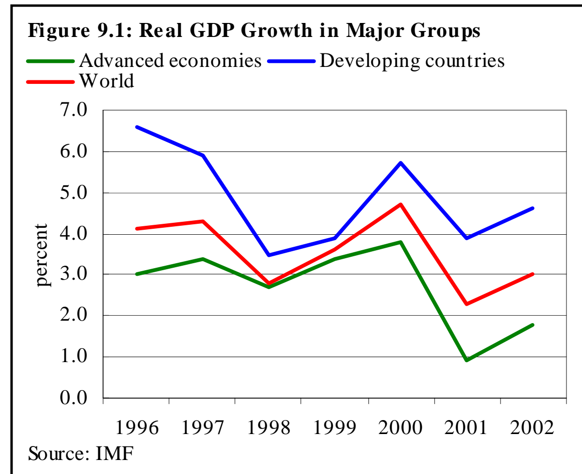
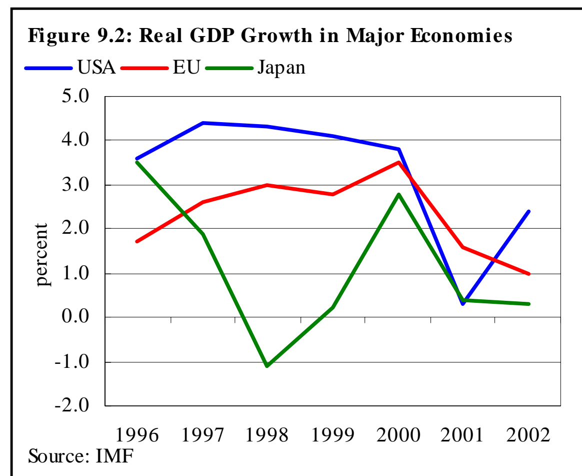
9 Balance of Payments and Exchange Rate Policy

9.1 International Economic Scenario

Global output staged a recovery during 2002, growing by an estimated 3 percent, which is a small improvement over the 2.5 present growth estimated for the preceding year. Although both the advanced economies and the developing countries shared in the recovery during 2002 (see **Figure 9.1**), the overall performance of the global economy remained well below the potential.



The growth in the advanced economies is important, as the progress in these economies gives a stimulus to economic growth in the developing countries as well - the US, EU and Japan, particular, constitute over 50 percent of the world economy. Within the advanced economies, however, it is only the USA (and to some extent the East Asian advanced economies), which contributed in the recovery shown by this group. Japan and the European members of this group showed a dismal performance, with growth decelerating to 1 percent and 0.3 percent respectively (see **Figure 9.2**). In contrast, developing countries performed turned in an aggregate growth of 4.6 percent, led by the robust 8 percent growth in China.



It seems that the rising uncertainty related to situation in Iraq during the latter half of 2002 accentuated the already slow business investment, which had been decelerating following September 11 and latter the corporate scandals in the US. However, the monetary stimulus policy opted by the US (and the EU), prompted by this recessionary tendency, then played a pivotal role in stimulating economic activities.

The deceleration in the US economy over the last few years forced the Fed to cut interest rates as the country faced slowdown in sales and production, weakening of consumer confidence affecting consumption and distressed financial markets (see **Figure 9.3**). The gloom over the economy after the September 11 incident intensified such interest rate cuts, as is evident form the 4 cuts in the federal funds rate in 4 months since the incident. The Fed had been cutting the federal funds rate since May 2000.

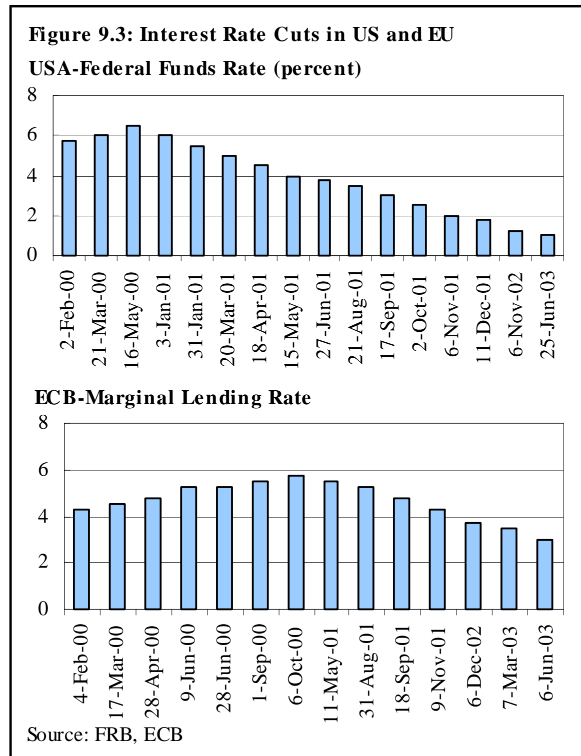
Despite the fact that the EU economy, which had been growing slower than the US economy for the last few years, began to show signs of slowdown in 2001, the European Central Bank (ECB), adopted a moderate posture in cutting the interest rates to boost the economy. In contrast to the cuts in interest rates by the Fed (which had begun right in January 2001), the ECB chose to reduce interest rate later

(and less aggressively). During the period January 2001 to June 2003, the Fed has cut the interest rate by 5.5 percentage points, while the ECB reduced the rates by 2.8 percentage points.

The slowdown in economic activity dragged inflation downwards both in the advanced economies and developing countries. While inflation level remained significantly higher in the developing countries than the advanced economies in 2002, nevertheless the deceleration was more pronounced in the latter than the former (see **Figure 9.4**). It must be noted that there has been a continuing slowdown in price hike in the developing countries since 1996. The deceleration in overall world inflation is becoming a matter of concern as a continuing deceleration might turn into a deflationary trend with adverse impact on the global economy. The deflationary trend in Japan and a sharp to moderate reduction in the US and the EU inflation, respectively, is giving fuel to such expectations. Japan has been witnessing deflationary trend since 1999 and is specially a source of concern for the advanced economies. The US and the EU, on the other hand, have been facing deceleration in the inflation since 2000. The reduction in US inflation rate in 2000 has been much stronger than the EU inflation rate (see **Figure 9.5**).

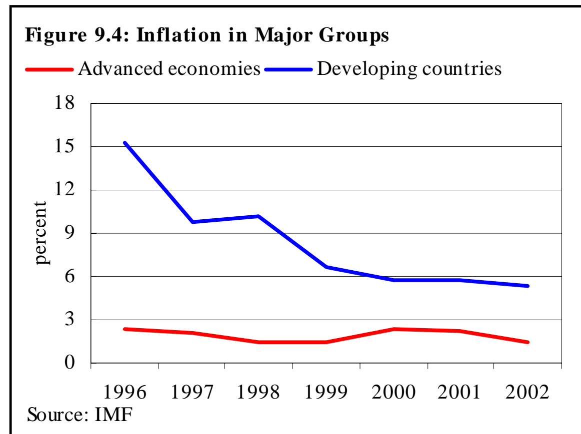
Though not very significant, the improving global economic activity helped the recovery of international trade in 2002 as well. The trade volumes grew significantly in 2002 (by 2.9 percent) when compared with the preceding year (0.1 percent) but nonetheless, remained significantly lower than the growth observed in the past. In fact, the growth in trade volumes is abnormally low when seen in the perspective of output-trade growth relationship. The growth in trade volumes has been significantly higher than the output growth since 1996 with the exception of 2001 when the trade volume growth was significantly lower than the output growth. The growth performance of trade, however, is still encouraging given the uncertainty prevailing during the latter half of 2002 related to the conflict in Iraq.

Figure 9.3: Interest Rate Cuts in US and EU



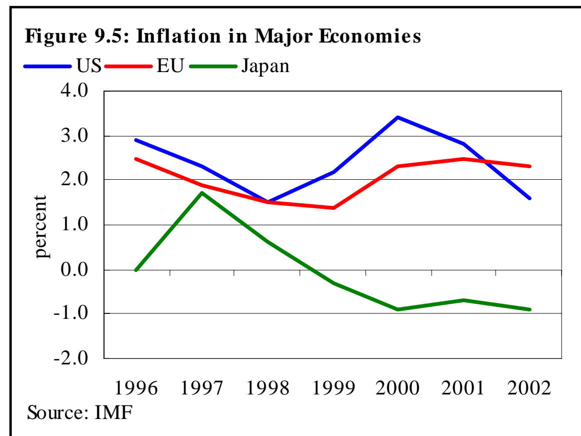
Source: FRB, ECB

Figure 9.4: Inflation in Major Groups



Source: IMF

Figure 9.5: Inflation in Major Economies



Source: IMF

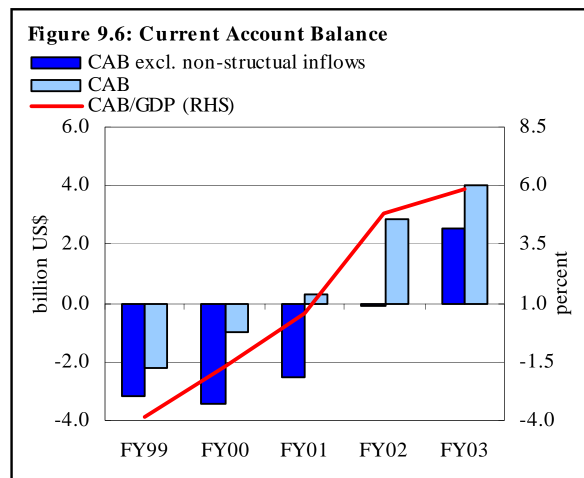
9.2 Balance of Payments

The improvement in Pakistan's external sector that began in FY00 and intensified in FY02, gathered further momentum in FY03 as improvements in both, the current and capital accounts, led to yet another record breaking overall BOP surplus of US$ 4.6 billion or 6.7 percent of GDP – nearly 70 percent higher than next largest overall surplus of US$ 2.7 billion that was recorded in FY02 (see **Table 9.1**).

The dominant contribution to this spectacular performance was from current account components, including: (1) workers' remittances which registered buoyant 79 percent growth during FY03 to reach a new all-time high of US$ 4.2 billion; (2) a sharp fall in interest payments following the retirement of expensive debt and liabilities as well as the partial substitution of expensive debt with soft loans from IFIs; (3) robust non-structural inflows;[1] and (4) tremendous growth in exports earnings, which rose to a record US$ 10.9 billion.

As a result, the current account balance (CAB) posted Pakistan's highest-ever surplus, totaling US$ 4.0 billion, during FY03, easily surpassing the FY02 surplus of US$ 2.8 billion (see **Table 9.1**). Consequently, the CAB to GDP ratio improved from 4.8 percent to 5.9 percent (see **Figure 9.6**). More encouragingly, non-structural factors (i.e. potentially non-repeating inflows) comprise only 37.6 percent of the improvement in the CAB during FY03. Even excluding the non-structural factors, the ratio of CAB to GDP for the period is a very healthy 3.7 percent.

Figure 9.6: Current Account Balance



Although Pakistan has been recording meaningful current account surpluses for the last three years, FY03 marks a watershed, as this is the first year that the CAB remains in surplus even after netting out the non-structural components, suggesting a potentially permanent improvement in the country's current account profile.

The capital account also recorded a sharp reversal, from a deficit of US$ 1.1 billion during FY02 to a surplus of US$ 113 million during FY03.[2] This capital account *improvement* needs some clarification; an inflow of approximately US$ 1.1 billion during FY03 in *short-term capital (others)* represents a *contra-entry* against forex loans disbursed by the banks. Adjusting for this, the capital account reverts to a deficit of US$ 1.0 billion, but even this is a 23.1 percent improvement over the deficit of US$ 1.3 billion recorded in FY02. This sharp reduction in the (adjusted) capital account deficit is mainly the reflection of higher foreign direct investment, increased suppliers' credit inflows (due to rising economic activity), as well as lower outflows on the account of Special US Dollar bonds and commercial loans, during FY03.

1 Non-structural inflows include logistic support receipts, Saudi Oil Facility (SOF) and cash grant from US.
[2] During FY03, capital account also includes the notional inflow & outflow of US$ 1.0 billion US debt write-off in *long-term capital official*.

Table 9.1: Balance of Payments- Summary Table
million US Dollar

Items	FY99	FY00	FY01	FY02	FY03	Absolute change	Change FY03 over FY02 percent
1. Trade balance	**-2085**	**-1412**	**-1269**	**-294**	**-536**	-242	82.3
Exports (fob)	7528	8190	8933	9140	10889	1749	19.1
Imports (fob)	9613	9602	10202	9434	11425	1991	21.1
2. Services (net)	**-2618**	**-2794**	**-3142**	**-2617**	**-2173**	444	-17.0
Shipment	-803	-751	-820	-740	-879	-139	18.8
Other transportation	110	71	61	103	212	109	105.8
Travel	-122	-142	-180	-147	-402	-255	173.5
Investment income	-1808	-2018	-2161	-2319	-2207	112	-4.8
Interest payments	-1399	-1596	-1548	-1469	-1103	366	-24.9
Profit and dividend	-270	-233	-301	-457	-631	-174	38.1
Purchase of crude oil	-139	-187	-312	-394	-473	-79	20.1
Other goods, services, & income	5	46	-42	486	1103	617	127.0
3. Current transfers (net)	**2847**	**3989**	**4737**	**5744**	**6737**	993	17.3
a) Private transfers -net	2274	3063	3898	4249	5737	1488	35.0
of which:							
i) Workers' remittances	1060	983	1087	2390	4237	1847	77.3
ii) FCA (residents)	539	322	534	285	-12	-297	-104.2
iii) Outright purchases	531	1634	2157	1376	0	-1376	-100.0
iv) Export of currencies	0	0	0	0	429	429	
b) Official transfers	573	926	839	1495	1000	-495	-33.1
of which: Saudi oil facility	390	790	683	579	637	58	10.0
4. Current account balance (1+2+3)	**-1856**	**-217**	**326**	**2833**	**4028**	1195	42.2
5. Capital account (net)	**-2278**	**-4177**	**-643**	**-1107**	**113**	1220	-110.2
6. Errors & omissions	**992**	**501**	**626**	**928**	**448**	-480	-51.7
7. Overall balance	**-3142**	**-3893**	**309**	**2654**	**4589**	1935	72.9
8. Financing	**3142**	**3893**	**-309**	**-2654**	**-4589**	-1935	72.9
I. Changes in reserves (-Inc/+Dec)	**-824**	**-71**	**-1000**	**-2792**	**-5210**	-2418	86.6
Assets	-1254	209	-1085	-3082	-5261	-2179	70.7
SDRs	2	0	1	-4	-233	-229	5725.0
Forex (State Bank of Pakistan)	-809	380	-727	-2713	-5678	-2965	109.3
Forex (commercial banks)	-447	-171	-359	-365	650	1015	-278.1
Liabilities	430	-280	85	290	51	-239	-82.4
Use of fund credit	430	-280	85	290	51	-239	-82.4
Repurchases	626	0	324	484	469	-15	-3.1
Purchases/drawings	196	280	239	194	418	224	115.5
II. Exceptional financing	**3966**	**3965**	**692**	**138**	**620**	482	349.3
SBP reserves (end-period)	1740	1358	2088	4809	9997	5188	107.9

Source: Statistics Department, SBP.

As a result of these developments, Pakistan's key BOP indicators exhibited a marked improvement during FY03 (see **Table 9.2**). Specifically, the export to GDP ratio improved to 15.8 percent from 15.5 percent last year while the import to GDP ratio increased to 16.6 percent. As a result, the trade openness (trade volume to GDP) ratio improved to 32.4 percent during FY03.

The ratios of services account (net) to GDP also improved mainly due to higher logistic receipts. Similarly, the lower interest payments coupled with the increased exports earnings (EE) improved the debt servicing capacity of Pakistan as shown by a reduction in the debt servicing to EE ratio during FY03.

This improvement in the external sector had strong policy implications for both the SBP and the government:

(1) The continued inflows throughout the year kept the Rs/US$ parity rate under upward pressure forcing the SBP to intervene in interbank market to curtail the strengthening of the rupee. As a result, SBP forex reserves posted an accretion of US$ 5.2 billion during FY03 to reach US$ 10.0 billion at end-June 2003 while the Rs/US$ parity experienced only a 3.9 percent appreciation.

(2) Due to comfortable forex reserve position, the SBP decided to allow pre-payment of foreign private loans (other than the government guaranteed loans)[3] while the government devised a strategy of pre-payment of expensive multilateral and IMF debt in next three years.[4]

(3) The continued forex inflows coupled with low inflationary pressures during FY03 allowed, the SBP to reduce discount rate to all-time low at 7.5 percent in November 2002. This led to a lowering of lending rates, including the EFS rate that lowered the cost of credit for exporters.

(5) The SBP further liberalized the foreign exchange regime by increasing the limits on advance remittance from 33.3 percent to 50.0 percent of the estimated C&F value of the goods to be imported, and delegated the power for approval to Authorized Dealers. Additionally, the SBP also relaxed restriction on repatriation of services payments related to life insurance, royalty and technical fee or service charges in the financial sectors.

(6) The higher external financing and improved fiscal discipline reduced the government borrowings from the banking system. Furthermore, the conclusion of agreement with the Paris Club countries and US Debt write-off reduced the debt servicing costs.

Table 9.2: Balance of Payments: Key Indicators

percent

	FY01	FY02	FY03
Trade			
Exports/GDP	15.3	15.5	15.8
Imports/GDP	17.5	16.0	16.6
Services account			
Services (net)/GDP	-5.4	-4.4	-3.2
Interest payment to EE ratio	17.3	16.1	10.1
Transfers			
Net transfers to GDP	8.1	9.8	9.8
Remittances/GDP	1.9	4.1	6.2
Current account			
Current receipts / GDP	26.0	28.8	30.0
Current receipts Growth	17.6	11.7	21.7
FEE (million US$)	14,337	15,456	19,622
Growth of FEE	12.4	7.8	27.0
NICAB (million US$)	1,874	4,302	5,131
NICAB/GDP	3.2	7.3	7.5
CAB/GDP	0.6	4.8	5.9
Capital account			
FDI/GDP	0.6	0.8	1.2
FDI/exports	3.6	5.3	7.3
Others			
Debt servicing to EE ratio	38.0	44.8	28.8
Import cover of reserves (in weeks)	10.1	24.3	47.3

Note: EE: Export earnings; FEE: Foreign exchange earnings;
NICAB: Non-interest current account balance;
FDI: Foreign direct investment.

Finally, in the light of the visible improvements in Pakistan external accounts, a surprising development that surfaced late in FY03 for a short duration was the re-emergence of the kerb market premium. However, three major factors appear to account for this development: (1) the decision of the Afghan government to ban the use of rupee as the medium of transactions in Afghanistan, that led to an upsurge in the demand for US Dollar; and (2) the under-declaration of the export of non-dollar currencies by Foreign Exchange Companies (FECs) and;(3) over-invoicing of merchandise exports.[5] It is notable that the kerb premium dropped after peaking at approximately 0.9 percent on June 25,2003 following the SBP interventions (including stringent action against FECs engaged in under-declaration of exports of non-dollar currencies).

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[3] Subject to the availability of the rupee counterpart available with them or they have the capacity to generate rupee funds at their own.

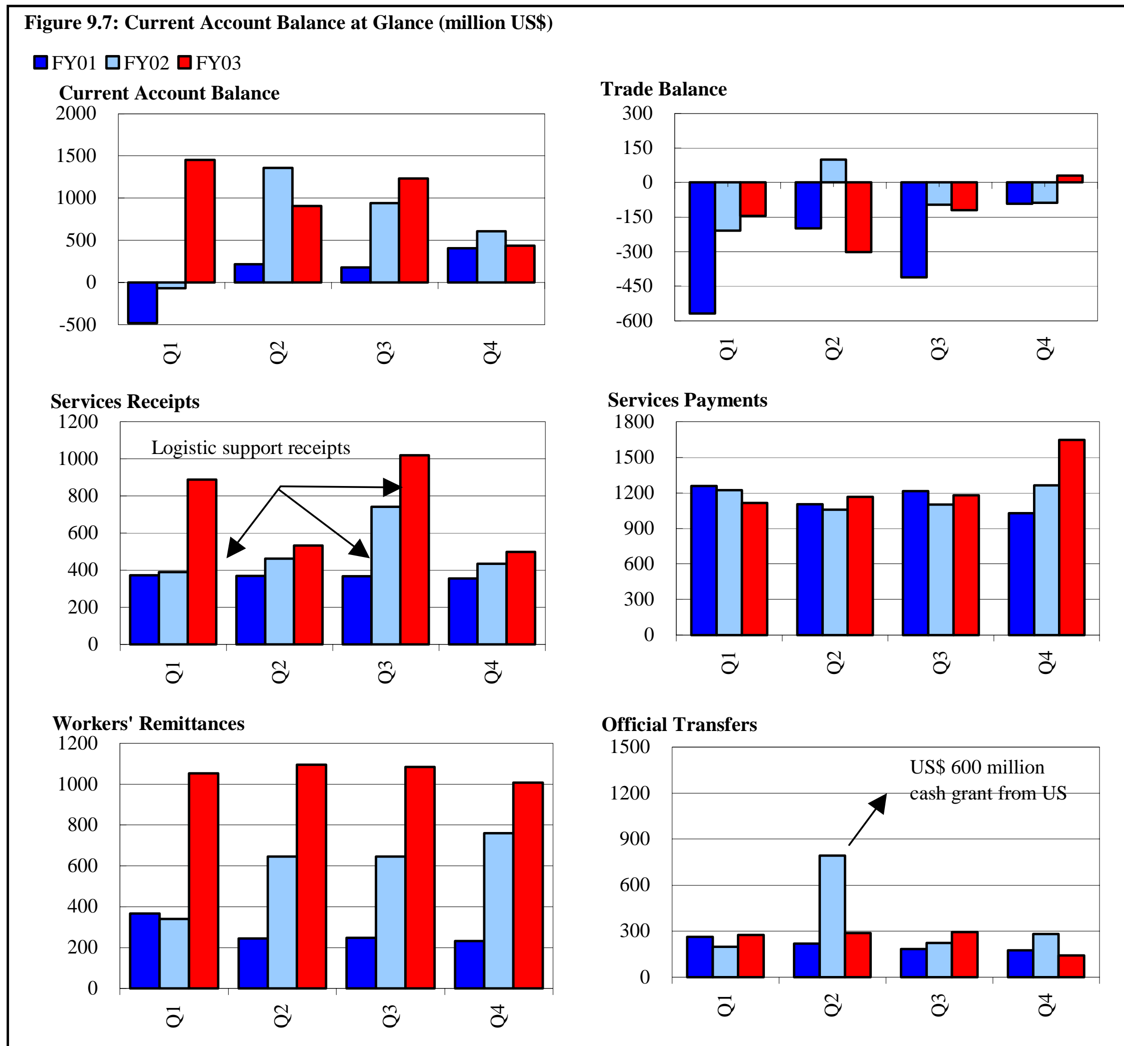
[4] Debt Office, MoF, plans to retire US$ 4.5 billion of expensive debt to World Bank, IMF and ADB in next three years. Of which, US$ 1.1 billion (US$ 500 million to World Bank, US$ 400 million to ADB and US$ 100 million to IMF) will be paid in FY04, US$ 1.5 billion in FY05 and US$ 2.0 billion in FY06.

[5] Some exporters indulged in over-invoicing of exports in order to claim Sales tax refund and more FE financing.

9.2.1 Current Account

The current account showed a marked improvement by posting a surplus of US$ 4.0 billion during FY03, up by 42.2 percent compared to FY02. After excluding the non-structural inflows, adjusted current account balance (CAB*) exhibited an even sharper reversal from a deficit of US$ 0.1 billion during FY02 to surplus of US$ 2.5 billion during FY03 despite the higher international oil prices and higher profit & dividend outflows (see **Figure 9.6**). The main factors behind this strong performance were the unprecedented workers' remittances and lower interest payments. Although quarterly BOP data showed that CAB was in surplus throughout FY03, the higher surplus during Q1 and Q3 was due to logistic support receipts in these quarters (see **Figure 9.7**).

Figure 9.7: Current Account Balance at Glance (million US$)



Trade Balance [6]

According to exchange data, the trade deficit during FY03 widened by US$ 242 million relative to preceding year to reach US$ 536 million, as the impact of impressive 19.1 percent export growth was more than offset by a 21.1 percent growth in imports. The highest contribution in export growth was

[6] This section is based on exchange records from the SBP, which will not tally with more detailed customs data used in the Trade sub-section.

again made by the textile sector, which witnessed a 25.0 percent growth during FY03. All the major value added textile categories contributed significantly to the exports growth on the account of rising trade volumes and higher unit values. Non-textile exports also grew by 17.2 percent during FY03. The import bill increased by 21.1 percent mainly due to the higher oil and machinery imports (for details, see **Section 9.4**).

Services Account

There is a remarkable stability in service account as the deficit has averaged about US$ 2669 million annually over the last five years. The 17 percent improvement in FY03 has occurred mainly due to exceptional receipts of US$ 847 million on account of flows from US for logistic support. If this amount is excluded, the deficit reverts close to its 5-year average (see **Table 9.3**).

Table 9.3: Services (net)
million US Dollars

	FY99	FY00	FY01	FY02	FY03
Service (net) I+II	**-2,618**	**-2,794**	**-3,142**	**-2,617**	**-2,173**
I. Invisible services (net)	-810	-776	-981	-298	34
Invisible receipts	1,314	1,384	1,351	1,916	2,767
Shipment	41	51	57	69	83
Other transportation	640	735	771	754	791
Travel	69	76	85	100	92
Other goods, services, & income	564	522	438	993	1,801
Invisible payments	2,124	2,160	2,332	2,214	2,733
Shipment	844	802	877	809	962
Other transportation	530	664	710	651	579
Travel	191	218	265	247	494
Other goods, services, & income	559	476	480	507	698
II. Investment income (net)	-1,808	-2,018	-2,161	-2,319	-2,207
Receipts	95	117	113	111	170
Interest on reserves	75	105	97	98	137
Others	20	12	16	13	33
Payments	1,903	2,135	2,274	2,430	2,377
Interest payments	1,494	1,715	1,661	1,579	1,273
Profit and dividend	270	233	301	457	631
Purchase of crude oil	139	187	312	394	473

Source: Statistics Department, State Bank of Pakistan

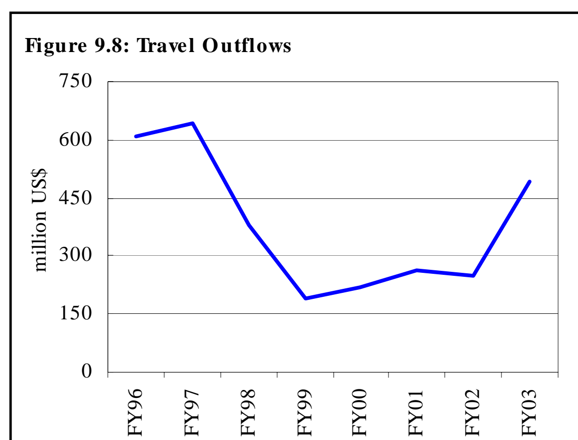
The invisibles account improvement was supported by a smaller, US$ 112 million, decline in the FY03 *investment income* outflows. This latter improvement owes to a sharp decline in interest paid on external debt and liabilities which, in conjunction with interest received on the country's burgeoning forex reserves, helped more than offset a US$ 253 million jump in outflows of '*investment income'* (excluding interest payments).

Travel Expenditures [7]

During FY03, the travel outflows witnessed a sharp 100 percent YoY jump in outflows, reversing the trend of low outflows evident since FY97 (see **Figure 9.8**). The trend reversal probably marks a structural shift due to the increased role of Exchange Companies (FECs), which account for US$ 241 million of the (approximately 48.7 percent) outflows.

[7] Travel includes all tourist receipts and foreign exchange expenditures by Pakistanis traveling abroad.

Prior to FY98, travel outflows had ranged from of US$ 600 to US$ 700 million, but these had dropped significantly following the onset of a forex crisis post-May 1998, when travelers had been asked to meet their requirements from the informal market. In this perspective, it seems that the FY03 rise in travel outflows, simply reflects the reversion to the pre-FY98 environment with the re-integration of these outflows into the formal system through FECs.



Interest Payments (net)

The net interest payments on Pakistan's external debt and liabilities declined by US$ 365 million to US$ 1.1 billion during FY03 as a consequence of lower international interest rates, as well as the efforts over the last three years to: (1) repay expensive foreign debt and liabilities (particularly commercial loans and forex liabilities); and (2) substitute high cost loans with soft term loans (see **Table 9.4**).

Of the FY03 interest payment on *long-term public & publicly guaranteed debt*, interest payments to the IFIs reflect actual cash flows, while recorded payments to Paris Club creditors overstate the cash impact.[8] This difference in the Paris Club payments is a result of the re-profiling of a large portion of Pakistan's bilateral external debt in FY02.

Additionally, it should be noted that FY03 fall in the interest paid on commercial loans, IDB and private loans/credits stems from the declining stock of such debt. Since the decline in these loans is expected to accelerate in FY04 due to the pre-payment of private loans & credits, the interest payments will probably continue to decline.
Finally, as far as the interest payments on foreign exchange liabilities are concerned, the lower LIBOR coupled with the declining stock of these liabilities from US$ 5.7 billion at end-June 2000 to US$ 2.1 billion at end-June 2003 has triggered the decline in interest payments since last year (see **Figure 9.9**).

Table 9.4: Details of Interest Payments and Receipts

million US Dollars

	FY01	FY02	FY03	Saving
Payments (I+II)	**1661**	**1579**	**1273**	**306**
I. Total external debt	1288	1330	1125	205
Public & publicly guaranteed	1031	1065	915	150
Long-term	858	914	814	100
Military	25	25	21	4
Euro bonds	62	64	60	4
Commercial loans/credits	78	42	13	29
IDB	8	20	7	13
Private loans/credits	197	212	170	42
IMF	60	53	40	13
II. External liabilities	373	249	148	101
Foreign currency deposits	71	55	24	31
Special US$ bonds	104	67	32	35
Central bank deposits	81	46	24	22
Others	117	81	68	13
Receipts	**113**	**111**	**170**	**59**
Interest on reserves	97	98	137	39
Others	16	13	33	20
Net payments	**-1548**	**-1468**	**-1103**	**+365**

Source: Statistics Department, State Bank of Pakistan

Investment Income Outflows (Excluding Interest Payments)

Investment income (excluding interest payments) comprises of profit & dividend and purchase of crude oil. Cumulatively, the outflows from the *Investment Income* (excluding interest payments) increased by US$ 253 million during FY03 to US$ 1104

[8] In accrual based accounting, foreign exchange payments are shown as if they have been made, with a contra-entry under '*exceptional financing*' for those payments that are only notional (see **Table 9.8**).

million (see **Table 9.5**). The upward trend of *profit & dividend* and *purchases of crude*[9] *oil* outflows during the last few years is large because of:

1) Higher volume of profit of foreign banks, energy sector companies, particularly the Independent Power Producers (IPPs); and
2) Relatively higher international crude oil prices during FY03, which increased the value of oil extracted by foreign oil & gas companies (see **Figure 9.10**).

Figure 9.9: Stock of Foreign Exchange Liabilties & its Interest Payments

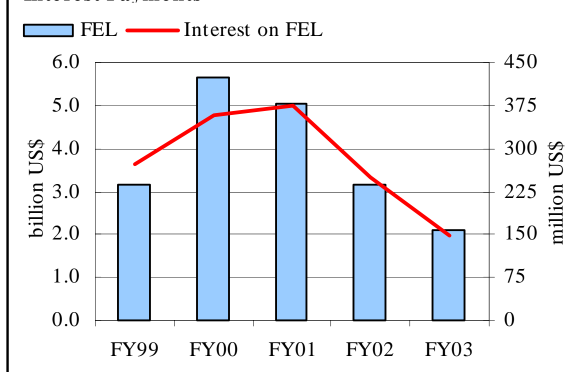


Table 9.5: Details of Investment Income (Excluding interest payments)

million US Dollars

	FY99	FY00	FY01	FY02	FY03
I. Profit & dividend	**270**	**233**	**301**	**457**	**631**
Profit	66	46	37	23	105
Dividend	113	124	148	335	423
Reinvested earnings	91	63	116	99	103
II. Purchase of crude oil	**139**	**187**	**312**	**394**	**473**
Export of crude oil	37	52	84	74	43
Remittances	102	135	228	320	430

Source: Statistics Department, SBP

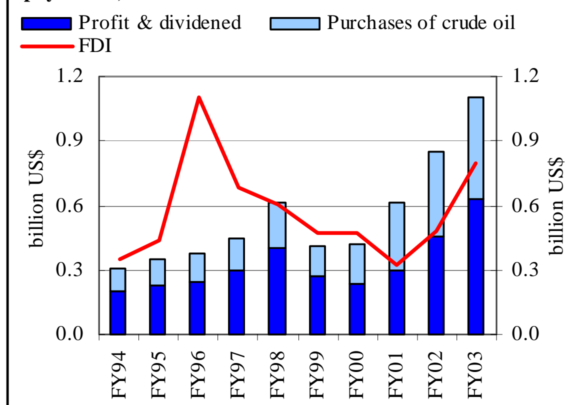
Transfers

The current transfers increased by US$ 993 million during FY03, up 17.3 percent over the preceding year. This largely stems from the huge surge in remittances and others transfers that easily offset the impact of: (1) the SBP decision to discontinue its kerb market purchases (US$ 1.4 billion during FY02); (2) the fall in resident FCAs; and (3) lower official transfers.

Private Transfers from Overseas Pakistanis

Overseas Pakistanis have sent their earnings to Pakistan through different channels since the freeze of foreign currency account in May 1998 i.e., through banks (recorded in BOP as '*workers' remittances')* and money changers (recorded in BOP as '*outright purchases')*. Over the last four years, the flows in this head of private transfers have averaged US$ 3,466 million.

Figure 9.10: Investment Income (excluding interest payments) & FDI



However, there was a substantial upsurge recorded in FY03 (77.3 percent growth to reach US$ 4.2 billion), which was about US$ 771 million above the trend line (see **Table 9.6**). It is quite probable that while part of it may represent the growth in remittances or diversion of previously unrecorded flows, a significant portion may constitute reversal of capital flight by resident Pakistanis.

[9] Purchase of crude oil reflects the amount paid by the government for the crude oil extracted in Pakistan by the foreign companies.

This exceptional growth is in fact the highest growth in remittances recorded for any country in FY03 (see **Figure 9.11** & **Table 9.7**).

Table 9.6: Trends in Private Transfers from Overseas Pakistanis

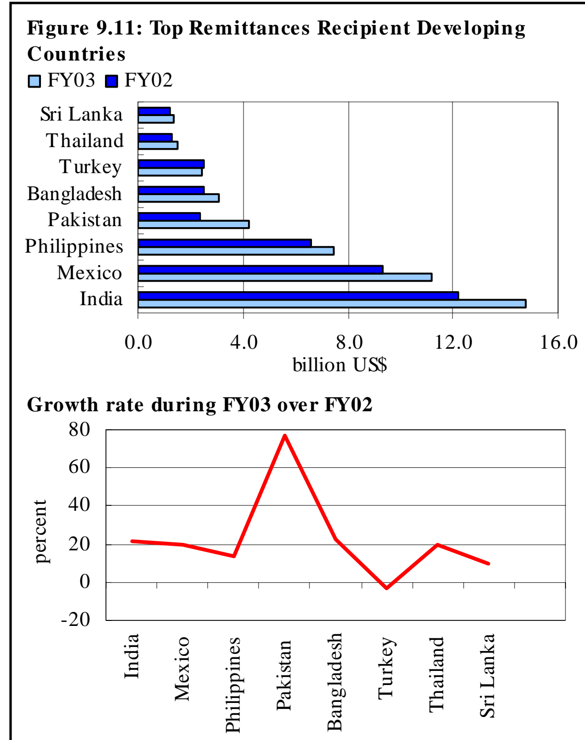
million US Dollars

	FY00	FY01	FY02	FY03	Last 4-year average
Workers' remittances	983	1087	2390	4237	2174
Outright purchases	1634	2157	1376	0	1292
Total	**2617**	**3244**	**3766**	**4237**	**3466**

Consequently, as a destination of global remittance flows, Pakistan's ranking improved from 14th position in 2001[10] to 4th position in FY03.[11] The main drivers for this continued up trend in Pakistan's remittances for the last two years, in particular, appear to be: (1) the increased global scrutiny of undocumented capital flows; (2) the elimination of the market kerb premium after 9/11; and (3) the increasing focus of banks on the speedy and secured delivery of remittances to recipients (see **Box 9.1** for more detail).[12]

Contrary to the trend in the last 22 months, the remittances during Jul-Aug 2003 recorded a YoY fall, mainly due to lower inflows from the US and the UAE (that jointly contribute about half of the annual remittances). This raised some questions on the continuity of the robust inflows seen in the preceding months.

Figure 9.11: Top Remittances Recipient Developing Countries



Specifically, the inflows from the US during this period are not only below the level witnessed during the corresponding period of FY03 but also significantly lower than the average monthly inflow during FY03. A similar, but more pronounced, declining trend is witnessed in the case of UAE (see **Figure 9.12**).

One of the prime factors for the decline in the overall inflows is the absence of remittances on account of Hajj Sponsorship Scheme (HSS), as this scheme was abolished before the beginning of FY04. Excluding for the remittances against HSS the fall in overall remittances is a meager US$ 4.6 million. Since the pattern of inflows from the UAE suggests that most of the remittances against HSS are likely to be from the UAE, the fall in remittances form the UAE is largely explainable. On the other hand, the remittances decline from US could represent the easing of a "reverse capital flight" from the US post-9/11.

[10] See "Striving for Stability in Development Finance" in Global Development Finance 2003, page 159.
[11] The data of remittances volume of 2001 are taken from World Bank publication "Global Development Finance (2003)" while the latest data for the FY02 and FY03 are downloaded from the websites of central banks of remittance receiving countries and converted at fiscal year basis accordingly.
[12] In fact, the dollar was cheaper in the open market than in the interbank market i.e., negative premium.

Table 9.7: Region-Wise Workers' Remittances
million US Dollars

	FY99	FY00	FY01	FY02	FY03	Growth rate in FY03 over FY02
I. Gulf region	**640.9**	**682.0**	**693.2**	**1070.1**	**1892.7**	**76.9**
Bahrain	33.3	29.4	23.9	39.6	71.5	80.5
Kuwait	106.4	135.3	123.4	89.7	221.2	146.7
Qatar	12.9	13.3	13.4	31.9	87.7	175.1
Saudi Arabia	318.5	309.9	304.4	376.3	580.8	54.3
Sultanat-e-Oman	44.7	46.4	38.1	63.2	93.7	48.2
UAE	125.1	147.8	190.0	469.5	837.9	78.5
II. US	**82.0**	**80.0**	**134.8**	**779.0**	**1237.5**	**58.9**
III. Other than Gulf & US	**152.7**	**151.6**	**193.6**	**491.7**	**1060.6**	**115.7**
Canada	3.5	3.9	4.9	20.5	15.2	-26.0
Germany	11.9	10.5	9.2	13.4	26.9	99.9
Japan	3.1	1.6	3.9	6.0	8.1	36.3
Norway	5.3	5.6	5.7	6.6	8.9	35.7
UK	73.6	73.3	81.4	151.9	273.8	80.2
Others	55.4	56.8	88.4	293.3	727.6	148.1
Total	**875.6**	**913.5**	**1021.6**	**2340.8**	**4190.7**	**79.0**
Encashment of FEBCs & FCBCs	**184.6**	**70.2**	**65.0**	**48.3**	**46.1**	**-4.4**
Grand total	**1060.2**	**983.7**	**1086.6**	**2389.1**	**4236.9**	**77.3**

Source: Statistics Department, SBP

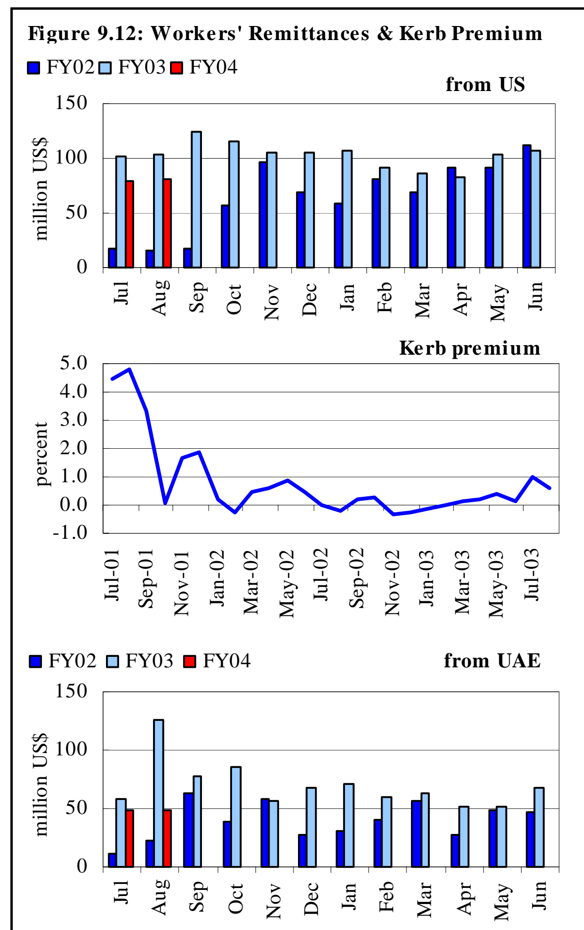
However, it would be premature to suggest a permanent deceleration in remittances on the basis of the data for only two months.

Resident FCAs

In sharp contrast to the inflow of US$ 285 million during FY02, resident FCAs registered an outflow of US$ 12 million during FY03. The main reasons for this sharp reversal were: (1) continued conversion of frozen FCAs into Pak Rupee due to its appreciation; and (2) the slower FE-25 deposit growth due to declining effective rate of return on these deposits (see **Figure 9.13**). As a result, the outstanding stock of Foreign Currency Accounts (FE-25 deposits and frozen FCAs) declined to US$ 2.5 billion by end-June 2003 from US$ 2.7 billion last year, showing an outflow of US$ 185 million during FY03.

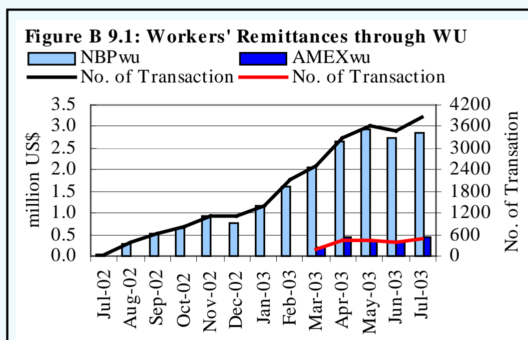
Figure 9.13 shows that the stock of FE-25 deposits witnessed significant volatility during H1-FY03. But this volatility is due to the accounting presentation of the fund transfers for the purchase of UBL. Q1-FY03 deposits increased due to inflow by investors for purchasing the bank, which was followed by a draw down FE-25 deposits during Q2-

Figure 9.12: Workers' Remittances & Kerb Premium



Box 9.1: Increasing Focus of Banks on Delivery of Workers' Remittances

An encouraging development related with workers' remittances during FY03 is the increased focus of banks on the speedy and secured delivery of remittances to recipients. In this connection, five major Pakistani commercial banks (NBP, HBL, MCB, UBL and ABL) have established a full-fledged home remittances cell at their head offices in order to collaborate to speed up the clearing among their branches. Additionally, NBP, American Express Bank and Pakistan Post Office (PPO) are modernizing their remittances operations and signed agreements with the Western Union (WU) during FY03. The volume handled through WU is not significant and it is quite understandable as WU is still expanding its outlets (see **Figure B 9.1**). However, it will take some time to establish a reputation with remitters.

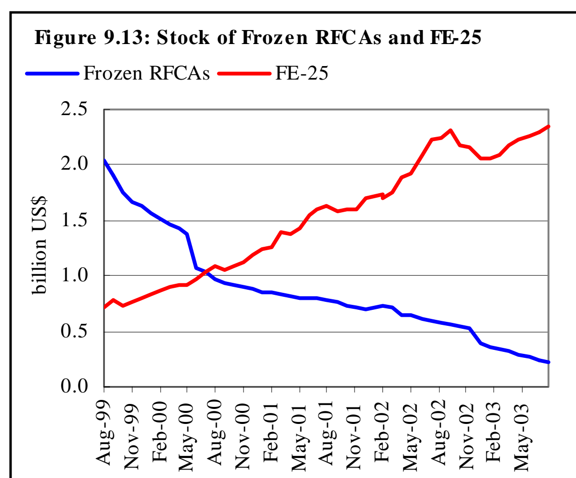


It is also pertinent to note that the WU cost of transferring remittances is expensive and also varies depending upon the numbers of expatriate Pakistanis in different countries and also on the maturity of the hundi channel. For instance, in case of Saudi Arabia and UAE where the larger numbers of Pakistanis live and hundi channel is more matured, the WU charged flat US$ 10 per transaction to beat hundi channel as against the variable charges in other countries like UK, US, etc.

FY03 when the transaction was realized. The increasing stock of FE-25 in H2-FY03 reflects the use of the FE-25 accounts by FECs for their operations. Additionally, the merger of FE-31 deposits with FE-25 deposits also explained the increasing stock of FE-25 deposits.

Other transfers

Other private transfers inflows saw a sharp increase during the current fiscal year mainly owing to the US$ 429 million export of currencies by moneychangers during Jul-02 to Jan-03.[13] However SBP decided to grant permission for currencies exports to these newly established FECs from mid-February 2003. Therefore, these inflows evaporated from February 2003, as FECs used the proceeds from exports of non-dollar currencies to satisfy the demand for travel expenses and technical fee etc. and only reported the net impact. However, the reporting structure has now been revised to properly record the remittances mobilized by these FECs. The FY03 flows reported by FECs are incorporated in the BOP table as '*other transfers*'.[14]



[13] Under the export of currencies, all non-dollar currencies are exported to abroad for the purpose of exchange into US dollar currency notes and bring it back to Pakistan within three days.

[14] With effect from mid-February 2003, the SBP allowed FECs to undertake export of currencies. Earlier, the moneychangers were required to surrender the remittances against the export of currencies to SBP through selected Authorized Dealers (ADs) and the amounts were recorded as other private transfers in the BOP. By contrast, the aggregate amounts collected by FECs (including remittances for export of currencies etc.) are used for their permissible transactions (e.g., remittances of profits, travel etc.). Only the remaining net aggregate amounts as retained in the FCAs of FECs, or the amounts sold to ADs (as remittances) are recorded under private transfers.

Also, as mentioned earlier in the discussion on workers' remittances, the under-declaration of exports of non-dollar currencies to custom authorities by these FECs had squeezed the supply of dollar in the face of over-invoicing from exporters.

Official Transfers

Official transfers during FY03 reflected a decline of US$ 495 million to US$ 1.0 billion despite the US$ 58 million higher SOF inflows mainly reflecting the higher international prices of the crude oil.[15] This is because, FY02 figures had been inflated by a one-time US$ 600 million cash grant by the US to cover the losses experienced by Pakistan's economy emanating from the Afghan war.

9.2.2 Capital Account

The capital account posted a sharp reversal, from a deficit of US$ 1.1 billion in FY02 to a surplus of US$ 113 million during FY03 (see **Table 9.8**). Although both gross inflows and outflows increased, the fall in the former was more pronounced, which helped in narrowing the capital account (net).

Table 9.8: Capital Account

million US Dollars

Items	FY99	FY00	FY01	FY02	FY03
Capital Account (1 through 9)	**-2,278**	**-4,177**	**-643**	**-1,107**	**113**
Inflows	**4,175**	**2,219**	**2,932**	**3,563**	**5,486**
Outflows	**6,453**	**6,396**	**3,575**	**4,671**	**5,373**
1. Direct investment abroad	-44	1	-37	-2	-27
2. Direct investment in Pakistan	472	472	323	485	798
3. Portfolio investment	142	-550	-141	-491	-239
of which: (stock markets)	28	73	-140	-8	22
Special US Dollar bonds	251	36	39	-453	-228
4. LT capital, (official)	797	-678	-600	-38	-74
of which: Project assistance	1,499	988	785	532	713
Food aid	230	191	0	0	10
Non-food aid	550	125	678	884	621
Amortization	-2,038	-1,967	-1,795	-1,513	-2,419
5. LT capital, (DMBs)	0	-2	-2	-1	-8
6. LT capital, (others)	10	-265	-212	-651	-502
of which: Suppliers credits/MNCs	195	167	191	185	392
Supplier credits repayments	-436	-591	-494	-530	-561
7. ST capital, (official)	-1,288	-373	338	-442	-224
of which: Commercial banks (net)	-858	-197	285	-260	-184
IDB (net)	-5	-23	146	-426	4
Others liabilities (NBP deposits)	-374	-135	-34	-155	-50
8. ST capital, (DMBs)	-1,315	-1,829	-19	-142	19
of which: Outstanding exports bills	46	-127	29	-53	-25
FCAs (non-residents)	-1,211	-1,164	-48	-47	-38
9. ST capital, (others)	-1,052	-952	-293	175	368
of which: Outstanding exports bills	-6	-305	-261	162	-132
FCAs (non-residents)	-1,084	-720	-48	-126	-65
Other liabilities (mainly foreign exchange lending)	38	73	-39	193	1,113

Note= LT: Long-term, DMBs: Deposit money banks, ST: Short-term.

Source: Statistics Department, SBP

Specifically, gross inflows increased from US$ 3.6 billion to US$ 5.5 billion during FY03 (despite the decline in non-food aid from IFIs) primarily due to higher FDI and suppliers' credit, the increased

[15] Started in FY99 after the nuclear test, the SOF has contributed a lot in financing of Pakistan's huge oil import bills in the last four years, as it covers about 50 percent of the crude oil imports.

disbursement of project aid and booming foreign exchange trade lending (see **Figure 9.14**). Additionally, the notional offsetting inflows and outflows in long-term capital also contributed significantly in gross inflows.

The gross outflows also witnessed an increase of US$ 0.7 billion to US$ 5.4 billion during FY03. Apart from notional outflows stemming from the US$ 1.0 billion debt write-off by the US, which increased the amortization, the gross outflows declined by US$ 298 million mainly due to: (1) lower outflows on the account of Special US Dollar Bonds during FY03; (2) lower volume of commercial debt outflows as Pakistan paid back the bulk of these loans during FY02; and (3) the increase in Outstanding Export Bills (OEBs) during FY03 (see **Figure 9.15**).

At the same time, exceptional financing increased by US$ 482 million to an inflow of US$ 620 million in FY03, which reflects: (1) the repayment of the first principal tranche on the sovereign Euro bonds, (2) remaining repayment of FE-45 institutional deposits frozen in FY98; and (3) decline in the relief from Paris club (see **Table 9.9**). [16] Apart from rescheduling of US$ 12.5 billion of pre cut-off bilateral debt, only 20 percent of restructured interest payment due during FY03 was capitalized against the 100 percent capitalization of post cut-off debt last year.

Net Foreign Investment (NFI)

The overall net foreign investment showed a sharp reversal, from an outflow of US$ 8 million in FY02 to an inflow of US$ 532 million during FY03 mainly due to lower outflows on the account of Special US Dollar Bonds, and higher foreign direct investment inflows.

Figure 9.14: Composition of Capital Inflows

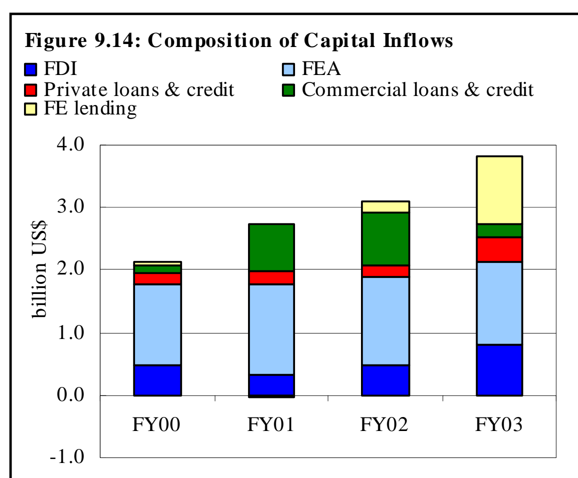


Figure 9.15: Composition of Capital Outflows

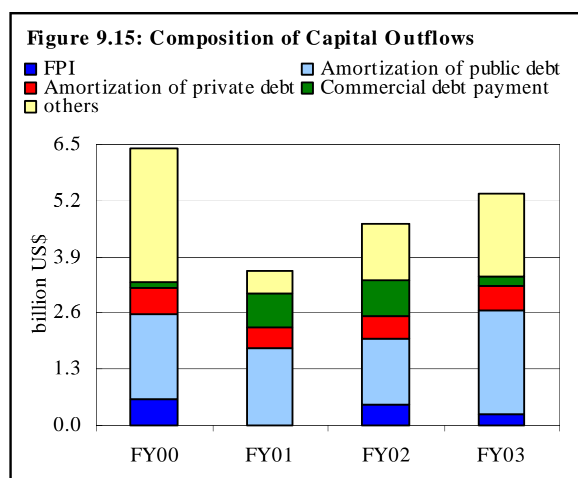


Table 9.9: Exceptional Financing

million US Dollars

	FY99	FY00	FY01	FY02	FY03
Total	**3,966**	**3,966**	**692**	**138**	**620**
Debt relief from Paris Club	1406	1,451	1,124	1209	910
Central bank deposit	150	300	250	0	0
Rollover of FE-45	1212	1,072	(299)	(541)	(235)
PTMA/commercial loans	830	152	(297)	(530)	100
Euro bond	0	610	0	0	-155
NBP deposits	150	500	0	0	0
Others	218	(119)	(86)	-	-

Within the NFI, the FDI posted a growth of 129 percent largely on account of the privatization of UBL and oil & gas field. Excluding privatization receipts of US$ 300 million, the FY03 FDI recorded an improvement of merely US$ 13 million compared to FY02, even though prospects for investment in Pakistan have improved.[17]

[16] The repayments of reschedule and rollover loans/liabilities are treated as outflow in exceptional financing because when these loans/liabilities were rescheduled or rollover, these are recorded as inflow in below the line in exceptional financing.
[17] The factors that favour the FDI inflows included higher economic growth, macroeconomic stability, reforms, privatization, up gradation of ratings and law and order situation.

The bulk of FDI came from USA, UK and UAE in few sectors like (1) financial business (through privatization of UBL); (2) mining and oil & gas exploration; (3) trade, transports & communication and (4) chemicals, pharmaceutical & fertilizers (see **Table 9.10**). Similarly the textile sector has also been attracting increased foreign investment during the last two years. Unfortunately FDI in Pakistan is currently dominated by *enclaved investments* that have fewer spillovers as compared to investment in export oriented industries. Such FDI needs to be complemented by FDI in other areas as well.

Table 9.10: Foreign Direct Investment
million US Dollars

	FY99	FY00	FY01	FY02	FY03
Food, beverages & tobacco	7.4	49.9	45.1	-8.1	7.9
Textiles	1.7	4.4	4.6	18.4	26.1
Chemicals, pharmaceuticals & fertilizers	54.1	119.9	26.3	17.8	92.4
Petro chemicals & petroleum refining	38.8	12.0	8.7	5.0	3.0
Cement	2.0	0.1	15.2	0.4	-0.4
Machinery	14.6	4.6	2.5	10.6	10.9
Electronics	1.2	2.3	2.8	15.9	6.7
Power	131.4	67.4	40.3	36.4	32.8
Construction	13.9	21.1	12.5	12.8	17.6
Trade, transport, storage & communication	38.8	38.6	94.7	68.3	153.2
Financial business	24.4	29.6	-34.9	3.5	207.5
Mining & quarrying-oil & gas explorations	112.8	79.7	84.7	274.8	188.2
Others	31.2	40.3	20.0	29.2	52.1
Total	**472.3**	**469.9**	**322.5**	**485.0**	**798.0**

In terms of portfolio investments, foreign investment in the stock market registered an inflow of US$ 22 million during FY03 against an outflow of US$ 8 million last year. However, the repayments of Special US Dollar Bonds were relatively low as compared to FY02, since a large part of issued Special US Dollar Bonds had a 3-year tenor, most of which have matured in FY02 (see **Table 9.8**).

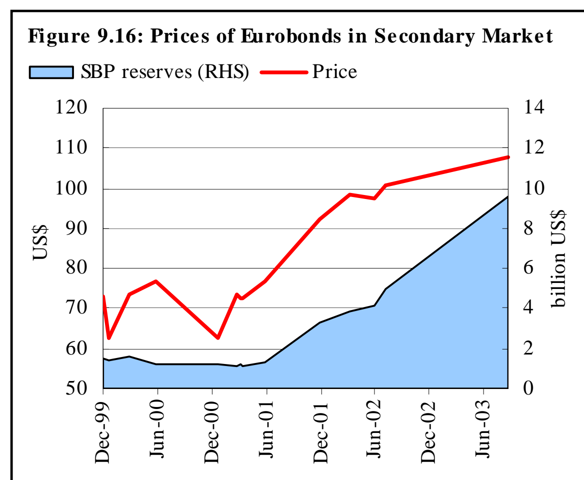
After the improvement in our forex reserves and improved risk perception as reflected by up gradation of Pakistan's sovereign rating[18] and secondary prices of Euro Bonds (see **Figure 9.16**), it is expected that FDI would gradually pick up in Pakistan.

Long-term Capital (Official)

Long-term capital (official) outflow recorded a slight increase from US$ 38 million in FY02 to US$ 74 million in FY03. This also includes the offsetting inflows and outflows of the US$ 1.0 billion US debt write-off during FY03.

Foreign economic assistance from IFIs (excluding the IMF) and sovereign governments to GoP, showed a slight fall of US$ 72 million despite the increase in project aid disbursement due to lower non-food aid. The upturn in project aid disbursement during FY03, as compared to the last three years, is

Figure 9.16: Prices of Eurobonds in Secondary Market



[18] In December 2002, S&P increased the Pakistan's long-term domestic and foreign currency ratings to BB- and B with stable outlook.

the reflection of the higher volume of commitments during last two years following the lifting of economic sanctions imposed by bilateral countries after Pakistan's 1998 nuclear tests (see **Figure 9.17**).

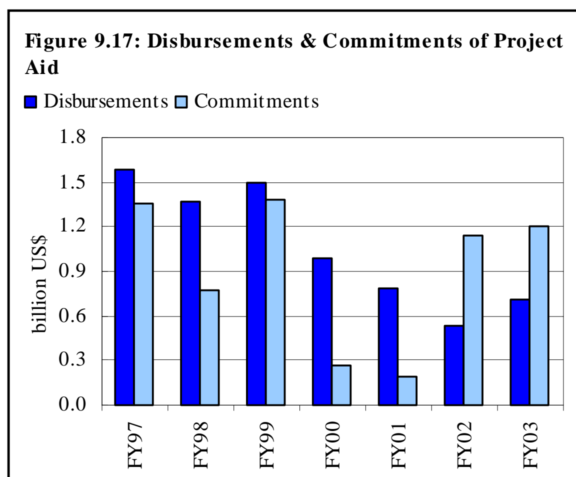


Figure 9.17: Disbursements & Commitments of Project Aid

Long-term Capital (Others)

Long-term capital (others) comprises of non-contractual flows from parent companies to MNCs operating in Pakistan, and flow of funds related to suppliers credit and swaps. This witnessed a substantial (US$ 149 million) YoY decrease in the net outflow, to record a deficit of US$ 502 million during FY03 (see **Table 9.8**). The disbursement of credit under suppliers' credits witnessed an increase of US$ 207 million reflecting the higher inflows in power, cement, textile, and fertilizer sectors. Additionally, US$ 140 million long-term loan contracted by PIA in June 2002 also contributed significantly in this rise in private loans inflows.

In contrast, the outflow of long-term capital (others) increased by US$ 31 million during FY03 over last year mainly due to; (1) the continued repayment of supplier credit which was also including the prepayment of approximately US$ 80 million during FY03;[19] (2) US$ 235 million payments of swaps during FY03 which significantly reduced the outstanding stock of these swaps to US$ 45 million by end-June 2003.

Short-term Capital (Official)

The net impact in this head shows an improvement of US$ 218 million during FY03, largely because of the fall in the contraction of these loans (see **Table 9.8**).[20] This significant change reflects the end to short-term commercial borrowings as well as the lower use of LC-based oil import financing from IDB following the unprecedented build up of SBP's forex reserves.

Short-term Capital (Deposit Money Banks and Others)

This mainly comprise of Outstanding Export Bills (OEBs) held by commercial banks and exporters, foreign currency denominated loans and non-resident FCAs mobilized by commercial banks and NBFIs. In aggregate, despite the increase in OEBs, this account recorded an increased inflow of US$ 387 million during FY03 as compared to US$ 33 million during FY02. The main driver of this improvement is the extraordinary volume of foreign trade financing (US$ 1,056 million) during FY03 (see **Section 6.2.2** for details).

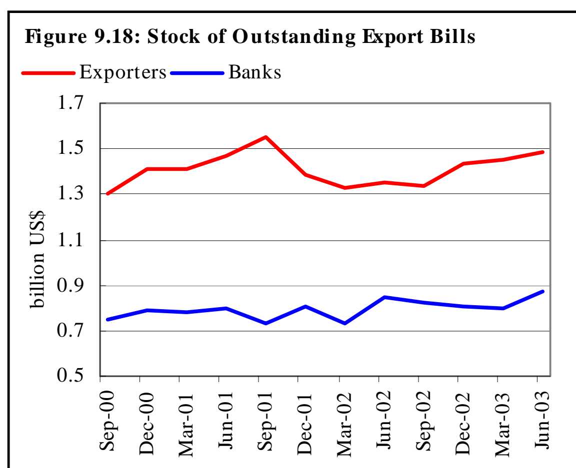


Figure 9.18: Stock of Outstanding Export Bills

[19] Some corporate like DG cement, Maple Leaf cement, Fauji Oil Terminal & Distribution Company (FOTCO) etc made pre-payment of their debt to their international creditors during FY03.

[20] Short-term capital is defined as loan obligations of 1-year maturity or less.

The impact of the rise in these loans was partially offset by a net US$ 198 million increase in OEBs.[21] This increase in OEBs during FY03 despite the continuing appreciation of Rupee/Dollar parity is a source of concern as the OEBs stock was continuously declining due to appreciating Rupee since September 2001 (see **Figure 9.18**). Within the OEBs, the increment in OEBs of exporters was more pronounced than the Banks. Possible explanations for the FY03 increase in exporters' OEBs include (1) the strong increase in Pakistani exports, and (2) increasing usage of OEBs as collateral for forex loans.

9.3 Foreign Exchange Reserves

The accumulation of foreign exchange reserves accelerated sharply in FY03, due to rising net external inflows, pushing up the aggregate reserves well over the US$10.0 billion mark by end-June 2003 (see **Table 9.11**) and significantly improving the country's reserve adequacy indicators. More encouragingly, a dominant portion of the increase in the country's forex reserves emanated from non-debt creating inflows (see **Box 9.2**).[22]

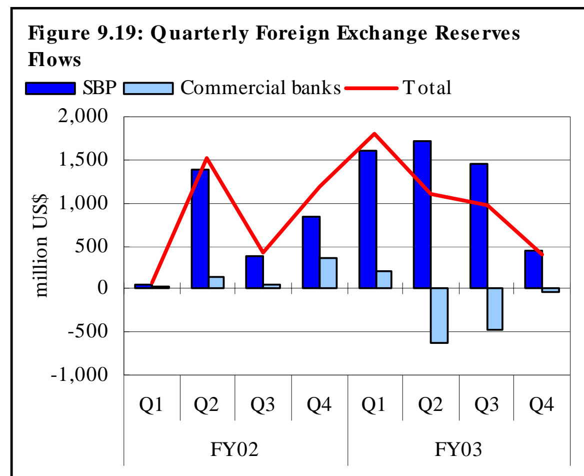
Table 9.11: Foreign Exchange Reserves
million US Dollars

	FY01	FY02	FY03	Percentage change FY02	Percentage change FY03
		Stocks			
SBP	1,677	4,333	9,525	158	120
Commercial banks	1,543	2,098	1,194	36	-43
Total	**3,219**	**6,432**	**10,719**	**100**	**67**
		Flows			
SBP	686	2,657	5,192	287	95
Commercial banks	566	556	-904	-2	-263
Total	**1,252**	**3,212**	**4,287**	**157**	**33**

Interestingly, while SBP reserves continued to grow very robustly during FY03, the forex reserves of commercial banks declined. The fall in the latter stems from two sources: (1) a decline in banks' FC deposits; and (2) the impact of increasing forex (FE-25) loans (see **Section 9.5** for details).

It is also worth noting that the lower growth in SBP reserves during FY03, relative to FY02, is simply due to the high *base* effect. In absolute terms, the US$ 5.2 billion increase in the period is apparently twice the rise in FY02, reflecting significant non-market flows (disbursements by IFIs and other government receipts) as well as greater SBP purchases from the inter-bank market. The rise in the SBP market purchases, in turn, stemmed from the overriding objective of exchange rate stability through the orderly absorption of (often lumpy) forex flows and maintenance of adequate foreign currency liquidity in the market. This is reflected in the quarterly growth profile of the reserves - accumulation jumped sharply in the initial quarters (see **Figure 9.19**), which witnessed greater market liquidity (and larger IFI inflows), but then decelerated sharply during Q4-FY03 due to both, significantly lower inflows (lower IFI flows, decline in FE-25 loans), and higher market outflows (widening trade deficit, a jump in debt payments, etc.).

Figure 9.19: Quarterly Foreign Exchange Reserves Flows



[21] Overall, the outflow of US$ 198 million in FY03 shows the increase in the stock of outstanding export bills withheld with banks and exporter, which implies that exporters have postponed repatriation of their earnings until after the due date mainly on the account of over-invoicing of exports and use of OEBs as collaterals for foreign exchange lending.

[22] The ratio of debt creating inflows to total inflows (excluding exports of goods & services) has declined from 28 percent in FY01 to 20 percent in FY03.

The FE-25 deposits and the foreign currency loans have a more pronounced effect on the distribution of reserves between the SBP and the commercial banks.[23] Since most of the foreign exchange inflows in the inter-bank market end up with the SBP as it is the *residual* buyer in the market, the difference between the reserves accumulation trends followed by the SBP and the commercial banks, during the last two fiscal years, lies in the inflows on account of FE-25 deposits and the foreign currency loans backed by FE-25 deposits. The SBP reserves doubled in FY03 as they did in FY02, whereas the commercial banks reserves declined significantly in FY03 as compared to the net increase witnessed in FY02. The commercial banks' reserves, on the other hand, fell sharply in FY03 due to both a decline in forex deposits and an increase in foreign currency loans. The forex deposits fell as the relative return on these deposits were unattractive and the expected gains from continual depreciation had evaporated. On the other, the interest rate on foreign currency loans by the commercial banks were quite low compared to Rupee loans. The FE-25 deposits accretion fell sharply in FY03 compared to FY02. The fall in the commercial banks reserves, however, is largely the reflection of *adjustment* made by the SBP on account of foreign currency loans against the FE-25 deposits disbursed by the commercial banks.

9.3.1 Causative Factors of Reserve Accumulation

The overall reserves increased by 66.7 percent during FY03 compared to an increase of 99.8 percent witnessed in FY02. The major contributors in the net increase of US$ 4.3 billion were the workers remittances, flows on account of logistic support and foreign direct investment (see **Box 9.2**).

The SBP Reserves

As against a net inflow of US$ 2.7 billion in FY02, the FY03 net inflows were US$ 5.2 billion i.e. 33.5 percent higher. The increase in net inflows to SBP, in FY03, was both due to the increasing inflows and declining outflows with the fall in the latter much stronger (34 percent) than the increase in the former (17 percent).

The inflows mostly constituted the net inter-bank transactions (58 percent of the overall inflows in FY03 against 37 percent in FY02), stemming largely from the robust workers' remittances and the foreign currency loans, and were devoid of the *kerb* purchases. Export of currency, however, had a significant contribution in the overall FY03 foreign exchange inflows. Inflows on account of loans and grants were also significantly lower in FY03. The loan inflows were lower due to the significant decline in IBRD/IDA loans, while the country did not receive any grant from the US in FY03, unlike in FY02. Other significant inflows were the receipts against *logistic support* and on account of UBL privatization. Finally, the stock of reserves is increasing, the return on these reserves also inched up in FY03 compared to FY02 (see **Table 9.12**).

The significantly lower outflows, on the other hand, are mainly the reflection of *rescheduling* and *write off* of some of the bilateral loans and falling interest rates. As the government was able to get the bilateral loans rescheduled, lower payments were required on account of both *principal* and interest amount. The effect of rescheduling of debt would have been more pronounced had the waivers given in FY02 and FY03 been the same. As compared to a 100 percent waiver given on account of some of the due interest payments in FY02, the waiver given in FY03 were only 20 percent of the interest amount due after rescheduling for the year (see **Section 8.3** for details). The cost of central banks' deposits also fell in FY03 reflecting a decline in the outstanding stock of deposits. The fall in the expenditure on these deposits were complemented by the falling interest rates to reduce the overall interest on deposits from US$ 558 million to a meager US$ 76 million. In the previous years the payments against PTMA were completed and certain other liabilities (FE-45 and FE-31) were retired. As such the FY03 witnessed a sharp decline in debt servicing payments.

[23] Till end June 2003, the total foreign loans disbursed by the commercial banks have been subtracted from the commercial banks reserves and added to the SBP reserves.

Table 9.12: Foreign Exchange Reserves with SBP
million US Dollars

	FY03					
	Q1	**Q2**	**Q3**	**Q4**	**FY02**	**FY03**
Opening balance	***4,804.9***	***6,392.9***	***8,068***	***9,523.1***	***2,080.0***	***4,804.9***
Receipts	*2,169.3*	*2,458*	*2,205.7*	*942.4*	*6,646.4*	*7,775.4*
Purchases	**1,278.3**	**1,659.2**	**14,34.8**	**603**	**3,858.7**	**4,975.3**
Kerb market	0	0	0	0	1375.7	0
Interbank (net)	1,145	1,396	1,402	603	2,483	4,546
Export of currency	1,33.3	263.2	32.8	0	0	429.3
Loans	**470.9**	**360.6**	**151.1**	**230.4**	**1,490.3**	**1,213**
IBRD/IDA	215.1	0	11.6	0	787	226.7
ADB	139.6	199.3	10.3	108.2	215.8	457.4
IMF	116.2	115.3	120.8	122.2	484.7	474.5
IDB (for PSO)	0	46	8.4	0	0	54.4
JBIC (OECF)	0	0	0	0	2.8	0
Grants	**52.6**	**50**	**31.3**	**0**	**692.1**	**133.9**
UK	0	0	31.3	0	42.1	31.3
USA	0	0	0	0	600	0
European commission	15.1	0	0	0	0	15.1
SAMA	37.5	50	0	0	50	87.5
Other receipts	**367.5**	**388.2**	**588.5**	**109**	**605.3**	**1,453.2**
Logistic support	317	0	530.2	0	300	847.2
UBL privatization proceeds	0	299.6	0	0	0	299.6
UN troops	0	54.6	12.3	51.4	63.5	118.3
Interest on deposit/discount	45.6	11.4	26.2	39	88.5	122.2
Miscellaneous receipts	4.9	22.6	19.8	18.6	153.3	65.9
Payments	*581.3*	*782.9*	*750.6*	*472.5*	*3921.4*	*2587.3*
Debt servicing to donors	**276.9**	**269.5**	**374.3**	**336.6**	**1,146.4**	**1,257.3**
IMF	100.3	85.7	125.5	147.8	243.5	459.3
IDA	33.8	26.4	36.2	26.5	94.7	122.9
IBRD	55.3	53.6	69.8	43.3	231.9	222
ADB	62.5	80.7	47	52.4	136.3	242.6
IDB	25	23.1	78.4	63.4	423.1	189.9
Miscellaneous payments[1]	0	0	17.4	3.2	16.9	20.6
Other payments	**304.4**	**513.4**	**376.3**	**135.9**	**2,692.4**	**1,330**
Swaps	110	0	0	0	227	110
Interest on deposits/profit on $ bonds	27.2	18.5	14.3	16	128.8	76
Euro bonds	0	186.6	0	30.7	62.3	217.3
FE-45	4.9	39.2	194	0	527	238.1
Payment for hajj	0	40.5	73	5.3	113.1	118.8
ACU settlement	30.4	20.5	69.4	54.3	146.6	174.6
PTMA	0.8	0	0	0	525.4	0.8
FE-31	0	0	0	0	199.6	0
Miscellaneous payments[2]	131.1	208.1	25.6	29.6	333.6	394.4
Closing balance	*6,392.9*	***8,068***	***9,523.1***	***9,993***	***4,805***	*9,993*
Overall increase	*1,588*	*1,675.1*	*1,455.1*	*469.9*	*2,725*	*5,188.1*

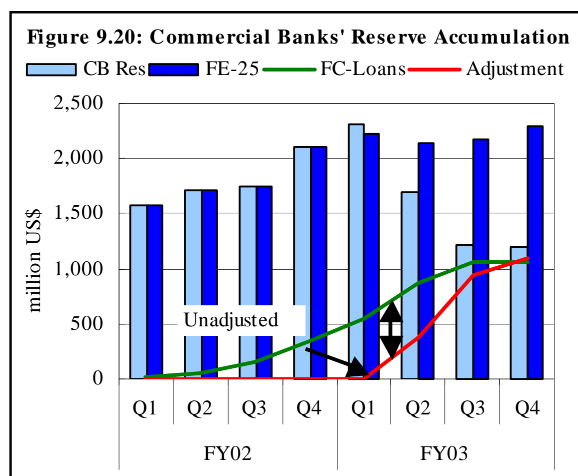
1) Includes IFAD (US$ 10.0 millions), OPEC (US$ 6.7 millions) and JBIC (OECF) (US$ 3.9 millions) for FY03.
2) Includes FCY Loan Bonds (US$ 29.1 millions), US Aid (US$ 30.6 millions), US$ Bond Encashment (US$ 60.3 millions), PL-480 (US$ 14.7 millions), NDRP (US$ 68.5 millions), SAINDAK Bonds (US$ 13.0 millions), Catic China (US$ 18.0 millions), Uch Power Project
Source: Exchange and Debt Management Department, SBP

Commercial Banks' Reserves

The commercial banks' foreign exchange reserves (CBER) principally comprise of their foreign currency deposits after adjusting for outstanding FE-25 loans.[24] During FY03, CBER dropped 43.1 percent as a 9.4 percent net rise in forex deposits of banks was substantially outpaced by the adjustment of FE-25 loans.

However, the FY03 adjustment of FE-25 loans was far larger than the net growth in these loans during the period (see **Figure 9.20**). This difference represented prior period adjustments. Though the banks began foreign currency lending in FY02, the corresponding adjustments in CBER began only in FY03. Thus, the steep fall in commercial bank reserves during the second and the third quarter of FY03 owes more to the sharp adjustment of the *backlog* of earlier FX loans (created in FY02) rather than for current loans.

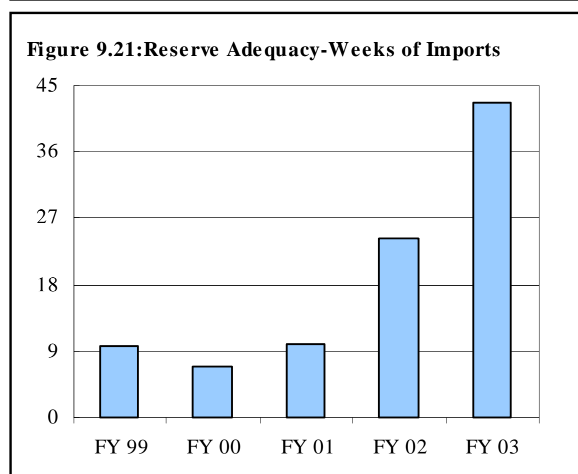
Figure 9.20: Commercial Banks' Reserve Accumulation



9.3.2 Adequacy of Reserves

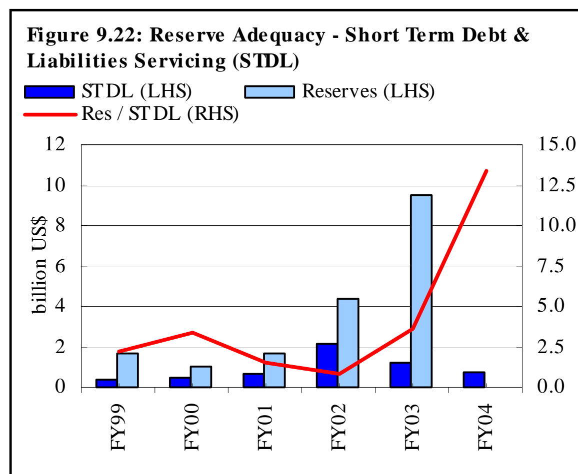
The massive reserves accumulation during the last two years has undoubtedly improved the country's ability to meet its requirements for financing imports and other foreign currency obligations, which is also reflected in the improvement in Pakistan's sovereign credit ratings.[25]

Figure 9.21:Reserve Adequacy-Weeks of Imports



The *reserves adequacy* [26] not only improved in terms of coverage of imports but also in terms of ability to service external debt. The resiliency of Pakistan's external sector in face of external shocks during the last three years is directly attributable to the high level of reserves accumulation.

Figure 9.22: Reserve Adequacy - Short Term Debt & Liabilities Servicing (STDL)



The import coverage ratio, which measures the country's ability to meet its imports through forex reserves alone, rose from a meager 7 weeks in FY00 to 43 weeks by the

[24] The proceeds of FE-25 loans represented a net addition to market liquidity and given the purchases of all residual market liquidity by the SBP, added to the country's aggregate reserves. Thus, in order to avoid double counting, the reserves of commercial banks were reduced by a notional value equal to the FE-25 loans outstanding. See 3rd Quarterly Report of FY03 for details.

[25] Moody's Investors Service upgraded Pakistan's sovereign credit rating to B2 from B3 on October 20, 2003.

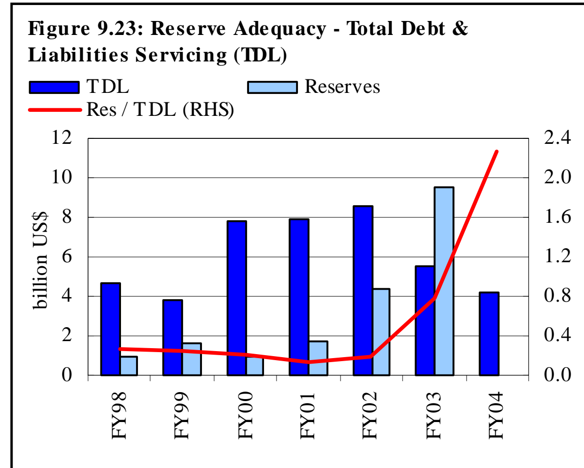
[26] Reserve adequacy is defined as 'the level of reserves that ensures smooth balance of payments and macroeconomic adjustment in unpredictably changing environment'.

end of FY03 (see **Figure 9.21**). It must also be noted that this is despite the fact that FY03 imports were 19 percent higher than the imports in FY00.

Similarly, the rise in the reserves, coupled with a decline in total external debt and liabilities, substantially improved the country's ability to service short-term debt and liabilities. At the beginning of FY02, the stock of reserves was lower than the maturing obligations on account of short-term debt and liabilities, but this has changed significantly by FY04 (see **Figure 9.22**).

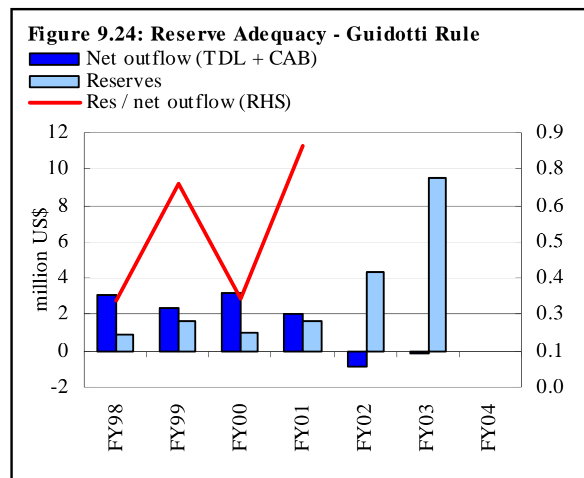
The reserves, however, appear to be even more adequate as the stock of reserves are enough to meet all the external debt and liabilities servicing requirements (see **Figure 9.23**).

Figure 9.23: Reserve Adequacy - Total Debt & Liabilities Servicing (TDL)



Another indicator of reserve adequacy now gaiing attention is the *Guidotti Rule*, which says that a country's reserves could be deemed adequate if it is able to meet its scheduled total external debt and liabilities as well as the projected current account deficit (excluding interest payments) for the next 12 months. On this criterion, Pakistan had not have enough reserves at the beginning of any fiscal year till FY02 (see **Figure 9.24**).

Figure 9.24: Reserve Adequacy - Guidotti Rule

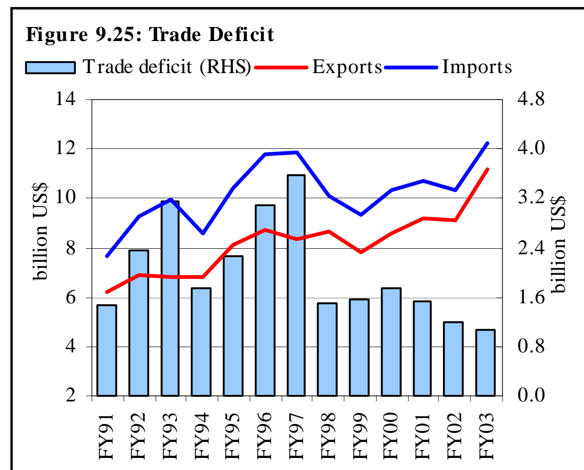


Nevertheless, the situation has improved significantly since the beginning of FY03 when the country had enough reserves to meet the obligations during FY03. At the end of FY03, given the projection of posting another current account surplus (excluding interest payments) over and above the scheduled total debt servicing, the reserves are expected to improve further.

9.4 Trade Account

The trade deficit narrowed for the third successive year in FY03, falling to a ten year low of US$ 1.1 billion (see **Figure 9.25**). However, unlike FY02, the 12 percent reduction in the trade deficit was in the face of a very strong export growth, which outstripped the fairly robust rise in imports. The exceptional rise in aggregate trade (imports and exports) during the year is a strong reflection of the rise in aggregate demand, and the supportive business environment during the year, including the relative stability of the rupee.

Figure 9.25: Trade Deficit



Pakistan's buoyant export performance was particularly impressive against the backdrop of continued global recession and slow down in world trade growth. The analysis in **Table 9.13** suggests that domestic production growth and trade liberalization policies were largely responsible for this outcome. Agriculture and manufacturing sectors provided exportable surpluses while low inflation, low financing costs and a stable exchange rate gave the needed impetus to maintain and enhance competitiveness. In addition, the entry in new markets, particularly for rice and wheat, also contributed meaningfully.

Table 9.13: Trade Supporting Indicators

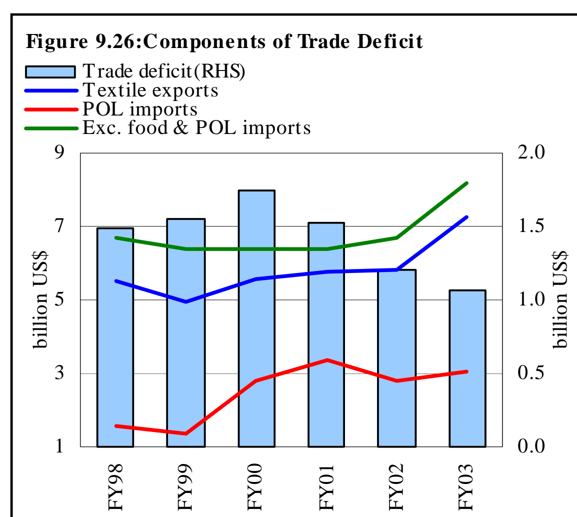
	FY02	FY03
	Growth rates	
Agriculture	-0.1	4.1
Manufacturing	5	7.7
CPI-based inflation	3.5	3
	***Lending rates*[1]**	
Weighted average lending rates	12.0	7.6
SBP export re-finance rate	6.5	2.0
Exchange rate appreciation	6.7	3.9
SBP market intervention ***(billion US$)***	3.9	5.0

[1] lending rates are quoted for the end June levels

Moreover, while the expansion in exports is a positive development, the structure of imports shows that the rising level of imports is also not unwelcome in view of rising non-food, non-oil imports, indicating improved production capacity and hence increased manufacturing activity in the economy in FY03.[27]

The most outstanding element of the export performance was clearly the US$ 1.5 billion increase in textile exports, led by an increase in value-addition and higher volumes. However, the gains were roughly matched by a strong rise in non-food non-POL imports. Similarly the increase in non-textile manufacture exports was roughly equal to the rise in POL imports during the period (see **Figure 9.26**). Thus, it was the substantial improvement in the other exports and in food group exports that helped reduce the trade deficit. In fact, the improvement in the trade in food commodities (predominantly in wheat and rice) that has been one of the most encouraging development in Pakistan's non-textile trade, underlining the export potential offered by Pakistan's agrarian economy.

Figure 9.26:Components of Trade Deficit



But the fact remains that given its dominant weight in the structure of exports, the growth in exports was primarily driven by remarkable performance of the textile sector. Five major export categories namely: cotton yarn, cotton fabrics, hosiery, bed wear and readymade garments, constituted over 52.4 percent share in the total receipts from exports, while the earnings from each of these individual categories (with the exception of cotton yarn) crossed the US$ 1.0 billion mark.

Regional Trade Balance

Pakistan's trade balance with the USA and the EU improved during FY03, primarily due to higher textile exports to both regions. However, much of this gain was lost to the deteriorating trade balance with Asia, largely owing to a rise in oil import bill and higher machinery imports (see **Table 9.14**).

[27] Non-food and non-oil categories largely comprise of capital goods and industrial raw materials

Table 9.14: Regional Trade Balance
billion US Dollars

	FY01			FY02			FY03		
	Exports	Imports	Trade balance	Exports	Imports	Trade Balance	Exports	Imports	Trade balance
USA	2.2	0.6	1.7	2.3	0.7	1.6	2.6	0.7	1.9
EU	2.4	1.6	0.8	2.5	1.8	0.8	3.1	2.0	1.0
Asia									
i- Middle East	*1.3*	*4.1*	*-2.9*	*1.5*	*3.6*	*-2.2*	*2.0*	*4.2*	*-2.2*
ii- Other Asia	*2.0*	*3.0*	*-1.0*	*1.8*	*3.1*	*-1.3*	*2.1*	*3.9*	*-1.8*
Others	1.2	1.4	-0.2	1.1	1.1	0.0	1.4	1.3	0.1
Total	9.2	10.7	-1.5	9.1	10.3	-1.2	11.2	12.2	-1.1

Destination of Exports

Due to the broad-based growth in Pakistan's exports, there were only small changes in their regional distribution. Asia remained the biggest market for Pakistan's exports, followed by the EU and USA (see **Table 9.15**).

The export in the latter two markets has traditionally been strongly correlated with market access, and FY03 was no exception. In fact, the stronger rise in exports to these markets simply reflects the greater market access provided to Pakistan.

Table 9.15: Pakistan's Major Export Markets (FY03)
percent

	North America	EU	Asia		Others	Total
			Middle East	Other Asia		
Share in Total						
FY02	26.6	26.3	16.1	19.5	11.5	100.0
FY03	25.3	27.5	18.1	18.6	10.5	100.0
Growth rate						
FY02	0.3	3.2	16.2	-13.0	-0.6	-0.6
FY03	16.0	27.8	37.1	16.8	22.2	22.2
Contribution in growth						
FY02	0.1	0.9	2.2	-2.9	-0.8	-0.6
FY03	4.3	7.3	6.0	3.3	1.3	22.2

Origin of Imports

The country's considerable dependence on imports of crude oil, petroleum products as well as edible oil ensures the Asian region's pre-eminence as the biggest supplier of Pakistan's imports (see **Table 9.16**). POL imports from Saudi Arabia, Dubai and Kuwait accounted for almost 54.6 percent of the total imports from Middle Eastern region. The main imports from Saudi Arabia and Dubai included crude petroleum and furnace oil respectively, while Kuwait exported high-speed diesel oil to Pakistan.

Similarly, about 5 percent of Pakistan imports constitutes of edible oil, largely supplied by Malaysia. On the other hand, imports from China[28] and Japan largely consists of electrical and textile machinery and road motor vehicles, respectively.[29]

Imports from EU, mostly originating from Germany and UK consisted mainly of machinery and articles of chemical & allied industries, while the major imports from US included Soya bean oil, durum wheat, textile materials and machinery.

[28] Besides electrical and textile machinery, some other important imports from China included railway vehicles, textile raw materials, articles of rubber and various organic chemicals.
[29] Japan captured 71 percent share in total automobile imports of the country.

Currency Composition of Trade Flows
The marginal shifts in the distribution of regional trade are outpaced by the changes in the currency composition of Pakistan's trade flows. In particular, the share of Euro denominated trade in Pakistan's exports and imports has risen swiftly following the Euro's introduction, but 90 percent of Pakistan's external trade is still transacted in US dollars (see **Table 9.17**).

Table 9.16: Pakistan's Major Import Markets

percent

	North America	EU	Asia: Middle East	Asia: Other Asia	Others	Total
Share in total						
FY02	6.6	16.9	35.1	30.2	11.1	100.0
FY03	6.0	16.8	34.2	32.1	10.9	100.0
Growth rate						
FY02	22.0	9.8	-12.2	3.4	-19.0	-3.6
FY03	7.1	17.0	15.0	25.5	16.2	18.1
Contribution in growth						
FY02	1.2	1.5	-4.7	1.0	-2.5	-3.6
FY03	0.5	2.9	5.3	7.7	1.8	18.1

9.4.1 Exports
Exports recorded an impressive 22.2 percent growth in FY03 as compared to FY02, to reach a record US$ 11.2 billion (see **Table 9.18**).

Table 9.17: Currency Composition of Trade Flows

percent (share)

	FY01	FY02	FY03
Exports			
US$	92.6	92.3	89.4
Euro	1.6	3.5	6.9
Imports			
US$	84.2	84.6	82.8
Euro	3.5	7.0	9.0

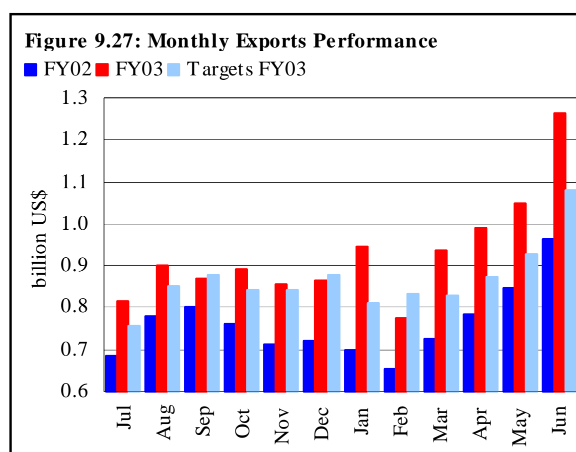
As a matter of fact, exports had been hovering in the vicinity of US$ 9.0 billion for the last two years, but it was only in FY03 that the country's exports crossed US$ 10 billion (for the first time in country's history) before surpassing the trade policy target set for FY03 (US$10.4 billion). Exports revival was smooth throughout the year, exceeding the monthly targets, with the monthly average of exports touching US$ 930 million (see **Figure 9.27**).

Table 9.18: Contribution in Growth by Major Export Groups

percent

	FY01 Growth	FY01 Contribution in growth	FY02 Growth	FY02 Contribution in growth	FY03 Growth	FY03 Contribution in growth
Primary commodities	8.4	1.1	-10.6	-1.4	17.8	2.1
Textile manufactures	3.6	2.4	0.3	0.2	25.0	15.9
Other manufactures	21.1	3.1	-0.4	-0.1	10.4	1.7
Other exports	11.4	0.8	6.9	0.5	29.9	2.4
Total	7.4	7.4	-0.7	-0.7	22.2	22.2

Figure 9.27: Monthly Exports Performance



A closer look at the major category-wise performance reveals that while all categories made positive contribution to FY03 exports (unlike the preceding year when two categories had negative contribution), textile sector remained in the forefront (see **Table 9.19**).

An important factor accounting for this performance, is the significant, broad-based,

Table 9.19: Major Exports

Value: million US Dollars; Unit value: US Dollars

	Unit	FY02		FY03			Change (percent)		
		Value	Unit value	Value	Unit value	Abs. chg. in value	Quantity	Value	Unit value
A. Primary commodities		**1,073.1**		**1263.9**		**190.8**		**17.8**	
1 Rice	MT	448.2	266.1	555.5	305.2	107.2	8.1	23.9	14.7
2 Raw cotton	MT	24.7	707.4	49.0	889.6	24.3	57.6	98.2	25.8
3 Raw wool (excluding wool tops)	MT	0.9	860.6	1.3	900.3	0.4	36.5	42.8	4.6
4 Fish and fish preparations	MT	125.6	1,487.7	134.5	1442.9	8.9	10.4	7.0	-3.0
5 Leather	SQM	239.9	13.9	234.8	15.3	-5.2	-11.2	-2.2	10.2
6 Guar and guar products	MT	16.4	698.3	23.8	932.9	7.4	8.7	45.2	33.6
7 Fruits	MT	83.1	286.7	83.2	316.2	0.1	-9.2	0.1	10.3
8 Vegetables	MT	29.1	183.5	31.5	161.6	2.5	23.2	8.5	-12.0
9 Crude animal material	MT	13.2	606.1	13.5	795.1	0.3	-21.9	2.5	31.2
10 Oil seeds & nuts etc.	MT	20.5	422.5	7.2	500.0	-13.3	-70.2	-64.7	18.3
11 Wheat	MT	71.4	111.1	129.6	114.0	58.2	76.9	81.6	2.6
B. Textile manufactures		**5,810.6**		**7,263.6**		**1,453.0**		**25.0**	
1 Cotton yarn	MT	929.7	1,721.6	928.4	1787.6	-1.3	-3.8	-0.1	3.8
2 Cotton fabrics (woven)	SQM	1,130.8	0.6	1345.7	0.7	214.8	6.7	19.0	11.6
3 Hosiery (knitwear)	DOZ	845.9	23.1	1146.7	22.0	300.7	42.6	35.5	-5.0
4 Bed wear	MT	918.6	5,070.2	1329.1	5494.6	410.5	33.5	44.7	8.4
5 Towels	MT	267.7	3,401.1	374.8	3726.6	107.1	27.8	40.0	9.6
6 Cotton bags and sacks	MT	15.8	3,931.2	17.0	4083.7	1.2	3.6	7.6	3.9
7 Readymade garments	DOZ	875.0	21.1	1092.6	30.0	217.7	-12.0	24.9	41.9
8 Tarpaulin & other canvas goods	MT	49.7	2,204.6	73.8	2290.9	24.1	43.0	48.6	3.9
9 Tule, lace embroidery etc.	(-)	9.7	---	11.2	---	1.6	---	16.3	---
10 Synthetic textiles	SQM	410.0	0.6	574.3	0.7	164.3	20.3	40.1	16.4
11 Other textile made-up	(-)	350.9	---	359.8	---	8.9	---	2.5	
12 Waste material of textile fibers/fabrics	MT	6.9	571.3	10.3	652.5	3.4	30.8	49.4	14.2
C. Other manufactures		**1,530.3**		**1688.8**		**158.5**		**10.4**	
1 Carpets, carpeting rugs & mats	SQM	249.6	49.1	220.9	51.9	-28.7	-16.2	-11.5	5.6
2 Petro and Petro. products	MT	190.7	186.7	248.6	247.4	57.8	-1.6	30.3	32.5
3 Sports goods	(-)	304.5	---	335.2	---	30.7	---	10.1	---
4 Leather manufactures	(-)	383.2	---	386.5	---	3.4	---	0.9	---
5 Surgical and medical instruments	NO	145.0	1.2	150.0	---	4.9	---	3.4	---
6 Cutlery	GR	24.5	33.6	29.6	31.1	5.1	30.6	20.7	-7.6
7 Onyx manufactured	MT	10.0	1,601.2	11.7	1764.0	1.7	6.0	16.8	10.2
8 Chemicals and pharmaceuticals	(-)	152.8	---	260.9	---	108.1	---	70.8	---
9 Molasses	MT	68.7	39.4	45.5	35.7	-23.2	-27.0	-33.8	-9.4
10 Sugar	MT	1.3	335.3	7.7	---	6.4		501.9	---
D. Others		**720.6**	**---**	**936.3**	---	**215.7**	**---**	**29.9**	---
Total exports		**9,134.6**		**11160.2**		**2025.7**		**22.2**	
excluding major food items and raw cotton		*8061.5*		*9896.3*		*1834.8*		*22.8*	
excluding major food, raw cotton and yarn		*7131.8*		*8968.0*		*1836.2*		*25.7*	

Source: Federal Bureau of Statistics

increase in the realized unit value of textile exports (see **Table 9.20**). This appears to be driven primarily by the on-going shift in the textile industry towards higher value addition, *within* each category.[30]

However, it is alleged that some of this increase in unit value is due to the over-invoicing by exporters, in order to obtain tax refunds and rebates. Anecdotal evidence suggests that this has been particularly evident in Dubai and Saudi Arabia. But the amounts involved, if any, are so small that they do not cast any shadow on the over all export performance.

Table 9.20: Realized Unit Values of Textile Manufactures
percent change

	FY02	FY03
Cotton yarn	-12.6	3.8
Cotton fabrics (woven)	-0.4	11.6
Hosiery (knitwear)	0.0	-5.0
Bed wear	1.0	8.4
Towels	-5.1	9.6
Cotton bags and sacks	-2.6	3.9
Readymade garments	-8.4	41.9
Tarpaulin & other canvas goods	-2.6	3.9
Synthetic textiles	-3.1	16.4
Waste material of textile fibers/fabrics	7.9	14.2

In fact, the cumulative FY03 exports, in readymade garments and bed wear, to Dubai and Saudi Arabia, rose by US$ 192 million compared to the preceding year; which represents almost a third of total increase in Pakistan's exports under the two categories during FY03. However, it should be pointed out that, this performance might simply reflect increased demand as well the capture of market share by Pakistani exports.

Primary Exports

Compared to FY02, primary exports registered a 17.8 percent improvement in earnings causing total exports to grow by 1.7 percent. The outstanding performers in this group were *rice*, *wheat* and *fish & fish preparations*.

Rice exports showed large improvement during FY03 (23.9 percent growth over FY02) and surpassed the annual export target (US$ 460 million) by 20.8 percent. As a result, during the last one and a half years (starting from Jan-02) Pakistan ranked as the world sixth largest rice exporter in terms of quantity (see **Table 9.21**). In addition to higher domestic production, the price competitiveness of exporters improved due to removal of the quality related market price (QRMP),[31] system on export of all types of rice and withdrawal of quality review check (QRC) on export of non-Basmati rice[32] in the FY03 trade policy. Interestingly, FY03 also

Table 9.21: International Comparison of Pakistan's Rice Exports
percent shares

	Jan 02-Jun 03	FY03
I. World market shares of rice export quantum and production		
	Exports	Production
1 Thailand	27.1	4.5
2 India	19.6	20.2
3 Vietnam	13.3	5.5
4 United States	12.7	1.7
5 China	7.7	32.0
6 Pakistan	5.5	1.1
II. World largest rice importers and Pakistan's share		
	Imports quantum share	Pakistan's exports share
1 Indonesia	12.9	1.16
2 Nigeria	6.1	0.34
3 Philippines	4.4	0.02
4 Iraq	4.2	0.24
5 Saudi Arabia	3.5	4.21

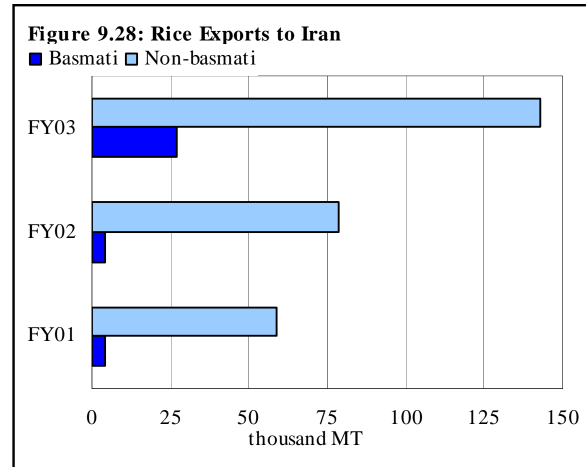
Source: www.fas.usda.gov

[30] It may be noted this trend is in addition the increased value addition across categories (e.g., from yarn to finished products), which is also evident in FY03.
[31] The production of rice registered a 15.4 percent rise in FY03 over FY02.
[32] The QRMP and QRC systems were introduced in 1999. Under the QRC the exporters had to share double burden of inspection fee - one by the local agencies and other by international inspectors, thus adversely affecting rice exports.

witnessed a 14.7 percent increase in the realized per unit export value due to the substitution of non-basmati varieties with high priced basmati rice.[33]

In addition to further strengthening their strong presence in the traditional markets, Pakistani rice exporters made significant in-roads in new markets during FY03, which can be attributed to the incentives announced in the FY03 trade policy to support the development of new markets.[34] Key markets of Pakistani basmati rice include the Middle East, USA, Netherlands, Mauritius, and Iran, while Kenya, Madagascar, Indonesia, Iran, Dubai, and Afghanistan are major importers of non-basmati rice from Pakistan.

Figure 9.28: Rice Exports to Iran



During FY03, total rice exports to Iran registered improvement and its share in total earnings from rice export increased from 3.5 percent in FY02 to 6.9 percent in FY03 (see **Figure 9.28**). However, the need is to further broaden this focus towards other world large rice importers, which currently import only a small fraction of their requirements from Pakistan.

Fish and fish preparations recorded a 7.0 percent YoY rise in FY03, mainly due to a 10.4 percent rise in the export volume. The major export categories include fresh and frozen fish, dried salted fish, shrimps and prawns. Country's fish export market analysis suggests that, China and Sri Lanka were the major recipients (i.e., 22.6 percent and 15.2 percent, respectively) of quantity of fish exported in FY03 (see **Table 9.22**). But the unit values offered by these markets were the lowest, whereas the high value giving exports to EU and the US witnessed a fall in quantum.[35]

Table 9.22: Fish Exports-Market Analysis

Quantum in million kg, unit value in million US Dollar per million kg

	Quantum exported		Unit values	
	FY02	**FY03**	**FY02**	**FY03**
China	7.6	21.1	1.0	0.9
Sri Lanka	17.7	14.2	0.5	0.5
EU	15.4	13.5	2.7	3.1
Japan	10.7	8.8	1.5	1.7
Hong Kong	4.6	5.8	1.8	1.7
Dubai	4.2	3.9	1.8	2.4
Saudi Arabia	3.4	3.8	1.2	1.2
Kuwait	1.8	2.6	2.0	1.8
USA	1.9	1.0	5.5	4.2

The latter may be due to the strict implementation of health safety measures[36] besides Technical Barriers to fish trade (TBT) by these regions. An important element of international standard guidelines is the compliance with HACCP,[37] a management system for food safety. Many countries around the world including USA, Canada, Australia and the EU countries have adopted

[33] The share of basmati variety in total quantum of rice-exported rose by 28.4 percent, while that of the non-basmati varieties underwent a 12.5 percent fall in FY03.
[34] Trade policy for 2002-03 announced freight subsidy of 25% for new markets i.e. Latin America, Africa, East Europe and Oceania; or for any country where Pakistan's total exports averaged less than US$ 10 million in the last three years.
[35] EU accounted for 30 percent of the total export earnings from the fish and fish products due to the higher realized unit values despite lower exported volumes.
[36] After detecting the presence of chloramphenicol in shrimps, EU imposed complete check on frozen fish imports from Pakistan. However, the ban was later lifted in November 2002.
[37] Due to the increasing concerns of the consumers of the food and fish importing countries, the adoption of a food safety management system such as Hazard Analysis Critical Control Points (HACCP) was recommended in 1993, which has been endorsed and made virtually mandatory due to the WTO agreements on Sanitary and Phytosanitary Measures (SPS) and Technical Barriers to Trade (TBT) (WTO 1995). (Source: www.worldfishcentre.org)

this system for both, domestic and global, fish trade. Pakistan is listed amongst the countries with an unclear status of seafood HACCP, but the government is taking various measures to improve this.[38]

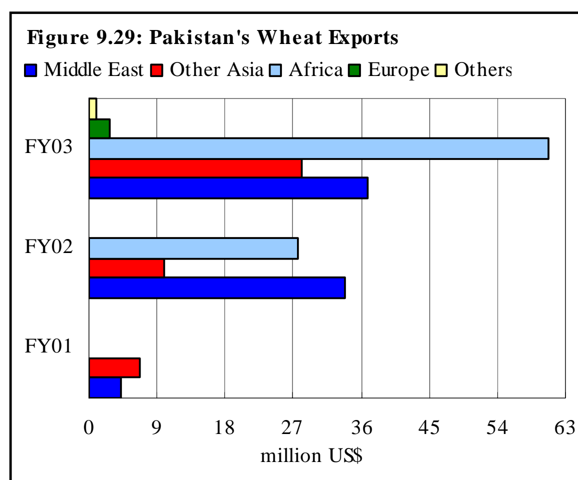


Figure 9.29: Pakistan's Wheat Exports

Wheat exports were another bright spot in Pakistan's FY03 primary export profile, totally approximately US$ 130 million. This not only represents an 80 percent increase in exports relative to FY02, but also marks Pakistan's entry into new markets, particularly Malaysia, Netherlands, and South Africa. Pakistan now exports wheat to 25 countries in 3 continents (see **Figure 9.29**).

It must be stressed that turnaround in Pakistan's wheat production has been a major plus for the trade profile, not only generating foreign exchange through exports, but also preventing a drain on forex reserves by meeting all domestic requirements.

Textile Manufactures

Textile exports recorded an impressive 25.0 percent growth in FY03, with earnings from this sector totaling to US$ 7.3 billion, raising its share in total exports from 63.6 percent in FY02 to 65.1 percent in FY03 (2.74 percent growth in share). Responding to increased market access granted by EU, USA and others, and exploiting the opportunity provided by the outbreak of SARS virus in Honk Kong, China, etc., exporters of cotton fabrics, hosiery, bed wear and readymade garments were able to achieve the unprecedented growth in country's textile exports. Export in each of these categories crossed the US$ 1.0 billion mark, and together with cotton yarn exports (which showed a slight decline over FY02) constituted over 80 percent of total earnings from the sector. The share of cotton yarn and cotton fabrics in the textile exports is rapidly falling and was down to 31.3 percent in FY03 from 35.5 percent a year ago.

FY03 witnessed a surge in international cotton prices, owing to lower size of world cotton production in 2002-03 (see **Figure 9.30**).[39] This rising trend in international raw cotton prices caused a slight improvement in the unit values of most of Pakistan's textile products. However, except ready-made garments and cotton yarn, the bulk of the improvement came from rising export quantum of various textile categories (see **Figure 9.31 & Table 9.23**).

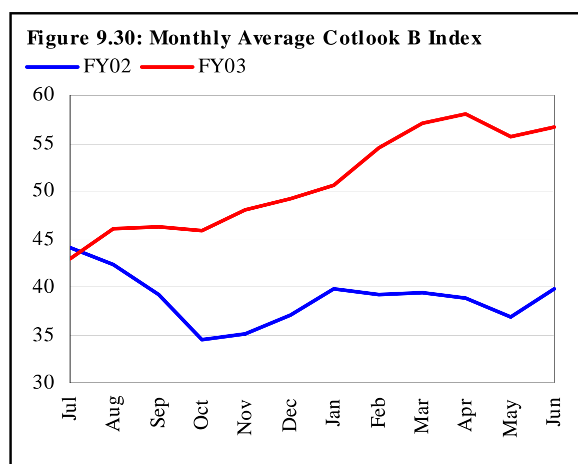


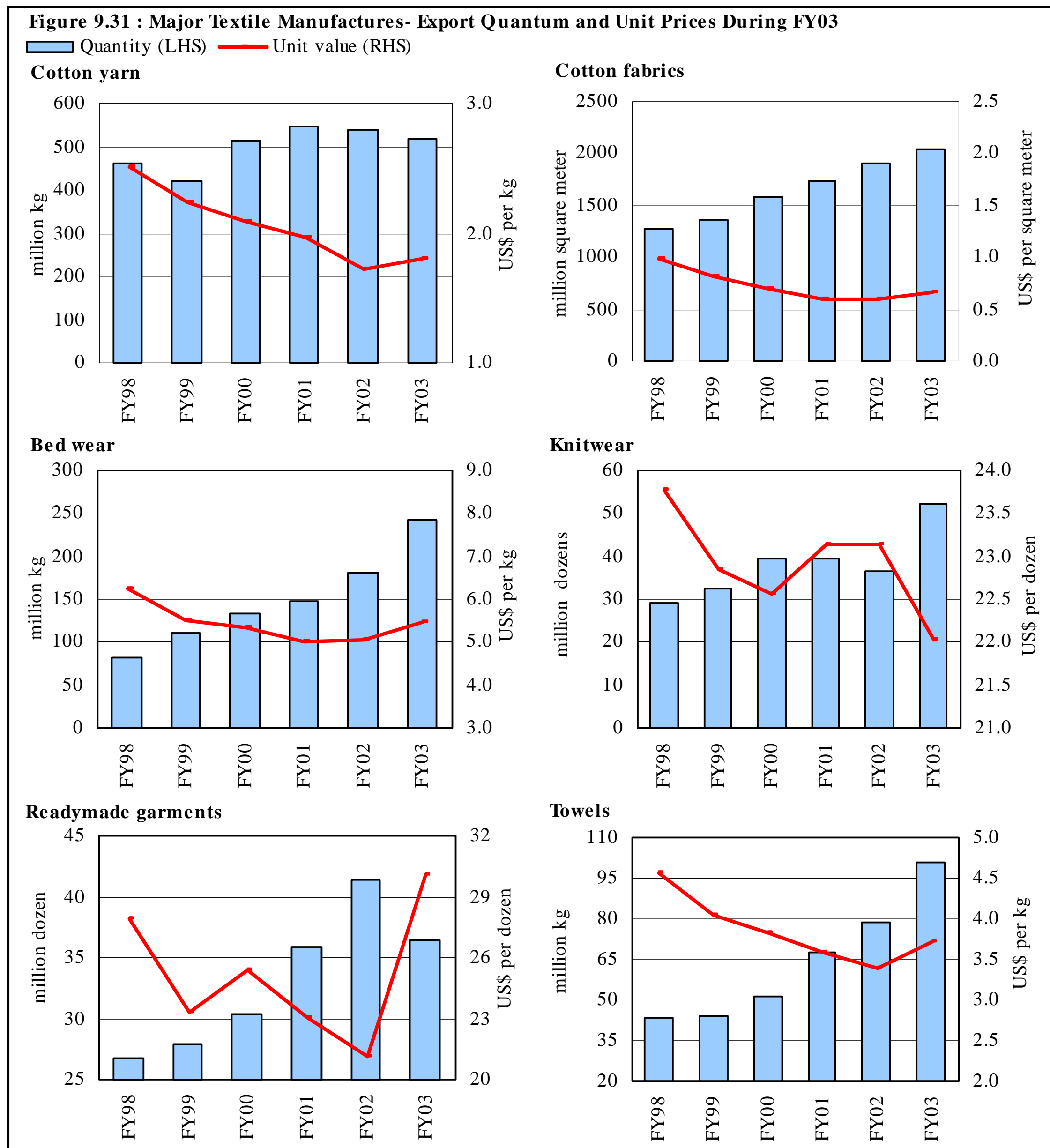
Figure 9.30: Monthly Average Cotlook B Index

Textile exports during FY03 witnessed significant increases to Asian market followed

[38] In order to maintain hygienic conditions and international standards at fish harbors for increasing country's seafood exports, a crate washing station was established at Karachi Fish Harbor in April 02. Besides, the introduction of plastic crates for fish catch has reduced the wastage considerably.

[39] World cotton production fell from 21.5 million MT in 2001-02 to 19.20 million MT in 2002-03. (Source: ICAC August 2003).

Figure 9.31 : Major Textile Manufactures- Export Quantum and Unit Prices During FY03



by quota exports to EU and the USA (see **Table 9.24**).

The rise in quota exports to EU is attributable to a 15 percent enhancement in the quota for all categories and withdrawal of import duties. Earnings from textile quota exports recorded a 23.9 percent growth in FY03, thus reaching an all time high of US$ 2.7 billion (37.5 percent of total textile export earnings) (see **Table 9.25**). This scenario when seen in terms of phasing out of quota restrictions in 2005 under the Agreement on

Textile and Clothing has raised concern for the future of country's export earnings from this sector, once the currently available fixed market access for textile exports ends. However, the domestic textile industry is preparing for this challenge through the on going BMR drive (which is also evident from the rising level of textile machinery imports). Moreover, in case of some categories, Pakistan's exporters are unable to meet the demand because of the quota restrictions.

These categories will certainly benefit from the removal of these limits.

Cotton yarn exports faced a marginal decline in FY03 compared to FY02, probably reflecting both, a higher domestic demand as well as a slowdown in demand from China and South Korea. Pakistan's yarn exports to these countries fell in the last quarter of FY03 due to the economic slowdown caused by the outbreak of the SARS epidemic in early 2003 (**see Figure 9.32**).

Bed wear exports recorded an impressive 44.7 percent surge during FY03, and in the process became the second highest earning category in the textile sector after cotton fabrics. The rise in export earnings was contributed both by rising quantum (US$ 307.9 million) and prices (US$ 102.6 million). In terms of quantum and value, EU remained the biggest market followed by the US during FY03 (see **Table 9.26**). However, this sector is facing a serious threat from the initiation of investigations by the EU to impose anti-dumping duty on bed linen exports from Pakistan.[40]

Knitwear exports recorded a 35.5 percent growth in FY03 over the corresponding period of FY02, to reach US$ 1.2 billion. This improvement is entirely due to a strong export volumes (42.6 percent), largely comprising exports to the EU regions and to the US, with the latter alone capturing a 61 percent share in the total export earnings from this category.

A comparison of Pakistan's knitwear export in this market with its competitors, China and India, provides some interesting insights (see **Table 9.27**). Although a large proportion of Pakistan's knitwear exports are to the US, Pakistan's US market share is small. Moreover, the unit value earned by country's exports in this region is lower than both competitors. This scenario when seen in the background of a large increase in the export

Table 9.23: Quantum and Price Impact on Textile Exports

million US Dollars

	Overall change	Quantum impact	Price impact
Cotton yarn	-1.3	-35.6	34.3
Cotton fabrics	214.8	75.3	139.6
Hosiery (knitwear)	300.7	360.5	-59.7
Bed wear	410.5	307.9	102.6
Readymade garments	217.7	-104.7	322.4

Table 9.24: Textile Export Market Analysis during FY03

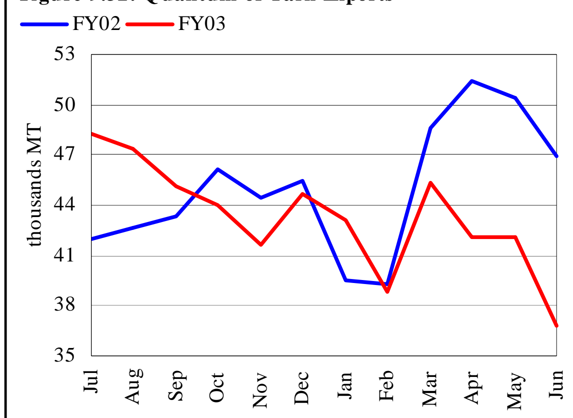
	Growth	Contribution in growth
A: Growth pattern of major quota exports (percent)		
US	17.1	3.1
EU	28.4	5.2
B: Growth pattern of major non-quota exports (percent)		
US	18.9	2.6
EU	18.1	1.5
Asia	27.4	7.7
Others	26.5	13.2
Total	**25.0**	**25.0**

Table 9.25: Textile Exports

Amount in million US Dollars, growth in percent

	FY02	FY03	Growth
Non-quota exports	**3613.5**	**4541.4**	**25.7**
Quota exports	**2197.2**	**2722.2**	**23.9**
US	*1047.8*	*1227.4*	*17.1*
EU	*1053.1*	*1352.6*	*28.4*
Turkey	*49.8*	*86.5*	*73.8*
Canada	*46.5*	*55.7*	*19.7*

Figure 9.32: Quantum of Yarn Exports



40 In mid-November 2002, European textile manufacturers lodged a complaint with EU authorities, against Pakistan's bed linen exports and related items to Europe on allegedly exceptional (below home market) low prices. Responding to these claims, EU initiated anti-dumping proceedings against Pakistani bed-linen on December 18, 2002.

quantum of this category in FY03 suggests that country's export to this region, as well as, in overall terms can expand further, as it has got the necessary competitive edge in the form of low production cost, which is evident from rising export quantum in the face of falling unit values.

Table 9.26: Shares of Major Bed Wear Export Markets FY03

Share in percent, unit value in US Dollars

	Quantity	Value	Unit Value
EU	44.6	40.7	5013.9
US	25.0	25.3	5571.2

Table 9.27: Knitwear Exports- US Market (Jan-Jul 03)

Share in percent, unit value in US Dollars per dozen

	Share		
	Quantum	Value	Unit value
Pakistan	3.4	2.7	19.6
China	11.1	9.4	21.2
India	1.6	2.4	37.9

9.4.2 Imports

Imports recorded an 18.2 percent growth in FY03 compared to the preceding year, to reach a record US$ 12.2 billion, with non-food non-oil imports (primarily machinery and industrial raw material) dominating this increase (see **Figure 9.33 & Table 9.28**).

A host of factors including the appreciation of rupee,[41] a reduction in import tariffs,[42] increased manufacturing activity in the economy and higher international prices of POL were responsible for this unprecedented increase in the import bill. While the first two factors impacted the import bill indirectly, by reducing the cost of imports, the rise in manufacturing activity directly raised imports of capital goods and raw materials (see **Figure 9.34**). Finally, the increase in the oil import bill is simply due to a large rise in POL prices.

Figure 9.33: Imports Growth Pattern

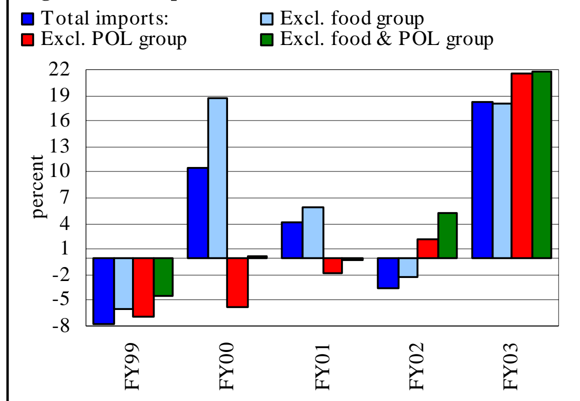


Table 9.28: Contribution by Major Import Groups

percent

	FY01		FY02		FY03	
	Growth	Contribution in growth	Growth	Contribution in growth	Growth	Contribution in growth
Food	-11.1	-1.2	-16.9	-1.6	18.8	1.5
Machinery.	3.4	0.7	5.3	1.0	30.5	6.4
Petroleum.	19.8	5.4	-16.5	-5.2	9.2	2.5
Textile.	6.0	0.1	15.9	0.2	18.2	0.3
Agricultural & other Chemical	-4.8	-0.9	-2.0	-0.4	16.0	2.9
Metal.	-2.9	-0.1	20.1	0.7	16.9	0.7
Miscellaneous	-1.1	0.0	7.5	0.2	7.4	0.2
Others	1.1	0.2	8.8	1.3	21.4	3.6
Total	**4.1**	**4.1**	**-3.6**	**-3.6**	**18.2**	**18.2**

The volume of oil imports actually declined during the year, mainly due to the substitution of imported fuels with cheaper local alternatives. If this trend persists it will have a salutary impact on the overall import bill of the country.

[41] In FY03 rupee witnessed a 3.7 percent appreciation.

[42] A reduction of 5 percent in the maximum customs tariff rate from 30 to 25 percent was announced in the FY03 Budget. With this reduction, only 4 tariff rates i.e. 25, 20, 10 and 5 prevailed from July 2002.

Machinery Imports

FY03 witnessed an exceptionally broad based growth in machinary imports, which rose 30.5 percent over the corresponding FY02 figures, reflecting the increased manufacturing activity in the country (see **Figure 9.35**). In particular, the continuation of the strong three-year rise in textile mchinary imports, was supported during FY03 by substantial increases in imports of transport equipment, and electrical appliances & apparatus.

The textile industry has invested heavily during the last few years, to prepare for the end of MFA regime by end-2004, importing machinery worth US$ 938.8 during the last two years alone. Continuing this on-going BMR and expansion drive, the textile sector imported *textile machinery* worth US$ 531.9 million during FY03, representing an increase of 30.7 percent over FY02. Since FY00, the imports of textile machinery in the country have totalled US$ 1.5 billion.

In contrast, the jump in vehicle imports was driven essentially by the surge in domestic demand due to increased availability of (relatively cheap) car financing. As a result, the automobile industry expanded production, leading to a 51.7 percent rise in imports of *road motor vehicles & parts* (see **Table 9.29**).

The growth in the *electrical machinery & apparatus*, on the other hand was driven by the booming telecommunications sector including mobile phones, radio and television broadcasting & reception apparatus, video cameras, apparatus for telephone and telegraph lines, etc. Imports of household appliances such as television sets, refrigerator, air conditioners, etc. also increased, reflecting the increasing availability of consumer finance from financial institutions.

Petroleum Group

POL imports recorded 9.2 percent growth in FY03 as compared to FY02, accounting for 13.8 percent of the growth in total imports. This rise in the oil import bill was entirely due to the higher average international oil prices in the wake of Iraq war (import volumes declined

Figure 9.34: Import Categories-Contribution in Growth

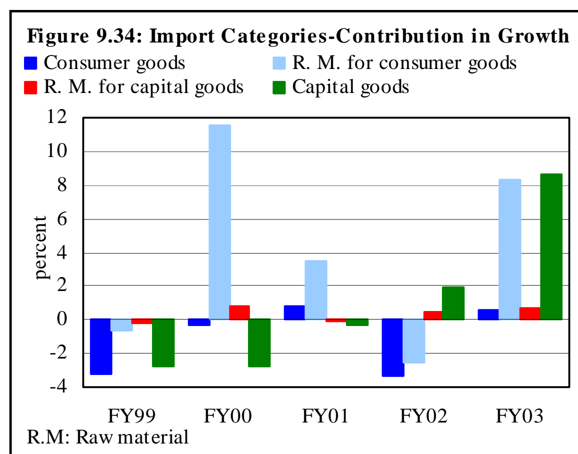


Figure 9.35: Machinery Imports and LSM Growth

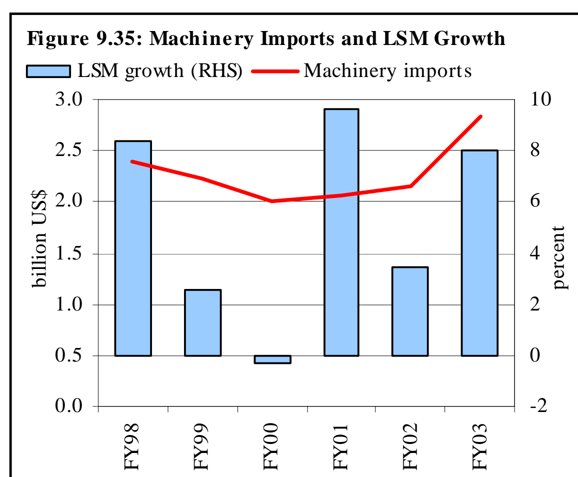


Table 9.29: Contribution in Machinery Group

percent

	FY02		FY03	
	Growth	Contrib. in growth	Growth	Contrib. in growth
Road motor vehicles	2.8	0.4	51.7	7.8
Textile	9.9	1.8	30.7	5.7
Electrical	-2.7	-0.2	69.2	4.1
Power generating	3.0	0.3	31.8	3.0
Agricultural & Implements	-32.4	-0.4	128.6	0.9
Railway vehicles	49.1	0.6	29.5	0.5
Aircraft, ships and boats	65.9	2.5	1.4	0.1
Office	-3.8	-0.4	-5.7	-0.6
Construction & mining	43.7	1.7	-14.6	-0.8
Others	-8.8	-2.6	36.5	9.7
Total	**3.9**	**3.9**	**30.5**	**30.5**

Table 9.30: Major Imports

value in million US Dollars, unit value in US Dollars

		FY02		FY03		Absolute change in value	Change in percent		
	Unit	Value	Unit value	Value	Unit value		Quantity	Value	Unit value
A. Food Group	**---**	**823.2**	**---**	**978.0**	**---**	**154.8**	**---**	**18.8**	**---**
1. Milk & cream including milk food for infants	MT	16.1	2293.8	22.8	1778.0	6.7	82.7	41.6	-22.5
2. Wheat un milled	MT	50.0	187.2	28.7	194.2	-21.3	-44.6	-42.6	3.7
3. Dry fruits	MT	31.2	342.0	25.8	303.7	-5.4	-6.9	-17.3	-11.2
4. Tea	MT	156.6	1575.1	172.7	1597.3	16.2	8.8	10.3	1.4
5. Spices	MT	17.0	793.5	23.0	654.7	6.0	64.0	35.3	-17.5
6. Edible oil	MT	393.0	328.4	586.8	453.6	193.8	8.1	49.3	38.1
Soya bean	MT	12.7	369.4	47.5	574.5	34.8	141.0	274.8	55.5
Palm oil	MT	380.3	327.2	539.3	445.4	159.0	4.2	41.8	36.1
7. Sugar	MT	23.5	273.7	2.6	315.2	-20.8	-90.3	-88.8	15.2
8. Pulses	MT	135.9	295.3	115.6	293.2	-20.3	-14.3	-14.9	-0.7
B. Machinery group	**---**	**2175.8**	**---**	**2839.1**	**---**	**663.3**	**---**	**30.5**	**---**
1. Power generating	---	203.8	---	268.5	---	64.7	---	31.8	---
2. Office	---	224.3	---	211.5	---	-12.9	---	-5.7	---
3. Textile	---	406.9	---	531.9	---	125.0	---	30.7	---
4. Construction & mining	---	118.6	---	101.3	---	-17.3	---	-14.6	---
5. Electrical & apparatus	---	128.0	---	216.6	---	88.6	---	69.2	---
6. Railway vehicles	---	38.3	---	49.6	---	11.3	---	29.5	---
7. Road motor vehicles	---	329.9	---	500.6	---	170.7	---	51.7	---
8. Aircraft, ships and boats	---	132.3	---	134.1	---	1.8	---	1.4	---
9. Agricultural & implements	---	16.1	---	36.7	---	20.7	---	128.6	---
10. Others	---	577.6	---	788.3	---	210.7	---	36.5	---
C. Petroleum group	**---**	**2807.0**	171.5	**3066.4**	**201.2**	**259.4**	-6.9	**9.2**	17.3
1. Petroleum products	MT	1576.2	170.8	1699.9	201.2	123.7	-8.4	7.8	17.8
2. Petroleum crude	MT	1230.8	172.4	1366.5	201.2	135.7	-4.9	11.0	16.7
D. Textile group	**---**	**187.5**	**---**	**221.6**	**---**	**34.2**	**---**	**18.2**	**---**
1. Synthetic fiber	MT	74.4	1242.1	92.0	1319.9	17.7	16.5	23.8	6.3
2. Synthetic & artificial silk yarn	MT	82.4	1521.3	91.8	1541.7	9.4	9.9	11.4	1.3
3. Worn clothing	MT	30.7	307.5	37.8	322.5	7.1	17.3	23.1	4.9
E. Agricultural and other chemicals group	**---**	**1862.9**	**---**	**2160.5**	**---**	**297.6**	**---**	**16.0**	**---**
1. Fertilizer	MT	176.2	144.5	239.8	185.1	63.5	6.2	36.1	28.1
2. Insecticides	MT	85.9	2703.6	58.5	2629.2	-27.5	-30.0	-31.9	-2.8
3. Plastic materials	MT	352.7	770.2	421.1	820.5	68.4	12.1	19.4	6.5
4. Medicinal products	MT	228.1	23471.0	221.8	25472.1	-6.3	-10.4	-2.8	8.5
5. Others	---	1019.9	---	1219.4	---	199.4	---	19.6	---
F. Metal group	**---**	**433.9**	**---**	**507.4**	**---**	**73.5**	**---**	**16.9**	**---**
1. Iron and steel scrap	MT	50.6	123.7	47.9	138.9	-2.8	-15.8	-5.5	12.3
2. Iron and steel	MT	336.1	293.3	402.3	366.1	66.3	-4.1	19.7	24.8
3. Aluminum wrought & worked	---	47.2	---	57.2	---	10.0	---	21.1	---
G. Miscellaneous group	**---**	**285.4**	**---**	**306.4**	**---**	**21.0**	**---**	**7.4**	**---**
1. Rubber crude	MT	41.1	628.5	49.1	770.0	8.0	-2.5	19.4	22.5
2. Rubber tyres & tubes	Nos	66.6	21.1	78.3	20.5	11.7	20.7	17.6	-2.6
3. Wood & cork	---	14.7	---	26.4	---	11.6	---	79.1	---
4. Jute	MT	26.2	288.1	21.0	235.6	-5.2	-1.9	-19.8	-18.2
5. Paper and paper board & manufactures	MT	136.8	693.7	131.7	606.4	-5.1	10.1	-3.8	-12.6
H. Others	**---**	**1763.8**		**2140.7**	**---**	**376.9**	**---**	**21.4**	**---**
Total imports:		**10339.5**		**12220.3**		**1880.7**		**18.2**	
excluding food group		*9516.4*		*11242.2*		*1725.9*		*18.1*	
excluding POL group		*7532.5*		*9153.8*		*1621.3*		*21.5*	
excluding food & POL groups		*6709.3*		*8175.8*		*1466.4*		*21.9*	

6.9 percent during the period (see **Table 9.30**). In fact, approximately US$ 453 million of the rise in the oil import bill during FY03 is attributable to higher prices.

The fall in the quantum of POL import can be attributed largely to increased conversion of vehicles to CNG, which is also evident by falling share of transport sector in the consumption of petroleum products[43], as well as drop in the country's fuel oil requirements. The latter is driven by lower generation of thermal electricity, the conversion of some cement plants from fuel oil to coal, as well as availability of smuggled POL products in regions bordering Iran.

Food Group

Food group imports witnessed an18.8 percent rise in FY03 compared to the previous year to reach US$ 978.0 million largely due to rising international prices and the larger quantum of imports of *edible oil* (see **Table 9.31**). Further, palm oil accounted for 93 percent of the FY03 edible oil imports. While the Soya bean oil imports also rose, this mainly represented the "in kind' payments owed to Pakistan.[44] The steep rise in edible oil imports was only partially offset by lower imports of sugar, pulses and wheat.

Table 9.31: Quantum and Price Impact on Edible Oil Imports

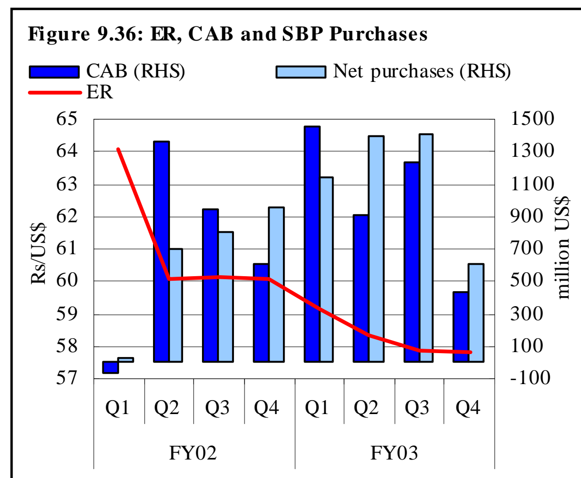
	Overall change US dollars	Quantum impact percent	Price impact percent
Edible oil	193.8	16.4	83.6
Soya bean	*34.8*	*51.3*	*48.7*
Palm oil	*159.0*	*10.0*	*90.0*

9.5 Exchange Rate Policy

The Rupee appreciated gradually by a net 3.9 percent against the US Dollar during FY03. Much of this rise was underpinned by a substantial year-on-year improvement in Pakistan's current account, which recorded its largest–ever annual surplus. The year also saw the further liberalization of the foreign exchange markets, as well as the introduction of Exchange Companies (which is expected to better integrate the informal markets into the formal market).

However, despite the record current account surplus as well as a substantial YoY improvement in the capital account, the appreciation of the Rupee during FY03 was substantially *lower* than the 6.7 percent witnessed in FY02. This apparently anomalous behavior stems directly from the SBP's interventions in the foreign exchange market, aimed at moderating the ascent of the Rupee in order to support exports (see **Figure 9.36**). In fact, two distinct periods can be clearly demarcated by shifts in the SBP's exchange rate stance during FY03.

Figure 9.36: ER, CAB and SBP Purchases



During the first period, comprising the initial three quarters of FY03, while the SBP made quarterly purchases in excess of US$ 1 billion each, it nevertheless permitted the Rupee to *appreciate* gradually. This reflected the SBP's efforts to strike a balance between:

[43] The consumption of petroleum products by the Transport sector fell from 47.5 percent in Jul-Mar 2002 to 46.3 percent in Jul-Mar 2003.
[44] Pakistan had agreed to accept soybean stocks in lieu of reimbursement of payments against undelivered F-16 aircrafts by the US.

1) allowing the exchange rate to respond to increased forex market liquidity due to the combined effect of an improvement in Pakistan's external accounts and rising forex loans[45] (see **Figure 9.37**); and,
2) preventing any abrupt (and therefore potentially destabilizing) rise of the Rupee which could have led to the loss of export markets.

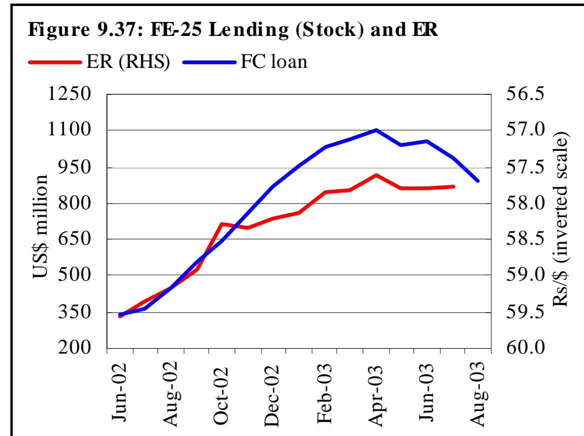


Figure 9.37: FE-25 Lending (Stock) and ER

However, by Q4-FY03 there was a sharp drop in the forex market liquidity as a decline in the quarterly current account surplus was compounded by a net retirement of forex loans. The SBP therefore responded by adjusting its exchange rate policy during this period, opting to stabilize the exchange rate by scaling down its net market purchases sharply.

In short, while the overall policy stance of the SBP during both periods remained supportive of exporters, the market forces were more favorable and kept the exchange rate relatively more stable in the latter period. This change stems from a number of developments including a deceleration of remittance flows, a widening of the country's trade deficit, as well as the linkages between the external sector surpluses and monetary policy.

Deceleration in remittances

The spectacular 76.9 percent YoY rise in cash remittances during FY03 was clearly a key factor underpinning the large current account surplus for the period. However, as elaborated in earlier SBP reports, it is still not possible to distinguish what proportion of the increase was attributable to a 'reverse capital flight' rather than being a function of the international crackdown on undocumented flows. This was very important because of the varied policy responses required:

(a) If the first component were dominant, the central bank would have cater to the possibility that the incremental flows would potential taper off in the near future. This argued for a policy of containing the market impact of the temporary flows, by reducing volatility in the exchange rate and Rupee interest rates, until the economy's fundamentals reasserted themselves, and remittances declined to 'normal' (lower) levels.

(b) On the other hand, if the dominant portion of the incremental remittance flows were structural in nature, i.e. represented a shift of existing inflows from the informal to the formal sector (possibly coupled with a *decline* in capital flight through the informal channels) it would be important to ensure that the domestic economy was 'acclimatized' to a permanent increase in forex inflows and attendant changes to the exchange rate environment and to the term structure of interest rates.

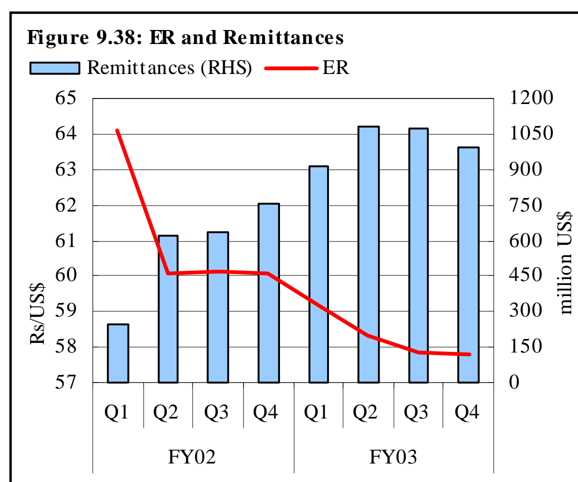
It is precisely because of this uncertainty that the SBP kept to a middle path by containing the appreciation of the Rupee in the initial months, until the growth in remittances slowed (see **Figure 9.38**). It was only following this deceleration in remittances in Q3-FY03, that the SBP interventions in the market become unnecessary.

[45] FE-25 loans taken by local businesses can add to liquidity in the inter-bank forex market since, typically, the forex funds are immediately sold to generate equivalent Rupee liquidity. Conversely, a fall in the stock of these loans effectively lowers market liquidity, as businesses need foreign currency to retire the debt (see **Box 9.x.x** for details).

Widening trade deficit
While Pakistan's export performance during FY03 was a significant improvement over the preceding year, imports also grew strongly in the period, leading to a steady deterioration of the quarterly trade balance through the year even as the Rupee appreciated in nominal terms.

Even more significantly, by April 2003, the Real Effective Exchange Rate (REER) was also registering an appreciation of approximately 1.6 percent from the beginning of the fiscal year (see **Section 9.5.2** for details).

Figure 9.38: ER and Remittances

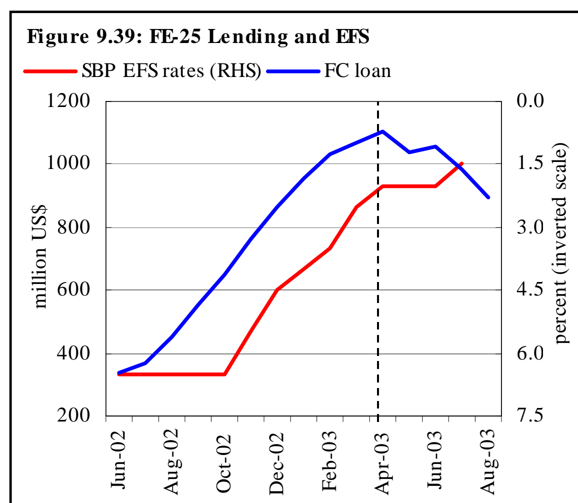


Interest rate impact
During the first period, the heavy SBP forex market interventions were not fully sterilized, helping drive down Rupee interest rates sharply, and thereby, also reducing the spread over the corresponding US Dollar rates. Specifically, the interest rate spread between FE-25 forex loans and EFS lending decreased.

Exporters had the option of substituting between FE-25 forex loans and the loans under the EFS, but initially, the weakening EFS rates had little impact since these remained more expensive (see **Figure 9.39**).

The cost of FE-25 loans typically ranged between 3 to 4 percent, and their attraction was compounded by expectations that the steady appreciation of the Rupee would continue, lowering the future costs of retiring the forex loans (i.e. reducing the effective cost of the loans).

Figure 9.39: FE-25 Lending and EFS



This led to an increase of US$ 750 million in the stock of FE-25 loans during the initial three quarters of FY03, with a corresponding increase in forex market liquidity. Also, since the SBP was the residual purchaser in the forex inter-bank market, the increased liquidity (a) indirectly facilitated a sharper increase in SBP forex reserves than would have been otherwise possible, and (b) helped increase the liquidity in the Rupee inter-bank market as well, since the SBP forex purchases were not completely sterilized.

However, by April 2003, amidst a general decline in the Rupee interest rates, the EFS rate had dropped to the 4 percent level. Moreover, given rising seasonal debt payments, a widening trade deficit, a slowdown in the growth in remittances and the relative stability of the Rupee in Q3-FY03, expectations of a strong appreciation of the Rupee were also fading.

As a result, FE-25 loans became relatively less attractive, and the stock of FE-25 loans witnessed a gradual decline in subsequent months. This, in turn, put pressures on forex market liquidity and

forced the SBP to inject funds in the spot forex market to stabilize the Rs/US$ parity during the latter half of Q4-FY03.

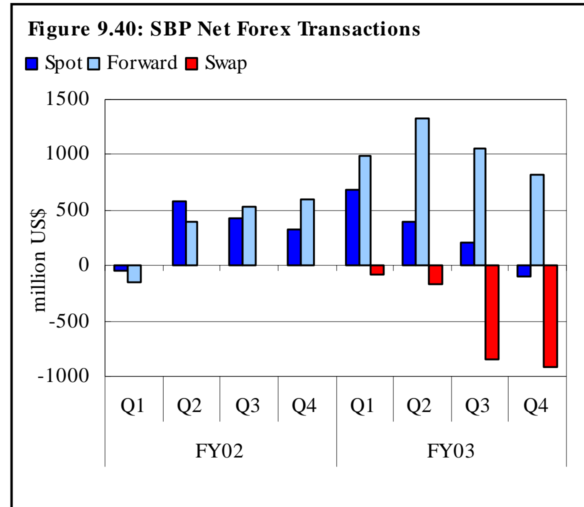


Figure 9.40: SBP Net Forex Transactions

9.5.1 SBP Market Operations

While the aggregate market interventions substantially increased in FY03 relative to FY02, there was a marked difference in the manner these were conducted. As evident from **Figure 9.40** the aggregate FY02 SBP purchases were almost equally divided between spot and forward transactions. By contrast, forward transactions dominated the SBP purchases during FY03. Moreover, the year also saw the introduction of the swap transactions.

The lower SBP spot purchases also reflect the liberalization of the foreign exchange markets that increased to role of Authorized Dealers (ADs). Most notably, SBP allowed ADs to further enhance the limit of advance remittance from 33.3 percent to the extent of the estimated C&F value of the total quantity of the goods imported. Moreover, SBP also permitted the remittance of re-insurance premia on life insurance policies, remittance of royalty/franchise and technical fee or service changes in financial sector. The impact of these measures started showing the results in the face of higher payments through ADs in FY03.

The increasing volume of forward transactions, on the other hand, owes to (1) differentials between Rupee and US Dollar interest rates and (2) exporters' desire to lock in the exchange rate in anticipation of a substantial appreciation of the domestic currency. In fact, the lower SBP spot transactions in the inter-bank market during FY03, in terms of both volume and frequency, can be traced directly to the rising forward volumes and, to a lesser extent, declining market flows into the spot market.

SBP entered into forward transactions with the banks for two reasons: (1) to support the forward premium, and; (2) to manage the Rupee-Dollar parity expectations.

Though the net forward purchases by the SBP had a limited impact on the forward premium, it had a significant role in reserve accumulation. In fact, the SBP mopped up over a billion US Dollar in each of the first three quarters of FY03 through its forward purchases, which reduced the need for SBP purchases in the spot market. However, it should be noted that by Q3-FY03 not only were the volume of forward purchases declining, the SBP was also *injecting* liquidity into the spot market through swap transactions.

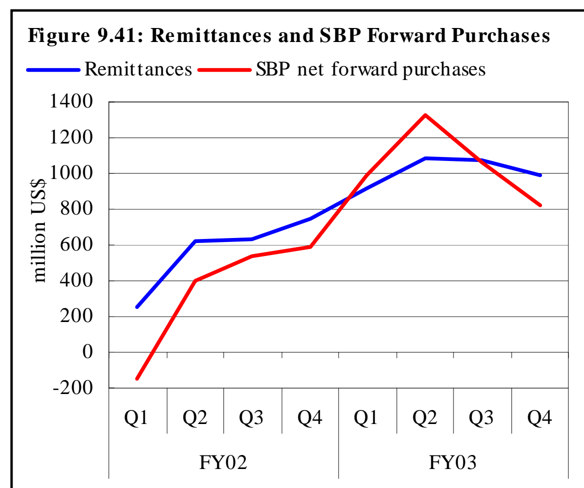


Figure 9.41: Remittances and SBP Forward Purchases

The expectations of a Rupee appreciation that drove the large volume of forward transactions, in turn, largely developed due to a host of factors such as the increasing workers' remittances, significant official

inflows and a strong reserve position of the SBP. In particular, workers' remittances, which had been on the rise since Q2-FY02, appears to have an especially strong influence on expectations as evident in the strong correlation of workers remittances with the forward purchases since FY02 (see **Figure 9.41**).

The sharp jump in forward transactions, particularly since Q1-FY03, as result of the exchange rate expectations, significantly depressed the forward premium, which was already under pressure due to the narrowing interest rate differential between the US Dollar and Rupee interest rates (see **Figure 9.42**).

In particular, the forward premium fell significantly below the differential during Q1-FY03, until the SBP increased purchases in order to contain expectations of an excessive rise of the Rupee (see **Figure 9.43**).

However, despite the heavy SBP interventions in the forward market, which signaled that market expectations of a heavy appreciation of the Rupee were excessive, the forward premium remained below the interest rate differential (i.e., market expectations about the Rs/US$ parity did not change significantly).

As a result, by January 2003, when the interest differential reached near 2 percent, the forward premium actually turned into a discount, i.e., the forward rate fell *below* the spot rate. This persisted through the remainder of the fiscal year. In fact, the relatively greater stability of the Rupee during H2-FY03 as well as lower negative forward premium probably contributed to declining interest in forward transaction during the period.

The heavy forward selling by the exporters also impacted the market liquidity as the banks, which had in turn been *selling* forward to the SBP (often holding short open positions) faced liquidity shortages upon the maturity of these transactions. This is one of the reasons that the overall banking system appears *short* in its net open position (see **Figure 9.44**).

Figure 9.42: Comparison of Interest Rates (3-month T-bill)

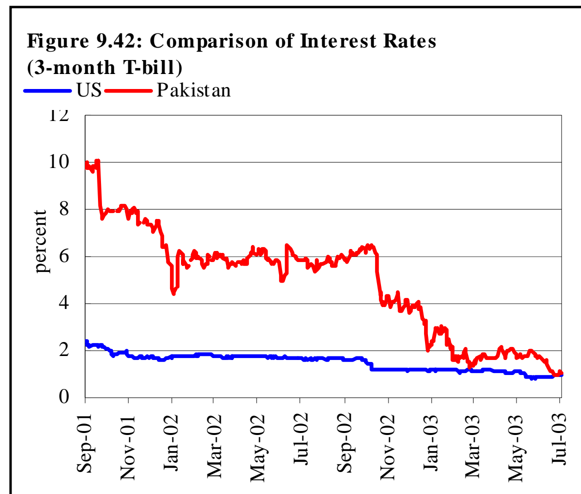


Figure 9.43: Interest Rate Differential (3-month US and Pak T-bills) and Forward Premium

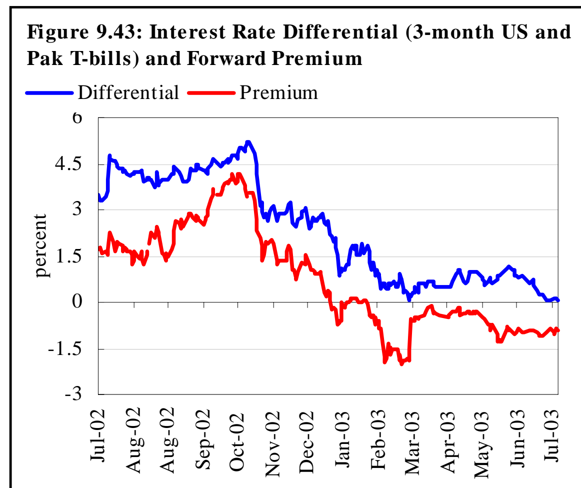
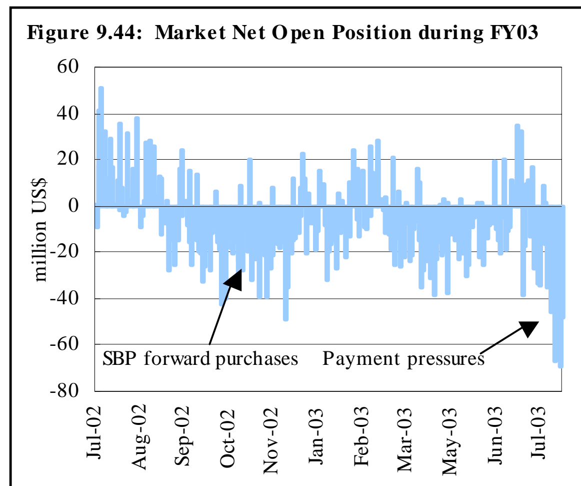
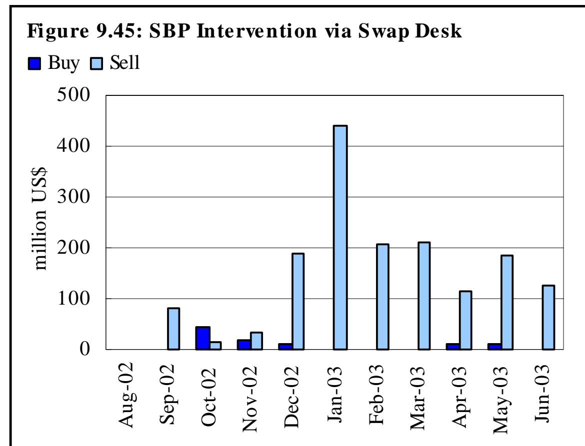


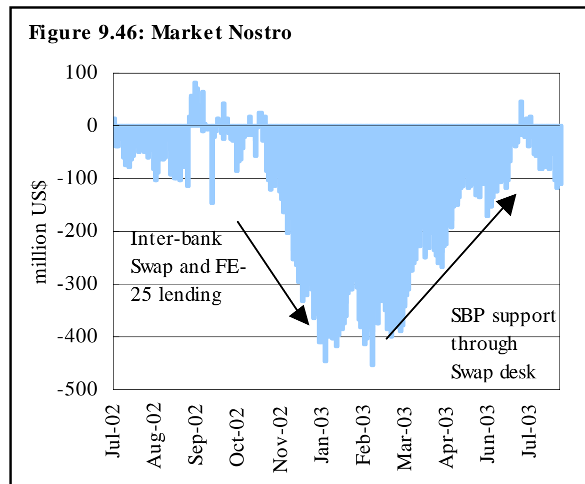
Figure 9.44: Market Net Open Position during FY03



The *net open position* of banks, which is generally used as indicator of market liquidity, appears to suggest liquidity *shortages* during most of the FY03, but this is deceptive. In fact the negative net open position is largely due to the banks *preference* to remain short in anticipation of a strengthening Rupee.

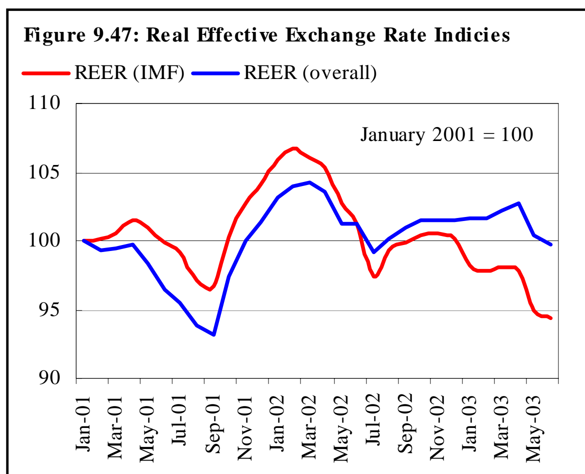
The banks, however, managed their liquidity situation by entering into buy/sell swap transactions with the SBP, as evident from the increase in swap transactions during the third and the fourth quarter of FY03 (see **Figure 9.45**). The swap transactions with the SBP also helped the banks in reducing their oversold *nostro* accounts, which had been ballooning due to foreign currency loans against FE-25 deposits (see **Figure 9.46**).





9.5.2 Real Effective Exchange Rate Indices

The competitiveness of Pakistani exports in real terms improved during FY03 relative to the position at the end of FY02. The competitiveness, as measured by the change in real effective exchange rate index (REER) is more pronounced in the case of REER (IMF) than the REER (Overall)[46]. Though in nominal terms, the Rupee appreciated significantly, the sharp appreciation of other currencies in the basket vis-à-vis the US Dollar and the relatively lower inflation in the country resulted in the improved competitiveness (see **Figure 9.47**).



As the major currencies like the Euro and the British Pound appreciated sharply (10.1 and 8.0 percent respectively) against the US Dollar, the relatively lower appreciation of Rupee against the US Dollar (3.9 per cent) had a net impact of Rupee depreciation against these currencies.[47] The Rupee depreciated by 11.9 and 3.1 per cent against the Euro and Pound respectively. The Rupee, however, witnessed a net appreciation of 3.7 per cent against the Japanese Yen (see **Figure 9.48**).

[46] REER (IMF) and REER (Overall) are the two variants of REER index assigning different weights to different countries.
[47] Pak Rupee exchange rate with other currencies is determined through cross rates based on the movement of the US Dollar against these currencies in the foreign exchange markets.

9.5.3 Kerb Market

A notable development during Q3-FY03 was the re-emergence of the kerb (informal) market premium by March 2003, after hovering around zero for the preceding 9 months. It then moved up very gradually during Q4-FY03 before moving above the 0.5 percent mark in July 2003, and then surged to a 1.5 percent peak before dropping again (see **Figure 9.49**).

This movement of the kerb premium gives rise to concerns of possible adverse effects in the form of the re-divergence of remittances into informal channels (these concerns being exacerbated by a softening of flows in July 2003) and the re-dollarization of savings (in fact, the conversion of US Dollar assets into Rupees slowed significantly in the period).

However, given that the rise in the premium the increased significantly, and moreover, has not been sustained, it is possible that this is only a temporary spike caused by transient factors, such the non-repatriation of proceeds from export of currencies.[48]

9.5.4 Exchange Companies

The Foreign Exchange Act 1947 was amended (permitting the creation of exchange companies, and the SBP regulating their operations).[49] Accordingly, by end-June 2003, a number of applications, had been received (including many from money changers) and the SBP had issued licenses to 5 companies.

In fact, some companies had commenced operations by February 2003, following which the SBP gradually transferred the 'export of currency'[50] operations to the ECs by March 15, 2003 (withdrawing the permission earlier accorded to the moneychangers). In addition, exchange companies were permitted to issue

Figure 9.48: Pak Rupee vis-à-vis Major Currencies

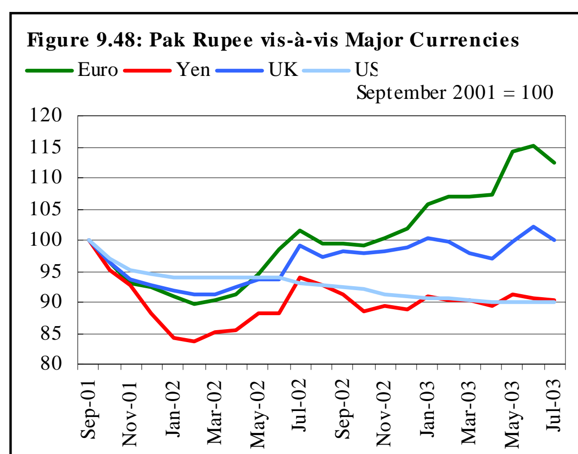


Figure 9.49: Inter-bank Rate & Kerb Premium

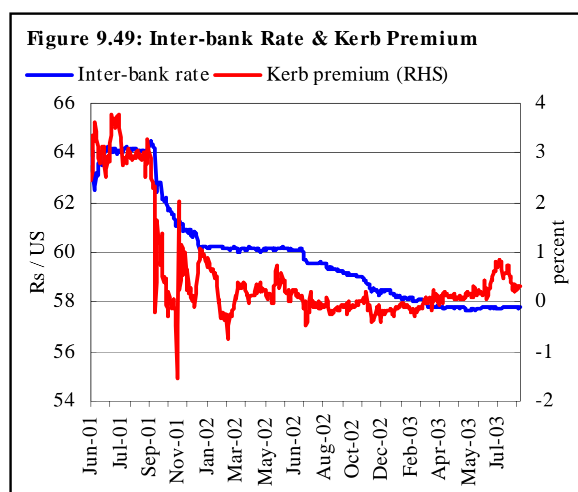


Table 9.32 ECs Volumes (nostro a/c based) during FY03

million US Dollars

Description	Purchase/ receipts	Sale/ payments
Inward/ outward remittances	1.6	13.7
Exchange transfers and adjustments	0.0	0.0
From/ to with exchange companies	0.0	0.6
Against sales/purchase of other currencies	484.4	0.0
Sales to authorized dealers	0.0	121.8
Against purchase of foreign currency	0.0	245.2
Branch transactions adjusted	0.0	102.4
Total	**485.9**	**483.6**

[48] Since the re-appearance of kerb premium could risk the re-diversion of remittances to the informal market, the SBP moved aggressively against errant exchange companies involved in smuggling and under declaration of export of currency. Further, SBP also supplied US Dollars through the NBP exchange company to fill the temporary market shortfalls. Followed by this SBP action, kerb premium again converging to zero level.

[49] Detailed in SBP Financial Sector Assessment 2001-2002

[50] This permitted exchange companies to export unapproved foreign currency notes of exchange for conversion into US Dollar currency notes subject to making declaration to the customs authorities at the Karachi airport at the time of departure and bring back the proceeds within three days.

Encashment Entitlement Certificate (EEC) against the remittances; this placed ECs at par with banks in attracting remittances, since the EEC would document remittance income for tax purposes. Data shows that the above developments contributed substantially to the EC transactions during FY03.

As evident in **Table 9.32**, of the US$ 490 million transacted by EC during FY03 through *nostro* accounts, approximately US$ 484 million comprised export of currency. Interestingly, the remittances through ECs remained very shallow, suggesting that commercial banks have merged as strong competitors in the business. The surplus liquidity of US$ 102 million that generated through the business operations was also sold to inter-bank market during the course of year.

On cash basis, residents transacted major volumes over the counter (see **Table 9.33**), with FY03 transactions totaling US$ 1.12 billion. The cash sales to ECs appear to reflect the de-dollarization of household savings as the Rupee appreciated. The inflows into FCAs however, are more intriguing, given the net decline in such account witnessed in FY03.

Table 9.33: Exchange Companies Volumes (cash based) during FY03

million US Dollars

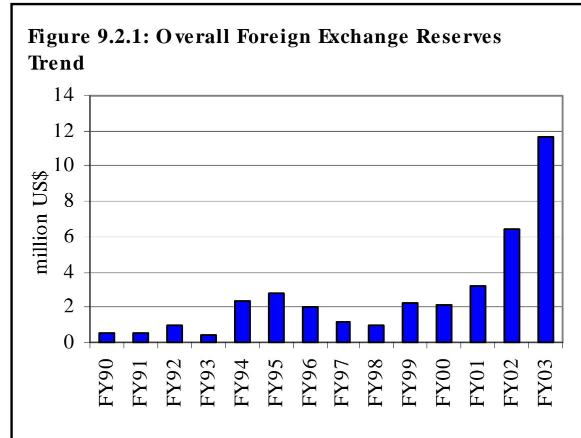
Description	Purchase/ receipts	Sale/ payments
From resident against payment in Rupee	653.4	0.0
From non resident against payment in Rupee	0.0	0.0
From/ to exchange companies	40.0	14.3
For credit to FCA of resident	0.0	292.4
Sales to authorized dealer	0.0	18.9
Contra to import/ export of foreign Currency	415.7	532.5
For travel	0.00	240.9
Total	**1,109**	**1,099**

Box 9.2: Foreign Exchange Reserves Accumulation (FY00 to FY03)
The profile of Pakistan's liquid foreign currency reserves has witnessed substantial changes over the past five years; not only has the *level* of the gross reserves risen substantially, from the paltry 930 million by end-June 1998 to the US$ 11.7 billion by end-June 2003, the *quality* of the reserves is also considerably improved (see **Figure 9.2.1**).

During the 1990s, while private individuals were permitted to maintain foreign currency accounts with commercial banks, the latter were required to surrender the resulting forex proceeds to the SBP, adding to the country's forex reserves (as well as increasing the *claims* on these reserves). Until FY98, the strong net inflow into the private accounts was one of the most significant contributors to the country's forex reserves.

However, since Pakistan's external account remained in deficit, which in turn was financed by the SBP, the forex reserves available to the latter rarely reached above US$ 1 billion, despite substantial external borrowings. At the same time, the *claims* on the forex reserves, represented by the growing stock of private accounts, also rose to over US$ 11 billion by May 1998. In short, the entire stock of Pakistan's forex reserves, until FY98 was, in net flows, effectively through the creation of debt and liabilities.

Figure 9.2.1: Overall Foreign Exchange Reserves Trend



This changed in the immediate aftermath of the May 1998 N-test, which precipitated a financial crisis and a freeze on withdrawals from existing private forex deposits. The consequent loss of confidence led to the sharply lower inflows through deposits (from US$ 1476 million in FY98 to US$ 322 million in FY00) and a substantial reduction in remittances (from US$ 1490 million in FY98 to US$ 983 million in FY00), even as international sanctions constrained access to IFI credit. Thus, the stabilization of forex reserves during FY99 and FY00, essentially reflected demand management by the SBP in the formal market, as well as increased reliance on the informal market (e.g. kerb market purchases, that were not undertaken in prior years, totaled US$ 2165 million by FY00). Thus, the net increase in the country's forex reserves between FY98 and FY00 essentially reflects the impact of both, debt creating and non-debt creating flows.

The orderly management of the forex market by the SBP until FY01 and the uptrend in the foreign exchange reserves, despite the floatation of the rupee on the inter-bank market, helped restore market confidence and allowed the central bank to, once again, gradually liberalize the exchange rate regime. It was in this environment that the post-September 11 accelerated remittances flows through the banking channels.

The sharp growth in workers' remittances through formal market during the last two years has led to an increase in its share of total inflows from a meager 5.8 percent in FY00 to 16.7 percent in FY03. As explained in **section 9.2.1**, the increase in remittances is more a change of *route* than an *actual* increase as is evident from the changing shares of both the remittances and the kerb purchases in the overall inflows. The shares of the two when combined are almost unchanged since FY00, reinforcing the view that the workers remittances are in fact now flowing through the inter-bank market rather than the kerb market.

In addition to the changes in workers' remittances, the substantial improvement in goods trade- especially the exports, has led to a sizable decline in the net outflows on this account (see **Table 9.2.1**).

Another important source of the accretion in forex reserves since FY01 has been the resumption of large borrowings and grants. However, in contrast to the recent past: (1) the loans are on concessional terms, and (2) while significant, the share of these in total annual reserve accumulation is lower.

Finally, there are two noticeable changes in forex outflows during FY02 and FY03. First, the share of interest payments has been on the decline sharply, reflecting the effects of external debt management policies. Second, a significant portion of external liabilities has been terminated giving a permanent reprieve to a country.

In effect, post-September 11, the forex reserves have risen largely on the back of non-debt creating flows, and the claims on these reserves have also declined sharply. In other words, the reserves have improved substantially in terms of both, quantity and quality.

Table 9.2.1: Overall Reserves as per BOP
million US Dollars

					Percent share			
	FY00	**FY01**	**FY02**	**FY03**	**FY00**	**FY01**	**FY02**	**FY03**
Opening balance	*2,370*	*2,163*	*3,244*	*6,398*				
Inflows	**16,835**	**20,020**	**22,228**	**25,327**	**100.0**	**100.0**	**100.0**	**100.0**
Exports of goods	8,190	8,933	9,140	10,889	48.6	44.6	41.1	43.0
Export of services (excluding interest)	1,396	1,367	1,929	2,801	8.3	6.8	8.7	11.1
of which: UK for logistic support	0	0	300	847	0.0	0.0	15.6	30.2
Workers' remittances	983	1,087	2,390	4,237	5.8	5.4	10.8	16.7
Kerb market purchases	1,634	2,157	1,376	0	9.7	10.8	6.2	0.0
Foreign direct investment	473	286	366	585	2.8	1.4	1.6	2.3
Foreign portfolio investment	73	-140	-8	22	0.4	-0.7	0.0	0.1
Loan disbursements	1,588	2,740	2,910	2,392	9.4	13.7	13.1	9.4
Privatization proceeds	*0*	0	117	186	0.0	0.0	0.5	0.7
Official grants	940	842	1,500	1,014	5.6	4.2	6.7	4.0
Other receipts	1,558	2,748	2,508	3,201	9.3	13.7	11.3	12.6
Outflows	**17,042**	**18,939**	**19,074**	**20,058**	**100.0**	**100.0**	**100.0**	**100.0**
Imports of goods	9,602	10,202	9,434	11,425	56.3	53.9	49.5	57.0
Imports of services (excluding interest)	2,160	2,332	2,214	2,733	12.7	12.3	11.6	13.6
Interest payments	*1,352*	1,369	1,111	974	7.9	7.2	5.8	4.9
Amortization of official loans	1,174	1,202	967	1,228	6.9	6.3	5.1	6.1
Profit and dividends	233	301	457	631	1.4	1.6	2.4	3.1
Purchase of crude oil	187	312	394	473	1.1	1.6	2.1	2.4
Principal repaid on private loans	591	512	584	646	3.5	2.7	3.1	3.2
Foreign exchange liabilities liquidated	494	1,940	3,590	1,192	2.9	10.2	18.8	5.9
Swaps	*0*	866	441	*235*	0.0	44.6	12.3	19.7
Other payments	*1,249*	769	323	756	7.3	4.1	1.7	3.8
Net inflows	**-207**	**1,081**	**3,154**	**5,269**				
Gross reserves at end of period	**2,163**	**3,244**	**6,398**	**11,667**				
Sinking fund*	*0*	0	0	920				
Net foreign exchange reserves	**2,163**	**3,244**	**6,398**	**10,747**				

* SBP has also built up a sinking fund of US$ 920 million (SBP: US$ 730 million and commercial banks US$ 190 million) through the purchases of foreign currency lending from the interbank market for extinguishing central banks deposits placed with SBP or prepayments of other expensive loans.