WHAT IS HAPPENING TO PAKISTAN'S EXTERNAL SECTOR?

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Recent media reports, commentators and editorials have raised questions about the growing trade deficit faced by Pakistan in the current fiscal year, as well as, about the rise in the absolute level of External Debt. In raising these issues a serious concern has been expressed about Pakistan's ability to pay its external obligations and the impact on foreign reserves in the future. Alternatively, it is argued, that these obligations can be paid only by incurring higher debt from abroad and thus increasing debt burden.

These questions are quite legitimate as the increased debt burden during the last decade had created serious difficulties in managing the economy and made the country vulnerable and exposed to high risks. The debt reduction strategy that has been successfully implemented during the last five years has helped the country reduce its debt burden and thus attain its economic sovereignty. Therefore, the fears that the rising trade deficit and increase in External Debt may push us back in the old direction are quite understandable.

As this group of senior Civil Servants will end up in key policy making positions I deem it my duty to address these questions in a systematic manner and explain the basic concepts which will help you in clarifying your understanding of this important topic. What distinguishes you from others is that you are trained to look at the facts rather than perceptions, to analyze the data rather than be carried away by rhetoric and to reach conclusions based on analysis rather than your own prior views. I would address in this session three questions that are frequently asked. First I would like to analyze the impact of rising trade deficit in the context

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of the balance of payments situation. Second, I would dwell on the external debt and liabilities position and its future evolution. Finally, I would respond to the popular perception that all the good that has happened to Pakistan's economy is a direct consequence of September 11 events.

BALANCE OF PAYMENTS:

A country's overall external balance of payments consists of two accounts – Current Account and Capital Account. If the Current Account is in deficit but it can be fully financed from the Capital Account, then the overall balance of payments remains zero. If the Current Account is in surplus but the Capital Account (before new loans) is in deficit to the same extent, then also the overall balance remains zero. It is only when both the Current Account and the Capital Accounts are in deficit then the reserves are drawn down or new debt is contracted to meet the deficit. Thus, the overall balance of payments surplus or deficit is the appropriate indicator to gauge the strength or weakness of a country's external sector and partial indicators such as trade deficit or Current Account deficit are not that meaningful. The level of foreign reserves is, therefore, determined by the interactions of the current and Capital Account balances showing itself in form of overall balance of payments deficit or surplus. For the last four years Pakistan had recorded overall balance of payments arising mainly due to the surplus on Current Account. This surplus showed itself in form of higher foreign exchange reserves. Reserves are thus a mirror image of the final outcome on the balance of payments of a country. Table I below summarizes the evolution of foreign reserves during the last five years.

TABLE I

Foreign Reserves Accumulation
FY00 – FY05

$ Million

	Current Account Balance	Capital Account Balance	Overall Balance	Change in Reserves
FY00	-217	-163	-380	-380
FY01	326	400	726	+726
FY02	2833	-116	2717	+2717
FY03	4070	841	5911	+5911
FY04	1811	-1389	422	+422
FY05 (Est)	-1409	925	-484	-484
Grand Total	7414	1498	8912	+8912

It can be seen that the reserve accumulation of $8.9 billion during FY00-FY05 has taken place as the country was able to achieve cumulative Current Account surplus of $7.4 billion and Capital Account surplus of $1.5 billion during this period. Annex Table presents the evolution of the balance of payments by each component for every single year of this period.

The data further shows that the country had a trade deficit every single year but despite that Current Account was surplus and positive reserve accumulation was recorded in four out of five years. More significant was deficit on services account that was twice as large as trade deficit. This evidence clearly shows that as long as these deficits can be financed without raising expensive debt there is not much to worry about.

A developing country usually faces Current Account deficit because its investment needs are much greater than its own domestic savings. It, therefore, relies upon foreign savings for meeting this gap. The form these foreign savings take is extremely critical. If these savings come in form of non-debt creating flows such as grants, foreign direct investment or foreign portfolio investment, there is not much to worry about. If these flows come in the form of concessional loans that can be repaid over the next 20-30 years at low interest rates then also there are no serious grounds for concern. The only proviso is that these loans are utilized effectively for productive purposes enabling a country to generate additional income stream with which these loans can be repaid. More worrisome are short term external commercial loans of less than one year maturity. If these loans are contracted for meeting the balance of payments deficit there is always a danger that they could be recalled or not allowed to roll over at a time when the country does not have sufficient foreign exchange resources at its disposal. This kind of situation has led several countries into financial and debt crisis in the past and should be avoided at all costs. The appropriate indicator to gauge whether a country is likely to be hit by a crisis is the ratio of external reserves to short term debt.

There is a school of thought that believes that a country remains inherently weak unless it continues to show a Current Account surplus. In my view this is flawed thinking. What does Current Account surplus mean? This means that the Central Bank of Pakistan is transferring the surplus national savings of Pakistan to finance the Current Account deficit of the United States. Is this what we would like to see? Of course, NO. A developing country should receive foreign savings to supplement its national savings for financing higher investment rate rather than the other way around.

Let us now dissect both Current Account and Capital Account to help us understand their components, implications and consequences.

Current Account consists of four main components:

i. Trade Balance – Sum of exports and imports of merchandise goods.

ii. Net Services Balance – Sum of receipts and payments on export and imports of services such as travel, freight, insurance, transportation, etc.

iii. Net Income Balance – Sum of all receipts and payments on interest on loans, profits, dividends, royalties, etc.

iv. Current Transfers – Sum of all private and official transfers such as workers' remittances through banks, receipts through Exchange Companies, foreign currency deposits of residents and grant flows.

So within this account if there is a large trade deficit that can be financed by other components then we can say that the deficit is manageable and there will be no pressure on the payments situation.

Let us see how the Current Account evolved during the last fiscal year 2003-04 following the above classification system:

TABLE II

Current Account Balance 2003-04

	$ Million
i. Trade Deficit	- 1279
ii. Services (net)	- 1316
iii. Income (net)	- 2207
iv. Current transfers (net)	+ 6613
Current Account Balance	+ 1811
Capital Account	- 1389
Overall Balance of Payments	+ 422

It can be seen from the above table that the trade deficit, deficit on services account and income account together were all wiped off by workers' remittances and other current transfers leaving a surplus of $1811 million on Current Account.

Capital Account (the correct nomenclature is Capital and Financial Account) consists of the sum of all foreign direct and portfolio investment, foreign long, medium and short term loan repayments of principal and disbursements of loans, foreign currency account of non residents, other unidentified flows and errors and omissions.

In FY 04 the net Capital Account was in deficit by $1,389 million. Thus, the overall balance of payments was surplus by $422 million and the gross reserves of the SBP and Banking System consequently went up by $422 million that year.

It is only in the current fiscal year that the situation has changed from the surplus (recorded for last three years) to deficit. In the ten months of the current fiscal year (2004-05) the position of the overall balance of payments is as follows:

TABLE III

Current Account Balance July 2004 - April 2005

		$ Million
i.	Trade Deficit	- 3818
ii.	Services (net)	- 2638
iii.	Income (net)	- 1816
iv.	Current transfers (net)	+ 7116
	Current Account	- 1156
	Capital Account	+ 1053
	Overall Balance of Payments	- 103

Pakistan's exports of merchandise have risen from $7.8 billion in FY99 to an estimated $14 billion in FY05 i.e. an increase of almost 80 per cent but at the same time the imports have grown much faster i.e. from $9.4 billion to an estimated $19 billion recording 102 per cent growth. This import expansion has been much faster in the last two years FY 04 and FY05. GDP growth and import growth are found to be highly correlated in developing countries and the data for Pakistan also supports this finding.

Trade deficit in this fiscal year has almost tripled compared to the previous year for three reasons (a) higher prices have pushed the oil import bill from $3.0 billion to almost $5 billion for the whole year; (b) the machinery imports recorded 55 percent increase in the first nine months of this year, and (c) imports of industrial raw materials including iron and steel and aluminum have jumped almost 50 percent. Overall import growth was 36 percent against export growth of 14 percent. As long as the trade deficit is originating because of higher investment goods rather than consumer goods there should be no cause for alarm because it is laying the foundation for sustainable growth in the future. It should also be noted that current transfers, i.e. mainly workers' remittances are quite substantial and have financed the trade deficit, services deficit and partially the incomes deficit.

One of the important structural changes that has taken place during the fiscal year 2003-04 is the inclusion of all remittances and other foreign exchange received by the exchange companies and the payments made by them for travel, medical and other business purposes. Therefore, you would note that the current transfers for the ten months of this year are $7.1 billion which includes $2.8 billion received by the exchange companies. This amount is offset by equivalent payments of $2.6 billion made by the exchange companies under services account and $0.2 billion under trade account. This structural change has made the balance of payments accounts more comprehensive and representative by bringing in previous informal receipts and payments of money changers into the system.

Capital Account shows a positive net inflow of $1053 million primarily due to foreign direct investment but despite this surplus on Capital Account there was an overall deficit on balance of payments of $103 million. This deficit on the overall external balance of payments amounts to 0.1% of GDP which is very insignificant and has been met so far by drawing down of reserves. Despite this deficit the foreign reserves of Pakistan in April 2005 had reached $13 billion or equivalent to almost 9 months of imports and, more important, they represent 8 times the external short debt of the country. This high level of reserves has also allowed the exchange rate to maintain stability.

It can thus be seen that the concerns for external balance of payments position for this fiscal year, despite the unanticipated huge trade deficit, are not well placed. However, this situation has to be reversed in the future years by increasing exports, foreign investment and workers' remittances. Pakistan's exports as a share of world exports have remained stuck at below 0.20 percent. This share has to be enhanced through better market access for textiles in the post-quota regime and, more importantly, by diversifying into engineering goods and other categories. Too much reliance on textiles and too few markets such as the EU and US are not desirable for developing a healthy, sound and diversified export base.

EXTERNAL DEBT AND LIABILITIES:

I now turn to the next question, i.e. the External Debt and liabilities of Pakistan. Here again, I will like to begin by clarifying some basic concepts.

External Debt was not fully reported until 1999 as External Liabilities such as Foreign Currency Deposits, U.S. Dollar deposits, Central Bank deposits of other countries were not publicly disclosed. We started to show a complete picture of all External Debt and liabilities since 1999 for the first time by including foreign currency deposits of residents and non-residents, US dollar deposits, the deposits of friendly central banks and the Military debt in this total picture. Thus, the past series on External Debt before 1999 is not strictly comparable to the current series that is more comprehensive and all inclusive.

It is true that Pakistan's External Debt and Liabilities (EDL) had declined from $38.9 billion in FY99 to $35.2 billion by FY04 but has risen to $36.6 billion by March 2005 – an increase of $1.4 billion during nine month period. It must be emphasized that the absolute amounts of debt stock or debt servicing are not pertinent but it is the burden of debt or debt servicing relative to the country's payment capacity that is the relevant indicator. Debt in absolute amount cannot remain static or constant but keeps on growing in a developing country.

What are the relevant debt indicators that can help us diagnose whether the debt burden is rising or declining or is unchanged? There are two types of indicators to watch. The first relates to the stock of debt with GDP, exports and foreign exchange earnings. The second describes the debt servicing (due) to exports, foreign exchange earnings and foreign exchange reserves. We also compute the net present value of the debt which depends upon the proportion of concessional debt in the whole debt stock. The key indicators are:

(a) Ratio of External Debt to GDP
(b) Ratio of External Debt to Exports
(c) Ratio of External Debt to Foreign Exchange Earnings
(d) Ratio of External Debt Service to Exports
(e) Ratio of External Debt Service to Foreign Exchange Earnings
(f) Ratio of External Debt to Foreign Reserves
(g) Ratio of Concessional Debt to External Debt

The moot point to consider is whether these key debt indicators have improved or not despite this increase in the absolute amount of debt. Table IV below shows the decline in almost all the Key Debt Indicators between June 1999 and March 2005.

TABLE IV

Key Debt Indicators

	June 1999	March 2005
External Debt & Liabilities /GDP	66	33
External Debt & Liabilities /Exports	517	262
External Debt& Liabilities /Foreign Exchange Earnings	346	142
External Debt Service due/Exports	36.1	18.8
External Debt Service/Foreign Exchange Earnings	24.1	10.3
External Debt & Liabilities /Foreign Exchange Reserves	22.3	3.4
Concessional Debt/External Debt	55	66

Pakistan's capacity has vastly improved to bear the existing External Debt burden, to contract new loans and to service the Debt Service payments on existing and new loans without much difficulty. Not only that, the terms on which Pakistan has contracted the new loans are highly favourable.

According to the World Bank data, the average interest rate on new loan commitments to Pakistan in 2003 has declined, the maturity has been extended, grace period was longer and grant element was much higher compared to the year 2000.

TABLE V

Average Terms of New Loan Commitments

	2000	2003
Interest rate (%)	6.3	1.7
Maturity (years)	12.5	19.9
Grace Period (years)	4.8	3.0
Grant Element (%)	19.9	52.7

As we argued earlier most developing countries contract loans from external creditors for financing development and Pakistan has also continued to borrow from both the World Bank and Asian Development Bank (ADB) in the last five years. We have stopped borrowing from the IMF because the economy is in good shape and the IMF assistance is invoked only when a country's economy is in trouble and it cannot meet its obligations. As we have shown, Pakistan does not face any difficulty and its capacity to meet its balance of payments needs, as well as, External Debt servicing has become quite strong. It, therefore, no longer requires the IMF assistance. But Pakistan has not stopped its development process as it is still a poor country with per capita income of $700 with one-third of its population living below the poverty line. There should be no doubt in anyone's mind that we have to continue borrowing from the World Bank and the ADB for the next ten years to sustain high growth and reduce poverty. These loans will be used for education and literacy, health, roads and highways, irrigation and water resources, power and energy, etc. As long as these loans are utilized properly not for consumption needs of the government but for public sector development program and private investment and the terms and conditions of the loans are concessional or reasonable it is in our collective interest to contract these loans.

The debt dynamics indicate that as long as the growth of real GDP is higher than the real cost of borrowing on External Debt and Non-Interest Current Account (NICA) surplus is generated the External Debt ratios will continue to decline. During 2000-04, the NICA was surplus by 3.6 percent of GDP and real cost of borrowing was 0.7 per cent and real GDP growth was 4.5 per cent. If such parameters hold in the future, the External Debt ratios will further decline. The apprehension that as soon as Pakistan resumes servicing its Paris Club Debt in 2015 it will face problems in meeting its debt servicing obligations is totally unjustified. The Foreign Exchange Earnings at that time will be manifold higher than the present level and the debt ratios much lower.

However, it is imperative that there should be no attempt to disturb the above debt dynamics or accelerate borrowing. The room for maneuver is very limited and the risk that debt ratios could reverse under the pressure of unanticipated exogenous shocks -external or domestic – cannot be ruled out. Prudent debt management requires that primary budgetary surpluses should be generated in order to reduce public debt ratios. Soft and concessional loans at favorable terms should remain the main staple of our external borrowing strategy in the next five years.

Non-debt creating external flows such as exports, workers' remittances, foreign direct and portfolio investment should be accelerated to finance the growing needs of investment goods in the economy while soft loans should be used for infrastructure expansion. This mix of external financing will keep the economy in good stead to meet unforeseen bad times and avoid resorting to the IMF support.

IMPACT OF SEPTEMBER 11, 2001 ON THE EXTERNAL SECTOR:

Another popular perception in the minds of most Pakistanis is that it is the massive aid flows and debt relief resulting from Pakistan's participation in the war against terror after September 11, 2001 that has been responsible for the large reserve accumulation and economic turnaround. As soon as these flows disappear we would once again be in serious financial trouble. This perception shows how little self confidence we have as a nation in our own capabilities and achievements. It is true that September 11 did help in diverting worker's remittances from open market to inter bank, in providing some debt relief and new loans and grants, in removing official sanctions, but there were huge costs incurred by Pakistan. Export orders of more than $1 billion were cancelled. Visits by foreign buyers were suspended, higher war risk premium was charged on freight and insurance premiums were raised. Table VI presents the sources of Foreign Exchange Earnings of Pakistan since FY00 by each major component.

TABLE VI
Sources of Foreign Exchange Earnings
FY00 - FY05

$ Million

		FY 00	FY 01	FY 02	FY 03	FY 04	FY 05 Est.
A.	Exports of Goods & Services	9,574	10,284	11,056	13,686	15,103	17,575
B.	Workers' Remittances	983	3,087	2,390	4,237	2,871	4,140
C.	Other Private Transfers	2111	2,853	1,899	1,559	2,293	4,250
D.	Official Transfers	940	842	1,500	1,051	634	393
E.	Debt Relief	-	-	-	1,000	-	495
F.	Foreign Direct Investment	472	323	485	798	951	1,025
G.	Euro / Sukuk Bonds	-	-	-	-	500	600
H.	Foreign Loans / Credits	1589	2812	2,910	2,293	1,726	2,587
I.	Others	158	175	164	271	199	330
	TOTAL:	**15,827**	**18,377**	**20,404**	**24,895**	**25,253**	**31,395**

The data shows that even if we assume the extreme case that all official transfers, debt relief and all foreign loans/credits represent the "gift" of September 11 to Pakistan, this combined amount represents only 11 per cent of total Foreign Exchange Earnings of the Country in FY05 and even lower 9.3 per cent in FY04. At its peak in FY02, this amount was 21.6 per cent. But this entire amount is not a direct fall out of September 11 because Pakistan has been receiving foreign loans and grants every year since the 1950s. For example, in FY00 and FY01, the two years prior to September 11, we received 16 per cent and 19.9 per cent of Foreign Exchange Earnings in form of foreign loans and grants. If we look at Table I again it is clear that the country had a positive overall balance and positive current and capital account balances in FY 2000-01 much before September 11, 2001 occurred. Even in FY 1999-00 the deficit on overall balance was quite small less than 1% of GDP. Pakistan's reserves had started accumulating in FY2000-01 and SBP's own reserves had almost doubled after paying off foreign currency deposits of almost $1.7 billion to the non-resident and institutional holders and $.2.8 billion in debt servicing to external creditors. Thus, this perception that every thing good that has happened to the country is a direct consequence of September 11 is not only incorrect but highly exaggerated.

To sum up, Pakistan's external sector is responding to the development and investment needs of the country and growing trade deficit is not a cause for concern in the short term. In the long term, Pakistan has to significantly increase its exports and diversify its export base. Debt servicing capacity has improved considerably. To the extent that the new loans are properly utilized for meeting the gap between domestic savings and investment, the people of Pakistan will be better off. September 11 did help in removing official sanctions, diverting remittances through banking channels, providing some debt relief and new grants and loans, but the contribution of these developments on foreign exchange earnings of the country has been highly exaggerated. Looking forward, prudent management of external sector to keep public debt and external debt ratios moving on a downward path will be absolutely necessary to meet the challenges of growth and unanticipated shocks either external or domestic.

Annex

PAKISTAN'S BALANCE OF PAYMENTS
FY 2000 - 2005

$ Million

		FY OO	FY 01	FY 02	FY 03	FY 04	FY 05 (Est.)	TOTAL FY00-FY05
A	Trade Balance	-1412	-1269	-294	-359	-1279	-4315	-8928
	Exports FOB	8190	8933	9140	10974	12459	14322	64018
	Imports FOB	-9602	-10202	-9434	-11333	-13738	-18637	-72946
B	Services (net)	-2794	-3142	-2617	-2213	-3523	-5594	19883
C	Current Transfers	3989	4737	5744	6642	6613	8500	36225
	Current Account Balance (A+B+C)	-217	326	2833	4070	1811	-1409	7414
	Capital Account Balance	-163	400	-116	1841	-1389	925	1498
	OVERALL BALANCE	-380	726	2717	5911	422	-282	8912