

21st June, 2004

**SBP BOARD OF DIRECTORS CLARIFIES THE POSITION
REGARDING FOREIGN EXCHANGE PURCHASES**

The Board of Directors of the State Bank of Pakistan, in its meeting held in Quetta on June 21, 2004, took note of the recent debate in the Parliament and the media on the SBP's foreign exchange purchases and its impact on SBP's profit and loss account.

The Board analyzed in detail the various issues under debate and has considered it appropriate to clarify the position as follows:

Issue 1: State Bank has accumulated foreign exchange reserves by purchases from the market.

Fact: Accumulation of foreign exchange reserves can take place only when the overall balance of payments of a country is positive i.e. the current account and the capital account taken together are in surplus. For the last four years this happens to be the case in Pakistan and hence reserves have gone up from approximately US\$ 1.0 billion in FY00 to over US\$ 12 billion by end-May 2004

As all foreign exchange earnings and sales of a country take place through the inter-bank market the State Bank, like all the Central Banks pursuing a floating exchange rate policy, intervenes (i.e. buys and sells foreign exchange) in the inter-bank market to smooth out the payments and reduce volatility in exchange rate. Thus, inter-bank market purchases are the normal mode through which a Central Bank pursuing a floating exchange rate policy accumulates its reserves.

Issue 2: SBP has built up foreign reserves by purchasing \$ 12 billion from the open market.

Fact: After the nuclear test in 1998 and consequential sanctions on Pakistan, official inflows declined considerably and these inflows were inadequate to meet the out-flow obligations. To avoid default on the country's external payments, the State Bank of Pakistan intentionally adopted a policy, with the approval of Federal Government, to make all payments on time, and build up foreign exchange reserves for future debt servicing liabilities by buying foreign exchange from the kerb market. The alternative was to borrow commercially on a very high rate, adding to the already high foreign debt burden. The purchases from the kerb market, though at higher than inter-bank rates, were non debt creating. All purchases from the kerb market were through Foreign Exchange Association of Pakistan, the representative body of authorized money changers, as well as big money changers through banking channels.

The State Bank of Pakistan purchased US\$ 5.654 billion from the kerb market from FY99 to FY02, mainly to discharge its obligations. As the flows in the inter-bank market improved, the SBP stopped purchases from the open market after FY02.

In addition to the US\$ 5.654 billion purchased from the open market, SBP also purchased \$ 10.838 billion from the inter-bank market in the period between FY99 and March 2004, at the prevailing inter-bank without paying any premium, and sold \$ 3.982 billion during the same period. Thus the net purchases from the inter-bank market in the period amounted to \$ 6.856 billion.

It can be seen that the total amount of US\$ 12.510 billion represents the cumulative purchases from both, the open market and inter-bank market, and not from the open market alone, as alleged. But during the same period the SBP also made debt servicing payments to external creditors totaling \$ 17.413 billion. Thus, it is obvious that if outflows exceed the total SBP purchases by \$ 4.903 billion, there is no way that the purchases from the open market alone can account for the reserve accumulation since FY99.

The factors contributing to the reserve accumulation have been explained, and the actual numbers presented, in the SBP Annual Reports since 1999-00. To recapitulate, the main factors were:-

- a) Significant reduction in debt servicing payments due to implementation of debt reduction strategy.
- b) Increased inflows of workers' remittances.
- c) Reduced imbalances in the trade account (until FY04)
- d) Higher disbursements of foreign economic assistance.
- e) FDI inflows showing some modest rise.

The success of the above strategy can be gauged from the fact that Pakistan has reduced its debt servicing payments from 50.1 percent of revenues in FY00 to 26 percent in FY04.

Issue 3: SBP has suffered a loss of Rs.25 billion in FY03 due to its foreign exchange purchases.

Facts: It is true that there was a difference between the open market and the inter-bank rates, and just like any other Pakistani buyer, the SBP also paid this difference on its purchases. The total amount paid on account of this differential rate, over a 4 year period, was Rs. 18.257 billion. This has been reported in every single audited financial statement of the SBP. As the alternative to these purchases was to borrow from external creditors at exorbitant interest rates (because of country's high risk premium) and accumulate future debt servicing obligation, this modest cost of about Rs. 18.257 billion (equivalent to US\$ 300 million) in acquiring non-debt flows of \$ 5.654 billion, was an attractive proposition.

The reduction in profits in the year FY03, which has been reported in the SBP Annual Reports and the Press, has nothing to do with the purchases from the open market, as there were no purchases made that year. The reduction in profits was mainly due to the revaluation of SBP's foreign exchange assets and liabilities required under the international accounting standards. The SBP accumulated large net foreign assets, totaling US\$ 7.986 billion in FY03, which were reported in rupees in its profit and loss statement. Thus, as the Pakistani Rupee, appreciated vis-à-vis the US dollar by Rs.2.21 during the financial year (from Rs.60.02/US\$ in June 2002 to Rs.57.81/US\$ by end June, 2003), the SBP suffered a revaluation loss of Rs.17.65 billion (the actual loss was compensated by gains of Rs.6.6 billion on forward cover). It should be noted that had the Rupee depreciated in this period by Rs.2.21, the SBP would have made a revaluation profit of Rs17.65 billion.

The other major component of the reduction in SBP's FY03 profits was due to a decline in T-bill rates. While the decline in interest rates on T-bills affected the profitability of SBP, it also significantly reduced the debt servicing costs of the Government of Pakistan. According to their estimates, the debt servicing payments during FY03 were Rs.207.8 billion as against the budget estimate of Rs.264.0 billion. The savings on domestic interest payments in the budget caused by lower T-Bill rates were thus higher than the diminution of SBP profits. In net terms, the Government was better off in FY03, the private sector got credit at cheaper rates, and the export refinance rate was drastically slashed.

This reduction in the profits of SBP in FY03 of Rs.7.339 billion because of lower discount income should be seen in the light of these significant gains to the economy.
