VISION

To be the pre-eminent financial institution in Pakistan and achieve market recognition both in the quality and delivery of service as well as the range of product offering.

MISSION

To be recognized in the market place by Institutionalizing a merit & performance culture, Creating a powerful & distinctive brand identity, Achieving top-tier financial performance, and Adopting & living out our core values.

Contents

Editor's Corner

Dear readers,

There is a growing interest worldwide in improving the performance of the financial sector through more stringent regulation and supervision. The objectives of financial sector regulation are broadly speaking; to safeguard the stability of the financial system, to promote efficiency in the operation of financial markets and to provide adequate protection to consumers of financial services.

Prudential regulation is a form of regulatory activity, with its main focus on the safety and soundness of financial institutions. It generally seeks to ensure that financial institutions have adequate resources to support the volume and nature of business undertaken, provide some minimum level of assurance to consumers about the financial soundness and integrity of financial institutions, ensures that financial institutions manage and monitor risks, keeps a close scrutiny of the quality and strategy of management, relies on professional experts among others.

The State Bank of Pakistan has established prudential regulations that act as the ground rules and guidelines for the financial industry. These mostly pertain to capital adequacy, quality of assets, management, classification and provisioning for loans, risk concentration, etc. Banks and development financial institutions are expected to operate within this framework and conduct their business in a safe and sound manner, taking into account the risks associated with their activities. It is the State Bank's intention to help develop the banks' internal capacity.

While regulations, have been in force for more than a decade, periodic revisions are made to improve upon the regulatory regime by the State Bank. Given the changes and new developments in the financial markets, the existing prudential regulations have been updated and have incorporated some of the best international practices. Separate sets of prudential regulations have been issued for Corporate/Commercial Bank, SME Financing, Mircofinance Banks/Institutions, and Consumer Financing. Earlier banks were applying the same single set of rules for all these sectors. The new Prudential Regulations would come into effect from January 1, 2004, giving banks time to prepare themselves for complying with the new set of rules.

The new Prudential Regulations for Corporate/Commercial Banking have four different sections, Risk Management, Corporate Governance, Know Your Customer and Anti Money Laundering, and Operations. For SME Financing and Consumer Financing the separate set of regulations cover only the Risk Management category, as for the remaining categories the Prudential Regulations for Corporate Banking would be applicable.

The new set of prudential regulations for SMEs is expected to encourage banks and development financial institutions to develop new products to meet the financing requirements of SMEs, be more pro-actively involved with the SMEs, than what they have been doing historically, or, in other words, let the SMEs become the focus for a significant portion of their lending portfolio.

This would assist the government's Poverty Reduction Strategy, as SMEs have been identified as one of the four sectors to lead the revival of economic growth. A key economic determinant of poverty in Pakistan has been the sluggish investment levels, particularly in the labour intensive sectors. If banks/DFIs enhance their lending to SMEs, it could go a long way in reviving economic activity, providing employment opportunity, kick start the economy, particularly, industrial activity, and lead to better human development.

As there are no general or universal programmes to provide social safety nets for the poor, a number of programmes are operating to respond to the needs of the poor. Microfinance is one such scheme, which enables the poor to gain access to capital to finance investment in income generating activities. Consumer financing would allow individuals to meet their personal or household needs. It should help stimulate capital investment and spur economic growth.

As such, State Bank of Pakistan while encouraging and promoting self-regulation, developing effective risk management capabilities in the banks/DFIs, improving corporate governance is at the same time lending support to the government's efforts at poverty alleviation.

Ayesha Mahmud

Abstract of the Bulletin

Small and Medium Enterprises – Promoting their growth in Pakistan

- Small and medium enterprises play a fundamental role in promoting economic and industrial production. They have linkages with larger enterprises and contribute towards value addition and exports.
- SMEs have strong links with growth, employment and poverty reduction.
- Recognizing the strength of SMEs, the government of Pakistan has established the SME Bank, and Small and Medium Enterprise Development Authority with the objective to launch an aggressive SME development strategy.
- Given the importance of SMEs in the economic development of Pakistan, and to encourage the flow of bank credit to this sector, a separate set of Prudential Regulations specifically for SMEs have been issued by the State Bank of Pakistan.
- These regulations should encourage banks/DFIs to develop new financing techniques and innovative products to meet the financial requirements of SMEs.

Pakistan's Bond Market

- Bonds are debt instruments, which can help raise funds for long term investment projects and short term financial needs.
- The bond market plays an active role in mobilizing and channeling savings into productive investment that promote economic growth and provides infrastructure for the development of a sound financial system.
- Pakistan's bond market is at an early stage of development. It currently covers debt and debt like securities issued by the government, statutory corporations and corporate entities. The government issues dominate the bond market. The market size is much smaller compared to many developed countries.
- The issuing and trading of corporate debt securities in not a new phenomenon in Pakistan. During the 1960s and early 1970s, corporate debentures issued by Pakistani companies were listed on the stock exchanges. This activity came to a stand still after the nationalization of financial institutions in 1972.
- Since 1995, several measures have been taken by the government to promote bond market in Pakistan. The economic environment for a healthy corporate bond market is much favourable now. Currently the Term Finance Certificates and Pakistan Investment Bonds provide an attractive opportunity for the investors.

Cotton – Current Demand and Supply Position

- Current cotton crop has been affected by heavy rains and pest attack.
- As consumption requirement of mills has grown at around 12 million bales, the gap is met through imports.
- Price of cotton has risen in the local cotton market and this has had an affect on the textile sector, which continues to dominate the industrial activity in the country, contributing the major share of export earnings and as a major employer of industrial labour force.

Pak Trade with Islamic Countries

- Pakistan enjoys cordial trade relations with Islamic countries.
- It imports petroleum and products from Saudi Arabia, Kuwait, UAE and Iran, and exports textile products, rice, leather, fruits and vegetables etc.

Market Analysis

- The market underwent a major correction in September and October 2003. Negative sentiment was fuelled by expectations of a rise in interest rates and new regulations governing bank investing activities in equity markets.
- Draft rules announced on margin financing did little to help market sentiment. It will take some time for shattered confidence to be restored and the market recovery is expected to be gradual.

Small and Medium Enterprises – Promoting their growth in Pakistan

Definition of SMEs

Small and medium enterprises (SMEs), have been defined against various criteria, such as the number of workers employed, the size of assets, the value of net sales. In Pakistan, there are three different definitions of SMEs. The State Bank of Pakistan says SMEs would be those who fulfil the following criteria in its entirety.

Nature of Business	Assets Requirement Criteria	Number of Employees Criteria	Net Sales Criteria
Trading/ Service	Total Assets at cost upto Rs.50 (M) excluding land and building	Not more than 50	Upto 300 (M)
Manufact-uring	Total Assets at cost upto Rs.100 (M) excluding land and building	Not more than 250	Upto 300 (M)

** Note SME means an entity, ideally not a public limited company.*

Meanwhile, Small & Medium Enterprise Development Authority (SMEDA) has defined SMEs in terms of employment generated as well as investment in productive assets.

	Employment	Productive Assets (Rs. Mn.)
Small	Between 10-35 people	2-20
Medium	Between 36-99 people	20-40

Source: SMEDA, Pakistan

SME Bank defines SMEs as: -

§ An enterprise with total assets of upto Rs.20 million is a small enterprise.

§ And if the total assets exceed Rs.20 million, upto Rs.100 million, the enterprise is a medium enterprise.

A comparison of the three definitions indicate that the State Bank of Pakistan has increased the asset size and now only those manufacturing or trading units who meet all the three criteria are considered as SMEs. Earlier, public limited companies were excluded from the purview of SMEs but now it is not a restriction. The size of SMEs as defined by SMEDA and SME Bank is much smaller.

There is growing awareness of promoting small and medium enterprises which operate in all sectors of the economy and comprise the majority of the private sector. They meet significant economic and social functions in the economies of both developed and developing countries.

International comparisons

For instance, small and medium enterprises have contributed greatly to Japan's economic expansion. The share of such enterprises in the total number of enterprises is among the world's highest (over 95%). While large enterprises have undertaken primarily mass production, SMEs have focused on limited production of diversified products. They have provided lots of innovation to the Japanese society through the development of new products during their growth. They have continued to grow both in number and size About 60% of all SMEs are sub-contractors supplying to large corporations, particularly to four industries: machinery, electrical equipment, transportation equipment and textiles.

In Japan, the government's system for assisting small and medium enterprises is one of the most extensive of its kind in the world. It includes financial assistance for modernisation, management consultation services etc. The tax system helps alleviate the financial burdens of SMEs. Emphasis in the government's policy for SMEs has gradually shifted from protection to cooperation with large firms and then to assistance for modernisation and improvement of technical and management skills.

In most advanced economies, SMEs are found in a wide array of industries. For instance, the SME sector in New Zealand is large and diverse, making up a large proportion of almost every industry. More than 70% of entities in all industries (except government and education) are small enterprises. In developing countries, they make valuable contribution to industrial value added, and play a crucial role in generating and diversifying exports. Around 40-70% of the value added originates from only a few industries, usually food & beverages, jewellery & gems, leather & leather products, furniture, textiles, wood & products and handicrafts.

In Pakistan the SME sector can be the engine of growth, given the large number of opportunities in the services sector, in the agriculture sector and in the industrial sector. They have however not been able to derive optimal benefits from time to time. This is largely because of the problems the SMEs face in Pakistan.

Pakistan National Human Development Report 2003, UNDP has highlighted constraints to the rapid growth of small scale enterprises in small towns of Pakistan. Following are the major constraints: -

Cons-traints to growth of SMEs

- Inability of small units to get vending contracts for the manufacture of components from the LSM sector.
- Due to lack of expertise in production management, the frequent inability to achieve quality control, and to meet tight delivery schedules.
- Lack of specific skills like advanced mill work, metal fabrication, precision welding, all of which are needed for producing quality products with low tolerances and precise dimensional control. In other cases accounting and management skills may be inadequate.
- Difficulty faced by small units in getting good quality raw materials, which often can only be ordered in bulk (for which the small entrepreneurs do not have the working capital), and from distant large cities.
- Lack of specialized equipment.
- Absence of fabrication facilities such as forging, heat treatment and surface treatment which are required for manufacture of high value added products, but are too expensive for any one small unit to set up.
- Lack of capital for investment and absence of credit facilities.

Box

Excerpts from Governor SBP's Speech Addressed at the SMEDA-IBP Seminar

In his key note address at the SMEDA-IBP seminar on "Issue of SME Financing" held at Lahore on October 24, 2003, Dr. Ishrat Husain, Governor State Bank of Pakistan, has talked about the major players who have to work together in a coordinated manner to contribute to the success of the SMEs. We reproduce here some excerpts from his speech: -

- First, the government and the regulatory agencies such as the State Bank of Pakistan should provide conducive enabling environment for SMEs to operate. This means that macro economic policies are sound, regulatory regime is supportive and legal system enforces contracts and property rights. In the past the SROs were being used to favour certain individuals or tariffs were raised to protect selective groups or banks loans were given to supporters of the ruling parties. In the past four years, however, these practices have been done away and neither any SRO has been issued nor any preference in the tariff has been given.
- The SBP reviewed its own role to determine whether or not it was creating any hurdles in the way of lending to SMEs. We found out that the same prudential regulations which applied to corporate borrowers were also made applicable to consumer, SME, Micro finance although the requirements were different for each market segment. We therefore decided to formulate a separate set of regulations for SMEs.
- The second player in this process is the Provincial and the local Governments. They have to allocate and earmark land for setting up industrial estates and deliver the infrastructure facilities in these estates.
- The third player is the Provincial Small Industries Corporations which used to provide common technical service centres such as design, fabrication, foundry, repair workshops, marketing outlets and other services to the SMEs. As the performance of this type of public sector corporations has not been very satisfactory in the past it is time to consider a public-private partnership in which the management and operations of these facilities and centres are entrusted to the private partners.
- Fourth, organizations such as SMEDA have to play a critical role in the business development support, advisory services and managerial training of SMEs. SMEDA can design simplified standardized book keeping, inventory management and ledger forms which can aid in the preparation of financials.
- Fifth, there is a widespread network of technical and vocational training institutes and polytechnics throughout the country. The provincial governments who own these institutes should examine the contents and curriculum, pedagogical tools, evaluation and assessment procedure,

incentive structure for the faculty members and bring about the necessary changes to align the supply of the graduates with the emerging needs of the SME sector.

- Sixth, the SME Bank alone cannot cater to the needs of the entire sector but it could develop a prototype of program lending, credit appraisal and delivery methodology, standardized documentation, monitoring mechanisms which can be replicated and followed by other commercial banks.

- Seventh, the commercial banks, leasing industry, modarabas themselves have to develop dedicated groups for servicing the SMEs. They should establish their presence and branches at the clusters and places such as Daska, D. I. Khan, Wazirabad, Khairpur, Kotri, Gwadar which have large untapped potential. The banking industry has to invest in people, processes and systems to minimize their risks and enhance their returns on the SME segment.

- Eighth, the Institute of Bankers has to play a role. As this is a new field of endeavour the banking staff have to be imparted training in credit appraisal, documentation, approval, monitoring and recovery and his can be done under the auspices of IBP.

- Ninth, the large firms have a major role to play in the promotion and growth of SMEs through sub-contracting arrangements. These large firms can also leverage their standing with the financial institution by borrowing at fine margins in their own name and advancing this to their sub-contractors and vendors. They can deduct the amounts advanced from the payments due for the goods supplied or services rendered.

- Finally, the associations of SMEs should launch awareness programmes among their members about the opportunities that are already available, assist them in linking up with the appropriate support institutions, listen to the genuine difficulties and problems faced by their members and articulate them to the right quarters.

- The State Bank of Pakistan would very much like the SME financing to become a mainstream activity of the banks in Pakistan.

SMEs and employment generation

SMEs role in the generation of employment, creation of income for a significant number of low income workers and for filling the domestic demand for low cost goods and services is significant. Unemployment and poverty are formidable challenges faced by a large segment of the population of many developing countries of Asia and the Pacific.

Rapid economic growth is a necessary condition for poverty reduction. Growth resulting in the increased capacity of the domestic labour market to absorb surplus labour is key to fighting poverty. Growth creates jobs that use labour, the main asset of the poor. As growth proceeds, private sector employment becomes the major source of economic support for the majority of workers and their families. SMEs play a central role in the development of private sector activity, in both urban and rural areas.

SME could be those with larger plant size and using modern technology often linked with large enterprises as sub-contractors and producing modern consumer and manufacturing products. These are mostly present in the urban areas. Then there is the traditional SME sector, consisting of artisans, workshops, craft industries which are normally found in rural areas. There is a third category of SMEs, the agro-based industries, most often found in semi-urban areas.

In Pakistan, approximately 220,000 SMEs operate, which provide employment to over 80% of the labour force, contribute around 50% to GDP, and more than 50% towards export earnings. They help the women in both the urban and rural areas to utilize their vocational skills and contribute and support the large industrial establishments. With population growing at 2.1% per annum and addition of 3.1 million persons every year, the growing labour force is a formidable challenge facing Pakistan.

The size of the labour force is around 43 million, where 70% reside in rural areas and 30% in urban areas. The government acknowledges the repercussions of growing unemployment and has taken steps to create job opportunities. These include among others, the development of small and medium enterprises, as it would help in generating jobs on a large scale.

In countries with growing population the probability of getting employment is low, which is reflected in low human resource development. Most are poor because of their inability to get a job. The unemployment problem has compounded in Pakistan because of the increased frequency of negative growth years in some of the major crops. The slowdown in growth and increased instability of output in major crops has resulted in sharply increased rural poverty. This alongwith slow growth of large scale manufacturing has made things worse.

SMEs in China

In most success stories of economic development, the growth of SMEs has been central, particularly in providing employment for poor people. In the case of China, the Township and Village Enterprise have played this role. In response to an initial set of reforms that created a better investment climate in the early 1980s, these enterprises sprung up quickly and generated a large amount of employment and income. Their success has contributed much to China's growth and poverty reduction.

Bangladesh / Thailand SMEs

SMEs in Bangladesh have contributed significantly to manufacturing growth and employment creation. There are around 27,000 medium sized enterprises and around 150,000 small scale enterprises in the country. 80% of manufacturing establishments are SMEs accounting for 80% of the labour force. The garments industry has contributed to SME development through orders for accessories, packaging materials etc, while the footwear industry increased sub-contracts to SMEs. In Thailand SMEs account for 70% of employment in the industrial sector, where the main industries which are dominated by SMEs include metal and steel, plastic products, rubber and garments.

It is not only in developing countries like Pakistan, where SMEs help in job creation, but an ILO report on "General conditions to stimulate job creation in small and medium sized enterprises" (1995) show that small and medium sized enterprises are major contributors to private sector employment in the industrialised countries. SME employment in member countries accounts for between 57% (US) and 81% (Italy) of employment in industry and market services combined. The share of small enterprises alone ranges from 44% (Canada) to 71% (Italy).

The focus on development of small scale industries, which have a low gestation period, are labour intensive and can generate a large output per unit of investment compared to the large scale manufacturing sector would not only accelerate economic growth in the medium term at relatively low levels of investment, but would also increase employment and exports for given levels of GDP growth.

SMEs and poverty alleviation

SME development is an effective tool to alleviate poverty. In our part of the world, the fundamental challenge is poverty reduction, as nearly two-thirds of the world's poor live in Asia. In Pakistan, the incidence of poverty has increased over the years and is currently at around 32%, with a higher percentage in rural than urban areas.

The governments have over the years taken initiatives at helping the poor. The Government of Pakistan's Poverty Reduction Strategy aims to provide an integrated focus on a diverse set of factors that impact poverty. Small and Medium Enterprises have been identified as one of the four sectors to lead the revival of economic growth. The importance of the private sector has been emphasised alongwith enhanced investment as core elements of the strategy for high growth and employment generation. It accords high priority to the development of micro, small and medium enterprises. Development of SMEs is a tool that has been introduced in many countries, particularly in developing, as one of the potential contributors to poverty alleviation.

SMEs are highly labour intensive and provide employment to the bulk of Pakistan's non-agricultural labour force. SMEs in the manufacturing sector also account for a significant share of manufactured exports. Promoting SME growth would thus lead to more job opportunities, better income, and in raising living standards.

The rapid growth of small scale enterprises would not only accelerate economic growth in the medium term at relatively low levels of investment, but would also increase employment and exports for given levels of GDP growth. Employment generation is critical for poverty reduction. The Poverty Reduction Strategy has recognized the centrality of employment generation for poverty reduction. SMEs are highly labour intensive and provide employment to the bulk of Pakistan's non-agriculture workforce. SMEs in the manufacturing sector also account for a significant share of manufactured exports. Promoting SME growth would help those 70% of the population who live in rural areas, who are pushed into poverty because of inadequate income.

SMEs and export promotion

In developing countries like Pakistan, SMEs are exporting a wide array of products. Specific sectors with large SME presence like carpet manufacturing, cutlery, surgical instruments, gems and jewellery, fisheries, power looms are involved in the export of unfinished products.

The contribution of these exporting small enterprises in the total export exchequer can be increased by shifting from low value added to higher value added or finished goods. SMEDA is driving industrial growth towards value added products, resulting in increased export earnings.

International experience shows that SMEs have played a significant role in the early phases of an export oriented industrialisation strategy by supplying low cost labour intensive products such as textiles and garments, leather goods and other consumer products. As they have developed, SMEs have produced light engineering goods. In countries like China, Korea, Philippines, Thailand, the electronics sector is proving to be highly productive, especially for exports from the SME sector.

In the newly industrialised economies, the export oriented development strategy made a significant contribution and in that context SMEs had a major role to play. In Malaysia, SME exports make up about 20% of total exports, in Pakistan SME exports account for about 80% of total exports of manufactured products and in the Philippines, some 90% of exporters fall into the category of SMEs and their contribution to export is estimated at around 20%.

SMEDA established

In the past, the Government of Pakistan had a uniform policy for large and small enterprises in industry and trade. As a consequence, the specific needs of the SMEs could not be met. Given the potential of the SME sector, the government has established the Small and Medium Enterprise Development Authority (SMEDA) and the SME Bank. The later by merging Small Business Finance Corporation and Regional Development Finance Corporation with a mandate to provide financial assistance and business support services to SMEs.

SMEDA has been created with an SME focus, with a mandate to act as the provider and facilitator of support services to SMEs, (financial, management, marketing etc); to be the resource base for the SMEs; and to be the voice of SMEs in Pakistan. In other words, it functions as the apex policy formulation body for the SMEs. It has identified business opportunities. As most of the SMEs are involved in the production of export oriented items, SMEDA is encouraging growth of value added products. It provides sector briefs, which help in understanding the sector; the regulatory procedures assist in knowing the prevailing laws of the country, pre-feasibility studies have been published on certain sectors, which introduces the subject matter and provide a general idea and information on the said area. As SMEs are highly labour intensive most of whom are unskilled and untrained, SMEDA is imparting training to them, primarily in three major areas: Management, Technical and Agricultural training and development.

In the provinces following organizations are involved in promotion of small and medium industries:

Punjab Small Industries Corporation
Sindh Small Industries Corporation
NWFP Small Industries Corporation
The Directorate of Small Industries Balochistan

These have helped set up small industries in the provinces, training centres of traditional crafts and providing job opportunities to a large number.

SME financing

Despite their dominant numbers and importance in job creation, SMEs have faced difficulty in obtaining formal credit. Although there is an established market structure for financial services, the access to them is not easy for SMEs. Most need some kind of collateral which the SMEs may not be able to provide. Some of the enterprises poorly document their business activities and are unable to provide the collateral needed.

SME Bank established

It was felt that a Bank must be established to exclusively cater to the needs of the SME sector, offering specialised financial products and services to help stimulate SME development. The SME Bank was set up in December 2001, with the objective to support and promote development of SMEs, concentrate on value addition and export oriented SMEs, and enable SMEs to play a role in stimulating GDP growth, create job opportunities and reduce poverty.

The Bank has also enhanced credit in export oriented SME areas such as Sialkot, Daska, Gujranwala, Gujrat, Faisalabad and Multan. It has also introduced specialised financial products and programme lending schemes under the name of Hunarmand Pakistan, that cater to a variety of credit needs of the SMEs. By the end of 2002, the Bank had introduced lending schemes for fans, cutlery, surgical instruments, doctors and dentists clinics, women entrepreneurs and CNG stations.

During the year 2002, the SME Bank made a credit disbursement of Rs.712 million to 1008 customers against a target of Rs.800 million. The following table gives the distribution of lending: -

SME Bank lending portfolio

Sectors	Percentage
Light Engineering	2.91
Rubber & Rubber Products	1.00
Chemical & Pharmaceuticals	0.64
Petroleum & Energy	7.43
Food & Beverages	6.57
IT	0.98
Sports Goods	0.03
Health Care	5.34
Dates	0.56
Fisheries	1.51
Furniture	1.00
Auto (OEM)	2.80
Textile	7.07
Gems & Jewellery	3.16
Transport Industry	5.62
Leather & Leather Products	0.90
Garments	6.15
Education	6.57
Plastic	3.47
Surgical	1.87
Printing & Packaging	1.09
Mining	2.75
Communication	2.36
Trading	12.40
Services & Miscellaneous Industries	15.82
Total	100.00

Source: Annual Report 2002 SME Bank

Half yearly results of the Bank show that at end June 2003, the number of SMEs financed had risen to 2213, while disbursement had risen to Rs.3146 million.

It is not only the SME Bank which is looking after the financial needs of the SME sector, but the commercial banks are also playing a vital role in developing small and medium enterprises. Beside other banks, National Bank of Pakistan, Habib Bank Ltd, Muslim Commercial Bank have an SME unit to look after the needs of the SMEs. National Bank of Pakistan has designated 36 branches all over Pakistan to look after the specific needs of the SMEs, by providing one window operation. The Bank gives emphasis to export oriented industries, given the large presence of SMEs in this sector. It would help develop the vendor industry and lend support to the government's deletion programme. Auto spare parts manufacturing is one of the priority areas under selected industries being fed by SMEs.

Banks cater to SMEs

One of the reasons banks have been hesitant to lend to SMEs is because of lack accounting records, inadequate financial statements or business plans, and lack of collateral which makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals. It is primarily because they are in the unorganized sector which is largely undocumented.

As a result, commercial banks are generally biased toward large corporate borrowers, who provide better business plans, more reliable financial information, and higher profitability for the banks.

Banks are now developing standardized services, focusing on the cash flow earning capacity of their clients. They would also support the companies, which help SMEs plan their financial statements, and bring their business to books.

Box

Prudential Regulations for SMEs Financing

Given the important role of Small and Medium Enterprises in the economic development of Pakistan, a separate set of Prudential Regulations specifically for SME sector has been issued by the State Bank of Pakistan. The objective is to encourage banks/DFIs to develop new financing techniques and innovative products so to meet the financial requirements of SMEs.

Highlights of the Regulations

REGULATION R-1
SOURCE AND CAPACITY OF REPAYMENT AND CASH FLOW BACKED LENDING

Banks/DFIs shall specifically identify the sources of repayment and assess the repayment capacity of the borrower on the basis of assets conversion cycle and expected future cash flows. In order to add value, the banks/DFIs are encouraged to assess conditions prevailing in the particular sector/industry they are lending to and its future prospects.

2. The rationale and parameters used to project the future cash flows shall be documented and annexed with the cash flow analysis undertaken by the bank/DFI.

REGULATION R-2
PERSONAL GUARANTEES

All facilities extended to SMEs shall be backed by the personal guarantees of the owners of the SMEs. In case of limited companies, guarantees of all directors other than nominee directors shall be obtained.

REGULATION R-3
LIMIT ON CLEAN FACILITIES

In order to encourage cash flow based lending, banks/DFIs are allowed to take clean exposure, i.e., facilities secured solely against personal guarantees, on a SME upto Rs.3 million provided that funded exposure should not exceed Rs.2 million.

REGULATION R-4
SECURITIES

Subject to the relaxation in Regulation R-3, for facilities upto Rs.3 million, all facilities over and above this limit shall be appropriately secured as per satisfaction of the banks/DFIs.

REGULATION R-5
MARGIN REQUIREMENTS

The banks/DFIs shall adhere to the margin requirements as prescribed by the State Bank of Pakistan from time to time.

REGULATION R-6
PER PARTY EXPOSURE LIMIT

The maximum exposure of a bank/DFI on a single SME shall not exceed Rs.75 million. The total facilities (including leased assets) availed by a single SME from the financial institutions should not exceed Rs.150 million provided that the facilities excluding leased assets shall not exceed Rs.100 million.

REGULATION R-7
AGGREGATE EXPOSURE OF A BANK/DFI ON SME SECTOR

The aggregate exposure of a bank/DFI on SME sector shall not exceed the limits as specified below: -

PERCENTAGE OF CLASSIFIED SMEs ADVANCES TO TOTAL PORTFOLIO OF SMEs ADVANCES		MAXIMUM LIMIT
a.	Below 5%	No limit
b.	Below 10%	3 times of the equity
c.	Below 15%	2 times of the equity
d.	Upto and above 15%	Upto the equity

REGULATION R-8
MINIMUM CONDITIONS FOR TAKING EXPOSURE

While considering proposals for any exposure (including renewal, enhancement and rescheduling/restructuring) exceeding such limit as may be prescribed by State Bank of Pakistan from time to time (presently at Rs.500,000/-), banks/DFIs should give due weightage to the credit report relating to the borrower and his group obtained from a Credit Information Bureau (CIB) of State Bank of Pakistan.

2. Banks/DFIs are encouraged to refer the prospective SME borrower to SME Associations for obtaining information about its character and credit worthiness.

3. Banks/DFIs shall, as a matter of rule, obtain a copy of financial statements duly audited by a practicing Chartered Accountant, relating to the business of every borrower who is a limited company or where the exposure of a bank/DFI exceeds Rs.10 million, for analysis and record.

4. Banks/DFIs shall not approve and/or provide any exposure (including renewal, enhancement and rescheduling/restructuring) until and unless the Loan Application Form (LAF) prescribed by the banks/DFIs is accompanied by a ‘Borrower’s Basic Fact Sheet’ under the seal and signature of the borrower as per approved format of the State Bank of Pakistan.

REGULATION R-9
PROPER UTILIZATION OF LOAN

The banks/DFIs should ensure that the loans have been properly utilized by the SMEs and for the same purposes for which they were acquired/obtained.

REGULATION R-10
RESTRICTION ON FACILITIES TO RELATED PARTIES

The bank/DFI shall not take any exposure on a SME in which any of its director, major shareholder holding 5% or more of the share capital of the bank/DFI, its Chief Executive or an employee or any family member of these persons is interested.

REGULATION R-11
LOANS/ADVANCES

Banks/DFIs shall observe the prudential guidelines given specific to the matter of classification of their SME asset portfolio and provisioning there-against.

The rescheduling/restructuring of non-performing loans shall not change the status of classification of a loan/advance etc. unless the terms and conditions of rescheduling/restructuring are fully met for a period of at least one year (excluding grace period, if any) from the date of such rescheduling/restructuring and at least 10% of the outstanding amount is recovered in cash.

For more details see www.sbp.org.pk

Pakistan's Bond Market

Bonds are debt instruments, which can provide funds for the financing of long-term investment projects and also short term financial needs. As a long-term fund raising instrument, bonds help promote the matching of long-term funds and investment. Borrowing through bonds helps diversify funding sources primarily from banks/international lending institutions to banks, insurance companies, pension funds and investment funds. Given the depth of the market and the sizes that can be transacted, bonds can raise large funds without much slippage.

Fund raising instrument

The bond market is the foundation of capital market and plays an important role in mobilizing and channeling savings into productive investment that promotes economic growth and provides basic infrastructure for the development of a financial system. Bond market development is beneficial, atleast, in two aspects: Firstly, it helps to resolve liquidity problem of banks in the country and secondly it helps to increase the inflow of foreign capital. It can also add to corporate transparency and market discipline.

Bond market promotes economic growth

The consequences of operating a financial system with a banking system and equity market but without a bond market are profound and far reaching. The absence of a bond market may render an economy less efficient and significantly more vulnerable to financial crisis. The underdevelopment of bond market limits risk-pooling and risk sharing opportunities for both households and firms.

To develop a bond market, three essential components are needed:

Three essential compo-nents

§ A deep and liquid government bond market to serve as benchmark yield curve against which corporate paper can be priced.

§ An adequate infra-structure, both legal and operational, to support trade and transfer of instrument and funds.

§ Collaboration of the intermediaries, the end users and the private sector.

A government bond market, if operating satisfactorily, can significantly increase investors confidence in the overall bond market and in the whole capital market. A well developed government bond market can help government to finance expenditure and conduct monetary policy efficiently.

Bond market allows a more efficient allocation of savings. Banks prefer to lend fairly short term loans because their funding sources are very short and at the sametime they are subject to regulation by the country's central bank. Bond markets with their long-term institutional investors on the other hand, help unleash major forces of savings that can be channeled into important investments for economic development. With their lower cost of capital and long term nature they help spur industrial development.

Bond market helps develop-ment

According to an Asian Development Bank study, bond markets in general and corporate bond markets in particular, have developed rapidly in countries with stable and predictable macro-economic environment. However, in countries having relatively unstable macro-economic environment, the corporate bond market has to rely heavily on government support.

Various studies conducted on the efficacy of generating funds through bond floatation generally highlights the benefits of the government bond markets and maintains that bonds can provide an alternative non-inflationary source of financing, fostering a healthy capital market and improve the functioning of the financial system. Active bond markets can have indirect benefits through better monetary management, enhanced transparency and a widening of investment opportunities.

Non inflat-ionary source of financing

In developing countries, the role of the bond market has been very small, relative to that of the banking system or equity market. Although there is considerable potential for developing domestic bond market in Asian emerging countries with high saving rates, little attention has been paid.

Role of bond market

One of the causes of the Asian financial crisis was the poorly developed bond markets in the region. Investors could not diversify their investment for lack of opportunities. The lack of sophisticated Asian bond market resulted in substantial official savings being invested outside the region.

Demand for quality bonds

Domestic savings in Asia, which stand at more than 30% of GDP, are the best funds for issuing bonds. There is also tremendous interest in high quality fixed income securities in Asia. There is a need for Asian central banks to invest their foreign currency reserves in bonds. The Asian financial institutions have a strong demand for quality bonds with good yields. However, the Asian bond market still lacks quality issuers and investors' confidence.

Pakistan's market

The equity market in Pakistan has grown in terms of size accompanied with institutional development, but fixed income securities market has only partly developed. At present, little attention is being paid to mopping up of funds from the fixed income market whereas, the entire corporate sector relies on securing funds either from the banks in the shape of loans or from the stock exchange by floating shares.

Early development stage

Consequently bond market development in the country has lagged as elsewhere in Asia. It currently covers debt and debt like securities issued by the government, statutory corporations and corporate entities. The market for bonds of statutory corporations and corporate entities though, in early stage of development, has great potential for growth. However government issues dominate the bond market, with corporate bond market accounting for only 0.6% of GDP.

Market size

In Pakistan the bond market size can be examined from the perspective of outstanding debt and trends in the issue of government securities. Based on outstanding government debt position, the market size appears to have increased from Rs.800 billion as of June 30, 1995 to around Rs.1852 billion as of June 30, 2003, an increase of 132%. However, it looks deceptively large as various forms of government debt take up nearly 40% of GDP. The actual bond market size is much smaller compared to many developed countries.

Several measures have been taken by the government to promote bond market in Pakistan.

Promoting bond market in Pakistan

The government started borrowing through auctions in the open market from 1991 to raise funds on market related rate of return. In an effort to develop bond market it introduced six month treasury bills, a zero coupon debt instrument, also known as Market Treasury Bills (MTBs), and a medium and long term FIBs, of 3-years, 5-years and 10-years maturities with coupon rates fixed at 13%, 14% and 15% respectively in March 1991. In July 1996. Short Term Federal Bonds (STFBs) were launched replacing 6-month MTBs, but in June 98, 6-month MTBs again replaced STFBs, and at the sametime MTBs of 3 months and 12 month maturity were also introduced.

Sales / auctions of debt instruments

The sale of FIBs was suspended in July'98, due to very thin participation of investors after banks, the largest bidder of FIBs, stopped bidding. However, sale and purchase of outstanding FIBs in the secondary market continued despite suspension of auctions. Trading in STFBs remain in vogue till their maturities, while trading in TBs of all maturities has picked up in the secondary market. After the lapse of 30 months since the suspension of FIBs auction, the government, in December 2000 introduced Pakistan Investment Bonds (PIBs), a new long term debt instrument aimed at expanding the horizon of investment for pensions and benevolent funds.

The bonds are of 3-years, 5-years and 10-years maturities available at fixed coupon rates, which were as high as 12.5%, 13.0% and 14.0% respectively at the time of launching. The rates have fallen considerably in the past three years. Currently the rates are 6%, 7% and 8%. The launching of PIBs has helped boost the development of corporate bond market in the country.

Debt instruments

The government debt instruments now comprise of Treasury Bills (TBs), which are purchased by financial institutions, both banks and non banks, through auction conducted by the State Bank of Pakistan. The issuance of STFBs was phased out in 1998-99, and replaced by MTBs. Federal Investment Bonds (FIBs) are medium and long term debt instrument sold at par with a fixed yield. PIBs, are mainly long term debt instrument. Both medium and long term FIBs and PIBs are permanent debt while floating debt comprises of TBs, which are short term.

Outstanding Domestic Debt

(End-June)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
A-Permanent Debt (Rs. Bn)	294	295	281	277	257	260	281	368	428
of which: (%)									
Federal Investment Bonds	56.5	55.3	54.8	52.0	52.9	51.2	40.2	22.0	10.5
Pakistan Investment Bond	-	-	-	-	-	-	16.4	41.8	53.5
Prize Bonds	15.3	17.3	21.7	25.6	31.5	31.2	32.7	28.0	30.4
B-Floating Debt (Rs.Bn)	294	361	434	474	562	647	738	558	516
of which: (%)									
Market Treasury Bills	-	-	-	-	25.3	13.9	14.1	37.3	78.1
6 Months Treasury Bills	59.9	67.9	-	7.2	-	-	-	-	-
Adhoc Treasury Bills	20.7	16.9	14.1	13.1	16.0	13.9	16.9	22.0	-
Short Term Federal Bonds	-	-	21.4	22.2	-	-	-	-	-
C-Unfunded Debt (Rs.Bn)	211	253	322	425	574	672	712	792	908
of which: (%)									
Defence Savings Certificates	40.3	41.5	42.5	39.7	37.2	38.0	38.2	37.1	34.1
Special Savings Certificates	34.1	39.8	39.4	34.8	31.9	25.0	24.9	27.0	32.4
Total Debt	799	909	1037	1176	1392	1579	1731	1718	1852

Source: SBP Annual Reports

Growth of MTBs and PIBs

Since 1995, the share of permanent and floating debts in total domestic debt have declined. Within the permanent debt, the share of FIBs has fallen from 56.5% in FY95 to 10.5% in FY03, while that of PIBs increased from 16% to 53.5% in the last 3 years. Within floating debt, the share of MTBs has increased significantly.

Corporate debt

The issuing and trading of corporate debt securities is not a new phenomenon in Pakistan. During the 1960s and early 1970s, before the nationalization of financial institutions in 1972, corporate debentures issued by Pakistani companies were not only listed on stock exchanges but there was also a secondary market for these instruments. However after nationalization, this activity came to a stand still. Pakistan's first corporate debt was a five-year bond issued in 1988 by WAPDA, a statutory corporation. But the market experience with these bonds proved unsatisfactory due to limited investors' interest and illiquid secondary market.

Launching of TFCs

In 1984, the government, in an effort to boost the development of corporate bond market, had also introduced Term Finance Certificates (TFCs), a market related debt instrument which the corporate sector can borrow directly from the general public through the stock exchanges. In Pakistan, the corporate bond and TFCs are used interchangeably.

Corporate bond market development

Till early 1990s, TFCs were issued by major state owned organizations only. The private sector Pakistani companies did not issue any TFCs during this period. It was in February 1995, that the first public TFC issued by Packages, the country's largest paper manufacturer in private sector, was listed on the stock exchanges followed by three others with a yield of between 17.8% and 19%.

The progress was slow in the presence of government guaranteed bonds with high coupon rates and also because of high interest rates paid on national savings schemes. However, the market for TFCs picked up after the decline in short-term interest rates and falling long term yields. In 1999 alone, four new TFCs were issued. With further decline in interest rates and cut in national savings schemes rates since 2000, the market for TFCs has picked up considerably. About 62 new TFC issues have been launched since 1995 including 28 issues that were launched in 2001 and 2002.

In FY03, 21 issues have been launched, of which, eight issues were by manufacturing concerns, 7 by leasing companies and remaining by banks or services companies. However, the outstanding stock of listed corporate bonds still remains low at 2% of GDP. TFCs offer a return that competes with gains and risks on investments in deposit schemes of financial institutions and the national saving schemes.

Currently TFCs and PIBs provide an attractive opportunity for the investors. The economic environment for a healthy corporate bond market is much favourable as the market characteristics have significantly changed in favour of the development of bond market. In the absence of Development Finance Institutions activity following the closure of Bankers Equity and merger of National Development Finance Corporation with the National Bank of Pakistan, the importance of bond market in raising long term funds for corporate sector can not be ignored.

Opportunity for investors

Auction of Federal Investment Bonds

(Rs.Bn)

Year	Amount accepted 3 year	5 year	10 year	Total
FY91	13.9	6.2	14.8	34.9
FY92	10.6	3.0	313	44.9
FY93	12.6	5.1	35.8	53.5
FY94	10.7	4.0	11.9	26.6
FY95	8.8	2.3	18.9	30.0
FY96	3.9	4.2	7.9	16.0
FY97	1.1	0.1	3.5	4.7
FY98	1.3	0.2	2.2	3.7
Total	62.9	25.1	126.3	214.3

Source: SBP Annual Report 2002-03

Auction of Pakistan Investment Bonds

(Rs.Mn)

Instrument	Year	Amount offered	Amount accepted	Average yield (%)	Average coupon (%)
3 year	FY01	8.5	4.7	12.5	12.5
	FY02	46.1	24.8	9.8	10.4
	FY03	26.1	9.7	5.5	8.0
5 year	FY01	6.7	5.3	13.0	13.0
	FY02	47.3	24.7	10.6	10.9
	FY03	45.6	14.4	6.5	9.1
10 year	FY01	43.6	36.1	14.0	14.0
	FY02	144.9	58.2	11.6	12.0
	FY03	139.8	50.8	6.8	10.0

Source: SBP Annual Report 2002-03

Growing Corporate interest

The corporate bond market has evolved rapidly after the picking up of TFCs market in the last two years. Most of the TFCs have been launched by the textiles and chemicals manufacturers. Some major companies, particularly the leasing companies are expected to utilize TFCs funding in future resulting in further growth of TFC market. Since the corporate interest in issuing TFCs has increased, many companies in the private sector have started or decided to issue privately placed TFCs.

Some commercial banks are also planning to participate actively in the floatation and issuance of TFCs. Infact few banks have already issued TFCs to improve upon their capital adequacy ratio. The trend will be further strengthened as the environment is being made conducive for the development of the corporate bond market. The decision to ban institutional investment in April 2000 has given a boost to corporate interest in issuing TFCs.

Need for a viable bond market

Pakistan needs a viable bond market in order to mobilize private savings efficiently for long term investments. The entry of big banks into the advisory and arranging business could further contribute in the promotion of TFCs primary market. Policies are being designed to promote bond market as an alternative source for long term project financing since commercial banks are shy of under taking risks of long term financing while DFIs suffer from lack of funds.

The State Bank of Pakistan has also advised commercial banks to float long term bonds to mobilize funds for housing loans. Innovative products have been developed by some banks for house financing. This includes floatation of bonds by banks to mobilise funds and undertake mortgage financing.

Cotton – Current Demand and Supply Position

Pakistan has emerged as one of the major textile products supplier in the world market. Despite the government's efforts to diversify exports and enlarge its industrial base, textiles continue to dominate the industrial activity in the country.

Textiles contribution to the economy

Given its share in GDP, export earnings and value added in manufacturing, makes it the single largest determinant of growth of the manufacturing sector. It currently accounts for 46% of total manufacturing activity, over 65% of export earnings, nearly 9% of GDP, employing 38% of industrial workers, and contributing Rs. one billion in direct taxes. Its share in world yarn trade is around 30% and about 8% in cotton cloth trade.

The textile sector depends on the agriculture sector for the supply of raw material. Pakistan is one of the four largest cotton growers in the world, the others being, United States, China and India. In addition to providing raw material to the local textile industry, lint cotton is also a major export item. As a main cash crop, it contributes substantially to the national income. Presently it accounts for nearly 12% of value added in agriculture, about 30% in value added of major crops and 3% of GDP.

Rise in production

Cotton production in the 1990s averaged 9.8 million bales. It touched historic highs of 12.8 million bales in 1991-92, above the 11.2 million bales of 1999-00. In the last 3 years (2000-2003), production has averaged 10.3 million bales. Though area under cotton has increased significantly, per hectare yield of cotton at 570 kgs is still the lowest. Efforts are needed to improve per hectare yield and boost production to meet the growing demand.

Raw Cotton

	Production (Mn bales)	% share in value added of major agriculture crops
1994-95	8.7	27.8
1995-96	10.6	31.6
1996-97	9.4	29.1
1997-98	9.2	20.6
1998-99	8.8	25.2
1999-00	11.24	28.9
2000-01	10.73	30.2
2001-02	10.61	30.3
2002-03	10.21	27.6
2003-04	10.0^{E}	NA

E = estimates *Source: Economic Survey 2002-03*

Expansion in capacity utilization

As capacity utilization of the mill sector has risen in recent years, the cotton requirement of domestic textile industry has simultaneously grown. Over the last four years there has been an investment of $3 billion in the industry for balancing, modernization and replacement. This BMR and capacity expansion in the textile industry is reflected in rising imports of textile machinery. Large scale balancing and modernisation of industry apart from addition of new spindleage has considerably raised the consumption of cotton.

Production of Yarn/Cloth

Year	No. of reporting factories	Capacity installed			Capacity worked			Raw Cotton consumption 000'Tonnes	Yarn production 000'Tonnes	Cotton Cloth Production Mn.Sq.Mts.
		Spindles 000'Nos	Looms 000'Nos	Rotors 000'Nos	Spindles 000'Nos	Looms 000'Nos	Rotors 000'Nos			
1993-94	320	8182	14	136	5886	6	80	1483	1310	315
1994-95	334	8307	14	130	5991	5	73	1559	1370	322
1995-96	349	8493	13	142	6356	5	79	1662	1495	327
1996-97	357	8137	10	143	6465	5	87	1670	1521	333
1997-98	353	8274	10	150	6556	4	80	1751	1533	340
1998-99	348	8298	10	166	6594	5	66	1840	1540	385
1999-00	351	8383	10	150	6750	4	66	1962	1670	437
2000-01	353	8507	10	146	7105	4	65	2070	1721	490
2001-02	354	8967	10	142	7078	5	65	2155	1809	568
2002-03	363	9216	10	147	7623	5	72	2371	1935	577

Source: Federal Bureau of Statistics

Cotton consumption grows

The mill consumption of cotton has gone up from 9.4 million bales in FY00 to an estimated 11 million bales in FY03, increasing at about half a million bales per year in the last four years. Consumption requirements of mills for the current season are being placed at 12 million bales and at around 15 million bales after 2005. The growing imbalance between demand and supply of cotton has necessitated imports, which have gone up from 0.5 million bales in FY00 to 1.1 million bales in FY03. Failing to meet the growing gap between demand and supply has turned the country from a surplus cotton producer to a cotton importing country.

As for the current season, the government had initially proposed a production target of 10.55 million bales, to be sown at over 2.86 million hectares. The current crop was promising as output was expected to reach 11 million bales from a sown area of 3.09 million hectares, up 9.1% from last year and 6.6% against the target.

Current crop affected by rains/pest

However, heavy downpour in August damaged cotton sown in Punjab and Sindh, and pest attacks in September damaged some 20-25% crop in both the provinces, adversely affecting expectations of higher production. Sindh has reported 4% decline in cotton output. While anticipating lower crop due to sizeable pest attack, the Federal Committee on Agriculture has revised down the production target by 5.2%, fixing the new target at 10 million bales.

Imports necessary

Based on phutti arrivals, the Pakistan Cotton Ginners Association is anticipating a crop of 9.5 million bales on ex-gin basis. Total arrivals as of November 1, are reported to be higher by 24% over the same period last year. However, trade circles are apprehensive that due to heavy pest infestation, the pace of arrivals in the coming weeks would slowdown. These circles express doubts about the government's revised target and are anticipating a final crop of between 8.5-9 million bales, further widening the demand/supply gap. Even a crop of 10 million bales, as anticipated by the government, will fall short of requirements, necessitating imports of 2 million bales this season. In the last two months, mills are reported to have booked imports of 0.7 million bales of cotton. In October alone about 0.3 million bales were booked.

Prices of cotton rise

In the local cotton market, the price of cotton has risen by more than 50% in recent weeks. This rise is not only because of a significant increase in the world cotton prices on account of supply shortages, but also because of fear of lower domestic crop and large scale holding of stocks by growers and ginners, anticipating a further rise. In the New York Cotton futures market, cotton prices reached 5 year peak at 80.59 and 82.72 cents per lb for December and March settlements respectively. In line with international trend, growers and ginners saw domestic lint prices rising in the local market to a record Rs.3600 per maund.

Speculators in the local market could create serious supply problems for the domestic textile industry by raising lint prices. Some weak spinners have already closed down their operations and it is expected that cotton demand by textile industry may fall. However, the government does not expect any abnormal price hike despite a shortfall in cotton output this season. In the international market, there was some drop in cotton prices in mid November but this was considered a temporary phenomenon, and lint prices could move up again. In the domestic market, prices have falledn in the past few weeks but they continue to remain high.

Adverse affects on textile sector

Pest infestation of the local cotton crop and reportedly large purchases of cotton by big textile mills has resulted in escalation in cotton prices with adverse affects for the industry and those associated with the sector. The farmers suffer because of low yields, and rising cost of inputs because of increased use of pesticides. It is largely the smaller or average growers with little resources who would be affected the most. With the closure of a large number of powerlooms in Faisalabad district, thousands of daily wagers have been rendered jobless. This is a great setback as it would see their incomes dwindle. Loss of economic opportunities would push them further into poverty.

The increase in poverty two years back was because of the severe drought which lowered agricultural growth and affected the lives of 68% of the people who live in rural areas and depend directly or indirectly on the agricultural sector for their livelihood. The current situation though not so severe would however, affect the lives of thousands associated with cotton and textiles.

Pest infestation in the country and the resulting damage of the local crop, and rising cotton price in the international market due to heavy purchases by the Chinese after poor weather destroyed their cotton crop, has exacerbated the situation. Cotton yarn prices have also risen in the local market. As raw cotton prices have rise by 50% to Rs.3,400 per maund, the millers have not only to pay higher price for cotton purchase but are also paying more to the banks in terms of cotton finance margin and as sales tax.

There were reports from Faisalabad, the textile hub of the country, that nearly 25,000 powerlooms faced with increase in cotton and polyester yarn prices have closed down. As the prices of cotton and polyester yarn had risen, many yarn exporters were finding it difficult to honour their commitment as per the already settled rates.

Majority of exporters who purchase cotton yarn on a day to day basis are the worst hit because of the unprecedented increase in the price of cotton yarn. Rates of all yarn brands and counts have gone up by Rs.10-Rs.15 per bundle in recent days.

The All Pakistan Cotton Powerlooms Association seeks a reduction in the price of cotton and yarn, a ban on the export of cotton yarn and encouragement of value addition. With polyester staple fibre industry having undergone capacity expansion and prospects that substitution by textile manufacturer from cotton to relatively cheaper synthetic fibre, could occur, the All Pakistan Cloth Exporters Association has sought reduction in import duty so that diversion towards polyester blend is facilitated and the value added textile sector, comprising of fabrics, bedlinen, knitted garments, textile made-ups does not receive any setback.

Pak Trade with Islamic Countries

Pakistan enjoys cordial trade relations with members of OIC. There is ample goodwill for expansion of trade and establishment of joint ventures in various industrial sectors. From countries like Kuwait, UAE and Saudi Arabia, Pakistan imports large quantities of oil and exports both traditional and non-traditional items. Similarly Iran is a major supplier of oil to Pakistan. Large quantities of palm oil are imported from Malaysia. Pakistan traditionally exports textile products, rice, surgical instruments, fruits and vegetables to these countries. There is regular exchange of visits by the trade delegations, members of the Chamber of Commerce and holding of seminars. Efforts are made to explore new avenues for expansion of trade and investment, cooperation in technical education, health and other fields.

Besides trade, these countries are a home to a large number of Pakistani expatriates who send back huge remittances. A large number of professionally qualified personnel are employed in the field of health, medicine and engineering.

(Rs.Mn)

	1998-99			1999-00			2001-01			2001-02		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
Afghanistan	48.2	37.0	11.2	115.2	40.8	74.4	140.4	29.5	110.9	169.3	22.9	146.4
Bahrain	34.8	78.4	(-)43.6	43.0	114.6	(-)71.6	43.8	80.0	(-)36.2	43.1	59.6	(-)16.5
Bangladesh	119.4	32.3	87.1	120.4	29.5	90.9	133.4	33.5	100.0	101.1	27.7	73.4
Egypt	35.3	30.5	4.8	35.4	36.9	(-)1.5	40.9	29.9	11.0	38.7	33.2	5.5
Iran	11.3	77.8	(-)66.5	11.5	130.2	(-)118.7	23.9	374.4	(-)350.5	29.2	158.2	(-)129.0
Iraq	9.6	-	-	2.3	-	-	16.3	0.2	16.1	30.3	0.2	30.1
Indonesia	125.3	213.8	(-)88.5	52.9	175.6	(-)122.7	136.4	161.7	(-)25.3	76.8	243.2	(-)166.4
Jordan	4.7	21.5	(-)16.8	6.1	53.7	(-)47.6	15.9	30.6	(-)14.7	28.4	27.7	0.7
Kuwait	36.8	558.3	(-)521.5	40.6	1236.8	(-)1196.2	45.8	964.6	(-)918.8	58.4	731.9	(-)673.5
Malaysia	33.4	634.5	(-)601.1	45.7	439.3	(-)393.6	50.9	428.1	(-)377.2	51.8	456.3	(-)404.5
Saudi Arabia	184.7	643.0	(-)458.3	214.8	923.0	(-)708.2	273.0	1259.2	(-)986.2	330.4	1200.7	(-)870.3
Sultanat-e-Oman	48.3	38.0	(-)10.3	53.0	31.0	22.0	43.7	26.3	17.4	47.3	6.9	40.4
Turkey	35.1	131.9	(-)96.8	61.0	106.6	(-)45.6	100.5	47.6	52.9	98.3	34.8	63.5
UAE	422.8	634.6	(-)211.8	493.0	907.6	(-)414.6	626.1	1328.1	(-)702.0	727.3	1354.6	(-)627.3

Source: Annual Report 2002-03
State Bank of Pakistan

Key Economic Indicators of Selected Islamic Countries

	Afghanistan	Bangladesh	Egypt	Iran	Iraq	Indonesia	Jordan	Kuwait	Malaysia	Pakistan	Saudi Arabia	Sultanat-e-Oman	Turkey	UAE
Population million (2002)	22	136	66	66	24	212	5	2	24	145	22	2.5	70	3
Gross National Income $ billion (2002)	-	48.5	97.6	112.1	-	150.0	9.1	-	86	59.2	140	-	174	-
Per Capia $ (2002)	-	360	1470	1710	-	710	1760	*	3540	410	**	-	2500	-
Population Density (people per sq.km. of land area)	33	1042	67	40	-	117	58	118	74	188	10	-	90	-
Agriculture value added as % of GDP (2001)	-	23	17	19	-	16	2	-	9	25	6	-	14	2
Industry value added as % of GDP (2001)	-	25	33	33	-	47	25	53^	49	23	50	-	26	64
Services value added as % of DGP (2001)	-	52	50	48	-	37	73	47^	42	52	44	-	60	35
Aid Per Capita $ (2001)	-	8	19	2	-	7	86	2	1	14	1	-	2	-
Gross domestic savings % of GDP (2001)	-	16	10	36	-	26	1	26	47	15	36	-	19	-
Crude death rate per 1000 (2001)	21	9	6	6	8	7	4	2	4	8	4	3	7	4
Crude birth rate per 1000 (2001)	48	28	25	22	30	21	29	20	22	33	33	27	20	17
Minimum wages $ per year (1995-99)	-	492	415	-	-	241	-	8244	-	600	-	-	1254	-
Public Expenditure on Health % of GDP (2000)	0.6	1.4	1.8	2.5	2.2	0.6	4.2	2.6	1.5	0.9	4.2	2.3	3.6	2.5
Public Expenditure on Education % of GDP (2000)	-	2.5	-	4.4	-	-	5.0	-	6.2	1.8	9.5	3.9	3.5	1.9
Average years of schooling (2000)	1.7	2.6	5.5	5.3	4.0	5.0	6.9	7.1	6.8	3.9	-	-	5.3	-
Urban Population % of total population (2001)	22	26	43	65	68	42	79	96	58	33	87	76	66	87
Gross international reserves months of import coverage (2002)	-	2.1	8.6	3.9	-	6.4	3.7	-	-	4.1	-	-	6.9	-
Total debt % of GDP (2000)	-	40.1	-	-	-	45.2	93.8	-	-	90.0	-	-	51.2	-
Total External Debt $ Million (2001)	-	15216	29234	7483	-	135704	7479	-	43351	32019	-	6025	115118	-

* estimated to be high income ($9076 or more)
^ 1990

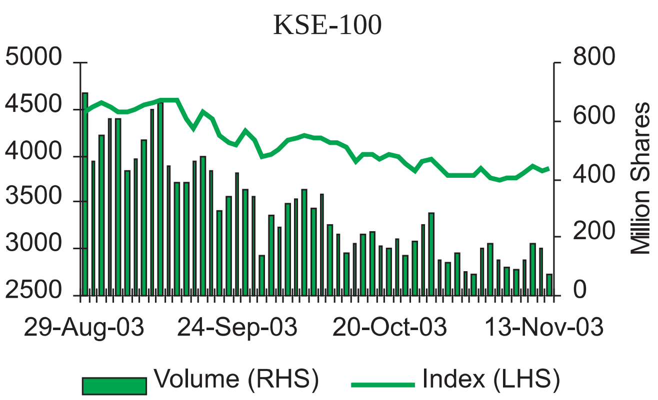
** estimated to be upper middle income ($2935-$9075)

Source: 1. *World Development Report 2004. The World Bank*
2. *World Development Indicators 2003. The World Bank*

Market Analysis

Market Outlook

The market underwent a major correction in September and October 2003. The KSE-100 lost 680 points over the two month period (823 points or 18% from the all time high of 4604 on September 12,'03 to the October low of 3781). By mid-November, the market appeared to have settled around the 3800 Index level but average daily trading volumes shrank considerably from 453m in September, to 215m in October and only 126m in the first two weeks of November.



The market had become over leveraged and a correction was due, but a number of factors combined to make the correction larger and longer than had been anticipated. The State Bank of Pakistan (SBP) announcement of a Rs50b Jumbo bond PIB offering between October and December '03 meant some of the excess liquidity would be removed from the market and led to expectations of a possible rise in interest rates. A lack of progress on the privatization of PSO also kept the market suppressed. Also preventing a recovery, or prolonging the slump, were the following factors:

§ SBP imposed ceiling on bank investment in shares
§ Introduction of draft margin financing rules
§ Restriction of "badla" stocks

Ceiling on bank investment in equity markets

The SBP's new Prudential Regulations place a ceiling on bank participation in the equity markets at 20% of bank equity (35% of equity for Islamic Banks and non-deposit taking DFIs). Exempt from this ceiling are bank shareholdings in strategic investments, associated companies, NIT units and OGDCL shares bought through subscription. Banks are important institutional investors in the equity market and this restriction on their investments will lead to some supply pressure, plus lower activity from banks in the long run. Banks have one year to comply with the limits.

Draft margin financing rules

Investors sentiment was adversely affected by the SBP's introduction of draft rules for margin financing, which is widely expected to eventually replace the existing badla / COT system of financing.

According to the SBP's draft regulations, banks will be able to extend margin financing to brokers that are registered as limited companies and are credit rated by an approved credit rating agency. A minimum margin of 30% of the current value of approved shares must be kept by the banks at all times. Margin financing will only be available against a list of approved shares. There is a general expectation that eventually, the new margin financing rules will replace the badla system.

On the positive side, margin financing by banks will remove the conflict of interest that exists in the badla system in which brokers and investors in the market are also badla financiers. The badla system could be used as a tool for market manipulation which it is hoped margin financing by banks will prevent. Bank margin financing could also lead to more stable financing costs, and avoid the daily turnover cost that exists in the badla system. However, from an operational point of view bank margin financing will be more difficult for brokerage houses to manage and so may raise transaction costs.

The fact that the minimum margin limit is proposed at 30% instead of 20% in badla finance means that the market will be less leveraged. Traders will of course not like this restriction, and this would lower trading volumes, but it will also help engender greater stability in the market. The proposed margin financing system is in use markets around the world and its implementation in Pakistan is in our view inevitable.

Restricted set of badla stocks

The KSE announced in October that it will reduced the number of scrips eligible as margin for badla transactions to 30. This will become effective on December 15, 2003, and has dampened trader enthusiasm somewhat, as the decision means less flexibility for speculators. In our view the market will adjust to the new rule fairly quickly.

Interest rates rising?

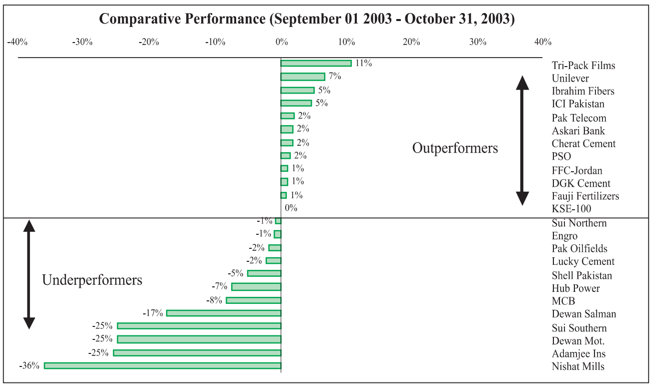
There is a general perception that interest rates have bottomed out and will increase slightly from now. This is needless to say a threat for the equity markets. The State Bank, in its 2003 Annual Report has also indicated that the surge in liquidity is bound to lead to inflationary pressures, and the focus may now shift to controlling inflation through interest rates and sterilization of excess funds. So far however the SBP has been very firm in controlling interest rates through its t-bill and PIB auction cut off yields and has not allowed a significant rise in interest rates.

OGDCL adds depth to the market

The offer for sale of 5% of OGDCL shares (including the green shoe option) worth Rs6.9b is big news for the market. This is the largest IPO in the history of the KSE, and the company will be a pivotal stock, in league with PTCL. The OGDCL IPO is good for the market as it will serve to both deepen and add breadth to what is really a very small market.

Market Outlook

Overall economic fundamentals remain good and there is a great deal of institutional interest in the market.

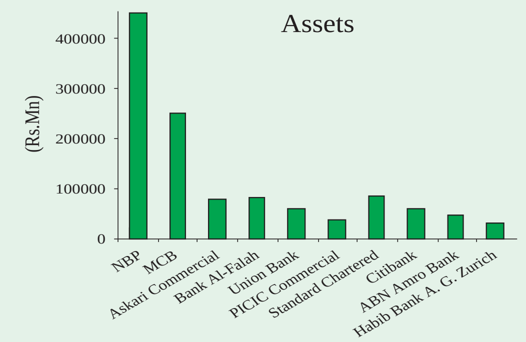


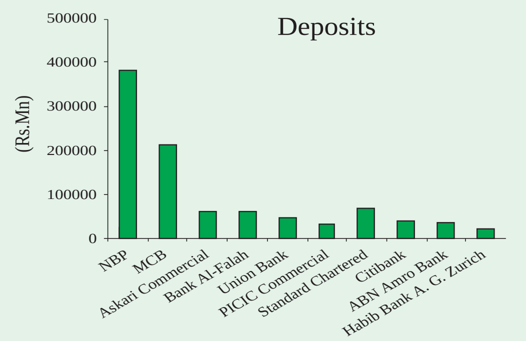
Despite falling remittances, there is still tremendous excess liquidity as evidenced from the OGDCL over subscription. An eventual improvement is therefore expected in market sentiment and share prices. Selling from banks and the time taken for the market to adjust to new interest rate expectations and badla rules could delay that recovery for the short term, but the snowballing negative sentiment seems to have come under check by early November.

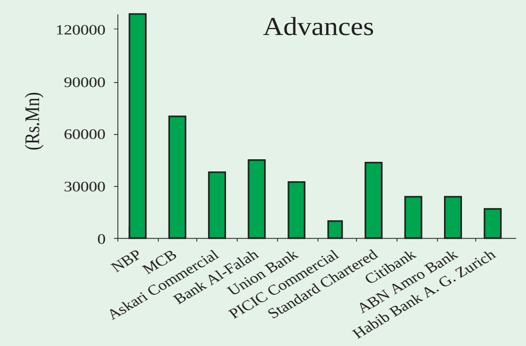
(Contributed by Taurus Securities Ltd, a subsidiary of National Bank of Pakistan)

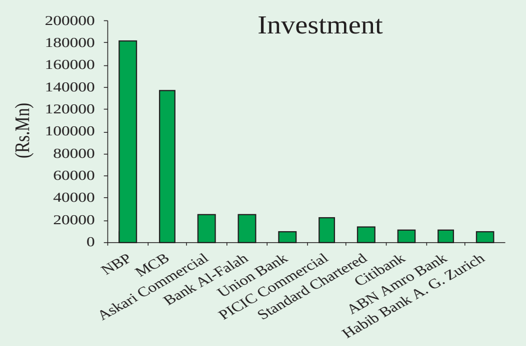
Banks' Performance at a Glance

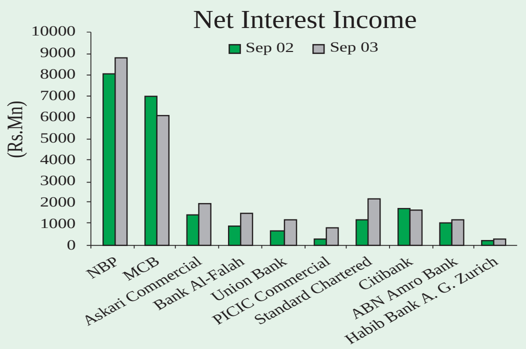
Nine Months Ended September 30, 2003

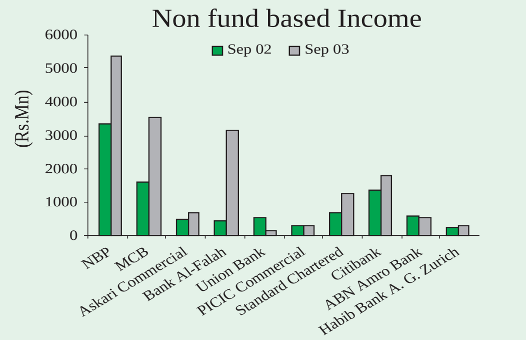


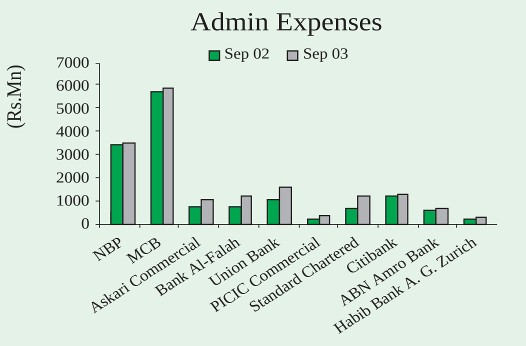


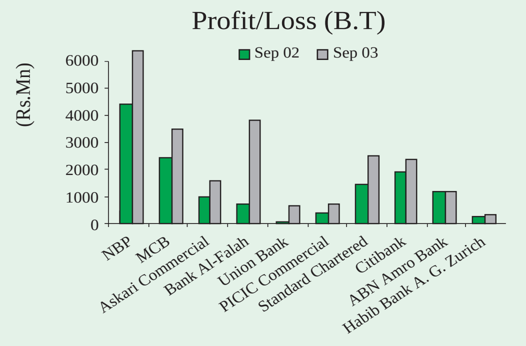












Key Economic Indicators

Economy Size & Growth		1999-00	2000-01	2001-02	2002-03
GNP - Market Prices	Rs bn	3132.3	3372.4	3660.7	4201.7
GDP - Market Prices	Rs bn	3177.2	3423.1	3628.7	4021.1
Per Capita Income	Market Prices Rs	23031	24248	25767	28945
	Market Prices US $	441	415	419	492
Growth*					
GDP	%	3.91	2.09	3.49	5.08
Agriculture	%	6.09	-2.74	-0.07	4.15
Manufacturing	%	1.53	8.21	5.00	7.67
Wholesale & Retail trade	%	1.92	5.37	2.28	7.32
Rate of Inflation	%				
Consumer Price Index**		3.6	4.4	3.5	3.1
GDP Deflator		2.8	6.0	3.2	4.5
Balance of Payments	$ mn				
Exports (f.o.b.)		8190	8933	9140	10889
Imports (f.o.b.)		9602	10202	9434	11425
Trade Balance		-1412	-1269	-294	-536
Services Account (Net)		-2794	-3142	-2617	-2173
Private Transfers (Net)		3063	3898	4249	5737
Current Account Balance		-1143	-513	1338	3028
Fiscal Balance	% of GDP				
Total Revenue (Net)		16.3	16.2	17.2	17.7
Total Expenditure		22.5	21.0	22.8	22.1
Overall Deficit		6.6	5.2	5.2	4.4
Domestic & Foreign Debt					
Domestic Debt	Rs bn	1579	1731	1718	1852
As % GDP		50.2	50.6	47.3	46.1
Total External Debt	$ bn	32.3	32.2	33.4	33.4
As % GDP		53.1	54.9	56.6	48.5
As % Export Earnings		395.1	360.0	365.7	364.7
Investment & Savings	% of GNP				
Gross Investment		16.2	15.8	14.6	14.8
Fixed Investment		14.6	14.1	13.0	12.5
National Savings		14.3	14.9	16.8	18.5
Domestic Savings	% of GDP	15.8	16.5	16.9	16.2
Foreign Investment	$ mn	543	182	475	820
Portfolio		73	-140	-10	22
Direct		470	322	485	798
Monetary Aggregates	%				
M1		14.9	3.0	15.2	26.2
M2		9.4	9.0	15.4	18.0
Interest Rates (Weighted Average)	%				
Deposits		5.47	5.27	3.60	1.61
Advances		13.52	13.61	13.19	9.40
Foreign Exchange Reserves^	$ mn	2163	3244	6398	10747
Exchange Rate++	Rs./$				
Official Rate		52.16	64.40	60.07	57.81
Open Market Rate		54.82	66.70	60.20	57.80

Source: SBP Annual Report 2002-03

* Constant Factor Cost of 1980-81
** Base 2000 - 01
^ Excludes FE 13/CRR and includes Indian pending transfers, new FCA and Trade Nostro.
++ End-June Buying Rate

NBP Performance at a Glance

(Rs. Bn)

Items	1998	1999	2000	2001	2002
Net Fund Based Income	8.9	10.4	8.8	12.4	12.8
Non Fund Based Income	2.7	4.0	4.0	4.5	4.8
Administrative Expenses	6.2	7.9	8.0	8.6	9.1
Pre-Tax Profit	2.14	0.52	1.03	3.02	6.04
After-Tax Profit	0.53	0.03	0.46	1.15	2.25
Total Assets	325.1	350.4	371.6	415.1	432.8
Deposits	273.4	294.8	316.5	349.6	362.9
Advances	109.5	122.6	140.3	170.3	140.5
Investments	103.0	91.5	72.6	71.8	143.5
Shareholders' Equity	10.0	10.4	11.4	12.0	14.3
Number of Branches	1434	1431	1428	1245	1204
Number of Employees	15785	15541	15351	15163	12195

Core Values That Define Us

We aim to be an organization that is founded on...

Growth through creation of sustainable relationships with our customers.

Prudence to guide our business conduct.

A national presence with a history of contribution to our communities.

We shall work to…

Meet expectations through Market-based solutions and products.

Reward entrepreneurial efforts.

Create value for all our stakeholders.

We aim to be people who…

Care about relationships.

Lead through the strength of our commitment and willingness to excel.

Practice integrity, honesty and hard work. We believe that these are measures of true success.

We have confidence that tomorrow we will be…

Leaders in our industry.

An organization maintaining the trust of our stakeholders.

An innovative, creative and dynamic institution responding to the changing needs of the internal and external environment.