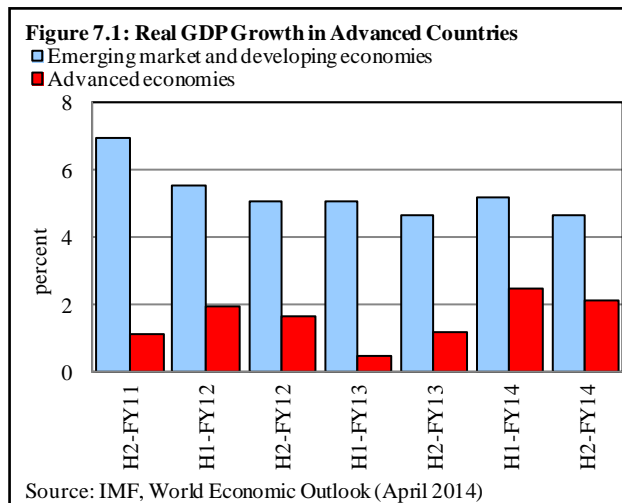


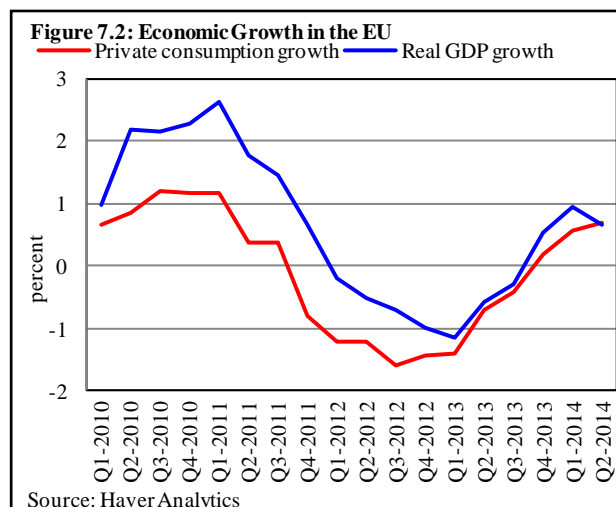
7 Balance of Payments

7.1 Global Economic Review

With multi-billion dollar stimulus programs of advanced economies in play, FY14 began with an upturn of the global economy.¹ This was reflected in higher-than-expected growth of 3.7 percent in global GDP during Jul-Dec 2013, compared to only 2.7 percent growth seen in the preceding 6 months.² Driven by pent up demand, and reduced drag from fiscal consolidation, the economic growth came primarily from the US, France, Germany, and the UK. Japan did well in the first quarter of 2014, but failed to consolidate its recovery as: (i) US GDP posted a contraction in the first quarter of 2014, due to severe winters and inventory corrections;³ (ii) lower-than-expected GDP growth in the Euro zone during the first and second quarters of 2014, which could be traced to the conflict in Ukraine;⁴ and (iii) Japan itself went into contraction in the second quarter due to an increase in retail sales tax. As a result, the IMF eventually reduced its forecast of global GDP growth from 3.7 percent (WEO April) to 3.3 percent (WEO October) for the year 2014.



Conditions in developing and emerging economies were even less favorable. Just before June 2013, the Fed hinted at reining in its stimulus package that caused a stir across these countries: massive capital outflows and sharp currency depreciations created a sense of uncertainty. Meanwhile, growth prospects were not promising: on the one hand, China faltered as it embraced a more balanced and sustainable growth path, and on the other, tight financial conditions and weak business sentiments held back investment and consumption in Latin America. India's economic woes also continued in FY14, as inflation remained high and corporate investment came to a virtual standstill. Growth in Russia was weighed down by geopolitical tensions, while South Africa remained downbeat due to power constraints and labor disputes.



¹ In April 2013, the new governor of Bank of Japan announced a monetary stimulus program, and joined the Fed, ECB and Bank of England in their efforts to spur economic growth and bring their economies to full potential.

² Source: IMF World Economic Outlook, April 2014.

³ US GDP contracted by 0.5 percent in the first quarter of 2014, compared to a growth of 1.1 percent and 0.9 percent in the preceding two quarters.

⁴ The Euro Area GDP posted a sharp deceleration in the second quarter of 2014: it showed a growth of only 0.05 percent, compared to 0.29 and 0.21 percent in the preceding two quarters. Germany posted a GDP contraction of 0.16 percent during the quarter compared to a growth of 0.67 percent in the preceding quarter, mainly due to weak spending amid Ukraine crisis and sanctions against Russia.

In overall terms, the global economy has shown signs of improvement, but a robust recovery remains elusive. A degree of desperation of policymakers is visible: in an extraordinary move, ECB cut its deposit facility rate below zero for the first time in June 2013; furthermore, President Draghi – who had committed to do whatever it takes to lift the EU, fell short of aggressive measures that had yielded better results in the US. Understandably, the resistance has come from creditor countries like Germany, and also France and Italy to some extent, which remain more concerned with high debt levels even as growth stalls. More recently, ECB shrugged off German resistance by announcing further rate cuts, and also launched an asset purchase program – the so-called QE-lite, which will initially focus on buying asset-backed securities from the market.⁵

On the contrary, Japan has refrained from pushing the stimulus further despite the fact that the country faced a sharp decline in GDP in Apr-Jun 2014, following the scheduled sales tax hike – the next scheduled hike is due in October next year. It is estimated that the country requires a stimulus of nearly US\$ 47 billion, to compensate for the sales tax impact on Japan's GDP growth.⁶ As far as the US is concerned, the Fed is making a measured reduction in the pace of its asset purchase program. The US economy appears to be doing reasonably well: consumer spending remains steady; hiring is strong; the jobless rate is low; and manufacturing is firming up. Nonetheless, the reluctance to give a firm date for the tapering suggests that their economic improvement is still vulnerable.

China also appears to be back-tracking on its rebalancing with the launch of a *mini-stimulus* in April 2014, which involves heavy investments in railway and housing projects. Local governments have been urged to speed up their spending commitments, and tax breaks were announced for small businesses. In addition, the People's Bank of China has reduced reserve requirements for banks that are active in lending to small businesses and agriculture. Some analysts believe that spending on housing and railway alone might add 0.8 percentage points to China's GDP growth.⁷

Similarly, in India, business sentiments have improved as the new government is expected to push through much needed reforms; boost investment; enhance growth; and reduce the fiscal deficit. The Indian economy seems to have bottomed out, as the new fiscal year has started with a 10-quarter high GDP growth of 5.7 percent in Apr-Jun 2014 – local bourses are also bullish. However, investors are expecting more radical measures than the ones that the government has undertaken so far.

Other emerging market and developing economies are adjusting to tighter financial conditions and weaker medium-term growth prospects. However, their capacity to respond with policy stimulus is constrained by external vulnerabilities, inflation pressures and fiscal space. Therefore, on balance, the IMF's forecast for the global GDP growth remains at 3.8 percent for the year 2015 – an improvement over 2014, but with an extended list of downside risks.

7.2 Pakistan's External Account

After a stressful beginning, Pakistan's balance of payments improved considerably by end-FY14. SBP's liquid foreign exchange (FX) reserves posted an increase of US\$ 3.1 billion, compared to a cumulative decline of US\$ 8.8 billion in FY12 and FY13. This improvement was primarily an outcome of the country's re-engagement with the IMF, which promised disbursements of US\$ 2.2 billion every year till FY16.⁸ This bail out, and the *comfort* it gave to other external lenders (mainly the World Bank and ADB), enabled the country to meet debt payments during the year. External debt servicing of US\$ 7.0 billion during FY14 was larger than the size of SBP reserves (US\$ 6.0 billion) available at the start of the year.

⁵ In September 2014, ECB reduced the refinancing rate to 0.05 percent, while taking the deposit facility rate to - 0.2 percent.

⁶ <http://www.bloomberg.com/news/2014-09-11/japan-seen-needing-47-billion-stimulus-for-next-tax-bump.html>

⁷ <http://www.bloomberg.com/news/2014-05-29/china-stretches-mini-label-for-stimulus-as-steps-grow.html>

⁸ Pakistan entered into Extended Fund Facility (EFF) program of the IMF in September 2013.

The Jul-Nov period was particularly tough, as large monthly current account deficits and bulky repayments to the IMF, put significant pressure on the country's FX reserves.⁹ Since the new IMF program was not frontloaded, it was unable to calm the FX market; in fact, the program unnerved the market as SBP made FX purchases as a prior action in July and August 2013. After November, the external position started to improve: the current account posted surpluses in December and February due to soft commodity prices and healthy remittances; and more importantly, net repayments to the IMF remained less of a concern.¹⁰

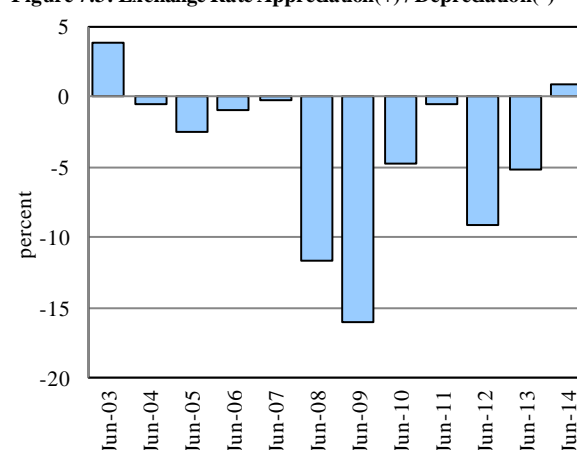
Pressure on SBP reserves eased further as Pakistan received US\$ 1.5 billion under the Pakistan Development Fund in February and March 2014; issued Euro Bonds in April 2014 worth US\$ 2.0 billion; and also managed to obtain fresh loans of US\$ 1.0 billion from the World Bank in Q4-FY14. In addition, proceeds from the long-awaited 3G/4G auction, and UBL divestiture, also contributed to the reserves build-up. Due to these inflows, along with spot purchases from the interbank market, SBP ended up with US\$ 9.1 billion FX reserves by end FY14. More importantly, SBP reserves now have a more robust standing in view of pre-determined short-term drains like maturing loans and forward/swap contracts (**Table 7.1**). Net International Reserves, which were negative US\$ 2.4 billion, have now increased to positive US\$ 2.7 billion at end FY14.

The PKR appreciated by 0.9 percent during FY14: 8.2 percent depreciation in Jul-Nov, followed by an appreciation of 9.8 percent in Dec-Jun 2014. This was the first year after FY03, when the PKR posted an appreciation (**Figure 7.3**).¹¹ The effective exchange rate, which reflects the relative strength of the PKR compared to a basket of other currencies, showed a nominal depreciation of 0.3 percent during the year. However, this depreciation could not offset a sharp rise in relative prices (i.e., Pakistan's CPI compared to that of other countries in the trade basket), leading to an *appreciation* of 5.5 percent in the real effective exchange rate (REER).

Table 7.1: Reserves Adequacy Indicators

	FY12	FY13	FY14
Import based adequacy			
Total reserves / import of goods	4.5	3.3	4.1
SBP reserves / import of goods	3.2	1.8	2.6
SBP reserves / import of goods and services	2.7	1.5	2.2
Pre-determined short-term drains			
<i>SBP reserves in terms of:</i>			
Maturing FX loans and deposits (1 yr)	4.3	0.9	1.5
Aggregate short position in forward (1 yr)	5.3	2.7	6.0
Net international reserves (billion US\$)		-2.4	2.7
Short-term debt			
Total reserves / short-term debt	9.5	8.7	5.3
SBP reserves / short-term debt	6.7	4.7	3.4
Total reserves / short-term debt and CAD	2.4	2.9	2.5
SBP reserves / short-term debt and CAD	1.7	1.6	1.6

Source: State Bank of Pakistan

Figure 7.3: Exchange Rate Appreciation(+) / Depreciation(-)

Source: State Bank of Pakistan

⁹ Only in the month of November, Pakistan repaid US\$ 725 million to the IMF.

¹⁰ During Dec-Jun 2014, net repayments to the IMF declined to only US\$ 343 million, from US\$ 1.1 billion in Jul-Nov 2013.

¹¹ In FY03, the PKR appreciated due to the positive shock of 9/11.

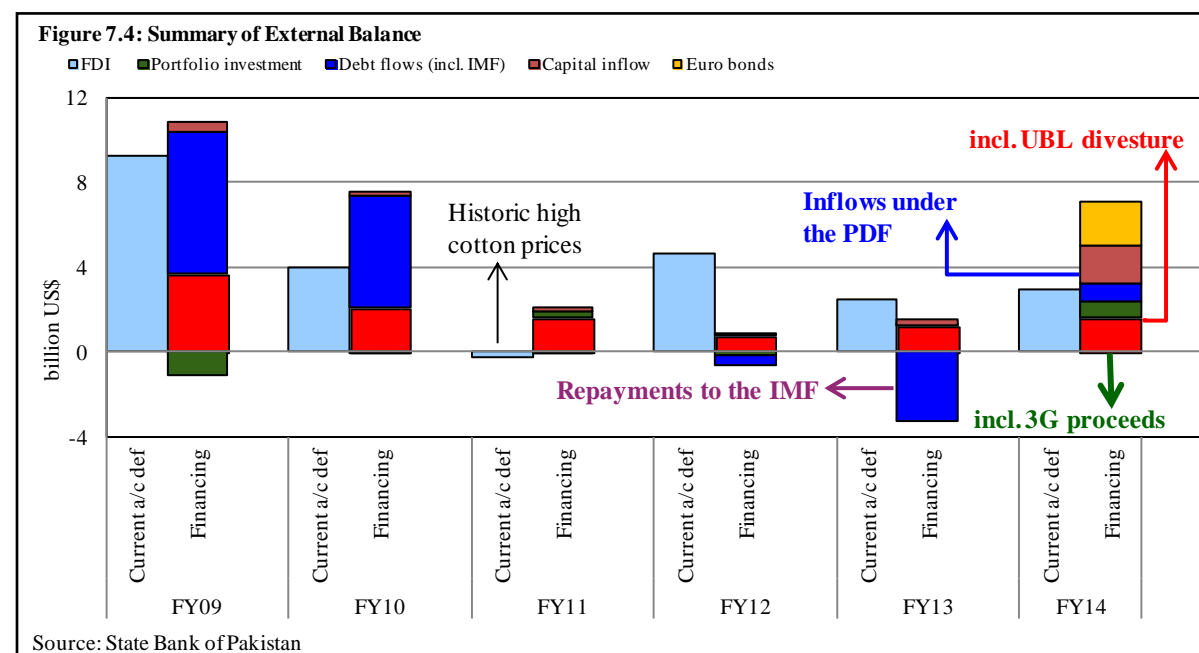
As far as the current account was concerned, the deficit in FY14 was right on target for the year.¹² Compared to last year, the deficit was larger in US Dollar terms, but this was entirely due to lower inflows under the coalition support fund (CSF): excluding CSF, the current account showed an improvement over the last year (**Table 7.2**). This improvement was driven primarily by record-high home remittances that reached US\$ 15.8 billion during the year – surpassing the target (US\$ 15.1 billion) by a significant margin. Exports posted a nominal growth over last year, mainly due to the award of GSP plus status by the EU. Imports also posted an increase, as the country's machinery requirements remained strong. However, the decline in unit price of fertilizer, furnace oil and palm oil helped contain the overall import bill (**Section 7.5**). The current account deficit reached US\$ 3.0 billion in FY14, compared to US\$ 2.5 billion last year.

Table 7.2: Current Account Balance

billion US Dollar

	FY13	FY14
Current account balance (A+B+C+D)	-2.5	-3.0
<i>excl.</i> CSF	-4.3	-4.1
A. Trade balance	-15.4	-16.5
Export	24.8	25.2
Import	40.2	41.7
B. Services balance	-1.6	-2.6
<i>o/w</i> CSF	1.8	1.1
C. Balance on primary income	-3.7	-3.9
D. Balance on secondary income	18.1	20.1
<i>o/w</i> Worker remittances	13.9	15.8

Source: State Bank of Pakistan



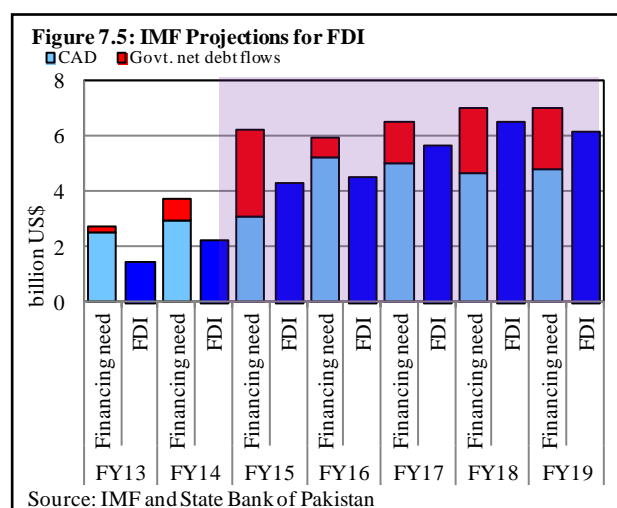
In many ways, FY14 was a typical year. Pakistan's *ability* to borrow from abroad determines the comfort on the external account, which if compromised, could easily become an FX crisis. This tendency has gained some significance in the last six years, when foreign investment has shied away from the country (**Figure 7.4**). The government should realize that the ability to borrow or attract FDI, depends on whether a credible structural reform program is in place, which would help the country generate a sufficient stream of FX earnings, to honor its debt payments. Pakistan had this advantage in FY14, as it entered an IMF program at the start of the year; this allowed other IFIs to make fresh loan commitments to Pakistan.

¹² The government had set US\$ 2.9 billion target for the current account deficit for FY14 (Source: Annual Plan 2013-14).

The role of financial institutions will remain crucial in the next few years, as Pakistan's external debt has increased in FY14. The debt servicing cost and scheduled repayments would put additional pressure on the country's external account. In the medium-term, reducing the current account deficit and/or attracting higher FDIs, is required, if Pakistan's BoP is to be managed properly. In view of the existing EFF, the IMF has projected exports to grow by over 6 percent per annum (on average) throughout the program period, and has also envisaged FDIs to more than finance the current account deficit (**Figure 7.5**). However, exports in the period FY10-14, has only managed an anemic 1 percent growth per annum.¹³

In the final analysis, we can say that Pakistan has successfully managed to avert a BoP problem in FY14; we presently have sufficient FX comfort to pay for our imports and external debt. Essentially, Pakistan has *borrowed* this comfort, whereas, a sustainable solution requires narrowing the FX gap with real *earnings* from exports and/or remittances; rationalization of imports; and curbing the smuggling. The next two years should be viewed as breathing space: repayments to the Paris Club (following the debt rescheduling of Dec 2001) would begin in FY17, whereas IMF repayments are starting from FY18.

Furthermore, analysts foresee stable commodity prices in FY15 and FY16, which implies that imports should not test our BoP resilience. Looking ahead, the country should use this window to take concerted measures to expand the country's export base, and keep pushing the remittance growth.



Previous chapters have discussed the reforms required in the fiscal and energy sectors, for a more conducive macroeconomic conditions and the need to reduce bottlenecks.

The following discussion presents an analysis of key vulnerabilities facing Pakistan's external sector, specifically in the context of FY14, along with a strategy that would help address these challenges.

- (i) Pakistan could not fully utilize the GSP plus due to persistent energy shortages. In our assessment, exporters diverted some of their export orders from other destinations to the EU, instead of producing more. Meanwhile, Pakistan is losing ground in the US textile market, due to a steady shift in the preference of US consumers from products made from cotton to man-made fiber (**Section 7.6**);
- (ii) Due to the gradual elimination of energy subsidies, electricity and gas tariffs for agriculture and the industrial sector, have increased domestic production cost. Furthermore, due to low investments in previous years, the country is not making much progress on the productivity front. In such circumstances, it has become challenging for exporters to compete.
- (iii) The PKR has posted an appreciation in real terms, whereas most other emerging market currencies have depreciated during FY14 (**Figure 7.6**). Exporters have been complaining of the loss of competitiveness, especially in the context of a decline in exports during Q4-FY14. However, their perceived causation seems misplaced, as export orders are typically booked 3 to 6

¹³ The average export growth during FY10-14 has been computed after excluding an extraordinary jump in exports during FY11, which was caused by historic-high cotton prices in the international market.

months in advance, which means the unexpected appreciation in Q3-FY14, cannot have caused the downturn in exports in Q4. However, Pakistan's exports in Q1-FY15 will have to be closely monitored (**Section 7.6**).

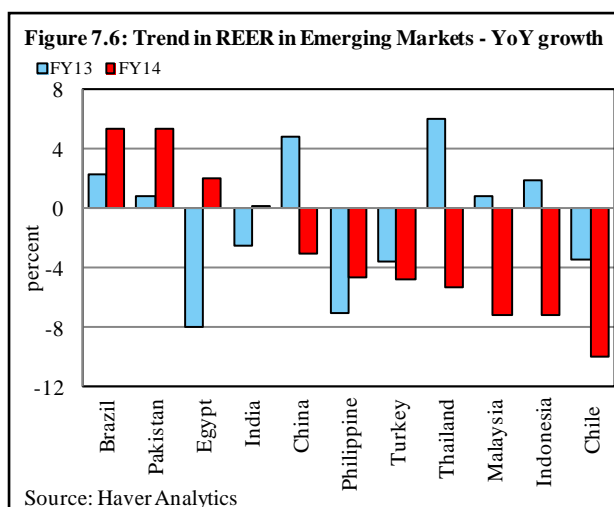
- (iv) FDI is still very low. Country comparisons show that while Pakistan offers a vibrant private sector, favorable labor and financial market conditions, security concerns and energy shortages deter foreign investments (**Section 7.5**).

Addressing these challenges is certainly not easy, but correct policies and their effective implementation, can fix at least some of the country's external constraints. For instance, the foremost thing to pursue is the product diversification in our exports, especially to optimize benefits from the GSP plus. One glaring example is the *man-made fiber* textile range, which is nearly half the global market, but Pakistan has still to make a niche. There is a need to design tariff and incentive structure, which encourages local manufacturers to think beyond cotton and start using man-made fibers. As mentioned earlier, Pakistan is fast losing the US textile market, as the US switches away from cotton towards synthetic products (**Section 7.6**). The emergence of Vietnam, Cambodia, Bangladesh and Sri Lanka in the global export market, is an added challenge for Pakistani exporters; governments in these countries are striving to capture a sizable share in the global market in labor-intensive exports.

A swing factor would be how Pakistan advances its trade relations with India, which is a key supplier of industrial chemicals (including textile dyes, synthetic fibers, etc). Pakistani exporters must realize the dynamics of competitiveness have changed: local availability of primary resources and cheap labor *per se* are not sufficient factors anymore; competitiveness now calls for advanced skills and technology; sophisticated value-chain; and distribution/marketing. The government, on the other hand, should ensure an adequate provision of infrastructure to bring down transaction costs; create an effective mechanism of rebates and refunds to exporting industries; and allow market-driven exchange rate adjustments.

In terms of import, there is a need to use domestic resources in the energy sector, since oil imports constitute nearly 35 percent of our import bill. If required, import substitution can also be considered in palm oil, which takes up nearly US\$ 2 billion per annum. To address the unwarranted competition of locally produced goods with smuggled or under-invoiced imports, the government should improve the information flows between departments dealing with import valuations, and the collection of customs duties. On an aggregate level, the government must rationalize its import policy keeping in view the factors that facilitate long-run economic activity, and what would our constrained FX resources allow. Institutions like the Trade Development Authority of Pakistan; Ministry of Commerce; Planning Commission; and Board of Investment, need to be strengthened to develop an internally consistent medium-to-long term trade and investment policy, which facilitates the broader growth objectives. Once the policy is formulated, it needs to be implemented.

In terms of remittances, anecdotal evidence suggests that a large amount is channeled via parallel FX market, despite international efforts to scrutinize informal money transfers. Our foremost priority is to divert funds from informal to formal channels using the Pakistan Remittance Initiative (PRI) (**Section 7.3**). Specific investment instruments may be designed for overseas Pakistanis. Philippines



and Bangladesh provide good examples for a more financially inclusive remittance mechanism (**Box 7.1**).

Finally, reviving FDI requires more than policy fixes. It appears that foreign investors would respond more positively if security concerns and the related businesses cost, are credibly addressed. Global investors also appear heartened by local efforts to target militants that have been operating on the Pakistan-Afghanistan border.

7.3 Current account

The current account posted a deficit of US\$ 3.0 billion in FY14, compared to US\$ 2.5 billion last year (**Table 7.2**). The higher deficit came primarily from lower inflows under CSF, which increased the services account deficit. The trade deficit also increased due to higher import payments during the year. Together, the deficit in these accounts, more than offset the significant improvement in home remittances in FY14.

Trade deficit

Pakistan's trade deficit widened in FY14 to reach a record high of US\$ 16.5 billion: in terms of GDP, the external gap however, was much lower than the imbalances seen in FY08 and FY09. The increase in the deficit came primarily from higher imports of machinery (especially telecom apparatus), fertilizers, and iron and steel (scrap). Exports continued to post modest growth on the back of higher supply to the EU under the GSP plus arrangement (especially textiles and leather); a rise in demand for non-basmati rice varieties in African countries; and a revival in petroleum refining that allowed for higher export of lubricant oils, naphtha and other chemicals (**Section 7.6**).

Services deficit

As mentioned before, the higher deficit in services in FY14, was driven primarily by lower inflow of CSF money (classified as an export of military services) compared to last year (**Table 7.3**). In addition to military services, Pakistan's net export of transport services, also deteriorated in FY14. While the freight related deficit (which constitutes over 90 percent of the transport deficit) showed a marginal increase over last year, passenger transport (domestic airlines) deteriorated significantly. This was primarily due to an increase in the number of Pakistani nationals travelling with foreign airlines, as *Pakistan International Airlines* continue to face serious operational constraints.¹⁴

Primary income deficit

This account posted a deficit of US\$ 3.9 billion during FY14, compared to US\$ 3.7 billion last year (**Table 7.4**). This deficit can be traced to income repatriation by foreign companies operating in Pakistan, mainly in the oil and gas exploration sector. Putting this in perspective, income repatriation on FDI in FY14 was nearly twice the *fresh* investment that came into Pakistan last year. Pakistan's

Table 7.3: Details of Services Balance

million US Dollar

	FY13	FY14
Total services balance	-1,564	-2,637
Maintenance and repair services n.i.e.	-63	-92
Transport	-2,028	-2,542
<i>Sea transport (freight)</i>	-2,262	-2,347
<i>Air transport (passenger)</i>	256	-89
Travel	-935	-774
Construction	19	-11
Insurance and pension services	-218	-134
Financial services	-79	-106
Charges for the use of intellectual property n.i.e.	-137	-144
Telecommunications, computer, and information	400	469
Other business services	-1,007	-726
Personal, cultural, and recreational services	2	2
Government goods and services n.i.e.	2,482	1,421
<i>o/w CSF</i>	<i>1,806</i>	<i>1,050</i>

Source: State Bank of Pakistan

¹⁴ Total number of travelers (via both domestic and international flights) increased from 13.2 million in FY13, to 14.4 million in FY14; however, those travelling from PIA declined from 5.7 million in FY13, to only 5.0 million in FY14. This was mainly due to fleet constraints of PIA, which reduced the number of departures during the year.

external debt servicing is also heavy, compared to the net inflow of FX loans into the country (**Section 7.4**).

Worker remittances

Home remittances reached US\$ 15.8 billion in FY14, showing an increase of 13.7 percent over the previous year.

Consistently strong remittances have provided Pakistan much-needed FX comfort in recent years, as the trade deficit continues to remain high. Putting the volume of remittances in perspective, such inflows have financed 38 percent of the country's import bill; 95 percent of the overall trade deficit; and contributed over 6 percent in Pakistan's national income (GNP) in FY14. Compared to other top remittance-recipient countries, these statistics are impressive: Pakistan ranked 8th in terms of absolute remittance inflows during 2013, and in terms of GDP, its performance was much above high-volume countries like China, India and Mexico (**Figure 7.7a** and **7.7b**).

Table 7.4: Primary Income Account
million US Dollar

	FY13	FY14
Primary income (A+B)	-3,669	-3,920
A. Compensation of employees	24	30
B. Investment income (I + II + III)	-3,693	-3,950
I. Direct investment (a+b)	-2,687	-2,891
a. Income on equity and investment	-2,666	-2,865
<i>of which:</i>		
Repatriation of profits by oil cos.	1,734	1,710
Repatriation of profits by other cos.	88	73
Repatriation of dividend incomes	755	927
b. Interest	-21	-26
II. Portfolio investment	-314	-304
a. Investment income on equity	-217	-208
b. Interest	-97	-96
III. Other investment	-692	-755
<i>of which:</i>		
Interest payments by the govt.	628	628

Source: State Bank of Pakistan

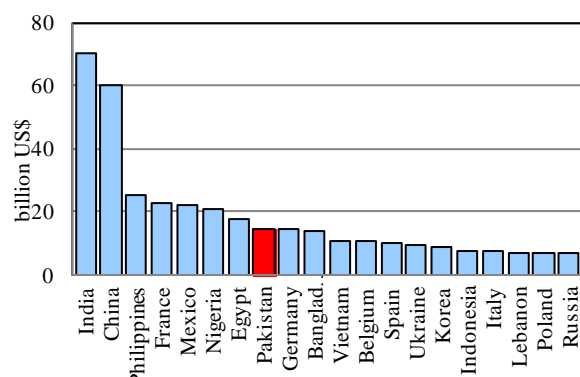
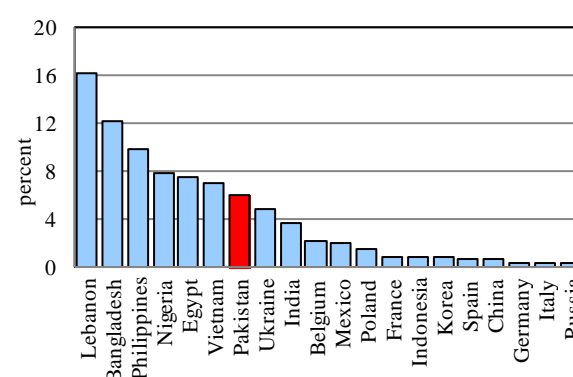
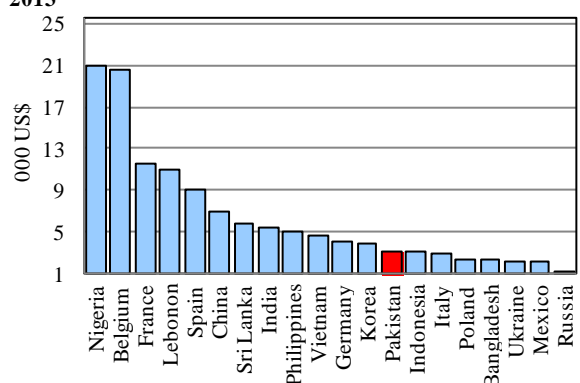
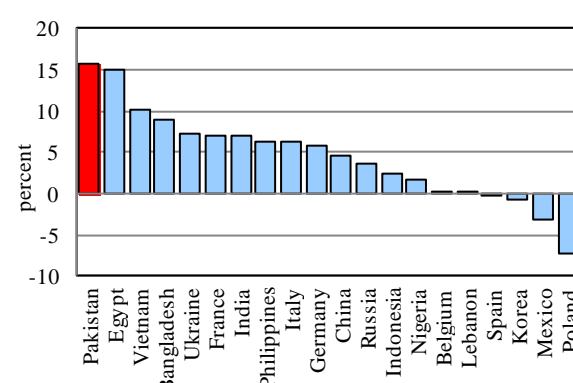
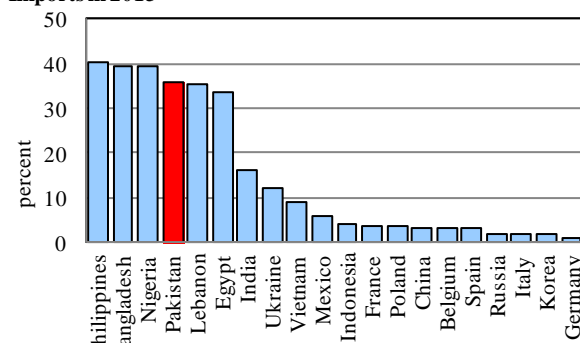
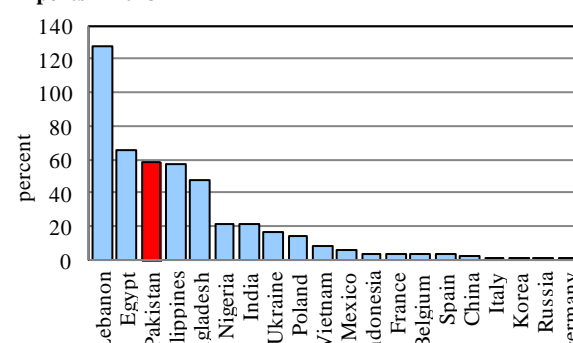
As far as remittance per migrant is concerned, although Pakistan's performance is better than Indonesia and Bangladesh; it gets less than most other countries. For developed countries like France, Germany and Spain, the difference in remittance per migrant is explained by the difference in qualification and skill sets. However, higher remittance per migrant into India, Sri Lanka, Nigeria and Philippines, probably reflects more effective mechanism to capture worker remittances.¹⁵ These countries put a lot of emphasis on facilitating customers in sending and receiving hard currency through banking channels.

Despite this, the growth of Pakistan's remittances since FY09 has been the highest in the top-20 recipients (**Figure 7.7d**). Although remittances into Pakistan have been strong since 9/11 (crackdown on *hundi/hawala* network), it gathered pace in 2008. More importantly, remittances remained resilient even when 2008-09 financial crisis hit the global economy, which took a heavy toll on Pakistan's exports. This resilience stems from multiple factors: (i) the consistent increase in the Pakistani Diaspora; (ii) overseas Pakistanis sending *more* than before;¹⁶ (iii) the diversion of remittances from informal to formal channels, as the surveillance on global money laundering increased; (iv) a rise in the share of skilled and qualified workers, in Pakistani migration that increased the remittance inflow per migrant (**Figure 7.8**); and (v) the lack of attractive investment opportunities in the origin countries (i.e., low interest rates in the US, UK and other advanced countries) and a dull real estate market in the Middle-East.¹⁷

¹⁵ Population of Nigeria is almost equal to that of Pakistan. It is not only per capita remittance, which is higher in Nigeria and Philippines compared to Pakistan; absolute volume of remittances is also large in these countries as shown in **Figure 7.7a**.

¹⁶ Media reports have suggested that this is because of the weak Pakistan's economy, compounded by the back-to-back floods in 2010 and 2011;

¹⁷ The real estate market of Dubai remained dull through most of the period 2009 to 2012. During 2013, however, the real estate in Dubai has rebounded, attracting many Pakistanis to invest in the sector. So far, its impact on remittances have been

Figure 7.7a: Top 20 Receptents of Home Remittances:**Figure 7.7b: Top 20 Receptents: Remittance to GDP****Figure 7.7c: Top 20 Receptents: Per Migrant Remittance in 2013****Figure 7.7d: Top 20 Receptents: 5-year Growth (CAGR -****Figure 7.7e: Top 20 Receptents: Remittance as percent of Imports in 2013****Figure 7.7f: Top 20 Receptents: Remittance as percent of Exports in 2013**

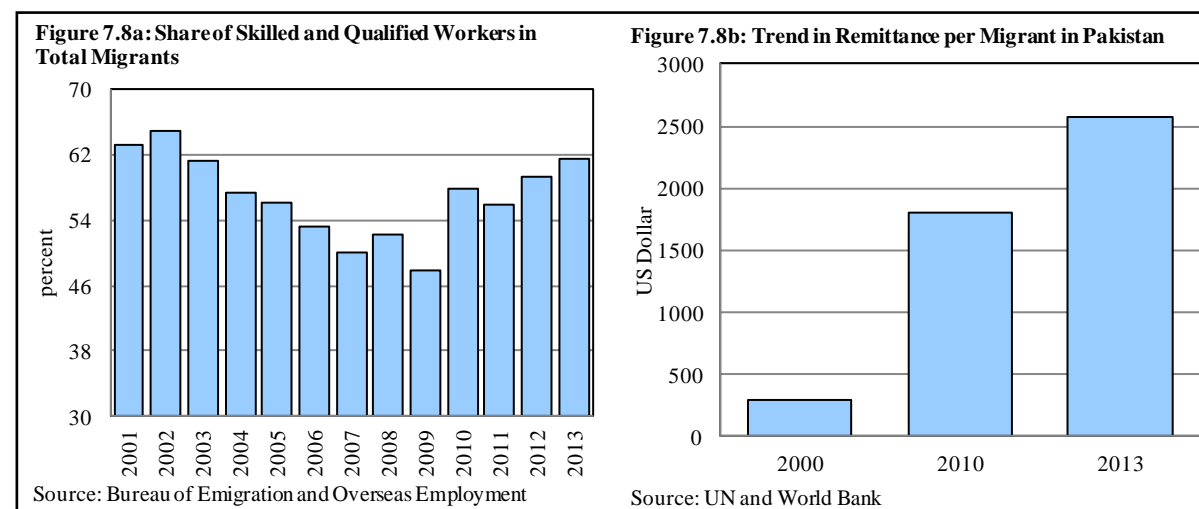
Source: UN Population Division and World

In FY14, several other positives supported Pakistan's remittance growth.¹⁸ First, the largest global money transfer organization (MTO) Western Union, introduced promotional offers for remitting money to Pakistan. In addition, a private commercial bank in Pakistan launched a *direct-to-bank* transfer facility with Western Union, which allows free-of-cost transfer of funds into beneficiaries' bank accounts in Pakistan. Furthermore, Islamic and microfinance banks are also marketing their

offset by a rise in the migration of Pakistani construction workers into the Emirate, as new infrastructure projects begin to realize.

¹⁸ For instance, additional workforce has been added. Bureau of Emigration and Overseas Employment reports an increase in gross outflow of Pakistanis during the year from 651 thousand in FY13, to 668 thousand in FY14. There might be some workers who returned to Pakistan during this period – especially construction related workers, but the anecdotal evidence suggests their number would be significantly less than those who went abroad. Unfortunately, hard data is not available for such workers.

remittance products aggressively to faith-sensitive and underserved customers, and have been successful in mobilizing significant volumes of remittances so far.



Pakistan needs to maintain this momentum. As mentioned before, Pakistan should reduce its current account deficit in next few years to be able to honor its rising debt servicing without having to borrow more. It is extremely important to minimize the use of informal channels for sending money, both by reducing transactional costs in the formal system and increasing administrative vigilance on informal money transfers. As far as the cost is concerned, growing competition among global MTOs, and their tie-ups with domestic commercial banks and exchange companies, has been of great help. In particular, GCC countries that account for the bulk of Pakistani Diaspora, have shown improvement in recent years: the cost of sending every US\$ 200 from the UAE was 7.3 percent back in FY08, which has been brought down to only 1.9 percent in FY14.¹⁹ Similarly in Saudi Arabia, the cost of remitting money has been halved from 5.7 percent in FY08, to only 2.6 percent in FY14.

Box 7.1: Measures taken by Bangladesh and Philippines to increase home remittances

Policymakers in Bangladesh and Philippines have taken various measures to increase remittances via banking channels.

Bangladesh

Bangladeshi government offers various savings and investment instruments to attract home remittances via official channels. These include:

1. **US Dollar Investment Bond:** This bond was launched in 2002 by Bangladesh Central Bank. The objective of this product was to provide non-resident Bangladeshis an investment opportunity, on which the government guarantees a secure and tax-free income. The interest rate on this 3-year bond is fixed at 6.5 percent per annum, and is payable in US Dollar in half-yearly basis. The principal and interest income are exempted from tax, and the bond can be used as a security to borrow from local banks. Death risk benefits are also available up to 15 to 25 percent of total investment. Principal and interest can be repatriated in the foreign country.

¹⁹ The remittance cost has two major components: transfer fee, and exchange rate margin. Transfer fee usually represents the charge which the remitter has to pay, and it varies across amounts within set bands. Exchange rate margin is what the money transfer agency earns when remittances are paid in local currencies. Although in some countries, remittances are paid in US Dollars as well, but in most cases, these are provided in local currencies, involving conversions at the pre-determined exchange rate. Researchers at the World Bank collect the data on remittance cost by contacting each money transfer firm, posing as customer. The database covers different forms of transactions. For each firm, the type of products offered is noted within the following categories: door-to-door, cash-to-cash, account-to-account (same bank), account-to-account (other bank), account-to-cash, cash-to-account (same bank), credit/debit card service, pre-paid card service, online service, mobile service, USD service, LCU service, and EUR service. For more details, see <http://remittanceprices.worldbank.org/en/methodology>.

2. US Dollar Premium Bond: This bond was also launched in 2002 by Bangladesh Central Bank, and carries more or less same features as the one mentioned above. The only difference being the interest is payable in Bangladeshi Taka, instead of US Dollar, and the rate is fixed at 7.5 percent per annum. Only principal can be repatriated in the foreign country.
3. Wage Earners' Development Bond (WEDB): Launched in 1981, this five-year bond is denominated in Bangladesh Taka. WEDB can be purchased without opening the foreign currency account with bank, and it earns a fixed interest rate of 12 percent per annum, payable on half-yearly basis. Investors can encash the bond before maturity, upon which principal is repaid along with the interest that ranges between 8.7 percent to 11.2 percent (depending upon years-to-maturity). If encashment is made after maturity, only the principal amount of the bond can be repatriated abroad in foreign exchange.
4. Non-resident Investor's Taka Account (NITA): Non-resident Bangladeshi nationals can open NITA with any authorized dealer, with freely convertible foreign currency remitted from abroad. This account can be used to invest in shares/securities listed in the country's stock exchanges. Major incentives include: no tax on capital gain on transaction of listed shares; 10 percent tax rebate allowed to on investment in listed securities; lower rate of tax on dividend income; 10 percent reserved quota for non-resident Bangladeshis in initial public offerings; participation in the secondary market through NITA and full repatriation of sale proceeds, capital gain & dividend income etc
5. Non-resident Foreign Currency Deposit: This deposit can be opened in a foreign currency (Dollar, Euro, Yen and Sterling), with a tenor from one month to one year. The balance in this deposit, along with the accrued interest, can be transferred in foreign exchange to any country, or to any foreign currency account maintained by Bangladeshi nationals abroad. The interest accrued is tax-free.

In addition to these, the government offers various tax incentives to non-resident Bangladeshis (NRBs). For instance, no tax identification number certificate is required on the purchase of fixed assets by NRBs. Similarly, they do not require income tax clearance before leaving the country after visiting Bangladesh.

Philippines

Banks in Philippines give specific attention to the aspect of origination of the remittances, in order to provide convenience to Filipino workers. Banks have tie-ups with Money Service Bureau and correspondent banks, and have also opened subsidiaries and overseas offices, to provide the remittance facility. Migrants can send remittances via phone using debit cards; do online transaction; and can also send text remittance by sending an SMS to the remitting office. If the beneficiary maintains an account with a bank, then a bank-to-bank transaction is done. If it does not, then door-to-door cash delivery is also offered by the banks. Since banks cap the transaction amount for providing door-to-door service, the beneficiaries can also claim the funds over-the-counter, in case the remittance amount is large.

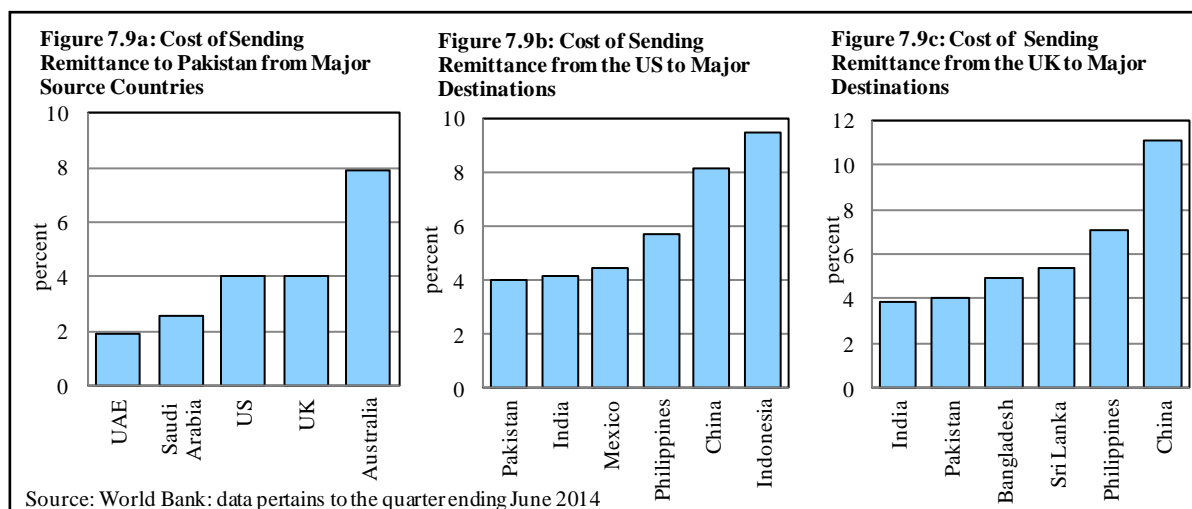
There exist nearly 29 organizations that conduct financial literacy trainings, targeting overseas Filipinos and their dependents. These include the central bank; commercial banks; bank associations; insurance companies; civil society; and financial literacy advocates. The training is provided to create awareness about legal rights; legal aspect of the contracts, assignment and the legal framework of the country where the person is going; and, explain the different means and ways in sending money to their families in Philippines. These pre-departure orientation programs give banks an opportunity to market the outgoing workers for having a bank account, and guide them to remit via their subsidiaries, branch, tie-ups or correspondents on overseas locations.

In 2010, the government issued the first tranche of multi-currency retail treasury bonds to provide overseas Filipino workers, migrants, and their families, an avenue for investment. These bonds are available with maturities of 3 and 5 years, with coupon rate varying from 2.87 percent to 4.125 percent. Interest is paid on quarterly basis. A tax incentive privilege was granted to them, as per which, the government assumes the 20 percent final withholding tax on the interest income on the bonds.

Source:

- i. Websites of Bangladesh Bank; Brac Bank (Bangladesh); Land Bank of Philippines; and Central Bank of Philippines
- ii. SBP Task Force Report on Home Remittances
- iii. Amjad, Rashid, Irfan, Muhammad and Arif G. M., How to Increase Formal Inflows of Remittances: An Analysis of the Remittance Market in Pakistan; International Growth Center Working Paper May 2013.
- iv. Role of Financial Inclusion Policies for Remittances, Global Forum on Remittances 2013.

Compared to these countries, sending money from the US and the UK is more expensive, but Pakistan is still a cheaper destination compared to others (**Figure 7.9a, b and c**).



As far as administrative measures are concerned, the Pakistan Remittance Initiative (PRI) is in process of launching various programs to increase awareness among Pakistani migrants to avoid using informal channels: (i) workers are encouraged to open bank accounts before departing; (ii) financial training programs have been launched to increase awareness of banking services; and (iii) the domestic aviation sector is being engaged to guide passengers on specific middle-eastern routes, about the *right* channels of sending money to their families. Keeping in view the recent trends, and the measures taken under PRI, the target for home remittances for FY15 has been set at US\$ 16.7 billion – a YoY growth of 5.3 percent.

7.4 Capital and Financial Account

Up until February 2014, Pakistan's capital and financial account was presenting a picture similar to the previous few years: low FDI volumes; very few FX loans; and, delays in privatization receipts and the proceeds from the 3G/4G auction. There was a surplus of only US\$ 1.4 billion in these accounts, which was insufficient to finance the current account deficit of US\$ 2.4 billion and net IMF repayments of US\$ 1.3 billion during Jul-Feb FY14. However, in the third week of February and early March, Pakistan received a grant of US\$ 1.5 billion from Saudi Arabia, which shored up its capital account surplus. The fourth quarter proved to be more important for the financial account, as Pakistan received the Euro Bond proceeds; fresh IFI loans; 3G/4G auction license fees; and proceeds from the UBL divestiture (**Table 7.5**).

Foreign direct investment

The roll-out of 3G/4G auction in FY14, pushed FDI inflows in the country to surpass the last year's level (**Table 7.6**).²⁰ Other than telecommunication, no other sector recorded much of an improvement: manufacturing, oil & gas, power and financial sectors, all posted a decline (in FDI) during FY14. Low FDI mainly reflects the absence of a one-off inflow in the FMCG sector last year.²¹ According to estimates provided in the Economic Survey 2013-14, terrorist attacks in the country have caused a cumulative loss of US\$ 8.1 billion of foreign investments during the last three

²⁰ The China-based cellular company borrowed from its parent company to pay US\$ 517 million to the government of Pakistan. Inter-company borrowing from abroad is treated as FDI in the BOP accounts.

²¹ This was in the form of a buyback of shares worth US\$ 500 million by Unilever, during Q4-FY13. The British parent company increased its stake in the business by acquiring 24.9 percent of issued shares in Pakistan.

years (FY12-FY14).²² In addition, concerns over energy availability and contract enforcement, also seem to have impacted FDI inflows into Pakistan.

Table 7.5: Capital and Financial Account
million US Dollar

	Jul-Mar		Q4		Full-year	
	FY13	FY14	FY13	FY14	FY13	FY14
Capital account	192	1,768	72	65	264	1,833
<i>of which Pakistan development fund</i>	0	1,500	0	0	0	1,500
Financial account (A+B+C+D)	-447	1056	996	4,179	549	5,235
A. Direct investment	440	561	818	922	1,258	1,483
Direct investment abroad	191	114	7	34	198	148
Direct investment in Pakistan	631	675	825	956	1,456	1,631
<i>of which 3G/4G auction</i>	0	0	0	517	0	517
B. Portfolio investment	110	128	-84	2,640	26	2768
Portfolio investment abroad	85	-24	14	2	99	-22
Portfolio investment in Pakistan	195	104	-70	2,642	125	2,746
<i>of which a. Euro bond</i>	0	0	0	2,000	0	2,000
<i> b. UBL divesture</i>	0	0	0	310	0	310
C. Net loan inflows	47	-601	-24	1,451	23	850
Disbursements	2276	2,192	663	2,271	2,939	4,463
Amortization	2229	2,793	687	820	2,916	3,613
D. Others	-160	-130	290	588	130	458
Investment assets	-602	420	288	-123	-314	297
Currency deposit liabilities	154	-107	-9	5	145	-102
Other liabilities	288	-443	11	706	299	263

Source: State Bank of Pakistan

Table 7.6: Sector wise Inflow of Foreign Direct Investment in Pakistan
million US\$

	FY13			FY14		
	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI
Manufacturing	1,020.9	284.4	736.5	555.2	232.2	323.0
Mining & quarrying	2.0	-	2.0	33.8	27.6	6.3
Oil & gas exploration	565.6	5.8	559.8	486.7	21.7	465.1
Power	162.6	135.8	26.8	230.3	183.6	46.6
Construction	51.2	3.6	47.7	32.1	7.7	24.4
Telecommunication	160.8	564.9	-404.1	903.0	334.9	568.1
<i>of which: 3G</i>	0	0	0	517.0	0	517.0
Financial business	388.9	74.8	314.0	237.8	80.9	156.8
Other services	243.9	132.6	111.3	126.3	90.6	35.8
Others	69.5	7.1	62.4	35.7	30.5	5.2
Total	2665.3	1,208.9	1,456.5	2,640.9	1,009.6	1,631.3

Source: State Bank of Pakistan

As shown in **Table 7.7**, FDI inflows into Pakistan are quite low compared to other emerging economies. Looking at Pakistan's comparative performance, it appears that security and energy are key factors that hamper its attractiveness as an FDI destination. Among the regional peers, the World

²² Economic Survey 2013-14. The loss of foreign investment for different years is estimated at US\$ 4.6 billion in FY12; US\$ 210 million in FY13; and US\$ 3.3 billion in FY14.

Economic Forum ranks Pakistan the lowest in terms of competitiveness (**Figure 7.10b**). Interestingly, of the three dimensions of competitiveness, Pakistan's performance is the worst in 'basic requirements' (134 out of 144 countries);²³ better in terms of 'efficiency enhancers' (101 out of 144);²⁴ and the best in 'innovation and sophistication factors' (83 out of 144).²⁵ Within 'basic requirements', the two most concerning factors are 'security' and 'quality of electricity supply', in which Pakistan is ranked 142 and 133 out of 144 countries, respectively. The only countries worse off than Pakistan in terms of security were Libya and Yemen. Due to security conditions, businesses have specifically complained of increased cost of terrorism, crime and violence in the country. In addition, 'irregular payments and bribes' is another area, which businesses consider a significant burden, especially in gaining access to public utilities and dealing with taxation issues.

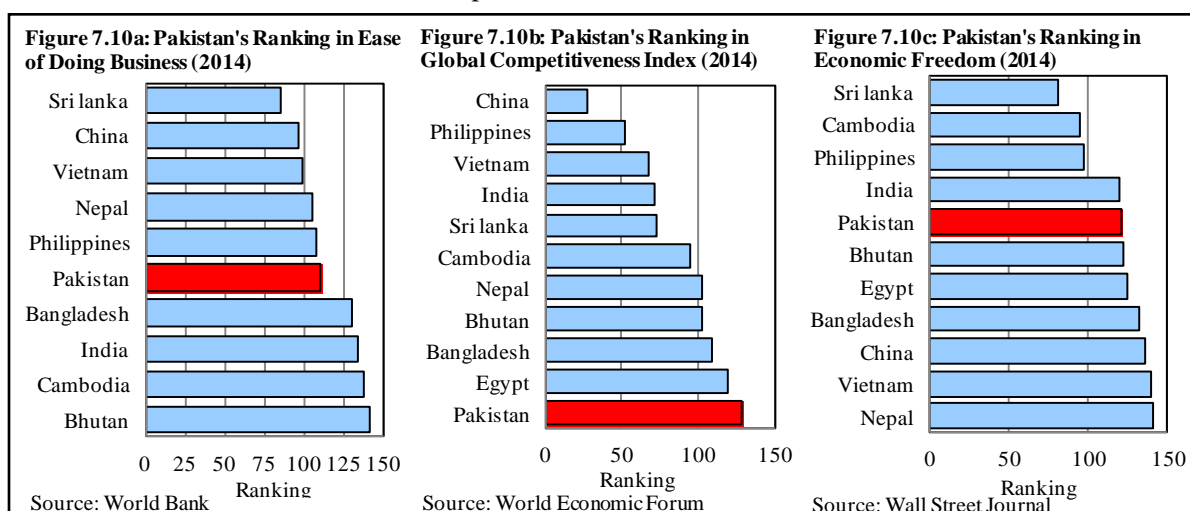
Table 7.7: Country-wise FDI as Percent of GDP

	Philippines	Indonesia	India	Bangladesh	Cambodia	Pakistan	Vietnam	Sri Lanka	Brazil	Chile
2009	1.2	0.9	2.6	0.9	4.9	1.4	7.2	1.0	1.9	7.5
2010	0.5	1.9	1.6	0.9	6.5	1.1	6.9	1.0	2.5	7.2
2011	0.9	2.3	1.9	1.1	6.2	0.6	5.5	1.6	2.9	9.3
2012	1.3	2.2	1.3	1.3	10.3	0.4	5.4	1.6	3.4	10.7
2013	1.4	2.1	1.5	1.2	8.8	0.6	5.2	1.4	3.6	7.3

Source: World Development Indicators

Pakistan's performance is better in terms of efficiency enhancing indicators. Corporate activity is considered conducive, when it is supported by relatively smooth regulatory procedures. In fact, because of a favorable regulatory structure, Pakistan's ranking is better than most of its peers in the 'Doing Business' category, as well as the index of 'Economic Freedom' prepared by the Wall Street Journal (**Figure 7.10a and 7.10c**). Furthermore, domestic market size, labor market conditions and financial sector development, are other key areas where Pakistan's performance has been quite reasonable. The latter reinforces the perception that Pakistan does not lack quality manpower – the concern is that this group is choosing to migrate abroad.

As mentioned before, innovation and sophistication factors are the most favorable indicators for



²³ As per these rankings, indicators like institutional quality, security, infrastructure, macroeconomic stability, and health and primary education are considered as 'basic requirements'.

²⁴ Higher education, goods and labor market efficiency, market size, financial markets and technological readiness are considered as factors enhancing efficiency.

²⁵ Business sophistication includes factors like quality and quantity of local suppliers; state of cluster development; international distribution; capacity for innovation; etc.

Pakistan. In particular, the country competes well with other emerging economies, in terms of the ability of developing value and supply chains, capacity for innovation, and cluster development. In terms of availability of scientists and engineers, Pakistan's performance is much better than most of its peers (49 out of 144 countries).

These indicators basically show that Pakistan's investment potential is significant (especially in infrastructure and energy sectors); business regulations are investor friendly; labor markets are flexible and abundant with both skilled and unskilled workforce; and above all, the size of domestic market. If only Pakistan is able to tackle governance related issues and provide a sense of security to businesses, it can attract significant volumes of FDI that would not only solve its FX problems, but would also contribute in enhancing productivity and efficiency of the economy.

Portfolio investment

Following the issuance of Euro Bond and the divestiture of UBL, foreign portfolio investment in Pakistan increased during FY14 (**Table 7.5**). Excluding these two items, the situation is not very encouraging: local bourses and domestic bonds are still not attractive for foreign investors, especially in view of the negative country image; sovereign risk; and volatility in inflation and the exchange rate.

Foreign loans

After a dry FY13, FX loans picked up in FY14. As mentioned in **Chapter 6**, the new IMF program was the deciding factor in resuming fresh loans from other IFIs (especially the World Bank and ADB), to finance the reform process in the country's energy, fiscal and social sectors. As shown in **Table 7.5**, up until March 2014, there was a net retirement of US\$ 601 million; but in the final quarter, the country received a net inflow of US\$ 1.5 billion. For an FX constrained country, resumption of IFI loans is critical; however, it puts extra responsibility on the government to initiate and expedite the underlying reform process, to strengthen the country's debt servicing capacity (**Chapter 6**).

7.5 Reserves and Exchange Rate

FY14 turned out to be an eventful year for Pakistan's FX market. The initial part of the year was marked by speculative attacks on the PKR; followed by a sense of calm; and later, unprecedented appreciation. For the sake of analysis, developments in this market can broadly be divided into four phases (**Figure 7.11**):

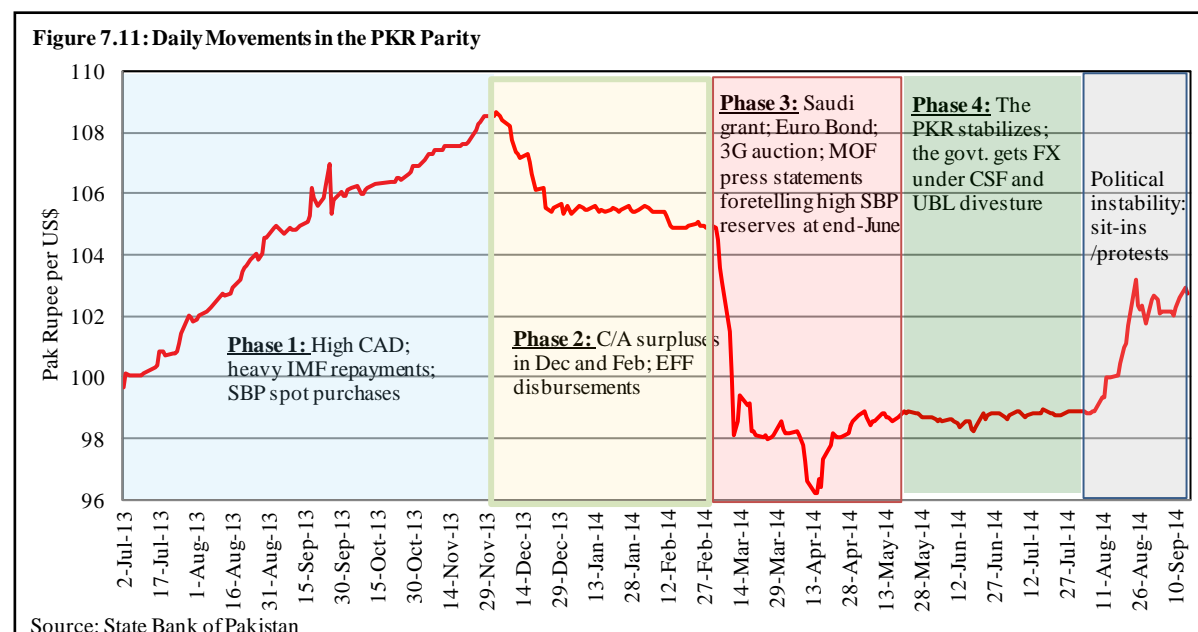
(i) Jul-Nov – FX pressures and the new IMF program

During this period, SBP reserves posted a sharp decline of US\$ 3.0 billion, which was almost 50 percent of the reserves available at end June 2013. This was caused primarily by a large current account deficit, and heavy debt servicing that included US\$ 1.7 billion repayments to the IMF. By the start of December 2013, there was only US\$ 3.0 billion left in SBP reserves, which was not sufficient to cover even a month of the country's import bill. Furthermore, SBP's net international reserves (NIR) were negative.²⁶

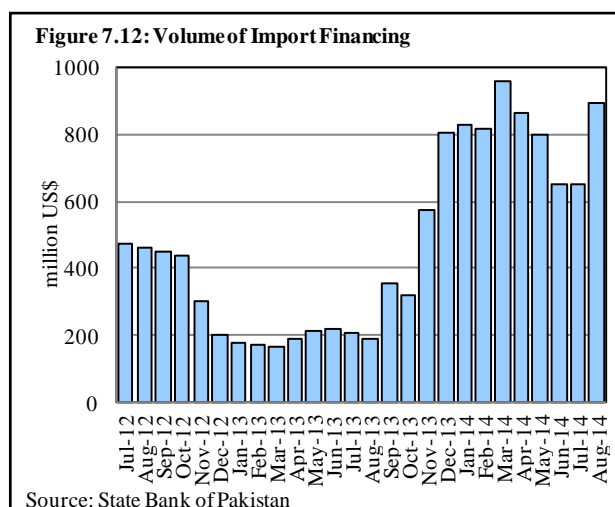
The PKR depreciated by 8.2 percent during this period. In the absence of FX support from SBP, the burden of financing the current account deficit felt heavily on commercial banks, which reduced their trade nostros. To mitigate BoP pressure arising from scheduled debt repayments, Pakistan entered another IMF program that promised disbursements of US\$ 2.2 billion during FY14. Since the program was not frontloaded, it did not help market sentiments much. In fact, as a prior action to this

²⁶ The IMF defines the stock of net international reserves (NIR) as the US Dollar value of the difference between gross international reserve assets and reserve related liabilities, evaluated at the program exchange rates. Hence short-term borrowed FX and IMF (IFI) loans are deducted to show the FX that can actually be used.

program, SBP made purchases from the interbank to build up its NIR, which further depreciated the PKR.



Major oil importers borrowed FX from commercial banks to settle a part of their L/Cs. As a result, import financing against FE-25 loans posted an increase of US\$ 357 million in Jul-Nov 2013, compared to a net retirement of US\$ 125 million in the same period last year (**Figure 7.12**). Most of these loans were taken by PSO, PARCO and other oil refineries for the import of crude oil and petroleum products. This effectively delayed the payment burden till the maturity of these loans, and helped ease pressure on the exchange rate. For borrowers, there was a benefit of 7.6 percentage point interest rate differential (on average) between PKR and US Dollar loans; later, these borrowers also benefited from a sharp appreciation of the PKR.



(ii) Dec-Feb: Easing pressures on the PKR

Once the bulky repayments to the IMF were made by end-November, concerns on Pakistan's BoP eased in December 2013. More specifically, repayments to the IMF were low and were largely offset by fresh disbursements from the Fund. The external position was further consolidated by surpluses in the current account in December 2013 and February 2014. As a result, SBP reserves increased by US\$ 870 million, and the PKR posted an appreciation of 3.5 percent during Dec-Feb FY14.²⁷ In fact, most of this appreciation was seen during the month of December 2013, when the PKR appreciated by 3.0 percent to reach Rs 105.3 per US Dollar. This level remained stable on average throughout January and February 2014. During the 3rd week of February, Pakistan received the first tranche of

²⁷ SBP reserves increased by US\$ 431 million in December 2013, and declined by US\$ 299 million in January 2014. During February 2014, SBP reserves posted an increase of US\$ 738 million mainly due the receipt of the first tranche of the Saudi grant.

the US\$ 1.5 billion under the Pakistan Development Fund (PDF). Although this boosted the level of SBP's reserves, it did not gain specific attention from the FX market (the way the second tranche did, as discussed below), since the nature and source of this inflow was not made public.

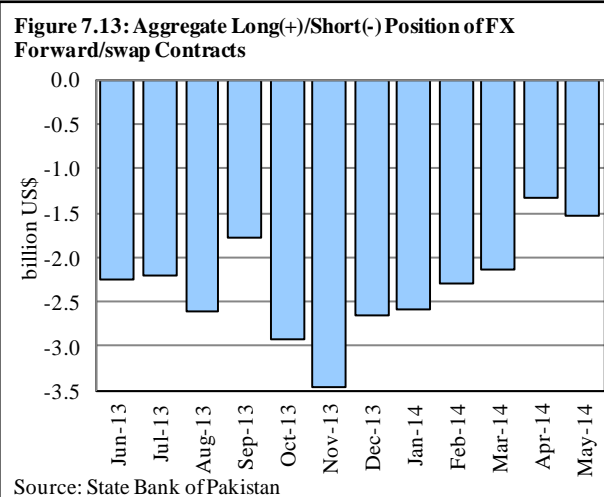
(iii) Mar-May 2014: strong FX inflows and a sharp appreciation of the PKR

This period was marked by a number of positives, which considerably improved the outlook of Pakistan's external sector:

- Events that unfolded after the receipt of the 2nd tranche under the PDF during the first week of March, caused an unprecedented appreciation in the exchange rate – the PKR appreciated by 5.1 percent in just three working days (between 10th to 12th March). This appreciation was fueled by panic FX selling by a few large exporters.
- During April, Pakistan issued sovereign bonds after a gap of 7 years, and mobilized US\$ 2 billion from international investors. In the same month, the government conducted the long-awaited auction of the 3G/4G spectrum licenses, which further shored up foreign exchange reserves of the country by US\$ 517 million.
- In May, Pakistan received US\$ 1.0 billion from the World Bank, and a further US\$ 375 million as part of the CSF.

The exchange rate came down to 98.7 by end-May, compared to 104.9 at end-February 2014. Although exporters did not welcome the PKR appreciation, others viewed it positively, including those who were skeptical of earlier government claims of bringing the PKR to this level.

(iv) June: Stability prevailed during the month of June, the PKR remained fairly stable and was traded at 98.6 per US\$ on average. The current account deficit was less than the monthly average, and debt repayments were low. The government sold more of its stake in UBL (US\$ 310 million) during the month, which was largely purchased by foreign investors. SBP reserves had already reached US\$ 8.7 billion at end-May, SBP's aggregate short position in forward/swaps also narrowed to only US\$ 1.5 billion, compared to nearly US\$ 3.5 billion as of November 2013 (**Figure 7.13**).



In overall terms for the year, the PKR appreciated by 0.9 percent during FY14 compared to a depreciation of 5.1 percent in FY13. The significant improvement in Pakistan's FX position can also be seen from the fact that after the first quarter, Pakistan comfortably met the NIR targets agreed with the IMF (**Table 7.8**). Spot purchases from the interbank were important in building up SBP's NIR throughout the year.

Table 7.8: IMF Target for Net International Reserves

billion US\$			
	Target	Adjusted target	Actual
Jun-13	NA	NA	-2,437
Sep-13	-2,499	-2,850	-3,154
Dec-13	-4,130	-5,107	-4,547
Mar-14	-2,750	-2,872	-2,140
Jun-14	1,800	n.a	2,678

Source: IMF and State Bank of Pakistan

7.6 Trade

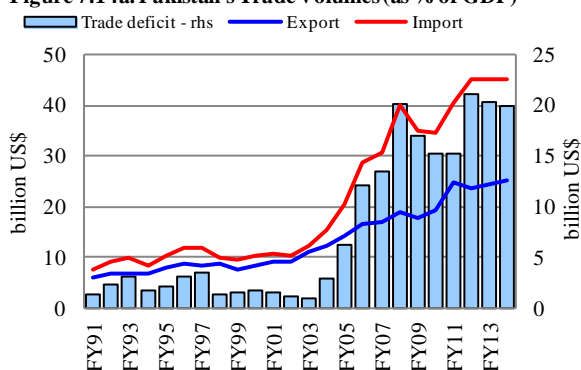
According to Payments Record data, Pakistan's trade deficit widened to US\$16.5 billion in FY14, compared to US\$ 15.4 billion last year. This dataset accounts for commercial transactions based on

payment realization (with a lag of one to two months), and not the physical movement of goods. Having said this, we base the remaining analysis of Pakistan's trade account on Customs data instead, which records transactions based on physical movement (as explained in past publications, Customs data has product details that are not captured by Payments Records).

As per this dataset, there was a marginal decline of 2.5 percent in the trade deficit, as the increase in exports was higher than the growth in imports during the year. While the award of GSP plus from the European Union supported Pakistan's exports, soft commodity prices helped contain the import bill. Before digging deeper, it is useful to look at the performance of the external trade in the previous few years. This reveals the following insights:

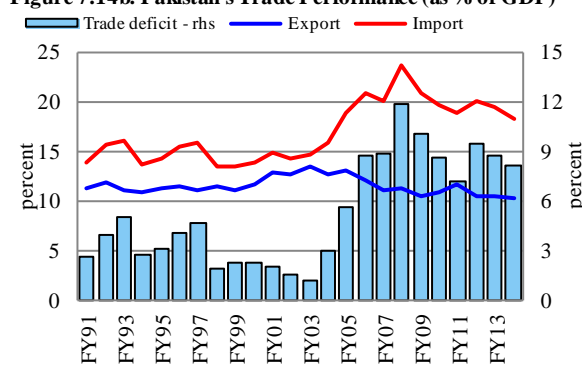
- (i) The current level of Pakistan's trade deficit, is the outcome of a sharp rise in imports from FY06. Although export growth also posted a modest increase, the rise in imports was much more

Figure 7.14a: Pakistan's Trade Volumes (as % of GDP)



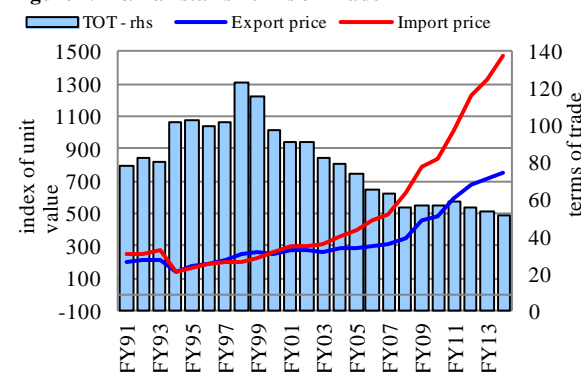
Source: Pakistan Bureau of Statistics

Figure 7.14b: Pakistan's Trade Performance (as % of GDP)



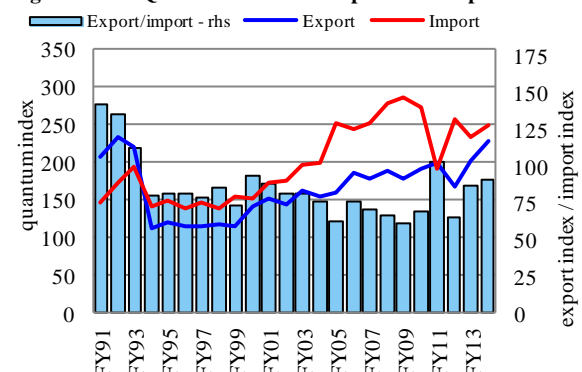
Source: Pakistan Bureau of Statistics

Figure 7.14c: Pakistan's Terms of Trade



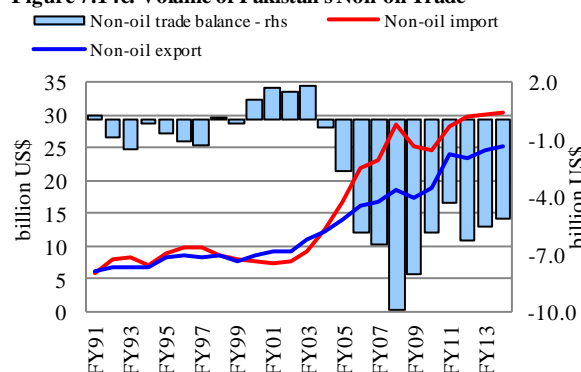
Source: Pakistan Bureau of Statistics

Figure 7.14d: Quantum Indices of Exports and Imports



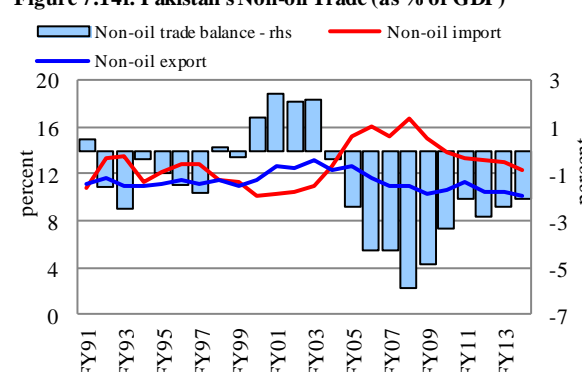
Source: Pakistan Bureau of Statistics

Figure 7.14e: Volume of Pakistan's Non-oil Trade



Source: Pakistan Bureau of Statistics

Figure 7.14f: Pakistan's Non-oil Trade (as % of GDP)



Source: Pakistan Bureau of Statistics

pronounced – both in absolute terms, as well as in terms of GDP (**Figure 7.14a and b**).²⁸ After a temporary easing in FY09, when Pakistan entered an IMF stabilization program, imports picked up again. Interestingly, although GDP numbers show a downbeat economy, domestic demand remained strong *fueled* by a vibrant informal sector and an increase in home remittances. External demand, on the other hand, remained sluggish, as recessions prolonged in Pakistan's major export destinations like the US and EU. This divergence in demand has been a key factor in explaining the rise in trade deficit in recent years.

- (ii) Another reason for the widening trade gap, is the deterioration in Pakistan's terms of trade. As shown in **Figure 7.14c**, the unit value of Pakistan's imports rose sharply after FY05, following the increase in global commodity prices, especially oil. As far as export prices are concerned, except for FY11 when cotton prices hit a record-high, the price of Pakistani exports grew modestly. In our view, this trend reflects the fact that Pakistani exporters are stuck in the lower end of the export value chain, despite the strong potential of moving up. In addition, Pakistani products fetch lower prices in the international market because of low technological base; lack of research and development; no branding; and quality issues. These issues can be resolved if private sector spends more on R&D, to maximize the potential it has in terms of value chain breadth and product sophistication.
- (iii) The trend in quantum was also not different; imports far exceeded exports since FY05. One obvious reason for this trend is Pakistan's growing energy requirements. As mentioned before, the divergent demand pattern in the local economy and Pakistan's export markets, could explain this trend. Furthermore, limited hydel power and dwindling gas reserves, have increased Pakistan's dependence on imported oil. Having said this, it is also important to mention that FY04 onwards, Pakistan is also posting a deficit in non-oil trade.
- (iv) Perhaps the most disturbing trend is the consistent fall in Pakistan's exports to GDP. Pakistan has one of the lowest exports-to-GDP ratio compared to other developing countries of this size (**Table 7.9**). This indicates that Pakistan's commodity producing sectors are struggling to produce an exportable surplus due to the persistent energy gap and the poor security that has constrained the economy's potential output. Other factors that undermine the country's competitiveness in the international market, include volatile inflation; lack of public investment; public sector inefficiencies; and lack of entrepreneurship amongst Pakistani exporters.

Table 7.9: Export-to-GDP* Ratio of Emerging Market Countries with Population More than 100 Million

percent

	China	India	Indonesia	Brazil	Pakistan	Nigeria	Bangladesh	Mexico	Philippines
1990	14.7	6.9	25.3	8.2	15.5	35.3	6.1	18.6	27.5
1995	20.2	10.7	26.3	7.3	16.7	35.8	10.9	25.2	36.4
2000	23.3	12.8	41.0	10.0	13.4	51.7	14.0	26.3	51.4
2005	37.1	19.3	34.1	15.1	15.7	31.7	16.6	26.6	46.1
2010	29.4	22.0	24.6	10.9	13.5	24.5	18.4	29.9	34.8
2013	26.4	24.8	23.7	12.6	12.7	26.7	22.8	31.7	27.9

*Export of goods and services. Figure 7.14b showed Pakistan's exports of goods only, as a percent of GDP.

Source: World Development Indicators

Exports

Pakistan's exports performed modestly during FY14; growth declined from 3.5 percent in FY13, to only 2.7 percent in FY14. This deceleration was explained primarily by two factors: the reduced limit for sugar export set by the government; and the clampdown on gold import, which lowered

²⁸ This does not, however, suggest a rise in import penetration. Import penetration is computed as imports in terms of total domestic demand, and gross national income. As per the official statistics, this is showing a declining trend (see later).

Table 7.10: Quantity Export of Key Items

	units	Absolute quantities			Growth rate	
		FY12	FY13	FY14	FY13	FY14
Basmati rice	000 MT	953	674	668	-29.3	-1.0
Non-basmati rice	000 MT	2,677	2,734	3,073	2.1	12.4
Fish	000 MT	132	139	151	5.3	9.2
Fruits	000 MT	737	718	784	-2.5	9.1
Sugar	000 MT	49	1,064	647	2086.5	-39.2
Meat	000 MT	56	63	74	11.3	17.0
Raw cotton	000 MT	257	93	115	-63.9	24.1
Cotton yarn	000 MT	576	738	663	28.1	-10.1
Cotton fabrics	mill. sqm	2,067	2,161	2,464	4.6	14.0
Knitwear	000 doz	98,674	97,920	109,564	-0.8	11.9
Bed-wear	000 MT	249	264	317	5.9	20.3
Towels	000 MT	146	170	170	16.6	-0.2
Readymade garments	000 doz	24,855	27,047	28,884	8.8	6.8
Carpets/rugs	000 sqm	3,284	3,016	3,278	-8.2	8.7
Footballs	000 doz	3,222	2,969	4,299	-7.9	44.8
Leather tanned	000 sqm	24,987	27,367	28,452	9.5	4.0
Leather garments	000 doz	868	939	1,356	8.2	44.4
Leather globes	000 doz	5,300	5,515	7,868	4.1	42.7
Leather footwear	000 pairs	6,383	5,746	7,460	-10.0	29.8
Other footwear	000 pairs	5,874	6,933	8,158	18.0	17.7
Electric fans	000 no.	1,484	1,800	1,999	21.3	11.1
Cement	000 MT	8,748	8,905	8,759	1.8	-1.6

Source : Pakistan Bureau of Statistics

Table 7.11: Export Values viz-a-viz Targets and FY13 Levels

million US Dollar

	FY14 Targets	FY14 ^E	FY13 ^A		FY14 Targets	FY14 ^E	FY13 ^A
Food	3,348.0	4,623.9	4,762.0	Towels	839.1	767.3	769.6
Rice	1,998.1	2,162.9	1,922.4	Readymade	1,919.1	1,955.6	1,799.6
Sugar	NA	286.8	528.8	Art, silk	417.7	383.5	405.7
Fish	346.1	367.5	317.7	Made up	629.1	666.9	598.6
Meat	39.4	230.2	211.1	Others	447.7	467.6	379.4
Textiles	13,167.9	13,738.7	13,047.6	Petroleum	0	721.4	28.3
Cotton	154.5	205.1	153.9	Sports goods	337.4	358.0	334.2
Cotton yarn	2,375.8	1,990.5	2253.0	Leather manufacture	569.2	621.5	561.3
Cotton cloth	2869	2773.6	2689.8	Cement	494.2	509.5	577.4
Knitwear	2,108.9	2,258.1	2043.0	Engineering	291.9	321.1	290.4
Bed wear	1854.6	2,138.6	1785.4	Jewelry	892.4	324.5	1,177.5

E: estimates; A: actual

Source: Pakistan Bureau of Statistics and Planning Commission

jewelry exports during the year.²⁹ Excluding these two, the growth in exports shows a significant improvement over last year (**Figure 7.15**). In terms of quantum, the export of knitwear, bed wear, fabrics and leather products was particularly strong (**Table 7.10**). In terms of values, most export categories posted higher growth in FY14, and also surpassed their respective targets (**Table 7.11**). As discussed below, this improvement appears to be an outcome of the award of GSP plus by the EU.

Food exports: positive trends but sugar muddled the picture

Overall food exports posted a decline in FY14, primarily due to a sharp reduction in sugar exports. Other items like rice, fish and meat posted a healthy increase during the year. In case of rice, the increase was driven primarily by strong demand for non-basmati varieties in

African countries (**Table 7.12**). China, which used to be Pakistan's major export destination, posted a decline in rice imports as it scales up local production.³⁰ Its place has been taken by Kenya, which imported over 400 thousand tons of rice from Pakistan this year – a growth of 47.6 percent over last year. However, this increase may not be sustainable: the government of Kenya has increased tariff on Pakistani rice effective from July 01, 2014.³¹ In fact, a part of the growth seen in FY14, can be explained by Kenyan importers buying Pakistani rice in bulk before the tariff increase became effective.

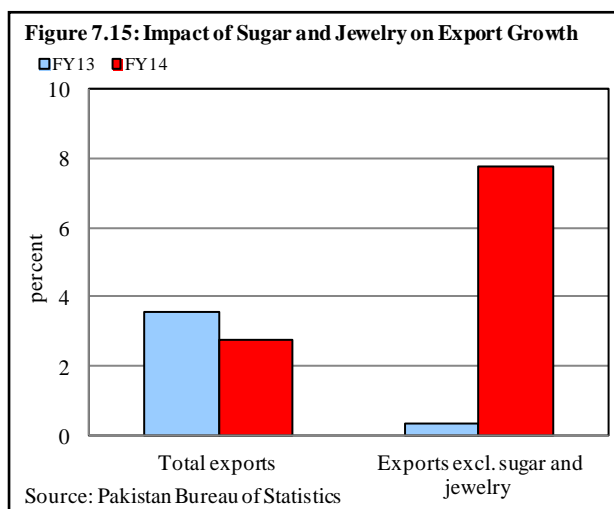


Table 7.12: Quantity Export of Rice (major destinations)

000 MT

	Non-basmati (not broken)				Basmati (overall)		
	FY13	FY14	YoY growth		FY13	FY14	YoY growth
Total	1994.1	2275.8	14.1	Total	613.9	613.7	0.0
Kenya	274.9	405.8	47.6	UAE	113.4	142.5	25.7
China	354.4	243.5	-31.3	Oman	60.7	56.7	-6.6
Madagascar	104.0	231.1	122.1	Yemen	43.9	55.8	27.2
Mozambique	133.1	136.3	2.4	Saudi Arabia	53.8	54.3	0.9
Tanzania	132.7	133.2	0.3	UK	38.0	39.9	4.8
Afghanistan	40.5	102.3	152.9	Belgium	5.9	21.6	265.4
Malaysia	79.7	93.7	17.6	US	18.5	21.6	16.9
Benin	79.5	92.1	15.8	Qatar	17.2	17.9	3.6
Cote d'Ivoire	66.8	78.4	17.2	Malaysia	16.1	17.0	5.5
Saudi Arabia	69.7	77.1	10.6	Bahrain	13.9	16.7	19.9

Source: Pakistan Bureau of Statistics

As far as basmati rice is concerned, after recording a decline in FY12 and FY13, basmati exports showed some stability in FY14, mainly due to higher unit prices. However, the decline in quantum was much small compared to last year, as demand was strong from the GCC and EU during the year:

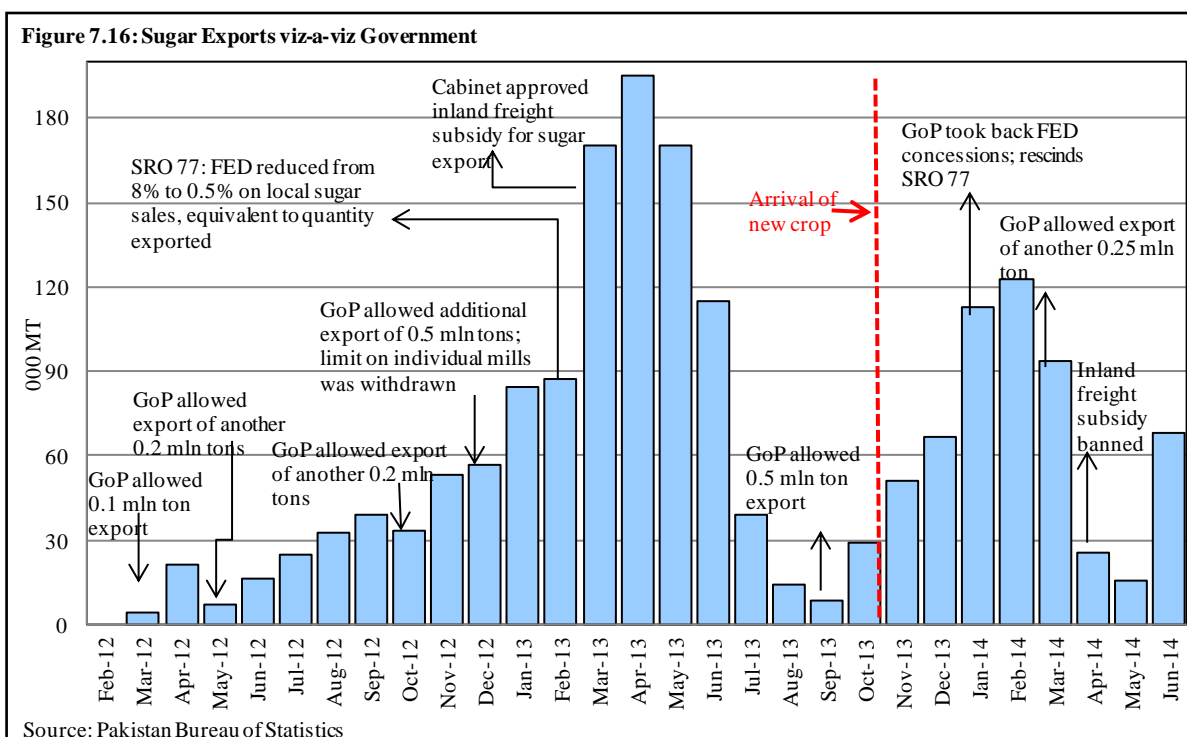
²⁹ In FY13, there was a temporary spike in jewelry (gold) prices in Dubai during the first quarter. Pakistani jewelers offloaded their gold stocks and exported a large amount of jewelry to the Emirate. When this blip was corrected, jewelry export returned to normal. FY13 was the only year, when jewelry exports surpassed US\$ 1 billion.

³⁰ The UN's Food and Agriculture Organization (FAO) has estimated China's paddy rice production at around 207.4 million ton, which is 2 percent higher than last year. This increase was an outcome of higher plantation and favorable weather.

³¹ Kenya has increased tariff rate on the import of Pakistani rice (long grain white) from 35 percent to 75 percent.

a sharp increase in the price of Indian basmati during FY14, diverted some orders to Pakistan. Basmati export may be under pressure going forward, as the competitive edge it had in FY14, may not last for long: Q4-FY14 onwards, price of Indian basmati has started to ease in the international market, as Iran reduced its demand on quality concerns. In fact, the upward pressure on Indian basmati prices stemmed from strong demand by Iran, which trades rice against oil under rupee payment mechanism with India.^{32,33}

Sugar exports declined in FY14 mainly due to a shift in government policy. Specifically, despite an estimated sugar surplus for the third consecutive year, the government reduced the export limit from 1.2 million ton in FY13, to 0.75 million ton in FY14, keeping in view lower stocks available with sugar mills.³⁴ In addition, the government also withdrew incentives it gave last year including the reduction in FED, and disbursement of inland freight subsidy to sugar exporters (**Figure 7.16**).



GSP plus contributed in FY14 exports

The entire increase in Pakistan's exports during FY14 came from the EU (**Figure 7.17a**). Six member countries – UK, Germany, Italy, Spain, Netherlands, and France, were among the 10 high-performing destinations for Pakistani exports. Last year, export to these countries had either declined, or posted a marginal increase.

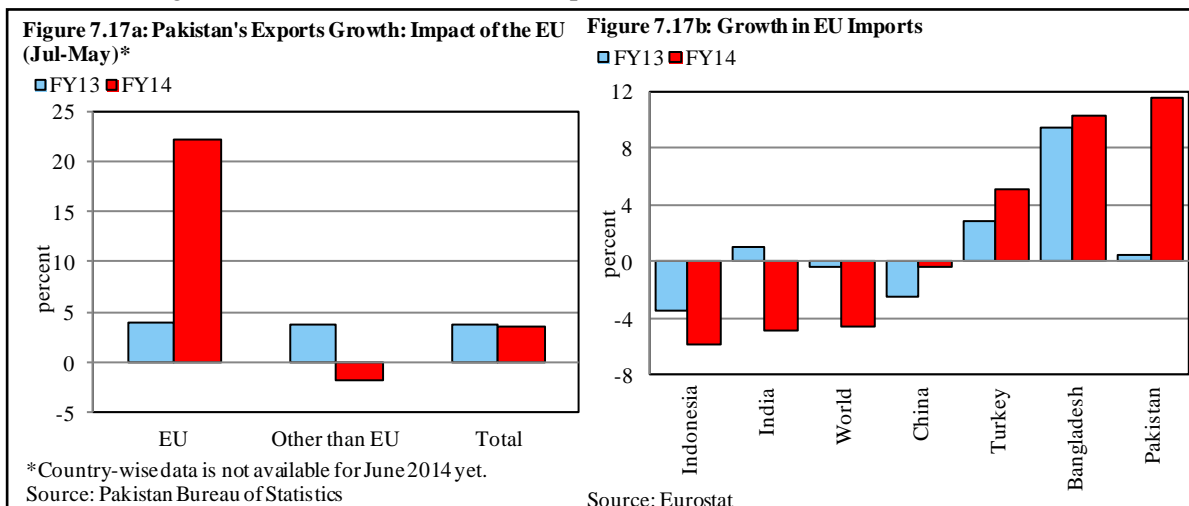
In overall terms, domestic demand in the EU increased, but this was met largely through intra-regional trade – imports from outside the EU, posted a decline during FY14 (**Figure 7.17b**).

³² Export unit price for Indian basmati increased to US\$ 1,367 per MT in FY14, compared to only US\$ 1,145 per MT in FY13 – a YoY growth of 19 percent (source: Agricultural and Processed Food Products Export Development Authority - APEDA).

³³ During Jul-Mar FY14, there was an increase of 14.4 percent YoY in the export of Indian basmati rice to Iran. However, this momentum was lost in the last quarter, when Iran reduced its demand for Indian basmati due to stringent standards on chemical contamination, and dissatisfaction with the quality. As a result, India posted a decline of 44.0 percent YoY in its export of basmati rice to Iran in Q4-FY14 (source: APEDA).

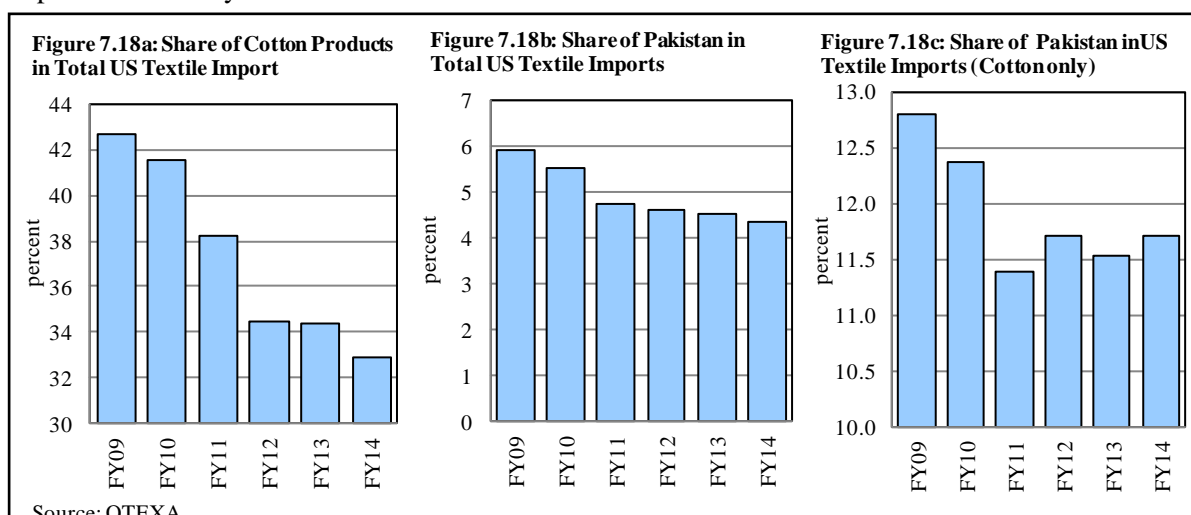
³⁴ According to Pakistan Sugar Mills Association, local mills had only 0.8 million MT of sugar stock at the beginning of FY14 season, compared to 1.4 million MT available at the beginning of FY13 season.

However, it appears that some switching took place across the partner countries: while EU imports from China and India declined, those from Pakistan, Bangladesh and Turkey posted an increase. Interestingly, these three countries gain because of special access to the EU market: Bangladesh has been granted the *Everything but Arm* (EBA) facility under the GSP plus; Turkey is offered zero tariff under the EU-Turkey Customs Union; and Pakistan has the GSP plus arrangement. Pakistan joined this group in January 2014, but its impact was felt from the middle of 2013, as European importers started building networks with Pakistani counterparts.



Pakistan losing the US textile market

The US market is gradually slipping away from Pakistani textile exporters. The key reason being the changing preference of US consumers from products made from cotton to man-made fibers. Unfortunately, Pakistani manufacturers have not adopted, and rely too much on cotton and produce only a negligible volume of synthetic products. Within cotton products, Pakistani manufacturers have barely maintained their market in recent years (**Figure 7.18**). Bulk suppliers like China and India, and relatively new entrants like Bangladesh, Vietnam and Cambodia are fast gaining grounds in the US non-cotton textile market. While China and India are self-sufficient in downstream petrochemical products, which are required to produce synthetic fiber, other Asian countries rely heavily on imported raw material. In Pakistan, ample availability of raw cotton and healthy margins in the sector, do not induce exporters to enter the synthetics market. Another factor that explains this lack of interest, is government policy over the years have ensured high level of protection to the polyester staple fiber industry.



Another setback that Pakistani exporters suffered this year was the cancellation of orders from Walt Disney Corporation, on grounds of unsafe labor conditions in the production facilities in Pakistan. It is feared that other US buyers like Nike, JC Penny, Strauss, GAP, etc., may also follow suit, if remedial measures are not taken.

Fourth quarter was a disappointment

7.59 The export growth momentum in the first 9 months of the year, was not maintained in the fourth quarter. During Apr-Jun FY14, there was a decline in exports reflected in both customs and payments record data. This decline was broad-based: export of rice, textiles, jewelry, cement, plastic, and sugar, remained lower than the same period last year. While cement, jewelry and sugar have been posting a YoY decline throughout FY14, the decline in textile and rice is concerning. As mentioned before, Indian basmati prices have started gaining competitive edge again, which could hurt Pakistani rice exports. Within textiles, the decline in exports was concentrated mainly in cotton yarn; more specifically, demand from China remained low, as bulk imports in previous years has caused a large inventory buildup. Encouragingly, export of knitwear, bed-wear and towels, continued to post an increase in the fourth quarter.

The decline in Pakistan's exports has coincided with a sharp appreciation of the PKR,³⁵ but there seems to be no underlying causality, as export orders are typically booked 3 to 6 months in advance. However, it is possible that new export orders will be hit, as the repercussions of the PKR appreciation play out in FY15.

Imports

Pakistan's import bill remained constrained for second year in a row, mainly due to soft commodity prices; restrictions on the import of gold and second-hand cars;³⁶ and import substitution in the steel sector (**Chapter 2**). Total imports only grew by 0.4 percent in FY14, compared to 0.1 percent last year.

Dull commodity prices helped

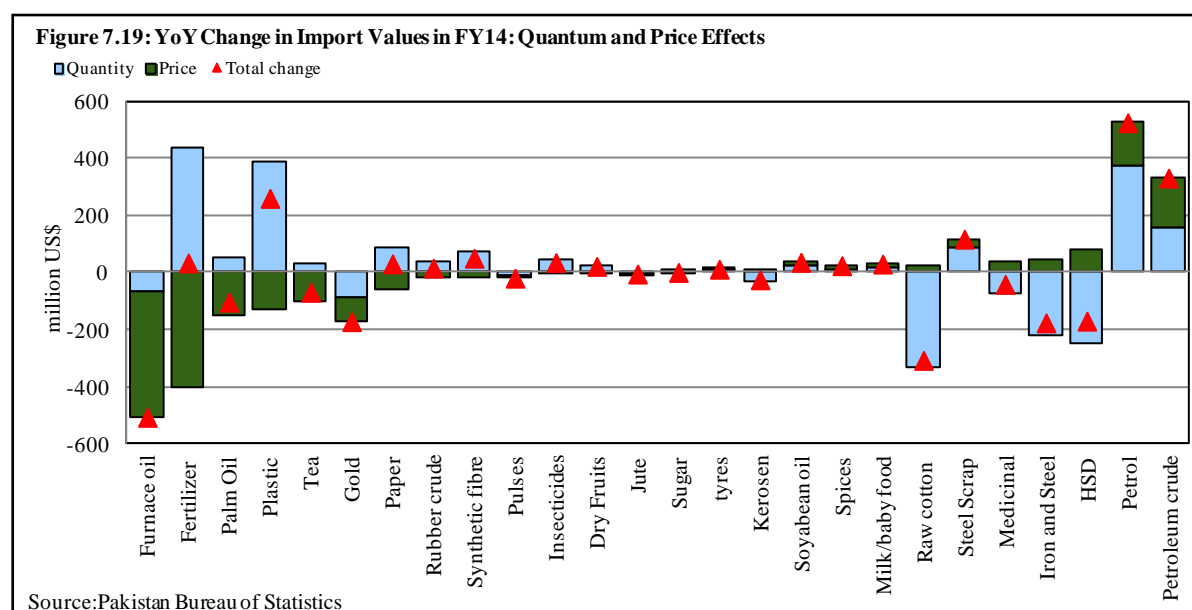
A major factor in containing the import growth during FY14 was the decline in unit prices – especially of fertilizer, palm oil and furnace oil (**Figure 7.19**). In the case of furnace oil, weak refining margins weighed heavily on global prices.³⁷ These margins were affected by capacity expansions in China, Saudi Arabia, UAE, Kuwait and Oman, amid sluggish demand from Europe and China. Viewing demand-supply conditions in the short-to-medium term, other expansion plans have been put off for a while.³⁸ Although analysts view these cutbacks as a signal of easing margin pressures in the future, they expect the global refining market to remain oversupplied during FY15. As far as domestic demand for furnace oil is concerned, this remained strong due to limited availability of natural gas for thermal power generation. The additional demand was met through higher local production, as smooth cash flows enabled domestic refineries to increase their capacity utilization.

³⁵ Prices of cotton and rice also declined in the international market from May 2014, but their impact on Pakistan's export values in Q4-FY14 was quite limited.

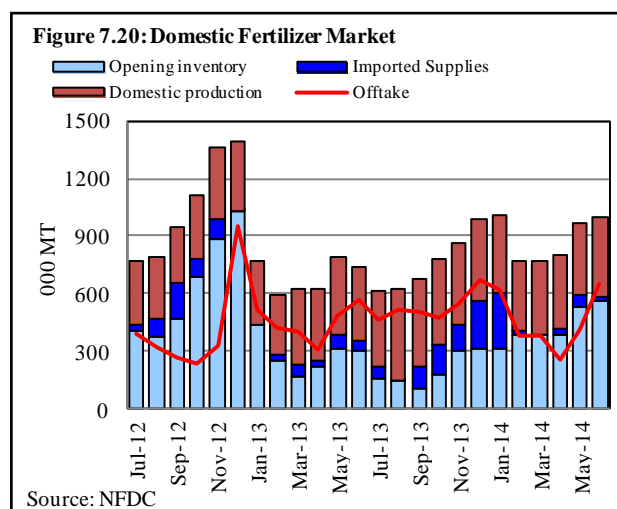
³⁶ January 2014 onwards, the government banned the import of gold into the country to curb outward smuggling to India (see Third Quarterly Report for 2013-14 for details). In case of automobiles, the government reduced the age-limit for imported cars from 5 years to 3 years on December 2012.

³⁷ The refining margin is the difference between the wholesale value of the oil products a refinery produces and the value of the crude oil from which they were refined. This margin depends mainly on the price of crude oil, and demand-supply gap of the refining products.

³⁸ For instance, British Petroleum has dropped its plan to invest in a 200,000 barrels per day refinery in China. Similarly, PetroChina has also scaled back its expansion plans with an existing capacity of 600,000 barrels per day.



The global fertilizer market remained oversupplied in FY14, and is likely to remain so in the near future, as leading importers like India, Brazil and the US are investing heavily to gain self-sufficiency.³⁹ An additional factor that helped reducing the price of fertilizer, was the decline in the price of coal, which is a major feedstock for fertilizer production in China.⁴⁰ As far as domestic demand is concerned, this remained high in FY14 compared to last year due to lower inventories, and a relatively higher average monthly off-take (**Figure 7.20**). In overall terms, however, lower unit prices offset the increase in quantum of imported fertilizer.



As for palm oil, low international prices were attributed to the bumper soybean crop in the US, and the delay in full implementation of bio-fuel mandate in Malaysia and Indonesia.⁴¹ Pakistan's import quantum increased only slightly over the last year, mainly because local refineries had ample inventories available from the previous year.

³⁹ Expansion plans in these regions are driven mainly by increased exploitation of shale gas reserves in the US; government incentives in India; and new gas discoveries in Brazil.

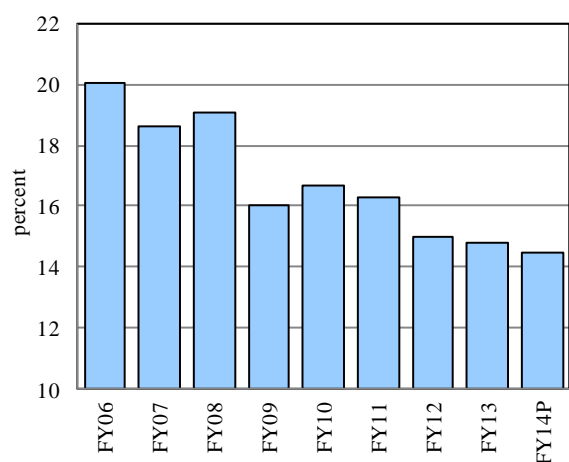
⁴⁰ Over 70 percent of urea was imported into Pakistan from China in FY14. Around 76 percent of urea production in China uses coal as feedstock.

⁴¹ Malaysia was given a mandate to involve 5 percent blending of palm methyl ester, with 95 percent of diesel petroleum. The so-called B5 mandate was expected to be implemented fully in Malaysia by end-July 2014, but has fallen short of its plan due to delays in installation of blending facilities. Similarly, Indonesia also raised the minimum bio content in diesel fuel used for transport to 10 percent, up from 3-10 percent previously. For the power industry, it doubled the minimum to 20 percent. However, Indonesia too fell short of target due to infrastructural and logistical problem. As such, both the countries (with 95 percent share in global palm oil production), failed to increase domestic consumption that was the major factor responsible for lower-than-expected price of the commodity.

Has import penetration declined?

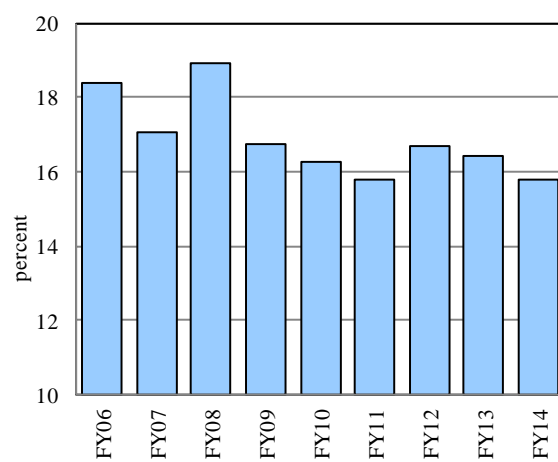
On a macro level, it appears that in last few years, Pakistanis have switched away from imports to locally produced goods (and services). As shown in **Figure 7.21a**, the share of (real) imports in total domestic demand has been declining over the last four years: around 14.5 percent of domestic demand was met through imports in FY14, compared to 20.1 percent in FY06. The share of national income spent on the import of goods and services, has also declined in the last couple of years (**Figure 7.21b**).

Figure 7.21a: Share of Imported Goods and Services in Pakistan's Domestic Demand



*Domestic demand is defined as total consumption and investment demand in the domestic public and private sectors

Figure 7.21b: Share of Gross Income spent on import of Goods and Services



*Gross national income is defined as C+I+G+X+net factor income from abroad

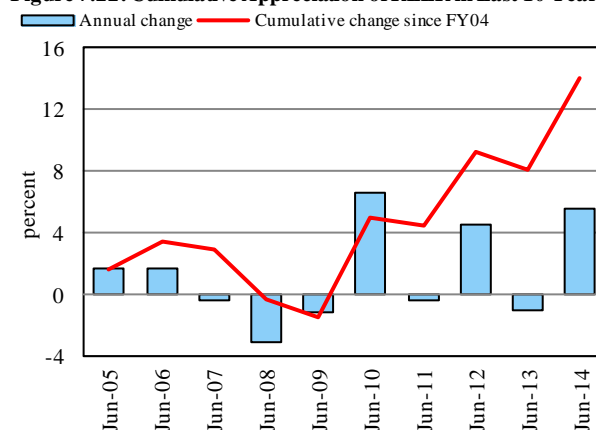
Capacity expansion in the industrial sector, and some improvement in energy availability during FY14, possibly explains this trend. However, we view this trend rather skeptically. At first, this trend is quite surprising given the consistent real appreciation of the PKR: during last 10 years, the REER has appreciated by nearly 14.0 percent, which implies that imported goods have become cheaper compared to the locally produced goods (**Figure 7.22**).

Secondly, we believe that informal trade is growing and a large volume of consumer goods and raw materials, is being smuggled into the country. Personal care items,

cigarettes, tea, rubber tyres, plastic items, synthetic filament and yarns, are a few items that enter Pakistan via the Afghan Transit Trade; sea routes from Dubai; and/or professional travelers (*khepias*) who carry the goods as personal items. In addition to smuggling, under invoicing of imports is also quite common. Importers declare lower-than-actual quantities and values to customs officials, to avoid full payment of tariffs and duties.

Adjusting for informal trade, we believe that import penetration has increased in Pakistan's economy (anecdotal evidence also supports this view). As have been mentioned in previous SBP Annual Reports, there exists strong demand for a number of products that are not manufactured locally. More specifically, cellular phones and accessories; energy saving bulbs; rechargeable fans; moulds and dies

Figure 7.22: Cumulative Appreciation of REER in Last 10 Years



Source: State Bank of Pakistan

for auto parts; processed milk; low-tech electrical appliances; remote controls; are some examples. Furthermore, despite having a strong agriculture base, Pakistan spends a large amount of FX to import food products like juices, cereals, seasonings, etc. In our view, local manufacturers have an opportunity to expand their operations and cater to this domestic demand, by upgrading their manufacturing units and marketing their products. This avenue of import substitution should not run foul of international trade agreements, as the imports that are being targeted are smuggled. The FX savings, by reducing cash imports, would reduce pressure on the kerb rate and force money changers to sell additional Dollars in the interbank market.