5 External Sector[1]

5.1 Overview

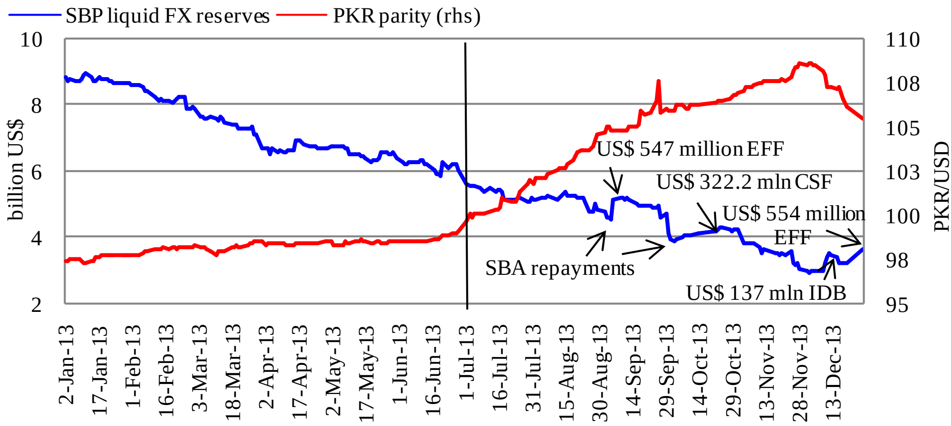
FY14 started with some concern on the external front: although Pakistan entered a new IMF program in Q1-FY14, the FX market remained volatile and PKR depreciated by 6.0 percent – the highest quarterly depreciation in five years (**Table 5.1**). This can be traced to: (i) a sharp rise in the current account deficit; (ii) FX purchases by SBP and the related speculative sentiments in the market; and (iii) US$ 1.8 billion external debt servicing.

Table 5.1: Key External Sector Indicators
billion US$

	FY13	Q1-FY13	Q1-FY14
SBP liquid FX reserves	6.0	10.4	4.7
Current account balance	-2.5	0.4	-1.2
Trade balance	-15.4	-3.6	-4.2
Worker remittances	13.9	3.6	3.9
Direct investment in Pakistan	1.3	0.1	0.2
Disbursement of external debt	2.9	1.2	0.6
External debt servicing*	6.5	1.1	1.8

*Including short-term debt servicing, and servicing to the IMF
Source: SBP

Figure 5.1: Comparison of SBP Reserves and PKR Parity in H2-FY13 and H1-FY14



Source: State Bank of Pakistan

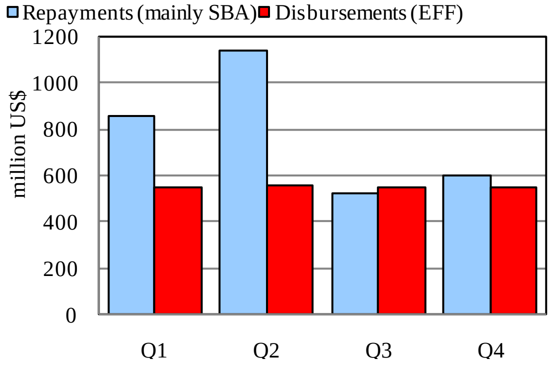
While debt repayments were known in advance, and the absence of coalition support fund (CSF) was already priced in, the FX market was unnerved by expectations of FX purchases by SBP to achieve quarter-end targets for net international reserves (NIR), as stipulated in the letter of intent. This even caused

[1] This section is based on 6th edition of the Balance of Payments Manual (BPM-6). State Bank of Pakistan has started compiling BoP statistics as per BPM-6 since July 2013, and has also transformed FY13 accounts according to these standards, for comparability. Please see **Box 5.1**, for a discussion on major heads of BoP under this edition, and interpretation of important indicators.

the interbank PKR parity to touch an all-time high of 110.5 on 26th September 2013, before closing at 105.35 on the same day (**Figure 5.1** and **Section 5.4**).

In this context, while the new IMF program provided much needed FX support to Pakistan, the fact that fresh disbursements have been tagged with quarterly targets of SBP's NIR, it could not calm the FX market. More specifically, the EFF program was not frontloaded, and the burden of net repayments to the IMF, did not help market sentiments during the first two quarters of FY14 (**Figure 5.2**).

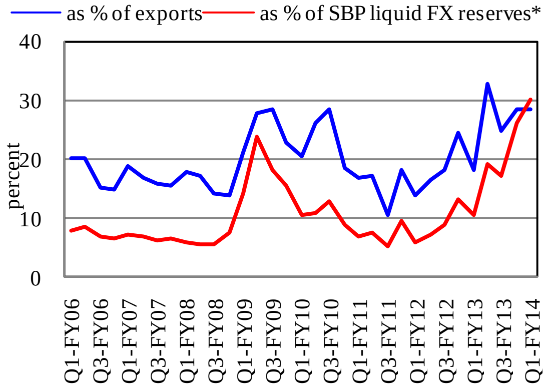
Figure 5.2: Measuring Net Inflows from the IMF during FY14



Source: IMF

In addition to the IMF, debt servicing to other foreign creditors was also challenging during Q1-FY14, totaling US$ 927.4 million.[2] Total external debt servicing during the quarter used 30 percent of liquid FX reserves available with SBP at the start of the quarter. Its use of quarterly export revenues was also of the same magnitude (**Figure 5.3**).

Figure 5.3: Burden of External Debt Servicing

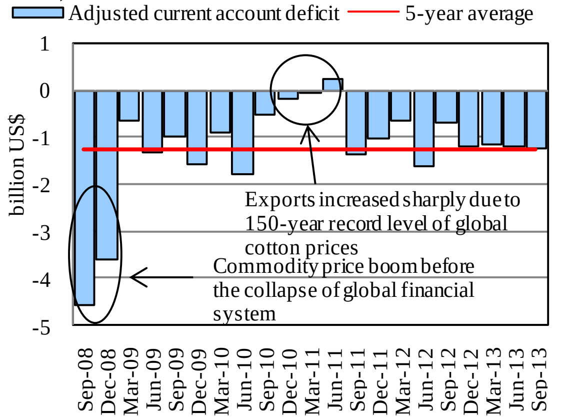


*debt servicing during the quarter as % of SBP's FX reserves at the start of the quarter
Source: State Bank of Pakistan

Pakistan's import bill was of growing concern, as it increased by 7.6 percent during Q1-FY14. This increase reflected rising demand for petroleum, to fill the demand-supply gap created by gas shortages in the country. The demand for crude oil was particularly strong, which can also be traced to the improved financial position of local refineries in Q1-FY14, compared

[2] In Q1-FY13, external debt servicing excluding the IMF was only US$ 645.2 million.

Figure 5.4: Quarterly Current Account Deficit (Excluding CSF)



Source: State Bank of Pakistan

to the previous year, as the government settled a significant portion of circular debt at end-June 2013 (**Section 5.5**).[3]

Export growth, on the other hand, remained modest, though there was a visible improvement in the export of some of the major items like textiles, rice and leather. In overall terms, trade deficit widened to reach US$ 4.2 billion; unlike Q1-FY13, this gap could not be *completely* filled by worker remittances, even though, increased by an impressive 9.1 percent during the quarter (**Table 5.1**). The absence of CSF inflows during Q1-FY14 widened the current account deficit to reach US$ 1.2 billion, which is about the same size, as it was in the past 5 years (after adjusting for CSF inflows) (**Figure 5.4**).

In contrast to the current account, the financial account performed relatively better in Q1-FY14, compared to the corresponding quarter of FY13. Foreign investments increased, and despite higher government debt repayments, net debt outflows were smaller due to FX borrowings by SBP and commercial banks (**Section 5.3**).[4] Nonetheless, the overall financial account continued to show a net outflow, and the country's FX reserves bore the entire burden of financing the external deficit.

[3] The quantum import of crude petroleum increased by 10.5 percent YoY in Q1-FY14. Moreover, quantum import of motor spirit (petrol) and furnace oil increased by 11.1 percent and 0.8 percent, respectively. In contrast, quantum import of high-speed diesel declined sharply by 17.5 percent YoY (**Chapter 2**). Since BoP data records imports at the time of actual payment, a *part* of the increase in petroleum bill was also on account of difference in timing of payments for furnace oil between the two periods: in Q1-FY13, most import payments were deferred to subsequent months, as PSO was facing severe liquidity constraints. Due to settlement of circular debt at end-June 2013, PSO's liquidity condition improved, and it was able to make import payments on time.

[4] SBP borrowed in the form of drawings from the currency swap arrangement with Bank of China. IMF loan for BoP support is not included in the financial account.

5.2 Current Account

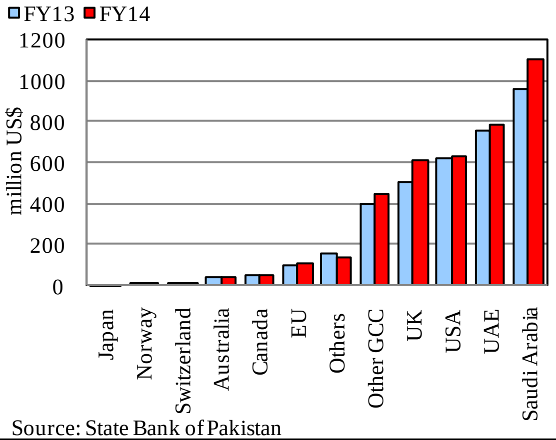
Table 5.2: Details of Current Account in Q1 as per BPM-6
million US$

	FY13	FY14
Current account balance	**439**	**-1,206**
Excl. CSF	***-679***	***-1,206***
A. Balance on trade in goods	-3,625	-4,243
Export of goods FOB	6,151	6,275
Import of goods FOB	9,776	10,518
B. Balance on trade in services	108	-890
Of which: CSF	1,118	0
C. Balance on primary income*	-692	-809
D. Balance on secondary income**	4,648	4,736
Of which: Worker remittances	3,599	3,927

*previously, income account; **previously, current transfers
Source: State Bank of Pakistan

Current account posted a deficit of US$ 1.2 billion in Q1-FY14, compared to a modest surplus of US$ 0.4 billion in the previous year. As mentioned before, this difference was explained mainly by an absence of coalition support fund this year, which had turned the deficit in the current account into a surplus last year (**Table 5.2**). Adjusting for CSF, the difference in current account deficits between two quarters, reduces significantly. The remaining difference was explained by higher import payments in Q1-FY14 (**Section 5.5**).

Figure 5.5: Country-wise Remittances -Q1



Source: State Bank of Pakistan

As mentioned before, worker remittances grew by 9.1 percent during the quarter. Most of the increase came from Saudi Arabia and UK (**Figure 5.5**). Interestingly, it was earlier feared that due to ongoing drive against illegal immigrants in Saudi Arabia, there could be some repatriation of Pakistanis from the Kingdom, and subsequently, a reduction in remittances. Fortunately, this did not happen: while it is reported that over 50,000 Pakistani immigrants were sent back, around 800,000 documented and regularized, as per the new requirements, during the grace period of 7 months.[5] Therefore, the increase in remittances may reflect a shift from

[5] Saudi Gazette. Initially, Saudi government gave an amnesty for three months, i.e., April 2013 to June 2013, to illegal foreign workers to either regularize their status, or leave the country without prosecution. At the end of this period, it extended the time limit of this amnesty till the end of October 2013.

informal to formal avenues to remit funds, by those who were legalized; but we cannot rule out the possibility of reverse capital flight by those who returned.

As far as the UK was concerned, the increase in remittances mainly reflects the initiation of direct-to-bank (D2B) project of a domestic commercial bank with Western Union during Q1-FY14, which has made remitting through Western Union cost-free.[6] While this project is meant for Western Union outlets all across the world, early success in UK can be traced to aggressive marketing there.

Box 5.1: Major Heads of Balance of Payments as per BPM-6, and their Interpretation

The overall framework of the methodology of BPM-5 and BPM-6 is conceptually the same. However, BPM6 deepens the harmonization of recommendations given by the IMF's external sector statistics, with the update of the System of National Accounts (SNA), and the international standards in the area of direct investment statistics and other macroeconomic statistics. We are presenting below the major heads of BoP in the BPM-6, along with their interpretations. The difference between BPM-5 and BPM-6 in various components is summarized in **Table 5.1.1**:

1. Current account

The current account shows flows of goods, services, primary income and secondary income between resident and non-residents.

The ***primary income account*** shows primary income flows between resident and non-resident institutional units. Primary income captures returns for the provision of labour and financial assets, and renting of natural resources. The international accounts show following types of primary income: compensation of employees;[7] dividend incomes; reinvested earnings; interest; investment income attributable to policy holders in insurance, standardized guarantees, and pension funds; rent; and, taxes and subsidies on products and production.

The ***secondary income account*** shows current transfers[8] between residents and non-residents. The international accounts classify the secondary current transfers in following broad categories: personal transfers; and other current transfers. Personal transfers consist of all current transfers in cash, or in kind, made or received by resident households to or from non-resident households, e.g., workers' remittances. Other current transfers include social contributions; social benefits; current taxes on income or wealth; non-life insurance premiums and claims; current international co-operations; and miscellaneous current transfers.

2. Capital account

The capital account shows debit and credit entries for non-produced non-financial assets, between residents and non-residents. This account also includes capital transfers, in which the ownership of

[6] In addition to direct-to-bank, Western Union also offered various promotion offers for cash over the counter during Jul-Oct 2013.

[7] Compensation of employees has three main components: wages and salaries in cash; wages and salaries in kind; and employer's social contribution.

[8] A transfer is an entry that corresponds to the provision of good, service, financial asset, or other non-produced asset by an institutional unit to another institutional unit, when there is no corresponding return of an item of an economic value.

an asset changes from one party to another; or which obliges one or both parties to acquire or dispose of an asset; or where a liability is forgiven by the debtor.

3. Financial Account

The financial account records transactions that involve financial assets and liabilities and that take place between residents and non-residents. The overall balance on the financial account is called net lending (+)/ net borrowing (-). Net lending (when financial account balance is a positive number)

Table 5.1.1: Comparison of Balance of Payments as per BPM-5 and BPM-6

billion US$	**BPM-5**	**BPM-6**	**Remarks**
Current account balance	**-1,206**	**-1,206**	
Trade balance	-4,267	-4,243	Repairs of goods and goods for processing are now shifted from trade account to services account; whereas, merchanting of exports shifted from services to trade
Services balance	-868	-890	
Primary income balance	-807	-809	Financial intermediation services indirectly measured is now included in services account, and excluded from primary income account.
Secondary income balance	4,736	4,736	Renamed from 'current transfer'
Capital Account,	**46**	**46**	
Financial Account	**382**	**-382**	In the BPM-5, increase in assets was reported with a negative sign; therefore, the balance used to be calculated as assets + liabilities. In the BPM-6, increase in assets is reported with a positive sign; and now the balance is calculated as assets – liabilities
Direct investment	172	-172	
Direct investment abroad	-59	59	
Direct investment in Pakistan	231	231	
Portfolio investment	107	-107	
Portfolio investment abroad	-1	1	
Portfolio investment in Pakistan	108	108	
Financial derivatives (asset-liability)	0	0	
Other investment assets	195	-195	
Other investment liabilities	-92	-92	
Monetary authorities	245	245	
General Government	-258	-258	
Disbursements	525	525	
Amortization	783	783	
Banks	-5	-5	
Other sectors	**-74**	**-74**	
Net errors and omissions	**-415**	**-415**	
Overall balance	**-1193**	**1,193**	

means that in net terms, the economy supplies funds to the rest of the world, taking into account acquisitions and disposal of financial assets; and incurrence and repayment of liabilities. Net borrowing (when financial account is a negative number) means that in net terms, the economy is receiving/borrowing funds from the rest of the world

Financial account has 5 components:

1. ***Direct investment***, which is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Direct investment has two components: net direct investment in rest of the world; and net direct investment in the reporting country. In case of

Pakistan, the balance in direct investment will be calculated as direct investment abroad (by Pakistanis) minus direct investment in Pakistan by the rest of the world. A positive balance in direct investment implies that in net terms, Pakistan invested in rest of the world (asset acquisition). Similarly, a negative balance in direct investment implies that in net terms, rest of the world invested in Pakistan (liability incurrence).

2. ***Portfolio investment*** is defined as cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets. The interpretation of a positive and negative balance for portfolio investment is the same as it is for direct investment. Therefore, there will be a negative balance in portfolio investment if portfolio investment in Pakistan by rest of the world exceeds portfolio investment by Pakistanis abroad. Similarly, there will be a positive balance in portfolio investment, if portfolio investment by Pakistanis abroad exceeds portfolio investment in Pakistan by rest of the world.

3. ***Financial derivatives*** and employee stock options: A financial derivative contract is a financial instrument that is linked to another specific financial instrument or indicator or commodity and through which specific financial risks can be traded in their own right in financial markets.

4. ***Other investment*** is a residual category, which includes positions and transactions other than those included in direct investment, portfolio investment, derivatives, and reserve assets. This category is comprised of currency and deposits; loans; trade credit and advances; SDR allocations; other accounts receivable/payable; non-life insurance technical reserves; and other equity. These items are classified under net acquisition of assets and net incurrence of liabilities for all the sectors of the economy. For instance, loans received by Pakistan are categorized under net incurrence of liabilities. For each sector, disbursements during the period are reported, along with the amortization of loans; net incurrence of liabilities will then be calculated as disbursements minus amortization during the period. If disbursements exceed amortization, the net incurrence of liabilities will be a positive number (an increase in liabilities), whereas, if amortization exceeds disbursements, then net incurrence of liabilities will be a negative number (a decline in liabilities).

5. ***Reserve assets*** are those external assets that are readily available to and controlled by monetary authorities for meeting BOP financing needs, for intervention in exchange markets to affect the currency exchange rates, and for other related purposes (e.g., maintaining confidence in the currency and the economy).

5.3 Financial Account

Before analyzing the financial account, it is important to revisit the data interpretation under the BPM-6. The US$ 0.4 billion deficit shown during Q1-FY14, does not imply net FX outflows from the country; in fact, this only shows the difference between net acquisition of financial assets, and net incurrence of financial liabilities during the period (**Table 5.3** and **Box 5.1**). For a more meaningful interpretation of the financial flows, it is important to discuss this account component-by-component.

Foreign investment

Foreign investment is the difference between net direct investment abroad and net direct investment in Pakistan. Net direct investment in Pakistan showed a strong recovery: it grew by 85.0 percent YoY during Q1-FY14, compared to a decline in Q1-FY13.[9]

Table 5.3: Details of Financial Account during Q1 as per BPM-6
million US$

	FY13	FY14
Financial account	**406**	**-382**
I. Direct investment (asset – liability; minus sign reflects net borrowing)	**-102**	**-172**
Direct investment abroad (asset)	23	59
Direct investment in Pakistan (liability)	125	231
II. Portfolio investment (asset – liability; minus sign reflects net borrowing)	**-109**	**-107**
Portfolio investment abroad (asset)	5	1
Portfolio investment in Pakistan (liability)	114	108
III. Other investment (A - B) (minus sign reflects net borrowing)	**617**	**-103**
A. Net acquisition of financial assets	420	-195
(i) Central bank	0	0
(ii) Deposit-taking corporations	285	-190
(iii) General government	-4	-2
(iv) Other sector	139	-3
B. Net incurrence of liabilities	-197	-92
(i) Central bank	0	245
(ii) Deposit-taking corporations	-310	-5
(iii) General government	17	-258
Disbursements	398	525
Amortization	381	783
(iv) Other sector	96	-74

Source: State Bank of Pakistan

This increase was driven by an 8.2 percent growth in gross FDI in the country, and a 20.0 percent decline in outflows (disinvestments from Pakistan) (**Table 5.4**). Despite this improvement, FDI inflows remain far from satisfactory:

At first, component-wise FDI shows that the entire increase was explained by an increase in reinvested earnings (mainly reflecting better corporate profitability this year), and a sharp decline in corporate loan

Table 5.4: Direct Investment in Pakistan
million US$

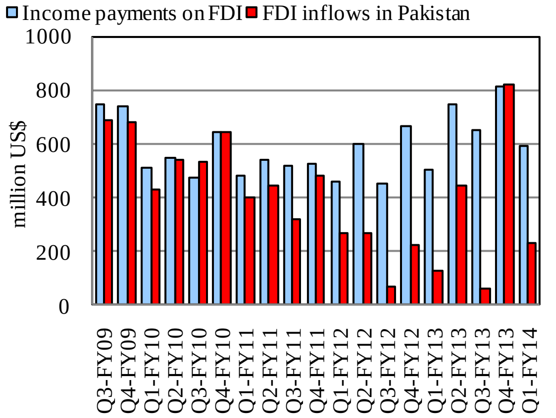
	Inflow	Outflow	Net
Q1-FY13	464	339	125
Q1-FY14	502	271	231
percent growth	*8.2*	*-20.0*	*85.0*

Source: State Bank of Pakistan

[9] Net direct investment in Pakistan had declined from US$ 263 million in Q1-FY12, to US$ 125 million in Q1-FY13.

repayments.[10] In contrast, investments in the form of cash equity and capital equipments, which are considered more productive form of FDI, remained lackluster.

Figure 5.6: FDI Income Payments vis-a-vis FDI Inflows



Source: State Bank of Pakistan

Secondly, the level of FDI is still too low to have much of an impact. Putting this in perspective, income repatriation from outstanding FDI continues to exceed FDI inflows in the country (**Figure 5.6**). Therefore, in net terms, foreign investments are causing a net FX outflow from the country.

Other investments

Other investments mainly represent the difference between net acquisition of financial assets and liabilities during a certain period. While assets mainly include holding of FX denominated asset including currency, deposits, and outstanding export bills; liabilities comprise borrowings from foreign sources by different sectors of the economy. A negative balance in other investments during Q1-FY14 mainly represents a sharp decline in financial assets, which more than offset the decline in financial liabilities.

The decline in financial assets during Q1-FY14 can be traced to depletion in commercial banks' total reserves: during Q1-FY14, banks' trade nostros declined by US$ 414 million compared to an increase of US$ 200 million in Q1-FY13.[11] While a part of this decline can be attributed to an increasing current account deficit, absence of FX support from SBP through most of the period, appears to be the major swing factor (**Section 5.4**).

As far as net liabilities were concerned, these continued to show a decline in Q1-FY14. Most notably, debt retirements by the government exceeded fresh

[10] Gross FDI inflows in the country represents: (i) cash equity; (ii) capital equipments; (iii) reinvested earnings; and (iv) loans from investing company. Outflows include disinvestments and loan repayments to investing company.

[11] Total FX reserves of commercial banks include their liquid FX reserves and trade nostros.

disbursements, which caused a net decline in its liabilities by US$ 258 million during Q1-FY14.[12] A large part of this decline, however, was offset by a rise in FX liabilities of the central bank, which was in the form of drawings from the currency swap arrangement with Bank of China. As a result, the overall decline in net liabilities was much smaller in Q1-FY14 compared with the corresponding quarter of FY13.

5.4 Reserves and Exchange Rate

The decline in SBP liquid FX reserves continued into FY14: there was a drawdown of US$ 1.3 billion in Q1-FY14 from SBP reserves, which was 3 times larger than the decline seen in Q1-FY13. This decline can be traced to: (i) unwinding of the swap/forward contracts by US$ 480 million; (ii) net repayment of US$ 311 million to the IMF; and (iii) debt repayment of US$ 258 million by the government (**Table 5.3**). In contrast, commercial banks' liquid FX reserves showed a modest increase during the quarter, reflecting a rise in foreign currency deposits.[13] On aggregate, the country's liquid FX reserves reached US$ 9.8 billion at end September 2013, which can just cover 3-month (or 12.5 weeks) of the import bill. Furthermore, the quarterly target set by the IMF for SBP's NIR was also missed: against an adjusted target of US$ -2.9 billion, SBP's NIR was US$ -3.2 billion at end-September 2014.[14]

This pressure on FX reserves was also reflected in the PKR parity: compared to the modest depreciation in the previous year, PKR depreciated by a 20-quarter high of 6.0 percent during Q1-FY14 (**Figure 5.7**). While a large current account deficit, and a decline in FX reserves, explains the depreciating *trend*, it does not fully explain the *magnitude* therein. The magnitude, we believe, can be traced to lack of SBP FX support, as well as self-fulfilling market expectations during the quarter. SBP refrained from intervening in the FX market throughout the quarter, due to insufficient FX reserves; in fact, it purchased over US$ 125 million in July

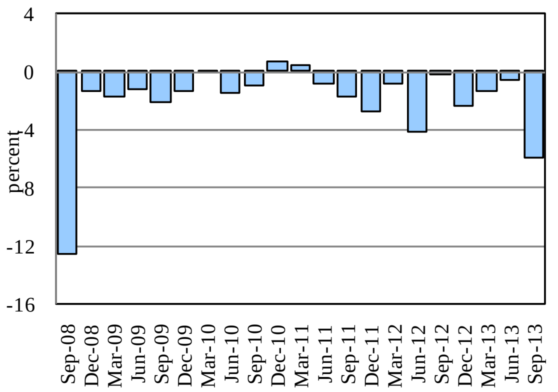
[12] Here, it is important to mention that the stock of external debt as reported in **Chapter 4** shows net increase, whereas, BoP accounts show net retirement of external loans. This difference stems mainly from revaluation of debt stock incurred in currencies other than US dollar (for details, see **Chapter 4**). The IMF loan for BoP support is another source of difference in these two data sets; while disbursement and retirement of IMF loans are included in the external debt data, these are not included in the balance of payments, and are reported below the line.

[13] Banks' liquid FX reserves are calculated as their holding of FE-25 deposits, minus trade financing. These do not include banks' trade nostros.

[14] IMF Country Report No. 14/1, dated January 2014, "First Review under the Extended Arrangement under the Extended Fund Facility, Request for Waiver of Nonobservance of a Performance Criterion and Modification of Performance Criteria".

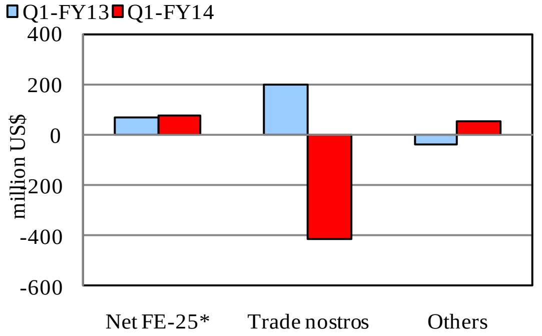
and August 2013 from the interbank as a prior action for the EFF program.[15] As such, the entire pressure of current account payments during the period was borne by commercial banks, which is evident in their depleting trade nostros (**Figure 5.8**).[16] In September 2013, the IMF released a detailed staff report for Article IV consultation, which emphasized the need for FX purchases from the interbank to shore up SBP's net reserves (NIR). This generated market speculations about future FX purchases by SBP to meet quarterly NIR targets, which pushed the interbank exchange rate to a record-high of 110.5 per USD on 26th September 2013.

Figure 5.7: Quarterly Depreciation of PKR



Source: State Bank of Pakistan

Figure 5.8: Change in Commercial Banks' Total Reserves



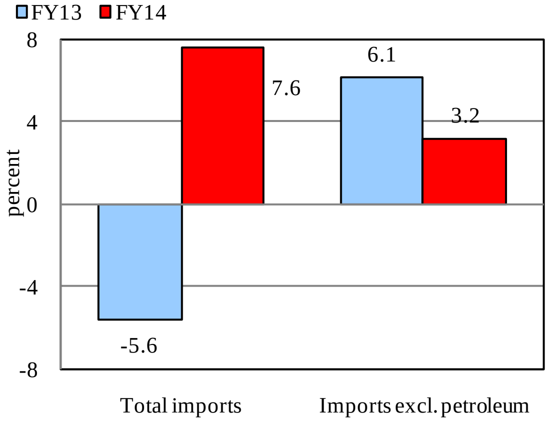
*These are calculated as commercial banks' holding of FE-25 deposits minus loans extended for trade finance, and other placements of these deposits inside Pakistan.
Source: State Bank of Pakistan

The FX market returned to calm, especially after the first IMF tranche of US$ 574 million was received at end-September 2013, and CSF inflow of US$ 322.2 million in October 2013. In mid-December 2013, Pakistan also received the second IMF tranche of US$ 554 million. Another important reason for the calm, is that Pakistan has already met the lumpy repayments from the old SBA; repayments in the second half of FY14 are relatively smaller, and will be compensated by scheduled disbursements of the EFF in that period (**Figure 5.2**). In addition to this, the market is expecting additional FX receipts

[15] IMF had suggested SBP to purchase US$ 125 million from the interbank to build up its NIR, as mentioned in the detailed letter of intent.
[16] Banks' trade nostros are not included in their liquid FX reserves.

under CSF; disbursements of IFI loans; 3G auction; and to a lesser extent, privatization proceeds from Etisalat.[17]

Figure 5.9: YoY Growth in Import Payments -Q1



Source: State Bank of Pakistan

5.5 Trade Account

Trade deficit widened during Q1-FY14, to reach US$ 4.2 billion. This increase can be traced to a sharp rise in imports, which outpaced the modest growth in exports. This outcome was driven primarily by the petroleum sector – excluding which, import growth showed a slight decline compared to Q1-FY13 (**Figure 5.9**). Two factors mainly explain the strong growth in petroleum payments.

First, the settlement of circular debt right before the first quarter, improved the liquidity situation across the energy sector value chain.[18] Refineries, in particular, were able to import crude oil to increase domestic production of key petroleum products (**Chapter 2**).[19] And second, reduced availability of CNG throughout the country has increased the demand for petrol: total sales of petrol countrywide increased by 11.6 percent YoY during Q1-FY14.

Non-petroleum imports

As mentioned before, non-petroleum imports tapered in Q1-FY14 compared to the previous year. This can be attributed to a number of items (**Figure 5.10**):

(i) Decline in international price of palm oil reduced its import bill by 19.2 percent, even though customs record shows a rise in import quantum.[20,21]

(ii) Better availability of gas to the fertilizer sector improved domestic production, and a corresponding decline in fertilizer imports (**Chapter 2**).

[17] The issue between Etisalat and Government of Pakistan still remains unresolved, regarding the transfer of all the agreed properties of PTCL to the UAE Company.

[18] The government paid Rs 322 billion to settle the circular debt in June 2013.

[19] Quantity import of crude oil has increased by 10.5 percent YoY in Q1-FY14 (Source: OCAC).

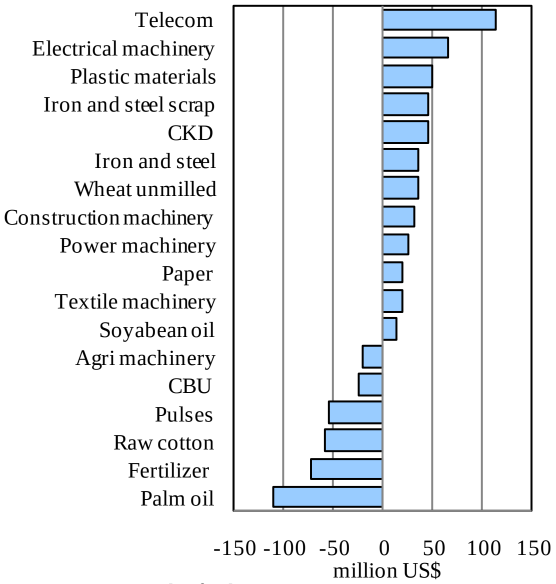
[20] Customs data shows an increase in quantum import of palm oil by 1.5 percent YoY in Q1-FY14, and a decline in its unit value by 10.9 percent YoY in the same period (source: Pakistan Bureau of Statistics).

[21] Higher domestic production of edible oil and ghee during Q1-FY14 also suggests a rise in import of palm oil. As noted in **Chapter 2,** production of edible oil and ghee has increased by 9.8 and 7.6 percent respectively in Q1-FY14.

(iii) Domestic production of pulses was strong in Q1-FY14 compared to the previous year, which reduced dependence on imports.

(iv) Till October 2012, import of CBUs was allowed for cars up to five years old. In November 2012, however, the government restricted this age limit to only three years, which caused a decline in import of CBU cars from 14,223 in Q1-FY13 to only 4,965 units in Q1-FY14.

Figure 5.10: YoY Change in NOn-petroleum Imports (Q1-FY14)



Source: State Bank of Pakistan

Encouragingly, machinery imports improved considerably, which bodes well for the economy. This increase was broad-based, including telecom, electrical, construction, power generating, and textile. A sharp increase in telecom imports was evident mainly in reception and transmission apparatus, as the country gears up to enter into 3G era that requires more innovative broadband services. While the increase in textile machinery may have been to capitalize on the GSP+ status January 2014 onwards, the increase in electrical machinery was primarily driven by the import of medical equipment. Finally, robust construction activity in the country continued to attract investment in the sector – the increase in import of construction machinery in Q1-FY14, was even larger than the full-year imports during FY13.

Table 5.5: Exports during Q1

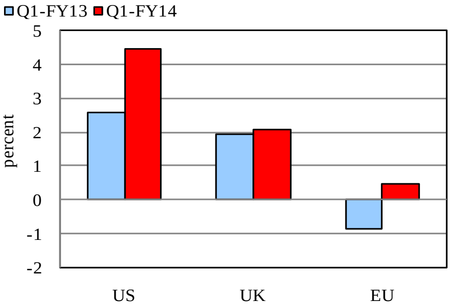
	Value in million US$		YoY growth (%)	
	FY13	**FY14**	**FY13**	**FY14**
Total exports	**6,151**	**6,275**	**0.0**	**2.0**
Textiles	3,220.8	3,462.9	-7.6	7.5
Food	886.6	867.2	-3.7	-2.2
Rice	339.7	402.8	-21.8	18.6
Basmati	189.2	209.2	-27.4	10.5
Non-basmati	150.5	193.6	-13.4	28.7
Fish	63.3	76.0	4.0	20.1
Jewelry	73.4	45.9	360.0	-37.5
Cement	147.3	142.3	15.7	-3.4
Leather	234.7	255.9	-4.2	9.0
Sports goods	128.3	132.4	-2.1	3.2

Source: State Bank of Pakistan

Exports After remaining constant in FY13, export receipts increased by 2.0 percent during Q1-FY14

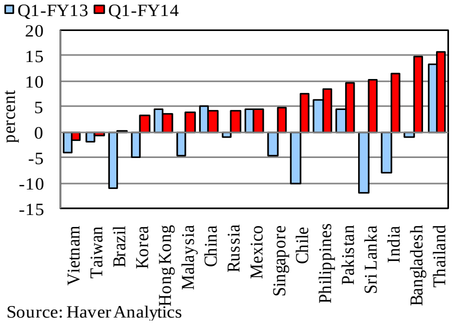
(**Table 5.5**). This improved performance can be traced to both domestic and external factors. While domestic factors include a relatively smooth energy supply, and a larger inventory of exportables (e.g., cotton and rice) (**Chapter 2**); external factors include the steady consumer demand in our export markets.

Figure 5.11a: YoY Growth in Retail Sales



Source: United States Census Bureau; Eurostat; and UK National Statistcis

Figure 5.11b: Recovery in Exports of Major Emerging Economies



Source: Haver Analytics

Figure 5.9c: Performance of Currencies of Emerging Economies

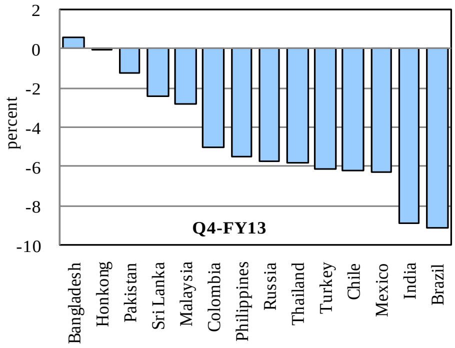
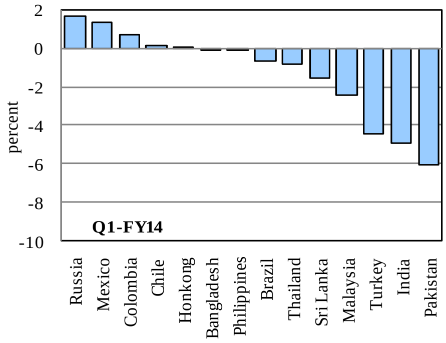


Figure 5.9d: Performance of Currencies of Emerging Economies



Source: Haver Analytics

Specifically, despite some uncertainty in key policy decisions, consumer demand in the US and European countries grew modestly during Q1-FY14 (**Figure 5.11a**). At the same time, there was a sharp depreciation of emerging market currencies soon after the Fed first flagged the need to begin tapering quantitative easing in June 2013. Together,

Table 5.6: Textile Exports during Q1

	Export value			YoY growth	
	FY12	FY13	FY14	FY13	FY14
Textile	**3485.9**	**3220.8**	**3462.9**	**-7.6**	**7.5**
Raw cotton	48.7	24.6	50.6	-49.5	105.5
Cotton yarn	432.1	510.4	561.3	18.1	10.0
Cotton cloth	673.6	644.0	726.4	-4.4	12.8
Knitwear	704.4	541.7	553.4	-23.1	2.2
Bed wear	538.0	459.5	501.7	-14.6	9.2
Towels	165.1	178.3	183.3	8.0	2.8
Garments	362.2	411.5	438.6	13.6	6.6

Source: State Bank of Pakistan

these factors helped the recovery of exports of most emerging economies, and Pakistan was no exception. However, South Asian competitors performed much better than Pakistan (**Figure 5.11a - c**).

Textile exports: The improvement in textile exports can be traced to three factors: (i) a rise in demand for cotton yarn in China; (ii) anticipation of Pakistan getting GSP + status from the EU January 2014 onwards; and (iii) PKR depreciation.

For the last couple of years, the Chinese government has been running a cotton stockpiling program through imports. However in FY14, there has been a shift in its policy; the government now promotes the import of cotton yarn instead of raw cotton, as China is now sitting on more than half of the world's cotton reserves. Pakistani yarn manufacturers capitalized on this opportunity, and were able to increase yarn exports by 10 percent during the quarter. While China scaled back its import of raw cotton, India, Indonesia and Vietnam have significantly increased their demand in Q1-FY14. As a result, Pakistan was able to double its export of raw cotton compared to the previous year (**Table 5.6**).

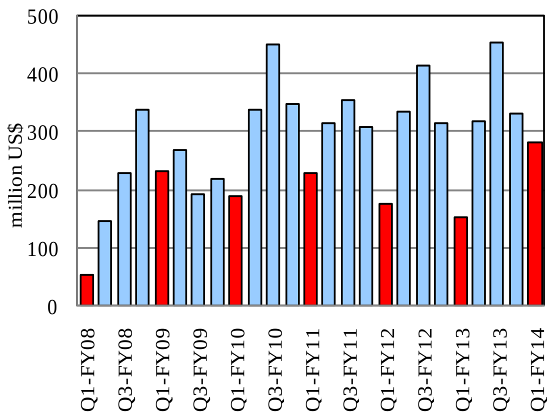
As far as value-added items are concerned, Pakistan's apparel exports to the EU have increased sharply in anticipation of duty-free access in 2014. Pakistani exporters have been strengthening their working relations with EU importers for the last few months, so they can fully utilize the opportunity of exporting certain items duty-free and quota-free from January 2014 onwards.

Food group

Major food exports performed well during Q1-FY14. ***Rice exports***, in particular, bounced back after declining in two consecutive years, principally due to carryover stocks of coarse rice from the previous season, and projections of higher production this year. As shown in **Figure 5.12**, exports remain typically low in Q1 before rice production comes in full swing October onwards. This year, however, exports have picked up in the first quarter due to available inventories. Furthermore, anecdotal evidence suggests that production of coarse rice will probably return to pre-flood levels in FY14. Major incentive to grow coarse rice includes lower water requirement; higher demand in China and Far-East Asia; and steady increase in domestic prices due to export-led buying.

Fish exports increased by 20.1 percent during Q1- FY14 compared to last year. This increase – evident mainly in frozen, fillet and crustacean categories – was primarily a result of Sindh government's decision to lift a ban on catching fish in July this year.[22] In addition, higher demand from Vietnam, Thailand and the Middle-East, has also supported export growth. In fact, ever since the EU imposed a ban on seafood import from Pakistan, local exporters have strived to capture lucrative export markets in the Middle-East and East Asia. Going forward, it is expected that Pakistan's exports will grow further as EU has lifted the ban it imposed on seafood from Pakistan six years back. However, local exporters need to remain cautious regarding the quality standards to retain this, and other hard-earned markets. In particular, the country cannot afford rejection and subsequently cancellation, of import orders by Kuwait and Saudi Arabia on quality grounds.

Figure 5.12: Seasonality in Export of Non-basmati Rice

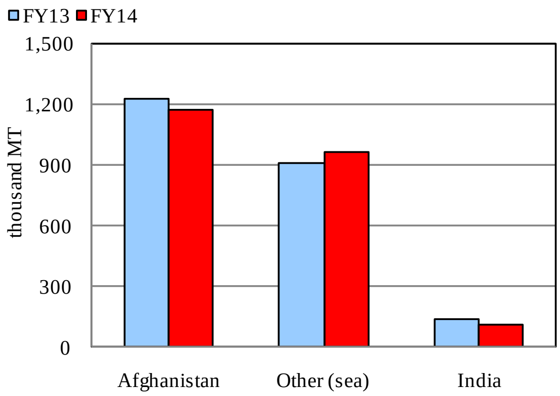


Source: State Bank of Pakistan

Cement

Cement exports weakened further in Q1-FY14, mainly as new capacity in India came in to use. Furthermore, Pakistan's exports to Afghanistan continued to suffer, due to the strengthening foothold of Iranian cement in the country. Excluding these two countries, export of cement showed an impressive growth of 12 percent during Q1-FY14 (**Figure 5.13**). In particular,

Figure 5.13: Quantum of Cement Exports - Q1



Source: APCMA

[22] Government bans catching of fish for June and July every year due to the breeding season. Technically, this was not a good move to lift this ban during the breeding season. Although fish exports have improved in Q1-FY14, this will negatively affect breeding, and availability of fish next year.

exports to Mozambique, South Africa, Tanzania, Djibouti, Kenya and Iraq have improved considerably during Q1-FY14. Due to prevailing demand and an optimistic outlook for construction in most African countries, a leading Pakistani cement manufacturer has invested in production facilities in the Republic of Congo. In addition, its cement grinding facility in Iraq, is also expected to commence commercial operation in January 2014. Moreover, three local manufacturers are seriously considering setting up manufacturing units in Sri Lanka.

Going Forward

A peek into the most recent data suggests tapering of both exports and imports. The country has recorded a YoY decline in the trade deficit in both October and November 2013, mainly as the growth in import of petroleum (both crude and products) declined substantially. On the other hand, a modest decline in exports is mainly evident in textiles, naphtha, leather and cement. As Pakistan's GSP+ status in the EU has become effective from January 2014 onwards, we expect a recovery in exports as this allows Pakistan to export key textile and leather goods to the region duty-free and quota-free.[23] We forecast the trade deficit to remain within the range of US$ 16.5 – 17.8 billion by end FY14.

[23] To gain maximum advantage of this facility, Pakistani exporters should develop new product lines (e.g., technical textiles) and increase the use of man-made fibers to produce garments and home textile products.