# 5 External Sector

## 5.1 Overview

The concerns on Pakistan's external sector, which remained muted throughout the second half of FY14, re-emerged with the start of FY15. The sharp increase in the country's current account deficit compared to preceding quarters, and the absence of financial inflows, put strain on Pakistan's balance of payments in Q1-FY15 (**Table 5.1**). Although the country received the 3rd tranche from the IMF in early July, delays in the 4th review of the program caused uncertainty in the FX market. That said, neither this uncertainty, nor the overall external pressures, was as severe in Q1-FY15, as it was in the same period last year.[1]

**Table 5.1: Summary of Pakistan's External Sector**
million US$; PKR trend in percent

| | Q1-FY14 | Q2-FY14 | Q3-FY14 | Q4-FY14 | Q1-FY15 |
|---|---|---|---|---|---|
| SBP liquid reserves (change) | -1,315 | -1,214 | 1,885 | 3,731 | -154 |
| Total FX reserves (change) | -1,203 | -1,504 | 1,761 | 4,065 | -630 |
| PKR depreciation(-)/appreciation(+) | -6.0 | 0.7 | 6.9 | -0.3 | -3.7 |
| Current account balance | -1,268 | -647 | -678 | -378 | -1,647 |
| Trade balance | -4,301 | -4,213 | -3,883 | -4,130 | -6,022 |
| Exports | 6,275 | 6,257 | 6,282 | 6,348 | 5,960 |
| Imports | 10,576 | 10,470 | 10,165 | 10,478 | 11,982 |
| Services balance | -894 | -603 | -619 | -521 | -505 |
| CSF | 0 | 322 | 353 | 375 | 735 |
| Worker remittances | 3,927 | 3,863 | 3,793 | 4,249 | 4,695 |
| FDI in Pakistan | 231 | 189 | 255 | 956 | 169 |
| Portfolio investment in Pakistan | 108 | -23 | 19 | 2,642 | 141 |
| External loans (net flows) | -289 | -210 | 77 | 1,450 | 218 |
| External debt servicing (gross) | 1,809 | 2,325 | 1,250 | 1,612 | 1,459 |

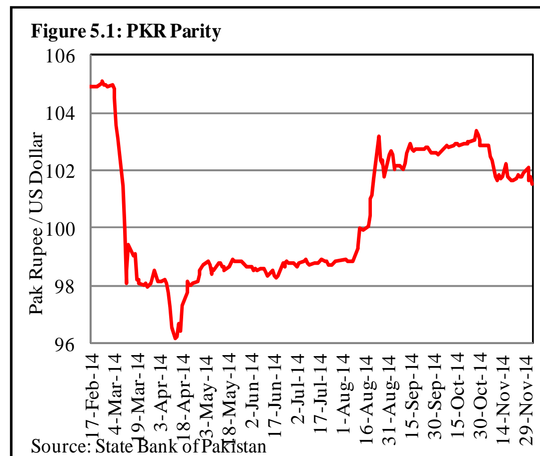
Source: State Bank of Pakistan

The fall in global commodity prices, was felt heavily on the country's exports; its impact on imports was diluted by a rise in the demand for imported steel and fertilizer; higher import of vegetables due to flood-related losses; and outlays on network up-gradation of telecom and data processing sectors (**Section 5.4**). As a result, trade deficit widened sharply during the period. Home remittances grew strongly, but these could finance only 80 percent of the trade deficit during the quarter. Therefore, the current account deficit increased by 11.4 percent YoY; in

[1] The first quarter of FY14 was quite challenging, mainly due to lumpy debt servicing to the IMF (which remained in place till end-November 2014).

the absence of financial flows, this had to be financed by drawing down the country's FX reserves.
The political environment was not helpful either. Since mid-August, protests in Islamabad made importers cautious about the PKR, and they opted to close their positions at a faster rate. This uncertainty created pressure in the FX market, and the PKR touched Rs 102.8 per US Dollar on 25th September – the first time after 7th March, and stabilized at 100.6 by the end of December (**Figure 5.1**).

**Figure 5.1: PKR Parity**



Source: State Bank of Pakistan

Going forward, we expect the external position to improve much more than initially projected. First, discussions with the IMF over the fourth and fifth reviews of the EFF program have successfully been concluded. According to the press release, the Fund "was encouraged by the overall progress in strengthening the macroeconomic stability and output growth.[2]" Pakistan has already received a combined tranche of US$ 1.1 billion in December 2014. Furthermore, the government has been able to mobilize US$ 1.0 billion from the international market, via Sukuk issuance in November. In addition to these, the government is expecting inflows from other sources, including: (i) around US$ 1 billion from the divestment of ABL and HBL; (ii) US$ 1.9 billion from the World Bank (budgeted); and (iii) US$ 1 billion from the ADB (budgeted).

However, a more comforting development from the sustainability perspective, is the recovery in exports in October 2014, along with healthy FDI inflows.[3] Imports have also shown higher growth, as local manufacturers benefited from currently low international prices of raw-materials. Moving ahead, the trend in commodity prices (especially oil) would determine where the current account balance would close at the year-end. Oil prices (Saudi Arabian Light) has already come down to only US$ 67.1/ barrel (4-year low) by end-November, and the expectations are

[2] Source: http://www.imf.org/external/np/sec/pr/2014/pr14505.htm
[3] During the month of October, exports have increased by 0.9 percent, as per the payments records; and by 5.0 percent, as per the customs records. FDI inflows increased from US$ 57 million in October 2013, to US$ 254 million in October 2014.

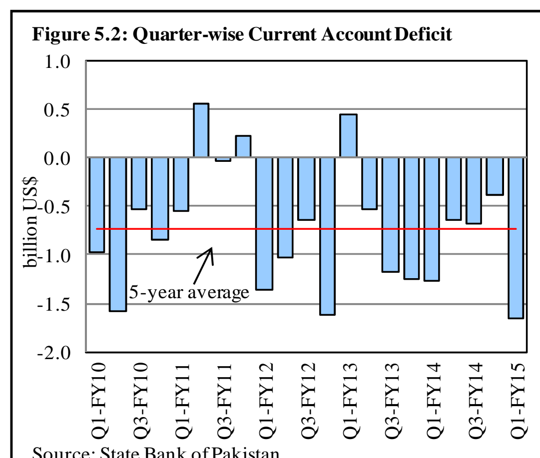
that these may not see a significant recovery throughout 2015.[4] Therefore, the biggest chunk in our import bill has become less of a concern, for this year.

In addition, food supplies in the domestic market seem to have improved, which should reduce their imports.[5] As far as other imports are concerned, most of the growth so far has come from machinery, chemicals and other inputs – items that directly support industrial activity.[6] Even if imports of these items continue to grow, it will be good for future growth. Our major concern remains the need to increase exports, and have the remaining trade deficit (or most of it) financed via FDI inflows and remittances. Until or unless we are able to finance the country's *strategic* import requirements via a sustainable increase in these inflows, our dependence on erratic external funding would remain high. This dependence alone is sufficient to make our growth vulnerable.

## 5.2 Current Account

The current account deficit stood at US$ 1.4 billion in Q1-FY15, which is 11.4 percent higher than Q1-FY14, and represents 50 percent of the full-year target set by the government.[7] Compared to the preceding three quarters, and the average in the past 5 years, the size of this deficit is a major concern (**Figure 5.2**).

**Figure 5.2: Quarter-wise Current Account Deficit**




Source: State Bank of Pakistan

[4] Key investment banks have slashed their forecasts for oil prices. Morgan Stanely has reduced its baseline prices to US$ 70 and US$ 88 for 2015 and 2016, respectively. Similarly, Goldman Sachs has also cut oil forecast for Brent and WTI crude to US$ 85 and US$ 75 per barrel during the first quarter of 2015 (Source: http://www.reuters.com/article/2014/12/08/us-markets-oil-idUSKBN0JM03P20141208 and http://www.bloomberg.com/news/2014-10-27/goldman-cuts-brent-wti-forecast-as-production-to-outpace-demand.html

[5] This view gets some support from a decline in food inflation to only 4.4 percent and 1.1 percent YoY, in the months of October and November, respectively, from 5.8 percent YoY in Jul-Sep 2014.

[6] 85 percent of Pakistan's imports are comprised of raw-materials and capital goods (Source: http://pbs.gov.pk/sites/default/files/tables/14.5.pdf).

[7] The government has set the target for current account deficit at US$ 2.8 billion in the Annual Plan for 2014-15.

***Record high trade deficit amidst depressed oil prices***

Pakistan's trade deficit reached an unprecedented level of US$ 6.0 billion during Q1-FY15. Imports were even higher than the peak seen in Jul-Sep 2008, when global commodity prices were at record highs (**Figure 5.3**). On the other hand, export receipts declined by 4.7 percent YoY, mainly because Pakistan fetched lower prices for its value-added products. Furthermore, saturation of the textile input market in China, and weaker activity in Bangladesh's garment industry, were also responsible for low exports of textile raw-materials like yarn and grey fabric from Pakistan (**Section 5.4**).

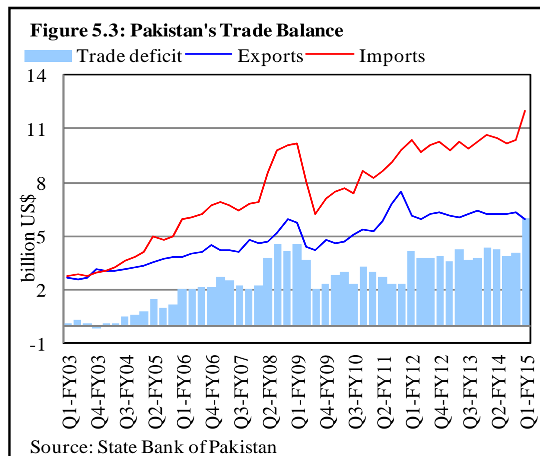


**Figure 5.3: Pakistan's Trade Balance**
Source: State Bank of Pakistan

A part of the divergence in export and import trends, can also be traced to developments in the global commodity market: prices of Pakistan's major exports (cotton and rice) declined *more* than the price of major imports (crude oil and some industrial metals) (**Figure 5.4**). Prices of other key import items like palm oil increased in the international market. Furthermore, the PKR's appreciation in Q4-FY14 also appears to have played a role in explaining the trade deficit (**Section 5.4**). Exporters, in particular, attribute declining orders to higher dollar prices they quoted to international buyers.

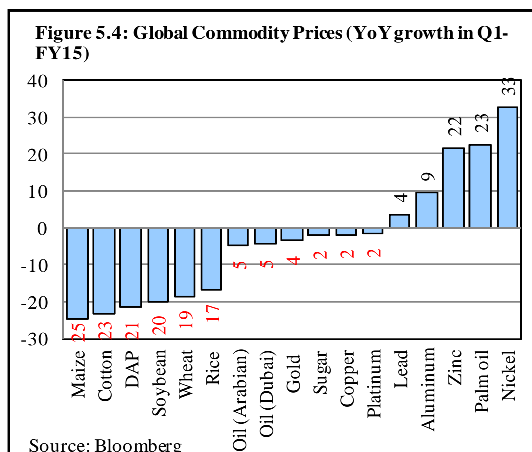


**Figure 5.4: Global Commodity Prices (YoY growth in Q1-FY15)**
Source: Bloomberg

The rise in trade deficit was largely offset by strong growth in home remittances, and an inflow of US$ 735 million under the coalition support fund (CSF), which helped reduce the services deficit. It is important to recall here that in Q1-FY14,

inflows under the CSF were delayed, which added to the pressures in the FX market.

**Home remittances**

Home remittances grew by 19.5 percent YoY during Q1-FY15. In our view, the strong growth reflects the *combined* seasonal impact of both Eid(s) during the quarter.[8] July and September witnessed strong remittance growth of 17.4 percent and 33.8 percent, respectively. However, it must be noted that during August and October, when there were no seasonal inflows, remittances still grew quite modestly.[9] Furthermore, flood-affected areas are likely to have received more remittances this year.

Most of the increase came from the GCC countries, especially the UAE and Saudi Arabia. In addition to seasonal inflows, remittances remained strong because of the vibrant non-oil sector in this region. According to the IMF, the GCC is expected to post 4.4 percent growth during the year 2014, on the back of non-oil sector – mainly infrastructure.[10]

Efforts continue to promote the use of formal channels in remittance transfer. Besides banks, microfinance institutions (MFIs) are now also being tied up with global money transfer organizations. Since MFIs are more agile and responsive to the need of customers, their inclusion would improve the remittance delivery mechanism. Bangladeshi experience highlights the importance of these institutions in efficient remittance delivery.

An important measure taken under the Pakistan Remittance Initiative (PRI) has been the mandatory opening of bank accounts by departing workers via simplified procedure. These accounts are treated separately from conventional bank accounts, and inward and outward funds movement is being monitored, which should help the authorities identify *problem* regions, from where the remittances originate.[11] Having a bank account would also address the negative perception of migrants and their families about the financial sector, which is one of the major reasons behind the use of informal avenues to send money (**Box 5.1**).

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[8] Eid-ul-Fitr was celebrated during the 3rd week of July, whereas, Eid-ul-Azha was celebrated during the first week of October. Expatriates send money to their families few days before the festival, therefore, the seasonal impact of Eid-ul-Azha on remittances was also felt during the first quarter.

[9] In August and October, remittances grew by only 7.1 percent and 2.6 percent, respectively

[10] Source: http://www.imf.org/external/pubs/ft/reo/2014/mcd/eng/pdf/c1c2.pdf

[11] For instance, if fund inflows from a particular region are consistently low, this might be taken as an indication that an alternative arrangement is available there for sending money. The PRI would then be able to highlight this issue with the concerned authorities in those regions.

**Box 2.1: Why Household prefers Informal Sources for Remittances**

Amjad et al (2013) analyzed the reasons behind workers sending remittances via informal channels, using micro-data from two household surveys. First was the Household Survey of Overseas Migrants and Remittances (2009), which comprised a small sample of 548 households from randomly selected nine districts of the country; each household had a member employed in Saudi Arabia. The second data set comprised of a panel survey conducted by Pakistan Institute of Development Economics (2010), which was conducted in 16 districts covering 4,000 households. Although dated, but the insights provided in these surveys are valuable:

- The use of banking channel is quite low: 43 percent in case of urban families, and only 33 percent in the case of rural families. Thus, more than half of the households even in the urban centers also receive money via non-bank channels. Survey suggested that migrants and their families appear *hesitant* to use the banking channel, compared to informal channels where money is delivered at the doorstep;
- Nearly one-fourth of the rural sample complained of longer time required to collect money from the nearest bank; whereas, urban households cited high transaction cost as major reason for not using banking channels;
- In the GCC countries, workers usually live in groups and have an informal group leader, who manages the transfer of money through informal sources; or through a mutual friend visiting Pakistan;
- There is no linear relationship between migrants' level of education, and their use of banking channels to transfer money;
- Longer stays abroad appear to enable workers to find informal channels to send money to Pakistan.

Source: Rashid Amjad, G.M. Arif, and M. Irfan, "How to Increase Formal Inflows of Remittances: An Analysis of the Remittance Market in Pakistan" February 2013, Joint publication of the Graduate Institute of Development Studies (Lahore School of Economics), International Growth Center (IGC) and the Pakistan Institute of Development Economics (PIDE).

PRI is carefully monitoring FX inflows into remittance-rich areas of Pakistan, and is working closely with law enforcement agencies to curb illegal FX handling. However, there is a need to strengthen controls over cross-border smuggling of hard currency, in order to break the ultimate operating cycle of informal remittances. Border forces as well as law enforcement agencies in the country, should make sure that SBP's FX regulations are strictly complied with.

<u>Why Pakistanis send less than other Asians Countries:</u> In SBP's *Annual Report FY14*, we analyzed the performance of Pakistan viz-a-viz the other large remittance recipient countries, and observed that on average, Pakistani migrants send less than others (**Figure 5.5**).

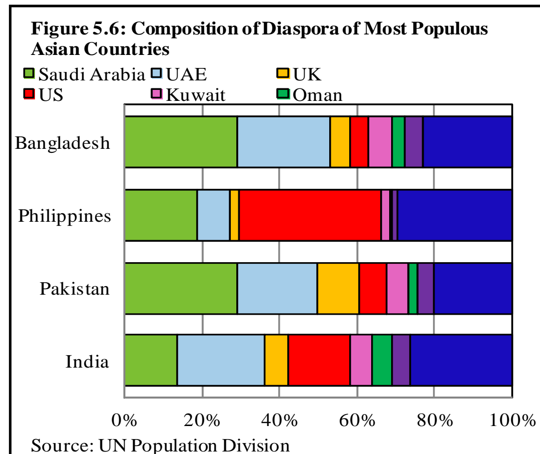



**Figure 5.6: Composition of Diaspora of Most Populous Asian Countries**

Source: UN Population Division

This section will attempt to explain the reasons behind this trend. At first, there could be multiple factors contributing to this trend including: (i) difference in geographical concentration of their migrants; (ii) the skill-set of migrating workers, and nature of jobs; (iii) status of migrant workers (legal/illegal, temporary/permanent, etc.); and (iv) quality of financial regulations in source countries, where most migrants are concentrated. As shown in **Figure 5.6**, most workers from Pakistan, India, Bangladesh and Philippines, find jobs in the US, UK and GCC countries – especially, Saudi Arabia. While most Pakistani and Bangladeshi labor work in the Gulf, Filipino workers prefer the US. Indian workers appear evenly distributed across these destinations.

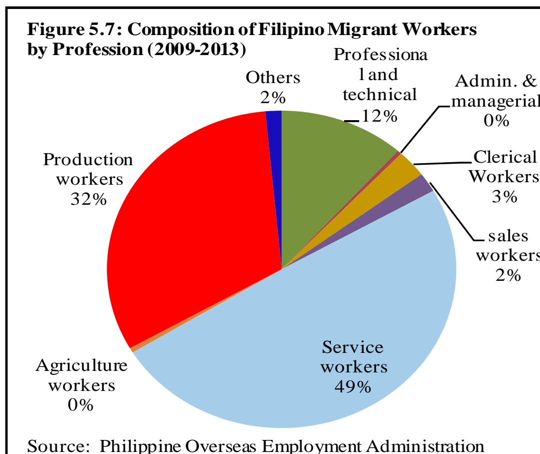
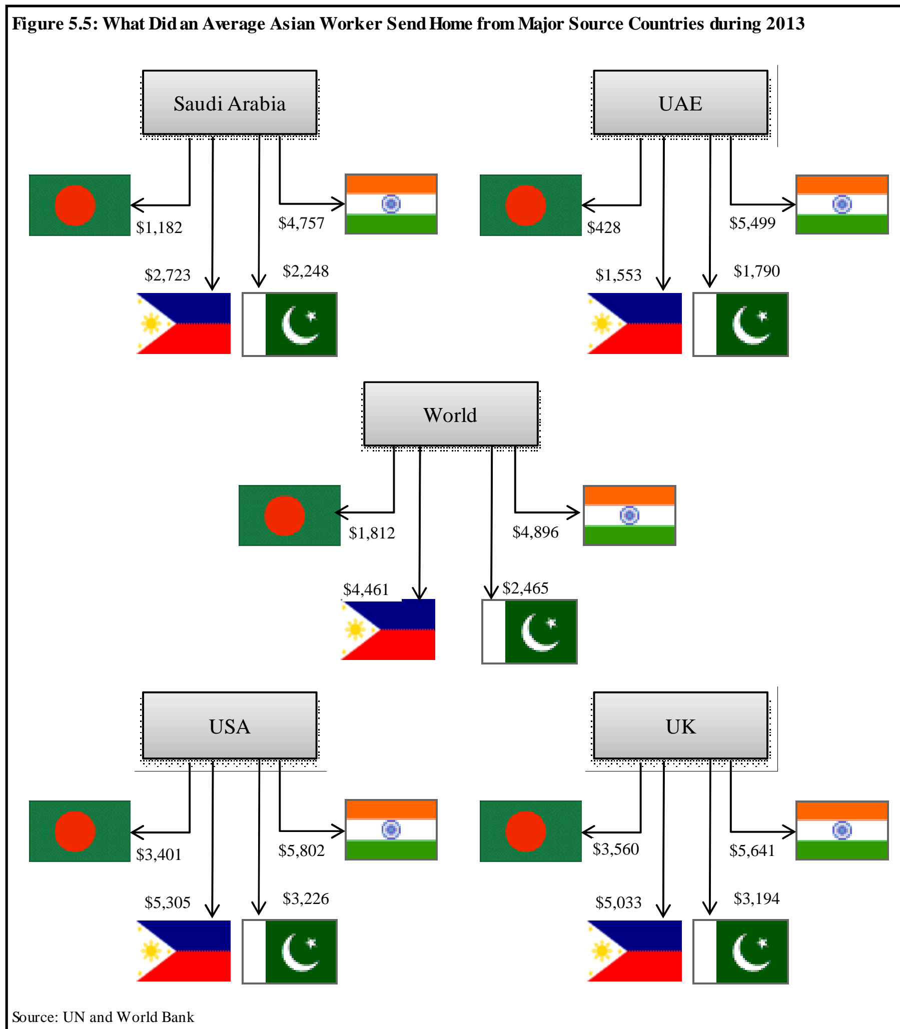



**Figure 5.7: Composition of Filipino Migrant Workers by Profession (2009-2013)**

Source: Philippine Overseas Employment Administration

It should be noted here that compared to the Philippines, there exists a huge difference with Pakistan in terms of the nature of migrant workers. Nearly half of the overseas Filipino workers are females, who work in services– mainly household help in the US, European and Asian countries (**Figure 5.7**). Certainly, this is not comparable to Pakistan, as our working migrant population predominantly comprises men, working mostly in construction, manufacturing and other professional sectors. However, in the case of Saudi Arabia, where Pakistanis

**Figure 5.5: What Did an Average Asian Worker Send Home from Major Source Countries during 2013**




Source: UN and World Bank

and Filipinos have a similar work profile, we do not observe much of a difference in remittance per migrant.

***From the US and UK***, an average Pakistani sends less than Indians and Filipinos, probably due to lower income. More specifically, the median annual income of a Pakistani household in the US was about $ 60,000, versus $89,000 for an Indian

household, and $74,000 for a Filipino household (**Table 5.2**).[12] This difference is primarily due to higher level of education in Indian and Filipino diasporas, compared to Pakistanis. As a result, nearly 32 percent of Pakistani migrants work in managerial or professional occupation in the US, against 50 percent and 35 percent of Indians and Filipinos. In the UK also, the Indian diaspora is known to be the highest earning group, and is involved in a wide range of businesses like steel, engineering, finance, retail, IT, hotels, pharmaceuticals, and media.[13]

**Table 5.2: Characteristics of the Asian Diaspora in the United States, 2009-13**

| | **Total US population** | **Pakistani diaspora** | **Indian diaspora** | **Bangladeshi diaspora** | **Filipino diaspora** |
|---|---|---|---|---|---|
| **Household (hh) Income** | | | | | |
| Median household income | $50,000 | $60,000 | $89,000 | $54,000 | $74,000 |
| Share of hh with high incomes ($90,000+) | 25% | 33% | 50% | 32% | 40% |
| Share of hh with very high incomes ($140,000+) | 10% | 18% | 27% | 15% | 18% |
| **Employment (total population age 16 and older)** | | | | | |
| *that was employed* | 91% | 90% | 94% | 93% | 92% |
| *that was in a professional occupation* | 31% | 32% | 50% | 31% | 35% |
| **Educational attainment (for population age 25 and older)** | | | | | |
| *with high school and some college education* | 57% | 34% | 16% | 35% | 43% |
| *with a bachelor's degree* | 20% | 33% | 35% | 28% | 43% |
| *with an advanced degree* | 11% | 23% | 44% | 25% | 9% |

Source: Migration Policy Institute, US

As far as Bangladeshis are concerned, although estimates suggest they earn less compared to Pakistanis in the US, they send back more remittances. While there could exist a difference between living standards of these two communities, it also appears that Pakistanis send more via informal channels. The starkest difference between Bangladesh and Pakistan lies at the remittance delivery stage – the presence of microfinance institutions (MFIs). In Bangladesh, MFIs enjoy an extensive outreach, both in terms of geographical presence as well as membership base, which enables the country to provide money transfer services to clients in the remotest areas. Since 2004, key MFIs like BRAC, BURO Bangladesh and TMSS, have been providing remittance delivery services in Bangladesh.[14]

[12] Migration Policy Institute is an independent think tank in Washington DC, which is dedicated to analysis of movement of the people worldwide.
[13] Nearly two-third of software professionals entering in the UK, are from India.
[14] Currently about 50,000 transfer transactions are made per month by BRAC Bank alone (source: http://www.bwtp.org/MF_Industry_Report_Bangladesh_ELECTRONIC.pdf).

Although MFIs in Pakistan are gaining ground in rural areas, their network and size is quite limited as compared to that in Bangladesh.

***In the case of GCC***, average remittance from Pakistanis is more or less similar to what Filipinos and Bangladeshis send home. However, a huge difference exists between Pakistanis and Indians. From Saudi Arabia, this difference is more surprising, since labor dynamics are quite similar: the share of professionals in both the Indian and Pakistani diasporas is quite small compared to labor and technicians. Secondly, if many Pakistanis do not have a legal status in the Kingdom, then many Indians are also working without legal sponsors, or have overstayed. In our view, the major difference lies in the incentives provided by governments in these two countries to use official channels to remit money.[15] It must be noted that non-resident Indians (NRIs) send nearly 44 percent of remittances via special rupee accounts, including, non-resident (external) rupee accounts (NRER), and non-resident ordinary rupee account (NRO).[16] These deposits (over the years) have provided an arbitrage opportunity for NRIs: the offered interest rates were generally higher than the foreign currency rates prevailing in the source countries, which in the presence of a stable (Indian) rupee, incentivized NRIs to even borrow from abroad, and invest in non-resident deposits in India.[17] In fact, when India and other Asian countries suffered massive capital outflows in mid-2013, the Reserve Bank of India (RBI) used this window to attract more FX inflows into the country.

Compared to Saudi Arabia, NRIs in the UAE have a better economic profile: nearly a quarter of NRIs working in the UAE are professionals, and are well-paid for their expertise and competence.[18] According to the Ministry of External Affairs, in addition to a large number of professionals like doctors, engineers, architects, bankers and chartered accountants, Indian white collar workers are now

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[15] For instance, according to the Ministry of External Affairs, NRIs in Saudi Arabia were the major contributors in Resurgent India Bonds and India Millennium Deposits, which were issued by the RBI back in 1998 and 2000, respectively to attract FX inflows.

[16] Only NRIs can invest in NRERs, whereas non-resident from any other country can invest in NROs.

[17] The Reserve Bank of India has acknowledged the presence of arbitrage opportunity in these deposits. In its Report of the Internal Group on External Liabilities of Scheduled Commercial Banks, released in May 2014, the RBI mentioned that "….the positive interest rate differential coupled with appreciating currency prompted large NRI inflows into Rupee accounts till the cap on interest rate was placed after which such inflows slowed down due to the reduced arbitrage opportunity". The complete report is available at: http://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=383#5

[18] http://indiandiaspora.nic.in/diasporapdf/part1-ord.pdf;

also working in government offices and public sector enterprises in the GCC.[19] As far as Pakistanis are concerned, although there has been an improvement in the skill-set of Pakistani workers lately, unskilled labor finds work more easily in the Emirates.

### 5.3 Capital and Financial Account

Activity in Pakistan's capital and financial accounts remained dull during Q1-FY15, after bulky transactions in the preceding quarter.

Foreign investments

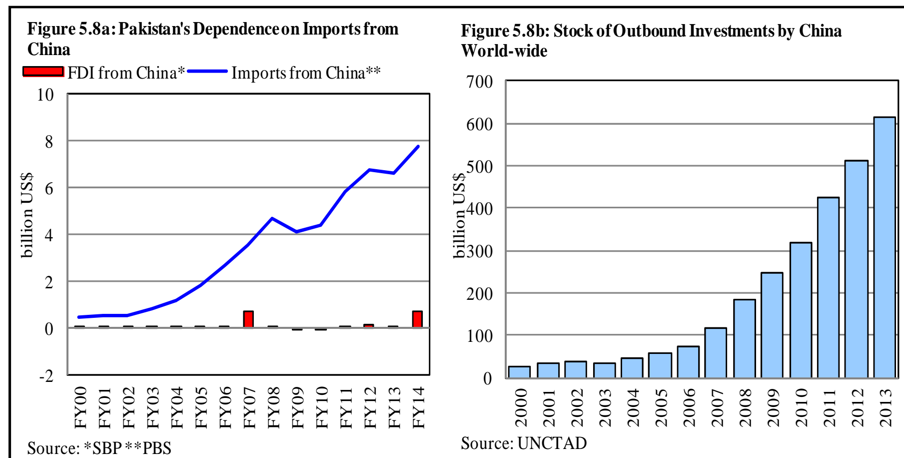
Low FDI continues to remain a major concern, as inflows declined further in Q1-FY15. Pakistan received only US$ 153.5 million FDI during Q1-FY15, compared to US$ 239.5 million in the same period last year. This decline was broad-based: except for metals, automobiles, power and a few services industries, nearly all the remaining sectors of the economy attracted less FDI so far this year.

Pakistan needs foreign investment in the energy and infrastructure sectors, but the response from foreign investors has not been that encouraging. The energy sector, in particular, offers tremendous investment opportunities to foreign investors. Not only well-head prices are above the global standards, exploration success rate is also attractive, compared to international standards.[20] However, it is the adverse law and order situation in the country, especially in the oil and gas-rich areas (of Balochistan, especially) that deters foreign investors. In case of power generation, existing idle capacities dilute the potential for foreign investment. However, as mentioned in the SBP Annual Report for FY14, there is a dire need to upgrade, and add capacity in power transmission network: this sector has been opened for foreign investment via the recently announced Power Policy. Petroleum refining is another sector, which requires heavy capital investment in the downstream industry (vertical integration).[21]

Similarly, in the manufacturing sector, Pakistan has the potential to become a hub for low-cost manufacturing. Pakistan enjoys freight advantages over East Asian countries for exporting to Middle-East and African countries. Furthermore, there are a large number of products in demand locally, which are imported from other countries. It is quite unfortunate that many low-technology products (for instance,

[19] Many others are in the business of gold, electronics, motor spare parts and hotel/restaurants. Together, these workers now constitute nearly 30 percent of Indian diaspora in the UAE.
[20] For details, see SBP Annual Report for 2013-14.
[21] For instance, to establish a fully integrated chemical industry in Pakistan, it is important to install a naphtha cracking plant in the country, which requires huge amount of capital and technology. Presently, India is the only south Asian country to have such facilities.

mobile batteries, basic cell phones, toys, and plastic items) are not being manufactured in Pakistan. Investment in these areas should be tapped from China, from where we import most of these products. It must be noted that Pakistan signed an FTA with China effective from 2007; since then, although Pak-China trade volumes have expanded significantly, investment flows have not picked up. Meanwhile, Chinese investment in other countries has grown very rapidly during this period (**Figure 5.8**).




Unfortunately, Pakistan's manufacturing sector has not been on the radar of foreign investors, while emerging exporters in Asia have benefited primarily from foreign investment. For instance, around 60 percent of Indonesian apparel exports are based on foreign investments (mainly from Malaysia and Singapore); Cambodia's apparel industry is almost entirely driven by FDI from China, Taiwan and Korea; the automotive parts sector of Thailand by Japanese firms; and Vietnam's high-tech boom (with the entry of Intel, Samsung, LG and Nokia) is also FDI-led. Similarly, in the case of Bangladesh, it was the Korean investments in ready-made garment sectors that enabled the country to become a leading exporter in the world.

One common element in all these success stories has been the strong regional integration, which generated a win-win situation for both investors as well as the host countries. The intra-regional investments among East Asian countries have been supported by the agreement of ASEAN free trade area. This integration was deepened further with the FTA of ASEAN with India, China and Korea in 2010. This bloc is also enjoying a comprehensive economic partnership agreement with Japan since 2008. Unfortunately, Pakistan has remained distant from these

countries, and besides a couple of FTAs with Malaysia and Indonesia, we have not initiated any economic partnership program that focuses on investments. As a result, other than Japan (which is primarily interested in Pakistan's domestic demand for automobiles), no other Asian country has invested in our manufacturing sector (despite the fact that Japanese investments in Pakistan are earning one of the most lucrative returns in the world).[22] In our view, Pakistan should deepen its trade and investment ties with East Asian economies, to benefit from the dynamism that exists in this region.

External Loans

There was some improvement in the net loan inflows during Q1-FY15, over the same period last year (**Table 5.3**). Although the government retired more to the IMF this year (primarily the Emergency Natural Disaster Assistance loans), these were more than offset by healthy disbursements from other creditors (**Section 4.5**). The private sector showed net outflow of US$ 124 million during the quarter, as PIA paid-off some of its FX loans.

### 5.4 Exchange rate and reserves

FX market remained under pressure during Q1-FY15: the country's FX reserves declined by US$ 630 million, and the PKR posted a depreciation of 3.7 percent during the period. This pressure came from a sharp rise in the current account deficit; delays in the 4th review of the IMF program; and political uncertainty in the country since mid-August. Nonetheless, compared to Q1-FY14 – when the PKR had registered an unprecedented depreciation of 6.0 percent, Q1-FY15 was less of a concern.

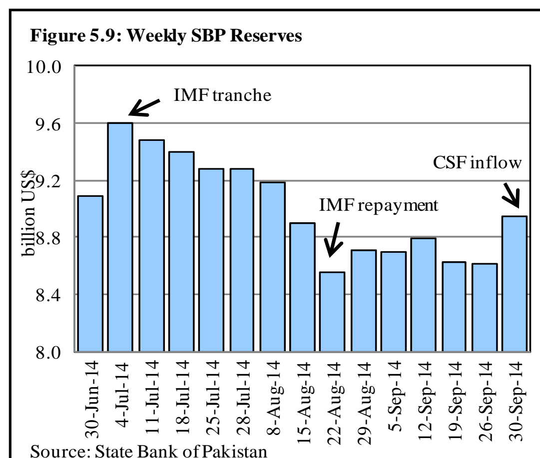
**Table 5.3: External Loans**

million US$

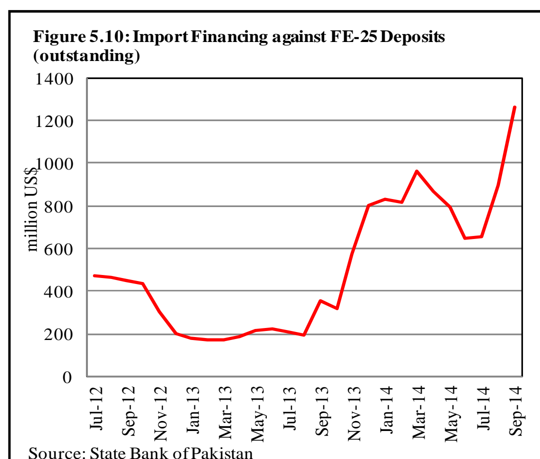
| | Q1-FY14 | Q1-FY15 |
|---|---|---|
| **External loans** | -289 | 218 |
| 1. Central bank | 0 | 0 |
| 2. Deposit-taking corporations | -20 | -4 |
| 3. General government | -258 | 51 |
| Disbursements | 592 | 1,161 |
| Long-term | 459 | 711 |
| Short-term | 133 | 450 |
| Amortization | 776 | 682 |
| Loans with the IMF | 180 | 237 |
| Other long-term | 596 | 445 |
| Short-term | 0 | 133 |
| 4. Other sectors | -85 | -124 |

Source: State Bank of Pakistan

[22] For instance, in 2013, Japan External Trade Organization (JETRO) survey ranked Pakistan as the second in the world, in terms of business growth. Pakistan's data was generated from 27 Japanese firms doing business here. The results found that 74.1 percent of the Japanese companies estimated operating profit in 2013, allotting second rank to Pakistan, only after Taiwan (81.8 percent).




The 3rd review of the IMF was successfully concluded in the last week of June 2014, after which, the Fund released the US$ 550 million tranche of the EFF loan. This took SBP reserves to US$ 9.6 billion during the first week of July (**Figure 5.9**). However since then, SBP reserves have been falling on account of payments for external debt (more specifically, the country retired US$ 1.5 billion). Some respite came from a US$ 735 million inflow under the CSF during the quarter.




The decline in commercial banks' FX reserves was more pronounced. On the one hand, customers withdrew more from their foreign currency accounts than they deposited, and on the other hand, importers borrowed heavily to make FX payments.[23] More specifically, the outstanding stock of import loans against FE-25 deposits, increased by US$ 615.5 million during Q1-FY15, to reach an unprecedented US$ 1.3 billion by end-September 2014 (**Figure 5.10**). FX borrowings suited local importers, since these carried lower interest rates compared to PKR loans; and secondly, this also helped defer pressure on the exchange rate.

[23] Liquid FX reserves of commercial banks are calculated as foreign currency deposits, minus FX loans extended to importers and exporters.

## 5.5 Trade account[24]

During Q1-FY15, the trade deficit posted a ten-quarter high growth rate of 44.4 percent. This significant increase is an outcome of both strong growth in imports, and a fall in exports **(Table 5.4).** The rise in imports can be traced to: (i) increase in investment by domestic cellular companies to make their networks compatible with 3G/4G requirements; (ii) higher off take of phosphatic and NPK nutrients during the quarter; (iii) some recovery in public-sector construction activity; and (iv) the increased use of man-made fibers by local textile manufacturers to benefit from the GSP plus. Not surprisingly therefore, most of the increase in imports was seen in steel, telecom machinery, fertilizer and textile.

**Table 5.4: Trade Balance (Jul-Sep)**

| billion US$ | | | | Growth rate YoY(%) | |
|---|---|---|---|---|---|
| | **FY13** | **FY14** | **FY15** | **FY14** | **FY15** |
| Export | 6.1 | 6.7 | 6.0 | 9.0 | -10.4 |
| Import | 10.9 | 11.2 | 12.4 | 3.0 | 11.6 |
| Trade balance | -4.7 | -4.5 | -6.5 | -4.8 | 44.4 |

These numbers are based on customs records, and will not tally with data provided in **Table 5.1,** which is based on payments records.
Source: Pakistan Bureau of Statistics

### Exports

Before discussing the trend in Pakistan's exports, it is important to look at economic conditions in our major partner countries, and export trends in the rest of Asia.

Since the beginning of 2014, growth in advanced economies has been patchy. While Jan-Mar was marked by a sharp contraction in the US; an upbeat UK; and a modest EU: the Apr-Jun period showed strong growth in the US and UK, but zero economic growth in the EU. As far as Jul-Sep is concerned, survey data suggests a positive outlook in consumer and business sentiments in the US and UK, but in the EU, private consumption appears to have slowed down. With the oil surplus likely to shrink significantly in 2015, UK growth is vulnerable, and US growth may ease.

[24] This section is based on customs data reported by the PBS. We use this information because it reports the value of exports and imports, when the physical movement of goods takes place. This data set also has the advantage over payments record data for analysis purpose, since this carries information on quantums and unit values. The information in this section does not tally with the payments record data, which is reported in the balance of payments. To understand the difference between two data series in detail, please see Annexure on data explanatory notes.

Looking at exports data, most Asian economies posted strong growth during Q1-FY15 (**Figure 5.11**); Pakistan, Russia and Thailand were the only exception.[25] China, Philippines, Vietnam and Sri Lanka, showed more impressive performances than others. While China's exports have been helped by strong sales in the US, Philippines and Vietnam continued to benefit from the shift of low-cost manufacturing from China to these countries.[26]

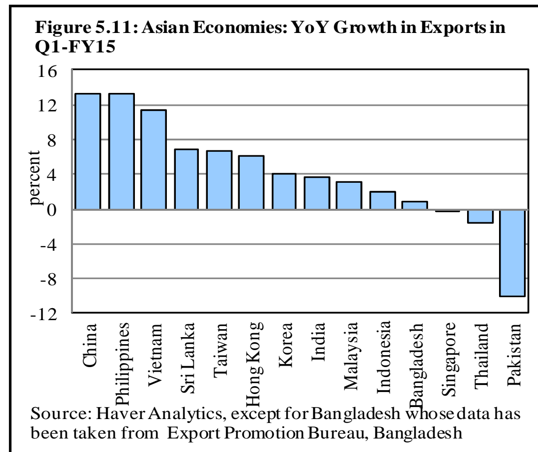



**Figure 5.11: Asian Economies: YoY Growth in Exports in Q1-FY15**

Source: Haver Analytics, except for Bangladesh whose data has been taken from Export Promotion Bureau, Bangladesh

In the case of Pakistan, exports declined by 10.4 percent in Q1-FY15, compared to a 9.0 percent rise in the same period last year. The decline was broad-based, but most prominent in five sectors: naphtha, yarn, fabric, chemicals and food (**Figure 5.12**). In addition to these, export of rice, fruits & vegetables, meat, leather goods, cement and jewelry, also declined. Value-added textiles like knitwear,

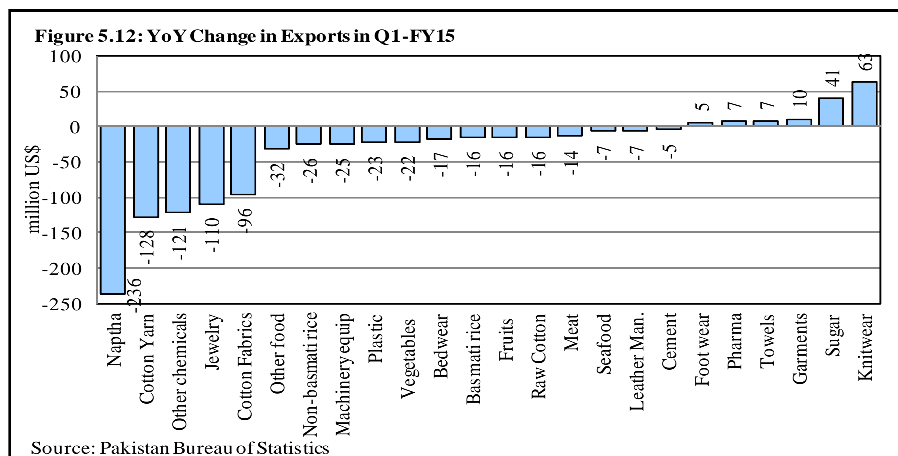



**Figure 5.12: YoY Change in Exports in Q1-FY15**

Source: Pakistan Bureau of Statistics

[25] Exports of Russia have suffered due to sanctions from the US, EU and international organizations, in response to Crimean crisis.

[26] Countries such as Indonesia, Vietnam, the Philippines, Cambodia and Myanmar are giving China a tough competition due to lower wages.

ready-made garments and towels, posted a YoY increase during the quarter. In fact, if international prices had remained stable, Pakistan's export growth in these categories would have been much stronger (**Table 5.5**).

**Table 5.5: Causative Factors of Change in Export Values (Price and Quantity)**
million US$

| | Jul-Sep FY14 | | | Jul-SepFY15 | | |
|---|---|---|---|---|---|---|
| | Quantity | Price | Value | Quantity | Price | Value |
| Basmati | -27.0 | 17.0 | -10.0 | -24.8 | 8.8 | -16.0 |
| Non-basmati rice | 82.5 | 14.3 | 96.8 | -21.7 | -4.2 | -25.9 |
| Fish | 15.2 | 6.6 | 21.8 | -8.7 | 2.0 | -6.7 |
| Fruits | 8.2 | 16.1 | 24.3 | -13.6 | -2.4 | -16.0 |
| Wheat | -29.2 | 0.5 | -28.7 | -4.0 | 0.0 | -4.0 |
| Sugar | -19.2 | -4.3 | -23.5 | 40.2 | 0.4 | 40.6 |
| Meat | 15.0 | -10.2 | 4.8 | -16.1 | 1.8 | -14.3 |
| Raw cotton | 38.3 | 2.5 | 40.8 | -12.1 | -3.6 | -15.7 |
| Cotton yarn | 40.0 | 10.9 | 50.9 | -98.9 | -28.7 | -127.5 |
| Cotton fabrics | 0.2 | -165.2 | -165.0 | -227.3 | 131.0 | -96.3 |
| Knitwear | 6.1 | -12.5 | -6.4 | 81.1 | -18.5 | 62.6 |
| Bed-wear | 133.1 | -9.7 | 123.4 | -10.6 | -6.3 | -16.9 |
| Towels | -15.8 | 1.9 | -13.9 | 25.0 | -17.5 | 7.5 |
| Readymade garments | 19.1 | 31.8 | 50.8 | 32.2 | -21.9 | 10.3 |
| Petroleum products | 26.0 | 7.8 | 33.7 | -7.1 | -0.2 | -7.2 |
| Leather garments | 34.3 | -23.6 | 10.8 | -21.3 | 15.0 | -6.3 |

Source: Pakistan Bureau of Statistics

In our view, the decline in exports was mainly due to supply-side issues. While the decline in naphtha exports appears to be linked with lower prices in the international market[27], floods eliminated the exportable surplus in the food sector. In the case of cotton yarn and fabric, higher domestic consumption was *one of* the reasons behind lower exports;[28] other reasons were mostly demand-driven, which are discussed below:

[27] Naphtha exports are linked directly with the domestic production of petroleum products. During Q1-FY15, local refineries faced liquidity shortages due to re-emergence of circular debt, and therefore, processed less amount of crude oil than Q1-FY14. It is important to recall here that due to the settlement of circular debt in June 2013, refineries had performed reasonably well, posting a growth of 6.8 percent in Q1-FY14. However in Q1-FY15, refining activity posted a decline of 4.5 percent; naptha production remained subdued; and its exports declined.

[28] Domestic consumption of cotton yarn and fabric has increased lately, mainly due to the increase in production of woven garments and knitwear for exports to the EU.

Pakistan exports cotton yarn and fabric to China, Bangladesh, and Turkey, who then export higher value added products like knitwear and woven garments to other countries. In Jul-Sep 2014, although China's apparel exports increased significantly, the country used its domestic inventories of yarn and fabric, instead of buying from resource countries like Pakistan. In contrast, the garment industry of Bangladesh is facing some challenges: ever since the US suspended its GSP privileges following the fire incident in one of Bangladesh's garment factory in 2012, its exports have remained subdued.[29] As a result, Bangladesh has reduced its import of yarn and fabric from resource countries like Pakistan. Finally, Turkey – the third largest buyer of Pakistani yarn and fabric, has imposed safeguard duties on fabric import from other countries. In addition to these demand related issues, Pakistani textile exporters complain that they are unable to deliver orders due to energy constraints and stuck-up refund claims with FBR.

Rice exports faced multiple setbacks. First, production remained lower than last year, however, it was the sharp decline in international prices, that kept growers/millers from exporting. As noted in **Chapter 2**, although global rice production in 2014 has been affected by adverse weather conditions in India, Pakistan, Thailand, Indonesia, Philippines and Sri Lanka, global prices are expected to remain depressed due to abundant inventories. Prices have declined by nearly 24.7 percent since the peak seen in early April 2014, and it appears that traders/middle-men are waiting for prices to recover before they offload their stocks in the international market.

A major concern for Pakistan (and also for India and Vietnam) is the return of Thai rice into the already over-supplied rice market. With the end of the subsidy program in February 2014, which had priced-out Thai rice from the international market, it is expected that global competition would stiffen again.[30] According to estimates, Thailand is now sitting on nearly 18 million MT of rice, which is half the global rice trade.[31,32] It is important to realize that Pakistan was one of the beneficiaries of this subsidy program, as it was able to increase its export of coarse rice since then.

[29] Vietnam and India have benefited the most from declining US orders to Bangladesh. Their export of textile and apparel to the US has increased by 15.7 and 8.5 percent YoY in Jul-Sep 2014, respectively. In contrast, exports from Bangladesh to the US have declined by 3.4 percent during the same period.

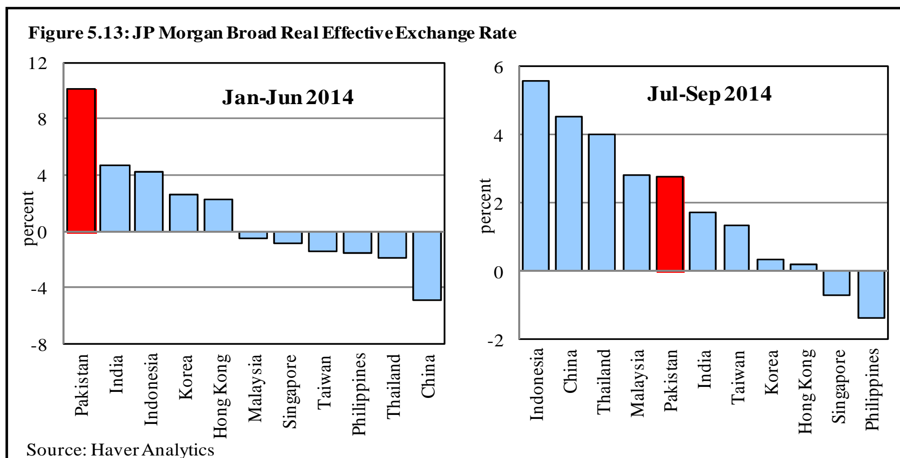
[30] The Thai government had initiated a populist rice purchase program in 2011. According to this program, the government purchased rice from its farmers at about 40 to 50 percent above the market price.

[31] Global rice trade stood at nearly 37.9 million MT on average during 2010-11 to 2013-14 (source: http://www.fao.org/worldfoodsituation/csdb/en/)

[32] Source: http://uk.reuters.com/article/2014/08/15/uk-thailand-rice-idUKKBN0GF19320140815

Notwithstanding the impact from sector-specific obstacles, the role of PKR appreciation in March 2014 in subsiding export growth, cannot be ignored – Pakistan's currency appreciated in both nominal and real terms during March 2014. Although the strong PKR was viewed positively by most, it raised concerns about the competitiveness of Pakistani products in the international market. Some of the *nominal* gains in the PKR were reversed during Jul-Sep, but in *real* terms, the PKR continued to appreciate in Q1-FY15 (**Figure 5.13**).

**Figure 5.13: JP Morgan Broad Real Effective Exchange Rate**




Source: Haver Analytics

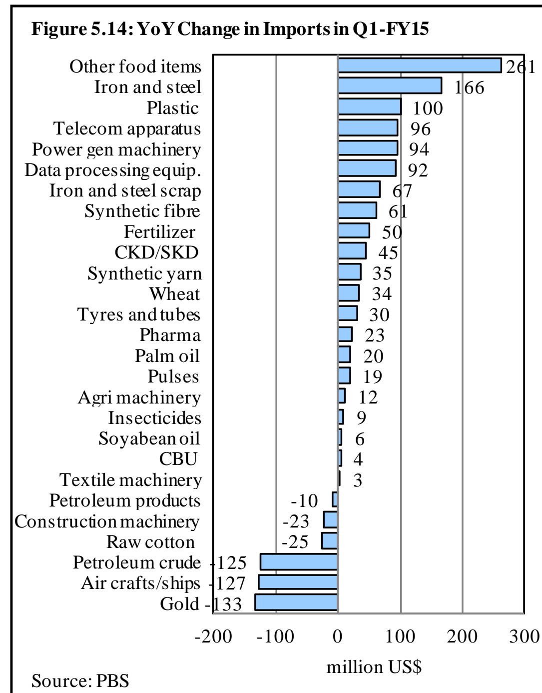
**Imports**

Imports posted 11.6 percent growth during Q1-FY15, compared to only 3.0 percent in the same period last year. As mentioned before, this increase was driven by higher imports of metals, machinery, fertilizer, and synthetic textile (**Figure 5.14**). Together, the import of these items more than offset the price-driven decline in Pakistan's oil import bill in Q1-FY15.[33]

Import of food items, which are not classified elsewhere, contributed most to the increase in imports during Q1-FY15. Although detailed data is not available for this category (nor is the production data of minor crops), it appears that the country has imported key food items like lentils and vegetables due to flood-related losses. The similar trend can be seen in SBP's payment record data, which shows higher import of potatoes from India; corns from the US; onions from China; and rapeseeds from Canada.

[33] The *quantity* import of petroleum (crude and products combined) increased by 5.2 percent YoY during Q1-FY15.

Import of metals has also remained strong: scrap quantity increased by 33.9 percent, whereas import quantity of iron and steel more than doubled. As noted in **Chapter 2**, domestic construction activity is gaining pace with higher PSDP spending, and private housing activity. In addition, steel consumption in the auto industry also seems to have increased.




Fertilizer imports present a mixed picture. The country did not import urea altogether during Q1-FY15, due to available inventories (**Chapter 2**). However, DAP imports nearly doubled in Q1 (compared to the same period last year) – anecdotal evidence suggests that Engro Fertilizer, the largest importer, made early purchase of nutrients, to take advantage of low international prices. In addition, local importers also seem to have taken advantage of China's low tax window.[34]

Pakistan's import of DAP was intended for the Rabi sowing, which started in October. In overall terms, the import of fertilizer grew by 33.0 percent during Q1-FY15, as compared to a 37.8 percent decline in Q1-FY14.

In overall terms, the real problem in Pakistan's trade account is stagnant exports. Import substitution can also be considered in some areas, like palm oil, and by establishing in-house manufacturing facilities for low-end consumer items. However, a large part of the import growth has come from machinery and other industrial inputs, which directly adds to Pakistan's production capacity. Furthermore, Pakistan is not self-sufficient in producing what it presently imports. Hence, there is a need to boost the country's exports by taking necessary structural

[34] Announced in May 2014, this window allowed Chinese traders to export phosphate fertilizer *only* to India and Pakistan, at a reduced tariff of 15 percent.

reforms; diversifying the export base; and promoting the local manufacturing of low-technology goods. Furthermore, the government should create an effective mechanism of rebates and refunds for exporting industries.

Keeping in view a sharp decline in global oil prices, and an unchanged oil output in the next six months, Pakistan's trade deficit is likely to stay soft in the remaining part of the year. Meanwhile, price of palm oil has also weakened in the international market since end-September, which should reduce the import bill.[35] As far as exports are concerned, these showed a recovery in October, after declining consistently in the first quarter.[36] The impetus to export growth has come from textiles, rice, footwear and petroleum products. In overall terms, the performance of trade sector for the full-year is likely to be better than Q1-FY15.

[35] Palm oil prices have reduced by 0.2 percent in the international market during October to 28th November 2014 (source: World Bank).
[36] Exports posted a growth of 5.0 percent YoY in October 2014.