6 External Sector

6.1 Balance of Payments

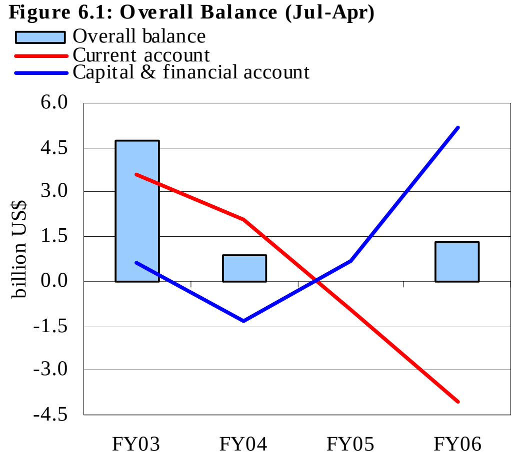
The pressure on the country's external account increased substantially during FY06, as the current account deficit swelled to a historic peak of US$ 4.1 billion by end-April FY06, sharply higher than the US$ 0.9 billion deficit recorded in the corresponding period of FY06. Even more significantly, as a percentage of GDP the annual current account deficit is estimated to rise from an innocuous 1.4 percent of GDP in FY05 to a more troubling 3.2 percent of GDP in FY06, indicating that a continued weakening could raise grave risks to the hard-won macroeconomic stability achieved in recent years.

As in the previous year, the deterioration in the current account deficit during Jul-Apr FY06 emanates essentially from the trade deficit, wherein the gains from a robust 13.0 percent increase in exports have been eclipsed by the exceptionally strong 28.5 percent increase in imports. Within the current account, trade deficit of US $ 6.5 billion was accompanied by services account deficit of US$ 3.5 billion, up 36 percent from last year; mainly due to higher transportation and other business charges associated with higher imports. Income account also recorded a deficit of US$ 2.1 billion. The rise in deficit in the trade, services and income account was partially offset by increase in the current transfers, which increased from US$7.1 billion in Jul-Apr 2005 to US$ 8.1 billion in Jul-Apr 2006, largely on account of the worker remittances and increase in official grants.

The strong rise in exports has been widely welcomed, and the public debate on correcting the trade imbalances have largely revolved around the need to contain import growth, and particularly those imports that contribute, either directly or indirectly to domestic consumption. Unfortunately, the problems, and therefore the policy options, are more complex.

While practically all imports sub-groups have seen a significant increase during FY06, the larger contribution to the rise in aggregate imports has been by machinery, industrial raw materials, and particularly the rise in the oil import bill. Moreover, given that consumer durables have a small share in the imports growth, and results of empirical studies showing that imports of capital goods are more elastic to exchange rate movements, it seems measures to contain aggregate imports through large exchange rate adjustments, required for any meaningful reduction in the external deficit, would have significant negative growth implications.[1] The problem is compounded by the fact the more targeted interventions (through taxes on specific imports) are unlikely to succeed, as evident from the past history – anecdotal evidence points to high tariffs leading to increased smuggling of goods.

Figure 6.1: Overall Balance (Jul-Apr)



Policy options in the short run, therefore revolve around the need to concentrate on supporting exports and securing the financing of the trade deficit through non-debt creating inflows such as remittances, FDI, portfolio investment, etc., or concessional debt flows. In the longer run, policy must focus more on ensuring that strong export growth is sustained, and on courting FDI flows. The government is already making efforts to provide a better enabling environment to facilitate exports, broaden the exports base, and reduce the cost of business, but these efforts are likely to yield results only in the medium to long-run time frame. Pakistan also had some success in tapping the international markets to finance its deficit, attracting FDI (including for its privatization program) and has obtained financing for development. All of these together with rising portfolio investments, are reflected in the country's substantial US$ 5.0 billion financial account surplus during Jul-Apr FY06 (see **Figure 6.1**), as compared to a surplus of only US$ 24 million in the corresponding period of FY05. As a result, the overall balance witnessed a surplus of US$ 1.3 billion during Jul-Apr FY06.

This also helped sustain the *relative* stability of the exchange rate - the rupee depreciated only 0.88 percent against the US$ during Jul-May FY06 to Rs 60.22/US$[2] - and sustaining SBP reserves around the US$ 10 billion mark. The foreign currency reserves of both, the central bank, as well of commercial banks

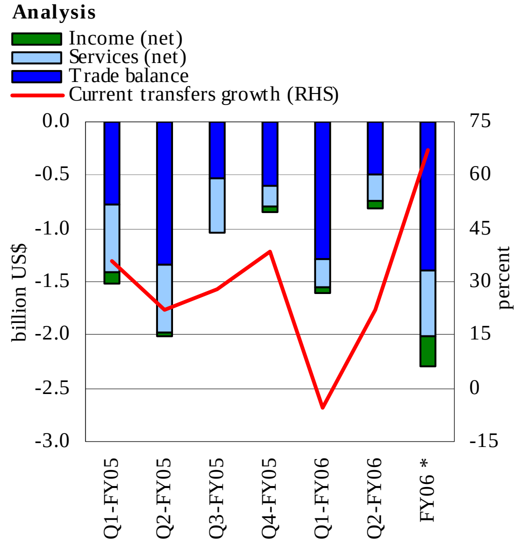
[1] It may also be remembered that an exchange rate adjustment would not be without a fiscal cost, through increasing foreign debt liabilities in rupee term. Furthermore, a one-time adjustment could also potentially trigger a cycle of self-fulfilling expectations of exchange depreciation, putting extra pressure on country's limited reserves to maintain the exchange rate stability.
[2] Average of buying and selling inter-bank floating rate.

initially steadily declined during Jul-Jan 2006; more specifically, in this period overall reserves dropped from US$ 12.6 billion to US$ 11.5 billion while that of the SBP dropped from US$ 9.8 billion to US$ 9 billion. Thereafter, however, SBP's liquid reserves, witnessed a substantial increase of US$ 1.6 billion on account of various inflows particularly in the month of March 2006. Interestingly almost two-third of the total 0.88 percent depreciation in the rupee value during Jul-May 2006 was witnessed in Feb-May 2006 period, after the substantial rise in the SBP reserves.

6.1.1 Current Account

The continued expansion in the country's trade deficit drew the current account deficit to a record high level of US$ 4.1 billion during the period of Jul-Apr FY06 (see **Table 6.1**). This US$ 3.1 billion YoY rise also caused the current account deficit-to-GDP ratio to soar to 3.2 percent from the level of 0.8 percent for Jul-Apr FY05. The trade deficit has witnessed a substantial rise in the last two years due to a sharp rise in imports. During Jul-Apr FY06 imports recorded a substantial YoY growth of 28.5 percent that outpaced the yet significant 13.0 percent rise in exports during this period. In addition to this the increase in imports also caused expansion in the services account deficit due to higher payments of transportation charges.

Figure 6.2: Components of CAB-YoY Change Analysis



However, this rise was partly compensated by greater inflows of logistic support payments as well as a large increase in current transfers during this period. Particularly the rebound in current transfers since Q1-FY06 which is reflected in a substantial expansion in the current transfers during Sep-Apr FY06 substantially contained the further expansion in the current account deficit during this period (see **Figure 6.2**).

Table 6.1: Current Account Balance

million US$

Items		H1 FY05	H1 FY06	Jan-Mar FY05	Jan-Mar FY06	Jul-Apr FY05	Jul-Apr FY06	Jul-Apr Change FY06 over FY05
I.	**Trade Balance**	**-2,276**	**-4,088**	**-1,050**	**-2,155**	**-3,610**	**-6,534**	**-2,924**
	Exports	6,946	7,912	3,751	4,092	11,921	13,420	1,499
	Imports	9,222	12,000	4,801	6,247	15,531	19,954	4,423
II.	**Services (net)**	**-1,441**	**-1,953**	**-976**	**-1,374**	**-2,612**	**-3,548**	**-936**
	Transportation	-613	-918	-331	-430	-1,038	-1,484	-446
	Travel	-512	-611	-254	-280	-842	-989	-147
	Communication services	128	56	84	3	251	72	-179
	Other business services	-927	-1,074	-666	-732	-1,853	-1,996	-143
	Government services	573	864	223	105	1,010	1,163	153
	Of which: logistic support	448	756	202	0	831	923	92
	Others	-90	-270	-32	-40	-140	-314	-174
III.	**Income (net)**	**-1,219**	**-1,348**	**-470**	**-543**	**-1,820**	**-2,103**	**-283**
	Direct investment	-775	-1,006	-381	-463	-1,296	-1,635	-339
	Of which: Profit & Dividend	-207	-246	-45	-54	-290	-325	-35
	Purchase of crude oil & minerals	-421	-500	-258	-284	-761	-882	-121
	Portfolio investment	-86	-71	-10	-22	-91	-118	-27
	Of which: Profit & Dividend	-48	-38	-14	-14	-69	-76	-7
	IMF charges & interest on official ext. debt	-356	-343	-81	-111	-449	-468	-19
	Interest on private ext. debt	-59	-42	-29	-19	-96	-71	25
	Others	56	112	31	69	111	183	72
IV.	**Current Transfers (net)**	**4,131**	**4,530**	**2,140**	**2,646**	**7,107**	**8,106**	**999**
	Private transfers	4,097	4,315	2,137	2,513	7,069	7,764	695
	Workers remittance	1,946	2,055	1,104	1,173	3,451	3,629	178
	FCA - residents	410	219	16	-21	466	268	-198
	Others	1,741	2,041	1,017	1,361	3,152	3,867	715
	Official transfers	34	215	3	133	38	342	304
	Cash grants	17	117	0	27	17	145	128
Current Account Balance (I+II+III+IV)		**-805**	**-2,859**	**-356**	**-1,426**	**-935**	**-4,079**	**-3,144**

Source: Statistics Department, State Bank of Pakistan

Trade Balance

Country’s trade deficit witnessed a sharp deterioration during Jul-Apr FY06 reaching US$ 6.5 billion during this period i.e. US$ 2.9 billion expansion as compared to the level of Jul-Apr FY05. This was due to a very substantial 28.5 percent rise in imports witnessed during this period. A major share of this rise came from sharply rising oil import bill due to high oil prices,[3] and from large machinery imports. Hence, this large increase in imports outpaced the substantial 13.0 percent growth in exports witnessed during this period, thus causing the trade deficit to rise to a historic high level.[4]

Services (Net)

Services account deficit reached US$ 3.5 billion during Jul-Apr FY06 showing 35.8 percent increase against the level of Jul-Apr FY05. This increase was largely attributable to rising transportation outflows caused by a sharp growth in imports as well as higher outflows under business services. In addition to this travel services also recorded higher outflows; whereas communication services recorded a fall in inflows during this period.

Further, the outflows under the head of *other services* also recorded a considerable expansion; this was mainly due to the deferred payments for the construction of Ghazi Brotha Dam during August FY06. However, these large outflows were substantially compensated by US$ 92 million increase in the logistic support inflows during Jul-Apr FY06.

Income account

The income account deficit witnessed a 15.5 percent YoY increase during Jul-Apr FY06 to reach US$ 2.1 billion. This rise was caused by higher direct investment income outflows. However, a significant share of this outflow was offset by higher earnings on country’s international reserves (see **Table 6.2**).

The repatriation of returns on FDI increased by US$ 339 million during Jul-Apr FY06 mainly due to higher payments of dividends along with higher purchase of crude oil and gas (see **Figure 6.3**). Further, the reinvested earnings also witnessed a large increase during this period.

[3] According to the FBS trade data, around 93 percent rise in the oil import bill was due to rising oil prices.
[4] For details, see section on *Trade*.

Besides, the interest payment on country's external debt also witnessed a marginal rise during Jul-Apr FY06.

The detail analysis of the components of external debt reveals that payments on public and publicly guaranteed debt witnessed a US$ 43 million rise in this period. However, this increase was largely offset by lower interest payments on private loans and IMF credit, thus causing the interest payments on external debt to rise only marginally.

The rise in the interest payments on public and publicly guaranteed debt was contributed by rising payments for Eurobonds as well as for IDB loans. However keeping in view the issuance of Eurobonds on an annual basis since FY04 besides the surge in IDB loans (for financing oil as well as fertilizer imports), the increase in these two components was expected.

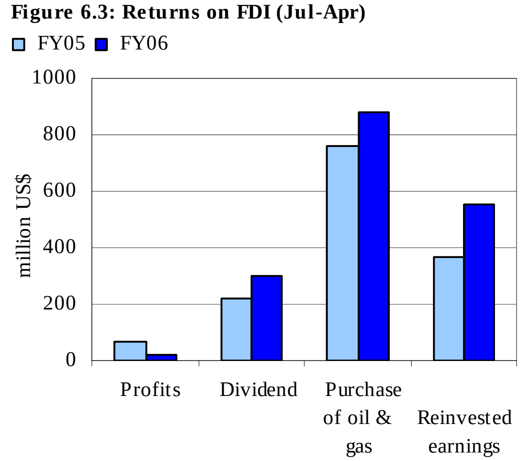
In addition, the interest payments for external liabilities also remained higher during Jul-Apr FY06 largely due to a rise in foreign currency loans extended to traders by commercial banks

Table 6.2: Details of Interest Payments and Receipts
million US$

	Jul-Apr		
	FY05	**FY06**	**Saving**
Payments (I+II)	**690**	**755**	**-65**
I. Total external debt	598	611	-13
Public & publicly guaranteed	486	529	-43
Long-term	416	430	-14
Military	11	8	3
Euro bonds	53	72	-19
Commercial loans/credits	6	6	0
IDB	0	13	-13
Private loans/credits	96	71	25
IMF	16	11	5
II. External liabilities	92	144	-52
Foreign currency deposits	12	20	-8
Special US$ bonds	26	22	4
Central bank deposits	18	28	-10
Others	36	74	-38
Receipts	**170**	**298**	**128**
Interest on reserves	115	204	89
Others	55	94	39
Net Payments	**-520**	**-457**	**63**

Source: Statistics Department, State Bank of Pakistan

Figure 6.3: Returns on FDI (Jul-Apr)

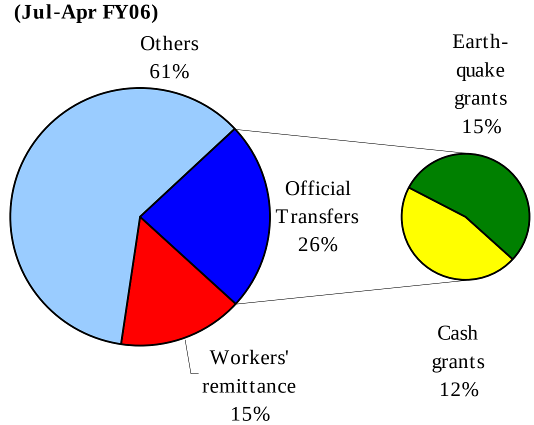


during this period[5] as well as the interest payments made by the foreign companies for the working capital requirement. These outflows, however, were compensated by higher interest receipts on country's international reserves during Jul-Apr FY06, resulting in net savings of US$ 63 million during the period.

Current Transfers

Current transfers recorded a pronounced increase during Jul-Apr FY06 reaching US$ 8.1 billion in this period as compared to US$ 7.1 billion recorded during Jul-Apr FY05. The average monthly level of current transfers rose from US$ 710 million witnessed during Jul-Apr FY05 to US$ 810 million during Jul-Apr FY06. The analysis of the sources of this increase reflects that apart from the usual rise in remittances and other transfers, official transfers also had a significant contribution in this increase during Jul-Apr FY06 (see **Figure 6.4**).

Figure 6.4: Sources of Rise in Current Transfers (Jul-Apr FY06)



<u>Worker remittances[6]</u>

Worker remittances (cash) reached US$ 4.1 billion during Jul-May FY06 recording 8.7 percent rise as compared to the same period last year. Rising remittances from Saudi Arabia were the largest source of this increase; however, this increase was to an extent offset by falling inflow of remittances from the US (see **Table 6.3**).

Apart from the USA, remittances from the UAE, particularly Dubai, also declined in this period. Anecdotal evidence suggests that this fall is partly attributable to rising investment opportunities in the real estate in Dubai. In addition to this, the rising cost of living[7] in UAE is also narrowing the margin of remittances from this region.

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[5] Outflows under this head are equally off set by the inflows in the *other receipts.*

[6] The discussion on Workers' remittances is based on data up to end-May 2006.

[7] http://www.ameinfo.com/74538.html

However, encouragingly the impact of this fall in remittances from the traditional source countries was mitigated by rising remittances from some non-traditional sources, especially Canada. In fact remittances from Canada have nearly doubled in each of the last two years. Their absolute level is although still very low; however, the pattern of remittance growth from this region points to the potential for substantial growth in future.

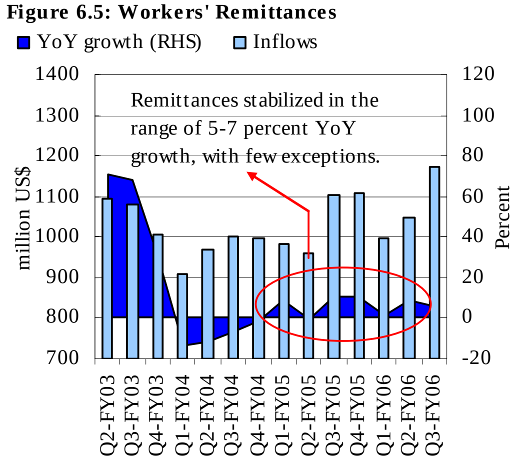
Table 6.3: Workers' Remittances (July-May)
million US$; share, percent

	FY05	FY06	FY06 Change	FY06 Share in Change
I. Gulf region	**1,692**	**1,844**	**104.7**	**58.6**
Bahrain	84	91	3.6	2.0
Kuwait	200	223	19.0	10.6
Qatar	79	105	21.5	12.0
Saudi Arabia	568	671	78.4	43.9
Oman	109	118	7.3	4.1
U.A.E.	652	636	-25.0	-14.0
II. U.S.A.	**1,185**	**1,119**	**-81.4**	**-45.5**
III. Other than Gulf & US	**933**	**1,173**	**155.5**	**87.0**
Canada	43	74	27.0	15.1
Germany	50	54	2.1	1.2
Japan	6	6	-0.3	-0.2
Norway	17	15	-2.8	-1.5
U.K.	338	400	36.1	20.2
Other	478.6	624.5	93.4	52.2
Total	**3,795**	**4,125**	**104.7**	**58.6**
Encashment of FEBCs/ FCBCs	**15**	**11**	**-4**	
Grand total	**3,810**	**4,136**	**326**	

Source: Statistics Department, State Bank of Pakistan

Apart from this, remittances from UK have also been witnessing a steady increase since FY02. The average monthly level of remittances from this region has risen from a mere US$ 13 million during FY02 to US$ 36.4 million in the current year. These positive factors have helped sustain the growth of remittances witnessed since last year. Apparently, remittances' growth seems to have generally stabilized in the range of 5-7 percent (see **Figure 6.5**).

Figure 6.5: Workers' Remittances



<u>Resident FCAs</u>

FCAs (resident) recorded a lower inflow of US$ 268 million in Jul-Apr FY06 as compared to US$ 466 million inflow during Jul-Apr FY05. In fact the higher level of inflows last year was due to some one-off inflows and in the absence of these, the level of inflows declined during Jul-Apr FY06. The month of December FY06 was however an exception, as some one-off inflows were received in this period.

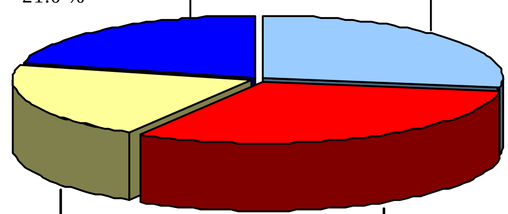
Official Transfers

Official transfers recorded a substantial rise of US$ 304.0 million during Jul-Apr FY06 reaching US$ 342.0 million as compared to a mere US$ 38.0 million during the same period last year. This was largely due to the availability of higher grants during this period: country received US$ 145 million as cash grant for budgetary support during Jul-Apr FY06 and US$ 152 million received on account of earthquake assistance against US$ 2.5 billion pledged by the international community.[8]

6.1.2 Financial Account

The financial account balance witnessed a sizeable surplus of US$ 5 billion during Jul-Apr FY06 compared to the US$ 24 million *surplus* recorded during Jul-Apr FY05 (see **Table 6.4**).[9]

Figure 6.6: Sources of Financial Account Surplus (Jul-Apr FY06)



The components of the financial account surplus reveals that the improvement in the financial account balance was broad based, contributed almost equally by FDI (excluding privatization proceeds), portfolio investment, other investment and privatization proceeds (see **Figure 6.6**).

Net Foreign Investment (NFI)

The net foreign investment recorded a robust YoY increase of US$ 2.5 billion during Jul-Apr FY06 reaching US$ 4.0 billion. A large share of this increase was contributed by rising FDI flows. In addition to this portfolio, investment also witnessed a substantial rise during the period.

[8] Source: http://www.pakistan.gov.pk/donor/pledges_grant.jsp

[9] Financial outflows during Jul-Apr FY05 included non-structural outflows such as (1) notional outflows as a result of debt write off, and (2) repayment of PARCO loans. After excluding these outflows, net financial account shows a surplus of US$ 600 million during Jul- Apr FY05.

Table 6.4: Financial Account

million US$

Items	H1		Jan-Mar		Jul-Apr		Abs. Change (Jul-Apr)
	FY05	FY06	FY05	FY06	FY05	FY06	
Financial Account (1 through 4)	**1276**	**2393**	**1226**	**2162**	**24**	**5027**	**5003**
1. Direct investment abroad	**-34**	**-12**	**1**	**-66**	**-51**	**-78**	**-27**
2. Direct investment in Pakistan	**445**	**1103**	**348**	**1121**	**892**	**3019**	**2127**
of which: Equity Capital	289	835	269	987	631	2572	1941
Reinvested earning	156	268	79	134	261	447	186
3. Portfolio investment	**7**	**311**	**621**	**782**	**643**	**1031**	**388**
of which: (Stock Markets)	59	359	48	47	134	355	221
Special US Dollar Bonds	-53	-53	-27	-68	-90	-133	-43
Euro bonds	-2	0	598	798	596	798	202
Net Foreign Investment	418	1402	970	1837	1484	3972	2488
4. Other investment	**1694**	**991**	**256**	**325**	**1460**	**1055**	**2515**
Assets	1122	376	7	62	1108	223	1331
i. Outstanding Exports Bills (Exporters)	-128	-181	-28	-48	-149	-241	-92
ii. Outstanding Exports Bills (DMBs)	-5	47	-104	-24	-105	-28	77
iii. Currency & deposits	-989	510	139	134	-854	492	1346
of which: Bank	-942	464	148	103	-792	403	1195
Liabilities	-572	615	249	263	-352	832	1184
i. Foreign Long-term loans/credits (net)	234	338	190	200	421	544	123
of which: Project Assistance	347	321	81	196	482	574	92
Food Aid	0	0	0	0	0	0	0
Non-Food Aid	862	591	300	221	1162	812	-350
Amortization	975	574	191	217	1223	842	-381
ii. Private loans	-160	0	-103	259	-300	237	537
of which: Suppliers Credits/MNCs	12	167	8	336	20	503	483
Supplier Credits Repayments	172	167	111	77	320	266	-54
iii. ST Capital, (official)	-27	-44	137	-136	122	-194	-316
of which: Commercial Banks (net)	-116	-116	0	0	-116	-116	0
IDB (net)	89	72	137	-136	238	-78	-316
iv. Currency & deposits	-409	286	31	23	-361	295	656
of which: Trade financing	-583	627	135	65	-430	610	1040
v. Other liabilities	-210	35	-6	-83	-234	-50	184

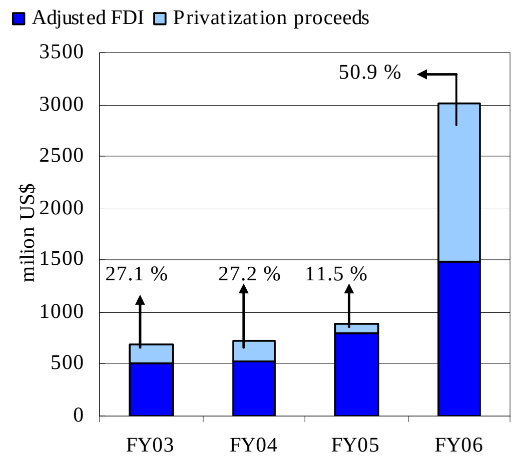
Source: Statistics Department, SBP

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

Foreign Direct Investment

The combination of rising foreign investment in the equity capital and significant increase in the privatization proceeds caused US$ 2.1 billion YoY expansion in the FDI flows during Jul-Apr FY06 (see **Figure 6.7**). Even after adjusting for privatization proceeds, the FDI flows demonstrated a substantial rise of US$ 692 million as compared to the same period last year. The highest increase was seen in the sectors of telecommunication, power, financial businesses, and oil & gas exploration.

Figure 6.7: FDI Flows (Jul-Apr)



The importance of FDI in the development process of any country can hardly be over-emphasized. However, in case of Pakistan it has become all the more important, not only for bringing in new technology and market access but also as a major source of financing the current account deficit. As discussed earlier, substantial current account deficit is likely to persist in the short run, and FDI would have to rise to support the financing gap. Therefore, the government needs to redouble its efforts to remove all the impediments to FDI.

While removing some of the impediments like infrastructure bottlenecks may take some time, others like bureaucratic hurdles, gross law and order situation, etc. can be tackled in relatively shorter period with a resolve.

Some concerns have also been raised on the composition of the FDI, as around 51 percent of the Jul-Apr FY06 FDI consists of the privatization proceeds. While the inclusion of the privatization proceeds in the overall FDI is technically correct, it does have different implications for the economy than the other FDI flows (see **Box 6.1).**

Portfolio Investment

Portfolio investment recorded a substantial YoY rise of US$ 388 million reaching US$ 1 billion during Jul-Apr FY06. A large share of this rise came from rising

Box 6.1: Foreign Direct Investment: Importance and Issues

The role of Foreign Direct Investment (FDI) in the developmental process is well established. Numbers of studies have been carried out (see, Chen 1992) to show that FDI produces a positive effect on economic growth in host countries. FDI brings with it not only capital but also technology, management techniques, and market access. FDI tends to be directed at those sectors that enjoy actual and potential comparative advantage creating economies of scale and linkage effects and raise productivity. Another benefit of FDI is a confidence building effect. While the local economic environment determines the overall degree of investment confidence in a country, inflows of FDI could reinforce the confidence, contributing to the creation of a virtuous cycle that affects not only local and foreign investment but also foreign trade and production

Therefore, it is heartening to see the rise of FDI in Pakistan; however, some issues have been raised, including the concerns over inclusion of the privatization proceeds in FDI and its utilization. It would be therefore pertinent to address some of these issues. The Data on FDI is compiled by the Statistics Department of the SBP according to the international standards of FDI compilation. FDI is a financial investment in a domestic enterprise by which foreign (non-resident) investors gain equity stake of 10 percent or more in the firm. Therefore, when a domestic asset is sold to a non-resident, privatization proceeds are counted as FDI. Thus, there is no foul play in inclusion of privatization proceeds in FDI.

However, FDI arising from privatization could have different implications for the economy than the normal FDI. Since, FDI is considered to contribute to growth by bringing in new technology and market access, the extent to which it is through privatization proceed, its positive impact on growth is likely to be relatively less. Further, FDI from privatization proceeds essentially represents switching of domestic asset to foreign asset against pure FDI which represents gross capital formation.

Another issue is in this regard is the utilization of the privatization proceeds which have been obtained from the selling of domestic assets. Recently the government has retired its central bank debt through these proceeds, since government expenditures are fungible it is hard to make out how much of these were developmental in nature. Thus, there is a possibility that privatization proceeds may have been used to finance non-developmental expenditures.

There is also a genuine concern that since public assets available for privatization are limited, current account can be financed through these inflows for only a limited period. Thus, in the long run there is a need to focus on non-privatization FDI.

foreign investment in the country's stock market, especially from USA, that was followed by yet a substantial rise in the inflows caused by the issuance of two new Eurobonds.

Although the size of portfolio investment in Pakistan is not significant, yet the volatile nature of these inflows does raise some concern (see **Box 6.2**). A cursory look at the movements in the KSE index in the recent months highlights these concerns. KSE index witnessed significant volatility in the month of March with the index witnessing a sharp fall in the mid of this month. Interestingly this fall during March FY06 coincided with a sudden reversal in the pattern of foreign portfolio investment in the stock market. The month of March witnessed a substantial outflow of US$ 64 million in contrast to the average monthly inflow of US$ 59 million in the period of Jul-Feb FY06. This coincidence points towards the presence of a positive correlation between the movement of the KSE index and the level of portfolio investment. The presence of this relative weak positive correlation implies that movements in the KSE index might partly be impacted by foreign portfolio investment flows in the stock market.

Eurobonds

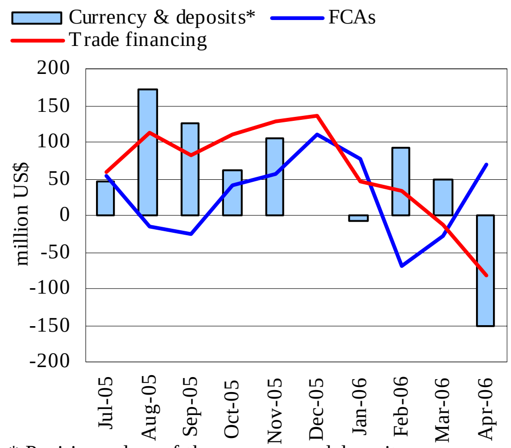
The country successfully issued two new Eurobonds worth US$ 800 million during the month of March FY06. With the issue of these bonds, the country witnessed a US$ 202 million rise in the inflows in this head as compared to the same period last year. These bonds included a 10-year US$ 500 million bond maturing in 2016 and a 30-year US$ 300 million bond maturing in 2036. The coupon rate fixed on these bonds was 7.125 percent and 7.875 percent respectively to be paid semi-annually.

Currency and Deposits

A decline in the nostro accounts of banks caused a US$ 492 million net drop in the currency and deposit assets during Jul-Apr FY06, in contrast to a US$ 854 million rise observed during Jul-Apr FY05.

The fall in the nostro holdings was in turn observed due to a deceleration in the growth of FCA deposits as well as a large expansion in trade financing during this period, both developments probably reflect the relative stability of the rupee in the period (see **Figure 6.8**).

Figure 6.8: Falling Currency and Deposit Assets-Causative Factors

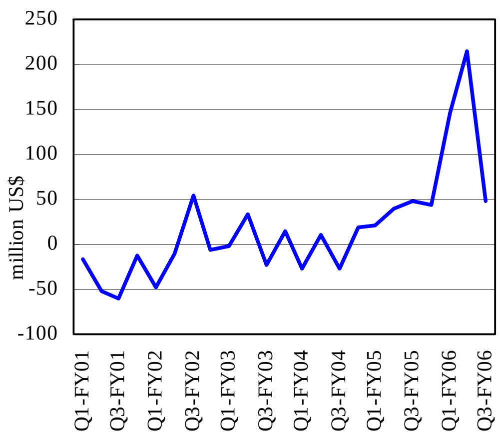


* Positive values of the currency and deposit assets imply reduction in their level

Box 6.2: Is a Rising Portfolio Investment a Source of Concern?
The surge in portfolio investment is always seen with a concern due to the high degree of volatility attached with these flows since its sudden withdrawal depresses the stock prices. Besides, it also reduces the recipient countries' central bank's ability to maintain the value of the currency of the respective country. The depreciation of the currency might in turn cause the debt crisis due to rising cost of the hard currency based foreign obligations.

In fact these volatile flows were one of the root causes of the East Asian crisis. These countries witnessed a dramatic increase in portfolio flows in the early 1990s. The net inflows into the emerging market economies totaled US$ 800 million in 1987 that soared to US$ 47 billion in 1996 - one year preceding the East Asian crisis. In this year Indonesia, Malaysia and Thailand received the third, fourth and sixth largest shares of foreign capital flows in the world - the ratio of foreign capital inflows reached 10 percent of GDP in Thailand and 6 percent of GDP in Korea and Indonesia in 1996.

Figure B1: Net Portfolio Investment (Inflows)



From these countries' experiences it can be seen that portfolio inflows might not directly induce a crisis, however their sudden withdrawal raises the vulnerability of an economy. Secondly these concerns are related to large volume of net inflows. In case of Pakistan, however, the country has started witnessing surge in the portfolio investment only recently (see **Figure B1**) which is also reflected in the marginal share of net portfolio inflows in the GDP, i.e. 0.28 percent in Jul-Apr FY06. However keeping in view the experience of East Asian countries, Pakistan has the option of introducing various measures to encourage longer-term inflows, and limit volatile short-term inflows in case of sharp surges in these flows. These measures include direct or administrative measures and indirect or market based controls.

- Administrative controls directly affect the volume of the cross-border capital transactions. They seek to restrict capital transactions and transfers of funds through outright prohibitions, explicit quantitative limits, or approval procedures. However, the imposition of direct controls would be in conflict with the process of liberalization of the foreign exchange regime underway in the country.
- Indirect or market-based controls may affect only the price or both, price and volume of a given transaction. They tend to discourage capital movements and the associated transactions by increasing their cost. These measures include adopting multiple exchange rates, explicit or implicit taxation of cross-border financial flows, besides other predominantly price-based measures.
- Explicit taxation of cross-border flows involves imposition of taxes or levies on external financial transactions or on income resulting from the holding by non-residents of domestic

financial assets, thus discouraging such investments by reducing their rate of return or raising their cost. Further tax rates can also be differentiated to discourage certain types of transaction and maturities.

- Indirect taxation of cross-border flows takes the form of non-interest-bearing compulsory reserve/deposit requirements with the central bank of the recipient country. This is one of the most frequently used market-based controls adopted by countries.

Hence, in case of substantial rise in these broadly short-term flows the country has the option of adopting the indirect controls in order to reduce vulnerability of country's external account.

References: Jhonston J. Michael, Wilamoski. Peter, "From Rich to Poor: A Plan for Stabilizing Investment Markets in Developing Countries". http://www.helleniccomserve.com/richtopoor1.html Grabel Ilene (1998), "Portfolio Investment". *Foreign Policy in Focus*. Vol 3: No.13.

Outstanding Export Bills (OEBs)

Outstanding export bills held by exporters increased by US$ 241 million during Jul-Apr FY06 as compared to the US$ 149 million rise witnessed during Jul-Apr FY05. This rise is attributable to high volume of exports during this period. On the other hand the OEBs held by banks recorded a fall of US$ 28 million during this period due to higher realization.

Foreign Long-term Loans

Net official long-term loans witnessed a marginal rise in inflows during Jul-Apr FY06 (see **Table 6.4** main financial account table). However, when these net inflows are adjusted for the US$ 495 million debt relief given by the US during Jul-Apr FY05 the net foreign long term loans show lower inflows during Jul-Apr FY06 (see **Table 6.5**).

Table 6.5: Adjusted Official Long Term Loans (Jul-Apr)
million US$

	FY05	**FY06**
Receipts	1644	1386
Amortization	728	842
Net inflows	916	544

Source: Statistics Department, State Bank of Pakistan

The fall in these inflows was due to lower inflows from World Bank and ADB. However, these loans also included US$ 506 million in earthquake assistance from the ADB (US$ 119 million), the IDA (US$ 200 million) and Japan (US$ 95 million).

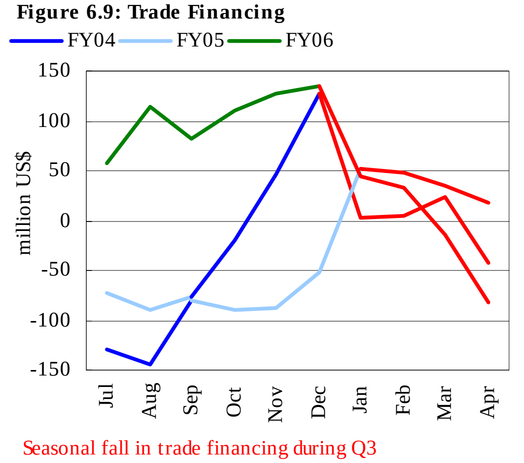
Private/Short-term Loans

Pakistan witnessed a 179.0 percent jump in net inflows of private loans during Jul-Apr FY06 as compared to 62.6 percent rise the same period last year. A large share of this rise was directed to the communication sector. Further the private loans proceeds also include US$ 329.0 million of loan taken by PIA to finance the purchase of two new aircrafts. The short-term loans inflows on the other hand witnessed a net retirement during this period.

FE-25 Related Trade Financing

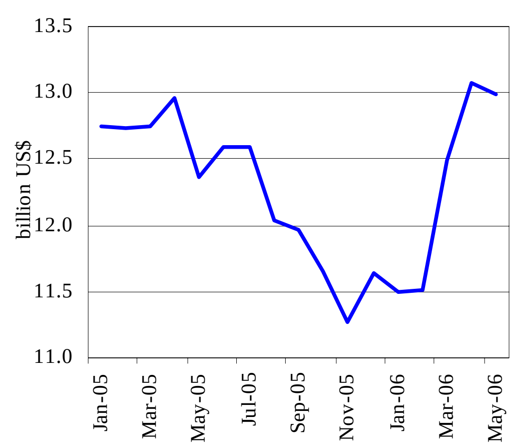
In overall terms trade financing against FE-25 deposits recorded a substantial rise of US$ 610 million during Jul-Apr FY06 against the net retirement of US$ 430 million in the same period last year. The substantial rise in disbursement of these loans during Jul-Apr FY06 is attributable to a wide difference between EFS and FE-25 weighted average lending rates as well as a stable exchange rate during this period.

Figure 6.9: Trade Financing



Further the analysis of the monthly data reveals that disbursement of these loans remained higher during H1-FY06; but Q3-FY06 witnessed a seasonal fall in the disbursement of these loans (see **Figure 6.9**).

Figure 6.10: Foreign Exchange Reserves



Foreign Exchange Reserves

The foreign exchange reserves of Pakistan reached US $ 13.0 billion by the end of May 2006 (see **Figure 6.10**). The total increase in the total foreign exchange reserves is US $ 372.1 million during the period of July-May FY06. Furthermore, the reserves of SBP increased by US $ 811.6 million, while the reserves held by the commercial bank decreased by US$ 439.5 million. The increase in the reserves held by SBP is notable as it was despite its continuous intervention in the forex market, particularly for the support of oil payments.

Indeed, the increase in the reserves of SBP was mainly based on the non-structural inflows. The issuance of Eurobond and PTCL privatization proceeds were the main sources, which added to the foreign exchange reserves. Furthermore, the receipts from logistic support, cash grants, president's earthquake relief fund, interest income on placement and purchase from the inter-bank market further added to the level of foreign exchange reserves.

The inflows from donor agencies, logistic support and privatization totaled US $ 5.8 billion during the period of Jul-May FY06. Importantly, more than 77.0 percent of these inflows are non-debt creating in nature. Such inflows include US$ 0.9 billion from logistic support, US $ 0.8 billion from the launching of Eurobond and US $ 1.7 billion from the privatization proceeds.

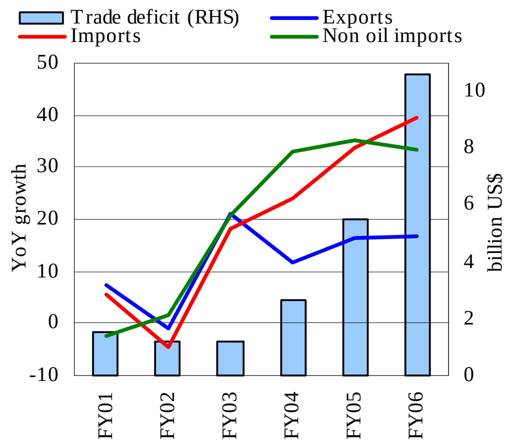
In the inter-bank market, SBP continued its support to induce stability in the exchange rate primarily by providing hard currency for lumpy oil payments and some other commodities. During the Jul-May FY06, SBP injected US $ 8.0 billion out of which US $ 5.3 billion was for the support of oil payments. However, SBP was also able to purchase foreign currency from the market. The SBP purchases totaled US$ 5.8 billion during the period Jul-May FY06.

The drawdown in the reserves of commercial banks was mainly due to increased demand for foreign currency loans. The foreign exchange loans became attractive on the back of relative stable exchange rate and rising interest rate on Pak rupee loans. The incremental forex loans extended by commercial banks to local traders rose by US $ 0.6 billion. However, the foreign exchange reserves of commercial banks were scaled down by relatively lower amount of US $ 0.4 billion, due to US$ 0.2 billion fresh mobilization of FE-25 deposit.

6.2 Trade Account[10]

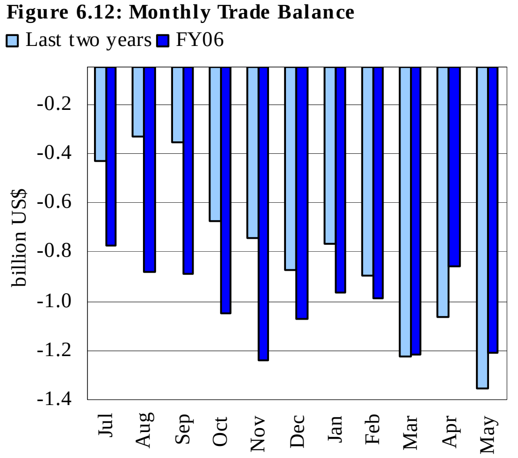
The steadily widening trade deficit touched US$ 10.6 billion during Jul-May FY06, substantially higher than the US$ 5.5 billion recorded in the same period last year (see **Figure 6.11**). The driving force behind the exceptionally high trade deficit remained the persistent surge in the import growth. During the period, the extraordinary import growth of 39.4 percent outstripped the otherwise healthy export growth of 16.7 percent. Indeed, the trade deficit in almost each month of FY06 has been greater than the corresponding aggregate figure for the preceding two years (see **Figure 6.12**).

Figure 6.11: Trade Deficit (Jul-May)



The major contributor in the trade defict were soaring international oil prices and machinery imports. In fact, the POL imports contributed almost one-third (32.2 percent) of the total import growth of 39.4 percent (see **Box 6.3**).[11] Machinery group contribution to imports growth was 22.7 percent.

Figure 6.12: Monthly Trade Balance



The trade deficit is likely to remain under pressure from increase in the oil imports as a decrease in the oil import bill is unlikely unless oil prices drop sharply (see **Box 6.1**). Indeed the oil bill could

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[10] The discussion in this section is based on provisional data provided by the Federal Bureau of Statistics (FBS). The data is subject to revision.
[11] More than 90 percent of growth in POL imports was contributed by the rising oil prices.

actually increase, as higher imports of furnace oil may be required in FY07 if (as feared) hydroelectricity generation drops due to water shortages in dams. Similalry, any policies at curtailing machinery imports could undermine efforts to overcome capacity constraints and develop infrastructre. Thus, as a sharp compression of imports does not seem achievable without a corresponding great drop in the economic activities, the focus of policy must perforce turn to encourging exports, in hopes that sustained growth here, together with a reversion of import growth to historic norms will eventually reduce the external deficits to managable levels. Encouragingly there is some evidence that a significant slowdown in import growth is underway; as evident from **Table 6.6**.

Table 6.6: Average Monthly Rise in Imports

million US$

	FY05		FY06	
	Jul-Jan	Feb-May	Jul-Jan	Feb-May
Food group	13	55	56	16
Machinery group	121	215	220	25
Petroleum group	75	65	201	231
Textile group	5	1	19	19
Agricultural and other chemicals group	74	52	85	11
Metal group	33	65	67	19
Miscellaneous group	7	9	12	7
Others	40	52	94	163
Total imports:	**368**	**515**	**752**	**491**

Exports growth averaged a healthy growth 16.7 percent, during July-May FY06, despite the stiff competition post-MFA (which has hit unit values in key export commodites), as well as punitive anti-dumping duties and loss of GSP benefits for textile exports to the EU region.[12] However, a relative weakness in export growth in the later half of FY06 is a matter of some concern, and it is hoped that with the recent reduction in anti-dumping duty by the European Union on Pakistan bed-linen exports (from 13.1 percent to 5.8 percent, effective May 7, 2006), and restoration of some GSP benefits (albeit at lower levels) exports growth could revive in FY07.[13]

Over the longer term, there is a clear need to ensure that the macroeconomic environment remains supportive of exporters, and that appropriate investments are made towards the requisite infrastructural requirements. The exporters need to focus on improving competitiveness by product diversification and market diversification, speedy adjustment to the changes in the international market, meeting delivery time lines and improving the quality of their products.

[12] In 1968, the United Nations Conference on Trade and Development (UNCTAD) recommended the creation of a 'Generalized System of Tariff Preferences' under which industrialized countries would grant trade preferences to all developing countries.

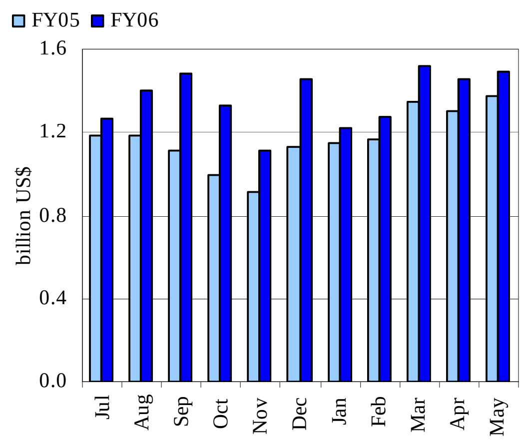
[13] With the normal duty of 9.6 percent the total duty on bed-linen exports to EU would be 15.4 percent from 25.1 percent.

At the same time policy-makers need to support exports by providing an enabling evironment for the private sector, through improvements in the infrastructure, negotiating improved access to markets, and macroeconomic stability. In this regard it is heartening to note that the present government has laid renewed emphasis on improving the infrastructure, with special focus on improving modes of transportation. Further measures are also expected in the forthcoming Trade Policy for FY07.

Exports

The exports recorded a healthy growth of 16.7 percent during Jul-May FY06 on the top of 16.2 percent growth in the corresponding period of last year (see **Figure 6.13**). However, this growth fell short of the 18.1 percent target for the period.

Figure 6.13: Monthly Exports

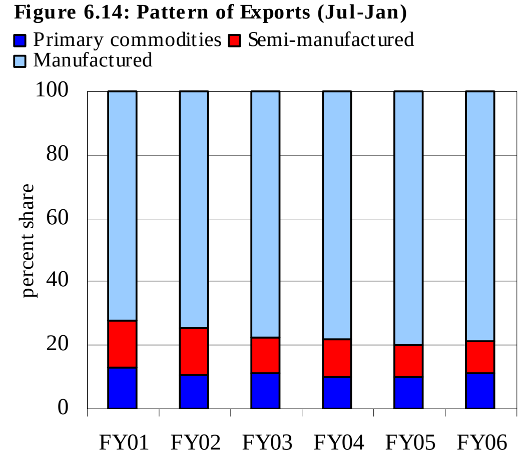


The strong export growth is commendable, particularly given headwinds from the withdrawal of the preferential access to Pakistan under the Generalized System of Tariff Preferences (GSP) and the anti-dumping duty on Pakistani bed linen exports by the EU. Further, the appreciation of Pak rupee against Euro up to Jan 2006, and relatively higher domestic inflation throughout FY06 probably also had an adverse affect on the export growth.

Also encouraging is the rise in the share of manufactured products in the total exports compared to primary and semi-manufactured goods (**see Figure 6.14**). Specifically, the share of manufactured products in the total exports has increased to 78 percent during Jul-Jan FY 06 from 72 percent in the same period of FY01. However, relative weakening of dollar against Euro Feb onward and consequently that of Rupee and reduction of anti- dumping duty from 13.1 percent to 5.8 percent May 2006 onwards is likely to give boost to exports in the EU region in the months ahead.

On the flip side, sustaining the high FY06 export growth is not likely to be easy. A closer look at the monthly growth profile reveals two distinct trends; a very strong growth of 20.9 percent during July-Jan FY06, followed by a considerable slowdown to an average monthly growth of 10.5 percent in the Feb-May FY06 period. The differences in exports performance in the two periods appear to lie essentially in the basis of the growth comparison. In the first half of the previous fiscal year, export growth had been constrained by the MFA quotas, and as exports in the comparable period of FY06 were not restricted by quotas, the growth rate appears that much stronger. The growth recorded for the Feb-May FY06 period however, is based on post-MFA performance in both years. The lower growth rate in the latter period, therefore, provides a better basis for estimating future export growth.

Figure 6.14: Pattern of Exports (Jul-Jan)



Primary Commodities

The primary commodities YoY growth slowed down to 10.2 percent during Jul-May FY06 from 33.3 percent in the same period of the last fiscal year.

As a result the group share in total exports has scaled down to 11.2 percent during the current year from 11.9 percent in the corresponding period of previous year. *Rice* was the major contributor in the group followed by *fish and fish preparatio*n. The *rice* export posted YoY increase of 21.2 percent during the period as compared to the substantial growth of 50.1 percent during the same period of last year. The increase was contributed by price as the quantum impact was negative (see **Table 6.7**).

Likewise, the fish and fish preparation witnessed 43.4 percent YoY growth during the period on the back of increase in its quantum and unit values. However, the considerable increase in the aforementioned categories was partially offset by decline in the export of raw cotton and leather.

Table 6.7: Major Exports (Jul-May)

Value: million US$; Unit value: US$

		FY05		FY06		Abs chg. In value	% change in Jul-May FY06/ Jul-May FY05		
	Unit	Value	Unit value	Value	Unit value		Qty	Value	Unit value
A. Primary commodities		**1530.8**		**1686.6**		**155.8**		**10.2**	
1 Rice	MT	850.6	320.7	1031.2	333.4	180.6	16.6	21.2	3.9
2 Raw cotton	MT	106.6	937.2	64.6	1045.9	-41.9	-45.6	-39.3	11.6
3 Raw wool (excluding wool tops)	MT	0.9	1147.6	0.7	913.7	-0.2	0.0	-20.4	-20.4
4 Fish & fish preparations	MT	124.9	5.5	179.1	8.3	54.2	-5.3	43.4	51.4
5 Leather	SQM	273.9	16.4	246.3	16.8	-27.6	-11.9	-10.1	2.1
6 Guar and guar products	MT	24.1	1179.7	13.8	1149.9	-10.2	-41.1	-42.6	-2.5
7 Fruits	MT	84.8	311.3	105.2	318.4	20.4	21.2	24.0	2.3
8 Vegetables	MT	28.7	313.8	25.6	299.2	-3.1	-6.5	-10.9	-4.7
9 Crude animal material	MT	15.1	3690.8	9.9	3365.9	-5.3	-28.5	-34.8	-8.8
10 Oil seeds & nuts etc.	MT	21.2	776.8	10.2	670.8	-11.0	-44.2	-51.8	-13.7
B. Textile manufactures		**7575.1**		**8972.3**		**1397.2**		**18.4**	
11 Cotton yarn	MT	954.4	2096.9	1290.0	2036.2	335.7	39.2	35.2	-2.9
12 Cotton fabrics (woven)	SQM	1681.3	0.8	1942.4	0.8	261.1	11.3	15.5	3.8
13 Hosiery (knitwear)	DOZ	1473.0	23.1	1563.9	22.7	90.9	7.9	6.2	-1.6
14 Bed ware	MT	1253.8	5480.8	1836.3	5488.3	582.5	46.3	46.5	0.1
15 Towels	MT	471.1	3741.0	531.7	3705.2	60.6	14.0	12.9	-1.0
16 Cotton bags and sacks	MT	12.6	4095.9	8.2	4117.3	-4.4	-35.6	-35.2	0.5
17 Readymade garments	DOZ	955.2	31.8	1213.5	35.5	258.3	13.8	27.0	11.6
18 Tarpaulin & other canvas goods	MT	61.8	2530.1	15.9	2249.4	-46.0	-71.1	-74.3	-11.1
19 Tule, lace, embroidery etc.	(-)	11.5	---	5.2	---	-6.4	---	-55.2	---
20 Synthetic textiles	SQM	268.6	0.8	182.4	1.1	-86.2	-53.6	-32.1	46.4
21 Other textile made up	(-)	422.4	---	375.6	---	-46.9	---	-11.1	---
22 Waste material of textile fibers/ fabrics	MT	9.4	626.4	7.3	838.6	-2.1	-41.7	-22.0	33.9
C. Other manufactures		**2057.5**		**2462.8**		**405.3**		**19.7**	
23 Carpets, carpeting rugs & mats	SQM	250.7	56.6	231.9	60.8	-18.8	-13.9	-7.5	7.5
24 Petroleum and products	MT	412.9	393.6	659.2	491.5	246.3	27.9	59.7	24.9
25 Sports goods	(-)	275.3	---	313.9	---	38.6	---	14.0	---
26 Leather manufactures	(-)	458.7	---	629.7	---	171.0	---	37.3	---
27 Surgical & medical instruments	NO	165.0	---	143.4	---	-21.6	---	-13.1	---
28 Cutlery	GR	29.4	19.4	29.7	34.5	0.4	-43.0	1.2	77.6
29 Onyx manufactured	MT	7.8	1704.3	11.7	1637.3	3.9	55.9	49.8	-3.9
30 Chemicals and pharmaceuticals	(-)	376.7	---	385.0	---	8.3	---	2.2	---
31 Molasses	MT	65.5	61.4	41.9	60.3	-23.6	-34.8	-36.0	-1.9
32 Sugar	MT	15.6	307.7	16.4	404.4	0.8	-20.1	5.0	31.4
Others		**1695.4**	---	**1886.0**	---	**190.5**	---	**11.2**	
Total exports		**12858.**		**15007.6**		**2148.8**		**16.7**	

Source: Federal Bureau of Statistics

Textile Manufactures

The textile manufacture export performance was remarkable, rising by 18.4 percent during Jul-May FY06, against nominal growth of 4.4 percent realized during the same period last year. Both the low value-added and high value-added products contributed in this impressive textile export growth.

The increase in the textile exports in the post Multi Fiber Agreement (MFA) period is a good omen for the economy, which remains heavily dependent on textiles exports. In FY05 textile exports suffered due to uncertainties surrounding the end of MFA in the mid of FY05. Although the growth in the post MFA period in FY05 was 9.3 percent, the growth prior to it was just 1.2 percent; as a result, FY05 growth was restrained to 4.9 percent.

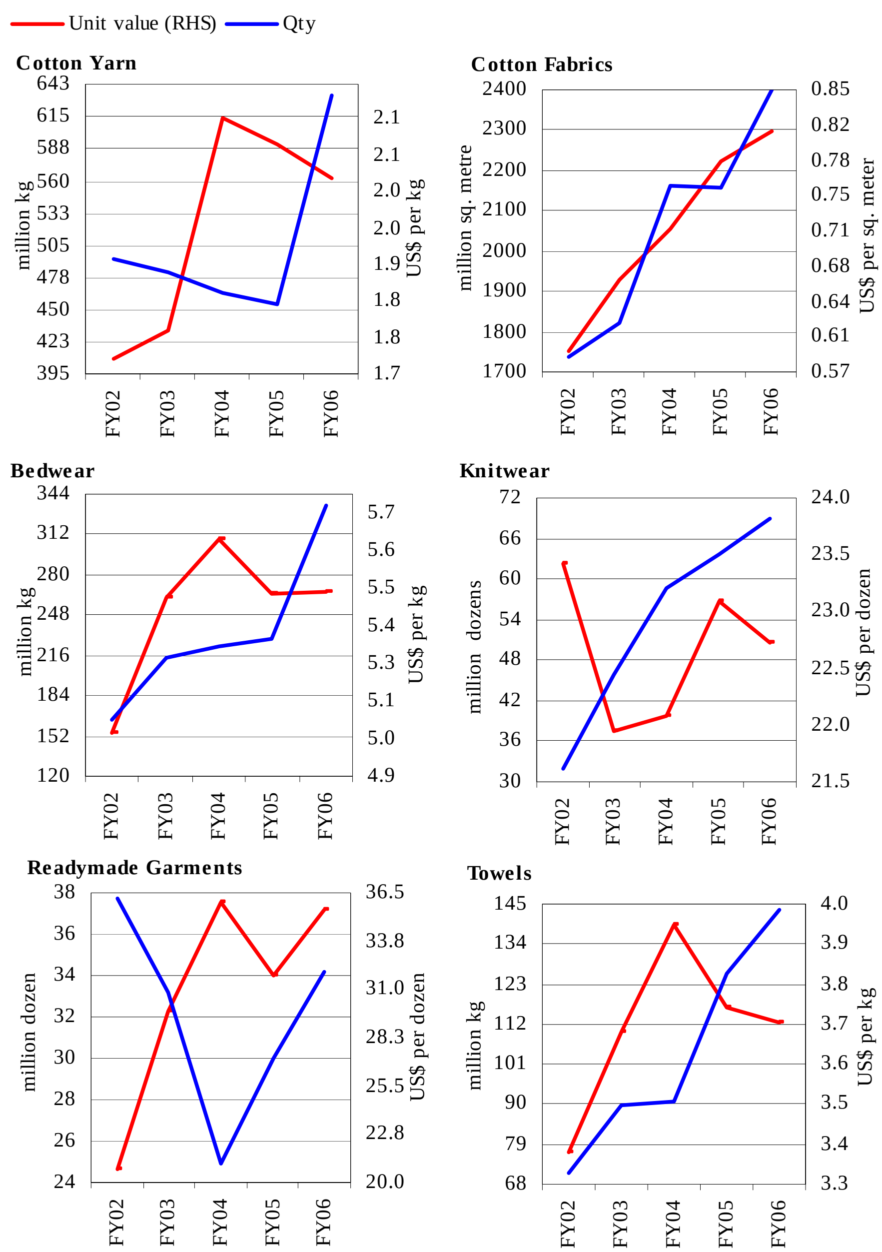
Within the low value-added group, cotton yarn and cotton fabrics showed 35.2 percent and 15.5 percent growth during the period, as against *minus* 4 percent and 9.3 percent growth in the same period of last year. Along with increase in quantum, the low base effect explains the growth in the group (see **Figure 6.15**).

With regard to high value added products, bed-wear and readymade garments were the major contributors, registering 46.5 and 27 percent growth during the period under review, against growth of *minus* 0.3 percent and 6.7 percent in the same period of last year. Almost the entire increase in bed-wear was explained by the quantum impact, while increase in readymade garments was also caused by high unit values. It is hoped that the reduction in the EU antidumping duty from 13.1 percent to 5.8 percent with effect from May 7, 2006 will have favorable impact on the export growth of bed-wear in the forthcoming months.[14]

However, fall in the unit values of knitwear and towels together with high base, affected the growth in these commodities adversely. The knitwear showed nominal growth of 6.2 percent during the period under review as compared to growth of 13.7 percent during the corresponding period of last year. However, despite the fall in unit values the export of towels witnessed a robust 12.9 percent growth, though this was sharply lower than the 31.2 percent rise seen during the corresponding period of FY05 (see **Figure 6.15**)

[14] Pakistan would be in a better position as compared to its major competitor India facing 6.6 percent anti-dumping duty on its bed-wear exports.

Figure 6.15: Textile Manufactures- Export Quantums and Unit Prices (Jul-May)



The exports of synthetic textiles, other textile made ups and tarpaulin & other canvas goods exports declined during the period.

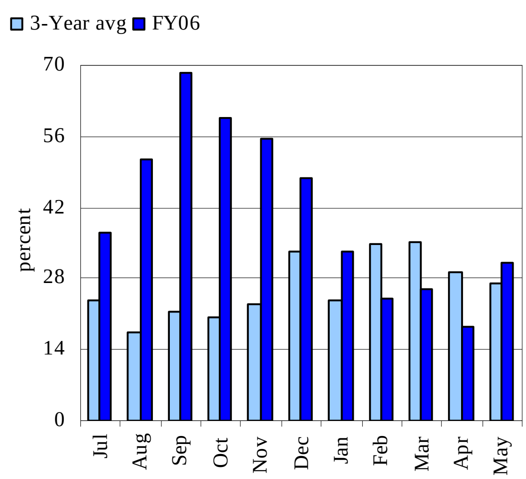
Other Manufactures

The strong growth in petroleum products and leather manufactures enabled the other manufactures to record noticeable growth of 19.7 percent during the period under consideration as compared to the substantial growth of 31.3 percent during the same period last year. The petroleum products showed impressive growth of 59.7 percent during the period on the top of 56 percent growth in the same period last year. Leather manufactures on the other hand, posted 37.3 percent growth during the period on the top of 23.2 percent growth in the same period last year. The increase of US$ 171 million in the export of manufactured leather was partially offset by a decline of US$ 27.6 million in the exports of crude leather.

Imports

Soaring international oil prices in the international market together with persistently increased demand for the import of raw material and machinery led the imports to record a 39.4 percent growth during Jul-May FY06 despite the high base set by the 33.8 percent growth realized during the corresponding period of the previous year.

Figure 6.16: Monthly Imports YOY Growth



A substantial increase of around 54.6 percent in the unit prices of petroleum group on the top of 22.1 percent increase in the same period of last year contributed significantly in inflating the total imports bill. Specifically, the exceptionally high oil prices contributed more than 90 percent in the total oil imports growth. However, the non-POL imports registered relatively lower growth of 33.2 percent as compared to the overall import growth of 33.8 percent in the corresponding period of last year.

In fact, there is a discernible slowdown in the imports growth February 2006 onwards (see **Figure 6.16**). The detailed analysis of the data shows that the growth in major heads is much lower in Feb-May 2006 compared to that in Jul-Jan 2006 (see **Table 6.8**). Furthermore, almost 80 percent of the growth is being contributed by just two broad items; 'petroleum' and 'other imports'. The share of machinery in imports growth has gone down from 29 percent in Jul-Jan 2006 to 7 percent in Feb-May 2006 (see **Table 6.8**).

Table: 6.8: Growth (YoY) and % Share of Major Groups in Total Import Growth

	YoY Growth		Percentage Share in import growth	
	Jul-Jan	Feb-May	Jul-Jan	Feb-May
Food group	57.0	10.8	7	3
Machinery group	55.4	4.2	29	5
Petroleum group	66.1	61.5	27	47
Textile group	69.5	90.1	3	4
Agricultural and other chemicals group	28.9	3.8	11	2
Metal group	75.6	16.2	9	4
Miscellaneous group	31.1	17.3	2	1
Others	36.2	44.4	13	33
Total imports:	50.0	25.0	100	100

Food Group

Driven by increased imports of sugar and wheat, the food group imports depicted 35.9 percent YoY growth during Jul-May FY06, as compared to 32.4 percent growth in the same period of last year (see **Table 6.9**). In fact, the sugar imports contributed 82.3 percent in the food group imports growth. However, the healthy wheat crop is likely to reduce the wheat import bill substantially in the near future.

Machinery Group

The growth of the machinery group imports decelerated to 31.5 percent during Jul-May FY06 from 49 percent in the same period of the last year (see **Figure 6.17**). The slow down in the import growth of machinery was partially explained by the high base effect and partially by the decline in the imports of textile machinery, aircrafts, ships & boats. Moreover, deceleration in the imports of other machinery might be another

Figure: 6.17: Machinery Imports (Jul-May)

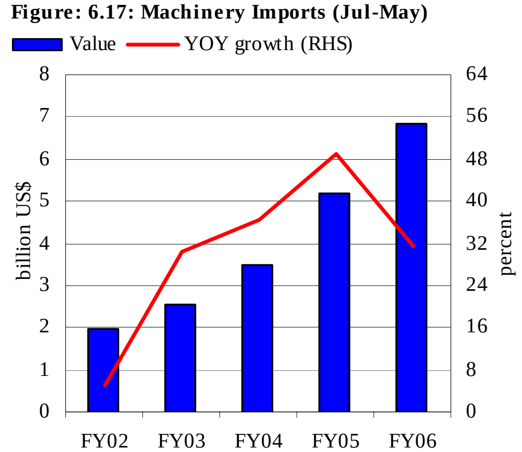


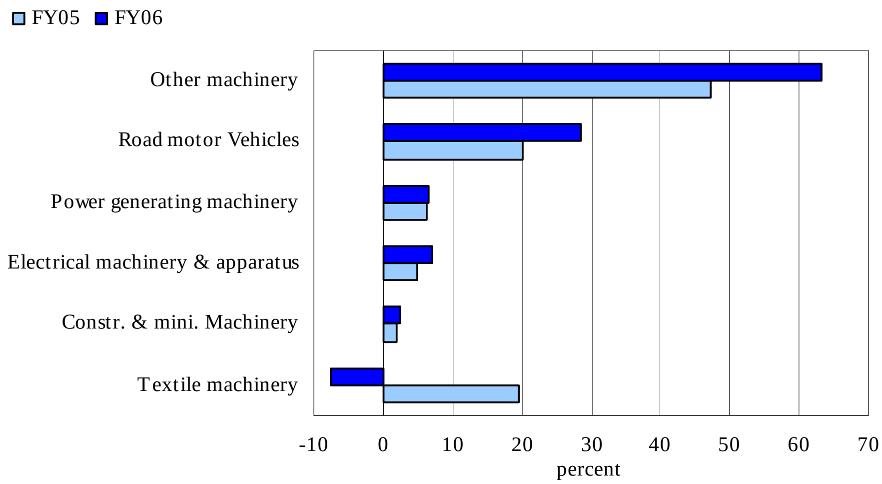
Table 6.9: Major Imports (Jul-May)
Value: million US$; unit value: US$

		FY05		FY06		Abs	% chg in Jul-May FY06/Jul-May FY05		
Commodities	**Units**	**Value**	**Unit Value**	**Value**	**Unit Value**	**chg. In value**	**Qty**	**Value**	**Unit value**
A. Food group		**1262.5**	**---**	**1,715.1**	**--**	**452.7**	**---**	**35.9**	**---**
1. Milk & Cream		**1262.5**	**---**	**1,715.1**	**--**	**452.7**	**---**	**35.9**	**---**
2. Wheat Unmilled	MT	29.6	1,994.1	51.0	2,329.6	21.5	47.7	72.6	16.8
3. Dry Fruits	MT	93.0	217.9	119.9	163.0	26.9	72.4	29.0	-25.2
4. Tea	MT	39.4	587.0	50.6	526.0	11.2	43.2	28.3	-10.4
5. Spices	MT	204.3	1,664.5	202.2	1,660.4	(2.1)	-0.8	-1.0	-0.2
6. Edible Oil	MT	44.4	767.6	47.3	676.5	2.9	21.0	6.6	-11.9
Soya bean	MT	684.7	475.2	663.6	467.5	(21.1)	-1.5	-3.1	-1.6
Palm Oil	MT	*51.8*	*749.3*	*19.8*	*704.3*	*(32.0)*	-59.4	-61.8	-6.0
7. Sugar	MT	*632.9*	*461.4*	*643.8*	*462.7*	*10.9*	1.4	1.7	0.3
8. Pulses	MT	61.5	340.0	433.9	355.3	372.4	575.2	605.6	4.5
B. Machinery group	**---**	**5203.4**	**---**	**6844.4**	**---**	**1641.0**	**---**	**31.5**	**---**
1. Power generating	---	356.3	---	463.0	---	106.6	---	29.9	---
2. Office machinery	---	244.4	---	253.0	---	8.6	---	3.5	---
3. Textile	---	866.6	---	741.7	---	(124.9)	---	(14.4)	---
4. Construction & mining	---	129.9	---	169.8	---	39.9	---	30.7	---
5. Electrical machinery & apparatus	---	312.4	---	429.2	---	116.8	---	37.4	---
6. Railway vehicles	---	40.5	---	50.7	---	10.2	---	25.3	---
7. Road motor vehicles	---	940.0	---	1,406.1	---	466.1	---	49.6	---
8. Aircraft, ships and boats	---	146.3	---	121.5	---	(24.9)	---	(17.0)	---
9. Agricul machinery & implements	---	61.4	---	123.5	---	62.1	---	101.2	---
10. Other	---	2105.7	---	3,086.0	---	980.3	---	46.6	---
C. Petroleum group	**MT**	**3626.2**	**287.5**	**5954.9**	**444.4**	**2328.7**	**6.2**	**64.2**	54.6
1. Petroleum products	MT	1636.9	312.0	2547.6	466.3	910.7	4.1	55.6	49.5
2. Petroleum crude	MT	1989.3	270.0	3,407.3	429.4	1,418.0	7.7	71.3	59.0
D. Textile group	**MT**	**277.8**	**------**	**488.6**	**---**	**210.8**	**---**	**75.9**	**---**
1. Synthetic fiber	MT	127.2	1818.2	230.4	1717.8	103.3	91.8	81.2	-5.5
2. Synthetic & artificial silk yarn	MT	114.8	1831.7	214.9	1,893.0	100.1	81.1	87.2	3.3
3. Worn clothing	MT	35.8	327.3	43.2	342.1	7.5	15.7	20.9	4.5
E. Agri and other chemicals	**MT**	**3206.2**	**---**	**3842.0**	**---**	**635.8**	**---**	**19.8**	**---**
1. Fertilizer	MT	311.9	243.6	581.2	280.7	269.3	61.7	86.3	15.2
2. Insecticides	MT	124.0	3328.7	103.4	3476.5	-20.7	-20.2	-16.7	4.4
3. Plastic materials	MT	707.0	1155.7	904.7	1,260.0	197.7	17.4	28.0	9.0
4. Medicinal products	MT	262.7	27217.7	296.6	31,752.0	33.9	-3.2	12.9	16.7
5. Others	---	1800.5	---	1,956.1	---	155.6	---	8.6	---
F. Metal group	**MT**	**1081.5**	**---**	**1623.6**	**---**	**542.0**	**---**	**50.1**	**---**
1. Iron and Steel Scrap	MT	200.0	223.1	300.7	267.4	100.6	25.4	50.3	19.9
2. Iron and Steel	MT	784.3	469.1	1,213.0	530.6	428.7	36.7	54.7	13.1
3. Aluminum wrought & Worked	--	97.2	---	109.8	---	12.7	---	13.0	---
G. Miscellaneous group		**422.9**	**---**	**531.7**	**---**	**108.8**	**---**	**25.7**	**---**
1. Rubber crude	MT	78.0	1073.6	96.6	1211.3	18.6	9.7	23.8	12.8
2. Rubber tyres & tubes	No.	118.6	25.0	*142.2*	*24.1*	*23.7*	24.8	*20.0*	-3.9
3. Wood & cork	---	26.2	---	*32.0*	---	*5.8*	---	*22.0*	---
4. Jute	MT	34.6	296.2	*37.7*	*356.6*	*3.0*	-9.7	*8.7*	20.4
5. Paper/ paper board & manufac	MT	165.4	644.9	223.2	723.5	57.8	20.3	35.0	12.2
H. Others		**3288.0**	---	**4598.1**	---	**1310.1**	---	**39.8**	---
Total imports:		**18368**		**25598.3**		**7229.9**		**39.4**	

Source: Federal Bureau of Statistics

factor for the recent slow down in the machinery import. The road motor vehicles, other machinery, electrical machinery & apparatus and power generating machinery mainly contributed in the growth of machinery group (see **Figure 6.18**).

Figure: 6.18: Machinery Imports: Shares in Growth (Jul-May)



Road Motor Vehicles

The YoY import growth of road motor vehicles was 49.6 percent during Jul-May FY06 on the top of 58.1 percent growth realized in the same period of last year. Importantly, the share of tractors in the total road motor vehicles imports has increased from 3.4 percent during Jul-Jan FY05 to 6.7 percent during Jul-Jan FY06.[15] However, the share of seemingly unproductive or indirectly productive motor cars has also increased to 52.3 percent during Jul-Jan FY06 from 51 percent in the same period of last year. The dominant factors behind the surge in road motor vehicles import were auto leasing finance facility and wide choice of imported vehicles available for domestic consumers which hitherto had a limited pool to select from.

Electrical Machinery and Apparatus

As a result of 37.4 percent YoY growth during Jul-May FY06, the group share in the increase in total machinery import has increased to 6.3 percent during the

[15] The analysis is limited up to January as the detailed data of Feb-May FY06 is still awaited from FBS.

period from 6 percent in the same period of the last fiscal year. The major imports in the group include dish washing machines, clean fill bottle and electronic integrated circuit, electric transformer, convertors, inductor, refrigerator freezer, other equipments and electrical apparatus for switching/protect etc.

Power Generating Machinery

The power generating machinery recorded 29.9 percent growth during Jul-May FY06 on top of 42.3 percent growth recorded in the same period last year. The import of air craft engine together with other generator set in/combustion pistil engine contributed substantially in the import growth of the group.

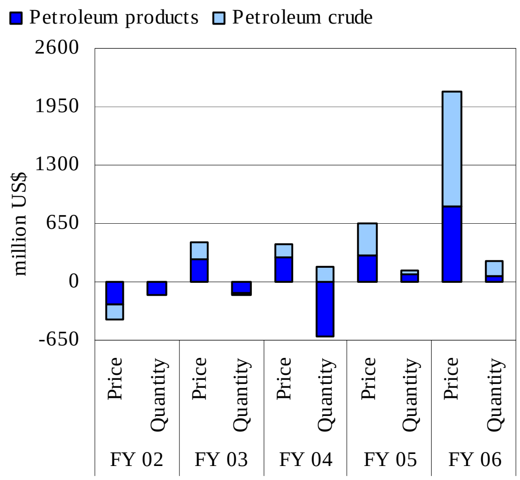
Other Machinery

During the period under review, the other machinery imports growth decelerated to 46.6 percent from 94.7 percent during the same period of the previous year. Even in value term, the rise of US$ 980.3 million in Jul-May FY06 is lower than the rise of US$ 1024.2 million in the corresponding period of last year. During Jul-Jan FY06, the major contribution in the other machinery import growth came from transmission apparatus and cellular mobile phones.[16]

Petroleum Group

As mentioned earlier, the petroleum group recorded an extraordinary increase of 64.2 percent during the period under review on the top of 27.7 percent growth recorded in the same period last year. The increase in the petroleum prices was the dominant factor behind this substantial growth (see **Figure 6.19**). The price impact was relatively higher in case of petroleum product (93 percent) as compared to 89 percent in case of petroleum crude. Interestingly, increase in exports of petroleum product offset some of the increase in petroleum product imports.

Figure 6.19: Petroleum Group Imports (Jul-May)



[16] The detail data from FBS is available only up to January FY06.

Other Imports

Against 17.4 percent YoY growth during Jul-May FY06, other imports registered a substantial growth of 39.8 percent during the period under consideration**.** The major contributors were Gold (monetary & non monetary), Oil Seeds & Oleaginous Fruits, Synthetic and Regenerated Fiber, and Coke & Briquettes etc.

Box 6.3: Future of Oil Prices

The international oil prices have been under pressure since the last couple of years. The crude oil prices touched US$73 per barrel on May 11, 2006 from USD56/barrel on June 30, 2005. Growing demand with limited supply was the dominant factor behind this price hike besides adverse geo-political developments.

The strong global economic growth particularly in the China, US and India increased the demand for oil, while slowdown in the Russian production together with United States low production caused by hurricane damages led to supply side constraints. Moreover, disruption in Nigeria and Iraq, and stronger political rhetoric from Iran led to put additional pressure on the international oil prices.

There are growing concerns about the persistently rising oil prices. The factors important for the future outlook of the prices includes: a) the global trend in the oil demand growth, b) the non-OPEC production trends, c) the OPEC production capacity expansion, d) the surplus supply capacity in the global oil market, and e) the possibilities for supply disruptions and market destabilization.

The global oil demand is projected to increase by 1.25 mb/d during CY06 from 1.05 mb/day during Calendar year 2005. The major chunk of oil demand growth is likely to be contributed by the China and US. Thus oil demand is expected to rise steadily in the near future. However, the continuously high oil prices may put some restrains on the growing oil demand.

While supply of oil is likely to remain stretched, there are some who believe in easing of pressure. Cambridge Energy Research Associates (CERA) report suggests that the Non-OPEC Capacity is expected to expand by 7.6 million barrel per day (mbd) to reach 55.8 mbd by 2010. The contribution to new capacity is likely to come from Russia, the Caspian, Brazil, Angola, and Canada.

Similarly, the report also indicates that OPEC productive capacity is expected to rise to 45.6 mbd by 2010. In this group the major increase is expected from Nigeria, Iran and Iraq. The unconventional liquids like Condensates, natural gas liquids, extra heavy oils and ultra deep water oils are thought to be the major sources for the expected production capacity expansion.

Assuming no major political issues and possible disruptions, the report concludes that supply is expected to outpace the demand growth in the coming years. This in turn could result in the decline or deceleration in the international oil prices around 2007-08. However, the report is uncertain about the productive capacity expansion in the post-2010 period.

References:

International Agency Oil Market Report of 12th May 2006.
Cambridge Energy Research Associates (CERA) report, "Oil & Liquids Capacity to outstrip Demand until At Least 2010"