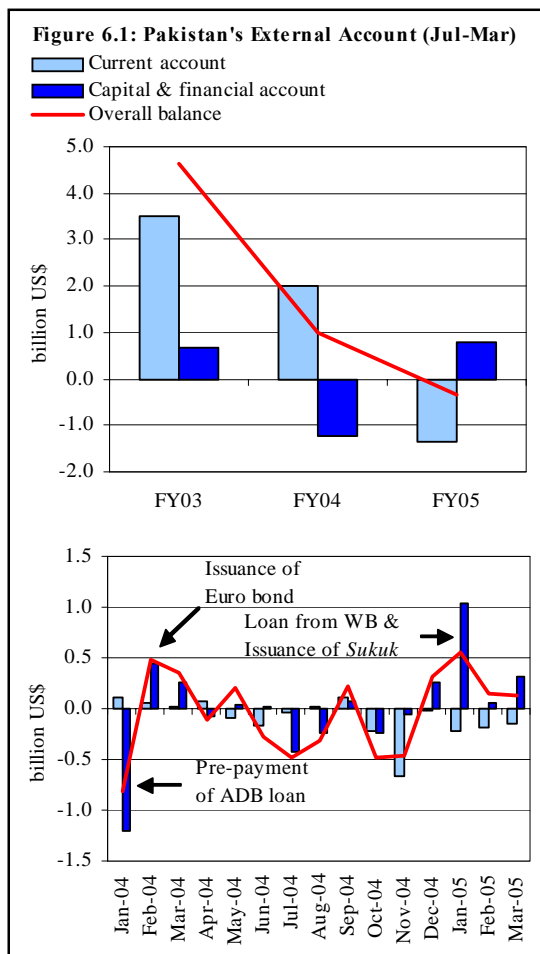


## 6 External Sector

### 6.1 Balance of Payment

During Jul-Mar FY05, Pakistan's overall external account balance posted a *deficit* of US\$ 0.33 billion, which was in sharp contrast to a *surplus* of US\$ 0.98 billion recorded during corresponding period last year (see **Figure 6.1**). While the issuance of *Sukuk*, higher disbursement of non-food aid from ADB and the World Bank, and privatization proceeds led the aggregate *capital and financial* account balance to a surplus of US\$ 792 million (against US\$ 1.2 billion deficit during same period last year),<sup>1</sup> these gains were more than offset by a sharper fall in the current account balance.

The current account witnessed a deficit of US\$ 1.3 billion during Jul-Mar FY05 in contrast to the US\$ 2.0 billion surplus recorded in Jul-Mar FY04. This deterioration in the latter period was primarily because of a sharp rise in the trade and the services account deficits during Jul-Mar FY05 which were, in turn, driven mainly by an exceptional surge in imports and a corresponding jump in import-related charges (e.g., shipment charges).



<sup>1</sup> Interestingly, almost US\$ 900 million (from the World Bank as well as issuance of *Sukuk*) were realized in the financial account during the month of January 2005 alone.

While the increasing activity in the domestic economy account for the greater part of the surge in the import bill, the impact of the rise in international oil prices on Pakistan's external account cannot be disregarded. In addition to inflating the oil import bill, the surge in oil prices has also led to increased *investment account* outflows (representing the value of the share of oil exploration companies in the domestic extraction of crude oil & gas).

Interestingly, however, although the current account deficit widened steadily throughout Jul-Mar FY05, by the end of the period, the Rupee witnessed a net depreciation of only 2.07 percent during this time. This relative stability of the domestic currency is probably the result of the SBP's public commitment to inject foreign exchange into the inter-bank market to meet large lumpy payments.<sup>2</sup>

Indeed, this commitment, that initially saw the SBP absorb a considerable portion of the market demand, catalyzed the end of the panic-driven pressure on the domestic currency that had forced the Rupee to a FY05 low of Rs 61.37/US\$ by end-October FY05 (a fall of 5.2 percent year-to-date), and subsequently helped the Rupee to recover part of its losses, reaching Rs 59.40/US\$ by end-March 2005. In fact, such was the turnaround in market expectations that the SBP was able to first gradually reduce its sales, and eventually to be a net purchaser of foreign exchange in the interbank market; in March 2005, SBP made *net purchaser* from the inter-bank market, as liquidity increased, probably due to higher net lending against foreign currency deposits and substantial jump in remittances to US\$ 443.7 million during that month.

Not surprisingly, the emergence of a large current account deficit took its toll on the country's foreign exchange reserves. These fell steadily from the US\$ 12.33 billion at end-FY04 to US\$ 11.5 billion by mid-December 2004, when the decline was reversed by a surge in *financial and capital account* inflows that pushed these reserves to a new high of US\$ 13.0 billion by third week of April 2005 (up 5.5 percent year-to-date).

It may be mentioned here that the current account deficit essentially reflects the gap between domestic saving and investment, which is then covered by the external borrowings. Thus, a current account deficit may not be a sign of concern as long as it is indicative of rising domestic demand for industrial raw material & capital goods, and remains small relative to the size of the economy. However,

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<sup>2</sup> On October 31, 2004, SBP made a formal commitment to provide foreign exchange for imports of key commodities such as oil, wheat and fertilizer.

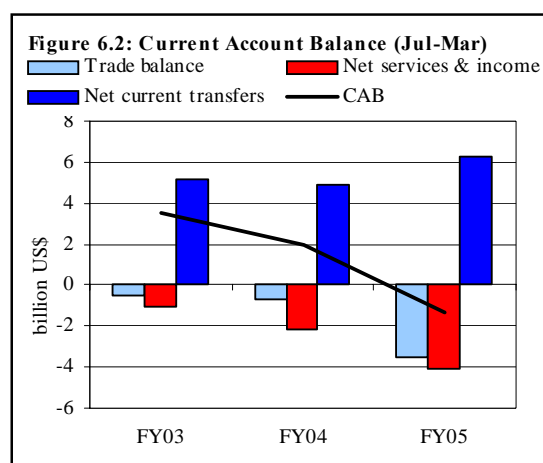
this argument implicitly assumes that the current higher imports in due course would lead to a rise in net exports relative to the domestic demand.

In this regard, it is heartening to note that monthly export growth which had been witnessing a slowdown in the second quarter of FY05 (mainly due to the imposition of anti-dumping duties on bed linen exports and uncertainty preceding the end of the GSP granted by the EU) have started recovering in Q3-FY05. While the recovery in exports is a welcome development, this also highlights one major concern, i.e., Pakistan's exports hold a high concentration in a few products and markets which increases the vulnerability of the external sector. In order to address this issue, there is a need to focus on improving the international export competitiveness, particularly through reducing the cost of production (by rationalizing the charges on public utilities and infrastructure) so that exporters could strengthen their product positioning and market place in international trade.

It may also be argued that the recent surge in current account deficit may be desirable to sustain the economic growth process as long as it is financed by low-cost external assistance. However, it is worth emphasizing that Pakistan's reliance *even* on low-cost foreign savings to finance its net current account outflows is not sustainable in the long-term.

### 6.1.1 Current Account Balance

During July-Mar FY05, the country's current account balance (CAB) posted a *deficit* of US\$ 1.3 billion, which is in sharp contrast to the *surplus* of US\$ 2.0 billion recorded in the corresponding period of FY04 (see **Table 6.1**). Most of this deterioration emerges from a rising import bill and trade-related charges (shipment charges). These outflows were however offset to an extent by the improvement in the form of falling interest payments on external debt & liabilities, rising exports, and a jump in the current transfers during the period under consideration (see **Figure 6.2**).



<b>Table 6.1: Current Account Balance</b>							
million US\$							
Items	H1		Jan-Mar		Jul-Mar		Change in FY05 over FY04
	FY04	FY05	FY04	FY05	FY04	FY05	
1. Trade balance	-159	-2,261	-526	-1,241	-685	-3,502	-2,817
Exports	6,108	7,002	3,118	3,625	9,226	10,627	1,401
Imports	6,267	9,263	3,644	4,866	9,911	14,129	4,218
of which mineral fuels, oils & their products	966	2,058	678	948	1,644	3,007	1,363
2. Services ( net )	-173	-1,453	-466	-970	-639	-2,423	-1,784
Transportation	-367	-611	-230	-316	-597	-927	-330
Travel	-457	-512	-360	-254	-817	-766	51
Communication services	107	128	31	85	138	213	75
Other business services	-64	-928	-63	-667	-127	-1,595	-1,468
Government services	680	570	184	218	864	788	-76
Of which logistic support	582	448	172	202	754	650	-104
Other	-72	-100	-28	-36	-100	-136	-36
3. Income ( net )	-1,063	-1,219	-498	-472	-1,561	-1,691	-130
Investment income( net )	-1,064	-1,220	-498	-472	-1,562	-1,692	-130
Direct investment	-522	-775	-296	-381	-818	-1,156	-338
Of which: Profit & dividend	-166	-206	-48	-46	-214	-252	-38
Purchase of crude oil & minerals	-248	-421	-202	-259	-450	-679	-229
Portfolio investment	-107	-87	-34	-11	-141	-98	43
Of which: Profit & dividend	-53	-48	-26	-14	-79	-62	17
IMF charges & interest on off. external debt	-368	-356	-148	-81	-516	-437	79
Interest on private external debt	-71	-59	-33	-29	-104	-88	16
Others	4	57	13	30	17	87	70
4. Current transfers ( net )	3,218	4,137	1,672	2,141	4,890	6,278	1,388
Private transfers	2,801	4,103	1,582	2,138	4,383	6,241	1,858
Workers remittance	1874	1946	1,001	1,104	2,875	3,050	175
FCA – residents	201	410	61	16	262	426	164
Others	726	1747	520	1,018	1,246	2,765	1,519
Official transfers	417	34	90	3	507	37	-470
Saudi oil facility	275	0	27	0	302	0	-302
Cash grants	134	16	51	0	185	16	-169
<b>Current account balance</b>	<b>1,823</b>	<b>-796</b>	<b>182</b>	<b>-542</b>	<b>2,005</b>	<b>-1,338</b>	<b>-3,343</b>
<b>Adjusted Current Account Balance</b>	<b>1,622</b>	<b>-1,206</b>	<b>121</b>	<b>-558</b>	<b>1,743</b>	<b>-1,764</b>	<b>-3,507</b>

### **Trade Balance**

As per the exchange record, the trade deficit during Jul-Mar FY05 widened by US\$ 2.8 billion over the same period last year to reach US\$ 3.5 billion (see **Table 6.1**). This significant deterioration in the trade balance was primarily due to the extraordinary 42.6 percent YoY growth in import which is fairly high compared to the export growth of 15.2 percent during Jul-Mar FY05 (for details, see **Section on Trade Account**).

### **Services (Net)**

During Jul-Mar FY05, the services account deficit swelled by US\$ 1.8 billion (a massive 279.4 percent YoY) to reach US\$ 2.4 billion. Net outflows increased almost under all major categories, such as *transportation* (due to higher imports), higher payment of *royalties & license fees* to the foreign companies investing or operating in Pakistan, and *other business services* (mainly reflecting the bulk of foreign currency transactions channeling through Foreign Exchange Companies (FECs)).<sup>3</sup> In addition, the services account deficit also witnesses a relative decline in payments of logistic support (these had significantly bolstered the services account in FY04).

However, a nominal improvement was witnessed under *travel and communication services*. In the case of *travel*, the YoY decline in outflows during Q3-FY05 simply reflects the fact that most of the payments for Hajj travel were realized in December 2004 - during the corresponding period last year, most of these payments fell in the month of January 2004.

### **Income (Net)**

A notable feature of the Jul-Mar FY05 income account was the continuing decline in net interest payments on external debt & liabilities. However, the resulting savings were more than offset by a higher direct investment income outflows. Thus, net income outflows registered 8.3 percent YoY growth during Jul-Mar FY05.

A further analysis of direct investment income outflows suggests that the substantial payments of profit & dividend had already been realized in H1-FY05. This reflects the seasonal trend as foreign companies largely repatriate their profit during the first half of the fiscal year (see **Table 6.1**).

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<sup>3</sup> As mentioned in previous quarterly reports that outflows under FECs has no impact on overall current account balance as it is offset by the proceeds of the FECs appearing under *other private transfers*.

In the case of *purchase of crude oil & gas* (other major element of direct investment income inflows), large outflows reflect the payments made by the government against its gas purchases from foreign gas exploration companies operating in Pakistan.<sup>4</sup> As discussed in the *Quarterly Report for Q2-FY05*, a large part of the rise in outflows was due to increased production as well as higher well-head prices for gas (which are indexed to international oil prices). In addition, the purchase of crude oil also increased during the same period.

On a positive note, the interest paid on external debt & liabilities continued to decline during Q3-FY05; net interest payments fell by 40.7 percent YoY during the period (see **Table 6.2**). This saving mainly stems from lower interest payments on official long-term loans.<sup>5</sup>

**Table 6.2: Details of Interest Payments and Receipts**  
million US\$

	H1		Jan-Mar		Jul-Mar		Saving
	FY04	FY05	FY04	FY05	FY04	FY05	
<b>Payments (I+II)</b>	<b>569</b>	<b>504</b>	<b>223</b>	<b>154</b>	<b>792</b>	<b>658</b>	<b>134</b>
I. <u>Total external debt</u>	<u>463</u>	<u>450</u>	<u>181</u>	<u>127</u>	<u>644</u>	<u>577</u>	<u>67</u>
Public & publicly guaranteed	377	379	143	94	520	473	47
Long-term	334	329	140	76	474	405	69
Military	13	11	0	0	13	11	2
Euro bonds	24	35	0	17	24	52	-28
Commercial loans/credits	4	4	2	1	6	5	1
IDB	2	0	1	0	3	0	3
Private loans/credits	71	59	33	29	104	88	16
IMF	15	12	5	4	20	16	4
II. <u>External liabilities</u>	<u>106</u>	<u>54</u>	<u>42</u>	<u>27</u>	<u>148</u>	<u>81</u>	<u>67</u>
Foreign currency deposits	13	7	5	3	18	10	8
Special US\$ bonds	16	15	6	8	22	23	-1
Central bank deposits	8	11	6	8	14	19	-5
Others	69	21	25	8	94	29	65
<b>Receipts</b>	<b>77</b>	<b>94</b>	<b>46</b>	<b>49</b>	<b>123</b>	<b>143</b>	<b>20</b>
Interest on reserves	55	66	32	29	87	95	8
Others	22	28	14	20	36	48	12
<b>Net Payments</b>	<b>-492</b>	<b>-410</b>	<b>-177</b>	<b>-105</b>	<b>-669</b>	<b>-515</b>	<b>154</b>

Source: State Bank of Pakistan

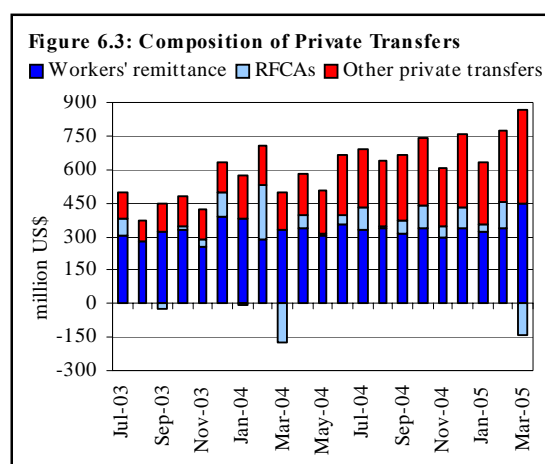
<sup>4</sup> Out of the total outflow of US\$ 679 million under *purchase of crude oil & gas* during Jul-Mar FY05, approximately US\$ 286 million reflected the remittance on account of gas purchase by the government.

<sup>5</sup> During the same period of FY04, the higher interest payment on official long-term loans includes US\$ 65.1 million on account of premature repayment of ADB loan that includes the premium of US\$ 35.4 million.

In the case of external liabilities, the lower interest payment during Jul-Mar FY05 period indicates (1) the net retirement of foreign currency loans by traders; (2) lesser net borrowing by the foreign companies for working capital; and (3) the decline in the outstanding stock of debt instruments such as the FEBC & DBC as these mature. Finally, the reduction in the outflows was complemented by a rise in the interest earned on the country's forex reserves (due to both the increase in the reserves and rising international interest rates) and improvements in the management of the funds.

### Current Transfers

During Jul-Mar FY05, net private transfers registered a growth of 42.4 percent YoY to reach US\$ 6.3 billion. While the workers' remittances increased by US\$ 175 million, more significant is the sharp rise in *other private transfers* that rose by US\$ 1.5 billion during Jul-Mar FY05 (see **Figure 6.3**). The rise in the latter simply reflected the increasing integration of FECs into formal channels and the increase in the conversion of resident FCAs into Rupees.



It may be mentioned here that in balance of payment accounting, any Rupee conversion from FCAs was *earlier* reported either as remittance or as foreign direct investment. However, since FY04, Rupee conversions from FCAs (residents) may also be classified under an additional category ("*other private transfers*") depending upon the nature or purpose of transaction. Thus, some portion of the foreign exchange inflows that used to be a part of remittances is now appearing under *other private transfers*.<sup>6</sup>

### Workers' Remittance

The workers remittance (cash) rose only 7.3 percent YoY during Jul-Mar FY05. This includes US\$ 136 million increase in receipts from the Gulf regions which

<sup>6</sup> This suggests that time series of remittances since FY04 is no more comparable with preceding numbers.

were supported by additional inflow of US\$ 69 million from the USA (see **Table 6.3**).

It is interesting to note from **Table 6.3** that while the remittances realized through Rupee conversion from resident FCAs are declining (this reflects change in accounting treatment in balance of payments), this decline has been completely offset by the rise in remittances flowing in through FECs.

***FCAs(resident)***

The net inflows under resident FCAs reached US\$ 426 million during Jul-Mar FY05, showing an increment of US\$ 164 million over corresponding period of last year. This was mainly due to rise in the deposits of a telecommunication company during the period.

FCAs (resident) are sometimes used to *temporarily* hold foreign exchange for investment in the country; such foreign inflows are initially categorized as FCAs, and are moved to foreign investment head only when investment is undertaken<sup>7</sup>. This has two implications: (1) the balance of payment impact of such foreign investment inflows is realized well before these flows hit the foreign investment head of the financial account; and, (2) since FCAs (resident) are part of current account, whereas foreign investment comes under financial account, thus, to the extent the

**Table 6.3: Workers' Remittances (Jul-Mar)**

million US\$	FY04	FY05	Change
<b>I. Gulf region</b>	<b>1,203</b>	<b>1,339</b>	<b>136</b>
Bahrain	59	69	10
Kuwait	129	161	32
Qatar	66	63	-4
Saudi Arabia	424	449	25
Sultanat-e-Oman	77	89	12
U.A.E.	447	508	61
<b>II. U.S.A.</b>	<b>887</b>	<b>955</b>	<b>69</b>
<b>III. Other than Gulf &amp; US</b>	<b>751</b>	<b>752</b>	<b>1</b>
Canada	16	33	17
Germany	35	40	5
Japan	4	5	2
Norway	8	15	7
U.K.	249	271	21
Other	440	389	-51
<b>Total</b>	<b>2,840</b>	<b>3,046</b>	<b>206</b>
<i>of which:</i>			
Exchange companies	73	258	185
Withdrawal FCAs (residents)	531	409	-122
Withdrawal FCAs (non-residents)	32	35	3
Encashment of FEBCs & FCBCs	35	4	-30
<b>Grand total</b>	<b>2,875</b>	<b>3,051</b>	<b>176</b>

<sup>7</sup> Initially the privatization proceeds are recorded in foreign currency deposits of the Privatization Commission and then in subsequent months these are transferred under the head of foreign direct investment.



resident FCAs includes inflows meant for investment in the country, the current account balance presents an improved position.<sup>8</sup>

There is also a debate on the inclusion of resident FCAs under the head of current account. Conceptually, resident FCAs (just like other short term external borrowings that are part of financial account) are immediate liabilities, but these are still considered under the current account.<sup>9</sup> The inclusion of resident FCAs in the current account implicitly suggests that these deposits can be used to fund deficits under trade and services account. Though this option was available under the old FCA scheme,<sup>10</sup> now banks are no more required to surrender these deposits to the central bank. In addition, SBP also ensures that banks do not use these deposits to fund the deficit in trade and services accounts. Thus, for analytical purpose, it may be desirable to adjust the current account balance by switching the resident FCAs to the financial account.<sup>11</sup>

#### *Other Private Transfers*

This head mainly comprises of private donations, withdrawal from residents FCAs, and receipts of FECs (see **Table 6.4**). During Jul-Mar FY05, the receipts under *other private transfers* increased by US\$ 1.5 billion compared to Jul-Mar FY04; which is 81.8 percent of YoY absolute change in private transfers. This was mainly due to the (1) increased coverage of inflows routed through FECs, and (2) a jump in Rupee withdrawal from the resident foreign currency account (as mentioned earlier, previously it was taken as a part of remittances).

**Table 6.4: Other Private Transfers (Credit)**

million US\$

	FY02	FY03	Jul-Mar	
			FY04	FY05
Private donations	102	113	84	104
Private transfers n.s.e.	127	742	335	431
FCAs withdrawal	0	0	32	80
Exchange Companies.	0	273	821	2,206
SBP purchases	1,376	429	0	0
Other	9	14	11	26

n.s.e. : not specified elsewhere

<sup>8</sup> In this regard, the privatization proceeds of US\$ 104 million for HBL provide a good example. These inflows were part of the resident FCAs till February 2005 before being formally treated as foreign investment in March 2005.

<sup>9</sup> Since FCAs (resident) are liabilities to domestic agents, these are considered under the current account. In contrast, external borrowings are liabilities to non-resident and are included in the financial account.

<sup>10</sup> Under the old FCA scheme, banks were instructed to surrender the Dollar amount to SBP and there were no clear restrictions on the use of these deposits to support excess expenditure in trade and services account.

<sup>11</sup> It is evident from **Table 6.1** that the adjusted current account deficit increases by US\$ 426 million from the headline deficit during the Jul-Mar FY05.

### **6.1.2 Financial Account**

During Jul-Mar FY05, Pakistan's financial account balance recorded a significant improvement as it posted a *surplus* of US\$ 804 million compared to a *deficit* of US\$ 209 million during the corresponding period last year.<sup>12</sup> Further details on the financial account suggests that most of the improvement is concentrated in January 2005 when Pakistan (1) raised US\$ 600 million through the issuance of *Sukuk*, and (2) received US\$ 300 million low-cost funding from the World Bank. This compares well with US\$ 897 million that Pakistan received during the first six months of FY05.

#### ***Net Foreign Investment (NFI)***

The foreign investment (net) showed a significant jump of US\$ 425 million during Jul-Mar FY05 compared to same period of FY04 (see **Table 6.5**). This was mainly due to 72.7 percent YoY growth in portfolio investment on account of the *Sukuk* issue, and a sharp increase in foreign investment in the stock market.

Another contributing factor in the overall increase in NFI during Jul-Mar FY05 was the continued rise in foreign direct investment (FDI) that increased by US\$ 164 million over the corresponding period last year.<sup>13</sup> The FDI in Pakistan remained largely concentrated in a few preferred sectors, i.e., telecommunication, trade, chemical, and textile sectors. Moreover, the bulk of FDI during the period under consideration was realized from Netherlands and USA.

During Jul-Mar FY05, the *reinvested earning* increased by US\$ 97 million over Jul-Mar FY04. As discussed in *Second Quarterly Report FY05*, this sharp jump in reinvested earning is largely due to the definitional change in the Balance of Payment Manual 5.<sup>14</sup>

In January 2005, Pakistan re-entered in the international bond market by offering US\$ 600 million *Sukuk*.<sup>15</sup> In addition, the investment in stock market<sup>16</sup> showed a

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<sup>12</sup> This refers to financial account adjusted for large one-off entries such as the pre-payment of US\$ 1.106 billion to ADB in January 2004 and a contra-entry of US debt write-off of US\$ 495 million shown under the amortization of long-term official loans, as well as a US \$ 100 million settlement of foreign currency loans of commercial banks to repay PARCO loans during Q1-FY05.

<sup>13</sup> This also includes US\$ 104 million from HBL privatization. However, as discussed earlier, this inflow was earlier part of resident FCAs.

<sup>14</sup> According to new definition, the *reinvested earning* includes bonus share and a certain proportion of undistributed profit/loss, whereas the earlier definition included only bonus shares.

<sup>15</sup> For details see section on external debt & liabilities Q2-FY05.

<sup>16</sup> This figure reflects the fresh inflow of the foreign investment either through Special Convertible Rupee Account or other accounts, indicating fresh dollar investment in the stock market. For further exposition of the definitions see **Box 9.1 Annual Report FY02**.

remarkable improvement by registering a *net inflow* of US\$ 107 million in contrast to *net outflow* of US\$ 46 million during Jul-Mar FY04. As a result, the portfolio investment recorded a higher net inflow of US\$ 627 million during Jul-Mar FY05 compared to the same period last year, which is more than 60 percent in overall rise in NFI during Jul-Mar FY05.

Table 6.5: Financial Account

million US\$

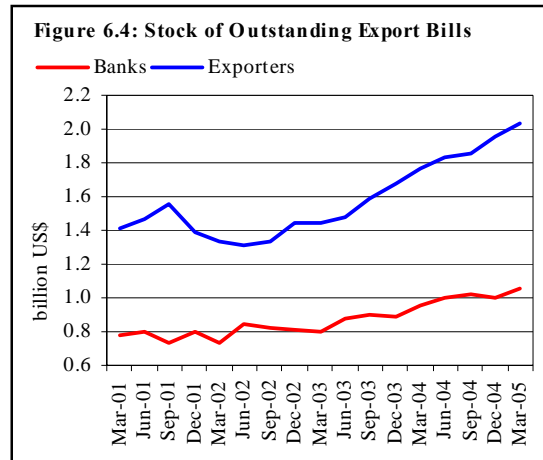
	Jan-Mar		Jul-Mar		Absolute change (Jul-Mar)
	FY04	FY05	FY04	FY05	
<b>Financial Account (1 through 4)</b>	<b>-515</b>	<b>1,402</b>	<b>-1,316</b>	<b>209</b>	<b>1,525</b>
<b>1. Direct investment abroad</b>	<b>-7</b>	<b>1</b>	<b>-30</b>	<b>-33</b>	<b>-3</b>
<b>2. Direct investment in Pakistan</b>	<b>355</b>	<b>352</b>	<b>633</b>	<b>797</b>	<b>164</b>
<i>of which: Equity Capital</i>	308	273	493	562	69
Reinvested earning	46	79	138	235	97
<b>3. Portfolio investment</b>	<b>443</b>	<b>621</b>	<b>363</b>	<b>627</b>	<b>264</b>
<i>of which: (Stock Markets)</i>	-28	48	-46	107	153
<i>Special US Dollar Bonds</i>	-26	-27	-72	-81	-9
<i>Euro bonds</i>	498	598	496	596	100
<i>Net Foreign Investment</i>	791	974	966	1,391	425
<b>4. Other investment</b>	<b>-1,306</b>	<b>428</b>	<b>-2,282</b>	<b>-1,182</b>	<b>1,100</b>
Assets	-123	20	-576	-1,101	-525
<i>i. Outstanding Exports Bills (Exporters)</i>	-88	-76	-286	-204	82
<i>ii. Outstanding Exports Bills (DMBs)</i>	-71	-53	-83	-58	25
<i>iii. Currency &amp; deposits</i>	36	149	-207	-839	-632
<i>of which: Bank</i>	53	149	-118	-794	-676
Liabilities	-1,183	408	-1,706	-81	1,625
<i>i. Foreign Long-term loans / credits ( net )</i>	-1,211	337	-1,229	594	1,823
<i>of which: Project Assistance</i>	93	225	334	572	238
Food Aid	-	-	-	-	-
Non-Food Aid	-	300	244	1,197	953
Amortization	1,304	188	1,807	1,175	-632
<i>ii. Private loans</i>	114	-105	-96	-248	-152
<i>of which: Suppliers Credits/MNCs</i>	340	8	418	20	-398
Supplier Credits Repayments	226	113	514	268	-246
<i>iii. ST Capital, (official)</i>	-56	133	-286	106	392
<i>of which: Commercial Banks (net)</i>	-	-	-133	-116	17
IDB (net)	-56	133	-153	222	375
<i>iv. Currency &amp; deposits</i>	-22	54	-36	-339	-303
<i>of which: Trade financing</i>	31	135	-54	-448	-394
<i>v. Other liabilities</i>	-8	-11	-59	-194	-135

Source: Statistics Department, SBP

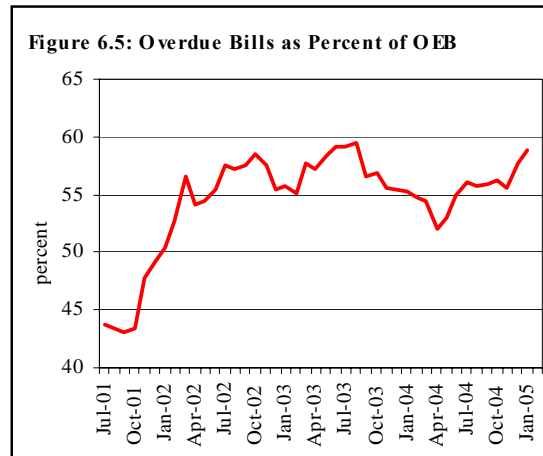
Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

### Outstanding Export Bills (OEBs)

The stock of OEBs held by exporters and commercial banks rose by US\$ 129 million in Q3-FY05 as compared to an increase of US\$ 159 million during the corresponding period of FY04. This was mainly due to lower discounting of export bills by banks and exporters. As a result, in aggregate terms, the stock of OEBs (both exporters & banks) increased by US\$ 262 million during Jul-Mar FY05 (see **Figure 6.4**).



Interestingly, the share of *overdue* export bills in total OEBs (exporters) after remaining stagnant during Aug-Nov 2004, started rising during Dec-Jan FY05 period. This might be due to increase in exports during the period under review relative to previous months (see **Figure 6.5**).



### Currency & deposit

This head mainly comprises of commercial banks' FE-25 Nostro deposits. During Jul-Mar FY05, banks' FE-25 Nostro saw a sharp YoY jump of US\$ 632 million to reach US\$ 839 million. But this growth is mostly concentrated in H1-FY05 as Q3-FY05 period is characterized by a fall in foreign currency account together with higher net lending against these deposits.

### Foreign Long-term Loans

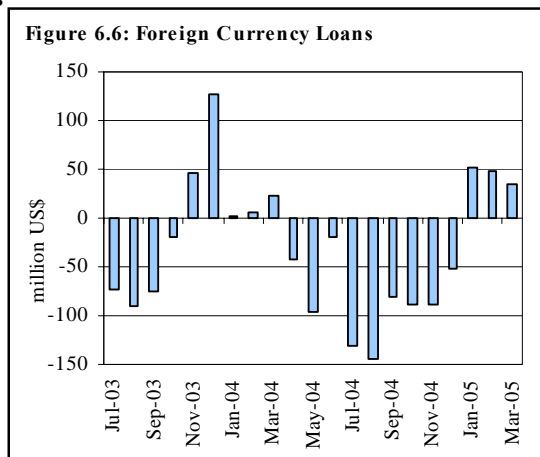
Due to greater availability of US\$ 1.2 billion under non-food aid in Jul-Mar FY05 over the corresponding period of FY04, the adjusted long-term official loans<sup>17</sup> recorded a *net inflow* of US\$ 1,089 million during Jul-Mar FY05, which is in contrast to a *net outflow* of US\$ 123 million in Jul-Mar FY04. This sharp rise in disbursement of non-food aid by the World Bank and ADB completely offset the amortization of long-terms loans, and thus significantly contributed in overall surplus recorded in financial account during the period under review.

### Short-Term Official Loans

In contrast to Jul-Mar FY04, the first nine months of the current fiscal year saw a net inflow of US\$ 106 million in short-term loans. This inflow was on account of net disbursement for oil imports of US\$ 222 million from IDB, which comfortably offset the net outflow under commercial loans during the period under review. As mentioned in *Second Quarterly Report FY05*, the short-term commercial loans reflect the rollover amount with an offsetting accounting entry in the exceptional financing.

### FE-25 Related Trade Financing

The recent stability in the exchange rate and the rise in domestic export finance rate have renewed the interest of traders in foreign currency loans. Thus, during Q3-FY05, the net lending of foreign currency trade related loans jumped to US\$ 135 million as against a mere US\$ 31 million in Q3-FY04 (see **Figure 6.6**). However, forex loans for Jul-Mar FY05 period in cumulative terms are still showing the net retirement of US\$ 448 million.

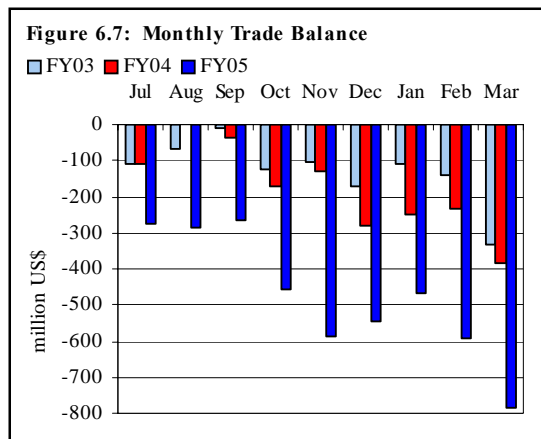


<sup>17</sup> In order to make data comparable, an adjustment is made for US debt write-off (US\$ 495 million) during August 2004 and one-off prepayment of US\$ 1.1 billion to ADB during January 2003.

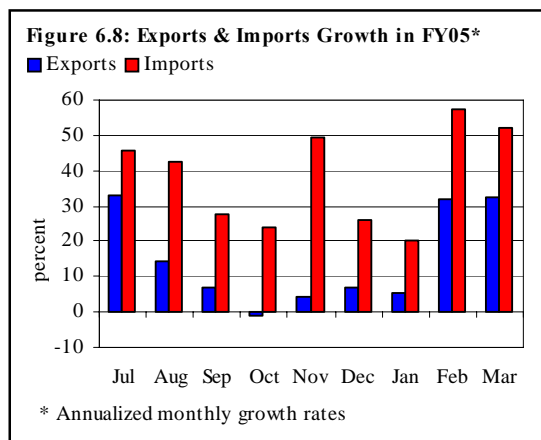
Lastly, the sharp net outflow in other liabilities during Jul-Mar FY05 mainly reflects the settlement of US\$ 100 million of foreign currency loans arranged by the commercial banks to repay PARCO loans.

## 6.2 Trade Account<sup>18</sup>

The overall trade deficit continued to surge steadily, reaching US\$ 4.3 billion during Jul-Mar FY05 (see **Figure 6.7**) - the largest deficit ever reached in the history of Pakistan. This exceptional increase in trade deficit stemmed primarily from persistent strong growth in imports that more than offset the increase in exports (see **Figure 6.8**). Specifically, during the first three quarters of FY05, overall imports grew by 37.8 percent, compared to 14.6 percent rise in exports during the same period.



On the positive side, monthly exports, which had been witnessing a slowdown in growth during most of the H1-FY05, have finally bounced back in February and March 2005. More notable is the sign of recovery in the textile sector as all major categories (cotton cloth, bed-wear, readymade garments, towels, synthetic textiles) showed increases both in quantum and value terms



<sup>18</sup> As discussed in the last quarterly report, there are significant lags in data availability from FBS due to major changes in data compilation process. Thus, the analysis is based on partial (and provisional) item-wise detail up to March 2005, whereas as the final item-wise data on trade (including country-wise data) is available up to September 2004.

**Table 6.6: Export Performance of Textile Manufacturers in Feb-Mar 2005**

	Value in (million US\$)		% change over Feb-Mar FY04		
	FY05	FY04	Quantum	Unit values	Values
Towels	93.1	61.8	65.3	-8.9	50.6
Readymade garments	211.6	151.1	50.4	-6.9	40.0
Tarpaulin & other canvas goods	15.9	11.5	-20.6	73.0	37.3
Bed-wear	264.5	231.2	28.5	-11.0	14.4
Cotton fabrics	337.0	304.5	3.9	6.5	10.7
Hosiery (knitwear)	212.3	206.5	-17.7	24.8	2.8
Synthetic textiles	55.0	54.9	6.1	-5.5	0.3
Cotton yarn	197.8	211.0	8.8	-13.8	-6.3
Other	84.80	61.12			38.7
<b>Total textile</b>	<b>1,471.8</b>	<b>1,293.6</b>			<b>13.78</b>

despite significant fall in export unit prices of some of the value-added items (see **Table 6.6**).

This export performance is impressive given the loss of duty free access to EU market from January 2005 onward.<sup>19</sup> Furthermore, the increase in bed wear exports during Feb-Mar 2005 indicates that the exporters in this category have been able to overcome the impact of the anti dumping duty imposed by the EU on bed-linen exports probably by reducing their margins (this is reflected in falling unit prices of bed-wear exports). However, whether bed-linen exporters have been able to tap other markets or not, cannot be ascertained due to unavailability of detailed commodity-by-country information on trade.

It is also evident that besides bed wear, unit values of readymade garments and towels have also fallen during Feb-Mar FY05 period. This suggests that exporters, in their bid to preserve export markets under post quota regime, are passing on savings (on quota rent) to their buyers. In view of rising competitive pressures, it is clear that only those exporters who have efficient production processes would be able to uphold their markets.<sup>20</sup> In this context, **Figure 6.9** shows indicative competition in apparel products to the US market. It is evident that other competitor countries are also going through the recovery phase in their export of apparel products to the USA. However, as a point of concern, upturn in Pakistan's exports of apparel products to the US is too late and too little when compared with other countries.

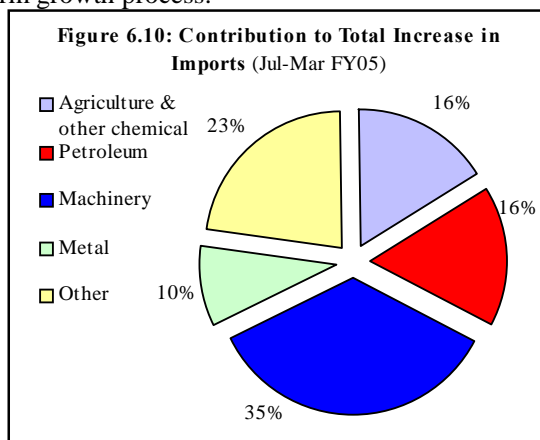
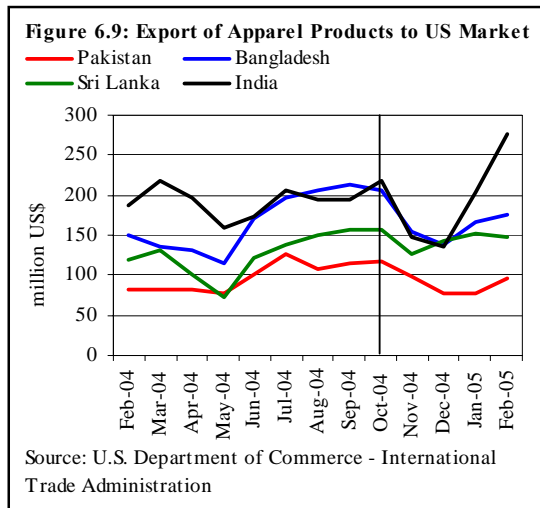
<sup>19</sup> Although the preference under GSP was withdrawn in January 2005, its impact on export orders from EU had realized much earlier as importers were restraining from placing orders probably due to looming uncertainty regarding the new preference regime.

<sup>20</sup> In this regard, proposed compensatory rebate on textile exports by the government would significantly help in sustaining the competitive pressures.

On the other hand, the overall import bill for Jul-Mar FY05 increased by 37.8 percent over corresponding period of FY04. Based on partial details available up to March 2005, it is evident that import of machinery, raw material and inputs (such as petroleum, and agriculture & chemical group) has major contribution towards the rise in overall import bill during Jul-Mar FY05 (see **Figure 6.10**). This is largely explainable by the accelerating aggregate demand, particularly of machinery and raw material, in the domestic economy and the continuously rising international oil prices; and is desirable to sustain the long term growth process.<sup>21</sup>

### 6.2.1 Exports

Pakistan's exports reached US\$ 10.2 billion during Jul-Mar FY05, depicting a growth of 14.6 percent over the corresponding period last year and 5.2 percent higher than the period target of US\$ 9.7 billion. What is more heartening is the fact that exports have finally started recovering from the considerable slowdown witnessed in September – November 2004 period (see **Figure 6.11**). This recovery is reflected in remarkable export growth of more than 32 percent witnessed in two successive months of February and March 2005 over the corresponding months of 2004 (see **Figure 6.8**).<sup>22</sup>



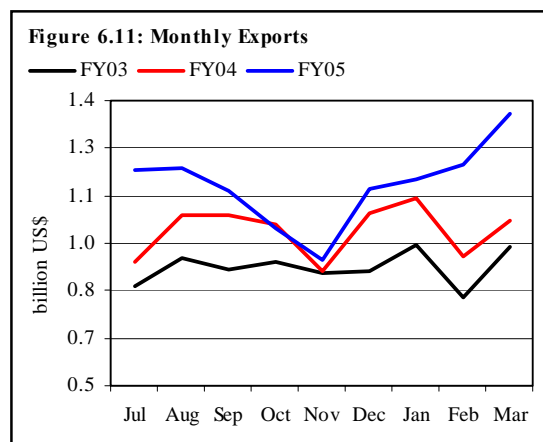
<sup>21</sup> Since imported capital goods generally involve attendant spillovers of technology and new business practices, this in turn may lead to rising productivity and higher growth.

<sup>22</sup> The export growth in February 2005 is more surprising as it is contrary to the usual seasonal slowdown.



A further analysis of export data for Q3-FY05 reveals that the recovery in the major categories of textile exports along with strong growth in exports of primary commodities and other manufacturers have been the key factors that led to this uptrend.

In the **textile sector**, exports of *cotton fabric, bed-wear, readymade garments, synthetic textiles, and towels* have posted strong growth in terms of quantum that more than offset the fall in their unit values (see **Figure 6.12**). In contrast, performance of *knitwear and tents, canvas & tarpaulin* was not very impressive as export values increased primarily due to higher unit values, rather than gains in quantum.

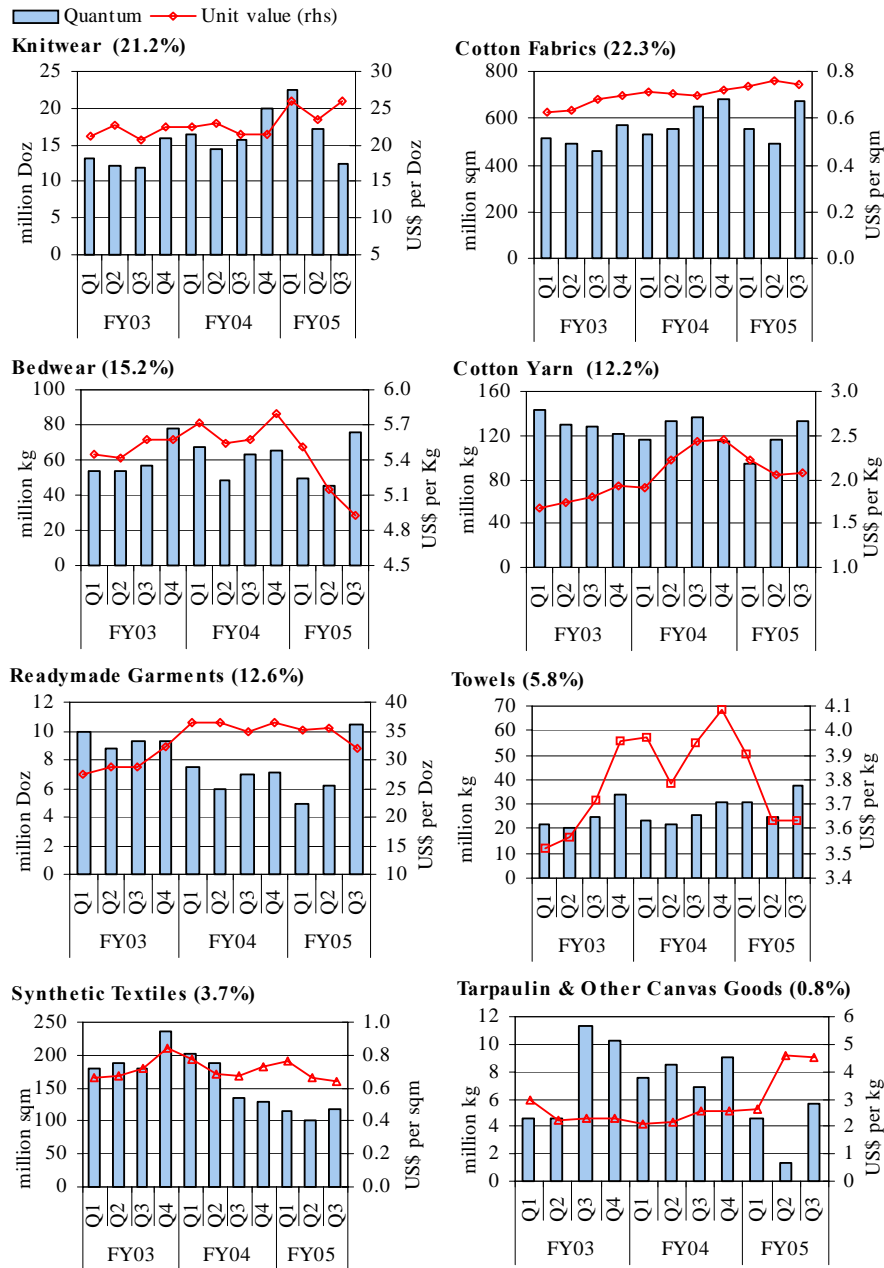


The upturn in exports is also visible in the **primary commodity** group that posted a massive growth of 23.2 percent (YoY) during Jul-Mar FY05. Major contribution in export of primary commodities comes from rice and raw cotton – both registering significant increases in quantum terms (see **Table 6.7**).

Another notable aspect of the export performance is the persistent rising trend in **miscellaneous** exports over several years that continued in FY05 as well. This, together with declining share of the textile sector in total exports,<sup>23</sup> provides some tentative evidence of diversification in the Pakistan's export basket.

<sup>23</sup> The share of textile exports in the total reduced to 58.5 percent in Jul-Mar FY05 from 65.7 percent in corresponding period last year.

**Figure 6.12: Export Performance of the Textile Sector**



Figures in parentheses are shares in total textile exports during Jul-Mar FY05

**Table 6.7: Major Exports**

Value: million US\$, Unit value: US\$

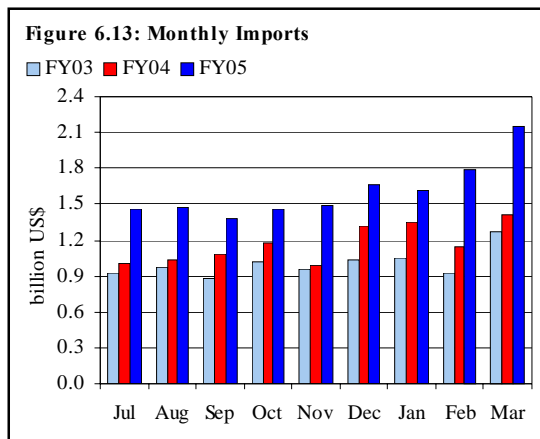
	Unit	Jul-Mar FY05		Jul-Mar FY04		Abs Δ in Value	% Δ in FY05/FY04		
		Value	Unit Value	Value	Unit Value		Qty	Value	Unit value
<b>A. Primary commodities</b>		<b>919</b>		<b>745</b>		<b>175</b>		<b>23</b>	
1. Rice	M.T	602	346	461	348	140	31	30	
2. Raw cotton	M.T	94	1,175	35	1,257	59	190	171	-7
3. Fish & fish preparations	M.T	98	1,710	115	1,528	-18	-24	-15	12
4. Fruits	M.T	71	345	77	295	-6	-21	-8	17
5. Vegetables	M.T	17	276	18	155	-1	-48	-7	78
6. Tobacco	M.T	7	1,511	9	1,418	-2	-27	-22	7
7. Wheat	M.T	--		6		-6	--	--	--
8. Spices	M.T	10	1,140	15	1,214	-5	-32	-36	-6
9. Oil seeds, nuts and kernels	M.T	21	487	8	624	14	247	171	-22
<b>B. Textile manufacturers</b>	-	<b>5,972</b>		<b>5,850</b>		<b>122</b>		<b>2</b>	
1. Cotton yarn	M.T	729	2,075	848	2,200	-118	-9	-14	-6
2. Cotton cloth	SQM	1,333	0.7	1,221	0.7	112	5	9	4
3. Knitwear	DOZ	1,265	24.8	1,030	22.2	235	10	23	11
4. Bed wear	M.T	910	5,112	1,008	5,617	-98	-1	-10	-9
5. Towels	M.T	344	3,696	277	3,909	68	32	24	-5
6. Tents, canvas, tarpaulin	M.T	49	3,566	52	2,257	-3	-40	-5	58
7. Readymade garments	DOZ	754	33	733	36	21	11	3	-7
8. Art, silk & synthetic textile	SQM	221	0.69	375	0.72	-154	-39	-41	-4
9. Made up textile articles (text)	-	366		307		59		19	
<b>C. Other manufacturers</b>	-	<b>1,944</b>		<b>1,590</b>		<b>354</b>		<b>22</b>	
1. Carpets, rugs & mats	SQM	188	57	164	54	24	9	14	5
2. Petroleum crude	M.T	0		28		-28	--	--	--
3. Petroleum products	M.T	316	337	166	291	150	65	90	16
4. Sports goods	-	212		229		-17		-8	
5. Leather tanned	SQM	202	16,010	177	15,567	26	11	15	3
6. Leather manufacturers		347		311		36		12	
7. Footwear	Pairs	83	6,217	65	7,517	17	53	27	-17
8. Surgical goods & medical instruments	-	118		100		18		18	
9. Cutlery	-	20		21		-1		-7	
10. Onyx manufactured	M.T	7	1,576	8	1,685	-2	-15	-20	-6
11. Chemicals & Pharmaceutical	-	256		196		60		31	
12. Engineering goods	-	115		69		46		67	
13. Gems	-	3		3		--		-2	
14. Jewelry	-	14		17		-3		-18	
15. Furniture	-	9		7		2		27	
16. Molasses	M.T	56	52	29	29	27	11	96	76
<b>D. Others</b>	-	<b>1,371</b>		<b>721</b>		<b>651</b>		<b>90</b>	
<b>Total</b>	-	<b>10,207</b>		<b>8,905</b>		<b>1,301</b>		<b>15</b>	

Source: Federal Bureau of Statistics

### 6.2.2 Imports

During Jul-Mar FY05 imports posted a sharp YoY increase of 37.8 percent, reaching US\$ 14.4 billion in this period. Interestingly, the growth is exceptionally high at 57.2 and 52.2 percent in the months of February and March 2005, respectively (see **Figure 6.8 & 6.13**). If imports continue to follow similar trends during the last quarter of the current fiscal year, the total import bill for FY05 would be

substantially above the annual target of US\$ 16.7 billion for FY05. However, as discussed earlier, the surge in imports during Jul-Mar FY05 is mainly due to a steep rise in domestic demand for *machinery, petroleum crude, agriculture & other chemical group* and *base metal* imports, which are essential for sustaining the long term economic growth (see **Table 6.8**).



**Machinery group**, which has the largest share of 26.9 percent in total imports, witnessed 55.0 percent rise during Jul-Mar FY05 on YoY basis. Within machinery, the textile machinery and road motor vehicles are in significant higher demand, and in turn responsible for the jump in overall machinery imports.<sup>24</sup> As discussed is earlier SBP reports, the increase in textile machinery imports is in response to Balancing, Modernization and Rehabilitation (BMR) drive under Textile Vision 2005. On the other hand, the rise in road motor vehicle is probably a function of increase in the automobile production<sup>25</sup> and higher spending for the improvement of infrastructure under public sector development program.

The **petroleum group** (with 19.1 percent share in total imports) is showing a YoY growth of 31.0 percent during Jul-Mar FY05. This mainly reflects more reliance on thermal sources for power generation owing to water shortages during H1-FY05, higher fuel consumption following a recent increase in automobile sale in the country, and significant rise in international oil prices.

<sup>24</sup> Import data for February 2005 shows an increase of US\$ 89.4 million under *aircraft, ships and boats*. This includes import of equipment for the development of Gawadar port; a part of these imports is supposed to be re-exported later.

<sup>25</sup> All CKD kits come under this category.

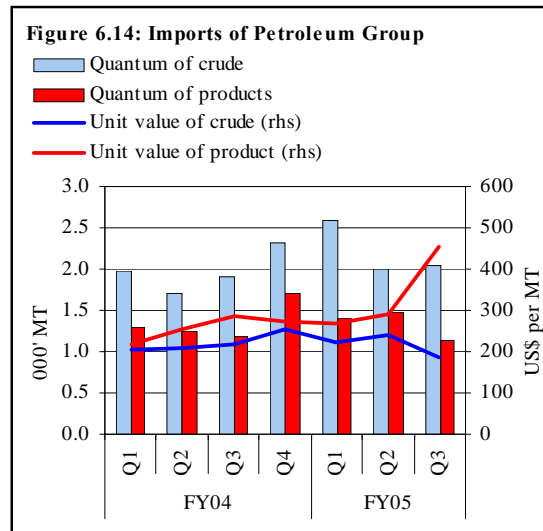
**Table 6.8: Major Imports**

Value: million US\$; Unit: US\$

	Unit	Jul- Mar FY05		Jul-Mar FY04		Abs Δ in Value	% Δ in FY05/FY04		
		Value	Unit value	Value	Unit value		Qty	Value	Unit Value
<b>A. Food group</b>	-	942		781		161		21	
1. Milk & cream	MT	24	1,912	14	2,016	10	81	71	-5.2
2. Wheat unmilled	MT	56	205	15	224	41	306	272	-8.4
3. Dry fruits	MT	30	585	12	316	18	38	156	85
4. Tea	MT	175	1,665	151	1,651	24	15	16	1
5. Spices	MT	37	824	28	532	10	-13	34	55
6. Edible oil	MT	526	486	506	467	20	0.1	4	3.9
<i>Soya bean</i>	MT	49	853	40	549	9	-22	21	55
<i>Palm oil</i>	MT	478	465	466	462	12	2	3	1
7. Sugar	MT	10	320	2	288	8	334	381	11
8. Pulses	MT	83	304	53	290	30	50	57	5
<b>B. Machinery group</b>	-	3,892		2,513		1,379		55	
1. Power generating machinery	-	272		205		67		33	
2. Office machinery	-	183		156		27		17	
3. Textile machinery	-	697		419		278		66	
4. Construction & mining machinery	-	112		73		39		54	
5. Electrical machinery & apparatus	-	228		180		49		27	
6. Road motor vehicles	-	706		482		225		47	
7. Aircraft, ships and boats	-	133		123		10		8	
8. Agricultural machinery & implements	-	49		24		25		105	
9. Other machinery	-	1,511		851		661		78	
<b>C. Petroleum group</b>	-	2,761		2,108		652		31	
1. Petroleum products	MT	1,149	286	936	252	214	8	23	13
2. Petroleum crude	MT	1,611	243	1,173	210	438	19	37	16
<b>D. Textile group</b>	-	238		194		44		23	
1. Synthetic fibre	MT	108	1,768	76	1,445	33	17	43	22
2. Synthetic & artificial silk yarn	MT	100	1,853	91	1,635	8	-4	9	13
3. Worn clothing	MT	30	329	27	324	3	8	10	1
<b>E. Agricultural and other chemicals</b>	-	2,621		1,972		649		33	
1. Fertilizer	MT	262	250	191	201	71	10	37	25
2. Insecticides	MT	107	3,146	78	2,981	29	29	36	6
3. Plastic materials	MT	581	998	387	884	194	33	50	13
4. Medicinal products	MT	200	23,854	201	28,106	-1	17	-1	-15
5. Others	-	1,471		1,115		356		32	
<b>F. Metal group</b>	-	857		477		380		80	
1. Iron and steel scrap	MT	157	166	66	166	92	140	140	0
2. Iron and steel	MT	625	376	351	388	274	84	78	-3
3. Aluminum wrought & worked	-	74		60		14		23	
<b>G. Miscellaneous group</b>	-	346		273		73		27	
1. Rubber crude	MT	65	1,101	50	872	15	3	30	26
2. Rubber tyres & tubes	NO	98	24	67	22	30	31	45	11
3. Wood & cork	-	21		18		3		14	
4. Jute	MT	31	285	22	240	8	15	36	19
5. Paper and paper board & manufactures	MT	133	577	115	618	17	24	15	-7
<b>H. Others</b>		2,812		2,179		633		29	
<b>Total imports</b>		<b>14,469</b>		<b>10,497</b>		<b>3,971</b>		<b>38</b>	

However, during the second half of FY05, the import quantum for petroleum products has reduced substantially (see **Figure 6.14**).<sup>26</sup> This can be largely explained by a rise in hydro-electricity generation (that rely more on furnace oil) due to improved water availability.

Furthermore, 19.0 percent YoY increase in Jul-Mar FY05 in import quantum of crude petroleum mainly reflects the impact of the Bosicar Petroleum Limited that started its commercial operation in July 2004.



**Agriculture and the chemical group** (with 18.1 percent share in total imports) has recorded 33.0 percent YoY growth during Jul-Mar FY05 mainly due to significant increases in the import of fertilizers, insecticides and plastic materials. Higher import of fertilizer and pesticide is associated with the improved farm income and availability of agri-credit. Import of fertilizer, in particular, remained exceptionally strong due to lower domestic production following the recent disruption in gas supplies from Sui (Balochistan). Since the domestic production of fertilizer is also facing capacity constraints, import of this product is likely to remain strong in near future.

### 6.3 Foreign Exchange Reserves

After touching a FY05 low of US\$ 11.5 billion by mid-December 2004,<sup>27</sup> Pakistan's overall foreign exchange reserves recovered strongly to cross the US\$ 13 billion mark on April 19 2005 (see **Figure 6.15**). This US\$ 1,491 million improvement in the country's *overall* reserves comes almost entirely from a rise in SBP reserves, which have swelled by US\$ 1,428 million since mid-December 2004 level (see **Figure 6.16**). The major inflows contributing to this *net* increase in SBP reserves include the loan disbursements by the ADB and the World Bank

<sup>26</sup> Gains from lower demand for petroleum products are visible in import bills for the months of January and February 2005.

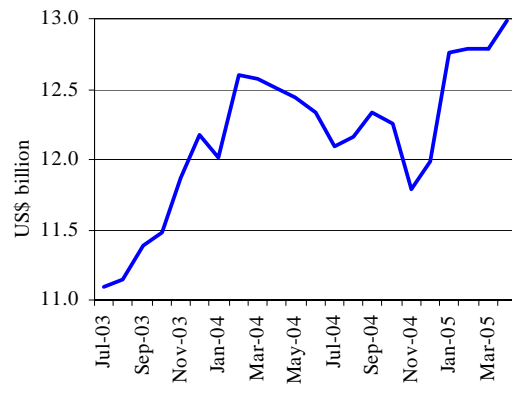
<sup>27</sup> Reserves declined by US\$ 1,859 million during Mar-Nov 2004 mainly due to SBP massive market support to contain excessive exchange rate volatility.

(US\$ 546 million), issuance of *Sukuk* by the government (US\$ 591 million), receipts against logistic support to US forces in Afghanistan (US\$ 375 million) and an increase in the net purchases from the inter-bank market (US\$ 185 million).

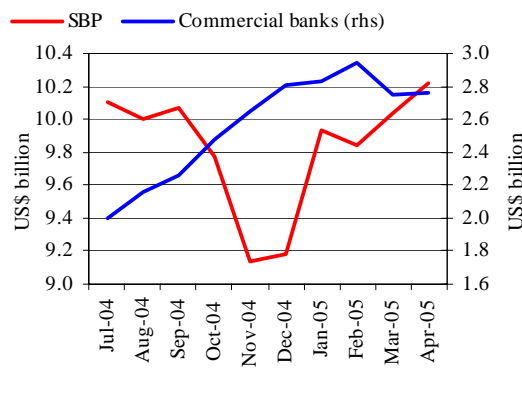
In this regard, SBP purchases from the inter-bank market seem quite surprising given the recent weaknesses in current account. However, as discussed earlier, SBP's public commitment at end-October 2004 to provide foreign exchange for meeting large oil payments was crucial not only in containing public expectations of weakening Rupee. This, led to an end to the panic driven rise in demand from the market, and probably also contributed to a narrowing of the monthly current deficit. The resulting increase in market liquidity eventually allowed the SBP to become a *net purchaser* in the interbank foreign exchange market by March 2005, despite continuing injections to meet oil payments of US\$ 2.1 billion. In fact, December 2004 onwards, SBP purchased US\$ 1,646 million from the interbank market against cumulative sales of US\$ 1,576 million in the same period (see **Figure 6.17**).

Reserves of commercial banks, on the other hand, increased by just US\$ 63 million since mid-December 2004. As evident from **Figure 6.16**, the foreign exchange reserves of commercial banks had been rising until end-Feb 2005 owing to net retirement of foreign currency loans and rising FE-25 deposits. Thereafter, as expectations of a Rupee depreciation were deflated by the systematic interventions by the SBP, both these contributions reversed.

**Figure 6.15: Total Foreign Exchange Reserves**



**Figure 6.16: Reserves of SBP & Commercial Banks**



**Box 6.1: Why Reserves?**

The holdings of foreign exchange reserves, according to the theory, can be justified on the following grounds.

**1) Insurance against External Shocks.**

The accumulation of foreign exchange reserves is one of self-insurance by any country against the external shocks. Importantly, the global capital mobility has increased with such speed over the past decade that capital flows can reverse as abruptly as they can course into a financial market. Moreover, financial integration has also increased the risks of contagion across markets. But, this is not a valid point in the case of Pakistan, because the sources of foreign exchange reserves were not dependent on capital mobility as in the case of China and India

**2. Intervention Motives**

The central banks engage in supervision and regulation of banking system and have very considerable powers of intervention in the event of serious disruption in the financial system. The power of intervention is positively correlated with the amount of foreign exchange reserve holdings. The comfort of reserves in such a scenario does provide authorities breathing space to ward off a speculative attack on a currency for a while, and enhances the ability to institute policies to deal with the crisis. Importantly, the duration and proportion of a crisis is always unanticipated.

**3. Microstructure Approach**

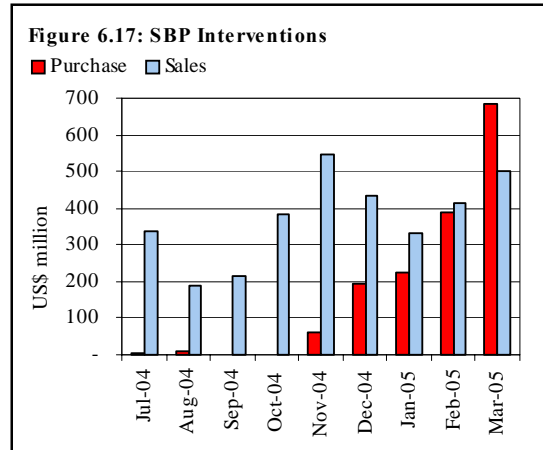
This new approach that focuses on structure of the foreign exchange market to explain pressures on exchange rate suggests that intermediaries individually take low exposure and therefore have a low capacity to absorb shocks. So, they try and rely on passing positions to other intermediaries and collectively the intermediaries' network extensively such that in total the market is able to shift risks efficiently. So, rather than acting as a shock absorber, the market appears to act as an efficient transmitter of shocks to end holders of exchange rate positions. This will lead to foreign currency risk and ultimately exchange rate volatility. The central banks intervene in the market to smooth out the volatility. So, central bank must have the foreign exchange reserves to absorb this shock to avoid to the risk for the end user of foreign exchange.

**4. For Business Operation**

Besides the exchange rate management the government also has a liquidity requirement in respect of its own foreign exchange business, servicing external debt & liabilities and as a cushion against unanticipated exogenous shocks. In the case of inadequate liquidity, the central bank and the government have to raise the fund from the expensive commercial loans. This approach of raising resource reduces the credit rating agencies' confidence in the country and the credit rating agencies have commonly placed considerable weight on the volume of country's official foreign currency reserves.

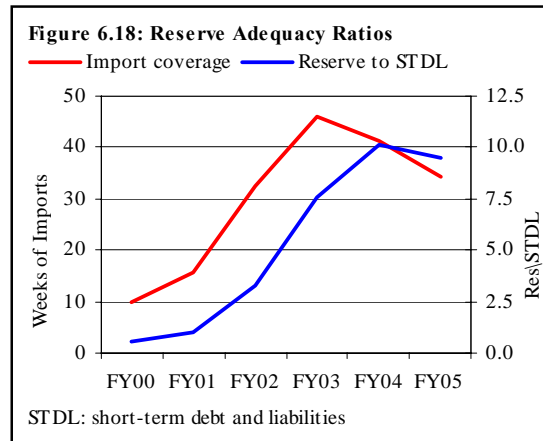


Lower inflows and the outflows from outstanding stocks led to a small net decline in FE-25 deposits. Simultaneously, the forex reserves of commercial banks also dropped due to the renewed growth in forex loans. Specifically, since end-February 2005, FE25 deposit went down by US\$ 76.5 million, and the foreign currency loans increased by US\$ 135 million.<sup>28</sup> As a result, after having risen by US\$ 1,172 million during July-February 2005, the forex reserves of commercial banks witnessed a net reduction of US\$ 170.3 million by mid-April 2005.



### Reserve Adequacy

The reserve adequacy ratios are showing the comfortable positions (see **Figure 6.18**). For example, despite a sharp increase in imports in recent months, by end-April 2005 the country's forex reserves are sufficient to cover 34.5 weeks of imports.<sup>29</sup> Similarly, current reserve holding is still 9½ times greater than the short term debt and liabilities.



While there are a number of explanations for holding large foreign exchange reserves (see **Box 6.1**), what is more important is the fact that reserve accumulation entails certain costs. In order to strike a balance between benefits of holding large reserves with its costs, sometimes countries also use their reserves

<sup>28</sup> The foreign currency loans add to the liquidity in the inter-bank market which is subsequently mopped up by the central bank.

<sup>29</sup> The broad rule of thumb for reserve adequacy was that reserve should be quite sufficient to pay for about three to four months of imports.

for the different purposes. One suggestion is to invest the foreign exchange reserves in the development of infrastructure (i.e., railway, roads, airport and telecommunications). It is generally argued that since growth potential of developing countries is hampered by weak physical infrastructure, an investment in this sector could lead to sustainable growth in the long run.

Proponents of using reserves for infrastructure investment point to China and Taiwan as example countries<sup>30</sup> who have used reserves for similar purpose. Even in India, there is a suggestion to use foreign exchange reserve for funding infrastructure investment.

**Box 6.2: If forex reserves are used for investing in infrastructure:**

- (1) The Government would increase its fiscal deficit for the purpose of investing in the infrastructure and would issue the government securities to generate funding.
- (2) The central bank would monetize this part of the deficit by directly purchasing these securities giving rise to reserve money and inflationary pressures.
- (3) The local currency resources obtained by the government would be used to purchase foreign exchange equivalent to imported expenditures.
- (4) The central bank would intervene in the market to meet this additional demand for foreign exchange.
- (5) The foreign exchange would be used to import infrastructure project. Consequently, the infrastructure will be setup at the cost of drop in reserves.

But what is generally missing in this entire debate is the fact that investment in infrastructure is primarily driven by fiscal consideration of the government. Just like any other public investment, using foreign exchange reserves for infrastructure investment would inevitably add to the fiscal deficit. Thus, suggesting that the government should use the foreign exchange reserves to finance infrastructure investment is equivalent to saying that government should spend on infrastructure development by expanding its fiscal deficit (see **Box 6.2**).

In fact, the inclination to view foreign reserves as a cheap source of financing may result to underestimate the cost of these funds, as compare to alternative sources of capital. In addition, the use of foreign exchange reserves to fund infrastructure investment could increase the vulnerability of the country against external shocks, create instability in the foreign currency market, which may be reflected in country's sovereign rating.

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<sup>30</sup> China had used US\$ 45 billion to bail out two state-owned banks; whereas Taiwan has decided to use US\$ 10 billion to refinance banks that fund infrastructure projects in the country.