

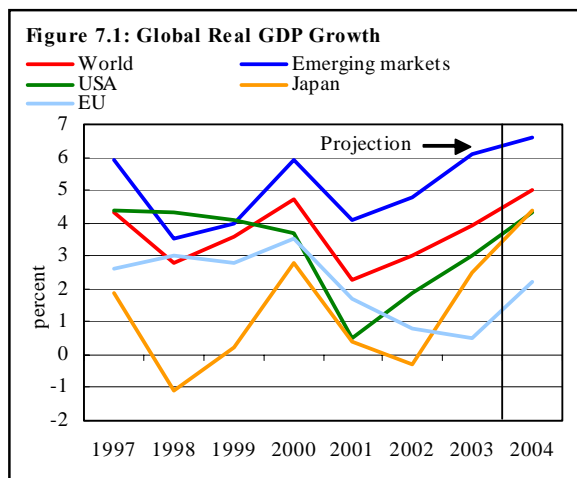
# 7 Balance of Payments

## 7.1 International Economic Environment<sup>1</sup>

The global economic recovery gained further ground in 2004 with world GDP growth projected to reach 5 percent for the year (see **Figure 7.1**); this would be the strongest growth for three decades. Though the economic upturn has been fairly broad-based – it covers industrial countries, emerging markets in Asia and Latin America and some oil exporting countries in Africa - the major impetus appears to be from consumer spending in USA and the investment boom in China.<sup>2</sup>

The remarkable growth performance of the United States appears to be largely due to higher private spending following the monetary and fiscal stimulus (spurred by tax cuts and low interest rates) as well as labor productivity gains. Moreover, the role of wealth effect from rising house prices on consumer spending is probably also very significant.<sup>3</sup> Thus, the downside risk to US economic performance is related to consumer spending, which, in turn, is vulnerable to any slowdown in the housing sector boom as well as a sustained increase in oil prices.<sup>4</sup> In addition, most of the incentives offered to households to increase their spending may not be available next year.<sup>5</sup> However, the scope of substantial productivity gains to US businesses, especially from outsourcing to low cost countries such as China and India, provides some cushion. Nevertheless, in the medium term, massive current account imbalance<sup>6</sup> and rising fiscal deficits<sup>7</sup> pose major risks to the economic revival.

The second source of the global recovery is the continuing economic boom in China, which is fueled by rapid investment and credit growth. Over the past three years, China has contributed almost one-fourth of the total increase in global real GDP (measured on PPP basis), which is significantly greater than the 20 percent contribution of the US economy.<sup>8</sup> The increasing role of China in the world growth is also supported by its rising share in the global trade and investment flows (see **Box 7.1**). However, the downside risks to China are the impact of sustained increase in oil prices and the possible overheating of the economy. Given the rapid integration of China with global economy, any slowdown in China raises concerns about its impact on other economies, particularly Japan which has strong trade links with China.



<sup>1</sup> This discussion is based on World Economic Outlook (WEO - September 2004) by International Monetary Fund.

<sup>2</sup> These two countries account for over 40 percent of the global GDP growth over the past year (Source: WEO database, IMF).

<sup>3</sup> Large increase in house prices affects households' net wealth and their capacity to borrow and spend.

<sup>4</sup> The sharp rise in oil prices has already reduced the private consumption during the second quarter of 2004, thereby raising concerns of a 'soft patch'.

<sup>5</sup> While the interest rates are rising gradually, the fiscal policy is also likely to be restrictive over the next few years.

<sup>6</sup> The impending risk with current account deficit is the rapid deterioration of the debt situation. It is expected that with rising indebtedness and interest rate trending higher, net foreign interest payments would grow and eventually turn negative in coming years.

<sup>7</sup> The social security and medicare promised to the 'baby boom' generation is also likely to keep pressures on fiscal account.

<sup>8</sup> Source: WEO database, IMF.

The Japanese economy also staged an exceptional recovery in 2003, growing at 2.5 percent after three years of recession. This economic upturn has been driven by strong exports (despite the appreciation of the Yen) as well as a moderate growth in private consumption and investment. This recovery is expected to persist in the near-term, but may be vulnerable to factors such as a sustained rise in oil prices<sup>9</sup> or a slowdown in China.

In contrast to the other major economic regions, the upturn in Euro area has remained relatively subdued owing to weak domestic demand (particularly in Germany). Growth in Latin America, however, strengthened with the rising exports accompanied by modest domestic demand; whereas, in Africa, the growth was mainly confined to oil exporting countries.

An important feature of the global economic recovery is that it is accompanied by a strong expansion of 4.5 percent in world trade volume during 2003 compared to a 3.1 percent growth in the preceding year. Interestingly, the trade volumes of emerging and developing countries grew more rapidly than those of industrialized economies – again mainly due to China.

However, the upsurge in world economic growth coupled with the depreciation of US Dollar against major currencies,<sup>10</sup> has put upward pressure in several key commodity prices, including crude oil, copper, iron, steel, soybeans etc. The oil prices, in particular, have climbed markedly, with spot prices rising from US\$ 23.4 a barrel in April 2003 to US\$ 27.9 a barrel in December 2003; recently, the spot prices have crossed US\$ 55 a barrel mark. Beside rising demand owing to economic recovery, other reasons for a sharp increase in the oil prices are: (1) relatively low commercial inventories; (2) frequent disruptions in Iraq's oil supply and production; (3) low spare oil production capacity that exposed the demand and supply balance in oil to sudden shocks; and (4) the terrorism premium due to fear of attacks on oil installation in major oil exporting countries. This sustained increase in fuel prices is a major concern as it could potentially choke off the nascent global economic recovery and raise inflationary pressures in the global economy.

In fact, the rapid economic growth and sharp rise in commodity prices has already led to stronger than expected increase in headline inflation across the globe. The core inflation (CPI excluding food and energy) however has remained at relatively moderate levels, but is edging up. This suggests that the

**Box 7.1: China's Role in Global Economy**

Over the past 20 years, China's role in the global economy has increased sharply. Its GDP has grown at an average annual rate of over 9 percent, while its share in world trade has risen from less than 1 percent to almost 6 percent. As a result, China is now the second largest economy (in PPP terms) and the fourth-largest trader in the world.

In terms of trade, while Chinese exports have gained significant global market share, the rapidly rising imports have supported the strong performance of its trading partner. In 2003, China's imports grew by over 40 percent, and during the last three years, it accounted for one-third of the total increase in world import volumes.

In addition, China's imports from the surrounding region have also increased very sharply. Together with Hong Kong, China absorbed 17 percent of exports of other countries in emerging Asia in 2002, and accounted for 35 percent of export growth of other countries in the region in 1998–2002. This reflects China's rising role as a regional reprocessing center and manufacturing hub for re-exports, and suggests that its impact as a regional engine of growth could soon become even larger than that of Japan.

At the same time, some developing countries are facing increased competition from China and continuously losing their market share for unskilled-labor-intensive manufactures. China is also the largest recipient of foreign direct investment as companies move their operations to China to benefit from low cost labor and large market.

However, the rapid growth in China has significantly increased world prices for some of the commodities, including agricultural products and energy. This could result in losses to countries who are net importers of such commodities.

Source: World Economic Outlook

<sup>9</sup> While Japan imports all of its oil requirements, its vulnerability to short-term oil price shocks is partially mitigated due to low energy intensity of production (measured as quantity of primary energy required to produce a unit of GDP).

<sup>10</sup> The US Dollar depreciated during 2003 against the currencies of other industrial countries, for instance, 17.72 percent against Euro, 10.70 percent against Yen and 10.74 percent against Pound Sterling.

monetary authorities may need to speed up the current pace of interest rates increases depending upon their cyclical positions.

The global economic recovery also had a positive effect on capital flows. Emerging markets have once again maintained their position as net exporters of capital. This is largely the result of (1) exceptional reserves accumulation by their central banks in Asia in order to maintain their competitiveness and to create a hedge against financial crisis; and (2) strong US current account deficit.

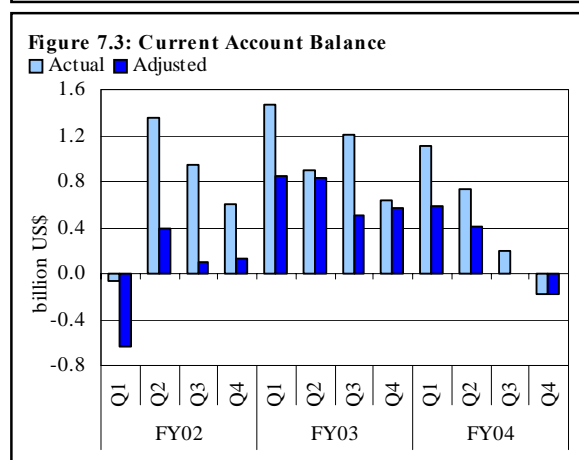
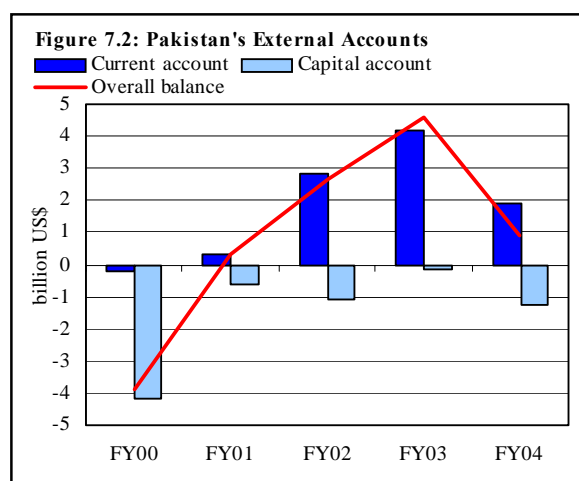
## 7.2 Balance of Payments<sup>11</sup>

The impact of the acceleration in the global economic recovery is also evident in Pakistan's external accounts with a robust increase in international trade. Not only did exports see a strong growth, imports too surged up as the domestic economy strengthened and local textile industry, in particular, geared up for a more competitive export market following the complete phase out of the MFA in 2005. The resulting rise in the country's trade deficit, and a sharp slowdown in non-structural inflows<sup>12</sup> contributed most of the 55 percent YoY decline in the FY04 current account surplus.

As the capital account also deteriorated in this period, with the deficit expanding sharply (mainly due to a one-off large pre-payment of expensive external debt), the overall balance, fell by 80.7 percent YoY to US\$ 887 million during FY04 (see **Figure 7.2**). Adjusting for this one-off pre-payment, the overall balance posted a US\$ 2,424 million surplus in FY04.

It is pertinent to note that the Rs/US\$ exchange rate movements were driven principally by the changes in the current account. The Rupee strengthened through most of H1-FY04 when the YoY decline in the current account surplus was low, and when SBP was also lowering its net purchases from the inter-bank forex market. However, the Rupee posted depreciation during H2-FY04 as the monthly current account surpluses diminished sharply and then turned into deficit by May 2004 (see **Figure 7.5**).

In fact, the depreciation in the Rupee would have been even steeper had the central bank not defended the Rupee aggressively, so as to allow the economy to adjust gradually to the changing exchange rate environment. Encouragingly, despite the weakness in the external account, the SBP continued to liberalize the foreign exchange regime during FY04 (see **Box 7.2**)



<sup>11</sup> The discussion on balance of payments is based on classification provided in the 4<sup>th</sup> manual by IMF. This classification is different from balance of payment table provided in the **Statistical Annexure**, which is based on the 5<sup>th</sup> Manual (for details see **Box 7.4**).

<sup>12</sup> These are defined as potentially non-repeating flows that were not principally driven by developments in the economy. These flows include the receipts for logistics support and *the Saudi Oil Facility*.

With current account surplus falling and capital account deficit rising, the increment in liquid reserves was limited to US\$ 1,609 million during FY04 compared to US\$ 4,287 million in the preceding year. As a result, Pakistan's total liquid reserves rose to US\$ 12,328 million at end-June FY04 compared with US\$ 10,719 million last year.

The developments in the balance of payments as well as in the broader economy have varying implications for key indicators of the external sector (see **Table 7.1**). The higher import growth led to a steady rise in the ratio of imports to GDP to 14.4 percent. As a result, the trade openness indicator also improved to 27.4 percent in FY04. In

addition, lower interest payments and higher export earnings have led to an improvement in the ratio of interest payment to export earnings. Similarly, the lower interest payments also remarkably improved the *non-interest current account balance*.

### 7.2.1 Current Account

Although the FY04 current account balance remained in surplus (for the fourth successive year), this was substantially lower than that in the preceding year (see **Table 7.2**). Much of this deterioration was evident only in the second half of the fiscal year. The factors responsible for this change included: (1) a sharp widening of the trade deficit; (2) an exceptional rise in payments for shipment; and (3) a decline in receipts on account of logistic support and the Saudi Oil Facility (SOF).

An important aspect of the decline in the FY04 current account is the role of the non-structural flows. In the preceding year, the current account had recorded substantial surpluses even after excluding non-structural flows. While this holds true to some extent for FY04 as the adjusted current account still posts a surplus of US\$ 0.81 billion, it is instructive to view the quarterly trends in non-structural flows (see **Figure 7.3**).

Specifically, these flows have been declining through FY04, but the fall in the last two quarters owed principally to the termination of the SOF (see **Figure 7.4**).

#### Box 7.2: SBP Liberalization Measures

The State Bank of Pakistan continued to liberalize the foreign exchange regime during FY04. Some of the important measures are as follows:

- (1) The SBP enhanced the limit for retention of export proceeds in Special Foreign Currency Account up to 10 percent.
- (2) The limit on import without opening letters of credits by actual/end user and by industrial user has been abolished. Earlier, this limit was US\$ 5,000 and US\$ 30,000 respectively.
- (3) The SBP also allowed the Authorized Dealers to release foreign exchange up to a maximum of US\$ 100,000 for private sector companies on account of utilization of IT services.
- (4) In order to bring the existing Authorized dealer within the network of Exchange Companies, SBP allowed establishment of Exchange Companies (under category B) with business scope limited to only sale/purchase of foreign currency notes & coins.

**Table 7.1: Balance of Payments: Key Indicators**  
percent

	FY01	FY02	FY03	FY04
<b>Trade</b>				
Exports/GDP	12.5	12.8	13.2	13.1
Imports/GDP	14.3	13.2	13.8	14.4
Trade openness	26.9	25.9	27.0	27.4
<b>Services account</b>				
Services (net)/GDP	-4.4	-3.7	-2.6	-3.8
Interest payment to EE ratio	17.3	16.1	10.2	7.0
Interest payment to FEE ratio	10.8	9.5	5.6	4.1
<b>Transfers</b>				
Net transfers to GDP	6.6	8.0	8.2	7.1
Remittances/GDP	1.5	3.3	5.1	4.1
<b>Current account</b>				
Current receipts / GDP	21.3	23.7	25.1	23.3
Current receipts growth	17.6	11.7	22.1	6.7
FEE (US\$ mlns)	14,337	15,456	19,652	21,481
Growth of FEE	12.4	7.8	27.1	9.3
Non-interest CAB (US\$ mlns)	1,874	4,303	5,310	2,757
NICAB/GDP	2.6	6.0	6.4	2.9
CAB/GDP	0.5	4.0	5.1	2.0
<b>Capital account</b>				
FDI/GDP	0.5	0.7	0.9	1.0
FDI/exports	3.6	5.3	7.3	7.7
<b>Others</b>				
Reserves in weeks of imports	10.1	24.3	45.4	39.4

Note: EE: Export Earnings; FEE: Foreign Exchange Earnings; NICAB: Non-Interest Current Account Balance; FDI: Foreign Direct Investment

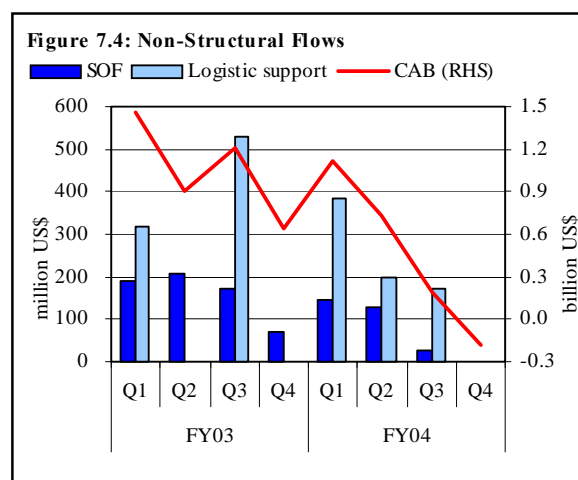
**Table 7.2: Current Account Balance**

million US Dollar

	FY02	FY03	FY04			Growth FY04 over FY03
			Full year	H1	H2	
<b>1. Trade balance</b>	<b>-294</b>	<b>-444</b>	<b>-1,212</b>	<b>-151</b>	<b>-1,061</b>	<b>173.0</b>
Exports (fob)	9,140	10,889	12,395	6,069	6,326	13.8
Imports (fob)	9,434	11,333	13,607	6,220	7,387	20.1
<b>2. Services (net)</b>	<b>-2,617</b>	<b>-2,128</b>	<b>-3,585</b>	<b>-1,236</b>	<b>-2,349</b>	<b>68.5</b>
Shipment	-739	-868	-1,159	-521	-638	33.5
Other transportation	103	237	161	110	51	-32.1
Travel	-145	-402	-1,035	-458	-577	157.5
Investment income	-2,321	-2,211	-2,206	-1,056	-1,150	-0.2
<i>Interest payments</i>	-1,470	-1,107	-870	-479	-391	-21.4
<i>Profit and dividend</i>	-457	-637	-632	-311	-320	-1
<i>Purchase of crude oil &amp; mineral</i>	-394	-467	-705	-266	-440	51
Other goods, services & income	485	1,116	654	689	-35	-41.4
<b>3. Current transfers (net)</b>	<b>5,744</b>	<b>6,775</b>	<b>6,684</b>	<b>3,256</b>	<b>3,428</b>	<b>-1.3</b>
a) Private transfers -net	4,249	5,737	6,110	2,802	3,308	6.5
i) Workers' remittances	2,390	4,237	3,871	1,874	1,997	-8.6
ii) FCA (residents)	285	-12	367	201	166	--
iii) Outright purchases	1,376	0	0	0	0	0.0
iv) Others transfers	198	1,512	1,872	727	1,145	23.8
b) Official transfers	1,495	1,038	574	454	120	-44.7
Of which: Saudi oil facility	579	637	302	275	27	-52.6
<b>Current account balance (1+2+3)</b>	<b>2,833</b>	<b>4,203</b>	<b>1,887</b>	<b>1,869</b>	<b>18</b>	<b>-55.1</b>

As a result, not only did the non-structural flows have a negligible contribution to the H2-FY04 current account position, it seems likely that going forward these flows will have no significant impact on the current account.

Another important feature of the FY04 current account performance was the strength of current transfers despite the sharp fall in SOF receipts. In particular, higher inflows under foreign currency accounts enabled the current account to remain in surplus during FY04, even though the trade and services account deficits rose sharply during this period (see **Table 7.2**).



### **Trade Balance**<sup>13</sup>

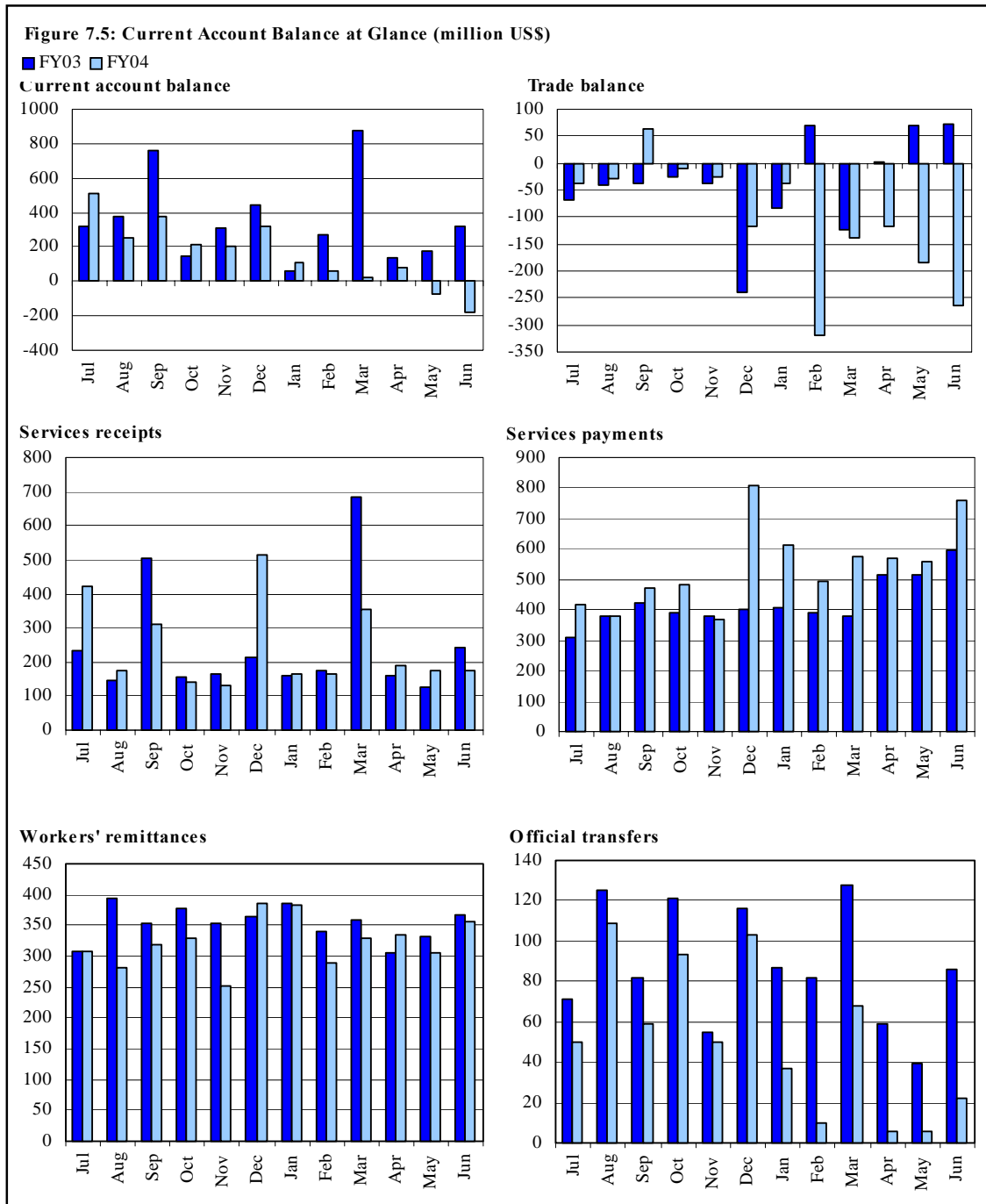
During FY04, the export growth of 13.8 percent surpassed the annual target set for the fiscal year. However, this was outstripped by the unusually strong 20 percent growth in imports. The annual trade deficit, therefore, expanded by 173 percent YoY to reach US\$ 1.2 billion. As mirrored in the aggregate current account, the deterioration in the trade balance is most evident in H2-FY04, as the impact of seasonal factors was compounded by the unusually high imports of machinery, oil and raw

<sup>13</sup> This section is based on the exchange record data of the SBP which is substantially different from the data based on the shipment of goods that is provided by the Federal Bureau of Statistics (FBS). The latter data set forms the basis of the detailed discussion on trade in **Section 7.4**.

materials. In fact, these elements comprised the larger proportion of the 39.4 percent growth in the non-food and non-oil import bill during FY04, which testifies to the pick up in economic activity.

**Services Account**

The net outflow of US\$ 3.6 billion in services account during FY04 was more pronounced over the corresponding FY03 level of US\$ 2.1 billion. This deterioration was mainly due to (1) escalating outflows under shipment and travel account; and (2) lower inflows on account of logistic support in FY04. However, *investment income* outflows saw little change from the preceding year as the fall in



interest payments was offset by higher outflows in *purchase of crude oil & minerals* (see **Table 7.2**).

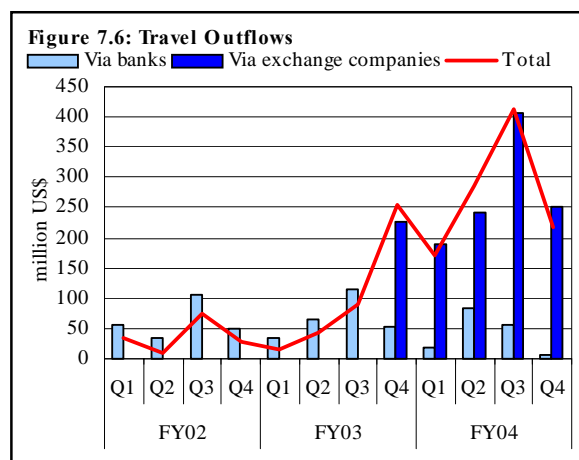
### Shipment<sup>14</sup>

The 33.5 percent YoY increase in payments for *shipment* primarily reflects the rise in trade volume as well as gradual increase in import under foreign economic assistance in FY04 compared to the preceding year.

### Travel

As discussed in previous quarterly reports, the re-integration of travel-related payments into formal channels sharply pushed up these outflows by 157.5 percent YoY during FY04. As evident from **Figure 7.6**, for some years prior to FY04, the balance of payment data only incorporated travel-related outflows made through banks (with the average quarterly outflow of US\$ 61.5 million). This probably comprised only a fraction of the actual outflows from the economy through the informal market.

However, from Q4-FY03 onward, travel payments are financed by the exchange companies, and outflows through the formal system increased sharply. However, since the exchange companies also inject their forex purchases into the formal system (shown as an inflow under *private transfers*), there is no net impact on the balance of payments.<sup>15</sup>



The fall in travel payments during the last quarter of FY04 is mainly due to some flaws in the reporting by the exchange companies. Specifically, the travel payments prior to Q4-FY04 were inflated as exchange companies were reporting various outflows of different heads under the travel account. The travel payments through banks during Q4-FY04 also showed a fall of US\$ 45 million over preceding year due to absence of Hajj Sponsorship Scheme during this quarter.<sup>16</sup>

### Interest Payments

The net interest outflows declined by US\$ 237 million in FY04 compared to the preceding year (see **Table 7.2**). This was mainly due to: (1) the relative decline in international interest rates,<sup>17</sup> and (2) the substitution of expensive debt with soft loans.

However, some of the gains were lost due to one-off penalties (totaling approximately US\$ 61 million) on pre-payments of expensive external debt, and a small rise in interest on external liabilities (see **Table 7.3**).

The interest payment on long term debt fell by 19.5 percent. This was primarily due to the absence of

<sup>14</sup> Shipment charges largely include 8 percent charges on cash import and 15 percent on import under foreign economic assistances.

<sup>15</sup> In effect, flows captured by exchange companies are being used to finance travel expenses, with no net effect on the flows through banking channels.

<sup>16</sup> Since a part of inflows under Hajj Sponsorship Scheme was being used to finance travel cost, it was showing up as outflows under travel account during Q4-FY03.

<sup>17</sup> Most of the Pakistan's floating rate loans are pegged to LIBOR, and average LIBOR during FY04 was lower compared to FY03.

notional payment in FY04 as compared to US\$ 279 million during FY03.<sup>18</sup> On the other hand, the rise in interest on external liability is mainly driven by a notional payment, representing the interest on foreign currency loans extended to Pakistani traders; the notional outflow of interest on these loans (*other external liabilities*) is offset by an equal inflow in 'other receipts' (see **Table 7.3**).

#### *Investment Income*

The *investment income* outflows (excluding interest payments) increased by 21 percent to reach US\$ 1,337 million during FY04 (see **Table 7.4**). Following three elements of this performance are noteworthy:

- (1) The big drop in *profit* outflows simply marks to normal flows after exceptional payments in FY03;
- (2) The big jump in the outflows under *purchase of oil & minerals* represents not only the sharp rise in international oil prices but also increased production of gas (the prices of which are indexed to international oil prices); and
- (3) Reinvested earnings have also risen strongly, but have no negative cash flow implications. The reinvested earning is treated as the notional outflow which is offset by an inflow in the capital account. The sectors witnessing the biggest reinvestments during FY04 include *financial businesses* (US\$ 76.4 million), the *petroleum refinery* sector (US\$ 64 million) and *oil & gas* exploration (US\$ 20 million).

#### *Current Transfers*

The current transfers declined only marginally (by 1.3 percent YoY) during FY04. While official transfers almost halved compared to the previous year, this was partially compensated by a 6.5 percent YoY rise in private transfers. Consequently, for yet another year, the current

**Table 7.3: Details of Interest Payments and Receipts**

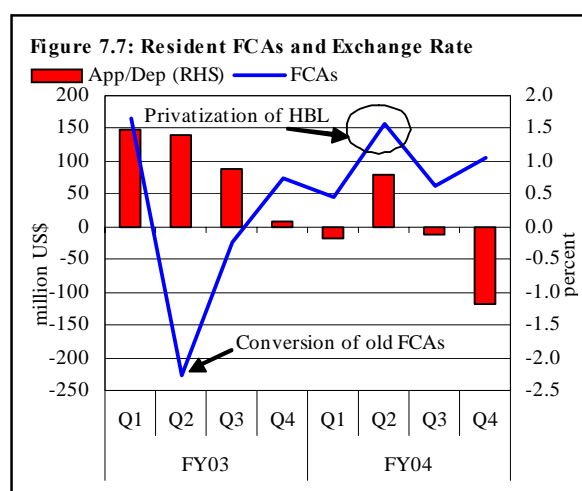
million US Dollar					
	FY01	FY02	FY03	FY04	Saving
<b>Payments</b>	<b>1,661</b>	<b>1,581</b>	<b>1,277</b>	<b>1,056</b>	<b>221</b>
<b>Total external debt</b>	<b>1,288</b>	<b>1,330</b>	<b>1,129</b>	<b>879</b>	<b>250</b>
Public/publicly guaranteed	1,031	1,065	917	722	195
Long-term	858	913	816	657	159
Military	25	24	21	14	7
Euro bonds	62	64	60	40	20
Commercial loans/credits	78	43	13	6	7
IDB	8	21	7	5	2
Private loans/credits	197	212	172	131	41
IMF	60	53	40	26	14
<b>External liabilities</b>	<b>373</b>	<b>251</b>	<b>148</b>	<b>177</b>	<b>-29</b>
FCAs	71	55	24	23	1
Special US\$ bonds	104	68	32	30	2
Central bank deposits	81	46	24	15	9
Others	117	82	68	109	-41
<b>Receipts</b>	<b>113</b>	<b>111</b>	<b>170</b>	<b>186</b>	<b>16</b>
Interest on reserves	97	98	137	118	-19
Others	16	13	33	68	35
<b>Net payments</b>	<b>-1,548</b>	<b>-1,470</b>	<b>-1,107</b>	<b>-870</b>	<b>+237</b>

Source: Statistics Department, SBP

**Table 7.4: Investment Income (Excluding Interest Payments)**

million US Dollar					
	FY00	FY01	FY02	FY03	FY04
<b>Profit &amp; dividend</b>	<b>233</b>	<b>301</b>	<b>457</b>	<b>637</b>	<b>632</b>
Profit	46	37	23	97.2	44.5
Dividend	124	148	335	420.4	403
Reinvested earnings	63	116	99	119.3	184
<b>Purchase of crude oil &amp; minerals</b>	<b>187</b>	<b>312</b>	<b>394</b>	<b>467</b>	<b>705</b>
Export of crude oil	52	84	74	36	27
Remittances	135	228	320	431	678

Source: Statistics Department, SBP

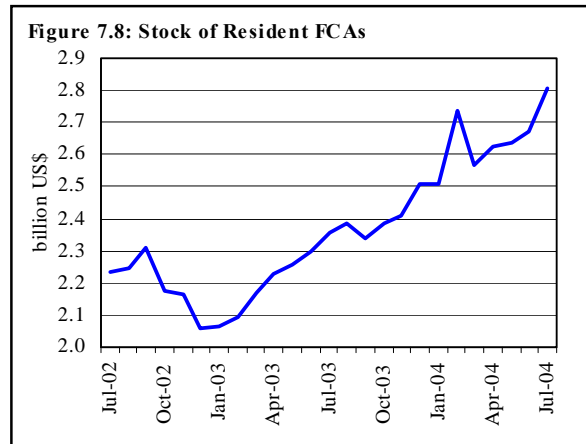


<sup>18</sup>The interest payment of US\$ 657 million in FY04 reflects the actual cash flows. The corresponding cash flow for FY03 had been US\$ 537 million. The remaining FY03 (notional) payment was offset by a contra-entry inflow recorded as 'exceptional financing' in the balance of payments record.

transfers remained strong in FY04 comfortably offsetting the deficits in the trade and services accounts to drive the current account balance into surplus.

Private Transfers from Overseas Pakistanis

The impact of a 8.6 percent YoY fall in remittances during FY04 was comfortably reversed by increased inflows into FCAs of Pakistani residents, as well as higher inflows of *other transfers* (mainly due to increased receipts from exchange companies) in the same period. Therefore, private transfers during the year jumped by 6.5 percent YoY to reach US\$ 6.1 billion.



FCAs

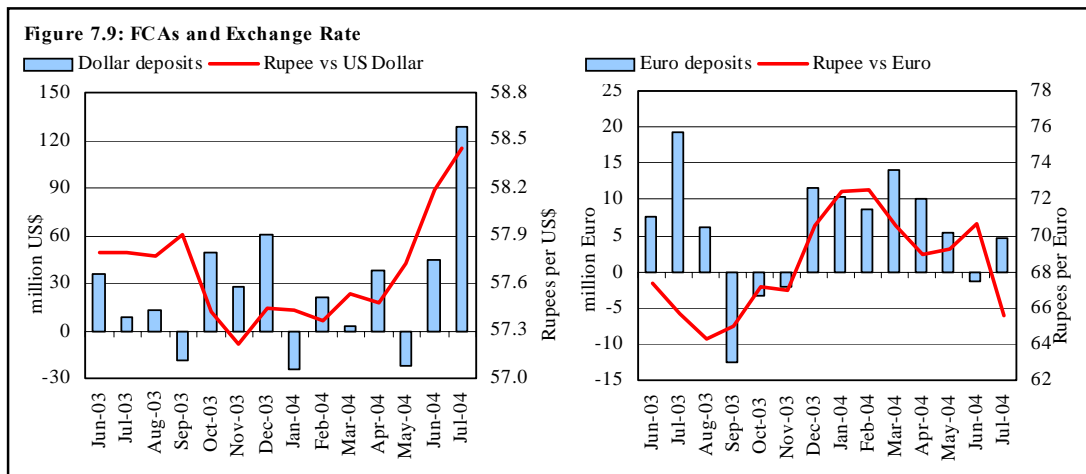
During FY04, resident FCAs registered an inflow of US\$ 367 million, in contrast to an outflow of US\$ 12 million in FY03 (that was primarily due to the conversion of old FCAs into Pak. Rupees). **Figure 7.7** shows shifts in FCA deposits which are mainly driven by exchange rate expectations; these deposits dropped sharply in FY03 as the Rupee strengthened and began rising only when the Rupee’s ascent first weakened and then reversed.

Thus, the fairly steady upward trend in FCA appears to be driven by expectations of a weakening Rupee. The jump in February 2004 and the decline in the subsequent month are unrelated to broad trend, and represent flows related to the privatization of a large public sector bank. Consequently, the outstanding stock of FCAs increased by US\$ 509 million to reach US\$ 2.8 billion by end-July 2004 (see **Figure 7.8**). The currency composition of FCA is sensitive to changes in Rupee exchange rate against US Dollar and Euro (see **Figure 7.9**).

Workers’ Remittances

Workers’ remittances declined by 8.6 percent during FY04 compared to the previous year (see **Table 7.5**), but nonetheless comfortably exceeded the target of US\$ 3.6 billion to reach US\$ 3.87 billion.

It is evident from **Figure 7.10**, that the decline in remittances was primarily from the continuous fall in receipts from the Gulf States, particularly UAE. It should be noted that the FY03 remittances from



**Table 7.5: Region-Wise Workers' Remittances**  
million US Dollar

	FY00	FY01	FY02	FY03	FY04	Growth rate in FY04 over FY03
<b>I. Gulf region</b>	<b>682.0</b>	<b>693.2</b>	<b>1,070.1</b>	<b>1,892.7</b>	<b>1,614.3</b>	<b>-14.7</b>
Bahrain	29.4	23.9	39.6	71.5	80.6	12.7
Kuwait	135.3	123.4	89.7	221.2	177.0	-20.0
Qatar	13.3	13.4	31.9	87.7	88.7	1.2
Saudi Arabia	309.9	304.4	376.3	580.8	565.3	-2.7
Sultanat-e-Oman	46.4	38.1	63.2	93.7	105.3	12.4
UAE	147.8	190.0	469.5	837.9	597.5	-28.7
<b>II. USA</b>	<b>80.0</b>	<b>134.8</b>	<b>779.0</b>	<b>1,237.5</b>	<b>1,225.1</b>	<b>-1.0</b>
<b>III. Other than Gulf &amp; USA</b>	<b>151.6</b>	<b>193.6</b>	<b>491.7</b>	<b>1,060.6</b>	<b>986.8</b>	<b>-7.0</b>
Canada	3.9	4.9	20.5	15.2	22.9	50.8
Germany	10.5	9.2	13.4	26.9	46.5	73.1
Japan	1.6	3.9	6.0	8.1	5.3	-35.1
Norway	5.6	5.7	6.6	8.9	10.2	14.6
UK	73.3	81.4	151.9	273.8	333.9	22.0
Others	56.8	88.4	293.3	727.6	567.9	-21.9
<b>Total</b>	<b>913.5</b>	<b>1,021.6</b>	<b>2,340.8</b>	<b>4,190.7</b>	<b>3,826.2</b>	<b>-8.7</b>
<b>Encashment FEBCs &amp; FCBCs</b>	<b>70.2</b>	<b>65.0</b>	<b>48.3</b>	<b>46.1</b>	<b>45.4</b>	<b>-1.5</b>
<b>Grand total</b>	<b>983.7</b>	<b>1,086.6</b>	<b>2,389.1</b>	<b>4,236.9</b>	<b>3,871.6</b>	<b>-8.6</b>

Source: Statistics Department, SBP

UAE included a significant proportion of the US\$ 125.7 million received under the Hajj Sponsorship Scheme (HSS). Thus, following the cancellation of the HSS in FY04, some weakness was to be expected, but the observed decline of US\$ 240 million masks this particular feature.

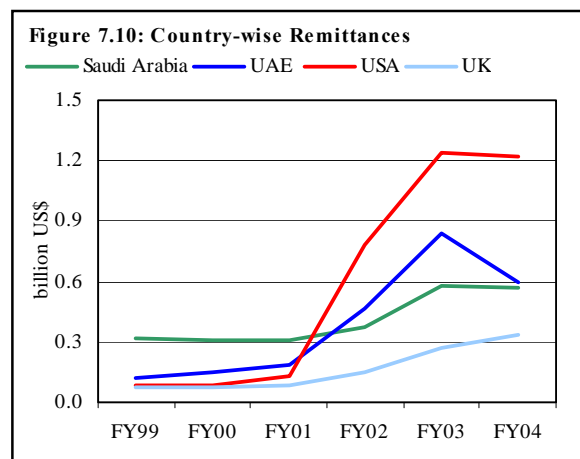
Other possible contributors to declining trend in UAE remittances could include (1) an end of reversal of capital flight, and (2) the increased investment in Dubai real estate as this sector was opened for investment by foreigners.

It is important to note that while the FY04 remittances are US\$ 365 million lower than recorded during FY03, there is only a minor difference in the actual forex injections into the economy during the two years.

This is because of the definition of remittances includes the rupee conversion of FCAs with local banks. These conversions contributed 5.4 percent of the FY03 remittances. Adjusting for these, and the impact of the HSS, the difference between FY03 and FY04 flows is considerably reduced (see **Table 7.6**).

### 7.2.2 Capital Account

With the rise in non-recurring net capital flows,<sup>19</sup> the net deficit on the capital account

**Table 7.6: Cash Impact of Falling Remittances**

	FY03	FY04
<b>Cash remittances</b>	<b>4,190.7</b>	<b>3,826.2</b>
Conversion of FCAs	227.0	19.0
HSS	125.7	--
<b>Sub-total</b>	<b>352.7</b>	<b>19.0</b>
Adjusted remittances	3,838.0	3,807.2
Cash impact		(-)30.9

<sup>19</sup> Non-recurring flows include pre-payment of expensive loans, trade financing against FE-25 deposits and short-term capital flows of commercial banks (in order to repay PARCO loan, commercial banks arranged financing of US\$ 100 million from the inter bank).

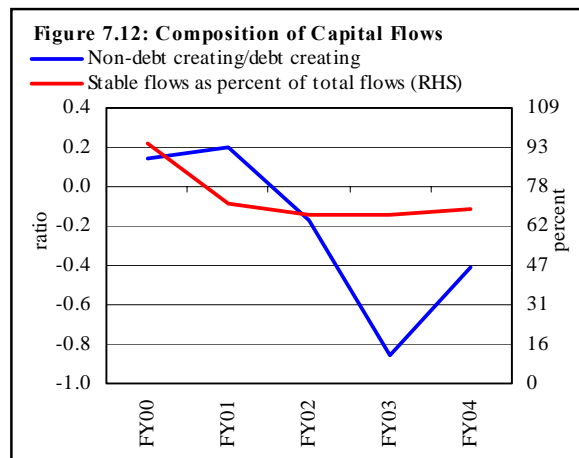
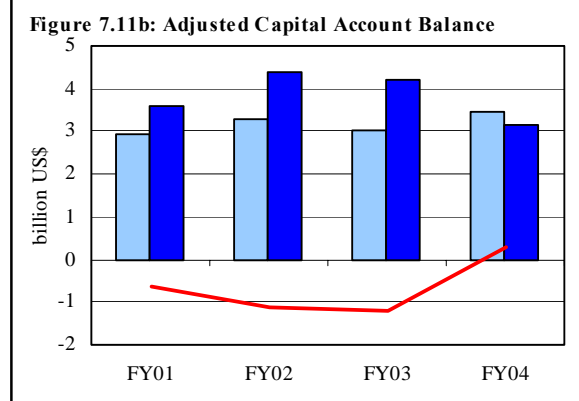
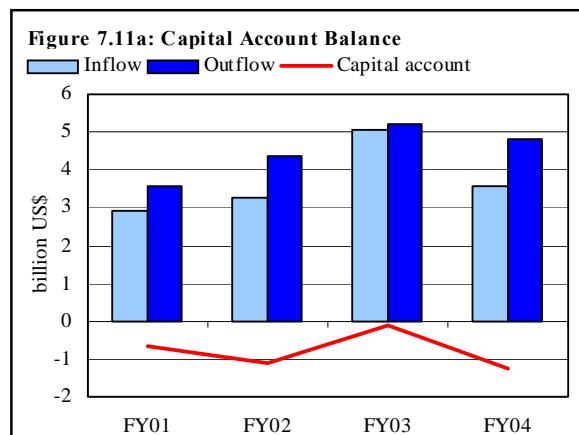
jumped to US\$ 1.25 billion during FY04 compared to deficit of US\$ 0.15 billion in the preceding year (see **Table 7.7 & Figure 7.11a**).

However, adjusting the non-recurring factors, the capital account witnessed a net surplus of US\$ 0.29 billion during FY04. The sharp reversal, from a net deficit to a net surplus since FY99, posted an improvement of 75.3 percent in FY04 over the last year (see **Figure 7.11b**). The improvement in the adjusted capital account balance is the reflection of (1) a rise in foreign direct investment; (2) the issuance of euro bond; (3) lower withdrawals on account of Special US Dollar bond; and (4) higher disbursement of suppliers' credit.

Looking at **Figure 7.12**, it is evident that since FY01, the proportion of *stable flows* to total capital flows<sup>20</sup> is almost constant, showing that the reliance on short-term credit is not rising. Similarly, there is a healthy improvement in the ratio of non-debt creating to debt creating flows,<sup>21</sup> which is indicative of increased foreign investment and the retirement of expensive debt flows. These compositional shifts in the capital account flows would endow strength to the current account balance in coming years.

#### **Net Foreign Investment (NFI)**<sup>22</sup>

The net foreign investment increased to US\$ 1.2 billion in FY04, mainly due to a rise in foreign direct investment (FDI) (see **Figure 7.13**). The higher FDI reflects the privatization proceeds of HBL and investment in telecommunication sector. The positive trend is visible even after deducting privatization proceeds, as adjusted FDI flows still record a significant improvement of US\$ 253 million compared to the corresponding figure for FY03.<sup>23</sup>



<sup>20</sup> Stable flows are defined as all capital flows excluding portfolio flows and short-term credits.

<sup>21</sup> Debt creating flows refer to net external assistance (official and private) and short-term borrowing, while non-debt creating flows are net inflows of foreign investment and other long and short-term assets.

<sup>22</sup> It includes direct investment abroad as well as in Pakistan and portfolio investment.

<sup>23</sup> The FDI recorded during FY03 adjusted for the privatization receipts of UBL and oil & gas field.

**Table 7.7: Capital Account Balance**

million US Dollar

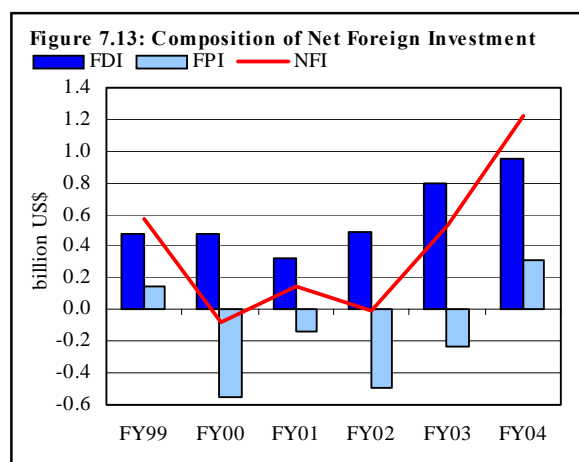
	FY00	FY01	FY02	FY03	FY04
<b>Capital account (1 through 9)</b>	<b>-4,177</b>	<b>-643</b>	<b>-1,107</b>	<b>-136</b>	<b>-1,247</b>
Inflows	2,219	2,932	3,271	5,080	3,556
Outflows	6,396	3,575	4,378	5,216	4,803
1. Direct investment abroad	1	-37	-2	-27	-42
2. Direct investment in Pakistan	472	323	485	798	951
3. Portfolio investment	-550	-141	-491	-239	314
<i>of which: (stock markets)</i>	73	-140	-8	22	-24
<i>Special US Dollar bonds</i>	36	39	-453	-228	-138
<i>Euro bond</i>					495
4. LT Capital, (official)	-678	-600	-38	-228	-1469
<i>of which: Project assistance</i>	988	785	531	571	434
Food aid	191	0	0	10	0
Non-food aid	125	678	885	621	541
<i>Amortization</i>	-1,967	-1,795	-1,513	-2,421	-2,420
5. LT capital, (DMBs)	-2	-2	-1	-8	-26
6. LT capital, (Others)	-267	-212	-651	-560	-167
<i>of which: suppliers credits/MNCs</i>	167	191	185	350	503
<i>Supplier credits repayments</i>	-591	-495	-530	-577	-617
7. ST Capital, (official)	-373	338	-442	-259	-419
<i>of which: commercial banks (net)</i>	-197	285	-260	-184	-133
IDB (net)	-23	146	-74	4	-183
<i>Others liabilities (NBP deposits)</i>	-135	-34	-155	-50	-3
8. ST Capital, (DMBs)	-1829	-19	-142	19	-34
<i>of which: outstanding exports bills</i>	-127	29	-53	-25	-120
<i>FCAs (Non-residents)</i>	-1,164	-48	-47	38	76
<i>Other liabilities</i>	0	0	0	0	100
9. ST capital, (others)	-952	-293	175	368	-355
<i>of which: outstanding exports bills</i>	-305	-261	162	-173	-349
<i>FCAs (non-residents)</i>	-720	-48	-126	-65	-8
<i>Other liabilities</i>	73	-39	193	1,113	-176
<i>of which: trade financing</i>				1,056	-210

Source: Statistics Department, SBP

Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

**Foreign Direct Investment**

Foreign direct investment rose to US\$ 951 million in FY04, up 19.2 percent YoY from the preceding year (see **Table 7.7**). The bulk of the FDI was channeled into telecommunication, financial business (through HBL privatization), mining, oil & gas exploration and the petroleum refining sectors (see **Table 7.8**). During FY04, the government's effort to attract FDI is reflected by the issuance of two new licenses in the telecommunication sector. This sector accounted for 23 percent of FDI during FY04. Specifically, this sector registered increased investment of US\$ 145.5 million and US\$ 56.1 million from Norway and UAE-based mobile companies respectively.



On the other hand, outflows to UK were evident in the power sector (US\$ 22.3 million, reflecting a reduction in the stake of International Power in Hubco), and the chemical sector.

#### *Portfolio Investment*

During FY04, the portfolio investment reflected a sharp increase of US\$ 314 million, primarily due to the issuance of US\$ 500 million five-year Euro bond.<sup>24</sup> In addition, the repayments of Special US Dollar bonds also fell in FY04. The choice in currency repayments of Special US Dollar bonds shows a significant variation over the year (see **Figure 7.14**). The encashment in Dollar increased mainly on account of (1) expectation of depreciation of Rupee; and (2) the incentive given by the government in October 2003 for premature encashment in US Dollar. Earlier the premature encashment was allowed only in the Pak Rupee.

#### *Long-term Capital (Official)*

The substantially higher net outflows of US\$ 1.47 billion in FY04 as compared to US\$ 0.23 billion during the preceding year were due to the pre-payment of loans in the second half of FY04 to Asian Development Bank (ADB) and to Japan Bank for International Cooperation (JBIC) by Pak Arab Refinery Limited (PARCO) (see **Figure 7.15**).

The overall outflow due to these prepayments was US\$ 2.4 billion, of which US\$ 1.11 billion owed to ADB and US\$ 325 million to JBIC for PARCO loans. The interest cost on these loans ranged between 6 to 11 percent. These payments not only reduced the stock of expensive loans but are also expected to provide future cash relief in terms of loan debt servicing costs.<sup>25</sup>

#### *Foreign Economic Assistance*

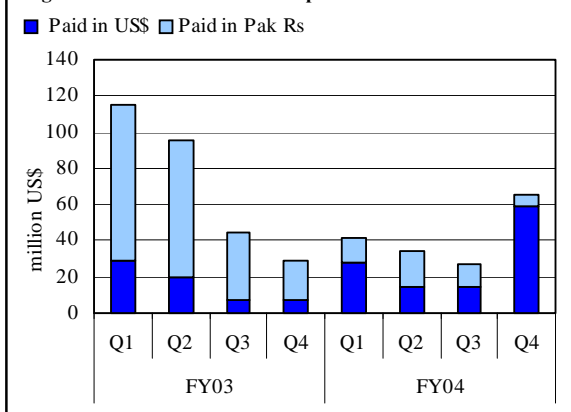
Foreign economic assistance declined by 18.9 percent YoY to US\$ 975 million during FY04. In particular, the overall inflow of non-food aid fell to US\$ 541 million during FY04, compared to US\$ 621 million in FY03. The

**Table 7.8: Foreign Direct Investment**  
million US Dollar

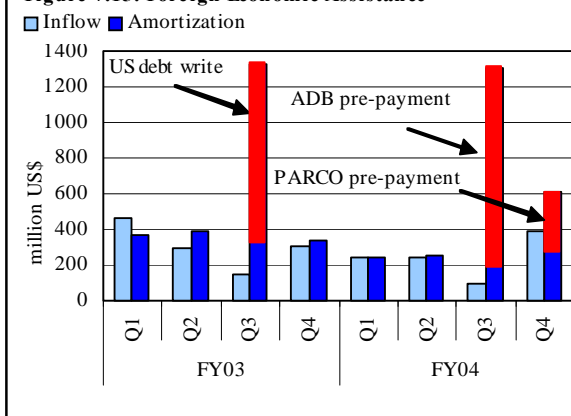
	FY02	FY03	FY04
Food, beverages & tobacco	-8.1	7.9	4.6
Textiles	18.4	26.1	35.4
Chemicals, pharmaceuticals & fertilizers	17.8	92.4	28.6
Petro chemicals & petroleum refining	5.0	3.0	72.4
Cement	0.4	-0.4	1.9
Machinery	10.6	10.9	9.4
Electronics	15.9	6.7	7.5
Power	36.4	32.8	-14.2
Construction	12.8	17.6	32.0
Trade, transport, storage & communication	68.3	153.2	266.3
Financial business	3.5	207.5	242.1
Mining & quarrying-oil & gas explorations	274.8	188.2	203.5
Others	29.2	52.1	60.0
<b>Total</b>	<b>485.0</b>	<b>798.0</b>	<b>949.4</b>

Note: The total FDI in FY04 may not match with one given in **Table 7.7** due to rounding off.

**Figure 7.14: Encashment of Special US Dollar Bond**



**Figure 7.15: Foreign Economic Assistance**



<sup>24</sup> For more detail see **Chapter 6**.

<sup>25</sup> See **Chapter 6** for more detail.

jump in Q4-FY04 reflects the higher disbursements from the ADB (US\$ 99.6 million) and the World Bank (US\$ 196 million) in that quarter as no inflows were received in the Q3-FY04 on this account (see **Figure 7.16**).

**Long-term capital (Others)**

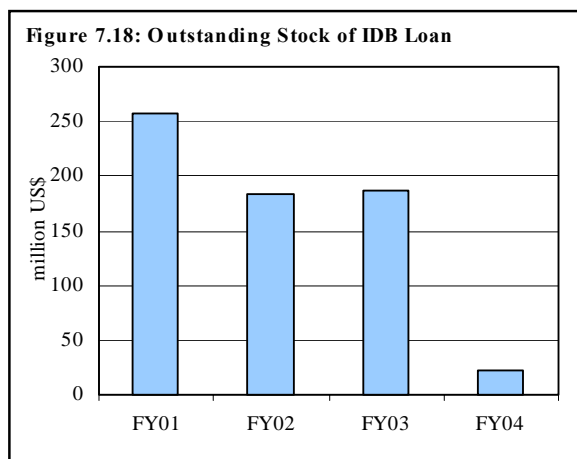
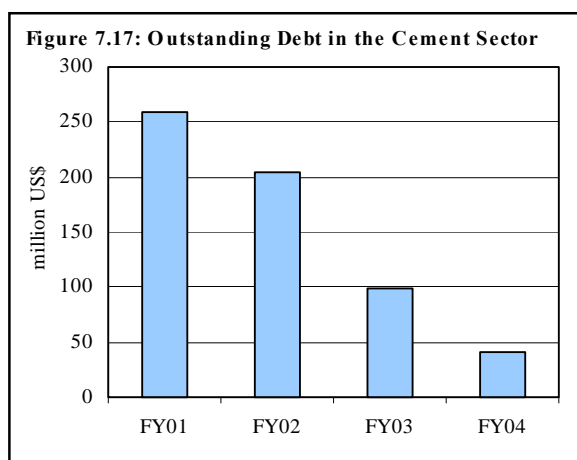
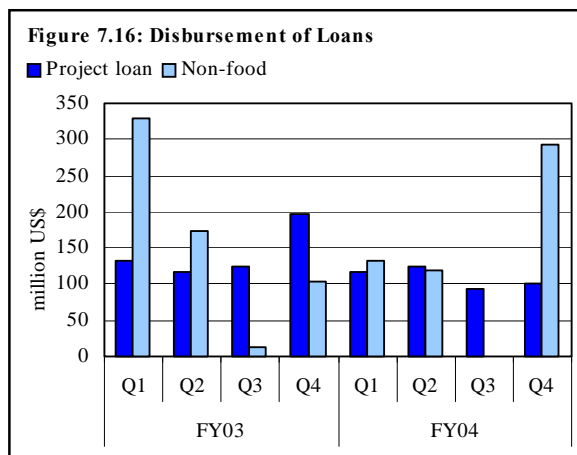
The net outflows under this head declined by 70.2 percent YoY to US\$ 167 million in FY04. The substantially large inflow of US\$ 503 million is mainly due to the higher disbursement from the US Exim Bank to PIA.<sup>26</sup> On the other hand, the outflow of suppliers' credit inched up by 6.9 percent YoY to US\$ 617 million during FY04. This includes pre-payments of private loans amounting to US\$ 65.9 million. Since bulk of the pre-payment under private loans had already been made in FY03, there was a decline in the amounts of pre-payment in the FY04.<sup>27</sup> Interestingly, the pre-payment of private loans in FY03 was mostly concentrated in the cement sector (see **Figure 7.17**).<sup>28</sup>

**Short-term Capital (official)**

This mainly comprises of short-term commercial loans & credit and IDB financing for oil import. The net withdrawals of these loans increased from US\$ 259 million in FY03 to US\$ 419 million in FY04, primarily on account of higher net outflow of IDB loans of US\$ 183 million. As a result, the stock of IDB loan has reduced sharply during this period (see **Figure 7.18**).

**Short-term Capital<sup>29</sup>**

This head registered a net *outflow* of US\$ 389 million during FY04 as against an *inflow* of US\$ 387 million during FY03. The main reason behind this deterioration is the change in expectation for Rupee depreciation that led to (1) a rise of US\$ 469 million in the stock of Outstanding Export Bills (OEBs) to reach US\$ 2,825 million; and (2) a net retirement of US\$ 210 million during FY04 in foreign currency loans.



<sup>26</sup> This presents US\$ 350 million for the purchase of aircraft during Q3-FY04.

<sup>27</sup> For further details see **Chapter 6**.

<sup>28</sup> The shares of cement and financial business sectors in total prepayment during FY03 were 61 and 15 percent respectively.

<sup>29</sup> This mainly comprises of Outstanding Export Bills (OEBs) held by banks and exporters, non-residents FCAs and foreign currency denominated loans.

### Outstanding Export Bills (OEB)

During FY04 the stock of OEBs posted a growth of 19.9 percent YoY as against 9.1 percent growth in FY03. Most of the increase was recorded in OEBs held by exporters (see **Figure 7.19**).

The OEBs of exporters are generally categorized as normal bills or overdue bills.<sup>30</sup> The increase in OEBs probably reflects (1) higher export growth (a proportion of which is likely to be overdue in the normal course of business); and (2) delayed remittances of proceeds in the hope of exchange gain amidst expectations of a Rupee depreciation.

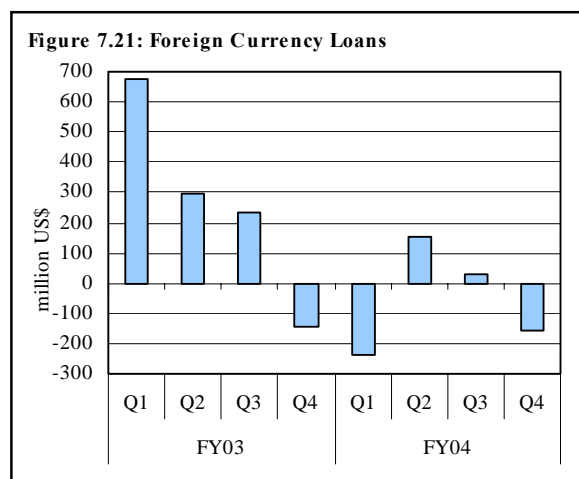
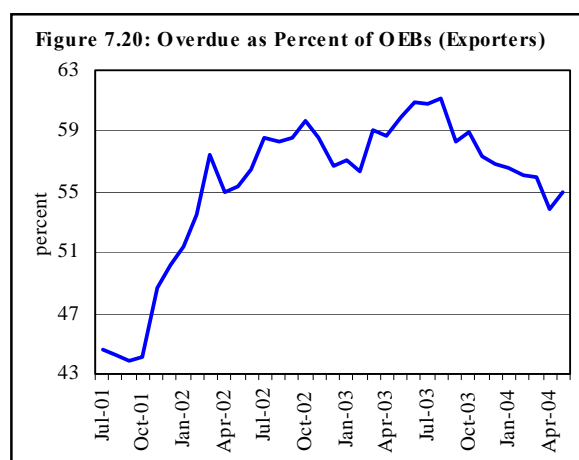
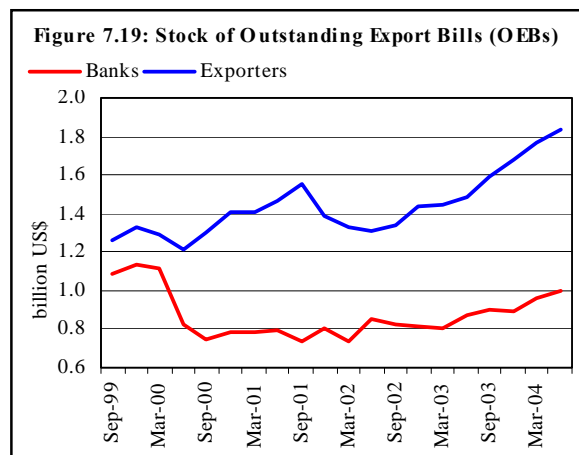
Interestingly, the share of overdue export bills in total OEBs has declined during FY04 after showing a gradual rise since October 2001 (see **Figure 7.20**).

### FE-25 Related Trade Financing

Foreign trade loans registered a sharp reversal from net borrowing of US\$ 1,056 million during FY03 to net retirement of US\$ 210 million in FY04. Most notably, the retirement of foreign currency loans was witnessed in Q1-FY04 and Q4-FY04 (see **Figure 7.21**), when expectations of a rupee depreciation gathered strength.

### **7.3 Foreign Exchange Reserves**

Pakistan's total liquid reserves rose to US\$12,328 million at end-June FY04 compared with US\$ 10,719 million last year. However, the increment of US\$ 1,609 million in FY04 was lower than US\$ 4,287 million in FY03 (see **Table 7.9**). This slowdown was not unexpected given the SBP's continued focus on liberalization of the exchange regime, the recovering economy (and attendant expectations of a rise in imports) as well as the anticipated pre-payment of expensive external debt. In fact, it is clear from **Table 7.11** that the erosion in the external account in FY04 is primarily driven by exceptional outflows and less from weakness in foreign exchange inflows; overall inflows, at US\$ 25.6 billion during FY04 were higher than the US\$ 25.2 billion experienced last year.



<sup>30</sup> An outstanding bill is categorized as overdue either on the day the payment is due or when it has been outstanding by 180 days, whichever is smaller

Due to early repayment of expensive debt, the total debt & liabilities servicing during FY04 was US\$ 5,278.5 million, which was US\$ 929 million more than in the preceding year (see **Table 7.10**). This increase in total debt servicing is funded by both SBP and the interbank market. In particular, the payment of US\$ 3,022 million made by SBP also includes early repayment of US\$ 1.17 billion to ADB in the third quarter of FY04.

The 20 percent YoY increase in import payments during FY04 is other major reason for higher foreign exchange outflows during the year.

In terms of inflows, SBP purchases from the interbank were markedly down during FY04 to US\$ 897 million from US\$ 4,546 million last year. Inflow of US\$ 499 million from Euro bond this year provided some additional resources.

On the other hand, inflows on account of export of foreign currency were notably absent this year. Last year, foreign exchange companies sold US\$ 429 million to authorized dealers, and this amount was subsequently purchased by the SBP. Though the inflows under export of currency were still available during FY04, their volume was shrinking as moneychangers were instructed to sell their foreign currency other than US Dollar to the exchange companies.

The reserve of the commercial bank showed an increase of US\$ 580.2 million during the year (see **Figure 7.22**). The change in market sentiments toward Rupee depreciation made FE-25 deposits more attractive (i.e., adding to commercial banks' reserves), thus reducing the demand for forex lending (foreign currency lending is subtracted from commercial bank reserves).<sup>31</sup> The trends in outstanding forex loans show almost mirror image of commercial banks' reserves.

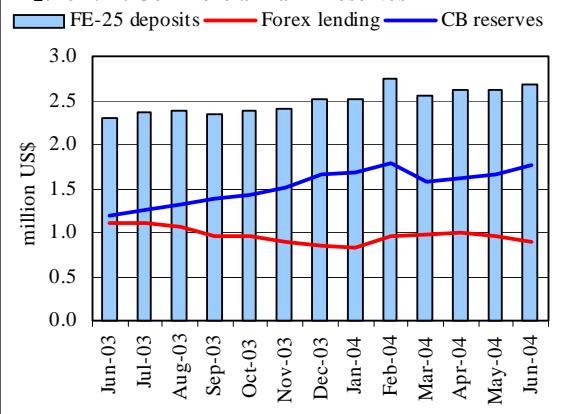
**Table 7.9: Foreign Exchange Reserves**

million US Dollars							
	FY01	FY02	FY03	FY04	Percentage change		
					FY02	FY03	FY04
<b>Stocks</b>							
SBP	1,677	4,333	9,525	10,554	158	120	11
Banks	1,543	2,098	1,194	1,774	36	-43	49
<b>Total</b>	<b>3,219</b>	<b>6,432</b>	<b>10,719</b>	<b>12,328</b>	<b>100</b>	<b>67</b>	<b>15</b>
<b>Flows</b>							
SBP	686	2,657	5,192	1,029	287	95	-80
Banks	566	556	-904	580	-2	-263	164
<b>Total</b>	<b>1,252</b>	<b>3,212</b>	<b>4,287</b>	<b>1,609</b>	<b>157</b>	<b>33</b>	<b>-61</b>

**Table 7.10: Pakistan's External Debt & Liabilities Servicing**

		SBP reserves	Banks	Others	Total
FY03	Q1	536.1	389.1	279.6	1,204.8
	Q2	669.5	391.5	139.5	1,200.5
	Q3	603.8	341.7	93.6	1,039.1
	Q4	417.7	358.7	128.6	905.0
	<b>FY03</b>	<b>2,227.1</b>	<b>1,481.0</b>	<b>641.3</b>	<b>4,349.4</b>
FY04	Q1	417.2	393.4	61.5	872.1
	Q2	601.9	523.4	58.8	1,184.1
	Q3	1,554.7	313.4	141.8	2,009.9
	Q4	448.9	722.0	41.5	1,212.4
	<b>FY04</b>	<b>3,022.7</b>	<b>1,952.2</b>	<b>303.6</b>	<b>5,278.5</b>

**Figure 7.22: Commercial Bank Reserves**



<sup>31</sup> Since forex loans are sold in the interbank market (which are subsequently purchased by SBP), the outstanding foreign currency loans are adjusted from commercial banks' reserves.

**Table 7.11: Overall Reserves as per BOP**  
million US Dollar

	<b>FY00</b>	<b>FY01</b>	<b>FY02</b>	<b>FY03</b>	<b>FY04</b>
Opening balance	2,370	2,163	3,244	6,398	11,667
<b>Inflows</b>	<b>16,835</b>	<b>20,020</b>	<b>22,228</b>	<b>25,239</b>	<b>25,645</b>
Exports of goods	8,190	8933	9,140	10,889	12,395
Export of services (excluding interest )	1,396	1,367	1,929	2,830	2,796
of which: logistic support	0	0	300	847	753
Workers' remittances	983	1,087	2,390	4,237	3,871
Kerb market purchases	1,634	2,157	1,376	0	0
Foreign direct investment	473	286	366	585	410
Foreign portfolio investment	73	-140	-8	22	-24
Euro bonds					500
Loan disbursements	1,588	2,740	2,910	2,208	1,731
<i>Official</i>	1,421	2,549	2,725	1,858	1,228
Long-term loans	1,304	1,787	1,900	1,671	1,220
<i>Program loans</i>	125	1,002	1,368	1,090	786
IMF	-	324	484	469	245
IDA/IBRD	-	344	699	213	192
ADB	125	334	185	408	349
<i>Project &amp; food loans</i>	1,179	785	532	581	434
Short-term including IDB	117	762	825	187	8
Private un-guaranteed	167	191	185	350	503
Privatization proceeds	-	0	117	186	199
Official grants	940	842	1500	1051	613
USA	-	0	600	0	0
Saudi oil facility	790	683	579	637	302
Others	150	159	321	414	414
Other receipts	1,558	2,748	2508	3231	3154
<b>Outflows</b>	<b>17,042</b>	<b>18,939</b>	<b>19,074</b>	<b>19,970</b>	<b>24,923</b>
Imports of goods	9,602	10,202	9,434	11,333	13,607
Imports of services (excluding interest)	2,160	2,332	2,214	2,714	4,107
Interest payments	1,352	1,369	1,111	976	1,056
Amortization of official loans	1,174	1,202	967	1,231	3,093
IMF	280	239	194	418	673
IDA/IBRD	289	294	314	338	390
ADB	236	244	238	268	1,396
Others actual paid	369	425	221	207	634
Profit and dividends	233	301	457	631	622
Purchase of crude oil	187	312	394	473	714
Principal repaid on private loans	591	512	584	663	617
Foreign exchange liabilities liquidated	494	1,940	3,590	1,192	391
FE-31	-	0	200	171	0
FE-45	308	299	541	235	0
PTMA & commercial loans-actual paid	45	443	1,286	84	33
IDB (short term)	141	185	403	183	191
Swaps	-	866	441	235	0
NBP deposits	-	147	249	0	0
Special \$ bonds	-	0	470	284	167
Other payments	1,249	769	323	757	716
<b>Net Inflows</b>	<b>-207</b>	<b>1,081</b>	<b>3,154</b>	<b>5,269</b>	<b>722</b>
<i>Gross reserves at end of period</i>	<b>2,163</b>	<b>3,244</b>	<b>6,398</b>	<b>11,667</b>	<b>12,389</b>
<b>CRR</b>	<b>361</b>	<b>399</b>	<b>472</b>	<b>468</b>	<b>553</b>
<b>Sinking fund</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>920</b>	<b>65</b>
<b>Net reserves of SBP</b>	<b>997</b>	<b>1,689</b>	<b>4,337</b>	<b>9,529</b>	<b>10,564</b>
<b>Commercial bank reserves (including CRR)</b>	<b>1,166</b>	<b>1,555</b>	<b>2,061</b>	<b>1,218</b>	<b>1,760</b>

### 7.3.1 Reserve Adequacy

As the country's foreign currency reserves are principally accumulated in order to improve the economy's ability to protect itself from external shocks, it is important to assess the adequacy of reserves. During FY04, most indicators continued to improve, even compared to the exceptional FY03 performance, despite a narrowing current account surplus and the remarkable growth in imports.

The most common measure of reserve adequacy is the import-coverage ratio, which indicates the ability of a country to meet its import requirements through its reserves. This has declined from 46 weeks to 41 as FY04 saw a sharp jump in imports (see **Figure 7.23**).

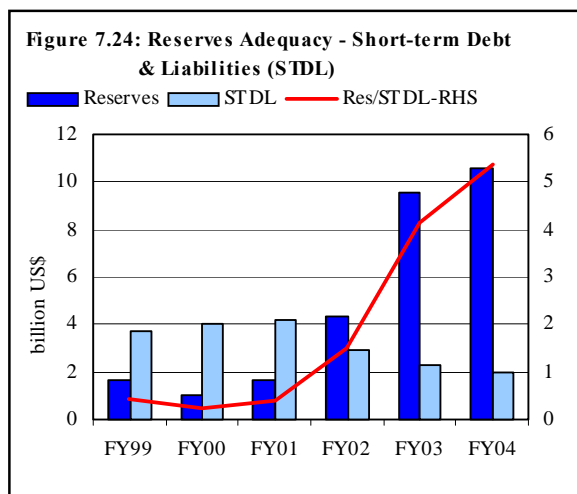
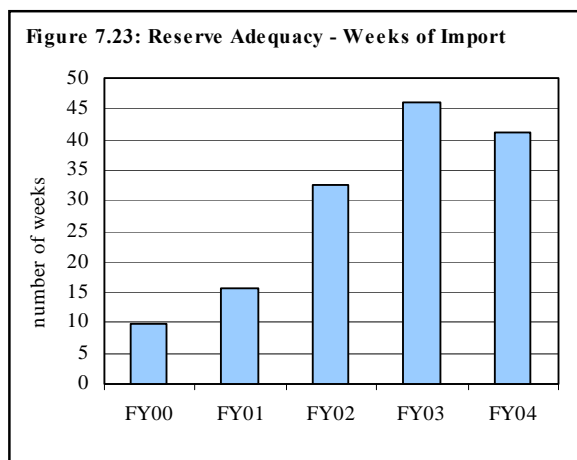
In contrast, the ratio of reserves to short-term liabilities has improved. This not only reflects the rise in the country's forex reserves, but also the continuing retirement of short-term external debt through the year (see **Figure 7.24**).

### 7.3.2 Reserve Management

The foreign exchange reserves are managed with the objectives of (1) ensuring safety of reserves; (2) maintaining adequate liquidity; and (3) obtaining a reasonable return on the risk profile.

The successful implementation of reserve management strategy is dependent upon having in-house capacity, whilst outsourcing the activity under strict guidelines approved by the Board.<sup>32</sup> Accordingly, the reserves are divided in cash, liquidity and long term tranches. The cash management portfolio objective is to provide liquidity for transactional and intervention purpose, which is at present managed in-house through short-term placement. The current reserve management policy allows placement with highly rated institutions including Bank, Supranationals, and Bank for International Settlements. A small portion of the cash management portfolio is also kept with other central banks and in sovereign treasury bills.

The portion of reserves managed by the external fund managers retains the liquidity and long-term characteristics of the portfolio. The overall high credit quality of the portfolio and the agreement structure with the external fund managers enables SBP to obtain temporary or permanent liquidity (in whole or in part), to meet any unforeseen cash or liquidity requirements. The investment guidelines, performance benchmarks, and the risk parameters for the external fund managers have been put together within the broad parameters approved by the central board of directors of the State Bank, and in conjunction with the assistance of independent international investment consultants. The



<sup>32</sup> The benefits of outsourcing a portion of reserve management activity include not only a market return on the approved benchmark, but also allows accelerated in-house capacity building through tailored capacity building program offered by external fund managers. This in turn would result in future additional reserve managed internally more efficiently and generating higher returns.

composite of the benchmarks defined for the external fund managers, has been based on internationally accepted fixed income benchmark, which was then tailored to adopt the risk/return profile approved by the Board in conformity with the State Bank Act 1956. Similarly the risk parameters defined for the portfolio set low tracking error and high information ratio, to reduce the volatility of returns and generate a higher return in low risk portfolio as compared to similar portfolio of equal risk. The maximum permissible maturity for the investment does not exceed 10 years. The uncertainty in the present global interest rates environment has dictated the need to deploy these forex reserves in the shorter duration.

#### 7.4 Trade Account

Despite strong growth in exports, the trade deficit more than tripled during FY04 to reach US\$ 3.3 billion during FY04; the unusual strong 27.6 percent rise in imports overshadowed the robust 10.3 percent jump in exports during the period (see **Figure 7.25**). This trade deficit was not only well above the annual target of US\$ 0.7 billion but also represented only the fourth time that the US\$ 3 billion mark has been exceeded.

It is important however, to place this figure in perspective. While trade deficit as a percentage of GDP is certainly large during FY04, it is slightly more than the average for the last fifteen years (see **Figure 7.26**). Moreover, in earlier years the trade deficit had crossed the US\$ 3 billion due to large one-off policy measures (see **Figure 7.25**). While such transitory factors also have a role in the FY04 deficit, their contribution is small.

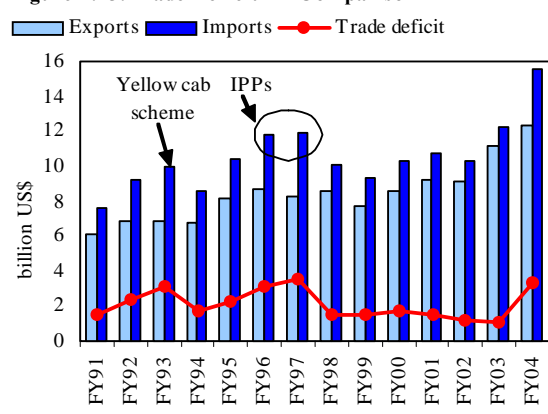
Unlike preceding years, the sharp jump in the FY04 trade deficit is clearly caused by a broad-based increase in the economic activity. Together with rising demand for country's exports, this boosted manufacturing growth (17.1 percent in LSM), necessitating higher imports of capital goods and industrial raw materials (see **Figure 7.27**).<sup>33</sup>

In light of the above, the trade-induced weakness in Pakistan's external account should not be a cause of concern, particularly in view of the fact that the FY04 import bill has been inflated by a number of non-recurring transactions. These include:

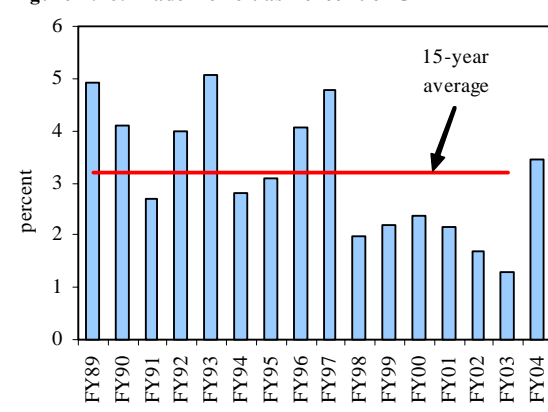
**Table 7.12: Deployment of International Reserves**  
million US Dollar

	As on June 30, 2004	As on June 30, 2003
1. Foreign currency reserves	11,110	9,993
Securities	2,378	953
Deposits with	8,494	8,796
Other central banks, BIS, IMF	364	542
Commercial banks	8,130	8,254
SDR	238	244
2. IMF reserve position	0.17	0.17
3. Gold	817.00	714
<b>Total</b>	<b>11,927.17</b>	<b>10,707.17</b>

**Figure 7.25: Trade Deficit - A Comparison**

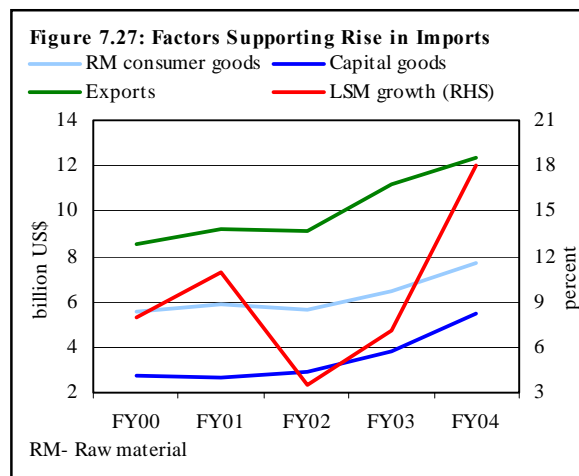


**Figure 7.26: Trade Deficit as Percent of GDP**



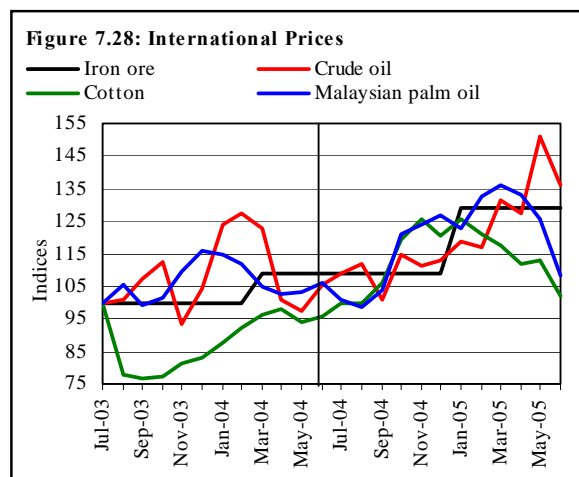
<sup>33</sup> Rising economic growth during FY04 is also reflected in higher CBR tax collection (12.6 percent growth) and increased corporate earnings during this period.

- Aircraft imports by PIA worth US\$ 316.7 million under its fleet renewal program;<sup>34</sup>
- Temporary imports of dredgers worth US\$ 269 million on re-export basis for the routine dredging operation of Port Qasim;<sup>35</sup>
- Higher imports of raw cotton to the tune of US\$ 529.2 million<sup>36</sup> caused by lower cotton production during FY04. Keeping in mind that on average raw cotton worth US\$ 230 million was purchased annually during last two years, the additional requirement of raw cotton amounting to US\$ 300 million can be attributed to lower production.<sup>37</sup>



The impact of these non-recurring factors is likely to be absent in the coming years. In fact, the import of dredgers this year may even be reversed. But the impact of rising wheat imports and hike in international oil prices during FY05 would certainly push up the overall import level.

Rising international prices of major imports especially oil was a major concern during FY04 (see **Figure 7.28**). Although, the FY04 petroleum import bill rose by US\$ 100.1 million YoY basis, this relatively low increase is deceptive. A closer look reveals that the higher oil prices significantly reduced the benefit that the country should have obtained from the lower domestic demand, and a change in the mix of energy supply away from petroleum imports. In fact, had the average FY03 oil prices been sustained, Pakistan's oil bill would have been significantly reduced during FY04 (see **Table 7.13**). It is also important to note that the rising international oil prices also inflated the prices of the wide range of petroleum derivatives that are used as raw materials in various industries e.g., the import units costs of ethylene glycol and paraxylene (petroleum derivatives used as inputs in the production of synthetic polyester fiber) rose by 26 percent and 29 percent YoY respectively.



<sup>34</sup> Out of the total amount i.e., US\$ 316.7 million of the aircraft purchase, US\$ 141.1 million had been paid earlier, and the cash payments under this head during FY04 were US\$ 175.6 million.

<sup>35</sup> Ports carry out the channel dredging operations as a routine feature. In case when these operations are outsourced by ports authorities to other firms, the relevant firms temporarily import dredging machinery, which is re-exported when their operation ends. There is no cash payment involved for such imports except the payment of small rental charges. However, FBS reports such items in the regular import list.

<sup>36</sup> The raw cotton imports are exceptionally high as the annual raw cotton imports of Pakistan generally range between US\$ 150 million to US\$ 250 million.

<sup>37</sup> Cotton production during FY04 stood at 10.05 million bales which was 4.8 percent less than the 10.55 million bales target for FY04.

Looking at exports, the remarkable growth for the second consecutive year was encouraging. The export volume reached US\$ 12.3 billion during FY04, recording a 10.3 percent rise over preceding year, and also surpassing the annual export target by 1.7 percent. This high export growth was mainly textile driven. Within this group, earnings from the four major categories namely: cotton fabrics, knitwear, bed wear and cotton yarn crossed US\$ 1 billion each. Apart from the textile sector, the earnings from *other manufactures* especially petroleum products and leather manufactures also improved during FY04, whereas the share of *primary exports* underwent a fall mainly due to falling exports of wheat.

This impressive exports performance was made possible by supportive domestic economic environment and rising external demand that in turn, originated from increased market access<sup>38</sup> and global economic recovery.<sup>39</sup> Realistic and stable exchange rate, low interest rates (see **Table 7.14**) and incentives given in trade policy for exploring non-traditional markets and products gave a boost to the profitability of exports.<sup>40</sup> In addition, rise in unit values of textile products largely due to rising cotton prices also made a significant contribution.

### Regional Trade Balance

FY04 saw only modest changes in the aggregate trade surplus with the EU and the US – a small rise in the former offset the fall in the latter. The EU is a major trading partner as it is not only an important destination for country's textile exports but also for other major export categories. The expansion in the surplus with EU came from rising textiles, sports goods, rice and leather manufactures exports (see **Table 7.15**).

**Table 7.13: Impact of Rising Oil Prices**

million US Dollar				
	FY03	FY04		Lost benefits
	Actual	Actual	On FY03 prices	
<b>Petroleum group</b>	<b>3066.4</b>	<b>3166.6</b>	<b>2676.6</b>	<b>490.0</b>
Petroleum products	1699.9	1401.4	1088.9	312.5
Petroleum crude	1366.5	1765.1	1587.7	177.4

**Table 7.14: Trade Supporting Indicators FY03**

percent			
	FY02	FY03	FY04
Manufacturing growth	5.0	6.9	13.4
Weighted average lending rates	12.0	7.6	5.1
Export refinance rates	6.5	2.0	2.0
Change in real effective exchange rate	3.09	-5.2	1.7

<sup>1</sup> Lending rates are quoted for the end June levels

**Table 7.15: Major Exports to EU**

percent			
Category	Shares in exports to EU		YoY Growth
	FY03	FY04	
<b>Textile and garments</b>	38.6	41.5	19.5
<b>Core categories</b>			
Rice	10.1	11.1	25.6
Leather manufactures	62.2	60.6	4.5
Medical instruments	37.7	41.8	-1.8
Sports goods	48.5	60.9	21.8
<b>Development categories</b>			
Fish & fish preparations	35.0	35.1	14.0

**Table 7.16: Regional Trade Balance**

billion US Dollar						
	FY03		FY04			
	Export	Import	Balance	Export	Import	Balance
<b>USA</b>	2.6	0.7	1.9	2.9	1.3	1.6
<b>EU</b>	3.1	2.0	1.0	3.6	2.3	1.3
<b>Asia</b>	4.1	7.9	-3.8	4.4	9.6	-5.3
<i>i- Middle East</i>	2.0	4.0	-1.9	1.8	4.9	-3.1
<i>ii-Other Asia</i>	2.1	3.9	-1.8	2.5	4.7	-2.2
<b>Others</b>	1.40	1.3	0.1	1.37	2.3	-0.9
<b>Total</b>	<b>11.1</b>	<b>12.0</b>	<b>-0.9</b>	<b>12.3</b>	<b>15.6</b>	<b>-3.3</b>

The trade deficit with the Middle East and Other Asia however deteriorated sharply (see **Table 7.16**).

<sup>38</sup> While the EU increased the quota ceiling by 5.6 and 9.4 percent for 2003 and 2004 respectively, the ceiling for US rose by 8.1 and 15.2 percent during these years.

<sup>39</sup> See section on international economic situation.

<sup>40</sup> In the Trade Policy for FY03 government allowed a freight subsidy of 25 percent on products whose exports in any of the years from FY00 to FY02 were not more than US\$ 5 million, and for all products exported to countries where average annual exports in the preceding three years were not more than US\$ 10 million. This policy continued in FY04 as well.

- The biggest rise in deficit was seen with the Middle East. This deterioration was caused by both, rising imports and a fall in exports. In addition to crude oil and petroleum products, this region supplies some of the major non-oil imports such as organic chemicals, plastic materials and gold. The rising import levels of these commodities caused the import bill from this region to rise (especially Saudi Arabia, Kuwait, and Dubai).<sup>41</sup> This impact was compounded by a substantial fall (US\$ 195.6 million) in readymade garments and bed wear exports to Saudi Arabia and Dubai.
- Trade deficit with the other Asian region rose mainly due to rising imports from China and India; the two countries together account for 59.3 percent of the increase in imports from the region.

### 7.4.1 Exports

Exports displayed a remarkable performance for the second consecutive year, reaching US\$ 12.3 billion during FY04. The performance was also remarkably consistent, with the monthly exports crossing the respective targets, and only in two months did exports drop below US\$ 900 million mark (**Figure 7.29**).

The surge in Pakistan’s exports that began in the preceding year, strengthened further in FY04 (see **Figure 7.30**), and appears to be continuing into FY05. In fact, despite a high-base effect, and the decline in cotton product prices, the exports growth in July-September 2004 has been showing a very robust 16.8 percent growth. As a result, the FY05 export target of US\$ 13.7 billion appears achievable.

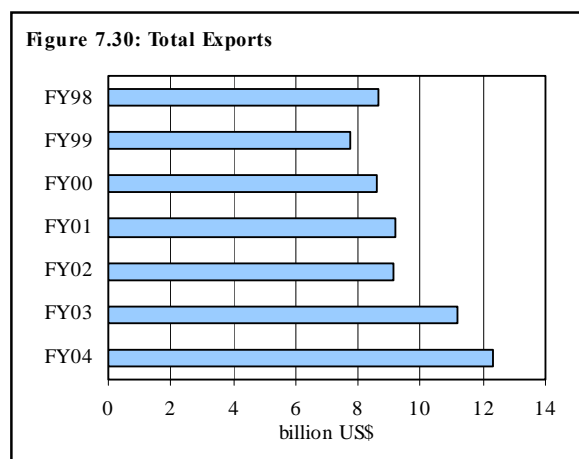
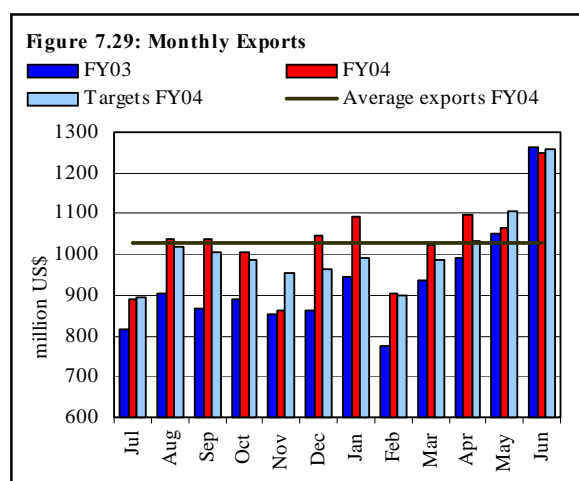
#### Composition of Exports

The category-wise analysis of export earnings during FY04 reveals that whereas textile sector had the highest share in growth, shares of *other manufactures* and *other exports* also increased in FY04 (see **Table 7.17**). In particular, exports of *leather manufactures* and *petroleum & petroleum products* recorded sizeable increases.

Another positive outcome this year was the growth in some of the *developmental exports* specifically chemical products and engineering goods.

#### Primary Exports

The growth in primary exports decelerated in FY04, climbing marginally to US\$ 1.3 billion (see **Table 7.19**). This is attributable to a sizeable reduction in wheat exports (due to below target



<sup>41</sup> The above-mentioned temporary imports of dredgers from Dubai also contributed to the rising import bill.

harvest),<sup>42</sup> and a marginal fall in the export of guar and raw cotton, which ate into the extraordinary growth in rice exports.

**Rice** exports (up 14.2 percent YoY in FY04) reached an all-time high of US\$ 634.5 million, comfortably surpassing the annual target of US\$ 575 million. This is due to both: (1) a larger share of expensive basmati rice in the total; and (2) a substantial rise in export prices for other rice varieties (see **Table 7.18**).

**Other Rice Varieties** recorded 8.8 percent fall in quantum during FY04 due to decline in domestic production,<sup>43</sup> but exports nonetheless rose due to higher prices.

The highest rise in the unit values came in the Middle East; however in terms of share, this market witnessed fall (especially in Kuwait and Iran- see **Table 7.20**). The EU market, on the other hand, recorded a rise in prices and export volumes.

**Basmati Rice:** The country's basmati rice exports recorded an increase both in terms of unit values and volume. In terms of shares, however, a larger fall was seen in the EU market. This drop in EU's share in basmati rice exports is attributable to the withdrawal of super basmati from the duty abatement list from April 2004. However, an agreement<sup>44</sup> was signed between Pakistan and EU according to which a zero duty facility<sup>45</sup> will be available on exports of Pakistan's basmati-370, kernel and super basmati to EU member countries effective from September 1, 2004.

### Textile Manufacture Exports

Textile exports recorded an impressive 11.2 percent growth over FY03 reaching US\$ 8.07 billion during FY04. Furthermore, earnings from four major categories namely; cotton yarn, cotton fabrics, bed wear and knitwear each crossed the US\$ 1 billion mark during FY04 (see **Figure 7.31**). These four categories saw an increase over and above the strong export-base of FY03. However, readymade garment exports, that had exceeded US\$ 1 billion in FY03, fell to US\$ 993 million in FY04.

**Table 7.17: Contribution in Growth by Major Export Groups**  
percent

	FY03		FY04	
	Growth	Percent share in growth	Growth	Percent share in growth
Primary commodities	17.8	9.4	0.9	1.0
Textile manufactures	25.0	71.7	11.2	70.2
Other manufactures	-3.0	-2.6	3.5	5.2
Other exports	85.4	21.5	26.9	22.1
<b>Total</b>	<b>22.2</b>	<b>100.0</b>	<b>10.3</b>	<b>100.0</b>

**Table 7.18: Composition of Rice Exports**

Share: percent: Unit Value: US Dollar per MT

	FY03		FY04	
	Quantum share	Unit value	Quantum share	Unit value
Basmati rice	39.4	503	44.8	517
Other rice	60.6	176	55.2	212

**Table 7.20: Rice- Export Markets Analysis**

	Shares		Unit value growth
	FY03	FY04	FY04
<b>Basmati</b>			
UAE	38.1	38.7	2.9
Other Middle East	21.6	23.8	-2.9
EU	14.6	12.7	1.6
Iran	3.8	5.7	-7.6
Saudi Arabia	6.9	5.6	4.7
<b>Other</b>			
East Africa	29.5	27.5	9.4
Other Middle East	23.3	18.0	24.2
Dubai	5.2	9.0	3.7
EU	1.7	7.7	18.3

<sup>42</sup> Though the wheat production rose by 3 percent during FY04 to reach 19.76 million tones, it was still 1.2 percent less than the target set for FY04.

<sup>43</sup> The production of other rice varieties fell from 2.2 million tones during FY03 to 1.977 million tones in FY04.

<sup>44</sup> This is however, a transitional arrangement for rice import which is an exception to earlier regulation (EC No.1785/2003) for the rice imports to the EU. The transitional arrangement will remain effective till June 30, 2005 or the time when a permanent amendment is made in the aforesaid regulation.

<sup>45</sup> The EU has imposed a bound rate of 264 Euros per ton on its import of husked rice. Out of this total amount, a duty withdrawal concession worth 250 Euros per ton was given for basmati rice. However, according to the current agreement, duty withdrawal for the full bound rate has been granted.

**Table 7.19: Major Exports**

Value: million US Dollar; Unit value: US Dollar

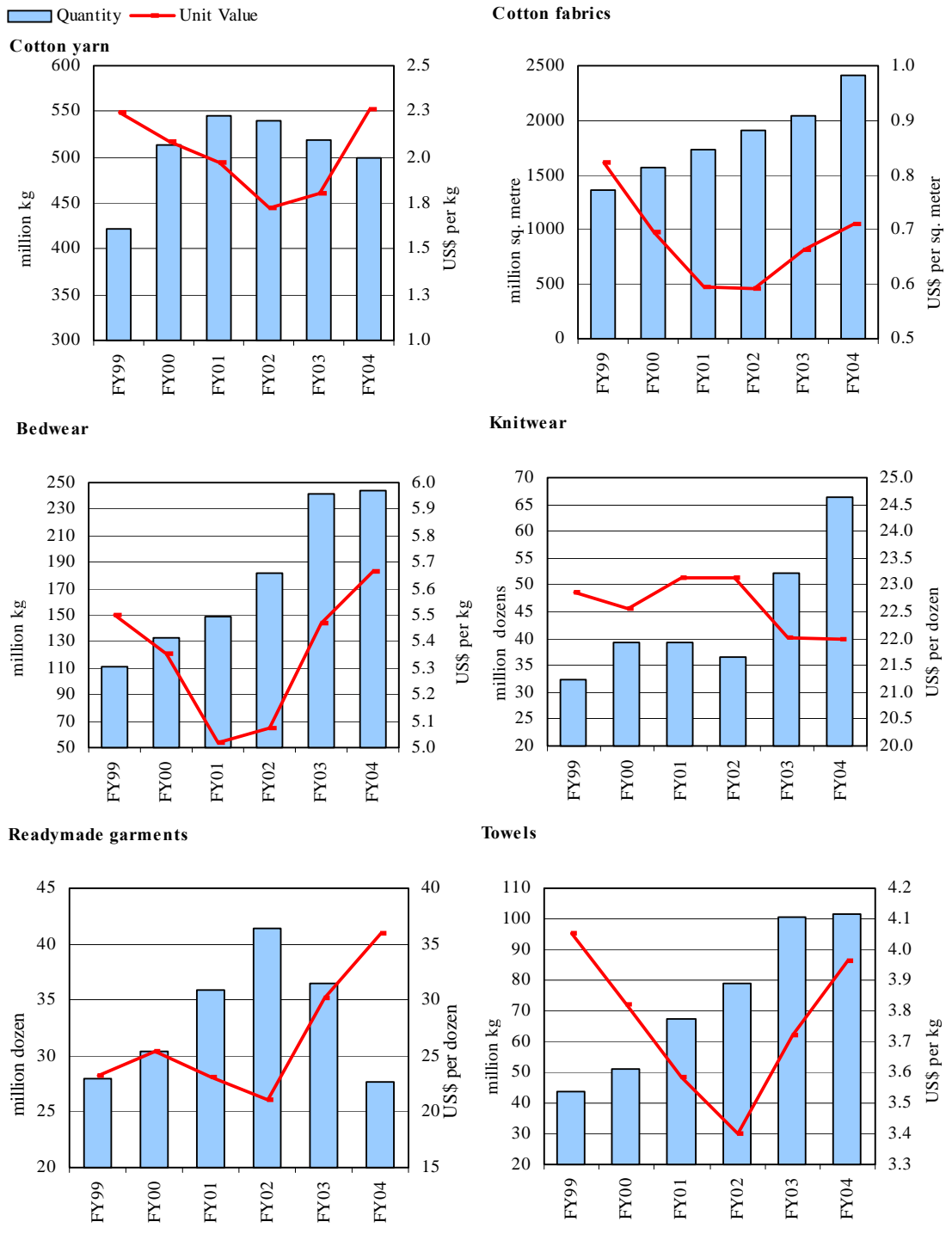
	Unit	FY03		FY04		Absolute Δ in value	Change (percent)		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
<b>A. Primary commodities</b>		<b>1,263.9</b>		<b>1275.0</b>		<b>11.1</b>		<b>0.9</b>	
1 Rice	MT	555.5	305.2	634.5	348.1	79.0	0.2	14.2	14.0
2 Raw cotton	MT	49.0	889.6	47.7	1,277.8	-1.3	-32.3	-2.7	43.6
3 Raw wool (excluding wool tops)	MT	1.3	900.3	1.4	632.8	0.1	50.6	5.8	-29.7
4 Fish and fish preparations	MT	134.5	1,442.9	152.9	1,480.8	18.4	10.8	13.7	2.6
5 Leather	SQM	234.8	15.3	251.7	15.7	16.9	4.6	7.2	2.5
6 Guar and guar products	MT	23.8	932.9	20.2	824.0	-3.6	-4.0	-15.2	-11.7
7 Fruits	MT	83.2	321.3	102.7	289.7	19.5	36.9	23.5	-9.8
8 Vegetables	MT	31.5	161.6	31.3	181.1	-0.2	-11.4	-0.7	12.1
9 Crude animal material	MT	13.5	795.1	15.5	2,023.4	1.9	-55.0	14.4	154.5
10 Oil seeds & nuts etc.	MT	7.2	500.0	11.2	577.5	4.0	34.4	55.2	15.5
11 Wheat	MT	129.6	114.0	6.0	140.2	-123.6	-96.2	-95.4	23.0
<b>B. Textile manufactures</b>		<b>7,263.1</b>		<b>8,073.0</b>		<b>809.9</b>		<b>11.2</b>	
1 Cotton yarn	MT	928.4	1,787.6	1,126.9	2,258.0	198.5	-3.9	21.4	26.3
2 Cotton fabrics (woven)	SQM	1,345.7	0.7	1,711.5	0.7	365.8	18.3	27.2	7.5
3 Hosiery (Knitwear)	DOZ	1,146.7	22.0	1,458.7	22.0	312.1	27.3	27.2	-0.1
4 Bed wear	MT	1,329.1	5,494.6	1,383.3	5,664.6	54.3	1.0	4.1	3.1
5 Towels	MT	374.8	3,726.6	403.5	3,963.4	28.7	1.2	7.6	6.4
6 Cotton bags and sacks	MT	17.0	4,083.7	15.5	4,133.7	-1.5	-10.0	-8.9	1.2
7 Readymade garments	DOZ	1,092.6	30.0	993.3	36.0	-99.3	-24.3	-9.1	20.1
8 Tarpaulin & other canvas goods	MT	73.3	2,275.3	74.8	2,342.1	1.5	-0.9	2.0	2.9
9 Tule, lace embroidery etc.	(-)	11.2	---	11.4	---	0.1	---	1.1	---
10 Synthetic textiles	SQM	574.3	0.7	470.8	0.7	-103.5	-16.9	-18.0	-1.3
11 Other textile made-up	(-)	359.8	---	416.6	---	56.8	---	15.8	---
12 Waste material of textile fibres/fabrics	MT	10.3	652.5	6.8	565.1	-3.5	-23.9	-34.1	-13.4
<b>C. Other manufactures</b>		<b>1,688.8</b>		<b>1,748.6</b>		<b>59.8</b>		<b>3.5</b>	
1 Carpets, carpeting rugs & mats	SQM	220.9	51.9	231.4	55.8	10.5	-2.6	4.8	7.6
2 Petroleum and petroleum products	MT	248.6	247.4	294.5	298.4	45.9	-1.8	18.5	20.6
3 Sports goods	(-)	335.2	---	324.8	---	-10.4	---	-3.1	---
4 Leather manufactures	(-)	386.5	---	414.3	---	27.8	---	7.2	---
5 Surgical and medical instruments	NO	150.0	---	132.6	---	-17.4	---	-11.6	---
6 Cutlery	GR	29.6	31.1	29.7	25.2	0.1	24.0	0.3	-19.1
7 Onyx manufactured	MT	11.7	1,764.0	11.6	1,706.8	-0.2	2.0	-1.3	-3.2
8 Chemicals and pharmaceuticals	(-)	260.9	---	263.0	---	2.0	---	0.8	---
9 Molasses	MT	45.5	35.7	46.9	32.2	1.4	14.5	3.1	-10.0
10 Sugar	MT	7.7	238.0	27.6	237.3	19.9	260.5	259.5	-0.3
<b>D. Others</b>		<b>944.4</b>	<b>---</b>	<b>1,216.7</b>	<b>---</b>	<b>272.3</b>	<b>---</b>	<b>26.9</b>	<b>---</b>
<b>Total exports</b>		<b>11,160.2</b>		<b>12,313.3</b>		<b>1,153.0</b>		<b>10.3</b>	

Source: Federal Bureau of Statistics

The strong growth in textile exports, visible in the last two years, appears to reflect both increased access to key markets as well as the impact of heavy investments in the sector. Textile machinery imports in the last five years have exceeded US\$ 2.17 billion as the industry prepared for the more competitive exports environment post-December 2004.

While this enabled the textile sector to increase value added exports, it should be noted that the FY04 textile export growth was also supported by higher unit values for cotton products in the wake of rising international cotton prices. This is visible in the higher price impact for some of the categories during FY04, especially cotton yarn, bed wear and ready-made garments (see **Figure 7.32**).

Figure 7.32 : Major Textile Manufactures



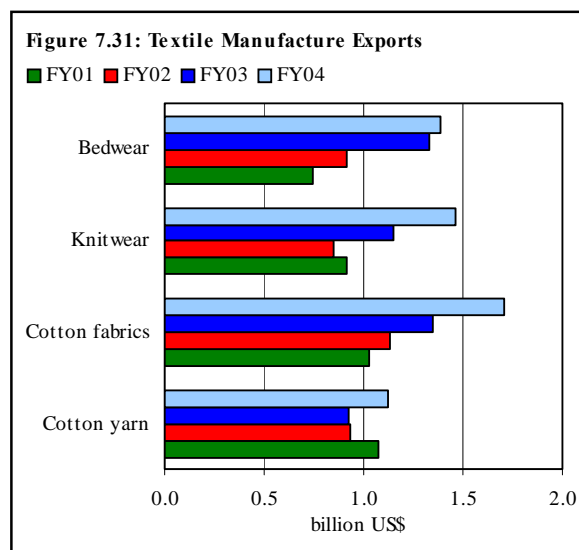
In the case of cotton fabrics and knitwear, however, the bulk of the improvement came from rising export volumes (see **Table 7.21 & Figure 7.32**).

Consequently, in contrast to the trend in recent years, the share of low value-added textile in total exports increased in FY04 (see **Figure 7.33**). In particular, the share of cotton yarn and cotton fabrics in the total textile exports rose to 35.2 percent in FY04 from 31.3 percent during the preceding year. In contrast, exports of readymade garments fell whereas growth in the bed wear exports slowed down during FY04.

**Quota Exports** In terms of composition, the share of quota exports in country's total textile exports rose from 37.4 percent in FY03 to 39 percent in FY04 (see **Table 7.22**). The highest increase was seen in EU market, due to stronger bed wear and cotton fabrics exports; both of these categories benefited from quota enhancements as well as an increased quota utilization rate during FY04.

**Cotton Fabric** (27 percent growth) exports reached US\$ 1.7 billion during FY04. This rise resulted from increased demand from major export markets like EU and the US, with the share of the former being stronger (see **Table 7.23**). For EU, this rise came from higher quota categories mainly due to:

1. An 11.5 increase in quota ceiling for this category over 2003.
2. Quota utilization rate<sup>46</sup> increased for this category during FY04 that might be attributable to higher production of cotton cloth during this period.<sup>47</sup>
3. The unit values improved by around 6.4 percent in the EU market.



**Table 7.21: Quantum and Price Impact on Textile Exports**

	Overall change million US\$	Quantum impact percent	Price impact in percent
Cotton yarn	198.5	-18.2	118.2
Cotton fabrics (woven)	365.8	67.4	32.6
Hosiery (knitwear)	312.1	100.4	-0.4
Bed wear	54.3	23.5	76.5
Readymade garments	-99.3	-267.6	167.6

**Table 7.22: Textile Exports**

Value: million US Dollar. Growth: percent

	FY03	FY04	Growth
<b>Non-quota exports</b>	<b>4,544.9</b>	<b>4,920.3</b>	<b>8.3</b>
<b>Quota exports</b>	<b>2,718.2</b>	<b>3,152.7</b>	<b>16.0</b>
<i>US</i>	1,229.9	1,331.2	8.2
<i>EU</i>	1,348.0	1,648.6	22.3
<i>Turkey</i>	56.5	56.8	0.4
<i>Canada</i>	83.8	116.1	38.6

**Table 7.23: Major Cotton Fabric Export Markets FY04**

million US Dollar

	FY03	FY04
<b>Total</b>		
EU	276.7	367.4
US	290.9	333.3
Turkey	60.6	117.6
Bangladesh	31.7	68.1
<b>Non-quota exports</b>		
EU	135.0	159.7
US	113.7	148.2
<b>Quota exports</b>		
EU	141.7	207.8
US	177.1	185.2

<sup>46</sup> The quota utilization rate for cotton fabrics increased to 100.4 in 2003 compared to the 90.0 percent during 2002. The rising trend continues even during H1-FY04 as the utilization rate is 53.2 percent, much higher than 45.3 percent experienced during same period last year.

<sup>47</sup> The production of cotton cloth in the LSM sector recorded 13.0 percent rise during FY04.

**Bed Wear** (4.1 percent growth) exports reached US\$ 1.38 billion during FY04. However, there was only a 1 percent rise in terms of the export quantum. This slower growth was caused by a steep fall in its exports during Q2-FY04 that might be attributed to expectations of the imposition of antidumping duty by EU. Due to the risk of antidumping duty, exporters availed much of the quota for CY2003 during the first half (i.e., Jan-Jun 2003 period). This left lesser quota available for the remaining Jul-Dec 2003 period, thereby reducing exports particularly during Q2-FY04 (see **Table 7.24**).

**Readymade Garments** exports dropped by 9.1 percent to US\$ 993 million in FY04. This fall was most evident in Dubai and Saudi Arabian market (US\$ 97.14 million). Interestingly both markets recorded a decline in a particular category, i.e., shawls. A part of this fall is allegedly attributable to the reported fall in the over invoicing tendency among exporters after the strict measures adopted by the authorities.<sup>48</sup>

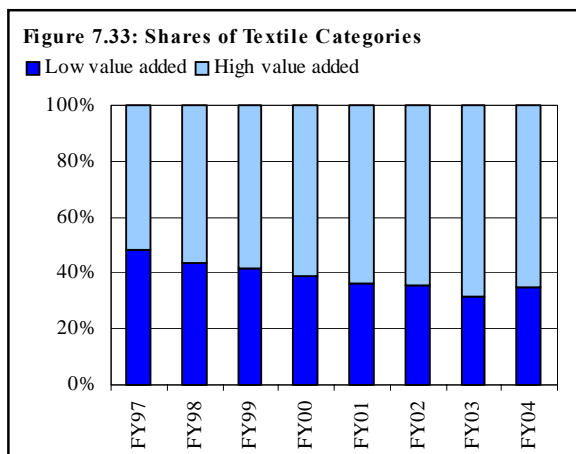
In addition, the exports to the US market fell marginally during the year against a rise in FY03. This fall may be attributed to the tough competition faced by Pakistan's readymade garment exports from the sub-Saharan Africa and Caribbean countries, which enjoy duty free access to the US market under the Trade Partnership Act of 2000.<sup>49</sup>

Apart from the garments, *knitwear exports* are also facing competition from these countries, particularly in the US which is a major importer (57.7 percent share in Pakistan's knitwear exports). The results of this competition are evident in the falling unit values for the knitwear exports (see **Figure 7.32**).

#### Other Manufactures

Other manufactures exports recorded 3.5 percent rise during FY04 reaching US\$ 1.75 billion. This rise was caused by growing exports of petroleum products and leather manufactures. In the *leather manufactures* category, exports of leather apparel to Dubai, EU and the US showed substantial gains.

**Petroleum Products** exports recorded 18.5 percent YoY rise during FY04. In this group, naphtha is the largest export category (58.9 percent share). However, in terms of quantum, its exports recorded a marginal fall of 2.6 percent in FY04. The resulting rise in total naphtha exports was due to high



**Table 7.24: Quarterly Bed Wear Exports**  
million US Dollar

	Q1	Q2	Q3	Q4
<b>Quota exports to EU</b>				
FY03	84.3	102.6	76.6	100.9
FY04	95.0	61.1	120.4	109.4
<b>Total bed wear</b>				
FY03	290.3	291.1	314.8	432.8
FY04	383.1	270.9	353.5	375.8

<sup>48</sup> After reports of over-invoicing, the duty drawback claims are now subject to rigorous scrutiny. The claims (both for the low tariff areas such as UAE and South Africa, and high tariff areas as the EU and the US) were sent to the Price Check Committee. Further, the introduction of Sales Tax Refund Repository (STARR) computer system will increase transparency in the system. This will categorize the refund claims on the basis of past record and annual turnover, and will divide the exporters among the high risk and low risk categories automatically. The high-risk cases are subjected to rigorous scrutiny.

<sup>49</sup> The Trade Partnership Act includes African Growth and Opportunity Act (AGOA) for the sub-Saharan Africa and Caribbean Basin Trade Partnership Act (CBTPA) for the Caribbean countries. The AGOA provides duty free access to apparel imports from the sub Saharan African less developing countries regardless of the origin of the fabric and yarn used in the production process. On the other hand, CBTPA grants duty free access to the apparel imports from the Caribbean countries that are assembled from the US fabric.

prices of petroleum derivatives as well as better marketing (exports were shifted to markets offering better prices - see **Table 7.25**).

#### *Developmental Exports*<sup>50</sup>

In the developmental exports; fish, fruits and engineering goods recorded reasonable growth rates. Encouragingly fish exports also recorded increasing share in exports to market offering better prices such as Dubai and EU.<sup>51</sup> In addition, rising exports of fresh kinos and mangoes to Afghanistan and Dubai respectively led to the rise in fruits exports.

**Engineering Goods** exports recorded 25 percent rise over FY03 reaching US\$ 130 million in FY04. Within this group, transport equipment and auto part exports recorded highest growth. In particular, the export of accessories of tractors, other large vehicles and tractors to Afghanistan and motorcycles to Bangladesh had a significant share in the growth of this group (see **Table 7.26**).

#### 7.4.2 Imports

Imports recorded a steep growth of 27.6 percent YoY during FY04 compared to the preceding year, reaching US\$ 15.6 billion, and surpassing the annual import target by 21.8 percent (see **Table 7.27**).

However, as discussed earlier, the large FY04 trade bill is not a source of concern, given the presence of non-recurring transactions, and the fact that bulk of the growth is caused by the imports of machinery and raw material for manufacturing (see **Figure 7.34 & Table 7.28**). In fact, the high import growth during FY04 was led by an unprecedented 39.4 percent rise in the non-food & non-oil imports.

Specifically, it was the strong growth in the automobiles, textile, construction and telecommunication sectors that led to higher imports of machinery and raw materials (see **Figure 7.35**).

**Table 7.25: Naphtha-Market Analysis**

shares: percent; Unit values: mln US\$ per '000'MT

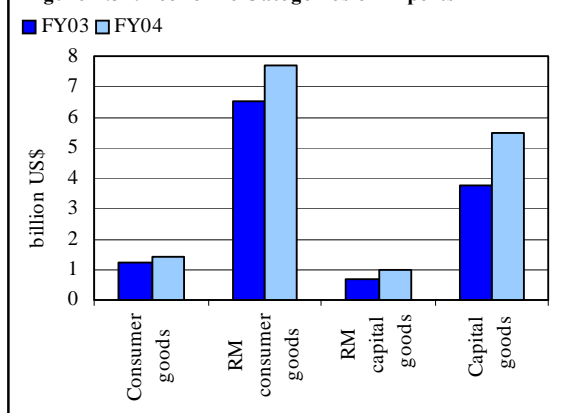
	FY03		FY04	
	Quantum share	Unit values	Quantum share	Unit values
Dubai	71.5	0.25	58.3	0.30
India	0.0	0.00	21.0	0.32
Singapore	7.0	0.22	9.9	0.32
Thailand	12.8	0.23	4.3	0.24

**Table 7.26: Engineering Goods Exports**

million US\$

	FY03	FY04	Growth FY04
Cutlery	30.0	30.0	0
Other machinery	22.7	26.9	18.2
Electrical machinery	16.2	19.4	20.3
Specialized machinery	14.5	17.2	18.6
Auto parts	6.3	14.7	133.8
Electric fans	10.1	11.8	17.1
Transport equipment	4.3	10.1	136.6

**Figure 7.34: Economic Categories of Imports**



<sup>50</sup> In a bid to diversify the export composition, certain products having export potential were identified as 'developmental exports' by the Ministry of Commerce and the EPB. The products under this head currently have quite low export volumes and were given long range of incentives in the Trade Policies for FY04 and FY05. This product group includes fish & fish preparations, fruits and vegetables, chemical products, engineering goods, onyx manufactured, gems and jewellery, I.T services, meat and meat preparations, poultry, wheat and services.

<sup>51</sup> The share of Dubai in country's fish exports rose from 7 percent in FY03 to 8.2 percent in FY04. Similarly the share of EU increased from 31.6 percent in FY03 to 35.0 percent in FY04.

Table 7.27: Major Imports

Value: million US Dollar; Unit value: US Dollar

	Unit	FY03		FY04		Absolute Δ in value	Change in percent		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
<b>A. Food group</b>	---	<b>978.0</b>	---	<b>1,033.3</b>	---	<b>55.3</b>	---	<b>5.7</b>	---
1. Milk & cream including milk food	MT	22.8	1,778.0	21.3	1,936.5	-1.5	-14.2	-6.5	8.9
2. Wheat unmilled	MT	28.7	194.2	23.6	218.6	-5.1	-27.0	-17.8	12.6
3. Dry fruits	MT	25.8	303.7	18.3	277.2	-7.5	-22.1	-28.9	-8.7
4. Tea	MT	172.7	1,597.3	192.5	1,660.1	19.8	7.2	11.4	3.9
5. Spices	MT	23.0	654.7	40.8	566.5	17.8	105.4	77.7	-13.5
6. Edible oil	MT	586.8	453.6	658.6	484.0	71.8	5.2	12.2	6.7
<i>Soya bean</i>	MT	47.5	574.5	45.6	564.8	-1.9	-2.3	-4.0	-1.7
<i>Palm oil</i>	MT	539.3	445.4	613.0	478.9	73.7	5.7	13.7	7.5
7. Sugar	MT	2.6	315.2	3.3	287.2	0.7	37.1	24.9	-8.9
8. Pulses	MT	115.6	293.2	74.9	286.4	-40.7	-33.7	-35.2	-2.3
<b>B. Machinery group</b>	---	<b>2,942.3</b>	---	<b>4,220.4</b>	---	<b>1,278.0</b>	---	<b>43.4</b>	---
1. Power generating machinery	---	268.5	---	277.8	---	9.3	---	3.5	---
2. Office machinery	---	211.5	---	209.5	---	-2.0	---	-1.0	---
3. Textile machinery	---	531.9	---	598.0	---	66.0	---	12.4	---
4. Construction & mining machinery	---	101.2	---	101.5	---	0.2	---	0.2	---
5. Electrical machinery & apparatus	---	216.7	---	258.1	---	41.4	---	19.1	---
6. Railway vehicles	---	49.6	---	72.5	---	22.9	---	46.3	---
7. Road motor vehicles	---	501.2	---	652.8	---	151.6	---	30.2	---
8. Aircraft, ships and boats	---	134.1	---	789.8	---	655.6	---	488.8	---
9. Agricultural machinery & implements	---	36.8	---	37.7	---	0.9	---	2.3	---
10. Other machinery	---	890.8	---	1,222.8	---	332.0	---	37.3	---
<b>C. Petroleum group</b>	---	<b>3,066.4</b>	<b>201.2</b>	<b>3,166.6</b>	<b>238.0</b>	<b>100.1</b>	<b>-12.7</b>	<b>3.3</b>	<b>18.3</b>
1. Petroleum products	MT	1,699.9	201.2	1,401.4	258.9	-298.5	-35.9	-17.6	28.7
2. Petroleum crude	MT	1,366.5	201.2	1,765.1	223.7	398.6	16.2	29.2	11.2
<b>D. Textile group</b>	---	<b>221.6</b>	---	<b>260.5</b>	---	<b>38.8</b>	---	<b>17.5</b>	---
1. Synthetic fibre	MT	92.0	1,319.9	106.1	1,485.9	14.1	2.4	15.3	12.6
2. Synthetic & artificial silk yarn	MT	91.8	1,541.7	118.0	1,699.7	26.2	16.5	28.5	10.3
3. Worn clothing	MT	37.8	322.5	36.4	323.4	-1.4	-3.9	-3.7	0.3
<b>E. Agricultural &amp; other chemicals group</b>	---	<b>2,160.7</b>	---	<b>2,797.7</b>	---	<b>637.0</b>	---	<b>29.5</b>	---
1. Fertilizer	MT	239.8	185.1	284.7	211.2	44.9	4.1	18.7	14.1
2. Insecticides	MT	58.5	2,629.2	124.1	2,997.3	65.6	86.2	112.2	14.0
3. Plastic materials	MT	421.1	820.5	549.3	907.4	128.2	18.0	30.5	10.6
4. Medicinal products	MT	221.8	25,472.1	274.6	28,965.4	52.8	8.9	23.8	13.7
5. Others	---	1,219.6	---	1,564.9	---	345.3	---	28.3	---
<b>F. Metal group</b>	---	<b>507.4</b>	---	<b>687.7</b>	---	<b>180.4</b>	---	<b>35.5</b>	---
1. Iron and steel scrap	MT	47.9	138.9	93.6	171.4	45.7	58.5	95.6	23.4
2. Iron and steel	MT	402.3	366.1	512.0	405.0	109.7	15.0	27.3	10.6
3. Aluminum wrought & worked	---	57.2	---	82.1	---	25.0	---	43.6	---
<b>G. Miscellaneous group</b>	---	<b>306.4</b>	---	<b>378.3</b>	---	<b>71.9</b>	---	<b>23.5</b>	---
1. Rubber crude	MT	49.1	770.0	68.2	891.0	19.1	20.0	38.9	15.7
2. Rubber tyres & tubes	Nos	78.3	20.5	89.0	21.9	10.8	6.6	13.8	6.7
3. Wood & cork	---	26.4	---	25.8	---	-0.6	---	-2.2	---
4. Jute	MT	21.0	235.6	30.9	273.7	9.9	26.5	46.9	16.2
5. Paper and paper board & manufactures	MT	131.7	606.4	164.4	624.1	32.7	21.3	24.8	2.9
<b>H. Others</b>	---	<b>2,037.3</b>	---	<b>3,047.3</b>	---	<b>1,010.0</b>	---	<b>49.6</b>	---
<b>Total imports:</b>		<b>12,220.3</b>		<b>15,591.8</b>		<b>3,371.5</b>		<b>27.6</b>	
<i>Memorandum item</i>									
<i>Total imports excl. aircrafts and dredgers</i>		12,220.3		15,016.8		2,796.6		22.9	

Source: Federal Bureau of Statistics

The increasing domestic demand for input on the back of the economic recovery was supported by the FY04 trade policy which further liberalized the import regime<sup>52</sup> in order to ease the supply of inputs to the economy.<sup>53</sup>

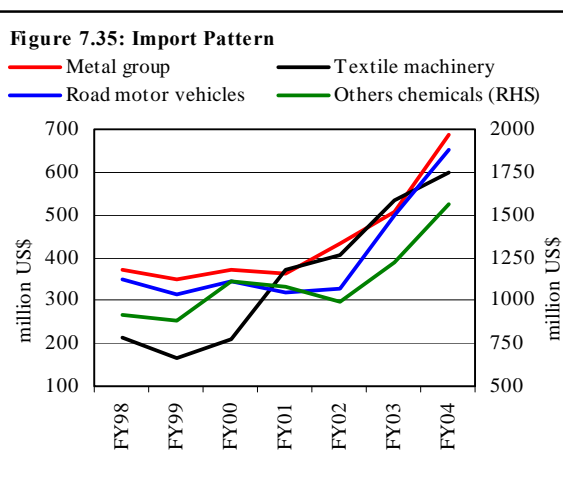
FY04 was characterized by a sharp growth in regional imports, particularly with India and China. The trade deficit with China has grown sharply in FY04, as low cost inputs from China have replaced more expensive inputs from other countries thus providing competitive edge to some domestic industries. Moreover, the domestic consumers also gained from the low prices due to increased competition and low production costs (see **Box 7.3** on Import from China).

**Machinery Group** imports recorded 23.9 percent YoY rise in FY04 reaching US\$ 3.6 billion.<sup>54</sup> The growth in this group was caused by higher road motor vehicles, textile machinery and other machinery imports.

- Road Motor vehicles imports recorded a 30.2 percent rise in FY04. In this group motorcars import (not exceeding 1000cc) captured the highest share (22.6 percent). Further, the import of accessories and parts of motorcycles (6.9 percent share) and vehicles (19 percent share) also recorded a substantial rise. The major supplier for these categories was Japan, which accounted for 68.6 percent of the imports in this category.
- Textile machinery imports recorded 12.4 percent rise over FY03. Within this group, the highest rise (US\$ 29.9 million) was seen in the spinning machinery imports. Interestingly, data shows a clear substitution of imports from more expensive sources to cheaper suppliers (see **Table 7.29**). Imports of weaving machinery however, recorded a sizeable fall during FY04.

**Table 7.28: Contribution in Growth by Major Import Groups**

	FY03		FY04	
	Growth	% Share in growth	Growth	% Share in growth
Food group	18.8	8.2	5.7	1.6
Machinery group.	37.1	42.3	43.4	37.9
Petroleum group.	9.2	13.8	3.3	3.0
Textile group.	18.2	1.8	17.5	1.2
Agriculture. & other chemicals group.	17.7	17.3	29.5	18.9
Metal group.	16.9	3.9	35.5	5.3
Miscellaneous group.	7.4	1.1	23.5	2.1
Others	7.2	7.3	49.6	30.0
<b>Total</b>	<b>18.2</b>	<b>100.0</b>	<b>27.6</b>	<b>100.0</b>



**Table 7.29: Spinning Machinery Imports**

million US\$	Overall increase	Quantum impact	Price impact
	<b>29.9</b>	<b>8.3</b>	<b>21.6</b>
China	29.4	22.2	7.2
Japan	-13.7	-27.0	13.2

<sup>52</sup> The SBP eased various monetary limits on the import through foreign currency demand draft in one fiscal year.

<sup>53</sup> Trade policy for FY04 allowed import of electro medical equipment, second hand forklift trucks above 5 tons, second hand boilers, used agriculture spraying machinery/lorries/sprinklers, used lab, surveying equipment and different chemicals.

<sup>54</sup> The level of machinery imports is adjusted for the aircrafts and dredgers imports. After including these two items, the import level of this group rises to US\$ 4.2 billion (43.4 percent rise over FY03).

- Other machinery imports, on the whole, increased by 37.3 percent YoY. This category includes machinery type used by different industries that are not classified separately. The fast growth by the telecommunication sector imports (US\$ 195 million), plastic and rubber machinery (US\$ 40 million), air-conditioners, refrigerators (US\$ 36 million), engines and other parts of vehicles and aircrafts (US\$ 21 million), industrial furnaces (US\$ 15 million), bulldozers & excavators (US\$ 16 million) were important contributors to the increase.

**Petroleum Group:** The 3.3 percent rise in the overall petroleum imports was witnessed despite a 35.9 percent YoY fall in the quantum of petroleum products. In fact, higher import quantum of crude petroleum during FY04 more than offset the impact of reduced quantum of petroleum products (see **Table 7.30 & Figure 7.36**).

The rise in the quantum of crude oil is due to the increase in the domestic refining capacity. This shift, which was particularly evident in FY04, caused a significant decline in the country's oil bill. This positive impact was also supported by the shifts to alternate energy sources.

In particular, (1) industries are shifting to coal and gas, and (2) thermal power generation is falling with increased availability of hydro-electricity during FY04. As a result, furnace oil imports registered a substantial fall of US\$ 589 million over preceding year.

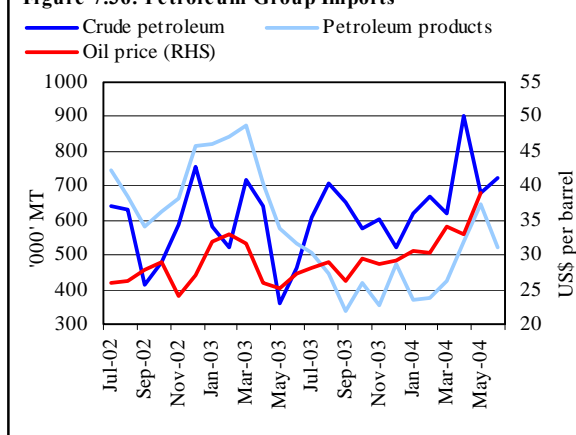
**Agriculture and Chemical Group Imports** (23.9 percent rise): The hike in other chemicals and plastic materials largely contributed in this increase (see **Table 7.31**).

- In *other chemicals*, the rise in organic chemicals<sup>55</sup> used for manufacturing synthetic fibre for textile industry, especially ethylene glycol (US\$ 75.2 million increase) and p-xylene (US\$ 52.7 million increase) was quite substantial.
- Inorganic chemicals increased by US\$ 63.6 million during FY04. In this group, the import of phosphoric acid, which is almost exclusively used in soft drinks industry, had the highest share (80 percent).

**Table 7.30: Impact on Petroleum Group Imports**  
million US\$

	Overall change US Dollars	Quantum impact percent	Price impact percent
<b>Petroleum group</b>	100.1	-389.9	490.0
Petroleum products	-298.5	-611.1	312.6
Petroleum crude	398.6	221.2	177.4

**Figure 7.36: Petroleum Group Imports**



**Table 7.31: Chemicals and Plastics Imports**  
growth & shares: percent

	Shares		Growth in FY04
	FY03	FY04	
<b>Organic chemicals</b>	747.3	976.2	30.6
<i>Shares</i>			
Ethylene glycol	14.7	18.9	68.6
p-Xylene	16.6	18.1	42.4
<b>Inorganic chemicals</b>	78.3	143.2	82.9
<i>Shares</i>			
Phosphoric acid	2.0	36.7	3232.6
<b>Plastics</b>	421.1	549.3	30.5
<i>Shares</i>			
Poly propylene	21.1	21.6	33.4
Poly ethylene	27.1	27.9	34.4

<sup>55</sup> Organic chemicals recorded US\$ 216.9 million in FY04.

- In plastics, the import of raw materials (poly propylene and polyethylene), used for making wide range of plastic items, recorded highest increase (US\$ 68.9 million).

### Box 7.3: Rising Imports from China

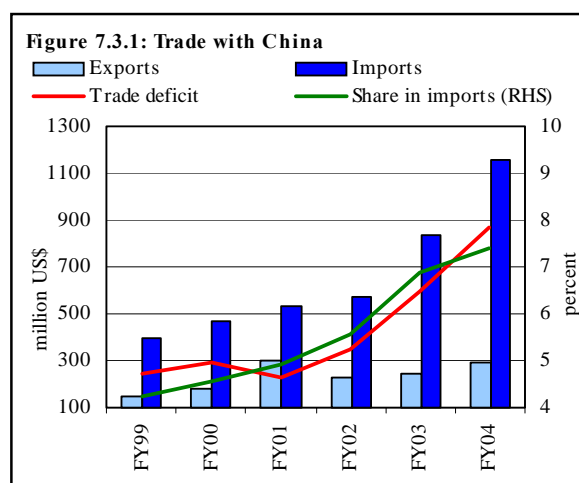
China has almost doubled its share in Pakistan's total imports during a short period of last five years and is now fourth largest import source after Saudi Arabia, USA and Dubai. A major jump in China's share in country's total imports is visible since FY03 that had resulted in worsening of trade balance (see **Figure 7.3.1**).

During the last two years, Pakistan's economy as well as its manufacturing sector has undergone substantial expansion. The resulting additional demand for industrial raw materials and machinery is being met by imports from China. Consequently, China is becoming a major supplier for imports to Pakistan (see **Table 7.3.1**). Since the Chinese goods are low priced, the surge in imports may not be a worrisome sign. But there are some concerns that need to be highlighted.

Firstly, the import of goods that are also domestically produced e.g., electronic goods, footwear, ceramics, plastic items, etc, can hurt the domestic industry. In fact, the continuous increase in supply of these goods at reduced prices is posing tough competition to the relevant manufacturing units (see **Table 7.33**). However, this competition is beneficial to consumers as they are enjoying lower prices. The domestic producers, on the other hand, will need to increase their efficiency so that they could offer lower prices and thus hold the market share.<sup>56</sup>

Secondly, in some cases, the imported Chinese goods have almost completely wiped out the branded foreign suppliers of the same goods.<sup>57</sup> The substitution of expensive goods with the low priced imports has the impact of lowering the country's over all trade deficit.

With a view to gain wider access in the Chinese market, Pakistan signed a Preferential Trade Arrangement (PTA) effective from January 2004. Under this arrangement both the countries provided tariff concessions on specified products. While China offered tariff concessions to Pakistan over a range of 893 goods, Pakistan responded with concessions on over 188 items. Unfortunately,



**Table 7.3.1: Imports from China-Shares Analysis**  
percent

	Shares			
	FY01	FY02	FY03	FY04
<b>Constant share</b>				
Insecticides/rodenticides	52.2	53.6	61.9	53.8
Rubber & manufactures	19.1	20.9	18.1	20.0
Tanning and dyeing extracts	14.9	17.4	18.2	15.4
<b>Increasing share</b>				
Railways	1.2	0.5	72.8	75.1
Air-conditioning machines	1.5	5.0	24.1	43.7
Electrical/communication machinery	11.8	16.5	18.5	19.9
Textile machinery	10.2	8.6	9.7	15.4
Textile materials	4.1	5.3	7.9	9.7
Organic chemicals	5.2	7.6	8.2	7.2
Automobiles	2.0	3.3	4.3	6.9
<b>Declining share</b>				
Inorganic chemicals	26.0	35.0	38.3	23.3
Pharmaceutical	8.8	9.4	6.2	7.5

<sup>56</sup> This has happened in the case of domestically produced motor cycles.

<sup>57</sup> In case of window/wall-type air conditioners, the previously large supplier i.e., Korea seems to have lost its share to China due to its inability to compete in terms of prices. The unit value comparison reveals that from Korea an air-conditioning unit bore a cost of Rs 16.8 thousand, as compared to Rs 11.6 thousand from China during FY03.

during FY04, Pakistan's exports of selected items to China fell by 42.7 percent over FY03. On the other hand, China showed a growth of 91.9 percent on items included in the list.

**Table 7.3.2: China Increasing Imports- A Comparison**

Unit Values: Thousand Rupees per unit

		Quantity		Unit Values	
		FY03	FY04	FY03	FY04
<b>Electric machinery</b>					
TV sets	No	53,235	118,327	6.37	5.12
Air conditioners	No	58,198	162,845	11.68	10.63
Refrigerator household type	No	756	5,363	9.23	6.97
Other refrigerator	No	16,105	10,537	7.75	7.69
Other transformer 500 KVA	No	2	248	1514	963
<b>Automobiles</b>					
M-Cycle capacity 50CC	No	10	142	17.80	14.99
M-Cycle capacity >50CC>250CC	No	7,338	27,604	18.53	17.15
<b>Footwear</b>					
Footwear outer sole leather	Pair	4,600	7,020	0.38	0.15
Other footwear	Pair	18,508	66,254	0.31	0.11
Footwear of other materials	Pair	566,812	720,688	0.10	0.10

#### **Box 7.4: Balance of Payments 5<sup>th</sup> Manual**

International Monetary Fund (IMF) provides guidelines to its member countries for compilation of balance of payments (BOP) statistics and related data on the international investment position. These guidelines or manuals are revised or updated regularly. Implementing a standardized framework for compiling information is important as it enables cross country comparisons and improves transparency and credibility of the data generating process.

Although the 5<sup>th</sup> manual on BOP was published in 1993, State Bank of Pakistan continued to compile these statistics on the basis of previous edition issued in 1977. Since then, important changes have occurred in international transactions mainly due to: (1) liberalization of financial markets; (2) innovations in the creation and packaging of financial instruments; (3) new approaches to external debt restructuring; and (4) unprecedented growth in the volume of international trade in services. In addition, there was also a need to harmonize the BOP statistics with the newly revised *System of National Accounts 1993 (SNA)* and with IMF statistical systems pertaining to money and banking and government finance statistics.

All these developments suggest the need for implementing 5<sup>th</sup> manual on BOP. Thus, from November 2003 and onward, Statistics Department of SBP has started compiling BOP statistics on the basis of revised manual. Since, in future, the analysis on balance of payments will be based on 5<sup>th</sup> manual, it is important to highlight the salient features of this format, particularly how it differs from previous version so that researchers/analysts could assimilate this transition into their analysis.

#### **Current Account Balance**

Compared to previous manual, the current account balance under 5<sup>th</sup> manual comprises of goods, services, income and current transfers only. The capital transfers, which were previously the part of the current account balance, have been moved to capital and financial account (see **Table 1**). The item-wise change in coverage and new addition in each category of current account balance are discussed in some detail below:

##### Goods

The scope of merchandise goods has been expanded and it also includes: (1) the movement of goods for processing; (2) the value of repairs on goods; (3) goods procured in ports by nonresident carriers; (4) non-monetary gold; and (5) held as store of value.

##### Services

Given their growing importance in global trade, international services transactions have been disaggregated in several categories. The important categories are: transport, travel, communications, construction services, insurance services, financial services, computer and Information services, royalties and licenses fees, other business services, personal, cultural & recreational services and government services not elsewhere specified.<sup>58</sup>

##### Income

In contrast to the treatment in the previous edition, income is now clearly separated from service transactions in 5<sup>th</sup> manual. The two main components of income flows i.e., compensation of employees and investment income are separately identified as components of the current account.

The compensation of employees refers to earnings of persons working outside their country of residence for less than one year and earnings of local staff working in embassies and consulates.

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<sup>58</sup> Transportation subsumes the shipment and other transportation items. However, this excludes freight insurance which is now part of insurance services.

Investment income covers earnings arising from foreign investors' investments in Pakistan and Pakistan's investment abroad.

	4th Manual	5th Manual
<b>Current Account Balance</b>	(1) Trade Balance (Goods) Exports Imports	(1) Trade Balance (Goods) Exports Imports
	(2) Services (net) Shipment, Others Transportation, Travel, Investment Income, Others goods & services.	(2) Services (net) Transportation, Travel, Communications services, Construction services, Insurance services, Financial services, Computer and information services, Royalties and license fees, Other business services, Personal, cultural, and Government services.
	(3) Transfers (both Current & Capital transfers)	(3) Income Compensation of employees Investment income Direct Investment Portfolio investment
<b>Capital Account</b>	<b>Capital Account</b> Foreign Direct Invest Abroad Foreign Direct Investment Foreign portfolio investment Long-term capital (official, Deposit money banks and other sector)	<b>Capital &amp; Financial Account</b> <b>Capital Account</b> 1. General government Debt forgiveness Others: project grants 2. Acquisition of non-produced, non-financial assets
	Short-term capital (official, Deposit money banks and other sector)	<b>Financial Account</b> 1. Direct Investment (Abroad & in reporting country) 2. Portfolio investment (Equity & Debt securities) 3. Other Investment: Assets & Liabilities (trade credit, loans, currency & deposits and other assets)
<b>Reserves</b>	Reserves as a separate group.	<b>4. Reserves are included in Financial Account</b> Monetary Gold Special Drawing Rights Use of Fund Credit Foreign Exchange (currency, deposits and securities)
<b>Use of Fund Credit</b>	A part of Reserves Assets	
<b>Other Items</b>	Exceptional Financing Error & omissions	Exceptional Financing Error & omissions

### Current Transfers

The new manual makes a distinction between current and capital transfers. Consequently, capital transfers are now included in an expanded and renamed capital & financial account.

### **Capital & Financial Account**

The former balance of payments capital account has been re-designated as the capital & financial account.

### Capital Account

It covers all transactions that involve the receipt or payment of capital transfers and acquisition or disposal of non-produced, non-financial assets (patents, copyrights, piece of land purchased by embassies etc.). As explained earlier, capital transfers which were previously part of current transfers are now included in the capital account. Capital transfers are classified under *general government* and *other sectors*. The *general government* is further arranged under *debt forgiveness* and *official capital*

*grants*<sup>59</sup> are specified under *general government*, while the migrants' transfers are included under *other sectors*.

#### The Financial Accounts

This covers all transactions associated with changes of ownership in the foreign financial assets and liabilities of an economy. The foreign financial assets of an economy consist of holdings of monetary gold, SDRs, and claims on nonresidents. On the other hand, the foreign liabilities of an economy consist of indebtedness to nonresidents. The financial account in 5<sup>th</sup> manual comprises four elements i.e., direct investment, portfolio investment, other investment and reserves assets.

Following important changes have been made under financial accounts:

(1) The coverage of portfolio investment (non-equity) is broadened to include long-term and short-term securities in order to cover new financial instruments;

(2) Apart from foreign investment (either direct investment or portfolio investment), all other financial transactions are covered under *other investment*. The assets and liabilities for *other investment* are classified primarily on instrument basis such as trade credit, loans, currency & deposits and other assets. These are sub-categorized on maturity basis, i.e., such as long-term & short-term. The coverage includes monetary authorities, general government, banks.

(3) Instead of reporting reserves assets as a separate group (as was the case in 4<sup>th</sup> manual), it is now a part of financial account as its fourth elements. The category of reserve assets comprises monetary gold, SDRs, reserve position in the Fund, foreign exchange assets (consisting of currency and deposits and securities), and *other claims*.

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<sup>59</sup> Official capital/investment grants consist of capital transfers (in cash or in kind) made by governments to nonresident units, or vice versa, to finance all or part of the costs of acquiring fixed assets. The recipients are obliged to use investment grants in cash for purposes of gross fixed capital formation, and the grants are often tied to specific investment projects, such as large construction projects. Investment grants in kind consist of transfers of transport equipment, machinery, other equipment, and the direct provision of buildings or other structures by governments to nonresident units.