9 Balance of Payments and Exchange Rate Policy

9.1 International Economic Situation

The outlook for the world economy started looking gloomy after the first half of 2000, despite a realized growth of 4.8 percent for the whole year. Although, the US is leading the recession, the most worrisome feature of the slump is its universality. With the bursting of the IT bubble and falling prices reflected in Nasdaq, the persistent decline in industrial production, diminishing corporate profits and continuing loss of consumer confidence, were the contributing factors in the economic slowdown. Notwithstanding the healthy growth of 4.1 percent during 2000, GDP growth fell sharply to a mere 1.3 percent in the first quarter of calendar 2001 and a dismal 0.2 percent in the second quarter. Such sentiments were not deflected by the repeated cuts in interest rates by the US Federal Reserve, which are currently at 2.5 percent (39 years low) compared with 6 percent in December 2000.

In terms of trade flows, both exports and imports (especially related to IT) declined substantially during the first half of 2001, transmitting the US recession to its major trading partners, especially in the East Asian economies. American imports fell at an annual rate of 13 percent, while imports of IT equipment declined by almost 50 percent. This is in sharp contrast to the situation in early 1999, when strong economic performance of the US and higher imports provided a growth impetus to other countries. With the exception of China, all the major economies are stumbling. Furthermore, following the recent terrorist attacks in the US, the expectations of a V-shaped recovery can be written off.

In the Euro area, annualized GDP grew by 2.0 percent in the first quarter of 2001 against 2.2 percent growth in the previous quarter. Industrial production fell to 1.3 percent compared to a positive growth of 5.5 percent in the preceding quarter. In Germany, the slowdown in industrial activity and faltering consumer confidence, have brought the leading market indices down nearly three percent in July 2001, from its recent peak in February 2000.[1] Uncertainty continued in the French economy as the leading index decreased by 0.4 percent in July, and is 3.0 percent below the high reached in June last year.

Japan, which was already in recession, recovered somewhat in the first quarter of 2001. This was due to a boost in consumer spending following a new recycling law, which encouraged households to bring forward purchases of consumer durables. Nevertheless, industrial production continues to dwindle, leading to more job losses. Furthermore, weak domestic demand due to negative income growth in recent months is forcing inventory build up in the first half of 2001. Despite the depreciation of the Yen (against US Dollar), Japanese exports fell for the third consecutive month in June 2001 relative to the previous year. The economic slowdown in the US has further aggravated the problem by hitting potential demand from other Asian countries whose growth is heavily dependent on electronics. Barring a modest increase in May, the leading index fell almost 5.4 percent in the month of June 2001, indicating that a significant weakness remains in the Japanese economy.

In other Asian economies, the fallout of the US led recession is resulting in fading growth rates. Countries like Singapore, Taiwan and South Korea, which have been heavily dependent on the export of high-tech equipment, especially to America, have been severely affected. Exports from East Asia

[1] Leading market index is the weighted average of the major economic indicators compiled by the Conference Board Plc, which assumed the responsibility for computing composite indices from the US Department of Commerce. The Board currently works out these indices for the US, Australia, France, Germany, Korea, Japan, Mexico and the UK.

(excluding China) have fallen by around 10 percent over the past year compared with growth of almost 30 percent in early 2000. Furthermore, since these Asian economies have substantial installed capacity, there is a real risk of a sharp plunge in investment. Singapore is already in recession, as its GDP fell at an annual rate of 11 percent in the first half of 2001. Taiwan's GDP shrank by 2.3 percent in the second quarter of 2001 ? the first decline in 26 years. South Korea's economy has slowed sharply, while Malaysia and Thailand are also at the brink of recession. In fact, the sharp recovery following the Asian crises of 1997, was anchored on strong US growth, which may have created a sense of complacency towards needed reforms in the banking system and the corporate debt structure. This in turn made these economies even more dependent on exports.[2] On the other hand, the Chinese economy, despite suffering a sharp contraction in exports, still managed to grow by an annual rate of 5 percent in the second quarter of 2001.

In Latin America, Argentina and Mexico are already in recession, while Brazil looks likely to follow after its GDP growth fell in the second quarter of 2001. Brazil has been hit by the regional contagion, whereas Mexico (with exports to America amounting to 25 percent of its GDP) is preparing for the direct consequences of the US slowdown. Argentina's problems stem from the Peso's link to the US Dollar, which has eroded its trade competitiveness and forced up interest rates on its massive debts. Although the IMF has recently agreed to a new package for Argentina, there is still a strong risk that the fiscal austerity required to meet IMF conditions are likely to prolong the recession.

The economic prospects of most countries in the Middle East region depended largely on international oil prices. Higher oil revenues driven by the rapid increase in prices (despite enhanced production quotas by OPEC), led to a substantial improvement in fiscal and external imbalances in many countries; this obviously also resulted in robust growth during 2000.

In Africa, the recent strengthening of economic policies, supported by debt relief through the enhanced HIPC initiative and the IMF's PRGF, has helped in improving the overall environment. In South Africa, GDP growth is estimated at 3.2 percent in 2000, despite the adverse impact of higher oil prices, unfavorable weather conditions, and contagion from the crisis in Zimbabwe. In other African countries, developments continue to depend primarily on commodity prices. The oil exporting countries of North and West Africa have experienced an improvement in their terms of trade, resulting in stronger fiscal and external balances. However, amongst non-oil countries and those ravaged by civil war and political uncertainty, economic growth remains weak.

The volume of world trade increased to 12.4 percent in 2000, from 5.3 percent in 1999. Exports of developed and developing countries sharply increased by 11.4 percent and 15.7 percent, respectively, while import volumes also posted strong growth of 11.4 percent and 16.9 percent, respectively. However, due to the widespread slowdown in economic activity since the beginning of 2001, growth in world trade may be far less than the original projection of 6.7 percent for the current year.

9.2 Pakistan's Balance of Payments [3]

Although FY00 was spent in relative calm, it was clear that Pakistan was unable to enhance repayment capacity as envisioned in the first debt rescheduling agreement. Since the consolidation period was to end in December 2000, this meant that either Pakistan would be in a position to meet normal debt payments in calendar 2001, or it would have to secure another round of debt rescheduling. A pre-requisite for the latter was an IMF program. Given this sense of urgency,

[2] South Korea's exports of goods and services jumped from 30 percent of GDP in 1996 to 45 percent last year and Thailand's from 39 percent to 66 percent thus exposing these economies more to global slump than ever.

[3] This section is based on SBP's exchange records data, which may not tally with customs data used in the subsection on **Trade Account**.

Pakistan's economic managers realized that the focus of the IMF stabilization program would be on improving the country's external sector.

The Standby Arrangement (SBA) signed with the IMF in November 2000, enabled Pakistan to resume net inflows from IFIs, and to obtain further rescheduling of its external debt. These actions provided the much needed comfort to the country's external payments position.

Despite the global slowdown, Pakistan's balance of payments showed strong signs of improvement during FY01. The most impressive development was the current account *surplus* of US$ 331 million, which was achieved for the first time in the history of Pakistan (see **Table 9.1**). A lower trade deficit, but more importantly, a sharp increase in current transfers, was able to exceed higher payments on account of services. Above all, this reversal in BOP was driven by two main factors: (1) a change in the accounting treatment of the Saudi Oil Facility (SOF) from non-food aid (loan) to a straight forward grant (official transfers), and (2) higher than projected purchases of hard currency from the kerb market.[4] If one were to compare the current account deficits for FY99 and FY01, by excluding the role of outright purchases and SOF, the external gap only narrows from US$ 2,776 million in FY99 to US$ 2,509 million during FY01.

The capital account witnessed a sharp decline in *notional* outflows, primarily because of the modalities of Pakistan's debt rescheduling arrangement and the resumption of external assistance; the exceptional financing gap fell from US$ 3,966 million in FY00 to only US$ 692 million during FY01 (see **Table 9.1**). More specifically, the improvement can be traced to the following factors: (1) fresh inflows from IFIs that were not available during FY00, (2) larger inflows in short-term financing (particularly in June 2001), and (3) the absence of restructuring/rollover of Euro bonds, commercial credit (PTMA[5]) and FE-45 deposits, as was the case last year. In fact, FY01 witnessed hard currency *payments* on account of PTMA and FE-45.[6]

With the change in the presentation (which will be discussed later), Pakistan's foreign exchange reserves rose to US$ 3,219 million as on end-June 2001, from US$ 1,968 million last year. However, the most visible change was the Rupee/Dollar parity; against almost negligible devaluation during FY00, the sharp depreciation of 18.6 percent seen during FY01, once again revived the domestic dollarization drive.

9.2.1 Current Account

As a result of the surplus, the ratio of current account to GDP improved to 0.6 percent in FY01, as against a revised figure of negative 0.4 percent in FY00 (see **Figure 9.1**). This was achieved despite a decline in the international prices of Pakistan's main export commodities and manufactures, and higher international oil prices. Nevertheless, the current account surplus reflects improved export performance mainly driven by higher volumes, subdued non-oil imports, and buoyant current transfers (outright purchases and SOF).

The services account continued to account for the external gap with a deficit of US$ 3.1 billion ? the highest level in the last three years. Almost all categories in this head posted larger outflows, but profit and dividend payments spearheaded the increase: more specifically, because of higher oil

[4] SOF initially offered a daily procurement of 100,000 barrels. However, it was later reduced to 80,000 barrels a day. Although, the facility was available since August 1998, its treatment in balance of payments was recently changed from aid to grant, retrospectively. *As a result, BOP data for FY99 and onward has been revised accordingly.*

[5] This refers to Pakistan Trade Maintenance Agreement, which is a credit from commercial banks for the financing primarily of oil imports. After the crisis in May 1998, this commercial debt was rescheduled.

[6] These payments were not reflected in the capital account (see **Box 9.1** for details).

Table 9.1: Balance of Payments
million US$

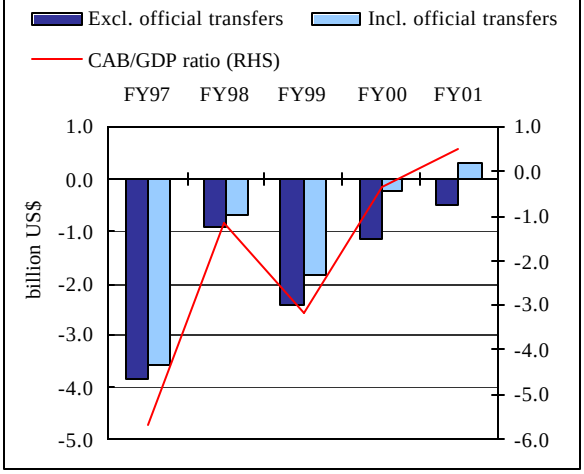
	FY97	FY98	FY99	FY00	FY01
1. Trade balance	**-3,145**	**-1,867**	**-2,085**	**-1,412**	**-1,269**
Exports (fob)	8,096	8,434	7,528	8,190	8,926
Imports (fob)	11,241	10,301	9,613	9,602	10,195
2. Services (net)	**-3,659**	**-3,264**	**-2,618**	**-2,794**	**-3,137**
Shipment	-928	-873	-803	-751	-820
Other transportation	13	76	110	71	61
Travel	-541	-279	-122	-142	-180
Investment income	-2,167	-2,330	-1,808	-2,018	-2,156
Interest payments	-1,717	-1,720	-1,399	-1,598	-1,547
Profit and dividend	-450	-610	-409	-420	-609
Other goods, services & income	-36	142	5	46	-42
3. Current transfers (net)	**3,247**	**3,430**	**2,847**	**3,989**	**4,737**
Private transfers (net)	2,958	3,210	2,274	3,063	3,898
of which: i) Workers' remittances	1,409	1,490	1,060	983	1,087
ii) FCA (residents)	1,347	1,476	539	322	534
iii) Outright purchases	0	0	531	1,634	2,157
Official transfers [1]	289	220	573	926	839
of which: Saudi oil facility			389	790	683
4. Current account balance (1+2+3)	**-3,557**	**-1,701**	**-1,856**	**-217**	**331**
Excluding official transfers	***-3,846***	***-1,921***	***-2,429***	***-1,143***	***-508***
5. Financing	**3,557**	**1,701**	**1,856**	**217**	**-331**
Capital account (net)	**2,459**	**1,048**	**-2,278**	**-4,177**	**-648**
Foreign investment	1,377	738	570	-76	137
Direct investment abroad (net)	18	-29	-44	1	-37
Direct investment in Pakistan (net)	682	601	472	472	323
Portfolio investment in Pakistan (net)	677	166	142	-549	-149
of which: stock markets	268	221	28	73	-140
Foreign long-term loans/credit (net)	702	1,266	0	-1,087	-636
Disbursements	2,671	3,414	2,474	1,471	1,654
Project aid	1,587	1,369	1,499	988	785
Food aid	409	623	230	191	0
Non food aid [1]	0	625	550	125	678
Others	675	797	195	167	191
Amortization	1,969	2,148	2,474	2,558	2,290
Official	1,592	1,724	2,038	1,967	1,795
Others	377	424	436	591	495
Official assistance (net)	-446	408	-863	-220	432
FCA (non-residents)	576	-70	-2,295	-1,884	-96
Outstanding export bills	-97	-383	40	-432	-232
Others	347	-911	270	-478	-253
Changes in reserves (-Inc/+Dec)	**1,032**	**306**	**-824**	**-72**	**-1,000**
Assets	1,199	148	-1,254	208	-1,085
SDRs	1	0	2	0	1
Forex (SBP)	925	194	-809	379	-727
Forex (commercial banks)	273	-46	-447	-171	-359
Liabilities	-167	158	430	-280	85
Use of Fund credit	-167	158	430	-280	85
Purchases/drawings	152	387	626	0	324
Repurchases	-319	-229	-196	-280	-239
Errors & omissions	**66**	**347**	**992**	**499**	**626**
Exceptional financing	**0**	**0**	**3,966**	**3,966**	**692**
SBP reserves	1,143	1,699	1,740	1,358	2,087
SBP reserves (excluding FE-25)	0	0	1,740	997	1,688

[1]. Adjustments were made in accounting treatment of Saudi oil facility from non-food aid to official transfers.
Source: State Bank of Pakistan

extraction and repatriated profits from the oil & gas sector (see **Figure 9.2**).[7] In terms of other service payments, the increase in shipping (mainly freight on cash imports) reflects the fact that Pakistani companies do not have the capacity to handle larger trade volumes. The other item *travel expenses (net)* increased during FY01 on account of more overseas trips by Pakistanis for recreational purpose. Over the past several years, this item is placing a growing burden on the country's foreign exchange reserves.

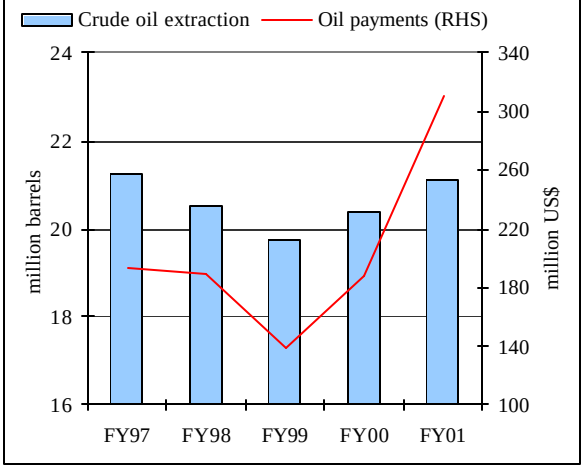
Interest payments, which account for the bulk of service expenses, registered a small dip in FY01, despite an increase in outflows on Special US Dollar Bonds and higher rates on rescheduled debts. The advantage came from: (1) principal repayments on FE-45 deposits, PTMA and private loans/credits, leading to low interest payment pressures, and (2) the fact that the country had to rely less on short-term commercial loans that carry relatively large interest payments.[8] Furthermore, lower foreign exchange earnings of PTCL were reflected in higher net *outflows* under other goods, services and income in FY01, compared with last year.

Figure 9.1: Current Account Balance



As shown in **Table 9.1**, current transfers have posted very strong growth after the nuclear tests in May 1998, and are largely responsible for financing the trade/services gap since then. Although inflows of resident FCAs and worker remittances have fallen and still remain stagnant, SBP's purchase from the kerb market, and the recent acknowledgement that the SOF is a grant, have been the saving grace for Pakistan. Nevertheless, since such transfers are stopgap measures taken after the imposition of international sanctions, these cannot be relied upon to narrow the external gap on a sustainable basis.

Figure 9.2: Crude Oil Extraction & Payments to MNCs



Although worker remittances increased by 11.8 percent and crossed the one billion Dollar mark in FY01 (the highest level since the nuclear detonation – see **Table 9.2**), they are still very disappointing compared to the level achieved in the 1980s and the 1990s. Furthermore, these receipts also include hard currency inflows on account of the Hajj Sponsorship Scheme (HSS) and compensation for Kuwait war affectees.[9] More specifically, inflows under HSS amounted to US$ 92.8 million whereas US$ 78.3 was received during FY01 as

[7] This is one of the sectors identified by the present government, which could attract sizeable foreign investment.
[8] Most of the short-term loans during FY01 were realized in June 2001.
[9] Hajj Sponsorship Scheme allows expatriate Pakistanis to sponsor a Hajj trip for a resident on payment of US$ 1,600. Although, treated as cash remittances, these are not exactly transfers as bulk of them is used as travel expenses shown in services account.

compensation for Kuwait war affectees. Excluding these inflows, cash remittances recorded growth of 15.2 percent over last year.

A region-wise analysis of remittances reveals a dismal 1.7 percent growth in cash remittances from the Gulf. Given the composition of overseas Pakistanis and taking into account their inclination/ necessity to send money back to the country, the Gulf region should account for the bulk of worker remittances. Except UAE and Qatar, all countries posted negative growth, which shows that efforts to solicit remittances from this region have not been successful. As shown in **Table 9.2**, remittances from UAE (where the Hundi network is based), grew sharply by 28.6 percent, particularly from Dubai. This aberration has a simple but anecdotal explanation: resident Pakistanis aspiring to secure a sponsorship under HSS, can do so by approaching the Hundi system in Pakistan. Hundi agents are able to arrange a bank draft in favor of the aspiring Haji from a fictitious party based in Dubai against Rupee payment in Pakistan.

Table 9.2: Country-wise Workers' Remittances

million US$

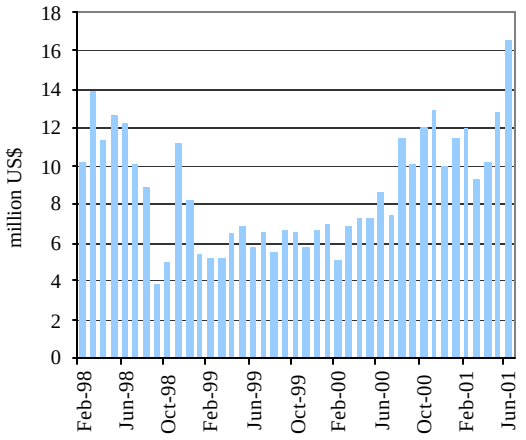
	FY97	FY98	FY99	FY00	FY01
Gulf region	**706.2**	**843.4**	**640.9**	**682.0**	**693.2**
Bahrain	29.2	34.3	33.3	29.4	23.9
Kuwait	38.4	52.4	106.4	135.3	123.4
Qatar	9.7	12.2	12.9	13.3	13.4
Saudi Arabia	418.4	474.9	318.5	309.9	304.4
Sultanat-e-Oman	46.1	62.0	44.7	46.4	38.1
UAE	164.4	207.7	125.1	147.8	190.0
Other than Gulf	**371.9**	**394.3**	**234.7**	**231.5**	**328.4**
Canada	3.6	4.1	3.5	3.9	4.9
Germany	19.0	16.6	11.9	10.5	9.2
Japan	3.1	2.7	3.1	1.6	3.9
Norway	8.0	7.2	5.3	5.6	5.7
UK	97.9	98.8	73.6	73.3	81.4
USA	146.3	166.3	82.0	80.0	134.8
Others	94.1	98.6	55.4	56.8	88.4
Total	**1,078.1**	**1,237.7**	**875.6**	**913.5**	**1,021.6**
Growth rate (%)	-12.2	14.8	-29.3	4.3	11.8
Excl. HSS & Kuwait war affecties (%)	-	-	-	-0.6	15.2
Encashment FEBCs & FCBCs	331.4	251.9	184.6	70.2	65.0
Grand total	**1,409.5**	**1,489.6**	**1,060.2**	**983.7**	**1,086.6**

HSS: Hajj Sponsorship Scheme

Source: State Bank of Pakistan

On a more positive note, remittances from the non-Gulf region recorded 41.8 percent growth in FY01 over the year before. More specifically, cash remittances from the US remained buoyant, which could either be on account of a larger number of working Pakistanis or a resumption of normal flows that were interrupted after the international sanctions (see **Figure 9.3)**.

Figure 9.3: Cash Remittances from USA



Stepping back a bit, since the export of abundant resources should dictate the trade patterns in a country, the fact that the Hundi system continues to divert worker remittances from official channels, implies that the country is not able to earn revenues from its *largest* export. It must be realized that during the mid-1980s, official remittances were larger than Pakistan's total export revenues, and had peaked at US$ 2.9 billion in FY83. Although the boom period of the 1980s had ended, the falling Dollar value of remittances into Pakistan from the Gulf, contradicts the flow patterns witnessed in other countries of South Asia.[10] This points toward the advantages of using the Hundi system: (1)

[10] There are approximately 3.2 million nonresident Pakistanis (NRPs) that can be classified into three categories namely workers, professionals and investors. On average, Pakistan received just US$ 316 per NRP in FY01 through banking channel, which is very low (Source: Report of Task Force on Overseas Pakistanis)

Rupees are provided at the kerb rate, (2) ease of transaction since the Hundi system does not involve any formal documentation, (3) a better service to both remitters and recipients back home, and (4) tax evasion. In fact, the lack of appropriate actions by the government to address this issue during the 1990s, gave the Hundi/Hawala system ample time to mature and establish an unblemished reputation among expatriate Pakistanis.

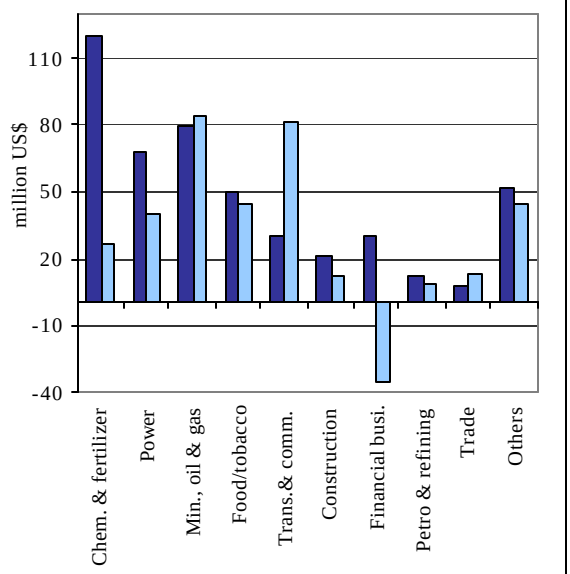
In order to attract remittances through proper banking channels, a number of steps were taken during FY01: SBP reduced the minimum limit for reimbursement of TT charges from US$ 200 to US$ 100, the business of moneychangers is to be monitored with a view to convert them into foreign exchange companies, and attention was given to improve the efficiency of banking channels. Nevertheless, it has been difficult to convince expatriates who are accustomed to the Hundi system to return to normal banking channels. Although, SBP has partially tapped into informal remittances through its outright purchases from the kerb market, this is not a satisfactory solution. The critical issue is to formalize the moneychanger business (Hundi) into foreign exchange companies and allow them to play an important role in the interbank (official) market once the two markets are merged.

Another notable development in FY01, is the large increase in resident-FCAs (see **Table 9.1**). Unlike FY00, which witnessed a great deal of exchange rate stability, this year recorded an 18.6 percent depreciation in the exchange rate, which rekindled the impetus to save in hard currency despite penal returns on FCAs.

9.2.2 Capital Account[11]

Pakistan's capital account recorded a steep decline in net outflows in FY01 over last year (see **Table 9.1**). Despite lower foreign direct investment (FDI) and project aid, gross inflows increased from US$ 2.2 to US$ 2.8 billion, due primarily to the resumption of assistance from IFIs, more inflows in private loans/credit, and higher short-term capital inflows from commercial banks and IDB. Outflows, on the other hand, fell mainly due to the absence of rollover of commercial debt and FE-45 funds and lower Rupee conversions from non-resident FCAs in FY01. Furthermore, the lower volume of repayments on public and publicly guaranteed debt in FY01, and the conspicuous absence of Pakistan's Eurobonds in the capital account (which were restructured in FY00), reduced the volume of notional outflows.

Figure 9.4: FDI by Economic Groups



Foreign direct investment (FDI) registered a 31 percent decline, which is very disappointing compared to inflows of US$ 472 million last year. Although, FY01 provided a better investment climate than the year before, in terms of the SBA and an amicable settlement of the longstanding dispute with Hubco, this could not translate into higher FDI.

In terms of FDI by economic groups, *chemicals & fertilizer*, *power* (IPPs), *food, beverages & tobacco*, and *construction* received lower inflows in FY01 (see **Figure 9.4**). In particular, last year

[11] For item-wise analysis see **Appendix 9.1**

posted inflows of US$ 120 million in *chemicals and fertilizer* due to ICI's investment in its PTA plant, which was not the case in FY01. Looking at the financial sector, investors withdrew US$ 35 million, which includes divestment by Bank of America and Gulf Commercial Bank. This deterioration was marginally neutralized by higher inflows in *transport & communication*, *mining*, and *oil & gas* on account of incentives provided by the government.

Outflows under portfolio investment declined to US$ 149 million in FY01 as against US$ 549 million last year. However, this is largely explained by the restructuring of Pakistan's Eurobonds that took place in FY00 and is shown as an outflow in that year. In fact, if one looks closer, FY01 witnessed the sharpest reversal in portfolio investment (specifically in the stock market) from *inflows* of US$ 73 million in FY00, to *outflows* of US$ 140 million during FY01. Heavy selling by foreign investors following the liquidation of Morgan Stanley's Pakistan fund in March 2001, was the key factor (for more detail see **Section 7.2**).

Project aid, which is part of long-term capital flows, further dipped to US$ 785 million in FY01, a manifestation of the drying up of pipeline aid following the international sanctions on Pakistan, which precluded new commitments from major donors (see **Table 9.1**). However, lower inflows were compensated by more assistance from the IFIs shown under non-food aid. With these sanctions in place, bilateral assistance from the US and France has stopped, while assistance from Japan and Germany fell sharply.

Short-term capital showed an improvement both in terms of inflows and outflows during FY01. Commercial inflows during the year included: US$ 200 million from Shamil Bank, US$ 150 million from NBP Bahrain for oil financing to PSO, and US$ 331 million from IDB for balance of payment support. Although, fresh inflows stopped following the nuclear test, notional repayments of contracted loans were shown in FY00 (e.g. rescheduling under PTMA and FE-45 deposits). During FY01, SBP paid certain rescheduled loans in hard currency as shown by *outflows* in the exceptional financing (see **Table 9.3**). Outstanding export bills, another item under short-term capital, declined during FY01, despite significant depreciation of the Rupee; this was on account of stringent measures undertaken by SBP.[12]

Table 9.3: Exceptional Financing
million US$

	FY99	FY00	FY01
Total	**3,966**	**3,966**	**692**
Debt relief from Paris Club	1406	1,451	1,124
Central bank deposits	150	300	250
Rollover of FE-45 deposits	1212	1,072	(299)
PTMA	830	152	(297)
Eurobond	0	610	0
NBP deposits	150	500	0
Others	218	(119)	(86)

Source: State Bank of Pakistan

As the capital account recorded lower notional outflows, the corresponding inflows in exceptional financing were also lower (see **Table 9.3**). In addition, the lower volume of exceptional financing was also due to actual hard currency payments of previously rescheduled loans (PTMA and FE-45), and the longer term rescheduling of certain NBP and Bank of China deposits (see **Box 9.1**). Furthermore, the huge inflows shown in *errors and omissions* during FY99 and FY00, were primarily on account of conversion of non-resident FCAs or Special US$ Bonds into Rupees; these are shown as inflows to neutralize those hard currency repayments that *never* have to be made. Unlike FY99 and FY00, the inflow under *errors and omissions* during FY01, reflect Rupee repayments (retirement) of par swaps conducted in the past. In more normal years, the *errors and omissions* item covers lags and

[12] In July 2000, SBP issued a circular on overdue export bills. Accordingly, in case where an exporter does not repatriate export proceeds within three days of the due date or within 4 months of the shipment date, whichever is earlier, he shall be entitled to export proceeds at the rate of exchange prevailing on the due date or at the rate prevailing on the date of realization of export proceeds whichever is lower.

leads in reporting external transactions, inaccuracies and gaps in data resulting from incomplete information, and adjustments in cross exchange rates in multi-currency transactions.

Box 9.1: Some Explanations on Accounting Practice

As explained in the last Annual Report, the balance of payments is compiled on accrual basis, which ensures that the temporary relief either from debt rescheduling or Rupee conversion is not used to show an artificial improvement in the balance of payments. This box will explain the accounting treatment for such relief.

1. First rescheduling or rollover

While the amount rescheduled for the first time is considered as 'normal payment' (as if they have been made), this is financed by notional inflow in exceptional financing. More specifically, a debit entry in current/capital account is matched by a credit entry in exceptional financing. Effectively, liability lying above the line is shifted to the exceptional financing head.

2. Second rescheduling or rollover

In the second round, the liability in the exceptional financing head (created in the first round) is offset by a notional outflow. However, it is simultaneously balanced by a notional inflow. In other words, a debit entry in exceptional financing is matched by a credit entry.

3. Dollar payment of the previously rescheduled amount

This would result in the reduction of liability under exceptional financing head which will be matched by a decline in assets i.e., foreign exchange reserves. More specifically, a debit entry in exceptional financing will be matched by a credit entry in reserves (decline in reserves).

4. Rupee conversion of Dollar liability

The Rupee conversion of the Dollar liability (non-resident FCAs/par-swaps) is matched by new inflows under errors and omissions to neutralize those hard currency repayments that never have to be made. In other words, a debit entry for outflow is matched by credit entry in errors and omissions.

9.2.3 Foreign Exchange Reserves

The major development in Pakistan's foreign exchange reserves was the change in the method of presentation following the decision to return FE-25 deposits that had been placed with SBP. According to the new definition, Pakistan's foreign exchange reserves rose to US$ 3,219 million as on end-June 2001 from US$ 1,968 million last year.[13] On the basis of the previous definition, liquid reserves have increased from US$ 991 million at June 2000 to US$ 1,677 million as on end-June 2001. This should clear up the popular misconception that Pakistan's reserves have only increased because of a change in the accounting treatment.

As explained in the third *Quarterly Report* for FY01, these reserves are very sensitive to lumpy inflows since the interbank market is generally short of hard currency, which explains the gradual decline in reserves between peaks (see **Figure 9.5**). This illustrated graph captures the major developments during the course of the year. What clearly shows up, are the concerted efforts taken to build up forex reserves to meet SBP's end-June NFA target; as shown, Pakistan's reserves increased by US$ 813 million in June 2001 alone.

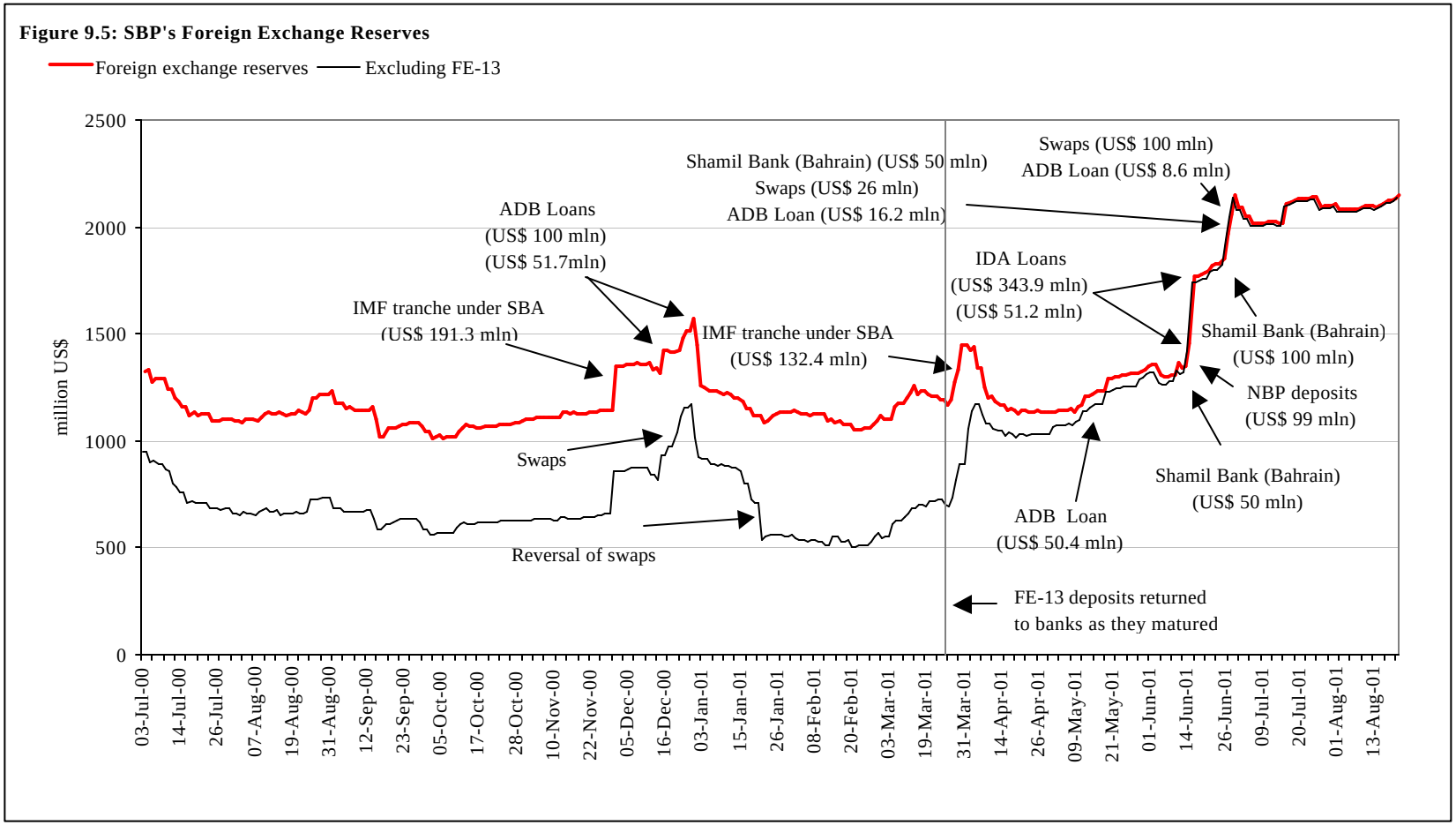
9.2.4 Trade Account[14]

The US$ 1.5 billion trade deficit recorded in FY01 was US$ 213.5 million less than last year largely because of higher export receipts (see **Figure 9.6**). This was achieved despite an oil import bill of

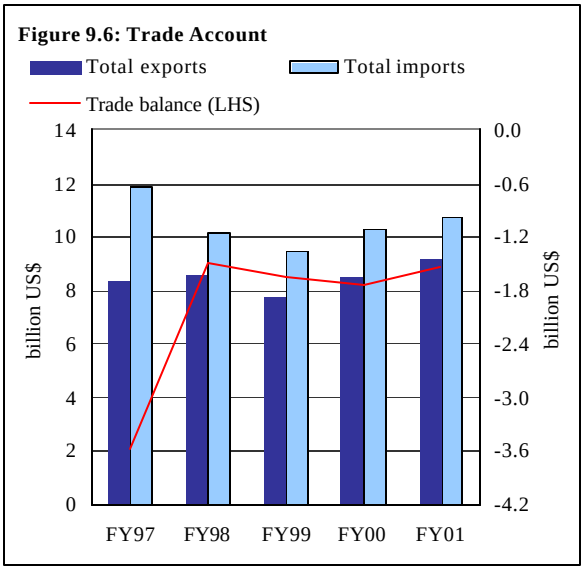
[13] According to new definition, foreign exchange reserves can be decomposed into (1) free reserves with SBP, and (2) reserves with ADs (FE-25 deposits).

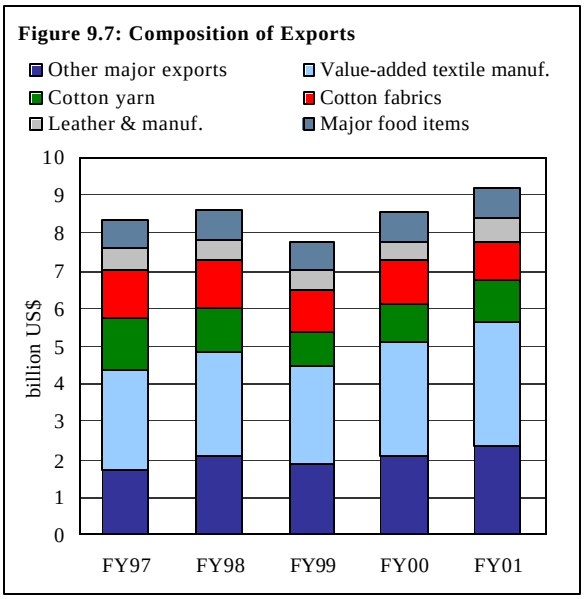
[14] The analysis is based on customs data received from FBS, as it is more detailed.

Figure 9.5: SBP's Foreign Exchange Reserves



US$ 3.4 billion (? by 19.8 percent), higher sugar imports and depressed prices of almost all major export items. The containment of imports this year is clearly shown by the fact that the ratio of exports to imports improved from 83.1 percent in FY00, to 85.8 percent this year.





Exports

Pakistan's export earnings crossed the psychological barrier of US$ 9 billion, posting a new high at US$ 9.2 billion (? by 7.4 percent). As shown in **Table 9.4** and **Figure 9.7**, this growth is based on export volumes since international prices still worked against the country.[15] The higher exportable surplus from two successive bumper cotton crops, strong growth in large-scale industrial production (excluding sugar) and improved competitiveness due to the massive depreciation of the Rupee during FY01, helped in achieving the export target. This performance is more commendable when viewed against the liquidity crunch faced by exporters (almost throughout the year) due to delayed refunds of sales tax and duty drawbacks, and adverse international commodity prices. Falling international prices cost the country more than US$ 703 million in lost revenues during FY01.

Over the years, Pakistan's export receipts have been vulnerable on account of the narrow base of exportable items, concentrated markets and low value addition. Although, textile products account for about 63 percent of total revenues, there has been a qualitative change in favor of high value-added items. Value added items now account for 55 percent of total cotton and textile manufactures compared to 46 percent in FY97. More specifically, marked improvements were recorded this year in towels (23.5 percent), synthetic textiles (19.0 percent), readymade garments (7.1 percent), bed ware (4.9 percent), and knitwear (2.8 percent). Another promising area is *other manufactures* (? by 19.0 percent), which is made up of non-traditional exports like carpets & rugs, petroleum products, cutlery, chemicals/pharmaceuticals, manufactured onyx items, and footwear etc.

The following points highlight the performance of specific export items during FY01:

[15] The enlarged export volume may be due to bunching effect as Export Promotion Bureau (EPB) in June 2001 initiated a 20-day crash program designed to accelerate the export shipments to achieve the export target for the FY01. The latest available data for Jul-Aug 2001 strongly support this view as most of the major export items (raw cotton, cotton fabrics, hosiery, synthetic textiles, carpets, onyx etc.) showed a marked decline over last year.

?? In FY01, export earnings from ***raw cotton*** increased by US$ 66.7 million owing largely to a 62.8 percent rise in the export volume, while higher international prices contributed US$ 21.1 million (see **Figure 9.8**).[16]. Notwithstanding the surplus raw cotton from two consecutive bumper crops, there were concerns about contamination and poor quality. In view of this, local textile mills and spinners imported around 80.9 thousand metric tons of high quality raw cotton, which was lower than last year due to a 11.8 percent increase in import unit price. Taking stock of this situation, in August 2001, the government set a target of one million bales of contamination-free cotton by

Table 9.4: Major Exports
million US$

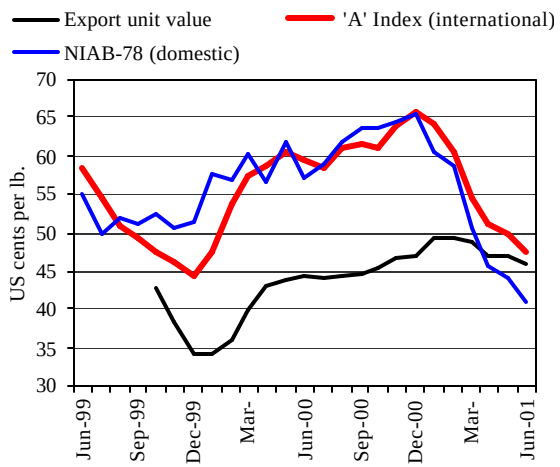
	FY97	FY98	FY99	FY00	FY01	Absolute change (FY01)
A. Cotton & textile manufactures	**5,585.5**	**5,648.0**	**4,975.6**	**5,660.7**	**5,930.2**	**269.5**
1. Raw cotton	30.7	126.1	2.3	72.6	139.3	66.7
2. Textile manufactures	5,554.8	5,521.9	4,973.3	5,588.1	5,790.9	202.8
Cotton yarn	1,411.6	1,159.4	945.2	1,071.6	1,073.5	1.9
Cotton fabrics (woven)	1,262.4	1,250.1	1,115.2	1,096.2	1,032.5	-63.7
Synthetic textiles	512.2	617.9	398.7	457.6	544.6	87.0
Hosiery (knitwear)	688.9	696.6	742.2	886.7	911.4	24.7
Bed ware	456.3	508.7	611.0	709.9	744.9	35.0
Towels	194.1	200.0	177.7	195.6	241.7	46.1
Cotton bags & sacks	27.6	23.1	20.8	19.2	19.0	-0.2
Readymade garments	736.4	746.4	651.2	771.7	826.8	55.0
Tarpaulin & other canvas goods	36.2	58.1	40.8	52.9	49.2	-3.7
Others	228.9	261.4	270.7	326.5	347.3	20.8
B. Major food items	**698.1**	**817.6**	**759.8**	**801.7**	**778.9**	**-22.8**
1. Rice	468.6	562.4	533.6	539.7	525.5	-14.1
2. Fish & fish preparations	149.1	171.6	122.6	138.9	137.8	-1.1
3. Fruits	70.7	64.3	55.5	79.9	78.7	-1.2
4. Vegetables incl. roots and tubers	9.7	19.3	48.1	43.3	36.9	-6.4
C. Leather & manufactures	**603.7**	**551.2**	**511.6**	**513.8**	**658.4**	**144.6**
1. Leather	239.6	207.8	177.3	175.2	232.9	**57.8**
2. Leather manufactures	364.0	343.4	334.3	338.7	425.5	86.9
D. Other major exports	**1,433.4**	**1,609.9**	**1,532.3**	**1,592.4**	**1,834.0**	**241.7**
1. Sports goods	308.8	383.5	256.2	279.2	270.6	-8.6
2. Carpets & carpeting rugs	199.1	200.1	202.6	264.3	288.7	24.5
3. Surgical and medical instruments	125.8	125.3	111.6	120.1	124.1	4.0
4. Petroleum and petroleum products	81.6	35.6	47.4	81.9	183.9	102.1
5. Chemicals and pharmaceuticals	48.3	55.8	49.3	100.0	156.9	56.9
6. Cutlery	19.9	17.6	18.0	22.9	26.4	3.5
7. Onyx manufactured	11.8	10.9	5.9	10.0	12.0	2.0
8. Molasses	51.0	59.1	39.4	42.5	41.3	-1.2
9. Foot wear incl. leather	51.5	43.0	35.0	37.2	42.5	5.2
10. Guar and guar products	32.3	32.3	32.9	36.0	20.5	-15.5
11. Crude animal material	23.9	20.4	17.0	15.8	15.8	0.0
12. Oil seeds & nuts etc.	7.7	10.9	10.9	4.9	11.8	7.0
13. Others	471.7	615.3	706.2	577.7	639.4	61.7
Total exports	**8,320.7**	**8,626.7**	**7,779.3**	**8,568.6**	**9,201.6**	**633.0**
Memorandum:						
Cotton based products	4,813.7	4,642.5	4,303.9	4,803.9	4,899.0	95.1

Source: Federal Bureau of Statistics

[16] The 'A' Index is a representat ive of the offering prices in the international raw cotton market. It is an average of the cheapest five quotations from a selection (at present numbering fifteen) of the principal upland cottons traded internationally.

announcing cash incentives to growers.[17] The government has also decided to allow inspection companies from the private sector to certify quality and grading of cotton prior to shipment. This should enable Pakistani cotton to be traded in the Liverpool Cotton Exchange.

Figure 9.8: Lint Cotton Prices and Export Unit Values



?? Export receipts from ***cotton yarn*** were severely affected by the persistent decline in international prices since FY96. Revenues from yarn export posted a mere 0.2 percent increase over last year due to lower prices (US$ 65.3 million in lost revenues) that almost nullified the advantage of the larger volume of exports (US$ 67.2 million) (see **Figure 9.9**).[18] There are, however, some encouraging developments as local spinners have recaptured a part of lost market share by offering quality products at competitive prices. In FY01, Pakistan's yarn exports to Hong Kong amounted to US$ 310.4 million (? by 9.4 percent over last year), while exports to South Korea have registered a substantial increase of 22.4 percent.

?? In FY01, ***cotton fabrics*** earned US$ 1.0 billion, depicting a fall of 5.8 percent over FY00. Although, exports maintained the rising trend in volume since FY97, depressed international prices resulted in lost revenues to the tune of US$ 175.7 million (see **Figure 9.9**).

?? Despite falling international prices that cost US$ 49.5 million in earnings, exports of ***bedware*** amounted to US$ 744.9 million in FY01 (? by 4.9 percent over FY00 – see **Figure 9.9**). It may be pointed out that the 6.4 percent anti-dumping duty imposed by the EU in December 1997, hit the country both in terms of quantity and value.[19]

?? ***Readymade garments***, the only textile item that saw a rise in per-unit price last year, experienced a 9.1 percent fall in prices in FY01, which caused a negative price effect of US$ 83.0 million (see **Figure 9.9**). Total export earnings, however, increased by 7.1 percent to US$ 826.8 million on account of higher export volumes (? by 17.9 percent). This item is still an under-performer relative to its potential and other neighboring countries.

?? ***Towel*** exports topped the list of textile manufactures by registering 23.5 percent growth in value during FY01, despite the imposition of countervailing duties by the US Commerce Department. A 6.2 percent decline in per-unit prices was more than offset by a marked improvement in the export volume (US$ 62.0 million), resulting in a net gain of US$ 46.1 million in export earnings.

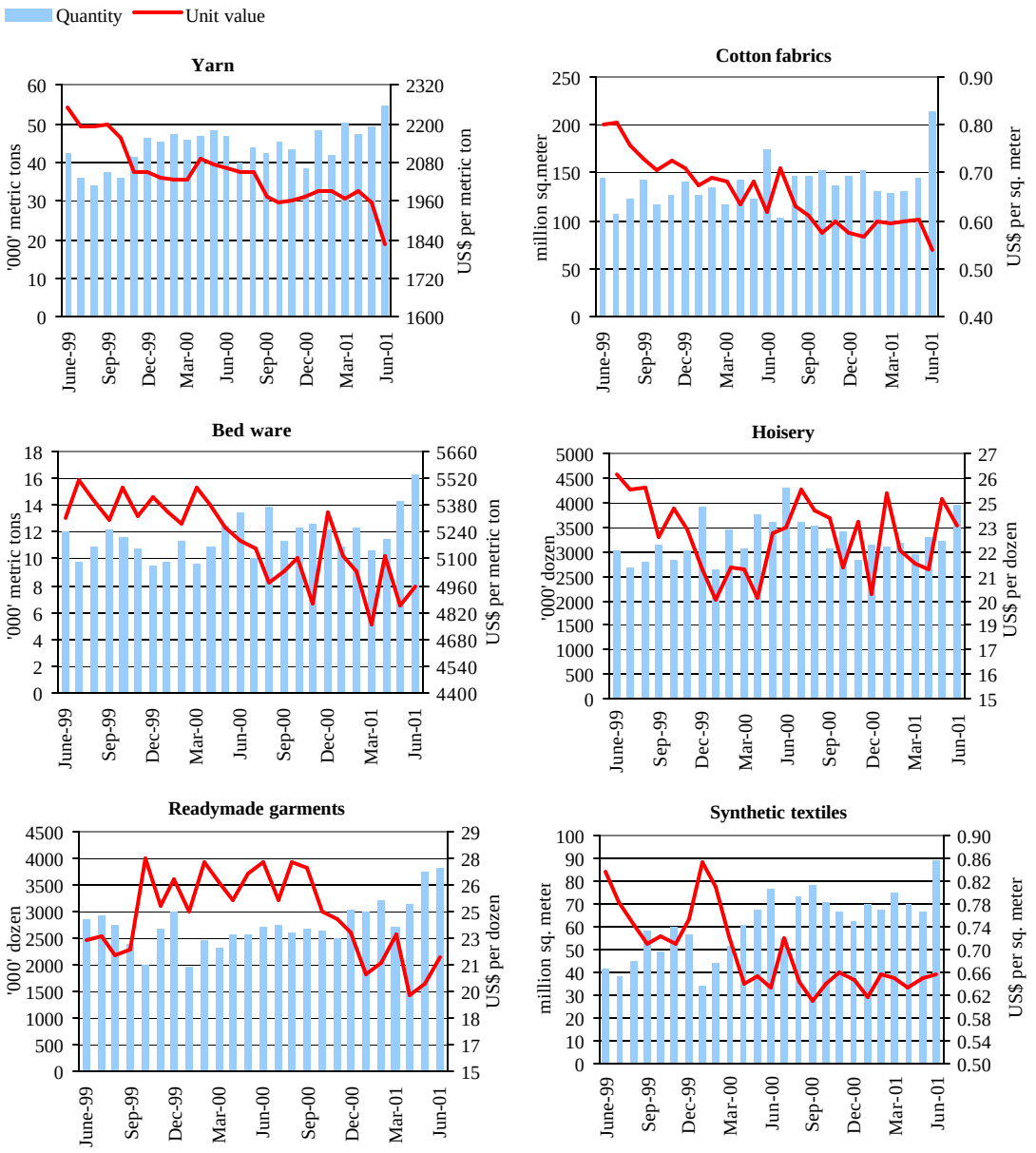
[17] Rs 200 per bale for contaminated free cotton and Rs 75 per bale for cotton having impurity up to 2.5 grams per kg.

[18] Exports of cotton yarn have been facing hardship in the form of anti-dumping duties in a number of important markets i.e., Japan since 1995, and USA for more than two years. However, WTO Dispute Settlement Body has since declared the US action illegal but America is yet to lift the ban on Pakistani combed cotton yarn. South Korea also initiated investigations for the imposition of anti-dumping duty, which was later withdrawn.

[19] The removal of this duty is expected in the near future after EU withdraws the anti-dumping duty on import of bed linen from India as a result of WTO Appellate Tribunal's ruling in India's favor. Moreover, South Africa has recently imposed 6 percent countervailing duty on export of Pakistani bed linen.

?? For the last several years, ***rice*** exports have been the second highest foreign exchange earner after textiles. However, despite the 28.2 percent increase in export volume in FY01 (2.5 million metric tons), total export earnings declined by 2.6 percent to US$ 525.5 million. A break-up of export volumes of basmati rice (premium quality known for its aroma) and other varieties (like irri-6 and irri-9) provides some interesting insights. During FY01, the share of basmati rice in total export volume declined from 30 to 20 percent resulting in a substantial loss of foreign exchange.[20] Falling international prices of rice, quality concerns and lack of proper marketing, were also

Figure 9.9: Textile Manufactures - Qantitative Exports and Unit Prices



[20] On average, basmati rice fetches more than three times the average unit price of other inferior varieties. This is reflected from the fact that an impressive increase of 45.1 percent in export volume of other varieties was insufficient to boost total earnings from rice exports.

responsible for the decline in export earnings.

Rice exports to Dubai, which serves as a distribution center for Pakistani rice, accounted for 34.2 percent and 4.9 percent of total export volumes of basmati and inferior varieties, respectively (see **Table 9.5)**. Keeping in view the size and population of Dubai, this relatively high share provides some credence to market reports that Indian traders in Dubai are selling Pakistani rice under their own "Taj Mahal" brand at much higher prices in other markets.[21] In the case of Saudi Arabia, Pakistan is losing its market share to India due to the non-availability of quality par-boiled rice; during FY01, basmati exports declined by 21.8 percent in terms of volume with a 30.9 percent fall in value. On a positive note, the following factors may go a long way in arresting the falling earnings from rice exports: (1) the recent decision by the Philippine government to allow Pakistani firms to take part in rice bidding, (2) the permission to private sector companies to certify quality specification and grading of rice prior to shipment from Pakistan, (3) the formation of a quality review committee to inspect rice export consignments, and (4) a joint stand with India against the patenting of three qualities of basmati by the US firm RiceTec.

Table 9.5: Export of Rice (Variety-Wise)
value: million US$; quantity: 000 metric tons; unit value: US$

	FY01			FY00		
	Qty	Value	Unit value	Qty	Value	Unit value
Total	**2,456.0**	**525.5**	**214.0**	**1,916.1**	**539.7**	**281.7**
Basmati	**502.1**	**235.6**	**469.3**	**569.8**	**290.4**	**509.7**
Dubai	171.9	77.8	452.6	171.4	83.5	487.3
Saudi Arabia	50.6	22.1	436.3	64.7	31.9	493.5
Oman	35.9	17.0	471.9	68.4	31.5	461.1
UK	26.9	13.9	518.0	27.5	17.6	642.7
Yemen	26.5	10.8	408.1	17.7	8.1	458.3
Qatar	26.4	12.2	460.4	44.7	21.0	469.9
Bahrain	20.9	11.3	541.3	23.4	14.2	607.9
Kuwait	19.1	9.8	512.4	23.2	12.5	541.5
Mauritius	14.9	7.3	488.2	14.8	8.0	538.7
USA	11.3	7.1	631.5	12.0	8.1	670.5
Other	97.6	46.4	475.0	102.2	53.9	527.6
Other varieties	**1,954.0**	**289.9**	**148.4**	**1,346.2**	**249.3**	**185.2**
Afghanistan	287.7	40.1	139.2	183.7	27.0	147.2
Iran	220.4	10.9	49.2	22.6	4.7	210.0
Ivory Coast	105.6	15.2	144.3	10.0	1.7	173.0
Dubai	95.5	21.2	222.5	86.9	21.9	252.4
Bangladesh	81.5	12.1	149.1	120.7	21.0	173.6
Kenya	75.7	13.0	171.2	14.5	2.7	188.3
Rep. of Congo	69.0	10.0	145.7	7.0	1.4	195.6
Malagasy	64.5	9.6	148.5	28.8	4.9	168.8
Iraq	39.4	7.9	199.2	-	-	-
Indonesia	37.4	6.0	161.5	15.1	3.0	197.8
Other	877.3	143.9	164.0	856.9	160.9	187.8

Source: Federal Bureau of Statistics

?? ***Fish and fish preparations*** earned US$ 137.8 million in FY01, a marginal decline of 0.8 percent over last year. Gains in unit export prices due to a greater quantum of shrimps and fish maws (that fetch good prices), and the upgradation of Pakistan's status in EU's veterinary list, were more than offset by lost revenues from lower export volumes. EU remained the main export market following the scare of *mad cow* and *foot & mouth* diseases. Adherence to international hygiene standards by processing plants in Pakistan increased to 14 after EU's approval.

?? Despite an 8.4 percent increase in the volume of ***fruit*** exports, revenues registered a slight decline of US$ 1.2 million in FY01 due mainly to lower realized unit prices (see **Table 9.6**). The exception was mangoes, which posted strong growth in revenues by 46.7 percent to US$ 17 million (volume ? by 12.3 percent and realized unit price ? by 30.7 percent). This was due to better marketing, sufficient air cargo space and swift custom procedures.[22] In terms of markets, while Dubai enjoys the biggest share (59 percent), UK has emerged as the quality conscious

[21] Rice in packeted form generally brings higher unit prices. Though data is not available, it seems that rice exports to USA, which shows a high unit price, are in packeted form.
[22] The EPB had organized mango exhibitions in a number of countries during the year to boost exports in target markets.

premium buyer (see **Figure 9.10**). Mango exports have also found their way to the Far East, Scandinavia, Middle East and other countries in Europe. Once the vapor heat treatment plant starts functioning, fresh fruit exports (especially mangoes which are particularly vulnerable to fruit flies) may also penetrate markets in Australia, South Korea, Japan and the US.[23]

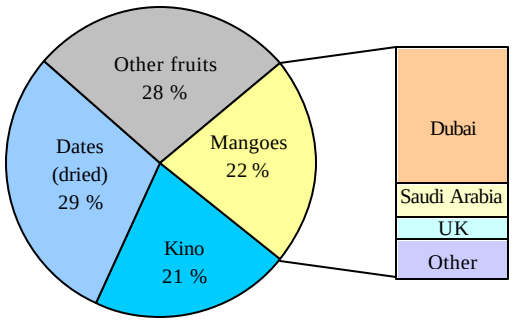
Table 9.6: Export of Major Fruits

value in million US$; quantity in 000 metric tons; unit value in US$

	FY01			FY00		
	Qty	Value	Unit value	Qty	Value	Unit value
Mangoes	53.4	17.0	318.2	47.6	11.6	243.5
Kino	97.0	16.3	168.1	82.8	13.9	168.2
Dates (dried)	73.3	23.5	320.4	57.5	20.6	358.6
Other fruits	36.3	21.9	603.0	51.9	33.8	650.4
Total	**260.1**	**78.7**	**302.6**	**239.8**	**79.9**	**333.2**

Source: Federal Bureau of Statistics

Figure 9.10: Export of Fruits During FY01



?? For the first time in Pakistan's history, the largest ever ***wheat*** crop (in excess of 21 million tons) created a substantial exportable surplus in FY01. Nevertheless, only a small quantity was exported to Iraq (35,001 metric tons valued at US$ 4.3 million) and Afghanistan (45,497 metric tons at US$ 6.7 million).

?? Pakistan's ***leather and leather products*** (excluding footwear) has been declining for the past several years mainly due to competition and quality concerns in the international market.[24] The spread of *foot & mouth* disease in Europe, especially in UK, which led to the mass incineration of livestock (including their hides), has bolstered dwindling leather exports during FY01. Furthermore, demand for leather garments and designer products have also increased in the US and other European countries in the last couple of years. Exports of leather (& products) contributed US$ 658.4 million to total export earnings (up 28.1 percent over FY00) ? exceeding the target set for FY01. As for exports of tanned leather, this increased by 33.0 percent (export volume ? by 35.9 percent and realized unit price ? by 2.2 percent). In terms of export markets, South Korea is the major market for tanned leather, whereas leading buyers of leather products include the US, Germany, UK and France.

?? Exports of ***petroleum and petroleum products*** witnessed robust growth of 124.7 percent to US$ 183.9 million during FY01. In volume terms, Pakistan exported 824.5 thousand metric tons of petroleum and products, but mostly crude oil.[25] Export of petroleum products is expected to rise sharply with the full capacity production by Pak-Arab Refinery Company (PARCO); this company is also expected to get permission to export other petroleum products including liquefied petroleum gas (LPG). To further accelerate the pace of such exports, the government has allowed the private sector to export petroleum products except high-speed diesel and furnace oil.

[23] The plant for fruit treatment, set up in Karachi with the aid of the Japanese government, is yet to start operation for want of electric generator and other accessories.

[24] Duty free import of raw hides and skins is allowed for re-export purposes from Saudi Arabia, Kenya, Sudan, Australia, New Zealand, Brazil, etc. to supplement the local supply of hides and skins which is only sufficient to meet about ¾ of the local demand.

[25] This largely reflects the lack of refining capacity for low-grade crude oil produced locally in the country.

Other exports in FY01 include: carpets & rugs at US$ 288.7 million (up 9.3 percent); chemicals and pharmaceuticals at US$ 156.9 million (? by 56.9 percent); surgical and medical instruments at US$ 124.1 million (? by 3.3 percent); and sports goods worth US$ 270.6 million (? by 3.1 percent).

Table 9.7: Economic Classification of Exports

value: million US$; share: percent

	FY97		FY98		FY99		FY00		FY01	
	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share
Primary commodities	928.9 (-33.9)	11.2	1,089.7 (17.3)	12.6	898.6 (-17.5)	11.6	1,039.6 (15.7)	12.1	1,158.8 (11.5)	12.6
Semi-manufactures	1,710.1 (-9.3)	20.6	1,497.8 (-12.4)	17.4	1,402.3 (-6.4)	18.0	1,317.3 (-6.1)	15.4	1,384.5 (5.1)	15.0
Manufactured goods	5,681.7 (4.9)	68.3	6,039.2 (6.3)	70.0	5,478.5 (-9.3)	70.4	6,211.6 (13.4)	72.5	6,658.3 (7.2)	72.4
Total exports	8,320.7	100.0	8,626.7	100.0	7,779.3	100.0	8,568.6	100.0	9,201.6	100.0

Note: Figures in parentheses represent annual growth rates.

Source: Federal Bureau of Statistics

In terms of economic classification, the share of manufactured exports has risen from 68.3 percent of total exports in FY97 to 72.4 percent in FY01. Similarly, the share of primary commodities has also gone up from 11.2 percent to 12.6 percent in the same period. Semi-manufactured exports, on the other hand, which constituted 20.6 percent of total exports in FY97, have come down to 15.0 percent in FY01 (see **Table 9.7**).

In terms of Pakistan's export markets, Asia as a region, remains the largest in FY01, improving its share from 34.5 percent in FY00 to 36.9 percent, followed by Western Europe whose share declined from 29.2 percent to 26.9 percent and North America (see **Table 9.8**). In terms of the five largest export markets, USA continues to dominate, followed by Dubai, UK, Hong Kong and Germany.

Table 9.8: Pakistan's Export Markets

value: million US$; growth/share: percent

	FY00	FY01		
	Value	Value	Growth	Share
North America	**2,306.8**	**2,428.7**	**5.3**	**26.4**
USA	2,123.1	2,245.6	5.8	24.4
Central America	**73.1**	**78.2**	**6.9**	**0.8**
South America	**99.1**	**113.0**	**14.0**	**1.2**
Western Europe	**2,502.0**	**2,474.0**	**-1.1**	**26.9**
E.C.	*2,435.6*	*2,420.6*	*-0.6*	*26.3*
France	282.7	265.8	-6.0	2.9
Germany	512.6	495.0	-3.4	5.4
Italy	209.3	230.3	10.1	2.5
Netherlands	229.1	233.2	1.8	2.5
UK	579.5	576.0	-0.6	6.3
Eastern Europe	**74.4**	**79.1**	**6.4**	**0.9**
Africa	**415.1**	**491.2**	**18.3**	**5.3**
Asia	**2,952.1**	**3,390.9**	**14.9**	**36.9**
Middle East	*1,054.5*	*1,331.8*	26.3	*14.5*
UAE	492.7	626.1	27.1	6.8
Dubai	488.4	615.4	26.0	6.7
Saudi Arabia	214.8	273.0	27.1	3.0
China	180.3	303.2	68.1	3.3
Hong Kong	524.9	504.5	-3.9	5.5
Japan	267.5	193.6	-27.6	2.1
South Korea	245.4	278.4	13.4	3.0
Oceania	**146.0**	**146.5**	**0.4**	**1.6**
Total exports	**8,568.6**	**9,201.6**	**7.4**	

Source: Federal Bureau of Statistics

Other important developments regarding Pakistan's export markets include:

?? Although it is still too early to gauge the impact of the IT collapse and the terrorist attacks in the US, Pakistan's exports to the US have not been adversely impacted in FY01. In fact, our quota-constrained exports (textiles) have registered a 10.7 percent growth in value during the first half of CY01 over same period last year.

?? Pakistan's exports to Western Europe have declined in FY01 despite an 18.6 percent devaluation of the Rupee/Dollar parity. It would seem that the country lost some advantage due to the strong US dollar vis-à-vis Euro.

?? Exports to China that include cotton yarn and a few other products, grew by 68.1 percent and in doing so, increased its share in total exports from 2.1 percent in FY00 to 3.3 percent in FY01.

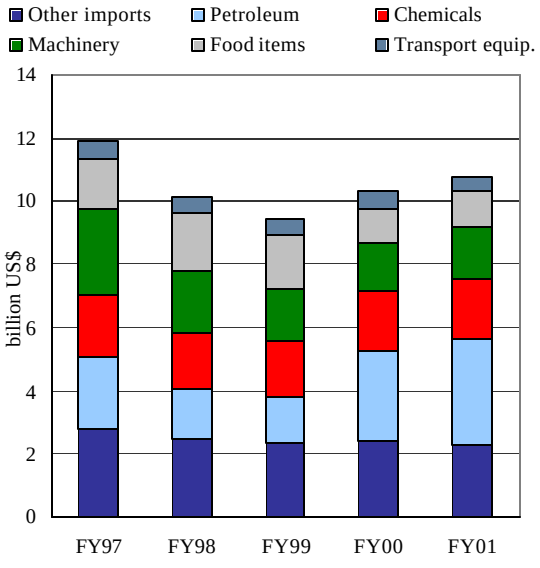
?? Pakistan's export to Saudi Arabia amounted to US$ 273.0 million in FY01, raising its share from 2.5 percent to 3.0 percent. The scope of Pakistani exports to Saudi Arabia has increased further after the Kingdom reduced import duties from 12 percent and 7 percent, to only 5 percent. This market has become very attractive for Pakistani exporters, as there are no duty or charges other than the 5 percent import duty.

Moving ahead, the Trade Policy for FY02 has set the export target at US$ 10.1 billion with a continuing emphasis on: (1) greater value addition, (2) diversification of products and markets, (3) rectifying any anti-export bias, and (4) improving the export culture. In addition to traditional exports, the emphasis has been placed on ceramics, engineering and chemicals. In order to achieve these objectives, various incentives have been provided, which include the Foreign Currency Export Finance Facility (FCEFF), the political risk guarantee facility, withdrawal of the export development surcharge, permission to retain 50 percent of *additional* export revenues in foreign currency accounts, and the establishment of specific groups to encourage exports of rice, engineering, horticulture, plastics and leather.

Imports

Pakistan's import bill in FY01 was US$ 10.7 billion, depicting a 4.1 percent increase over FY00 (see **Table 9.9** and **Figure 9.11 & 9.12**). Excluding POL, the pattern of imports during the FY01 indicated almost all round decrease with the exception of industrial machinery, which continued to show a rising trend due mainly to sizeable increases in the import of textile machinery. However, anecdotal evidence suggests that the slowdown in imports of a number of items, reflects growing smuggling of manufactured goods from India and China. Lower imports of industrial raw materials over the last many years reflect the markedly low level of investment activity in the industrial sector. In FY01, import of industrial raw materials (at US$ 2.2 billion) declined by 5.3 percent relative to the year before.

Figure 9.11: Composition of Imports



The composition of Pakistan's imports shows that the share of raw material for consumer goods continues to rise from 43.6 percent in FY97 to 55.2 percent in FY01. On the other hand, the share of raw material for capital goods has stagnated at around 5 percent, whereas capital goods (in total imports) is still showing a declining trend, falling to 25.0 percent in FY01 from 36.5 percent in FY97. The share of consumer goods has fluctuated between 14.1-17.9 percent since FY97 (see **Table 9.10**). Just on the basis of these broad statistics, it is clear that the poor investment climate in the

Table 9.9: Major Imports
million US$

	FY97	FY98	FY99	FY00	FY01	Absolute change (FY01)
A. Food group	**1,596.0**	**1,872.9**	**1,634.8**	**1,113.1**	**1,131.4**	**18.3**
1. Wheat unmilled	477.1	709.0	407.0	283.5	15.4	-268.1
2. Tea	134.2	226.7	222.9	210.4	206.4	-4.0
3. Edible oil	611.7	767.9	824.1	413.4	327.6	-85.9
4. Sugar (incl. raw sugar)	254.2	41.4	3.1	14.8	393.3	237.1
5. Pulses	41.9	50.4	63.7	89.6	113.0	23.4
6. Others	76.9	77.6	113.9	101.4	75.8	-25.6
B. Petroleum group	**2,255.1**	**1,572.1**	**1,463.5**	**2,804.4**	**3,360.8**	**556.5**
1. Petroleum crude	583.3	468.4	429.0	805.0	1,360.6	555.6
2. Petroleum products	1,671.8	1,103.6	1,034.5	1,999.4	2,000.3	0.9
C. Machinery group	**2,735.4**	**1,918.6**	**1656.7**	**1433.6**	**1,640.0**	**206.4**
1. Power generating machinery	995.6	462.3	235.1	141.7	197.9	56.1
2. Textile machinery	129.7	212.0	164.0	211.0	370.2	159.2
3. Construction & mining machinery	155.0	168.0	93.7	88.4	82.5	-5.9
4. Electrical machinery & apparatus	424.9	309.4	147.9	155.0	131.6	-23.4
5. Office machinery	48.5	73.4	125.6	158.0	233.1	75.1
6. Other machinery	981.7	693.6	890.4	679.5	624.8	-54.7
D. Transport equipment	**560.0**	**483.2**	**541.3**	**564.1**	**426.2**	**-137.8**
E. Chemical group	**1,981.4**	**1,791.5**	**1,812.0**	**1,997.2**	**1,901.7**	**-95.5**
1. Fertilizer	387.3	208.0	265.1	197.6	170.5	-27.1
2. Insecticides	138.6	113.2	112.8	90.7	61.2	-29.5
3. Plastic materials	326.8	303.4	310.6	332.9	354.3	21.4
4. Medicinal products	272.5	248.9	263.8	259.4	238.7	-20.7
5. Others	856.2	918.1	883.5	1,116.6	1,077.0	-39.6
F. Miscellaneous group	**2,766.9**	**2,478.1**	**2,323.3**	**2,397.1**	**2,268.7**	**-128.4**
1. Synthetic fiber	117.1	118.2	94.2	76.5	77.8	1.2
2. Iron & steel	463.9	320.5	292.8	304.5	277.9	-26.6
3. Jute	29.5	23.7	16.6	20.5	23.2	2.7
4. Paper and paper board & manufactures	128.2	121.4	113.1	117.5	125.3	7.8
5. Synthetic & artificial silk yarn	50.3	38.3	44.7	47.5	59.5	12.0
6. Iron & steel scrap	39.1	20.0	18.7	23.8	43.0	19.2
7. Aluminum wrought & worked	46.8	31.9	37.7	43.9	40.4	-3.5
8. Rubber tyres & tubes	69.0	74.1	72.4	69.4	62.5	-6.9
9. Rubber crude	60.0	48.3	38.5	37.0	39.2	2.2
Others	1,762.9	1,681.7	1,594.5	1,656.3	1,519.8	-136.5
Total imports	**11,894.8**	**10,116.4**	**9,431.7**	**10,309.4**	**10,728.9**	**419.5**

Source: Federal Bureau of Statistics

Table 9.10: Economic Classification of Imports
value: million US$; share: percent

	FY97		FY98		FY99		FY00		FY01	
	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share
Consumer goods	1,803.3 (12.6)	15.2	1,809.3 (0.3)	17.9	1,485.9 (-17.9)	15.8	1,453.1 (-2.2)	14.1	1,536.1 (5.7)	14.3
Raw material for consumer goods	5,183.6 (-3.3)	43.6	4,527.2 (-12.7)	44.8	4,463.8 (-1.4)	47.3	5,558.1 (24.5)	53.9	5,926.7 (6.6)	55.2
Raw material for capital goods	571.9 (-14.5)	4.8	540.2 (-5.5)	5.3	519.8 (-3.8)	5.5	593.2 (14.1)	5.8	585.3 (-1.3)	5.5
Capital goods	4,336.0 (3.9)	36.5	3,239.7 (-25.3)	32.0	2,962.2 (-8.6)	31.4	2,705.0 (-8.7)	26.2	2,680.8 (-0.9)	25.0
Total imports	**11,894.8**	**100.0**	**10,116.4**	**100.0**	**9,431.7**	**100.0**	**10,309.4**	**100.0**	**10,728.9**	**100.0**

Note: Figures in parentheses represent annual growth rates.
Source: Federal Bureau of Statistics

country since even before the nuclear tests has been responsible for a decline in imports of capital goods and industrial raw material.

Important developments in the Pakistan's large import categories are as under:

?? Although oil prices have not shown too much volatility during most of FY01, the volume of crude imports increased significantly to over 6.8 million tons (? by 53.9 percent) over last year (see **Figure 9.13)**.[26] This is in addition to the 10.1 million tons of imported petroleum products worth about US$ 2 billion brought into the country in FY01. As a result, Pakistan's oil import bill, which had averaged 18.8 percent during the last 5 years, shot up to 31.3 percent in FY01. The power-generating sector is the main consumer of imported oil, as most of the IPPs are currently running on costly furnace oil.[27] To make matters worse, the drought in FY01 also adversely affected hydel power generation, which in turn further increased the dependency on thermal energy. The commissioning of Pak-Arab Oil Refinery (PARCO), which should reduce the country's dependency on imported petroleum products, also added to the import of crude oil during FY01.

Figure 9.12: Imports Excluding Food and POL

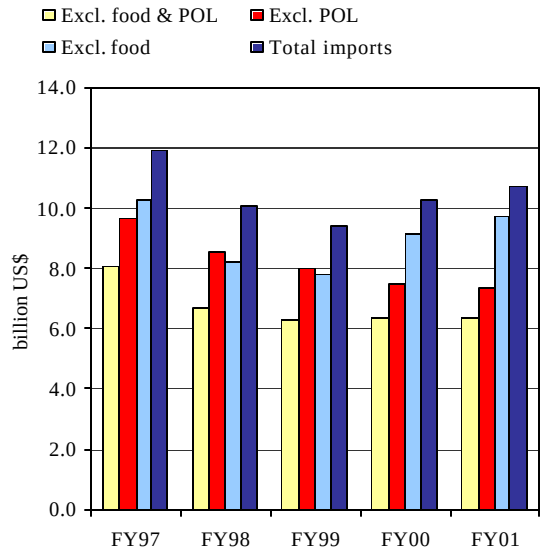
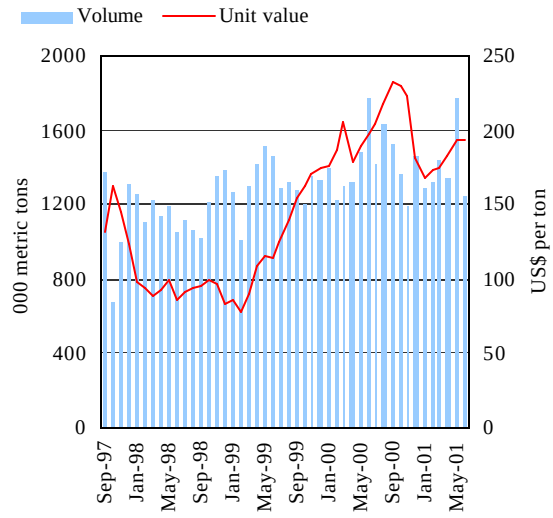


Figure 9.13: Volume and Unit Value of POL Imports



?? During the year in question, 0.9 million metric tons of refined sugar (worth US$ 251.9 million) was imported.[28] A poor sugarcane harvest due to water shortages and the price dispute between growers and mill owners, which delayed the crushing season by one month, put pressure on sugar prices during FY01 (see **Figure 3.3**). In order to ward off any further pressure on prices and to support the sugar industry, in September 2000, the government permitted the import of 0.6 million metric tons of raw sugar during the remaining part of the year. Of this permissible limit, 0.5 million metric tons of raw sugar was actually imported by the sugar mills incurring extra outlay of US$ 141.4 million. The total sugar production during the year combined with the

[26] Brent crude prices, on average had gone up by 14.3 percent to US$ 28.3 per barrel compared to US$ 24.8 per barrel during FY00.

[27] IPPs running on furnace oil include Hubco, AES Lal Pir, AES Pak Gen., Saba power, Tapal Energy, Gul Ahmad Energy, Southern Electric Power, Kohinoor Energy, Japan Power Generation. One more power plant, Power Generation System, using furnace oil is to be commissioned soon.

[28] This supplemented the lower domestic production of 2.5 million metric tons during the last season against the estimated demand of about 3.1 ? 3.3 million metric tons.

carryover stock from the previous year is expected to meet domestic consumption, thus eliminating the need for sugar imports during FY02.

?? In FY01, edible oil was the second largest food import after sugar (refined and raw). The tariff reduction on oilseed import from Rs 1,220 per ton to a flat 5 percent ad valorem, proved to be a disincentive to local farmers who were unable to compete with cheaper imported oilseeds. The resulting 7 percent decline in local production of edible oils (cottonseed oil, sunflower, canola and others) in FY01, meant that over 71 percent of total demand (at 1.95 million tons) was met through imports. In terms of volume, edible oil imports during the year registered an 8.8 percent increase over last year, which was led by palm oil that accounted for 88.8 percent of total volume. However, falling international prices, particularly of palm oil, allowed the country to import more but still post a 20.8 percent fall in its import bill over FY00. In disaggregated terms, falling unit-prices accounted for a net saving of US$ 122.3 million, which was significantly higher than the additional expenditure of US$ 36.4 million due to the larger volume of imports.

?? Following the 1994 Power Policy, machinery imports increased substantially on account of the incentives given to private investment in the power generation sector. However, the completion of independent power projects (IPPs), the subsequent dispute between the IPPs and Pakistan's public utilities, and the economic uncertainty following nuclear tests in 1998, drastically reduced this foreign direct investment in Pakistan. During FY01, import of machinery (including transport equipment) recorded a slight increase of 3.4 percent over last year, and stood at US$ 2.1 billion. In this group, textile machinery showed an impressive growth of 75.5 percent over FY00, a reflection of the continued BMR drive that has been ongoing in the last two years.[29] During this period, investment of US$ 581 million has been booked under this head, which is an encouraging development given business sentiments during the past two years.

?? The decrease in both volume and value of the import of pesticides reflects the absence of any significant pest attack during FY01. Moreover, the fall in international prices by 17.1 percent also helped in reducing the import bill by US$ 12.6 million.

?? In FY01, import of fertilizer declined by 13.7 percent over FY00 and accounted for US$ 170.5 million. This is on account of an increase in domestic production of DAP following the commissioning of Fauji Jordan's fertilizer plant.

9.3 Transactions with the IMF

As discussed in the last *Annual Report*, Pakistan cannot boast of an impressive past record with the IMF, as all programs in the 1990s were suspended because of our inability to implement policy changes that had been agreed to. Within this context, the stabilization program signed in November 2000 was done so from a position of weakness. Other than the need to return to the macroeconomic path envisaged in the previous ESAF/EFF programs, the fact that the economic team representing Pakistan had come into power following the military takeover in October 1999, did not strengthen our case.

Despite prolonged discussions between GOP and the IMF after April 2000, where there was a view that Pakistan would be able to secure a three-year Poverty Reduction & Growth Facility (PRGF), the IMF offered a 10-month stringent stabilization program with up-front conditionalities in November 2000. The most binding targets in this program were focused on ensuring that government borrowing

[29] The Exim Bank of China has recently agreed to extend a credit line of US$ 200 million to Pakistan for financing BMR and expansion of the country's textile capacity.

was contained and not dependent on the central bank, and that liquid reserves were built up. Although tax revenue targets were also agreed upon, slippages were not allowed to interfere with the planned reduction of government borrowing. In effect, this forced the government to reduce its expenditures when revenue shortfalls threatened to breach the deficit target. Unlike an orthodox stabilization program, structural changes in the exchange rate regime (and SBP management of the foreign exchange market) were to be implemented alongside quarterly targets for liquid reserves.

Table 9.11: Transactions With the IMF

million US$

Facility	FY00	FY01
Purchases		
Standby Arrangement (SBA)	**Nil**	**324**
Repurchases		
Extended Fund Facility (EFF)	18.3	26.3
Poverty Reduction & Growth Facility (PRGF)	36.9	44.2
Standby Arrangement (SBA)	168.0	133.2
Structural Adjustment Facility (SAF)	52.1	27.6
Saudi Fund for Development (SFD)	4.0	7.7
Total	**279.3**	**239.0**
Use of Fund Credit (Net)	**-279.3**	**85.0**

Source: State Bank of Pakistan

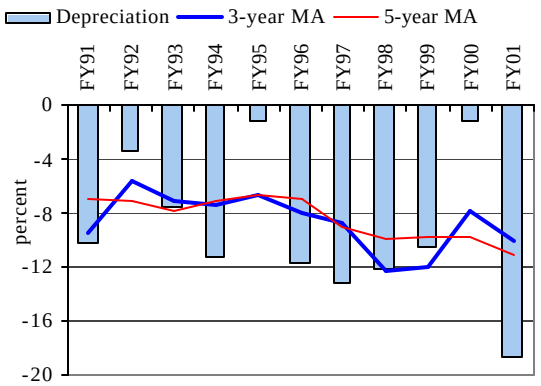
The SBA has been successfully implemented and the fourth and last tranche was released on September 26, 2001 ? exactly after 10 months from the approval by the IMF Board.

Transactions with the IMF are reported in **Table 9.11**. In net terms, inflow of US$ 324 million under the SBA was largely offset by repurchases (repayment) of US$ 239 million, thereby resulting in net inflows into Pakistan of only US$ 85 million.

9.4 Exchange Rate Policy

In sharp contrast to FY00, the Rupee/Dollar parity weakened dramatically by 18.6 percent during FY01, raising the question ? what was so different in FY01 vis-à-vis the previous year? Looking at **Figure 9.14**, it would seem that the depreciation in FY01 is cumulative of two fiscal years — FY00 and FY01. In FY00, the induced stability had kept nominal exchange rate almost unchanged. If this factor is taken into account, the Rupee/Dollar parity returns to its historical trend

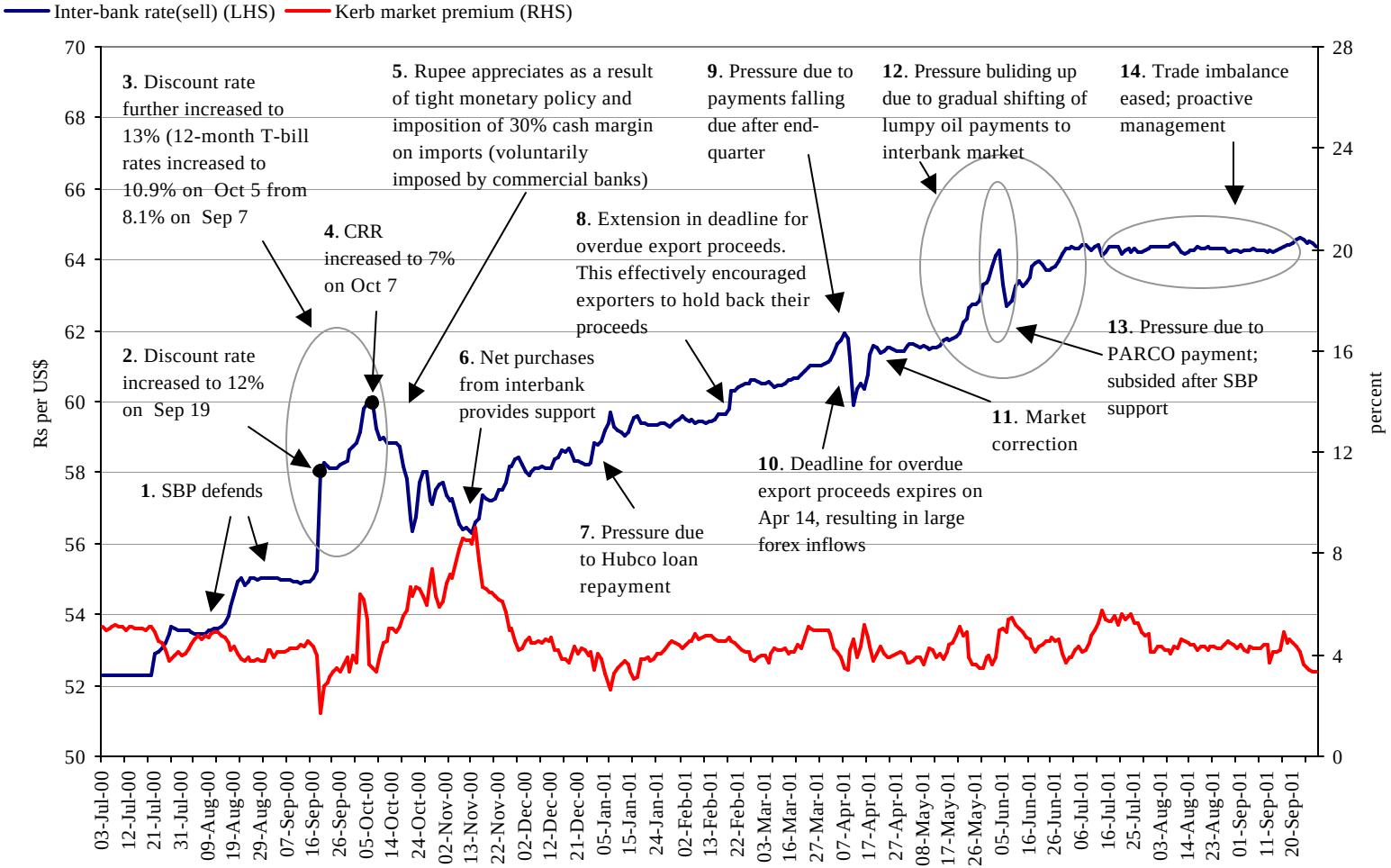
Figure 9.14: Annual Depreciation



Although, low inflation and a narrowing of the current account deficit characterized FY00, more important was the absence of an IMF program that allowed a degree of freedom to manage the exchange rate as deemed necessary.[30] This leeway allowed SBP to maintain a stable parity during the year, but at the cost of stagnant liquid reserves. In comparison, almost similar macroeconomic conditions prevailed during FY01: first, inflation was relatively higher compared to last year, but in terms of the differential with other trading partners and competitors, it did not require a large adjustments to maintain purchasing power parity; and second, looking at the current account excluding kerb purchases and SOF, the deficits in FY00

[30] It can be argued that improvement in current account balance was mainly the outcome of large SBP purchases from the kerb market and as such does not reflect any strengthening of the balance of payment structure. To answer this, there is no doubt that outright purchases by SBP do not address the inherent problems of the external sector. In fact, it stands to reason that kerb purchases have created a sense of complacency that has delayed the implementation of structural reforms in the foreign exchange market. However, the real advantage of kerb purchases is more hard currency in the tills to meet lumpy demand for foreign exchange without placing unwarranted pressure on the interbank market.

Figure 9.15: Inter-bank and Kerb Market Rate



and FY01 were very similar (at US$ 2,641 and US$ 2,509 million, respectively). The only striking difference in the two fiscal years was the constraints of the stabilization program.

Pakistan was able to meet all external payments during FY00 by managing inflows and outflows very carefully. Although no assistance from the IFIs was forthcoming during the year, SBP was able to tap into the kerb market to meet the Dollar deficit in the interbank market. On account of this induced stability in the Rupee/Dollar parity and the deficit in the interbank market, SBP was unable to build up liquid reserves. Given the reserve position in end-FY00 and the fact that the country only had 6 months before the end of CY2000, the need for another round of rescheduling before January 2001 was obvious. This urgency to have an IMF program was clearly reflected in exchange rate developments, particularly before the disbursement of the first tranche on November 30, 2000 (see **Figure 9.15**).

Since float of the Rupee/Dollar parity, its movement can be divided into four phases:

The first phase covers the period from July to November, i.e., prior to agreement on SBA. As shown in **Figure 9.15**, the period witnessed some startling developments.

- This 5-month period included two distinct episodes, which resulted in a sharp depreciation of the Rupee. Within a month of floating the Rupee (by August 22), the rate had already approached Rs 55. Although initial efforts by SBP to calm the market using moral suasion and tempered injections, were successful in keeping the rate stable for a month, limited appetite to defend the exchange rate allowed the interbank rate to breached Rs 55 on September 18, 2000. On the very next day, the Rupee witnessed a free fall as the interbank sell rate moved to Rs 58 from just Rs 55.2 a day earlier. Since this depreciation followed a period of stability where importers were not really tempted to hedge their foreign exchange exposure, the adjustment was driven by panic buying by importers. The resulting bandwagon effect led to overshooting, as exporters also withheld their proceeds in an effort to gain from a further depreciation. The real carnage of the Rupee started at the end of September 2000 when it overshoots the Rs 58 per US Dollar level by significant margin. By October 6, the Rupee had reached Rs 60.12 (interbank selling rate) ? showing a depreciation of 13.0 percent over the pre-float level.

- Under the floating exchange rate regime, where interest rates are supposed to serve as the new nominal anchor, SBP had little choice but to tighten monetary policy in order to quell the market panic (see **Figure 9.15**). The resulting increase in T-bill rates in the third week of September did squeeze market liquidity, which in turn, made Dollar holdings relatively more expensive. Nevertheless, despite a number of measures announced on October 5 (see **Table 9.12)**, including a 30 percent cash margin on new L/Cs voluntarily imposed by commercial banks, the Rupee continued its slide.[31] The rapidity of the adjustment on September 19 (which had created a virtual panic in the market), coupled with the market view that SBP would still be constrained from acting, prompted another slide in the first week of October. At the moment when the Rupee crossed Rs 60, SBP acted using its very blunt instrument; cash reserve requirement (CRR) on banks was increased on October 7, from 5 to 7 percent. Although painful, this policy response was successful in interrupting the slide and the Rupee started to appreciate. In an environment where the exchange rate generally moves in one

[31] In the case of cash margin requirement on imports, this has been one of key instruments used by SBP to contain foreign exchange demand. In the recent past, in order to quell pressures on the Rupee, SBP had earlier imposed such cash margins in July 1998 and again in October 1999. However, this time, despite requests from commercial banks, SBP did not levy the restriction, as it went against the thrust of the SBA framework.

direction, exporters do not book forward rates and try to hold their proceeds. With the appreciation of the Rupee and the realization that SBP could act if required, exporters began pouring in hard currency in the interbank market. The ensuing bandwagon effect acted in the opposite direction and the Rupee appreciated to Rs 56.3 on October 21.

Table 9.12: Chronology of Measures to Curb Pressure on Pak-Rupee

19th September 2000	Discount rate was increased from 11 percent to 12 percent
21st September 2000	Weighted average 6-month T-bill rate increased from 7.4 percent to 8.1 percent
5th October 2000	Discount rate was again increased to 13 percent
5th October 2000	Weighted average 6-month T-bill rate further increased to 10.5 percent
5th October 2000	30 percent cash margin voluntarily imposed by commercial banks
7th October 2000	Cash reserve requirement was increased from 5 percent to 7 percent

In this five-month period, the Rupee depreciation was not orderly. It reflects the transition in SBP's exchange rate management, but more importantly, how this episode unhinged the *market's expectations* concerning the central bank's ability to manage the Rupee in the future. As will be discussed in more detail in **Subsection 9.5**, this change in market sentiment explains why the central bank actually injected more for market support during this year, even compared to the stability achieved during FY00. It is also clear that the exchange market could become extremely volatile within a very short period of time if the market develops a view that the central bank may not be able to inject hard currency to defend the Rupee. As shown in **Figure 9.15**, the Rupee has shown stepwise movement *till* September 18, reflecting SBP's willingness to defend the rate by injecting hard currency. Thereafter, in view of the need to build reserves, which automatically limits SBP intervention in the interbank market, the central bank had to rely on untested monetary measures to stabilize the exchange rate. In fact, the wild fluctuations in the Rupee/Dollar parity witnessed from mid-September to mid-November, capture the actual transition in the management of the Rupee.

The second phase, which goes up to mid-May 2001, shows a more gradual depreciation of the Rupee from 58.4 to 61.7 per US Dollar ? reflecting continuing market pressures. However, the exchange rate was comparatively less volatile (see **Figure 9.15**). This is also evident from the fact that the Rupee posted a daily move of more than 0.5 percent only on eight occasions, whereas during the first phase it witnessed 23 such movements. This shows several things: (1) following the exchange rate volatility in the first phase, SBP's management was perceived by the market to be consistent with the SBA, (2) the relative stability provided comfort to exporters and importers (self fulfilling), and (3) except for the sharp movements created by the deadline for overdue export proceeds in mid-April, banks had become accustomed to a tempered weekly adjustment of the Rupee/Dollar parity.

The third and last phase in FY01 starts in mid-May 2001, with SBP's decision to shift all oil payments to the interbank market. In response, the last week of May experienced tremendous pressure on the Rupee. During the period May 21 to June 4, the Rupee depreciated from Rs 61.9 to Rs 64.3 ? a depreciation of 3.7 percent (see **Figure 9.15**). However, since SBP has a tough liquid reserve target for end-June, the capacity to intervene in the market was severely limited. The only other avenue to stop the slide of the Rupee was to tighten monetary policy.[32]

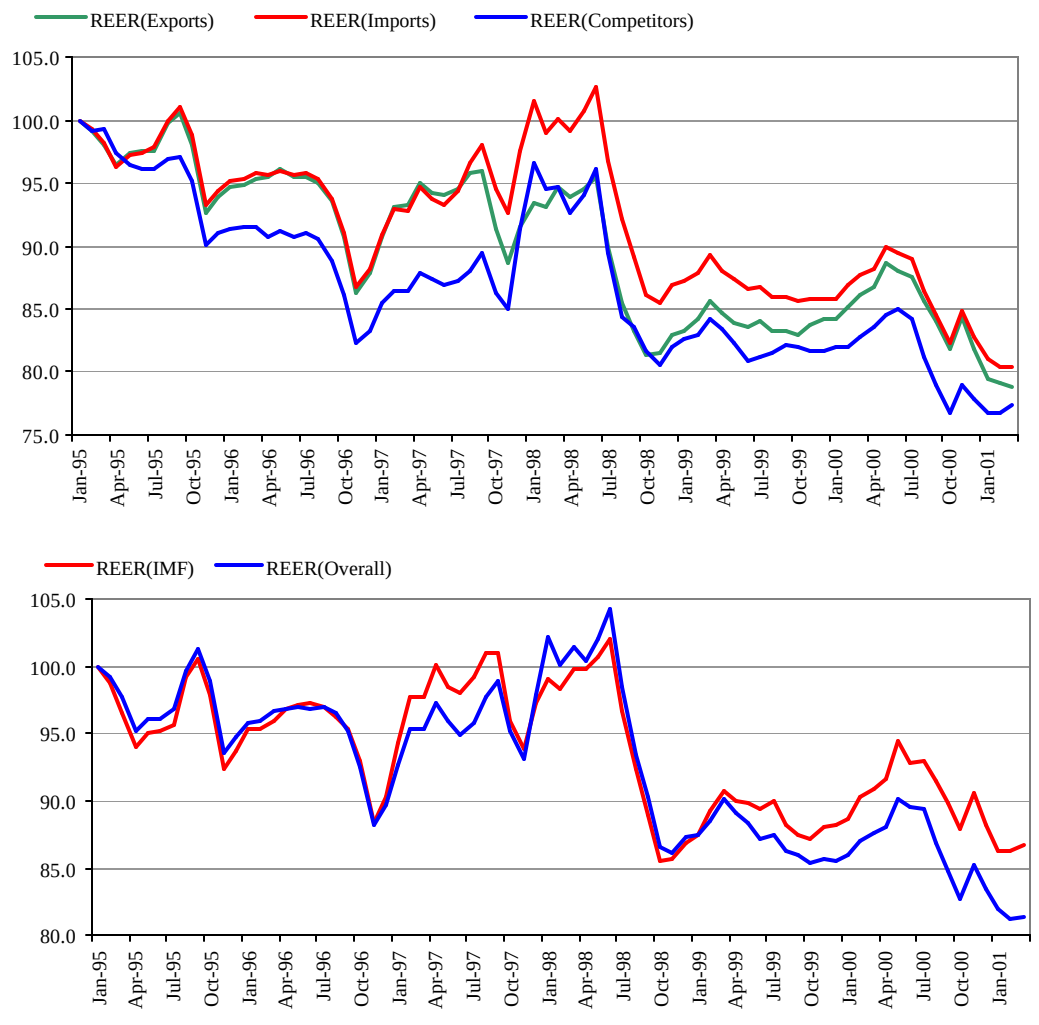
The fourth phase begins in early July 2001 and is characterized by a fairly stable exchange rate; as of end-September, the interbank sell rate has been contained in a narrow range of Rs 64.13 ? 64.63 per

[32] The 6-month weighted average yield was increased by 127.6 basis points in the two auctions dated 14th and 28th June 2001. However, as discussed in the section on **Money Market**, this was more an effort to achieve end-June NDA target.

US Dollar. This is mainly due to three factors: (1) oil payments have been more evenly distributed, (2) foreign exchange inflows have been relatively stronger, and (3) strategic market support by SBP. The orderly market conditions allowed SBP to soften its monetary stand by reducing the discount rate (to 13 percent on July 19 and then to 12 percent on August 17) and easing T-bill and PIB coupon rates (see section on **Money Market** for more details).

The impact of Rupee depreciation on its real effective exchange rate (REER), using different weighting schemes, is presented in **Figure 9.16**.[33] The indices based on exports and imports moved quite closely till August 1997, when the outbreak of the East Asian crisis in mid-1997 impacted the two indices differently. The REER based on imports, shows greater appreciation relative to REER (exports), which is to be expected as Pakistan's imports from East Asia are more than what we export to this region. The two indices have been converging as the impact of the Asian crisis, especially on their currencies, has reverted back to normal. Furthermore, it is evident that movements shown by

Figure 9.16: REER Indices Developed by SBP (January 1995=100)



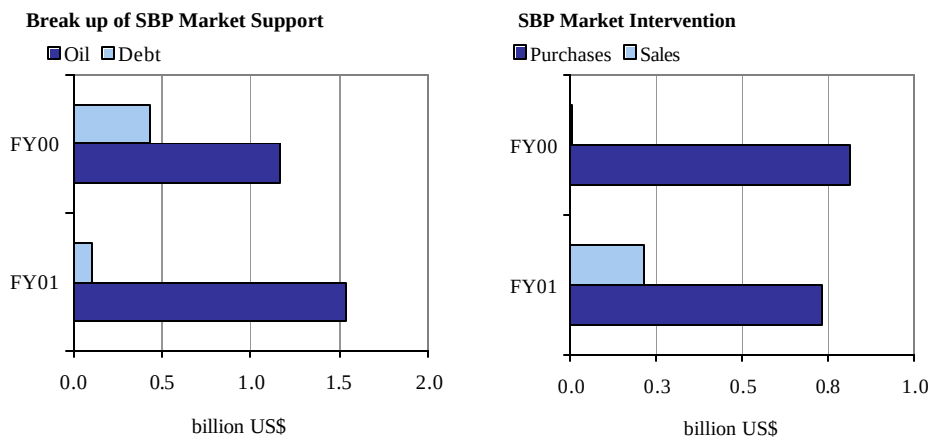
[33] A detailed analysis of various REER indices was provided in first *Quarterly Report* for FY01.

various indices are very sensitive to the choice of currencies and their respective weights in the basket. For example, in June 2001, the index (overall) has attained the most depreciated level since January 1995, whereas the REER based on IMF's choice of countries, still shows a degree of appreciation over the October 1998 level. A more customized evaluation of the real value of the Rupee shows that with the sharp depreciation witnessed during FY01, the Rupee is undervalued vis-à-vis its competitors during the decade of the 1990s.

9.5 Exchange Rate Management

Given the stark contrast in the Rupee/Dollar parity during FY00 and FY01, a comparison of these two years will form the basis of this analysis. In terms of responsibility, SBP manages the foreign exchange market to prevent self-fulfilling expectations, contain speculative activities and maintain orderly market conditions. For this purpose, SBP has placed a number of restrictions on market participants to curb their ability to speculate.[34] Furthermore, this assumes the notion that the forex market is primarily based on trade and related transactions, and in the absence of genuine demand, limited exchange should take place – this however is not the case.[35] In order to manage mismatches in import demand and export proceeds, which could disrupt the exchange rate, SBP had been *intervening* in the interbank market, and providing one-sided *market support* when needed (e.g. lumpy payments for POL and debt repayments).[36] To keep the distinction clear, one could think of market support as being instigated by the bank, whereas SBP itself takes the initiative in deciding on intervention.

Figure 9.17: Market Support and Intervention



During the period when SBP had an informal band on the Rupee, it was engaging in both intervention and market support. However, as part of the required change in the foreign exchange regime, SBP had to dismantle the Rupee band and allow market forces to set the interbank rate. The latter implies that market support would have to be curtailed. In view of the rapid depreciation of the Rupee after July 2000, it would seem that the fall in SBP market support was the critical factor. However, *this is*

[34] In particular, ADs were not allowed to provide cover to their clients for imports of less than one month. Furthermore, forex transactions in the interbank market by ADs were limited to sales and purchases backed by permissible (essentially trade) transactions.

[35] The need to impose requirement of commercial based transactions also arise due to lack of liquid risk management tools, which includes deep and diversified derivative market facilitating risk transfer, accounting and disclosure standards and a strong regulatory framework. Lack of such tools necessitates commercial based transactions.

[36] During periods of uncertainty, while importers tend to bunch their current and future requirements of foreign exchange, exporters may hold back export receipts in anticipation of further depreciation.

not the case; as a point of fact, one-sided market support during FY01 was marginally *higher* than the previous year when the band was in place (see **Figure 9.17)**. The reason for this seeming contradiction can be traced to market expectations.

To explain this further, the use of the band sent a very clear signal to the market that SBP would be ready to meet any payment from its own resources if the market was short. Over the course of the first few months, it was not SBP support *per se* that mattered, but the commitment shown by the band. Market players got accustomed to this band and their own expectations were hinged to this stability. In effect, with no foreseeable changes in the exchange rate regime, the band itself created its own self-fulfilling expectations. Looking at **Figure 9.17**, in view of the market support provided (US$ 1,603.4 million in FY00 and US$ 1,641.9 million in FY01) and the need to maintain liquid reserves, SBP was a net *purchaser* of hard currency in the interbank market in both years. In terms of intervention, the central bank actually sold more and purchased less during FY01 compared to the last year, with the result that in net terms, SBP bought US$ 516.3 million in FY01 against US$ 806.4 million during FY00. The need to purchase hard currency from the interbank market was clearly driven by the need to shore up reserves, and by doing so, neutralize as much as possible, the market support provided.

Another interesting observation in these two years is the composition of market support. As shown in **Figure 9.17**, oil payments were heavily supported in FY01, while more of the debt payments were left to the interbank market. Although the total volume of support was almost the same in the two years, the compositional shift is important; with a record oil bill during FY01, SBP supported oil payments since their lumpy nature and the jittery market would have created far more volatility in the foreign exchange market than was actually witnessed. However, to compensate for this larger role, SBP pushed most debt payments into the interbank market.

Broadly speaking, Pakistan has experienced extremes in exchange rate management – from a pegged rate; to strict adherence to a band; to a complete free float. Although, it should be easy to identify the better system, the upfront cost in the form of excessive exchange rate volatility, the incentive to Dollarize and high interest rates during FY01, cannot be ignored.[37] More importantly, although there is a general tendency to advocate floating exchange rate regimes (which follows the neoclassical paradigm that the market should be able to set prices), this is contingent on a market that is not grossly distorted or segmented. Although Pakistan has committed to a free float regime, it is time to seriously address the segmentation that currently exists in the foreign exchange market(s) in the country.

9.6 Kerb Market

As far as the exchange rate in the kerb market is concerned, there are two important issues that need to be highlighted:

1. Causality between the kerb and interbank rates

As explained in the second *Quarterly Report* for FY01, after the Rupee was floated on July 21, 2000, a clear causality has been established between the official and the kerb market rate, whereby changes in the official rate *cause* a movement in the kerb rate. The results of the Granger causality test on the basis of more recent data are reported in **Table 9.13**, whereas the kerb market premium and the corresponding interbank rate are shown in **Figure 9.15**. A closer look at **Figure 9.15** suggests that the kerb market responds swiftly to changes in the official rate when the latter depreciates, whereas it

[37] In terms of choosing an appropriate exchange rate regime, the economic literature has identified a number of factors influencing the choice: structural characteristics of the economy, susceptibility to external shocks, and macroeconomic and institutional conditions. Although, the new thinking favors adoption of corner solutions: either fixed or flexible, it should be noted that support for bipolar world is largely based on the shortcomings of intermediate systems, not on the merits of corner alternatives.

reacts with a lag when the official rate appreciates. The recent developments in the kerb market following Sept 11 attacks will be discussed in the forthcoming first Quarterly Report for FY02.

Looking at the kerb premium, the sticky/unresponsive kerb rate is obvious when the official exchange rate *appreciated* by Rs 3.8 per US Dollar, from Rs 60.1 on October 6, to Rs 56.3 on October 21. As shown, the kerb rate did *not* adjust quickly enough; the rate only appreciated by Rs 2.4 from Rs 62.3 to Rs 59.9. Furthermore, after December 2000, even the substantial swings in the interbank rate did not push the kerb premium beyond 5.7 percent. This seems to suggest that although the kerb rate is not sensitive on a day-to-day basis, the Rupee spread between the two rates is almost always maintained. This reaffirms our view that the kerb rate *follows* the interbank (official) rate, and kerb players have enough market power to always maintain a certain fixed wedge between the two rates. This finding has important implications as kerb premium is often used as an indicator of overvaluation of the Rupee.

Table 9.13: F-statistics for Granger Causality

Dependent variable	F-statistics for hypotheses testing			
	Hypothesis 1	Hypothesis 2	Hypothesis 3	Hypothesis 4
Data set 1				
Official exchange rate	---	5.1206 [0.006]	2.6967 [0.101]	5.0455 [0.001]
Data set 2				
Official exchange rate	2.7487 [0.004]	---	---	---
Kerb rate	---	2.4382 [0.010]	---	---
Data set 3				
Official exchange rate	---	2.3151 [0.988]	0.2904 [0.591]	1.7534 [0.158]
Kerb rate	5.7063 [0.004]	---	5.0320 [0.026]	5.5967 [0.001]

Figures in square brackets show the level of significance for rejecting the null hypothesis.

Hypothesis 1: Official rate does not Granger cause kerb rate.

Hypothesis 2: Kerb rate does not Granger cause official rate.

Hypothesis 3: Causality is through the lagged error term.

Hypothesis 4: Hypothesis one or two, and three above.

2. Impact of SBP purchases on the kerb premium

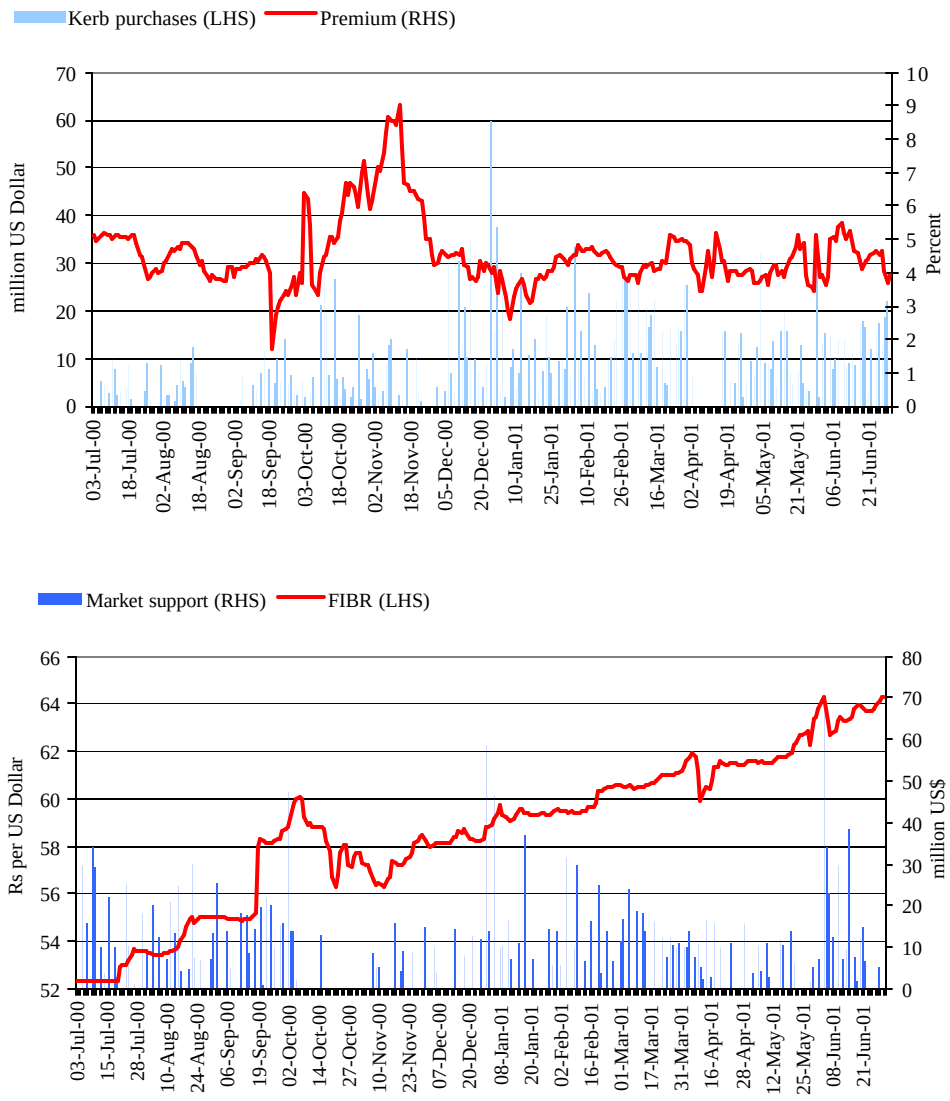
The second issue relates to the impact of SBP's outright purchases on the kerb premium. Theoretically speaking, if kerb purchases by the central bank are used to defend the Rupee in the interbank market, this should put upward pressure on the kerb premium. With this chain of reasoning, it is argued that in order to reduce the kerb premium, SBP should not only reduce its purchases from the kerb, but also reduce support to the interbank market. However, ground reality is different; it has been shown in the third *Quarterly Report* for FY01 that there exists *no consistent* relationship between SBP purchases and the kerb premium. In fact, the kerb market was able to maintain an almost fixed Rupee wedge over FIBR irrespective of the volumes purchased (see **Figure 9.18**). This again points to the stickiness of the kerb rate on account of market power of the large suppliers of foreign exchange in the kerb market.

With regard to the use of purchases to support the interbank market, since the freeze of FCAs, SBP has relied on kerb market to finance the current account deficit without putting pressure on the exchange rate.[38] Although this strengthened the Hundi system, it also formalizes the segmentation

[38] Traditionally, SBP has been acting as a medium to direct the kerb market flows (which was in surplus) to interbank market (which was in deficit). Prior to kerb purchases, resident FCA scheme was effectively providing a conduit to attract remittances flowing through the Hundi into the banking system.

between the two markets. From this perspective, the narrowing of the external payment gap during FY01 did not translate into a stable Rupee/US Dollar parity, since SBP was restrained from supporting FIBR using kerb purchases. Given the fixed wedge between the kerb-interbank rate and the limited impact on premiums despite sharp fluctuations in purchases, implies that the kerb market is in surplus and *much* deeper than thought.

Figure 9.18: Kerb Purchases, Premium and Market Support



Appendix 9.1: Capital Account

This section explains the item-by-item details of the capital account.

Net foreign investment

Realized direct investment and portfolio investment presented a dismal picture in FY01. Foreign portfolio investors withdrew from stock market in hordes. Bank of America and Gulf Commercial Bank divested their equity shareholding. ICI's PTA plant was completed and no new inflow came on that account and losses were incurred by one of the NCBs on its overseas operation.

Long-term capital (official)

Official long-term capital experienced a marginal decline in outflows on account of lower project and food aid. More specifically, disbursements under project aid declined by US$ 203 million as pipeline inflows dried up further in FY01. Food aid, primarily aid under US-PL480 and the Australian wheat board, was nil due to the bumper wheat crop last year. The rollover of a US$ 250 million central bank deposit, maturing in August 2000, also posted a large notional outflow in this head (see item 4.3 in **Table 9.14**). Nevertheless, the resumption of non-food aid from IFIs and lower scheduled repayments neutralized the overall impact (see **Table 9.14**).

Long-term capital (others)

Long-term capital (others) includes external flows related to suppliers and PAYE credit to the private sector (item 6.2), non-contractual flows from parent companies of MNCs operating in Pakistan and foreign exchange swaps of greater than one-year maturity (item 6.3). On a net basis, long-term capital (others) recorded an outflow of US$ 293 million during FY01. Looking specifically at the components, inflows under suppliers and PAYE credit picked up by US$ 24 million in FY01 over the last year, with the main beneficiaries being cement followed by fertilizer and power sectors. On the repayment side, lower outflows partly reflect the declining stock of these loans (see **Table 8.5**) and the fact that certain IPPs and a fertilizer company were asked to reschedule their debt repayments to make it comparable with the Paris club rescheduling. Item 6.3, which is only available on a net basis, covers non-contractual flows to MNCs operating in Pakistan and swaps conducted by SBP with moneychangers and commercial banks. This head shows lower inflows by US$ 11 million during FY01, on account of the net impact of closing out par swaps with moneychangers (dollar liability was retired in Rupees) and contraction of special swaps with various commercial banks.[39]

Short-term capital (official)

Official short-term capital (obligations of one-year maturity or less) staged the sharpest reversal from *outflows* of US$ 373 million in FY00 to *inflows* of US$ 337 million during FY01. More specifically, inflows increased by US$ 644 million, which includes US$ 193 million from NBP Bahrain and Citibank for oil financing to PSO, US$ 331 million from IDB for BOP support; and US$ 200 million from Shamil Bank. In contrast, FY00 posted huge outflows since fresh inflows were not forthcoming, while notional repayments of past loans continued in FY00 (this refers to the rescheduling of PTMA).[40] Furthermore, the rollover of central bank deposits of US$ 300 million in FY00 also explained the higher outflows in FY00.[41]

[39] The counter entry for close out in Rupees is carried out in *errors & omissions* to reflect a reduction in the country's foreign exchange liability.

[40] However, FY01 witnessed the hard currency payments of rescheduled PTMA loans as shown by outflows in exceptional financing (see **Table 9.3**).

[41] The notional outflow of central bank deposit was reduced by a fresh placement of US$ 164 million by NBP last year relative to outflow of US$ 33 million NBP deposit this year.

Short-term capital (deposit money banks)

Net outflows on account of short-term capital (involving commercial banks) sharply fell from US$ 1,829 million in FY00 to US$ 19 million in FY01. Item (8.1) represents outstanding export bills (OEBs) held by commercial banks, or more simply OEBs that were discounted with banks for Rupee liquidity. With the stability in the Rupee/Dollar, exporters were more interested in Rupees to forego the opportunity cost, but banks were building up their stocks in anticipation that the Rupee would eventually depreciate. However, during FY01, with the depreciation of the Rupee, exporters were less interested in discounting OEBs, while banks were off-loading their holdings (from FY00) to realize a higher Rupee rate.

Of greater importance in this head is item 8.5, which refers flows on account of FE 45 (swap) funds, other non-resident-FCAs and NBP deposits.[42] Since bulk of non-resident FCAs were rolled-over or voluntarily converted into Rupees during FY00 (which were not the case this year), while FY01 actually witnessed hard currency payments of FE 45 deposits, item 8.5 shows net outflows falling from US$ 1,664 million to only US$ 48 million during FY01.

Short-term capital (others)

OEBs held by exporters are shown by item 9.1, but is only available in net terms. An accumulation of this stock implies that exporters were not surrendering their export receipts on time, which is shown as an outflow in the capital account. As shown in **Table 9.14**, during FY00 exporters were accumulating OEBs perhaps because they were disappointed by the stable Rupee/Dollar parity. However, after the sharp build up in FY00, SBP issued a circular to banks informing them that exporters must surrender their export receipts by mid-April 2001. This course of action was required, since the sharp depreciation of the Rupee in the first half of FY01, had exporters holding out again, this time in anticipation of *windfall* gains. As mentioned above, the NBFI component of FE-45 (item 9.3, or swaps with NBFIs) and other non-resident FCAs posted a sharp contraction in notional outflows from US$ 647 million in FY00 to only US$ 7 million in FY01.

[42] In terms of FE-45 swaps, representatives of institutional foreign currency deposits holders have agreed to rollover 75 percent of their deposit for a period of two years.

Table 9.14: Capital Account

million US$

	FY99			FY00			FY01		
	Cr.	**Dr.**	**Net**	**Cr.**	**Dr.**	**Net**	**Cr.**	**Dr.**	**Net**
1. Direct investment abroad	6	50	-44	1	0	1	0	37	-37
2. Direct investment in Pakistan	472	0	472	472	0	472	323	0	323
3. Portfolio investment	142	0	142	0	549	-549	0	149	-149
(of which Stock market)	28	0	28	73	0	73	-140	0	-140
4. Long-term capital -official sector	3,188	2,391	797	1,304	1,982	-678	1,463	2,057	-594
4.1. Assets	330	353	-23	0	0	0	0	0	0
4.2. Loans drawn	2,279	2,038	241	1,304	1,967	-663	1,463	1,795	-332
4.3. Other liabilities	579	0	579	0	15	-15	0	262	-262
5. Long-term capital -deposit money banks	0	0	0	0	2	-2	0	2	-2
5.1. Assets	0	0	0	0	0	0	0	0	0
5.2. Loans	0	0	0	0	0	0	0	0	0
5.3. Other liabilities	0	0	0	0	2	-2	0	2	-2
6. Long-term capital -other sectors	446	436	10	324	591	-267	202	495	-293
6.1. Assets	0	0	0	0	0	0	0	0	0
6.2. Loans	195	436	-241	167	591	-424	191	495	-304
6.3. Other liabilities	251	0	251	157	0	157	11	0	11
7. Short-term capital -official sector	211	1,499	-1,288	118	491	-373	762	425	337
7.1. Assets	0	51	-51	0	18	-18	0	59	-59
7.2. Loans	211	1,074	-863	118	338	-220	762	330	432
7.3. Other liabilities	0	374	-374	0	135	-135	0	36	-36
8. Short-term capital -deposit money banks	46	1,361	-1,315	0	1,829	-1,829	29	48	-19
8.1. Assets	46	0	46	0	127	-127	29	0	29
8.2. Bilateral balances-assets	0	0	0	0	0	0	0	0	0
8.3. Bilateral balances -liabilities	0	0	0	0	0	0	0	0	0
8.4. Liabilities under NR Accounts	0	0	0	0	38	-38	0	0	0
8.5. Other liabilities	0	1,361	-1,361	0	1,664	-1,664	0	48	-48
9. Short-term capital - other sectors	0	1,052	-1,052	0	952	-952	54	268	-214
9.1. Assets	0	6	-6	0	305	-305	0	261	-261
9.2. Loans	0	0	0	0	0	0	54	0	54
9.3. Other liabilities	0	1,046	-1,046	0	647	-647	0	7	-7
Capital account	**4,511**	**6,789**	**-2,278**	**2,219**	**6,396**	**-4,177**	**2,833**	**3,481**	**-648**

Source: State Bank of Pakistan