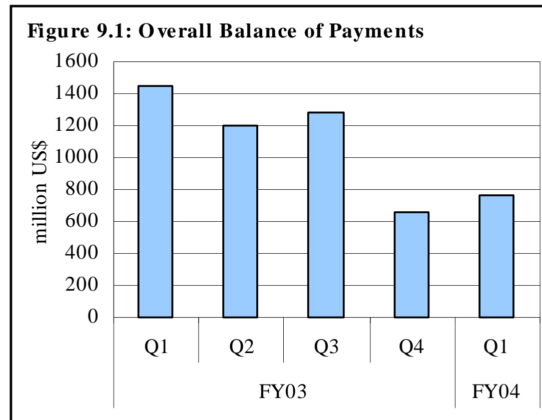
9 External Sector

Balance of Payments[1]

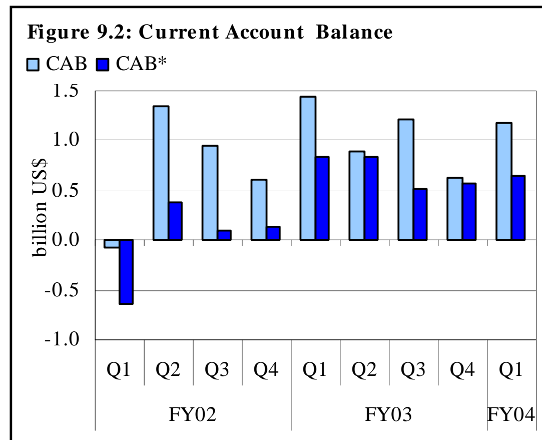
During Q1-FY04 the external sector witnessed a smaller current account surplus as well as a larger capital account deficit compared to the correspounding Q1-FY03 figure (see **Table 9.1**). But even the resulting lower external account surplus was quite substantial at US$ 770 million (see **Figure 9.1**).

Figure 9.1: Overall Balance of Payments



The larger part of the Q1-FY04 fall in the external surplus was contributed by the 18.5 percent decline in the quarterly current account surplus relative to Q1-FY03. However, despite this relative weakness, the current account surplus for Q1-FY04 remained over US$ 1 billion. More significantly, the current account surplus remains substantial, even if non-structural elements are netted out. As evident from **Figure 9.2**, while the adjusted current account balance (CAB*)[2] witnessed a marginal YoY deterioration during Q1-FY04, in nominal terms, it has remained in surplus for the eight consecutive quarters. Moreover, for the last five quarters the surplus has remained stable at over US$ 0.5 billion. This evidence reinforces the view that the current account has probably undergone a positive structural shift.

Figure 9.2: Current Account Balance



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

[2] CAB* is computed after adjusting for one-time factors, such as Saudi Oil Facility (SOF), US aid and logistic support receipts.

Table 9.1: Summary Balance of Payments during Q1

million US Dollars

Items	FY02	FY03	FY04	Change during FY04 over FY03	
				Absolute	Percent
1. Trade balance	**-209**	**-147**	**72**	**218**	**-149.2**
Exports (fob)	2,203	2,623	3,078	455	17.3
Imports (fob)	2,412	2,769	3,006	237	8.6
2. Services (net)	**-830**	**-229**	**-376**	**-147**	**64.2**
Shipment	-194	-211	-258	-47	22.3
Other transportation	-8	45	41	-4	-8.9
Travel	-35	-14	-170	-156	1114.3
Investment income	-583	-507	-424	83	-16.4
Interest payments	-386	-266	-180	86	-32.3
Purchase of crude oil	-104	-148	-136	12	-8.1
Profit and dividend	-93	-93	-108	-15	16.1
Other goods, services, & income	-10	458	435	-23	-5.0
3. Current transfers (net)	**970**	**1,826**	**1,487**	**-339**	**-18.6**
Private transfers - net	772	1,551	1,283	-268	-17.3
of which:					
Workers' remittances	340	1,053	906	-147	-14.0
FCA (residents)	21	166	45	-121	-72.9
Outright purchases	398	0	0	0	
Official transfers	198	275	204	-59	-21.5
of which Saudi oil facility	173	189	147	-42	-22.2
4. Current account balance (1+2+3)	**-69**	**1,451**	**1,183**	**-268**	**-18.5**
5. Capital account (net)	**-587**	**-214**	**-496**	**-282**	**131.8**
6. Errors & omissions	**361**	**206**	**83**	**-123**	**-59.7**
7. Overall balance	**-295**	**1,443**	**770**	**-673**	**-46.6**
8. Financing	**295**	**-1,443**	**-770**	**673**	**-46.6**
I. Changes in reserves (-Inc/+Dec)	**80**	**-1,713**	**-770**	**943**	**-55.0**
Assets	-140	-1,739	-629	1,110	-63.8
SDRs	2	-3	5	8	-266.7
Forex (State Bank of Pakistan)	-45	-2,175	-578	1,597	-73.4
Forex (commercial banks)	-97	439	-56	-495	-112.8
Liabilities	220	26	-141	-167.0	-642.3
Use of fund credit	220	26	-141	-167.0	-642.3
Repurchases	267	115	0	-115	
Purchases/drawings	-47	-89	-141	-52	58.4
II. Exceptional financing	**215**	**269**	**0**	**-269**	
Net SBP reserves (End period)	1,724	5,941	10,019	4,078	68.6

Source: Statistics Department, SBP.

The impact of the decline in the nominal current account surplus during Q1-FY04, was compounded by a widening capital account deficit; it rose by 131.8 percent relative to that in Q1-FY03 to reach US$ 0.5 billion. Consequently, the external account surplus nearly halved from US$ 1.4 billion in Q1-FY03 to US$ 0.8 billion by end Q1-FY04. The lower external account surplus squeezed the inter-bank forex market liquidity, raising market expectations of a possible depreciation of the Rupee. In fact, despite a significant reduction in net SBP forex market purchases, the Rupee temporarily weakened by a marginal 0.2 percent against the US Dollar during Q1-FY04.

9.1 Current Account

The current account balance (CAB) declined by US$ 268 million to US$ 1.2 billion during Q1-FY04 over the corresponding period of FY03 (see **Table 9.1**). This reduction was primarily caused by a larger services account deficit (due to higher shipping charges and a rise in travel related payments) and a decline in current transfers (due to lower remittances and a decline in FCAs).[3]

9.1.1 Trade Balance

The '*exchange record*' data depicts a trade surplus of US$ 72 million during Q1-FY04 compared to a deficit of US$ 147 million during the corresponding period of FY03 (for details, see section on **Trade Account**). Although both exports and imports grew substantially, the spectacular growth in exports (17.3 percent YoY), comfortably outpaced the growth in imports (8.6 percent YoY) during Q1-FY04. As customary, the growth in exports was led by the textile sector, while a considerable increase in capital goods and raw materials (reflecting the substantial growth in LSM) contributed most of the rise in imports.

9.1.2 Services (Net)

Despite a reduction in investment income outflows, the services account deficit increased by 64.2 percent to US$ 376 million during Q1-FY04 as compared to the corresponding period of FY03. The widening of the services deficit was entirely due to the sharp increase in the '*invisibles account payments'*, mainly due to higher *shipment* and *travel* charges (see **Table 9.2**).

The rise in the former simply reflects the rising trade volumes *and* higher shipping charges. On the other hand, the increase in the latter reflects the re-integration of travel-related payments into the formal forex market.[4] In fact, during Q1-FY04,

[3] Q1-FY03 current account surplus had been inflated by a temporary increase in forex deposits stemming from the privatization of UBL.

[4] For details see **SBP Annual Report for 2002-03**, Section 9.2.

approximately 92.0 percent of the travel payments were financed by the recently established Foreign Exchange Companies (FECs). Excluding US$ 188.6 million of FECs financed travel expenditure (in order to facilitate a comparison), the services account deficit drops to US$ 187.4 million during Q1-FY04, which is marginally *lower* than in Q1-FY03.

The pressure on the invisible account due to *shipments* and *travel* was partially mitigated by a 28.4 percent YoY reduction in *interest payments* during Q1-FY04 (see **Table 9.2**). These savings reflect the combined impact of a falling stock of external debt and liabilities, the Paris Club debt re-structuring, and the continued substitution of expensive external debt with cheaper loans. The decision to pre-pay another US$ 1.0 billion of expensive external debt to IFIs during the current fiscal year is expected to further augment these savings.

Given that trade flows are expected to grow further in FY04, and that the future travel payments are to be financed by the formal sector,

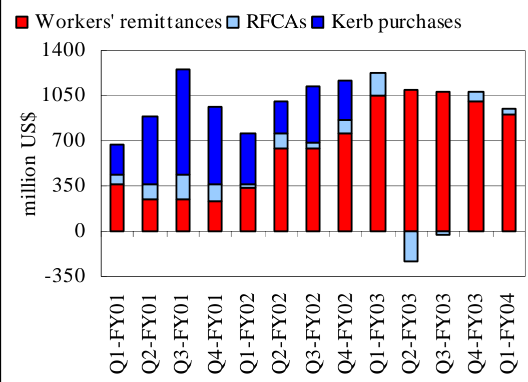
Table 9.2: Services (net) during Q1

million US Dollars

	FY02	FY03	FY04
Service (net) I+II	**-830**	**-229**	**-376**
I. Invisible services (net)	-247	278	48
Invisible receipts	359	857	846
Shipment	17	22	24
Other transportation	204	180	199
Travel	20	21	35
Other goods, services, & income	118	634	588
Invisible payments	606	579	798
Shipment	211	233	282
Other transportation	212	135	158
Travel	55	35	205
Other goods, services, & income	128	176	153
II. Investment income (net)	-583	-507	-424
Receipts	32	30	32
Interest on reserves	27	29	25
Others	5	1	7
Payments	615	537	456
Interest payments	418	296	212
Purchase of crude oil	104	148	136
Profit and dividend	93	93	108

Source: State Bank of Pakistan

Figure 9.3: Composition of Private Transfers from Overseas Pakistanis



the annual FY04 invisibles account deficit is expected to be higher than its FY03 counterpart.

9.1.3 Transfers

Current transfers recorded a sharp decline of 18.6 percent during Q1-FY04 to US$ 1.5 billion over the corresponding period of FY03 (see **Table 9.1**). The main contributors to this reduction were: (1) lower remittances (see **Figure 9.3**); (2) a significant slowdown in FCAs and, (3) lower official transfers (representing the lower imputed value of the Saudi Oil Facility).

Workers' remittances

Workers' remittances (cash) declined by 14.0 percent to US$ 906 million during Q1-FY04 compared to the corresponding quarter of FY03 (see **Table 9.3**), but this does not seem a source of concern, as is largely caused by the abolishment of the Hajj Sponsorship Scheme (HSS). Adjusting for the HSS inflows, Q1-FY04 remittances are seen to be only 2.1 percent lower than the corresponding figure for Q1-FY03.

Table 9.3: Country-wise Workers' Remittances during Q1
million US Dollars

Countries	FY02	FY03	FY04	Growth rate
I. Gulf region	**216.3**	**513.5**	**409.4**	**-20.3**
Bahrain	6.7	15.5	19.2	23.9
Kuwait	12.5	46.6	37.8	-18.9
Qatar	3.7	16.2	21.0	29.2
Saudi Arabia	85.4	151.4	161.0	6.3
Sultanat-e-Oman	10.9	21.4	24.0	12.3
U.A.E.	97.1	262.4	146.5	-44.2
II. U.S.A.	**50.1**	**330.3**	**258.0**	**-21.9**
III. Other than Gulf region & USA	**59.0**	**199.3**	**222.9**	**11.9**
Canada	2.3	2.6	4.3	64.3
Germany	2.4	4.5	17.1	278.4
Japan	1.0	1.7	1.6	-3.0
Norway	1.6	2.1	2.6	23.0
U.K.	22.7	57.3	74.3	29.8
Others	29.0	131.1	123.0	-6.2
Total	**325.4**	**1,043.1**	**890.3**	**-14.6**
Encashment of FEBCs & FCBCs	14.6	9.8	16.2	65.3
Grand total	**340.1**	**1,052.9**	**906.5**	**13.9**

Source: State Bank of Pakistan.

Of greater significance for future prospects is the declining *trend* in remittance inflows after peaking in Q2-FY03[5] (see **Figure 9.4**). However, even this trend is far from clear in recent months. More specifically, almost the entire decline in aggregate remittances into Pakistan was accounted for by the lower flows from the US and the UAE, and **Figure 9.5** suggests that the downtrend in remittances from both countries *may* be bottoming out.

[5] One possible explanation of this downtrend is that the one-time inflows (representing reverse capital flight) are tapering off.

In view of the uncertainty over the source of the relatively lower remittances since Q2-FY03 the unclear, earlier (conservative) SBP projections of FY04 remittances have been retained at between US$ 3.6 to US$ 3.7 billion, particularly as more than 200,000 new migrant workers have joined the rank of overseas Pakistanis in FY03. They are likely to add to the flow of remittances once they have settled down.

Figure 9.4: Monthly Workers' Remittances

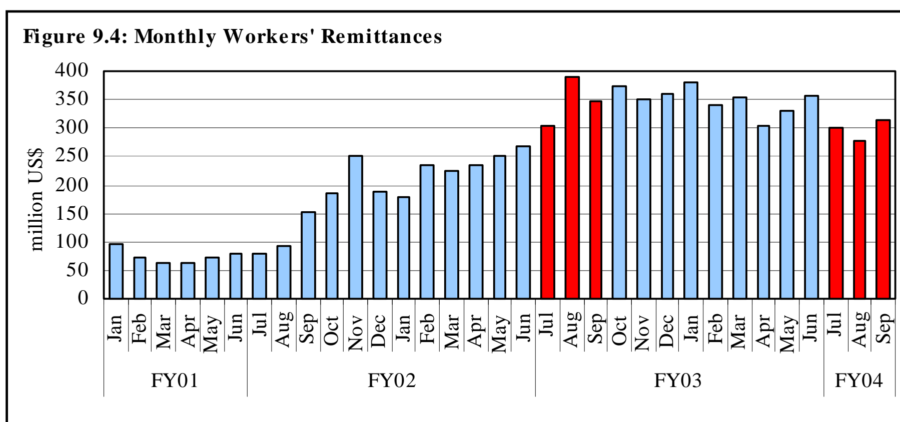
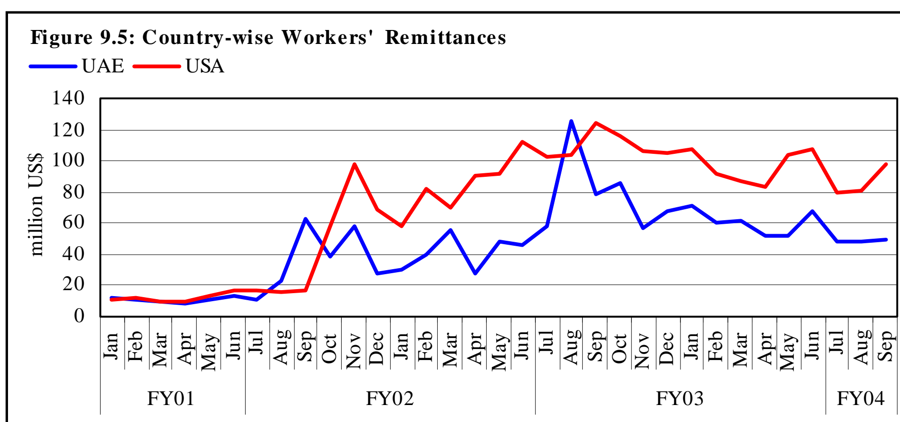


Figure 9.5: Country-wise Workers' Remittances



Resident FCAs

The net inflows under resident FCAs also declined by 72.9 percent (to US$ 45 million) during Q1-FY04 relative to the corresponding period of FY03. However, the US$ 121 million difference in net flows is almost entirely accounted for by a temporary increase in FCAs during Q1-FY03 related to the UBL privatization.

9.2 Capital Account

The capital account deficit increased from US$ 214 million in Q1-FY03 to US$ 496 million during Q1-FY04 (see **Table 9.4**) as a fall in gross outflows was more than offset by a larger drop in gross inflows. The main reasons for lower gross inflows were: (1) the increasing settlement of foreign exchange trade financing against FE-25 deposits during Q1-FY04 as against the net increase in these liabilities over the corresponding period last year; (2) the reduction in non-food aid; (3) the decline in foreign direct investment; and (4) lower inflows of suppliers' credit. On the other hand, outflows were also lower due to the smaller volume of maturing Special US Dollar Bonds, decline in closure of outstanding swaps (as the outstanding stock of swaps was very low by end-FY03) and the contra entry of trade receivables against trade financing.

Table 9.4: Capital Account during Q1

million US Dollars

Items	FY02	FY03	FY04
Capital Account (1 through 9)	-587	-214	-496
Inflows	556	1,494	469
Outflows	1,143	1,706	965
1. Direct investment abroad	0	1	1
2. Direct investment in Pakistan	69	170	117
3. Portfolio investment	-53	-130	-53
Of which:			
Stock markets	-47	-3	-28
Special US Dollar bonds	3	-115	-16
4. Long term capital (official)	-261	68	-23
Of which:			
Project assistance	128	132	182
Food aid	0	0	0
Non-food aid	0	332	136
Amortization	-382	-373	-247
5. Long term capital (DMBs)	-1	0	-13
6. Long term capital (others)	-347	-358	-145
Of which:			
Swaps		200	10
Suppliers credits/MNCs	13	126	58
Supplier credits repayments	-153	-171	-162
7. Short term capital (official)	32	-59	-130
Of which:			
Commercial banks (net)	-72	-40	-17
IDB (net)	61	3	-35
8. Short term capital (DMBs)	53	19	-50
Of which outstanding exports bills	62	24	-27
9. Short term capital (Others)	-79	75	-200
Of which:			
Outstanding exports bills	-81	-7	-135
Trade financing	0	677	-238

Source: Statistics Department, SBP

Note: DMBs: Deposit money banks.

Net foreign investment [6]

During Q1-FY04, the *net* foreign investment (NFI) increased by US$ 24 million

[6] Net Foreign Investment comprises foreign investment both in portfolio and direct investment in Pakistan and abroad.

to US$ 63 million over the corresponding period last year (see **Table 9.4**). However, Q1-FY04 Foreign Direct Investment (FDI) fell 31.2 percent relative to Q1-FY03 to US$ 117 million. A disaggregation of FDI by economic groups reveals that this fall was led by a sharp decline in FDI in the *chemical* sector (the exceptional inflow during Q1-FY03 last year from UK-based ICI was not repeated in Q1-FY04). FDI in the *oil & gas* sector was largely unchanged during this period.

On the other hand, the outflow of portfolio investment decline mainly due to lower volume of maturing Special US Dollar Bonds during Q1-FY04 (treated as outflows in capital account) while the portfolio in stock market increased as the foreign investors realized their capital gains by selling their share holdings in stock market.

Long-term capital (official)

Long-term capital (official) inflows also saw a decline of US$ 91 million during Q1-FY04 over the corresponding period of Q1-FY03. This difference is largely accounted for a lower disbursement (by US$196 million) of non-food aid from IFIs during Q1-FY04, which offset gains from the decline in amortization payments in the same period (see **Table 9.4**). Moreover, as the World Bank and ADB have also agreed to increase the annual assistance to Pakistan, it is expected that these soft-term inflows will increase in the remaining period of FY04.

Long-term capital (others)

Net aggregate outflows under this head (which includes suppliers' credit and swaps) declined by US$ 213 million during Q1-FY04 as compared to the outflows during Q1-FY03 (see **Table 9.4**).

The sharp fall in net outflows of swaps during Q1-FY04, which simply reflects the fact that most swap transactions had already been retired in the preceding fiscal year. This decline in swap outflows comfortably offset the US$ 59 million increase in *net* outflows on account of suppliers credit during Q1-FY04 relative to Q1-FY03. While there was a minor difference in outflows in the corresponding quarters, inflows had been sharply higher in Q1-FY03 (principally due to the supplier's credit availed by PIA).

Short-term capital (deposit money banks & others)

This head comprises of Outstanding Export Bills (OEBs) held by the commercial banks and exporters, foreign currency denominated loans (mainly from FE-25 deposits) and non-resident FCAs mobilized by the commercial banks and NBFIs. Overall, the short-term capital (DMBs & others) recorded a sharp reversal, from

an inflow of US$ 94 million in Q1-FY03 to an outflow of US$ 250 million during Q1-FY04 (see **Table 9.4**). The main driver of this change was: (1) the increase in OEBs stock by US$ 162 million during Q1-FY04, and (2) the increasing settlement of their foreign trade financing liabilities as against the net increase of US$ 677 million in trade financing during Q1-FY03. The increase in the OEBs was probably due to the higher exports and the use of this instrument as a collateral in foreign trade financing.

9.3 Trade Account

Trade deficit narrowed by 23.1 percent to US$ 144.8 million during Q1-FY04 as compared to the same period last year (see **Table 9.5**). This reduction was led by the robust export growth, which easily outpaced the rise in imports, keeping the aggregate trade deficit in line with the US$ 0.7 billion annual target for FY04.[7] As a result of impressive export growth, the import coverage ratio improved to 95.3 percent in Q1-FY04 from 93.2 percent during the same period a year before.

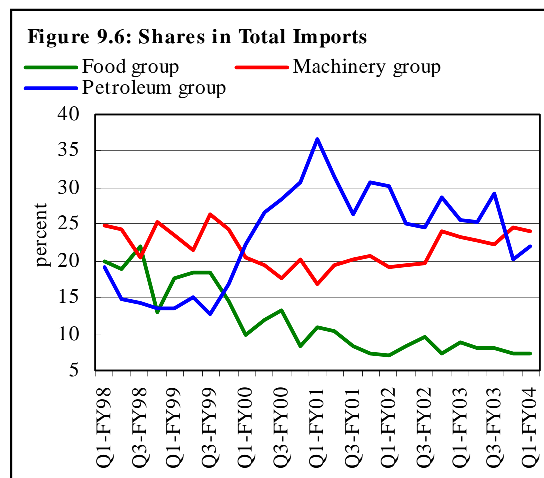
Table 9.5: Trade Deficit during Q1

million US Dollars

	FY03	FY04	Percent change
Imports	2776.8	3112.5	12.1
Exports	2588.4	2967.6	14.7
Trade deficit	188.4	144.8	-23.1

This improvement in trading activity testifies that the FY03 recovery in the economy has continued into Q1-FY04 following an upsurge in agriculture and acceleration in industrial activity. For exports, the textile sector remained the chief contributor to growth, supported by a rise in agricultural product exports.

Figure 9.6: Shares in Total Imports



Within imports, capital goods and raw materials for industry registered an increase, while consumer goods and

[7] Trade policy for FY04 envisaged an export level of US$ 12.1 billion along with US$ 12.8 billion imports projecting the trade deficit for FY04 to be US$ 0.7 billion.

petroleum products fell appreciably in Q1-FY04 pushing up the share of non-food and non-oil imports. This higher non-food and non-oil imports corroborate the view that manufacturing activity in the economy is increasing (see **Figure 9.6**).

9.3.1 Regional Trade Balance

The largest growth in exports was recorded in the Middle Eastern region, mainly caused by higher textile exports to Dubai and Turkey. This, in turn, led to a slight improvement in the trade balance with this region despite higher imports. Pakistan continued to strengthen its trade surpluses with the EU and the US although the magnitude of the improvement was marginally backed by higher textile exports. On the other hand, higher imports of machinery and raw materials from other Asian countries led to worsening of trade balance with this region (see **Table 9.6**).

Table 9.6: Regional Trade Balance during Q1

million US Dollars

	FY03			FY04		
	Exports	**Imports**	**Trade balance**	**Exports**	**Imports**	**Trade balance**
USA	683.5	174.9	508.6	732.1	174.3	557.8
EU	697.8	485.5	212.3	863.0	478.6	384.4
Asia						
Middle East	402.3	899.3	-497.0	505.9	966.7	-460.8
Other Asia	486.2	922.7	-436.5	549.5	1105.0	-555.5
Others	318.5	294.4	24.1	317.2	387.8	-70.6
Total	2588.4	2776.8	-188.4	2967.7	3112.5	-144.8

9.3.2 Exports

Pakistan's Q1-FY04 exports rose to US$ 2.97 billion; not only was this 1.8 percent above the target for the period, it represented a robust 14.7 percent growth over the corresponding period of FY03 (see **Table 9.7**). With the exception of July 2003, the monthly exports are consistently above the US$ 1 billion mark, (see **Figure 9.7**). Thus, given that exports traditionally witness a seasonal rise in the second half of the fiscal year, it appears that the country's

Figure 9.7: Monthly Exports

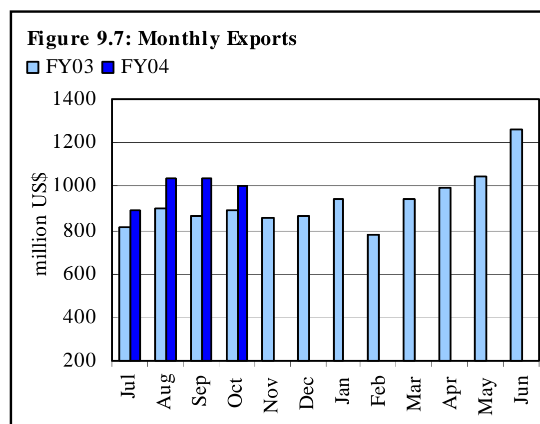


Table 9.7: Major Exports during Q1

Value: million US Dollars: unit value: US Dollars

		Unit	FY03		FY04		Abs chg. In value	% change in FY04/FY03		
			Value	Unit Val.	Value	Unit Val.		Qty	Value	Unit val.
A.	**Primary commodities**		**292.5**		**297.2**		**4.6**		**1.6**	
1	Rice	MT	105.7	342.2	147.9	354.8	42.2	34.9	39.9	3.7
2	Raw cotton	MT	15.1	737.4	3.9	1139.6	-11.2	-83.3	-74.2	54.5
3	Raw wool (excluding wool tops)	MT	0.2	758.4	0.5	978.3	0.3	126.7	192.5	29.0
4	Fish and fish preparations	MT	31.9	1895.6	44.2	1983.5	12.3	32.3	38.4	4.6
5	Leather	SQM	59.0	14.4	53.7	16.0	-5.3	-17.9	-8.9	11.0
6	Guar and guar products	MT	4.1	713.6	5.4	940.8	1.3	0.5	32.5	31.8
7	Fruits	MT	19.3	404.9	27.0	367.1	7.8	54.7	40.3	-9.3
8	Vegetables	MT	3.5	245.9	5.6	195.5	2.1	102.3	60.8	-20.5
9	Crude animal material	MT	3.5	583.7	3.1	1379.3	-0.4	-62.0	-10.1	136.3
10	Oil seeds & nuts etc.	MT	3.4	472.1	0.6	560.1	-2.8	-85.6	-82.9	18.6
11	Wheat	MT	47.0	112.3	5.2	140.8	-41.7	-91.1	-88.9	25.4
B.	**Textile manufactures**		**1705.0**	---	**2000.5**	---	**295.5**	---	**17.3**	---
12	Cotton yarn	MT	238.9	1697.9	222.9	1912.4	-16.0	-17.2	-6.7	12.6
13	Cotton fabrics (woven)	SQM	322.4	0.6	376.0	0.7	53.6	2.4	16.6	13.9
14	Hosiery (knitwear)	DOZ	274.9	22.2	366.1	22.4	91.1	31.6	33.1	1.2
15	Bed-wear	MT	290.3	5385.3	383.1	5713.9	92.8	24.4	32.0	6.1
16	Towels	MT	76.3	3529.9	92.6	3974.2	16.3	7.8	21.3	12.6
17	Cotton bags and sacks	MT	3.8	4080.3	3.5	4066.3	-0.3	-6.3	-6.7	-0.3
18	Readymade garments	DOZ	271.5	30.0	271.3	36.4	-0.2	-17.6	-0.1	21.2
19	Tarpaulin & other canvas goods	MT	13.6	2222.9	15.8	2088.5	2.2	23.9	16.4	-6.0
20	Tule, lace embroidery etc.	---	2.3	---	2.5	---	0.2	---	11.0	---
21	Synthetic textiles	SQM	119.2	0.6	156.1	0.8	36.9	9.5	31.0	19.6
22	Other textile made up	---	88.4	---	108.8	---	20.4	---	23.1	---
23	Waste material of textile fabrics	MT	3.3	628.5	1.7	501.9	-1.6	-37.0	-49.7	-20.2
C.	**Other manufactures**		**412.7**	---	**443.6**	---	**31.0**	---	**7.5**	---
24	Carpets, carpeting rugs & mats	SQM	47.6	49.5	47.8	58.9	0.2	-15.6	0.4	19.0
25	Petroleum and petroleum products	MT	43.5	208.3	62.4	248.2	18.9	20.5	43.6	19.2
26	Sports goods	---	76.9	---	73.4	---	-3.5	---	-4.6	---
27	Leather manufactures	---	113.8	---	114.9	---	1.0	---	0.9	---
28	Surgical and medical instruments	No	34.2	---	28.2	---	-6.0	---	-17.6	---
29	Cutlery	Gr	7.7	23.3	7.1	29.5	-0.5	-26.3	-6.7	26.6
30	Onyx manufactured	MT	3.0	1807.3	2.9	1693.7	-0.1	3.2	-3.3	-6.3
31	Chemicals and pharmaceuticals	---	59.8	---	67.4	---	7.7	---	12.8	---
32	Molasses	MT	9.3	40.9	9.8	30.0	0.5	43.1	5.1	-26.6
33	Sugar	MT	0.1	345.6	10.7	218.6	10.6	19712.6	12435.9	-36.7
34	Footwear		16.9	6.6	19.1	7.5	2.2	-0.5	12.9	13.5
	Others		**178.2**		**226.3**	---	**48.1**	**---**	**27.0**	---
	Total exports		**2588.4**		**2,967.6**	---	**379.2**	---	**14.7**	---
	Excl. major food items and raw cotton		2295.9		2670.5	---	374.6	---	16.3	---
	Excl. major food, raw cotton and yarn		2057.0		2447.6	---	390.6	---	19.0	---
	Memorandum item:									
	Developmental exports		*200.0*		*186.0*	---	14.0	---	7.0	---

annual exports are likely to surpass the US$ 12 billion mark, in accordance with the annual target for FY04 unless the recent pressures on cotton and yarn prices translate into lower volumes of textile exports.

As usual, *textile manufactures* led the export growth, contributing approximately three-fourth of the total increase in exports during Q1-FY04 relative to Q1-FY03, and this was supported by a rebound in exports of *other manufactures* (see **Table 9.8**). Textile manufactures consequently improved their share from 73.6 percent to 78.2 percent in the total exports.

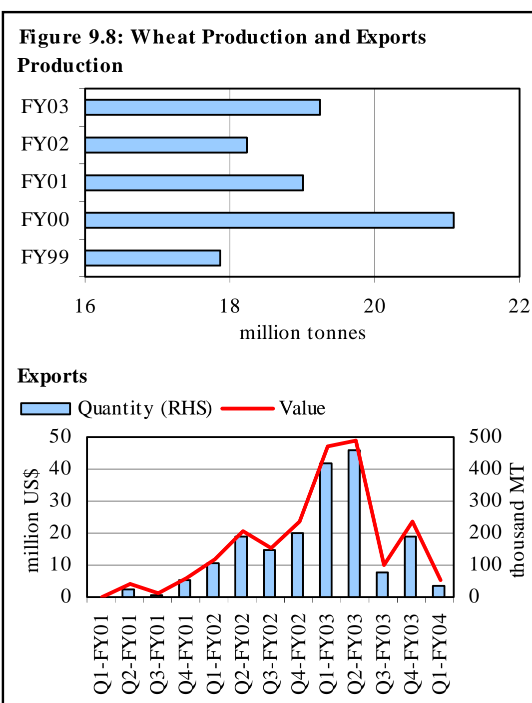
Table 9.8: Share in Growth by Major Export Groups in Q1

percent

	FY03		FY04	
	Growth	Share	Growth	Share
Primary commodities	15.6	12.2	1.6	1.2
Textile manufactures	16.2	73.6	17.3	78.2
Other manufactures	-1.8	-2.3	7.5	8.3
Other exports	37.2	16.5	27.0	12.3
Total	14.3	100.0	14.7	100.0

The performance of the other major exports groups was less satisfactory. *Other exports* and *primary exports* witnessed a deceleration relative to Q1-FY03. The slow down in primary commodities exports, in particular, seems driven by a decline in exports of cotton and leather (possibly due to higher domestic consumption) and wheat (due to a relatively weak harvest).

Figure 9.8: Wheat Production and Exports

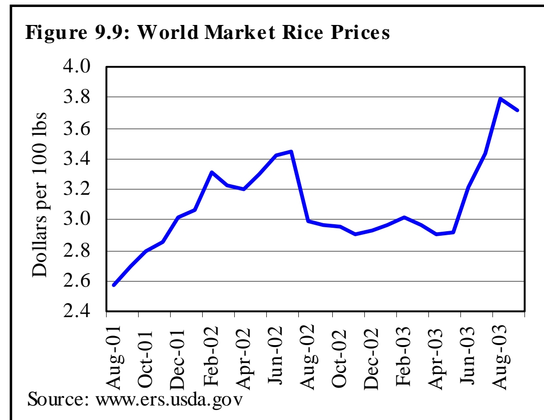


Wheat exports, after registering a record growth in FY03, witnessed a sharp fall (88.9 percent) in Q1-FY04, mainly due to below target production for the last two successive years. In effect, therefore, the wheat exports since FY01 were possible only due to the bumper crop in FY00 (see **Figure 9.8**).

The fact that some wheat was exported in Q1-FY04 despite the obvious shortfall in production (and the emergence of an import requirement to meet domestic requirements), owes to a deliberate policy to retain a presence in world markets in anticipation of an exportable surplus after the FY04 wheat harvest.

Rice exports recorded a 39.9 percent growth in Q1-FY04 over the same period last year. As the period from July to September marks the end of rice marketing season in Pakistan, the export growth in this period was largely due to fulfillment of old contracts. However, the annual FY04 exports are expected to continue to depict robust growth following the good FY04 harvest and a small rise in international prices; the unit values for both basmati and non-basmati varieties witnessed improvement in this period due to tightening supplies in some major exporting countries, particularly Australia, India, and the United States (see **Figure 9.9**).

Figure 9.9: World Market Rice Prices



Source: www.ers.usda.gov

The value of exports of both IRRI and basmati rice increased, but the share of basmati rice in the total witnessed a marginal fall in terms of volume during Q1-FY04. While exports of non-basmati rice rose in Africa and the EU, improving the market shares; basmati exports gained ground in the UAE, Iran and the EU markets (see **Table 9.9**).

Table 9.9: Regional Distribution of Rice Exports during Q1

percent

	FY03	FY04	FY04
	Quantum shares		*U. Val. growth*
Basmati	51.1	50.6	3.7
Non-Basmati	48.9	49.4	5.3
Basmati	*Market shares*		
UAE	37.8	45.1	2.9
Saudi Arabia	6.1	6.4	15.4
Iran	3.9	6.2	0.8
EU	8.6	10.3	4.6
Non-Basmati	*Market shares*		
UAE	36.0	22.7	16.6
Saudi Arabia	2.5	2.4	-4.1
Iran	30.0	14.7	16.2
EU	0.5	9.4	-3.8
Major African Markets	21.4	36.5	5.7

Given the importance of the EU market for both basmati and non-basmati exports, the

threat of reduced duty-free access for some varieties of rice exports, however, has clouded export growth prospects. The EU has announced its intention to end duty-free access to Basmati rice after negotiations under Article XXVIII of the GATT with countries exporting rice to the EU region.[8] This decision, which reflects the June 2003 Common Agricultural Policy (CAP),[9] is probably a consequence of the increased rice production in EU that has led to an increased protectionist pressures.[10]

Textile Exports

Textile exports recorded a 17.3 percent growth over the same period last year, contributing 78.2 percent of the *growth* in overall exports during Q1-FY04. Encouragingly, this growth was caused by higher unit prices for major categories, as well as an increase in the quantum of exports for most major categories (other than cotton yarn and ready-made garments) (see **Table 9.10 and Figure 9.10**). The trend of changing intra-sectoral composition of textile exports shifting towards value added textiles, compared to combined cotton yarn and cotton cloth, was discernible as the former accounted for 70 percent of the textile manufactures in Q1-FY04 compared to 67 percent in the corresponding period of FY03. A positive aspect of the Q1-FY04 textile performance was the impressive growth in non-quota textile exports (see **Table 9.11**).

Table 9.10:Quantum and Price Impact on Textile Exports
million US Dollars

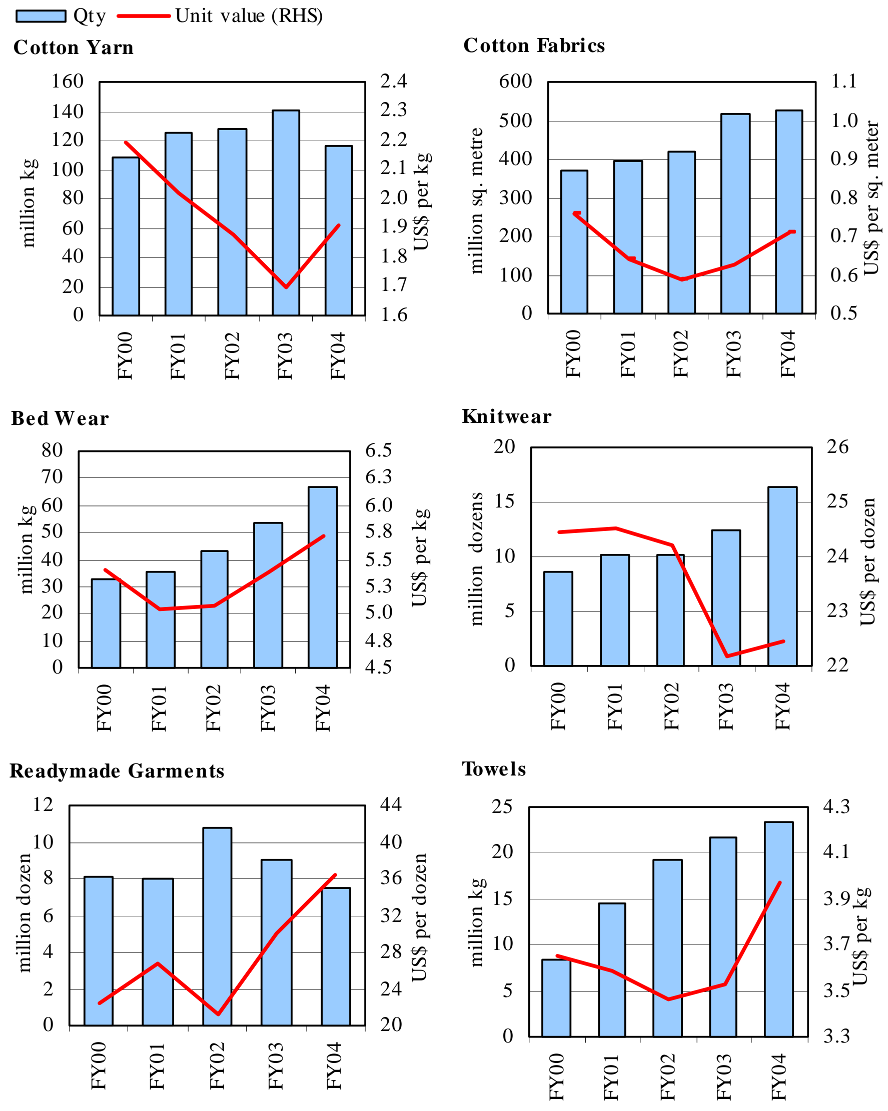
	Quantum	Price	Overall
Cotton yarn	-41.0	25.0	-16.0
Cotton fabrics	7.7	45.9	53.6
Hosiery (knitwear)	86.8	4.3	91.1
Bedwear	70.8	22.0	92.8
Readymade garments	-47.7	47.5	-0.2

Table 9.11: Composition of Textile Export Markets in Q1
percent

	Share in exports		Growth in exports
	FY03	FY04	
Non-quota exports	**59.6**	**60.5**	19.1
Quota exports	**40.4**	**39.5**	14.8
USA	20.1	18.3	6.6
EU	18.3	19.1	22.1
Canada	0.8	0.6	-9.4
Turkey	1.1	1.5	59.3

[8] Article XXVIII of the GATT of 1994 provides the procedure for a country to re-negotiate concessions granted under trade agreements to rationalize the trade structure.
[9] CAP reforms halved the intervention price that was guaranteed to its rice growers. As this move is expected to trigger a flood of imports, the council has authorized the commission to open negotiations with its trading partners under the framework of Article 28 of the WTO, in order to curtail the level of imports.
[10] USDA estimates indicate an 8 percent increase in EU rice production in 2002-03 compared to the previous year, to 1,759 thousand metric tones.

Figure 9.10: Major Textile Manufactures- Q1 Export Quantum and Unit Prices



Bed-wear exports were the highest earning category in the textile sector, registering a 32 percent rise over the same period last year. Encouragingly, exports to non-quota destinations made the highest contribution to this growth.

While most of the quota exports were directed towards EU, the US remained the major destination for country's non-quota bed-wear export (see **Table 9.12**). The rising share of non-quota exports is a positive sign for the long run export growth of this category, as it mitigates the concerns regarding loss of fixed market access after phasing out of quota restrictions in 2005.[11]

Table 9.12: Growth Pattern of Bed-wear Export Markets

percent

	Q1-FY04	
	Growth	**Contribution in growth**
Quota exports	11.4	4.7
Non-quota exports	46.6	27.1
Quota exports	**11.4**	**4.7**
US	3.2	0.4
EU	12.8	3.7
Canada	-1314.4	0.6
Non-quota exports	**46.6**	**27.1**
US	60.1	10.8
EU	89.3	8.7
Canada	-24.7	-0.4
Turkey	160.7	0.0
Others	28.0	8.1
Total	**31.9**	**31.9**

Cotton yarn exports continued the declining trend that started in FY03 and registered a 6.7 percent fall in Q1-FY04 over the same period last year. This fall was caused by falling export quantum (17.2 percent) while unit values for cotton yarn continued the upward trend of the last year (12.6 percent growth). This fall in the quantum of yarn exports can be attributed to the rising domestic consumption of cotton yarn[12] that has caused the exportable surplus to fall as well as the declining external demand.

Hong Kong, South Korea and China are major markets for country's yarn exports accounting for around 52.3 percent share in the total yarn export quantum. Yarn exports to China and Korea have however declined since last year after the outbreak of SARS (see **Figure 9.11**). The decline of export volume to Korea is however alarming; although Korea imported lower volume of yarn from almost all its suppliers in 2003, but the fall recorded for Pakistan was the highest in absolute terms in the period of Jan-Jul 2003.[13] As a matter of fact Pakistan was the largest

[11] The share of non-quota bed-wear exports (in total bed-wear exports) increased from 58.2 percent in Q1-FY03 to 64.7 percent in Q1-FY04.
[12] Domestic production of cotton cloth that uses cotton yarn as a basic raw material, registered a 21.3 percent growth in the period of Jul-Aug 2003 as compared to 4.0 percent growth in the same period last year.
[13] Pakistan's yarn export quantum to S. Korea fell by 18,604 MT in the period of Jan-Jul 2003; while in the same period India's yarn export quantum fell by 1,353 MT. (Source: www.globecotnews.com).

supplier of cotton yarn to Korea in 2001, seems to have lost its market share to India.[14]

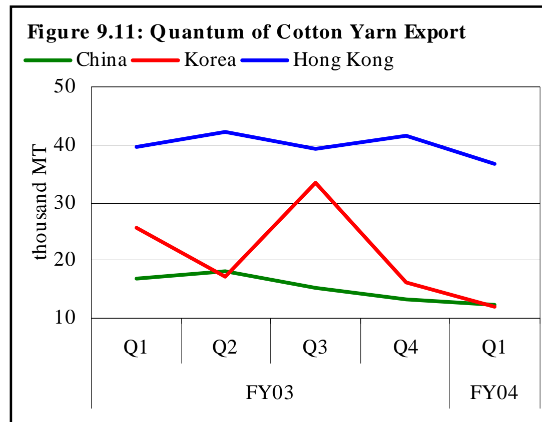


Figure 9.11: Quantum of Cotton Yarn Export

9.3.3 Imports

Imports recorded a 12.1 percent growth in Q1-FY04 reaching US$ 3.1 billion i.e., 24.3 percent of the annual target for FY04. Encouragingly, the rise in imports was contributed largely by higher imports of capital good and industrial raw material (see **Figure 9.12**). By contrast, the imports of *consumer goods* registered a marginal (2 percent) fall in the period, mainly due to lower food group imports (see **Table 9.13**).

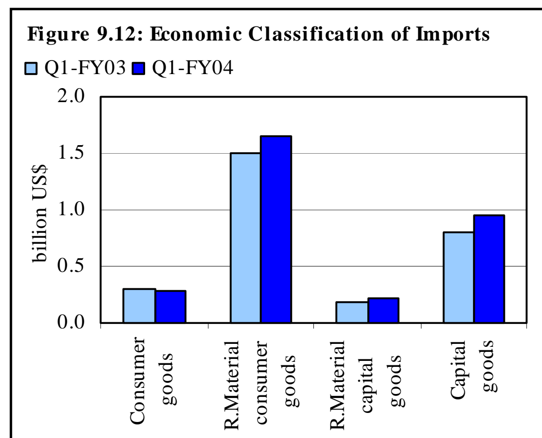


Figure 9.12: Economic Classification of Imports

Food Group imports recorded a 6.5 percent fall in Q1-FY04 over the same period last year. This fall has taken place due to lower demand of imports for agricultural commodities such as, pulses, un-milled wheat, dry fruits and milk & milk preparations, as the domestic production was higher (see **Figure 9.13**). The import of pulses, in particular, registered a sizable fall.[15] However, the import of edible oil and tea remained substantial (see **Table 9.13**).

[14] Pakistan was the single largest supplier of cotton yarn for S. Korea in 2001; capturing 42.9 percent share in its total yarn imports. This position was however snatched by India in the preceding years, and now in Jan-Jul 2003 despite a fall in Korean Yarn imports it captured 45.3 percent share in this market, whereas share of Pakistan's export shrank to 31.1 percent.

[15] The production of the three major pulse varieties i.e., *masoor*, *mung* and *mash* registered 8.0, 16.5 and 22.3 percent growth in FY03 as compared to FY02.

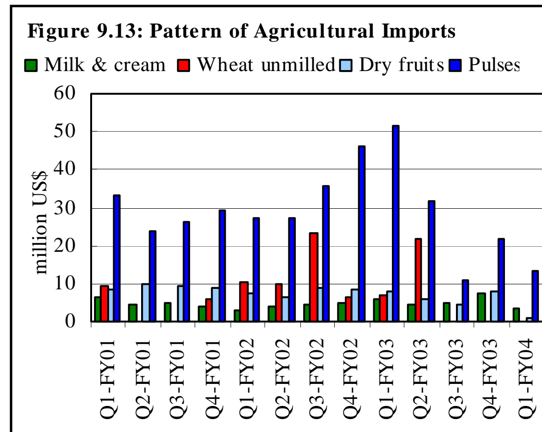
Table 9.13: Major Imports

Value: million US Dollars; unit value US Dollars

Sr. No	Commodities	Units	Q1-FY03		Q1-FY04		Abs chg.	% chg in Q1-FY04/Q1-		
			Value	Unit Val.	Value	Unit Val.		Qty	Value	Unit Val.
A.	**Food group**		**242.7**		**227.0**		**-15.7**	**---**	**-6.5**	**---**
1.	Milk & cream and milk food	MT	5.9	1803.1	---	,297.7	-2.3	-52.5	-39.4	27.4
2.	Wheat unmilled	MT	7.0	192.8	---	---	-7.0	-100.0	-100.0	---
3.	Dry Fruits	MT	7.9	317.2	---	255.8	-7.0	-85.9	-88.6	-19.4
4.	Tea	MT	37.8	1588.6	---	1,561.0	2.6	8.8	6.9	-1.7
5.	Spices	MT	5.0	640.4	---	490.1	3.2	113.1	63.1	-23.5
6.	Edible oil	MT	127.1	418.5	---	452.8	33.1	16.5	26.1	8.2
	Soya bean	MT	2.0	408.4	---	*545.2*	5.3	174.7	266.8	33.5
	Palm oil	MT	125.1	418.6	---	*449.2*	27.9	14.0	22.3	7.3
7.	Sugar	MT	0.5	333.4	---	308.8	0.2	45.0	34.4	-7.4
8.	Pulses	MT	51.4	301.4	---	288.1	-38.5	-73.7	-74.9	-4.4
B.	**Machinery group**	---	**646.6**	---	---	---	**103.3**	---	**16.0**	---
1.	Power generating machinery	---	69.8	---	---	---	7.0	---	10.0	---
2.	Office machinery	---	51.2	---	---	---	-0.5	---	-0.9	---
3.	Textile machinery	---	111.6	---	---	---	7.0	---	6.3	---
4.	Construction & mining mach.	---	25.0	---	---	---	3.6	---	14.5	---
5.	Elect. machinery & apparatus	---	45.4	---	---	---	11.4	---	25.0	---
6.	Railway vehicles*	---	15.7	---	---	---	18.9	---	120.5	---
7.	Road motor vehicles	---	111.4	---	---	---	30.4	---	27.3	---
8.	Aircraft, ships and boats	---	20.7	---	---	---	8.1	---	39.1	---
9.	Agri. mach. and implements	---	7.8	---	---	---	-2.5	---	-31.8	---
10.	Other machinery	---	188.0	---	---	---	19.9	---	10.5	---
C.	**Petroleum group**	**MT**	**707.5**	**192.1**	---	210.2	**-22.8**	**-11.5**	**-3.2**	**9.4**
1.	Petroleum products	MT	380.4	190.5	---	219.6	-97.0	-35.3	-25.5	15.2
2.	Petroleum crude	MT	327.2	194.0	---	204.0	74.2	16.7	22.7	5.2
D..	**Textile group**	**MT**	**54.7**	---	---	---	**7.6**	---	**14.0**	---
1.	Synthetic fibre	MT	22.6	1215.9	---	1,422.0	0.6	-12.2	2.6	17.0
2.	Synthetic & artif. silk yarn	MT	22.5	1489.0	---	1,549.0	6.8	25.4	30.4	4.0
3.	Worn clothing	MT	9.7	307.1	---	330.2	0.2	-4.9	2.2	7.5
E.	**Agri/. & other chem. group**	**MT**	**542.9**	---	---	---	**102.9**	---	**18.9**	---
1.	Fertilizer	MT	62.3	183.0	---	197.9	1.4	-5.5	2.2	8.1
2.	Insecticides	MT	30.0	2582.5	---	3,024.9	11.4	17.7	37.9	17.1
3.	Plastic materials	MT	100.7	799.9	---	832.0	20.1	15.3	19.9	4.0
4.	Medicinal products	MT	52.1	25527.0	---	27,497.0	11.5	13.3	22.1	7.7
5.	Others	---	297.7	---	---	---	58.6	---	19.5	---
F.	**Metal group**	**MT**	**106.5**	---	---	---	**36.4**	---	**34.2**	---
1.	Iron and steel scrap	MT	9.6	137.2	---	154.7	12.0	99.4	124.8	12.7
2.	Iron and steel	MT	85.7	347.3	---	378.9	19.1	12.1	22.3	9.1
3.	Aluminum	---	11.1	---	---	---	5.2	---	47.1	---
G.	**Miscellaneous group**		**73.4**	---	**86.3**	---	**12.9**		**17.6**	---
1.	Rubber crude	MT	10.4	708.9	---	858.2	6.4	33.5	61.6	21.1
2.	Rubber tyres & tubes	No.	19.8	20.2	---	20.6	3.0	13.0	15.3	2.0
3.	Wood & cork	---	10.0	---	---	---	-5.4	---	-54.1	---
4.	Jute	MT	2.8	270.0	---	239.4	3.3	147.4	119.4	-11.3
5.	Paper, paperboard and Manu.	MT	30.4	586.7	---	591.9	5.6	17.2	18.3	0.9
H.	**Others**		**402.4**		**513.4**		---	---	---	
	Total imports:		**2776.8**		**3112.5**		**335.7**	---	**12.1**	---
	Excl. food group		2534.1		2885.4		351.4		13.9	---
	Excl. POL group		2069.3		2427.7		358.4	---	17.3	---
	Excl. food & POL group		1826.5		2200.7		374.1	---	20.5	---

Machinery Group imports continued to show an upward trend and recorded a 16 percent rise this quarter over the same period of FY03, accounting for almost a third of the growth in the import bill in Q1-FY04 relative to Q1-FY03 (see **Table 9.14**). The machinery imports, in turn, were led by road motor vehicle and textile machinery imports.

Figure 9.13: Pattern of Agricultural Imports



The growth in the road motor vehicles imports reflected the increased demand for automobiles in the country due to the increased access to consumer finance, whereas the 6.3 percent jump in import of textile machinery mirrored the increased focus on BMR to prepare for the expected increase in competitive pressures post 2004. A substantial part of the textile machinery imports were from the EU region (see **Table 9.15**).

Table 9.14: Share in Q1-Growth by Major Import Group
percent

	FY03		FY04	
Groups	**Growth**	**Share**	**Growth**	**Share**
Food	38.4	24.7	-6.5	-4.7
Machinery	34.8	61.2	16	30.8
Petroleum	-6.4	-17.6	-3.2	-6.8
Textile	36.2	5.3	14	2.3
Agri. & other Chem.	12.6	22.2	19	30.7
Metal	-8.9	-3.8	34.2	10.8
Miscellaneous	16.1	3.7	17.6	3.8
Others	3	4.3	27.6	33.1
Total	**10.9**	**100**	**12.1**	**100**

Table 9.15: Major Textile Machinery Suppliers during Q1
million US Dollars

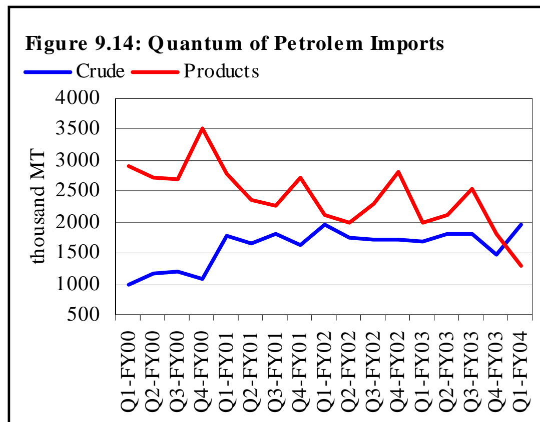
	FY03	**FY04**
Japan	27.5	32.6
China	7.5	14.7
EU	56.4	38.0
Others	20.3	33.4
Total	111.6	118.7

POL Group

The petroleum group imports, were marginally lower (3.2 percent) in Q1-FY04 when compared with Q1-FY03, despite almost a 10 percent rise in the unit values of POL. The net effect of the sharp decline in the quantity of *petroleum products* imports was, however, partially offset by the rise in *petroleum crude* imports (see **Table 9.13**). The quantum of petroleum product imports has been declining since Q4-

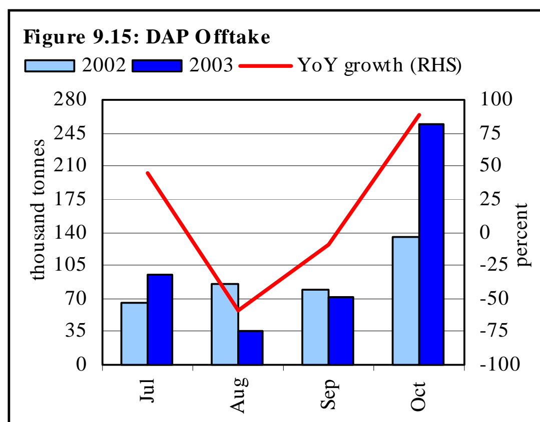
FY01, and the quantum imported in Q1-FY04 is now approximately a third of that peak (see **Figure 9.14**). This trend not only represents a substitution of POL products with alternative fuels[16], but also incorporates the increased output of domestic refineries (as evident in the consistently high crude oil imports since Q4-FY01).

Figure 9.14: Quantum of Petrolem Imports



Agriculture and other Chemicals group imports recorded an 18.9 percent rise in Q1-FY04. This rise was caused by both, higher quantum of imports (other than *fertilizers)* and increased unit values in all sub-categories.

Figure 9.15: DAP Offtake



Fertilizer category imports largely constitute of Diammonium Phosphate (DAP), which dropped during Q1-FY04 relative to the corresponding period of FY03, despite the closure of domestic production capacity, probably due to high international prices.[17] However, the sharp jump in October 2003 is a harbinger of a rising demand for DAP due to increased demand for the wheat production. The rise in the support price for FY04 wheat sowing season probably contributed to this higher demand (see **Figure 9.15**).

[16] Growth in petrol consumption has probably slowed due to increasing dependence on natural gas, while fuel oil demand would have been affected by substitution with coal (and lately high hydel power production).

[17] The prices of DAP in the world's three largest producer countries displayed increasing trend, which is reflected in the high spot prices in Jordan, North Africa and the US which recorded 9.4,12.9 and 6.5 percent growth respectively during August 2003 over the same period last year.

Metal group imports registered 34.2 percent rise in Q1-FY04 compared to Q1-FY03, which reflects an increase in international prices as well as higher industrial (and particularly construction) activity in the country. The rise in iron and steel scraps however, reflects the renewed activity at the Gadani ship-breaking yard.

9.4 Exchange Rate Policy

The Rupee has generally traded within a narrow band (Rs 0.15/US$) since March 2003, owing largely to the SBP's effort to stabilize the exchange rate (see **Figure 9.16**). However, through most of Q1-FY04 the Rupee traded in the higher ranges of this trading band.

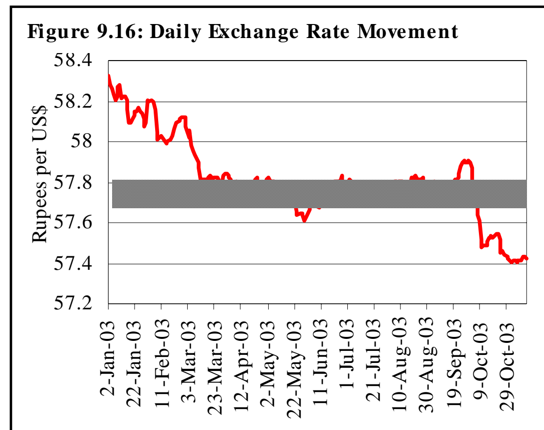


Figure 9.16: Daily Exchange Rate Movement

In fact, this was because of a short-term squeeze in market liquidity which forced the Rupee/US$ parity to a six-month high of Rs 57.91/US$ by end-September 2003, before declining again. Therefore Q1-FY04 was the first quarter since Q3-FY02 to record a net depreciation of the Rupee. More specifically, the Rupee depreciated marginally by 0.19 percent in Q1-FY04, in contrast to the appreciation of 1.50 percent in Q1-FY03 and relatively stable exchange rate (0.04 percent appreciation) in Q4-FY03.

A decline in inter-bank liquidity had been evident since Q4-FY03 due to the declining remittances (**Figure 9.17**), the net retirement of FE-25 loans, and the relatively higher debt related payments which, taken together with a positive kerb market premium, had raised market concerns of a possible depreciation of the Rupee. This behavior is clearly reflected by the increased

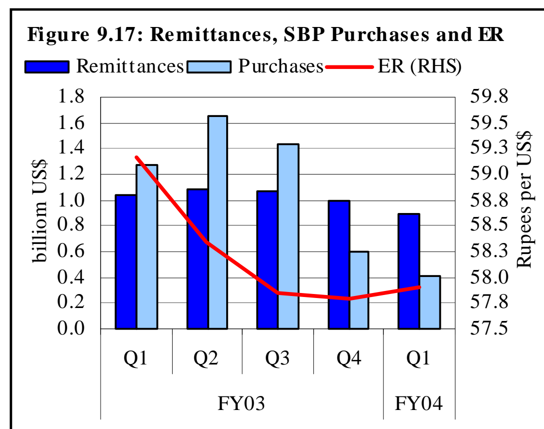


Figure 9.17: Remittances, SBP Purchases and ER

holdings of outstanding export bills by the exporters during Q1-FY04 (see **Figure 9.18**). In response, the SBP sought to allay these concerns by lowering its net purchases from the inter-bank market.

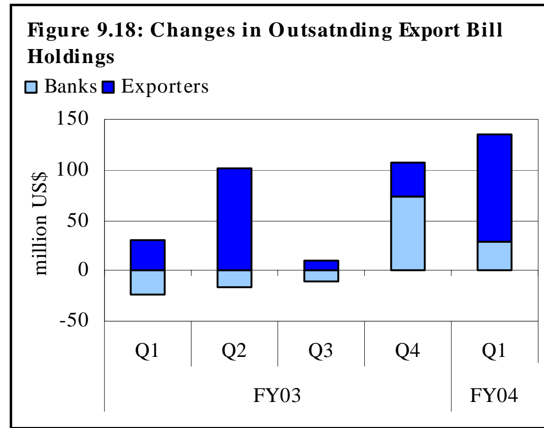


Figure 9.18: Changes in Outsatnding Export Bill Holdings

In fact, the SBP was a net seller in the forex SPOT market during both Q4-FY03 as well as Q1-FY04. Similarly, in the forward market too, the SBP moved from being a net purchaser in Q4-FY03 to a net seller by Q1-FY04. The SBP's aggregate net forex *purchases* in the latter quarter were essentially due only to maturing prior period transactions (i.e., forward transactions undertaken in earlier quarters).

The changes in the profile of SBP's forward transactions clearly captures the shift in the market expectations on the Rupee/US$ parity. During Q1-FY04, exporters that had earlier sold forward began covering short positions. Similarly, importers also sought to hedge exchange rate risk by increasing forward purchases.

The net rising demand in the forward market due to short covering (and lower sales by exporters) and demand from importers, during Q1-FY04 also pushed up the forward premium marginally into positive territory by August 2003 (**Figure 9.19**). This upward movement in the forward premium was supported by a small rise in Rupee interest rates which pulled up the differential between Rupee and US$ interest rates.

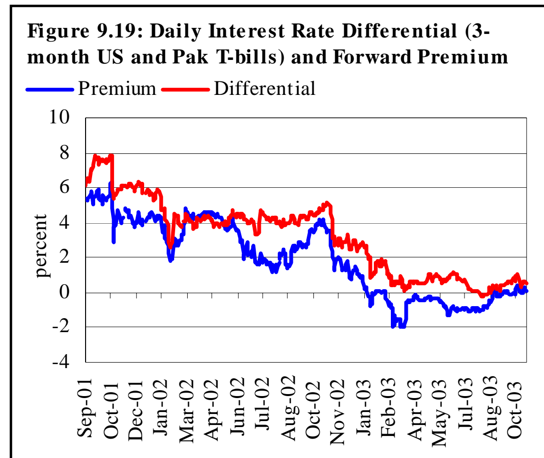


Figure 9.19: Daily Interest Rate Differential (3-month US and Pak T-bills) and Forward Premium

The fading expectations of a Rupee appreciation coupled with the narrowed interest rate differential made the FE-25 loans unattractive by April 2003. The impact of both these factors that initiated net retirement of forex loans in Q4-FY03 gained further momentum in Q1-FY04 (see **Figure 9.20**). In fact, the expectation of a Rupee depreciation was so strong that market players sought to adjust forex loans (even ahead of maturity) from the inter-bank market (after taking permission from SBP) (see **Figure 9.21**). This, in turn, put further pressure on forex market liquidity and forced the SBP to inject the liquidity in the market during Q1-FY04.

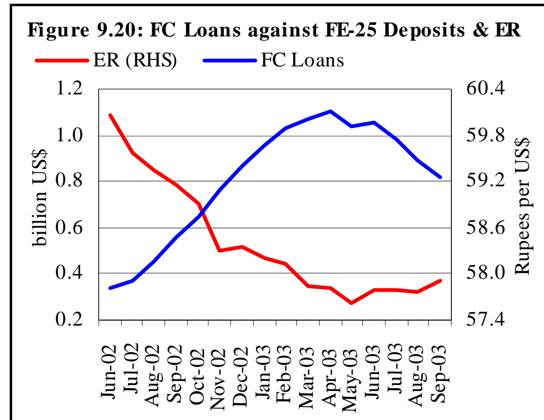


Figure 9.20: FC Loans against FE-25 Deposits & ER

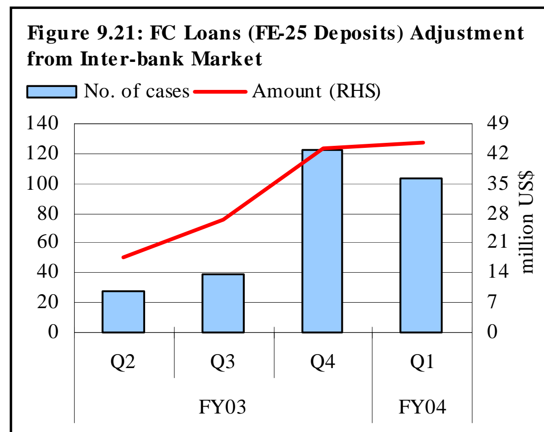


Figure 9.21: FC Loans (FE-25 Deposits) Adjustment from Inter-bank Market

A point worth making here is that the market expectations of Rupee depreciation were fundamentally flawed in view of the significantly positive SBP market purchases, even during periods when the Rupee witnessed marginal appreciation. Clearly, the central bank had ample room to protect the Rupee through lower purchases as well as simple forex market injections. Indeed this is precisely what transpired as timely SBP liquidity injections through SPOT and swap transactions ensured that a weakening of the Rupee did not take root.

Thus, amidst a lower SBP net market purchases as well as the absence of payment pressures, a renewed ascent of the Rupee in October 2003 finally put to rest any lingered concerns over the direction of the Rupee/US$ parity.

Going forward, concerns over the substantial NFA-denominated reserve money growth (discouraging higher forex market purchases), the rise in invisible account outflows and weakness in remittances flows, are likely to moderate the rate of Rupee appreciation.

Table 9.16: Rupee vis-à-vis Selected Currencies (Changes)
percent

	FY03				FY04
	Q1	Q2	Q3	Q4	Q1
US Dollar	1.5	1.2	0.9	0.0	-0.2
Euro	-1.0	-2.5	-4.9	-7.3	3.8
Japanese Yen	-3.1	2.7	-2.0	-0.2	-2.8
Pound Sterling	-4.7	-0.6	0.8	-4.3	2.9
Indian Rupee	0.3	0.7	-0.1	-1.9	-2.1
Chinese Yuan	1.5	1.4	0.9	0.1	-0.2
Indonesian Rupiah	-21.9	1.1	38.2	-6.6	2.4
Thai Bhat	1.1	2.5	37.1	-28.8	-3.0

9.4.1 Real Effective Exchange Rate (REER)

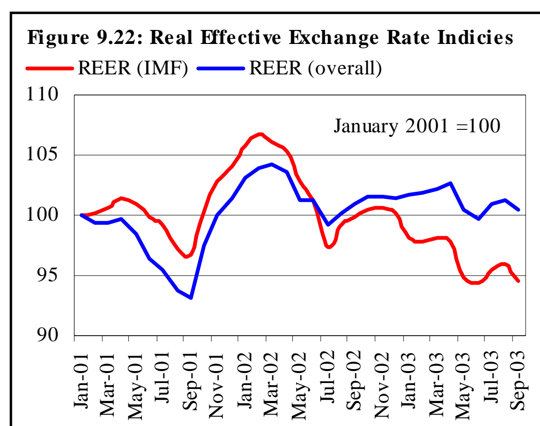


Figure 9.22: Real Effective Exchange Rate Indicies

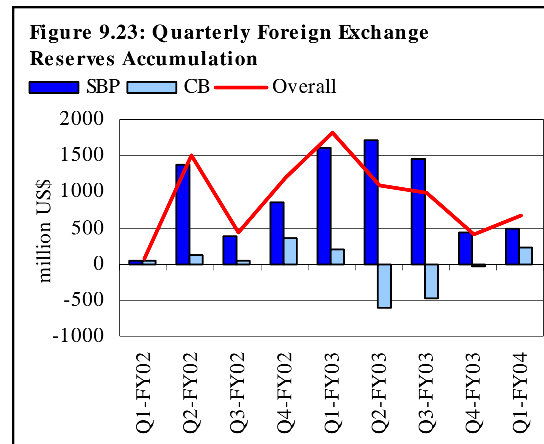
In nominal terms, the rupee depicted a mixed trend against major currencies in its basket of trading partners/competeitors (see **Table 9.16**). However, the appropriate indicator of competitiveness is the real effective exchange rate (REER). The movements in REER showed that the Rupee, during Q1-FY04, appreciated by 0.8 percent and 0.3 percent relative to end June 2003 as measured by REER (overall) and REER (IMF) respectively (see **Figure 9.22**). The slight loss in competitiveness has occurred due to the relatively higher domestic inflation compared with the major trading partners.

9.5 Foreign Exchange Reserves

As discussed in the preceding section, the developments in inter-bank forex market resulted in a slow down in the rate of accumulation of foreign exchange reserves in Q1-FY04 relative to the corresponding quarter of FY03; the increase was limited to US$ 674 million compared to US$ 1.8 billion recorded in Q1-FY03. The aggregate level of forex reserves rose to US$ 11.4 billion. The Q1-FY04 increase in reserves, however marks a robust 66 percent jump over the accumulation in the immediately preceding quarter, reversing (at least temporarily) the steady deceleration in the pace of reserve accumulation in each quarter after Q1-FY03 (see **Figure 9.23**).

The relatively weaker reserves growth compared to corresponding quarter last year is largely due to the *lower inflows* on account of workers' remittances, loan disbursement and FCA held by residents; as well as *higher outflows* mainly due to higher imports, travel account and outstanding export bills (see **Table 9.17**). Encouragingly, much of the rise in foreign exchange reserves in Q1-FY04 was backed by the non-debt creating flows. More specifically, as against 90 percent in Q1-FY03, the ratio of non-debt creating inflows to total inflows has increased to 93 percent in Q1-FY04.

Figure 9.23: Quarterly Foreign Exchange Reserves Accumulation



Another significant development in Q1-FY04 is the re-emergence of commercial banks' contribution to reserve growth; since Q1-FY03, this contribution had been negative, reflecting both, a decline in forex accounts held with commercial banks, as well as the adjustment of FE-25 loans.[18] However, the fading expectations of a Rupee appreciation (as well as the absence of interest rates differentials) reversed the impact by Q1-FY04. The US$ 227.0 million growth in forex reserves of commercial banks in this period was principally contributed by the retirement of foreign currency loans availed against the FE-25 deposits that reached US$ 963.2 million at end quarter from US$ 1102.5 million and inflow of new FE-25 deposits that increased by US$ 43.0 million to US$ 2339.4 million by Q1-FY04.

Nonetheless, even in Q1-FY04, the greater contribution to reserve growth continued to be through SBP reserves (US$ 487 million); the 5.1 percent growth in SBP reserves in the period was higher than growth of 4.8 percent in Q4-FY03 but lower than 36.9 percent growth in the corresponding quarter last year. A comparison with Q1-FY03 reveals that while both gross inflows and gross outflows declined in Q1-FY04, the decrease in former overshadowed the fall in latter. The lower SBP purchases in the face of a decline in remittances and lower disbursements of multilateral loans, were the major factors behind sharp decline of

[18] Since December 2002, the forex loans (against FE-25) disbursed by commercial bank have been subtracted from the commercial banks reserves and added to the SBP reserves.

Table 9.17: Overall Reserves as per BOP[1]
million US Dollars

	FY03				FY04
	Q1	**Q2**	**Q3**	**Q4**	**Q1**
Opening balance	6398	8818	10070	11037	11,667
Inflows	**7,273**	**6,380**	**5,677**	**5,912**	**6,173**
Exports of goods	2623	2550	2606	3110	3078
Export of services (excluding interest)	858	497	987	488	853
Of which: logistics support	317	0	530	0	384
Workers' remittances	1053	1095	1083	1006	906
Foreign direct investment	161	164	116	144	117
Foreign portfolio investment	-3	33	-24	16	-28
Loan disbursements	730	531	349	598	451
Official	604	486	319	449	393
Long-term loans	577	408	264	422	318
Program loans	445	292	129	224	136
IMF	115	115	118	121	0
IDA/IBRD	202	0	11	0	0
ADB	128	177	0	103	136
Project & food loans	132	116	135	198	182
Short-term including IDB	27	78	55	27	75
Private un-guaranteed	126	45	30	149	58
Privatization proceeds	10	176	0	0	0
Official grants	278	292	301	183	220
USA	0	0	0	0	0
Saudi oil facility	189	207	170	70	147
Others	89	85	131	113	73
Other receipts	1563	1042	259	367	576
Outflows	**4,853**	**5,128**	**4,710**	**5,282**	**5,538**
Imports of goods	2769	2853	2744	2967	3138
Imports of services (excluding interest)	579	586	649	900	826
Interest payments	227	246	239	264	212
Amortization of official loans	257	329	284	361	388
IMF	89	74	117	138	141
IDA/IBRD	93	72	98	75	108
ADB	48	84	56	80	57
Others actual paid	27	99	13	68	82
Profit and dividends	241	290	234	339	244
Principal repaid on private loans	172	140	178	173	162
Foreign exchange liabilities liquidated	432	263	392	105	93
FE-31	18	88	65	0	0
FE-45	5	39	191	0	0
PTMA & commercial loans	40	14	15	15	17
IDB (short term)	24	22	76	61	35
Swaps	230	5	0	0	0
NBP deposits	0	0	0	0	0
Special $ bonds	115	95	45	29	41
Other payments	176	421	-10	173	475
Net inflows	**2,420**	**1,252**	**967**	**630**	**635**
Gross reserves at end of period	*8,818*	*10,070*	*11,037*	*11,667*	*12,302*
CRR	459	422	434	468	476
Sinking fund[2]	637	900	915	920	920
Net reserves of SBP	*5,940*	*7,654*	*9,093*	*9,529*	*10,019*
CB Reserves (including CRR)	2241	1516	1029	1218	1363

[1]The data used in the Table (9.5.1) differs from the data in the text because (1) it is based on exchange records (2) overall reserves includes sinking fund (3) SBP reserves includes Indian Pending Transfers and (4) CB reserves includes Trade Nostro.
[2] This fund is established through the purchases of foreign currency lending from the inter-bank for extinguishing central banks deposits placed with SBP or prepayments of other expensive loans.

inflows. The outflows declined because of the fall in debt servicing and lower payments of external liabilities, in particular swaps.

Adequacy of Reserves

Conventional measures of reserves adequacy clearly indicate that Pakistan's ability to meet any external shock has improved further in Q1-FY04.

The *import coverage* ratio, which measures the import finance capacity of country, increased from 45.9 weeks to 46.4 weeks by the end of Q1-FY04 (see **Figure 9.24**),[19] despite the substantial growth in the country's import bill. The jump in reserves also moderated Pakistan's net external debt ratios and enhanced short-term debt coverage capacity. As compared to the preceding quarter, the reserves to short-term debt & liabilities ratio increased from 4.6 at end-June 2003 to 5.1 by end September 2003 (see **Figure 9.25**). Similarly, foreign exchange reserves in terms of the total debt and liabilities further improved in Q1-FY04 to 0.32 from 0.30 in the preceding quarter (see **Figure 9.26**).

Figure 9.24 : Reserves Adequacy - Weeks of Imports

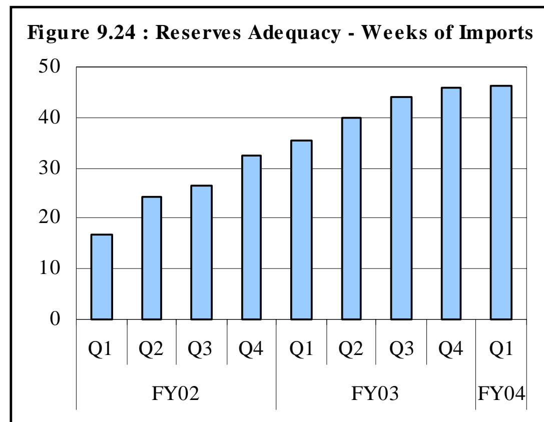
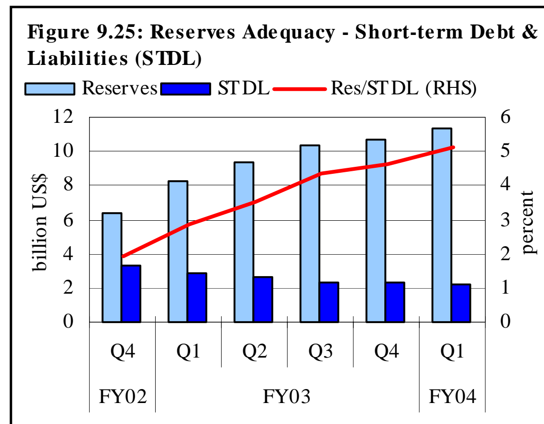
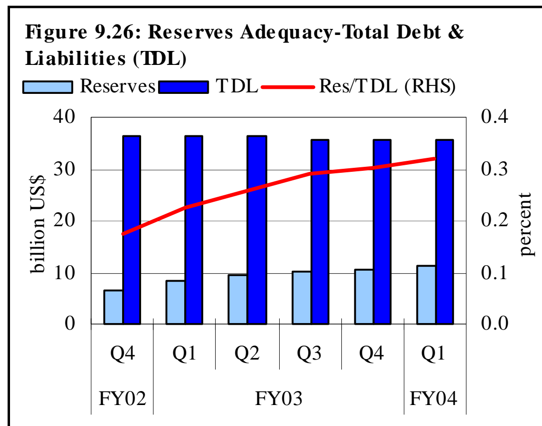


Figure 9.25: Reserves Adequacy - Short-term Debt & Liabilities (STDL)



Not surprisingly, the continued rise in forex reserves, fueling the improvement in debt ratios, contributed to an up-gradation of Pakistan's sovereign foreign currency rating by prominent international credit

[19] The level of reserves at the end of Q1-FY04 is sufficient to finance 99.7 percent of imports level of FY03.



rating agencies. The Moody's Investors Service upgraded Pakistan's sovereign credit rating to B2 from B3 on October 20, 2003. Similarly, Pakistan credit rating has also been upgraded from minus B to B by another international rating agency, Capital Intelligence on November 20, 2003. Another leading rating agency, S&P, has improved the outlook on Pakistan's long-term sovereign credit ratings from stable to positive on December 2, 2003.[20]

While the foreign exchange reserves continue to grow substantially, SBP has adopted a new *investment strategy* for its *foreign exchange reserves management* (see **Box 1**). In an attempt to diversify the composition of reserves, SBP for the first time, invested reserves in the commercial market,[21] choosing five-year Islamic Bond worth of US$ 25 million.[22]

[20] This does not guarantee change in the rating as such. Positive outlook only endorses that performance is currently better than the current sovereign ratings of the country.
[21] Traditionally, SBP had been investing foreign exchange reserves only in short-term placement outside Pakistan.
[22] Islamic Development Bond had been assigned AAA rating by Standard & Poor's and AA by Fitch Ratings.

Box 1: Foreign Exchange Reserves Management

The overall objective of this management strategy, in order of priority, is to ensure safety (preservation of capital), liquidity and maximum return on these reserves within the above constraints. The management strategy entails both, the development of in-house capacity and the partial outsourcing of reserve management to reputable foreign investment companies. The following are the salient features of the reserve management strategy:

- Since the overall objectives, are by definition, conflicting, the optimal strategy is to strike a balance among them through dividing the overall portfolio into three sub-portfolios buckets including *cash portfolio*, *liquidity portfolio* and *long-term portfolio.* Given the level of reserves at the time of finalizing the strategy, the three portfolios had the fund allocation of US$ 3 billion, US$ 4 billion and US$ 2 billion respectively. Any increment to the reserves, thereafter, would be allocated to the *cash portfolio*.

- The *cash portfolio* will be managed internally through short-term placements as per the current reserve management practice.

- Of the total US$ 6 billion allocated currently for the liquidity portfolio and the long-term investment portfolio, US$ 3.2 billion would be invested in global short duration government bonds, global longer-dated treasuries and global non-government bonds through external fund managers.

- The remaining US$ 2.8 billion of the above mentioned two portfolios would be placed as cash portfolio. However, during the next 18 months while the in-house capacity for investment would be developed, US$ 1.4 billion would be allocated to the in-house reserve management team.

- The maximum duration of *long-term portfolio* would not exceed five years.

- The overall portfolio rating would be at least ‘AA’ while rating of any single instrument would not be below investment grade. The investment in equities is not permitted.

- The bank may appoint 8 to 10 fund managers and the funds will be distributed among the external fund mangers according to their expertise.

- Similarly, a custodian bank may be appointed out of top highest-rated banks offering custodial services.

- All the matters pertaining to foreign exchange reserve position would be monitored and reviewed regularly.