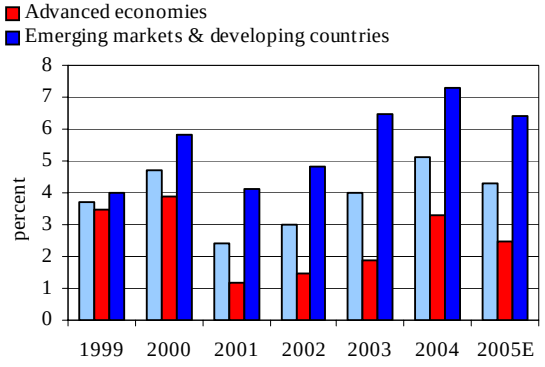
7 Balance of Payments

7.1 International Economic Situation[1]

The world economy gained considerable growth momentum during 2004, expanding by almost 5.1 percent during the year – which is the fastest growth since 2000 (see **Figure 7.1**) – despite a sharp rise in oil prices. This expansion continued to be led by the United States, China and other emerging markets.

Figure 7.1: GDP Growth Rates



Source: World Economic Outlook, September 2005

In the United States, the key impetus for economic growth came from strong consumption spending that reflects the impact of rising equity and housing prices. This was well supported by solid growth in business investment and substantial increase in productivity. Though the growth momentum has eased moderately, it is still the highest amongst G-7 countries.

However, the growing US current account imbalance, at a record 5.7 percent of GDP in 2004 (despite a significant nominal effective depreciation of the US Dollar), poses a considerable risk to the stable growth of the global economy. The financing of this large deficit so far has not been a problem. In fact, the demand for US assets in emerging Asian economies as well as in Middle East and central Asian oil exporting countries has been resilient despite the depreciation of the US Dollar. This situation cannot continue indefinitely, and a decision to diversify reserve portfolio by any of the important central banks could upset the global financial markets, and adversely impact the long-term prospects of world economic growth, but the timing and the severity of the eventual adjustments still remain a matter of considerable debate.

In Euro area, recent evidences indicate strengthening of activities in the second half of 2005, resisting the impact of high and volatile oil prices on domestic demand, and the fall in export growth (induced by the appreciation of the euro) that had earlier slowed the economic recovery in the region. The economic growth in Japan is also regaining momentum as GDP rose sharply in early 2005.

Among developing regions, East and South Asia posted 7.1 percent growth in 2004 which was the strongest performance after the1997 financial crisis. The performance was led by the China with 9.5 percent growth in 2004, which was fueled by both domestic and foreign demand. The foreign demand was quite robust as the region's exports continued to grow at double-digit rates in 2004.

While the global economy is expected to continue its growth momentum in 2005 as well, the persistent higher oil prices posed an increasing risk to the outlook. The prices of West Texas Intermediate crude oil rose to US$ 69.8 per barrel by end-August 2005 compared to US$ 42.3 per barrel a year earlier. While the rise in oil prices reflects the ongoing expansion of the world economy (mainly in the US, China and India), the volatility in prices is mainly a function of limited spare capacity among OPEC producers, temporary supply shocks, and heightened geopolitical uncertainties. As the investment in building spare capacity has not been sufficient to keep pace with the growing

[1] The discussion in this section is based on World Economic Outlook by IMF for September 2005, and Trade and Development Report 2005 by UNCTAD.

demand, this has probably weakened the OPEC's influence in containing the pressure on oil prices.[2] This also suggests that the oil supplies are unlikely to respond to increased demand in the medium term; thus, oil price are not expected to retreat to their 2003 level in the near future (see **Box 7.9**).

However, the world economy has been quite resilient to the impact of rising oil prices. Unlike previous episodes when fall in supplies led to oil price hike, the recent pressure on oil prices are driven by economic expansion, and thus relatively less damaging. Moreover, in real terms oil prices were still lower than levels seen during the oil shocks of the 1970s and that the reliance on oil has decreased for many advanced economies through increased efficiency of usage. More surprisingly, worldwide inflationary pressures are not only low but the expectations regarding inflationary pressures are also subdued, thus allowing central banks to keep interest rates lower than that experienced in earlier rounds of sharp rises in oil prices.

The strong growth performance also had its impact on world trade of goods that grew by 22.5 percent in 2004 (in current dollars) reflecting both higher volume as well as higher prices. The export volume from developed economies experienced a sharp recovery of 11 percent in 2004 against a 3 percent growth in the preceding year. Merchandise exports from developing countries continued to expand at 16 percent in volume terms. In overall terms, their share in world exports rose to 33.4 percent in 2004, compared to 27.7 percent 10 years earlier. In 2005, the abolishment of quantitative restriction on trade in textile & clothing under MFA, subsequent aggressive export performance by China particularly in products that were liberalized in the final phase, and the response of the US and EU against emerging threats to their domestic industries, are the major issues in the global trade.

International capital markets remained calm during 2004. Flows of foreign direct investment reversed their three-year downward trend. Flows of official development assistance reflect the earlier increase in commitments. In overall terms, except sub-Saharan Africa, all developing countries experienced a negative net transfer of resources. In some cases, this was a result of strong growth in foreign exchange revenues as countries chose to use their current account surpluses either to increase foreign exchange reserves or reduce foreign debt. Besides reflecting the countries' desire to improve their self-insurance against possible balance of payment difficulties, this proved to be a major supportive factor for the US dollar.

A major development in international foreign exchange market was the much awaited revaluation of the Chinese yuan against the US dollar.[3] The Chinese central bank decided to abandon the yuan peg to the US dollar and adopt a basket of foreign currencies as a reference to manage its exchange rate. While the major currencies in the basket are US dollar, euro, yen and Korean won, their weights remain undisclosed. This change in exchange rate regime was accompanied by wider reforms in the Chinese foreign exchange market. Furthermore, this also prompted Malaysia to abandon its exchange rate peg with the US dollar and adopt a basket of foreign currencies to manage its exchange rate. In the long run, it is expected that greater exchange rate flexibility in Asian economies would help in reducing global imbalances in the current account.

7.2 Balance of Payments: An overview

The major highlight for the external sector in Pakistan during FY05 was the record high trade deficit of US$ 4.5 billion compared to a deficit of US$ 1.3 billion during the preceding year. This sharp deterioration in the trade account primarily occurred due to large import payments together with a rise in shipment freight charges during FY05. The persistently higher oil prices in the international market as well as the increasing activity in the domestic economy led to a significant increase of 38.2

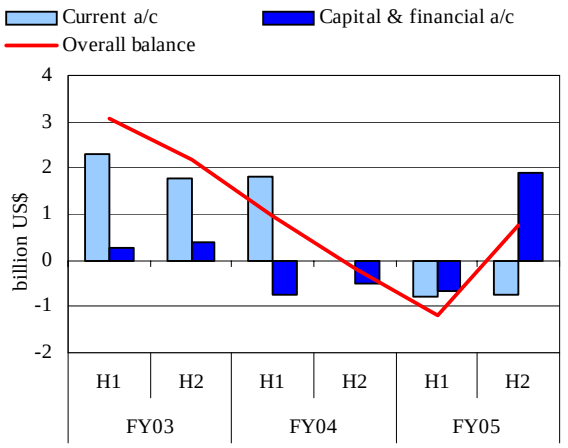
[2] In fact, supply concerns and consequent uncertainties have added a 'fear premium' to oil prices.
[3] On July 21, 2005, the People's Bank of China revalued the yuan by 2.1 percent to CNY 8.11 per US dollar.

percent in Pakistan's import bill during FY05. Similarly, on account of the higher international oil prices the *investment income outflow* were higher than those in FY04.[4]

This sharp increase in import payments even overshadowed the 16 percent growth in exports. In fact, Pakistan's exports performed fairly well during FY05 despite the rising global competitive challenges in the post MFA regime, which were compounded by: (1) a loss of duty free access to the EU since January 2005; (2) imposition of antidumping duty by the EU on bed wear imports from Pakistan; and (3) relatively higher inflation compared to the trading partners and competitors.

What is encouraging is the fact that the large deficit under trade and services account did not entirely translate into an equally large current account deficit as the strong growth in remittances from expatriates and gains from the lower interest payment on external debt & liabilities partially offset the impact of the substantial trade gap. Nonetheless, the current account balance witnessed a *deficit* of US$ 1.6 billion in FY05 (1.4 percent of GDP) in contrast to a *surplus* of US$ 1.8 billion during FY04 (1.9 percent of GDP).

Figure 7.2: External Account Balance



Fortunately, this current account deficit was largely financed by the substantial capital flows in the financial account. The more significant capital flows include one-off inflows (such as US$ 364 million through privatizations, and US$ 600 million through sovereign debt issued internationally) as well as a jump in concessional long-term loans from the World Bank and ADB.[5] In net terms, the financial account registered a surplus of US$ 568 million during FY05 compared to a deficit of US$ 1,335 million in the preceding year. Hence, despite the unprecedented YoY deterioration in trade account in FY05, the overall balance recorded a deficit of only US$ 0.41 billion during the period.[6]

Despite the easy availability of capital flows under financial account, it would be desirable to focus on current account sustainability. In this context, the recent surge in the current account deficit seems sustainable in the short-run as it reflects the increase in domestic economic activity (which would lead to a higher export growth in future) and it is financed by the low-cost external financing. But in the long-run export growth at least should keep pace with the surge in imports.

It may be important to note that the changes in the external account have a close relationship with exchange rate movements. In the case of Pakistan, empirical results suggest a significant bi-directional Granger causality between the current account balance and the exchange rate (see **Box 7.1**). In other words, not only do the developments in the current account Granger cause changes in the Rupee/US$ parity in Pakistan, trends in exchange rate have predictive content to forecast the current account.[7] In a broad sense, this suggests that fundamental weaknesses in the external account

[4] Investment income outflows (purchase of crude oil & mineral) reflect the value of the oil purchased by the government of Pakistan form the foreign oil exploration companies.
[5] For discussion on concessional loans, see section on External debt in Chapter 5.
[6] Further analysis reveals that as most of the capital inflows were realized in the second half of FY05, this led to a surplus of US$ 0.7 billion in the overall balance during H2-FY05 (see **Figure 7.2**).
[7] Granger causality measures whether one series has contents to forecast the other series. Thus, it is different from *causality* in real sense.

could have snowball effect, as resulting expectations of rupee depreciation cause a further weakening of the current account. The results also suggest that exchange rate adjustments to changes in fundamentals need to be implemented quickly in order to reduce excessive volatility due to persistent expectations.

This strong relationship is particularly evident in the movements of the rupee during H1-FY05, when the current account deficit widened significantly as oil prices rose. Not surprisingly, the rupee initially witnessed a gradual slide against the US dollar, but this continued decline, in turn, led to a generalized market panic that augmented the pressure on the rupee. In fact, the rupee quickly weakened by 5.2 percent during Jul-Oct 2004, despite the fact that SBP had been quietly injecting foreign exchange into the system. The magnitude of the pressure on the rupee solely due to expectations became evident only when the SBP made a public (and quantifiable) commitment to smooth (the lumpy) oil payments. This immediately led to a rally by the rupee, wiping out much of its losses during the initial months. The significant point here was that the SBP quickly became a net buyer in the market by December 2004, even as the currency appreciated. This suggested that at least a part of the August-October 2004 pressure on the rupee was due to demand generated by the expectations of the rupee deprecation alone.

Indeed, even though the current account deterioration continued, by the end of the fiscal year, the rupee witnessed a net deprecation of only 2.54 percent (to reach Rs 59.40/US$ by end June 2005) compared to the 0.64 percent depreciation in FY04.

Despite the deterioration evident in the overall balance, the SBP continued with measures to further liberalize the foreign exchange regime in FY05 (see **Box 7.2**).

Finally, since the large net injection by the SBP were partially offset by the gains from the capital flows, the SBP reserves fell to US$ 9.8 billion in FY05 as against US$ 10.6 billion in FY04. A part of the drop in SBP reserves simply reflected the switch in holding from SBP to commercial banks as FE-25 loans were retired.

Box 7.1: Exchange Rate & Current Account Balance

There can be bi-directional relationship between the exchange rate and current account balance. The exchange rate changes may impact the current account balance through their influence on the prices of the exports /imports of goods & services. However, the degree of this impact depends upon the price elasticities of foreign demand for exports and domestic demand for imports which according to the Marshall- Lerner condition, should sum more than one.

On the other hand, the deficit/surplus in current account balance leads to create a demand/supply of foreign currency in the domestic market. This in turn move the value of rupee/dollar parity in upward/ downward direction.

In the Pakistan context, there appears to be bi-directional causality between the current account balance and exchange rate. However, the result must be interpreted with caution, as this analysis does not take into account structural changes in the exchange rate regime during 1982-2005.

Granger Causality between Exchange Rate & CAB (1982-2005)

Null Hypothesis	Level of significance	Result
Changes in nominal exchange rate do not Granger cause the CAB/GDP ratio	8.868 (0.007)	Reject Null
CAB/GDP ratio does not Granger cause the changes in nominal exchange rate	6.749 (0.017)	Reject Null

Box 7.2: SBP Liberalization Measures

In order to liberalize foreign exchange regimes following amendments have been made by the State Bank of Pakistan (SBP) during FY05.

(1) The SBP allowed Authorized Dealers (AD) to provide foreign exchange up to a maximum of US$ 100,000 or equivalent amount in other currencies to branches of foreign companies, which are operating in Pakistan, for payments on account of utilization of IT services.
(2) SBP allowed airlines to remit their sales funds twice a month on receipts of payments from the travel agents.
(3) SBP also granted permission to Pakistani companies to purchase and sell foreign currency notes and coins.
(4) Similarly, SBP enhanced Private Travel Exchange Quota (PTEQ) limit on Pakistani nationals traveling to India, from US$ 25 per person per day to US$ 50 per person per day subject to a maximum of US$ 21,000 per calendar year.

External sector indicators

The key balance of payments indicators depicted a mixed picture (see **Table 7.1**) during FY05. Some of the important indicators are discussed below:

Particularly interesting is the acceleration in the trade openness of the economy. While the FY05 acceleration owes principally to a sharp jump in import growth in FY05, which pushed up the *ratio of import to GDP*, it should be noted that a steady contribution to the openness is also emanating from the continuing strength of exports in recent years.

The declining interest payments and higher export earning steadily improved the *ratio of interest payments to export earning* in FY05. Similarly, due to higher export receipts and rising remittance flows, the current receipts also recorded a significant growth during FY05. Furthermore, the sharp rise in foreign direct investment led to an improvement in *ratio of foreign direct investment to export earnings.*

Another important indicator to measure the country's external account position is the non-interest current account balance. Despite a fall in interest payments, this balance deteriorated, moving from substantial surplus in FY04 to a significant deficit in FY05 – for the first time in five years – reflecting the extent of the deterioration in the external account balance (see **Figure 7.3**).

Table 7.1: Balance of Payments: Key Indicators

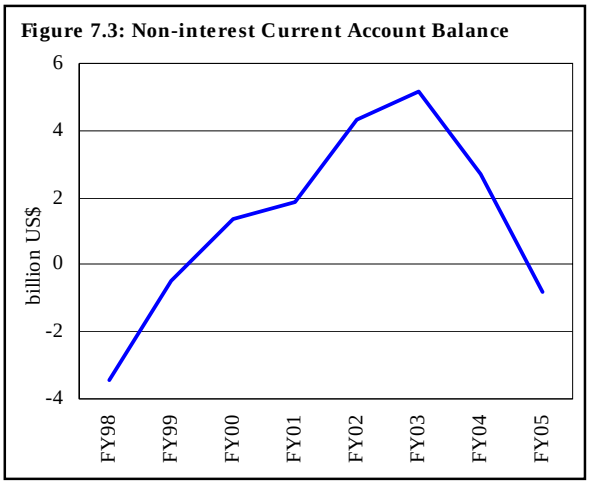
percent

	FY02	FY03	FY04	FY05
Trade				
Exports/GDP	12.81	13.32	12.97	13.10
Imports/GDP	13.18	13.76	14.30	17.20
Trade openness	25.99	27.08	27.27	30.31
Services account				
Services (Net)/GDP	-0.46	0.00	-1.37	-3.01
Interest payment to EE Ratio	17.24	11.64	8.48	6.48
Interest payment to FEE Ratio	10.30	6.55	4.97	3.57
Transfers				
Net transfers to GDP	7.9	8.1	6.9	7.9
Remittances/GDP	3.3	5.1	4.0	3.8
Current account				
Current receipts / GDP	23.5	25.0	22.9	24.4
Current receipts Growth	11.0	22.1	7.0	22.1
FEE (US$ mlns)	15,347	19,482	21,267	26,275
Growth of FEE	7.0	26.9	9.2	23.5
Non-interest CAB (US$ mlns)	4,199	5,182	2,702	-808
NICAB/GDP	6.0	6.3	2.8	-0.7
CAB/GDP	4.0	4.9	1.9	-1.4
Capital account				
FDI/GDP	0.7	1.0	1.0	1.4
FDI/Exports	5.3	7.3	7.6	10.6
Others				
Import cover of reserves (in weeks)	24.0	43.8	40.1	26.9

7.2.1 Current Account Balance

The current account balance posted a *deficit* of US$ 1.6 billion in FY05 after recording a *surplus* for three successive years (see **Figure 7.4**). The YoY deterioration in the current account balance was primarily due to the widening trade deficit and higher payments outflow for shipment freight charges, as well as the higher direct investment income outflows (due to large payments made by the government against the purchase of crude oil & gas from foreign companies operating in Pakistan). These resulting outflows were however offset to an extent by the sharp jump in private transfers, higher earnings on reserves, and lower interest payments on

Figure 7.3: Non-interest Current Account Balance



external debt & liabilities.[8]

It may be pointed out that the lower deficit in the overall balance may not be a good indicator of the health of the external sector provided that the deficit in the current account is financed by short-term flows and portfolio investments. In such a case, though the overall deficit may be very low, the nature of capital flows that are financing the current account deficit would make the external sector highly vulnerable to external shocks. However, if the current account deficit is financed by stable non-debt creating flows such as foreign direct investment then there be less cause of concern. Hence, it would be more reasonable to focus on the financing pattern of the current account deficit and the composition of the deficit to gauge the overall health of the external sector. Any analysis of the current account sustainability should examine not only the composition of the deficit, but also the underlying reasons and the financing sources (see **Box 7.3**).

Figure 7.4: Current Account Balance

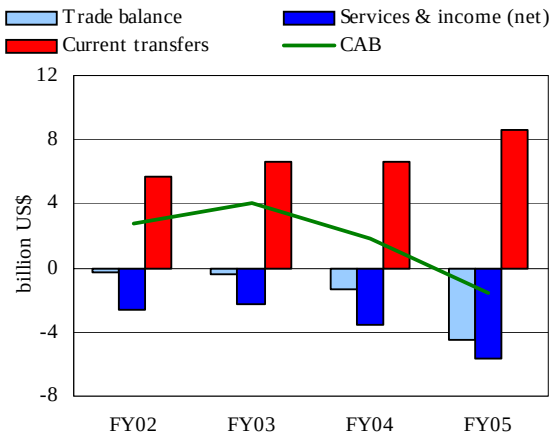
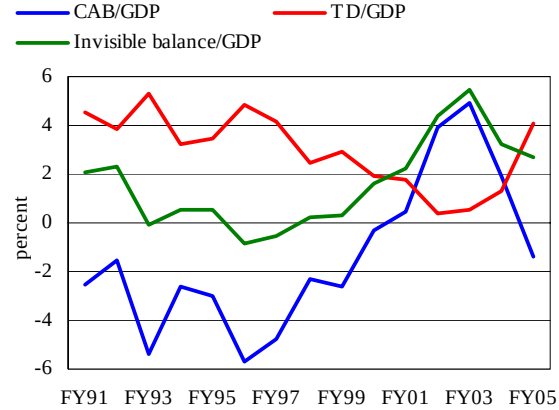


Figure 7.5: Current Account Balance in Pakistan



The following analysis of the sustainability of the large current account deficits, as witnessed in FY05, is based on the above-mentioned principles. In this regard, a comparison of the current account deficit in FY05 with previous peaks witnessed in FY93 and FY97 suggests that while the deficit in all the cases occurred due to large trade imbalance, there is a wide difference in the composition of the deficit (see **Figure 7.5**). While the recent rise in the trade deficit is caused by the broad-based increase in the economic activity together with the higher international commodity prices, during 1990s, the merchandise deficit was largely the result of one-off policy decisions, as in FY93 due to yellow cab scheme, and subsequently during FY97, when contracts with independent power projects pushed up the import bills.[9]

It is also argued that the current account deficit is not a source of policy concern as long as the imbalance is caused by a rise in the investment rate.[10] From **Table7.2** it is clear that during 1990s the average saving & investment gap was -7.8 percent of GDP (indicating large public sector dis-saving in the economy), as compared to -1.7 percent in FY05. Thus in 1990s the current account deficit

[8] The inclusion of resident FCAs in the current account implicitly suggests that these deposits can be used to fund deficits under trade and services account. Since banks do not use these deposits to fund the deficit in trade and services accounts, it may be desirable for analytical purpose to adjust the current account balance by switching the resident FCAs to the financial account. The current account balance adjusted for FCAs (residents) reflects a higher deterioration of US$ 521 million form the headline deficit.

[9] Thus the imports of automobile and power generating machineries increased during FY93 and FY97 respectively.

[10] According to national income accounts, the current account deficit is the mirror image of the domestic saving & investment gap.

Box 7.3: Current Account Sustainability:
The current account deficit is an important indicator to gauge the pressures on a country's external sector. A large and persistent current account deficit may threaten the viability of the external account and thus requires a policy response. This note illustrates various approaches for analyzing the sustainability of current account imbalances. Generally, there are three perspectives on the current account deficit sustainability:

1. National account perspective
Theoretically, the current account is equal to the difference between national saving and national investment. According to this approach, the current account is likely to be unsustainable if (i) the current account imbalance is large relative to GDP; (ii) the imbalance is caused by a reduction in the domestic saving rate rather than a rise in the investment rate, and (iii) domestic saving rates are low.

Furthermore, a current account deficit caused by lower public saving is potentially more problematic than the one caused by a fall in private savings. This is because a large and persistent negative pubic saving (in other words, a budget deficit) may result in the building up of foreign debt, which may not be sustainable. On the other hand, a fall in private savings is often considered to be a transitory phenomenon, as 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.

2. Trade balance perspective
The current account may become vulnerable due to a large and persistent trade deficit reflecting structural competitiveness problem (Roubine and Wachtel 1998). For example, erosion in the competitiveness may lead to lowering of export growth. However, on the other hand, the current account deficit due to higher imports of capital goods is likely to add to the productive capacity of the economy, and thus is relatively more sustainable.

3. Flows and holdings of financial assets perspectives
The sustainability of the current account deficit also depends on its financing. Theoretically, the deficit which is financed by the equity flows is more sustainable than the one financed by debt flows. In the case of equity financing, at least a part of any negative shock is borne by the foreign equity investors, whereas in the case of foreign currency debt, the country bears the entire burden of the shock. Furthermore, relatively higher share of foreign direct investment (FDI) in capital flows can ensure sustainability even if the current account ratio (CAD/GDP) is relative high. In the case of financing from debt flows, short term maturities and variable interest rates will enhance the risk of unsustainability.
Reference*:*
Roubine and Wachtel 1997: Current Account Sustainability in Transition Economies. NBER working No. 6468

primarily explained by a low domestic saving rate. In recent years, gross fixed investment as a percentage of GDP has been almost stagnant which is quite surprising given the behavior of other components that form the investment goods basket (see **Section 2.6**).

Besides the composition of current account, its financing is also an important criterion in assessing sustainability. During 1990s, the huge current account deficits were largely financed by the debt flows, thereby increasing the outstanding stock of external and liabilities to US$ 38.92 billion in FY99. However, in FY05 it is largely financed from the higher equity flow specifically foreign direct investment (see **Table 7.2**).[11]

In the Pakistan's context, the analysis of different indicators reflects that during FY96-97 the current account deficit was

Table 7.2: Major Indicators of Current Account Sustainability
percent

			million US Dollar		
	CAB/GDP	TD/GDP	Equity flows	Debt flows	Public (S-I) /GDP
FY91	-2.5	4.5	230	1,209	-8.3
FY92	-1.5	3.8	562	498	-10.3
FY93	-5.4	5.3	447	2,265	-9.3
FY94	-2.6	3.2	649	2,508	-9.0
FY95	-3.0	3.5	1,529	947	-8.7
FY96	-5.7	4.9	1,311	2,657	-8.4
FY97	-4.7	4.2	968	1,491	-6.9
FY98	-2.3	2.5	793	255	-5.0
FY99	-2.6	3.0	456	-2,355	-6.1
FY00	-0.3	1.9	544	-4,722	-5.7
FY01	0.5	1.8	146	-789	-4.1
FY02	4.0	0.4	475	-1,582	-2.4
FY03	4.9	0.5	793	-1,940	-2.3
FY04	1.9	1.3	882	-2,117	-1.1
FY05	-1.4	4.1	1,610	-205	-1.7

[11] As from FY03 onwards SBP started compiling the BoP according to IMF 5th manual so in order to make consistent long-term series the figure for FY03 till FY05 is adjusted for commercial bank FE-25 Nostro account.

Table 7.3: Current Account Balance

million US Dollar

Items	FY03	FY04	FY05 Full year	FY05 H1	FY05 H2	Difference FY05 over FY04
1. Trade balance	**-359**	**-1,279**	**-4,515**	**-2,275**	**-2,240**	**-3,236**
Exports	10,974	12,459	14,450	6,948	7,502	1,991
Imports	11,333	13,738	18,965	9,223	9,742	5,227
Of which mineral fuels, oils & their products	2,091	2,475	3,900	2,058	1,842	1,425
2.Services (net)	**-2**	**-1,316**	**-3,317**	**-1,439**	**-1,878**	**-2,001**
Transportation	-711	-890	-1248	-603	-645	-358
Travel	-402	-1,034	-993	-512	-481	41
Communication services	230	166	272	128	144	106
Other business services	-42	-332	-2,214	-927	-1,287	-1,882
Government services	1,014	905	1,052	575	477	147
Of which logistic support	847	754	831	448	383	77
Other	-91	-131	-186	-100	-86	-55
3. Income (net)	**-2,211**	**-2,207**	**-2,393**	**-1,219**	**-1,174**	**-186**
Investment income(net)	-2,211	-2,208	-2,394	-1,220	-1,174	-186
Direct investment	-988	-1,215	-1,622	-775	-847	-407
Of which: profit & dividend	-97	-338	-376	-206	-170	-38
Purchase of crude oil & minerals	-431	-678	-951	-421	-531	-273
Portfolio investment	-223	-201	-156	-87	-69	45
Of which: profit & dividend	-421	-109	-146	-48	-98	-37
IMF charges & interest on off. external debt	-897	-708	-656	-356	-300	52
Interest on private external debt	-172	-131	-108	-59	-49	23
Others	69	47	148	57	91	101
4. Current transfers (net)	**6,642**	**6,614**	**8,666**	**4,134**	**4,532**	**2,052**
Private transfers	5,737	6,102	8,418	4,100	4,318	2,316
Workers remittance	4237	3871	4168	1946	2,222	297
FCA – residents	-12	367	521	410	111	154
Others	1512	1864	3729	1744	1,985	1,865
Official transfers	905	512	248	34	214	-264
Saudi oil facility	637	302	0	0	0	-302
Cash grants	209	202	231	16	215	29
Current account balance	**4,070**	**1,812**	**-1,559**	**-799**	**-760**	**-3,371**
Adjusted current account balance	***4,082***	***1,445***	***-2,080***	***-1,209***	***-871***	***-3,525***

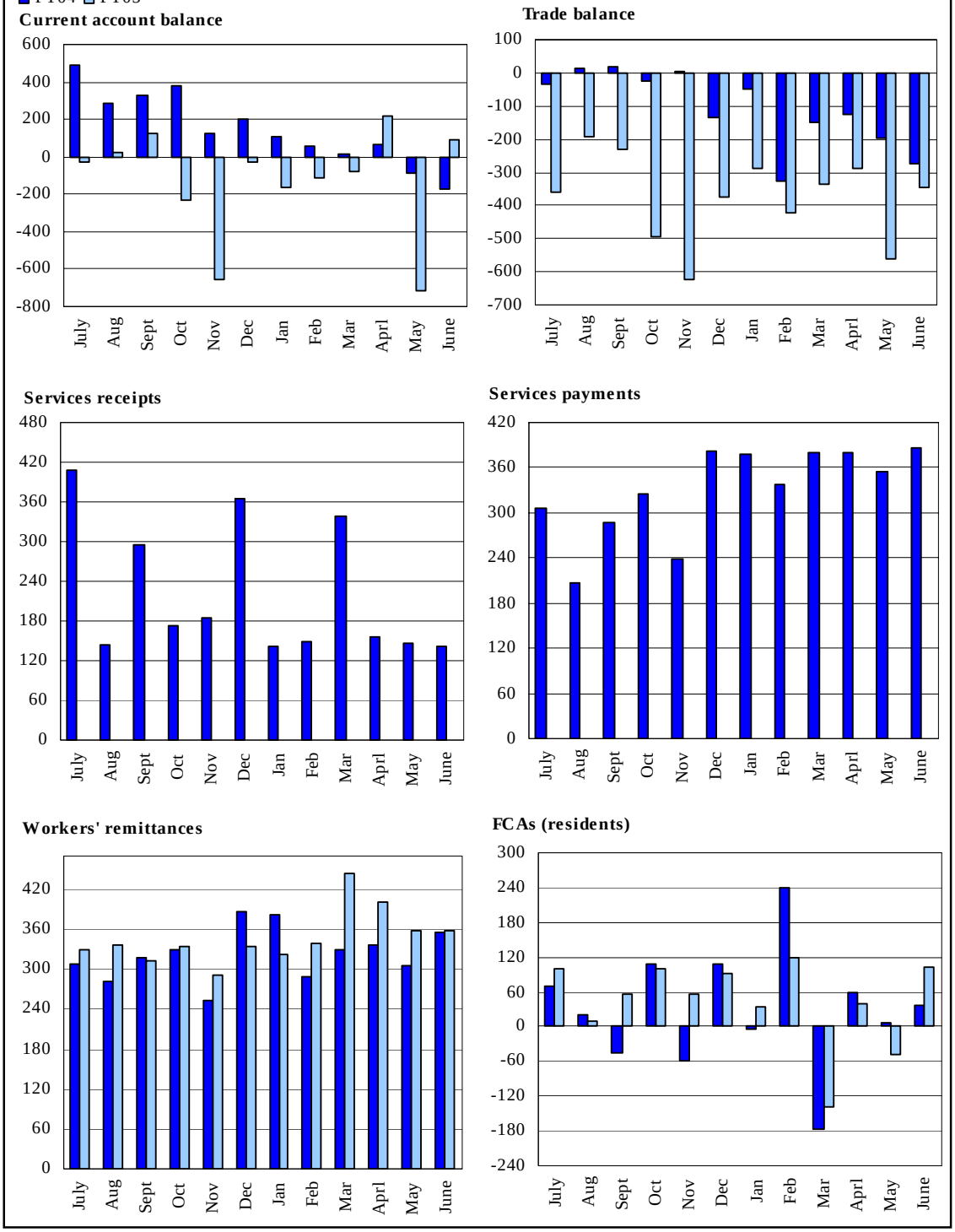
unsustainable leading to an external debt crisis. While, the recent surge in the current account deficit seems sustainable in the short-run as long as (1) it indicates the increase in domestic economic activity which would led to a higher export growth in future and (2) it is financed by the low-cost external financing.

Trade Balance[12]

The exchange record data depicts an extraordinary YoY 38.0 percent import growth, which more than offset the impact of 16 percent export growth during FY05. As a result, the deficit in trade account widened by US$ 3.2 billion in FY05 relative to the preceding year (see **Table 7.3**). Additionally in contrast to the previous year, the monthly trade account witnessed a deficit through out FY05 (see **Figure 7.6**).

[12] This section is based on exchange records data from the SBP, which will not tally with more detail customs data used in the Trade sub-section.

Figure 7.6: Current Account Balance at a Glance (million US$)



The surge in import bills during FY05 was mainly due to the higher import of machinery, industrial inputs and oil products. On the other hand, the export growth saw a slowdown in H1-FY05 on account of the GSP issue and the imposition of anti-dumping duties on bed linen exports, but then recovered in H2-FY05 (for detail, see **Section on Trade Account**). The impact is particularly evident in textile exports under post-MFA regime.

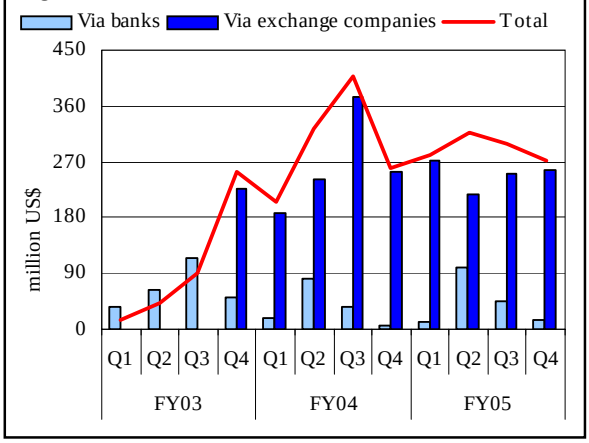
Services (Net)

The net outflow under the services account registered a sharp jump of US$ 2 billion in FY05 as compared to last year. This deterioration largely reflects: (1) the impact of accelerated payments on account of shipment freight charges for imports (approximately by US$ 431 million in FY05 over FY04); and, (2) higher payments of *royalties & license fees* to the foreign companies investing or operating in the country. In addition, the other important factor in burgeoning services account deficit was the net outflow under *other business services*, which reflects the increased coverage of foreign exchange transactions routed through FECs.[13] However, during FY05 a marginal improvement was evident in *travel*, *communication* and *government services* (see **Table 7.3**).

Travel

During FY05, the net outflow under travel payments witnessed a decline of only US$ 41 million to reach US$ 993 million as compared to FY04. As discussed in previous annual report, that from Q3-FY04 travel outflows through the formal system increased sharply primarily due to the re-integration of informal flows into formal channels through exchange companies.[14]

Figure 7.7: Travel Outflows



However, it is important to note that prior to Q4-FY04 the travel transaction by the exchange companies were inflated, as various transactions of different heads were reported under the travel account (see **Figure 7.7**). This suggests that the time series of travel outflows since Q4-FY04 is not comparable with the statistics for preceding years.

Within total travel outflows the significant portion (approximately 85.9 percent) stems from personal travel. The fall in personal travel outflow during H2-FY05 primarily reflects the lower seasonal Hajj payments, most of which were realized in H1-FY05. While, the business travel outflow depict a rise of US$ 25 million during the second half as compared to the first half of FY05.

Government services

This head mainly comprises logistic support, foreign mission transactions and UN troop receipts. During FY05, the receipts under government services depict a rise of US$ 202 million relative to the preceding year to reach US$ 1.3 billion. This increase was primarily due to large receipts from the UN and higher inflows under logistic support in FY05 as compared to the previous year.

Income (Net)

During FY05 the net interest payment on Pakistan's external debt & liabilities continued the declining

[13] As mentioned in previous SBP reports that outflow under FECs has no impact on overall current account balance as it is offset by the contra entry (reflecting the receipts of the FECs) appearing under the other private transfers.
[14] For detail see Annual report FY04.

trend visible since FY00. The YoY saving of US$ 172 million in FY05 stems mainly from the lower interest payments on external liabilities and official long-term loans (see **Table 7.4**).

The higher interest on foreign liabilities in FY04 mainly reflects a notional payment on foreign currency loans extended to exporters & importers[15], while during FY05 most of these forex loans were retired by the Pakistani traders. In addition, the net borrowing by the companies for working capital requirement also remained low during FY05. Furthermore, interest paid on FEBC and DBC during FY05 was much lower than that in the previous year, as the outstanding stock of these debt instruments declined during the period under review.

The interest payment on external debt fell by 11.4 percent. This was primarily due to the absence of higher interest payment on account of premature repayment of official loans in FY05 as compared to FY04.[16] However, the deferred interest paid on Paris club debt this year was US$ 128 million.[17] The private loans/credit registered a decline of US$ 23 million in FY05.[18] However, this gain was offset by higher interest of US$ 21 million paid on Eurobond issued in FY04.

While the higher return on official forex reserves (due to both the increase in stock of official reserves as well as the rising international interest rate) in FY05 also provided some cushion. The *investment income outflows* (excluding interest payments) under direct and portfolio investment registered an

Table 7.4: Details of Interest Payments and Receipts

million US Dollar

				FY05			
		FY03	FY04	Full year	H1	H2	Saving
Payments (I+II)		**1277**	**1056**	**936**	**504**	**432**	**120**
I.	Total external debt	1129	879	825	450	375	54
	Public & publicly guaranteed	917	722	694	379	315	28
	Long-term	816	657	614	329	285	43
	Military	21	14	12	11	1	2
	Euro bonds	60	40	61	35	26	-21.0
	Commercial loans/credits	13	7	7	4	3	0
	IDB	7	4	0	0	0	4
	Private loans/credits	172	131	108	59	49	23
	IMF	40	26	23	12	11	3
II.	External liabilities	148	177	111	54	57	66
	Foreign currency deposits	24	23	14	7	7	9
	Special US$ bonds	32	31	31	15	16	0
	Central bank deposits	24	17	23	11	12	-6
	Others	68	106	43	21	22	63
Receipts		**165**	**166**	**217**	**94**	**123**	**51**
	Interest on reserves	123	117	147	66	81	30
	Others	42	49	70	28	42	21
Net payments		**-1112**	**-890**	**-719**	**-410**	**-309**	**172**

Source: State Bank of Pakistan

[15] The notional outflow of interest on these loans (other external liabilities) is offset by an equal inflow in 'other receipts'.
[16] The interest payment on official loans in FY04 includes US$ 65.1 million on account of premature repayment of ADB loan that includes the premium of US$ 35.4 million.
[17] As mentioned in December 2001 rescheduling agreement, all interest payments falling between 30th November, 2001 and 30th June 30, 2002 and 20 percent of annual interest accrued on restructured debt for FY03 and FY04 had been deferred. These are semi-annual payments thus the next installment is in November 2005.
[18] During FY04 US$ 25.4 million reflects the premium paid on payment of PARCO loan.

increase of US$ 362 million to reach US$ 1,778 million during FY05 (see **Table 7.3**). However, the direct investment income account for more than 80 percent in total investment income outflow.

Direct investment income outflow reflects the sharp jump of US$ 407 million, mainly due to rising *profit & dividend* outflows and a jump in *purchase of oil & minerals*.

(1) Higher profit & dividend outflow of US$ 38 million in FY05 primarily reflects the high profit earnings of the foreign banks operating in Pakistan during FY05, compared to the preceding year;

(2) The outflows under *purchase of oil & minerals* registered a rise of US$ 273 million in FY05. This primarily reflects the hefty payments by the government to the foreign companies exploring oil & minerals in Pakistan. It is important to note that a significant portion of the rise in outflows was due to increased production, higher international prices of oil as well as the higher prices of gas (which are indexed to international oil prices).

Current Transfers

The 31 percent growth in current transfers to US$ 8.7 billion during FY05 largely reflects a significant rise in private transfers. Official transfers have declined sharply in FY05, largely reflecting the termination of the Saudi Oil Facility (SOF) in January 2004 (see **Table 7.3**).

During FY05, private transfers increased to US$ 8.4 billion compared to US$ 6.1 billion received during FY04. This was mainly due to the impact of: higher inflows of other transfers (reflecting the increased integration of receipts from foreign exchange companies and higher conversion of FCAs deposits into rupees); stronger inflows of worker remittance; and an increase in the volume of FCA deposits (see **Figure 7.8**).

Figure 7.8: Composition of Private Transfers

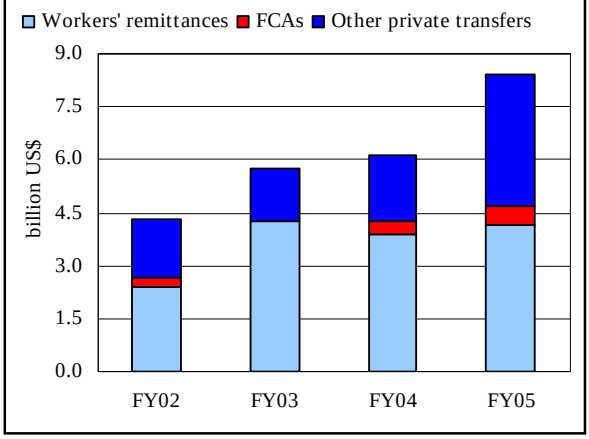
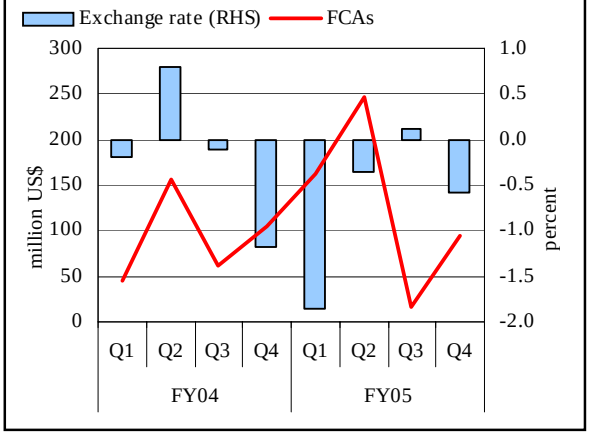


Figure 7.9: Resident FCAs and Exchange Rate Changes



FCAs

During FY05, resident FCAs registered an increase of US$ 521 million as compared to a rise of US$ 367 million in FY04. A large part of the increase in FCA deposits during FY05 is probably a consequence of expectations of rupee depreciation – as seen in **Figure 7.9**, these deposits jumped sharply in H1-FY05, when the rupee was weakening, and decelerated sharply in Q3-FY05 following the rupee resurgence November 2005 onwards. The modest growth of FCAs in the final quarter is mainly due to inflows into the accounts of local telecom companies.

Worker remittance

In sharp contrast to the previous year, workers' remittance witnessed growth of 7.7 percent to reach US$ 4.2 billion, surpassing the target of US$ 3.7 billion set for the fiscal year. As seen in **Figure 7.6**, the growth in remittances is particularly evident in the latter half of the fiscal year; during H1-FY05 these grew by 3.6 percent, compared to a growth of over 11.2 percent during H2-FY05. Inflows during March 2005, in particular, witnessed a 31.0 percent rise.

Most of the growth in remittances was from the Gulf countries (probably reflecting the increased economic prosperity there on the back of higher oil prices), and from the USA (see **Table 7.5**).

Table 7.5: Workers' Remittances

million US Dollar

	FY03	FY04	FY05	Change
I. Gulf region	**1,893**	**1,614**	**1,852**	**238**
Bahrain	71	81	91	11
Kuwait	221	177	215	38
Qatar	88	89	87	-2
Saudi Arabia	581	565	627	62
Sultanat-e-Oman	94	105	119	14
U.A.E.	838	597	713	115
II. U.S.A.	**1,238**	**1,225**	**1,294**	**69**
III. Other than Gulf & US	**1,061**	**987**	**1,007**	**20**
Canada	15	23	48	26
Germany	27	47	54	7
Japan	8	5	7	1
Norway	9	10	18	8
U.K.	274	334	372	38
Other	728	568	507	-61
Total (A)	**4,191**	**3,826**	**4,153**	**326**
of which:				
Exchange companies	29	141	392	251
Withdrawal FCAs (residents)	737	688	543	-145
Withdrawal FCAs (non-residents)	10	39	41	1
Encashment of FEBCs & FCBCs (B)	**46**	**45**	**17**	**-29**
Grand total (A+B)	**4,237**	**3,872**	**4,169**	**297**

It is possible that the reported increase in FY05 remittances may be understated due to an improvement in the quality of data reported by banks. Earlier, the reported remittances included a significant part of rupee encashments from resident non-corporate FCAs that should have been more properly included in *other private transfers*, thus slightly overstating the *remittance* inflows and correspondingly understating the flows under the former head. However, the historical series could not be adjusted due to data constraints.

The change in the data reporting explains the FY05 decline in remittances routed through FCAs and the corresponding jump in *other private transfers* through FCAs. The impact of the US$ 145 million drop in remittances through FCAs on overall FY05 remittances was, however, masked by the US$ 251 million jump in remittances through exchange companies in the same period. In order to further facilitate and to bring the informal remittance flows into formal channel through exchange companies, SBP has now authorized FECs to establish payment booths.

Other private transfers[19]

During FY05, other private transfers rose by 100 percent to US$ 3.7 billion. As seen in **Table 7.6**, the higher inflows were due to (1) higher receipts of exchange companies reflecting the gradual increase in coverage of forex flows, (2) a rise in unclassified private transfers and (3) the increased Rupee withdrawal from the resident foreign currency account (which, as explained above, were earlier included in remittances). As a result, the

Table 7.6: Other Private Transfers (Credit)

million US Dollar

	FY02	FY03	FY04	FY05
Private donation	102	113	115	150
Private transfers n.s.e.	127	742	479	595
FCAs withdrawal	-	-	47	105
Exchange Coc.	-	273	1,273	2,932
SBP purchases	1,376	429	-	-
Other	9	14	11	38
Total	**1,614**	**1,571**	**1,925**	**3,820**

[19] This head mainly comprises of unclassified private transfers, private donation, withdrawal from the residents FCAs and receipts of exchange companies.

share of other private transfers in total private transfers continued its rise since FY03 (see **Figure 7.8**).

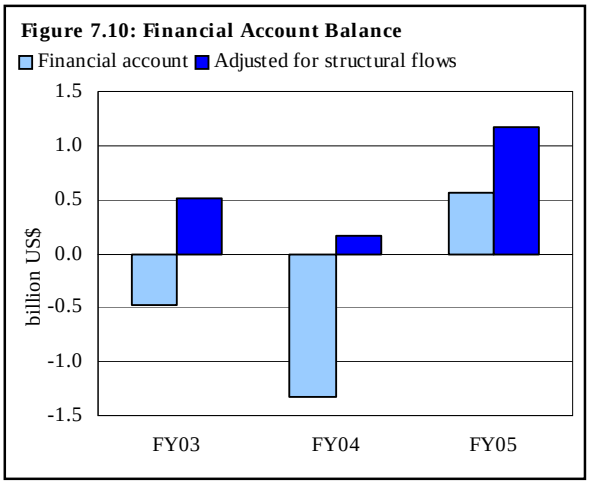


Figure 7.10: Financial Account Balance

7.2.2 Financial Account

The net financial account posted a sharp reversal from a net deficit of US$ 1.33 billion in FY04 to a net surplus of US$ 0.57 billion in FY05 (see **Table 7.7**). Adjusting for non-repeating flows, it is clear that the financial account has remained in surplus in recent years, and this surplus has increased to US$ 1.16 billion during FY05[20].

The FY03 unadjusted deficit incorporated a US$ 1.0 billion debt write-off, while the corresponding FY04 deficit incorporates the pre-payment of expensive debt (see **Figure 7.10**). The strong FY05 improvement was largely evident in H2-FY05: (1) in January 2005 Pakistan issued US$ 600 million of *Sukuk* in the international market, (2) higher FDI flows on account of privatization proceeds of HBL, PTCL as well as increased investment in the telecommunications sector, (3) concessional funding from the World Bank & ADB and (4) net loan inflow from the IDB.

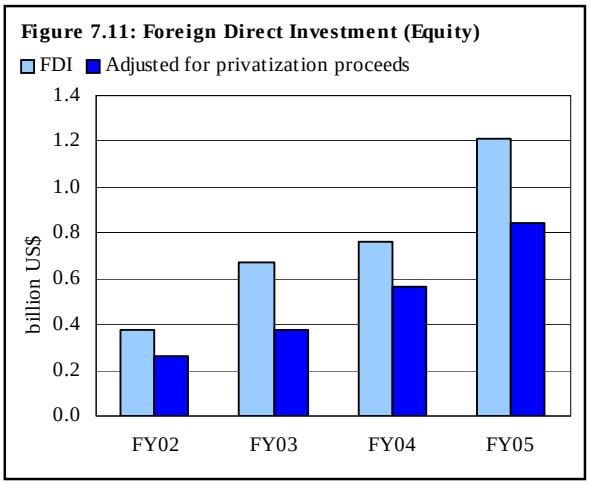


Figure 7.11: Foreign Direct Investment (Equity)

An important aspect of the financial account balance is the decomposition of total flows into financial assets and liabilities. The net financial inflows can be a source of concern, as it reflects the increase in liabilities or decrease in assets (see **Box 7.4**), depending upon the proportion of non-stable and debt creating flows in total flows. The capital flows in FY05 not only stable, but also largely concessional debt-creating flows. Therefore, the rise in net financial inflows does not appear to be a source of concern.

Net Foreign Investment (NFI)

The overall net foreign investment showed a growth of 70.4 percent in FY05 as compared to FY04. This was mainly due to higher Foreign Direct Investment (FDI), reversal in foreign investment in stock market, and issuance of *Sukuk.*

Foreign Direct Investment

The FDI posted a sharp jump of US$ 574 million during FY05 as compared to last year. It would be interesting to see the impact of one-off flows on account of privatization receipts on the total FDI flows. In fact, even after excluding the privatization proceeds of US$ 364 million, the FDI still depicts a significant amount of US$ 847 million which is in line with the previous rising trend of

[20] Non-recurring flows during FY05 include US$ 495 million of US debt write-off, and US$ 100 million of settlement of foreign currency loans of commercial banks to repay PARCO loans.

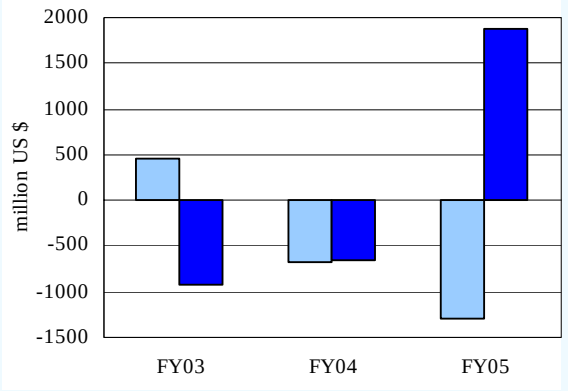
adjusted FDI flows[21] (see **Figure 7.11**).

Box 7.4: Financial Account under BPM5 – Some More Explanations

Since September 2004, State Bank of Pakistan has started publishing the Balance of Payments statistics based on the 5th manual (BPM5).[1] In the new manual, the capital account (as defined in the previous version) has been re-designed into the capital & financial account. Under the new definition, the capital account covers all transactions relating to capital transfers and acquisition or disposal of *non-produced, non-financial* assets; while the financial account comprises all transaction associated with the change of ownership in the external *financial* assets and liabilities of an economy. This note elaborates on the analytical presentation of the financial account.

Any change in the financial account happens due to variations either in assets or in liabilities[2]. An increase in assets or a decrease in liabilities is represented by a negative sign in the financial account. In an accounting sense, this can be considered as a foreign exchange outflow from the country. Similarly, a decrease in assets or an increase in liabilities is reported with positive sign, i.e., this will be treated as a foreign exchange inflow.

Figure 7.4.1: Composition of Financial Account



Looking at **Figure 7.4.1**, it is evident that liabilities of Pakistan's economy to the rest of the world have been declining gradually since FY03 – representing net foreign exchange outflows. Of course, this outflow would bring overall balance of payments under pressure. But from an analytical perspective, this net outflow may represent the strength of the external accounts that allowed the economy to pay off its liabilities (say, through pre-payment of expensive external debt).

During FY05 a sharp rise in net foreign investment and disbursement of non-food aid from multilateral institutions caused the liabilities to increase by US$ 2.5 billion as compared to FY04. While this represents foreign exchange inflows, helping overall balance of payments, it is important to analyze whether this inflow is creating any vulnerability to the economy. Certainly, any short term borrowing or higher portfolio investment without adequate exchange controls would make the external account susceptible to financial crisis. Fortunately, the increase in liabilities during FY05 was on account of direct investment as well as long term and concessional borrowing from multilateral institutions.

On the assets side (as explained earlier, increase in assets is represented by negative sign), FY03 witnessed a fall in foreign exchange assets which is largely explained by the decline in FE-25 Nostro of banks. On the other hand, increase in assets during FY04 and FY05 reflects rising FE-25 Nostro accounts of commercial banks; which is represented as an outflow in the balance of payment account.

1. See **Box 7.4** in SBP Annual Report for FY04.
2. Foreign exchange liabilities of an economy consist of loans & investment flows.

Although the equity component of FDI in Pakistan is currently concentrated in a few sectors and needs to be diversified in other areas as well, it is encouraging to note that the FDI flows are now received by a larger number of companies. The latter is clear from **Table 7.8**, which shows that the number of companies receiving FDI increased substantially in FY05. At the same time, total amounts disinvested declined sharply from US$ 62 million in FY04 to US$ 38.6 million during FY05.[22]

A further analysis reveals that the *trading* sector accounts for a higher proportion of companies receiving FDI followed by the *communication* and *personal services sector*. However, the FDI flows are highly concentrated in 18 companies (engaged in *telecommunication, oil and gas and financial services* sectors) which received two-thirds of all FDI flows in FY05 (see **Table 7.9**). This trend is also substantiated by the Lorenz Curve (see **Box 7.5**).

[21] The FDI recorded in FY02 adjusted for oil & gas field, FY03 adjusted for UBL and oil & gas field, and FY04 number is adjusted for HBL.
[22] The large amount of disinvestment in previous year primarily reflects US$ 30 million from the power sector.

Table 7.7: Financial Account

million US Dollar

Items	FY03	FY04	FY05 Full year	FY05 H1	FY05 H2	Difference FY05 over FY04
Financial account (1 through 4)	**-482**	**-1,335**	**568**	**-1,199**	**1,767**	**1,903**
1. Direct investment abroad	**-27**	**-45**	**-66**	**-34**	**-32**	**-21**
2. Direct investment in Pakistan	**798**	**951**	**1,525**	**445**	**1,080**	**574**
of which: equity capital	674	763	1,211	289	922	448
Reinvested earning	124	183	314	156	158	131
3. Portfolio investment	**-239**	**314**	**620**	**6**	**614**	**306**
of which: (stock markets)	22	-28	151	59	92	179
Special US dollar bonds	-228	-137	-131	-54	-77	6
Euro bonds	-7	496	596	-2	598	100
Net foreign investment	532	1,220	2,079	417	1,662	859
4. Other investment	**-1,014**	**-2,555**	**-1,511**	**-1,616**	**105**	**1,044**
Assets	438	-670	-1,299	-1,121	-178	-629
i. Outstanding exports bills (exporters)	-173	-335	-343	-128	-215	-8
ii. Outstanding exports bills (DMBs)	-25	-120	-49	-5	-44	71
iii. Currency & deposits	636	-215	-907	-988	81	-692
of which :bank	665	-100	-837	-942	105	-737
Liabilities	-1,452	-1,885	-212	-495	283	1,673
i.Foreign long-term loans / credits (net)	-1,219	-1,449	452	269	183	1,901
of which :project assistance	571	434	583	347	236	149
Food aid	10	-	-	-	-	-
Non-food aid	621	536	1,302	897	405	766
Amortization	2,421	2,419	1,433	975	458	-986
ii. Private loans	-227	-109	-352	-161	-191	-243
of which: suppliers credits/MNCs	350	503	20	12	8	-483
Supplier credits repayments	577	612	372	173	199	-240
iii. ST capital, (official)	-180	-317	147	-27	174	464
of which: commercial banks (net)	-184	-133	-116	-116	-	17
IDB (net)	4	-184	263	89	174	447
iv. Currency & deposits	555	-26	-260	-393	133	-234
of which: trade financing	1,056	-210	-356	-583	227	-146
v. Other liabilities	-381	16	-199	-183	-16	-215

Source: Statistics Department, SBP

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

The *reinvested earning* portion of FDI increased by 71.6 percent (US$ 131 million) during FY05. This primarily reflects the definitional change in the Balance of Payment Manual 5, in which *reinvested earning* is computed according to IIP standard (International Investment Position). Accordingly, the new definition of *reinvested earning* comprise of bonus share and a certain portion of undistributed profit/loss (earlier *reinvested earning* only included the bonus shares). The sectors witnessing the biggest reinvestments during

Table 7.8: Total No. of Companies by Investment & Disinvestment

million US Dollars

	No. of companies		Disinvested amount
	Received FDI	Disinvested FDI	
FY02	1001	3	23.5
FY03	1387	4	37.7
FY04	1262	13	62.2
FY05	1647	39	38.6

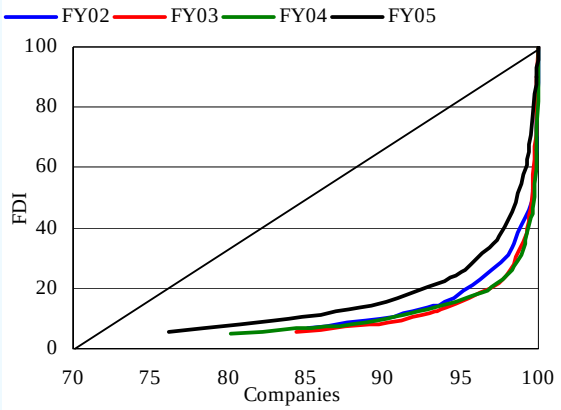
FY05 include *financial businesses* (US$ 91.8 million), the *power* sector (US$ 62.9 million) and *oil & gas* exploration (US$ 37.4 million).

Box 7.5: Lorenz Curve for FDI

The Lorenz curve for FDI is an effective way to measure the concentration of FDI flows among different companies. The curve shows the relationship between the cumulative percentage of the FDI and the cumulative percentage of number of companies. The 45-degree line (called as line of absolute equality) reflects the even distribution of FDI among different companies. The closer the Lorenz curve is to the 45-degree line, the more equal will be the distribution of FDI among firms.

The Lorenz curve shown in **Figure 7.5.1** for four fiscal years suggests that there is high concentration of FDI flows in few companies. Year wise analysis depicts that the concentration of FDI inflows has decreased over time. Specifically, FY02 was characterized by a relatively uneven distribution of FDI amount among companies as almost 90 percent of the companies attracted only 10 percent of FDI.

Figure 7.5.1: Lorenz Curve for FDI



However, in later the curve has shifted upward, reflecting a slight change in the company-wise holding of FDI flows compared to previous years. Specifically in FY05, the number of companies receiving more than US$ 1million of FDI rose by approximately 15 percent. Nevertheless, there is still need to further diversify the FDI amount company-wise as well as across sectors.

Table 7.9:Total Number of Companies by Sector (Top ten Sectors)

percent

Sector	FY02		FY03		FY04		FY05	
	No. of Companies	Share amount	No. of Companies	share amount	No. of Companies	Share amount	No. of Companies	Share amount
Financial business	5	1	4	26	5	26	4	18
Oil & gas explorations	7	55	4	23	6	21	3	13
Transportation	2	4	2	11	3	1	2	1
Chemicals	6	2	5	11	5	2	3	3
Trade	19	7	22	5	18	4	22	3
Power	3	8	2	4	2	-2	1	5
Textile	8	4	9	3	7	4	8	3
Communications	11	3	10	3	10	23	11	34
Personal Services	10	2	12	2	12	2	10	2
Construction	3	3	4	2	4	3	5	3

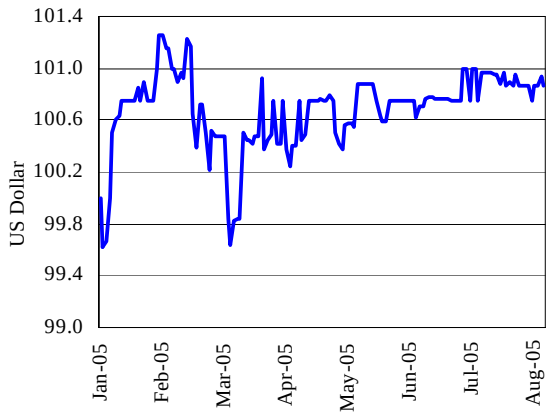
Portfolio Investment

In term of portfolio investment, a rise of US$ 306 million during FY05 was primarily due to the issuance of Pakistan's first international Islamic bond of US$ 600 million and the remarkable performance of the stock market[23] that attracted a net inflow of US$ 151 million as against the net outflows of US$ 28 million in FY04.

[23] The KSE-100 registered a net gain of a robust 41.1 percent during FY05, thereby leaving KSE amongst the better-performing emerging markets for the period.

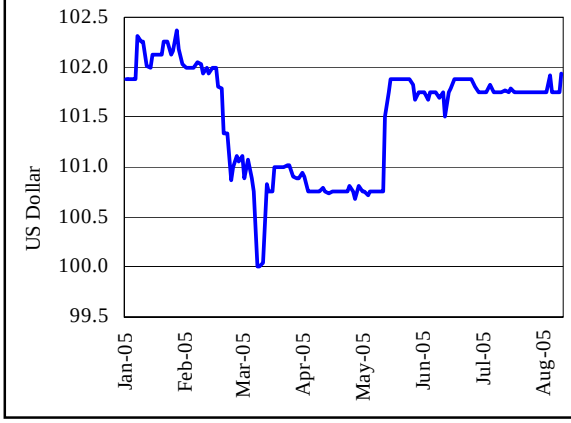
It may be mentioned here that the secondary market prices of the two sovereign Pakistani bonds appear to reflect the improvement in country risk profile, as both have been trading favorably since flotation. However, in case of *Sukuk* the secondary market prices after trading at premium registered a gradual decline from end Feb 2005(see **Figure 7.12)**. Consequently, the bond started trading at a discount between 24 March 2005 and 1st April 2005. Currently the *Sukuk* was trading at 110 basis points above US$ Libor.

Figure 7.12: Secondary Market Price of Sukuk



The secondary trading prices of Euro bond issued in FY04 also experienced the similar trend, was trading at premium during the period of analysis (see **Figure 7.13**).

Figure 7.13: Secondary Market Price of Euro Bond

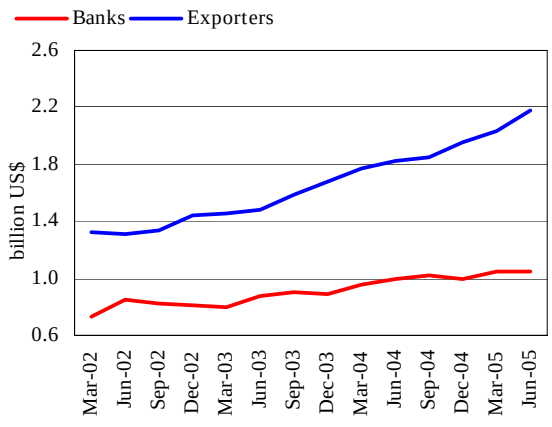


Outstanding Export Bills (OEBs)

The aggregate stock of OEBs held by exporters and commercial banks increased by 13.9 percent in FY05, in contrast to a 19.9 percent in FY04 (see **Figure 7.14**), with the deceleration in growth mainly reflecting a high-base effect.

Most of the increase was recorded in OEBs held by exporters, and the greater part of this too, was seen in the second half of FY05. The larger rise in OEB of exporters during H2-FY05, probably reflects the greater increase in exports during the period, relative to H1-FY05.

Figure 7.14: Stock of Outstanding Export Bills



Similarly, the discounting of export bills by banks was also much lower in H1-FY05 as compared to H2-FY05. The lower discounting of OEBs by banks in the latter period was probably due to lower usage of OEBs as collateral for forex loans during this period (H1-FY05 saw a net retirement of forex loans).

Currency & Deposit[24]

During FY05 the commercial banks' FE-25 Nostro registered a jump of US$ 837 million as compared to a rise of US$ 100 million during FY04. The acceleration in these Nostro account balances during FY05, probably mirrors the net impact of a rise in FE-25 deposits, as well as the net fall in the outstanding stock of Fe-25 loans. Since both of these elements were more

[24] This head mainly comprises on commercial banks' FE-25 Nostro deposits.

visible in H1-FY05, the greater part of the net rise in Nostro deposits was seen in this period of the fiscal year.

Foreign Long-term Loans

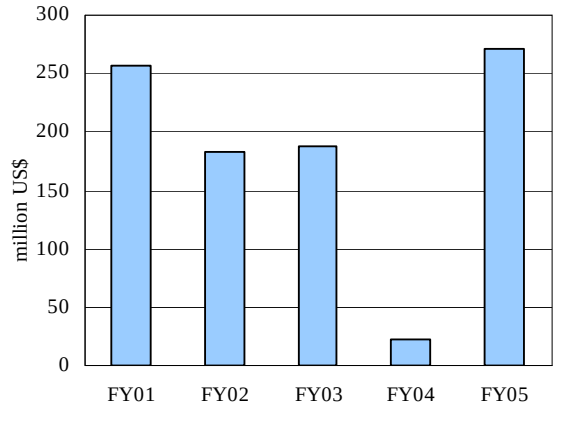
This head registered a net inflow of US$ 452 million during FY05 as against an outflow of US$ 1,449 million in FY04. As evident from **Table 7.7**, the improvement during FY05 reflects 34.3 percent YoY increase in project aid, a sharp rise in program loans, as well as a fall in amortization payments. However, the changes in these flows relative to FY05 numbers, has been exaggerated by one-off elements – adjustments for these lead to a lower variation in net LT loan flows over the two years.

Table 7.10: Adjusted Official Long-term Loans

million US Dollars

	FY04	FY05
Receipts	970	1,885
Amortization	1,013	938
Net flows	-43	947

Figure 7.15: Outstanding Stock of IDB Debt

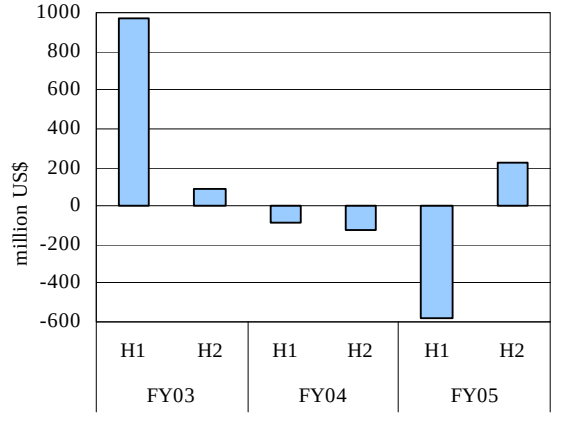


Specifically, amortization payments during both FY04 and FY05 were inflated by one-off factors. In FY04, amortization outflows were inflated by a US$ 1.4 billion pre-payment of public debt, while the FY05 figure was pushed up by the US$ 495 million debt write-off by the USA. **Table 7.10** presents a clearer picture of the trends in LT loans, after adjusting for the one-off factors.[25]

Private loans

The net outflow of suppliers' credit inched up by US$ 243 million during FY05 as compared to FY04. This was primarily due to lower YoY (96 percent) disbursement of foreign private loans, as during FY04 the private inflow primarily reflects inflow of US$ 350 million from the Exim bank to PIA. Meanwhile, the repayment also remained subdued as (1) in FY05 there was no pre-payment made on account of private loans, as seen in FY03 and FY04;[26] and (2) the outstanding stock of these loans was also lower in FY05.

Figure 7.16: Foreign Currency Loans



Short-term Loans

These mainly comprise of short-term commercial loans and IDB financing for oil import. The short-term loan flows witnessed a reversal during FY05, rising by US$ 147 million, as compared to an outflow of US$ 317 million in FY04 (see **Table 7.7**). The rise in the stock of short-term loans simply reflects increased recourse to IDB loans

[25] The adjusted official long-term loans for FY04 reflect US$ 1106 million prepayment of ADB expensive loan and US$ 300 million for PARCO loan. For details, see section on **External debt & Liabilities** in Chapter 6.

[26] This includes pre-payments of private loans amounting to US$ 65.9 million during FY04 and US$ 92.0 million in FY03.

to finance imports of FY05, after the termination of the Saudi Oil Facility in FY04. As a result, the stock of IDB loans jumped to US$ 271 million in FY05 (see **Figure 7.15**).

Further more, as discussed in previous quarterly reports of FY05, the net outflow under commercial loans reflects the rollover amount of US$ 100 million with an offsetting entry in the exceptional financing.[27]

FE-25 Related Trade Financing

The FE-25 loans registered an increased settlement of US$ 356 million in FY05 as compared to the preceding year. Interestingly, the net retirement of foreign trade financing liabilities during H1-FY05 completely offset the net lending under these loans in H2-FY05 (see **Figure 7.16**).

The main driver behind the increased demand of foreign currency loans during second half of FY05 was the lower effective cost of forex loans.[28]

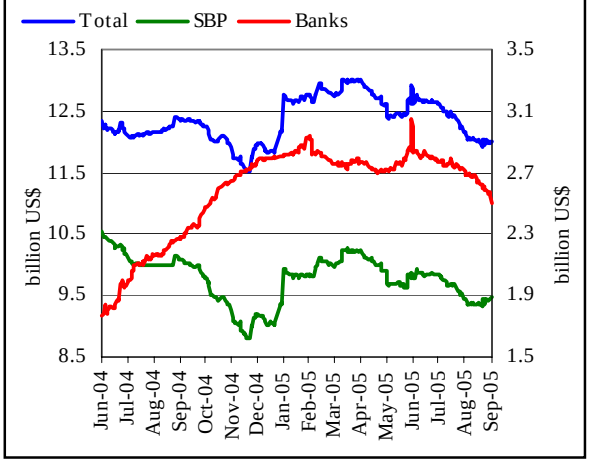
[27] Since FY03 Pakistan has not taken any short-term commercial loans.

[28] The higher domestic refinance rate and the stable exchange rate made the foreign currency loans more attractive to the exporters and importers.

7.3 Foreign Exchange Reserves

Pakistan's overall foreign exchange reserves saw an increase of US$ 295 million during FY05. Indeed, the reserves reached a historic high of US$ 13 billion in mid-April 2005 before closing the year at US$ 12.6 billion.[29] Moreover, as evident from **Figure 7.17**, there was a marked change in the composition of overall reserves: while SBP reserves declined by US$ 0.76 billion, this was largely offset by an increase of US$ 1.05 billion in commercial banks' reserves. SBP reserves fell as payments for loans and oil imports were only partially offset by large concessional debt inflows such as from the World Bank (WB) and Asian Development Bank (ADB), and USA; receipts on account of logistic support provided by Pakistan to support US led coalition operation in Afghanistan and, importantly, receipt from the sovereign *Sukuk* offering. On the other hand, commercial banks' reserves increased due to both fresh inflows in FE-25 deposits as well as net retirement of forex loan.

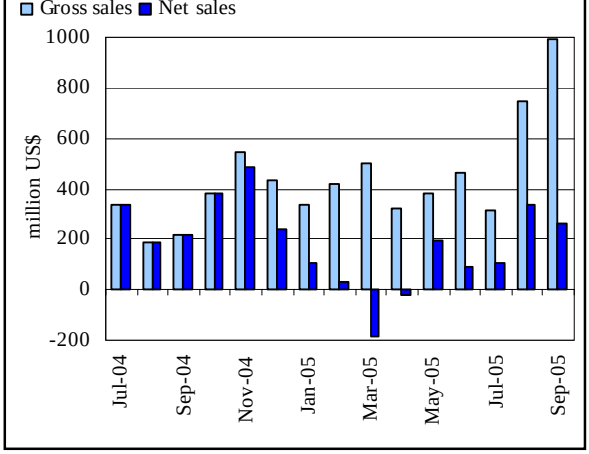
Figure 7.17: Foreign Exchange Reserves



The decline in SBP reserves was principally due to its decision to provide foreign exchange liquidity for oil payments. It may be pointed out that the SBP has been intervening in the forex market since around April 2004 to contain the downward pressure on the Rupee. The important features of the intervention policy were (1) SBP was meeting only the *net* demand of foreign exchange in the market, i.e., market players were approaching the central bank only when the foreign exchange supply was insufficient to meet the demand in the market; and (2) SBP was mostly relying on its sinking fund for forex interventions, thus the impact of market intervention on reserve holding was not evident during the first quarter of FY05. Nonetheless, despite the intervention, downward pressure on the Rupee persisted. The persistence of these negative sentiments, and the belief that the pressure on the Rupee was likely to be temporary; prompted SBP to formally announce its commitment on October 31 2004 to provide foreign exchange for lumpy oil payments.[30]

Through this strategy, SBP made a quantifiable intervention commitment, thereby reducing uncertainty as well as demand pressures generated due to expectations. This in turn allowed SBP to become a net buyer in the market by December 2005, even as the currency appreciated (see **Figure 7.18**). Hence, during the period Nov 2004-Sep 2005, though SBP injected around US$ 4.14 billion only on account of oil imports, its purchases from the market totaled US$ 3.8 billion; i.e., SBP was able to change the market expectations and at the same time, the impact on SBP's reserves was minimal. In contrast, the volume of SBP

Figure 7.18: Forex Market Intervention

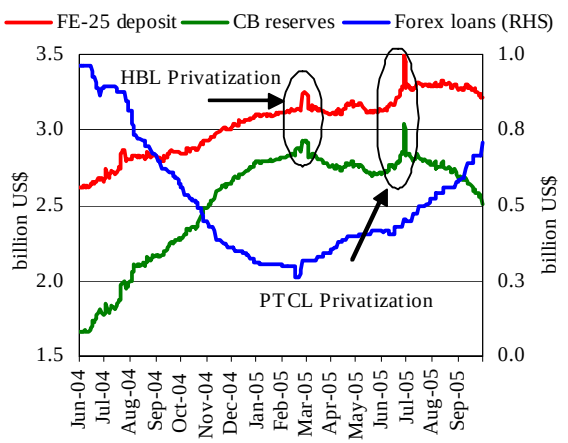


[29] By end-September 2005, the reserves had further declined to reach US$ 11.99 billion.
[30] Later this facility was extended to wheat and fertilizer imports as well.

net intervention during July-October 2004 was US$ 1.12 billion.

As mentioned earlier, commercial banks' reserves showed an increase of US$ 0.73 billion during FY05 (see **Figure 7.19**). The strengthening expectations of the Rupee depreciation against US Dollars made the forex loans extended by commercial banks to traders unattractive. The consequent retirement of the forex loans until mid-February 2005 augmented the reserves of commercial banks. However, the forex loans have again became attractive due to stable Rupee in the last quarter of FY05 and rising rupee interest rates. Nonetheless, despite a small jump in foreign exchange loans in Q4-FY05, the year saw a net retirement of US$ 447 million during FY05 that led to an equivalent increase in commercial banks' reserves. This rise was supplemented by fresh FE-25 deposits totaled US$ 604 million during FY-05.

Figure 7.19: Reserves of Commercial Banks



7.3.1 Reserve Adequacy

Pakistan has been maintaining foreign exchange reserves at more than US$ 12 billion level since December 2003.[31] While the overall reserve adequacy indicators are showing considerable change during FY05, these are still at a comfortable level (see **Table 7.11**). Reserve to import ratio has declined to 31 weeks in FY05 from 41 weeks last year, reflecting the impact of higher imports during FY05 – imports were around US$ 100 million per week larger as compared to FY04. Reserve to short term dent and liabilities (STDL) ratio is also showing a comfortable position despite a decline in FY05 due to the debt inflow of US$ 271 million from IDB. Reserve to GDP ratio has also declined due to higher growth in GDP. Similarly, the reserves to monetary aggregates are also showing the declining trends due to higher growth in the reserve money during FY05.

Table 7.11: Reserves Adequacy Ratios

	FY01	FY02	FY03	FY04	FY05
Liquid reserve (million US$)	3,219.5	6,431.6	10,719.0	12,330.9	12,626.0
Reserve to GDP share (%age)	5.0	8.8	13.1	13.0	11.2
Import coverage (weeks)	15.7	32.4	45.9	41.2	31.0
Reserve to external debt	0.1	0.2	0.3	0.4	0.4
Reserve to STDL	1.0	3.3	7.6	10.1	8.3
Reserve-(Imports+STDL)***	-2,675.7	1,882.2	6,260.3	7,207.9	5,634.1
Reserve to M2	0.1	0.2	0.3	0.3	0.3
Reserves to reserve money	0.4	0.7	0.9	0.9	0.8

* Based on the July-Oct 2005 data

**Provisional Data

***Million US$

But it should be recognized that the reserves are built up during favorable times and drawn down when the conditions take a downturn. Had the SBP not accumulated this level of reserves until FY04,

[31] The uncertain benefits would be realized when there are sufficient reserves to meet the needs of the country at a time of a financial or liquidity crises.

it would have been difficult to maintain stability in the foreign exchange markets and ensure predictability for exporters to book foreign orders.

In overall terms of foreign exchange receipts (inflows) and payments (outflows), there was a rise in the receipts from US$ 25.6 billion to US$ 32.3 billion – about 27 percent increase – in FY05 but the upsurge in payments was even more rapid, i.e., from US$ 24.9 billion to US $ 32.1 billion. The net inflows thus remained about in balance (**Table 7.12**).

7.3.2 Reserve Management

State Bank of Pakistan as a Central Bank of the country is responsible for managing foreign exchange reserves of Pakistan. After considerable increase in Pakistan's foreign exchange reserves position in the last four years, a need arose to revisit the investment policy in order to bring it in line with the best practices of other central banks in the world. Hence new strategy was evolved based upon the three fundamentals, i.e., security, liquidity, and maximizing returns while ensuring the first two considerations. Under that strategy, a portion of our reserves has been outsourced and is being invested in fixed income securities through external fund managers.

To manage the relationship with all external fund managers, custodians, and investment consultant Investment Services Cell (ISC) has been created in the State Bank of Pakistan with effect from February 1, 2005. This cell is also responsible for the following:

- Performance management of fund managers.
- Prepare analytical reports on the performance of fund managers for management.
- Formulation of safe and flexible investment strategy for the management of SBP funds under the guidelines of the Central Board.
- Explore new avenues to enhance returns while ensuring liquidity and security of reserves in line with the parameters approved by the Central Board.
- Capacity building measures to bring reserve management within SBP at par with global best practices.

Keeping in view our fundamental preferences of safety, liquidity and return in this order, the services of fund managers and custodians of international repute have been availed with the help and assistance of investment consultant and after exercising due diligence pursuant to our investment strategy. Fund Managers have been given different customized absolute and relative return benchmarks to reap the benefits of diversification. It may be added that benchmarks are not single currency parameters; rather it is made of customized combination of various currencies. The benchmark aims to provide broad representation of risk/return characteristics for admissible asset classes and provide a performance hurdle that fund managers are expected to beat.

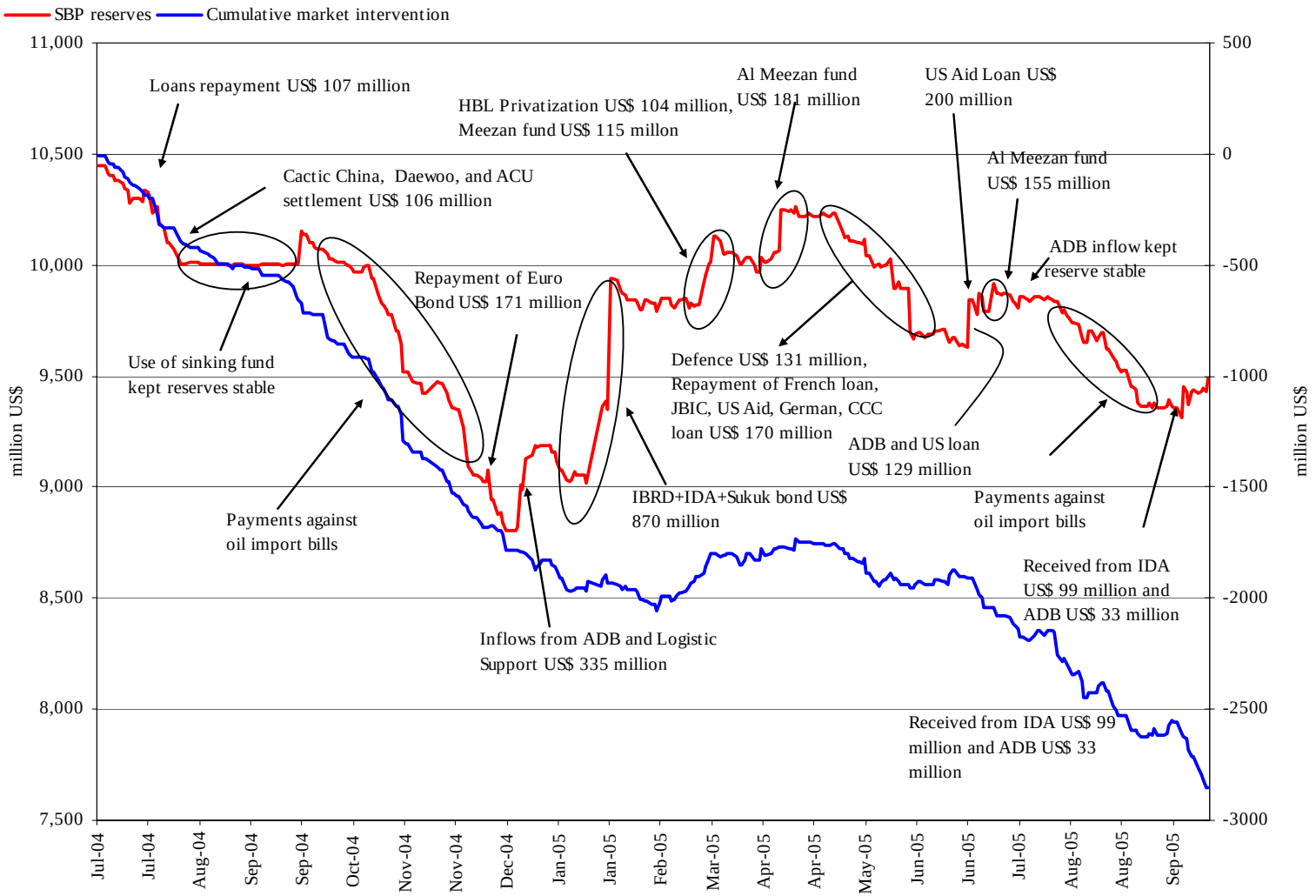
In fixed income securities, the major tools for risk and returns management are duration and tracking error limits. Duration is the time in years it takes a bond's cash flows to repay the investor the total price of the bond. Since bonds with higher duration carry higher risk, SBP has kept its duration relatively low to limit its risk appetite. While tracking error is the risk limit allocated to the portfolio to deviate from the benchmark. Tracking error is measured in terms of standard deviation. Since higher tracking error limit increases the overall portfolio risk; as with the duration, SBP has kept the tracking error limit relatively low. Other measures such as maximum country, currency, issue and credit quality exposures are also in place to ensure safety.

SBP's Reserve Management has been entirely successful since disbursement of funds to the external managers in June 2004 as it outperformed its above-mentioned benchmarks and has added value. It

Table 7.12: Overall Reserves as per BOP- BPM-5
million US$

	FY 04				Total	FY 05				Total
	Q1	Q2	Q3	Q4	FY 04	Q1	Q2	Q3	Q4	FY 05
Opening Balance	**11,667**	**12,302**	**12,759**	**12,496**	**11,667**	**12,389**	**12,458**	**12,141**	**12,855**	**12,389**
Inflows	**5,779**	**6,277**	**7,035**	**6,532**	**25,623**	**7,391**	**8,137**	**8,447**	**8,363**	**32,338**
Exports of goods	3037	3071	3118	3233	12,459	3393	3555	3750	3752	14,450
Export of services	849	723	629	443	2,644	860	804	787	824	3,275
reimbursement logistic support	384	198	172	0	754	280	168	202	181	831
Income	36	47	47	57	187	57	58	77	137	329
Workers' remittances	906	968	1001	996	3,871	983	963	1104	1118	4,168
Foreign direct investment	118	137	149	303	707	159	252	246	439	1,096
Foreign portfolio investment	-28	10	-28	18	(28)	21	38	48	44	151
Euro / Sukuk bond	0	0	500	0	500	0	0	600	0	600
Loan disbursements	300	516	433	477	1,726	828	745	527	331	2,431
Official	*242*	*496*	*93*	*392*	1,223	*818*	*743*	*519*	*331*	2,411
Long-term loans	*242*	*488*	*93*	*392*	1,215	*721*	*743*	*382*	*294*	2,140
Program loans	*126*	*363*	-	*292*	781	*596*	*521*	*300*	*140*	1,557
IMF	0	245	0	0	245	255	0	0	0	255
IDA/IBRD	0	0	0	192	192	310	115	300	0	725
AsDB	126	118	0	100	344	31	406	0	140	577
Project & food loans	116	125	93	100	434	125	222	82	154	583
Short-term including IDB	0	8	0	0	8	97	0	137	37	271
Private un-guaranteed	58	20	340	85	503	10	2	8	0	20
Privatization proceeds	0	0	199	0	199	0	0	103	260	363
Official grants	219	248	117	35	619	39	60	64	235	398
Saudi oil facility	147	128	27	0	302	0	0	0	0	-
Others	72	120	90	35	317	39	60	64	235	398
Other receipts	342	557	870	970	2,739	1051	1662	1141	1223	5,077
Outflows	**5,144**	**5,820**	**7,298**	**6,639**	**24,901**	**7,322**	**8,454**	**7,733**	**8,597**	**32,106**
Imports of goods	3038	3229	3644	3827	13,738	4175	5048	4800	4942	18,965
Imports of services (Excluding interest)	800	945	1095	1120	3,960	1441	1662	1763	1726	6,592
Interest payments	216	353	223	264	1,056	225	279	152	281	937
Amortization of official loans	387	457	1493	752	3,089	361	365	258	353	1337
IMF	141	202	189	140	672	107	139	68	85	399
IDA/IBRD	108	80	116	86	390	124	86	134	92	436
AsDB	57	88	1177	73	1,395	41	80	50	71	242
Others actual paid	81	87	11	453	632	89	60	6	105	260
Profit and dividends	136	193	120	210	659	163	246	138	287	834
Purchase of crude oil /Gas	99	149	202	228	678	196	225	258	272	951
Principal repaid on private loans	164	123	226	104	617	103	70	111	88	372
Foreign exchange liabilities liquidated	93	120	83	96	392	27	50	27	50	154
PTMA & commercial loans-actual paid	*17*	*16*	*0*	*0*	33	*0*	*16*	*0*	*0*	16
IDB (Short Term)	*35*	*70*	*56*	*31*	192	*0*	*8*	*0*	*0*	8
Special $ bonds	*41*	*34*	*27*	*65*	167	*27*	26	27	50	130
Other payments	*211*	*251*	*212*	*38*	712	631	509	226	598	1,964
Gross reserves at end of period	*12,302*	*12,759*	*12,496*	*12,389*	*12,389*	*12,458*	*12,141*	*12,855*	*12,621*	*12,621*
CRR	476	507	522	553	553	587	637	645	682	682
Sinking Fund	920	920	0	65	65	235	0	0	200	200
Net reserves of SBP	**10,019**	**10,525**	**11,001**	**10,564**	**10,564**	**10,079**	**9,182**	**10,062**	**9,792**	**9,792**
DMB Reserves without sinking fund includes CRR	**1,363**	**1,314**	**1,499**	**1,760**	**1,760**	**2,144**	**2,959**	**2,793**	**2,616**	**2,616**

Figure 7.20: SBP Reserves and Intervention

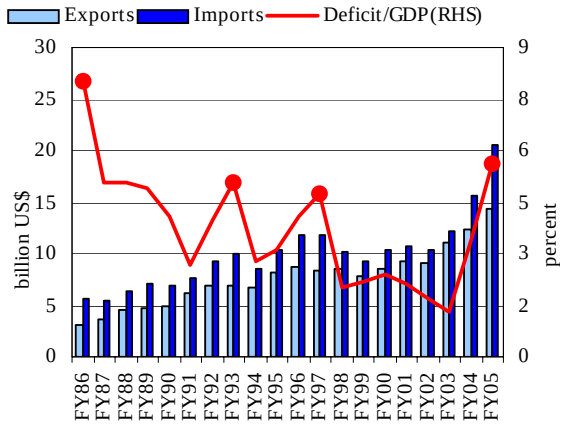


may further be added that not only fund managers have succeeded to outperform the benchmark, but they also managed to add substantial value to the portfolio if compared to the other avenues are available to SBP.

7.4 Trade Account[32]

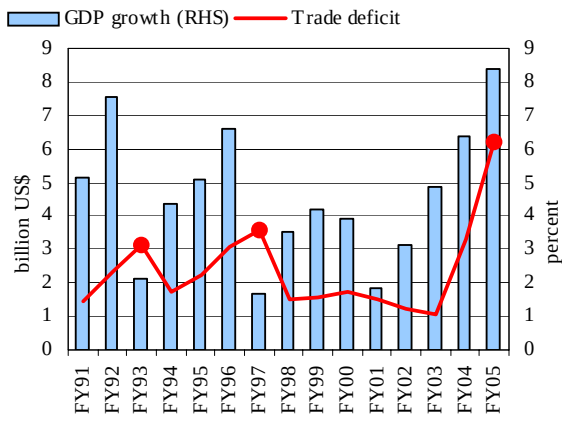
Pakistan's overall trade deficit continued to expand sharply during FY05 as well, reaching a record US$ 6.2 billion as the extraordinary rise of 32.1 percent in imports outstripped even the healthy 16.9 percent growth in exports. At this level, the trade deficit was significantly higher than both, the target of US$ 3.0 billion for FY05 as well as the deficit of US$ 3.3 billion recorded in the preceding year. Indeed, even when seen in comparison to the size of the economy, this is one of the largest trade deficit recorded by Pakistan; at 5.6 percent of GDP, the FY05 trade deficit is the largest in almost two decades (see **Figure 7.21**).

Figure 7.21: Trade Deficit - a Historical Perspective



Whether this high trade deficit is a source of concern or not, depends whether it is caused by structural factors or is simply the result of a temporary shock. In the latter case, the real issues would be the magnitude and duration of the adjustment process, and the country's ability to finance the deficit on favorable terms. On the other hand, if the change is likely to persist, it would be very important also to assess the composition of the rise in imports, and to determine if a change in policy may be required to narrow the deficit.

Figure 7.22: Trade Deficit and GDP Growth



In order to answer the first issue, it is useful to compare the trade imbalance with other recent periods when Pakistan suffered large trade deficits, i.e. in FY93 and FY97. In each of these years, the worsening of the trade deficit was due to one-off policy measures that led to a sharp jump in imports,[33] and each year had also coincided with a period of stagnant exports and weak economic growth (see **Figure 7.21** & **7.22**). By contrast, the FY05 trade deficit is not due to one-off policy measures, but is rather the result of a strong economic recovery, suggesting that the rise in imports would be sustained.

Thus, it becomes important to determine the composition of the rise in the trade deficit. A persistent higher trade deficit could be a source of concern if the higher net imports: (1) are mainly consumption oriented, i.e., instead of adding to the productive capacity, are displacing the domestic production; and (2) are financed through foreign exchange inflows at costs more than the economic returns on these imports, and (3) are caused by weak exports.

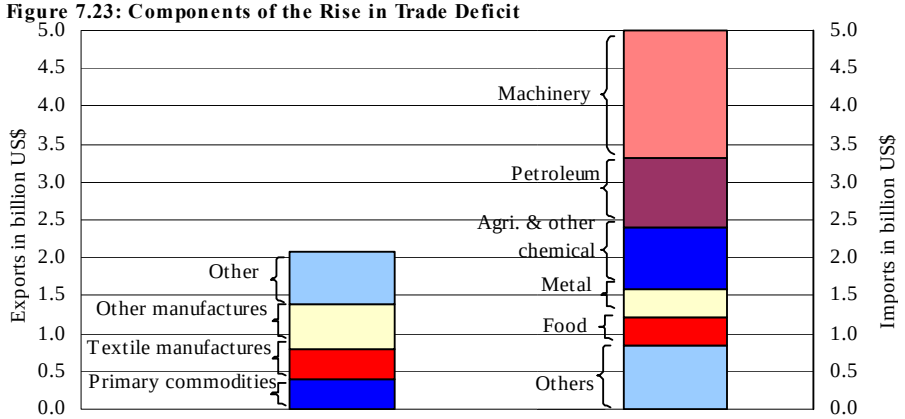
Encouragingly, data shows that the trade deficit during FY05 was primarily caused by higher imports of machinery, raw material (which may be helpful in improving the capacity use as well as in expanding the productive capacity of the economy, thereby leading to a broad-based increase in

[32] The discussion in this section is based on customs data provided by the Federal Bureau of Statistics (FBS) which may vary from trade numbers compiled by the SBP.
[33] For example, yellow cabs were imported in FY93 whereas power generation machinery was imported in FY97.

economic activities) and petroleum products (reflecting the impact of persistently higher oil prices in the international market and rising consumption in the growing economy) – see **Figure 7.23**.

Moreover, increase in the deficit was not due to weak exports, as these recorded a remarkable 16.9 percent YoY growth to reach US$ 14.4 billion during FY05, comfortably surpassing the annual target of US$ 13.7 billion (see **Figure 7.21**). Finally, as already discussed in **section on balance of payments,** the financing of this high trade deficit, at least for now, is not a problem due to substantial offsetting transfer flows as well as concessional financial inflows.

Figure 7.23: Components of the Rise in Trade Deficit



However, relying only on easy and cheap funding is not enough. In the short run, the elasticities of Pakistan's imports with respect to GDP is much higher than that of exports, but in the long run the divergence between the two elasticites is minimal (see **Box 7.6 on Trade Elasticities**). In the short run, imports are therefore likely to continue rising strongly, and this trend may be accentuated by persistent high international oil prices. This suggests that efforts to reduce the trade balance must focus principally on raising exports of goods and services. On the other hand, sustaining export growth will be a challenging task. Pakistan's exports are witnessing rising competitive pressures since January 2005 due to (1) elimination of global quota regime for trade in textile and clothing; and (2) loss of special preference offered by the EU on imports from Pakistan. Moreover, the country's competitive position also suffered due to imposition of antidumping duty by EU on its bedwear imports from Pakistan.[34] Thus, the adjustment costs to Pakistan's export under new globally competitive environment, particularly in textile & clothing sector, are greater than the costs faced by its competitors.

As far as preferential access to the EU market is concerned,[35] Pakistan had been enjoying duty free access to this region from 2002-2004 under drug related Generalized System of Preferences (GSP). However, following a scheduled review of this scheme, the country has been placed under a general category that was receiving low preference. This change in status in the EU market has put Pakistan at a relatively disadvantageous position against Bangladesh and Sri Lanka (Pakistan's two competitors in textile exports) which have been provided with duty free access.[36]

[34] While the overall bedwear exports increased by 4.6 percent, it fell by 6.96 percent in the EU market.
[35] EU is a major destination for the country's textile exports capturing 30 percent share in Pakistan's total textile exports during FY05.
[36] See SBP's *Second Quarterly Report* for FY05 for more detail.

The abolition of quantitative restrictions on trade in textile & clothing under MFA effective from January 1, 2005 has become a source of considerable concern not only in the large import markets but also in those developing countries which benefited from the constraints imposed on the most competitive producers.[37]

Box 7.6: Trade Elasticities for Pakistan

The empirical investigation of the import and export demand elasticities has been one of the most widely researched areas in international economics. In Pakistan, most of the studies on import demand function provide elasticity estimates with respect to relative prices of imports, nominal or real exchange rate and real domestic income. On the other hand, export demand elasticities are estimated with respect to relative prices of exports, nominal or real exchange rate and the real GDP of the world, trading partners or the region. **Table 7.6.1** provides an overview of various short run and long run estimates for trade elasticities using selected empirical literature on Pakistan.

Table 7.6.1: Trade Elasticities for Pakistan

		Export				Import			
Author	**Period**	**ER**	**RER**	**RPX**	**GDP**	**ER**	**RER**	**RPM**	**GDP**
					Short Run				
Mohsin Khan[1]	1951-69	-		-0.526	0.375	-		-0.819	1.371
Sarmad Khawja and Riaz Mehmood[2]	1969-84	-	-	-	-			-0.23	1.29
Sajjad Akthar and Fauzia Malik[3*]	1982-96	-	0.63	-1.61	2.36	-	-0.19	-0.51	1.31
Abdelhak Senhadji[4]	1960-93	-				-	-0.42		0.7
M. Aynul Hasan. & A.H.Khan[5]	1972-91	1.14			0.8	-0.88			1.39
					Long Run				
Mohsin Khan	1951-69			-1.82	0.919			-0.779	1.021
Abdelhak Senhadji[3]	1960-93	-		-	-	-	-0.49		0.82
Zehra Aftab & Aurangzeb[6]	1980-00	-		-0.41	1.91	-		-0.69	0.79
Mohsin Bahmani-Oskooee[7]	1973-90	-2.99		1.84	-2.26	0.002		-1.23	1.11

1. Khan, Mohsin, (1974),"Import and Export Demand in Developing Countries" *IMF Staff Papers*, 678: 840.
2. Akthar, Sajjad and Fauzia Malik, (1987),"Disaggregated Import Demand Function for Pakistan" The Pakistan Development Review, (26:1) pp-71:80
3. Akhtar, Sajjad and Fauzia Malik, (2000)" Pakistan's Trade Performance vis-à-vis its Major Trading Partners" *Pakistan Development Review*, (39:1) pp 37-50
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Notes:

RPX= Index of the county unit values of exports or weighted index of the export prices of the region, trading partners or the world

RMP=Index of the unit values of imports/GDP deflator

RER= Real Exchange Rate, computed as the ratio of imports deflator to GDP Deflator, and GDP minus Exports

M. Aynul Hasan. & A.H. Khan has used nominal exchange rate PKR/USD while, the Mohsin Bahmani-Oskooee has used NEER (Nominal Effective Exchange Rate) defined as unit of foreign currency per unit of domestic currency.

All studies (except Zehra Aftab and Aurangzeb) have used real import & real exports
*Only the US specific, price and income elasticities of export and import demand functions are quoted from Sajjad Akhtar and Fauzia Malik Study.

[37] Since the major part of the textile trade was liberalized on January 1, 2005, this abruptly exposed the textile exporting countries as well as domestic producers of the importing markets (i.e., EU, US and Canada) to competition in the global market; providing them insufficient time to strengthen their abilities and improve competitive advantage.

Box 7.7: Quota Restrictions under Post-MFA Regime

The agreement on textile and clothing envisaged a complete phasing out of multi-fiber agreement (MFA) by December 31, 2004. Consequently, the global textile trade in 2005 and onward was to take place under quota free regime. However, the world textile trade in 2005 still suffers from quantitative limits reintroduced by the US, EU, Turkey and Argentina on their import of certain textile products from China. These restrictions have been imposed on the basis of terms agreed by the China for its accession to the WTO in 2001. Specifically, these terms included a 'textile specific safeguard clause' that allows WTO members to impose quantitative restrictions until the end of 2008 on imports of Chinese textiles and clothing if these imports are found to disrupt markets. Under the safeguard, members can limit specific products to an increase of 7.5 percent above the preceding year's import levels.

Thus, taking advantage of this safeguard clause, Turkey and Argentina acted preemptively and imposed quantitative restrictions as early as in January 2005 on import of certain textile and garment products from China so that the import growth of these product could be constrained to 7.5 percent per year. On May 13, 2005, the US also imposed quantitative limits on three textile import categories on the basis of evidence of market disruption. Subsequently, on May 27, 2005 import limits were imposed on four more categories simply to deal with the threat of further disruption. Later, on September 1, 2005, quantitative restrictions were extended to two more categories, thereby increasing the total number of categories under quota limits to nine.

Similarly in May 2005, the EU formally requested WTO consultations with China on two categories of textile and clothing products. The process would have forced China to limits its exports to the EU under these categories to no more than 7.5 percent above the base period. However, under a deal reached with the EU in June 2005, China agreed to limit export growth of ten textile categories (out of the 35 categories of Chinese imports into the EU that were liberalized on January 1, 2005) into the EU market to between 8 and 12.5 percent above a specified base period.

But the textile imports from China into the Europe soon exceeded their agreed quantitative limits when the European retailers, in order to avoid import restrictions, utilized the time period from June 10th (the agreement date) and July 12th (when import limiting regulations were announced) to order large quantities of textiles. To their surprise, the quota limits were made effective retroactively from June 11th, thus exhausting the quota limits specified for the June-December 2005 period very quickly. Consequently, large quantities of textile imports were impounded at the EU borders. This situation led to review of the June 10th agreement. Under the new deal, impounded textile products were released; half of these goods were to be counted against the import quota of 2006 and the rest were imported over and above the previously agreed limits.

Thus it appears that despite phasing out of MFA, quota restrictions by developed countries on textile imports from China, particularly on products that have shown extraordinary growth in post-MFA, are still in place. It is ironic that textile importing developed countries removed most of their quantitative restrictions under MFA at the final stage of their phase out plan. It can be argued that an evenly spread phase out plan would have provided textile industries in these countries sufficient time to adjust in response to new challenges. This means that the cost of skewed phasing out plan is being borne by developing countries as well in the form of safeguard measures taken by developed countries, which is unfortunate.

Source: *BRIDGES*, weekly trade news digest available at www.ictsd.org

In the post MFA regime, though there are still quantitative limits in place on exports of some of the textile products from China (see **Box 7.7 on Quota in Post MFA environment**), nonetheless price competition among suppliers has intensified, as the elimination of quota costs allowed exporters to increase their market share through price reduction, thus leading to substantial downward pressure on the prices of textile and clothing products. However, simply by reducing margins, exporters cannot maintain their market share for long – there is a need to improve efficiency and productivity, and diversify the markets, particularly into higher value added products so that the textile sector could meet the post-MFA challenges in a robust manner.

In this regard, there are various channels through which removal of quota is influencing the world trade pattern in textile and clothing. For example, before January 2005, decisions on supply source location by major importers were mainly linked to the availability of quotas; now the cost competitiveness has become a major consideration. This has enabled importers and retailers to reduce the number of their supply sourcing locations, and in turn increase their economic power as they are now able to exert more pressure on prices.

Similarly, the removal of quota has allowed suppliers to utilize their resources more efficiently through division of their production processes in specialized activities, where each activity is performed at the lowest cost. The resulting cost rationalization and economies of scale from this reorientation of the production processes allows suppliers to efficiently use its competitive advantage. However, competitive advantages also include other factors, such as reliability, delivery time lines, ability to respond quickly to changes in demand, etc.

In order to meeting these challenges producers/exporters need to focus on international integration of their production processes as this induces efficiencies and learning on a global scale (see **Special Section 7.4 on Inter-industry trade**). The government's role would be to seek preferential access through trade agreements, and improve the environment for investment & production so that businesses can develop longstanding relationships with importing partners.

Box 7.8: Regional Trade Balance

The sharp rise in overall trade imbalance during FY05 is also visible in all the major markets (see **Table 7.8.1**). Major trends in regional trade balance are:

- Trade surplus with the EU deteriorated by US$ 400 million during FY05, mainly due to the imposition of antidumping duty by EU on bedwear imports from Pakistan as well the removal of the special preference available to Pakistan's exports in the EU market.
- The trade surplus with the US showed increase of US$ 261 million during FY05 primarily because Pakistan was able to post significant growth in the export of *articles of apparel & clothing (knitted)* as well as in *man-made textile articles* in the US market.
- The trade imbalance with Asian countries rose significantly by US$ 2 billion to reach US$ 6.8 billion in FY05. Similarly share of the Asian countries in Pakistan's trading volume increased sharply to 43 percent during FY05 from 41.5 percent in the preceding year. While Pakistan was able to export more to Eastern Asia and South Central Asia, it was more than offset by higher imports from East Asia and Western Asian countries. The impact of rapid increase in oil prices in the international market led to a sharp rise in imports from Western Asian countries.

Table 7.8.1: Regional Trade Balance

	FY04						FY05					
	Value in billion US$			% share in total			Value in billion US$			% share in total		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
USA	2.9	1.3	1.6	23.9	8.5	-49.3	3.4	1.6	1.9	23.9	7.6	-30.3
EU	3.7	2.4	1.3	30.3	15.3	-41.1	4.1	3.1	0.9	28.3	15.1	-15.3
Asia	3.4	8.2	-4.8	27.6	52.4	145.6	4.1	10.9	-6.8	28.6	53.0	109.7
Eastern	1.1	2.5	-1.3	9.3	16.0	41.0	1.2	3.8	-2.6	8.6	18.5	41.6
South Central	1.0	0.8	0.2	8.1	5.3	-5.3	1.6	1.0	0.6	11.0	4.8	-9.8
South Eastern	0.4	1.8	-1.4	3.0	11.3	42.6	0.4	2.1	-1.8	2.4	10.3	28.4
Western Asia	0.9	3.1	-2.2	7.2	19.9	67.4	0.9	4.0	-3.1	6.6	19.4	49.4
UAE	0.9	1.7	-0.8	7.7	10.9	23.2	1.1	1.6	-0.5	7.6	7.9	8.5
Others	1.3	2.0	-0.7	10.6	12.9	21.6	1.7	3.4	-1.7	11.6	16.4	27.5
Total	**12.3**	**15.6**	**-3.3**	**100.0**	**100.0**	**100.0**	**14.4**	**20.6**	**-6.2**	**100.0**	**100.0**	**100.0**

Pakistan's exports to India increased by US$ 194.88 million to reach US$ 288.23 million during FY05. The major increase was realized in the export of petroleum products. On the other hand, imports from India during the same period, rose by US$ 165.85 million mainly on account of higher imports of organic chemical and plastic material. Imports from China also increased sharply to US$ 1.85 billion during FY05 from US$ 1.15 billion during the corresponding period last year. Major imports included: machinery & mechanical appliances, electrical machinery & equipments, telecommunications equipments, television sets, air conditioners, locomotives etc.

The free trade agreements (bilateral as well as regional) particularly have gained new importance to improve access in key markets as following the elimination of quotas, differentially applicable tariff

levels have become more important instrument in determining the market access.[38] Pakistan is already making considerable efforts to enter into trade agreements with a number of countries. In April 2005, an early harvest program with China was initiated which is a step towards a free trade agreement (FTA). Similarly an early harvest program with Malaysia will be implemented from January 1, 2006. In addition, an FTA with Sri Lanka has been operational since June 2005. On January 1, 2006, South Asian Free Trade Agreement (SAFTA) will come into effect, and it is expected that the consequent significant reduction in tariffs and the removal of non-trade barriers (NTBs) would generate substantial gains for Pakistan (see **Special section 7.3 on SAFTA**).

Figure 7.24: Exports

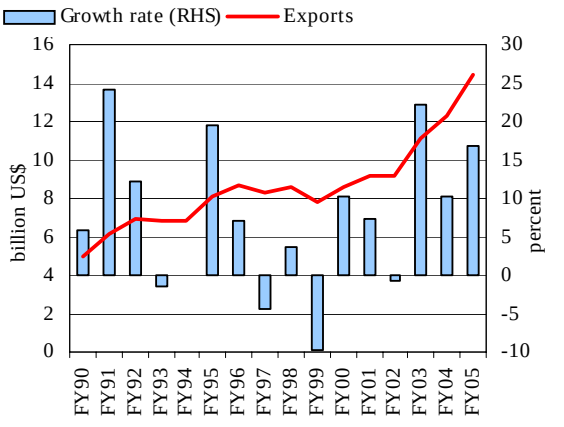
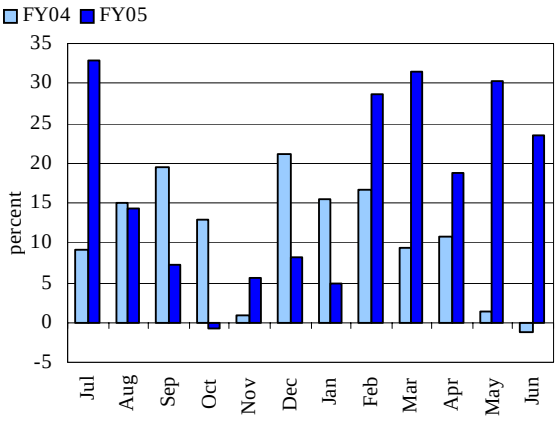


Figure 7.25: Monthly Export Growth



7.4.1 Exports

The overall exports reached US$ 14.4 billion during FY05, showing a strong growth of 16.9 percent on top of 10.2 percent growth posted in the preceding year (see **Table 7.14**). As evident from **Figure 7.24**, a major shift in Pakistan's export performance that was visible since FY03, continued in FY05 as well. In fact during the last three years, the increment in total exports is almost equal to the cumulative rise in export value during the 15 years prior to FY03.[39]

Table 7.13: Export Diversification by Markets and Commodities

Percent	Percent of commodities		Percent of markets	
of Export Value	FY00	FY05	FY00	FY05
00--10	93.7	93.7	84.0	83.2
11--20	2.8	3.1	7.0	7.5
21--30	1.3	1.2	2.7	3.1
31--50	1.4	1.1	3.7	3.5
51--100	0.9	0.8	2.7	2.7

The export performance during FY05 is impressive given the slowdown in the growth momentum in United States, and concerns about economic recovery in Euro area and in Japan – key export markets for Pakistan. However, monthly trends show that the export growth during Aug'04-Jan'05 period was quite weak. This was probably the impact of antidumping duty imposed by the EU and an embargo imposed by the US on country's bed wear exports to check over-shipment in this category. Exports however recovered sharply from February 2005 and onward (see **Figure 7.25**). The growth rate for Feb-Jun 2005 period averaged 26.5 percent per month compared to 10.3 percent for the preceding seven month period.

Over the years, Pakistan has been struggling to diversify its export, both in terms of products and markets. In terms of export destination, share of markets covering half of Pakistan's total exports has

[38] The abolition of quotas has eliminated some, but not all, of the distortions affecting global trade in textiles and clothing – tariffs on textiles and clothing are already in place at very high levels.

[39] In trade history of Pakistan, only on two occasions (i.e., in FY91 and FY95) exports in value terms increased by more than US$ 1 billion mark (mainly on the back of export of raw cotton). In contrast, during the last three years, incremental exports value crossed US$ 2 billion mark in FY03 and FY05.

Table 7.14: Major Exports

value: million US Dollar; Unit value: US Dollar

			FY04		FY05P		Absolute	Change (percent)		
		Unit	Value	Unit value	Value	Unit value	Δ in value	Qty	Value	Unit value
A.	**Primary commodities**		**1,275.0**		**1,675.7**		**400.7**		**31.4**	
1	Rice	MT	634.5	348.1	932.3	322.6	297.8	58.6	46.9	-7.3
2	Raw cotton	MT	47.7	1277.8	110.0	939.1	62.3	213.8	130.7	-26.5
3	Raw wool (excluding Wool Tops)	MT	1.4	632.8	1.0	1055.7	-0.4	-57.3	-28.8	66.8
4	Fish and fish preparations	MT	152.9	1480.8	138.9	1436.7	-13.9	-6.3	-9.1	-3.0
5	Leather	SQM	251.7	15.7	303.6	16.5	51.9	14.9	20.6	5.0
6	Guar and guar products	MT	20.2	824.0	26.5	1061.8	6.3	1.7	31.1	28.9
7	Fruits	MT	102.7	289.7	90.7	324.4	-12.0	-21.1	-11.6	12.0
8	Vegetables	MT	31.3	181.1	34.9	325.2	3.6	-37.8	11.6	79.6
9	Crude animal material	MT	15.5	2023.4	16.2	3756.9	0.7	-43.5	4.8	85.7
10	Oil Seeds & nuts etc.	MT	11.2	577.5	21.6	722.4	10.4	53.8	92.3	25.1
11	Wheat	MT	6.0	140.2	0.0	0.0	-6.0			
B.	**Textile manufactures**		**8,073.0**		**8,465.0**		**392.0**		**4.9**	
1	Cotton yarn	MT	1,126.9	2258.0	1,054.7	2093.3	-72.2	1.0	-6.4	-7.3
2	Cotton fabrics (woven)	SQM	1,711.5	0.7	1,858.3	0.8	146.8	-0.6	8.6	9.2
3	Hosiery (Knitwear)	DOZ	1,458.7	22.0	1,631.5	23.0	172.7	6.8	11.8	4.7
4	Bed wear	MT	1,383.3	5664.6	1,446.8	5481.8	63.5	8.1	4.6	-3.2
5	Towels	MT	403.5	3963.4	519.9	3740.1	116.4	36.5	28.8	-5.6
6	Cotton bags and sacks	MT	15.5	4133.7	14.1	4094.5	-1.4	-7.9	-8.8	-0.9
7	Readymade garments	DOZ	993.3	36.0	1,086.0	31.8	92.7	23.7	9.3	-11.6
8	Tarpaulin & other canvas goods	MT	74.8	2342.1	66.6	2518.1	-8.2	-17.2	-11.0	7.5
9	Tule, lace embroidery etc.	(-)	11.4	---	12.3	---	0.9	---	7.8	---
10	Synthetic textiles	SQM	470.8	0.7	297.8	0.7	-172.9	-39.1	-36.7	4.0
12	Other textile made-up	(-)	416.6	---	466.0	---	49.4	---	11.9	---
13	Waste material of tex. fibres/fabrics	MT	6.8	565.1	11.2	629.7	4.4	47.3	64.1	11.4
C.	**Other manufactures**		**1,776.2**		**2,374.8**		**598.6**		**33.7**	
1	Carpets, carpeting rugs & mats	SQM	231.4	55.8	277.8	55.7	46.4	20.2	20.0	-0.1
2	Petro. and petroleum products	MT	294.5	298.4	495.6	389.6	201.1	28.9	68.3	30.6
3	Sports goods	(-)	324.8	---	307.1	---	-17.6	---	-5.4	---
4	Leather manufactures	(-)	414.3	---	526.3	---	111.9	---	27.0	---
5	Surgical and medical instruments	NO	132.6	1.4	182.7	1.3	50.1	47.6	37.8	---
6	Cutlery	GR	29.7	25.2	34.3	19.4	4.6	49.4	15.5	-22.7
7	Onyx manufactured	MT	11.6	1706.8	8.7	1716.4	-2.9	-25.2	-24.8	0.6
8	Chemicals and pharmaceuticals	(-)	263.0	---	452.6	---	189.6	---	72.1	---
9	Molasses	MT	46.9	32.2	72.4	62.9	25.6	-21.0	54.6	95.6
10	Sugar	MT	27.6	237.3	17.3	313.1	-10.2	-52.4	-37.2	32.0
D.	**Others**		**1,189.1**	---	**1,875..5**		**686.4**	---	**57.7**	**---**
	Total Exports		**12,313.3**		**14,391.0**		**2,077.7**		**16.9**	

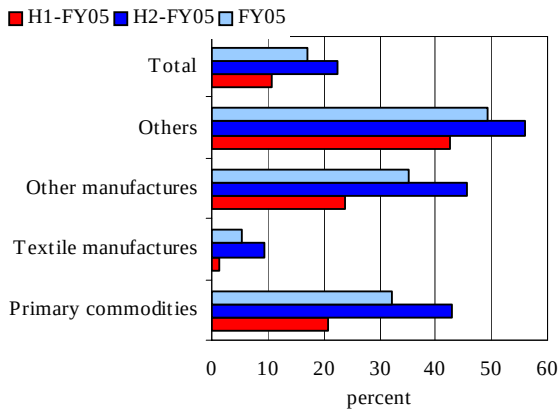
Source: Federal Bureau of Statistics

remained unchanged at 2.7 percent during FY00-FY05 (see **Table 7.13**). Similarly in terms of export products, around 50 percent of Pakistan's exports in FY00 were concentrated in only 0.9 percent of products. In FY05, product concentration remained more or less unchanged. These results suggest that despite sharp increase in exports during the past three years, Pakistan's efforts to diversify export products and markets have not been as yet, very fruitful.

Composition of Exports

In terms of commodity group however exports witnessed major changes in FY05, with as the share of textile manufacture exports fell sharply to 58.8 percent in FY05 from 65.2 percent in the preceding year. In terms of contribution to growth, textile sector explains only 17 percent of the growth in total exports compared to its significant share of over 70 percent during the preceding year. This mainly reflects the impact of slowdown in textile exports during H1-FY05 when it posted a YoY growth of just 1.2 percent over the corresponding period of FY04. However, during the second half of FY05, textile exports increased by 9.7 percent on YoY basis, explaining over 22 percent growth total exports during this period (see **Figure 7.26**).

Figure 7.26: Export Growth Category-wise

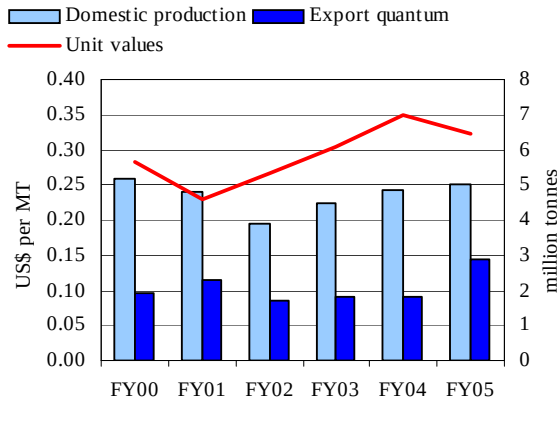


On the other hand, all the remaining categories (*primary commodities, manufacturers other than textile* and *other exports*) increased their contribution in both export value as well as in export growth. As evident from **Figure 7.26**, the growth rate was stronger for all categories during the second half of FY05. Major contributors in these categories are *rice, raw cotton, petroleum & petroleum products, chemical & pharmaceuticals, leather manufactures, carpets, carpeting rugs & mats, surgical & medical instruments, molasses, machinery & transport equipments, articles of plastic, foot wears,* and *wheat flour*.

Primary Exports

The higher export of rice, raw cotton and leather led to a significant rise of 31.4 percent in primary exports that account roughly 20 percent of the FY05 growth in total exports. In contrast, primary exports had risen by only 1 percent during the preceding year. Interestingly, export growth of primary goods accelerated from 20 percent YoY during H1-FY05 to a remarkable YoY growth of 42.89 percent during H2-FY05. While growth in primary export during the first half of FY05 was on account of higher raw cotton exports, it was the export of rice that accounted for the growth in primary products during H2-FY05.

Figure 7.27: Rice - Domestic Production and Exports



Rice

The rice exports reached record US$ 932.3 million, showing an extraordinary increase of US$ 297.8 million (46.9 percent) during FY05 despite a fall in unit values (see **Figure 7.27**). An interesting development is the sharp increase of 106.3 percent in export quantum of *other varieties* (which are relatively cheap). This increase in quantum was well supported

Table 7.15: Rice Exports

	FY05 Value	YoY Growth in percent		
	million US$	Values	Quantity	Unit Values
Rice	932.3	46.9	58.6	-7.3
Basmati rice	439.0	4.1	-0.2	4.3
Other varieties	493.6	132.1	106.3	12.5

Source: Federal Bureau of Statistics

by rise in their unit prices. As a result, share of *other varieties* in total rice exports jumped to 52.94 percent in FY05 from 33.52 percent in the FY04 (see **Table 7.15**).

Pakistan was able to increase its export of *other rice varieties*, particularly to Afghanistan, Cameroon, Cote d' Ivoire Iran, , Mozambique, Togo and Sri Lanka. Rice exports to these seven countries rose to US$ 214.7 million during FY05 from US$ 57.3 million during the corresponding period last year (see **Table 7.16**). Exports to Kenya, however, fell during FY05, reflecting the impact of a temporary rise in tariff imposed by Kenya on import of rice from Pakistan.[40]

Basmati rice exports on the other hand posted a growth of mere 4.1 percent mainly on the basis of higher unit prices as export quantum declined by 0.2 percent. The major decline was evident in EU market despite the fact that since September 2004, EU re-included super basmati rice in the list of zero tariff imports subject to certain conditions.[41]

This sharp jump in Pakistan's rice exports was accompanied by an increase of US$ 62.3 million (130.7 percent) in export of raw cotton during FY05. The higher export of raw cotton was led by a massive rise of 213 percent in export quantum which was partially offset by a fall in unit values (see **Table 7.17**). The extraordinary rise in cotton production (and lower prices in the domestic market) enabled exporters to increase the quantum of raw cotton exports.

Textile Manufacture Exports

The textile manufacture exports increased by 4.9 percent during FY05 compared to 11.2 percent growth recorded in FY04. However the performance of this sector fluctuated during the year. In the first half of FY05, textile sector posted a YoY growth of just 1.2 percent, but then recovered to 9.29 percent YoY during H2-FY05 following a sharp rise in exports of cotton fabrics, knitwear, and readymade

Table 7.16: Rice Export Markets

value: million US$; quantum: 000'MT; growth in percent

	FY05		FY04		YoY Growth in unit value
	Quantity	Value	Quantity	Value	
Basmati	**814.9**	**439.0**	**816.3**	**421.6**	**4.1**
UAE	336.2	181.2	316.4	163.1	11.1
Other Middle East	258.7	133.8	246.9	124.3	
EU	89.3	49.9	104.8	54.1	-7.7
North America	16.1	17.3	23.3	16.0	8.1
Other	203.9	106.7	229.8	118.2	-15.0
Others varieties	**2014.7**	**479.9**	**1000.8**	**211.5**	**126.9**
Afghanistan	153.3	27.9	127.0	23.9	17.0
Cameroon	138.1	32.3	6.0	1.6	--
Cote de Ivoire	129.9	31.6	3.1	0.7	--
Iran	162.6	45.3	91.4	22.3	103.3
Kenya	140.9	27.2	165.4	27.8	-2.1
Mozambique	115.4	27.2	36.9	7.1	--
Togo	128.2	28.6	6.6	1.4	--
Sri Lanka	91.4	21.9	1.4	0.4	--
U A E	64.9	20.9	69.0	19.2	8.6
Other	**890.1**	**217.1**	**493.9**	**107.2**	**102.6**

Source: Federal Bureau of Statistics

Table 7.17: Raw Cotton Production and Exports

	Exports			Domestic production (000 MT)
	Quantity (000MT)	Value (million US$)	Unit value US$ per MT	
FY00	83.0	72.6	0.87	1,734.6
FY01	135.1	139.3	1.03	1,656.5
FY02	35.0	24.7	0.71	1,637.5
FY03	55.1	49.0	0.89	1,575.8
FY04	37.3	47.7	1.28	1,550.4
FY05	117.1	110.0	0.94	2,255.3

Source: FBS and Pakistan's Economic Survey (MoF)

Table 7.18: Impact of Unit Value Change

million US$

	H1-FY05	H2-FY05
Cotton yarn	-17.3	11.0
Cotton fabrics (woven)	65.1	147.3
Hosiery (knitwear)	87.5	-17.8
Bed wear	-27.2	-51.3
Towels	-13.7	-27.4
Readymade garments	-71.2	-81.0

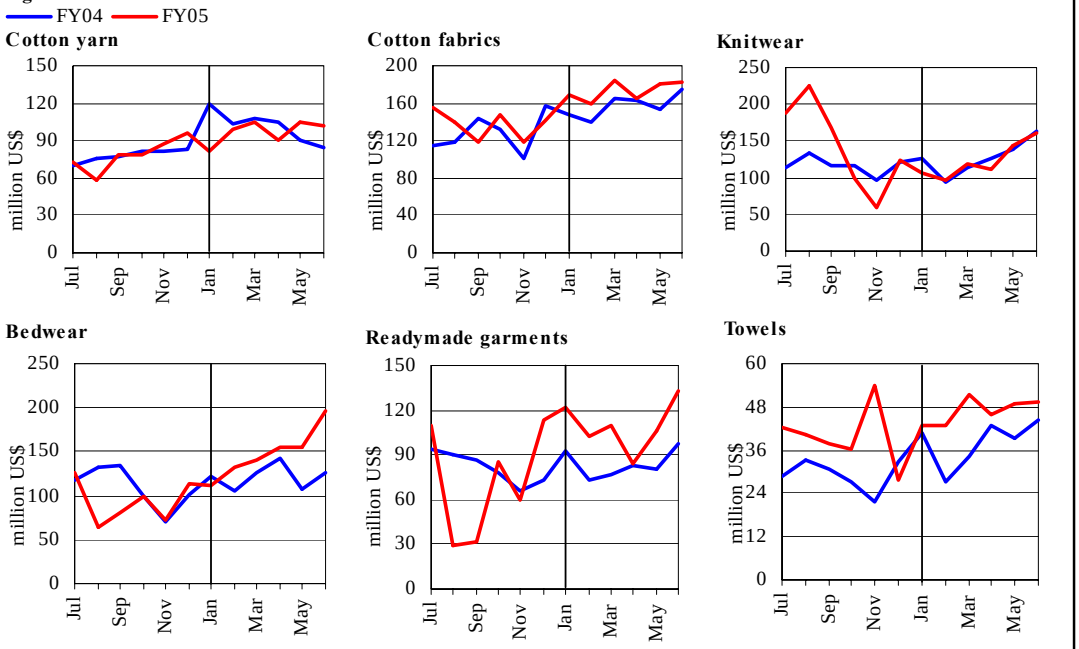
[40] As a part of the new regional tariff arrangements under the East African Community Bloc (EACB) trading protocol, Kenya, Tanzania and Uganda increased the import duty on rice to 75 per cent against the previous 35 per cent from January 1, 2005. However, after negotiations Kenya has agreed to defer the imposition of the duty for two years.

[41] In December 2003, EU removed the super basmati from the list of varieties that were exempted from import duty to the extent of 250 euros per tonne. Two other varieties (kernel and basmati 370) were already allowed duty exemptions.

garments (see **Figure 7.28**). Interestingly, the downward pressure on unit values was evident even before the dismantling of the quota on textile & clothing as countries were competing to secure larger share of the market in quota free regime (see **Table 7.18**).

Towels exports showed a 28.8 percent growth driven by higher quantum of exports as unit values during the year fell by 5.6 percent. In particular, the export quantum increased significantly in the EU market during the H1-FY05 on the back of falling unit values. In the post-MFA period, the YoY growth in exports to the EU was relatively low (probably reflecting the impact of withdrawal of zero-rated tariff preference), but it was compensated by higher exports to the US (see **Table 7.19**).

Figure 7.28: Textile Manufactures



The export of *readymade garments* increased by 9.3 percent during FY05 compared to a fall of 9.1 percent in the preceding year. In fact, impact of falling unit values is more evident in the case of readymade garment where 11.6 percent decline in unit value eroded more than half of the 19.6 percent gain in export volume (largely reflecting the low base of the previous year). The pick up in the volume of readymade garments exports since January 2005 is encouraging.

Bedwear exports witnessed YoY increase of 4.6 percent during FY05 compared to 4.1 percent growth during the preceding year, despite the impact of anti-dumping duty imposed by the EU. It may be pointed out that the investigation for alleged anti dumping started in June 2003, which resulted in the imposition of a 13.1 percent antidumping duty for five years effective from March 2004.[42] Surprisingly, during H1-FY05, exports of bed wear declined not only in the EU but also in other markets such as the US.

However, bed wear exports managed to recover following the removal of worldwide quota regime in January 2005. Specifically, bedwear exports which fell by 14.8 percent in value terms during the first half of FY05 (due to decline in both the quantum as well as unit values) increased sharply to post 22.5 percent YoY growth during the second half of FY05 period. The major gain came from the US market where YoY growth of 39.1 percent in export quantum was bolstered by 38.9 percent rise in

[42] The anti-dumping duty was recently revised downward to 9.1 percent.

unit values. In contrast, the EU export market continued to post fall in terms of quantity exported as well as unit prices.

Figure 7.19: Market Analysis of Major Textile Items

YoY percent growth

	FY05			H1-FY05			H2-FY05		
	Quantity	Value	UV	Quantity	Value	UV	Quantity	Value	UV
Towels									
Overall	36.5	28.8	-5.6	42.1	37.0	-3.5	32.2	22.6	-7.2
EU	69.4	35.3	-20.1	100.6	61.2	-19.7	46.8	17.6	-19.9
USA	27.0	32.0	4.0	20.3	34.2	11.6	31.9	30.5	-1.0
Others	27.1	15.4	-9.2	37.4	20.0	-12.7	17.0	10.6	-5.5
Garments									
Overall	23.7	9.3	-11.6	3.2	-12.2	-14.9	42.8	30.0	-8.9
EU	16.4	1.1	-13.1	0.1	-15.1	-15.2	30.5	15.4	-11.6
USA	22.8	11.8	-9.0	-6.5	-18.2	-12.5	48.7	39.3	-6.3
Others	41.1	25.6	-11.0	21.1	3.1	-14.9	65.1	55.5	-5.8
Bed wear									
Overall	8.1	4.6	-3.2	-10.9	-14.8	-4.4	25.2	22.0	-2.6
EU	-1.8	-7.0	-5.3	-4.4	-5.9	-1.5	0.2	-7.8	-7.9
USA	39.1	38.9	-0.1	-9.5	-11.4	-2.2	85.6	88.2	1.4
Others	-12.5	-18.1	-6.4	-22.1	-31.5	-12.0	-1.5	-1.8	-0.3
Knitwear									
Overall	6.8	11.8	4.7	19.9	28.1	6.9	-4.6	-3.2	1.4
EU	1.7	10.2	8.4	17.3	44.9	23.5	-12.2	-18.3	-6.9
USA	9.1	10.2	1.0	18.7	14.3	-3.7	1.0	6.3	5.2
Others	15.5	29.9	12.5	35.1	59.1	17.8	-3.7	-2.4	1.3

In the case of *knitwear*, export value increased by 11.8 percent during FY05 on the top of 27.2 percent rise witnessed last year. As evident from **Figure 7.28**, growth in knitwear exports is concentrated in the first quarter of FY05, showing a YoY growth of 58.9 percent during this period. In the remaining three quarters, knitwear exports fell by 7.1 percent YoY basis. The knitwear export performance continued to deteriorate even after the removal of textile quotas. This impact is more relatively more severe in the EU market, probably due to suspension of special preference under GSP (see **Table 7.19**).

Textile sector under post-MFA regime

It would be interesting to analyze how Pakistan's exports are performing relative to other countries in major international markets under post-MFA regime. However, such an exercise is constrained by the timely availability of appropriate data on trade flows

Table 7.20: USA Textiles Imports (Jan-Jul)[1]

	(Amount billion US dollar)			YoY Growth (%)	
	CY05	CY04	CY03	CY05	CY04
US imports from					
World	54.09	49.57	47.59	9.1	4.27
Pakistan	1.64	1.51	1.31	8.9	15.1
% age share	3.04	3.04	2.75		
China	14.99	9.66	8.04	55.2	20.2
% age share	27.72	19.50	16.90		
Bangladesh	1.36	0.97	1.20	41.0	-19.6
% age share	2.52	1.95	2.53		
Sri Lanka	0.99	0.85	0.90	15.6	-4.9
% age share	1.82	1.72	1.88		
India	2.99	2.38	2.24	25.6	6.6
% age share	5.53	4.81	4.70		
Vietnam	1.48	1.50	1.59	-1.2	-5.7
% age share	2.73	3.02	3.33		
Thailand	1.20	1.15	1.16	4.2	-0.4
% age share	2.22	2.33	2.43		
Overall % coverage	**45.6**	**36.4**	**34.5**		

Source: US Census Bureau

[1] Represent trade based on NAICS codes of 313, 314 and 315

for all major markets. Nevertheless, this section provides a partial analysis on the basis of the data on US imports of textile and clothing products during Jan-Jul 2005 period.

The analysis suggests that US imports of textile and clothing from Pakistan increased by 8.9 percent YoY during Jan-Jul 2005 which was significantly less than 15.1 percent growth witnessed during the corresponding period of FY04 (see **Table 7.20**). In contrast, textile & clothing imports from China showed extraordinary growth of 55.2 percent during Jan-Jul 2005 period, increasing its share in US imports. In fact, such unusually higher exports from China forced US to introduce controls on the import of selected textile & clothing items from China.

India also performed better in the US market in the post-MFA regime, increasing its share in US imports of textile & clothing to 5.5 percent during Jan-Jul 2005 from 4.8 percent during the corresponding period last year. Pakistan's performance however cannot be compared with Sri Lanka and Bangladesh as imports from these two countries are recovering from a low base realized in Jan-Jul 2004.

Table 7.21 provides a further break up of US import of textile and clothing from Pakistan, China and India. It is evident that the Pakistan has performed well in the export of *textile mill products* which is in the middle of value addition range. In fact, Pakistan's export growth in this category was higher than both India and China. However, its share in *apparel & accessories* (which are high value added items) remained unchanged. What is more surprising is the sharp fall of 24.5 percent in US imports of *textile & fabrics* from Pakistan that led to a decline in its market share in exports of low value added items to the US.

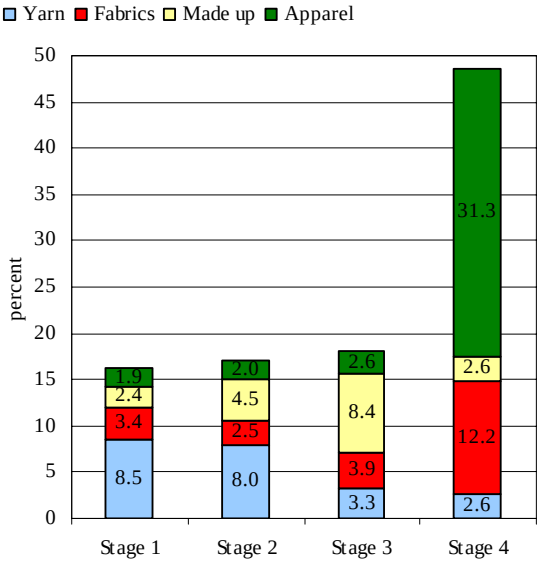
China on the other hand increased its share in the US market in all three categories, with substantial gains accruing in *apparel & accessories*. Similarly India also managed to modestly increase its market share in all three categories, with major gains concentrated in

Table 7.21 Category wise Textile Imports of the US (Jan-Jul)
amount in million US Dollar, growth in percent

	Amount			YoY Growth	
	CY05	CY04	CY03	CY05	CY04
Pakistan					
Textiles and fabrics	242.3	321.1	239.7	-24.5	34.0
% age share	5.5	7.2	6.0		
Textile mill products	690.7	519.4	459.4	33.0	13.1
% age share	9.1	7.9	8.2		
Apparel and accessories	709.9	667.6	610.8	6.3	9.3
% age share	1.7	1.7	1.6		
China					
Textiles and fabrics	549.3	397.9	313.9	38.0	26.8
% age share	12.4	9.0	7.79		
Textile mill products	3,099.4	2,440.2	1,850.0	27.0	31.9
% age share	40.7	36.9	33.1		
Apparel and accessories	1,1345.7	6,826.1	5,879.4	66.2	16.1
% age share	27.0	17.7	15.5		
India					
Textiles and fabrics	171.3	158.0	146.3	8.4	8.0
% age share	3.9	3.6	3.6		
Textile mill products	948.9	813.2	678.5	16.7	19.9
% age share	12.5	12.3	12.1		
Apparel and accessories	1,870.8	1,411.2	1,410.8	32.6	0.03
% age share	4.5	3.7	3.7		

Source: US Census Bureau

Figure 7.29: Quota Phase Out Schedule of the US



Source: Samar Verm (2001), "WTO Agreement on Textile and Clothing: Impact on Indian Textile & Clothing Industry" published in "WTO and the Indian Economy" edited by G. K. Chadda in 2001 in association with Indian Economic Association

apparel & accessories.

Thus, while Pakistan's exports posted strong growth in *textile mill products*, China and India focused on *apparel & accessories* after January 1, 2005. In order to understand how much of this improved export performance is linked to removal of quota, we need to examine the quota liberalization schedule of the US. As evident in **Figure 7.29**, around 64 percent of the textile quotas that were to be removed in the final stage belonged to the *apparel* category. Unfortunately, Pakistan's performance in the *apparel* does not compare well with its competitors, particularly China and India – both increased their market share in this category. Furthermore, around 25 percent of the quota removed in the final stage falls under the category of *fabrics*, where Pakistan's exports fell by 24.5 percent during Jan-Jul 2005. Thus, Pakistan may be at risk in losing its market share in the US for *textile and fabrics* in post-MFA regime, suggesting that exports under this category were largely protected by quotas, and therefore competitive pressures in 2005 led to a sharp fall in exports under this category. Interestingly most of the *textile mill products*, where Pakistan performed strongly, had already been liberalized before 2005. This indicates that Pakistan has strong competitive advantage in *textile mill products* and the removal of quota allowed Pakistan to expand its exports under this category.

Table 7.22: Pakistan's Textiles Exports to USA (Jan-Jul)

Description	million US dollar CY05	CY04	YoY % Growth	Description	million US dollar CY05	CY04	YoY % Growth
NAICS Category 313				Hosiery and socks	43.46	35.83	21.3
Non woven fabrics	0.03	0.03	28	Women's/girls' lingerie, loungewear,	30.65	26.85	14.2
Narrow fabrics	0.2	0.21	-3.4	and nightwear			
Knit fabrics and lace	1.34	1.56	-14.1	Men's/boys' underwear & nightwear	26.04	22.9	13.7
Yarns	68.11	84.11	-19	Men's/boys' trousers, slacks, & jeans	50.37	44.42	13.4
Broad woven fabrics	171.18	232.92	-26.5	Men's/boys' suits, coat, & overcoats	0.98	0.87	11.9
Coated fabrics	1.47	2.24	-34.3	Women's and girls' suits, coats,			
NAICS Category 314				tailored jackets, and skirts	19.7	18.51	6.4
Ropes, cordage, and twine	0.55	0.29	94	Men's/boys' shirts (except work shirt)	289.57	272.67	6.2
Textile sacks and bags	0.91	0.47	92.6	Women's and girls' blouses and shirts	59.1	60.78	-2.8
Other household textile products	565.29	409.28	38.1	Women's and girls' dresses	9.34	10.13	-7.8
Carpets and rugs	70.94	60.1	18	Other apparel accessories	8.26	9.12	-9.5
Other miscellaneous textile products	21.21	19.11	11	Infants' apparel	3.11	3.53	-12
Curtains and draperies	31.59	29.73	6.2	Fur and leather apparel	20.53	25.33	-18.9
Canvas and related products	0.24	0.43	-43.3	Men's and boys' other outerwear	52.42	67.11	-21.9
NAICS Category 315				Hats and cap	0.68	1.09	-37.9
Women's and girls' other outerwear	67.01	47.74	40.4	Men's & boys neckwear	0	0.01	-60
Gloves & mittens	28.73	20.75	38.5	**Total**	**1,642.99**	**1,508.12**	**8.9**

Table 7.22 provides further detail of US imports on textile and clothing from Pakistan. It is evident that under *textile and fabrics*, import of broad woven fabrics from Pakistan posted a sharp YoY decline of 26.5 percent during Jan-Jul 2005. In apparel & accessories, Pakistan's performance is reasonable in most major categories. However, exports in a few categories (e.g., *women's & girls' blouses & shirts; men's & boys' other outerwear; and fur & leather apparel*) posted considerable declines. Although these results are highly tentative as they are based on the first seven months of post-MFA period but they are useful so far as they point to the direction in which our exporters have to strive to capture the market share or avoid loss in the future.

Other manufactures

A positive development for Pakistan is the strong growth in categories other than textile manufactures, which in turn helped in neutralizing the relatively slower growth of the textile exports, particularly in the first half of FY05.

In this regard, *other manufactures* showed an astonishing growth of 33.7 percent during FY05 compared to just 4.7 percent increased witnessed in the previous year. The rise in this category contributed around 32.8 percent in total export growth. Major categories that showed sharp rise were *petroleum & petroleum products, chemical & pharmaceuticals, leather manufactures, carpets, carpeting rugs & mats, surgical & medical instruments,* and *molasses.*

Table 7.23: Other Exports
million US dollar

	FY05	FY04	% YoY growth
Total 'Other' exports	**1,884.4**	**1,189.1**	**58.5**
Of which			
Textile	260.54	58.46	345.7
Machinery & transport equipments	181.79	99.99	81.8
Foot wears	137.71	88.79	55.1
Wheat flour	91.13	43.17	111.1
Articles of plastic	111.50	33.45	233.3
Household equipments	16.63	11.18	48.7
Furniture	13.13	10.33	27.2
Other items	883.22	659.37	33.9

The increased export quantum of *petroleum & petroleum products* was supported by higher unit values thereby leading to sharp rise of 68.3 percent during FY05 on the top of 18.5 percent growth realized in the preceding year. It appears that chemicals and pharmaceuticals are beginning to emerge as a new export category of significance. In the last few years, starting from almost a modest level, this category has become the third largest non-textile manufactured exports of Pakistan. The export of *chemical & pharmaceutical* showed a remarkable recovery by posting 72.1 percent growth during FY05. Export of surgical & medical instrument recovered, recording 37.8 percent growth after falling by 11.6 percent in FY04.

Other exports

Other exports have been consistent in their high performance; rising by 57.7 percent during FY05 following 26.9 percent YoY increase in FY04 (see **Table 7.23**). The rise in this category makes a contribution of 44.6 percent in total exports. *Other exports* include some textile items as well, such as, *cotton thread, textile fabrics woven other than cotton and artificial fabrics, and knitted or crocheted fabrics*). As evident from **Table 7.24**, latter two textile products have shown considerable rise during FY05. The growth in *other exports* is quite robust as excluding textile items, *other exports* increased by 30.2 percent during FY05.

Table 7.24: Other Textile Exports
million US dollar

	FY05	FY04
Textile	260.54	58.47
Cotton thread	0.95	0.30
Textile fabrics woven (other than cotton & artificial fabrics)	73.53	3.24
Knitted or crocheted fabrics	186.07	54.93

It is interesting to note that the number of items exported in the recent years has shown a remarkable upsurge at the same time when the value of some established categories is growing rapidly after long stagnation. The fastest growing exports in this category are machinery and transport equipment, plastic goods and household equipments. Wheat flour exports are an exception as they fluctuate widely depending on the availability of surpluses from the wheat crop.

7.4.2 Imports

Table 7.25 Imports Supporting Indicators

	FY03	FY04	FY05
GDP growth rate (%)	4.8	6.4	8.4
Textile growth (%)	3.6	6.5	24.7
Arabian light (%) increase in price		8.0	36.3
Private sector credit growth (%)	17.7	25.5	25.2
REER App (+)/Dep (-)	-1.6	0.3	3.7

* Real effective exchange rate (REER) indices depict real appreciation/ depreciation of the Pak Rupee against trading partners' currencies.

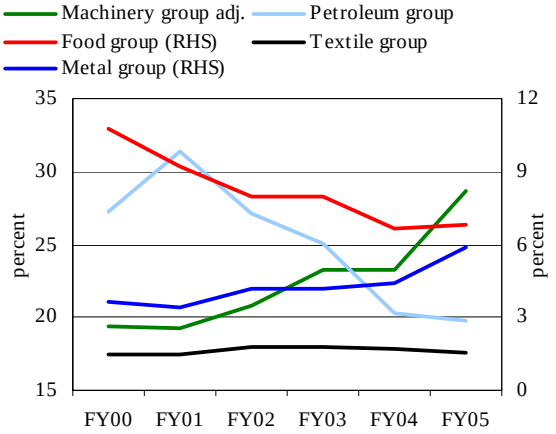
The continued increase in domestic demand for machinery and raw material needed for the fast growing economy, exceptionally higher oil prices in the international market, substantial food imports to improve their domestic availability and the cumulative impact of gradual reduction in tariff rates and import liberalization were the key factors putting severe pressure on Pakistan's import bill (see **Table 7.25**). Consequently, import increased by 32.1 percent to reach US$ 20.598 billion during FY05 markedly higher than the annual target of US$ 16.7 billion and import growth of 27.6 percent during FY04.

Table 7.26: Economic Classification of Imports
value in million US$; share and growth in percent

	FY04			FY05		
	Value	share	YoY growth	Value	share	YoY growth
Consumer goods	1,439.2	9.2	16.6	2,064.2	10.0	43.4
Raw material for consumer goods	7,669.7	49.2	18.0	9,387.5	45.6	22.4
Raw material for capital goods	995.3	6.4	41.2	1,713.2	8.3	72.1
Capital goods	5,487.5	35.2	45.1	7,433.2	36.1	35.5
Total	**15,592**		**27.6**	**20,598**		**32.1**

As far as the impact of broad-based economic activity on import growth is concerned, the empirical evidence suggests relatively higher elasticity of imports with respect to income for Pakistan (see **Box 7.6**). This implies that higher income leads to more demand for imports. At the same time, import of raw material and machinery provides necessary impetus to economic growth. This relationship is particularly evident in automobiles, telecommunication and textile sectors where strong growth in FY05 is well reflected in higher imports. For example, impact of the substantial rise in value addition in the textile industry during FY05 is evident in higher imports of textile machinery, organic chemicals, dyeing tanning & color material and other raw material.

Figure 7.30: Share of Major Categories in Total Imports



Machinery group has been adjusted for the import of dredgers and aircrafts in FY04

The extraordinary rise in oil prices in the international markets also led to substantial surge in import bill during FY05. Out of the total increase in oil imports, around 92.8 percent is explained by higher prices. The rise in import quantum of petroleum products reflects increased consumption of furnace oil due to more reliance on thermal power generation.

In order to alleviate price pressure on domestic food items, the government allowed import of sugar and wheat[43] so that the domestic availability of these key food items could be improved (see **Figure 7.31**). Consequently the food group contribution to total imports growth has increased to 7.7 percent during FY05 from 1.6 percent during FY04. However, the share of the food group in total imports remained unchanged during FY05 from the preceding year.

[43] The government not only permitted duty free imports of refined and raw sugar with effect from February 2005, but also lifted a four-year old ban on sugar import from India. Furthermore, the government allowed private sector to import wheat.

Table 7.27: Major Imports

value: million US Dollar; Unit value: US Dollar

			FY04		FY05		Absolute	Change in percent		
		Unit	Value	Unit value	Value	Unit value	Δin value	Qty	Value	Unit value
A.	**Food group**	**---**	**1,033.3**	**---**	**1408.8**		**375.5**	**---**	**36.3**	**---**
1.	Milk &cream incl. milk food for infants	MT	21.3	1,936.5	34.2	2000.0	12.9	55.5	60.6	3.3
2.	Wheat unmilled	MT	23.6	218.6	93.0	217.9	69.4	295.2	293.9	-0.3
3.	Dry fruits	MT	18.3	277.2	43.6	575.5	25.3	14.5	137.8	107.6
4.	Tea	MT	192.5	1,660.1	222.6	1653.3	30.0	16.1	15.6	-0.4
5.	Spices	MT	40.8	566.5	47.4	764.8	6.6	-14.0	16.2	35.0
6.	Edible oil	MT	658.6	484.0	757.7	472.2	99.1	17.9	15.0	-2.4
	Soyabean	MT	*45.6*	*564.8*	54.5	743.5	8.9	-9.2	19.6	31.6
	Palm oil	MT	*613.0*	*478.9*	703.2	459.2	90.2	19.6	14.7	-4.1
7.	Sugar	MT	3.3	287.2	87.9	365.0	84.6	2012.4	2584.7	27.1
8.	Pulses	MT	74.9	286.4	122.5	327.5	47.6	43.1	63.6	14.3
B.	**Machinery group**	**---**	**4,220.4**	**---**	**5918.2**	**---**	**1697.8**	**---**	40.2	**---**
1.	Power generating machinery	---	277.8	---	392.6	---	114.8	---	41.3	---
2.	Office machinery	---	209.5	---	273.5	---	64.1	---	30.6	---
3.	Textile machinery	---	598.0	---	928.6	---	330.6	---	55.3	---
4.	Construction & mining machinery	---	101.5	---	140.5	---	39.1	---	38.5	---
5.	Electrical machinery & apparatus	---	258.1	---	355.5	---	97.4	---	37.7	---
6.	Railway vehicles	---	72.5	---	41.1	---	-31.4	---	-43.3	---
7.	Road motor vehicles	---	652.8	---	1068.8	---	416.1	---	63.7	---
8.	Aircraft, ships and boats	---	789.8	---	169.2	---	-620.6	---	-78.6	---
9.	Agricultural machinery & implements	---	37.7	---	73.8	---	36.1	---	95.8	---
10.	Other machinery	---	1,222.8	---	2474.4	---	1251.6	---	102.4	---
C.	**Petroleum group**	**---**	**3,166.6**	**238.0**	**4080.7**	**300.5**	**914.1**	**2.1**	**28.9**	**26.2**
1.	Petroleum products	MT	1,401.4	258.9	1931.9	337.7	530.4	5.7	37.8	30.4
2.	Petroleum crude	MT	1,765.1	223.7	2148.8	273.4	383.7	-0.4	21.7	22.2
D.	**Textile group**	**---**	**260.5**	**---**	**317.2**	**---**	**56.8**	**---**	**21.8**	**---**
1.	Synthetic fibre	MT	106.1	1,485.9	146.9	1806.0	40.7	13.9	38.4	21.5
2.	Synthetic & artificial silk yarn	MT	118.0	1,699.7	130.2	1832.7	12.2	2.3	10.3	7.8
3.	Worn clothing	MT	36.4	323.4	40.2	327.7	3.8	9.1	10.5	1.3
E.	**Agricultural and other chemicals**	**---**	**2,797.7**	**---**	**3604.7**	**---**	**807.0**	**---**	**28.8**	**---**
1.	Fertilizer	MT	284.7	211.2	416.9	252.1	132.2	22.7	46.4	19.3
2.	Insecticides	MT	124.1	2,997.3	139.7	3362.1	15.6	0.4	12.6	12.2
3.	Plastic materials	MT	549.3	907.4	792.9	1160.9	243.6	12.8	44.3	27.9
4.	Medicinal products	MT	274.6	28,965.4	292.3	27716.4	17.7	11.2	6.4	-4.3
5.	Others	---	1,564.9	---	1962.8	---	397.8	---	25.4	---
F.	**Metal group**	**---**	**687.7**	**---**	**1218.3**	**---**	**530.6**	**---**	**77.2**	**---**
1.	Iron and steel scrap	MT	93.6	171.4	222.1	226.7	128.5	79.4	137.2	32.3
2.	Iron and steel	MT	512.0	405.0	890.2	475.7	378.2	48.0	73.9	17.5
3.	Aluminum wrought & worked	---	82.1	---	106.1	---	24.0	---	29.2	---
G.	**Miscellaneous group**	**---**	**378.3**	**---**	**482.9**	**---**	**104.6**	**---**	**27.6**	**---**
1.	Rubber crude	MT	68.2	891.0	86.0	1073.3	17.8	4.6	26.0	20.5
2.	Rubber tyres & tubes	Nos	89.0	21.9	133.8	24.7	44.8	33.3	50.3	12.8
3.	Wood & cork	---	25.8	---	28.9	---	3.1	---	12.2	---
4.	Jute	MT	30.9	273.7	39.0	303.7	8.2	13.9	26.4	11.0
5.	Paper and paperboard & manufactures	MT	164.4	624.1	195.1	649.7	30.7	14.0	18.7	4.1
H.	**Others**	**---**	**3047.3**	**---**	**3567.3**	**---**	**520.0**	---	**17.1**	---
	Total imports:		**15591.8**		**20598.1**		**5006.3**		**32.1**	
	Memorandum item *Total imports excl. Aircrafts and Dredgers*		12220.3		*15016.8*		*2796.6*		22.9	

Source: Federal Bureau of Statistics

Finally, higher domestic inflation compared to the trading partners/competitors during FY05 led to a significant real appreciation of the Pak Rupee. This means that imported goods have become relatively cheaper, thereby leading to a rise in import growth.

The surge in imports stemming from higher imports of machinery and raw material may be desirable due to its positive correlation with the GDP growth rate (see **Figure 7.32**). However, this argument implicitly assumes that the import of raw material and machinery would not only add to the productive capacity of the economy but in turn would translate into higher exports in future or at least substitute potential imports.

Machinery Group

The machinery group with the largest share of 28.73 percent in total imports depicted 40.2 percent growth during FY05 on the top of 43.4 percent rise witnessed during FY04.[44] The growth in machinery import is driven largely by imports of textile machinery; road motor vehicles and other machinery (see **Table 7.29**).

- Road motor vehicles witnessed 63.7 percent growth during FY05 against the growth of 30.2 percent during FY04. The share of road motor vehicles imports (that includes completely built units, completely/semi knocked down kits) in total machinery imports has picked up marginally from 15 percent during FY04 to 18.1 percent during FY05. More importantly, the import of trucks, trailers and tractors (that provide significant support to economic activity) has shown YoY increase of 137 percent during FY05, thereby increasing its share in import of road motor vehicles to 24 percent from 17 percent during the preceding year. However, what is disappointing is the fact that the share of completely/semi knocked down kits in the imports of road motor vehicles group is

Table 7.28: Contribution in Growth by Major Import Groups

	% share in growth	
	FY04	**FY05**
Food group	1.6	7.5
Machinery group	37.9	34.7
Petroleum group	3.0	17.2
Textile group	1.2	1.0
Agricultural & other chemicals group	18.9	15.2
Metal group	5.3	13.7
Miscellaneous group	2.1	1.9
Others	30.0	8.9
Total	100.0	100.0

Source: Federal Bureau of Statistics

Figure 7.31: Sugarcane Production and Sugar Imports

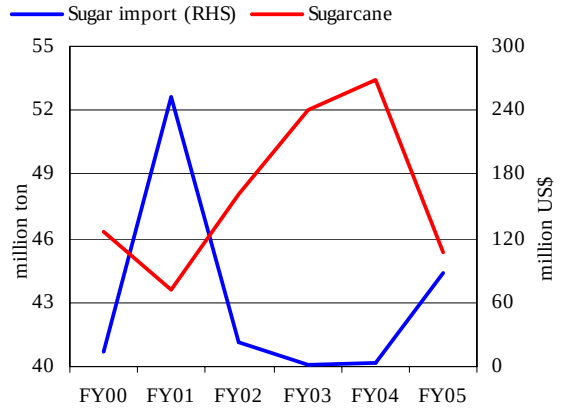
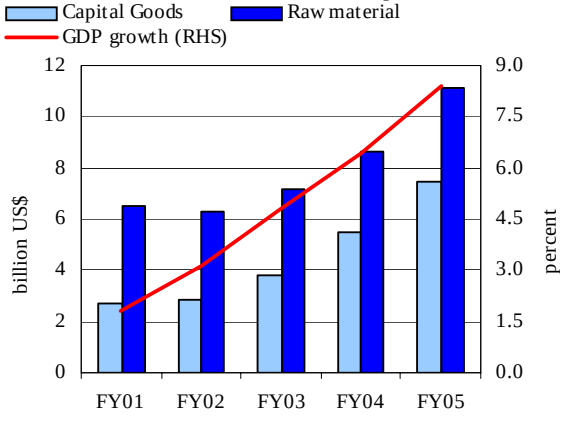


Figure 7.32: GDP Growth and Imports of Capital Goods & Raw Material Imports



[44] If the level of machinery imports is adjusted for the aircraft and dredgers imports worth US$ 600 million during FY04 then total machinery depicted 67.6 percent growth during FY05.

only 31.59 percent.[45] This suggests that of all the imports under road motor vehicles category, only one-third are utilized for assembling in Pakistan (and in turn promoting allied industries); while rest of the imported road motor vehicles are completely built units (CBUs). To put this in perspective, not all imported CBUs are personal vehicles. In fact, of the total CBUs, over 20 percent consisted of tractors, trucks and trailers.

Table 7.29: Analysis of Machinery Imports
value in million US$

	FY-04		FY-05	
	Value	**% change**	**Value**	**% change**
Power generating machinery	278.0	3.5	393.0	41.4
Textile machinery	598.0	12.4	929.0	55.4
Agriculture machinery& equipments	38.0	2.6	74.0	94.7
Telecom & sound recorder	479.9	64.1	1181.4	146.2
Metal working machinery	34.4	66.0	73.4	113.0
Industrial machinery and equipments	480.9	22.1	829.7	72.5
Other machinery	2310.8	78.5	2437.6	5.5
Dredgers& air crafts	789.8	488.8	169.0	-788.4
Road vehicles	653.0	30.4	1069.0	63.7
CKD road vehicles	-	-	337.7	-
CBU road vehicles	-	-	731.3	-
Total machinery imports	**4220.0**	**43.0**	**5918.0**	**40.2**
Machinery imports (Excluding-dredgers, air crafts)	**3430.2**	**26.8**	**5748.8**	**67.6**

- The textile machinery continued to demonstrate a persistent growth path rising by 55.4 percent during FY05, reflecting the impact of balancing, modernization and rehabilitation (BMR) drive to prepare for the increased competition under post-MFA regime. The import of spinning machines increased by US$ 79.33 million followed by US$ 63.83 million increase in weaving machines and US$ 31.70 million increase in other textile winding machines. The source country for the import of spinning machinery witnessed a clear shift from Japan to China probably because of low machinery prices in China. Likewise source of weaving machinery imports have also shifted from Japan to China and Switzerland.

- In addition, a sharp rise was witnessed in imports of telecom[46] & sound recorder group (146.2 percent), metal working machinery (113.0 percent) and general industrial machinery & equipments/parts (72.5 percent). Within telecom & sound recorder group, the major contributor were magnetic tape recorders, electric sound/VIS signal apparatus, reception appliances for TV, microphones and loud speakers.

- Other machinery import recorded substantial growth of 5.5 percent during FY05 against 78.5 percent increase during FY04. The increase in other machinery was mainly driven by office machinery including data processors and electrical machinery& apparatus depicting 30.52 and 37.80 growth during FY-05 respectively.

[45] The import of CKDS/SKDS is part of road motor vehicle machinery, but the FBS allocated separate HS code for the import of CKDS/SKDS since July 2004.
[46] The telecom industry grew by 27.67 percent during FY05 against 14.44 percent growth during FY04.

Petroleum Group

Petroleum group imports recorded 28.9 percent increase to reach US$ 4,080.7 million during FY05 against 3.3 percent increase during FY04. This increase was primarily due to higher import quantum and unit values for both, the petroleum products as well as crude (see **Table 7.30** & **Figure 7.33**). The rise in quantum of petroleum products was primarily caused by higher furnace oil demand reflecting more reliance on thermal power generation during FY05 and higher fuel consumption following a recent increase in the automobile sales in the country.[47]

Table 7.30: Oil Price Impact on Petroleum Group Imports (FY05)

value in million US$; share in percent

	Absolute change	Quantum impact		Price impact	
		value	share	value	share
Petroleum group	914.1	66.0	7.2	848.1	92.8
Petroleum products	530.4	79.9	15.1	450.5	84.9
Petroleum crude	383.7	-7.0	-1.8	390.7	101.8

Box 7.9: Why Oil Prices are High?

The oil prices that have been continually under upward pressure in the international market since mid-2004, crossed US$ 70 per barrel mark on August 29, 2005, representing an increase of around 60 percent over June 2004 prices. This note provides some explanation for this relentless rise in oil prices.

A key reason for rising oil prices is the sharp increase in global oil demand driven by economic growth. According to International Energy Agency, the world demand for oil went up by 3.7 percent during CY04, as compared to an average 1.3 percent annual increase between 1990 and 2003. While United States, OECD Europe and Japan remain major oil consumers, the rising oil demand from China and India made significant contribution to increase in demand. Between 1990 and 2003, oil demand from China and India increased by 7 percent, and these two countries accounted for almost 40 percent of the growth in demand since 1990 [ADB (2005)].

At present the supply of oil roughly matches demand, but the lack of spare crude oil production capacity is increasingly becoming a source of concern since even minor uncertainty in oil supplies can lead to a substantial impact on oil prices. The narrower production buffer even erodes OPEC's ability to prevent the market from overreacting to unexpected supply disturbances. In fact, the spare capacity has reached to 20-year low due to underinvestment in the oil industry following protracted period of low oil prices in the 1990s. The problem is compounded by a mismatch between type of available spare crude production capacity and available refining capacity. Industry reports indicate that recent addition to production has been in heavy sour crude whereas demand from refinery industry is principally for light sweet crude.

It is owing to this lack of spare production capacity that minor supply concerns have major impact on oil prices. For example, political unrest (in Middle East and Venezuela), labor unrest (in Nigeria), and natural disasters (such as hurricane Ivan and Katrina) etc. had led to significant increase in oil prices. In addition, fear of terrorist attack on oil supplies is adding a premium to oil prices to cover the delivery risk of oil contract. This limited spare capacity and supply concerns prompted countries to increase their inventory level as well, further exacerbating pressures on oil prices.

Thus, the rise in oil prices basically reflects tight demand and supply condition, and in response companies are hedging themselves against the impact of higher prices. In this situation, it would be incorrect to term the recent oil price hike as 'purely speculative', particularly when the biggest players involved in hedging against price hike are the commercial oil companies rather than the hedge funds (Leeb 2005).

It is therefore expected that until the new capacity comes on stream, the oil prices would remain high and continue to spike in response to supply concerns.

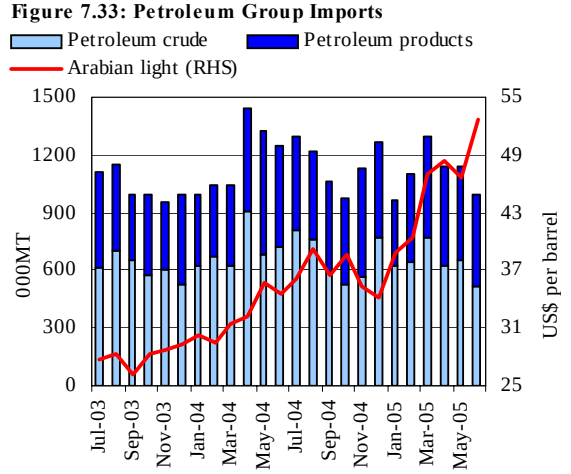
Reference:

Data is taken from "International Energy Agency – Oil Market Report of 11th August 2005.
Leeb Stephan (2005) Energetic Disagreement on oil in *BusinessWeek Online* of 5th July 2005.
Asian Development Outlook 2005 update
"Oil in troubled waters", *The Economist*, April 28, 2005.

[47] The consumption of petroleum product in power generation and transport sector increased by 61 percent and 7.2 percent respectively during Jul-Mar FY05. Moreover, the share of thermal source in total electricity generation by WAPDA increased from 58 percent during Jul-Mar FY04 to 67.3 percent during Jul-Mar FY05.

The increase in petroleum imports is likely to continue in the rising global oil prices (Arabian Light Price climbed to US$ 58 per barrel during August 2005 – see **Box 7.9**) and broad based economic activity.[48]

Figure 7.33: Petroleum Group Imports



Metal Group

The metal group registered an impressive growth of 77.2 percent during FY05 against 35.5 percent growth during FY04. The iron & steel and scrap were the major contributors in the growth of metal group imports, witnessing growth rate of 73.9 percent and 137.2 percent respectively. The growth in iron and steel scraps import may have stemmed from the raw material needed for steel production due to slow down in ship breaking industry in Pakistan, lower production of Pakistan Steel Mills, leading to higher demand by re-rolling mills, while the increase in iron and steel import was caused by higher growth rate of construction industry, automobiles and consumer durables etc.

Agriculture and Other Chemical Group

This group witnessed 28.2 percent growth in FY05 against 29.5 percent growth during FY04. The major contribution to this rise came from plastic materials, fertilizer and other chemicals with growth rate of 44.3 percent, 46.4 percent and 25.4 percent respectively.

Table 7.31: Growth Rate of Other Chemicals

percent

	FY04	FY05
Organic chemicals	30.60	25.50
Inorganic chemicals	82.90	40.13
Dyeing tanning & color material.	9.50	16.83
Essential oil, perfumes toiletries etc	24.21	19.25
Other chemicals products	7.20	24.57

- The growth in import of fertilizer is explained by high demand arising from increased agriculture credit, improved farm income, improved water availability; and slowdown in fertilizer production following disruption in gas supply from Sui.[49]

- The plastic materials imports increased by US$ 243.6 million during FY05. However, the increase in export of articles of plastic worth US$ 78.04 million offset some of the increase in plastic material import.

- Within *other chemicals*, the organic chemicals and dyeing, tanning and color materials showed higher growth during FY05 as compared to the preceding year, primarily because these chemicals are used as inputs in the leather and textile industries, both of which depicted impressive growth during FY05 (see **Table 7.31**).

[48] In the case of oil prices, higher oil demand and the lack of spare crude oil production capacity are the key reasons for continuing pressures on oil prices. Thus, until the new capacity comes on stream, the oil prices would remain high and continue to spike in response to unexpected supply concerns. Since the import of *crude oil and petroleum products* has significant share in overall imports, higher oil prices are likely to keep the trade account under pressure. Moreover, to the extent the persistently rising oil prices are affecting the global aggregate demand, higher oil prices would hurt country's exports. Thus, the trade imbalance may persist for undesirably longer period.

[49] The fertilizer industry capacity utilization during FY05 was 105 percent against 101 percent during FY-04 and 93 percent during FY-03.

To sum up, import demand expansion in Pakistan in the last few years has indeed widened trade deficit. Countries in East Asia and China have demonstrated that the secular increase in imports has been accompanied pari passu with higher exports. The ease with which inputs, raw material, components and equipment can enter the country and the prices at which they can be procured (lower tariffs) do make a substantial difference inter alia to the growth of exports. Pakistan's own limited experience shows that as restrictions on imports have been eased and the average tariff rates have been reduced, the recovery of exports has been quite strong – almost doubling in US$ terms over a six year period. Of course, the macroeconomic variables have to remain supportive. Empirical studies of long term elasticities also show that the trade deficit is likely to narrow over time as the short term elasticities converges towards their long term coefficients.

Special Section 7.1: International Investment Position (IIP) Framework and Methodology

As discussed in **Box 7.4**, IMF defines the procedures for dissemination of BOP statistics and related data on International Investment Position (IIP). In this regard, though the 4th edition of the Balance of Payments Manual published in 1977 has defined the IIP, it did not provide the standard components and framework. The IMF, for the first time, addressed IIP statistics under its Special Data Dissemination Standard (SDDS) in 1993.

The IIP shows the stock of economy's external financial assets and liabilities as per standard classification recommended by IMF. In this classification, the financial assets and liabilities are grouped according to the functional type (direct investment, portfolio investment, financial derivates, other investments and reserve assets) and on a sectoral basis (general government, monetary authorities, banks and other sectors). The IIP shows the cumulative outcome of all flows resulting from the trade and financial transactions made by residents and non-residents, at their market value. It also tracks changes in values resulting from capital gains and losses due to exchange rate fluctuations, price changes and other changes such as write off, reclassifications etc.

Following the Asian financial crisis of 1997-98, the IIP has particularly been focus of attention in assessing the impact of policies on the composition of capital flows and the vulnerability of the economy (through analyzing the currency wise breakup of external assets and liabilities). It can also be used as one of the important indicators to measure the degree of financial openness. Moreover, it not only provides the information for the central bank to estimate the affects of external account imbalances but also the impact of any domestic as well as foreign shocks on stock value of external assets and liabilities.

Box 7.1.1: Problems in the Compilation of IIP
Although IMF provides guidelines, countries still encounter problems in compiling the IIP statements. While information on monetary authorities and banking sector are available from the balance sheet, and annual stock data of general government can also be collected easily, collecting other data can be a problem. Statisticians use specific forms to collect other sector data for inclusion in the IIP; different surveys relating to assets or liabilities are conducted, such as for direct investment and portfolio investment[1]. In appropriate or incomplete response in particular are significant some of discrepancies with in IPP data set.

Not surprisingly, an increasing number of countries now prepare the IIP. Despite the problems faced in IIP compilation (see **Box 7.1.1**), the Statistics Department of the State Bank of Pakistan has started compiling IIP from December 2003 onward on annual basis. The main features and linkages of IIP with other sectors of the economy are highlighted below:

Relationship with BOP and External debt
The transactions recorded in IIP are closely linked to that of the BOP flows. Although there is no direct relationship between BOP transactions and the IIP (other than those recorded in the financial account or as investment income), an indirect relationship does exist as due to double entry accounting system, each transaction outside the financial account has an offsetting entry in the financial account.

In the current account, investment income reflects the income accruing on an external financial assets and liabilities. In general, the greater the stock of financial assets, the greater would be the investment income accruing on these external claims and vice versa. Thus, investment income data together with the stock composition of investment shown in IIP can provide meaningful information to assess the return on external claims. Thus, to an extent the transactions in current account having an offsetting entry in financial account, it would effect the IIP statement.[50]

[50] The increase in foreign exchange reserves may be as a result of exports of goods and services.

As far as the financial account of BOP is concerned, it comprises of financial transactions of assets and liabilities with the rest of the world during the period, while IIP shows the stock of previous transactions with nonresidents at a particular point in time. Any transaction in assets and liabilities, among other factors, affects the stock of these assets and liabilities. Thus, together, the balance of payments transactions and the international investment position constitute the set of international accounts for an economy. The relationship between IIP and BOP is shown in **Table 7.1.1**. As it is clear from the **Table 7.1.1** that IIP statement consists of the stock at the end of the previous period adjusted by the BOP flows, valuation (price and exchange rate changes) and other adjustments that occurred during the period.

Moreover, IIP statement also reflects the outstanding position of the country's gross external debt stock at a specific period. The gross external debt of a country is defined as the sum of non-equity liability component in the IIP statement of an economy. Thus, the non-equity liability of the IIP is the same as the aggregate value of gross external debt.

Table 7.1.1: Relationship between the International Investment Position and the Balance of Payments

	Current Account				
	Capital Account				
		Other Changes in Position			
Position at the beginning of the period	**Financial Account**	**Price Changes**	**Exchange rate Changes**	**Other Adjustment**	**Position at the end of the period**
Assets	**Assets**				**Assets**
Direct Investment abroad	Direct Investment abroad	√	√	√	Direct Investment abroad
Portfolio Investment	Portfolio Investment	√	√	√	Portfolio Investment
Financial Derivatives	Financial Derivatives	√	√	√	Financial Derivatives
Other Investment	Other Investment	√	√	√	Other Investment
Reserves Assets	Reserves Assets	√	√	√	Reserves Assets
Liabilities	**Liabilities**				**Liabilities**
Direct Investment in reporting economy	Direct Investment in reporting economy	√	√	√	Direct Investment in reporting economy
Portfolio Investment	Portfolio Investment	√	√	√	Portfolio Investment
Financial Derivatives	Financial Derivatives	√	√	√	Financial Derivatives
Other Investment	Other Investment	√	√	√	Other Investment
Net International Investment Position					**Net International Investment Position**

Source: IMF – IIP (A Guide to Data Sources)

Table 7.1.2 reflects the summary of IIP statistics for the period end-December 2003 to end-December 2004. The composition of net IIP of Pakistan largely consists of foreign exchange liabilities. Of the gross foreign liabilities, loans are the dominant component, and other liabilities such as foreign direct investment and portfolio investment are relatively small (see **Table 7.1.2**). On the other hand, the gross country's' assets were mainly comprised of foreign exchange assets of SBP, FE-25 Nostro deposits of commercial banks and Outstanding export bills.

The end December-04 position indicates an increase in net foreign liabilities of US$ 773 million over December-03 primarily due to a sharp rise in foreign direct investment, followed by the portfolio investment and loans (see **Table 7.1.2**). The value of gross foreign liabilities to assets may be compared to assess a short-term financial crisis (liquidity crunch) or a long-term financial crisis (solvency crisis). The change in net foreign liabilities can be disaggregated as follows:

The net direct investment[51] (NDI), non-liquid part of the IIP, increase by US$ 1billion mainly due to direct investment in Pakistan. On the other hand, the net liabilities on securities posted a rise of US$ 360 million. This change is largely due to the net sale of debt securities to non-residents. Similarly, the ratio of financial openness[52] at end December 03 was 72 percent of GDP, fell to 66 percent of GDP at end December 04 as a result of the overwhelming flows of direct and portfolio investment.

The net other investment dwindled to US$ 30.6 billion primarily due to a substantial jump in currency and deposits assets, of which a large portion comprises of FE-25 Nostro deposits of commercial banks. Of the increase of US$ 1.3 billion in currency and deposits assets mainly reflects the net change in flows (US$ 957 million).

Relationship with Exchange Rate

Theoretically, there is a bi-directional relationship between the net IIP and the real exchange rate movement. In the long-run the net IIP impacts the real exchange rate via current account balance. Assuming a surplus in the current account, the net stock of external assets leads to real appreciation of exchange rate through higher interest income accruing on these assets. On the other hand, net external liability causes higher interest payments, which must be financed by a trade surplus.

Table 7.1.2: International Investment Position

million US Dollar

	End-Dec 03	End-Dec-04	Absolute change
A. Assets	**16,046**	**16,995**	**949**
1. Direct investment abroad	*638*	*731*	*93*
1.1 Equity capital and reinvested earnings	630	691	61
1.2 Other capital	8	40	32
2. Portfolio investment	*72*	*117*	*45*
2.1 Equity securities	61	106	45
2.2 Debt securities	11	11	0
3. Other investment	*3,676*	*5,324*	*1,648*
3.1 Trade credits	1,692	1,957	265
3.2 Loans	80	83	3
3.3 Currency and deposits	1,017	2,284	1,267
3.4 Other assets	887	1,000	113
4. Reserve assets	*11,660*	*10,823*	*-837*
4.1 Monetary gold	860	904	44
4.2 Special drawing rights	246	243	-3
4.3 Foreign exchange	10,779	9,570	-1209
4.4 Other claims	-225	106	331
B. Liabilities	**44,304**	**46,026**	**1,722**
1. Direct investment in Pakistan	*7,083*	*8,218*	*1,135*
1.1 Equity capital and reinvested earnings	5,460	6,579	1,119
1.2 Other capital	1,623	1,639	16
2. Portfolio investment	*1,400*	*1,805*	*405*
2.1 Equity securities	435	638	203
2.2 Debt securities	965	1,167	202
3. Other investment	*35,821*	*36,003*	*182*
3.1 Loans	33,828	34,161	333
3.2 Currency and deposits	1,159	1,165	6
3.3 Other liabilities	834	677	-157
Net external liability (B-A)	**28,258**	**29,031**	**773**
Net external liability (as percent of GDP)	**33.86**	**30.52**	

Exchange rate fluctuations also affect the net IIP via changes in the value of external assets and liabilities denominated in foreign currency. In addition, any market expectation of domestic depreciation of local currency may influence the decision of economic agents to increase their holding of assets denominated in foreign currency.

[51] Net direct investment includes only equity capital and reinvested earning, however, the transactions such as loans and deposits should be excluded from net direct investment.

[52] This ratio is defined as the ratio of stock of external assets and liabilities to gross domestic products.

Special Section 7.2: Capital Account Convertibility

It is often argued that free international capital mobility may increase the aggregate growth and then welfare by facilitating the efficient allocation of investment irrespective of political boundaries.[53] Furthermore, as developing countries need external capital to sustain an excess of investment over domestic saving, an open capital account could attract larger foreign capital. In this backdrop, with the support from the International Monetary Fund (IMF), a number of countries started to adopt the capital account convertibility in the first half of 1990s.

However, following the East Asian crisis in 1997, the debate on capital account convertibility took a new turn, when policy makers started exploring the desirability of capital controls to mitigate volatility in the international capital markets. In this regard, the following arguments are presented:

1. The capital account convertibility is very different from current account convertibility; if the international trade of goods & services is beneficial, this does not mean that the trade of financial assets would also be beneficial (Rodrick 1998). While the markets of goods & services work with a certain degree of efficiency and predictable even if they are not perfect, the financial markets are unpredictable and may fail due to the asymmetric information and incompleteness of dependent markets.

2. The critics on capital account convertibility have also argued that the theoretical efficiency gains from capital account openness are often not realized in practice (Rodrick 1998).

3. It is also claimed that the capital does not always flow from surplus to deficit region or from least productive to most productive uses. In fact, capital flows mostly to areas where it makes the most profit (where markets are large, technology available and human capital highly skilled); and that is not necessarily where it benefits the most people (Legum, 2002).

Table:7.2.1 Capital Account Transactions

Capital Transactions	No of Countries	Australia	China	Iceland	Poland	Turkey	U.S.	Finland	Korea	Norway	Sweden
Controls on……											
Capital market securities	126	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Money market securities	105	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Collective investment securities	96	Yes	Yes	Yes	No	Yes	No	No	Yes	No	No
Derivative instruments	79	Yes	Yes	Yes	No	no	No	No	Yes	No	No
Liquidation of direct investment	56	No	No	Yes	No	No	No	No	No	No	No
Commercial credits	98	Yes	Yes	No	Yes	Yes	No	No	Yes	No	No
Financial credits	109	Yes	Yes	No	Yes	Yes	No	No	Yes	No	No
Financial backup facilities	89	No	Yes	No	Yes	No	No	No	Yes	No	No
Direct investment	143	yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Real estates transaction	136	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Personal capital movements	95	Yes	Yes	No	Yes	Yes	No	No	Yes	No	No

Source: IMF Annual Report on Exchange Arrangements and Restrictions 2004

A review of capital account status reveals that more than half of the countries in the world still retain significant restrictions on their capital accounts (**Table 7.2.1**). Even the developed countries like USA, UK and Australia have restriction on some of its capital account transactions. China which is

[53] Efficiency implies that the price already reflects the available information. Thus, in the presence of efficient markets, the players try to acquire the best available information and this will lead to optimizing behaviors.

showing continual high growth performance also maintains restriction on its capital account. Thus, it can be argued that the capital account convertibility is not a necessary condition for better economic performance.

An analysis of (selected) developing country experiences with capital account convertibility suggests that most of these countries witnessed low growth in the liberalization phase (see **Table 7.2.2**).[54] Only Bolivia, Togo and Indonesia showed improved growth rate, but even this performance cannot be attributed to capital account convertibility. In overall terms, the correlation between the openness of the capital account and better economic performance cannot be explained from the data. Furthermore, with the exception of Malaysia, Hong Kong, Indonesia, and Panama, all countries reintroduced controls on their capital transactions.

Table 7.2.2: Economic Performance Pre - and Post Convertibility

GDP growth in percent

	Periods of Convertibility	Pre-convertibility	After-convertibility
Argentina	1994-2001	1.07	0.004
Bolivia	1987-1993	-2.63	1.20
	2001-2004		
Costa Rica	1973-1974	3.11	-4.33
	1981-1982		
	1996-2004		
Ecuador	1973-1993	1.76	1.47
Gambia	1992-2004	-0.25	-0.36
Guatemala	1974-1980	2.85	0.52
	1990-2004		
Honduras	1973-1980	1.87	0.78
Hong Kong	1973-2004	6.93	4.44
Indonesia	1983-2004	2.47	4.04
Iran	1975-1978	-2.73	0.72
Liberia	1973-1984	2.41	-10.76
Malaysia	1974-2004	4.22	3.84
Mexico	1972-1982	3.46	2.58
Nicaragua	1973-1978	2.14	-3.17
Niger	1996-1998	-1.00	0.39
Panama	1973-2004	4.30	1.14
Paraguay	1983-1984	4.07	-0.36
Peru	1977-1987	1.92	0.13
	1994-2004		
Singapore	1979-2004	8.01	4.52
Togo	1995-1995	-1.44	1.27
Uruguay	1979-1993	2.57	0.45
Yemen	1973-1990		1.63

These findings indicate that there are some pre-requisites for capital account liberalization which had been lacking in most the developing countries undergoing capital account liberalization. In contrast, developed countries moved to the convertibility in a more phased manner. These countries maintained restrictions on transactions relating to short term or medium term debt flows.[55]

Thus, the key issue is to define the pre-requisites for capital account liberalization. In this regard, a gradual approach to opening up the capital account has been the most emphasized in economic literature along with the need for a stable macroeconomic environment. The macroeconomic stability includes low fiscal deficit, stable inflation, appropriate foreign exchange reserves, stability of its currency, and stable GDP growth rate. Moreover, the prudent norms of behavior and an effective mechanism for regulation of the banking and financial sector needs to be in place before the country could move towards liberalization of the capital account.

[54] This data is collected from the IMF's annual reports on exchange arrangements and exchange restriction (AREAER).

[55] According to *AREAE*R, these transactions are defined as: (1) Capital Market Transactions: shares and securities of participating nature and other securities with an original maturity of one year or more than one year. (2) Money Market Transaction: Securities and other instruments with an original maturity of less than one year. (3) Direct Investment: These investments are essentially for the purpose of producing goods and services, and, in particular, investments that allows investor participation in the managements of the enterprise. (4) Real Estate Transactions: acquisition of real estate not associated with direct investment.

Special Section 7.3: Regional Trade Integration: the Case of SAFTA

On January 1, 2006, South Asian Free Trade Agreement (SAFTA) will come into effect, and it is expected that the consequent significant reduction in tariffs and the removal of non-trade barriers (NTBs) would generate substantial trade in the region. However, in view of the very slow pace of regional integration in South Asia so far, there are some doubts on the realization of potential benefits from SAFTA. In this background, this section reviews recent trends in intra-regional trade in South Asia and provides some explanations as to why the South Asia has lagged behind in the process of regional integration. In addition, this note highlights the potential benefits from SAFTA.

Introduction

South Asian Association of Regional Cooperation (SAARC) was formed in 1985 to foster economic, social and political ties. In this course, a major milestone was achieved in 1995 when the South Asian Preferential Trade Agreement (SAPTA) came into existence to harness trade gains from concessional tariffs in the region. In 2004, countries signed a framework to transform the SAPTA in two year period into South Asian Free Trade Agreement (SAFTA), envisaging zero customs duty on the trade of practically all products in the region by end 2013.

Table 7.3.1: Planned Phase Tariff Cuts on Intra-SAFTA Trade

First phase		Second phase	
For LDCs Jan 1, 2006 – Jan 1, 2008	**For Non-LDCs Jan 1, 2006 – Jan 1, 2008**	**For LDCs Jan 1, 2008 – Jan 1, 2013**	**For Non-LDCs Jan 1, 2008 – Jan 1, 2016**
Reduce maximum tariff to 30%	Reduce maximum tariff to 20%	Reduce tariffs to the 0-5% range in 8 years (Equal annual reductions recommended, but not less than 10%)	• Reduce tariffs to the 0-5% range in 5 years (Sri Lanka in 6 years). It is recommended that reduction be done in equal installments – at least 15 percent reduction each year). • Reduce tariffs to the 0-5% range for products of the LDCs within a timeframe of 3 years

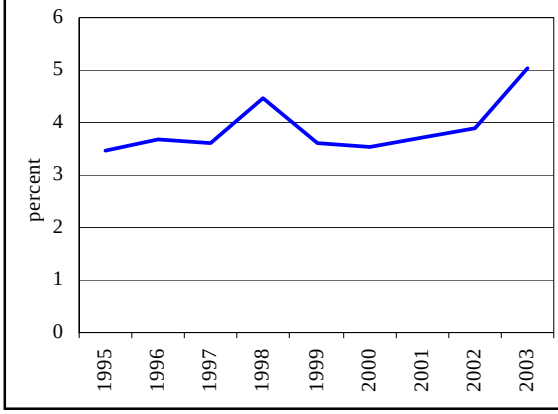
Note: The phased tariff cuts for intra-SAFTA trade may not apply to items on each country's 'sensitive list'.

LDCs are Bangladesh, Nepal, Bhutan, Maldives, whereas non-LDCs are India, Pakistan, and Sri Lanka.

Source: Trade Policies In South Asia: An Overview (2004), Report by the World Bank, p. 138

Specifically, SAFTA requires the developing countries in South Asia (India, Pakistan and Sri Lanka) to bring their duties down to 20 percent by the end of 2007. In the second phase by 2015, the 20 percent duty is to be reduced to 0-5 percent in a series of annual cuts. The least developing countries of the group (Nepal, Bhutan, Bangladesh and Maldives) will reach 0-5 percent duty by 2016 (see **Table 7.3.1**). However, there is a risk that the effective duty cuts may not realized as SAFTA allows member countries to notify the list of sensitive commodities on which phased tariff cuts would not apply.

Figure 7.3.1: Intra-SAARC Trade as Percent of SAARC Trade



Trade trends in South Asia

A cursory look at SAARC trade performance reveals that intra-regional trade has posted an annual average growth of 14.5 percent during 1995-2003 which is more than the 9.2 percent growth of total SAARC trade with rest of the world (see **Table 7.3.2**). What is however disappointing is the fact that intra-regional trade as a percent of total SAARC trade has increased only marginally during this period (see **Figure 7.3.1**). Moreover, even this marginal increase in intra-regional trade cannot be

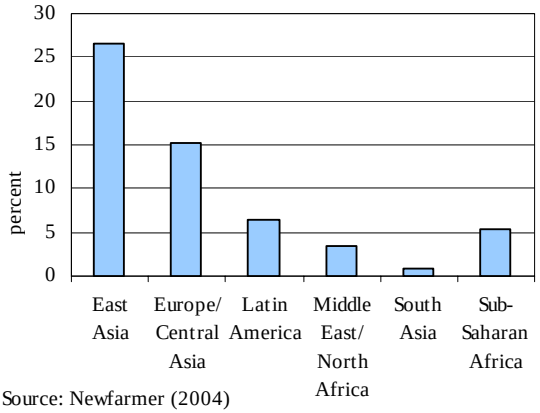
entirely attributed to tariff concessions made under the SAPTA as countries is this group were also experiencing trade liberalization under WTO and bilateral trade agreements.[56]

The intra-regional trade as percent of SAARC GDP was only 0.8 percent in 2002, making this the least integrated region in the world (see **Figure 7.3.2**). The economic literature offers various explanations for such a low economic cooperation in this region.

1. It is argued that the tariff reduction under SAPTA was not adequate as a wide range of goods were not covered under preferential tariff arrangements and particularly some of the actively traded goods were excluded from SAPTA. While quantifying the extent of trade liberalization during 1995-2002, Mukherji (2000) found that most of the tariff concessions were offered in sectors with low trade intensity.[57] Thus, while the number of concessional products increased, their impact on import value coverage was very limited.[58] The study further found that only few of the products in which potential trade[59] was substantial (with India as the market and Pakistan as the supplier) were included in the SAPTA concessions.

2. Newfarmer (2004) identifies relatively high trade tariff in South Asia as one of the major explanations for low integration. Even if countries in the South Asia region have been reducing tariff barriers, these tariffs are still higher than in other regions of the world (see **Figure 7.3.3**). This suggests that South Asian countries charge each other more for market access than any other region

Figure 7.3.2: Intra-regional Trade as Percent of GDP, 2002



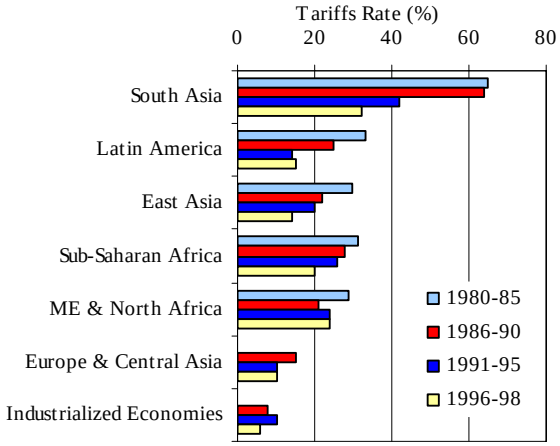
Source: Newfarmer (2004)

Table 7.3.2: Trade Performance of SAARC Region
CAGR in percent

	SAARC world trade	Intra-SAARC trade
1990-95	8.7	16.3
1995-03	9.2	14.5

Source: COMTRADE

Figure 7.3.3: Average Tariffs Rate Across Regions



Source: The World Bank (2004)

[56] Indo-Lanka BFTA in 1998, Indo-Nepal 1996, sub regional initiatives Growth Quadrangles (Bangladesh, Bhutan, Nepal and India), and another sub regional agreement between Sri Lanka, Maldives and South India were signed. While other wider trade agreements such as Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation (BIMSTEC), were also signed mainly to promote sectoral trade.

[57] Trade intensive sectors are those sectors (at a two digit level of classification) that accounted for 5 percent or more of all bilateral imports.

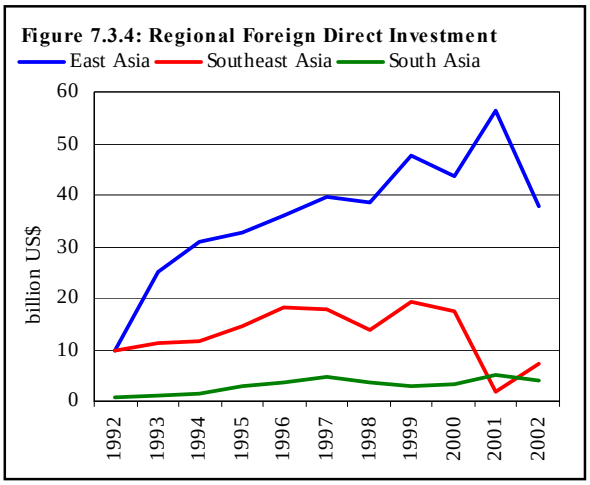
[58] Mukherji estimated that during the first three rounds of negotiation, the total import of negotiated products by all member countries was amounting to only US$ 479.8 million.

[59] Mukherji defined the potential trade in any product between two countries (a supplier and its market) as the minimum of the supplier's global exports (i.e. exports to all its trading partners) and the importer's global imports.

charges its own exporters. In fact, higher tariffs together with non-tariff barriers are one of the major explanations for substantial informal trade in this region.[60] Although it must be conceded that the movement on tariff reduction in both India and Pakistan in the last five years has been quite substantial.

3. It is argued that South Asian countries have comparative advantage in similar, mostly labor intensive products and the economic benefits from intra-regional trade are limited compared to inter-regional trade [see Srivansan (1994)]. This view was also supported by a study by Kemal, et. al. (2000) which analyzed the revealed comparative advantage[61] as well as trade complementarities[62] for SAARC member countries. The analysis suggests similar pattern of revealed comparative advantage across South Asia as well as low trade complementarity among member countries – both findings may explain the low values of intra-regional trade (see **Figure 7.3.2**).

4. The low intra-industry trade in the region was also cited as one of the reasons for low regional integration [see Kemal, et. al. (2000)]. According to their findings, (a) intra-industry trade is highly erratic in the region, (b) a few products dominate such trade, and (c) their share in the total trade is low. While low trade complementarities and similar comparative advantage largely explain limited intra-industry trade, Roy (2005) suggests lower volume of foreign direct investment (FDI) inflows in South Asia as one of the explanations for low intra-industry trade. This view is supported by Newfarmer (2004) which suggests that the FDI inflows, an important catalyst to integration through trade, are comparatively very low in the region (see **Figure 7.3.4**).[63]



Potential benefits from SAFTA

An analysis of the effects of first three rounds of SAPTA on the region found that the net increase in the regional trade after the conclusion of the third round is very small [see Bhattacharya (2001)]. This is reasonable as members of SAFTA have limited trade complementarities and similar pattern of comparative advantage. However, this does not necessarily imply low potential for intra-regional trade as the current trade pattern in South Asia, which largely reflect various existing trade barriers (both tariff and non-tariff) may change with liberalization effort [see Roy (2005)]. Furthermore, this *static* analysis does not take into account potential dynamic gains from trade liberalization.

In order to reap the maximum benefits from SAFTA, it is important for member countries that they reduce trade barriers for each other. Although SAFTA provides a framework for gradual reduction in

[60] See Nisha Taneja (1999)

[61] Revealed comparative advantage of a good is the ratio of its share in a country's total exports relative to that good's share in world trade.

[62] The Trade Complementarity Index measures how well the export performance of a country, or a group of countries in a single area, meets the import needs of other countries in the same area. The higher the index number, the better the prospects for that country's trade with other countries.

[63] During 2001-2002, FDI flows into East Asia surpassed US$ 50 billion and Latin America received US$ 58 billion. On the other hand, South Asia received only US$ 5 billion.

tariff barriers, countries may still have incentive to include significant products in the 'sensitive' list on which tariff concessions do not apply. Certainly, a long list of sensitive items would not make any notable shift in the current trade pattern. Similarly, complex rules regarding origin[64] may prove to be an important impediment to trade.

Furthermore, the historical political differences between Pakistan and India (the two largest South Asian economies) have been a dominant trade barrier; thereby retarding progress towards free trade in the region. In a situation when these two countries are in the process of resolving their political differences, it is expected that countries in the region would also realize potential trade benefits due to geographical proximity as well.

It may be interesting to note that the slow implementation of SAPTA has encouraged member countries to prefer bilateral trade agreements. While these bilateral trade agreements provide flexibility to countries to offer selective preferences, these multiple and overlapping trade agreements (with different rules of origin, tariff schedules and period of implementation) may create a complex web of trade preference thus diminishing the benefits from trade liberalization. Looking from this perspective, SAFTA can be a mean to achieving broader trade liberalization.

What is more important is to understand that the benefits from regional integration are realized over time when domestic resources are reallocated in response to new competitive challenges. Thus, regional trade agreements are likely to be successful when the level of protection is low; thus the adjustment costs of regional integration would also be low. This means that reduction of trade barriers is essential for the success of SAFTA; half-hearted efforts would only lead to failure.

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[64] Countries with the lowest external tariff find it beneficial to meet their own requirements for a product with imports from the rest of the world and export the corresponding amount to fellow members. Thus, imports effectively enter the PTA through the country with the lowest external tariff schedule, a phenomenon known as "indirect trade deflection". In order to address this issue, rules of origin should be transparent.

Special Section 7.4: Intra Industry Trade - Measuring Globalization of Industries

The point lying at the heart of globalization drive is that economic integration generates net welfare gains. This belief has led to greater integration of international markets for goods and services, and thus countries have been liberalizing their trade regimes by lowering tariff and non-tariff barriers.[65] Consequently the global trade as a percent of GDP witnessed a rise from some 20 percent in the early 1970s to about 55 percent in 2003.[66] However, while the globalization of trade offers opportunities to explore new markets with expanding list of tradeables, this also poses challenges to the domestic industries. Global integration of goods markets may place domestic producers against foreign competitors who have achieved benefits of cost rationalization and economies of scale through production for larger market space. It is therefore important that domestic producers also take advantage of international integration in production.

In this background, this section analyzes trends in globalization of selected industries in Pakistan based on intra-industry trade (IIT) index.[67] The intra-industry trade index (IIT) measures the extent of the absolute amount of exports in a particular industry which is offset by imports in the same industry, and expresses this intra-industry trade as a proportion of the total trade in this industry. Thus, rising level of IIT for an industry is indicative of higher degree of the global integration.

The analytical framework for intra-industry trade[68] suggests that a particular industry engages in trade with a similar industry to (1) achieve horizontal integration so that different varieties of a product are available to the consumers; and/or (2) to attain vertical integration so that product of varying quality become available to consumers. While industries generally integrate their production process domestically, we are focusing on global integration as it induces more efficiency in the production process due to global scale efficiencies and world-wide learning. Nonetheless, for a particular industry, the propensity to globalize depends on various conditions that include: its competitive conditions requiring cost rationalization and scale economies, high technological intensity, access to raw materials, etc[69]. In this way, growing integration may reflect improvement in competitiveness and efficiency of industries – *"without a high concurrent cost of transferring factors of production to different locations and lines of work"*.[70]

For the purpose of this analysis, standard Grubel and Llyod Index (GLi index) of IIT has been estimated using trade data based on SITC 2 digit level classification (59 commodity groups) from 1985 to 2004.[71] The value of IIT lies between zero and one, with zero indicating no intra-industry trade (trade consists of only exports or imports) and one indicating complete intra-industry trade (exports equal to imports within the industry). Furthermore, a cut-off point of 0.5 has been taken as the critical limit to differentiate between low and high IIT levels. On the basis of trends in IIT index, we have divided the industrial trade pattern into four categories for our analysis: (1) industries that have moved from low to high IIT; (2) industries that have moved from high to low IIT; (3) industries that have been moving in high IIT range; and (4) industries that have been moving in low IIT range.

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[65] For detail information on the liberalization efforts by Pakistan see Box 6.2 in the SBP report for Q2-FY05.
[66] World Economic Outlook. April 2005, IMF.
[67] Since the international integration of industries affects the trade flows of the economy with rest of the world, we can use trade data to derive a measure of industrial integration.
[68] Trade *between* industries is largely explained by trade theories based on comparative advantage.
[69] Makhija V. Mona, Kim Kwangsoo and Williamson D. Sandra (1997), "Measuring Globalization of Industries Using a National Industry Approach: Empirical Evidence across Five Countries and Over Time", Journal of International Business Studies, Vol. 28, No. 4. pp 679-710.
[70] Caves E. Richards (1981), "Intra-Industry Trade and Market Structure in the Industrial Countries", Oxford Economic Papers, Vol. 33, No.2, pp 203-223.
[71] IIT index is calculated as: $IIT = 1 - \left[\left| (X - M) \right| / (X + M) \right]$, where IIT is intra-industry trade for an industry I in year t, X is exports and M is imports.

The estimated values of the GLi indices show that in more than 90 percent trade flows from industries in Pakistan *uni-directional* trade is dominant. In other words, simultaneous exchange of goods in each of these industries is less than 50 percent of the total trade. This reflects a lower level of intra-industry trade, and hence limited international integration (see **Table 7.4.1**). Textile sector which is the most dominant sector in both trade (33 percent share in country's trade during FY01-04) and manufacturing displayed one of the lowest IIT levels.[72] However, keeping in view the manufacturing pattern of textiles and the competitive edge that it has attained in the international market, it can be said that textile sector has undergone significant domestic integration instead of global integration.

Table 7.4.2 helps in understanding the pattern of trade flows for industries that have been categorized according to different scales of international integration in **Table 7.4.1**. Major findings from **Table 7.4.1 & 7.4.2** are summarized as follows:

Table 7.4.1: Trends in Intra-industry Trade of Various Industries (1985-2004)

Industries moving from low to high IIT (0.9 percent share in total trade)	**Industries moving in high IIT range (5.9 percent share in total trade)**
1 Miscellaneous food preparations	1 Fruit and vegetables
2 Beverages	2 Crude animal and vegetable materials,
3 Explosives and pyrotechnic products	3 Non metallic mineral manufactures,
4 Firearms of war and ammunition	4 Sanitary, plumbing, heating and lighting fixture.
5 Manufactures of metal,	5 Scientific & control instruments, photograph goods, clocks
6 Travel goods, handbags and similar articles	6 Miscellaneous manufactured articles,
	7 Wood and cork manufactures
Industries moving from high to low IIT (8.0 percent share in total trade)	**Industries moving in low IIT range (85.3 percent in total trade)**
1 Meat and meat preparations	1 Feed. Stuff for animals excl. Un milled cereals
2 Cereals and cereal preparations	2 Crude fertilizers and crude minerals
3 Sugar, sugar preparations and honey	3 Perfume materials, toilet & cleansing preparations
4 Oil seeds, oil nuts and oil kernels	4 Fertilizers, manufactured
5 Crude chemicals from coal, petroleum and gas	5 Plastic materials, etc.
6 Furniture	6 Medicinal and pharmaceutical products
7 Textile fibers, not manufactured, and waste	

Source: Comtrade database

For the sake of simplicity industries with IIT levels below 20 percent are not shown in this table

1. Some industries (such as *hunting and sporting ammunition, explosives and pyrotechnic products, prepared explosives, cutlery and other manufactures of metal, infant food, lemonade and flavored water*) are showing rising IIT index, which suggests the rising level of global integration for these industries. In fact, these industries (with the exception of travel goods and hand bags) have transformed from highly import dominant setting to a more balanced trade flows due to growing exports of these industries. Further the expansion in the export shares was quite broad based and was accompanied by fall in the import levels in these industries.

2. Some industries are showing falling IIT index, indicating fall in degree of integration over time. In this category, *meat and meat preparation, cereal and cereal preparation and furniture* are the industries where increase in export share was far more than the rise in import share. On the other hand, *crude chemical from coal, petroleum & gas*; and *oil seeds, oil nuts and oil kernels* have become import dominant with the passage of time.

[72] The highest IIT value attained by textile, yarns, and fabrics and made up articles was 10 percent in 2003, and for clothing this value was 1 percent in 2003.

3. Some industries are highly integrated. The trade flows of these industries are balanced and showed no significant change during the period under consideration. However the industries exhibiting rising and even mixed pattern of export shares can be considered successful in attaining competitive edge. Some of these are wood and cork manufactures, miscellaneous manufactured articles, scientific and control instruments, etc.

4. A large share of industries displayed limited international integration. In the categories shown in **Table 7.4.2**, with the exception of feed stuff for animals, all industries witnessed shift to export oriented industries.

As mentioned earlier, the textile sector is one of the industries that displayed significantly low level of international integration. Keeping in view the importance of the textile sector,[73] we have computed

Table 7.4.2: Industry-wise Trade Pattern Driving Change in the IIT Levels (FY 85-04)

		Nature of Change in Trade Flows	Export Shares	Import Shares
	Industries moving from low to high IIT (0.9 percent share in total trade) *			
1	Miscellaneous food preparations	From import oriented[1] to equal trade flows[2]	Rising	Falling
2	Beverages	Mixed trend; equal trade flows in current period	Rising	Mixed
3	Explosives and pyrotechnic products	From import oriented to equal trade flows	Rising	Falling
4	Firearms of war and ammunition	Mixed trend; equal trade flows in current period	Rising	Falling
5	Manufactures of metal,	From higher import flows[3] to equal trade flows	Rising	Mixed
6	Travel goods, handbags and similar articles	From export oriented to equal trade flows	Mixed	Rising
	Industries moving from high to low IIT (8.0 percent share in total trade)			
1	Meat and meat preparations	From equal trade flows to export oriented	Rising	Rising
2	Cereals and cereal preparations	From equal trade flows to export oriented	Mixed	Mixed
3	Sugar, sugar preparations and honey	Mixed trend; higher exports in current period	Mixed	Mixed
4	Oil seeds, oil nuts and oil kernels	From equal trade flows to import oriented	Mixed	Rising
5	Crude chemicals from coal, petroleum and gas	From equal trade flows to import oriented	Mixed	Mixed
6	Furniture	From equal trade flows to export oriented	Rising	Mixed
7	Textile fibers, not manufactured, and waste	Mixed trend; higher imports in current period	Falling	Rising
	Industries moving in high IIT range (5.9 percent share in total trade)			
1	Fruit and vegetables	Equal trade flows	Rising	Rising
2	Crude animal and vegetable materials,	- do -	Falling	Falling
3	Non metallic mineral manufactures,	- do -	Mixed	Mixed
4	Sanitary, plumbing, heating and lighting fixture.	- do -	Mixed	Rising
5	Scientific & control instruments, photograph goods, clocks	- do -	Mixed	Falling
6	Miscellaneous manufactured articles,	- do -	Rising	Rising
7	Wood and cork manufactures	- do -	Rising	Rising
	Industries moving in low IIT range (85.3 percent in total trade)			
1	Feed. stuff for animals excl. un-milled cereals	From higher exports to higher imports	Falling	Mixed
2	Crude fertilizers and crude minerals	Higher imports; exports rising slightly	Falling	Mixed
3	Perfume materials, toilet & cleansing preparations	Higher imports; exports rising slightly	Rising	Rising
4	Fertilizers, manufactured	Higher imports; exports remained low	Falling	Mixed
5	Plastic materials, etc.	Higher imports; exports rising slightly	Rising	Rising
6	Medicinal and pharmaceutical products	Higher imports; exports rising slightly	Rising	Mixed

Source: Comtrade database

[1] Higher imports with negligible exports

[2] Export and import flows almost equal

[3] Imports higher; exports also high but less than imports

* Shares in trade pertain to period FY01-04

[73] Not only the exports are highly concentrated in textiles, a substantial share of the value addition from country's large scale manufacturing is also contributed solely by textile sector. In FY04 out of the total value addition by the LSM sector 34.7 percent was contributed by textile sector.

the extent of product differentiation, which is an indicator of horizontal integration.[74] It shows the ability of an industry to cater to the demands of various market segments by introducing variations in product quality, location, color, size etc. This in turn aids in enhancing efficiency and competitiveness of the whole industry and reduces possibilities of concentration.

The results of product differentiation analysis[75] show that only two categories namely, readymade garments and tarpaulin and canvas goods displayed an increasing trend of product variation during the period of analysis (see **Table 7.4.3**). Other categories especially bed wear and knit wear despite being strong performers in the international market displayed low levels of product variation.

Table 7.4.3: Extent of Product Differentiation in Textiles
percent

	FY90-95	FY96-00	FY01-05
Cotton yarn	13.3	13.5	11.1
Cotton fabrics (woven)	21.7	14.7	9.8
Knitwear	12.8	3.8	3.7
Bed wear	9.6	9.7	5.3
Towels	5.8	10.3	5.6
Cotton bags and sacks	13.1	5.6	2.1
Readymade garments	5.1	10.8	23.1
Tarpaulin & other canvas goods	12.3	9.0	20.6
Synthetic textiles	12.0	9.2	6.6
Waste material textile fibre/fabric	NA	14.8	8.9

This low level of integration of the textile sector with rest of the world does not necessarily rule out domestic integration. But there are various interpretations to this finding: there is a possibility that most of the production processes in the textile are being performed domestically (a case of vertical integration) and/or most of varieties demanded by domestic consumers are being produced domestically (a case of horizontal integration). Furthermore, this trend could be a sign of an efficient textile sector that has been successfully exploiting complete competitive advantage, economies of scale and opportunities of cost rationalization through *domestic* integration. In this case, high domestic integration is not a sign of concern.

Another possible explanation for this trend could be the higher level of protection available to this industry (textile quotas are one example). In this case, it can be argued that due to protections, textile producers may not have any incentive to take advantage of global integration. Thus, high domestic integration becomes a sign of great concern, particularly when (1) textile trade has become more competitive following the elimination of quota in January 2005, and (2) competitor countries are relying more on regional trade agreements to gain from economies of scale. Even if Pakistan opts for bilateral trade agreements, this will exert competitive pressures on domestic producers. It is therefore essential for Pakistani producers to globally integrate their production processes so that they could gain advantage over their competitors.

[74] Balassa, Bela (1986), "The Determinants of Intra-Industry Specialization in United States Trade", Oxford Economic Papers, New Series, Vol. 38, No.2, pp 220-233.
[75] The Hufbauer (1970) proxy for product differentiation (PD), as reported in Makhija, Kim and Williamson (1997), is used here. It calculates PD as coefficient of variation of export unit values of various export categories. Hufbauer suggested that rising value of coefficient of variation of unit value for any export category is associated with higher level of product differentiation in that industry and vice versa.

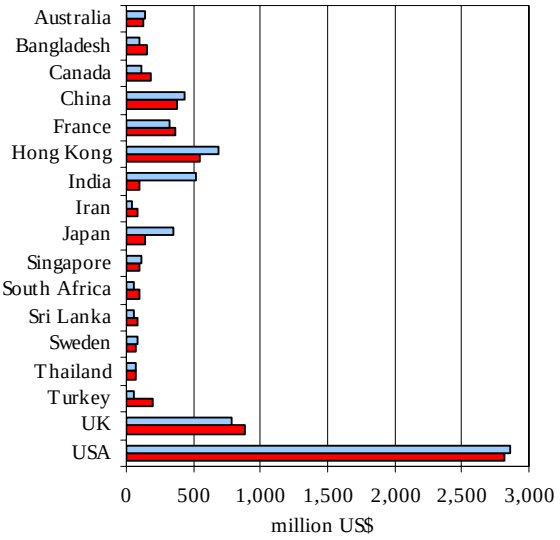
Special Section 7.5: Pakistan's Export Potential: A Gravity Model Analysis

The gravity model suggests that the trade potentials between two countries is directly proportional to magnitude of their GDP (economic activity) and inversely proportional to distance between them.[76] The source of inspiration for gravity model originates from pioneer work of Tinbergen (1962), Poyhonen (1963) and Linneman (1966).[77]

The gravity model has been extensively used to determine the trade patterns and potentials after controlling for factors that generally impact the trade.[78] However, recent work on Gravity Model such as Bergstrand (1989), Deardoff (1995) and Anderson and Wincoop (2003), ITC (2005) have incorporated the micro foundations and tried to reach at more robust and consistent conclusions.[79]

The application of gravity model on Pakistan is rather limited and often focuses on SAPTA/SAFTA such as Rahman (2003), Hirantha (2004) and New Farmer (2004). Similarly, Betra (2004) has estimated trade potential of India with Pakistan and other regional countries and blocks. However, the focus of these studies was on overall trade – ignoring sectoral and product level analysis. A recent study by Baroncelli (2005) estimates trade potential between India and Pakistan at sectoral level by incorporating the simulated SAFTA bound future tariffs. But even this study covers only three sectors, namely textile, chemicals and food.

Figure 7.5.1: Export Potential with Selected Countries



An application of gravity model using improved methodology[80] and a detailed dataset covering 15 sectors and cross sectional data on 132 exporting and 154 exporting countries for 2002 and 2003 yields estimates of trade potential for Pakistan with selected trading partners (see **Figure 7.5.1**). The results identify trade potentials with USA, Sweden, Singapore, India, Hong Kong, China, and Australia; whereas Pakistan is exporting either close or some cases above the trade potentials with rest of the selected countries. However, these estimates are based on some values for control variables (common border, tariffs, common language, conflict and geographical location etc) prevailing in 2002 and 2003. Certainly any change in these variables (say reduction in tariff or resolution of conflict) is likely to change the estimates of the trade potential.

[76] An astronomer Stewart and socialist ZIPF introduced the application of this law in social sciences [see Rahman (2003)].
[77] Later on, various studies such as Frankel and Wei (1993), Evenet and Hutchinson (2002), Anderson and Wincoop (2003), ITC (2005), have worked by extending these models.
[78] This may include transportation costs, geographical and cultural features, border & non-border barriers and other regulatory constraints.
[79] Bergstrand (1989) introduced micro foundation to this model and suggested that the gravity model is a reduced form equation of a general equilibrium of supply and demand systems.
[80] This methodology applied a linear-log-model and included control variables such as common border, tariffs, common language, conflict and geographical location. Further, a multilateral resistance term in the form of importer and exporter fixed effects has been employed to captures the individual country's features. Thus, with the application of *pseudo maximum likelihood technique* on the gravity model, the study provides robust sectoral results. This approach takes care of heteroskedasticity and also provides a natural way to deal with the zero values of the dependent variables as some countries do not trade with each other in sometime period.

Focusing on Pakistan's trade potential with India, the results identify significant scope for expanding trade between these two countries. At the hindsight, the *true* trade potential would have been far greater had these countries not engaged in conflict or tariff and non-tariff barriers were low.[81]

A sectoral level analysis for trade potential between India and Pakistan reveals that scope for trade expansion exists in sectors, such as (1) *textiles, clothing and leather products* (US$ 309.5 million); (2) *food, beverages and tobacco* (US$ 86.2 million); and (3) *chemicals and chemical products* (US$ 21.3 million) – see details in **Table 7.5.1**. Thus, there is a significant import demand for the Pakistani products from the neighboring country even in the presence of high tariff rates.[82]

The other sectors such as (1) *forestry and fishing*, (2) *other manufacturing*, (3) *machinery and equipment*, (4) m*ining and quarrying*, (5) *precision instruments* (6) *recycling instrument* and (7) *electrical and electronic equipment* etc. hold a moderate level of trade potential.[83] In this regard, it is interesting to note that both the countries despite being member of SAPTA in the past were unable to bring the average tariff rates to a competitive level as it exists in other regional and bilateral trade pacts such as EU and ASEAN. In the case of ASEAN, in most of instances the average tariff rates are below 10 percent for the other member countries in majority of products.

Table 7.5.1: Pakistan's Export Potential with India (2003)

thousands US dollar

		Actual	% Share in total exports of the sector	Predicted	Difference	Protection (percent)
		(1)	(2)	(3)	(3)-(1)	
0	Total	91,988	0.9	515,798	423,811	
1	Coke, petroleum products and nuclear fuel	38,921	36.9	14,268	-24,653	25-30
2	Agriculture and hunting	32,611	12.5	23,311	-9,301	30-35
3	Textiles, clothing and leather	10,650	0.1	320,174	309,525	30-35
4	Chemicals and chemical products	2,888	1.2	24,241	21,353	15-20
5	Food, beverages and tobacco	1,944	0.3	88,156	86,213	30-35
6	Wood and wood products	786	1.9	2,952	2,167	25-30
7	Forestry and fishing (products)	738	2.2	8,898	8,159	10-15
8	Other manufacturing	673	0.2	5,777	5,104	30-35
9	Rubber and plastic products	510	2.4	2,603	2,093	25-30
10	Machinery and equipment	469	0.9	3,889	3,420	25-30
11	Mining and quarrying	432	1.9	10,381	9,949	10-15
12	Precision instruments	405	0.3	5,738	5,334	20-25
13	Publishing, printing & reproduction of recorded media	396	4.3	1,366	969	30-35
14	Recycling	184	3.3	3,299	3,115	30-35
15	Electrical and electronic equipment	184	0.8	745	561	10-15

In case of *forestry & fishing* and *mining & quarrying*, the average tariff rates are quite competitive (around 13 percent). Pakistani exporters can particularly focus on these areas and can explore huge market in respective sectors.

[81] This statement is reinforced by the regression results where conflict variable has shown significant and more pronounced negative effect in the case of these two countries.

[82] In the case of *textile, clothing leather* and *food, beverages and tobacco* sectors the average tariff is around 35 percent, whereas in the case of chemicals sectors the average tariff rate is 17.7 percent.

[83] In this regard, a product level analysis may further unleash various landmarks in these sectors, but this model is only focusing only on the sectoral level analysis. So, in future there is need to conduct further research to a product level so that there may be more useful disaggregated level analysis can be made for policy purposes.

On the other hand, Pakistani exporters are capturing more than their potentials in sectors such as (1) *coke, petroleum products and nuclear fuel*, and (2) *agriculture and hunting*. These sectors despite high average tariff rates of around 30 and 32.1 percent respectively, are competitive and are able to export 36.9 percent and 12.5 percent of total exports in these categories respectively.

In sum, though common border facilitates trade between two countries, the degree of protection and nature of relationship shape the trade pattern. Currently, India and Pakistan maintain a high level of protection against imports from each other. However, the expected possible reduction in both tariff and non-tariff barriers (following the softening up of the strained relationship and implementation of SAFTA), may lead to expansion in the trade potential between these two countries.

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