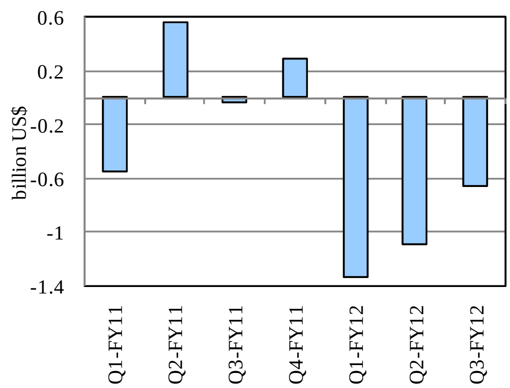
5 External Sector

5.1 Overview

The most significant development in Pakistan's external account has been the less than expected deterioration during the third quarter (**Figure 5.1**). Specifically, the current account deficit for Q3-FY12 came out at US$ 0.7 billion, which was significantly lower than the individual deficits in the preceding two quarters **(Table 5.1)**. Larger flows of remittances and a lower trade deficit during the quarter explain this improvement.

Figure 5.1: Quarterly Trend of Current Account Balance



Source: State Bank of Pakistan

Nonetheless, on a cumulative basis, the external account deficit reached US$ 2.7 billion during Jul-Mar FY12 compared to a *surplus* of US$ 1.8 billion during corresponding period of FY11. As highlighted in our earlier reports, the FY11 surplus was owed to one-off factors and sustaining it, as such, was difficult.[72]

In the current account, the expected receipts under Coalition Support Fund (CSF) have not realized so far. The financial & capital accounts also recorded a lower surplus in Jul-Mar FY12. While there was an increase in project grants,[73] proceeds from the auction of 3G licenses, and arrears from PTCL's privatization, did not materialize during this period.

Accordingly, Pakistan's foreign exchange reserves and exchange rate remained under pressure during Jul-Mar FY12. Gross reserves declined by US$ 1.7 billion

[72] Pakistan's current account balance recorded a surplus in FY11 after remaining in deficit for six consecutive years. This extraordinary performance was due to unexpected rise in cotton prices which led to record export earnings and kept the trade deficit in check. Inflows under the coalition support fund (CSF) also contributed towards the improvement of the current account.

[73] Project grants in the capital account increased from US$ 89.0 million during Jul-Mar FY11 to US$ 167 million during Jul-Mar FY12.

to reach US$ 16.5 billion by end-Mar 2012, whereas the exchange rate depreciated by 5.2 percent from end-June 2011 level.

5.2 Current Account

Despite deteriorating less than expected during Q3-FY12, the current account for Jul-Mar FY12 recorded a deficit of US$ 3.1 billion – significantly larger than a deficit of US$ 10.0 *million* in the corresponding period last year.

The worst hit was the *trade account*, where the deficit reached US$ 11.7 billion during Jul-Mar FY12, from US$ 8.2 billion in Jul-Mar FY11. This was primarily due to a sharp rise in imports, which overshadowed the modest growth in exports.

The deficit in *Services* almost doubled to US$ 2.1 billion during Jul-Mar FY12 compared to the same period last year, mainly due to the absence of the Coalition Support Fund (CSF) inflows.[74] Having said this, the government remains optimistic that US$ 400 million will be realized in FY12.

Current transfers, in contrast,

Table 5.1: Summary of External Accounts

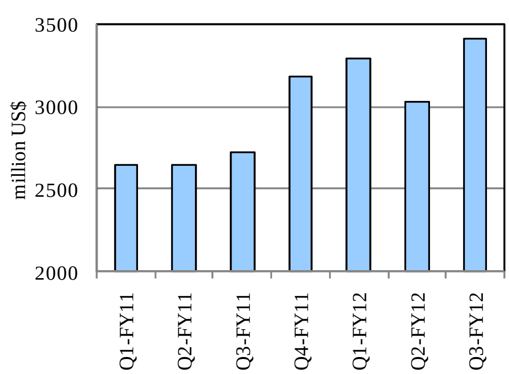
billion US Dollar

	FY11	FY12			
	Jul-Mar	Jul-Mar	Q1	Q2	Q3
A-C/A balance	**0.0**	**-3.1**	**-1.3**	**-1.1**	**-0.7**
i) Trade balance	-8.2	-11.7	-4.2	-3.7	-3.8
Exports	17.7	18.3	6.1	5.9	6.3
Imports	25.8	30.0	10.3	9.7	10.0
ii) Services account	-1.1	-2.1	-0.7	-0.6	-0.8
iii) Income account	-2.2	-2.3	-0.6	-0.9	-0.7
iv) Current transfers	11.4	12.9	4.2	4.2	4.5
Remittances	8.0	9.7	3.3	3.0	3.4
B-Financial/Capital balance	**1.8**	**1.0**	**0.6**	**0.0**	**0.4**
i) FDI	1.2	0.6	0.3	0.3	0.1
ii) FPI	0.2	-0.1	0.0	-0.1	0.0
iii) Others	0.4	0.5	0.3	-0.1	0.3
C-Errors & omissions	**0.0**	**-0.6**	**0.0**	**0.0**	**-0.6**
Overall balance	**1.8**	**-2.7**	**-0.8**	**-1.0**	**-0.9**
FX reserves (31st Mar)	17.6	16.5			
Exchange rate (Rs/US$) (31st Mar)	85.9	90.7			

P: Provisional

Source: State Bank of Pakistan

Figure 5.2: Quarterly Worker's Remittances



Source: State Bank of Pakistan

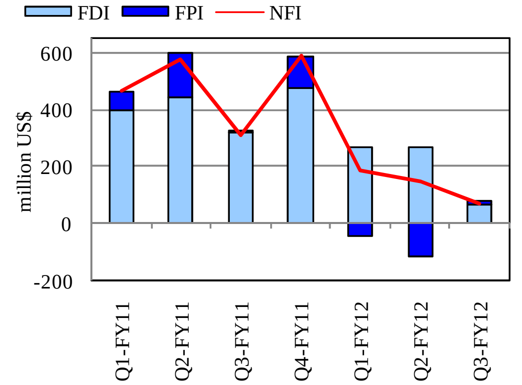
[74] The government had received US$ 743 million under CSF during FY11.

continued to provide much needed support on the back of a 21.2 percent growth in workers' remittances. The strong recovery in the third quarter suggests that the annual inflow of remittances could exceed US$ 13.0 billion by the end of FY12 **(Figure 5.2)**.

5.3 Financial & Capital Account

The financial & capital accounts registered a lower surplus of US$ 1.0 billion during Jul-Mar FY12, compared to a surplus of US$ 1.8 billion during the corresponding period last year. A YoY fall of 66.0 percent in net foreign investment was one of the key reasons behind this decline.

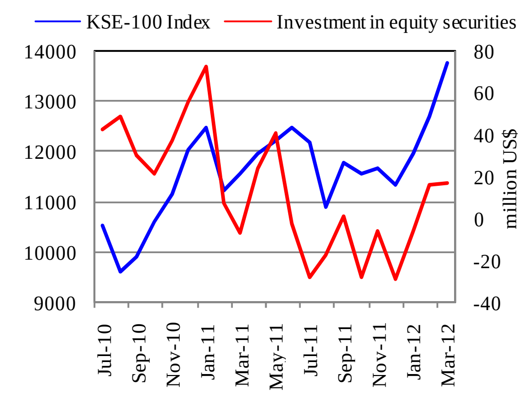
Figure 5.3: Net Foreign Investment



Source: State Bank of Pakistan

Foreign direct investment contracted sharply from US$ 1.2 billion in Jul-Mar FY11 to US$ 0.6 billion during Jul-Mar FY12 (**Figure 5.3**). The continuing fall in foreign investment during the last few years is taking a toll on the financial account. Domestic constraints are a major deterrent to foreign investment into Pakistan. It may be noted that foreign investment flows to regional economies have recovered from the global slowdown following the financial crisis (**Box 5.1**).

Figure 5.4: Foreign Investment in Equity Securities

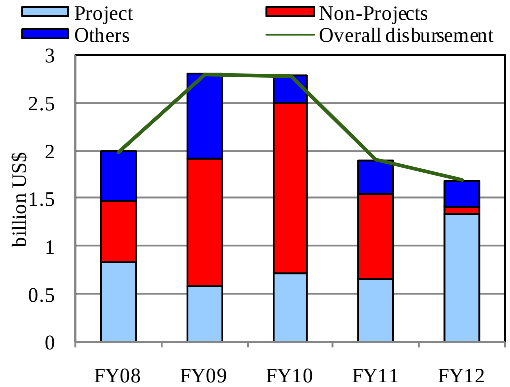


Source: Karachi Stock Exchange, State Bank of Pakistan

Foreign inflows in equity and government securities also remained subdued this year. However, the recent uptrend in the KSE-100 index encouraged some foreign investment in the Karachi Stock Exchange (KSE) during Q3-F12 **(Figure 5.4)**. Pakistan has a long history of receiving *project & non-*

project loans from International Financial Institutions (IFIs) like the World Bank and the Asian Development Bank.[75] However, such inflows have declined in recent years (**Figure 5.5)**. The IFIs seem reluctant to extend such support in the absence of a letter of comfort from the IMF as Pakistan is currently not under any program with the Fund.[76]

Figure 5.5: Disbursement of Loans (Jul-Mar)



Source: State Bank of Pakistan

5.4 Foreign Exchange Reserves and Exchange Rate

Pakistan's foreign exchange reserves reached US$ 16.4 billion by end-March 2012, from US$ 18.3 billion at end June 2011. SBP's reserves declined throughout FY12, whereas reserves of scheduled banks increased during this period **(Table 5.2**).

Table 5.2: Pakistan's Foreign Reserves Position (end period)

billion US Dollar

	Q4-FY11	Q1-FY12	Q2-FY12	Q3-FY12
SBP	14.8	13.7	12.9	11.8
Commercial Banks	3.5	3.7	4.0	4.6
Total Reserves	**18.3**	**17.3**	**16.9**	**16.4**

Source: State Bank of Pakistan

The depletion of SBP's reserves is understandable as the central bank remained a net seller of US$ 828.8 million in the FX market during Jul-Mar FY12. In addition, SBP repaid US$ 720.0 million (interest and principal) to the IMF during the year.[77]

The FX reserves of scheduled banks on the other hand increased, mainly on account of the retirement of FE-25 loans by traders as the depreciation of the Pak Rupee made these loans costlier. Pressure on the Rupee also encouraged a build-up in foreign currency accounts (FCA).[78]

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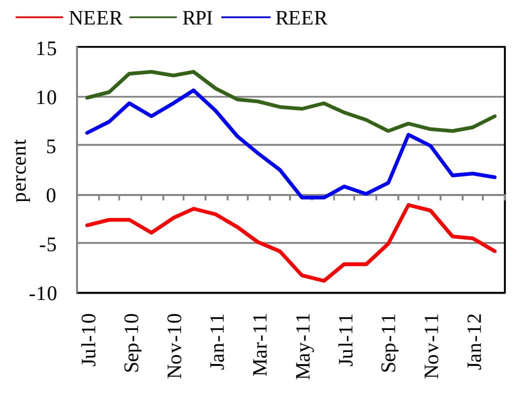
[75] A project loan is strictly for a specific project and it cannot be used for other purposes. A program loan on the other hand may not only be limited for specific projects but also for overall economic development. For instance a project loan is granted for improving infrastructure or building a damn etc, while a program loan is for social services, i.e. reducing poverty.
[76] IMF generally issues letter of comfort to countries which enter into a program with the Fund.
[77] Repayments to the IFIs generally do not enter into the interbank FX market.
[78] FE-25 deposits increased by US$ 752.0 million during Jul-Mar FY12 compared with a rise of US$ 349.5 million during the corresponding period last year.

On the whole, the Rupee depreciated by 5.7 percent on a YoY basis against the basket of currencies of trading partners. However, the resulting gains were more than offset by domestic inflationary pressures. Hence, in real terms, the Rupee appreciated by 1.7 percent during this period **(Figure 5.6)**.

Figure 5.6: YoY Appreciation/Depreciation



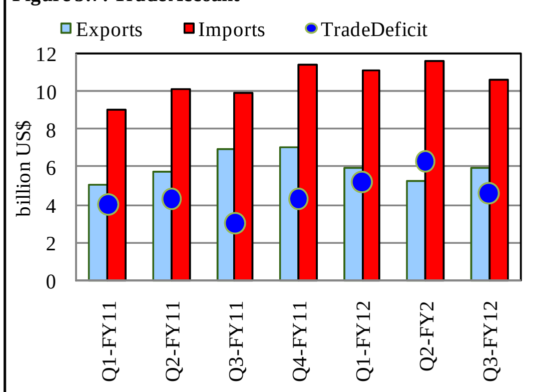
Source: State Bank of Pakistan

5.5 Trade Account

Pakistan's trade deficit expanded by 42.6 percent YoY during Jul-Mar FY12, to reach US$16.1 billion compared to US$11.3 billion during the corresponding period last year.

The overall number, however, masks the relative improvement in Q3-FY12, when the deficit declined by 26.6 percent on a QoQ basis, after showing a persistent rise for three previous quarters **(Figure 5.7)**. It remains to be seen if this trend continues in the final quarter of FY12.

Figure 5.7: Trade Account



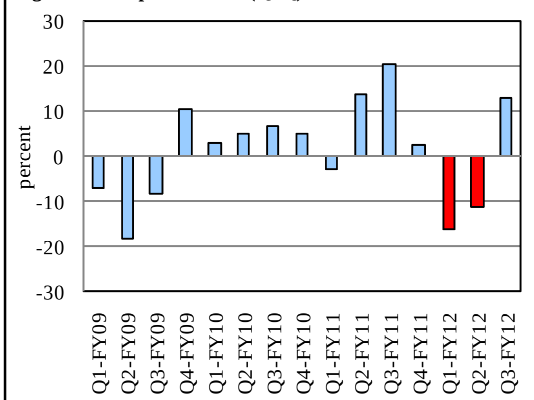
Source: Pakistan Bureau of Statistics

Exports

On a cumulative basis, exports recorded a YoY decline of 3.2 percent during Jul-Mar FY12, in contrast to the 26.1 percent growth witnessed the corresponding period last year. A major decline was observed in textile, followed by food and petroleum groups.

However, an encouraging development is the increase of 13.0 percent in Q3-FY12 over the preceding quarter **(Figure 5.8)**. This is particularly welcome when seen in the context of persistent domestic energy shortages, the sluggish recovery in global demand, and domestic security concerns.

Figure 5.8: Export Growth (QoQ)



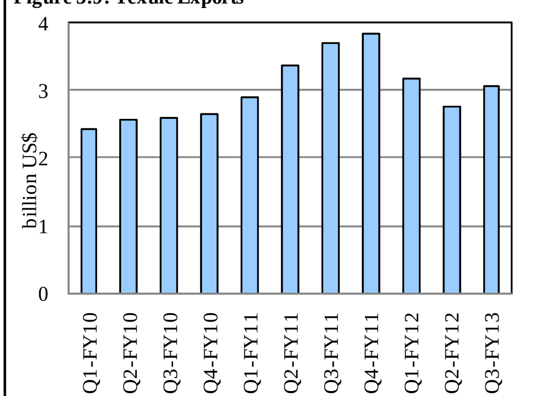
Source: Pakistan Bureau of Statistics

Even if a part of this recovery is seasonal, this is mainly driven by an increase in quantum. Moreover, this upturn has been observed in both textile and non-textile categories.

Textiles

Textile exports fell by 9.5 percent during Jul-Mar FY12 on YoY basis, in contrast to a rise of 31.5 percent during the corresponding period of last year. This decline is mainly due to a fall in quantity whereas unit value has had positive impact (**Figure 5.9**).

Figure 5.9: Textile Exports



Source: Pakistan Bureau of Statistics

In overall terms, the decline in textile exports was contributed by both low-value added (i.e., cotton yarn, raw cotton, cotton fabrics and synthetic textile); and high value added categories (i.e. knitwear, bed wear, towels and readymade garments). In the case of low value added textiles, the price impact played a dominant role; whereas in high-value added textiles, the negative quantum impact led to the decline in textile exports (see **Table 5.3**).

Furthermore, a cross-country analysis of textile export (based on quantum) suggests that Pakistan's apparel exports have performed better in the EU market compared to its competitors (**Annexure 1**).

Table 5.3: Major Textile Exports Price & Quantum Impact (YoY) (Jul-Mar FY12) – million US$

	Abs. change	Qty	Price
Textile Group	**-939.1**		
Of which			
Raw cotton	85.4	189.0	-103.7
Cotton yarn	-424.3	-115.9	-308.3
Cotton fabrics	-85.1	-0.4	0.3
Knitwear	-198.3	-415.1	216.8
Bed wear	-191.9	-309.2	117.3
Towels	-39.7	-99.6	59.9
Readymade garments	-34.8	-305.6	270.8
Art silk & synthetic textiles	-20.3	-101.5	81.2

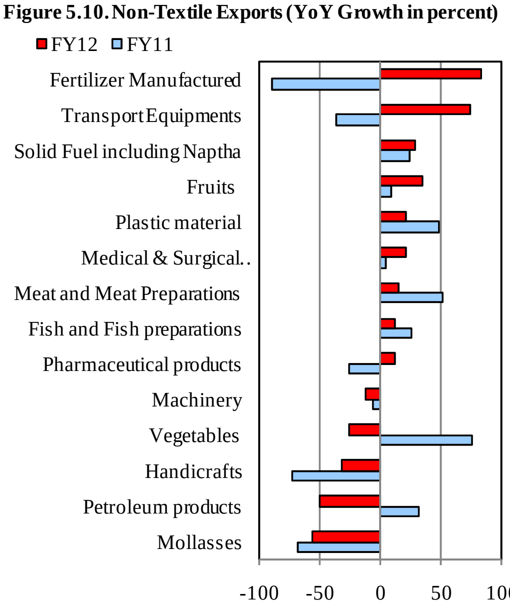
Source**:** Pakistan Bureau of Statistics

One explanation, is that Pakistan generally exports low value added items, which are relatively less responsive to income changes – i.e., demand is not badly hit even if the country (export destination) is struggling economically.

Non-Textiles

Non-textile exports recorded a rise of 4.8 percent during Jul-Mar FY12, compared to a 19.6 percent growth in the corresponding period of last year. While exports of *other manufactures* remained strong at 20.9 percent growth, exports *petroleum* groups declined 20.3 percent, respectively, mainly due to a decline in their quanta (**Figure 5.10**).

Figure 5.10. Non-Textile Exports (YoY Growth in percent)



Source: Pakistan Bureau of Statistics

Despite a strong showing during Q3-FY12, *rice exports* recorded a decline of 5.0 percent during Jul-Mar FY12 compared to a 2.2 percent decline during Jul-Mar FY11. This was driven by lower quanta of both basmati and non-basmati rice, despite the increase in unit values (**Table 5.4)**. According to the Rice Exporters Association of Pakistan (REAP), exports of basmati rice fell as Iran (which was the third largest rice market for Pakistan in FY11) decided to import from India because of significantly lower prices.

In the coming months, Pakistan's non-basmati rice exports could slowdown, due to the bumper crop expected in Vietnam (one of the largest exporters in the world). On the other hand, basmati rice exports may improve once Indian stocks deplete.

Table 5.4: Non-Textile Exports (Jul-Mar FY12)

million US$

	Quantum Impact	Price Impact
Rice	-231.8	152.2
Petroleum products	-345.9	63.6
Leather garments	-47.8	-0.3
Cement	-10.2	-15.7
Pharmaceutical products	-9.5	22.0
Gloves	-21.9	14.5
Fruits	6.9	69.0
Leather gloves	40.9	-3.8
Plastic material	30.2	33.3
Solid fuel	-30.6	129.0

Source: Pakistan Bureau of Statistics

In *other manufactures*, export of sports goods increased after the introduction of better quality products in sport garments. Medical and surgical instrument exports have also registered a rise, mainly due to minimum export prices in this sector which have increased export earnings by US$30 – 40 million. Previously, the unit value of medical and surgical instruments had been lower due to stiff competition among Pakistani exporters. However, after the imposition of the minimum export price, following an initiative from Medical and Surgical Instruments Association of Pakistan, exporters were able to sell their products at higher prices in the international market. Their quality and marketing strategy have also improved accordingly.

Pakistan has already started cement exports to India, and it is expected that unit value and quantum will increase in the coming months. Pakistan has a price advantage in the Indian market, as the landed cost of cement in India is Rs 30 to 40 per bag higher than Pakistan, but still below retail prices in India.

The export of *petroleum products*, on the other hand, fell as the local refineries imported lower quantities of crude oil due to high prices in international markets, and the persistent circular debt problem.

Imports

On a cumulative basis, imports have increased by 14.7 percent during Jul-Mar FY12, compared to 15.6 percent during Jul-Mar FY11. A quarterly analysis suggests a slowdown in import growth to 7.0 percent on a YoY basis during Q3 FY12, from 14.8 percent and 23.1 percent in the preceding quarters **(Table 5.5)**.

Excluding petroleum, import growth remained significantly lower than last year, and even turned negative during the third quarter of FY12.
A significant part of the deceleration in imports during Q3-FY12 was driven by a decline in the import quantum of crude oil, sugar, palm & soybean oil, **raw** cotton, synthetic fiber and iron & steel. The price impact, on the other hand, remained high and positive for almost all key imports.

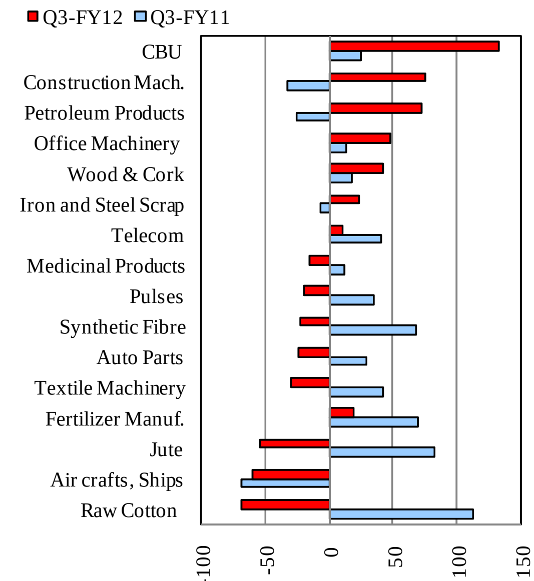
Table 5.5: Import Performance (FY12)

	YoY Growth (%)			% Contribution in Growth		
	Q1	**Q2**	**Q3**	**Q1**	**Q2**	**Q3**
Food	7.2	-11.6	2.1	4.0	-12.0	7.0
Machinery	-12.9	23.0	8.3	-8.5	20.0	15.0
Transport	5.2	-5.4	2.5	1.2	-2.1	1.7
Petroleum	62.6	22.5	33.3	70.6	46.7	127.1
Textile	-0.9	-1.3	-38.4	-0.3	-0.5	-51.5
Agri. & Chem.	24.0	39.6	-4.2	17.3	36.5	-10.1
Metals	6.3	12.6	1.1	1.9	5.2	1.1
Misc.	-9.7	-3.2	-9.5	-0.9	-0.5	-3.5
Total	**23.1**	**14.8**	**7.0**	**100**	**100**	**100**

Source**:** Pakistan Bureau of Statistics

This decline in import quantum does not necessarily reflect any slowdown in domestic demand. For example, better domestic harvest of cotton and sugar lowered the demand for their imports, whereas some recovery in the ship breaking industry brought down the imports of iron & steel. Similarly, the decline in the import of palm and soybean oil was due to higher levels of domestic inventories. In the case of crude oil, the inventories and continuing circular debt problem forced refineries to lower crude imports.

Figure 5.11: Import Performance (YoY Growth in percent)

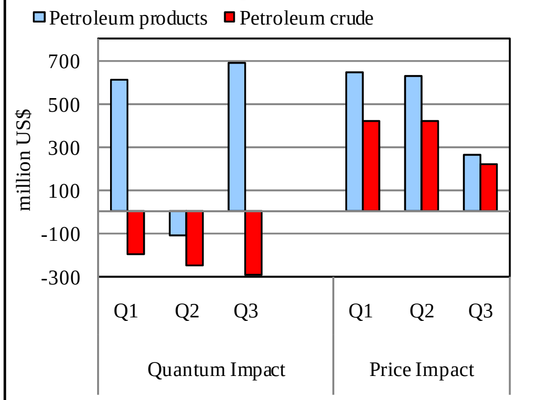


Source: Pakistan Bureau of Statistics

Food imports recorded a YoY growth of 1.7 percent during Q3 FY12, which was significantly lower than 60.6 percent growth during the same period last year. One reason for the deceleration was the ample availability of domestic sugar that ruled out the possibility of any imports this year. In the previous year, substantial imports of sugar had inflated the food import bill.

Raw cotton imports recorded a YoY decline during Q3-FY12 on account of a good domestic cotton crop (**Figure 5.11**).

Figure 5.12: Petroleum Imports (FY12)



Source: Pakistan Bureau of Statistics

As expected, due to increasing oil prices in the international market, *petroleum* imports increased by 37.7 percent during Jul-Mar FY12 compared to 10.1 percent in the corresponding period of previous year. In Q3-FY12 alone, import of petroleum products increased by 72.8 percent. This increase was because of a rise in quantum and unit values. The rise of crude oil imports on the other hand was caused entirely by the price effect, as the quantum actually declined **(Figure 5.12)**.

Table 5.6: Road Motor Vehicles (Jul-Mar)
million US$

	FY10	FY11	FY12
Road Motor Vehicles	844.4	958.1	1,161.6
of which:			
Motor Cars	*378.4*	*446.0*	*599.4*

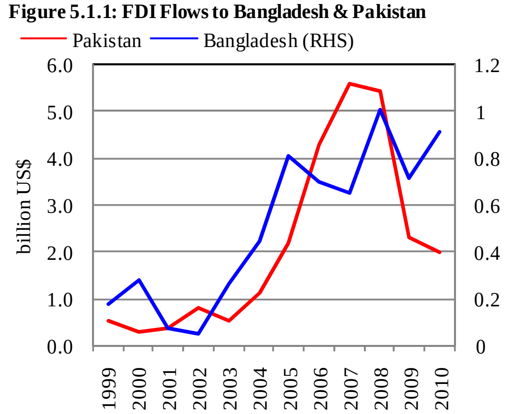
Source: Pakistan Bureau of Statistics

The imports of CBUs (cars), construction machinery, office machinery, and telecom, recorded YoY increases during Jul-Mar FY12. In particular, the imports of road motor vehicles recorded a rise of around US$200 million during Jul-Mar FY12 compared to US$113.7 million increase during the same period last year **(Table 5.6)**. This can be attributed to a rise in the import of motor cars which account for 75 percent of the rise in imports of road motor vehicles. According to market sources, Pakistan imported around 34,500 units of used cars during Jul-Mar FY12, compared to 6,000 units during same period last year. This was mainly due to the increase in the age limit from three years to five years for used cars.

Box 5.1: Pakistan's Dying FDI – What's Wrong With Us?
According to the recent World Economic Outlook by the IMF, FDI flows to developing economies are expected to recover strongly from US$ 280.0 billion in 2009 to US$ 364.0 billion in 2011. This is true for a number of South Asian economies, particularly for

Bangladesh which shares a number of features with Pakistan. In contrast, foreign investment in Pakistan has been falling persistently **(Figure 5.1.2)**.

Figure 5.1.1: FDI Flows to Bangladesh & Pakistan



Source: IMF

It seems that domestic factors such as energy shortages, macroeconomic instability, law & order situation etc are hampering FDI in Pakistan. According to World Economic Forum's Global Competitiveness Report 2011-12, Pakistan is lagging its counterpart in terms of competitiveness. Macroeconomic environment (which includes fiscal discipline, inflation, interest rate spread and country credit rating) is one of the worst in Pakistan; it stands at 138th position out of 142 countries. Bangladesh stands at 75th position. Similarly, the business cost of terrorism is very high in Pakistan (the second worst in the world after Somalia). The overall ranking of Bangladesh is 108 while Pakistan is at 118th position. [79]

Table 5.1 1: Sector and Source-wise FDI during last 15 years

share in percent

	FDI by sector			FDI by source	
	Bangladesh	Pakistan		Bangladesh	Pakistan
Telecom	28.8	27.6	USA	27.0	21.4
Petroleum, Power and Oil & Gas	24.8	24.6	UK	24.2	11.2
Financial business	7.0	18.5	UAE	6.2	15.9
Textile	10.5	1.4	Singapore	4.3	2.2
Cement	2.6	1.1	China	6.7	5.6
Others	26.3	26.8	Others	31.6	43.7

Source: Board of Investment, Bangladesh, State Bank of Pakistan

[79] The Global Competitiveness Report of 2007-08 ranked Pakistan at 92nd position while Bangladesh was at 107th position.