

7 Balance of Payments

7.1 Overview

International Developments¹

Despite various adverse developments such as rising international commodity prices and US sub prime mortgage crisis, the world economy is likely to show resilience in 2007, with growth estimated to moderate to 5.2 percent, compared to 5.4 percent in 2006 (see **Figure 7.1**). The major support to the growth momentum stems from sustained high growth in China and India as well as a recovery in EU and Japan during 2006 (see **Table 7.1**).

The growth in the emerging markets and developing countries was led by China, India and Russia, which registered 11.1 percent, 9.7 percent and 6.7 percent growth respectively in 2006. Although the US economy started showing some signs of a slowdown during

2006 due to a downturn in the housing market; the decline in oil prices in the second half of 2006 helped in sustaining the growth momentum. Nevertheless, the growth estimate of 1.9 percent for 2007 remains largely dependent on the pace of recovery from the recent sub-prime mortgage crisis.

In the Euro area, growth of 2.8 percent in 2006 was the fastest in last six years. This acceleration in growth was mainly led by domestic demand conditions. Germany recorded 2.9 percent growth due to consumption boost from World cup, increase in spending in anticipation of the Value-added tax (VAT), and strong exports performance. Growth rates in France, Italy and Spain were also noticeably higher as compared to 2005 and expected to sustain in 2007. United Kingdom also recorded 2.8 percent growth in 2006 mainly led by domestic consumption boost.

In Japan, growth of 2.2 percent during 2006

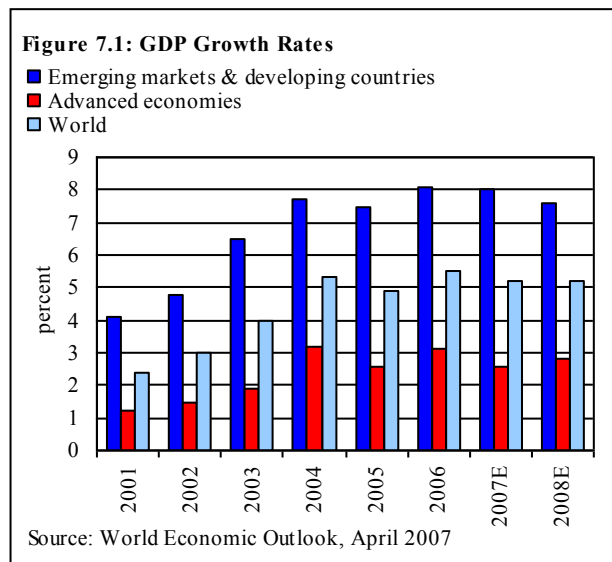


Table 7.1: Major Economic Indicators of World Economies

Indicators	Output Growth		Inflation Rate		CA Balance (% of GDP)	
	2006	2007*	2006	2007*	2006	2007*
World	5.4	5.2				
Developed countries	2.9	2.5	2.3	2.1	-1.4	-1.3
USA	2.9	1.9	3.2	2.7	-6.2	-5.7
Euro area	2.8	2.5	2.2	2.0	-0.3	-0.2
Japan	2.2	2.0	0.2	0.3	3.9	4.5
UK	2.8	3.1	2.3	2.4	-3.2	-3.5
Emerging markets	8.1	8.1	5.3	5.7		
China	11.1	11.5	1.5	4.5	9.4	11.7
Russia	6.7	7.0	9.7	8.1	9.7	5.9
India	9.7	8.9	6.1	6.2	-1.1	-2.1
Pakistan	6.6	7.0	7.9	7.8	-3.9	-4.8
Bangladesh	6.4	5.8	6.5	7.2	1.2	1.3
Philippines	5.4	6.3	6.2	3.0	4.3	3.8
Indonesia	5.5	6.2	13.1	6.3	2.7	1.6

Source: World Economic Outlook April 2007 and IMF Outlook Update, July 2007

* indicates projections

Note: Data on various variables in the IMF Outlook table may not match with data from other sources. Figures for Pakistan have been changed to those reported in the Economic Survey of Pakistan 2007.

¹ The discussion in this section is based on World Economic Outlook by IMF for October 2007, and Trade and Development Report 2006 by UNCTAD.

was above 1.9 percent recorded in the previous year. The monetary accommodation was helpful in exit from a decade long stagnation, though it encouraged carry trade that contributed to weakening of Yen.

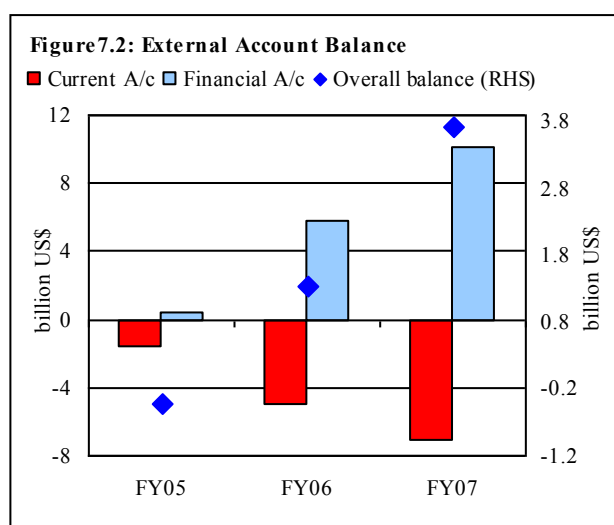
The sustained world economic growth during last few years, and particularly the spectacular growth in emerging economies has brought substantial pressures on the commodity and energy prices. In particular strong demand, and persistent supply concerns meant that oil prices soared, and second round impact of the rise in oil prices translated into upward pressures on the general price level, prompting central banks to change their monetary stance from accommodative to tight. The inflationary pressures have however, not ebbed. The Oil prices after initially declining in 2007 reverted towards record highs observed in 2006 mainly because of limited spare capacity and unrelenting demand for energy. Food inflation is also on the rise due to supply shortages and diversion of some key commodities towards production of bio-fuels.^{2,3} Food staple prices which were already under pressure from their alternate use as bio-fuels are likely to further escalate due to shortfall in global wheat production. The rise in the food staples prices can feed into prices of dairy products as farmers pass-on the impact of rise in their input cost (dairy feed) to customers. To counter inflationary pressures central banks of key economies have responded by increasing the interest rates.

However, the fear of inflation has, of late been replaced by fear of a liquidity crisis due drop in growth, particularly in the US. The impact of the US sub-prime collapse continues to ripple through the global financial market particularly through the collapse of many derivative markets and consequence rise of liquidity shortages in the financial markets. The liquidity that had generated investment euphoria has all but evaporated.

The major central banks responded by injecting money in the financial system to curtail volatility in the stock prices, and to avoid credit crunch in the money markets. However, they have refrained from easing the monetary policy, which would had a wider impact on the economy and inflation. With the intervention of major central banks the confidence of markets is recovering, however, worries are still enduring that when the sub-prime market crisis will actually end. Given this uncertainty and resulting risk averseness of the global investor it would become increasingly challenging for the developing countries to access international bond and equity market to fulfill their capital needs thus hurting the overall growth.

7.2 Pakistan's External Account

As a result of a relative slowdown in the growth of the current account deficit (CAD) and a record increase in investment inflows, Pakistan's external account surplus improved substantially during FY07 to reach US\$ 3.7 billion (see **Figure 7.2**). This surplus is more than twice that recorded in FY06, and is exceeded only by that in FY03, when the country saw a large current account surplus (see **Figure 7.3**). The increase in investment flows is certainly quite creditable, suggesting that the sustained economic growth, relative stability of the exchange rate, and the

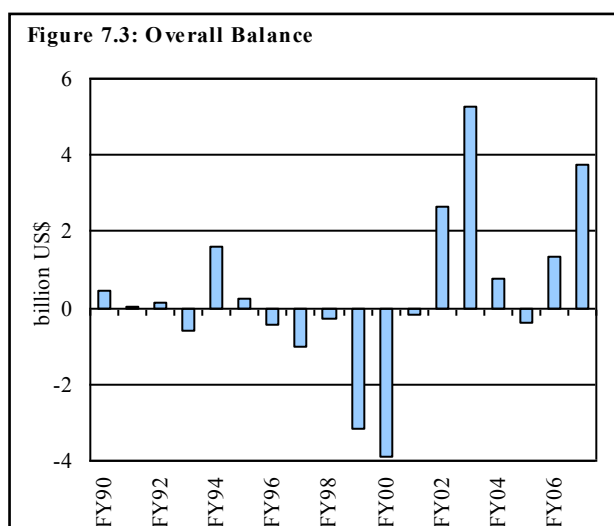


² USA is the biggest importer of ethanol which uses corn as an input. In 2006, 17.6 percent corn and 5.6 percent soybean was used to produce bio-fuels.

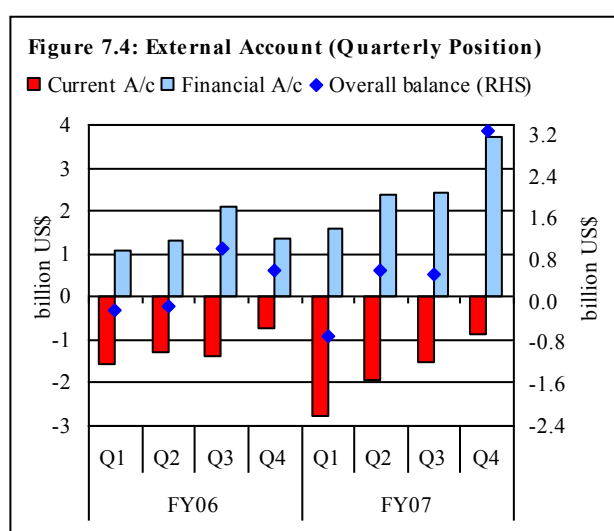
³ In 2006, food prices increased by 10 percent due to surge in prices of corn, wheat, and soybean oil. Besides poor wheat crop, the dominant source of rise in food prices was burgeoning US demand for ethanol and bio-diesel.

government's commitment to long-term policies and macroeconomic stability, are beginning to bear fruit.⁴

However, the continued presence of a large (US\$ 7.1 billion) CAD is troubling, particularly given that the deficit, as share of GDP, has risen from 3.9 percent in FY06 to 4.9 percent in FY07. While the growth in the CAD has moderated from the 225.3 percent in FY06, even the 42.2 percent increase in the deficit in FY07 is not sustainable for the economy. One positive development in FY07 however has been the gradual decline in the quarterly deficit as the year progressed (see **Figure 7.4**). The FY07 moderation in the growth of the CAD is attributable mainly to a sharp fall in the growth of imports (that compensated for an unexpected deceleration in exports) and strong increase in remittances (that partially offset the rise in investment income outflows).



The deceleration in the FY07 import growth was not unexpected; the Annual Development Plan for the year incorporated an 11.3 percent rise in imports against the recorded growth of 31.3 percent in FY06. This expectation incorporated a fall in energy prices, better domestic food crops, moderation in machinery imports after exceptional growth in the previous two years, as well as the impact of demand management policies. While the realized import growth in FY07 was even lower, at only 8.1 percent, the impact on the trade deficit was offset due to the unanticipated weakness in exports. Export growth fell from 14.3 percent in FY06 to only 3.2 percent in FY07.



The extent of the fall in export growth was not anticipated because Pakistan's textile sector, which is the main stay of its exports, appeared to be performing reasonably well in the post quota environment till end of FY06.⁵ Although the slowdown in the textiles growth was the major contributing factor behind the decline in the overall export growth, the accompanying fall in exports of non-textile manufacturers and commodity producing sector made matters worse. Had the fall in textiles export growth not coincided with the fall in the exports of the other sectors, the overall export performance might not have been as dismal.

Finally, while remittances grew strongly in FY07 to a record US\$ 5.5 billion (up 19.4 percent YoY), the impact of this on the current account was partially offset by a sharp increase in investment income outflows. On the other hand, one very encouraging development in the external sector during FY07

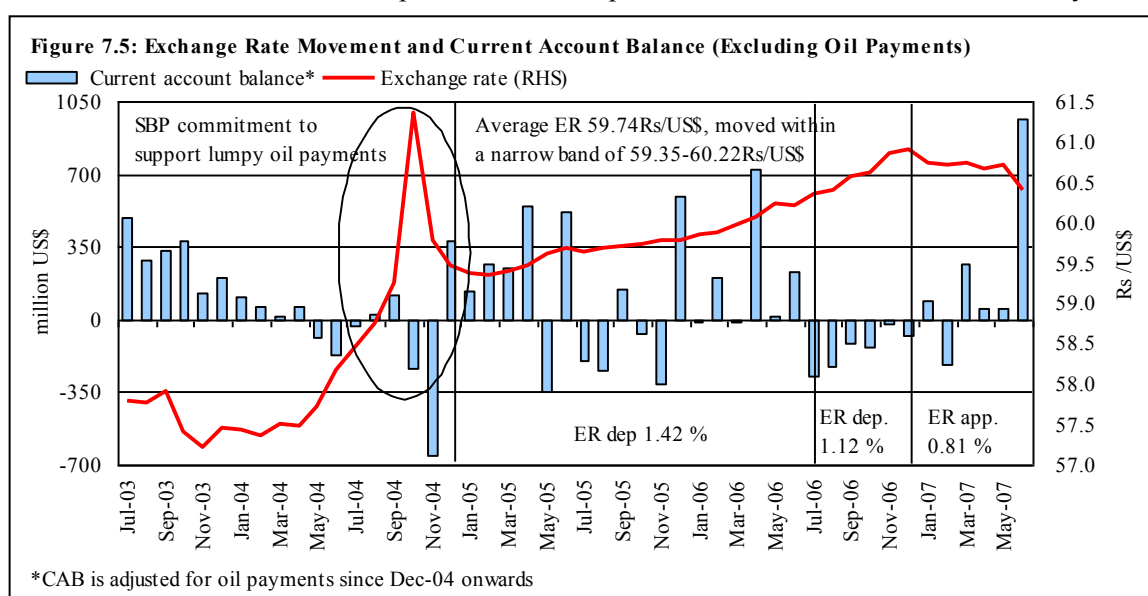
⁴ Encourage by the improvement in the external account position, SBP has further liberalized the foreign exchange regime in FY07 (see **Box 7.3**).

⁵ For detail see section on *Trade Account*.

was a rise in the foreign private investment. Not only was this the largest inflow ever recorded in Pakistan for any fiscal year, it is significant that the major part reflects equity flows rather than debt, as financial account recorded a substantial surplus of US\$ 10.1 billion during FY07, up sharply from the previous year (see **Figure 7.2**).

This resulted in a substantial increase in the liquid foreign exchange reserves of the country from US \$ 13.1 billion in FY06 to US \$ 15.6 billion in FY07. It also contributed to the relative stability of the rupee. The PKR depreciated only by 0.32 percent against the USD during FY07 compared to 0.87 percent in FY06. More importantly, the appreciation in the real effective exchange rate was also limited to 0.81 percent in FY07 compared to 1.9 percent in FY06, as the impact of rise in the relative price index was largely neutralized by the depreciation in the nominal effective exchange rate.⁶

The stability of the PKR was helped by the SBP commitment (continuing since November 2004) to provide dollar liquidity support for lumpy oil payments.⁷ Although the SBP did not target an exchange rate, leaving that to the market, the presence of the central bank in the market nonetheless lent support to the domestic currency. A reflection of this is found in **Figure 7.5**, which shows a weak relationship between the current account balance (CAB) excluding oil payments and the rupee/US dollar exchange rate; when the CAB adjusted for oil payments witnessed surpluses, the down-ward pressure on rupee eased to some extent (see **Figure 7.5**). In particular, the adjusted monthly CAB was in deficit throughout H1-FY07 and in absence of any major financial account inflows during the period the rupee depreciated by 1.12 percent against the US dollar. Thereafter, a sustained rise in financial flows helped PKR recover part of its losses occurred earlier in the year..



Going forward, Pakistan's CAB is likely to remain under pressure due to a large trade deficit as well as higher investment income outflows. Pakistan's export growth, in particular, could come under further pressure due to end of the quota restrictions under safeguard measures on China, and entry of Vietnam in the WTO. Import growth may also witness some resurgence due to rise in the international oil prices and an expected increase in the import of power generation machinery.

Raising funds from international capital market would also become more challenging in coming years. As international financial market has become increasingly risk averse in the wake of the

⁶ For detail see section on *Exchange Rate and Reserves*.

⁷ However, with effect from Jul 13, 2007, SBP has directed banks and Authorized dealers (ADs) to purchase foreign exchange for the financing of imports and purchase of crude oil from interbank.

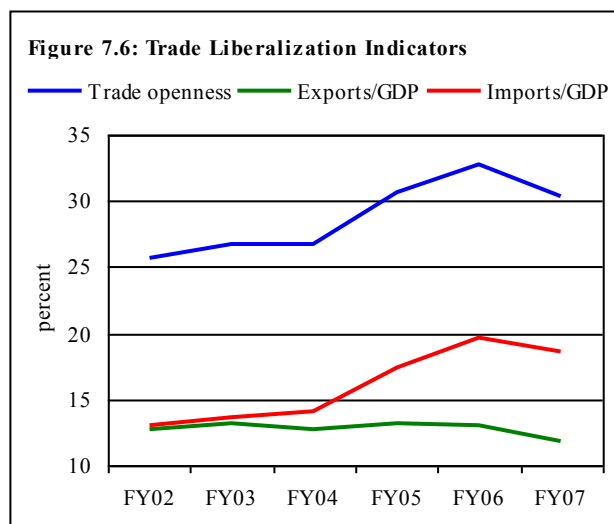
ongoing turbulence in the international credit markets. Under these circumstances, countries like Pakistan may find it relatively difficult to attract both foreign direct investment (FDI) and portfolio investment. Already some domestic companies have scrapped plans to tap international market for funds, while at the global level some countries have postponed their sovereign issues due to weaker investor response.

External Sector Indicators

Overall most of Pakistan's external sector indicators exhibited an improvement in FY07.

Trade Liberalization⁸

The trade openness is a widely used indicator of current account liberalization. For the last five years, Pakistan's economy has become increasingly open, with trade openness ratio improving from 25.7 percent in FY02 to 32.7 percent in FY06. However, the ratio dropped to 30.4 percent in FY07 (see **Figure 7.6**), as the growth in both imports and exports decelerated.

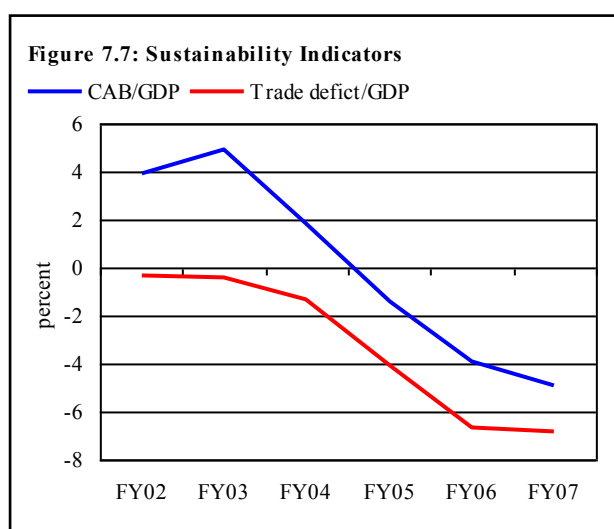


Sustainability Indicators

The CAD is an important indicator to gauge the pressures on a country's external sector, as a large and persistent CAD may threaten the viability of the external account. Theoretically, the sustainability of CAD depends not only on the composition of the deficit, but also on the financing sources. Some important sustainability ratios are analyzed below.

Sustainability of current account imbalances as measured by CAB to GDP ratio not only worsened from the FY06 level of 3.9 percent but also breached the Annual plan target of 4.3 percent, to reach 4.9 percent in FY07 (see **Figure 7.7**).

Despite a precipitous decline in import growth, the downward trend in CAB to GDP ratio continued, primarily due to the expansion in income account deficit and a lower export growth. However, though the CAB to GDP ratio further deteriorated in FY07, the pace of the rise declined substantially.



Besides CAB to GDP ratio, the other two important sustainability indicators are the trade deficit as a percent of GDP, and saving-investment gap as a percent of GDP. The former shows the vulnerability of the current account due to a large and

⁸ See **Box 7.1**, for the impact of trade liberalization on Pakistan's CAB.

persistent trade deficit⁹, while the latter simply reflects the source of imbalance; either cause by low domestic savings or rise in investment rate.¹⁰

The YoY decline in import growth has helped in reducing pressure on trade deficit to GDP ratio, which recorded a slight deterioration to 6.8 percent in FY07 as compared to 6.7 percent in FY06 (see **Figure 7.7**).

The private saving-investment gap, as a percent of GDP, has fallen to 0.3 percent in FY07 as against the FY06 level of 0.6 percent (see **Figure 7.8**). The deterioration in public saving-investment gap widened to 3.1 percent of GDP during FY07 as compared to 2.3 percent in FY06. This was mainly due to continuous fall in public saving growth on account of expansionary fiscal expenditures during FY07.¹¹

Financing Indicators

Financing of CAD can be done either through debt creating flows or through non-debt creating flows. Although there is no overwhelming evidence in favor or against either of the two financing options, some literature suggests that if a deficit is largely financed from the equity flows, particularly foreign direct investment, rather than debt flows then there would be less cause for concern.¹²

Figure 7.9 reveals that in the recent past a portion of equity flows in financing current account imbalance is relatively higher than the debt creating flows. Specifically, in FY07 the substantial flows under FDI and the portfolio investment provided a cushion against the worsening CAD.

Sovereign Rating

The relative improvement in many of the country's macroeconomic indicators, stable policy environment and sustained high growth is reflected in the improved investment

Figure 7.8: Saving-Investment Gap as Percent of GDP

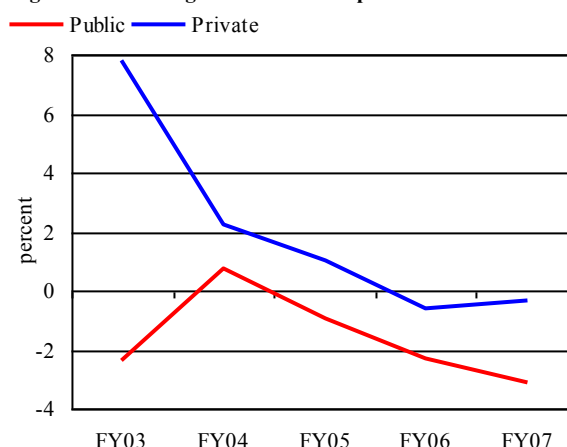


Figure 7.9: Financing Pattern

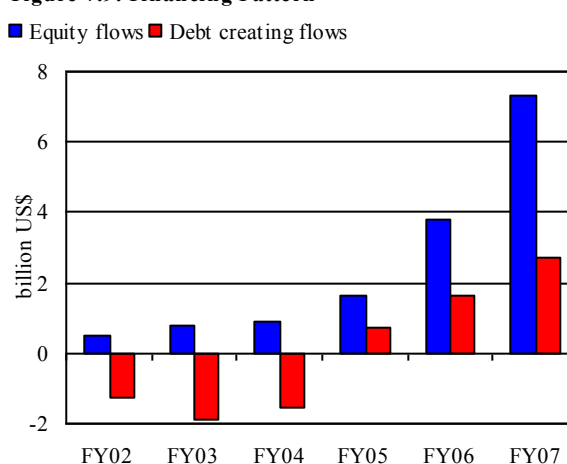
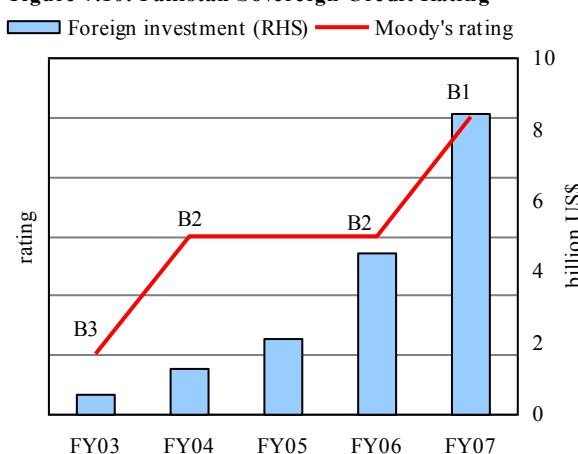


Figure 7.10: Pakistan Sovereign Credit Rating



⁹ Roubine and Wachtel 1998.

¹⁰ Theoretically, current account is equal to the difference between national saving and national investment.

¹¹ For details see section on *Economic Growth, Saving and Investment*.

¹² 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.

outlook for the country. As a result Pakistan's sovereign credit rating has improved significantly in recent years. For example, as seen in **Figure 7.10** after witnessing a stable rating of B2 by Moody's during FY04-FY06, Pakistan's sovereign long-term foreign currency rating was raised to B1 in FY07.¹⁴

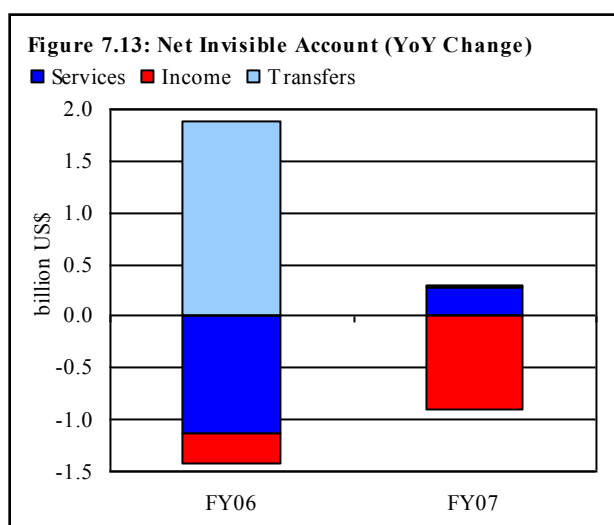
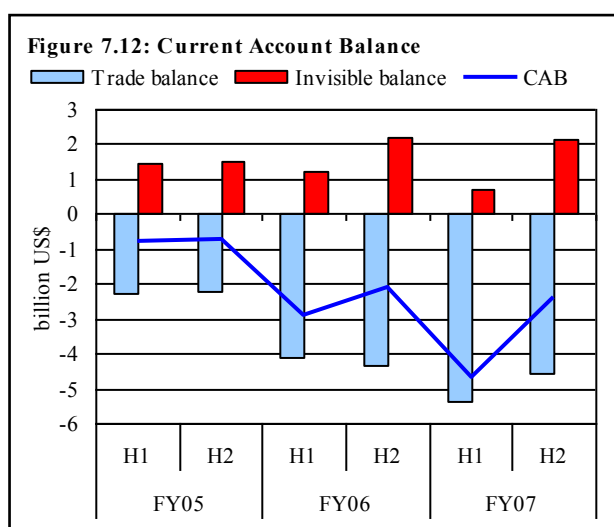
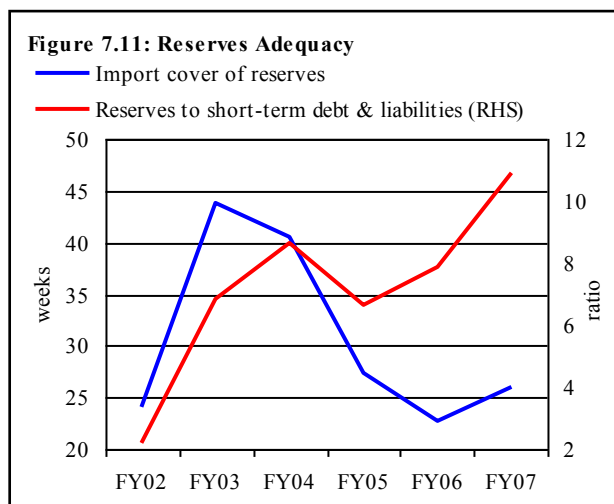
Reserves Adequacy

An appropriate level of foreign exchange reserves can help cushion an economy from external shocks, and thus can also provide a greater degree of comfort to foreign investors. Literature on gauging the appropriate levels of these reserves suggests two main indicators: (1) reserves to the short-term debt and liabilities (STDL) ratio, and (2) import-coverage ratio. As seen in **Figure 7.11**, both of these ratios depict an improvement in FY07. The import coverage ratio has increased to 26.1 weeks during FY07 from 22.8 weeks in FY06, while the reserves to STDL ratio was 11.1 times in FY07; 3.2 times higher than in the previous year. The improvement in both ratios was mainly visible due to rise in foreign exchange reserves and lower growth in both imports and STDL.

7.2.1 Current Account Balance (CAB)

The expansion in country's CAD seen in the previous two years continued into FY07, reaching to US\$ 7.1 billion (see **Table 7.2**).

However, in key respects the FY07 trend was visibly different from that in previous years. Specifically, the CAD in FY05 and FY06 was primarily driven by the unprecedented rise in the imports and an accompanying rise in the services account deficit (even as exports recorded substantial growth). By contrast, the CAD in FY07 owed more to the unexpected fall in export growth and a rise in the investment income outflows (see **Table 7.2**). Moreover, the larger part of deterioration was concentrated in H1-FY07, while the pace of the expansion slowed in H2-FY07 (see **Figure 7.12**).



¹⁴ There are two main international credit agencies i.e. Standard & Poor's and Moody's Investor services, which assign credit rating to a country after considering all significant factors like economic, financial, social, and political. A change in credit rating of a country mainly reflects risk profile of the country.

An emerging concern in the FY07 CAD is the decline in the surplus of the invisible account to US\$ 2.8 billion, 17.4 percent lower than the US\$ 3.5 billion in FY06.¹⁵ The principal contributing factor to the US\$ 601 million fall emanates largely from a sharp rise in the income account deficit (see **Figure 7.13**). On the positive side, the services outflows were subdued in FY07.

To elaborate, transportation outflows, a major component of services account, saw lower increase as a result of deceleration in import growth. On the other hand, the recent surge in foreign investment led to an increase in repatriation of profits and dividends. Thus, the gain from the lower growth in transportation outflows was neutralized by the rise in repatriation of profits and dividends.

In this perspective, even though the government is trying to contain the growth in the CAD (see **Box 7.2**), the pressure emanating from the income account outflows on the CAD is likely to persist in the short run. The need for financing, through foreign investment or loans, in turn, would sustain the rise in income account outflows. This dynamic underlines the need to increase export growth and encourage unilateral transfers (remittances).

Box 7.1: Impact of Trade Liberalization on the Current Account Balance of Pakistan¹⁶

Trade liberalization is thought to promote efficient utilization of resources through enhancing competition leading to efficient allocation of resources, which assists in the overall growth process. Thus trade liberalization is deemed to have strong and positive correlation with economic growth¹⁷.

However, trade liberalization could also generate excess demand for imports leading to worsening of the CAB of the country. According to Khan and Zahler (1985), “trade liberalization may promote growth from the supply side but, if the balance of payments worsens, growth may be adversely affected from the demand side because the payments deficits resulting from liberalization are usually unsustainable and not easily rectified by relative price (real exchange rate) changes”.

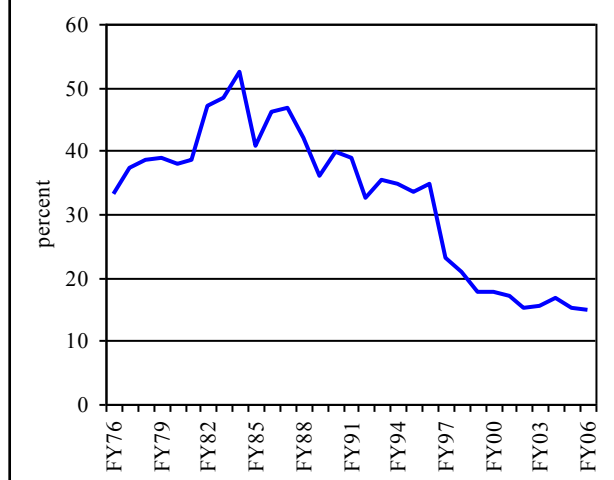
Pakistan has liberalized its trade regime throughout the 1990s and the process of reforms is still going on.¹⁸ As a result average effective tariff rate has fallen to 14.9 percent in 2006 from around 40 percent in the beginning of 1990s (see **Figure 7.1.1**).

In recent years, however, trade liberalization has coincided with the deterioration in the CAD which has swelled to US\$ 7.1 billion (4.9 percent of GDP) in FY07. The objective of this study is therefore to empirically investigate the impact of trade liberalization on the CAB of Pakistan.¹⁹

The study follows Paulino and Thirlwall (2004) and Lopez (2004) to develop following model.

$$CABR = c_0 + c_1 \text{ rer} + c_2 \text{ yf} + c_3 \text{ yd}(-1) + c_4 \text{ tot} + c_5 \text{ tropen} + c_6 \text{ Dum01} + \text{et}$$

Figure 7.1.1: Average Effective Tariff Rates in Pakistan



¹⁵ Invisible account includes the difference between exports and imports of services, receipts and payments of income and unilateral transfer.

¹⁶ This box is based on a study titled “The Impact of Trade Liberalization on Current Account Balance of Pakistan” conducted by Atif Ali Jaffri for upcoming SBP Working Paper.

¹⁷ For literature on relationship between trade liberalization and growth, see Dollar (1992), Sachs and Warner (1995), Edwards (1998) and Frankel and Romer (1999).

¹⁸ For details on the history of trade liberalization reforms in Pakistan, see, Khan (1998), Kemal et. al. (2003), Din et. al (2003), and Thoburn (2004).

¹⁹ The impact of trade liberalization on trade balance or current account balance is discussed in the recent literature (e.g. Khan and Zahler (1985); UNCTAD (1999); Chinn and Prasad (2000); Parikh (2004); and, Paulino and Thirlwall (2004)).

Where the dependent variable CABR is the current account balance to GDP ratio; rer is percentage change of real exchange rate between Pak-rupee and US Dollar; yd(-1) is domestic GDP growth in the previous year; yf is world income growth; tropen is trade openness (or liberalization) calculated as the percentage share of exports plus imports in GDP; tot is the growth in terms of trade (terms of trade is the ratio of unit value of exports and unit value of imports) and DUM01 is dummy variable to capture change in CAB from deficit to surplus after 9/11 shock and et is an error term. It is expected that c1 is positive as real exchange rate depreciation leads to enhance competitiveness of exports thus improving trade balance and current account balance of the country, c2 is expected to be positive as increase in foreign income leads to

increase in demand of our exports, c3 is expected to be negative as high domestic income leads to greater demand for imports, c4 would be positive (negative) if substitution effect is lower (greater) than income effect of improvement in terms of trade, c5 is expected to be negative when as a result of openness imports are liberalized and exports growth do not match import growth, and c6 is expected to be positive as it captures current account surplus in two years after the 9/11 shock mainly due to high remittances inflows.

The study uses annual time series data from 1976 to 2006, and the data source for all variables except average effective tariff rate and world income is IFS-CD ROM. The source of data on average effective tariff rate is Central Board of Revenue, Pakistan; and, data on world GDP is taken from World Development Indicators.

Table 7.1.1: Estimation results

Dependent variable: CABR

Explanatory Variables	Coefficients	t-statistic
Constant	0.07	2.38***
DLGDP (-1)	-0.11	-3.23***
TROPEN	-0.32	-3.24***
GTOT	-0.06	-2.21***
Dum01	0.06	7.44***
Adjusted R-squared	0.81	
DW-statistics	1.72	

***Significant at 1percent

According to the findings of the study, trade liberalization, GDP growth and growth in terms of trade are important determinants of CABR of Pakistan.²¹ The results (see **Table 7.1.1**) show that a rise in overall trade by one percent of GDP worsens CAB by 0.32 percent of GDP. Furthermore, one percent rise in GDP growth worsens CAB by 0.11 percent of GDP in the next year, and an increase in growth of terms of trade by one percentage point deteriorates the CABR by 0.06 percent. Thus the empirical finding suggests that for a sustainable CAB in Pakistan, the process of import liberalization should be accompanied by measures to enhance export competitiveness.²² Moreover, the process of rapid economic growth in recent years has aggravated demand for imports due to domestic supply constraints; therefore output gap should be reduced through productivity enhancement and tackling supply side bottlenecks.

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²¹ The variables real exchange rate depreciation, world income growth, average effective tariff rates, fiscal balance and financial deepening were also considered as control variables but dropped after being found to be insignificant.

²² Rapid liberalization of imports can cause payment difficulties as well as dislocations in the economy, unless it is appropriately sequenced or combined with effective measures designed to enhance competitiveness and to promote exports (see, e.g. UNCTAD, 1999).

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Box 7.2: Current Account Deficit and Adjustment Policies

The current account balance (CAB) is one of the key indicators for gauging the economic condition of a country as it reflects fiscal balance and private savings-investment gap. A negative balance in the current account is thus reflective of the internal imbalance. However this does not mean that a negative current account is necessarily always bad. Countries in their initial stages of development can witness large deficits as surge in imports due to capital investment can cause the balance to tilt adversely. Over time, as these investments start paying off, the deficit is most likely to diminish.²³ However, if the CAD is driven by lower savings as a result of "excessive consumption" then deficit could widen and eventually become unsustainable, thus requiring appropriate policy response.

Although in Pakistan's case, the CAD has been on the rise in the recent years, mainly due to higher import demand to cater the needs of the growing economy, its continuous rises has initiated a policy debate on whether the policy responses to address the rising deficit have been appropriate. In this backdrop, the analysis below uses vector autoregression (VAR) approach to analysis the current account dynamics following various policy shocks such as fiscal and monetary.

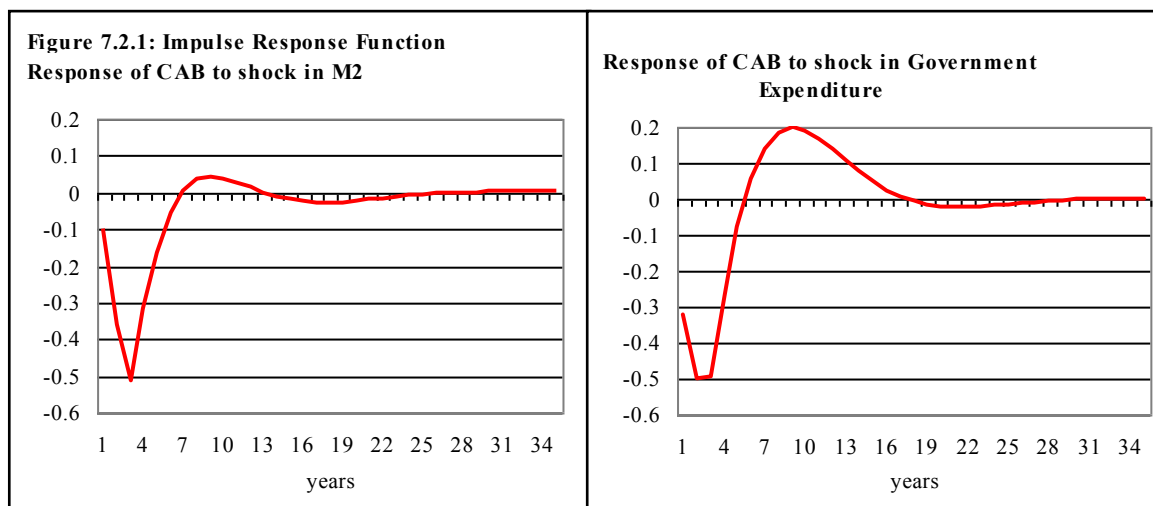
The analysis estimates an impulse response function of CAB to see whether the current account reverts to some long-term trend following a one standard deviation shocks to aforementioned policies. This would also provide meaningful insights to understand the likely impact of current monetary and fiscal policies on the growth of CAD.

This study estimate current account balance through following specification:

$$CAB = f(CAB_{t-1}, GDPG, GOVEXP, M2, ToT, REM)$$

Where CAB denotes current account balance as a percent of GDP (negative value indicate deficit); GDPG stands for GDP growth; GOVEXP is the total government expenditure as percent of GDP (proxy for fiscal policy stance); M2 as percent of GDP (proxy of monetary policy stance); ToT represent terms of trade, an exogenous non-policy variable, and REM is remittances as percent of GDP to capture change in CAB from deficit to surplus during FY01-04. Moreover, one period lag of the dependent variable is included to capture persistence in error. The estimation in the study has been done on annual data from Jun 1985 to Jun 2007 using 1 year as optimal lag length in the VAR system. The estimated VAR model verifies the expected signs of all variables (i.e. CAB is positively related to its past value and remittances, while negatively related to all remaining variables).

The impulse response function shows that the initial response of CAB to an expansionary monetary policy shock results in sharp deterioration of the current account, which bottoms out after three years before dissipating completely (see **Figure 7.2.1**). There are several channels through which monetary policy can affect CAB. For instance, cheaper availability of private sector credit, as a result of expansionary monetary policy, would tends to stimulate domestic demand leading to a



²³ See intertemporal approach to current account deficit

rise in imports and thus contributing to deterioration in trade balance. Moreover, domestic inflation can also affect CAB through appreciation of REER. It may be pointed out that the likely impact of inflation on export performance and finally on CAB would depend upon the lag involved in the transmission of changes in monetary policy to inflation.

The impact of fiscal policy on the CAD is investigated through spending shocks.²⁴ The impact of a positive shock to government expenditure, on CAB is negative; however, the effect of this shock also bottom out after three years. This behavior is in line with the twin deficit hypothesis according to which an increase in government expenditure, without corresponding rise in the revenue, leads to deterioration of the trade deficit.

The SBP's current tight monetary stance is expected to help in limiting the CAD. However, if the fiscal deficit is not curtailed the likely impact of the tight monetary stance on CAD could be offset.

Trade Deficit²⁵

The growth in the country's trade deficit slowed to 17.8 percent during FY07 as compared to 87.0 percent in FY06. Consequently the trade deficit widened to a record US\$ 9.9 billion in FY07, against US\$ 8.4 billion for the previous year.

The main contribution to the sluggish import growth of 8.1 percent in FY07 was from the deceleration in the growth of petroleum and machinery imports. In addition, imports under food, transportation and metal group declined. However, the slowdown in import growth was offset by the lower export performance, as exports grew by only 3.2 percent in FY07 compared with the FY06 growth of 14.3 percent.²⁶

Services Account

The deficit in the services account narrowed by 6.5 percent YoY during FY07 to US\$ 4.1 billion (see **Table 7.2**). This improvement was caused by the increase in services export of US\$ 353 million which more than offset a rise of US\$ 66 million in services payments (see **Figure 7.14**).

Figure 7.15 shows the services payment grew by only 0.8 percent in FY07 as compared to 24.0 percent during FY06. The sluggish payment growth was mainly attributed to (1) lower rise in freight outflows as a result of a slowdown in imports (2) a substantial decline in *other business services outflows* and deceleration in growth of *other services* outflows.²⁷

Box 7.3: SBP Forex Liberalization Measures

The improved foreign exchange liquidity in the inter-bank market has helped SBP to further liberalize foreign exchange regime during FY07. In this regard, few of the important measures that have been taken by SBP are as follows.

- (1) The SBP has enhanced the Foreign Exchange Exposure Limit (FEEL) of banks and Authorized Dealers (ADs) from 10 percent of their paid up capital to 15 percent.
- (2) Another key measure is that SBP require banks and ADs to purchase foreign currency from inter-bank in settlement of Furnace Oil imports and purchase of crude oil.
- (3) To further liberalize foreign exchange regime, SBP has allowed ADs to borrow in foreign currency from International Financial Institutions subject to some conditions such as (1) borrowing is permitted in USD, Euro, GBP and JPY; (2) there is a cap on borrowing of maximum 50 percent of their unimpaired capital; (3) minimum tenor should not be less than 1 year; (4) Interest rate should not exceeds LIBOR + 1.50 percent etc. For detail see circular no.03, dated 15 Jun, 2007.
- (4) The SBP has allowed the ADs to make remittances on behalf of institutions in Pakistan with international affiliations on account of membership fees to the principals abroad. Earlier this facility was available to individual only.
- (5) SBP has directed exchange companies to route their all transaction either through their Nostro Accounts with the banks abroad or their foreign currency accounts maintained with commercial banks in Pakistan.
- (6) SBP has required exchange companies to sell a minimum of 10 percent of foreign currency on account of inward home remittances and against export of currency (other than US\$) in the interbank market.

²⁴ In most of the literature the impact of fiscal policy on current account deficit is studies through either spending shocks (government expenditure) or fiscal deficit

²⁵ This section is based on exchange record data compiled by SBP that does not tally with the Customs data compile by the FBS, and used in sub-section 7.4.

²⁶ For detail, see section on *Trade Account*.

²⁷ It may be pertinent to note that other services growth is adjusted for one-off payment of Ghazi brotha dam in Aug 2006.

Table 7.2: Current Account Balance
million US\$

million US\$

Items	FY06	FY07			Difference FY07 over FY06
		Full year	H1	H2	
1. Trade balance	-8,441	-9,944	-5,363	-4,581	-1,503
Exports	16,553	17,080	8,343	8,737	527
Imports	24,994	27,024	13,706	13,318	2,030
2.Services (net)	-4,430	-4,143	-2,451	-1,692	287
Transportation	-1783	-2043	-1064	-979	-260
Travel	-1195	-1,350	-710	-640	-155
Communication services	97	23	25	-2	-74
Other business services	-2,562	-2,099	-995	-1104	463
Government services	1,348	1,517	455	1062	169
Of which: logistic support	1070	1242	425	817	172
Other	-335	-191	-162	-29	144
3. Income (net)	-2,667	-3,569	-1,808	-1,761	-902
Investment income (net)	-2,672	-3,576	-1,812	-1,764	-904
Direct investment	-2,076	-2,806	-1,461	-1,345	-730
Of which: profit & dividend	-433	-537	-337	-200	-104
purchase of crude oil & minerals	-1,149	-1,392	-711	-681	-243
Portfolio investment	-93	-242	-95	-147	-149
Of which: profit & dividend	-88	-266	-107	-159	-178
IMF charges & interest on off. external debt	-664	-735	-364	-371	-71
Interest on private external debt	-85	-149	-58	-91	-64
Others	246	356	166	190	110
4. Current Transfers (net)	10,548	10,562	4,943	5,619	14
Private transfers	9,867	10,058	4,758	5,300	191
Workers remittance	4600	5494	2568	2926	894
FCA - residents	312	196	24	172	-116
Others	4955	4368	2166	2202	-587
Official transfers	681	504	185	319	-177
Cash grant	464	329	31	298	-135
Others	217	175	154	21	-42
Current account balance	-4,990	-7,094	-4,679	-2,415	-2,104

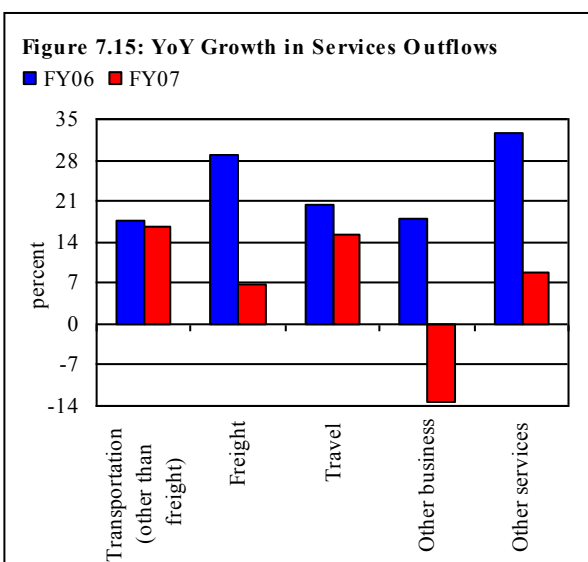
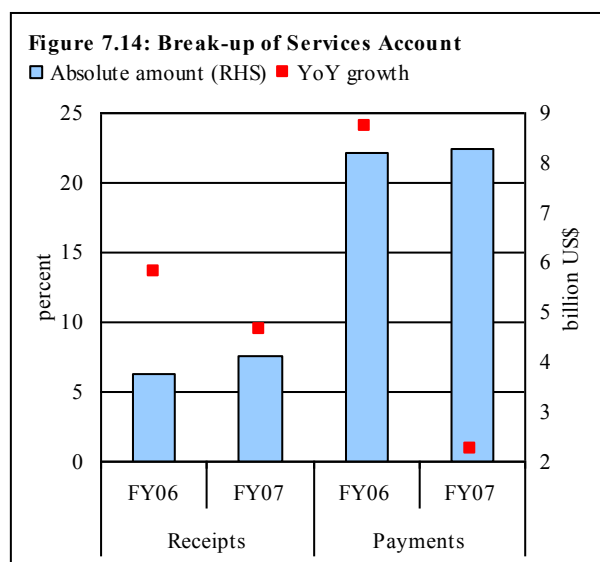
The negative growth in *other business services* was recorded on account of a US\$ 570 million decline in transaction routed through Foreign Exchange Companies (FECs).²⁸ However, the impact of this decline was partly offset by a US\$ 175 million increase in outflows through the formal system.

A breakup of the exchange companies (ECs) transactions shows that these are mainly reported under *travel* and *other business services*. The fall in ECs transaction in *other business* head (see **Figure 7.16**) reflected SBP measures to tighten documentation procedures after reports that a few ECs were not properly following SBP instructions. On the formation of ECs, SBP had allowed ECs to facilitate individual transactions other than trade related activities.²⁹ However, the rising portion of *business services outflows* since FY05 had raised some questions as to whether the restrictions were being followed.³⁰ Inquiries found that transactions reported under the *other business* head was inflated as

²⁸ The outflow under FECs has no impact on overall CAB as it is offset by the contra entry (reflecting the receipts of the FECs) appearing under the other private transfers.

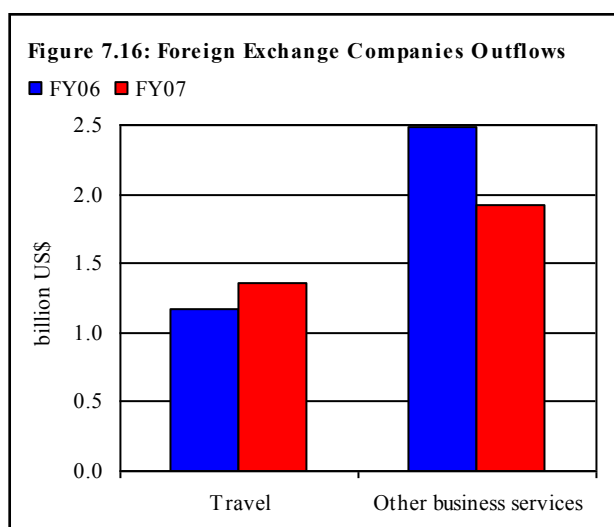
²⁹ See SBP F.E Circular No. 9 of Jul 30, 2002.

³⁰ In this context, SBP had issued a circular to restrict exchange companies from unauthorized transactions. For detail see circular letter No.11 of Jun 16, 2005.



some of the ECs were reporting non-permitted transactions under this head. When this activity was curtailed in FY07 the transaction reported in this head recorded a sharp fall.

On the export side, a US\$ 172 million YoY rise in logistic support on account of services provided to the UN troop explains part of the increase in services export during FY07. The remaining contribution came from the construction services. It may be pertinent to mention that there were certain factors which limited the services export growth to 9.4 percent during FY07.³¹ These mainly include: (1) lower remittances received by the embassies operating in Pakistan from their home countries; and (2) continued decline in communication exports in general and telecom exports in particular. The latter may be a reflection of increased usage of international calling cards, offering a concessional rate, by Pakistani residents for making international calls that could have reduced inward international calls (and hence earnings).



Income Account

The income account deficit grew by 33.8 percent growth in FY07, to US\$ 3.6 billion during FY07 as compared to US\$ 2.7 billion in the previous year (see **Figure 7.17**). This was caused by a sharp increase in investment income outflows that offset the small improvement in net interest payments.

Although the interest payment on country's external debt & liabilities witnessed a rise of US\$ 197 million during FY07, this increase was more than offset by the higher earning on country's international reserves during the year under review (see **Table 7.3**). The rise in the interest payment in FY07 was mainly caused by higher payment on Eurobonds; surge in interest payment on private loans as well as on official loans. However, keeping in view of Eurobond issuance on annual basis, and a rising stock of private sector debt, the increase in these two components was not unexpected.³²

³¹ Services export grew by 9.4 percent as against to 13.4 percent in last year.

³² For detail see section on External debt.

On the liability side, the payment made by the foreign companies for the working capital finance and interest payment on foreign currency loans extended to Pakistani trade by commercial bank explained a large portion of rise in interest payments on external liabilities during FY07.

The investment income outflows depict a 40.6 percent YoY growth in FY07 as compared to 23.7 percent growth during FY06.³⁴ A decomposition of investment income outflows shows that the contribution of purchase of crude oil & mineral to the rise in investment income outflows was significantly higher during FY07 (see **Figure 7.18**). In addition, the *reinvested earnings* and *profit & dividend* also explained substantial part of the increase in investment income outflows in FY07. In particular, the sectors which recorded hefty outflows under *profit & dividend* were telecom, power, financial business and petroleum refining (see **Figure 7.19**), reflecting the substantial investment in these areas in earlier years.

A sector wise comparison between profit & dividend repatriation and reinvested earning reveals an interesting insight. The telecom sector which had attracted hefty foreign investment witnessed more profit outflow as compared to the amount which is reinvested in the same sector during FY07 (see **Figure 7.20**). On the other hand, in the case of the financial business sector, much of the profit has been reinvested in FY07.

It is clear from above discussion that the deficit financing either through external loans or investment flows is a mixed blessing, with repercussions for external account as well as for internal balance.

To elaborate further, financing from afore-mentioned sources can exert pressure on current account in form of interest payments or profit repatriation. While, interest payments also imply fiscal costs for the government, there is no fiscal cost in case of investment flows. Therefore, among these two sources the more preferable are the investment flows. The impact of profit outflows could be mitigated if the investors are enticed to reinvest their earning instead of repatriating it.

Another significant outflow was on account of *purchase of crude oil & mineral*. The government of Pakistan paid US\$ 1.4 billion during FY07 as compared to US\$ 1.1 billion in FY06 to the foreign

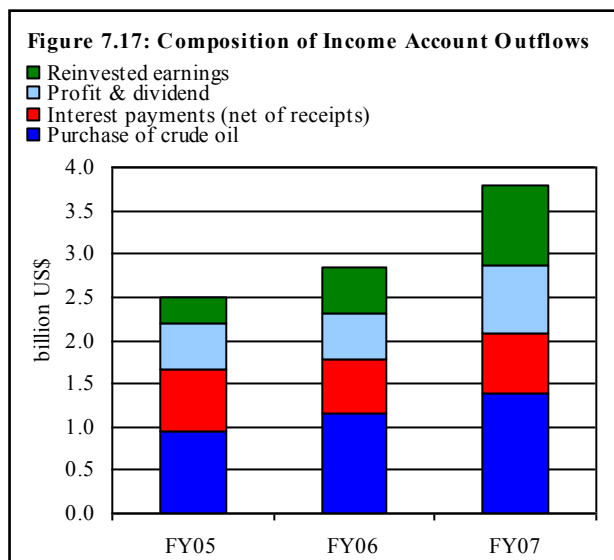


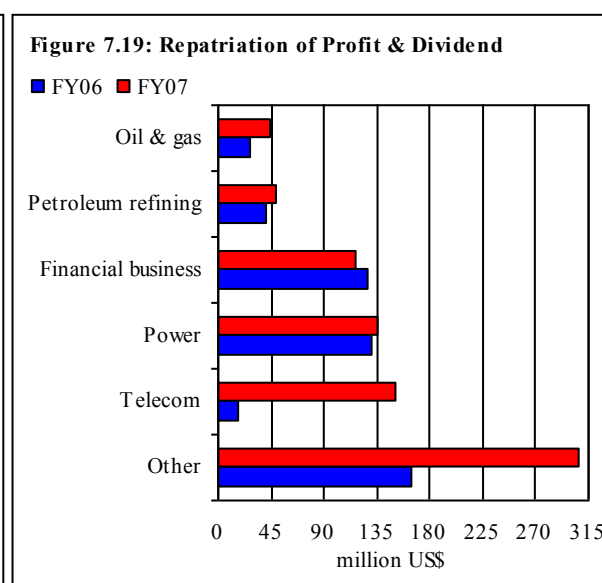
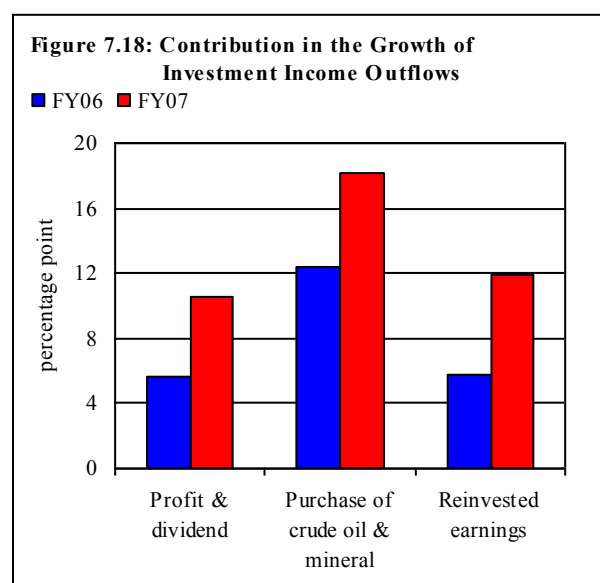
Table 7.3: Details of Interest Payments and Receipts
million US Dollar

	FY06	FY07	Savings
Payments (I+II)	1013	1210	-197
I. Total external debt	840	993	-153
Public & publicly guaranteed	739	820	-81
Long-term	618	664	-46
Military	8	7	1
Euro bonds	91	128	-37
Commercial loans/credits	8	13	-5
IDB	14	8	6
Private loans/credits	85	149	-64
IMF	16	24	-8
ii. External liabilities	173	217	-44
Foreign currency deposits	22	33	-11
Special US\$ bonds	28	13	15
Central bank deposits	34	27	7
Others	89	144	-55
Receipts	382	530	148
Interest on reserves	268	412	144
Others	114	118	4
Net payments	-631	-680	-49

Source: State Bank of Pakistan

³⁴ Comprises of profit and dividend on foreign investment, reinvested earning on FDI and purchase of crude oil by foreign companies exploring oil in Pakistan.

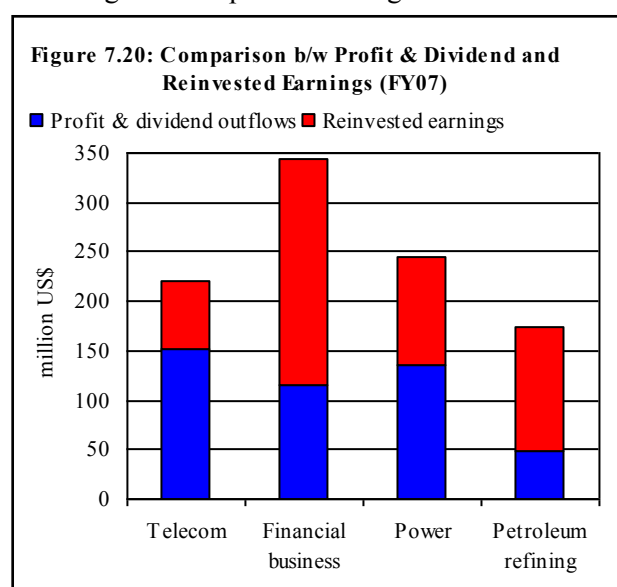
investor.³⁵ This rise probably reflects higher prices, as there was no substantial increase in the production of crude oil, gas or LPG during the year.³⁶



Current Transfers

These flows largely remained unchanged from the previous year, increasing by US\$ 14 million during FY07 to reach US\$ 10.6 billion (see **Table 7.2**). The marginal 0.13 percent YoY growth in current transfer in FY07 was quite puzzling, given that the remittances – a major component of transfers- depicts an impressive growth of 19.4 percent in FY07 as compared to 10.3 percent growth during FY06.

A breakup of current transfers shows that even this nominal increase was mainly achieved in H1-FY07, with a decline witnessed in the second half of FY07. As shown in **Figure 7.21** the main factor behind the lower increase in current transfers during FY07 was other private transfers. During the first half of FY07 increase in other private transfers supplemented the workers' remittances, but during H2-FY07 the fall in other private transfers completely offset the impact of increases in remittances and FCAs.³⁷



On the other hand, the official transfers recorded a decline of US\$ 177 mln in FY07 over last year.³⁸

³⁵ In fact, it is the foreigner's share in total exploration of oil & gas, other than the government's share, which they can sell to government of Pakistan or export it.

³⁶ For example, while the international oil prices started to decline gradually since Jul-2006, however, average international oil prices during FY07 (62.78 US\$ per barrel) is still higher than the corresponding average prices (61.45 US\$ per barrel) during FY06; thus possibly explains the higher purchase of crude oil & mineral outflows during FY07.

³⁷ The lower inflow of US\$ 196 million in FCA during FY07 as compared to an inflow of US\$ 312 million in FY06 was mainly a result of relatively stable rupee and widening spread between returns on rupee and FCAs.

Workers' Remittances

An encouraging aspect of current transfers is the remarkable growth of 19.4 percent YoY in workers' remittances during FY07 to reach US\$ 5.5 billion (see **Table 7.4**). The higher growth in remittances emanated largely from the traditional sources, i.e., the Middle East and the USA (see **Figure 7.22**). A part of the sharp rise in remittances during years may also partly reflect investments in the Pakistan's asset markets, particularly in equity market.

The sharp surge in remittances from the Middle East was largely from Saudi Arabia and UAE (see **Figure 7.23**). It is worth

mentioning that during FY07, the YoY increase in remittances from UAE was substantially higher, i.e., US\$ 150.2 million compared to a rise of US\$ 3.7 million in the previous year. Anecdotal evidence suggests that this rise is partly attributable to (1) rising construction activity due to real estate boom in Dubai and (2) higher economic activities in Gulf region as a result of the oil boom. This has raised demand for labor and led to higher wages contributing to higher remittances.

Remittances from USA have also been witnessing a steady increase, with the monthly average rising to US\$ 121.6 million in FY07 compared to US\$ 103.5 million last year. Interestingly, there appears to be a shift in the channels of these flows; with entire increase routed through exchange companies, as the remittances flowing from banking channels declined during FY07 (see **Figure 7.24**).

Moreover, remittances from an important source, i.e., UK fell sharply; in contrast to a 17.9 percent increase in FY06, FY07 saw a negative growth of 2.0 percent (see **Figure 7.25**).³⁹ This deceleration probably represents a reversion to normal flows after a substantial increase in the previous year in wake of the October 2005 earthquake.

Other private transfer (credit)⁴¹

Other private transfers (credit) recorded a US\$ 610 million fall during FY07 as compared to FY06 (see **Figure 7.26**). As seen in **Figure 7.27**, this decline was largely evident in H2-FY07 and was

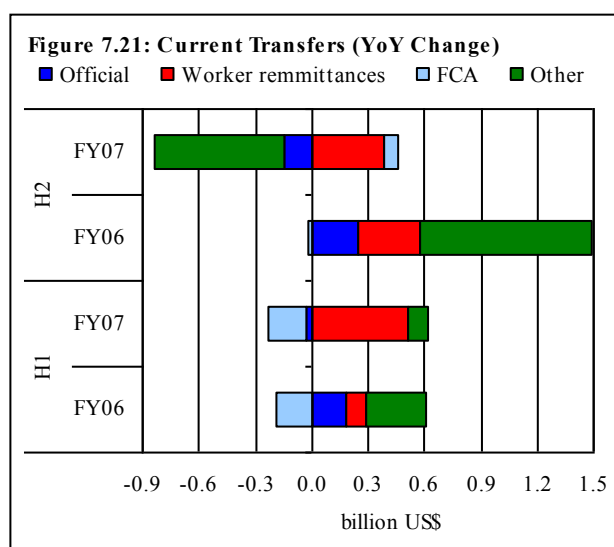


Table 7.4: Workers' Remittances
million US\$

	FY06	FY07	Change
I. Gulf region	2,063	2,647	584
Bahrain	101	136	36
Kuwait	247	289	42
Qatar	119	171	52
Saudi Arabia	750	1024	273
Sultanat-e-Oman	130	162	31
U.A.E.	716	866	150
II. U.S.A.	1242	1460	217
III. Other than Gulf & US	1282	1384	102
Canada	82	87	5
Germany	59	77	18
Japan	7	4	-2
Norway	17	22	5
U.K.	439	430	-9
Other	680	764	84
Total	4,588	5,491	903
of which: Exchange Companies	623	950	327
Encashment of FEBCs & FCBCs	12	3	-9
Grand total	4,600	5,494	894

³⁸ This was mainly due to lower cash grant of US\$ 329 million for budgetary purpose and US\$ 9 million earthquake grant.

³⁹ In absolute term, the YoY decline in remittances was US\$ 9 million during FY07.

⁴¹ This head mainly comprises of unclassified private transfers, private donation, withdrawal from the residents FCAs and receipts of exchange companies.

caused mainly by (1) fall in receipts of ECs; (2) decline in private donations and (2) lower receipts in unclassified private transfers.

Figure 7.22: Contribution to Remittance Growth

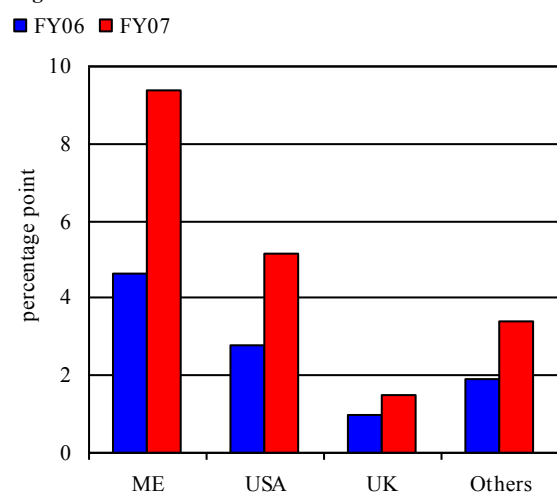


Figure 7.23: Sources of Rise in Remittances from ME

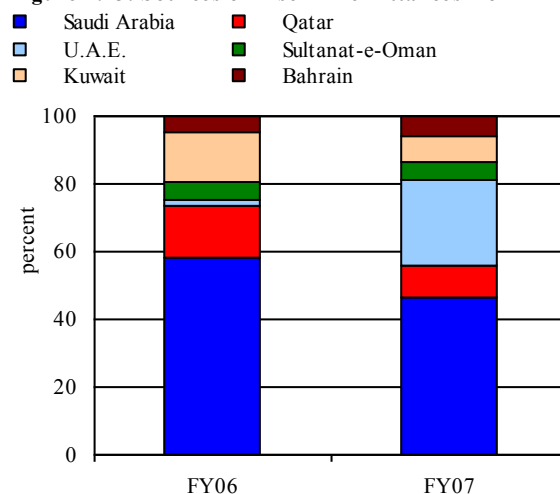


Figure 7.24: Sources of Change in Remittances from USA

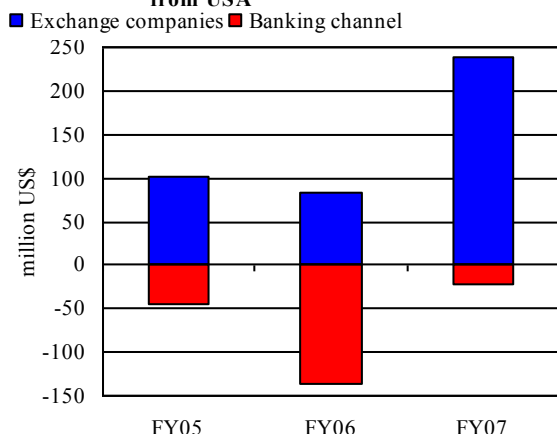
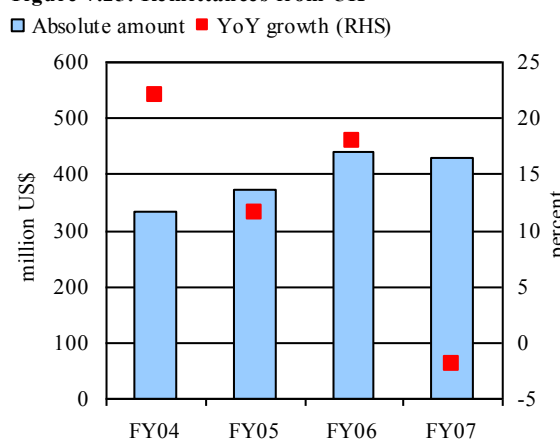


Figure 7.25: Remittances from UK



In specific terms, receipts of ECs were limited to US\$ 2.3 billion in FY07 as compared to US\$ 3.0 billion in last year. It is pertinent to mention here that the private transfers routed through ECs have increased substantially since FY05 due to integration of informal flows into formal channels through ECs.⁴²

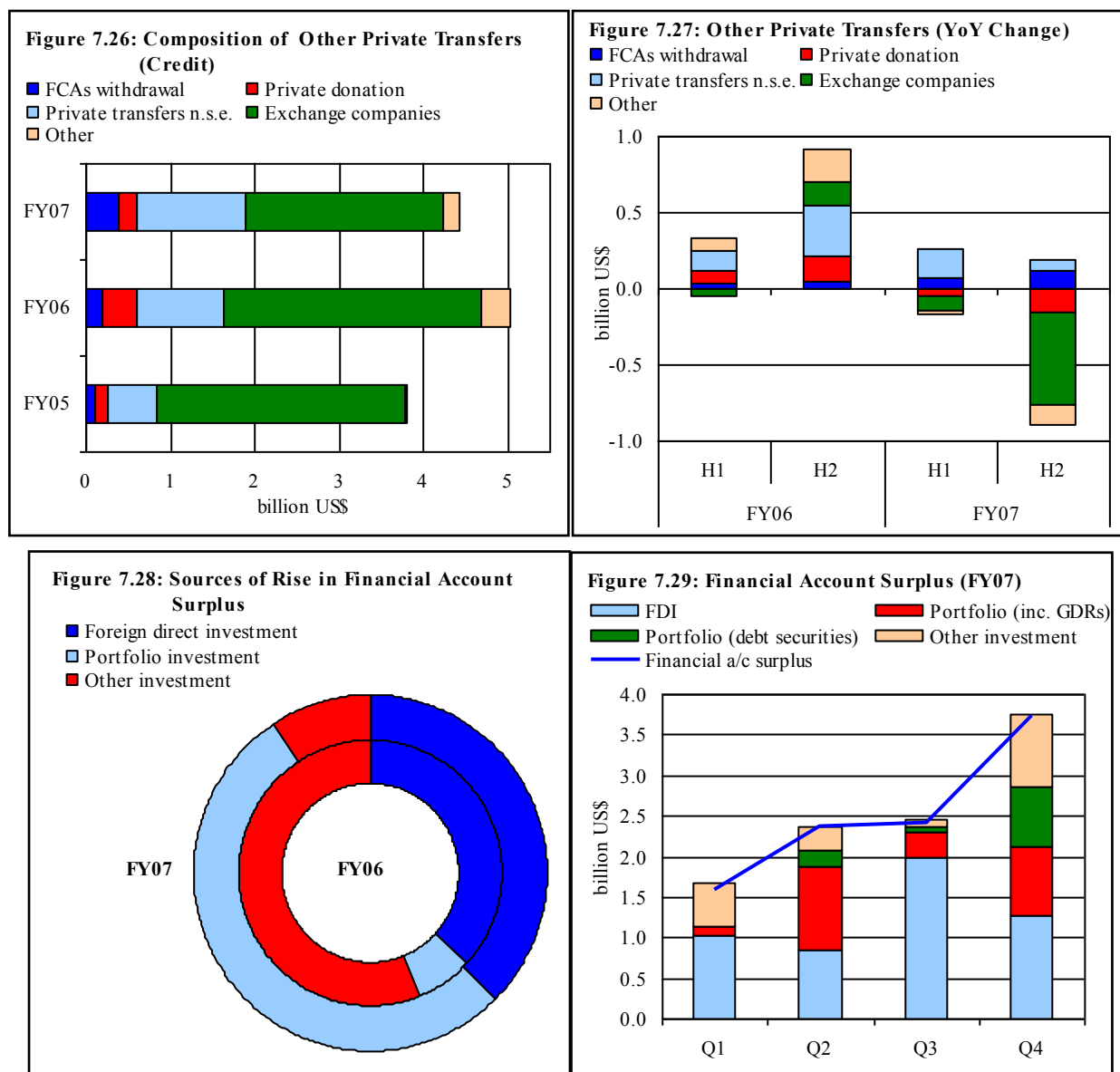
However, the recent fall in inflows under this head is a reflection of fall in other business services outflow, as mentioned earlier. In fact, receipts of the ECs under other private transfers are a contra entry of services outflow of ECs.

Besides exchange company's receipts, the inflow from the private donations during FY07 was also subdued probably due to lower contribution for earthquake relief activities.

Financial Account

⁴² In June 2004, the State Bank of Pakistan required informal moneychangers to convert into and register as foreign exchange companies by August 30, 2004.

The country's financial account posted a largest ever surplus of US\$ 10.1 billion in FY07, US\$ 4.3 billion higher compared to that in the previous year (see **Table 7.5**). The sharp rise in the surplus was mainly explained by the significant increase in portfolio investment, as well as FDI (see **Figure 7.28**).



Privatization proceeds contributed only US\$ 266 million to the FY07 surplus, in contrast to the US\$ 1.5 billion recorded in FY06.

A quick look at quarterly trend of financial account surplus reveals that a large part of the surplus materialized in the last two quarters of FY07. In particular, Q4-FY07 witnessed US\$ 3.7 billion surplus which is the highest surplus ever recorded in any quarter (see **Figure 7.29**).

Table 7.5: Financial Account

million US\$

	FY06	FY07			Difference FY07 over FY06
		Full year	H1	H2	
Financial Account (1 through 4)	5,830	10,105	3,964	6,141	4,275
1. Direct investment abroad	-71	-110	-51	-59	-39
2. Direct investment in Pakistan	3,521	5,140	1,873	3,267	1,619
Equity capital	2,925	4,230	1,443	2,787	1,305
<i>Of which: privatization proceeds</i>	1,540	266	133	133	-1,274
Reinvested earnings	537	907	428	479	370
3. Portfolio investment	986	3,281	1,295	1,986	2,295
Equity securities	351	2,303	1,153	1,150	1,952
<i>Of which: stock markets</i>	351	862	272	590	511
Debt securities	613	977	149	828	364
<i>Of which: Euro bonds</i>	796	820	-1	821	24
Net foreign investment(1+2+3)	4,436	8,311	3,117	5,194	3,875
4. Other investment	1,394	1,794	847	947	400
Assets	148	-589	-36	-553	-737
I. Outstanding exports bills (exporters)	-283	-281	-180	-101	2
II. Outstanding exports bills (DMBs)	-80	10	41	-31	90
III. Currency & deposits	511	-320	103	-423	-831
<i>Of which: Bank</i>	461	-472	48	-520	-933
Liabilities	1,246	2,383	883	1,500	1,137
I. Foreign long-term loans / credits (net)	1,010	1,389	509	880	379
<i>Of which: project assistance</i>	696	833	442	391	137
<i>non-food aid</i>	1,373	1,582	572	1,010	209
<i>amortization</i>	1,059	1,026	505	521	-33
II. Private loans	231	443	169	274	212
<i>Of which: supplier credits</i>	551	843	349	494	292
<i>supplier credits repayments</i>	320	400	180	220	80
III. ST capital, (official)	-218	-83	-58	-25	135
<i>Of which: commercial banks (net)</i>	-116	-116	-116	-	-
<i>IDB (net)</i>	-102	33	58	-25	135
IV. Currency & deposits	316	326	96	230	10
<i>Of which: Trade financing</i>	697	268	99	169	-429
V. Other liabilities	-93	308	167	141	401

Source: Statistics Department, SBP

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

Foreign Investment (Net)

Net foreign Investment (NFI) depicts a sharp rise of US\$ 3.9 billion YoY during FY07 to record US\$ 8.3 billion. This was mainly caused by higher FDI, and a remarkable surge in investments in the local stock market and GDRs issues (see **Figure 7.30**).

Foreign Direct Investment

As discussed earlier, the contribution of FDI in financial account surplus in general and NFI in particular, remained substantial during FY07. In absolute terms, Pakistan received US\$ 5.1 billion of FDI during FY07, which is 46.0 percent higher than the FY06 level (see **Table 7.5**). A significant portion of the FDI inflows-US\$ 3.3 billion was recorded in the second half of FY07 (see **Figure 7.31**). During FY07 the share of privatization proceeds in FDI inflows was 5.2 percent only as compared to a more pronounced share of 43.7 percent last year.

A decomposition of FDI inflows into equity capital and reinvested earning reveals that a large portion of FDI inflows came from the rising investment in equity capital, the bulk of which was realized as a result of mergers and acquisitions, particularly in financial sector (see **Figure 7.32**). To be specific, country received US\$ 195.4 million from Standard Chartered Bank's acquisition of Union Bank⁴³; US\$ 110.2 million net inflow in ABN Amro Bank for the acquisition of Prime Bank; US\$ 98.9 million from the Samba group of Saudi Arabia to acquire Crescent Commercial Bank; and lastly US\$ 68.0 million in Habib Metropolitan Bank. Besides financial sector, telecom sector also witnessed US\$ 721.7 million of investment as a result of Paktel's acquisition by the China Mobile and another US\$ 382 million investment was in Lakson Tobacco by Philips Morris International (PMI). The other major equity flows includes: US\$ 386 million in Telenor Pakistan; US\$ 187 million in Warid Telecom; US\$ 545.1 million in oil & gas exploration sector; US\$ 154.4 million in petroleum refining and US\$ 193.4 million in power sector.

Figure 7.30: Net Foreign Investment

■ Foreign direct investment ■ Portfolio investment

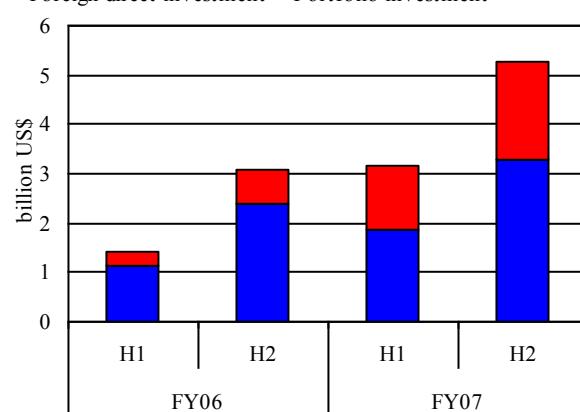


Figure 7.31: Foreign Direct Investment

■ FY06 ■ FY07

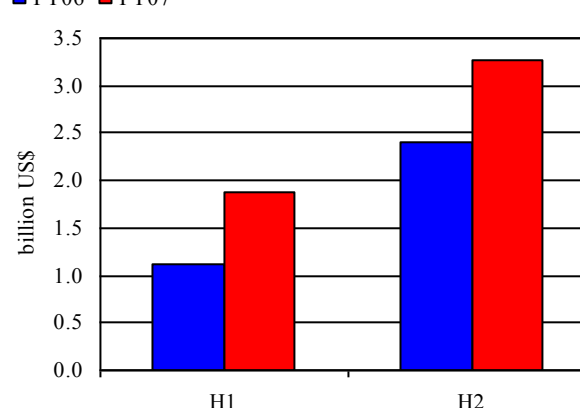


Table 7.6: Major sector wise FDI

million US\$	FY04	FY05	FY06	FY07
Communications	222	518	1,938	1,899
Financial business	242	269	329	930
Oil & gas explorations	202	194	313	545
Tobacco & cigarettes	1	7	2	389
Power	-14	73	321	193
Trade	36	52	118	172
Food & beverages	4	16	57	125
Textile	35	39	47	59
Chemicals	15	51	63	46
Leather and rubber products	4	7	8	7

⁴³ It may be important to note that total amount of Standard Chartered Bank's acquisition of Union Bank was US\$ 487 million; however, only US\$ 195.4 million was realized in FY07, whereas the remaining amount was paid to the external share holder.

Furthermore, a sector wise analysis of FDI inflows shows that in Pakistan FDI is mostly concentrated in non-tradable sectors such as financial business, telecommunication, and power. While the contribution of sectors which can generate export revenue like textile, leather products and chemicals was relatively low over the period (see **Table 7.6**).

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Nevertheless, investment in non-tradable sector is equally important as it promotes efficiency and economic growth (see **Box 7.5**). Lastly, it must be noted that as a result of gradual rise in FDI in recent years, performances of FDI at regional level - gauge by the Inward FDI performance index ranking⁴⁴ - has improved and is significantly better than that of many South Asian countries (see **Table 7.7**).

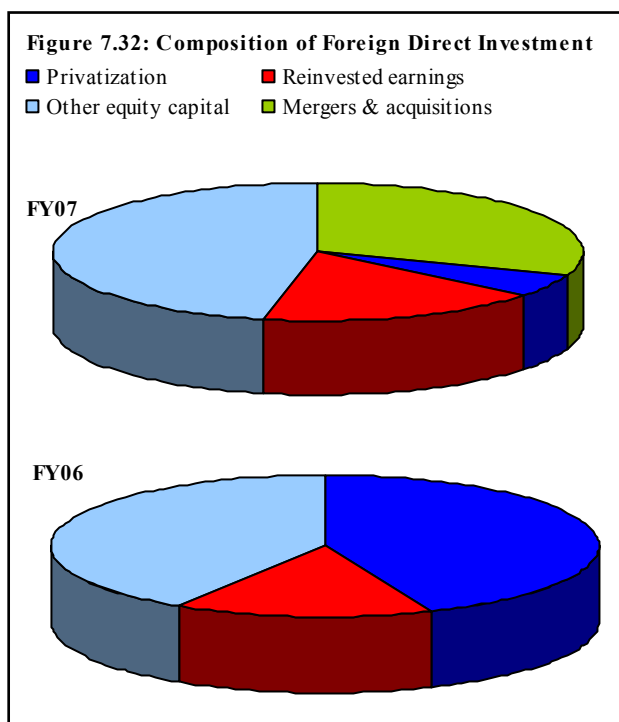


Table 7.7: Pakistan's Ranking in the Inward FDI Performance Index

	2002	2003	2004	2005
Pakistan	120	115	109	102
Sri Lanka	108	100	96	106
Bangladesh	115	121	119	116
India	111	109	112	119
Nepal	135	135	136	135

Source: UNCTAD, World Investment Report 2006

⁴⁴Inward FDI performance index is a measure of the extent to which a host country receives inward FDI relative to its economy size. It is calculated as the ratio of a country's share in global FDI inflows to its share in global GDP. Each year index shows three-year moving averages, using data for the three previous years, including the year in question.

Box 7.4: Long-run Implications of FDI Inflows on Pakistan's Economy

The importance of foreign direct investment as a source of direct capital financing is well established in literature which suggests foreign trade as one of the possible transmission channel from FDI to economic growth. Certainly, the contribution of FDI in exportable industries leads to increases in the export capacity, while in case of imports; the investment can lower the demand for imports by promoting import substitution industries. Besides, the spillover impacts of FDI such as transfer of technology and market access plays important role in the economic growth of a country. However, such impacts of FDI may not be uniform across the board, as some sectors are slow in absorbing technological changes. For example Hirschman(1958), points out that "in agriculture and mining these linkages are weak". Likewise Kokko(1994) notes that "enclave investments offers little scope for the local economy to benefit". Similarly, Wang and Bloomstrom (1992) find that in case of the services sector, the spillover impacts, especially in terms of transferring technology, are significant

Along with the benefits there may also be some costs of the FDI. Unregulated FDI flows can bring about serious difficulties to balance of payments owing to high import content and profit outflows related to multinational capital"(UNCTAD, 2002).

Usually the policy maker prefers FDI in tradable sector, due to potential of this sector to produce exportable surplus, which can help elevate pressure on countries external accounts. FDI in the services sector while less preferred also has substantial benefits in the form of its spillover effects. These are realized in the form of economic efficiency through infusion of new technology and management techniques that can provide important impetus to the growth. The benefits, could thus override the costs associated with the profit outflows.

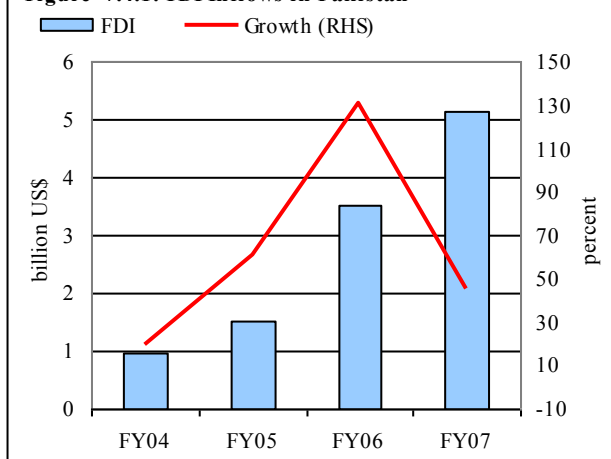
Pakistan has witnessed a sharp increase in the Foreign Direct Investment inflows since FY04. Specifically in FY07, the inflows under FDI were US\$ 5.12 billion, 46 percent higher from FY06 level and 440 percent higher than FY04 (see **Figure 7.4.1**). Like earlier inflows majority of inflows in FY07 were concentrated in the services sector; telecommunication and financial businesses (see **Table 7.4.1**).

The impact of the FDI in Pakistan's two major recipients in the services sectors, i.e. Telecommunications and Banking sectors is discussed below.

The impressive performance of the banking sector in recent year has made this sector very attractive for the foreign investors. As a result the sector attracted approximately US\$ 1.53 billion investment during last 3 years. The gain in technical efficiency as a result of these FDI could be seen in indicators such as the increasing number of installation of ATMs (Automated Teller Machines) and the number of electronic transactions (see **Table 7.4.2**) which has pushed up the operating performance of the banking sector (based on the operating cost to total assets ratio) since FY04.⁴⁵ The efficiency gain in operation, beside others, is probably one of the explanatory factors for the higher growth in profitability and assets, the banking sector is witnessing since the influx of FDI in this sector. The higher profitability at the same time indicates that the sector could be attracting more FDI going forward.

Table 7.4.1: Sector Wise Share in FDI (in percentage)

	FY06	FY07
Oil & gas exploration	8.9	10.6
Power	9.1	3.8
Communication	55.0	37.0
Telecommunication	54.1	35.6
Financial business	9.3	18.2
Tobacco & cigarettes	0.1	7.6
Others	17.6	22.8
Total	100.0	100.0

Figure 7.4.1: FDI Inflows in Pakistan**Table 7.4.2: Growth in the Banking Sector**

	2005	2006	2007
M2 to GDP ratio	45.64	44.99	44.01 ^a
No. of ATMs	1028	1612	2294
No. of electronic transactions(000)	43687	70119	99368
Operating cost to total assets ratio*	2.24	2.21	2.28

^a Provisional; * Calendar Year

⁴⁵ The ratio indicates that operating efficiency has decreased in the CY06. This is primarily due to the one time higher cost incurred by the banking sector for improvement in the IT infrastructure and the human skills, as required by the SBP, for banking sector automation and effective risk management.

A large body of empirical literature has found that the growth of financial sector is a very important determinant of the long term economic growth. For example, Levine (2004) have established that the well developed financial systems ease external financing of firms, which illuminates a mechanism through which financial development influences economic growth. FDI inflow in the financial sector therefore, would aid economic growth.

Similarly, FDI in the telecommunication sector has not only provided much needed impetus to this sector, but it has had multifaceted impacts on the economy. The growth in the telecommunication could be seen in the increasing teledensity⁴⁶ of the country, which has grown from 2.8 percent in FY01 to 45.1 percent in FY07⁴⁷. Other impacts have been captured in the empirical research that has confirmed the existence of significant causal link between the telecommunication development and economic growth. This channel works with the growth of the telecommunication sector which requires supply chains of vendors that provides communication sets and/or connection services. In either case, new employment and income generation opportunities are created. Kevin Stiroh (2002) has found that Information Technology (IT) is strongly associated with higher firm level productivity. Besides, IMF Report on Information Technology (2005-06) points out that Information and Communication Technology (ICT) has helped in increasing the total Factor Productivity (TFP) by one third of a percentage point per year in the industrial economies and significantly in the Asian economies⁴⁸. Furthermore, modern development gurus like Parnab Bardhan agree that growth oriented policies that lead to allocative efficiency of resource use, may help poor possibly by enhancing their purchasing power and/or by creating new employment opportunities.⁴⁹

References:

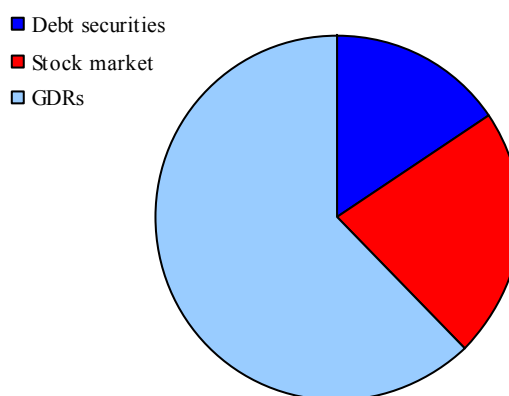
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Portfolio Investment

Foreign portfolio investment witnessed a substantial YoY rise of US\$ 2.3 billion during FY07. These flows contributed significantly in the financing of large CAD during the year.

The improvement in portfolio investment in FY07 mainly came from the rising investment in equity securities, particularly in the Global Depositary Receipts (GDRs) issued by the government (for OGDC and UBL) and by a private sector bank (see **Figure 7.33**). Besides GDRs, a significant portion in equity securities comprises of foreign investment in the country's stock market. These increased by US\$ 510.5 million in FY07.

Figure 7.33: Sources of Rise in Portfolio Investment (FY07)



This said, foreign investment in local stock market appeared lower than the net inflows recorded under Special Convertible Rupee Account (SCRA) during FY07.⁵⁰ In specific terms, in FY07, the net inflows routed through SCRA were US\$ 979.6 million, while the actual investment made in the stock market was US\$ 861.5 million during the same period. The difference of US\$ 118.1 million primarily

⁴⁶ Teledensity is defined as number of users over entire population.

⁴⁷ The figure includes fixed line mobiles and WLL - Source: www.pta.gov.pk.

⁴⁸ Based on the SBP First Quarterly Report FY07 - Special Section 2.

⁴⁹ This said, FDI in this sector can also exert some import pressures as well. For instance, Pakistan has recorded approximately US\$ 2.0 billion of import bill under other transmission apparatus and mobile phones imports during FY06-07. It may be pertinent to mention, the import growth in this head has slowdown to 17 percent in FY07 from 53 percent last year.

⁵⁰ Non-residents are allowed to invest in the domestic stock market and money market securities through SCRA. For detail see Q3-FY07.

reflects; US\$ 43 million on account of 5 percent shares of Lakson Tobacco Company limited bought back by PMI; by acquiring a 51 percent share of Lakson Tobacco, PMI became a major share holder in the company and therefore this amount is recorded in FDI rather than in portfolio investment. Another US\$ 73.5 million was routed through SCRA in FY07 for investment in money market securities such as Treasury bills and Pakistan Investment Bonds. Nevertheless, most of the SCRA flows in FY07 still constituted equity investments by non-residents foreign investments (see **Figure**

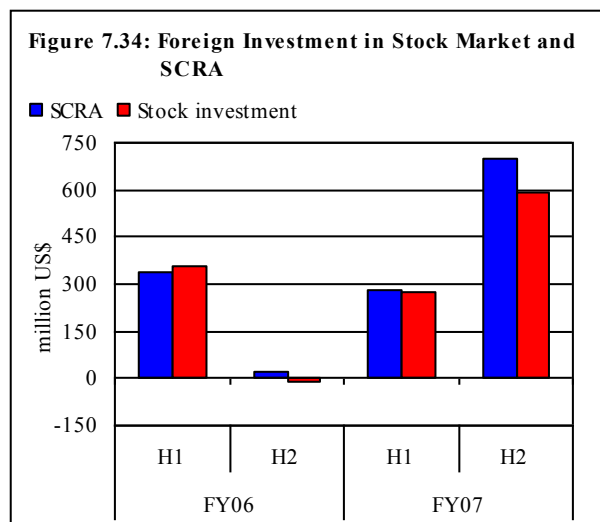
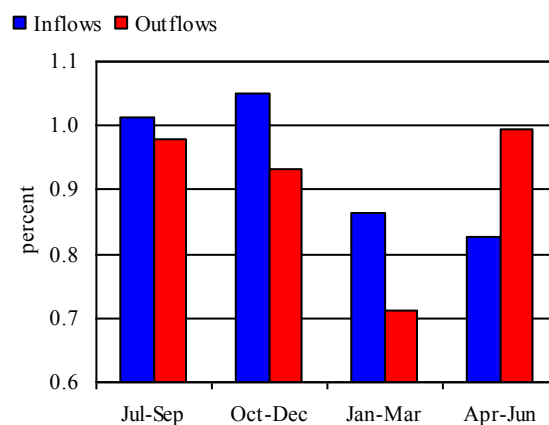


Figure 7.35: Coefficient of Variation of Daily SCRA Flows Across Quarters (FY07)



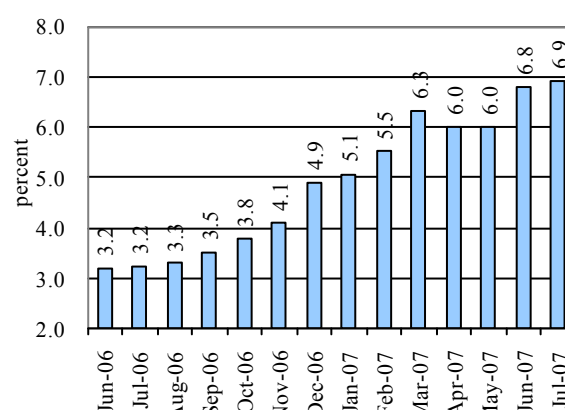
7.34).

While the surge in net inflows under SCRA reflects auspicious performance of local bourse, it also reflects vulnerability in the external sector. The daily volatility-gauge by the co-efficient of variation in SCRA flows increased substantially as the year progressed (see **Figure 7.35**). In particular, in the last three month of FY07 the co-efficient of variation of daily SCRA outflow jumped to 1.0 percent from 0.71 percent during Jan-Mar FY07. The increased volatility was possibly a reflection of profit making by the foreign investors on account of striking performance of Karachi stock exchange (KSE-100) which depicts 103 percentage points increase in Q4-FY07 over the preceding quarter.

Though the substantial increase in equity investment owes to improving country's fundamentals, there is need to continuously monitor these flows to avoid any financial crisis, since such flows are volatile. Moreover, it is also important to maintain adequate foreign reserves in order to protect the economy from short-term shocks.⁵¹

This caution has become increasingly relevant due to the rising share of foreign equity portfolio investments. To put this in perspective it may be noted that the share of market value of foreign investment in the aggregate KSE market capitalization has increased sharply from 3.2 percent in Jun-FY06 to 6.8 percent in Jun-FY07 (see **Figure 7.36**). More importantly, the

Figure 7.36: Foreign holding as percent of agg. market cap



⁵¹Besides short-term debt, portfolio investment can also be categorized as short-term foreign liabilities. For detail see (Athukorala and Warr, 2002).

adequacy of foreign currency reserves against these flows – as gauged by ratio of SBP foreign currency reserves to outstanding market value of foreign holdings - has declined to 3.0 times by end-June 2007 from 7.3 times in end-FY06 (see **Figure 7.37**). This decrease was mainly due to relatively higher growth in market value of the equity investments.

The surge in market value of foreign equity investments was concentrated in H2-FY07, reflecting: (1) capital gains due the better performance of the KSE-100 in the period. This is evident from **Table 7.8**, which shows that the change in per share prices of major stock increased substantially during H2-FY07 compared to H1-FY07, and; (2) large conversion of GDRs into ordinary shares during the latter half of FY07 may have inflated the value of outstanding shares without affecting the actual cash inflow into the SCRA⁵².

With regard to GDR conversions, out of total GDRs issuance of 98.3 million approximately 39.9 million of GDRs have been converted into ordinary shares in FY07 (see **Table 7.9**).⁵³ Theoretically, foreign investors convert their GDRs into ordinary shares when GDRs trade at a discount relative to underlying share (after adjusting for exchange rate and exchange ratio between the GDR and the domestic stock).

Specifically, MCB recorded a 2.4 million of GDRs conversion in FY07.⁵⁴ A detailed analysis shows that a large portion of MCB

GDRs conversion was recorded during the period when the share price differential existed between the markets, which possibly provided arbitrage opportunity to investors.^{55,56} However, the price differential has started diminishing since April 2007 onwards partly due to PKR stability, which has possibly reduced the GDR conversions (see **Figure 7.38**).

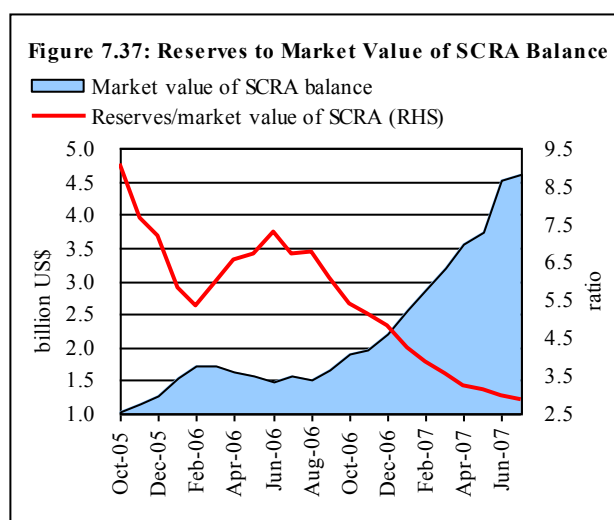


Table 7.8: Performance of Major Stocks

	Change in per share prices	
	Dec-06 over Jun-06	Jun-07 over Dec-06
LUCK	-31.70	79.39
DGKC	-23.70	72.98
KAPCO	-1.04	45.49
MCB	29.49	44.93
ENGRO	-2.52	42.58
UBL	16.28	35.55
PSO	1.08	32.26
HUBCO	27.23	30.54
FFBL	-4.18	30.31
Bank Al-falah	13.47	24.96
PTC	7.08	17.63
PPL	15.23	11.73
Bank of Punjab	30.61	11.13
Faysal Bank	1.13	10.57
FFC	-8.17	7.44
NBP	23.07	4.72
OGDC	-8.96	2.13
POL	6.54	-4.45

Source: Karachi Stock Exchange

⁵² Once the foreign investors convert their GDRs into ordinary shares they have the option to trade those ordinary shares either in the local stock market or dis-invest.

⁵³ In case of GDRs, country saw three GDRs issues-OGDC of US\$ 738 million; MCB of US\$ 150 million and UBL of US\$ 650 million in FY07. Out of 650 million of UBL GDR, approx US\$ 560 million was realized in the month of June 2007, while the remaining amount was recorded in Jul 2007.

⁵⁴ MCB had one-way convertibility guarantee available to the foreign investor to hedge risk and was granted the two-way convertibility in Jun-2007 (see **Box 7.5**).

⁵⁵ Approx. 2.1 million of MCB GDRs was converted into ordinary shares during Oct-Mar FY07.

⁵⁶ The GDRs prices in US dollar were converted into Pakistani rupees by adjusting for the exchange rate for each day of trade. Then to compare the converted prices with the price of underlying shares in Pakistani stock market, the GDR to ordinary ratio for each stock is calculated.

The OGDC share prices in international market, after correcting for exchange rate, follow the same pattern as in domestic market (see **Figure 7.38**). The similar, OGDC share prices in both domestic and international markets seems intriguing since no re-conversions of ordinary shares into GDRs have been reported during FY07.⁵⁷

Despite the fact that the price differential in both markets was very dismal throughout the period under review, approximately 63 percent of total GDRs issued were converted after first month of the issuance date; thus the trading volume of OGDC GDRs in London stock exchange (LSE) dropped significantly thereby reducing liquidity in the international market during the same period.

Nonetheless, the issuance of GDRs has both positive and negative implications for the local stock market. On the one hand, GDRs conversion increases the stock market capitalization, but on the other hand, the international listing has significance for the firms' domestic stock prices (see **Box 7.6**).

Investment in debt securities also witnessed an increase of US\$ 364.0 million during FY07 to reach US\$ 977 million. This amount includes both private sector flows - Mobilink bond of worth US\$ 250 million⁵⁹ - as well as the public investment.

Outstanding Export Bills (OEBs)

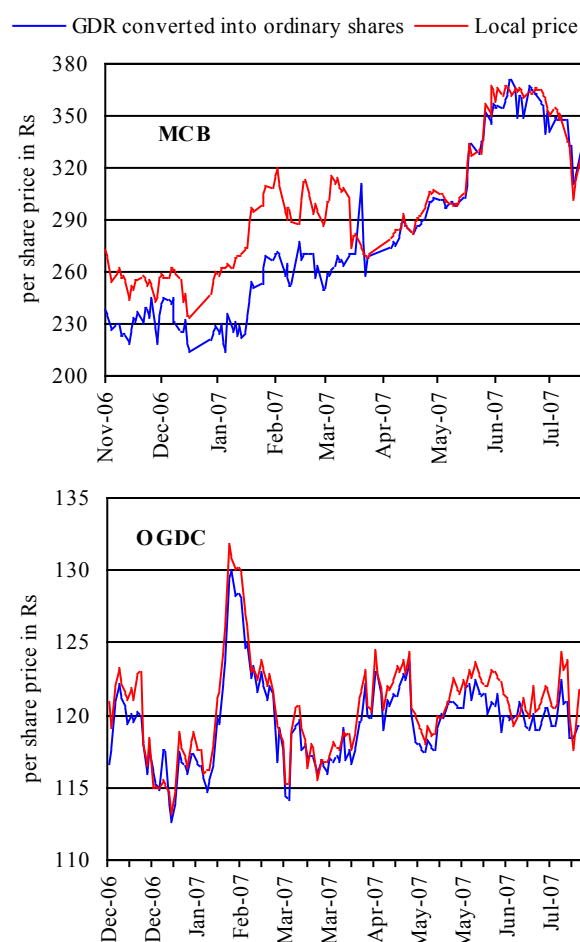
The aggregate stock of outstanding export bills held by exporters and banks increased by US\$ 271 million during FY07 as against US\$ 363 million rise in FY06 (see **Table 7.5**). The lower increase in OEBs was principally due to net realization of bills held by banks. Specifically, during FY07 the discounting of export bills by banks was much lower than the previous year. The lower discounting of OEBs by banks was probably due to lower usage of OEBs as collateral for forex loans during FY07 (as net forex lending against FE-25 was only US\$ 268 million in FY07).

Table 7.9: Information on GDRs (FY07)

	million		million	
	No. of Issuance		No. of Conversion	
	GDRs	Ordinary shares*	GDRs	Ordinary shares*
MCB	8.6	34.5	2.4	9.5
OGDC	39.1	390.6	29.8	298.1
UBL**	50.6	202.3	7.7	30

*against GDRs
 ** conversion is reported in month of Jul-2007
 Source: Local custodian banks

Figure 7.38: Share Price Comparison



⁵⁷ In the month of Jul 2007 GDR re-issuance totaled to 14 million of ordinary shares.

⁵⁹ Out of US\$ 250 million private bond, US\$101 million was utilized in loan repayment of the company; reflected as debit entry in other liabilities of financial account, thus have no impact on BoP.

Currency and Deposit⁶⁰

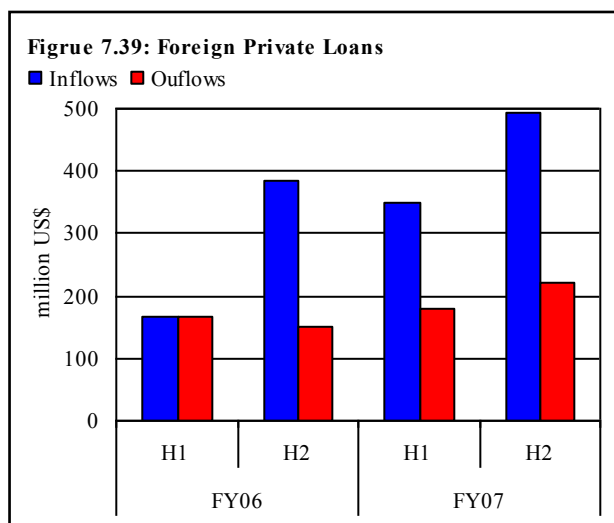
In contrast to FY06, FE-25 Nostro deposit assets⁶¹ registered a rise of US\$ 472 million in FY07. This caused overall currency and deposit assets to increase by US\$ 320 million during FY07 (see **Table 7.5**). Interestingly, the increase in FE-25 Nostro in FY07 was visible despite the deceleration in FCA deposits which has offset part of the gains from the lower net lending against FE-25 loans. This rise in FE-25 Nostro was concentrated in H2-FY07, primarily due to commercial bank's placement of *other than FE-25 deposits* on back of higher foreign private flows in the same period.

Official loans

This head recorded a net inflow of US\$ 1.4 billion during FY07-US\$ 379 million higher than the last year (see **Table 7.5**). If adjusting for earth quake loans, this increase becomes even more pronounced to US\$ 891 million in FY07. The improvement during FY07 was a result of US\$ 209 million YoY increase in program loans mainly from ADB and World Bank. At the same time, a rise of US\$ 137 million in project loans further strengthened the foreign loans receipts. On the payment side, amortizations decline by US\$ 33 million in FY07.⁶²

Private and short-term loans

The net inflows under *private loans* inched up by US\$ 212 million during FY07 over the previous year (see **Table 7.5**). As evident from **Figure 7.39** this improvement was primarily caused by a sharp rise in receipts during FY07. In specific terms, in FY07 the communication sector witnessed a substantial inflow of US\$ 303.2 million. Private loan inflows were also recorded in cement, financial businesses and textiles, sectors.⁶³ The recent surge in private foreign currency loans inflows mainly reflects local corporate desire to take advantage of lower interest rates and relative stability of the exchange rate.



On the other hand, the short-term loans, mainly comprising of commercial loans and IDB financing for oil imports, witnessed a lower net outflow of US\$ 83 million in FY07 compared to US\$ 218 million during FY06.⁶⁴ This was primarily due to higher inflow of US\$ 225 million under IDB loans during FY07 as against US\$ 169 million in FY06.⁶⁵

⁶⁰ This head mainly comprises of commercial bank's FE-25 Nostro.

⁶¹ FE-25 nostros deposits constitute the placements by domestic commercial banks with their foreign counterparts out of FE-25 deposits, placements other than FE-25 and cash in hand.

⁶² For detail see section on *External Debt*.

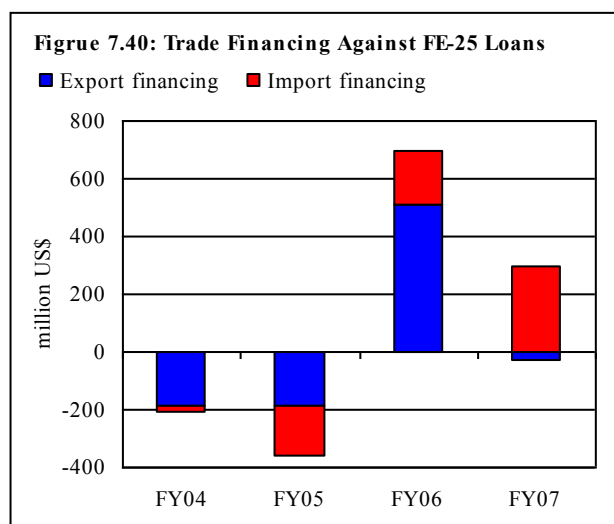
⁶³ For detail see section on *External Debt*.

⁶⁴ As discussed in previous reports, the net outflow under commercial loans reflects the rollover amount of US\$ 100 million with an offsetting entry in the exceptional financing in both years.

⁶⁵ Moreover, amortization of IDB loans recorded a YoY fall of US\$ 79 million in FY07.

Trade Financing

Trade financing against FE-25 loans declined by US\$ 429 million in FY07. This was primarily due to the widening spread between cost of FE-25 loans and EFS loans. In absolute term, the net trade financing against FE-25 loans was limited to US\$ 268 million during FY07 compared to US\$ 697 million last year (see **Table 7.5**). A further breakup of trade financing into export and import finance depicts that most of the slowdown was recorded in the export finance, (in fact these loans registered a net retirement of US\$ 28 million in FY07 as against to substantial net lending of US\$ 508 million in FY06) (see **Figure 7.40**). Nevertheless, importers (that do not have access to concessional financing) continued to finance their expenditures through FE-25 loans, to take advantage of lower nominal interest rates and the relative stability of the rupee.⁶⁶



Box.7.5: One-way and Two-way Fungibility/Convertibility

In principle, a dually listed share in both international and domestic markets should trade at same price because of arbitrage activity. In other words, if there is a divergence in share prices, an arbitrage opportunity arises to sell the share where it is overpriced and vice versa. This whole mechanism works if there is no restriction on DRs and underlying share movement between international equity market and the domestic markets; such types of arrangement are largely observed in developed countries. Under this arrangement if the prices are high in domestic market, then investors have the option to convert their DRs into ordinary shares and thus can trade in the domestic market. Hence reducing the number of DRs outstanding and increasing the number of shares traded in the domestic market. Similarly, when DRs are traded at higher prices, new DRs can be issued thus increases the outstanding balance of DRs and decreasing the underlying shares in the local market. This is an example of unrestricted two-way DRs convertibility program, where share prices are expected to differ by the transaction cost of arbitrage.

On the other hand, there are limited two-way convertibility arrangements where the re-issuances of ordinary shares into DRs are subject to the availability of headroom⁶⁷. Such types of options are usually found in developing countries, where capital account is not fully liberalized, including Pakistan. In addition, there is also a one-way convertibility option in which once the DRs has been cancelled then no subsequent re-issuance is allowed; this is a most restricted type.

There is a growing concern in Pakistan with regard to two-way fungibility option that GDRs conversion can increase the stake of foreign investors in the equity markets and thus can add more volatility in the domestic stock market.⁶⁸ In this context, it is important to mention that in Pakistan the guidelines issued by SECP allows a foreign investor to hold only 5 percent or in some cases 10 percent of local shares, either through GDRs representing such equity shares or direct holdings of equity shares in local stock market.⁶⁹ Therefore, beyond above-mentioned limit GDR conversions cannot influence the Pakistani stock market. Thus country can limit the extent of any unpleasant shock at time of abrupt withdrawal of these flows.

Box 7.6: Impact of International listing by Banks and Firms: A Case of Pakistan

As a result of global integration, capital markets around the world and those in developing countries in particular have experienced sweeping changes in form of tapping international equity markets to raise capital beyond national borders. Depositary Receipts have emerged as a preferable way in developing countries to access international equity markets.⁷⁰

⁶⁶ For detail see chapter on Money & Banking.

⁶⁷ Headroom is the number of GDRs available for convertibility, as a result of cancellation.

⁶⁸ Since the abrupt withdrawal of foreign equity investment can adversely affect the domestic stock prices.

⁶⁹ For more than 10 percent permission is required from SECP.

⁷⁰ There are two types of DRs; (1) one which are traded on US stock exchange such as NYSE are named as ADRs and (2) DRs that are traded on stock exchanges at other parts of the globe such as London stock exchange are called Global Depositary Receipts (GDR).

Indeed, it provides an opportunity to both investors and companies to invest or to raise funds from the foreign equity markets.

It is generally argued that companies mostly prefer to list local shares in the international equity market primarily due (1) to maintain presence on the radar screens of international investors (2) to reduce the cost of raising capital; (3) to reduce illiquidity; and (4) to increase number of foreign shareholder. From the investors' viewpoint, DR is a way to diversify their portfolios by investing in the international stock market and thus reducing market and exchange risks. Moreover, foreign investors are normally reluctant to invest into equity market of emerging countries mainly due to legal and institutional restrictions; and brokerages fees.

Pakistan's case:

In case of Pakistan, equity market remained outside such type of global integration until 1994.⁷¹ However, Pakistan re-entered the international equity market through successful issuances of public and private GDRs in London Stock Exchange (LSE); which includes MCB, OGDC, and UBL. Floatation of these GDRs received remarkable response from the international investors and brought one-time proceeds of US\$ 1.5 billion.⁷² The purpose of going to the international capital market of afore-mentioned public and private sector was to maintain a presence in the international equity market for the projection of country's strong economic position.

Since in Pakistan the pace of global integration gained a major impetus from the recent GDRs issuances therefore it is important to understand its impact on domestic stock market. There are empirical studies of countries that have analyzed the affect of GDRs listing on local stock market through various channels such as share prices of domestic stocks and trading volume before and after foreign listing.⁷³ The empirical evidence suggests mixed results; in some cases GDR/ADR listing reduce the liquidity/prices of the domestic underlying shares, while there are cases where international listing increases the liquidity/prices of the domestic stock prices. Thus, the post-listing share price performance varies across companies and sometimes the initial increase or decrease in share prices dissipates over the next year.

Literature on GDRs, attempts to propose several reasons to explain the share prices behavior. For instance, it is argued that the increase in share prices around international listing can be related to diversification of global market risk exposures for the company and thus in reduction in its cost of equity. In addition, the liquidity changes, measured in terms of increase in trading volume; increase trading hours-in most case 24 hour and shifts in the shareholder base, following a cross-listing also explain a part of price change.

On the other hand, several studies have found that post listing decline in local returns could be due to; (1) price pressures due to new issuances of stock following listing (2) biases in initial listing prices; (3) selection biases in management timing their application for listing, usually an offer is launched after the stock has performed well in the local market.⁷⁴

For this study, we have done a statistical exercise on the afore-mentioned GDRs to find if there is any gain in domestic stock prices following GDR issuance. We have taken daily closing share prices of MCB and OGDC on domestic stock exchange for 100 days prior to and 100 days after the foreign listing date; since UBL GDRs are recently issued therefore we are unable to do the same exercise for UBL. The results are based on t-test of difference of means of the domestic share prices for each stock. **Table 7.6.1** indicates that in case of MCB the dually listed shares registered an increase in domestic share prices following the foreign issuance. This was possibly a reflection of ongoing impressive performance of banking sector, which may have further strengthened expectations of increased returns.

Table 7.6.1: Effect on Average Domestic Stock Prices Before and After GDR Issuance

Stock	Prior Mean	Post Mean	% Change in prices	t-Test for two Sample Means
MCB	222.6	275.0	23.5	16.0*
OGDCL	133.8	120.2	-10.2	16.8*

Prior Mean is calculated as average stock price on KSE for 100 trading days before GDR listing

Post Mean is calculated as average stock price on KSE for 100 trading days after GDR listing.

*Significant at 5 percent level

⁷¹ The very first GDR was issued by PTCL in 1994 of amount US\$ 900 million thereafter HUBCO and Pakistan Cement raised capital from the international market through GDR in 1994 and 1995 respectively.

⁷² MCB, OGDC and UBL GDRs were oversubscribed by 4.7, times, 2 times and 3.8 times respectively.

⁷³ For detail see: (Kumar & Saudagaran) "The impact of International Listings on Liquidity: Evidence from the Indian Stock Market".

⁷⁴ In fact, most of the literature, such as McConnell (1986); Dharan and Ikenberry (1995); and McConnell et al., 1995, supports strongly the management timing problem as one of the main reasons behind the fall in returns.

7.3 Exchange Rate and Reserves

During FY07, Pak rupee exhibited a mixed trend vis-à-vis benchmark currency US dollar, depreciating by 1.15 percent in the first half and then appreciating by 0.89 percent in the second half. In the first half, the widening trade deficit drove the rupee depreciation while in the second half, improved market related inflows helped rupee to recover some of the losses. As a result, rupee depreciated only by 0.25% during FY07 (see **Figure 7.41**).

The relative stability of the rupee against the US dollar appears to be a function of (1) the structure of the forex market in Pakistan, (2) dynamics of Pakistan's trade and (3) special arrangements to support for oil payments.

Almost two-thirds of Pakistan's trade is carried in US dollar and rest in the other currencies. Low composition of third currencies in the external trade has resulted in the domestic foreign exchange market being dominated by USD/PKR currency pair transactions in the Interbank Market. Consequently, traders in the local market have overwhelmingly (almost 99 percent) borrowed in US dollar (see **Figure 7.42**).⁷⁵ Similarly, more than 75 percent of foreign currency deposits are dollar denominated.

Thus any change in market sentiments, even based on the misreading of the fundamentals results at times in speculative attack on Rupee Dollar parity causing severe strain on the other policy variables.

Such episodes have caused significant volatility in the exchange rate since SBP opted for a free float regime in 2000. These episodes of volatility in the exchange rate have, however, been masked by the overall stability of the exchange rate during the period. Specifically between June 2002 and 2007, apparently there is only 0.6 percent change in the value of rupee, however during this period there were occasions when huge mismatches in Demand/Supply accompanied

Figure 7.41: Volatility in Interbank Exchange Rate

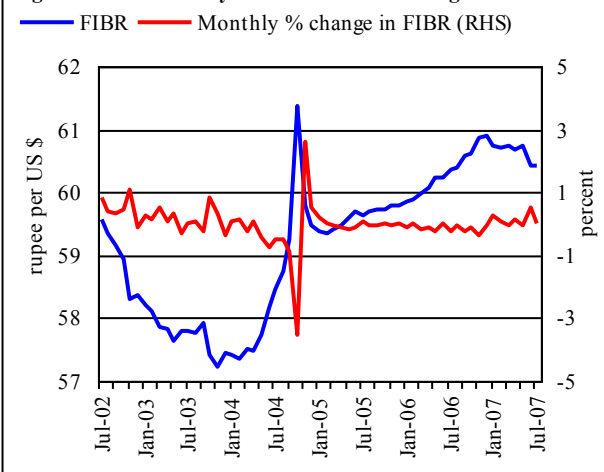


Figure 7.42: US\$ Denominated FE Lending

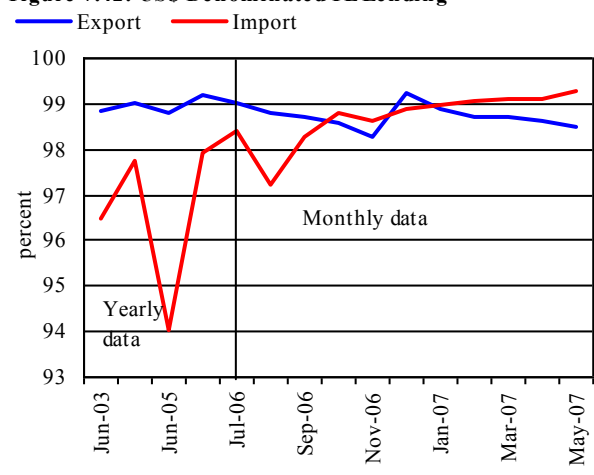
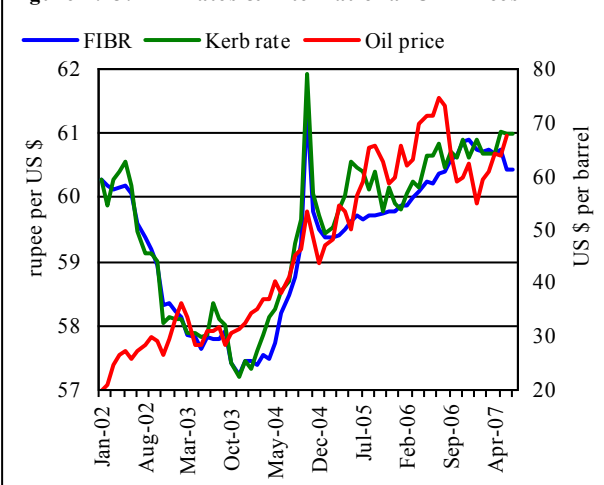


Figure 7.43: FIB Rates & International Oil Prices



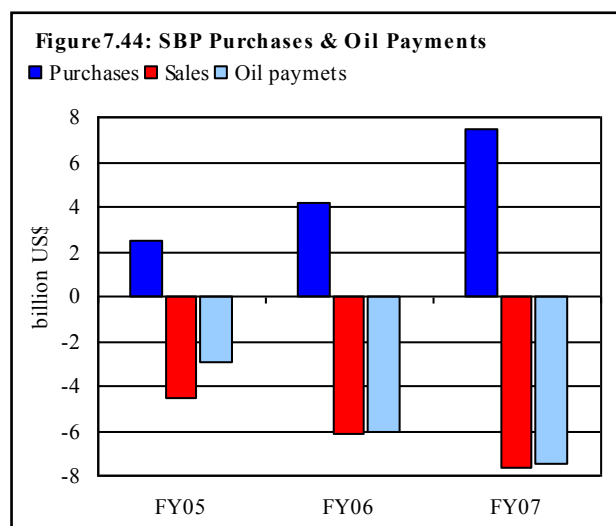
⁷⁵ Borrowings in FE serves two purposes, first it helps in managing currency risk for the borrowers and second cost of borrowing in FE typically remains lower than the other available avenues.

by speculations caused rupee to appreciate and depreciate significantly (see **Figure 7.41**).⁷⁶

For example, when oil price started moving upwards in April 2004; Pak rupee felt pressure and depreciated against the US Dollar by almost 6.8% by October 2004. However, once the SBP committed officially in November 2004, to support the market for the lumpy oil payments the rupee rallied to regain much of the lost ground in December 2004 (see **Figure 7.43**).

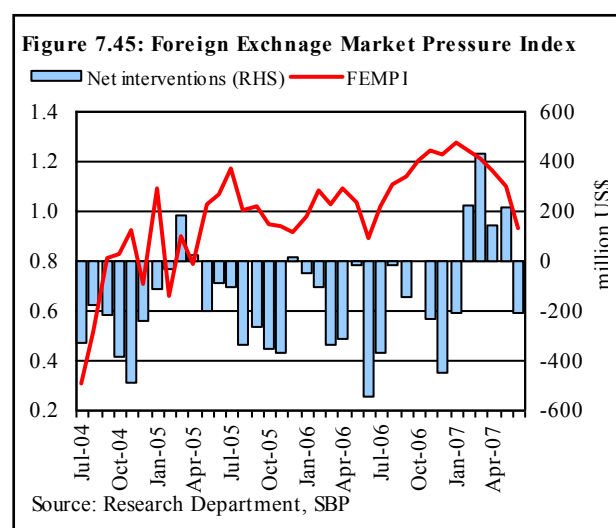
Despite the pledge, SBP since then has generally injected very little foreign exchange into the market from its own reserves except in FY06, when market inflows were low (see **Figure 7.44**).⁷⁷ Most of the time SBP's effort was directed towards eliminating mismatches between inflows and the outflows, i.e., purchasing when market had excess FE inflows and selling the same for Oil Payments.

Given the importance of the dollar in Pakistan's trade, and its susceptibility to speculative attacks requires SBP to closely follow the market developments and intervening to remove excessive volatility in the exchange rate. SBP's commitment for the Oil Payments therefore, played an important role in warding off speculative attacks on the currency. The aim was to build market's confidence on SBP's ability to successfully hold off any untoward pressures in the domestic currency without eyeing any particular level or range for the rupee dollar parity.



The latter is evident from the bi-directional movement in the exchange rate since 2002 (see **Figure 7.43**). Initially the exchange rate appreciated reflecting improvement in forex inflows and current account, and depreciated in latter period as rise in oil prices and other imports deteriorated the current account. However, since the deterioration in the current account was more than offset by financial and other inflows, the adverse impact on the foreign exchange reserves was not realized. As a result the impact of widening current account deficit on the exchange rate was also moderate. The broad trend in the exchange rate, however, remained in line with changes in the fundamentals.

Foreign Exchange Market Pressure Index (FEMPI) calculated on the basis of volatility of exchange rate, interest rate and foreign exchange reserve also shows that SBP interventions were basically aimed at removing excessive volatility; despite SBP



⁷⁶ Rupee appreciated by 4.7 percent during 2002-2003, it depreciated by 6.7 percent during Apr-Oct 2004 and by 1.2 percent in Jun- Nov 2006

⁷⁷ Besides, SBP's Foreign Exchange sales for Oil support, other market support in form of FE sales is negligible.

interventions there remained pressures on exchange rate reflecting that SBP interventions were not directed to offset impact of changes in the fundamentals (see **Figure 7.45**).^{78, 79}

Similarly, the Kerb market rate (see **Figure 7.43**) which is more reflective of cash market conditions has also moved in tandem with the Floating Interbank Market Rate (FIBR) since 2002. Any short run misalignment in Kerb rates with FIBR was subsequently followed by the convergence between the two, indicating that the movement in FIBR were not managed and did reflect the changes in the fundamentals.

As discussed earlier, since adopting the free float regime SBP's aim had been to earn confidence of the market in its ability to read and handle market pressures correctly. Confidence building process naturally takes time and as SBP becomes comfortable with the level of market's maturity, it is likely to gradually reduce its frequency and volume of interventions. Already SBP has started taking actions in this direction.

In Mar, 2007 SBP increased the aggregate Foreign Exchange Exposure Limit (FEEL) of Banks and the Authorized Dealers to 15% of their Paid-up Capital, with a maximum cap of Pak Rs1,500 million.⁸⁰ This step was taken to further enhance the capacity of Authorized Dealers to manage increased volume of FX Market and to match future demand arising from growth in trade volumes. With banks' capacity to handle large payments enhanced, SBP in July 2007 announced withdrawal of its support for providing foreign exchange for furnace oil imports, which constitutes approximately one third of oil payments. This would reduce the volume & frequency of SBP interventions in the forex market; however, SBP is likely to continue its monitoring of the market to ensure smooth transition.⁸¹

Effective Exchange Rates

NEER

During FY07, Pakistan's Nominal Effective Exchange Rate (NEER) depreciated by 3.76 percent against 2.54 percent last year. Significant decline in NEER in FY07 was due to depreciation of Pak rupee against almost all the basket currencies of its trading partners and competitors, except Japanese yen⁸² (see **Figure 7.46(b)**). Relative stability of rupee vis-a-vis weak US dollar⁸³ coupled with the widening trade deficit explains persistent weakness of Pak rupee against the baskets currencies. Pak rupee appreciated against the Japanese yen due to weakness of the yen against the US dollar possibly a consequence of carry trades.

Within FY07, as discussed earlier, the net outflow due to the widening trade deficit caused NEER to shed its value more in H1FY07 compared to H2, when improved inflows moderated the impact of trade deficit (see **Figure 7.47**).

RPI

Figure 7.46(a) depicts growth in Pakistan's CPI relative to its trading partners and competitors. The CPI inflation continued to show substantial rise in inflation in Pakistan, during FY07 rising by 7.8

⁷⁸ For detail of methodology of construction, see Eichengreen, B., A.K. Rose, and C. Wyplosz (1995), "Exchange Rate Mayhem", *Economic Policy*, Vol. 21, p. 249-312.

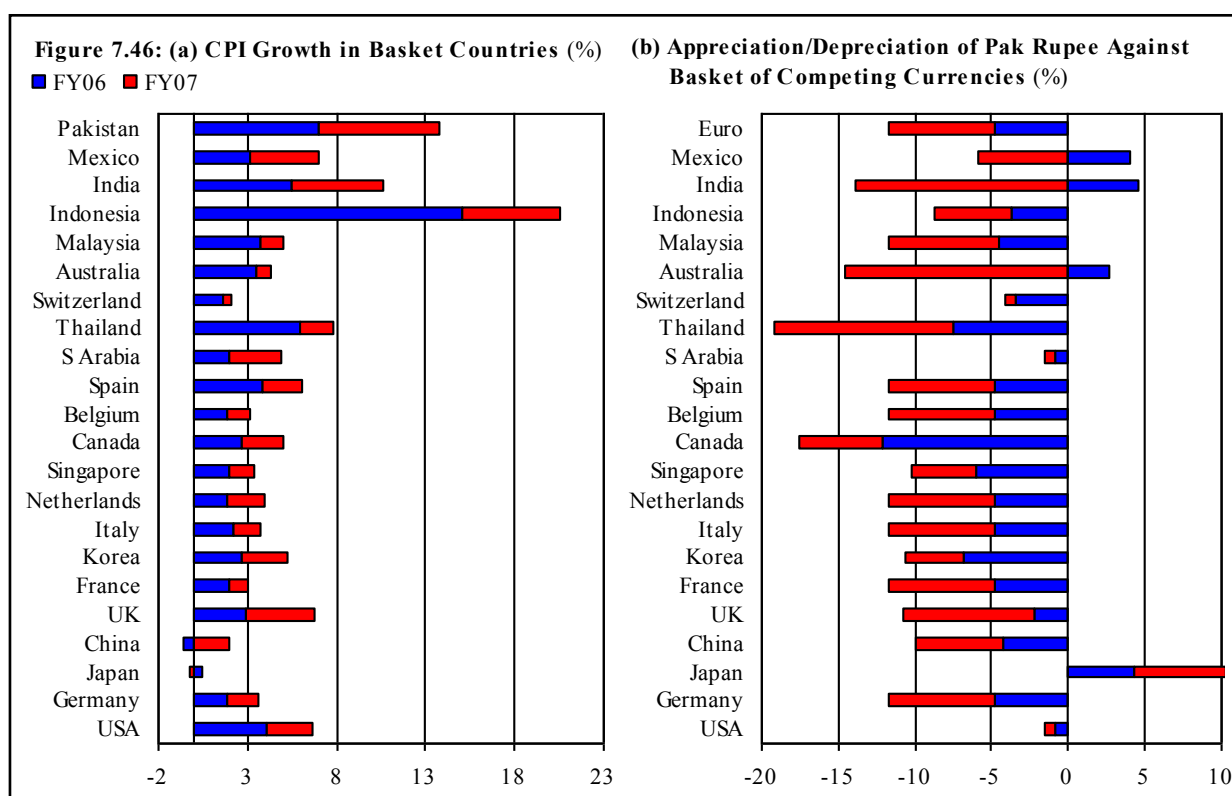
⁷⁹ An upward movement in FMPI Index indicates a depreciation pressure on exchange rate while a downward movement indicates a appreciation pressure.

⁸⁰ See FSCD Circular No.6, March 26 2007.

⁸¹ See EPD Circular Letter No. 16, July 11 2007.

⁸² Pak rupee depreciated against Aus\$, Mexican Peso and the Indian rupee, in FY07 against which it had appreciation in FY06.

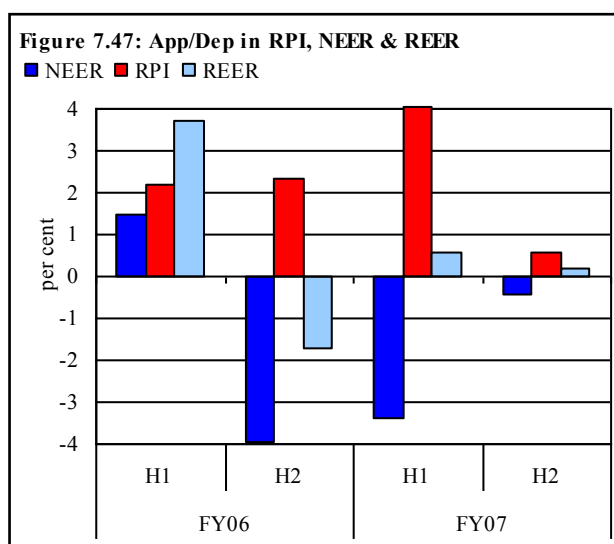
⁸³ US Dollar remained weak against major international currency, except Japanese Yen, due to higher global imbalances.



percent during the year. In contrast, CPI growth in the economies of major trading partners moderated slightly compared to last year. As a result, Relative Price Index (RPI) drifted upward in FY07 registering growth of 4.7 percent compared to 4.6 percent last year. As against the NEER the RPI witnessed a sharp growth in the first half of FY07 which moderated in the second half.

REER

Movements in the Real Effective Exchange Rate (REER) during FY07 are reflective of the cumulative movements in the NEER and RPI. The impact of a significant rise in the RPI in H1FY07 was compensated, to an extent, by a relatively larger depreciation in the NEER. Similarly, in the second half of the financial year, lower depreciation in the NEER was compensated by relatively slower growth in the RPI. The counteracting movements of RPI and NEER kept the appreciation in REER relatively moderate (see **Figure 7.47**). As a result REER appreciated by 0.74 percent significantly lower compared to 1.93 percent recorded in FY06.



As the REER reflects the country's relative external competitiveness with regard to its exchange rate, it is closely monitored to evaluate the exchange rate policy. An appreciation in the real effective exchange rate indicates that country's currency is overvalued as compared to its trading partners and competitors. This could potentially lead to deterioration in country's terms of trade by making its exports expensive compared to its competitors. Given the policy implications, the movements in the

REER ought to be interpreted carefully as these depend on number of factors such as selection of countries in the trade basket, trade weights allotted to these countries and choice of the base year etc. Even small differences in the selection of these variables can lead to considerable variation in the end results.

Box 7.7: REER Indices of IMF, SBP and World Bank; How They Differ? An explanatory note

The Nominal Effective Exchange Rate (NEER) is defined as the weighted average exchange rate of a domestic currency against the basket of currencies of trading partners and competitors of the country. Weights are applied according to the trade pattern of that country and its competitors against their trading partners.

REER is an extension of NEER, which along with the exchange rates of the trading partner countries also takes in to account the CPI inflation of the respective countries. REER is mostly indicative of the long term equilibrium exchange rate and the competitiveness of a country and therefore has assumed greater importance within external sector macroeconomic indicators.

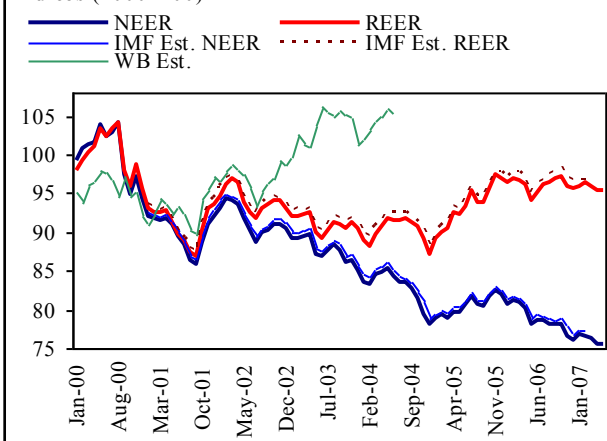
Given this relevance, a large number of countries calculate NEER and REER to keep track of their external competitiveness with respect to exchange rate. IMF also reports NEER and REER indicators for the countries from whom it has a prior approval, to portray the level of global competitiveness and direction of trade. The calculation of the indices is although sensitive to computation methodology and choice of representative variables, it is likely that the indices calculated with different methodologies would follow similar trend despite some variation in the actual numbers.⁸⁴

Figure, shows NEER and REER indices for Pakistan computed by State Bank of Pakistan, IMF and the World Bank.⁸⁵ Interestingly, all three indices broadly use the same methodology and representative variables, however while the SBP and IMF NEER and REER indices differs only marginally, the one computed in the World Bank report differs from IMF and SBP indices quite significantly. The slight difference in the SBP and IMF indices is mainly because SBP limits the number of trading partner countries to those which have one percent or higher trade share while the IMF makes no such restrictions. As such, the IMF basket of trade partner countries of Pakistan is larger which results in slight difference in the REER index from the one computed by SBP.

The World Bank REER index for Pakistan differs from the that of SBP and the IMF mainly due to two reasons: (1) World Bank in its calculations has taken only the top ten trading partner countries and normalized the remaining weights among these top ten countries, resulting in significant upward bias in the actual trade weights of those 10 counties, (2) trade weights used in the World Bank computation are based on trade pattern as of 1989-91. These weights have since been revised to reflect changing trade pattern and currently both the IMF and SBP use the 1999-01 trade pattern based trade weights.

One of the consequences of using old base and normalizing the total weight to top ten trading partners is that Japan gets unusually higher weight and since Pakistan's currency is consistently appreciating against the Japanese Yen, this leads to significantly higher value of REER index compared to the one computed by the IMF or SBP.

Figure 7.7.1 : Comparison of SBP, IMF & WB REER/NEER Indices (2000=100)

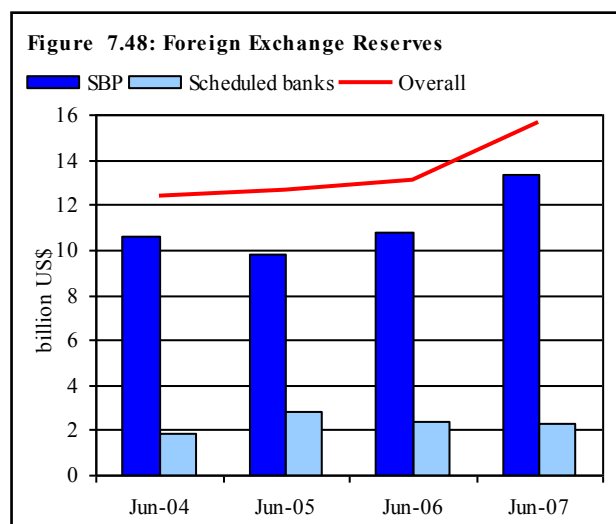


⁸⁴ For instance relative unit labor cost, relative normalized unit labor cost, CPI, or any other index may be used to capture inflation; similarly exchange rate could be monthly average or end period.

⁸⁵ World Bank (2006), 'Pakistan's Economy in 2006: Performance and Outlook', Growth and Competitiveness Conference, December 5-6, 2006, Lahore.

Foreign Exchange Reserves

Pakistan's overall Forex Reserves increased by US\$ 2.524billion in FY07 compared to a rise of US\$ 524million in FY06. The increase in the overall reserves was mainly due to US\$2.580billion rise in the SBP reserves, which were mostly accumulated in the second half of FY07. The broad pattern of reserve accumulation in FY07 is almost the same as in FY06. During both the years reserves had depleted in the first half and increased in the second half on the back of strong external inflows. This year, however, reserves were relatively under less pressure from deterioration in the current account as its pace slowed in H2FY07 compared to H2FY06. Besides the sharp growth in SBP reserves, the decline in the commercial banks reserves also moderated to US\$ 56.0million, while the same decline was US\$ 436million in FY06 (see **Figure 7.48**).



The causative factors of SBP reserves accumulation could be broadly categorized in four main categories; (1) revenue generated due to the government disinvestment of public sector enterprises that brought foreign investments, for example, in OGDCL (issuance of GDRs worth US\$ 738million) and PTCL (the receipt of remaining privatization proceeds), (2) financing raised through External Borrowings,⁸⁶ (3) receipts for the logistic support services provided to coalition forces and (4) earning on investment income on reserves.

Table 7.10: Firm Specific Major Foreign Exchange Equity Inflows in Private Sector

Underlying Institution	Acquiring Entity	Source Country	Nature of Deal	Approximate Transaction Volume in US\$
Union Bank	Standard Chartered	England	Acquired	US\$ 487 mn
Metropolitan Bank	Habib Bank AG Zurich	Switzerland	Merger	-
Prime Bank	ABN AMRO	Netherlands	Acquired	US\$ 228 mn
Crescent Com. Bank	Samba Group	Saudi Arabia	Acquired 68% Share	US\$ 98.75 mn
Paktel Ltd	China Mobile	China	Acquired	US\$ 460 mn
Lakson Tobacco	Philip Morris International	USA	Increased holdings (40% to 97.6%)	US\$ 382 mn
MCB Bank		LSE - UK	MCB GDR	US\$ 150 mn
Crescent Inv. Bank Ltd (FY08)	Innovative Housing Finance Ltd.	UK	Merger	US\$12.7 mn
	NIB Bank			
PICIC	(Subsidiary of Tamasek Holdings)	Singapore	Purchased 63.39% share	US\$ 339mn

In contrast to SBP reserves, the scheduled banks reserve registered a nominal decline, despite the significant market inflows on account of merger and acquisition. The major beneficiaries of FY07 inflows were financial businesses and telecommunication sectors. A summary of major foreign exchange inflows impacting the inter-bank foreign exchange market is given in the **Table 7.10**.

Besides the equity related inflows, a number of private corporation raised debt from the international institutions, such as US\$ 250 million bonds floated and US\$256.3million loan acquired by the Mobilink, US\$ 26.85 million by Warid telecom, US\$ 44.5million by the DG Khan Cement and US\$20 million by Paktel Ltd.

⁸⁶ Including official aids and grants received from various multilateral donor agencies such as IDA, IDB and ADB, and other bilateral donors such as the USA, also includes US\$ 750 million Eurobond

Reserve Adequacy

The strong growth in the SBP foreign exchange reserves during FY07 had a healthy impact on the reserve adequacy and all ratios recorded improvement over FY06 levels. Money-based indicators which measure the strength of the economy against potential capital flight by residents, also show improvement over FY06 despite significant growth in monetary aggregates in FY07 (see **Table 7.11**).

Table 7.11: Reserves Adequacy Ratios

	FY02	FY03	FY04	FY05	FY06	FY07
Liquid Reserve(Million Us dollar)	4333	9525	10561	9802	10762	13342
Import Coverage (Weeks)*	24.00	43.80	40.50	27.30	22.80	26.20
Reserve to External Debt	0.13	0.29	0.32	0.29	0.30	0.34
Reserve to STDL	2.21	6.74	8.64	6.66	7.71	10.88
Reserve To M2	0.15	0.27	0.25	0.20	0.19	0.20
Reserve to Reserve Money	0.45	0.84	0.79	0.64	0.63	0.67
Reserve to GDP Share	5.91	12.99	12.65	8.88	8.40	10.41

P: Provisional; Some of the Variables used in computation are subject to revision. * Based on SBP Reserves

STDL includes Central Banks deposits and NBP/BoC Deposits

7.4 Trade Account¹⁰⁰

After persistent widening during last four years, the difference between import and export growth seems to be converging during FY07 (see **Figure 7.49**). As a consequence, the trade deficit as compared to the size of economy declined slightly from record high level of 9.46 percent during FY06 to 9.34 percent during FY07. Nonetheless, in absolute terms, the trade deficit reached an all time high of US\$ 13.5 billion during the period under review. However, this welcome slowdown in import growth could not help in reducing the trade deficit due to a concurrent slowdown in export growth from average 15.9 percent during last four years to 3.2 percent during FY07.

The slowdown in import growth is broad based (see **Figure 7.50**) mainly explained by the decline in global oil prices, the reduction in excess demand, gradual assimilation of one-off impact of liberalizing of automobile & telecommunication sectors and improved domestic production of food items such as sugar. On the other hand, the sudden decline in export growth remains little perplexing especially when analyzed in the perspective of better environment in the form of robust growth in the domestic economy and key

Figure 7.49: Export and Import Growth Against Trade Deficit to GDP Ratio

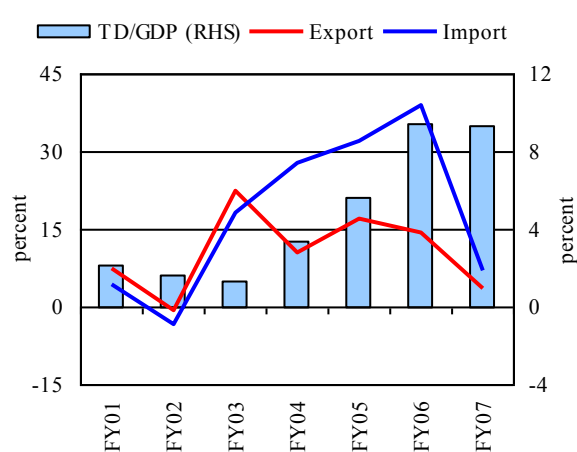
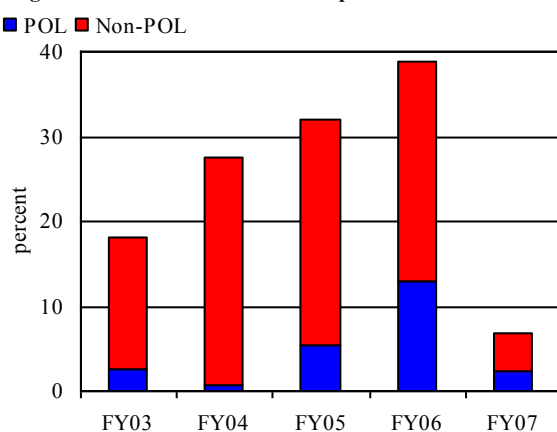


Figure 7.50: Contribution in Import Growth



¹⁰⁰ The discussion in this section is based on custom data provided by the Federal Bureau of Statistics (FBS) which may vary from trade numbers compiled by the SBP based on exchange record. The trade statistics in this section will therefore not be the same as in the remaining sections of this chapter.

global markets together with the support extended to this sector in policy formulation.^{101,102} The slowdown in export growth was also broad based (see **Figure 7.51**) as the textile exports growth declined from last four years average of 14.4 percent to only 4.9 percent during FY07, whereas non-textile export growth declined from last four years' average of 19.2 percent to only 0.6 percent during FY07.

The sluggish growth in non-textile exports is partly explained by the reduced exportable surplus of commodity producing sector on account of poor rice, fruit and cotton crop and partly by the trade barriers imposed by developed countries on fish & fish preparations and leather & leather manufactures imports from Pakistan on grounds of sanitary and phyto-sanitary standards.¹⁰⁴ Industry specific problems in petroleum & petroleum products, sports goods and carpets were the other factors which affected non-textile exports adversely during FY07.

On the other hand, the slowdown in textile exports is generally attributed to: (a) low quality of the textile products on account of contaminated cotton and unskilled labor, (b) concentration of exports in the low and middle value added textile items which fetch lower price in the international market as compared to high value added textile items, (c) frequent power failures in the country, and (d) EU market specific issues like antidumping duty on the bedwear exports and only partial restoration of GSP facility.¹⁰⁵

The other contributory factors in the slowdown of overall export could be: (a) low prices (see **Figure 7.52**), (b) lack of export diversification (see **Box 7.8**), (c) delay in adoption of international standards, (d) reduction in duty draw back rates and zero rating of sales tax for major exports which may have lowered the incentives to over invoice exports (see **Box 7.9**), and (e) indications of exports under invoicing to China (see **Figure 7.53**).

Going forward, the rising price of cotton which is the main input for textile industry coupled with

Figure 7.51: Contribution in Export Growth

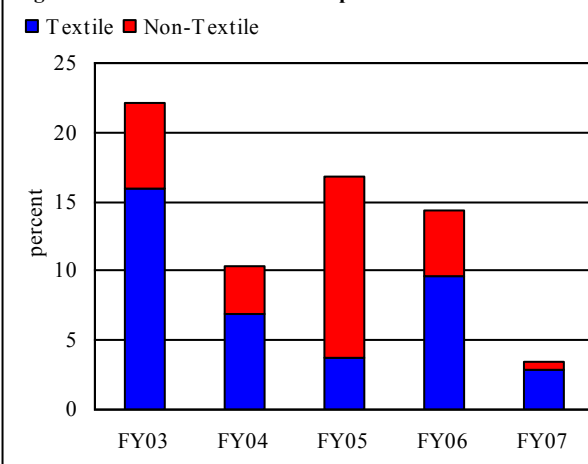
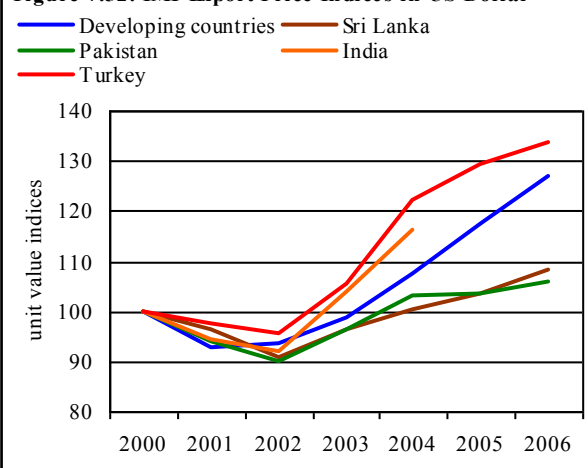


Figure 7.52: IMF Export Price Indices in US Dollar



¹⁰¹ The export sector enjoys various fiscal and monetary incentives such as tax exemptions & rebates and concessional financing under Export Finance Scheme (EFS) & Long Term Financing of Export Oriented Projects (LTF-EOP).

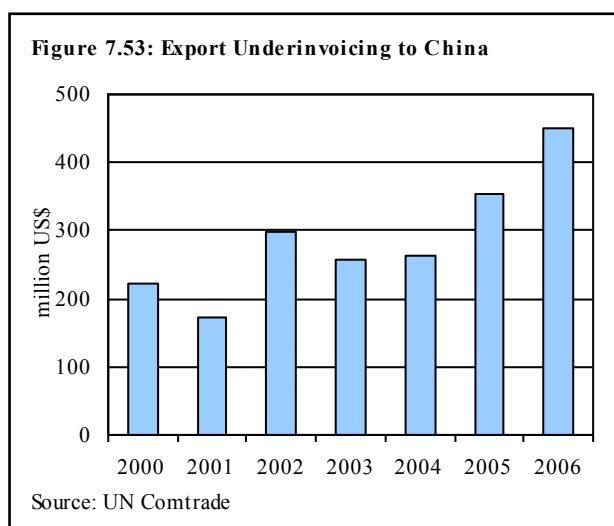
¹⁰² Some analysts argue that increasing contribution of non-export sectors like construction, finance & insurance, livestock and retail trade etc in the GDP growth during the recent years have weakened the GDP-export nexus.

¹⁰⁴ The EU-27 nations block banned fish & fish preparation imports from Pakistan with effect from 12 April, 2007 while it is demanding that leather goods should carry the certification marks of international Standard Organization (ISO) regarding pollution-free environment at the factory premises where the products are manufactured.

¹⁰⁵ In contrast to Pakistan, Bangladesh and Sri Lanka enjoy duty free access to EU market.

abolition of China specific textile and clothing safeguards in 2008 by EU and US, along with accession of Vietnam to WTO are some factors that are likely to give tough time to Pakistan's textile industry. However, the rising cotton prices may not increase Pakistan's costs of production relative to its competitors as global cotton prices are also anticipated to rise. Nonetheless, Pakistan's apparel exports to US markets and EU may weaken following the end of the US and EU safeguard measures imposed on China (see **Section on Exports**).

On the import side, uncertainty in the global oil prices, increasing commodity prices, anticipated increase in the import of telecom machinery following China's investment in Pakistan's telecom sector and likely increase in power generating machinery may put upward pressure on the import bill. However, increase in hydro power generation on account of better water availability and capacity constraints in the thermal power generation may lead to slow down in the growth of furnace oil import, thereby relieving some pressure from the overall oil import growth.¹⁰⁶



In this backdrop, there is an urgent need to address the aforementioned export weaknesses (see **Box 7.12**). For instance, in order to fetch good prices in the international market, Pakistan would have to improve its image as a supplier of quality products along with increasing the share of the high value added items. Likewise infrastructural issues such as a reliability of the power supply needs to be addressed on priority basis to help the exporters to meet the tight delivery time lines in the increasingly competitive international market. Moreover, the vulnerability of Pakistan's apparel industry export to Sino-US textile and clothing agreement calls for need of strong, dynamic and internationally competitive apparel industry. In this regard, joint ventures with the foreign apparel manufacture may introduce the industry in the international supply chain along with bringing new technology. Moreover, it may also help in introducing Pakistani brands in the global market.

Getting free or preferential market access through different bilateral and multilateral trade arrangements is another way to increase exports. The Free Trade Agreement with China, which is the world's third largest exporter as well as importer, has become operational with effect from July 1, 2007. It is now up to exporters to take advantage of this opportunity. The similar opportunities are available to the exporters in Malaysia, Sri Lanka and South Asian markets (see **Box 7.10**). Japan is another major player in the international trade, with a significant share in global exports and imports. Pakistan needs to regain its market share in this market. Amongst other growing markets where Pakistan has negligible market share, are four East Asian countries, namely Singapore, Hong Kong, Taiwan and Korea, which together constitute around a quarter of Asian exports and imports.

¹⁰⁶ According to the market sources, Furnace oil demand in August 2007 declined by 11.0 percent on account of improved water level owing to heavy rainfall.

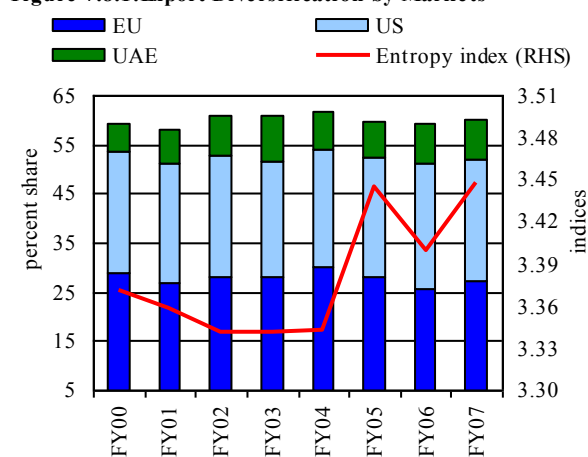
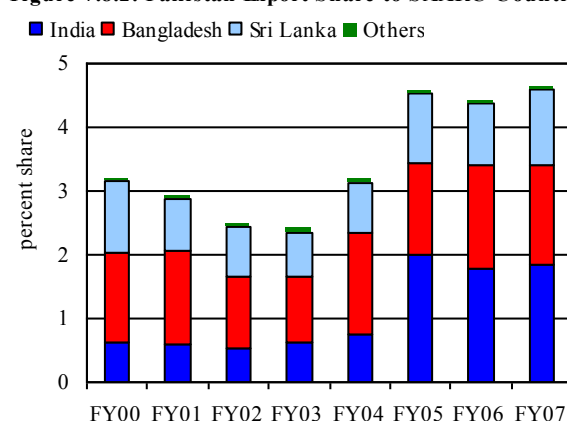
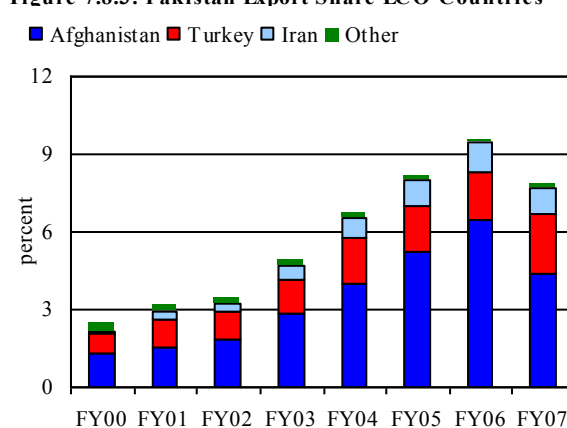
Box 7.8: Export Diversification in Pakistan

The persistent integration of the global economies has intensified competitive pressures in the international market, which has made it difficult for Pakistan, like some other developing countries, to maintain its export share in the international market. Among others, lack of export diversification (both by products and markets) is thought to be the major factor behind Pakistan's inability to increase or maintain its export share in the international market. Lack of export diversification creates a number of problems with regard to export earnings, which includes: a) negative impact of price fluctuations in international market, b) risk of demand fluctuations in international markets, c) risk of supply chain shocks and d) market saturation. In this backdrop, it would be pertinent to analyze the patterns of export diversification in Pakistan during the ongoing decade by making use of the Entropy Index.¹⁰⁷

During the last eight years (FY00-07), EU-25 nation's block of European Union, United States and United Arab Emirates remained Pakistan's major export destinations. These three markets together constituted around 60 percent of Pakistan's overall exports during the aforementioned period thereby, suggesting limited export diversification with respect to markets. Entropy Index also indicates only limited diversification in the last three years (FY05-07) (see **Figure 7.8.1**). With no change in destination of 60 percent of our exports, this diversification took place in the remaining (40 percent) of export's destinations.

These destinations are those where Pakistan has preferential market access under different trade arrangements such as Economic Cooperation Organization (ECO), South Asian Association of Regional Cooperation (SAARC) and China. Specifically, Pakistan's share of overall exports to SAARC countries increased from 2.4 percent during FY03 to 4.6 percent during FY07 while its share of overall exports to ECO countries increased from 4.9 percent during FY03 to 7.8 percent during FY07. Within the SAARC block, share of India, Sri-Lanka and Bangladesh in Pakistan's overall exports increased considerably (see **Figure 7.8.2**). Along with SAFTA arrangements, Free Trade Agreement with Sri-Lanka, relatively better political relationship with India and increased imports of yarn and fabrics by India and Bangladesh in the post-MFA period partly explains the rise in share of the aforementioned SAARC countries in Pakistan's overall exports.

The rise in share of ECO countries in Pakistan's overall exports is mainly explained by increased exports to Afghanistan (see **Figure 7.8.3**). The total share of ECO block in Pakistan's overall exports is 7.8 percent, out of which 4.4 percentage points was on account of exports to Afghanistan during FY07. The increased

Figure 7.8.1: Export Diversification by Markets**Figure 7.8.2: Pakistan Export Share to SAARC Countries****Figure 7.8.3: Pakistan Export Share ECO Countries**

¹⁰⁷ The formula for Entropy Index is $\sum_{i=1}^N P_i \cdot \ln(1/P_i)$ Where P_i represents the actual value of i^{th} commodity or markets in the total exports and N is the total number of export commodities or markets in the export portfolio. The maximum value of Entropy Index occurs when all P_i are equal. This implies maximum diversification as all the commodities or markets in the export portfolio have identical shares. Thus, higher the value of Entropy Index implies higher diversification.

reconstruction activity and food shortage in Afghanistan were the contributory factors behind this increase in exports. Turkey and Iran were the other major share holders of Pakistan overall exports in the ECO block. On the other hand, already negligible share of Central Asian Republics in Pakistan's exports declined further during the period under consideration.

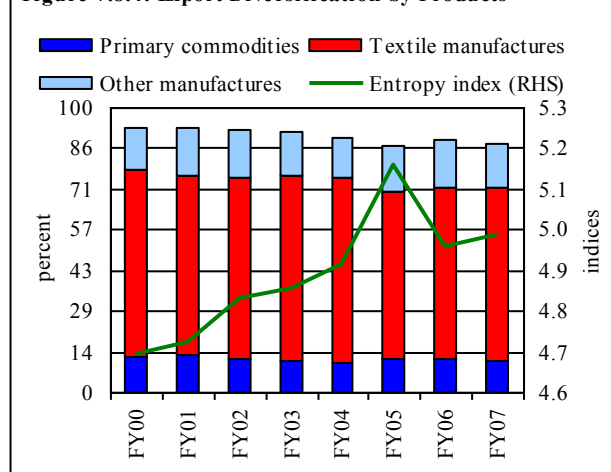
China is another country with whom Pakistan has got preferential market access under the trade arrangement. Share of China in Pakistan exports has also increased in the last three to four years. Specifically, share of China in Pakistan's exports has increased from 2.34 percent during FY04 to 3.34 percent during FY07 (see **Table 7.8.1**).

Table 7.8.1: Share in Total Exports
percent

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Hong Kong	6.1	5.5	4.8	4.6	4.7	3.9	4.1	3.9
China	2.1	3.3	2.5	2.2	2.3	2.5	2.8	3.3
Saudi Arabia	2.5	3.0	3.6	4.3	2.8	2.5	2.0	1.7
South Africa	1.0	0.8	0.8	1.0	1.0	1.4	1.6	1.7
Canada	2.1	2.0	1.9	1.8	1.5	1.3	1.3	1.2
Korea	2.9	3.0	2.9	2.0	1.6	1.3	1.2	1.0
Japan	3.1	2.1	1.8	1.3	1.1	1.1	0.8	0.8
Australia	1.3	1.2	1.1	1.1	1.1	0.8	0.7	0.8
Kenya	0.2	0.2	0.6	1.0	0.5	0.4	0.4	0.6
Russian	0.0	0.1	0.1	0.1	0.2	0.3	0.3	0.5
Other (excluding EU-25, US, UAE, ECO and SAARC)	13.5	14.8	13.2	12.4	11.5	12.0	11.5	12.0

With respect to export diversification by product during FY00-FY07, more than 75 percent of Pakistan's total exports remained concentrated in the four major products i.e. textile manufactures, rice, leather & leather manufactures and petroleum & petroleum products. Within these products, textile manufacture alone constitutes around 60 percent of overall exports. The share of textile in total exports has declined from 65.2 during FY00 to 60.8 percent during FY07, which indicates diversification of exports by products (FY05 was an exception which witnessed relatively higher degree of diversification). Petroleum & petroleum products and chemical & pharmaceutical were the two major commodities which have continuously gained share in total exports during the period. The share of petroleum group increased from 1.0 percent during FY00 to 4.9 percent during FY07 while share of chemicals & pharmaceutical increased from 1.2 percent during FY00 to 2.28 percent during FY07. The export diversification during the first eight years of the ongoing decade is also depicted by the upward movement of the Entropy Index (see **Figure 7.8.4**).¹⁰⁸

Figure 7.8.4: Export Diversification by Products



The above analysis suggests that although there is some degree of export diversification with respect to both the markets and products, nevertheless, major chunk of exports is still concentrated in few markets and few products. Hence efforts need to redouble the efforts find new exportable products and markets. The products which have better prospects for market expansion includes office & telecom equipments, agricultural products, automotive parts and pharmaceuticals.¹⁰⁹ The potential market includes Central Asian Republics (CARs), China, European Free Trade Association (EFTA) countries (Norway, Switzerland, Iceland and Liechtenstein) and African countries.

With passive response from EU countries, Pakistan is already making effort to conclude some trade arrangement with EFTA countries. The EFTA countries have higher per capita income and provide better prospects for market expansion. With

¹⁰⁸ The Entropy Index was constructed using export commodities at HS-8 digits.

¹⁰⁹ For detail please consult State Bank of Pakistan's Third Quarterly Report for the Fiscal Year 2006-2007.

regard to China, Pakistan has already concluded a Free Trade Agreement with China which has become operational with effect from July 1, 2007.

Box 7.9: Export Incentives and Export Over-invoicing

Besides concessionary export finance scheme, the duty drawback on exports and sales tax refund are considered as major incentives for the exporters. Unfortunately, while promoting exports, these facilities are also used as an opportunity for rent seeking. These incentives are discussed in greater detail as follows:

Table 7.9.1: Refunds/Rebates and Export Refinance as Percent of Total Exports

	FY01	FY02	FY03	FY04	FY05	FY06	Jul-Mar FY07
Custom refund	3.2	4.8	2.6	2.0	1.9	1.9	1.4
Sales tax refund	5.5	6.4	6.7	7.4	6.4	3.3	4.1
EFS outstanding	14.0	10.6	8.7	12.5	12.8	11.0	17.5

Duty Drawback on Exports.

Under the provisions of section 21 (c) of the Custom Act 1969, custom duties paid on imported inputs used in the production, manufacturing or processing of goods meant for exports are to be refunded. The duty drawback rates are determined on the bases of input-output coefficients (this coefficient determines the quantity of imported material required for use in a given quantity of manufactured end product) worked out by Central Board of Revenue (CBR). Thus higher the value of end product export, higher the amount of duty drawback. As a result, the exporters have the incentives to over-invoice their exports to get more refund. Textile and leather sectors have been the major beneficiaries of this scheme. However, with the liberalization of imports, the importance of duty drawback rates have declined as a percent of total exports thereby reducing the incentives to over-invoice exports (see **Table 7.9.1**).

Sales Tax Refund

Since the promulgation of the Sales Tax Act 1990, the sales tax refund facility is available to both commercial exporter and manufacturer-cum exporter. Since commercial exporter, generally do not have a permanent establishment, that manufacturers have in the form of land, building and machinery etc, there is a rise of fake invoices for claiming sales tax refunds. Moreover, the undocumented nature of the economy also helps in over-invoicing of export. However, with the zero rating of sales tax for major export groups in the FY06 budget, the absolute amount of sales tax refunds and its share to total exports has recorded declined (see **Table 7.9.1**).

Export Finance Scheme

The export finance scheme provides short term pre-shipment and post-shipment finance in local currency to the direct exporters. Under this scheme the exporters are provided funds at substantially subsidized rates compared to the market. The availability of concessional finance on exports is also an incentive to over-invoice the value of exports so as to obtain large funds at subsidized rates which can then be invested in other high return avenues such as real state, stock market or even the National Savings Schemes.

The empirical evidence of presence of over invoicing can be found in a number of studies, for instance Mahmood and Azhar (2001) found that on account of export subsidies there is strong presence of export over-invoicing across trading partners countries and products¹¹⁰. Similarly, the study by Nadeem-ul-Haq and Ali Kemal (2007) also found that export promotion subsidy schemes are subject to manipulation for rent seeking purposes. They also concluded that these subsidies have insignificant impact on the export performance in the long run however; they have small positive impact in the short run. Another study by Bilal Zia also indicated that half of all the subsidized loans are assigned to exports of publically listed and corporate groups (they are financially unconstrained) implying a substantial misallocation of credit.

Table 7.9.2: Export Mis-Invoicing in Pakistan

	million US Dollar			
	Total	USA	EU	UAE
2002	-774.6	-178.9	-158.3	-588.7
2003	-734.1	-46.8	-37.0	-500.5
2004	-772.4	-340.9	-174.1	-0.2
2005	-2336.1	-403.2	-368.8	-552.9
2006p	-931.8	-0.4	11.2	-0.1

In line with the above empirical work, an attempt is made to determine the over-invoicing of exports in Pakistan. The literature on the subject suggests the use of partner-country technique to test the over-invoicing of exports. For instance,

¹¹⁰ The over-invoicing can take place in different forms like a) misdeclaration of quantity, misdeclaration of value, and misdeclaration of blend values and presentation of fake bank advice.

Bhagwati (1964, 1967), Mahmood (1997), Mahmood and Nazli (1999), Naya and Morgan (1969), Simkin (1970), Mahmood and Azhar (2001) have already used this technique to test mis-invoicing. In this technique, the country's exports which are f.o.b based are first adjusted to allow for the cost of freight and insurance.¹¹¹ These adjusted exports are then compared with the c.i.f imports of the partner to test for mis-invoicing of exports.¹¹² Thus mis-invoicing is defined as:

$$\text{MIS} = \text{MIC} - \text{XP}_{\text{adj}}$$

Where MIS is the mis-invoicing of exports, MIC is the c.i.f based imports of the partners from Pakistan and XP_{adj} is the f.o.b exports from Pakistan adjusted for the cost of freight and insurance. The negative MIS value implies over-invoicing of exports.¹¹³

The data analysis suggests that there are discrepancies between exports from Pakistan and partners imports from Pakistan. These discrepancies appear to be mainly on account of export over-invoicing. The over-invoicing reached to US\$ 2336.1 million during 2005 which is highest during the last four years. Incidentally, this coincides with one of the highest growth in exports during the recent years. The main sources of over-invoicing are United States of America, European Union (25 countries) and United Arab Emirates; the major trading partners (see **Table 7.9.2**).

Going forward, the reduction in custom duty rates and zero rating of sales tax for major export groups are likely to reduce the incentive for over-invoicing of exports. Similarly, recent changes in the export refinance scheme are also likely to reduce over-invoicing. The reduction in over-invoicing would however, may cause decline in exports growth in the short run, as base year would have inflated figures compared to current year. This would also explain the exaggerated slowdown in exports during FY07. In long run, however, it is expected that the support export growth would benefit as the funds would be properly channelized to genuine exporters.

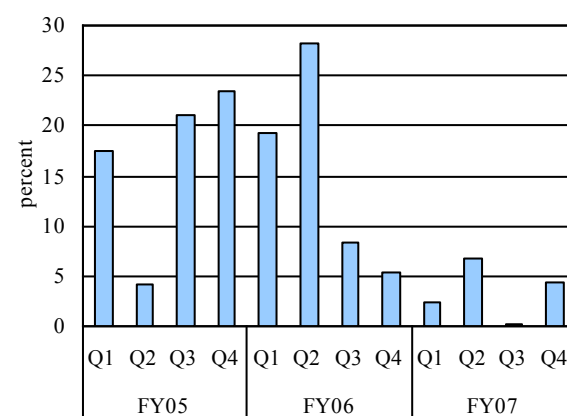
Exports

The broad based slowdown in export growth which emerged in the latter half of FY06 continued throughout FY07 as well (see **Figure 7.54**). During FY07, the overall export grew by only 3.2 percent as compared to fairly healthy growth of 14.3 percent during FY06. As a result, Pakistan exports worth US\$ 16.97 billion during FY07 were substantially lower (US\$ 1.6 billion) than the target (US\$ 18.6 billion).¹¹⁴

Although some of the slowdown in the overall exports may be attributed to vagaries of nature such as crop failures and some other to the EU specific issues i.e. adverse impact of antidumping duty, loss of duty free access to EU market and provision of same to Bangladesh and Sri Lanka and ban on fish & fish preparation export. Nevertheless, more than 10 percentage points decline in export growth in a single year remains partially unexplained.

The export data of major categories indicates that a decline in exports of primary commodities and non-textile manufactures, which together constitute around 29 percent of overall exports, was the dominant factor behind this sluggish export growth (see **Figure 7.55**). Specifically, exports of primary commodities declined by 1.0 percent during FY07 as compared to 15.9 percent growth during FY06 whereas non-textile manufacture exports declined by 10.5 percent during FY07 as compared to robust growth of 21.5 percent during the same period last year. As mentioned earlier, the low

Figure 7.54: Export Growth - Quarterly Perspective



¹¹¹ The adjustment factor is 1.1 taken from IMF Direction of Trade Statistics for 2006.

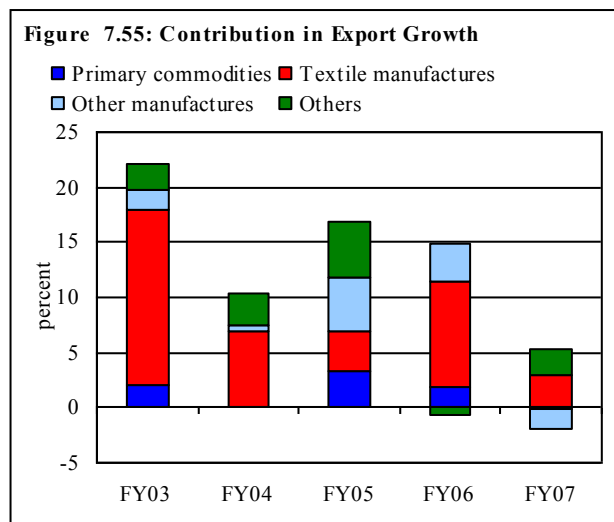
¹¹² However, even after adjusting for freight and insurance costs, there may be some discrepancies on account of a) classification concepts and detail, b) time of recording, c) valuation, d) coverage and e) processing errors.

¹¹³ The data source used is Direction Trade Statistics of the International Monetary Fund.

¹¹⁴ The export target is taken from Trade Development Authority.

production of commodity sector and industry specific issues were the major contributory factors behind the decline in exports of aforementioned groups.

Due to its 60 percent share in country's total exports, the deceleration in textile manufacture exports contributed significantly in the slowdown of overall export growth. It is generally argued that increased costs of production and stiff competition in the international market in the textile quota free trade regime are the principal factors behind the poor performance of the country's textile exports.

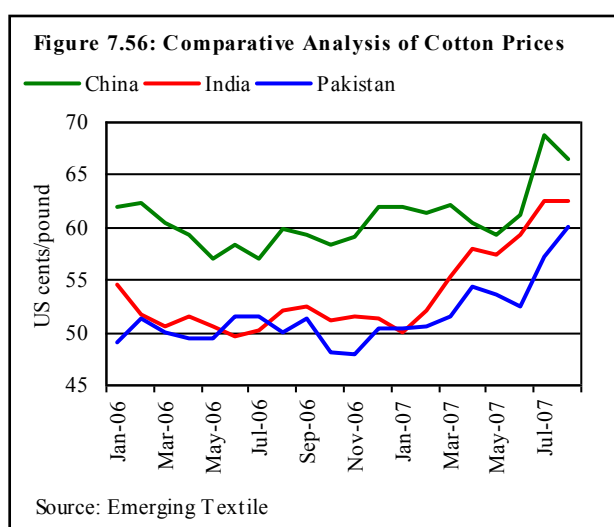


However, the US Ministry of Commerce and Euro-stat datasets suggests that Pakistan's textile export performance in the world's two major textile markets i.e. US and EU cannot be termed as unsatisfactory. In the US market, Pakistan's textile exports increased by 14.1 and 11.9 percent during 2005 and 2006, respectively. However, during Jan-May 2007, Pakistan exports to US markets declined marginally by 1.3 percent. Nevertheless, it remains the second largest exporters of textile and clothing in volume terms to the US market. In the EU market, after initial setbacks on account of some adverse developments during 2005, Pakistan recovered its market share quite convincingly as is evident from 11.9 and 10.7 percent growth during 2006 and Jan-Apr 2007 respectively.

Regarding costs of production, the comparative analysis of costs of production reveals that Pakistan is not in disadvantageous position so far as cotton prices (raw material), labor wages and utility prices are concerned¹¹⁵ (see **Table 7.12**).¹¹⁶ With respect to financial costs, except Bangladesh Pakistan's rate of short term and long term concessional financing is lowest as compared to its competitors. Moreover, Pakistan and Bangladesh are the only countries which provide cash subsidy to the exporters. In contrast to other competitors, Pakistan also provides freight subsidy to its exporters.

In the light of aforementioned facts, explaining the slowdown in textile export growth indeed becomes difficult. Hence, there is need to conduct a comprehensive study to explore the causative factors behind this poor performance of textile exports.

On the positive side, non-traditional exports which are categorized as "other exports" recorded commendable growth of 20.3 percent during FY07 as compared to negative growth of 4.9 percent during FY06. It was this remarkable increase in non-traditional exports which, together with export growth in textile manufactures, enabled the overall



¹¹⁵ However, it can be argued that labor wages in India and China are relatively high because their labor is more skilled. Likewise, the relatively high prices in India and China may be attributed to high quality cotton over there.

¹¹⁶ Source: Ministry of Commerce

exports to record a nominal growth of 3.2 percent during the period.

Table 7.12: Comparison of Incentives to Textile Industry

	Pakistan	India	China	Bangladesh	Sri Lanka
Cost of Production					
Cotton prices (US Cents/pound) (2006)	49.93	51.37	59.46	na	na
Labor wages Cents/hour	39	47	57	27	44
Electricity prices industrial Cent/KWh	5.87	8.14	8.5	5.23	7.28
Gas price commercial Cent/mm3	12.08	20.45-40.54	n.a	11.95	na
Gas price industrial Cent/mm3	10.73	20.45	n.a	7.61	na
HOBC/Octane Cent/Litre	97.72	99.77	n.a	68.62	83.89
HSD	57.88	64.81	n.a	45.75	49.35
Container cost US\$ 40 GP (East coast USA)	3400	2600	3850	3400	3984
(A) Long term financing					
(i) Normal (%)	12-13	9-15.0	5.5	14-15.5	15-16
(ii) Concessionary (%)	7.5*	4-10.0**	n.a	same	same
(B) Cost of short term					
borrowing for exports only					
(i) Commercial lending rate (%)	12.57-13.57	15	n.a	11-14.0	upto18
(ii) Concessionary finance rate (%)	6.5+1	9	na	6-7.0	same
(C) Cash Support					
R&D support for eligible countries					
Textile garments (%)	6	nil	nil	5***	nil
Leather footwear (%)	6	nil	nil	nil	nil
Freight subsidy (%)	25****	nil	nil	nil	nil
Fiscal incentives (%)					
(D) Income tax on proceeds of exports or profits	0.75-1.5	33	12	0.25	15

Source: Ministry of Commerce

nil-Facility not provided na not available

* Concessionary long term financing is available to all export oriented projects

** Concessionary long term financing is available only to textile units whether export oriented or not under Technology up gradation Funding Scheme. Under the scheme India subsidizes 5 percent interest rate of normal lending rate all export oriented projects

*** Refund available on net value addition on the export of textile

**** This subsidy is provided on eligible products and eligible destinations.

It may be pointed out that anticipated increase in the cotton (main input for textile industry) prices and abolition of China specific textile & clothing safeguards in 2008 by US and EU, are likely to add to the difficulties of the textile industry in the near future.

With respect to the first threat, the global prices of cotton are also expected to rise in the face of 3.0 percent projected decline in the world cotton production for FY08 and 5.1 percent increase in world cotton consumptions.¹¹⁷ The increase in global prices of cotton suggests that increase in domestic

¹¹⁷ According to Cotton and Wool Outlook of United States Department of Agriculture (USDA), the decline in cotton production and increase in cotton consumption during FY08 will lead to reduce the stock to use ratio thereby putting pressure on the cotton prices.

cotton prices in Pakistan are not likely to increase its costs of production as compared to that of its major competitors (see **Figure 7.56**).

However, Pakistan would have to struggle hard to maintain its market share with the end of China specific safeguards by US and EU in 2008. In the US market, almost 45.4 percent rise in exports was contributed by quota restricted categories during 2006 (see **Table 7.13**). During Jan-May 2007, it was only quota restricted categories which recorded 5.2 percent growth as the exports of non-restricted categories declined by 5.7 percent.

Importantly, the growth in Pakistan's exports of high value added apparel to US market is vulnerable to the removal of China specific safeguards measures, as the share of restricted exports in Pakistan's total apparel exports to US markets is more than 80 percent. The major categories which are dependent on the US- China quota include cotton trousers and cotton knit shirts.

Table 7.13: Vulnerability of Pakistan Textile Exports to China Specific Safeguards Measures Imposed by US

Years	Total YoY change	YoY change (%)	% share of restricted categories in change	% share of restricted products of total imports
2005	358.3	14.1	21.7	38.4
2006	345.8	11.9	45.4	39.2
2007*	-16.3	-1.3	-159.3	43.1

Source: US Ministry of Commerce

*Jan-May

The accession of Vietnam in World Trade Organization (WTO) with effect from January 2007 and the subsequent removal of US textile and clothing imports limits from the country may also affect Pakistan's textile exports adversely.

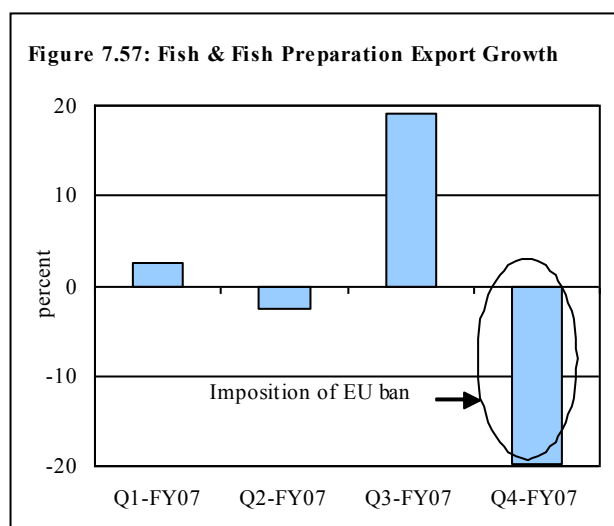
The above analysis suggests that giving boost to exports in FY08 would be a challenging task for Pakistan.

Primary Commodities

During FY07, the poor rice, cotton and fruits crops reduced the exportable surplus of primary commodities. As these three items together constitute around 70 percent of the overall primary commodities exports, the group exports declined by 1.0 percent during FY07 as compared to fairly healthy growth of 15.9 percent during the preceding year.

The decline in fish & fish preparation exports which constitute around 10 percent of the group exports is another major contributor in the decline of primary commodities exports.

The decline in fish & fish preparations is concentrated in the last quarter of FY07 (see **Figure 7.57**), when EU-27 nations block imposed ban on imports from Pakistan with effect from April 12, 2007 on the basis of lack of Hazard Analysis and Critical Control Point (HACCP) implementation.



On the other hand, the highest ever wheat production of 23.5 million ton against the domestic consumption of 21.9 million ton led to wheat exports worth US\$ 47.7 million during FY07.

However, later in the view of rise in domestic prices of wheat and flour, Pakistan government banned the wheat exports with effect from May 23, 2007.

The other items which registered positive growth in the group include leather and vegetable. The increase in raw leather exports may be attributed to slowdown in the downstream industry as is

depicted by considerable decline (23.2 percent) in the leather manufacture exports during FY07. Moreover, wet blue semi tanned leather is exported to avoid spew problem because of the chemical reaction.

Rice

Despite a 14.4 percent increase in prices, rice exports declined by 2.4 percent during FY07 as compared to the 24.2 percent growth during the previous year. The decline in rice exports was entirely driven by fall in export of non-basmati varieties; the growth of basmati rice exports accelerated to 16.1 percent during FY07 from 9.2 percent in FY06 (see **Table 7.14**).

The comparison of rice exports relative to its production provides some useful insights. Firstly, in quantum terms the fall in rice exports (15.3 percent) is far higher than the decline in production (2.0 percent). This resulted in the fall of export share in total production during FY07 (see **Figure 7.58**). Second, the rice production data suggests that entire decline in rice production is contributed by fall (5.6 percent) in basmati rice as the production of other varieties of rice registered nominal growth (1.4 percent). This is in sharp contrast to rice exports where basmati rice depicted impressive growth and other varieties exports declined.

The decline of export share in total production is attributed to relatively large fall in other varieties exports. The high domestic prices of other varieties as compared to international prices suggests that traders preferred to sell the low quality other varieties domestically (see **Table 7.15**).

The rise (16.1 percent) in exports of basmati rice, despite fall in its production, on the other hand is attributed to last year stock, (the basmati rice requires seasoning/processing (for period of up to 1 year) before it is exported for the best price) and relatively high price of basmati rice in the international market on account of rice crop failure in India.

The Middle East remained the major market for basmati rice exports during FY07. The major destinations where basmati rice registered healthy growth included United Arab Emirates, Iran, and Oman (see **Table 7.16**). Importantly, during FY07, prices of Pakistan's basmati rice exports increased in almost all the major markets except Kuwait.

Table 7.14: Rice Exports

	FY06		FY07	
	Share (%)	Growth (%)	Share (%)	Growth (%)
Basmati	42.1	9.2	50.0	16.1
Others	57.9	37.5	50.0	-15.8
Total		24.1		-2.4

Table 7.15: Price Comparison of Rice (Rs/kg)

	Domestic prices		International price	
	FY06	FY07	FY06	FY07
Basmati	32	27.7	36.5	34.1
Other varieties	17	15.6	15.5	14.3

Domestic basmati price is the average of basmati varieties taken from CPI data

Table 7.16: Rice Export Market

Share: percent unit value US\$/metric ton

	FY06		FY07	
	Share	Unit Value	Share	Unit Value
Basmati		571.7		612.8
UAE	39.4	555.0	42.4	621.1
Iran	6.1	605.0	8.0	611.7
Oman	6.2	540.0	7.0	585.8
Saudi Arabia	2.4	539.9	4.5	571.9
U.K	5.1	552.7	4.3	595.6
Kuwait	6.3	632.5	4.2	630.5
Yemen	4.0	571.4	3.9	611.6
Qatar	3.4	569.3	3.5	623.3
Bahrain	3.7	555.6	3.5	593.9
Others	23.3	570.5	18.8	620.1
Other varieties		238.1		253.5
Kenya	4.9	200.6	10.4	218.7
Iran	10.0	269.1	9.1	261.6
Mozambique	7.5	223.9	8.4	238.1
Madagascar	10.1	215.5	7.0	224.1
Cote d'Ivoire	4.0	225.3	6.7	243.9
Afghanistan	5.4	181.6	4.6	214.8
UAE	5.1	322.8	5.2	338.0
Guinea	1.7	276.2	3.9	323.5
South Africa	2.8	216.6	3.8	229.5
Iraq	1.4	224.4	3.7	251.5
Sierra Leone	2.8	217.5	3.4	229.5
Saudi Arabia	0.0	307.4	3.3	258.4
Singapore	2.6	349.4	2.6	344.9
Others	41.78	246.41	27.91	270.92

On the other hand, export markets for other varieties showed a mixed trend. Kenya, Mozambique, South Africa, Iraq and Sierra Leone were the major markets where *other varieties* exports depicted growth while Iran, Madagascar and Afghanistan were the major markets where other varieties exports declined during the period under consideration. Encouragingly, unit prices of the other varieties increased during FY07 in most of the markets.

Textile Manufactures

There was a sharp deceleration in the exports of textile manufactures during FY07 as indicated by a growth of 4.9 percent compared with an impressive growth of 16.2 percent last year. However, the performance of this sector fluctuated during the year. In the first quarter of FY07, the textile sector posted a nominal growth of just 2.3 percent, then recovered to post 13.4 percent YoY and 4.6 percent YoY growth during the second and third quarters of FY07 respectively, following a sharp rise in the exports of high valued added knitwear and readymade garments. However, during the last quarter of FY07, the textile exports could record only a negligible growth of 0.1 percent YoY (see **Figure 7.59**).

The improved performance in the second quarter might be attributed partly to the political turmoil in Bangladesh and the resultant diversion of international buyers of high value added garments from Bangladesh to Pakistan. Whereas, power shortages and rains in Karachi along with growing security concerns appears to have hampered textile manufactures production and thereby its exports in the last quarter.

It may be pointed out that in FY06 remarkable export growth was entirely driven by increase in export volumes as that offset decline in unit prices. However, during FY07 despite overall positive impact of unit prices, the fall in quantum of fabrics, bedwear and towels slowed down the textile exports significantly (see **Table 7.17**).

Figure 7.58: Rice Exports and Production

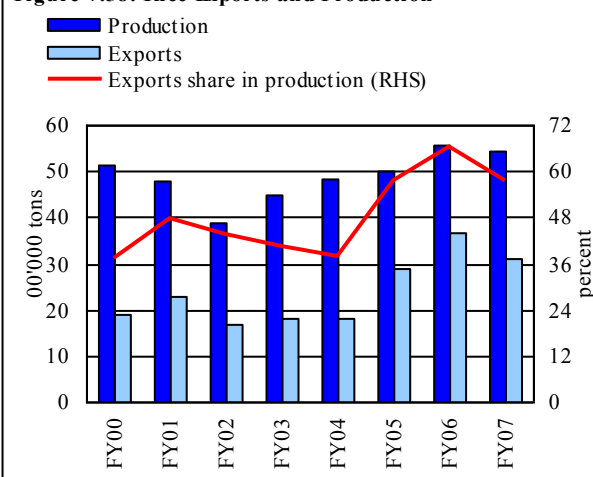


Figure 7.59: Export Growth of Textile Manufacture

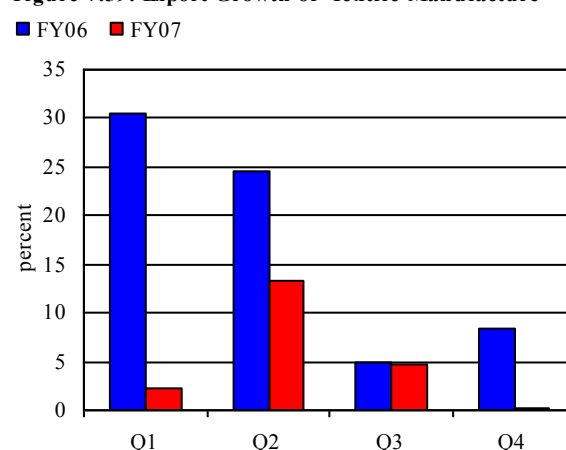


Table 7.17: Impact of Price and Volume on the Major Textile Exports

	million US\$					
	FY06			FY07		
	Total change	Due to Quantum	Due to Price	Total change	Due to Quantum	Due to Price
Cotton yarn	326.3	349.5	-23.2	42.9	6.5	36.4
Cotton fabrics (woven)	245.3	182.1	63.2	-90.6	-338.4	247.8
Hosiery (Knitwear)	116.5	315.3	-198.8	213.1	178.8	34.3
Bed wear	588.5	578.0	10.6	-79.4	-25.6	-53.8
Towels	67.2	73.3	-6.2	7.4	-6.1	13.5
Readymade garments	222.0	96.7	125.3	69.7	125.9	-56.2

Cotton Yarn

Cotton yarn exports depicted a nominal growth of 3.1 percent during FY07 compared with robust growth of 30.9 percent in FY06. The decline in exports to US which is fourth largest export market for Pakistan's cotton yarn is one of the dominant reason behind this poor export performance (see Table 7.18). The decline in exports to US was driven by the decline in quantum as the unit prices increased marginally during the period under review.

In fact, US demand for the yarn fell following the slowdown in its downstream industry (clothing). This is evident from the fact that US imports of yarn from the world declined by 6.4 percent and 12.4 percent during 2006 and Jan-May 2007.

However, there was a significant increase in Pakistan's cotton yarn exports to China and EU as is depicted by 26.2 percent increase to China and 31.5 percent increase to EU-27 nation block during FY07. The other markets where Pakistan was successful in increasing its exports during FY07 included Egypt, Indonesia, Guatemala, India and Thailand etc.

The diversion of Pakistan's cotton yarn exports from US and Hong Kong to China and EU countries was in line with the international trends. It can be observed from Table 7.19 that China and European countries are the world's major growing markets for cotton yarn. However, cotton yarn prices in China are the lowest in all the world major cotton yarn importing countries. As a result, major fallout of diversion of Pakistan's cotton yarns exports from US to China was the downward pressure on unit values of Pakistan's cotton yarn exports (see Figure 7.60).

Cotton Fabrics

The cotton fabrics exports declined by 4.3 percent during FY07 as compared to fairly healthy growth of 13.2 percent in FY06. In sharp contrast to FY06 where this healthy growth was mainly contributed (74.2 percent) by increase in quantum, during the outgoing year the reduction occurred entirely because of the plunge in quantum as the unit values increased during this period (see Figure 7.60).

The major reduction in the cotton fabrics exports was observed to US market where the category exports declined by 35.5 percent during FY07. Following the slowdown in US clothing industry, the US imports of fabric from the world declined by 4.3 percent and 1.1 percent during 2006 and Jan-May 2007 respectively.

Table 7.18: Pakistan's Cotton Yarn Exports Markets

	Market share		Unit values	
	FY06	FY07	FY06	FY07
Hong Kong	30.5	28.0	2.0	2.1
China	19.1	23.1	1.9	2.1
EU	8.6	10.8	2.3	2.4
U.S.A	8.0	6.2	2.0	2.1
Korea	9.2	5.7	2.4	2.3
Bangladesh	5.4	4.7	2.0	2.0
Japan	3.0	3.5	2.3	2.3
Turkey	3.6	3.4	2.1	2.2
Egypt	0.9	1.4	1.7	2.1
Indonesia	1.0	1.2	1.8	2.0
India	0.6	0.9	2.3	2.5
Guatemala	0.4	0.7	1.9	1.9
Colombia	1.0	0.6	2.0	2.2
Thailand	0.4	0.6	2.0	2.1
Sri Lanka	0.6	0.6	2.2	2.1
Brazil	0.5	0.6	2.2	2.3
Honduras	0.1	0.6	2.5	2.3
Vietnam	0.2	0.5	1.9	1.9

Figure 7.60: Unit Values of Cotton Yarn and Fabrics

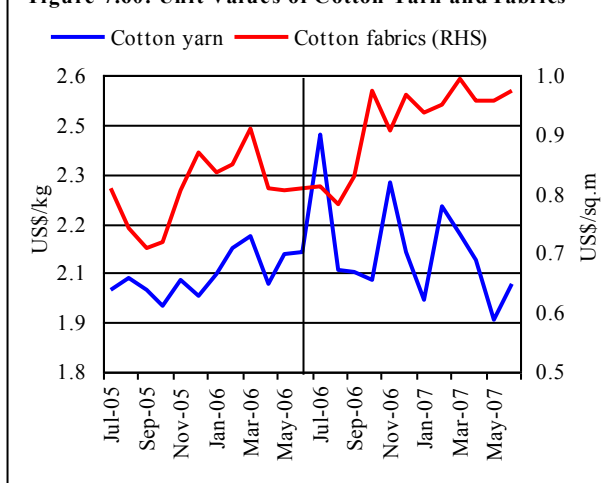


Table 7.19: World's Major Markets of Cotton Yarn (Containing 85% or More Cotton by Weight) in 2004-2006

	Value (US\$ billions)			Volume (000MT)			Unit price (US\$/kg)		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
China	1.45	1.57	1.85	685.8	749.7	881.7	2.1	2.1	2.1
Hong Kong	1.84	1.7	1.83	625.9	639	664.2	2.9	2.7	2.8
Italy	0.46	0.43	0.55	118.3	117.4	129.8	3.9	3.7	4.2
South Korea	0.5	0.45	0.54	182.4	186.2	202.6	2.7	2.4	2.7
USA	0.41	0.33	0.31	126.7	116.8	102.4	3.2	2.8	3
Turkey	0.25	0.26	0.25	85.7	98.2	88.6	2.9	2.6	2.8
Japan	0.32	0.24	0.24	86.9	75.7	67.3	3.6	3.2	3.6
Germany	0.24	0.21	0.2	71.4	66.7	63.7	3.3	3.1	3.2
France	0.16	0.13	0.12	40.1	33.3	28.8	4.1	3.8	4.3

The major markets where Pakistan's cotton fabrics exports increased are EU, Turkey, Bangladesh, Sri Lanka and India (see **Table 7.20**). EU is the largest markets for Pakistan's cotton fabrics accounting for around 30 percent of Pakistan's total exports. Importantly, the unit prices in the most of the aforementioned markets are higher as compared to that in the United States.

Consequently, the diversion of Pakistan's cotton fabrics exports from US to EU, Bangladesh, Turkey and India resulted in the improvement of unit prices of cotton fabrics (see **Figure 7.60**).

Table 7.20: Pakistan's Cotton Fabrics Export Markets

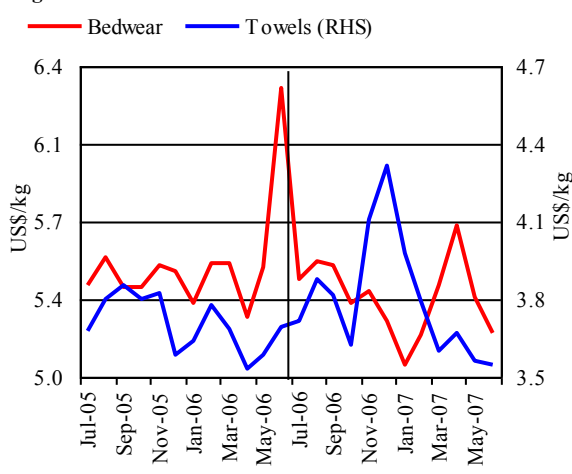
	Market share		Unit values	
	FY06	FY07	FY06	FY07
EU	30.4	33.0	0.8	0.9
Turkey	8.1	10.6	1.0	1.0
U.S.A.	14.7	9.5	0.8	0.8
Bangladesh	5.4	5.9	1.0	1.0
Sri Lanka	4.2	5.3	1.0	1.1
Hong Kong	5.9	4.8	0.8	1.0
South Africa	3.2	2.7	0.8	0.9
India	1.6	2.5	1.1	1.1
China	2.2	2.5	0.9	1.0
Saudi Arabia	1.8	1.3	0.7	0.7
Argentina	1.3	1.0	0.6	0.7

Encouragingly, decline of US\$ 90.6 million in the cotton fabrics during FY07 was more than offset by US\$ 229.5 million increase in synthetic textile exports (mainly fabrics of synthetic textile) during the same period. The synthetic textile exports increased by 114.5 percent during FY07 as compared with 33.3 percent decline in the same period last year.

According to the market sources, polyester staple prices are stable while the cotton prices are increasing. As a result, some millers have shifted to polyester-cotton yarn and polyester-cotton fabrics production¹¹⁸. Both the quantum and unit prices contributed in this remarkable export growth of synthetic textile.

Towel

Against the robust growth of 12.9 percent during FY06, the towel exports registered a nominal growth of 1.3 percent during FY07. Contrary to the last year where the whole growth was contributed by quantum increase, the nominal growth during FY07 was entirely contributed by increase in unit values.

Figure 7.61: Unit Values of Bedwear and Towels

¹¹⁸ The price difference between Polyester Fiber and cotton has reduced from 0.33 US\$/kg from Jan-FY07 to 0.25 US\$/kg during April-FY07. However, it increased again to 0.3 US\$/kg during end June-FY07.

Although the unit values of towel fluctuated during FY07, the average price during FY07 remained higher than that of FY06 (see **Figure 7.61**).

The EU and US markets remained the major markets during FY07, as the two markets together constitute around 83 percent of Pakistan's total exports. Importantly, exports to both the aforementioned markets increased during FY07.

Bedwear

The bedwear exports recorded a negative growth of 3.9 percent during FY07 as compared to robust growth of 40.6 percent last year. The decline in bedwear exports is contributed by fall in both the volume and unit prices (see **Figure 7.61**). However, this decline is little puzzling given the 5.0 percent research & development support to the bedwear sector and some favorable development in the EU market such as partial restoration of GSP facility and reduction in antidumping duty^{119 120}. As a result of these developments, Pakistan's bedwear export to EU market increased by 11.4 percent during FY07.

Knitwear

Knitwear was the only major textile item whose exports recorded double digit growth during FY07. The growth in knitwear exports accelerated from 7.1 percent during FY06 to 12.2 percent during FY07. The remarkable growth in the high value added knitwear was contributed by an increase in prices as well in volumes (see **Figure 7.62**).

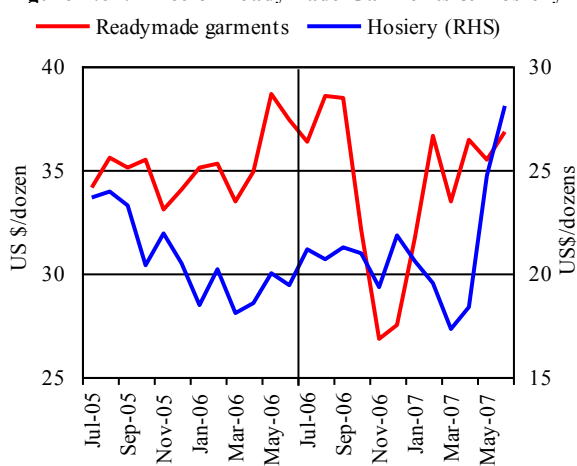
EU and US markets remained the major destinations for Pakistan's knitwear exports. During FY07, the knitwear exports to US and EU markets recorded remarkable growth of 13.3 percent and 13.1 percent respectively (see **Table 7.21**). However, with the abolition of China specific safeguards measures by EU and US in 2008, it would be challenging task for Pakistani knitwear exporters to maintain their market in the world's two major markets.

Table 7.21: Market Analysis of Major Textile Items

YoY growth in percent; percentage share in the item export

	Growth in FY07			Share in value	
	Quantity	Value	Unit value	FY06	FY07
Towels	0.4	3.8	2.1		
USA	-0.5	4.7	3.9	55.4	55.8
EU	2.1	1.3	-2.1	26.1	25.4
Others	1.2	5.0	2.4	18.5	18.7
Bed wear	-2.2	-0.8	0.1		
USA	-10.1	-8.9	0.0	51.4	47.2
EU	10.0	11.4	0.0	34.5	38.7
Others	-4.6	-1.1	2.4	14.1	14.1
Garments	9.2	7.1	-3.2		
USA	4.4	3.8	-1.8	39.8	38.6
EU	16.2	15.7	-1.7	37.4	40.4
Others	5.3	-1.3	-7.5	22.8	21.0
Knit wear	14.5	12.1	-3.4		
USA	13.9	13.3	-1.8	54.2	54.8
EU	16.6	13.1	-4.2	38.1	38.5
Others	10.6	-1.6	-12.2	7.6	6.7

Figure 7.62: Price of Readymade Garments & Hosiery



¹¹⁹ Under the partial restoration of GSP facility, Pakistan's textile products exports to EU market would be allowed 20 percent concession on the Most Favored Nation (MFN) tariff with effect from January 1, 2006.

¹²⁰ With partial restoration of GSP and reduction in antidumping duty, the de facto duty on the bedwear exporters is decreased from 25.1 percent to around 15.5 percent.

Readymade Garments

The readymade garments recorded 5.3 percent growth during FY07 on top of 20.4 percent growth last year. Importantly, the volume growth (9.6 percent) during FY07 was higher than volume growth (8.9 percent) in FY06. It was on account of lower prices, that overall readymade garments growth was 15 percentage points lower in FY07. The 6.0 percent Research and Development subsidy along with US and EU restriction on apparel imports from China appears to be the contributory factors behind this growth. The major categories which contributed in this volume driven growth are cotton trousers and cotton knit shirts which would be highly vulnerable to China specific restrictions. Hence going forward, Pakistan readymade garments would have to face stiff competition in EU and US market.

As a result of this growth, Pakistan's share of readymade garments exports to EU market increased while it fell slightly in the US market during FY07. Specifically, the category export share to EU market increased from 37.4 percent FY06 to 40.4 whereas in the US market, the category export share declined by 1.2 percentage points during FY07.

Other Manufacture

The *other manufactures* export registered negative growth of 10.5 percent during FY07 as compared to robust growth of 21.5 percent during the last year (see **Table 7.22**). Petroleum & petroleum products, leather manufactures, chemical & pharmaceutical, sports goods and carpets which together constitute around 90 percent of the total other manufacture exports were the contributory factors behind this fall in the other manufactures exports. The fall in other manufactures exports is attributed to industry specific issues.

The lower capacity utilization of petroleum refineries in Pakistan, on account of their inability to market the product mix domestically¹²¹, led the petroleum and petroleum products exports to depict a negligible growth of 0.2 percent during FY07.

During FY07, the 27.2 percent decline in exports of football is the dominant contributor behind the fall (16.1 percent) in sports good exports. The Pakistan Sports Goods Manufacturing & Export Association (PSMEA) claims that tough competition from relatively cheaper machine-made foot ball in the EU area as compared with Pakistan's hand-stitched football and Nike (a major buyer) decision to pull out of Pakistan¹²² on the issue of child labor are the main contributory factors behind decline in foot ball exports during the period under review.

The decline (23.2 percent) in exports of leather manufactures was primarily driven by leather garments exports which constitutes around 73 percent of the total leather manufactures exports. The decline in the rebate on leather garment exports may be one of the probable factors behind the decline in leather garment exports¹²³. The substantial decline in leather garments exports during FY07 along with acceleration in the production of leathers products from 5.8 percent in FY06 to 8.6 percent during FY07 give further credence to the argument of dubious leather exports last year.

Other Exports

The items categorized as "other exports" have depicted a remarkable growth of 20.3 percent during FY07 as compared to 4.9 percent decline last year. The items which mainly contributed in this healthy export growth included cement, wheat flour, chromium ores & concentrates, vegetables & its fractions, furniture, filament yarn of polyester and Jewelry etc. The increase in exports of cements is attributed to increased productive capacity of the cement industry while wheat flour exports increased on the back of bumper wheat crop during the period under consideration. Afghanistan remained the

¹²¹ The domestic demand for the furnace oil and diesel has increased while that for petrol and kerosene has gone down.

¹²² The NIKE had asked the Saga sports to complete its markets until March 2007.

¹²³ For detail, consult third quarterly report for the year 2006-07 of the State Bank of Pakistan.

Table 7.22: Major Exports

value: million US Dollar; unit value in US Dollar

	Unit	FY06		FY07P		Absolute Δ in value	Change (percent)		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
A Primary commodities		1,940.1		1,920.5		-19.5		-1.0	
Rice	MT	1,148.9	315.7	1,121.8	359.2	-27.1	-14.2	-2.4	13.8
Raw cotton	MT	68.2	1,087.7	50.7	1,104.5	-17.4	-26.7	-25.6	1.5
Raw wool (excluding Wool Tops)	MT	1.9	770.8	2.0	810.4	0.1	0.0	5.1	5.1
Fish and fish preparations	MT	194.2	1,511.6	188.3	1,483.7	-5.8	-1.2	-3.0	-1.8
Leather	SQM	292.4	16.8	302.8	17.0	10.4	2.3	3.5	1.3
Guar and guar products	MT	22.1	1,374.3	11.8	1,263.6	-10.3	-42.0	-46.6	-8.1
Fruits	MT	134.6	300.1	101.5	298.8	-33.1	-24.3	-24.6	-0.4
Vegetables	MT	41.3	325.5	62.9	300.2	21.6	65.2	52.4	-7.8
Crude animal material	MT	16.6	2,919.5	13.0	2,492.8	-3.6	-8.3	-21.7	-14.6
Oil Seeds & nuts etc.	MT	11.1	639.3	18.0	749.2	6.9	38.7	62.6	17.2
Wheat		0.0	0.0	47.7	0.0	47.7	---	---	---
B Textile manufactures		9,860.7		10,342.7		482.0		4.9	
Cotton yarn	MT	1,382.9	2,058.8	1,425.8	2,112.8	42.9	0.5	3.1	2.6
Cotton fabrics (woven)	SQM	2,108.2	0.8	2,017.6	0.9	-90.6	-16.1	-4.3	14.0
Hosiery (knitwear)	DOZ	1,751.5	20.7	1,964.6	21.0	213.1	10.2	12.2	1.8
Bed wear	MT	2,038.1	5,510.0	1,958.6	5,362.7	-79.4	-1.3	-3.9	-2.7
Towels	MT	587.6	3,701.0	595.0	3,786.9	7.4	-1.0	1.3	2.3
Cotton bags and sacks	MT	14.1	4,258.9	11.4	3,799.0	-2.7	-9.5	-19.3	-10.8
Readymade garments	DOZ	1,310.0	35.2	1,379.7	33.8	69.7	9.6	5.3	-3.9
Tarpaulin & other canvas goods	MT	38.9	2,268.8	69.1	2,696.5	30.2	49.4	77.5	18.9
Tule, lace embroidery etc.	(-)	8.0	---	8.8	---	0.8	---	9.5	---
Synthetic textiles	SQM	200.3	0.7	429.8	0.8	229.5	95.0	114.5	10.0
Other textile made-up	(-)	408.3	---	473.9	---	65.5	---	16.0	---
Waste material of tex. Fibers/ fabrics	MT	12.8	684.2	8.5	679.3	-4.2	-32.7	-33.2	-0.7
C Other manufactures		2,863.7		2,563.3		-300.5		-10.5	
Carpets, carpeting rugs & mats	SQM	257.3	60.8	233.1	61.9	-24.1	-11.1	-9.4	1.9
Petro. And petroleum products	MT	838.1	535.2	840.0	775.1	1.8	-30.8	0.2	44.8
Sports goods	(-)	343.3	---	287.9	---	-55.4	---	-16.1	---
Leather manufactures	(-)	711.2	---	546.1	---	-165.1	---	-23.2	---
Surgical and medical instruments	NO	163.1	---	184.4	---	21.3	---	13.1	---
Cutlery	GR	34.3	21.6	45.0	50.3	10.8	-43.6	31.5	133.0
Onyx manufactured	MT	13.3	1,606.0	12.3	1,762.0	-1.0	-15.4	-7.2	9.7
Chemicals and pharmaceuticals	(-)	433.0	---	388.0	---	-45.0	---	-10.4	---
Molasses	MT	43.6	87.7	26.4	73.6	-17.1	-27.8	-39.3	-16.0
Sugar	MT	26.6	435.3	0.0	451.7		-100.0	100.0	3.8
D Others		1,786.7	---	2,149.8	---	363.1		20.3	---
Total exports		16,451.1		16,976.6		525.1		3.2	

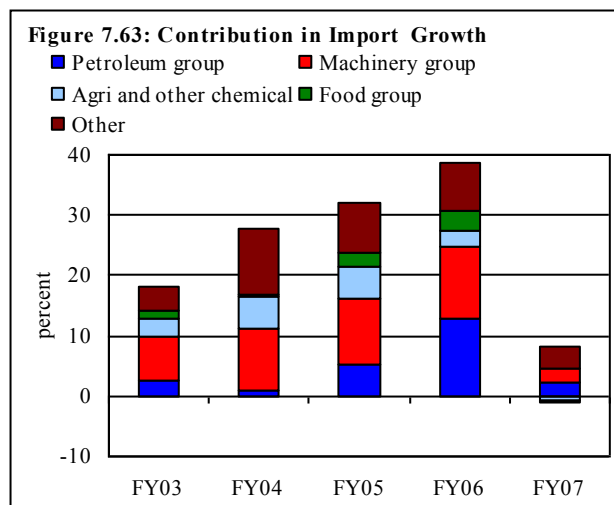
Source: Federal Bureau of Statistics

major markets for wheat flour as well as for cement. The other markets of cements included Iraq, United Arab Emirates and Kuwait. The growth in exports of chromium ores & concentrates is primarily attributed to increase in its extraction and its major destination is China.

Imports

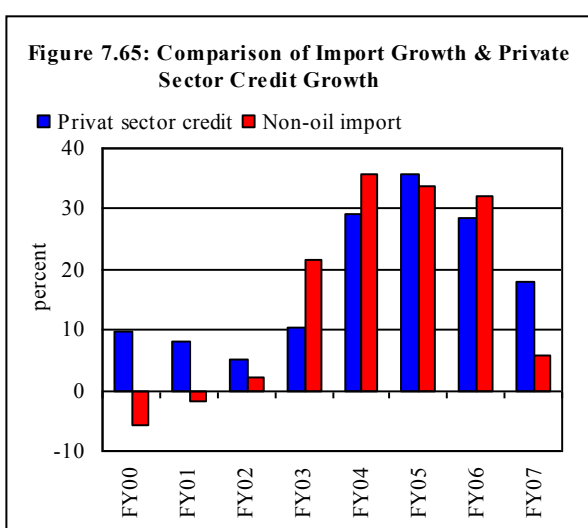
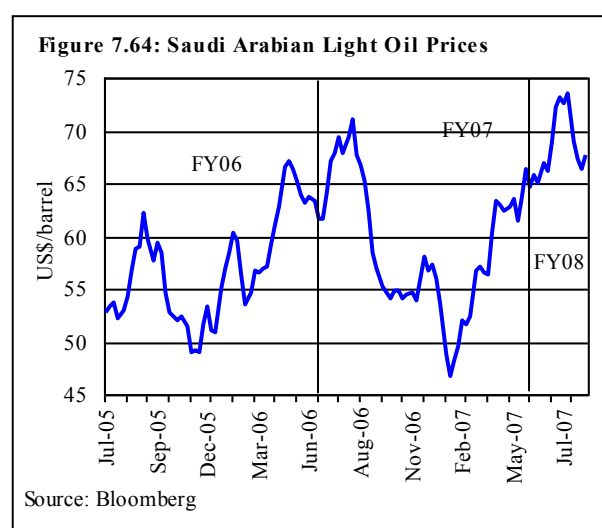
The import growth substantially slowed down to 6.9 percent during FY07 as compared with 38.8 percent growth during FY06 and 29.2 percent average growth during the last four years (see **Figure 7.63**). The slowdown in import growth was broad based as it was contributed by deceleration in imports of both the POL and non- POL imports.

The deceleration in the import growth of POL imports was entirely driven by the decline in global oil prices (see **Figure 7.64**). Specifically, the unit prices of petroleum group imports declined by 2.9 percent during FY07 as compared to 53.1 percent increase during FY06. As a result the petroleum group imports growth fell from 66.9 percent during FY06 to 10.0 percent during FY07.



The deceleration in imports growth of non-POL imports was attributed to a combination of various factors. On the one hand, tight monetary policy moderated the exceptional demand for imports (see **Figure 7.65**). On the other hand, the absorption of one off impact of opening up of automobile and telecom sector together with decline in the textile machinery imports after the bulk of textile machinery imports under the balancing, modernization and rehabilitation (BMR) drive to prepare for the increased competition under post-MFA regime lead to slow down the non-POL imports during FY07 (see **Figure 7.65**). In particular, the road motor vehicles and textile machinery depicted negative growth of 20.4 and 38.5 percent respectively during FY07.

Moreover, improved supply of food items also contributed in the deceleration of import growth. In particular, as compared to strong import growth during FY06, the imports of wheat and sugar declined significantly during FY07.



Food Group

Against an extraordinary growth of 46.5 percent during FY06, the food group imports declined by 6.8 percent during FY07. The decline in imports of food group was mainly driven sharp fall in the imports of wheat (68.7 percent) and sugar (58.2 percent), reflecting the impact of strong domestic production. On the other hand, the increase in international prices of palm oil, soybean oil (see **Figure 7.66**), pulses and milk & cream meant that these import increased.¹²⁴

Machinery Import

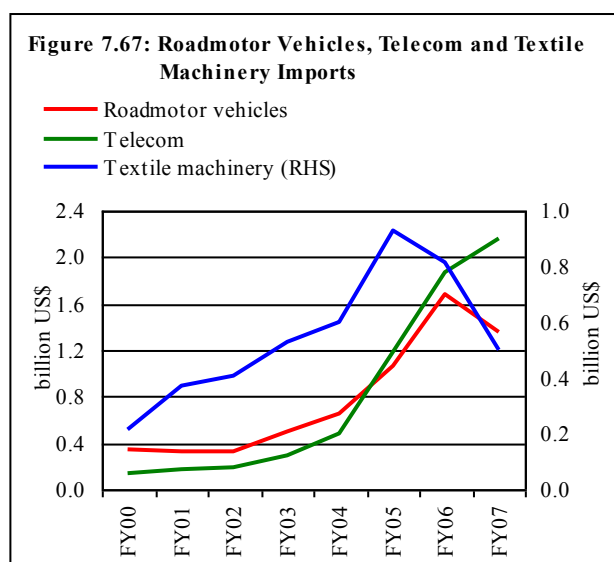
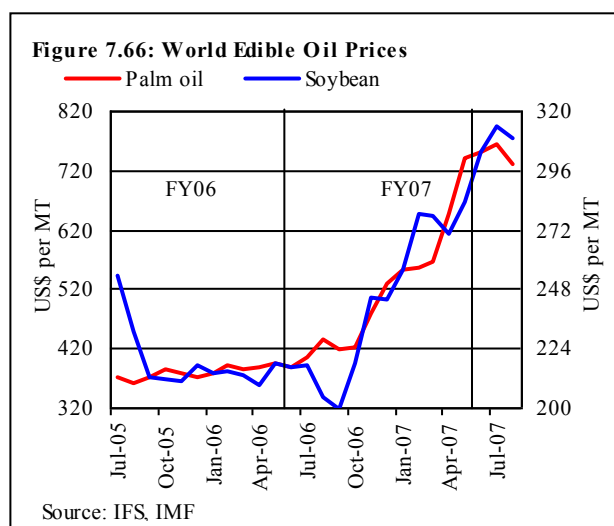
During FY07, the machinery import growth fell to 8.1 percent from 40.6 percent growth last year. The declines in imports of road motor vehicles and textile machinery together with slowdown in import growth of telecom (see **Figure 7.67**) and electrical machinery (which together constitute around 52 percent of the overall machinery imports) were the contributory factors behind this sharp deceleration in the growth of overall machinery. In fact, the machinery import growth falls to 2.6 percent during FY07, if adjusted for the one off imports of aircrafts.

On the other hand, the increase in power generating machinery, agriculture machinery, and construction machinery depicted considerable growth during FY07. The increased imports of the aforementioned categories are mainly explained by the growing needs of the fast growing domestic economy.

To meet the growing appetite for the power in the country, import of power generating machinery recorded robust growth for the third successive year, growing at 44.8 percent in FY07 on the top of 41.3 percent and 30.3 percent growth recorded in FY05 and FY06 respectively.

The imports of construction and mining machinery also registered robust growth of 16.9 percent during FY07 on the top of 35.2 percent increase during FY06. The increased construction activities in the economy, reflected by 17.2 percent growth during FY07, are the main contributory factors behind this healthy import growth of the category.

As a result of increase in imports of tractors for the third year in a row, the import of agriculture



¹²⁴ The commodities prices in the international markets are increasing on the back of huge demand from emerging economies like China and India. Moreover, the weather anomalies and increased competition between crops for land space in contributing to supply constraints in agriculture sector. In particular, the edible oil (palm and soybean) prices have risen significantly on the back of rise in demand for bio fuel industry with the increase in global oil prices.

machinery recorded 17.7 percent growth during FY07 as compared to 91.7 percent and 95.8 percent growth during FY06 and FY05 respectively.

The categories which contributed significantly, in decelerating the machinery import growth are discussed below.

Road Motor Vehicles

After recording robust growth during the last four successive years, the imports of road motor vehicles declined by 20.4 percent during FY07 (see **Table 7.23**). This decline was contributed by fall in both the imports of Completely Built up Units (CBUs) and Completely Knocked-Down Systems (CKDs/SKD). The decline in imports of small cars, which constitutes more than 50 percent of the overall road motor vehicles imports, was the dominant factor behind the decline in imports of the category.

Table 7.23: Analysis of Machinery Import

percent	FY05		FY06		FY07	
	Growth	Share	Growth	Share	Growth	Share
Power generating machinery	41.3	6.6	30.3	6.1	44.7	8.2
Office machinery	30.6	4.6	7.3	3.5	5.5	3.4
Textile machinery	55.3	15.7	-12	9.8	-38.5	5.6
Construction & mining machinery	38.5	2.4	35.2	2.3	16.9	2.5
Electrical machinery & apparatus	37.7	6	43.1	6.1	28.1	7.2
Telecom	146.2	20	58.1	22.4	15.2	23.9
a) Mobile phones	110.2	5.9	96.8	8.3	20.8	9.2
b) Other apparatus	165.3	14.1	41.9	14.2	12.0	14.7
Railway vehicles*	-43.3	0.7	91.7	0.9	-52.9	0.4
Road motor vehicles	63.7	18.1	57.8	20.3	-20.4	14.9
Aircraft, ships and boats	-78.6	2.9	173.4	5.6	102.1	10.4
Agricultural machinery & implements	95.8	1.2	91.7	1.7	17.7	1.8
Other machinery	74	21.8	36.4	17.8	50.3	24.7
Total machinery import	40.2		40.6		8.1	
Machinery import (excluding air craft)	67.6		36.7		2.6	

It may be pointed out, that three to four years back, the decline in the domestic interest rates on the back of increased liquidity in the interbank market made the car financing scheme attractive for the buyers. The cheaper car financing scheme substantially increased car demand. On account of capacity constraints, the domestic automobile industry was not able to meet this fast growing demand as was reflected in increased car premium. In order to control car premium in Pakistan and to make local car assemblers more efficient, the government reduced the custom duties on the import of cars thereby, leading to increase the cars imports. Moreover, the permission to import used cars not more than two years old during FY05 and import cars under transfer of residence, personal baggage and gift scheme gave further boosts to the imports of cars. The cars imports touched its peak in FY06, when government dropped the age limit on car imports.

However, with the absorption of one off impact of reduction of custom duties on car imports, increase in the domestic interest rates with the tightening of monetary policy and restrictions on the imports of motor cars older than five years¹²⁵ paved the way for a decline in imports of motor cars in particular and road motor vehicles in general, during FY07.

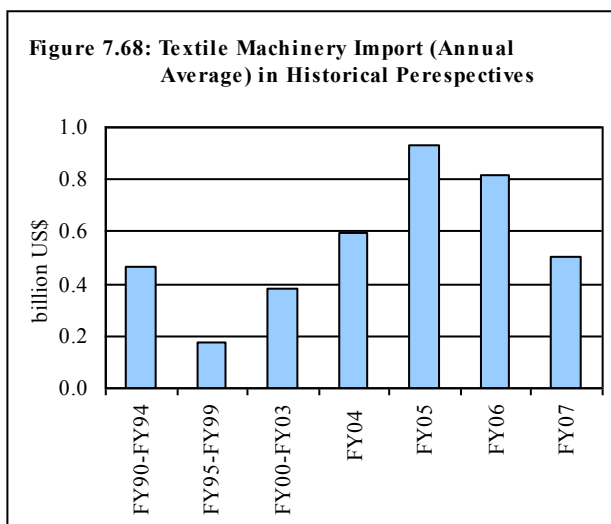
¹²⁵ For FY08, the restrictions on the imports of used cars are reduced from 5 years to 3 years.

Telecom Group

The telecom group imports, with the second highest share (23.9 percent) in the overall machinery imports, decelerated to 15.2 percent during FY07 from 58.1 percent during FY06. Both the cellular phones and other telecommunication apparatus contributed in the relatively lower growth of the group imports. This implies that economic agents might have absorbed the impact of policy changes in the sector to the large extent and imports would now continue to grow at the moderate level. However, the investment of China in Pakistan's telecom sector may put upward pressures on the group imports in FY08.

Textile Machinery

Textile machinery import declined by 38.5 percent during FY07 as against the decline of 12.0 percent in FY06. In fact, a major part of textile machinery was imported in recent years was during the period between FY00 to FY05, under the textile vision 2005 as the industry prepared for the relatively more competitive international market in the post-MFA period (see **Figure 7.68**). The textile machinery imports peaked at US\$ 0.9 billion during FY05. In this perspective, some decline in textile machinery import was to be expected during FY06 and FY07 (post-MFA period). Nonetheless, the textile machinery imports in FY07 remained higher than the annual average imports of pre-Textile Vision period (FY90-FY00). During FY07, fall in imports of spinning and weaving machinery contributed more than 50 percent in overall decline of textile machinery.¹²⁶



Petroleum Group Imports

During FY07, the petroleum group imports increased by a nominal amount of US\$ 0.66 billion as compared to extraordinary increase of US\$ 2.6 billion during FY06 (see **Table 7.24**). As a result, growth in petroleum group import decelerated to 10.0 percent during FY07 as compared to 66.9 percent growth in the same period of last year. This deceleration was entirely driven by the decline (2.9 percent) in unit values of the group imports. It may be pointed out that the increase in global oil prices was the dominant contributor (87 percent) in the 66.9 percent growth last year (see **Table 7.24**).

Table 7.24: Impact of Price and Volumes in Total Rise of Petroleum Group Imports

	million US\$					
	FY06			FY07		
	Total change in value	Due to		Total change in value	Due to	
		Qty	Price		Qty	Price
Petroleum group	2675.2	359.3	2315.9	665.6	883.9	-218.4
Products	1030	120.1	909.9	853.4	1179.2	-325.8
Crude	1645.1	231.9	1413.2	-187.9	-230.0	42.1

Within the petroleum group, almost all the increase was contributed by the rise in imports of petroleum products (refined), as the petroleum crude imports declined by 5.0 during FY07 on account of lower demand of oil refineries that continued to operate at the lower capacities relative to the preceding years.

¹²⁶ Under Textile Vision 2005, around 73 percent of the total investment of US\$ 5.5 billion during 1999-2005 went into spinning and weaving sector (see First Quarterly Report for the year 2006-2007 of the State Bank of Pakistan).

Table 7.25: Contribution in Total Petroleum Products Imports

	FY06	FY07			
	Value US\$ million	Value US\$ million	Share (%)	YoY growth (%)	Contribution in growth
Light oils and preparations	2850.1	3702.6	98.22	29.9	29.41
i) Furnace oil	591.3	1374.8	36.47	132.5	27.03
ii) High speed diesel oil	2191.4	2235.5	59.30	2.0	1.52
Petrol gas gaseous hydrocarbon	16.5	36.9	0.98	124.2	0.71
Tar from coal/lignite/peat etc	0.0	0.6	0.02	1261.6	0.02
Pitch from coaltar/mineral tar	0.2	0.3	0.01	49.2	0.00
Bitumen & asphalt, natural	0.3	0.1	0.00	-60.4	-0.01
Oils & oth products nes	13.7	18.4	0.49	34.6	0.16
Bitumen mixtures, natural	0.9	0.4	0.01	-51.6	-0.02
Petroleum jelly & wax.	8.8	7.0	0.19	-20.6	-0.06
Petroleum coke bitumen/residue	8.5	3.5	0.09	-58.6	-0.17
Total	2899.0	3769.9		30.0	30.04

The import growth of the petroleum products was entirely driven by the increase in volumes as the unit prices of the petroleum products declined by 8.0 percent during the period. The increase in petroleum products imports was chiefly driven by increase in imports of furnace oil and high speed diesel oil, which together constitutes almost 96 percent of overall petroleum products imports (see **Table 7.25**). The furnace oil imports increased on the back of increased demand from thermal power¹²⁷ while high speed diesel oil imports increased mainly on account of its increased use in agriculture activities in the country coupled with increased use of electricity generator in the frequent power failures in the country.¹²⁸ Specifically, out of 30.0 percent increase in petroleum products imports during FY07, 27.0 percentage points was contributed by the furnace oil imports while 1.5 percentage was contributed by increase in imports of high speed diesel oil.

Metal Group

The metal group imports declined by 5.2 percent during FY07 as against extraordinary growth of 52.1 percent in last year (see **Table 7.26**). The improved domestic productions of metal, revival of ship breaking industry and slowdown in the automobile industry along with increase in metal prices in the international markets were the main contributory factors behind the lower imports of metal group during FY07.

Other Imports

The other imports increased by 13.3 percent during FY07 on the top of 19.0 percent growth during last year. The main items which contributed in this strong import growth included musical instruments & parts, professional scientific & control equipments, coal, coke & briquettes, oil seeds & oleaginous fruits, organic chemicals, feeding stuff for animals and manufactures of metal necessities.

¹²⁷ The use of fuel oil in power generation has increased by 60.0 percent during FY07. The demand for furnace oil originates mainly from WAPDA, KESC, IPPs and few captive power plants. The demand also originates from industries which mainly include cements, fertilizers and sugars

¹²⁸ The use of high speed diesel (HSD) in agriculture increased from 3.7 thousands metric tons in FY06 to 11.7 thousands metric tons in FY07, while in industry its use has increased from 734.8 thousands metric tons in FY06 to 772.2 thousands metric tons in FY07.

Table 7.26: Major Imports

Value in million US Dollars; Unit value in US Dollars

	Unit	FY06		FY07		Absolute Δ in ---	Change in percent		
		Value	Unit	Value	Unit		Qty	Value	Unit
A. Food group	---	2,063.3	---	1,923.4	---	-140.0	-	-6.8	---
1. Milk & cream incl. milk food for infants	MT	61.4	1,826.7	84.2	2,114.3	22.8	18.5	37.2	15.7
2. Wheat unmilled	MT	132.8	162.6	41.6	305.7	-91.2	-83.4	-68.7	88.0
3. Dry fruits	MT	57.8	559.6	68.2	592.5	10.4	11.5	18.0	5.9
4. Tea	MT	222.8	1,753.2	213.8	1,906.7	-9.0	-11.8	-4.0	8.8
5. Spices	MT	52.8	608.7	54.0	626.7	1.3	-0.6	2.4	3.0
6. Edible oil	MT	738.7	435.6	956.4	543.5	217.7	3.8	29.5	24.8
<i>Soya bean</i>	MT	21.5	658.5	40.7	824.4	19.2	51.3	89.4	25.2
<i>Palm oil</i>	MT	717.3	431.3	915.8	535.4	198.5	2.8	27.7	24.2
7. Sugar	MT	623.3	408.2	260.3	529.7	-363.0	-67.8	-58.2	29.8
8. Pulses	MT	173.8	375.8	244.8	488.5	71.0	8.3	40.8	30.0
B. Machinery group	---	8,323.2	---	8,999.1	---	675.8	-	8.1	---
1. Power generating machinery	---	511.6	---	740.2	---	228.6	-	44.7	---
2. Office machinery	---	293.6	---	309.6	---	16.0	-	5.5	---
3. Textile machinery	---	817.2	---	502.9	---	-314.3	-	-38.5	---
4. Construction & mining machinery	---	190.1	---	222.2	---	32.1	-	16.9	---
5. Electrical machinery & apparatus	---	508.7	---	651.9	---	143.1	-	28.1	---
6. Railway vehicles	---	78.8	---	37.1	---	-41.7	-	-52.9	---
7. Road motor vehicles	---	1,687.1	---	1,342.3	---	-344.8	-	-20.4	---
8. Aircraft, ships and boats	---	462.6	---	934.9	---	472.3	-	102.1	---
9. Agricultural machinery & implements	---	141.4	---	166.4	---	25.0	-	17.7	---
10. Other machinery	---	3,632.0	---	4,091.5	---	459.5	-	12.7	---
C. Petroleum group	---	6,674.9	450.1	7,340.4	437.1	665.6	13.2	10.0	-2.9
1. Petroleum products	MT	2,880.9	472.9	3,734.3	435.0	853.4	40.9	29.6	-8.0
2. Petroleum crude	MT	3,794.0	434.2	3,606.1	439.3	-187.9	-6.1	-5.0	1.2
D. Textile group	---	545.8	---	540.8	---	-5.0	-	-0.9	---
1. Synthetic fiber	MT	260.7	1,613.2	235.1	1,786.8	-25.7	-18.6	-9.8	10.8
2. Synthetic & artificial silk yarn	MT	237.4	1,696.3	250.2	2,119.0	12.9	-15.6	5.4	24.9
3. Worn clothing	MT	47.7	335.8	55.5	354.5	7.8	10.3	16.4	5.6
E. Agricultural and other chemicals	---	4,183.0	---	4,402.2	---	219.3	-	5.2	---
1. Fertilizer	MT	681.7	278.8	447.2	304.9	-234.5	-40.0	-34.4	9.4
2. Insecticides	MT	113.8	3,350.5	96.6	3,322.6	-17.2	-14.4	-15.1	-0.8
3. Plastic materials	MT	1,020.2	1,245.2	1,152.6	1,412.9	132.5	-0.4	13.0	13.5
4. Medicinal products	MT	335.8	32,238.2	429.7	35,028.1	93.9	17.8	28.0	8.7
5. Others	---	2,031.6	---	2,276.2	---	244.6	-	12.0	---
F. Metal group	---	1,852.7	---	1,756.6	---	-96.1	-	-5.2	---
1. Iron and steel scrap	MT	363.2	248.2	382.2	255.3	18.9	2.3	5.2	2.9
2. Iron and steel	MT	1,367.1	501.6	1,191.2	534.6	-175.9	-18.2	-12.9	6.6
3. Aluminum wrought & worked	---	122.4	---	183.3	---	60.9	-	49.8	---
G. Miscellaneous group	---	596.2	---	659.5	---	63.3	-	10.6	---
1. Rubber crude	MT	104.1	1,227.4	114.8	1,421.8	10.7	-4.8	10.3	15.8
2. Rubber tyres & tubes	Nos	155.3	21.4	151.3	17.0	-4.0	22.6	-2.6	-20.5
3. Wood & cork	---	37.6	---	46.2	---	8.6	-	22.8	---
4. Jute	MT	42.4	379.2	48.8	386.1	6.4	13.1	15.1	1.8
5. Paper and paperboard & manufactures	MT	256.8	708.4	298.5	714.8	41.7	15.2	16.2	0.9
H. Others	---	4,341.8	---	4,917.7	---	575.8	-	13.3	---
Total imports		28580.9		30539.7		1958.8		6.9	

Source: Federal Bureau of Statistics

Box 7.10: South Asian Free Trade Agreement

The history of South Asia Free Trade Agreement dates back to 1985 when seven countries including Pakistan, India, Bangladesh, Sri Lanka, Nepal, Maldives and Bhutan formed South Asian Association for Regional Cooperation (SAARC)¹²⁹. Major aim behind this cooperation was to accelerate economic, social and cultural coordination among the region countries. Under the umbrella of SAARC, the member countries agreed on the South Asian Preferential Trade Agreement (SAPTA) which was implemented in December 1995. The SAPTA was avant-garde as all negotiations were conducted on an item by item basis. But, due to longer negative lists, higher tariffs and non-tariff barriers, and specifically inter and intra state disputes, intraregional trade could not move ahead. At the 10th SAARC summit in 1998 SAPTA was extended to South Asian Free Trade Agreement (SAFTA), a legally binding agenda for freeing trade.

Table 7.10.1: Share Of Intra SAARC Trade In World Trade of SAARC Member Countries
million US\$

Years	Intra SAARC trade	World trade of SAARC countries	Share of intra SAARC trade in world trade of SAARC countries
1985	1,054	44,041	2.39
1990	1,584	65,041	2.44
1995	4,228	104,159	4.06
2000	5,884	141,978	4.14
2005 (P)	14,714	333,133	4.42

Sources: (i) <http://unstats.un.org/unsd/comtrade> ; (ii) international financial statistics, IMF;
iii) www.southasianmedia.net/conference/Regional_Cooperation/safta.htm

(P) Provisional

Compared with the intra-trade of other regional blocks such as European Union, North American Free trade Area (NAFTA) and Association of South East Asian Nations (ASEAN), the trade among SAARC countries as percent of their global trade remained negligible. For instance, during 2005, the intra regional trade of EU, NAFTA and ASEAN countries as percent of their global trade was 61, 56 and 25 percent respectively as against 4.42 percent of intra SAARC trade (see **Table 7.10.1**).

It may be pointed out that the SAARC countries intra regional trade could not increase significantly during the last twenty years despite the fact that these countries are endowed with abundant natural and human resources. Moreover, the region is ambitious for the fruits of free trade as is reflected by a number of multilateral and bilateral trade agreements among SAARC and with non-SAARC countries. Some of such intraregional agreements are BBIN-GQ¹³⁰, Indo-Bhutan, Indo-Nepal, Indo-Sri Lanka FTA, and Pak-Sri Lanka FTA.

This languid growth can be attributed to several policy making as well as structural aspects which include identical comparative advantage, trade in similar goods, lack of exportable surpluses, lack of communication link, restrictive trade policies, mistrust among member countries, lack of finance, illegal trade or informal sector trade, and unresolved political disputes. Moreover, concessions have been given on the commodities which are not of export interest of the other countries. SAARC member countries have not been able to utilize the opportunities which free trade and/or regional trade have.

Moreover, political tensions between India and Pakistan, two giants of the region, have hampered the intra regional trade. Two middle economies i.e. Sri Lanka and Bangladesh, however, performed a little better than India and Pakistan. Nepal, Maldives and Bhutan are small size economies; their increased share in intra regional trade may not be able to accomplish the SAARC aim (see **Table 7.10.2**).

To make SAFTA effective, SAARC must follow the model of the NAFTA or ASEAN Free Trade Area. Firstly, they must reduce the political unrest in the region and trust one another. Secondly, the member countries should locate the products in which they have comparative advantage and other members decide to give concessions on that product. Thirdly and most importantly, besides commodities it should take account of services, investment and create an environment to attract FDI, trans-regional communications, energy and water projects, construct infrastructure, development of labor force etc. Finally, areas like tourism, energy, communication, education, information, and health and poverty alleviation should also be the centre of attention so that there would be strong foundations for regional cooperation.

¹²⁹ Afghanistan is a new member of SAARC

¹³⁰ Bangladesh-Bhutan-India-Nepal growth quadrilateral initiative

Table 7.10.2: Percentage Share of Intra Regional Exports and Imports In Total Exports and Imports

Year	Bangladesh		India		Nepal		Pakistan		Sri Lanka	
	Share in exports	Share in imports	Share in exports	Share in imports	Share in exports	Share in imports	Share in exports	Share in imports	Share in exports	Share in imports
1985	7.6	3.46	3.25	0.69	38.32	32.43	5.28	1.59	3.8	6.17
1986	6.1	3.57	3.01	0.49	38.11	32.44	3.2	1.75	4.52	7.64
1987	4.1	4.28	2.82	0.5	27.84	18.8	3.92	1.61	3.58	6.49
1988	5.0	5.28	2.78	0.48	17.63	18.09	5.04	1.86	5.76	7.79
1989	3.9	4.48	2.43	0.28	2.69	12.11	3.51	1.75	5.21	5.79
1990	3.6	6.84	2.71	0.41	7.19	11.7	3.97	1.64	3.3	6.74
1991	4.7	7.47	1.78	0.54	7.86	13.76	3.33	1.42	2.6	6.88
1992	2.2	10.13	3.83	0.83	13.07	17.4	4.93	1.48	1.97	11.89
1993	2.4	11.88	4	0.45	4.69	17.23	3.21	1.55	2.17	10.11
1994	2.3	12.76	4.13	0.49	3.87	18.37	3.25	1.55	2.37	10.58
1995	2.6	17.66	4.98	0.53	8.7	17.53	3.13	1.46	2.28	11.08
1996	1.8	16.29	4.92	0.5	12.99	28.55	2.54	2.41	2.27	12.59
1997	2.3	12.91	4.36	0.45	25.44	26.76	1.75	1.96	2.05	10.7
1998	2.7	17.3	5.46	1.11	36.49	31.66	4.08	2.42	1.53	10.09
1999	1.9	13.5	4.82	0.8	28.85	31.99	3.27	1.94	2.03	9.78
2000	1.6	11.7	4.43	0.73	29.95	33.15	2.92	2.32	1.81	10.11
2001	1.1	12.3	4.62	1.21	N.A*	N.A*	2.73	2.98	3.37	13.38
2002	1.0	13.0	5.17	0.89	N.A*	N.A*	2.31	2.06	5.42	15.68
2003	1.2	15.0	6.50	0.93	53.85	53.63	3.11	3.17	7.07	18.28
2004	1.9	20.1	5.39	0.94	N.A*	N.A*	3.71	3.12	9.09	19.32
2005 (P)	2.4	16.2	5.25	0.91	42.34	51.92	4.56	2.84	12.88	21.97

Sources: (i) <http://unstats.un.org/unsd/comtrade> ; (ii) international financial statistics, IMF;(iii) www.southasianmedia.net/conference/Regional_Cooperation/safta.htm

* Data not available

(P) Provisional

Box 7.11: Trade Policy Overview**Export Promoting Measures for FY08:**

The major export promoting measures are:

- The LTF-EOP has been extended to export oriented, core and development sectors, purchase of Locally Manufactured Machinery and Compact spinning.
- Establishment of Equity Funds, not surpassing \$ 5 million per proposal for brand acquisition. The equity fund can be used for participation in investment in SPS facilities and testing laboratories.
- To promote Sectoral investments, government has decided to allow first year allowance (FYA) on investment in plant, machinery and equipment (PME). The rates @ the cost of PME are 90 percent for Hi-tech and value added industries, @ 75 percent for developmental categories and agro based industries and @ 50 percent for other industries. Additionally, hi-tech and value added industries will be exempted from customs duty and taxes on the import of PME.
- Social, Environment & Security compliance Board will be set up in TDAP to educate, coordinate and monitor the local laws relating to these standards.
- Establishment of Export Skills Development Council and convert the existing institutes into technological and skill development centers.
- Agri-Marketing Integrated centers (AMICs) will establish close linkages with selected farmers to obtain their produce for storage and sales on their behalf. It will provide common facilities such as grading, packaging, fumigation, testing, certification, etc.
- Hire international consultants for selected companies on cost sharing basis. The consultants would benchmark the firm characteristics relative to international levels. The consultants would identify the deficiencies and assist the firms in removing them. The scheme will initially include textiles and apparel, surgical instruments, leather products and sports goods.
- The government has been providing a subsidy of 50% for various compliance certifications (quality, environment and social). The subsidy level will be increased to 100% for ISO 9000, ISO 14000, OHSAS 18001, SA 8000, WRAP, EKOTEX, BSCI and BRC in the following manner: a) One Certification 50%, b) Two Certifications 66%, c) Three Certifications 82%; and d) Four or more Certifications 100%.
- To set up three overseas business support units (OBSU) in USA, EU and China in first phase and in Africa, ASEAN and East Europe in second phase.
- To establish online presence and undertake Internet Marketing for web portal of exporters. TDAP will also hire IT Co. to assist the exporters in web development and train in internet marketing.

- To diversify exports, international consultants will be engaged to: a) Identify Industrial, Agricultural and Service sectors where Pakistan may have or create some competitive advantage internationally and b) Prepare short, medium and long term plans for such sectors so that in future policy making, the totals focus of the government is on such identified sectors.
- Allow the import of semi-finished carpets on temporary basis for processing for exports under Customs SRO 1065, to arrest decline in the exports of carpets.
- To develop export quality slaughterhouses, financial assistance will be provided to investors initially from EDF.
- In order to further exploit the export potential of pharma sector, it has been decided to provide a) 50% cost of audit/accreditations by international health regulatory bodies and b) 50% cost of bio-equivalence and similar testing in WHO accredited labs.
- Exporters of footwear are allowed to import duty free footwear samples to meet their export commitments. Furthermore, this facility will be extended to manufacturers as well.
- To promote the exports of Fruits and Vegetables, and Floriculture, 39 modern pack houses, completely automated and equipped with advanced electronic devices for packing/grading and storage plants will be set up at 31 fruits and vegetable growing areas throughout the country.

Import Strategy for FY08

- Commercial importers will be allowed to import machinery, equipment, specialized machinery excluding dump trucks and mobile transit mixers. The imports will be subject to pre shipment inspection by the designated companies to the effect that machinery is in working condition and not older than 10 years.
- Only PEC registered construction companies will be allowed to import second hand PME.
- Facilitation of exhibitions will be extended to all Pakistan based trade associations subject to endorsement of TDAP.
- Import of motorized wheel chairs (new/in use) as donations and gifts to charitable institutions and hospitals, is allowed.
- In order to eliminate the undue delay in the release of goods from FBR, the authority to grant exemptions from sales tax registration will be delegated to collector of customs concerned.
- To prevent the misuse of imported narcotic drugs and psychotropic substances, only those companies will be allowed to import which have valid drugs manufacturing licenses on the authorization of Ministry of Health.
- To discourage import of stolen and chassis tempered vehicles, it has been decided that in addition to confiscation, the importers will be liable to such penalty as may be imposed by any other law for the time being in force. Re-export facility will also not be available for such vehicles.