6 External Sector

6.1 Balance of Payments

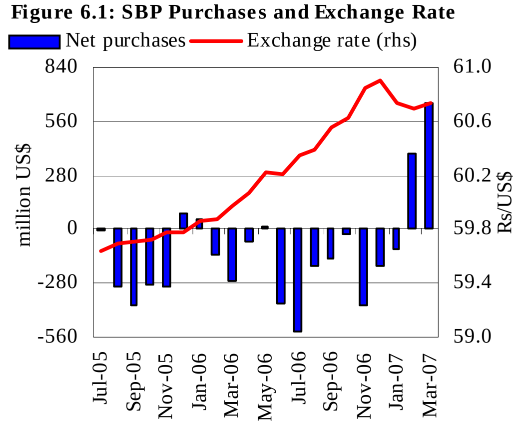
Pakistan's current account deficit continued to widen during Jul-Mar FY07, rising to a record US$ 6.0 billion, up sharply from the corresponding period of FY06 (see **Table 6.1**). Encouragingly, the data also shows a distinct improvement in the pace of the growth of the current account deficit that has fallen sharply, with Q3-FY07 even witnessing a marginal (and probably temporary) year-on-year decline. The improvement largely reflects the sharp deceleration in the growth of the trade deficit during the course of FY07. Moreover, Pakistan continued to record large surpluses in the capital & financial account that comfortably financed the current account deficits; and generated an external account surplus of US$ 373 million during the first nine months of the current fiscal year. Encouragingly, only 30.2 percent of the *capital & financial account* receipts[1] during Jul-Mar FY07 were debt creating compared with 52.4 percent last year.[2] Moreover, the impact of one-off flows in the form of privatization proceeds was also limited to US$ 133 million in Jul-Mar FY07 as against US$ 919 million during the same period last year.

Table 6.1: External Account Position (Jul-Mar)

	FY06	FY07	YoY percent
Current A/c	-4,247	-6,015	41.6
Q1	-1,585	-2,753	73.7
Q2	-1,292	-1,905	47.4
Q3	-1,370	-1,357	-0.9
Financial & capital A/c	4,633	6,352	37.1
Errors & omission	359	36	-90.0
Overall Balance	**745**	**373**	**-49.9**

Pakistan's exchange rate as witnessed during the last few years remained broadly stable and moved within a narrow band of 60.2-60.9 Rs/US$ during Jul-Mar FY07.

Figure 6.1: SBP Purchases and Exchange Rate



[1] These capital inflows include: FDI, portfolio investment and official & private loans.
[2] The main debt creating inflows during Jul-Mar FY06 were the two new Euro bond issues worth US$ 800 million.

However, there were some upward pressures on Pak rupee due to the substantial rise in forex inflows during Q3-FY07.[3] As a result, a slight appreciation in rupee was witnessed even as SBP purchases from the inter-bank market increased substantially Jan 2007 onwards. In fact, SBP became a net purchaser of forex in the months of Feb and Mar 2007 (see **Figure 6.1**). If this trend continues, it would pose a serious challenge to SBP's monetary and exchange rate policies (see **Section 4.1** on **Money and Banking** for details).

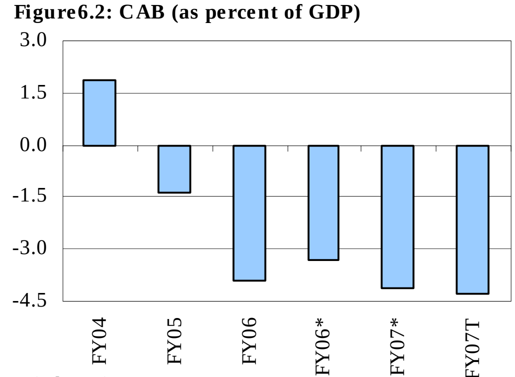
However, the appreciation in Pakistan's real effective exchange rate (REER) since Jun 2006 has been primarily due to the rise in the relative prices compared to its trading partners, while the nominal (NEER) depreciation in rupee of 4.04 percent has kept the real appreciation limited to 2.06 percent.

This real appreciation would be significantly higher if the rupee had appreciated in nominal terms. Since Jan 2007, rupee appreciation has been limited and only against the US, Canadian dollar and Japanese Yen, and therefore its impact is not evident in the REER.[4]

Current Account Balance (CAB)

The current account deficit (CAD) soared to US$ 6.0 billion during the first nine months of FY07 as compared to US$ 4.2 billion in Jul-Mar FY06 (see **Table 6.2**). This caused the CAD to GDP ratio to increase to 4.1 percent compared with the corresponding FY06 level of 3.3 percent. If current trend persists, the current account deficit is likely to breach the Annual Plan target of 4.3 percent of GDP for FY07 (see **Figure 6.2**).[5]

Figure6.2: CAB (as percent of GDP)



* (Jul-Mar)
T: Annual Plan Target

The principal factors responsible for the widening of the CAD during Jul-Mar FY07 include: a widening trade deficit by US$ 1.3 billion and a US$ 730 million

[3] Pakistan received substantial capital flows in FDI, SCRA and worker remittances during Q3-FY07.
[4] Due to depreciation of the rupee against Euro and other currencies during Q3-FY07, the extent of rupee's appreciation against the US$ was largely offset.
[5] SBP projections for FY07 put the annual current account deficit at 4.8 percent of GDP.

Table 6.2: Current Account Balance
million US Dollars

	Jan-Mar		Jul-Mar		YoY change
	FY06	**FY07**	**FY06**	**FY07**	
1. Trade balance	**-2,135**	**-2,199**	**-6,237**	**-7,581**	**-1,344**
Exports	4,126	4,156	12,023	12,506	483
Imports	6,261	6,355	18,260	20,087	1,827
2. Services(net)	**-1,372**	**-1,012**	**-3,350**	**-3,469**	**-119**
Transportation	-409	-474	-1,342	-1,539	-197
Travel	-285	-366	-900	-1,074	-174
Other business services	-731	-538	-1,808	-1,533	275
Government services	92	386	957	839	-118
of which logistic support	0	298	756	723	-33
Others	-39	-20	-257	-162	95
3. Income (net)	**-532**	**-806**	**-1,880**	**-2,610**	**-730**
Investment income(net)	-532	-808	-1,882	-2,616	-734
Direct investment	-463	-654	-1,469	-2,115	-646
of which: Profit & dividend	-54	-85	-300	-421	-121
Purchase of crude oil & minerals	-284	-338	-784	-1,050	-266
Portfolio investment	-25	-38	-98	-133	-35
Other (net)	-44	-116	-315	-368	-53
4. Current transfers (net)	**2,669**	**2,660**	**7,220**	**7,645**	**425**
Private transfers	2,545	2,610	6,879	7,414	535
Workers' remittances	1,173	1,368	3,228	3,937	709
FCA-residents	-21	41	198	65	-133
Others	1,393	1,201	3,453	3,413	-40
Official transfers	124	50	341	231	-110
Current account balance (1+2+3+4)	**-1,370**	**-1,357**	**-4,247**	**-6,015**	**-1,768**

rise in the income deficit.[6] The increase in the current transfers of US$ 425 million, on the other hand, helped in curtailing the deficit to an extent.

An encouraging aspect with regard to the CAD during Jul-Mar FY07 is the broad monthly declining trend in both, the trade deficit and the CAD (with few exceptions in Dec and Feb FY07). Specifically, from US$ 1.1 billion deficit in Jul FY07, the monthly CAD fell to its lowest level of US$ 263 million in Mar FY07 (see **Figure 6.3**).

One prominent exception to the declining trend was in Feb 2007, when the fall in

[6] Trade deficit has contributed approximately 76.0 percent in the absolute rise in CAD during Jul-Mar FY07, while the share of income deficit is 41.3 percent.

net inflows in invisible account (that is, the difference between exports and imports of services, receipts and payments of income and unilateral transfers) reversed the monthly declining trend in CAD-by US$ 180 million.[7] The lower net inflows under invisible account were primarily due to sharp rise in services and income deficits.

Figure 6.3: CAB (monthly position)

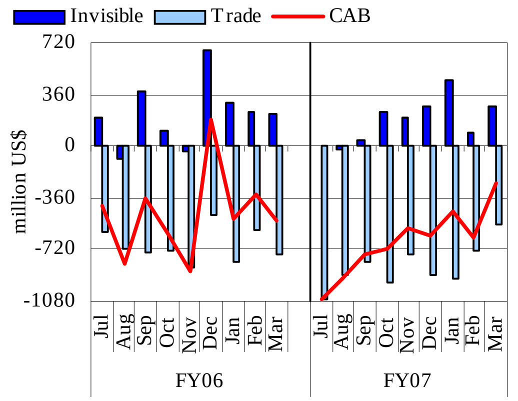
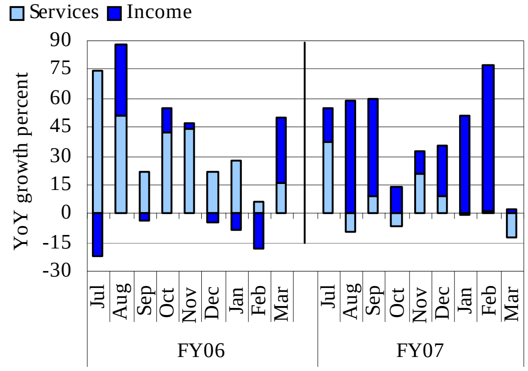


Figure 6.4: Compositional Change in Services & Income Deficits



Since the re-emergence of the CAD in FY05, the rise in the services account deficit, which mainly reflects the transportation charges related to imports, has come down as import growth declined. On the other hand, the income account deficit, which primarily reflects the repatriation of the profits and dividends and purchase of crude oil by the foreign companies operating in Pakistan, has continued to rise. Consequently, year-on-year growth in the adjusted[8] income account deficit was much higher than the adjusted growth in the services account deficit throughout Jul-Mar FY07 (see **Figure 6.4**).

[7] It may be pertinent to note here that the contribution of net invisible balance in CAD was almost negligible during Q1-FY07; however, the CAD still recorded a decline primarily due to sharp decline in trade deficit.

[8] Income account is adjusted for the reinvested earnings as it has an offsetting credit entry in FDI under financial account, thus having no cash impact in BoP. Similarly, the services account is adjusted for the one-off payment under construction services in Aug FY05 and a non-structural flow related to logistic support. In fact, Pakistan received approximately US$ 650 to 700 million per annum on account of services provided to the UN troops, which is unequally disbursed among

Thus, while the trade deficit is showing a declining trend even as exports growth remains nominal; the rising trend in the income account deficit continues to exert pressure on the current account. There is a likelihood of the trade deficit narrowing in the months ahead as exports pick up, however, the income account deficit would continue to rise due to increase in the repatriation of profits and dividends resulting from increased investment inflows.

***Trade Deficit*[9]**

The exchange record data on Pakistan's trade depicts a US$ 1.3 billion increase in the trade deficit during Jul-Mar FY07 to US$ 7.6 billion (see **Table 6.2**). This deterioration in country's trade account was despite a precipitous decline in import growth, as export growth also fell sharply.

Import growth slowed down to 10.0 percent during Jul-Mar FY07 as compared to 30.2 percent growth seen in Jul-Mar FY06. This was mainly due to a deceleration in petroleum imports on account of declining international oil prices; and a sharp deceleration in the growth of machinery imports. On the other hand, exports grew by only 4.0 percent in Jul-Mar FY07 as against a healthy growth of 12.4 percent during Jul-Mar FY06.[10]

Services Account

Growth in the services account deficit, adjusted for one-off payment of Ghazi Brotha dam in Aug FY06, slowed down to 6.7 percent during Jul-Mar FY07 as compared with 34.5 percent growth in the corresponding period of FY06 (see **Table 6.2**).[11] This improvement was mainly attributed to 4.6 percent services payment growth in Jul-Mar FY07, much lower than 22.4 percent recoded during Jul-Mar FY06.

The main contribution to the lower growth in payments was from the fall in freight charges caused by a slowdown in imports (see **Figure 6.5**). In addition, payments under other services and other business also remained subdued during Jul-Mar FY07. However, the travel payments routed through exchange companies recorded an expansion of US$ 195 million during this period.

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different months in a year, therefore to remove the sharp jump, the services account is adjusted for logistic support.

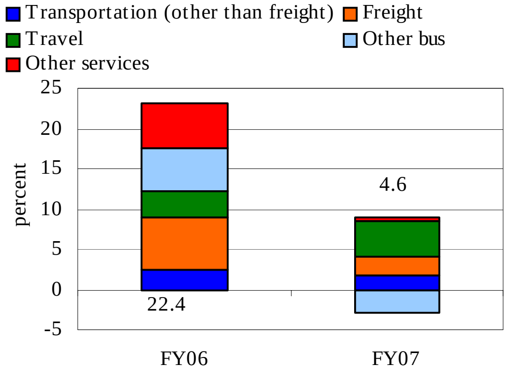
[9] This section is based on exchange record data compiled by SBP that does not tally with the Customs data compile by the FBS, and used in sub-section 6.3.

[10] For detail, see section 6.3 on **Trade**.

[11] Even this nominal growth was mostly due to relatively higher deficit in H1- FY07, while the deficit dropped in Q3-FY07.

It is worth mentioning that the impact of deceleration in the growth of services payment on the net services balance would have been more pronounced, had the services exports performed better. Unfortunately, during Jul-Mar FY07, services export grew by only 2.0 percent as compared to 10.5 percent growth in the corresponding period last year.

Figure 6.5: Contribution in Services Payments Growth

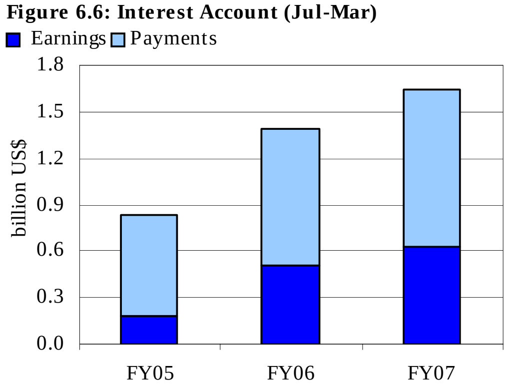


The lower services export growth during Jul-Mar FY07 was primarily due to a US$ 122 million YoY fall in government services, which emanated from lower receipts in logistic support and lower remittances to the embassies operating in Pakistan from their home countries. Another factor was the US$ 45 million YoY fall in communication exports, particularly telecom services; which may have resulted due to extensive use of international calling cards (offering concessional rate) by the Pakistani residents that has possibly reduce the inward international calls (and thus net earnings).

***Income Account*[12]**

The income account deficit widened to US$ 2.6 billion during Jul-Mar FY07 compared to US$ 1.9 billion in the same period last year (see **Table 6.2**). The 38.8 percent YoY growth in the income account deficit was caused by a substantial increase in outflows under investment income, attributed to profit remittances and purchase of crude oil by foreign investors. Net interest payments, were also

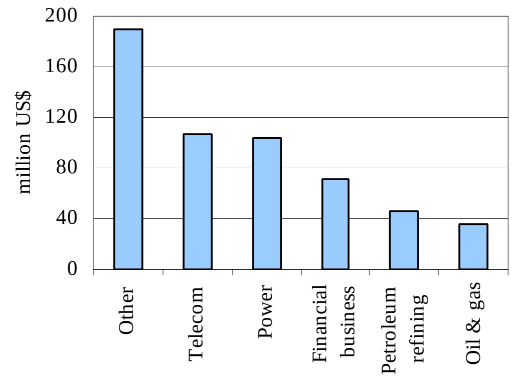
Figure 6.6: Interest Account (Jul-Mar)



[12]The income account balance can be broadly split into interest paid on loans and returns earned by the investors.

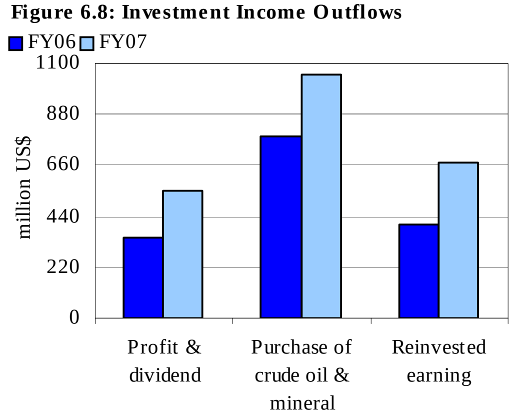
slightly higher at US$ 368 million during Jul-Mar FY07 as compared to US$ 315 million in Jul-Mar FY06. On the positive side a continuing rise in interest earnings, particularly on the country's international reserves, partially offset the impact of a marginal rise in interest payments owed to external creditors in the same period (see **Figure 6.6**).

Figure 6.7: Repatriation of Profit & Dividend (Jul-Mar FY07)



Under the net investment income (outflows)[13] (excluding interest payments) repatriation of profit earned on both direct as well as portfolio investment depicts a 56.1 percent YoY growth during Jul-Mar FY07 as compared to 12.5 percent growth in Jul-Mar FY06. The hefty outflows under profit & dividend in the first nine months of FY07 was visible mainly in the telecom, power, petroleum refining, and banking sectors (see **Figure 6.7**).

Figure 6.8: Investment Income Outflows



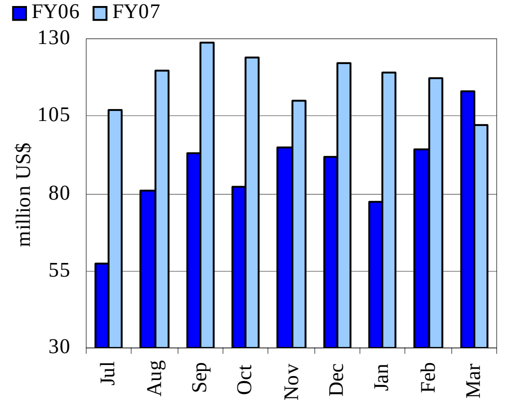
Since most of the businesses that received FDI are in the process of consolidation, the outflows under this head could potentially to grow unless they decide to reinvest their earnings. Encouragingly, the reinvested earnings have also witnessed a sharp increase during this period (see **Figure 6.8**).

In addition, the payments made by the government to the foreign companies exploring crude oil & mineral in Pakistan also increased by US$ 266 million

[13] Investment income outflow comprises of outflows under profit & dividend, reinvested earning and purchase of crude oil.

during Jul-Mar FY07.[14] However, the monthly trend is quite encouraging, as it appears to be falling (see **Figure 6.9**).

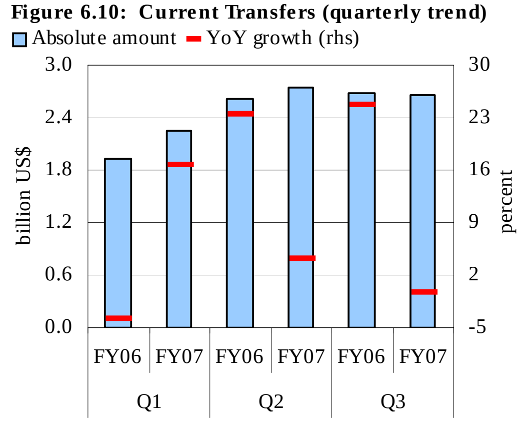
Figure 6.9: Purchase of Crude Oil & Minerals



It is pertinent to note that there is no noticeable change in the production of crude oil and mineral, thus the recent hike in outflow under this head was probably a reflection of higher prices.[15]

Current Transfers

Figure 6.10: Current Transfers (quarterly trend)



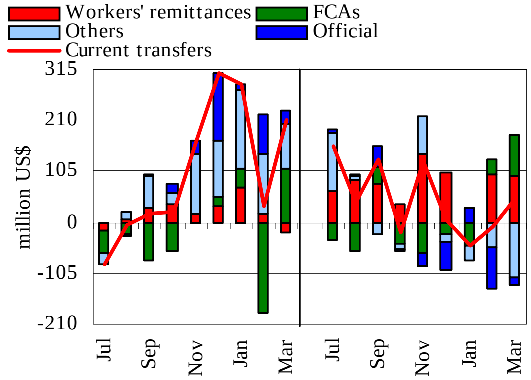
Despite an impressive growth of 21.9 percent in worker's remittances, current transfers reflect a marginal 5.9 percent rise during Jul-Mar FY07 as against a more pronounced growth of 15.1 percent in Jul-Mar FY06. In absolute terms, current transfers recorded a US$ 425 million YoY increase during Jul-Mar FY07 reaching US$ 7.6 billion (see **Table 6.2**). This growth was witnessed mostly in Q1-FY07, while the YoY growth in the remaining quarters of FY07 declined substantially (see **Figure 6.10**). The stronger growth in the first quarter was mainly due to the fact that 23.1 percent growth in remittances was compounded by the YoY 11.3 percent growth

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

[15] The international oil prices started to decline gradually since Aug 2006, however, average international oil prices during Jul-Mar FY07 (US$ 61.66 per barrel) is still higher than the corresponding average prices (US$ 59.17 per barrel) during Jul-Mar FY06; thus possibly explains the higher purchase of crude oil & mineral outflow during Jul-Mar FY07.

in other private transfers during Q1-FY07. In the next two quarters of FY07, growth in remittances was partly offset by the fall in other private transfers.[16]
Thus apart from the rise in worker's remittances all other components of current transfers had no significant contribution to the rise in current transfers during Jul-Mar FY07 (see **Figure 6.11**).[17]

Figure 6.11: Composition of Current Transfers (YoY change)



Workers' Remittances

Workers' remittances of US$ 3.9 billion proved an important cushion to contain the growth in CAD during Jul-Mar FY07 (see **Table 6.3**). The 21.9 percent YoY rise (US$ 709 million) in Jul-Mar FY07's remittances was mainly on the back of significant increases from Middle East and the USA. It is encouraging to see that country recorded a historic peak of US$ 520 million in the month of Mar FY07 (see **Figure 6.12**). SBP projections show that this

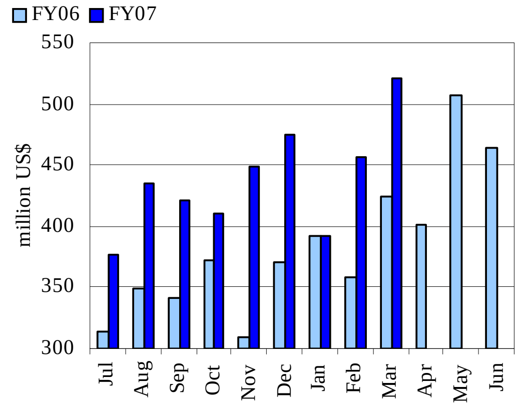
Table 6.3: Workers' Remittances
million US Dollars

	Jul-Mar		Change
	FY06	FY07	
I. Gulf region	**1436**	**1868**	**432**
Bahrain	76	93	18
Kuwait	176	206	30
Qatar	82	120	38
Saudi Arabia	516	733	218
Sultanat-e-Oman	95	118	23
U.A.E.	491	596	105
II. U.S.A.	**894**	**1035**	**141**
III. Other than Gulf & US	**1379**	**1032**	**-347**
Canada	58	62	4
Germany	43	58	15
Japan	5	3	-2
Norway	12	14	3
U.K.	305	319	14
Other	956	575	-381
Total	**3218**	**3935**	**717**
of which: Exchange companies	450	659	209
Encashment of FEBCs &	11	2	-9
Grand total	**3228**	**3937**	**709**

[16] It may be important to note here that after workers' remittances, the second largest component in the current transfers is other private flows which mainly comprises of unclassified private transfers, private donations, withdrawal from the residents FCAs and receipts of exchange companies.
[17] The higher inflows in official transfers during Jul-Mar FY06 was mainly due to US$ 144 million received on account of earthquake grant and US$ 144 million of cash grant for budgetary support, while these flows were limited to US$ 81 million in Jul-Mar FY07. The lower inflow of US$ 65 million in FCAs during Jul-Mar FY07 as compared to an inflow of US$ 198 million in Jul-Mar FY06; was mainly a result of relatively stable rupee and widening spread between rupee and FCAs.

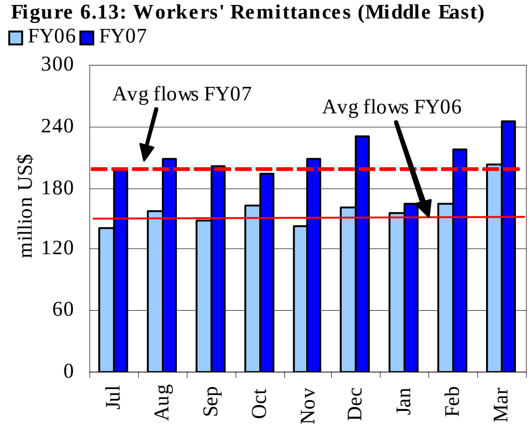
rising trend will continue in the upcoming months of FY07; bringing the FY07 total of approximately US$ 5.5 billion.

Figure 6.12: Workers' Remittances



Break up of remittances by source shows that flows from Middle East, particularly Saudi Arabia and Dubai, during Jul-Mar FY07 were substantially higher, with a monthly average of US$ 207.5 million, as compared with US$ 159.6 million in the corresponding period of FY06 (see **Figure 6.13**).

Figure 6.13: Workers' Remittances (Middle East)



Apart from the Middle East, remittances from USA have also been rising strongly during Jul-Mar FY07. The average monthly level from this particular region reflects a YoY increase of US$ 15.7 million during this period. However, in case of UK, growth in remittances slowed down to 4.6 percent during Jul-Mar FY07 as compared to 12.8 percent in Jul-Mar FY06.

Financial Account

The financial account witnessed a surplus of US$ 6.2 billion during Jul-Mar FY07 as compared to a US$ 4.5 billion surplus in the same period of FY06 (see **Table 6.4**).

The decomposition of the financial account reveals that, this surplus was mainly on account of foreign direct investment (excluding privatization proceeds) and the

Table 6.4: Financial Account
million US Dollars

	Jan-Mar		Jul-Mar		YoY change
	FY06	**FY07**	**FY06**	**FY07**	
Foreign direct investment	1,121	1,986	2,242	3,859	1,617
of which: equity capital	987	1,746	1,840	3,189	1,349
Reinvested earning	134	240	402	668	266
Portfolio investment	779	394	1,091	1,697	606
of which: Equity securities	48	306	407	1,466	1,059
Debt market	729	85	670	236	-434
1. Net foreign investment	**1,833**	**2,352**	**3,254**	**5,480**	**2,226**
2. Other investment	**280**	**163**	**1,216**	**681**	**-535**
Assets	40	170	396	12	-384
i. Outstanding export bills (exporters)	-38	-113	-219	-150	69
ii. Outstanding export bills (DMBs)	-34	115	13	14	1
iii. Currency & deposits	112	168	602	148	-454
of which: Banks	103	99	567	148	-419
Liabilities	240	-7	820	669	-151
i. Official loans	177	70	515	577	62
ii. Private loans	259	6	257	175	-82
iii. Short-term loans	-137	0	-181	-58	123
iv. Currency & deposits	24	232	310	328	18
of which: trade financing	65	145	693	245	-448
v. Other liabilities	-83	-315	-81	-353	-272
Financial account	**2,113**	**2,515**	**4,470**	**6,161**	**1,691**

portfolio investment in equity securities (due to issuances of public and private GDRs and sizeable investment in stock market).

However, the contribution of privatization proceeds to the surplus dropped sharply in FY07 in contrast to FY06 when the financial account surplus was almost equally contributed by FDI, privatization proceeds; portfolio investment and other investment (see **Figure 6.14**).

In the remaining months of FY07, financial account surplus is likely to remain strong on account of (1) floatation of new GDRs both private as well as public; (2) private sector bonds in international capital market; and (3) the issuance of Euro bond worth US$ 800 to 1000 million by the government.

Foreign Investment (net)

The net foreign investment recorded a substantial YoY rise of US$ 2.2 billion in Jul-Mar FY07 to reach US$ 5.5 billion. This sizeable increase was mainly possible due to continued increase in foreign direct investment. At the same time, an impressive growth in portfolio investment further strengthened the country's investment position (see **Figure 6.15**).

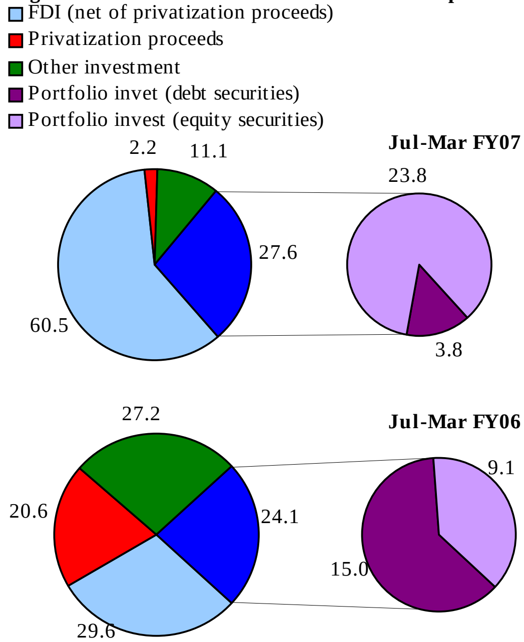
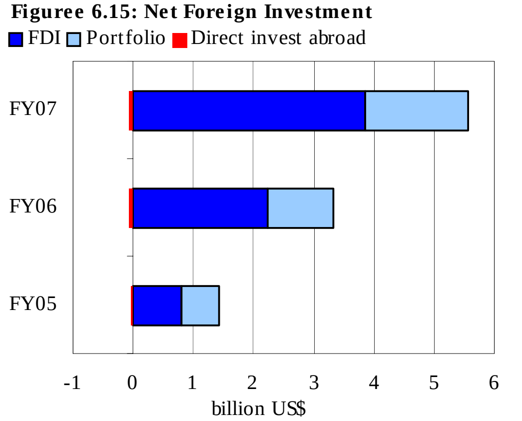


Figure 6.14: Source of Financial Account Surplus



Figuree 6.15: Net Foreign Investment

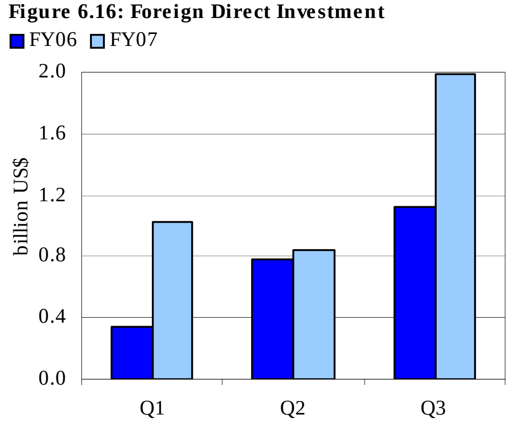
Foreign Direct Investment

Foreign direct investment recorded a significant expansion of US$ 1.6 billion during Jul-Mar FY07. As stated earlier, in Jul-Mar FY07 the contribution from privatization proceeds in FDI was limited to US$ 133 million as compared to US$ 919 million during Jul-Mar FY06. Indeed, after adjusting for privatization proceeds FDI inflows reflects an impressive rise of US$ 2.4 billion in this period. Moreover, the average monthly FDI jumped to US$ 428.8 million during Jul-Mar FY07 from US$ 249.2 million in Jul-Mar FY06.

Interestingly, the quarterly data during Jul-Mar FY07 shows that half of the FDI inflows-US$ 2.0 billion were realized in the third quarter alone (see **Figure 6.16**).

This was mainly because of the huge inflows of US$ 704 million in telecom sector as a result of acquisition of Paktel by the China mobile company, and a US$ 382 million investment in Lakson Tobacoo from the Philip Morris International (PMI). PMI has recently acquired the Lakson Tobacco Company by increasing its stake in company from 40 percent to 91 percent. In terms of attracting FDI Tobacco & Cigarettes became the forth largest recipient of FDI after communication, financial, oil & gas exploration sectors.

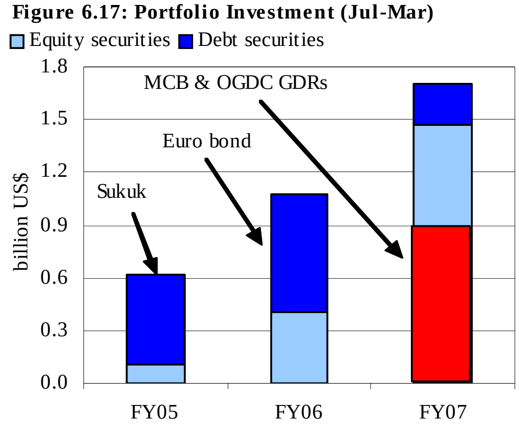
Figure 6.16: Foreign Direct Investment



FDI in the communication sector during Jul-Mar FY07 excluding privatization proceeds of PTCL (US$ 133 million) and China mobile proceeds totaled US$ 513 million for business expansion. FDI of US$ 107 million was also received in oil & gas exploration sector.

Mergers and acquisitions in financial sector also contributed significantly in FDI during Jul-Mar FY07. Specifically, Pakistan received US$ 195.4 million from Standard Chartered Bank's acquisition of Union bank; US$ 99 million for the stake of Crescent Commercial Bank acquired by the Samba group of Saudi Arabia and US$ 68 million in Habib Metropolitan Bank.

Figure 6.17: Portfolio Investment (Jul-Mar)

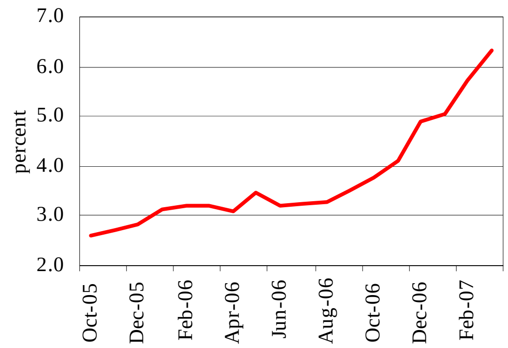


Portfolio Investment

Foreign portfolio investment depicted a substantial growth of 55.5 percent YoY during Jul-Mar FY07 to reach US$ 1.7 billion (see **Table 6.4**). This increase was caused by the rising investment in equity securities, partly from the sale of Global Depositary Receipts (GDRs) by the government oil exploration company and a private sector bank (see **Figure 6.17**). Adjusting for the GDRs of US$ 888 million, portfolio investment in equity securities reflects US$ 578 million in the country's stock market, especially from USA and UK. While Special Convertibility Rupee Account (SCRA) depicts a higher net inflow of US$ 671 million during Jul-Mar FY07.[18] This apparent difference is primarily explained by the foreign investment in money market through SCRA (see **Box 6.1.1**).

The recent surge in portfolio investment, particularly in the stock market, has both positive and negative implications. On the one hand, these flows helped finance the country's current account deficit, but on the other hand, there are some concerns in terms of volatility attached with these flows since their abrupt withdrawal can adversely affect the domestic stock prices and the stability of the domestic currency.

Figure 6.18: Foreign Stake on Domestic Stock Market (as percent of agg. market capitalization)



Analyzing the extent of foreign stake on country's stock market-gauged by the outstanding market value of foreign shares to aggregate market cap-reflects a sharp jump from 3.2 percent in Jun FY06 to 6.3 percent by end Mar FY07 (see **Figure 6.18**). This impact is more pronounced from the flow data; the foreign holdings as percent of market cap increased to 35 percent during Jul-Mar FY07 as compared to 4.7 percent in Oct-Mar FY06.

In the context of GDRs, Pakistan saw two GDRs issues-OGDC of US$ 738 million and MCB of US$ 150 million-in the London stock market against ordinary shares during Jul-Mar FY07.[19] The MCB GDRs incorporates a one-way convertibility guarantee available to the foreigners to hedge risk. Through the one-way convertibility, foreign investors have the option to convert their GDRs into ordinary shares and thus can trade (or dis-invest) in the local market. Similarly, the OGDC GDRs have two-way convertibility options. Indeed, this

[18] In Pakistan, non-residents are allowed to investment in the domestic stock market by maintaining a "Special Convertible Rupee Account" with any authorized dealer.
[19] Global Depository Receipts is an instrument through which a listed firm/investor raises money from the foreign equity markets. Through GDRs foreign investors actually avoid exchange risk, which is apparent if they invest in domestic stock market.

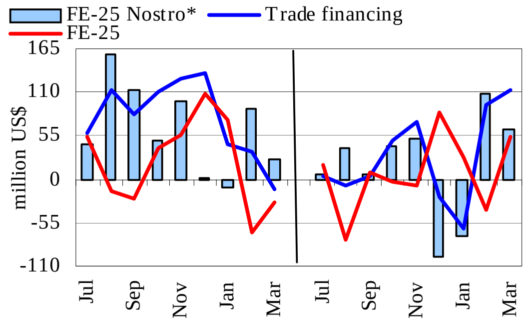
facility is in addition to one way convertibility, under this any foreigner can also reconvert its ordinary shares into GDRs, given the available "*headroom*".[20]

Investments in debt securities also contributed to portfolio investment inflows. The Jul-Mar FY07 flows included US$ 250 million Mobilink bond in the international market and another US$ 50 million foreign investment in Mobilink TFCs; as compared to US$ 670 million in the corresponding period of FY06.[21] Thus the US$ 236 million receipts are essentially private sector flows, while the US$ 670 million inflows during Jul-Mar FY06 largely represented two sovereign Euro bonds.

Currency and Deposits

A lower fall in FE-25 Nostro deposits[22] caused currency and deposit assets to decline only by US$ 148 million during Jul-Mar FY07 as compared to a significant drop of US$ 602 million in Jul-Mar FY06 (see **Table 6.4**).[23] This was mainly due to lower net disbursements against FE-25 loans in Jul-Mar FY07. However, the deceleration in growth of FCA deposits has offset part of the gain from the lower trade financing during Jul-Mar FY07 (see **Figure 6.19**).

Figure 6.19: Causative Factors of FE-25 Nostro Deposits



* Positive values of the FE-25 Nostro deposit assets imply reduction in their level

Official loans

Net official loans recorded a marginal US$ 62 million YoY rise in inflows during Jul-Mar FY07. However, these net inflows after adjusting for earthquake loans, reflects a significant increase of US$ 423 million in Jul-Mar FY07 (see **Table 6.5**).

[20] Headroom is simply the number of GDRs available, as a result of any cancellation.
[21] Out of US$ 250 million private bond, US$ 101 million was utilized in loan repayment of the company; reflected as debit entry in other liabilities of financial account, thus have no impact on BoP.
[22] FE-25 nostros deposits constitute the placements by domestic commercial banks with their foreign counterparts out of FE-25 deposits mobilized by these banks.
[23] In fact, the FE-25 Nostro deposits declined by US$ 148 million during Jul-Mar FY07 as compared to US$ 567 million fall in Jul-Mar FY06.

A breakup of the foreign loans shows that during Jul-Mar FY07 Pakistan received US$ 685 million from the ADB and US$ 168 million from the World Bank under program loans. While the project loans amounted to US$ 479 million during Jul-Mar FY07.[24]

Table 6.5: Adjusted Official Long-Term Loans (Jul-Mar)
million US Dollars

	FY06	FY07
Receipts	1,321	1,332
of which: Earthquake	522	161
Amortization	806	755
Net adjusted inflows	-7	416

Private/Short-term Loans

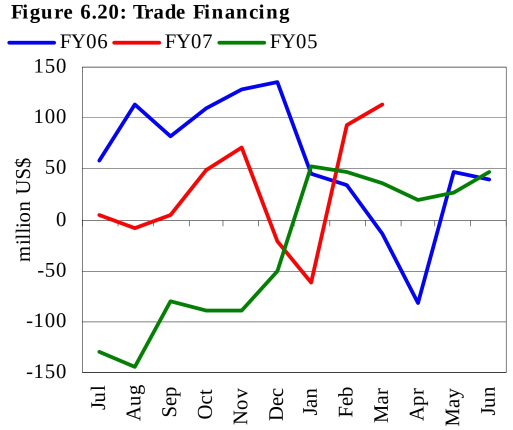
Private loans registered a net inflow of US$ 175 million in Jul-Mar FY07 as against of US$ 257 million net inflows during Jul-Mar FY06. This was primarily due to higher amortization of US$ 310 million in Jul-Mar FY07 as compared to US$ 245 million in the same period last year. The FY07 loan inflows remained almost unchanged from the previous year.[25]

On the other hand, the short-term loans witnessed a lower net outflow of US$ 58 million as compared to net outflows of US$ 181 million in the same period of FY06. This was primarily because of lower loan amortization of US$ 283 million in Jul-Mar FY07 as against of US$ 350 million during Jul-Mar FY06.[26] The disbursement of loans reflects a marginal rise of US$ 56 million YoY in this same period.

Trade Financing

The trade financing against FE-25 loans witnessed a rise of US$ 245 million during Jul-Mar FY07 as compared to substantial increase of US$ 693 million in Jul-Mar FY06. This was mainly a reflection of widening spread between the cost of FE-25 and

Figure 6.20: Trade Financing



[24] For detail see **Second Quarterly Report** FY07.
[25] During Jul-Mar FY06, the communication sector received substantial loan proceeds of US$ 164 million, while this year the disbursement under communication was US$ 136 million.
[26] The repayments on short-term loans include US$ 116 million to commercial credits in both periods. Out of this US$ 100 million is a rollover amount which has an offsetting entry in the exceptional financing.

(concessional) EFS loans, which made FE-25 financing unattractive for the exporters during this period.[27] However, importers continue to avail financing through this mode, as these loans are still cheaper than the market-based rupee financing.

Table 6.6: Appreciation/Depreciation of Pak rupee Against Major Currencies

	FY06	Jul-Apr*	
		FY06	FY07
US Dollar	-0.87	-0.62	-0.76
GB Pound	-2.39	-1.71	-9.69
Euro	-6.12	-5.20	-8.14
JP Yen	3.08	2.48	3.13

*End period buying selling averages

The monthly trend shows that these loans were largely disbursed during Q3-FY07; which is in contrast to a seasonal fall in the disbursement of FE-25 loans (see **Figure 6.20**).

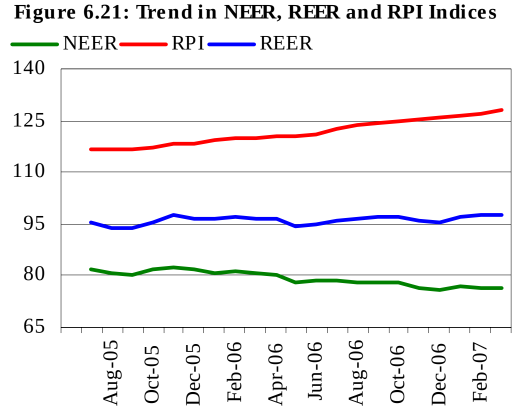
6.2 Exchange Rate

The rupee depreciated against most major currencies other than Japanese Yen during Jul-Apr FY07. While the decline vs. the US dollar was nominal 0.76 percent, the weakness of dollar was reflected in larger depreciations against Euro and Pound Sterling (see **Table 6.6**).

Effective Exchange Rate

Despite relatively lower depreciation against the US dollar and an appreciation against the Japanese yen, Pak rupee's nominal effective exchange rate (NEER) index depicted a cumulative depreciation of 4.04 percent during Jun-Apr FY07. Such an aggregate depreciation occurred because rupee depreciated by larger magnitudes against most of the other basket currencies. However, on account of relatively higher domestic inflation (RPI) compared to the trading partner/competitor countries, the REER index appreciated by 2.06 percent during Jul-Apr FY07, although it shows some improvement compared to a higher appreciation of

Figure 6.21: Trend in NEER, REER and RPI Indices



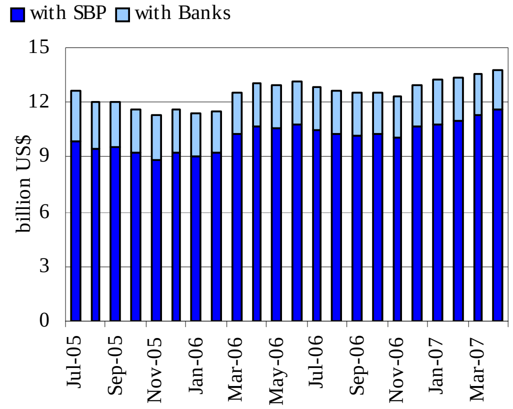
[27] For detail see section 4.1 on **Money & Banking**.

2.51 percent in Jun-Mar FY07 (see **Figure 6.21**). The appreciation of Pak rupee, in real terms, underlines the importance of containing inflation to maintain the competitiveness.

Foreign Exchange Reserves

Pakistan's total foreign exchange reserves grew by US$ 616 million to reach US$ 13.74 billion at end-April 2007, compared to a level of US$13.12 billion at end-June 2006. The growth in reserves was essentially due to a rise in the SBP reserves (see **Figure 6.22**).

Figure 6.22: Liquid Foreign Exchange Reserves



In the Jul-Apr-FY07 period SBP reserves increased by US$ 796.5 million while the banking sectors reserves declined by US$ 180.1 million. In the corresponding period of FY06 the SBP reserves had increased by US$ 877 million largely due to the sovereign Eurobond and PTCL privatization proceeds.

Interestingly, SBP reserves had declined by US $126 million during H1 FY07, when it had been supporting the market through net injections (principally reflecting the position of liquidity for oil payments) before recovering in subsequent months, as ample market liquidity allowed SBP to repurchase a substantial portion of its net injections. Therefore, in Jan-Apr FY07 the SBP reserves increased by US$922 million when the SBP absorbed the forex liquidity through net purchases.

Table 6.7: Causative Factors for Changes in SBP Foreign Exchange Reserves

(million US $)

	FY07	
	Jul-Dec	**Jan- Mar**
Inflows	***5632.3***	***4127.4***
Purchase	2478.1	2711.5
Loan & grants	1075.2	299.3
ADB	658.6	169.6
Others	2079.0	1116.6
Logistic supports	423.9	298.1
Privatization proceeds	133.2	0.0
Sale of OGDC	731.1	0.0
Outflows	***5758.3***	***3204.9***
Sale	3961.8	1766.4
Oil support	*3842.8*	*1681.4*
Debt servicing	622.3	219.2
Others	1174.2	1219.3
Net change in reserves	**-126.0**	**922.5**

Source: DM&MMD, SBP

The accumulation in SBP reserves during Jul-Apr FY07 was contributed primarily to the floatation of OGDC GDRs, receipt of the part payments for the PTCL privatization proceeds, ADB's support for various projects, receipts under logistic support and other inflows. However, these inflows were partly offset by outflows on account of oil and other payments for necessary items. Resultantly, the SBP reserves recorded an increase of US$ 796.5 million during the ten months of current fiscal year. A summary of the causative factors is given in **Table 6.7**.

6.3 Foreign Trade[1]

During Jul-Mar FY07, the import and export could record only 8.1 percent and 3.5 percent growth respectively, in contrast to high double- digit growth in the same periods of the preceding four years (see **Table 6.8**). Thus, while the trade deficit continued to widen, the pace of the increase was appreciably slower, falling to 14.6 percent during Jul-Mar FY07 as compared to an average growth of 88 percent during the corresponding period of the last four years.

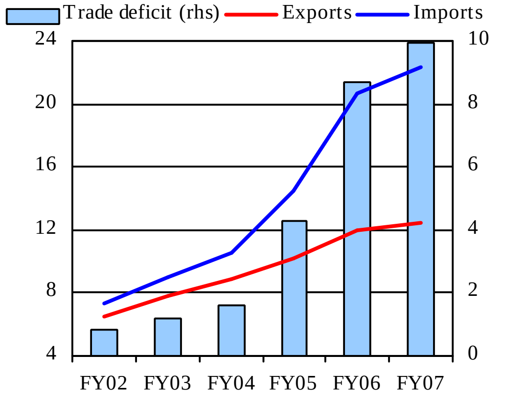
Table 6.8: Summary of Trade Balance (Jul-Mar)

	FY03	FY04	FY05	FY06	FY07
Export Growth	20.2	13.4	14.3	18.0	3.5
Import Growth	22.8	16.3	37.6	43.2	8.1
Trade Deficit (US$ billion)	1.2	1.6	4.3	8.7	9.9
Trade Deficit (%Change)	43.7	35.6	167.8	103.5	14.6

Source: Federal Bureau of Statistics

The decline in the import growth is not unexpected and reflects a number of factors, including the return to normal levels of investment by the textiles sector after a surge ahead of the end of export quotas, the absorption of one-off demand created by economic liberalization measures (e.g. in the telecom and media sectors), a moderation in aggregate demand as a result of monetary tightening (most visible in the fall of automobile imports), as well as a fall in oil prices (that limited the growth of oil import bill).

Figure 6.23: Foreign Trade (Jul-Mar)



Unfortunately, the gains from the (largely) anticipated deceleration in import growth have been offset by an unexpected weakness in export growth. The abrupt deceleration in export growth in FY07, after strong increases in the previous four successive years, is a source of some disquiet, and has been the source of speculation, with the decline being variously attributed to (1) a conspiracy by exporters to force exchange rate adjustments, (2) to a fall in "spurious" exports

[1] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This may not tally with the trade data based on exchange record reported in the section on *Balance of Payments*.

following a reduction in rebates, as well as (3) to the loss of competitiveness as a result of high domestic inflation and rising funding costs. However, there is little evidence for any of these claims.

While Pakistan's competitiveness has certainly been hurt in recent years, it remains to be seen if this was sufficient to account for the scale of the deceleration in export growth, particularly given the additional incentives provided to exporters. Indeed, there is some evidence also that a significant part of the export deceleration is due to one-off elements (e.g. the decline in raw cotton, rice and citrus fruit exports mainly reflected relatively poor harvests), or due to sector specific issues (i.e. petroleum products, leather manufactures, sports goods, carpets, etc.).

The textile exports also present a mixed picture. While many categories saw export growth weaken somewhat and some have seen growth accelerate, most of the items depicted positive growth except cotton fabrics and bedwear. Interestingly, while cotton fabric exports declined, the exports of synthetic fabrics saw a much strong jump, and as a result the aggregate growth in fabric exports saw only a small deceleration to 7.2 percent YoY during Jul-Mar FY07 compared to 9.2 percent YoY during Jul-Mar FY06. Similarly, even the decline in bedwear exports may be attributed to competitive pressures in the EU market only (on account of loss of GSP and an anti-dumping duty) - exports to the US market have strengthened (see **Table 6.9**).

Table 6.9: Pakistan's Bedwear exports market value share (%) in US and EU

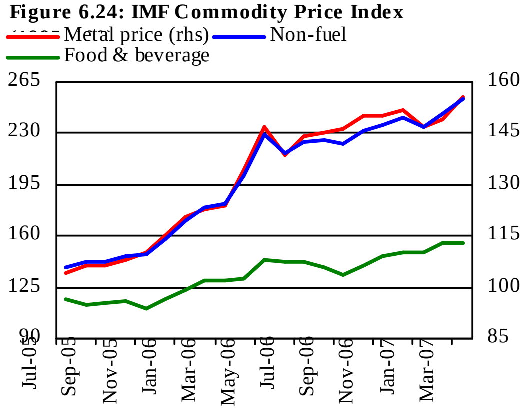
	2004	2005	2006
[1]US*	15.5	25.3	27.3
[2]EU	29.0	23.2	24.2

* The bedwear included pillow cases, cotton sheets and bedspreads
1) Source: US Department of Commerce- office of textile and apparel
2.) Source: Eurostat

Finally, non traditional exports appear to be strengthening, as evident in the 37.8 percent rise in "other exports" during July-March FY07, as compared to a decline of 1.7 percent in the corresponding period last year. These exports include, cement, and ethanol (see **Box 1**).

The above analysis suggests that the sluggishness in exports growth originated from a combination of factors, which include one-off supply shocks, EU-specific preferences & safeguards, as well as some competitive pressures. In any event, whatever the causes, there is no denying that the magnitude of the slowdown in export growth is worrisome.

Figure 6.24: IMF Commodity Price Index



Going forward, the rising trend of commodity prices in the international market, higher demand for furnace oil by the thermal power plants and anticipated increase in the import of power generating machinery may put upward pressure on the import bill (see **Figure 6.24**). On the export side, Pakistan's textile industry needs to be more competitive as it would face increased competition in international markets after the abolishing of China specific textile and clothing safeguards in 2008 by the EU and the US.

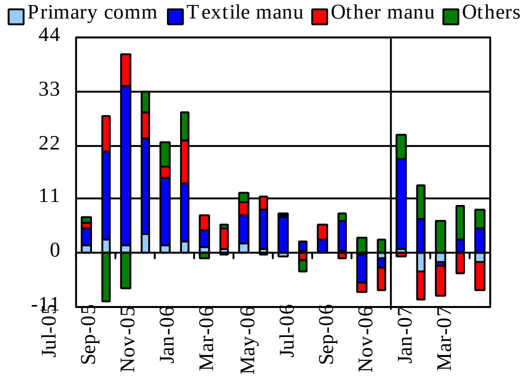
In this backdrop, there is need to focus on devising a comprehensive export promotion strategy to narrow down the trade gap. Major issues to be addressed in the export strategy are: a) lack of exports diversification, b) supply side constraints, c) low labor productivity, d) relatively low quality of products, e) delay in the adoption of international standards, f) lack of scale economies, and g) inefficiencies caused by infrastructural bottlenecks (see **Box 2**).

In a more liberalized and competitive world, Pakistan's exports prospects will depend heavily on the adaptability of its industry to the fast changing dynamics of international markets. Pakistan has got the opportunity of duty free access in the fast growing and biggest market of the world by entering into a free trade agreement (FTA) with China to be effective from July 1, 2007. Given that China has such a free trade arrangement only with Chile and Pakistan; therefore, it is a window of opportunity for Pakistani exporters to exploit this market to the maximum. Moreover, similar opportunities of duty free market access are opening up through FTAs with Malaysia and Sri Lanka.

6.3.1 Exports

During Jul-Mar FY07, the exports could only register a nominal growth of 3.5 percent as compared to healthy growth of 18 percent during the same period last year. The export growth, after declining since January FY06, has begun to recover somewhat from November FY07 (see **Figure 6.25**). Specifically, the monthly average export growth of 6.5 percent during Nov-Mar FY07 was higher than the monthly average growth of 0.8 percent during Jul-Oct FY07.

Figure 6.25: Contribution in Export Growth



The increased exports of high value added textile items and other exports were the main factors behind this welcome increase in export growth in the later part of Jul-Mar FY07 period. This export growth may be attributed to various incentives given to the exporters as well as the recovery in prices of high value added exports. In fact, the overall export growth could have recovered considerably had it not been for the dip in exports of primary commodities and other manufactures.

Primary Commodities

The exports of primary commodities declined by 7.6 percent YoY during Jul-Mar FY07, sharply down from the growth of 17.1 percent YoY during the same period of FY06. The significant contribution to this deceleration in growth was accounted for by the relatively poor rice, cotton and citrus fruit crops.

However, fish & fish preparations, vegetable and oil seeds & nuts registered positive growth during the period under review. The exports growth of fish & fish preparation and vegetable was entirely contributed by the increase in unit prices, which offset the impact of lower export volumes while growth in the export of oil seeds & nuts was contributed by both volumes and price (see **Table 6.10**). Going forward, the EU ban on the fish & fish preparation from Pakistan with effect from April 12, 2007 will be drag on export growth in this category (see **Box 3**), but the growth rate should nonetheless improve as wheat exports pick up[2].

Textile Manufactures

The textile group exports have recovered somewhat from Q1-FY07, to record 5.8 percent growth during Jul-Mar FY07 in contrast to the robust growth of 19.4

[2] Wheat exports have reportedly already commenced in April 2007, and significant quantities are anticipated to be exported in the remaining months of FY07 and the early months of FY08.

Table 6.10: Major Exports (Jul-Mar)

Value: million US$; Unit value: US Dollar

			FY06		FY07p		Abs	% change in Jul-Mar FY07/Jul-Mar FY06		
		Unit	Value	Unit value	Value	Unit value	chg. in value	Qty	Value	Unit value
	Primary Commodities		**1,401.6**		**1,295.3**		**-106.4**		**-7.6**	
1	Rice	MT	846.2	312.6	818.2	362.6	-28.0	-16.7	-3.3	16.0
2	Raw cotton	MT	52.4	1,084.5	44.8	1,078.6	-7.6	-14.0	-14.5	-0.5
3	Raw wool (excl wool tops)	MT	1.4	895.5	0.8	505.6	-0.6	0.0	-43.5	-43.5
4	Fish & fish preparations	MT	133.2	1,493.4	139.4	1,725.0	6.2	-9.4	4.7	15.5
5	Leather	SQM	208.8	16.9	185.2	16.8	-23.6	-10.9	-11.3	-0.5
6	Guar and guar Products	MT	17.9	1,152.3	12.2	1,176.7	-5.6	-33.0	-31.6	2.1
7	Fruits	MT	95.3	281.9	39.3	193.4	-56.0	-39.9	-58.8	-31.4
8	Vegetables	MT	25.9	293.1	37.1	450.3	11.2	-6.7	43.3	53.6
9	Crude animal material	MT	12.5	3,765.1	4.1	2,847.7	-8.4	-56.9	-67.4	-24.4
10	Oil seeds & nuts etc.	MT	8.1	625.1	13.0	714.5	4.9	40.2	60.2	14.3
11	Wheat	MT			1.2	--	1.2			
	Textile Manufactures		**7,244.6**		**7,662.1**		**417.5**		**5.8**	
1	Cotton yarn	MT	1,002.0	2,049.5	1,036.2	2,092.6	34.2	1.3	3.4	2.1
2	Cotton fabrics (woven)	SQM	1,567.0	0.8	1,458.2	0.9	-108.9	-14.7	-6.9	9.1
3	Hosiery (knitwear)	DOZ	1,275.9	21.2	1,469.2	22.1	193.3	10.6	15.1	4.1
4	Bedwear	MT	1,494.0	5,451.0	1,435.6	5,399.8	-58.3	-3.0	-3.9	-0.9
5	Towels	MT	431.3	3,736.4	440.4	3,777.5	9.1	1.0	2.1	1.1
6	Cotton bags and sacks	MT	10.4	4,130.1	4.4	3,318.9	-6.0	-47.1	-57.5	-19.6
7	Readymade garments	DOZ	968.5	34.6	1,052.2	35.1	83.7	6.9	8.6	1.6
8	Tarpaulin & other canvas goods	MT	25.3	2,231.8	59.1	2,448.4	33.8	112.6	133.2	9.7
9	Tule, lace, embroidery etc.	(-)	6.2	---	1.2	---	-5.0	---	-80.5	---
10	Synthetic textiles	SQM	145.8	0.7	377.9	0.8	232.2	130.7	159.3	12.4
11	Other textile made up	(-)	309.1	---	324.2	---	15.1	---	4.9	---
12	Waste material of textile fibres/fabrics	MT	9.1	701.8	3.5	756.4	-5.6	-64.5	-61.7	7.8
	Other Manufactures		**2,089.4**		**1,715.5**		**-373.9**		**-17.9**	
1	Carpets, rugs & mats	SQM	193.2	60.2	168.1	63.4	-25.1	-17.4	-13.0	5.3
2	Petro and petro products	MT	591.6	519.5	583.7	840.7	-7.9	-39.0	-1.3	61.8
3	Sports goods	(-)	232.0	---	193.9	---	-38.1	---	-16.4	---
4	Leather manufactures	(-)	556.5	--	351.8	---	-204.7	---	-36.8	---
5	Surgical & medical instru	NO	119.2	---	86.6	---	-32.6	---	-27.3	---
6	Cutlery	GR	24.9	21.8	26.4	38.3	1.5	-39.6	5.9	75.4
7	Onyx manufactured	MT	9.4	1,604.5	10.9	1,889.1	-0.8	16.8	17.7	-0.8
8	Chemicals & pharmaceuticals	(-)	311.0	---	271.3	---	---	-12.8	---	---
9	Molasses	MT	28.7	84.4	22.9	75.9	-11.2	-20.1	-10.1	-11.2
10	Sugar	MT	23.0	422.5			-	-	-	-
	Others		**1,278.1**		**1,761.6**		**483.5**	**---**	**37.8**	**-**
	Total		**12013.7**		**12434.5**		**420.8**		**3.5**	

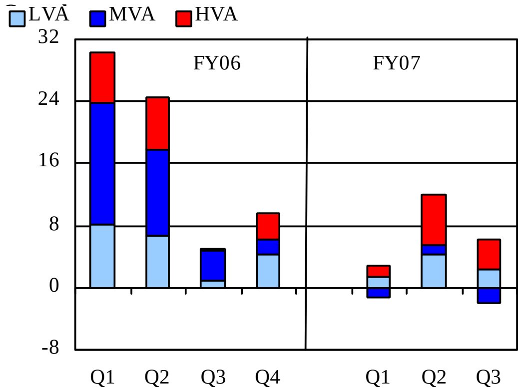
Source: Federal Bureau of Statistics

P : Provisional

percent during the same period of last year.

It may be pointed out that after showing a remarkable performance in H1-FY06, the export growth of textile manufactures started deceleration since Q3-FY06 onward. However, after recording the lowest growth during Q1-FY07 of the last two years, textiles exports have started picking up from Q2-FY07 onward probably because of an increase in unit prices (see **Figure 6.26**). Importantly, the increasing exports of high value textile items seem to be the driving force behind the export growth of textile group, although the exports of low value added textile exports also contributed in the overall growth of textile exports.

Figure 6.26: Contribution in Textile Exports



1) Low Value Added Exports

Cotton yarn and cotton fabrics constitute around 36 percent of the total textile exports, and the growth in the exports of both decelerated sharply during Jul-Mar FY07. Exports of the former recorded a nominal growth of 3.4 percent during Jul-Mar FY07 as compared to impressive growth of 31.8 percent during the same period of last year. Similarly, the cotton fabrics exports declined by 6.9 percent during Jul-Mar FY07 against 17.3 percent growth in the same period of last year despite the considerable increase in its unit price and provision of a 3 percent Research and Development (R&D) subsidy (see **Figure 6.27)**.

Figure 6.27: Cotton vs. PSF Price in Pakistan

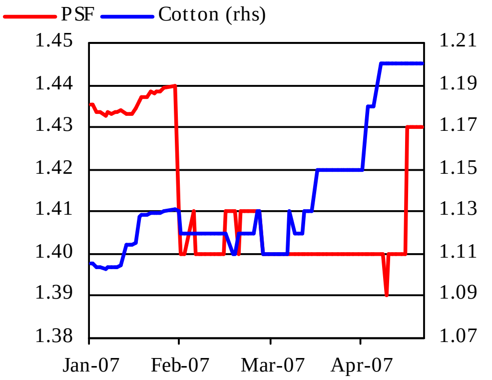
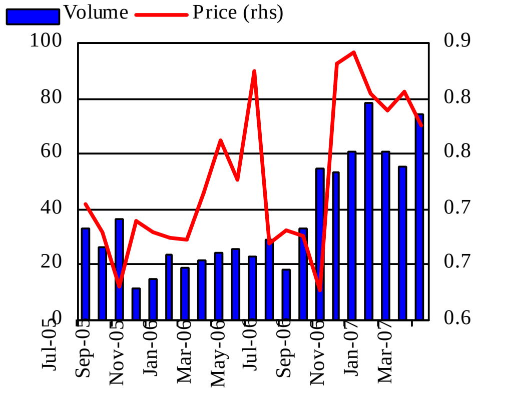


Figure 6.28: Volume and Unit Value of Synthetic Textile



It may be mentioned here that decline of US$ 108.9 million in cotton fabrics exports was more than offset by US$ 232 million increase in the synthetic textile exports (mainly fabrics of synthetic textile) during the same period. The synthetic textile exports recorded extraordinary growth of 159.3 percent during Jul-Mar FY07 as compared to a decline of 37.2 percent in the same period of last year. With the increasing pricing of cotton and falling prices of polyester staple fiber in Pakistan, the local producers might have substituted cotton with the polyester staple fiber, thereby increasing the exports of fabrics of synthetic textile. This extraordinary growth in exports was contributed by both the increase in unit price and the quantum from September FY07 onward (see **Figure 6.28**).

2) Middle Value Added Exports

The textile made ups (middle value added) has traditionally been the main strength of Pakistan's textile exports. The bedwear and towels are the important items in the group which have significant share in the two dominant markets of the world, i.e. EU and the USA. The decline in export growth in both categories is a little puzzling as the bedwear exports declined despite the reduction in antidumping duty from 13.1 percent to 5.8 percent in May 2006 and the grant of R&D subsidy of 5 percent with effect from August 2006. The bedwear exports declined by 3.9 percent during Jul-Mar FY07 against the strong growth of 58.4 percent in the same period of last year.[3] The decline in bedwear exports may partially be explained by the slight decline in unit price.

Driven by both the increase in price and volume, the towel exports registered a nominal growth of 2.1 percent during Jul-Mar FY07 on the top of 14.7 percent increase in the same period of last year (see **Figure 6.29**).

[3] During Jul-Mar FY06, the bedwear exporters were paying 13.1 percent antidumping duty and no R&D was allowed.

3) High Value Added Exports

The high value added textile items i.e. hosiery and readymade garments constitute around 30 percent of the total textile exports of Pakistan, which are facing stiff competition from China, India, Bangladesh and Sri Lanka in both the US and the EU markets. In the EU market, Bangladesh and Sri Lanka enjoy duty free access under GSP plus facility whereas Pakistan is at a disadvantageous position in this market. Moreover, unit prices of Pakistan's high value added textile items are lower than that of its major competitors.

In this backdrop, the robust exports growth of high value added textile items during Jul-Mar FY07 is really commendable. The exports of readymade garments increased by 8.6 percent during Jul-Mar FY07 against a 26.6 percent growth in the same period of FY06. More impressively, exports growth in hosiery items accelerated to 15.1 percent during Jul-Mar FY07 against a nominal growth of 4.8 percent in the same period of last year. The appreciable increase in the exports of these two items was contributed by increases in both the price and the volumes. However, the positive effect of unit price was more pronounced in case of hosiery than that of readymade garments. The continuation of R&D subsidy of 6 percent for the readymade garments might have provided additional support to the product's exports. The increase in the high value added textile items is important for two reasons, firstly, it fetches good price in the international market and secondly, there are better prospects for the expansion of high value added textile items. However, the abolishing of China specific safeguards in the year 2008 imposed by the US and EU against textile and clothing imports may pose a challenge for Pakistan's high value added textile items.

Other Manufactures

The exports of other manufacture declined by 17.9 percent during Jul-Mar FY07 in contrast to a robust growth of 29 percent in the same period of last year. Exports of almost all the major items such as carpets & rugs, sports goods, leather manufactures, petroleum & petroleum products and chemical & pharmaceuticals declined during Jul-Mar FY07.

Figure 6.29: Major Textile Manufactures- Export Volume and Unit Prices

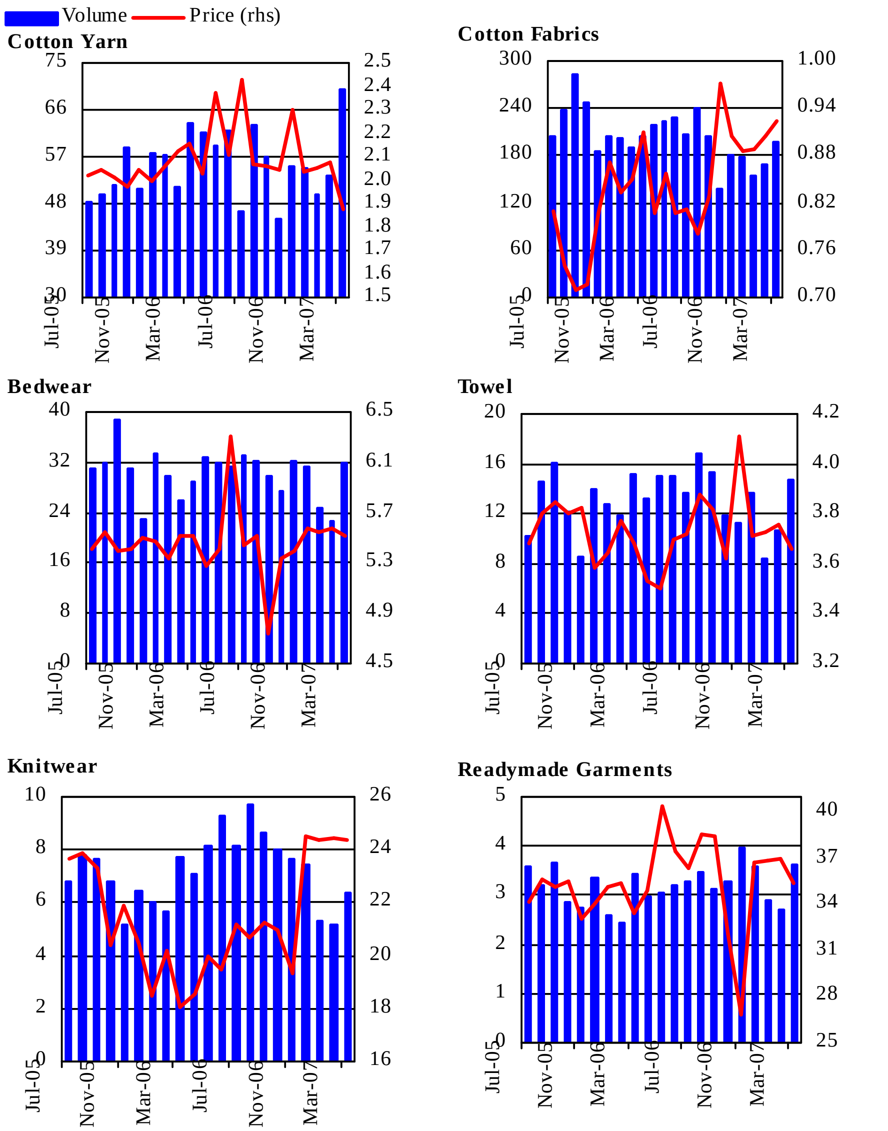
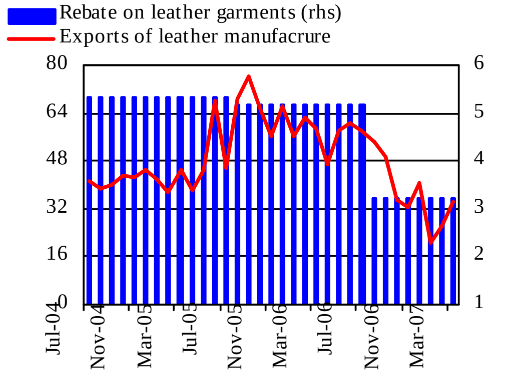


Figure 6.30: Leather Manufacture Exports Agiants Rebate

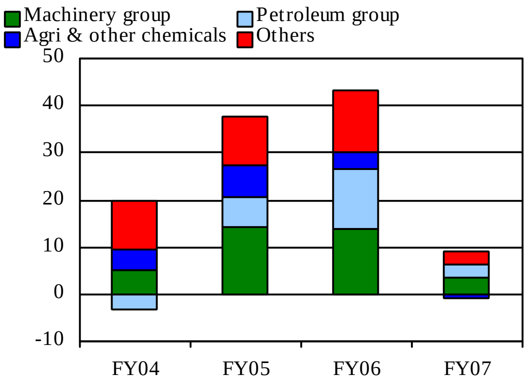


This decline in exports is attributed to industry specific issues.[4]

The leather garment exports, which constitutes almost 73 percent of the total leather manufacture exports, was the dominant factor behind the decline of leather manufacture exports. Interestingly, the leather manufactures exports decline coincided with the decline in rebate on leather garments from 5.17 percent during JulyFY07 to 3.22 percent during August FY07 (see **Figure 6.30**). Also given the claim of the leather manufactures of dubious leather garment exports last year and one off high exports to Iran lends some credence to the arguments that leather exports growth last year may have been overstated due to the rebate.[5]

6.3.2 Imports

Figure 6.31: Contribution in Import Growth (Jul-Mar)



After depicting extraordinary growth of 30 percent, on average, during the last four years, the imports growth sharply declined to 8.1 percent during Jul-Mar FY07 (see **Figure 6.31**). This was contributed by a significant deceleration in the import of all major groups such as machinery, petroleum group, agriculture & other chemicals group and other imports. For example the lower oil prices

[4] See *SBP 2nd Quarterly Report FY07*, Section 6.2, Page 93

[5] The Federal Bureau of Statistics suggests that Pakistan's exports to Iran under the head of special transaction used to be around US$ 0.3 million to US$ 0.8 million during FY03 to FY05, however the exports under this head touched US$ 35.77 million during FY06 out of which US$ 33.993 million were of leather manufacture exports.

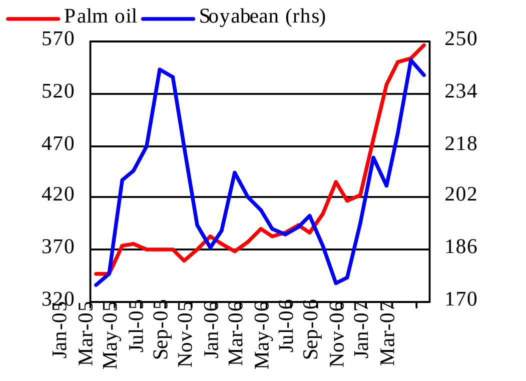
in the international market decelerated the oil bill growth during the period. Specifically, the unit prices contributed only 4 percent to the additional oil imports bill during Jul-Mar FY07 as compared to 96 percent contribution in the same period of last year.

The absorption of one-off impact of structural changes in the telecommunication and automobile sectors together with slowdown in credit for fixed capital and consumer loans have paved the way for deceleration in growth of machinery import.

Food Group

Food imports increased by 6.7 percent during Jul-Mar FY07, as compared to extraordinary growth of 40.5 percent in the same period of last year (see **Table 6.11**). Even this modest growth, despite the positive impact of a bumper wheat harvest and strong domestic sugar production, was caused by an increase in the prices of almost all food items in the international market. The price impact was quite pronounced in the import of pulses as around 70 percent of the total increase in pulses imports growth of 60.8 percent during Jul-Mar FY07 was contributed by an increase in prices.
However, the biggest contribution to the growth in the food import bill was by the sharp increase in the prices of edible oils, on account of strong global demand, and supply constraints. The price hikes contributed significantly to the 107 percent increase in the import bill of soybean oil, and 19 percent increase in the palm oil import during Jul-MarFY07 (see **Figure 6.32).**

Figure 6.32: International Market Edible Oil Prices



Machinery Group

After an extraordinary import growth of 50 percent during Jul-Mar FY06, the import growth of machinery has dropped to 11.7 percent during Jul-Mar FY07. The deceleration in import growth of textile machinery and road motor vehicles together with deceleration in import growth of telecom, electrical and other machinery were main driving forces behind the slowdown of overall machinery import growth (see **Figure 6.33**).

Table 6.11: Major Imports (Jul-Mar)

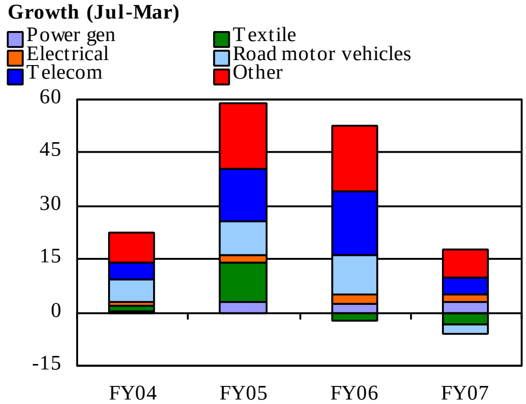
Value: US$ million; unit value US$

Commodities	Units	Jul-Mar FY06 Value	Jul-Mar FY06 Unit Value	Jul-Mar FY07p Value	Jul-Mar FY07p Unit Value	Abs chg. In value	% chg in Jul-Mar FY07/Jul-Mar FY06 Qty	% chg Value	% chg Unit value
A. Food group		**1392.3**	**---**	**1485.4**	---	**93.1**	**---**	**6.7**	**---**
1. Milk & cream incl. milk food for infants	MT	41.3	1761.8	53.2	2362.2	11.9	-11.6	28.8	34.1
2. Wheat un milled	MT	126.8	159.2	32.6	277.1	-94.2	-75.9	-74.3	74.1
3. Dry fruits	MT	39.8	551.6	49.4	494.9	9.6	28.9	24.1	-10.3
4. Tea	MT	173.8	1693.3	167.4	1922.3	-6.4	-13.7	-3.7	13.5
5. Spices	MT	39.6	630.8	40.8	674.9	1.2	-10.7	3.0	7.0
6. Edible Oil	MT	566.7	432.9	687.3	479.2	120.6	-1.1	21.3	10.7
Soyabean	MT	14.4	654.5	30.0	850.1	15.6	89.0	108.3	29.9
Palm Oil	MT	552.3	429.1	657.3	469.9	105.0	-2.4	19.0	9.5
7. Sugar	MT	278.9	364.7	253.0	773.0	-25.9	-50.5	-9.3	112.0
8. Pulses	MT	125.4	372.2	201.7	503.9	76.3	18.9	60.8	35.4
B. Machinery group	**---**	**5989.2**	**---**	**6687.9**	**---**	**698.7**	**---**	**11.7**	**---**
1. Power generating machinery	---	362.2	---	526.9	---	-5462.3	---	45.5	---
2. Office machinery	---	209.5	---	233.4	---	-128.8	---	11.4	---
3. Textile machinery	---	598.8	---	392.8	---	183.3	---	-34.4	---
4. Construction & mining machinery	---	138.0	---	139.8	---	-459.0	---	1.3	---
5. Electrical machinery & apparatus	---	349.2	---	479.0	---	341.0	---	37.2	---
6. Railway vehicles	---	65.0	---	7.0	---	-342.2	---	-89.2	---
7. Road Motor vehicles	---	1176.4	---	1009.8	---	944.8	---	-14.2	---
8. Aircraft, ships and boats	---	398.1	---	802.5	---	-373.9	---	101.6	---
9. Agricultural machinery & Implements	---	110.3	---	129.7	---	-268.4	---	17.6	---
10. Other machinery	---	2581.7	---	2967.0	---	2856.7	---	14.9	---
C. Petroleum group	**MT**	**4630.6**	**435.4**	**5224.5**	**437.2**	**2642.8**	**14.4**	**12.8**	**0.4**
1. Petroleum products	MT	1849.0	459.7	2639.1	433.1	790.1	59.6	42.7	-5.8
2. Petroleum crude	MT	2781.6	420.7	2585.5	441.6	-196.1	-12.2	-7.0	5.0
D. Textile group	**MT**	**399.6**	**---**	**382.1**	**---**	**-17.5**	**---**	**-4.4**	**---**
1. Synthetic fiber	MT	186.1	1598.5	169.8	1863.0	-16.3	-26.0	-8.8	16.5
2. Synthetic & artificial silk yarn	MT	179.2	1629.9	173.0	2199.2	-6.2	-31.9	-3.5	34.9
3. Worn clothing	MT	34.4	335.2	39.4	339.4	5.0	11.6	14.5	1.3
E. Agricultural and other chemicals group	**MT**	**3199.3**	**---**	**3020.9**	**---**	**-178.4**	**---**	**-5.6**	**---**
1. Fertilizer	MT	543.6	278.7	258.9	281.3	-284.7	-56.5	-52.4	0.9
2. Insecticides	MT	88.7	3435.7	73.3	3592.1	-15.4	-28.2	-17.4	4.6
3. Plastic materials	MT	765.6	1225.2	843.8	1403.6	78.2	-8.4	10.2	14.6
4. Medicinal products	MT	250.9	31549.6	296.9	33949.9	46.0	1.7	18.3	7.6
5. Others	---	1550.5	---	1548.0	---	-2.5	---	-0.2	---
F. Metal group	**MT**	**1412.8**	**---**	**1242.7**	**---**	**-170.1**	**---**	**-12.0**	**---**
1. Iron and steel scrap	MT	274.6	251.9	217.1	274.9	-57.5	-37.0	-20.9	9.1
2. Iron and steel	MT	1049.7	493.8	893.8	615.4	-155.9	-38.3	-14.9	24.6
3. Aluminum wrought & worked	---	88.5	---	131.8	---	43.3	---	48.9	---
G. Miscellaneous Group		**436.3**	**---**	**481.9**	**---**	**45.6**	**---**	**10.5**	**---**
1. Rubber crude	MT	77.6	1223.7	82.0	1344.0	4.4	-2.4	5.7	9.8
2. Rubber tyres & tubes	No.	116.3	21.6	116.0	22.1	-0.3	-25.5	-0.3	2.3
3. Wood & cork	---	26.7	---	28.9	---	2.2	---	8.2	---
4. Jute	MT	32.9	368.8	33.9	412.5	1.0	-13.0	3.0	11.8
5. Paper, paper board & manufacture	MT	182.8	701.8	221.1	720.9	38.3	9.3	21.0	2.7
H. Others		**3227.4**		**3846.7**		**619.3**	**---**	**19.2**	**---**
Total imports		**20687.6**		**22372.1**		**1684.5**		**8.1**	

Source: Federal Bureau of Statistics, p: provisional

On the other hand, the one-off items such as power generating machinery, aircrafts, ships and boats, and agriculture machinery contributed significantly in the overall machinery import growth.[6]

Figure 6.33: Contribution in Machinery Import Growth (Jul-Mar)



Power Generating Machinery

The import of power generating machinery increased by 45.5 percent during Jul-Mar FY07 on the top of 31.6 percent growth in the same period of last year. The import of power generating machinery is likely to increase further with the rapidly growing appetite for the power in the country. A large number of power generating plants are under process, which are importing electric power generators for their projects.[7]

Road Motor Vehicles

After depicting an extraordinary import growth in the last three years, the road motor vehicle imports declined by 14.2 percent during Jul-Mar FY07. This decline was contributed by both the decline in imports of Completely Built up Units (CBUs) and Completely Knocked-Down Systems. The imports of CBUs of all the categories declined (except of motor cycles whose share in the total CBUs imports is negligible). The imports of CKDs of busses, trucks, other heavy vehicles and motor cycles also increased while that of motor cars declined.

Telecom Group

In line with expectations, the growth of telecom group imports decelerated to 18.5 percent during Jul-Mar FY07 as compared to 104.8 percent growth in the same period of last year. The mobile phones imports increased by 32.3 percent while the other telecom apparatus imports increased by 10.7 percent during Jul-Mar FY07.

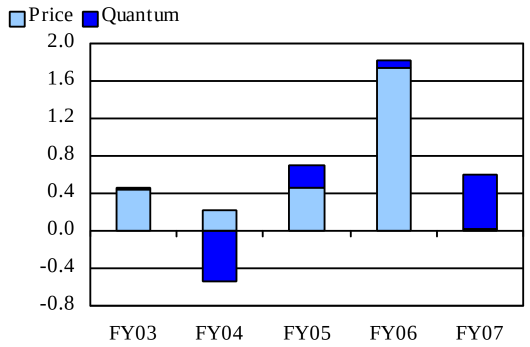
[6] After adjusting for the one-off imports of Aircraft, Ships and Boats, the growth in machinery imports drops to 5.3 percent during Jul-Mar FY07.

[7] Some of the power generating projects includes 220 Mega Watt (MW) power in Korangi, 1800 MW power consortium near Port Qasim, 225 MW power plants in Shaikhupura, Bhikki.

Petroleum Group

The import growth of petroleum group decelerated to 12.8 percent during Jul-Mar FY07 as compared to 65 percent increase in the same period of last year. With the relatively low global oil prices, 96 percent of the increase in the petroleum group was contributed by rising import volumes during Jul-Mar FY07. In contrast increase in prices were the dominant contributor (96 percent) to import growth during the same period of FY06 (see **Figure 6.34**).

Figure 6.34: Rise in Petroleum Group Imports (Jul-Mar)



Within the petroleum group, almost all the increase was contributed by the petroleum products, as petroleum crude imports declined by 7.1 percent during the period on account of the lower demand of oil refineries that continued to operate at the lower capacities relative to preceding years. The import growth of petroleum products was entirely driven by the quantum as the demand for the furnace oil was increased by the power generation units.[8] With the growing need for power in the country, the dependence on the thermal power generation and thereby on the furnace oil is on increase which may put further pressure on the petroleum group imports in future.[9]

Metal Group

Against a robust growth of 62.7 percent during Jul-Mar FY06, the metal group imports declined by 12 percent during Jul-Mar FY07. One of the major contributory factors behind this decline was increase in the metal prices in the international market. Moreover, the improvement in the domestic steel production and revival of ship breaking industry were the other factors behind the decline of metal group imports.

[8] The demand for furnace oil originates mainly from WAPDA, KESC, IPPs and few captive power plants. It also originates from industries which mainly include cements, fertilizers and sugar.

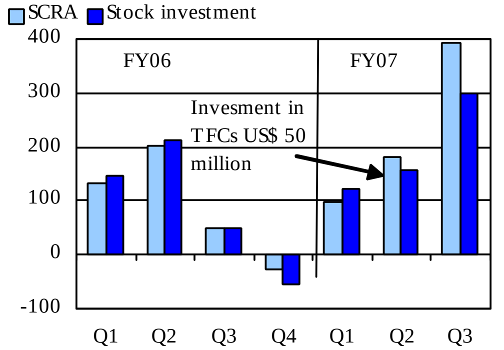
[9] The probable reasons behind the increased dependence on the thermal power generation includes i) controlled water outflow from the dams for agriculture and ii) decrease in gas fired power generation.

Box 6.1: Differences in Foreign investment in stock market and SCRA balance
Non-residents are allowed to invest in the local stock market through Special Convertibility Rupee Account (SCRA).[1] Generally, the foreign investment in stock market that appears in the financial account under portfolio investment is reflection of SCRA flows.[2] However, differences can arise in a given period.

This could be due to number of factors, including (1) non-residents' investment in money market securities through SCRA (2) the fact that non-resident can invest through non-SCRA means as well such as remitting dollars in their brokerage account and withdrawal of rupee from resident enterprises FCAs for stock market investment. However, it is also pertinent to mention here that the larger part of foreign investment in the local bourses is routed through SCRA.

At a glance, quarterly trends in SCRA flows and stock market investment reveal that the difference between the two accounts has customarily been negligible. However during Jul-Mar FY07, the difference between the SCRA flows and stock market investment has increased (see **Figure B1**). Specifically, in Q2-FY07 foreign investors purchased Mobilink TFCs of worth US$ 50 million through SCRA; which was not reflected in the stock investment. Similarly, in Q3-FY07 the foreign investment in the stock market reflects US$ 299 million, while the SCRA balance shows US$ 393 million of net inflow. In fact, a difference of US$ 94 million is partly due to the reason that PMI, bought back 5 percent shares of Lakson Tobacco Company Limited (worth of US$ 43 million). Although this amount is routed through SCRA, however, this is not part of stock market investment. As stated earlier that by acquiring 51 percent share of Lakson Tobacco, PMI now become major share holder in the company therefore this amount is recorded in FDI. While the remaining balance of US$ 51 million was kept in SCRA balances with the authorized dealers, and was not invested during Q3-FY07.

Figure 6.1.1: Foreign Investment in Stock Market and SCRA



[1] Investors are bound to surrender dollars with the authorize dealers and the equivalent rupee amount has being credited in their SCRA balance, which can be replenished through fresh remittances from abroad or by transferring from their foreign currency account maintained in Pakistan.
[2] Equity securities in the portfolio investment are adjusted for GDRs.

Box 6.2 Pakistan's Ethanol Exports

Ethanol is used for three major purposes a) industrial use i.e., for perfumes, after shaves, and cleaners, b) beverages (drinking) and c) fuel (It is blended with gasoline to increase the fuel blend's octane or to produce a cleaner burning fuel). While Ethanol can be made from any commodity containing starch or sugar, including vegetable, sorghum, barley, grasses, and even paper; sugarcane has the highest output level of ethanol per pound of matter. With the rise in global oil prices, the use of ethanol as an alternative fuel is rising as compared to its other uses.

In terms of the market, the USA is the fast growing and largest world market for ethanol followed by Germany and Korea (see **Table 6.2.1**). As a result of better prospects for ethanol markets expansion, countries are producing ethanol to meet the growing demand for ethanol. In particular, Brazil which is the single largest exporter of ethanol is directly converting the sugarcane into ethanol for domestic use and export. Brazil began producing ethyl alcohol from sugar to cut petroleum imports after petroleum prices rose in 1973. The Brazilian Government specifies the percentage of alcohol to be included in gasoline, depending on sugar prices, and encourages the production of automobiles that run on alcohol. As a result, Brazil was the largest share holder (73.5 percent) of ethanol in the world market followed by South Korea and USA during 2006 (see **Table 6.2.2**).

In Pakistan, major source of ethanol is molasses which is byproduct of sugar manufacturing. Until recently, due to lack of awareness, the sugar industry was focused on producing refined sugar while the molasses was exported. However, during the last two years there is considerable rise in the ethanol exports.

Table 6.2.1: World Major Importers of Ethanol

Value in US$ million and Share in percent

	2005		2006	
	Value	**Share**	**Value**	**Share**
World	**2371.4**	**100.0**	**2440.6**	**100.0**
USA	374.6	15.8	1705.8	69.9
Germany	216.7	9.1	279.1	11.4
Belgium	219.3	9.2	112.2	4.6
Korea	87.4	3.7	107.8	4.4
Finland	31.2	1.3	48.7	2.0
Japan	212.6	9.0	n.a	n.a
India	142.7	6.0	n.a	n.a
Others	1086.9	45.8	186.9	7.7

Source: com trade

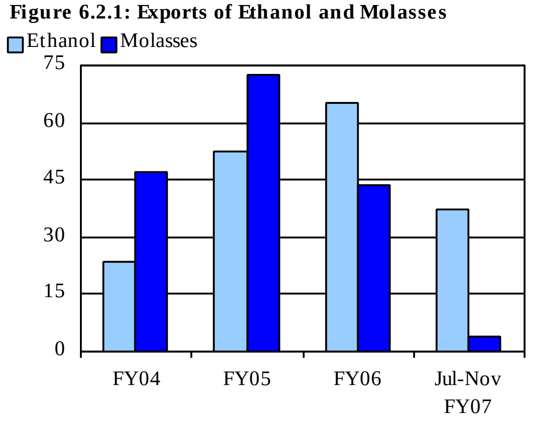
Table 6.2.2: World Major Exporters of Ethanol

Value in US$ million and Share in percent

	2005		2006	
	Value	**Share**	**Value**	**Share**
World	**2328.4**	**100.0**	**2183.6**	**100.0**
Brazil	765.6	32.3	1604.8	73.5
South Africa	139.1	5.9	112.1	5.1
USA	141.1	5.9	108.6	5.0
Germany	94.9	4.0	106.8	4.9
Belgium	49.4	2.1	80.6	3.7
France	221.2	9.3	n.a	n.a
U.K	161.3	6.8	n.a	n.a
Others	755.8	31.9	170.7	7.8

Source: com trade

Figure 6.2.1: Exports of Ethanol and Molasses



Pakistan's sugar industry is now converting larger volume of molasses into ethanol which fetch far higher price in the international market as compared to molasses .[1] It can be observed from the **Figure 6.2.1** that ethanol exports is increasing consistently while molasses exports are falling.

EU had been the major market for Pakistan's ethanol exports. For instance during 2002-04 period, Pakistan was holding almost 20 percent share of the EU total ethanol imports, mainly because of duty free access to EU market under Everything But Arms (EBA) initiative. Importantly, Pakistan has been successful in diversifying its markets for ethanol products as is depicted by the increased share of ethanol exports to USA, Korea, Japan, Jamaica, Nigeria and Philippines (see **Table 6.2.3**).

With the greatest focus on USA, which is the world largest and fast growing market for Ethanol, along with Korea, Philippines and Japan, Pakistan can increase its foreign exchange earnings. Moreover, the unit price of ethanol in USA, Japan and Philippines is higher than average price in the EU market.

Table 3: Major Markets for Pakistan's Ethanol Exports

Value in US$ million and Share in percent

	2003		2004		2005		2006	
	Value	**Share**	**Value**	**Share**	**Value**	**Share**	**Value**	**Share**
World	**23.6**	**100.0**	**20.7**	**100.0**	**56.9**	**100.0**	**64.8**	**100.0**
Netherlands	0.7	2.8	0.8	3.6	13.8	24.2	28.0	43.2
USA	0.0	0.0	0.0	0.0	0.0	0.0	7.1	11.0
Turkey	0.0	0.0	0.0	0.0	1.6	2.8	6.8	10.6
Spain	0.0	0.0	0.0	0.0	0.0	0.0	4.4	6.8
Korea	0.0	0.0	0.0	0.0	2.6	4.6	3.6	5.6
Italy	16.6	70.0	13.8	66.4	32.3	56.7	3.3	5.1
Japan	0.0	0.0	0.0	0.0	0.0	0.0	3.2	4.9
France	1.5	6.2	2.0	9.8	6.0	10.6	2.2	3.4
Jamaica	0.0	0.0	0.0	0.0	0.0	0.0	2.1	3.2
Nigeria	0.0	0.0	0.0	0.0	0.0	0.0	1.4	2.2
Philippines	0.0	0.0	0.0	0.0	0.0	0.0	1.0	1.5
Switzerland	2.5	10.7	1.9	9.0	0.0	0.0	0.8	1.2
Others	2.4	10.3	2.3	11.2	0.7	1.1	0.9	1.3

Source: com trade

1) According to the market sources the ethanol is being quoted around US$ 550 per ton against the molasses price of US$ 61 per ton.
2) According to Federal Bureau of Statistics data, during FY06 per liter price of Pakistan's ethanol exports in US is US$ 0.60, in Japan US$ 0.57, in Philippines US$ 0.58 as compared to EU average price of US$ 0.56 per liter.

Box 6.3: Export's Concentration in Textile Sector

Pakistan's exports are highly concentrated in the textile sector. Pakistan's share of textile exports in total exports (60 percent) is higher than that of India (29 percent), Sri Lanka (47 percent) and China (20 percent) during CY05. Thus a downturn in this single sector may have significant impact on the overall export performance. Since the major input of the textile industry is cotton which heavily depends on the vagaries of nature, the overall performance of export remains uncertain.[1]

Moreover, the textile and clothing exports have relatively low prospects for market expansion as compared to other products (see **Table 6.3.1**). The products which have greater share in the world exports and whose market is expanding fast include office & telecom equipments, other machinery, agricultural products, automotive products and pharmaceuticals. The expanding market of these products provides Pakistan an opportunity to diversify its exports by moving to the exports of the engineering products, agricultural products, pharmaceuticals and other chemicals.[2]

Table 6.3.1: World merchandise exports by product group, 2005

(Annual Growth and Share in percent)

	Share	Growth
Fuels	15.8	41
Ores & minerals	1.7	26
Iron and steel	3.6	18
Non-ferrous metals	2.2	16
Other chemicals	9.4	13
Scientific and controlling instruments	2.4	12
Office & telecom. equip.	14.3	11
Other semi manufactures	8.0	10
Pharmaceuticals	3.1	10
Other machinery	14.3	9
Agricultural products	9.6	8
Automotive products	10.3	6
Clothing	3.1	6
Textiles	2.3	4

Source: WTO International Trade Statistics

[1] After textile, rice is the second largest foreign exchange earner for Pakistan whose exports are also climate dependant and hence volatile.
[2] In chemical Pakistan has the potential to capture the expanding ethanol market while in agricultural products such as milk, meat, seafood and fruits have the potential for exports.

Box 6.4: EU-27 Ban on Pakistan's Fish and Fish Preparation Exports

The EU 27-nations block of European Union is the largest market for Pakistani sea food as is evident from the fact that during FY06 almost 22.4 percent of our total fish and fish preparations exports were destined for this market. Importantly, Pakistan exports of fish and fish preparations were fetching the highest price (US$ 3/ kg) in EU market as compared to other markets. However, EU countries were showing their concern on the processing condition of seafood since last couple of years. For instance, Pakistan government had self-imposed a ban on seafood exports to the EU in 2005 after the EU experts had pointed out lapses at the facilities and for which the government of Pakistan had also submitted guarantees with the EU to improve the conditions at the harbor.

During January 2007, an EU team visited Karachi fish harbor and other seafood processing facilities to check seafood quality. The visit led EU to impose a ban on exports from all Pakistani processing factories on lack of Hazard Analysis and Critical Control Point (HACCP) implementation, lack of traceability of raw materials and poor fish processing.[1] The initial letter from EU has informed Pakistan that no consignments of fishery products will be accepted to enter into the EU after April 12, 2007.

Table 6.4.1: Destination of Pakistan's Fish and Fish Preparation Exports

	FY06			FY05		
	Share (%)		US$/kg	Share (%)		US$/kg
Countries	Vol	Val	Price	Vol	Val	Price
Total	100	100	1.5			1.4
EU-27	11.3	22.4	3.0	8.9	19.1	3.1
China	23.4	15.5	1.0	24.6	16.4	1.0
Thailand	18.6	11.4	0.9	8.2	4.9	0.9
UAE	5.0	9.2	2.8	7.2	13.5	2.7
Malaysia	8.7	5.6	1.0	13.0	7.9	0.9
Japan	2.9	5.6	2.9	3.9	9.2	3.4
Singapore	3.0	5.3	2.7	0.5	0.7	1.8
Korea	5.1	4.6	1.4	7.1	6.9	1.4
Hong Kong	3.5	4.6	2.0	4.3	6.2	2.1
Saudi Arabia	2.8	3.1	1.7	2.9	2.3	1.1
Sri Lanka	7.0	2.8	0.6	11.3	3.9	0.5
Kuwait	2.6	2.6	1.5	2.9	3.2	1.6
U.S.America	0.6	0.9	2.4	0.5	1.0	3.0
Others	5.4	6.3	1.8	4.7	4.7	1.4

This ban has serious repercussions for the fish and fish preparation exports. Firstly, Pakistan has lost its largest market for seafood exports. Secondly, the per unit price in the other market is relatively lower as compared to EU, thirdly, the EU ban is having fallout on the other major international importers from Pakistan. As a result prices of Pakistani seafood have nosed-dived in the international market. According to the World Trade Review report, within a week after April 12, 2007 prices of Pakistani seafood in the international market have declined by almost 20 per cent.

With ban on exports to EU, the other potential markets that can be explored and where seafood fetches relatively good price are: United Arab Emirates, Japan, Singapore, Hong Kong and U.S. America. Along with finding the new markets, both the public and private sector need to make all out efforts to improve the quality of seafood, as it will not only boost our exports but it will also ensure better quality for the domestic consumers.

1 HACCP is a systematic preventative approach to food safety that addresses physical, chemical and biological hazards as a means of prevention rather than finished product inspection.