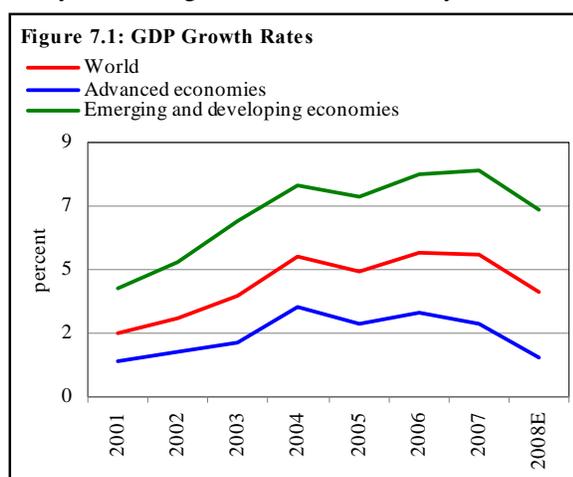


7 Balance of Payment

7.1 International Developments¹

As 2008 progressed, the initial optimism regarding world economy's resilience to international financial crisis has faded away considerably and the world economy is entering a major downturn. Continued heavy capital losses, and greater uncertainty over future trends has significantly increased risk averse behavior, reducing credit availability in capital markets globally. It is also becoming clearer that the earlier hopes of a "decoupling" of the US economy and other global markets (particularly emerging markets such as India and China) were misplaced.

Moreover, inflationary pressures in the global economy also strengthened. This was led by acceleration in international commodity prices through most of 2008, with many commodities reaching record highs. While a part of increase in the commodity prices was driven by temporary factors such as crops failures, some structural changes are also evident. Consequently, it is believed that while some key commodity prices may weaken somewhat from near-term peaks, particularly as global demand slows; there is a risk that the average levels for 2008 will remain significantly higher than seen in past years. The global slowdown has, however, moderated the inflation expectations somewhat and as such the financial stabilization has become the major challenge.



These developments have contributed to substantial downward revision of world growth prospects for 2008. World economic growth is now expected to decelerate to 3.7 percent in 2008 from 5.0 percent last year (see **Figure 7.1**). Although, inflation is projected to increase to 3.6 percent in developed countries and 9.4 percent in emerging markets in 2008, it is likely to moderate to 1.4 percent in the former and 7.1 percent in the latter in 2009.

The advanced economies are likely to be in or close to recession in the second half of 2008 as these have greater exposure to most severe financial shock. In the US, despite substantial monetary and fiscal support, economic growth is expected to fall to 1.4 percent in 2008 from 2.0 percent in 2007. Other developed economies are also witnessing significant slowdown (see **Table 7.1**).

Table 7.1: Major Economic Indicators of World Economies

	Output growth		Inflation rate		CAB (% of GDP)	
	2007	2008*	2007	200	2007	2008*
				8*		
World	5.0	3.7				
Developed countries	2.6	1.4	2.2	3.6	-0.9	-1.0
USA	2.0	1.4	2.9	4.2	-5.3	-4.6
Euro Area	2.6	1.2	2.1	3.5	0.2	-0.5
Japan	2.1	0.5	-	1.6	4.8	4.0
UK	3.0	0.8	2.3	3.8	-3.8	-3.6
Emerging markets	8.0	6.6	6.4	9.2		
China	11.9	9.7	4.8	6.4	11.1	9.5
Russia	8.1	6.8	9.0	14.0	5.9	6.5
India	9.3	7.8	6.4	7.9	-1.4	-2.8
Pakistan	6.4	5.8	7.8	12.0	-4.8	-8.7
Bangladesh	6.3	7.0	9.1	10.1	1.1	1.0
Philippines	7.2	4.4	2.8	10.1	4.4	2.4
Indonesia	6.3	6.1	6.2	9.8	2.5	0.1

Sources: World Economic Outlook October 2008 and World Economic Outlook November 2008 Update.

* Indicates projection

¹ The discussion in this section is based on World Economic Outlook by IMF for October 2008.

Similarly, against the robust performance of 2007, the emerging economies are also losing steam in 2008 on account of spill over from the significant slowdown in advance economies and tight monetary policies to deal with rising inflationary pressures. Growth in these economies is expected to moderate to 6.6 percent in 2008 from 8.0 percent in 2007. Within the group, economic growth in China, India and Russia, which were earlier driving strong growth in the region, is expected to ease considerably during 2008 (see **Table 7.1**).

7.2 Pakistan's External Account

The deterioration in current account deficit, which emerged in FY05, continued for the fourth successive year, reaching 8.4 percent of GDP during FY08, the highest level in the last thirty years. The impact of this sharp deterioration on Pakistan's external account was further exacerbated by decline in the financial account surplus during the period (see **Table 7.2**). Consequently, the exchange rate and SBP foreign exchange reserves remained under pressure.

In FY08, the impact of strong domestic aggregate demand on the deteriorating current account deficit was further compounded by a host of external and domestic factors (see **Table 7.2**). On one hand, Pakistan faced an unprecedented rise in global oil and other commodity prices, slowdown in Pakistan's major textile export markets. On the other hand, import demand was stoked by lower production growth in the real sector (amid power shortages, disappointing crops, etc.) and a very expansionary fiscal policy. The attempts to protect local economy from rising commodity prices also proved expensive, due to extensive trading and smuggling of the subsidized goods, leading to local shortages. All of these factors contributed considerably in the current account deterioration in FY08. The only factor which provided some respite was the continued rise in workers' remittances which increased by 17.4 percent during FY08.

Prior to FY08, the congenial international and domestic environment had allowed Pakistan to comfortably finance its large current account deficit through non-debt creating inflows and concessional loans from multilateral agencies. However, as pointed out by SBP in various reports, this had increased risk that the economy could be hit by any slowdown in these financing flows. In particular, portfolio investment is notoriously volatile, and the rising share of these in the financial flows of recent years was a concern.

Thus, as the global financial crisis unfolded in FY08, and country risk perception was heightened by domestic political developments (see **Table 7.3**); the country's ability to tap international capital markets was severely impaired. Planned privatization transactions had to be

Table 7.2: External Account Summary

	Value (US\$ billions)		Change (%)	
	FY07	FY08	FY07	FY08
CAB	-6.9	-14.0	37.8	104.1
TB	-9.7	-15.3	15.0	57.5
Exports	17.3	20.1	4.4	16.5
Imports	27.0	35.4	8.0	31.2
Invisible balance	2.8	1.3	-17.9	-55.6
Remittances	5.5	6.4	19.4	17.4
Cap & FAB	10.4	7.8	72.1	-25.6
FDI	5.1	5.2	46.0	0.3
FPI	3.3	0.0	233.0	-98.9
Other investment	1.8	2.5	31.7	38.5
Error & omission	0.2	0.5	-37.2	216.4
Overall balance	3.7	-5.8	179.6	-254.3

Table 7.3: Major Factors Explains External Accounts Deterioration

	FY04	FY05	FY06	FY07	FY08
Saudi Arabian light oil prices (US\$/barrel)	33.8	46.0	63.7	64.6	120.8
Cotton production (mn bales)	10.0	14.3	13.0	12.9	11.7
Wheat production (mn ton)	19.5	21.6	21.3	23.3	21.8
World economic growth (%)	4.9	4.4	5.1	5.0	3.7
Pakistan GDP growth (%)	7.5	9.0	5.8	6.8	5.8
KSE-100 Index	5279	7450	9989	13772	12289
Pak Euro bond (5 year) spread	337	249	165	161	755
Foreign currency credit rating (Moody)	B2	B2	B2	B1	B2

deferred, sovereign debt issues postponed, and portfolio investment plunged. The fall in capital inflows also resulted in drawdown of foreign exchange reserves and mounting pressure on exchange rate during the period.

The fall in capital inflows in the wake of sharply widening current account deficit and the resultant drawdown of foreign exchange reserves does necessitate current account deficit adjustments. The global experience suggests that current account adjustments take place either through a sharp deceleration in domestic demand, a depreciation of the real effective exchange rate or some mix of the two (see **Box 7.1**).

Box-7.1: Global Patterns of Current Account Adjustment- Lesson for Pakistan

The global experience of current account deficit adjustment² suggests that either economic slowdown or real effective exchange rate depreciation or combination of the two facilitated this adjustment. The episodes where current account improvement came through a slowdown in domestic demand are termed as “internal adjustment” while the episodes where depreciating real exchange rate helped in current account adjustment are termed as “external adjustment”. Moreover, the combination of slowdown in domestic demand and depreciating exchange rate to correct current account is termed as “mixed adjustment”. The global current account adjustment trends suggest that more than one half of the adjustments came through slowdown in economic growth while rest of the fifty percent was characterized by external adjustment (25 percent) and mixed adjustments (25 percent).

The literature on the subject suggests that these adjustment types are function of underlying economic problems of the deficit country and does not depend on the size of the country, its degree of openness, its degree of industrialization or its exchange rate regime choice. The type of the adjustment depending on the economic problem is as follows:

1. Internal Adjustments

This type of adjustment typically takes place when current account deficit is principally driven by buoyant domestic demand growth which is mainly indicated by positive and widening output gap and the resultant inflationary pressures. The improvement in current account comes from slowdown in domestic demand growth and import compression. These adjustments are also accompanied by a statistically significant decline in inflation.

2. External Adjustments

External adjustment is more preferable when current account deficit is characterized by the sluggish export growth on account of economic stagnation and exchange rate overvaluation. The exchange rate depreciation improves country competitiveness which increases country’s net exports. The increase in net exports not only improves the current account balance but it also provides a positive impetus to economic growth.

3. Mixed Adjustments

The combination of the two types is used in crises like situation where current account deficit is caused by both the indications of potential overheating and overvalued exchange rate. The economic slowdown and exchange rate depreciation in this case are more pronounced than those in internal and external adjustments. The current account improvement takes place through both the sharp contraction in domestic demand (imports compression) and sharp improvement in country’s competitiveness (export promotion).

Moreover, internal and mixed adjustments occur during the phase of increasing oil prices.

In this backdrop, analysis of Pakistan’s current account deficit suggests that it is mainly contributed by the surge in import growth. This rapid import expansion is partly contributed by the overheating of economy which is reflected in inflationary pressure as a result of robust economic growth in the last five successive years and partly due to rise in international commodity prices. Moreover, the slowdown of textile export growth in the face of international competitive pressures is also a drag on current account deficit.

The stylized facts from the global experience suggest that current account deficit adjustment in Pakistan would occur through the combination of internal and external adjustments. Internal adjustment process is already underway in Pakistan in the form of tight monetary policy. However, there is need to consider external adjustment option by smoothly depreciating exchange rate in the real term.

Reference

² The current account adjustment episodes are defined as the improvement in current account position of the countries that are relatively rapid (within 4 years), substantial (improve at least one third of the initial deficit) and sustained (no subsequent deterioration).

Bernardina Algeri and Thierry Bracke 2007: *Patterns of Current Account Adjustment Insights from Past Experience*, European Central Bank Working Paper No. 762

Beside these factors, the analysis of major underlying weaknesses in Pakistan's current account deficit suggests that there is need to focus on promoting saving and exports (see **Box 7.2**). Finally, regional comparison suggests that Pakistan has the potential to further increase its remittances to curtail current account deficit to some extent.

Box-7.2: Current Account Balance Determinants: Medium to Long Term

After persistent widening in the last four successive years, Pakistan's current account deficit to GDP ratio reached unprecedented level of 8.4 percent in FY08. This large and persistent current account deficit is worrisome as it threatens the viability of external account and thus requires policy response.

This note reviews the various empirical investigations of medium and long term determinants of current account balance in both the developing and developed countries and thereby pin down some important underlying weaknesses behind Pakistan's widening current account deficit.

The review of the recent studies identifies three variables i.e. fiscal balance, Net Foreign Assets (NFA) and oil trade balance as the statistically significant determinants of current account balance (see **Table 7.2.1**)^{3 4}.

Fiscal Balance is found to have significantly positive relation with the current account balance. Specifically, one percentage point increase in fiscal balance is associated with 0.15-0.39 percentage point increase in current account balance.

Likewise, countries that have large stock of foreign assets net of foreign liabilities tends to run large current account surpluses. The higher foreign liabilities (lower net foreign assets) imply higher investment income (repatriation of profit and dividends) and debt income (debt servicing) outflows which, in turn, increase current account deficit.⁵

Oil trade balance is the third important determinant of current account balance. Higher oil-prices decrease the current account balance of net oil-importers and increase the current account balance of oil exporting countries. Particularly, one percentage point increase in oil trade balance to GDP ratio increases the current account balance by around 0.15 to 0.23 percentage points.

Besides these variables, output gap, trade openness, private sector credit and financial deepening are the other important determinants of current account balance discussed in the literature. Increase in the output gap (with respect to its potential), trade openness and credit to private sector reduce the current account balance through increased imports while financial deepening increase the current account balance through increase in national saving.

Table 7.2.1: Findings of Recent Studies on Current Account Determinants

	Jesman Rahman	CGER, IMF	Chin and Ito	Chin and Prasad
	2008	2006a	2007	2003
Fiscal balance	0.39***	0.19***	0.15**	0.306***
Net foreign assets	0.04***	0.02***	0.049***	0.048***
Oil trade balance	0.15***	0.23***		
Adjusted R2	0.42	0.52	0.42	0.42
Sample countries	21 Industrial and 38 developing	22 Industrial and 32 developing	19 Industrial and 70 developing	18 Industrial and 71 developing
Time period	1971-2006	1973-2004	1971-2004	1971-1995

Note: **,*** implies statistical significance at 5% and 1% respectively

Table 7.2.2: Major Weaknesses Behind CAD Widening in Pakistan**

	FY04	FY05	FY06	FY07	FY08
Current account balance	1.9	-1.4	-4.0	-4.8	-8.4
Budget deficit	-2.4	-3.3	-4.3	-4.3	-7.0
Nominal investment	17.8	20.3	23.1	22.9	21.6
Nominal savings	17.9	17.5	17.4	17.8	13.9
NFA*	-28.9	-27.0	-28.1	-30.3	-
Credit to private sector	22.6	26.3	27.8	28.4	27.6
Oil-trade balance	-2.1	-2.8	-4.1	-4.5	-5.5

* NFA is available on calendar year basis.

** All the variable are expressed as percent of GDP

³ Though these studies have used other variables as well, but this note only quotes the variables which were significant in all the studies reviewed.

⁴ All the variables are scaled by the gross domestic product (GDP).

⁵ These findings contradict the inter temporal perspective which suggests that a country with a significant stock of net foreign liabilities relative to its GDP would eventually have to run surpluses to pay off its liabilities.

In this backdrop, recent widening in Pakistan's current account deficit is mainly contributed by the deterioration of fiscal deficit and oil-trade balance (see **Table 7.2.2**). The former is principally driven by fall in national saving (during FY08) while the latter is caused by unprecedented rise in global oil prices. The widening of current account deficit that reflects decrease in saving (not increase in investment) is more worrisome as it does not build up productive capacity to enhance inter-temporal solvency⁶ (Milesi-Ferretti and Razin 1996).

Increase in foreign liabilities and relatively high credit to private sector in the recent years are the other contributory factors behind deterioration in current account deficit in Pakistan.

References

Chin and Prasad 2003: *Medium-Term Determinants of Current Accounts in Industrial and Developing Countries*. *Journal of International Economics*, Vol. 59, Non.1, pp, 47-76.

Chin and Ito 2007: *Current Accounts, Financial Development and institution: Assaying the World Savings Glut*. *Journal of International Economics*, Vol. 26, Non.1, pp, 546-69.

IMF 2006a: *Methodology for CGER Exchange Rate Assessments: IMF Report No. 06/283*.

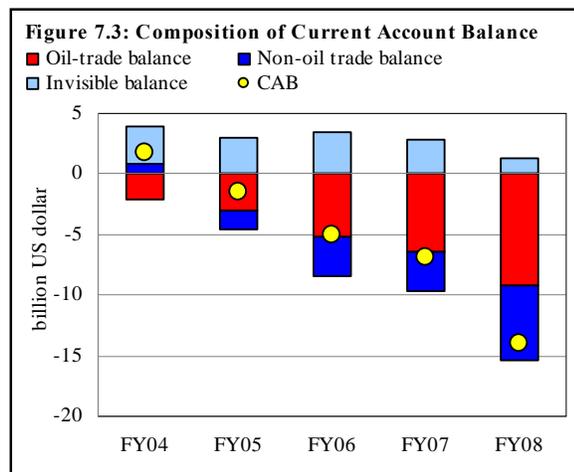
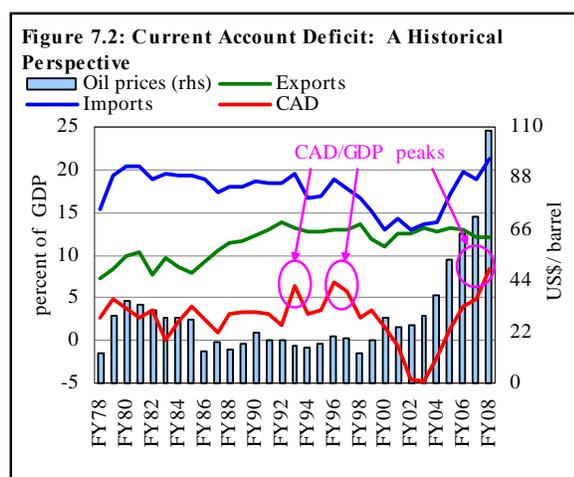
Jesman Rahman 2008: *Current Account Developments in New Member States of the European Union: Equilibrium, Excess, and Eu-Phoria*. *IMF Working Paper No. 08/92*

7.2.1 Current Account Balance

The current account deficit recorded an extraordinary expansion of 104.1 percent during FY08 to reach a historic high level of US\$ 14.0 billion.

While Pakistan has recorded current account deficit in excess of 5.0 percent of GDP⁷ on few occasions in the last thirty years, these were temporary as they were caused by one-off policy decisions⁸ and therefore reverted to the trend. However, the recent large rise in the current account deficit is less likely to revert back to normal trend quickly as it is caused by falling exports to GDP ratio and trend rise in imports as percent of GDP (see **Figure 7.2 and Table 7.4**).⁹

A large part (close to 80 percent) of this deterioration was contributed by increase in trade deficit. This, in turn, was driven by surge in import growth on the back of strong



⁶ Inter-temporal solvency means sustainability of current account deficit in the long run i.e. a country's ability to sustain its current account deficits without defaulting on its debt.

⁷ The current account deficit to GDP ratio in excess of 5.0 is largely considered as unsustainable level of the deficit in literature.

⁸ During FY93, the current account deficit was caused by surge in automobile imports on account of yellow cab scheme while in FY96 and FY97, the contracts with the independent power projects pushed up the power generating machinery imports and thereby the current account deficit.

⁹ The extraordinary import growth is explained by above trend growth in GDP during the last five years and rising global oil and other commodity prices.

Table 7.4: Current Account Balance

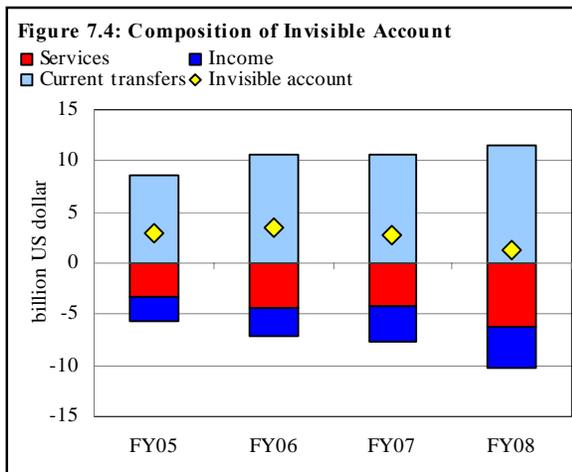
million US dollar

Items	FY06	FY07	FY08			Difference FY08 over FY07
			Full year	Jul-Oct	Nov-Jun	
1. Trade balance	-8,441	-9,711	-15,295	-3,356	-11,940	-5,584
Exports	16553	17,278	20,122	6,185	13,937	2,844
Imports	24994	26,989	35,417	9,541	25,877	8,428
2. Services (net)	-4430	-4,170	-6,307	-2,122	-4,185	-2,137
Transportation	-1783	-2075	-2635	-717	-1918	-560
Travel	-1195	-1348	-1,317	-370	-947	31
Communication services	97	25	10	23	-13	-15
Other business services	-2562	-2,098	-2,998	-961	-2,037	-900
Government services	1348	1,527	942	20	922	-585
Of which logistic support	1070	1242	655	0	655	-587
Other	-335	-201	-309	-117	-192	-108
3. Income (net)	-2,667	-3,582	-3,909	-1,227	-2,682	-327
Investment income(net)	-2672	-3,588	-3,919	-1,228	-2,691	-331
Direct investment	-2076	-2,809	-3,065	-1,065	-2,000	-256
Of which: profit & dividend	-433	-672	-262	-410	-135	-135
Purchase of crude oil & minerals	-1149	-1,458	-486	-972	-66	-66
Portfolio investment	-93	-259	-319	-88	-231	-60
Of which: profit & dividend	-88	-249	-43	-206	17	17
IMF charges & interest on off. external debt	-664	-718	-771	-142	-629	-53
Interest on private external debt	-85	-154	-184	-55	-129	-30
Others	251	358	430	123	307	72
4. Current transfers (net)	10548	10,585	11,475	3,712	7,763	890
Private transfers	9867	10,060	11,048	3,693	7,355	988
Workers remittance	4600	5494	6449	2079	4370	955
FCA - residents	312	196	444	203	241	248
Others	4955	4370	4155	1411	2744	-215
Official transfers	681	525	427	19	408	-98
Budgetary support cash grant	464	284	408	20	388	124
Others	217	241	19	-1	20	-222
Current account balance	-4,990	-6,878	-14,036	-2,993	-11,044	-7,158
Memorandum items						
CAB (monthly average)	-416	-573	-1170	-748	-1380	

domestic demand, unprecedented rise in global oil and other commodity prices, and domestic food shortages (see **Figure 7.3**). The expansion in oil trade deficit¹⁰ alone explains around 37.8 percent of the overall deterioration in current account deficit during FY08.

Moreover, the fall in invisible account surplus on account of higher import related freight charges and investment income outflows contributed more than 20 percent in the current account deterioration during the period under review.

The invisible account, however, remained in



¹⁰ Around 75 percent of this increase was contributed by increase in oil prices.

surplus as the outflows from services and income accounts were more than offset by strong increase in current transfers (workers' remittances) during the period (see **Figure 7.4**). Importantly, the invisible account surplus has been continuously decreasing over the last five years and if increase in current transfers do not keep pace with the widening income and services account deficit, the invisible account is likely to turn into deficit.

Not only the magnitude of current account deficit is worrisome, the change in financing pattern of current account deficit during FY08, compared with the last year, is also a source of concern. With fall in non-debt creating inflows during FY08, the larger part of current account deficit was financed from the mix of debt creating inflows and depletion of reserves. The rise in former increases the country debt burden while the depletion in the latter reduces the country's ability to absorb adverse external shocks.

Likewise, the sharp deterioration in current account deficit during FY08 was mainly the reflection of significant fall in national savings in the face of rise in consumption expenditures showing strong aggregate demand pressures (see **Figure 7.5**).¹¹ Literature on the current account deficit suggests that widening of current account deficit that is caused by decline in national savings (not increase in investment) may not build up productive capacity of the economy to enhance inter temporal solvency (see **Box 7.2**).

In this backdrop, Pakistan's current account deficit is worrisome and requires corrective policy action. As mentioned earlier, global current account adjustment episodes indicates that correction of current account deficit which is caused by the aggregate demand pressures and increase in global oil prices (as is the case of Pakistan) largely take place

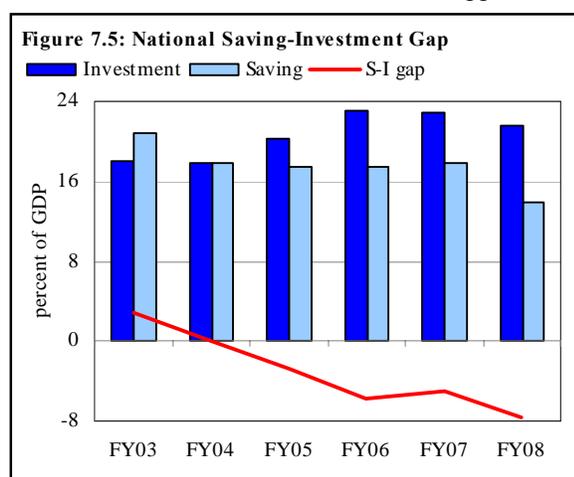


Table 7.5: Regional Comparison of Variable Important for Current Account Balance (percent of GDP)

	2006			2007		
	Savings	Exports	Remittances	Savings	Exports	Remittances
Pakistan	15.3	13.3	4.0	16.1	12.4	4.2
India	33.5	13.8	2.9	32.3	13.2	2.5
Sri Lanka	17.0	25.5	8.7	17.6	25.8	9.0
Bangladesh	20.3	14.0	8.4	19.5	14.1	8.8
Vietnam	31.4	64.9	7.9	31.1	69.0	7.1
Philippines	18.3	40.3	13.0	20.0	34.9	11.8

Source: a) Economic and Social Survey of Asia and Pacific 2008 (b) International Monetary Fund

through mix of both slowdown of domestic aggregate demand and depreciation of real effective exchange rate.

Beside this, the regional comparison of important variables for current account deficit suggests that Pakistan's exports and national savings are the lowest in the region while its remittances are higher only than that of India (see **Table 7.5**). Thus strenuous efforts need to be made to promote exports and national savings to improve current account balance. Likewise, there is potential to increase

¹¹ In national income accounts perspective, the current account deficit is the mirror image of the domestic savings and investment gap.

remittances to offset the impact of larger payments from goods & services and income accounts to some extent.

Looking ahead, although current account deficit has widened further to US\$ 5.9 billion in Jul-Oct FY09 compared with US\$ 3 billion in the corresponding period last year, the expansion is likely to decelerate from November FY09 onward owing to likely deceleration in import growth. The deceleration in import growth is expected to be driven by significant fall in global oil and other commodity prices, noticeable depreciation in exchange rate, passing on the oil price increases to consumer, recent tariff and non-tariff barriers on imports and slowdown in domestic economy.

Trade Balance¹²

During FY08, trade deficit expanded by 57.5 percent compared with a moderate increase of 15.0 percent last year. This increase in trade deficit emanated from extraordinary increase (31.2 percent) in import as export growth of 16.5 percent during FY08 was more than the last five year average growth of 13.5 percent.

The sharp rise in import growth during FY08 was mainly caused by higher increases in imports of petroleum group and foods imports which together contributed more than 50 percent of the rise in import. The rise in the former was principally driven by higher global oil prices while the increase in latter stemmed from the domestic food shortages and higher international prices. Other main contributors in overall import growth during the period included higher import of cotton, fertilizer and power generating machinery.

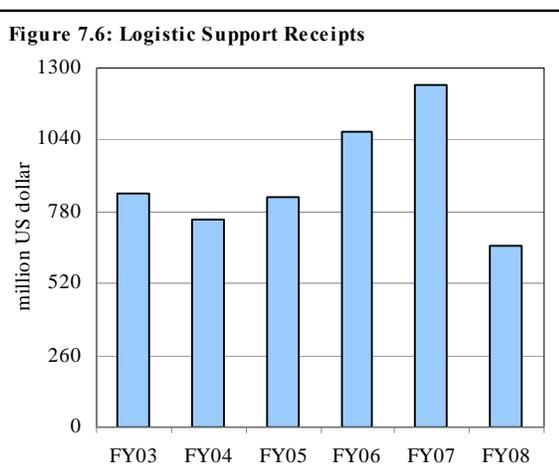
The commendable export growth during FY08, on the other hand, was mainly driven by the bounce back in non-textile exports as the textile export growth significantly slowed down in FY08. The slowdown in textile export was principally attributed to severe power shortages, increased political unrest and stiff regional competition in textile exports.¹³

Services Account

The services account deficit increased by US\$ 2.1 billion during FY08. A large part of this deterioration was explained by increase in net outflows from transportation and other business services and lower government services receipts (net) during the period (see **Table 7.6**). The higher transportation payments (net) mainly reflect the combined effect of higher freight charges and a sharp rise in imports while higher payments from other business services were largely the

Table 7.6 : Sources of Deficit in Services Trade

million US dollar			
	FY06	FY07	FY08
a) Transportation	-1783	-2075	-2636
<i>of which freight charges</i>	-1959	-2097	-2772
b) Government services	1348	1527	945
<i>of which logistic support</i>	1070	1242	655
c) Other business services	-2562	-2098	-2998
<i>of which exchange companies</i>	-2488	-1918	-2504
d)-Others	-1433	-1524	-1618
Total	-4430	-4170	-6307



¹² This section is based on the exchange record data compiled by SBP that does not tally with the customs data compiled by FBS data analyzed in Trade Account section.

¹³ For detail, see section on **Trade Account**.

result of net outflow from foreign exchange companies.¹⁴

The lower logistic support receipts, on the other hand, mainly led to fall in government services receipts during the period. It may also be noted that logistic support receipts recorded in FY08 were the lowest in the last six years (see **Figure 7.6**).

Income (Net)

The expansion in income account deficit moderated to 9.1 percent during FY08 from 34.3 percent in FY07. While interest income outflow (net) increased in FY08 after continuous decline in the last seven successive years, this moderation in net income outflows entirely stemmed from relatively lower increase in investment income. The smaller increase in the latter mainly reflects deceleration in repatriation of profit and dividends. Against an extraordinary increase of 54.1 percent during FY07, the repatriation of profit and dividends on foreign investment (direct and portfolio) decelerated to 14.7 percent in FY08. A large part of this deceleration was contributed by sharp fall in repatriation of profit & dividends by the communication sector on account of PTCL's lower profits owing to its Voluntary Separation Scheme (VSS).¹⁵ Moreover, the cash flow problem facing oil marketing companies and petroleum refineries also contributed in decelerating the overall repatriation of profit and dividends during FY08. The main sectors which witnessed increase in repatriation of profit & dividends include oil & gas exploration, power and financial business (see **Figure 7.7**).

The interest payment on external debt and liabilities increased considerably during FY08. The increase in the former is contributed by higher interest payments on both the public and private external debt while the increase in the latter mainly reflects higher interest payments on foreign currency accounts in the wake of noticeable increase in FE-25 deposits during the period under review (see **Table 7.7**).

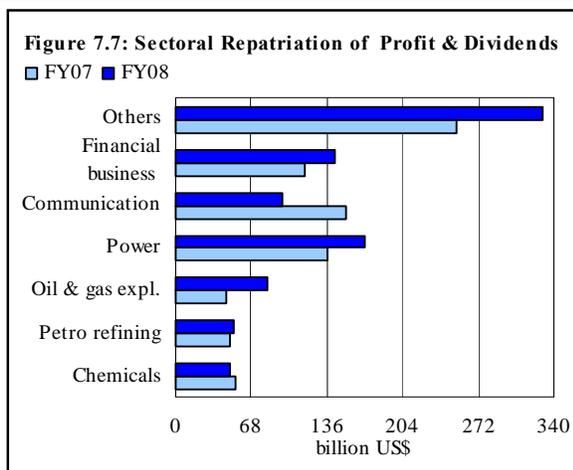


Table 7.7: Details of Interest Payments and Receipts

million US dollar

	FY06	FY07	FY08	Change FY08 over FY07
Payments (I+II)	1013	1236	1405	169
I. <u>Total external debt</u>	<u>840</u>	<u>1017</u>	<u>1147</u>	<u>130</u>
Public & publicly guaranteed	<u>739</u>	<u>840</u>	<u>945</u>	<u>105</u>
Long-term	618	666	731	65
Military	8	8	4	-4
Euro bonds	91	145	192	47
Commercial loans/credits	8	11	10	-1
IDB	14	10	8	-2
Private loans/credits	85	154	184	30
IMF	16	23	18	-5
II. <u>External liabilities</u>	<u>173</u>	<u>219</u>	<u>258</u>	<u>39</u>
Foreign currency deposits	22	33	56	23
Special US\$ bonds	28	13	8	-5
Central bank deposits	34	27	30	3
Others	89	146	164	18
Receipts	382	554	667	113
Interest on reserves	268	410	479	69
Others	114	144	188	44
Net	-631	-682	-738	-56

Source: State Bank of Pakistan

¹⁴ As is mentioned in the earlier reports, outflow from the foreign exchange companies has no impact on the current account balance as it is offset from the contra entry appearing under the other private transfers.

¹⁵ The repatriation of profit & dividends by PTCL declined to US\$ 48.2 million during FY08 from US\$ 114.6 million during last year.

It may also be noted that net interest payments on external debt and liabilities witnessed declining trend during FY01-FY05. A part of this declining trend was explained by debt rescheduling agreement in December 2001 and retirement of expensive debt and a part to continuous increase on foreign reserves earnings (see **Figure 7.8**). While the latter continued to increase strongly till FY08, significant increase in interest payments on external debt and liabilities started showing upward trend in net interest payments since FY06. Going forward, this increasing trend is likely to continue in the wake of significant decline in foreign exchange reserves and increase in external debt.

Current Transfers

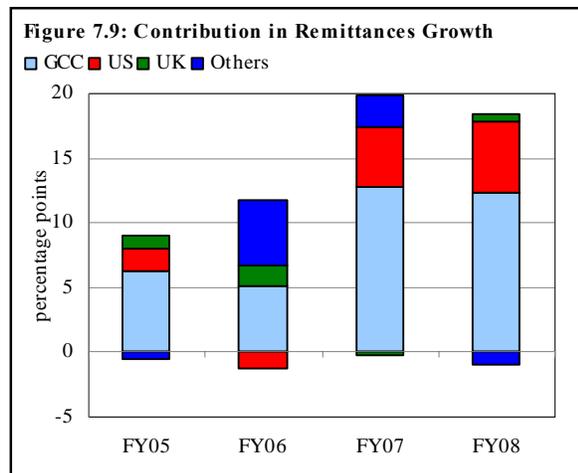
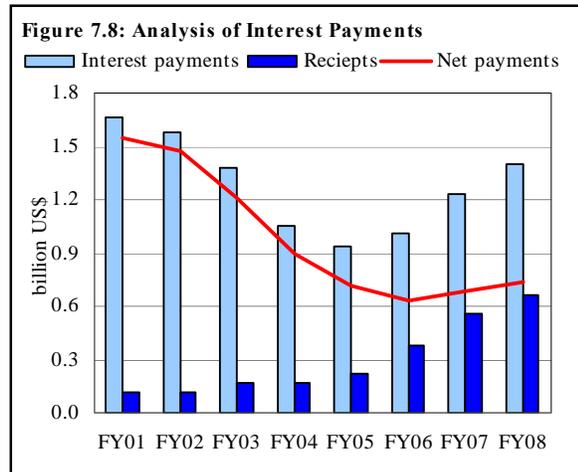
The current transfers increased by 8.4 percent during FY08 on the back of strong increase in private transfers. Impressive performance of worker’s remittances and higher inflows in resident foreign currency accounts were the major contributory factors behind this increase in private transfers.

On the other hand, despite budgetary support receipt of US\$ 300 million from Saudi Arabia, official transfers declined marginally during FY08 on account of lower receipts of earthquake grants compared with last years.

Workers’ Remittances

Workers’ remittances recorded impressive growth of 17.4 percent during FY08 on the top of 19.7 percent growth during last year. While a large part of this growth was contributed by oil rich Gulf countries (around 70 percent) and US (around 30 percent) (see **Figure 7.9**), euro area and Canada also contributed positively to this remittances growth.

The substantial increase (25.6 percent) in remittances from the Gulf region partly reflects the higher oil prices and consequential prosperity there and partly the rising cost of living at home. The empirical support for the former factor is provided by Nadeem Ilahi and Riham Shendy (2008), who found that Gulf region remittances outflows were strongly correlated with sustained oil boom and the resultant GDP growth in GCC countries.¹⁶ The historical trends of oil prices and remittances from Gulf region also suggests that higher remittances flows from the region coincided with the higher oil prices (see **Figure 7.10**).



¹⁶ IMF Working Paper No. WP/08/167 titled “Do the Gulf Oil-Producing Countries Influence Regional Growth? The Impact of Financial and Remittances Flows”.

Moreover, against 17.3 percent last year, around one fourth of the overall remittances were routed through foreign exchange companies during FY08.

Resident FCAs

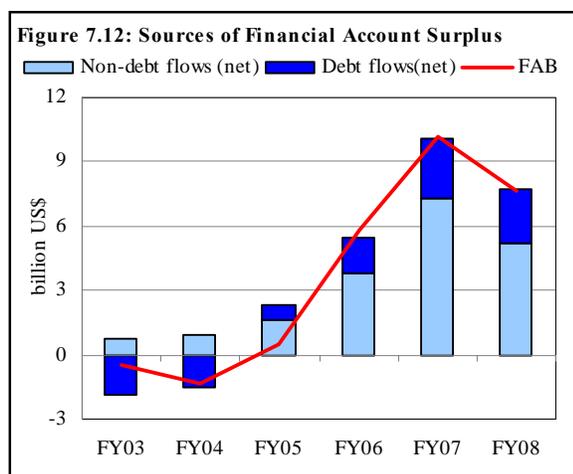
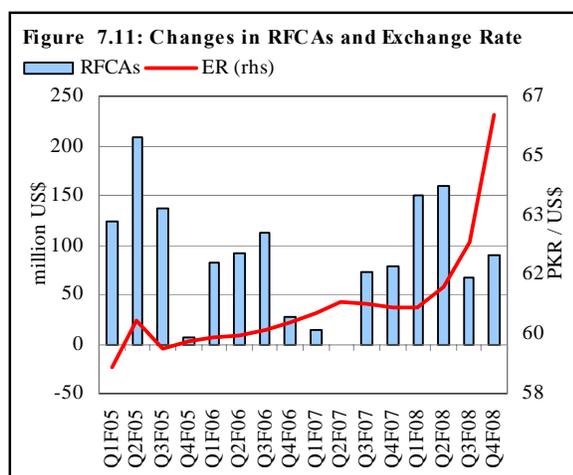
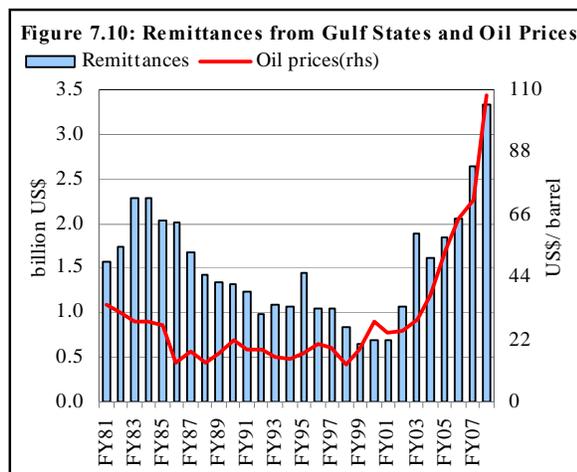
The resident FCAs increased by US\$ 444 million during FY08 compared with relatively lower increase of US\$ 196 million during last year. This higher increase is probably attributed to exchange rate depreciation which makes these deposits attractive. However, most of the inflow in these deposits took place in the first half of the year when exchange rate was relatively stable. In the latter half of FY08, the inflows in resident FCAs moderated despite relatively higher depreciation of exchange rate (see **Figure 7.11**).

The anecdotal evidence suggests that lower rise in resident FCAs, despite higher depreciation in exchange rate, probably reflects capital flight in real estate in the neighboring Gulf country.

Financial Account

After registering impressive increase in the last three years, the surplus in financial account declined in FY08 (see **Figure 7.12**). The entire decline is explained by substantial fall in portfolio investment as both the foreign direct investment and other investment inflows increased during the period.

While deepening sub prime losses have also affected the portfolio investment of the other regional countries through (a) large sell-offs in regional stock markets and (b) substantial fall in the offshore bond issuance, Pakistan was the worst hit on account of heightened political uncertainty and growing security concerns at home. For instance, Pakistan's sovereign bond spread over the US Treasury bond has increased to 912 basis points on August 19, 2008 from below 200 basis points a year earlier. This spread is considerably higher than that of other regional countries.¹⁷



¹⁷ The sovereign bond spread for Vietnam, Indonesia, Malaysia and Philippines on August 19, 2008 were 365, 355, 268 and 156 basis points respectively.

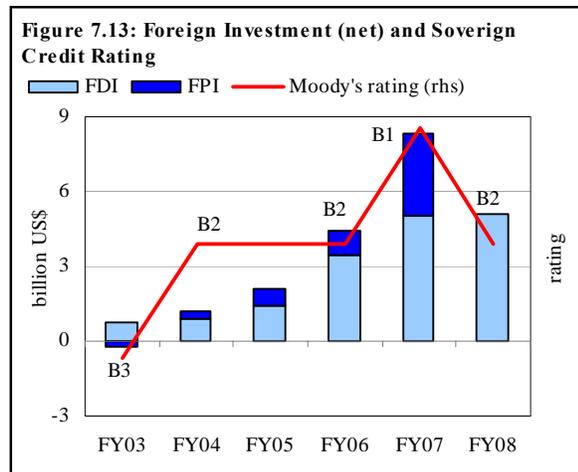
What is disturbing is the changing composition of financial flows in FY08. On the one hand, the share of debt creating flows in the total financial flows has increased to around 32.9 percent during FY08 from last three year average of 27.3 percent¹⁸ (see **Figure 7.12**). On the other hand, there was a sharp increase in the short term component of debt creating flows. The increase in debt creating flows in FY08 mainly reflect higher earthquake related inflows (US\$ 863 million), Islamic Development Bank (IDB) short term inflows (net) (US\$ 483 million) and Bank of China's deposits with the State Bank of Pakistan (US\$ 500 million).

Net Foreign Investment (NFI)

In sharp contrast to extraordinary growth of 87.3 percent last year, the NFI declined by 38.5 percent during FY08. This decline was entirely explained by substantial fall (98.9 percent) in portfolio investment as the foreign direct investment managed to register a marginal increase during the period (see **Figure 7.13**).

Foreign Direct Investment

Despite the lower receipts of privatization proceeds and relative liquidity squeeze in international financial market, Pakistan has been able to attract marginally higher foreign direct investment in FY08 compared with the last year.



It may be pointed that rapid economic growth and relative political stability have led to booming FDI inflows in Pakistan during the last four year (FY04-FY07). These inflows were further strengthened by aggressive privatization program and saving glut available in the international market. As a consequence, FDI increased from below US\$1 billion in FY03 to US\$ 5.1 billion in FY07. During FY08, however, the heightened political uncertainty, slowing down of privatization process and emerging economic imbalances and the resultant downward revision of Pakistan's rating by international credit rating agencies affected the FDI inflows adversely. Encouragingly, despite these challenges Pakistan has been able to record US\$ 5.2 billion FDI in FY08.

A large part of the increase in FDI flows during FY08 was contributed by financial business on the back of US\$ 663 million investment in MCB bank and US\$ 177 million investment in Saudi Pak Bank Ltd. The other sectors which attracted major chunk of FDI during FY08 include communication, oil and gas exploration, cement, and fertilizer.

FDI has witnessed compositional shift in the last five years. Traditionally, a large part of the FDI had been concentrated in oil and gas producing sector which now have been diversified to telecommunication and financial sectors in the wake of liberalization of the latter. The increased inflows in these basic services are likely to enhance the future productivity of the economy by improving the infrastructure.

¹⁸ In case of equity flows, at least a part of any negative shock is borne by the foreign equity investors, whereas, in case of foreign currency debt, the country bears the entire burden of the shock.

However, the share of manufacturing sector in overall FDI could improve over the period (see **Table 7.8**). As the investment in tradable has the potential to improve external account either through export promotion or import substitution, there is a need to attract higher investment in this sector.

Particularly, attracting FDI in textile sector, the share of which in overall FDI is continuously declining, may be helpful for increasing the sector exports.

Encouragingly, FDI in cement sector increased significantly in the last two years (FY07 to FY08), which added production capacity in this sector. As a result, cement sector exports has witnessed manifold increase in the last couple of years. This investment is particularly welcome in the wake of rising cement demand from the region.

Moreover, the sources of FDI have also changed in the last five years. During the period, there has been shift from US and UK (traditionally major sources of FDI in Pakistan) to western Asian countries (see **Figure 7.14**). In particular, the share of UAE in total FDI, which averaged around 3.9 percent during FY90 to FY02, has increased to more than 20 percent during FY03-FY08. During FY08, however, USA was the largest source of FDI for Pakistan.

Portfolio Investment

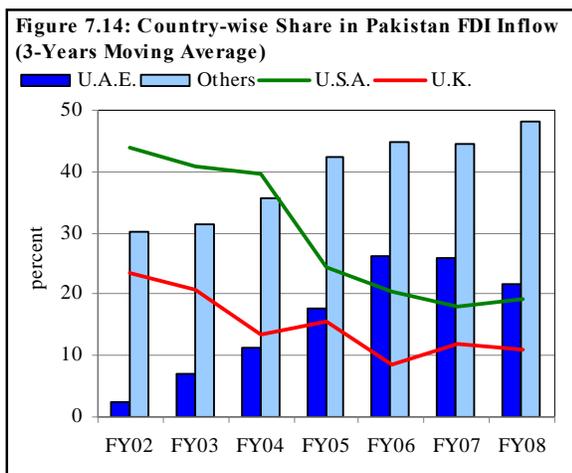
Portfolio investment declined substantially by 98.9 percent during FY08, in sharp contrast to extraordinary growth of 233.0 percent during the last year. This decline, however, is not surprising given the volatile nature of portfolio investment and drastic changes on domestic and international scenario during the period.

Domestically, confluence of factors such as political noise, growing security concerns and weakening economic fundamentals increased the country political and economic risk during FY08. The increase in the aforementioned risks was reflected in widened spread on the sovereign debt issuance and Moody's and Standard & Poor's downward revision of Pakistan long term foreign and local currency sovereign credit rating.

The adverse impact of domestic development on portfolio investment was further compounded by the liquidity crunch in the international financial market on account of subprime crises. Consequently, not only Pakistan's stock market witnessed capital flight but Pakistan also delayed its plan to raise funds

Table 7.8: Sector wise Share in FDI
percent

	FY04	FY05	FY06	FY07	FY08
I Manufacturing	17.9	16.8	7.1	18.8	11.9
1 Transport equipment	0.3	2.2	0.9	1.0	2.2
2. Cement	0.2	0.9	1.1	0.7	2.0
3. Chemicals	1.6	3.3	1.8	0.9	1.5
4. Textiles	3.7	2.6	1.3	1.2	0.6
5.others	12.0	7.9	2.0	15.1	5.6
II Non-manufacturing	82.1	83.2	92.9	81.2	88.1
A-extractive industries	21.4	12.8	9.2	11.2	13.2
1. Oil & gas explorations	21.3	12.7	8.9	10.6	12.3
2.others	0.1	0.1	0.3	0.6	0.8
B-Other services	60.6	70.4	83.7	69.9	75.0
1. Communications	23.4	34.0	55.0	37.0	31.5
A) Telecommunications	21.8	32.4	54.1	35.6	27.9
B) Information Technology	1.4	1.5	0.9	1.4	3.5
2. Financial business	25.5	17.7	9.3	18.2	31.2
3. Trade	3.8	3.4	3.4	3.4	3.4
4. Construction	3.4	2.8	2.5	3.1	1.7
5. Transport	0.9	0.7	0.5	0.6	1.4
6. Power	-1.5	4.8	9.1	3.8	1.4
7.Others	5.2	7.0	3.8	3.9	4.3



from international market.

Specifically, GDR issues totaled US\$ 0.2 billion¹⁹ during FY08 which is substantially lower than the issues worth US\$ 1.4 billion previous year (see **Table 7.9**). Likewise, after successful issuance of euro bonds in the last three successive years, Pakistan delayed issuance of euro bond this year in the wake of above mentioned rise in risk premium.

Outstanding Export Bills (OEBs)

The total stock of OEBs held by exporters and commercial banks increased by US\$ 578 million during FY08 in contrast to US\$ 271 million increase in the same period last year. As in the previous year, almost the entire increase was contributed by OEBs held by exporters. The OEBs held by commercial banks declined marginally during FY08.

Importantly, more than 92 percent of the increase in OEBs was recorded in Nov-Jun FY08 period which coincided with the depreciation pressure on exchange rate. It may also be noted that similar coincidence had been witnessed during Jul-Oct FY05 period, when exchange rate was under pressure (see **Figure 7.15**). The aforementioned coincidences give further credence to the view that exporters hold back their proceeds in expectations of exchange rate depreciation. However, a part of the increase in OEBs in H2-FY08 may also be attributed to improvement in exports relative to the first half of FY08.

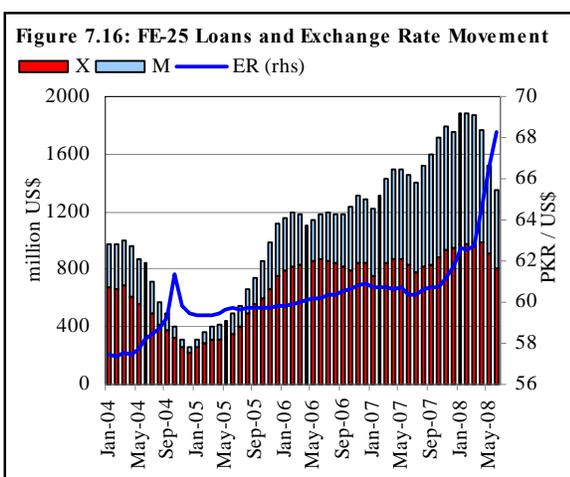
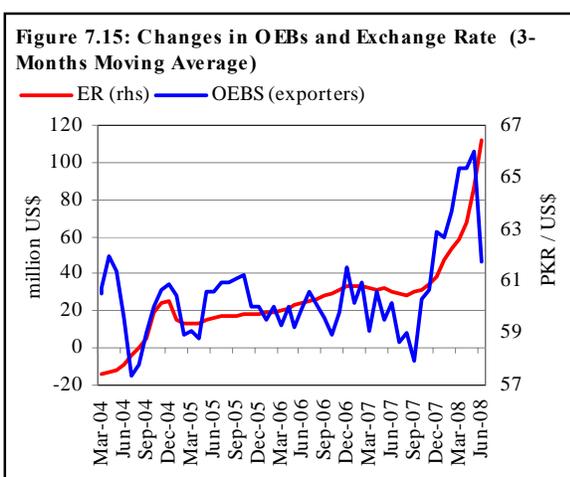
Currency and Deposits

The foreign currency deposits declined by US\$ 359 million during FY08 compared with US\$ 316 million increase during the preceding year. The decline is mainly attributed to fall in FE-25 nostro balances on account of increase in trade financing against FE-25 deposits. However, this decline was offset to the greater extent by higher retirement of FE-25 loans during the last quarter in the wake of sharp depreciation of

Table 7.9: Detail of Portfolio Investment (Net)

	FY06	FY07	FY08
Portfolio investment	986.5	3283.0	36.0
A) Equity securities	373.5	2305.0	15.0
Assets	22.0	-5.0	-5.0
Liabilities	351.5	2310.0	20.0
<i>of which GDRs of MCB bank</i>	-	150.0	-
<i>GDRs of UBL bank</i>	-	559.7	90.5
<i>GDRs of Lucky cement</i>	-	-	106.5
<i>GDRs of OGDC</i>		738.0	
B)-Debt securities	613.0	978.0	20.8
<i>International bonds of PMCL</i>	-	250.0	-
Euro bond	800.0	750.0	-
Other public securities	-187.0	-22.0	20.8.0

*Net sale/purchase of Special US\$ bonds, FEBC, DBC, T-bills and PIBs



¹⁹ This amount includes Lucky cement GDR worth US\$ 106.5 million and UBL GDRs worth US\$ 90.5 million. It may be noted that UBL floated GDR worth US\$ 650 million in June FY07. However, part of the proceeds (US\$ 90.5 million) was realized in July FY08.

exchange rate. It can be observed from **Figure 7.16** that sharp depreciation of exchange rate is associated with the retirement of FE-25 loans. This is because sharp depreciation of exchange rate makes these loans expensive for the importers and exporters.

Foreign Long-term Loans

During FY08, foreign long term loans recorded a net increase of US\$ 1.44 billion which is slightly higher than the net increase of US\$ 1.41 billion in the last year. This nominal increase was entirely reflected in 56.9 percent increase in project loans (on account of higher inflows in earthquake related loans) which more than offset 27.5 percent decline in project loans and 7.5 percent increase in amortization during FY08.

Private Loans

Private loans recorded a net inflow of US\$ 691 million during FY08, considerably higher than net inflow of US\$ 459 million during the last year (see **Table 7.10**). This increase is contributed by both increase in gross disbursements and decrease in credit repayment. A large part of the gross disbursement was explained by US\$ 440 million by Warid Telecom and US\$ 28 million by Mobilink.

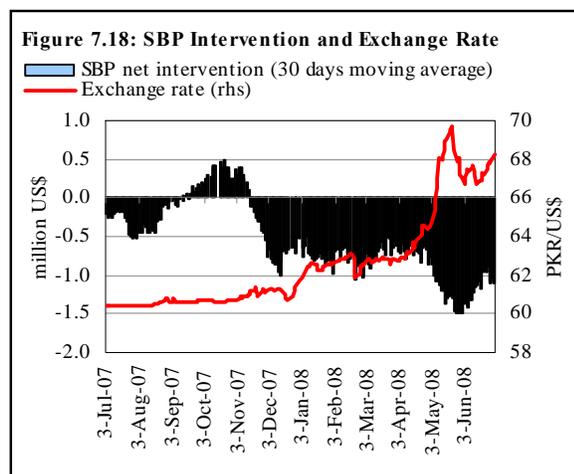
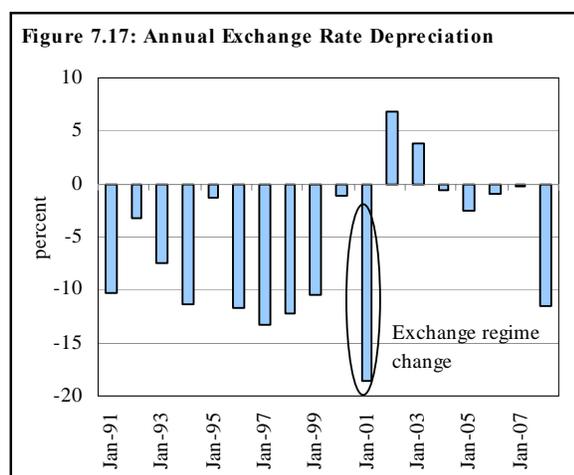
Short-term Loans

Compared with net retirement of US\$ 83 million last year, short term loans recorded a net increase of US\$ 367 million during FY08. The entire increase is explained by higher IDB financing for oil imports in the wake of rising oil import bill. This increase is a source of concern as it is not only expensive but it is for less than one year meaning that it will be reflected in outflow in the next year.

7.3 Exchange Rate

After remaining stable for last four years Pakistan's exchange rate depreciated sharply by 11.3 percent in FY08; a fall reminiscent of the decade of 90s (see **Figure 7.17**). The loss in the value of rupee is attributable to a combination of rise in the current account deficit, fall in the financial inflows, and increase in political noise. The pressures on the rupee were further intensified by mounting speculative activity in the forex market.

In the absence of these factors, rupee had remained stable in the initial months of FY08. Specifically, up to October 2007, a benign trade deficit, coupled with strong financial flows enabled Pakistan to record its highest ever reserves position, which stood at US\$ 16.4 billion at end October 2007. However, in the following months a series of adverse developments both on domestic and external fronts resulted in rapid depletion of reserves and unprecedented loss in the value of rupee. Consequently, by end June FY08, reserves stood at US\$ 11.4 billion witnessing a



depletion of US\$ 5.1 billion, while exchange rate depreciated by 11.5 percent.

The changing market conditions are reflected in SBP forex market management. Initially, expecting better inflows and lower current account deficit, SBP shifted payment of furnace oil to the interbank market.²⁰ The relative stability of the exchange rate and the fact that SBP was even able to purchase forex from the inter-bank market indicates that market was fairly liquid during this period (Jul-Oct 2007) (see **Figure 7.18**).

Table 7.10: Financial Account

million US dollar

Items	FY06	FY07	FY08			Difference FY08 over FY07
			Full year	Jul-Oct	Nov-Jun	
Financial account (1 through 4)	5,830	10,145	7,657	3,206	4,451	-2,488
1. Direct investment abroad	-71	-114	-75	-9	-66	39
2. Direct investment in Pakistan	3,521	5,140	5,153	1,319	3,834	13
<i>of which: equity capital</i>	2,925	4,229	4,144	998	3,146	-85
<i>privatization proceeds</i>	1,540	266	133	-	133	-133
Reinvested earning	537	907	1,009	321	688	102
3. Portfolio investment	986	3,283	36	311	-275	-3,247
<i>Equity securities</i>	351	2,310	20	346	-326	-2,290
<i>Debt securities</i>	613	978	21	-31	52	-957
<i>of which: Euro bonds</i>	796	820	56	-23	79	-764
<u>Net foreign investment</u>	4,436	8,309	5,114	1,621	3,493	-3,195
4. Other investment	1,394	1,836	2,543	1,585	958	707
Assets	148	-585	-219	411	-630	366
<i>i. Outstanding exports bills (exporters)</i>	-283	-281	-597	-45	-552	-316
<i>ii. Outstanding exports bills (DMBs)</i>	-81	10	19	27	-8	9
<i>iii. Currency & deposits</i>	511	-316	359	429	-70	675
<i>of which :bank</i>	461	-473	257	361	-104	730
Liabilities	1,246	2,421	2,762	1,174	1,588	341
<i>i. Foreign long-term loans / credits (net)</i>	1,010	1,413	1,441	524	917	28
<i>Project assistance</i>	696	921	1,445	524	921	524
<i>Non-food aid</i>	1,373	1,523	1,104	344	760	-419
<i>of which earthquake loans</i>	768	313	863	340	523	550
<i>Amortization</i>	1,059	1,031	1,108	344	764	77
<i>ii. Private loans</i>	231	459	691	103	588	232
<i>of which: suppliers credits/MNCs</i>	551	861	1,025	163	862	164
<i>Supplier credits repayments</i>	320	402	334	60	274	-68
<i>iii. ST capital, (official)</i>	-218	-83	367	64	303	450
<i>of which: commercial banks (net)</i>	-116	-116	-	-	-	116
IDB (net)	-102	33	483	164	319	450
<i>iv. Currency & deposits</i>	316	325	-47	231	-278	-372
<i>of which: trade financing</i>	697	268	-107	267	-374	-375
<i>v. Other liabilities</i>	-93	307	254	102	152	-53

Source: Statistics Department, SBP

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

However, November onwards, not only the trade deficit rose sharply but adverse developments on the political front, resulted in large outflows from portfolio investment forced SBP to intervene heavily in the market besides taking administrative measures. These efforts to contain the market pressure,

²⁰ The State Bank shifted payment of furnace oil to interbank market with effect from July 4, 2007(The decision was reverted on July 8, 2008). It may be pointed out that State Bank of Pakistan was making all the oil payments from its reserves with effect from November 2004.

although provided temporary respite to the market, overall pressures continued to mount during the subsequent months as weakening fundamentals gave way to speculative activity. This prompted SBP to take further regulatory measures. **Table 7.11** gives a synopsis of steps taken by SBP during FY08, in chronological order:

Table 7.11: Chronology of Amendments in Exchange Market Regulations During FY08

Reference:	Focus of guidelines:	Directions:
<i>BSD circular #09 dated December 3, 2007</i>	Banks/DFIs	Special Cash Reserve requirement reduced from 15% to 5% of total FE-25 deposits
<i>BSD circular #08 dated April 5, 2008</i>	Islamic Banks (IBs)/Islamic Banking Branches (IBBs)	Special Cash Reserve Requirement reduced from 6% to 2% of total FE-25 deposits
<i>FE circular #2 dated April 29, 2008.</i>	Exchange companies.	1-Limit to surrender a minimum of 15%, instead of earlier 10%, of foreign currencies received by them from home remittances to the interbank markets. 2- Limit to bring minimum of 25 percent of foreign currencies exported by them in their foreign currency accounts with banks in Pakistan.
<i>FE circular #3 dated April 29, 2008.</i>	Authorized dealers	1-Advance payments on imports were restricted to maximum of 50 percent of value of imports, and that too against letter of credits only. 2- Some reforms were introduced in the forward hedging mechanism available to importers / exporters to curb the misuse of the facility other than true hedging
<i>FE circular #4 dated May 09, 2008.</i>	Exchange companies.	1-Abolishment of the Nostro accounts held by them outside Pakistan, and shifting the balances in their Nostro accounts to commercial banks in Pakistan. 2-Restriction to affect outward remittances to the extent of 75% of the home remittances mobilized by the respective company during the preceding month 3-Restriction to surrender their surplus foreign currency to State Bank of Pakistan. Earlier exchange companies were exporting most of the foreign currency, except dollars to exchange companies abroad. Hence, besides dollar, they will not be able to export Pound Sterling, Euro and UAE Dirham.
<i>May 23, 2008 (SBP interim monetary policy)</i>	--	1-Imposition of 35 percent margin requirement on opening of import L/C (except for petroleum and food imports) announced on May 23, 2008 ¹ . 2- Discount rate increased by 150 basis points, to 12 percent (from 10.5 percent)
<i>BSD circular # 14 dated June 21, 2008</i>	Banks/DFIs	Special cash reserve requirement against FE-25 deposits reverted back to its original rate (prior to December 3, 2007 ²) with effect from June 30, 2008. Now the banks / DFIs have been directed to maintain 15 percent (up from 5 percent) of their total FE-25 deposits on daily basis with State Bank of Pakistan.
<i>BSD circular #.15 of June 21, 2008.</i>	Islamic Banks (IBs)/Islamic Banking Branches (IBBs)	Similarly the reserve requirement (SCRR) for Islamic banks has been reverted back to 6 percent from 2 percent, the original rate prior to its reduction in April 2008.
<i>FE circular #.6 dated July 08, 2008.</i>	Exchange companies.	Requirement of prior approval of State Bank for all transactions of US \$ 50,000 or above (or equivalent in other foreign currencies) on account of outward remittances or sale of foreign currencies to the customers.
<i>FE circular #.7 dated July 08, 2008.</i>	Exchange Companies of 'B' Category.	Requirement of prior approval of State Bank for all transactions of US \$ 50,000 or above (or equivalent in other foreign currencies) on account of sale of foreign currencies to the customers.
<i>FE circular #.8 dated Jul 08, 2008.</i>	Authorized dealers	1-Advance import payments were further restricted to the extent of 25% of value of imports, and that too against letter of credits only. 2-Forward forex booking against all type of imports was suspended (temporarily). 3-State Bank of Pakistan will provide foreign exchange to the Authorized Dealers for the import of all categories of Furnace oil (as well as against all POL payments on the basis of Form 'M' approvals). 4-Trading time for all types of Foreign Exchange Transactions by Authorized Dealers with their customers reduced in order to curb the speculative pressures on the market.
<i>EPD circular letter #.6 dated July 11, 2008</i>	Authorized dealers	Authorized Dealers advised to immediately launch campaign for realization of overdue export proceeds.
<i>Monetary Policy Statement on July 29th, 2008</i>	Authorized dealers	Discount rate increased by 100 basis points, to 13 percent (from 12 percent)

BPRD circular # 11
Dated August 27, 2008

Imposition of 100 percent LC margin on imports of non-essential and luxurious items.

Exchange Companies

PD circular#8
Dated September 29, 2008

Exchange Company are required to revisit the compliance status of each of its business location including branches, CEBs, franchises, payment booths with respect to documentation of transaction and adherence to SBP rules and regulation through all available means and submit a certificate to this effect by October 31, 2008 duly signed by the CEO and all directors of the company confirming therein that the company management is satisfied with the compliance status of each of its business location.

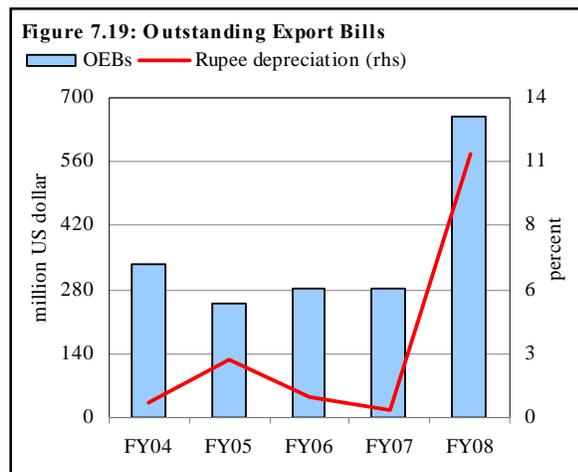
¹ Recently, SBP has relaxed this requirement for most of the capital goods in order to provide support to export sector.
² This was a temporary arrangement to provide liquidity comfort to the then tight market.

Nonetheless, Pak rupee continued its weakening trend in the initial period of FY09. Specifically, it depreciated by 12.5 percent against US dollar in first quarter of the current fiscal year.

Although most of the loss in the value of rupee is attributable to the weakness in the country's external account, rising expectations of rupee depreciation also played an important role in enhancing these pressures thus making them self fulfilling. An analysis of the export bills, kerb market premium, forward rates and FC loans, lends credence to this assertion.

Outstanding Export Bills (OEBs)

Expectations of rupee depreciation tend to increase the volume of OEBs as exporters hold back their export proceeds to maximize benefits arising from depreciation. In an event when the rupee is continuously depreciating, the longer they hold, the higher will be their return. During FY08, the stock of outstanding export bills (OEBs) witnessed an increase of US\$ 661 million which is more than twice the increase seen in FY07 (see **Figure 7.19**). Further, almost all the increase in OEBs was on part of the exporters, since the bills held by banks witnessed a net decline during the year.



The behavior of the importers is opposite to that of exporters; fearing depreciation importers tend to book forward their forex requirements. This activity on part of the exporters and importers added to the pressures on already tight market, thus weakening the rupee further. The expectation of rupee depreciation and the resulting behavior of market participants make them self fulfilling. SBP, in an effort to contain these self fulfilling expectations issued guidelines to ADs regarding the realization of export proceeds within the timelines²¹.

Kerb Market Premium

The differential between Kerb rate and interbank rate widened over time with Kerb premium reaching as high as 2.6 percent on May 2, 2008²² (see **Figure 7.20**).

²¹ EPD Circular Letter No.06 dated July 11, 2008.

²² Anecdotal evidence suggests that kerb market players even mis-quoted the rates to the regulator and hence actual kerb premium may have been even higher.

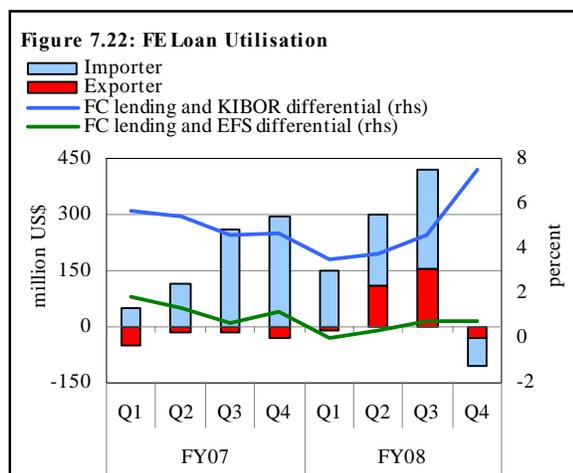
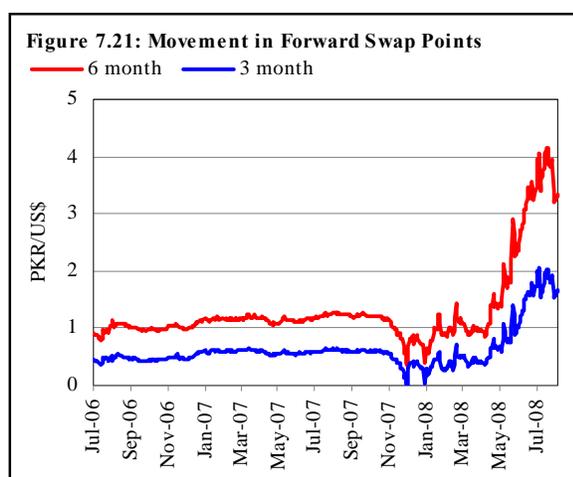
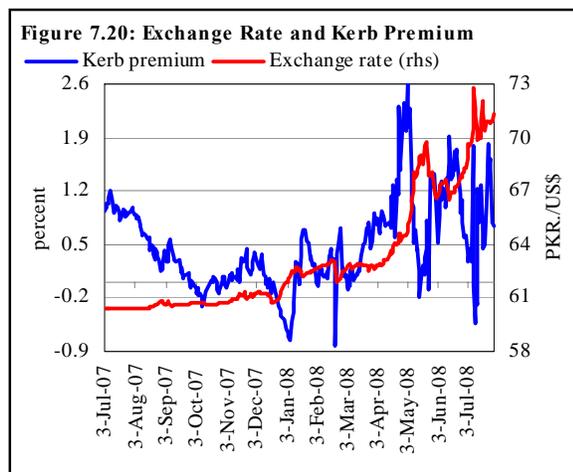
Also, the movement in Kerb differential remained bi-directional and there were instances when Kerb market traded foreign currency at a discount. This bi-directional movement of Kerb market differential, besides widening of the differential points towards uncertain inflows in the Kerb market. Going forward, these developments indicate potential for market segmentation, and rerouting of workers' remittances through the informal means to gain from depreciation of the rupee.

Forward Rates

The steep movement in swap points/forward rates coincides strongly with the trend in rupee dollar parity. During the period of relative stability in rupee dollar exchange rate, forward market also showed stability with swap points for 6 months forward transactions remaining around Rs. 1 per US dollar. However, the weakening of rupee since November 2007 resulted in a pressure on forward rates as well, which started inching up simultaneously (see **Figure 7.21**). Average swap points on six month forward transactions reached as high as Rs. 2 per US dollar in April 2008, further moving up to Rs. 3.06 per US dollar in May 2008 and Rs. 3.72 per US dollar in June 2008. A part of the rise in forward swap points could be the result of speculative activity in the forex market.

FE-25 Loans

Another indicator which points towards expectations playing their part in weakening of rupee is the rise in FE-25 deposits²³ and net retirement of FE-25 loans, despite rise in differential between rupee and dollar interest rates. Specifically, FE-loans retirement took momentum in the last quarter, while during first nine months both the exporters as well as importers availed these loans mainly to take advantage of the rising differential between the lending rate of foreign currency and domestic currency (see **Figure 7.22**). This behavior on part of traders further added to squeeze in dollar liquidity, since net retirement of these loans entails a rise in demand for foreign currency (see **Box 7.3**).



²³ Although, the extent of increase in FE deposits did not match the historical trend of their co-movement with rupee depreciation.

Box 7.3: FE-25 Loans and Forex Market Liquidity

FE circular No. 25 of 1998, allowed the authorized dealers to open and operate foreign currency accounts of residents and non-residents without surrendering the deposits mobilized thereof to SBP. The circular also allowed authorized dealers to use these FE 25 deposits for investment, placements as well as lending to traders.

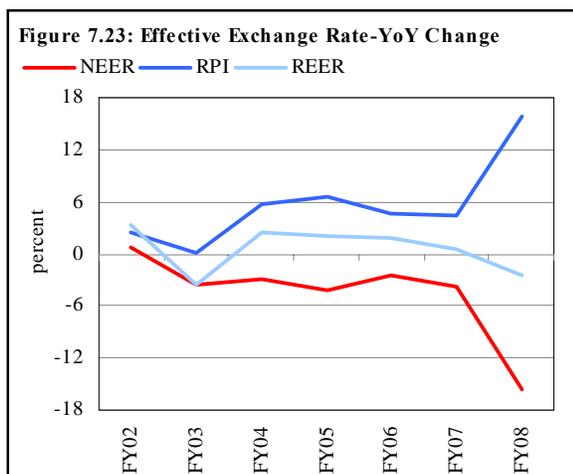
These FE deposits and lending against them have a crucial role in day to day market liquidity. Higher financing against these deposits can result in higher forex liquidity in the market when traders sell the foreign currency obtained through these loans. Conversely, retirement of these loans implies buying the foreign exchange from market which adds to the demand pressures for the foreign currency.

Demand for these loans in turn depends upon a host of factors including the size of international trade, the differential between interest rate on local currency borrowing and on FE loans, and hedging on part of traders against movements in exchange rate. Recently, although both the former factors entailed increase in FE financing for traders, the loss on account of rupee depreciation more than offset the gains from interest rate differential. As a result, we saw a net retirement of these loans on part of exporters as well as importers.

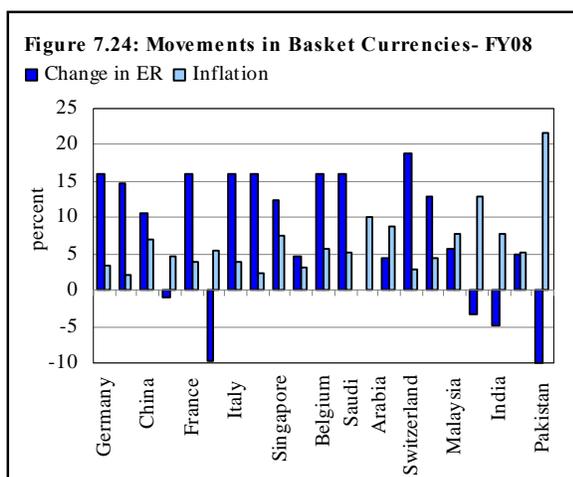
Anecdotal evidence suggests that outflows through undocumented channels, mainly towards the UAE real estate market also increased as speculators hedged themselves against rupee downside, if true, this would have added further to pressures in forex market.

7.3.3 Real Effective Exchange Rate

Multilateral exchange rates are calculated in order to judge the general dynamics of a country’s currency towards the rest of the world. Here, one takes a basket of different currencies (mostly the currencies of major trading partners), and using a set of relative weights for these currencies computes the effective exchange rate of the country. This nominal effective exchange rate is then discounted for the prices impact by deflating it with relative price index (RPI) to calculate the real effective exchange rate (REER). Theoretically the depreciating trend in real effective exchange rate implies improvement in country’s competitiveness against its major trading partners.



Despite prevalence of steep inflationary trends in the economy, the nominal depreciation of rupee has helped in gaining absolute advantage in real terms as is evident from 2.3 percent depreciation of REER during FY08 (see **Figure 7.23**). The depreciation in REER further strengthened to 3.5 percent in the first quarter of FY09. This favorable movement in REER is perhaps reflected in improved performance of exports in the last quarter of FY08 and first quarter of FY09 as nominal depreciation of Pak rupee was the highest among the trading partner countries (see **Figure 7.24**).



7.4 Foreign Exchange Reserves

As forex inflows fell, country had little option but to fall back on its forex reserves, consequently, by end June 2008, reserves had declined to US\$ 11.4²⁴ billion from US\$ 16.5 billion at end June 2007 and further to US\$ 6.7 billion by end October FY09 (see **Table 7.12**). Although the reserves of both, commercial banks and SBP declined during FY08, the fall in SBP reserves was more pronounced. Reserves held by central bank fell to US\$ 8.6 billion by end June 2008 from US\$ 13.3 billion by end June 2007, witnessing net outflow of US\$ 4.8 billion.²⁵ Most of this fall in reserves was recorded in H2-FY08 as SBP market interventions increased sharply (see **Figure 7.25**). Various factors contributing to the fall in reserves are presented in (**Figure 7.26**).

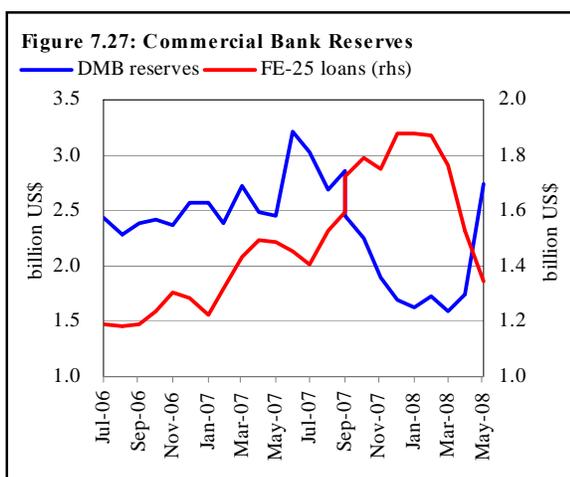
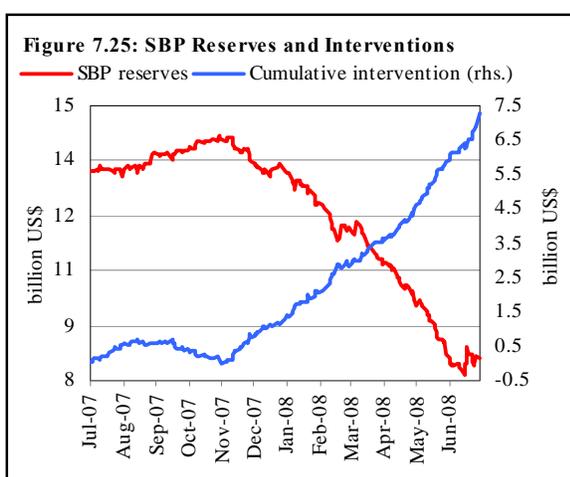
Similar to SBP reserves, reserves held by commercial banks witnessed a net outflow during FY08, and stood at US\$ 2.7 billion at end June FY08, against US\$ 3.2 billion at end June FY07 (see **Figure 7.27**). The net depletion of US\$ 472 million in commercial bank reserves despite consistent rise in FE-25 deposits, is a reflection of higher utilization of FE-25 loans during the first three quarters of FY08 by importers. Usually importers are more interested in the FE loans as they cannot borrow on concessional Export Finance rate available to the exporters. It may be pointed out that the impact on borrowing by the exporters on the inter-bank liquidity is quite the opposite to that of borrowing by the importers. Borrowing of exporters tend to increase market liquidity as exporter convert dollars to rupees. In case of importer, since the dollar amount is remitted abroad to foreign sellers the borrowing by importer squeezes the market liquidity. Interestingly, as rupee slipped sharply May 2008 onwards, since both importers and exporters rushed to repay their loans, exporters even made advance repayments. Hence a sharp fall in FE-25 loans and associated rise in commercial bank reserves was recorded in the May-Jun period (see **Figure 7.27**). However, generally

Table 7.12: Foreign Exchange Reserves

million US dollar

	FY06	FY07	FY08
Stocks			
SBP	10,765	13,345.0	8,569.7
Commercial banks*	2,537	3,213.0	2,741.0
Total	13,302.0	16,558.0	11,310.7
Flows			
SBP	960.0	2580.0	-4775.3
Commercial banks	-79.0	676.0	-472.0
Total	881.0	3256.0	-5247.3

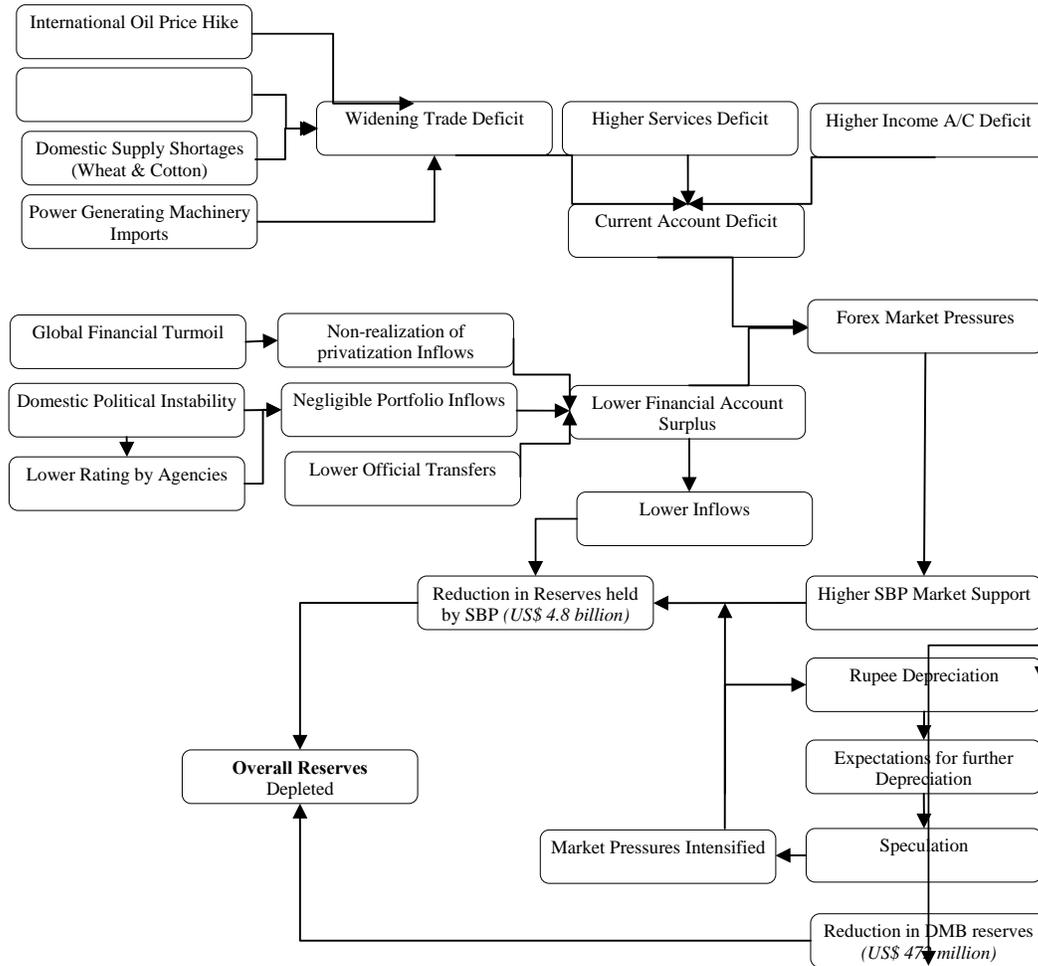
* Commercial bank reserves using BoP definition as reported by Statistics and data warehouse department.



²⁴ Reserves figures used in the discussion are as per the BoP and may differ from the data reported by Domestic Markets and Monetary Management Department (DMMD), due to difference in definition followed in compilation of BOP reserves data by Statistics and Data warehouse Department.

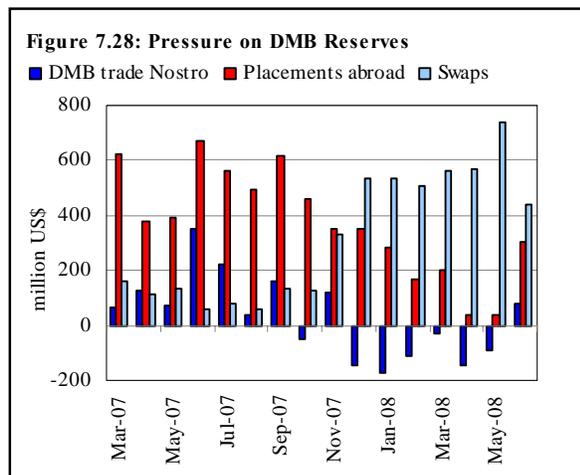
²⁵ The reserves held by central bank further fell to US\$ 3.5 billion by end October FY09, whereas commercial banks reserves fell to US\$ 3.4 billion in this period.

Figure 7.26: Factors Leading to Depletion in Reserves- A Panoramic View



commercial banks' reserve remained under pressures through most of FY08. These pressures are quite discernible from the trend in trade Nostro balances and banks' placements abroad. Dec 2008 onwards, banks placements declined significantly, Nostro balance also indicated that banks were overdrawn and were carrying negative positions (see **Figure 7.28**).

However, generally commercial banks' reserve remained under pressures through most of FY08. These pressures are quite discernible from the trend in trade nostro balances and banks' placements abroad. Dec 2007 onwards, banks placements declined significantly, nostro balance also indicated that banks were



overdrawn and were carrying negative positions (see **Figure 7.28**). However, retirement of FE-25

Table 7.13: Overall Reserves as per BoP- BPM-5 (million US dollar)

	FY07				Total FY 07	FY08				Total FY 08
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4	
Opening balance	13,302	12,570	13,237	14,067	13,302	17,498	17,091	15,289	12,858	17,498
Inflows	9,918	11,529	11,473	14,220	47,140	10,715	11,728	12,114	14,352	48,909
Exports of goods	4,191	4,202	4,142	4,743	17,278	4,568	4,668	5,079	5,807	20,122
Export of services	646	1,127	1,000	1,367	4,140	628	763	1,007	1,192	3,590
reimbursement logistic support	0	425	298	519	1,242	0	-	282	373	655
Income	148	271	247	274	940	274	562	434	343	1,613
Workers' remittances	1,233	1,335	1,369	1,557	5,494	1,501	1,565	1,662	1,723	6,451
Foreign direct investment	893	847	1,986	1,148	4,874	1,014	919	983	2,104	5,020
Foreign portfolio investment	121	1,237	407	793	2,558	56	70	(171)	65	20
Euro / Sukuk bond	-	-	-	823	823	34	92	74	52	252
Loan disbursements	753	835	637	1,305	3,530	1,041	866	735	1,496	4,138
<i>Official</i>	676	563	313	1,117	2,669	883	727	466	981	3,057
Long-term loans	451	563	313	1,117	2,444	721	381	466	981	2,549
<i>Program loans</i>	211	361	120	831	1,523	344	49	250	461	1,104
AsDB	211	361	120	50	742	344	49	250	461	1,104
<i>Project & food loans</i>	240	202	193	286	921	377	332	216	520	1,445
<i>Short-term including IDB</i>	225	-	-	-	225	162	346	-	-	508
<i>Private un-guaranteed</i>	77	272	324	188	861	158	139	269	515	1,081
Privatization proceeds	133	-	-	133	266	-	133	-	-	133
Official grants	145	197	129	344	815	44	73	379	106	602
USA	0	-	-	-	-	20	10	30	35	95
Others	145	197	129	344	815	24	63	349	71	507
Other receipts	1655	1478	1556	1733	6,422	1555	2017	1932	1464	6,968
Outflows	10,650	10,862	10,643	10,789	42,944	11,122	13,530	14,545	15,878	55,075
Imports of goods	6,933	6,768	6,454	6,834	26,989	6,937	8,536	9,853	10,092	35,418
Imports of services (excluding interest)	2,039	2,193	2,014	2,064	8,310	2,222	2,465	2,554	2,656	9,897
Interest payments	289	355	368	404	1,416	440	631	483	602	2,156
Amortization of official loans	267	296	262	326	1,151	303	347	308	323	1,281
IMF	10	43	10	57	120	8	75	22	68	173
IDA/IBRD	129	69	132	71	401	139	77	146	79	441
AsDB	49	74	60	78	261	63	88	79	103	333
Others actual paid	79	110	60	120	369	93	107	61	73	334
Profit and dividends	342	532	345	494	1,713	418	576	344	565	1,903
Purchase of crude oil /gas	356	355	338	343	1,392	366	365	359	368	1,458
Principal repaid on private loans	77	103	132	90	402	40	85	121	88	334
Foreign exchange liabilities liquidated	199	32	15	53	299	133	19	11	13	176
IDB (short term)	163	4	-	25	192	25	16	-	-	41
NBP deposits	0	-	-	-	-	100	-	-	-	100
Special \$ bonds	36	12	15	28	91	8	3	11	13	35
Other payments	148	228	715	181	1,272	263	506	512	1171	2,452
<i>Gross reserves at end of period</i>	12570	13237	14067	17498	17498	17091	15289	12858	11332	11332
CRR	705	717	727	737	737	751	374	381	794	794
Sinking fund	0	33	0	940	940	361	25	44	14	14
Net reserves of SBP	10187	10639	11336	13345	13345	13876	13372	11086	8577	8577
DMB reserves without sinking fund*	2383	2565	2731	3213	3213	2854	1892	1728	2741	2741

loans May onwards eased off some of the pressures on commercial bank reserves as evident from increase in the DMB trade Nostro as well as rise in placements. Detailed causative factors affecting flows in BoP reserves is given in (see **Table 7.13**).

7.4.1 Reserve Adequacy

Adequacy of reserves has emerged as an important parameter in gauging the ability of economy to absorb external shocks. With the changing profile of capital flows, the traditional approach of assessing reserve adequacy in terms of import cover²⁶ has been broadened to include new measures based on various types of external shocks to which the economy is vulnerable. Most widely used of these measures are ratios of reserves to monetary aggregates and to measures of external debt. Specifically, countries with significant but uncertain access to international capital markets tend to use so called Guidotti rule for assessing adequate level of their reserves. According to this rule the reserves must cover all short - term debt with the remaining maturity of one year or less or, if to put it differently, all external debt payments scheduled in the coming year. Furthermore, reserves to

Table 7.14: Reserves Adequacy Ratios

	FY03	FY04	FY05	FY06	FY07	FY08	FY09*
Liquid reserve (million Us dollar)	10769	12389	12598	13122	15646	11387	8286
Import coverage (weeks)	49.5	47.5	35.0	27.8	30.6	16.8	11.67
Reserve to external debt	0.32	0.37	0.37	0.37	0.40	0.26	0.19
Reserve to STDL**	7.76	10.14	8.56	9.59	12.77	4.92	3.58
Reserve to M2	0.30	0.29	0.25	0.23	0.23	0.17	0.14
Reserve to reserve money	0.93	0.93	0.83	0.79	0.78	0.53	0.42
Reserve to GDP share	12.92	12.65	11.50	10.35	10.88	6.81	4.73

* Ratios are calculated using reserves as on August 30th, 2008. All other data corresponds to FY08

**STDL includes Central Banks deposits and NBP/BoC deposits

monetary aggregates ratios are quite useful in assessing the risks of capital flight specifically on part of the residents. Essentially all these indicators, including import cover ratio, are rules of thumb based on different types of international liabilities.

Table 7.14 shows that the depletion in overall reserves held by the economy during FY08 has eroded nearly all the indicators of reserve adequacy. However, as of end-June 2008 compared to benchmark, all the ratios were still in comfort zone with import cover ratio at 16.8 weeks (almost four months), reserves to M2 ratio at 17 percent²⁷ and reserves to short term debt liabilities ratio at 6.64.

However, more recent position of these ratios shows significant deterioration, as during Q1-FY09 all the ratios have eroded considerably.

7.5 Trade Account

During FY08, Pakistan's trade deficit

Table 7.15: Trade Indicators

value; billion US\$, ratios and growth; in percent

	TD*	TD/ GDP	X/M**	Growth		
				Export	Import	TD
FY03	1.1	1.3	91.3	22.2	18.2	-12
FY04	3.3	3.3	79	10.3	27.6	209.3
FY05	6.2	5.7	69.9	16.9	32.1	89.3
FY06	12.1	9.6	57.6	14.3	38.8	95.4
FY07	13.5	9.4	55.7	3.4	6.9	11.5
FY08	20.9	12.5	47.7	12.2	30.9	54.2

* Trade deficit ** X (exports), M (imports)

²⁶ This benchmark is especially relevant to low-income countries exposed to current account shocks and without significant access to capital markets.

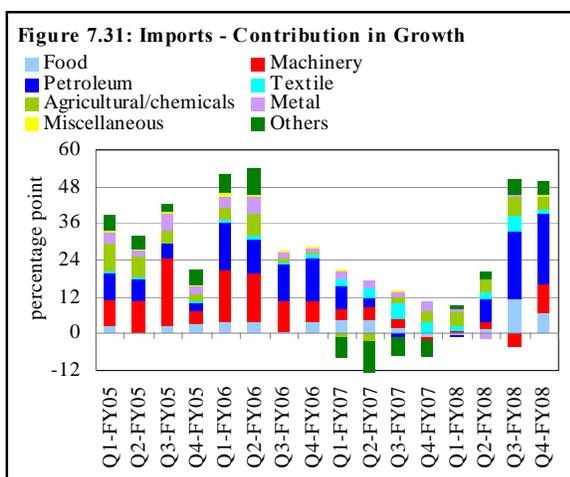
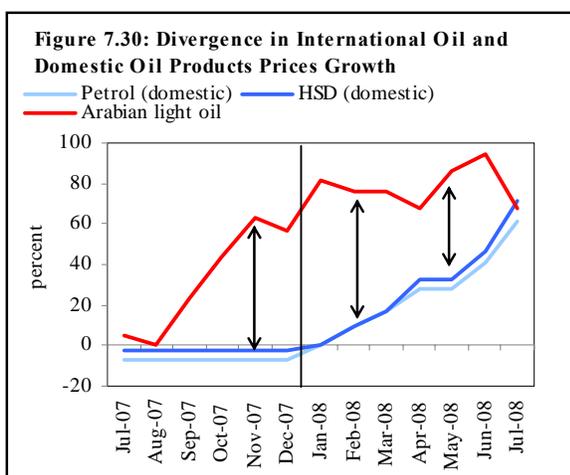
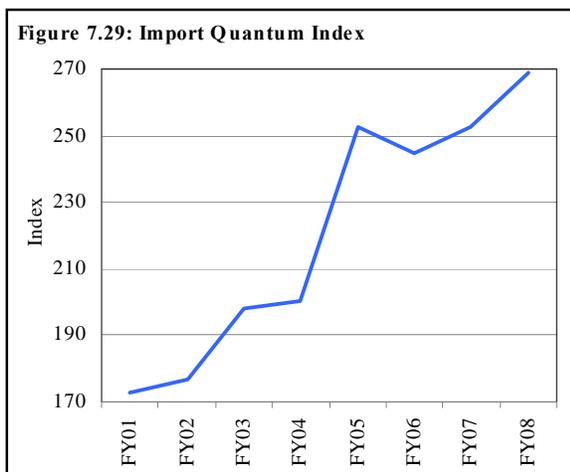
²⁷ Reserves equal to roughly 5-20 percent of M2 are considered to be the threshold level for the economy to be able to absorb the risk of capital flight.

widened for the sixth consecutive year reaching unprecedented level of US\$ 20.9 billion (see **Table 7.15**). This widening of trade deficit is attributable essentially to a sharp jump in imports that overshadowed a reasonably strong recovery in export growth.²⁸

The resurgence in imports growth was observed on account of large external and domestic shocks that compounded the effects of already strong aggregated demand in the economy.²⁹ While the rise in international commodity prices has played an important role in inflating the import bill in FY08 it should be noted that even if the prices had not increased, the import bill would still have been significantly higher than the level of FY01. The latter is evidenced by a consistent rise in import quantum index (see **Figure 7.29**).

More than 47.0 percent of Pakistan's FY08 imports comprise petroleum, machinery which are relatively inelastic. Import growth was also sustained by the government's decision to subsidize the local prices of tradable such as key fuels (see **Figure 7.30**) and wheat. On one hand domestic consumption was not rationalized to reflect higher resource costs and on the other this contributed to local shortages by encouraging hoarding and smuggling/trading as well as a large fiscal deficit.

Encouragingly, realizing these problems with imports government has taken number of measures to curtail excess demand, while gradually reducing subsidies' pressures and introducing administrative measures to reduce hoarding and smuggling. Recently government has also imposed heavy duties on import of luxury items. On its part, SBP has been tightening the monetary policy for some time now. A part of the broad based slowdown during Q3-FY06 – Q1-FY08 may be attributed to SBP tight monetary policy (see **Figure**



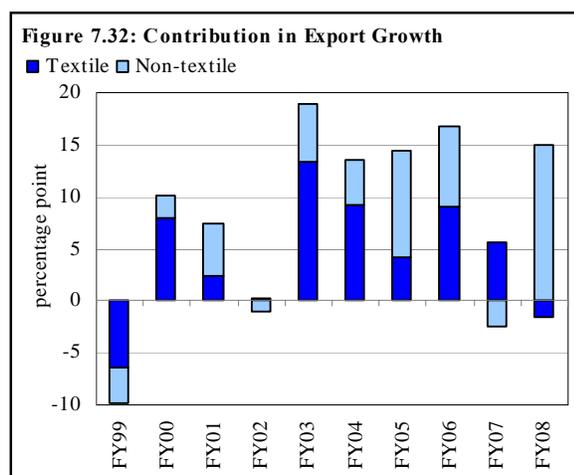
²⁸ Exports growth in FY08 was significantly higher than the level observed in FY07.

²⁹ Rising oil prices alone had 32.1 percent share in the overall import increase during FY08, whereas the share of wheat and cotton in the total import increase stood at 15.5 percent during this period.

7.31). However, the effect of monetary tightening was to a large extent offset by external and domestic shocks, besides revival of demand in certain sectors Q2-FY08 onwards.³⁰

While policy response to slowdown imports is underway and may yield results in the coming 6-12 months, the issues surrounding exports are much more complex. The factors ailing our exports range from poor country image to poor physical and human infrastructure. The strategy to overcome these problems is likely to be more complex and long drawn.

In this context export performance in FY08 is indeed commendable. Despite a YoY fall in textile exports during FY08, overall exports displayed a remarkable performance due to rising non-textile exports (see **Figure 7.32**). Though, a part of this increase in FY08 was based on incidental factors such as rising rice and gold price,³¹ a large share of non-textiles export increase came from quantum increases³² based on structural factors such as capacity enhancements besides, rising international demand for some non-textiles. In addition depreciation in the value of rupee against US Dollar also enhanced export's competitiveness.³³ Exports are thus expected to continue the current growth trajectory going forward.



Preliminary trade figures for Jul-Oct FY09, however, show a sharp increase in the trade deficit.

This rise is observed due to lower base effect during same period last year (see **Table 7.16**). Both exports and imports recorded lower growth during Jul-Oct FY08 consistent with the overall trade deceleration witnessed during FY07, whereas their respective growths during Jul-Oct FY09 are in line with the trend during H2-FY08. In fact due to the lower base effect the trade deficit growth during entire Jul-Oct FY09 remained higher than the same period last year.

Table 7.16: Trade Performance (Jul - Oct)

Billions US dollar

	FY07	FY08	FY09
Export	5.5	5.8	6.8
growth (%)	0.7	5.1	16.6
Import	9.6	11.4	14.3
growth (%)	7.7	19.7	24.9
Trade Deficit	4.0	5.6	7.5

For long term correction of trade balance there is a need to focus on structural issues faced by export sector. This is especially

important, since a part of the rise in imports appears to be permanent due to growth in the size of the economy over past few years and hence cannot be compressed.

Two important structural issues are country's lower physical capital base and deficiency of skilled labor force. Both these issues

Table 7.17: Some Determinants of Productivity - Ratios with GDP

in percent

	FY05	FY06	FY07	FY08
Development expenditure	3.8	4.8	4.9	4.0
Education expenditure	0.2	0.2	0.3	0.2

³⁰ Especially, agriculture & chemical (particularly fertilizers and industrial chemicals) and machinery imports (due to power generating machinery import).

³¹ The rise in rice (price impact) and jewelry exports had 31.2 percent share in the absolute increase of exports during FY08.

³² Particularly in the sectors of chemicals & plastics, petroleum products and cement.

³³ During H1-CY08 while Pak Rupee recorded 9.8 percent depreciation against dollar, China's currency witnessed 6.3 percent appreciation, whereas currencies of India, Vietnam and Bangladesh recorded lesser depreciation of 8.4 percent, 8.0 percent and 3.8 percent.

originate from the dearth of resources to be spent on development of relevant infrastructure in the country. This is evident from low level of spending on development expenditure and education in the past years (see **Table 7.17**). This limitation has resulted in weakening of country's competitive strength vis-a vis its competitors as identified in the Global Competitiveness report for 2007-08 prepared by World Economic Forum³⁴ (see **Table 7.18**).³⁵

Table 7.18: Global Competitive Rankings* 2008-09

	Pakistan	India	Sri Lanka	Bangladesh	Indonesia
Overall competitive ranking	101	49	76	111	54
Basic requirements	110	80	92	117	76
Institutions	95	53	66	127	68
Infrastructure	85	72	63	122	86
Macroeconomic stability	116	109	132	101	72
Health & primary education	116	100	53	105	87
Efficiency	89	33	74	97	37
Higher education and training	123	63	65	131	71
Goods market efficiency	100	47	42	106	37
Labor market efficiency	121	89	115	107	43
Financial market sophistication	71	34	65	82	51
Technological readiness	100	69	82	126	88
Market size	29	5	64	53	17
Innovation	85	27	34	115	45
Business sophistication	87	27	32	105	39
Innovation	82	32	36	122	47

Source: Global Competitiveness Report 2008-09, World Economic Forum. These rankings are given out of total 131 countries.

Pakistan's global ranking on macroeconomic stability, health and primary education, higher education and training and labor market efficiency is among the lowest as compared to some other regional countries during 2008-09. While low ranking on macroeconomic stability is a consequence of external and domestic shocks faced by economy during FY08, the ranking on education and labor market efficiency is a source of grave concern. The solution of this issue lies in making huge investment in physical infrastructure and education sector. In addition to the above mentioned factors, *lack of efficient institutional base, governance related issues and political instability also have a large contribution in poor export performance.*

This situation aptly explains the case of Pakistan. The historical inadequacy of proper human and physical capital and efficient institutional framework has made transition of exports to relatively high value added products difficult for the country. As the unit values of Pakistan's exports have not been able to catch up with sharply increasing import unit values caused by fast increase in the international prices of technologically advanced goods.

³⁴ This report noted deterioration in Pakistan's global competitive ranking during 2007-08 as compared to the same period last year.

³⁵ On education and training, country has low primary, secondary, and tertiary enrollment rates, (ranked 120th, 120th, and 116th), due to poor assessment for the quality of the educational system, and the availability of staff training. Health indicators are also worrisome, placing country at 106th position. Finally, country received poor rank for labor market efficiency (ranked 113th), with low female participation in the labor force, high firing costs, little reliance on professional management within companies.

This has led to a *persistent fall in country's terms of trade for the past few years*, which is in turn a contributory factor for deterioration in trade deficit over the years (see **Figure 7.33**).

This situation requires a long term strategy for complete revamping of country's physical and human capital base and improvement in institutional set up to improve the level of productivity and efficiency in the production processes. Besides, improving export earnings from available resources, this will also aid in transforming country's manufacturing sector to a technologically sophisticated one.

Recovery in exports during FY08 structural or incidental?

Exports recorded a marked recovery during FY08 reaching a historic peak of US\$ 19.1 billion during FY08, significantly higher than the level observed in FY07 (see **Figure 7.34**). Recovery in exports is exceptional due to two factors 1) – Total exports recorded this large increase despite fall in textile sector exports; 2) – Growth in exports was achieved despite a number of adverse domestic supply side issues e.g., power shortages, rising domestic cost of production, inadequate infrastructure, political instability and law & order issues hampering export sector throughout FY08.

Analysis of monthly export performance reveals that a large share of this recovery was observed in H2-FY08 (see **Figure 7.34** and **7.35**). This happened on account of various positive developments such as;

a) Rise in international commodity prices observed since end of CY07 particularly of rice, gold and oil that helped in improving export earnings (see **Table 7.19**). The rise in exports on account of this factor may be regarded as temporary, since this performance is a result of external developments which may not last e.g., rice prices are expected weakening after improvement in supplies from 2008-09 crop. As regards jewelry export, the anecdotal evidence suggests that during FY08 raw gold with minimum required value addition was exported to UAE, to take benefit of the price differential existing between Dubai and Pakistan market.

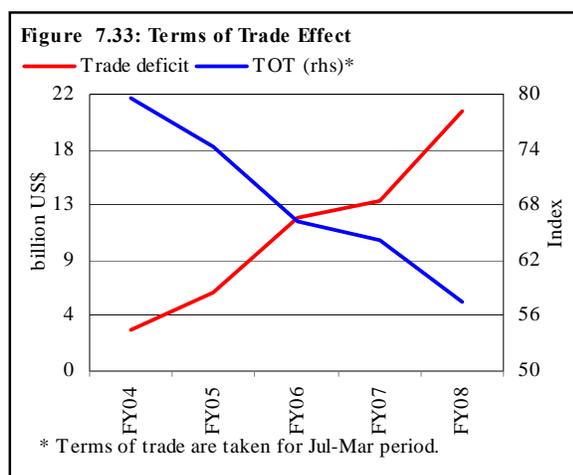
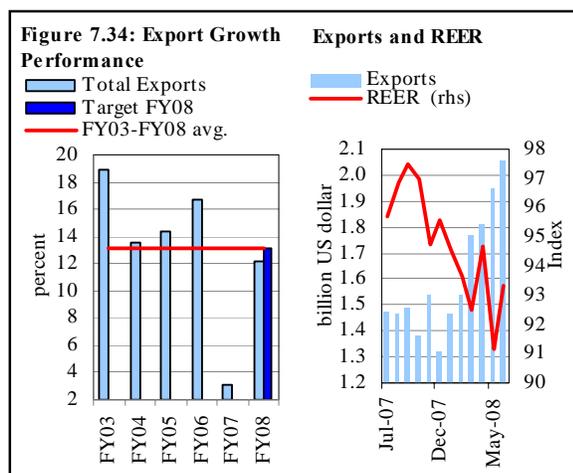
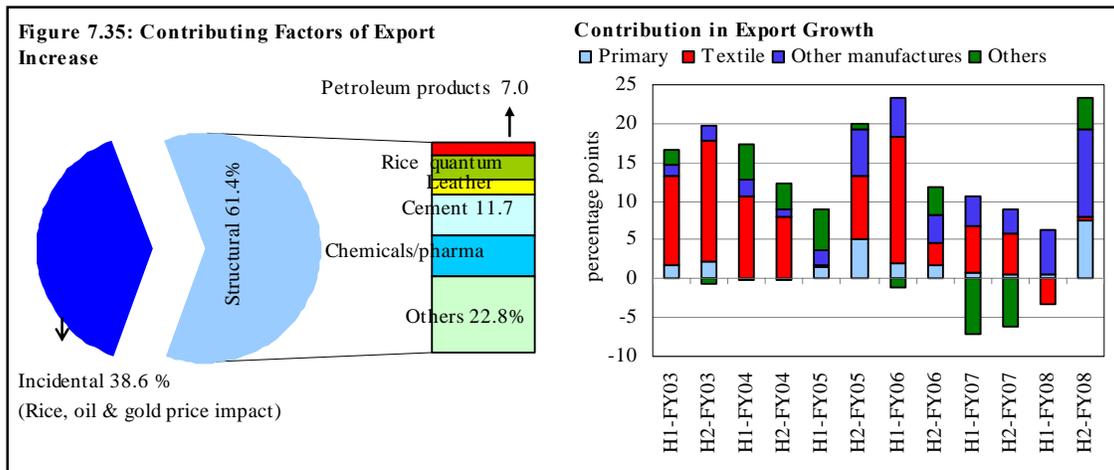


Table 7.19: Top 12 Exports - Shares in Export Increase
shares in percent

	Abs. Δ	Quantum impact	Price impact
Basmati rice	18.0	9.6	8.4
Cement and products	11.7	10.2	1.5
Other rice	11.2	-1.1	12.3
Petroleum products	10.4	7.0	3.4
Other chemicals	7.0	N-A	N-A
Readymade garments	7.0	-1.3	8.3
Jewelry	6.2	N-A	N-A
Leather garments	6.0	7.7	-1.7
Synthetic textiles	5.6	1.6	3.9
Leather	4.9	4.6	0.4
Plastic material	4.4	3.9	0.6
Naphtha	4.0	0.0	4.0
Total	96.5	42.2	41.1



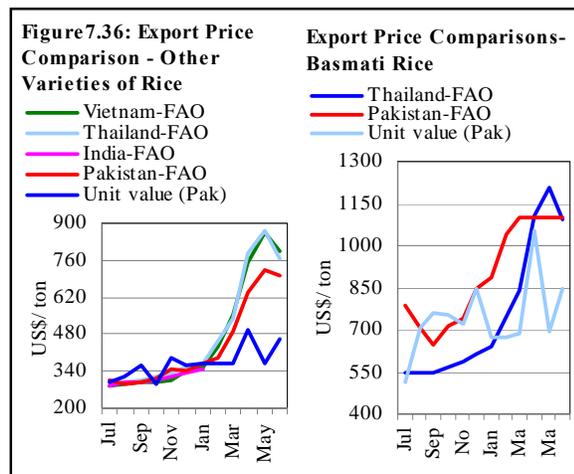


This export is likely to start a downward trend with a reversal in gold price movement.³⁶ Similarly, the oil prices also have started a downward movement from Jul FY08.

b) Depreciation of exchange rate improved country’s competitive strength vis-à-vis other competitors (see **Figure 7.34**). Importantly, depreciation of country’s exchange rate was accompanied by appreciation in the currencies of country’s major competitors, which probably led to the diversion of export orders towards Pakistan. This factor seems especially important for textile exports that recorded small growth during H2-FY08 as opposed to a fall recorded in H1-FY08 (see **Figure 7.35**).

c) In addition to these factors, capacity enhancement undertaken by some sectors (cement, chemicals and plastic sector) started bearing fruits leading to improvement in quantum of exports. Further, petroleum group exports increased due to both higher prices and higher demand from neighboring market of Afghanistan.

On account of these strengths, in the absence of first two supporting factors (a & b) the entire export growth witnessed during H1-FY08 was on the back of higher non-textiles (especially *other manufactures*) exports, which points towards large growth potential of this sector provided that the supply side issues faced by exports sector are resolved (see **Figure 7.35**). In fact, share of incidental factors in the overall export increase during FY08, though large, is significantly less than the impact of last two structural factors (see **Figure 7.35**). This fact suggests likelihood for current improvement in export performance to continue in FY09 as well.



Major performers during FY08 – issues, challenges and opportunities

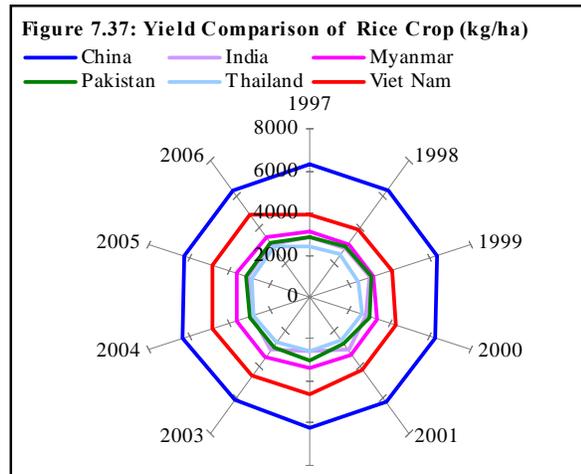
Rice was the largest contributor in overall export increase during FY08, largely on the back of rising international prices (see **Table 7.19**). Especially higher price impact was evident in case of other varieties of rice exports. However, the comparison of unit values obtained by Pakistani exports both

³⁶ Jewelry exports recorded 16.9 percent YoY fall during Q1-FY09.

for, basmati and other varieties of rice, with the international rice prices, depict an interesting scenario. The international rice prices of these varieties as reported by Food and Agriculture Organization (FAO) of the United Nations are significantly above the export unit values of rice reported by the FBS data for Pakistan (see **Figure 7.36**).

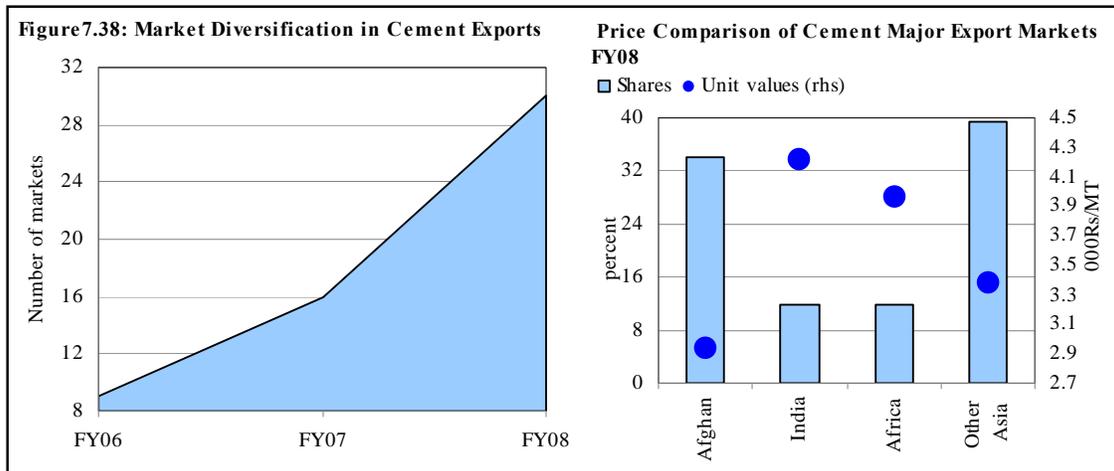
Going forward rice exports have a potential to grow, Pakistan is already a major rice exporter, and can increase its gains by increasing rice export quantum. The anecdotal evidence suggests that in response to higher international prices, in Pakistan growers have switched from the plantation of cotton to rice crop for FY09. This fact will to some extent help in stemming deceleration in rice exports as a result of weakening international rice prices during FY09.

In the medium term production increases to support exports can be achieved by sowing of high yielding, short duration rice varieties. Presently the yeild of rice crop in Pakisatn is among the lowest in the major rice producing nations (see **Figure 7.37**).³⁷



Significant gains can also be had by reducing wastage from existing rice production by improving rice handling infrastructure. Provision of grain silos is necessary to reduce wastage by storing that paddy in these warehouses after drying rather than left in the open, which is the common practice presently. Further mechanical drying of paddy by using rice driers can also reduce loss as against drying paddy in the sun and hence can result in higher exportable surplus.

Cement export had the second largest contribution in overall export increase during FY08. This rise is attributable to both improved production capacities at home and rising international demand from some regional e.g, India and UAE and African markets. The sustainability of these higher earnings,



³⁷ Pakistan is lagging behind its competitors in the field of agriculture research. For instance, Pakistan has so far introduced two varieties of basmati namely *basmati 385* (introduced in 1988) and *super basmati* (introduced in 1996), which have attracted recognition in the world market. On the other hand India that is world's third largest rice exporter has introduced various basmati varieties – namely *Dehra Dun & 41*, *Taraori Basmati & 40*, *HBC-19 & 41*, *Basmati 217*, *Ranbir Basmati* and *Pusa Basmati*³⁷ – and has emerged as a big *basmati rice* exporter in the world as compared to Pakistan.

however, requires understanding the pattern of demand in various markets on the part of exporters.

There is a need to diversify market base of cement exports towards the markets offering higher prices. Over the period of last three years cement exports have undergone substantial market diversification (see **Figure 7.38**). Yet a large share of these exports during FY08 was concentrated in Afghanistan – a market that offered lowest prices as compared to other destinations (see **Figure 7.38**). The price comparison highlights Indian and African markets as the most attractive destinations. The demand from the Indian market might fluctuate, with fast domestic capacity expansions currently in progress in India.³⁸ On the other hand, in the medium term global cement demand is likely to undergo a healthy expansion due to fast growing construction activities in eastern European, Latin American, Asian and the African countries.³⁹ There is a need to further explore African markets to take advantage of the economic growth in that region. Further, Sri Lanka with whom Pakistan has entered into FTA, might also offer great potential for Pakistan's cement exports in view of the reported cement shortage in this market.

Textile exports demonstrated discouraging performance, recording a broad based decline during FY08 (see **Table 7.22**). Disappointingly, all major categories recorded fall in export quantum during this period. This lackluster performance of textile sector is attributable to both adverse supply and demand side factors. On the supply side this sector continued to face structural issues arising from rising cost of production, lack of skilled labor, low productivity, power shortages, reported diversion of export orders to other destinations due to law and order issues, etc. On the other hand, slowdown in textile and apparel demand from major markets of the EU and US impacted exports performance of this sector externally (see **Table 7.20**).

Table 7.20: Textile & Apparel Export Growth - Market Analysis
percent

	FY07		FY08	
	Textiles	Apparel	Textiles	Apparel
US Market (Jul-May)				
Pakistan	-6.0	12.8	-6.8	0.9
World	3.3	7.4	3.2	-1.9
EU Market (Jul-Mar)				
Pakistan	11.6	5.0	1.8	-2.3
World	8.2	7.0	0.6	2.2

Source: US Census Bureau & Euro stat

This said, however, the FY08 textile sector performance represents two distinct phases. During H1-FY08 textile exports recorded a broad based decline (see **Figure 7.39**), whereas **H2-FY08 marks a shift as the overall textile exports recorded a marginal increase** on account of rising exports in the categories of garments, synthetic textiles, etc (see **Figure 7.39**).

Apparel exports from Pakistan performed better in the US as compared to EU market specifically in H1-CY08 (see **Table 7.20 & 7.21**). This may be attributable to deterioration in strength of Pakistan's textile competitors, particularly China in this period.

Apparel exports from China recorded fall in the US market during H1-CY08, resulting in a contraction in share of this large supplier in this market.

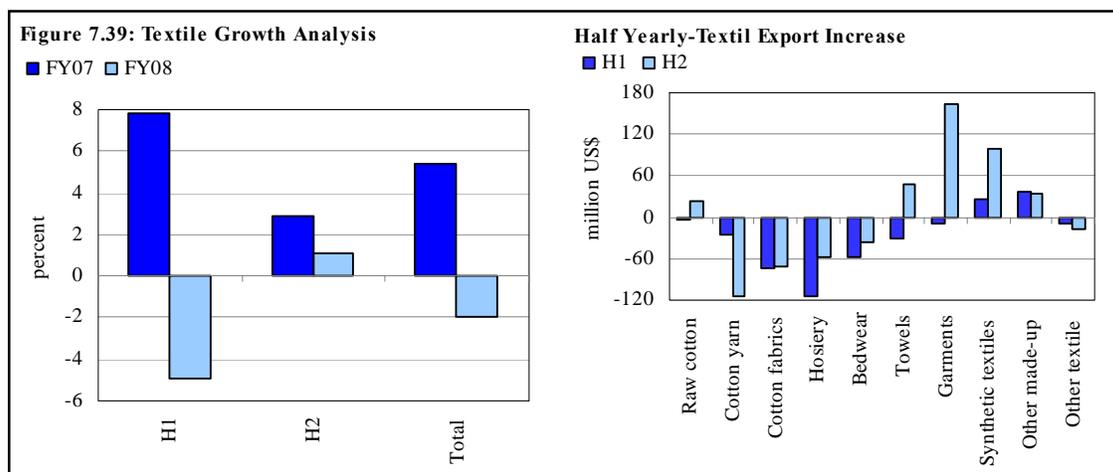
Table 7.21: US Apparel Imports
percent

	Growth			Shares	
	Q1-CY08	Q2-CY08	H1-CY08	H1-CY07	H1-CY08
World	-5.1	-3.0	-4.0		
China	-9.6	-2.4	-6.0	28.1	27.5
India	1.0	-5.4	-2.0	5.2	5.3
B.desh	5.3	8.2	6.7	4.4	4.9
Pakistan	-1.7	0.9	-0.3	2.0	2.1

Source: Emerging textiles

³⁸ Reportedly, the Indian cement industry is poised to add 111 million tonnes (mt) of annual capacity by the end of 2009-10 (FY 2010), on the back of approximately 141 outstanding cement projects. <http://www.ibef.org/industry/cement.aspx>

³⁹ The global cement demand is likely to grow 4.7 percent annually through 2010. <http://www.freedoniagroup.com/pdf/2076smwe.pdf>



On the other hand suppliers from India, Bangladesh and Pakistan witnessed improvement in their shares during this period. Importantly, apparel exports from Pakistan recorded a small increase in this market during Q2-CY08.

Table 7.22 : Major Exports
million US dollar

		FY07		FY08(P)			% YoY Δ		
		Value	Unit value	Value	Unit value	Abs.Δ value	Qty	Value	Unit value
A	Food Group	2036.8		2759.6		722.8		35.5	
	of which								
	Rice	1121.8	359.23	1795.7	628.5	673.9	-8.5	60.1	74.9
B	Textile Group	10757.3		10553.7		-203.6		-1.9	
	of which								
	Cotton yarn	1425.8	2112.7	1293.2	2288.3	-132.6	-16.3	-9.3	8.3
	Cotton fabrics	2017.6	912.4	1948.3	994.9	-69.3	-11.4	-3.4	9.0
	Knitwear	1964.6	21.0	1834.2	19.7	-130.4	-0.3	-6.6	-6.3
	Bed wear	1958.6	5362.7	1880.9	5674.0	-77.7	-9.2	-4.0	5.8
	Towels	595.0	3786.8	606.9	3939.5	11.9	-1.9	2.0	4.0
	Readymade garments	1379.7	33.8	1489.9	37.0	110.3	-1.2	8.0	9.3
	Synthetic textiles	429.8	0.8	475.7	0.9	45.9	-8.3	10.7	20.7
	Other textile made-up	473.9		545.3		71.4	-	15.1	
	Other textile material	312.1	---	281.6	---	-30.4	-	-9.8	
C	Petroleum Group	840.4		1220.4		380.0		45.2	
D	Other Manufactures Group	2608.6		3620.9		1012.4		38.8	
	of which								
	Leather excluding reptile	302.8	17.0	416.8	17.2	114.0	36.4	37.6	0.9
	Leather								
	Leather manufactures	546.1	---	684.4	---	138.3	-	25.3	
	Chemicals and pharmaceuticals	388.0	---	639.6	---	251.6	-	64.9	
	Jewelry	38.9	---	189.1	---	150.2	-	385.9	
	Cement and cement products	139.7	53.0	408.7	57.0	269.0	171.9	192.6	7.6
	All other items	733.3		897.7		164.4		22.4	
	Total exports	16976.3		19052.3		2075.9		12.2	

One major development during H1-CY08 was *sharp depreciation in Pakistan's exchange rate* that improved competitiveness of country's exports. This situation became especially important when rupee started this declining trend at a time when the currencies of other major textile exporters were either appreciating or were already stronger than rupee (see **Figure 7.40**). However, the beneficial

impact of exchange rate depreciation may also to some extent be offset by rising cost of imported inputs. This factor had an important contribution in improving competitiveness of Pakistan's apparel exports in the US market.

Box 7.4 : Exchange Rate and Textile Export Competitiveness

Hanif and Jafri (2008) empirically tested the determinants of Pakistan's textile sector competitiveness during the period 1974-2004. In this study competitiveness was measured by calculating the revealed comparative advantage (RCA) index for textile exports by taking the ratio of the share of Pakistan's textile exports in the total exports with the share of world's textile exports in the world's total textile exports. Their findings (see **Table 7.4.1**) reveal that country's cotton production (CTP), real effective exchange rate (REER) and financial sector development (TCS) as important determinants of the competitiveness of Pakistan's textile sector exports in the long run. While, in the short run nominal exchange rate (NER) and power tariffs (IP) turned out to be important determinants of textile exports competitiveness.

Source: Hanif, M.N. and S. K. Jafri (2008), "Financial Development and Textile Sector Competitiveness: A Case Study of Pakistan", *South Asian Economic Journal*, 9:1 (2008): 141-158.

In addition, anecdotal evidence suggests that labor market reforms in China are causing a re-allocation of Chinese labor to other better remunerating sectors away from textiles, besides increasing cost of labor.⁴⁰ On the other hand as regards cost of labor, Pakistan is already competitive as the cost of labor in Pakistan is among one of the lowest in the region (see **Figure 7.41**). On the back of these factors current uptrend in apparel and some other high value added exports may continue giving a little boost to textile exports.

The strengths in non-textile sector is likely to aid exports in maintaining the current growth trajectory through FY09.

An Anatomy of the Increase in Import Bill – FY08

Import growth marked a reversal during FY08 recording a sharp 30.9 percent YoY rise as compared to deceleration witnessed during FY07 (see **Figure 7.42**). This increase was observed on three counts 1) a large external shock in the form of significant increases in international commodity prices 2) – domestic shortages of wheat and cotton 3) – revival in demand in some sectors e.g., power generating machinery, industrial chemicals, steel etc (see **Figure 7.42**). Especially, the first two factors pronouncedly impacted import bill during H2-FY08 (see **Figure 7.42**). In the absence of these two

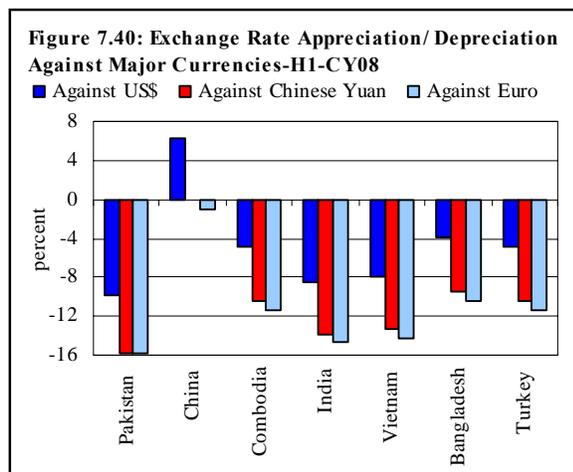


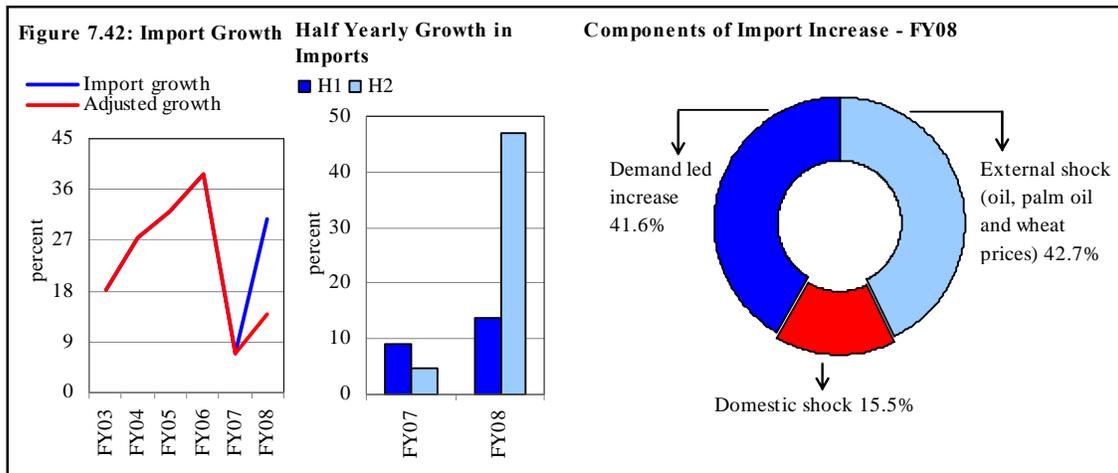
Table 7.4.1: Elasticities of Determinants of Textile Sector Competitiveness

in percent

	REER	CTP	TCS
Long run	-0.2	0.1	0.2
	NER	IP	TCS
Short run	0.4	-0.1	0.3

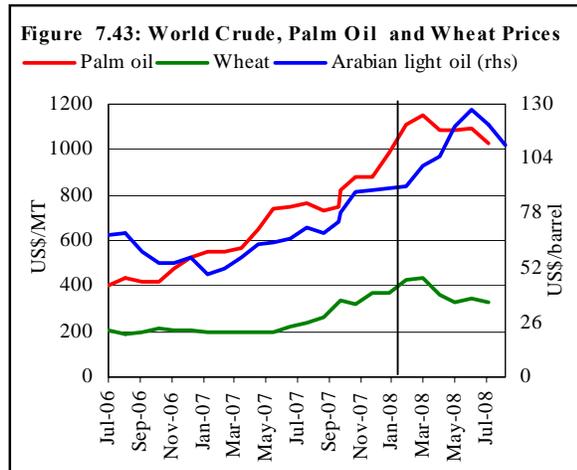


⁴⁰ <http://www.emergingtextiles.com/?q=art&s=080515-china-country-report&r=country-reports&n=6>

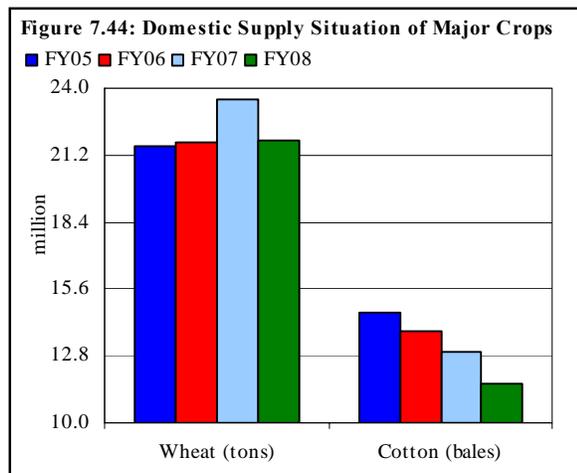


elements import growth backed by resurgence in aggregate demand is though higher than that in FY07 yet it reflects a slowdown compared to last few years (see **Figure 7.42**).

However, uptrend in prices of almost all these commodities have started to ease from Q4-FY08 due to marketing of new wheat supplies, higher inventories of palm oil and concerns about falling petroleum demand due to continuation of US economic slowdown (see **Figure 7.43**).⁴¹ Thus the impact of price shock is likely to moderate in FY09.



Mechanics of domestic shock show a perturbing scenario regarding domestic supply situation of raw cotton. Production of cotton is undergoing a continuous decline since FY05 due to falling area under cultivation, caused by pests and virus attacks (see **Figure 7.44**).



The situation has not changed in the current year either. Reportedly, for FY09 crop growers continued to switch to rice to take advantage of higher prices, which implies a likelihood for cotton shortage and hence its import to continue through FY09 as well. As regards wheat, although the FY08 production level was slightly higher than the FY05 and FY06 level, government has decided to continue importing in order to counter any shortages during FY09.

⁴¹ The United States Department of Agriculture forecasts record high production in world wheat output in 2008-09. http://usda.mannlib.cornell.edu/usda/current/WHS-yearbook/WHS-yearbook-05-09-2008_Special_Report.pdf

The impact of demand led growth in imports

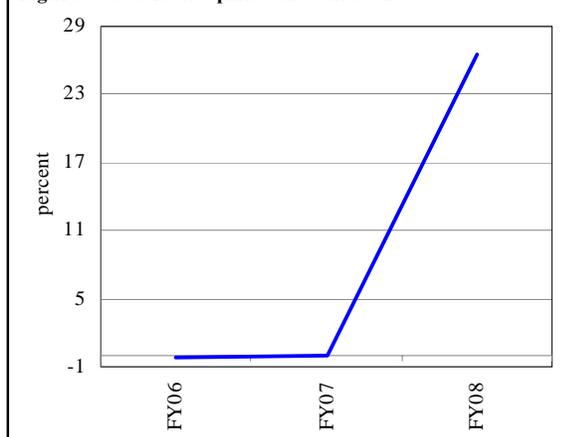
largely came from increases in petroleum products, other chemicals, fertilizer and iron and steel scrap imports (see **Table 7.23 & Table 7.24**). Especially *the rise in petroleum product import quantum was the largest*. The contributing factors were higher HSD, furnace oil and motor spirit imports, with the share of the former being the highest. The increase in HSD import despite rising oil prices is a reflection of increased economic activity that has raised fuel demand of the transport sector, whereas, furnace oil import represents domestic power generation needs. Motor spirit imports however, recorded an abnormal increase during FY08 due to control of smuggling activity from Iran (see **Figure 7.45**).

Rise in petroleum imports though reflects the need of the growing economy, but the sharp rise in international oil prices has caused a huge pressure on import bill during FY08. *In this context, the decision of withdrawing of subsidy on oil prices is regarded as a measure to control POL demand in the country. Yet, in case of developing countries the demand for oil is considered to be of a relatively less elastic nature, and the case of Pakistan is no exception to that* (see **Box 7.5**). This implies a scanty fall in import demand for petroleum products going forward due to rise in international and domestic oil prices.

Table 7.23: Top 10 Products Share in Overall Import Increase
percent

	Abs. Δ	Quantum impact	Price impact
Petroleum products	25.7	8.8	16.9
Petroleum crude	17.1	2.0	15.1
Wheat un-milled	8.6	5.2	3.4
Palm oil	7.6	0.5	7.2
Other chemicals	7.6	N-A	N-A
Raw cotton	6.9	5.9	1.0
Power generating machinery	5.0	N-A	N-A
Fertilizer manufactured	4.7	2.0	2.7
Iron and steel scrap	2.6	1.8	0.8
Other telecommunication apparatus	1.8	N-A	N-A
Total share	87.7	26.2	47.1

Figure 7.45: Motor Spirit Sales Growth



Box 7.5: Domestic high speed diesel consumption elasticity with respect to domestic diesel prices

An empirical exercise was conducted to estimate the price elasticity of consumption demand for petroleum products. Due to data limitations this analysis was limited to high speed diesel oil, which contributed slightly less than half of the total petroleum products demand during last three years. Various control variables were also included in this model namely share of transport and communication sector in GDP, GDP adjusted for share of transport and communication sector, value of trade in rupees adjusted for POL group imports and share of hydel power generation in total power generation. In various model specifications the results of this exercise showed that *consumption demand for diesel is relatively in-elastic with respect to prices since one percent growth in the domestic diesel prices is associated with only 0.12 to 0.20 percent fall in growth of domestic consumption of HSD*. As regards other control variables as expected, trade, transport and communication, GDP adjusted for transport and communication sector have positive association with HSD consumption, hydel power generation share have negative association with HSD. In view of the large share of HSD in total petroleum products the results of this exercise can be used as a proxy for overall petroleum products consumption.

Second large contributor to imports increase was other chemicals imports. This is a broad sector that largely reflects the needs of various industries.⁴² During FY08 import of chemicals used in textile, bottle grade resin, beverages, plastics industry recorded large increases. As regards, fertilizer imports, closure of a domestic DAP plant for maintenance purposes led to surge in these imports during FY08. Whereas, the rise in power generating machinery indicates increasing power shortages in the country leading to higher imports of generators. Besides, this head also includes power plants machinery

⁴² For example textile, beverages, paints, dyes, pharmaceuticals, washing detergents, rubber, etc.

being imported by IPPs that has attained financial closures.⁴³ Further, expansion of telecommunication sector has led to large increases in the apparatus imports used in this sector.

Containing import demand- a dilemma?

Above discussion suggests significance of major contributors in import growth during FY08, for smooth industrial and economic growth of the country. The financing of huge import bill caused by sharp rise in these imports, however, is emerging as a serious issue as shown by the sharp depletion of international reserves and the resultant fall in the value of rupee against US\$ (see **Figure 7.46**). This situation points towards the need of restricting import demand, to avoid adverse economic implications of an excessive fall in the value of rupee, and depletion of reserves.⁴⁴ In this context following measures are being taken by the government and SBP:

1) - Government has announced imposition of additional import duty, regulatory duty and 100 percent LC margin on imports of non-essential luxury goods.⁴⁵ In addition 35 percent LC margins has also been imposed on a long range of products. The duties and LC margin imposed on luxury goods are expected to curtail import of these goods effectively. On the other hand imposition of lower rate of LC margin is also expected to discourage imports of relatively less essential goods. In view of large volume of these goods imports are expected to record significant deceleration during FY09 (see **Table 7.24**).

2) - A large part of the increase in import growth was constituted by raw material for consumer goods which included jet fuel, petroleum crude, palm oil, fertilizer, textile raw materials, etc (see **Figure 7.47**). For these imports, a part of surge can be controlled indirectly by containing aggregate demand. To this end the rise in interest rates by SBP is an effective policy solution.

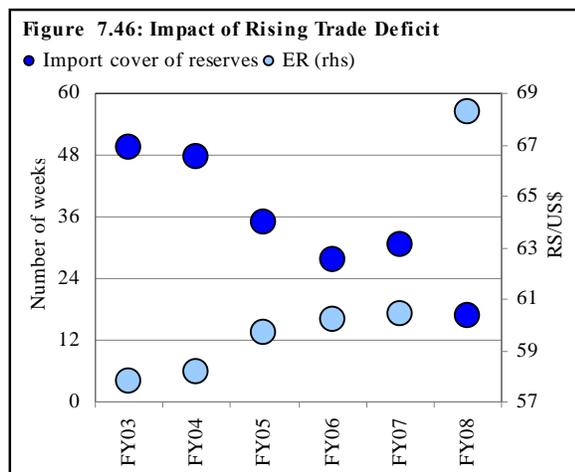
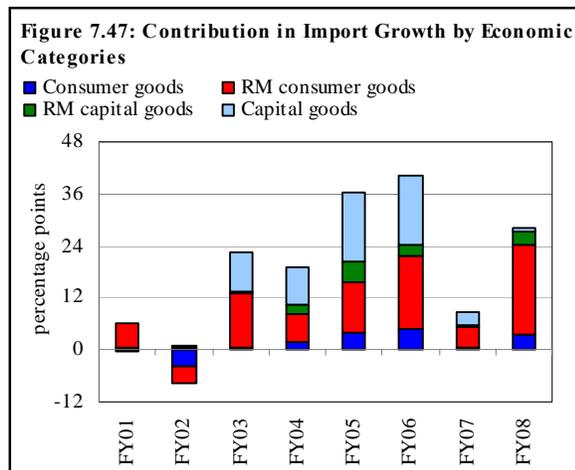


Table 7.24: Impact of Direct and Indirect Controls on Imports
billion US\$

	FY07	FY08
Luxury goods*	1.4	1.5
35 % LC margin *,**	8.6	10.6
Petroleum imports	7.3	11.4
Total	17.3	23.4

* The values for full fiscal years are obtained by extrapolating the import shares of these categories in Jul-April imports data.

** The calculation for the impact of LC margin is based on SBP data.



⁴³ According to PPIB three IPPs are expected to start operation during FY09, whereas another five power plants will be commissioned during FY10.

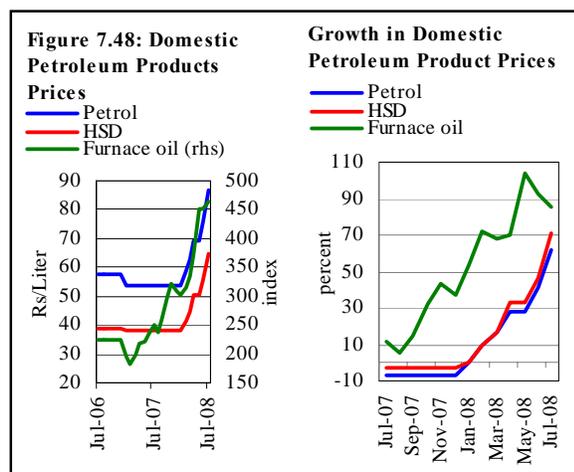
⁴⁴ Sharp depreciation in the value of the rupee is likely to raise public debt burden in terms of rupees. In addition, the sharp rise in the trade deficit will increase the need of external financing.

⁴⁵ These restrictions were imposed on import of some 379 luxury goods. The duty on these items was increased from 25 per cent to 35 per cent in the 2008-09 budget with the accumulative duty at 50 per cent. Further 15-50 percent regulatory duty was also imposed on import of these goods.

3) - Petroleum group import constituted around 43 percent of total rise in imports during FY08. This rise is expected to record a slight slowdown due to rise in domestic prices of petroleum products (see **Figure 7.48**).

Especially domestic petroleum product prices are witnessing sharp increase since Q4-FY08 (see **Figure 7.48**). As growth in these prices increases their demand is expected to slow down gradually, which will be realized in deceleration of these goods with a small lag.

⁴⁶Petroleum products imports therefore are expected to face slowdown from Q1-FY09 onwards.



4) - Apart from these direct and indirect measures for controlling import demand, there is a need to revamp domestic engineering goods sector to ensure domestic production of such intermediate products, which do not require sophisticated technological advancement. For instance;

- The items imported in electrical machinery group include electric and telephone cables, electric appliances switches, etc. The import of these items constituted around 28 percent share of total electrical machinery imports during FY08. ⁴⁷The large scale domestic production of these products can reduce import dependence.
- The needs of power generating machinery can also be met by domestic production. This belief is also strengthened by the decision of the government to disallow import of power generating machinery at concessional duties for the power plants achieving financial closure after April 2008.
- Similarly the surge in telecommunication machinery imports can be controlled by developing domestic manufacturing base for these goods. This can be done by attracting FDI in this sector. One way of accomplishing this objective might be to provide incentives to the foreign telecommunication companies already operating in Pakistan to develop manufacturing base for their products in Pakistan. In this way the transfer of technology will help in not only controlling pressure on imports but will also help in diversifying country's manufacturing base. The need is to enforce such measures in true spirits.

The imposition of direct and indirect controls is a difficult policy solution owing to the focus of WTO on trade liberalization. Therefore, this measure cannot be adopted on a long term basis. In this scenario the forth option of expansion of domestic engineering goods sector appears to be more realistic. However, this is also a long term solution and its usefulness depends on effective policy formulation and implementation.

⁴⁶ In case of international oil prices the impact of increase is felt on import unit values with a lag of one to three months.

⁴⁷ This percentage is based on SBP data for Jul-April FY08.

Table 7.25 : Major Imports

million US dollar

		FY07		FY08(P)		Abs.Δ in value	% YoY Δ		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
A Food group		2711.7		4209.6		1495.8		55.2	
<i>of which</i>									
Wheat un-milled	MT	41.5	305.4	852.3	489.1	810.8	1182.2	1953.1	60.1
Palm oil	MT	891.7	531.5	1614.8	919.3	720.9	4.7	81.1	73.0
B Machinery group		6605.8		7359.9		754.1	-	11.4	-
<i>of which</i>									
Power generating machinery	-	706.3		1177.0		470.7	-	66.6	-
Textile machinery	-	502.9		438.5		-64.4	-	-12.8	-
Construction and mining machinery	-	222.0		260.7		38.7	-	17.4	-
Telecom	-	2153.1		2239.9		86.8	-	4.0	-
C Transport group		2364.0		2212.7		-151.3	-	-6.4	-
<i>of which</i>									
Road motor vehicles	-	1405.4		1329.3		-76.1	-	-5.4	-
Air crafts, ships and boats	-	921.4		858.0		-63.4	-	-6.9	-
D Petroleum group		7339.8		11465.0		4125.2	13.9	55.1	38.8
Petroleum products	MT	3733.3	435.1	6240.5	598.4	2507.2	22.2	67.2	37.6
Petroleum crude	MT	3606.5	439.4	5222.0	617.2	1615.5	5.2	44.8	40.5
E Textile group		1566		2335.7		769.7	-	49.1	-
<i>of which</i>									
Raw cotton	MT	643.0	1414.8	1291.3	1544.1	648.3	94.9	100.8	9.1
F Agricultural and other chemical group		4385.4		5801.5		1416.1	-	32.3	-
<i>Of which</i>									
Fertilizer manufactured	MT	447.0	311.1	889.4	432.7	442.5	43.0	99.0	41.3
Other chemicals	-	2262.7	---	2970.1	---	707.5		31.3	
G Metal group		2598.3		2656.4		58.2	-	2.2	-
<i>of which</i>									
Iron and steel scrap	MT	365.9	264.4	626.2	289.2	260.2	46.9	71.1	9.4
H Miscellaneous group		654.6		729.4		74.7	-	11.4	-
I All other items		2327.0		3195.4		868.3	-	37.3	-
Total imports		30539.8		39965.5		9425.8	-	30.9	-