5 External Sector

5.1 Overview

Pakistan's balance of payments continued to present a challenging picture in Q1-FY19, as a significant uptick in global oil prices pushed the country's energy import payments past the US$ 4.0 billion-mark for the first time since Q1-FY15. This offset much of the gains from a decline in non-energy imports, continued growth in exports, and a healthy uptick in workers' remittances. As a result, even though the current account deficit (CAD) declined slightly for the first time in over two years, it stayed at an elevated level of US$ 3.6 billion in Q1-FY19 (**Table 5.1**).

This deficit could only partially be financed by available financial inflows, as foreign investments could not keep up last year's momentum. Even in terms of liabilities, only the official borrowings provided some support, as external borrowings by banks and the non-financial private sector dried up. Thus, with financial inflows falling short, the remaining deficit had to be financed from SBP's FX reserves, which declined US$ 1.4 billion during the quarter. The exchange rate also remained under pressure and depreciated by 2.2 percent during Q1-FY19.

Table 5.1: Pakistan's Balance of Payments

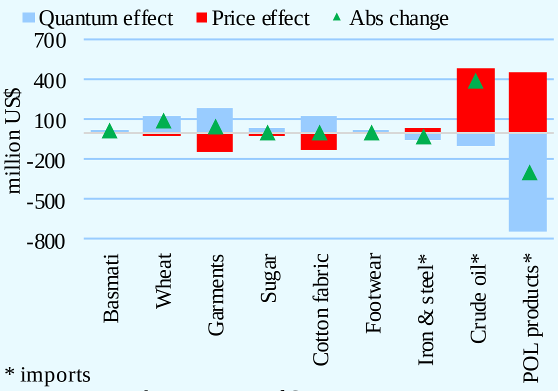
million US dollars

	Q1-FY18	Q1-FY19	Absolute change
Current account balance	-3,761	-3,622	139
Trade balance	-7,314	-7,848	-534
Exports	5,679	5,897	218
Imports	12,993	13,745	752
Oil	2,945	4,130	1,185
Non-oil	10,048	9,615	-433
Services balance	-1,276	-904	372
Primary income balance	-1,057	-1,098	-41
Secondary income balance	5,886	6,228	342
Workers' remittances	4,790	5,420	630
Capital account balance	107	103	-4
Financial account balance	-1,870	-2,391	-521
Direct investment inflow	765	439	-326
Portfolio investment inflow	-126	-185	-59
Other investment	-1,205	-2,086	-881
Net incurrence of liabilities.	817	1,700	883
Gen. government	126	1,561	1,435
Banks	333	73	-260
Private (excluding banks)	358	65	-293
SBP's reserves (end-period)	13,857	8,409	-5,449
Total reserves (end-period)	19,775	14,921	-4,854
PKR app(+)/dep(-) in percent	-0.53	-2.21	-

Data source: State Bank of Pakistan

Notwithstanding the continued BoP stress during the quarter, it is important to note a few emerging trends as the economy now enters a stabilization phase. First, as the government has cut down its development spending and as early-harvest CPEC projects approach completion, the import of power generation and electrical machinery has remained subdued. In fact, a sharp fall in machinery-related payments contributed the most to the declining non-oil import bill in Q1-FY19. Similarly, the imposition of a ban on non-filers from purchasing cars suppressed the domestic car sales and CBU imports alike; the growth in CKD imports was also lower as compared to last year. Furthermore, a broad-based decline in quantum imports suggests that the overall shift in the policy mix towards stabilization and demand-compression appears to be yielding the desired results. The policy shift is reflected by the exchange rate adjustments, 200 bps policy rate hike, pass-through of the increase in the oil prices to domestic prices, cuts in development expenditure, and the raising of customs duty and imposition of cash margins on a wide range of consumer imports.

Figure 5.1: Breakdown of Change in Pakistan's Major Export & Import Items



* imports
Data source: Pakistan Bureau of Statistics

Second, the country's external account has taken a setback from worsening terms of trade. Specifically, the unit prices of Pakistan's principal imports, petroleum and its products, have risen quite significantly this year, whereas those of its major exports, particularly garments, wheat, basmati rice and sugar, have dropped (**Figure 5.1**). In the case of exports, the growth in FX receipts slowed down to just 3.8 percent in Q1-FY19 from 12.4 percent last year, as lower unit prices partially offset the growth in quantum exports of a number of items. On the other hand, energy import payments reached their highest level in four years, at US$ 4.1 billion. With international oil prices on average 50.9 percent higher in Q1-FY19 as compared to Q1-FY18, the savings from lower quantum energy purchases (excluding LNG), as well as a decline in non-energy imports, were completely offset.

Third, attracting private financial inflows has become challenging for the country, as the completion of early harvest CPEC projects has led to a 42.6 percent contraction in net FDI (mostly from China), as well as a drop in external borrowing by mainly private power sector firms.[1] Furthermore, outflows from portfolio investment also accelerated this year. Under such circumstances, the burden of arranging BoP financing is falling disproportionately on official sources. Here, too, IFI funding is not forthcoming and therefore, Pakistan is counting increasingly on government-to-government funding arrangements.

So, in sum, the depleting FX reserves and the country's access to limited external financing during Q1-FY19 have led to increased external vulnerability. SBP's FX reserves had reached US$ 8.4 billion by the end of September, with the import coverage falling below the 2-month mark. This has come at a time when geopolitics and trade-related tensions between the US and China are impacting key commodity prices and creating uncertainty about the demand dynamics in some of the major export destinations for Pakistan (as discussed in **Box 5.1**). Building FX buffers has therefore become important. On a positive note, the government has recently managed to sign trade and investment agreements with Saudi Arabia, China, UAE and Malaysia, and short-term BoP support has already materialized from some of these countries. That said, for attaining medium to long-term external sector sustainability, instituting reforms that stimulate efficiency and competitiveness, and discourage rent-seeking in the economy, are needed.

Box 5.1: Opportunities and Challenges for Pakistan Amid US-China Trade Tensions

The ongoing tensions between the US and China has contributed to big swings in key commodity prices and has added uncertainty to the global trade dynamics.[2] Together, the US and China accounted for 21.8 percent of global exports and 23.5 percent of worldwide imports in 2017.[3] Bilateral trade between these two amounted to US$ 584.8 billion in 2017, accounting for 3.3 percent of global trade in the year.

Since July 2018, additional tariffs have been imposed on US$ 360.0 billion of goods traded between the US and China, which account for 61.6 percent of the bilateral trade between the two countries last year. China has been hit harder as US$ 260.0 billion of its exports are now attracting higher tariffs in the US; against this, US$ 100.0 billion of American exports to China are affected by the retaliatory tariffs. These tariffs are in addition to across-the-board tariffs on iron and steel products that the US had put in place in May 2018.

For Pakistan, the imposition of these cross-tariffs offers some interesting opportunities as well as challenges. On a positive note, key food items, such as rice, seafood and soybean (both seeds and oil), have come in the crosshairs, which offer an opportunity for Pakistan to reduce its trade deficit.

[1] A large chunk of this YoY decline in FDI (51.3 percent) came from China. This was in line with the progress on early harvest CPEC-related power projects, most of which have either been concluded or are nearing completion.

[2] So far in FY19, the IMF, World Bank and WTO have all lowered their projections of global economic growth and trade volumes.

[3] Source: International Trade Center.

On the other hand, the volatility in iron and steel prices in recent months after the imposition of tariffs by the US presents a challenge from Pakistan's perspective.

Impact on Pakistan's exports

Among the thousands of items on which additional tariffs have been imposed by the two countries, three product categories stand out from Pakistan's exports standpoint: seafood, rice and cotton (raw cotton, fabric and yarn). Specifically, American seafood exports to China are now much costlier as a result of the tariffs, as are Chinese exports of rice and cotton items to the US.

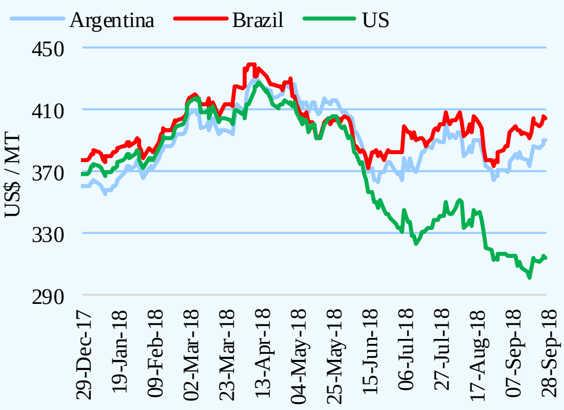
Seafood: China is a major global importer of seafood items, and imported 16.3 percent of its overall seafood imports from the US in 2017 (worth US$ 1.3 billion). It mainly imports lobsters, oysters, flatfish and sardines, all of which are now attracting additional tariffs, and all of which are also exported by Pakistan. Pakistan's global exports of these specific products amounted to US$ 338.9 million in FY18 and constituted 75.1 percent of the country's overall seafood exports in FY18. As the US' seafood exports to China have now become much costlier, Pakistani exporters might increase their presence in the Chinese market.

Impact on Pakistan's Imports

Though Pakistan can benefit from the diverging trend in soybean prices, its iron and steel imports may come under strain from the trade tensions.

Soybean: China is the world's largest importer of soybean, and the US is the second-largest producer and exporter of the commodity, after Brazil. Importantly, soybean is the US' single largest export item to China, and the country accounted for 56.9 percent of the US' soybean exports in 2017 and 9.4 percent of the US' total exports to China.

Figure 5.1.1: Divergence in Soybean Export Prices



Data source: USDA

Given these dynamics, soybean was among the first items targeted by China when the first round of retaliatory tariffs went into effect in July 2018. China then shifted its demand for soybeans to Brazil and Argentina. As a result, soybean export prices of Brazil and Argentina have spiked, whereas those of the US have plunged since the tariffs went into effect (**Figure 5.1.1**). This presents an opportunity for edible oil mills in Pakistan to reduce their imports of soybean oil and seed in value terms by diverting their purchases to the US, where the prices are falling.

Encouragingly, there are indications that this switch is already taking place. Brazil's share in Pakistan's overall soybean imports (both seeds and oil) fell to 49.5 percent in FY18 from 58.4 percent in FY17, whereas the US' share rose to 45.4 percent from 32.1 percent. Further enhancing soybean imports from the US will yield more FX savings for Pakistan, assuming that the US prices stay depressed in the wake of a record-high projected inventory level for 2018-19.[4] This dynamic also helped Pakistan's soybean oil imports in Q1-FY19, when the unit value imports were 20.3 percent lower as compared to Q1-FY18.

Table 5.1.1: US's Imports of Iron & Steel Products Attracting Across-the-Board Tariffs

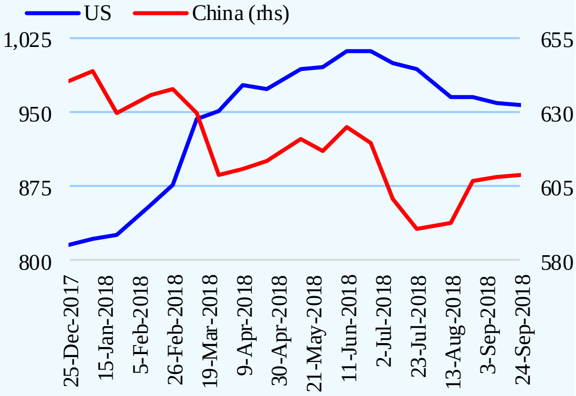
	Values (million US dollars)		Growth (% change, YoY)		Shares (%)	
	2017	**Jun-Sep 2018**	**2017**	**Jun-Sep 2018**	**2017**	**Jun-Sep 2018**
Canada	5,152.2	1,654.7	27.6	-3.4	18.2	18.1
South Korea	2,790.9	692.1	18.9	-36.6	9.9	7.6
Mexico	2,411.5	861.3	26.9	-0.7	8.5	9.4
Brazil	1,869.2	934.3	55.6	40.8	6.6	10.2
Japan	1,653.4	522.6	0.9	-12.8	5.9	5.7
Germany	1,506.8	500.4	17.5	-8.2	5.3	5.5
Russia	1,387.4	398.6	107.2	-30.5	4.9	4.4
China	1,001.7	254.4	8.4	-30.8	3.5	2.8
Others	10,466.4	3,331.1	39.9	-15.0	37.1	36.4
Total	**28,239.4**	**9,149.5**	**31.4**	**-11.5**	-	-

Data source: US Census Bureau

Iron and steel: Iron and steel prices have been volatile ever since they came under the crosshairs of US tariffs. These tariffs were applied in two phases. In the first phase in May 2018, the US imposed additional tariffs *across the board* on roughly 44.0 percent of the iron and steel products that it imported. These tariffs particularly affected the US' neighbors and allies (specifically Canada, Mexico, South Korea and Japan), instead of China. However, some of these countries were later exempted from the tariffs after they agreed to export quotas. While China is the largest exporter of overall iron and steel products to the US, its share in the *specific* products attracting the additional tariffs was minimal (**Table 5.1.1**).

In September 2018, with anti-trade measures in full swing, the US targeted the bulk (49.1 percent) of the iron and steel products that it imported from China (and which were not part of the earlier across the board tariffs), and imposed additional tariffs on them. For these specific products, China was the single largest exporter to the US, with a market share of 27.0 percent in Jan-Sep 2018.

Figure 5.1.2: Trends in Cold Rolled Coil (CRC) Prices in US & China (US$/MT)



Data source: Steel Benchmarker

[4] According to the US Department of Agriculture, soybean inventory in the US is projected to more than double to 885.0 million bushels by end-Sep 2019, from 438.0 million bushels by end-Sep 2018. A significant increase in the crop's yield, coupled with tepid ex-China global demand, is credited with the projected stock build-up.

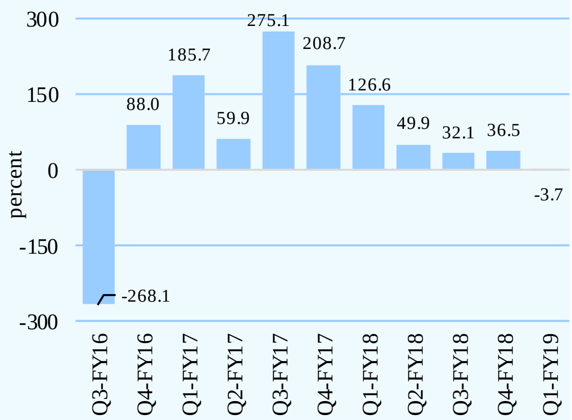
Steel prices in China also present a complicated picture. Prices were falling during the first half of 2018, as uncertainty loomed about the extent of the protectionist measures that would be adopted by the US. Further downward pressure came from a cooling off in China's economy this year, which has impacted its demand for steel. However, Chinese steel prices have been rising since August 2018 (**Figure 5.1.2**), partly as a result of an expected drop in steel production in the winter months as the country tries to limit the harmful emissions and control smog.

All of this uncertainty has created challenges for Pakistan, as the unit value of the country's iron and steel imports (both scrap and finished products) has been rising, though with significant fluctuations. Even though Pakistan imports most of its steel from China, the unit value of its steel imports have not dipped. Nonetheless, a slowdown in broader economic activity as the country tries to stabilize its economy, has already stalled the demand for imported iron and steel products. In Q1-FY19, quantum imports of these items have already dropped 10.1 percent on YoY basis.

5.2 Current Account

Tapering demand for machinery, along with the demand compression measures taken by the government in the recent past, arrested the growth in import payments in Q1-FY19. This, coupled with a sharp rise in workers' remittances and a steady increase in exports, led the current account deficit to decline by a marginal 3.7 percent YoY; this was the first drop in 10 quarters (**Figure 5.2**).

Figure 5.2: Growth in Current Account Deficit (YoY)



Data source: State Bank of Pakistan

This moderation was observed in the months of August and September; in July 2018, the current account deficit had hit US$ 2.1 billion, as the country cleared the payment backlog for earlier oil purchases. Oil payments had risen by 69.6 percent YoY during the month to US$ 1.8 billion, which was the highest monthly level ever.

Table 5.2 Pakistan's Trade in Services
million US dollars

	Value in Q1			Growth (%)	
	FY17	FY18	FY19	FY18	FY19
Exports	1,204	1,312	1,290	9.0	-1.7
Imports	2,366	2,588	2,194	9.4	-15.2
Trade Balance	-1,162	-1,276	-904	9.8	-29.2

Data source: State Bank of Pakistan

Services Account[5]

The services trade deficit narrowed by 29.2 percent and reached US$ 0.9

[5]Analysis in this section is based on data compiled by State Bank of Pakistan. The data is compiled as per BPM6(EBOS-2010) classification and is aligned with MSITS-2010.

billion in Q1-FY19. Despite a marginal decline of 1.7 percent in the services exports, the fall of 15.2 percent in the services import payments kept the services deficit relatively contained **(Table 5.2)**.

Importantly, the decline in the services imports was broad-based, as transport, travel, and government services imports all witnessed significant declines (**Table 5.3**). Within transport, the import of freight services declined by 20.0 percent in Q1-FY19 due to a lower quantum of merchandise imports. This is in contrast to Q1-FY18, when freight imports had risen by 26.9 percent.

Table 5.3: Key Services Imports in Q1
million US dollars

	FY17	FY18	FY19
Transport	907	946	864
Travel	590	611	418
Telecom, Comp, &Info	111	119	112
Other Business	430	536	527
Government	119	158	119
Others	209	218	154
Total	**2,366**	**2,588**	**2,194**

Data source: State Bank of Pakistan

At the same time, the import of foreign travel services, particularly FX purchases by residents going abroad for tourism, and for covering educational expenses, decreased by 31.6 percent in Q1-FY19, after rising 3.5 percent in the same period last year. The first quarter of FY19 also included the *hajj* period, when travel for *umrah* and other religious activities typically declines. Moreover, higher travelling costs following the PKR's depreciation may have also tapered the demand for these services.

Table 5.4: Corridor-wise Workers' Remittances in Q1
million US dollars

	FY17	FY18	FY19
Total	4,740	4,790	5,420
GCC	2,975	2,869	2,985
Saudi Arabia	1,324	1,228	1,263
UAE	1,076	1,078	1,196
Other GCC	576	563	526
Non-GCC	1,766	1,921	2,434
UK	550	643	759
USA	613	626	828
EU	123	160	166
Others	480	492	681

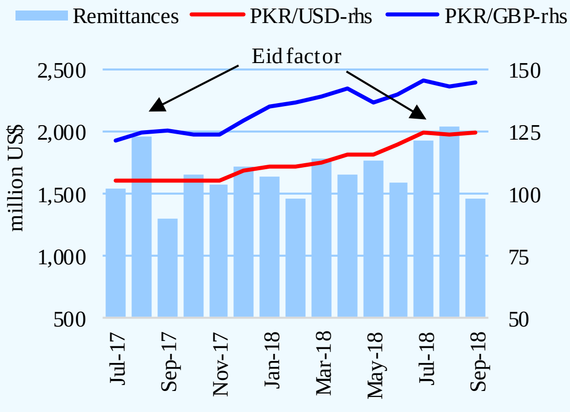
Data source: State Bank of Pakistan

<u>Workers' remittances</u>

Workers' remittances witnessed a robust growth of 13.2 percent YoY in Q1-FY19, with inflows crossing the US$ 5.0 billion mark in a quarter for the first time.

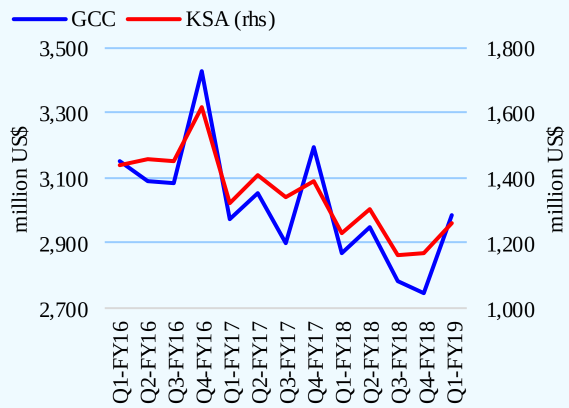
The increase in remittances was more pronounced from the non-GCC corridors, especially the US and the UK (**Table 5.4**). This can be attributed to multiple factors. First, increased economic activity in the developed economies may have incentivized the Pakistani diaspora in these countries to remit more to their families. Besides, the months falling before *Eid-ul-Azha* usually witness an uptick in inflows, as expatriates remit funds back home for buying sacrificial animals (**Figure 5.3)**. Importantly, remittances from the GCC in general, and Saudi Arabia (KSA) in particular, witnessed marginal growth in this quarter, which might be due to a seasonal phenomenon. Since Q1-FY17, remittances from these corridors have been largely following a declining trajectory, barring small seasonal spikes (**Figure 5.4**). In Q1-FY19, inflows from the GCC and the KSA grew by 4.0 percent and 2.8 percent, respectively. It is possible that the pace of layoffs of Pakistani workers in the region has fallen in recent months, which might have led to a bottoming out of the decline in remittances from the GCC. That said, it remains to be seen if this trend reversal would continue going forward.

Figure 5.3: Remittances & Exchange Rate Movements



Data source: State Bank of Pakistan

Figure 5.4: Workers' Remittances from GCC & KSA



Data source: State Bank of Pakistan

Workers' remittances remain a key source of financing of Pakistan's persistent trade deficit. More importantly, it does not create a repayment or repatriation obligation. Generally, these obligations keep the current account balance under pressure, especially when the trade deficit widens. It is not surprising that the government remains committed to supporting the flow of remittances into the country. **Box 5.2** details the various measures taken by the government and SBP to support the inflow of remittances into Pakistan.

Box 5.2: Government Support for Enhancing Workers' Remittance Inflows
The remittance inflows have been under stress for the past couple of years due to low oil prices and the Gulf economies' adoption of nationalization policies and fiscal consolidation measures.

As workers' remittances remain a key source of balance of payments support for Pakistan, the government has intensified its efforts for increasing these inflows into the country. In this regard, Pakistan expects early implementation of Qatar's decision to allow 100,000 workers from Pakistan to come and work in the country.[6] Moreover, following the government's suggestion, Saudi Arabia has agreed to reduce the visa fee for Pakistani workers. This step will help enhance Pakistan's workforce in the kingdom. Furthermore, the government is initiating a survey of overseas Pakistani workers, specifically those in the Middle East, to get their feedback on further facilitating and incentivizing the home remittance process.

Besides the government, the SBP has also taken a number of measures to incentivize overseas Pakistanis to send remittances through legal channels.

- SBP has allowed authorized dealers (banks) to implement Business to Customer (B2C) and Customer to Business (C2B) transactions through foreign correspondent entities under either existing or new home remittance agency arrangements.

- An individual, in B2C transactions, is allowed to receive up to US$ 1,500 per month for providing freelance and information systems services. Service providers other than of computer and information services are also allowed to receive up to US$ 1,500 per individual per month. Individual pensioners can now also receive up to Rs 250,000 per month in remittances.

- Meanwhile, in C2B transactions, overseas Pakistanis can directly pay utility bills, fees of Higher Education Commission-accredited institutions, insurance premiums, and charges incurred at superstores and on credit cards. Overseas Pakistanis are also allowed to remit funds to purchase residential and commercial houses, plots, flats and buildings from reputed real estate builders/developers and housing societies. However, remittances cannot be sent for equity participation in an enterprise.

- Moreover, the government has increased the incentive for mobile wallet users who receive remittances; now, users will receive up to Rs 2.0 as airtime for every US$ 1.0 of remittance transaction, up from Rs 1.0 previously. Similarly, exchange companies and banks that bring in 15.0 percent more remittances than they did in the previous financial year will also get Rs 1.0 for each US$ 1.0 incremental remittance that they brought.

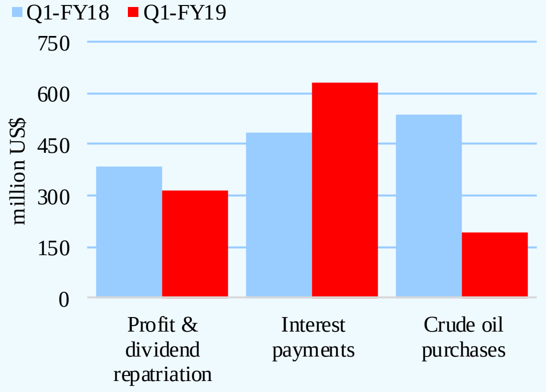
Primary income

5.1 The primary income deficit increased by a marginal 3.9 percent in Q1-FY19 to US$ 1.1 billion. This was despite a significant 30.0 percent rise in interest payments and a 17.5 percent growth in the repatriation of profits and dividends by foreign firms operating in the country (**Figure 5.5**). The substantial increase in the

[6] Press release issued by the Prime Minister's Office dated October 19, 2018 (http://www.pmo.gov.pk/news_details.php?news_id=897). Already during Q1-FY19, an 80.6 percent YoY increase was noted in the number of Pakistanis who went to Qatar for work (source: Bureau of Emigration and Overseas Employment).

interest payments and profit repatriation, however, was offset by a 64.6 percent decline in the repatriation of profit under the purchase of crude oil.

Figure 5.5: Outflows from Primary Income Account



Data source: State Bank of Pakistan

In Q1-FY19, foreign companies repatriated US$ 190.0 million on account of profit on the purchase of crude oil; this was much lower than last year's comparable amount of US$ 537.0 million. The decline in the quantum of POL product sales in the quarter may have resulted in lower profit being repatriated under this head.

5.3 Financial Account

Inflows in the financial account increased by 27.9 percent to US$ 2.4 billion in Q1-FY19, from US$ 1.9 billion received in the same period last year. The entire increase came from external loans/liabilities, as not only did the foreign direct investment decline significantly, but outflows from the portfolio investment also remained higher as compared to Q1-FY18.

<u>Foreign direct investment</u>

The net FDI inflows into Pakistan posted a broad-based decline of 42.6 percent in Q1-FY19. As many of the early-harvest energy projects under CPEC are nearing completion, FDI inflows from China into the power sector have been slowing down. However, Chinese investment in the construction sector improved in Q1-FY19, and as a result, China continued to remain the top investor in Pakistan, with a 64.0 percent share in net FDI in the quarter **(Table 5.5)**.

Table 5.5: Net FDI in Pakistan (sector wise)

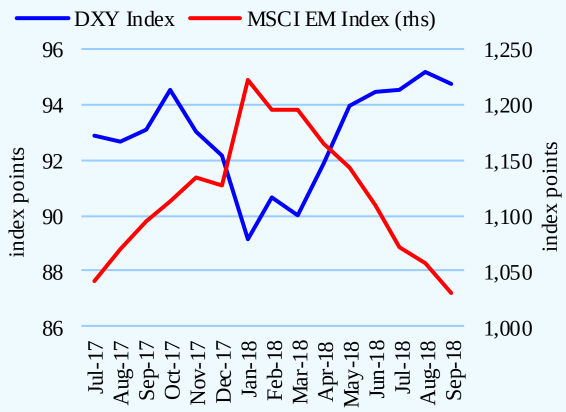
million US dollars

	FY18				FY19
	Q1	**Q2**	**Q3**	**Q4**	**Q1**
Construction	124.8	226.1	176.0	181.6	180.2
Power	205.3	406.6	111.3	273.9	74.7
Financial business	190.1	86.0	85.0	39.1	50.1
Exploration & prod.	52.8	53.9	46.2	39.6	35.4
Pharmaceuticals	0.8	1.2	12.1	1.1	26.4
Textiles	10.8	15.0	10.8	13.1	4.7
Telecommunications	62.8	-78.0	3.2	112.1	-48.6
Others	118.0	156.1	191.5	163.3	116.6
Total	**765.2**	**867.0**	**636.0**	**823.8**	**439.5**

Data source: State Bank of Pakistan

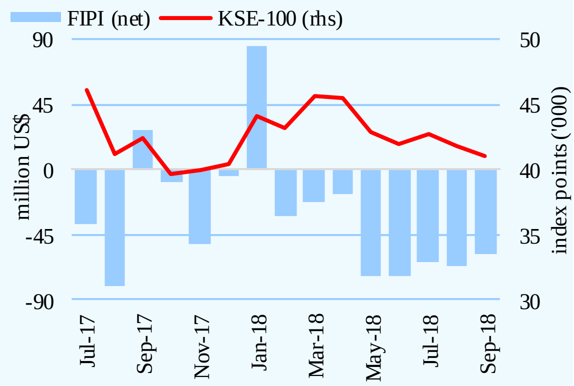
Apart from CPEC-related inflows from China, no major activity was observed in FDI. The non-CPEC related FDI that Pakistan has received over the past couple of years has remained mostly concentrated in a few non-export oriented manufacturing sectors, such as power, construction, financial business, oil & gas explorations, telecommunications and food. In fact, over the last five years, 80.6 percent of the average annual FDI received by Pakistan went into these six sectors. On the contrary, the key exporting sectors, such as textiles and leather products, attracted only 1.3 percent of the net FDI, on average, in the same period. Therefore, there is a need to promote foreign investment in the export-oriented manufacturing sectors, such as textiles and leather products. This may help boost the country's exports.[7]

Figure 5.6: Trend in Dollar Index and MSCI EM Index



Data source: Bloomberg

Figure 5.7: Foreign Investment in Pakistani Equities & PSX's Performance



Data source: NCCPL & Pakistan Stock Exchange

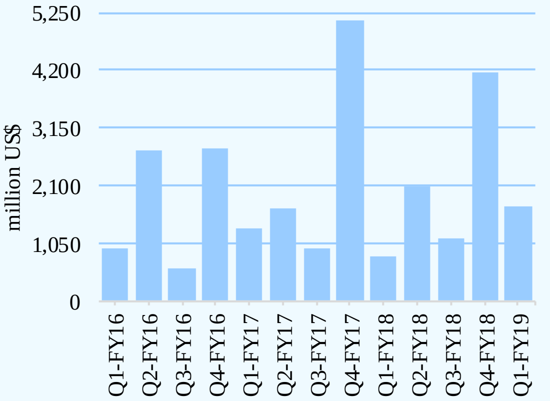
<u>Foreign portfolio investment</u>

Portfolio investment witnessed a higher net outflow of US$ 185.0 million in Q1-FY19, compared to an outflow of US$ 126.0 million recorded in the same period last year. Private investment entirely led this outflow.

The recent strengthening of the US dollar against major currencies in the wake of monetary tightening by the US Fed has prompted global fund managers to realign their portfolio positions. This has led to outflows in portfolio investment from the

[7]According to the Ministry of Commerce's draft 'Trade Related Investment Policy Framework 2015-23', the FDI in Pakistan's manufacturing sector remains market-seeking rather than efficiency-seeking; the latter could have helped make the export-oriented sectors more competitive.

Figure 5.8: Net External Loan Inflows



Data source: State Bank of Pakistan

emerging equity markets across the globe (**Figure 5.6**). Pakistan's equity market, similarly, remained under pressure in Q1-FY19 and witnessed a net foreign selling of US$ 189.0 million, compared to a net selling of US$ 90.6 million during the same period last year (**Figure 5.7**). Besides global factors that triggered the private equity outflow, domestic factors such as the uncertainty over weakening macroeconomic indicators (specifically the external account position) did not allow any recovery in investors' confidence. Going forward, official inflows may continue to dominate the overall foreign portfolio inflows, as the government is planning to raise US$ 3.0 billion by issuing bonds in the international capital market during FY19.[8]

Net incurrence of liabilities

The net inflow of FX liabilities more than doubled in Q1-FY19 to US$ 1.7 billion, from US$ 0.8 billion recorded in the same quarter last year (**Figure 5.8)**.

The short-term debt repayments of the government exceeded short-term loan disbursements in Q1-FY19. However, the government secured US$ 2.0 billion in long-term loans, which lent major support in partially closing the current account gap.

5.4 Exchange Rate and Reserves

SBP's foreign exchange reserves depleted by US$ 1.4 billion during Q1-FY19. This drawdown was relatively contained compared to the same period last year, when 50.0 percent of the CAD was financed by reserves.

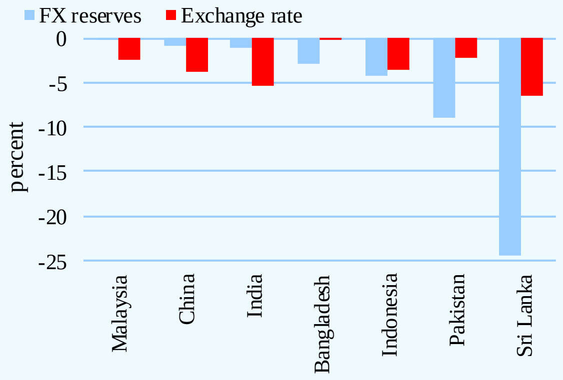
With the pressure on FX reserves, the Pak rupee continued to depreciate against the US dollar, sliding by 2.2 percent in Q1-FY19. However, the magnitude of the depreciation was lower than the preceding quarter (Q4-FY18) when the Pak rupee had weakened by 4.9 percent. Importantly, not just the PKR, but the currencies (and FX reserves) of a number of EMs also dropped significantly against the US

[8] Source: Economic Affairs Division.

dollar during the period under review (**Figure 5.9**).

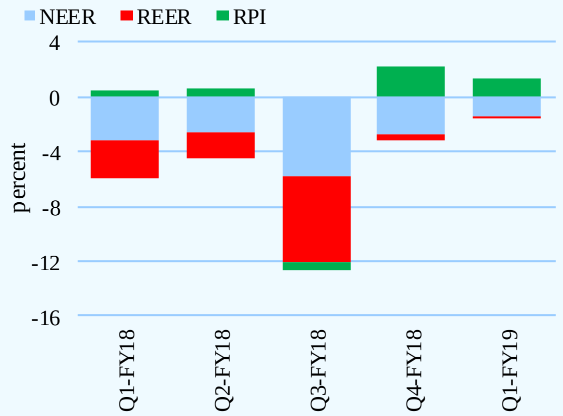
Furthermore, the increase in domestic inflation has also eroded most of the potential competitive gains that Pakistan could achieve from the currency depreciation. This is evident from a marginal depreciation of 0.04 percent in the country's real effective exchange rate (REER) in Q1-FY19. By contrast, other EMs witnessed sizable deterioration in their REERs **(Figure 5.10)**. It is important to recall here that Pakistan's REER had experienced a hefty depreciation of 11.0 percent in FY18, whereas the REERs of the other EMs had declined only marginally.

Figure 5.9: Change in FX Reserves and Exchange Rates against US dollar for Selected Asian Economies (Jul-Sep 2018)



Data source: Haver Analytics, State Bank of Pakistan

Figure 5.10: Change in PKR's REER and its Components



Data source: State Bank of Pakistan

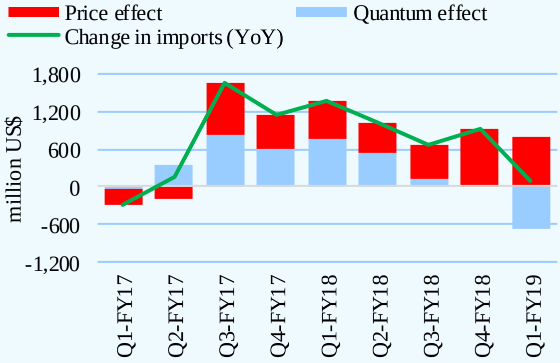
5.5 Trade Account[9]

After growing consistently for the past 11 consecutive quarters, Pakistan's trade deficit declined 2.5 percent YoY to US$ 8.8 billion in Q1-FY19. The drop originated from a slowdown in import growth (wherein a contraction in machinery imports partially offset the price-led uptick in energy imports), as well as a continued growth in exports. While the decline in PSDP spending and completion of early harvest CPEC power projects have lowered the imports of power generation and electrical machinery, a slowdown in broader economic activity amid exchange rate adjustments and other demand compression measures has led to a slackening in the demand for both

[9] This section is based on customs data reported by the PBS. The information in this section may not tally with the SBP data reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

energy and non-energy imports as well (**Figure 5.11**).[10] This led to a drop in quantum purchases of both. However, the potential FX savings from lower import quantums were entirely offset by the higher international oil prices, which remained, on average, 50.9 percent higher in Q1-FY19 as they were in the same quarter last year.

Figure 5.11: Contribution of Quantum & Price Effects to Change in Import Values

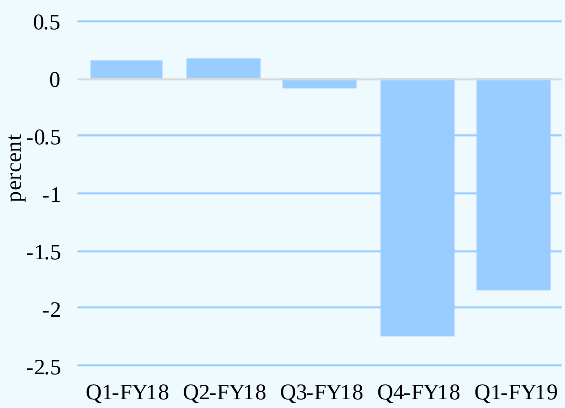


*excluding LNG
Data source: Pakistan Bureau of Statistics

In the case of exports, unit prices moved in unfavorable direction as well. While the export quantum was higher for a wide range of products as compared to last year, lower unit prices subdued the export revenue growth.[11]

Thus, the worsening trend in Pakistan's terms of trade that began in Q4-FY18, continued to keep the trade deficit at a high level in Q1-FY19 as well (**Figure 5.12**). Going forward, if this trend continues, then maintaining the current growth momentum of overall exports may become challenging. Similarly, the continuation of subsidies on agricultural exports will also determine the country's export performance down the road.

Figure 5.12: YoY Change in Pakistan's Terms of Trade



Data source: Pakistan Bureau of Statistics

This is because in Q1-FY19, the export growth was largely driven by the food group, particularly wheat and sugar (**Figure 5.13**), and subsidies were in play for

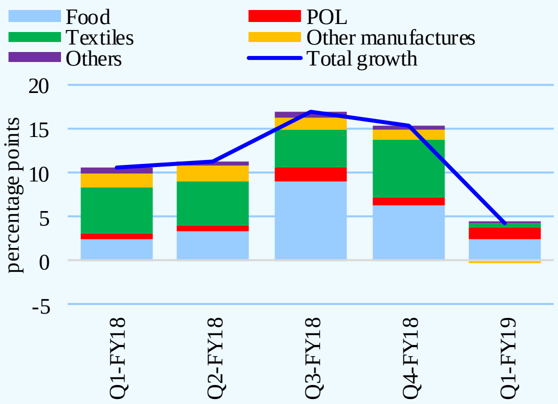
[10] A drop in large-scale manufacturing, and sales of automobiles and transport fuel in Q1-FY19 all point to a slowdown in general economic activity in the country.
[11] It is possible that some exporters, particularly those of apparel, are taking hits on their profit margins while trying to retain their shares in competitive markets, such as the US. This would have resulted in a drop in the unit values of their exports.

both these items. Already, the subsidy on sugar exports have been rolled back, and it is uncertain if Pakistani sugar exporters can compete on their own in the international market.

Exports

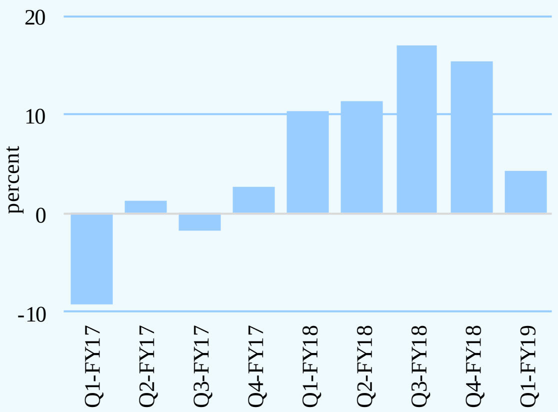
Pakistan's export growth momentum entered its sixth straight quarter in Q1-FY19, with values rising 4.2 percent to US$ 5.4 billion. However, the growth rate has dropped significantly from the previous few quarters (**Figure 5.14**). The major reason was a hefty drop in textile exports, which were pulled down by lower unit prices. Nonetheless, Pakistan is not unique in this respect, as the export growth of many EMs has also fallen this quarter as compared to the same period last year (**Figure 5.15**). What differentiates Pakistan from the rest, though, is that its export growth moderated in Q1-FY19 while its currency remained stable in real terms. On the contrary, other EMs saw their export growth subside despite witnessing a significant depreciation in their REERs (**Section 5.5**).

Figure 5.13: Sector-wise Contribution to Export Growth



Data source: Pakistan Bureau of Statistics

Figure 5.14: Annual Growth in Pakistan's Export Values



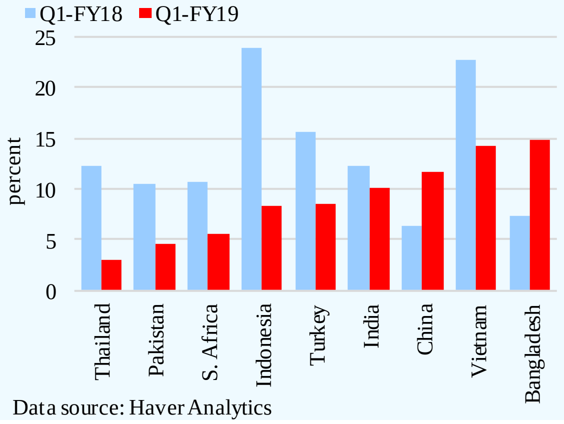
Data source: Pakistan Bureau of Statistics

Textile exports stagnate amid falling unit values

Overall textile exports grew by 0.6 percent YoY and reached US$ 3.3 billion in Q1-FY19, after rising by 7.9 percent in Q1-FY18. The exports of readymade garments and raw cotton, which had propelled last year's performance, both declined this year, pulling down the growth in the overall textile exports to their lowest in almost two years. That said, in the case of readymade garments, the decline was entirely due to lower unit prices, which completely offset a healthy growth in their quantum exports. The US, as opposed to the EU, emerged as the main drag on the garment exports.

In the US market, Pakistani exporters failed to increase their share. The US' total textile and apparel imports grew at a higher rate in Q1-FY19 than they had last year (**Table 5.6**), as robust economic growth and low unemployment encouraged consumers to spend more.[12] While the demand for synthetic garment imports maintained their growth momentum from last year, the demand for cotton apparel witnessed a trend reversal (**Table 5.7**). This was in response to the rising prices of synthetic garments, which, in turn, reflected an uptick in the prices of polyester and other man-made fibers.

Figure 5.15: Export Performances of Major EMs (YoY Growth)



Data source: Haver Analytics

Table 5.6: US' Total Quantum Textile & Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	1.4	3.7	3.1	3.0
Cambodia	4.3	8.6	1.7	1.7
China	5.4	4.9	52.7	52.4
Germany	-16.5	26.9	0.7	0.8
India	5.8	10.9	7.2	7.6
Indonesia	-9.3	-3.9	2.2	2.0
Italy	-7.5	22.1	0.4	0.5
Pakistan	8.3	-0.9	3.6	3.3
Turkey	2.7	7.5	1.1	1.2
Vietnam	7.8	5.6	7.1	7.1
US' overall imports	3.2	5.6	-	-

Data source: Office of Textiles and Apparel

Despite higher imports by the US, Pakistan's overall textile and apparel exports to the country could not benefit and instead declined by 0.9 percent YoY in quantum terms. Even within the cotton apparel segment, the growth in Pakistan's quantum exports in Q1-FY19 was lower than last year, despite a rebound in the US' cotton apparel imports in the quarter under review.[13]

On the other hand, Pakistan's non-cotton apparel exports to the US dropped by a

[12] Retail sales of clothing and accessories in the US rose 5.4 percent YoY in Q1-FY19, as opposed to rising by 1.1 percent in Q1-FY18 (source: US Census Bureau).
[13] Perhaps, Pakistani exporters are more focused on the duty-free access of the EU market.

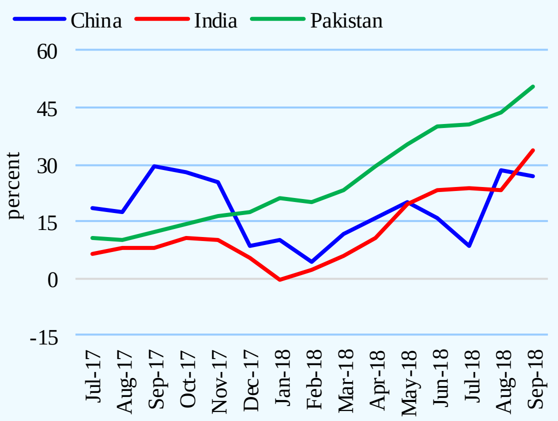
sharp 14.6 percent in quantum terms, as the exporters found it hard to control costs in the wake of spiking polyester staple fiber (PSF) prices in local currency terms. PSF prices have risen more rapidly in Pakistan than they have in China and India, which made it harder for Pakistani exporters to compete against their peers (**Figure 5.16**).

Table 5.7: US' Quantum Cotton Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	-3.2	5.8	11.3	11.8
Cambodia	8.3	21.2	3.6	4.3
China	-3.0	-1.5	32.5	31.6
India	3.0	4.9	5.7	5.9
Indonesia	-4.3	0.3	4.3	4.3
Pakistan	5.2	2.0	4.0	4.0
Turkey	11.3	-1.8	0.3	0.3
Vietnam	5.0	0.2	12.6	12.5
US' imports	-2.8	1.1	-	-

Data source: Office of Textile and Apparel

Figure 5.16: Growth in PSF Prices in Local Currency Terms



Dara source: Emerging Textiles & SBP calculations

At the same time, to Pakistan's detriment, a gradual shift in the US' sourcing of textile and apparel products also seems to be underway, both in response to the trade tensions with China and evolving consumer preferences. First, the ongoing trade tensions with China have induced US retailers to look for other low-cost producers. This increasingly means countries that enjoy concessional or duty-free market access to the US, such as Cambodia. Usual suppliers like India and Vietnam have also benefitted. Pakistan is at a disadvantage on both counts, as its costs tend to skew upwards and it also does not enjoy duty-free access to the US. Even though Pakistan is a beneficiary under the US' GSP scheme, its textile and apparel products do not fall under the duty-free regime.

In contrast to the US, Pakistani exporters did quite well in the EU, where they managed to increase their market share (**Table 5.8**). While the growth in the EU's overall textile and apparel imports actually declined in Q1-FY19 in volume terms, in line with a moderation in the bloc's GDP growth, not all apparel suppliers were affected equally.[14] In fact, countries enjoying duty-free access to the EU, namely Bangladesh, Pakistan and Cambodia, experienced sizable export growth, at the expense of China and India. Moreover, Vietnam's exports to the EU also maintained their momentum, as the two parties edged closer to ratifying the free trade agreement.[15]

Meanwhile, the 74.0 percent decline in Pakistan's quantum raw cotton exports in Q1-FY19 can be traced to lower expected local production of the crop in the 2018-19 season, which led the spinning industry to accumulate stocks for domestic use instead of export.[16] In fact, the entire decline in cotton's export values was due to lower quantums, as unit prices were just marginally higher than last year.

Going forward, Pakistan's textile exporters are likely to face a tough time, given the shifting dynamics in the US, and Vietnam's expected surge in the EU market. That said, there are a few upshots in the offing. First, in September, Bangladesh announced a 51.0 percent increase in the minimum wage for its garment workers, which will go into effect in January 2019. The wages were last increased in 2013. Any net increase in production costs in the country could allow Pakistani exporters to compete more effectively in the EU and possibly increase their market share at Bangladesh's expense. Second, the EU launched a six-month review process in October 2018 to determine the continuity of Cambodia's duty-free access to the bloc under the Everything-But-Arms (EBA) scheme, following controversial elections in the country in July. While the eventual outcome of this review is uncertain, Pakistani exporters would stand to gain if Cambodia's garment exports to the EU, which are rising quite rapidly (**Table 5.8**), come

Table 5.8: EU's Quantum Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	6.5	8.2	21.6	23.6
Cambodia	14.3	12.0	4.7	5.3
China	0.2	-11.3	43.4	38.8
India	0.1	-5.9	4.6	4.4
Indonesia	-2.0	-5.8	1.1	1.0
Pakistan	13.4	4.7	4.1	4.4
Turkey	2.4	8.2	7.5	8.2
Vietnam	5.5	2.3	2.9	2.9
EU's total imports	3.9	-0.8	-	-

Data source: Eurostat

[14] Real GDP growth in the EU-28 slid to 1.9 percent YoY in Q1-FY19, from the average growth of 2.3 percent in the previous three quarters (source: Eurostat).
[15] As per the draft of the agreement made public in September 2018, the EU has proposed either immediate or phase-wise elimination of tariffs on clothing and apparel products from Vietnam (under HS Codes 61 and 62). Currently, some of these products attract tariff as high as 12.0 percent.
[16] Local cotton sowing had missed its target by 8.0 percent, and the production target was revised down by 25.0 percent to 10.8 million bales, according to the Cotton Crop Assessment Committee.

under the normal duty regime.

Food group leads the way in non-textile exports
Overall food exports rose 16.7 percent to US$ 866.3 million in Q1-FY19, with wheat and sugar cumulatively responsible for 84.5 percent of this increase. For both of these commodities, a hefty uptick in quantum exports offset lower unit prices, as exporters continued to utilize the subsidies that were in place during the period.[17] Meanwhile, rice exports declined by a marginal 2.6 percent to US$ 312.1 million in the quarter. In the case of basmati rice, quantum exports rose sufficiently enough to offset a drop in unit prices. Like last year, shipments to European countries, such as Belgium, Italy, Netherlands and the UK, were up significantly.

Among other products, cement exports surged 58.6 percent YoY to US$ 77.6 million. With additional capacity coming online in the south in H2-FY18, firms in the region have been aggressively marketing to foreign buyers. That said, initial customs data as well as market intelligence suggests that clinkers, instead of finished (Portland) cement, drove the increase in quantum exports in Q1-FY19.[18] Clinker is a relatively lower value product that is further processed to make cement. Pakistani firms are said to be more price-competitive in this segment instead of cement, and are exporting clinkers to countries like Bangladesh and Kenya, where local companies process them to make Portland cement.

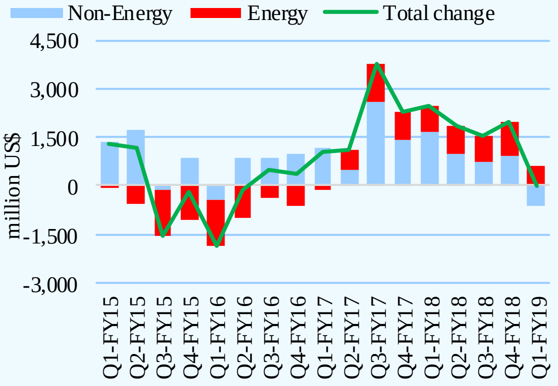
<u>Imports</u>
Pakistan's import growth declined marginally (by 0.04 percent) in Q1-FY19, against the 21.4 percent increase recorded last year, with import values reaching US$ 14.2 billion. The slowdown originated entirely from the 5.3 percent YoY decline in non-energy imports, which was the first such drop in three years (**Figure 5.17**). Imports of almost all major non-energy categories, led by machinery, declined during the quarter. Energy imports, on the other hand, rose significantly, mainly due to the higher international oil prices.

[17] Intriguingly, despite international wheat prices being 20.8 percent higher, on average, during Q1-FY19 over last year, unit prices of Pakistan's wheat exports were down 23.3 percent on YoY basis. One reason could be that exporters were willing to offload their surplus stocks at lower prices, and then claim the difference from subsidies already in place. However, in case of sugar, average international prices were 21.2 percent lower in Q1-FY19, indicating that subsidies played a prominent role in boosting its quantum exports.
[18] In both SBP and PBS' trade data, "cement" comprises both Portland cement and clinkers. As per PBS, quantum clinker exports in Q1-FY19 amounted to 631,673 MT, significantly higher than the 2,747 MT exported in the same period last year.

Energy imports

Pakistan's energy imports rose 8.6 percent to US$ 3.4 billion in Q1-FY19, with LNG contributing the most to this increase. Unlike other POL products, LNG imports are being driven by both higher prices and quantum purchases. With LNG replacing natural gas and furnace oil in the power, fertilizer, transport (CNG) and other industrial sectors, its quantum imports have been rising consistently ever since its introduction in the domestic fuel mix in Q1-FY16. The power sector has a dominant share in LNG consumption, followed by general industry, fertilizer and transport. Moreover, its imports are likely to stay elevated going forward, given the government's announcement that industries will be supplied LNG during the winter months, as cheaper and locally produced natural gas is diverted to domestic consumers.[19]

Figure 5.17: Breakdown of Absolute Change in Import Values



Data source: Pakistan Bureau of Statistics

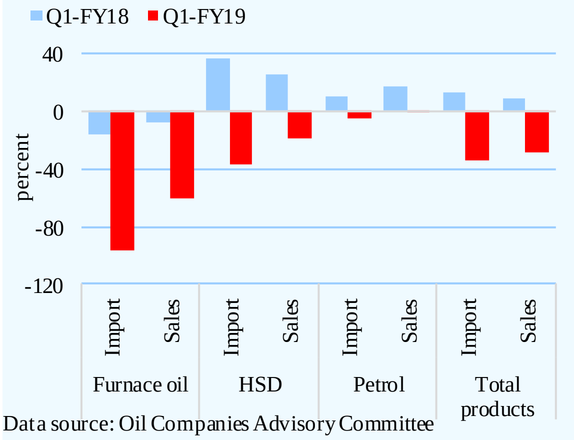
With regards to price, Pakistan mainly imports LNG from Qatar under a state contract, with the import prices linked with those of crude oil. During Q1-FY19, Arab Light crude prices averaged US$ 75.9 per barrel, against last year's average price of US$ 50.3.[20] Inevitably, LNG imports more than doubled in value terms and reached US$ 939.2 million in the quarter.

On the other hand, quantum imports of POL products declined 37.0 percent during the quarter.[21] Unlike previous quarters, furnace oil (FO) was not the sole drag on quantum product imports, as foreign purchases of transportation fuels, such as high speed diesel (HSD), petrol and jet fuel, were all lower as compared to last year (**Figure 5.18**). The lower imports corresponded with a drop in the sales of these fuels. While the decline in FO imports is understandable given its reduced usage in power generation, the drop in sales and imports of transport fuels is intriguing. Nonetheless, some factors explain this development.

[19] Source: Press Information Department press release dated October 16, 2018.
[20] Benchmark spot LNG prices in Japan were also 23.5 percent higher, on average, in Q1-FY19 as compared to Q1-FY18 (source: Haver Analytics).
[21] Source: Oil Companies Advisory Committee (OCAC).

First, the overall POL sales during Q1 were pulled down due to an exceptionally low consumption in August. Extended Eid holidays during the month led to a heavy contraction in the sales of HSD, and a relatively minor drop in those of petrol.[22] Data for September indicates that all fuel sales had returned to normalized levels. Second, domestic production of petrol had risen by a solid 17.6 percent during Q1-FY19, which lowered the demand for its imports. Third, the pass-through of the hefty rise in international oil prices to domestic petrol and HSD prices also played a role in curbing the demand for these fuels. Some substitution between petrol and CNG is also possible, as prices of the former had risen far more than those of the latter.[23]

Figure 5.18: Growth in Import and Sales of POL Products



Data source: Oil Companies Advisory Committee

Meanwhile, subdued demand for FO and transportation fuels led refineries to lower their purchases of crude oil, which recued the demand for imports of the commodity. Yet, the sizable increase in its international prices completely offset the impact of lower quantums, and contributed entirely to the 48.2 percent rise in import values during the period.

Non-energy imports

Pakistan's non-energy imports amounted to US$ 10.4 billion in Q1-FY19, down 5.3 percent from Q1-FY18. The broad-based decline was led by lower purchases of machinery during the period (**Figure 5.19)**. With the completion of many early-harvest CPEC projects, purchases of foreign power generation and electrical machinery have declined (along with FDI inflows in this sector from China).[24] At the same time, transport imports dropped 17.4 percent to US$ 790.9 million in

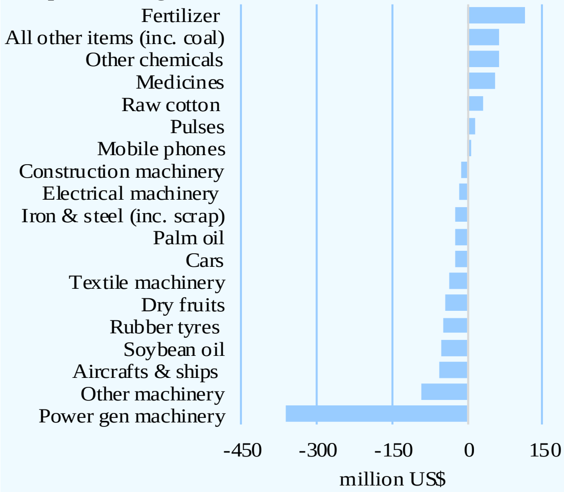
[22] HSD sales in August 2018, at 493,941 MT, had dropped to their lowest monthly level since March 2014. That said, sales then picked up to 736,807 MT in September 2018 (source: Oil Companies Advisory Committee).

[23] Petrol and HSD prices were, on average, 33.7 percent and 41.9 percent higher in Q1-FY19 as compared to Q1-FY18. By contrast, average CNG prices were 13.1 percent higher this year as compared to last year. Average CNG prices, in absolute terms, were also much lower (at Rs 81.9) than those of petrol and HSD (Rs 94.6 and Rs 111.0 per liter).

[24] For details, see **Section 5.4**.

the quarter. A sizable 35.9 percent decline was noted in car CBU imports, as additional customs duty was imposed on vehicle imports in the budget 2018-19, and the government decided to ban non-filers from purchasing cars. Meanwhile, imports under the ships and aircraft category were also lower than last year, mainly due to a low-base effect.[25]

Figure 5.19: Absolute YoY Change in Non-Energy Imports during Q1-FY19



Data source: Pakistan Bureau of Statistics

Further relief came from the low international prices of palm and soybean oil, which reduced the import values of these two commodities during Q1-FY19. In the case of palm oil, a build-up of inventories in the second-largest producer Malaysia, coupled with the ongoing slump in the Malaysian Ringgit against the US dollar, led to a drop in its international prices.[26] This encouraged edible oil mills in Pakistan to purchase higher quantities while the prices were low. As a result, even though quantum palm oil purchases went up 12.8 percent, its import values declined 4.8 percent to US$ 485.7 million in Q1-FY19. Similarly, lower international prices of soybean oil kept its import values in check, though quantum imports of the commodity were also lower as compared to the same period last year.

Meanwhile, the cumulative quantum imports of iron and steel (both scrap and finished products) dropped 5.9 percent YoY in the quarter due to a general slowdown in construction activities in the period. This was also reflected by lower domestic cement dispatches and steel production during the period.[27] Due

[25] Import of airplanes and parts (propellers, etc.) had amounted to US$ 74.5 million in Q1-FY18, which had inflated that quarter's transport imports. During Q1-FY19, aircraft imports had fallen to US$ 22.4 million, according to customs' data.

[26] Between Jun-Sep 2018, palm oil prices fell 18.8 percent (source: Bloomberg). Malaysian palm oil stocks had reached an eight-month high by Sep 2018, as a seasonal uptick in production and a simultaneous slowdown in exports led to this build-up (source: USDA Oil Crops Outlook, Oct-2018).

[27] Domestic cement dispatches declined by 0.4 percent YoY in Q1-FY19, after rising by a strong 21.9 percent in Q1-FY18 (source: All Pakistan Cement Manufacturers Association). Meanwhile,

to lower quantum, the import values of these items dipped 2.3 percent from last year.

On the other hand, upward pressure in the non-energy imports came particularly from coal, which is classified under "all other items" under both SBP's and PBS' trade data (**Figure 5.19**). Coal imports stayed elevated as the international prices reached their highest levels since April 2012; average coal prices were 23.7 percent higher on YoY basis in Q1-FY19. Besides, the demand for coal from the power and cement sectors remained strong, putting further upward pressure on its imports. As a result, coal import payments surged 120.1 percent YoY and reached US$ 464.3 million in the quarter.[28]

Meanwhile, fertilizer imports grew 49.6 percent and reached US$ 344.2 million, as domestic production declined by 5.1 percent during Q1-FY19. Local production was down as three fertilizer plants shut their operations amid gas supply issues. Going forward, fertilizer imports will stay elevated, as the government has allowed the import of 100,000 MT of urea to offset domestic supply shortages in the current cropping season.[29]

Besides these items, import demand for raw materials of the textile industry also stayed strong, as the industry tried to maintain its export growth momentum. Raw cotton imports surged 86.4 percent to US$ 65.2 million as the industry procured the material from abroad in the wake of lower expected cotton production. Imports of high staple cotton, used primarily to make export-quality garments, also continued. At the same time, import values of synthetic fibre and of chemicals used to make man-made fibres also went up, following the rising trend in their international prices as well as the local textile industry's efforts to catch up with the changing global clothing trends.[30]

domestic steel production declined by 3.3 percent YoY in Q1- FY19, after growing by a phenomenal 48.4 percent in Q1-FY18.

[28] Power generation from coal was over two hundred percent higher in Q1-FY19 as compared to the same period last year.

[29] The necessity of these imports has risen at an inopportune time, as international fertilizer prices are floating near three-year highs. Average foreign prices of urea and DAP were 31.6 percent and 28.2 percent higher in Q1-FY19 as compared to last year (source: Haver Analytics).

[30] For details about how Pakistan has continued to produce cotton-based clothing while the foreign demand has shifted towards synthetic textiles, see the Special Section titled "Synthetic Textiles is Key to Sustaining Export Growth Momentum" in SBP's *State of the Economy Report* for Q3-FY18.