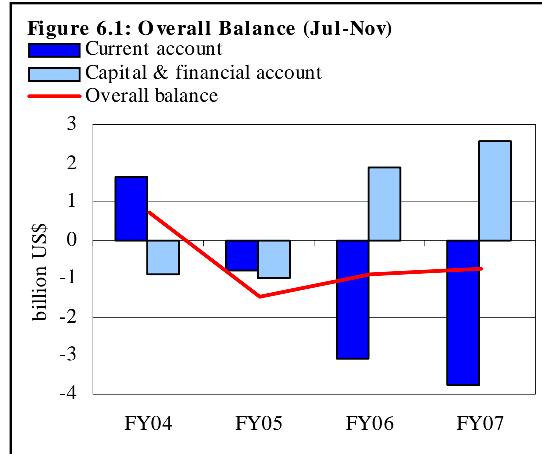
6 External Sector

6.1 Overview

Pakistan's overall external account position improved during Jul-Nov FY07 compared to the same period last year despite a worsening of the current account deficit. Specifically, while the current account deficit increased from US$ 3.1 billion to US$ 3.8 billion, an increase of 22.3 percent, the overall external account deficit shrank to US$ 0.74 billion compared to US$ 0.88 billion in Jul-Nov FY06.



As in the previous year, it was the surpluses in the *capital* and *financial* accounts that offset most of the deficit in the current account. The bulk of the 35.6 percent YoY increase in the aggregate surplus in the *capital* and *financial* accounts during Jul-Nov FY07 was contributed by foreign investment (see **Figure 6.1**).

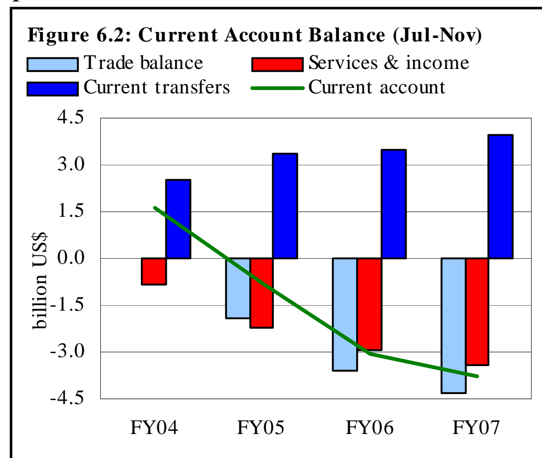
Foreign direct investment inflows increased to US$ 1.5 billion during Jul-Nov FY07 as compared to US$ 752 million in Jul-Nov FY06. Key FDI inflows included: (1) US$ 195 million on account of acquisition of Union Bank by Standard Chartered Bank, (2) US$ 133 million installment of PTCL privatization proceeds, and (3) US$ 175.7 million of a mobile phone company. Portfolio investment of US$ 591 million during Jul-Nov FY07 was also significantly higher than US$ 245 million recorded in the same period in FY06. This increase in portfolio investment was mainly on account of the Muslim Commercial Bank's Global Depository Receipts (GDR) of US$ 150 million, US$ 148 million on account on Mobilink bonds, and US$ 50 million foreign investment in Term Finance Certificates issued by Mobilink.[1]

[1] Mobilink floated US$ 250 million worth of International Bonds, out of which US$ 148 million was received till November 2006.

Although Pakistan was able to finance the Jul-Nov FY07 current account deficit relatively easily, the rise in the deficit nonetheless remains a source of some concern, particularly because unlike the previous years, it owed more to a substantial slowdown in the country's exports rather than an extraordinary rise in imports. Specifically, while the imports growth during Jul-Nov FY07 slowed substantially to 11.8 percent compared to 33.2 percent in the corresponding period last year, it was the unusual decline in the exports growth that dropped to 7.8 percent compared to 13.8 percent in the corresponding period last year, which drove the trade deficit up by 18.8 percent to US$ 4.3 billion.

In addition, the current account deficit was also adversely affected by an unusual rise in the income account deficit arising from higher direct investment outflows. The rise in the trade, services, and income account deficits was, however, mitigated to an extent by the increase in the current transfers by 13.4 percent during Jul-Nov FY07 (see **Figure 6.2**).

Figure 6.2: Current Account Balance (Jul-Nov)



Due to substantial inflows, both on account of current transfers and foreign investment during Jul-Nov FY07, the impact of the widening current account deficit on the country's reserves was relatively low. Pakistan's overall foreign exchange reserve declined by US$ 799.4 million during Jul-Nov FY07 compared to decline of US$ 1,321.6 million in the same period last year.

Interestingly, despite lower depletion of reserves and significant slowdown in the imports growth, some speculations about exchange rate were witnessed due to incorrect conclusions drawn from IFI reports and reported by some local papers that called for a large adjustment of the exchange rate.

This forced central bank to aggressively correct these misperceptions in order to avoid unnecessary market volatility. Specifically, the central bank pointed out that: (1) the exchange rate continued to be set in the inter-bank market; and (2) the SBP interventions remained limited to the provision of liquidity for lumpy oil payments in order to dampen excessive market volatility.

It is important to realize that the exchange rate adjustment is not an end in itself but a means to an end. If the aim is to curtail imports, then there is already a broad based slowdown apparent in the imports since H2-FY06, which seems to have strengthened during Jul-Nov FY07. As impact of monetary tightening measures

taken during July 2006 take effect (due to time lag in monetary transmission mechanism), the imports are likely to be constrained further. Thus, adjustment in the exchange rate to curtail imports seems unnecessary.

The argument for devaluations to boost exports is debatable, as analysis of the past 30 years data show no consistent relationship between exports growth and devaluation. One risk is that excessive volatility in exchange rate would adversely raise domestic cost of production, thus rendering exports uncompetitive instead of boosting them and could also deter foreign investment. Past experience also shows persistent large exchange rate adjustments can also generate self fulfilling expectations that could lead to added pressures on the exchange rate and inflation, as well as on the country's foreign exchange reserves and encourage dollarization of the economy.

Thus, in short, best policy option is to let the market determine the exchange rate in light of supply and demand pressures, and the macroeconomic fundamentals at large. Indeed the data reveals that by Nov 2006, in nominal terms, Pak Rupee against basket of currencies has depreciated by 6.7 percent since July 2005, and it is only due to the increase in the relative price index that has not allowed similar depreciation in real terms. Thus, if exports competitiveness is to be enhanced, the appropriate channel in this scenario is through controlling domestic inflation.

6.2 Current Account Balance

The current account balance worsened further in the first five months of FY07. The deficit reached to US$ 3.8 billion during Jul-Nov FY07 as compared to US$ 3.1 billion recorded in the corresponding period of FY06. The increase in deficit was contributed by goods and income deficit along with services deficit. However, current transfer inflows showed improvement of US$ 465 million over the corresponding period, mainly due to higher remittances inflows. It is worth mentioning that despite persistent current account deficit since FY05, Pakistan's debt to GDP ratio is continuously improving (see **Table 6.1**).[2]

[2] see **Section 6.3** on External Debt in *SBP Annual Report FY06*

Table 6.1: Current Account Balance(Jul-Nov)

million US$

Items	FY06	FY07	Change FY07 over FY06
1. Trade balance	**-3,624**	**-4,304**	**-680**
Exports	6,415	6,917	502
Imports	10,039	11,221	1,182
of which: petroleum group	2,364	3,325	961
2.Services (net)	**-1,778**	**-1,871**	**-93**
Transportation	-791	-828	-37
Travel	-462	-550	-88
Communication services	57	22	-35
Other business services	-879	-839	40
Government services	532	458	-74
Of which: logistic support	474	425	-49
Other	-235	-134	101
3. Income (net)	**-1,147**	**-1,524**	**-377**
Investment income(net)	-1,148	-1,527	-379
Direct investment	-842	-1,197	-355
Of which: profit & dividend	-217	-274	-57
Purchase of crude oil & minerals	-408	-590	-182
Portfolio investment	-56	-85	-29
Of which: profit & dividend	-30	-81	-51
IMF charges & interest on off. external debt	-315	-336	-21
Interest on private external debt	-37	-39	-2
Others	102	130	28
4. Current transfers (net)	**3,481**	**3,946**	**465**
Private transfers	3,407	3,844	437
Workers remittance	1684	2093	409
FCA - residents	110	-61	-171
Others	1613	1812	199
Official transfers	74	102	28
Cash grants	17	33	16
Current account balance	**-3,068**	**-3,753**	**-685**

Source: Statistics and Data Warehouse Department, State Bank of Pakistan

Trade Balance[3]

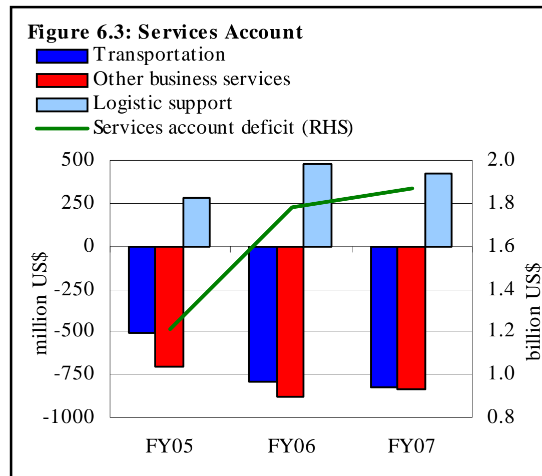
The trade balance deteriorated further during Jul-Nov FY07, though the growth was limited to 18.8 percent against 90.6 percent recorded in the same period last year. The rise in the trade deficit during the last three years was mainly driven by extraordinary jump in the imports. This rise was understandable given the increase in the economic activity after a prolong period of recession. The imports were therefore not discouraged, as they were deemed necessary to enhance the productive capacity of the economy. It was also assumed that as economy's productive capacity increases the imports would gradually fall. This has exactly been the case. The imports growth which started declining in H2-FY06, further fell to 11.8 percent during Jul-Nov FY07 compared to 33.2 percent in the corresponding period last year, with all major heads except for food and transport recording significantly lower growth than last year.

Unfortunately, the desired growth in exports has not been sustained. Contrary to expectations, the exports have decelerated at a much faster pace than the imports, thus widening the trade deficit by 18.8 percent during Jul-Nov FY07 (for a more detailed discussion (see **Section 6.6** on Foreign Trade).

Services (Net)

The services account deficit recorded an increase of 5.2 percent during Jul-Nov FY07 to reach US$ 1.9 billion as compared to 46.5 percent rise in the corresponding period last year (see **Figure 6.3**). An unusual lower growth in services account deficit was largely due to the absence of one-off outflow for construction services. The payments for construction services declined by US$ 77 million during Jul-Nov FY07 as compared to the same period in FY06. The higher payments for construction services during Jul-Nov FY06 were related to

Figure 6.3: Services Account



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

the deferred construction payments for the Ghazi Brotha Dam. Similarly, the net outflow under other business services also recorded YoY fall of 40 percent during Jul-Nov FY07. Thus the saving on construction services and other business services partially offset the routine outflows on account of transportation and travel account.

Income (Net)

Income account deficit recorded YoY expansion of US$ 377 million during Jul-Nov FY07, mainly due to higher investment income outflows.

Table 6.2: Returns on Direct Investment (Jul-Nov)

million US$

	FY06	FY07	Change
Direct investment (net)	842	1197	355
Profits	22	10	-12
Dividend	195	264	69
Reinvested earning	223	348	125
Purchase of oil & gas	408	590	182

Source: Statistics and Data Warehouse Department, SBP

The net direct investment outflows recorded a rise of US$ 355 million, mainly due to higher payments for the *purchase of oil & gas* (see **Table 6.2**).

During Jul-Nov FY07 net interest payments on external debt and liabilities decreased by US$ 13 million. The rise in interest payments on external debt and liabilities by US$ 49 million was partially offset by a US$ 36 million increase in receipts during the period.

Table 6.3: Details of Interest Payments and Receipts

million US$

	Jul-Nov		
	FY06	FY07	Savings
Payments (I+II)	**472**	**521**	**-49**
I. Total external debt	399	449	-50
Public & publicly guaranteed	356	402	-46
Long-term	294	310	-16
Military	7	7	0
Euro bonds	47	74	-27
Commercial loans/credits	3	4	-1
IDB	5	7	-2
Private loans/credits	37	39	-2
IMF	6	8	-2
II. External liabilities	73	72	1
Foreign currency deposits	4	9	-5
Special US$ bonds	11	4	7
Central bank deposits	17	12	5
Others	41	47	-6
Receipts	**159**	**195**	**36**
Interest on reserves	111	149	38
Others	48	46	-2
Net Payments	**-313**	**-326**	**-13**

Source: Statistics and Data Warehouse Department, SBP

Interest payments on external debt increased to US$ 402 million during Jul-Nov FY07 from US$ 356 million in the corresponding period in FY06 (see **Table 6.3**). This increase was mainly due to higher interest payments on Euro bonds, which increased to US$ 74 million during Jul-Nov FY07 from US$ 47 million in the same period during FY06.

On the receipts side, the YoY increase of US$ 36 million during Jul-Nov FY07 was due to higher interest earnings on reserves and other investments. The returns on reserves improved from US$ 111 million during Jul-Nov FY06 to US$ 149 million during Jul-Nov FY07.

Current Transfers (net)
Current transfers registered 13.4 percent YoY rise during Jul-Nov FY07.[4] This was mainly due to 12.8 percent YoY increase in net private transfers during the period.

Within the net private transfers of US$ 3.8 billion, US$ 2.09 billion were contributed by workers' remittances and US$ 1.81 billion by other private transfers (remittances through exchange companies). However, residents' FCAs declined by US$ 61 million during Jul-Nov FY07 (see **Figure 6.4**).

Workers' Remittances
Workers' remittances (cash) recorded 24.3 percent YoY increase reaching US$ 2,093 million during Jul-Nov FY07 as compared to only 4.6 percent growth observed

Figure 6.4: Composition of Foreign Private Transfers (Jul-Nov)

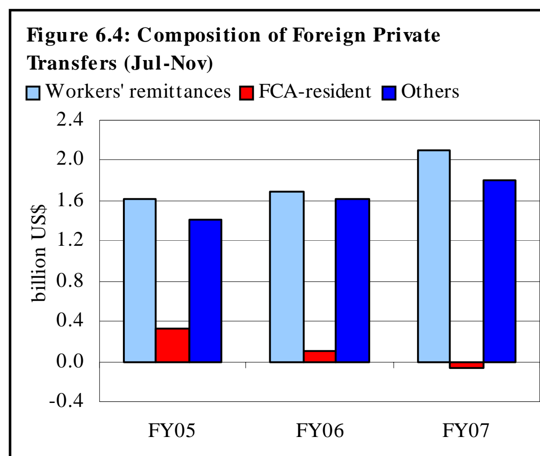


Table 6.4: Workers' Remittances
million US$

	Jul-Nov		
	FY06	**FY07**	**Change**
I. Gulf region	**752**	**1,009**	**256**
Bahrain	41	52	10
Kuwait	92	114	22
Qatar	43	62	19
Saudi Arabia	281	399	118
Sultanat-e-Oman	52	64	12
U.A.E.	243	318	75
II. U.S.A.	**482**	**533**	**52**
III. Other than Gulf & US	**442**	**550**	**107**
Canada	32	35	3
Germany	24	33	10
Japan	3	2	-1
Norway	7	8	1
U.K.	173	180	7
Other	203	291	87
Total	**1676**	**2,092**	**416**
Encashment of FEBCs & FCBCs	**8**	**1**	**-7**
Grand total	**1684**	**2,093**	**409**

Source: Statistics and Data Warehouse Department, SBP

[4] This head comprises of private and official transfers.

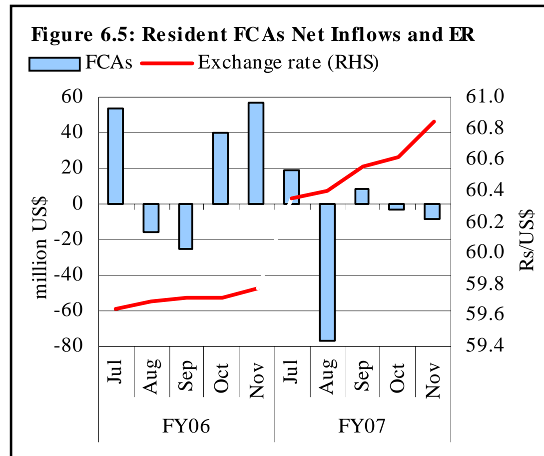
during Jul-Nov FY06.

The increase in the workers' remittances stemmed largely from the traditional sources; USA, Saudi Arabia and U.A.E (see **Table 6.4**). The increase in the remittances from the Gulf region is probably due to the booming regional economies, particularly in the wake of high international oil prices.

Resident FCAs

During Jul-Nov FY07, resident FCAs recorded net outflow of US$ 61 million as compared to net inflow of US$ 110 million during Jul-Nov FY06. This outflow in FE-25 deposits was mainly observed in the month of August FY07 (see **Figure 6.5**).

Figure 6.5: Resident FCAs Net Inflows and ER



Movements in the foreign currency accounts usually reflect the changing expectations with regard to domestic currency. However, with exchange rate more or less stable, the changes in the FCA have been limited and reflect mostly one-time transactions.

6.3 Financial Account

The financial account posted a net surplus of US$ 2.5 billion during Jul-Nov FY07 as compared to US$ 1.8 billion surplus in Jul-Nov FY06 (see **Table 6.5**). The main contributing factor to the increase in the financial account surplus was higher net foreign investment of US$ 2.0 billion during Jul-Nov FY07 as compared to US$ 984 million in Jul-Nov FY06.

Net Foreign Investment

The net foreign investment registered a significant YoY rise of US$ 1.0 billion during Jul-Nov FY07 due to high foreign direct investment as well as foreign portfolio investment inflows.

Foreign direct investment inflows increased to US$ 1.5 billion during Jul-Nov FY07 as compared to US$ 752 million in Jul-Nov FY06. The leading sources of FDI inflows during Jul-Nov FY07 were UK, USA and UAE.

Table 6.5: Financial Account

million US$

	Jul-Nov		Change FY07 over FY06
	FY06	**FY07**	
Financial account (1 through 4)	**1,814**	**2,466**	**652**
1. Direct investment abroad	**-13**	**-51**	**-38**
2. Direct investment in Pakistan	**752**	**1,476**	**724**
of which: Equity capital	529	1,126	597
Reinvested earning	223	348	125
3. Portfolio investment	**245**	**591**	**346**
of which: (stock markets)	271	426	155
Special US Dollar bonds	-29	-43	-14
Euro bonds	-2	-	2
Net foreign investment	984	2,016	1,032
4. Other investment	**830**	**450**	**-380**
Assets	427	200	-227
i. Outstanding exports bills (Exporters)	-141	37	178
ii. Outstanding exports bills (DMBs)	77	-49	-126
iii. Currency & deposits	491	212	-279
of which: Bank	463	147	-316
Liabilities	403	250	-153
I. Foreign long-term loans / credits (net)	233	113	-120
of which: Project assistance	267	367	100
Food aid	-	-	-
Non-food aid	446	211	-235
Amortization	480	465	-15
II. Private loans	21	5	-16
of which: Suppliers credits/MNCs	166	128	-38
Supplier credits repayments	145	123	-22
III. ST capital, (official)	-28	-42	-14
of which: Commercial banks (net)	-100	-100	-
IDB (net)	72	58	-14
IV. Currency & deposits	220	186	-34
of which: Trade financing	492	121	-371
V. Other liabilities	-43	-12	31

Source: Statistics and Data Warehouse Department, SBP

The increasing trend in the FDI inflows in a capital deficient country like Pakistan is indeed a healthy development. It not only helps in funding the current account deficit but at the same time, it brings in new technology and management skills. During the past few years, while telecommunications, financial business services

and oil and gas exploration remain the major recipients of the FDI, other sectors such as; trade, power, textiles, personal services have also witnessed increased foreign investment (see **Table 6.6**).

More than half of the total FDI inflows of US$ 1.5 billion during Jul-Nov FY07 came in the month of September including: (1) US$ 197.6 million from Standard Charted Banks' acquisition of Union Bank; (2) US$ 133 million installment of PTCL privatization proceeds; and, (3) US$ 98.4 million reinvested earnings by Telenor Company.

Table 6.6: Top Ten Recipients of Foreign Direct Investment

million US$

	Jul-Nov	
Economic group	**FY07**	**FY06**
Total Foreign Investment	**1,476.0**	**752.1**
of which:		
Chemicals	24.2	24.2
Financial business	393.7	59.7
Oil & gas explorations	221	114.5
Personal services	32.6	23.5
Petroleum refining	35.3	11.8
Power	76.1	281.2
Telecommunications	392.3	157.4
Textiles	28.5	13.4
Trade	84.4	49.3
Transport equipment (Automobiles)	19.6	13.2

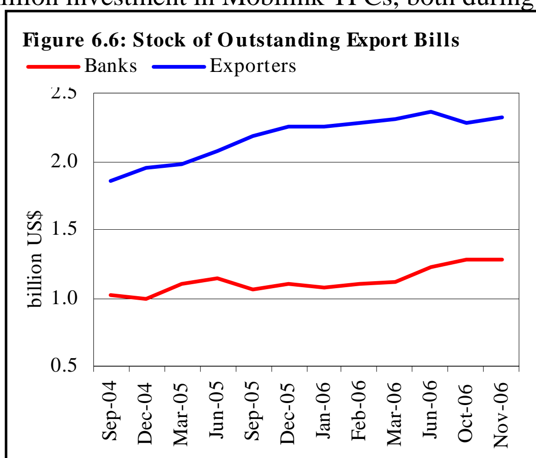
Source: Statistics and Data Warehouse Department, SBP

Portfolio investment also registered a substantial increase of US$ 591 million during Jul-Nov FY07 as compared to US$ 245 million in Jul-Nov FY06. During Jul-Nov FY07, US$ 426 million foreign investment was recorded in the stock market as compared to only US$ 271 million in Jul-Nov FY06. Out of this, US$ 150 million was received on account of MCB Bank's Global Depository Receipts (GDRs) from UK, and US$ 50 million investment in Mobilink TFCs, both during the month of October FY07.

Outstanding Export Bills (OEBs)

The stock of outstanding export bills held by exporters and commercial banks recorded a US$ 12 million rise during Jul-Nov FY07 as compared to the US$ 64 million increase during Jul-Nov FY06.

Figure 6.6: Stock of Outstanding Export Bills



OEBs held by exporters witnessed a decline of US$ 37

million during Jul-Nov FY07 against US$ 141 million rise in Jul-Nov FY06 (see **Figure 6.6**).

On the other hand, the OEBs with commercial banks recorded a rise of US$ 49 million during Jul-Nov FY07 as compared to US$ 77 million decline in Jul-Nov FY06.

Currency and Deposits

This head comprises of currency & deposits held by monetary authorities, general government, commercial banks and other sectors. During Jul-Nov FY07 the currency and deposits observed a decline of US$ 212 million as compared to US$ 491 million fall in Jul-Nov FY06. Comparitively lower fall in currency and deposits during Jul-Nov FY07 was due to lower trade financing of US$ 121 million as compared to US$ 492 million in Jul-Nov FY06.

Foreign Long-term Loans

The long-term official loans witnessed a net inflow of US$ 113 million during Jul-Nov FY07 as compared to the US$ 233 million net inflow in Jul-Nov FY06. High net inflows in the latter are explained by program loan receipts (non-food aid) including World Bank loan of US$ 296 million and US$ 150 million loan from ADB. On the other hand, during Jul-Nov FY07 program loan receipts were only US$ 211 million received from ADB. The amortization of loans declined to US$ 465 million during Jul-Nov FY07 as compared to US$ 480 million in the same period during FY06.

Private/Short-term Loans

Private loans recorded net inflow of US$ 5 million during Jul-Nov FY07 as compared to US$ 21 million in Jul-Nov FY06. Credit repayments of US$ 123 million off set a large portion of the US$ 128 million inflows.

Short-term loans witnessed net outflow of US$ 42 million during Jul-Nov FY07 as compared to the US$ 28 million outflows during Jul-Nov FY06.[5] Further analysis shows that US$ 58 million net inflows from IDB during Jul-Nov FY 07, was offset by repayment of US$ 100 million by commercial banks, thus leading to net outflow of US$ 42 million.

FE-25 Related Trade Financing

Trade financing against FE-25 deposits recorded a rise of US$ 121 million during Jul-Nov FY07 as compared to US$ 492 million during Jul-Nov FY06. In contrast

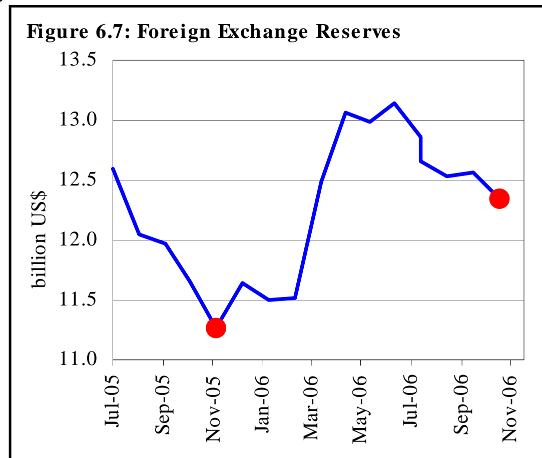
[5] Short term loans contain commercial loans along with the IDB financing for oil imports.

to US$ 307 million rise during Jul-Nov FY06 a decline of US$ 16 million in exports financing from FE-25 deposits was observed during Jul-Nov FY07. However, US$ 137 million rise in imports financing from FE-25 deposits was recorded during Jul-Nov FY07 as compared to US$ 185 million rise observed in the same period in FY06.

6.4 Foreign Exchange Reserves

Pakistan's foreign exchange reserves declined by US $ 0.8 billion during Jul-Nov FY07 due to persistent and rising current account deficit. However, this fall in reserve was comparatively lower than the US$ 1.32 billion recorded in the corresponding period last year. The reserve position during Jul-Nov FY07 benefited from substantial increase in the financial inflows emanating from foreign investment. Unlike the previous year, when bulk of the inflows were concentrated at the end of the fiscal year, in FY07 these inflows appear to be more evenly distributed. As a result not only the depletion of reserves during Jul-Nov FY07 was lower than the corresponding period last year, but on aggregate the reserves were also higher by a billion US dollar compared to the same period last year (see **Figure 6.7**).

Figure 6.7: Foreign Exchange Reserves



As a result of increased inflows in the inter-bank on account of financial receipts as well as the remittances and higher outflow due to rising trade deficit, SBP market intervention increased substantially during Jul-Nov FY07 compared to the corresponding period last year. SBP market support for oil payments increased from US$ 2.4 billion in Jul-Nov FY06 to US$ 3.3 billion in Jul-Nov

Table 6.7: SBP Reserves
million US$

	Jul- Nov	
	FY06	**FY07**
SBP Reserves (end Nov)	**8,890.9**	**10,086.0**
Change	*-900.7*	*-674.2*
Inflows	**4,226.1**	**5,123.1**
SBP Purchases	1,204.7	2,136.1
Donor Agencies and Others	3,021.4	2,987.0
Outflow	**5,126.8**	**5,797.3**
Oil payments	2,394.6	3,318.5
External Debt Servicing	1,207.1	1,474.2
Others	1,525.1	1,004.6

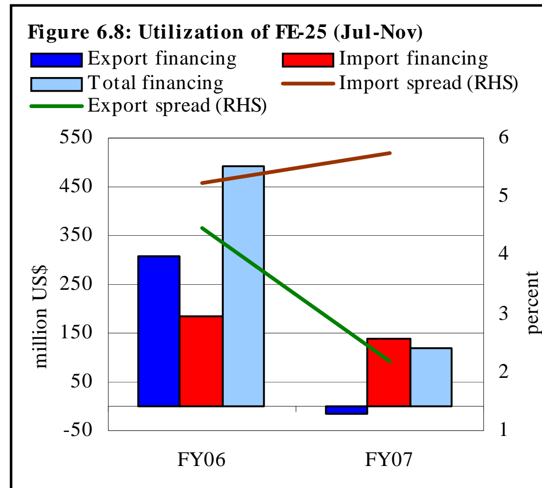
FY07. Similarly, SBP purchases from the inter-bank increased by almost a billion US dollar (see **Table 6.7**).

While the depletion in the SBP reserves was arrested due to rise in the financial inflows and SBP market purchases, the lower depletion in the commercial banks' reserve was mainly due to fall in the lending against FE-25 deposits.

Trade financing against FE-25 deposit declined to US$121.0 million during Jul-Nov FY07 against US$ 492 million in the corresponding period last year (see **Figure 6.8**). The fall was witnessed in both the import as well as export related financing. This fall appears to be the function of interest rate differential between the foreign currency loans and alternate financing modes.

With the fall in the Export Finance Scheme (EFS) rates from 7.5 to 6.5 percent with further narrowing of the bank's spread by 0.5 percent and rise in the LIBOR rates, the difference between EFS rate and LIBOR rate substantially declined (see **Figure 6.8**).[6] With exchange risk further eroding any benefits, financing through the EFS became more attractive. Consequently, while foreign currency loans for export financing witnessed retirement of US$ 16.4 million, the loans under EFS increased by Rs 17 billion during Jul-Nov FY07.

Figure 6.8: Utilization of FE-25 (Jul-Nov)



Unlike the exporters the importers borrow at non-concessional rates, with rise in domestic interest rates, foreign currency loans for imports are still attractive as the differential between the Weighted Average Lending Rates (proxy rate for lending) and 6-month LIBOR appears to have increased since Jul-Nov FY06. However, with concerns over the stability of the domestic currency the exchange risk has probably increased. As a result, although importers utilized the foreign currency loan, nevertheless, the volume of these loans was lower in Jul-Nov FY07 compared to the same period last year.

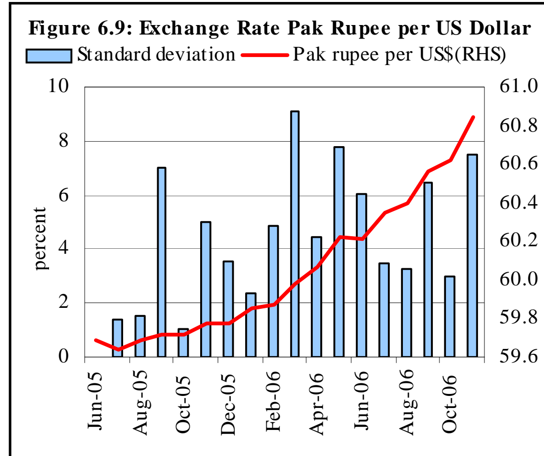
[6] See SMED Circular No.14 of July 14, 2006.

6.5 Exchange Rate

Owing to the pressures on the external sector, Pakistan's currency, vis-à-vis US$ depreciated by 1.05 percent during Jul-Nov FY07 as compared to the 0.13 percent in the corresponding period last year.

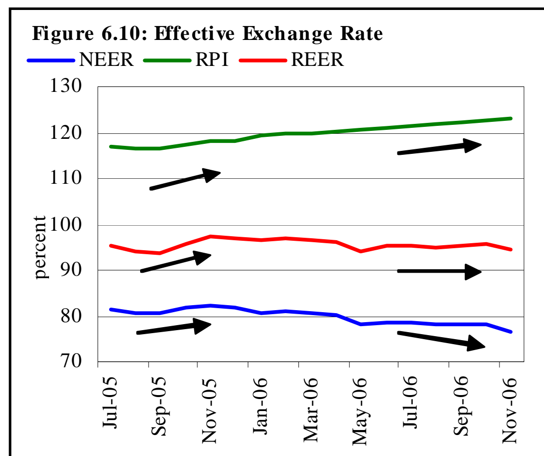
Not only the rupee depreciated continuously throughout Jul-Nov FY07, but the volatility in the exchange rate within each month was also significant. Standard deviation of the average interbank market exchange rate on occasions was as high as 9 percent (see **Figure 6.9**). On average, standard deviation for the Jul-Nov FY07 was 4.73 percent compared to 3.19 percent in the same period of FY06. The continuous depreciation of the rupee and significant volatility in the exchange rate within each month indicates that, while SBP considers it important to remove the volatility, it is not aiming at any targeted rate.

Figure 6.9: Exchange Rate Pak Rupee per US Dollar



As against US$, the exchange rate against the basket of currencies as measured by the Nominal Effective Exchange Rate (NEER) also showed 2.77 percent depreciation during Jul-Nov FY07 against appreciation of 2.06 percent during the same period last year (see **Figure 6.10**).

Figure 6.10: Effective Exchange Rate



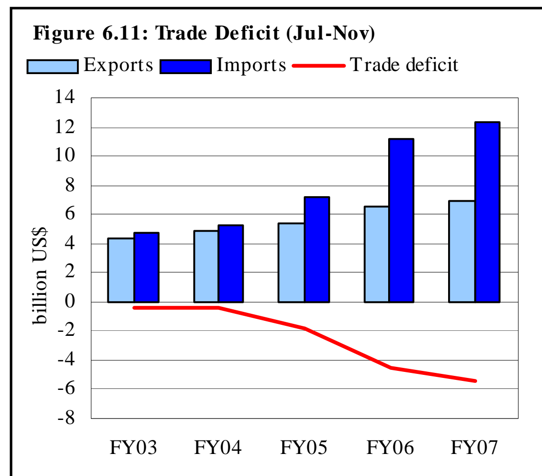
However, the depreciation in the Real Effective Exchange Rate (REER) was limited to 0.87 percent due to continuous rise in the Relative Price Index (RPI) that is due to higher domestic inflation compared to the trading partner countries. In contrast, REER appreciated 4.4 percent during Jul-Nov FY06.

6.6 Foreign Trade[7]

The trade deficit continued to rise during Jul-Nov FY07, although the growth slowed substantially to 17.8 percent from the 147.5 percent YoY increase recorded during the corresponding period last year (see **Figure 6.11**). This welcome deceleration in the growth of the trade deficit during Jul-Nov FY07 is principally due to the slowdown in the import growth.

Specifically, the moderation in import growth, which has been apparent since H2-FY06 further strengthened during Jul-Nov FY07 as all major imports categories other than *petroleum*, *machinery* and *other products*, recorded negative growth rates. As a result, the overall growth in imports during the period fell to 10.4 percent during Jul-Nov FY07 against the 54.3 percent rise in the corresponding period last year. Indeed, the trade deficit could have been lower, had it not been for the unexpected sharp deceleration in export growth during Jul-Nov FY07 that dropped to a mere 5.2 percent compared to the 22.3 percent in the corresponding period last year.

Figure 6.11: Trade Deficit (Jul-Nov)



A part of the decline in the exports growth is understandable given the more challenging economic environment as compared to a year earlier, both domestically and externally. On the one hand, export prices are under pressure due to increased competition post-MFA, and on the other hand, high domestic costs (especially for energy), and slow progress in relieving infrastructural bottlenecks and improving productivity hamper improvements in competitiveness. Nevertheless, the magnitude of the slowdown in exports is still puzzling. Adding to the confusion is the inconsistency of FBS (customs record) data with that of the SBP (exchange record data) as well as with the import data of EU and the US.

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[7] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data will not tally with the exchange record numbers reported in the section on *Balance of Payments*. Data differences are due to different methodologies for customs-based trade data by FBS and exchange-based BoP data by SBP. For details see **Special Section 1** in the SBP 2nd *Quarterly Report on the State of the Economy for FY06*.

Specifically, while the FBS data shows a 4.2 percent decline in the textiles exports during Jul-Nov FY07, exchange records show 11.0 percent growth. Furthermore, EU textiles and clothing imports from Pakistan show a rise of 3.2 percent during Jul-Sep FY07,[8] and similarly, the US imports data show a rise of 8.8 percent in textile and clothing imports from Pakistan.[9]

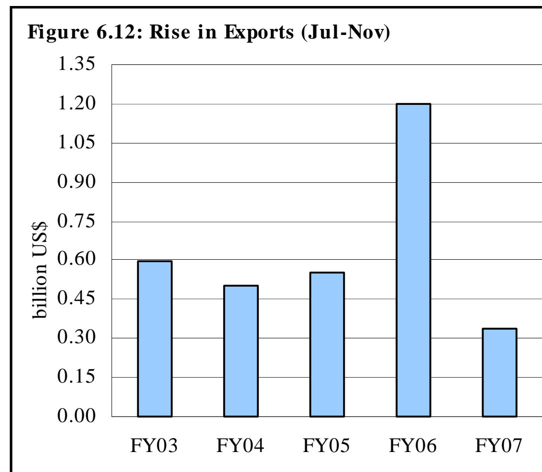
It is therefore not surprising that some quarters have shown skepticism over the low export growth figures. However, trade figures for the month of November are some consolation; although detailed data is not yet available, the increase of 23.9 percent YoY in overall exports is nevertheless quite encouraging. Further data points and details on the export data will be required to assess policy implications.

Exports

According to the FBS data, exports growth dropped to 5.2 percent during Jul-Nov FY07 compared to 22.3 percent in the corresponding period last year. Exports rose by only US$ 339.9 million during Jul-Nov FY07, which is significantly lower than the increases in the preceding four years (see **Figure 6.12**). The exports also fell short of the target by US$ 318 million during the period under review.[10]

It may be pointed out that 16 percent average growth during the last four years was the outcome of an extraordinarily congenial export environment. On external front, Pakistan gained increased market access through favorable GSP provisions and increase in quotas (that were finally ended in January 2005), and the world demand was also on a rise. On the domestic front, domestic inflation was relatively low and real interest rates were negative

Figure 6.12: Rise in Exports (Jul-Nov)



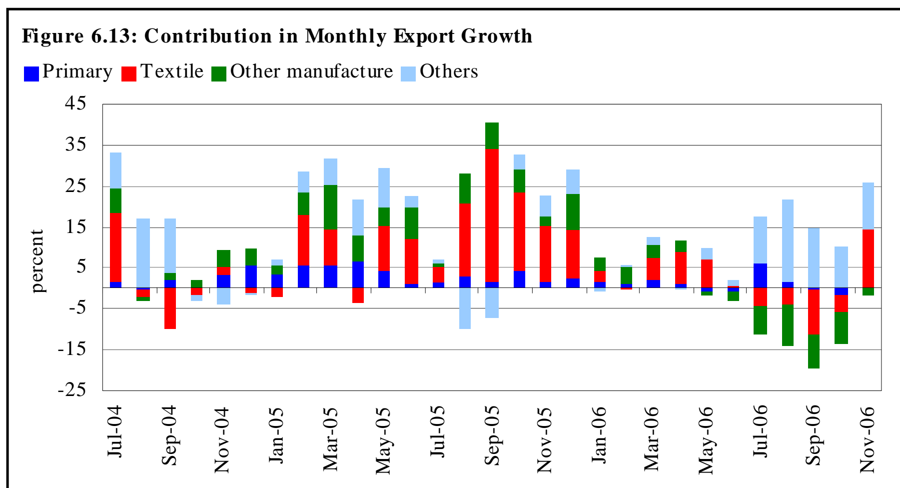
[8] Source: Eurostat
[9] Source: US Census Bureau
[10] Jul-Nov FY07 Export Target was US $ 7.246 billion against which actual exports realized were US$ 6.928 billion. Monthly export targets are available at Trade Development Authority (former Export Promotion Bureau) website: www.epb.gov.pk

or very low, energy costs had yet to rise, and competitive pressures were lower.[11]

However, this congenial environment has gradually become more challenging. The quotas regime has ended (thereby increasing competition, particularly in textile commodities), Pakistan has lost some of the gains under GSP (which some key competitors continue to enjoy)[12], and the world demand is slowing. On the domestic front, inflation remains high (despite having declined significantly in recent months), and real interest rates have also increased (although they still remain below regional norms). The rise in the international oil prices has also added to cost pressures.

Given the above developments, some slowdown in exports growth was to be expected. However, the magnitude of the slowdown is puzzling, especially when taken in light of auxiliary information (as mentioned earlier). Nonetheless, it is clear that the country has to address structural issues urgently, with regard to increasing efficiency and productivity of our export industry, which is principally the domain of the private sector. Unfortunately, it appears that our exporters continue to rely heavily on government interventions to boost their competitiveness. However, the government also has a role in facilitating exporters by providing improved infrastructure, supportive policy environment and negotiating better market access.

Figure 6.13: Contribution in Monthly Export Growth



[11] Average inflation for FY03, FY04 and FY05 was 5.65 percent compared to average inflation of 8.1 percent during FY06 and Jul-Nov FY07

[12] Countries with least developed status enjoy special market access.

The dismal export performance during Jul-Nov FY07 is attributed to the decline in exports of both the textile and non-textile manufacturing sectors. It was rice and other exports which helped the overall exports to record the positive growth, however during the month of November textile exports indicate substantial growth of 24.5 percent YoY, which is a good omen for overall exports growth (see **Figure 6.13**).

Primary Commodities

The major non-textile foreign exchange earner, rice exports, helped commodity exports register a reasonable growth of 8.5 percent during Jul-Nov FY07 as compared to 43.1 percent growth in same period last year (see **Table 6.8**). Helped by a bumper crop, rice exports increased by 42.8 percent during the period under review. The exports of basmati rice contributed almost 65 percent in the total rice exports. By contrast, *raw cotton*, *fish and fish preparations* exports declined by 29.2 percent and 2.4 percent respectively during the period, as against -52.8 percent and 32.7 percent growth respectively recorded in Jul-Nov FY06. The raw cotton exports declined on account of the smaller cotton crop and consequent higher domestic prices.

Textile Manufactures

After showing a remarkable performance in 2005, the growth in the exports of textile manufactures decelerated from the very beginning of 2006, probably reflecting both increased competition and rising costs of business. Moreover, aggressive marketing and export subsidies by China, India and Bangladesh to their textile sectors might also have been a contributing factor for slowdown in Pakistan's textile export.[13]

The group's export, which constitutes almost 57.0 percent of the total exports, recorded a negative growth of 4.2 percent during Jul-Nov FY07 in contrast to robust growth of 29.3 percent in the same period of last year.[14]

Moreover, the decline in group export was broad based as exports of all the major textile items except cotton yarn and knitwear decline during the period under review mainly because of fall in their quantum (see **Figure 6.14**).

[13] To promote the investment in the high tech-textile units, under the Technology Up- gradation Fund Scheme (TUFTS), the Indian Government provides 5 percent interest reimbursement on the loans to textile industry. Moreover, for processing sector, 10 percent capital subsidy is also given in addition to the 5 percent interest subsidy.

[14] However, as noted earlier, SBP data shows that textile exports grew by 8.9 percent during Jul-Oct FY07.

Table 6.8: Major Exports (Jul-Nov)
Value: US$ million: unit value: US$

			FY06		FY07			% change Jul-Nov-FY07 over Jul-Nov-FY06		
		Unit	Value	Unit value	Value	Unit value	Abs chg. In value	Qty	Value	Unit value
A.	**Primary commodities**		**709.5**		**769.7**		**60.1**		**8.5**	
1	Rice	MT	382.8	463.6	546.8	507.6	164.0	30.5	42.8	9.5
2	Raw cotton	MT	25.5	1,456.6	18.1	1,722.3	-7.5	-40.1	-29.2	18.2
3	Raw wool (excluding wool tops)	MT	0.5	833.0				---	---	---
4	Fish and fish preparations	MT	82.0	2,030.7	80.1	2,117.3	-1.9	-6.4	-2.4	4.3
5	Leather	SQM	120.5	21.0	90.7	20.4	-29.9	-22.5	-24.8	-3.0
6	Guar and guar products	MT	9.3	1,377.0	10.6	1,845.1	1.3	-14.5	14.5	34.0
7	Fruits	MT	52.8	377.4	10.5	156.0	-42.2	-51.7	-80.0	-58.6
8	Vegetables	MT	23.9	359.3	7.2	642.0	-16.6	-83.1	-69.7	78.7
9	Crude animal material	MT	7.8	5,136.6	0.0	---	-7.8	---	---	---
10	Oil seeds & nuts etc.	MT	4.5	754.8	5.7	1,390.7	1.2	-31.5	26.3	84.3
B.	**Textile manufactures**		**4,104.8**		**3,932.4**		**-172.4**		**-4.2**	
1	Cotton yarn	MT	522.7	2,510.2	586.6	2,520.8	63.9	11.8	12.2	0.4
2	Cotton fabrics (woven)	SQM	870.5	0.9	731.7	1.1	-138.7	-32.0	-15.9	23.6
3	Hosiery (knitwear)	DOZ	778.1	26.8	793.7	30.5	15.6	-10.6	2.0	14.1
4	Bed wear	MT	849.0	6,383.0	738.7	7,085.9	-110.3	-21.6	-13.0	11.0
5	Towels	MT	234.1	4,406.5	228.6	4,632.7	-5.5	-7.1	-2.4	5.1
6	Cotton bags and sacks	MT	5.3	4,963.5	0.0	---	-5.3	---	---	---
7	Readymade garments	DOZ	560.1	41.9	535.0	45.6	-25.2	-12.2	-4.5	8.8
8	Tarpaulin & other canvas goods	MT	12.9	2255.0	28.5	3,141.3	15.6	58.5	120.8	39.3
9	Tulle, lace embroidery etc.	---	3.8	---	0.0	---	-3.8	---	---	---
10	Synthetic textiles	SQM	82.7	0.8	146.1	1.6	63.4	-15.6	76.6	109.1
11	Other textile made up	---	180.3	---	143.4	---	-36.9	---	-20.5	---
12	Waste material of textile fibers/ fabrics	MT	5.1	1,162.9	0.0	---	-5.1	---	---	---
C.	**Other manufactures**		**1,062.1**		**616.2**		**-445.9**		**-42.0**	
1	Carpets, Carpeting Rugs & Mats	SQM	111.3	74.1	83.6	84.3	-27.6	-34.0	-24.8	13.8
2	Petroleum and Petroleum Products	MT	270.6	628.2	90.3	789.6	-180.3	-73.5	-66.6	25.7
3	Sports Goods	---	119.0	---	75.7	---	-43.3	---	-36.4	---
4	Leather Manufactures	---	312.6	---	176.7	---	-135.9	---	-43.5	---
5	Surgical and Medical Instruments	No	67.1	---	38.2	---	-28.9	---	-43.1	---
6	Cutlery	Gr	15.3	30.3	11.1	---	-4.2	-100.0	-27.3	---
7	Onyx Manufactured	MT	5.5	1,893.4	4.9	2,228.9	-0.6	-23.9	-10.4	17.7
8	Chemicals and Pharmaceuticals	---	142.5	---	125.4	---	-17.1	---	-12.0	---
9	Molasses	MT	7.9	79.1	10.3	165.4	2.4	-37.4	30.8	109.0
10	Sugar	MT	10.3	417.0	0.0	---	-10.3	---	---	---
11	Others		715.5		1,613.5		898.0	---	125.5	---
	Total exports		**6,591.9**		**6,931.8**		**339.9**		**5.2**	

The exception of the cotton yarn exports may be explained by the fact that 47 percent of the total investment of US$ 5.5 billion during 1999-2005 under textile vision 2005 went into the spinning sector (see **Table 6.9**).

The decline in the exports of high value added textile products is more pronounced as compared to the low value added textile products. Within the low value added textile products, the cotton yarn exports increased by 12.2 percent as compared to the increase of 37.8 percent in the same period of last year while the cotton fabrics exports declined by 15.9 percent against the increase of 27.7 percent in the same period of last year.

Figure 6.14: Textile Exports (Jul-Nov)

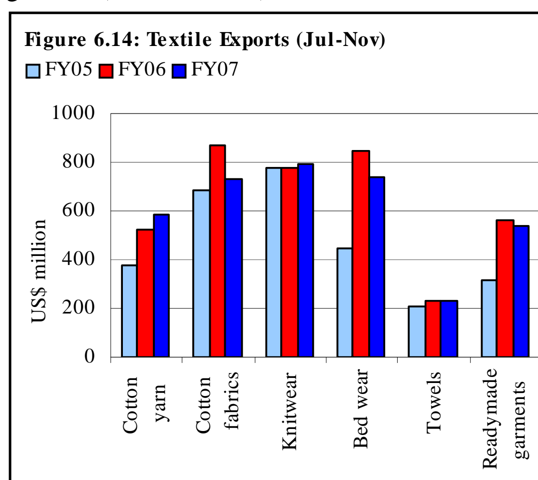


Table 6.9: Investment in Textile Under the Textile Vision 2005

	As percent of total
Spinning	47
Weaving	26.3
Knitwear and Garments	4.8
Made ups	7.7
Synthetic Textile	5.2
Textile processing	10.5
Total Investment (1999-2005) in billion US $	**5.5**

Source: EPB/ E Survey

Within the high value added textile products, the bed wear export performance was most disappointing; with exports declining by 13.0 percent despite the reduction of antidumping duty in the EU market from 13 to 5.8 percent from May 2006. Moreover, almost the entire decline was quantum driven as its unit values registered a nominal increase of 3 percent during the period.

The prices of towel in the international market remained under pressure for the third successive year, which in turn lead to a decline of 2.4 percent in exports of towel during the period under review. The decline in towel export was also contributed by the fall in the quantum (see **Figure 6.15**).

Knitwear export after recording a negative growth during Jul-Oct FY07 registered a slight increase of 2.0 percent during Jul-Nov FY07. The slowdown in the knitwear exports from the very beginning of the quota phase out, suggests that this sector has been facing stiff competition in the post MFA regime.

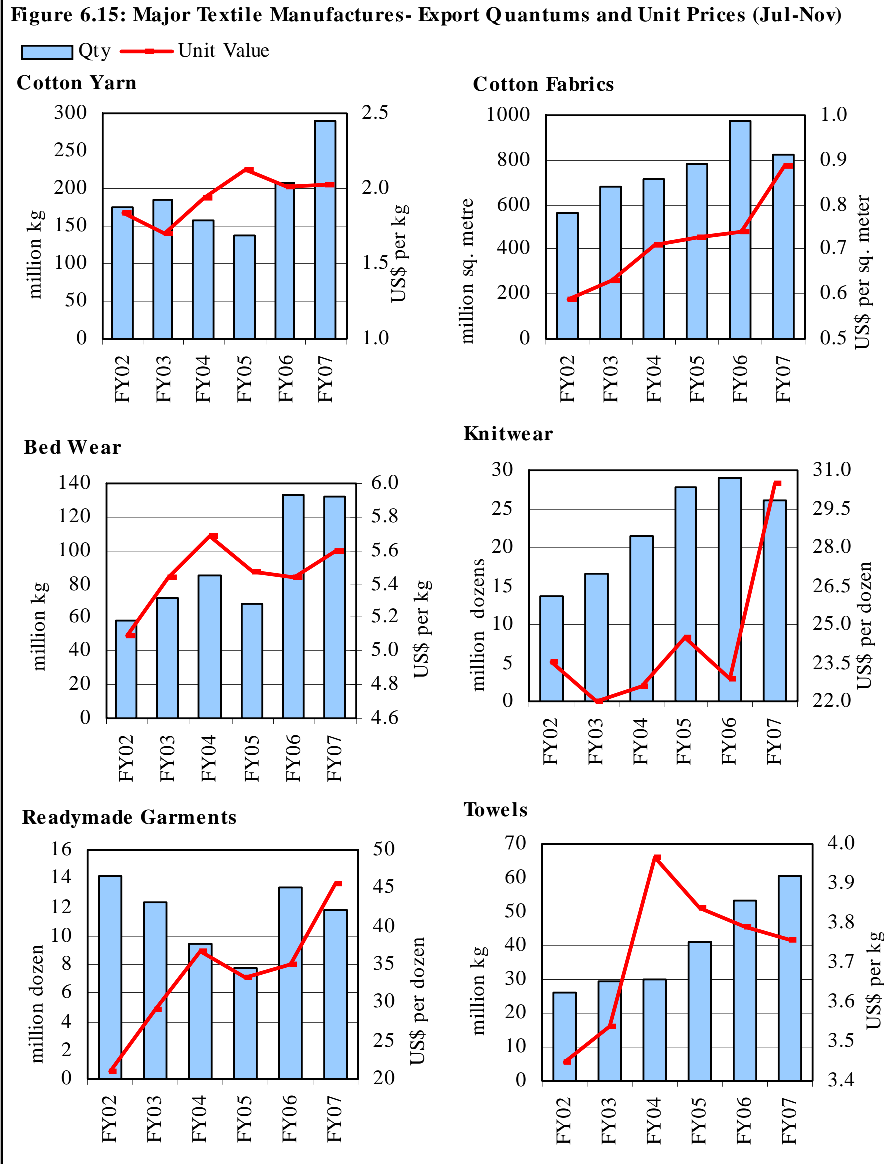


Figure 6.15: Major Textile Manufactures- Export Quantums and Unit Prices (Jul-Nov)

Despite the 6.0 percent research and development subsidy provided by the government and around 5.7 percent increase in its prices, the exports of ready made garments declined by 4.5 percent during Jul-Nov FY07 as compared to the extraordinary growth of 76.5 percent in the same period last year. It may be noted that by Dec 19 2007, absolute amount of Rs 10.2 billion has been disbursed as subsidy on research and development which is quite huge.

<u>Other Manufactures</u>

The other manufactures exports declined by 42.0 percent during Jul-Nov FY07 as compared to 27.1 percent growth in the corresponding period of last year. All sub-groups under other manufactures including: leather manufactures (leather garments), sport goods, chemical and pharmaceutical products, petroleum products and engineering goods etc recorded negative growth during Jul-Nov FY07, with only molasses showing a positive growth of 30.8 percent.

Imports

The overall imports growth decelerated sharply to 10.4 percent YoY during Jul-Nov FY07 as against strong growth of 54.3 percent YoY in the corresponding period of previous year. The decline in the imports was broad based with all major groups recording negative growths with the exception of petroleum group, machinery and other imports (see **Table 6.10**).

Moreover, the bulk of the rise in the Jul-Nov FY07 imports was registered in the first two months of FY07, when imports of *petroleum* and *other imports* categories increased, on average, by 53.5 and 46.2 percent, respectively. Although the imports showed a declining trend throughout Jul-Oct FY07, they staged a strong comeback in the month of November recording growth of 20.6 percent YoY. The main contributors to this rise were petroleum products, machinery and food group imports (see **Figure 6.16**).

Figure 6.16: Contribution in Monthly Import Growth

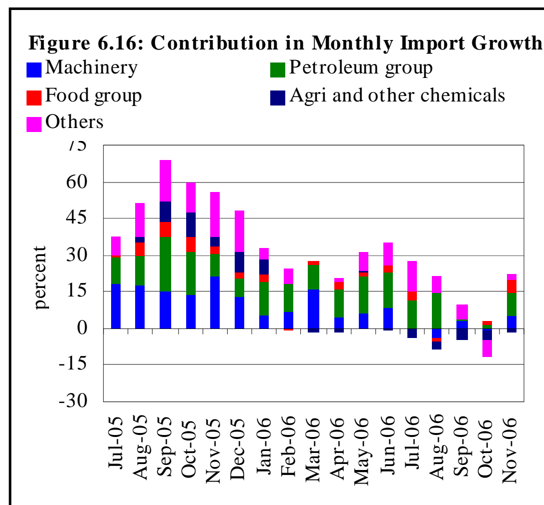


Table 6.10: Major Imports (Jul-Nov)
Value: US$ million: unit value: US$

			FY06		FY07			% change in Jul-Nov-FY07/Jul-Nov-FY06		
		Unit	Value	Unit value	Value	Unit value	Abs chg. In value	Qty	Value	Unit value
A.	**Food group**		**800.0**	**--**	**753.1**	**---**	**-46.9**	**--**	**-5.9**	---
1.	Milk & cream incl. milk food	MT	20.1	1,913.1	21.4	3,049.6	1.3	-33.3	6.3	59.4
2.	Wheat un-milled	MT	44.7	160.2	29.0	228.9	-15.8	-54.7	-35.2	42.9
3.	Dry fruits	-MT	20.8	463.5	17.8	415.7	-3.0	-4.8	-14.6	-10.3
4.	Tea	MT	85.2	1,655.4	88.6	1,842.4	3.3	-6.6	3.9	11.3
5.	Spices	MT	20.8	628.9	22.9	736.4	2.1	-5.9	10.2	17.1
6.	Edible oil	MT	331.6	433.8	335.1	455.4	3.5	-3.7	1.0	5.0
	Soybean	MT	6.7	713.5	*15.9*	783.6	9.2	115.9	137.1	9.8
	Palm oil	MT	324.9	430.3	*319.2*	446.1	-5.7	-5.2	-1.8	3.7
7.	Sugar	MT	200.5	338.7	130.5	430.3	-70.0	-48.7	-34.9	27.0
8.	Pulses	MT	76.3	355.1	107.9	474.0	31.7	6.0	41.5	33.5
B.	**Machinery group**	**---**	**2,986.0**	**---**	**3,055.6**	**--**	**69.6**	**--**	**2.3**	**---**
1.	Power generating machinery	--	209.8	--	247.0	---	37.2	--	17.7	---
2.	Office machinery	---	110.6	---	121.4	--	10.8	---	9.8	---
3.	Textile machinery	---	351.1	---	231.9	---	-119.3	--	-34.0	---
4.	Construction & mining machinery	--	63.2	---	64.0	---	0.8	---	1.2	---
5.	Electrical machinery & apparatus	---	189.9	---	246.0	---	56.1	---	29.5	---
6.	Railway vehicles	--	47.8	---	20.3	--	-27.5	---	-57.5	---
7.	Road motor vehicles	--	574.8	---	526.8	---	-47.9	---	-8.3	---
8.	Aircraft, ships and boats	---	42.3	---	103.5	---	61.2	--	144.5	---
9.	Agri machinery & implements	--	58.5	---	58.4	---	-0.1	--	-0.1	---
10.	Other machinery	---	1338.0	--	1,436.3	---	98.3	---	7.3	---
C.	**Petroleum group**	**MT**	**2,581.4**	**431.9**	**3,383.8**	**461.2**	**802.5**	**22.8**	**31.1**	**6.8**
1.	Petroleum products	MT	1,036.6	455.8	1,768.4	452.0	731.8	72.1	70.6	-0.9
2.	Petroleum crude	MT	1,544.8	417.2	1,615.4	471.8	70.7	-7.5	4.6	13.1
D.	**Textile group**	**MT**	**230.5**	**---**	**206.0**	**---**	**-24.6**	**---**	**-10.7**	**---**
1.	Synthetic fibre	MT	98.3	1,587.1	89.4	1,977.2	-8.9	-27.0	-9.0	24.6
2.	Synthetic & artificial silk yarn	MT	112.5	1,517.4	93.9	1,540.1	-18.6	-17.8	-16.5	1.5
3.	Worn clothing	MT	19.8	330.3	22.7	339.5	2.9	11.6	14.7	2.8
E.	**Agricultural and other chemicals**	**MT**	**1,884.8**	**---**	**1,509.0**	**---**	**-375.8**	**---**	**-19.9**	**---**
1.	Fertilizer	MT	375.2	279.0	155.8	314.1	-219.5	-63.1	-58.5	12.6
2.	Insecticides	MT	67.7	3,409.4	43.3	3,600.4	-24.3	-39.3	-35.9	5.6
3.	Plastic materials	MT	428.6	1193.5	398.6	1,359.7	-30.0	-18.4	-7.0	13.9
4.	Medicinal products	MT	140.1	31485.3	130.0	3,097.2	-10.1	-11.7	-7.2	5.1
5.	Others	--	873.2	---	781.3	---	-91.9	---	-10.5	---
F.	**Metal group**	**MT**	**737.3**	**---**	**582.1**	**---**	**-155.2**	**---**	**-21.0**	**---**
1.	Iron and steel scrap	MT	139.6	250.3	85.2	294.7	-54.4	-48.2	-39.0	17.7
2.	Iron and steel	MT	551.5	488.2	439.7	652.0	-111.8	-40.3	-20.3	33.6
3.	Aluminum wrought & worked	-	46.2	-	57.2	---	11.0	---	23.8	---
G.	**Miscellaneous group**		**242.4**	**---**	**242.3**	**---**	**-0.1**	**---**	**-0.1**	**---**
1.	Rubber crude	MT	44.6	1,190.8	44.4	1,207.2	-0.3	-2.0	-0.6	1.4
2.	Rubber tyre & tubes	No.	70.1	21.1	63.4	33.1	-6.6	-42.2	-9.5	56.7
3.	Wood & cork	--	14.9	---	14.6	-	-0.4	---	-2.4	---
4.	Jute	MT	14.7	329.3	14.7	404.2	0.0	-18.8	-0.3	22.7
5.	Paper paper board & manufactures	MT	98.1	708.9	105.2	763.0	7.2	-0.3	7.3	7.6
H.	**Others**		**1,713.7**		**2,601.8**		**888.1**	**---**	**51.8**	**---**
	Total imports:		**11,176.2**		**12,333.8**		**1157.6**		**10.4**	

Going forward, along with the petroleum products, machinery imports on account of expansion in the power generation capacity, and imports of textile related inputs like cotton and textiles chemicals would continue to exert pressure on imports.

Food Group

The food group imports declined by 5.9 percent during Jul-Nov FY07 as against a strong growth of 59.0 percent in the same period last year. Imports of this group demonstrated a mix trend during the period, with wheat (un-milled), sugar, and dry fruits recoding substantial decline. Sugar imports probably declined due to large domestic stocks and prospects of a substantial rise in production following a good sugarcane harvest in FY07. As a result, the share of this group's imports in the total imports decreased to 6.1 percent during Jul-Nov FY07 from 7.1 percent in the same period of last year.

Machinery Group

Against the extraordinary 71.1 percent YoY increase during Jul-Nov FY06, the machinery group imports recorded a nominal growth of 2.3 percent during the corresponding period of FY07.

Resultantly, the group share in the total imports has decreased to 24.8 percent during Jul-Nov FY07 from 26.7 percent during Jul-Nov FY06. While the textile, railway vehicles, and road motor vehicles show decline in imports during Jul-Nov FY07, the nominal growth in the imports appears to be largely due to one off items of aircraft ships and boats, which show 144.5 percent growth during the period. (see **Table 6.11**)

Table 6.11: Analysis of Machinery Imports (Jul-Nov)

	FY06		FY07	
	Share	**Growth**	**Share**	**Growth**
Machinery group		**71.1**		**2.3**
Power generating machinery	7.0	48.1	8.1	17.7
Office machinery	3.7	25.9	4.0	9.8
Textile machinery	11.8	7.4	7.6	-34.0
Construction & mining machinery	2.1	-0.7	2.1	1.2
Electrical machinery & apparatus	6.4	83.3	8.1	29.5
Telecom	1.6	127.0	0.7	-57.5
Road motor vehicles	19.2	80.6	17.2	-8.3
Aircraft, ships and boats	1.4	35.7	3.4	144.5
Agricultural machinery & implements	2.0	256.4	1.9	-0.1
Other machinery	44.8	111.0	47.0	7.3

Besides this one off item, power-generating machinery, electrical machinery, apparatus, and the office machinery also contributed positively to the group's import growth.

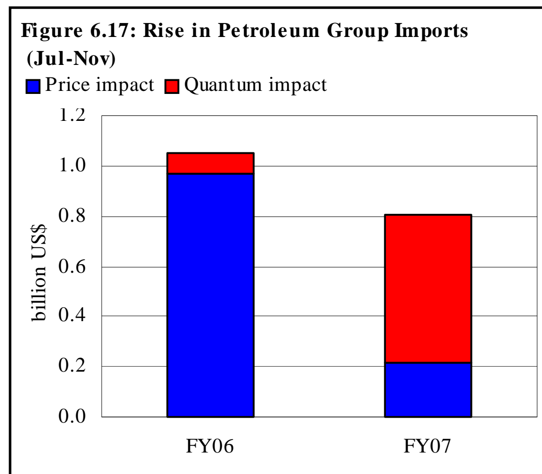
After depicting strong import growth of 80.6 percent during Jul-Nov FY06, the road motor vehicles imports declined by 8.3 percent during the corresponding period of FY07. However, almost the entire decline in the imports in this category was contributed by a fall in the imports of Completely Knock Down (CKD) or Semi Knock Down (SKDs) kits; in contrast, imports of Completely Built Units (CBUs) rose by 34.0 percent during Jul-Nov FY07. Within CBU imports, the entire increase was contributed by the motorcar imports. However, anecdotal evidence suggests that surge in the demand of imported cars has also eased, and the contribution to import growth could fall in months ahead.

The telecommunications equipment imports depicted an increase 17.2 percent YoY during Jul-Nov FY07 against an extraordinary import growth of 253.8 percent in the same period of last year. The decline in imports of transmission apparatus was the dominant factor behind the group imports slowdown.

Petroleum Group

The petroleum group imports portrayed a relatively low growth of 31.1 percent YoY during Jul-Nov FY07 as compared to the robust import growth of 68.7 percent YoY in the same period of the pervious year. Unlike the Jul-Nov FY06 period, when the increase in these imports was largely driven by the rising prices (up 90 percent), the rise in these imports during the corresponding period of FY07 was largely contributed by the rising export volumes (up 63.4 percent YoY see **Figure 6.17**). Within the group, almost the entire increase was contributed by the petroleum products imports as the petroleum crude imports increased by only 4.6 percent during Jul-Nov FY07. This was principally because of prevailing low prices of refined products, which were lower than the cost of crude petroleum.

Figure 6.17: Rise in Petroleum Group Imports (Jul-Nov)



Metal Group

During Jul-Nov FY07, the metal group imports declined by 21.0 percent on account of the lower imports of iron and steel and iron and steel scraps. The imports of iron & steel and iron & steel scraps declined, due to increased domestic

production of steel. Anecdotal evidence also suggests that there are stocks available that were imported before the recent hike in the international metal prices. If correct, metal imports could rise in months ahead.