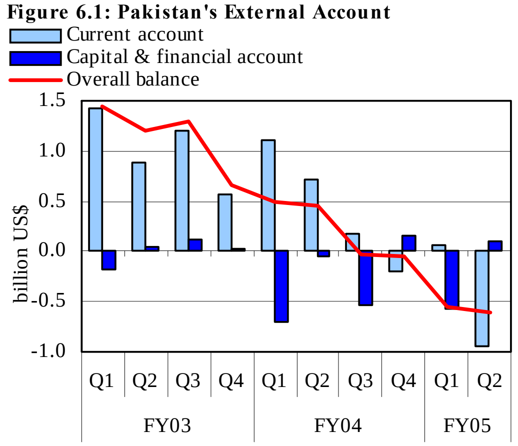
6 External Sector

6.1 Balance of Payments[1]

Pakistan recorded a large external account deficit for the second successive quarter during FY05 (see **Figure 6.1**), pushing the aggregate H1-FY05 deficit to US$ 1.2 billion. This is in sharp contrast to the surplus of around US$ 1.0 billion recorded in the corresponding period of the previous year. In net terms, practically all of the deterioration emerges from a large US$ 2.1 billion jump in the country's trade deficit from a mere US$ 0.2 billion in H1-FY04 to approximately US$ 2.3 billion in H1-FY05.

Figure 6.1: Pakistan's External Account



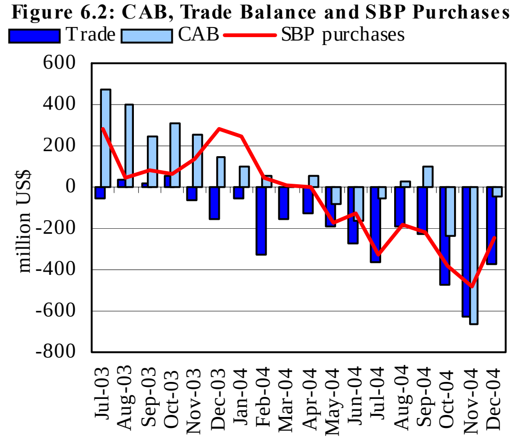
The widening of the trade gap, in turn, was caused by a massive 47.7 percent YoY jump in imports during H1-FY05, principally due to a big rise in the oil bill and machinery imports. The impact of the surge in imports was compounded by the weakness in Q2-FY05 textile exports, which held down exports growth to a relatively modest 14.6 percent YoY during the half-year. The large import-led trade gap and its impact on the rise in shipping charges accounted for a significant part of US$ 884 million current account deficit during H1-FY05.

Initially, the evident deterioration in the trade account through H1-FY05 put pressure on the exchange rate, leading to frantic efforts by importers to lock-in the exchange rate. As discussed in the SBP *Quarterly Report for Q1-FY05*, the risk of the self-sustaining pressure on the Rupee finally forced the SBP to intervene more visibly in the inter-bank market by end-October 2004 by announcing its willingness to ensure ample availability of foreign exchange to meet lumpy payments for oil imports. This had an immediate impact on the inter-bank market, which was effectively assured that the exchange rate movements would not be too

[1] The figures of the current and 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.

volatile. The resulting impact on the liquidity comfort in the inter-bank market was distinctly visible in the evident stability in the inter-bank forex market even though the net interventions by the SBP were gradually reduced (see **Figure 6.2**). It must be kept in mind that the SBP had intervened in the market during Q1-FY05 as well, but this had not been of great comfort to the market because the interventions were opaque. There was little information available for the market to assess the size of the interventions nor any way for it to determine to what extent to these would continue. These concerns were removed by the end-October 2004 SBP announcment referred above.

Figure 6.2: CAB, Trade Balance and SBP Purchases



Not surprisingly, the larger and more systematic interventions by the SBP to inject foreign exchange into the inter-bank market led to an accerated decline in its forex reserves during Q2-FY05, compared to the preceding quarters. However, the country's overall liquid reserves did not decline as much. This divergence is explained by the rise in reserves of commercial banks due to both, increases in FE-25 forex deposits, as well as the retirements of forex loan extended by commerical banks.[2]

6.1.1 Current Account Balance

In sharp contrast to the US$ 1.8 billion surplus in H1-FY04, the current account posted a deficit of US$ 884 million during H1-FY05. As evident from **Table 6.1**, the H1-FY05 deterioration in the current account was entirely due to the US$ 951 million Q2-FY05 deficit, which offset the small surplus recorded in the preceding quarter.

[2] Forex loans taken from domestic banks by traders effectively add to the forex market liquidity. Thus, to prevent a double count of these funds in the reserves, the loans disbursed are deducted from the banks' forex reserves figure. When the loans are re-paid, this deduction is reversed.

Table 6.1: Current Account Balance
million US $

	Q1		Q2		H1		Δ H1-FY05 over H1-FY04
	FY04	FY05	FY04	FY05	FY04	FY05	
1. Trade balance	**-1**	**-786**	**-158**	**-1,471**	**-159**	**-2,257**	**-2,098**
Exports	3,037	3,392	3,071	3,608	6,108	7,000	892
Imports	3,038	4,178	3,229	5,079	6,267	9,257	2,990
mineral fuels, oils & their products	541	906	425	1151.9	966	2058	1092
2. Services (net)	**48**	**-628**	**-222**	**-914**	**-174**	**-1,542**	**-1,368**
Transportation	-190	-315	-177	-368	-367	-683	-316
Travel	-171	-233	-286	-277	-457	-510	-53
Communication services	68	60	39	67	107	127	20
Other business services	-19	-395	-45	-536	-64	-931	-867
Government services	403	317	277	235	680	552	-128
Of which logistic support	384	280	198	169	582	449	-133
Other	-43	-62	-30	-35	-73	-97	-24
3. Income (net)	**-415**	**-528**	**-649**	**-691**	**-1,064**	**-1,219**	**-155**
Investment income(net)	-415	-528	-649	-691	-1,064	-1,219	-155
Direct investment	-214	-346	-308	-429	-522	-775	-253
Of which:							
Profit & dividend	-61	-80	-105	-126	-166	-206	-40
Purchase of crude oil & gas	-99	-196	-149	-225	-248	-421	-173
Portfolio investment	-36	-25	-71	-63	-107	-88	19
Of which:							
Profit & dividend	-20	-5	-33	-42	-53	-48	5
IMF charges & interest on official external debt	-118	-152	-250	-203	-368	-355	13
Interest on private external debt	-45	-23	-26	-36	-71	-59	12
Others	-2	18	6	40	4	58	54
4. Current transfers (net)	**1,477**	**2,009**	**1,741**	**2,125**	**3,218**	**4,134**	**916**
Private transfers	1,279	2,000	1,522	2,103	2,801	4,103	1,302
Workers remittance	906	983	968	963	1,874	1,946	72
FCA – residents	45	163	156	247	201	410	209
Others	328	854	398	893	726	1,747	1,021
Official transfers	198	9	219	22	417	31	-386
Saudi oil facility	147	0	128	0	275	0	-275
Cash grants	44	0	90	16	134	16	-118
Current account balance	**1,110**	**67**	**712**	**-951**	**1,822**	**-884**	**-2,706**

Source: Statistics Department, SBP

The major factors responsible for this worsening were (1) rising imports and consequent jump in import-related charges; (2) increased *net income* outflows in the services account; and (3) lower receipts of *logistic support* payments. Indeed, the 28.5 percent YoY growth in receipts under current transfers during the period was overwhelmed by the higher imports and shipment freight charges alone.

Trade Balance[3]

The trade deficit worsened during H1-FY05 by US$ 2.1 billion to reach US$ 2.3 billion. As mentioned earlier, this was due to both, an exceptional rise in the country's imports as well as a deceleration in the growth of exports (for details please see section on **Trade**).

As customary, the growth in imports saw a strong contribution from the rise in non-food and non-oil imports (up 33.0 percent YoY) during the period. Within machinery imports, the major share is of textile machinery (21.2 percent) indicating that the textile companies were positioning to cope with the post-quota regimes.

However, the largest contribution to the widening of the trade gap was due to sharp rise in the imports of petroleum products. Indeed, almost half of growth in the H1-FY05 trade deficit relative to H1-FY04 was on account of the higher outflows on import of *mineral fuel & oil*.

Services (Net)

The services account registered a higher net outflow of US$ 1.5 billion in H1-FY05 as compared to an outflow of only US$ 0.2 billion during the corresponding period of FY04. As evident from **Table 6.1**, this deterioration in the services account owes to:

(1) A large increase in outflows under *transportation*. This appears to mainly reflect the rising freight charges following the sharp rise in the country imports.

(2) Lower receipts of payments for logistic support. While these receipts offer significant support to the current account balance, these are not regular, and the amounts vary (typically ranging between US$ 133 to US$ 300 million per quarter).

---

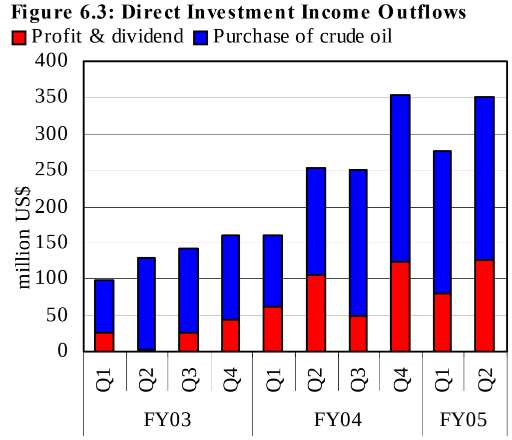
[3] This section is based on exchange record compiled by SBP that does not tally with more detailed custom data used in **sub-Section 6.2**. In BoP, the trade data is recorded on accrual basis (after the realization of actual receipts and payments), while trade section based on custom basis (which include the receipts and payments on the basis of physical movement of goods).

(2) Higher net outflow under other business services and travel. As discussed in the *Quarterly Report for Q1-FY05*, the rise in outflows under this head mainly reflects the improved coverage of foreign exchange transaction routed through Foreign Exchange Companies (FECs). Most of this outflow has no impact on the overall current account balance as it is matched by the receipts of the FECs (appearing as current transfer inflows under *private transfers*).

Income (Net)

During H1-FY05, the 14.6 percent YoY increase in net income outflows was primarily due to the higher direct investment income outflow of US$ 253 million. This was offset to an extent by the saving originated from the lower net interest payments.

Figure 6.3: Direct Investment Income Outflows



The net income outflow under direct investment witnessed a 48.5 percent YoY growth during the first half of current fiscal year. **Figure 6.3** depicts the higher repatriation of *profit & dividend* in first half of current fiscal year as compared to the same period of FY04. As discussed in the previous SBP *State of the Pakistan Economy* quarterly report, the higher profit outflows registered in Q1-FY05 reflect the profitability of foreign companies during the calendar year.

Furthermore, the *purchase of crude & gas* also shows the rising trend during H1-FY05. This was largely due to the higher purchase of gas (approximately US$ 231 million) reflecting the impact of both higher prices as well as increased production.[4] Meanwhile, the remittances on account of crude oil also increased despite a small decline in output during H1-FY05 over the same period last year.

On the other hand, the net interest outflows during Q2-FY05 decreased by 28.7 percent YoY to US$ 224 million, more than offsetting the 3.4 percent YoY (to

[4] As gas prices are indexed to international oil prices, any change in international oil prices may cause change in the gas prices.

US$ 184 million) rise in these outflow during Q1-FY05. As a result, in aggregate, during H1-FY05 the net interest outflows decreased by 17.1 percent YoY to reach US$ 408 million (see **Table 6.2**).

Specifically, the saving originated due to lower net interest outflow during Q2-FY05 was primarily on account of lower interest payment on official long-term loans (reflecting lesser scheduled payment on these loans)[5] as well as the lower outflow of external liabilities.

Table 6.2: Details of Interest Payments and Receipts

million US $

	Q1		Q2		H1		Saving
	FY04	FY05	FY04	FY05	FY04	FY05	
Payments (I+II)	**213**	**225**	**356**	**279**	**569**	**504**	**65**
I. Total external debt	164	192	299	257	463	449	14
Public & publicly guaranteed	113	165	264	213	377	378	-1
Long-term	96	135	238	194	334	329	5
Military	13	11	0	0	13	11	2
Euro bonds	1	17	23	18	24	35	-11
Commercial loans/credits	2	2	2	1	4	3	1
IDB	1	0	1	0	2	0	2
Private loans/credits	45	23	26	36	71	59	12
IMF	6	4	9	8	15	12	3
II. External liabilities	53	33	53	22	106	55	51
Foreign currency deposits	8	3	5	5	13	8	5
Special US$ bonds	6	9	10	6	16	15	1
Central bank deposits	6	6	2	5	8	11	-3
Others	33	15	36	6	69	21	48
Receipts	**35**	**41**	**42**	**55**	**77**	**96**	**19**
Interest on reserves	25	26	30	40	55	66	11
Others	10	15	12	15	22	30	8
Net payments	**-178**	**-184**	**-314**	**-224**	**-492**	**-408**	**84**

Source: Statistics Department, SBP

The interest paid on external liability was higher during Q2-FY04 due to (1) notional payment, representing the interest on foreign currency loans extended to

[5] During Q2-FY04, the higher interest payment on official long-term loans was primarily due to the payment of debt arrears following the finalization of the debt rescheduling agreement.

Pakistani traders,[6] and (2) higher interest payments made by the foreign companies for the working capital requirement. However, both of these outflows declined during Q2-FY05 as the foreign currency loans extended during the period were lower as well as foreign companies did not borrow much for working capital.

Current Transfers

Net receipts under *current transfers* totaled US$ 4.1 billion during H1-FY05, up 28.5 percent YoY from the US$ 3.2 billion recorded during the corresponding period of FY04. This was largely explainable by a 46.5 percent YoY growth in private transfers, which comfortably offset the decline in receipts of official transfers during the same period. Within the private transfers, both remittances and FCAs increased, jumping by US$ 72 million and US$ 209 million respectively during H1-FY05 as compared to the corresponding period of the preceding year.

Table 6.3: Workers' Remittances

million US $

	FY04		FY05		Jul-Dec	
	Q1	**Q2**	**Q1**	**Q2**	**FY04**	**FY05**
I. Gulf region	**409**	**385**	**444**	**419**	**795**	**864**
Bahrain	19	18	25	21	37	46
Kuwait	38	45	49	54	83	103
Qatar	21	21	24.6	14	42	39
Saudi Arabia	161	134	158.5	142	295	300
Sultanat-e-Oman	24	25	26.2	34	49	60
U.A.E.	147	142.7	161.1	154	289	315
II. U.S.A.	**258.0**	**317.2**	**313.8**	**274.1**	**575.1**	**587.9**
III. Other than Gulf & US	**223**	**252**	**223.3**	**268**	**475**	**491**
Canada	4	6	10	10	10	20
Germany	17	10	14.0	13	27	27
Japan	2	1	2.1	1	2	4
Norway	3	2	3	8	5	11
U.K.	74	85	74.8	104	159	179
Other	123	149	119.8	131	272	251
Total	**890.3**	**954.6**	**981.5**	**961.4**	**1844.9**	**1942.9**
of which: exchange companies	**33.9**	**30.8**	**67.5**	**29.1**	**64.6**	**96.6**
Encashment FEBCs & FCBCs	**16.2**	**12.7**	**1.6**	**1.6**	**28.9**	**3.2**
Grand total	**906.5**	**967.3**	**983.1**	**963.0**	**1873.8**	**1946.1**

Source: Statistics Department, SBP

[6] The notional outflow of interest on these loans (*other external liabilities)* is offset by an equal

Remittances

The workers remittances (cash) continued a pace during H1-FY05, reflecting a 5.3 percent YoY growth to US$ 1.94 billion during H1-FY05 as compared to USS$ 1.84 billion during the same period last year (see **Table 6.3**).

Disaggregated by country, it is evident that the strong remittance flows were sustained primarily from USA and Gulf countries. Within H1-FY05, the remittances slightly declined during Q2-FY05; however this weakening was to be expected on account of Eid-ul-Fitar.[7] Remittances from the UK also saw a small rise in Q2-FY05, at least a part of which probably reflects the strong appreciation of the UK pound against the US Dollar.

FCAs

FCAs (resident) experienced an inflow of US$ 410 million during H1-FY05 as against US$ 201 million during the corresponding period of FY04. This increase was mainly due to the huge inflow in the deposits of (1) a government institution in July 2004; and (2) a new telecommunication company during October 2004.

6.1.2 Financial Account

The surplus in the financial account during Q2-FY05 helped offset part of the deficit recorded in the first quarter of current fiscal year and thus, in aggregate terms, H1-FY05 adjusted financial account deficit declined by 46.8 percent YoY to reach US$ 427 million (see **Table 6.4**).[8]

This improvement in the financial account owed to (1) greater availability of non-food aid relative to corresponding period of the preceding year; (2) higher net foreign investment; and (3) net inflow of IDB short-term loans.

Net Foreign Investment (NFI)

NFI recorded a significant growth of 135.6 percent YoY during H1-FY05 to reach US$ 410 million. The higher inflows under Foreign Direct Investment (FDI) as well as the reversal in portfolio investment in the stock market (from an outflow of US$ 18 million during H1-FY04 to an inflow of US$ 59 million in H1-FY05) were the underlying factors behind the impressive growth in NFI (see **Table 6.4**).

inflow in '*other receipts'*.

[7] During Eid, normally the remittances sent by immigrant slow down as they bring money with them.

[8] The financial account deficit is adjusted for a contra-entry of US debt write-off of US$ 495 million shown under the amortization of long-term official loans and US$ 100 million of settlement of foreign currency loans of commercial banks to repay PARCO loans during Q1-FY05.

Table 6.4: Financial Account
million US $

	Q1		Q2		H1	
	FY04	**FY05**	**FY04**	**FY05**	**FY04**	**FY05**
Financial account (1 through 4)	**-723**	**-1,096**	**-79**	**74**	**-802**	**-1,022**
1. Direct investment abroad	**1**	**-22**	**-24**	**-12**	**-23**	**-34**
2. Direct investment in Pakistan	**117**	**182**	**160**	**264**	**277**	**446**
of which: Equity Capital	71	105	114	185	185	290
Reinvested earning	46	77	46	79	92	156
3. Portfolio investment	**-54**	**-16**	**-26**	**14**	**-80**	**-2**
of which: (Stock Markets)	-28	21	10	38	-18	59
Special US Dollar Bonds	-16	-28	-30	-26	-46	-54
Euro bonds	-2	-2	0	0	-2	-2
Net Foreign Investment	64	144	110	266	174	410
4. Other investment	**-787**	**-1240**	**-189**	**-192**	**-976**	**-1432**
Assets	-482	-521	29	-512	-453	-1033
i. Outstanding Exports Bills (Exporters)	-108	-25	-90	-101	-198	-126
ii. Outstanding Exports Bills (DMBs)	-27	-32	15	27	-12	-5
iii. Currency & deposits	-347	-464	104	-438	-243	-902
of which: Bank	-272	-486	101	-457	-171	-943
Liabilities	-305	-719	-218	320	-523	-399
i. Foreign Long-term loans / credits (net)	-6	-284	-12	516	-18	232
of which: Project Assistance	116	125	125	144	241	269
Food Aid	0	0	0	0	0	0
Non-Food Aid	126	340	118	592	244	932
Amortization	248	749	255	220	503	969
ii. Private loans	-106	-93	-104	-50	-210	-143
of which: Suppliers Credits/MNCs	58	10	20	2	78	12
Supplier Credits Repayments	164	103	124	52	288	155
iii. ST Capital, (official)	-52	97	-178	-25	-230	72
of which: Commercial Banks (net)	-17	0	-116	-116	-133	-116
IDB (net)	-35	97	-62	91	-97	188
iv. Currency & deposits	-84	-261	70	-138	-14	-399
of which: Trade financing	-238	-355	154	-229	-85	-583
v. Other liabilities	-57	-178	6	17	-51	-161

Source: Statistics Department, SBP
Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

A break up of FDI flows into *cash* and *reinvested earnings* reveals that the cash component witnessed a 56.8 percent YoY growth in H1-FY05. This higher *cash FDI* was directed mainly to the telecommunications, trade, chemicals, and textile sectors. In fact, the bulk of the US$ 29 million investment in the telecommunication sector was from the Netherlands and USA.

On the other hand, the jump in *reinvested earning* is due to a definitional change. In the *Balance of Payment manual 5*, the definition of *reinvested earning* follows the IPP standard (International Investment Position), according to which the *reinvested earning* comprises of bonus share and a certain proportion of undistributed profit/loss (the earlier definition included only bonus shares). As a result, the *reinvested earning* increased by US$ 64 million during H1-FY05 as compared to the corresponding period preceding year.

On the other hand, during the first half of current fiscal year, the investment in stock market shows striking improvement. Accordingly the portfolio investment registered a lower net outflow of only US$ 2 million during H1-FY05 compared to a net outflow of US$ 80 million in H1-FY04.

Furthermore, the Special US Dollar bonds depict an outflow of US$ 54 million during H1-FY05.[9] During the period under review, the encashment of Special US Dollar bonds (in rupee and dollar) was much lower (US$ 54 million) as compared to the total encashment of US$ 75 million.[10]

Outstanding Export Bills (OEBs)

During H1-FY05 the stock of outstanding exports bills held by exporters and commercial banks increased by US$ 131 million as against an increase of US$ 210 million witnessed during the corresponding period of the preceding year (see **Table 6.4**).

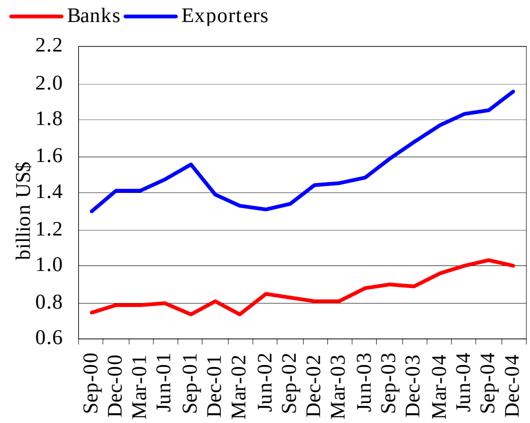
However, there was a marked difference in the behavior of OEBs held by exporters and banks (see **Figure 6.4)**. The OEBs held by exporters increased by US$ 126 million during H1-FY05 mainly due to the increase in export volume in Q2-FY05. On the other hand, the realization of export proceeds by banks on account of discounted OEBs more than offset the impact of fresh bills discounted

[9] During H1-FY05 the encashment includes repayment of 5-year bonds which was started in October 2003, however, H1-FY04 reflects both the repayment of 5 and 3 year bonds. For further detail see **Annual Report 2003-04**.

[10] The total encashment during H1-FY04 was partially offset by the sale of bonds against frozen foreign currency account (US$ 29 million).

in H1-FY05; stock of OEBs held by banks thus marginally increased during the period.

Figure 6.4: Stock of Outstanding Export Bills



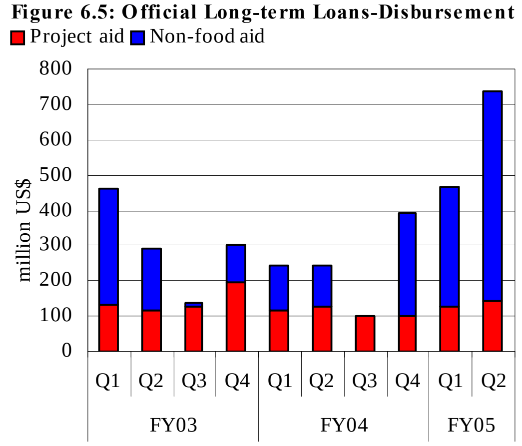
Currency and Deposits

The *currency and deposits* assets registered an increase of US$ 659 million in H1-FY05 over the same period last year. This was mainly back by the rise in commercial banks' FE-25 Nostro holdings, which depicts a jump of US$ 772 million to reach US$ 943 million during the period. The major cause of this increase in commercial banks' forex holdings are (1) increased forex deposits; and (2) the higher net retirement of foreign currency trade loans during H1-FY05 as compared to H1-FY04.

Foreign Long-term Loans

The long-term official loans recorded a net inflow of US$ 232 million in H1-FY05 as compared to net outflow of US$ 18 million during H1-FY04. In fact, adjusting for the US debt write-off (US$ 495 million) during Q1-FY05, it is evident that the long-term loans saw an even higher inflow of US$ 727 million during H1-FY05. This sharp jump in net inflows was mainly contributed by a substantial increase in disbursement of non-food concessional aid by World Bank and ADB during H1-FY05 (see **Figure 6.5**).[11]

Figure 6.5: Official Long-term Loans-Disbursement



[11] For detail see section on external debt & liabilities.

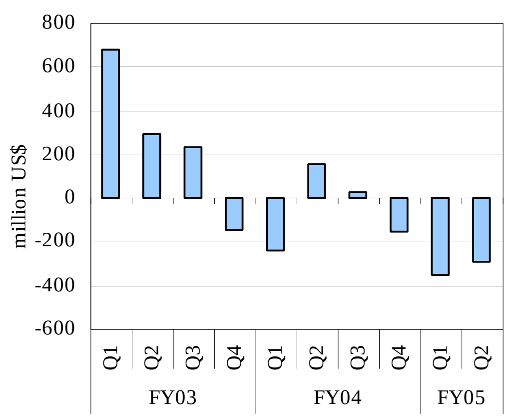
Short-Term Official Loans[12]

Short-term official loans, comprising mainly of short-term borrowings for oil imports and commercial borrowings, posted a net inflow of US$ 72 million during H1-FY05 compared to an outflow of US$ 230 million in H1-FY04 (see **Table 6.4**). Since FY03 Pakistan has not taken any short-term commercial loans, so the net outflow in commercial loans reflects the rollover amount of a US$ 100 million loan with an offsetting entry in the exceptional financing. Nonetheless, the short-term net disbursement for oil imports of US$ 188 million entirely offset the impact of net outflow under commercial loans during the period under review.

FE-25 Related Trade Financing

The foreign currency trade related loans saw a net outflow of US$ 583 million during H1-FY05 in contrast to much lower net outflow of US$ 84 million in the corresponding period last year. This increased settlement of the foreign trade financing liabilities during the period was due to the net retirement of US$ 229 million in Q2-FY05 as against of the net lending of US$ 154 million in trade financing during the same period preceding year (see **Figure 6.6**).

Figure 6.6: Foreign Currency Loans



The main driver for the lower demand of foreign trade loans, even with rising exports are (1) the higher effective cost of forex loans;[13] and (2) increased advance export receipts by US$ 168 million to US$ 635 million during Q2-FY05 over the corresponding quarter last year.

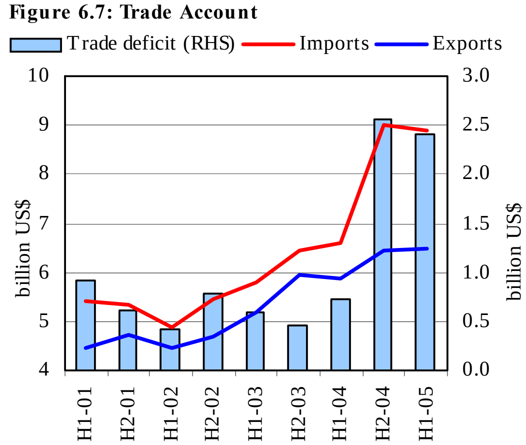
[12] Short-term loans are such loans which have repayment period of three year.

[13] The expectation of the Rupee depreciation made the foreign currency loans unattractive to the exporters and importers.

6.2 Trade Account[14]

A continued rise in machinery and raw material imports, together with a slight (but unusual) *fall* in textile exports in Q2-FY05, led to a considerable widening of the trade deficit during H1-FY05. According to provisional figures, the trade deficit recorded a US$ 1.7 billion rise during H1-FY05 to reach US$ 2.4 billion.[15] As seen in **Figure 6.7**, this is very close to the record deficit for any half year.

Figure 6.7: Trade Account



A large trade deficit is not surprising given that domestic economic activity continues to rise, and that the petroleum prices are still significantly higher than in the preceding years. However, the fact that H2-FY04 deficit had included large one-off components had suggested that the H1-FY05 trade deficit would have been substantially lower. The sustained large H1-FY05 deficit is therefore a little puzzling. Unfortunately, the significant lag introduced in the availability of the final data for Q2-FY05 (and indeed the questions raised on the quality of the provisional data – see **Box 6.1**) means that this puzzle cannot be investigated at present.[16]

It is interesting to note that the sharp increase in the trade deficit stems from a quite uncharacteristic divergence between the import and export growth rates over the preceding 12 months (see **Figure 6.8**).

[14] Typically, the analysis in this section of the SBP "*State of Pakistan's Economy*" quarterly report is based on detailed final trade data. Unfortunately, a change in the process of compilation of the data has led to significant lag in the availability of the final data. Thus, the analysis presented is based on final data only up to Q1-FY05, and only partial (and provisional) data for up to Q2-FY05. No useful breakup of the trade data is available for January 2005.

[15] H2-FY04 registered highest ever level of trade deficit for the country reaching the level of US$ 2.55 billion.

[16] The record deficit witnessed in H2-FY04, incorporated a large non-repeating component including aircraft imports by PIA (over US$ 300 million) and a temporary import of a dredger for Port Qasim (US$ 325 million).

Much of the growth in imports in recent years has been on account of machinery, as well as raw material and inputs such as petroleum, and agriculture & chemical group imports. Moreover, this has been encouraged by the gradual liberalization of trade in recent years (see **Box 6.2** at end of section). Clearly, this is not undesirable, given that it only reflected the rising economic activity in the country, and the rising imports of cheap inputs can help reduce cost of exports (and can improve efficiency of domestic industry through greater competition) as well. Indeed, until H2-FY04, import growth had been matched by a corresponding growth in exports.

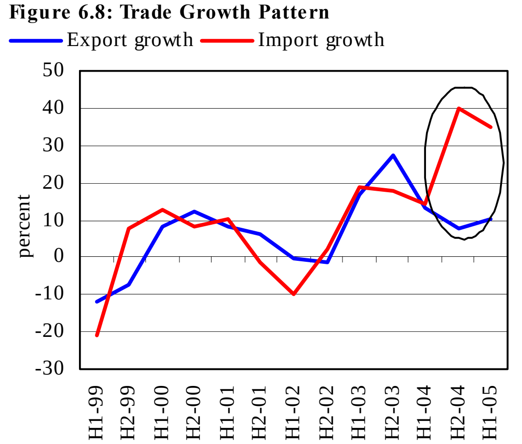
Box 6.1: Correction of Import Figures released by the Federal Bureau of Statistics (FBS)

FBS has revised downwards the import figures for petroleum product by US$ 143 million and U$ 505 million respectively for October and November 2005. As a result, July-November FY05 imports now total US$ 7.2 billion, rather than the US$ 7.9 billion reported earlier. It is possible that corrections may be required for later months as well.

In fact, these corrections only raise further questions about the reliability of the entire provisional trade data set for FY05, following the changes in the data compilation system. Given the serious policy dependency on this data, it is essential that the problems be corrected urgently.

The divergence between export and import growth seems driven by an extraordinary rise in import growth; the rise in both H2-FY04 and H1-FY05 is well above the norms for recent years. In the former period, a large part of this appeared due to one-off aircraft and ships imports. However, in both periods, the greater part of the rise in imports appears structural, representing rising demand for capital goods and industrial raw materials. It is yet to be seen whether this investment will appear in the form of increased export capacity with some time lag or translate in goods for domestic markets. If the later is the case, efforts will have to be intensified to focus on larger export expansion for attaining a sustainable trade deficit.

Figure 6.8: Trade Growth Pattern



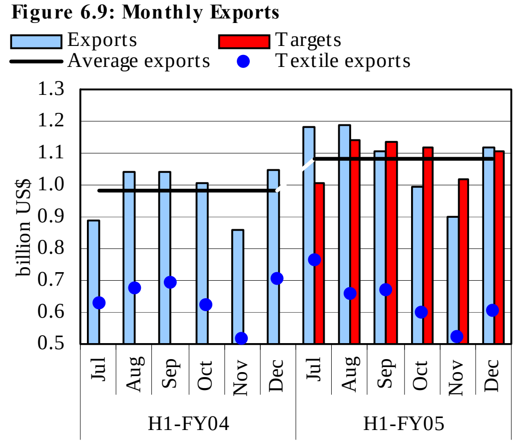
The almost doubling of miscellaneous exports in H1-FY05 after a persistent rising trend over several years does suggest further exploration of goods and commodities that are becoming competitive enough to penetrate international markets. Unfortunately, non-availability of detailed commodity by country tarde data limits such analysis.

More importantly, textile exports to the EU market that have been hit by both the imposition of an anti dumping duty of key products as well as the loss of duty free access from January 2005 need supportive policy measures in the short term. Fortunately, the government is quite aware of this need and a support package is expected in the near future. In the longer term, however, sustained growth in exports is only possible through a long term commitment to improving the competitiveness of Pakistan's industry in terms of reducing the cost of production (e.g. by ensuring availability of cheaper, more reliable power supplies, education reforms to provide ample trainable labor force, reducing red-tape, introducing labor market flexibility etc.).

6.2.1 Exports

Pakistan's exports totaled US$ 6.5 billion during H1-FY05; this was 10.5 percent higher than the exports during the corresponding period of FY04, but was 0.6 percent lower than the export target set for this period (see **Table 6.5**). Monthly analysis shows that exports recorded a continuous decline in the period of Aug-Nov FY05 largely due to falling textile exports (see **Figure 6.9**).

Figure 6.9: Monthly Exports



Textile manufactures exports recorded a marginal fall of 2.7 percent during H1-FY05. The major categories whose performance remained unsatisfactory were bed wear, synthetic textiles and readymade garments. On the other hand, knit wear exports displayed a strong performance during this period.

Bed wear the apparent decline in these exports appears attributable to two factors: (1) an embargo imposed by the US on country's bed wear exports to check over

Table 6.5: Major Exports

Value: Million US $; Unit value: US $

			H1-FY04		H1-FY05		Abs chg. In value	% chg in H1-FY05/H1-FY04		
		Unit	Value	Unit value	Value	Unit value		Qty	Value	Unit value
A.	**Primary commodities**		**625.8**		**681.5**		**55.7**		**8.9**	
1	Rice	MT	311.3	342.5	344.2	352.2	32.9	7.5	10.6	2.8
2	Raw cotton	MT	25.4	1,215.0	49.9	1,189.4	24.6	101.1	96.9	-2.1
3	Raw wool (excl wool tops)	MT	0.8	967.6	0.1	861.7	-0.7	-87.0	-88.5	-10.9
4	Fish & fish preparations	MT	87.0	1,689.7	67.6	1,482.9	-19.4	-11.4	-22.3	-12.2
5	Leather	SQM	117.1	15.7	135.3	16.1	18.2	12.9	15.5	2.3
6	Guar and guar products	MT	10.4	871.4	6.4	879.4	-4.0	-39.3	-38.7	0.9
7	Fruits	MT	46.4	338.2	40.1	338.4	-6.3	-13.7	-13.6	0.1
8	Vegetables	MT	12.4	189.9	15.2	295.5	2.8	-20.9	23.0	55.6
9	Crude animal material	MT	6.5	1,465.6	4.1	3,751.3	-2.4	-75.5	-37.4	155.9
10	Oil seeds & nuts etc.	MT	2.6	647.4	18.7	487.5	16.1	854.0	618.3	-24.7
11	Wheat	MT	6.0	140.1	0.0	0.0	-6.0	0.0	0.0	0.0
B.	**Textile manufactures**		**3,847.3**		**3,743.4**		**-103.8**		**-2.7**	
12	Cotton yarn	MT	516.7	2,075.9	447.6	2,126.8	-69.1	-15.4	-13.4	2.5
13	Cotton fabrics (woven)	SQM	768.0	0.7	785.1	0.7	17.2	-3.0	2.2	5.4
14	Hosiery (knitwear)	DOZ	698.3	22.7	986.8	24.9	288.5	28.9	41.3	9.6
15	Bed wear	MT	654.0	5,641.0	503.5	5,330.4	-150.5	-18.5	-23.0	-5.5
16	Towels	MT	174.3	3,884.4	209.5	3,783.3	35.2	23.4	20.2	-2.6
17	Cotton bags and sacks	MT	6.8	4,129.8	3.2	3,965.4	-3.7	-51.5	-53.4	-4.0
18	Readymade garments	DOZ	488.7	36.4	389.5	35.4	-99.2	-18.0	-20.3	-2.8
19	Tarpaulin & other canvas goods	MT	34.3	2,137.5	18.5	3091.1	-15.8	-62.7	-46.0	44.6
20	Tule, lace, embroidery etc.	---	4.8	---	2.8	---	-2.0	---	-42.4	---
21	Synthetic textiles	SQM	284.9	0.7	155.1	0.7	-129.8	-44.7	-45.5	-1.5
22	Other textile made up	---	212.8	---	240.5	---	27.7	---	13.0	---
23	Waste material of textile fabrics	MT	3.6	524.0	1.3	527.5	-2.4	-65.3	-65.1	0.7
C.	**Other manufactures**		**849.6**		**800.1**		**-49.5**		**-5.8**	
24	Carpets, carpeting rugs & mats	SQM	108.4	53.8	105.2	58.0	-3.2	-9.9	-3.0	7.7
25	Petroleum and products	MT	120.8	259.8	104.7	347.8	-16.0	-35.2	-13.3	33.9
26	Sports goods	---	144.7	---	128.9	---	-15.8	---	-10.9	---
27	Leather manufactures	---	224.1	---	195.5	---	-28.6	---	-12.8	---
28	Surgical & medical instruments	No	63.6	---	61.0	---	-2.5	---	-4.0	---
29	Cutlery	Gr	15.0	35.6	7.6	24.0	-7.4	-24.8	-49.1	-32.4
30	Onyx manufactured	MT	6.1	1,732.3	5.4	1,631.1	-0.6	-5.2	-10.7	-5.8
31	Chemicals and pharmaceuticals	---	135.4	---	150.6	---	15.2	---	11.2	---
32	Molasses	MT	16.8	29.1	38.1	51.2	21.3	29.0	127.1	76.1
33	Sugar	MT	14.8	225.5	3.0	237.2	-11.8	-80.9	-80.0	5.2
	Others		**558.4**		**1,270.8**		**712.4**		**127.6**	**---**
	Total exports		**5,881.0**		**6,495.9**		**614.8**		**10.5**	
	excl. Major food items and raw cotton		*5,255.2*		*5,814.3*		559.1		10.6	
	excl. Major food, raw cotton and yarn		*4,738.5*		*5,366.7*		628.2		13.3	

Source: Federal Bureau of Statistics

shipments in this category; and (2) imposition of antidumping duty on this sector by the EU.

> **Box 6.3: Measures Taken for the Resolution of the Antidumping Issue.**
> (1) In response to government's request to start review investigations, on the ground that the decision of imposition of duty was taken on the basis of incomplete investigations, EU has reportedly agreed to send review mission to Pakistan.
>
> (2) Government also did strong lobbying efforts to gather support for complete suspension of dumping duty till the end of on ongoing partial interim review of anti-dumping measures. However this effort apparently could not succeed as the EC member states in a meeting held in end January 2005 voted against duty suspension.

However, at least a part of the impact of the US embargo may be mitigated as the government announced the freight subsidy for the shipments that were disrupted by this action.[17] Also for the antidumping duty, government is undertaking various efforts to address this issue in order to restore competitiveness of this sector in the EU market (see **Box 6.3**). EU is a large destination for country's bed wear exports having around 44 percent share in country's exports in this category. On the other hand, Pakistan is also one of the largest suppliers for this category to the EU, with a 28 percent market share in this category.

History of EU's antidumping investigations against Pakistan:
This is not the first time that EU has imposed an anti-dumping duty on Pakistan.

(1) The first proceeding against imports of cotton-type bed linen from Pakistan was initiated in January 1994 and terminated in July 1996 after a withdrawal of complaint by EU textile manufacturers.[18]

(2) Less than three months after the termination of the first proceeding, Eurocoton filed a new complaint, which led to the imposition of 6.4 percent anti-dumping duty in November 1997. This second proceeding was terminated in January 2002, after having been declared unlawful by the WTO Dispute Settlement Body. However anecdotal evidence suggests that since some of the major bed wear exporters were not included in the dumping margin, therefore the imposition of duty did not significantly hurt country's bed wear exports at that time.

[17] To facilitate those exporters whose goods were ready for shipment by sea in December 2004 and likely to reach the US destinations in January 2005, but their shipments schedules were disrupted due to over-shipments and embargo in some categories, the government decided to facilitate such exporters so that their goods reach in time by providing airlifting facility.
[18] The complaint was lodged by the Committee of the Cotton and Allied Textile Industries of the European Communities (EUROCOTON).

(3) Fresh anti-dumping proceedings were initiated in October, 2002 – a mere ten months after the termination of the second proceeding. The investigations were started in June 2003, which resulted in the imposition of a 13.1 percent antidumping duty effective from March 2004. The Pakistan's bed wear exporters however are not satisfied by this decision. According to them, since EU and Pakistani exporters do not compete on the same markets as EU production has been shifted towards high value added bed linen items, there is no question of any sort of injury to the EU bed wear industry. Further Pakistani exporters prior to imposition of anti-dumping duty made all out efforts to find a constructive solution in the form of giving a price undertaking. However, the EU firmly rejected this idea.

The issue of antidumping duties highlights following two general observations: (1) the pace of opting for this trade policy tool for the protection of the domestic industry is on the rise since the inception of WTO; and (2) more investigations are being carried out against developing countries so they are significantly affected by this process. Keeping in view the fact that antidumping investigations hamper export prospects of the affected sector (even when the duties are not eventually imposed), this can be concluded that this measure is a serious threat to the process of liberalization of global trade (see **Box 6.4** at the end of section).

Preferential access to EU: Presently the most crucial issue for Pakistan is to restore its duty free access to the EU, which is a major destination for the country's textile exports.[19] Pakistan enjoyed duty free access to this region from 2002-2004 under drug related Generalized System of Preferences (GSP). However this facility ended in December 2004 and currently Pakistan exports to this region are not enjoying any preferential status. Moreover, EU is in the process of replacing the old system of preferences with a new scheme that will come into effect in July 2005. Pakistan is currently lobbying to get maximum support for its access to the most beneficial part of this scheme, i.e., GSP Plus that envisages duty free access for the beneficiary countries (see **Box 6.5** at the end of section).

The performance of *other manufactures* also remained disappointing as with few exceptions all categories in this group recorded decline (see **Table 6.5**). Highest fall was seen in the leather manufactures exports category. However, in order to

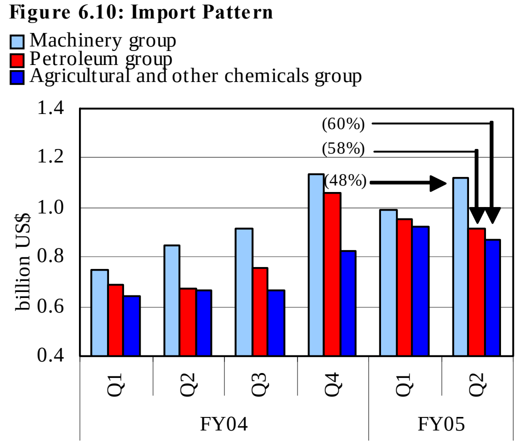
[19] EU captured 33 percent share in Pakistan's total textile exports during FY04.

help this sector, government has approved a 25 percent freight subsidy for leather garments exports in CY 2005.[20]

6.2.2 Imports

Imports witnessed a steep rise of 34.8 percent during H1-FY05 reaching US$ 8.9 billion (see **Table 6.6**). This rise was led by a sharp increase in *machinery*, *petroleum* and *other chemicals* imports (see **Figure 6.10**). The strength of the domestic economy suggests that imports will not dip sharply in the near future, although the growth rate will be lower due to a high-base effect.

Figure 6.10: Import Pattern



Figures in parentheses are import as % of target

The level of machinery imports, while significantly higher than that in corresponding period of FY05, was largely in line with the annual import target for this category. The single biggest contribution (34.6 percent share) to the rise in these imports was from textile machinery, which suggests the confidence of the textile exports in their ability to benefit from the end of textile export quotas.

In fact, even a significant part of the jump in the *Agriculture and other chemical* group imports reinforces this trend in other sectors too. The imports of organic chemicals (largely textile inputs) has risen 43.4 percent[21] YoY suggesting that production (and possibly exports of textile) may rise in coming months. Imports in this group are also likely to remain strong due to the higher demand for fertilizers amidst bumper crops. There is no large capacity addition expected in the near future and demand growth will therefore be dependant on imports (import prices too are higher than domestic prices). Finally, imports of plastics have risen 49.7 percent during H1-FY05, but this was compensated by higher exports of plastic materials.[22]

---

[20] Export Development Fund approved 25 percent freight subsidy on both air and sea shipments of leather garments exports for the period of January 1, 2005 till December 31, 2005.
[21] This number pertains to Q1-FY05.
[22] Plastic materials exports recorded 38.3 percent growth during H1-FY05.

Table 6.6: Major Imports

Value: Million US $; Unit value: US $

	Commodities	Units	H1-FY04 Value	H1-FY04 Unit val.	H1-FY05 Value	H1-FY05 Unit val.	Abs chg. In value	% chg in FY05/FY04 Qty	% chg in FY05/FY04 Value	% chg in FY05/FY04 U val.
A.	**Food group**		**493.1**	**---**	**577.7**	**---**	**84.6**	**---**	**17.2**	**---**
1.	Milk & cream including milk food	MT	8.8	2,156.3	12.4	2,025.9	3.6	50.0	40.9	-6.0
2.	Wheat unmilled	MT	-	-	20.5	227.7	20.5			
3.	Dry fruits	MT	2.9	285.4	16.7	514.3	13.8	216.9	471.1	80.2
4.	Tea	MT	94.3	1,626.8	103.8	1,671.5	9.6	7.2	10.1	2.8
5.	Spices	MT	16.9	498.7	24.6	832.4	7.7	-13.0	45.3	66.9
6.	Edible oil	MT	332.1	453.1	346.3	490.3	14.2	-3.7	4.3	8.2
	Soyabean	MT	*19.8*	*537.6*	*27.6*	*722.6*	7.8	3.6	39.2	34.4
	Palm oil	MT	*312.3*	*448.6*	*318.7*	*477.1*	6.4	-4.0	2.0	6.3
7.	Sugar	MT	1.2	300.5	1.5	353.7	0.3	8.2	27.3	17.7
8.	Pulses	MT	36.8	286.3	51.9	307.0	15.0	31.2	40.7	7.2
B.	**Machinery group**		**1,595.5**	**---**	**2,131.4**	**---**	**535.9**	**---**	**33.6**	**---**
1.	Power generating machinery	-	143.9	---	171.9	---	28.0	---	19.5	---
2.	Office machinery	--	100.4	---	111.7	---	11.3	---	11.3	---
3.	Textile machinery	--	265.6	---	451.4	---	185.8	---	69.9	---
4.	Construction & mining machinery	---	51.4	---	73.0	---	21.6	---	42.1	---
5.	Electrical machinery & apparatus	--	120.2	---	129.3	---	9.2	---	7.6	---
6.	Railway vehicles	--	50.4	---	11.0	---	-39.3	---	-78.1	---
7.	Road motor vehicles	--	307.8	---	389.7	---	81.9	---	26.6	---
8.	Aircraft, ships and boats	---	83.3	---	33.6	---	-49.7	---	-59.7	---
9.	Agricultural machinery & implements	---	11.4	---	19.0	---	7.6	---	66.9	---
10.	Other machinery	-	461.2	---	740.8	---	279.6	---	60.6	---
C.	**Petroleum group**	**MT**	**1,355.7**	**218.4**	**1,869.9**	**249.8**	**514.1**	**20.6**	**37.9**	**14.4**
1.	Petroleum products	MT	599.5	236.3	808.1	279.4	208.6	14.0	34.8	18.2
2.	Petroleum crude	MT	756.2	206.0	1,061.8	231.2	305.5	25.1	40.4	12.2
D.	**Textile group**	**MT**	**132.6**	**---**	**165.5**	**---**	**32.9**	**---**	**24.8**	**---**
1.	Synthetic fibre	MT	51.3	1437.5	76.7	1,823.4	25.4	17.9	49.5	26.8
2.	Synthetic & artificial silk yarn	MT	61.5	1635.8	69.2	1,763.8	7.7	4.4	12.5	7.8
3.	Worn clothing	MT	19.8	325.0	19.6	317.0	-0.2	1.3	-1.2	-2.4
E	**Agricultural and other chemical**	**MT**	**1,308.1**	**---**	**1,798.5**	**---**	**490.5**	**---**	**37.5**	**---**
1.	Fertilizer	MT	173.7	205.2	224.9	247.3	51.2	7.4	29.5	20.6
2.	Insecticides	MT	64.6	3,019.4	95.7	3,090.0	31.1	44.8	48.1	2.3
3.	Plastic materials	MT	245.3	858.2	367.1	976.1	121.9	31.6	49.7	13.7
4.	Medicinal products	MT	132.2	27,753.7	124.8	23,330.2	-7.3	12.4	-5.5	-15.9
F.	**Metal group**	**MT**	**316.6**	**---**	**472.3**	**---**	**155.6**	**---**	**49.2**	**---**
1.	Iron and steel scrap	MT	47.9	160.2	86.0	173.0	38.0	66.2	79.4	8.0
2.	Iron and steel	MT	230.4	383.4	343.0	409.5	112.6	39.4	48.9	6.8
3.	Aluminum wrought & worked		38.3	---	43.3	---	5.0	---	13.1	---
G.	**Miscellaneous group**		**179.5**	**---**	**224.7**	**---**	**45.3**	**---**	**25.2**	**---**
1.	Rubber crude	MT	33.9	877.7	43.2	1,096.7	9.3	2.1	27.6	25.0
2.	Rubber tyres & tubes	No.	44.0	21.4	65.5	24.0	21.4	32.4	48.6	12.3
3.	Wood & cork	---	10.1	---	14.0	---	3.9	---	39.1	---
4.	Jute	MT	16.8	238.1	15.2	264.2	-1.6	-18.3	-9.4	11.0
5.	Paper and paper board & manuf.	MT	74.7	599.6	86.8	616.5	12.1	13.1	16.3	2.8
H.	**Others**		**1,223.2**		**1,664.9**		**441.7**	**---**	**36.1**	**---**
	Total imports		**6,604.3**		**8,904.9**		**2,300.6**		**34.8**	

Source: Federal Bureau of Statistics

Petroleum group recorded 37.9 percent rise during H1-FY05 reaching US$ 1.9 billion during this period. The analysis of change in prices and quantities reveal that both contributed almost equally in the overall growth seen in this group (see **Table 6.7**).

Table 6.7: Quantum and Price Impact of Petroleum Group

million US$

	Total change	Quantum impact	Price impact
Petroleum group	514.1	278.9	235.5
Petroleum products	208.6	84	124.6
Petroleum crude	305.5	189.8	115.7

As a matter of fact, petroleum group import pattern is likely to undergo some changes due to the commencement of commercial operations of a new small petroleum refinery Bosicar Pakistan Limited since July 2004.[23] This will cause a substitution of import demand for petroleum products with crude petroleum. In H1-FY05 also there was a visible increase in the crude petroleum imports, however the expected fall in the petroleum products imports was not evident due to the severe water shortage in the country that led to higher thermal power generation, and an attendant rise in fuel oil imports (see **Table 6.8**).

Table 6.8: Demand/ Supply Situation of Petroleum Products

000 MT

	H1-FY04		H1-FY05	
	HSD*	**Fuel oil**	**HSD**	**Fuel oil**
Demand				
Domestic sales/ consumption	3,618.4	1,644.7	3,966.9	2,405.7
Supply				
Production	1,400.3	1,465.4	1,806.6	1,546.0
Imports	2,178.9	271.6	2,123.9	981.2

* High Speed Diesel Oil

Source: OCAC

Furthermore, on account of higher economic activity,[24] energy demand is also growing and to fulfill this demand refineries are operating at higher capacity utilization rates causing demand for crude petroleum to rise.[25]

Fortunately, imports of petroleum products are expected to decline somewhat in H2-FY05. Not only are international oil prices expected to decline in spring, Pakistan oil requirements are expected to be reduced by the lower dependence on thermal electricity following improved water prospects (and attendant rise in hydro-electricity generation).

[23] Bosicar captured 30.3 percent share in the total crude imports increase in H1-FY05.
[24] Rise in domestic demand for HSD due to a bumper cotton crop that needed a large harvesting operation also caused a rise in domestic petroleum products demand. However this demand was fulfilled through increased domestic production.
[25] Capacity utilization rate of Parco, Pakistan's largest oil refinery rose from 71.18 percent in H1-FY04 to 83.16 percent in H1-FY05.

6.3 Foreign Exchange Reserves

The country's overall reserves touched a historic high of US$ 12.78 billion by end February 2005; showing an increase of US$ 452.1 million since July 2004. However, as evident from **Figure 6.11**, overall reserves have however undergone a significant compositional change during this period. Specifically, during this period SBP's reserves declined by US$ 706.7 million, despite some major inflows, including disbursements by the World Bank (WB) and Asian development Bank (ADB) as well as receipts for *sukuk*[26] offering. On the other hand, reserves held by commercial bank increased by US$ 1,158.8 million.

Figure 6.11: Overall Reserves

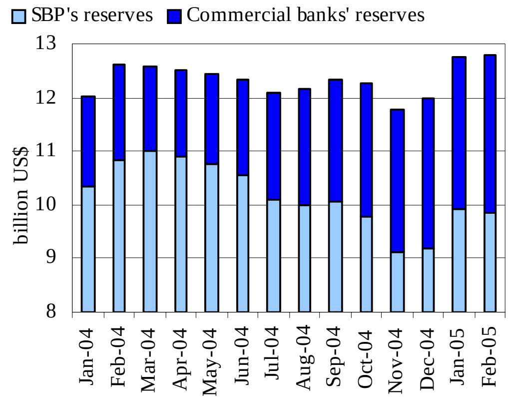
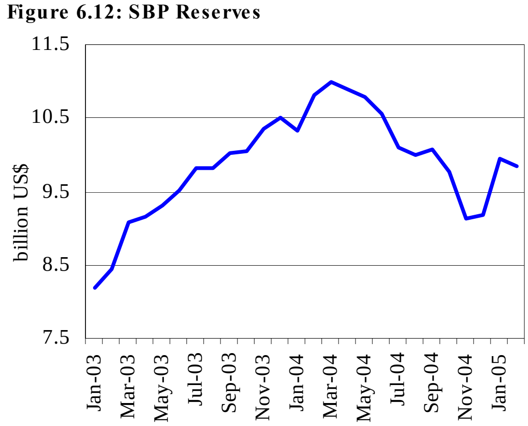


Figure 6.12: SBP Reserves



(1) The SBP reserves which have been showing a downward trend since March 2004 (see **Figure 2.12**), declined by US$ 1,859 million till end-November 2004 due to massive SBP support to the market mainly aimed at containing excessive exchange rate volatility.[27]

---

[26] *Sukuk* is an Islamic certificate/bond having no fixed yield, and instead of making any regular payments to investors, returns are based on profit earned from the investments.

[27] In particular, SBP formally committed on October 31, 2004 to provide foreign exchange for lumpy oil payments; later this facility was extended to wheat and fertilizer imports. During the period Nov'04-Jan'05, SBP paid around US $ 1,100 million only on account of oil imports.

Table 6.9: Overall Reserves as per BOP (July-December)

million US $	FY03	FY04	FY05
Opening balance	*6,398*	*11,667*	*12,389*
Inflows	**1,3653**	**1,2056**	**1,5443**
Exports of goods	5,213	6,108	7,000
Export of services	1,307	1,572	1,578
Of which: logistic support	317	582	448
Income	73	83	115
Workers' remittances	2148	1874	1,946
Foreign direct investment	325	255	412
Foreign portfolio investment	30	-18	59
Loan disbursements	1,261	816	1,664
Official	1,090	738	1,652
Long-term loans	985	730	1,456
Program loans	737	489	1,187
IMF	230	245	255
IDA/IBRD	202	0	494
AsDB	305	244	438
Project & food loans	248	241	269
Short-term including IDB	105	8	196
Private un-guaranteed	171	78	12
Official grants	570	467	80
Others	174	192	80
Other receipts	2,540	899	2,589
Outflows	**9,981**	**10,964**	**15,691**
Imports of goods	5,622	6,267	9,257
Imports of services (excluding interest)	1,165	1,745	3,120
Interest payments	472	569	504
Amortization of official loans	588	844	720
IMF	163	343	246
IDA/IBRD	165	188	210
AsDB	132	145	121
Others actual paid	128	168	143
Profit and dividends	303	329	409
Purchase of crude oil /gas	228	248	421
Principal repaid on private loans	312	287	155
Foreign exchange liabilities liquidated	695	213	78
PTMA & commercial loans-actual paid	54	33	16
IDB (short term)	46	105	8
Special $ bonds	210	75	54
Other payments	596	462	1027
Gross reserves at end of period	**10,070**	**12,759**	**12,141**
CRR	422	507	637
Sinking fund	900	920	0
Net reserves of SBP	7,654	10,525	9,182
DMB reserves without sinking fund & includes CRR	1516	1314	2,959

Source: Statistics Department, SBP

This drawdown of reserves was however, partially offset by additional inflows, mainly from WB, ADB, and USA (on account of logistic support provided by Pakistan) (see **Table 6.9**). In addition, Pakistan launched the *Sukuk* offering – the country's first Islamic international debt instrument which added US$ 600 million to SBP reserves.

(2) The reserves of the commercial banks, on the other hand, increased by US $ 1,158.8 million during July-February FY05. As explained in *SBP's Report* for Q1-FY05, the strengthening expectations of the Rupee depreciation against US Dollar led to the retirement of forex loans extended by commercial banks to traders. This in turn augmented the commercial banks' reserves. In addition, commercial banks' reserves also increased due to fresh inflows in FE-25 accounts. The total increase in the reserves of commercial banks was US$ 1,158.8 million during the FY05; of which, US$ 583.4 million were due to retirement of FE 25 loans and the remaining US$ 575.4 million were due to additional deposits.

6.3.1 Reserve Adequacy[28]

Despite a considerable decline in SBP reserves during H1-FY05, the overall reserve adequacy indicators are still showing a comfortable position.

The data reveals that reserves still well exceeds the eight-month imports coverage (see **Table 6.10**). These reserves also show a comfortable position according to Guidotti and Greenspan rule. A reserve to short terms debt and liabilities (STDL) ratio has declined during the H1-FY05 due to reserve drawdown and debt inflow of US$ 100 million from IDB. But the liquid reserves are still seven and half times greater than the STDL.

Table 6.10: Reserves Adequacy Ratios

	FY00	FY01	FY02	FY03	FY04	H1-FY05
Liquid reserve (million US$)	1,967.60	3,219.48	6,431.60	10,719.03	12,327.90	11,987.20
Reserves to GDP share (%age)	2.71	4.96	8.77	13.07	13.14	N.A
Import coverage (weeks)	9.95	15.65	32.43	45.87	41.22	35.13
Reserve to external debt	0.06	0.10	0.19	0.32	0.37	0.36
Reserve to STDL	0.50	1.00	3.27	7.59	10.09	8.99
Reserve-(Imports + STDL)*	-4,516.05	-2,675.73	1,882.22	6,260.25	7,207.91	6,206.85
Reserve to M2	0.07	0.14	0.22	0.30	0.29	0.29
Reserves to reserve money	0.21	0.39	0.66	0.94	0.93	0.87

*: Million US $

[28] For detail please see **Box 6.6** at the end of section.

6.4 Pakistan's External Debt & Liabilities (TDL)

The new flows of multilateral debt and the rise in the value of Paris Club and multilateral debt stock arising out of the appreciation of Yen and Euro vis-à-vis US Dollar brought about a 4.1 percent increase in the country's stock of TDL (see **Table 6.11** & **Table 6.12**). However, total external debt as percentage of GDP *declined* by one percentage point to 35 percent.

Table 6.11: Pakistan's External Debt & Liabilities

million US $

	FY03	FY04	End Sep.04p	End Dec.04[p]	Abs. change during H1-FY05 over FY04
1. Public and publicly guaranteed debt	**29,232**	**29,875**	**29,695**	**31,415**	**1,540**
A. Medium and long term(>1 year)	**29,045**	**29,853**	**29,576**	**31,304**	**1,451**
Paris Club	12,607	13,558	13,038	13,991	433
Multilateral	14,950	14,349	14,589	15,508	1,159
Other bilateral	512	720	734	761	41
Euro bonds	482	824	822	667	(157)
Military debt	263	204	195	195	(9)
Commercial Loans/credits	231	198	198	182	(16)
B. Short Term (<1 year)	**187**	**22**	**119**	**111**	**89**
IDB	187	22	119	111	89
II. Private non-guaranteed debts	**2,028**	**1,670**	**1,574**	**1,537**	**(133)**
Medium and long term (>1 year)	2,028	1,670	1,574	1,537	(133)
III. IMF	2,092	1,762	1,910	1,876	114
Total external debt (1 to III)	**33,352**	**33,307**	**33,179**	**34,828**	**1,521**
IV. Total external liabilities	**2,122**	**1,951**	**1,900**	**1,876**	**(75)**
Foreign currency accounts	-	-	-	-	-
FE – 45	-	-	-	-	-
FE-13	-	-	-	-	-
FE - 31 deposits (incremental)	-	-	-	-	-
Special U.S $ bonds	696	552	524	500	(52)
National debt retirement program	6	1	-	-	-
Foreign currency bonds (NHA)	175	153	131	131	-
Central bank deposits	700	700	700	700	-
NBP/BOC deposits	500	500	500	500	-
Other liabilities	45	45	45	45	-
Total external debt & liabilities (1 to IV)	**35,474**	**35,258**	**35,079**	**36,704**	**1,446**
FEBCs/FCBCs/DBCs (payable in Rs)	**42**	**22**	**20**	**19**	**-3**

P: Provisional

Source: Statistics Department, SBP

The increase in total external debt (TED), in turn, can be attributed mainly to the rise in the value of the outstanding stock of Paris Club. While the stock of other bilateral, IDB and IMF debt also inched up, their impact was small. All other categories of external debt & liabilities either remained unchanged or declined during the period.

Table 6.12.: Causative Factors for the Rise in Debt Stock
million US $

	Paris Club	Multilateral	Other bilateral	Total
Stock as on end June-04	**13,558**	**14,349**	**720**	**28,627**
Inflow	65	1,096	40	1,201
Repayment of principal	65	338	11	414
Debt relief	495	0	0	495
Exchange rate fluctuation	928	401	12	1,341
Stock as on end Dec-04	**13,991**	**15,508**	**761**	**30,260**

6.4.1 Paris Club
The US$ 433 million rise in the stock of Paris Club during H1-FY05 may appear surprising in the first stance, given the US$ 495 million of debt relief granted by the USA in August 2004, and fresh inflows of a mere US$ 65 million.

The explanation lies in exchange rate movements. Pakistan receives loans in different currencies and for reporting purposes these amounts are converted into the US Dollar at a particular point in time. Thus, exchange rate movements can cause changes in the US Dollar value of TED.[29] In fact, a significant amount of TED is denominated in Euro and Yen, and the H1-FY05 depreciation of US Dollar against Euro (by 10.7 percent) and against Japanese Yen (by 6.3 percent) accounts for most of the rise in the stock of the Paris Club when expressed in US Dollar.[30] This more than offset the gain from the USA debt write-off during the same period.

6.4.2 Multilateral Debt
A largest contributor to the rise in the TED increase, however, was the increase in the stock of external debt owed to multilateral creditors, which rose by US$ 1.2 billion during H1-FY05. This was mainly due to the fresh disbursements from the World Bank and ADB during the period. During H1-FY05, the following major fresh flows have been realized from these creditors: ADB disbursed US$ 129

[29] For detail see Annual Report FY04.
[30] More than one third rise in stock of Paris club was explained by the revaluation of non- US $ denominated debt

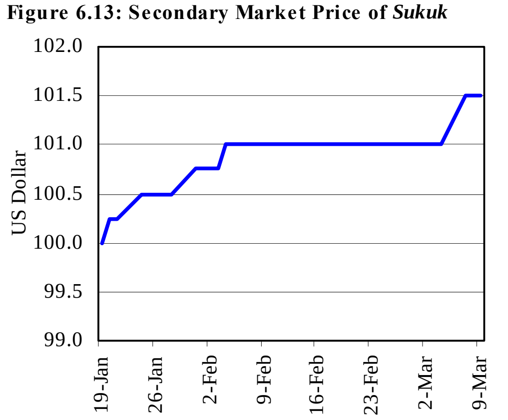
million for Decentralization Support Program, US$ 88.3 million for Excess to Justice, US$ 68.8 million for Balochistan Resource Management Program, and US$ 50 million for Rural Finance Support. The disbursements form IDA during the same period are: US$ 300 million for Poverty Reduction Support Program and US$ 115.6 million for Banking Restructure Privatization.

6.4.3 Issuances of *Sukuk*

After a remarkably successful Euro bond issue in FY04, Pakistan re-entered the international capital markets with a US$ 600 million five-year Islamic (*Sukuk*) offering in January 2005.[31] This was the fourth largest Islamic sovereign issue by any country.

The principle idea behind the issuance of the *Sukuk* was to diversify the investor base and to strengthen Islamic banking in the country.[32] In addition, the bond provides a new and alternative source of funding for infrastructure projects based on pure Islamic capital financing rules. The *Sukuk* were priced at US$ LIBOR + 220 bps, and the instrument is also tradable on the secondary market, similar to bonds.

Figure 6.13: Secondary Market Price of *Sukuk*



The primary offering of the *Sukuk* received a strong response (the total subscription was US$ 1.2 billion) mainly reflecting the improvement in Pakistan's macroeconomic indicators[33] as well as the rarity of the issue. This is also evident from the secondary market prices of *Sukuk*.

[31] *Sukuk* is an Islamic certificate/bond having no fixed yield, and instead of making any regular payments to investors, returns are based on profit earned from the investments.
[32] During the last fiscal year Pakistan issued the Euro bond, in which Middle East obtained only 12 percent share, however, this time the allocation was in favor of the Middle East for 47 percent, Asian 31 percent and Europe received 22 percent in order to meet the demand of Middle East countries.
[33] This is also reflected by the up gradation of credit rating by Moodys' credit rating agency from stable to positive outlook.

The bond was priced at a margin of US$ LIBOR + 220 bps. In addition, the bond is also tradable on the secondary market just like any other bond irrespective of the market size. This is also evident from the secondary market prices of Sukuk bond; the bond has traded broadly favorably since floatation (see **Figure 6.13**).

Following the successful experience of two international debt offering, the government is considering floatation of an international bond offering each fiscal year.[34] This would ensure continued investor interest in the Pakistan's markets.

[34] Firstly, government can easily borrow funds from the international market without facing any conditionality. Secondly, the improvement in macro economic indicators further increases the investor's confidence on the economy.

Box 6.2: WTO Agreements and Trade Liberalization-Status of Pakistan:

The basic principles underlying WTO agreements emphasize on a freer, predictable, competitive and non-discriminatory trading system. These agreements include commitments by member countries to reduce and "bind" their customs duty rates on imports of goods.[35, 36]

Table 1: Tariff Rates -A Comparison

percent

	Average tariff rates		Agriculture[4]	
	1998[1]	2003	Bound tariff	Actual applied tariff (2001)
India	35	29[2]	114	38
Pakistan	16	9.6[3]	101	25

[1]Source: WTO Trade Policy Review

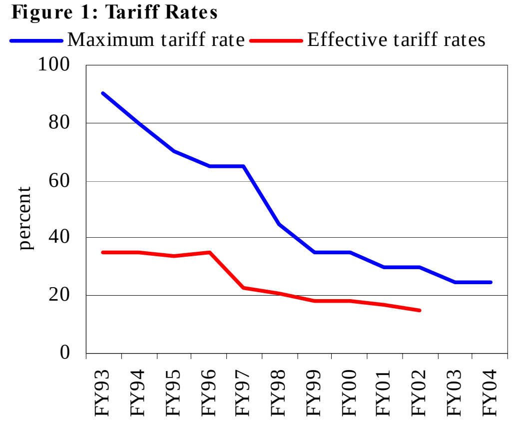
[2] Source: Indian Council for Research on International Economic Relations Policy Briefs December 2004

[3] Calculated on the basis of CBR data

[4] Source: www.ers.usda.gov/db/wto

Normally for developed countries, the bound rates are the rates actually charged. However, most developing countries have bound rates that are higher than the actual rates, so the bound rates serve as ceilings. Many developing countries have kept this margin as a cushion to enable them to protect domestic economy, in case of need, by increasing the tariff level.

Figure 1: Tariff Rates



In case of Pakistan too, bound rates are quite high, especially for agricultural imports. However the country's actual applied tariff rates are quite lower than that in the region. India provides a good example of a country with substantially higher average applied rate than Pakistan. However India has also recognized the need of greater integration with international economy for acceleration in country's growth and is moving on the path of greater liberalization (see **Table 1**).

As far as Pakistan is concerned, it started liberalization efforts in the early 1990s as a part of its reform efforts to lower the level of protection extended to the domestic producers and to improve the overall efficiency. As a result, country's average and maximum tariff rates[37] are undergoing a gradual reduction over the last decade (see **Figure 1**).

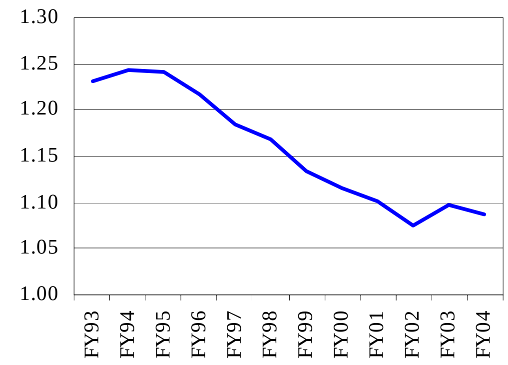
[35] However, these agreements are not legally binding. Countries can raise tariff level above the bound rate. To do so they have to negotiate with the countries most concerned and it can result in compensation for trading partners' loss of trade.

[36] Source: www.wto.org

[37] Maximum tariff rate pertains to the tariff rate of the fourth slab.

These liberalization efforts also resulted in lowering of anti export bias that persisted in the country's trade policy regime on account of the excessive protection it extended to the import substituting industries.[38] The domestic incentive structure as a matter of fact was highly tilted in favor of the import competing industries creating a bias against exports. The prevalence of high tariff rates made availability of raw materials difficult and more expensive for the exports sector. However with more openness of country's trade sector, this anti export bias has been significantly reduced (see **Figure 2**).

Figure 2: Anti Export Bias



Box 6.4: Anti-dumping duties and the issues involved:

Procedure for filing antidumping complain:

Dumping is defined as a practice of a firm to sell a product at a price lower than the price it charges in its own home market. If a country believes that the goods are being dumped then it may consider introducing measures to curb the dumping. The process for implementing an anti-dumping measure begins with the domestic industry making a complaint. This is then investigated by the domestic government, based on the detailed requirements of the WTO Agreement. If they find evidence to support the claim, which requires proof of injury and causation, then anti-dumping measures can be applied for up to five years. If the country from which the goods have been exported disagrees with the finding, then that country can initiate a dispute settlement in the WTO.

What are the losses for the country on which the AD has been imposed?

The frequent recourse to this tool of implicit protectionism is a potential threat for the process of trade liberalization. More importantly, since developing countries have been hit harder by these investigations, it has more significant ramifications for these countries. In 2000, out of the 251 anti dumping investigations 61 percent were carried forward against developing countries. Since developing countries products are subject to more investigations, this means that developing countries firms will be perceived as unreliable sources of those products on which antidumping duties have been imposed. Secondly if an industry is facing these investigations, the uncertainly

[38] The anti export bias is calculated on the basis of the methodology given in "Trade and Industrial Policy in Pakistan. Post Uruguay Round Challenges", a paper prepared for the World Banks' WTO 2000 Project by Shaukat Ali. This paper describes anti export bias as a ratio of effective exchange rate for imports (EERM) to effective exchange rates of exports (EERX). The extent by which this ratio exceeds one determines the magnitude of implicit bias against exports, whereas the equality of this ratio implies neutrality of incentives between import and export sector. This is also worth mentioning that the effective exchange rates are not calculated by deflating the nominal exchange rate with the domestic price level as for the analysis of incentive structure usage of trade duties and subsidies is more relevant. Therefore EERM was calculated by adding import duty into rupee value of imports divided by dollar value of imports. The same exercise was repeated for exports.

associated with the outcome dampens the prospects of future investment in that sector, thus causing a permanent loss to that sector.

In this connection, it is worth mentioning that recourse to the dispute settlement mechanism in WTO is time consuming and can take a year in resolution of the matter. And even if the dumping duty is waived from a country, the confidence loss that this whole process causes for this sector is quite substantial.

Box 6.5: EU Schemes for Generalized System of Preferences (GSP)[39]

In 1968, the United Nations Conference on Trade and Development (UNCTAD) recommended the creation of a "Generalized System of Tariff Preferences" (GSP). The objective of this system was to help developing countries to develop a strong and diversified manufacturing base with the help of the trade preferences granted by industrialized countries. GSP was regarded by UNCTAD as an effective trade policy instrument favoring developing countries through the stimulus it provided to the expansion and diversification of exports. The EU was the first to implement a GSP scheme in 1971. The EU's GSP was implemented following cycles of ten years. The last cycle spanned from January 1995 to December 2004.

GSP scheme for 1995-2004: There were five types of GSP schemes offered in this cycle that included:
General scheme: provided reduction of 3.5 percent over the normal custom duty for sensitive products and reduction of duties to zero for non-sensitive products as identified by the EU.

Special scheme for the protection of labor rights, for those countries that engaged themselves in the respect of core ILO conventions. Sensitive products receive a tariff reduction of 8.5 percentage points on the MFN tariff (MFN minus 40% for textiles/clothing). Beneficiary countries-Moldova and Sri Lanka.

Special scheme for the protection of the environment, same as above but no beneficiaries.

Special scheme to combat drug production and trafficking: benefited all Central American countries, countries belonging to the Andean Community as well as Pakistan. The number of products covered was higher (around 7200) with duty-free access.

Special scheme for Least Developed Countries (LDCs) - “Everything but Arms”, for the world 50 poorest countries. All products except arms and ammunitions were covered giving duty-free and quota-free access.

Future EU GSP scheme 2006-2008[40] The new GSP scheme will replace the above mentioned five arrangements with three arrangements given below:

General scheme: Product coverage will be increased and duty concession will remain same.

[39] Source: Source: www.trade-info.cec.eu.int.
[40] The new GSP scheme had to be started from July 2005, however in order to extend help to the Tsunami affected countries it might possibly be implemented from April 2005.

Special scheme for Least Developed Countries (LDCs) - "everything but Arms" same as before.
New Special GSP Plus: Zero duty access for 7200 products. This scheme is for vulnerable countries with special development needs. The beneficiaries must meet a number of criteria including ratification and effective application of 27 key international conventions on sustainable development and good governance which are given below. In addition these countries need to demonstrate that they are small beneficiaries and that their economies are poorly diversified. For this they need to fulfill following two conditions:
(1) Five largest sections of a country's GSP covered exports to the EU must represent more than 75 percent of its total GSP-covered exports.

(2) GSP covered imports from that country represent less than I percent of total EU imports under GSP.

Pakistan's position on new GSP scheme: It seems likely that Pakistan will gain access to the general scheme, however government is currently lobbying for gaining access to the most beneficial GSP plus scheme. It has demanded from the EU relaxation in two conditionalities necessary for getting access to the GSP plus scheme. 1) A grace period of three years up to 2008 for ratifications and implementation of all the 27 conventions attached with the new GSP scheme. 2) Increase in the limit of share from one per cent to two per cent in the total GSP trade, which was necessary for qualifying for the new GSP plus scheme.

List of conventions to qualify for GSP plus

Core human and labor rights UN/ILO conventions

1. International covenant on civil and political rights.
2. International covenant on economic social and cultural rights.
3. International convention on the elimination of all forms of racial discrimination.
4. Convention on the elimination of all Forms of discrimination against women.
5. Convention against torture and other cruel, inhuman or degrading treatment or punishment.
6. Convention on the rights of the child.
7. Convention on the prevention and punishment of the crime of genocide.
8. Minimum age for admission to employment.
9. Prohibition and immediate action for the elimination of the worst forms of child labor.
10. Abolition of forced labor convention.
11. Forced compulsory labor convention.
12. Equal remuneration of men and women workers for work of equal value convention.
13. Discrimination in respect of employment and occupation convention.
14. Freedom of association and protection of the right to organize convention.
15. Application of the principles of the right to organize and to bargain collectively convention.
16. International convention on the suppression and punishment of the crime of apartheid.

Conventions related to environment and governance principles

17. Montreal protocol on substances that deplete the ozone layer.
18. Basel convention on the control of trans boundary movements of hazardous wastes and their disposal.
19. Stockholm convention on persistent organic pollutants.
20. Convention on international trade in endangered species.
21. Convention on biological diversity.

22. Cartagena protocol on bio safety.
23. Kyoto protocol to the UN framework convention on climate change.
24. UN single convention on narcotic drugs (1961).
25. UN convention on psychotropic substances (1971).
26. UN convention against illicit traffic in narcotic drugs and psychotropic substances (1988).
27. Mexico UN convention against corruption.

Box 6.6: Reserves Adequacy Ratios

The continuous rise in the ratio of reserve holding to GDP explains the protection against instabilities of international monetary system. But, this is not the single benchmark of checking the adequacy of reserves.

For the post war period, the reserves to import ratio became the standard way of quantifying reserve adequacy. The broad rule of thumb for reserve adequacy was that reserves should be sufficient to pay for about three to four months of imports. The reserve to imports criterion was quite appropriate when international capital flows were highly limited. However, in recent years, most of the developing countries have become far more exposed to the risk of sudden stops or outright capital reversal during the liberalization of short term capital movements during 1990s.

In recognition of this, Pablo Guidotti, former Deputy Minister of Finance of Argentina and Alan Greenspan, Chairman of Fed proposed that countries hold reserves at least equivalent to short term debt cover. This implies, at a minimum, that usable international reserves should exceed scheduled external amortization for one year. But, the modified debt based measure of reserve adequacy has a significant limitation.

The reserve to short term external debt gives an indication of the vulnerability to an “external drain”, it fails to take into account internal drain associated with capital flight by resident. This internal drain may be best captured by measures of broad money supply (M2). Specifically, the reserves-to-M2 ratio captures the extent to which liabilities of the banking system are backed by international reserves; a low and declining ratio is among the leading indicators of currency crises.