6 External Sector

6.1 Overview

Pakistan's external accounts posted a surplus of US$ 1.6 billion during Jul-Feb FY11 compared to a surplus of US$ 0.5 billion in the corresponding period of the previous year.

The improvement in the country's external accounts owes to the significant fall in the current account deficit, since the financial account surplus declined considerably during Jul-Feb FY11 compared to the same period last year (see **Table 6.1**).

Table 6.1: Summary of External Accounts (Jul-Feb)
billion US Dollar

	FY10	FY11	Abs. Change	Percent Change
A-C/A Balance	-3.0	-0.1	2.9	96.8
i) Trade Balance	-7.6	-7.2	0.4	5.3
Exports	12.5	15.5	3.0	23.7
Imports	20.1	22.6	2.6	12.8
ii) Invisible Balance	4.5	7.1	2.5	55.7
Remittances	5.8	7.0	1.2	20.3
B-Financial/Capital Balance	3.0	1.4	-1.6	-53.7
i) FDI	1.3	1.0	-0.3	-21.8
ii) FPI	-0.3	0.2	0.5	176.3
iii) Other Investment	2.0	0.1	-1.9	-93.7
C-Errors & Omissions	0.5	0.2	-0.2	-50.4
D-Overall Balance	0.5	1.6	1.1	212.7

All the sub heads of the current account contributed to the decline in the current account deficit with the largest contribution coming from current transfers that increased by US$ 1.6 billion followed by US$ 0.7 billion improvement in the services account.

Notwithstanding the contributions of the current transfers and services accounts, the most encouraging development during Jul-Feb FY11 was the 23.7 percent growth in exports despite a host of impediments. Growth in exports appears to be a function of rising unit prices following global economic recovery. The performance of the exports so far suggests that if this trend continues, Pakistan would be able to post a new record for exports in FY11.

Unlike the current account, macroeconomic issues and government's failure to convince IFIs of its commitment to reforms, took its toll on the financial account. While foreign long term loans declined drastically from US$ 1.7 billion last year to only US$ 342 million, investments improved somewhat only due to absence of the US$ 600 repayments related to Sukuk, that had caused the investments to decline in the previous year. Resultantly, the financial and capital account surplus fell to US$ 1.4 billion during Jul-Feb FY11 from US$ 3.0 billion in the corresponding period last year.

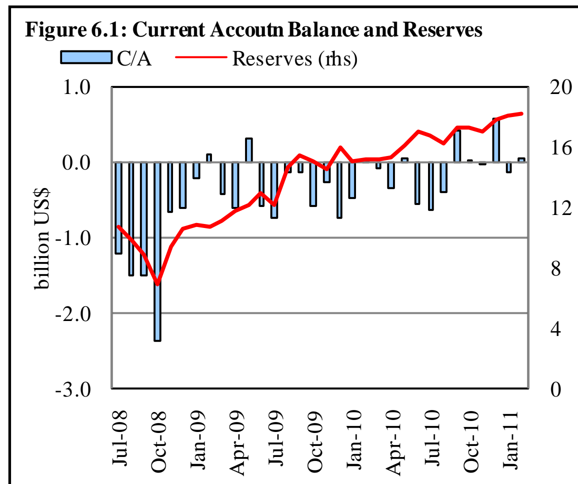


Figure 6.1: Current Accoutn Balance and Reserves

This surplus nevertheless, helped in improving the country's overall reserves, which reached all time high of US$ 18.1 billion as of end Feb 2011 (see **Figure 6.1**). With ample flows on account of remittances and export proceeds entering the inter-bank forex market, the pressures on the rupee were relatively subdued during Jul-Feb 2011, consequently rupee depreciated by only 0.24 percent compared to 4.5 percent in the same period last year.

At its current pace, FY11 current account deficit is likely to be less than 2.0 percent of the GDP, which is a remarkable achievement given that just two years back the deficit was almost 6 percent of GDP. However, there is no room for complacency as the existing decline is mainly due to transitional reasons. The trade deficit is down due to rise in unit prices of traditional exports and could stagnate once prices normalize. Similarly, imports, which were relatively subdued till the end of the previous fiscal year due to slowdown in domestic economic activity and fall in global commodity prices, have been rising since July FY11 and could surge with the further escalation in world price especially that of oil.

Improvement in the services account owes to logistic support, which have been notoriously unreliable lest for their timing. Similarly, current transfers could also suffer from the ongoing turmoil in the Middle East. To make matters worse the slowdown in financial account inflows appears to be more of medium to long-term nature. Rise in the investment inflows is linked to improvement in law and order, political and macroeconomic stability, while the inflow of foreign loans is dependent on the credibility of the government to undertake politically sensitive reforms.

Thus when the deterioration in the current account occurs, the financial account in its present state may not be able to support it, and the country would have to fall back on its reserves which are currently lending stability to the exchange rate.

This situation was faced a few years back and had forced the country to approach the IMF.

The Stand-by Arrangement agreed with the IMF in Nov 2008 is presently in a suspended state as Pakistan has not been able to fulfill its commitments. While the conditions imposed by IMF are no doubt politically difficult, they are nevertheless necessary to put the economy on a sound footing. Brining IMF on board is important not only because it would revive inflows from the IMF and other donors who seek IMF endorsement, but it would also restore foreign and domestic investor confidence in government's economic policies.

Past experience has shown that deferring unpopular decisions only aggravates the problems and increases the cost to the economy.

Figure 6.2: Current Account and its Components

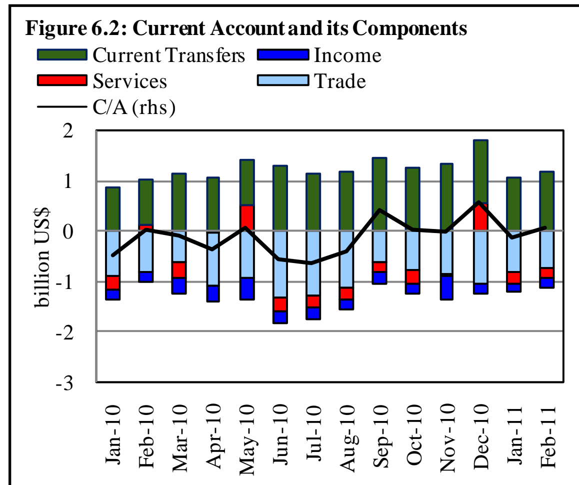
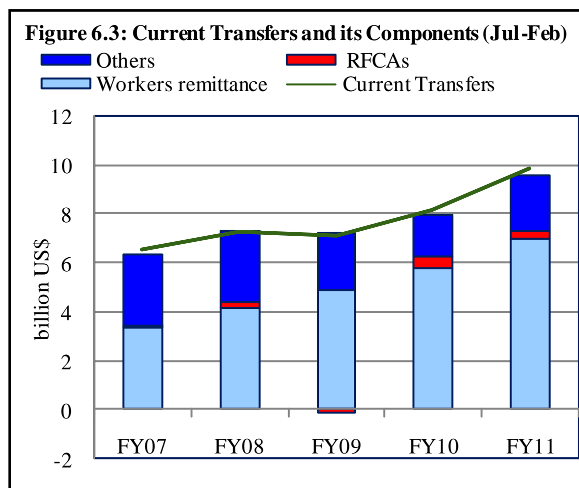


Figure 6.3: Current Transfers and its Components (Jul-Feb)



6.2 Current Account Balance

Though the year started on a negative note with current account deteriorating by 18.0 percent during the initial two months of FY11, later months saw significant improvement. In September, current account recorded a surplus of US$ 419 million and again of over US$ 500 million in December. Consequently the current account deficit for Jul-Feb was just US$ 98 million against US$ 3.0 billion in the corresponding period last year (see **Figure 6.2**).

Trade account[1], which is the largest component of the current account and largely dictates the overall performance of the current account contracted by 5.3 percent during Jul-Feb FY11 against a 20.1 percent contraction a year before. More importantly, while last year's improvement in trade account was due to a significant decline in import bill, this year's improvement was the result of strong export growth that considerably offset the impact of 10.2 percent growth in imports.

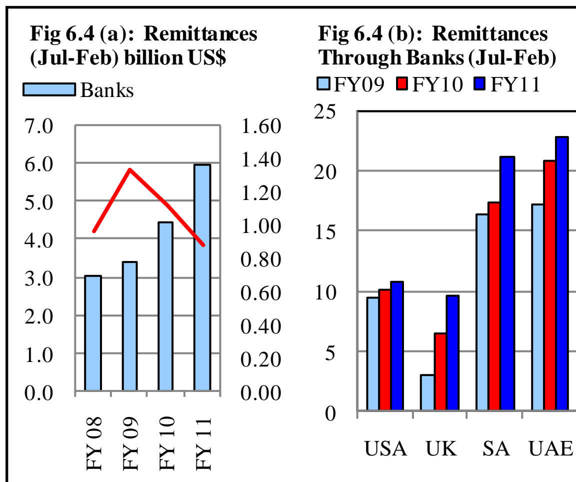
As against the small contraction in trade account during Jul-Feb FY11, services account deficit contracted by a hefty 43.7 percent mainly reflecting the impact of US$ 743 million receipts under logistic support. However, even after excluding logistic support related receipts, services account deficit shows 16.3 percent improvement. This was due to better performance of transportation, travel other business services sub-groups.

Although all sub-heads of the current account contributed to the improvement in current account in absolute terms the largest contribution came from the current transfers. Continued strong growth in workers' remittances and inflows on account of flood relief led current transfer to grow by 20.7 percent during

Table 6.2: Country-wise Workers' Remittances (Jul-Feb)

million US$

Countries	FY10	FY11	Share (%)	Contribution (%age points) in growth
Gulf region:	**3294.1**	**4010.1**	**57.6**	**12.4**
Bahrain	101.0	103.0	1.5	0.0
Kuwait	297.1	308.8	4.4	0.2
Qatar	243.3	198.9	2.9	-0.8
Saudi Arabia	1148.9	1563.0	22.4	7.2
Sultanat-e-Oman	185.5	209.4	3.0	0.4
U.A.E.	1318.3	1627.1	23.4	5.3
U.S.A.	1173.2	1298.3	18.6	2.2
U.K	596.3	770.9	11.1	3.0
Canada	71.6	127.6	1.8	1.0
Germany	57.5	67.5	1.0	0.2
Japan	4.3	3.0	0.0	0.0
Norway	24.8	24.8	0.4	0.0
Others	564.3	661.1	9.5	1.7
TOTAL	**5786.1**	**6963.3**	**100.0**	**20.3**



[1] For detailed discussion on trade see **sub-section 6.2.** Trade date in section 6.2 will not tally data used here as the two are based on data from two different sources.

Jul-Feb FY11 (see **Figure 6.3**).

Workers' Remittances continued to perform strongly during Jul-Feb FY11, posting growth of 20.3 percent on top of 17.6 percent last year. This was the first time when monthly remittances surpassed US$900 million figure in three out of seven months.

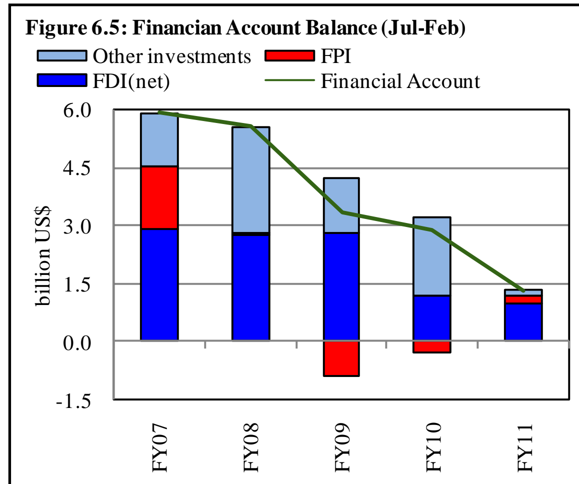


Figure 6.5: Financian Account Balance (Jul-Feb)

Country wise data shows that 57.0 percent of the remittances originated from the Gulf region followed by USA and United Kingdom (see **Table 6.2**). Within the Gulf region, UAE remained the largest contributor followed by Saudi Arabia. Encouragingly in case of the UAE, remittances from Dubai bounced back following the country's partial recovery from the economic downturn. Thus, as against the decline of 14.6 percent last year, remittances from Dubai increased by 33.6 percent during Jul-Feb FY11.

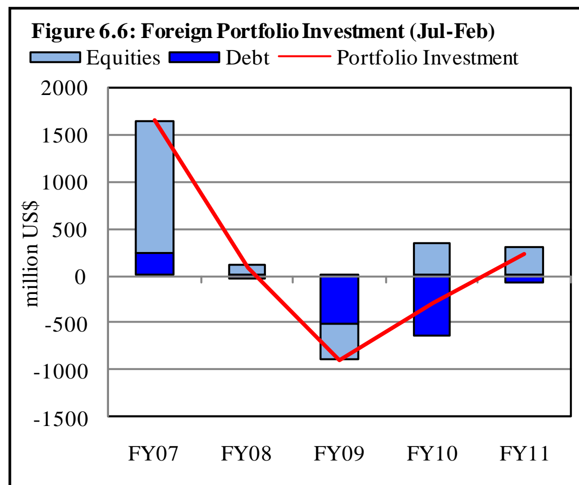


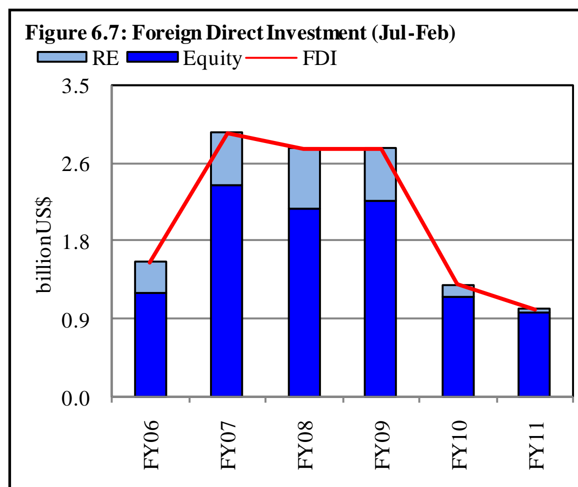
Figure 6.6: Foreign Portfolio Investment (Jul-Feb)

Channel-wise data shows that remittances through banks have increased consistently since FY09 whereas through exchange companies have declined (see **Figure 6.4 a**). This switching of channels is attributed to number of reasons. Initially, it was perhaps the crackdown by the law enforcement agencies on some of the big exchange companies such as Zarco, and Khanai & Kalia exchange companies discouraged remitters to use this channel. However, more recently joint efforts by the SBP and the government to facilitate remitters has increased the inflows through the banks. Some of these initiatives include: (1) real time Inter Bank

Fund Transfer (IBFT) facility[2]; (2) cash over counter facility[3] and (3) direct debit facility in the beneficiary's bank account. During the past two years PRI has also established around 200 highways (bilateral arrangements with the banks/money changers) and have resolved issues with the labors and overseas agents to enhance remittances through formal channels.

6.3 Financial Account Balance

The declining trend in the financial account balance since FY09 continued during Jul-Feb FY11 as well. The entire decline in the financial account balance was on account of fall in other investment liabilities (loans) since the foreign investment flows improved slightly during this period.



Steep decline in other investments largely owed to absence of one off SDR allocation that had inflated the other investment liabilities in the previous year. However, even after adjusting for the SDR allocation, other investments remained subdued compared to the previous year mainly due to lower net loan inflows and substantial increase in non repatriation of export bills (see **Figure 6.5**).

Net Foreign Investment (NFI) recorded YoY increase of 33.5 percent during Jul-Feb FY11. Within NFI, while foreign direct investment continued to perform poorly for the 2nd consecutive year, foreign portfolio investment recorded a net inflow US$ 232 million compared to net outflow of US$ 304 million in the corresponding period last year. This improvement was entirely on account of lower outflows under debt securities compared to the same period last year[4] (see **Figure 6.6**).

[2] In IBFT, beneficiary's bank has an arrangement with the exchange companies/banks abroad. The remitter can transfer funds through these exchange companies and banks to beneficiary's bank account instantly.
[3] A beneficiary can receive cash from the bank even without having an account by showing national identity card along with the specific code provided by the sender from abroad.
[4] This was due to Sukuk bond payment worth US$ 600 million in January, 2010.

Given that the improvement in portfolio investment is not due to increase in equity investment is rather disappointing as generally there has been a recovery in capital flows to emerging markets during CY10. The foreign portfolio equity investment in emerging economies is forecasted to reach US$ 186 billion by end of CY 2011, up from an average of US$ 62 million per year during 2005-2009.[5]

Similarly, FDI to South and South-East Asian economies rose by 18 percent in CY10.[6] Surge in profits of foreign affiliates due to improved economic condition in the region significantly increased the level of reinvested earnings. Despite these encouraging developments in the region, factors like weak economic growth, poor security situation, circular debt and energy crises have limited the profitability of foreign inventors in Pakistan. This is reflected by the sharp fall in reinvested earnings that accounted for 36 percent fall in FDI flows during Jul-Feb FY11(see **Figure 6.7**).

Table 6.3: SBP Reserves

million US$

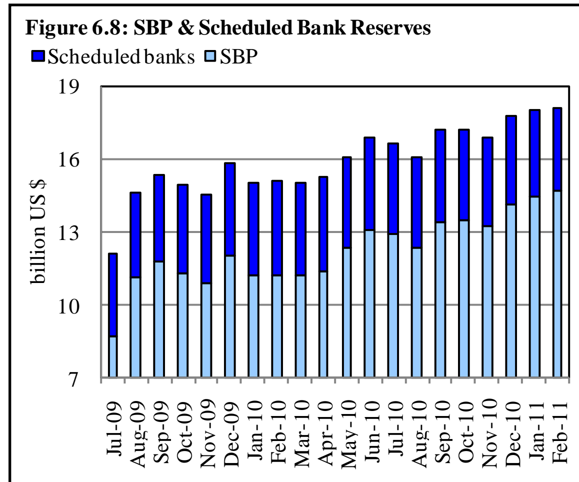
	FY11		
	Jul-Sep	**Oct-Dec**	**Jan-Feb**
Inflows	**3595.3**	**4039.6**	**2623.3**
Purchases	**315**	**1225**	**950**
Loans & Grants	595.8	180.2	390.6
ADB	60.8	72.9	20
IMF	453.4	1.1	1.2
Others	2,685	2,634	1,283
USA-Logistic Support	0	743	0.3
Forward maturities	1,969	1,283	906
Interest on dep./discount	53.3	33.1	15.1
Miscellaneous receipts	662.7	575.4	361.5
Outflows	**3333.1**	**3663.7**	**2055.9**
Inter-bank sales	90	0	0
Debt Servicing	365.1	431.2	199.2
IMF	91.8	124.2	84.2
ADB	84.8	177.4	44.7
others	188.5	129.6	70.3
Others	2,878	3,233	1,856
of which			
Forward maturities	1,944	1,709	1,525
Defence	147.9	331.4	44.3
Miscellaneous payments	197.2	379.5	286.9
Net change in reserve	**262.2**	**375.9**	**567.4**

Source: DMMD

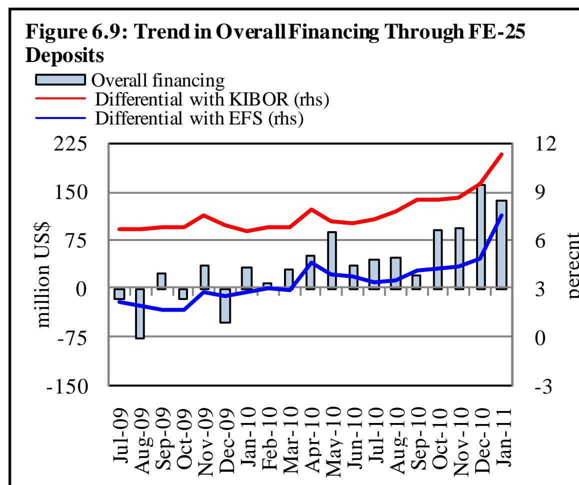
[5] "Capital Flows to Emerging Market Economies" IIF research note, October 4, 2010.
[6] Major countries that recorded inflows in this region include Singapore, Hong Kong, China, Indonesia, Malaysia and Viet Nam. "UNCTAD Global Investment Trend Monitor NO.5, January 17,2011."

6.4 Foreign Exchange Reserves and Exchange Rate

The improvement in the country's external accounts was reflected in the buildup of foreign exchange reserves, which reached a new peak of US$ 18.1 billion by end Feb-FY11 (see **Figure 6.8**). The rise in the overall reserves improved the reserves adequacy ratio measured in weeks of imports from 28.2 weeks as at end-June 2010 to 28.6 weeks as of end February 2011.



Monthly analysis shows that the SBP reserves recorded positive growth throughout Jul-Feb FY11, except for November 2010 which recorded net outflow of US$ 390.9 million. This was on account of debt servicing to the multilateral and bilateral donors. Specifically, the debt servicing payment to IMF and the ADB constituted almost 66 percent of the total debt serving in the November 2010 (see **Table 6.3**). However, foreign exchange reserves received a boost in December and January due to inflow of coalition support fund.



As against the SBP reserves scheduled banks reserves declined by US$ 378 million during Jul-Feb FY11. Although the scheduled bank's reserves benefited from robust performance of the workers' remittances, trade related outflows more than to offset their impact, resulting in net outflow. Along with import payments, import loans also depleted their reserves. Rise in the trade related loans were influenced by increasing differential between foreign currency lending rates and EFS and benchmark KIBOR rate (see **Figure 6.9**).

Owing to strengthening of the country's external accounts Pak rupee exhibited relative stability against the US dollar during Jul-Feb FY11. Thus as against a depreciation of 4.5 percent during the previous year, Pak rupee depreciated by only 0.24 percent during Jul-Feb FY11.

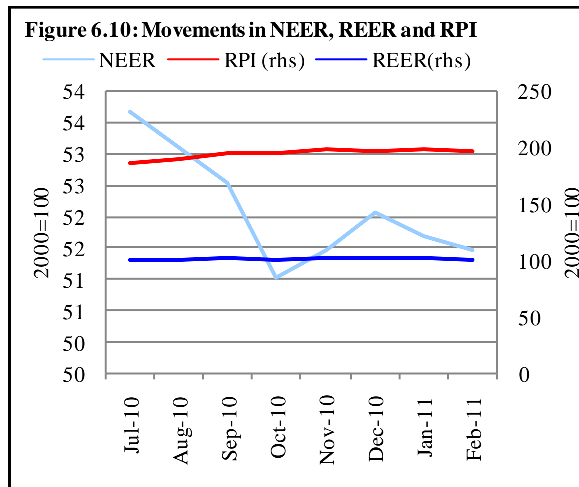


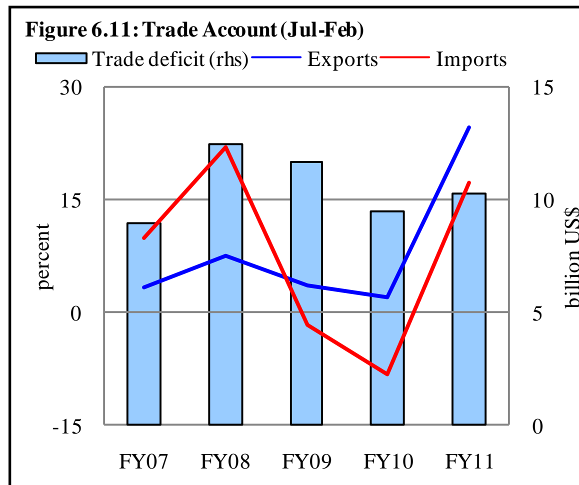
Figure 6.10: Movements in NEER, REER and RPI

Besides the improvement in the country's external accounts, rupee's relative stability also owes to the weakening of the US dollar against other the major world currencies.

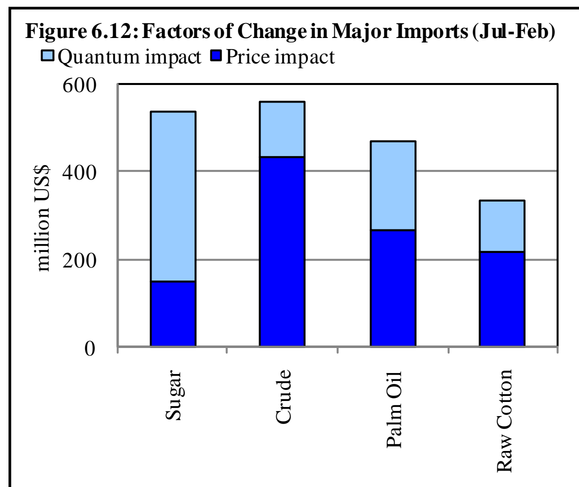
In terms of Nominal Effective Exchange Rate (NEER), rupee depreciated by 6.4 percent during Jul-Feb FY11, which was offset by 6.7 percent rise in relative prices, consequently, Real Effective Exchange Rate (REER) appreciated by 0.4 percent during Jul-Feb FY11 against 1.9 percent in the corresponding period last year (see **Figure 6.10**).

Trade Account[7]

Despite the decent growth in exports, trade deficit widened by 7.9 percent during Jul-Feb FY11and touched the level of US$ 10.3 billion (see **Figure 6.11**). This deterioration in trade account is mainly due to an increase of US$ 3.8 billion in the import bill which more than offset the rise of US$ 3.0 billion in export earnings.



Analysis of import indicates that more than 50 percent of increase in the import bill during Jul-Feb FY11 originated from high imports of sugar, crude oil, palm oil, petroleum products and raw cotton. On one hand, rising international prices of these commodities translated into higher import prices. On the other hand, increased import quantum of these commodities due to domestic shortages and high demand further inflated the import bill (see **Figure 6.12**).



In case of exports, both textile and non-textile sectors contributed to overall export growth; however the role of textile sector was more prominent (see **Figure 6.13**). Increased export quantum amid improved external demand[8] and rising export prices facilitated the textile exporters. In case of rise in non-textile exports, food, petroleum and other manufactures groups recorded positive growth numbers. Higher export prices due

[7] Discussion in this section is based on FBS data.

[8] US textile and apparel imports in terms of value from the world increased by 22.8 and 17.6 percent respectively during Jul-Dec FY11.

to rising international commodity prices, improved demand in traditional markets and discovery of new markets were the main factors behind the decent performance of the non-textile sector.

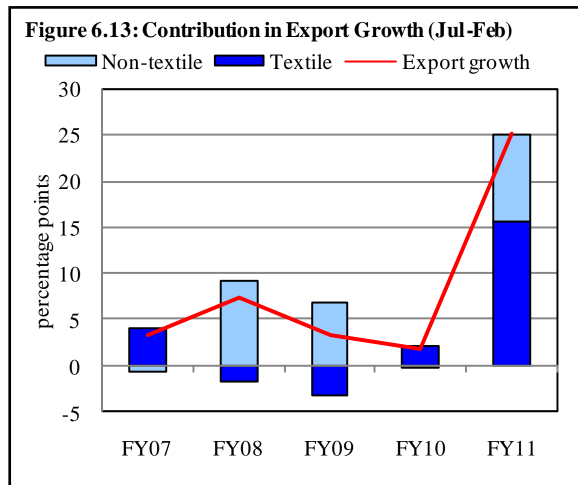


Figure 6.13: Contribution in Export Growth (Jul-Feb)

Going forward, trade deficit is likely to widen as rising international commodity prices especially that of petroleum products and palm oil would inflate imports. Shortages of some key commodities such as sugar and cotton would put additional burden on the import bill. Although exports are also expected to grow at a decent pace amid improving external demand and higher export prices however; import growth is likely to outpaced export growth in remaining months of FY11.

Exports

Remarkable growth in textile exports accompanied by a decent performance of non-textile exports led to a 24.6 percent YoY rise in overall exports during Jul-Feb FY11 as compared to a modest rise of 1.9 percent during the same period last year. While the rise in textile exports is a function of improved external demand and export prices, improved performance of non-textile products is attributed to market diversification and increased export prices. Due to strong performances of textile and non-textile sectors, export earnings broke the level of US$15.0 billion for the first time for Jul-Feb period (see **Figure 6.14**). If this trend continues, export is likely to hit a new record in FY11.

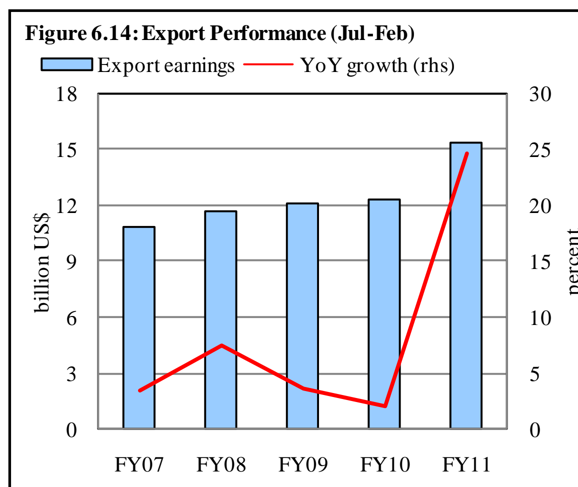


Figure 6.14: Export Performance (Jul-Feb)

Textile group

Following the improved demand in US and EU (major importers of textile products), textile exports increased by 28.8 percent during Jul-Feb FY11. In absolute terms, textile exports touched the level of US$ 8.6 billion as both low-value and high value sectors contributed. Despite the shortfall in cotton production, raw cotton and yarn exports were higher than last year's level due to better export prices.

Table 6.4: US Textile and Apparel Demand (Jul-Dec)

growth in percent

	Textile		Apparel	
	FY10	FY11	FY10	FY11
Bangladesh	2.1	38.3	-9.5	26.8
China	-9.1	31.2	-1.3	20.6
India	-9.3	27.0	-7.2	13.1
Pakistan	-10.7	7.8	-13.5	17.1
World	-12.0	22.8	-12.4	17.6

As far as high value added sector is concerned, anecdotal evidence suggests that high value sector was facing both demand and supply side issues during the last two years. On the demand side, economic slowdown in both US and EU had led to fall in export orders, however with the gradual improvement in demand; exports of major textile and apparel exporters including Pakistan have increased during the first half of FY11 (see **Table 6.4**).

Table 6.5: Product Analysis of Textile Sector (Jul-Feb)

YoY change in percent

	Qty	Value	Unit value
Low-value products			
Raw Cotton	-45.3	12.9	106.2
Cotton Yarn	-20.1	44.9	81.3
Cotton Fabrics	7.9	33.3	23.5
Art Silk and Synthetic Textiles	44.7	64.2	13.5
High-value products			
Hosiery (Knitwear)	19.0	26.7	6.5
Bedwear	-2.8	16.5	19.9
Towels	0.1	7.1	7.0
Readymade Garments	21.6	33.7	10.0

On the supply-side, issues such as liquidity constraints, shortage of raw material and prolonged power shortages were adversely impacting the production process. Some of these issues were partially addressed, particularly the shortage of raw material after the imposition of restrictions on exports of cotton yarn. Anecdotal evidence suggests that some major exporters have installed their own power generating units to mitigate power shortages. The rise in international cotton prices also kept the export price impact positive during the period under study.

Product-analysis show that unit value of all the major products of textile sector increased during the period due to rising international cotton prices. Although in terms of quantum, raw cotton and yarn recorded a fall but sharp rise in unit values more than offset the impact of falling quantity (see **Table 6.5**). In case of high value products, with the exception of bedwear, which recorded a fall in terms of quantum, all other products recorded a rise in terms of both unit values and quantum (see **Table 6.5**).

Non-Textile Sector

Analysis of non-textile exports shows that all the major groups i.e. food, petroleum and other manufactures posted positive growth numbers during the period under review.

In food group, main impetus came from fish and meat exports, recording a YoY growth of 27.8 and 52.6 percent respectively. In case of fish, exports were driven by increased quantum. Anecdotal evidence suggests that bulk of these exports were to Egypt. As regard the rise in meat exports, it increased mainly on the back of increased export quantum to Saudi Arabia. Higher unit values also facilitated the exporters. Rice exports failed to record a substantial rise mainly on account of declining export quantum. The shortfall in rice production largely explains the low export quantum.

The strong performance of petroleum group is entirely a function of higher export prices as quantum of petroleum product declined during the period under review.

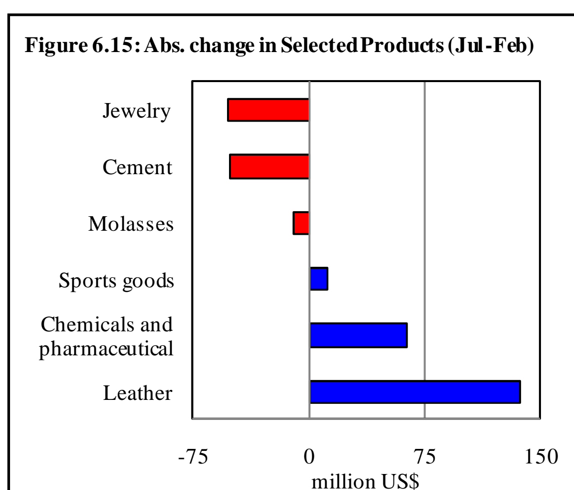


Figure 6.15: Abs. change in Selected Products (Jul-Feb)

In other manufactures group, exports of leather, chemicals and sports goods recorded a rise; however this rise was partially offset by negative growth in exports of cement, jewelry and footwear (see **Figure 6.15**). The rise in leather, chemicals and engineering goods was a function of improved external demand in traditional markets, discovery of some new markets and relatively better export prices. On the other hand, the decline in cement exports was in line

with the declining demand in Middle East countries. Moreover commissioning of new cement capacities in India led to fall in exports to India during the period under review. Competition from Saudi Arabia is also an explanatory factor of low cement exports. Exports of molasses remained subdued due to low sugar production, whereas jewelry exports recorded a fall amid low external demand.

Imports

High import prices along with increased import quantum led to 17.3 percent YoY growth in imports during Jul-Feb FY11 in contrast to a fall of 8.2 percent during the same period last year. Although quantum impact was positive in FY10 as well, but negative price impact had more than offset the impact of rise in quantum. In FY11 however, both price and quantum impact together brought a positive change in the import bill (see **Figure 6.16**).

Figure 6.16: Sources of Change in Import bill (Jul-Feb)

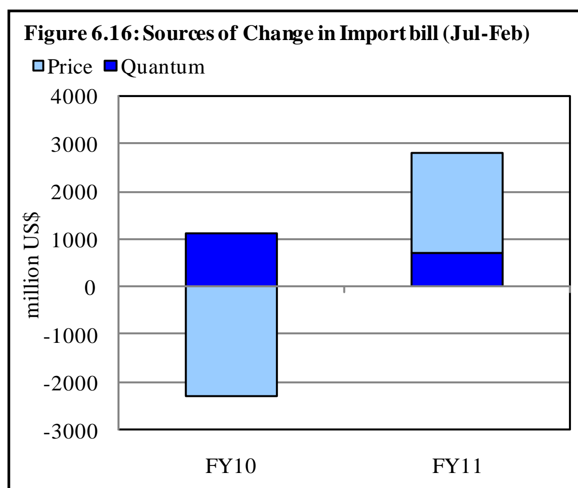
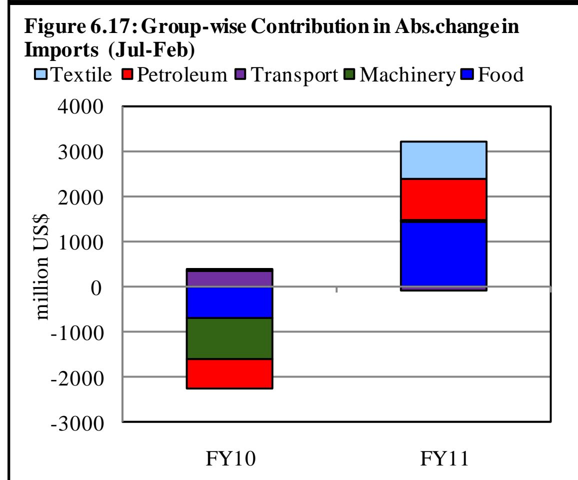


Figure 6.17: Group-wise Contribution in Abs.change in Imports (Jul-Feb)



Group-wise analysis shows that with the exception of transport group, all other major groups recorded a substantial rise during the period under review (see **Figure 6.17**). Food group played the dominant part in inflating the import bill. Textile group also recorded a substantial rise amid shortfall in domestic cotton production. Higher cotton prices further put upward pressures on the import bill. Similarly, relative higher crude oil prices inflated the petroleum group imports.

Analysis of food group reveals that main contribution came from sugar, palm oil and pulses (see **Table 6.6**). Domestic shortages of sugar

led to reliance on imported sugar. In case of palm oil, on one hand, reduction of import duty[9] led to increased import quantum, on the other hand rising palm oil prices put additional pressure on the import bill.

Petroleum group imports increased by US$ 908 million during Jul-Feb FY11 in contrast to a fall of US$ 650 million during the same period last year. The dominating factor behind this surge is the rising import price impact. Average import prices during Jul-Feb FY11 were US$ 577/MT as compared with average import prices of US$494/MT during FY10.

Textile group imports recorded a substantial increase of 74.7 percent amid increased import quantum and rising import prices. The domestic shortfall of cotton [10]due to devastating floods meant more dependence on imported cotton; rising international cotton prices further inflated the import bill.

Machinery group imports registered a growth of 0.3 percent during Jul-Feb FY11 with main impetus coming from textile and telecom machinery. Textile machinery import has been on a rise since September 2009[11] following the elimination of import duty. The inclusion of textile machinery under the Long Term Financing Facility (LTFF)[12] also facilitated the importers of textile machinery. Telecom imports also recorded a substantial rise amid increased demand of cellular phones.

Table 6.6: Sources of Change in Food Imports (Jul-Feb)

million US$

	Quantum impact	Price impact	**Total change**
Milk Products	8.5	30.9	**39.4**
Dry Fruits	6.1	-0.9	**5.2**
Tea	39	1.2	**40.2**
Spices	10.2	17.1	**27.3**
Palm Oil	197.6	217.1	**414.8**
Sugar	373.4	163.2	**536.6**
Pulses	79.1	40.4	**119.5**

Transport group imports fell by 7.3 percent mainly due to fall in the category of aircrafts, ships & boats and other transport equipments. Road motor vehicles imports on the other hand grew by 14.1 percent amid high domestic demand.

[9] Import duty on crude palm oil was reduced from Rs. 8,000/MT to Rs. 7,000/MT.
[10] Estimates indicate that cotton production will fall short by 1.2 million bales MT.
[11] SRO 809(I)/2009 dated 19th September 09, allows reduction of import duty on textile machinery from 5 percent to zero.
[12] SMEFD Circular Letter No. 03 of 2010.

Agricultural and chemical group imports also recorded a fall during Jul-Feb FY11. This decline is largely attributed to fall in fertilizer imports. Increased domestic production explains the drop in import of this category.