarn groups (see **Table 3.9**).

Central Excise Duty

Excise duties have lost much importance over the last couple of years largely on account of the government policy to replace it with the sales tax. As a result of this deliberate policy change, the share of this tax in total tax collections has declined from 16.7 percent in H1-FY00 to only 9.8 percent by H1-FY03.

[31]For details on Sales tax collections and policy initiatives, please see SBP Annual Report 2001-2002.

Excise collections during H1-FY03 not only recorded a negative growth of 1.9 percent over last year, but also fell short of the half yearly target of Rs 21.5 billion (see **Table 3.6** and **Table 3.8**). A stronger than envisaged negative impact of the downward revision in duty rates on beverages and cigarettes,[32] as well as the replacement of excise with sales tax and custom duties for POL products, are the key factors for the poor performance.

Table 3.9: Gross Domestic Sales Tax Receipts - FY03
Growth rates

	Q1	Q2	H1
Services	96.2	-13.7	42.2
Pol products	22.1	23.6	23.0
Electric energy	50.3	60.5	55.1
Natural gas	16.9	-10.4	1.7
Sugar	25.6	7.0	16.0
Cement	20.9	-5.3	7.2
Cotton yarn	-14.2	-16.7	-14.9
Cigarettes	6.9	22.7	15.0
Cotton not carded	-30.9	21.0	10.9
Aerated water	19.9	19.4	19.7
Others	36.5	21.6	29.1
Total	31.9	15.7	23.2

Source: Central Board of Revenue

Custom Duties

As with excise duties, the share of custom duties in total taxes also witnessed a decline over H1-FY01, mainly due to successive cuts in the maximum tariff rates. Specifically, the share of custom duties in total tax receipts has declined to 13.7 percent during H1-FY03 from a 19.7 percent in H1-FY00.

However, H1-FY03 custom collections not only witnessed a steep rise of 53.3 percent over the last year, but also crossed the set target of Rs 23.0 billion with an impressive over target collections of Rs 4.7 billion (see **Table 3.6 & 3.8**). Thus customs duties made an important contribution to offsetting the shortfall in receipts of direct taxes and excise duties.

Monthly custom receipts showed that impressive growth realized during the first quarter not only remained intact, but also strengthened during the second quarter of FY03. In absolute terms, H1-FY03 custom collections were Rs 9.6 billion higher than in the previous year (see **Figure 3.5**).

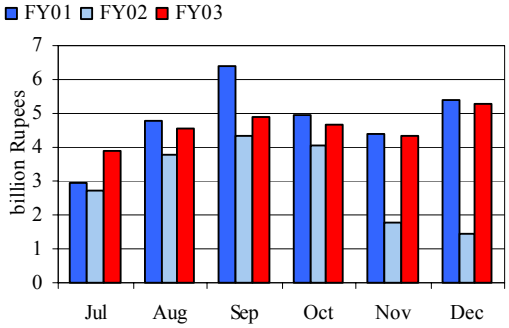
This substantial increase was primarily driven by a strong growth in imports, rise in the share of dutiable imports in total imports during first half of the year and levy of import duty on POL products with effect from July 1, 2002. In addition,

[32] The expected volume increase due to price elasticities was not realized as the benefit of reduction in excise duty (from 15 to 12 percent) for beverages was not passed on by manufacturers to consumers.

higher imports of items, which have the highest tariff rates, also accelerated receipts under custom duties.[33]

Therefore, despite a 5-percentage points reduction in the maximum tariff rate with effect from July 1, 2002, the average tariff rate during H1-FY03 remained unchanged from the previous fiscal year, at 15.8 percent.

Figure 3.5: Custom Collections (Net)

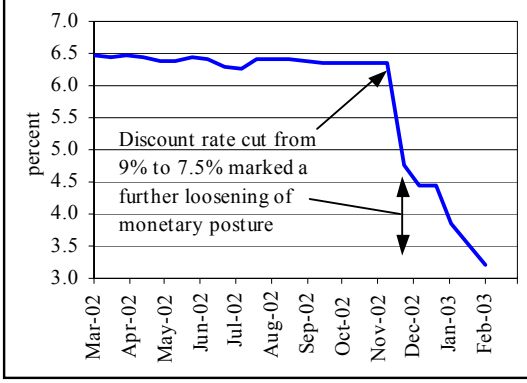


4. Money and Credit

The external account improvements continued to heavily influence the SBP monetary policy during Q2-FY03, as it strove to reconcile the conflicting imperatives of preventing a too-abrupt rise of the rupee while simultaneously avoiding a de-stabilizing rise in reserve money. Therefore, under the weight of the continuing external inflows, as in the preceding quarter, the SBP again chose to allow a gradual adjustment of the Rs/US$ parity by mopping up the liquidity in the inter-bank forex market, but crucially in Q2-FY03, it also loosened its hold on the benchmark 6-month T-bill rates.

As evident from **Figure 4.1**, the SBP initially continued to hold interest rates steady, in order to assess the impact of the sharp slide in interest rates during FY02, on the demand for credit in FY03. Consequently, when the expected seasonal pick-up in credit failed to materialize in September and October 2002, pressure increased for yet another cut in the discount rate.

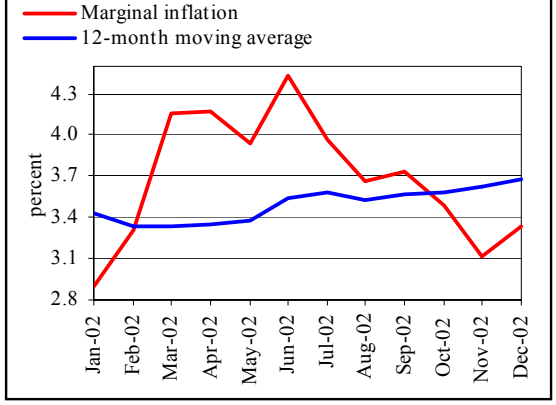
Figure 4.1: 6 Month T-Bill Yeilds



[33] For example, dutiable imports of vehicles, edible oil, dyes & paints, and man-made filaments recorded a rises of 59.2, 36.1, 11.5, and 24.9 percent respectively. While the effective tax rate on these items ranged from highest 34.7 percent on editable oil to 17.8 percent on man-made filaments.

From the SBP's perspective, the room for a further cut in interest rates was provided by the continuing weakness in inflationary pressures. During H1-FY03, the marginal CPI inflation rate continued to drop until November 2002, bottoming out below the 12 month moving average (see **Figure 4.2**). Therefore, in the face of apparent weakness in net private sector credit growth, SBP opted to implement a 150 basis points discount rate cut on November 18, 2002.

Figure 4.2: Marginal Vs Moving Avg. CPI Inflation



There was a gratifyingly immediate response to the change, as net credit to the private sector by commercial banks jumped sharply thereafter, recorded an impressive increase of Rs 103.7 billion during Q2-FY03 as against Rs 72.2 billion in the same period last year. Moreover, the acceleration in net credit expansion was not limited only to the banking sector. The Non-Bank Financial Institutions (NBFIs), which showed only a nominal credit expansion of Rs 1.2 billion during H1-FY02, and a contraction of Rs 1.6 billion a year before, recorded a significant increase of Rs 14.5 billion in H1-FY03.[34]

However, it is worth mentioning that the discount rate cut by the SBP coincided with a fall in political uncertainty, as the PML-Q (that is thought to favor the continuation of prevailing economic policies) gained power. The lower political uncertainty and market expectations of a discount rate cut were both cited as underlying reasons for the pre-November 2002 weakness in net private sector credit but it is difficult to disentangle the impact of one factor from the other.

A less desirable effect of the discount rate cut was the buildup of expectations of a further cut, as evident in the abrupt rise in the bid spread in T-bill auctions by mid-

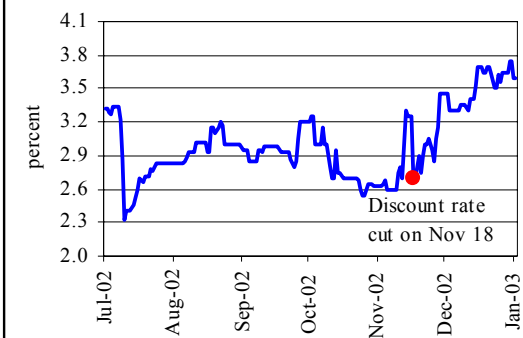
[34] Figure of net credit expansion for NBFIs has been calculated from their un-audited balance sheets and is the total of (a) advances and lease finance to private corporate sector, unincorporated entities and individuals; (b) inland bills; and (c) investment in private corporate bonds, shares and term finance certificates.

November 2002 (see **Figure 5.5**).[35] The market apparently misread the discount rate cut as being more a response to rising liquidity rather than to the relatively weak domestic net credit growth.

While the SBP has repeatedly sought to stamp out these misperceptions,[36] there was some confusion regarding the change in the SBP's usage of monetary tools. By mid-Q2-FY03, the targets for T-bill auctions were no longer being determined solely by the expected inflows from maturing T-bills. Instead, the auction target was now incorporating the SBP estimates of excess market liquidity.

An immediate, inadvertent consequence of this change was that the T-bill auctions effectively took on the functions of OMOs. Thus, rising liquidity and strengthening market expectations of a further interest rate cut, were sufficient to force a gradual slide in T-bill yields through Q2-FY03. This also meant that monetary policy was now effectively anchored to the discount rate rather than T-bill yields.

Figure 4.3: Spread between 6 Month T-bills and Discount Rate



In this context, it is important to note that the rising spread between the discount rate and market yields (see **Figure 4.3**) is a result of a deliberate policy decision, aimed at quelling overbidding in T-bill auctions (see **Section 5.3**). Therefore, as set out in the Monetary Policy Statement, unless there is a material change in relevant monetary variables, the SBP is unlikely to adjust the discount rate, and will continue with its policy of sterilizing the monetary impact of its forex market purchases.

Presently, the sterilization of the SBP forex market interventions is conducted principally through the retirement of SBP holdings of government paper (causing a Rs 229.6 billion fall in these holdings during CY02). However, now that the

[35] During July 2002 to mid-November 2002, when discount rates remained unchanged, the spread in the bids in the benchmark 6-month T-bill auctions averaged 29 basis points. After the November 2002 discount rate cut, until end-December 2002, the average bid spread rose to 104 basis points.
[36] Including the issue of a formal Monetary Policy Statement setting out its viewpoint in January 2003.

Table 4.1: Monetary Survey

billion Rupees

	H1-FY02	H1-FY03	
	Actual	**IMF proj.**	**Actual**
A. Government sector borrowing (net)	**-13.1**	**-23.3**	**-55.1**
1 Net budgetary borrowing	-6.8	-15.8	-34.0
from State Bank of Pakistan	*-2.5*	*-134.7*	*-161.8*
from scheduled banks	*-4.3*	*118.9*	*127.8*
2 Commodity operations	-5.4	-7.0	-21.0
3 Net effect of zakat fund/privatization proceeds	-0.9	-0.8	-0.1
B. Non-government sector borrowing	**52.9**	**17.8**	**68.4**
1 Autonomous bodies[1]	5.8		-2.1
2 Net credit to private sector and PSCEs	47.0	17.8	70.6
Commercial banks	52.0	22.9	74.7
i. PSCEs other than B(1)	*-1.6*	*11.8*	*-2.0*
ii. Private sector	*53.7*	*11.1*	*76.8*
of which: export refinance	*-18.2*		*-9.4*
Specialized banks	7.3		3.8
Other financial institutions	-11.4	-5.1	-5.1
PSCEs special account-debt repayment with SBP	-0.9	0.0	-2.9
C. Other items (net)	**12.9**	**0.4**	**-42.9**
D. Net domestic assets of the banking system	**52.7**	**-5.1**	**-29.6**
E. Net foreign assets of the banking system	**71.3**	**142.8**	**196.2**
F. Monetary assets (M2)	**124.0**	**137.6**	**166.6**
Growth	8.1%	7.8%	9.5%

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

Source: Economic Policy Department, SBP.

country's forex reserves are at comfortable level, it would appear more prudent to focus on the pre-mature retirement of expensive forex debt. Not only would this help sterilize the immediate forex inflows, but also would significantly lower Pakistan's debt servicing costs.

While the SBP has permitted such early repayments of registered private sector debt, the response, to date, has been a little disappointing.[37] However, significant gains are likely in future through the pre-mature retirement of the expensive

[37] To date, retirement of registered private debt totals only US$ 13 million.

component of public debt, expected in H2-FY03 and beyond (see **Special Section 2: *Pre-mature repayment of Pakistan's expensive external debt & liabilities*).**

In overall terms, the monetary survey indicates that the main policy objective i.e., a stimulus to private sector was achieved in H1-FY03. Commercial banks' credit to private sector was 43.0 percent higher than the corresponding period last year. Also, the government had no problem retiring its budgetary borrowings. Net domestic assets declined by 1.9 percent in H1-FY03, as retirement in government borrowing and other items net of the banking system out stripped growth in the credit to private sector. However, money supply grew by a healthy 9.5 percent due to a 83.6 percent growth in the NFA. By comparison, in H1-FY02, the growth in money supply was 8.1 percent; while this too was mainly driven by NFA growth, the NDA had also shown an increase of 3.5 percent in the period.

Growth in reserve money in H1-FY03 was 9.6 percent as against a 10.4 percent rise in H1-FY02. Although the growth in both the reserve money and money supply appears high, it should be noted that the 2nd quarter of a fiscal year is a period of peak expansion in credit due to seasonal credit off-take by the private sector. Moreover, Q2-FY03 also saw increased individual activity due to Ramazan, Eid and Hajj etc. In view of the above factors, the end-H1-FY03 numbers do not look unusually high.

4.1 Government Sector

The H1-FY03 net government borrowings for budgetary support were significantly lower than the target, reflecting a continuing improvement in the government's fiscal position, greater availability of external financing and increased non-bank borrowings.

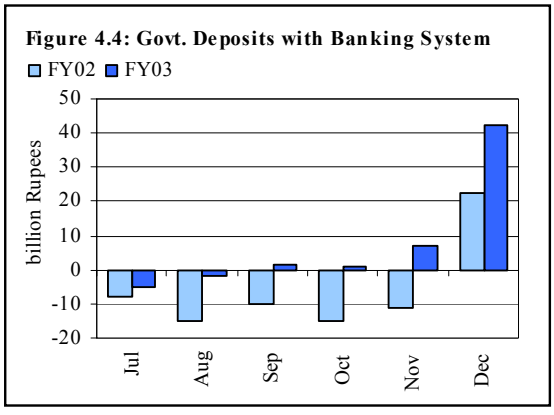


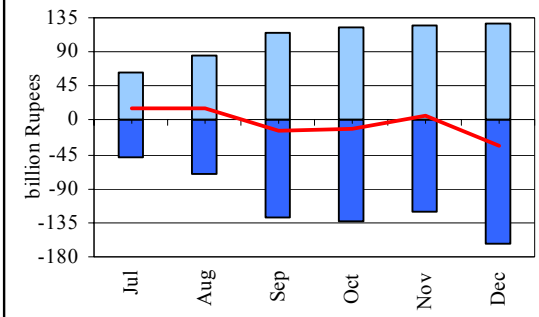
Figure 4.4: Govt. Deposits with Banking System

The improvement in the fiscal position (higher revenues, and disciplined spending) meant that government's *gross* borrowings were low, and the *net* borrowings were further

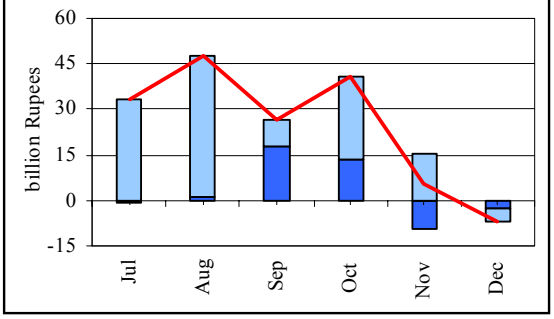
depressed by a stronger accumulation of government deposits with the banking system relative to H1-FY02 (see **Figure 4.4**).[38]

Also, within the bank borrowings, there was a continuing shift from SBP borrowings to commercial bank borrowings, reflecting the on-going SBP policy of sterilizing its forex market purchases (see **Figure 4.5**).

Figure 4.5: Budgetary Borrowings - FY03



FY02



While the government retired its debt to SBP throughout the H1-FY03; up to September 2002, it was primarily the market related treasury bills (MRTBs) holdings that were being retired.[39] However, this was depressing the SBP's profitability, and therefore, September 2002 onwards, the SBP preferred to retire its ad-hoc T-bills (see **Figure 4.6**).

Finally, while the fiscal performance and the availability of relatively cheap external financing are positives, the greater dependence on non-bank borrowings is troubling.

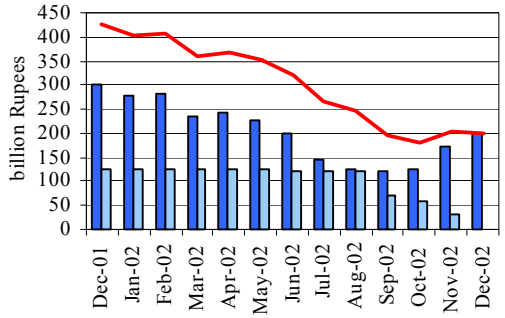
Since the NSS instruments are sold "on tap" and offer relatively high interest rates, the government effectively has no discretion in modulating these flows. As a consequence, for any given period, the financing sought by the government from

[38] An increase in government deposits at the end of the first half of the fiscal year is a routine phenomenon as the government receives various receipts, i.e., income tax, custom duties, dividend incomes etc., and these are generally depleted in the second half.

[39] SBP has two kinds of government treasury bills, one which carries mark-up equal to the market rate is called MRTBs (or market related treasury bills) while the other treasury bills which carry a nominal fixed mark up of 0.5 percent are called Ad-hoc treasury bills. The latter are usually created to cover some extraordinary government expenditure.

the market is a residual net of NSS flows. In other words, the government must, perforce, accept expensive debt in place of cheaper debt, severely constraining its ability to lower its debt servicing costs. This problem is particularly acute now that market based interest rates are at historical lows but the returns on NSS instruments have not adequately mirrored the fall in market yields.

Figure 4.6: SBP Holdings of T-bills



In fact, since rate of return on these instruments is still relatively higher, the inflows from NSS have gone up from Rs 21.1 billion in H1-FY02 to Rs 38.1 billion in H1-FY03. In this regard, government's decision to market these instruments in the Gulf countries, offering annual returns in excess of 10 percent (with no tax), does not appear prudent. In effect, the government was borrowing funds from banks at 4 percent or less, while simultaneously offering individual investors returns of 10-12 percent through the NSS instruments.

4.1.1 Commodity Operations

The July through March period generally witnesses retirement of commodity operation loans. However, the volume of retirement in H1-FY03 (Rs 21.0 billion) was quite high compared to Rs 5.4 billion retired in H1-FY02. There can be two explanations for this:

a) Improved fiscal position of the government due to higher revenues may have increased its capacity to retire commodity operation loans. Judging from the average level of government deposits with the banking system, which have gone up from (-)Rs 6.0 billion in H1-FY02 to Rs 7.5 billion in H1-FY03, this is quite plausible.

b) Since about 60 percent of commodity operation loans are for procurement of wheat, better prices of wheat and a surge in its exports in FY03 could have also resulted in lower inventories and improved cash flow of various agencies involved in the procurement of wheat, thereby increasing their capacity to retire the loans.

4.2 Non-Government Sector

4.2.1 Credit to Private Sector

The slowdown in net credit in FY02 and in Q1-FY03, despite falling interest rates *and* improvements in the fundamentals of the economy was quite intriguing.

Table 4.2: Adjusted Credit to Private Sector

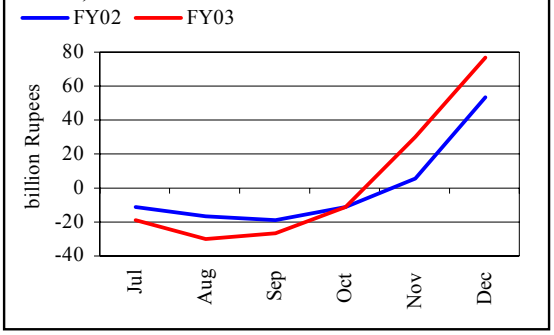
billion Rupees

	H1-FY02	H1-FY03
Credit to private sector (Monetary Survey)	53.7	76.8
Adjusted for export finance	-18.2	-9.3
Credit to private sector (including export finance)	**71.9**	**86.1**
Credit to private sector by NBFIs	1.2	14.5
Credit to private sector including NBFIs*	**73.1**	**100.6**

*Credit to private sector includes credit extended against FE-25 deposits by commercial banks and investment in TFCs by financial institutions.

In FY02, SBP was not too disturbed by the low headline numbers, since (1) the underlying net credit remained unchanged from the previous year and (2) there was higher availability of funds to businesses (through high tax refunds, lower input cost and self financing, etc.).

Figure 4.7: Credit to Private Sector (Commercial Banks)



The Q1-FY03 fall, however, was quite unsettling, as it seemed to show an *actual* decline in credit utilization. However, in the *1st Quarterly of the SBP for FY03,* it was postulated that the net credit growth may had weakened in the quarter due to political uncertainty and the market expectations of a sharp cut in the discount rate. The sharp increase in credit off-take during Q2-FY03 suggests that this assessment was probably correct (see **Figure 4.7**).

This is not only evident from the figures of commercial banks' credit to private sector that increased by Rs 103.7 billion during Q2-FY03, but also by the sharp increase in the credit disbursed by Non Bank Financial Institution (NBFIs). The overall increase in credit expansion by NBFIs was Rs 14.5 billion in H1-FY03 against a mere Rs 1.2 billion in the corresponding period last year. Among the NBFIs, Development Finance Institutions (DFIs) showed an expansion of Rs 8.5 billion in HI-FY03 against Rs 1.2 billion in HI-FY02. Similarly, Housing Finance Companies showed an expansion of Rs 4.2 billion against a contraction of Rs 0.01

billion in the corresponding period last year. Leasing companies on the other hand showed a contraction of Rs 1.6 billion against an expansion of Rs 1.4 billion in H1-FY02, perhaps due to increased competition from commercial banks.

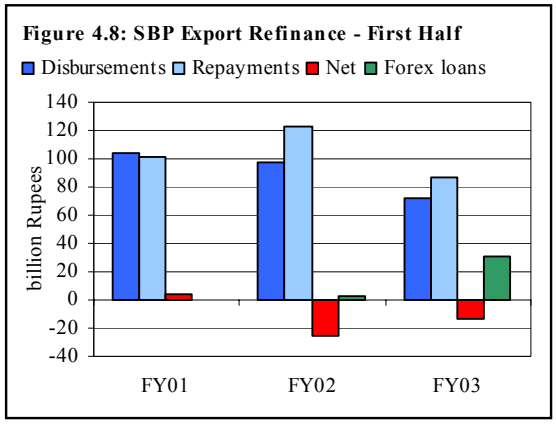
After making adjustments for credit by NBFIs, the total credit flow to private sector in H1-FY03 was Rs 100.6 billion as compared to Rs 73.1 billion in corresponding period last year (see **Table 4.2**).

In addition, it should be noted that the remittances represents private sector flows. It is likely that a portion of these flows is available to finance business activities.

Export Finance

The net retirement in EFS credit during H1-FY03 was lower than that witnessed in H1-FY02 (see **Figure 4.8**) and repayments continued to exceed fresh disbursements.

Figure 4.8: SBP Export Refinance - First Half



The EFS disbursements have gradually fallen each year since FY01, as Pakistan's external account strengthened and the rupee appreciated. In particular, as expectations of further rupee appreciations strengthened, exporters increasingly preferred forex denominated loans over EFS credits; this is visible not only in the rising volume of forex loans, but also in the strong retirement of EFS credit.

Banks had earlier been permitted to extend these trade-related forex loans against their FE-25 deposits, at rates much lower than available under the EFS. However, it was only after the rupee appreciation expectations gained credence by October 2001 that exporters began availing this facility enthusiastically, helping reduce the outstanding stock of EFS credit by 23.0 percent by end-December 2002. However, now that the EFS rates have been adjusted downwards, the EFS credit is likely to re-gain its momentum.[40]

[40] Rates of EFS have been reduced to 5.0 percent effective from March 1, 2003.

Credit to Public Sector Enterprises (PSEs) and Autonomous Bodies

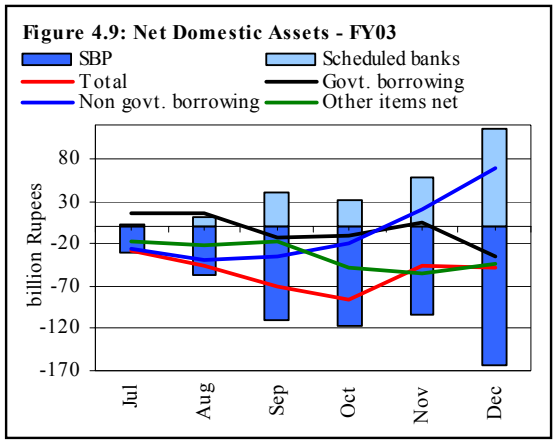
In FY02, the classification of PSEs underwent major changes, as a result of which many of the PSEs were re-classified as private enterprises. However, this has not resulted in any significant change in their borrowing pattern. PSEs retired net credit by Rs 2.0 billion in H1-FY03 against Rs 1.6 billion in H1-FY02.

Autonomous bodies retired Rs 2.1 billion during H1-FY03 against an expansion of Rs 5.8 billion in H1-FY02. The expansion of Rs 5.8 billion in H1-FY02 was largely on account of KESC. This year KESC borrowings were relatively lower at Rs 1.8 billion; in addition, WAPDA retired Rs 4.9 billion of its debt. The lower borrowing of the two organizations was expected since government had picked up Rs 83 billion and Rs 20 billion in accumulated losses of KESC and WAPDA, respectively during FY02.

4.3 Net Domestic Assets (NDA)

Net domestic assets of the banking system, which reflects the combined claims of commercial banks and SBP on government and the private sector, showed a contraction of Rs 29.6 billion (1.9 percent) in H1-FY03 as compared to an expansion of Rs 52.7 billion in H1-FY02.

Figure 4.9: Net Domestic Assets - FY03

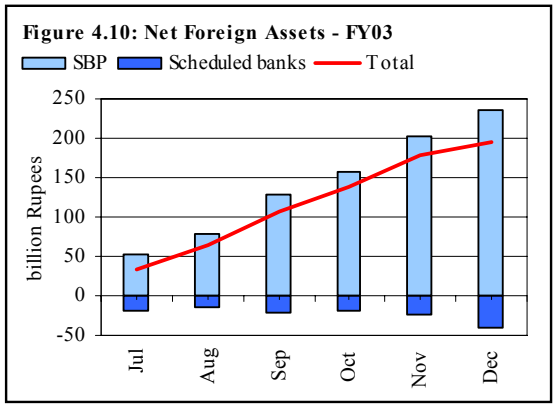


Although the claims of the banking sector on the private sector increased in H1-FY03, this was more than offset by a decrease in its claim on government and *other items (net)* (see **Figure 4.9**). SBP's retirement of government debt was mainly responsible for this contraction in net domestic assets. This was however expected given SBP's commitment to sterilization.

The impact of *other items (net)* is assumed to be neutral (zero) when preparing the credit plan, but in practice it usually plays an important role in the final outcome of NDA figures. In H1-FY02, their contribution in overall expansion was Rs 12.9 billion whereas in H1-FY03, these had a contractionary impact of Rs 42.9 billion.

4.4 Net Foreign Assets (NFA)

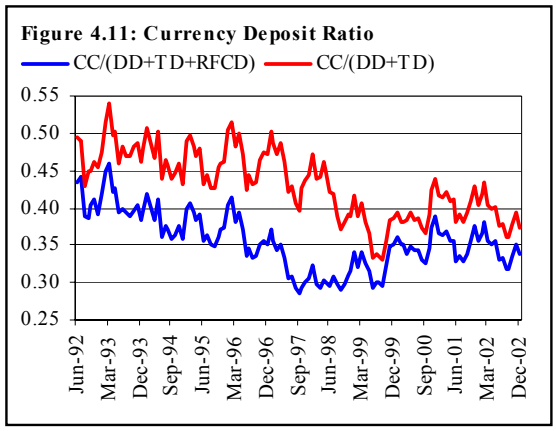
The NFA of the banking system continued to grow strongly during H1-FY03, reflecting the continued improvement in the country's external account.



Not surprisingly, given rising workers' remittances, the receipts of payments for logistic support, and increased IFIs assistance, the NFA of SBP almost tripled during H1-FY03. By contrast, the NFA of the commercial banks declined (see **Figure 4.10**), reflecting a decline in Nostro balances, probably due to the impact of rising forex denominated loans.

4.5 Money Supply

During H1-FY03, money supply grew by 9.5 percent despite a Rs 29.6 billion contraction in the NDA of the banking system. It is noteworthy that the growth in M2 is entirely attributable to the increase in NFA, since the Rs 114.9 billion rise in the NDA of commercial banks has been more than offset by the Rs 162.5 billion reduction in the SBP NDA.



The components of money supply largely continued to follow the trends set in the latter half of FY02. However, an interesting trend reversal is visible in the *cash-to-deposit* ratio (CDR). The movements in the CDR (see **Figure 4.11**) show three distinct trends:

(1) The fall in the CDR upto 1998 reflects the influence of the growing private forex deposits (which captured informal sector flows).

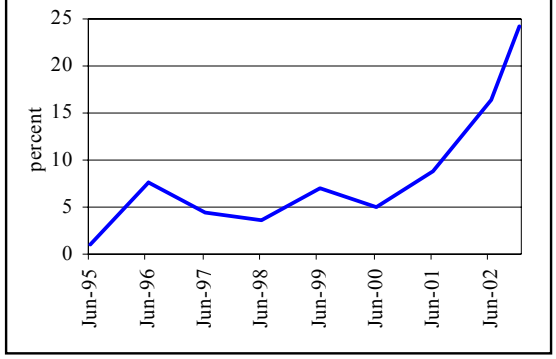
(2) CDR began an equally steady climb as the growth in forex deposits slowed (the forex flows presumably shifted to the informal markets).

(3) This up trend seems to have been arrested in FY02 (and may indeed be declining), as rupee deposits grew strongly, following an acceleration in remittances.

These CDR trends thus appear to support the view that the jump in remittances in recent months does indeed capture at least part of the "normal" (informal or formal) forex flows into Pakistan.

Another interesting observation stems from the liquid reserves to money supply (LRM) ratio (see **Figure 4.12**). This ratio is a measure of monetary stability and is used to assess the vulnerability of domestic interest rates to fluctuations in the country's external account.

Figure 4.12: Liquid Reserves to M2 Ratio



While an improvement in this indicator in recent years is not unexpected, the timing of the up-trend is revealing. The indicator is clearly showing an improvement from June 2000, well before Pakistan's monetary picture was aided by the impact of Pakistan's external accounts improvement post-September 11, 2001.

5. Money Market

Typically, the second quarter of the fiscal year is characterized by an increased demand for bank credit by the private sector, the SBP therefore tries to facilitate commercial banks during this period by injecting liquidity into the market. In Q2-FY03, while private sector demand had finally rebounded strongly by November 2002, ample liquidity with banks meant that the market behavior was markedly different relative to the corresponding period of preceding years:

(1) While commercial banks were forced to the discount window on 32 days during Q2-FY03, this number was substantially lower than in the past

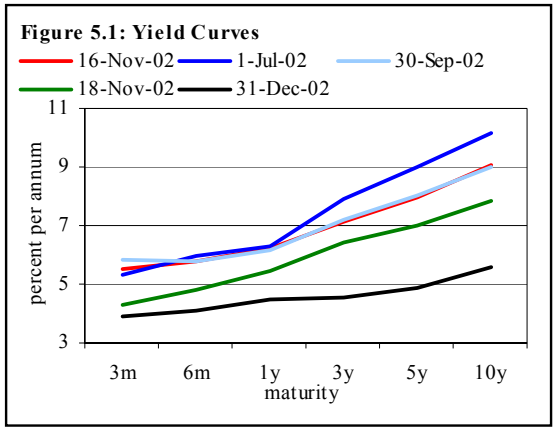
years. This suggests liquidity shortages were not a binding concern for banks,[41] and

(2) The SBP did not inject any liquidity into the market through OMOs. This was done to (a) condition the behaviour of the commercial banks to minimize the probability of excessive bidding in auctions in anticipation of liquidity support by the SBP, and because (b) the forex interventions of the central bank were also gradually injecting domestic currency in the money market, throughout this period.

However, it was lackluster growth in the credit to private sector until mid-November 2002 and benign inflation that induced the SBP to cut the discount rate by 150 basis points, taking it to a new all-time low of 7.5 percent.

5.1 Movements in the Yield Curve

As shown in **Figure 5.1** not only did the yield curve for government securities continue to shift downwards during H1-FY03, it also became flatter as long-term yields witnessed a larger fall.



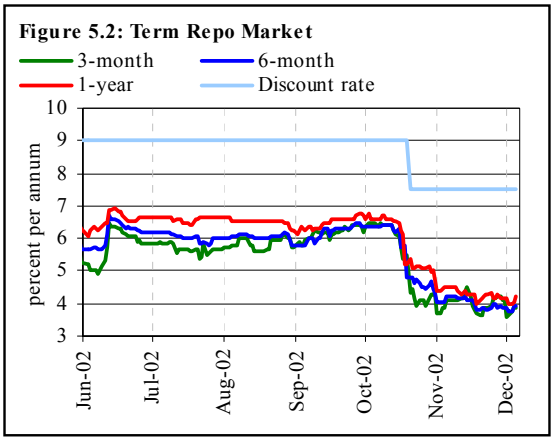
Interestingly, market expectations of an interest rate cut in Q2-FY03 initially appear to have cooled off, with the yield curve remaining practically unchanged until mid-November 2002 – this suggests that the market was surprised at the *timing* of the 150 basis points reduction in the discount rate on November 18, 2002 (see **Figure 5.1**). Thereafter, however, these expectations re-surfaced, driving the yield curve substantially downward through the remaining period of the quarter even though the SBP signaled its intention to stand firm on the discount rate.

[41] The average overnight rate was 5.8 percent (average discount rate was 8.25 percent) during Q2-FY03 as compared to 10.4 percent (average discount rate was 11 percent) in the corresponding period last year.

Given these expectations of an imminent further reduction in interest rates, it is not surprising that banks retained their interest in long tenor securities that offered a greater possibility of quick gains. The flattening of the yield curve was then accentuated by reports that the government was seeking to reduce its relatively expensive long-term PIB borrowings. This only led to an increased "scarcity premium" on these bonds in anticipation of a lower supply of long term bonds in future, further decreasing their yields. As a consequence, the fall in PIB yields was disproportionately greater than in T-bill yields. In fact, the term premium (10-year rate less the 3-month rate) decreased to 167 basis points at end-December 2002 from 480 basis points at the beginning of FY03.

An interesting consequence of the sharp fall in market rates following the November 2002 discount rate cut is the widening spread of the short tenor rates to the discount rate. The spread between the 6-month T-bill and the discount rate during FY03 averaged 288 basis points before November 18, 2002, but rose to an average of 335 basis points for the period from mid-November 2002 to end-December 2002, and continued to widen thereafter (see **Figure 5.2**).

Figure 5.2: Term Repo Market

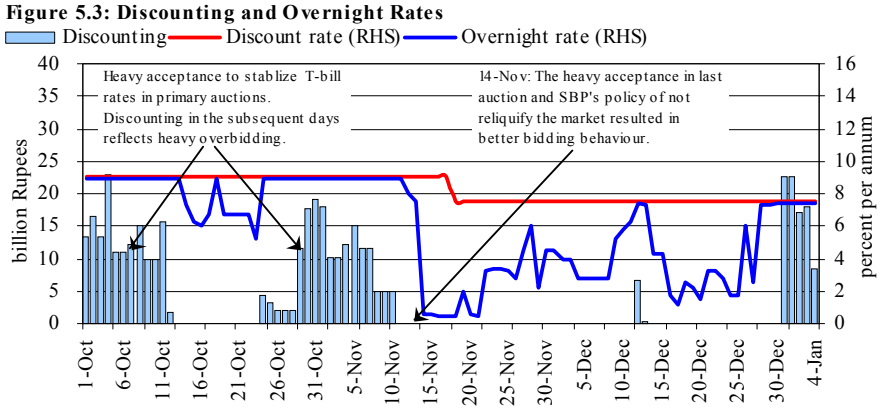


This widening spread between the discount rate and the respective tenor rates implies that banks would have to bear a relatively higher cost to fund a low yielding investment in case of a prolonged liquidity crunch in the market. In theory, this would suggest that banks would be relatively less inclined to bid excessively in T-bill auctions. The post-November 18, 2002 data seems to support this view (see **Figure 5.3**).

5.2 SBP Market Support and Rupee Interventions

Since the second quarter of the fiscal year corresponds with an increase in seasonal economic activity in the private sector, the market usually faces a liquidity squeeze. Banks more often take recourse to the SBP discount window, and the SBP too, intervenes more frequently to inject funds into the market through OMOs. However, banks were visibly more comfortable in Q2-FY03

Figure 5.3: Discounting and Overnight Rates



relative to prior years, as evident from the lower number of days that witnessed discounting during Q2-FY03 (see **Table 5.1**).

Table 5.1: Activities at Discount Window
billion Rupees

	No. of visits to discount window (No. of days)			Total amount of discounting			Average per visit		
	FY01	FY02	FY03	FY01	FY02	FY03	FY01	FY02	FY03
October	28	25	20	438.2	107.4	215.0	15.6	4.3	10.8
November	30	26	10	282.7	211.5	103.2	9.4	8.1	10.3
December	22	6	2	138.9	17.3	7.1	6.3	2.9	3.5
Q2	**80**	**57**	**32**	**859.8**	**336.1**	**325.3**	**10.7**	**5.9**	**10.2**

Source: State Bank of Pakistan

During the previous two fiscal years, the SBP often moved to inject liquidity into the market through OMOs in order to facilitate the commercial banks in their lending activities to the private sector (see **Table 5.2**). However, this support was absent in FY03.

One reason for the lack of OMOs was the perception that the SBP's proactive liquidity management that led to the prompt re-liquification of the market after T-bill auctions, created a moral hazard, encouraging banks to overbid in primary auctions (see **Figure 5.4**). However, the dominant reason remained the ample liquidity in the system.

While the SBP was also transacting forex swaps, in net terms, these transactions did not mop-up any rupee liquidity from the market during Q2-FY03. On the

other hand, the SBP foreign exchange purchases remained a major source of rupee injections. These injections totaled Rs 97.1 billion in Q2-FY03, a significant part of which was not sterilized during the period.

Table 5.2: Open Market Operations

billion Rupees

	Injection			Absorption		
	FY01	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**
October	-	50.1	-	-	-	-
November	9.4	16.2	-	-	-	13.0
December	22.4	11.1	-	-	-	-
Total	**31.8**	**77.4**	**-**	**-**	**-**	**13.0**

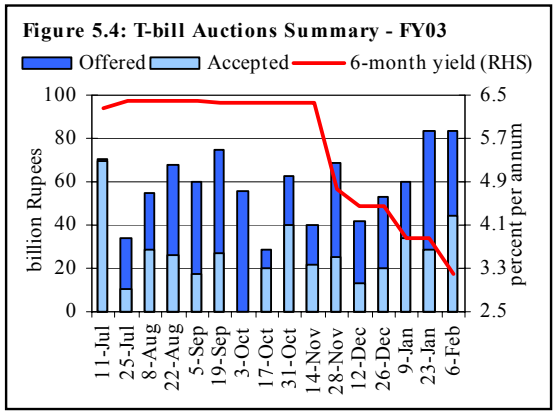
Source: State Bank of Pakistan

As a result of these massive injections there was no shortage of market liquidity even after the credit to private sector actually picked up in mid-November 2002.

5.3 Treasury Bills Auctions

Despite a slowdown in bank deposit growth, and an upsurge in private sector credit, the demand for T-bills was not reduced significantly during Q2-FY03 (see **Figure 5.4**).

Figure 5.4: T-bill Auctions Summary - FY03



Participation in auctions remained high due to (1) the sheer scale of the liquidity injections into the market by SBP's foreign exchange purchases, (2) T-bill maturities of approximately Rs 112 billion during the period, and (3) the continued preference of institutional investors for government paper, amidst expectations of further rate cuts.

Interestingly, while the expected decline in the discount rate was duly realized by mid-November 2002, it only served to increase market expectations of further reductions (see **Sections 4.1** for details); these expectations were bolstered by the gradual slide in the acceptance cut-off in succeeding T-bill auctions.

This is also evident from the sudden increase in the bid spreads in the primary auctions that shows the uncertainty of bid pricing by the auction participants (see **Figure 5.5**).

In particular, the market apparently expected that the SBP would bring down the discount rate, maintaining the "normal" spread[42] of about 230 basis points between the 6-month T-bill yields and the discount rate (**Figure 5.6**). However, as noted in **Section 5.2**, the SBP was concerned by the high level of speculative positions in the money market, and it therefore preferred to allow the spread to increase. This rising spread would, in theory, discourage speculative positions, especially when long term positions were funded from a potentially volatile short term market.[43]

Figure 5.5: Bid Spreads in T-bill Auctions - CY02

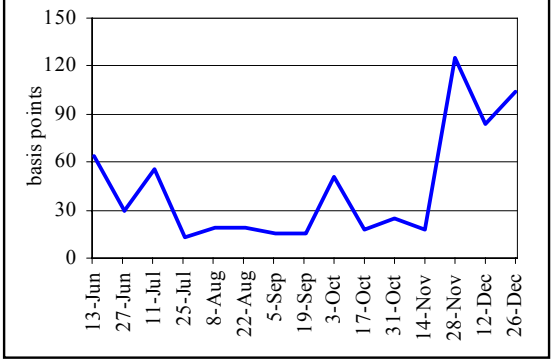
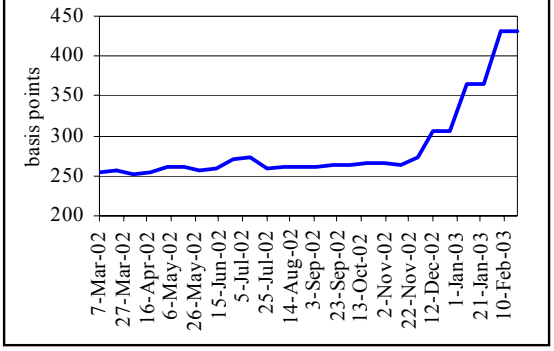


Figure 5.6: Spread between Discount Rate and 6 month T-bill Yield



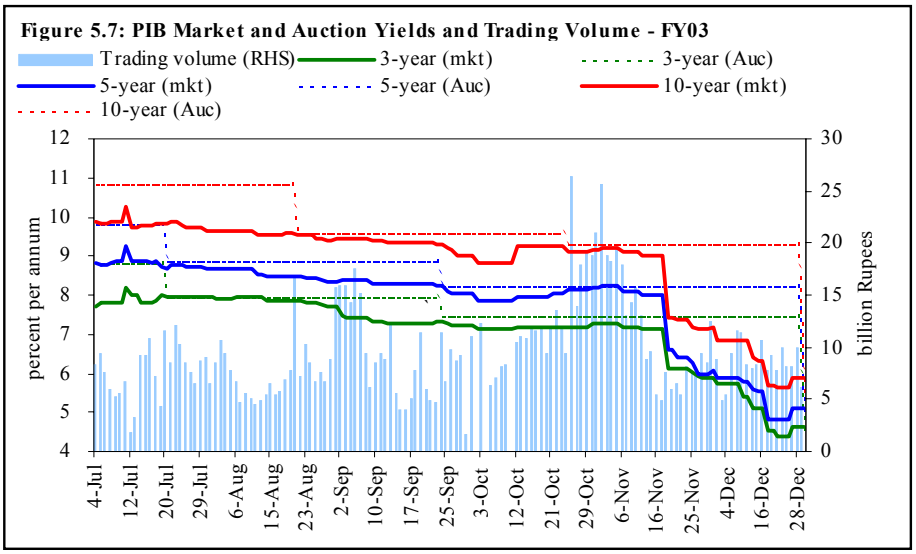
5.4 Pakistan Investment Bonds Auctions

As elaborated in **Section 5.1**, following the fall in interest rate and the expectations of further decline; PIBs were increasingly attractive for the commercial banks. Not surprisingly, banks appear to have snapped up approximately 80 percent of the fresh issues of Rs 17.2 billion during Q2-FY03, despite suggestions by the SBP that these institutions lower their PIB holdings.

However, there is a visible fall in trading activity following the November 2002 discount rate cut (see **Figure 5.7**). It appears as if the banks were booking capital gains prior to the cut and subsequently opted for a holding strategy. But, a more plausible explanation may be that bidders were no longer interested in buying long term paper at the present low yield.

[42] Based on 17-month average spread.
[43] Evidence suggests that the measure did indeed lower speculative bidding.

Figure 5.7: PIB Market and Auction Yields and Trading Volume - FY03



In overall terms, the government mobilized Rs 17.2 billion for PIBs during Q2-FY03, in close conformity with the pre-auction target, compared with a mobilization of Rs 27.4 billion (against a target of Rs 27.0 billion) in the corresponding period last year (see **Table 5.3**). The lower mobilization in Q2-FY03 is because of fewer auctions held during the quarter. This, in turn, is a function of the government's reduced appetite for relatively more expensive market debt. This lower appetite for long-term debt is not surprising, given that the exceptionally large increase in the availability of very expensive non-discretionary funds through the NSS and the fact that it has already exceeded the budgeted PIB sale target of Rs 25.0 billion for FY03.

Table 5.3: PIB Auctions - Summary of Results

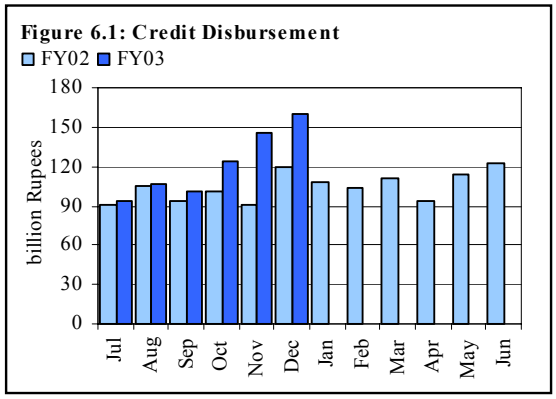
billion Rupees

Auction	Tenor	Target	Coupon rate (%)	Amount Offered	Range of price offered/Rs. 100	Amount Accepted	W. A. % p.a.	% Accepted of total acceptances
23rd Oct 24, 02	3 Years							
	5 Years							
	10 Years		11.0	28.4	100.00--111.43	12.2	9.2951	100.0
	Total	**12.0**		**28.4**		**12.2**		**100.0**
24th Dec 31, 02	3 Years		7.0	4.3	100.00--107.25	2.0	4.5564	40.6
	5 Years		8.0	4.6	104.41--114.50	2.0	4.8557	39.9
	10 Years		9.0	4.1	107.29--127.25	1.0	5.5249	19.5
	Total	**5.0**		**13.0**		**5.0**		**100.0**
Grand Total		**17.0**		**41.5**		**17.2**		

Source: State Bank of Pakistan

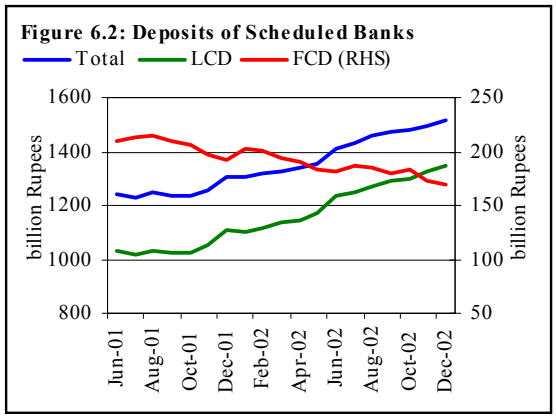
6. The Banking Sector

After a lackluster Q1-FY03, credit disbursement grew phenomenally in Q2-FY03 (see **Figure 6.1**).[44] As a result, the net credit of the banking sector grew by Rs 90.6 billion during the quarter, up 19.9 percent from the corresponding figure for Q2-FY02.



The strong growth in net credit was a very welcome development for the banking industry, which had been pressured by the continuing decline in interest rates (particularly on government securities), amidst increased market liquidity. The growth in net credit extension from mid-November 2002, appears to be driven by both, lower political uncertainty and a sharp fall in interest rates.

It is interesting to note that, contrary to earlier occasions, the November 2002 cut in the discount rate saw an immediate impact on banks' lending rates. This is testament to the pressure on banks to increase credit stemming from the continuing strong growth in deposits (relative to earlier years). Both, the lending and deposit rates, witnessed declines, however it was more pronounced in case of former, resulted in lowering the spread by 132 basis points during Q2-FY03.



As in the previous quarter, it was the local currency deposits that drove the rise in the total deposit base of the banking industry during Q2-FY03; foreign currency

[44] The disbursement is only against lending in local currency and does not include the amount disbursed in foreign currency.

deposits continued to decline (see **Figure 6.2**). However, the Q2-FY03 growth in banking sector deposits was visibly lower than in Q1-FY03. Finally, while the NPLs of the banking sector increased Rs 11.6 billion during Q2-FY03 by, all of the increase was entirely attributable to a single specialized bank.

6.1 Deposit Growth

As mentioned earlier, the scheduled bank deposits continued to grow during Q2-FY03, however, the growth rate went down significantly not only compared to the previous quarter of the current fiscal year but also relative to that of Q2-FY02 (see **Table 6.1**).

Table 6.1: Growth in Deposits
percent

		LCD	FCD	Total
Q2	FY02	8.6	-7.7	5.8
	FY03	4.3	-6.4	3.0
Q1-FY03		4.8	-0.7	4.1
H1	FY02	7.9	-8.3	5.2
	FY03	9.3	-7.1	7.2

On face value, this relative slowdown is puzzling given:

(1) A sharp growth in reserve money. The SBP's increased foreign exchange purchases in Q2-FY03, to mop up rising remittances, and a portion of this was not sterilized (see **Table 6.2**).[45]

(2) The rise in credit off-take. This should also have had a multiplier effect on banking sector deposits.

The explanation lies in the higher (seasonal) increase in the currency in circulation[46] and the rising investments in NSS instruments[47] (see **Figure 6.3**), which depressed deposit mobilization in Q2-FY03.

Table 6.2: Major Possible Determinants of Deposit Growth
billion Rupees

	FY02	FY03	
	Q2	Q1	Q2
Cash remittances	32.1	53.1	50.0
SBP forex purchases	75.4	89.9	145.7
Reserve money	57.7	-1.6	57.6
Currency in circulation	47.4	-0.8	54.7
NSS net mobilization	12.4	14.8	23.3

[45] Since November 2001, workers' remittances (cash) and the SBP foreign exchange purchases were the prime factors behind remarkable growth in banking sector deposits.
[46] Demand for currency generally follows a seasonal trend; it started increasing since September and follows a rising trend till February. Currency to deposit ratio jumped from 0.32 in September 2002 to 0.34 in December 2002 against 0.34 and 0.35 in the same months of 2001.
[47] Higher demand was due to the expected downward revision in NSS rates from January 1, 2003.

Within the banking sector, nationalized and foreign banks showed negative deposit growth during Q2-FY03 (see **Table 6.3**). While the drop in the deposits of foreign banks appears to be caused by continuing withdrawals from foreign currency accounts (Rs 5.6 billion in the period),[48] the decline in deposits of nationalized banks was mainly due to heavy withdrawals by PSEs in December 2002.[49]

Figure 6.3: NSS - Monthly Net Mobilization

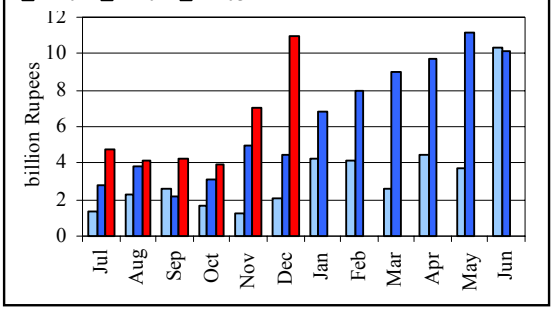


Table 6.3: Bank Deposit s

billion Rupees

	Q2		H1	
	FY02	**FY03**	**FY02**	**FY03**
Nationalized	26.2	-3.8	29.4	21.1
Privatized	12.4	19.4	6.8	20.5
Private	26.5	31.0	26.5	68.0
Foreign	4.5	-3.3	0.1	-8.3
Specialized	2.4	1.2	1.3	0.9
All	**72.0**	**44.5**	**64.2**	**102.1**

Note: For meaningful comparison, deposits of UBL are included in Privatized banks both for FY02 and FY03.

By contrast, private and privatized banks not only managed to enhance their deposit base but also saw higher growth during Q2-FY03 compared to the same quarter last year (see **Table 6.3**). The comparatively better performance of private banks reflects their higher deposit rates, increasing branch network, as well as improved marketing efforts.

Moreover, since borrowers typically deposit their funds with lending banks, institutions recording high credit growth would also be expected to witness stronger deposit growth. This factor also helps explain the deposit performance of both, private and privatized banks, during Q2-FY02.

6.2 Credit Growth

The most important development for the banking sector during Q2-FY03 was the pick up in credit demand (see **Figure 6.4**); net credit recorded a growth of 9.4 percent during the quarter against 8.0 percent growth in Q2-FY02.

[48] As these banks still have the largest foreign currency deposit to total deposit ratio, overall declining trend in FCDs affecting these banks more severely. Moreover, with the changing focus on rupee deposits, foreign banks are at a relative disadvantage due to their limited branch networks.

[49] Deposit of PSEs declined by Rs 26.6 billion in December 2002, the fall was primarily because of dividend, paid by PTCL to share holders at the end of the calendar year.

As discussed in ***Section 4***, it was the sharp pick-up in private sector demand that underpinned the rise in aggregate net credit disbursements by banks in Q2-FY03. In fact, by contrast, credit to PSEs and autonomous bodies saw a net retirement in Q2-FY03 against an increase in Q2-FY02 (see **Table 6.4**). Moreover, the government's net borrowing for commodity operations also, registered a relatively sharp retirement in Q2-FY03.[50]

Figure 6.4: Net Credit - Cumulative Flows

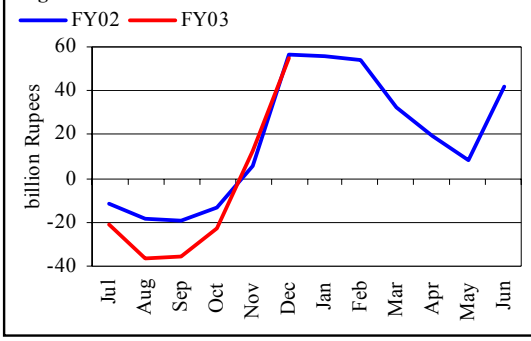


Table 6.4: Sector-wise Credit (Net) Distribution during Q2
billion Rupees

	FY02	FY03
Commodity operations	-4.5	-16.3
PSEs & autonomous bodies	4.2	-4.3
Private sector	75.9	111.2
Total	**75.6**	**90.6**

Source: State Bank of Pakistan

Another interesting development is the increasing role of foreign currency lending (against FE-25 deposits).[51] During Q2-FY03, these loans recorded an unprecedented flow of Rs 17.8 billion – the highest for any single quarter (see **Table 6.5)**. These loans are provided only for trade financing purposes, and appear to be substituting export finance credit, due to the relative attractiveness of foreign currency loans amidst the strengthening of the rupee.[52]

Table 6.5: Lending in Foreign Currency*
Cumulative flows

		million US Dollar	billion Rupees
Q1-FY03		215.0	12.4
Q2	**FY02**	36.7	2.2
	FY03	312.7	17.8
H1	**FY02**	47.3	2.8
	FY03	527.7	30.3

*: Only against FE-25 deposits

[50] It is important to note that total credit includes schedule banks advances (other than those to banks), import bills, inland bills, investment in other approved securities and other investments. This is the same definition that are being used in Monetary Survey and one may arrive at these figures by adding schedule banks credit for commodity operations and non-government sector. The government borrowing for budgetary support is not included here.

[51] In addition to FE-25 deposit banks are allowed to fund foreign currency loans through foreign currency swaps.

[52] Disbursement under EFS during Q2-FY03 was Rs 23.8 billion against Rs 48.7 billion during Q1-FY03 and Rs 55.6 billion in the second quarter of FY02.

Table 6.6: Bank Credit
billion Rupees

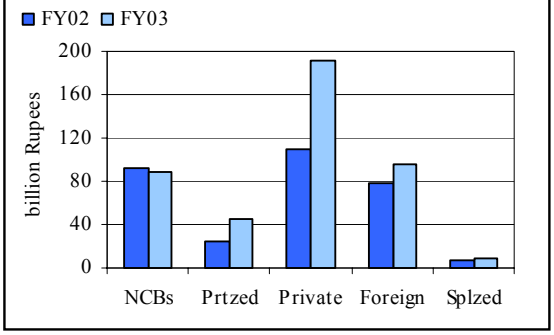
	Q2		H1	
	FY02	**FY03**	**FY02**	**FY03**
Nationalized	39.2	10.7	38.6	-8.3
Privatized	20.9	23.3	5.0	10.0
Private	9.1	40.3	5.1	48.6
Foreign	9.6	13.9	3.8	1.0
Specialized	-3.3	2.4	4.1	3.8
Total	**75.6**	**90.6**	**56.6**	**55.2**

Note: For meaningful comparison deposit of UBL are included in privatized banks both for FY02 and FY03.

Within the banking sector, other than nationalized banks, all groups extended higher net credit in Q2-FY03 compared to same quarter of the previous year (see **Table 6.6**).

As the larger portion of credit demand from PSEs, autonomous bodies and the government (for commodity operations) is catered by nationalized banks,[53] the fall in net borrowing from these sectors hampered the credit growth for banks in this group. Moreover, the inability of nationalized banks to reduce their relatively high lending rates to the extent of the other groups, made it more difficult for them to compete.[54]

Figure 6.5: Credit Disbursement - First Half



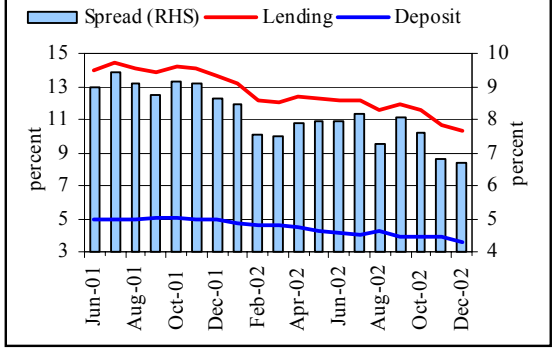
However, as in Q1-FY03, private banks again registered the highest growth, both in disbursements and net credit (see **Figure 6.5** and **Table 6.6**) helped by relatively low lending rates. In fact, during Q2-FY03, the weighted average lending rates of private banks declined by 180 basis points. Most of the banks in this group created specialized teams that are playing an important role in enlarging their client base. Some private banks have already established niches in consumer banking during the last two years.

Finally, while foreign banks also saw a significant rise in their net credit during Q2-FY03,[55] it appears that this was achieved only as the result of a steep 235 basis

[53] Around 70 percent of total credit for commodity operations and more than 50 percent to PSEs and autonomous bodies is extended by nationalized banks.
[54] Large NPLs and diseconomies of scales in the nationalized banks restricted banks in this group to operate at higher spread.
[55] Foreign banks only managed to disburse Rs 60.9 billion during Q1-FY03 against Rs 90.0 billion in Q1-FY02.

point reduction in their lending rates over the period. Interestingly, as a group, foreign banks had reduced their lending rates by 167 basis points even before the cut in discount rate by the SBP in November 2002. This apparently pro-active fall in their lending rates could be attributable to their poor credit extension performance in the preceding quarter.

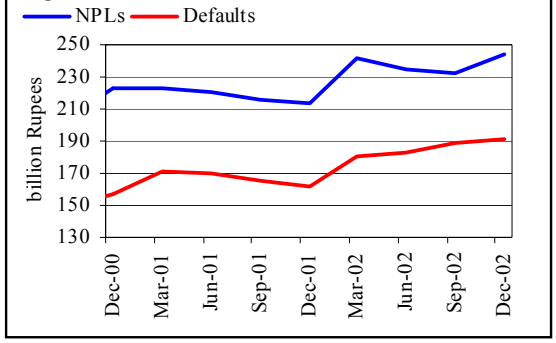
Figure 6.6: Weighted Avg. Deposit & Lending Rates



6.3 Banking Spread

Banks saw both, lending and borrowing rates, decline in Q2-FY03.[56] The larger decline in the weighted average lending rate squeezed the banking spread by 132 basis points during the period (see **Figure 6.6**).[57] Interestingly, only nationalized banks saw their spreads narrow by *less* than 100 basis points.[58]

Figure 6.7: NPLs and Defaults



6.4 Non-performing Loans

Unlike the first quarter of FY03, net NPLs of the banking sector increased from Rs 232.6 billion at the end-September 2002 to Rs 244.2 billion by end-December 2002 (see **Figure 6.7**).

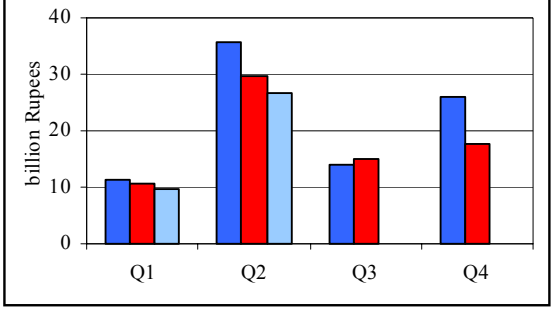
[56] The weighted average lending rates were 10.3 percent in December 2002 (13.6 percent in December 2001). While the weighted average deposit rates were 3.6 percent in December 2002 (5.0 percent in December 2001).

[57] The weighted average lending rates are only against loans disbursed in local currency. Due to non-availability of data on disbursement in foreign currency, it is difficult to calculate the weighted average lending rates on total disbursement. According to a conservative estimate, if foreign currency loans disbursement also included weighted average lending rates would go down by another 25 basis points.

[58] The banking spread of privatized, foreign and private banks narrowed by 1.82, 1.76 and 1.17 percentage points, respectively.

This was because, a sharp upsurge in the NPLs of one of the specialized bank overshadowed the improvement made by the other banks.[59] On excluding the data for this entity, aggregate NPLs of the remaining scheduled banks registered a *fall* of Rs 0.9 billion. In any case, the *net NPLs to net advances* ratio of the banking sector improved from 12.8 percent in June 2002 to 11.7 percent in December 2002.

Figure 6.8: Fresh NPLs



It is encouraging to note that the growth of *fresh* NPLs (following the seasonal pattern) has been constantly declining over last two years and this trend has continued into Q2-FY03 despite the sizeable increase in the NPLs of a specialized bank (see **Figure 6.8**).

7. Prices

Annualized inflation during Q2-FY03 remained visibly higher than in the preceding quarter, as reflected by all three indices (see **Table 7.**1). However inflationary *pressures* appear to have moderated during the period with the respective marginal inflation rates for two key price indices, the benchmark CPI and the SPI, dropping below their corresponding 12-month moving averages (see **Figure 7.4**).

Table 7.1: **Annualized Inflation Trends**
percent

	Month to month basis		Quarter to quarter basis		Half year to half year basis	
	December		Q2		H1	
	FY02	FY03	FY02	FY03	FY02	FY03
CPI	2.6	3.3	2.8	3.3	3.3	3.6
Food	1.4	2.4	1.6	2.9	1.5	4.0
Non-food	3.4	4.0	3.7	3.6	4.4	3.3
WPI	-1.5	7.2	0.4	6.2	3.0	4.7
Food	1.4	3.1	1.5	3.0	1.8	3.1
Non-food	-3.8	10.7	-0.4	8.9	4.8	6.0
SPI	3.0	3.3	2.7	3.5	2.5	4.3

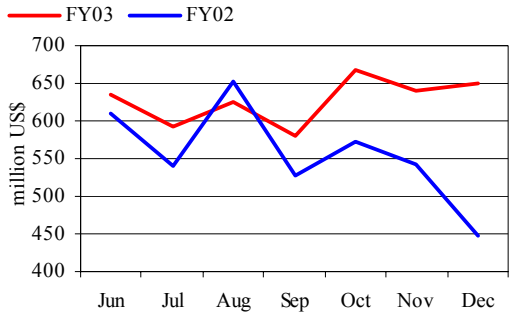
Source: Federal Bureau of Statistics

As a result, the CPI inflation of 3.8 percent recorded during Q1-FY03 dropped to 3.3 percent in Q2-FY03 and similarly, SPI inflation dropped from 5.2 percent to 3.5 percent in the corresponding periods (see **Table 7.1**).

[59] NPLs of Zarai Taraqiati Bank Limited (former ADBP) increased by Rs 12.6 billion during Q2-FY03.

However, it is unclear at this point, if this relatively benign picture will be sustained going forward as:

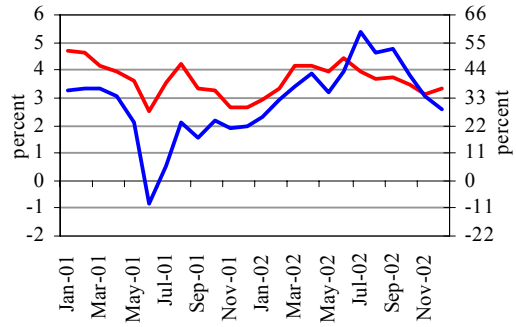
Figure 7.1: Imports of Consumer Goods and Raw Material for Consumer Goods



1. The movement of the WPI is in sharp contrast to the other two indices. WPI inflation marched steadily upwards through H1-FY03, rising from 3.2 percent in Q1-FY03 to 6.2 percent in Q2-FY03. This could be a point of concern since historically, the movement of the CPI has seen a lagged though weak correlation with the WPI.

2. The December 2002 up-tick in the marginal inflation rates of the other two indices appears to signal a possible trend reversal.[60]

Figure 7.2: Food Inflation

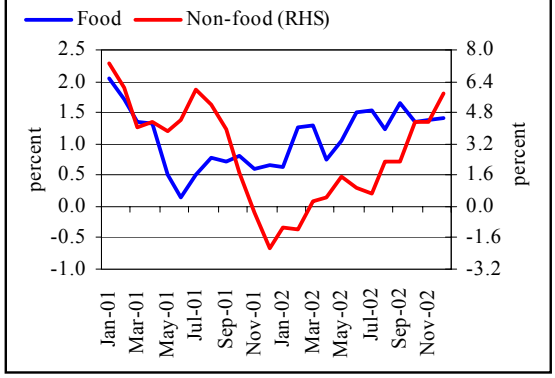


Interestingly, however, in contrast to Q1-FY03, it was non-food group that contributed to inflationary pressures; prices of many important food items either registered a decline or stagnated during Q2-FY03. Also, higher imports of consumer goods and raw materials for consumer goods during the first half of FY03 (see **Figure 7.1**) relative to FY02, amidst a strengthening rupee *and* lower unit prices of imports, seem to have cushioned price pressures.

[60] Additional data points are needed to confirm a reversal in a trend.

The declining contribution of food inflation in H1-FY03 is visible in **Figure 7.2**. Despite its smaller weight in the CPI, it was the higher prices in the food group that contributed to inflation in the Q1-FY03. Thereafter, it is the moderation in food prices that appears to have contained CPI inflation in Q2-FY03.

Figure 7.3: WPI-Food & Non Food Inflation (weighted)



This picture is reinforced by looking at the behavior of sub-components of the WPI (see **Figure 7.3**).

The decline in food inflation largely seems a function of supply side factors, as well as *imported deflation.* The improved market conditions due to the relatively good production and lower exports of some of the important crops including onion, potatoes and tomatoes combined with better availability of sugar and milk, as well as lower prices of POL products, appear to have contributed to a subdued rate of inflation in the second quarter of the current fiscal year.

7.1 Consumer Price Index

During Q2-FY03 the CPI increased by 3.3 percent as against 2.8 percent in Q2-FY02. While the annualized inflation figure was higher in Q2-FY03, marginal inflation was declining, primarily due to a deceleration in food inflation, as noted earlier.

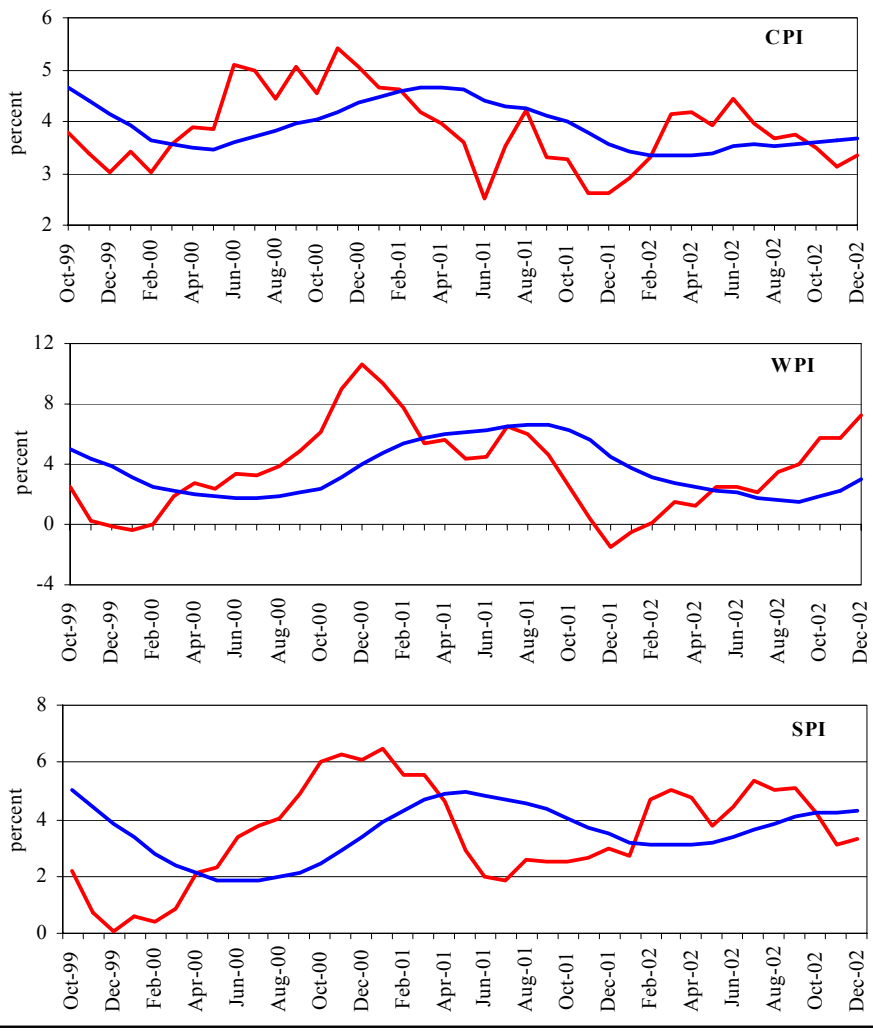
7.1.1 Food

The growth in food prices lost momentum in Q2-FY03, with increases in some items being partially offset by falls in prices of other key essentials.

The prices of wheat and wheat flour did see a gradual rise through FY03, possibly reflecting higher wheat exports. However, since the country has ample wheat stocks and the prospects of the current wheat crops seem good, its price should now stabilize.

Moreover, the prices of vegetable ghee were higher by 20.1 percent during Q2-FY03 over Q2-FY02 and about 4 percent over Q1-FY03. The increase in the

Figure 7.4: 12-monthly Changes in Price Indices



import unit value of edible oil by 42.3 percent and decline in the domestic production of vegetable ghee by 9.8 percent during H1-FY03 continued to put upward pressure on the prices of these goods.

Significantly, many important food items in CPI such as sugar, milk, as well as chicken farm, *besan* and garlic recorded a *fall* in prices. During Q2-FY03 the

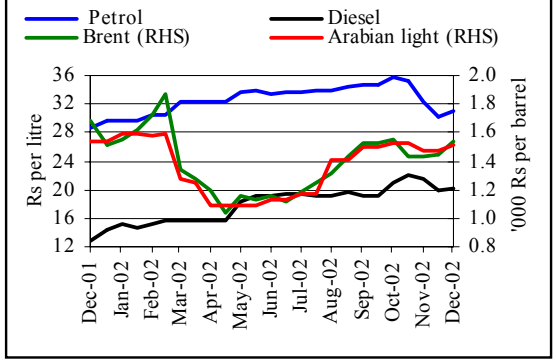
prices of pulses declined across the board both over last year level as well as over the first quarter of the current fiscal year largely due to availability of cheaper imports.[61] A notable decline was also observed in the retail prices of sugar and *gur* in contrast to the rise recorded in the first three months of FY03; the prices of sugar declined by 4 percent in Q2-FY03 over the same period last year due to improving supply prospects.

Other major food items that recorded a decline in prices include, tomatoes, onion, and potatoes, reflecting successive good crops, and lower exports.

7.1.2 Non-food

During Q2-FY03 non-food group prices increased by 3.6 percent as against a 3.7 percent rise in the corresponding period last year, however, the group's contribution in the aggregate inflation, increased. The deceleration in non-food inflation resulted mainly from the lower increases observed in groups like *apparel, textile & footwear*, *house rent*, *recreation & entertainment*. While *fuel & lighting, transport & communication, cleaning, laundry & personal appearance* and *medicines* recorded higher increases over the same period last year. Although *fuel & lighting* rose by 9.8 percent during Q2-FY02 as against 8 percent in the preceding year, however, on a half yearly basis it recorded lower increases compared to the same period last year.

Figure 7.5: Brent Crude, Arabian Light & Petrol Prices



The prices under *fuel & lighting* sub-group saw a rise of 8.9 percent in H1-FY03 as against an increase of 10.4 percent during the same period last year. The deceleration was the effect of the downward revision in both POL products and electricity rates. The lower POL product prices in the months of October and November 2002 were mainly the reflection of downward trend in

[61] Imports of pulses rose by 55.3 percent YoY during H1-FY03. The combined impact, of a fall of 1.7 percent in the US$ price of these imports and the rupee appreciation over the preceding 12 months implies a substantial decline in the rupee cost of the imports.

international oil prices in that period (see **Figure 7.5**).[62] Along with these developments, NEPRA reduced the electricity rates for various categories of consumers.[63] However, with the upward revision in gas charges,[64] the full benefits of these changes could not be passed on to the consumers, as is visible from the trend in the fuel and energy index.

7.2 Wholesale Price Index

The WPI, which had recorded a marginal growth of 0.4 percent during Q2-FY02, rose sharply at the rate of 6.2 percent in Q2-FY03.

As with the CPI, the major share to annualized WPI inflation was by non-food items during Q2-FY03. As evident from **Table 7.2**, the impact of food inflation was muted by the countervailing price movements of individual food items.

Table 7.2: WPI-Food Price Changes

No. of items	weights	percent growth
8	8.65	Above 10
10	13.83	1 to10
2	11.60	0 to1
19	11.71	Less than 0
Total 39	**45.79**	**3.0**

Source: Federal Bureau of Statistics

7.2.1 Food

In line with the price developments at the consumer level, food prices in wholesale markets, as measured by the WPI, recorded an increase of 3 percent during Q2-FY03 as against a 1.5 percent rise in Q2-FY02. Major items that recorded substantial increases in prices included cooking oil & vegetable ghee, rice, wheat flour, maize and fresh fruits.

The higher prices of cooking oil and vegetable ghee reflected rising (and more expensive) imports of edible oils, particularly *palm oil*. Although the production of Malaysian palm oil was close to the previous year's level, the decline in global edible oil production this year, due to the drought in different parts of the world, kept edible oil prices high in the world markets.

[62] The domestic oil prices are linked with that of the Arabian light. However, the domestic price variations also incorporate other factors such as time lags, taxes and seller margins etc.
[63] The tariff reduction took into consideration the variation in furnace oil between October-December 2002, resulting net decrease in the fuel bill of WAPDA and other electricity producing companies.
[64] Under the existing mechanism, upward revision of gas prices is made after every six months and the prices are determined keeping in view the wellhead price, transmission, distribution, utilities and taxation cost etc.

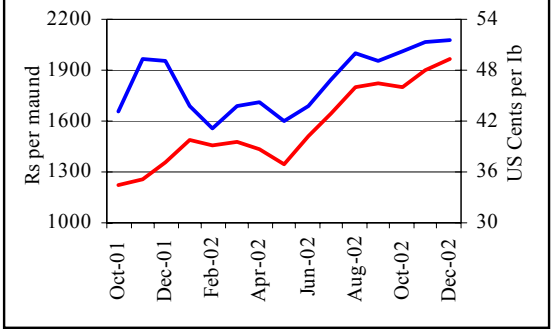
The increase in import unit value of edible oil by 42.3 percent, domestic cottonseed prices by 15.6 percent, and a decline in the domestic production of ghee, probably further fueled cooking oil and vegetable ghee prices in the wholesale market.

7.2.2 Non-food

In case of non food items, substantial increases were recorded in Q2-FY03 the prices of *fuel, lighting & lubricants*, *raw materials* while *manufactures* has shown lower increases over the second quarter of the last year. During Q2-FY03, *fuel, lighting & lubricants* recorded a sharp growth of 18.9 percent compared with the decline of 2.7 percent last year (on a month over month basis it is as high as 25.2 percent). The Brent crude prices declined in November 2002 by US$ 6.8 per barrel from the high levels recorded a month earlier. Oil prices saw an increase, however, in the subsequent months, on account of the uncertainty stemming from geo-political developments in the Middle East.

The acceleration in the *raw material* prices was mainly due to the rise in wholesale prices of cottonseed, cotton, mustard & rapeseed and hides. Domestic cotton prices continued to fetch higher prices during H1-FY03 amidst reports of a below-target domestic crop, and relatively low international production, as well as rising domestic consumption.

Figure 7.6: Domestic and International Lint Prices



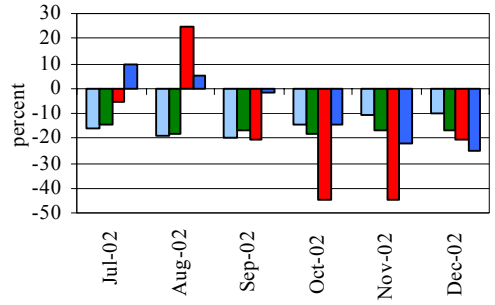
Looking at **Figure 7.6**, world cotton prices have also shown a rising trend during the last few months. The Cotlook "A" Index in the month of December reached 55 US Cents per lb; this is the highest level since March 2001 and is also significantly more than the 40 Cents fetched in December 2001.

7.3 Sensitive Price Indicator

Although during H1-FY03 the growth in the SPI was higher than in H1-FY02, it was lower than in Q1-FY03, i.e. SPI inflation appears to have peaked, and is now trending downwards.

The moderation in the SPI during Q2-FY03 is yet another reflection of the deceleration in food inflation evidence in the CPI and WPI. In fact, during Q2-FY03, many SPI items recorded a *decline* in prices, including pulses, sugar, gur, tea, tomatoes, onion, and toilet soap (see **Figure 7.7**) relative to the previous quarter. This helped mitigate the impact of higher prices of other essentials such as wheat flour, vegetable ghee and kerosene.

Figure 7.7: Price Changes of Pulses & Vegetables



8. Capital Market

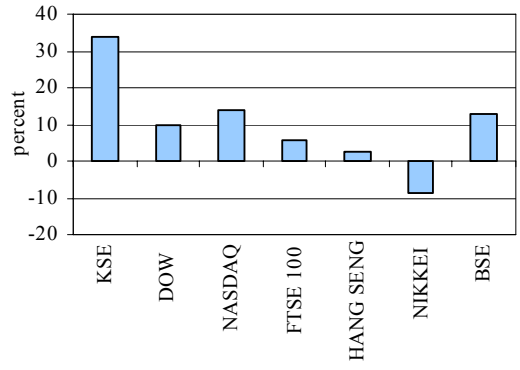
The FY03 bull trend of August 2002 continued, unabated, into Q2-FY03. The resulting 33.8 percent gain by the KSE-100 index during the quarter, pushed the market's aggregate CY02 gains to a stunning 112.2 percent (see **Table 8.1**), rendering Pakistan the best performing market in the world during the calendar year (see **Figure 8.1**).

Table 8.1: Highlights of KSE (as on December 31, 2002)

billion Rupees, billion Stocks

Listed companies at KSE	711
KSE-100 Index	2701.4
Change in KSE-100 since end-September 2002 (%)	33.8
Year on Year change in KSE-100 Index (%)	112.2
Market capitalization	588.4
Shares traded at KSE during the quarter	14.9
Average daily volume of shares traded during Q2-FY03	0.245

Figure 8.1: KSE and Other Leading Indices - Q2-FY03

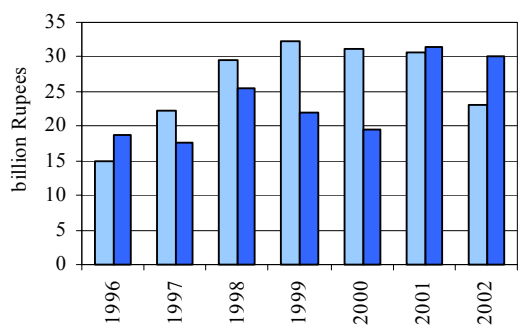


This spectacular CY02 performance was attributable to a number of factors including (1) substantial improvement in economic fundamentals, (2) a further easing of border tensions with India, (3) relatively cheap market valuations (see **Table 8.2**) and the declining returns on alternative investments, (4)

burgeoning rupee liquidity, driven in large part by continuing forex inflows into Pakistan, that drove down interest rates, and (5) the expectations of early privatizations (raising speculative interest in some scrips).

However, of these, the latter two were probably the more important drivers of the spectacular Q2-FY03 rise, which accounted for over half the CY02 increase in the KSE-100, and saw market capitalization at the KSE rise to Rs 588.4 billion, a 28.4 percent increase during the quarter.

Figure 8.2: Financial Charges and PAT



Data for 85 companies--excluding Hubco

The market had been buoyant from the very beginning of the quarter, with the KSE-100 index recording a gain of 14.4 percent in October 2002 over the previous month amidst declining border tensions, and robust corporate results during H1-FY03 (see **Figure 8.2**).[66] However, the up trend accelerated significantly as expectations of a stable pro-reform government crystallized by mid-November 2002. This process was then helped by positive indications by the political government on the continuation of the privatization program (and in particular, on the privatization of PSO).

The impact of the increased liquidity is evident in the spectacular 120.7 percent Q2-FY03 increase in average daily trading volumes to 245 million shares. In fact, the dizzying rise in the turnover ratio (value of stocks traded over the total market capitalization) in the latter weeks of the quarter, suggests that speculative interest was indeed a significant contributor to the rise during the period (see **Figure 8.3**).

Table 8.2: Top 20 Companies in Karachi Stock Exchange[65] by Market Capitalization

	2000	2001	2002
PE Ratio	8.41	4.30	13.83
ROE	0.17	0.28	0.19

[65] These companies account for 60 percent of the total market capitalization and approximately 72 percent of the average daily trading volume during the quarter.

[66] Hubco data is excluded because of large one off arrear payments by WAPDA during previous year.

Figure 8.3: Movement in KSE-100 Index and Turnover Ratio

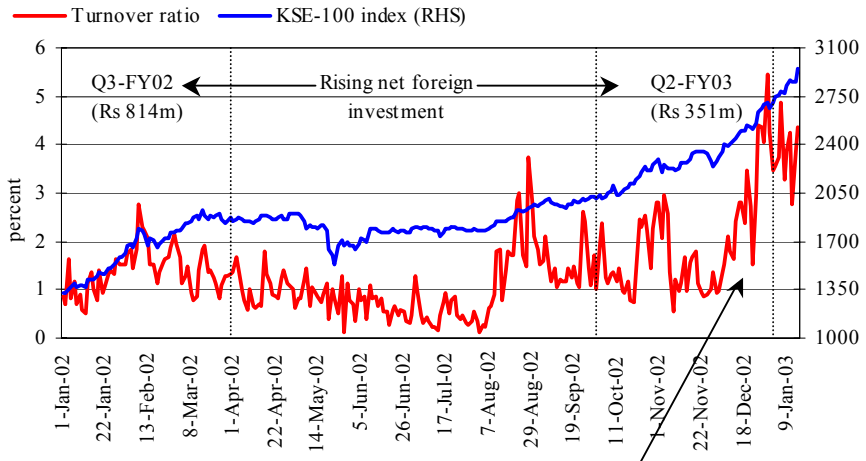
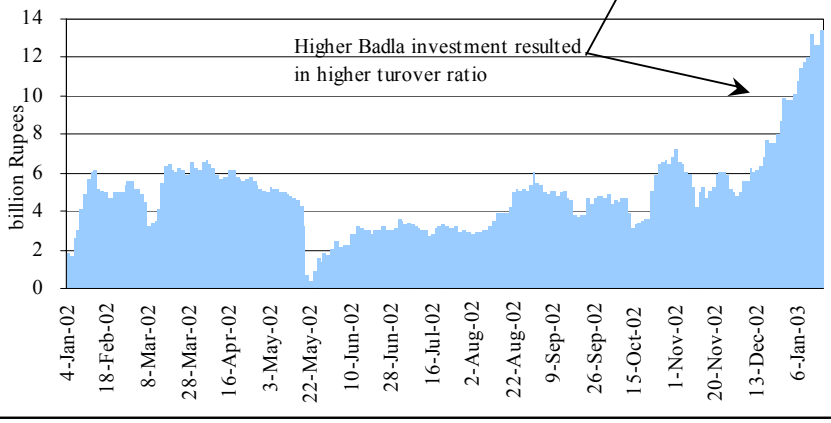


Figure 8.4: Badla Investment



This view is supported by the fact that badla[67] volumes that had already risen significantly since July 2002 rose substantially higher in the corresponding period. The badla rates averaged approximately 16 percent in Q2-FY03, as against an average of approximately 12.7 percent for the previous three quarters. Moreover, badla financing volumes too, were 44.9 percent higher during Q2-FY03, averaging Rs 5.7 billion daily as compared to the Rs 3.9 billion daily in the previous quarter

[67] Badla refers to the short term financing for transactions that purchasers are unable to settle themselves, but which they wish to retain in hopes of favorable price movements. High badla volumes therefore imply a larger number of speculative holdings.

(see **Figure 8.4**). Such a high (and rising) dependence on badla financing clearly indicates vulnerability of the market to any adverse development or change in sentiment.

Recognizing this risk a new procedure of COT financing was launched from November 11 by SECP. Under it, all carry over transactions are to be for a period of 10 days in order to mitigate the potential risk of the sudden withdrawal of massive funds from badla operations as happened in the past when financing was done on a daily basis. As a result of this measure, the badla players were initially uneasy and withdrew funds, pushing badla rates to 30 percent. However, lacking attractive investment opportunities elsewhere and gradually adjusting to the new badla rules, these funds soon returned to the market, normalizing the rates at around 15 percent, on average, for the rest of the quarter.

8.1 Regulatory Measures

The SECP and KSE continued to introduce measures to improve governance and transparency in the market.

- On October 8, 2002, the KSE stopped disclosing identities of parties to transactions. This measure was aimed at preventing small investors from copying positions taken by larger market players (the earlier practice had encouraged speculative holdings and market manipulation).

- SECP, introduced an amendment in the Companies Ordinance 1984, under which, the companies are now required to present their quarterly accounts to shareholders within one month of the respective quarter-end. Moreover, the penalty for the non-compliance of the provisions relating to auditing was increased from Rs 2,000 to Rs 100,000.

- A "take-over law" proposed by the SECP was promulgated on November 1, 2002.

- Another significant reform was introduced in the Badla market. Badla providers were required to commit their funds to the market for 10 days. This is aimed at preventing an artificial liquidity crunch due to an abrupt withdrawal of financing from the market.

8.2 Corporate Bond Market

The primary corporate debt market remained relatively inactive in Q2-FY03; just three new issues were launched worth Rs 2.2 billion in the period, as against eight issues worth Rs 4.6 billion issued in Q1-FY03 (see **Table 8.3**). With these

Table 8.3: Issues Since October 2002
million Rupees

Security	Issue Date	Maturity	Issue Size	Coupon Rate	Ratings
Quetta Textile Mills	24-Oct-02	24-Oct-07	750	SBP Discount rate +2.50% with a floor of 13% and a cap of 18%	A-
Bank Al-Falah	19-Dec-02	19-Dec-08	650	Cut-off yield of 5 yrs PIB + 1.35% Floor 10.00% , Cap 15.00%	A+
Union Bank	19-Dec-02	19-Dec-08	750	Cut-off yield of 5 yrs PIB + 2.25% Floor 11.00% , Cap 15.50%	A-
Security Leasing 2	9-Jan-03	9-Jan-07	299	SBP Dis Rate + 2.25 First Year floor 11.50, Cap: 15.50 for 2-4 Years floor 11.00, Cap: 15.50	A
KASB Leasing	14-Jan-03	14-Jan-08	200	Base rate + 2.25%, Floor 11.50%, ceiling 14.50%	A

issuances the total amount of listed TFCs outstanding reached Rs 25.0 billion by end-December 2002.

Although most TFCs issued in recent years have been floating rate instruments, a majority of these also incorporated coupon ceilings and floors to protect issuers and investors respectively. However, in the event, the collapse in benchmark interest rates[68] have rendered the ceilings redundant – practically all floating rate bonds have hit their floors, providing ample opportunity for investor to book capital gains.

The domestic debt market is expected to be one of the focal points in the second phase of the ADB-funded capital market development program, particularly with respect to increase the market depth, and introduction of new instruments.

[68] Most TFCs were anchored to either the discount rate or the 5-year PIB.

9. External Sector

Balance of Payments[69]

Pakistan's external account picture remained significantly positive during Q2-FY03, despite a rising trade deficit and a fall in services account inflows compared to Q1-FY03. The weaker current account surplus of Q2-FY03 was partially offset by a reversal in the capital account, which also recorded a surplus (see **Table 9.1**). As a result, the H1-FY03 aggregate current and capital account surplus rose 135 percent compared to the corresponding period of FY02.

Encouragingly, while 46.6 percent of the H1-FY02 current account surplus constituted *non-structural* inflows (e.g. a US grant), the corresponding H1-FY03 surplus is not only larger, it is mainly a consequence of *structural* improvements (lower interest payments, and accelerating inflows of remittances) that are likely to continue in future.

Table 9.1: Current & Capital Accounts
million US Dollar

	Q1	Q2	H1
Current account balance			
FY03	1227	488	1715
FY02	-69	1357	1288
Change	*1296*	*-869*	*427*
Capital account balance			
FY03	-67	173	106
FY02	-587	75	-512
Change	520	98	618
Adjusted capital account balance			
FY03	-304	-3	-307
FY02	*-615*	*38*	*-577*
Change	*311*	*-41*	*270*

On the other hand, the capital account "improvement" needs some explanation. Approximately US$ 413 million of the inflow represents a contra-entry against forex loans disbursed by banks. Adjusting for this, the capital account shows a deficit of US$ 307 million, that nonetheless represents a 47 percent improvement over the corresponding figure for FY02. In any case, a liquid interbank forex market, led SBP to increase purchases, so as to ensure only a gradual rupee appreciation. Consequently, the rupee appreciated by 3.1 percent through H1-FY03. The purchases also helped push the SBP's forex reserves to US$ 8.1 billion by end-December 2002.

It is worth noting here that with effect from December 2002, Pakistan's foreign currency reserves are being reported net of loans extended to exporters and importers against the FE-25 deposits. As a result, there was a compositional change in total forex reserve holdings, with a large portion of commercial banks' reserves shifting to the SBP.

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

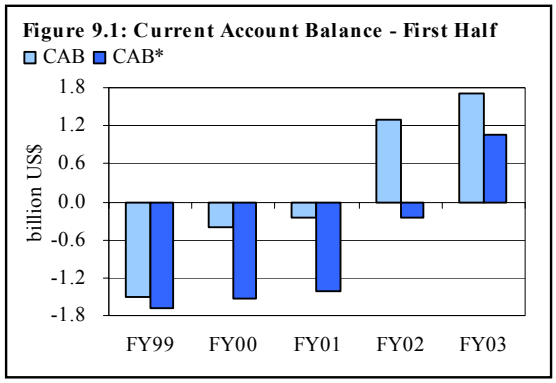
Table 9.2: Balance of Payments
million US Dollar

Items	FY2		FY3		H1-FY02	H1-FY03
	Q1	Q2	Q1	Q2		
1. Trade balance	**-209**	**100**	**-164**	**-275**	**-109**	**-439**
Exports (fob)	2203	2318	2606	2540	4521	5146
Imports (fob)	2412	2218	2770	2815	4630	5585
2. Services (net)	**-830**	**-597**	**-220**	**-775**	**-1427**	**-995**
Shipment	-194	-172	-209	-222	-366	-431
Other transportation	-8	9	45	77	1	122
Travel	-35	-9	-14	-22	-44	-36
Investment income	-583	-503	-507	-605	-1086	-1112
Interest payments	-386	-315	-267	-299	-701	-566
Profit and dividend	-197	-188	-240	-306	-385	-546
Other goods, services, & income	-10	78	465	-3	68	462
3. Current Transfers (net)	**970**	**1854**	**1611**	**1538**	**2824**	**3149**
a) Private transfers -net	772	1061	1339	1287	1833	2626
of which: Workers' remittances	340	645	1053	1095	982	2148
FCA (Residents)	21	117	154	-205	138	-51
Outright purchases	398	239	0	0	637	0
b) Official transfers	198	793	272	251	991	523
of which: Saudi oil facility	173	127	189	161	300	350
4. Current account balance (1+2+3)	**-69**	**1357**	**1227**	**488**	**1288**	**1715**
5. Capital account (net)	**-587**	**75**	**-67**	**173**	**-512**	**106**
6. Errors & omissions	**361**	**73**	**272**	**116**	**434**	**388**
7. Overall balance	**-295**	**1505**	**1432**	**777**	**1210**	**2209**
8. Financing	**295**	**-1505**	**-1432**	**-777**	**-1210**	**-2209**
I. Changes in reserves (-Inc/+Dec)	**80**	**-1412**	**-1687**	**-810**	**-1332**	**-2497**
Assets	-140	-1482	-1713	-851	-1622	-2564
SDRs	2	-1	-3	9	1	6
Forex						
State Bank of Pakistan	-45	-1414	-1587	-1681	-1459	-3268
Commercial banks	-97	-67	-123	821	-164	698
Liabilities	220	70	26	41	290	67
Use of fund credit	220	70	26	41	290	67
Repurchases	267	110	115	115	377	230
Purchases/drawings	-47	-40	-89	-74	-87	-163
II. Exceptional financing	**215**	**-93**	**253**	**34**	**122**	**287**
SBP reserves (end period)	2134	3538	6400	8068	3538	8068

Source: State Bank of Pakistan

9.1 Current Account

The current account posted a surplus of US$ 1.7 billion during first half of the current fiscal year as compared to a surplus of US$ 1.3 billion in the corresponding period last year. Even excluding the potentially non-structural elements such as the Saudi Oil Facility (SOF), kerb purchases, US aid, and receipts against logistic support, the current account balance (CAB*) improved substantially during H1-FY03, registering a surplus of US$ 1048 million as against a corresponding deficit of US$ 249 million during H1-FY02 (see **Figure 9.1**).



The H1-FY03 improvement in the current account was not as broad-based as in H1-FY02, as the trade deficit *widened* by US$ 330 million to US$ 439 million. However, the rise in the trade deficit was offset by a sharp reduction in net services account outflows. As a result, the YoY improvement in the H1-FY03 current account surplus roughly reflects the jump in the net current transfers during the period, spearheaded by accelerating remittances.

9.1.1 Trade Balance

While exports and imports both rose strongly in H1-FY03, the YoY growth in imports (20.6 percent) more than offset the rise in exports (13.8 percent), pushing up the trade deficit to US$ 439 million (for details, see **Trade Account** sub-section).

9.1.2 Services (net)

Despite the higher outflows on account of *profits and dividends*, the services deficit contracted to US$ 1.0 billion during H1-FY03 as compared to a deficit of US$ 1.4 billion in H1-FY02 (see **Table 9.2**).

The improvement was mainly contributed by lower *net interest payments* and higher receipts from *other transportations* (due to lower operating expenses by

PIA), and *other goods and services* (reflecting increased communication charges and receipts for logistic support to the international forces in Afghanistan.[70]

Specifically, the retirement of expensive debt and liabilities during the last year paid dividends in the form of a US$ 117 million decline in interest payments during H1-FY03 (see **Table 9.3**).[71] At the same time, the interest earnings on the forex reserves increased in correspondence with the rise in country's reserves.

On the other hand, outflows on account of *profits and dividend* increased by US$ 161 million to US$ 546 million during H1-FY03 relative to US$ 385 million in the same period last year (see **Table 9.4**).[72] The higher international crude oil prices pushed up the amount realized against exports of crude oil, which in turn resulted into higher outflows. Similarly, the high repatriation of *profit & dividend* and increased *reinvested earnings*

Table 9.3: Details of Interest Payments and Receipts
million US Dollar

	H1-FY02	H1-FY03
Payments (I+II)	**757**	**640**
I. Total external debt	620	561
Public & publicly guaranteed	497	478
Long-term	414	418
Military	13	13
Euro bonds	31	37
Commercial loans/credits	28	8
IDB	11	2
Private loans/credits	93	62
IMF	30	22
II. External liabilities	137	78
Foreign currency deposits	45	22
Special US$ bonds	34	21
NHA bonds	15	7
Central bank deposits	26	14
Others	17	14
Receipts	**56**	**74**
Interest on reserves	50	65
Others	6	9
Net Payments	**-701**	**-566**

Source: State Bank of Pakistan

Table 9.4: Details of Profit and Dividend
million US Dollar

	H1-FY02	H1-FY03
Profit and Dividend	**385**	**546**
Profit	16	35
Dividend	131	217
Purchase of crude oil	195	237
Export of crude oil	155	201
Remittances	40	36
Reinvested earnings	44	58

Source: State Bank of Pakistan

[70] In H1-FY02, number of international airlines reduced their operations in Pakistan due to war risk and higher insurance premiums.
[71] SBP retired US$ 1.9 billion and US$ 702 million of total external liabilities during FY02 and H1-FY03 respectively. As a result, the stock of Special US Dollar Bonds, FCAs and commercial & private loans/credit, NBP deposits and swaps declined significantly.
[72] Purchase of crude oil reflects the amount paid by the Government against the share of crude oil extracted in Pakistan by the foreign companies.

reflects the increased profitability of MNCs and gains to foreign investors in Pakistan.

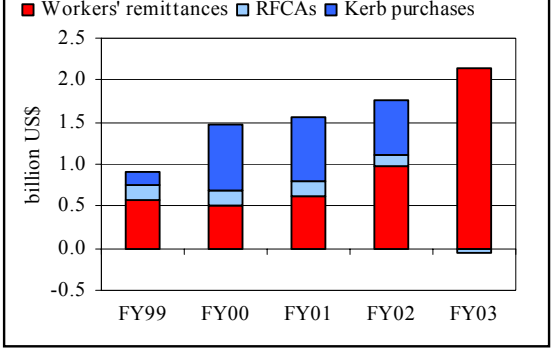
9.1.3 Transfers

Net transfers increased by US$ 325 million relative to H1-FY02. While the inflows of workers' remittances more than doubled in H1-FY03 to reach a stunning US$ 2148 million, this gain was partially offset by the greater net outflows from resident FCAs, absence of SBP kerb purchases, and reduced *official transfers* (the one-off US$ 600 million H1-FY02 grant was not available during Q2-FY03).

Private Transfers

The structural shift in the *private transfers* is visible in H1-FY03. Flows shifted from resident foreign currency accounts (RFCAs) and SBP's kerb purchases to higher remittances. Moreover, the YoY growth in private transfers suggests that this is not just a transfer of flows from the kerb to the formal market but also some partial reversal of capital flight. And almost subdued lower capital flight through the informal markets (see **Figure 9.2**).[73]

Figure 9.2: Composition of Private Transfers - First Half



Workers' remittances

Remittances continued apace during H1-FY03 registering a growth of 124 percent compared to the corresponding period last year (see **Table 9.5**).[74] On the one hand, Pakistani nationals increasingly felt themselves vulnerable as their assets came under increasing scrutiny abroad, and on the other hand, forex assets were no longer attractive following the creeping appreciation of the rupee.[75] A continuation of these trends would be expected to take FY03 remittances over the US$ 4 billion mark.

[73] Since July 2002, SBP voluntarily decided to discontinue the practice of purchasing dollar from the kerb market.
[74] See *SBP's First Quarterly Report* for FY03.
[75] This is also evident in the conversion of FE-25 deposits totaling US$ 365 million into Rupee. Pre-September 11, the double-digit annual depreciation of the rupee had led to considerable interest in US dollar denominated saving avenues.

Table 9.5: Country-wise Worker's Remittances – First Half

million US Dollar

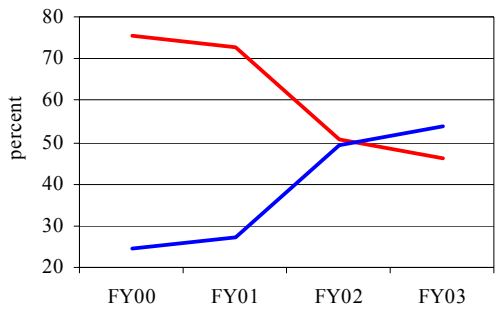
	Inflows in million US Dollar				Shares in percent				Change in H1-FY03 over H1-FY02	
	FY00	FY01	FY02	FY03	FY00	FY01	FY02	FY03	Absolute	Percent
Gulf Region	**369.0**	**415.7**	**481.9**	**981.4**	**75.7**	**72.7**	**51.3**	**46.1**	**487.6**	**98.7**
Bahrain	15.2	12.9	14.6	33.8	3.1	2.2	1.5	1.6	19.3	132.1
Kuwait	64.0	81.9	34.6	107.1	13.1	14.3	3.6	5.0	72.5	209.5
Qatar	7.5	7.5	13.4	40.8	1.5	1.3	1.4	1.9	27.4	204.3
Saudi Arabia	168.6	167.8	170.0	283.4	34.6	29.3	17.6	13.3	113.4	66.7
Sultanat-e-Oman	25.2	19.8	27.5	44.4	5.2	3.5	2.9	2.1	16.9	61.3
U.A.E.	88.6	125.9	221.8	471.9	18.2	22.0	23.0	22.2	250.1	112.8
Other than Gulf	**118.5**	**156.5**	**469.5**	**1148.2**	**24.3**	**27.3**	**48.7**	**53.9**	**678.8**	**32.1**
Canada	2.1	2.2	9.5	7.3	0.4	0.4	1.0	0.3	-2.2	-23.0
Germany	6.1	4.9	5.5	12.7	1.3	0.9	0.6	0.6	7.3	133.2
Japan	0.8	1.7	2.5	4.3	0.2	0.3	0.3	0.2	1.9	75.9
Norway	3.0	3.2	3.2	4.2	0.6	0.6	0.3	0.2	0.9	28.9
U.K.	38.0	41.3	61.1	129.9	7.8	7.2	6.3	6.1	68.8	112.7
U.S.A.	37.9	62.6	274.0	657.1	7.8	10.9	28.4	30.9	383.2	139.9
Others	30.6	40.6	113.8	332.7	6.3	7.1	11.8	15.6	218.9	192.3
Total	**487.5**	**572.1**	**951.3**	**2129.7**	**100.0**	**100.0**	**100.0**	**100.0**	**1178.3**	**123.9**
Encashment of FEBCs & FCBCs	**30.1**	**37.0**	**31.0**	**18.0**					**-13.0**	**-41.9**
Grand Total	**517.6**	**609.2**	**982.3**	**2147.7**					**1165.4**	**118.6**
Growth rate (%)	-10.9	17.7	61.3	118.6						
Growth rate (excluding HSS & KWA)		16.6	96.1	124.7						

HSS: Hajj Sponsorship Scheme; KWA: Kuwait War Affectees

Source: State Bank of Pakistan

Disaggregated by country, it is evident that remittances have increased from all countries other than Canada. Significantly, the share of remittances from Gulf countries continues to decline despite a steady increase in absolute terms. This is mainly due to the larger and sustained increase in remittances from the USA, post-September 2001 (see **Table 9.5** and **Figure 9.3**).

Figure 9.3: Share of Remittances from Gulf & Other than Gulf Region - First Half



Resident FCAs

RFCAs posted a sharp reversal in Q2-FY03, witnessing an outflow of US$ 205 million as against an inflow of US$ 154 million in Q1-FY03 (see **Table 9.2**). This reversal represents an exceptional movement of funds arising from the privatization of a large nationalized commercial bank.

Excluding this exceptional item, resident FCAs witnessed an outflow of US$ 51 million during the first half of current fiscal year as against an inflow of US$ 138 million over the corresponding period of FY02. This represents the higher conversion of frozen FCAs into rupees.

Official Transfers

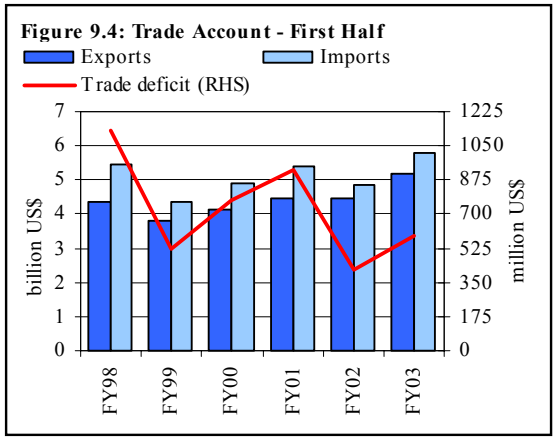
Net inflows in official transfers showed a decrease of US$ 468 million to US$ 523 million during H1-FY03. Excluding the one-time US grant of US$ 600 million, the official transfers increased by US$ 132 million during H1-FY03. The main reason for higher inflows are grants from Saudi Arabia and higher Saudi Oil Facility (SOF) transfers due to rising international oil prices.

9.2 Trade Account[76]

The trade deficit for H1-FY03 was up 41.3 percent compared to H1-FY02, largely because of robust Q2-FY03 imports, and the low base of H1-FY02 imports (see **Figure 9.4**).

[76] This section is based on customs data, which will not tally with exchange records data used in **Balance of Payments** sub-section.

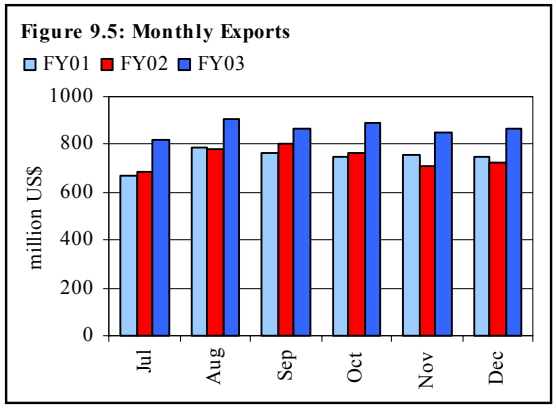
However, the anatomy of the trade deficit during the period is not too alarming. Firstly, despite the sharp increase, the H1-FY03 deficit, in absolute terms, is still much smaller than the average trade deficit (during the first six months) for the preceding five years. Secondly, H1-FY03 exports grew at a very impressive rate of 16.6 percent. Finally, the high growth in imports (18.7 percent) was led primarily by non-food non-oil imports (74 percent of total import growth), which appears to suggest an increase in economic activity and consumer demand.



The detailed analysis of exports and imports provides some further insights into the trade performance.

9.2.1 Exports

Exports continued the upward trend seen in the first quarter of FY03 (see **Table 9.6**), reaching US$ 5.2 billion by end-H1-FY03, i.e. 50.0 percent of the annual target (US$ 10.4 billion). Moreover, the monthly average of exports during H1-FY03 stood at US$ 866 million, as against US$ 743 million during H1-FY02 (see **Figure 9.5**). This sustained performance is unprecedented for Pakistan. Since Pakistan's exports traditionally rise in the second half of a fiscal year, this suggests that the FY03 export target may be exceeded.



A partial explanation postulated for the strong FY03 exports growth is that exporters may now be reporting their *true* exports, as the economic incentives for

Table 9.6: Major Exports
Value: million US Dollar; Unit values: US Dollar

			H1-FY02		H1-FY03			Change (percent)		
		Unit	Value	Unit value	Value	Unit value	Absolute Δ in value	Qty	Value	Unit value
A.	**Primary Commodities**		**533.1**		**618.0**		**84.9**		**15.9**	
1	Rice	MT	224.1	263.0	240.2	311.7	16.1	-9.6	7.2	18.5
2	Raw cotton	MT	5.0	880.2	24.7	771.5	19.7	466.4	396.4	-12.3
3	Raw wool (excluding wool tops)	MT	0.6	912.4	0.4	745.3	-0.2	-23.7	-37.7	-18.3
4	Fish and fish preparations	MT	73.6	1677.3	69.7	1,710.2	-3.9	-7.1	-5.3	2.0
5	Leather	SQM	114.7	13.7	115.4	14.9	0.7	-7.1	0.6	8.3
6	Guar and guar products	MT	8.4	720.8	10.4	836.4	1.9	5.8	22.8	16.0
7	Fruits	MT	38.6	364.2	40.1	339.8	1.5	11.4	3.9	-6.7
8	Vegetables	MT	16.8	195.9	10.1	179.9	-6.6	-34.1	-39.5	-8.2
9	Crude animal material	MT	6.6	525.7	6.7	676.1	0.1	-21.6	0.9	28.6
10	Oil seeds & nuts etc.	MT	12.2	434.7	4.3	487.8	-7.9	-68.4	-64.5	12.2
11	Wheat	MT	32.5	109.7	95.9	109.7	63.5	195.7	195.5	0.0
B.	**Textile manufactures**		**2862.5**		**3,364.0**		**501.5**		**17.5**	
1	Cotton yarn	MT	469.3	1778.5	466.2	1,720.4	-3.0	2.7	-0.6	-3.3
2	Cotton fabrics (Woven)	SQM	522.3	0.6	635.6	0.6	113.3	14.6	21.7	6.2
3	Hosiery (Knitwear)	DOZ	435.8	23.9	549.0	22.4	113.2	34.5	26.0	-6.4
4	Bed wear	MT	453.4	5082.7	581.4	5,399.3	128.0	20.7	28.2	6.2
5	Towels	MT	131.8	3414.6	148.5	3,545.4	16.8	8.6	12.7	3.8
6	Cotton bags and sacks	MT	7.7	4104.0	8.8	4,158.3	1.1	12.7	14.2	1.3
7	Readymade garments	DOZ	433.3	20.8	526.4	29.5	93.1	-14.4	21.5	41.9
8	Tarpaulin & other canvas goods	MT	21.8	2233.2	23.8	2,227.4	2.0	9.6	9.3	-0.3
9	Tule, lace embroidery etc.	(-)	5.0	---	4.7	---	-0.4	---	-7.0	---
10	Synthetic textiles	SQM	207.9	0.6	246.5	0.7	38.6	8.3	18.6	9.5
11	Other textile made-up	(-)	171.1	---	167.5	---	-3.6	---	-2.1	---
12	Waste mat. of tex. fibres/fabrics	MT	3.3	580.5	5.6	655.6	2.3	51.7	71.4	12.9
C.	**Other manufactures**		**740.9**		**797.3**		**56.4**		**7.6**	
1	Carpets, carpeting rugs & mats	SQM	110.8	47.5	105.1	50.4	-5.7	-10.5	-5.2	6.0
2	Petro. and petro. products	MT	98.4	183.2	98.4	224.9	0.0	-18.5	0.0	22.8
3	Sports goods	(-)	126.2	---	148.2	---	22.1	---	17.5	---
4	Leather manufactures	(-)	221.1	---	218.7	---	-2.3	---	-1.1	---
5	Surgical and medical instruments	No	70.6	---	74.6	---	4.0	---	5.6	---
6	Cuttlery	Gr	12.3	33.4	14.3	27.8	2.0	39.5	16.5	-16.5
7	Onyx manufactured	MT	5.1	1508.8	6.1	1,860.5	1.0	-3.0	19.6	23.3
8	Chemicals and pharmaceuticals	(-)	66.2	---	114.4	---	48.3	---	72.9	---
9	Molasses	MT	30.2	40.9	17.3	41.0	-12.9	-42.8	-42.7	0.2
10	Sugar	MT	0.0	330.1	0.1	---	0.1			
D.	**Others**		**321.3**	---	**418.1**	**---**	**96.8**	**---**	**30.1**	---
TOTAL EXPORTS			**4457.8**		**5,197.5**		**739.7**		**16.6**	
excl. major food items and raw cotton			*3,924.8*		*4,579.5*		*654.8*		*16.7*	
excl. major food, raw cotton and yarn			*3,455.5*		*4,113.3*		*657.8*		*19.0*	

Source: Federal Bureau of Statistics

under-invoicing would have decreased with the appreciation of the rupee. However, there is, as yet, no evidence to support this hypothesis.

In terms of major commodity groups (see **Table 9.7**) *other exports (non-traditional)* have grabbed a larger share, at the expense of *other manufactures (traditional)* [77] *(*this was due to lower exports of molasses, carpets, and leather manufactures).

Table 9.7: Shares of Major Exports
percent

	H1-FY01		H1-FY02		H1-FY03	
	Growth	Share in exports	Growth	Share in exports	Growth	Share in exports
Primary commodities	17.2	12.9	-8.3	12.0	15.9	11.9
Textile manufactures	3.2	63.1	1.4	64.2	17.5	64.7
Other manufactures	23.6	17.2	-3.6	16.6	7.6	15.3
Other exports	9.1	6.8	6.8	7.2	30.1	8.0
Total	**8.4**	**100**	**-0.4**	**100.0**	**16.6**	**100.0**

Source: Federal Bureau of Statistics

Among primary commodities, with the exception of oil seeds & nuts, vegetables, fish & fish preparations and raw wool, almost all major categories of exports registered a notable rise during H1-FY03 (see **Table 9.6**).

Table 9.8: Pakistan's Major Export Markets
percent

	North America	EU	Asia	Others
Share in total				
H1-FY02	27.0	28.4	34.4	10.2
H1-FY03	26.6	27.5	35.2	10.7
Growth rate				
H1-FY02	-1.1	6.4	-2.8	-6.9
H1-FY03	14.7	13.0	19.4	22.0
Share in growth				
H1-FY03	24.0	22.3	40.2	13.5

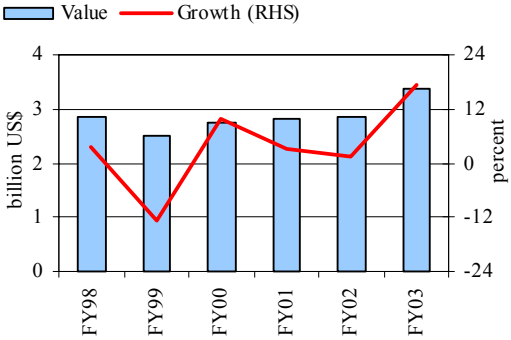
The regional distribution of Pakistan's total exports remained almost unchanged from FY02 (**Table 9.8**). However, the *growth* in the H1-FY03 exports is contributed primarily by Asia (mainly to the Gulf countries and to Afghanistan) followed by EU and North America.

[77] H1-FY02 provides an unusual base period for the purpose of comparison, as in this period country's exports were faced with negative consequences of September 11 event in the form of cancellation of export orders and levy of war risk surcharge premium. Therefore, it is pertinent to compare H1-FY03 export performance with H1-FY01.

Textile Manufactures

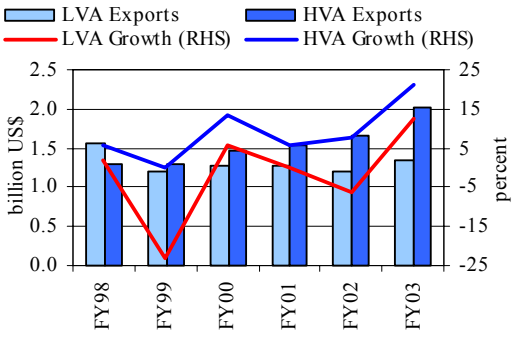
Exports of textile manufactures registered a 17.5 percent growth in H1-FY03 as compared to the corresponding period last year. This was for the first time in Pakistan's history that its export earnings from the textile sector crossed US$ 3 billion in the first half of a fiscal year (see **Figure 9.6**).

Figure 9.6: Textile Exports - First Half



While this performance owes to both, rising unit values *and* a higher quantum of exports in most categories (see **Figure 9.8**), the contribution of rising export volumes predominates. Of the major textile export categories, unit values either weakened or saw a small increase. Only readymade garments exports saw a sharp rise in unit prices.

Figure 9.7: Textile Export Performance - First Half

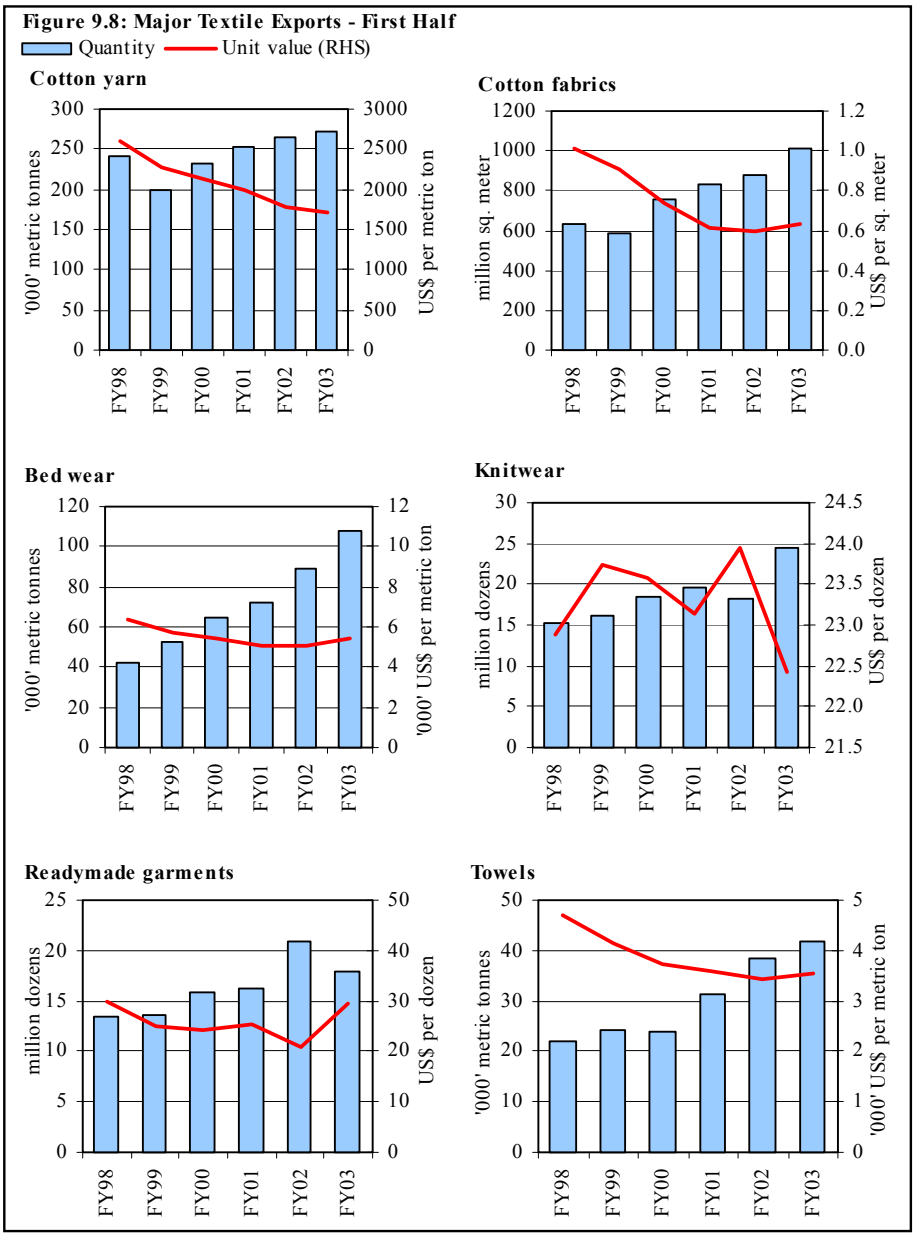


Similarly, growth in the high value added (HVA) textiles maintained the previous trend, and remained higher than that of the low value added (LVA) textiles (see **Figure 9.7**).

- ***Knitwear*** exports registered a 26 percent increase in H1-FY03 over the same period last year. This growth was, however, contributed by a 34.5 percent rise in the quantum of exports, whereas the unit values faced a 6.4 percent fall in this period. A large portion of Pakistan's knitwear exports is directed to the US where competitive pressures have increased due to the duty free access granted to African countries.

- ***Cotton fabrics*** export recorded an impressive 21.7 percent increase in H1-FY03 over the corresponding period last year, thus raising its share in total exports from 11.7 percent to 12.2 percent. Further, the monthly average

Figure 9.8: Major Textile Exports - First Half



of export receipts from this category stood at US$ 105.93 million, as against US$ 87.05 million during H1 FY02 (see **Figure 9.9**).

- ***Ready-made garments*** exports recorded a 21.5 percent rise in H1-FY03 over the same period last year. This rise was contributed by an impressive 41.9 percent increase in its unit values, the quantum exported registered a 14.4 percent fall over H1-FY02. The rising share of high value added exports in this category is responsible for the rise in average unit values.

Figure 9.9: Cotton Fabric Exports

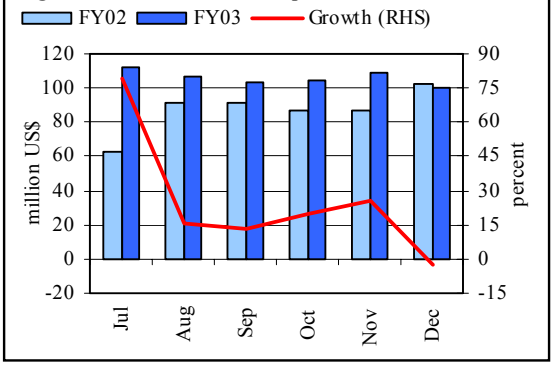
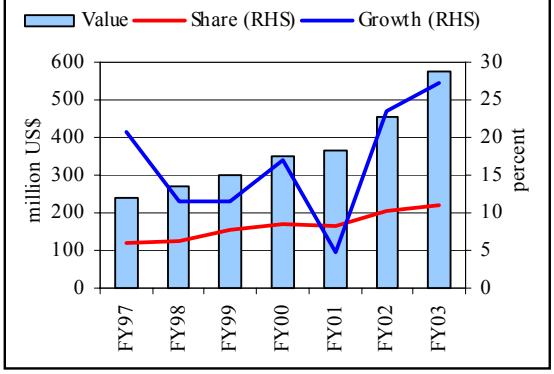


Figure 9.10: Bed Wear Exports - First Half

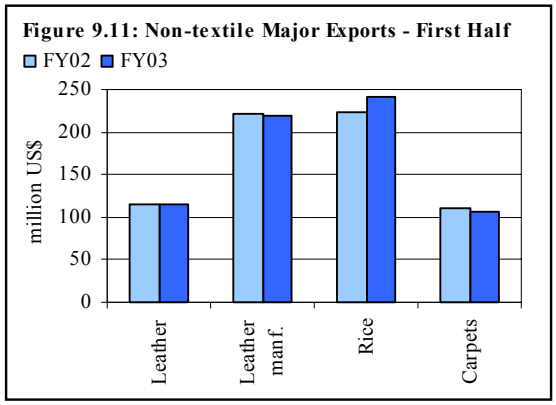


- ***Bed wear*** exports recorded a 28.2 percent rise in H1-FY03 over H1-FY02 (see **Figure 9.10**). This is an important foreign exchange earner accounting for almost 11 percent of total exports. A large portion of country's bed wear exports is directed towards EU market.[78] The concessions given by the European Union to Pakistan earlier this year by allowing a 15 percent rise in exports of quota items and duty-free entry of Pakistani exports of value-added items, contributed largely to this high performance. However, towards the end of H1-FY03, bed wear exports were threatened with the imposition of anti-dumping duty by the European Commission.[79]

[78] For details see *SBP's Annual Report* for FY02.
[79] In mid-November 2002, European textile manufacturers lodged a complaint with EU authorities, against Pakistan's bed linen exports and related items to Europe on allegedly exceptionally lower prices.

Non-Textile Major Exports

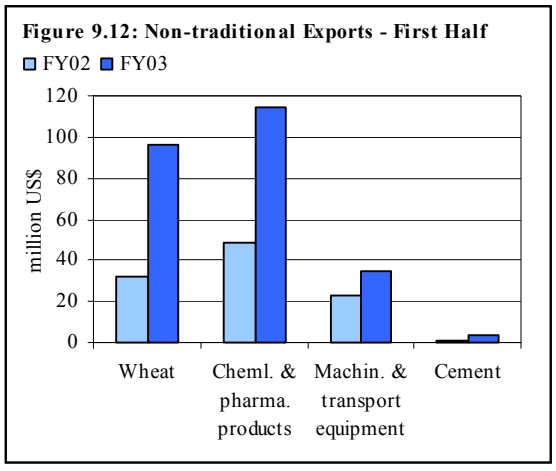
Non-textile sector exports grew by 14.9 percent during H1-FY03 over H1-FY02, but their share in total exports declined from 35.8 percent to 35.3 percent during the same period since the growth in textile exports was stronger (see **Figure 9.11**).



- ***Leather and leather manufactures exports*** again observed a decline in H1-FY03. Finished leather recorded a marginal increase of 0.6 percent in its value during H1-FY03 compared with H1-FY02. While unit values saw a rise of 8.3 percent, a lower quantum of exports offset much of this gain.

  On the other hand, leather manufactures registered a decline of 1.1 percent in H1-FY03 over H1-FY02. The leather and leather manufactures as a whole witnessed a decline of 0.5 percent in the same period.

- ***Rice*** remained the top foreign exchange earner amongst primary commodity exports, recording a 7.2 percent increase in H1-FY03 exports compared to the same period last year. The rise in the average unit value of rice exports stems from the substitution of relatively cheaper *irri* rice exports by relatively lower volumes of *basmati* rice, which attracts higher prices. The rice exports are likely to improve further in H2-FY03 on the back of a good FY03 harvest.



Non-traditional exports

The non-traditional exports of the country appreciably continued the upward momentum set in the beginning

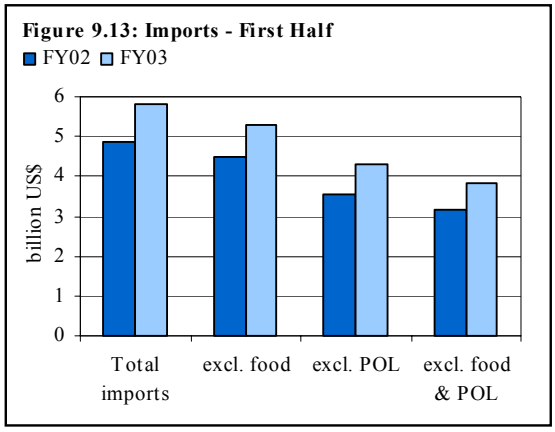
of FY03 (see **Figure 9.12**). The exports of *machinery and transport equipment* rose by 52.5 percent, whereas *chemicals and pharmaceutical products* recorded a 72.9 percent increase during H1-FY03 compared to the same period last year.

- ***Wheat*** export earnings reached US$ 95.9 million in H1-FY03, almost three times the value recorded in the H1-FY02 due to rising export volumes. A third of these exports were to Kenya, while another 30 percent of the exports went to Egypt and Iraq.

- ***Cement*** exports earned US$ 3.5 million in H1-FY03 against US$ 0.6 million in H1-FY02, as some manufacturers exploited the opportunities offered by reconstruction activities in Afghanistan. Cement exports rose to 158,666 tonnes during H1-FY03, 49.0 percent higher than in H1-FY02.

9.2.2 Imports

Imports witnessed a 18.7 percent rise (US$ 912.2 million) in H1-FY03 over the corresponding period last year, and reached US$ 5.8 billion (see **Figure 9.13 & Table 9.9**). This import growth was driven by higher imports of non-food and non-POL imports (machinery and other raw materials for industrial and consumer goods), with the machinery group having the biggest share. These developments suggest an appreciable increase in industrial activity in the economy.



- ***POL*** imports registered a 9.2 percent (US$ 123.7 million) rise in H1-FY03 compared to the same period last year. This increase was seen in both crude oil (5.4 percent) and petroleum products (12.6 percent). The hike in the oil import bill is due to rising world prices (see Figure 9.14), as each of these categories witnessed a fall in their quantum of imports (see **Table 9.9**).

Table 9.9: Major Imports

Value: million US Dollar; Unit values: US Dollar

	H1-FY02			H1-FY03			Change in percent		
	Units	Value	Unit value	Value	Unit value	Absolute change in value	Qty	Value	Unit value
A. Food Group	**---**	**371.2**	**---**	**483.6**	**---**	**112.3**	**---**	**30.3**	**---**
1. Milk & cream incl. milk food for infants	MT	7.0	2475.4	9.6	1742.6	2.7	96.4	38.3	-29.6
2. Wheat unmilled	MT	20.6	178.9	28.7	194.2	8.1	28.2	39.1	8.5
3. Dry fruits	MT	13.7	362.5	13.6	312.4	-0.1	14.8	-1.1	-13.8
4. Tea	MT	78.9	1598.8	76.8	1607.7	-2.1	-3.2	-2.6	0.6
5. Spicies	MT	7.7	917.1	10.3	796.2	2.6	54.0	33.7	-13.2
6. Edible oil	MT	166.5	299.7	260.7	426.5	94.2	10.0	56.6	42.3
Soyabean	MT	7.0	346.5	7.1	478.7	0.2	-26.0	2.2	38.2
Palm oil	MT	159.5	297.9	253.6	425.2	94.1	11.4	59.0	42.7
7. Sugar	MT	22.4	271.3	0.8	326.2	-21.6		-96.4	20.2
8. Pulses	MT	54.4	302.5	83.0	297.3	28.6	55.3	52.6	-1.7
B. Machinery group	**---**	**938.4**	**---**	**1266.4**	**---**	**327.9**	**---**	**34.9**	**---**
1. Power generating machinery	---	78.1	---	143.5	---	65.5	---	83.9	---
2. Office machinery	---	104.4	---	98.3	---	-6.1	---	-5.8	---
3. Textile machinery	---	233.4	---	246.6	---	13.2	---	5.7	---
4. Construction & mining machinery	---	52.7	---	46.3	---	-6.5	---	-12.3	---
5. Electrical machinery & apparatus	---	54.7	---	101.5	---	46.8	---	85.6	---
6. Railway vehicles	---	16.3	---	18.7	---	2.4	---	14.7	---
7. Road motor vehicles	---	141.9	---	231.0	---	89.1	---	62.8	---
8. Aircraft, ships and boats	---	26.6	---	37.2	---	10.6	---	39.9	---
9. Agricultural machinery & implements	---	5.8	---	17.2	---	11.4	---	196.0	---
10. Other machinery	---	224.5	---	326.0	---	101.5	---	45.2	---
C. Petroleum group	**---**	**1347.9**	**172.5**	**1471.6**	**193.5**	**123.7**	**-2.7**	**9.2**	**12.2**
1. Petroleum products	MT	704.8	171.5	793.7	193.6	88.9	-0.2	12.6	12.9
2. Petroleum crude	MT	643.1	173.6	677.9	193.4	34.8	-5.4	5.4	11.4
D. Textile group	**---**	**87.2**	**---**	**112.3**	**---**	**25.1**	**---**	**28.8**	**---**
1. Synthetic fibre	MT	35.4	1272.5	43.8	1246.1	8.4	26.4	23.8	-2.1
2. Synthetic & artificial silk yarn	MT	37.5	1499.0	48.5	1494.6	11.0	29.8	29.4	-0.3
3. Worn clothing	MT	14.3	311.7	20.0	314.4	5.7	38.5	39.7	0.9
E. Agricultural and other chemicals group	**---**	**951.2**	**---**	**1023.0**	**---**	**71.8**	**---**	**7.5**	**---**
1. Fertilizer	MT	141.1	145.3	185.2	184.9	44.1	3.2	31.2	27.2
2. Insecticides	MT	48.0	2922.5	38.1	2619.9	-9.9	-11.5	-20.7	-10.4
3. Plastic materials	MT	160.6	791.2	202.8	799.0	42.2	25.0	26.3	1.0
4. Medicinal products	MT	107.0	22024.4	103.3	24615.3	-3.8	-13.7	-3.5	11.8
5. Others	---	494.5	---	493.7	---	-0.8	---	-0.2	---
F. Metal group	**---**	**213.3**	**---**	**232.6**	**---**	**19.3**	**---**	**9.1**	**---**
1. Iron and steel scrap	MT	25.8	120.3	21.3	130.3	-4.4	-23.6	-17.2	8.3
2. Iron and steel	MT	169.5	297.2	186.7	350.4	17.2	-6.6	10.1	17.9
3. Aluminium wrought & worked	---	18.0	---	24.6	---	6.6	---	36.6	---
G. Miscellaneous group	**---**	**133.7**	**---**	**149.1**	**---**	**15.4**	**---**	**11.5**	**---**
1. Rubber crude	MT	20.1	644.7	21.8	728.2	1.7	-4.2	8.2	13.0
2. Rubber tyres & tubes	Nos	30.3	21.4	39.8	20.2	9.6	39.6	31.6	-5.7
3. Wood & cork	---	5.7	---	14.4	---	8.6	---	149.9	---
4. Jute	MT	10.8	287.6	9.2	245.9	-1.7	-1.0	-15.3	-14.5
5. Paper and paper board & manufactures	MT	66.7	723.3	64.0	593.9	-2.8	16.7	-4.2	-17.9
H. Others	**---**	**832.6**	**---**	**1049.0**		**216.5**	**---**	**26.0**	**---**
Total Imports:		**4875.4**		**5787.6**	**---**	**912.2**		**18.7**	
excl. Food group		*4504.2*		*5304.0*		*799.8*		*17.8*	
excl. POL group		*3527.6*		*4316.0*		*788.4*		*22.4*	
excl. Food & POL group		*3156.3*		*3832.4*		*676.1*		*21.4*	

Δ = change; Source: Federal Bureau of Statistics

- ***Machinery*** group recorded an impressive 34.9 percent (US$ 327.9 million) increase in H1-FY03 over the same period last year. As a result, (1) the share of machinery in total imports rose to 21.9 percent in H1-FY03 as compared to a 19.2 percent share in H1-FY02, while (2) the machinery imports accounted for 36 percent of the growth in H1-FY03 imports (see **Table 9.10**). The highest share in total machinery imports was occupied by textile machinery followed by road motor vehicles and power generating machinery. While agricultural machinery imports also recorded higher growth rates, this rise might have been contributed by reduction in the duties on the import of agricultural plants and machinery.[80]

Table 9.10: Contribution in Growth by Major Import Groups

Percent

	H1-FY02		H1-FY03	
	Growth	Share in Growth	Growth	Share in Growth
Food	-35.2	38.8	30.3	12.3
Machinery	-4.0	7.4	34.9	36.0
Petroleum	-26.8	94.8	9.2	13.6
Textile	17.5	-2.5	28.8	2.8
Agri. & other Chemicals	0.5	-0.9	7.5	7.9
Metal	36.4	-11.0	9.1	2.1
Miscellaneous	8.5	-2.0	11.5	1.7
Others	18.2	-24.6	26.0	23.7
Total	**-9.6**	**100**	**18.7**	**100.0**

- ***Food*** group imports registered a 30.3 percent (US$ 112.3 million) rise in H1-FY03 over the corresponding period last year. The higher food import bill is largely due to higher imports of just two commodities; edible oil (higher prices) and pulses (increased volumes) that was only partially offset by a US$ 21.6 million reduction in sugar imports.

9.3 Capital Account

The capital account posted a reversal from a deficit of US$ 512 million during H1-FY02 to a surplus of US$ 106 million in H1-FY03, (see **Table 9.11**). This improvement in the capital account was mainly driven by higher net foreign investment, increased inflows of project assistance, greater availability of non-food aid and suppliers' credit inflows and larger disbursements of foreign currency denominated loans.

[80] The Federal Budget for 2002-03 announced reduction in imports duty on agricultural plant and machinery for development of grain handling and storage facilities.

Table 9.11: Capital Account - First Half

million US Dollar

Items	H1-FY01	H1-FY02	H1-FY03
Capital Account (1 through 9)	**-764**	**-512**	**106**
Credit	**1277**	**1515**	**2084**
Debit	**2041**	**2027**	**1978**
1. Direct investment abroad	-11	-5	-20
2. Direct investment in Pakistan	144	204	541
3. Portfolio investment	-70	-121	-195
of which: Stock Markets	-67	-57	30
Special US Dollar Bonds	19	-47	-208
4. LT Capital (official)	-654	-253	-32
Credit	558	570	774
of which: Project Assistance	405	280	322
Food Aid	0	0	0
Non-Food Aid	153	245	451
Debit	1212	823	806
of which: Amortization	945	804	784
5. LT capital (DMBs)	-1	-1	0
Credit	0	0	0
Debit	1	1	0
6. LT capital (Others)	-272	-388	-483
Credit	73	55	171
of which: Supplier Credits/MNCs	73	55	171
Debit	345	443	654
of which: Supplier Credits Repayments	240	257	304
7. ST Capital (official)	133	-12	-70
Credit	277	571	136
of which: Commercial Banks	290	296	0
IDB	214	176	136
Debit	144	583	206
of which: Commercial Banks	62	421	54
IDB	75	161	46
Others liabilities (NBP deposits)	0	0	-49
8. ST Capital (DMBs)	-5	-19	-6
of which: Outstanding Exports Bills	39	-8	-4
FCAs (Non-Residents)	-43	-15	-5
Credit	39	4	3
Debit	44	23	9
9. ST capital (Others)	-28	84	371
of which: Outstanding Exports Bills	-203	84	-87
FCAs (Non-Residents)	-22	-38	-39
Other liabilities	190	65	413
Credit	186	111	459
Debit	214	27	88

Note: LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

Source: State Bank of Pakistan

Net foreign investment (NFI)
The NFI increased by US$ 249 million to reach US$ 326 million during H1-FY03 over the corresponding period last year. Excluding UBL privatization sale proceeds and repayments of Special US$ bonds, the NFI increased by US$ 111 million to US$ 235 million during H1-FY03 over the corresponding period last year (see **Table 9.12**).

Table 9.12: Net Foreign Investment
million US Dollar

	H1-FY02	H1-FY03
Net Foreign Investment (NFI)	**77**	**326**
Direct investment abroad	-5	-20
Direct investment in Pakistan	204	541
Portfolio investment	-122	-195
of which: *Stock markets*	-57	30
Special US Dollar Bonds	-47	-208
NFI excluding privatization proceed and US$ bonds	**124**	**235**
Direct investment excluding privatization proceeds	**204**	**242**

The portfolio investment in the stock market staged a sharp improvement during the first half of current fiscal year as the KSE significantly outperformed other regional stock markets (**see Section 8** on **Capital Market**). However, it is interesting to note that FDI proceeds (excluding sale proceed of UBL and oil & gas field) rose by only US$ 38 million during H1-FY03 despite the improved economic fundamentals, concerted marketing efforts of the government, and the country's improved creditworthiness.[81]

Long-term capital (official)
During H1-FY03, the outflows on account of long-term capital (official) declined sharply by US$ 221 million over the corresponding period H1-FY02 (see **Table 9.11**). This improvement was mainly driven by an increase in the disbursement of concessional loans mainly from the World Bank and ADB.

Long-term capital (others)
This mainly comprises of *supplier credits* and swaps. In H1-FY03, there was a net outflow of US$ 483 million, up US$ 95 million over the corresponding period last year (see **Table 9.11**). This increase in net outflows is mainly attributed to increased repayments of private loans and credits and the settlement of swaps with commercial banks. These offset the increase in inflows through *supplier credits* to the power sector and to PIA (US$ 70 million).[82]

[81] Several international credit rating agencies (Moody's in November 2002 followed by Standard & Poor and Capital Intelligence in December 2002) have upgraded Pakistan's rating due to improved macroeconomic indicators and continued economic reforms. These ratings play a significant role in changing the mindset of the investors for any investment in potential recipient country.
[82] In December 2002, SBP allowed the premature repayment of private foreign loans to all borrowers who fulfill certain criteria of availability of rupee counterpart or have the capacity to generate rupee funds at their own.

Short-term capital (official)

Short-term capital (official), comprising mainly of short-term borrowings for oil imports, and commercial borrowings, posted a net outflow of US$ 70 million during H1-FY03 against an outflow of US$ 12 million during the corresponding period last year (see **Table 9.11**). Pakistan has not taken any short-term commercial loans during FY03, and therefore the period has only seen a US$ 54 million retirement of such loans. The short-term borrowings for oil imports have continued, with IDB provided the net financing of US$ 90 million for oil imports, mainly to PSO.

Short-term capital (deposit money banks & other)[83]

Inflows under this head recorded an increase of US$ 300 million during H1-FY03, mainly due to the exceptional increase of US$ 413 million in the FE-25 loans for export financing (covered under item 9 of **Table 9.11** as *other liabilities)*.[84]

The impact of the rise in these loans was offset by a net US$ 91 million increase in Outstanding Export Bills (OEBs). This increase is a little curious given that exporters had, in earlier quarters, significantly *reduced* these balances as the rupee gained strength. Possible explanations for the H1-FY03 increase include (1) the strong increase in Pakistani exports, and (2) increasing usage of OEBs as collateral for forex loans.

9.4 Exchange Rate Policy

Rising current account surpluses, and the resulting liquidity in the interbank market, increased the pressure on the Rs/US$ parity through H1-FY03. However, the SBP retained its cautious policy stance, and continued to mop up most of the excess market liquidity, allowing the rupee to appreciate only gradually. As a result, the rupee rose only 3.1 percent through the period, with the gains being equally distributed through the first two quarters of FY03 (see **Figure 9.15**).

[83] This account comprises Outstanding Export Bills (OEBs) held by commercial banks and exporters, foreign currency denominated loans (mainly from FE-25 deposits) and non-resident FCAs mobilized by commercial banks and NBFIs.

[84] The weighted average rupee lending rate was around 11.3 percent during July-December 2002.

The evident jump in December 2002 SBP net market purchases, not only includes spot transactions but a substantial impact of maturing forward transactions undertaken in the July-September 2002 period. The other point that emerges clearly from **Figure 9.15** is the role of the SBP purchases in stabilizing the exchange rate - much of the rupee's appreciation in H1-FY03 took place when the SBP purchases were relatively low. This suggests that the rupee would be expected to strengthen abruptly, with potentially disastrous consequences for exporters, if the SBP support is removed.

Figure 9.15: SBP Purchases & Exchange Rate - FY03

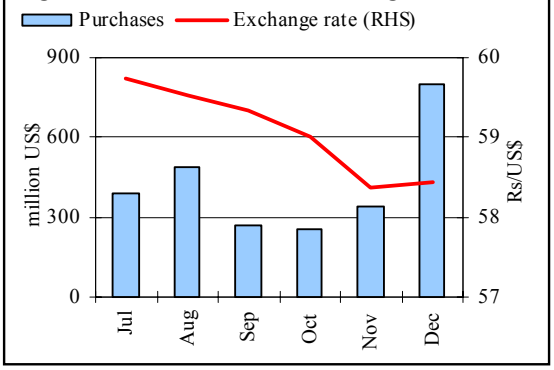
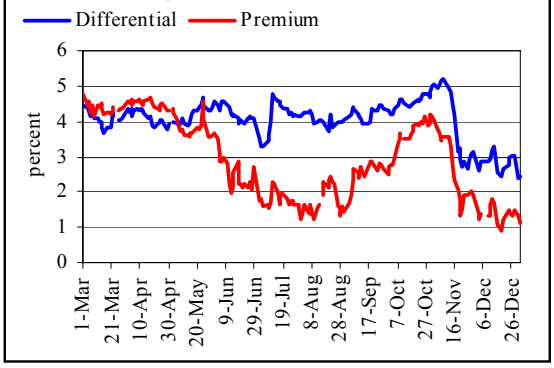


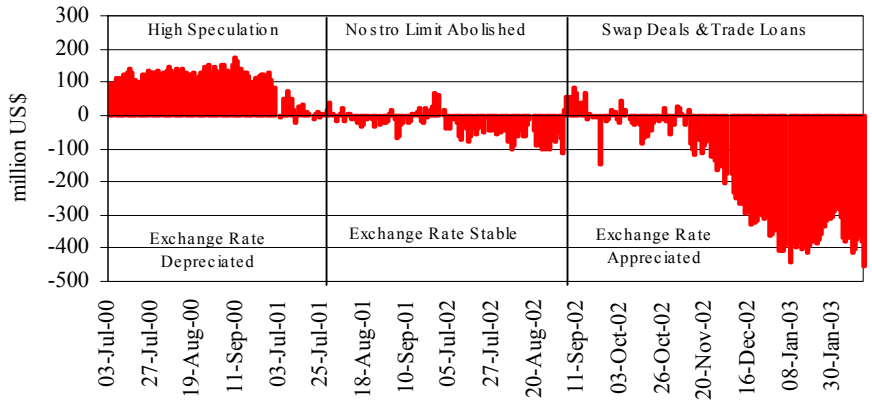
Figure 9.16: Interest Rate Differential (3-month US and Pak T-bills) and Forward Premium - CY02



The under-valuation of the rupee was also evident in the forward market, in which the forward premium moved below the 1.0 percent mark by end-December 2002. The sharp drop in the Rs/US$ forward premium, which has continued beyond December 2002, incorporates not only a fall in domestic interest rates (relative to US$ rates) but also the increasing interest of exporters in hedging their exchange rate risk on future export receipts (**Figure 9.16**).

As discussed in the Quarterly Report for Q1-FY03, the underlying reasons for the oversold Nostro accounts of the banks were (1) the low forward premia creating an incentive to arbitrage Rupee/US$ interest rate differentials and (2) the rising trade financing loans against FE-25 deposits.

Figure 9.17: Market Nostro (Trade)

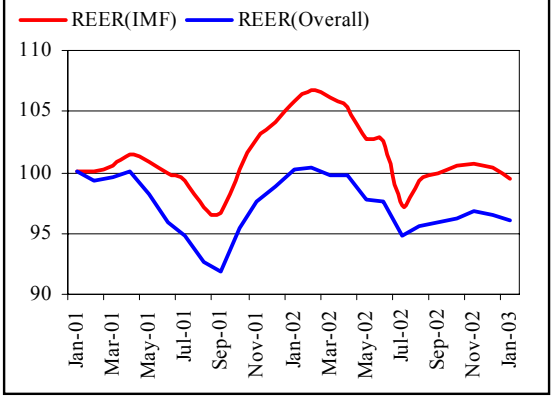


The oversold position has widened rapidly after mid-November 2002, mainly reflecting acceleration in the disbursements of forex loans. However, it is likely that sharp cuts in the EFS rates post-January 2002, will significantly reduce the attraction of forex loans in future.

9.4.1 Real Effective Exchange Rate

All the REER indicators, except for REER (exports), indicate that since July 2002, the Rupee is undervalued. This is largely due to the fact that the dollar has been weakening against major currencies included in the different baskets.

Figure 9.18: Real Effective Exchange Rate Indicies



The REER (exports), on the other hand shows rupee to be overvalued. The reason for this difference lies in the composition of currency basket. REER (exports) has more weight for US dollar than any other currency basket. Major currencies like Euro and British pound, which have a maximum weight of 41 percent among different indicators, have appreciated significantly during July-December 2002 (2.7 and 2.2 percent respectively). Japanese Yen against the dollar, when seen during July 2002 to December 2002 has depreciated

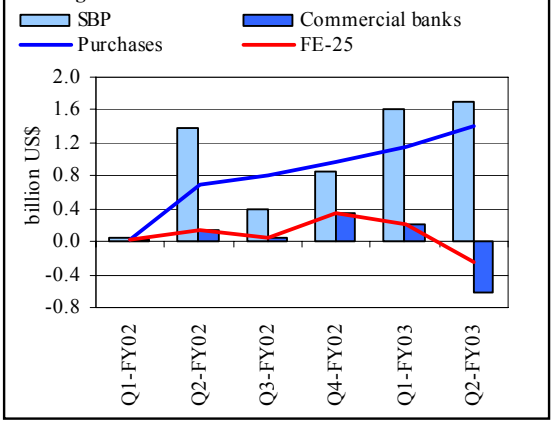
by 3.4 percent, but when compared with June 2002, it has also appreciated significantly by 3.4 percent.

Finally, by contrast, REER (IMF) suggests that the loss of competitiveness due to the appreciating rupee has been offset by shifts in international exchange rates and relative inflation rates (see **Figure 9.18**).

9.5 Foreign Exchange Reserves

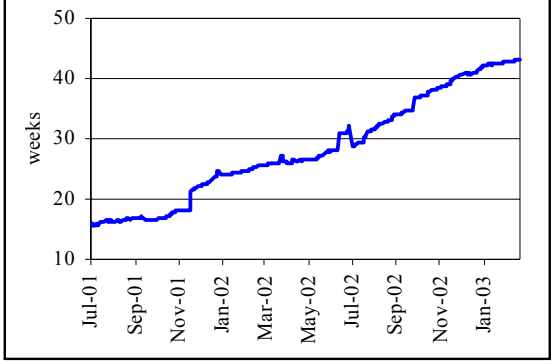
Pakistan's liquid forex reserves continued a secular rise in Q2-FY03, moving up by US$ 1.1 billion during the period, to reach US$ 9.3 billion by end-December 2002. However, this growth was lower than in Q1-FY03.

Figure 9.19: Foreign Exchange Reserves - Quarterly Changes



The Q2-FY03 rise in the overall forex reserves continued to be powered by surging SBP reserves (largely due to market purchases), but the growth of total reserves was nonetheless slowed by a fall in reserves held by commercial banks (see **Figure 9.19**).

Figure 9.20: Foreign Exchange Reserves in Equivalent Weeks of Imports



The major causes of this decline in commercial banks' forex holdings are (1) banks' declining forex deposits and (2) the adjustment of banks' foreign currency loan disbursements.

The slowdown in the *growth* of forex reserves is also reflected in **Figure 9.20**, which depicts the weeks of import cover offered by Pakistan's reserves; the growth trend of this indicator has clearly flattened by mid-FY03.

Table 9.13: Foreign Exchange Reserves with SBP
million US Dollar

	H1-FY02	H1-FY03
Opening balance	***2,080.0***	***4,804.9***
Receipts	**2,792.6**	**4,627.3**
Purchases	**1,356.7**	**2,937.5**
Kerb market	637.0	0.0
Interbank (net)	719.7	2,541.0
Export of currency	0.0	396.5
Loans	**670.1**	**831.5**
IBRD/IDA	129.1	215.1
ADB	164.1	338.9
IMF	376.9	231.5
IDB (for PSO)	0.0	46.0
Grants	**600.0**	**102.6**
USA	600.0	0.0
European Commission	0.0	15.1
SAMA	0.0	87.5
Other receipts	**165.8**	**755.7**
Logistic support	0.0	317.0
Privatization proceeds	0.0	299.6
UN troops	27.8	54.6
Miscellaneous receipts*	138.0	84.5
Payments	**1,334.6**	**1,364.2**
IMF	115.6	186.0
IDA	50.2	60.2
IBRD	109.4	108.9
ADB	57.4	143.2
PTMA	208.8	0.0
IDB	171.6	48.1
Swaps	0.0	110.0
Interest on deposits	224.7	45.7
Euro bonds	31.2	186.6
FE-45	148.1	44.1
Payment for Haj	0.0	40.5
ACU settlement	70.7	50.9
Miscellaneous payments**	146.9	340.0
Closing balance	***3,538.0***	***8,068.0***

*: Includes interest on Deposits/Discount US$ 57 million.
**: Includes NHA bonds (US$ 29.1 million), US Aid (US$ 30.0 million), US$ Bond Encashment (US$ 47.2 million), PL-480 (US$ 10.7 million), NDRP (US$ 41.7 million), SAINDAK Bonds(US$ 11.1 million), FE-25 (CRR)(US$ 49.9 million)
Source: State Bank of Pakistan

Nonetheless, it should be noted that Pakistan's import coverage has improved by 49.9 percent during H1-FY03, owing to the aggregate US$ 2.9 billion rise in overall reserves during the period.

The contributions to the changes in SBP reserves during Q2-FY03 are detailed in **Table 9.13**. While the jump in inflows is not unexpected, it is interesting to note that outflows have remained almost unchanged over the same period last year due to the reduced interest cost, lower payments against FE-45 deposits and absence of some payments such as the PTMA.

In **Table 9.13** the head *export of currencies* needs a little explanation. Earlier, the SBP had been purchasing US dollars received by the money-changers against the export of *non-dollar* currencies. Since July 2002, money-changers sell such dollar proceeds to the NBP, and the funds are then purchased by the SBP.

Also, the significant increase in payments against eurobonds is due to the scheduled US$ 155 million re-payment of principal.

Special Section 1: National Saving Schemes: The fiscal problems

1. Introduction

In the 1990s, as a part of the financial liberalization reforms, the government shifted domestic bank borrowings to a market-based system, introducing auctions of short-term (T-bills) and long-term (FIB) government securities (which were tradeable in the inter-bank market), and adjusted the offerings of the National Savings Schemes (NSS).[85]

However, the yields offered by NSS instruments were (1) invariably higher than those on the T-bills and, FIBs of corresponding maturities, and (2) the NSS debt instruments remained available on demand i.e. there was no limit on fresh issues. As a result, investments in the newer instruments were almost entirely confined to institutions that were either (a) restricted from holding NSS instruments, or (b) needed liquid (tradable) debt instruments.

While the institutional access to NSS was eliminated totally by FY00, the interest rate differential continued to persist, raising vociferous complaints by the financial sector, which feared increasing dis-intermediation and price distortions in the market e.g. all private sector debt (TFC) issues had to be priced significantly higher than comparable NSS instruments.

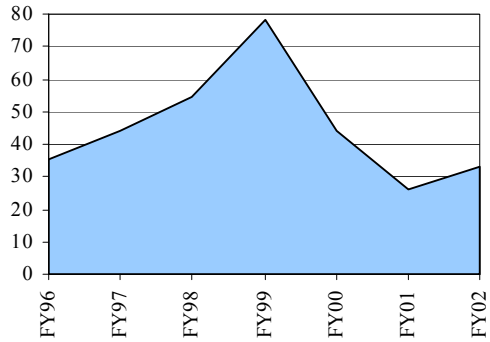
Specifically, the financial industry sought the elimination of the NSS schemes, arguing that since the government was the issuer in both cases, there was no rationale for varying interest payments for instruments of identical risk and tenor. However, wary of socio-political costs, the government preferred to simply lower the interest rate differentials by (1) linking the returns on NSS instruments to the yields on comparable market-based government paper and (2) removing the tax exemptions on the NSS instruments. These moves helped lower (but not eliminate) the yield differentials between the traded and non-traded government debt.

The stunning influx of market liquidity since mid-FY01, led to a dramatic fall in interest rates, and engendered a surge in NSS investments.

[85] It stopped issuing the lucrative Khas Deposits Certificates (KDCs) and banned institutional investments in the high-yielding National Defense Savings Certificates (NDSCs).

The higher-than-expected inflows into the NSS sharply limited the government's ability to reap the full benefits of the decline in interest rates, since (1) NSS borrowings remained significantly more expensive than bank borrowings for budgetary support, and (2) the share of NSS borrowings increased (see **Figure 1**).

Figure 1: NSS as Percent of Budget Deficit



(1) The Problems with NSS Flows

In the budget making process, the ministry of finance (MOF) sets the targets for gross and net mobilization from NSS. These targets are worked out after taking into account the financing commitments of foreign creditors (external financing) and monetary authorities (bank borrowing). This means that the target for NSS is determined as a residual (see **Chart 1**).

Chart 1: Control Over Cash Flows of Deficit Financing

	Targets	In practice
External	Based on Commitment	Exogenously determined,
Domestic		
Bank	Based on Monetary Policy	Residual
Non-Bank	Residual	Demand of NSS by the individuals

Unfortunately, in practice:

(1) External flows are mostly exogenous and heavily depend on international, political and economic conditions.

(2) Similarly, the government has no control over cash flows into the NSS, as these inflows are determined by the prevailing public appetite.[86]

[86]The government has no control over cash flows into the NSS due to (1) NSS carry early encashment facility without any cash penalty (only Regular Income Certificates (RICs) attracts cash penalty on early redemption). Therefore on tap sale and purchase of NSS limits the government ability to control cash flows in these schemes. (2) Non-interest mechanism (change in maturity period, discontinuation of old scheme and introduction of scheme, Zakat and tax treatment, imposition of cash penalty on early encashment etc.) to control inflows in NSS seems to be ineffective, at least in short term. However, this mechanism may have some relevance for controlling funds in medium term.

Therefore, for any given budgetary deficit, the (discretionary) borrowings for budgetary support incorporate the difference for excesses/shortfalls in external and non-bank flows.

In effect, if non-bank financing jumps unexpectedly due to rising NSS inflows, the government could be forced to retire cheap bank debt (e.g. T-bills) to offset the non-discretionary increase in relatively expensive NSS instruments (see **Box 1**). This disadvantage is in addition to the disruptive effect of such flows on the conduct of monetary policy.

Box 1

Against the planned target, the budgetary requirements of the government rose to Rs 189.1 billion and external inflows fell Rs 40.7 billion short of target. However, inflows from the non-banking sector (largely from NSS) during FY02 not only helped to finance additional requirements (a positive), but forced the government to take a smaller amount of (cheaper) financing from the banking sector.

Financing of Budget Deficit during FY02

billion Rupees

	Targets	Actual
Total financing	186.9	189.1
External (net)	121.6	80.9
Domestic	65.3	108.2
Bank	10.5	13.0
Non-bank	54.8	95.2

Note: Total may differ due to rounding-off.

(2) Cost of Financing Deficit from NSS

As mentioned earlier, there is a wedge between the profit rates on NSS and the yields on comparable tradable government paper. In fact, since mid-FY01, this wedge has increased slightly because the fall in interest rates on the traded government debt is relatively greater than the decline in profit rates on NSS (see **Table 1**).

Table 1: Interest Rates on Bank Barrowings and NSS

percent

Instruments	FY01	H2-FY03	Difference
Banking sector			
T-bills	10.47	3.04	7.43
PIBs			
3-year	12.46	6.86	5.60
5-year	12.98	7.83	5.15
10-year	13.98	8.14	5.84
Savings schemes			
3-year (SSCs)	11.43	8.5	2.93
5-year (RICs)	14.48	9.12	5.36
10-year (DSCs)	14.01	10.03	3.98

Note: Weighted average rate of returns on T-bills and PIBs during FY01 is compared to the weighted average rates during Jan & Feb FY03. And, average profit rates on NSS during FY01 are compared to the prevailing profit rates.

It should be pointed out that while this wedge is lower (in basis points) than that prevailing pre-FY01, *relative* to current market interest rates, it is larger (see **Table 2**).

A closer look on interest rate differential suggests that a Rs 100 borrowing from the baking sector for five year will cost only Rs 8.14 to the government as compared to Rs 10.03 from the national savings schemes (higher by Rs 1.89 per hundred).

Table 2: A Wedge Between FIBs/PIBs Yields and NSS Rates
basis points

	3-Year	5-Year	10-Year
FY96	281	64	99
FY97	388	400	304
FY98	383	400	304
FY99	169	200	97
FY00	63	98	49
FY01	-103	-50	3
FY02	286	189	297

Note: (1) Weighted average yield on FIBs and PIBs

(2) If average of NSS compound rates is used, if rates changed twice in a year

The potential variation in debt servicing cost stemming from the source of funding is illustrated in **Table 3**,[87] which shows some hypothetical variations to the H1-FY03 deficit financing costs, if NSS borrowings are replaced either with PIBs or with T-bills.

Table 3: Cost differential of Borrowing from NSS and Banking Sector during H1-FY03
million Rupees

		Interest/Profit Rates		Cost of Borrowing		Implicit Cost
Maturity	Borrowing from NSS	NSS	Banks*	NSS	Banks	Differential
10-year	9988.5	11.6	8.1	1159.7	813.1	346.6
5-Year	53.3	10.6	7.9	5.6	4.2	1.4
3-Year	30652.1	10.3	6.9	3157.2	2128.2	1029.0
Other	5754.0	6.5	6.0	374.0	345.4	28.6
Total	46447.9			4696.5	3290.8	1405.6

*: 10, 5 and 3 year weighted average (WA) yield of PIBs and 6-month WA yield of T-bills are used. Profit rates on DSC, RICs, SSCs are used for 10, 5, and 3 year maturity, while saving rate is used for others.

During H1-FY03, the government borrowings from NSS (net mobilization) stood at Rs 46.4 billion, which, at the prevailing interest rates, translates into an annual interest cost of Rs 4.7 billion. As shown in **Table 3**, a simple shift to market-based instruments could substantially lower this cost. Furthermore, if this amount had been borrowed through T-bills only, the interest cost would drop to a mere Rs 2.8 billion.[88]

[87] In this calculation, an implicit assumption is that the interest rates on bank borrowing will not shoot up due to extra borrowing from the banking sector. This assumption seems plausible, as the resources directly mobilized by the government through NSS will shift to the banking sector.
[88] However, change is mode of deficit financing from non-banking to banking sector may have negative implications for inflation.

Policy Options

Although the government has taken various policy measures including rate cuts and linkage of profit rate major NSS instruments with a market based instruments PIBs, [89] the government has to come a long way to rationalize its cost of borrowing.

- The linkage of profit rates on NSS and PIB should be strengthened. It is suggested that the government could maintained a fixed differential between NSS and PIB rates. When this differential crosses the set limits, the rates should be adjusted. And the pre announced schedule of rate adjustment should be abandoned.

- A more viable alternative, however, is to cap borrowings from NSS to the budgeted level. This would (a) cap the government's losses due to the interest rate differentials, and (b) limit the disruptive impact on the conduct of monetary policy, by ensuring more deterministic flows. At the same time, pensioners and widows etc. could retain access to the recently announced Pensioners Benefit Account Scheme offered slightly higher return.

[89] Besides rate cut, other policy measures include the linkage of profits rates on medium to long term NSS with a market determined interest rate on PIB, and levy of 10 percent withholding tax (with effect from July 1, 2001) on profits from NSS, if the amount in these schemes exceeds Rs 300,000. The exemption limit was further slashed to Rs 150,000 only with effect from July 1, 2002.

Special Section 2: Pre-mature Repayments of Pakistan's Expensive External Debt & Liabilities

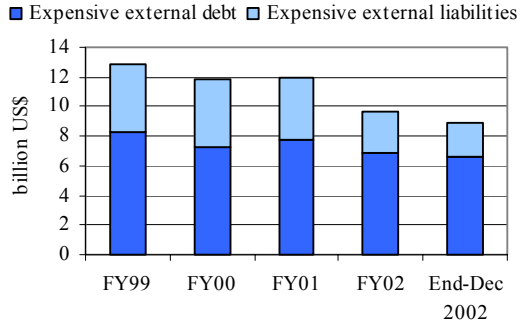
Comfortable forex reserves, prospects of continuing current account surpluses, and low domestic & international interest rates, have rendered the retirement of expensive external debt an increasingly attractive option for Pakistan. Accordingly, the SBP permitted the premature retirement of private loans in December 2002,[90] and the government is also exploring the possibility of pre-mature retirement of the expensive *public and publicly guaranteed* external debt (PPG).

The latter, in particular, could significantly reduce the country's future (net) debt servicing outflows. The resulting fiscal space could then allow increased spending on social uplift and infrastructure development, which is essential to generate employment, reduce poverty and accelerate future economic growth.

Theoretically, any category of External Debt & Liabilities[91] (EDL) is expensive if its cost is greater than the average return on forex reserves. In practice, this means that the definition would change over time as (1) the average return on forex reserves changed, and (2) as the Rs/US$ parity changed. However, for the purposes of this analysis, as a simplifying assumption, a 2 percent threshold has been used to define "expensive" debt.

In this backdrop, this note presents an overview of Pakistan's expensive EDL over the last three and half years. An attempt is also made to define the categories of expensive EDL with respect to interest cost, and to assess the fiscal and monetary implications of the pre-payment of debt in each category.

Figure 1: Stock of Expensive External Debt & Liabilities



2.1 Changes in Expensive EDL

As of end-December 2002, Pakistan's EDL totaled US$ 36.3 billion. Of this, the expensive EDL totaled

[90] This was subject to case-by-case approvals and some additional conditions.
[91] Foreign exchange liabilities are different from external debt in the sense that repayments are not structured by any set schedule; it is not generally solicited; and is primarily held by residents.

US$ 9.0 billion, sharply lower than the US$ 12.9 billion at end-June 1999 (see **Figure 1** and **Table 1**).

The US$ 1 billion decline in the expensive EDL during FY00 is mainly due to the *scheduled* repayments of private loans & credits and SBA loans. However, the stock of expensive EDL increased by US$ 500 million during FY01 mainly due to the net impact of (1) the revaluation of IBRD outstanding debt stock carried out by

Table 1: Pakistan's Expensive External Debt & Liabilities

million US Dollar

Categories	End June 99	End Dec 02	FY03	FY04	FY05	Current Interest Rates (%)	Original Contracted Rates
			Estimated				
PPG **	4,462	3,853	3,537	2,973	2,528		
IBRD	2,542	2,895*	2,642	2,266	1,992	6.75-7.50	6.75-7.50%
Eurobonds	608	465	465	310	155	10	10%
Commercial loans/credits	1,160	260	230	197	181	3.21	Libor + 1 to Libor + 2.65%
IDB	152	233	200	200	200	2.883	Libor + 1.5%
Private loans/credits	3,435	2,081	1,853	1,626	1,324	3.76 (avg)	B/w 12.5 & Libor + 4%
IMF: SBA	340	637	637	568	274	3.35	Basic rate + 150 basis point
Expensive external debt	8,237	6,571	6,027	5,167	4,126		
Expensive external liabilities	4,620	2,385	1,197	497	319		
FE-45	1,380	191	0	0	0	2.3833	Libor +1%; FC: 5.5%
FE-31	272	70	0	0	0	2.133	Libor + 0.75; FC: 8.0%
NDRP	225	34	0	0	0	8.25 (avg)	7.5 to 9.0%
Special US$ bonds	1,164	715	472	344	188	2.88 (avg)	B/w Libor + 1 & Libor + 2%
Central bank deposits	700	700	250	0	0	2.47(avg)	UAE: 450 @ US 3-month T-Bill rate + margin and Kuwait: 250 @ 4%
NBP (BOC)	616	500	300	0	0	3.45(avg)	6.6-7.0%
FCY bonds (NHA)	263	175	175	153	131	2.383	Libor + 1%
Expensive EDL	**12,857**	**8,956**	**7,744**	**5,664**	**4,445**		
Total external debt & liabilities (EDL)	36,600	36,318					
Expensive EDL as percent of EDL	35.1	24.6					
Libor based debt & liabilities (LBDL)	7,826	3,725					
LBDL as percent of EDL	21.4	10.3					

Where: PPG: Public Publicly Guaranteed; ** PPG excludes the expensive debt of ADB due to the non-availability of data.
* End-September 2002 stock; Six-month LIBOR: 1.383 percent (December 2002); FC: Forward Cover.

EAD in FY01[92] and (2) the disbursement of SBA loans negotiated in November 2000, and (3) the outflow due to the repayment of FE-45 deposits.[93]

[92] Data on PPG debt is provided by Economic Affairs Division (EAD). Historically, EAD data diverged significantly from creditor's external debt stock primarily due to the revaluation treatment.

The sharp decline in expensive EDL in subsequent years is a function of Pakistan's improved external accounts post-September 11. Specifically, between end-June 2001 and end-December 2002:

(1) the expectations of rupee appreciation triggered accelerated net liquidation of forex-denominated assets (e.g. the aggregate stock of Special US$ bonds and NDRP deposits fell by US$ 776 million).

(2) also, the unprecedented increase in forex reserves allowed the SBP to return FE-31 liabilities to mobilizing commercial banks ahead of schedule, in addition to the scheduled retirement of FE-45 liabilities and of commercial loans.

As a result of these developments, the stock of expensive EDL declined by US$ 3.9 billion over the three and half years under review. This decline is expected to accelerate in coming months due to the proposed pre-payment of expensive EDL.

2.2 Fiscal & Monetary Implications for Pre-mature Repayments

The bulk of Pakistan's expensive external liabilities (US$ 1.9 billion), including FE-45, FE-31 and NDRP deposits as well as Special US Dollar Bonds, are scheduled to be retired by end-June 2004 (see **Table 1** and **Table 2**). Similarly, the stock of expensive external debt is scheduled to decline from US$ 6.6 billion at end-December 2002 to US$ 5.2 billion at end-June 2004.

Nonetheless, Pakistan's interest bill on expensive EDL is estimated at US$ 262 million during FY05, based on the end-June 2004 estimated EDL stock of US$ 5.7 billion. The implied average annualized interest cost of 4.6 percent underlines the need for the early retirement/re-payment of the EDL stock, where appropriate.

SBA Loans [94]

Approximately a third of the total IMF debt of US$ 2 billion at end-December 2002 constitutes high-priced SBA credit (see **Table 1**). This debt can be retired most expeditiously since it does not require the government to increase

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In order to remove these discrepancies, the EAD carried out a revaluation of Pakistan's PPG debt during FY01, which significantly increased the outstanding external debt stock.

[93] Originally solicited under circular FE 45 of 1995, these deposits carry interest payments at LIBOR + 1 percent. Rupee liquidity and forward cover (at 5.5 percent) is provided to mobilizing banks.

[94] IMF provided short-term balance of payments financing to its member countries through one to two-year stand-by arrangements (SBAs), which have repurchase (repayment) obligations of 3¼–5 years.

Table 2: Estimated Debt Servicing of External Debt & Liabilities

million US Dollar

	FY03 E			FY04 E			FY05 E		
Categories	**P**	**I**	**Total**	**P**	**I**	**Total**	**P**	**I**	**Total**
PPG M/LT	719	218	937	787	199	986	857	166	1,023
IBRD	253	141	394	253	128	381	274	115	390
Eurobonds	163	54	217	155	39	194	155	23	178
Commercial loans/credits	84	13	97	75	16	91	28	12	39
IDB	219	10	229	305	16	321	400	16	416
Private loans/credits	442	119	561	377	89	466	302	63	364
IMF: SBA	0	21	21	69	19	88	293	9	302
Expensive external debt	1,161	359	1,520	1,233	308	1,540	1,452	238	1,690
Expensive external liabilities	1,463	99	1,562	497	53	550	178	24	202
FE 45s	235	10	245	0	0	0	0	0	0
FE 31	144	0	144	0	0	0	0	0	0
NDRP	50	4	54	0	0	0	0	0	0
Special US$ Bonds	262	45	307	75	33	108	156	20	176
Central bank deposits	450	16	466	250	10	260	0	0	0
NBP (BOC)	300	17	317	150	6	156	0	0	0
FCY Bonds (NHA)	22	7	29	22	4	26	22	4	26
Debt servicing expensive EDL	**2,624**	**457**	**3,081**	**1,730**	**361**	**2,091**	**1,630**	**262**	**1,892**
Total debt servicing (TDS)	**4,078**	**1,116**	**5,194**	**2,343**	**1,128**	**3,471**	**2,424**	**1,182**	**3,606**
Ratio of debt servicing of expensive EDL to TDS	64.3	41.0	**59.3**	73.8	32.0	**60.2**	67.2	22.1	**52.5**

E: Estimated

borrowings and carries no monetary implications.[95] Moreover, the early repayment of IMF credit is a very strong and clear indicator of the improvement in Pakistan's fundamentals.

IBRD Credit [96]

Interest on IBRD credit accounts for approximately 27 percent of the total interest paid on expensive EDL during FY03, and this share is expected to rise to 44 percent by FY05 (see **Table 2**).

[95] IMF loans are provided to SBP for balance of payments support, and are reported in the SBP's balance sheet (as assets and liabilities). The repayment of this debt has no monetary impact since the resulting fall in SBP's NFA is offset by an equal reduction in liabilities.

[96] World bank provides lending to its member countries through IBRD and IDA. IBRD borrowers are typically middle-income countries that enjoy some access to private capital markets. Some countries are eligible for IDA lending (at zero interest rate but carries 0.5 percent service charges) due to their low per capita incomes, but they are also creditworthy for some IBRD borrowing. These countries are known as blend borrowers.

The pre-payments of this credit could therefore create substantial fiscal savings. However, the retirement of IBRD credit will require increased rupee borrowings by the government to purchase the necessary foreign exchange from SBP. This has a number of implications:

(1) The government will need to re-negotiate the IMF mandated limits on its budgetary borrowings from the banking sector. Alternatively, the rupee borrowings for the retirement of external debt could be excluded from the fiscal deficit.

(2) This means that the government will effectively be substituting the expensive external debt with relatively cheaper rupee borrowings. The fiscal space gained thereby will therefore depend on the source (and therefore cost) of the rupee borrowings.

(3) In case, if government mobilized rupee resources through T-Bills issues then it would be tantamount to creating short-term debt for repayments of long-term debt. In other words, net interest savings could reverse if rupee costs rise sharply in future years. However, given the low rupee funding costs expected in the foreseeable future, the NPV impact is expected to remain positive.

(4) Moreover, such repayments of external debt could help relieve upward pressure on the exchange rate (Rs/US$), and simultaneously help reduce the growth in reserve money.

Eurobonds

The direct monetary & fiscal implications stemming from the pre-mature payment of the sovereign Eurobond are theoretically the same as for IBRD credit. However, in practice, this debt will ***not*** be re-paid prematurely. The sovereign Eurobond was floated as benchmark issue, the market price of which would indicate the underlying risk premium desired by foreign investors for investment in Pakistan. Therefore the government will not wish to distort this premium.

Private loans and credits

Generally, the federal government does not explicitly guarantee private loans and credits. However, a large portion of this debt does carry either implicit government guarantees, or else explicit guarantees by the SBP, multilateral agencies, NCBs, and Export Credit Agencies in OECD countries.

By end-December 2002, the stock of private loans and credits was US$ 2.1 billion, with maturities ranging between 5 to 15 years. Approximately US$ 1.1 billion comprise fixed rate loans with a weighted-average cost of 8 percent per annum. The remainder constitute floating-rate loans (US$ 0.9 billion), priced as high as LIBOR + 4 percent; the current weighted average cost of this debt is 2.21 percent.

Recently, State Bank has allowed the pre-payment of foreign private loans by the Pakistani private companies and firms to their creditors on a case-to-case basis to all those borrowers who have the rupee counterpart available with them or have the capacity to generate rupee funds. However, the pre-payment of these loans is subject to the approval of SBP and can be remitted only after completion of certain formalities.

It was expected that private firms would capitalize on this opportunity to swap their expensive interest rate foreign loans with less costly rupee loans. However, the initial response was not very enthusiastic. Only a few private firms applied for pre-payment of loans totaling US$ 16 million. Of these, by end-February 2003, SBP has allowed pre-payments for loans totaling US$ 13 million, and the remaining applications are being processed.

The pre-payment of private external loans carries no fiscal implications, but does have some monetary implications. These outflows would mitigate (or even offset completely) the continuing current account surpluses, help stabilize the rupee/US$ parity and contain excessive expansion in money supply.