

7 Balance of Payment

7.1 International Developments

The global economy is still in the throes of the biggest economic slump since World War II and CY2009 is expected to record the first contraction in world output since that time.

The global financial crises has severely dented global aggregate demand, decimated liquidity in the international capital markets, and reduced investor confidence.

Consequently, world trade, investment and industrial production fell sharply from the last quarter of 2008. These developments adversely impacted social indicators globally, as unemployment is on rise and poverty is likely to increase in developing economies.

To counter the economic slump, central banks have responded by a substantial easing of monetary policy, and several governments have introduced substantial stimulus packages. As a result, by the second quarter of 2009, there are some signs that recession may finally be bottoming out, but these are still tenuous and the future trend of the global economy remains uncertain. Moreover, many observers believe that any recovery of the global economy is likely to be a slow and gradual process (see **Figure 7.1**).¹

Although, economic activity in both the developed and emerging economies weakened, the impact was more severe in the former. The financial institutions here suffered the greatest capital losses, rendering many large institutions insolvent and credit markets saw serious liquidity issues. The consequent direct impact on business and industry was worsened by a sharp shrinkage in consumer demand as credit dried up, and job losses accelerated. As a result, despite aggressive counter-cyclical policies by the economic authorities, practically all developed economies are expected to record output contraction in 2009 (see **Table 7.1**). US, for instance, is expected to record its worst contraction in the last sixty years.

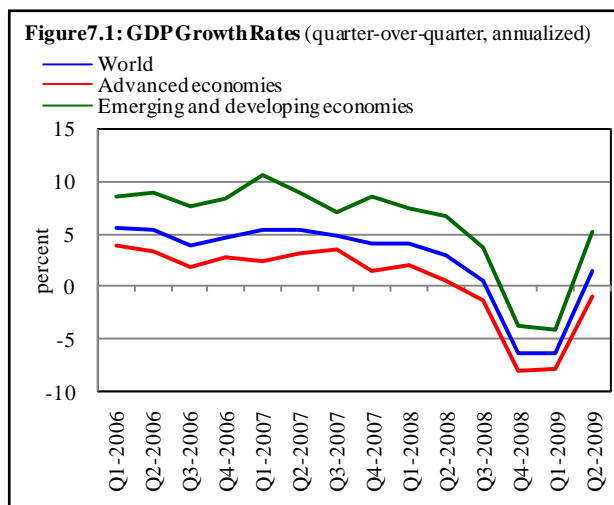


Table 7.1: Major World Indicators of World Economies

	GDP growth		Inflation rate		CAB (% of GDP)	
	2008	2009	2008	2009	2008	2009
World	3.0	-1.1				
Developed countries	0.6	-3.4	3.4	0.1	-1.3	-0.7
USA	0.4	-2.7	3.8	-0.4	-4.9	-2.6
Euro Area	0.7	-4.2	3.3	0.3	-0.7	-0.7
Japan	-0.7	-5.4	1.4	-1.1	3.2	1.9
UK	0.7	-4.4	3.6	1.9	-1.7	-2.0
Emerging markets	6.0	1.7	9.3	5.5		
China	9.0	8.5	5.9	-0.1	9.8	7.8
Russia	5.6	-7.5	14.1	12.3	6.1	3.6
India	7.3	5.4	8.3	8.7	-2.2	-2.2
Pakistan	2.0	2.0	12.0	20.8	-8.3	-5.1
Bangladesh	6.0	5.4	7.7	5.3	1.9	2.1
Philippines	3.8	1.0	9.3	2.8	2.5	3.2
Indonesia	6.1	4.0	9.8	5.0	0.1	0.9

Sources: World Economic October 2009.

Although the financial institutions in developing economies, by and large, fared much better than their developed economy counterparts, these economies are also expected to record substantial slowdown in economic growth during 2009 (see **Table 7.1**). Emerging economies were mainly affected through

¹ Claessens, Stijn, M. Ayhan Kose, and Marco Terrones, 2008, "What Happens During Recessions, Crunches and Busts?" IMF Working Paper 08/274.

trade and credit channels. Indeed, falling demand for emerging economies exports directly translated into slowing GDP growth. This is particularly true for economies where net exports accounted for a larger share of output, e.g. for most ASEAN countries. This impact was heightened by the uncertainty (and increasing risk aversion) in international credit markets. In the latter context, the countries with substantial macroeconomic imbalances were particularly badly hit, as the access to international capital flows was abruptly curtailed, and their governments were often not in a position to initiate counter-cyclical fiscal or monetary policies.

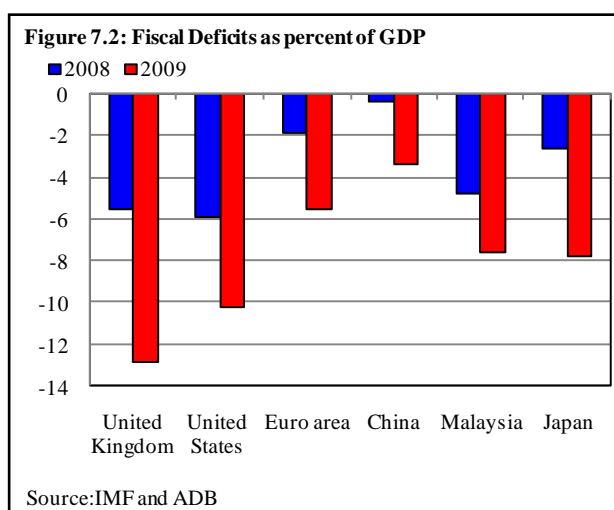
Ironically, the slowdown in global demand provided one major boon to many countries, particularly those economies that were net commodity importers, in the form of a fall in commodity prices from mid 2008 onwards. This had a direct bearing on inflationary pressures in these economies, while also contributing to improvements in current account positions. As a result of the weakness in demand, and lowering of cost-push pressures global inflation is expected to decline in 2009. In developed economies, inflation is expected to fall to 0.1 percent from 3.4 percent in the previous year, while, inflation in emerging economies is expected to decelerate to 5.5 percent during 2009 compared to 9.3 percent last year. Even the impact of the recent recovery in commodity prices on global inflation is likely to be limited as, there is (a) significant excess capacity; and (b) global economic recovery is expected to be slow.

Encouragingly, global slump may be nearing its trough. Quarterly data shows that, after sharp contraction in the last quarter of 2008 and first quarter of 2009, emerging economies growth has turned to positive while contraction in developed economies has significantly slowed in the second quarter of 2009. Likewise, stock markets have recovered considerably, credit default risks have narrowed and emerging market sovereign spread retreated from their peaks.

A substantial contribution to this relative improvement came from the active use of monetary and fiscal stimuli by economic authorities. In many countries, fiscal stimulus packages have not only directly injected demand, but have also bolstered subdued private demand. However, the fiscal stimulus can support the growth only temporarily as rising budget deficits are not a route to sustainable growth (see **Figure 7.2**).

Similarly, liquidity provisions and other non conventional support by the central banks run the risk of nurturing inflationary expectations in the future.

Rising debt and inflationary pressures necessitate well-planned exit strategies from fiscal expansion and easy monetary policies, which must be carefully timed so that a premature policy reversal does not strangle any nascent recovery. This is, by definition very challenging, given the inherent difficulty in assessing growth figures and given the significant lags between initiation of macroeconomic policy shifts and their impacts.



7.2 Pakistan's External Account

After continuous expansion in the last four successive years, the current account deficit contracted considerably to 5.3 percent of GDP during FY09 from 8.4 percent in FY08. This improvement in current account deficit more than offset the fall in financial account surplus during the period. Consequently, overall external account deficit declined by 40.1 percent in FY09 (see **Figure 7.3**).

The entire improvement in the annual external account picture accrued during Nov-June FY09. The initial four months of the fiscal year witnessed significant YoY deterioration. During Jul-Oct FY09, the trend deterioration in current account deficit seen in FY08 accelerated further, mainly owing to higher import prices and a sharp fall in financial inflows. This led to a rapid depletion of foreign exchange reserves along with substantial pressure on exchange rate. The fall in reserves severely impaired the country's ability to meet its external obligations and, given the inability to access international capital markets due to global financial crisis, Pakistan had no option but to approach International Monetary Fund to avert a BoP crisis (see **Box 7.5**).² The subsequent implementation of a macroeconomic stabilization program led to a marked improvement in the external account position in the ensuing months (Nov-June FY09) (see **Table 7.2**).

In Nov-June FY09, steep fall in import prices, subsiding aggregate demand pressures and significant exchange rate depreciation all contributed to a sustained contraction in imports (see **Table 7.3**). This fall in imports, supported by strong growth in remittances, allowed a large contraction in the current account deficit. In fact, the improvement in current account deficit would have been even higher, were it not for a fall in foreign exchange earnings, and had there not been a fall in exports during the period. Fall in exports, in turn, probably owed substantially to the severe power shortages and unstable security situation, which further aggravated the impact of slowing demand in Pakistan's major export markets.

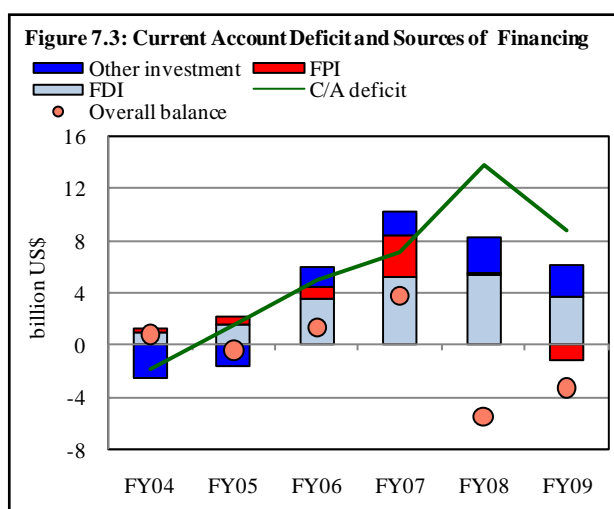


Table 7.2: Summary of External Accounts

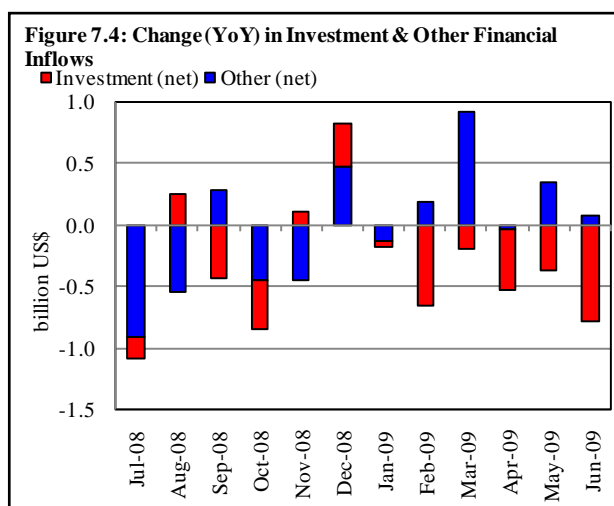
	Jul-Jun		Nov-Jun	
	FY08	FY09	FY08	FY09
A-C/A balance	-13.9	-8.9	-10.9	-2.5
i) Trade balance	-15.0	-12.5	-11.7	-6.2
Exports	20.4	19.2	14.2	12.1
YoY growth (%)	18.2	-6.0	20.1	-14.9
Imports	35.4	31.7	25.9	18.2
YoY growth (%)	31.2	-10.5	44.8	-29.4
ii) Invisible balance	1.1	3.6	0.8	3.7
Remittances	6.4	7.8	4.4	5.5
B-Financial/capital balance	8.3	5.6	4.5	4.1
i) FDI	5.4	3.7	3.8	2.4
ii) FPI	0.0	-1.1	-0.3	-0.9
iii) Other investment	2.8	2.6	0.9	2.3
C-Errors & omissions	0.1	0.0	0.6	0.1
D-Overall balance	-5.5	-3.3	-5.8	1.8

Table 7.3: Factors Behind Recent Improvement in External Accounts

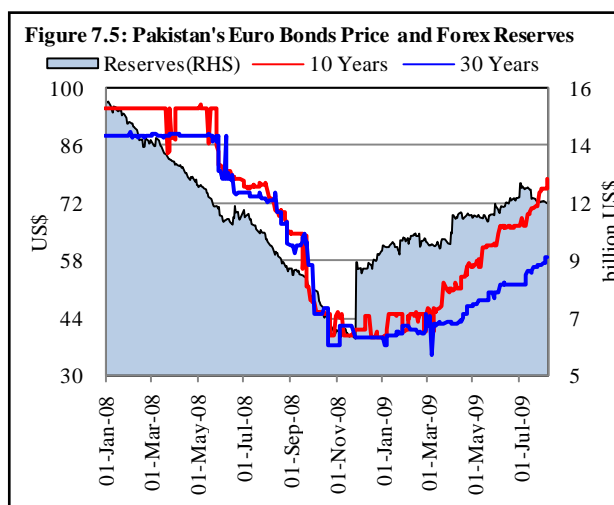
	FY07	FY08	FY09
Private sector credit growth	15.4	22.4	2.3
Petroleum imports unit value (US\$/MT)	437.1	616.0	513.6
Wheat import unit value (US\$/MT)	305.4	472.5	331.9
Palm oil import unit value (US\$/MT)	521.3	916.5	783.9
Pak GDP growth	6.8	4.1	2.0
PKR/US\$ app(+)/dep(-)	-0.3	-11.5	-16.1
Rice production (million ton)	5.4	5.6	7.0

² For detail, see State Bank of Pakistan First Quarterly Report on "the State of Pakistan Economy" for FY09.

Financing of the current account deficit was also challenging in FY09. As in the previous year, the surplus in financial account declined during FY09 compared with the previous year. This fall largely owed to considerable decrease in investment inflows (51.0 percent) during the period, as global financial crises worsened and country's risk premium increased owing to heightened security concerns. In fact, even the surplus in the financial account was essentially due to a recovery in *other investment inflows* (which mainly consist of loans) reflecting the availability of IMF support for macroeconomic stabilization program. Foreign investment inflows actually remained depressed almost throughout the year (see **Figure 7.4**).



As a result of recovery of loan inflows and substantial reduction in current account deficit, overall external account turned to surplus in H2-FY09. This also helped SBP build up foreign exchange reserves which had dropped to US\$ 6.7 billion in October FY09 back to almost end June FY08 level of US\$ 11.4 billion. As a result, exchange rate also became relatively stable; despite shifting of oil payment to the interbank forex market and payment of Eurobond of US\$ 500 million in Feb 2009. This improvement was also reflected in recovery of Pakistan's euro bond price in the international market and upgrading of Pakistan sovereign rating by international credit rating agencies (see **Figure 7.5**).³



Environment Likely to Remain Challenging in FY10

As mentioned earlier, sharp fall in current account deficit was the driving force behind improvement in overall external account in FY09. However, maintaining the contraction in current account deficit would be challenging going forward. For instance, a large part of fall in current account deficit was being contributed by import compression which is now vulnerable to (a) recovery of commodity prices in international market, (b) revival of the domestic economic activity and, (c) higher oil import on the back of rental and other power projects and relative ease of circular debt issue. Likewise, notwithstanding strong growth in initial months of FY10, there is risk that the strong rise in remittances may not be sustained at the same levels. More than 80 percent of the increase in remittances during FY09 stemmed from the Gulf region, where economic activity has slowed. Besides this, there is also risk attached with receipts against logistic support on account of their erratic behavior in the past. Moreover, other key indicators for the medium to long term current account sustainability are also showing signs of weakness (see **Box 7.1**).

³ In August 2009, Standard & Poor's upgraded Pakistan sovereign rating from CCC⁺ to B⁻ while Moody's changed Pakistan's economic outlook from negative to stable.

Box 7.1: Current Account Sustainability

Large and persistent current account deficit is always a cause of concern as it may threaten external viability by leading to exchange rate or foreign debt crises. In this regard, there is no simple rule to decide whether current account deficit is sustainable or not. However, various authors have identified a number of indicators which help in assessing the current account sustainability. This note illustrates some of these important indicators.

Saving and investment ratio

In the light of twin deficit identity, current account deficit can emerge from either a fall in saving or increase in investment. Current account deficit is less worrisome when it is used to finance investment rather than consumption (lower saving). Higher investment enhances the productive capacity of the economy which can be used to service the foreign debt. Moreover, current account deficit caused by the large and persistent structural fiscal deficit (public saving investment gap) is more dangerous than one caused by private saving investment gap as it may result in unsustainable build up of external debt whereas decrease in private saving is temporary. Expectations of high GDP growth may lead people to increase their current consumption temporarily; but the savings rate generally recovers in future once the increase in income is realized.

Growth rate of output

In rapidly growing economies, widening current account deficit is less problematic. As higher growth rate make the country more reliable to service its external debt. From Folkerts-Landau, (2000) perspective, country can generate current account deficit while maintaining stable ratio of net foreign liabilities to GDP. To maintain this ratio constant, GDP growth rate should be proportional to accumulation of net foreign liabilities.

Openness-ratio of export to GDP

Ability of a country to sustain current account deficit also weakens with a narrow export base. It is relatively easy for a country to service its debt with higher export to GDP ratio.

Composition and size of capital flows

Current account deficit financed from foreign direct investment and official creditors is more sustainable than those financed from portfolio and short term private inflows which are vulnerable to changes in market conditions. Moreover, maturity structure, currency composition and interest rate structure of the debt also matter in the sustainability of current account

Table 7.1.1: Key Indicators of Current Account Sustainability

(percent of GDP)

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09p
National saving	18.6	20.8	17.9	17.5	17.7	17.4	13.4	14.3
Total investment	16.8	16.9	16.6	19.1	22.1	22.5	22.0	19.7
Saving-investment gap	1.9	3.8	1.3	-1.6	-4.4	-5.1	-8.6	-5.4
GDP growth	3.1	4.7	7.5	9.0	5.8	6.8	4.1	2.0
Exports	12.6	13.1	12.7	13.2	13.0	12.1	12.4	11.5
Exchange rate (PKR/USD)**	60.0	57.8	58.2	59.7	60.2	60.4	68.3	81.4
Fiscal deficit	-4.3	-3.6	-2.4	-3.3	-4.3	-4.4	-7.6	-4.4
External debt & liabilities	50.4	42.6	36.0	32.7	29.2	28.3	28.2	30.1
Net foreign liabilities*	-	-	27.1	25.4	22.9	24.8	30.9	42.1

* Calendar Year while the GDP is of fiscal year

** end-period

p provisional

deficit. For instance, short term maturities and variable interest rates are vulnerable to various shocks and make the current account deficit less sustainable.

Exchange rate flexibility and policy

Sustainability of current account deficit also depends on the degree of flexibility of exchange rate. The deficit is more sustainable in the countries where exchange rate adjusts to new fundamentals in case of external shocks. On the other hand, rigid exchange rate regimes usually lead to speculative attacks that precipitate external crisis.

It is generally believed that close attention should be paid to any current account deficit in excess of 5 percent of GDP, particularly if it is financed in a way that can cause reversal (Edwards, 2000).

In case of Pakistan, most of these indicators are showing signs of weakness. For instance, in last eight year, compared to size of economy exports are lowest while savings are only second to lowest in FY09 (see **Table 7.1.1**). Similarly, investment and external debt indicators have also deteriorated in FY09. Further, current account deficit is still above the threshold level of 5.0 percent of GDP which need close monitoring.

References

- Edwards, S, (2000), “Does the Current Account Matter?” Draft for presentation at the NBER’s Conference on Crises Prevention, Florida, January 2001. National Bureau of Economic Research, November, 2000.
- Folkerts-Landau, D, (2000), “Latin America-Current Accounts: Can they Achieve Sustainability?”
- Milesi-Ferritti, G.M and A. Razin, (1996), *Current Account Sustainability*, Princeton Studies in International Finance, No 81, October 1996.
- Roubini, N, and P. Watchel, (1997), *Current Account Sustainability in Transition Economies*, Paper presented at the Third Dubrovnik Conference on Transition Economies, Dubrovnik, Croatia, June 1997.

Likewise, investment inflows are subjected to large risks as Pakistan’s sovereign credit risk is still considerably high and prospects for world investment remain uncertain. For instance, UNCTAD recent survey on world investment prospects for 2009-2011 indicates that foreign direct investment would fall in 2009 before moderately recovering in 2010 and gaining momentum in 2011 (see **Box 7.2**). Moreover, mode of foreign direct investment is changing from equity investment to non-equity investment.⁴ In this perspective, revival of foreign direct investment in Pakistan would be difficult in the year ahead.

Box 7.2: World Investment Prospects Survey 2009-2011

The ongoing economic and financial crisis is affecting major Transnational Corporations (TNCs) decision to expand and invest abroad. In particular, TNCs faltering profits, reduced access to financial resources, declining market opportunities and risk of possible worsening of current economic crises are major causes of concerns. To assess the effect of these crises on international investment strategies of major companies, United Nations Conference on Trade and Development (UNCTAD) has conducted a survey by questioning the TNCs executives. This note briefly describes the main finding of the survey.

The survey results show that companies expect a sharp decline in FDI expenditure in 2009 on the back of ongoing economic

Table 7.2.1: Summary of Survey Results

(percent of responses)

Global prospects (% of respondents)

Global prospects (% of respondents)					
FDI growth prospects (compared with 2008)	Increase		Remain the same		Decrease
2009	22		20		58
2010	33		26		41
2011	50		31		19
Impact of the economic and financial crisis on FDI plans	Negative		No impact		Positive
Global economic downturn	85		13		2
Financial crisis and credit crunch	79		18		3
Exchange rate fluctuations	48		38		14
State intervention in the financial sector	14		70		16
Major risk factors for global FDI flows, 2009–2011	Very unlikely	Unlikely	Neutral	Likely	Very likely
Exchange rate fluctuation	1	4	20	54	23
Worsening of the global economic downturn	1	15	28	39	17
Volatility of petroleum and raw material prices	2	10	23	53	13
Volatility of prices in general (inflation or deflation)	3	11	27	49	10
Increased financial instability	1	18	32	40	10
Growing protectionism and changes in investment regimes	5	12	22	53	9
Environmental crisis (e.g. climate change)	13	27	32	23	6
War and political instability	19	31	31	16	4
Threats to personal and business safety (e.g. terrorism, crime)	13	32	31	21	4
Food crisis (e.g. shortage in supplies, retail price volatility)	13	30	36	18	3

United Nations Conference on Trade and Development

⁴ In case of Pakistan, equity is the main mode of foreign direct investment.

and financial crises and major uncertainties about its evolution in the short run. Specifically, looming risks that could affect the companies' FDI plans are (a) deepening of global recession, (b) increase in financial instability, (c) rise in protectionism and, (d) exchange rate instability. However, there is possibility of moderate recovery in FDI expenditure in 2010 which may gain momentum in 2011. Indeed, half of the respondents expect their FDI expenditure to be higher in 2011 compared with 2008. Nonetheless, it can be observed from the **Table 7.2.1** that there is still substantive downside risk to this outlook.

The survey also found that the TNCs are more cautious about equity investment such as merger & acquisition and greenfield projects. They have more tendencies to non-equity entry modes e.g licensing and partnership to cut their costs and expenditures. Thus this mode could be the major contributory factor behind expected revival of FDI from 2010 onward.

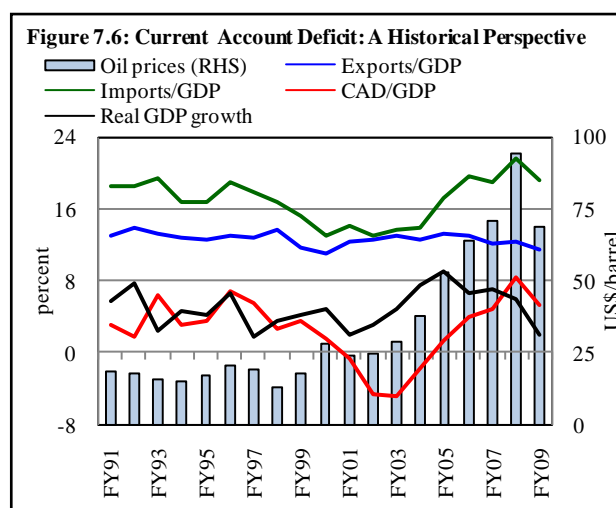
Moreover, maturing Sukuk bond (worth US\$ 600 million) in January 2010 would put additional pressure on net investment flows. Thus Pakistan would have to rely on debt creating flows⁵ to finance the current account deficit, realization of which is not only uncertain (particularly bilateral loans like FODP), but they also do not bode well for external account sustainability in the medium to long term.

In this backdrop, efforts for greater saving mobilization and increasing merchandize exports by addressing the structural problems would be pivotal in reducing the current account deficit on a sustainable basis. Likewise, services exports can also be enhanced by addressing the problem like unskilled labor, and lack of information technology parks etc (see **services section**). Similarly, steps to divert remittances from informal to formal channel may also address the downside risk to remittances growth (see **Box 7.3**). In this regard, recently launched Pakistan Remittance Initiative (PRI) is a step in right direction (see **Box 7.4**). On the financing side, foreign direct investment needs to be promoted by (a) improving infrastructure, (b) addressing bureaucratic delays, (c) enforcement of the intellectual property rights and, (d) improving law and order situation.

7.2.1 Current Account Balance

In sharp contrast to extraordinary expansion of the current account deficit in FY08, when it had more than doubled over the previous year, in FY09 the current account deficit contracted by 36.1 percent. In absolute terms, the deficit has come down to US\$ 8.9 billion in FY09 from the historic high level of US\$ 13.9 billion last year.

With around 40 percent share in overall transactions of the current account, the sharp fall in imports was the main driving force behind improvement in current account during the period. This is also in line with the historical trend which shows that current account and imports are highly correlated (see **Figure 7.6**).⁶



The import-led contraction of the current account was complemented by a strong increase in remittances during the financial year. Moreover, relatively higher receipts against logistic support and lower payments on account of import freights and travel also contributed positively to contraction in current account deficit during the period (see **Table 7.4**).

⁵ Augmentation of access under IMF Stand By Arrangement (SBA) and pledged support under Tokyo conference are likely to be used to finance the current account deficit.

⁶ Specifically, past thirty years (1980-2009) data shows that negative correlation between current account balance and an import is not only high but is also statistically significant.

However, some of these gains were offset by fall in exports and expansion in income account deficit during the period. In particular, the aforementioned losses roughly equal to gains from contraction in services trade. As a result, decline in current account deficit was almost equivalent to fall in imports and increase in remittances during the period (see **Figure 7.7**).

Trade Balance⁷

Steeper fall in imports compared to exports led to contraction (16.8 percent) in trade deficit during FY09. This was in sharp contrast to extraordinary expansion of 54.2 percent in trade deficit previous year when extraordinary import growth outstripped even the healthier rise in exports.

During FY09, exports declined by 6.0 percent against commendable increase of 18.2 percent in the previous year. A large part of this fall stemmed from contraction in textile exports amid shrinking external demand due to global crises and severe domestic power shortages. However, strong increase in rice and cement exports moderated the overall fall in exports during the period. The increase in the former was principally driven by bumper rice crop while the increase in latter mainly stemmed from strong demand from Middle East and some African countries.

More than two-third of the 10.5 percent contraction in imports during FY09, on the other hand, was due to lower petroleum group, telecom group and raw cotton imports. Fall in petroleum group, in turn, was largely (95 percent) caused by fall in oil prices while lower telecom group imports mainly owed to imposition of custom duty on cellular phones and increase in GST on the telecom sector. Likewise, lower raw cotton imports largely reflected better domestic cotton crop and lower domestic demand.

Services Account

Unlike extraordinary expansion of 54.8 percent last year, deficit in services trade contracted by 49.2 percent during FY09. Although a large

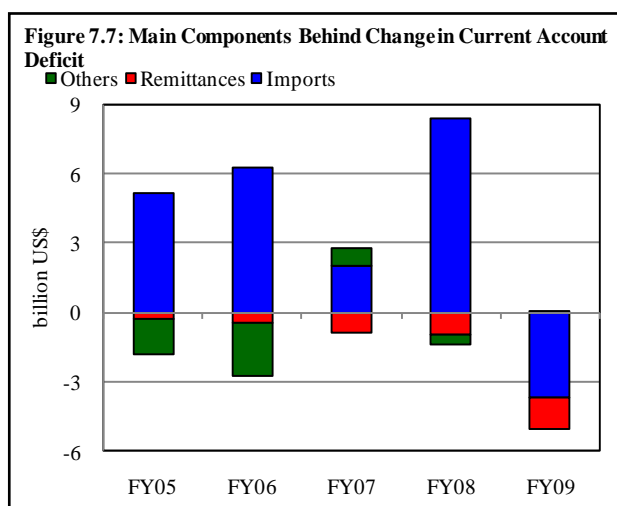


Table 7.4: Major Services Exports and Imports
million US Dollar

	FY08		FY09		Abs. YoY change
	Value	Share	Value	Share	
Exports					
Transportation	1,035	28.8	1,283	31.7	248
Travel	264	7.4	222	5.5	-42
Communication	117	3.3	196	4.8	79
Computer & information	154	4.3	184	4.6	30
Government services	1,380	38.5	1,523	37.7	143
<i>of which logistic support</i>	655	18.3	912	22.6	257
Other	639	17.8	635	15.7	-4
Total	3,589	100.0	4,043	100.0	454
Imports					
Transportation	3,785	37.7	3,524	48.1	-261
<i>of which freight</i>	2,959	29.5	2,676	36.5	-283
Travel	1,578	15.7	997	13.6	-581
<i>of which exchange companies</i>	1,297	12.9	685	9.4	-612
Other business services	3,432	34.2	1,632	22.3	-1800
<i>of which exchange companies</i>	2,504	24.9	530	7.2	-1,974
Others	1,251	12.5	1,172	16.0	-79
<i>Total</i>	10,046	100.0	7,325	100.0	-2,721
Services net	6,457		3,282		-3,175

⁷ This section is based on the exchange record data compiled by SBP that does not tally with the custom data compiled by FBS data analyzed in Trade Account section.

part (85.7 percent) of this improvement stemmed from fall in imports, respectable growth in services exports also contributed positively.

Services exports increased by 12.8 percent during FY09 against 13.3 percent fall during the last year. Increase in transportation and logistic support were the major contributory factors behind this performance.

Fall in services imports largely reflected (a) fall in freight charges on account of lower merchandise imports and, (b) fall in travel and other business services imports mainly because of substantial fall in outflows from foreign exchange companies (for detail see **section on Services**).

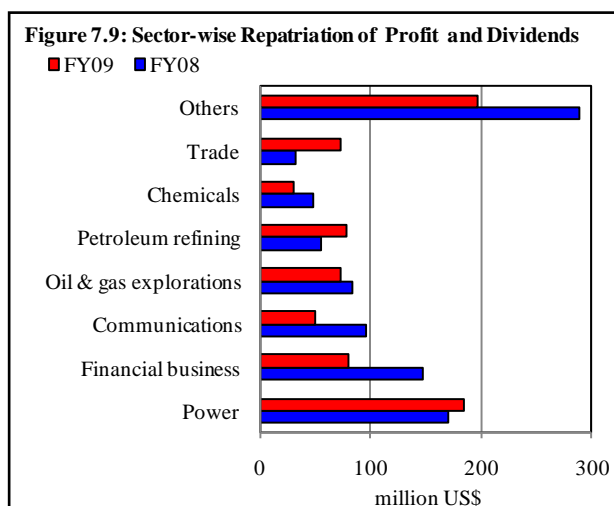
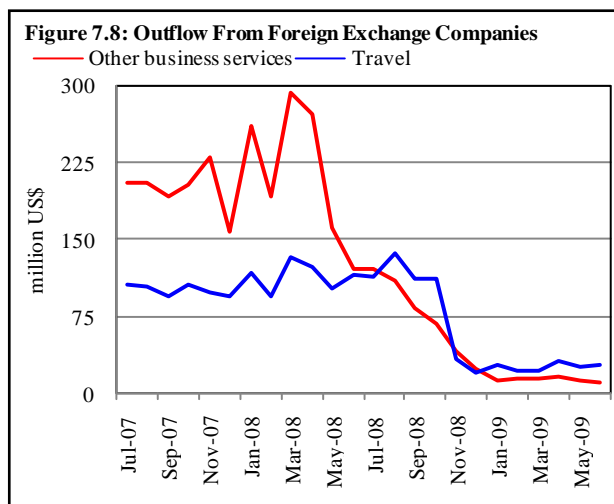
It may be pointed out that outflow from exchange companies for other business services fell considerably since May 2008, when the central bank linked overall outflows to 75 percent of the home remittances collected by the exchange company in the preceding month (see **Figure 7.8**).⁸ Moreover, tight monitoring of exchange companies outflows also led to noticeable decline in exchange companies outflow (particularly for travel) from November 2008 onward.

Income (net)

Income account deficit increased by 10.9 percent in FY09 on the top of 9.4 percent rise last year. With only marginal increase in net investment income outflow, this deterioration mainly stemmed from increase in net interest payments.

Increase in investment income net outflow decelerated to 0.9 percent during FY09 from 7.4 percent last year. This deceleration mainly resulted from lower repatriation of profit & dividends in FY09 compared to last year. Close to three-fourths of this decline was driven by financial business and communication. Profits of the former was mainly hit by the slowdown in economy and rise in non-performing loans while the latter was adversely affected by fall in PTCL's profit owing to its Voluntary Separation Scheme.⁹ While a part of this lower repatriation owed to lower corporate profitability, considerable depreciation of exchange rate also contributed to this fall.¹⁰

The sectors which witnessed increase in repatriation of profit and dividends during FY09 included power, petroleum refining and trade. This mainly reflects higher profit of oil marketing and



⁸ For detail see FE circular No. 04 of 2008, dated May 09, 2008.

⁹ The repatriation of profit & dividends by PTCL declined to US\$ 1.1 million in FY09 from US\$ 48.2 million last year.

¹⁰ Earnings of most of these companies are in Pak rupee, while repatriation is in dollars.

Table 7.5: Current Account Balance

million US Dollar

	FY08	FY09^P	Absolute change
1. Trade balance	-1,4970	-12456	2514
Exports	20,427	19,212	-1216
Imports	35,397	31,668	-3729
2.Services (net)	-6,457	-3,282	3175
Transportation	-2750	-2241	509
Travel	-1314	-775	539
Communication services	10	52	42
Construction services	-19	-50	-31
Insurance services	-98	-71	27
Financial services	-141	-105	36
Computer & information services	25	62	37
Royalties and license fees	-79	-82	-3
Other business services	-2,982	-1,164	1,818
Personal & cultural & recreational services	2	0	-2
Government services	889	1,092	203
of which: Logistic support	655	912	257
3. Income (net)	-3,918	-4,337	-419
Investment income(net)	-3,928	-4,351	-423
Direct investment	-3,065	-3,153	-88
of which: Profit & dividends	-672	-569	103
Purchase of crude oil and minerals	-1,458	-1,669	-211
Portfolio investment	-319	-400	-81
of which: Dividend	-249	-171	78
IMF charges & interest on off. external debt	-780	-746	34
Interest on private external debt	-184	-108	76
Interest on reserves	479	82	-397
Others (net)	-49	-12	37
4. Current transfers (net)	11,476	11,215	-261
Private transfers	11,048	11,043	-5
Workers' remittances	6,449	7,811	1,362
FCA - residents	444	-248	-692
Others	4,153	3,480	-673
of which: Exchange companies	2,222	247	-1,975
Official transfers	428	171	-257
Current account balance	-13,869	-8,861	5,008

* Provisional

petroleum refining companies on account of inventory gains (high oil prices) in FY08. As they announced their results by the end of the last fiscal year, the payments fell in FY09. Some of these companies included Shell Pakistan limited, Pak-Arab Refinery Ltd and Pakistan Petroleum Ltd.

Higher net interest payments, on the other hand, were driven by sharp fall in earnings on foreign exchange reserves as gross interest payment were lower in FY09 compared with the last year (see **Table 7.6**). In particular, interest earnings on foreign exchange reserves in FY09 were the lowest in the last nine years which more than offset the fall in gross interest payments. Lower gross interest payments, in turn, were contributed by both government and private interest payments. However,

interest on IDB and IMF loans increased during FY09 on account of higher debt. Going ahead, interest payments would increase in the wake of increased IMF loans.¹¹

Current Transfers

During FY09, current transfers declined by 2.3 percent against a respectable growth of 8.4 percent during the previous year. With only a marginal decline in private transfers, this decline mainly owed to fall in official transfers on account of lower budgetary support receipts during the period.

Nominal fall (US\$ 5 million) in private transfers during FY09, on the other hand, mainly resulted from lower other private transfers and outflow from resident foreign currency accounts, whereas workers' remittances recorded robust increase during the period. The entire decline in other private transfers, in turn, was caused by fall in foreign exchange companies inflows during the period under review.

It may be mentioned here that other transfers through exchange companies continuously declined since May 2008, when SBP linked exchange companies outflow to home remittances, and reached zero in December 2009 onward (see **Figure 7.10**). In fact, after adjusting for the aforementioned inflows of exchange companies,¹² overall current transfers increased by 18.5 percent during the period.

Workers' Remittances

Continuing the last four year trend, workers' remittances recorded impressive growth in FY09 (see **Figure 7.11**). Specifically, workers' remittances grew by 21.1 percent in FY09 on the top of 14.0 percent average growth during the last four years.

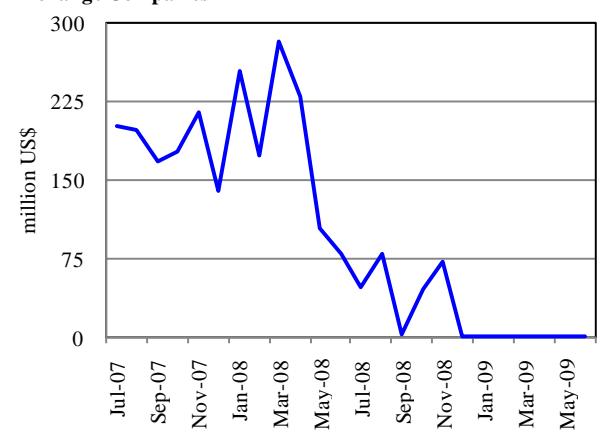
Unlike the previous four years, however, when higher inflows through exchange companies contributed around 60 percent of the average growth, remittances growth in FY09 was mainly (more than 60 percent) explained by higher inflows through banks. Monthly data on remittances suggests that this change from previous four year trend was more pronounced from November FY09 onward i.e after FIA crackdown against undocumented fund transfer (see **Figure 7.12**).¹³

Table 7.6: Details of Interest Payments and Receipts
million US Dollar

	FY07	FY08	FY09
Payments (I+II)	1,236	1,414	1,231
I. Total external debt	1,017	1,156	1,032
Public & publicly guaranteed	840	954	872
Long-term	666	737	655
Military	8	4	2
Euro bonds	145	192	178
Commercial loans/credits	11	10	7
IDB	10	11	30
Private loans/credits	154	184	108
IMF	23	18	52
II. External liabilities	219	258	199
Foreign currency deposits	33	56	57
Special US\$ bonds	13	8	5
Central bank deposits	27	30	15
Others	146	164	122
Receipts	526	643	216
Interest on reserves	410	479	82
Others	116	164	134
Net	-710	-771	-1,015

Source: State Bank of Pakistan

Figure 7.10: Other Current Transfers Through Foreign Exchange Companies



¹¹ In SDR terms, debt servicing on IMF debt would increase from 46.9 million in FY09 to 88.2 million in FY10 and would peak at 186 million in FY12 before falling in FY13 onward.

¹² These inflows continuously declined since May FY08, when SBP linked exchange companies outflow to home remittances, and reached zero in December FY09 onward.

¹³ During Nov-June FY09, close to three fourth of total YoY increase (25.1 percent) in remittances was explained by banks.

Country-wise data suggests that higher inflows through banks from November FY09 onward were largely sourced from United Arab Emirates (UAE) and Kingdom of Saudi Arabia (KSA). While the former witnessed marked upward shift, higher inflows in the latter appear to be a trend increase. In particular, monthly average remittances inflows from UAE increased by 90.4 percent during Nov-June FY09 compared with the same period of last year (see **Table 7.7**). At least a part of this increase could be attributed to possible diversion of undocumented fund transfer to documented channel as this increase coincided with the Federal

Investigation Agency (FIA) action against undocumented fund transfer. Likewise, job losses and consequent shifting of migrants to Pakistan along with their savings and possible reverse capital flight in the wake of collapse in booming real estate business in the neighboring country may be the other probable factors behind increase in remittances inflows from UAE.

Country wise data on exchange companies, on the other hand, suggests that remittances inflows became almost stagnant at lower level after continuously increasing till September FY09. With around 50 percent share in overall inflows, fall in remittances from US was the major reason behind this weakening trend (see **Figure 7.13**). This fall also coincided with the action against Khanani and Kalia, which may imply that migrants might have withheld their fund transfers for the time being in anticipation of further action against other exchange companies.¹⁴ Encouragingly, month over month change shows some signs of recovery in remittances during the last quarter of FY09. Moreover, shrinking US job market and workers' unwillingness to return home on account of the difficulties in reentering the market may also have decelerated the remittances inflow from US. Unlike US, remittances inflows sourced from UK have increased considerably in the post October FY09 period. Data suggests that a large part of this increase took place through Dollar East Exchange Company (Pvt.) Ltd.

Figure 7.11: Contribution in Remittances Growth

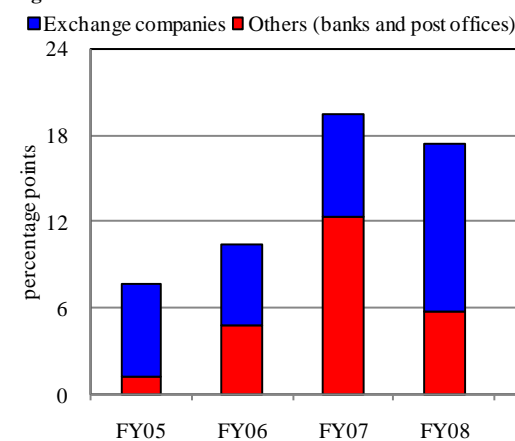


Figure 7.12: Contribution in Remittances Growth (YoY)

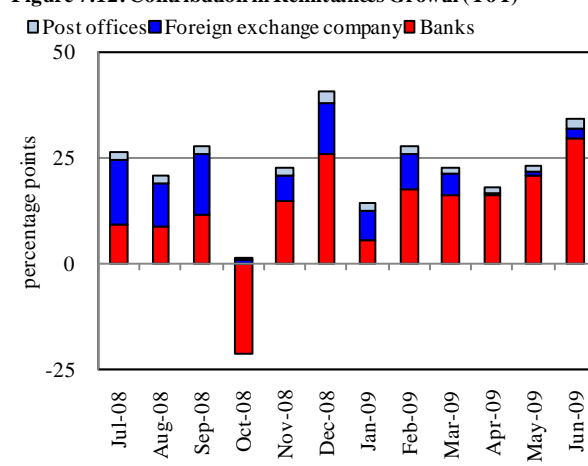
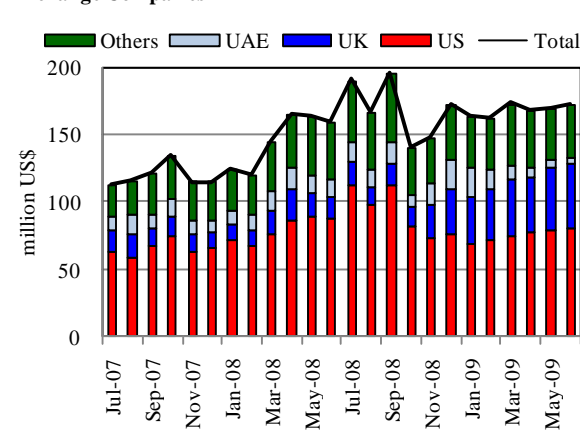


Figure 7.13: Country-wise Remittances Inflows Through Foreign Exchange Companies



¹⁴ During Jul-Oct FY09, Khanani and Kalia accounted for 17.0 percent of the overall exchange companies' inflows from US.

Table 7.7: Monthly Average of Workers' Remittances
million US Dollar

	FY08				FY09			
	Jul-Sep	Oct	Nov-June	Jul-June	Jul-Sep	Oct	Nov-June	Jul-June
Total								
Banks	370.6	429.2	390.7	388.9	420.0	306.7	490.0	457.2
FECs*	116.7	134.6	138.1	132.5	184.1	140.0	165.9	168.3
Post offices	12.9	16.4	17.2	16.1	22.5	19.4	27.2	25.4
Total	500.2	580.2	546.0	537.4	626.6	466.1	683.1	650.9
US								
Banks	77.7	95.4	70.3	74.2	59.1	44.9	63.7	61.0
FECs*	62.6	74.5	76.1	72.6	107.4	82.3	75.0	83.7
Total	140.3	169.9	146.4	146.8	166.6	127.3	138.6	144.7
UAE								
Banks	63.0	78.1	76.2	73.1	83.0	60.3	139.1	118.5
FECs*	11.9	13.9	12.5	12.4	14.4	9.6	12.6	12.8
Post offices	4.2	5.4	5.8	5.4	6.7	6.1	10.9	9.4
Total	79.1	97.4	94.4	90.9	104.1	75.9	162.6	140.7
UK								
Banks	24.3	30.7	21.8	23.2	23.5	17.6	18.2	19.5
FECs*	15.7	13.9	15.0	15.1	16.0	13.6	38.8	31.0
Total	40.0	44.6	36.8	38.2	39.5	31.2	57.0	50.5
KSA								
Banks	88.3	84.1	93.3	91.3	112.0	80.1	111.7	109.1
FECs*	5.0	5.7	7.9	7.0	11.7	9.4	12.3	11.9
Post offices	5.1	6.2	6.3	6.0	9.0	7.3	9.2	9.0
Total	98.3	95.9	107.6	104.3	132.7	96.8	133.1	130.0

* Foreign Exchange Companies

As a result its share in overall remittances from UK increased from around 11.0 percent in October FY09 to 61.8 percent in June FY09. Anecdotal evidence suggests that this company has captured the share of Khanani & Kalia which accounted for more than 50 percent of the remittances from the country in October FY09.

On the aggregate basis, a large part of the remittances growth in FY09 was contributed by Gulf region (in particular UAE) and United Kingdom. This is unlike the previous year, when United States was the largest contributor in remittances growth (see **Table 7.8**).

Table 7.8: Country-wise Remittances Analysis

	Values (billion US Dollar)		Contribution in growth (%)	
	FY08	FY09	FY08	FY09
USA	1.76	1.74	5.50	-0.41
U.K.	0.46	0.61	0.52	2.27
Saudi Arabia	1.25	1.56	4.15	4.78
UAE	1.09	1.69	4.07	9.27
Other GCC	0.98	1.20	4.11	3.40
EU countries	0.18	0.25	0.50	1.10
Others	0.73	0.77	-1.44	0.66
Total	6.45	7.81	17.43	21.08

Resident FCAs

During FY09, RFCAs recorded a net outflow of US\$ 248 million against net inflow of US\$ 444 million during the last year. This entire decline was recorded in the initial four months of FY09, as RFCAs recorded increase of US\$ 68 million in the ensuing months (Nov-June). This fall mainly resulted from non-institutional withdrawal during October FY09 amid sharp depreciation in exchange rate and rumors of possible freezing of foreign currency accounts. However, with the stability in exchange rate in subsequent months (Nov-June), RFCAs recovered some of the losses suffered during

Jul-October FY09 (see **Table 7.9**).¹⁵ This recovery was absolutely driven by increase in non dollar denominated currencies, which together constitute close to one fourth of the overall resident foreign currency accounts. In fact, part of the increase in non dollar denominated RFCAs was offset by appreciation of US\$ against Euro and Pound during the period.¹⁶ Had US dollar against Euro and Pound been constant at end June FY08 period, recovery in RFCAs would have been relatively higher.

Box 7.3: Measures Needed To Divert Remittances to Formal Channel

Workers' remittances have become an increasingly important source of external financing for many developing countries. Pakistan has also witnessed sharp increase in remittances in the recent years (see **Figure 7.3.1**). In particular, Pakistan workers' remittances have increased from around US\$ 1.0 billion during FY01 to US\$ 7.8 billion in FY09.

Notwithstanding this strong increase in remittances, there are evidences that a considerable part of remittances in developing countries continue to be routed through informal channel. For instance, World Bank estimates suggest that flow through informal channel may conservatively add 50 percent of the officially recorded remittances. Usually, informal channels operate in countries where flows are not attractive to banks because of their small amount, where technology is still inaccessible to persons and businesses, or where consumers have greater trust and preference for person-to person delivery. Moreover, lower transaction fee, high speedy service and availability of better service to both the sender and recipient are other factors which promote Informal Value Transfer System (IVTS).

Most of the abovementioned factors fit in Pakistan's case. For instance speed of transferring money through banks from three major destinations is 2-5 days which is substantially higher than less than one hour speed of Money Transfer Operators (MTOs) (see **Table 7.3.1**). As a result, remittances statistics are still known to be underreported due to the presence of Hundi/Hawala channel. Anecdotal evidence suggests that unrecorded remittances are roughly close to officially recorded remittances.

Since unrecorded inflow may add substantially to recorded flows, efforts must be made to divert these flows to formal channel. In this regard, technological improvement, market development and learning by successful practices of other countries (see **Table 7.3.2**) can be of great help.

Particularly, following measures are important to encourage remittances through formal channel:

Table 7.9: Currency wise Composition of RFCAs

Unit of currency, million					
	US dollar	Euro	Pound	Yen	
End FY08	2,874.5	307.5	226.5	224.9	
End Oct-FY09	2,747.8	288.4	231.3	180.6	
End FY09	2,656.1	308.3	278.9	1,054.3	
Equivalent US dollar					
	US dollar	Euro	Pound	Yen	Total
End FY08	2,874.5	485.4	451.4	2.1	3,813.3
End Oct-FY09	2,747.8	369.9	378.2	1.8	3,497.7
End FY09	2,656.1	435.0	463.7	11.0	3,565.7
After adjusting for exchange rate changes (US\$ versus Euro, Pound and Yen)					
	US dollar	Euro	Pound	Yen	Total
End FY08	2,874.5	485.4	451.4	2.1	3,813.3
End Oct-FY09	2,747.8	455.1	460.9	1.7	3,665.6
End FY09	2,656.1	486.5	555.7	9.9	3,708.3

Source: SBP

Figure 7.3.1: Workers' Remittances

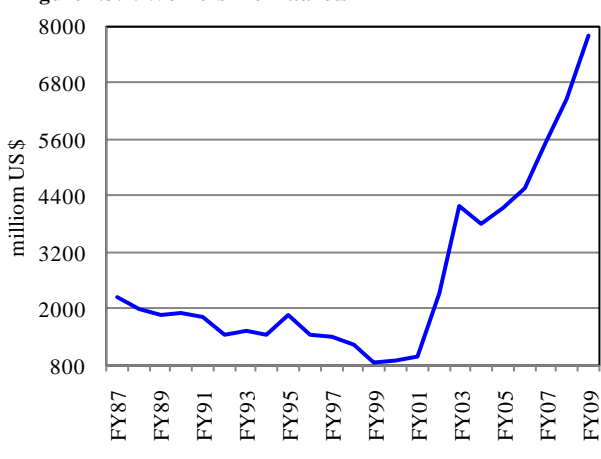


Table 7.3.1: Cost Structure of Remittance Flows

Country	Banks Fee		MTO's Fee		Transfer speed (days)	MTO
	US\$200	US\$500	US\$200	US\$500		
U.S.A.	23.9	29.75	17.94	33.05	3-5	<1 hour
KSA	3.4	3.85	6.58	7.8	3-5	<1 hour
U.K.	4.94	12.35	14.52	21.85	2	<1 hour

Source: www.remittanceprices.worldbank.org

¹⁵ During Nov-June FY09, RFCAs increased by US\$ 68 million, thereby offsetting part of the total loss of US\$ 315 million suffered during Jul-Oct FY09.

¹⁶ During FY09, US dollar appreciated by 10.6 percent against Euro and 16.6 percent against Pound.

- The legal status of migrant workers sending the remittances is not always regularized. Banks are reluctant to enter the financial service market for migrant whose status is not regularized. To shift the flow of undocumented migrants' worker remittances through formal channel, bilateral dialogue and cooperation with the sending countries authorities is needed to resolve the legal issues faced by migrants to open the bank account in host countries. A case in point is Mexico where undocumented workers can open account in US-based commercial banks using identification cards issued by Mexican consulates. This has allowed them to send money home through formal channels of money transfers.
- Lack of competitiveness in banking sector for remittances transaction services and limited number of bank branches in the remote areas. For instance, three largest banks in Pakistan transact more than 70 percent of the total remittances. To expand the commercial bank's branch network, especially in rural areas, one approach is to establish partnership between leading banks and government post offices for cost effective and speedy transfer of workers' remittances.

Box 7.3.1: Practices Followed by Other Countries

In Philippines, remittances can be done through phone, online and via text. The banks have invested extensively in the latest technology in web, online and phone security.

Phone Remittance

It is done through debit card of the remitter. Remittances over the phone take about 2 minutes. Calls are recorded for security purposes.

Online Remittance

24 hours 7 days online remittance service is being provided in the comfort of remitter's home. The remitter can track his remittances, print receipt and even change his password.

Text Remittance

It is done by sending an SMS message to the remitting office.

Pre-departure Orientation Program

At the departure of Filipino workers, the training is provided related to

- Awareness of his/her rights.
- Legal framework of the country where the person is going.
- Benefit of the saving and sending remittance to Philippines.
- Guidance towards certain associations working for the welfare of remitters.

These training programs give banks an opportunity to market the outgoing Filipino workers for having his account in their banks and motivate them to remit money back through their branches or subsidiaries.

FedACH International Mexico Service

ACH (Automated Clearing House) is a low-cost payments channel and is already in place in almost every financial institution in the United States. For this reason, there are no setup costs for most banks that choose to offer the program. It uses standardized formats for the payments to be channeled to Mexico in an automated mode and delivered electronically to bank accounts there. Banks that use the service can offer remittances for less than \$5 a transaction.

Computer Kiosk System

ICICI Bank, a private Indian bank, provides "Money2India" service to remote villages of India via computer kiosks. According to this system, a sender remits money to the recipient's ICICI account. As soon as the transactions take place, Money2India agent informs the kiosk, which is equipped with a low-cost ATM. This service is very convenient for rural recipients and provides the local population with electronic access to financial services.

Card-Based Services

Card-based services provide senders and recipients with convenient and affordable remittance products, because they do not require carrying large amount of cash and card holder are able to use card terminals and ATMs. In India, Visa is working on card-account to card-account transfer in Europe and India. Similarly for Mexican migrants, US bank offers Secure Money Transfer at the ATM. The ATM-only card is sent to the recipient in Mexico, who can get funds at any of the 20,000 plus ATM networks in Mexico.

- The information relating to different instruments and products for remitting money is not disseminated for costumers' knowledge. The better dissemination of information regarding fees of each of the different products for remitting money will cause competitive environment in the market. As in the case of Mexico and Sri Lanka,

authorities in both countries play an active role in collecting, comparing and disseminating the cost of the each of the available instrument for sending remittances from the USA and Middle East countries.

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Box 7.4: Pakistan Remittance Initiative

To encourage Pakistan's migrant to use banking channel for home remittances and protect the remitter and beneficiary from any loss, State Bank of Pakistan, Ministry of Finance and Ministry of Overseas Pakistanis have jointly launched Pakistan Remittance Initiative (PRI) on August 22, 2009. The initiative aims to boost and facilitate remittance transactions through fast, transparent, reliable and efficient banking services. There will be an Advisory Group which will, in consultation with other stakeholders, formulate strategy to achieve the following PRI's objectives.

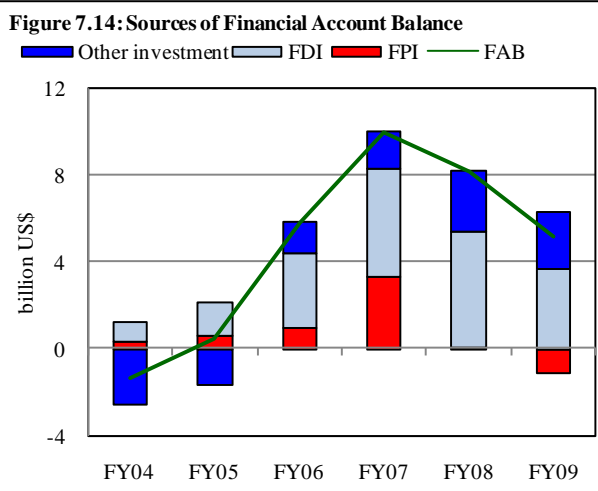
- Automatic delivery of home remittances in beneficiary account/ over the counter system in real time; generating confirmation SMS to remitter and the beneficiary.
- Development of robust and reliable ATM Network to offer an option to beneficiary of home remittances to withdraw cash even after banking hours and holidays.
- Development of integrated and secured payment system infrastructure of Alternate Delivery Channels (ATM POS, IVR, Call Centre, Mobile Banking) offering option to beneficiary of home remittances to make P2P payments, payments at merchant sites, payment of utility bills, fund transfer etc. This would encourage beneficiaries to maintain balance in bank accounts eventually helping increase savings/deposits.
- In this regard, initially five major banks i.e. Allied Bank, Habib Bank, MCB, National Bank of Pakistan and United Bank have been selected. In the first phase, RTGS will enable these banks to transfer interbank transaction into the beneficiary account on same day.

Furthermore, a PRI website and a call centre have also been established to facilitate senders and beneficiaries. To improve the formal channel of remitting money, financial incentives will be given to those overseas financial entities able to mobilize US\$ 100 million remittances in a year. A Complaint Handling Mechanism has been put in place and SBP is also introducing a mechanism for compensation to remittance beneficiaries for delay by the banks.

FE Circular No.04 dated August 22, 2009.
PSD Circular No.02 dated August 22, 2009.

7.2.2: Financial Account

Financial account surplus declined for the second successive year in FY09. The fall in capital inflows was relatively moderate last year as global financial crises was still unfolding, growth prospects were relatively better and the domestic stock market had seen only a small decline. However, as FY09 progressed, the global financial crises intensified, growth prospects weakened, stock



market plunged, security risk heightened and country's credit default risk peaked. Confluence of these factors led to 36.6 percent decline in financial account surplus during FY09 compared to 18.4 percent decline last year.

Unlike the previous year, when the entire decline was caused by fall in portfolio investment, deterioration in FY09 was broad based as foreign direct investment and other investment (which mainly includes loans) also declined (see **Figure 7.14**). Other investment inflows, however, revived after IMF support for macroeconomic stabilization program in November 2008. This support not only helped in increasing loan inflows from other sources but also decelerated the retirement of FE-25 loans significantly by stabilizing exchange rate. Nonetheless, investment inflows remained under pressure throughout the year.

Going forward, financial inflows are likely to remain under pressure as not only investment inflows have limited chances to revive but bilateral loan inflows are also not certain. In particular, most of FODP related bilateral pledges are project loans, disbursement of which would be subject to the progress on the project.

Net Foreign Investment

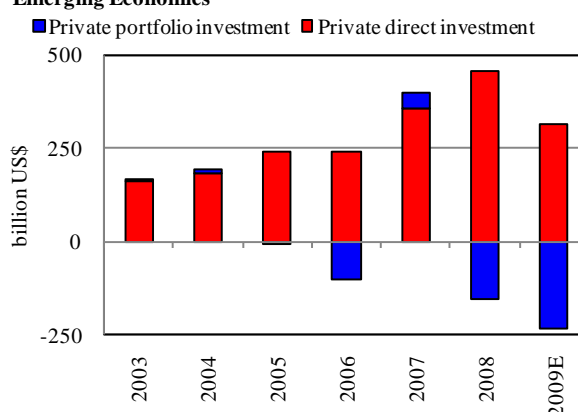
In line with the emerging and developing market trend, net foreign investment to Pakistan continued its declining trend for the second consecutive year (see **Figure 7.15**). This fall in investment inflows mainly owed to worsening financial crises which weakened capacity of the international investors to invest on account of falling corporate profits, heightened risk and reduced access to financial resources. In case of Pakistan, the impact of global financial crises on foreign investment was further compounded by weakening macroeconomic fundamentals and deteriorating law and order situation. As a result, net foreign investment declined by 51.1 percent during FY09 compared with 35.3 percent decline last year (See **Table 7.10**).

It may also be noted that foreign portfolio investment, being volatile in natures, reacted relatively fast to global crises compared with foreign direct investment (see **Figure 7.15**). In absolute terms, during FY09, foreign direct investment shrunk by US\$ 1.7 billion while foreign portfolio investment recorded net outflow of US\$ 1.1 billion.

Foreign Direct Investment

Foreign direct investment declined considerably during FY09, after rising continuously in the last seven years (see **Figure 7.16**). As mentioned earlier, this decline was attributed to both the external and internal factors. On the external front, global financial crisis reduced overall outward foreign

Figure 7.15: Private Investment Flows (net) to Developing and Emerging Economies



Source: IMF; E: estimates

Table 7.10: Net Inflow of Foreign Investment in Pakistan
million US Dollar

	FY08	FY09	Growth (%)
Foreign investment	5,450.2	2,665.4	-51.1
I. Private investment	5,429.4	3,209.5	-40.9
Foreign direct investment	5,410.2	3,719.9	-31.2
of which: Privatization proceeds	133.2	0	-
Portfolio investment	19.3	-510.4	-2751.4
Equity securities	19.3	-409.8	-2228.8
Debt securities	0	-100.0	0
II. Public investment	20.8	-544.1	-2,715.9
of which: Debt securities*	20.8	-544.1	-2,715.9

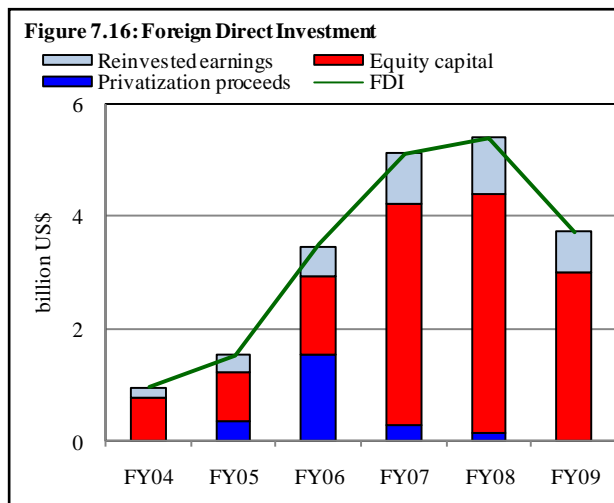
* Net sale/purchase of Special US Dollar Bonds, Eurobonds, FEBC, DBC, T bills and PIBs

direct investment from US and UK while fall in oil prices significantly slowed down foreign investment from UAE during 2008.

As these were the major source countries of foreign direct investment to Pakistan, inflows to it also declined. Indeed, close to 62 percent of the fall in foreign direct investment during FY09 was contributed by decline in inflows from these countries (see **Table 7.11**).

Similarly, on the domestic front, lower corporate profits and weakening growth prospects reduced reinvested earnings during the period (see **Figure 7.16**). Consequently, foreign direct investment declined by 31.2 percent during FY09 against respectable increase of 5.3 percent last year.

Despite deterioration in FY09, however, Pakistan is still well placed compared to other regional countries in terms of Inward FDI Performance Index (see **Box 7.5**). This relatively better ranking is perhaps the reflection of higher FDI in 2006 and 2007 as this index is based on three years average.



Box 7.5: Inward FDI Performance Index

The Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size. It is the ratio of a country's share in global FDI inflows to its share in global GDP. Value greater than one indicates that the country has received more FDI than its relative economic size; a value below one suggests that it received less FDI (a negative value means that foreign investors disinvest in that period).

The index thus captures the influence on FDI of factors other than market size, assuming that, other things being equal, size is the "base line" for attracting investment. These other factors can be diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, opportunities for participating in privatization or the effectiveness of FDI promotion.

$$IND_i = \frac{FDI_i / FDI_w}{GDP_i / GDP_w}$$

Where,

IND_i = The Inward FDI Performance Index of the i^{th} country

FDI_i = The FDI inflows in the i^{th} country

FDI_w = World FDI inflows

GDP_i = GDP in the i^{th} country

GDP_w = World GDP

This measure is widely used to evaluate the performance of a country in receiving FDI. Pakistan scored 1.06 on FDI performance index during CY2008. Although it is less than the previous years' index value but it still indicates that Pakistan is receiving more FDI relative to its economic size. Moreover, Pakistan is ranked highest among the other South Asian countries (see **Table 7.5.1**).

Source: UNCTAD

Table 7.5.1: Inward FDI Performance Index				
Countries	2003-2005	2004-2006	2005-2007	2006-2008*
Bangladesh	0.46	0.48	0.40	0.33
Nepal	0.05	-0.01	0.00	0.00
India	0.45	0.62	0.63	0.71
Pakistan	0.75	1.03	1.12	1.06
Sri Lanka	0.66	0.61	0.54	0.57
China	2.02	1.32	0.99	1.08

*Estimated on the basis of IMF data

Although most of the sectors received lower foreign direct investment during FY09, a large part of overall fall was contributed by communication and financial business, which together constituted more than 60 percent of the overall foreign direct investment in FY08. Lower investment in communication mainly emanated from (a) lower equity flows on account of absence of privatization

proceeds and relative saturation of the market¹⁷ and, (b) lower reinvested earnings on account of lower profits. Lower investment in financial business, on the other hand, was probably explained by lack of mergers & acquisitions owing to weakening growth prospects and lower reinvested earnings. Other major sectors which received lower foreign direct investment during FY09 included trade, transport equipments, electronics and cement.

On the other hand, oil & gas exploration, power, food packaging and petroleum refining recorded increase in foreign direct investment during FY09 (see **Table 7.12**). Higher inflows in oil & gas exploration largely reflect higher investment in BP petroleum and ENI Pakistan (Pvt) Ltd while higher inflows in food packaging reflects higher investment in Tetra Pak Pakistan Limited. Similarly, higher investment in petroleum refining mainly owed to Pak-Arab Refinery limited whereas higher investment in power was mainly concentrated in thermal sector during FY09.¹⁸

Foreign Portfolio Investment

Foreign Portfolio investment registered a historic high net outflow of US\$ 1.1 billion during FY09 against net inflow of US\$ 36 million during last year (see **Figure 7.17**). This capital outflow was contributed by both equity and debt securities.

Higher equity outflow largely reflected poor performance of stock market while higher outflow from debt securities was on account of Euro bond payment worth US\$ 500 million and buy back of US\$ 100 million bond by Pakistan Mobile Communications Limited (PMCL). It may be pointed out that PMCL bond (worth US\$ 250 million) was to mature in 2013, but it bought it back at a discount of 23-30 percent to reduce its indebtedness and future interest expense.

Outstanding Export Bills

Falling trend in exports was also reflected in declining aggregate stock of outstanding export bills during FY09. Specifically, the stock declined by US\$ 316 million during FY09 compared with

Table 7.11: Outward FDI Flows From Selected Countries
billion US Dollar

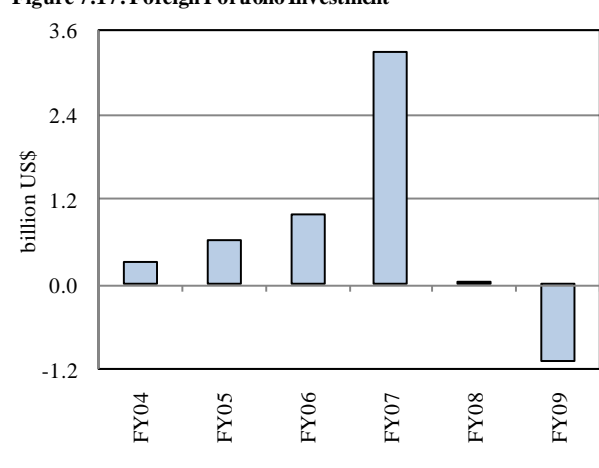
	2005	2006	2007	2008
World				
USA	36.2	244.9	398.6	332.0
UK	80.8	85.6	275.5	139.3
UAE	3.8	10.9	14.6	15.8
Switzerland	50.8	76.6	50.6	85.0
Pakistan				
USA	0.4	0.7	1.4	0.9
UK	0.2	0.6	0.5	0.5
UAE	0.4	1.6	0.7	0.4
Switzerland	0.2	0.2	0.1	0.2

Source: International Monetary Fund

Table 7.12: Sector-wise Foreign Direct Investment
million US Dollar

	FY08		FY09	
	Value	Share	Value	Share
Oil & gas explorations	634.8	11.7	775.0	20.8
Transport equipment	111.4	2.0	82.4	2.2
Power	70.3	1.3	130.6	3.5
Construction	89.0	1.6	93.4	2.5
Trade	175.8	3.2	166.6	4.5
Communication.	1,626.8	30.0	879.1	23.6
Financial business	1,864.9	34.4	707.4	19.0
Personal services	94.7	1.7	100.1	2.7
Others	742.2	13.7	785.1	21.1
Total	5,410.2		3,720.1	

Figure 7.17: Foreign Portfolio Investment



¹⁷ Annual report FY08 by Pakistan Telecommunication Authority

¹⁸ Increasing reliance on thermal power, however, may lead to increase the furnace oil import, thereby making the import bill more vulnerable to global oil prices.

increase of US\$ 557 million in FY08. As mentioned in the earlier reports, Central Bank's close monitoring of overdue outstanding export bills also contributed to this decline during the period under review.¹⁹ Moreover, stability in exchange rate after IMF support for macroeconomic stabilization program may also have contributed in decreasing the stock of outstanding export bills during FY09.

Currency and Deposits (Assets)

Currency and deposits recorded a decline of US\$ 262.0 million during FY09 against decline of US\$ 609 million in FY08. This is mainly due to the increase in commercial banks' FE-25 nostros on account of retirement of FE-25 loans by exporters and importers amid Pak rupee depreciation during FY09.

Official Long Term Loans

Official long term loans recorded a net inflow of US\$ 1.6 billion during FY09 against an inflow of US\$ 1.2 billion received during FY08. The improvement during FY09 was a result of US\$ 1.0 billion YoY increase in program loans (ADB and World Bank), as project loans reduced by US \$ 441 million during the period. Moreover, higher amortizations in FY09 also offset the part of increase in long term loan inflows.

Official Short Term Loans

The official short term loans registered net outflow of US\$ 148 million during FY09 compared with net increase of US\$ 559 million in the preceding year. This was primarily due to repayment of US \$ 688 million to Islamic Development Bank during FY09.

It may be pointed out that short term lending from IDB increased in the wake of high oil prices in FY08. As this lending is for less than one year, it is reflected in outflows in the very next year. Thus in FY09, almost all of the short term drawings were used to repay the previous year debt (see **Table 7.13**).

Table 7.13: IDB Debt Drawing and Payments (less than one year)
million US Dollar

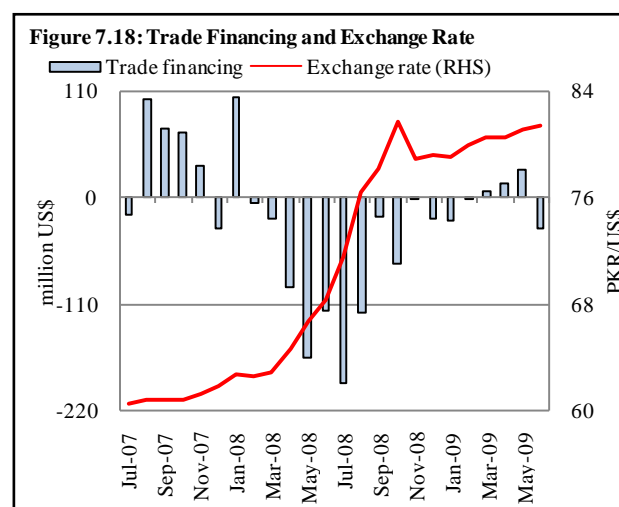
	FY05	FY06	FY07	FY08	FY09
Drawing	271.0	169.0	25.0	700.0	656.0
Repayment	8.0	271.0	192.0	25.0	688.0

Private Loans

During FY09, private loans recorded a net inflow of US\$ 598 million against US \$ 693 million of net inflow in the previous year. The major companies that recorded inflows were Warid Telecom (US\$ 308 million), Engro Chemicals (US\$ 223 million), Pakistan Mobile Communication (US\$ 110 million) and Engro Energy (US\$ 104 million) during the period under review.

Currencies and Deposits (liabilities)

Currency and deposits declined by US\$ 445 million during FY09 compared with the decline of US\$ 47 million in the corresponding period last year. This was largely on account of decline in trade financing. Despite increased differential in WAFC²⁰ and local currency lending rates retirement of forex



¹⁹ From July FY09, banks were asked to provide data on outstanding exports bills on monthly basis to the central bank. From August FY09 onward, the frequency of reporting was increased to weekly basis.

²⁰ Weighted Average Foreign Currency.

loans accelerated due to the expectations of the Rupee depreciation against US dollar in the initial months of FY09. However, with the stabilization in exchange rate from November onwards, retirement of these loans slowed down significantly (see **Figure 7.18**).

Table 7.14: Financial Account

million US Dollar

	FY08	FY09 ^p	YoY Change (%)
Financial account (net)	8131	5222	-35.8
Direct investment abroad	-75	-25	-66.7
Direct investment in Pakistan	5410	3720	-31.2
Equity capital	4401	3007	-31.7
of which: Privatization receipts	133	0	-100.0
Reinvested earnings	1009	713	-29.3
Portfolio investment	32	-1096	-3525.0
Equity securities	15	-552	-3780.0
Debt securities	17	-544	-3300.0
Net foreign investment	5367	2599	-51.6
Other investment	2764	2623	-5.1
Assets	32	715	2134.4
1-Outstanding export bills (exporters)	-595	178	-129.9
2-Outstanding export bills (DMBs))	18	153	750.0
3-Currency and deposits	609	384	-36.9
of which banks	507	190	-62.5
Liabilities	2732	1908	-30.2
1-Foreign Long-term govt loans / credits (net)	1223	1616	32.1
Project loans	1250	809	-35.3
Non- project loans	1104	2115	91.6
Amortization	1131	1308	15.6
2-Short term capital (official)	559	-148	-126.5
of which: IDB (net)	675	-32	-104.7
3-Private loans	693	598	-13.7
of which: Supplier credits	1027	959	-6.6
Suppliers credit repayments	334	361	8.1
4-Currency and deposits	-47	-445	846.8
5-Other liabilities	254	287	13.0

Source: Statistics Department, SBP

p: provisional

Box 7.6: Pakistan Back into IMF program

Global financial crisis has severely impacted both the developed and developing economies. In particular, the developing countries faced severe balance of payments problems as both the export earnings and financial inflows were badly hurt by the crises. As a result, number of developing countries approached IMF to avert balance of payment crises during 2008 onward (see **Table 7.6.1**). Pakistan also signed a stabilization program with IMF in the wake of fast depletion of foreign exchange reserves, sharply depreciating exchange rate and increasing difficulty in meeting external obligations. Since Pakistan has a long history of using IMF resources, it would be pertinent to have a brief overview of history of Pakistan's various arrangements with IMF and some lessons from this experience.

Pakistan and IMF-A Historical Perspective

Pakistan's history of using IMF resources can be divided into three distinct phases. In the first period, 1970 to 1988, Pakistan had four one-year Stand By Arrangements (SBAs) followed by one three year Extended Fund Facility (EFF). The special characteristics of this phase were (a) with the exception of two, rest of the SBAs were fully disbursed, (b) there was little emphasis on structural reforms (except in EFF) and, (c) repeated approach to Fund resources, in between periods of break.

In the second period, 1988 to 1999, Pakistan had both the short term and multiyear arrangements with the IMF (see **Table 7.6.2**). Unlike the first phase, these arrangements emphasized on variety of structural reforms along with demand management policies. Almost all the arrangements went off-track sooner or later on account of policy slippages. As a result, throughout this period Pakistan was continuously under one or other IMF program.

In the third period, 2000-2004, Pakistan availed one facility of SBA and PRGF each. These arrangements were completed successfully as Pakistan met most of the structural performance criteria. With the recovery from macroeconomic crises, Pakistan exited from IMF program in 2004.

Effectiveness of IMF programs

With no way of assessing the counterfactual, effectiveness of these programs is hard to judge. Nonetheless, IMF-Independent Evaluation Office (IEO) report suggests that these programs had limited effectiveness. According to the report in the first period, 1970-1988, though amounts agreed under most of these arrangements were entirely disbursed, they did not succeed in correcting the underlying imbalances. The second phase, 1988-2000, was even worse compared with the first phase as macroeconomic performance deteriorated and financial imbalances largely persisted. For instance, on average GDP growth fell to less than 4 percent during 1988-2000 from 6 percent during 1970-88 while average export growth was less than 7.0 percent during 1988-2000 from more than 11 percent during 1970-88. Though not covered in IEO report, the third phase, 2000-2004, appears to be more successful compared with the first two phases. As economic growth recovered, fiscal and external vulnerabilities declined and Pakistan was able to tap international capital market to meet its financing needs.²¹

Table 7.6.1: List of Countries Entering into IMF Stand By Arrangements (SBA) as of August 31, 2009
(million of SDRs)

Member	Date of arrangement	Expiration	Total amount agreed	Undrawn balance
Georgia	15-Sep-08	14-Mar-10	477	189
Ukraine	5-Nov-08	4-Nov-10	11,000	6,125
Hungary	6-Nov-08	5-Apr-10	10,538	2,951
Seychelles	14-Nov-08	13-Nov-10	18	11
Iceland	19-Nov-08	18-Nov-10	1,400	840
Pakistan	24-Nov-08	30-Dec-10	7,236	3,833
Latvia	23-Dec-08	22-Mar-11	1,522	986
Belarus	12-Jan-09	11-Apr-10	2,270	1,752
El Salvador	16-Jan-09	31-Mar-10	514	514
Serbia	16-Jan-09	15-Apr-11	2,619	1,918
Armenia	6-Mar-09	5-Jul-11	534	269
Mongolia	1-Apr-09	1-Oct-10	153	77
Costa Rica	11-Apr-09	10-Jul-10	492	492
Guatemala	22-Apr-09	21-Oct-10	631	631
Romania	4-May-09	3-May-11	11,443	7,073
Bosnia	8-Jul-09	30-Jun-12	1,015	832
Sri Lanka	24-Jul-09	23-Mar-11	1,654	1,447

Other IMF facilities availed by the countries are:

Flexible Credit Line (FCL)-Colombia (2009), Mexico (2009) and Poland (2009).

Exogenous Shock Facility (ESF)-Kyrgyz Republic (2008), Malawi (2008), Senegal (2008), Mozambique (2009), Tanzania (2009), Ethiopia (2009).

Poverty Reduction and Growth Facility (PRGF)-Burundi (2008), Congo (2008), Djibouti (2008), Liberia (2008), Mali (2008), Niger (2008), Togo (2008), Zambia (2008), Cote d'Ivoire (2009), Sao Tome & Principe (2009), Tajikistan (2009), Ghana (2009).

Source: International Monetary Fund

The IEO report also points out the major reasons of limited effectiveness of the first two phases. Some of these are:

- While Pakistan made significant progress in areas like trade, capital and current account liberalization, it could not introduce structural reforms to increase its tax revenue to GDP, which is necessary for longer term fiscal sustainability. In particular, reduction of tariff and other taxes on international trade was fast relative to introduction of new taxes such as general sales tax which resulted in bulk of the revenue short falls. In this backdrop to meet the IMF fiscal balance target, the government often cut the developmental and social spending which hampered GDP growth and in turn tax revenues.
- Strict conditionality is another factor which has limited the effectiveness of these programs. In particular, implementation of complex reforms (may be necessary for longer term sustainability) was difficult in short time frame. For instance, tax reforms, which require parliamentary approval for the given measure, could not be implemented during the program period.
- Lower participation of local experts in the IMF policy formulation also reduced effectiveness of the programs. Some experts, like Stiglitz, claim that optimum economic program can best be formulated by the first rated economist already working on solving that country's problems. Empirical research²² also shows that reforms give the best results when they are based on the strategies prepared by the beneficiaries themselves.

²¹ This could equally be attributed to congenial domestic and international environment as well as host of other factors.

²² Goldin, J.; Rogers, H.; Stern, N. The Role and Effectiveness of Developmental Assistance: Lesson from World Bank Experience. The World Bank, 2002.90 p.

- According to IEO report, most of the programs, particularly in 1990s, were based on overoptimistic projections of key macroeconomic indicators such as GDP, exports and domestic saving and investment. For instance, average exports growth projection during 1990s was 15 percent against the actual growth around 5 percent. This led to underestimation of current account deficit and build up of external debt. As a result, Pakistan face severe debt sustainability problem, which was not analyzed in IMF reports until late 1990s. Similarly, the report points out that IMF staff agree that tax revenue targets were also unrealistic.

Table-7.6.2: Pakistan's History of Arrangements with IMF
amount in million SDRs

Facility	Date of arrangement	Initial date of expiration	Actual date of expiration	Amount agreed	Amount drawn	Percent undrawn
SBA	8-Dec-1958	7-Dec-1959	22-Sep-1959	25.0	0.0	100.0
SBA	16-Mar-1965	15-Mar-1966		37.5	37.5	0.0
SBA	18-May-1972	17-May-1973		100.0	84.0	16.0
SBA	11-Aug-1973	10-Aug-1974		75.0	75.0	0.0
SBA	11-Nov-1974	10-Nov-1975		75.0	75.0	0.0
SBA	9-Mar-1977	8-Mar-1978		80.0	80.0	0.0
EFF	24-Nov-1980	23-Nov-1983		1,268.0	1,079.0	14.9
SAF	28-Dec-1988	27-Dec-1991	15-Dec-1992	382.4	382.4	0.0
SBA	28-Dec-1988	7-Mar-1990	30-Nov-1990	273.2	194.5	28.8
SBA	16-Sep-1993	15-Sep-1994	22-Feb-1994	265.4	88.0	66.8
ESAF	22-Feb-1994	21-Feb-1997	13-Dec-1995	606.6	172.2	71.6
EFF	22-Feb-1994	21-Feb-1997	13-Dec-1995	379.1	123.2	67.5
SBA	13-Dec-1995	31-Mar-1997	30-Sep-1997	562.6	294.7	47.6
PRGF	20-Oct-1997	19-Oct-2000		682.4	265.4	61.1
EFF	20-Oct-1997	19-Oct-2000		454.9	113.7	75.0
SBA	29-Nov-2000	30-Sep-2001		465.0	465.0	0.0
PRGF	6-Dec-2001	5-Dec-2004		1,033.7	861.4	16.7
SBA*	24-Nov-2008	30-Dec-2010		7,235.9	3,402.6	53.0
Total				11,934.3	7,027.0	41.1

SBA-Stand By Facility

EFF-Extended Fund Facility

SAF-Structural Adjustment Facility

ESAF-Enhanced Structural Adjustment Facility

PRGF-Poverty Reduction and Growth Facility

Source-IMF

*As on August 31, 2009

- Lastly, frequent changes in the government in 1990s also contributed to ineffectiveness of the programs. There is a point of view that most of the programs that had gone off track, would have been back on track if there was no disruption of political process.

However, like in the past strong commitment is needed by the government to take hard decisions, especially on the fiscal front- taxing the untaxed segments of the economy and doing away with subsidies to minimize slippages.

In FY08, Pakistan once again faced an imminent balance of payments crisis. With other alternatives exhausted, Pakistan had little option but to approach IMF. An agreement on a macroeconomic stabilization was reached with the IMF in November 2008. In August 2009, access under the current SBA was augmented from 500 percent to 700 percent of Pakistan's SDR quota in the wake of uncertainty of capital inflow from other sources. The current SBA signed with the IMF is different from the previous arrangements in two respects. First, macroeconomic stabilization is prepared by Pakistani authorities themselves and approved by the IMF. Second, IMF has modernized its conditionality by making it more focused and adequately tailored to fundamentals of a member country.²³ These factors are favorable for the program success.

²³ This change was made in the wake of criticism that some IMF loans have too many conditions that were insufficiently focused on core objectives.

So far, the program is on track as Pakistan has done well in meeting quantitative performance targets. Looking ahead, however, implementation of structural reforms on the fiscal side would be challenging. For example, IMF envisages reducing fiscal deficit to 3.4 percent of GDP in FY10 on the back of elimination of fuel and electricity subsidies along with ambitious tax reforms by the end of FY09. So far, given the severe power shortages and resulting protest, and resistance from the powerful lobbies government has neither been able to do away with subsidy on electricity nor has it been able in widening the tax net. Past experience also suggests that introducing tax reforms is not likely to be easy in the wake of weakening economic activity. Fiscal slippages could lead to domino effect that could impair the whole stabilization program.

In this backdrop following suggestions may be helpful for the successful implementation of the program.

- Past experience suggests that most of the program went off-track on account of failure to implement structural reforms during the program period. While structural reforms usually take more time relative to demand management measures, flexibility on IMF part in this regard may keep this program on track. Likewise, IMF need to be more flexible in case of exogenous shocks or if agreed policy do not produce the desired results.
- In the past, Pakistan could only partly carry out structural reforms. As a result, these programs helped Pakistan only in the short run and economic imbalances could not be corrected on sustainable basis. Thus greater focus on addressing structural problems, particular on fiscal side, is necessary for the program to be successful in the medium to long term.

In short, like most of the previous arrangements the current SBA with the IMF has also benefitted Pakistan for the time being as it has helped in a) building up foreign exchange reserves, b) stabilizing exchange rate and c) improving sovereign rating. However, sustainability of these improvements along with recovery of economic activity and other macroeconomic indicators for a longer period of time will depend on how these funds are used to address the underlying structural weaknesses of the economy.

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www.imf.org

Evaluation of prolonged use of IMF resources (2002): International Monetary Fund

7.3 Trade in Services

Services sector has emerged as the leading and the fastest growing sector in the global economy in the last two decades, contributing more than 60 percent of the world output. Similarly, world's services trade has grown at a rapid rate over the last few years. The major contributors in the world's services trade are transportation, travels, telecommunication, financial and insurance services. Like the world's services contribution in production, South Asian regional countries also have the largest share of services sector in their respective gross domestic output (see **Figure 7.19**). During 2007, services sector contributed almost half of the domestic production in most of the regional economies. However, the performance of this sector in terms of services exports is not the same as in the output. This is probably due to the intangible nature of services, which makes them prone to the quantification issues compared to the trade in goods. While tangible goods may be produced, stored and consumed at any time and at any place, intangible services on the other hand, can hardly be disassociated from its production and consumption (see **Box 7.7**).

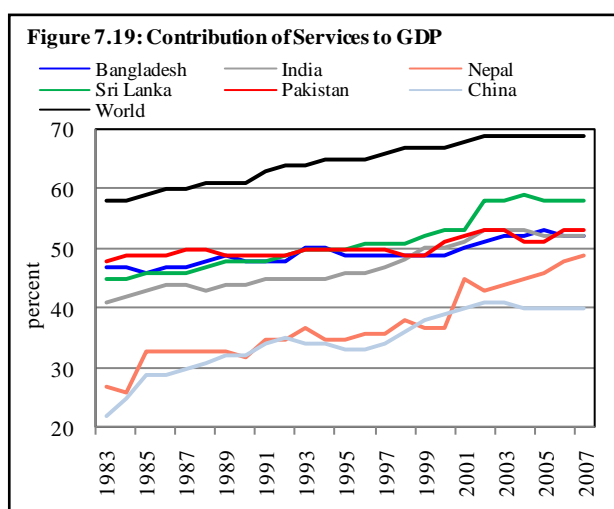


Table 7.15: Share of Pakistan's Services Exports in World's Imports
amount in million US Dollar; share in percent

	amount		Share of Pakistan's exports in world's imports
	Pakistan exports	World imports	
1982	0.8	451.5	0.18
1987	1.0	595.0	0.16
1992	1.6	1,039.9	0.15
1997	1.6	1,363.3	0.12
2002	2.4	1,608.5	0.15
2007	3.8	3,154.1	0.12

Source: World Development Indicators

Box 7.7: Definition and Nature of Services

By definition, service is an economic activity which adds value either directly to an economic unit or to a good belonging to another economic unit; therefore, consumer and producer must interact with one another to record provision of a service.

Services are very heterogeneous in nature and cover a wide range of economic activities of industries that normally provide output and employment. It comprises both intermediate and final services. Intermediate services can be both distributive such as: transport, communication, and construction services and producer services such as business, financial and professional. Final demand services include tourism, recreation, health, education and environmental services. Services can also be differentiated on the basis of private and public services, knowledge based or tertiary services. Insurance, technical, information technology, advertising are some of the examples of knowledge based services. Whereas, tertiary services include leasing, shipping, franchising, distributing, retail trade, etc.²⁴.

World's services imports have increased manifolds over the level they were in the past. Specifically, in 2007 these were more than 5 times of what they were twenty years back. However, Pakistan has a negligible contribution in world's services import.

Pakistan's services exports grew by 287 percent during 1987 to 2007 against an increase of 430 percent in world exports (see **Table 7.15**). Moreover, as the world services exports grew strongly over the years, Pakistan's share declined persistently from 0.18 percent in 1982 to 0.12 percent in

²⁴ Gloria O. Pasadilla (2004)

2007. It may be pointed out that if Pakistan was even able to retain its share at the 1982 level, its services exports would have been around US\$ 6.0 billion against present US\$ 3.8 billion.²⁵

During FY09, Pakistan's services exports stood at US\$ 4.0 billion representing 12.6 percent growth over FY08. This is a significant improvement over FY08 in which services exports had declined by 13.3 percent. In contrast to the services exports, Pakistan's services imports dropped to US\$ 7.3 billion or by 27.6 percent in FY09. As a result services trade deficit contracted by around 50.0 percent to US\$ 3.2 billion (see **Figure 7.20**).

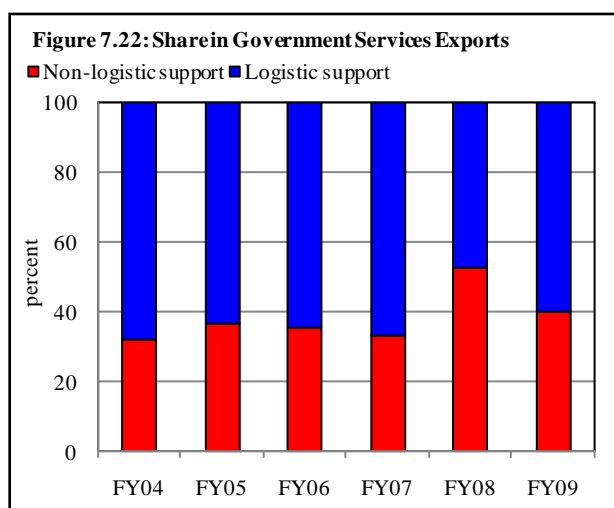
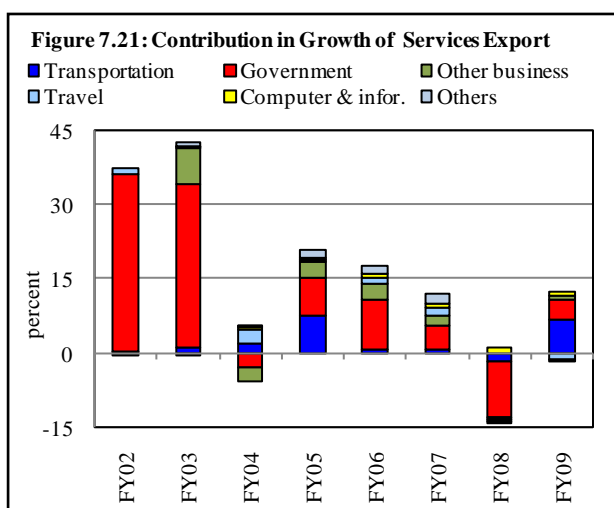
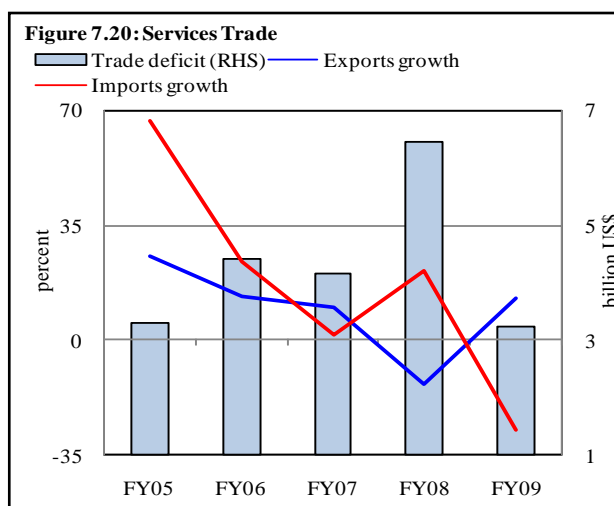
7.3.1 Services Exports

Major services exports of Pakistan consist of transportation, travel, other business services and government services. Together, these categories constitute more than 92 percent of services exports (see **Chart 7.1**).

Prior to FY02 transport services exports had the largest share in services exports growth, however, government services export increased sharply FY02 onwards and remained the largest contributor to services export growth till FY07. Government services exports include: *logistic support*, *other receipts on account of foreign missions* and *others* (see **Chart 7.1**).

Government services exports posted 10.4 percent growth in FY09 against steep decline of 25.6 percent in FY08. The rise in the government services was largely on account of the logistic support which registered a strong growth of 39.2 percent in FY09 against significant decline of 47.3 percent in FY08. In fact, the healthy performance of the overall services exports during FY02- FY09 largely owes to the logistics support (see **Figure 7.21**).

Along with the logistic support, non-logistic support also contributed significantly to the government services exports in FY09 (see **Figure 7.22**). Among the non-logistic support, *foreign missions remittances* is the largest contributor.



²⁵ Estimated based on 2007 data.

Transportation services exports is the second largest foreign exchange earner in total services exports after government services exports (see **Table 7.16**). The major sub-categories include sea transport, air transport and other transport (see **Chart 7.1**).

Of these, the major contribution comes from passage earnings of Pakistani air companies and other local disbursements of foreign transport companies.

During FY09 overall transportation services exports grew by 24.0 percent compared to a decline of 6.1 percent last year. FY08 was very challenging for world airline industry as well as for Pakistani airline industry due to rising fuel costs.²⁶ It compelled the national carrier and other airlines to increase air fares, reduce the number of flights and discontinue subsidized routes.

Most adverse impact of higher oil prices on PIA earnings fell in H2-FY08. To counter this, the national airline continuously increased its fares for both domestic and international flights. However, during H1-FY09 as oil prices began to fall, the fares were not decreased accordingly, as a result, PIA's operational profitably increased (see **Figure 7.23**).

PIA earned record revenues during 2008: both on account of improved passengers and freight revenues (see **Table 7.17**). While the available seats declined (due to cancellation/discontinuation of flights/routes), this increased the turnover as seat factor improved. During this period, many international airlines also curtailed their operations from Pakistan, which also had a positive impact on the PIA's revenues.

Passenger load increased on Pakistan to UAE route as a connected link. During the same period, PIA also reduced passengers' luggage limit, and strictly monitored the extra luggage, which also added to PIA's revenues. Similarly, half yearly (Jul-Dec FY09) profit and loss statement of PNSC shows 30.3 percent increase in revenues. Of which freight charges grew by 16.6 percent.

Cargo handling data shows 6.3 percent growth in exports cargo handling in FY09 compared to 58.8 percent growth in last year. This

Table 7.16: Major Services Exports

million US Dollar

	FY08	FY09	Growth in FY09 (%)
Govt. services	1,379.7	1,522.7	10.4
Transportation services	1,035.5	1,283.1	23.9
Other business services	450.4	468.1	3.9
Travel services	263.5	222.1	-15.7
Computer & information services	154.1	183.8	19.3
Communication services	117.2	195.5	66.8
Insurance services	54.0	59.1	9.4
Royalties & licenses fees	50.9	11.9	-76.6
Financial services	42.6	63.0	47.9
Construction services	37.0	30.8	-16.8
Personal, cultural & recreational services	3.6	2.9	-19.4
Total services exports	3,588.5	4,043.0	12.7

Figure 7.23: International Crude Oil Prices

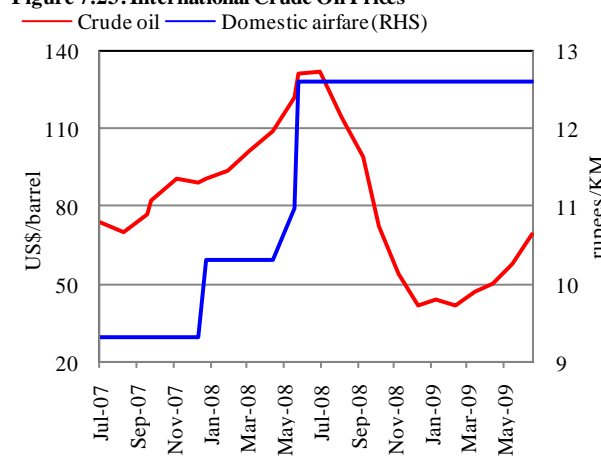


Table 7.17: Revenue Composition of PIA

million Rupees

	CY07	CY08	%age change
Passenger	62,002	79,817	28.7
Freight	4,850	5,459	12.6
Others	3,629	3,926	8.2
Total	70,481	89,202	26.6

source: PIA Annual Reports

²⁶ 2008 was a very volatile year in respect of oil prices and exchange rates. The oil price rose to an unprecedented level of US\$ 147 per barrel since the very beginning of FY09 and subsequently dropped to US\$ 40 per barrel at the end of 2008. The exchange rate of Pak Rs per US\$ depreciated to 79.7 during FY09 from 62.2 Rs/US\$ during FY08.

deceleration was contributed by rise in the cargo handling activities of dry bulk cargo on the back of rising exports of rice, cement etc. which partially offset by the reduction in the liquid cargo handling activities.

Other business services are very complicated to analyze due to the fact that sub-categories under *other business services exports* include variety of services such as trade related, operational leasing, legal, accounting, auditing & tax consultancy, business & management, agency commission, processing, repair fees and miscellaneous etc (see **Chart 7.1**). Interestingly out of all these the share of miscellaneous is the largest (see **Table 7.18**). Furthermore, refunds, i.e. receipts on account of loss in weight, quality and claims on price etc. in respect of imports also add to the complexity in analyzing other business services exports.

During FY09, other business services exports posted relatively better growth of 3.9 percent compared to 1.9 percent fall in FY08 (see **Table 7.18**). The growth in this category was on account of fine performances by business & management consultancy, agency commissions, and architecture, engineering & technical services exports. The notable performance has been shown by architecture, engineering and technical services (see **Figure 7.24**) with a significant growth of 66.3 percent in FY09 against 55.2 percent during the same period last year. The growth in this sub-group reflects the impact of low base effect.

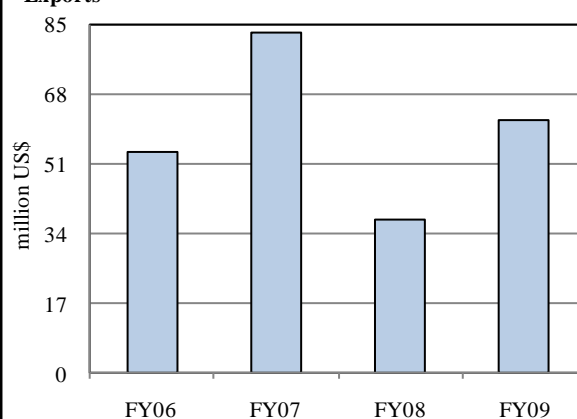
However, declining exports of trade related, charter of ships without crew, and advertising market research partially offset the positive contribution of above mentioned sub-sectors (see **Table 7.18**). The largest decline of 95.4 percent was witnessed in charter of ships without crew services²⁷ in FY09 on account of drastic fall in world merchandise trade as well as freight charges owing to global recession.

A travel services export includes both business and personal travel. Business travels has further sub categories - official, commercial and others whereas personal travel includes health, education and others related travels activities (see **Chart 7.1**). Travel services exports are one of the major exports category contributed around 7-8 percent of overall services exports. The major share is of United States, accounting for more than 85 percent on average for the last five years.

Table 7.18: Major Categories of Other Business Services Exports
in percent

	Share		Growth	
	FY08	FY09	FY08	FY09
Misc. other business services	35.1	35.1	24.4	3.8
Agency commission	29.4	30.3	11.1	7.1
Business. & management consultant.& public relations	17.4	17.4	76.1	4.1
Architecture., engineering, & technical services	8.3	13.2	-55.2	66.3
Trade related services	6.1	5.6	-17.4	-5.1
Advance. market research & public opinion poll	5.3	4.3	-0.4	-16.3
Charter of ships without crew-on leasing	5.1	0.2	57,302.5	-95.4
Others	8	9.4	-31.6	21.9
Refunds	-14.6	-15.4	168.6	9.6
Other business services			-1.9	3.9

Figure 7.24: Architecture, Engineering and Technical Services Exports



²⁷ This sub-category of other business services earned about US\$ 1 million during FY09 as against US\$ 23 million in the corresponding period.

During FY09, travel services exports declined by 15.9 percent as compared to a fall of 4.7 percent during the same period last year. The major category under travel services is foreign tourists with 90 percent share. Declined in foreign tourists' receipts by 12.8 percent was the major reason behind the fall in travel services exports during FY09. Worsening law & order situation, suicide attacks in major cities, frequent terrorist activities and war against terrorism within the country particularly in the northern areas, which are the major tourist destinations, kept tourist away from the country. In addition, global recession and losses on long-term savings in advanced economies also responsible for lower tourism activities worldwide.

Pakistan's **computer and information services exports** are flourishing for the last four years with an average YoY growth of 41.3 percent recorded during FY06-FY09. The share of this category in overall services exports was at 4.5 percent during FY09, with *software exports* and *software consultancy services* being the major sub-categories (see **Table 7.19**).²⁸

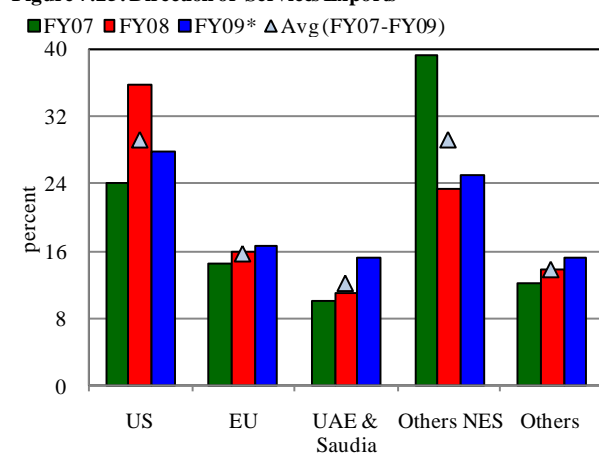
The presence of a huge US\$ one trillion world market²⁹ with a negligible share of Pakistan's export, points towards a vast untapped potential in this area for the country. The global information technology services exports are divided into two categories: (a) IT services & software exports and (b) business process outsourcing (BPO). In fact out of the total US\$ one trillion world market for IT services, potentially US\$ 160 billion market is related to IT services and exports, while around US\$ 120 billion market is potentially for BPO, which in turn has around 40-50 percent share of call centres. Out of this large outsource able figure, only 3.8 percent (US\$ 40 billion) was being outsourced in 2006³⁰, which hints at the presence of significant potential for Pakistan. Further the overall economic slowdown is driving demand for cost efficient businesses, providing opportunities for low cost IT companies in Pakistan.

The government being cognizant of the large growth potential in this sector has given various incentives to the IT companies: (a) tax exemptions till 2016, (b) establishment of IT Parks with low rent, (c) foreign ownership of equity invested in IT and (d) 100 percent repatriation of profit³¹, for attracting FDI in this sector. Based on these measures and the substantial growth recorded in the IT services export for the last few years, the government has set a target of US\$ 6 billion for this sector by the year 2015.³²

Table 7.19: Computer and Information Services Exports
in percent

	Share		Growth in FY09
	FY08	FY09	
Export of computer software	65.5	65.2	18.8
Software consultancy services	18.5	13.6	-12.5
Other computer services	13.8	19.3	66.7
Others	2.2	2.0	6.7
Overall	100	100	19.4

Figure 7.25: Direction of Services Exports



²⁸ The SBP does not report the data of call centers revenues under IT exports, as it is a very minor amount. Further, there are small scale software houses having business only on internet rather than having some of the permanent clients. They don't register themselves because of excessive documentation; avoid declaration so as to evade commercial treatment of the entity and uncertain nature of business as these small scale software houses get business only from web portals where they have to bid to win the projects.

²⁹ Bearing Point's 2006 study puts the global IT/ITES/BPO industry at about US\$ 1.045 trillion.

³⁰ Source: Bearing Point Study.

³¹ Source: PSEB.

³² source: TDAP.

From the diversification aspect, status of Pakistan's exports of services is not much different from the merchandise exports. Not surprisingly, given the large share of logistic support, United States was the leading services exports destination with 35.8 percent share in overall export during FY08³³. At second place come *others NES*³⁴ which accounted for 23.4 percent share in FY08. The share of services exports to EU region has approximately 15-16 percent, Saudi Arabia and UAE collectively have 11-12 percent share, while the share of services exports to SAARC member countries is negligible at only 0.5-0.6 percent (see **Figure 7.25**).

Lack of understanding and orientation of the nature of services is the major hurdle in the services sector exports. In fact, since becoming the member of General Agreement on Trade in Services under the umbrella of WTO, no significant efforts have been made in terms of capacity building in this area. Unfortunately, for quite some time, Pakistan could not set up any intermediary or institution, which could take up the issues in services exports. Recently, however, TDAP has established services exports development cell to enhance services sector exports by facilitating the industry through target oriented approach. The cell marked five priority areas having extensive potential. These include information technology, financial, construction, medical and professional services.

As the services sector is entirely based on human capital, low volumes of human resource quality is another major issue limiting potential of services exports from Pakistan. The labor market particularly in the cases of professional, technical, information technology, and medical services is not geared to produce high quality skilled labor in the volumes, required for faster growth in services exports. Thus, there is need for student-industry interactions to fulfill the market requirements. Other issues include standardization, international quality certifications, lack of intellectual property rights which hamper brand development and discourage innovation. In particular, all these require political stability to ensure promotion in services exports growth.

Table 7.20: Imports of Selected Services Groups

	FY08 Absolute amount (million US dollar)	FY09	FY09	
			Growth	Share
Transportation	3,785	3,527	-6.8	48.5
Travel	1,578	997	-36.8	13.7
Communications	107	144	34.6	2.0
Construction	56	81	44.6	1.1
Insurance	152	127	-16.4	1.7
Financial	184	168	-8.7	2.3
Information technology	129	122	-5.4	1.7
Royalties etc.	130	93	-28.5	1.3
Other business	3,434	1,635	-52.4	22.5
Government	491	380	-22.6	5.2
Total services import	10,046	7,274	-27.6	100

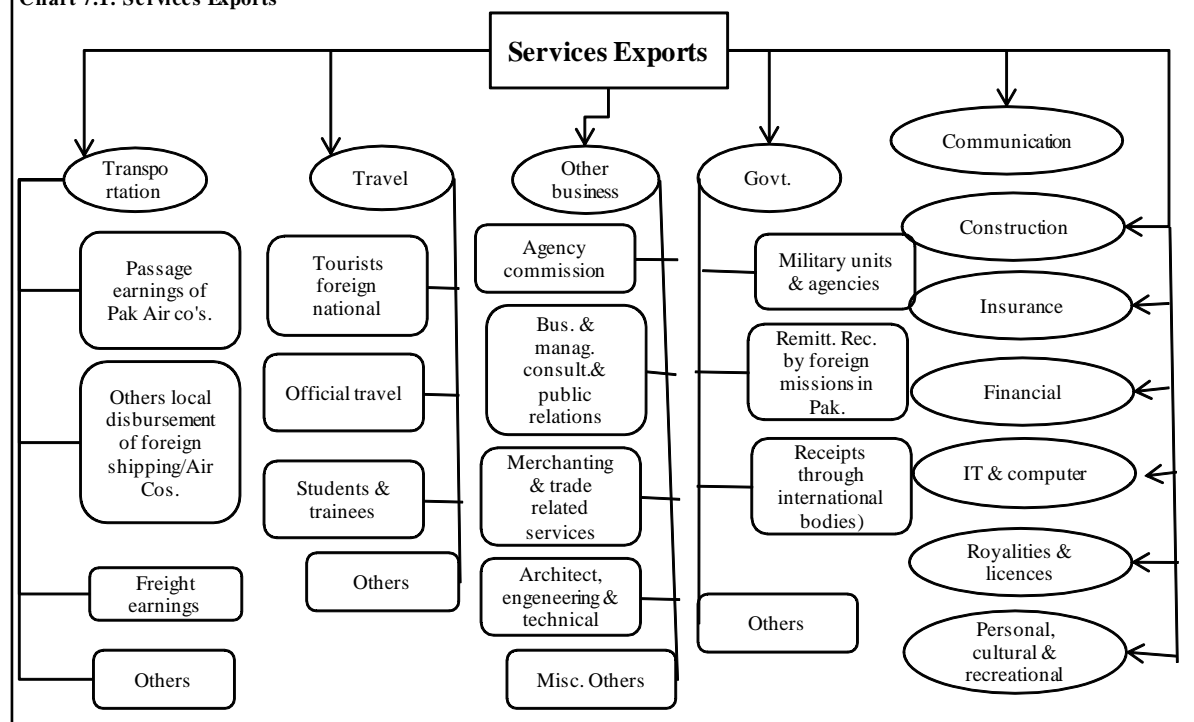
Further, IT services can be flourished through developing information technology parks. Currently only one IT park is in functional form at Islamabad. No strategy has been developed due to lack of orientation in information technology sector. Moreover, travel services exports are directly related to the tourism industry which is dependent upon political stability and law & order situation prevailing in the country.

However, the importance of services sector is gradually being realized and it may challenge dominance of textile sector as the leading export sector in Pakistan. While, government should provide favorable environment to facilitate the services sector exports, a lot depends upon the private sector to tap the opportunities in fast growing trade in services sector.

³³ Full year data is available up to FY08.

³⁴ NES or not elsewhere specified classification is either due to grouping of small destinations or destinations which are not disclosed perhaps due to security reasons.

Chart 7.1: Services Exports



7.3.2 Services Imports

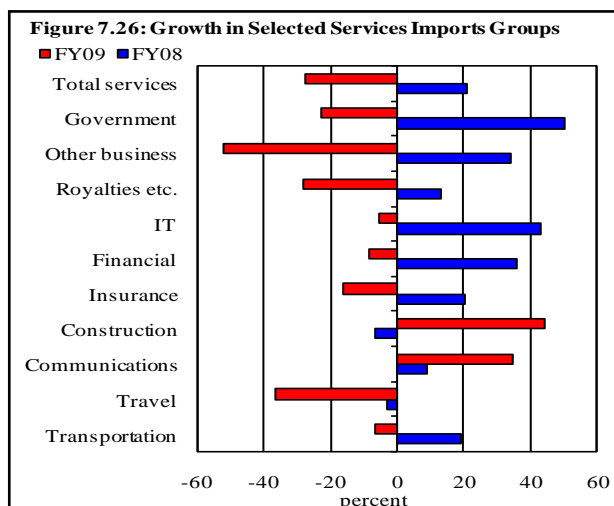
The major services imports of Pakistan are: *transportation, travel, government and other business services* with around 90 percent share in total services imports (see **Chart 7.2** and **Table 7.20**). Services imports after growing on average by 31.5 percent during the last five years, declined by 27.6 percent in FY09.

The decline in services imports was broad based (see **Figure 7.26**). Apart from construction and communication (share of these categories in overall imports of services is very small) import of all other groups experienced fall in FY09 as against a broad based growth recorded last year.

Within the services imports, transportation services imports has the largest share. Transportation services imports mainly reflect freight charges on imports, therefore higher the merchandise imports, higher will be the transportation services imports (see **Figure 7.27**). This is also evident from the positive and very high (0.96) correlation between the two variables.

During FY09, imports of transportation services fell by 6.1 percent compared to strong growth of 19.1 percent in FY08. This is largely attributable to the fall in the merchandise import during FY09. After *freight on cash imports, passage earnings of foreign airlines and expenses of Pakistani air/shipping companies* are the major sub-category under transportation services.

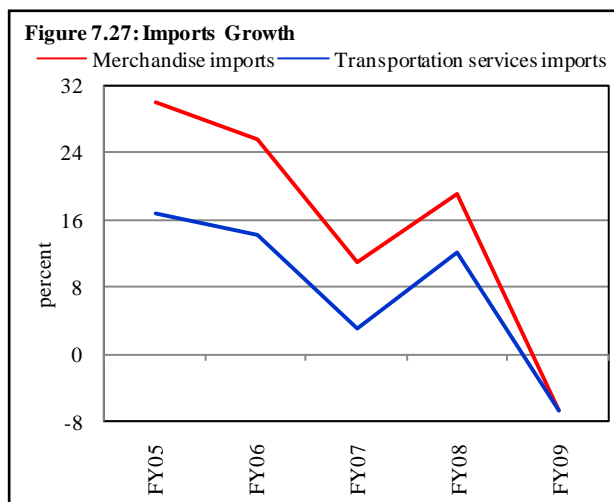
Suspension of flight operations by some foreign airlines like British Airways, Air France and Royal



Dutch Airlines (KLM) etc. due to poor domestic law & order situation was the main reason behind decline in the earnings of foreign airlines.

Imports of travel services also witnessed decline of 36.8 percent during FY09, as compared to the decline of 2.9 percent during FY08. Purchase of foreign currency through exchange companies for travel purposes is the major sub-category. In fact, any purchase at counter of exchange companies is recorded as 'for travel purposes' as the Performa on which the recorded transactions are being sent to SBP does not contain any other details.

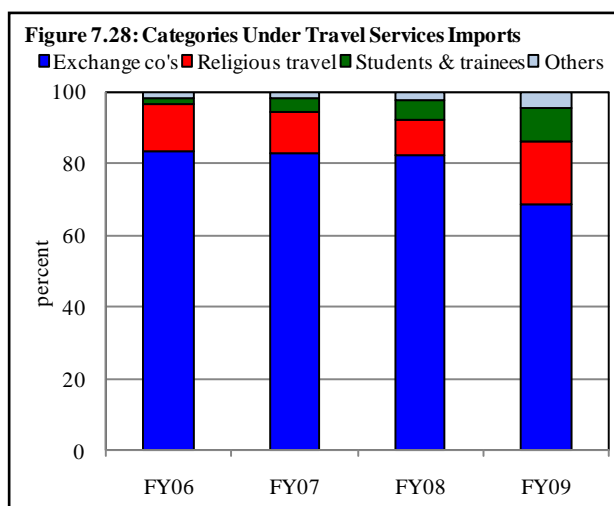
The restrictions imposed by SBP, to stabilize the forex market, and the crackdown on one of the major exchange companies during FY09, caused the decline in this category's imports. As a result, the share of exchange companies in travel services imports dropped to 68.7 percent in FY09 from 81.5 percent in FY08 (see **Figure 7.28**).



On the other hand, religious travel posted 5.5 percent growth during FY09 as compared to the decline of 8.6 percent last year. Consequently, share of religious travel increased to 17.3 percent in FY09 from 10.3 percent in FY08. The significant growth under this head is principally attributed to (a) rise in air fares, (2) increased accommodation charges and, probably (c) increased number of pilgrims.³⁵

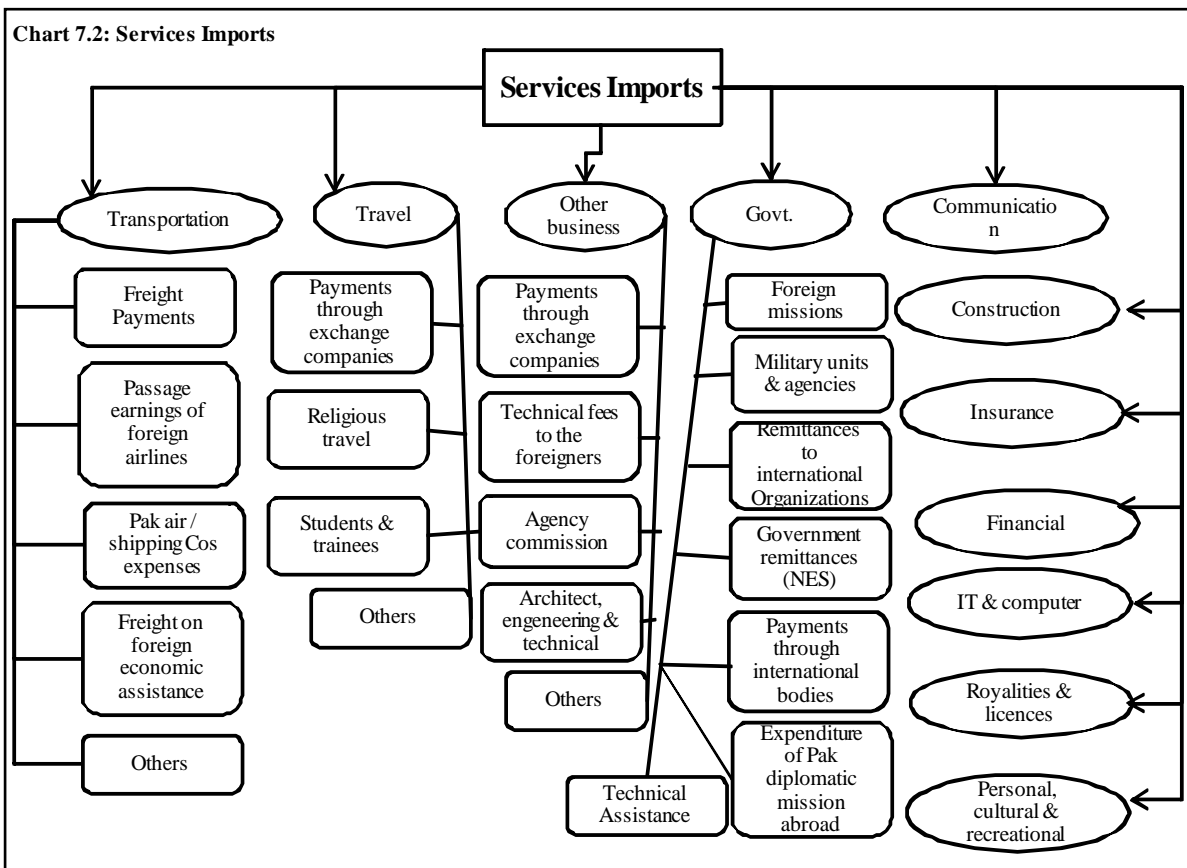
As with *other business services exports*, *other business services imports* consist of various services. This category witnessed a fall of 52.4 percent in FY09 compared to a growth of 34.2 percent last year, primarily on account of falling payments through exchange companies. The payments through exchange companies fell by 78.2 percent during FY09 and as a result, share of exchange companies in business services dropped to 32.5 percent in FY09 as compared to 72.9 percent during FY08. The restrictions imposed by SBP to stabilize the forex market and the crackdown on one of the major exchange companies during FY09 is the principal cause of the decline in category's imports.³⁶

Interestingly, Pakistan services imports are predominantly from the same countries where Pakistan exports its services. Pakistan's major services import partners are US, EU, UAE and China. Mutually, Pakistan imports fifty percent of services from these four origins.



³⁵ The pilgrims increased by more than 5000 in Hajj 2008. Reportedly, the air fares have been increased by at least 15 percent and accommodation charges also increased by 200 Saudi Riyals.

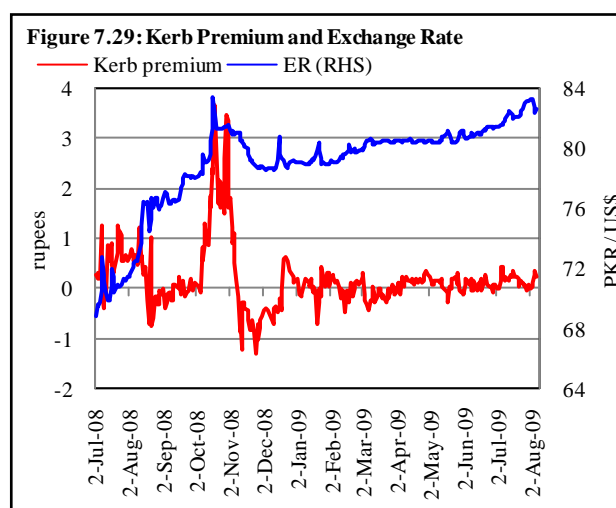
³⁶ SBP required exchange companies to report the transactions of US\$ 50,000 and above (or equivalent) on daily basis with complete particulars of the remitter, the beneficiary and the purpose of remittance, see FE circular 06, July 08, 2008 and others for example FE circulars 04 and 10 of 2008 and FE circular 01 of 2009.



7.4 Exchange Rate

The decline of the rupee seen during FY08 gathered pace in the initial four months of FY09, as the country's macroeconomic fundamentals continued to weaken. Thus, as against a depreciation of 11.5 percent during the whole of FY08, Pak rupee suffered a further 16.3 percent decline during the first four months of FY09 (i.e. Jul-Oct 2008).

The continuing slide of the rupee during this period was also accentuated by the worsening international financial crisis that squeezed Pakistan's capital and financial account surplus, and left the country unable to tap international capital markets (Pakistan was unable to launch a fresh sovereign bonds, and had to defer planned privatization transactions). The consequent rapid depletion of the country's FX reserves severely dented the confidence in the domestic currency, leading to pre-mature retirement of FX loans, efforts to hedge against further depreciation, and probably also encouraged speculative activities. All of this was reflected in the sharp increase in the premium in the kerb (informal) foreign exchange market that peaked in October 2009 (see **Figure 7.29**)³⁷.



³⁷ During Oct 2008, kerb premium rose by Rs 4 per USdollar.

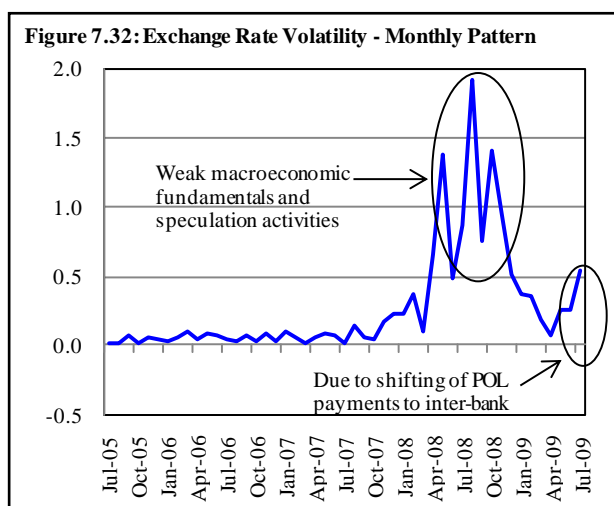
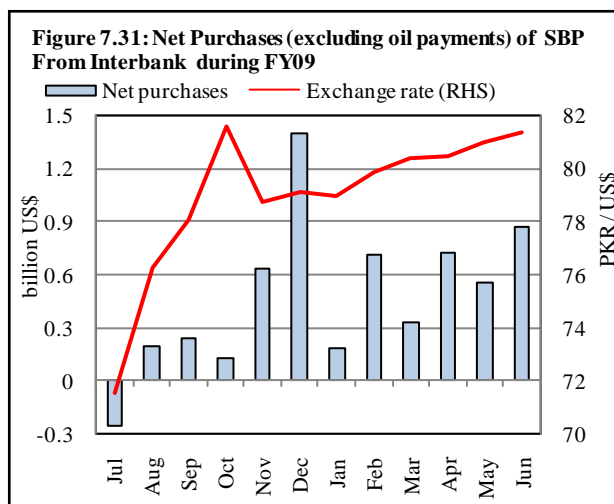
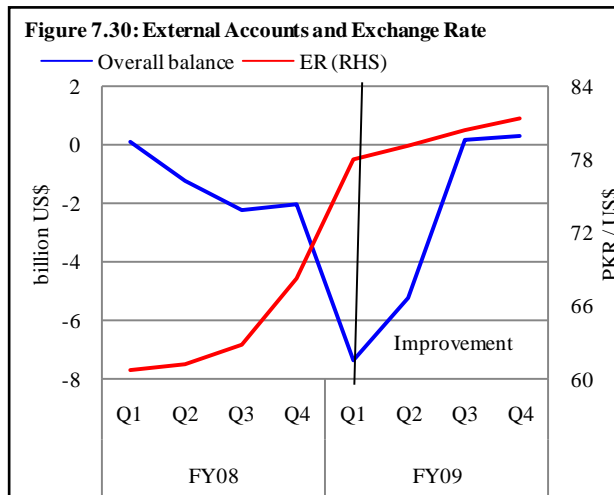
However, the situation improved substantially November 2008 onwards (see **Figure 7.30**) as Pakistan began implementing an aggressive macroeconomic stabilization program, with the assistance of the IMF Stand-By Arrangement. This led to small but sharp correction, with the rupee seeing a 0.3 percent appreciation during Nov-Jun FY09. The resulting improvement in the inflow of multilateral and bilateral loans stabilized the country's reserves, and restored confidence. The latter was also helped by the continued strong rise in workers' remittances and a crackdown on illegal activities of exchange companies. The improved confidence helped restore normal flow in the domestic FX markets, and allowed the SBP to gradually reduce liquidity support to the market for oil payments.

The restoration of normal flows in the FX market was aided by the sharp reduction in external deficits consequent to the stabilization program and a concurrent fall in international commodity prices. These developments meant that rupee remained relatively stable even when the SBP ended the provision of FX liquidity for imports of furnace oil in February 2009, and resumed net purchases from the market to buildup FX reserves (see **Figure 7.31**). The stability of rupee is highlighted by the net 0.3 appreciation in the last 8 months against, a full year net depreciation. The changing trends in the domestic FX market are clearly captured in the Exchange Pressure Index developed by the SBP (see **Box 7.8**).

However, FX market has become more volatile in the backdrop of SBP's decision to shift the remaining import payments of other POL products August 2009³⁸ onwards (see **Figure 7.32**). Moreover higher net purchases of SBP to meet the NFA target also put exchange rate slightly under pressure.

Box 7.8: Exchange Market Pressure Index for Pakistan

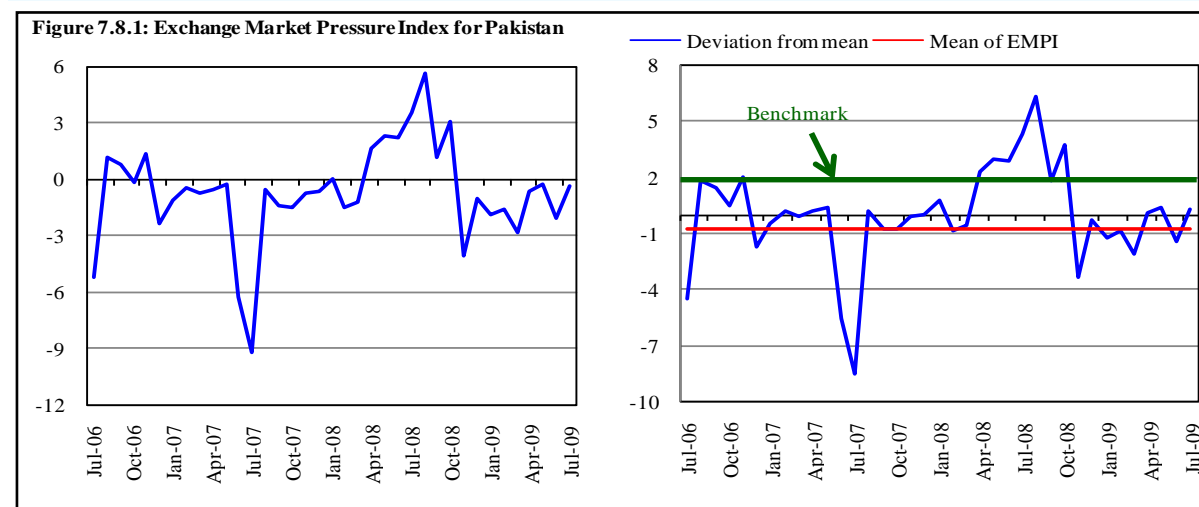
Exchange Market Pressure (EMP) index is a weighted average of exchange rate changes, reserve changes, and interest rate changes to measure the exchange pressure by using the following formula:



³⁸ See FE Circular No.3 dated July 15, 2009.

$$EMPI = \frac{\Delta e}{e_t} - \frac{\sigma_e}{\sigma_r} \frac{\Delta r}{r} + \frac{\sigma_e}{\sigma_{int}} \Delta int \quad (1)$$

Where EMPI is the exchange rate market pressure index in period t ; e_t the units of currency per US dollars in period t ; σ_e the standard deviation of the rate of change in the exchange rate ($\Delta e | e_t$); r_t the gross foreign exchange reserves in period t ; int_t nominal interest rate in period t ; σ_r in the standard deviation of the rate of change in reserves ($\Delta r | r_t$) and σ_{int} the standard deviation of the change in interest rate. A rise in the value of



index reflects a stronger selling pressure on the domestic currency and vice-versa. In this analysis monthly data from July 2006 to July 2009 has been used to calculate the EMPI. A situation in which the value of EMPI exceeds two standard deviation from the mean is treated as an episode of severe pressure.

The exchange market pressure index, calculated on the basis of 6-months T-bills repo rate is illustrated in **Figure 7.8.2**. **Table 7.8.1** summarizes the incidence rate of the exchange market pressure index for the reviewed period. Incidence rate is the ratio of number of severe pressure episodes over the total number of EMPI observations. During the study period of July 2006 to July 2009 eight severe pressure episodes have been identified, which is about 21.6 percent of incidence rate. Most of the crises occurred during the last quarter of the FY08 and FY09. **Figure 7.8.2** shows SBP response to increase/decrease in EMPI.

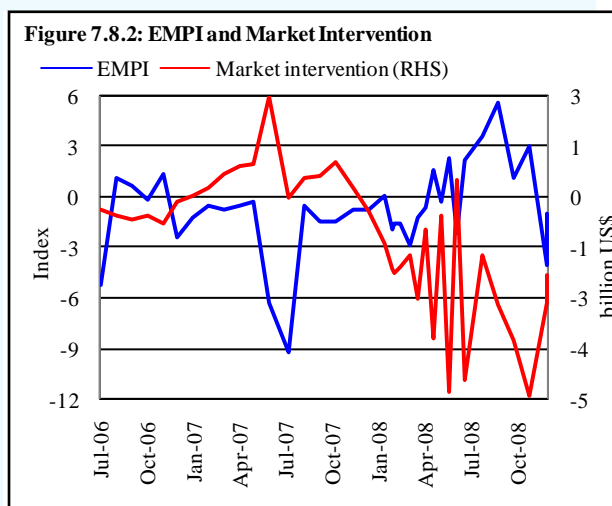
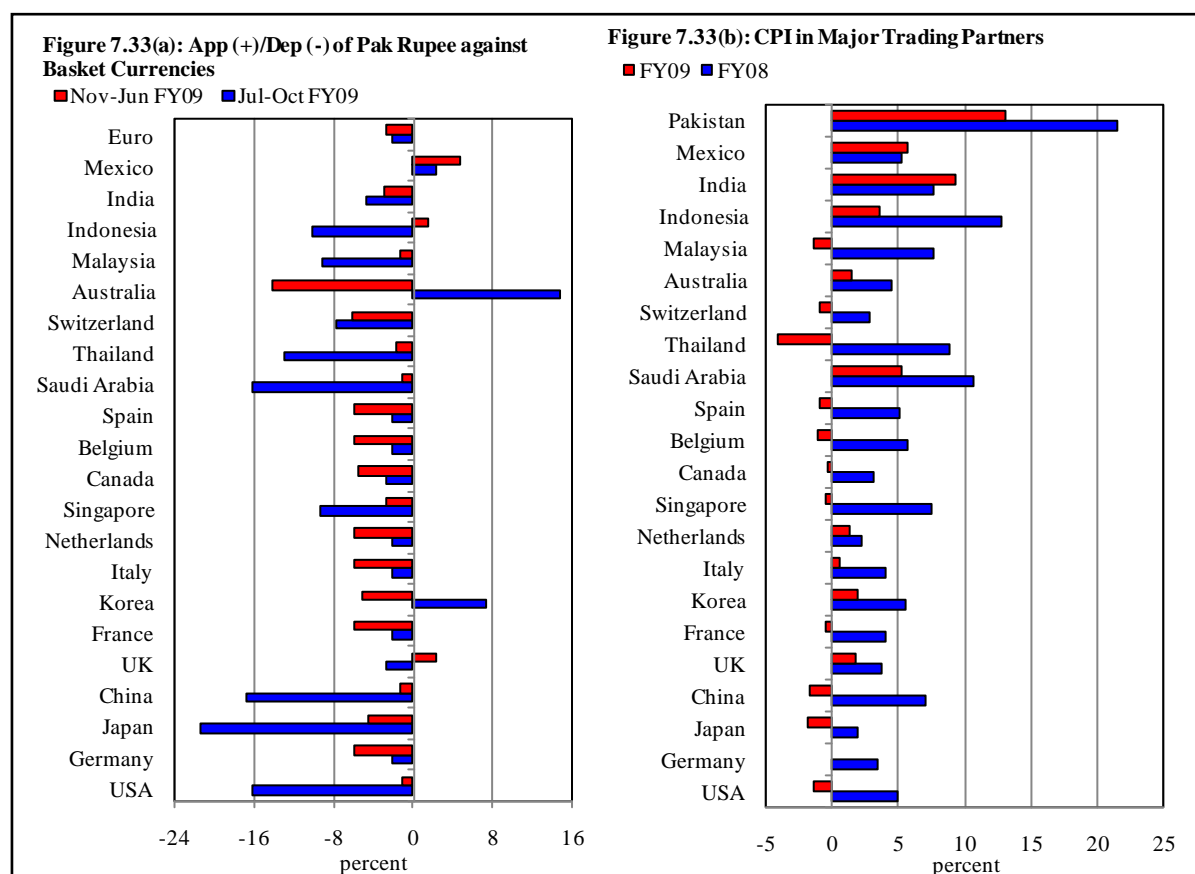


Table 7.8.1: Number of Crises and Incidence

	Jul-FY07 to Jul-FY09
Number of crises	8.0
Number of observation	37.0
Incidence (in percent)	21.6

NEER

Pakistan's nominal effective exchange rate (NEER) depreciated by 12.0 percent in FY09 as compared to 15.7 percent depreciation during FY08. This considerable fall was due to the depreciation of Pak rupee against all trading partners basket currencies except Korea and Mexico (trade weights of both countries are very small). Major chunk of depreciation came under the first four months of current fiscal year as Pak rupee lost its value against the major trading partners' currencies like US, UK China, Japan Saudi Arabia etc. (see **Figure 7.33(a)**). However, as currencies of (Euro zone, Malaysia, Thailand etc.) having 38 percent share in total trade volume of Pakistan depreciated more during Nov-Jun FY09 owing to slowdown in their exports due to global recession, Pak rupee's depreciation against these currencies was relatively less during this period.



This depreciation of other currencies against Pak Rupee is on account of slowdown or decline in economic activities particularly in the second half of the year (see **Figure 7.34**). During Jul-Oct FY09, widening trade deficit along with lower inflows caused NEER to lose its value more as compared to Nov-Jun FY09 period as inflows were consistent in this period.

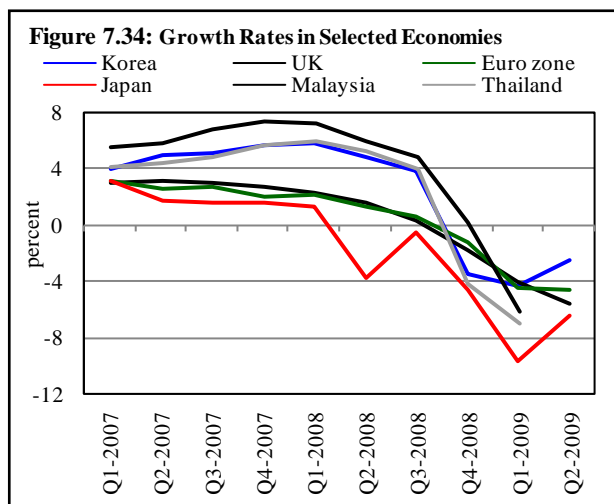
RPI

Pakistan saw exceptionally high average inflation during FY09, even as inflation in major trading partners weakened (countries either saw inflation decline to single digits or experienced deflation) (see **Figure 7.33b**).

As a consequence, relative price index (RPI) increased by 13.4 percent in FY09 as compared to 15.9 percent during FY08. Similar to NEER, RPI improved in Nov-Jun FY09 as compared to the first four months of FY09.

REER

While NEER depreciated significantly during FY09, increase in domestic inflation almost entirely offset the advantage gained by the NEER depreciation (see **Figure 7.35**). As a result, Real Effective Exchange Rate (REER) which is often used to evaluate exchange rate policy as it mirrors the export



competitiveness of a country vis-à-vis its trading partners and competitors, depreciated by only 0.3 percent in FY09 as compared to the depreciation of 2.3 percent during FY08.

7.5 Foreign Exchange Reserves

Pakistan's foreign exchange reserves declined precipitously in the initial months of FY09, dropping from US\$ 11.4 billion as of end Jun-FY08 to a low of US\$ 6.8 billion by end Oct-FY09, reflecting the continuous weakening in the macroeconomic fundamentals in this period. Subsequently however, as the country began to implement a macroeconomic stabilization program, the IMF balance of payments support helped foreign exchange reserves to recover. Hence, from November FY09 onwards, there is a continuous increase in the level of reserves on monthly basis, except for February 2009 (see **Figure 7.36**). In overall terms, country's reserves reached the level of US\$ 12.4 billion at the end of FY09 (see **Table 7.21**).

On disaggregated basis, fall and rise in SBP reserves dictated the movements in total reserves position during FY09 (see **Figure 7.37**). The fall in SBP reserves was caused by SBP oil support (US\$ 9.2 billion) and payment of euro bond (US\$ 500 million).³⁹ However, the inflows from IMF (US\$ 3.9 billion), ADB (US\$ 1.5 billion), IDA (US\$ 708 million) and logistic support (US\$ 913 million) led to increase in the level of foreign exchange reserves during FY09.

In contrast, DMB's reserves did not witness sharp swings and rose only by US\$ 485.3 million during FY09 and remained in the vicinity of US\$ 3.2-3.5 billion during FY09 (see **Figure 7.37**). DMB's reserves did not deplete despite the worsening external accounts even in the initial months of FY09 due to continuous SBP support of the market (in the form of provision of forex liquidity for oil payments) and the retirement of FE-25 loans (see **Figure 7.38**). However, February 2009 onwards, FE-25 lending increased substantially, this along with the remittances and loan inflows allowed SBP to withdraw its support of furnace oil imports without any significant impact on the exchange rate (see **Figure 7.39**).

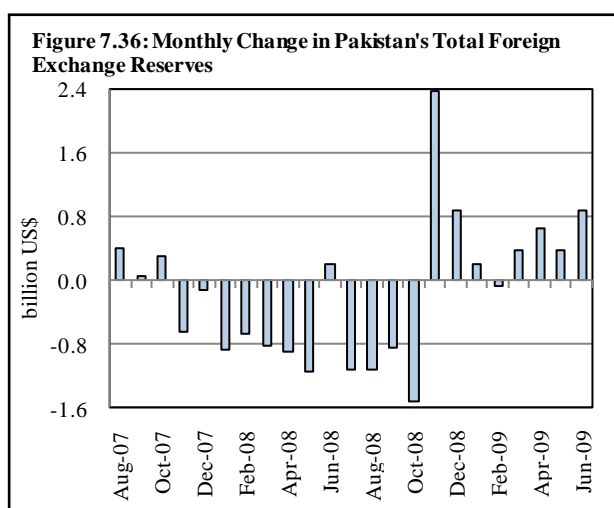
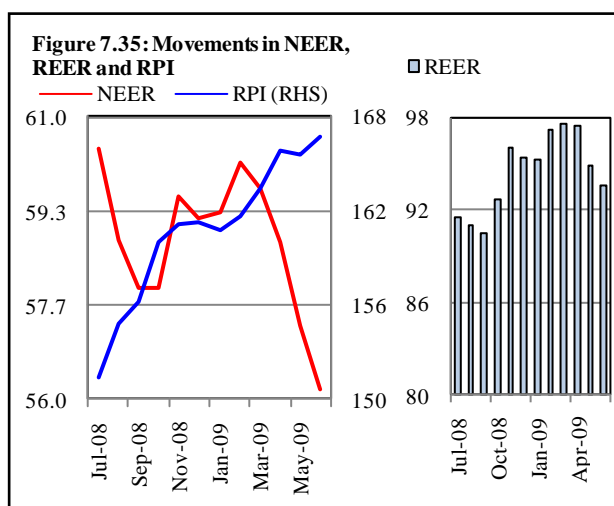


Table 7.21: Total Foreign Exchange Reserves - Quarterly Review (FY09)
million US Dollar

	Q1	Q2	Q3	Q4
Absolute change	-3101	1731	509	1890
<i>major contributors</i>				
Trade balance	-5718	-4503	-2619	-2885
Workers' remittances	1880	1760	2018	2153
FDI	1114	1213	715	680
Donor agencies (IFIs)	644	3278	667	1766
Miscellaneous receipts	205	882	976	-203
External debt servicing	-500	-737	-299	-419
Euro/Sukuk/Pak. Sov bonds	-63	-26	-563	-26

Source: DMMD

³⁹ The payment of Eurobond worth US\$ 500 million that was launched in February 2004, fell due in FY09.

It may be mentioned that SBP has also shifted the payments for diesel and other refined products imports to the interbank market with effect from August 1, 2009.⁴⁰ SBP will, however continue to provide foreign exchange to the banks for the import of crude oil (see **Figure 7.39**).

Reserve Adequacy

In literature different criteria have been used to measure the reserve adequacy, which reflects the financial soundness of the country. Most of these measures are in the form of ratios such as reserves to imports, reserve to external debt, reserve to short term debt & liabilities, etc. (see **Table 7.20**). Reserves are important to maintain liquidity in the market and for the absorption of internal as well as external shocks, particularly in situations where access to borrowing is curtailed or is very costly. In addition, foreign exchange reserves also provide confidence to investors on the ability of the central bank to timely discharge external liabilities maintain exchange rate stability.

The traditional measure of import coverage ratio, which shows the duration for which a country's imports can be financed by reserves, reached to 20.3 weeks in FY09 – a level that was considerably higher than the import coverage of the last year. The main factors for FY09 improvement were rise in foreign exchange reserves which rose by 8.4 percent, significant drop in imports on the back of noteworthy fall in oil prices and slowdown in the economy. Money-based indicators which measure the strength of the economy against potential capital flight by residents, also improved in FY09 compared to FY08 on account of deceleration in monetary aggregates in FY09 (see **Table 7.22**). The important measure of reserves to STDL compares reserves and short-term external debt and liabilities (payable within the period

Figure 7.37: SBP and DMB's Reserves

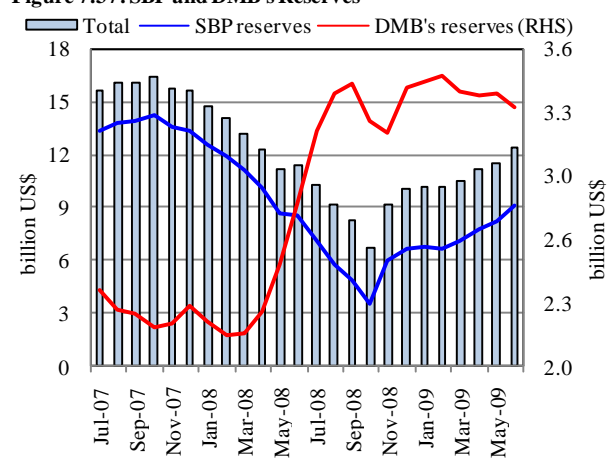


Figure 7.38: Overall Foreign Exchange Lending During FY09

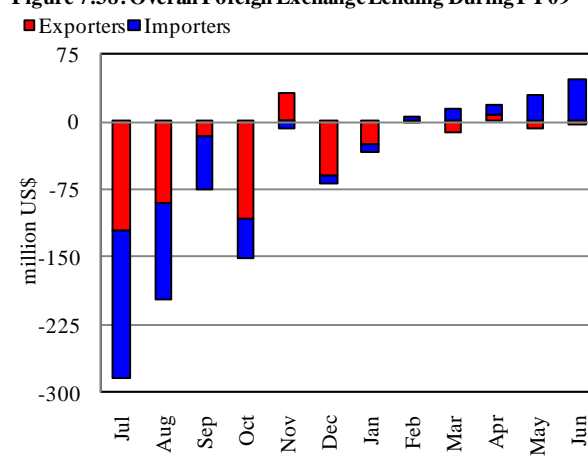
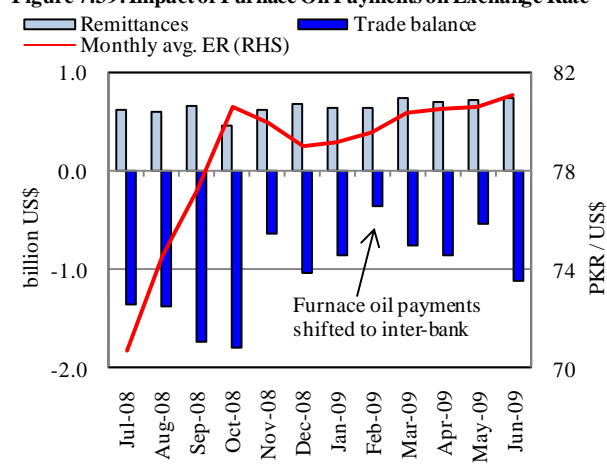


Figure 7.39: Impact of Furnace Oil Payments on Exchange Rate



⁴⁰ FE circular no. 03, dated July 15, 2009.

Table 7.22: Reserves Adequacy Ratios

	FY05	FY06	FY07	FY08	FY09
Liquid reserve (million US Dollar)	12,598	13,122	15,646	11,399	12,354
Import coverage (weeks)	35.0	27.8	30.6	16.8	20.3
Reserve to external debt	0.37	0.37	0.40	0.26	0.24
Reserve to STDL*	8.56	9.59	12.77	4.93	4.66
Reserve to M2	0.25	0.23	0.23	0.15	0.19
Reserve to reserve money	0.82	0.78	0.78	0.48	0.64
Reserve to GDP share	11.5	10.3	10.9	6.9	7.4

*STDL includes central banks deposits and NBP/BoC deposits

of one year) that determines the capacity of the country to pay the current obligation. This measure, however, worsened further during FY09 (see **Table 7.22**).⁴¹ Similarly reserve to external debt ratio also declined for the second consecutive year on the back of 14.5 percent higher external debt in FY09.

Going forward the inflows from international financial institutions are anticipated for different projects including higher education, poverty alleviation, hydro and other social sector projects. For example: ADB has approved US\$ 4.4 billion for Pakistan under Country Partnership Strategy (CPS) 2009-13 for different projects including energy, infrastructure, reforms, and urban services. World Bank has approved US\$ 900 million for social sector projects, whereas, IDB has approved US\$ 137 million for hydro unit. The International Monetary Fund has also approved an additional \$3.23 billion for Pakistan by increasing the country's Special Drawing Rights (SDR) from 500 percent to 700 percent which pushed up the total assistance to \$11.327 billion from \$7.6 billion.

⁴¹ The smaller the ratio the greater the incidence of crises as the ratio is very important predictor particularly in countries with uncertain access to capital markets.

7.6 Trade Account

Pakistan's trade account recorded a significant improvement during FY09. Country recorded a large 18.5 percent YoY contraction in the trade deficit during FY09, despite a 6.7 percent YoY fall in exports during this period. This was due to 12.9 percent YoY fall in imports during FY09 which outpaced the impact of fall in exports (see **Figure 7.40**). In view of the global recession and a fall in international commodity prices, some slowdown in country's import and export growth was expected during FY09. The impact of these developments, however, was intensified by a broad range of domestic factors during this period, which included (see **Table 7.23**):

- 1) A large 16.1 percent depreciation in the value of rupee against US dollar, which provided a cushion to exports, but discouraged imports by raising their rupee cost.
- 2) A relatively contractionary fiscal policy and tight monetary policy stance during most of FY09 for discouraging domestic demand.
- 3) Slowdown in domestic economic activity, due to external and domestic issues.
- 4) Financial constraints in the petroleum group that caused a large fall in both imports and exports of this category.
- 5) Intensification of domestic issues, e.g., energy crisis, poor law & order situation, etc.

Hence, the combined effect of all these factors brought about a larger than expected fall in exports⁴² and imports during FY09. The contraction in imports and exports during FY09 marked a disruption in their rising trend witnessed since FY03 (see **Box 7.9**).

In the case of exports, large fall in textile and petroleum group exports brought about an overall YoY decline during FY09. On a positive note, despite the adverse effects of worsening domestic issues, country's overall export performance was broadly in line with some of the other regional competitors during FY09 (see **Figure 7.41**). This was partly

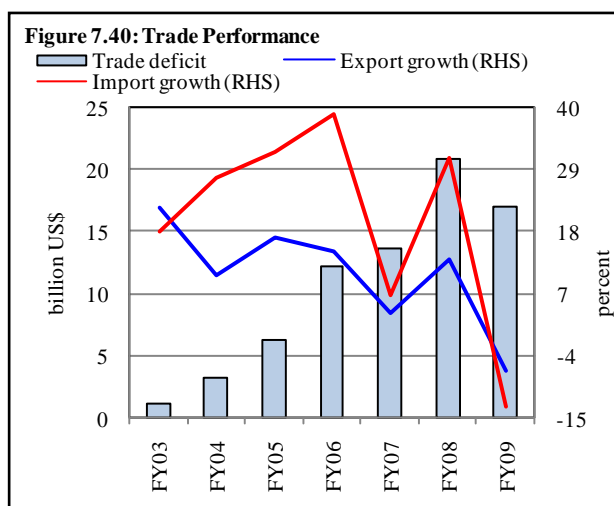
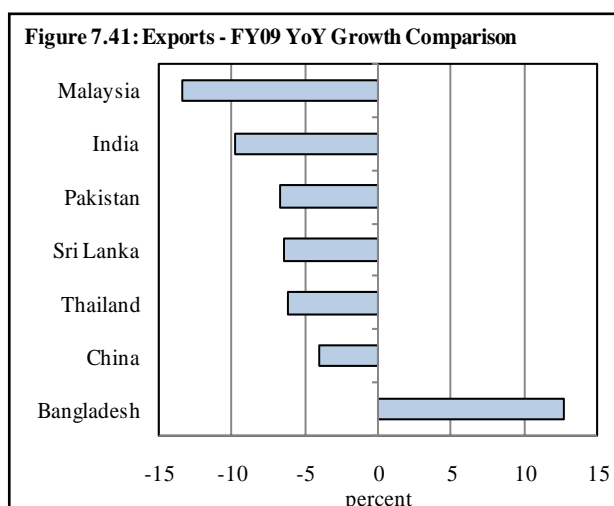


Table 7.23: Factors Responsible for Falling Import and Export Growth- FY09

price impact: million US Dollar, rate: percent

	FY07	FY08	FY09
External factors			
World import growth	15.8	19.6	-3.5
Import price impact	170.8	5,283.0	-2,050.0
Domestic factors			
WALR*	10.3	12.8	14.3
Exchange rate depreciation	-0.3	-11.5	-16.1
Textile exports growth	5.7	-2.0	-9.5
Non-textile exports growth	-0.8	37.0	-3.1
Import quantum index YoY growth	3.1	10.7	-0.4
Food and POL import growth	6.8	18.6	-12.8
Non-food non-POL import growth	6.9	55.9	-12.9
Import YoY growth	6.9	30.9	-12.9
Export YoY growth	3.2	12.2	-6.7
Trade deficit YoY growth	11.8	54.2	-18.5

*Weighted Average Lending Rate



⁴² Exports during FY09 were 7.8 percent lower than the revised target set by the Ministry of Commerce for this period.

attributable to the YoY rise in international prices of rice during FY09 that stemmed a larger YoY decline in exports during FY09. Further, a large depreciation in the value of rupee against US dollar and Euro at a time when currencies of other competitors were strengthening might also have provided a competitive edge to country's exports (see **Figure 7.42**). In the absence of these two factors exports would have also recorded a steeper fall during FY09.

As regards imports, falling import prices and slowing domestic demand caused a broad based decline in imports during FY09 (see **Table 7.23**). Given the low levels of foreign exchange earnings of the country, the broad based fall in imports was welcoming.

However, the persistence of such broad based contraction in imports is likely to translate in poor performance of country's manufacturing and export industries, a fact which was also observed in FY09.⁴³ Therefore to maintain the country's trade deficit within manageable limits, focus should be on enhancing export capacity and containing imports by reducing foreign dependence for products that can be produced locally.

To improve the country's export performance, the need is to address various sector specific issues hampering country's export performance.⁴⁴ In addition, an earlier resolution of the energy crisis and improvement in physical and human capital base is also likely to lead to a persistent improvement in country's export competitiveness by reducing inefficiencies. Similarly, efforts should be made to curtail the need for consumer goods imports, particularly of the food group categories. Broad ranging reforms in the agriculture sector aiming at attaining self sufficiency in food products can help in saving scarce foreign exchange resources spent on these imports.

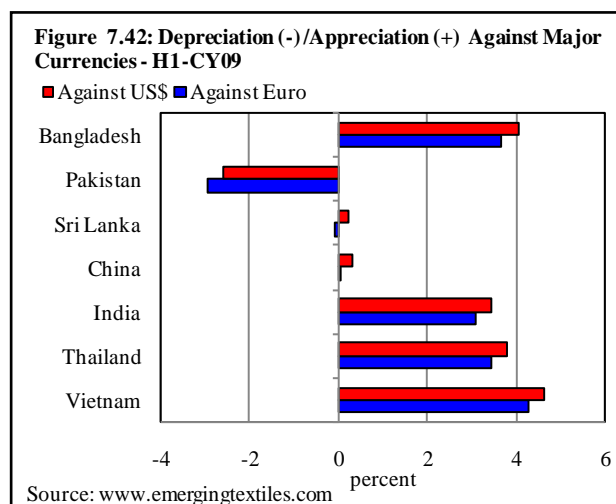
The concern for revival in export and manufacturing sectors has also led to change in government's policy stance to support to these sectors. This is evident from various credit related incentives announced by SBP during FY09, the monetary policy loosening by SBP since Q4-FY09, a broad range of fiscal support measures announced by the government in the federal budget for FY10, the Strategic Trade Policy Framework 2009-12, and Textile policy 2009-14. The change in policy stance is likely to cause some recovery in exports, accompanied by an increase in imports towards the end of CY 2009. Further, the trade deficit during Q1-FY10 is likely to record a sharp fall due to high base effect during the same period last year.⁴⁵

Box 7.9: FY09 – A break from the structural shift.

In this section, instability indices for exports and imports for the period FY90-09, are calculated by estimating the deviation of exports and imports from the long term trends following Najeeb and Tariq (1995), to find out the evidence for structural shift in exports and imports during FY03-08.⁴⁶ For this purpose following equations are estimated;

$$\text{Log}X_t = c + a_1T + u_t \quad (1)$$

$$\text{Log}M_t = c + a_1T + u_t \quad (2)$$



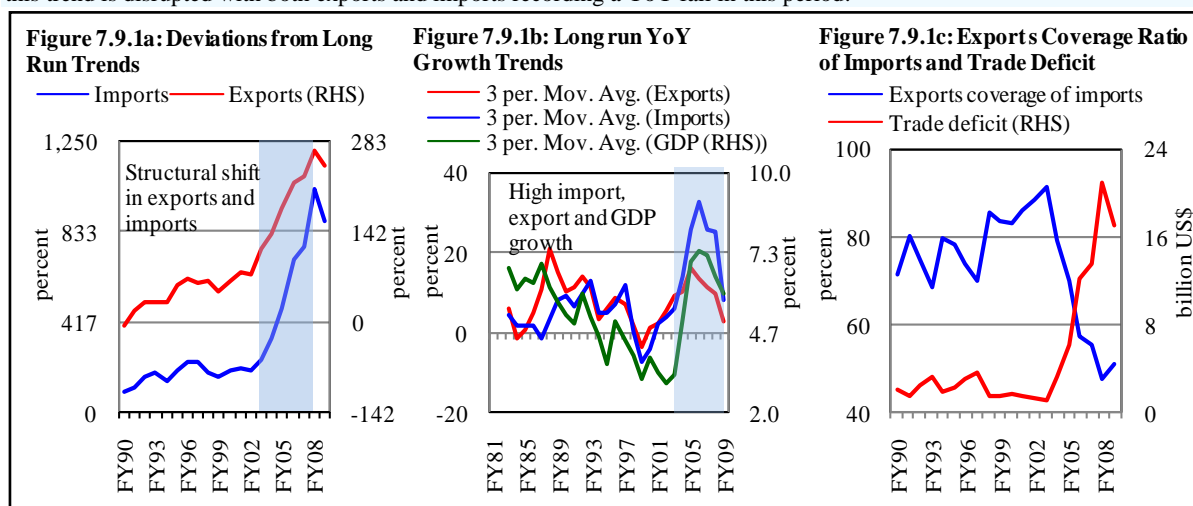
⁴³ During FY09 manufacturing sector recorded 3.3 percent YoY fall.

⁴⁴ For details see section on Exports.

⁴⁵ Trade deficit recorded a sharp 38.5 percent YoY fall in July-Aug FY10.

⁴⁶ Tariq, Ahmad and Najeeb. Qazi, (1995), "Export Earnings Instability in Pakistan", *The Pakistan Development Review*, 34 : 4 Part III (Winter 1995) pp. 1181—1189.

Where X_t is value of exports, M_t is value of imports and T is long run trend variable. The indices for instability show large deviations of exports and imports from their long run trends since FY02 (see **Figure 7.9.1a**). In FY09, however, this trend is disrupted with both exports and imports recording a YoY fall in this period.



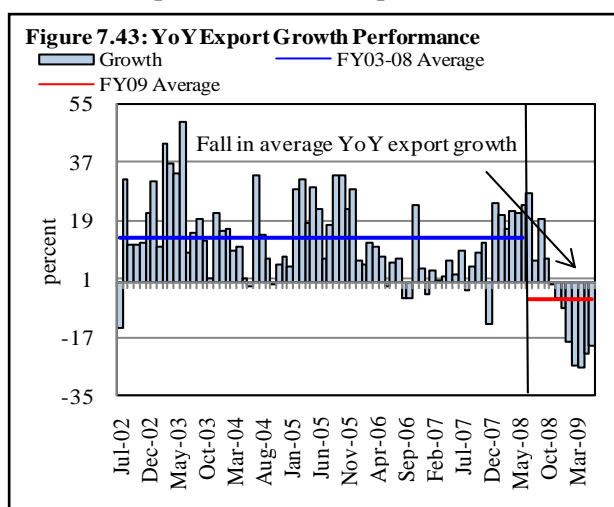
The analysis reveals that the period of FY03-08 can be characterized with high economic activity, led by macroeconomic and political stability and conducive external environment⁴⁷. Resultantly, healthy growth in GDP, and improvement in external and domestic environment resulted in an upward structural shift in both exports and imports growth during FY03-08 (see **Figure 7.9.1a & b**). Further, due to country's low export coverage ratio of imports, high economic activity also translated into higher trade deficits during this period (see **Figure 7.9.1c**).

However, since FY08, the favorable domestic and external environment has undergone a reversal. The country on the one hand, witnessed substantial deterioration in the domestic law and order situation, on the other hand, sharp increase in domestic inflation due to surge in international commodity prices and excessive domestic demand led authorities to adopt contractionary monetary and fiscal policy approach. In addition, the deepening of international recession also resulted in a steep fall in external demand for country's exports during FY09. All these factors finally led to deterioration in country's economic performance and resultantly, exports and imports recorded a YoY fall during FY09 after period of rejuvenation in FY03-08.

7.6.1 Exports

A combination of both external and domestic issues caused exports to record 6.7 percent YoY fall during FY09 compared to a healthy 12.2 percent YoY growth witnessed in exports during FY08. The analysis of monthly export performance reveals an accelerated deterioration in export growth from November 2008 which was broadly in line with the deepening of international recession by the end of CY 2008 (see **Figure 7.43**). In fact the impact of the adverse external and domestic factors was intensified in H2-FY09, which caused a steep 20.1 percent YoY fall in exports during H2-FY09 nullifying the impact of 9.4 percent YoY growth recorded in exports during H1-FY09.

The YoY fall in exports during FY09 also



⁴⁷ In addition to the improvement in domestic environment, export growth also received a boost from duty free market access provided by EU under the special GSP initiative during FY02-FY04.

marked disruption in the rising trend of exports witnessed since FY03. And the monthly average YoY export growth, which was at 13.7 percent during FY03-FY08 dipped to a negative 5.7 percent during FY09 (see **Figure 7.44**).

In view of the ongoing global financial crisis and the resulting depression in international demand some deterioration in country's export performance during FY09 was already expected (see **Box 7.10**). However, the effect of recession was complemented by intensification of domestic issues particularly energy crisis and poor law and order situation, etc.

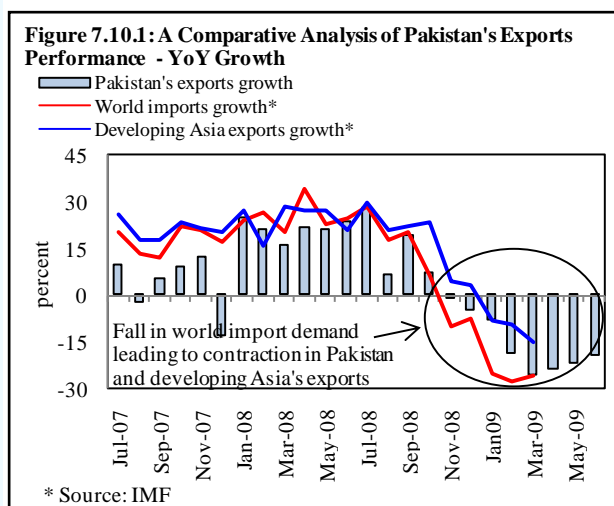
Box 7.10: Exports and Global Financial Crisis.

The global financial crisis hampered Pakistan's exports performance through both direct and indirect channels.

Contraction in international demand. The deterioration in country's export performance was in line with the deepening of global economic crisis that caused the global import demand to squeeze from Q2-FY09 onwards. A review of country's monthly export performance reveals a continuous fall in country's exports from November 2008 that is supported by a large fall in world imports from this period (see **Figure 7.10.1**).

Trade financing issues. According to the IMF (Apr 2009) report on Global Financial Stability 'financial crisis has affected the cost, volume, and modalities of trade financing'. The presence of defaulted assets on the balance sheets of trade financing institutions squeezed their ability to provide funds for trade finance, which resulted in a more stringent procedure for the provision of such credit, and hence less disbursement. The reduced availability of trade finance affected buying capacity of importers in many countries. Thus many instances of default or requests for extension in payment periods from buyers were reported by country's exporters (especially of textile and clothing) during FY09.

Problems in obtaining domestic financing. Reportedly the uncertainty attached to the financial health of foreign buyers led to rising stock of unsold goods with the country's exporters that raised doubts about their ability to pay off liabilities. This fact together with increasing volume of non-performing loans with the domestic banks made these banks more cautious in lending activities. The reduced availability of finances created further problems for exporters by hampering their ability to produce and export.



Further, the impact of adverse external and domestic issues was compounded by persistent structural problems faced to export industries that include – lack of proper infrastructure, unskilled labor, fragmentation of export industries, lack of vertical integration and lack of entrepreneurship, low market, and product diversification, etc. All these issues exposed the un-sustainability of high growth path followed by exports in the past few years. This situation demands to devise a well thought out strategy for bringing about sustained improvement in country's export performance (see **Box 7.11**).

The Strategic Trade Policy Framework 2009-12 announced by the government contains many positive initiatives for the development of various export industries, e.g., sports goods, surgical goods, cutlery, agro based exports, textile, pharmaceuticals, light engineering industries, etc. by providing financial support, duty and tax exemptions, establishment of training institutes, etc. To achieve desired results, the need is to implement these measures in the letter and spirit. There is a need to devise a strict monitoring mechanism for the efficient utilization of financial support provided by the government to rule out misuse of the scarce sources that has watered down such initiatives in the past.

Box 7.11: Quest for Export Growth Recipe

Back ground. The story of Pakistan's export performance is a mix of failures and successes. After remaining range bound between US\$ 4.0–8.0 billion through most of the decade of 1990s, exports were finally able to cross the US\$ 10 billion mark

in FY03. Congenial domestic and external environment then helped exports to grow to a peak of US\$ 19.2 billion in FY08. However, even this extra ordinary performance seemed dismal when compared with some other regional success stories for two reasons; 1) exports remained largely concentrated in few categories and destinations; 2) the growth was not robust and was very susceptible to domestic and external shocks as is apparent from the dismal performance of FY09. Though the fall recorded in export growth in FY09 is partly attributable to the slackening external demand, various structural issues have also contributed in the current deterioration of export performance.

In this background this section is an attempt to understand some of the main export growth initiatives taken by world's major achievers, such as the East Asian economies, which attained remarkably high levels of export and economic growth. This analysis will help us in identifying weaknesses in domestic trade policy formulation and implementation which have plagued export performance of the country.

Export growth strategies of the East Asian economies

A brief survey of literature reveals that 'export push' strategies of almost all East Asian economies contained the following elements:

Provision of adequate infrastructure. These economies invested heavily in physical infrastructure with a special focus on improving port facilities, transportation system and ensuring adequate supply of energy to industries.

Monetary and fiscal policy initiatives. In some of the countries, i.e., Korea, Japan, Singapore, and Taiwan conscious efforts were made by governments to promote priority industries which had strong backward and forward linkages. This was done by providing incentives in the form of availability of cheap credit, provision of tax breaks, and income tax incentives, etc to encourage manufacturing and export in such industries.

Duty free availability of imports for export industries was also ensured. For this purpose different strategies were followed that included: establishments of free trade zones, export processing zones, duty drawbacks or tariff exemptions. Further in cases where duties were not removed on imports, the export industries were subsidized to neutralize the effects of such duties.

Developing new export markets. For addressing problems that came across exporters in their efforts in penetrating new markets, governments played an active role. This was done by providing financial support in the form of subsidies and direct income tax incentives on the exploration of new markets. In some instances i.e., Japan and Korea trading agencies were established by governments, for providing information about consumption trends and extent of competition in the foreign markets. In addition, in some of the countries, e.g., Taiwan, government also focused on providing benefits to export firms for establishing brand names.

An important feature of the support provided by government was linking incentives with the level of performance. This was to ensure that less efficient firms did not enjoy government support at the cost of efficient firms.

Further, most of these countries, e.g., Indonesia, Korea, and Taiwan resorted to devaluation for improving competitiveness of their exports.

Macroeconomic environment. The above mentioned policy measures were not introduced in isolation, rather the thrust for export promotion was introduced in a very stable macroeconomic environment. To ensure macroeconomic stability in the economy, public deficits to GDP ratios were kept within manageable limits, so these countries did not come across financing difficulties during the course of high economic growth. Inflation rates were also at moderate levels which helped in stabilizing the real lending rates.⁴⁸

Industrial policies. Further the export policies in these countries were supported by equally aggressive industrial policies which aimed at increasing domestic manufacturing capacities for producing a wide range of intermediate goods. The major focus of these policies was on accumulation of both physical and human capital. This was done by encouraging savings and increasing expenditure on education. In addition, in many of these countries, governments with the help of financial regulations ensured the movement of capital to high technology sectors instead of relatively less productive sectors such as real estate. Further, large industries were provided with research and science centers that aimed at development of new products. High quality control standards were adopted and firms were also encouraged to follow international standards.

Foreign direct investment. The stable macroeconomic environment, well organized labor markets with skilled and educated labor, high quality of production facilities and a stable political environment also led to increased inflow of FDI in the export

⁴⁸The average inflation rate of High Performing East Asian Economies (HPAEs) during 1960-91 was at 7.5 percent. The average public deficit/GDP ratio during 1980-88, was 1.9 percent for Korea, 5.8 percent for Thailand and 10.8 percent for Malaysia. These numbers were although not very low but high GDP growth enabled these countries to obtain financing for these deficits without difficulty.

industries. This resulted into much desired transfer of technology from abroad that further improved the product mix produced by these countries.

Government's commitment with the objective of growth. Governments of these countries were fully committed to the objective of achieving high growth. Thus the policies devised at various levels were implemented in the letter and spirit.

Table 7.11.1: A Comparative Position of Pakistan's World Competitiveness Rankings

	Pakistan	India	Sri Lanka	Bangladesh	Indonesia
Global Competitiveness					
Rankings	111	106	98	123	93
Institutions	95	53	66	127	68
Infrastructure	83	48	65	122	86
Macro stability	116	109	132	122	72
Primary education	116	100	53	105	87
Higher education/ training	123	63	65	131	58
Goods market efficiency	101	37	42	106	101
Labor market efficiency	121	81	115	107	91
Technological readiness	100	69	82	126	56
Business sophistication	87	27	32	105	35
Innovation	82	32	36	122	43
Per capita income (million US\$)	909	978	1,506	456	1,925

Source: The State of Pakistan's Competitiveness Report 2009, Competitiveness Support Fund.

Lessons for Pakistan:

The above mentioned export growth strategy adopted by the East Asian economies highlights following points:

- 1) The objective of export growth cannot be achieved in isolation; rather it needs a complete support of a stable macroeconomic and political environment.
- 2) The improvement in infrastructure, human capital and accelerated accumulation of physical capital lie at the heart of any export or for that matter economic growth strategy.
- 3) To stay competitive in the world market, export industries do need government support. However, this support must be administered in a way that does not distort production efficiency of these industries.
- 4) The development of new markets and products cannot be left alone to exporters. This needs active participation of government for achieving the objective of product and market diversification.
- 5) The objective of export and economic growth needs serious commitment of the government.

In the case of Pakistan while various trade policies announced by governments from time to time focus on product specific export initiatives, a coordinated strategy covering other important aspects such as improving physical infrastructure, quality of human capital and diffusion of latest technology from abroad, etc. seems to be missing. This inability arises from the fiscal resource constraint faced by the government which reduces its ability to develop infrastructure and invest in human capital. The depressed growth of export, in turn, further dints the availability of resources, which can be used for improving infrastructure.

Moreover, the paucity of fiscal resources and the resultant low quality of living has catalyzed the phenomenon of extremism, which has given rise to serious law and order issues in the country during the last few years. This is acting as an additional constraint on country's export performance by distorting country's image which leads to diversion of export orders to other competitors. In addition, the chronic issue of political instability, which is often accompanied by macroeconomic instability in the country, discourages the flow of both private and foreign investment. Thus over the years a combination of all these factors has constricted Pakistan's export potential. These issues have also translated in eroding country's competitiveness ranking vis-à-vis its competitors. In the areas of primary education and labor market efficiency, the country's comparative ranking is even worse than Bangladesh, which is at a far lower level of economic development than Pakistan in terms of per capita income (see **Table 7.11.1**).

Further, despite the scarcity of resources, government does provide some support to the export industries. However, the important element of linking support with performance is usually missing from such initiatives, which distorts the incentives for inducing efficiency in production process and breeds rent seeking. This fact points towards the need to devise a performance based criterion for providing government support to various export industries.

Similarly government needs to take a proactive part in the area of development of new markets and products for the purpose of diversification of country's exports. Government in the last few years did follow an aggressive marketing strategy by entering into PTAs and FTA with different countries, holding and attending various international exhibitions, etc. This role needs to be extended by establishing different markets and products research centers with the help of private sector.

In fact the financing issue faced by the government can also be addressed by incentivizing public-private partnership for investment in the areas of education, health, establishment of skill development centers and research and development institutes. A mix of public and private investment in these areas together with a fully committed government effort can certainly mark a sustainable upward structural shift in the export performance of the country.

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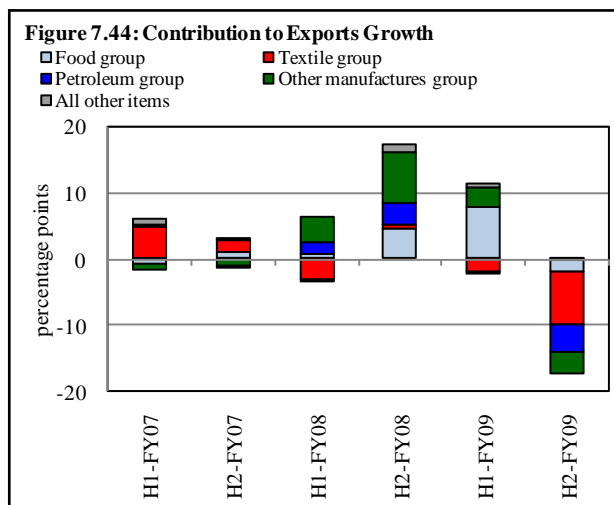
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Composition of Fall in Export growth

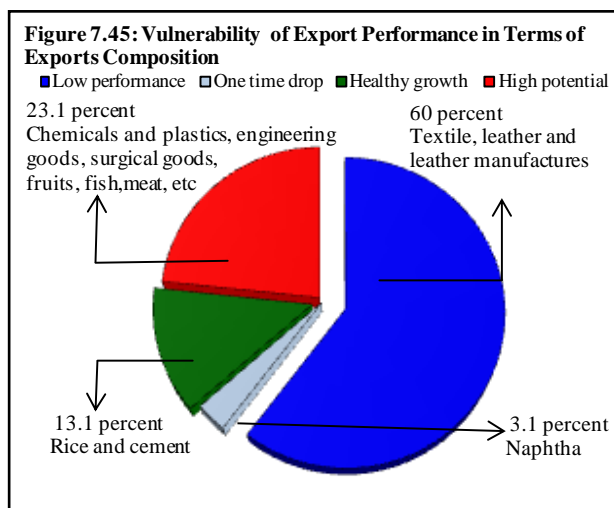
In terms of composition, *textile, petroleum* and *leather & leather manufactures* recorded the largest declines in exports during FY09, whereas the *food group* and some categories of *other manufactures* recorded increases in export earnings in this period (see **Figure 7.44** and **Table 7.24**). In fact the impact of the various impediments to exports was partly offset by two supporting factors during FY09 that included; (a) a large 16.1 percent depreciation in the value of rupee recorded during FY09 that helped exporters by improving their competitiveness in various categories; and (b) a significant 19.9 percent rise in export unit values of rice during FY09. In the absence of these two factors country's exports would have recorded an even larger fall in this period.



Export Performance – Strengths & Weaknesses

The analysis of the category wise export performance reveals that;

- Textile and leather group exports that capture on average around 60 percent share⁴⁹ in the country's total export earnings are facing the greatest pressure from the adverse external and domestic environment (see **Figure 7.45**);
- Almost 13 percent exports earnings originate from rice and cement which have bright prospects for growth;
- Categories that capture around one-fourth share of the total export earnings have a large potential to grow, subject to resolution of sector specific issues in some of these



⁴⁹The analysis in this section and Figure 6.7 is based on average shares of categories during FY08 and FY09.

categories;

(d) Around 3 percent of export earnings were subject to the effect of domestic financial issues of refineries, and are likely to recover in the short term.

a) Low performing categories

Textile was among the major export categories that faced a serious impact of the adverse external and domestic factors and recorded a large US\$ 1 billion YoY decline during FY09. In addition to the above mentioned problems, this sector also faced liquidity issues because of : (a) lower export earnings; (b) banks becoming more cautious in extending loans to textile companies because of rising NPLs of this sector ⁵⁰; (c) delay in sales tax refunds by government; (d) with the deepening global recession, international buyers either opted for default or demanded extension in payment periods.

Although 16.1 percent depreciation of Pak rupee during FY09 partly mitigated the impact of adverse factors, all categories of textile group, with the exception of raw cotton, cotton carded and towels, posted declines during FY09 (see **Table 7.24**). ⁵¹ In fact towel was the only major category that posted quantum growth during FY09. A review of monthly export performance of textiles reveals that the deterioration in textile exports was accompanied by a deepening of global recession from Q4-FY09 that resulted into weakening of the world import demand (see **Figure 7.46a**).

The impact of recession had a mixed effect on Pakistan's textile exports during FY09 vis-a- vis the competitors. The country comparison of textile and clothing export performance (see **Table 7.24**) in the major markets of the EU and the US reflects that (a) Pakistan's textile and clothing exports performed better than certain other competitors ,i.e., Mexico, Turkey, Sri Lanka, etc.; (b) the country is facing tough competition in both the markets of EU and the US in both the categories, i.e., textile and clothing; (c) Pakistan's textile exports are recording consistent fall in the US market since FY08 while in EU the situation has started to worsen since FY09.

In fact an analysis of country's textile and clothing export performance reflects that this sector has not been able to meet the challenges imposed by high competitive post quota regime which is evident from an almost increasing deterioration in textile export earnings since FY07 (see **Figure 7.46a**).

Category- wise analysis

The categories of cotton yarn and cotton fabrics recorded quantum declines almost throughout FY07 and FY08 (see **Figure 7.46 B & C**). Moreover, due to rupee depreciation, in FY08 these categories

Table 7.24: Textile & Apparel Export Performance - International Comparison
in percent

	Textile		Apparel	
	FY08	FY09	FY08	FY09
USA (Jul-Apr)				
World	3.8	-13.9	-1.7	-6.1
Bangladesh	3.4	14.9	1.9	13.6
China	9.2	-8.2	2.1	2.5
India	-21.2	18.7	0.6	-7.2
Indonesia	-6.9	-14.2	-0.3	0.3
Mexico	-1.0	-22.6	-13.2	-13.4
Pakistan	-6.4	-6.3	1.5	-4.6
Sri Lanka	-5.9	-26.7	-11.2	-4.6
Turkey	8.8	-31.6	-30.4	-31.4
EU (Jul-Mar)				
World	1.1	-8.7	2.9	3.7
Bangladesh	9.3	3.0	-0.7	12.1
China	9.6	-0.03	7.0	18.0
India	1.6	-10.0	3.5	5.4
Pakistan	2.4	-3.5	-0.6	5.9
Tunisia	3.0	-7.8	-0.2	-4.1
Turkey	-2.0	-14.6	3.5	-14.7
Vietnam	3.3	-7.4	26.7	5.4

Source: US Census Bureau & Euro Stat

⁵⁰ For details see Chapter 4 Money and Banking

⁵¹ In rupee terms textile export recorded 13.2 percent YoY growth during FY09.

got some room for lowering their export unit values, to attract demand. The resultant fall in export unit values led to some improvement in the export quantum growth of these categories in FY09. The performance of bed wear exports, however, is not discouraging when seen against the imposition of antidumping duties by the EU (see **Figure 7.46D**). After the removal of these duties from May 2009, the export of this category to EU is expected to increase.

Knitwear exports remained broadly resilient to the domestic issues till H1-FY09, as the quantum growth of this category remained mostly in the positive range from July 2006 to January 2009 (see **Figure 7.46E**). To maintain their market positions, knitwear exporters also resorted to reducing unit values from time to time. However, since the start of FY09 the export of knitwear is also facing quantum declines despite the fall in unit values. This is attributed to the country's over dependence on the US market that captures over 60 percent share in country's knitwear exports (see **Figure 7.46B**). With the deepening of recession, US is experiencing a sharp fall in clothing imports⁵², which has also depressed Pakistan's clothing exports to this country.

Table 7.25: Major Exports
million US Dollar

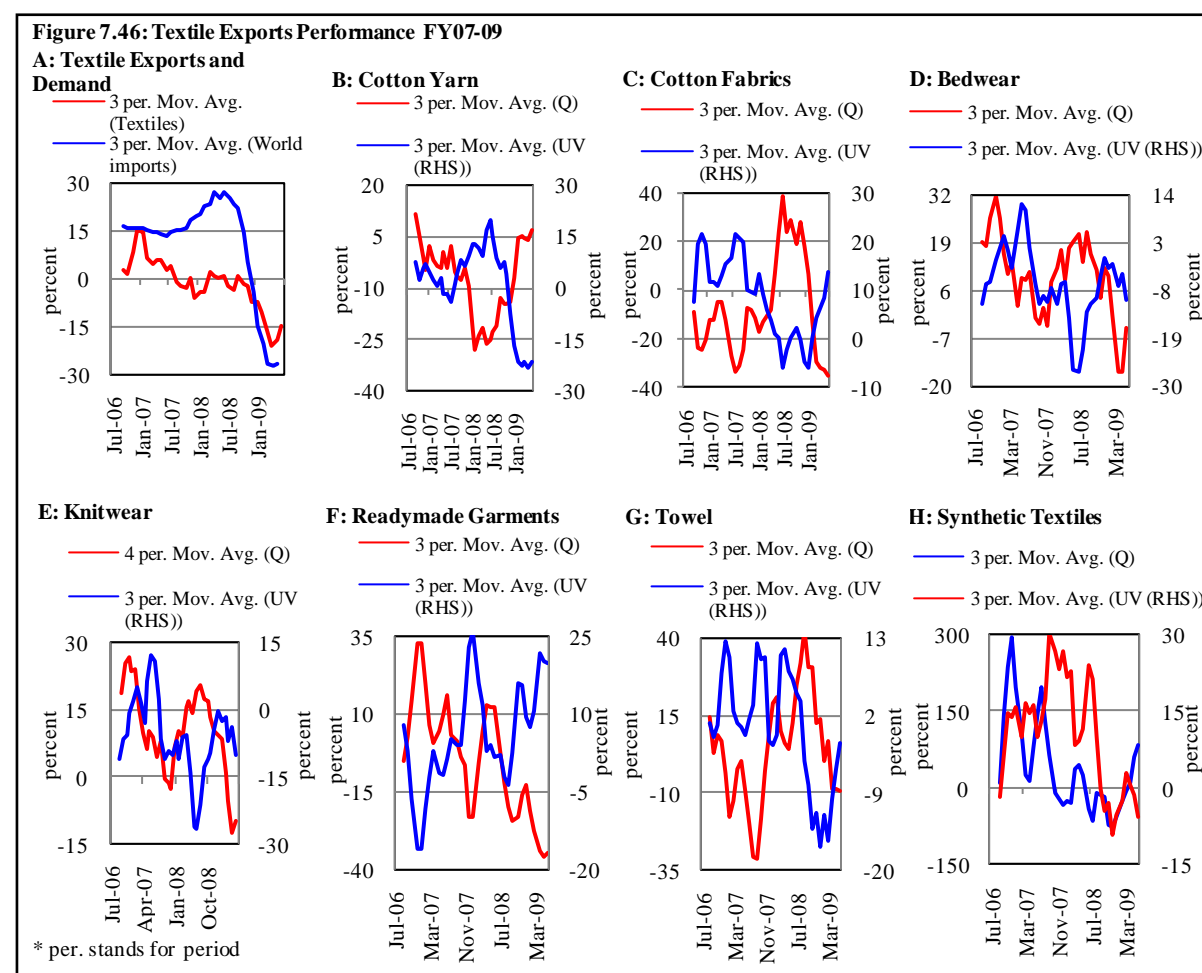
	Unit	FY08		FY09(p)			Qty	% YoY Δ	
		Value	Unit value	Value	Unit value	Abs.Δ value		Value	Unit value
Food group		2,833.0		3,023.2		190.2		6.7	
of which									
Rice	MT	1,836.1	653.6	1,986.8	776.1	150.8	-8.9	8.2	18.7
Textile group		10,571.8		9,564.4		-1,007.4		-9.5	
of which									
Cotton yarn	MT	1,301.0	2,344.9	1,105.8	2,111.2	-195.1	-5.6	-15.0	-10
Cotton fabrics	SQM	2,010.6	987.9	1,929.2	1,024.9	-81.4	-7.5	-4.0	3.7
Knitwear	DOZ	1,732.1	17.4	1,724.0	16.0	-8.2	8.5	-0.5	-8.3
Bed wear	MT	1,903.5	5,719.3	1,709.6	5,321.6	-193.9	-3.5	-10.2	-7
Towels	MT	613.1	4,024.8	627.7	3,789.5	14.6	8.7	2.4	-5.8
Readymade garments	DOZ	1,592.4	37.9	1,247.2	42.0	-345.2	-29.4	-21.7	10.9
Synthetic textiles	SQM	410.3	0.9	319.5	0.9	-90.8	-18.8	-22.1	-4.1
Other textile made-up		537.1		489.1		-48.0	---	-8.9	---
Other textile material		270.8	---	224.4	---	-46.4	---	-17.1	---
Petroleum group		1,259.4		812.4		-447.0		-35.5	
Other manufactures group		3,658.6		3,581.7		-76.8		-2.1	
of which									
Chemicals and pharmaceuticals		619.2	---	606.1	---	-13.1	---	-2.1	---
Molasses	MT	54.7	70	95.8	102.3	41.1	19.9	75.2	46.1
Cement	MT	417	55.1	576.6	59.6	159.6	27.8	38.3	8.2
All other items		729.5		800.2		70.6		9.7	
Total exports		19,052.3		17,781.9		-1,270.4		-6.7	

p provisional

In addition to the impact of recession, Pakistan is experiencing more competitive pressure in the US market after the removal of quotas on China since January 2009. While the impact of recession is not a permanent feature, the difficulty faced by Pakistan in maintaining its market share in the US market after the quota free entry of China is, however, a matter of concern. Similarly the quantum growth of readymade garments exports after recording increases in FY07 and FY08 in YoY terms is following a

⁵² <http://www.emergingtextiles.com/?q=art&s=090710-apparel-us-import&r=us-apparel-import&n=6>

declining trend since the start of FY09 (see **Figure 7.46F**). This category is also experiencing tough competition from China, in both the EU and the US markets after removal of quotas from January 2008 and 2009.



The category of towels started to record impressive quantum growth in FY08. However, on account of the adverse factors, this momentum could not be maintained in H2-FY09 (see **Figure 7.46 G**). The above analysis highlights that;

- 1) Low value added categories of cotton fabrics and cotton yarn are finding it hard to compete in the post quota regime.
- 2) The high value added categories of clothing which performed relatively better till FY08, have also come under pressure because of the recession, removal of quotas on China, over dependence on the US market and structural issues.

Reportedly, the inability to compete in the highly competitive environment has led many textile and clothing exporters to close their businesses. To counter the impact of recession, Pakistan like other competitor countries has also taken various supportive measures from time to time (see **Box 7.11**).

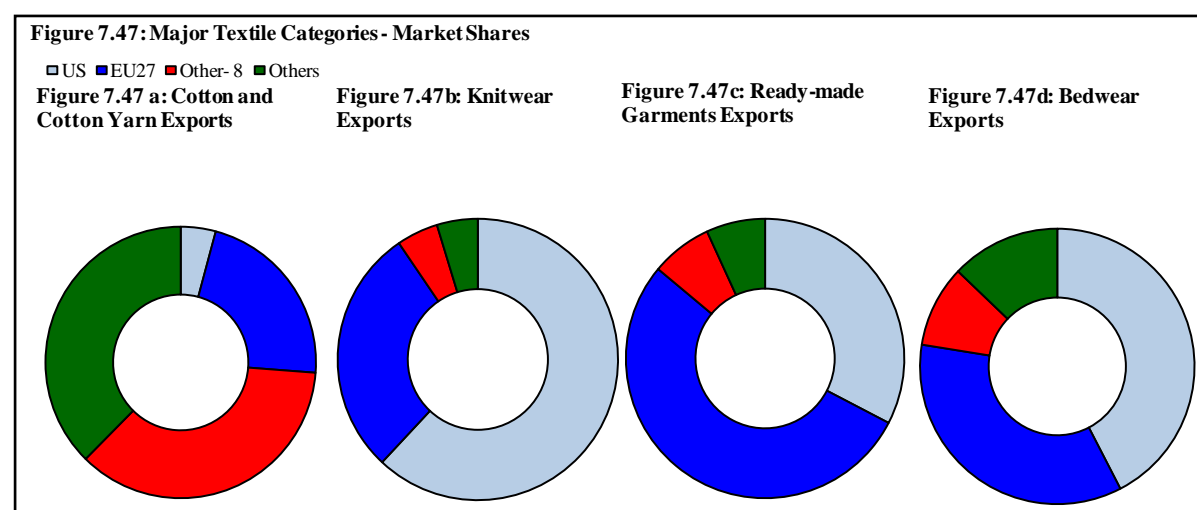
Opportunities for market diversification

This section, explores the opportunities for diversification of Pakistan's textile and clothing export for the categories of cotton and cotton yarn, bed wear, knitwear and readymade garments. This analysis

includes the following steps: (a) identification of world top importers (other than US and EU)⁵³ of all these categories; (b) conducting share analysis of imports from Pakistan vis-à-vis other competitors, in these top world import markets for the above mentioned textile and clothing categories.

The comparison of market composition of Pakistan's textile group exports reveals negligible presence of Pakistan in world's other big import markets as compared to the competitors (see **Table 7.25**). The category wise analysis highlights that; in the category of cotton and cotton yarn, Pakistan has relatively diversified market presence (see **Figure 7.47a and Table 7.25**).

In clothing sector of knitwear and garments, Pakistan's exports are largely concentrated in the US and EU markets (see **Figure 7.47 b & c and Table 7.25**). Thus country lags behind its competitors, e.g., India and Bangladesh in terms of market share in other large markets. As opposed to Pakistan, in the knitwear segment India has penetrated the markets of UAE, Switzerland, Canada, Mexico, etc. Bangladesh has also managed to capture some share in these markets. Similarly, in case of readymade garments, India has impressive shares in the UAE and Saudi Arabia, whereas Pakistan's exports of these categories focus on mainly the EU and the US markets. Pakistan's bed wear exports are also broadly targeted to the two large destinations of EU and the US (see **Figure 7.47d and Table 7.25**).



This fact demands the need for focusing efforts for market diversification in textile group exports. While it is difficult for Pakistan to enter in the markets of Japan and Korea that are almost completely captured by China, in the other markets Pakistan can certainly attempt to snatch some share from India and Bangladesh. Especially Canada, which has close proximity to US has only 1 percent and 0.5 percent presence of Pakistan in the knitwear and readymade garments exports. In view of the similarities in the tastes and consumption patterns of the US and Canada, Pakistan can focus on gaining some presence in the Canadian market as well.

A similar opportunity exists in UAE and Saudi Arabia, where India has captured a large market. In fact Pakistan's bed wear exports have a notable presence in the markets of UAE, Saudi Arabia, Switzerland, Canada and Russia. This implies that country can explore these markets for the clothing exports as well, by differentiating its products according to the needs of these markets and improving quality of the products. Due to deteriorating law & order conditions in the country, it might be difficult to attract new importers as they are reluctant to visit Pakistan. To this end support may be

⁵³ As the focus of the analysis is on finding out other potential destinations for country's exports of textile and clothing out of these top importers US and EU are eliminated.

provided by government by making comprehensive marketing strategies, holding exhibitions, entering into preferential trade agreements with these markets, etc.

In this regard, encouragingly, to address various issues which are hampering export performance of textile group, the government has announced a comprehensive textile policy 2009-14, containing a broad range of incentives for this sector.⁵⁴

The mix of domestic and external factors also led to a large 29.8 percent and 22.5 percent YoY fall in *leather and leather garments* exports during FY09. The availability of basic raw material due to large livestock production in Pakistan gives country a comparative advantage in this industry. Yet, this advantage is not fully being tapped due to a number of issues in this sector, for instance, lack of skilled labor, obsolete machinery, lack of awareness in the manufacturers about changing world fashion trends, low quality of products, power crisis, etc. As a result, the country's leather group exports are facing tough competition from China, India, and Bangladesh in the major export markets of the EU and the US.

This is worth-mentioning that despite the impact of depressed external demand India's leather group exports recorded 2.8 percent YoY increase during Apr-Feb (2008-09)⁵⁵, whereas Pakistan's exports of this category recorded 8.1 percent YoY decline in the same period. Indian leather industry was provided 2 percent interest rate subvention from December 1, 2008 to September 30, 2009, however⁵⁶. To address the issues faced by this category Pakistan's government has also announced various measures in the Strategic Trade Policy Framework for FY09-12.⁵⁷

Carpets and rugs exports also being luxury goods faced the impact of falling external demand recording a large 32.9 YoY fall during FY09. The exports to US alone which is the largest destination for this category, recorded 30.5 percent YoY decline during FY09. However, this industry is recording almost a steady fall in exports since FY07. This is because of some other structural issues in this sector. The carpet industry lags behind the competitors in the fields of designing, quality standardization, labor skills, low production capacity, etc. Buyers of this category require big lots of same specification –color, pattern, size, etc. – which is not possible to produce in the present set up of production. Further, after the exodus of Afghan refugees, availability of skilled labor has also become an issue. These issues can be partly resolved by establishing training centers to educate labor about the designs, quality issues, etc. in the areas where this cottage industry is concentrated. On its part, State Bank of Pakistan reduced export performance requirements under part II of export finance scheme (EFS) for hand knotted carpets for FY09.⁵⁸

Box 7.12: Export Supportive Measures Announced by Various Governments from Time to Time

The international recession and the resultant fall in global demand, has negatively impacted export growth of Pakistan as well as various other regional competitors during FY09. To counter the impact of compression in external demand and to improve export competitiveness various countries announced a large number of policy support measures during FY09. These include;

⁵⁴ Immediate measures to improve supply of gas and electricity to the textile industry, establishment of Technology Up gradation Fund (TUF) to encourage investment and adaptation to new technology, creation of Textile Investment Support Fund for infrastructure development, skills development, tax free import of machines, etc., availability of export refinance at lower rates and interest rate relief on existing long term loans, 1 % drawback on exports to small industries, zero-tax on exports, establishment of ginning research institute, etc.

⁵⁵ <http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/IFTBUJULY0809.pdf>.

⁵⁶ <http://indiabudget.nic.in/es2008-09/sector.htm>.

⁵⁷ Provision of expert advisory services to leather apparel exporters, announcement of grant to establish design studios/centers in factories and effluent treatment plants in tanneries, grants to district governments for installing flaying machines to minimize wastage of raw material, sharing of 25% financial cost of setting up laboratories in tanneries, facilitation of up-gradation of tanneries to help meet international standards, compensation of inland freight cost to leather garments exporters.

⁵⁸ <http://www.sbp.org.pk/sme/d/circulars/2009/C10.htm>.

India

- Provision of 2 percent interest subvention to labor intensive sectors, e.g., textiles, carpets, leather, etc.
- Allocation of export incentives schemes of Rs 350 crore.
- Provision of additional funds to textile exporters to clear their liabilities of the subsidized credit Technology Upgradation Funds Scheme.

Table 7.12.1: Textile Exports- Opportunities for Market Diversification

52- Cotton and Cotton Yarn								
	China	Turkey	B.desh	Korea	Japan	Vietnam	Mexico	Tunisia
Shares in world imports ^a	17.9	6.6	3.7	2.8	1.8	2.6	2.6	2.4
Share in Pakistan exports ^b	11.8	7.4	10.6	2.6	1.9	0.6	1.1	0.2
Competitors shares ^a								
China		6.7	12.3	34.3	30.9	35.9	4.5	1.5
India	13.1	13.3	21.6	17.5	11.1	4.3	0.3	2.4
Bangladesh	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pakistan	9.5	11.0	7.7	8.3	7.5	2.0	1.2	0.4
63- Bed wear								
	Japan	Russia	UAE	Korea	KSA	Switzerland	Canada	Mexico
Shares in world imports	6.3	1.4	0.9	0.9	0.7	1.4	2.9	0.9
Share in Pakistan exports ^b	0.1	0.2	4.4	0.0	2.5	0.1	1.9	0.4
Competitors shares ^c								
China	80.4	46.7	42.2	75.0	24.2	6.3	42.8	15.7
India	0.1	3.8	9.3	0.8	6.3	2.9	7.6	3.2
Bangladesh	0.0	0.5	0.1	0.0	0.3	0.3	3.7	1.8
Pakistan	0.0	1.5	6.8	0.1	9.0	2.7	6.2	1.8
61- Knitwear								
	Japan	Russia	UAE	Korea	Singapore	Switzerland	Canada	Mexico
Shares in world imports ^a	7.2	0.8	0.6	0.8	0.9	1.3	2.2	0.8
Share in Pakistan exports ^b	0.1	0.0	2.0	0.0	0.1	0.1	2.3	0.2
Competitors shares ^a								
China	87.8	49.7	48.0	78.9	24.6	11.5	51.8	1.3
India	0.0	0.3	12.7	0.4	2.4	4.5	5.3	4.5
Bangladesh	0.1	2.9	1.2	0.1	1.9	2.4	6.7	3.4
Pakistan	0.0	0.4	0.5	0.0	0.1	0.2	1.6	1.3
62- Garments								
	Japan	Russia	UAE	Korea	Norway	Switzerland	Canada	S Arabia
Shares in world imports ^a	7.2	1.0	0.7	1.7	0.7	1.7	2.2	0.9
Share in Pakistan exports ^b	0.1	0.1	3.1	0.0	0.6	0.1	1.2	1.9
Competitors shares ^a								
China	80.4	53.7	39.6	79.7	40.9	9.1	53.7	61.1
India	0.1	2.1	16.7	0.4	3.2	1.0	4.2	10.5
Bangladesh	0.0	1.4	0.6	0.3	2.1	1.4	6.1	1.0
Pakistan	0.0	0.5	1.3	0.0	0.9	0.5	0.5	1.0

^a Shares of world top importers in respective categories, Source: Comtrade CY2007^b Market shares of world top importers in Pakistan's exports in respective categories Jul-Feb FY09^c Export market shares of competitors in world large import markets, Source: Comtrade CY2007.

- Under an Export Promotion Capital Goods (EPCG) scheme, the custom duty was reduced from 5 percent to 3 percent to promote modernization of manufacturing and services exports.

- Interest rate subvention already granted to the specified sectors was extended for one year and the average export obligation under EPCG was reduced for the affected sectors.
- Payment of interest to exporters in case of delay in refund of duties.

China

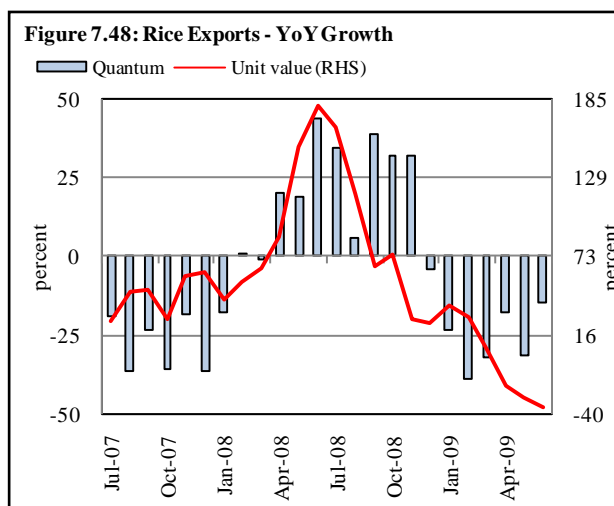
- Increase in the tax refund rate for exported textiles and clothing to 17 percent from the earlier 16 percent from April 2009 onwards.
- To aid the textile and clothing industry a comprehensive 3 years 'Textile Plan' was introduced in April 2009. The focus of this program will be on improving productivity, research and development for new products and moving towards automatization, textile standardization and market diversification.

Pakistan

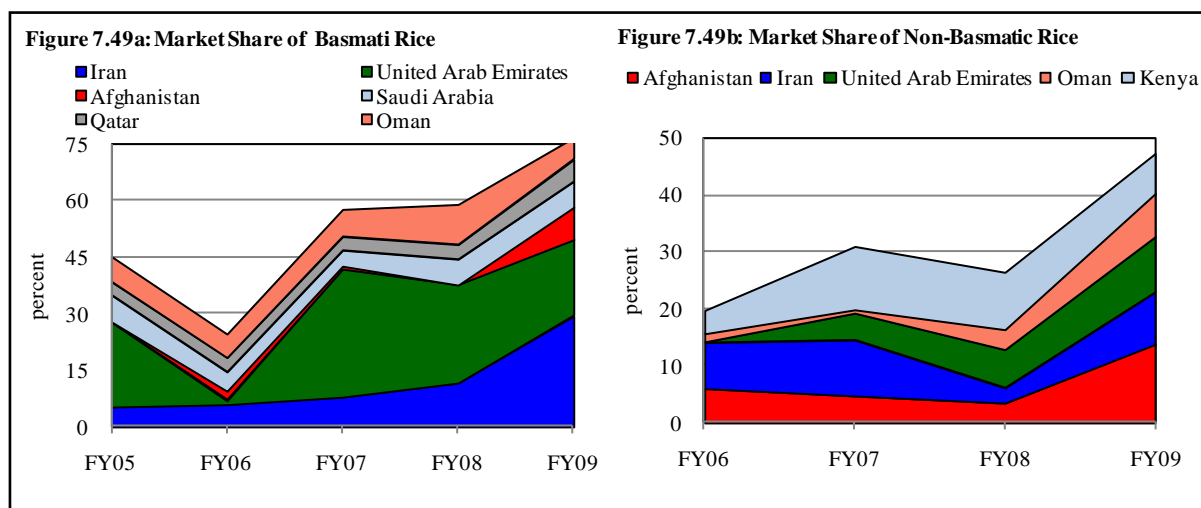
- One year extension in mark-up subsidy for spinning sector (SMEFD Circular No. 05, 2009, SBP).
- Provision of 100 percent re-financing to banks against export finance provided to exporters (SMEFD Circular No. 03 of 2008, SBP).
- Provision of one year moratorium on loans availed under the Long Term Financing Facility (SMEFD Circular No. 01, 2009, SBP).
- Extension in the period of refinancing under EFS (SMEFD Circular No. 04, 2009, SBP), and provision of EFS to some categories of cotton fabrics (SMEFD Circular Letter No. 04, 2009, SBP).
- Provision of LTFF to various spinning sectors (SMEFD Circular No. 08, 2009, SBP), Ethanol (SMEFD Circular No. 02, 2009, SBP) furniture and pharmaceuticals for producing exportable goods (SMEFD Circular No. 08, 2009, SBP).
- Announcing performance based mark-up rates by lowering mark-up rates for high performers (SMEFD Circular No. 06, 2009, SBP).
- To facilitate the export oriented industries to overcome the prevailing crises and to remain competitive in the world market, it was announced to allow a one time opportunity to the exporters (excluding Textile & Garments) to refinance their outstanding long term loans availed from banks/DFIs during 01-01-2005 to 31-03-2009 for import/purchase of plant & machinery with loans under SBP's LTFF Scheme (SMEFD Circular No. 09 of 2009).
- To facilitate exports of hand knotted carpets, required performance for financing facilities availed under Part II of EFS during FY 2008-09 was announced to be revised to 1.5 times as against existing performance requirements of 2 times (SMEFD Circular No. 10 of 2009).
- Provision of LTFF for plant, machinery & equipment to be used by the export oriented projects for regeneration of textile waste into usable fiber for producing value added exportable products (SMEFD Circular No. 11 of 2009).

b) Strong performing categories

Rice was one of the very few categories that recorded large YoY increase during FY09. The increase in rice exports was almost solely caused by rising international rice prices that translated in higher unit values of rice exports during FY09. Had the international prices of rice stayed at their FY08 levels, the overall export growth would have recorded a larger 9.2 percent YoY fall during FY09. Further, entire surge in this category's exports was witnessed during H1-FY09



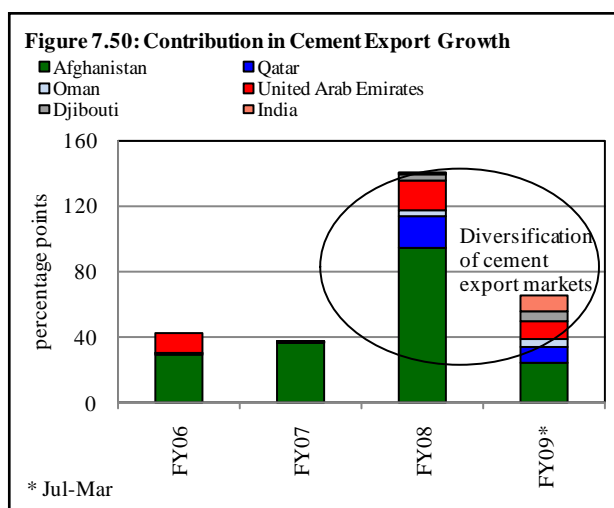
due to both higher quantum and unit values. With the drop in the average unit values from \$905 per MT in H1-FY09 to under \$700 in H2-FY09 as well as a YoY fall in export quantum, a fall in rice exports was observed during H2-FY09 (see **Figure 7.48**).



The FY09 YoY quantum decline in rice export, in turn, was partly caused by government procurement of rice by Pakistan Agriculture Storage and Supply Corporation (PASSCO). This decision by government caused uncertainties in the domestic market, as reportedly growers were not willing to sell their produce to exporters in the hope of getting better rates from PASSCO. The resultant stagnation in domestic rice prices and uncertainties regarding the availability of exportable volumes caused difficulty for exporters in attracting foreign demand for this commodity. Further the international demand for rice also declined as the 2008 rice season recorded bumper crops in world's major rice importers, e.g., Bangladesh, Indonesia, Philippines, Africa, and Turkey, which caused difficulties for exporters in capturing markets.

In terms of market shares, a disquieting development was the declining share of Pakistani rice exports to the UAE during FY09. Reportedly this is due to some concerns regarding quality of rice exported to this destination, which has resulted in lowering of demand for rice from UAE. On a positive note, as a result of market diversification efforts of exports, Pakistan increased its rice export share in the Iranian market (see **Figure 7.49a**). Further, encouragingly, Kenya, a major importer of Pakistani Irri-6 rice (see **Figure 7.49b**) has extended the preferential import duty for Pakistani rice by one year.⁵⁹

Cement export continued its last year's performance pattern as it grew by 37.8 percent YoY during FY09. The impressive performance of cement exports is attributed to external demand and improved domestic production capacities. The production of cement grew by 6.1 percent during FY09 YoY. Another positive development was diversification of cement export markets during the period under review; Afghanistan



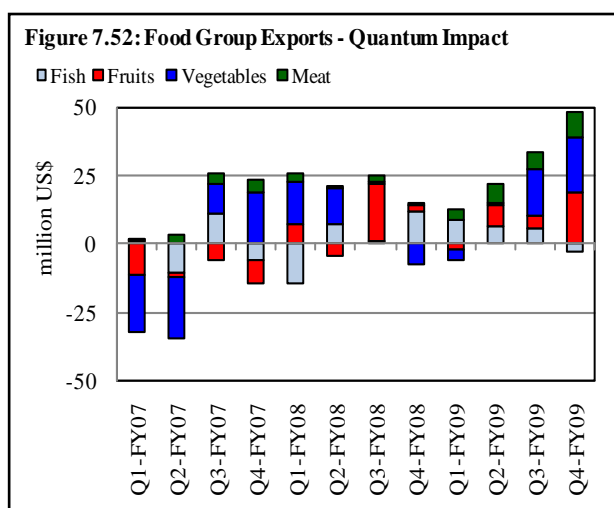
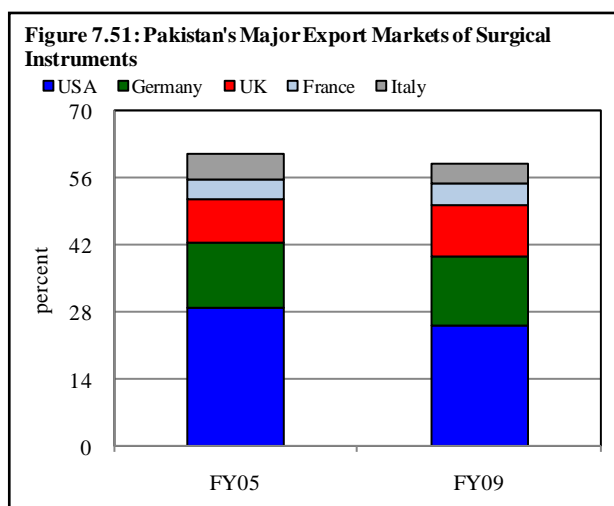
⁵⁹ Pakistani rice imports are being charged 35 percent import duty while others are charged 70 percent.

remained the major market for cement products over the years but this year Oman, India, Djibouti and UAE also emerged as potential markets (see **Figure 7.50**).

An interesting development was the increasing share of India during FY09 in country's cement export growth despite the imposition of import duty on this category by India. A major reason for this fact was the reduction in international coal prices that helped exporters to lower their unit values to maintain their market presence in this country. Looking forward, new construction projects in Qatar and Oman are being planned, which are likely to boost Pakistan's cement exports in the coming years. However, an increase in Saudi Arabia's cement production capacity⁶⁰ might divert demand from Middle Eastern countries away from Pakistan in the medium term.

c) Categories with growth potential

Surgical and medical instruments are an important traditional export industry of Pakistan. Country has a comparative advantage in the production of this category because of presence of geographically concentrated areas of production, and the possibility of tapping economies of scale. The presence of skilled labor is a further strength of this sector. However, the export of this sector recorded a small 4.8 percent YoY fall during FY09. The inability of this sector to develop brand names and diversify its markets is an important impediment to the growth of this sector. The fact that the market shares of top five importers of these products from Pakistan are almost unchanged in the five year reflects export market stagnation in this category (see **Figure 7.51**). Further, the products exported by this sector lack good quality finishing which leads to earning lower unit values for these products. Reportedly, these products are marketed internationally through the channel of wholesalers and other intermediaries, which earn a high profit margin by giving lower unit values to exporters. To address this issue, in the Strategic Trade Policy Framework 2009-12, the government has announced provision of 25 percent support to this sector for brand development activities.

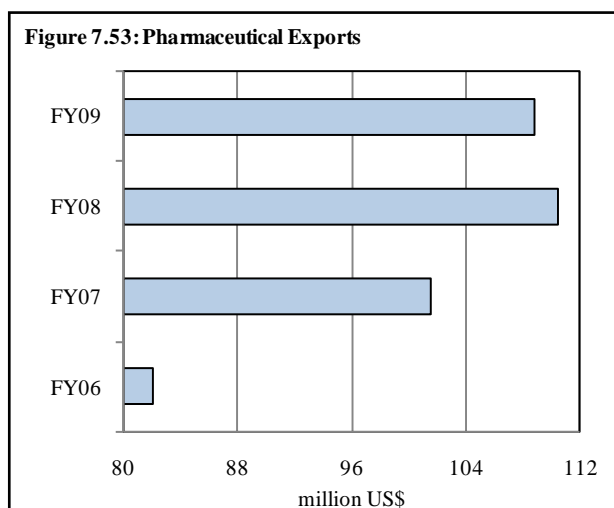


A major development during FY09 was the quantum increase in almost all **food group** export categories namely fruits, vegetables, meat, fish, (see **Figure 7.52**), etc. This was due to various sector specific initiatives which have been taken in this sector from time to time. The 12.4 percent YoY rise in fish exports is attributable to improved fish processing capacities along the Baluchistan coastal highway, and market diversification by exploring the markets of Malaysia, Thailand, UAE, and Indonesia.

⁶⁰ http://www.menafn.com/qn_news_story_s.asp?StoryId=1093200542

The 11.1 percent YoY rise in fruits exports was caused by higher exports of dates, kinos, mangoes, apples, etc. Improved market access to Iran for kinos, the establishment of food irradiation plant for fruits in FY09, and establishment of apple grading plant led to increased exports of these fruits. In this respect TDAP has also announced the establishment of cool chain for preventing huge post harvest losses and assuring good quality of fruits. This initiative is likely to improve export quantum of these categories. Similarly Pakistan, being a large producer of livestock, has also a huge potential to become an important exporter of *halal* meat. However, non-compliance with Sanitary and PhytoSanitary standards (SPS), poor hygiene conditions of slaughter houses, etc. are some major hurdles in the growth of this sector. In view of the growth potential, private sector can be encouraged to invest in this sector for the establishment of livestock farms, good quality slaughter houses, etc. During FY09 meat exports recorded 18.3 percent YoY increase; especially exports to UAE underwent a large 136.5 percent YoY rise.

A sector specific problem solving strategy for increasing food exports can help in increasing the export earnings from this category. In the Strategic Trade Policy Framework for FY09, the government has announced to provide support to processed food exports initially by reimbursing 6 percent Research & Development costs to these exports.



In line with export product diversification efforts of Pakistan, **pharmaceutical exports** have emerged as a relatively new export category for the country. Though the current export earnings from this category hover around US\$ 100 million (see **Figure 7.53**), this category has a significant potential to grow given the large size of global market.⁶¹ To facilitate production and export in this sector, SBP has provided Long Term Financing Facility (LTFF) to this sector from March 2009.⁶² Further, in the strategic Trade Policy Framework for FY09-FY12, the government has also announced to zero rate pharmaceutical exports. This sector is, however, confronted with the problem of rising cost of raw material, as most of the raw material is imported in large quantities from different parts of the world, which raises the cost of production.

The main destinations of the pharmaceutical exports are Afghanistan and African countries. Geographical diversification is important to earn more earnings from this potential sector. In this regard, efforts are underway to expand trade in Central Asian States. Further, countries with low certification requirements as Vietnam, Philippines, etc. also provide attractive opportunities. Export earnings from pharmaceutical products, recorded a marginal 1.5 percent YoY fall during FY09.

The medium to long term development of this industry requires efforts for ensuring domestic availability of raw material by strengthening the supply chain. This can be done by encouraging establishment of more research institutes in the field of pharmacy. Further imperatives in this sector are: (a) close liaison with the international agencies responsible for providing export certifications to

⁶¹ According to TDAP sources there is around US\$ 6.9 billion export market of countries with almost no regulations and requirements, imports of countries with mild certification requirements are US\$ 50 billion and the developed countries market for this category is around US\$ 546 billion.

⁶² <http://www.sbp.org.pk/sme/fd/circulars/2009/C7.htm>

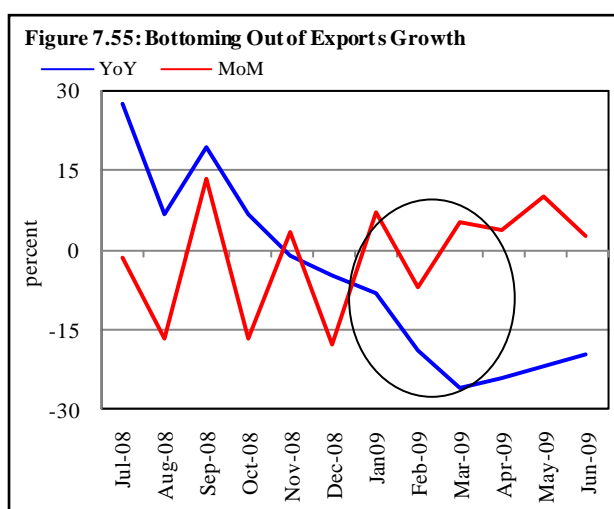
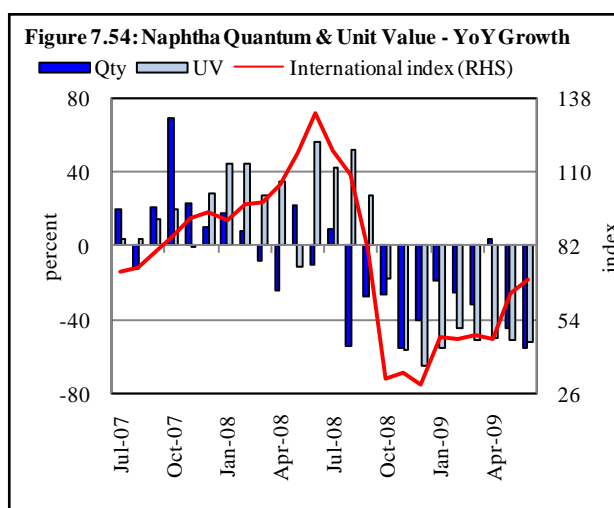
manufacturing companies; (b) participation in international exhibitions; c) dissemination of information about international regulations to exporters, etc. for the development of new markets in this sector.

In addition to these categories ethanol, engineering goods, sports goods, plastics, gems & Jewelry, marble, etc also have a substantial potential to grow due to various sector specific factors. To encourage production of ethanol mixed fuel, the government has imposed ⁶³15 percent regulatory duty on export of molasses. This measure will lead to increased domestic production of ethanol, which might also lead to increased exports of this category. Engineering goods exports recorded a large 26 percent YoY rise during FY09 mainly due to increased exports of specialized machinery for particular industries. Trade Policy 2009-12 also gave due importance to this sector as a special fund of Rs 2.5 billion is to be created for product development and marketing to grasp the actual potential of this sector.

d) Fall in naphtha exports due to domestic factors

In terms of share, *naphtha* exports had the largest contribution in the YoY fall recorded in exports during FY09.⁶⁴ The quantum fall of naphtha exports, however, was largely caused by the financial constraints faced by refineries that hampered their ability to import crude petroleum and produce this category. Further, falling international prices of naphtha also led to a fall in the unit values of this category during FY09 (see **Figure 7.54**). Thus the impact of falling quantum and unit values of this category brought a sharp 53 percent YoY fall in this category's exports during FY09. After the settlement of the financial issues of refineries, the production and hence export of naphtha is expected to revert back to the FY08 level. A number of refineries are working on extensions in their production plants. Such extensions are likely to result in increasing production and hence export of naphtha as well.

In summary, huge concentration of exports in sectors, i.e., textile and leather, in which demand is highly income sensitive, is a risk for sustainable performance for country's exports. In this scenario efforts should be focused on exploiting export potential in other manufactures and food group categories to improve the country's products base. Similarly efforts should also be made on market diversification by exploring the non-traditional markets.



⁶³ SRO 321(I)/2009 dated April 10, 2009.

⁶⁴ Around one-third of the total fall in exports during FY09 was caused by falling naphtha exports.

The analysis of export growth hints at the possibility of some improvement in export performance in the coming months. The monthly YoY export growth after recording a sharp dip in March 2009 is showing an improvement (see **Figure 7.55**). This is also supported from a positive month-on-month export growth since February 2009. In terms of categories, small improvements were witnessed in textile and other manufactures exports. This trend might be reflective of the impact of various supportive measures announced by government during FY09, a loosening monetary policy stance by SBP and slight improvement in external demand. The promised resolution of energy crisis by the government along with the support announced to various export industries is likely to help the current recovery in exports to continue through FY10 as well.

7.6.2 An Assessment of the Contraction in Import Bill – FY09

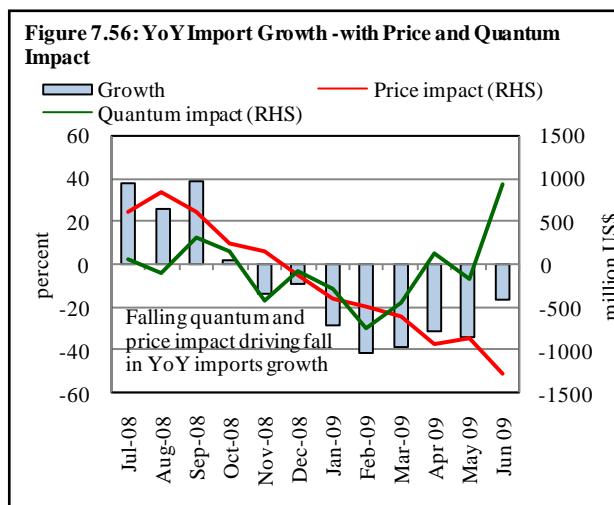
In line with the contraction in domestic demand and falling international prices, imports recorded 12.9 percent YoY fall during FY09 compared to a steep 30.9 percent YoY rise during FY08. Almost the entire YoY fall in imports was witnessed during H2-FY09 as the impact of higher import prices kept YoY import growth for Q1-FY09 to a high level of 34.2 percent. However, the lagged impact of the fall in international prices started to translate in lowering import unit values from October 2008 onwards (see **Table 7.26**). Thus the combination of falling import prices and quantum caused a sharp 31.8 percent YoY fall in imports during H2-FY09 (see **Figure 7.56**), which outweighed the 12.8 percent YoY growth in imports recorded during H1-FY09.

Table 7.26 : Price Impact and Average International Commodity Prices

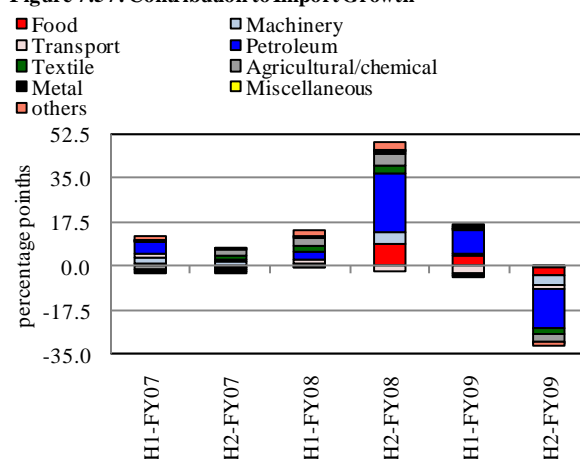
	Unit	FY08				FY09				FY10
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	July
Arabian light oil	US\$/barrel	71.3	85.2	93.7	117.2	113.8	54.9	40.1	55.9	64.3
Palm oil	US\$/MT	746.4	861.6	1,081.1	1,088.9	828.4	453.3	536.3	718.8	602
DAP	US\$/MT	432.5	522.1	860.2	1,191.6	1,153.7	663.3	362.2	303.6	293.3
Wheat	US\$/MT	274.9	341.9	411.4	346.5	317.7	228.1	231.7	247.9	225
Price impact	million US\$	187.0	865.7	1,719.9	2,517.7	2,064.4	276.7	-1,500.0	-3,070.8	-627.4

Factors leading to fall in imports

A number of factors were responsible for compressing imports during FY09: (a) conscious policy efforts by authorities by adopting a contractionary monetary (until the loosening announced in Q4-FY09) and fiscal policy stance to discourage domestic demand; (b) general slowdown in economic activity in the wake of global recession and domestic issues led to weakening of domestic demand during FY09; (c) large percent depreciation in the value of rupee that raised rupee cost of imports; (d) weakening real incomes; (e) better domestic cotton crop; (f) fall in fertilizer imports due to poor off-take amidst uncertainties regarding prices; (g) financial issues faced to the POL group; (h) energy crisis in the country that depressed industrial activity brought about a broad based decline in imports during FY09 (see **Figure 7.57**, **Table 7.27** & **Table 7.28**).



In fact a comparison of Pakistan's imports with some other regional countries shows that due to the domestic factors the country's imports recorded a larger YoY decline as compared to some other regional countries (see **Figure 7.58**). This is also evident from the fact that countries like India and Sri Lanka which have almost the same levels of oil intensities of import bills⁶⁵ as Pakistan, and would therefore have recorded almost the same level of benefit from the falling international oil prices, witnessed smaller YoY contraction in their imports bills during FY09.

Figure 7.57: Contribution to Import Growth**Table 7.27: Major Imports**
million US Dollar

	Units	FY08		FY09(p)		Abs. Δ value	Qty	% YoY Δ	
		Value	Unit value	Value	Unit value			Value	Unit value
Food group		4,211.9		4,136.9		-74.9		-1.8	
of which									
Wheat	MT	860.0	472.5	1,058.1	331.9	198.1	75.1	23.0	-29.7
Palm oil	MT	1,616.6	916.5	1,390.8	783.9	-225.8	0.6	-14.0	-14.5
Machinery group		7,368.1		6,594.7		-773.4		-10.5	
of which									
Power generating machinery		1,177.7		1,748.7		571.0		48.5	
Telecom		2,246.2		961.3		-1,284.9		-57.2	
Transport group		2,275.0		1,339.4		-935.6		-41.1	
of which									
Road motor vehicles		1,352.0		929.1		-422.8		-31.3	
Aircrafts, ships and boats		897.6		402.5		-495.1		-55.2	
Petroleum group		11,462.9		9,509.7		-1,953.2		-17.0	
Petroleum products	MT	6,240.9	614.8	5,515.5	519.7	-725.4	4.6	-11.6	-15.5
Petroleum crude	MT	5,222.0	617.2	3,994.2	507.4	-1,227.8	-7.0	-23.5	-17.8
Textile group		2,334.4		1,657.8		-676.5		-29.0	
of which									
Raw cotton	MT	1,291.9	1,456.7	639.6	1,525.4	-652.2	-52.7	-50.5	4.7
Agricultural and other chemical		5,801.8		5,230.4		-571.4		-9.8	
of which									
Fertilizer manufactured	MT	890.2	445.6	539.0	489.5	-351.1	-44.9	-39.4	9.9
Other chemicals		2,969.7	---	2,866.0	---	-103.7		-3.5	
Metal group		2,706.2		2,754.1		47.9		1.8	
of which									
Iron and steel scrap	MT	639.1	286.6	683.7	304.3	44.6	0.8	7.0	6.2
Miscellaneous group		738.7		674.2		-64.5		-8.7	
All other items		3,066.5		2,924.8		-141.8		-4.6	
Total imports		39,965.5		34,822.1		-5,143.5		-12.9	

p provisional

⁶⁵ The share of imports of petroleum groups in total imports was at 30.5 percent for India (FY09), 24.0 percent for Sri Lanka (CY08) and 27.3 percent for Pakistan (FY09).

a) Category wise composition of fall in import demand

The fall in the following categories is attributable to depressed domestic demand.

Telecom machinery imports recorded a substantial decline in both the categories of **telecom apparatus** and **mobile phones** during FY09 (see **Table 7.27** and **Table 7.28**). The fall in telecom imports is attributable to; a) imposition of duties on import of cell phone and activation charges of new SIMs by government,⁶⁶ b) large scale use of second hand cellular phone sets, and 3) slowdown in economic activity which generally discouraged these imports.

Broad based fall in imports of road motor vehicles was observed as Completely Built up Units (CBUs) and Completely Knocked-Down (CKDs/SKD) recorded 62 percent and 30 percent YoY fall during FY09. This is attributable to falling domestic demand due to high cost of borrowing for car financing and higher automobiles prices through most of FY09. The fall in domestic demand of automobiles is also reflected from a large decline in production and sales in various categories of automobiles (see **Figure 7.59**). Slowdown in domestic automobile production also hampered the demand for rubber tyres and tubes; as a result, the imports of *Rubber Tyres and Tubes* plunged by 28.7 percent during the period under review.

Textile machinery continued with the falling trend witnessed over the last few years. However, the dip recorded in the category, during FY09, was steeper compared to the same period last year (see **Figure 7.60**).⁶⁷ This might be attributable to domestic and external issues which are hampering performance of textile sector and thus have reduced the demand to upgrade capital in this sector.

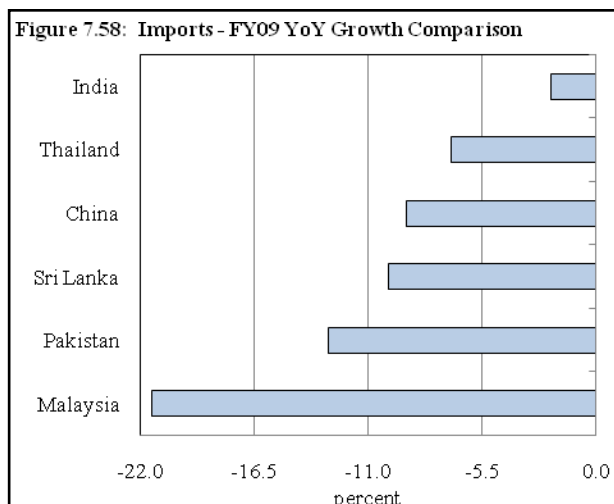


Table 7.28: Composition of Fall in Imports During FY09
million US Dollar

	Absolute Δ	Quantum impact	Price impact
Petroleum crude	(1,227.7)*	(363.5)	(864.3)
Petroleum products	(725.5)	284.2	(1,009.7)
Telecom apparatus	(712.6)	N.A	N.A
Raw cotton	(652.3)	(681.1)	28.8
Mobile phone	(572.3)	N.A	N.A
Air crafts, ships and boats	(495.1)	N.A	N.A
Road motor vehicles	(422.3)	N.A	N.A
Fertilizer manufactured	(351.1)	(399.5)	48.4
Textile machinery	(226.3)	N.A	N.A
Palm oil	(225.8)	9.4	(235.2)
Plastic material	(161.9)	(303.0)	141.1
All other food items	(117.5)	N.A	N.A
Total ^a	(5,890.4)^b	(1,453.5)	(1,890.8)

^aThe import of all these items had 46 percent share in total imports during FY09

^b The fall in these categories was greater than the total fall in imports during FY09. This was offset by increases observed in some other categories.

*Parenthesis show negative values

⁶⁶ The federal government in the last budget imposed Rs500 customs duty per set and later imposed Rs250 regulatory duty in August 2008.

⁶⁷ The 51.6 percent YoY fall recorded in this category during FY09 is very large as compared to 12.8 percent YoY fall in these imports during FY08.

The decrease in *palm oil* imports was led by falling price impact, whereas quantum of this category recorded only a small YoY increase during FY09 (see **Table 7.28**). This was due to low demand for ⁶⁸vegetable ghee and cooking oil due to significantly higher domestic prices and good domestic production of oil seeds.⁶⁹

b) Contraction in imports due to other factors

In terms of categories around 38 percent fall in imports during FY09 was caused by falling *petroleum group* imports alone. The fall recorded in this category was contributed by both quantum and price impact (see **Table 7.28**). The decline in import quantum of petroleum group resulted from the financial issues experienced by refineries and OMCs that hampered their ability to import crude oil and petroleum products.⁷⁰ However, due to lower crude imports, the production of HSD, furnace oil, kerosene oil, and motor spirits ⁷¹declined substantially during FY09 on a YoY basis. Therefore, to fulfill domestic demand, the quantum of petroleum products recorded small increases in FY09 (see **Figure 7.61**). In this connection this is worth mentioning that elimination of subsidies on domestic fuel prices might also have led to a slowdown in domestic demand during FY09. The overall slowdown in domestic demand for fuel can be evidenced from a 0.1 percent YoY fall in the sales of petroleum products during FY09, whereas the sales of HSD recorded 7.2 percent YoY fall during FY09, with a 42.5 percent YoY rise in domestic prices during this period.

Raw cotton imports also recorded a sharp fall during FY09 which was primarily led by better domestic cotton crop.⁷² In addition, the dull performance of the domestic textile market might also have weakened domestic demand of this category.

Figure 7.59: Growth of Road Motor Vehicles During FY09

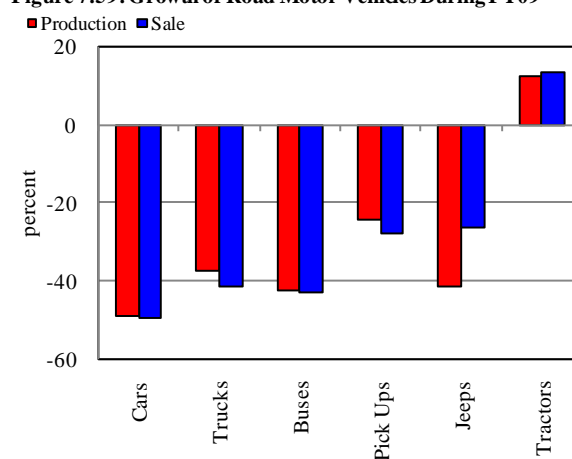


Figure 7.60: Textile Machinery Imports

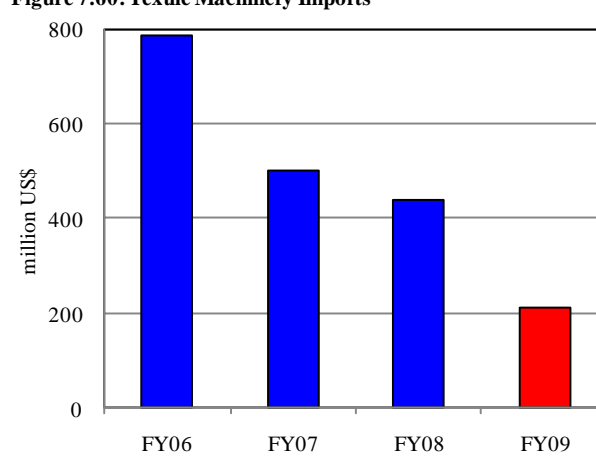
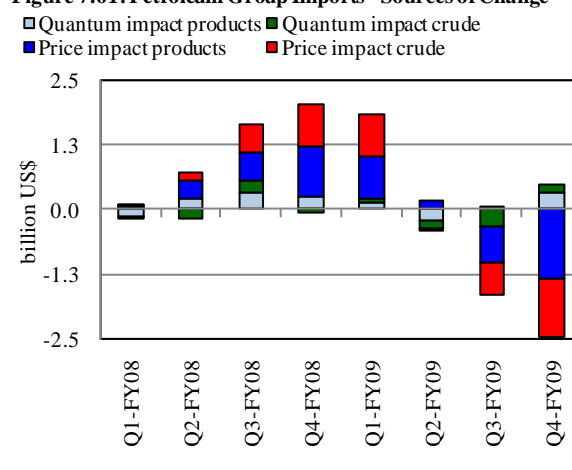


Figure 7.61: Petroleum Group Imports - Sources of Change



⁶⁸ The production of vegetable ghee and cooking oil dropped by 4.8 and 1.2 percent respectively.

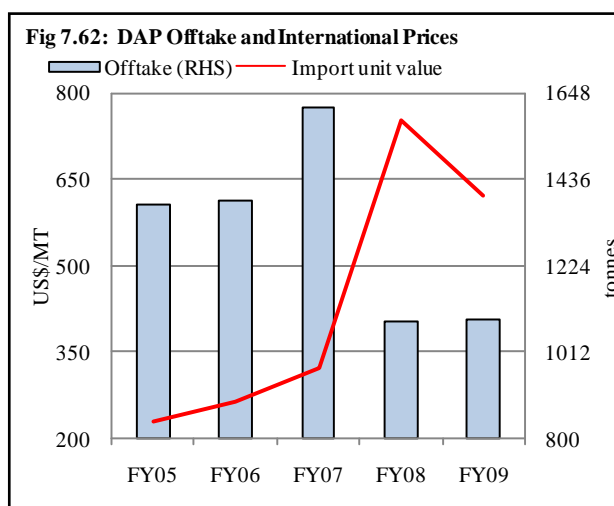
⁶⁹ The estimated production of oil seeds showed a modest growth of 6.4 percent during FY09. The estimated production of sunflower crop grew by 41 percent during FY09.

⁷⁰ For details see Money and Banking.

⁷¹ Domestic production of HSD, furnace oil, kerosene oil and motor spirit dropped by 8.5, 7.1, 20.4 and 3.9 percent YoY during FY09.

⁷² During FY09 cotton production recorded 3.5 percent YoY rise reaching 14.1 million bales during this period.

Plastics materials was another category which recorded a substantial 12.4 percent fall in import during FY09. This is attributable to rupee depreciation and the impact of various import restrictive measures taken during FY09⁷³. Both these factors discouraged the import of this category which is used as raw material in plastic industry. Reportedly, the low availability of raw materials depressed production and also resulted in deceleration in export growth of plastics during FY09. Finally, the large fall in the **aircraft, ship and boats** category reflects high base effect due to a substantial one-off import in this head during FY08.



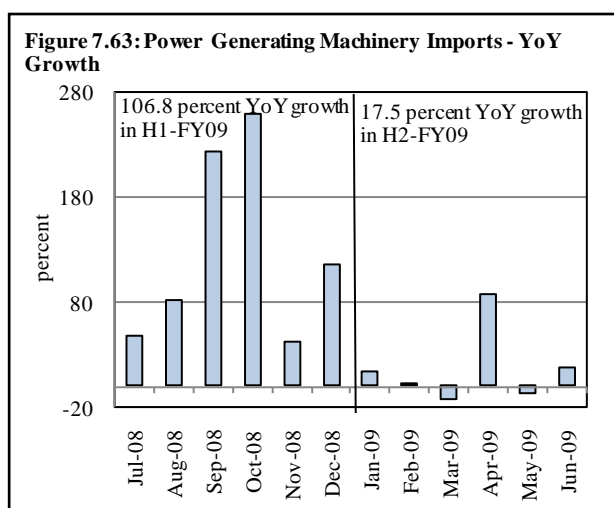
The fall in **fertilizer manufactured** imports was caused mainly by falling quantum of DAP imports during FY09 (see **Figure 7.62**). Large domestic inventories of DAP from⁷⁴ imports of FY08, stagnation in DAP fertilizer⁷⁵ off-take, rise in domestic production during FY09⁷⁶ and hike in international prices during the first two quarters were the prime reasons for slowdown in import of DAP. However, a small increase in fertilizer import quantum was observed towards the end of FY09.⁷⁷ This was to fulfill domestic shortages of Urea.⁷⁸

c) Categories with strong import demand in FY09

While imports recorded a broad based decline during FY09, a few categories did post modest to strong growth in imports during this period.

The import of **wheat** recorded substantial increase during FY09 mainly due to rise in quantum. This is because of domestic shortages of this commodity which led government to announce the accumulation of one million tonnes wheat reserves in the country during this period. To this end, government announced the import of 2.5 million tonnes of wheat during FY09. However, in view of a good domestic crop only 49.6 percent of the targeted amount was imported during FY09.

Power generating machinery imports continued the rising trend witnessed since the



⁷³To contain import growth SBP announced imposition of 35 percent LC margin on a broad range of products towards the end of FY08. Further government also increased duty on some 379 luxury and non-essential goods from 25 per cent to 35 per cent in the 2008-09 budget with the accumulative duty at 50 per cent. Further 15-50 percent regulatory duty was also imposed on import of these goods.

⁷⁴ During FY08, large quantum of DAP fertilizer was imported to avoid shortages because of closure of DAP plant for BMR.

⁷⁵The DAP fertilizer offtake during FY09 at 1090 thousand tonnes was almost the same as the last year level of 1087 thousand tonnes.

⁷⁶ According to FBS data phosphatic fertilizers recorded 28 percent YoY rise in production during FY09.

⁷⁷ NFDC, Fertilizer Situation: Mid April 2009, Rabi 2008-09 and Outlook for Kharif 2009

⁷⁸ According to Ministry of Industries and Production, the total demand for Urea during Kharif 2009 remained 2.9 million tonnes, while the domestic production was 2.5 million tonnes.

last few years and recorded 48.5 percent YoY growth during FY09. The demand for power generating machinery originates from the household sector, small businesses and Independent Power Producers (IPPs). In terms of sectors, a large share of the demand for small generating sets is originating from the household sector.⁷⁹ However, the sharp growth in these imports weakened during H2-FY09 (see **Figure 7.63**). According to importers, in view of the current energy crisis a large quantum of generators was imported during FY09. However, due to the current slowdown in economic activity and weakening real incomes the demand for generators was not as strong as anticipated both from the business sector as well as households, resulting into accumulation of large inventories. This fact coupled with possible improvement in power supply from H2-FY10 point towards the possibility of a further slowdown in these imports going forward.

Construction and mining machinery imports also recorded a modest 6.3 percent YoY growth during FY09. The demand for this machinery originated from development projects initiated through Public Sector Development Programme (PSDP).⁸⁰ Further, increased⁸¹ investment in mining for oil and gas exploration during FY09 resulted in higher imports of mining machinery during this period.

The Sustainability of import demand compression

As mentioned above in terms of domestic factors, the YoY decline in imports recorded during FY09 was a mix of policy-led contraction as well as fall in import demand due to various sector specific issues. However, with the start of FY10 there is a change in policy stance towards providing support to the industrial activity in the economy. This is especially evident from the monetary policy loosening announced by SBP in Q4-FY09 and Q1-FY10 as well as various sector specific incentives announced by the government in the budget for FY10 and Strategic Trade Policy Framework for FY09-12. In addition to the supportive policy factors, the sector specific dynamics are also indicative of increasing demand in certain categories.

The POL import quantum which recorded a marginal 0.7 percent YoY increase during FY09 is likely to post larger YoY increase after resolution of the circular debt issue in FY10. Further additional demand for furnace oil is likely to emerge after some of the new IPPs and rental power plants start functioning towards the end of CY 2010. On a positive note, however, the E-10 project of the government which aims at blending of ethanol with motor spirit to moderate the use of the latter is likely to result in an annual saving of US\$ 13.4 million on imports.⁸²

The dynamics of the transport group which have been leading to fall in imports since the last two years are also expected to undergo some change during FY10. A slight revival of transport demand is expected because of the reduction in car prices in Q4-FY09 by various companies, loosening monetary policy stance by SBP, and a removal of federal excise tax on the purchase of new cars in the budget for FY10. The imports of CNG buses are likely to surge in the upcoming year as the federal and provincial governments have initiated CNG buses projects to ease transport and pollution problems. All these factors point towards a possibility of some revival in transport import demand in FY10.

Similarly, the category of telecommunication is also likely to record some reversal of import growth on the back of various relief measures announced in the budget for FY10 for this sector. Particularly the mobile phone imports are likely to record some increase due to reduction in the SIM activation

⁷⁹ During FY09, 37 percent share of the total power generating machinery imports was composed of small generating sets.

⁸⁰ The government spending in the PSDP recorded 31 percent YoY increase in FY09.

⁸¹ Private investment in mining and quarrying posted positive growth of 20 percent, while public investment grew by 39 percent during FY09.

⁸² This calculation is based on the average values of motor spirit imports during FY08 and FY09.

charges, federal excise tax, and custom duty on the import of cell phones, and complete elimination of regulatory duty on these imports as announced in the budget for FY10.⁸³

In the food group due to a large domestic bumper crop of wheat, the possibility of further wheat imports has been eliminated. In fact to encourage wheat production the government had announced a support price for wheat at Rs 950/40 kg for FY09. As a result, improvement in wheat output was recorded as the estimated output rose by 11.7 percent during FY09. However due to 21.7 percent fall in the domestic production of sugarcane during FY09, sugar imports are likely to surge in FY10.⁸⁴

This implies that in the absence of contractionary impact of the policies and certain sector specific factors, import growth is likely to witness some rebound going forward. This conclusion is also supported from the analysis of monthly year-on-year and month-on-month import growth during FY09. This reflects a deceleration in the degree of YoY contraction of import growth since Feb 2009, while on m-o-m basis; import growth has largely turned into positive after this month (see **Figure 7.64**). The impact of these factors, however, is likely to become more pronounced from Q2-FY10, whereas the higher base effect is likely to keep the import growth subdued during Q1-FY10.⁸⁵

Desirability of a fall in import demand

The need to restrict import arises from the deficiency of foreign exchange earnings of a country. Theoretically in the absence of a stable stream of foreign exchange earnings in the form of exports, workers' remittances or non-debt creating capital flows, increase in imports simply adds up to a country's debt burden [World Bank (2005)].⁸⁶ Conversely, a fall in imports is also like to have a negative impact on a country's exports depending upon

Figure 7.64: Analysis of Import Growth

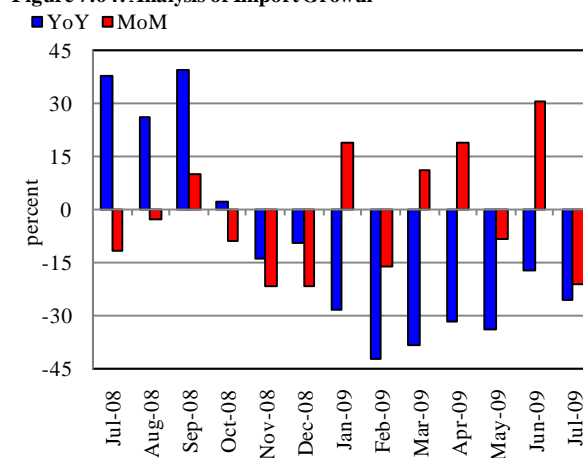


Figure 7.65: Reserves Equivalent Weeks of Imports

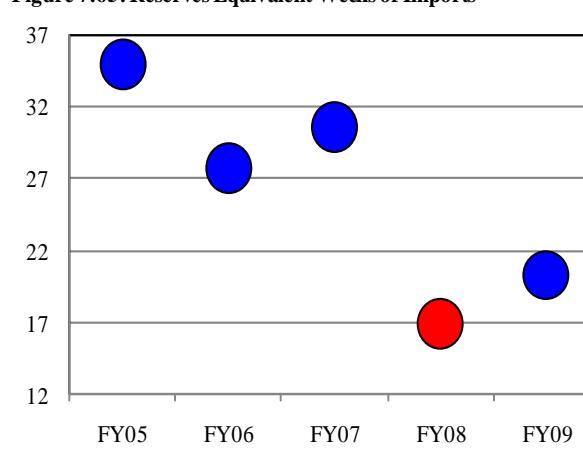
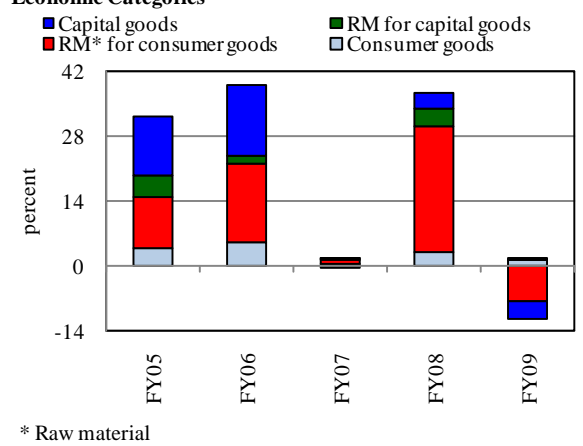


Figure 7.66: Contribution in Import Growth By Economic Categories



* Raw material

⁸³ The budget for FY10 introduced a 50 percent reduction in sim activation charges and import duty on mobile phone sets.

⁸⁴ Sugar production declined by 32 percent during FY09 as compared with the same period last year.

⁸⁵ During July-Aug FY10 imports recorded a large 26.3 percent YoY fall.

⁸⁶ World Bank (2005), A Guide to LIC Debt Sustainability Analysis

<http://siteresources.worldbank.org/INTDEBTDEPT/Resources/DSAGUIDEv7.pdf>.

the import dependence of its exports. In the case of Pakistan, during FY08 the concern regarding depletion of country's foreign exchange reserves (see **Figure 7.65**) led to the imposition of various restrictions on country's imports. In addition, the large depreciation in rupee also discouraged imports by raising their rupee cost. The impact of these factors in addition to the other constraints on imports growth as discussed above was seen in the form of a large decline in import growth during FY09.

In terms of economic classification, the greatest impact of all these factors was felt by *raw materials for consumer goods* and *capital goods* (see **Figure 7.66**). Conversely, *consumer goods* imports recorded an increase during FY09 mainly due to higher wheat imports. The fall in *raw materials for consumer goods* imports, was due to raw cotton, DAP fertilizer, industrial chemicals and raw materials for textile industry imports during this period. As regards the fall in *capital goods* imports this was recorded largely due to falling textile and telecom machinery imports (see **Figure 7.67**). The impact of fall in the imports of these categories partly translated into dismal performance of LSM and exports during FY09.

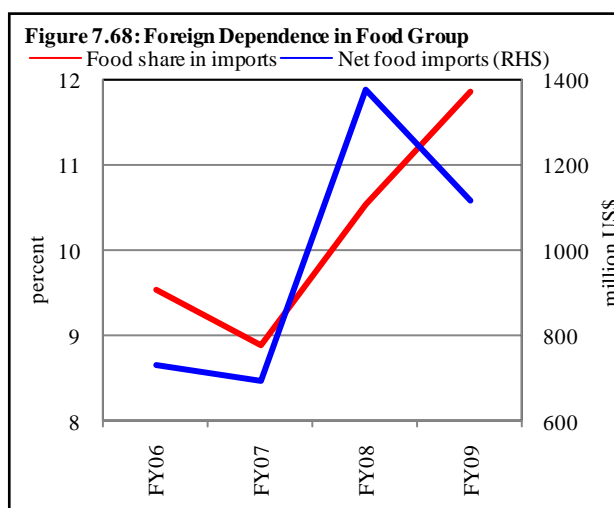
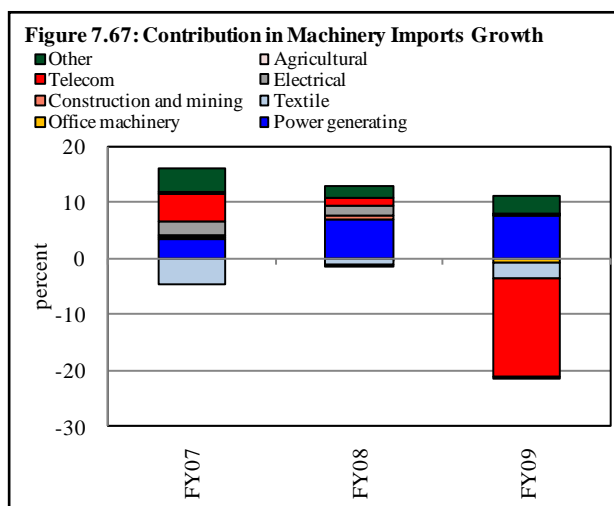
This analysis suggests that a broad based decline in imports as observed in FY09 is not a welcoming factor as it depresses the production activity in the economy. Therefore efforts should be focused on reducing country's foreign dependence for products which can be domestically produced.

In this connection the rising food group imports are particularly an area of concern. Despite being an agricultural country, Pakistan is not only a net importer of food, rather the foreign dependence of this category is increasing continuously since FY07 (see **Figure 7.68**).

Despite 40 percent share of wheat crop in country's total area under cultivation, a huge amount of wheat had to be imported during FY08 and FY09. The need to import wheat arose from various reasons, e.g., lower production in FY08, large scale smuggling and hoarding of this commodity. Similarly after recording a sharp increase in production during FY08 domestic production of sugar recorded a sharp fall during FY09 which gave rise to the need to import this commodity during FY10. Further a large quantum of pulses and palm oil is imported every year due to lower domestic production and unavailability of substitutes.

The import dependence of these commodities can be reduced in various ways;

- 1) The need to import wheat can be avoided by improving yield from the current area of cultivation by provision of better seeds and ensuring balanced use of nutrients. In addition the timely announcement of support prices is also necessary to give growers an incentive to grow more.



- 2) A sustainable high level of sugar production can be ensured by improving the pricing and payment system for this crop. Lower prices and delayed payments discourage sugar growers from planting sugar which gives rise to a huge need of imports.
- 3) The import of pulses can be reduced by encouraging their plantation in the irrigated areas, provision of better seeds and improvement in yield. The current production of pulses is concentrated in un-irrigated areas and low rainfalls very often lead to high imports of this category.
- 4) For curtailing palm oil imports there is a need to improve production of oil seeds crops. Improvement in the yield of wheat can lead to higher production of this crop and even some of the area under cultivation can be reduced for production of oil seeds crops.
- 5) The issue of smuggling and hoarding of food grains should be addressed expeditiously.

In addition, import of light engineering machinery, for instance, generators used by households, TV sets, refrigerators, air conditioners, etc. can also be reduced by encouraging their domestic production. A focus on ensuring adequate supply of agricultural products and strengthening domestic engineering industry can help in curtailing the need of excessive imports on a long term basis.