5 External Sector

5.1 Overview

The first five months of FY12 saw a sharp deterioration in the external account position compared to the previous year. Specifically, external account posted a deficit of US$ 1.7 billion during Jul-Nov FY12 compared to a surplus of US$100.0 million in the corresponding period of the previous year. The deficit in overall external account is attributed to the deteriorations recorded in both, the current and financial accounts during the period under review (**Table 5.1**).

Table 5.1: Summary of External Accounts (Jul-Nov)
billion US Dollar

	FY11	FY12P
A-C/A balance	**-0.6**	**-2.1**
i) Trade balance	-4.7	-6.4
Exports	9.0	10.0
Imports	13.7	16.5
ii) Services account balance	-1.0	-1.1
iii) Income account balance	-1.2	-1.3
iv) Current transfers	6.3	6.8
Remittances	4.4	5.2
B-Financial/Capital balance	**0.6**	**0.2**
i) FDI	0.6	0.4
ii) FPI	0.2	-0.1
iii) Others	-0.2	-0.1
C-Errors & omissions	0.1	0.2
D-Overall balance	**0.1**	**-1.7**
Foreign reserves (21st Dec)	16.3	16.6
Exchange rate (21st Dec)	85.7	89.9

P: Provisional
Source: State Bank of Pakistan

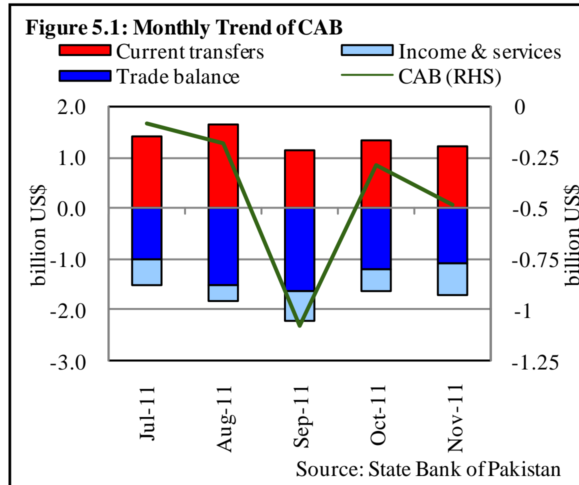
Current Account Deterioration

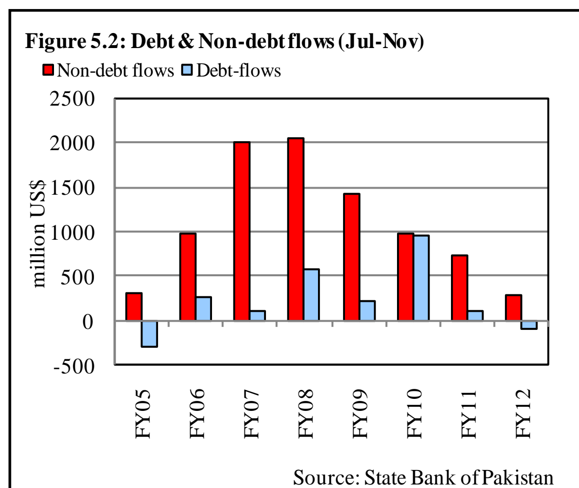
Although deterioration in current account was on the cards, the timing and magnitude was unexpected. This larger than expected worsening was mainly concentrated in the month of Sep 2011 when simultaneous surge in trade deficit and fall in current transfers led to over a billion dollar deficit in the current account during this month alone **(Figure 5.1).**

Trade deficit widened due to the surge in POL and fertilizer imports, and deceleration in exports, particularly textiles. Current transfers, on the hand declined, due to a 29.1 percent MoM decline in remittances.

The fall in remittances was driven by a seasonal slowdown; delays in the payment of commission to banks bringing in funds and speculative pressures in the forex market. Fortunately, remittances picked up pace Oct 2011 onwards; consequently despite the MoM decline in Sep 2011, remittances recorded a healthy growth of 18.3 percent for Jul-Nov FY12 over the year before.

As against the current transfers, deterioration in the trade account is likely to get worse in the coming months due to adverse development in international commodity prices. In FY11, price movements favored Pakistan, but are now against it. Specifically, while the prices of commodities that Pakistan imports (POL, fertilizer etc) have increased, prices of its main exports (textiles) have collapsed. To make matters worse, demand in Pakistani major export markets is also sagging, which suggests that the decline in export revenues could be prolonged, while the import bill could continue to rise, primarily driven by the prices and quantum of POL imports.





Unfortunately, unlike the past, when the deficit in the current account was financed by surpluses in capital & financial accounts; during Jul-Nov FY12, capital & financial accounts recorded only a modest surplus of US$ 200.0 million. As such, most of the deficit in the current account had to be financed through reserves, which brought some pressures on the exchange rate.

Capital & Financial Account and External Sector's Vulnerability

Jul-Nov FY12 developments have revealed the vulnerability of Pakistan's external account. Pakistan's financial account has been in surplus since FY05; a conducive domestic and international climate coupled with generous IFI support, helped Pakistan post over US$ 10.0 billion financial account surplus in FY07 alone. This

surplus not only financed a widening current account deficit, but also helped build up reserves.

The global and domestic environment, however, changed in FY08. First the global financial crisis tapered FDI inflows and later lack of support from the IFIs saw both the Pak Rupee lose value and depletion in FX reserves. As such, financial account surplus steadily declined FY08 onwards **(Figure 5.2)**.

The serious consequences of a declining financial account surplus were overlooked in FY11 due to the comfort in the current account. Nevertheless it was evident that Pakistan will be challenged even by a small current account deficit without support from the financial account.

Pakistan must make all efforts to ensure the resumption of financial inflows. In case, resumption of IFIs funding is to be delayed, Pakistan must focus on non-traditional bilateral funding.

An encouraging development in this regard is the Currency Swap Arrangements (CSA) that Pakistan has entered into with Peoples Republic of China and Turkey. The objective of these swaps is to promote the use of regional currencies for trade settlement purposes and specifically in the case of China; to enhance the role of the Chinese Yuan in international trade and investment.[43]

Depleting Foreign Exchange Reserves & Volatility in Exchange Rate

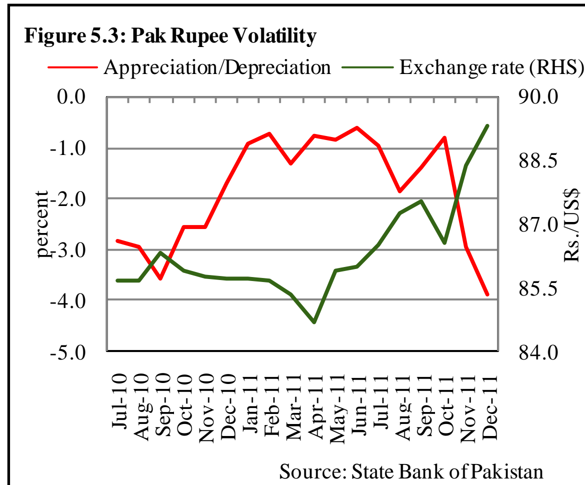
After peaking at US$ 18.2 billion in end- Jun 2011, Pakistan's foreign exchange reserves dropped to US$ 16.6 billion by 21 Dec 2011. This decline, as explained earlier, is driven by the widening current account deficit, and SBP's effort to calm the forex market.

The US$ 1.6 billion decline in liquid foreign exchange reserves since end Jun FY11, is entirely on account of a fall in SBP reserves, which have declined by over US$ 2.0 billion during the Jul-Dec period. The reserves of the scheduled banks actually increased by US$ 0.4 billion during this period. The decline in SBP reserves reflects lower inflows and higher payments compared with last year. In particular, inflows from donor agencies remained much lower than projected, while debt servicing to ADB increased compared to last year.

[43] In case of China, CSA has been executed for a tenor of 3 years in respective local currencies, Pakistan Rupee 140 billion and Chinese Yuan 10 billion, while in case of Turkey the CSA arrangement is for equivalent US$ 1.0 billion in respective currencies.

This deterioration in external flows was reflected in the weakness of Pak Rupee especially from Oct onwards. In absolute terms, the mid weighted rate in inter-bank market reached Rs 89.96 on 21st Dec 2011 (**Figure 5.3**). The pressure on the exchange rate was initially brought about by a genuine shortage of hard currency due to large deficit in the current account; however, this was subsequently supplemented by speculative pressures in the FX market. Pakistan's exit from the IMF program in end Sep 2011 and growing tensions with the US, created an opportunity to speculate for short-term gain. SBP interventions consequently increased during Sep and Oct 2011 compared to last year.

Figure 5.3: Pak Rupee Volatility

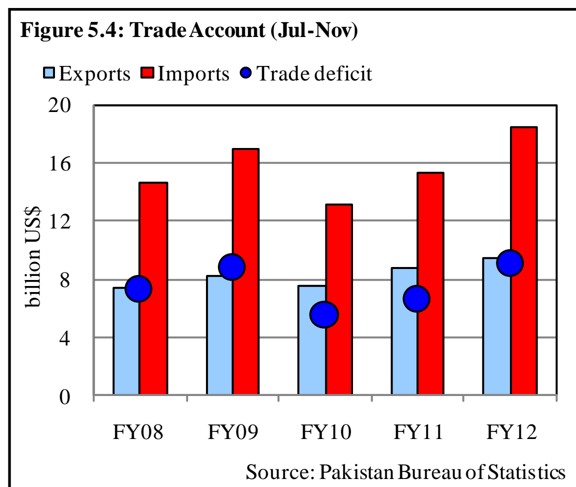


Source: State Bank of Pakistan

5.2 Trade Account[44]

Trade account deteriorated for the second consecutive year, and the deficit widened by 36.7 percent to US$ 9.1 billion during Jul-Nov FY12, compared to 6.6 billion during the same period last year (**Figure 5.4**). This deterioration in trade account was the result of an increase in commodity prices, the impact of which was more pronounced on the imports than exports (**Figure 5.5**); and the slowdown in export demand in Pakistan's major export destinations.

Figure 5.4: Trade Account (Jul-Nov)

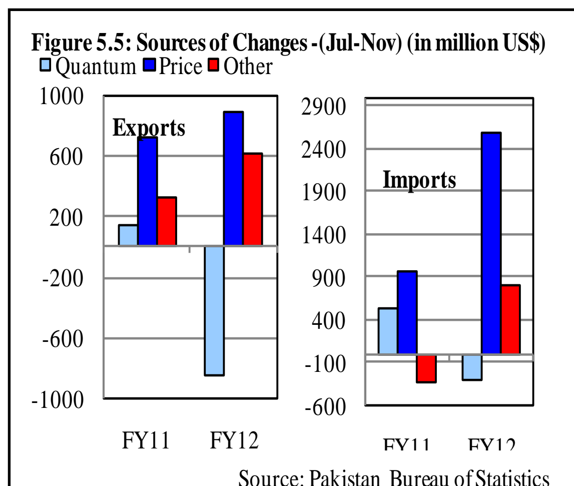


Source: Pakistan Bureau of Statistics

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

Exports

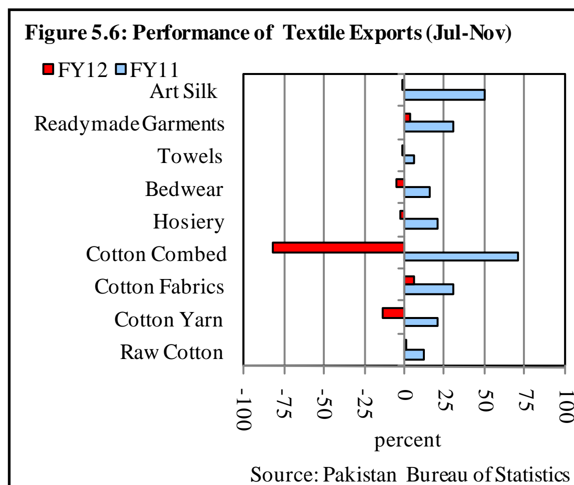
Exports posted growth of 7.6 percent during Jul-Nov FY12, compared to 15.8 percent during the same period last year. The lower export is mostly the result of a decline in textile exports. Other items that recorded a decline include: rice, fish, carpets, sports goods and leather.



On the other hand, exports of fruits & vegetables, raw cotton, footwear, medical & surgical instruments, chemicals & pharmaceuticals, registered a significant rise over the previous year.

Textiles

Textile exports declined by 1.3 percent during Jul-Nov FY12 in contrast to YoY rise of 21.9 percent last year. The decline in textile exports is mainly due to the fall in quantity. Almost all textiles posted a decline during the period under review. The exports of cotton yarn, cotton cloth, knitwear, bed wear, towels and readymade garments, have shown lower growth rates or have declined compared to last year (**Figure 5.6**).



The fall in textile exports in Oct and Nov is particularly alarming, as both, unit value and quantity registered a fall. It is feared that if this trend continues, textile exports could end up lower than last year. The prospects are indeed not very bright given worsening energy shortages and likely recession in Euro Zone and its contagion on rest of the world. The slowdown in demand is already visible from

the fall in textile and apparel exports to US and EU during the recent months **(Table 5.2)**.

Non-Textiles

Non-textile exports recorded a YoY rise of 20.2 percent with all sub groups posting higher growth during Jul-Nov FY12 compared to the same period last year. Food exports recorded a growth of 22.7 percent, petroleum 13.7 percent, and the other manufactures 13.6 percent **(Figure 5.7)**.

Table 5.2: Textile & Apparel Demand (Jul-Sep)
growth in percent

	US		EU*	
	FY11	FY12	FY11	FY12
Bangladesh	11.4	-21.3	9.4	4.4
China	22.2	-5.6	14.6	3.3
India	4.0	12.4	13.2	-7.2
Pakistan	2.4	-4.7	15.1	-11.4
World	16.7	-5.4		

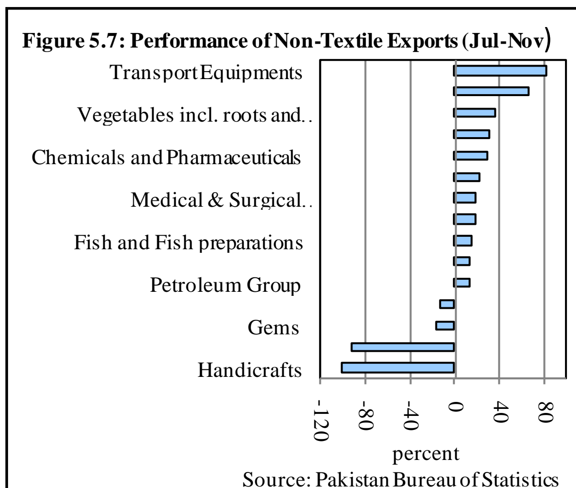
*Jul-Aug

Source: OTEXA and Eurostat

Rice exports: From the five months of FY12, rice exports were US$ 701.1 million, which suggests that Pakistan would probably miss US$2.5 billion rice export target for FY12. Exports of both basmati and irri rice declined by 15.9 and 8.1 percent during Jul-Nov FY12 entirely due to a quantum effect. However, Pakistan's rice exports could benefit from additional demand in the international market due to a possible shortage because of the floods in Thailand. Also Pakistan's rice crop is expected to be higher than initial target.

In *other manufactures*, export of sports goods, medical instruments, pharmaceuticals, and engineering goods, recorded a rise; however this rise was partially offset by negative growth in leather manufactures, cement, and handicrafts.

Figure 5.7: Performance of Non-Textile Exports (Jul-Nov)



Source: Pakistan Bureau of Statistics

Imports

Imports continued a rising trend for the second consecutive year registering 18.5 percent growth during Jul-Nov FY12. This increase in the import bill is a function of an increase in import prices of almost all products, whereas the quantum of most imports

declined during the period. The highest increase (48.6 percent) was recorded in petroleum imports, followed by agricultural & other chemicals (22.8 percent) and textile group (9.6 percent). On the other hand, food, machinery and transport registered YoY decline **(Table 5.3)**.

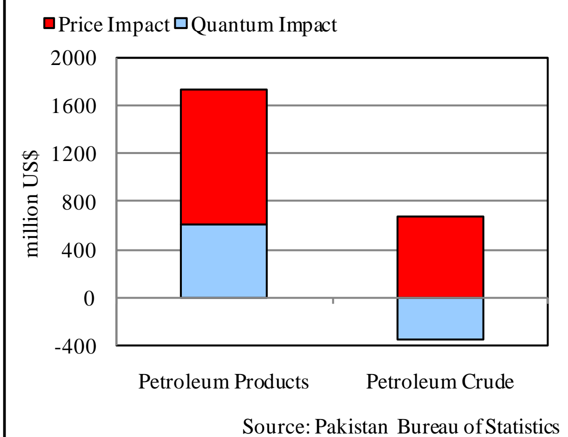
Petroleum group imports during Jul-Nov FY12 increased by a significant US$2.1 billion over last year. Of the total increase around 87.8 percent was due to higher prices and remaining 12.2 percent due to increase in quantity **(Figure 5.8).**

Table 5.3: Import Performance (Jul-Nov)

	billion US$		YoY growth	Contribution in growth (%)	
	FY11	**FY12**	**FY12**	**FY11**	**FY12**
Food	2.2	2.1	-1.1	37.9	-0.8
Machinery	2.2	2.0	-8.5	3.4	-6.2
Transport	0.8	0.8	-7.7	10.4	-2.1
Petroleum	4.2	6.3	48.6	20.3	67.9
Textile	1.0	1.1	9.6	18.6	3.1
Agri. & Chemical	2.4	2.9	22.8	-4.1	17.9
Metal	1.1	1.1	5.5	5.8	1.9
Misc.	0.3	0.3	0.7	2.8	0.1
Total	**15.4**	**18.5**	**20.2**	**100**	**100**

Source: Pakistan Bureau of Statistics

Figure 5.8: Source of Changes in Petroluem Group (Jul-Nov)



Source: Pakistan Bureau of Statistics

Food group imports recorded a YoY fall of 1.1 percent during Jul-Nov FY12 in contrast to an increase of 58.8 percent during the same period last year. During FY11, substantial imports of Sugar had inflated the food import bill. However, the rise in domestic sugar production in FY12 does not require imports which explain the 96.9 percent decline in sugar imports this year. As against sugar, soybean oil, palm oil, tea and spices registered increases during Jul-Nov FY12.

Machinery imports posted a decline of 12.4 percent in contrast to a small rise of 2.5 percent during the same period last year. Category-wise analysis reveals that imports of textile, construction, electrical and power generating machinery declined, which outstripped the positive growth in office, telecom and agricultural machinery **(Table 5.4)**.

In the case of *telecom* imports, out of the US$ 137.8 million increase, US$101.5 million was due to imports of cellular phones while US$36.3 million increase was due to import of infrastructure equipment. The demand for cellular phone has been on the rise since the government allowed for the import of cheaper Chinese mobile phone brands.

Table 5.4: Imports of Machinery (Jul-Nov)
million US$

	FY11	FY12	Abs. change
Textile	193.2	141.1	-52.1
Telecom	378.7	516.4	137.8
Electrical machinery and apparatus	344.3	275.4	-68.9
Agricultural	38.9	63.9	25.0
Power generating	469.8	347.2	-122.6
Construction and mining	52.4	47.3	-5.1
Other machinery	644.5	524.6	-119.9
Total	**2214.5**	**2025.6**	**-188.9**

Source: Pakistan Bureau of Statistics

Imports of *textile* increased by 8.4 percent mainly due to synthetic fiber, artificial silk yarn and second-hand clothing. However, import of raw cotton that increased during FY11 (owing to quantity as well as price impact), declined during Jul-Nov FY12 because of better availability of the product in domestic markets. Fertilizer imports, on the other hand, increased by 34.4 percent principally due to higher import price. A decline in domestic production due to gas shortages, also led to higher imports.