9 External Sector

Balance of Payments[1]

The deterioration in Pakistan's external account balance, already evident in H1-FY04, accelerated sharply in Q3-FY04, with the period witnessing a deficit of US$ 79 million against a surplus of US$ 1288 million in Q3-FY03. Although marginal, this deficit is nonetheless very significant; not only is this the first quarterly deficit since Q2-FY02, it appears to be caused by a *trend* deterioration in the external balance (see **Figure 9.1b**).

Figure 9.1a: External Account Position (Jul-Apr)

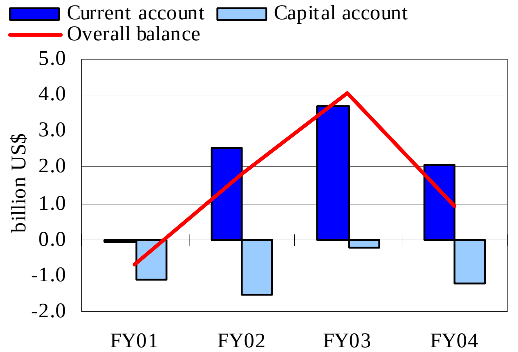
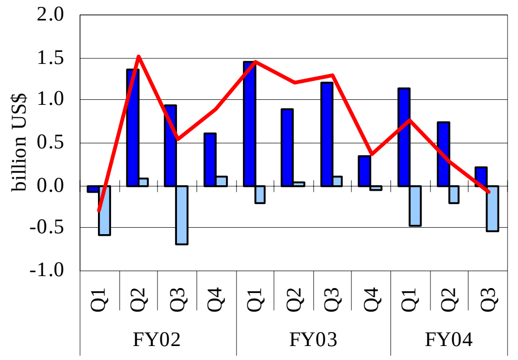


Figure 9.1b: Quarterly Position



In this context, it is very important to assess the sources of decline in the cumulative July-April FY04 external account surplus to US$ 911 million as compared to the US$ 4047 million in the corresponding FY03 period. Firstly, this is because a worsening of the external balance is not necessarily a negative for a growing economy, e.g. if the deficit is caused by import of machinery and raw material to increase productive capacity this is seen as a positive trend, it can be seen to be a positive development.

Secondly, if the deterioration in the external account were largely due to temporary factors, then there would be a strong case for an unchanged policy posture. For more permanent changes, it may be desirable to allow the market to

[1] The figures of the current account and the capital account may not tally with the ones reported in earlier quarterly reports due to the revision in the BOP data.

reach a new exchange rate equilibrium. In either case, however, there would probably be a need for the to SBP to smooth short-term forex market fluctuations.[2]

As seen in **Figure 9.1 & Table 9.1**, the weakness in the external account is largely attributable to a substantial drop in the current account surplus. The impact of this was compounded by an increase in the capital account deficit during the period. A closer look at the current account balance indicates that the Q3-FY04 deterioration stems principally from a fall in logistics support receipts (which could potentially re-emerge in the next quarter) and the end of Saudi oil facility (SOF) (see **Table 9.2**). This, together with a worsening trade balance suggests that current account balance could see an incremental deterioration in the quarters ahead.

Table 9.1: Current & Capital Account
million US Dollar

	Q3		Jul-Apr	
	FY03	**FY04**	**FY03**	**FY04**
Current account balance	1,214	211	3,705	2,056
Capital account balance	98	-547	-201	-1,212
Total	1,312	-336	3,504	844
Adjusted*				
Current account balance	514	12	2,260	1001
Capital account balance	-134	40	-1,410	-497
Total	380	52	850	504

* Adjusted for non-repeating and non-structural inflows and outflows such as SOF and logistic support receipts for CAB while euro bonds receipts, prepayment of expensive multilateral debt and FE-25 trade lending are adjusted from capital account.

Conversely, the sharp rise in the capital account deficit appears principally due either to non-recurring factors (the pre-payment of expensive debt that was partially offset by the Eurobond issuance) or due to accumulating outstanding export bills. In fact, adjusting for non-structural factors, the capital account depicts a visible improvement (see **Table 9.1**), and this trend is expected to see a further improvement in quarters ahead (after a one-time rise due to a further pre-payment of expensive debt).

The above analysis suggests that overall balance would likely either remain in surplus, or witness a temporary (6-months to one year) moderate deficit before reverting to a surplus. This view, in turn, suggests that the SBP could potentially seek to keep its exchange rate regime unchanged, and use its reserves to moderate exchange rate movements stemming principally from short term inter-bank market shortfalls.

[2] Indeed Q3-FY04 onwards, the SBP has significantly reduced its net forex purchases from the inter-bank market. These fell to US$ 135.8 million during Jan-May FY04, slowing the accretion in SBP reserves to US$ 261 million (down 84.4 percent YoY), and allowing the rupee/dollar parity to slightly depreciate (by 0.48 percent) during Jan-May FY04.

Table 9.2: Balance of Payments- Summary
million US Dollar

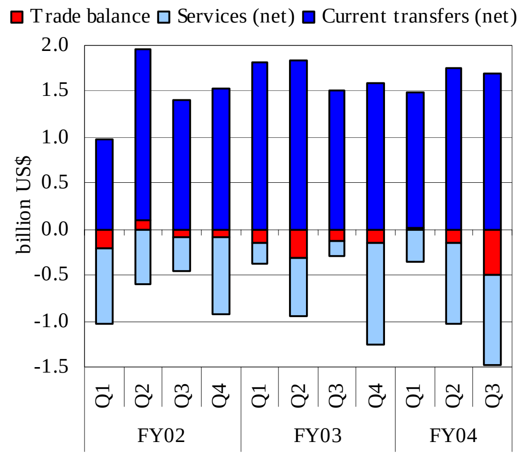
Items	FY03	FY04		July-April		
	Q3	Q2	Q3	FY03	FY04	Abs. change
1. Trade balance	**-138**	**-150**	**-494**	**-584**	**-850**	**-266**
Exports (fob)	2,606	3,055	3,106	8,761	10,197	1,436
Imports (fob)	2,744	3,205	3,600	9,345	11,047	1,702
2. Services (Net)	**-163**	**-877**	**-992**	**-1,388**	**-2,618**	**-1,230**
Shipment	-207	-263	-306	-715	-935	-220
Other transportation	56	64	27	177	143	-34
Travel	-91	-287	-360	-258	-930	-672
Investment income	-499	-645	-501	-1,713	-1,712	1
Interest payments	-265	-303	-180	-857	-677	180
Purchase of crude oil	-115	-149	-202	-353	-518	-165
Profit and dividend	-119	-193	-119	-503	-517	-14
Other goods, services, & income	578	254	148	1,121	816	-305
3. Current transfers (Net)	**1,515**	**1,763**	**1,697**	**5,677**	**5,524**	**-153**
a) Private transfers -net	1,219	1,522	1,584	4,761	4,959	198
of which: Workers' remittances	1,083	968	1,001	3,537	3,210	-327
FCA (residents)	-23	156	61	-53	321	374
b) Official transfers	296	241	113	916	565	-351
of which: Saudi oil facility	170	128	27	598	302	-296
4. Current account balance (1+2+3)	**1,214**	**736**	**211**	**3,705**	**2,056**	**-1,649**
5. Capital account (net)	98	-195	-547	-201	-1,212	-1,011
6. Errors & omissions	-24	-264	257	543	67	-476
7. Overall balance	**1,288**	**277**	**-79**	**4,047**	**911**	**-3,136**
8. Financing	**-1,288**	**-277**	**79**	**-4,047**	**-911**	**3,136**
I. Changes in Reserves (-Inc/+Dec)	**-1,316**	**-222**	**79**	**-4,512**	**-856**	**3,656**
Assets	-1,317	-265	268	-4,513	-526	-874
SDRs	-126	4	4	-117	13	130
Forex (State Bank of Pakistan)	-1,491	-520	324	-5,219	-706	4,513
of which: Sinking fund	-165	0	810	-540	730	1,270
Forex (Commercial banks)	300	251	-60	823	167	-656
Liabilities	1	43	-189	1	-330	-331
Use of Fund credit	1	43	-189	1	-330	-331
Repurchases	118	245	0	348	245	-103
Purchases/drawings	-117	-202	-189	-347	-575	-228
II. Exceptional financing	28	-55	0	464	-55	-519
Net SBP reserves (end Period)	9,092	10,525	11,001	9,160	10,897	

Source: Statistics Department, SBP

9.1 Current Account

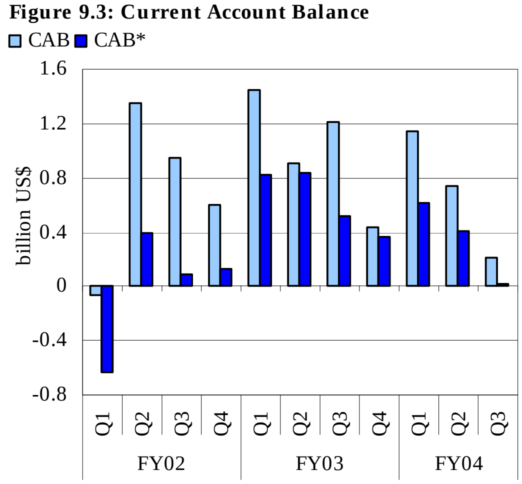
The 71.3 percent fall in the current account surplus during Q3-FY04, relative to the preceding quarter of the current fiscal year, was primarily driven by: (1) a widening trade deficit, caused by rising imports of machinery, equipment and raw material; (2) higher services outflows (e.g, *travel* and *shipment* payments); (3) a decline in *logistic support* receipts; (4) termination of the Saudi Oil Facility (SOF); and small decline in current transfers (see **Figure 9.2**).

Figure 9.2 : Current Account Balance



Excluding the non-structural flows (SOF and Logistic support receipt), the adjusted current account balance (CAB*) recorded a substantial decline of US$ 398 million to reach US$ 12 million during Q3-FY04 over the preceding quarter of current fiscal year (see **Figure 9.3**).

Figure 9.3: Current Account Balance



9.1.1 Trade Balance[3]

During Q3-FY04, the trade deficit widened by US$ 344 million to reach US$ 494 million compared to US$ 150 million during the preceding quarter of current fiscal year. On YoY basis, both exports and imports rose substantially during Jul-Apr FY04, although, the imports growth of 18.2 percent outpaced the healthy 16.4 percent export growth (for

[3] This section is based on exchange record compiled by SBP that do not tally with more detailed custom data used in **sub-section 9.3**.

details, see **Trade Account** sub section). Encouragingly, the surge in imports came mainly from a 36.8 percent growth in non-food and non-oil imports during Jul-May FY04, which appears to reflect the increasing activity in the domestic economy.

9.1.2 Services (net)

Net outflows on the services account rose to US$ 992 million during Q3-FY04 as compared with US$ 163 million during Q3-FY03. As shown in **Table 9.2**, the increase mainly reflects the reintegration into the formal system of *travel* related payments through exchange companies,[4] that was aggravated by a fall in receipts for *logistic support*, a rise in *shipment* charges (due to rising imports), and rising outflows of *profit and dividends* (mainly due to higher crude oil prices in international market)[5].

The large Q3-FY04 net outflow pushed the cumulative Jul-Apr 2004 net S*ervices* account deficit to US$ 2.6 billion, approximately twice the US$ 1.4 billion for Jul-Apr FY03. The one bright spot in this performance was the appreciable fall in the net *interest payments*, which declined by 16 percent YoY to US$ 827 million during Jul-Apr FY04. In particular, each category of external debt saw a fall in interest payments (see **Table 9.3**), with the biggest savings evident in categories where debt has been pre-paid, i.e., *long-term public debt* and *private loans/credits.*[6]

Table 9.3: Details of Interest Payments and Receipts
million US Dollar

	July-Apr		
	FY03	**FY04**	**Saving**
Payments (I+II)	**985**	**827**	**158**
I. Total external debt	861	673	188
Public & publicly guaranteed	684	542	142
Long-term	610	495	115
Military	20	13	7
Euro bonds	37	24	13
Commercial loans/credits	12	5	7
IDB	5	5	0
Private loans/credits	147	111	-81
IMF	30	20	104
II. External liabilities	124	154	-30
Foreign currency deposits	36	32	4
Special US$ bonds	28	23	5
Central bank deposits	23	13	10
Others	37	86	-49
Receipts	**128**	**150**	-22
Interest on reserves	111	98	13
Others	17	52	-35
Net Payments	**-857**	**-677**	**-180**

Source: State Bank of Pakistan

[4] Of which 84.1percent of the total travel expenditure was financed by Exchange Companies.
[5] This head comprises of profit, dividend, reinvested earning by corporates, as well as, purchase of crude oil. The latter is the amount paid by the government against the purchase of crude oil from foreign oil extracting companies operating in Pakistan.
[6] The stock of private loans was US$ 1.7 billion by end-March 2004 as compared to end-March 2003 of US$ 2 billion.

9.1.3 Transfers

During Q3-FY04, net transfers declined by 4.1 percent (to US$ 1.7 billion) over the preceding quarter of FY04 mainly due to lower inflows of resident FCA and termination of the SOF during Q3-FY04. On the other hand, workers' remittances slightly increased by US$ 33 million to US$ 1 billion in Q3-FY04 as compared to US$ 968 million in preceding quarter of FY04. Cumulatively, the net transfers declined by US$ 153 million during Jul-Apr FY04 to US$ 5.5 billion over the corresponding period of FY03 mainly due to (1) the expected moderation in workers' remittances; and (2) the lower official transfers inflows in SOF (see **Box 9.1**). Workers' remittances declined by 9.2 percent to US$ 3.5 billion during Jul-May FY04 as compared to US$ 3.9 billion during the corresponding period of FY03 (see **Table 9.4**).[7]

SBP projections of annual FY04 remittances remain unchanged at US$ 3.75 billion (which is 11.5 percent lower than the FY03 annual receipts). In recent months, the strong remittances inflows have been sustained by a rise in flows from USA, even as those from Kuwait and the UAE have declined.

The *trend* decline in remittances from the UAE is at least potentially a source of concern as it could represent the shifting of flows from the formal to the informal market in the wake of the recent re-emergence of a kerb market premium.[8]

Table 9.4: Country-wise Workers' Remittances

million US Dollar

	Q3		Jul-May		
	FY03	**FY04**	**FY03**	**FY04**	**% Change**
1. Gulf region:	**481**	**408**	**1,740**	**1,473**	**-15.3**
Bahrain	19	22	66	74	12.3
Kuwait	77	47	210	160	-23.7
Qatar	26	24	81	81	0.2
Saudi Arabia	139	129	527	516	-2.2
Sultanat-e-Oman	25	28	86	96	12.4
U.A.E.	194	158	770	546	-29.1
2. U.S.A.	**286**	**311**	**1,131**	**1,100**	**-2.7**
3. Other than Gulf & USA:	**304**	**276**	**963**	**900**	**-6.5**
Canada	4	6	14	21	49.0
Germany	5	8	23	42	79.7
Japan	2	1	8	5	-35.5
Norway	2	3	8	9	17.3
U.K.	68	90	246	300	22.0
Others	223	168	664	523	-21.2
TOTAL (1+2+3)	**1,071**	**996**	**3,833**	**3,473**	**-9.4**
Encashment FEBCs & FCBCs	11	6	**40**	**44**	**8.1**
Grand total	**1,082**	**1,001**	**3,873**	**3,517**	**-9.2**

Source: State Bank of Pakistan

[7] Excluding HSS, the YoY fall in cumulative remittances is only 6.1 percent during Jul-May FY04 over the corresponding period of FY03.

[8] The kerb premium increased sharply during April due to heavy dollar buying of gold importers and the increasing trend to switch investment from real estate and stocks to hard currency.

Box 9. 1: Termination of the Saudi oil facility and its impact on the External Sector

The Saudi oil facility (SOF) was initiated in FY99 after the nuclear test in May 1998, when Pakistan was facing an acute shortage of foreign exchange due to the imposition of international economic sanctions. Initially, 100,000 barrels of crude oil per days were provided under this facility, which were subsequently reduced to 80,000 barrels a days.

Table B 9.1: Receipts of SOF and CAB

million US$

	SOF	Oil imports bill	SOF share in Oil imports bills	CAB	CAB excl. SOF	Contribution in Govt. Financing (billion Rs.)
FY99	390	1,371.4	28.4	-1,845	-2,235	15.9
FY00	790	2,804.4	28.2	-212	-1,002	40.9
FY01	683	3,360.8	20.3	326	-357	40.5
FY02	579	2,807.0	20.6	2,833	2,254	33.2
FY03	637	3,066.4	20.8	4,203	3,566	42.2
Jul-Apr FY04	302	2,108.0	14.3	1,922	1,620	14.2
Total	**3,381**					**186.9**

The SOF financed approximately 22.1 percent of the country's oil import bill during the last five years, with an annual value averaging around US$ 564 million for the FY99-FY04 (see **Table B 9.1**).

The termination of this facility will have an adverse impact on both, the country's external account as well as the government's financing needs. While the former may not be felt as strongly in the face of current account surpluses, the latter will significantly raise the government's borrowing for budgetary support.[1] Interestingly, the federal budget for FY05 suggests that the negative fiscal impact of the termination of SOF for FY05 is being offset by an expected rise in other external receipts.

---

[1] While the termination of the SOF will substantially increase the foreign exchange requirements to pay for oil imports, Pakistan is expected to continue recording net current account surpluses. This suggests that while liquidity in the inter-bank forex market would decline, the impact on the exchange rate could be mitigated by lower net forex purchases by SBP.

9.2 Capital Account

The capital account posted a sharp reversal from a surplus of US$ 98 million in Q3-FY03 to deficit of US$ 547 million during Q3-FY04. This was because the impact of a rise in inflows due to higher portfolio investment (from the Eurobond issue), an increase in project loans and higher supplier's credit inflow, was comfortably overshadowed by the prepayment of US$ 1.1 billion expensive loans to ADB (see **Table 9.5**).

Table 9.5: Capital Account

million US Dollar

Items	Q3		July-Apr		
	FY03	FY04	FY03	FY04	Change
Capital Account (1 through 9)	98	-547	-201	-1,212	-1,011
Inflows	1,777	1,375	4,607	2,848	-1,759
Outflows	1,679	1,922	4,808	4,060	-748
1. Direct investment abroad	2	-7	-26	-33	-7
2. Direct investment in Pakistan	114	355	694	761	67
3. Portfolio investment	-77	445	-262	257	519
of which: (Stock Markets)	-24	-26	-2	-130	-128
Special US Dollar Bonds	-45	-25	-232	-92	140
Euro/Sandik bonds	-2	498	-7	496	503
Net Foreign Investment	39	793	406	985	579
4. LT Capital, (official)	-183	-1,203	-237	-1,239	-1,002
of which: Project assistance	125	101	439	374	-65
Food aid	10	0	10	0	-10
Non-Food aid	13	0	518	345	-173
Amortization	1,326	1,304	2,195	1,935	-260
5. LT capital, (DMBs)	-4	0	-5	-25	-20
6. LT capital, (Others)	-83	106	-605	-154	451
of which: Suppliers credits/MNCs	30	340	201	435	234
Supplier Credits repayments	157	226	495	545	50
7. ST Capital, (official)	-15	-66	-194	-414	-220
of which: Commercial Banks (net)	-15	0	-169	-133	36
IDB (net)	-21	-41	42	-165	-207
8. ST Capital, (DMBs)	65	-86	82	-100	-182
of which: Outstanding exports bills	10	-71	41	-90	-131
9. ST capital, (Others)	279	-90	352	-265	-617
of which: Outstanding exports bills	*-11*	*-88*	-175	-286	-111
Trade financing	*232*	*32*	1,209	-96	-1,305

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

It is encouraging to note that apparent worsening of the capital account deficit is dominated by debt pre-payments. Given that the stock of expensive external debt is declining, and that pre-payments will also reduce interest payments in future, the recent weakness in the capital account should be seen as a temporary phenomenon and therefore not a source of concern.

9.2.1Net Foreign Investment

Overall net foreign investment increased to US$ 793 million in Q3-FY04 as compared with only US$ 39 million in corresponding period of the previous year. The strong growth was due to the issuance of Euro bond, lower payments of special US dollar bond and higher FDI (due to the privatization of HBL).

Cumulatively, FDI increased by US$ 158 million to US$ 902.8 million during Jul-May FY04 as compared to same period of FY03. Oil and gas exploration remained the most attractive sector for foreign inventors followed by communication (US$ 220 million) and financial business (US$ 245 million) due to the privatization of HBL. On the other hand, the inflow of foreign investment declined in chemical, electrical machinery, power, transports and communication sector during Jul-Apr FY04 as compared to the corresponding period of FY03.

On the other hand, portfolio investment recorded an increase of US$ 522 million during the current quarter compared to the corresponding quarter of FY03. This was entirely based on inflow received from the issuance of five-year Eurobonds of US$ 500 million at 6.75 percent yield during February 2004.[9]

Long-term Capital (official)

The outflow on account of long-term capital (official) substantially increased from US$ 237 million during Jul-Apr FY03 to US$ 1239 million during Jul-Apr of the current fiscal year. Not only did the inflow on account of foreign economic assistance (FEA) decrease, the impact of this was compounded by the prepayments of expensive multilateral debt.

Foreign Economic Assistance

The disbursement of foreign economic assistance under long-term capital declined by 25.7 percent to US$ 719 million during Jul-Apr FY04, mainly reflecting the sharp contraction of US$ 173 million in non-food aid from the World Bank and ADB. Project assistance also recorded a decline of US$ 65 million to US$ 374 million during Jul-Apr FY04 as compared to US$ 439 million during the corresponding period of the preceding year (see **Table 9.5**).

[9] As discussed in Second quarterly report of FY04, the main objective of the Euro bonds issuance was to put Pakistan on the radar screen of the international capital market by making a strategic re-entry.

Pre-payments of Expensive Multilateral Debt

During Q3-FY04, Pakistan has prepaid expensive loans totaling US$ 1.17 billion, to the ADB. These loans carried a fixed interest rates ranging between 6.31 to 11.0 percent and maturing during FY05-FY19. As a result, the share of *EDL* in *TDL* dropped from 30.2 to 25.3 percent at end-March 2004 (see **Table 9.6**).

Table 9.6: Pakistan's Expensive External Debt & Liabilities
million US Dollar

Categories	FY99	FY03	End-Mar FY04[P]
Expensive Debt	**10,345**	**8,629**	**7,110**
PPG M/LT	6570	6020	4986
ADB	1980	2291	1184
IBRD	2542	2706	2598
IFAD	127.5	123	130
Euro/Sandik bonds (inclu. new issue)	608	482	824
Commercial Loans/Credits	1,160	231	198
IDB	152	187	53
Private Loans/Credits	3,435	2,028	1,731
IMF: SBA	340	581	393
Expensive Liabilities	**2,968**	**2,077**	**1,973**
Foreign currency deposits	1,652	0	0
NDRP	225	6	2
Special US$ Bonds	1,164	696	618
Central bank deposits	700	700	700
NBP (BOC)	616	500	500
FCY Bonds (NHA)	263	175	153
Expensive Debt & Liabilities (EDL)	**13,313**	**10,706**	**9,083**
Total Debt & Liabilities (TDL)	**36,600**	**35,474**	**35,846**
EDL as percent of TDL	36.4	30.2	25.3

P: Provisional

Suppliers' Loans & Credits

During Q3-FY04, *Suppliers' credit (net*) posted a reversal from an outflow of US$ 103 million during the preceding quarter of FY04 to an inflow of U$ 114 million. The rise in net inflow was mainly due to the disbursement of a US$ 350 million loan from the US Exim Bank to PIA in Q3-FY04 to finance the purchase of aircraft. This was, however, offset by the repayment of private loans totaling US$ 226 million (see **Table 9.5**), including early repayment of US$ 19.2 million by the cement and storage companies (see **Table 9.7**).

Table 9.7: Prepayment of Foreign Private Loans
million US Dollar

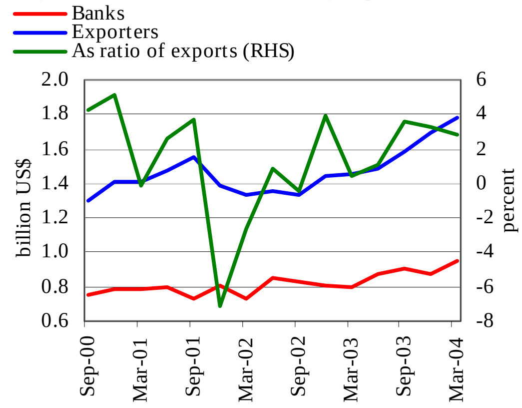
Sector	FY03 Q3	FY03 Q4	FY04 Q1	FY04 Q2	FY04 Q3	FY04 Apr-May	Total
Cement	25.9	34.9	3.8	12.9	11.4		88.9
Chemical			8.6				8.6
Textile		3.8	4.0				7.8
Financial business		14.4	0.6			0.2	15.2
Storage facility	6.4				7.8		14.2
Others	6.6			16.6			23.2
Total	**38.9**	**53.1**	**17.0**	**29.5**	**19.2**	**0.2**	**158.0**

By end May 2004, prepayments of US$ 158 million have been made by private companies since the inception of this scheme, of which 56.4 percent were made by cement companies. It is expected that some IPPs will also make large debt prepayments in the months ahead, substantially reducing the outstanding stock of private loans and credits.

Outstanding Export Bills

The stock of OEBs increased by US$ 374 million during Jul-Apr FY04 as compared to an increase of US$ 134 million during the corresponding period of FY03. The rise in the stock of outstanding export bills by both exporters and banks (discounted by exporters) shown in **Figure 9.4** appears mainly to reflect a rise in the exports, with possible contribution, also, from rising expectations of a rupee depreciation.

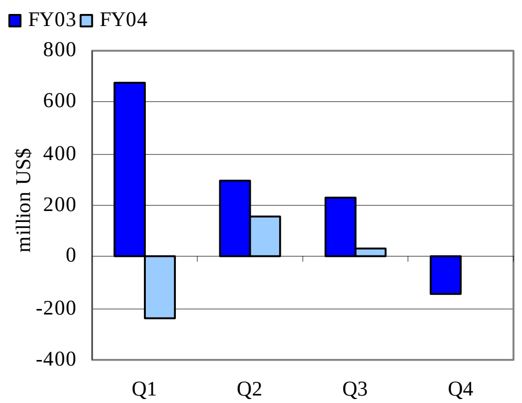
Figure 9.4: Stock of Outstanding Export Bills



FE-25 Related Trade Financing

The foreign trade lending exhibited a net retirement of US$ 96 million during Jul-Apr FY04 as compared to net borrowing of US$ 1.2 billion during the corresponding period of FY03 (see **Table 9.5** & **Figure 9.5**). This stemmed from: (1) expectations of a rupee depreciation (which could raise the effective cost of the forex loans); and (2) lower cost of rupee loans.

Figure 9.5: Quarterly Trade Financing



The interest in forex loans could re-emerge following the recent increase in rupee interest rates, particularly, if expectations of a weakening rupee subside (see section on **Money & Credit**).

9.3 Trade Account

The trade deficit recorded a 128.2 percent YoY rise to US$ 2.7 billion during Jul-May FY04 (see **Figure 9.6**). Not only is this well above the annual target, it is also about twice the average *annual* trade deficit in the preceding five years. However, the higher trade deficit does not appear to be a cause for concern given that it is *not* due to any weakness in exports, and that machinery, chemicals and other raw materials, all of which reflect an acceleration of economic activity, dominate the profile of the import growth[1].

Figure 9.6: Trade Deficit during Jul-May

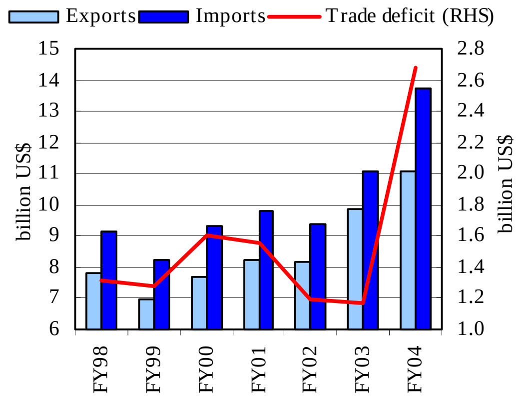
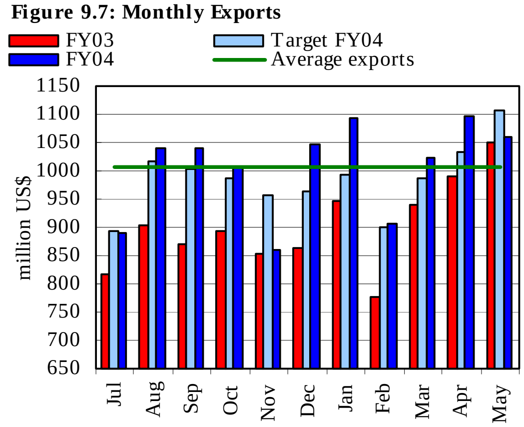


Figure 9.7: Monthly Exports



9.3.1 Exports

Exports grew by 11.8 percent YoY during Jul-May FY04, exceeding the export target for the period by 2 percent, to reach US$ 11.1 billion (see **Table 9.8**). This rise has been exceptionally well distributed through the year, with monthly exports rarely dipping below the US$ 1 billion mark (see **Figure 9.7**).

Of the overall growth in exports, textiles remained the largest contributor (see **Table 9.9**) (65.1 percent) despite several hiccups (detailed below), followed by *rice,* and *leather manufactures*. Exports of wheat, which were quite substantial in

[1] As evident in the 17.1 percent YoY growth in Large scale Manufacturing, and the 11.8 percent YoY rise in exports, during Jul-May 04.

FY03, declined sharply due to a fall in domestic production, leading to the fall in the aggregate exports of primary commodities.

Table 9.8: Major Exports during Jul-May

Value: million US Dollar; Unit value: US Dollar

			FY03		FY04		Abs. chg. in val.	Change (Percent)		
		Unit	Value	Unit val.	Value	Unit val.		Qty	Value	Unit val.
A.	**Primary Commodities**		**1,105.7**		**1065.8**		**-40.0**		**-3.6**	
1	Rice	MT	506.8	303.7	557.7	354.7	50.9	-5.8	10.0	16.8
2	Raw cotton	MT	48.0	885.0	44.7	1281.1	-3.3	-35.6	-6.8	44.8
3	Fish and fish preparations	MT	124.1	1,454.6	137.7	1501.5	13.6	7.5	10.9	3.2
4	Leather	SQM	209.6	15.2	206.7	15.6	-2.9	-3.7	-1.4	2.4
5	Fruits	MT	74.1	325.3	89.1	284.1	15.0	37.6	20.2	-12.7
6	Vegetables	MT	24.6	161.4	23.9	164.5	-0.7	-4.7	-2.9	1.9
7	Wheat	MT	118.5	112.8	6.0	140.1	-112.5	-95.9	-94.9	24.2
B.	**Textile Manufactures**		**6,469.1**		**7,227.9**		**758.8**		**11.7**	
8	Cotton yarn	MT	856.3	1,774.7	1075.8	2168.8	219.5	2.8	25.6	22.2
9	Cotton fabrics (woven)	SQM	1,204.5	0.661	1524.3	0.7	319.8	18.3	26.5	7.0
10	Hosiery (Knitwear)	DOZ	1,005.9	21.9	1270.5	22.1	264.6	25.3	26.3	0.8
11	Bed wear	MT	1,175.1	5,470.9	1242.0	5634.6	66.9	2.6	5.7	3.0
12	Towels	MT	330.0	3,679.3	348.9	3890.6	18.9	0.0	5.7	5.7
13	Cotton bags and sacks	MT	15.4	4,082.4	10.6	4145.5	-4.8	-32.1	-31.1	1.5
14	Readymade garments	DOZ	986.8	29.7	896.8	35.4	-90.1	-23.8	-9.1	19.3
15	Tarpaulin & other canvas goods	MT	66.6	2,280.3	59.1	2290.3	-7.5	-11.6	-11.2	0.4
16	Tule, lace embroidery etc.	---	9.4	---	7.4	---	-2.0	---	-21.4	---
17	Synthetic textiles	SQM	495.7	0.7	419.7	0.7	-76.0	-14.8	-15.3	-0.6
18	Other textile made-up	---	323.3	---	372.8	---	49.5	---	15.3	---
C.	**Other Manufactures**		**1,425.7**		**1,443.0**		**17.3**		**1.2**	
19	Carpets, carpeting rugs & mats	SQM	189.8	51.4	203.9	54.0	14.1	2.2	7.4	5.1
20	Petroleum. & Petroleum Products	MT	207.1	247.0	237.7	287.3	30.6	-1.3	14.8	16.3
21	Sports goods	---	290.4	---	274.8	---	-15.6	---	-5.4	---
22	Leather manufactures	---	338.3	---	358.1	---	19.8	---	5.8	---
23	Surgical and medical instruments	NO	131.5	---	110.6	---	-20.9	---	-15.9	---
24	Cutlery	GR	25.8	31.6	23.6	32.9	-2.2	-12.3	-8.7	4.2
25	Onyx manufactured	MT	10.7	1,779.9	10.3	1649.4	-0.4	4.0	-3.7	-7.3
26	Chemicals and pharmaceuticals	---	232.0	---	224.0	---	-8.0	---	-3.5	---
D.	**Others**		**895.3**		**1,324.4**		**429.1**		**47.9**	
	Total exports		**9,895.8**		**11061.0**		**1165.2**		**11.8**	

Source: Federal Bureau of Statistics

Textile Exports

Textile exports recorded a 11.7 percent rise in Jul-May 04 compared to Jul-May FY03 on the back of rising exports in all major categories other than readymade garments. Exports in four categories, namely cotton fabrics, knitwear, bed wear and cotton yarn, crossed the US$ 1 billion mark. This was helped by both, higher prices and greater volumes (see **Table 9.10 & Figure 9.8**).

Table 9.9: Contribution in Growth by Major Export Groups-during Jul-May

percent

	FY03		FY04	
	Growth	Share in Growth	Growth	Share in Growth
Primary commodities	21.0	11.1	-3.6	-3.4
Textile manufactures	23.7	71.9	11.7	65.1
Other manufactures	10.5	7.9	1.2	1.5
Others	21.2	9.1	47.9	36.8
Total	21.1	100.0	11.8	100.0

The rise in the quantum of textile exports in the presence of rising domestic and international prices of cotton is indicative of the resilience of domestic textile sector. However, textile exports are faced with significant challenges going forward, which can be overcome by close partnership between the industry and government. These challenges include:

Table 9.10: Quantum and Price Impact on Textile Exports during Jul-May

million US$

	Overall Change	Quantum Impact	Price Impact
Cotton yarn	219.5	24.1	195.5
Cotton fabrics	319.8	220.4	99.4
Knit wear	264.6	254.6	9.9
Bed wear	66.9	30.8	36.1
Readymade garments	-90.1	-234.8	144.8

The imposition of antidumping duty on bed linen:

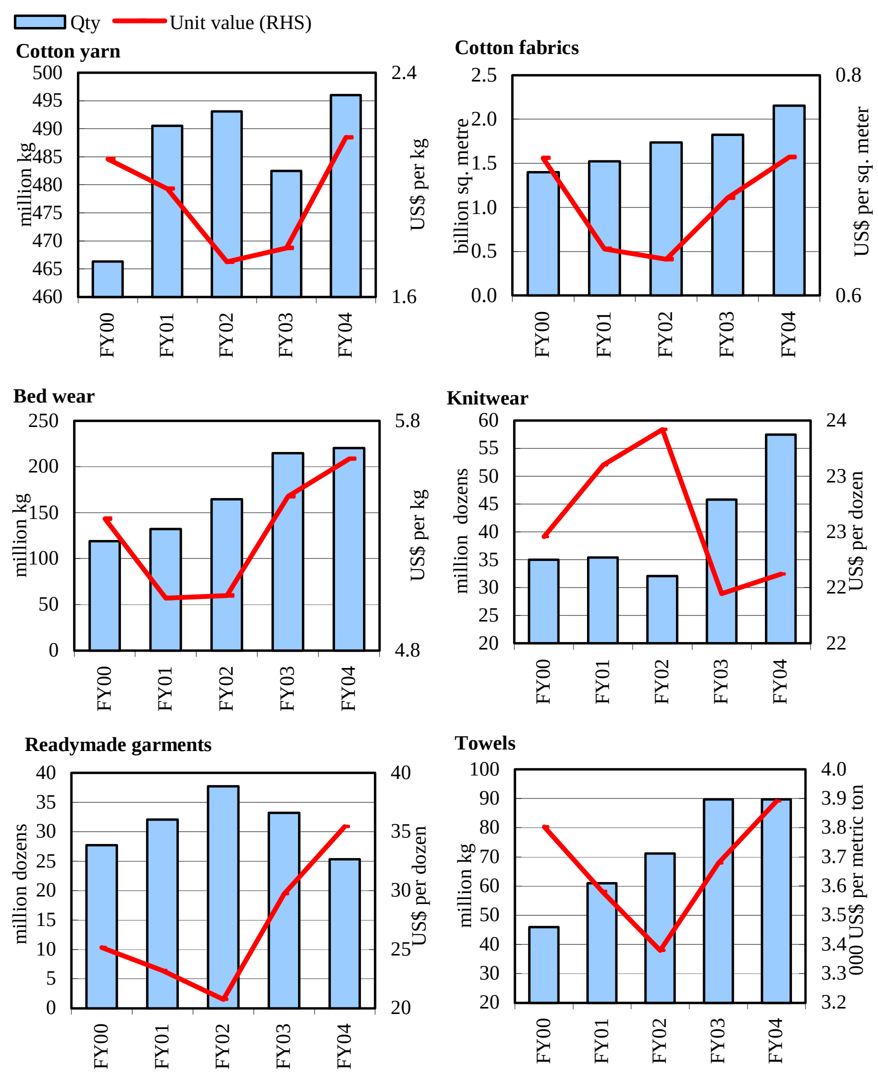
Currently, the EU is the largest single market for Pakistan's bed wear exports (see **Table 9.11**). The imposition of 13.1 percent anti-dumping duty by the EU from March 2004 on this category may jeopardize annual exports totaling approximately US$ 500 million.

Table 9.11: Regional Bed Wear Exports

million US$

	FY03	Jul-Mar	
		FY03	FY04
EU	541.3	372.9	431.3
US	336.6	231.3	312.4

Figure 9.8: Major Textile Manufactures during Jul-May



The withdrawal of GSP concession by the EU:

Pakistan is expected to lose duty-free concessions under General System of Preferences (GSP) from January 2005. This could mean imposition of an average 12.4 percent duty by EU countries on the import of clothing (HS Code 61, 62 and

63) products from Pakistan. The EU imports a substantial share of this category from Pakistan (see **Table 9.12**). The imposition of duty will erode the competitiveness of Pakistan's clothing sector exports, as some key competitors would remain exempt.[2] This situation looks even more alarming for bed wear exports, which are already facing an anti-dumping duty of 13.1 percent.

Table 9.12: Clothing Exports (Including Bed wear & Made-ups) during Jul-Mar

billion US $

	FY03	FY04
EU	1.1	1.3
US	1.3	1.5
Total	3.1	3.5

Inclusion of 10 new states in the EU from May 2004:

With the expansion of the EU to include 10 new states[3] from May 2004, the textile trade with these countries would come under the quota regime. The level of Pakistan's textile exports to these countries (prior to their accession to the EU) is quite low, and therefore the imposition of quotas on exports to these markets is unlikely to be significant.[4] The EU has also notified a 5 percent expansion of Pakistan's textile quota for all categories to the aggregate EU market. Finally, in order to guard itself against possible losses, Pakistan has also filed a provisional claim in the World Trade Organization (WTO) for compensation of losses stemming from the induction of these 10 countries into the EU.

Rice exports recorded 15 percent growth in the period of Jul-May FY04 over the same period last year to reach US$ 557.7 million (98 percent of the annual target). This rise in growth was largely contributed by high basmati rice exports (see **Table 9.13**).

Table 9.13: Rice Exports during Jul-Mar

Unit value: US Dollar; Quantity 000MT

	FY03		FY04	
	Quantity	Unit Value	Quantity	Unit Value
Rice	1356.3	295.3	1327.2	347.6
Basmati	501.6	502.0	617.3	513.9
Other varieties	854.7	174.0	709.9	203.1

This fall in quantum is attributable to slow arrival of the new crop in the market (see **Figure 9.9**).

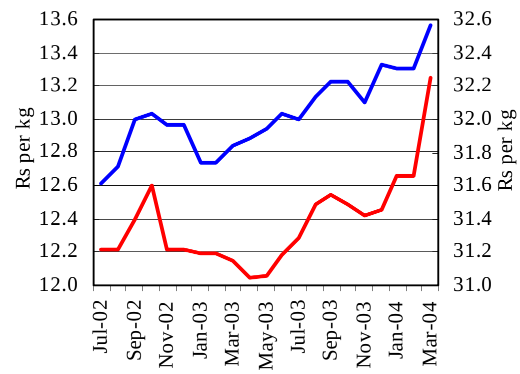
[2] On the imports of same goods from India, a concessional rate of duty 9.92 percent is being applied.

[3] Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia and Slovakia.

[4] The level of textile export to the 10 new EU states stood at US$ 51.1 million during Jul-Mar 04 as compared to US$ 37 million during he same period last year.

Basmati rice exports are also expected to be affected by the withdrawal of duty concessions by the EU. Fortunately, the Q3-FY04 exports were sustained by the temporary (3-month) continuation of EU duty concessions on Super Basmati rice.[5]

Figure 9.9: Domestic Rice Prices

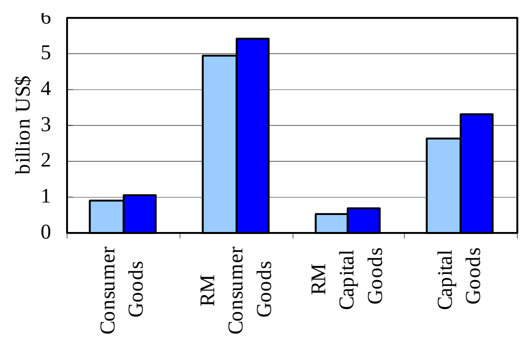


On a positive note, Pakistan's rice exporters are reported to be planning the purchase of parboiled rice plants from India. Since parboiled rice is in great demand in Middle East and Europe this value addition will further increase the demand for Pakistan's rice exports.

9.3.3 Imports

Imports reached US$ 13.7 billion during Jul-May FY04, up 24.1 percent over Jul-May FY03. This growth was mainly due to a surge in imports of capital goods and raw material (see **Figure 9.10**) reflecting the increasing momentum of economic activity in the country.

Figure 9.10: Economic Classification of Imports during Jul-Mar



In particular, the strong manufacturing growth in automobiles, pharmaceuticals and chemicals is mirrored in a rise in imports related to these sectors, such as *machinery*, *agriculture & chemicals* group, etc., (see **Table 9.14 & 9.15**).

[5] Basmati rice exports to the EU recorded 33 percent rise during Jul-Mar 04 over the same period last year.

Table 9.14: Major Imports (Jul-May)

Value: million US Dollar; Unit value: US Dollar

			FY03		FY04		Abs. Chg. in val.	Change in percent		
		Unit	Value	Unit val.	Value	Unit val.		Qty	Value	Unit val.
A.	**Food Group**	**---**	**813.8**		**838.9**		**25.1**		**2.7**	**---**
1	Tea	MT	161.8	1594.8	185.7	1655.2	23.9	10.6	14.8	3.8
2	Edible oil	MT	541.7	453.6	592.6	475.6	50.9	4.3	9.4	4.9
	Soya bean	MT	46.7	571.7	43.7	556.3	-3.0	-3.8	-6.4	-2.7
	Palm oil	MT	495.1	444.9	548.9	470.2	53.9	4.9	10.9	5.7
3	Pulses	MT	110.2	296.9	60.6	289.4	-49.7	-43.6	-45.1	-2.5
B.	**Machinery Group**	**---**	**2557.6**	**---**	**3412.8**	**---**	**855.2**		**33.4**	**---**
1	Power generating machinery	---	246.2	---	234.3	---	-11.9		-4.8	---
2	Office machinery	---	185.9	---	181.4	---	-4.6		-2.5	---
3	Textile machinery	---	478.6	---	497.7	---	19.1		4.0	---
4	Construction & mining mach	---	84.7	---	91.4	---	6.7		7.9	---
5	Elect. machinery & apparatus	---	192.9	---	211.4	---	18.6		9.6	---
6	Railway vehicles	---	37.3	---	53.4	---	16.1		43.0	---
7	Road motor vehicles	---	445.7	---	557.1	---	111.4		25.0	---
8	Aircraft, ships and boats	---	68.2	---	406.4	---	338.2		496.2	---
9	Agri. mach. and implements	---	33.9	---	27.7	---	-6.2		-18.3	---
10	Other machinery	---	784.2	---	1151.9	---	367.7		46.9	---
C.	**Petroleum group**	**---**	**2868.8**	**201.4**	**2831.7**	**234.9**	**-37.1**	**-15.4**	**-1.3**	**16.6**
1	Petroleum products	MT	1591.6	201.0	1252.8	257.2	-338.8	-38.5	-21.3	27.9
2	Petroleum crude	MT	1277.2	201.8	1578.9	219.7	301.7	13.5	23.6	8.9
D.	**Textile group**	**---**	**202.4**	**---**	**221.9**	**---**	**19.6**		**9.7**	**---**
1	Synthetic fibre	MT	85.8	1320.7	87.8	1458.5	2.1	-7.3	2.4	10.4
2	Synthetic & artificial silk yarn	MT	82.0	1524.6	102.4	1641.6	20.4	16.0	24.9	7.7
E.	**Agri. & other chem. group**	**---**	**1961.8**	**---**	**2422.6**	**---**	**460.8**		**23.5**	**---**
1	Fertilizer	MT	214.5	183.2	236.7	213.8	22.2	-5.4	10.3	16.7
2	Insecticides	MT	52.6	2628.0	94.4	2884.2	41.8	63.5	79.4	9.7
3	Plastic materials	MT	379.3	822.1	467.9	881.8	88.6	15.0	23.4	7.3
4	Medicinal products	MT	197.6	---	237.5	---	40.0	9.1	20.2	10.2
5	Others	---	1117.8	---	1386.0	---	268.2		24.0	---
F.	**Metal group**	**---**	**442.3**	**---**	**568.9**	**---**	**126.6**		**28.6**	**---**
1	Iron and steel scrap	MT	39.3	135.7	74.5	168.4	35.2	52.9	89.8	24.1
2	Iron and steel	MT	352.5	366.8	424.2	397.3	71.7	11.1	20.3	8.3
G.	**Miscellaneous group**	**---**	**279.9**	**---**	**210.2**	**---**	**-69.7**		**-24.9**	**---**
1	Rubber tyres & tubes	Nos	71.6	20.8	75.1	21.7	3.4	0.7	4.7	4.0
2	Paper, paperboard and Manuf.	MT	118.9	603.7	135.2	620.0	16.3	10.7	13.7	2.7
H.	**Others**	**---**	**1941.0**		**3228.2**	**---**	**1287.2**	**---**	**66.3**	**---**
	Total imports:		**11067.7**		**13735.3**		**2667.6**		**24.1**	

Source: Federal Bureau of Statistics

Table 9.15: Contribution in Growth by Major Import Groups during Jul-May

percent

	FY03		FY04	
	Growth	Share in growth	Growth	Share in growth
Food group	29.3	10.8	2.7	0.8
Machinery group.	30.3	34.9	33.4	32.1
Petroleum group.	11.8	17.8	-1.3	-1.4
Textile group.	40.9	3.5	9.7	0.7
Agri. & other Chem. Gp.	18.7	18.2	23.5	17.3
Metal group.	24.9	5.2	28.6	4.7
Miscellaneous Gp.	55.1	5.8	-24.9	-2.6
Others	3.4	3.8	66.3	48.3
Total	**18.2**	**100.0**	**24.1**	**99.9**

Table 9.16: Other Chemicals imports during Jul-Mar

million US Dollar

	FY03	FY04	Growth
Other chemicals	**862.4**	**1114.5**	**29.2**
Organic chemicals	518.2	704.7	36.0
Inorganic chemicals	56.5	91.6	62.1

Agriculture and chemicals group imports recorded a 23.5 percent YoY growth during Jul-May FY03. While all categories other than fertilizers contributed this increase, the biggest growth was evident in '*other chemical*' imports (see **Table 9.16**). The rise in chemicals imports is attributable to stronger activity in the textile industry.

Machinery group imports recorded a 33.4 percent growth during Jul-May FY04 as compared to the same period of the previous year. Within this group, all categories with the exception of *agriculture machinery and implements* witnessed growth. The three categories witnessing notable growth were textile machinery, other machinery and motor vehicles.

The high import of road motor vehicles, in particular, mirrors the exceptional manufacturing activity in the automobiles sector (see **Section** on **Industry** for details), in which output rose 52.8 percent YoY on the back of strong credit-led demand for cars, rising production of tractors and a jump in imports of buses (for the urban transport scheme)

Petroleum group imports recorded a 1.3 percent *fall* during Jul-May FY04 over the same period last year. This fall was caused by declining imports of petroleum products, which offset the impact of a 23.6 percent YoY rise in imports of crude oil on account of both, higher prices and a rise in import volumes.

Pakistan's imports of refined petroleum products have been declining in recent years; this stems from the increase in domestic refining capacity that has allowed the substitution of relatively expensive refined products with cheaper crude oil imports.

In particular, the substantial increase in availability of domestically refined furnace oil during FY04 had been exacerbated by the fall in domestic furnace oil consumption due to a shift to alternative fuels (coal and natural gas) and a decline in thermal electricity generation[6]. However, its demand was again revived towards the end of Q3-FY04, in the wake of lower hydroelectric power output, caused by inadequate water levels at reservoirs.

The rise in crude petroleum imports, on the other hand, coincided with the hike in international oil prices (see **Figure 9.11**). However, since crude petroleum imports did not see an unusual rise in the period, this hike in prices could not very strongly impact the oil import bill (see **Table 9.17**).

Figure 9.11: Oil Prices & Petroleum Imports

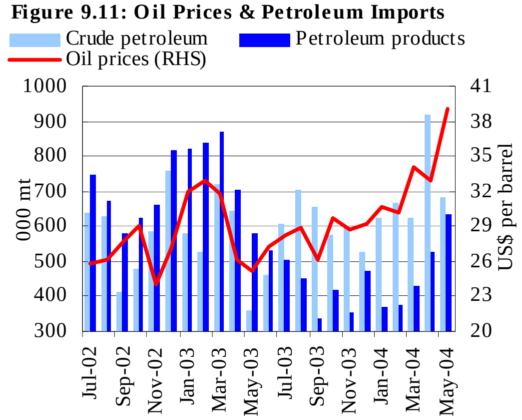


Table 9.17: Quantum and Price Impact on POL Imports

million US Dollar

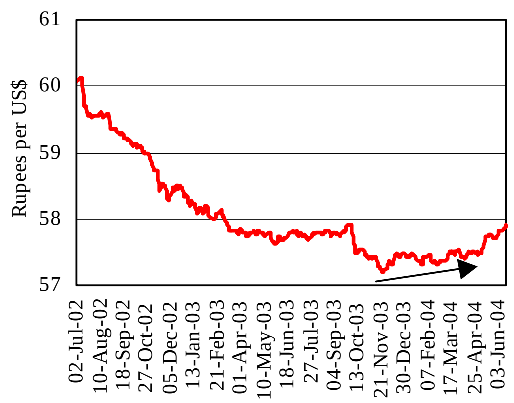
	Quantum Impact	Price Impact
Petroleum Group	**-441.2**	**404.1**
Petroleum Products	-612.4	273.6
Petroleum Crude	172.6	129.1

[6] As a result, furnace oil import recorded 92.9 percent fall during July-March FY04 reaching US$ 41.3 million from US$ 580.8 million in July-March FY03.

9.4 Exchange Rate Policy

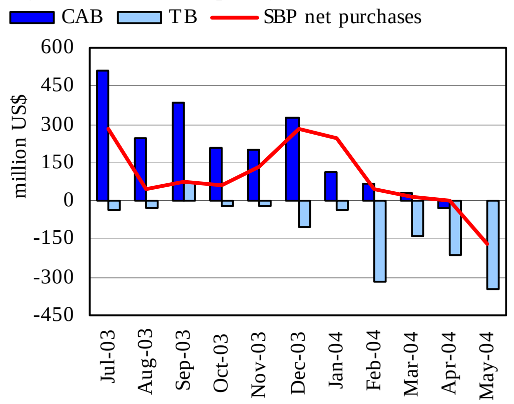
The trend appreciation of the rupee in recent years appears to have bottomed out after touching a three year low of Rs 57.21/US$ in November 2003 (see **Figure 9.12**). Since then the rupee has *depreciated* by approximately 0.9 percent until end-May 2004, raising some expectations of a further weakening of the rupee. Given that the persistence of this trend could significantly harden these expectations, it is very important to assess the causes of the recent weakness of the rupee.

Figure 9.12: Daily Exchange Rate Movement



As evident in **Figure 9.13**, while the current account continued to record surpluses until Q3-FY04, these were shrinking, and by April 2004 the current account recorded a small deficit. Clearly, the exchange rate movement is reflecting this underlying trend. A further analysis reveals that the following factors played key role in the trend reversal in exchange rate movements:

Figure 9.13: Forex Liquidity and Net Purchases



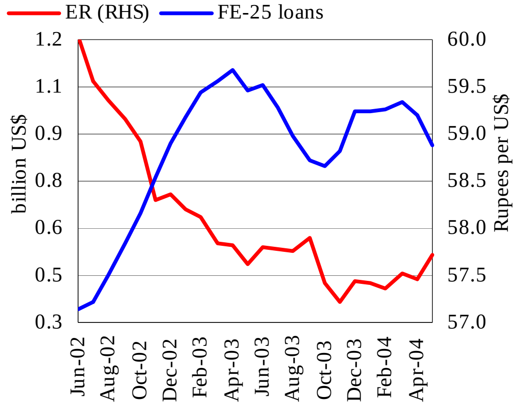
Widening Trade Deficit

The demand for foreign exchange rose sharply during Q3-FY04 due to the widening trade gap as imports witnessed a much sharper growth compared to exports, especially after March 2004 (see **Section 9.3**). However, it is instructive to note that at least part of the Apr-May FY04 surge in imports was driven by some unusual transactions, which may not be evident in Q1-FY05.

End of the Saudi Oil Facility (SOF)
The termination of the Saudi Oil facility, led to a corresponding increase in the forex demand from the inter-bank market. The incremental demand is estimated at over US$ 180 million for Feb-May FY04.

Slowdown in Forex Loans
The retirement of FE-25 loans effectively drains liquidity from the inter-bank market. The Apr-May FY04 net retirements lowered the inter-bank liquidity by approximately US$ 137 million probably due to availability of cheaper rupee financing and amidst expectations of rupee depreciation (see **Figure 9.14**).

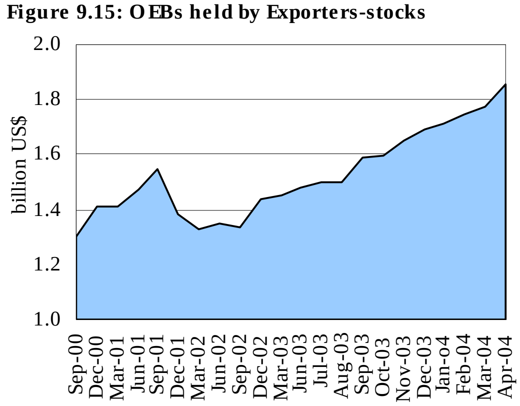
Figure 9.14: FE-25 Lending and Exchange Rate



Pre-payment of External Debt
The demand for prepayment of foreign private loans gained momentum in April 2004 onwards, adding to demand in the inter-bank market.[1]

Rise in Stock of Outstanding Export Bills (OEBs)
The rising stock of outstanding export bills is also a significant contributor to the fall in inflows into the inter-bank market. In

Figure 9.15: OEBs held by Exporters-stocks

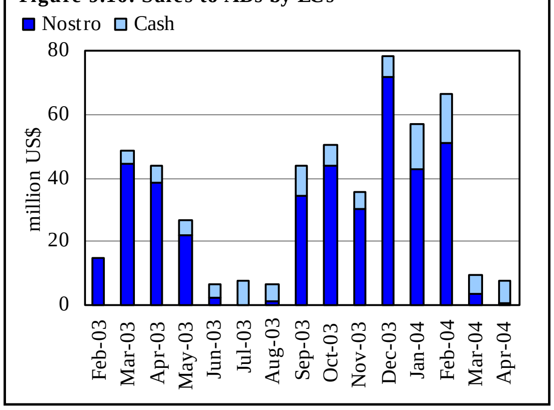


[1] The Civil Aviation Authority made a pre-payment of US$ 70 million in April 2004. This was followed by a pre-payment of US$ 388 million by PARCO in June 2004. Though PARCO's payment was made in the first week of June 2004, the market had already started taking *long* positions to capitalize the gains from Rupee's expected depreciation due to higher demand from the corporate sector. The pressure on Rupee is likely to remain there in the market on account of more prepayments in the pipeline by IPPs.

particular, this stock witnessed a rise in April 2004, even as the export growth slowed. This raises the possibility that export proceeds are being delayed in anticipation of a weakening rupee (see **Figure 9.15**).

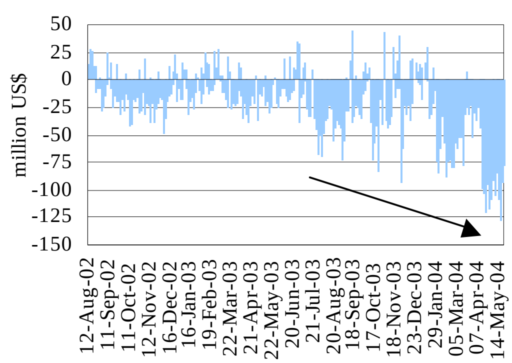
Finally, the lower inflows from exchange companies also augmented pressures on inter-bank market rate (see **Figure 9.16**).

Figure 9.16: Sales to ADs by ECs



These developments intensified payment pressures on inter-bank market; the aggregate net open position (NOP) of banks rose significantly, reaching negative US$ 100 million by April 2004[2] (see **Figure 9.17**). Thus, in order to maintain Rupee Dollar parity, SBP re-profiled its forex market operations, providing forex liquidity through net sales to the market since April 2004[3](see **Figure 9.18**).

Figure 9.17: Aggregate Net Open Position



In fact, SBP was a net seller in the market during Apr-May FY04. SBP's policy to reduce its purchases from the market, however, had two additional impacts:
(1) it reduced the pace of reserve accumulation. However, given the high reserves this is not a worrisome development; and

[2] Major factors contributing in this sharp decline in April 2004 include: (1) exceptionally higher trade deficit (grew by 7.6 percent over March 2004) due to increase in import of crude oil; (2) prepayment of Foreign Private Loan for Civil Aviation (amounting US$ 70 million); and (3) outstanding Portfolio disinvestment of US$ 86.9 million in April 2004.

[3] The pressures on exchange rate was much severe in May 2004 as a result SBP had to heavy forex liquidity to the inter-bank market.

(2) it helped contain reserve money growth. This was desirable in order to contain inflationary pressure in future.

9.4.1 Kerb Premium

A noticeable development since February 2004 is the upward trend in the kerb market premium.

However, the premium is too small[4] to cause a diversion of forex flows from the inter-bank market. Moreover, the growth of the informal market is also likely to be constrained by the increased documentation of funds transfer in the UAE, which is the major hub for the informal market (see **Figure 9.19**).[5]

The revival of the kerb premium probably results from: (1) higher speculative buying; and (2) increasing demand of dollars by gold merchants (payments against gold imports are generally met from kerb market).

Figure 9.18: SBP Purchases and SBP Reserves (net)

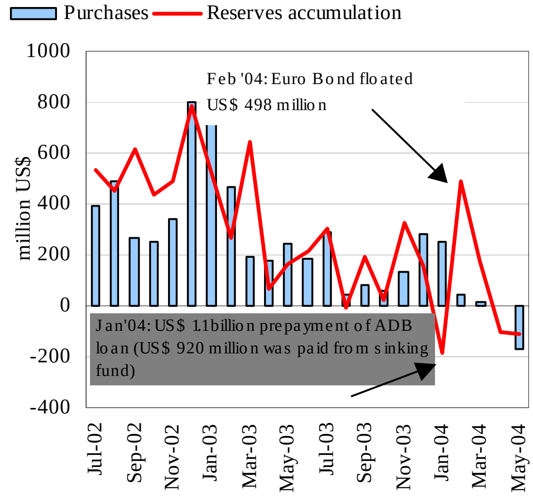
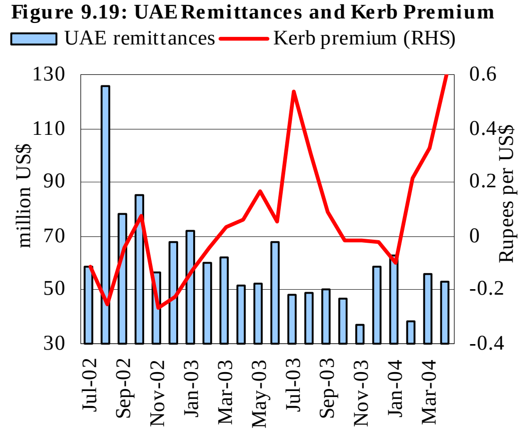


Figure 9.19: UAE Remittances and Kerb Premium



[4] The kerb premium has ranged between –0.28 percent and 0.95 percent during Jul-May FY04.
[5] It has been alleged that the rise in premium was actually a tactic used by moneychangers to pressurize the SBP to allow them to continue their business in the current form.

9.4.2 Real Effective Exchange Rate Indices

As evident from **Figure 9.20,** the Pakistani Rupee depreciated in real terms by 0.6 percent during Q3-FY04 making the exports more competitive. This is however, largely due to the weakness in dollar against other currencies in the basket as in terms of price rise, the relative price index shows a relatively higher inflation in Pakistan than the countries in the basket. The change in REER during, however, is relatively lower than the 1.9 percent change in Q2-FY04 and 4.3 percent in Q3-FY03.

Figure 9.20: Effective Exchange Rate Indices (IMF)

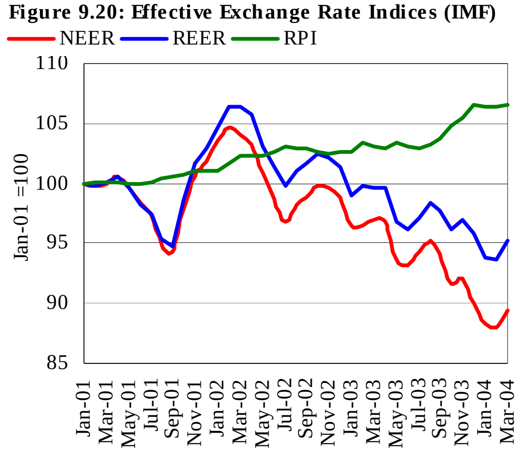


Table 9.18 shows that during the quarter, the Rupee depreciated against all the major currencies except for Euro. This is probably due to the relatively higher supply of Euros in the market as the exporters shifted their exports to Euro from US Dollar.

Table 9.18: Rupee vis-à-vis Selected Currencies

percent changes

		Euro	GBP	JPY	US$
FY03	Q1	2.3	-0.5	3.2	1.5
	Q2	-4.9	-1.1	-1.1	1.4
	Q3	-2.4	2.6	1.6	0.9
	Q4	-5.2	-4.6	0.4	0.1
FY04	Q1	-1.9	-1.3	-7.6	-0.2
	Q2	-6.8	-5.5	-2.9	0.8
	Q3	2.7	-3.4	-2.6	-0.1

9.5 Foreign Exchange Reserves

The weakeness in Pakistan's external account flows (see **Section 9.1** for details) is quite evident in the changes in the total forex reserves post-January 2004, with the Jan-May FY04 reserve accumulation totalling US$ 341.0 million as compared with the US$ 1453.0 million during H1-FY04 (see **Figure 9.21**).

However, even this relatively weak growth, that took reserves to US$ 12.5 billion by end-May 2004, helped improve the import coverage ratio to approximately 51 weeks, despite a sharp increase in the average monthly import bill.

The composition of the changes in the foreign exchange reserves during Jul-May FY04 also reveals interesting insights (see **Figure 9.22**). In sharp contrast to FY03, commerical bank reserves increased by US$ 469 million to US$ 1,663.0 million during Jul-May FY04 after experiencing sharp fall of US$ 887.4 million in the corresponding period of FY03 (see **Figure 9.22**). This upturn in the commercial bank reserves holdings in Jul-May FY04 was the upshot of:

Figure 9.21: Foreign Exchange Accumulation

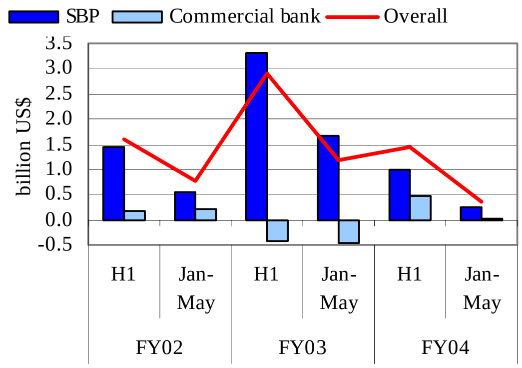
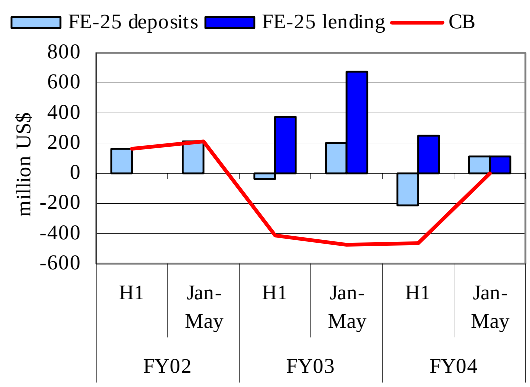


Figure:9.22: Commercial Banks Reserves Flows



(1) The net retirement of FE-25 loans totalling US$ 142.6 million in Jul-May FY04 against a massive increase of US$ 1048 million in the corresponding period last year[6].

(2) The relatively higher FE-25 deposit growth of US$ 326.3 million in Jul-May FY04 compared with much lower increase in FE-25 deposits of US$ 160.1 million in FY03. The factors contributing to the relative improvement in FE-25

[6] That is also why the commercial banks reserves witnessed a sharp decline during FY03. When a commercial bank extends a loan against FE-25 deposits, the borrower only receives the Rupees and not the Dollars. Since banks sell the Dollars in the inter-bank market and since SBP is the largest purchaser of foreign currency in the inter-bank market, these dollars simply move from the commercial banks to the SBP. However, when this loan is repaid to the commercial banks, the reverse does not happen since the loan is repaid usually with the dollar receipts against exports. Bulk of the FE-25 loans is for exports.

deposit include: (1) the absence of hefty withdrawals[7] related to temporary deposits of Privatization Commission; and (2) the rise in non-US$ forex deposits (probably reflecting the strengthening of the Euro against Rupee).

On the other hand, the evident deceleration in the growth of SBP reserves owed to lower purchases from inter-bank market, absence of net inflows from '*export of currency*[8] and lower receipts from donor agencies (see **Table 9.19**).

[7] During Q3-FY03, privatization proceeds of UBL and Pakistan Oil Fields were transferred to government account with SBP from National Bank.
[8] The 'export of currency' stopped contributing in SBP reserves as the moneychangers were instructed to sell their foreign currency other than the US Dollar to the exchange companies instead of banks.

Table 9.19: Overall Reserves as per BOP[1]
million US Dollars

	FY03			FY04			July-April	
	Q1	**Q2**	**Q3**	**Q1**	**Q2**	**Q3**	**FY03**	**FY04**
Opening Balance	*6398*	*8819*	*10070*	*11,667*	*12,302*	*12,759*	***6,398***	***11,667***
Inflows	**7,273**	**6,380**	**5,673**	**5,996**	**6,489**	**7,030**	**21,192**	**21,653**
Exports of goods	2623	2550	2606	3,014	3,055	3,106	8761	10197
Export of services (excluding interest)	858	497	987	*877*	*739*	*637*	2487	2464
of which: logistics support	317	0	530	384	198	172	847	754
Workers' remittances	1053	1095	1083	906	968	1001	3537	3210
Foreign direct investment	161	164	116	118	137	149	508	562
Foreign portfolio investment	-3	33	-24	-28	10	-26	-2	-130
Euro bonds	0	0	0	0	0	500	0	500
Loan disbursements	730	531	349	295	516	441	1672	1407
Official	604	486	319	237	496	101	1471	972
Long-term loans	577	408	264	*237*	*488*	*101*	1305	964
Program loans	445	292	129	126	363	0	866	590
IMF	115	115	118	0	245	0	348	245
IDA/IBRD	202	0	11	0	0	0	213	101
ADB	128	177	0	126	118	0	305	244
Project & food loans	132	116	135	111	125	101	439	374
Short-term including IDB	27	78	55	*0*	*8*	*0*	166	8
Private un-guaranteed	126	45	30	58	20	340	201	435
Privatization proceeds	10	176	0	0	0	199	186	199
Official Grants	278	292	297	210	247	114	926	588
Of which: Saudi oil facility	189	207	170	147	128	27	598	302
Other receipts	1563	1042	259	604	817	909	3117	2656
Outflows	**4,852**	**5,129**	**4,706**	**5,361**	**6,032**	**7,293**	**16,420**	**20,906**
Imports of goods	2769	2853	2744	3,004	3,205	3,600	9345	11047
Imports of services (excluding interest)	579	586	649	817	970	1127	2145	3318
Interest payments	227	246	239	213	349	227	765	827
Amortization of official loans	257	329	284	388	458	1493	1009	2510
Of which: IMF	89	74	117	141	202	189	347	575
IDA/IBRD	93	72	98	108	80	114	295	341
ADB	48	84	56	57	89	1177	219	1346
Profit and dividends	241	290	234	235	342	321	856	1035
Principal repaid on private loans	172	140	178	164	123	226	495	545
Foreign exchange liabilities liquidated	432	263	392	93	120	83	1103	342
FE-31/ FE-45	23	127	256	0	0	0	406	0
PTMA & commercial loans	40	14	15	17	16	0	69	33
IDB (short term)	24	22	76	35	70	56	127	188
Swaps	230	5	0	0	0	0	235	0
Special dollar bonds	115	95	45	41	34	27	266	121
Other Payments	175	422	-14	447	465	216	702	1282
Net inflows	**2421**	**1251**	**967**	**635**	**457**	**-259**	**4772**	**747**
Gross reserves at end of period	8,819	10,070	11,037	12302	12759	12500	11,170	12,414
CRR	*459*	*422*	*434*	*476*	*507*	*522*	*451*	*548*
Sinking fund	637	900	915	920	920	0	*915*	*0*
Net reserves of SBP	5941	7654	9093	10019	10525	11001	*9160*	*10897*
Com. Banks reserves (including CRR)	*2,241*	*1,516*	*1,029*	*1,363*	*1,314*	*1,499*	*1,094*	*1,517*

[1]The data used in the Table (9.5.1) differs from the text because (1) it is based on latest available Balance of Payments data and (2) SBP reserves include Indian Pending Transfers.

Box 9.2: SBP Foreign Exchange Reserve Accumulation and Market Purchases – Some Issues and Facts

<u>Issue 1</u>**: State Bank has accumulated foreign exchange reserves by purchases from the market.**
Fact: Accumulation of foreign exchange reserves can take place only when the overall balance of payments of a country is positive i.e. the current account and the capital account taken together are in surplus. For the last four years this happens to be the case in Pakistan and hence reserves have gone up from approximately US$ 1.0 billion in FY00 to over US$ 12 billion by end-May 2004

As all foreign exchange earnings and sales of a country take place through the inter-bank market the State Bank, like all the Central Banks pursuing a floating exchange rate policy, intervenes (i.e. buys and sells foreign exchange) in the inter-bank market to smooth out the payments and reduce volatility in exchange rate. Thus, inter-bank market purchases are the normal mode through which a Central Bank pursuing a floating exchange rate policy accumulates its reserves.

<u>Issue 2</u>**: SBP has built up foreign reserves by purchasing US$ 12 billion from the open market.**
Fact: After the nuclear test in 1998 and consequential sanctions on Pakistan, official inflows declined considerably and these inflows were inadequate to meet the out-flow obligations. To avoid default on the country's external payments, the State Bank of Pakistan intentionally adopted a policy, with the approval of Federal Government, to make all payments on time, and build up foreign exchange reserves for future debt servicing liabilities by buying foreign exchange from the kerb market. The alternative was to borrow commercially on a very high rate, adding to the already high foreign debt burden. The purchases from the kerb market, though at higher than inter-bank rates, were non-debt creating. All purchases from the kerb market were through Foreign Exchange Association of Pakistan, the representative body of authorized money changers, as well as big money changers through banking channels.

The State Bank of Pakistan purchased US$ 5.654 billion from the kerb market from FY99 to FY02, mainly to discharge its obligations. As the flows in the inter-bank market improved, the SBP stopped purchases from the open market after FY02.

In addition to the US$ 5.654 billion purchased from the open market, SBP also purchased US$ 10.838 billion from the inter-bank market in the period between FY99 and March 2004, at the prevailing inter-bank without paying any premium, and sold US$ 3.982 billion during the same period. Thus the net purchases from the inter-bank market in the period amounted to US$ 6.856 billion.

It can be seen that the total amount of US$ 12.510 billion represents the cumulative purchases from both, the open market and inter-bank market, and not from the open market alone, as alleged. But during the same period the SBP also made debt servicing payments to external creditors totaling US$ 17.413 billion. Thus, it is obvious that if outflows exceed the total SBP purchases by US$ 4.903 billion, there is no way that the purchases from the open market alone can account for the reserve accumulation since FY99.

The factors contributing to the reserve accumulation have been explained, and the actual numbers presented, in the SBP Annual Reports since 1999-00 (also see Table 1 below). To recapitulate, the main factors were:

Significant reduction in debt servicing payments due to implementation of debt reduction strategy.
Increased inflows of workers' remittances.
Reduced imbalances in the trade account (until FY04)
Higher disbursements of foreign economic assistance.
FDI inflows showing some modest rise.

The success of the above strategy can be gauged from the fact that Pakistan has reduced its debt servicing payments from 50.1 percent of revenues in FY00 to 26 percent in FY04.

Issue 3: SBP has suffered a loss of Rs.25 billion in FY03 due to its foreign exchange purchases.

Facts: It is true that there was a difference between the open market and the inter-bank rates, and just like any other Pakistani buyer, the SBP also paid this difference on its purchases. The total amount paid on account of this differential rate, over a 4 year period, was Rs. 18.257 billion. This has been reported in every single audited financial statement of the SBP. As the alternative to these purchases was to borrow from external creditors at exorbitant interest rates (because of country's high risk premium) and accumulate future debt servicing obligation, this modest cost of about Rs. 18.257 billion (equivalent to US$ 300 million) in acquiring non-debt flows of US$ 5.654 billion, was an attractive proposition.

The reduction in profits in the year FY03, which has been reported in the SBP Annual Reports and the Press, has nothing to do with the purchases from the open market, as there were no purchases made that year. The reduction in profits was mainly due to the revaluation of SBP's foreign exchange assets and liabilities required under the international accounting standards. The SBP accumulated large net foreign assets, totaling US$ 7.986 billion in FY03, which were reported in rupees in its profit and loss statement. Thus, as the Pakistani Rupee, appreciated vis-à-vis the US dollar by Rs.2.21 during the financial year (from Rs.60.02/US$ in June 2002 to Rs.57.81/US$ by end June, 2003), the SBP suffered a revaluation loss of Rs.17.65 billion (the actual loss was compensated by gains of Rs.6.6 billion on forward cover).[1]

The other major component of the reduction in SBP's FY03 profits was due to a decline in T-bill rates. While the decline in interest rates on T-bills affected the profitability of SBP, it also significantly reduced the debt servicing costs of the Government of Pakistan. According to their estimates, the debt servicing payments during FY03 were Rs.207.8 billion as against the budget estimate of Rs.264.0 billion. The savings on domestic interest payments in the budget caused by lower T-bill rates were thus higher than the diminution of SBP profits. In net terms, the Government was better off in FY03, the private sector got credit at cheaper rates, and the export refinance rate was drastically slashed. This reduction in the profits of SBP in FY03 of Rs.7.339 billion because of lower discount income should be seen in the light of these significant gains to the economy.

[1] It should be noted that had the Rupee depreciated in this period by Rs.2.21, the SBP would have made a revaluation profit of Rs17.65 billion.