5 External Sector

5.1 Overview

Q2-FY12 data indicates further deterioration in external accounts with overall deficit widening to US$ 1.0 billion compared to US$ 0.8 billion in Q1-FY12. It may be recalled that against the deficit of US$ 1.8 billion in H1-FY12, the country had posted a surplus of almost US$ 1.0 billion in H1-FY11.

The worsening in external account was caused by both the current account and the financial account relative to the previous year.

In the current account, the problem arose because of the widening of the trade deficit as exports growth during H1-FY12 decelerated to 9.1 percent from 19.3 percent last year.

Imports growth on the other hand accelerated to 17.8 percent compared to11.2 percent last year. More than 60 percent of this increase was due to rise in the imports of the petroleum products and fertilizer, which showed 37.2 and 18.7 percent increase in their unit values.

Table 5.1: Summary of External Accounts
billion US Dollar

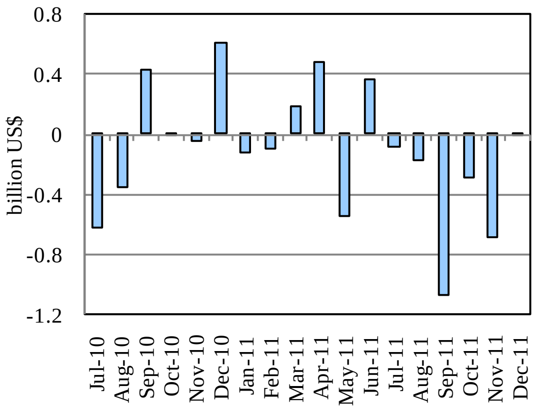
		FY12		
	H1-FY11	**H1**	**Q1**	**Q2**
A-C/A balance	**0.0**	**-2.3**	**-1.3**	**-1.0**
i) Trade balance	-5.8	-7.8	-4.2	-3.6
Exports	11.1	12.1	6.1	6.0
Imports	16.9	19.9	10.3	9.6
ii) Services account balance	-0.3	-1.3	-0.7	-0.6
iii) Income account balance	-1.5	-1.6	-0.6	-1.0
iv) Current transfers	7.6	8.4	4.2	4.2
Remittances	5.3	6.3	3.3	3.0
B-Financial/Capital balance	**1.0**	**0.4**	**0.6**	**-0.2**
i) FDI	0.8	0.5	0.2	0.3
ii) FPI	0.2	-0.1	0.0	-0.1
iii) Others	0.0	0.0	0.4	-0.4
C-Errors & omissions	**0.0**	**0.1**	**0.0**	**0.1**
Overall balance (A+B+C)	**1.0**	**-1.8**	**-0.8**	**-1.0**
Foreign reserves (31st Dec)	17.2	16.9		
Exchange rate (31st Dec)	85.7	89.9		

P: Provisional
Source: State Bank of Pakistan

While the rise in imports was attributable to increase in the unit values, the fall in export was largely due to decline in quantum, particularly textiles. Though textile exports may also have suffered from slowdown in demand in its main markets (EU and US); across the board increase in unit values of value added textiles indicates that domestic issues, particularly energy shortages, may have been the main reason for slowdown in the country's exports.[1]

A point of consolation was the slowdown in the pace of deterioration of the current account in Q2-FY12 relative to the first quarter (**Figure 5.1**). Specifically, compared to a deficit of US$ 1.3 billion in Q1-FY12, the current account deficit was US$ 1.0 billion in Q2-FY12 (**Table 5.1**). This was primarily due to lower trade deficit in Q2-FY12, as the country's service deficit and current transfers were more or less the same in both the quarters.

Figure 5.1: Monthly Trend of Current Account Balance



Source: State Bank of Pakistan

As against the current account, the pace of deterioration in the financial and capital account accelerated in Q2-FY12. Financial and capital account, which posted a surplus of US$ 0.6 billion during Q1-FY12, posted a deficit of US$ 0.2 billion in Q2-FY12. While fresh inflows remained constrained, a large retirement of trade financing loans by importers fearing depreciation of rupee caused the financial account to post a deficit in Q2. Accordingly, the financial and capital account surplus declined to US$ 0.4 billion in H1-FY12 against a surplus of US$ 1.0 billion in the corresponding period of FY11 (**Table 5.1**).

Although the government remains optimistic regarding PTCL privatization proceeds, inflows on account of 3G license fees and a Euro bond issue, these inflows have not materialized so far.

The combined deterioration of current and financial accounts during H1-FY12 brought pressures on SBP reserves and exchange rate. During H1-FY12, Pakistan's liquid foreign exchange reserves declined by US$ 1.4 billion, while the exchange rate depreciated by 4.4 percent. The pressure on the country's reserves and exchange rate could increase in H2-FY12 with a further widening of the trade

[1] EU and US textile imports from the world as of end-October and end-November 2011 declined by 18.0 and 8.1 percent respectively.

deficit and external debt servicing. In this scenario, it is important for the government to have a clear and credible strategy for shoring up the external position to avoid undue speculative pressures.

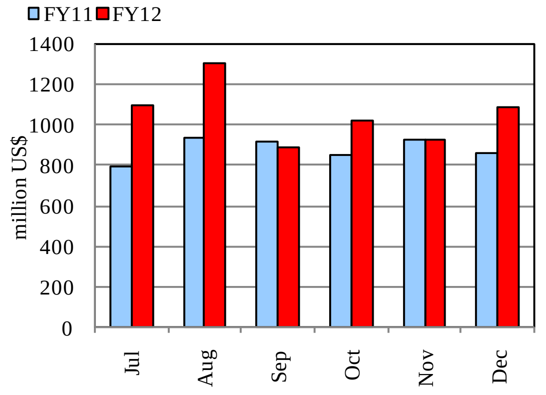
5.2 Current Account

While the bulk of the increase in the current account deficit was due to widening of the trade deficit; increase in the services account deficit also contributed to the widening of deficit in the current account during H1-FY12.

Services account deficit increased to US$ 1.3 billion during H1-FY12 compared to US$ 0.3 billion during the same period last year. This increase in the deficit was due to: (1) the absence of inflows under the coalition support fund (CSF); and (2) increase in outflows for travel services. It is pertinent to mention that against US$ 743.0 million in H1-FY11 Pakistan has not received any inflow under CSF in the current fiscal year.

Current transfers continued to be the only source of comfort for the external sector, posting YoY growth of 9.7 percent during Jul-Dec FY12. Within current transfers, workers' remittances recorded a healthy growth of 19.5 percent on top of 16.8 percent growth recorded during the same period of the previous year. Monthly data reveals that workers' remittances dropped sharply in September 2011, before recovering in the following months (**Figure 5.2**).[2]

Figure 5.2: Monthly Workers' Remittances



Source: State Bank of Pakistan

Channel-wise data indicates that remittances through banks increased by 24.9 percent while remittances through exchange companies declined by 4.7 percent during the period under review. Since the start of Pakistan Remittance Initiative in August 2009, remittances through the banking channel have increased

[2] The remittance dropped sharply by 32.0 percent MoM in September 2011, contributing to the widening of the current account deficit. The fall in remittances owed to seasonal slowdown, delays in payment of commission to authorized money changers and due to speculative pressures in the forex market.

significantly. During H1-FY12, share of remittances received through banking channel was 89.0 percent compared with 84.0 and 76.0 percent in FY11 and FY10 respectively.

5.3 Financial Account

Financial account surplus declined to US$ 309 million during H1-FY12 against US$ 990.0 million last year. Decline in both debt (loans) and non-debt creating (investment) inflows contributed to reduction in surplus.

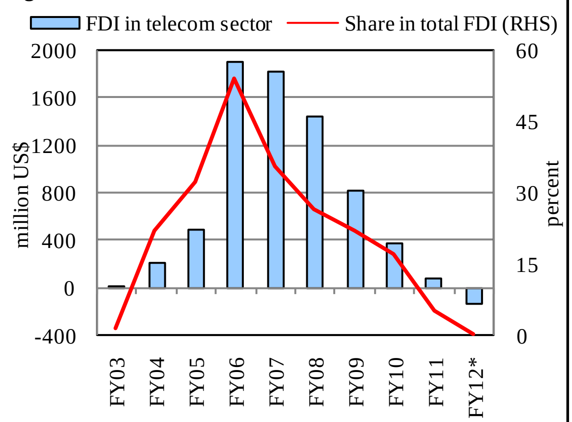
Foreign direct investment recorded inflow of US$ 532.0 million during H1-FY12 against US$ 840.0 million received last year. Sectoral distribution of FDI shows that major contributor to this decline was the telecom sector, recording a fall of US$ 232.0 million. Disinvestment by one of the cellular company largely explains the fall in the telecom sector during this period.

FDI in the telecom sector, which in the past was a major attraction for foreign investors, has been falling since last few year; factors responsible for this fall have been analyzed in (**Box 5.1**).

Box 5.1: FDI Trend in the Telecom Sector

The telecom was one of the most attractive sectors for foreign investors from FY05 to FY08 **(Figure 5.1.1)**. The share of telecom in total FDI started to rise gradually and reached 45.0 percent in FY06. Privatization of PTCL and investment of foreign cellular companies, initially Telenor and Warid and later China Mobile were dominant factors behind the sharp rise in FDI during FY05-FY08.

Figure 5.1.1: Trend of FDI in the Telecom Sector

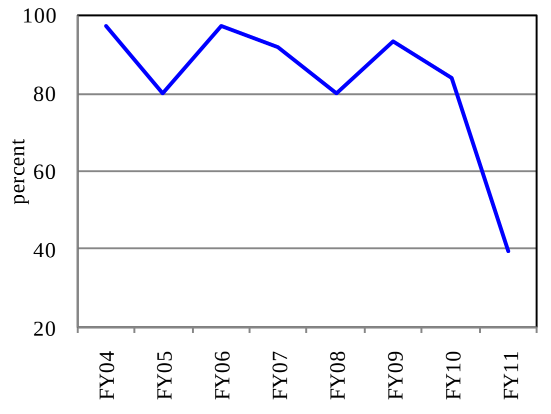


* Jul-Dec Source: State Bank of Pakistan

One obvious reason for the sharp jump in FDI in the telecom sector was the privatization of PTCL. However, even after excluding the privatization proceeds of PTCL, the FDI in the telecom sector was encouraging. Within the telecom sector, FDI flows were concentrated in five companies (PTCL, Telenor, Warid, Pakcom and China Mobile). Foreign investment in these companies stood at 95 percent of FDI (on average) in telecom sector during FY04-FY10. However, the share of these five companies declined sharply in FY11 **(Figure 5.1.2**). The share of companies providing broad-band internet services such as Qubee (subsidiary of Augere), Wateen and Wi-tribe increased in FY11.

Following are the prominent factors that led to a drop in share of these companies.

Figure 5.1.2: Share of Top 5 Companies in Telecom Sector



Source: State Bank of Pakistan

Pakistan Telecommunication Ltd (PTCL)'s 26 percent stake along with management control was sold to Etisalat for US$ 2.8 billion in FY05. These proceeds helped in increasing the financial account surplus at that point of time; however, US$ 800 million payment was held back by Etisalat due to a dispute with the government of Pakistan over legal transfer of land and property titles. If this issue is resolved then the inflow of US$ 800 million would definitely provide support to the financial account.

Another factor that led to disinvestment was the cancellation of license of Pakcom (Instaphone) by Pakistan Telecommunication Authority because of Pakcom's failure to pay outstanding dues on account of license fee of US$ 291.0 million for the next 15 years. After an unsuccessful legal battle, Pakcom started to disinvest FY10 onwards.[3] Recently, the government has decided to auction the license of Instaphone, which could generate US$ 291.0 million in the upcoming months.

The problem of falling average revenue per user (ARPU) is also a challenge for all the cellular operators.[4] With growing competition and entrance of three foreign cellular companies during FY04-09; profits started to squeeze and ARPU/month declined from US$ 3.2 in FY07 to US$ 2.4 in FY09 onwards. Even the latest data of December 2010 shows that APRU/month is US$ 2.5 only.[5] Due to falling average revenues, the existing cellular companies are not only reluctant to bring new investment but one of the cellular company is continuously disinvesting from Pakistan.

Cellular teledensity reached 65 percent by the end FY11, starting from only 3.0 percent in FY04; this reflects that the telecom sector is at the verge of saturation. This factor is also impeding fresh FDI in this sector. Furthermore, we believe that all the existing cellular companies suffered losses following the cancellation of 16 millions unregistered SIMs by PTA.

These are the factors which are hampering FDI flows to telecom sector in Pakistan. However, upcoming auction of 3G licenses, and expected release of PTCL privatization proceeds by Estilate may lead to some rebound in FDI.

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[3] M/s Pakcom (Instaphone) challenged the Authority's decision in Islamabad High Court which was dismissed by the honorable Court. The operator appealed against the decision of the Islamabad High Court in the Supreme Court of Pakistan. The honorable Supreme Court also disposed off the appeal on 27th May 2010 in favor of PTA. On receipt of the detailed judgment, PTA issued final cancellation letter on 24th January 2011.

[4] ARPU is one of the key indicators to gauge the financial status of telecom market in any country.

[5] Pakistan Telecom Authority, Telecom Quarterly Report, December 2010.

Portfolio investment recorded an outflow (net) of US$ 140.0 million during H1-FY12, in contrast to net inflows of US$ 219.0 million in the corresponding period last year. Details indicate that US$ 375.0 million fall was recorded in equity securities, a reflection of bearish stock market during the period under review. At the same time, FPI inflows in fixed income instruments remained unchanged over the previous year even after the tax incentive given in the Federal Budget of FY12.[6] This shows that non-economic factors are impeding foreign inflows. Global Competitiveness Index 2011-12 indicates that Pakistan is ranked at 118th number out of 142 countries in terms of competitiveness. The most problematic factors are political instability, corruption and policy inconsistency. The index further indicates that the law & order situation and the costs of terrorism in Pakistan is the second worst in the world after Somalia.[7]

Other investment which primarily comprises of foreign loans and credits also recorded a fall during the period under review. Disbursement of loans declined by US$ 7.0 million with a major fall in program loan receipts (decline of US$ 389.0 million). However, project loan receipts increased by US$ 438.0 million during the period under review.[8] *Going forward*, potential external flows , includes project loans from World Bank and ADB in the range of US$ 1.0 to 1.2 billion.

Trade financing recorded a decline of US$ 412.0 million during H1-FY12 in contrast to a rise of US$ 328.0 million in the corresponding period last year.[9] This decline was attributed to the retirement of forex loans, which accelerated due to depreciation of Pak Rupee.[10]

Exchange Rate and Foreign Exchange Reserves

The impact of worsening in the current and financial accounts during H1-FY12 is reflected in the depletion of foreign exchange reserves and pressures on Pak Rupee. Specifically, liquid foreign exchange reserves declined to US$ 16.9 billion by end- December 2011, compared with US$ 18.3 billion as of end June 2011.

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[6] For encouraging investments made by non-residents in government securities, the withholding tax on profit on debt deductible @ 10 percent is proposed to be a final tax. This measure will relieve the non-residents from the statutory requirement of filing of return of income, and will boost national economy.

[7] The Global Competitiveness report 2011-12, *World Economic Forum.*

[8] A project loan is strictly for a specific project and it cannot be used for other purposes. A program loan on the other hand can be utilized for a specific project as well as for overall economic development.

[9] Trade financing is basically the financing provided by the banks to exporters/importers for manufacturing, processing, distributing, clearing and other trade related activities.

[10] The decline in trade financing was mainly due to retirement of loans by importers.

While SBP reserves declined by US$ 2.0 billion, those of scheduled banks increased by US$ 0.6 billion during H1-FY12 (**Table 5.2**).[11]

Owing to the weakening of overall external accounts and the subsequent depletion of foreign reserves, Pakistan's currency vis-à-vis US dollar depreciated by 4.4 percent during Jul-Dec FY12 (**Figure 5.3**). Data indicates that fall in reserves generated negative sentiments in the forex market causing exaggerated loss in the value of rupee.

Table 5.2: Sources of Foreign Exchange Inflows During H1

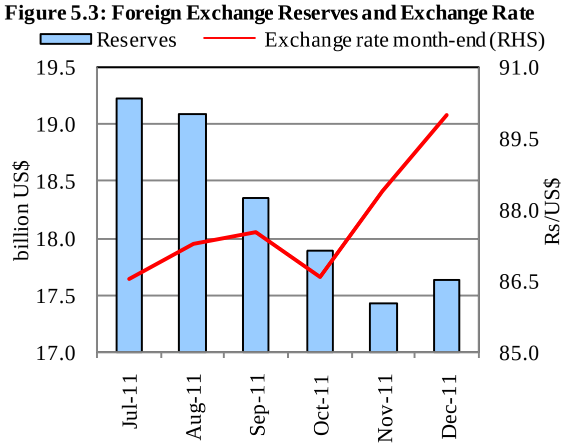
million US Dollar

	FY11	FY12
SBP purchases	1,540.0	850.0
Swaps	3,251.1	2,194.0
Donor agencies & others	2,843.8	1,555.5
IMF	454.5	2.6
IBRD	19.9	87.1
IDA	78.7	161.2
ADB	133.7	206.9
UN troops	109.8	138.9
US/UK/EU COMM/SAMA Grants	202.2	66.9
Logistic support	743.3	0.0
Total	7,634.9	4,599.5

Source: State Bank of Pakistan

In terms of Nominal Effective Exchange Rate (NEER) Pak rupee depreciated by 0.7 percent during Jul-Dec FY12. This was due to the fact that compared to 4.4 percent depreciation against the US dollar, Pak rupee depreciated by 8.5, 6.5 and 0.2 percent against Yen, Euro and Pound. Higher nominal depreciation against these currencies is attributable to weakness of the dollar against these major currencies in the international market.

Figure 5.3: Foreign Exchange Reserves and Exchange Rate



Source: State Bank of Pakistan

The real effective exchange rate (REER) takes into account the exchange rates of trading partners as well as their CPI inflation. REER is mostly indicative of the

[11] SBP was also a net seller of US$ 403.0 million during Jul-Dec FY12.

competitiveness of a country, and therefore has assumed greater importance as an external sector indicator.

During H1- FY12, the depreciation in the NEER was offset by higher inflation in Pakistan compared to its trading partners. Relative price index increased by 3.7 percent in H1-FY12. Therefore, the net result was the *appreciation* of the Pak rupee in real terms by 3.0 percent during period under review (**Table 5.3**).

Table 5.3: Appreciation/Depreciation during H1
percent

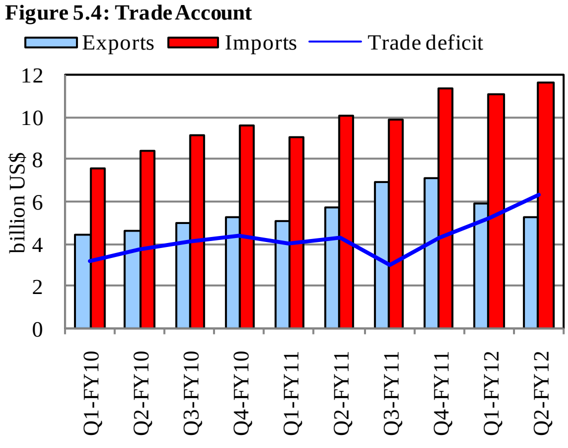
	NEER	RPI	REER
FY08	-4.8	4.3	-0.7
FY09	-7.4	5.4	-2.4
FY10	-6.2	3.6	-2.7
FY11	-5.1	6.4	0.9
FY12	-0.7	3.7	3.0

Source: State Bank of Pakistan

5.4 Trade Account[12]

A combination of sustained growth in imports and deceleration in exports cause the trade deficit to increase by 38.4 percent YoY during H1-FY12 (**Figure 5.4**). The increase in the imports was largely driven by rise in petroleum and fertilizer imports as both quantum and prices rose. Exports on the other hand, decelerated principally due to declining quantum of textiles.

Figure 5.4: Trade Account



Source: Pakistan Bureau of Statistics

Exports

Exports posted a nominal YoY growth of 3.6 percent during Jul-Dec FY12 compared to an impressive growth of 18.7 percent in the corresponding period last year. Given the falling cotton prices, persistence in the energy shortages and poor law and order situation, the deceleration in the exports is likely to continue in the remaining months of FY12 (**Figure 5.5**). As such, SBP expects the exports to contract by around 3.0 percent during the current fiscal year.

[12] The Analysis of trade account is based on PBS data, which differs from the SBP exchange record data.

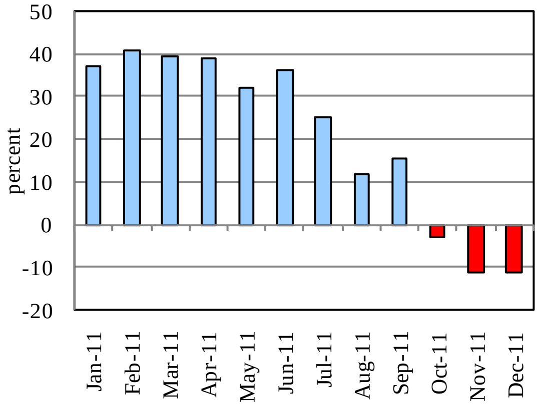
The decline in export growth is largely attributed to fall in textile exports. Textiles that contributed more than 73 percent to last year's export growth had a negative contribution this year, though this was largely offset by positive contributions made by overall food and other manufactures groups (**Table 5.4**).

Within the food and other manufactures groups; fish, fruits & vegetables, footwear, medical & surgical instruments, chemicals & pharmaceuticals, registered a significant rise over the previous year. Exports of rice, carpets and petroleum products, however, declined.

Textiles

Textile exports contracted by 4.8 percent during H1-FY12 against an increase of 25.2 percent last year. This contraction was mainly due to decline in the quantum of exports during Q2-FY12. Textiles in Q1-FY12 had registered a YoY growth of 9.9 percent (**Figure 5.6)**. Both demand and supply side factors were at play in the decline of textile exports with later being more significant. On the supply side, worsening energy situation (especially of gas) remained

Figure 5.5: Export Growth (YoY)



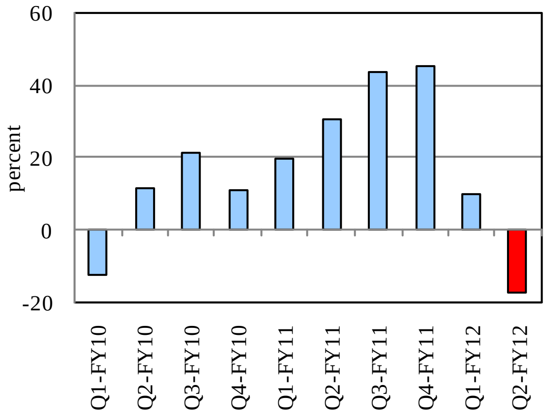
Source: Pakistan Bureau of Statistics

Table 5.4 Exports Performance (Jul-Dec)

	Value in billion US$		Cont. in Growth (%)	
	FY11	**FY12**	**FY11**	**FY12**
Food	1.6	1.9	9.0	66.2
Textile	6.3	6.0	73.4	-68.7
Petroleum	0.6	0.6	11.3	-9.4
Other manufactures	1.9	2.1	4.4	58.9
Others	0.5	0.7	1.8	53.0
Total exports	10.8	11.2	100	100

Source: Pakistan Bureau of Statistics

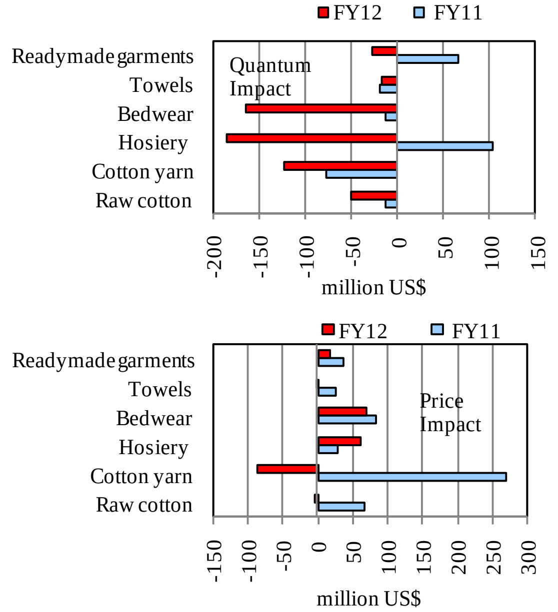
Figure 5.6: Textile Exports Growth (YoY)



Source: Pakistan Bureau of Statistics

a major drag on production activities of textile sector. The situation was particularly bad for the textile industry in Faisalabad, which contributes substantially to textiles related exports. In addition to electricity load shedding, the city faced increased shortages of natural gas.

Figure 5.7: Textile Exports During Second Quarter



Source: Pakistan Bureau of Statistics

With Euro Zone economies struggling and recovery in the US likely to be slow, the IFIs have revised downward their forecast for world growth.[13] The decline in demand in these two important economies would have adverse consequences for small emerging economies like Pakistan. Already decline in demand is clearly discernable from the fall in textile imports in both the EU and the US. This was more apparent in the Q2-FY12 as along with quantum, price impact also became negative (**Figure 5.7**).

Table 5.5 Non-Textile Exports During H1-FY12

million US Dollar

	Quantum Impact	Price Impact
Rice	-333.4	224.3
Petroleum products	-172.6	74.3
Leather garments	-29.9	6.8
Cement	-46.8	34.4
Pharmaceutical products	-68.8	63.1
Gloves	-12.4	8.4
Fruits	-32.2	44.0
Leather gloves	33.3	-7.9
Plastic material	-1.8	45.2
Solid fuel	-25.6	83.6

Source: Pakistan Bureau of Statistics

To counter the impact of decline in the demand, it is high time that the government address long standing structural issues of this sector, the government should chalk out medium to long-term strategy including technology up gradation, development of standards, projects for skill development

[13] World Economic Outlook Jan 2012

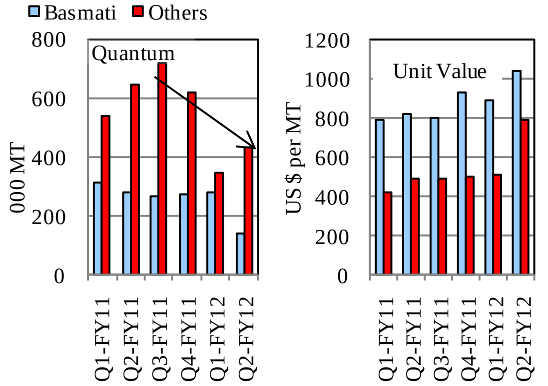
and infrastructure development with the effective involvement of private sector.

Non-Textiles

Non-textile exports recorded a YoY rise of 15.2 percent during Jul-Dec FY12 over the same period last year. Food exports recorded a growth of 17.6 percent, and the other manufactures 13.4 percent. This was largely attributed to higher prices as the quantum for most of the non-textile items declined during the period under review (**Table 5.5**).

Within the non-textile, one of the otherwise strong performers, *rice exports* declined by 10.7 percent during H1-FY12 compared to the same period last year due to the decline in quantum (**Figure 5.8**). The decline in rice exports is attributable to a number of factors including:

Figure 5.8: Rice Exports



Source: Pakistan Bureau of Statistics

- Fall in the demand in Euro area;
- India's decision to allow export of non-basmati rice after four years that has augmented the world supply. India is offering non-basmati rice at much lower price due to both large carryover stocks and recent depreciation of the Indian currency;
- A part of this slowdown may be attributed to problems faced by rice mills due to frequent power shortages.

The situation may, however, ease March 2012 onwards on account of an increase in rice procurement by the Indian government ahead of elections, which would constrain world supply and benefit Pakistani exporters. Nevertheless, despite exportable surplus, the country may not be able to meet its full year rice export target of US$2.5 billion due to shortfall in exports up to H1-FY12.

The exports of *petroleum products* also declined despite higher prices; circular debt problem appears to have constrained refineries capacity to import.

Imports

Imports continued to rise during Q2-FY12 registering a YoY growth of 14.8 percent. This rise in import bill was a function of increase in import prices of almost all products, whereas quantum of imports fell during the period.

Highest contribution in this growth came from the petroleum group followed by agricultural, other chemical group and machinery group (**Table 5.6**).

Commodity wise data shows that import of fertilizer witnessed the highest YoY growth in Q2-FY12 (**Figure 5.9**). Specifically, fertilizer imports increased by 286.3 percent (to US$ 202.0 million) due to both higher prices and increased quantity. Decline in domestic production of fertilizer due to gas shortages, led to increase in fertilizer imports.

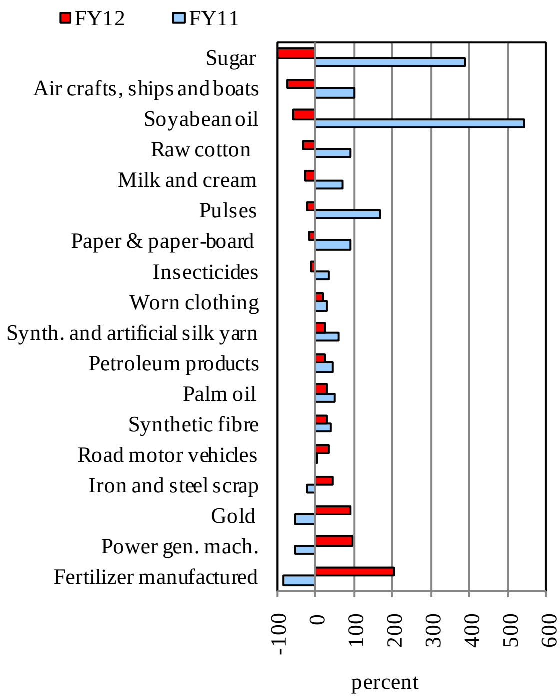
Petroleum products imports increased by 24.1 percent during Q2-FY12 over the same period last year. In absolute terms, POL imports increased by US$ 2.1 billion, out of which US$ 2.0 billion was due to price impact. In terms of quantum, petroleum imports recorded a decline

Table 5.6: Import Performance (FY12)
percent

	YoY Growth		Contribution in Growth	
	Q1	**Q2**	**Q1**	**Q2**
Food	7.2	-12.4	4.0	-12.5
Machinery	-12.9	18.7	-8.5	15.9
Transport	5.2	-16.1	1.2	-6.0
Petroleum	62.6	22.3	70.6	45.1
Textile	-0.9	4.8	-0.3	2.0
Agri. & chemical	24.0	18.2	17.3	16.4
Metal	6.3	9.0	1.9	3.6
Misc.	-9.7	-6.1	-0.9	-1.0
Total	**23.1**	**15.1**	**100**	**100**

Source: Pakistan Bureau of Statistics

Figure 5.9: Import Performance During Second Quarter

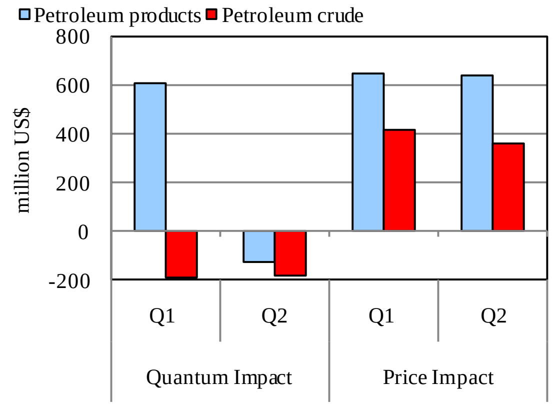


Source: Pakistan Bureau of Statistics

during Q2-FY12 after registering a rise in Q1-FY12 (**Figure 5.10**). The slowdown in POL group import quantum can be attributed to the circular debt issue that limited the ability of refineries to import.

Machinery imports posted a rise of 19.0 percent during Q2-FY12 in contrast to a decline of 12.9 percent during Q1-FY12. Category-wise data reveals that imports of construction, electrical and power generating machinery increased, which outstripped the negative growth in textile and agricultural machinery. *Raw cotton* import recorded a YoY decline on account of good domestic cotton crop.

Figure 5.10: Petroleum Imports During First Half of FY12



Source: Pakistan Bureau of Statistics

Similarly, *Sugar* imports also declined sharply by 97.3 percent during Q2-FY12 on account of better production of this commodity in the country.