9 Balance of Payments and Exchange Rate Policy

9.1 International Economic Scenario

The world output is estimated to have grown by 2.5 percent during calendar year 2001, which is substantially lower than the 4.7 percent achieved a year earlier. However, contrary to fears, the events of September 11, 2001 had only a short run impact on economic activities, and the contagion effects of Argentinean crisis were likewise limited. During 2002, while the US economy is still trying to recover from multiple shocks to the corporate sector and industry and the Japanese economy remains depressed, it is an expected upturn in Euro area together with better performance by Singapore, Taiwan, China, and economies-in-transition, which are projected to contribute to a growth of 2.8 percent in 2002 for the world economy.

In the USA, despite a 1.1 percent growth for the second quarter of calendar 2002, which is surprisingly lower than in the preceding two quarters, the Fed appears reluctant to ease monetary policy further as the federal funds target rate is already at 1.75 percent – the lowest since 1955.[1] The recent corporate bankruptcies, stock market crash and an unprecedented declining trend in fixed investment since the fourth quarter of 2000, suggest unfavorable economic prospects. A major impediment to a recovery is cautious bank lending following disclosure of inappropriate accounting practice of many US corporates that may hamper growth prospects. This in turn would hurt household savings and add to their debts, which are already under stress. On the other hand, the weak US Dollar, an expansionary fiscal policy, inventory buildup, productivity gains, and the fact that consumer spending remains strong despite the stock market collapse, are important positives for prospects of a modest recovery.

A moderate recovery is visible in the Euro area after the negative growth during the fourth quarter of 2001. The improvement is mainly due to the inventory buildup and an expansion in exports. Moreover, industrial production is also rising after touching a bottom in January 2002. In overall terms, the Euro-area GDP growth is expected at around one percent for 2002. The weakness in the German economy, however, remains a disturbing factor. In particular, the budget deficit for Germany is registered at 2.8 percent of GDP in FY02, which is close to the maximum allowed limit of 3.0 percent of GDP for individual Euro member countries. It is expected that the compensation to the victims of recent floods, will put further pressure on the fiscal balance.

The Japanese economy finally registered positive growth (albeit of less than 1 percent) in the second quarter of 2002 after showing sharp declines during last three consecutive quarters of 2001.[2] The improvement was largely on account of stronger electronic exports to Asia and inventory rebuilding. However, problems in the financial sector, and the slow restructuring and reform processes are still impeding economic recovery. Similarly, despite the liberal monetary stance that prevented deflationary pressures from worsening, inflation is not likely to occur in the near future. The overall negative outlook of the Japanese economy also impedes recovery of other important Asian economies, though the growing trade among ASEAN countries, China and Korea may dampen these impulses.

In Latin America, Argentina faced another major crisis in December 2001 – the third in 20 years. The Peso had lost 256 percent of its value by end-June 2002; and inflation soared to 28 percent during January-June, FY02. The economy posted a decline of 16 percent during the first quarter of 2002

---

[1] While the discount rate is 1.25 percent.

[2] The 5.7 percent growth in the first quarter of 2002 is considered as a statistical anomaly.

compared with the same period last year. This crisis underlines the importance of fiscal discipline for long-term economic growth and stability. This time, however, Argentina has not yet been offered any bailout package by the IFIs; this could be an important watershed, deterring moral hazard problems in future. In the past, expectations of a bailout have generally encouraged private investors to take unwarranted exposure despite high risks. Fortunately, the contagion effects of the Argentina crisis were not as strong as they were in 1980s. Although neighboring Brazil saw its currency – the *real* – come under attack, this was due more to political uncertainty arising from the presidential election. The *real* depreciated by more than 40 percent during January-June, 2002, and Brazil's industrial production also decreased due to a sharp decline in exports to Argentina. This led to a fall of 0.7 percent in Brazilian GDP during the first quarter of 2002.

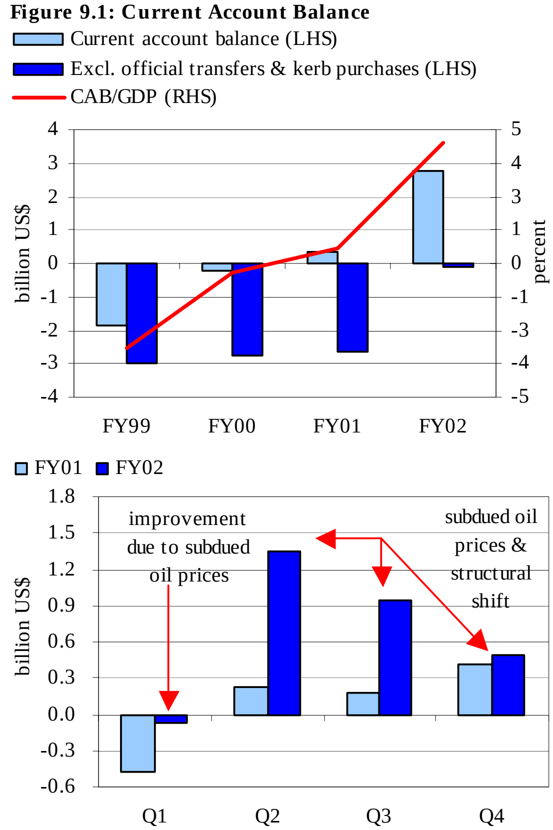
The emerging economies of Singapore and Taiwan recovered during 2002 after registering a decline in output last year. China is estimated to grow below the trend level but still above 7 percent growth witnessed last year. The GDP and industrial growth for Russia are impressive. After many years, the outlook for most of the African countries is bright, with GDP estimated to grow by relatively higher rates. A better economic performance in this region would help to reduce poverty and improve the living conditions of millions of the poorest.

9.2 Pakistan's Balance of Payments [3]

FY02 proved to be one of the most positive years, in terms of external sector developments, in the history of Pakistan, as reflected in the unparalleled surplus of US$ 2.7 billion in the overall balance of payments.

A number of inter-related developments propelled this improvement: (1) the kerb premium collapsed and the Rupee appreciated sharply, both in the kerb and the interbank markets, following the international crackdown on undocumented currency transactions; (2) this, in turn, caused a phenomenal increase in remittances through the banking channel, helping the country post its largest-ever current account surplus; (3) at the same time, improved relations with major creditors, due to greater credibility of economic policies and support to the international anti-terrorism campaign, led to greater assistance from sovereign creditors and IFIs; and (4) successful PRGF negotiations that, in turn, paved the way for a generous re-profiling of external debt by Paris Club creditors. The debt-re-profiling is expected to offer a sharp Net Present Value (NPV) reduction on external debt (between 27 to 43 percent) without having a HIPC or IDA only status.[4]

Figure 9.1: Current Account Balance



[3] Since this section is based on SBP's exchange records data, the trade numbers mentioned in this section may not tally with customs data used in the subsection on **Trade Account**.
[4] In a sense this is beneficial for Pakistan as HIPC or IDA only status restricts borrowings on normal terms from IBRD, ADB or market sources.

Not surprisingly therefore, the FY02 current account picture is notable for the depth of improvement, witnessing a surplus of US$ 2.7 billion during FY02 compared with US$ 0.3 billion in FY01 (see **Table 9.1** & **Figure 9.1**). In fact, even excluding official transfers and kerb purchases, the current account still shows an improvement of US$ 2.6 billion during the year. Indeed, the country's vulnerability to external shocks has reduced considerably.

Table 9.1: Balance of Payments - Summary

million US Dollar

	FY99	FY00	FY01	FY02	FY02	
					Jul-Sep	Oct-Jun
1. Trade balance	**-2,085**	**-1,412**	**-1,269**	**-360**	**-194**	**-166**
Exports (fob)	7,528	8,190	8,933	9,133	2,225	6,908
Imports (fob)	9,613	9,602	10,202	9,493	2,419	7,074
2. Services (net)	**-2,618**	**-2,794**	**-3,142**	**-2,620**	**-826**	**-1,794**
Shipment	-803	-751	-820	-746	-197	-549
Other transportation	110	71	61	103	-15	118
Travel	-122	-142	-180	-145	-35	-110
Investment income	-1,808	-2,018	-2,161	-2,311	-570	-1,741
Interest payments	-1,399	-1,598	-1,548	-1,464	-373	-1,091
Profits and dividends	-409	-420	-613	-847	-197	-650
Other goods, services, & income	5	46	-42	479	-9	488
3. Current transfers (net)	**2,847**	**3,989**	**4,737**	**5,724**	**959**	**4,765**
Private transfers –net	2,274	3,063	3,898	4,255	775	3,480
Workers' remittances	1,060	983	1,087	2,389	340	2,049
FCA (residents)	539	322	534	285	23	262
Outright purchases	531	1634	2157	1376	397	979
Official transfers	573	926	839	1,469	184	1,285
of which: Saudi oil facility	390	790	683	579	173	406
4. Current account balance (1+2+3)	**-1,856**	**-217**	**326**	**2,744**	**-61**	**2,805**
5. Capital account (net)	**-2,278**	**-4,177**	**-642**	**-1,050**	**-596**	**-454**
6. Errors & omissions	**992**	**500**	**625**	**961**	**359**	**602**
7. Overall balance	**-3,142**	**-3,894**	**309**	**2,655**	**-298**	**2,953**
8. Financing	**3,142**	**3,894**	**-309**	**-2,655**	**298**	**-2,953**
Changes in reserves (-Inc/+Dec)	**-824**	**-72**	**-1,001**	**-2,790**	**83**	**-2,873**
Assets	-1,254	208	-1,085	-3,080	-137	-2,943
SDRs	2	0	1	-9	2	-11
Forex (State Bank of Pakistan)	-809	380	-727	-2,707	-45	-2,662
Forex (commercial banks)	-447	-171	-359	-364	-97	-267
Liabilities	430	-280	84	290	220	70
Use of fund credit	430	-280	84	290	220	70
Repurchases	485	0	205	484	267	217
Purchases/drawings	55	280	121	194	47	147
Exceptional financing	**3,966**	**3,966**	**692**	**135**	**215**	**-80**
SBP reserves	1,740	1,358	2,084	4,809	2,134	4,809

Source: Statistics Department, SBP

By contrast, outflows under the capital account increased by US$ 0.4 billion to US$ 1.0 billion during FY02. The reasons can be traced to the following: (1) the Rupee repayment and redemption of maturing Special US Dollar bonds; (2) higher *notional* payments of long-term public & publicly guaranteed debt; (3) termination of swaps; and (4) repayment of commercial and PAYE loans/credits. Interestingly, the above developments had only a limited cash impact, as most of the payments are either *notional* or denominated in Rupees.

Nevertheless, the overall balance posted a surplus of US$ 2.7 billion compared to US$ 0.3 billion in the corresponding period last year, which in turn boosted the foreign exchange reserves to an unprecedented level of US$ 6.8 billion at end-June 2002.

This improvement in the external sector also has a major impact on SBP policies. In particular, the need to protect exporters from eroding competitiveness compelled SBP to set a floor for the Rupee/Dollar parity in the interbank market. Furthermore, the resultant mopping up of Dollar flows from the formal market led to an unparalleled buildup of reserves and allowed the retirement of expensive commercial and short-term liabilities. Indeed, the reserve accumulation also has implications for the conduct of monetary policy, as the absence of pressures on the exchange rate allowed SBP to reduce the Bank discount rate to all-time low.

It is significant that the positive turnaround in the balance of payments was partially the outcome of external shocks following September 11 events, and in particular, the international crackdown on undocumented fund flows. In fact, foreign exchange flows through the informal channels have been a major issue troubling Pakistan’s external sector for the past decade, and it was this leakage due to lax international practices that had essentially forced the SBP to purchase forex directly from the kerb market. Also, the past attempts to attract remittances through formal channels were somewhat unsuccessful mainly due to the sheer outreach of the informal system.

Thus, from Pakistan’s perspective, the international focus on undocumented flows has been a major boon for the domestic economy, diverting the forex flows from informal to formal channels. However, the resulting 129 percent growth in FY02 inward cash remittances only emphasizes the vulnerability and underlines strongly the urgency to cement and institutionalize the increased current transfers, in order to protect against any adverse developments in the future.

9.2.1 Current Account

Although the current account has been steadily improving over the last three years, the FY02 recovery is the first that is very *broad-based*. The trade deficit narrowed due to savings from lower oil prices in the international market; the services account showed lower net outflows following receipt of payments for logistic support; transfers receipts rose on account of buoyant growth in workers’ remittances and a large grant from the US (see **Figure 9.2**). This FY02 upturn is reflected in almost all key indicators of the external account.

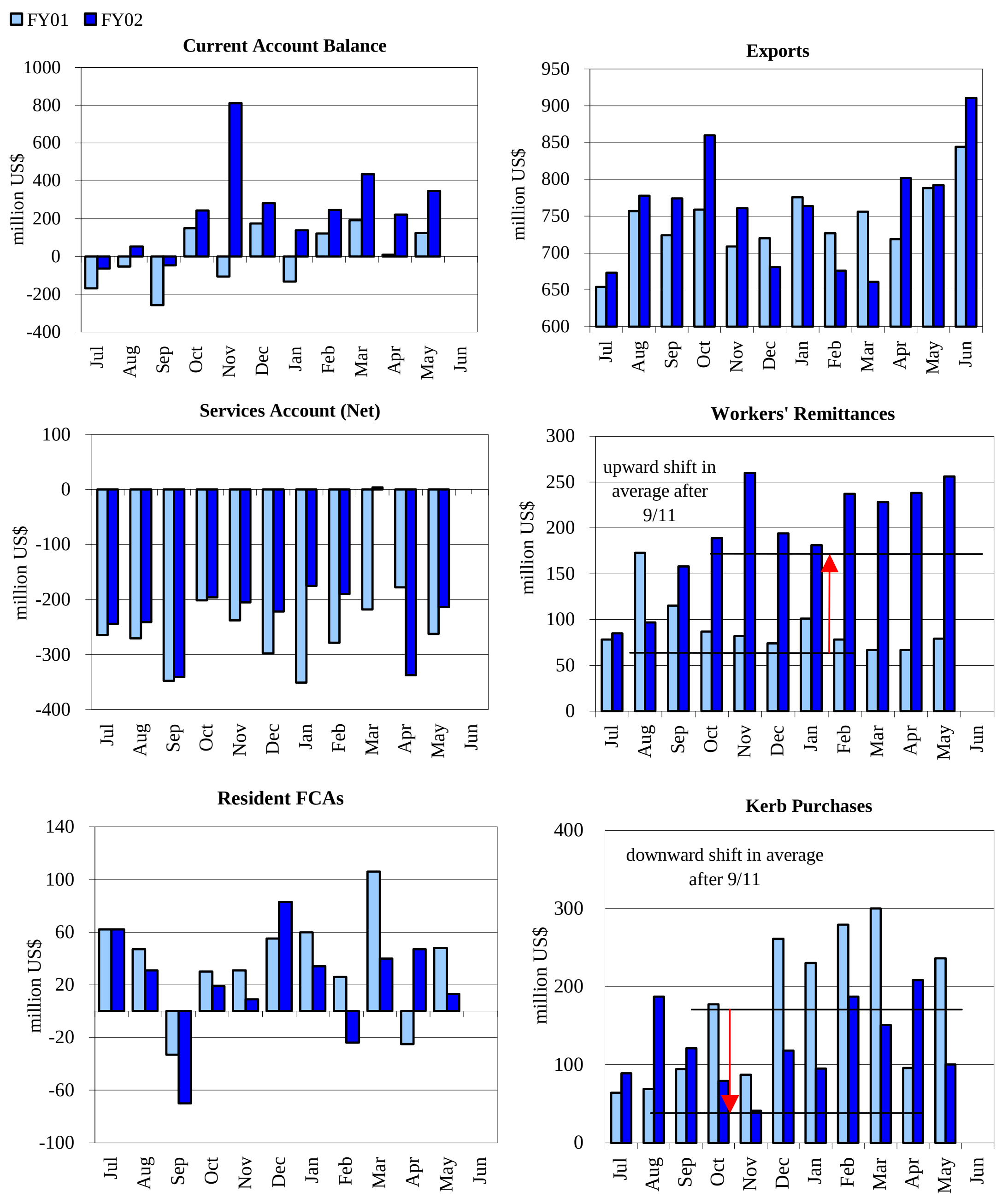
By contrast, improvements in previous years were largely concentrated under current transfers (see **Table 9.2**). The reason for this was simple: (1) as falling unit prices for key exports neutralized much of the gains in export volumes, over time, prospects of improvements in the trade account became a function of changes in oil prices in the international market. Similarly, (2) the services account was hostage to the debt servicing payments–any substantial drop in interest payments would require not only a reduction in overall debt stock but also

Table 9.2: Balance of Payments: Key Indicators
percent (or mentioned otherwise)

	FY99	FY00	FY01	FY02
Trade				
Exports/GDP	12.9	13.5	15.3	15.1
Imports/GDP	16.4	15.8	17.5	15.7
Services Account				
Services (net)/GDP	-4.5	-4.6	-5.4	-4.3
Debt-service to EE Ratio	18.6	19.6	17.3	16.0
Transfers				
Net transfers to GDP	4.9	6.6	8.1	9.5
Remittances/GDP	1.8	1.6	1.9	4.0
Current Account				
Current receipts/GDP	19.5	21.2	26.0	28.0
Current receipts growth	-13.0	16.4	17.6	11.5
FEE (million US$)	11,633	13,544	14,337	15,455
Growth of FEE	-15.9	13.4	12.4	7.8
Non-interest CAB (million US$)	-457	1,381	1,874	4,208
NICAB/GDP	-0.8	2.3	3.2	7.0
CAD/GDP	-3.2	-0.4	0.6	4.5
Capital Account				
FDI/GDP	0.8	0.8	0.6	0.8
FDI/exports	6.3	5.8	3.6	5.3
Others				
Import cover of reserves (in months)	2.2	1.7	2.4	6.1

Note: EE: Export Earnings; FEE: Foreign Exchange Earnings; NICAB: Non-interest Current Account Balance; FDI: Foreign Direct Investment changes in its composition.[5] Under such circumstances, current transfers become the only head in the external account that could show improvement in the short term.

Figure 9.2: Current Account Balance at Glance



[5] The government is already focusing on debt management strategy to reduce the overall debt burden.

Trade Balance

On the basis of SBP exchange records, the trade deficit declined by US$ 909 million to reach US$360 million during FY02, mainly due to lower oil prices in international markets. In fact, this outturn could have been even better if not for the continuing fall in unit prices of key exports, and the negative impact of risk perceptions due to the war in neighboring Afghanistan and subsequently, border tensions with India.[6] Fortunately, the increased access to the EU markets through larger textile quotas and reduced tariffs, provided some relief towards the end of the fiscal year and helped exports to cross the US$ 9.0 billion mark marginally (see **Trade Section** for more details).

Services (net)

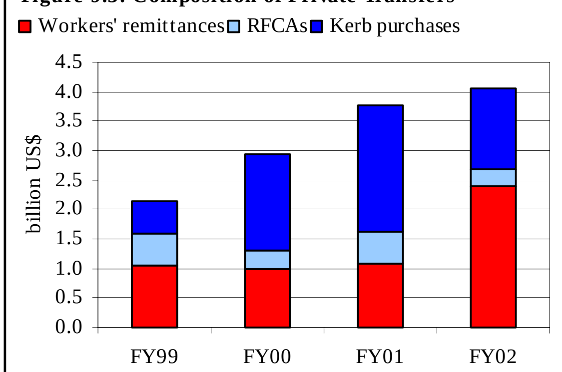
This deficit narrowed by US$ 0.5 billion to US$ 2.6 billion in FY02. The receipt of US$ 300 for logistic support in the war against terrorism, and increased earnings of PTCL (both appearing under '*other goods, services & income*') were the main contributing factors to this improvement.[7] In addition, the net receipts under '*shipment*' improved by US$ 74 million as lower imports offset higher per unit shipment charges during the year; '*other transportation*' increased by US$ 42 million due to higher aviation and bunker charges; and '*travel*' receipts jumped by US$ 35 million following the influx of foreign media personnel and journalists for the coverage of war in Afghanistan.

On the other hand, '*investment income*' witnessed a higher outflow of US$ 150 million in FY02 over the last year, despite falling interest rates in international markets and diminishing stock of external debt & liabilities (e.g. FE-45 deposits, Special US$ bonds, and commercial & private loans). The increased outflows mainly reflect higher *notional* payments on long-term publicly guaranteed debt. Moreover, the higher repatriation of dividend and income from sale of crude oil by foreign companies engaged in oil/gas extracting activities in Pakistan led to more outflows under '*profit and dividend*'.

Current Transfers

Although the events following September 11 influenced all categories of the external account, the impact was more intense for the current transfers, which experienced an unambiguous structural shift in the composition of private transfers (see **Figure 9.3**). The share of workers' remittances rose to 42 percent in FY02 from 23 percent last year, whereas the share of kerb purchases fell from 46 to 24 percent during the same period. It may be noted that the overall level of private transfers in FY01 (US$ 3.9 billion) and FY02 (US$ 4.3 billion) showed a slight change reflecting the fungibility between workers' remittances, inflows through kerb market and foreign currency deposits. In addition, Pakistan received a US$ 600 million grant from USA.

Figure 9.3: Composition of Private Transfers



Workers' Remittances

The cash remittances registered a phenomenal growth of 129 percent during FY02, which stretches to 145.5 percent after adjusting for receipts on account of Hajj Sponsorship Scheme (HSS) and payments to Kuwait war affectees (see **Table 9.3**). During the first quarter of FY02, cash remittances recorded

[6] In particular, exporters were facing cancellation of orders due to risk perceptions, higher freight costs, a slow-down in cargo handlings of international airlines.
[7] Interestingly, this resulted into a surplus of US$ 4 million under services (net) during March 2002 despite higher debt servicing at the end-quarter.

an inflow of US$ 325 million only. Indeed, the turning point was the international crackdown on the Hundi network, and the consequent collapse of the kerb premium that favorably changed the market dynamics of remittance inflows; as a result the remittances posted an inflow of US$ 2.0 billion during the last three quarters of FY02 (see **Figure 9.2**).[8]

Table 9.3: Country-wise Workers' Remittances

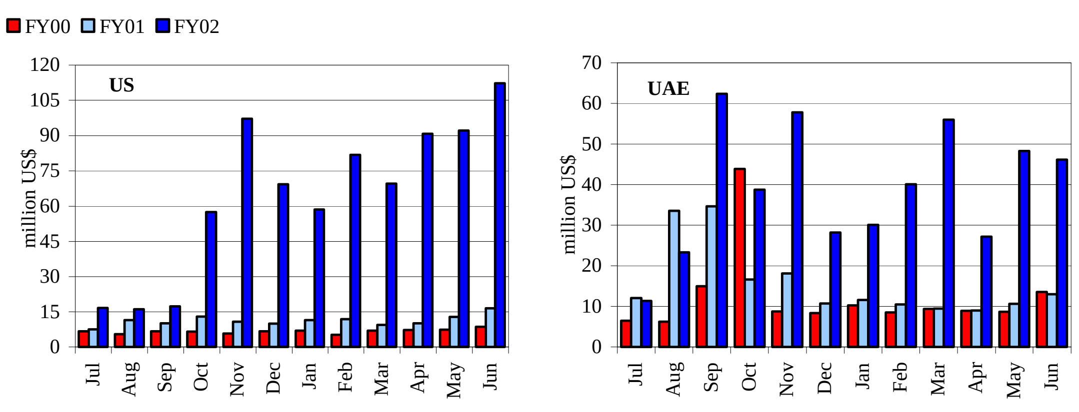
million US Dollar

					Jul-Sep		Oct-Jun	
Countries	**FY99**	**FY00**	**FY01**	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**
Gulf region:	**641**	**682**	**693**	**1,070**	**275**	**216**	**418**	**854**
Bahrain	33	29	24	40	7	7	17	33
Kuwait	106	135	123	90	70	13	53	77
Qatar	13	13	13	32	4	4	9	28
Saudi Arabia	318	310	304	376	102	85	202	291
Sultanat-e-Oman	45	46	38	63	11	11	27	52
U.A.E.	125	148	190	469	80	97	110	372
Other than Gulf region:	**235**	**232**	**328**	**1,271**	**76**	**109**	**253**	**1,162**
Canada	3	4	5	21	1	2	4	18
Germany	12	10	9	13	3	2	6	11
Japan	3	2	4	6	1	1	3	5
Norway	5	6	6	7	2	2	4	5
U.K.	74	73	81	152	21	23	61	129
U.S.A.	82	80	135	779	29	50	106	729
Others	55	57	88	293	20	29	69	264
Total	**876**	**913**	**1,022**	**2,341**	**351**	**325**	**671**	**2,015**
Growth rate (percent)	-29.3	4.3	11.8	129.1		-7.3		200.5
Growth Rate (excluding HSS & KWA)	-	-0.6	15.2	145.5				
Encashment FEBCs & FCBCs	185	70	65	48	15	15	50	34
Grand Total	**1,060**	**984**	**1,087**	**2,389**	**366**	**340**	**721**	**2,049**

HSS: Hajj Sponsorship Scheme; KWA: Kuwait War Affectee

Source: Statistics Department, SBP

Figure 9.4 : Worker's Remittances from US & UAE



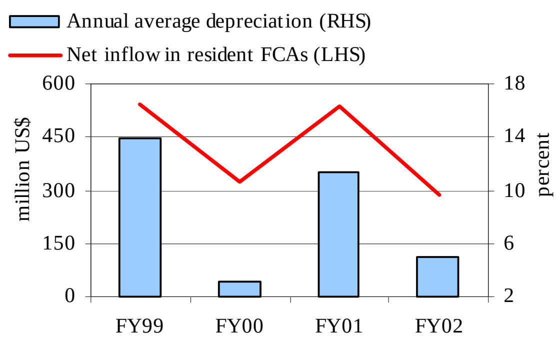
[8] To put this in into perspective, the full year FY01 remittances totaled US$ 1.0 billion.

Although remittances from all countries (except Kuwait) posted a double-digit growth during FY02, the inflows from the UAE & the US were exceptional, accounting for 70 percent of the total increase (see **Figure 9.4**). It seems that the increasing international restrictions on undocumented transactions have reduced Dubai's role as a hub of the Hundi network, which explains the larger formal sector flows into Pakistan directly from countries of origin.

Resident FCAs

The inflows in resident FCAs fell by US$ 249 million to US$ 285 million in FY02. Although, the Rupee/Dollar parity is still showing a depreciation of 5.0 percent on annual average basis, the reversal of devaluation expectations coupled with the meager dollar returns on FCAs, quelled incentives for the dollarization of savings in the economy. This opinion is also re-affirmed from **Figure 9.5** which portrays the direst relationship between inflows in resident FCAs and the annual average depreciation of the Rupee/US Dollar parity.

Figure 9.5: Resident FCAs and Depreciation



Kerb Purchases

The SBP purchases from the kerb market during FY02 were US$ 1.4 billion against US$ 2.2 billion last year (see **Table 9.1**). Initially, the SBP purchased heavily from the kerb market to maintain the foreign exchange reserves in view of end-quarter debt payments. After September 11, these purchases dipped before strengthening again in December 2001, as SBP purchased US$ 859 million during the Dec 01-May 02 period (see **Figure 9.2**).[9, 10] Nevertheless, as the country attained a comfortable position, SBP stopped purchasing from the kerb market with effect from June 2002.

Official Transfers

Despite lower inflows under Saudi Oil Facility (SOF), official transfers improved by US$ 630 million during FY02. The main contributing factors were the grants received from the US (US$ 600 million) and other countries to compensate for the revenue shortfall and a decline in exports following the war in Afghanistan. In terms of SOF, the inflow decreased by US$ 104 million as oil prices fell in the international market.

9.2.2 External Vulnerabilities

As discussed earlier, the current account has been improving over the last three years. During this period, the external sector has witnessed a narrowing of the trade deficit, an increase in non-debt creating inflows, reduction in debt servicing, and higher inflows of concessional loans.

Despite these improvements, the FY02 upturn in the current account is better than the combined improvement in the earlier three years. Nonetheless, **Table 9.4** also highlights the fact that a significant contribution to the FY02 improvement was from factors that may be absent in future years.

This not only underlines the prudence of the SBP moves to boost forex reserves through market purchases, but also the urgency to document the informal market flows.

[9] Since SBP purchases from the interbank market are already part of the formal flows, these are not considered in current transfers.

[10] It is also worth noting that by December 2001, the market exchange rate was identical to the interbank rate, i.e. the SBP had the luxury of purchasing from both the kerb and interbank market without adversely affecting the market exchange rate.

9.3 Capital Account

The successful completion of IMF's Stand-by program by Pakistan led to a major shift in the relationships with International Financial Institutions (IFIs). Also, Pakistan's decision to join hands with the international community in the war against terrorism revived the previously strained relationship with bilateral creditors. These developments had a positive impact on the capital account as well, in terms of higher official assistance, on concessional terms, from multilateral and bilateral creditors, and re-profiling of bilateral debt on particularly generous terms. At the same time, the sharp appreciation of the Rupee has not only triggered the realization of outstanding export bills but also encouraged extinguishments of maturing special US$ bonds, through local currency payments as well redemption in dollars. The higher current account inflows also gave teeth to the debt management reduction strategy, enabling the country to retire most of its expensive debt.

Table 9.4: External Sector Vulnerability

million US Dollar

Vulnerabilities	FY02 Contribution	Future outlook
Oil saving	554	This saving may be curtailed sharply by the upward pressure on international oil prices (especially if fears of a US attack on Iraq materialize).
Workers' remittances	1,302	The permanence of workers' remittances will depend on the continuity of global scrutiny of Hundi transactions and successful merger of Pakistan's formal and informal foreign exchange markets.
Kerb purchases	-781	The SBP has decided to discontinue kerb market purchases.
Saudi oil facility	-104	Expected to become positive due to higher oil prices, but the tern of this arrangement is unclear
US aid	600	Expected to fall to US$ 200 million in FY03.
Logistic support	300	Will depend on the ongoing operation in Afghanistan.
Total	**1,871**	

In overall terms, the capital account deficit increased by US$ 407 million during FY02 to US$ 1,050 million (see **Table 9.1**). The higher outflows are on account of maturing Special US$ bonds and termination of swap contracts. Since most of the above-mentioned payments were made in the Rupees, the *notional* hard currency outflows were offset by inflows under errors and omissions. Furthermore, the hard currency payments on account of rescheduled PTMA and FE-45 deposits resulted in the reduction of exceptional financing by US$ 557 million to US$ 135 million this year (see **Table 9.5**).

Table 9.5: Exceptional Financing

million US Dollar

	FY99	FY00	FY01	FY02
	3,966	**3,966**	**692**	**135**
Debt relief from Paris Club	1,406	1,451	1,124	1206
Central bank deposits	150	300	250	0
Rollover of FE-45	1,212	1,072	(299)	(540)
PTMA	830	152	(297)	(531)
Euro bond	0	610	0	0
NBP deposits	150	500	0	0
Others	218	(119)	(86)	-

PTMA: Pakistan Trade Maintenance Agreement
Source: Statistics Department, SBP

9.3.1 Net Foreign Investment[11]

Net Portfolio Investment

Net portfolio investment comprises of foreign investment in stock exchange and government securities. Looking at **Table 9.6**, the outflows from stock market fell to US$ 8 million in FY02 against US$ 140 million last year (for detail, see chapter on **Capital Market**).[12]

The repayment of Special US$ bonds, which started maturing from August 2001, dominated the outflow of US$ 482 million from investments in government securities during FY02. In order to

[11] It covers items 1-3 of **Table 9.6**, which also include investment of Pakistanis abroad.
[12] The foreign investment in stock market is different from figure reported by Karachi Stock Exchange due to varying definitions (see **Box 9.1**).

Table 9.6: Capital Account

million US Dollar

	FY99	FY00	FY01	FY02	FY02	
					Jul-Sep	Oct-Jun
Capital Account (1 through 9)	**-2,278**	**-4,177**	**-643**	**-1,050**	**-596**	**-454**
Credit	**4,511**	**2,219**	**2,932**	**3,343**	**552**	**2,791**
Debit	**6,789**	**6,396**	**3,575**	**4,393**	**1,148**	**3,245**
1. Direct investment abroad	-44	1	-37	-2	0	-2
2. Direct investment in Pakistan	472	472	323	486	69	417
3. Portfolio investment	142	-550	-141	-491	-53	-438
of which: (Stock markets)	28	73	-140	-8	-47	39
Special US Dollar bonds	251	36	39	-452	3	-455
4. LT Capital, (official)	797	-678	-600	75	-252	327
Credit	3,188	1,304	1,463	1,608	166	1,442
of which: Project assistance	1,499	988	785	643	166	477
Food aid	230	191	0	0	0	0
Non-Food aid	550	125	678	885	0	885
Debit	2,391	1,982	2,063	1,533	418	1,115
of which: Amortization	2,038	1,967	1,795	1,512	396	1,116
Central bank deposits	250	0	-250	0	0	0
5. LT capital, (DMBs)	0	-2	-2	-1	0	-1
Credit	0	0	0	0	0	0
Debit	0	2	2	1	0	1
6. LT capital, (Others)	10	-265	-212	-667	-337	-330
Credit	446	324	283	184	13	171
of which: Suppliers credits/MNCs	195	167	191	184	13	171
Debit	436	591	495	851	350	501
of which: Suppliers credits repayments	436	591	495	531	141	390
7. ST capital, (official)	-1,288	-373	338	-438	5	-443
Credit	211	118	762	875	226	649
of which: Commercial banks	59	0	431	496	104	392
IDB	152	118	331	330	100	230
Debit	1,499	491	424	1,313	221	1,092
of which: Commercial banks	917	197	146	753	176	577
IDB	157	141	185	404	45	359
Others liabilities (NBP deposits)	374	135	34	155	0	155
8. ST capital, (DMBs)	-1,315	-1,829	-19	-144	51	-195
Credit	46	0	29	3	63	-60
Debit	1,361	1,829	48	147	12	135
of which: Outstanding exports bills	46	-127	29	-54	62	-116
FCAs (non-residents)	-1,211	-1,164	-48	-47	-12	-35
NBP deposits	-150	-500	0	-46	0	-46
9. ST capital, (Others)	-1,052	-952	-293	132	-79	211
Credit	0	0	72	187	15	172
Debit	1,052	952	365	55	94	-39
of which: Outstanding exports bills	-6	-305	-261	120	-81	201
FCAs (non-residents)	-1,084	-720	-48	-126	-13	-113
Other liabilities	38	73	-39	193	28	165

Note: LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term
Source: Statistics Department, SBP

Box 9.1: Issues in the reconciliation of SBP & KSE figures for foreign investment in stock market

Investment by non-residents in the equity market is reported separately by the SBP and the KSE, but the wide variation in these two figures is a source of considerable confusion. In this background, an attempt has been made to identify the reasons for the difference.

The data reported by SBP in the balance of payments (BOP) account is based on statements submitted by commercial banks on a monthly basis. On the other hand, KSE reports foreign investment based on information provided by brokers/brokerage houses.

The resulting difference in the definition of the two reported figures is illustrated by considering transactions in a typical account meant for portfolio investment by a non-resident (see **Table 9.1.1**).

It becomes clear that a major discrepancy between the two arises due to different timing of reporting. Any fresh *inflow* of the foreign investment either through Special Convertible Rupee Account or other accounts will appear in the BOP statement for that month – indicating fresh Dollar investment in the stock market. The KSE, on the other hand, will report this foreign investment only at the time when the Rupee counterpart is *used* for the purchase of shares.

Table 9.1.1: Transactions in FPI Account

Items	Impact on KSE	Impact on BOP
1 Fresh Inflows	No	Yes, there will an inflow as FPI in the stock market
- Fresh Buying	Yes	No
2 Profits & Dividends		
- Outflow	No	No, there will be no impact for FPI in the stock market, but it will appear as outflow from 'Investment Income' head of the BOP
- Re-investment	Yes	Yes, there will an inflow as FPI in the stock market
3 Sale Proceeds		
- Outflow	Yes	Yes, there will an outflow as FPI in the stock market
- Re-investment	No	No

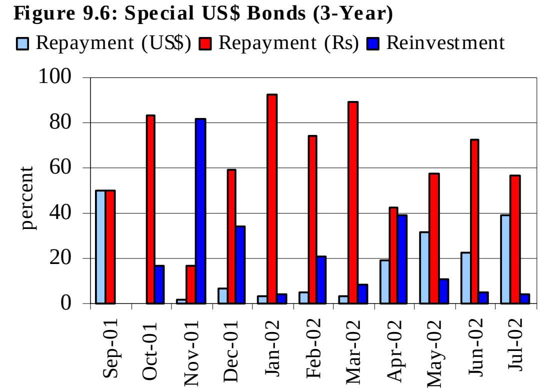
Similarly, when a non-resident sells his shares, this transaction will be promptly accounted for in the KSE records when reported by the brokers/brokerage houses. However, this transaction will appear in the BOP account *only* when (and if) the non-resident *repatriates* the sale proceeds. If the proceeds from the sale of shares are kept in an account in Pakistan or are invested elsewhere within Pakistan, the BOP figure will be unaffected. This difference is an additional source of difference.

The difference in coverage is the second major source of variation. The volume of foreign investment in stock market reported by KSE does not cover investments made through the Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE). It implies that any fresh flow, reinvestment of profit and sale proceeds adding to LSE and ISE would not show up in KSE numbers.

Summing up, the net flows in or outside the *country* by the non-residents, in respect of the sale and purchase of shares on any stock exchange of Pakistan would appear in BOP account. On the other hand, KSE reports the net sale or purchase of shares *only on Karachi Stock Exchange* by the non-residents. In effect, these are two different variables.

protect its slender foreign currency reserves, the government announced a 5 percent bonus on Rupee redemption, which was equivalent to the then-existing kerb market premium. Despite this incentive, the re-investment remained relatively more attractive till November 2001. Later, following the collapse of the kerb premium, the Rupee redemption increased in December 2001 (see **Figure 9.6**). However, after the withdrawal of bonus in March 2002, the Dollar encashment is again becoming more attractive.

Figure 9.6: Special US$ Bonds (3-Year)



Foreign Direct Investment

Foreign direct investment (FDI) in the country showed an improvement of US$ 163 million over the last year to US$ 486 million during FY02. Of this inflow, US$ 417 million were received in the last three quarters. This reflects enhanced investors confidence following a buildup of foreign exchange reserves, improved credit worthiness and reduction in country risk.[13] The latter is also evident from secondary market prices of Eurobonds, which have increased from US¢ 73 in December 1999 to more than US$ 1.0 by July 2002 (see **Figure 9.7**). Similarly, taking the difference between Eurobond yield over comparable US treasury bonds also reflects the extent of the improvement in country risk (see **Figure 9.8**). In addition, the Moody's investment rating agency also upgraded Pakistan's sovereign credit rating to B3 in March 2002.

Figure 9.7: Prices of Eurobonds in Secondary Market

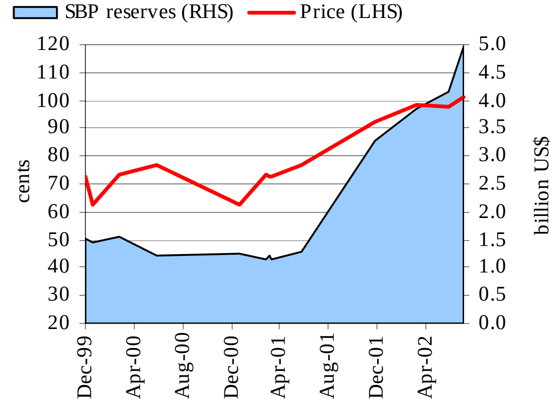
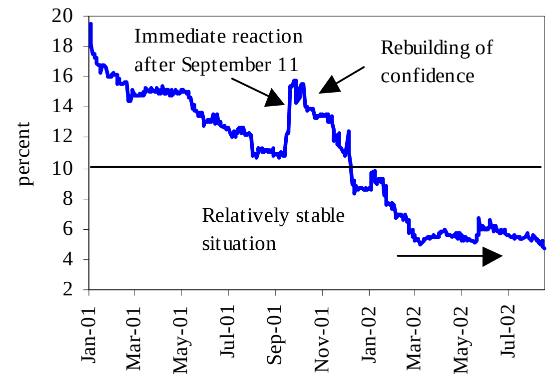


Figure 9.8: Country Risk 'Spread over 10-year US Treasury Bond'

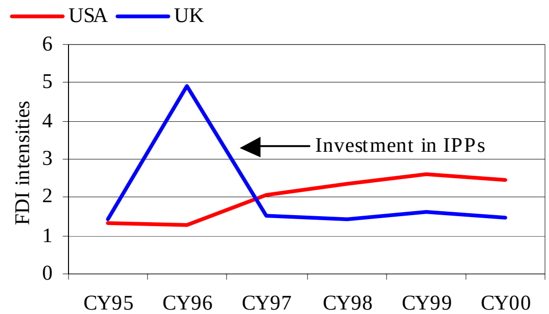


Intensities of FDI

The analysis based on FDI intensities provides a picture of a source country inflow in Pakistan with respect to its international position. In other words, FDI intensity is the ratio of two factors: (1) share of source country in total FDI flows in Pakistan; and (2) the share of source country in total world FDI.

The US and the UK are the major investors in Pakistan and their investment constitutes almost 60 percent of total FDI. The interest of US investors in oil & gas exploration sector is reflected in rising investment intensities despite the fact that its share in Pakistan's total investment has declined (see **Figure 9.9**). On the other hand, UK has almost constant intensity, whereas its share of FDI in Pakistan is increasing over the time.

Figure 9.9: FDI Intensities of Source Countries



9.3.2 Long-term Capital (official)

The drying up of the aid pipeline following economic sanctions in May 1998 meant that the long-term capital (official) showed net outflows during FY00 and FY01. In comparison, higher non-food aid (BOP assistance) from IFIs and reduced principal payments of long-term debt during FY02 resulted in a net inflow of US$ 75 million. Although, project assistance is still on a declining trend, it is hoped that the improved relations with major creditors and Pakistan's emerging positive track record in implementing projects will result in

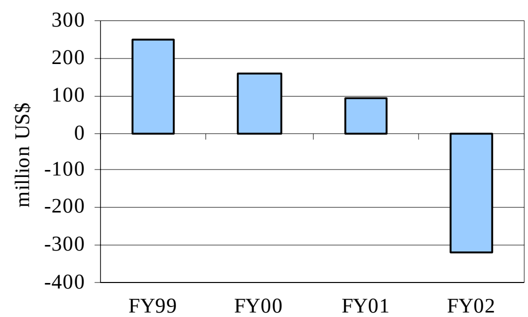
[13] The major share in these flows was again from the US investors (US$ 326.4 million) as their investment interest remained high in oil & gas sector. For country shares and sectoral distribution of FDI, see **Section 2.6.2**.

its reversal.[14] On the debit side, the absence of any rollover of the central bank deposits, this year, is notable.

9.3.3 Long-term Capital (others) [15]

The net outflow under long-term capital (others) was higher by US$ 455 million in FY02 (see **Table 9.6**). This was mainly driven by the closure of swaps of US$ 320 million with banks and moneychangers, and higher repayments of suppliers' credit (see **Figure 9.10**). On the inflow side, suppliers' credit and PAYE credit remained low at US$ 184 million as compared to US$ 191 million last year.

Figure 9.10: Net Swaps (more than one year)



9.3.4 Short-term Capital (official)

The short-term capital (official) posted an *outflow* of US$ 438 million this year against an *inflow* of US$ 338 million in FY01. This turnaround reflects higher repayments of expensive short-term loans from commercial banks, and IDB credits for oil imports. This outflow also includes repayment of a short-term swap to Shamil Bank (Bahrain) in July 2001.

9.3.5 Short-term Capital (DMBs and others)

The short-term capital mainly comprises of outstanding export bills (OEBs) held by commercial banks and exporters, and non-resident FCAs mobilized by commercial banks and NBFIs. In aggregate, this showed a net outflow of US$ 12 million during FY02 as compared to a net outflow of US$ 312 million last year. This marked improvement comes mainly on account of a fall in outstanding exports bills (OEBs) held by commercial banks and exporters, following the reversal of devaluation expectations.

On the debit side, outflows from non-resident FCAs (with NBFIs) have risen by US$ 78 million over the last year, and at the same time, due to stability in rupee/dollar parity, a decline of US$ 10 million was observed in the inflows in FE25 deposits with commercial banks.

9.4 Foreign Exchange Reserves

The most noteworthy economic development during FY02 was the unprecedented increase in liquid foreign currency reserves to US$ 6,432 million at end FY02, of which the SBP reserves comprised US$ 4,805 million with the rest being held by commercial banks.[16] However, contrary to popular view, the reserve build up had begun well before September 2001, and the reserves had already crossed the US$ 3 billion mark by end-June 2001; the factors associated with September 11 simply acted as catalyst to accelerate the reserve accumulation (see **Figure 9.12**). The latter is evident in the shift in pattern of SBP forex purchases during FY02 following the October 2001 collapse of the kerb market premium (see **Table 9.7**).

Table 9.7: SBP Market Purchases - FY02

million US Dollar

	Jul-Sep	Oct-Jun
Net purchases	421.0	3,437.0
Share (percent)		
- Kerb market	94.4	28.4
- Interbank market	5.6	71.6

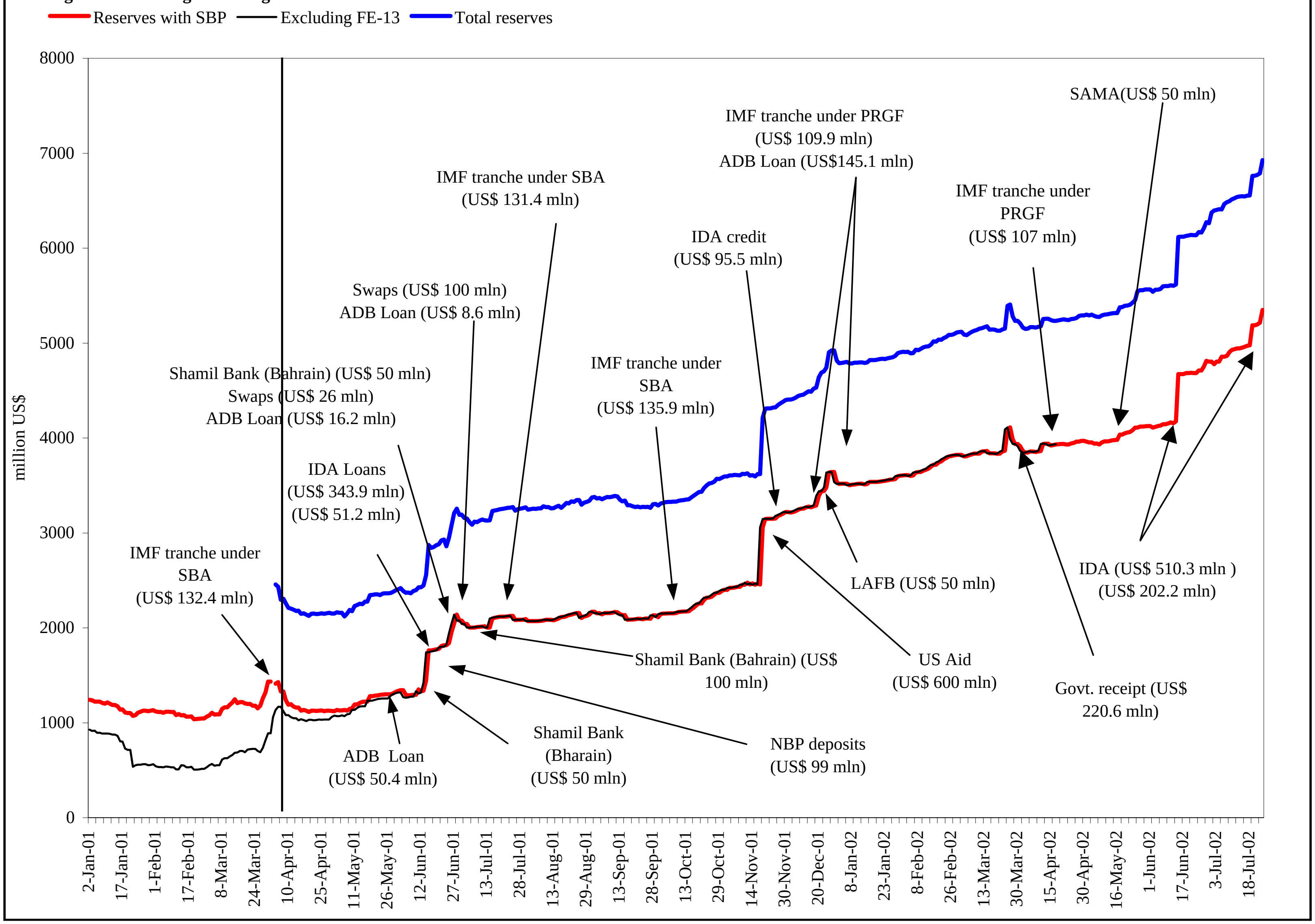
Source: Exchange & Debt Management Department, SBP

[14] Whereas higher than expected disbursement from World Bank was observed during FY02, US$ 787 million (of which US$ 640.4 million came in the last quarter) as compared to US$ 395 million last year, the inflows from Asian Development Bank were lower (US$ 215.8 million against US$ 394.6 million last year) due to delays in certain agriculture reforms and privatization of KESC.

[15] This comprises of suppliers' credit, PAYE loans and foreign exchange swaps.

[16] The SBP reserves also include US$ 471.5 million as CRR/SLR on FE-25 deposits.

Figure 9.12: Foreign Exchange Reserves



As a result, for the full year, the FY02 kerb purchases fell by US$ 781 million over FY01. In contrast, the purchases (net) from the interbank market showed a dramatic shift of US$ 3,609 million from a *negative* US$ 1,126 to a *positive* US$ 2,483 million (see **Table 9.8**). This primarily reflects conscious effort by SBP to stabilize the exchange rate and to ensure competitiveness of Pakistani exports.[17]

Table 9.8: Foreign Exchange Reserves with SBP - FY02

million US Dollar

	Q1	Q2	Q3	Q4	FY02
Opening balance	**2,080.0**	**2,126.0**	**3,538.0**	**3,937.0**	**2,080.0**
Receipts	**717.4**	**2,075.2**	**1,722.4**	**2,131.4**	**6,646.4**
Purchases	**421.4**	**935.3**	**1,238.3**	**1,263.7**	**3,858.7**
Kerb market	397.9	239.1	431.6	307.1	1375.7
Interbank (net)	23.5	696.2	806.7	956.6	2483.0
Loans	**272.2**	**400.6**	**26.5**	**791.0**	**1,490.3**
IBRD/IDA	0	129.1	17.5	640.4	787.0
ADB	2.6	161.5	9.0	42.7	215.8
IMF	267.4	109.5	0	107.8	484.7
JBIC (OECF)	2.2	0.5	0	0.1	2.8
Grants	**0**	**600.0**	**42.1**	**50.0**	**692.1**
USA	0	600.0	0	0	600.0
UK	0	0	42.1	0	42.1
SAMA	0	0	0	50.0	50.0
Other receipts	**23.8**	**139.3**	**415.5**	**26.7**	**605.3**
Logistic support	0	0	300.0	0	300.0
UN troops	0	27.8	31.5	4.2	63.5
Misc. receipts[1]	23.8	111.5	84	22.5	241.8
Payments	**671.4**	**663.2**	**1,323.4**	**1,263.4**	**3,921.4**
IMF	61.7	53.9	47.5	80.4	243.5
IDA	29.6	20.6	24.2	20.3	94.7
IBRD	72.6	36.8	78.8	43.7	231.9
ADB	35.3	22.1	52.4	26.5	136.3
IFAD	2.7	2.0	2.9	2.1	9.7
OPEC	3.2	0.6	2.7	0.7	7.2
Euro bonds	0.1	31.1	0	31.1	62.3
PTMA	105.7	103.1	159.3	157.3	525.4
IDB (Short term)	48.8	122.8	133.0	118.5	423.1
Swaps	0	0	136.0	91.0	227.0
Deposits	142.7	82.0	260.7	92.4	577.8
NDRP	5.0	2.4	15.2	40.0	62.6
FE-45	0	148.1	244.9	134.0	527.0
FE-31	21.8	0	0	177.8	199.6
Repayment of Hajj	0	0	107.0	6.1	113.1
ACU settlement	68.7	2.0	38.1	37.8	146.6
Miscellaneous payments[2]	73.5	35.7	20.7	203.7	333.6
Closing balance	**2,126.0**	**3,538.0**	**3,937.0**	**4,805.0**	**4,805.0**

[1] Includes interest on deposits US$ 88.5 million, increase in CRR US$ 71.2 million and Libyan Deposit US$ 50 million.

[2] Includes Catic China US$ 83.2 million, Uch power project US$ 43.2 million, FCY loan bond US$ 37.7 million, Al-Faysal bank US$ 25.8 million, interest on FE-45 US$ 29.9 million and encashment of US Dollar bonds US$ 32.5 million.

Source: Exchange & Debt Management Department, SBP

[17] The total SBP purchases during FY02 at US$ 3.85 billion were almost sufficient to meet all payments of US$ 3.9 billion from SBP reserves.

The exchange rate management through reserve accumulation offered other advantages as well. Firstly, this helped in repaying most of the expensive commercial and short-term liabilities, which in turn improved country's creditworthiness. Secondly, reserve buildup also contributed in the reversal of market expectations of devaluation, thereby supporting exchange rate stability. More importantly, the vulnerability of the country to external shocks has been reduced considerably.

The relationship between SBP purchases and liquid reserves is shown in **Figure 9.11**. It is clear that reserves (excluding foreign loans and grants) were increasing steadily despite repayments of expensive and short-term debt. Had these loans not been paid, the forex reserves would have reached US$ 6.7 billion by end-June 02.

Foreign loans & grants were also important contributors to the reserve buildup. While grants are a one-off phenomenon, a part of foreign loans should be considered in the context of debt management strategy, whereby non-concessional loans from multilateral institutions are being substituted with fresh loans on concessional terms. It is evident from **Figure 9.11** that loans and grants have led to perceptible increase in reserves (excluding purchases) in June 2001, November 2001 and June 2002.

In terms of import coverage, the liquid foreign exchange reserves have improved remarkably from 2.6 months of import at end-April 2001 to 8 months by June 2002 (see **Figure 9.13**).[18] The reserve ratios with external debt are also important indicators. These ratios have also improved considerably following the reserve buildup and repayment of short terms debt (see **Figure 9.14**).

9.5 Transactions with IMF

The completion of SBA in September 2001 was the first-ever successful conclusion to an IMF

Figure 9.11: Foreign Exchange Reserves with SBP

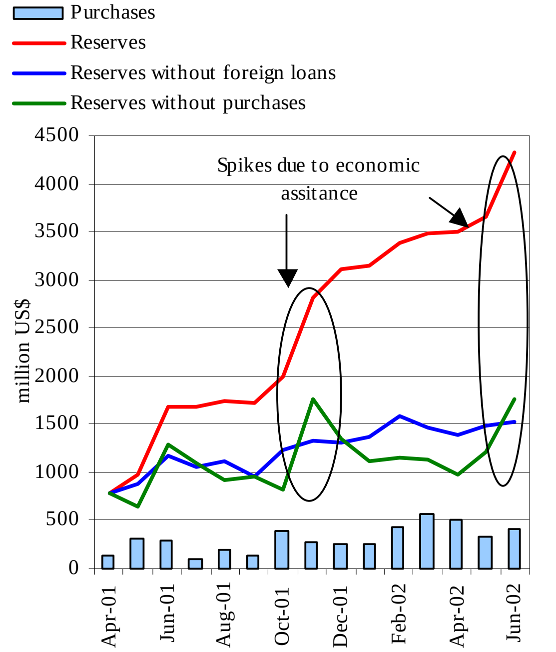


Figure 9.13: Reserves and Import Coverage

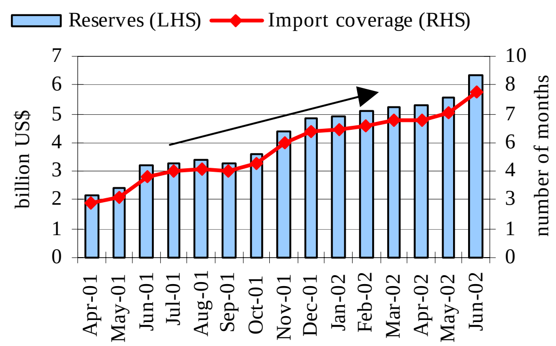
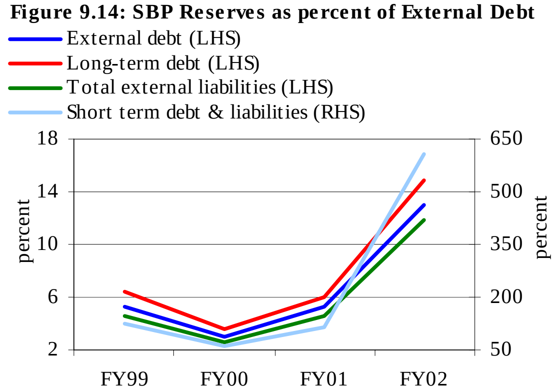


Figure 9.14: SBP Reserves as percent of External Debt



[18] This ratio takes into account openness and size of the economy by scaling reserves in terms of number of months a country can support its imports.

program during the last ten years.[19] This also paved the way towards cheap and long-term assistance through PRGF facility (amounting to US$ 1.3 billion that is equivalent to 100 percent of the SDR quota of Pakistan).[20] The program that was approved on December 6, 2001 will expire on December 5, 2004. The structural targets embodied in this program mainly cover reforms in tax policy and administration, public expenditure, fiscal transparency and liberalization of financial sector.

So far, the current government is maintaining a very good record for the fulfillment of IMF conditionalities other than the CBR revenue targets. Nonetheless, since this slippage was attributed to reduced imports due to exogenous factors, a waiver from IMF for the revenue target allowed Pakistan to avail third tranche in July 2002.

Although, the comfortable external account suggests that Pakistan would not need any further assistance from the IMF after the completion of PRGF, this essentially requires the continuation of economic reforms even after the induction of a new political government.

In FY02, the country received US$ 484.4 million under SBA and PRGF that is US$160.4 higher million than in FY01. In net terms, inflows at US$ 291.5 million were significantly more than US$ 85 million received during the preceding year (Details of purchases and repurchases with IMF are given in **Table 9.9**).

Table 9.9: Transactions with IMF

million US Dollar

Facility	FY00	FY01	FY02
Purchases			
Stand by Arrangement (SBA)	Nil	324	267.1
Poverty Reduction & Growth Facility (PRGF)	Nil	Nil	217.3
Total		**324.0**	**484.4**
Repurchases			
Extended Fund Facility (EFF)	18.3	26.3	30.2
Poverty Reduction & Growth Facility (PRGF)	36.9	44.2	43.6
Stand by Arrangement (SBA)	168.0	133.2	42.4
Structural Adjustment Facility (SAF)	52.1	27.6	13.9
Saudi Fund for Development (SFD)	4.0	7.7	7.6
Contingency & Compensatory Financing Facility (CCFF)	Nil	Nil	55.2
Total	**279.3**	**239.0**	**192.9**
Use of Fund Credit (Net)	**-279.3**	**85.0**	**291.5**

Source: Accounts Department, SBP

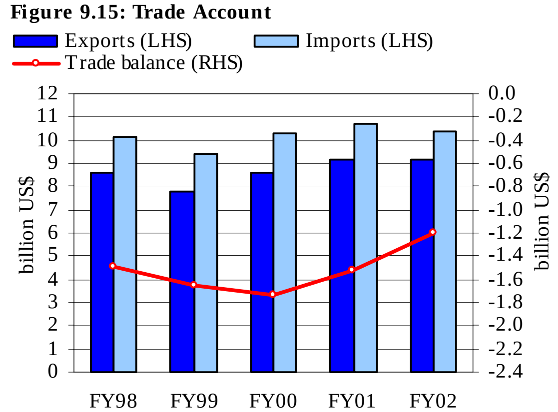
Table 9.10: Foreign Trade Performance at a Glance

billion US Dollar

		FY02		% Δ over	
	FY01	**Target**	**Actual**	**FY01**	**Target**
Imports	10.7	10.9	10.3	-3.6	-5.1
Exports	9.2	10.0	9.1	-0.7	-8.7
Trade deficit	1.5	0.9	1.2	-21.1	33.9

Source: Federal Bureau of Statistics and Trade Policy FY02

Figure 9.15: Trade Account



9.6 Trade Account[21]

The continuing weaknesses in key export markets and extraordinary events of September 11 have adversely impacted Pakistan's foreign trade during FY02. Both exports and imports declined but the fall in the latter was greater, which resulted in an improvement in the trade balance. The trade deficit narrowed by US$ 322.4 million to US$ 1.2 billion, it was still higher than the target of US$ 0.9 billion envisaged in the FY02 trade policy (see **Figure 9.15** & **Table 9.10**). During the year, export receipts financed 88.3 percent of imports compared to 85.8 percent last year.

---

[19] For a chronological series of agreements with IMF since 1988, see SBP Annual Report FY00.

[20] The PRGF is the IMF's concessional facility for low-income countries. Such facilities are based on country-owned poverty reduction strategies adopted in a participatory process and articulated in a Poverty Reduction Strategy Paper (PRSP).

[21] The analysis is based on customs data received from FBS, as it is more detailed.

9.6.1 Exports

September 11 events and the subsequent war in neighboring Afghanistan added to difficulties of Pakistani exporters, who were already under strain due to sluggish international markets. In particular, the imposition of a war risk surcharge by shippers, cancellation of export orders, and suspension of flight operations by the foreign airlines, all adversely affected export efforts. In addition, the competitiveness of exports was also eroded by the sharp appreciation in the Rupee/Dollar parity during FY02.

In this backdrop, it is quite creditable that total export earnings, at US$ 9.1 billion, recorded only a small decline of 0.7 percent over the record earnings of FY01.[22]

Looking at **Figure 9.16**, it is clear that the impact of September 11 events on exports became visible in November, 2001 when exports declined by 5.7 percent over the same month last year – this falling trend continued till February 2002. In order to stem this slide, the GOP and the SBP initiated immediate relief measures by pushing down interest rates on EFS, and accelerating payment of tax refunds, the impact of which boosted by successful negotiation for enhanced market access to EU and the US markets. Consequently, the exports reversed their downward trend from March 2002 and continued to grow thereafter. The cumulative export receipts in the last quarter of FY02 registered a positive growth of 4.7 percent over the same period last year.

FY02 also saw a continuation of the shift in Pakistan's export structure towards manufactured goods, which reached an all time high of 74.9 percent of total exports, up 3.5 percent from FY01. Semi-manufactured and primary commodities accounted for 14.3 percent and 10.8 percent of total export earnings respectively, during this period.

The rise in the share of manufacturing has been almost a continuous feature throughout the 1990s, increasing from 56.0 percent in FY90 to 72.5 percent in FY00. At the same time, primary

Figure 9.16: Monthly Growth of Exports (YoY) -FY02

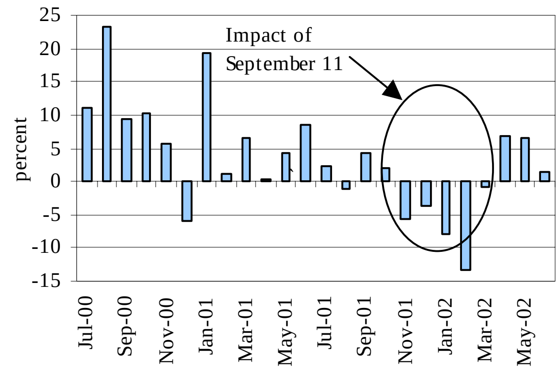


Table 9.11: Pakistan's Major Export Markets

value: million US Dollar; share: percent

	FY01		FY02	
	Value	**Shares**	**Value**	**Shares**
Total Exports	**9,201.6**	**100.0**	**9,134.6**	**100.0**
North America	**2,428.7**	**26.4**	**2,432.6**	**26.6**
Central America	**78.2**	**0.8**	**92.1**	**1.0**
South America	**113.0**	**1.2**	**78.2**	**0.9**
Western Europe	**2,474.0**	**26.9**	**2,555.8**	**28.0**
Eastern Europe	**79.1**	**0.9**	**87.5**	**1.0**
Africa	**491.2**	**5.3**	**426.6**	**4.7**
Asia	**3,390.9**	**36.9**	**3,326.9**	**36.4**
Oceania	**146.5**	**1.6**	**134.7**	**1.5**
Middle East	***1,331.8***	***14.5***	***1,548.6***	***17.0***
E.C.	***2,420.6***	***26.3***	***2,503.7***	***27.4***
U.S.A.	2,245.6	24.4	2,257.5	24.7
Dubai	615.4	6.7	719.6	7.9
U.K.	576.0	6.3	659.1	7.2
Germany	495.0	5.4	452.1	4.9
Hong Kong	504.5	5.5	442.2	4.8
Saudi Arabia	273.0	3.0	330.4	3.6
South Korea	278.4	3.0	261.9	2.9
France	265.8	2.9	246.7	2.7
China	303.2	3.3	228.6	2.5
Japan	193.6	2.1	166.5	1.8
Australia	113.1	1.2	101.3	1.1

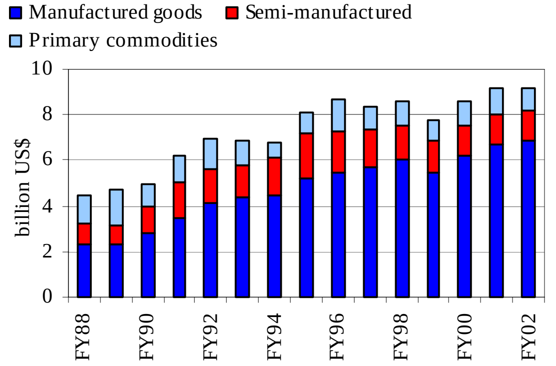
Source: Federal Bureau of Statistics

[22] In comparison, Indian exports during the fiscal year (April 2001-March 2002) recorded a decline of 2.2 percent over last year, while Sri Lanka's exports declined by 15.2 percent in Jan-Mar 2002 over the corresponding period. During July 2001-March 2002, Bangladesh also registered a 9.9 percent decline in exports.

commodities and semi-manufactures have seen their shares shrink from 20.3 percent and 23.6 percent to 12.1 percent and 15.4 percent respectively (see **Figure 9.17**).

In FY02, the Asian region remained the largest export market for Pakistani products, followed by Western Europe and North America (see **Table 9.11**). USA continued to dominate the top 10 export markets. During FY02, Italy and Netherlands replaced China whose share declined from 3.3 percent in FY01 to 2.5 percent.

Figure 9.17: Economic Classification of Exports



Textile Manufactures

In FY02, total export earnings of textile manufactures increased merely by 0.3 percent to US$ 5.8 billion (see **Table 9.12**). However, what is more encouraging is the enhanced share of high value-added items within the group, which went up from 54.2 percent to 57.5 percent despite depressed prices in the international market (see **Figure 9.18**). This clearly indicates the success of the BMR drive currently underway to revitalize the textile sector to face the challenges of a quota free environment from 2005.[23]

Figure 9.18: Composition of Textile Exports

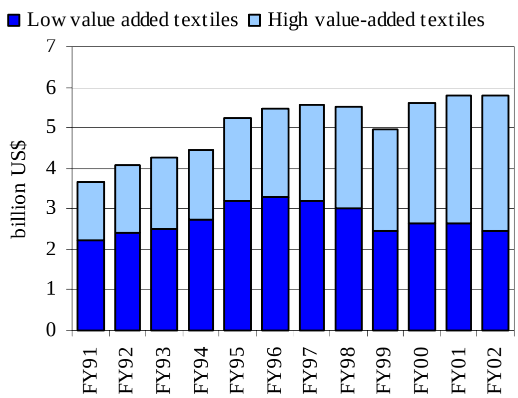
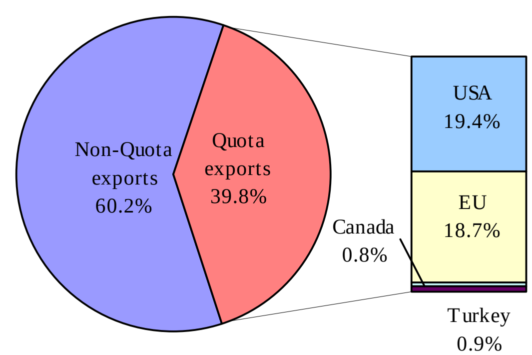


Figure 9.19: Textile Exports - FY02



During FY02, quota exports accounted for 39.8 percent of total export of textile manufactures and earned US$ 2.3 billion, registering a 1.7 percent rise over FY01 (see **Figure 9.19**).[24] Export of non-quota textile items earned an additional US$ 1.4 billion from these quota countries, showing a 5.3 percent increase over FY01 (see **Table 9.13** & **Figure 9.20**).

Table 9.13: Textile Exports during FY02

million US Dollar; percent

		Growth	
	Value	**FY02**	**H2-FY02**
Total	**5,810.6**	**0.34**	**-0.66**
Non-Quota	3,499.8	-0.54	-0.41
Quota	2,310.8	1.71	-1.14
USA	*1,127.7*	*-4.25*	*-11.48*
EU	*1,084.8*	*10.45*	*11.51*
Canada	*46.9*	*-17.51*	*-29.83*
Turkey	*51.4*	*-6.82*	*21.42*

Source: Federal Bureau of Statistics and Export Promotion Bureau

[23] Under the vision 2005, a massive balancing, modernization and replacement (BMR) drive is underway in the textile sector since FY00. Textile mills are investing huge amounts to improve the quality of the products and efficiency of the textile mills in order to stand with major competitors like India, China and Vietnam in the world markets.

[24] Exports of textile manufactures are generally subject to quota restrictions in four markets, i.e. USA, EU, Canada & Turkey.

Interestingly, during the second half of FY02, quota exports to EU depicted a slightly higher growth of 11.5 percent, which clearly shows the impact of 15 percent quota increase from January 2002.[25] On the other hand, the impact of quota enhancements by the USA is not yet clearly visible.

Table 9.12: Major Exports

value: million US Dollar; unit value: US Dollar

Commodities	Unit	FY01		FY02		Absolute Change in Value	% Δ in FY02 over FY01		
		Value	Unit Value	Value	Unit Value		Quantity	Value	Unit Value
A. Primary Commodities		**1,199.9**		**1,001.7**		**-198.2**		**-16.5**	
1 Rice	MT	525.5	229.1	448.2	266.1	-77.3	-26.6	-14.7	16.2
2 Raw cotton	MT	139.3	1,031.0	24.7	707.4	-114.5	-74.1	-82.2	-31.4
3 Raw wool (excl. wool tops)	MT	0.7	1,209.3	0.9	860.6	0.3	101.7	43.6	-28.8
4 Fish and fish preparations	MT	137.8	1,679.4	125.6	1,487.7	-12.1	2.9	-8.8	-11.4
5 Leather	SQM	232.9	13.3	239.9	13.9	7.0	-1.2	3.0	4.3
6 Guar and guar products	MT	20.5	926.9	16.4	698.3	-4.1	6.1	-20.1	-24.7
7 Fruits	MT	78.7	302.6	83.1	286.7	4.4	11.4	5.6	-5.3
8 Vegetables	MT	36.9	193.0	29.1	183.5	-7.8	-17.2	-21.2	-4.9
9 Crude animal material	MT	15.8	517.1	13.2	606.1	-2.6	-28.7	-16.4	17.2
10 Oil seeds & nuts etc.	MT	11.8	519.7	20.5	422.5	8.7	113.2	73.3	-18.7
B. Textile Manufactures		**5,790.9**		**5,810.6**		**19.7**		**0.3**	
11 Cotton yarn	MT	1,073.5	1969.3	929.7	1,721.6	-143.9	-0.9	-13.4	-12.6
12 Cotton fabrics (woven)	SQM	1,032.5	0.6	1,130.8	0.6	98.3	10.0	9.5	-0.4
13 Hosiery (knitwear)	Doz.	911.4	23.1	845.9	23.1	-65.5	-7.2	-7.2	0.0
14 Bed ware	MT	744.9	5,020.6	918.6	5,070.2	173.7	22.1	23.3	1.0
15 Towels	MT	241.7	3582.6	267.7	3,401.1	26.0	16.7	10.8	-5.1
16 Cotton bags and sacks	MT	19.0	4,034.9	15.8	3,931.2	-3.2	-14.7	-16.9	-2.6
17 Readymade garments	Doz.	826.8	23.1	875.0	21.1	48.2	15.5	5.8	-8.4
18 Tarpaulin & other canvas goods	MT	49.2	2,262.8	49.7	2,204.6	0.4	3.5	0.9	-2.6
19 Tule, lace embroidery etc.	---	10.4	---	9.7	---	-0.7	---	-7.2	
20 Synthetic textiles	SQM	544.6	0.6	410.0	0.6	-134.6	-22.3	-24.7	-3.1
21 Other textile made up	---	330.9	---	350.9	---	20.0	---	6.0	
22 Waste material of textile fibres/fabrics	MT	6.0	529.6	6.9	571.3	0.9	7.0	15.5	7.9
C. Other Manufactures		**1,577.9**		**1,583.5**		**5.5**		**0.4**	
23 Carpets, carpeting rugs & mats	SQM	288.7	45.2	249.6	49.1	-39.2	-20.4	-13.6	8.6
24 Petroleum and petroleum products	MT	183.9	223.1	190.7	186.7	6.8	23.9	3.7	-16.3
25 Sports goods	---	270.6	---	304.5	---	33.9	---	12.5	
26 Leather manufactures	---	425.5	---	383.2	---	-42.3	---	-9.9	
27 Foot wear	PAIR	40.9	5.4	54.4	5.9	13.5	22.2	33.0	8.8
28 Surgical and medical instruments	No	124.1	1.3	145.0	1.2	20.9	24.5	16.8	-6.2
29 Cutlery	GR	26.4	34.9	24.5	33.6	-1.9	-3.9	-7.3	-3.5
30 Onyx manufactured	MT	12.0	1,711.8	10.0	1,601.2	-2.0	-10.8	-16.6	-6.5
31 Chemicals and pharmaceuticals	---	164.3	---	152.8	---	-11.5	---	-7.0	
32 Molasses	MT	41.3	34.7	68.7	39.4	27.3	46.4	66.2	13.5
D. Others		**632.9**	**---**	**738.8**	**---**	**105.9**		**16.7**	
Total Exports		**9,201.6**		**9,134.6**		**-67.0**		**-0.7**	
excluding Major food items and raw cotton		8,271.6		8,403.3		131.8		1.6	
excluding Major food items and raw cotton and yarn		7,198.0		7,473.6		-67.0		3.8	

Source: Federal Bureau of Statistics

[25] The EU has increased textile quotas by 15 percent for all categories and withdrew duties on all imports from Pakistan, except five items (yarn, fabrics, leather and leather products and carpets) with effect from January 2002. However, the USA allowed 'selective' quota increases with no tariff suspensions after protracted negotiations.

A point of concern is that Pakistani exporters are facing a continual decline in prices of almost all the major export items, and especially textile manufactures (see **Figure 9.21** & **Table 9.14**).[26] The pass-through effect of the persistent fall in international prices of lint cotton (that has reached historic low during FY02), in conjunction with regular depreciation of the Rupee over the years could be possible explanation, as suggested by the graph below.

Since Pakistani exporters are essentially price takers, they tend to compete for market access by lowering prices, thus passing on their exchange gains to foreign importers. The monthly price effect in terms of US dollars (textile manufactures group) and exchange rate depreciation, when plotted together against time suggests some co-movements in both the variables, which needs to be looked into in much more detail (see **Figure 9.22**).

The following points highlight the performance of specific export items during FY02:

Figure 9.20: Textile Exports to Quota Countries - FY02

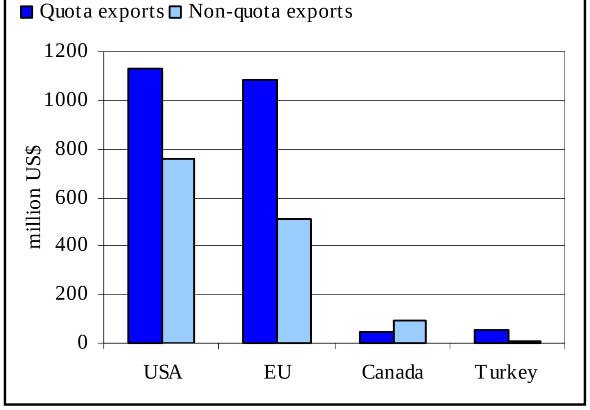


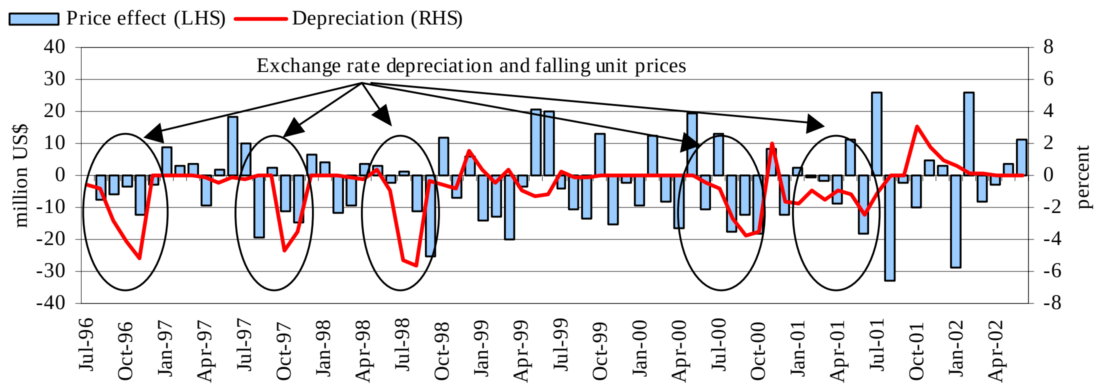
Table 9.14: Quantum and Price Impact on Selected Commodities

quantum and price impact: million US Dollar

Commodities	% change in quantity	% change in price	Quantum impact	Price impact
Rice	-26.6	16.2	-139.7	62.4
Raw cotton	-74.1	-31.4	-103.2	-11.3
Cotton yarn	-0.9	-12.6	-10.1	-133.8
Cotton fabrics	10.0	-0.4	103.1	-4.8
Bed-wear	22.1	1.0	164.7	9.0
Towels	16.7	-5.1	40.3	-14.3
Readymade garments	15.5	-8.4	128.1	-79.9
Carpets	-20.4	8.6	-58.9	19.7
POL group	23.9	-16.3	43.9	-37.1

- ***Raw cotton*** exports during FY02 decreased by US$ 114.5 million largely because of a decline in the export volume and depressed international prices (see **Table 9.14** & **Figure 9.23**). In FY02, the higher world production of raw cotton against limited consumption (due to global economic slowdown), improved technology and competition from synthetics kept the world market prices at historic lows. This, in turn, also depressed the domestic prices.

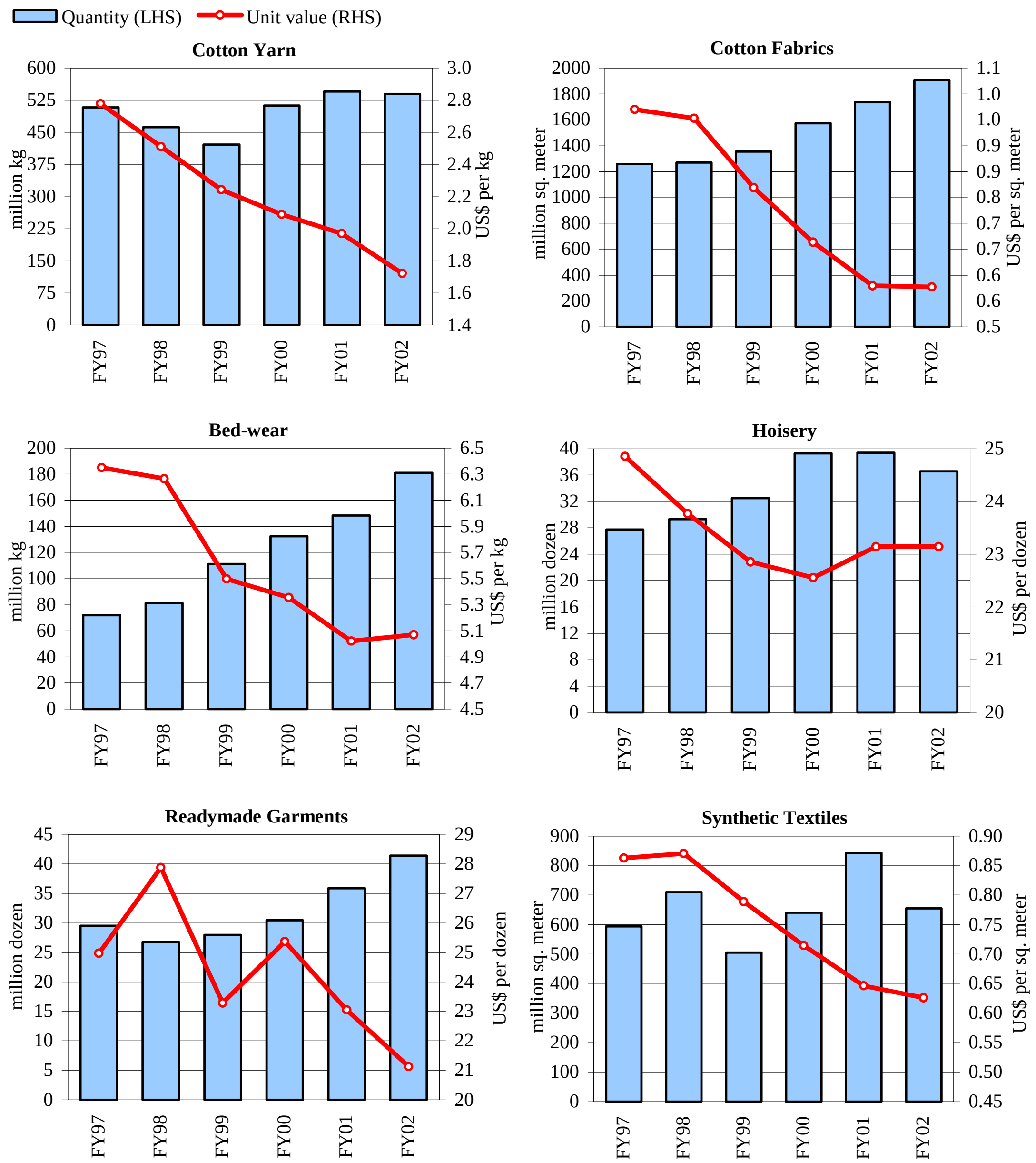
Figure 9.22: Relationship between Price Effect and Exchange Rate Depreciation



[26] This decline in export earnings can be decomposed into quantity effect (+ US$ 51.7 million) and a price effect (–US$ 224.0 million). The quantity and price effects are calculated on the basis of detailed data available on 27 items covering 78.8 percent of total exports.

In addition, over the years, exports of Pakistani cotton have suffered from the concerns about contamination and poor quality.[27] Interestingly in the same period, local spinners imported 202,298 metric tons of high quality raw cotton, a substantial 146.7 percent increase over FY01,

Figure 9.21: Exports of Major Textile Manufactures



[27] In August 2001, the government set a target of one million bales of contamination-free cotton by announcing cash incentives to growers (Rs 200 per bale for contaminated free cotton and Rs 75 per bale for cotton having impurity up to 2.5 grams per kg.). Unfortunately, these incentives did not produce desired results and only 0.1 million bales of contamination-free cotton were produced in the last cotton season. However, the cash incentives have since been revised (for a bale having

apparently in a bid to manufacture yarn of higher counts to satisfy the increasing demand by the high value-added textile manufacturers both at home and abroad.

- Export receipts from ***Cotton yarn*** continued to suffer due to a persistent decline in international prices. However, in contrast to the previous two years, the export volume during FY02 also posted a marginal fall. Consequently, export revenues at US$ 929.7 million showed a significant decline of 13.4 percent (see **Figure 9.21**). The decline in export volume may be attributed to the rising domestic consumption in the high value added textile sector.

- Within '*textile manufactures*', ***bed-wear*** exports showed remarkable improvement in terms of both value and volumes during FY02 (see **Figure 9.24**). Enhanced market access by EU and USA, exemption from custom duties and withdrawal of 6.4 percent anti-dumping duty by the EU helped in augmenting their exports.[28] As a result, bed-wear exports to USA and EU, in terms of volume, increased by 36.1 and 29.0 percent respectively, earning a total of US$ 643.4 from these two major markets (see **Figure 9.25**). Importantly, per unit export price registered an improvement of 4.6 percent in the US market. In overall terms, export receipts from bed-wear increased by 23.3 percent over previous year to reach US$ 918.6 million.[29]

- The fall in export unit prices is also noticeable for ***cotton fabrics***, ***readymade garments***, and ***towels*** (see **Table 9.13** & **Figure 9.21**). The resulting losses were, however, more than offset by significant increase in the export volumes. Consequently, the total export receipts from these items increased by US$ 172.5 million during FY02.

Figure 9.23: Export/Import of Raw Cotton (YoY Growth) - FY02

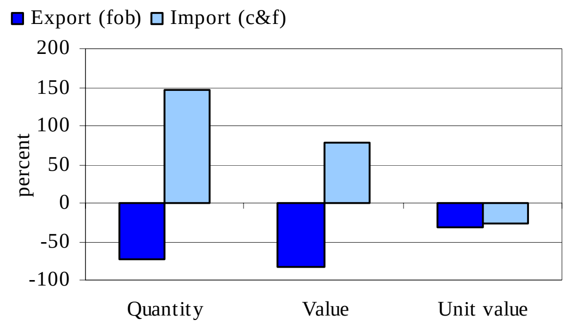


Figure 9.24: Exports of Bed-wear (YoY Growth) - FY02

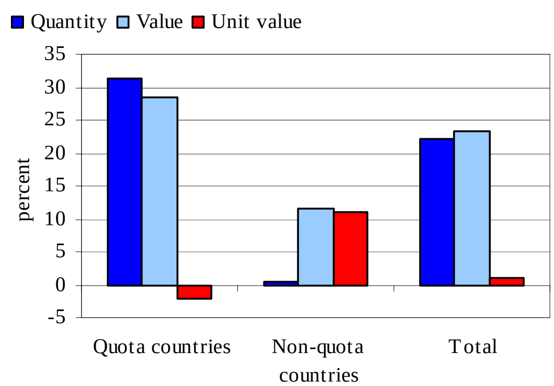
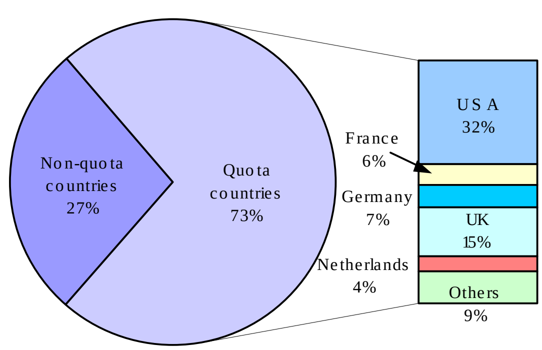


Figure 9.25: Bed-wear Exports to Major Markets - FY02

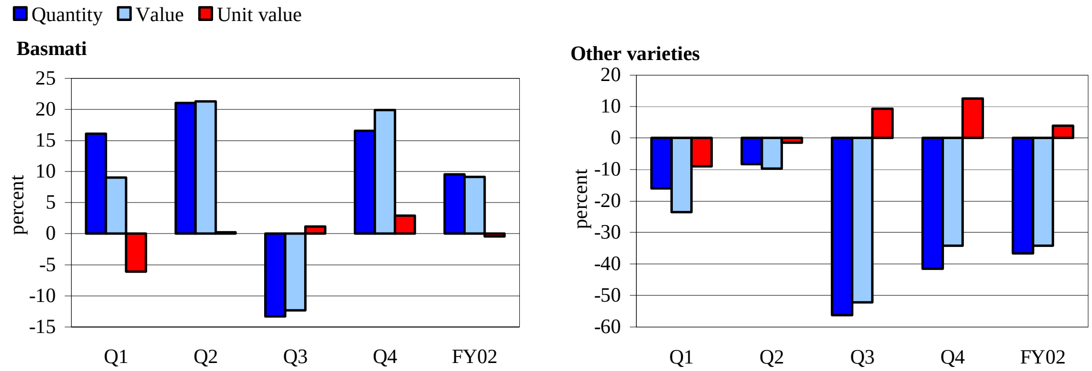


2.0 gm contamination per kg, the premium rate would be Rs 100 per maund; Rs 75 for a bale of 2.5 gm as premium and a bale with 3.0 gm contamination will get Rs 50 premium).

[28] The reported imposition of 9.8 percent anti-dumping duty by the European union (EU) on bed-wear imports from India also gave an edge to the Pakistani exporters.

[29] The quality assurance committee on bed linen in consultation with the Quota Supervisory Council (QSC) has fixed the minimum export price of bed linen at US$ 5 per kg to ward off the risk of anti-dumping proceedings from the EU.

Figure 9.26: Exports of Rice (YoY Growth) - FY02



- Export of ***Rice*** during FY02 showed a dismal performance registering a net loss of US$ 77.3 million in foreign exchange earnings, despite 16.2 percent increase in the average per unit export price over FY01 (see **Table 9.15** & **Figure 9.26**). The increase in domestic prices following lower production of Irri-varieties (in view of water shortages) rendered Pakistani rice exporters non-competitive against major competitors (Vietnam, China, India).[30] The quality and marketing concerns are also adding to difficulties faced by Pakistani Irri-rice exporters. For example, exports of inferior varieties fell significantly in African markets (53.9 percent in terms of volume and 55.4 percent in value), while there was no export to Bangladesh (in FY01, 81,457 metric tons of inferior quality rice was exported to Bangladesh), resulting in the loss of US$ 98.8 million export revenues.

  In contrast, during FY02, basmati rice exports increased despite a slight fall in per unit export price, fetching an additional US$ 21.5 million. Dubai is the main market for Pakistani rice (importing US$ 94.5 million and US$ 17.1 million worth of basmati and other varieties of rice respectively) while other major buyers include Saudi-Arabia, Oman, Yemen, UK, Qatar, Bahrain, Mauritius, Kuwait, Netherlands and USA.

Table 9.15: Export of Rice

value: million US Dollar; quantity: 000 metric tons

	FY02		FY01	
	Quantity	Value	Quantity	Value
Basmati	550.0	258.0	502.1	236.5
Other varieties	1,134.3	190.3	1,792.2	289.1
Total	**1,684.3**	**448.2**	**2,294.3**	**525.5**

Source: Federal Bureau of Statistics

Table 9.16: Export of Wheat

quantity: metric tons; value: million US Dollar

	FY02		FY01	
	Quantity	Value	Quantity	Value
Export	**642,595**	**71.38**	**80,498**	**11.01**
Abu Dhabi	24	0.00	--	--
Afghanistan	48,764	6.11	45,497	6.69
African countries	40,050	4.26	--	--
Dubai	148,940	15.78	--	--
Iran	3,259	0.36	--	--
Iraq	137,098	16.87	35,001	4.31
Kenya	132,895	13.95	--	--
Kuwait	11,800	1.24	--	--
Malaysia	110	0.01	--	--
Republic of Turkmenistan	2,160	0.43	--	--
Sudan	63,670	6.72	--	--
Egypt	25,000	2.70	--	--
Viet Nam	28,825	2.95	--	--

Source: Federal Bureau of Statistics

- The two consecutive bumper wheat crops in FY00 and FY01 created a substantial exportable surplus in FY02.[31] A substantial quantity of ***wheat*** valuing US$ 71.4 million was exported during

[30] India is reported to have large rice stocks and emerged as a leading rice exporter this year due to its competitive prices.
[31] In FY01, Pakistan was able to export only a small quantity thus leaving a substantial carryover stock.

Table 9.17: Export of Leather and Leather Products
million US Dollar

	FY01	FY02	Percent change over FY01			Quantum effect	Price effect
			Quantity	Value	Unit value		
Total	**693.2**	**671.7**		**-3.1**		**-12.4**	**-9.0**
Finished leather	232.9	239.9	-1.2	3.0	4.3	-2.9	9.9
Leather footwear	34.8	48.6	47.0	39.9	-4.8	16.3	-2.5
Leather gloves	37.3	51.3	36.0	37.5	1.1	13.4	0.6
Leather apparel and clothing	375.6	321.3	-9.8	-14.4	-5.1	-37.0	-17.3
Other leather manufactures	12.6	10.5	-18.6	-16.3	2.8	-2.3	0.3

Source: Federal Bureau of Statistics

- the period to markets in Middle East, Africa, Southeast Asia and Afghanistan (see **Table 9.16**).[32] However, the absence of a grading system and lack of experience and track record as a reliable supplier, are the main factors limiting wheat exports.

- Export receipts of ***leather and leather products*** (*including leather footwear*), which is second only to textiles in terms of export earnings, has been declining since FY97 (except in FY01 – due to the spread of *foot & mouth* disease in Europe). During FY02, export earnings from this sub-group amounted to US$ 671.7 million, registering a 3.1 percent decline over FY01 (see **Table 9.17** & **Figure 9.27**). During the year, despite a 6.0 percent increase in the per unit import price, Pakistan imported raw leather (hides and skins) valuing US$ 20.6 million for domestic utilization and re-export after value addition.[33] Exports to USA, the main market of Pakistani *leather apparel & clothing*, which accounted for 19.0 percent share (US$ 61.1 million), registered a decline of 9.0 percent over FY01.

Figure 9.27: Export of Leather and Leather Manufactures - FY02

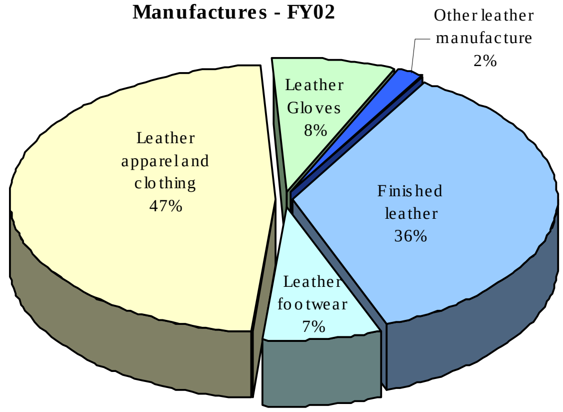
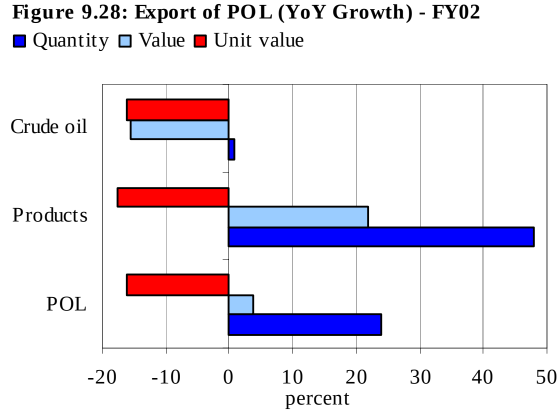


Figure 9.28: Export of POL (YoY Growth) - FY02



- ***Petroleum and petroleum products (POL)*** exports earned US$ 190.7 million during FY02, registering a 3.7 percent increase over previous year despite a decline in per unit export prices (see **Figure 9.28**). Export of petroleum products contributed US$ 115.8 million, while crude oil exports amounted to US$ 74.9 million. During the period, 599.9 thousand metric tons of petroleum products and 421.5 thousand metric tons of crude oil were exported.[34] The increase in export earnings was not commensurate

[32] Government allowed the private sector to export wheat without any restriction on quantity, value and purchase from any source. On February 16, 2002, SBP also allowed export finance facility to wheat exporters under part-I of the export finance scheme at post shipment stage.
[33] Pakistan imported raw hides and skins from Kenya, Tanzania, Uganda, Yemen, Sudan, Somalia, Dubai, Saudi Arabia, Afghanistan, Iran, United Kingdom, etc.
[34] This reflects the lack of refining capacity for low-grade crude oil produced in the country.

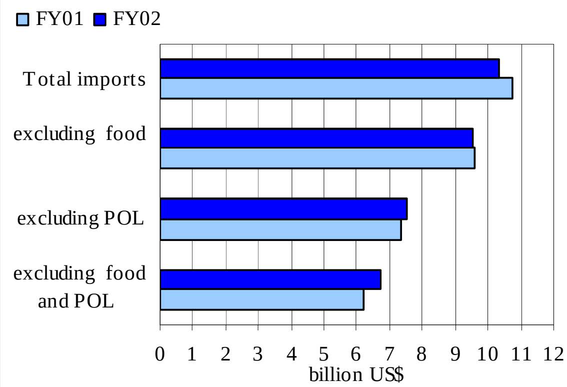
with the enhanced volumes due to sharp reduction in the international prices. In FY02, Pakistan exported all its exportable *crude oil* to Indonesia, Thailand, Singapore and China while 99.1 percent of total export of *petroleum products* went to Dubai, South Korea, Japan, Afghanistan and Jordan.

- Exports of ***carpets and rugs*** during FY02 registered a net fall of US$ 39.2 million compared to FY01 despite an improvement of 8.6 percent in the realized per unit export prices. Carpet exports came under pressure in major markets due to continuing world recession and especially after September 11, 2001 incident. A 25.1 percent fall in the export volume to USA (accounting for 30.0 percent share in FY02) resulted in the overall decline of 20.4 percent over previous year.

9.6.2 Imports

The total import bill in FY02 amounted to US$ 10.3 billion, depicting a decline of 3.6 percent over the previous year (see **Table 9.18** and **Figure 9.29**). A significant reduction in the POL import bill (resulting from a sharp fall in international oil prices as well as lower import volumes) and lower imports of food items were mainly responsible for this decline.[35] Excluding POL group, the import bill in fact increased by 2.2 percent, while non-food non-oil imports increased by a wider margin of 7.6 percent. During the period, almost all the major import items (including palm oil and pulses from the food group) showed positive growth, especially the machinery for the textile industry. Import of industrial raw materials (including crude oil and some petroleum products), which showed a 23.4 percent increase in FY01, again registered a 5.9 percent growth during FY02 indicating some improvement in industrial activity in the country.

Figure 9.29: Imports Excluding Food and POL



Important developments in the Pakistan's major import categories are as follows:

- During FY02, a sharp decline in world oil prices coupled with lower domestic consumption of petroleum products resulted in a net saving of US$ 553.8 million in ***POL*** imports (against US$ 3,360.8 million in FY01 – see **Table 9.19**).[36, 37] As a result, oil import bill, which shot up to 31.3 percent of total imports in FY01 again fell to 27.1 percent, but was still higher than the 5 years average of 21.7 percent.

  The import volume of 'petroleum products' declined by 8.9 percent to 9.2 million tons in FY02. The following factors contributed to this fall: (1) the commissioning of Pak-Arab Oil Refinery (PARCO) in FY01 (which reduced the need for imported petroleum products); (2) switching of some of the power and cement plants to other energy sources; (3) increased conversion of

[35] However, it is expected that with the reduction in average tariff rate from 30 percent to 25 percent, the imports may pick-up in the coming months. In order to fulfill its international obligations under WTO, the government has reduced the maximum customs tariff rate, with four slabs of 25, 20, 10 and 5 percent.
[36] Average Brent crude prices during FY02 were US$ 22.7 per barrel compared to US$ 28.4 per barrel during FY01.
[37] September 11 incident and tension on our eastern borders caused a slump in industrial activity, which resulted in reduced domestic consumption of petroleum products. According to market sources, industrial consumption of petroleum, oil and lubricants (POL) declined by 4 percent in FY02 over last year. Despite improved bus and truck sales in FY02, consumption of high-speed diesel (HSD) declined by 0.34 percent. Similarly, consumption of petrol fell by 1.8 percent.

Table 9.18: Major Imports

value: million US Dollar; unit value US Dollar

	Commodities	Unit	FY01 Value	FY01 Unit value	FY02 Value	FY02 Unit value	Abs. Change	% Δ in FY02 over FY01 Quantity	% Δ in FY02 over FY01 Value	% Δ in FY02 over FY01 Unit value
A	**Food Group**	---	**1,131.4**	**---**	**823.3**	**---**	**-308.1**	**---**	**-27.2**	**---**
	Milk & cream *incl.*milk food for infants	MT	20.0	1,961.1	16.1	2,293.8	-3.9	-31.3	-19.7	17.0
	Wheat un-milled	MT	15.4	192.4	50.0	187.2	34.6	233.9	224.9	-2.7
	Dry fruits	MT	37.2	438.0	31.2	342.0	-6.0	7.5	-16.1	-21.9
	Tea	MT	206.4	1,845.0	156.6	1575.1	-49.8	-11.1	-24.1	-14.6
	Species	MT	18.6	1,107.2	17.0	793.5	-1.6	27.3	-8.8	-28.3
	Edible oil	MT	327.6	286.4	393.0	328.4	65.4	4.7	20.0	14.6
	Soya bean	*MT*	*44.1*	*343.5*	*12.7*	*369.4*	*-31.4*	*-73.3*	*-71.3*	*7.5*
	Palm oil	*MT*	*283.5*	*279.2*	*380.3*	*327.2*	*96.9*	*14.5*	*34.2*	*17.2*
	Sugar	MT	393.3	270.2	23.6	273.5	-369.7	-94.1	-94.0	1.2
	Pulses	MT	113.0	309.7	135.9	295.3	22.9	26.2	20.3	-4.7
B	**Machinery Group**	**---**	**2,066.3**	**---**	**2,116.6**	**---**	**50.3**	**---**	**2.4**	**---**
	Power generating machinery	---	197.9	---	203.8	---	5.9	---	3.0	---
	Office machinery	---	233.1	---	224.3	---	-8.8	---	-3.8	---
	Textile machinery	---	370.2	---	406.9	---	36.8	---	9.9	---
	Construction & mining machinery	---	82.5	---	118.6	---	36.1	---	43.7	---
	Electrical machinery & apparatus	---	131.6	---	128.0	---	-3.6	---	-2.7	---
	Railway vehicles	---	25.7	---	38.3	---	12.6	---	49.1	---
	Road motor vehicles	---	320.9	---	329.9	---	9.1	---	2.8	---
	Aircraft, ships and boats	---	79.7	---	132.3	---	52.6	---	65.9	---
	Agricultural machinery & implements	---	23.8	---	16.1	---	-7.7	---	-32.4	---
	Other machinery	---	601.0	---	518.4	---	-82.6	---	-13.8	---
C	**Petroleum Group**	**MT**	**3,360.8**	**197.9**	**2,807.0**	**171.5**	**-553.8**	**-3.6**	**-16.5**	**-13.3**
	Petroleum products	MT	2,000.3	197.5	1,576.2	170.8	-424.0	-8.9	-21.2	-13.5
	Petroleum crude	MT	1,360.6	198.5	1,230.8	172.4	-129.8	4.2	-9.5	-13.2
D	**Textile Group**	**---**	**161.8**	**---**	**187.5**	**---**	**25.7**	**---**	**15.9**	**---**
	Synthetic fibre	MT	77.8	1,291.3	74.4	1242.1	-3.4	-0.6	-4.4	-3.8
	Synthetic & artificial silk yarn	MT	59.5	1,753.5	82.4	1521.3	22.9	59.6	38.5	-13.2
	Worn clothing	MT	24.5	303.6	30.7	307.5	6.2	23.8	25.3	1.3
E	**Agricultural and Other Chemicals Group**	**---**	**1,901.7**	**---**	**1,839.6**	**---**	**-62.1**	**---**	**-3.3**	**---**
	Fertilizer	MT	170.5	178.7	176.2	144.5	5.7	27.8	3.4	-19.1
	Insecticides	MT	61.2	2,878.5	85.9	2,703.6	24.7	49.5	40.4	-6.1
	Plastic materials	MT	354.3	847.0	352.7	770.2	-1.6	9.5	-0.5	-9.1
	Medicinal products	MT	238.7	22,534.1	228.1	23,471.0	-10.6	-8.2	-4.4	4.2
	Others	---	1,077.0	---	996.6	---	-80.5	---	-7.5	---
F	**Metal Group**	**---**	**361.4**	**---**	**433.9**	**---**	**72.5**	**---**	**20.1**	
	Iron and steel scrap	MT	43.0	117.1	50.6	123.7	7.6	11.4	17.7	5.6
	Iron and steel	MT	277.9	337.0	336.1	297.0	58.2	37.2	20.9	-11.9
	Aluminum wrought & worked	---	40.4	---	47.2	---	6.8	---	16.7	
G	**Miscellaneous Group**	**---**	**265.5**	**---**	**285.4**	**---**	**19.9**	**---**	**7.5**	**---**
	Rubber crude	MT	39.2	668.0	41.1	628.5	1.9	11.5	4.9	-5.9
	Rubber tyres & tubes	No.	62.5	22.4	66.6	21.1	4.1	13.2	6.5	-5.9
	Wood & cork	---	15.3	---	14.7	---	-0.6	---	-4.0	---
	Jute	MT	23.2	259.4	26.2	288.1	3.0	1.7	12.9	11.1
	Paper and paper board & manufactures	MT	125.3	780.7	136.8	694.1	11.5	22.8	9.2	-11.1
H	**Others**	**---**	**1,480.0**	**---**	**1,846.3**	**---**	**366.3**		**24.7**	
Total Imports			**10,728.9**		**10,339.5**		**-389.4**		**-3.6**	
excl. Food group			9,597.5		9,516.2		-81.3		-0.8	
excl. POL group			7,368.1		7,532.5		164.5		2.2	
excl. Food and POL groups			6,236.7		6,709.2		472.6		7.6	

Source: Federal Bureau of Statistics

Table 9.19: Import of POL
value: million US Dollar; Quantity: '000' metric tons

	FY02			FY01		
	Quantity	Value	Unit value	Quantity	Value	Unit value
Total POL	**16,368.9**	**2,807.0**	**171.5**	**16,983.6**	**3,360.8**	**197.9**
Crude Oil	**7,140.4**	**1,230.8**	**172.4**	**6,855.0**	**1,360.6**	**198.5**
Petroleum Products	**9,228.5**	**1,576.2**	**170.8**	**10,128.5**	**2,000.3**	**197.5**
High speed diesel oil	4,547.4	881.0	193.7	4,724.4	1,132.8	239.8
Furnace oil	4,615.9	663.3	143.7	5,331.6	831.7	156.0
Aviation sprit	1.3	0.8	611.1	0.8	0.5	678.3
Parafin liquid (white oil)	3.3	1.6	467.3	2.3	1.2	541.5
Lubricating petroleum oil (ns)	24.8	14.5	587.5	24.6	15.6	634.9
Lubricating mineral greases	2.1	0.9	415.4	1.7	1.1	629.4
Lubricating preparations	5.8	3.8	664.4	5.0	3.5	688.6
Petroleum jelly	1.5	1.0	636.0	1.2	0.8	636.8
Parafin wax	7.1	3.1	441.4	5.8	2.9	494.6
Xylole	5.4	2.0	368.9	4.7	1.8	383.0
Petroleum bitumen (ns)	6.6	1.2	187.9	2.4	0.4	176.2

Source: Federal Bureau of Statistics

automobiles to compressed natural gas – CNG; and (4) suspension of flights by various international airlines.[38] However, PARCO necessitated the higher imports of crude oil, which rose by 4.2 percent over FY01. Pakistan met crude oil requirements from Saudi-Arabia (under Saudi oil facility), Abu Dhabi, Iran and Dubai, while Kuwait, Fujairah, Dubai, Saudi Arabia, and Bahrain accounted for 98.0 percent of total import of petroleum products.

- In ***edible oils***, out of the annual domestic consumption of around 1.95 million metric tons, only 29 percent is met through domestic production. This ranks edible oils as the single largest food import item. During FY02, its imports at US$ 393.0 million showed a sharp increase of 20.0 percent over previous year. The increase in volume and international prices led to additional expenditures of US$ 15.3 million and US$ 50.2 million, respectively. In value terms, palm oil accounted for 96.8 percent of total edible oil imports. In addition to edible oils, imported oil seeds are also crushed to extract oil and during the FY02, US$ 171.8 million were spent to import oil seeds (mainly soya bean, rapeseed and canola – see **Table 9.20**).[39]

Table 9.20: Import of Oilseeds during FY02
value: million US Dollar; Quantity: '000' metric tons

	FY01		FY02		% Δ over FY01	
	Quantity	Value	Quantity	Value	Quantity	Value
Soya beans		--	257.1	61.9	--	--
Rape seeds / Canola seeds	298	69.1	451.3	109.9	51.0	59.0
Total	**298**	**69.1**	**708.5**	**171.8**	**137.0**	**148.6**

Source: Federal Bureau of Statistics

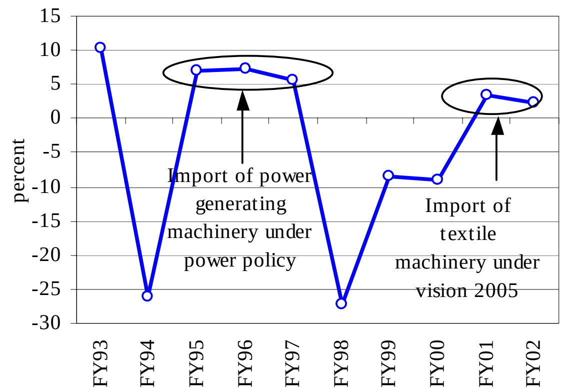
- In FY02, the outlay on the import of fertilizer increased by 3.4 percent over FY01 to US$ 176.2 million. FFC-Jordan Fertilizer Company's decision to stop Di-Ammonium Phosphate (DAP) production due to heavy losses and dismal prospects (following sharp decline in the price of DAP in the world market) forced greater reliance on imports during FY02.[40] A total of 1,072 thousand metric tons of DAP, costing US$ 161.1 million, was imported during the year.

- For the last many years, import of machinery group depicts an erratic behavior (see **Figure 9.30**). During FY02, import bill of machinery group amounted to US$ 2,116.6 million registering a rise

[38] In terms of volume, furnace oil import during FY02 declined by 13.4 percent, while its value declined by 20.2 percent over FY01.
[39] Import of canola seed was exempted by the GOP from the payment of sales tax in October 2001.
[40] Compared with FY01, average import price of DAP fell sharply by 21.0 percent in FY02.

of 2.4 percent over FY01. Share of this group in total imports also increased from 19.3 percent in FY01 to 20.5 percent in FY02. Within this group, textile machinery imports after registering an impressive growth of 75.5 percent in FY01, again increased by 9.9 percent during FY02, showing the continuation of BMR in the textile sector under vision 2005.[41] During the last two years, the textile industry has imported machinery amounting US$ 777 million. Construction & mining machinery imports also registered a 43.7 percent increase over FY01 and amounted to US$ 118.6 million.[42]

Figure 9.30: Import of Machinery Group (YoY Growth)

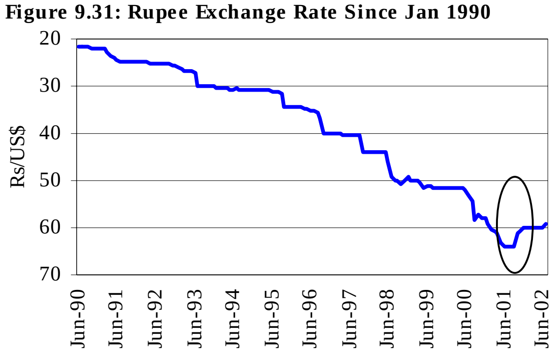


- In order to bridge the gap between domestic production and consumption, a total of 460,346 metric tons of pulses (rise by 26.2 percent over FY01) at a cost of US$ 135.9 million was imported in FY02. Resultantly, the import bill of *pulses* registered a net increase of US$ 22.9 million during FY02. The US$ 29.6 million positive quantum effect was partially neutralized by the negative price effect of US$ 6.6 resulting from lower unit prices.

9.7 Exchange Rate Policy

The FY02 was an extraordinary year for the Rupee (see **Figure 9.31**). The global crackdown on Hundi network led to (1) the collapse of the kerb market premium; (2) a reversal of market devaluation expectations; and (3) a consequent U-turn in the exchange rate management strategy of SBP. All of which set the basis for accelerating liberalization of the foreign exchange market, and particularly, the removal of segmentation between the interbank and the kerb markets.

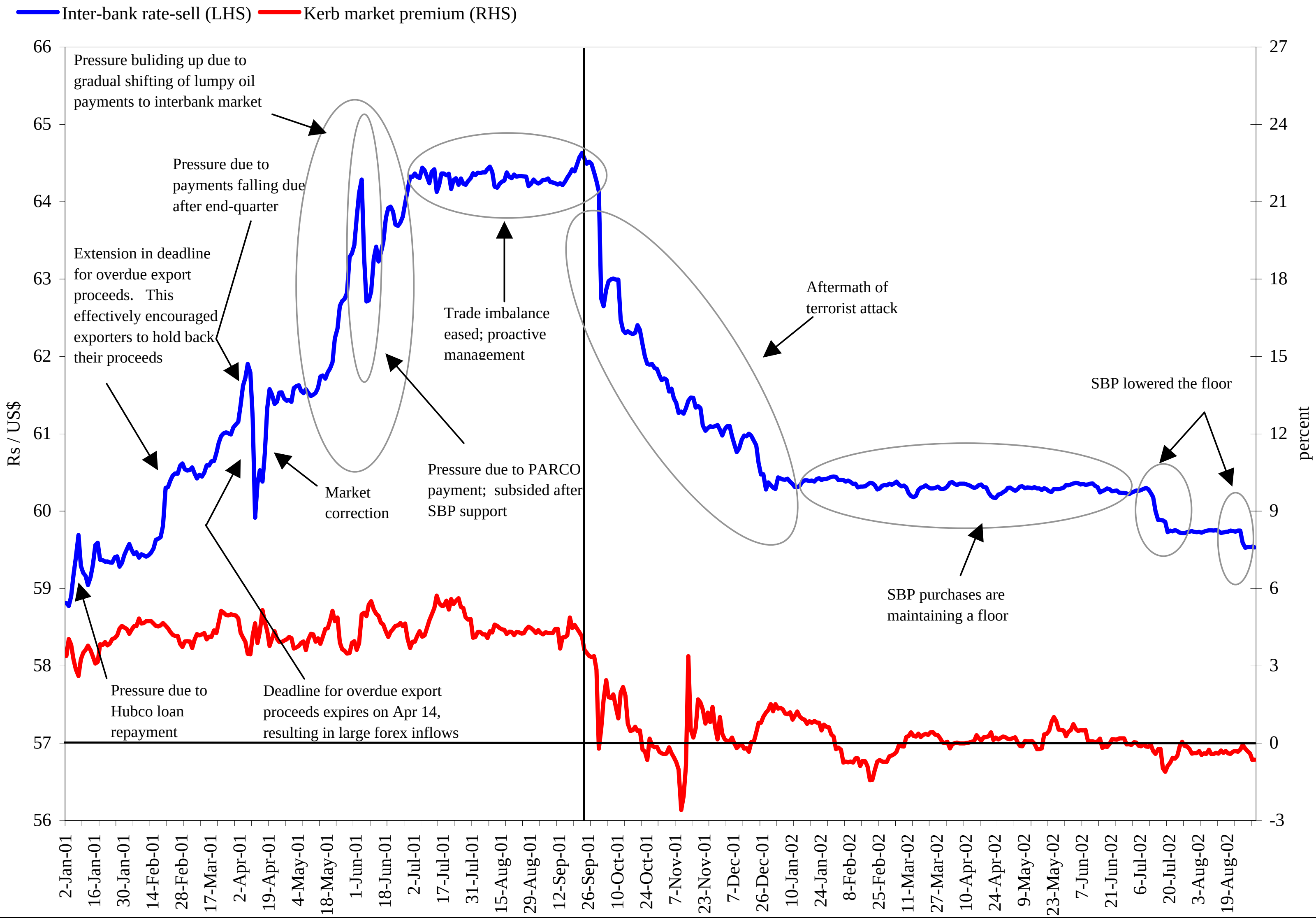
Figure 9.31: Rupee Exchange Rate Since Jan 1990



It is important to note that the massive improvement in the forex market post-September 2001 overshadowed the notable exchange rate stability already evident during July-September FY02. This stability was in sharp contrast to the 10.9 percent depreciation of the Rupee during the same period last year (see **Figure 9.32**). The narrower trade deficit during this period, and the fact that the Rupee had already depreciated by 18.6 percent in the interbank market during FY01 were the important contributors to exchange rate stability during this period. However, the most important factor was the pro-active management by SBP that allowed Authorized Dealers (ADs) to meet lumpy payments even without recourse to support from the central bank (see **Figure 9.35**).[43]

[41] An investment of Rs 23.0 billion in textile spinning sector, Rs 5.3 billion in weaving, Rs 4.4 billion in polyester fibre, Rs 3.4 billion in processing and Rs 4.3 billion in knitting and garment sector has reportedly been made till the end of FY02.
[42] Immense opportunities are likely to emerge in the reconstruction and rebuilding of Afghanistan.
[43] In such cases, SBP occasionally provided support in the forward market with the expectations that the contract would be settled in due course from the market itself at a time when the forex liquidity improves.

Figure 9.32: Interbank Rate and Kerb Premium



The collapse of the kerb market premium: Initially, in line with its traditional role as a precautionary hedge, demand for US Dollar rose in the immediate aftermath of September 11. Anxiety came to the fore in the kerb market only when the US government decided to crack down on possible funding avenues for terrorist organizations. The Dollar suffered heavily in the kerb market when it depreciated by 3.9 percent on October 1, 2001. In another important development, UAE central bank introduced documentation requirement for any outward or inward flows (beyond AED 5,000). These developments led to the collapse of the kerb market premium (see **Figure 9.33**).[44] The impact was so overwhelming that on several occasions, the kerb rate for cash transactions even dipped below the interbank TT rate (see **Figure 9.32**).[45] In overall terms, the Rupee appreciated by 11.0 percent in the kerb market during FY02 against 17.8 percent depreciation last year.

Figure 9.33: Monthly Average Kerb Market Premium

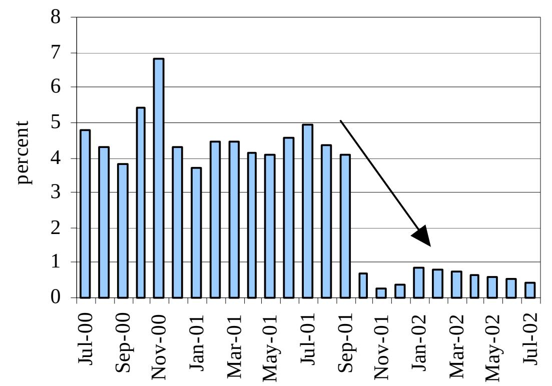
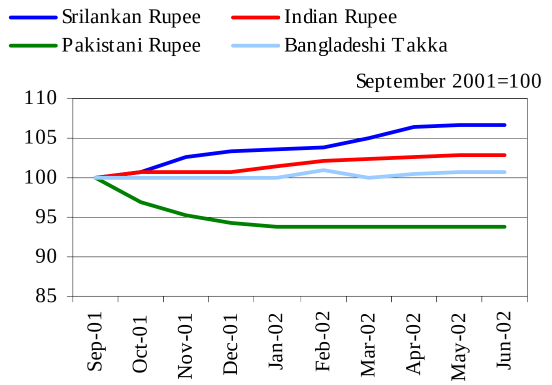


Figure 9.34: Index of Regional Currencies vs US Dollar



It is worthwhile to mention here that a clear statistical causality had been established from the interbank to the kerb rate after the free float on July21, 2000, implying that changes in the interbank rate were leading to changes in the kerb rate.[46] However, the external shock to the kerb market following international drive against informal networks was so strong that it impacted the interbank rate as well. Afterward, the changes in the kerb rate continued to be driven by the interbank rate. This assertion is re-affirmed from the fact that the recent slide of the Rupee/Dollar parity during May 2002 in the interbank market immediately carried forward to the kerb rate (see **Figure 9.32**).

Interestingly, the kerb rate appreciated by 11.0 percent during FY02, while the interbank rate showed gains of 6.7 percent. This tendency is in contrast to past practice, when the kerb rate was sticky in downward direction. This downward stickiness was thought to reflect the market power of the large suppliers of foreign exchange in the kerb market.[47] The recent developments support this hypothesis as it appears that the worldwide probe against Hundi network that coincided with large inflows through the kerb market has constrained the capacity of those large suppliers to hold the hard currency.[48]

---

[44] The developments in the foreign exchange market following September 11 are covered in SBP First *Quarterly Report* for FY02.

[45] Since the kerb market transfer funds through the normal banking channels, the Telegraphic Transfer (TT) rate in the kerb typically cannot be less than that prevailing in the interbank market.

[46] See SBP Second *Quarterly Report* for FY01.

[47] See Special Section in SBP Second and Third *Quarterly Reports* for FY01.

[48] Despite a very low average premium of 0.14 percent during the Oct 01– Aug 02 period, moneychangers are still continuing their business.

The exchange rate of other regional countries (Sri Lanka, India, and Bangladesh) did not strengthen following the crackdown on the Hundi network (see **Figure 9.34**). This simply suggests that remittances in these countries are not under-reported by high margins, and therefore, the size of their informal forex market is small relative to that in Pakistan. In other words, while the exchange rate for these countries already incorporated large remittances,[49] the Rupee assumed this impact only after the collapse of the kerb market.

A setback to market expectations for devaluation:
The reversal in devaluation expectations was another important implication of the post-September 2002 developments. Since the historical trends of the Rupee/Dollar parity are generally characterized by long periods of stability before being interrupted by sharp phases of depreciation, this created a general perception that the Rupee/US$ parity would *move only in one direction* (see **Figure 9.31**).[50] Although, the Rupee has even shown some minor phases of appreciation during second quarter of FY99 and FY01, these were preceded by large Rupee depreciation, and therefore, may be termed as correction in the parity. Similarly, the Rupee stability during FY00 was more due to an unofficial cap imposed by the SBP in the interbank market than some improvement in market flows.

With this background, the appreciation of the Rupee caught market participants by surprise, and their response added further strength to the Rupee.[51] However, its impact on total FCAs mitigated as many individuals brought back their foreign currency deposits held abroad.

A U-turn in the exchange rate management strategy of SBP:
In terms of exchange rate management, FY02 was completely different from earlier years as demand management strategies gave way to the need to stem the rise of the Rupee.

To put this into perspective, a 2-year background is instructive. During FY00, the absence of an IMF program allowed SBP to place an unofficial ceiling on the Rupee/Dollar parity along with a number of restrictions on market participants to prevent speculative activities and maintain orderly conditions.[52] In order to maintain parity, SBP had been providing one-sided market support (Dollar sales to the interbank market) to match inflows and outflows in the interbank market; and the resulting draw down of reserves was largely neutralized by SBP purchases from the kerb market.[53] At the same time, SBP was able to keep interest rates at lower levels.

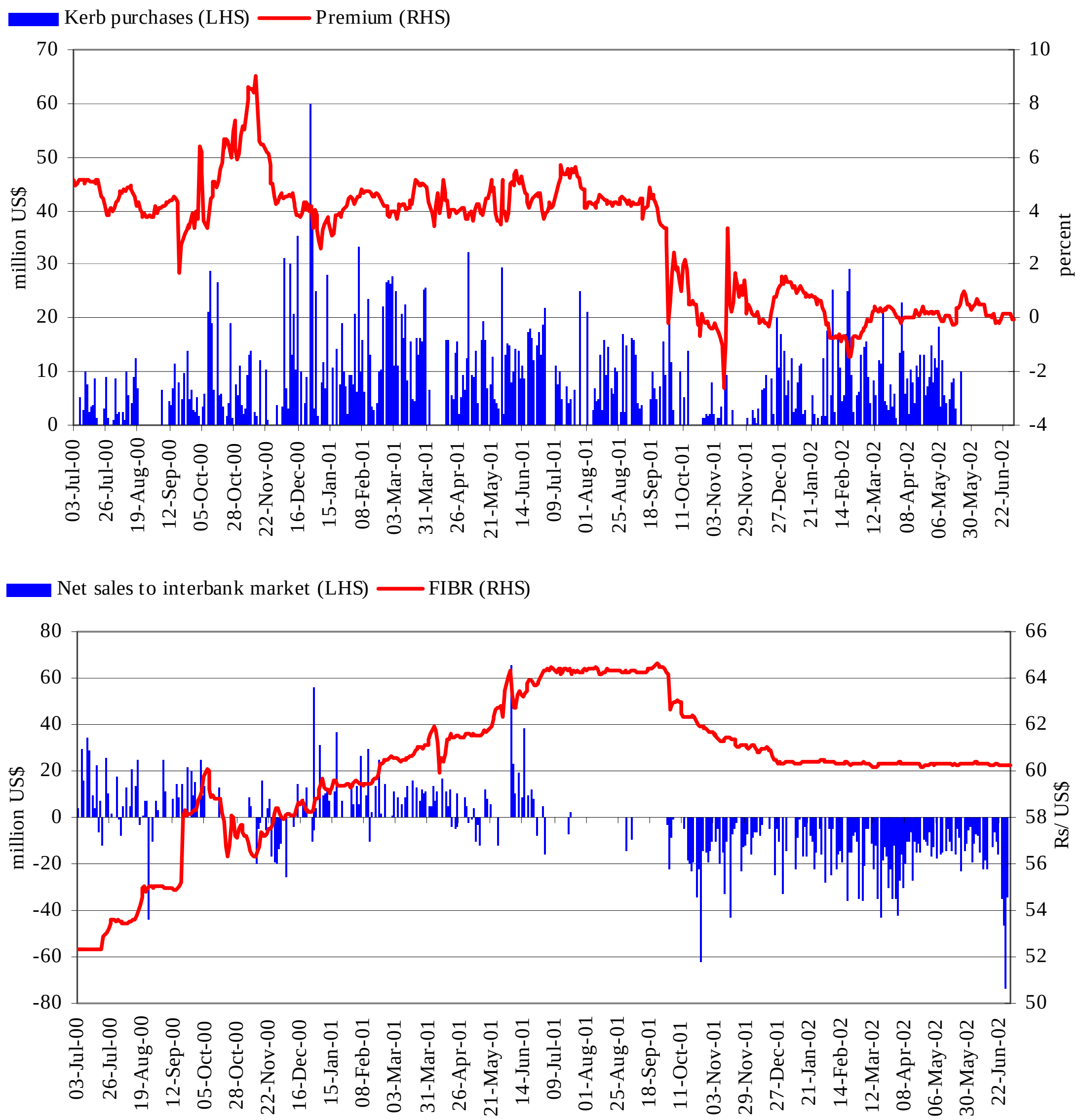
During FY01, as a part of stabilization program, the Rupee band was dismantled in July 2000, and the monetary policy was used to quell market pressures and smooth out volatility. However, in the absence of any commitment *per se* for the desired exchange rate parity, the need to provide one-sided market support also increased marginally during the year, which coincided with higher SBP purchases from the kerb market during the year (see **Table 9.21)**. In overall terms, despite sharp increase in interest rates to stabilize the Rupee/Dollar parity, the exchange rate depreciated by 18.6 percent during the year.

However, what distinguishes FY02 is the heavy SBP *purchases* from the interbank market to stabilize the exchange rate. Looking from a different perspective, since these purchases are preventing the exchange rate from appreciating, the quantum of support required during FY02 was much higher

[49] For example, during FY02, Bangladesh saw a 32% YoY increase in remittances as against the 129% YoY growth posted by Pakistan for the same period
[50] On annual basis, the Rupee has witnessed average depreciation of 8.7 percent during FY90-FY01.
[51] See SBP Second *Quarterly Report* for FY02.
[52] This includes the condition of commercial backing for all forex transactions in the interbank market by ADs.
[53] See SBP Third *Quarterly Report* for FY01.

compared to the last two years (see **Figure 9.35**). The impact of upturn in forex flow through interbank market was sufficient enough to meet the payments independently without the recourse to the central bank; in fact, SBP ensured that even the lumpy payments were directed towards banks. This was clearly reflected in reduced sales to the market, which remained to mere US$ 120 million in FY02 (practically all pre-Sept 11) against US$ 1856 million in FY01. In a concurrent development, the absence of speculative pressures in the forex market also allowed SBP to bring interest rates to their historical lows.

Figure 9.35: Kerb Purchases, Premium and Market Support



The prime objective of the FY02 SBP purchases from the interbank market was to ensure that the stable exchange rate did not erode the competitiveness of the Pakistani exporters. This was important, as exporters were already facing the loss of export orders and imposition of a war risk premium on shipments and, in some cases, are unable to meet their commitments. It can be argued that the SBP's resistance at the current level of exchange rate has eroded the potential benefits to consumers/

Figure 9.21: SBP Purchases
million US Dollar

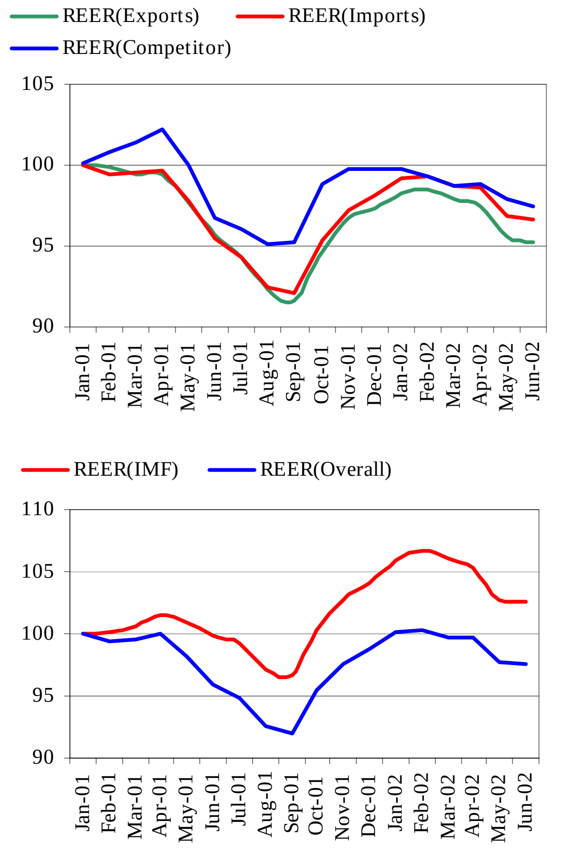
	Q1		Q2		Q3		Q4			
	FY01	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**	**FY01**	**FY02**
Kerb purchases	**227**	**398**	**528**	**239**	**806**	**432**	**596**	**307**	**2,157**	**1,376**
Interbank	**-396**	**28**	**15**	**696**	**-459**	**796**	**-286**	**957**	**-1,126**	**2,477**
Purchases	171	33	266	705	142	902	152	957	731	2597
Sales	567	5	251	9	601	106	438	0	1857	120

rce: Exchange and Debt Management Department, SBP

producers in the form of low import costs in domestic currency. While this is true, it can be argued that the benefits of such a policy would have been limited as prices are somewhat sticky for downward adjustments in Pakistan. Also any loss of export markets to competitors is always difficult to recover.

In this regard, it is worth mentioning that the strengthening of the Rupee in the interbank market has already led to its sharp appreciation in real terms (see **Figure 9.36**). Since other major currencies depreciated against the US Dollar in the aftermath of September 11 (see **Figure 9.37**), this further eroded the competitive edge of the Rupee. Fortunately, this was offset to some extent on account of relatively lower inflation in Pakistan compared to the major competitors. Also, with the depreciation of the Dollar against major currencies since February 2002, the REER of the Rupee is now depicting a downward trend.

Figure 9.36: Real Effective Exchange Rate Indicies



9.7.1 Liberalization of the Foreign Exchange Market

The relative exchange rate stability during the Q1-FY02 allowed SBP to abolish limits on Nostro balances held by banks with effect from August 31, 2001.[54] Later developments in the forex market allowed SBP to further liberalize the exchange rate regime. For example,

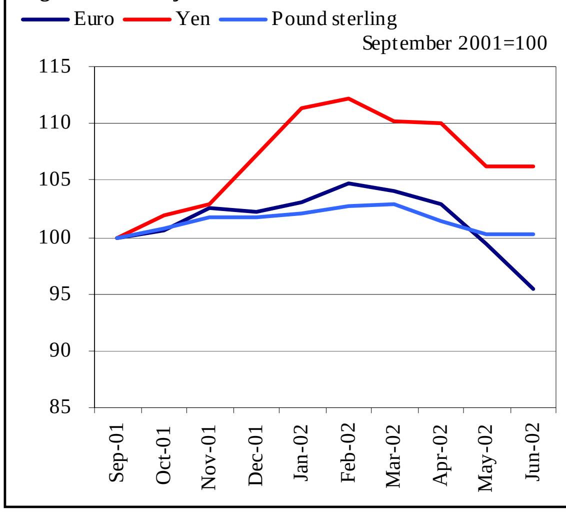
- The condition of approved commercial transaction for any interbank deal was abolished.
- The limits on foreign exchange payments relating to travel, education and health were also abolished.
- The facility to back-to-back remittances was reinstated as ADs were allowed to issue traveler's check against surrender of an equivalent amount of foreign exchange in cash.

[54] These are the foreign currency balances in bank's own accounts with the correspondent banks outside Pakistan for clearance purpose only.

- The surrender requirement on FCAs mobilized under FE-31 scheme was withdrawn. This measure not only resulted into the integration of the two deposit schemes (i.e. FE-25 and FE-31), but also reduced the foreign exchange liability of SBP. In the short term, this decision also led to a fall in the *Rupee liquidity* in the market.[55]

- With the withdrawal of surrender requirement, the forward cover facility also stands abolished. This effectively eliminates the risk of any FCA freeze due to mandatory surrender requirement to SBP. In a scenario when the Rupee is appreciating, this forward cover facility could have been a major source of earning for SBP. However, in principle, the forward cover facility should rest with the market.

Figure 9.37: Major Currencies vs US Dollar



The most significant implication provided by recent external shock to Hundi network is the opportunity to remove segmentation in the foreign exchange market, which is one of the conditions of the current PRGF. With the kerb premium floating around almost 'zero' level, and the fact that the forces responsible for the structural shift in forex market are still in place, this sets the stage for the merger of the two markets.

Accordingly, on July 30, 2002 the SBP issued the guidelines for the establishment of exchange companies (ECs). The formulation of ECs would corporatize the moneychangers' business, while ensuring that various types of risks associated with this activity are properly addressed and covered.[56]

In this new mechanism, the prescribed paid-up capital of Rs 100 million would allow only commercial banks and large existing moneychangers to operate. However, a period of 3 years is granted to the moneychangers to enable a full transition of the existing business under the stated guidelines.

[55] Under FE-31, commercial banks were to surrender the foreign exchange to SBP against the equivalent Rupee counterpart. Now, in order to take out the foreign exchange from SBP, banks are required to surrender Rupee equivalent. Thus, abolishment of this restriction would shift the foreign exchange back to bank and squeeze the Rupee liquidity.
[56] The exchange companies are authorized to deal in foreign currency notes, coins, postal notes, money orders, bank drafts, travelers' cheques and transfer.