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

1. Overview

Pakistan's macroeconomic fundamentals and prospects for economic growth saw further improvement in Q1-FY03 (see **Table 1.1**).[1] Not only did the external sector continue to demonstrate a better performance over the already impressive FY02 outturn, but the fiscal picture too saw a noticeable betterment. In the real sector, the substantial rise in water availability for agriculture has increased the likelihood that the crops sub-sector will rebound strongly from the dismal performance of the preceding two years. As a result, the domestic economy seems on track to reach the FY03 target real GDP growth of 4.5 percent.

Table 1.1: Quarterly Economic Indicators

percent	July-September		
Growth rates	**FY01**	**FY02**	**FY03**
Large-scale manufacturing[1]	6.0	4.8	2.2
Exports	14.6	1.8	14.3
Imports	12.5	-8.3	10.9
Home remittances[2]	16.4	14.6	251.2
CBR Tax revenues	10.0	-3.1	16.6
CPI (Q3 over Q3)	4.8	3.7	3.8
Private sector credit (CBs)	-0.7	-2.9	-4.0
Money supply (M2)	-0.3	-0.5	2.1
Total liquid forex reserves[3]	1,646	3,295	8,244
As percent of GDP[4]			
Fiscal deficit	1.8	1.7	1.0
Trade deficit	-0.9	-0.4	-0.3
Current a/c balance	-0.8	-0.1	1.9

[1] Based on 70 items.
[2] Excluding receipts on a/c of Kuwait war affectees & Hajj.
[3] With SBP & with banks. end-September, in million US$.
[4] Based on full year GDP. GoP projections used for FY03 GDP

In the face of the improved economic environment, the weak growth recorded by large scale manufacturing (LSM), and the (apparently complementary) lower net credit from banks, relative to Q1-FY02, is puzzling and inconsistent with the behavior of other aligned indicators such as corporate earnings growth[2], manufactured exports expansion, domestic

[1] As of December 12, 2002 Pakistan's sovereign long term foreign currency rating was upgraded one notch by Standard & Poors from *single B minus* to *single B*. It may be recalled that the SBP had indicated in its Annual Report for FY02 that Pakistan's credit rating at the time did not reflect the improvement in the country's macroeconomic fundamentals.

[2] For example, 44 of the 100 constituent companies in the benchmark KSE-100 index have reported their full-year audited earnings for FY02. On aggregate, the companies reported a 14.6 percent earnings growth. Excluding Hubco (which booked a one-time accounting gain in FY01, which lowered the FY02 aggregate earnings growth through a high-base effect), the FY02 earnings growth of the remaining 43 companies jumps to 31.6 percent. While admittedly not necessarily representative of LSM at large, this data does *suggest* that LSM growth should be stronger.

sales tax collections and imports of machinery & raw materials. Thus, it is probable that the LSM growth depicted by the official statistics understates the true improvement.[3]

While it is admittedly too early to generate firm expectations for the full year, the Q1-FY03 statistics suggest that the FY03 real GDP growth is likely to be led primarily by an above-target recovery in agriculture that is expected to compensate for a slowdown in LSM growth,[4] enabling the economy to reach the 4.5 percent FY03 annual GDP growth target.

On the external account, for yet another quarter, during Q1-FY03 it was remittances that spearheaded the remarkable US$ 1,296 million improvement in the current account; the rise in remittances accounted for 55 percent of the change over the corresponding quarter of FY02. This was strongly supplemented by the large payments by the US for logistics support, which helped achieve a 73 percent year on year reduction in the services account deficit to US$ 220 million for Q1-FY03.

The strong (and growing) remittances appear to support the view that these flows are durable, being driven by the switch of inflows from the informal to the formal markets as well as the *absence of capital flight* through the informal sector. The latter, in particular, would explain the increase in assets prices (equities, real estate, etc.) that emerged in the wake of rising official inward remittances.

Although the trade deficit figure saw little change in absolute terms from Q1-FY02, it too had positive aspects: (1) Unlike Q1-FY02, exports grew strongly on the back of a substantial increase in both volumes and unit prices of key textile products. This appears to vindicate the SBP stance of helping exporters adapt to the changed economic environment by allowing only a gradual adjustment of the

[3] One *possible* explanation is that the apparent slowdown is largely visible due to data constraints. Data for large-scale manufacturing are collected from three sources, namely the Ministry of Industries, Provincial Bureau of Statistics, and Central Board of Revenues (CBR). The CBR used to collect production data for 25 industries/excisable items. As part of the on-going tax reforms bulk of these excisable items have now been shifted to sales tax and for the remaining items a new proforma (RT-I) has been introduced which does not provide for the collection of production data. Therefore, the numbers pertaining to large-scale manufacturing are not comparable. Besides that, production data collected by other two sources namely, Ministry of Industries and Provincial Bureau of Statistics are also weak and under reported, therefore, do not represent the true developments taking place in Pakistan's industrial sector. However, this picture is still unclear. The apparent slowdown in LSM despite a clear improvement in economic indicators can also be caused by non-economic factors, such as political uncertainty.

[4] Going forward, LSM growth may be further pressured by the sugar industry (an important contributor to overall LSM growth) where production *could* be hit by a delayed crushing season.

exchange rate, and reducing funding costs; (2) While imports also rose a healthy 10.9 percent, non-food non-oil imports dominated this increase (suggesting an industrial recovery) with machinery imports accounting for more than half of the import growth.

While the trade picture looks good for now, this should not be allowed to foster complacency. In the short-term, key textile exports to important markets (especially the US) are threatened by possible anti-dumping actions and import restrictions based on allegations of over-programming of quotas in key categories. Moreover, if the current account inflows into Pakistan are sustained, the Rupee will inevitably strengthen further; in such an environment, export growth will require increasing focus on enhancing efficiency and value-addition. Over the longer term, the need to diversify the export base & export markets (especially to regional markets), and productivity gains, will remain important focus areas.

In any case, given the questions over the *root cause* of the growth in remittances, as well as the vulnerability of the trade account and services accounts elaborated in the SBP Annual Report for FY02, it seems prudent for the SBP to continue to support only a gradual appreciation of the rupee, and to continue building up forex reserves by mopping up excess liquidity in the interbank forex market. In fact, during Q1-FY03, the SBP increased its market purchases by 19.7 percent over the immediately preceding quarter to reflect the rising net forex inflows.[5]

The liquidity injections due to the SBP forex purchases were largely mopped up through T-bill auctions and used to retire SBP holdings of government paper. This effective sterilization of the SBP interventions was made possible by the fact that government did not need to utilize the higher banking sector borrowings to finance the budgetary deficit. As a result of the sterilization, during Q1-FY03, reserve money growth was contained (it *fell* a marginal 0.28 percent), but nonetheless the rise in the NFA of the banks drove an unseasonal 2.1 percent increase in M2.

The monetary discipline is expected to help keep inflationary pressures in check, helped by the lower imported inflation (as the rupee strengthens). Some support for this view is visible in the subdued non-food inflation year-to-date. In fact, unlike in FY02, food inflation is the larger contributor to the rise of the CPI during Q1-FY03.

[5] There is some confusion as to the usage of the forex reserves. Higher SBP reserves do not constitute funds available to the government for investment. Instead, they reflect the country's ability to meet foreign currency claims arising from private sector or the public sector spending.

It should be noted that in general, higher T-bill sales would have driven up interest rates, but in this case the sheer scale of the rupee injections were such that despite the exceptional increase in bank borrowings, interest rates remained under pressure. In fact, market interest rates for all tenors remained below the corresponding auction yields throughout Q1-FY03, testifying to market expectations of a interest rate cut. These market expectations, in fact, were realized in November 2002, with the SBP reducing the discount rate by 150 basis points to a new all time low of 7.5 percent. The SBP timed this decision when it became obvious that inflationary pressures remained subdued, private sector net credit from commercial banks was not picking up, government demand for bank borrowings was lower than expected, the differential between domestic and international interest rates had widened after the US Fed reserve rate cut and the competitor countries had also resorted to a reduction in their bank rates. The current monetary policy stance is unlikely to be altered unless there is a material shift in the inflation outlook. It is hoped that the sharply lower interest rates and increasing expectations of policy stability will foster a revival in credit off take in coming months, and provide a non-inflationary stimulus to the economy.

Exceptional growth in tax receipts aided by fiscal discipline kept the overall budgetary deficit for the quarter at approximately 1 percent of GDP – well on track for the 4 percent of GDP target for the full year. High points of this performance include:

(1) *The government's tax and non-tax revenues were both substantially higher* than in Q1-FY02. This is one of the most positive facets of the economy's performance in Q1-FY03. In particular, it should be noted that the rise in tax revenues appears to have a sound base in the form of higher dutiable imports and an improved tax administration. Unfortunately, non-tax revenues appear less stable, e.g. declining SBP profitability is certain to be a serious drag on these revenues.

(2) *Growth in expenditure was contained* well below the revenue growth rate, holding down the budgetary deficit for the period. An encouraging feature of the expenditure profile is that approximately half of the increase in spending was for development. Also, lower financial support to Public Sector Enterprises (PSE) suggests that the financial restructuring of these entities is finally bearing fruit.

(3) And, the resulting *lower budgetary deficit* (Rs 41 billion) was financed entirely by external (Rs 34.6 billion) and domestic non-bank (Rs 20.5 billion) borrowings. This allowed a net retirement of banking sector (SBP) borrowings, helping contain inflationary pressures.

While this fiscal performance during Q1-FY03 is quite encouraging, it is important that this discipline be maintained in order to bring down the annual deficit towards more sustainable levels. Already, non-tax revenues seem certain to fall substantially going forward due to declining SBP profitability.

The developments of the last three years interspersed with the positive trends in fiscal outcome, export and economic growth rates during the last six months lead to two important conclusions:

(1) *A focus on macroeconomic discipline pays dividends for the economy*

(2) *The continuation of fiscal discipline and economic reforms do not necessarily represent a trade-off with economic growth.*

Two specific examples will illustrate the benefits of macroeconomic discipline. First, a lower fiscal deficit has reduced financial costs for the economy, as interest rates have weakened in the absence of crowding out by the government. It should be noted that the two major downtrends in market-driven rates (during FY00 and during FY02) both had one common denominator – a sharp fall in government borrowings for budgetary support.

Second, the appreciation of the rupee is already bearing dividends in the form of a lower cost of external debt, and cheaper imported inputs (helping keep inflation in check). The latter gain could become increasingly visible in coming years, particularly if domestic energy and transportation costs can be contained by the lower rupee cost of imported oil.

The induction of the newly elected government has generated expectations in some quarters that fiscal discipline, institutional restructuring, social economic policies and good governance practices pursued during the last three years will gradually give way to more populist policies. This, if it happens, will be most unfortunate. The economy, having achieved stability, eased itself from pressures of external sector payments and gained credibility in financial markets, and is now poised for take off towards higher growth, employment and poverty reduction. But this will require that the on-going reforms in CBR, WAPDA and KESC, and privatization should continue with vigor and seriousness and tax revenues are not frittered away on subsidies. Instead, we should implement the next phase of reforms where development expenditures on infrastructure, education, health, water and sewerage, Khushali programs in the districts, irrigation, water storage and conservation can be enhanced without fear of breaking the fiscal targets. At

the same time, monetary and credit policy is being geared to channel banking sector resources towards agriculture, small and medium enterprises, housing, construction, consumer financing and micro credit. These sectors employ the majority of the labor force and have the potential of creating the highest number of jobs. Increased public sector investment and higher private sector credit to these labor-intensive sectors, and not budgetary subsidies, are the key to revival of growth, employment generation and poverty reduction.

Executive Summary

Agriculture

On the back of improved water availability, during *kharif* FY03, preliminary estimates on production of four important crops i.e., cotton, sugarcane, rice and maize have boosted the expectations of higher growth in agriculture during FY03.

Higher monsoon rains in the catchment areas filled the major water reservoirs to their full capacity in 2002 for the first time during the past three years. Consequently, release of water from canal-heads during April 1 to September 10, 2002 period (i.e. almost the entire *kharif* season) was 15.1 percent higher than in the corresponding period last year.

Except for cotton, cultivation area under sugarcane, rice and maize crops exceeded the target as well as the actual area sown during FY02. The aggregate area under these crops registered an increase of 40 thousand hectares over the previous year. The area sown under cotton crop not only fell short of the target, but also lower than the area sown in FY02. This was due to the late supply of irrigation water during sowing season in Punjab.

All major *kharif* crops surpassed the targets, and other than cotton, exceeded the previous year's production levels significantly. The cotton crop is provisionally estimated at 10.4 million bales, higher than the target of 10.1 million bales for the year, albeit marginally lower than the production of 10.6 million bales in FY02.

In value terms, the better-than-expected recovery in the production of sugarcane, rice and maize crops is likely to exceed the value addition loss on account of the below target cotton crop. In net terms, the value addition by these crops in FY03 is expected to exceed the outcome of FY02 by 2.6 percent, finally taking the overall growth in major crops into the positive after two successive years of negative growth.

Large-scale Manufacturing

The overall growth in large-scale manufacturing (LSM), based on a sample of 70 items, remained lower at 2.2 percent during Q1-FY03 relative to 4.8 percent in last year. Growth excluding sugar (which had an out-of-season production during Q1-FY02), comes to 2.9 percent in Q1-FY03 as against 4.1 percent during Q1-FY02. In addition, the decline in the production of vegetable ghee was even sharper during Q1-FY03. Above all, the statistics on the textile industry in terms of production did not show the buoyancy that should been visible in light of the 16.5 percent growth in textile exports.

The increase in steel and cement sales during Q1-FY03, indicate an improvement in construction and engineering activities in the country. Unfortunately, the higher steel sales mainly appear to reflect a draw down of inventories rather than an increase in production. On the other hand, in the case of cement, the improvement reflects higher production; the Ministry of Industries and Production estimates show a more than 9.0 percent increase in the production of cement. The production of engineering items also recorded a sharp increase of 19.0 percent during Q1-FY03.

Automobile and tyres & tubes were other two sub-sectors, which showed double digit increase in production during Q1-FY03. Consumer financing, especially lease financing for the purchase of vehicles, has been the major force behind this growth. Another positive development was the increase in demand for buses and trucks as witnessed in increased sales and production. However, the contribution in overall growth by these three sub-sectors is limited as could be seen in the lower *weighted* growth rates of these sectors.

Fiscal Developments

The overall budget deficit, during Q1-FY03, narrowed down to Rs 41.0 billion showing an improvement of Rs 21.7 billion over Q1-FY02. The improvement came from the revenue side, which had an extraordinary growth of 33.1 percent. Both tax and non-tax revenues contributed to this favorable outcome. These revenue gains, however, were partially offset by higher expenditures that registered a 9.3 percent growth during the same period. The deficit was largely financed through external sources (Rs 34.6 billion in Q1-FY03 as against Rs 6.4 billion in Q1-FY02).

Consolidated revenues saw strong growth, largely on account of higher CBR tax collections and surcharges. The natural growth in tax base, improvement in tax administration, and comparatively lower refunds in terms of gross collections

appear to be the major factors behind this growth in CBR tax collections. Tax revenues witnessed a 22.5 percent increase in Q1-FY03 over Q1-FY02.

Non-tax revenues witnessed remarkable growth of 81.8 percent during the quarter under review. While transfer of profit from SBP was higher due to advance payments made, the real impetus came from higher defense receipts on account of logistic support to the US armed forces operating in Afghanistan. The latter is a one-off item and should be discounted from future non-tax revenue estimates. The outlook for growth in non-tax revenues looks, at this stage, rather unpromising.

Consolidated expenditures reached at Rs 194.5 billion in Q1-FY03 with an increase of Rs 16.5 billion over the same period last year. While both current and development expenditures contributed to this increased expenditure, the decline in net lending to the PSEs had an offsetting impact. Current expenditures contributed more to the increase (rising Rs 22.4 billion), largely on account of higher spending on defence, subsidies and the provincial governments. However, interest payments on foreign and domestic debt registering a notable decline (Rs 15.8 billion in Q1-FY03 over the comparable period last year). On a positive note, development expenditures also witnessed impressive increase of Rs 8.2 billion and reached Rs 21.7 billion in Q1-FY03.

Money and Credit

The Q1-FY03 monetary environment was quite different to the one that existed in Q1-FY02. The SBP's policy to extend support to the Rupee continued into FY03. Although the Rupee was allowed to appreciate gradually, the higher SBP forex purchases injected considerable Rupee liquidity injections into the banking system, pressuring the SBP's monetary policy. The eventual policy options available to the Bank were:

(1) Allowing the Rupee to appreciate (with the SBP refusing to purchase the excess liquidity in the forex market),
(2) Decreasing the interest rate (through the net injection of Rupee liquidity in the inter-bank market through un-sterilized purchases of forex by the central bank, and
(3) Using some combination of the above two options.

For reasons elaborated in the *SBP Annual Report 2001-02*[6], the SBP chose to allow only a *gradual* appreciation of the Rupee in Q1-FY03, by increasing its purchases in the inter-bank market in response to rising forex inflows during the

[6] See Section 9.7: Exchange rate policy.

period. But, at the same time, it held interest rates unchanged by sterilizing the monetary impact of its purchases. This meant that, effectively for the period, the interest rate became the de-facto nominal anchor for monetary policy.

Although SBP was able to contain the growth of reserve money, the 2.1 percent growth in money supply was unusually high for the first quarter.[7] With regard to net domestic assets, both government and private sector retirement exceed the targeted estimates. Government's higher retirement is mainly attributable to the availability of higher non-bank as well as external resources, while higher private sector retirements may be the combined result of (a) self financing (b) expectation of cut in interest rates and (c) policy uncertainties with regard to new political setup. Now that the issues regarding the future policy direction and interests rates are more or less resolved, credit off take figures should improve in Q2-FY03. However, they might remain below target due to a high self-financing component.

During the Q1-FY03, the inter-bank money market remained relatively liquid. The overnight rate averaged around 6.4 percent as compared to 8.3 percent in the corresponding period last year. The availability of liquidity in the market is also evident from the fact that the market witnessed a fewer number of days when the overnight rate remained very close to SBP's discount rate compared with Q1-FY02 (22 days versus 33 days). However, the volatility in overnight rates did not show any notable decline.

Banking

The surge in banks deposits, witnessed November 2001 onward, continued during Q1-FY03. It was again the huge foreign exchange inflows and the SBP interventions in inter-bank market that helped banks in generating large deposits. During the quarter, aggregate deposits of the banking sector rose by a remarkable 4.1 percent, against a fall of 0.6 percent during Q1-FY02. Another, encouraging development during Q1-FY03 was the decline in NPLs of the banking sector by Rs 2.0 billion.

Despite a larger deposit base and lower lending rates, the seasonal fall in banks credit was significantly higher in Q1-FY03 when compared with Q1-FY02.[8] Nationalized banks were mainly responsible for this sharp decline in overall net credit. On the other hand, private banks saw a positive growth in net credit in Q1-FY03 against a decline registered during Q1-FY02.

[7] Since the first quarter is a period of subdued economic activity dominated by seasonal credit retirement, money supply usually shrinks or remains low during the first quarter.
[8] Weighted average lending rates declined from 14.4 percent in June 2001 to 12.0 in June 2002.

Prices

During the first quarter of the current fiscal year the annualized rate of inflation was slightly up, mainly due to higher prices of food items. While both the Consumer Price Index (CPI) and Sensitive Price Indicator (SPI) exhibited an upward trend, the increase recorded in SPI was more pronounced. By contrast, Wholesale Price Index (WPI) in which food items have a lower share, recorded a decline in inflationary pressures.

Capital Markets

During the period under discussion, the bench mark KSE-100 index gained 13.1 percent making it one of the better performing markets in the world. Market rally which started in January, continued well into the first quarter of FY03 on the back of improvement in fundamentals such as rising corporate profitability, ample liquidity flows towards equity market (due to fall in yields on alternate investment), and improved geo-political situation. Energy sector stocks proved to be the key drivers of the rally.

Like the equity market, corporate debt sector also remained buoyant. Nine new TFC issues worth Rs 5.3 billion entered the market since the beginning of the fiscal year. With interest rates at record low levels and in the absence of any expectations of a reversal in the medium-term rise, additional issuers are poised to enter the market in the near future.

External Sector

The balance of payments witnessed a marked improvement in Q1-FY03 over the corresponding period last year. Not only did the current account post a huge surplus (US$ 1.2 billion), the capital account also contributed through lower outflows (US$ 67 million). These improvements helped SBP in: (1) building up its foreign exchange reserves to US$ 6.4 billion by end-September 2002; and (2) moderating the appreciation of the Rupee against US Dollar.

The improvement in current account is unprecedented as the growth was contributed by all of its constituents; trade balance improved by 21.5 percent, services (net) recorded 73.5 percent lower outflows and current transfers (net) increased by 66.1 percent. The growth in exports (14.3 percent- based on customs data) outweighed the increase in imports (10.9 percent), receipts of US$ 317 million for logistics support to the US contributed significantly in lowering the net outflows under the services account and the unprecedented robust growth in workers' remittances (US$ 1.05 billion) led to the sharp rise in current transfers (net). Even excluding the receipts for logistics support the current account surplus was about US$ 900 million.

An important element of Q1-FY03 export performance is that it was achieved despite the continuing strength of the Rupee, which appreciated 8.3 percent during October 2001 to September 2002. The sharp rise in exports was mainly contributed by textile sector, which contribution three fourth of the overall growth in exports. Within the textile sector the major contributors were cotton fabrics, knitwear, bed wear and readymade garments. It is pertinent to mention here that this increase in textile exports was shared by both, a rise in unit values, as well as an increased quantum of exports. However, the country did not fare well on the non-textile major exports (leather and leather manufactures, carpets, rice, petroleum and petroleum products).

The import growth in Q1-FY03 was largely driven by growth in machinery imports that accounted for 57.8 percent of the overall YoY import *growth* of 10.9 percent. Food group stands as the second major category by contributing 24.8 percent in the overall growth, while the petroleum group imports witnessed a 6.4 percent decrease in Q1-FY03 over the same period last year; imports of both, crude petroleum and petroleum products, declined in this period.

The capital account improved significantly by posting a sharp contraction in net outflows. While the major contributing inflows were FDI, increased project and non-food aid and inflows under PAYE credits, the major outflows included encashment of Special US Dollar bonds under portfolio investment and long-term capital. The net foreign investment witnessed a moderate increase of US$ 26 million during Q1-FY03 over the corresponding period last year. This is due to the outflows under Special US Dollar bonds (US$ 115 million). The encouraging development is the increase in foreign direct investment by US$ 101 million during Q1-FY03 over Q1-FY02 with major investments in the oil & gas sector.

Contrary to the stability witnessed during H2-FY02, the Rupee appreciated further (by 1.5 percent) during Q1-FY03. The gradual rise was in accordance with the SBP policy of avoiding abrupt adjustments, and hinged on a number of factors such as continuing increase in forex inflows, the need to pass on the benefit of a stronger Rupee to the broader economy and the decreasing vulnerability of exporters. The importance of the SBP's role is underlined by the fact that the Rupee appreciated despite an increase in the SBP purchases from the inter-bank market (the central bank SBP had earlier been successful in stabilizing the Rupee/Dollar parity with much lower inter-bank purchases).

The improvement in the external account were well accounted for in the expectations for an appreciating Rupee. This resulted in increased interest by

exporters in selling their future dollar proceeds lowering the forward premium. The forward premium was, however, saved from further decline by the opening of swap window at SBP.

The overall liquid foreign exchange reserves of the country continued to strengthen as a consequence of inflows from IFIs, logistics support from the US and reduced payment requirements. The foreign exchange reserves rose by US$ 1,813 million during the quarter in question, against an increase of US$ 76 million in the corresponding quarter last year; this massive increase was enough to push reserves to US$ 8,244 million at end-September 2002. It is noteworthy that contrary to FY02, SBP did not approach the kerb market for forex purchases to build its reserves.

Improvement in foreign exchange reserves is fully reflected in the improvement in the sovereign credit rating for Pakistan to B3 by Moody's in March 2002 and in the form of a reduced Pakistan country risk premium by ADB in its Political Risk Guarantee (PRG) facility. More recently, Standard & Poors raised Pakistan sovereign rating one notch from "single B minus" to "single B".

2. Real Sector

2.1 Agriculture

By the end of Q1-FY03, it had become clear that, unlike in the previous year, water will not be a binding constraint on agricultural growth in FY03; the availability of irrigation water during *kharif* (April – September 2002) was distinctly better than in the corresponding period of the previous year. Accordingly, this also raised expectations that, barring unforeseen calamities, the agricultural sector will comfortably achieve the growth target of 2.4 percent for FY03.

In terms of water availability, it was increased monsoon rains in catchment areas that filled the major water reservoirs to their full capacity for the first time during the past three years. This was also reflected in higher peaks for water levels in 2002 for both the Mangla and Tarbela dams (see **Table 2.1**). In turn, the release of water from canal-heads during April 1 to September 10, 2002 period (almost the entire *kharif* season) was 15.1 percent higher than in the corresponding period last year. Looking forward, the improved water situation is expected to continue in the forthcoming *rabi* season (October 2002 to March 2003) as well.

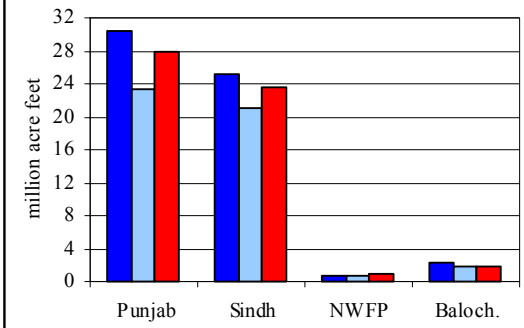
Table 2.1: Peak Water Levels in Dams
in feet

Dams	2001	2002	Maximum conservation level
Mangla	1,181	1,206	1,202
Tarbela	1,551	1,552	1,550

Source: Indus River System Authority

The province-wise distribution of irrigation water shows improved availability for all provinces; though these allocations are still less than the Accord shares (see **Figure 2.1**).[9] While a total of 58.7 million acre-feet (MAF) of irrigation water was to be released throughout the country during April 1 to September 10, 2002 under the

Figure 2.1: Availability of Irrigation Water



[9] Although dams were filled to their capacity this year, the overall availability of irrigation water still remained below the Water Accord of 1991, as the continuous accumulation of silt in major dams eaten into their storage capacity.

Accord, the actual discharge remained at 54.3 MAF (7.5 percent below the Accord). Nonetheless, it was still more than the 47.1 MAF released during the same period of the previous year.

2.1.1 Crops

Although the outlook for the overall agriculture sector generally starts assuming shape with the arrival of the first estimates on *kharif* crops,[10] projections for the crop sub-sector, in particular, are seriously constrained by their vulnerability towards exogenous developments (e.g., weather, pest attacks, etc.). Yet, the preliminary estimates on area and production suggest prospects of a significant recovery in major crops during FY03. Notably, this upturn will take place after two successive years of dismal performance, when the value addition by major crops failed to reach the level recorded in FY00.

Area under cultivation

Initial estimates of the area under cultivation for major *kharif* crops show a comprehensive improvement. Except for cotton, area under sugarcane, rice and maize crops exceeded the target as well as the actual area sown during FY02 (see **Table 2.2**). In particular, a record area of 1,093 thousand hectares was brought under sugarcane (a 9.3 percent increase over last year).

Table 2.2: Area Under Important *Kharif* Crops

Crops	During FY02	During FY03 Target	During FY03 Sown	% Change over FY02	% Change over Target
Cotton	2,862	2,971	2,699	-5.7	-9.2
Sugarcane	1,000	991	1,093	9.3	10.3
Rice	2,115	2,114	2,201	4.1	4.1
Maize	938	958	962	2.6	0.4
Total	**6,915**	**7,034**	**6,955**	**0.6**	**-1.1**

Area in thousand hectares.

Sources: i) Federal Committee on Agriculture.
ii) Economic Survey, 2001-2002.

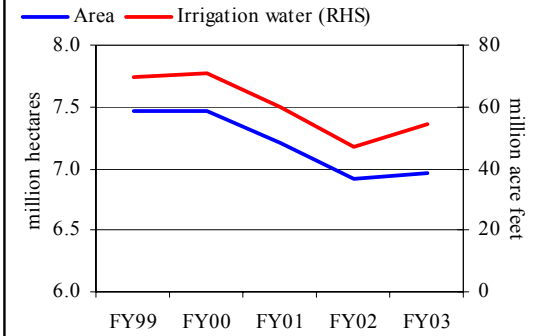
On the other hand, the area under FY03 cotton crop not only fell short of the target, but also was lower than for the previous year's crop.[11] In fact, the late supply of irrigation water at the sowing stage in the Punjab led to a 12.2 percent decline in area under cotton in the province.[12] However, this was partially offset by a 34.7 percent increase in the cotton crop area in Sindh region. Hence, the

[10] *Kharif* season (April to September) includes: cotton, sugarcane, rice, maize with more than 63 percent share in major crops and 24 percent in agriculture.
[11] The cotton crop has the second largest share in area under cultivation after wheat.
[12] The sowing season for cotton, which extends over a month, generally starts latest by March 15 in Sindh, and by April 15 in Punjab.

countrywide decline in area under cotton was only 5.7 percent for the FY03 crop.[13]

In terms of acreage, the aggregate area under major *kharif* crops registered an increase of 40 thousand hectares. To put this in perspective, this increase is close to the area under 'tobacco' alone – a less important major crop. In this regard, **Figure 2.2** suggests that the improved water availability during *kharif* FY03 was one of the main determinants of the increase in area under cultivation.

Figure 2.2: Irrigation Water and Area Under Crops



Production of the crops

Preliminary estimates on the production of major *kharif* crops also suggest prospects for a strong recovery in the crop sub-sector during FY03. Other than the cotton crop, which is falling behind the FY02 production, all major *kharif* crops surpassed the target and the previous year's production with significant margins (see **Table 2.3**). Obviously, these encouraging estimates are also consistent with the increase in area under cultivation.

The sugarcane crop showed the most remarkable performance by producing its third largest harvest – the first was registered in FY99 with crop size of 55.2 million tonnes and the second largest in FY98 with 53.1 million tonnes.

Table 2.3: Production of Important *Kharif* Crops

Crops	FY02	FY03		% Change over	
		Target	Prel.	FY02	Target
Cotton	10.6	10.1	10.4	-2.0	3.3
Sugarcane	48,042	46,000	52,517	9.3	14.2
Rice	3,882	4,000	4,227	8.9	5.7
Maize	1,665	1,700	1,860	11.8	9.4

Production: Cotton million bales; Other crops 000' tones.
Sources: i) Federal Committee on Agriculture; ii) Economic Survey, 2001-2002; and iii) MINFAL.

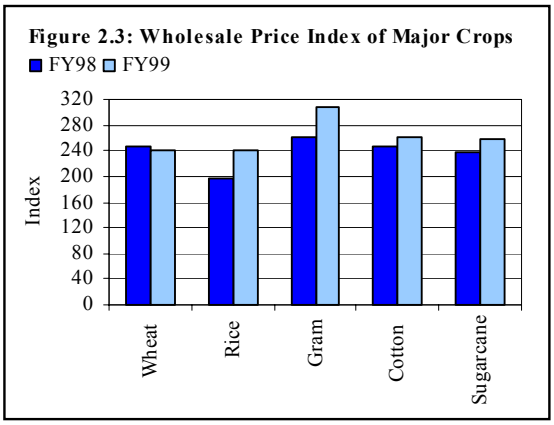
Although the initial estimates for cotton crop suggest smaller production than in the previous year, the increase in yields is an encouraging sign. According to

[13] Of the total area under cotton during FY03, Punjab contributed 79.4 percent, followed by Sindh (18.9 percent), Balochistan (1.6 percent), and NWFP (0.1 percent).

preliminary estimates, cotton crop at 10.4 million bales sets the yield at 655 kgs./hectare for FY03 compared to 570 kgs./hectare achieved last year. Since the current yield is significantly lower than the record 769 kgs./hectare attained in FY92, this only highlights the available margin for further improving the cotton crop yield.

Higher yields were also observed for rice, sugarcane and maize. In addition to better availability of water, this can be attributed to rising consumption of farm inputs. For instance, the actual off-take of fertilizers during *kharif* FY03 was 8.6 percent higher than the *kharif* FY02. Similarly, the overall procurement of paddy seeds for onward distribution among farmers was higher by 7.0 percent for FY03 crop, and the procurement of certified cottonseed increased considerably by 27.1 percent.

Despite higher procurement of certified seeds, their availability is considerably less than the actual requirements. In the case of cotton, certified seeds met only 45.2 percent of the total estimated requirement in FY03. The situation was even worse for paddy and maize seeds, where the ratio stood at 8.3 percent and 8.9 percent respectively.



The expected upturn in major crops for FY03 is encouraging, as this will occur following two successive years of negative growth. It is important to note that besides water shortages, lack of market incentives has been a key reason for the dismal performance during these years. The significance of market incentives is evident from the FY99 experience when higher output prices of major crops such as, cotton, wheat, rice and sugarcane (see **Figure 2.3**) led to a remarkable growth of 15.4 percent for major crops in FY00.[14]

[14] Although wheat prices witnessed a decline in FY99, a 25 percent increase in procurement price at the sowing stage encouraged farmers to grow more wheat during FY00.

Market incentives

The government has been pursuing various initiatives to help farmers.[15] These, inter-alia, include, upward revisions in support/procurement prices of major crops, search for new export markets, research and development of hybrid crop varieties, premium for higher quality product, concessions in tariff rates on farm machinery, and facilitation of priority credit policies.

The focus on enhancing the quality of Pakistani cotton is a case in point. In this regard, recognizing the cost and efforts involved in the process, the government has announced price incentive for producing uncontaminated cotton. Under this program, which was launched in Rahim Yar Khan district, a premium price of Rs 200 per 40 kg was set for FY02 crop to be paid to the ginners/growers for clean cotton. As a result, the contamination level was significantly reduced from 19 grams per bale to 4 – 5 grams per bale. The program was further improved on August 16, 2002 by setting different premiums depending on the level of contamination (see **Table 2.4**).

Table 2.4: Premium for Contamination Free Cotton

Contamination level (gms/bale)	1.5	2.5	3.0
Premium (Rs/maund)	150	75	50

Source: Federal Committee on Agriculture.

Under this program, the Pakistan Cotton Standard Institute (PCSI) would depute one classer at each ginning factory who would grade cotton on the basis of length of staple and the contents of contamination at post ginning stage. However, the disbursal of premium is supposed to start from the top-end of the chain, i.e., from textile mill-owner to the ginner and then to the farmer.

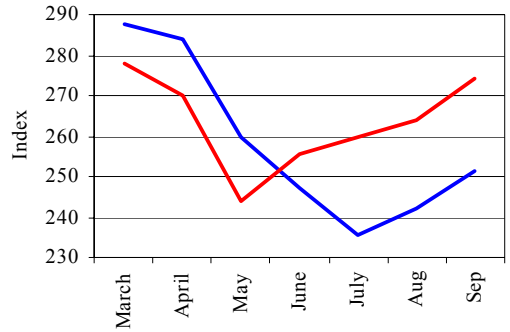
Steps taken by State Bank of Pakistan

SBP, being vigilant on the marketing problems faced by wheat growers during FY01, laid down procedures on December 3, 2001 to facilitate the private sector in their wheat procurement activities. These procedures were also providing support to the government's policy of deregulating the wheat purchase. Accordingly, all commercial banks were advised to extend loans to the private sector (including the flourmills) for wheat procurement under Commodity Operations at 12 percent interest rate. This mark up will subsequently be linked with market-based T-bill

[15] There is also a considerable debate in economic literature about the desirability of government intervention in the agricultural sector, particularly in the face of heavy subsidies provided by many developed countries that distort the international market prices. In the case of Pakistan, owing to structural weaknesses in marketing, direct government support for agriculture is being phased out more gradually.

rates. Needless to say, this facility will add to SBP's earlier incentives to the private sector for wheat procurement.[16]

Figure 2.4: Wholesale Price Index of wheat



The market response to SBP initiatives was encouraging as, despite ample wheat stocks and relatively lower procurement by the government, the seasonal decline in wheat prices was less than in the preceding year.[17] Moreover, the seasonal price reversal began earlier, and the price up-trend was even stronger than in the previous year (see **Figure 2.4**). In fact, it appears that the commodity financing facility to flourmill owners improved their cash flows, allowing them to make higher than the routine purchases and boosting the demand at peak marketing time. This, in turn, eased downward pressures on wheat prices. In the past, flourmill owners were dependent upon the informal sector credit, which was expensive and difficult to obtain.

During the marketing season of wheat, i.e., from April-June 2002, financing of Rs 1.3 billion was provided to the private sector for wheat purchase, with the heaviest amount of Rs 442.6 million falling in the second half of June 2002.[18] During Q1-FY03, the wheat financing was at Rs 843 million compared to Rs 706 million last year, even with a slightly smaller wheat crop this year. Since this financing would ultimately help traders/flourmill owners to make early payments to wheat growers, a case can be made that it might have improved the financial position of farmers during Q1-FY03.

It may be noted that institutional efforts alone cannot eliminate market rigidities; this would require participation by farmers as well. In this regard, farmers as a

[16] In June 2001, marginal requirement for advances extended by commercial banks for wheat purchase was reduced from 25 percent to 10 percent for manufacturing/processing, and from 35 percent to 15 percent for traders/growers.
[17] The crop size for FY02 was not very different from the preceding year.
[18] Since the wheat harvesting starts in April, the quantity of wheat being brought to the marketplace is concentrated in the months of April and May, with only marginal volumes arriving in June. The traders, however, settle amounts payable to farmers by the end of June.

community may take part in building on-farm storage capacity for their marketable surplus. In this regard, off-farm silos construction is also being encouraged by the SBP.

2.1.2 Agricultural Credit

Disbursement

A total of Rs 10.1 billion were disbursed in Q1-FY03, against Rs 11.3 billion during the corresponding quarter last year, showing a significant decline of 10.0 percent. This fall in disbursement can be attributed to a weakening demand, as the total number of applications for agricultural loans declined by 10.2 percent during Q1-FY03 compared to the first quarter last year. This depressed credit demand can be explained by (1) fall in area under major crops; (2) the preoccupation of the farming community with the election campaign (which started in August and continued till the first week of October 2002); and (3) the overall stagnation in agricultural incomes over the past two years that forced framers to postpone capital expenditures.[19]

In terms of institution-wise breakup, Agriculture Development Bank of Pakistan (ADBP) posted the major fall of Rs 909 million, followed by a decline of Rs 351 million by commercial banks. A positive development is the presence of smaller private banks in the sector; these institutions disbursed Rs 149 million during Q1-FY03 (see **Table 2.5**). Similar to trends in credit disbursement, the decline in the

Table 2.5: Credit to Agriculture Sector

million Rupees

	Q1-FY02	Q1-FY03	% change
		Disbursement	
ADBP	6,558	5,649	-13.9
Commercial banks[1]	4,073	3,722	-8.6
New private CBs[2]	--	149	--
PPCB	645	629	-2.5
Total	**11,276**	**10,148**	**-10.0**
		Recovery	
ADBP	3,724	3,218	-13.6
Commercial banks[1]	2,950	2,785	-5.6
New private CBs[2]	--	56	--
PPCB	601	530	-11.8
Total	**7,275**	**6,588**	**-9.4**

[1] Includes: NBP, HBL, MCB, UBL, and ABL.

[2] Started lending since Q2-FY02.

Source: Agricultural Credit Department, SBP

Table 2.6: Number of Applications for Loan

	Q1-FY02	Q1-FY03	% change
ADBP	141,799	124,535	-12.2
Commercial banks[1]	92,789	86,525	-6.8
PPCB	32,209	28,569	-11.3
Total	**266,797**	**239,629**	**-10.2**

[1] Includes: NBP, HBL, MCB, UBL, and ABL.

Source: Reporting by the respective banks.

[19] For detailed analysis, see SBP's *Annual Report* for FY02, pp 12-13.

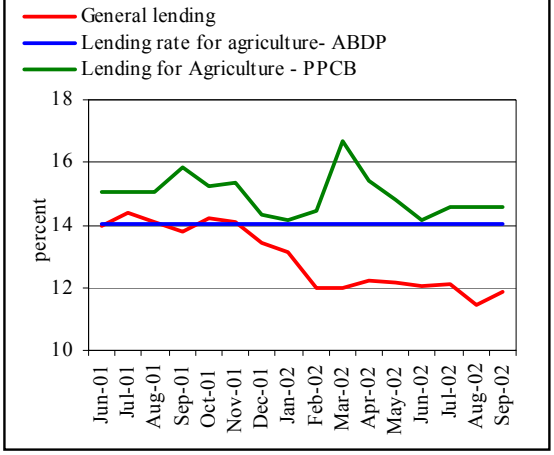
number of borrowers is also common to all participating banks (see **Table 2.6**).

In the case of ADBP, credit availed by farmers for the purchase of tractors and installation of tubewells during Q1-FY03, declined by 27.0 percent and 32.2 percent respectively, compared to the same period last year. Adding these two accounts, the disbursement fell by Rs 311.5 million compared to Q1-FY02.

The lower credit disbursement by Habib Bank is owing to lesser credit demand under National Rural Support Program. Further, in the wake of general election 2002, the demand for credit remained weak in the latter part of Q1-FY03, and for the *rabi* crops the demand emerged late, i.e., in the first week of October (first month of Q2-FY03) instead of September.

It is also worth noting that while the cost of commercial borrowings is falling, lending rates on agricultural credit (particularly by ADBP) have remained static for more than a year. This may also be contributing to depressed demand for agri-credit. Since July 2001 to June 2002, the weighted average lending rate on working capital for businesses (other than agriculture) has declined from 14.4 percent to 12.0 percent, and further to 11.9 percent by September 2002. In contrast, financing cost by ADBP remained unchanged at 14.1 percent during this period. In case of Punjab Provincial Cooperative Bank (PPCB), the lending rate though moving in a narrow band, are still higher than the commercial banks' lending for other business loans (see **Figure 2.5**).

Figure 2.5: Weighted Average Lending Rates



Interestingly, the lending rate for agricultural credit (particularly for ADBP) was fixed at 14 percent primarily to insulate farmers against market variations, and this was a subsidized rate as borrowing cost for other businesses was relatively higher. However, the large volume of non-performing loans has made it difficult for specialized banks to follow the declining trend in lending rate as posted by commercial banks for other businesses.

On the supply side, due to delays in loan repayments, the credit-line to most of the farmers could not be rolled-over during Q1-FY03 and the overall disbursement remained less than in the previous year. Furthermore, in case of PPCB, the disbursement was lower as: (1) the lending to newly registered societies was restricted in the loan policy, (2) the loan up to the enhanced credit limit was banned, and (3) the formation of model cooperative societies was also banned by the Registrar (Cooperatives, Punjab). This, in turn, hampered the aggregate credit off-take by such societies.

Similarly, rescheduling of loans by ADBP, following the government's policy to delay collection of dues in severely drought-hit areas, was amongst the major constraints in achieving higher level of disbursement during Q1-FY03. During FY02, ADBP rescheduled Rs 2,407 million worth of loans compared to 2,115 million last year. The continued rescheduling, while hurts the capacity of lender, also reduces the number of potential borrowers by making them ineligible for fresh credit-lines.

It also seems that the golden handshake scheme, a part of restructuring plan of ADBP (which was offered to the employees in August and continued till September 12, 2002), had also contributed towards constraining the delivery of credit.

Recovery

Although the rescheduling of loans may be a valid reason for most of the 9.4 percent fall in recovery during Q1-FY03, it is distressing for the desired faster growth of institutional credit to the agriculture sector. The ever-rising outstanding amount of loans in agriculture is constraining banks' ability to lend to the farmers. With a lower recovery ratio, banks find it difficult to plan any priority package for financing the farming sector at their own. The outstanding amount, which had already exceeded Rs 100 billion mark at the end of June 2002, reached Rs 105 billion as on September 30, 2002. Ironically, this outstanding amount has become an integral part of the production cycle for the agriculture sector and the importance of this float is generally not recognized. At present, outstanding credit constitutes 12.2 percent of the value addition by agriculture in GDP at FY02 prices.

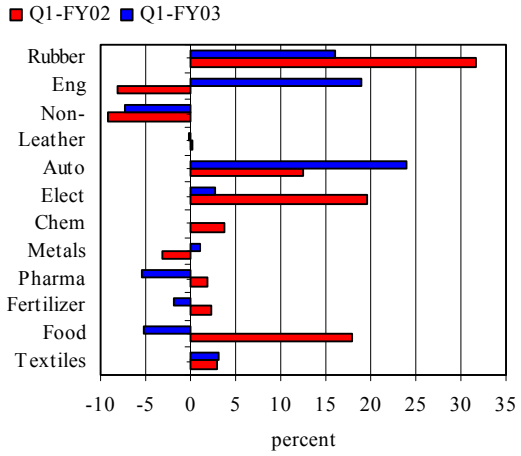
2.2 Large-scale Manufacturing

The performance of large-scale manufacturing (LSM), based on provisional data of only 70 manufactured goods (compared to 95 items reported for previous quarters), shows a slowdown of overall growth to 2.2 percent during Q1-FY03 relative to 4.8 percent in the same period last year (see **Table 2.8**). Unfortunately,

the lower coverage of items and its non-conformity with the national accounts data at this stage, make it less reliable than the past reported numbers. Thus, the growth rates are reported with strong reservations.[20]

Among the sub-sectors showing negative growth were food, beverages & tobacco, fertilizers, pharmaceuticals, and non-metallic minerals. On the positive side, the higher production of automobiles, and the increasing activity in the construction and engineering industries provided some support to LSM. Moreover, while seven sub-sectors posted growth during Q1-FY03, only two showed acceleration over the previous year, and three sub-sectors showed a growth of over 5 percent (see **Figure 2.6)**.

Figure 2.6: Growth in Seclected Industrial Groups



However, as mentioned earlier, the Q1-FY03 LSM growth is not directly comparable with the historic growth figures due to a change in the basket of industries being monitored. Specifically, the Q1-FY03 statistics on LSM exclude the contribution of 25 industries that had a combined weight of 16.17 percent in the previous basket.

Historically, the growth contribution of these excluded industries had been disproportionately greater than their combined weight, e.g. excluded industries such as petroleum products, cigarettes, cement and paper & board, had contributed approximately a quarter of the overall growth during Q1-FY02. Thus, going by

[20] In order to arrive at the LSM growth rate, the Q1-FY03 data was compared to a corresponding *sub-set* of the FY02 statistics.
The CBR used to collect production data for some high performing industries/excisable items. As part of the on-going tax reforms bulk of these excisable items have now been shifted to sales tax and for the remaining items a new pro forma (RT-I) has been introduced which does not provide for the collection of production data.
Besides that, production data collected by other two sources namely, Ministry of Industries and Provincial Bureau of Statistics are also weak and under-reported, therefore, probably do not represent the true developments taking place in Pakistan's industrial sector.

the performance in recent quarters, the reported Q1-FY03 LSM growth could be understated.

Table 2.7: Estimated LSM Growth Rates (based on old definition)
percent

	Q1-FY02	Q1-FY03
Overall	6.00	4.63
Excluding sugar	5.46	5.17

Source: Federal Bureau of Statistics

However, in the absence of data, we have attempted to estimate the possible contribution of the "missing" industries (see **Table 2.7**). A strong assumption underpinning these estimates is that Q1-FY02 growth in these industries was repeated in Q1-FY03. Also, due to data limitations, the provisional output figures reported for Q1-FY02 for the excluded industries were not revised. However, even under these strong assumptions, it seems that LSM growth during Q1-FY03 is weaker than in the previous year.

The weakness in LSM depicted by the reported data is puzzling and can not be substantiated by the behavior of aligned indicators, e.g. non-food, non-oil imports (that are often used to proxy the import of inputs for manufacturing) have grown by 16.1 percent, tax receipts (particularly income tax, and domestic sales tax which are most closely aligned with domestic economic activity) have risen by 16.6 percent, and export of manufactured goods have expanded by 17.9 percent during this period.

Particularly surprising is the reported performance of *textiles* in terms of production. It may be recalled that the investment in textile industry has seen a significant rise during the last three years. In fact, even in Q1-FY03, the textile industry continued importing machinery for Balancing, Modernization and Replacement (BMR) under textile vision 2005. This perception is further strengthened by the strong growth in textile exports during Q1-FY03; it should be noted that this export growth is led by a sharp jump in the quantum of major textile exports, which should have been reflected in higher production as well.

However, the reported LSM figures do not reflect this buoyancy in textile industry's performance during Q1-FY03, as it recorded a growth of 3.2 percent – a mere 0.3 percentage points higher than the same period last year. One obvious explanation is that the export growth may be led primarily by small-scale manufacturing or by the undocumented economy (on which the data is unavailable). Growth in the latter, in particular, would also help explain a part of the lower demand for credit from the banking sector.

During Q1-FY03, the production of *food, beverages & tobacco sub sector* showed a sharp decline compared to a strong growth last year. This was mainly due to the unusual processing of imported raw sugar during Q1-FY02. Sugar mills were permitted to do so late in FY01 to compensate for a very poor sugarcane crop that year, and this activity had spilled over into Q1-FY02. This non-seasonal

Table 2.8: Growth in the Production of Large-scale Manufacturing Items
percent

Items	Weights	Q1-FY02	Q1-FY03	Items	Weights	Q1-FY02	Q1-FY03
Textile	**19.069**	**2.95**	**3.19**	**Chemicals**	**2.849**	**3.72**	**0.08**
Cotton yarn	8.850	3.79	6.13	Caustic soda	0.621	2.84	-1.34
Cotton cloth	4.881	10.35	-3.42	Soda ash	0.320	0.93	6.24
Cotton ginned	3.893	-1.18	-4.72	Other four items	1.908	7.00	-0.49
Other five items	1.445	-20.80	9.12	**Electronics**	**2.681**	**19.53**	**2.66**
Food, beverages & tobacco	**17.336**	**17.88**	**-5.23**	Electric transformers	0.577	-2.99	67.85
Sugar[1]	8.630	0.00	0.00	T.V. sets	0.363	-11.61	-0.67
Vegetable ghee	3.004	-5.52	-9.63	Air conditioners	0.120	-83.52	8.45
Tea	1.785	16.23	0.93	Refrigerators	0.015	24.79	16.25
Cooking oil	0.448	21.30	12.21	Other five items	1.155	24.35	-11.75
Fertilizer	**5.871**	**2.29**	**-1.87**	**Automobile**	**2.348**	**12.60**	**24.05**
Nitrogenous	5.441	2.83	3.35	Trucks	0.698	-26.67	165.03
Phosphatic	0.430	-2.87	-55.05	Tractors	0.593	-5.01	-7.82
Pharmaceuticals	**5.798**	**1.80**	**-5.33**	LCVs	0.369	16.85	34.01
Tablets	2.705	5.66	-5.44	Cars & jeeps	0.309	20.68	25.43
Liquid/Syrup	1.602	-1.03	-4.70	Motorcycles	0.249	20.11	28.80
Injections	0.466	-10.56	-11.98	Buses	0.130	-40.62	56.40
Capsules	0.228	-7.84	4.96	**Non metallic minerals**	**1.915**	**-9.12**	**-7.29**
Galenicals (Tincture)	0.179	-14.81	-28.26	Glass sheets	0.069	-9.12	-7.29
Ointment	0.104	50.37	0.00	**Engineering items**	**0.712**	**-8.07**	**18.98**
Basic metal industries	**3.317**	**-3.20**	**1.01**	Bicycles	0.348	-17.60	27.32
Pig iron	1.477	-6.53	-2.35	Safety razor blades	0.109	15.85	4.65
Coke	1.319	2.17	-4.90	Diesel engines	0.065	-42.11	-15.15
Billets	0.311	-5.60	11.68	Sewing machines	0.052	20.85	3.24
H.R/coils and plates	0.074	24.36	-3.05	Power looms	0.051	17.65	86.00
C.R coils/plates/sheets	0.013	-23.32	10.30	Other six items	0.087	-30.85	-10.74
Leather products	**2.333**	**0.26**	**-0.14**	**Tyres & tubes**	**0.452**	**31.71**	**15.97**

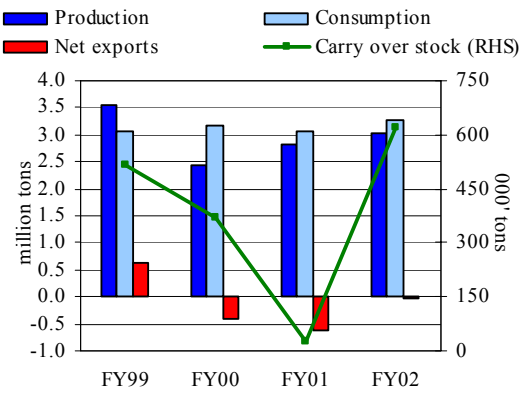
[1] There was no production during Q1-FY01 and Q1-FY03; hence calculating growth for this quarter and the corresponding quarter last year is meaningless.

Source: Federal Bureau of Statistics.

production of sugar in Q1-FY02 caused a base-effect, depressing the growth figures for Q1-FY03.

It should be noted that due to a combination of unusual FY02 production, and higher imports, domestic sugar inventories are very high (see **Figure 2.7**). This, in turn, may force manufacturers to decelerate their production cycle for FY03 despite a good sugarcane crop.[21]

Figure 2.7: Sugar Scenario

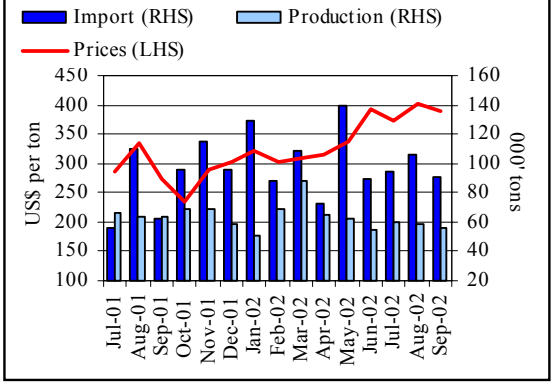


Sugar Year i.e. October to September

Production of vegetable ghee continued its downward slide in FY03 as well, probably reflecting growing output by the non-documented units in response to the increase in the (non-adjustable) general sales tax (GST) on the import of edible oils.

It will be noted that the import quantum of edible oil during Q1-FY03 has actually risen by 24.1 percent year-on-year basis, despite higher prices, and a 9.6 percent decline in the recorded production of vegetable ghee (see **Figure 2.8**). Hence, it seems that the informal sector has increased its market share during Q1-FY03 at the expense of the formal sector units.

Figure 2.8: Import of Palm Oil and Vegetable Ghee Production



[21] The production of sugar usually starts in October and November in Sindh and Punjab provinces respectively. However, in FY03 sugar mills claim that their cash flows have been squeezed by large inventories of sugar. As a result, they expressed their inability to make their normal sugarcane purchases, unless (1) sugarcane prices are reduced substantially, and (2) they are allowed an increase in the tax refunds/rebates in order to increase export sales.

The robust performance of the *consumer durables*, especially cars & jeeps, motorcycles, air conditioners and refrigerators, continued for a third successive year. This demand driven growth has been on rise since the introduction of new attractive models of cars and increasing popularity of purchase through lease finance and consumer financing by commercial banks.

The latter is particularly visible in the *auto sector*, where the production of cars, jeeps and motorcycles remained strong following the rising availability of financing. By contrast, the production of trucks and buses had remained under pressure in the last few years, and in fact, the sharp jump in the Q1-FY03 growth is mainly due to a base effect. In absolute terms, the production of trucks and buses has actually risen slightly due to the increase in transportation of goods to Afghanistan and the induction of new buses by transporters on inter-city routes.

The strength of the demand for cars and jeeps is such that manufacturers have actually been able to *increase* prices in FY02, despite substantial *reduction* in major costs of production.[22] Interestingly, a relative slowdown in the production of cars & jeeps (despite the sustained demand growth), during the latter half of FY02, created a backlog of bookings that further benefited assemblers and dealers (see **Box 2.1**).

A welcome development in the motorcycle market was the entry of Chinese manufactures, which introduced two brands. These two units (PCICS Sohrab and Triwheeler Sohrab) started production in September 2002.

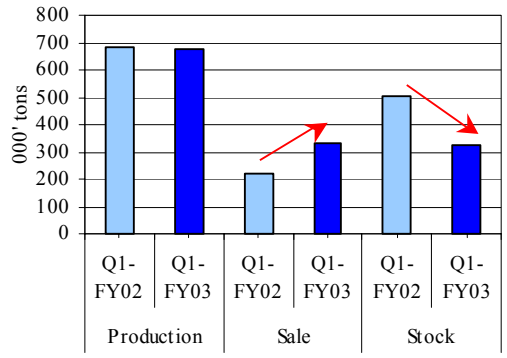
Production of *basic metals* posted only a meager recovery with 1.0 percent growth during Q1-FY03, mainly driven by higher sales.[23] Sales of Pakistan Steel products had been on decline over the last couple of years due to slackened engineering and construction activities.

[22] An appreciating Rupee has lowered the cost of CKD kits and machinery, and this gain was complemented by a steep decline in interest rates, reducing funding costs. Moreover, even the funding requirements fell as an increased proportion of cars were sold well in advance, thus improving manufacturers' cash flows.

[23] Comparing the absolute numbers, the production of steel products shows a decline of 0.48 percent, but weighted growth on 1980-81 base is 1.01 percent.

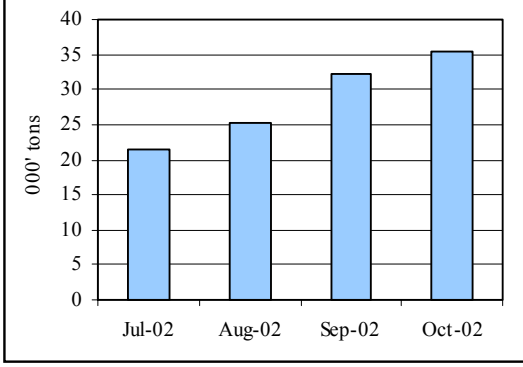
This situation changed with the launch of some construction projects by the federal and local governments as well as increased private sector construction activities.[24] Yet, this clear improvement in sales is not reflected in production as Pakistan Steel has been consuming inventories to meet rising demand (see **Figure 2.9**).

Figure 2.9: Performance of Pakistan Steel



The growing activity in the construction sector is also reflected in higher cement dispatches during Q1-FY03, which increased to 2.7 million tons – showing an 11.1 percent increase over the same quarter last year. Furthermore, cement exports have also been increasing since July 2002 (see **Figure 2.10**). The capacity utilization of the industry, therefore, improved to 65.6 percent during the first four months of FY03. The Ministry of Industries & Production estimates show 9.7 percent increase in cement production during Q1-FY03.

Figure 2.10: Export of Cement



The manufacturing of *engineering goods* also showed a sharp recovery, with a significant increase in the production of bicycles, power looms and bobbins during Q1-FY03. This increase in the production of power looms and bobbins is mainly due to BMR in textile and availability of financing facility for the locally manufactured machinery (LMM) from the SBP.

[24] Increased remittances and higher disbursement by the House Building Finance Corporation (HBFC) have resulted in higher demand for housing construction.

Box 2.1: Rising Prices of Automobiles and Consumer Loss

In Pakistan, the considerable dependence of the automobile industry on a large number of imported components leaves the car prices vulnerable to depreciating Rs/Dollar parity. In this background, the CY02 increase in car prices has very different dynamics, as it accompanies an *appreciating* Rupee. Thus, it appears that manufacturers, instead of transferring the benefit of lower import costs to consumers, preferred to increase their margins.

In fact, assemblers apparently failed to increase supply in response to rising demand. As a result, the time lag between the sale of a vehicle and its eventual delivery by the manufacturers of popular models increased from between 3-6 months to over 8 months, since the beginning of CY02.

Table 1: Indicative Savings to Manufacturer

Payment received by the manufacturer	**Rs 600,000**
Saving to manufacturer[1]	Rs 36,000
Opportunity cost of customer funds[2]	Rs 13,650

[1]At the rate of 12 percent (weighted average) for a six-month.
[2]At the rate of 4.55 percent, weighted average deposit rate.

Concurrently, the amount of *down payments* made at the time of booking was also raised from 25 percent to 100. Thus, car manufacturers, instead of borrowing from banks, were utilizing the advance payment to support financing for their operations. For instance, if a 1000cc car at the rate of Rs 0.6 million is booked on 100 percent down payment with a six-month delivery period, a manufacturer would be saving approximately Rs 36,000 by financing production out of it (see **Table 1**). Clearly, an increase in the sale-to-delivery time lag would result in additional gains (savings) for manufacturers. Finally, it should be noted that the steep decline in domestic interest rates would have also helped reduce manufacturer's cost of production.

Anecdotal evidence suggests that some dealers also exploited this situation by purchasing stocks of popular car brands to sell at premium to customers unwilling to wait for the extended delivery period. This premium represents an additional loss of consumer surplus.

Although, following government intervention, car manufacturers later increased their production, and some of them were also forced to pay mark up on the advance payments by customers, the downward sticky prices for automobiles are still a matter of concern. It should be noted that the gains of the auto industry already come on the back of protective policies that ultimately result in high consumer prices.

3. Fiscal Developments

The overall budget deficit during Q1-FY03 was down to Rs 41.0 billion (or 1.0 percent of projected GDP for FY03), showing a considerable reduction of Rs 21.7 billion over the same period last year. In particular, a major increase of Rs 38.2 billion in total revenues offset the Rs 16.5 billion rise in total expenditures, leaving the government well placed to meet the lower deficit target of Rs 162.5 billion for FY03. The realized deficit was largely funded through external sources, with financing from domestic borrowings limited to Rs 6.4 billion only (see **Table 3.1**).

3.1 Expenditures

Compared to Q1-FY02, the consolidated expenditures of federal and provincial governments registered an increase of 9.3 percent during the quarter under review. Even though, both current and development expenditures have increased, it is reassuring that the share of development expenditures in the total has expanded to 11.2 percent during Q1-FY03 from 7.6 percent during the first quarter of FY02;

Similarly, net lending to PSEs posted a reversal from a heavy borrowing of Rs 5.7 billion during Q1-FY02 to a marginal retirement of Rs 0.6 billion this quarter. This appears to be the result of the financial restructuring of major PSEs last year.

A close analysis of current expenditures during Q1-FY03 reveals that the increase under this head was mainly on account of higher provincial government expenses, possibly due to expanding economic and administrative activities of local bodies. On the other hand, overall growth in current expenses of the federal government was relatively lower, but still, wide variations exist across sub-categories.

Table 3.1: Fiscal Operations During Q1

billion Rupees

	FY02	FY03	(%) Change
Total revenues	**115.3**	**153.5**	**33.1**
Tax revenues	94.4	115.6	22.5
Non-tax revenues	20.9	38.0	81.8
Total expenditures	**178.0**	**194.5**	**9.3**
Current	138.8	161.2	16.1
Development	13.5	21.7	60.7
Net lending to PSEs	5.7	-0.6	-110.8
Unidentified	20.0	12.3	-38.7
Budget deficit	**-62.7**	**-41.0**	**-34.6**
Financing	62.7	41.0	-34.6
External	6.4	34.6	438.7
Domestic	56.2	6.4	-88.6
Bank	24.6	-14.1	-157.3
Non-bank	31.7	20.5	-35.3

Source: Ministry of Finance

For instance, interest payments on foreign and domestic debt, which form the largest component of current expenditures, registered a notable decline of Rs 15.8 billion during Q1-FY03 over the corresponding period. The fall of Rs 9.6 billion in interest payments on domestic debt reflects the all-time low interest rates on government securities and relatively lower government financing needs. Likewise, the re-profiling of external debt and repayment of more expensive short-term debt during previous years dragged down the foreign component of interest payments.

However, higher defense expenditures appeared to have offset some of the savings realized on interest payments. Specifically, the increase of Rs 7.5 billion in defense expenses over Q1-FY02 is the upshot of prolonged border tensions with

India.[25] Going forward, as troops pull-out has started following ease at borders, the defense expenses are likely to be contained.

3.2 Revenue Receipts

The consolidated revenues of federal and provincial governments registered an impressive increase of Rs 38.2 billion (33.1 percent year-on-year basis) during the quarter under review (see **Table 3.1**).

CBR tax collections improved due to discretionary measures taken in the federal budget for FY03, natural growth in the tax base and restructuring in tax administration. The rise in *surcharges* is the result of an upward revision in the petroleum development levy announced last year. Consequently, aggregate tax revenues witnessed a strong growth of 22.5 percent during Q1-FY03 over same period last year.

Non-tax revenues registered an increase of Rs 17.1 billion (81.8 percent) during Q1-FY03 over the corresponding period last year. A breakdown of this number shows that the major contribution came from higher civil administration receipts that surged due to inflows on account of logistic support to US forces operating in Afghanistan. The other important contribution came from higher transfers of SBP profits (Rs 6.0 billion compared to Rs 5.0 billion in the previous year).

3.3 CBR Tax Collections

The impressive growth observed in CBR collections in the last quarter of FY02, continued in Q1-FY03 as well. Tax receipts rose by a remarkable 16.6 percent, in contrast to a fall of 3.1 percent in the same period last year (see **Table 3.2**). The improvement is evident both in direct and indirect taxes, with the latter being more pronounced.

Table 3.2: Monthly Tax Collections (Net)
billion Rupees

	FY02	FY03	Growth Rates	
			FY02	FY03
Jul	19.7	23.6	-6.7	20.1
Aug	26.8	29.6	1.7	10.2
Sep	31.0	37.2	-4.7	20.0
Q1	**77.5**	**90.4**	**-3.1**	**16.6**

Note: Growth rates are in percent
Source: Central Board of Revenue

Interestingly, the strong growth in tax collections is visible in each month of the quarter. Since the growth figures benefited from lower tax base of the last year, the performance in July and August (having a *pre-September 11 base*) is more

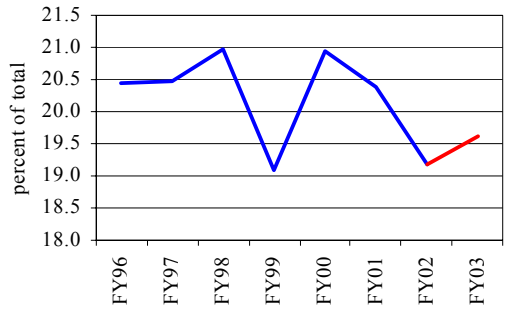
[25] The current problems began following the December 13, 2001 terrorist attack on the Indian Parliament. India accused Pakistan of complicity in the attack and threatened military action against alleged terrorist camps in Pakistan.

important as it suggests that the impact of September 11 events is no longer very significant.

3.3.1 Revenue Collections vs. Targets

The tax performance can also be analyzed by comparing the extent to which collections are meeting the budget target. During Q1-FY03, tax collections covered 19.6 percent of the annual target, which is slightly better than the performance in FY02 (see **Figure 3.1**).[26]

Figure 3.1: Tax Collections During Q1



Note: Value for FY03 is as percent of annual target

In comparison, tax collections during the corresponding period last year were 19.2 percent of the *annual receipts*. It can therefore be argued that, if similar trends continue, the annual targets for FY03 will be achieved comfortably.

Furthermore, it should be noted that the FY03 target (at Rs 460.6 billion) is based on last year's revised target of Rs 414.2 billion. Since the eventual collection for FY02 proved to be Rs 10.3 billion lower, the adjusted FY03 target for this change in the base would be Rs 450.3 billion. In which case, the Q1-FY03 performance would look even better.

In terms of quarterly targets, as evident from **Table 3.3**, CBR tax collections were slightly higher than the target of Rs 90 billion for Q1-FY03, with both direct and indirect tax revenues achieving their marks. Within indirect taxes, the growth in sales tax collection was sufficient to offset the shortfall in central excise and customs receipts.[27] In this regard, the shortfall in CED collection is immaterial due to its gradual phasing out and replacement by the sales tax. The more relevant indicator is the aggregate collection of sales tax and CED, which also posted an

[26] As budgetary targets for revenue can be ambitious, a realistic picture of tax performance is presented by comparing the share of Q1 collections compared to the actual annual receipts. For the current year, the budget target is used to proxy actual collections.

[27] Sales tax collections seem even more impressive if we adjust the negative impact of around Rs 2.0 billion due to withdrawal of sales tax on medicine.

Table 3.3: Tax Collections in Q1
billion Rupees

	FY03 Target		Net Collection in Q1				Percent of Target	
	Annual	Q1	FY00	FY01	FY02	FY03	FY03	Q1
Direct taxes	**148.4**	**23.2**	**21.3**	**21.6**	**22.1**	**23.6**	**15.9**	**101.7**
Indirect taxes	**312.2**	**66.8**	**51.4**	**58.3**	**55.4**	**66.8**	**21.4**	**99.9**
Sales tax	205.7	42.4	21.4	31.5	34.6	43.8	21.3	103.3
Central excise	50.0	10.6	12.9	12.7	9.9	9.6	19.2	90.7
Customs	56.5	13.8	17.1	14.1	10.8	13.4	23.6	96.8
Total	**460.6**	**90.0**	**72.7**	**79.9**	**77.5**	**90.4**	**19.6**	**100.4**

Source: Central Board of Revenue.

impressive growth of 20.0 percent during Q1-FY03 over same period last year. Similarly, growth in custom revenues may be suffering due to tariff cuts and appreciation of the Rupee.

3.3.2 Refunds and Gross Collections

Since the build up of tax refund arrears had historically been misused to *artificially* improve net tax collections, it would be more instructive to analyze trends in gross collections and refunds separately. It is encouraging that while gross collections posted a robust growth of 14.2 percent during Q1-FY03 (see **Table 3.4**), refunds also swelled by 5.2 percent during this period.[28]

Table 3.4: Monthly Gross Collections
billion Rupees

			Growth Rate	
	FY02	FY03	FY02	FY03
Jul	27.9	33.1	-2.5	18.6
Aug	35.1	36.5	13.7	4.1
Sep	35.5	42.9	-1.8	20.8
Q1	**98.5**	**112.5**	**3.0**	**14.2**

Note: Growth rates are in percent.
Source: Central Board of Revenue

Contrary to common perception that sales tax refunds are held up for long periods of times, the 5.2 percent growth in tax refunds for Q1-FY03 is on top of exceptionally high refunds provided during Q1-FY02. Since most of arrears had already been cleared during FY02, the growth in Q1-FY03 can only be attributed to expansion in VAT-type sales tax net. This reasoning is also supported by an increase of 8.7 percent in sales tax refunds during Q1-FY03 (with a share of 58.0

[28] The refunds as percentage of gross collections have declined from 21.4 in Q1-FY02 to 19.7 percent during first quarter of FY03.

percent in total refunds) compared to the preceding year.[29] The refunds on customs levy, on the other hand, have declined.

With this background information on gross collections and tax refunds, the strong growth of 16.6 percent in *net* collection is indeed credible, as unlike in the past, this was achieved without holding back refunds. This clearly indicates that the government efforts to broaden the tax base, increasing tax compliance, etc. have started paying dividends.

3.3.3 A Disaggregated Position

Direct Taxes

Direct tax collections showed a reasonable growth of 6.9 percent over the same period last year; higher than the average growth of 4.1 percent needed to meet the annual target. The growth in direct tax revenues is also significant when considering downward adjustments in tax rates (from 50 to 47 percent for banking sector, and from 45 percent to 43 percent for private limited companies) and reductions in a number of withholding taxes.

Table 3.5: Income Tax Collections during Q1
million Rupees

			Change over FY02	
	FY02	**FY03**	**Absolute**	**Percent**
Voluntary payments	5269.3	7393.5	2124.2	40.3
Collection on demand	1727.8	1421.3	-306.5	-17.7
Withholding taxes	17382.8	18246.0	863.2	5.0
Miscellaneous	119.9	137.9	18.0	15.0
Gross total	**24499.8**	**27198.7**	**2698.9**	**11.0**
Refund	2715.0	3020.5	305.5	11.3
Net collections	**21784.8**	**24178.2**	**2393.4**	**11.0**

Source: Central Board of Revenue

A detailed analysis of income tax – the main component of direct taxes – is more instructive. Gross income tax collections recorded an impressive increase of 11.0 percent on the back of stunning rise of over 40.3 percent in voluntary payments.[30] There is evidence to suggest that government policies to improve tax compliance, and addition of new income tax payers due to the tax survey and registration drive have made noteworthy contributions.

Collection on demand, which includes receipts against arrears and current demand (amount collected during the ongoing year), registered a decline of 17.7 percent

[29] In VAT mode sales tax system, tax paid at the buying stage is deducted from the total tax collected at the selling stage. If the difference is positive, it is paid to the government; and if negative, the refund is to be claimed from the government.

[30] Voluntary payments include collections under Self Assessment Scheme (SAS), with normal returns (u/s 80-D, u/s 54 (other than 80-D) and u/s 53) and under tax amnesty schemes (u/s 59-D).

during Q1-FY03 (see **Table 3.5**). However, this fall, after additional tax efforts from CBR, must be interpreted with caution.

(1) Since higher arrears had already been collected during FY02, a decline in FY03 collections is not surprising; (2) higher current demand collections alongwith tax administrative measures signaled the improvement in audit and administrative capabilities of the CBR, which may have helped to reduce misreporting by taxpayers in Q1-FY03. These factors seem to have led the fall in collections on demand during the quarter under review. The explanation is also reinforced due to substantial growth in voluntary tax payments.

Interestingly, overall withholding taxes witnessed a respectable growth of 5.0 percent during Q1-FY03, despite lower collection on government securities, bank interest income (due to prevailing lower interest rates and reduction in the tax rates), and other banking transactions (see **Table 3.5**). The growth was driven largely by higher withholding tax collection on imports, exports, salaries and contracts.[31]

In this backdrop, the changing composition of income tax is largely in line with the government claims that the share of withholding taxes is on decline (from 71.0 to 67.1 percent) and voluntary payments are surging up (from 21.6 to 27.2 percent).

Sales tax

Sales tax collections contribute almost one half (48 percent) to the total tax collections (see **Figure 3.2**). While sales tax on import items has a larger share of 28 percent, the remaining 20 percent is collected from domestic goods.

During Q1-FY03, sales tax collections posted an impressive growth of 26.6 percent over the corresponding period last year. Import related sales tax surged up due to higher imports. On the other hand, the higher sales tax collection on domestic items largely reflects the widening of the tax net to ghee and cooking oil industry, the services sector and utilities (electricity and gas).

A compositional breakdown of gross domestic sales tax receipts shows that the services sector has become the single largest source of sales tax. Compared to sectoral value addition (around 50 percent), the tax incidence is still low (15.8 percent). However, the growth rate is impressive as the gross collections from this sector approximately doubled, with an increase of Rs 2.4 billion over Q1-FY02

[31] The higher development expenditures led to a notable increase in collections from contracts.

(see **Table 3.6**). This steep rise is largely attributable to widening sales tax net to various services, which were either not in the tax net or were subject to excise duty.

Table 3.6: Gross Domestic Sales Tax Collections During Q1
million Rupees

			Change over FY02	
	FY02	**FY03**	**Absolute**	**Percent**
Services	2493.3	4891.4	2398.1	96.2
POL products	3348.0	4089.5	741.6	22.1
Electric energy	1800.3	2705.3	905.0	50.3
Natural gas	1819.9	2128.0	308.1	16.9
Sugar	1619.2	2034.3	415.1	25.6
Cement	861.2	1041.2	180.0	20.9
Cotton yarn	1172.6	1005.6	-167.0	-14.2
Cigarettes	909.4	971.7	62.3	6.9
Cotton not carded	1045.4	722.9	-322.5	-30.9
Aerated water	576.0	690.5	114.4	19.9
Others	7781.8	10622.4	2840.7	36.5
Total	**23427.1**	**30902.8**	**7475.7**	**31.9**

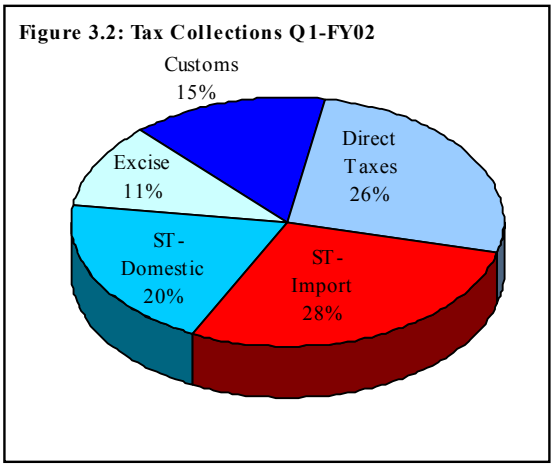
Source: Central Board of Revenue

Gross collections from utilities, both electricity and gas, also recorded growth of 50.3 and 16.9 percent respectively. The upward revision in electricity tariff and increase in electricity consumption mainly accounts for this upsurge. In the case of sugar, the increased collections reflect higher sales rather than a rise in production.

Central Excise Duty

Not surprisingly, central excise duty (CED) collections posted 3.0 percent decline during the quarter under review. The realized growth in CED is lower than envisaged in the budget for FY03 and well below the quarterly target. Lower collections on beverages (due to reduction in duty rates) and cigarettes are mainly responsible for this decline. However, the impact on overall tax collections remained insignificant due to its small (11 percent) share in total tax collections (see **Figure 3.2**). The share of CED has been declining over the last couple of years following government policy to replace CED with sales tax.

Figure 3.2: Tax Collections Q1-FY02



Customs

Like sales tax, custom collections also recorded an exceptional growth of 24.1 percent during Q1-FY03 over the corresponding period last year. This growth is

even higher than the average quarterly growth of 17.5 percent required for meeting the annual target and has occurred despite (1) the dampening effects of a stronger Rupee (which has appreciated over 8 percent since September 2001), and (2) a downward adjustment in the maximum tariff rate. Due to the rationalization of tariff structure, the effective tax rate for the first quarter this year has declined to 15.8 percent from 16.2 percent in Q1-FY02.

The impetus thus clearly came from higher dutiable imports (in Rupee terms), better tax administration and improved coverage. In particular, higher import of POL products, edible oil, machinery and vehicles attracted more custom collections.

In other words, not only has the quantum of imports seen a rise, a greater proportion attracts customs duties. Specifically, the share of dutiable imports in total imports increased to 59.3 percent from 56.3 percent during Q1-FY02. Additionally, customs collections also benefited from relatively lower refunds during the quarter.

4. Money and Credit

The continuing heavy current account surpluses left the SBP facing the classical "impossible trinity" of targeting (1) a stable (market driven) exchange rate, (2) stable interest rates, and (3) unrestricted forex inflows. Since restricting the forex inflows was obviously not an *option* for the SBP, it was clear that the increasing current account surpluses during Q1-FY03 would eventually lead to an adjustment in either the exchange rate or domestic interest rates (or both). In this context, the only real unknowns were the timing(s) and the rates of the eventual adjustments in these variables.

For reasons elaborated in the **Section** on *Exchange rate*, the SBP chose to allow only a *gradual* appreciation of the Rupee in Q1-FY03, while increasing its purchases in the interbank market in response to rising forex inflows during the period. But at the same time, it held interest rates unchanged by sterilizing the monetary impact of its purchases. This meant that, effectively for the period, the interest rate became the *de-facto* nominal anchor for monetary policy.

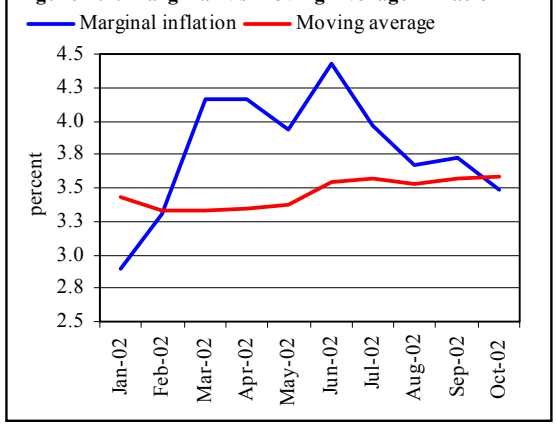
It should be made clear at the onset that monetary sterilization is, by definition, not sustainable in the long run as it can entail heavy costs to the economy as well as to the central bank. In particular, on the one hand, the switch from Rupee to forex assets, implied by the sterilization, lowered the SBP's profitability (since the returns on US Dollar assets were lower), and on the other hand, domestic interest

rates remained anchored at relatively higher levels (For a detailed discussion on sterilization see **Special Section 1**).

During the initial months of FY03, from the SBP's perspective, there were three main reasons for steadying Rupee interest rates in the short term.

(1) While the CPI *inflation rate* remained low throughout the quarter, the up trend in the marginal (point-to-point) inflation rate observed during the previous two quarters could not be overlooked. Interestingly, this up-trend also coincides with the strong reserve money growth in FY02 (which theoretically can presage inflationary pressures). Certainly, a spillover of this tendency into FY03 would have required SBP to respond with a *tightening* of monetary policy. Hence, SBP preferred to monitor inflationary developments during the quarter while maintaining a neutral bias in its monetary policy. Thereafter, as inflationary pressures clearly diminished (see **Figure 4.1**), this opened the door to a further easing of the SBP monetary posture.

Figure 4.1: Marginal Vs Moving Average Inflation

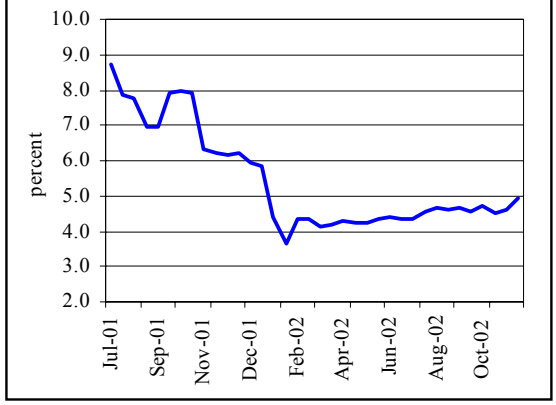


(2) By end-FY02 it was unclear how uncertainties due to the political environment had affected credit off-take. The evidence, at the time, suggested that bank credit had not declined appreciably and that the funding requirements of the private sector were also being met through a degree of internal financing as well as higher tax refunds. Furthermore, the net credit figures for earlier months of FY03 tracked well with the FY02 performance. This encouraged SBP to keep its monetary posture unchanged.[32]

[32] In fact, the SBP reduced the discount rate, once it was clear that political uncertainty and market expectations of a further cut in benchmark rates are depressing even the seasonal credit off-take.

(3) Since the fall in Rupee interest rates during FY02 had been much sharper than the corresponding decline in US$ LIBOR,[33] their differential was also squeezed sharply during the period (see **Figure 4.2**).[34] The later up trend in the spread (due to declining LIBOR rates) was initially not significant, especially given the extended periods of relative stability. Thus, it was only when aggregate increase became significant (and threatened to grow further) that SBP focused on this variable as well.

Figure 4.2: Interest Rate Differential



However from the market's point of view, the SBP's decision to keep the interest rates stable, in the absence of any significant increase in private sector credit demand from commercial banks, made government securities an increasingly attractive investment option. This was also supported by the continuing liquidity injections from SBP interventions (purchases) to mop up the rising forex inflows and stabilize the exchange rate. In fact, it was primarily these injections that influenced the market expectations of a steep decline in interest rates, and could have exacerbated the weakness in net credit.

In hindsight, it seems that the SBP's management of market liquidity could also have played a role in banks' reluctance to pursue credit growth. In effect, the greater focus on curtailing reserve money by mopping up market liquidity (increasing the supply of bonds) provided ample safe investment options for banking sector liquidity. Consequently, there was less pressure on banks to aggressively market credit.

[33] We focus on the US$ LIBOR because the US$ is the intervention currency for the basket of currencies against which the Rupee is floated. Also, a significant portion of Pakistan's trade is denominated in US$.

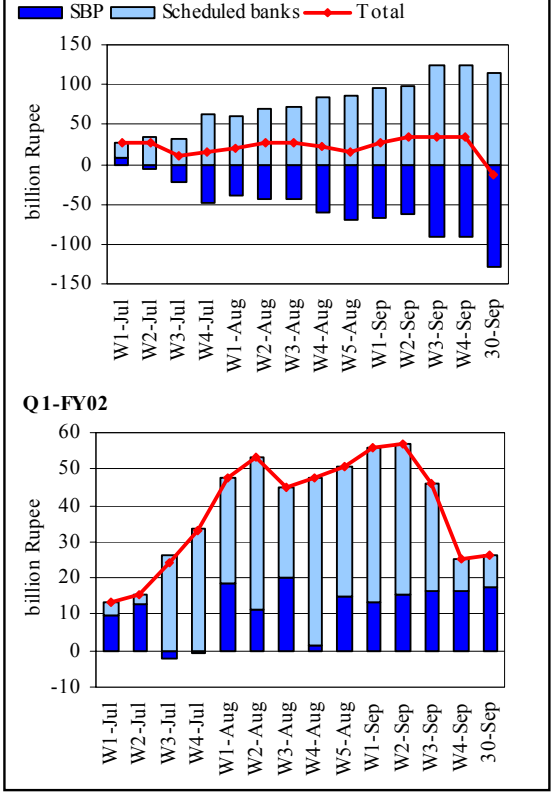
[34] In should be noted that the reduction in interest rate differential during October 2001 onwards also appears to capture the expectations of a stable Rs/US$ exchange rate; as the parity stabilized during H2-FY02, the spread also steadied.

4.1 Growth in Monetary Assets

4.1.1 Government Borrowings

Given that the Q1-FY03 monetary environment was heavily influenced by the continuing exceptional improvement in the external sector that occurred post-Q1-FY02, it is not surprising that the first quarter of FY03 is enormously different from the same period last year. This is also true for government borrowings (see **Figure 4.3** and **Table 4.1**).

Figure 4.3: Budgetary Borrowings (Q1-FY03)



During Q1-FY02, the overall government borrowings were not only higher, but also substantially sourced from the SBP. In contrast, the government continued to *retire* its debt to SBP almost throughout the first quarter of this fiscal year. This, in turn, helped SBP to almost completely sterilize the impact on reserve money of the increase in NFA during Q1-FY03 that stemmed from SBP forex market purchases.

Similarly, the Q1-FY03 performance targets set in the IMF program also proved quite irrelevant. The external inflows easily allowed the SBP to increase its Net Foreign Assets (NFA) well beyond the target. Also, the resulting Rupee liquidity equally facilitated the government's retirement of SBP debt, thus reducing the Net Domestic Assets (NDA) of SBP comfortably beyond the target. Likewise, limits on aggregate government borrowings from the banking sector for budgetary support, were also met comfortably due to strong non-bank borrowings (NSS receipts rose 52 percent, while PIB sales to non-banks increased 20 percent,

Table 4.1: Monetary Survey
billion Rupees

	IMF proj Q1-FY03	Actual Q1-FY03	Actual Q1-FY02
A. Government sector borrowing (net)	**-6.0**	**-16.0**	**24.9**
1 Net budgetary borrowing	-4.0	-12.7	26.2
From State Bank of Pakistan	-2.7	-128.1	17.7
From scheduled banks	-1.3	115.3	8.5
2 Commodity operations	-1.0	-4.8	0.9
3 Net effect of zakat fund/privatization proceeds		1.5	-0.4
4 Privatization commission A/c with NBP	0.0	-5.4	0.0
B. Non-government sector borrowing	**16.0**	**-36.0**	**-28.9**
1 Autonomous bodies[1]		-5.3	-6.3
2 Net credit to private sector and PSCEs	16.0	-30.6	-22.6
Commercial banks	16.0	-26.8	-19.2
i. PSCEs other than B(1)	7.0	0.1	-0.6
ii. Private sector	9.0	-26.9	-18.6
of which export refinance		*-7.7*	*-12.1*
Specialized banks		1.5	7.4
Other financial institutions		-5.1	-11.1
PSCEs special account-debt repayment with SBP		-0.2	0.3
C. Other items (net)	**1.0**	**-17.6**	**11.0**
D. Net domestic assets of the banking system	**11.0**	**-69.5**	**7.0**
	0.72%	-4.60%	0.47%
E. Net foreign assets of the banking system	**13.0**	**107.2**	**-14.6**
F. Monetary assets (M2)	**24.0**	**37.6**	**-7.6**
	1.37%	2.14%	-0.46%

[1.] WAPDA, OGDC, PTC, SSGC, SNGPL, KESC, PR, PSMIC & PIA.
Source: Economic Policy Department, State Bank of Pakistan.

during the quarter) and higher external financing (US$ 855.8 million in Q1-FY03 against US$ 296.5 million in Q1-FY02).

It must be noted that while a lower target for FY03 fiscal deficit had *reduced* the funding needs of the government (see **Table 4.2**), expectations of a further decline in interest rates raised the market *demand* for the high yielding government

Table 4.2: Budgeted Government Deficit and Its Sources of Funding
billion Rupees

	FY03 (Budget)	FY02 (Revised)
Budget deficit	162.5	257.1
Sources of funding		
External financing	129.1	134.9
Domestic financing	33.4	122.2
Non-bank	64.5	60.2
Bank	-31.1	62.0

papers, i.e. PIBs and, NSS instruments. Hence, in the face of largely non-discretionary increase in non-bank funding,[35] and higher external financing, the government effectively had to *retire* its cheaper net borrowings from the banking sector.

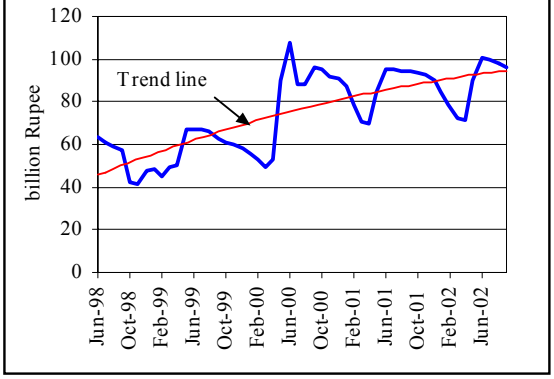
In fact, by end Q1-FY03 government's non-bank borrowings were already equal to half of the FY03 annual target. In this regard, the recent decision by the government to market national savings scheme instruments in Gulf countries needs to be carefully reviewed; the reliance on this relatively expensive borrowing would probably increase further in comings months due to strong investor interest in the high-yielding paper, hampering the government's ability to significantly lower its domestic borrowings costs.

4.1.2 Commodity Operations

The first three quarters of the fiscal year generally witness net retirement under the commodity operations. But, the retirement in Q1-FY03 (Rs 4.8 billion) was higher than the same period last year (Rs 0.9 billion). This is because FY02 commodity operations had unusually continued till July, and retirement picked up from August onwards.

Also, a glance at **Figure 4.4** reveals that the outstanding stock of commodity financing is steadily increasing over time, implying poor recovery. This clearly indicates that as long as provincial governments continue to get funding for commodity operations irrespective of their recovery track record, they are not likely to take this issue seriously, and as such, commodity operations will remain a burden on the government.

Figure 4.4: Commodity Operations - Outstanding Credit



[35] (1) Since NSS instruments are sold on demand, there is no way for the government to regulate demand except a general reduction in interest rates; (2) While PIB sales to non-banks can be regulated by limiting supply, this could distort the PIB's market yields, thereby reducing its effectiveness as a market benchmark.

4.1.3 Credit to Private Sector

The slower credit off-take in Q1-FY02 was understandable. Higher retirements, a sharp increase in tax refunds, bad loans write-off, and lower input prices etc. were the important contributors to the apparent decline in net credit figures.

Since then, the prospects of the economy have improved substantially with domestic interest rates at their lowest, a strong recovery by exports, a reduction in border tensions with India, etc.; all of which should have spurred economic activity (and increased funding demand). In the event, the net credit off-take for Q1-FY03 proved substantially *lower* than even the weak Q1-FY02 figure (see **Figure 4.5**). This is obviously contrary to expectations, as quarterly projections had envisaged an expansion of Rs 9.0 billion.

Figure 4.5: Credit to Private Sector

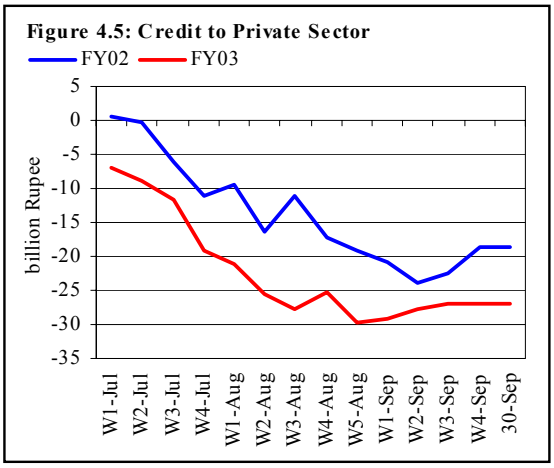


Table 4.3: Adjusted Credit to Private Sector

billion Rupees

	Q1-FY03	Q1-FY02
Credit to private sector (Monetary Survey)	-26.9	-18.6
Adj. for deletion, and write-offs	8.2	18.7
Credit to private sector (excluding export finance) after adjustments	**-18.7**	**0.1**
Adj. for export finance	-7.7	-12.1
Credit to private sector (including export finance) after adjustments	**-11.0**	**12.2**

The picture becomes even more depressing considering the adjusted net credit figures (see **Table 4.3**). This is despite the fact that the retirement in key sub-component *net credit for export finance* in Q1-FY03 (Rs 7.7 billion) is lower than the Q1-FY02 figures (Rs 12.1 billion).

The gross disbursement figures provide a more interesting comparison. On face value, it seems that gross disbursements are immune to the slowdown visible in the net credit figures; the Q1-FY03 gross disbursements of Rs 263.8 billion were almost unchanged from the Q1-FY02 figure of Rs 264.6 billion. However, this also means that gross credit disbursement has *failed to increase* for the first time in the last 6 years.

It is important to note here that this does not necessarily mean a slowdown in economic activity. In fact, all aspects considered, it is likely that the change in the credit pattern reflects the impact of factors, such as:

1. The massive increase in remittances, which essentially represent an inflow of resources to the private sector. A substantial portion of these could have been used for self-financing of business activities.

2. Expectation of a further sharp decrease in domestic interest rates, which prevailed for much of Q1-FY03, would have led business to minimize the credit off-take at prevailing interest rate levels. In fact, this would also help explain the difference between the gross and net credit figures, i.e., businesses could be even more relying on short term funding, which would be repeatedly rolled over (increasing gross credit even as net credit remained unchanged), in anticipation of an interest rate cut in the near term.

3. Political uncertainty (and more specifically, policy uncertainty) ahead of the October 2002 elections would also have lowered credit demand.

If these explanations hold, the latter half of Q2-FY03 should see a relative improvement in net credit to the private sector once expectations on the interest rates and political uncertainty stand resolved. This said, however, an increased element of self-financing is likely to keep net credit figures lower than the projections.

Export finance

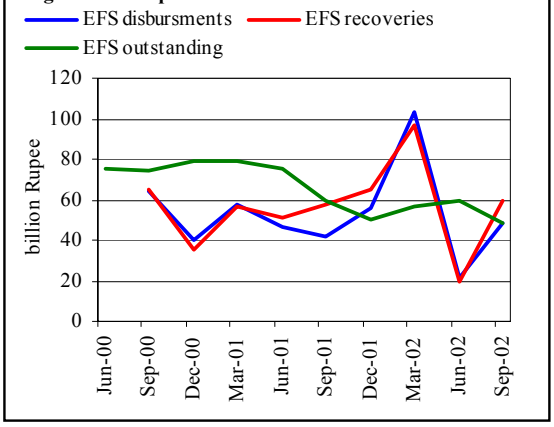
The lower net retirement of Rs 7.7 billion of export finance in Q1-FY03 compared to Rs 12.1 billion during Q1-FY02 largely reflects the impact of the ineligibility of cotton yarn and grey cloth for EFS financing in the earlier years.[36] In addition, it should be noted that *gross* lending figures have also gone up from Rs 41.6 billion in Q1-FY02 to Rs 48.7 billion in the first quarter this year. This appears to reflect a genuine increase in EFS demand; as the refinance rate has not changed since April 2002, it would seem that re-pricing of loans was not a significant factor in this improvement.

With regard to outstanding stock of export finance, an appreciated Rupee has resulted in a steady decline in its volume. This trend continued in Q1-FY03, as outstanding stock fell by Rs 10.9 billion (see **Figure 4.6**) and recoveries outpaced disbursements.

[36] The two commodities were again made eligible for EFS financing in January 2002.

Since Dollar lending is not only easily available, but also costs less than the EFS rate, export finance figures are likely to remain constrained, despite strong growth in exports.

Figure 4.6: Export Finance

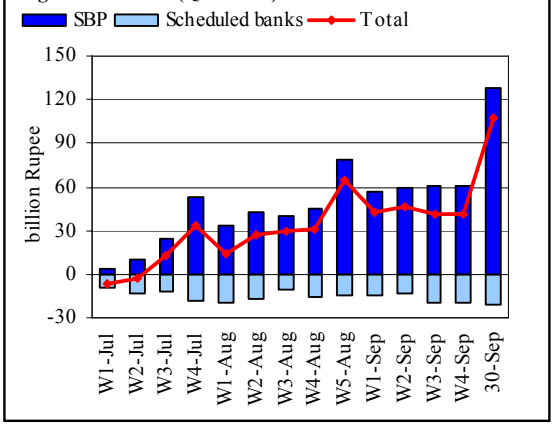


Specialized banks show lower credit growth in Q1-FY03 as compared to the same period last year (see **Table 4.1**). This is mainly due to lower credit demand by the agriculture sector (see **Section 2.1.3**) and improvement in recoveries by the ADBP. Other financial institutions show contraction of credit on account of: (1) closure of foreign currency swaps worth Rs 1.2 billion with Crescent Investment Bank, and (2) provisioning of bad and doubtful debt of SBP's investment in BEL (Rs 3.5 billion).

4.1.4 Net Foreign Assets (NFA)

NFA of the banking system has been steadily improving since October 2001; this trend continued in Q1-FY03 as well (see **Figure 4.7**).

Figure 4.7: NFA (Q1-FY03)



While NFA of SBP increased by Rs 127.9 billion, the NFA of scheduled bank decreased by Rs 20.7 billion. The increase in NFA of SBP was brought about by improvement in its reserves, which benefited both from SBP purchases (US$ 1.3 billion) and inflows from donor agencies (US$ 0.9 billion).

4.2 Money Supply

In overall terms, money supply increased by Rs 37.6 billion (2.1 percent) in Q1-FY03 as compared to a contraction of Rs 7.6 billion or *minus* 0.5 percent in the

same period last year. Since the first quarter is usually a period of subdued economic activity, particularly dominated by seasonal credit retirement, money supply usually shrinks or remains low during this period. However, this quarter was an exception, as the 2.1 percent growth in money supply is unprecedented in the last 10 years.

This growth would have been even greater, but the larger-than-expected expansion in NFA was mostly offset by more-than-expected contraction in NDA, leaving the money growth only a little higher than the target. Other than the net retirement of credit by the private sector, the government's retirement of SBP debt was the other major factor that constrained the growth of net domestic assets.

4.3 Reserve Money & Monetary Indicators

Despite a 65.5 percent rise in the SBP-NFA during Q1-FY03, reserve money declined marginally by 0.28 percent. This was largely due to (1) a massive sterilization of the NFA growth through the retirement of the SBP holdings of government paper, and (2) a supporting role attributable to a change in the accounting practice followed by SBP.[37]

Table 4.4 Monetary Indicators

	Q1-FY03	Q1-FY02
Currency to deposit ratio	0.32	0.34
Money multiplier	3.29	2.86
Deposit growth rate	3.92%	-1.40%
Deposit growth rate including RFCDs	3.85%	-1.15%
Growth in Currency in circulation	-0.18%	1.72%
SBP NFA growth	93.21%	-51.24%
RM growth	-0.28%	-0.42%
Growth in M2	2.14%	-0.46%

Also, both, the currency to deposit ratio and the money multiplier have improved since Q1-FY02 (see **Table 4.4**).

The currency to deposit ratio, which measures financial intermediation, improved due to both, a decline in currency in circulation and an increase in deposits. In Q1-FY02, post-September 11 event uncertainties had increased the preference for cash balances. This is evident from the increase in currency in circulation and decrease in deposits during Q1-FY02; this appears to be correcting now.

The rising trend in deposits post-September 11 continued in Q1-FY03. In the face of falling interest rates, this indicates limited investment options. As pointed out

[37] Up to 30-6-2002, employees retirement benefit fund was treated as other deposits with SBP and was part of reserve money. However from 1-7-2002, this account is being treated as other liabilities of SBP. Considering this adjustment of Rs 10.0 billion, reserve money growth comes out to be around 1.6 percent.

in earlier reports, the increase in deposits is essentially due to rising external sector inflows (primarily remittances).

5. Money Market

During the Q1-FY03, the interbank money market remained relatively liquid. The overnight rate averaged around 6.4 percent as compared to 8.3 percent in the corresponding period last year, but this statistic is a little deceptive given that the discount rate was lower in FY03. More relevant therefore is the fact that the market witnessed a fewer number of days when the overnight rate remained very close to SBP's discount rate compared with Q1-FY02 (22 days versus 33 days).[38] However, the volatility in overnight rates did not show any notable decline.

The expectations of a large interest rate cut persisted throughout the quarter, and were fueled by (1) the rising external sector inflows; and (2) the comments of the Finance Minister on the likelihood of lower interest rates.[39] Therefore, while the SBP held the benchmark 6-month T-bill yield unchanged at 6.4 percent throughout Q1-FY03 (see **Section 4)**, the strong expectations of a further decline persisted, as clearly captured by the lower 6-month rate in the secondary market (average 6.1 percent).

Demand for government securities was also considerably higher during Q1-FY03 as compared to the previous few quarters.[40] This was primarily due to ample liquidity inflows to the banks and their strategy to lock in the prevailing interest rates in anticipation of further decline.[41] An important consequence of this exceptional interest in government securities was that it permitted the sterilization of SBP interventions in the forex market without a rise in T-bill yields. However, since PIBs were not used to sterilize the SBP forex interventions, the yields on

[38] In Pakistan, the discount rate sets a ceiling for the secondary market repo rates. If secondary market rates are very close (no more than 5 percent below) to the discount rate, it is an indication that the market is short of liquidity, and vice versa. This is reflected in **Figure 5.3 –** on days when the market witnesses discounting, the overnight rate is almost at the level of the discount rate.

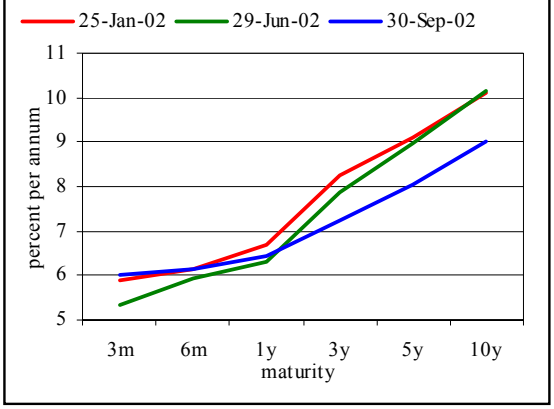
[39] Although the discount rate has been cut from 9 to 7.5 percent effective from November 18, this decision was primarily driven by decline in interest rates of US and other international competitors besides low domestic inflation.

[40] Although the demand for GOP securities had remained high since early FY02, there has been an exceptional surge in Q1-FY03.

[41] The sources of liquidity inflows are discussed in next section.

these long term instruments continued to decline during Q1-FY03.[42] The resulting flattening of the yield curve, at the longer end, is visible in **Figure 5.1.**[43]

Figure 5.1: Yield Curves



5.1 Discounting

In overall terms, during Q1-FY03 banks discounted Rs 144.1 billion against Rs 161.5 billion in the same period of the previous year (see **Table 5.1**). Notably, though the number of visits was lower, the average discounting per visit was much higher compared to Q1-FY02, i.e.

Table 5.1: Activity at Discount Window

billion Rupees

	No. of visit to discount window (no. of days)			Total amount of discounting			Average per visit		
	FY01	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**
July	3	11	8	29.8	75.2	94.2	9.9	6.8	11.8
August	8	12	2	44.0	38.9	9.5	5.5	3.2	4.7
September	9	16	6	64.9	47.4	40.5	7.2	3.0	6.7
Quarterly	**20**	**39**	**16**	**138.7**	**161.5**	**144.1**	**6.9**	**4.1**	**9.0**

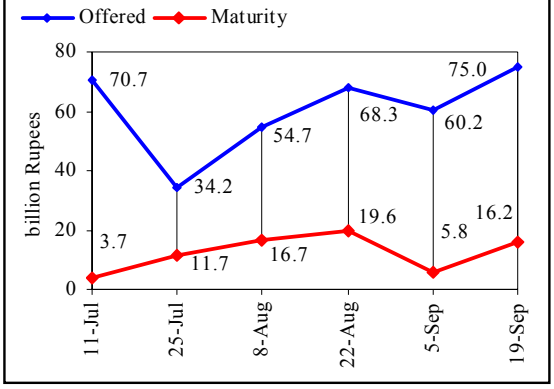
despite occasional liquidity shortage, banks required more support from SBP. This was because of over-bidding by banks in some auctions (anticipating lower interest rates) and hefty acceptances (sterilization) by SBP resulted in severe liquidity crunches for short periods until fresh inflows or SBP OMOs returned liquidity to the market (see **Figure 5.3**).

[42] In T-bill auctions, the SBP focused on the stability of rates and predominantly accepted funds in excess of the pre-auction targets. In the case of PIBs, the SBP adhered to the pre-auction targets, resulting in a decline in primary yields on PIBs of all tenors.

[43] A flattening of yield curve at the longer end may imply: (1) an expectation of lower inflation, and (2) the continuity of easy monetary policy in future.

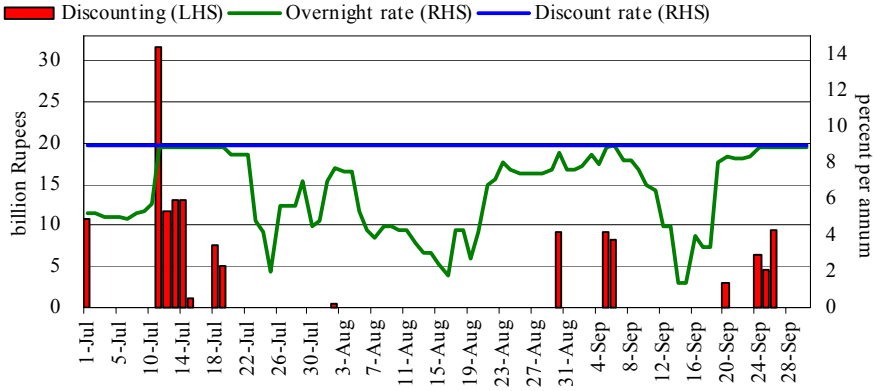
It must be noted that the amounts on offer in every Q1-FY03 auction were substantially higher than the maturing amounts (see **Figure 5.2**). However, this alone does not mean banks were overbidding in all auctions, it also reflects (1) the growth in bank deposits, and (2) weak credit demand for the private sector.

Figure 5.2: T-bill Amount Offered Vs Maturity



As discussed earlier, the liquidity conditions in the market remained comfortable throughout the quarter apart from a few episodes of discounting (see **Figure 5.3**). In the first instance, the market was short just after the July 11 auction in which SBP accepted a hefty Rs 69.3 billion against a maturity of a paltry Rs 3.7 billion. There was indeed a big component of overbidding which is clearly reflected in heavy discounting on the settlement date (Rs 31.7 billion). Although SBP re-liquefied the market through an OMO the very next day, the amount injected was not enough for the market to square itself.[44] Subsequently, a couple of more OMOs were needed to accommodate the market.

Figure 5.3: Discounting and Overnight Rates



[44] This was done deliberately to caution the market participants against indulging in overbidding for subsequent auctions. However, this approach proved ineffective.

In September 2002, the market was short on two occasions. On the first occasion, the shortage was due to overbidding in September 5 auction, and in the last week of the quarter, discounting was on account of tax payments, PIB auction and other end-quarter withdrawals.

The major sources of inflows in the market during Q1-FY03 were, (1) an unprecedented increase in banks' Rupee deposits, (2) retirement of private sector credit, commodity operations and export refinance, as well as (3) SBP forex purchases.

5.2 Open Market Operations

Since the beginning of FY02, the usual pressures on the forex markets have been absent, giving SBP a certain degree of leeway to improve the conduct of OMOs. Looking at **Table 5.2**, the change is evident in the two-way flow of funds during latter years. Specifically, during Q1-FY01 the mounting pressure on the exchange rate, following its complete float in the market, was mitigated through the tightening of money market liquidity. By contrast, in the first quarters of the last two years, OMOs were rather used pro-actively to smooth out market liquidity.

Table 5.2: Open Market Operations

billion Rupees

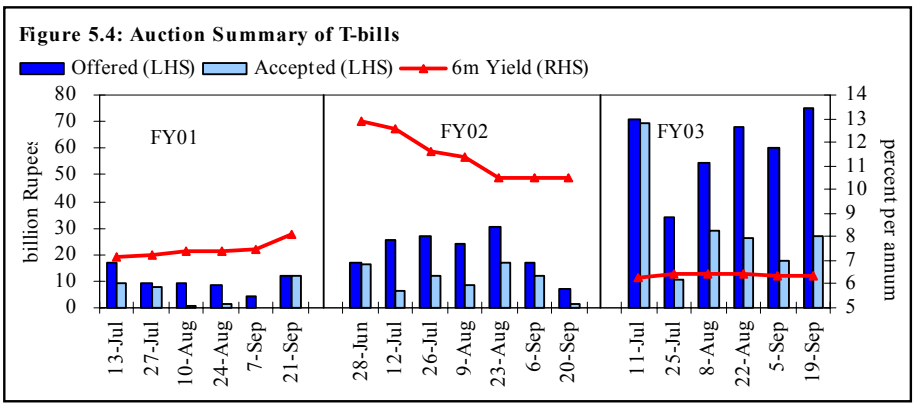
	Injection			Absorption		
	FY01	**FY02**	**FY03**	**FY01**	**FY02**	**FY03**
July	-	1.1	51.7	7.7	22.1	12.0
August	-	10.7	-	17.2	7.5	-
September	-	49.3	-	13.9	4.0	16.9
Total	**-**	**61.0**	**51.7**	**38.8**	**33.6**	**28.9**

Another significant development during the quarter was the inception of a 'swap window' by SBP early in September 2002. An active swap window provides SBP an additional facility to manage market liquidity in both the Rupee and forex markets. In addition, the swap window could help in sterilization of SBP forex market interventions.

5.3 Treasury Bills Auctions

The strong demand for T-bills seen in FY02 continued into Q1-FY03. Not only were banks expecting lower interest rates going forward, their appetite was further reinforced by the 4 percent year-to-date increase in deposits as well as the continued weakness in the private sector credit demand. In fact, the amount on offer in T-bill auctions was a stunning five times greater than the maturities.

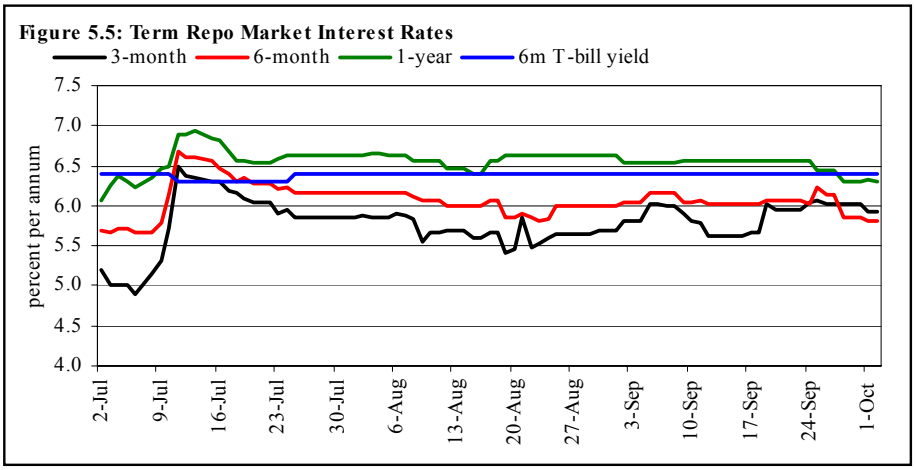
This enabled the government to post a massive increase in mobilizations, despite SBP holding interest rates unchanged at their all-time low (see **Figure 5.4**). The government mobilized Rs 179.8 billion, representing 49.5 percent of the offered



amount, from the primary auction of T-bills during Q1-FY03 compared to Rs 57.5 billion (44.1 percent of total bids) last year. The FY03 T-bill auction acceptances represented a 212.7 percent increase over the corresponding quarter of FY02. Since the government funding requirements had actually declined year-on-year basis, the increased borrowings were used to retire maturing SBP T-bills, effectively sterilizing the central bank's purchases in the forex market.

However, despite large acceptances in the T-bill auctions, the SBP was unable to change market expectations of lower interest rate, e.g. **Figure 5.5** shows that the 6-month term repo rates has consistently remained lower than the auctions yields. Furthermore, in all auctions held during the quarter, the bid pattern shows that on average 75 percent of the bids were cheaper than the prevailing T-bill rates, which were largely stagnant.

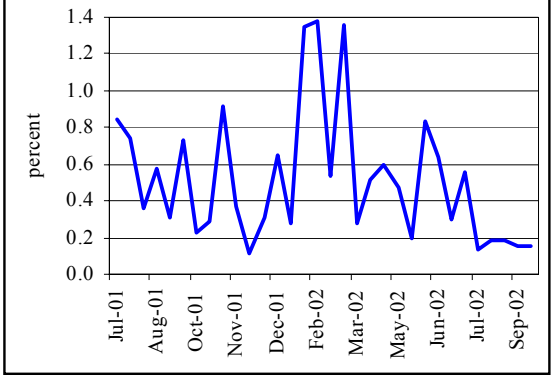
The SBP attempted to discourage the overbidding and stabilize rates in the very first T-bill auction by accepting almost all bids in every tenor, but it failed to



significantly change market expectations. Thus, in subsequent auctions the SBP tried to limit acceptances by rejecting all bids in some tenors.

SBP's perspective in doing so was primarily to stabilize rates without hampering system wide liquidity. But even this strategy proved shortsighted and counter productive, as banks predictably *increased* their bids in *all* tenors.[45]

Figure 5.6: Bid Spread (6m)



The change in the bid spreads in the primary auctions over the quarter is also interesting. As evident from **Figure 5.6,** FY02 saw considerable volatility, which peaked at the February 7 auction when the SBP finally acted to accept all bids to squelch the market's expectations for the rate cut. However, it was only a prolonged stability in auctions that eventually led to a tightening of the bid spread during Q1-FY03.

However, despite the tightening spread in the primary market, the secondary market continued to trade at lower yields. One possible explanation is that while the market accepted the possibility of near term stability in primary (auction) interest rates (and they continued to bid at the previous cut-offs to get the highest available yield), it was not convinced of the SBP's ability to sustain these yields (hence the lower yield in the secondary market).

5.4 Pakistan Investment Bonds Auctions

As shown in **Table 5.3**, overall Rs 19.8 billion were accepted out of the total bid amount of Rs 64.2 billion in Q1-FY03 in three successful auctions of PIBs compared with Rs 15.5 billion out of the total bid amount of Rs 49.3 billion in the corresponding period of last year.

[45] With effect from October 2002, the auctions for 6-month and 3 &12-month papers are held separately on alternate fortnights, in a bid to eliminate this distortion (EDMD Circular No. 17 dated October 11, 2002).

Table 5.3: Pakistan Investment Bonds Auctions - Summary of Results
billion Rupees

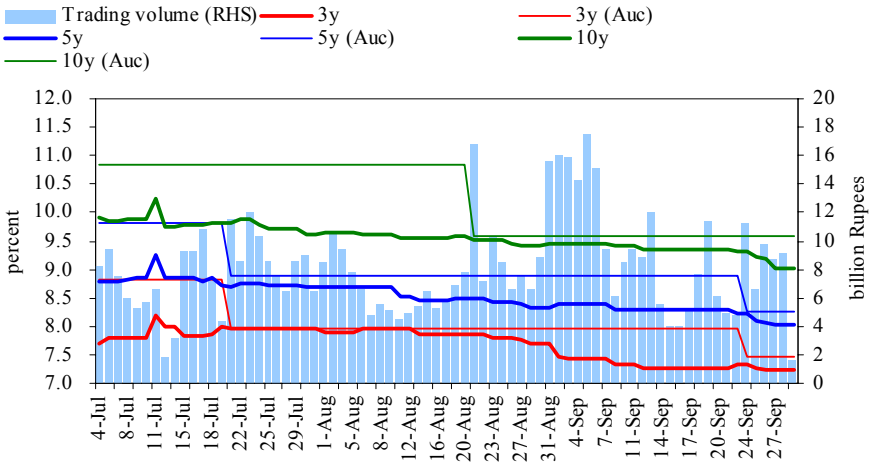
Auction	Tenor	Target	Coupon rate	Amount offered	Range of price offered/Rs. 100	Amount accepted	W. A. % p.a.
20th Jul 20, 02	3 Years		9.00%	3.79	103.60--100.52	1.56	7.9516
	5 Years		10.00%	13.92	104.55--100.00	3.52	8.8870
	10 Years		-		-	-	-
	Total	**5**	**-**	**17.7**	**-**	**5.08**	**-**
21st Aug 21, 02	3 Years		-	-	-	-	-
	5 Years		-	-	-	-	-
	10 Years		11.00%	24.0	109.25--101.50	8.0	9.5874
	Total	**8**	**-**	**24.0**	**-**	**7.96**	**-**
22nd Sep 24, 02	3 Years		9.00%	7.9	104.28--100.00	2.9	7.4644
	5 Years		10.00%	14.6	107.06--103.95	3.9	8.2633
	10 Years		-	-	-	-	-
	Total	**7**	**-**	**22.5**	**-**	**6.79**	**-**
Grand total	**-**	**20**	**-**	**64.2**	**-**	**19.8**	**-**

The popularity of PIB auctions can be judged from the level of over-bidding and amount of premium offered. Specifically, despite unchanged coupon rates, the premium increased in every successive auction. This was because, contrary to the practice in T-bill auctions, SBP strictly adhered to its pre-auction targets for PIB. As a result, since demand outstripped supply, yields of all PIBs dropped, flattening the upper end of the yield curve (see **Figure 5.1** and **5.7**).

This demand supply imbalance for PIBs needs some clarification. It must be remembered that the pre-auction targets for PIBs are set in consultation with PDs, in view of the market appetite of *non-banks* for these bonds (especially from institutional investors).[46] Since the *actual* market demand exceeded the pre-auction target, this shows that the banks had greater interest in PIBs, which proved to be the case during CY02 (see **Figure 5.8**). In fact, the growth in banks' PIB holdings may have been even larger if SBP had not warned the banks against this trend.

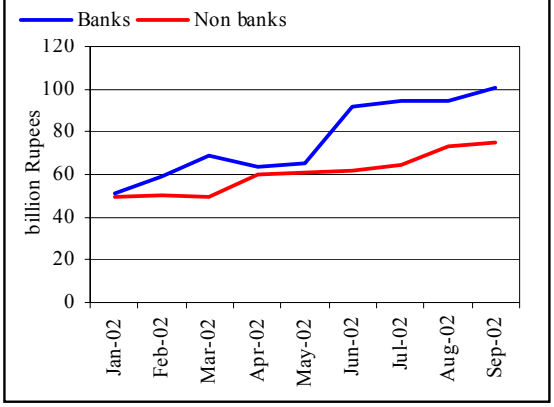
[46] The source of long-term funds is the maturing institutional investment in the NSS and FIBs, which is primarily indicated by the pre-auction target.

Figure 5.7: PIB's Market & Auction Yields and Trading Volume



It is worth noting also that in anticipation of SBP's adherence to the pre-auction target, PDs in particular, had the option to place their bids at lower yields and corner the market in order to ensure capital gains (prices in secondary market were invariably higher as the secondary market yields for the 3, 5 and 10-year bond were around 150 basis points lower than the respective coupon rates).

Figure 5.8: PIB Holdings



The considerable activity in the secondary market suggests that this was indeed happening. The trading volume shows a considerable increase in activity as average daily activity has risen from around Rs 5.2 billion (Jan-Jun 2002) to Rs 8.2 billion (Jul-Sep 2002).

6. The Banking Sector

The sharp up trend in deposits, seen November 2001 onwards, continued into Q1-FY03, and for much the same reasons; an increasing current account surplus matched by rising SBP purchases. As a result, aggregate banking sector deposits rose by an unprecedented 4.1 percent during Q1-FY03, in contrast to a decline of 0.6 percent in Q1-FY02 (when the exceptional external account flows were absent).

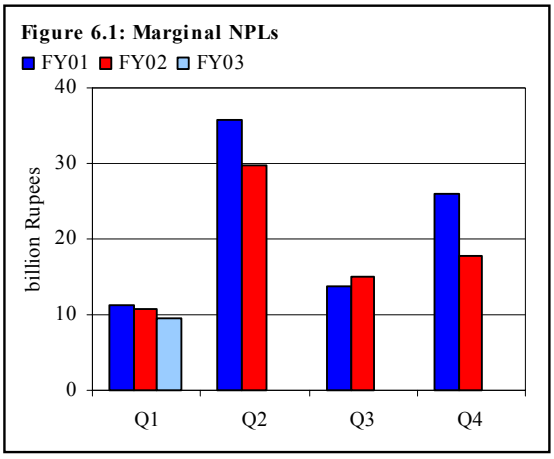
Table 6.1: Foreign Currency Loans During Q1

Cumulative flows

	FY02	FY03
Million US Dollar	10.6	215.0
Million Rupees	677.3	12,421.3

However, on the credit side, banks faced a substantial contraction in demand, despite falling lending rates (the weighted average rate dropped from 14.4 percent in June 2001 to 11.9 percent in September 2002). It should be noted that the first quarter of the fiscal year is generally a period of net credit retirement (low fresh disbursements and high seasonal retirements). Yet, the Q1-FY03 decrease in net credit growth was extraordinary (Rs 31.3 billion vs. Rs 8.9 billion in Q1-FY02). Interestingly, lending in foreign currency sharply increased by Rs 12.4 billion during Q1-FY03 (see **Table 6.1**).[47]

Figure 6.1: Marginal NPLs



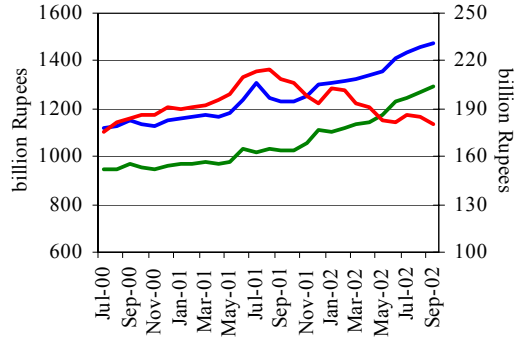
In terms of non-performing loans of the banking sector, the *net* NPLs showed a further decline of Rs 2.0 billion during Q1-FY03. It is worth noting that the improvement in banks' management, better regulatory framework and, to an extent, risk aversion on the part of banks have led to a significant reduction in the fresh NPLs (see **Figure 6.1**). Thus, the fall in the aggregate NPLs, despite a quarterly marginal increase, marks a particularly welcome Rs 11.6 billion reduction in the old stock of bad loans.

[47] The foreign currency loans, which started picking up during H2-FY02, are extended for trade purpose against FE-25 deposits.

6.1 Deposit Growth

As mentioned earlier, SBP's rising forex interventions underpinned the continuing growth in Rupee deposits of banks.[49] Consequently, as shown in **Table 6.2**, banking sector saw an increase of Rs 57.6 billion in deposits during Q1-FY03. This was in sharp contrast to falling deposits during the first quarter of the previous year.

Figure 6.2: Deposits of Scheduled Banks



Similar to trends in the last three quarters of FY02, the growth in Rupee deposits during Q1-FY03 again outstripped the increase in overall deposits (see **Table 6.2**). In contrast, the foreign currency deposit (FCD) base that was facing erosion post September, declined only in Rupee terms due to a lower exchange rate.[50]

Table 6.2: Deposit Growth During Q1

billion Rupees

	Local currency		Foreign currency		Total	
	FY02	**FY03**	**FY02**	**FY03**	**FY02**	**FY03**
Nationalized	0.0	14.8	1.7	6.2	1.8	21.0
Privatized	-4.7	6.4	0.6	-1.4	-4.2	5.0
Private	-0.7	37.7	0.7	-0.7	0.0	37.0
Foreign	0.0	0.4	-4.4	-5.4	-4.4	-5.1
Specialized	-1.1	-0.3	0.0	0.0	-1.1	-0.3
All	**-6.5**	**58.9**	**-1.4**	**-1.3**	**-7.9**	**57.6**
Adjustment for Emirates bank[48]						
Private	-0.7	28.5	0.7	-4.3	0.0	24.2
Foreign	0.0	9.5	-4.4	-1.8	-4.4	7.7

In Dollar terms, FCDs recorded a positive growth by US$ 23 million. Since, this rise is the upshot of one-time inflow ahead of payment for the purchase of the United Bank Limited, it is expected that FCDs would resume their downtrend in coming months.

[48] The adjustment is required for the merger of Emirates Bank (foreign bank) with Union Bank Limited (private sector bank) w.e.f. September 10, 2002.

[49] Higher foreign exchange inflows from official channel and SBP foreign currency purchases to restrain sharp appreciation of the Rupee resulted in a surge in banks' deposits (for detail see **SBP *Annual Report* FY02**). Specifically, during Q1-FY03, US$ 1.1 billion total remittances were recorded. Similarly around Rs 69 billion were injected in the interbank market on account of SBP (net) foreign exchange purchases, which were largely sterilized.

[50] The appreciation of Rupee since October 2001 and prevailing expectation for the same in future eroded the effective return on foreign currency holdings, and banks saw a continuous decline in FCDs. This erosion was clearly absent in Q1-FY03.

The institution-wise breakup shows that all groups other than specialized banks registered a significant positive growth in deposits compared to the same period previous year, with private banks accounting for almost half of the growth (see **Table 6.2**).[51]

Since the liberalization of the branch licensing policy by SBP in March 2001, the private banks have been aggressively expanding their networks. In fact, during Q1-FY03 alone, private banks opened 34 new branches. Moreover, the absence of NPL overhang allows these banks to offer relatively higher returns on deposits. On the other hand, despite non-competitive rates, nationalized banks were also able to record growth in deposits, mainly due to their large branch network.

6.2 Credit Growth[52]

The first quarter of the fiscal year is usually characterized by subdued economic activity, as the fresh lending remains low while repayments continue at a much faster rate. While, net credit posted a seasonal decline during Q1-FY03 as well, this was noticeably sharper compared to the first quarter of FY02 (see **Figure 6.3**). This major decline can be explained by both, higher retirements and the slowdown in fresh disbursements during the quarter (see **Figure 6.4**). However, it should be noted that fresh disbursement figures do not include the foreign currency advances (which grew rapidly since the beginning of CY02).

Figure 6.3: Net Credit -Cumulative Flows

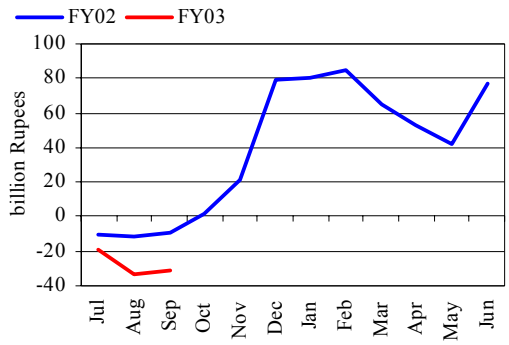
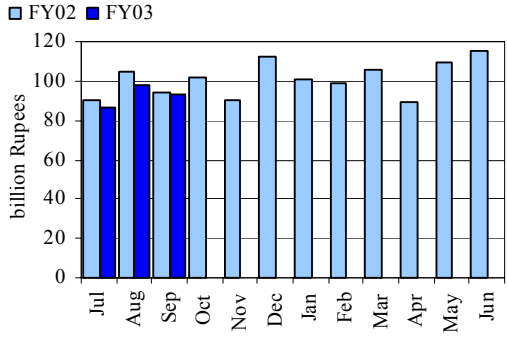


Figure 6.4: Credit Disbursement



[51] The outflow in foreign bank deposits is mainly due to the merger of Emirates bank with Union bank (see adjusted deposits in **Table 6.2**)

[52] For more meaningful analysis, net credit values in this section are adjusted for write-offs and deletions

Another source of concern is the fact that bank net credit even failed to respond to considerably lower lending rates.[53] More surprisingly, net credit demand was depressed during Q1-FY03 despite a substantial improvement in economic prospects over the previous year (see **Overview** of the Report).

This seeming failure in credit expansion by the banking sector may have several possible explanations. For instance, (1) low inflation since last couple of years;[54] (2) massive inflows of remittances and significant decline in opportunity cost of self-financing;[55] (3) alternative sources of financing such as capital markets and Non-bank Financial Institutions (NBFIs); (4) uncertainty about the new political setup and continuation of reforms by new government; (5) stringent prudential requirement, and (6) accountability drive (see **Section 4.1.3** on *Money and Credit*, for details).

Within the banking sector, nationalized banks saw the largest fall in net credit during Q1-FY03 against a marginal growth during the same period last year. With a slowdown in overall net credit demand, banks in this group failed to compete for market share. On the other hand, private banks showed improvement in both net credit and gross disbursement (see **Table 6.3**).

Table 6.3: Credit Growth During Q1
billion Rupees

	Net credit[1]		Disbursement	
	FY02	**FY03**	**FY02**	**FY03**
Nationalized	0.6	-20.7	76.7	69.5
Privatized	-9.7	-8.4	19.0	17.4
Private	-4.0	8.7	95.5	122.9
Foreign	-5.4	-12.7	90.0	60.9
Specialized	9.6	1.8	9.8	6.7
All	**-8.9**	**-31.3**	**291.0**	**277.5**
Adjustment for Emirates bank				
Private	-4.0	2.6	-	-
Foreign	-5.4	-6.6	-	-

[1]: Net credit figures are adjusted for write-offs and deletions against NPLs.

Focusing on private banks, relatively lower lending rates during most of Q1-FY03 helped these banks in extending higher credit (see **Table 6.4**). Similarly, the smaller spread between lending and deposit rates also attracted more credit demand from these banks. In terms of the latter point, since most borrowers generally borrow and keep deposits with the same bank, private banks that offer

[53] Weighted average lending rates declined from 14.0 percent in June 2001 to 12.0 in June 2002.
[54] Since Pakistan has been experiencing low inflation, with FY02 inflation rate being the lowest in the last 33 years, this could lead to a depressed credit demand in nominal terms.
[55] The effective return on NSS instruments and FCDs has historically remained considerably higher than the prevailing lending rates, thus raising the opportunity cost of self-financing to very high level. However, during the last one year, NSS rates have been substantially reduced and appreciation of the Rupee has eroded the effective return on FCDs.

lower gap between the lending and deposits rates, could be expected to attract more borrowers. In addition, it is generally observed that private banks are aggressive in expanding their client base. Most of the banks in this group created specialized marketing teams that are playing an important role in generating awareness among customers.

Table 6.4: Banking Spread
percent

	NCBs	Private banks
July		
W.A. lending rates	12.7	12.2
W.A. deposit rates	3.4	5.5
Spread	9.2	6.8
August		
W.A. lending rates	11.9	11.5
W.A. deposit rates	4.3	5.6
Spread	7.6	5.9
September		
W.A. lending rates	11.6	12.2
W.A. deposit rates	3.4	5.5
Spread	8.2	6.7

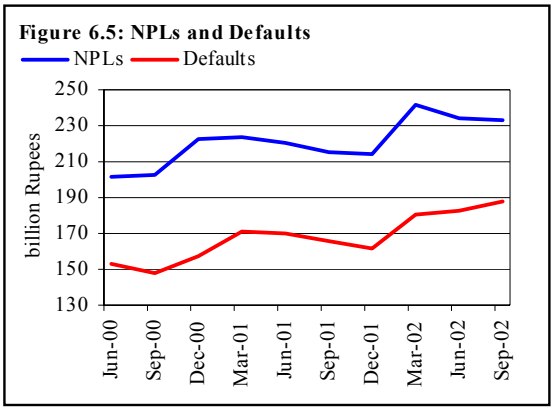
NCBs, on the other hand, are operating at much higher spreads, mainly because of their large infected portfolio, overstaffing, etc. Moreover, due to their larger share in NPLs of banking sector, NCBs have become more prudent in lending.

6.3 Non-performing Loans

An encouraging development during Q1-FY03 was a further decline in net NPLs of the banking sector by Rs 2.0 billion to Rs 232.6 billion.

Over the last two years, the focus on NPLs has increased considerably. In particular, a multi-pronged strategy has been adopted that consists of (1) a vigorous recovery by banks, (2) restructuring under Committee for Revival of Sick Industrial Units (CRSIU), (3) transfer and subsequent auction of loans by Corporate and Industrial Restructuring Corporation (CIRC), and (4) transfer of cases of willful defaulters to National Accountability Bureau (NAB).

Figure 6.5: NPLs and Defaults



Defaulted loans on the other hand recorded an upward trend, which is not a good sign (see **Figure 6.5**). However, when seen in relation to falling NPLs, it suggests that (1) new loans are of better quality; and (2) it is the historical loans that are causing a drag on banks' balance sheets.

In this regard, it is noted that a large portion of banking sector NPLs is rooted in aged loans, against which any meaningful recovery seems quite improbable. Also, even in cases where banks had already made substantial provisioning, they were unable to delete these loans from their books mainly due to lacuna in the judicial system. In order to address this issue, SBP has developed a new set of guidelines in consultation with banks and FPCCI.[56] It is expected that the guidelines will help banks (especially nationalized banks) in improving their financial health and concentrating on fresh lending. Furthermore, since NPLs are also contributing towards higher interest rate spread, the fall in NPLs should be reflected in lower spreads for banks.[57]

7. Prices

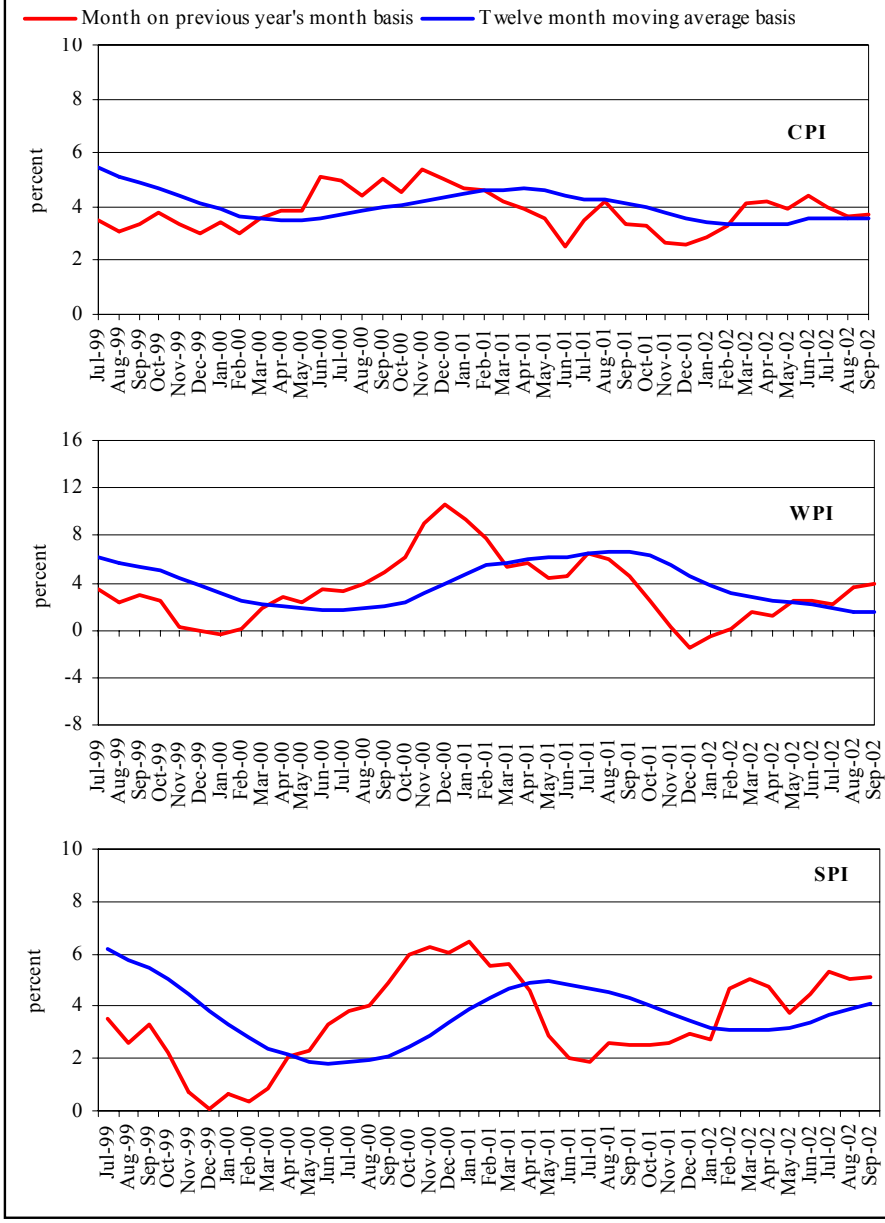
During Q1-FY03, the annualized rate of inflation has picked up slightly, with the pressure mainly coming from food items. Not surprisingly therefore, it is the SPI (which focuses on "kitchen" items) that depicted the strongest rise. The more broad-based (and therefore more representative) CPI registered a smaller increase. The WPI, by contrast, indicated a decline in inflationary pressures.

Since the marginal (month-on-month) inflation rates are all above (or around) the 12-month moving average, this would suggest that the annualized rate could rise further in coming months (see **Figure 7.1**). However, it is possible that the high food price inflation is a consequence of high fuel costs (transportation charges have a disproportionately strong bearing on food prices); if this is true, then prices could ease in coming months.

It must be noted that the variation in inflation reported by the three price indices is to be expected given that they differ in terms of commodity coverage, selection of units and relative weights assigned to various items. In particular, the WPI basket has not been updated by FBS, and it therefore continues to reflect price trends on the basis of wholesale market shares (weights) developed in 1990-91. The deceleration in the prices of manufactures, raw materials and building materials seems to be the other reason for slower growth of WPI, as these are not fully reflected in the CPI basket of commodities.

[56] For detail see BPD Circular No. 29 dated October 15, 2002.
[57] See special section on "*Long-run dynamics of interest rate spread and banking efficiency in Pakistan*" in SBP *Annual Report* for FY02.

Figure 7.1: 12-monthly Changes in Price Indices



7.1 Consumer Price Index

The annual average rate of inflation measured by the consumer price index was marginally higher in Q1-FY03 compared to the same period last year. However, unlike Q1-FY02 when higher prices of *non-food* items pushed up the CPI, the impetus for inflation during Q1-FY03 stems mainly from *food* items (see **Table 7.1**).

Table 7.1: Inflation Trends
Percent

	Cumulative		Annualized inflation			
	Jul-Sep		September		Jul-Sep	
	FY02	FY03	FY02	FY03	FY02	FY03
CPI	2.3	1.6	3.3	3.7	3.7	3.8
Food	3.1	3.1	1.4	4.9	1.5	5.1
Non-food	1.8	0.6	4.6	3.0	5.2	2.9
WPI	2.3	3.8	4.6	3.9	5.7	3.2
Food	3.4	3.7	1.6	3.6	1.5	3.2
Non-food	1.4	3.8	7.3	4.2	9.4	3.2
SPI	3.0	3.6	2.5	5.1	2.3	5.2

7.1.1 Food

The increase in the sub-index for *food* was mainly due to upward trends in the prices of food staples such as wheat, wheat flour, cooking oil/vegetable ghee, rice, eggs and onion. Prices of wheat flour, which usually follows the price trends in wheat grain, increased during Q1-FY03 over the corresponding period of last year, both at retail and wholesale levels.

The food inflation generally exhibits a seasonal pattern associated with the harvesting cycles of major crops. However, the increase in wheat and wheat flour prices despite sufficient stocks is unusual.[58] This seems to be the combined effect of hoarding by the private sector[59] as well as costlier transportation.

On the other hand, in the case of rice, supply shortages since last year's crop season gained strength due to purchases by exporters/stockists, resulting in higher prices. This price hike seems likely to continue until the arrival of a fresh crop.

The prices of ghee and cooking oil continued to escalate during the first quarter of the current fiscal year, partially reflecting higher prices of palm oil in world markets.[60] In addition, higher import duties on edible oil and the imposition of

[58] Although last year's production fell short of the target due to water shortages, the total availability of wheat stocks is estimated about 22.1 million tons against the total domestic requirements of 20.7 million tons for FY03.
[59] Improved availability of agri-credit led to an unusual surge in wheat prices (see **Section 2.1.1** "Steps taken by State Bank of Pakistan").
[60] The total domestic requirement of edible oil is around 1.9 million tons, of which only 30 percent is coming from the domestic production. Thus, every year a substantial foreign exchange is spent on the import of edible oils.

General Sales Tax on vegetable ghee/cooking oil contributed towards price increases.

Interestingly, the prices of onions went up despite considerable improvement in the domestic production. Since the price surge seems to be the result of a late arrival of the new crop in the market, it is expected that the fresh harvest would stabilize its prices in the months ahead.[61]

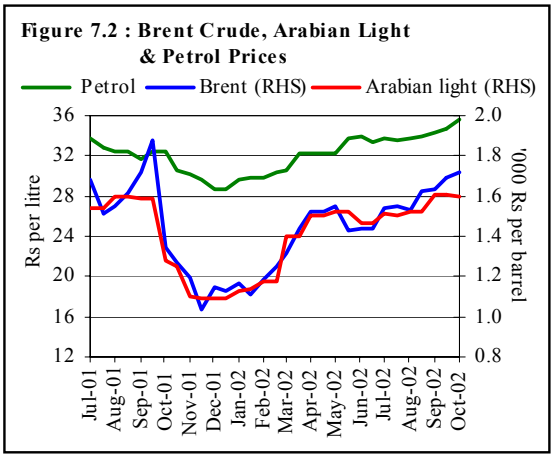
The prices of pulses remained relatively low on a year-on-year basis. The improved availability of the gram in the market was mainly due to better domestic production coupled with cheap imports that recorded quantum jump by 97.4 percent during the first quarter.

Milk is the most important food item of daily use having weight of 7.3 percent in CPI basket. Its prices remained stable mainly due to both, the improvement in domestic production, as well as the larger and cheaper imports of powdered milk. During the quarter, import unit value of milk and milk food fell by 30.1 percent.

7.1.2 Non-food

Non-food group in CPI posted an increase of 2.9 percent in the first quarter of FY03, against a 5.2 percent rise in the same period last year. Within the non-food group, *fuel & lighting* rose by 7.9 percent, *medicare* by 5.7 percent and *education* by 4.2 percent.

Figure 7.2 : Brent Crude, Arabian Light & Petrol Prices



The increase in *fuel & lighting* reflects the upward adjustment in domestic oil prices. During Q1-FY03, the petrol prices were revised upwards on five occasions, and downward only once. A similar behavior was seen in the prices of diesel oil.[62]

[61] The recent estimates by Federal Committee on Agriculture (FCA) show an improvement in the domestic production of onion (except in Sindh province).

[62] Effective from September 1, 2002, the government deregulated diesel prices. Accordingly, Oil Marketing Companies (OMCs), i.e. Pakistan State Oil, Shell Pakistan and Caltex Oil, were authorized to set high speed diesel prices. This decision will allow OMCs to evaluate their stocks

The hike in oil prices was partly explained by a steady rise in international crude oil prices. Both Brent and Arabian light have shown a rising trend amidst fluctuations during the period under review (see **Figure 7.2**).[63] Since the larger portion of domestic oil requirements are met through imports, the transmission of international prices has a significant impact on domestic prices. Furthermore, in the recent past, the government has raised the dealer and distributor margins.[64] Notably, the downward adjustment in the petroleum development levy by the government and the impact of exchange rate appreciation during Q1-FY03 could not completely mitigate the hike in domestic oil prices.

An associated development was the increase in the electricity tariff during September 2002, which is linked to the upward adjustment in the price of furnace oil – one of the basic inputs for thermal power generation.[65]

The prices of medicines also recorded an increase of 5.7 percent compared with 1.9 percent in the same period last year, reflecting the imposition of general sales tax on drugs. Since the GST on drugs was subsequently withdrawn in August 2002, it is expected that medicine prices would stabilize in coming months.

7.2 Wholesale Price Index

The wholesale prices during Q1-FY03 recorded lower increases as compared to last year. Since *non-food* group has larger weight in the index, falling prices in this category during the quarter offset the higher growth recorded in *food* group prices.

The breakdown of WPI by commodity groups indicates that *manufacturing* group (weight 25.53 percent) recorded a marginal increase of 0.2 percent during Q1-FY03 as compared to 5.0 percent last year. Similarly, *raw materials* and *building materials* sub-indices posted lower increases of 4.3 percent and 0.8 percent

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fortnightly in line with international prices, and manage delivery to respective refinery, depots and petrol pumps. On the other hand, consumers will also benefit from quality products at competitive prices.

[63] Because of the close geographical proximity to Middle East region, domestic oil prices are generally viewed in the context of movement in the Arab light crude.

[64] The adjustment mechanism for oil prices also includes dealer and company margin, which are determined by the government as a percentage of the fixed sale price. The margins for OMCs (2.0 percent) and dealers (3.0 percent) were revised in February 2002 to 3.0 percent and 3.5 percent respectively, and further to 3.5 percent and 4.0 percent respectively in July 2002.

[65] Out of the total electricity generation, the thermal electricity contributes around 70 percent, mostly by the private sector.

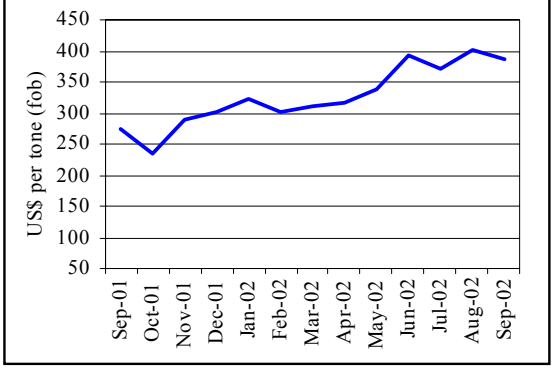
respectively over the preceding year's level. *Manufactures* and *raw materials* groups were seem to be partly affected by the lower prices of raw materials and manufactures in international market. Furthermore, the prices of *fuel, lighting & lubricants* increased by 6.2 compared to 16.4 percent last year.

7.2.1 Food

Within the *food group,* a significant rise was recorded in onion (123 percent), cooking oil (15.8 percent), eggs and rice (15.4 percent), and wheat (9.5 percent).

As mentioned earlier, the higher prices of palm oil in the world market (see **Figure 7.3**) and the fiscal measures announced in the Federal Budget 2002-2003 have led to an increase in the production cost of vegetable ghee and cooking oils.[66] However, keeping in view the likely fall in palm oil prices and the continued appreciation of the Rupee against the US dollar, it is expected that the hike in ghee and cooking oil would be contained.[67]

Figure 7.3: Palm Oil Prices



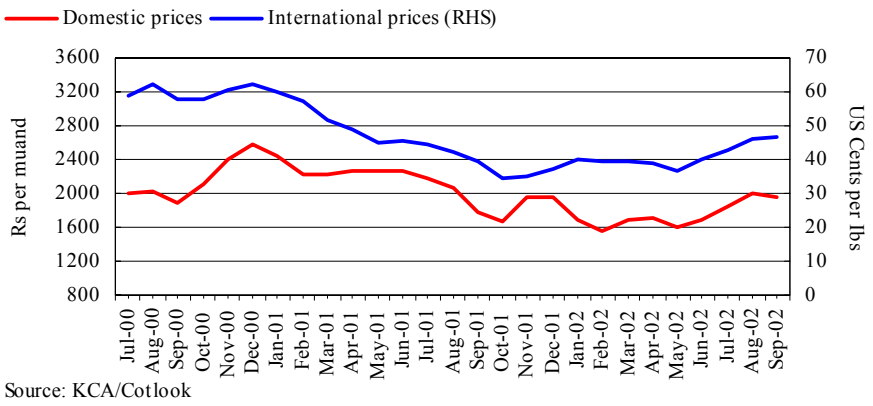
7.2.2 Non-food

The deceleration in *raw material* index was primarily on account of the lower wholesale prices of cotton, groundnut seed and pig iron. Although the cotton prices continued to rise since May 2002, on average, these were lower than the corresponding period of last year. A closer look reveals that during July-August, cotton prices continued to display a rising trend before stabilizing in September (see **Figure 7.4**). It seems that the improvement in cotton prices was due to active buying by spinners and Trading Corporation of Pakistan. However, with the arrival of fresh crop and a significant decline of 24.9 percent in the export unit value of raw cotton, the market prices would probably be depressed.

[66] In the Federal Budget 2002-2003, sales tax exemption was withdrawn on supplies of vegetable ghee and cooking oils, and tax rate on imported vegetable oils was increased from 15 percent to 20 percent. Similarly, imposition of GST and increase in the import duty on raw materials (used in manufacturing of these commodities) raised the cost of the product.

[67] Since the production of Malaysian palm oil is rising continuously since July 2002 and imports by the top buyer China and India have been lower, prices of palm oil would probably fall in near future (Source: The Public Ledger September 2002).

Figure 7.4: Domestic and International Lint Prices



Source: KCA/Cotlook

On the other hand, both Cotlook "A" and "B" Indices for cotton posted a modest improvement.[68] The improvement seems to be influenced by rising consumption in US, China, India and European countries. With global cotton consumption projected to grow by 3 percent, it is expected that international cotton prices would improve in coming months. This, in turn, may influence the domestic lint cotton prices as well.

In terms of manufactured products, prices fell for cotton yarn, blended yarn, nylon yarn, chemicals and papers. In particular, the slowdown in the international yarn market, and subsequent decline in export unit value of cotton yarn (9.4 percent) and hosiery (8.3 percent) seems to have depressed their prices.

The sub-index of *fuel, lighting & lubricants* grew by 6.2 percent compared with 16.4 percent last year. As discussed earlier, the impetus came mainly from the upsurge recorded in the prices of motor fuels and electricity. The prices of other items in the *non-food* group, i.e., coal, coke and firewood have either declined or remained pegged.

7.3 Sensitive Price Indicator

SPI covers prices of 51 essential consumer items of daily use, and generally act as lead indicator for food prices. This index was designed to evaluate the impact of

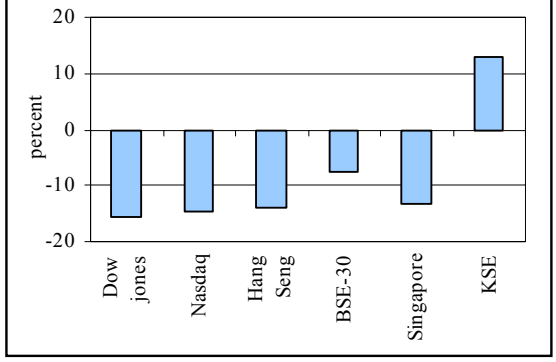
[68] The 'A' and 'B' indices are representative of the offering prices in the international raw cotton market. The 'A' index is the average of cheapest 5 quotations (out of 16) offered for the sale with medium and long staple 1-1/32". On the other hand, the 'B' index is an average of the cheapest 3 quotations (out of 8) principal upland cotton, i.e. of short staple less than 25 mm.

price changes on the living cost of the low-income groups. During Q1-FY03, SPI increased by 5.2 percent compared with 2.3 percent in the same period last year, showing a continuous rise at all point of times. This increase is attributed mainly to the higher prices registered by some of the essential items, i.e., wheat flour, cooking oil and ghee, meat, chicken, eggs, onion and kerosene oil.

8. Capital Market

The robust market rally that began in January 2002, and survived several non-economic shocks and disruptive market developments, continued into Q1-FY03 as well. In fact, Pakistan's benchmark stock market index, the KSE-100, rose 14.1 percent during the quarter, making it one of the better performing markets in the world, for the period (see **Figure 8.1**).

Figure 8.1: KSE & World Leading Markets - Q1-FY03



Not surprisingly, the average daily volume during the quarter jumped up by 88.7 percent (to reach at 110 million shares) relative to the corresponding period of FY02. The summary statistics of the market for the quarter are presented in **Table 8.1**.

Table 8.1: Highlights of KSE (as on September 30, 2002)

Rupees and stocks in billion

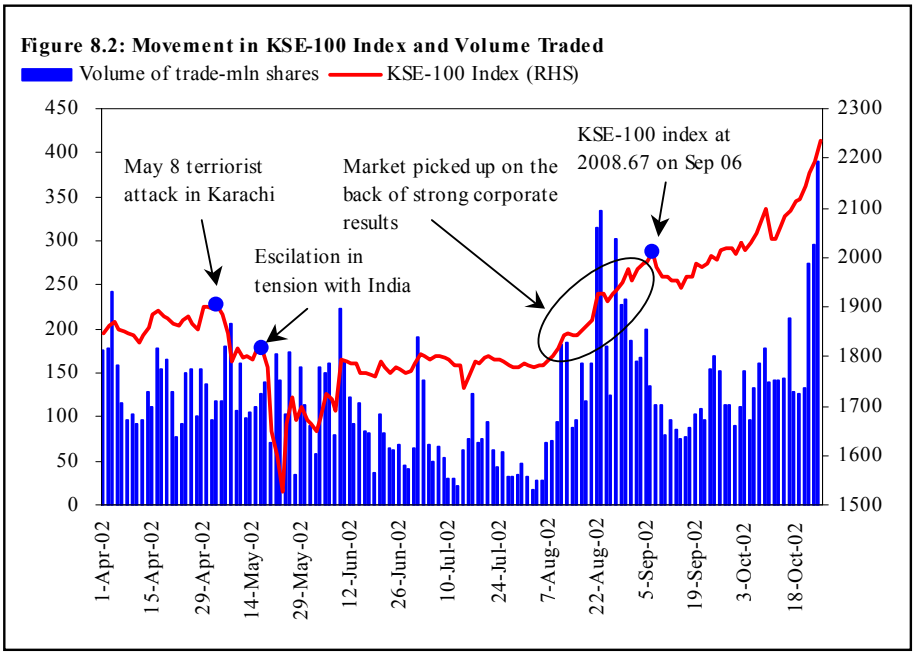
Listed companies at KSE	723
KSE-100 index	2018.8
Change since June 2002 (%)	14.1
Year on year (%)	78.1
Market Capitalization	458.3
Shares traded at KSE during quarter	7.2
Average daily volume of shares traded during quarter	0.11
Average turnover ratio for quarter	24.6

While there is little doubt that this strong performance of the KSE-100 index during CY02 is driven, at least in part, by a significant improvement in fundamentals such as rising corporate profitability, and a fall in yields on alternative investments; other factors such as the declining threat of a war with India, and more importantly, liquidity flows into the market, made important contributions to the rally.

The market began the quarter on a cautious note, with investors showing some jitters due to the tensions on the border with India, as well as a lack of interest by

financial institutions, which continued well into July 2002. As a result, the KSE-100 index, which started this quarter at 1785.14 points, hovered around this mark for rest of the month. The lack of enthusiasm is also captured in the daily trading volume, which averaged around 67 million shares — well below the eventual average of 110 million shares for the quarter (see **Figure 8.2**).

Figure 8.2: Movement in KSE-100 Index and Volume Traded



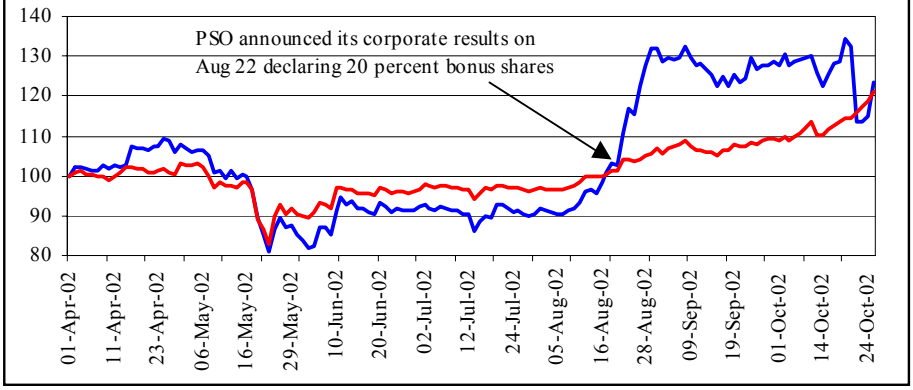
However, with interest rates expected to remain low, and the ample liquidity with market players, it was anticipated that the market would pick up on the back of the (expected) strong earnings of key corporates (the earnings announcements were due in August 2002).

This indeed proved to be the case. The KSE-100 index resumed its uptrend by second week of the August 2002 amidst rumors of strong corporate earnings by index heavyweights.[69] The dividend announced by the Pakistan State Oil (PSO) on August 22, 2002 (80 percent cash dividend and 20 percent bonus shares) was particularly important in propelling the index upwards.[70]

[69] Lever Brothers, Shell Pakistan, PSO, Adamjee Insurance, Hubco and PTCL announced strong corporate results during August and September 2002.
[70] PSO last announced such bonus payouts in FY99.

Historically, the bonus payouts[71] by PSO have been an important part of the overall return on the scrip. This is because contrary to theory, the increase in the shares outstanding led only to a temporary adjustment in its stock price[72]before rising again.[73] However, as PSO had not been announcing bonus payouts in recent years, the FY02 announcement was an unexpected plus for the market, as evident in the price reaction (see **Figure 8.3**).

Figure 8.3: PSO Vs. KSE-100 Index



This upward movement of the KSE-100 continued into early September and the index breached the crucial psychological barrier of 2000 points on September 6, 2002. However, market failed to sustain this level and lost 69.61 points in next six trading days. The investors' perception that index may not sustain itself above 2000 level proved self-fulfilling, triggering a liquidation of positions. However, the fact that volumes fell drastically during this period, suggests that investors still retained a bullish view on the market (see **Figure 8.4**).

In fact, subsequently, in the presence of strong fundamentals and a low interest rate environment, the bulls once again dominated the market. In short, the strong positive sentiments overpowered the negatives like uncertainty regarding the outcome of the election scheduled for October 2002.

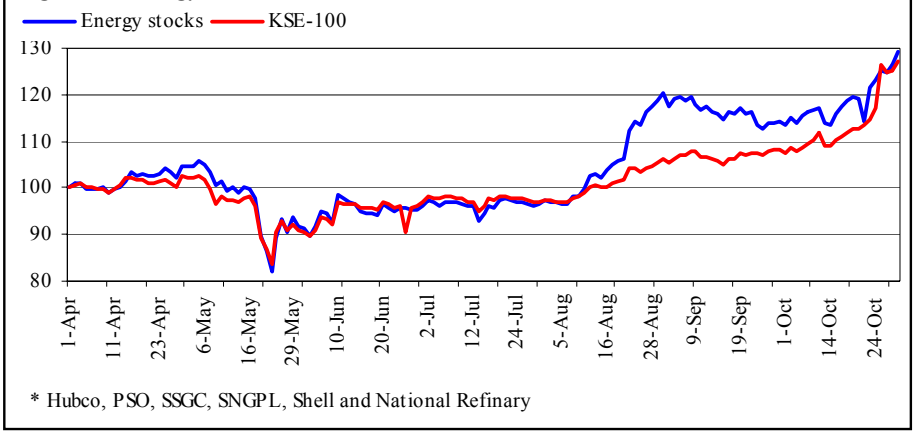
[71] Stock dividend.
[72] This would be expected since the increased number of shares held claim to unchanged earnings.
[73] Since bonus shares are issued against retained earnings, they do not add to the capital of the company. Any bonus issue will cause an increase in the equity holdings for the same amount of capital. In such circumstances, it is expected that share price would fall.

Figure 8.4: KSE-100 Index

This rally continued to persist through October 2002, and the announcement by the Indian government that it would pull back its troops from the borders, boosted these positive sentiments further. Although, investors were a bit nervous due to the unexpected results in the October 2002 elections, some reassuring statements helped relieve this initial anxiety.

A distinguishing element of the rally is the strong presence of energy stocks. This sector, which enjoys a 30 percent weight in the KSE-100, was one of the key drivers of the index during the period (see **Figure 8.5**):

Figure 8.5: Energy Sector* Vs. KSE-100

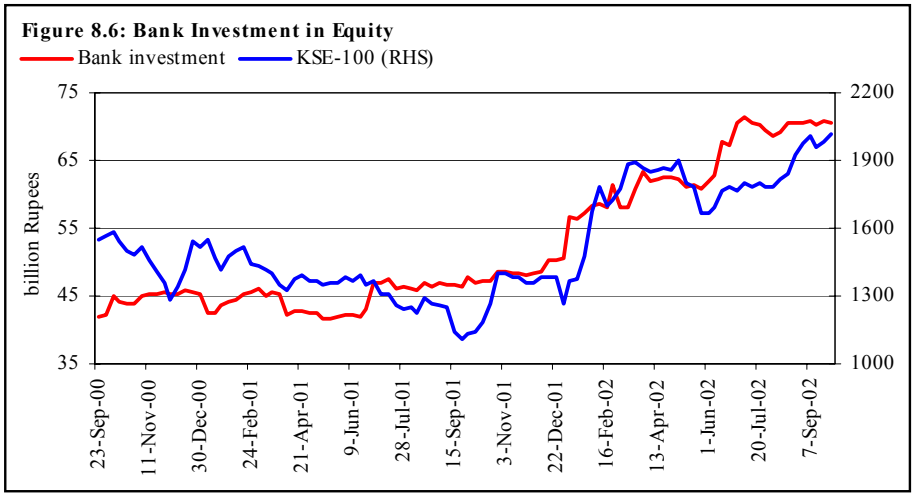


* Hubco, PSO, SSGC, SNGPL, Shell and National Refinary

- Firstly, the profitability of Oil Marketing Companies (OMC) had risen sharply following the liberalization of their margins in the previous fiscal year,[74] but due to the then-prevailing geo-political uncertainty, this change was earlier not fully incorporated in their stocks' prices. This was corrected in Q1-FY03.
- Secondly, PSO (with 7.50 percent weight in the index) remained especially attractive for investors due to reports of significant progress towards its privatization. It was thought that the management stake would be sold at a steep premium, which would also be reflected in the prevailing market price. Thus, speculative investment in the stock also rose sharply.
- Thirdly, energy sector stocks with stable cash flows (and returns) such as Hubco, Sui North, and Sui South benefited from the declining returns on alternate investments.[75]

Another feature is the strong influence of liquidity flows. As evident in **Figure 8.6,** banks' investment in securities mirrors the rise of the KSE-100. While this evidence is not conclusive (as it also includes some non-equity securities), it does strongly suggest that the two phenomenon are linked. Unfortunately, the lack of disaggregated data on the banks' investments, at this time, does not permit a more detailed analysis.

Figure 8.6: Bank Investment in Equity



[74] Available data reveals that profit after tax for this sector improved substantially.

[75] Since, the power generation company Hubco has earnings indexed to its costs, its scrip acts as a quasi-fixed-income instrument. Similarly, both gas utilities, Sui North and Sui South have earnings indexed to their operating assets. The prices of all three stocks thus see a rise when interest rates decline.

Other market developments

During the period under discussion several important market developments have taken place. In continuation with the policy of making the stock exchanges' functioning more transparent and efficient, the Securities and Exchange Commission of Pakistan (SECP) on August 13, 2002 and later on September 2, 2002 ordered some amendments in the Article of Association of the stock exchanges to address the sensitive issues, such as *conflict of interest* in the management of bourses. The salient features of this amendment are following:

- Five directors to be elected amongst the members by the general body of the exchange;
- Five non-member directors (including Managing Director) to be nominated and appointed by the SECP from professionals;
- The Chairman of the exchange shall be elected by the Board amongst the elected-member directors, whereas the managing director shall not participate in the election process, and;
- The position of Vice Chairman is to be abolished.

Another important development in the market is the implementation of "Undisclosed Trading System". On October 7, 2002, KSE launched this trading system where the identity of the buyer and seller are not disclosed. This is aimed at discouraging a "herd" culture where small investors try to mirror the activities of larger players in hopes of speculative gains rather than investing on the basis of stock fundamentals.

Corporate Debt Market

Like the equity market, the corporate debt market also remained buoyant during the first quarter of FY03. Since the start of the current fiscal year, the outstanding amount of corporate debt rose to approximately Rs 23.5 billion with the issuance of nine new instruments worth Rs 5.3 billion (see **Table 8.2**). An important feature of the TFC issues is their coupon arrangement. Almost all new issues in the last two years have floating interest rate structure with a ceiling and a floor. This arrangement protects both issuers and buyers from any sudden movement in the interest rates.

Interestingly, some of these instruments are anchored to the PIBs and rest are linked with SBP discount rate, with the latter being predominant. With no expectation for interest rates to rise, many issuers are poised for fresh issuances to lock-in long term capital at unprecedented low rates.

Table 8.2: Corporate Debt (issues since July 03)
million Rupees

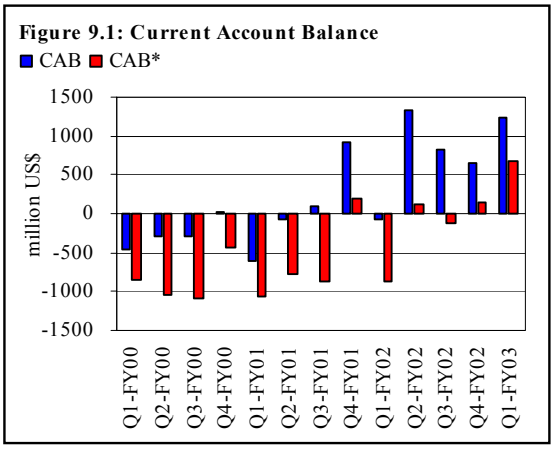
Security	Issue Date	Maturity	Issue Size	Coupon Rate
ENGRO CHEMICAL 2	4-Jul-02	4-Jul-07	1000	Weighted average last 3 cut off 5 year PIB + 1.15%, Floor 11%, Ceiling 15%
MAPLE LEAF CEMENT	18-Jul-02	18-Jul-06	225	5 Years PIB Rate + 2.50%, Floor 15.25%, Ceiling 17.75%
DAWOOD LEASING 2	25-Jul-02	25-Jul-07	250	DR + 1.75% Floor 12.25%, Ceiling 16.25%
ORIX LEASING 2	29-Jul-02	29-Jul-06	710	DR + 2, Floor 10%, Ceiling 13%
MCB	8-Aug-02	8-Feb-07	1600	5 years PIB cut off yield + 1.50%, Floor 11.75%, Ceiling 15.75%
CRESCENT LEASING 2	4-Sep-02	4-Sep-07	250	Base Rate+ 2% p.a. Floor at 12.25% and cap of 15.75% where base rate is the cut-off yield on the last successful SBP auction of 5-year PIBs.
WORLD CALL	30-Sep-02	30-Sep-07	350	DR + 1.75% Floor 12.25%, Cap 16.25%
SHAKARGANJ MILLS 2	Sep-02	Sep-02	200	DR+200bps Floor 12.25%, Cap 15.75%
QUETTA TEXTILE MILLS	24-Oct-02	24-Oct-07	750	DR +2.50%, Floor 13%, Cap 18%

9. External Sector

Balance of Payments[76]

The external sector improvement visible during FY02, gained further momentum in Q1-FY03, with an exceptional growth in workers' remittances being augmented by stronger exports, a smaller services account deficit and larger net capital inflows. What is more

Figure 9.1: Current Account Balance



[76] 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 9.1: Balance of Payments- Summary
million US Dollars

	Jul-Sep		
	FY01	**FY02**	**FY03**
1. Trade balance	**-568**	**-209**	**-164**
Exports(fob)	2,135	2,203	2,606
Imports (fob)	2,703	2,412	2,770
2. Services (net)	**-884**	**-830**	**-220**
Shipment	-213	-194	-209
Other transportation	18	-8	45
Travel	-28	-35	-14
Investment income	-653	-583	-507
Interest payments	-483	-386	-267
Profit and dividend	-170	-197	-240
Other goods, services, & income	-8	-10	465
Of which: Logistics			***317***
3. Current transfers (net)	**971**	**970**	**1,611**
a) Private transfers -net	707	772	1,339
i) Workers' remittances	366	340	1,053
ii) FCA (residents)	76	21	154
iii) Outright purchases	227	398	0
b) Official transfers	264	198	272
of which: Saudi oil facility	215	173	189
4. Current account balance (1+2+3)	**-481**	**-69**	**1,227**
5. Capital account (net)	**-441**	**-587**	**-67**
6. Errors & omissions	**43**	**361**	**272**
7. Overall balance	**-879**	**-295**	**1,432**
8. Financing	**879**	**295**	**-1,432**
I. Changes in reserves (-Inc/+Dec)	**303**	**80**	**-1,687**
Assets	366	-140	-1,713
SDRs	0	2	-3
Forex (State Bank of Pakistan)	320	-45	-1,587
Forex (Commercial banks)	46	-97	-123
Liabilities	-63	220	26
Use of Fund credit	-63	220	26
Repurchases	0	267	115
Purchases/drawings	-63	-47	-89
II. Exceptional financing	**584**	**215**	**253**
SBP reserves	1,034	2,134	6,400

Source: State Bank Of Pakistan

encouraging is the fact that the current account surplus increased despite the absence (or substantially lower contribution) of many factors that improved the FY02 outcome. As can be seen in **Figure 9.1**, in contrast to the FY02 position, the Q1-FY03 current account balance (CAB*) is substantially positive even after adjusting for these one-time factors, i.e., Saudi Oil Facility (SOF), kerb purchase, US aid and payments against logistic support.

In fact, both the current and the capital accounts demonstrated marked improvement during the first quarter of FY03 (see **Table 9.1**), underpinning a gradual appreciation of the Rupee. The unprecedented current account surplus, coupled with the sharp reduction in capital outflows, allowed SBP to build up its foreign exchange reserves to US$ 6.4 billion at end-September 2002 through increased purchases from the interbank forex market. As during most of FY02, these interventions by the SBP were instrumental in moderating the ascent of the Rupee, thus protecting exporters from too abrupt a shift in the exchange rate.

9.1 Current Account

The current account registered a surplus of US$ 1.2 billion during Q1-FY03 relative to a deficit of US$ 69 million over the corresponding period last year (see **Table 9.1**), largely reflecting the paradigm shift in Pakistan's external account post-September 11. Thus, a straightforward comparison of the corresponding periods of FY02 and FY03 may not be very meaningful. It is more useful therefore, to compare the broad aggregates of Q1-FY03 with the overall structure of current account flows in previous year.

As in FY02, the Q1-FY03 improvement in the current account balance is broad-based; the trade deficit declined, services account witnessed lower outflows and current transfers continued to surge (see **Table 9.1**). However, there are still significant differences in the FY03 performance.

Notably, while the trade deficit has narrowed, unlike FY02, the Q1-FY03 improvement is led by *rising exports,* rather than falling imports. Impressively, the above-target growth in exports has more than offset the impact of a sharp *jump* in imports. Similarly, the outflow on the services account deficit fell by 74 percent in Q1-FY03 over the same period last year, mainly on the back of receipts for logistics support to US forces and a decline in *interest payments* on external debt. Finally, the Q1-FY03 transfer (net) receipts surged 66.1 percent mainly due to a spectacular rise in workers' remittances, despite an *absence of kerb market forex purchases* (which contributed 41 percent of Q1-FY02 transfers).

9.1.1 Trade Balance

According to exchange data, the trade deficit during Q1-FY03 contracted by US$ 45 million (21.5 percent) over the corresponding period last year to reach US$ 164 million on the back of a strong surge in exports that offset the rising imports (for details, see section on **Trade Account**).

Table 9.2: Details of Profit and Dividend

million US Dollars

	Q1-FY02	Q1-FY03
Profit & dividend	**197.0**	**240.0**
Profit	14.3	24.9
Dividend	72.9	91.4
Purchase of crude oil	93.0	91.9
Export of crude oil	*64.0*	*73.9*
Remittances	*29.0*	*18.0*
Reinvested earnings	16.8	31.8

9.1.2 Services (Net)

The services account posted a sharp contraction in outflows during Q1-FY03 relative to the corresponding period of FY02, despite higher *shipment* charges (due to the rising trade volume) and greater outward remittance of *profit & dividend* (detailed in **Table 9.2**).

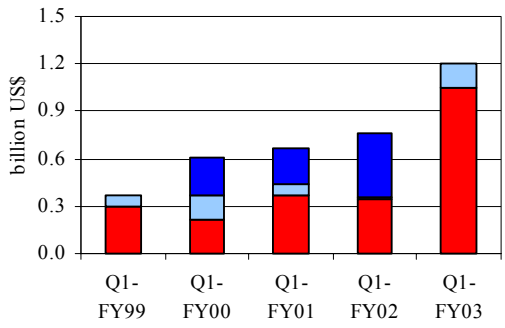
The main contributors to the improvement were the receipts of US$ 317 million for logistic support to the US and higher receipts by PTCL;[77] the two accounted for approximately 69 percent of the improvement in the Q1-FY03 services account.

Furthermore, the falling stock of Special US Dollar Bonds, FE-45 deposits, and commercial & private loans/credit, coupled with lower international interest rates (LIBOR) have led to the reduction in interest payments on external debt and liabilities.

9.1.3 Transfers

Private transfers surged as workers' remittances tripled to a record US$ 1.05 billion during Q1-FY03, up by a massive US$ 713 million over the corresponding period of the preceding year. This rise was aided by a significant increase in resident's FCAs and *official transfers*. As a

Figure 9.2: Composition of Private Transfers



[77] PTCL – Pakistan Telecommunications Corporation Limited is the monopoly in fixed line telephone utility that has substantial forex earnings from incoming calls.

Table 9.3: Country-wise Workers' Remittances (July-September)
million US Dollars

	Inflows (July-September)			Share (July-September)			Change in Q1-FY03 over Q1-FY02	
	FY01	FY02	FY03	FY01	FY02	FY03	Absolute	Percentage
Gulf	**275**	**216**	**514**	78.4	66.5	49.2	**297**	**137**
Bahrain	7	7	16	2.1	2.1	1.5	9	130
Kuwait	70	13	47	20.1	3.9	4.5	34	272
Qatar	4	4	16	1.2	1.1	1.6	13	338
Saudi Arabia	102	85	151	29.1	26.2	14.5	66	77
Sultanat-e-Oman	11	11	21	3.1	3.4	2.0	10	96
U.A.E.	80	97	262	22.9	29.8	25.2	165	170
Other than Gulf	**76**	**109**	**530**	**21.6**	**33.5**	**50.8**	**420**	**385**
Canada	1	2	3	0.3	0.7	0.3	0	14
Germany	3	2	5	0.8	0.7	0.4	2	86
Japan	1	1	2	0.2	0.3	0.2	1	59
Norway	2	2	2	0.5	0.5	0.2	0	30
U.K.	21	23	57	5.9	7.0	5.5	35	153
U.S.A.	29	50	330	8.2	15.4	31.7	280	559
Others	20	29	131	5.6	8.9	12.6	102	353
Total	**351**	**325**	**1043**	**100.0**	**100.0**	**100.0**	**718**	**221**
Encashment FEBCs & FCBCs	15	15	10				-5	-33
Grand total	**366**	**340**	**1053**				**713**	**210**
Growth rate (%)	*74*	*-7*	*221*					
Growth rate (excluding HSS & KWA)	*16*	*15*	*251*					

HSS: Hajj Sponsorship Scheme; KWA: Kuwait War Affectees

Source: State Bank of Pakistan

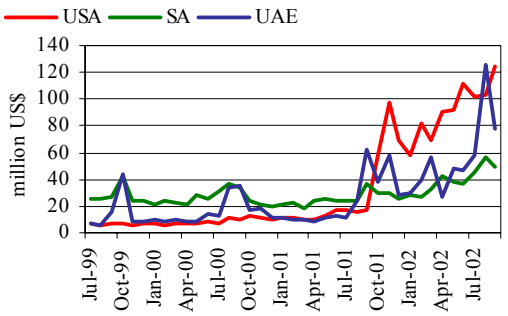
result, the overall Q1-FY03 transfers jumped by US$ 641 million relative to Q1-FY02, despite the halt to SBP forex purchases from the kerb market (see **Figure 9.2**).

Workers' remittances

Workers' remittances (cash) registered an extraordinary growth of 221 percent (US$ 1.05 billion) during Q1-FY03 compared to the corresponding quarter last year (US$ 340 million) (see **Table 9.3**). Excluding inflows on the account of Hajj Sponsorship Scheme (HSS) and Kuwait War Affectees (KWA), the growth is even more pronounced (251 percent).

While remittances have increased from all countries where expatriate Pakistanis reside, the inflows from UAE (170 percent) and US (559 percent) are phenomenal (see **Table 9.3** & **Figure 9.3**). Also, encouraging is the rise of 77 percent in workers' remittances from Saudi Arabia. Earlier, remittances from this country had not been proportional to the community of Pakistani expatriates **(Figure 9.3)**.[78]

Figure 9.3: Workers' Remittances from UAE, USA and Saudi Arabia



A look at the share composition of workers' remittances is also instructive. The share of remittances from USA has doubled to 31.7 percent, making it the largest contributor in total remittances. At the same time, while remittances from UAE have almost tripled when compared with last year, their share has declined over the same period. Similarly for Saudi Arabia, the share has declined despite a rise in remittances.

Table 9.4: Composition of Private Transfers (net)

million US Dollars

Annual	FY01	FY02	Change
Total	3,898	4,249	351
Workers' remittances	1,087	2,390	1,303
FCA (residents)	534	285	-249
Outright purchases	2,157	1,376	-781

Quarterly	Q1-FY02	Q1-FY03	Change
Total	759	1,207	448
Workers' remittances	340	1,053	713
FCA (residents)	21	154	133
Outright purchases	398	0	-398

Stepping back a bit, it is clear that the structure of current transfers has changed markedly after September 2001 due to the surge in remittances. This was not very visible for the entire FY02, as the increase in remittances is marginally higher than the fall in resident FCAs and SBP kerb purchases, suggesting a mere transfer of flows from the kerb to the formal market. However, this explanation clearly does not hold in Q1-FY03 (see **Table 9.4**).

[78] From total 3.5 million expatriate Pakistani workers, approximately 1.5 million are residing in Saudi Arabia followed by UAE with 0.5 million etc. (Source: Bureau of Immigration and Overseas Employment).

One explanation repeatedly put forward for the increase in remittances post-September 11, is the "reverse flight" of capital to Pakistan, i.e., expatriate Pakistanis are bringing back capital that had been earlier spirited out through the informal market. This theory would help explain the rise in asset prices in recent months, e.g. the meteoric rise of the stock market, the increase in real estate prices, higher consumer durable sales, etc. If true, this would also suggest that the remittance inflows over and above the historical levels of private transfers of US$ 3.5-3.8 billion annually could eventually taper off.

However, an interesting alternative explanation is that informal market *inflows* have not changed as much as the *outflows*, i.e., the capital flight has also been curtailed due to the increased scrutiny of international fund flows. In other words, pre-September 11, high informal sector inflows would have been partially offset by capital flight. Now that (1) forex assets were no longer attractive (due to the stability of the Rupee); (2) the cost of whitening money through remittances is lower (the kerb market premium has disappeared); (3) undocumented investments abroad attract greater scrutiny and risk; this outflow may have been greatly staunched, leaving more capital for investment domestically (hence the rise in asset prices). Under this explanation, the high remittances flows could continue, (and even increase).

At this time, it is unclear, which trend is dominant, but if the inflows continue apace, the second explanation will gain more credence.

Resident FCAs

Despite the appreciation of Rupee/Dollar parity by 1.5 percent during Q1-FY03, the resident FCAs saw a significant increase from US$ 21 million during Q1-FY02 to US$ 154 million over the corresponding period this year. This sharp rise in FCAs, however, is not an indication of *dollarization* of bank deposits. Instead, following two reasons explain this abrupt change: (1) the sharp increase in FCAs in Q1-FY03 is due to the large inflows from UAE on account of the payment for UBL.[79] (2) in Q1-FY02, FCA deposits declined sharply post September 11, pushing down the net inflows for the quarter (giving rise to a 'base' effect, relative to Q1-FY03).

Official Transfers

Inflows under official transfers also increased by US$ 74 million during Q1-FY03 over the corresponding period last year, mainly due to grants from Saudi Arabia

[79] This large inflow deflated during October 2002 when payment was made to the government.

and the higher valuation of the SOF due to rising oil prices in the international market.

9.2 Trade Account

As of July 2002, the Federal Bureau of Statistics (FBS) has switched to 'Harmonized Commodity Description and Coding System' 2002 version (HS02) for the compilation of trade statistics. Previously, FBS was maintaining data on the basis of Standard International Trade Classification (SITC) 3rd Revision.

Since trade data for previous years cannot be converted to the new system, FBS has provided trade data for the current year only (see **Box 9.1**). Despite this limitation, the commodity groups reported under new system are broadly similar to those reported under SITC. But it should be noted that some of the items comprising these groups might not be exactly comparable due to variation in their description.

Box 9.1: Commodity Classifications SITC and HS

In order to promote international comparability of trade statistics, the United Nation had recommended Standard International Trade Classification (SITC) to all countries for their external trade data. These standards were revised/updated regularly, with 3rd Revision made in 1988.

On the basis of these classifications, the Statistical Commission of the United Nations had been maintaining a Commodity and Trade (COMTRADE) database since 1962 for almost every country in the world. However, in 1995 the commission recommended to add the Harmonized System (HS) classification to the COMTRADE database system.

The HS classification is maintained by the World Customs Organization and is considerably more detailed than the SITC. The new system makes it possible to combine/compare data that have been collected for different populations, for different periods and/of by different data collection methods or statistical units.

Currently most data are reported to United Nation Statistical Division (UNSD) according to the HS classification (1996 version) but countries have now started switching to the new 2002 version (HS02). While these standards enforce consistency across different data sets, the frequent revisions make the data collected on the basis of old definitions *non-comparable* with that collected on new definitions. It is not always possible to accurately convert data from SITC to HS, nor is it possible to convert data from an older to a newer revision of a given classification.

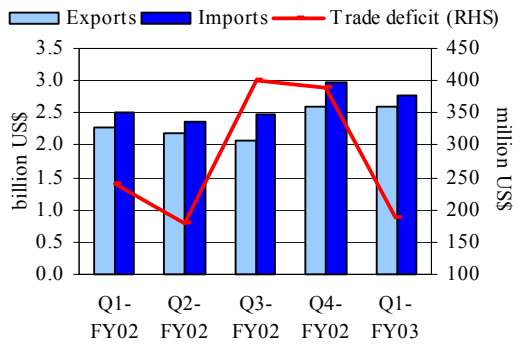
With this qualification, the Q1-FY03 trade statistics depict an encouraging continuation of the H2-FY02 trend improvement in exports. As a result, the trade deficit for the quarter was squeezed to US$ 188 million, 21.3 percent lower than in the corresponding period of FY02 (see **Figure 9.4**).

Impressively, unlike much of FY02, the reduction in the Q1-FY03 trade deficit was achieved in the face of a robust growth in imports, with a 10.9 percent (US$

272.7 million) YoY growth in the latter being outweighed by a stronger 14.3 percent (US$ 323.9 million) YoY rise in exports.

Also, while textile exports continue to dominate the export profile, an encouraging development is the increasing share of high value-added textile products. Finally, even the sharp rise in imports is not unwelcome, given that machinery imports accounted for over half of the overall increase during the quarter, suggesting growing industrial activity in the country.

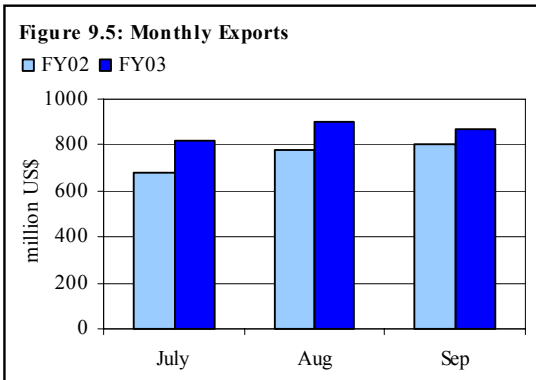
Figure 9.4: Trade Account



9.2.1 Exports

The Q1-FY03 export growth is creditable indeed as the exports are well above the Q1-FY02 levels, with export receipts for the period totaling to US$2.58 billion (see **Figure 9.5** & **Table 9.5**).

Figure 9.5: Monthly Exports



In absolute terms, monthly exports never dipped below US$ 800 million during Q1-FY03 – this is Pakistan's best-ever export performance during the first quarter of a fiscal year.

Creditably, this has been achieved despite the continuing strength of the Rupee, which appreciated 8.3 percent during October 2001 to September 2002. It is worth mentioning that while the Rupee remained steady during H2-FY02 (when orders for the Q1-FY03 exports would typically have been placed), exporters would have nonetheless incorporated a stronger Rupee into their costing when competing for orders. Some exporters would, however, have been able to hedge

Table 9.5: Major Exports
Value: US$ million, Unit value: US$

			Q1-FY03		Q1-FY02			% Change in Q1-FY03 over Q1-FY02		
		Unit	Value	Unit value	Value	Unit value	Abs chg. In value	Qty	Value	Unit value
A.	**Primary commodities**		**286.1**		**253.0**		**33.1**		**13.1**	
1	Rice	MT	105.7	342.2	103.7	282.8	2.0	-15.8	1.9	21.0
2	Raw cotton	MT	15.1	737.4	3.2	982.2	11.8	519.2	364.9	-24.9
3	Raw wool (excluding wool tops)	MT	0.2	758.4	0.4	940.9	-0.2	-42.9	-54.0	-19.4
4	Fish and fish preparations	MT	31.9	1895.6	35.4	1984.2	-3.5	-5.6	-9.9	-4.5
5	Leather	SQM	52.5	15.0	61.3	13.8	-8.8	-20.8	-14.4	8.2
6	Guar and guar products	MT	4.1	713.6	4.2	750.9	-0.1	2.5	-2.6	-5.0
7	Fruits	MT	19.3	372.0	18.4	408.8	0.8	14.9	4.6	-9.0
8	Vegetables	MT	3.5	245.9	6.2	202.2	-2.8	-54.0	-44.1	21.6
9	Crude animal material	MT	3.5	583.7	3.5	418.2	0.0	-29.2	-1.1	39.6
10	Oil seeds & nuts etc.	MT	3.4	472.1	4.6	457.5	-1.1	-27.5	-25.1	3.2
11	Wheat	MT	47.0	112.3	12.0	112.6	35.0	292.6	291.7	-0.3
B.	**Textile manufactures**		**1708.0**		**1466.7**		**241.3**		**16.5**	
11	Cotton yarn	MT	238.9	1697.9	239.6	1874.3	-0.7	10.1	-0.3	-9.4
12	Cotton fabrics (woven)	SQM	322.4	0.6	246.0	0.6	76.4	23.7	31.0	6.0
13	Hosiery (knitwear)	DOZ	274.9	22.2	247.6	24.2	27.4	21.1	11.0	-8.3
14	Bed wear	MT	293.4	5441.7	217.7	5073.4	75.7	25.6	34.8	7.3
15	Towels	MT	76.3	3529.9	66.9	3464.5	9.4	12.0	14.1	1.9
16	Cotton bags and sacks	MT	3.8	4080.3	4.0	4086.9	-0.2	-5.3	-5.4	-0.2
17	Readymade garments	DOZ	271.5	30.0	228.8	21.1	42.7	-16.5	18.7	42.1
18	Tarpaulin & other canvas goods	MT	13.6	2222.9	6.5	2186.9	7.1	105.5	108.8	1.6
19	Tule, lace embroidery etc.	---	2.3	---	2.5	---	-0.2		-9.0	
20	Synthetic textiles	SQM	119.2	0.6	114.7	0.6	4.5	-0.9	3.9	4.8
21	Other textile made up	---	88.4	---	90.6	---	-2.2		-2.4	
22	Waste material textile fibres/fabrics	MT	3.3	628.5	1.8	577.9	1.6	73.1	88.2	8.8
C.	**Other Manufactures**		**393.2**		**391.9**		**1.3**		**0.3**	
23	Carpets, carpeting rugs & mats	SQM	47.6	49.5	47.7	44.1	-0.2	-11.3	-0.4	12.3
24	Petroleum and petroleum products	MT	43.5	208.3	66.0	201.1	-22.6	-36.4	-34.2	3.5
25	Sports goods	---	76.9	---	61.1	---	15.8		25.8	
26	Leather manufactures	---	113.8	---	123.0	---	-9.2		-7.5	
27	Surgical and medical instruments	No	34.2	---	32.6	---	1.6		4.9	
28	Cutlery	Gr	7.7	23.3	6.4	29.5	1.2	51.3	19.3	-21.1
29	Onyx manufactured	MT	3.0	1807.3	2.9	1589.6	0.0	-11.2	1.0	13.7
30	Chemicals and pharmaceuticals	---	57.2	---	31.8	---	25.5		80.2	
31	Molasses	MT	9.3	40.9	20.3	42.4	-11.0	-52.4	-54.1	-3.6
32	Sugar	MT	0.1	345.6	0.0		0.1			
D.	**Others**		**201.1**	**---**	**153.0**	**---**	**48.1**	**---**	**31.5**	
	TOTAL EXPORTS		**2588.4**		**2264.6**		**323.9**		**14.3**	
	excl. Major food items and raw cotton		*2302.3*		*2011.6*		*290.8*		*14.5*	
	excl. Major food, raw cotton and yarn		*2063.4*		*1771.9*		*291.5*		*16.5*	

Source: Federal Bureau of Statistics

their positions, to an extent, against an increase in the value of Rupee by entering into forward contracts for the sale of their future export receipts.[80]

It is also pertinent to mention here that the bulk of the FY03 growth in exports has been contributed by the textile sector, which improved upon the H2-FY02 growth. In the aggregate Q1-FY03 export growth of 14.3 percent, 10.7 percentage points were contributed by rising textile exports, which saw an increase in almost all major categories (see **Table 9.6** & **Figure 9.6)**.

Yet another positive for the export profile is that, unlike FY02, the improvement in the FY03 exports appears quite broad-based geographically (see **Table 9.7**).

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

Textile manufactures

Textile manufactures posted a remarkable performance during Q1-FY03 by recording a 16.5 percent growth

Table 9.6: Contribution in Growth by Major Export Groups

percent

	Q1-FY02		Q1-FY03	
	Growth	Share in growth	Growth	Share in growth
Primary commodities	-0.8	-42.8	1.5	10.2
Textile manufactures	1.3	74.6	10.7	74.5
Other manufactures	1.2	67.7	0.1	0.4
Other exports	0.0	0.5	2.1	14.9
Total	**1.8**	**100.0**	**14.3**	**100.0**

Figure 9.6: Textile Exports

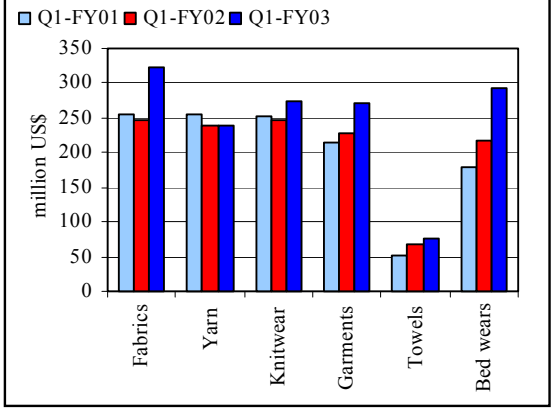


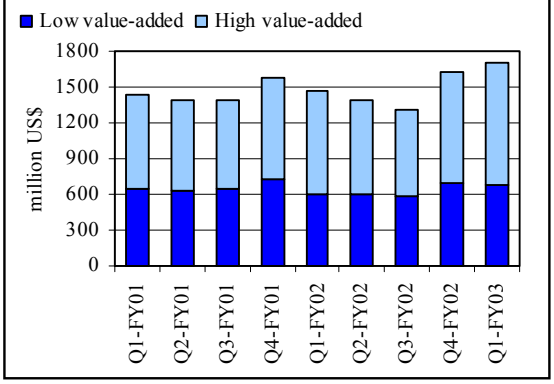
Table 9.7: Pakistan's Major Export Markets

	North America	EU	Asia	Others
Exports (million US$)				
Q1-FY01	647.3	576.3	764.2	236.9
Q1-FY02	652.2	609.2	776.2	226.9
Q1-FY03	734.2	697.8	888.6	267.9
Share in Overall Growth (in percent)				
Q1-FY02	12.1	82.6	30.2	-24.9
Q1-FY03	25.3	27.4	34.7	12.6

[80] These hedging operations protected the exporters from a fall in their export earnings in the face of 1.5 percent appreciation in the Rupee/Dollar parity during Q1-FY03.

compared to the same period last year (see **Figure 9.6**).[81] The increase is due to both, a YoY rise in unit values, as well as higher quantum of exports. Also, the growth in the high value added textile exports surpassed that for low value added textiles (see **Figure 9.7**).

Figure 9.7: Composition of Textile Exports



As seen in **Figure 9.8,** the quantum of exports increased for all categories except readymade garments. Moreover, most categories have seen an increase in unit values, marking the end of a long period of declining unit prices of Pakistan's textile exports.

It may be recalled that in recent years, unit values of textile exports, on average, had suffered a secular decline. As a result, textile exports had stagnated (or seen low growth) despite a higher quantum of exports. The Q1-FY03 increase in unit value of most textile categories, if continued, will underpin the export gains through the coming quarters.

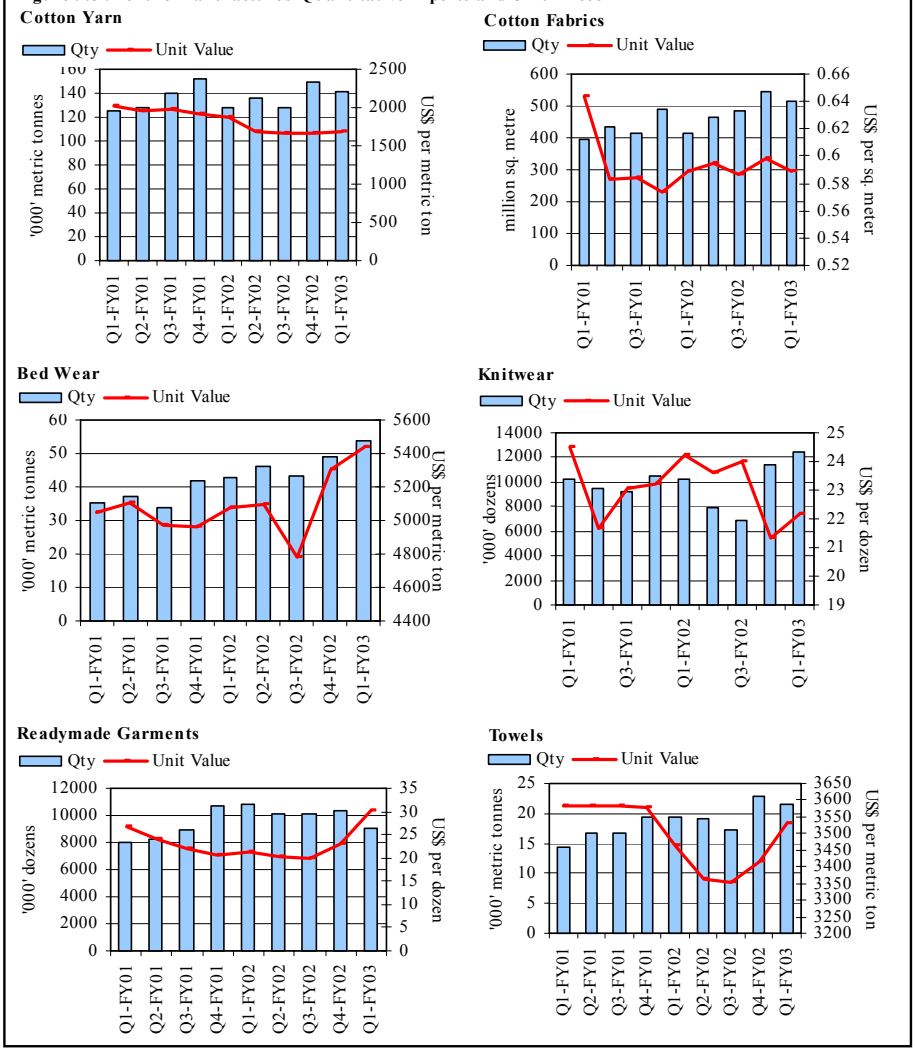
Table 9.8: Quantum and Price Impact on Selected Textiles

million US$

	Q1-FY02			Q1-FY03		
	Change in value	Quantum impact	Price impact	Change in value	Quantum impact	Price impact
Cotton yarn	-14.6	4.0	-18.9	-0.7	24.1	-24.8
Knitwear	-3.5	-0.3	-3.2	76.4	52.3	-25.0
Towels	15.0	16.7	-2.3	27.4	8.0	1.4
Cotton fabrics	-9.2	12.3	-22.7	75.7	58.3	18.1
Bed wear	39.8	38.9	1.1	9.4	55.8	19.9
Readymade garments	14.1	58.7	-60.0	42.7	-37.7	80.4

[81] Since in FY02 trade sector was affected by adverse implications of September 11 event, the **Figures 9.7** & **9.8** compare the performance of textile sector with FY01 also. This comparison provides ample proof of high growth of textile exports in this quarter.

Figure 9.8 : Textile Manufactures-Quantitative Exports and Unit Prices



A few policy changes also helped in maintaining this growth in the textiles sector. Following considerable complaints by exporters, the government increased the duty drawback rates on all kinds of fabrics, garments, apparels and made ups. Moreover, payments of duty drawbacks were also accelerated. These measures reinforced the positive impact of higher unit value increases (see **Table 9.8**).

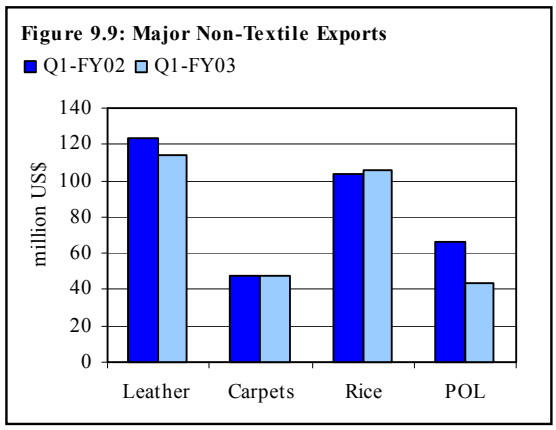
- ***Cotton yarn*** exports registered a marginal 0.3 percent decline in Q1-FY03 over the corresponding period last year. Though in volume terms its exports did increase by 10.1 percent, yet the low international yarn prices nullified the country's foreign exchange earnings from this category.

- ***Cotton fabrics*** displayed an impressive performance in this quarter both in terms of value and quantity, rising 31.0 and 23.7 percent YoY, respectively. This increase was mostly contributed by a surge in orders from the US, Asia and Europe. In the first eight months of 2002, Pakistan managed to obtain a prominent position among the large suppliers, (Canada, China and Mexico) of cotton fabrics to the US.

- ***Bed wear*** exports recorded a 34.8 percent increase in Q1-FY03 as compared to the same period last year. Thus, this category had 3.3 percentage point contribution in the total export growth of 14.3 percent. Accordingly, the share of this category in total textile exports rose from 14.8 percent in Q1-FY02 to 17.2 percent in Q1-FY03.

Other Non-Textile Major Exports

The performance of other major exports, i.e., leather and leather manufactures, carpets, rice, petroleum and petroleum products, however, remained dismal during this quarter (see **Figure 9.9**). There were a number of factors at work causing this slow down.



- ***Leather manufactures*** were facing liquidity shortage as their funds were blocked in stocks of leather and leather garment production. In addition, in this quarter the duty drawback rates on both finished leather and leather made-ups were slashed; thus, further aggravating problems for exporters.[82] This resulted in a 7.5 percent fall in exports for this group as compared to the corresponding period last year.

[82] The CBR slashed drawback rates on export of leather made-ups by 89 percent and on finished leather by 74 percent, from July 1, 2002, while implementing 4th phase of gradual reduction in drawback rates. It may be noted that the substantial reduction cleared the backlog from third phase

- ***Carpets*** are another category facing the impact of world economic slowdown and the resultant fall in exports demand. Consequently, Q1-FY03 witnessed a 0.4 percent decline in exports earnings as compared to the same period last year. This decrease was caused by lower export volumes, which were partially offset by a 12.3 percent increase in the unit value of carpets as compared to last year. Anecdotal evidence suggests that the domestic carpet industry is facing fall in production levels because of the return of skilled Afghan weavers to their homeland. Besides, owing to appreciation of the Rupee and the resulting fall in export earnings, exporters were facing liquidity problems, thus slowing down the manufacturing process. Therefore, in order to promote healthy business activity in this sector, the duty drawback rate was enhanced for carpet exports in September this year, which could positively impact future exports.

- ***Rice*** exports faced a marginal 1.9 percent increase over the same period last year. In fact, despite higher demand, exporters were unable to meet the requirements due to low levels of stocks. This excess demand is reflected in 21 percent increase in unit values for rice exports. The government also undertook some important decisions in the trade policy for FY03. These measures included abolishing the Quality Related Market Price (QRMP) system on export of all types of rice and the withdrawal of Quality Review Check (QRC) on export of non-Basmati rice.[83]

Non-traditional exports

One encouraging development in Q1-FY03 was an increase in the country's non-traditional exports, especially the *machinery and transport equipment* and *chemicals and pharmaceuticals* exports showed an impressive performance in this quarter. The exports of machinery registered a 39.6 percent increase compared to same period last year, whereas an 80.2 percent increase was recorded in chemicals and pharmaceuticals exports. ***Wheat*** exports also recorded an impressive improvement in the first quarter of FY03. Its total exports amounted to US$ 47 million as compared to US$ 12 million in the same period last year.[84]

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of gradual reduction (January 1, 2002 to March 2002) which was postponed by the Central Board of Revenue due to recession in exports after September 11, 2001 incidents.

[83] The QRMP and QRC systems were introduced in 1999. Under the QRC, the exporters had to share double burden of inspection fee - one by the local agencies and other by international inspectors, thus adversely affecting rice exports.

[84] Since prior to FY02, wheat exports were negligible, the very low base of the last year has yielded extraordinary high growth rates for wheat exports as calculated in the **Table 9.9**.

There is no doubt that the share of these commodity groups in the total export earnings is still very small, and when seen in terms of their weight, the impact of this rise in total exports is small (see **Table 9.9**). Nonetheless, even this small contribution leading to the diversification of exports is welcome, given the country's vulnerability to any adverse development in the textiles sector that currently contributes more than 60 percent of Pakistan's total export earnings.

Table 9.9: Weighted Growth Rates of Non-Traditional Exports

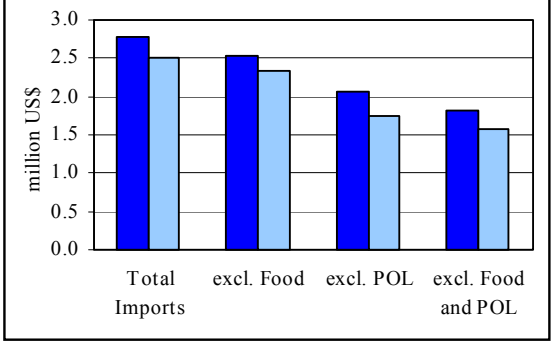
	Chemical and pharmaceutical products.	Machinery & transport equipment	Wheat
Growth rates			
Q1-FY02	-29.7	17.8	28,731.2
Q2-FY02	26.6	26.7	426.2
Q3-FY02	-33.2	0.2	1,602.7
Q4-FY02	32.7	22.7	281.2
Q1-FY03	80.2	39.6	291.7
Weighted growth rates			
Q1-FY02	-0.60	0.08	0.54
Q2-FY02	0.32	0.10	0.74
Q3-FY02	-0.79	0.00	0.65
Q4-FY02	0.50	0.13	0.70
Q1-FY03	1.12	0.20	1.54

In recognition of this concern, the government has announced various incentives for the growth of the non-traditional exports. These include reduction in customs duty for the imports of necessary raw materials for such exports and a freight subsidy for the exports of new products.

9.2.2 Imports

Imports during Q1-FY03 recorded a 10.9 percent increase over the corresponding period of the last year to reach US$ 2.78 billion (see **Table 9.10**). Key factors underpinning this increase, appear to be the appreciating Rupee, reduction in import tariffs,[85] and most importantly, growing economic activity (as suggested by the rise in non-food and non-POL imports - see **Figure 9.10**).

Figure 9.10: Imports excl. Food and POL



[85] The Budget 2002-03 announced a 5 percent reduction in the maximum customs tariff rate from 30 to 25 percent. With this reduction effective from July 2002, only 4 tariff slabs, i.e., 25, 20, 10 and 5 percent will prevail.

Table 9.10: Major Imports

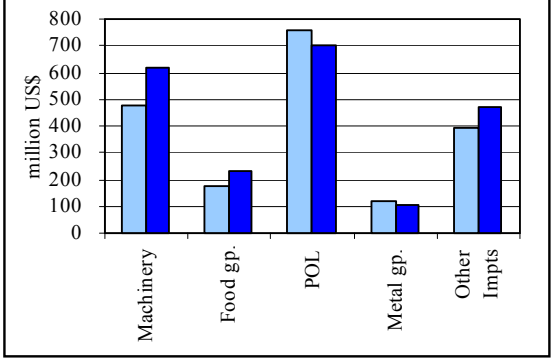
Value: million US Dollars; unit value US Dollars

		Q1-FY03		Q1-FY02			% Change in Q1-FY03/Q1-FY02		
	Unit	Value	Unit value	Value	Unit value	Abs chg. in value	Qty	Value	Unit value
A. Food group		**242.1**	**---**	**175.4**	**---**	**66.8**	**---**	**38.1**	**---**
Milk & cream incl. milk food for infants	MT	5.3	1692.1	3.2	2421.3	2.1	137.2	65.8	-30.1
Wheat unmilled	MT	7.0	192.8	10.7	193.6	-3.7	-34.1	-34.3	-0.4
Dry fruits	MT	7.9	317.2	7.2	380.6	0.7	31.4	9.5	-16.7
Tea	MT	37.8	1588.6	36.6	1576.4	1.2	2.6	3.4	0.8
Spices	MT	5.0	640.4	3.5	844.4	1.5	89.4	43.7	-24.2
Edible Oil	MT	127.1	418.5	71.7	292.9	55.4	24.1	92.5	42.8
Soyabean	MT	2.0	*408.4*	5.6	348.4	-3.7	-70.2	-65.1	17.2
Palm Oil	MT	125.1	*418.6*	66.0	289.0	59.1	1745.5	89.5	44.5
Sugar	MT	0.5	333.4	15.4	268.1	-14.9	-97.2	-96.5	24.3
Pulses	MT	51.4	301.4	27.1	313.7	24.3	97.4	89.7	-3.9
B. Machinery group	**---**	**638.1**	**---**	**479.7**	**---**	**158.3**	**---**	**33.0**	**---**
Power generating machinery	---	69.8	---	37.2	---	32.5	---	87.4	---
Office machinery	---	51.2	---	57.4	---	-6.2	---	-10.8	---
Textile machinery	---	111.6	---	118.6	---	-6.9	---	-5.9	---
Construction & mining machinery	---	25.1	---	35.7	---	-10.7	---	-29.8	---
Electrical machinery & apparatus	---	45.4	---	24.6	---	20.8	---	84.7	---
Railway vehicles	---	15.7	---	8.6	---	7.1	---	82.5	---
Road motor vehicles	---	111.4	---	74.1	---	37.3	---	50.3	---
Aircraft, ships and boats	---	20.7	---	11.3	---	9.4	---	83.2	---
Agricultural machinery & implements	---	7.8	---	2.6	---	5.2	---	198.6	---
Other machinery	---	179.4	---	109.6	---	69.8	---	63.7	---
C. Petroleum group	**MT**	**707.4**	**192.1**	**755.5**	**185.5**	**-48.1**	**-9.6**	**-6.4**	**3.6**
Petroleum products	MT	380.3	190.5	389.1	183.4	-8.8	-5.9	-2.3	3.9
Petroleum crude	MT	327.2	194.0	366.5	187.7	-39.3	-13.6	-10.7	3.3
D. Textile group	**MT**	**54.7**	**---**	**40.2**	**---**	**14.5**	**---**	**36.2**	**---**
Synthetic fibre	MT	22.6	1215.9	14.7	1302.3	7.8	64.0	53.1	-6.6
Synthetic & artificial silk yarn	MT	22.5	1489.0	18.2	1503.9	4.2	24.5	23.3	-1.0
Worn clothing	MT	9.7	307.1	7.2	318.3	2.5	39.1	34.2	-3.5
E. Agricultural & other chemicals group	**MT**	**529.9**	**---**	**482.3**	**---**	**47.6**	**---**	**9.9**	**---**
Fertilizer	MT	62.3	183.0	50.8	120.0	11.5	-19.6	22.6	52.6
Insecticides	MT	30.0	2582.5	33.2	2788.3	-3.2	-2.8	-8.9	-6.3
Plastic materials	MT	100.7	799.9	78.2	821.0	22.5	32.1	28.7	-2.6
Medicinal products	MT	52.1	25527.0	50.1	20671.2	2.0	-15.8	4.0	23.5
Others	---	284.8	---	269.9	---	14.9	---	5.5	---
F. Metal group	**MT**	**106.5**	**---**	**116.9**	**---**	**-10.4**	**---**	**-8.9**	**---**
Iron and steel scrap	MT	9.6	137.2	10.5	116.9	-0.9	-22.3	-8.8	17.4
Iron and steel	MT	85.7	347.3	96.6	288.8	-10.8	-26.2	-11.2	20.2
Aluminum wrought & worked	---	11.1	---	9.8	---	1.3	---	13.7	---
G. Miscellaneous group		**73.4**	**---**	**63.2**	**---**	**10.2**	**---**	**16.1**	**---**
Rubber crude	MT	10.4	708.9	9.5	653.2	0.9	0.8	9.4	8.5
Rubber tyres & tubes	No.	19.8	20.2	15.1	21.2	4.6	18.0	24.8	5.7
Wood & cork	---	10.0	---	3.3	---	6.7	---	205.8	---
Jute	MT	2.8	270.0	3.6	280.5	-0.8	-24.4	-23.7	0.9
Paper and paper board & manufactures	MT	30.4	586.8	31.7	742.3	-1.3	21.3	-4.1	-21.0
H. Others		**424.7**	**---**	**390.8**	**---**	**33.9**	**---**	**8.7**	**---**
Total imports		**2,776.8**		**2,504.1**		**272.7**		**10.9**	
excl. Food group		*2,534.7*		*2,328.7*		*206.0*		*8.8*	
excl. POL group		*2,069.3*		*1,748.5*		*320.8*		*18.3*	
excl. Food & POL group		*1,827.2*		*1,573.2*		*254.1*		*16.1*	

Source: Federal Bureau of Statistics

As a matter of fact, the import growth in Q1-FY03 was largely driven by higher machinery imports (as growth in food imports was almost completely offset by decline in POL imports). The commodity-wise discussion of major imports during Q1-FY03 provides further insights into this trend.

Figure 9.11: Composition of Imports



- ***POL*** imports continued to decline, registering a 6.4 percent decrease over the same period last year (see **Figure 9.11**). It is worth mentioning that imports of both, crude petroleum *and* petroleum products declined in this period. This fall in POL import can be attributed to a contraction in domestic demand, possibly owing to a continuation of the FY02 slowdown in the transport sector, conversion of many power and cement plants to alternative fuels (gas and coal), the increasing usage of CNG in vehicles, as well as smuggling of relatively cheap POL from Iran in some northwestern areas.

- ***Machinery*** imports staged an impressive upturn in Q1-FY03, recording a US$ 158.3 million (33 percent) increase over the corresponding period last year. Almost half of the overall growth of imports in the quarter was contributed by this group (see **Table 9.11**), which is a welcome development as it suggests a revival of business confidence. This increase was caused by substantial rise in imports of road motor vehicles, power-generating machinery and electrical & agricultural machinery (see **Figure 9.12**).

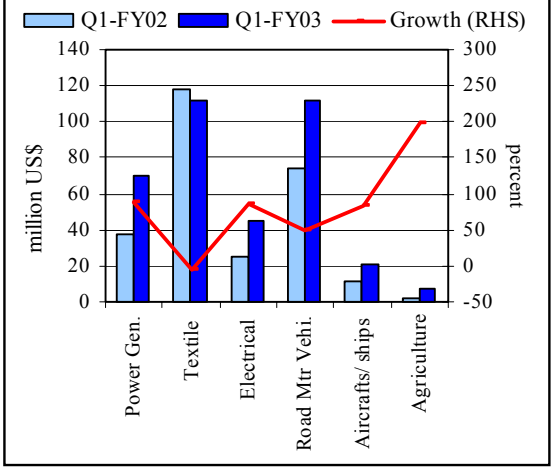
Table 9.11: Contribution in Growth by Major Import Groups

percent

	Q1-FY02		Q1-FY03	
	Growth	Share in growth	Growth	Share in growth
Food	-4.4	53.3	2.7	24.8
Machinery	0.7	-9.0	6.3	57.8
Petroleum	-8.9	107.6	-1.9	-17.4
Textile	0.2	-2.9	0.6	5.5
Agriculture & other chemicals	0.8	-9.7	1.9	17.4
Metal	1.4	-16.6	-0.4	-3.7
Miscellaneous	0.0	-0.4	0.4	3.7
Others	1.8	-22.1	1.4	12.8
Total	**-8.3**	**100.0**	**10.9**	**100.0**

The textile machinery imports registered a 5.9 percent fall over the higher imports in the corresponding period of the last year, but were still a major contributor (17.5 percent) to overall machinery imports.

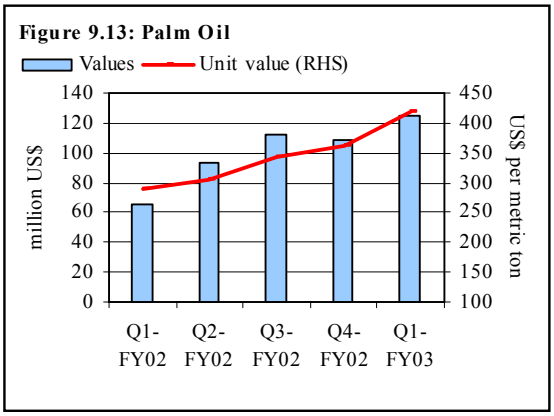
Figure 9.12: Machinery Imports



- ***Food group*** registered a steep rise of US$ 66.8 million (38.1 percent) in Q1-FY03 as compared to the corresponding period of the last year. Its import bill amounted to US$ 242.1 million raising its share in total import to 8.7 percent – about 1.7 percent more than in Q1-FY02.

The main factor behind this rise in food import bill is the continued dependency on edible oil imports. With an import bill of US$ 127.1 million during the period of analysis, the edible oil constituted nearly 52.5 percent of the food group imports – which is 12 percent higher than the same period last year. The worrisome part of the story, however, is that the increase in import quantum was faced at a time when the international prices for palm oil were increasing, as evident from the 44.5 percent increase in the unit values for this item in this quarter (see **Figure 9.13**).[86]

Figure 9.13: Palm Oil



[86] Palm oil accounts for 98 percent of total edible oil imports.

9.3 Capital Account

As shown in **Table 9.12**, the capital account deficit posted a very sharp contraction during Q1-FY03, falling to only US$ 67 million, down 88.6 percent from the US$ 587 million in the first quarter of FY02.

The major drivers for this improvement were: (1) the higher FDI inflows, (2) increased project and non-food aid flows from donor countries and IFIs, (3) increased inflows under PAYE credits; and (4) lower repayments of commercial loans/credit (as no new commercial loans were availed in FY02). In addition, the spectacular growth in disbursement of foreign currency denominated loans (against FE-25 deposits) also contributed toward the inflows in capital account.

Net foreign investment

During Q1-FY03, the capital account saw a modest US$ 26 million increase in *net* foreign investment over the corresponding period last year (see **Table 9.12**), but this low growth is a little deceptive. Excluding the repayment of Special US Dollar Bonds during the first quarter (which are treated as outflows in capital account), the net foreign investment jumped to US$ 157 million due to the exceptional growth in Foreign Direct Investment (FDI), mainly in the oil & gas sector.

The pick up in FDI could be taken as an indication that the commitment to economic reforms, and the lower foreign currency risk (due to stronger reserves) could pay rich dividends going forward if complemented by investments in human capital and infrastructure.

In terms of Foreign Portfolio Investment (FPI), the outflows increased to US$ 129 million during Q1-FY03 as compared to US$ 53 million during same period last year (see **Table 9.12**). However, the Q1-FY03 outflow was driven mainly due to Special US Dollar Bonds whereas last year outflow was mainly from the domestic equity markets; outflows from the stock markets decreased sharply from US$ 47 million to US$ 3 million during Q1-FY03, following an initiation of a bullish trend in KSE-100 index.

Long-term capital (official)

Long-term capital (official) posted the sharpest reversal from outflows of US$ 261 million in Q1-FY02 to inflows of US$ 91 million during the same period this year. This is due to the availability of significant funds for the structural adjustment programs from World Bank and ADB. The inflows on account of project

Table 9.12: Capital Account
million US$

	Jul-Sep		
	FY01	**FY02**	**FY03**
Capital Account (1 through 9)	**-441**	**-587**	**-67**
Credit	**725**	**556**	**1,060**
Debit	**1,166**	**1,143**	**1,127**
1. Direct investment abroad	0	0	1
2. Direct investment in Pakistan	36	69	170
3. Portfolio investment	-9	-53	-129
of which: (Stock markets)	-16	-47	-3
Special US Dollar Bonds	16	3	-115
4. LT capital (official)	-586	-261	91
Credit	199	143	481
of which: Project assistance	199	128	151
Food aid	0	0	0
Non-food aid	0	0	330
Debit	785	404	390
of which: Amortization	513	382	369
Central bank deposits	250	0	0
5. LT capital (DMBs)	-1	-1	0
Credit	0	0	0
Debit	1	1	0
6. LT capital (others)	22	-347	-358
Credit	167	13	126
of which: Suppliers credits/MNCs	34	13	126
Debit	145	360	484
of which: Supplier credits repayments	145	153	171
7. ST capital (official)	168	32	-50
Credit	246	253	36
of which: Commercial banks	130	314	0
IDB	130	106	36
Debit	78	221	86
of which: Commercial banks	12	176	40
IDB	66	45	24
Others liabilities (NBP deposits)	0	0	0
8. ST capital (DMBs)	38	53	19
of which: Outstanding exports bills	77	62	24
FCAs (Non-residents)	-38	-10	2
Credit	77	63	26
Debit	39	10	7
9. ST capital (others)	-109	-79	189
of which: Outstanding exports bills	-90	-81	-30
FCAs (Non-residents)	-22	-13	-17
Other liabilities	3	28	237
Credit	0	15	220
Debit	109	94	31

Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.
Source: State Bank Of Pakistan

assistance from countries like Japan, the US, Germany and France were also increased. Looking forward, the foreign economic assistance is likely to increase as IFIs and donor's countries have recently increased their commitments to Pakistan.

Long-term capital (others)

Long-term capital (others), comprise suppliers credit, PAYE loans and swaps. Despite the increased inflows under PAYE loans, the net outflows under this head posted a mild increase of US$ 11.0 million to reach US$ 358 million in Q1-FY03 (see item 6 in **Table 9.12**). The main reasons of this increased outflow were the closure of swaps (US$ 230 million) and higher repayments of PAYE credits during Q1-FY03.

Short-term capital (official)

Short-term capital exhibited outflow of US$ 50 million during Q1-FY03 relative to inflows of US$ 32 million during the corresponding period last year (see **Table 9.12**). Traditionally, borrowings under this head largely represented short term financing for oil imports. However, the ample forex interbank liquidity led to lower borrowings during H2-FY02 and Q1-FY03. Also, the lower FY02 borrowings meant that Q1-FY03 re-payments were correspondingly smaller.

Short-term capital (deposit money banks & others)

This head 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. In broad terms, the short-term capital (DMBs & others) exhibited the sharpest reversal from outflow of US$ 26 million to an inflow of US$ 208 million during Q1-FY03. The following two factors contributed towards this improvement: (1): OEBs increased nominally by US$ 6 million, during Q1-FY03 relative to last year mainly due to the reversal of devaluation expectations of Rupee/Dollar parity after September 2001; (2) the rise of US$ 230 million in foreign currency denominated loans (mainly from FE-25 deposits) due to expectations of a appreciating Rupee, as these loans were extremely attractive in the absence of the exchange rate risk, with nominal interest rates ranging from 2-5 percent compared to much higher Rupee lending rate.[87]

[87] The weighted average rate on Rupee lending was around 12.0 percent at end-June 2002.

9.4 Exchange Rate Policy

After an extended period of near stability during most of H2-FY02, the Rupee resumed its upward climb in Q1-FY03,[88] appreciating by 1.5 percent against the US Dollar to close at Rs 58.98/US$ by end-September 2002.[89]

As elaborated in the *SBP Annual Report* FY02, it was the sudden appearance of massive current account surpluses post-September 11 2001 that propelled the gains of the Rupee during Q2-FY02. While the surpluses only increased thereafter, the SBP chose to protect exporters from this shock by purchasing heavily in the interbank market, build up the country's forex reserves in the process. In doing so, the SBP effectively set a floor for the Rupee during the latter half of FY02. While the interbank forex purchases continued during FY03, the SBP now allowed the Rupee to drift upwards again.

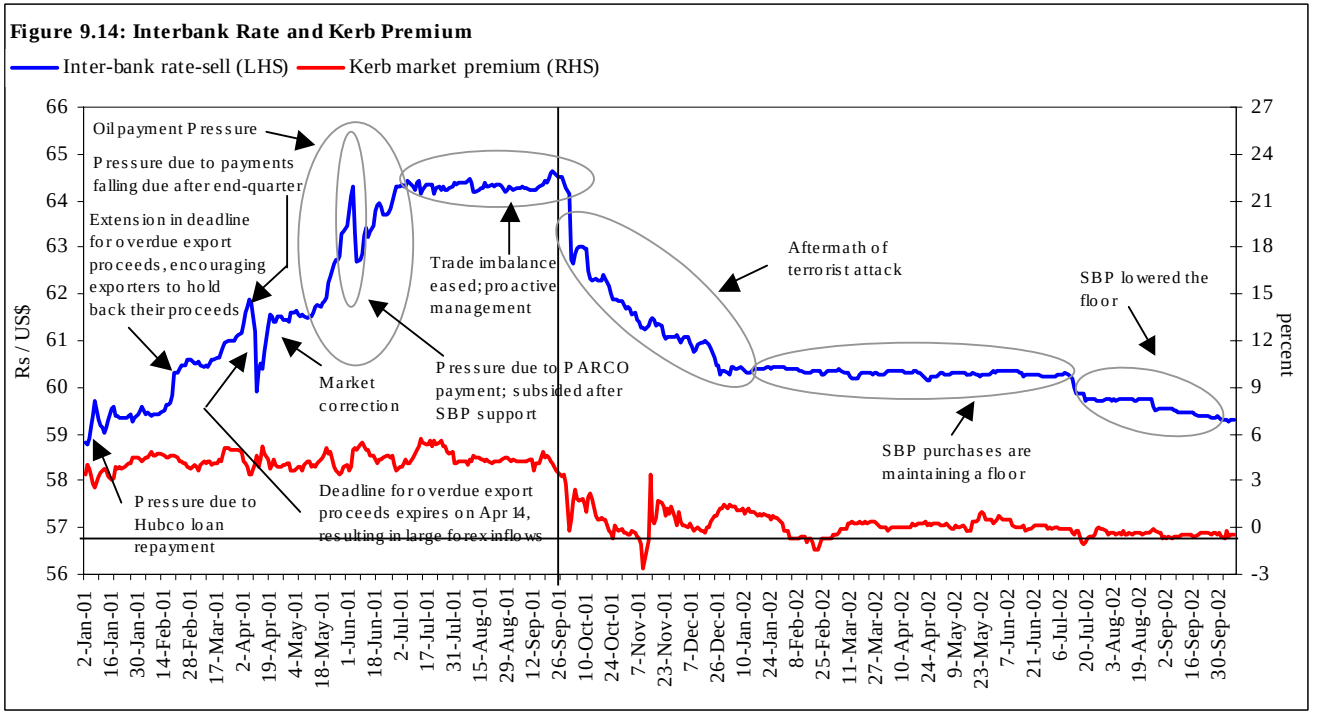
This change in the SBP stance is underpinned by:

1. a continuing increase in net forex inflows into the country despite the absence of one-time flows seen in FY02 (suggesting that the improvement is permanent);
2. the need to pass on the benefit of the stronger Rupee to the broader economy in the form of cheaper imported inputs (especially cheaper oil).
3. the lower vulnerability of exporters as they now had some opportunity to adjust to the changed external account environment. This could be attributed to the following factors (i) textile exports have seen a sharp increase in unit values for most product categories; (ii) their funding costs have declined sharply,[90] and (iii) exporters have increasingly resorted to hedging against the Rupee appreciation through forward sales of exports proceeds.

It is significant that the Q1-FY03 appreciation of the Rupee was despite an *increase* in the SBP purchases from the interbank market (see **Figure 9.14**), i.e. the SBP had earlier (in FY02) been successful in stabilizing the Rs/Dollar parity with much lower interbank purchases. This implies the following:

[88] Since Q2-FY02, in the face of appreciating Rupee, a floor was maintained to ensure *competitiveness* of Pakistani exports.
[89] Since July 2002 to November 30, 2002 the Rupee has appreciated by Rs 1.66, i.e. 2.86 percent.
[90] EFS rates fell from 13 percent to 8 percent by April 2002. With effect from December 1, 2002, EFS have now been further reduced to 7 percent. Moreover, exporters are also availing low cost US Dollar denominated loans.

Figure 9.14: Interbank Rate and Kerb Premium

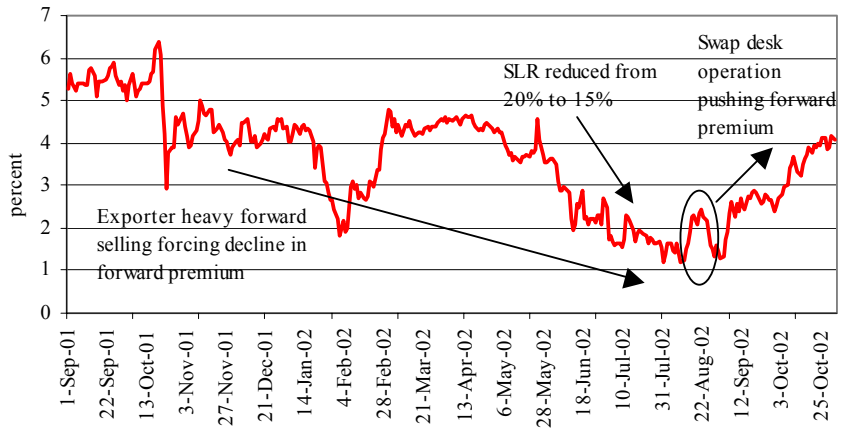


- The interbank demand-supply imbalance has increased. On the one hand, rising remittances and FDI growth underpinned a sharp rise in inflows, and on the other, the outward cash flows were weak due to a low trade deficit, and smaller debt servicing payments (following the retirement of expensive debt and liabilities as well as the Paris Club debt rescheduling).

- While the SBP did take advantage of the higher flows to further build up its forex reserves, it also deliberately allowed the Rs/US$ exchange rate to strengthen by purchasing only at relatively lower levels. This was in accordance with the SBP's stated policy objective of allowing the exchange rate to reflect the changing fundamentals of the forex market through a process of *gradual* adjustments.[91]

Not surprisingly, the evident improvement in Pakistan's external sector and the consequent expectations of a Rupee appreciation, led to increasing interest by exporters in forward sales of their receipts. Consequently, the forward premium declined significantly reflecting that expectations of a Rupee appreciation were so high that exporters were ready to incur interest losses in order to avoid exchange rate risk.

Figure 9.15: Forward Premium (3 months)



[91] See **Chapter 1**, SBP *Annual Report* for FY02.

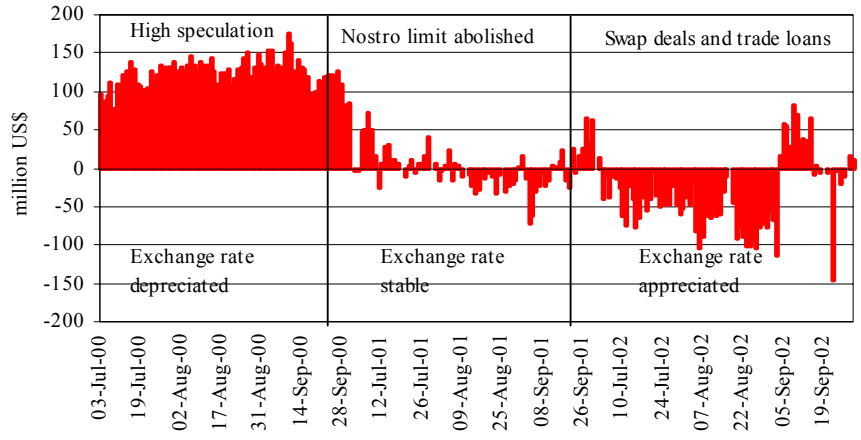
Figure 9.15 presents the decline of the 3-month forward premium soon after July 2002, with two episodes of upward movement. The reasons underlying the two episodes of an increase in the 3-month forward premium Q1-FY03 are detailed below:

- In August 2002, *cash reserve requirement* on forex deposits was reduced from 20 percent to 15 percent, which glutted banks' Nostros. Eventually banks offloaded these funds by entering into sell/buy swap deals, which temporarily pushed up forward premiums.

- In the second case, in order to facilitate exporters who have been facing a declining forward premium, SBP established a swap desk in the first week of September 2002. The SBP's sell/buy swaps with banks (which also helped in containing reserve money growth) not only strengthened the Rupee against US Dollar, but also stabilized and pushed up the forward premium.

- It should be noted that low forward premiums raised the incentive for banks to conduct sell/buy swaps during Q1-FY03 to arbitrage Rupee/US$ interest rate differentials. This partially accounts for the aggregate oversold Nostro (trade) position of the market **(**see **Figure 9.16)**.[92]

Figure 9.16: Market Nostro



[92] During the first two weeks of September 2002, the aggregate Nostro position of bank was temporarily reverted in the positive territory due to SBP's sell/buy swap deals with banks.

- Another contribution to the short (oversold) position in banks Nostro accounts emerged because banks have been financing trade (against FE-25 deposits) from the trade-Nostro accounts.[93] Since this is a self-liquidating facility, the shortfall due to such loans would be offset once the transaction matures.

Nonetheless, in terms of the exchange rate management strategy, SBP's heavy purchases of foreign exchange flows in the interbank market ensured continued support to the exporters (see **Figure 9.17**).[94] In fact, during Q1-FY03, net purchases (or sales) of US$ 1,145 million were among the highest quarterly purchases to date; during the same quarter last year, SBPs net interbank purchases were a mere US$ 28 million (see **Table 9.13**).

Table 9.13: Cash Flows and SBP Purchases

million US Dollars	FY02				FY03
	Q1	Q2	Q3	Q4	Q1
Remittances	340	643	646	762	1053
Trade balance[1]	174	579	351	161	196
FDI	52	107	53	168	138
Total	**566**	**1329**	**1,050**	**1,091**	**1,387**
Interbank purchases (net)	28	696	796	957	1,145
Kerb purchases	398	239	432	307	0
Total purchases	**426**	**935**	**1,228**	**1,264**	**1,145**

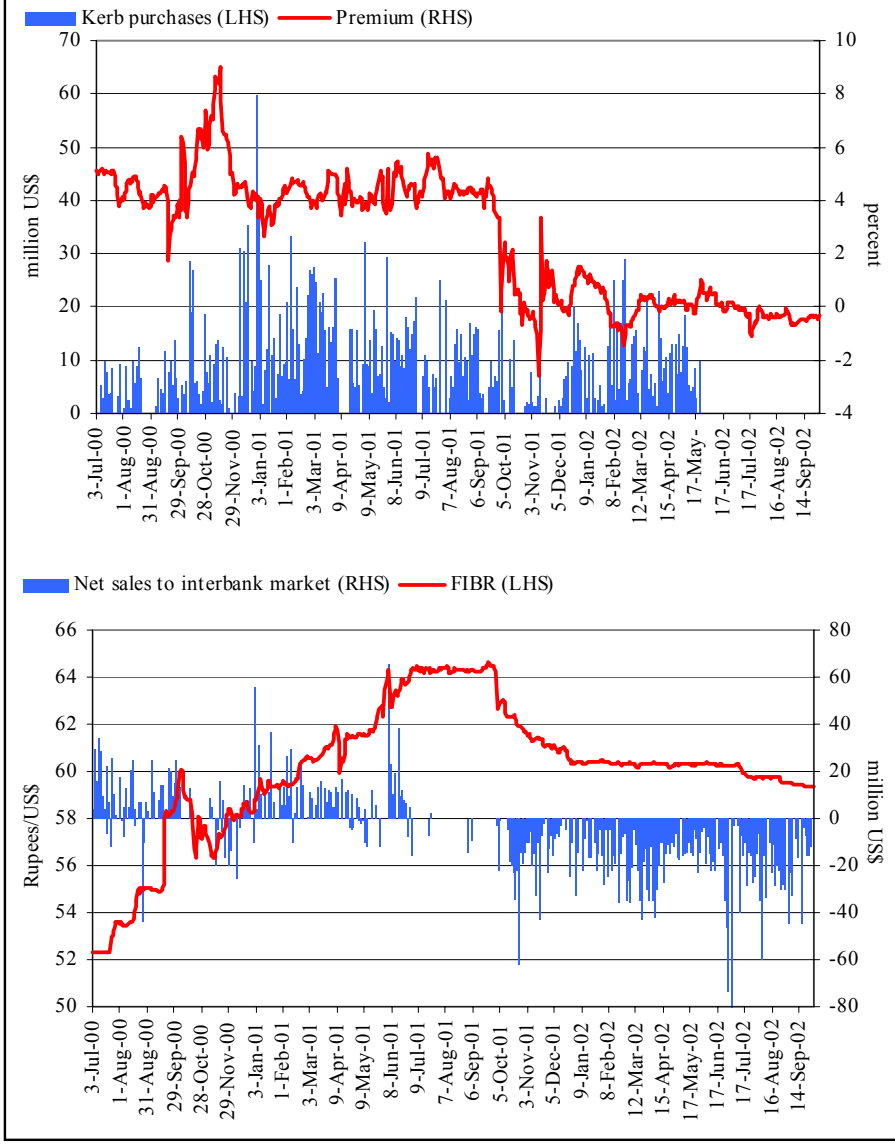
[1] Trade balance is based on the 'Exchange Record' and is different from the trade balance reported in **Table 9.1** in which exports and imports are reported on fob basis

It must be noted that due to the ample market inflows, SBP was not required to inject Dollars into the market.[95] This was in sharp contrast to the historical trend, where due to payment pressures in September and October, *sales* to the interbank market were usually heavily concentrated in these months.[96]

In another step to render further benefit to small exporters, SBP reduced the maximum permissible margin between buying and selling rates to 20 paisas per US Dollar for ready and forward transactions.[97]

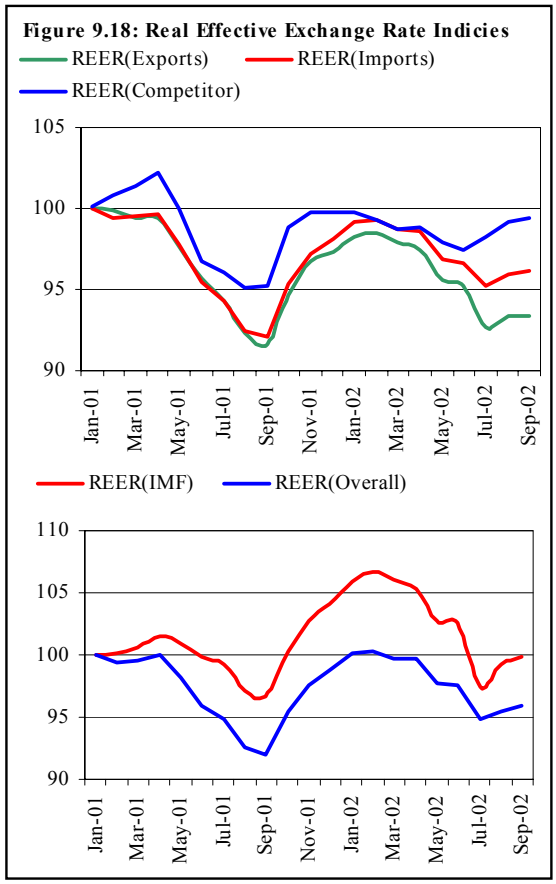
[93] On March 31, 2001, banks have been allowed to use/invest their deposits mobilized under FE-25 for financing of import/export. The SBP directive was aimed at extending cheap funding to the exporters/importers and also, providing avenues to banks for investment within Pakistan.
[94] Since Q2-FY02, exchange rate management strategy has been reversed, wherein in order to *maintain Rs/Dollar parity* SBP was purchasing Dollars from the interbank market. In contrast, previously SBP had to inject Dollars into the interbank market *for the same purpose*.
[95] In fact, SBP proactive management has been allowing authorized dealers (ADs) to meet the lumpy payments without recourse to support from the Central Bank.
[96] SBP had been buying from the kerb market to fill the mismatch of inflows and outflows in the interbank market.
[97] This condition does not apply to interbank transactions.

Figure 9.17: Kerb Purchases, Premium and Market Support



Real Effective Exchange Rate

The appreciation in the Rupee was also reflected in the real effective exchange rate indices (REER) for Q1-FY03 (see **Figure 9.18**).[98]



Since February 2002, the weakness of the US Dollar against the major international currencies was putting downward pressure on the REER. However, during Q1-FY03, the strength regained by Dollar led to the appreciation of the REER (see **Figure 9.19**).

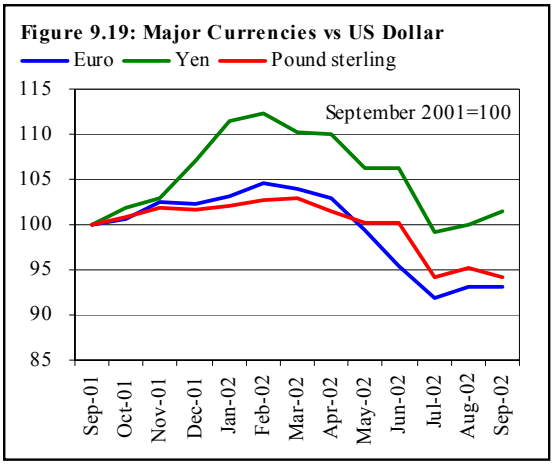
In particular, Euro, which stood at par to the US Dollar in July 2002 failed to regain the parity and started waning again. Although the overall trends are similar in different variants of REER, the brief deviations of REER indices suggest important implications. During Q1-FY03, REER (IMF) appreciated more relative to REER (overall) as European countries have a total share of 45 percent in former compared with 24 percent weight in latter.

On the other hand, the REER (competitor), which includes developing countries (with the exception of Singapore) depreciated during the quarter. This divergence from other indices is largely due to the fact that the inflation rate in those countries with which Pakistan's export compete in third market is higher. REER (import), which shows the price elasticity of Pakistan's import, is indicating a very small adjustment in the quarter.

[98] In real terms, the Rupee appreciated by 1.9 percent during Q1-FY03.

Kerb market

There were also some interesting developments during Q1-FY03 in the kerb market. One is the absence of kerb market purchases by the SBP, which does not need much explanation given the interbank market inflows and the restriction put by the IMF.



The second is that the kerb market premium remained negative throughout the quarter. In theory, this should have opened arbitrage possibilities, with kerb purchases being deposited with banks, to be reconverted into Rupees at the (higher) official rate. Anecdotal evidence suggests that this did indeed happen initially, boosting forex deposits despite the Rupee appreciation expectations, until banks increased 'cash handling charges' to close off the arbitrage.

Exchange companies

The establishment of foreign exchange companies on July 30, 2002, was another step taken by SBP to ensure full documentation of remittances and to curb the activities of the unauthorized moneychangers and hundi business.

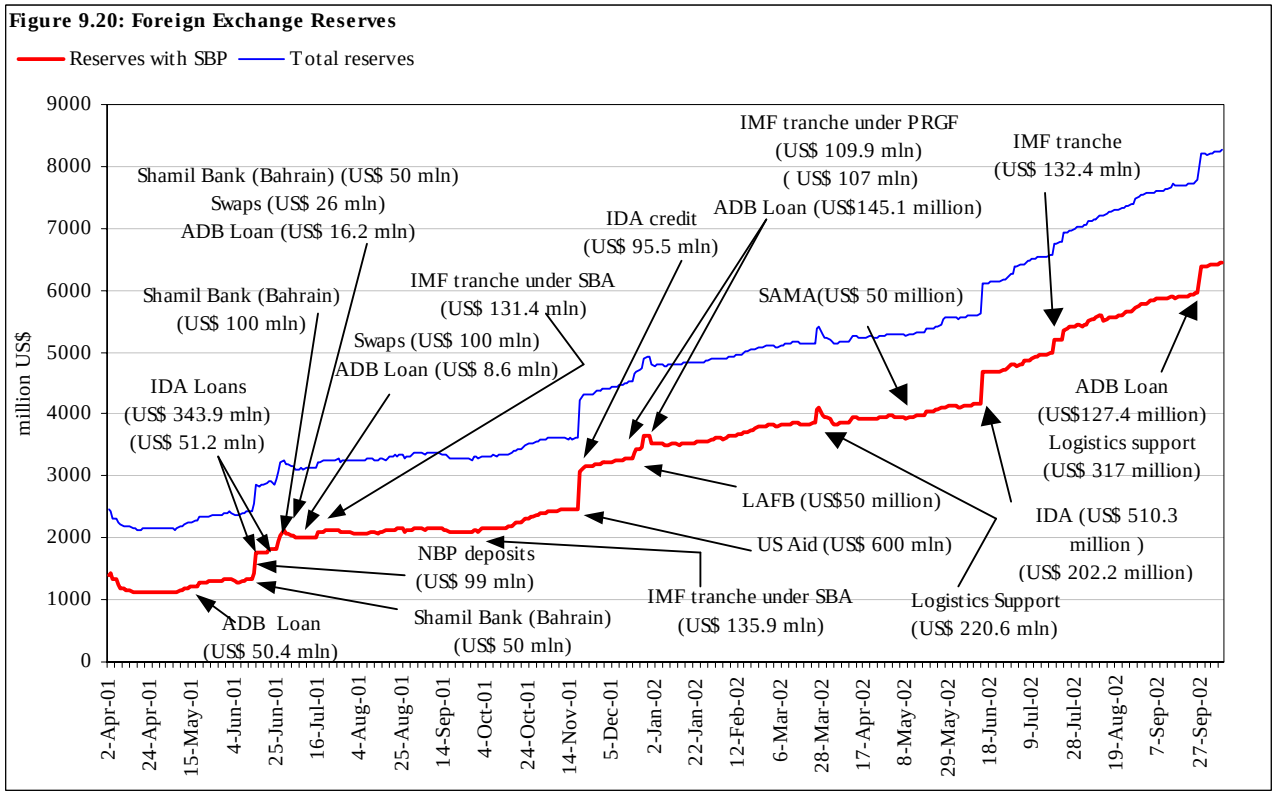
9.5 Foreign Exchange Reserves

The overall liquid foreign exchange reserves of the country continued to strengthen in Q1-FY03, with an unprecedented acceleration in remittances.[99] The overall liquid foreign exchange reserves increased by US$ 1,813 million during Q1-FY03, against an increase of US$ 76 million in the corresponding quarter last year and US$ 1,198 million in Q4-FY02. This massive increase was enough to push the country's reserves over the US$ 8 billion mark with total reserves reaching US$ 8,244 million at end-September 2002. Of this, the SBP held US$ 5,934 million,[100] while US$ 2,311 million was held by commercial banks (see **Figure 9.20**). The major inflows, which helped building up reserves, included

[99] The workers' remittances registered a phenomenal growth of 210 percent during Q1-FY03 over Q1-FY02 reaching US$ 1,053 million.

[100] These are the *SBP reserves* excluding the US$ 459.09 million in reserve requirement on FE-25 deposits.

Figure 9.20: Foreign Exchange Reserves



interbank purchases, inflows from IFIs, logistic support from the US and reduced payment requirements (see **Table 9.12**).

As in FY02, the SBP reserve accumulation in Q1-FY03 was largely on account of forex market purchases to manage the Rs/US$ exchange rate floor (see **Table 9.12**). The Q1-FY03 interbank market purchases totaled US$ 1.1 billion, which is over three times the purchases in Q1-FY02, and another US$ 133 million were purchased from banks on account of the export of currency. However, contrary to FY02, the SBP did not approach the kerb market for its purchases.

Looking at grants, while Q1-FY02 did not experience any major inflow, Pakistan received US$ 37.5 million from Saudi Arabian Monetary Agency (SAMA) during the first quarter of the current fiscal year. Similarly, receipts in the form of loans/purchases from IFIs were twice in Q1-FY03 than that in Q1-FY02 mainly due to inflows from IBRD/IDA (US$ 215.1 million) and ADB (US $139.6 million). Another one-off inflow of US$ 317 million against support lent by Pakistan to US troops for their operation in Afghanistan.

On the other hand, the outflows during Q1-FY03 were showing a decline, relative to Q1-FY02. These lower payments were due to the rescheduling of loans and repayment of short term and expensive debt in FY02.[101] The benefit of repaying short-term debt is also evident from the low interest paid. In fact, the only major outflow during Q1-FY03 was the settlement of swaps (US$ 110 million) and debt servicing to IMF (US$ 100.3 million).

Higher foreign exchange reserves, reinforced by better prospects of the economy, have led to an improvement in the credit ratings by creditors and crediting rating agencies. As of December 12, 2002 Pakistan's sovereign long term foreign currency rating was upgraded one notch by Standard and Poors from *single B minus* to *single B*. It may be recalled the SBP had indicated in its *Annual Report* for FY02 that Pakistan's credit rating at the time did not reflect the improvement in the country's macroeconomic fundamentals. The Asian Development Bank (ADB) has reduced Pakistan's country risk premium for its Political Risk Guarantee (PRG) facility, since September 2002.[102] Moody's had already upgraded Pakistan's sovereign credit rating to *B3* in March 2002.

[101] The debt under PTMA was mostly paid out in FY02.
[102] The PRG facility of US$ 150 million was provided to exporters to lower the costs of imported raw materials, spare parts and production equipment.

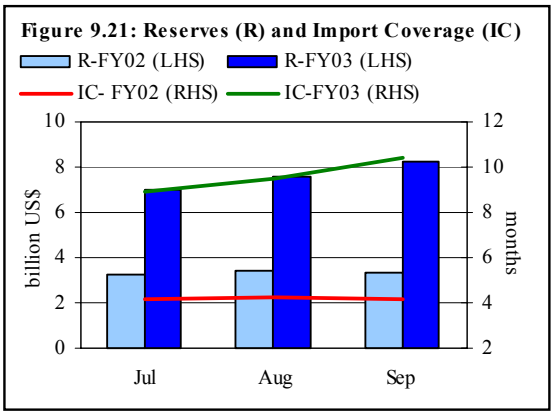
Table 9.12: Foreign Exchange Reserves with SBP

million US Dollar

	FY02	FY03
	Q1	Q1
Opening balance	**2,080.0**	**4,804.9**
Receipts	**717.4**	**2,169.3**
Purchases	**421.4**	**1278.3**
Kerb market	397.9	0.0
Interbank (net)	23.5	1145
Export of Currency	0	133.3
Loans	**272.2**	**470.9**
IBRD/IDA	0	215.1
ADB	2.6	139.6
IMF	267.4	116.2
JBIC (OECF)	2.2	0.0
Grants	**0**	**52.6**
European Commission	0	15.1
SAMA	0	37.5
Other receipts	**23.8**	**367.5**
Logistic support	0	317.0
Misc. receipts[1]	23.8	50.5
Payments	**671.4**	**581.3**
IMF	61.7	100.3
IDA	29.6	33.8
IBRD	72.6	55.3
ADB	35.3	62.5
PTMA	105.7	0.8
IDB (Short term)	48.8	25.0
Swaps	0	110.0
Interest on Deposits	142.7	27.2
NDRP	5	23.1
FE-45	0	4.9
FE-31	21.8	0.0
ACU settlement	68.7	30.4
Misc. payments[2]	79.5	108
Closing balance	2,126.0	6,392.9

[1.] Includes wheat exports US$ 4.9 millions

[2.] Includes FCY Loan Bonds (US$ 29.1 millions), US Aid (US$ 14.0 millions), US$ Bond Encashment (US$ 11.1 millions), SAINDAK Bonds (US$ 11.1 millions), CRR on FE-25 (US$ 13.7 millions)



Besides the improvement in the creditworthiness, high level of reserves help in bolstering country's monetary stability, reducing market volatility (since the central banks ability to intervene is not in doubt), and above all, boosting market confidence by providing the ability to absorb external shocks. In this regard, in terms of the traditional trade based indicator of reserve adequacy, i.e., the import cover of reserves, which was 4 months of import at end-September 2001, has sharply improved to 10 months of import at end-September 2002 (see **Figure 9.21**).

It is anticipated that even in the absence of lumpy one-off inflows, continuation of IFI inflows and more strongly the remittances would keep building up the reserves, giving further strength to the Rupee and therefore, to the economy.

Special Section 1: SBP Sterilization Policy- An Explanatory Note[103]

1.1 Backdrop

Pakistan is enjoying a substantial improvement in foreign exchange inflows October 2001 onwards,[104] that has since led to an appreciation of over 8 percent in the Rs/Dollar exchange rate. This rise of the Rupee would have been considerably larger if the SBP had not intervened in the inter-bank forex market, purchasing US dollars (or selling Rupees) to slow down the ascent of the domestic currency. These purchases by the central bank represented a massive injection of Rupee liquidity in the banking system that could have serious repercussions for the monetary policy, banking sector stability and inflationary expectations in the economy. Thus, it was essential for the SBP to simultaneously offset or 'sterilize' its forex market intervention. In this backdrop, this note attempts to explain certain issues regarding the SBP sterilization.

1.2 Forex Market Interventions and Rupee Liquidity

Although, under the floating exchange rate regime the Rs/US$ exchange rate is determined by the market, as in the case of many central banks, the SBP also closely monitors the Rupee's value and intervenes through the sale and purchase of foreign exchange to stabilize the exchange rate when it perceives the need. For instance, as elaborated in the *Annual Report* for FY02, the SBP has made heavy net forex purchases through most of FY02, to stabilize the Rs/US$ parity and to build up the country's forex reserves. These purchases have risen in FY03 amidst an increase in inflows.

It should be noted that the need for foreign exchange purchases depends on the nature of inflows in the market, i.e., whether the inflows are permanent or temporary. For instance, economic literature suggests that the domestic currency should be protected from large volatile foreign exchange inflows ("hot money") that have a tendency to abruptly leave the economy, and can therefore contribute to instability in the domestic economy, e.g. loss of export markets (through a rapid appreciation of the exchange rate), large interest rate fluctuations, etc.

On the other hand, if foreign exchange inflows are permanent in nature, it would be preferable to allow the domestic currency to gradually adjust according to the improvement. Unfortunately, in any case, the the most difficult task in deciding appropriate policy response is to guage the extent to which foreign exchange

[103] The ownership of this section goes to Syed Sajid Ali (Research Economist) and Asma Khalid (Analyst).
[104] For details see, SBP *Annual Report* for FY02.

inflows are transitory. In practice therefore, when in doubt, central banks perfer to err on the side of caution.

Since each time the central bank intervenes to purchase foreign exchange, it adds to liquidity in the Rupee market, it is equally important that the SBP also neutralizes the monetary impact of the forex market intervention. Without this "sterilization", the resultant increase in domestic liquidity, often sans output expansion, can give rise to inflationary pressures.

1.3 What is Sterilization?

Before discussing how SBP offsets its foreign exchange purchases from the interbank market, it would be useful to clearly understand the concept of sterilization with the help of a stylized balance sheet of SBP.

Assets	Liabilities
Net domestic assets (NDA)	**Reserve money**
Claims on government	Currency in circulation
Claims on private sector	Commercial banks' reserves with SBP
Net foreign assets (NFA)	

The movement in SBP balance sheet can also be presented by the following identity:

$$\Delta NDA + \Delta NFA = \Delta RM$$

Where NDA, NFA and RM are net domestic assets, net foreign assets and reserve money (monetary base) of SBP respectively; and Δ symbol represents a change in the variable.

Now consider the case when the central bank intervenes by purchasing foreign currency from the interbank market. Such intervention would increase the stock of the SBP's NFA. On the liability side, commercial banks' reserves with SBP would improve, thereby leading to an increase in the reserve money of SBP.

As evident from the balance sheet, the impact on the reserve money can be offset ("sterilized") by an equal reduction in NDA of SBP.[105]

$$\text{Intervention: } \Delta NDA + \uparrow\Delta NFA = \uparrow\Delta RM$$
$$\text{Sterilization: } \downarrow\Delta NDA + \Delta NFA = \downarrow\Delta RM$$

[105] Since the SBP T-bill holdings are the biggest component of SBP NDA, a fall in the latter is usually achieved by lowering these holdings.

This suggests that sterilization is the first line of defense against large foreign exchange inflows, i.e., while absorption of foreign exchange reserves by the SBP is viewed as a mean to resist any tendency toward nominal appreciation, a simultaneous reduction in domestic assets is considered a way to ward off the inflationary pressures associated with an expansion of the money supply.[106] In other words, sterilization provides breathing room to policymakers, allowing them to assess whether inflows are transitory or permanent.

Although, the choice of intervention (and sterilization), and its size, essentially depends on the exchange rate flexibility desired by authorities, it should be noted that (1) only a part of foreign exchange inflow, which appears in central bank balance sheet, requires sterilization;[107] and (2) any *contraction* in NFA would also require offsetting expansion in NDA of the central bank if the reserve money is to be kept unchanged.

1.4 Sterilization by the SBP

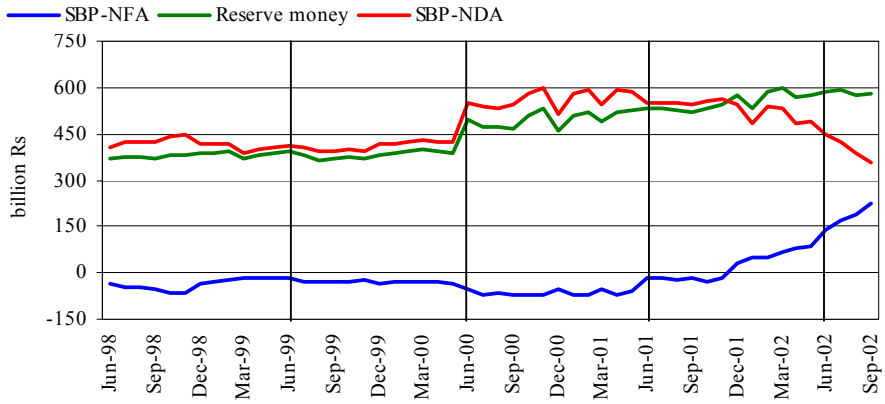
The analysis of reserve money and its constituents since FY99 provide some interesting perspectives on the SBP's sterilization policy (see **Figure 1**). It is clear that the trends in SBP NDA and NFA are showing almost mirror images, suggesting that the movement in NFA have been largely neutralized by changes in NDA. This is reasonable since SBP has been using reserve money as an operational target for pursuing its monetary policy. Thus, any change in SBP-NFA was offset by corresponding change in SBP-NDA so that the reserve money growth remains on target. In this regard, SBP had generally been facing contraction in NFA (a fall in forex reserves), this provided policymakers the scope to expand NDA while keeping reserve money growth constrained within targets.

[106] Depending upon the available scope in the base money growth, a central bank may also use non-sterilized intervention.

[107] In other words, if there were no intervention by the SBP (i.e., exchange rate regime is pure float), SBP-NFA would remain unchanged and there will be no need for sterilization. However, the increase in foreign exchange inflows would lead to an appreciated Rs/US Dollar parity in the interbank market, and the incremental inflows would be used up to finance the higher import demand.

Focusing on post September 11 foreign exchange inflows, it is clear that the extent of central bank interventions (purchases) in the interbank market is unparalleled. The resulting increase in SBP-NFA was, however, largely offset by reduction in SBP-NDA, helping contain a very sharp growth of the reserve money (see **Figure 1**).

Figure 1: Sterilization Efforts



The process of SBP-NDA reduction was particularly very intriguing, as the increased market liquidity (against SBP intervention) was neutralized without actually pursuing any explicit instrument for sterilization. Specifically, while most of the increased market liquidity was being channeled to the government securities, the government was retiring SBP debt using borrowings from commercial banks. This resulted into a reduction of SBP-NDA. Hence, what seems to be a shift in domestic debt structure of the government, actually helped the SBP's efforts to restrict monetary base expansion.

In a sense, the sterilization pursued by SBP is not very different from open market operations: while this process shifts the SBP holdings of government securities to commercial banks *indirectly*, the open market operation achieves similar results *directly*.

Looking at sterilization during FY02, the retirement of Rs 287 billion worth of government securities with SBP more than offset the impact of SBP intervention

in the foreign exchange market. Consequently, the reserve money growth was held down to 9.6 percent despite sizeable foreign exchange purchases by SBP.[108]

Table 1: Sterilization during Q3-FY03
billion Rupees

	Impact on	
	NFA	**NDA**
Interbank US$ purchases[1]	76	
SBP holding of GOP securities		-78
Net Impact	**76**	**-78**
Net impact on reserve money		**-2**

[1]. Includes export of currencies

Not surprisingly, this process continued even during the first quarter of the current fiscal year. In Q1-FY03, SBP purchased US$ 1.28 billion from the foreign exchange market that led to an equivalent injection of Rs 76 billion. In the meanwhile, government raised Rs 127 billion from commercial banks and used these funds to retire SBP debt. In overall terms, SBP holdings of GoP securities fell by Rs 78 billion (see **Table 1**). This also includes a total of Rs 10.7 billion worth T-bills that were off-loaded via open market operations.

Post September foreign exchange inflows in Pakistan are the current account inflows, which are relatively less sensitive to interest rate movements. Furthermore, contrary to theory, the sterilization process did not bring any upward movement in interest rates.[109] In fact, the sterilization efforts were assisted by the following factors: (1) the interbank market remained fairly liquid, which not only allowed interest rates to fall, but also kept the budgetary cost of commercial bank borrowings at low levels;[110] and (2) banks were willing to invest in government papers owing to lack of other preferred investment avenues and due to expectations of interest rate cuts;

1.5 Cost of Sterilization

Since the sterilization entails substitution of SBP T-bill holding with foreign exchange reserves, the immediate cost will be the difference between falling SBP earnings from lower T-bill holdings and the returns on SBP investment of foreign

[108] See SBP *Annual Report* for FY02.
[109] Under normal circumstances, increased borrowing from commercial banks, effectively, lays an upward pressure on domestic interest rates thus widening the difference over international interets rates. This, in turn, subject to the interest sensitivity of capital mobility, can attract even more inflows which may nullify earlier sterilization efforts.
[110] The interest rate pressures were absent as the market was fairly liquid throughout this period, owing to a depressed demand for private sector credit, banks' own cautiousness in pursuing credit, massive deposit growth, higher credit retirement and extensive liquidity injections against SBP foreign exchange purchase.

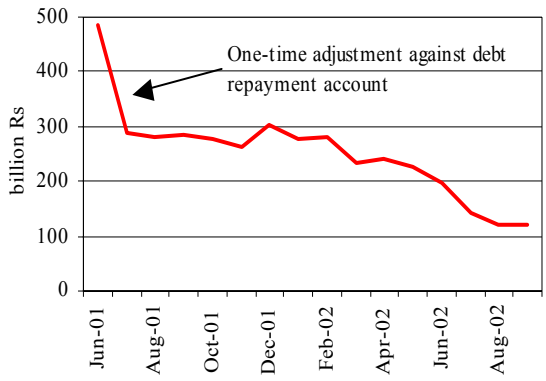
currency reserves.[111] Concurrently, the reserve build up will also increase the revaluation cost to any appreciation of the Rupee/Dollar parity, which would show up in the SBP balance sheet.

The consequent fall in SBP profits will lead to lower transfers to the government. As SBP has transferred most of the earned profits to the federal government in the first quarter, there will be a serious shortfall in government's non-tax revenue receipts by at least Rs 20 billion compared to FY03 budget estimates.

It should be noted that the government is also re-pricing its debt by substituting high-cost borrowings from SBP with low cost financing from commercial banks. The resulting fiscal space would offset to some extent the loss of receipts of SBP profits.

In terms of SBP T-bill holdings, these have declined from Rs 485 billion at end-June FY01 to Rs 119 billion at end-September 2002. However, this massive decline of Rs 366 billion is not entirely attributed to sterilization. In fact, T-bills worth Rs 197 billion were adjusted against special debt repayment account with SBP (see **Figure 2**).[112] It implies that T-bill holdings due to sterilization alone actually fell by Rs 169 billion.

Figure 2: SBP T-bill Holdings



Yet, any policy decision to make sterilized interventions is based on the likely economic implications of foreign exchange inflows. In this regard, the counter-factual reasoning is useful, i.e., what if SBP had not intervened in the interbank market? Or what if SBP had not sterilized its intervention?

[111] The SBP earning would also drop due to the falling T-bill rates.

[112] Despite rescheduling of the external debt repayments, the government was depositing the Rupee counterpart of foreign exchange payment in a special account with SBP as and when these payments became due according to the original payments schedule. Although the purpose of this account was to neutralize the fiscal benefit of debt rescheduling to the government, the government, in practice, was depositing the Rupee equivalent after borrowing from the SBP against T-bills. However, following recent re-profiling of the external debt, the government closed the account, and retired the T-bills held by SBP using its balance.

In the first case, the SBP would not require sterilization. But, in this case,

(1) Rupee would be driven up very abruptly by rising forex inflows, resulting in the loss of hard-to-recapture export markets, damage to the export-oriented industries and increased unemployment.
(2) Businesses would have substantially increased exposure to forex denominated liabilities (taking unhedged foreign currency loans), increasing vulnerability to external shocks. Also, SBP forex reserves would be lower, hampering the central banks' ability to guard against such shocks.
(3) Even if businesses exposure to forex lending would be curtailed through regulations, banks would then have no option but to export capital (i.e. invest their increased forex deposits abroad).

In effect, this was not a policy option given that the increased inflows are potentially exogenous to domestic policy, i.e. it is unclear, for how long this improvement will persist.

In the second case, if the SBP had not sterilized its intervention, the resulting impact on reserve money and expectations for higher prices would make the economy vulnerable to inflationary pressures. On the other hand, banks could be faced with excessive liquidity. The resulting plunge in interest rates could have then forced banks to increase exposure to high-risk borrowers.

Thus, in light of the economic implications of massive foreign exchange inflows, it appears that the SBP had little choice but to make sterilized intervention so that the economic agents may adjust smoothly against the external shock. The fact that the catalyst for the rise in foreign exchange inflows was the policies of other countries towards informal flows, also underlies SBP's decision for gradual adjustment in exchange rate policy.

1.6 Tools of sterilization

1.6.1 Open market operations

The classic form of sterilization is through open market operations that shift the central bank's claims on the government to commercial banks, thus reducing the reserve money. Although the effectiveness of this policy tool for developing countries is limited by a relatively thin and illiquid market for government securities, SBP does not face this constraint as the money market is sufficiently developed in Pakistan. In fact, SBP has been using *indirect* OMOs for sterilizing post September foreign exchange inflows, i.e., the government retired SBP holding of T-bills by means of borrowing from commercial banks.

However, there is a view that since SBP has already offloaded a major share of T-bill holdings in sterilizing earlier interventions, this has curtailed its capacity to neutralize further inflow of foreign exchange. Certainly, this opinion assumes that the SBP has limited instruments of sterilization. As shown below, this is not the case.

1.6.2 Foreign exchange swaps

SBP has also been conducting foreign exchange swaps to restrict growth of the monetary base.[113] According to this arrangement, SBP agrees to sell foreign exchange against the domestic currency and buys it back in future at the forward exchange rate. This sell/buy swap reduces the foreign component of monetary base till such time when the contract matures. In particular, by selling foreign exchange in spot, SBP is reducing net foreign assets, and in turn, the monetary base.[114] However, as soon as the contract is settled, the monetary base expands to its initial level. Hence, foreign exchange swaps are short-term instruments of sterilization.

In a way, this instrument is similar to a repo agreement undertaken for open market operations, where SBP uses government securities to mop up Rupee liquidity from the interbank market; in the case of swaps, SBP is using foreign exchange reserves. Likewise, while the cost of repo for SBP is the difference between the repo rate and foregone earnings on T-bill holdings, the cost of swap shows the difference between forward premium and the foregone earning on reserves.

However, in a situation where the foreign exchange and money markets both are flush with liquidity, conducting a sell/buy swap requires attractive pricing. In this regard, the recent swap sell/buy swaps conducted by SBP were aimed more at addressing the problem faced by exporters as they were getting a very low premium on forward sale of their foregin exchange proceeds.[115]

1.6.3 Using government deposits

It should be noted that the SBP holding of T-bills in no way limits its capacity to sterilize foreign exchange intervention. Even after retiring all of the SBP debt, the

[113] Swap is the simultaneous purchase or sale of an amount of foreign currency against a sale or purchase of the same amount of local currency for a future date.
[114] On the other hand, the mopping up of the Rupee market liquidity would reduce the SBP liability.
[115] In view of the expectations of further Rupee appreciation, exporters were selling their export proceeds in forward. Consequently, large supplies of foreign currency in the forward market forced the premium to levels which were significnatly lower than what interest parity condition suggests.

government can still deposit a certain portion of its borrowing from commercial banks in a special account with SBP – this would sterilize the SBP intervention in the exchange market. However, the cost of sterilization in this case will be assumed by the government, which will be paying market based interest on borrowing from commercial banks whereas its deposits with SBP would be zero return.

Similarly, the reserve money can be contained by shifting public sector deposits from commercial banks to the central bank (as government deposits). But this tool is not effective when such deposits are already held by the central bank by law, or these are not within the government's control or have minor share in banking system's deposit base. On the part of commercial banks, frequent and unpredictable shifting of these deposits is also cumbersome.

Alternatively, the central bank can also float its own securities in the market to mop up the Rupee liquidity. However, such a measure would raise the cost to the central bank.

1.7 Other Supplementary tools

There are other tools for sterilization which do not directly impact the reserve money as such. Instead, these tools influence the monetary expansion by affecting the credit extending capacity of commercial banks.

1.7.1 Raising the reserve requirements

The reserve requirement is also used to sterilize the monetary expansion.[116,117] Since this measure in effect reduces the lending capacity of commercial banks, it restricts the monetary expansion through the multiplier effect. In terms of cost, these requirements effectively serve as a tax on banking system and therefore have a tendency to raise the intermediation cost, that may lead to financial dis-intermediation, and lowering of banks' profitability. Furthermore, frequent changes in these requierments may also be disruptive in efficient management of banks' portfolios.

However, this requirement defeats its purpose in a condition when banks are already maintaining high excess reserves (see **Figure 3**).

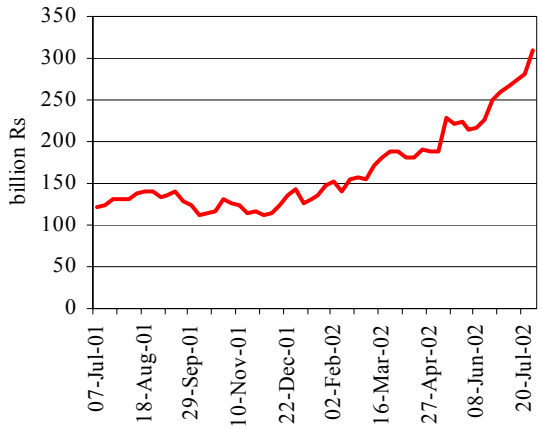
[116] Reserve requirement is the proportion of deposits, which the commercial banks must hold on with the central bank as a statutory requirement. These include cash reserve requirement & statutory liquidity requirement. This tool is generally used in countries where markets for government securities are not well developed.

[117] For example, Colombia in 1991 raised reserve requirements to sterilize capital inflows. See IMF Paper, Sterilizing Capital Inflows (1997) by Jang-Yung Lee

1.7.2 Increasing the discount rate

Similarly by raising the discount rate, the commercial banks' access to central bank credit can be restricted. But, when translated into lending rates, this measure hampers the credit demand from private sector, and that is how M2 growth can be controlled. The effectiveness of this tool is held up by the following factors: (1) this tool requires a rapid transmission mechanism, translating discount rates into lending rates; (2) since commrecial banks' discounting activities are determined by the liquidity available in the market rather than the discount rates, banks may still resort to the discount window if market is short of liquidity; and (3) infusion of the Rupee liquidity following intervention in the foreign exchange market reduces the need to avail central bank financing.

Figure 3: Excess Reserve with Commercial Banks



1.8 Conclusion

The foregoing discussion clearly suggests that (1) given the nature of external shock that prompted abrupt foreign exchange inflows, there was little option for SBP but to intervene in the forex market, and concurrently sterilize its likely impact on monetary policy, banking system, and inflationary expectations; (2) the sterilization policy always involve direct cost; the choice of sterilization instrument simply shifts this cost among concerned economic agents, i.e., commercial banks, SBP, and the government (see **Table 2**).

Table 2: Allocation of Sterilization Cost

Policy instruments	Direct cost on		
	Commercial banks	SBP	Government
Open market operation	✗	✓	✗
Foreign exchange swaps	✗	✓	✗
Use of govenrment deposits	✗	✗	✓
Use of public sector deposits	✓	✗	✗
Use of SBP own debt instruments	✗	✓	✗
Reserve requirement	✓	✗	✗
Discount rate	✓	✗	✗