

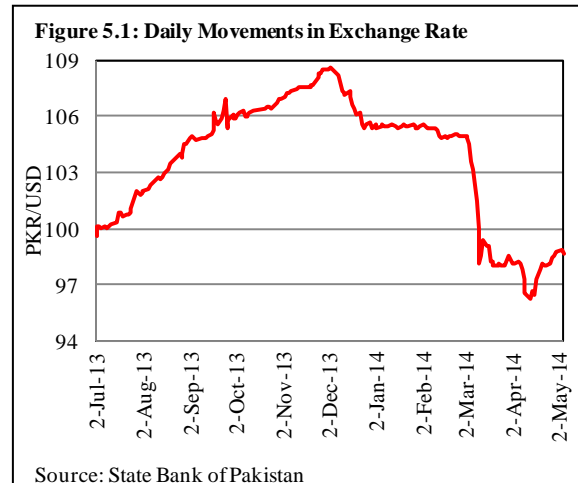
## 5 External Sector

### 5.1 Overview

Pakistan's external account witnessed a sharp improvement in Q3-FY14: the country's FX reserves increased by US\$ 1.8 billion, and the PKR appreciated by 6.9 percent to touch 98.53 per US\$ by end-March 2014 – close to the level seen during June 2013 (**Figure 5.1**). While some improvement in the external sector was expected (e.g., proceeds under 3G/4G auction; divestiture of public shares; and assistance from

IFIs), the significant improvement in the external outlook during the quarter came as a surprise. More specifically, the PKR parity appreciated sharply following the receipt of US\$ 1.5 billion grant from a friendly country; moreover, market expectation of additional bilateral inflows triggered a degree of panic selling in the FX market.<sup>1</sup> Although less decisive, several other factors also helped ease FX pressure during the quarter: a reduction in the current account deficit (**Table 5.1**); commercial loans mobilized by the government; ban on import of gold; and the roll-over of maturing FX loans for oil import (**Section 5.5**).

Market sentiments improved further in April 2014, when Pakistan re-entered the global capital market after 7 years. The government was able to mobilize US\$ 2 billion via the issuance of Eurobonds of 5 and 10 years maturity.<sup>2</sup> The exchange rate touched PKR 96.21 per US\$ on 14<sup>th</sup> April 2014, when this news was made public (**Figure 5.1**).<sup>3</sup> Two weeks later, the government conducted its much



<sup>1</sup> It is important to note that since this was an *official* bilateral inflow, it came into SBP's FX reserves and did not impact the interbank market. The reason it impacted the exchange rate was mainly market speculation of additional inflows, and not SBP intervention. In fact, SBP made FX purchases in March 2014 from the interbank to build reserves and to stop the PKR appreciating further (**Section 5.5**).

<sup>2</sup> Against the target of US\$ 0.5 billion, the government received bids of US\$ 7 billion.

<sup>3</sup> Between 8<sup>th</sup> April (announcement date) to 15<sup>th</sup> April (issuance date), the PKR gained 2.0 percent.

anticipated license auction for the 3G/4G spectrum, which further shored up SBP's reserves by US\$ 516 million. These sequence of events (unexpected bilateral inflows, a much larger Eurobond issue and 3G/4G auction), was followed by lumpy inflows from both the World Bank and Asian Development Bank (ADB) (Section 5.4).<sup>4</sup> Since late 2001, Pakistan has not experienced such a sequence of positive developments in the external sector. It is, therefore, not surprising that sentiments about the economic outlook have improved considerably.

Notwithstanding the needed increase in the country's FX reserves, underlying fundamentals do not show much of an improvement. Foreign direct investment has still to pick up; export growth remains modest; and the trade account continues to show a sizable deficit.<sup>5</sup> During Jul-Mar FY14, the current account deficit stood at US\$ 2.1 billion, compared to only US\$ 1.3 billion in the same period last year (Table 5.1). Although quarter-wise data shows a YoY decline in the deficit during Q3-FY14, this does not represent any structural improvement in the domestic economy, as it stemmed primarily from a rise in home remittances and receipt of CSF inflows during the quarter (Section 5.2).<sup>6</sup> As shown in Table 5.2, deficits in

**Table 5.1: Major External Sector Indicators**  
million US\$

	Q3		Jul-Mar	
	FY13	FY14	FY13	FY14
Country's FX reserves (change)	-1,609	1,761	-3,041	-945
SBP's FX reserves (change)	-1,861	1,885	-3,677	-644
Current account balance	-1,172	-350	-1,255	-2,107
Net capital flows*	94	1,561	192	1,726
Net FDI in Pakistan	62	250	631	670
FX loans and liabilities	-252	172	-395	-212

\*This includes the capital grant from a friendly country.

Source: State Bank of Pakistan

**Table 5.2: Composition of Current Account**  
million US\$

	Q3		Jul-Mar	
	FY13	FY14	FY13	FY14
Current account balance	-1,172	-350	-1,255	-2,107
I. Trade balance	-3,679	-3,661	-11,585	-12,027
Exports	6,192	6,372	18,346	18,904
Imports	9,871	10,033	29,931	30,931
II. Services balance	-735	-532	-782	-2,019
o/w CSF	0	353	1,806	675
III. Primary income*	-847	-848	-2,559	-2,844
o/w Payments on FDI**	679	683	1,902	2,121
IV. Secondary income***	4,089	4,691	13,671	14,783
o/w Home remittances	3,237	3,793	10,354	11,583

\*Includes receipt and payments related to dividend; mark-up; reinvested earnings; profit repatriation, etc.

\*\* Repatriation of profit and dividend income by foreign investors

\*\*\*Includes all current transfers

Source: State Bank of Pakistan

<sup>4</sup> Pakistan has also received US\$ 375.0 million CSF in May 2014.

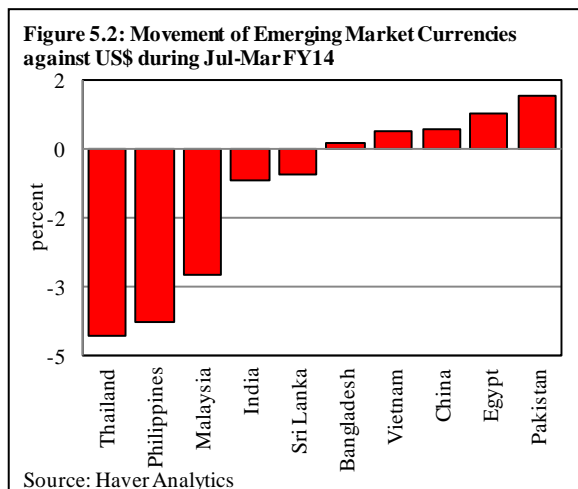
<sup>5</sup> Trade deficit stood at US\$ 3.7 billion in Q3-FY14, and US\$ 12.0 billion in Jul-Mar FY14.

<sup>6</sup> Pakistan received US\$ 353 million CSF inflows in February 2014. Home remittances totaled US\$ 3.8 billion during Q3-FY14, showing a growth of 17.2 percent over the same period last year.

trade and primary income account, remained almost unchanged during Q3 from last year same period.

As far as capital and financial inflows are concerned, these were sufficient to finance the current account deficit. In addition to the grant, Pakistan also attracted net FDI of US\$ 250 million and loan receipts of US\$ 172 million during Q3-FY14, which helped to comfortably finance the current account deficit of US\$ 350 million. Moreover, repayments to the IMF during the quarter were less problematic as these were surpassed by fresh disbursements under the EFF program.

Going forward, we expect the full-year current account deficit to settle between US\$ 2 – US\$ 2.5 billion (i.e., around 1 percent of GDP) for FY14. However, some downside risks remain, like a possible slowdown in the Chinese economy, and how the PKR appreciation could impact Pakistan's trade balance going forward. As shown in **Figure 5.2**, the PKR has appreciated the most compared to currencies of other emerging economies. Having said this, a part of this loss of competitiveness could be offset by the availability of cheaper imported inputs, which most Pakistani exporters are dependent upon.



As far as remittances are concerned, we expect a mixed impact of the PKR appreciation. A positive effect may come from overseas Pakistanis who would compensate for the appreciation by sending more foreign exchange into the country (for immediate consumption), whereas a negative effect may come from those who would wait for the PKR to depreciate to realize more (say, for investment).<sup>7</sup>

<sup>7</sup> According to market analysts, the latter could explain the month-on-month decline in home remittances in April 2014. In our view, however, it is still too early to give a definitive assessment of the impact of the PKR appreciation on remittances.

In our view, while realizing one-off FX inflows (bilateral grants and 3G/4G auction) and raising fresh loans were necessary steps to avert a crisis-like situation in the external sector, the real challenge is to improve the fundamentals to sustain reserves adequacy, and ensure exchange rate stability over the medium-to-long-term. This task seems difficult without addressing structural weaknesses that keep Pakistan's trade deficit at stubbornly high levels. An added challenge is to enhance the country's external debt repayment capacity to avoid payment pressures when newly taken loans fall due.

## **5.2 Current account**

As mentioned before, the current account posted a larger deficit in Jul-Mar FY14, compared to the same period last year (**Table 5.2**). However, the deficit in Q3-FY14 was about one-third the deficit seen in Q3-FY13, with the improvement coming from a rise in home remittances and receipt of CSF money during the quarter.

### Home Remittances

With an additional US\$ 3.8 billion in Q3-FY14, the cumulative growth in home remittances nearly doubled from 6.3 percent YoY in Jul-Mar FY13, to 11.9 percent in Jul-Mar FY14. With remittance growth of 3.3 percent (on average) in other developing countries during 2013, and expected growth of 7.8 percent in 2014, Pakistan's performance is impressive.<sup>8</sup> If remittance continues to grow with the same pace in the final quarter, the annual target of US\$ 15.1 billion set for the year, is likely to be achieved.

The growth in home remittances is primarily due to a rise in Pakistanis working abroad, and tighter compliance of anti-money laundering laws. During Jul-Feb FY14, 406 thousand more Pakistanis proceeded abroad for employment.<sup>9,10</sup> More than half of these workers chose to go the UAE.

In addition to a rise in economic activity in the Emirate, the UAE remains a preferred destination compared to other countries in the GCC. For example, Oman has put a ban on foreign recruitments in cleaning and construction sectors in October 2013, in addition to carrying out raids on illegal workers. Similarly, Bahrain has also become a less attractive destination for Pakistani workers due to

---

<sup>8</sup> Source: Migration and Remittances: Recent Development and Outlook; World Bank; April 2014.

<sup>9</sup> This data has been taken from the Bureau of Emigration and Overseas Employment (BEOE), Government of Pakistan. The number includes only those migrants, who are registered with the BEOE.

<sup>10</sup> There may be some Pakistanis returning to the country during this period, but their number would be insignificant.

political uncertainty and security concerns in the Kingdom. Kuwait, has been discouraging Pakistani workers by implementing a strict visa policy, while Saudi Arabia continues to implement a policy to indigenize its work force.

Pakistani workers in Saudi Arabia, which used to absorb the largest number of Pakistanis up until last year, declined sharply during Jul-Feb FY14 as per their indigenization policy (**Table 5.3**). Nevertheless, it is surprising that most of the remittance growth during Jul-Mar FY14 came from Saudi Arabia (**Table 5.4**). This can be explained by the regularization and documentation of Pakistanis as per the new labor rules – more specifically, this forced these workers to use banking channels to send money to their families.<sup>11</sup> Furthermore, higher remittances may also reflect money sent back by thousands of Pakistanis who have been deported, or are in the process of deportation.<sup>12</sup>

**Table 5.3: Number of Pakistanis Proceeded Abroad for Employment during Jul-Feb**

	Number		%Share		% growth in FY14
	FY13	FY14	FY13	FY14	
UAE	130,058	211,063	29.9	52.0	62.3
Bahrain	6,534	5,570	1.5	1.4	-14.8
Iraq	97	1,100	0.0	0.3	
Libya	2,851	2,782	0.7	0.7	-2.4
Oman	42,204	28,907	9.7	7.1	-31.5
Qatar	4,407	5,585	1.0	1.4	26.7
Saudi Arabia	243,805	143,616	56.1	35.4	-41.1
UK*	103	121	0.0	0.0	17.5
US*	100	212	0.0	0.1	112.0
Others	4,728	7,196	1.1	1.8	52.2
<b>Total</b>	<b>434,887</b>	<b>406,152</b>	<b>100.0</b>	<b>100.0</b>	<b>-6.6</b>

\*Number of workers proceeding to US and UK is grossly understated, because this data only shows migration of those Pakistanis who get registered with the Bureau of Emigration and Overseas Employment (BEOE), and are predominantly recruited through licensed overseas employment promoters (OEPs). The role of OEPs is most critical in case of Middle-East, from where formal demand letters come from foreign employers, with job requirements, and terms & conditions. On the contrary, workers who are recruited directly (on their own) by foreign firms, may choose not to get registered with the BEOE, which is mostly common in case of US and Europe.

Source: Bureau of Emigration and Overseas Employment

Remittance inflow from the UAE also remained strong – especially from Dubai. As mentioned earlier, the UAE remains an attractive destination for Pakistanis lately, both blue and white collar workers. Remittances from the US and UK also increased with the economic recovery in these countries.<sup>13</sup>

<sup>11</sup> According to most recent estimates, around 950,000 Pakistanis regularized their status as per the new rules. Furthermore, around 2,000 illegal workers also got registered during the campaign.

<sup>12</sup> According to Pakistan's Embassy in Saudi Arabia, a total of 59,000 Pakistani workers have already left the Kingdom since April 2013.

<sup>13</sup> Anecdotal evidence suggests a rise in the number of Pakistanis working in these countries as well, but reliable data is unavailable.

In addition to these factors, tight scrutiny of the global hundi network, and aggressive marketing of remittance products by commercial banks helped channelizing remittances via formal avenues. Small sized banks, microfinance institutions and Islamic banks are also entering the remittance business, and global money transfer organizations like Western Union have started participating in direct-to-bank transfers.<sup>14</sup> Furthermore, the government has cleared the backlog of Rs 10.5 billion during Jul-Apr FY14 that was due as a rebate to banks.<sup>15,16</sup>

**Table 5.4: Country wise Home Remittances in Jul-Mar**

	Amount in million US\$			YoY growth in percent		Contribution to growth (%age pt)	
	FY12	FY13	FY14	FY13	FY14	FY13	FY14
USA	1,724.4	1,636.7	1,820.9	-5.1	11.3	-0.90	1.78
U.K.	1,131.9	1,435.0	1,632.2	26.8	13.7	3.11	1.90
Saudi Arabia	2,655.4	2,979.3	3,391.3	12.2	13.8	3.33	3.98
UAE	2,140.9	2,085.9	2,288.9	-2.6	9.7	-0.56	1.96
of which Dubai	1,085.8	914.7	1,140.8	-15.8	24.7	-1.76	2.18
Other GCC	1,099.5	1,195.9	1,357.7	8.8	13.5	0.99	1.56
Bahrain	149.7	211.9	230.6	41.6	8.8	0.64	0.18
Kuwait	432.0	459.2	501.7	6.3	9.3	0.28	0.41
Qatar	235.8	238.9	246.1	1.3	3.0	0.03	0.07
Oman	282.0	285.9	379.3	1.4	32.7	0.04	0.90
EU Countries	273.5	269.0	318.9	-1.6	18.5	-0.05	0.48
Other	710.5	752.1	772.8	5.9	2.7	0.43	0.20
<b>Total</b>	<b>9,736.0</b>	<b>10,353.9</b>	<b>11,582.8</b>	<b>6.3</b>	<b>11.9</b>		

Source: State Bank of Pakistan

### 5.3 Capital account

The capital account showed a surplus of US\$ 1.7 billion in Jul-Mar FY14, compared to only US\$ 0.2 billion surplus in the same period last year. This abnormal development can be traced to the receipt of *capital* grant of US\$ 1.5 billion from a friendly country in two equal tranches during February and March 2014.<sup>17</sup> According to the latest conventions in presenting a country's BoP

<sup>14</sup> Direct-to-bank transfer is a facility as per which, the sender can directly credit money into the designated bank account in Pakistan.

<sup>15</sup> To encourage banks and exchange companies in their remittance mobilization efforts, the government of Pakistan partially reimburses the telegraphic transfer (TT) cost that these institutions bear in transferring money to Pakistan (25 Saudi Riyal for every US\$ 100).

<sup>16</sup> As a result of this, all outstanding claims related to reimbursement of TT charges up till June 2013, have been cleared.

<sup>17</sup> Grants are typically treated as transfer incomes, as no good, service or asset is provided in return from the counterparty. These transfer incomes are recorded in the secondary income account, which is a sub-component of the Current Account. However, the grant that Pakistan received from a

position, infrequent inflows are captured in the capital account, with normal debt and portfolio inflows being posted in the financial account (see below).

#### 5.4 Financial account

Financial account did not show much of an improvement during Jul-Mar FY14: foreign investments continued to remain low, and expected debt inflows did not materialize during the period.

##### Foreign investment

Net FDI posted a growth of 6.1 percent YoY in Jul-Mar FY14, compared to 5.3 percent in the same period last year. This improvement was more pronounced in the third quarter of FY14, in which there was a net FDI inflow of US\$ 250 million – nearly four times the inflow in Q3-FY13. However, this recovery came primarily from a decline in gross FDI *outflows* (disinvestments) in Q3-FY14, compared to Q3-FY13, as gross FDI *inflows* failed to recover (**Table 5.5**).<sup>18</sup>

**Table 5.5: Composition of FDI in Pakistan**

(million US\$)	Jul-Mar FY13	Jul-Mar FY14	Q3-FY13			Q3-FY14		
	Net FDI	Net FDI	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI
<b>Total</b>	<b>631.0</b>	<b>669.8</b>	<b>502.2</b>	<b>440.0</b>	<b>62.3</b>	<b>467.9</b>	<b>218.3</b>	<b>249.6</b>
Food	41.8	73.0	13.0	1.2	11.8	38.9	8.4	30.6
Tobacco	7.8	55.5	10.1	17.4	- 7.4	25.2	15.0	10.2
Chemicals	- 73.4	76.0	33.9	136.1	- 102.3	16.0	5.1	10.9
Oil & Gas	426.1	346.9	134.4	0.5	133.8	140.4	5.4	135.0
Power	39.3	28.7	44.4	22.9	21.5	57.9	32.2	25.7
Communications	- 313.7	- 132.5	59.4	186.5	- 127.0	47.2	69.1	- 21.9
o/w Telecom	- 331.6	- 138.4	51.4	180.9	- 129.6	39.9	59.6	- 19.7
Financial Business	225.7	118.7	103.3	17.3	86.0	59.4	19.8	39.5
Cement	6.1	15.4	2.1	0.1	2.0	7.0	2.0	5.0
Construction	29.4	16.0	5.8	0.7	5.1	8.4	1.9	6.5
Others	241.9	72.0	95.9	57.2	38.6	67.5	59.3	8.1

Source: State Bank of Pakistan

On a cumulative basis, gross FDI inflows declined by 11.2 percent in Jul-Mar FY14, over the same period last year. In fact, the current level of FDI is even smaller than profit repatriation on previous investments in the country.<sup>19</sup> This drying up of fresh inflows can be traced to: inadequate infrastructure; persistent

friendly country has been recorded in the Capital Account; this is because it is a long-term capital grant, which will be used to finance development projects in the country.

<sup>18</sup> Gross FDI outflows in Q3-FY13 were exceptionally large due to heavy debt repayment by Telenor to its parent company, and de-merger and sale of ICI Pakistan with Dutch-based AkzoNobel.

<sup>19</sup> Payments on existing direct investment in Pakistan (in the form of repatriation of profit and dividend) reached US\$ 2.1 billion in Jul-Mar FY14.

energy shortages, and a poor law and order situation. Furthermore, despite extensive policy deliberations, structural issues that impede the ease of doing business, governance and taxation are yet to be addressed.

Despite this, market sentiments regarding the outlook for foreign investment have turned positive after the improvement in the external outlook, and reports that China is planning to invest US\$ 32 billion in the country, under the China-Pakistan Economic Corridor program.<sup>20</sup>

#### FX loans and liabilities

Pakistan's FX liabilities posted an increase of US\$ 172 million during Q3-FY14, after recording net declines in the previous four quarters. However, due to heavy debt payments in the first two quarters by the government, the cumulative FX loans and liabilities showed a net decline in Jul-Mar FY14 (**Table 5.6**).

During Q3-FY14, most of the increase in FX loans was by commercial banks' borrowing from abroad to finance part of the country's current account deficit (**Section 5.5**). As for official loans, the government continued to post net retirements during the quarter – especially long-term loans. However, the government was able to mobilize short-term commercial loans of US\$ 248 million from a syndicate of foreign commercial banks.

**Table 5.6: Pakistan's FX Liabilities**

million US\$	Jul-Mar		Q3	
	FY13	FY14	FY13	FY14
<b>Net flow of FX liabilities</b>	<b>-395</b>	<b>-212</b>	<b>-252</b>	<b>172</b>
Central bank	-5	245	-3	0
Deposit-taking corporations	-339	174	-1	332
General government	157	-395	-172	-43
i. Disbursements	1,905	1,883	499	601
IMF loans	0	0	0	0
Other long-term	1,649	1,265	499	353
Short-term	256	618	0	248
ii. Amortization	1,748	2,278	671	644
IMF loans	226	660	136	240
Other long-term	1,131	1,618	405	404
Short-term	391	0	130	0
iii. Other liabilities (net)	0	0	0	0
Other sector	-208	-236	-76	-117

Source: State Bank of Pakistan

<sup>20</sup> The economic corridor is being developed as part of a strategic partnership between the governments of two countries. Announced in July 2013, this corridor will connect Gwadar Port to China's northwestern autonomous region of Xinjiang via highways, railways, and pipelines, to transport oil and gas. Special Economic Zones (SEZ) will be established in areas alongside the corridor that will target specific products and services based on availability of local raw materials and labor force. The BOI, in consultation with provincial governments and National Industrial Parks, is working to identify areas where SEZs can be established. So far 22 sites all over the country have been identified; one SEZ – based in Khairpur district, has been approved.

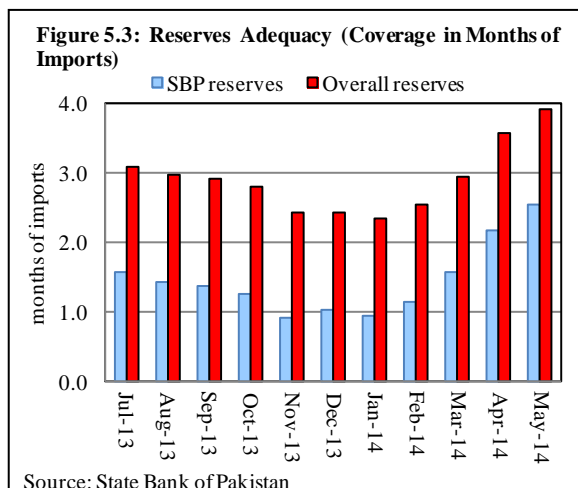


Going forward, Pakistan is expected to receive support from the IFIs to finance various projects in the country. In particular, the World Bank Group (WBG) has approved the Country Partnership Strategy (CPS) for Pakistan that covers the period FY15-19. This strategy envisages a financing program of about US\$ 11 billion over the CPS period. In addition to this, Pakistan has also received IDA loan of US\$ 1 billion in May 2014. Moreover, the Asian Development Bank (ADB) has also approved the Sustainable Energy Sector Reform Program of US\$ 400 million to initiate the government's long-term restructuring of the power sector to make it more sustainable (**Chapter 4**).

### 5.5 Reserves and exchange rate

Pressure on the country's FX reserves had started to ease in December 2013, as Pakistan had met lumpy repayments to the IMF, and repayments in remaining part of the year were to be offset by fresh disbursements.<sup>21,22</sup> During Q3-FY14, the country's FX reserves increased by US\$ 1.8 billion, compared to a decline of US\$ 1.6 billion in Q3-FY13. As mentioned before, this improvement was driven mainly by the receipt of a bilateral grant of US\$ 1.5 billion.

Within the banking system, SBP's reserves increased by US\$ 1.9 billion during the quarter, as the bilateral grant came directly to its reserves. SBP further shored up its FX reserves by purchasing hard currency directly from the interbank market. Because of these efforts, and after the receipt of Eurobond proceeds, the import



<sup>21</sup> Current account also recorded a surplus of US\$ 157 million in December 2013.

<sup>22</sup> After the country met bulky repayments to the IMF in November 2013, the external sector outlook improved considerably. This was evident in a 3.0 percent appreciation of the PKR in December 2013, after a cumulative depreciation of 8.2 percent in Jul-Nov FY14. This improvement, however, was not aligned with market's view on the direction of interest rates: banks continued to bid in 3m papers in the T-bill auctions held during the month. It was only when December inflation numbers came out (early January) – that showed a steep fall of 1.7 percentage points compared to the preceding month, the market expectations turned in favor of a rate cut. These expectations were reinforced by a stable PKR, and a surplus in the December's current account. A more pronounced shift in market expectations was seen in March 2014, when the country received a bilateral grant of US\$ 1.5 billion, and the PKR posted a sharp appreciation (discussed later in detail).

coverage of SBP's reserves rose to 2.5 months at end-May 2014, from only one month at end-December 2013 (**Figure 5.3**). Import coverage, in terms of overall reserves, increased to 3.9 months, from 2.4 months at end-December 2013. Commercial banks' reserves, posted a decline of US\$ 125 million during the quarter, which was mainly due to the use of FE-25 deposits to finance lumpy oil imports.<sup>23</sup>

In overall terms, the PKR posted an appreciation of 1.1 percent during Jul-Mar FY14, compared with a 4.0 percent depreciation in the same period last year. However, most of the gain in the PKR parity was recorded in Q3-FY14, when the PKR appreciated by 6.9 percent, which more than offset the depreciation of 5.4 percent in H1-FY14. In fact, most of this appreciation took place between 10<sup>th</sup> to 12<sup>th</sup> March 2014 (**Figure 5.4**).<sup>24</sup> Pakistan received the grant from a friendly country in two tranches of US\$ 750 million each: first during the 3<sup>rd</sup> week of February 2014, and the second in the 1<sup>st</sup> week of March 2014.

When the first tranche was received, the interbank market did not react, even after the impact on the country's FX reserves was made public on 27<sup>th</sup> February (**Figure 5.4**).<sup>25</sup> This was because the source of this inflow was not known, and the market attributed the increase in FX reserves to expected bilateral and multilateral inflows, and higher-than-expected remittances. However, when the second tranche was received (during the week ending 7<sup>th</sup> March 2014), the market responded almost with a sense of panic, even before the FX reserves data was made public.<sup>26</sup> We identify two reasons for this: First was the press statement by the Finance Minister on 10<sup>th</sup> March, disclosing the level of the country's FX reserves (inclusive of the second tranche), and the claim that FX reserves would reach US\$ 10.0 billion by end-March 2014.<sup>27</sup> Second was panic selling by exporters in the interbank – especially after some large exporters offloaded their FX holdings in bulk, in an anticipation that this would be followed up by a deferred oil payment facility from Saudi Arabia, which Pakistan was given in late 1998.

---

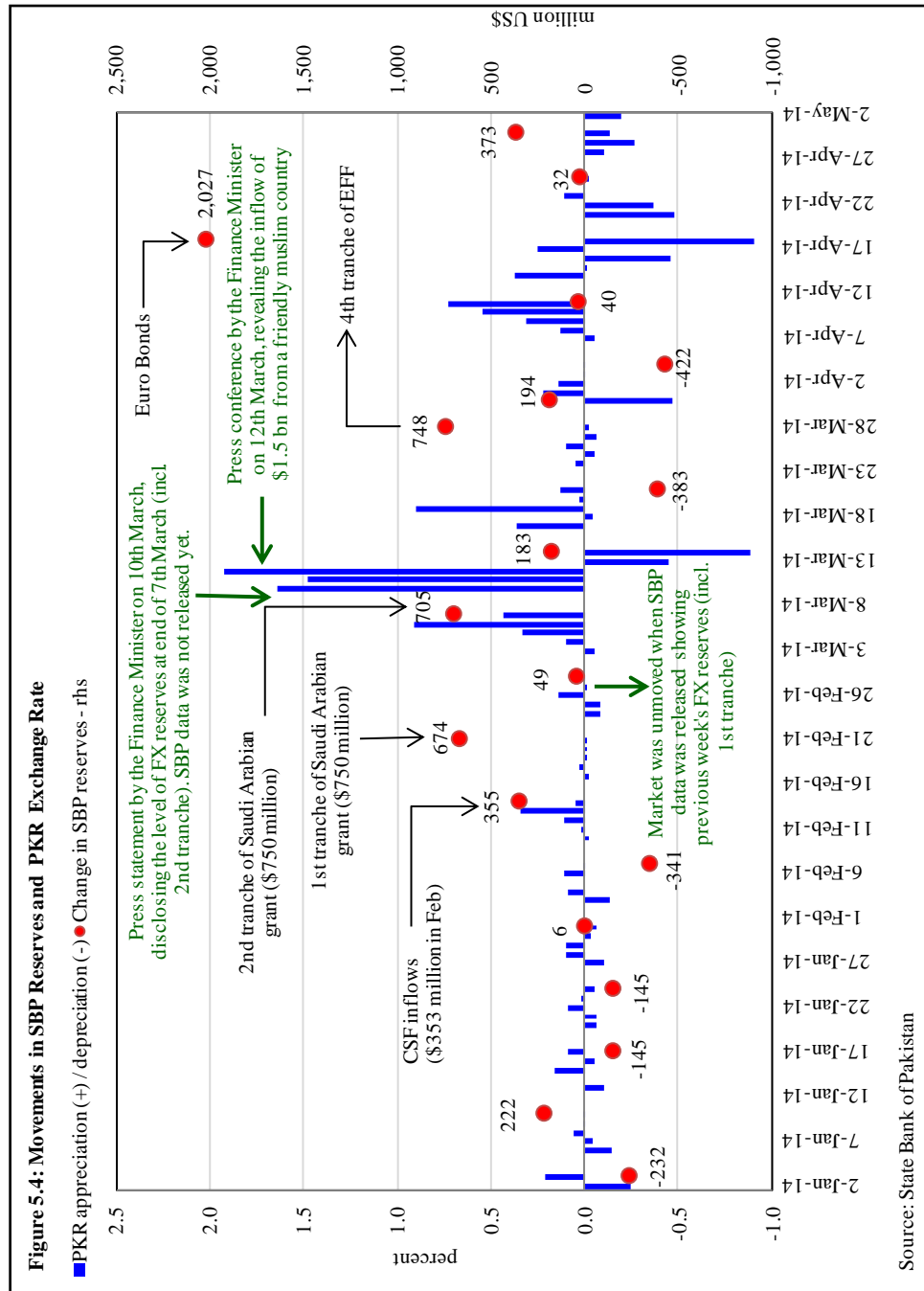
<sup>23</sup> Commercial banks' reserves are calculated as FE-25 deposits minus trade financing.

<sup>24</sup> The PKR gained 5.1 percent between 10<sup>th</sup> to 12<sup>th</sup> March 2014, followed by a correction of 1.0 percent during 13<sup>th</sup> to 18<sup>th</sup> March 2014.

<sup>25</sup> SBP releases end-week data on country's FX reserves on every subsequent Thursday.

<sup>26</sup> SBP released data on FX reserves (inclusive of the second tranche) on 13<sup>th</sup> March 2014.

<sup>27</sup> Two days later, on 12<sup>th</sup> March 2014, the Finance Minister specified that the country has received a total of US\$ 1.5 billion from a 'friendly Muslim country'.



In addition to the receipt of the grant and expectations of additional inflows, there were other factors that eased pressures in the interbank exchange rate during the quarter. These included:

Import financing from FE-25 deposits

As mentioned in the *Second Quarterly Report*, importers financed a part of their import bill via FX borrowings from commercial banks during H1-FY14.<sup>28</sup> This enabled importers to benefit from a wide interest rate differential between PKR and FX loans, amid an outlook of a stable exchange rate. In addition, financing of imports through FX loans deferred the pressure on the exchange rate till the maturity of these loans, which in most cases was 3 months. Some of the maturing loans were rolled over in Q3-FY14, especially those taken by oil marketing companies and oil refineries.<sup>29</sup> These companies were facing liquidity problems because of the re-emergence of circular debt.<sup>30</sup>

FX borrowings by commercial banks from abroad

Commercial banks arranged short-term FX funding of US\$ 332 million from abroad in Q3-FY14, to finance the current account gap. Of this, banks borrowed US\$ 242 million in the month of March 2014. Commercial banks' FX requirements from abroad were higher as SBP had started spot purchases of hard currency from the interbank market (see footnote 26).

Ban on import of gold

The government of Pakistan banned the import of gold under the duty-free scheme for January 2014; subsequently, it extended this ban to February 2014 as well. This was done to avoid the import of gold for onward smuggling to India, which had put curbs on gold import (**Figure 5.5**).

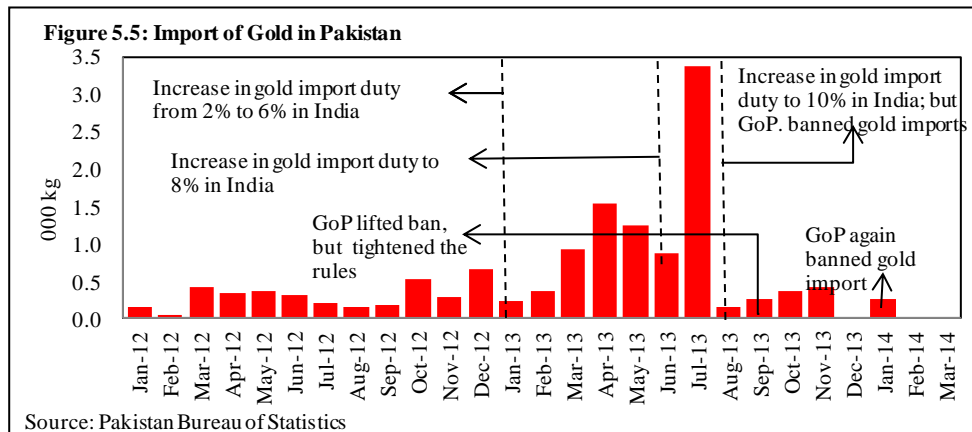
The above discussion clearly shows that the PKR rally during Q3-FY14 was heavily influenced by one-off inflows; the resulting improvement in market sentiments; and short-term arrangements to alleviate FX pressures. Hence, the appreciation of the PKR was abrupt, characterized by sharp inter-day and intra-day variations during the quarter. A further repercussion of this rally, was the increase in kerb market premium: from 13<sup>th</sup> March till end-April 2014, the kerb premium averaged around 1.7 PKR per US\$.

---

<sup>28</sup> Banks are allowed FX lending to importers and exporters, against foreign currency deposits (commonly known as FE-25 deposits) placed with them.

<sup>29</sup> There was an increase of only US\$ 155 million in the stock of import financing against the FE-25 deposits during Q3-FY14, compared to an increase of US\$ 449 million in the preceding quarter.

<sup>30</sup> Interest rate differential between PKR and FX loans rose to 8.1 percent on average in Q3-FY14, from 7.0 percent in the preceding quarter.



The increase in the kerb premium came from both demand and supply-side factors: since the bulk of PKR appreciation took place on 3 working days, there was a lack of confidence over the sustainability of exchange rate. Therefore, there was a rush to purchase cash Dollars from the kerb market, which put pressure on the exchange companies. These companies, on the other hand, started hoarding FX in anticipation of a reversal in the PKR parity; the perception of an FX shortage with exchange companies added to the sense of panic. In fact, the kerb market had become dysfunctional, as it was hard for the public to buy FX Dollars at designated rates.<sup>31</sup> Both SBP and government advised exchange companies and other market players to avoid unnecessary speculation.<sup>32</sup>

Given the fact that Pakistan has met lumpy repayments to the IMF, and also considering the expected FX inflows in Q4-FY14, we believe the current level of the exchange rate is sustainable in the short-to-medium term.<sup>33</sup> SBP's management of the FX market was driven by the twin goals to limit excessive volatility in the exchange rate and to gradually build FX reserves. The current level of SBP's reserves has surpassed the level seen at end-June 2013, therefore, the current PKR parity touching the level at the year start should not appear unusual.

<sup>31</sup> Anecdotal evidence has it that exchange companies would not sell at designated rates, but could be more obliging if the buyer was willing to offer a higher rate.

<sup>32</sup> As a result of these measures, as well as lumpy repayments from IFIs in late April and May 2014, the kerb market returned to calm and the premium dropped to 0.7 PKR per US\$ on average in May 2014.

<sup>33</sup> Pakistan has already received US\$ 400 million from the ADB and US\$ 1 billion from the World Bank in April and May 2014, respectively.

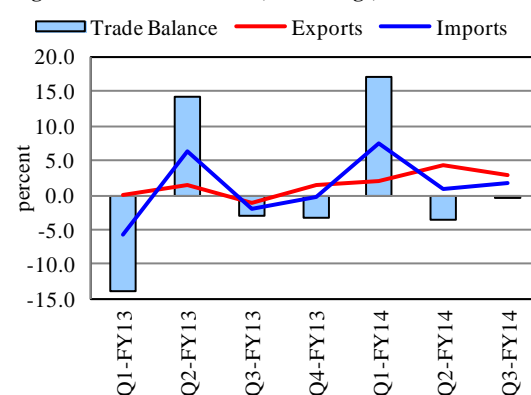
## 5.6 Foreign trade

Pakistan's trade deficit was US\$12.0 billion during Jul-Mar FY14, showing an increase of 3.8 percent over the corresponding period last year. In fact, much of this deficit was realized during the first quarter of the year, when imports increased sharply (**Figure 5.6**). Key items that led to higher growth in imports, were POL (after the settlement of power sector circular debt), machinery for telecom and power generation; fertilizer and metal. On the other hand, exports also showed some recovery during Jul-Mar, FY14, which can be attributed to: the GSP plus status that helped textile and leather exports; higher exports of petroleum products as oil refineries increased production; and rice exports from an above target crop.<sup>34</sup>

### Exports

Exports grew by 3.0 percent reaching US\$ 18.9 billion during Jul-Mar FY14, compared to US\$ 18.3 billion in the same period last year. As usual, more than half came from the textile sector, which showed a YoY growth of 6.3 percent during this period.<sup>35</sup>

**Figure 5.6: Trade Account (YoY change)**



Source: State Bank of Pakistan

**Table 5.7: Textiles Exports (Jul-Mar)**

	Export value million US\$		Cont. to textiles export growth (%)	
	FY13	FY14	FY13	FY14
Cotton	161.2	191.5	-3.0	0.3
Yarn	1553.1	1612.0	3.1	0.6
Cotton cloth	1944.4	2051.1	0.0	1.1
Other textile materials	526.6	494.6	0.5	-0.3
Synthetic textile	324.4	321.3	-1.8	0.0
Knitwear	1527.7	1634.9	-2.7	1.1
Bed wear	1375.4	1530.1	-0.7	1.6
Towels	518.9	541.3	0.2	0.2
Readymade garments	1241.3	1351.5	1.9	1.1
Other textiles	409.8	462.7	0.4	0.6
<b>Textiles total</b>	<b>9582.8</b>	<b>10191.0</b>	<b>-2.1</b>	<b>6.3</b>

Source: State Bank of Pakistan

<sup>34</sup> Rice production recorded 6.8 million MT against a target of 6.2 million MT.

<sup>35</sup> The textile export growth was negative and overall exports showed zero growth during the same period last year.

### Textile exports

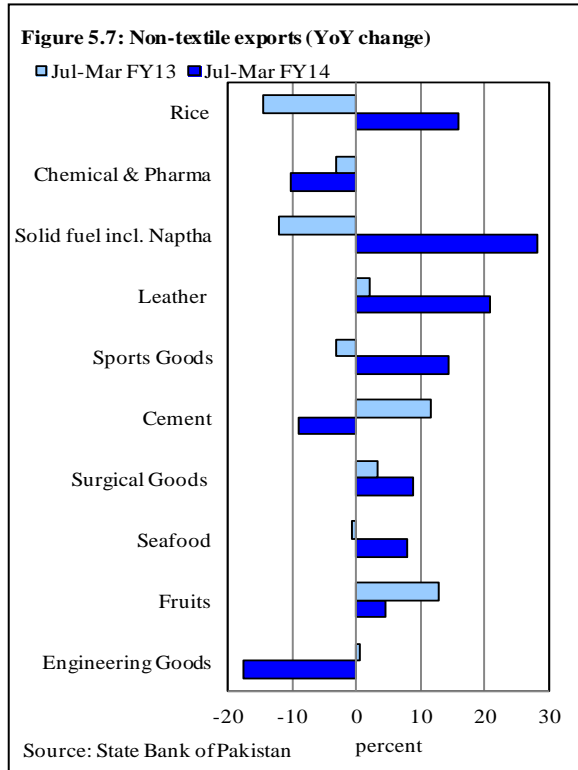
The growth in textile exports can entirely be attributed to higher export quantum, as the price impact remained negligible. During the first nine months of FY14, Pakistan exported higher volume of yarn, cotton fabrics, knitwear, bed-wear and readymade garments. Improvement in energy supply and opportunities from *GSP Plus* enabled the textile sector to increase production and its export business.

Although *GSP plus* is not restricted to textiles, Pakistani textiles are better placed to benefit from this facility, due to its established infrastructure, expertise in global trade, and specialized manpower. Nevertheless,

these benefits can only be realized fully if the sector gets adequate supply of energy and other raw materials – especially cotton. However, there is also a risk to the sector, as safeguard measures introduced by the EU, do not leave much room for our existing export base, which is highly concentrated in terms of commodities.<sup>36</sup> Thus, Pakistan needs to focus on diversification of its exports to maximize the benefits from *GSP plus* status in the medium to long-run.

### Non-textile exports

In case of non-textiles, while exports of rice, leather, sports goods, seafood, and POL products increased; cement, engineering goods, chemicals and pharmaceutical exports declined during this period (**Figure 5.7**). Key sectors that figured prominently in the trade sector (other than textile) are as follows:



<sup>36</sup> EU has put limit on the import volume of a single item, that is: it should not exceed 6 percent of total EU's GSP imports of that commodity. Previously the restriction was placed on overall sector.

- a) Rice – the second largest export after textiles – showed strong growth of 15.9 percent during Jul-Mar FY14, in contrast to a 14.5 percent decline in the same period last year. Both quantum and price contributed to this increase in export proceeds.
- b) Exports of *fish and fish preparation* increased by 8.0 percent, reaching US\$ 254 million during Jul-Mar FY14. The rising trend in seafood exports can be traced to: (1) the resumption of shipments to EU countries; (2) increased exports to the Chinese market; and (3) higher foreign sales of frozen fish and crustaceans like shrimp and lobsters.<sup>37</sup>
- c) Petroleum products (including naphtha) contributed 25 percent of the total export growth during Jul-Mar FY14.<sup>38</sup> While Pakistan's export of naphtha has been increasing continuously since the early 2000s, FY14 has witnessed an unprecedented volume of exports, as oil refineries increased capacity utilization using the more comfortable liquidity position after the settlement of the circular debt during the first quarter of the year.<sup>39</sup>

The major markets for Pakistani naphtha are China, India, Japan, Korea and the UAE. Going forward, higher global demand for paraxylene, which uses naphtha as an input, may provide an opportunity for Pakistan to increase its share in global trade of this commodity.

- d) Leather, a traditional export for Pakistan, recorded a 17.2 percent YoY growth during Jul-Mar FY14, compared with a 4.2 percent increase in the same period last year. According to the Leather Manufacturers Association of Pakistan, the country's share in the world leather exports is only 2 percent, and can be increased further through concerted efforts to resolve long standing issues like the disruption in energy supplies, unskilled labor force and obsolete machinery.
- e) *Cement* exports lost the momentum of last two years and posted a decline of 9.0 percent during Jul-Mar FY14, due to lower quantum and export price. While, cement production also came under pressure due to increased cost of production, exports to Afghanistan also slowed down due to increasing competition from Iran.

---

<sup>37</sup> In FY13, about one-third of total seafood export earning originated from China and Vietnam.

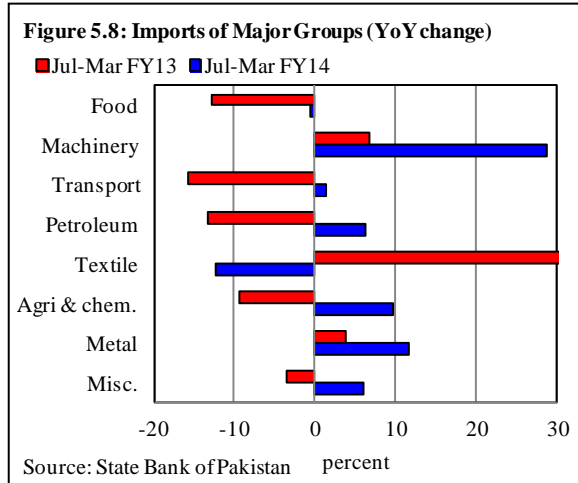
<sup>38</sup> Naphtha, a by-product of oil refining process, is further refined for making high-octane fuels and chemicals used in plastic and man-made fibre industries.

<sup>39</sup> LSM data released by Pakistan Bureau of Statistics shows that petroleum production is up by 8.6 percent during Jul-Feb FY14 compared with the same period last year.



**Import payments**

Total imports increased by 3.4 percent during Jul-Mar FY14, compared with a 0.6 percent decline during the same period last year. As mentioned earlier, this increase in imports was mainly driven by higher demand for machinery, petroleum, fertilizer, and metals (**Figure 5.8**). The rise in the import bill was largely the result of higher quantities, as the price impact was negative.



*Machinery imports* recorded a YoY growth of 28.7 percent during Jul-Mar FY14, which bodes well for the LSM sector in Pakistan. The highest contribution to machinery imports came from the construction sector followed by telecom, textiles and power generation.

The import of petroleum products increased by 6.3 during this period, which was entirely due to higher quantities, as the unit value declined during Jul-Mar FY14. This increase was largely driven by higher demand for furnace oil, thinner for paints, lubricating oil and motor spirit oil. We believe this can be traced to more frequent shutdown in CNG supply to the transport sector.

Despite higher domestic production of fertilizer,<sup>40</sup> its imports increased by 20.2 percent during Jul-Mar FY14. This rise is the result of the Government's decision to import 0.5 million tons of urea for *Rabi* 2013-14. The current pace of fertilizer imports is likely to continue with the planned import of 0.35 million tons of urea for the *kharif* season.

<sup>40</sup> The industry sources said that main fertilizer plants were operating at about 90 per cent capacity during this period.