6 External Sector

6.1 Overview

After remaining in deficit for six consecutive years, Pakistan's current account posted a surplus of US$ 0.7 billion in Jul-Apr 2011. This improvement overshadowed the deterioration in the financial account during this period, resulting in an overall surplus of US$ 1.2 billion during Jul-Apr 2011, compared to US$ 0.7 billion in corresponding period of the previous year (see **Table 6.1**).

The current account surplus is primarily a result of strong export growth, and an increase in worker remittances. We expect the improvement in the current account to be sustained through the remaining two months of FY11.

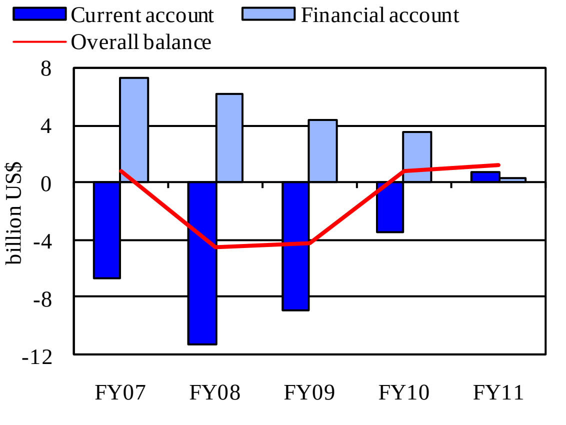
A key concern, however, is the sharp and continuous deterioration of the financial account. Specifically, the surplus under this head declined for the fifth consecutive year during Jul-Apr 2011(see **Figure 6.1**): the financial account posted a meager surplus of US$ 0.5 billion during Jul-Apr 2011 against US$ 3.7 billion last

Table 6.1: Summary of External Accounts (Jul-Apr)

billion US$

	FY10	FY11	Abs. Change	Percent Change
C/A balance	**-3.5**	**0.7**	**4.2**	**120.0**
Trade balance	-9.3	-8.3	1.0	10.8
Exports	16.2	20.5	4.4	27.0
Imports	25.5	28.8	3.4	13.2
Invisible balance	5.8	9.0	3.2	54.2
Remittances	7.3	9.0	1.7	23.8
Financial/Capital balance	**3.7**	**0.5**	**-3.2**	**-86.5**
FDI	1.7	1.2	-0.5	-29.4
FPI	0.0	0.3	0.3	500.0
Other investment	1.9	-1.2	-3.1	-163.1
Errors & omissions	0.5	0.0	-0.5	-100
Overall balance	**0.7**	**1.2**	**0.5**	**71.4**

Figure 6.1: External Sector



year since both investment and loan inflows experienced a decline during the period under review.

Another concern is that Pakistan's textile exports may not be able to repeat the performance shown in FY11 as (a) recovery in global demand appears fragile; (b) the price gain in textiles, which helped create a surplus in FY11, may not be available going forward following a sharp drop in cotton prices; and (c) domestic constraints such as energy and a deteriorating law & order situation, have only got worsened. Hence, with imports showing no sign of contracting, there is a likelihood of the trade deficit widening in FY12.

Net financial inflows in the past few years have remained low, but the situation could deteriorate as Pakistan has to make substantially large debt repayments to the IMF in FY12. Since the global financial environment remains uncertain, mobilizing financial resources from international markets would be challenging.

6.2 Current Account Balance

Record export earnings, strong growth in worker remittances and increase in receipts on account of the coalition support fund and flood related grants, helped transform the current account balance into a surplus for the first time in 6 years (see **Table 6.2**).

Table 6.2: Current Account (Jul-Apr)

billion US$

	FY10	FY11
Major inflows		
Exports	16.2	20.5
Remittances	7.3	9.0
Services exports	3.7	4.7
Major outflows		
Imports	25.5	28.8
Services imports	5.7	6.1
Overall C/A	**-3.5**	**0.7**

The trade deficit– the largest component of the current account – contracted significantly, as the sharp growth in exports outpaced imports.

Although the rising unit prices of textile items account for majority of the improvement in export performance, higher demand particularly in the US and the EU also contributed.[1,2] On the other hand, imports posted a growth of 13.2 percent during Jul-Apr 2011 due to a rise in international commodity prices (e.g., food and oil).

[1] Textile exports increased by US2.0 billion, of which US$ 1.6 billion was due to rising export unit prices.

[2] This is the highest level of export proceeds during the first 10 months of a fiscal year.

The deficit in the *services* also showed a contraction of 28.1 percent during Jul-Apr 2011, primarily driven by inflows under the coalition support fund (US$ 743 million) and flood-related grants (roughly US$ 500 million).

The *income account*, however, did not show any major change, but did experience higher payments on account of IMF charges, interest on official and private external debt, and repatriation of profits and dividends (particularly in oil & gas and financial businesses). However, payment pressures eased somewhat due to lower outflows of income on equity.

The most significant development in the external account is the sharp increase of 23.8 percent in workers' remittances during Jul-Apr 2011. This growth represents a continuing improvement over and above last year's increase of 14.9 percent. At its current pace, workers' remittances would surpass US$ 10.5 billion by end of FY11. The ongoing global economic recovery, SBP and government efforts to channelize remittances into the banking system,[3]coupled with support from expatriates to the flood affected households, largely explain this strong performance.

Interestingly, more than 60 percent of remittances originated from the Gulf region (particularly UAE). More importantly, remittances from Dubai which declined substantially last year following the financial crisis in the country, staged a sharp recovery this year.

6.3 Financial Account Balance

As mentioned earlier, the financial account surplus declined for the fifth consecutive year in FY11, to US$ 0.5 billion in Jul-Apr 2011 compared with US$ 3.5 billion in the corresponding period last year. Unlike the previous year, when only *investment* inflows declined, this year *loan* inflows fell sharply (see **Figure 6.2**).

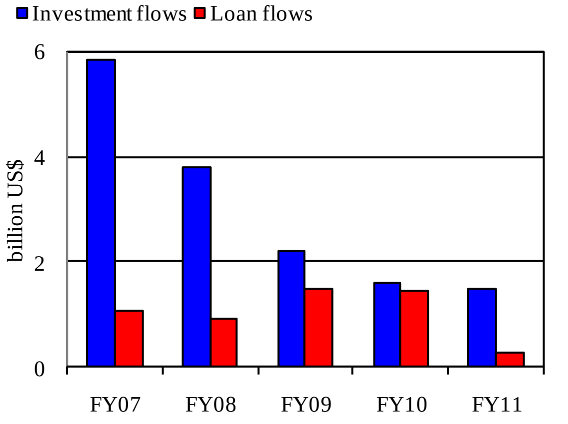
Net foreign private investment fell by 8.6 percent, primarily due to a decline of US$ 500 million in foreign direct investment during Jul-Apr 2011. On the other hand, foreign portfolio investment recorded a net inflow of US$ 298 million during this period, which was in sharp contrast to an *outflow* of US$ 48.0 million during Jul-Apr 2010. The outflow during 2010 was mainly on account of the

[3] Initiatives under PRI such as Xpress money, incentives in the form of interbank fund transfer facility and Easy-paisa by Telenor Pakistan has helped in increasing the remittances through formal channels.

repayment on Sukuk bonds worth US$ 600 million. This means the absence of any large repayment this year, is responsible for the improvement in net terms.

A detailed analysis of FDI reveals that major declines were recorded in telecommunication (US$233.8 million) and oil & gas exploration (US$191.8 million) sectors. The decline in Telecom is understandable as this sector has already reached a saturation point in the country. In case of the oil & gas exploration, a growing circular debt and the deteriorating law & order situation seem to be major hurdles in attracting fresh FDI. [4]

Figure 6.2: Financial Account (Jul-Apr)



On the other hand, FDI inflows in power [5] and financial sector, recorded increases. In the financial sector, one-off injection (US$ 74.0 million) in one particular bank, explains the rise in FDI.[6]

In case of loan inflows, suspension of the IMF Stand-by Arrangement is impacting inflows from other IFIs. It is therefore not surprising that the ratio of realized to pledged loans has declined considerably since the suspension of the IMF program.[7]

6.4 Exchange Rate and Reserves

The improvement in the external account also lent stability to the exchange rate; during Jul-May 2011, the Rupee showed a marginal depreciation of 0.2 percent against a depreciation of 4.5 percent during the corresponding period of the

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[4] It may be worth noting that the country's overall ranking in terms of World Bank's *Doing Business* report has dropped to 83 in 2011 from 75 in 2010.

[5] KESC inaugurated a water purification plant in April 2011. FDI inflow is most likely on account of import of plant equipment.

[6] Injection of US$ 74.0 million in NIB by Bugis Investments – a wholly-owned subsidiary of Fullerton Financial Holdings of Singapore.

[7] The World Bank and the ADB pledged US$ 1.0 billion each, however only US$0.55 and US$0.40 have been realized so far.

previous year. However, the Rupee appreciated by 3.0 percent in real terms against Pakistan's trading partners due to higher domestic inflation in the country.

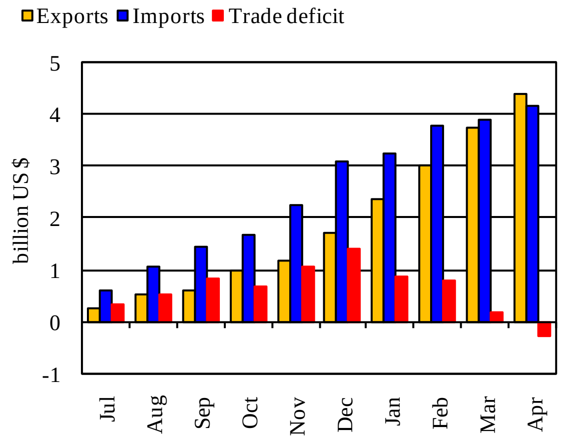
Comfort on the external sector allowed SBP to make substantial purchases from the inter-bank market during the year. As a result, FX reserves increased sharply and reached US$ 17.1 billion by end-May 2011. However, reserve adequacy, measured in terms of weeks of imports, declined slightly from 26.4 weeks of imports to 25.7 weeks, reflecting a pick-up in import growth.

6.5 Trade Account[8]

Pakistan's trade deficit continued to narrow for the third consecutive year, declining by 2.1 percent YoY during Jul-Apr 2011.

Unlike the previous two years, however, this decline was not due to contraction in the import bill, but due to the stellar performance of exports. Despite a challenging economic environment, a YoY growth of 27.9 percent during Jul-Apr 2011 is indeed commendable.

Figure 6.3: Trade Account YoY Change - Monthly Cumulative



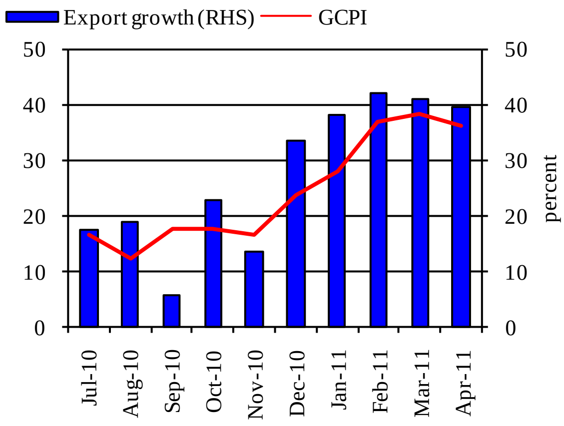
Imports also posted a significant rise of 14.7 percent during Jul-Apr 2011 after declining during the previous two consecutive years. In fact, the import bill initially increased the YoY trade deficit and it was only in Q3-FY11 that a surge in exports resulted in the contraction of the trade deficit (see **Figure 6.3**).

The surge in exports was driven by both rising demand owing to global economic recovery and rising trend in international commodity prices. Pakistan benefited particularly from the increase in cotton prices during Jul-Apr 2011. As a result, exports were driven by both increase in quantum and prices (see **Figure 6.4**). More encouragingly, not only did textile exports record a substantial improvement, but non-textile exports also made a sizeable contribution.

[8]The analysis is based on provisional data provided by the Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section of *Balance of Payments.*

Although the rise in the global demand and favorable commodity prices benefited Pakistan's exports, they also led to a rise in imports which have remained dormant during the previous two years. Not surprisingly, therefore, the major contributors to import growth were food, petroleum and textile groups.

Figure 6.4: Global Commodity Price Index & Export Growth

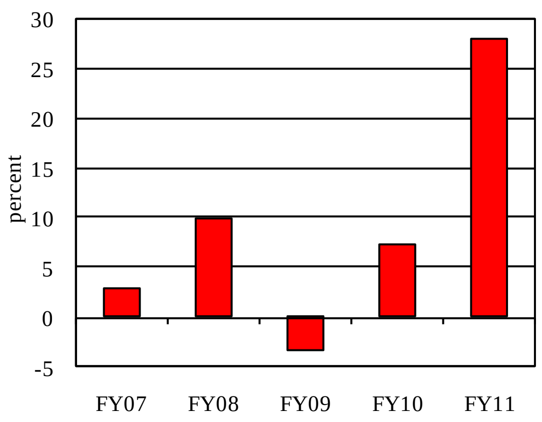


Both exports and imports are expected to witness a seasonal increase in the fourth quarter. However, the performance of exports suggests that the rise in imports would be more than offset and as a result, the country's trade deficit could narrow further in Q4-FY11.

Exports

A combination of both external and domestic factors caused exports to record a healthy YoY growth of 27.9 percent during Jul-Apr 2011 compared to a rise of 7.3 percent during the corresponding period of last year (see **Figure 6.5**). The analysis of the monthly export performance reveals acceleration in export growth from December 2010 onwards, which was broadly in line with the rising trend in international commodity prices. The recovery in exports has been broad-based, led by better performance of food group, textiles and jewelry exports

Figure 6.5: Eport Growth (Jul-Apr)



Textile group

Textile exports increased by 32.1 percent YoY during Jul-Apr 2011 compared to a 6.8 percent rise in the corresponding period last year. This improvement largely emanated from strong demand for textile and clothing in the EU and the US.

In overall terms, 25.6 percent of the total increase in textile exports was contributed by low value-added categories, i.e., cotton yarn, raw cotton and synthetic textiles. The rise in these categories of exports was due to better prices since export quantum declined compared to last year (see **Table 6.3**).

Table 6.3: Major Textile Exports Price & Quantum Impact (Jul-Apr)

million US$

	FY10			FY11		
	Absolute change	Qty	Price	Absolute change	Qty	Price
Textile Group	**385.1**			**2,333.8**		
Of which						
Raw cotton	113.0	99.7	13.3	43.0	-85.7	128.7
Cotton yarn	269.8	298.3	-28.5	392.2	-253.4	645.6
Cotton fabrics	-180.0	-144.1	-35.9	354.5	-5.6	360.2
Knitwear	-15.2	-49.0	33.8	422.3	349.2	73.1
Bed wear	-2.6	12.5	-15.1	273.0	47.6	225.4
Towels	21.9	69.9	-48.0	87.8	99.6	-11.8
Readymade garments	12.2	-66.1	78.4	365.6	242.3	123.3
Art silk and synthetic textiles	101.2	66.2	35.0	196.0	161.9	34.1

Although Pakistan's cotton crop was partially damaged due to floods earlier this year, this coincided with global supply shortages in key textile inputs. As a result, Pakistan was able to get better prices for both raw cotton and yarn. This advantage is, however, diminishing with the arrival of the new crop; cotton prices have started to recede from March 2011 onwards. Going forward, cotton prices are expected to decline further, which will reduce the price impact in these categories in the coming months of FY11.

Unlike the low value-added group, growth in high value-added textile was driven by a strong increase in quantum supplemented by higher prices (see **Table 6.3**). This reflects gradual improvement in global demand for textiles as exports of major textile and apparel producing countries, including Pakistan, increased during the third quarter of FY11.

Non-Textile Sector

The analysis of non-textile exports shows that most major groups posted positive growth, although with a declining quantum.

The export under the 'food group' however witnessed an increase in quantum mainly driven by *wheat, raw tobacco & vegetable*. Improvement in export quantum of *wheat* was supported by higher carryover stocks of FY10 and expectations of a bumper FY11 wheat crop. Furthermore, the rise in international wheat prices (due to bad weather conditions in Russia, USA and Canada) and a decent domestic output helped in exporting of wheat during the period under review.

In the *other* manufactures' group, exports of leather, chemicals and sports goods recorded an increase; however, this rise was partially offset by negative growth in exports of cement and the jewelry. The increase in leather, chemicals and engineering goods was a function of improved external demand in traditional markets and relatively better export prices. On the other hand, Pakistan's cement exports continued to decline during Jul-Apr 2011, as overall cement exports decreased by 11.0 percent YoY. The decline in the both – export value and volume – is due to (a) qualitative barriers in exporting to India; (b) higher import duty in Afghanistan[9], and (c) increased production capacities in the Middle East and India. Going forward, cement exports to India may pick-up following the renewal of export license in April 2011 by them. Furthermore, the expected installation of scanners at Wagah border in FY12 would make truck-based export to India possible.[10]

Imports

After recording YoY contraction during the previous two years, the country's imports surged by 14.7 percent YoY during Jul-Apr 2011. A large part of this increase in the import bill was recorded in Dec-Apr 2011, mainly due to higher *petroleum, food and textile group* imports. As with exports, a significant part of this rise was caused by a surge in the international prices of *oil, raw cotton* and *palm oil*. Rising international oil prices alone contributed 36.5 percent to the total increase in the import bill during Jul-Apr 2011.

[9] Beyond immediate borders, cement's cost competitiveness quickly erodes as freight charges rapidly escalate on the bulky commodity. Over 50 percent of Pakistan's cement exports are directed to Afghanistan while around 7 percent are routed to India.

[10] Since reserves for lime and gypsum (input for cement) in India are drying up fast, it will either need to import raw material from Pakistan, or the final commodity itself. Low-priced Pakistani cement is apparently the better alternative.

Disaggregation of the *food group* reveals that palm oil and sugar imports accounted for almost 70 percent of the total increase in group imports. A large part of the rise in palm oil imports was due to higher prices and a reduction in import duty on this commodity. Imports of sugar, on the other hand, increased on account of domestic supply shortages (see **Table 6.4**). As such, with the arrival of new sugar stocks in the market, imports of sugar have all but stopped since Jan 2011.

Table 6.4: Major Food Imports (Jul- Apr)

value: million US$, growth: percent

		Value		Δ in	% Δ FY11 over FY10		
		FY10	FY11	Value	Quantity	Value	Unit Value
Food group		**2,784.7**	**4,314.1**	**1,529.5**			
Of which							
Palm oil	MT	1,040.9	1,599.5	558.6	16.1	53.7	32.3
Pulses	MT	209.5	342.6	133.1	48.9	63.6	9.9
Tea	MT	227.8	288.4	60.6	31.7	26.6	-3.9
Sugar	MT	187.8	681.8	494.0	206.9	263.1	18.3
Wheat un-milled	MT	35.4	5.2	-30.3	-89.4	-85.4	37.7

As expected rising international oil prices inflated petroleum group imports, which increased by 8.4 percent YoY during Jul-Apr 2011. This rise, however, was partially compensated by the decline in quantum (see **Table 6.5**).

Table 6.5: Price and Quantum Impact of Petroleum Group Imports (Jul-Apr)
million US$

	FY10			FY11		
		Change in Value due to			Change in Value due to	
	Abs Δ	Quantity	Price	Abs Δ	Quantity	Price
Petroleum group	71.3	912.8	-841.5	703.8	-806.6	1,510.4
Petroleum products	662.7	1,233.4	-570.7	-330.6	-1,096.9	766.3
Petroleum crude	-591.4	-320.6	-270.8	1,034.3	290.3	744.0

The import of raw cotton increased sharply by 71.6 percent YoY during Jul-Apr 2011. Majority of this increase was recorded in Q3-FY11. The jump in raw cotton imports is attributable to the damage caused to the domestic cotton crop by floods earlier in FY11. Higher international prices for cotton further inflated the import bill during the period under review.