6 External Sector

6.1 Balance of Payments [1]

A sharply reduced current account surplus, and a widening financial account deficit, easily offset the impact of a one-off surge in the capital account surplus. This dragged down Pakistan's overall external balance into a deficit of US$ 559 million during Q1-FY05, in sharp contrast to the surplus of US$ 578 million recorded in Q1-FY04 (see **Table 6.1**).

The 89 percent YoY fall in the current account surplus during Q1-FY05 owes to (1) a sharp reduction in non-structural flows; and (2) increasing imports mainly reflecting the accelerating aggregate demand in the domestic economy as well as high international commodity prices (especially oil prices).

Table 6.1: Summary Balance of Payments (Jul-Sep)
million US Dollars

Items	FY04	FY05
Current account balance	1,117	124
Capital account (net)	17	521
Financial account (net)	-673	-1,097
Errors & omissions (net)	117	-107
Overall balance	**578**	**-559**
Reserves and related items	-578	559
Reserve assets	-578	559
SDR	5	3
Foreign exchange (SBP)	-578	271
Foreign exchange (DMB)	136	137
Use of fund credit and loans	-141	148
Exceptional financing	0	0

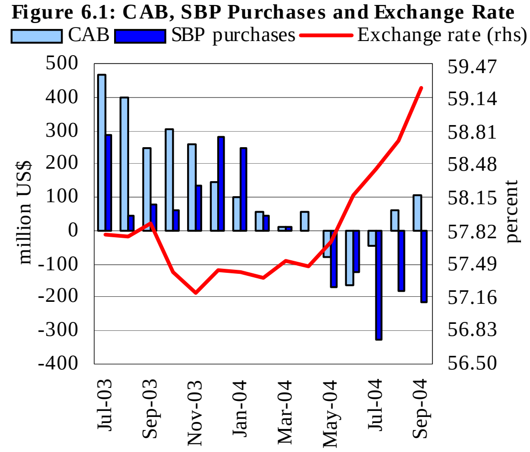
Interestingly, the worsening of the net financial account deficit as well as the large rise in the capital account surplus, both reflect the impact of a US$ 495 million debt relief by the USA.[2] In fact, adjusting for this one-off flow, it becomes clear that the capital account surplus drops a mere US$ 26 million (in line with trends in previous quarters), while the net financial account deficits also sees a 25.4 percent YoY decline.[3] In other words, the deterioration in the Q1-FY05 external balance can be attributed entirely to the sharp YoY decline in the current account balance.

[1] The figures of the current account and the capital account may not tally with the ones reported in earlier quarterly reports due to the revision in the BOP data and change in format following the implementation of 5th edition of the IMF's manual (for more discussion, see *SBP's Annual Report for FY04*).
[2] This adjustment led to a notional inflow into the capital account, with a countervailing outflow of the same amount under the financial head.
[3] The improvement in the Q1-FY05 financial account become even more visible after adjusting for yet another one-off payments – the termination of a US$ 100 million forex swap by PARCO to pre-pay external debt.

It is important to note here that for a developing economy such as Pakistan the emergence of small current account deficit is not a source of concern as long as these are caused by rising imports of machinery and raw materials in order to increase the productive capacity of the economy. Furthermore, it seems likely that the pressure on the current account would be expected to lessen somewhat in the near future as international oil prices retreat from all-time highs.

The weakening current account inflows exacerbated fears of a sharp decline of the Rupee, adding to pressure on the domestic currency. In particular, the retirement of FE-25 foreign currency loans accelerated and forward booking by the importers increased during Q1-FY05, raising incentives for the deferral of forex inflows by exporters. Thus, in order to stabilize the exchange rate, and prevent self-fulfilling pressures on the Rupee, the SBP quietly increased its net injections into the forex market (see **Figure 6.1**).

Figure 6.1: CAB, SBP Purchases and Exchange Rate



However, these interventions initially proved insufficient to end the pressure on the Rupee, and during July-October 2004 period the Rupee suffered a cumulative depreciation of 5 percent to reach Rs 61.2/US$ by end-October 2004. It eventually took a formal commitment by the SBP to provide foreign exchange for imports of key commodities such as oil, wheat and fertilizer, as well as administrative measures to discourage excessive speculation, before the Rupee recovered some of its losses.[4]

Significantly, the large market interventions by the SBP did not lead to an immediate fall in its foreign currency reserves during July-October 2004, as the impact of sales in the inter-bank market was offset by fresh inflows into its reserves. However, if oil prices remain high necessitating significant further foreign exchange support by the SBP, it is clear that SBP reserves will gradually decline in months ahead. This is not necessarily negative, as long as the central bank uses its reserves only to mitigate *excessive* volatility on the domestic

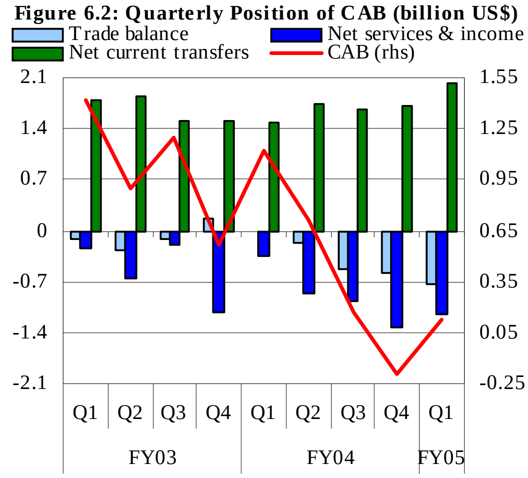
[4] As a result, by mid-December 2004, the Rupee saw accumulated depreciation of 2.6 percent.

currency, and to allow the domestic economy time to adjust to the changing external account environment. It would however, not be desirable to use its forex reserves to artificially peg the domestic currency to an uneconomic exchange rate. The SBP is quite conscious of its responsibility to strike this balance.

6.1.1 Current Account

Cumulatively, during Q1-FY05 the current account witnessed a surplus of US$ 124 million; however, this was significantly (89 percent) lower as compared to the corresponding quarter of last year (see **Table 6.2**). The deterioration was evident in almost all major heads of the current account other than current transfers (see **Figure 6.2**). This worsening in the current account was mainly due to: (1) higher imports and shipment freight charges; (2) increased net income outflows; and (3) lower receipts of payments for logistic support. These were partially offset by a relatively modest increase in exports and a sharp jump in current transfers.

Figure 6.2: Quarterly Position of CAB (billion US$)



The rise in outflows under *other business services* and *travel* has no significant net impact on the balance of payments. It only reflects a better coverage of the current account transactions as a result of bringing transaction of Exchange Companies carried out under the services head in the official account. This is because the bulk of these outflows represent transactions routed through the Foreign Exchange Companies (FECs); the

Figure 6.3: Quarterly Position of CAB

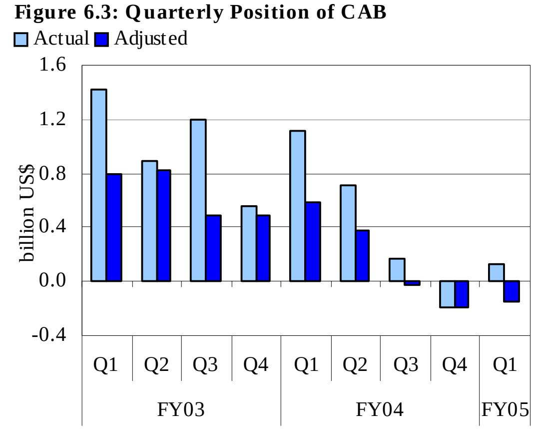


Table 6.2: Current Account Balance
million US Dollars

Items	Q1-FY04	Q1-FY05	YoY change
1. Trade balance	**-2**	**-747**	**-745**
Exports	3,037	3,430	393
Imports	3,039	4,177	1,138
Of which: mineral fuels, oils & their products	541	906	365
2.Services (net)	**53**	**-618**	**-671**
Transportation	-190	-315	-125
Travel	-171	-233	-62
Communication services	68	60	-8
Other business services	-19	-385	-366
Government services	406	317	-89
Of which logistic support	384	280	-104
Other	-41	-62	-21
3. Income (net)	**-411**	**-528**	**-117**
Investment income (net)	-411	-528	-117
Direct investment	-214	-346	-132
Of which: profit & dividend	-61	-80	-19
Purchase of crude oil & gas	-99	-196	-97
Portfolio investment	-35	-25	10
Of which: profit & dividend	-20	-5	15
IMF charges & interest on off. external debt	-118	-152	-34
Interest on private external debt	-45	-23	22
Others	1	18	17
4. Current transfers (net)	**1,477**	**2,017**	**540**
Private transfers	1,279	2,008	729
Workers remittance	906	983	77
FCA – residents	45	163	118
Others	328	862	534
Official transfers	198	9	-189
Saudi oil facility	147	0	-147
Cash grants	44	0	-44
Current Account Balance	**1,117**	**124**	**-993**

payments by FECs are completely matched by inflows into the current transfers, under *other private transfer*, mainly representing receipts of FECs.

It is important to note, that unlike the first quarter of last year, the non-structural flows were substantially lower in Q1-FY05. This fall in non-structural flows owed principally to the termination of Saudi Oil Facility (SOF). Interestingly, these lower non-structural flows played a pivotal role in the surplus recorded in Q1-FY05; adjusting for these, the current account balance turns into a deficit of US$ 156 million (see **Figure 6.3**).

6.1.1.1 Trade Balance[5]

During Q1-FY05, the '*exchange record'* data shows that the YoY growth in imports (37.4 percent) outpaced the export growth (12.9 percent), thus resulting in a sharp increase in trade deficit of US$ 745 million. The increase in imports continues mainly due to strengthening domestic demand (reflecting 38.7 percent increase in non-food non-oil imports) and petroleum products. The surge in non-food non-oil import primarily reflects the machinery import of 23 percent and the agricultural & chemical product of 43.4 percent. On the other hand, the import of petroleum product was 21.9 percent during the period under review. Both the prices (55 percent) and quantity (45 percent) are responsible for this surge in import of petroleum products (for details, see **Trade Account** sub section). The exceptional volume increase in imports of petroleum products needs to be verified, as it neither represents a movement along or around the past trends nor is consistent with elasticity estimates.

6.1.1.2 Services (Net)

The services account posted a sharp reversal from a net surplus of US$ 53 million in Q1-FY04 to a net deficit of US$ 618 million in Q1-FY05. The deterioration was entirely due to a sharp YoY rise of 83.2 percent in the payments, owing mainly to the higher outflow under *other business services*, *transportation* and *travel charges*. In addition, the lower inflows of logistic support of US$ 104 million compared to the same period last year further deteriorated the services head.

The pressure on the invisibles account due to the higher net outflow of transportation primarily reflects the shipment freight charges due to rising imports.[6] However, the substantial rise in the net outflow of other business services & travel charges primarily reflects the increased data coverage through the Foreign Exchange Companies (FECs).[7] During Q1-FY05, approximately 60

[5] This section is based on exchange record compiled by SBP that does not tally with more detailed custom data used in sub-section 6.2.
[6] The shipment freight charges include 8 percent on cash import and 15 percent on import under foreign economic assistance.
[7] As mentioned earlier, these transactions have no effect on the current account as the outflow routed through the FECs is equally offset by the contra-entry shown as an inflow under the private transfers.

percent of other business services and 85 percent of travel charges were financed by the FECs.

6.1.1.3 Income (Net)

The 28.5 percent YoY increase in investment income outflows in Q1-FY05 was registered due to: (1) the higher direct investment income outflows and (2) a rise in net interest payments. However, the increase in former was more pronounced than the latter. During Q1-FY05, the net income outflow under direct investment went up by 61.7 percent compared to the corresponding period of FY04 largely because:

(1) The higher profit outflow of the foreign banks. This appears to reflect the high earnings of foreign banks operating in Pakistan during January-September 2004 relative to the corresponding period of 2003, and possibly the expectations of a Rupee depreciation (raising the incentive to repatriate profits);

(2) The jump in the outflows under *purchase of crude oil/gas*[8] largely reflects the higher purchase of gas. During Q1-FY05, the purchase of gas was approximately US$ 110 million due to both increased production as well as higher prices (these are indexed to international oil prices). Further, with the higher international oil prices, the remittances on account of crude oil also increased during Q1-FY05 despite a small decline in output as compared to the same period of FY04 (see **Table 6.3**).

Table 6.3: Details of Direct Investment Income during Jul-Sep (Profit & Dividend)

million US Dollars

Item	FY04	FY05
Cash payments	**160**	**276**
Profit	10	52
Dividend	52	28
Purchase of crude oil/gas	99	196

Finally, the net interest outflows rose by US$ 6 million in Q1-FY05 over the same quarter of FY04 (see **Table 6.4**), primarily reflecting: (1) the higher international interest rates;[9] and (2) a one-off US$ 65.4 million payment of accrued interest on a restructured long term official loan to JBIC.[10]

[8] The purchase of crude oil/gas reflects the amount of crude oil/gas extracted by the foreign companies operating within the country, which are bound to sale certain amount to the government of Pakistan. The purchase of crude oil/gas do not form part of cash imports.

[9] Most of the Pakistan's floating rate loans are pegged to LIBOR, and average LIBOR in Q1-FY05 was higher than the Q1-FY04.

6.1.1.4 Current Transfers

Contrary to public expectations following the termination of the Saudi Oil Facility, current transfers registered a 36.6 percent YoY rise during Q1-FY05. This owed to (1) higher worker remittances, (2) a significant increase in FCAs and, (3) a rise in other private transfers.[11]

Table 6.4: Details of Interest Payments and Receipts (Q1)

million US Dollars

	FY04	FY05	Savings
Payments (I+II)	**213**	**225**	**-12**
I. Total external debt	164	192	-28
Public & publicly guaranteed	113	165	-52
Long-term	96	135	-39
Military	13	11	2
Euro bonds	1	17	-16
Commercial loans/credits	2	2	0
IDB	1	0	1
Private loans/credits	45	23	22
IMF	6	4	2
II. External liabilities	49	33	16
Foreign currency deposits	7	3	4
Special US$ bonds	6	9	-3
Central bank deposits	6	6	0
Others	30	15	15
Receipts	**35**	**41**	**6**
Interest on reserves	25	26	1
Others	10	15	5
Net Payments	**-178**	**-184**	**-6**

Source: State Bank of Pakistan

Workers' Remittances[12]

Workers' remittances (cash) increased by 8.5 percent YoY to US$ 1316.0 million during July-Oct FY05 (see **Table 6.5**). Out of these, approximately US$ 96.6 million of workers' remittances were routed through FECs.

The surge in the absolute amount of remittances was primarily from the US and the UAE. However, the percentage growth in remittances shows increased receipts from the Gulf States – this might be a reflection of boom in the economies of Gulf region on the back of higher oil production (a rise in international oil prices) – the monthly trend of remittances suggests that the workers' remittances may exceed the target level of US$ 3.5 billion for FY05.

[10] During Q1-FY05, Pakistan paid 80 percent of interest in respect of bilateral agreement signed between JBIC and Government of Pakistan. Under bilateral rescheduling agreement in December 2001, all interest payments falling between 30th November 2001 and 30th June 2002, and 20 percent of annual interest payments accrued on restructured debt for FY03 and FY04 were deferred.

[11] This head mainly reflects the increased receipts from the exchange companies.

[12] This section analyzes the data from July-October 2004.

Resident FCAs

The net inflows into resident FCAs increased by US$ 118 million during Q1-FY05 compared to Q1-FY04 (see **Table 6.2**). This rise in FCAs (which represents 262 percent YoY increase) is mainly due to the huge inflow in the deposits of a government institution in July 2004.

Interestingly, the monthly data shows a net withdrawal in 'US Dollar' deposits during September 2004 largely due to the massive withdrawals of deposits by one of the foreign banks operating in Pakistan.

Table 6.5: Workers' Remittances (Jul-Oct)

million US Dollars

	FY04	FY05	Growth rate
I. Gulf region	**538**	**586**	**8.8**
Bahrain	25	32	28.1
Kuwait	52	66	27.8
Qatar	28	33	19.2
Saudi Arabia	208	206	-1.3
Sultanat-e-Oman	32	35	9.6
U.A.E.	194	214	10.5
II. U.S.A.	**375**	**407**	**8.5**
III. Other than Gulf & US	**299**	**323**	**8.0**
Canada	6	13	101.7
Germany	21	18	-15.9
Japan	2	3	31.8
Norway	3	5	39.8
U.K.	103	116	12.5
Other	163	169	3.7
Total	**1212**	**1316**	**8.5**
of which: Exchange Companies	**44.8**	**96.6**	**115.5**
Encashment of FEBCs & FCBCs	**23**	**2**	**-91.0**
Grand total	**1,235**	**1,317.9**	**6.7**

6.1.2 Capital & Financial Account

6.1.2.1 Capital Account

The capital account comprises of receipt or payment of capital transfers (earlier in IMF 92 format, the figure was part of current transfers; whereas under the 5th edition of the IMF's balance of payments format, it is included in the capital account). During Q1-FY05, this head recorded a net inflow of US$ 521 million on account of US debt write-off (US$ 495 million) (see **Table 6.1**). [13]

6.1.2.2 Financial Account

The net financial account deficit recorded a growth of 63 percent YoY to reach US$ 1,097 during Q1-FY05 (see **Table 6.6**). However, adjusting for non-recurring factors,[14] the net financial account during the Q1-FY05 registered a lower deficit of US$ 502 million as against of US$ 673 million during Q1-FY04.

[13] The contra-entry of US debt write-off is shown in the financial account under the amortization of long-term official loans.

Table 6.6: Financial Account (Q1)

million US Dollars

Items	FY04	FY05	Abs. change
Financial Account (1 through 4)	**-673**	**-1,097**	-424
1. Direct investment abroad	**1**	**-22**	-23
2. Direct investment in Pakistan	**117**	**181**	64
of which: Equity Capital	71	105	34
Reinvested earning	46	76	30
3. Portfolio investment	**-54**	**-16**	38
of which: (Stock Markets)	-28	21	49
Special US Dollar Bonds	-16	-28	-12
Euro bonds	-2	-2	0
Net Foreign Investment	64	143	79
4. Other investment	**-737**	**-1,240**	-503
Assets	-404	-521	-117
i. Outstanding Exports Bills (Exporters)	-108	-25	83
ii. Outstanding Exports Bills (DMBs)	-27	-32	-5
iii. Currency & deposits	-269	-464	-195
of which: Bank	-192	-486	-294
Liabilities	-333	-719	-386
i. Foreign Long-term loans / credits (net)	-10	-287	-277
of which: Project Assistance	111	132	21
Food Aid	0	0	0
Non-Food Aid	126	330	204
Amortization	247	749	502
ii. Private loans	-106	-93	13
of which: Suppliers Credits/MNCs	58	10	-48
Supplier Credits Repayments	164	103	-61
iii. ST Capital, (official)	-52	100	152
of which: Commercial Banks (net)	-17	0	17
IDB (net)	-35	100	135
iv. Currency & deposits	-83	-261	-178
of which: Trade financing	-238	-355	-117
v. Other liabilities	-82	-178	-96
of which: FCAs (Non-Residents) DMBs	-27	-2	25
Other liabilities (DMBs)	0	-96	-96

Source: Statistics Department, SBP

The underlying factors for the improvement in financial account were (1) increased foreign direct investment; (2) higher disbursement of non-food aid; and (3) the net inflow of US$ 100 million of short-term loans during Q1-FY05 as against net outflow of US$ 52 million over the corresponding period last year.

Table 6.7: Foreign Direct Investment (July-Sep)
million US Dollars

	FY04	FY05
Food, beverages & tobacco	2	4
Textiles	5	11
Chemicals, pharmaceuticals & fertilizers	5	14
Petroleum refining	16	5
Power	5	19
Construction	6	9
Trade, transport, storage & communication	11	44
Financial business	8	3
Mining & quarrying-oil & gas explorations	45	43
Others	14	29
Total	**117**	**181**

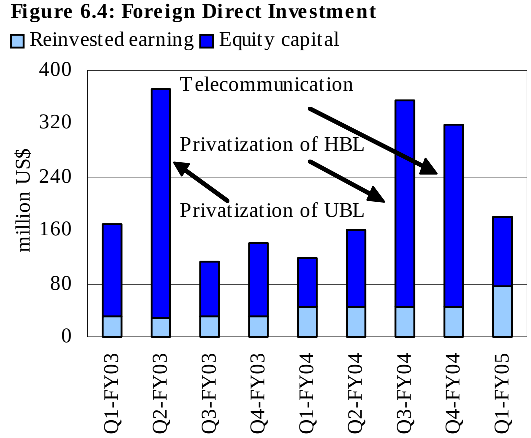
Net Foreign Investment

During Q1-FY05, the net foreign investment increased by US$ 79 million over Q1-FY04 to reach US$ 143 million. The increase was mainly due to the higher inflow of foreign direct investment (FDI - see **Table 6.7**). The 54.7 percent YoY rise in FDI during Q1-FY05 reflects the higher FDI in the telecommunications sector.

A further breakdown of the FDI flows reveals that the reinvested earning increased by US$ 30 million in Q1-FY05 over the corresponding quarter of FY04 (see **Figure 6.4**). The sectors witnessing higher reinvestments during Q1-FY05 includes *financial business* (US$ 22 million), *power sector* (US$ 14.8 million), *oil & gas exploration* (US$ 9.3 million), and *pharmaceutical sector* (US$ 6.9 million).

A breakdown of FDI (equity capital) by economic groups reflects higher FDI in telecommunication, oil & gas exploration, textile and trade. Specifically, the bulk of investment registered in telecommunication sector reflects the investment of US$ 10.8 million and US$ 7.1 million from Netherlands and USA respectively.

Figure 6.4: Foreign Direct Investment



On the other hand, the net outflow under portfolio investment declined mainly due to the reversal in stock market from net outflow of US$ 28 million in Q1-FY04 to net inflow of US$ 21 million during Q1-FY05.

Outstanding Export Bills (OEBs)

During Q1-FY05 the stock of OEBs held by the commercial banks and exporters increased by US$ 57 million (see **Figure 6.5**). The increase in the OEBs appears simply to reflect the rise in exports.

Interestingly, the share of *overdue* export bills in total OEBs (exporters) has increased during Q1-FY05. This could potentially reflect the significant Rupee depreciation during the period under review, which created an incentive to defer repatriation of revenues (see **Figure 6.6**).

Figure 6.5: Outstanding Export Bills (stocks)

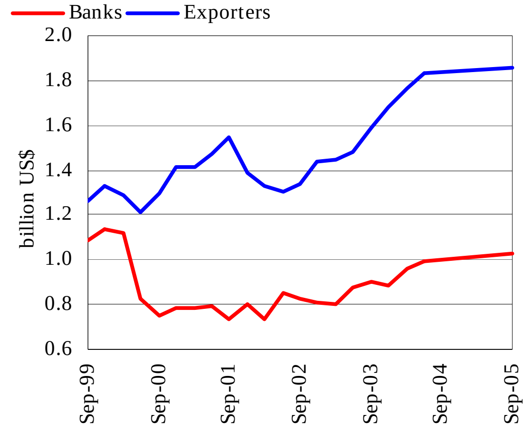
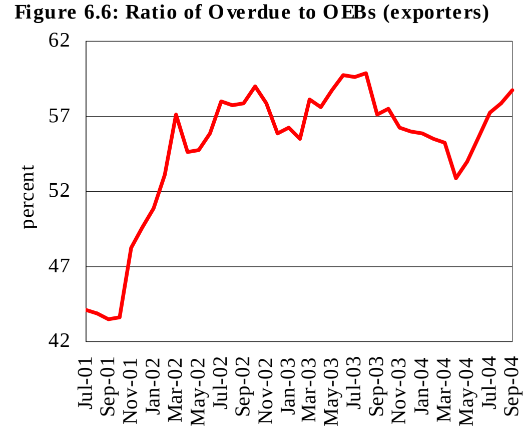


Figure 6.6: Ratio of Overdue to OEBs (exporters)



Currency and Deposits

This head comprises of currency and deposits held by monetary authorities, general government, commercial banks and other sectors. In aggregate, the *currency and deposits* assets recorded an increase of US$ 195 million in Q1-FY05 over Q1-FY04. This increase caused principally to a rise in banks' FE-25 Nostro holdings by US$ 294 million to US$ 486 million during the period. The rise in foreign currency accounts as well as the net retirement of trade financing loans extended from these deposits (increasing FE-25 reserves of banks) during Q1-FY05 explains this increase.

Foreign Long-term Loans

The long-term official loans registered a net outflow of US$ 287 million during Q1-FY05, primarily due to the contra-entry of US$ 495 million of US debt write-off. Adjusting for this notional outflow, the long-term loans depict a net inflow of US$ 208 million, in contrast to the net outflow of US$ 10 million in Q1-FY04. Higher disbursements of non-food aid (by US$ 330 million) during Q1-FY05, more than offset the outflows due to amortization in the same period. The non-food aid jumped because of a US$ 300 million disbursement by the World Bank in September 2004 for the Poverty Reduction Support Program.

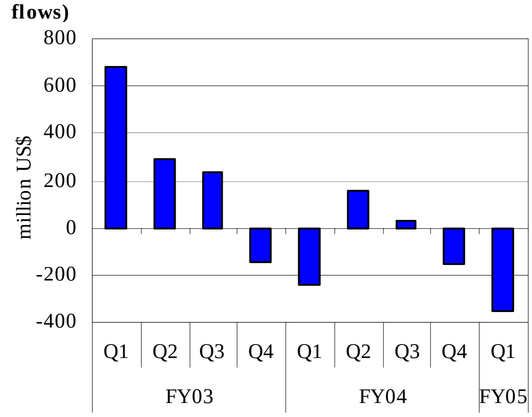
Short-term Loans

In contrast to Q1-FY04, the first quarter of FY05 saw a net inflow of US$ 100 million in short-term loans arising from net disbursement of IDB financing for oil import. In contrast, net outflow of US$ 35 million took place in Q1-FY04 (when the country's oil payments were lower and the current account was in surplus).

FE-25 Related Trade Financing* and *Other Liabilities

The net retirements of foreign trade loan accelerated in Q1-FY05, as the weakening Rupee and rising international interest rates rendered these unattractive to Pakistani traders (see **Figure 6.7**). The consequent drain on the forex market as traders purchased forex to pay off these loans augmented the short-term pressure on the Rupee.

Figure 6.7: Foreign Currency Loans (quarterly flows)

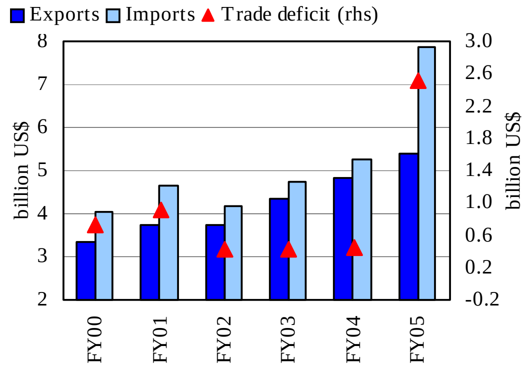


Finally, the sharp increase in net outflows of other liabilities during Q1-FY05 reflects the settlement of foreign currency loans arranged by the (US$ 100 million) commercial banks in Q4-FY04 to repay PARCO loans.

6.2 Foreign Trade[1]

Provisional figures show that the trade deficit rose steeply during July-November FY05 to reach US$ 2.5 billion, as compared to a mere US$ 0.4 billion in July-November FY04. As evident from **Figure 6.8**, this deterioration appears to stem almost entirely from an exceptional 49.3 percent YoY rise in July-November FY05 imports, which comfortably outstripped the continued strong 11.1 percent YoY growth in exports during the same period.

Figure 6.8: Trade Account (Jul-Nov)



In fact, the trade deficit had begun to widen significantly during the latter half of FY04, amidst a general rise in imports as economic activities accelerated, and international oil prices rose strongly; approximately two thirds of the total FY04 imports were recorded in the last four months of the year. This trend appears to be continuing into FY05, with the July-November imports already at 47.2 percent of the US$ 16.7 billion annual import target. This suggests that the FY05 import bill is likely to be significantly higher than anticipated as the oil imports will be considerably higher compared to FY04. The reason for this extremely abnormal rise in imports needs to be further investigated particularly in the context of import volume of oil products. This does not make sense either on the basis of elasticity estimates or historical trends of consumption.

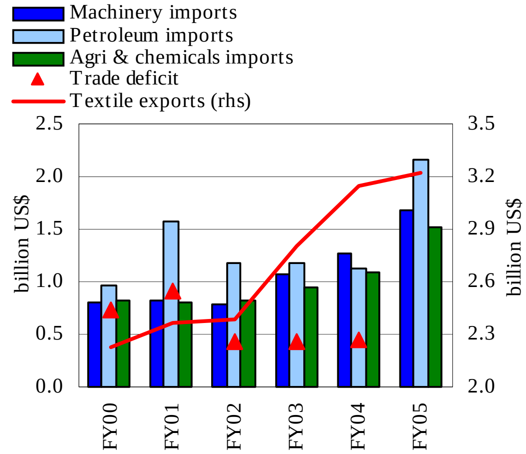
The exceptional growth in imports, by itself, is not a cause for alarm given that the current account remains in surplus, and that a substantial portion of the rise in

[1] This analysis does not include discussion on direction of trade due to unavailability of data for this period. It may be pointed out that the detailed analysis of trade performance is based on the data provided by the FBS that used to compile these numbers directly from the Goods Declaration (GD) forms filled by exporters and importers. However, this process has been recently changed and now Pakistan Revenue Automation Limited (PRAL) provides the data to FBS after compiling it from GD forms. This additional layer in the data generation process has led to considerable delays in the finalization of trade numbers and raises serious questions about the reliability and accuracy of the reported data under the new arrangements. Therefore, FBS has so far provided *final* data for the months of only Jul-04 and Aug-04, whereas detailed country-wise data is still not available for the purpose of analysis.

imports is on account of machinery and other inputs for industry and agriculture (see **Figure 6.9**).

However, the import profile does highlight two areas where significant structural improvements may be possible in the medium term: (1) the substantial share of petroleum products in the oil bill underscores the need to understand the sources of this higher consumption; and similarly (2) the large food imports (especially of edible oil, wheat[2] and milk) could be curtailed by raising domestic production through appropriate supportive policies.

Figure 6.9: Causative Factors of Trade Deficit (Jul-Nov)



Of greater immediate concern is the export performance, as the aggregate July-November FY05 exports are marginally lower than the FY05 target set for this period. A closer look at the provisional trade data reveals an apparent deceleration in textile exports.[3] Also, with effect from January 1, 2005, Pakistan's textile exports will face a more competitive trading environment, as the end of the *Agreement on Textile and Clothing* removes access restrictions (quotas) to key Western markets (see **Box 6.1**).

6.2.1 Exports

Exports reached US$ 5.4 billion during July-November FY05, recording 11.1 percent rise over the same period last year (see **Table 6.8)**, which is 0.9 percent lower than the export target set for the period. The analysis of monthly export performance reveals that the sharp fall in the exports of October & November FY05 is largely responsible for the shortfall in exports against the target for the period (see **Figure 6.10**).

[2] A case in point is the relatively low prices on offer to domestic wheat producers relative to effective import price for the commodity.
[3] Unfortunately, in the absence of detailed trade data, these trends cannot be properly analyzed at present.

Table 6.8: Major Exports (Jul-Nov)

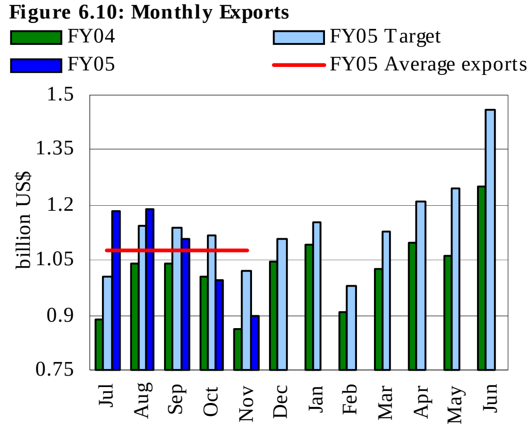
value: million US Dollars; unit value: US Dollars

			FY04		FY05			% YoY change		
		Unit	Value	Unit value	Value	Unit value	Abs chg. in value	Qty	Value	Unit value
A.	**Primary Commodities**		**514.5**		**500.4**		**-14.1**		**-2.7**	
1	Rice	MT	251.8	342.6	255.4	359.6	3.5	-3.4	1.4	4.9
2	Raw cotton	MT	19.2	1209.7	29.3	1208.9	10.1	52.8	52.7	-0.1
3	Raw wool (excluding wool tops)	MT	0.8	963.7	0.1	1.3	-0.7	7625.5	-89.9	-99.9
4	Fish & fish preparations	MT	76.1	1806.9	54.2	1302.0	-21.9	-1.1	-28.7	-27.9
5	Leather	SQM	95.4	15.9	103.1	16.1	7.7	7.0	8.1	1.1
6	Guar and guar Products	MT	8.4	901.1	3.8	841.5	-4.6	-52.0	-55.2	-6.6
7	Fruits	MT	38.9	365.5	29.3	317.3	-9.6	-13.2	-24.7	-13.2
8	Vegetables	MT	10.9	192.4	9.9	231.6	-1.0	-24.6	-9.2	20.4
9	Crude animal material	MT	5.8	1569.4	2.8	3400.3	-3.0	-77.7	-51.7	116.7
10	Oil seeds & nuts etc.	MT	1.4	597.7	12.6	478.6	11.3	1054.6	824.4	-19.9
11	Wheat	MT	6.0	140.1	0.0	0.0	-6.0	-100.0	-100.0	---
B.	**Textile manufactures**		**3,141.5**		**3,216.5**		**74.9**		**2.4**	
12	Cotton yarn	MT	386.6	1988.5	366.6	2172.0	-20.0	-13.2	-5.2	9.2
13	Cotton fabrics (woven)	SQM	610.1	0.7	673.1	0.7	63.0	5.5	10.3	4.6
14	Hosiery (knitwear)	DOZ	577.5	22.6	888.8	23.9	311.3	45.5	53.9	5.7
15	Bed wear	MT	552.3	5622.0	395.3	5456.5	-157.0	-26.2	-28.4	-2.9
16	Towels	MT	141.6	3927.4	166.7	3801.4	25.1	21.6	17.7	-3.2
17	Cotton bags and sacks	MT	5.7	4111.7	2.8	3956.6	-2.9	-48.7	-50.7	-3.8
18	Readymade garments	DOZ	415.5	36.5	394.8	36.3	-20.6	-4.5	-5.0	-0.5
19	Tarpaulin & other canvas goods	MT	26.4	2126.4	13.2	2829.7	-13.3	-62.6	-50.2	33.1
20	Tule, lace, embroidery etc.	---	3.8	---	1.8	---	-2.0	---	-53.2	---
21	Synthetic textiles	SQM	240.7	0.7	111.4	0.7	-129.3	-52.8	-53.7	-2.0
22	Other textile made up	---	178.0	---	200.9	---	23.0	---	12.9	---
23	Waste material of textile fibres/fabrics	MT	3.2	530.6	0.9	544.6	-2.3	-73.5	-72.8	2.6
C.	**Other manufactures**		**717.6**		**639.1**		**-78.6**		**-10.9**	
24	Carpets, carpeting rugs & mats	SQM	91.8	54.4	86.9	59.3	-4.9	-13.2	-5.3	9.1
25	Petroleum and petroleum products	MT	99.2	257.1	75.6	342.3	-23.7	-42.8	-23.9	33.1
26	Sports goods	---	122.1	---	112.4	---	-9.7	---	-8.0	---
27	Leather manufactures	---	195.5	---	154.8	---	-40.8	---	-20.9	---
28	Surgical & medical instruments	No	52.9	---	41.1	---	-11.8	---	-22.3	---
29	Cutlery	Gr	12.8	33.5	5.8	24.1	-7.0	-37.0	-54.6	-28.0
30	Onyx manufactured	MT	5.3	1778.9	4.6	1740.8	-0.6	-10.0	-11.9	-2.1
31	Chemicals and pharmaceuticals	---	110.5	---	118.9	---	8.4	---	7.6	---
32	Molasses	MT	14.1	29.2	36.0	50.2	21.9	48.6	155.1	71.6
33	Sugar	MT	13.3	221.3	3.0	237.2	-10.3	-79.2	-77.7	7.2
D.	**Others**		**462.3**		**1016.9**		**554.7**		**120.0**	
	Total exports		**4,835.9**		**5,372.9**		**537.0**		**11.1**	

Note: Figures are separately rounded off.

This below-target aggregate export performance is attributable to the deceleration in the textile export growth during this period. It is worth noting, however, that since the data set used in the analysis contains final numbers only for the months of July and August FY05, there is a possibility of an upward revision of export values once the final data for the remaining months is available.

Figure 6.10: Monthly Exports

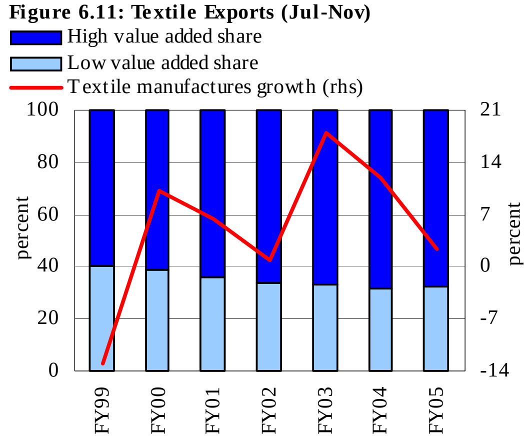


One bright spot in the export performance is the rising exports of some *developmental export* categories especially chemicals & pharmaceuticals and engineering goods as well as *other manufactures* namely molasses and articles of plastic. The rise in these exports in particular, probably reflects the supportive measures by the government in recent years aimed at providing better incentives to exporters of non-traditional items (see **Box 6.2**).

Textile Exports

Textile export growth slowed down mainly due to a steep fall in the bed wear and synthetic textile exports during Jul- Nov FY05 period.[4] Also the share of textiles in total export earnings fell to 59.9 percent during this period as compared to 65 percent in the comparable period of the last year (see **Figure 6.11**).

Figure 6.11: Textile Exports (Jul-Nov)

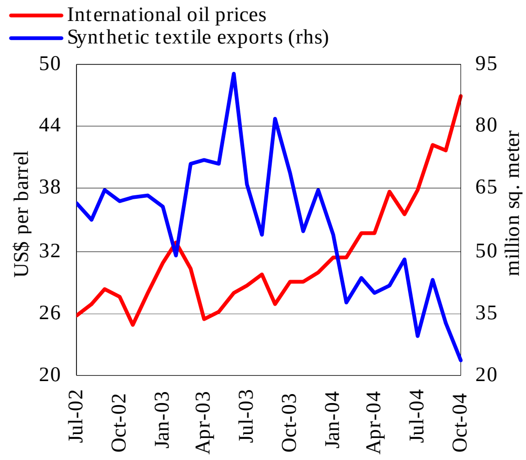


[4] The textile exports at US$ 3.2 billion recorded 2.4 percent YoY growth during July-November FY05 compared to 11.8 percent growth witnessed during same period last year.

The weakness in the performance of *bed wear exports* might be attributable to two reasons: (1) Imposition of antidumping duty on this category by the EU; and (2) the Embargo imposed by the US on bed wear exports in mid November 2004 due to over-shipments in this category.

On the other hand, *synthetic textile exports* are affected by a steep rise in the price of polyester staple fiber due to rising international oil prices since April 2003 (see **Figure 6.12**). In this connection, the downward revision of duty drawback by CBR on polyester staple fiber has added to the concerns of the textile industry.

Figure 6.12: Synthetic Textile Exports



On the positive side, however, knitwear exports reached record high level of US$ 888.8 million during July-November FY05, followed by cotton fabrics exports, which recorded 10.3 percent growth reaching U$ 673.1 million. The improvement in these categories came both from rising prices and quantum (see **Figure 6.13**). In this connection, the increase in unit prices of these categories despite a steep fall in the international cotton prices hints at higher value addition.

Quota Exports

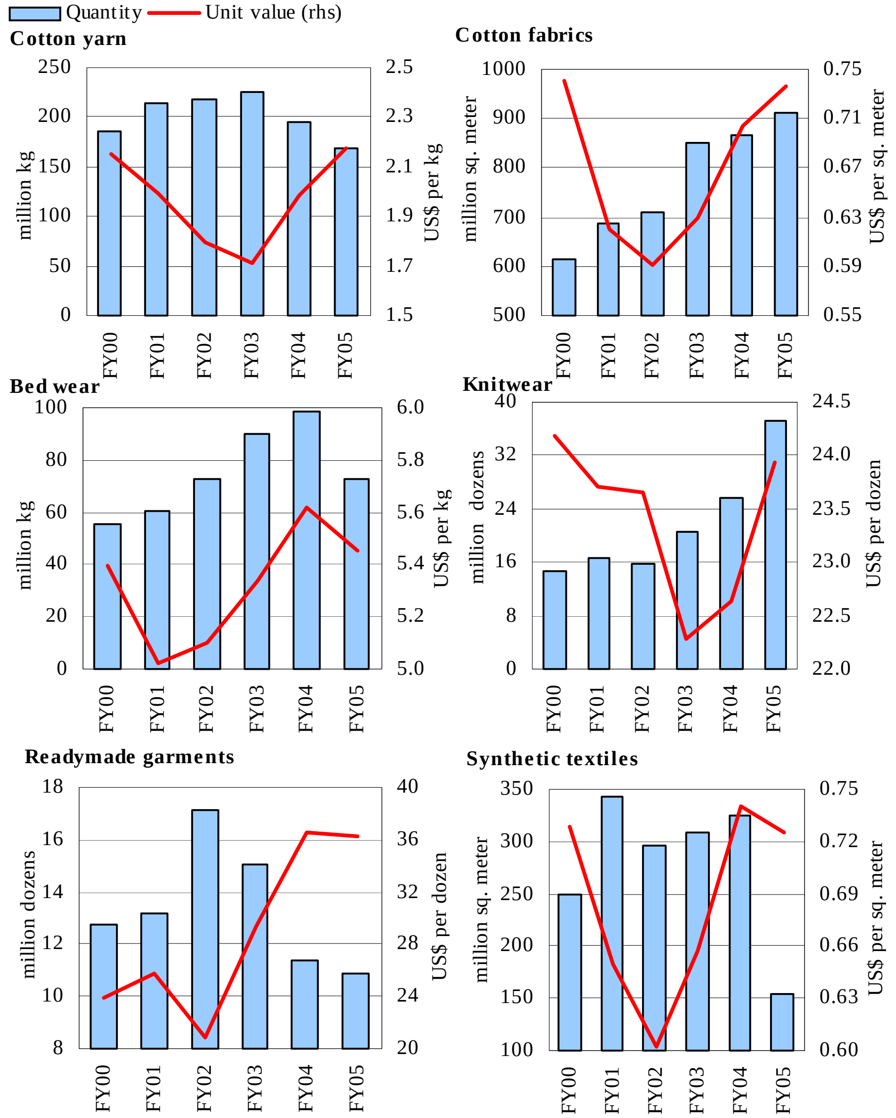
The share of quota exports in total rose from 39.2 percent in Q1-FY04 to 44 percent in Q1-FY05 (see **Table 6.9**). This rise came from higher growth in quota exports to the US and the EU, with the latter having larger share on account of increased exports of cotton fabric to this region.

Table 6.9: Textile Exports-Q1

Value: million US Dollars; Growth: percent

	FY04	FY05	Growth
Non-quota exports	**1,216.9**	**1,172.3**	**-3.7**
Quota exports	**783.6**	**920.0**	**17.4**
USA	363.2	429.6	18.3
EU	376.1	457.6	21.7
Turkey	31.6	16.1	-49.0
Canada	12.8	16.7	30.5

Figure 6.13 : Major Textile Manufactures- Export Quantum and Unit Prices (Jul-Nov)



However, the real test for country's textile exports would come after the implementation of the last phase of the Agreement on Textile and Clothing (ATC).[5] The impact of liberalization of textile trade so far is not very significant for Pakistan as the integrated categories account for only a small share in country's total textile exports.[6] This poses a difficult challenge for the textile sector as almost entire phasing out of the remaining quota restriction affecting Pakistan would take place in the final year leaving less time for Pakistan's textile sector to adjust to the new environment.

However, Pakistan already enjoys a strong position in bed wear and cotton fabric exports to USA, whereas its share in knitwear exports is gradually improving. In the EU market, knitwear, cotton fabric and bed wear are important export categories (see **Box 6.3**). Keeping in view country's current encouraging performance in the major markets of EU and the US, Pakistan is expected to maintain its present status of a large textile and clothing supplier in the international market despite facing tough competition from China and India.

A second opportunity available to Pakistan lies in the relocation of textile manufacturing units from industrial to developing countries in order to take advantage of lower production cost. Since Pakistan is world's fourth largest cotton producer after China, the US and India, it can be considered as a country of choice by some of the big foreign textile producers. Realizing this opportunity, government has already announced certain incentives in the trade policy for FY04 (see **Box 6.1**). Despite these strengths, country's textile sector is also faced with certain issues in the post liberalization era.

Preferential Access

In the absence of quota restrictions, countries having preferential access to the big markets seem likely to be the largest gainers. It may be pointed out here that most of the developing countries enjoy such preferences either under GSP (from EU) or in the context of free trade agreements (FTA). For example, in case of the US market, African and the Caribbean counties have zero duty access under the Trade Partnership Act.[7] Pakistan also enjoyed zero duty access to the EU market (from

[5] The ATC envisaged removal of textile quotas in four stages over a period of ten years from 1994-2005. However, this process is heavily back-loaded, as in the first three stages so far 51 percent textile trade have been liberalized, whereas the remaining 49 percent was left to be integrated in the final stage. This is to be effective from January 1, 2005.

[6] The major categories liberalized in the period of last four years were bathrobes, bar mops, woven gloves and flat dishtowels that capture almost negligible share in country's total textile exports.

[7] The Trade Partnership Act includes African Growth and Opportunity Act (AGOA) for the sub-Saharan Africa and Caribbean Basin Trade Partnership Act (CBTPA) for the Caribbean countries. The AGOA provides duty free access to apparel imports from LDCs in the sub Saharan Africa

2002) under the GSP scheme, which helped a long way in enhancing exports to this country.

However, from January 1, 2005 this concession would be withdrawn and an average tariff rate of 12.5 percent would be imposed on the textile and clothing imports from Pakistan. But in October 2004, the European commission proposed a simpler method of trade preferences for the period 2006-08 under which the current five GSP arrangements would be reduced to three:[8,9]

- A general arrangement (reduction of 3.5% over the normal customs duty for sensitive products, reduction of duties to zero for non-sensitive products);
- "Everything but Arms", giving duty-free and quota free access for all products for the world's 50 poorest countries;[10]
- A new "GSP+" giving tariffs preferences to vulnerable countries that meet the new objective criteria for sustainable development and good governance (this arrangement offers zero duty for a total of 7200 products);

Pakistan can be a beneficiary from GSP+ scheme, subject to the fulfillment of the condition that the beneficiary country have less than 1 percent share in EU imports under GSP.

Antidumping Duties

Another issue is the increasing trend in the developed countries (such as Australia, Canada, the EU and the US) to impose antidumping duties so that they could not only restrict their import levels but also provide implicit protection to their domestic industries. As a matter of fact, under WTO an importing country can impose an antidumping duty if there is a proof that dumping is occurring and it is causing injury to the local firms. Since the use of this measure is not always fair, there is a need to make this procedure more transparent. Currently Pakistan is

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regardless of the origin of the fabric and yarn used in the production process. On the other hand, under the CBTPA, duty free access is accorded to the apparel imports from the Caribbean countries that are assembled from the US fabric.

[8] Source: www.eu.int

[9] After adoption from European Council, European parliament and Economic and Social Committee, this modification will become effective from July 1, 2005.

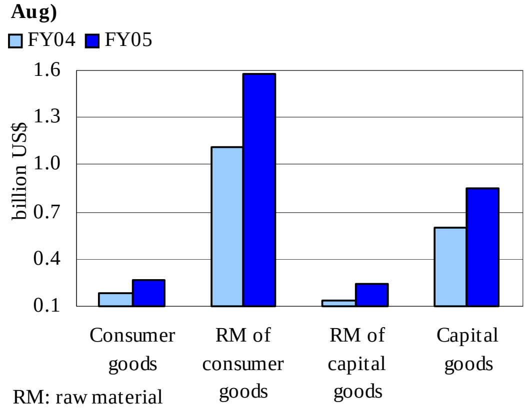
[10] Bangladesh, a major woven garments exporter, is already enjoying zero duty access under the Everything But Arms (EBA) initiative. On the other hand, textile and clothing imports from India bear a concessional rate of duty at 9.92 percent.

facing antidumping duty on one of its major textile export category i.e. bed wear, that has resulted in a steep fall in country's bed wear exports during Q1-FY05.

6.2.2 Imports

Imports recorded a sharp 49.3 percent rise during July-November FY05 reaching US$ 7.9 billion in this period (see **Table 6.10**). The highest share in this growth was contributed by raw materials for consumer goods – a category that includes petroleum imports – followed by capital good imports (see **Figure 6.14** and **Table 6.11**).

Figure 6.14: Economic Classification of Imports (Jul Aug)



RM: raw material

As discussed earlier, the surge in imports had begun during the latter half of FY04. This largely reflects acceleration in economic activity as well as an unusual increase in oil prices in the international market. The government had already announced several measures to support the domestic economic activity by ensuring uninterrupted availability of necessary raw materials and machinery to industries (see **Box 6.4).**

Consequently, imports of machinery and chemicals have made a significant contribution in overall import growth during July-November FY05. In addition, the increase in oil prices in the international market also led to a sharp jump in petroleum imports as well as in petroleum based products.

In fact, had the oil prices stayed at the FY04 levels, the oil import bill would have

Table 6.11: Contribution in Growth by Major Import Groups (Jul-Nov)

percent

	FY04		FY05	
	Growth	**Share in growth**	**Growth**	**Share in growth**
Food group	-6.3	-5.1	23.9	3.6
Machinery group.	18.4	37.5	32.2	15.7
Petroleum group	-4.5	-10.1	93.8	40.3
Textile group	12.5	2.2	28.1	1.1
Agriculture & chemical group	15.6	28.0	39.5	16.5
Metal group	31.8	11.4	52.9	5.0
Miscellaneous group	19.5	4.6	26.2	1.5
Others	22.3	31.5	46.6	16.2
Total	**11.1**	**100.0**	**49.3**	**100.0**

Table 6.10: Major Imports

Value: million US Dollar; Unit value: US Dollar

Sr. No.	Commodities	Unit	Jul-Nov-FY04 Value	Jul-Nov-FY04 Unit Value	Jul-Nov-FY05 Value	Jul-Nov-FY05 Unit Value	Abs chg. In value	%YoY change Qty	%YoY change Value	%YoY change Unit value
A.	**Food group**		**393.8**		**488.0**		**94.2**		**23.9**	
1.	Milk, cream & milk food for infants	MT	6.3	2,248.8	8.4	1,991.0	2.0	49.1	32.0	-11.5
2.	Wheat unmilled	MT	-	-	20.5	267.5	20.5	100.0	100.0	---
3.	Dry fruits	MT	2.3	279.8	13.9	482.5	11.6	245.4	495.6	72.4
4.	Tea	MT	71.8	1,600.2	84.8	1,669.6	13.0	13.1	18.1	4.3
5.	Spices	MT	14.1	503.2	21.2	795.8	7.1	-5.0	50.2	58.1
6.	Edible oil	MT	270.5	453.0	294.9	491.4	24.4	0.5	9.0	8.5
	Soya bean	MT	*15.5*	*547.9*	*21.8*	*699.6*	6.3	10.0	40.4	27.7
	Palm oil	MT	*255.0*	*448.3*	*273.2*	*480.1*	18.1	0.0	7.1	7.1
7.	Sugar	MT	1.1	305.2	1.1	297.2	0.1	9.0	6.1	-2.6
8.	Pulses	MT	27.5	281.8	43.0	316.1	15.5	39.2	56.2	12.2
B.	**Machinery group**	**---**	**1269.3**	**---**	**1,678.2**	**---**	**408.9**	**---**	**32.2**	**---**
1.	Power generating machinery	---	120.4	---	135.8	---	15.4	---	12.8	---
2.	Office machinery	---	83.1	---	85.8	---	2.7	---	3.2	---
3.	Textile machinery	---	197.5	---	329.0	---	131.5	---	66.6	---
4.	Construction & mining machinery	---	42.6	---	59.2	---	16.5	---	38.7	---
5.	Electrical machinery & apparatus	---	100.1	---	99.3	---	-0.8	---	-0.8	---
6.	Railway vehicles*	---	36.2	---	9.9	---	-26.2	---	-72.6	---
7.	Road Motor vehicles	---	247.6	---	312.9	---	65.3	---	26.4	---
8.	Aircraft, ships and boats	---	63.0	---	31.4	---	-31.6	---	-50.1	---
9.	Agricultural machinery & implements	---	8.3	---	15.6	---	7.3	---	87.9	---
10.	Other machinery	---	370.5	---	599.3	---	228.8	---	61.8	---
C.	**Petroleum group**	**MT**	**1119.9**	**214.9**	**2,169.9**	**253.5**	**1050.0**	**64.2**	**93.8**	**18.0**
1.	Petroleum products	MT	475.4	230.4	1,299.4	266.9	824.0	135.9	173.3	15.8
2.	Petroleum crude	MT	644.5	204.7	870.4	234.8	226.0	17.8	35.1	14.7
D.	**Textile group**	**MT**	**106.0**	**---**	**135.7**	**---**	**29.8**	**---**	**28.1**	**---**
1.	Synthetic fibre	MT	40.8	1432.7	61.5	1,809.8	20.7	19.4	50.8	26.3
2.	Synthetic & artificial silk yarn	MT	48.6	1619.4	58.0	1,765.5	9.4	9.5	19.4	9.0
3.	Worn clothing	MT	16.6	326.8	16.2	302.9	-0.4	5.6	-2.2	-7.3
E.	**Agricultural and other chemicals group**	**MT**	**1089.8**	**---**	**1,519.7**	**---**	**429.9**	**---**	**39.5**	**---**
1.	Fertilizer	MT	146.5	202.5	216.1	251.5	69.6	18.8	47.5	24.2
2.	Insecticides	MT	55.7	3002.4	88.2	3,077.3	32.5	54.5	58.3	2.5
3.	Plastic materials	MT	192.0	855.0	305.8	927.3	113.8	46.9	59.3	8.5
4.	Medicinal products	MT	106.9	27918.3	100.8	23,380.0	-6.1	12.6	-5.7	-16.3
5.	Others	---	588.7	---	808.9	---	220.2	---	37.4	---
F.	**Metal group**	**MT**	**247.8**	**---**	**378.9**	**---**	**131.1**	**---**	**52.9**	**---**
1.	Iron and steel scrap	MT	40.3	158.5	68.2	180.0	27.9	49.1	69.4	13.6
2.	Iron and steel	MT	179.1	385.4	276.3	438.8	97.1	35.5	54.2	13.8
3.	Aluminum wrought & worked	---	28.4	---	34.4	---	6.0	---	21.1	---
G.	**Miscellaneous group**		**146.8**	**---**	**185.3**	**---**	**38.5**	**---**	**26.2**	**---**
1.	Rubber crude	MT	28.7	875.5	37.0	1,095.1	8.3	3.2	29.0	25.1
2.	Rubber tyres & tubes	No.	35.8	20.7	53.9	22.5	18.1	38.5	50.7	8.9
3.	Wood & cork	---	8.1	---	12.0	---	4.0	---	49.5	---
4.	Jute	MT	13.4	239.0	10.1	262.4	-3.4	-31.8	-25.2	9.8
5.	Paper and paper board & manufactures	MT	60.8	594.7	72.2	616.4	11.4	14.6	18.7	3.6
H.	**Others**		**907.2**		**1330.0**		**422.7**	**---**	**46.6**	**---**
	Total imports:		**5280.5**		**7,885.5**		**2605.0**		**49.3**	

been lower than the present amount by US$ 330.5 million, thus lowering the trade deficit by 13.2 percent.

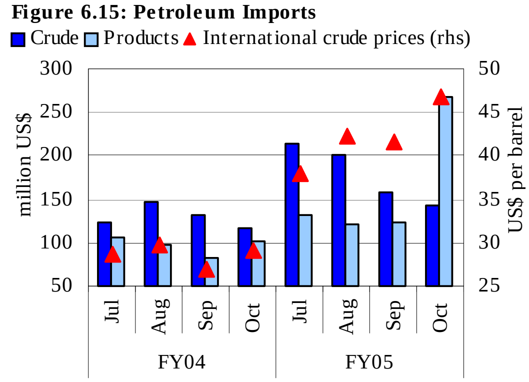
Keeping in view the rising trends in domestic economic activity, and the fact that the oil prices in the international market are still higher compared to the same period last year, the government envisaged 7.1 percent growth in imports over already high base of the last year. During the first five months of FY05, the import level was 47.2 percent of the total annual target set for this period.

Machinery Group recorded a 32.2 percent YoY rise during Jul- Nov FY05, with imports reaching the level of US$ 1.7 billion. The strongest growth in this category was recorded by textile machinery mainly reflecting the impact of various government incentives.[11] This was followed by import of road motor vehicles.

Within the road motor vehicles group, imports of motor vehicles with cylinder capacity of more than 1000cc witnessed the highest rise, followed by parts of motorcycles. In order to ease pressure on the prices of locally manufactured cars, government has announced reduction in the duty rates for the import of new cars.[12] This measure is expected to further increase automobile imports in coming months.

Petroleum Group imports recorded a 93.8 percent YoY rise during July-November FY05 reaching US$ 2,169.9 million. However, approximately one third of this increase in the import bill was caused by steeply rising international oil prices since the beginning of FY05 (see **Figure 6.15**).[13] The oil

Figure 6.15: Petroleum Imports



[11] As a tariff rationalization measure, tariff on import of plant, machinery equipment (not manufactured locally) was reduced to 5 percent in the budget for FY05.

[12] The newly announced duty rates on import of CBU cars up to 1300cc would be 50 percent, up to 1600cc 70 percent and for cars up to 1800cc, the duty would be 80 percent and for cars of higher engine capacity would be charged at 100 percent from the previous levels of 75 percent, 100 percent, 125 percent and 150 percent, respectively.

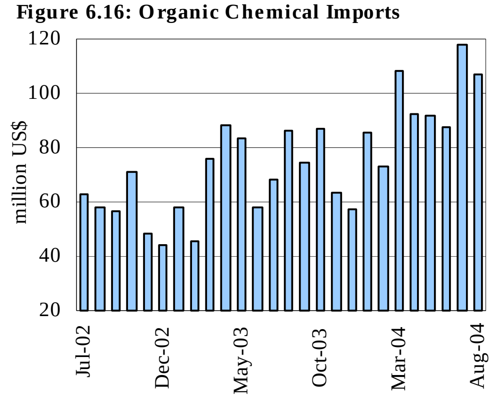
[13] The rise in international crude oil prices resulted in 31.5 percent rise in the total rise in the petroleum group imports. In case of petroleum crude, the rising prices lead to 49.3 percent rise in the crude oil import.

import bill also increased due to apparently much higher and very questionable larger quantum, particularly of petroleum products import.

Agriculture & Chemical Group Imports recorded 39.5 percent rise during July-November FY05, with chemical imports having highest share in this rise. As a matter of fact, organic chemicals imports are rising steadily since FY03 mainly on the back of rising imports of raw materials used in the manufacture of synthetic fiber (see **Figure 6.16**).

Further, plastic imports also rose by a substantial US$ 113.8 million, largely due to rising polyethylene and polypropylene imports. In fact, the rising oil prices also have impacted the cost of petroleum-based products. Similarly, fertilizer and insecticides imports rose due to seasonal demand for the *Kharif* crop.

Figure 6.16: Organic Chemical Imports



Box 6.1: Quota Phase-Out – Threat or Opportunities?
Historically, the textile and apparel sector is an important contributor to economic growth in Pakistan. It accounts for a significant portion of traded goods, contributing 65.0 percent of the total value of exports in FY04. The dismantling of the quota regime therefore represents both an opportunity as well as a threat. An opportunity because markets will no longer be restricted; a threat because markets will no longer be guaranteed by quotas, and even the domestic market will be open to competition. Several studies have attempted to estimate the likely impact of the post-quota scenario on Pakistan's textile industry – this note attempts to highlight the findings of these studies with special emphasis on the likely impact on Pakistan's textile sector.

In a recent report prepared by Will Martin (World bank) on the "*Implications* for Pakistan of Abolishing Textile and Clothing Export Quotas" which was released on April 30, 2004 by the World Bank, the author used general equilibrium analysis to examine the consequences for Pakistan of abolishing the system of quotas installed under the Multi-Fibre Arrangement (MFA) that are being dismantled under the Agreement on Textiles and Clothing (ATC). The aim was to capture vertical product linkages and the rent transfers associated with quota abolition. The main findings of the report are as under:

- Whether Pakistan will be better or worse off depends, *inter alia*, on the extent to which exports from Pakistan are restricted relative to exports from other suppliers; the strength of the competitive relationship between suppliers; and the extent of complementarities associated with global production sharing—particularly the benefits from increased demand for textiles and clothing as inputs.
- The abolition of quotas in January 2005 will eliminate some, but not all, of the distortions affecting global trade in textiles and clothing. While the quotas will be abolished, tariffs on textiles and clothing will remain, frequently at very high levels.
- Pakistan will benefit substantially from the abolition of its own quotas, with the benefits resulting from improvements in efficiency of resource allocation and in world market prices outweighing the loss of quota rents.
- Pakistan may suffer a fall in output and exports of clothing, a result of stronger competition from countries currently more restricted in this sector.
- Output of the Apparel sector could decline by over 10 percent and exports by 17 percent if the productivity is not improved.
- The adverse impacts of increased competition may be softened by the diversity of the industry, with many of the products in which Pakistan specializes, such as men's knit shirts, being much less important to competing countries.
- The removal of the quotas on China in the EU and the US and expansion of the Chinese textile and clothing sector is likely to lead to increased demand for intermediate inputs such as yarn and textiles from Pakistan.
- Overall, the MFA abolition would result in a decline by perhaps half a percent of real income, if no actions are taken to improve productivity.
- Raising productivity – either by improving the efficiency of the production process or the range and the quality of the products produced – is a key to reaping the benefits from the abolition of the MFA.
- The increase in textiles and clothing sector productivity in Pakistan by around 60 percent – to reach China's prevailing productivity levels – would result in the welfare gain of over US$ 1 billion per year.

The World Bank Investment Climate Assessment surveys provided international comparisons of cost structures of various countries. The table below provides an indication of the cost structure of the apparel and textile industries in four key countries—Bangladesh, China, India and Pakistan.

A striking feature of the survey results was the very low share of cash costs in total sales of Pakistan's apparel sector—54 percent—a figure that suggests that at least some firms in this sector have generated substantial cash returns in recent years.

An important source of cost reduction and efficiency improvement in many countries is the use of imported intermediates that are of better quality than domestic substitutes, or at least better suited to the needs of the domestic industry.

The above table shows that Pakistan's apparel sector has moved a long way from its traditional pattern of reliance on domestic inputs towards international sourcing of intermediate inputs. If Pakistan is to participate in the fully-globalized market for textiles and clothing that will emerge after the abolition of the quotas, it seems likely that it will need to a greater degree of international sourcing of textile inputs.

The American Textiles Manufacturers Institute in a study entitled "The China Threat to World Textile and Apparel Trade" concluded that China's share of US textile and apparel market will rise to over two-thirds of the US market within 24 months after the complete phasing out of quota regime. This analysis is based on the fifteen months US trade data on imports from China and the other supplier countries in 29 apparel categories that were removed from quota restrictions on January 1, 2002. They also claimed that US export orders worth US $ 42.0 billion from other countries will shift to China due to sharp fall in Chinese apparel prices.

Reference:

1. The China Threat to World Textile and Apparel Trade, Study by The American Textiles Manufacturers Institute
2. Implications for Pakistan of Abolishing Textile and Clothing Export Quotas, by Will Martin (World Bank Policy Note April 2004)
3. World Bank Investment Climate Assessment Surveys, 2001-02

Table 1: Composition of Cash Costs in Apparel and Textile Production
percent

	Pakistan		Bangladesh		India		China
	Apparel	Textiles	Apparel	Textiles	Apparel	Textiles	Apparel
Materials	56.1	82.4	75.4	64.2	47.8	39.3	74.8
Electricity	3.5	3.9	0.7	1.9	0.9	6.4	0.0
Other energy	0.9	0.9	0.5	1.4	0.9	5.6	2.9
Wages	13.9	4.6	11.6	5.6	11.3	11.2	13.7
Benefits	0.4	0.2	2.0	2.6	0.8	0.9	0.0
Sales and General Admin	7.2	1.2	2.0	3.5	2.3	7.4	0.0
Transport/Communication	3.7	2.7	0.9	0.5	28.4	4.3	1.0
Other costs	1.1	0.3	2.3	6.6	3.6	8.5	5.1
Interest and rent	13.1	3.8	4.6	13.5	4.0	16.4	2.6
Total	100	100	100	100	100	100	10
Cash costs as share of sales	54.1	72.3	87.1	96.2	84.0	123.8	82.8

Sources: World Bank Investment Climate Assessment Surveys, 2001-02

Table 2. Comparisons of Input Sourcing in the Apparel and Textile Industries (percent)

	Pakistan		Bangladesh		India	
	Apparel	Textiles	Apparel	Textiles	Apparel	Textiles
Domestic	59	97	27	39	94	91
Imported	41	3	73	61	6	9

Box 6.2: Export Supporting Measures

Trade blocks: In order to ensure enhanced market access, Pakistan is focusing on joining various regional and bilateral trade blocks. After signing a preferential trade agreement with ECO countries in July 2003, and Preferential Trade Agreement (PTA) with China in November 2003, Pakistan is now focusing on increasing exports to Japan. The plan is to start collaboration with Japanese trading houses on cost sharing basis for market research, product identification and subsequent joint marketing in Japan.

Textile sector

(1) The government plans to establish textile and garment cities to help boost export earnings from this sector. The textile city will be an exclusive production area with necessary infrastructure. This city will specialize in large-scale production of value added textile products. For this purpose, land has already been identified for garment cities in Lahore and Faisalabad; whereas Pakistan Textile City Limited (PTCL) has been set up by government in Karachi, which has been listed with the SECP.

(2) The ginned cotton was exempted from sale tax in the trade policy for FY05. In addition, with a view to support the towel manufacturers, import of waste material of textile has also been allowed.

(3) Some industries are relocating from developed countries to countries where production costs are lower. The EPB has launched a scheme to assist Pakistani companies in this industrial relocation by sharing 50 percent of the transfer costs.

Financing facility by the SBP

In order to improve the financing facility available to the manufacturing sector, the SBP revised the scheme for financing Locally Manufactured Machinery in July 2004. Under the new scheme, manufacturers and purchasers of locally manufactured machinery would be provided credit on concessional terms with mark up rates of 5 to 7.5 percent repayable over a period of 2 to 7½ years.

Non-traditional products and markets: For the diversification of export products and markets the government had earlier allowed 25 percent freight subsidy on products whose exports were not more than US$ 5 million and for all products exported to countries where country's average annual export in the preceding three years were not more than US$ 10 million. This scheme would continue in FY05.

In order to increase country's exports, the government with the help of Export Promotion Bureau has launched various schemes. In addition, various initiatives have been undertaken to improve quality and volume of developments exports including fisheries, horticulture, gems and jewelry, footwear, sports, surgical instruments and carpets.

Box 6.3: Market Analysis of Pakistan's Textile Exports

The US is the largest destination for country's textile exports that captured 33.3 percent share in country's total textile exports during FY04, followed by the 32.8 percent share of the EU.

US market

The data analysis for exports to the US reveals that Pakistan is performing quite impressively for its bed wear, cotton fabrics and knitwear export and is able to face the increased competition in the wake of quota liberalization due to its competitive strength in this sector.

For ***bed linen*** Pakistan has captured a substantial share in the US market while China and India are the close competitors (see **Table 1**). The larger availability of quota for this category helped Pakistan to attain this position.[1] However, since Pakistan has strong manufacturing capacity for low cost production of bed wear,[1] it is likely to remain the major exporter of bed wear to the US.

For ***cotton fabrics*** Pakistan's share is continuously undergoing expansion. Encouragingly, this growth in country's cotton fabric exports came from an expanding share of non-quota categories. However, substitution of low value added categories with high value added types such as dyed, and denim fabric would help in further growth in export earnings.

For ***knitwear***, although Pakistan sends around 60 percent of exports to the US, yet it has captured only a small share in this market. However, this share has undergone a marginal improvement over time. In this category, a large share is captured by the Caribbean countries (CBI) that are given duty free access by the US market. However, the rule of origin[1] in this preferential arrangement raises hopes that after the elimination of quotas, some of the buyer might shift to Asian suppliers including Pakistan. Besides, in the case of Pakistan the growth in the knitwear exports is largely emanating from higher quantum exported as prices in this market are continuously under pressure due to the competition with the CBI countries. This shows the competitive strength and the potential of further expansion of country's export in this category.

EU market

As far as the EU is concerned, Pakistan' share in this market is expanding for all major categories (see **Table 2**). However, data analysis reveal following points:
Knitwear exports are witnessing substantial expansion in the EU market largely on the back of non-quota categories exports. This trend highlights the strong position of the knitwear exports to this destination after removal of quotas. Within quota categories, Pakistan's greatest strength lies in export of knit shirts and jerseys as evident in the 100 percent quota utilization in these categories.

Bed wear is the highest earning export category to the EU market. However, two-third of these earnings came from quota items. Currently, bed wear exports are faced with the issue of imposition of antidumping duty by the EU market and have recorded a steep fall during Q1-FY05.

Table 1: Share of Major Textile Suppliers to the US

percent

	2001	2002	2003	Jan-Jun 2004		2001	2002	2003	Jan-Jun 2004
Cotton Fabric					**Knit Apparel**				
Pakistan	14.5	18.5	21.1	23.1	Pakistan	2.4	2.3	2.6	2.9
India	5.9	5.5	5.3	5.2	India	1.9	2.1	1.9	2.2
China	10.2	11.1	12.2	11.2	China	8.5	9.4	10.8	11.6
Mexico	*	7.6	5.4	5.2	CBI	*	20.2	20	21
Woven Apparel					**Bed Linen**				
Pakistan	0.9	0.8	0.7	0.8	Pakistan	21.9	19.4	17.8	19.4
India	4	4.5	4.5	4.9	India	7.4	10.2	13.7	14.2
China	13.1	14.5	16.5	18.7	China	12.7	11.2	11.3	12.1
Bangladesh	4.6	4.1	3.8	3.8					
CBI	*	12.6	11.2	10					

* Data not available

Source: www.otexa.ita.doc.gov

Table 2: Pakistan's Textile Exports to the EU

Value: million US$; shares; percent

	Value		Quota	Non-Quota
	FY03	FY04	FY04 Shares	
Bed wear	542.1	591.0	65.3	34.7
Ready made garment	443.1	469.4	77.8	22.2
Knit wear	333.4	495.3	44.7	55.3
Cotton Fabrics	276.7	367.4	56.5	43.5

Box 6.4: Import Liberalization Measures

Important import liberalization measures include:

(1) Removal of the necessary condition of obtaining NOCs from ministry of commerce has been removed for the import of all permissible items.

(2) Relocation of industrial projects from abroad has been allowed in all manufacturing and industrial projects in order to reduce the cot of doing business in Pakistan.

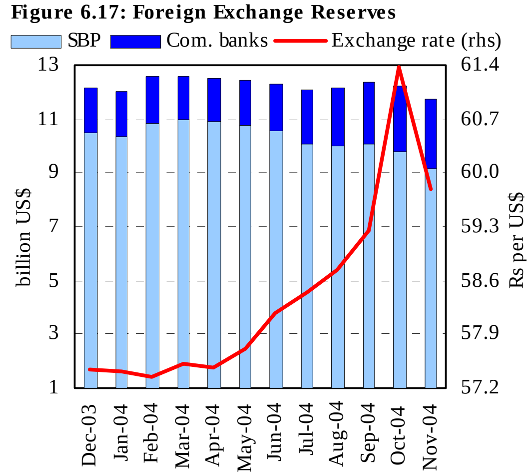
(3) Import of plant, machinery and equipment that is required in national interest has been allowed in second hand condition for enabling transfer of technology at lower cost.

6.3 Foreign Exchange Reserves

The weakness in the external balances that emerged in H2-FY04 on the back of rising economic activities, a fall in non-structural flows and a surge in international oil prices, continued into FY05 as well thereby keeping the Rupee under some pressure. Consequently, Pakistan's *overall* foreign exchange reserves scaled down by US$ 548.9 million during July-November 2004 to reach at US$ 11,179.1 million at the end November 2004.

The pressure on the reserves was not apparent initially in FY05 (see **Figure 6.17**). In fact, as the current account reverted to a marginal surplus in July-September 2004, the SBP choose to intervene quietly in the inter-bank, mainly aiming only to match leads and lag between inflows and outflows, and to meet lumpy payments (pre-payment of external loans, retirements of FE-25 loans, etc.) in order to moderate market volatility.

Figure 6.17: Foreign Exchange Reserves



However, while SBP interventions in this period totaled US$ 724.2 million, SBP reserves fell only US$ 481 million because of additional inflows in the same period. Moreover, reserves with commercial banks increased in Q1-FY05, due to both, incremental deposits (US$ 165.7 million) as well as the retirement of FE-25 loans.[1]

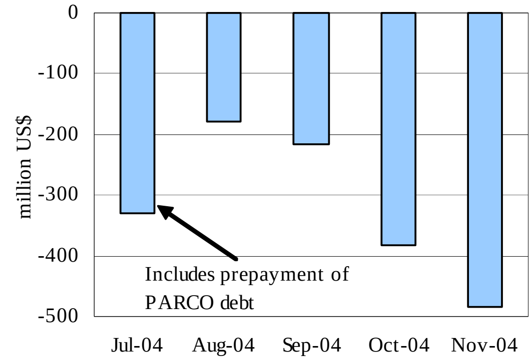
Interestingly, the smaller net decline in SBP reserves and the rise in commercial banks reserves meant that Pakistan's aggregate reserves marginally inched up during Q1-FY05, even as the rupee *depreciated* by 1.8 percent.[2]

[1] These forex loans extended from FE-25 deposits add to market liquidity and thereby effectively augment the country foreign exchange reserves. Thus, in order to avoid double-counting, the foreign exchange reserves of commercial banks were adjusted downward to the extent of the outstanding amount of FE-25 forex loans. This adjustment is then reversed when the loans are retired.

[2] This apparent discordance is explained by the fact that while the retirement of FE-25 loans drained market liquidity, the rise in FE-25 deposits did not add to flows in the inter-bank market (since FE-25 Nostros are not tradable in the domestic market).

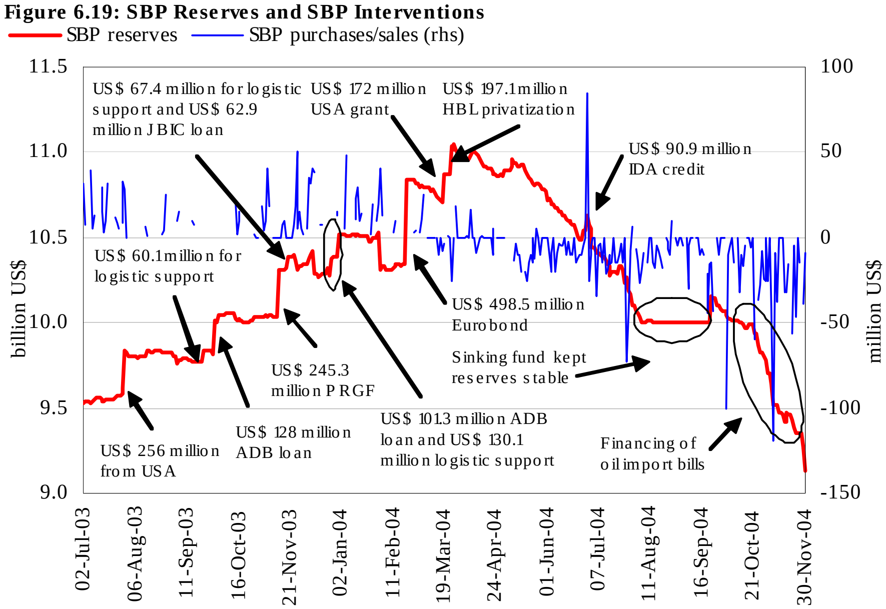
The steady weakening of the Rupee probably contributed to an increase in speculative pressures on the Rupee. Not only did the rising import bill pushed the current account back into deficit, importers sought to lock-in the exchange rate by opening L/Cs; and the stock of overdue export bills also rose, thereby significantly augmenting pressures on the inter-bank market. The excessive pressure on the Rupee forced the SBP to intervene more aggressively by end-October 2004 (see **Figure 6.18**).

Figure 6.18: SBP Market Interventions



At this time, SBP formally announced that it would provide foreign exchange to meet the lumpy outflows for oil payments (later this facility was expanded to wheat and fertilizer). In addition, SBP also introduced administrative measures to curb excessive speculation in the inter-bank market. While the pressures on the

Figure 6.19: SBP Reserves and SBP Interventions



Rupee subsided thereafter, the pressure on SBP reserves increased due to high oil payments as well as the decision to provide forex to meet lumpy debt payments (see **Figure 6.19**).

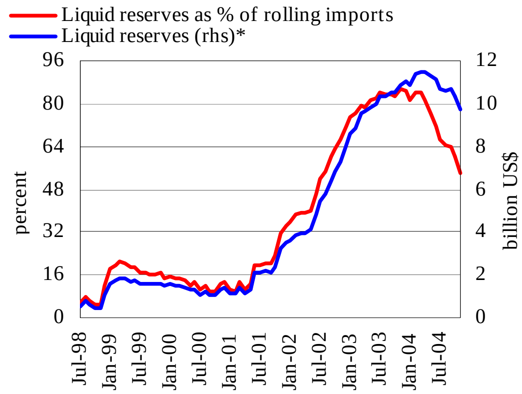
During the same period, ironically, market expectations of a continuing Rupee depreciation also led to an increase in foreign exchange reserves with commercial banks as people had incentives to hold more foreign exchange in their FE-25 deposits. The early retirement of foreign currency loans by traders (as rising international interest rates and expectations of Rupee depreciation increased the expected effective cost of these loans) also replenished the pool of FE-25 deposits with commercial banks (see **Figure 6.17**).

In fact, it was an increase of US$ 870.8 million in commercial bank reserves during July-November 2004 that helped in containing the overall reserves to US$ 11,179.1 million at the end November 2004.

Reserves Adequacy

The adequacy of foreign exchange reserves has attracted renewed concern with the deterioration in external accounts. However, the reserve adequacy indicators continued to present a comfortable position by the end of October 2004.

Figure 6.20: Import Coverage Indicator



* Including CRR

Conventionally, the import coverage indicator and reserves to short-term debt ratio are used to assess the country's ability to absorb the external shock. The import coverage ratio, defined as the liquid reserves as percent of 12-month moving average of imports plunged during July-October 2004 (see **Figure 6.20**). However, the 60.3 percent coverage of import at the end-October 2004 is still substantial.

The other key measure is the *reserves to short-term debt and liabilities* ratio that provides the estimate of country's cushion against the financial crises. This ratio

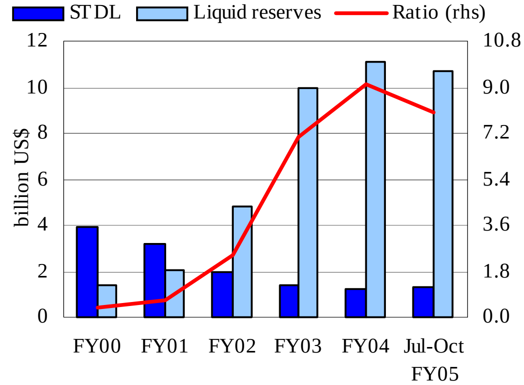
Table 6.12: Overall Reserves as per BOP- BPM-5 (Jul-Sep)
million US$

	FY03	FY04	FY05
Opening Balance	*6,398*	*11,667*	*12,389*
Inflows	**7,273**	**5,779**	**7,429**
Exports of goods	2,643	3,037	3,430
Export of services	837	849	840
of which: logistic support	317	384	280
Income	30	37	56
Workers' remittances	1,053	906	983
Foreign direct investment	161	118	159
Foreign portfolio investment	-3	-28	21
Loan disbursements	730	300	827
Official	604	242	817
Long-term loans	577	242	717
Program loans	445	126	585
IMF	115	0	255
IDA/IBRD	202	0	300
ADB	128	126	30
Project & food loans	132	116	132
Short-term including IDB	27	0	100
Private un-guaranteed	126	58	10
Official grants	278	218	35
Saudi oil facility	189	147	0
Others	99	71	35
Other receipts	1,534	342	1,078
Outflows	**4,852**	**5,144**	**7,360**
Imports of goods	2,769	3,039	4,177
Imports of services (excluding interest)	579	796	1,458
Interest payments	227	213	225
Amortization of official loans	259	388	361
IMF	89	141	107
IDA/IBRD	93	108	124
ADB	48	57	41
Others actual paid	29	82	89
Profit and dividends	148	127	163
Purchase of crude oil /gas	93	108	196
Principal repaid on private loans	172	164	103
Foreign exchange liabilities liquidated	432	93	28
FE-45, FE-31	23	0	0
PTMA & commercial loans-actual paid	40	17	0
IDB (short term)	24	35	0
Swaps	230	0	0
Special US$ bonds	115	41	28
Other payments	173	216	649
Net change	*2,421*	*635*	*69*
Gross reserves at end of period	**8,819**	**12,302**	**12,458**
SBP reserves	5,941	10,019	10,079
Sinking fund	637	920	235
Commercial bank reserves	2,241	1,363	2,144
CRR	459	476	587

Note: Other inflows and outflows constituted of contra entry items, which nullify their impact on reserves.

has also crept down at the end of Q1-FY05 (see **Figure 6.21**), mainly due to a debt-creating flow of US$ 100 million from IDB as well as the decline in reserves.

Figure 6.21: Reserves and STDL



Reserves Management

An important feature of the reserves management strategy is the diversification of foreign exchange reserves. Though the conventional practice of allocating foreign exchange reserves in short term Dollar treasury bills continued to dominate the foreign reserves composition, a noticeable portion is also invested in high credit portfolio with longer maturity

Table 6.13: Official Reserve Assets (Jul-Oct)
million US$

	FY04	FY05
A. Official reserve assets	**12,198.9**	**11,248.6**
(1) Foreign currency reserves (in convertible foreign currencies)	11,236.5	10,138.2
(a) Securities	*1,177.4*	*3,234.3*
(b) Total currency and deposits with:	*9,096.6*	*6,904.0*
(i) Other national central banks, IS and IMF	349.8	63.4
(ii) Banks headquartered in the reporting country	185.4	77.8
(iii) Banks headquartered outside the reporting country	8,561.4	6,762.7
(2) IMF reserve position	0.2	0.2
(3) SDRs	243.5	231.4
(4) Gold (including gold deposits and, if appropriate, gold swapped)	718.8	878.7
— volume in millions of fine troy ounces	2.1	2.1
(5) Other reserve assets (specify)	-	-

through external managers (see **Table 6.13**). This is clearly visible in the reserves deployment pattern witnessing the higher share of securities in foreign exchange reserves.