

6 External Sector

6.1 Overview

As feared, Pakistan was unable to sustain the modest improvement in the current account deficit seen during Q1-FY08, and the deficit widened sharply in succeeding months (see **Figure 6.1**).

Consequently, the cumulative Jul-Jan FY08 current account deficit rose by 47.1 percent YoY, compared to the 51.0 percent YoY increase in the same period of the previous year (see **Table 6.1**). Dominant contribution to the post-Q1-FY08 deterioration in the current account was from an abrupt rise in the country's oil bill, large one-off aircraft import, the impact of political disturbance in December 2007 as well as delays in the receipt of coalition support funds; all of which overshadowed the sustained increase in remittances.

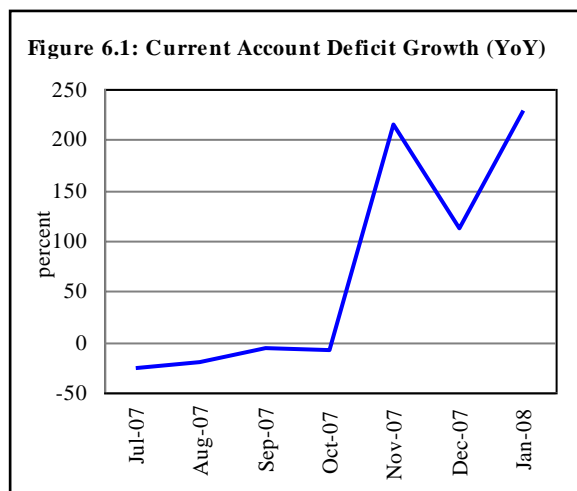


Table 6.1: Summary of External Account (Jul-Jan)

billion US\$			
	FY06	FY07	FY08
A-Current account balance	-3.4	-5.1	-7.5
<i>Trade balance</i>	-4.9	-6.2	-7.8
<i>Invisible balance</i>	1.5	1.1	0.3
B-Financial/Capital balance	2.6	4.8	4.6
<i>FDI</i>	1.2	2.1	2.3
<i>FPI</i>	0.3	1.4	0.0
<i>Other investment</i>	0.8	1.1	2.2
C-Errors & omissions	0.2	0.4	0.4
D-Overall balance	-0.6	0.0	-2.5

Impact of the widening current account deficit on the country's overall balance was compounded by a decline in the financial & capital account balance in the same period. In particular, while FDI flows improved slightly, there was a precipitous US\$ 1.4 billion drop in net foreign portfolio investment.¹ The decline reflected partly the outflows from the

¹ In portfolio investment, the gross inflows declined to US\$ 0.5 billion during Jul-Jan FY08 from US\$ 1.4 billion in the same period of last year while gross outflows increased to US\$ 0.5 during Jul-Jan FY08 from meager outflow of US\$ 0.006 billion in the comparable period of last year.

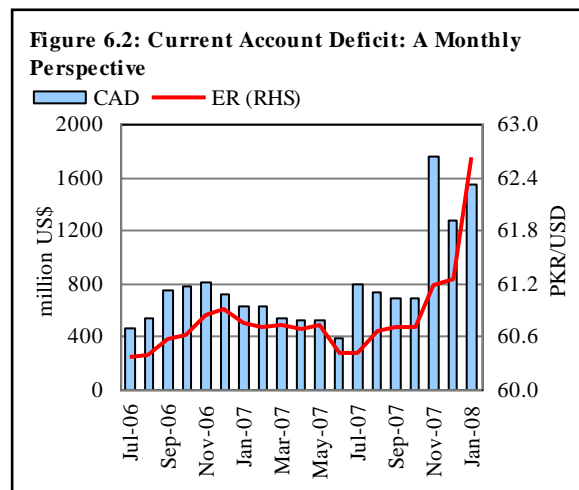
equity markets due to perception of increased political risk, and partly due to the delays in the planned floatation of Global Depository Receipts (GDRs) in the face of global financial turmoil and perceived increase in country risk.² A part of the impact of the fall in portfolio investment was mitigated by a large rise in other investments, including FE-25 nostros, short-term loans, etc.³

Given that the decline in the financial account surplus was quite moderate, it is clear that the depletion in the country's forex reserves essentially reflects the sharp increase in the current account deficit. Overall foreign exchange reserves declined to US\$ 14.8 billion at the end of January FY08 compared with US\$ 15.6 billion at the end of June FY07.

Moreover, as a result of worsening of external account during Jul-Jan FY08, Pak Rupee could not hold its grounds against the US dollar (see **Figure 6.2**). In particular, Pak Rupee depreciated by 3.5 percent during Jul-Feb FY08, highest depreciation since H1-FY05, as compared to nominal depreciation of 0.8 percent in the same period last year. It may also be noted, the depreciation was more

pronounced during Nov-Jan FY08 reflecting partly rising pressures on the external account and partly speculative activity following the political disturbance in the country. However, the exchange rate recovered part of the losses, following FDI inflows and easing of political tensions after peaceful elections.

The Jul-Jan FY08 developments thus serve to highlight the fact that sustained large current account deficits pose risks to the country's macroeconomic stability. Over the last few years, Pakistan was able to comfortably sustain current account

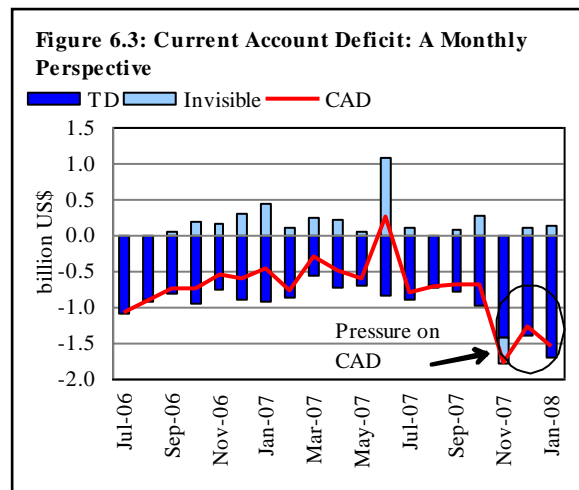


² The impact of a general increase in risk-averseness in the troubled global financial market was compounded by the increased risk perception on Pakistan due to the pre-election uncertainty, particularly following the assassination of a former prime minister.

³ FE-25 nostros constitute the placement by domestic commercial banks with their foreign counterparts out of FE-25 deposits mobilized by these banks. The decline in these placements is regarded as inflows in the other investments.

deficit due to favorable domestic and international investment conditions that encouraged large non-debt creating financial inflows into the country. As a result Pakistan was not only able to run large deficit but also added to its foreign exchange reserves. However, that will be increasingly risky strategy, given the stresses on the domestic economy as well as the relatively less favorable dynamics in the international capital markets.

It may also be pointed out that current account deficit, during Jul-Jan FY08, largely followed the trend in trade deficit as the strong current transfers' inflows (mainly remittances driven) almost entirely offset the deficit in services and income accounts (see **Figure 6.3**). Thus a small improvement in the trade deficit in the initial four months of FY08 was well reflected in the modest improvement in current account deficit. Thereafter (Nov-Jan FY08), the worsening of trade deficit on the back of increased wheat and petroleum group imports and low export growth led to significant deterioration in current account deficit. The aforementioned trend implies that soaring trade deficit is the major underlying weakness of the external sector



Clearly, correction in external imbalance lies either in import compression or export promotion; or a combination of the two. The policy options for import compression include imposition of tariff, tight monetary policy and exchange rate depreciation. The former option is exercisable only in limited cases where the MFN rates are significantly lower than those required under WTO obligation. Regarding the latter two options, Pakistan has already tightened its monetary policy to reduce the aggregate demand and Pak Rupee depreciated considerably against the US dollar in the recent months.

As a result, the real import growth (adjusted for price effect) has slowed down significantly⁴. Unfortunately, this slow down has been offset by the rise in oil and

⁴ For details, see section 6.6 on Foreign Trade.

commodity prices in the international market and not too benign fiscal expansion at home. Moreover, the potential for further import compression is limited due to (a) Pakistan needs to invest heavily in building up infrastructure, (b) rise in oil import bill on the back of high global oil prices and increased domestic consumption, (c) price effect of rising commodity prices on import bill and (d) anticipated increase in import of power generating machinery.

Boosting export growth, on the other hand, will be challenging against the power shortages, increased competition in textile exports, declining growth in the demand for textile (Pakistan's major exports) in key markets and relatively high domestic logistic costs (see **Box 6.1**). In this regard, more strenuous efforts are required to promote exports such as to move from low value added to high value added exports, to diversify exports market by capturing the fast growing emerging markets, to address the issues like infrastructural bottlenecks, power shortages and low productivity.

Beside these challenges, raising funds from the international market to finance the current account deficit is another challenge. In particular, raising funds from the international capital market has become expensive in the wake of global financial turmoil and political uncertainty at home (see **Box 6.2**). However, the expected post election stability may help in attracting the foreign inflows mainly because (a) Pakistan's stock market is still relatively safe from global financial turmoil,⁵ and (b) Pakistan's stock market is trading at discount as compared to other regional markets. Moreover, persistent flows of foreign direct investment combined with expected proceeds of NBP and HBL's floatation of GDRs and issuance of euro bond in the later half of the year would help in financing the current account deficit.

Going forward, the current account deficit is likely to remain under pressure mainly due to (a) adverse effect of increased cotton prices compounded with frequent power shortages on the export growth, (b) slowdown in Pakistan's major export markets (see **Box 6.3**), (c) lack of compliance with international standards, and (d) infrastructural bottlenecks. However, the consistent flows of remittances and favorable impact of Pak Rupee's considerable depreciation (Nominal Effective Exchange Rate Index depreciated by 7.3 percent during Jul-Jan FY08) against trading partners' currencies on the export proceeds are likely to provide some relief to the widening current account deficit.

⁵ www.economist.com

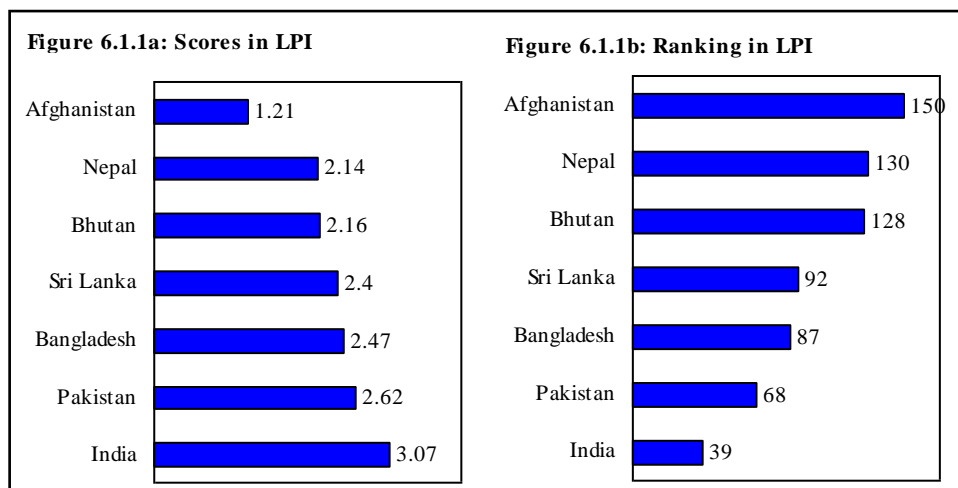
Box 6.1: Logistic Performance Index

The Logistic Performance Index (LPI) is an interactive benchmarking instrument to help countries identify the challenges and opportunities they face in their performance on trade logistics and what they can do to improve their performance. Introduced by the World Bank in 2007, the LPI covers an assortment of actions, from transportation, consolidation of cargo, warehousing, and border clearance to in-country distribution and payment systems. Like the World Bank group's Doing Business report and the World Economic Forum's Global Competitiveness Index, the LPI provides a set of indicators to gauge international competitiveness. The LPI and its indicators are based on a survey of multinational freight forwarders of the world's largest logistics providers, which cover 150 countries. The performance of each country was evaluated by using a one to five point scale (one being the worst performance for the given dimension). The LPI was aggregated as a weighted average of the seven areas of performance, which are:

1. Efficiency of clearance process by customs and other border agencies.
2. Quality of transport and information technology infrastructure for logistics.
3. Ease and affordability of arranging international shipments.
4. Competence of the local logistics industry.
5. Ability to track and trace international shipments.
6. Domestic logistics costs.
7. Timeliness of shipments in reaching destination.

Pakistan's ranking in the 2007 logistics performance index is 68th among the 150 countries with 2.62 overall score (see **Figure 6.1.1** and **Table 6.1.1**). Amongst the South Asian countries, Pakistan is ranked at number two. As far as the indicators-wise ranking is concerned, Pakistan has better standing in area of competence of the local logistic industry (with 63rd position) as compared to worst place in the area of domestic logistic cost (with 90th ranking).

The LPI also classifies countries according to income⁶ groups. Economies are divided according to 2006 gross national income (GNI) per capita, calculated using the World Bank Atlas method. The

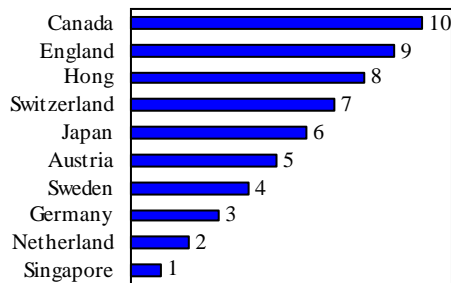
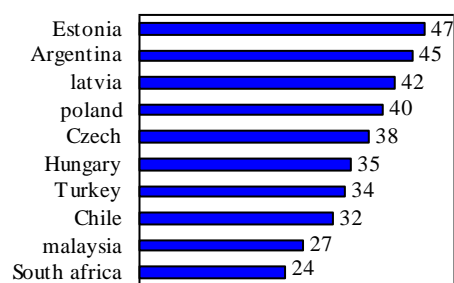
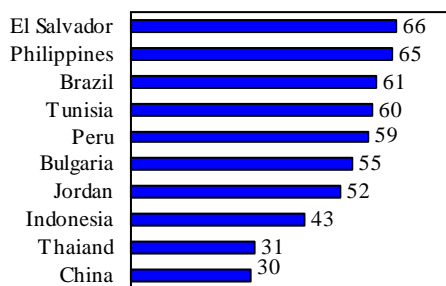
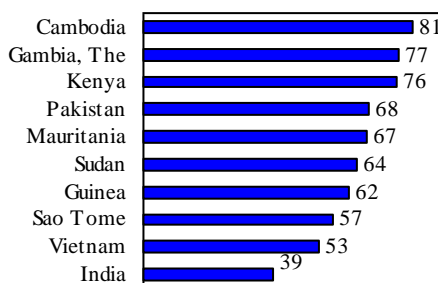


⁶ Income classifications are set each year on 1st July. These official analytical classifications are fixed during the World Bank's fiscal year (ending on 30th June), thus countries remain in the categories in which they are classified irrespective of any revision to their per capita income data.

Table 6.1.1: Logistics Performance Index of South Asian Countries for 2007

	Pakistan		India		Bangladesh		Sri Lanka		Nepal	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Logistic performance index	68	2.62	39	3.07	87	2.47	92	2.40	130	2.14
Customs	69	2.41	47	2.69	125	2.00	91	2.25	141	1.83
Infrastructure	71	2.37	42	2.90	82	2.29	106	2.13	144	1.77
International shipments	65	2.72	39	3.08	96	2.46	112	2.31	131	2.09
Logistics competence	63	2.71	31	3.27	103	2.33	85	2.45	124	2.08
Tracking & tracing	76	2.57	42	3.03	88	2.46	75	2.58	102	2.33
Domestic logistics costs	90	2.86	46	3.08	50	3.08	47	3.08	8	3.43
Timeliness	88	2.93	47	3.47	54	3.33	113	2.69	122	2.63

groups are: low income group, US\$905 or less (with 52 countries); lower-middle income group, US\$906-US\$3595 (with 41 economies); upper-middle income group, US\$3596-US\$11115 (having 24 nations); and higher income group, US\$11116 or more (with 33 states **Figure 6.1.2**, Pakistan is classified in lower income group having 7th position in top ten countries.

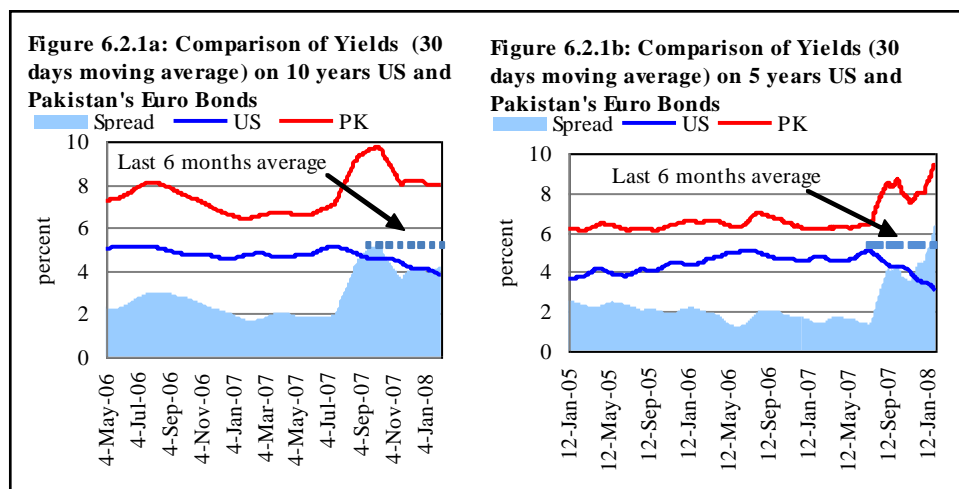
Figure 6.1.2a: Top 10 Countries Higher Income**Figure 6.1.2b: Top 10 Countries Upper Middle Income****Figure 6.1.2c: Top 10 Countries Lower Middle Income****Figure 6.1.2d: Top 10 Countries Lower Income**

As mentioned above, Pakistan has worst position (ranked 90) in the field of domestic logistic cost that include: port charges, domestic transport agent fees, warehousing service charges, rail transport rates, less than full truck load services rates and full truck load rates. In Pakistan, the typical charges

for a 40-foot export container/import container are US\$ 382/444, while in Bangladesh and Sri Lanka these charges are US\$ 211/397 and US\$ 245/263 respectively. Similarly, Pakistan's ranking (88) in timeliness captured by both, the time to import and export and predictability of this time is also very low. It is evident that countries with higher logistic costs are more likely to miss the benefits of globalization. Thus there is a need to tackle issues that impede Pakistan's performance on LPI now that a benchmark has become available for evaluation.

Box 6.2: Global Financial Turmoil and External Bond Issuance

The recent turmoil in financial markets have significant implications for borrowing in the international debt market. The tighter global lending conditions and investors lack of confidence in credit evaluation has made the issuance of external bonds costlier. Even borrowing in the securities and bonds backed by government debt, typically thought to be free of credit risk, were affected by the turmoil in credit markets. As a result, the issuance of the external bonds slowed down in the third and fourth quarter of 2007. The IMF global financial stability report update (29th January 2008) shows that like developed economies, emerging markets also witnessed pronounced decline in the issuance of bonds during the aforementioned period (see **Figure 6.2.2**).



Pakistan, being one of the emerging economies, has also not issued euro bonds in the latter half of 2007. In this backdrop, it would be interesting to explore the costs of new issues in the international market in the face of financial turmoil at the external front and political uncertainty at the domestic front. One way to address this question is to analyze the yields of the already issued bonds of different tenors in the secondary markets. It can be observed from the **Table 6.2.1** that average yield on all the bonds issued has increased in the second half of 2007. Moreover, as depicted by the coefficient of variation, the risk on these bonds has also increased in the aforementioned period. Thus the preliminary data analysis suggests that Pakistan will have to pay more to attract the foreign investors. For instance, the spread between Pakistan's 5 years euro bonds over US bonds of the same tenor widened to 620 basis points at end January 2008 from 140 basis points at end June 2007.

To support the economic activity in the face of financial turmoil and partly to increase country risk at home and resultant downward revision (from stable to negative) by Standard & Poor's of Pakistan outlook on the long-term foreign and local currency sovereign credit rating.

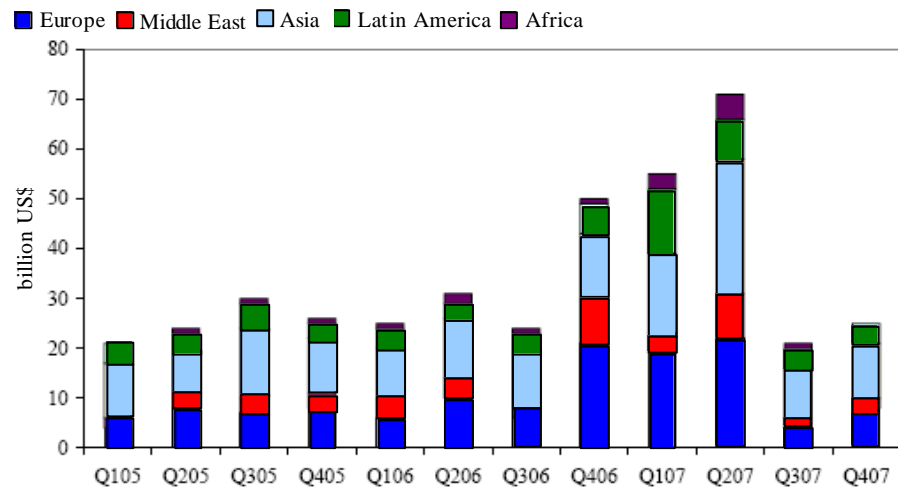
However, even if the yields on US bonds had followed the previous six months average assuming no reduction in federal fund rate, the risk premium on the Pakistan's euro bonds would have increased on account of increased political uncertainty at home (see **Figure 6.2.1**). Moreover, risk premium on the medium term bonds witnessed sharp increase as compared to the long-term bonds. The above analysis implies that Pakistan would have to pay more to raise capital from the international market owing to increased risk premium.

Table 6.2.1: Pakistan's Euro bonds Price and Yield in the Secondary Market

10 years Bond				
Mar27,2006-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	100.3	7.1	91.7	8.5
CV	3.6	7.6	5.1	9.8
5 years Bond				
Feb 12,2004-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	101.1	6.3	98.5	8.0
CV	0.7	3.8	1.3	14.0
Sukuk				
Jan 11,2006-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	102.9	6.5	99.6	7.5
CV	0.1	1.0	1.4	8.2

Source: Bloomberg

Figure 6.2.2: Emerging Market Private Sector Gross External Bond Issuance



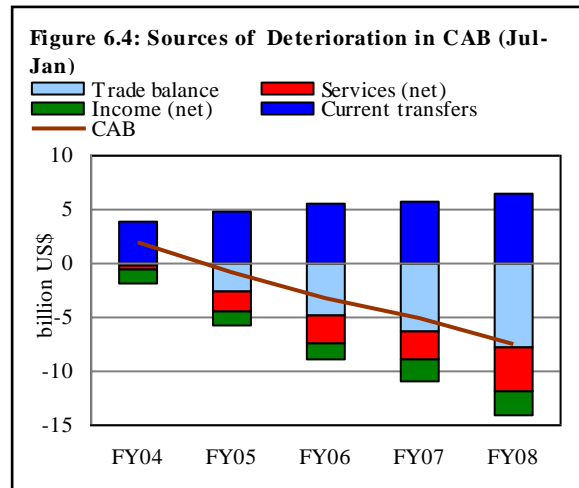
References

Bank for International Settlement Quarterly Review (December 2007)
IMF Global Financial Stability Report Market Update (January 2008)

6.2 Current Account Balance

Current account deficit continued to widen for the fourth year in a row touching US\$ 7.5 billion in Jul-Jan FY08 compared with US\$ 5.1 billion in the same period last year (see **Figure 6.4**).

Deterioration in current account deficit is primarily driven by the widening trade deficit, delay in logistic support receipts and higher direct investment income outflows (see **Table 6.2**). All of these overshadowed the impact of strong growth in workers' remittances and higher earnings on foreign exchange reserves.



6.2.1 Trade Account⁷

As was feared, the modest decline in trade deficit in the initial four months of the current fiscal year, compared with the same period last year, could not be sustained in the ensuing months. In the subsequent months (Nov-Jan FY08) sharp increase in import growth and low export growth translated into higher trade deficit. As a result, the trade deficit reached US\$ 7.8 billion during Jul-Jan FY08 against US\$ 6.2 billion in the same period last year.

The higher import growth was chiefly attributed to inflated petroleum group imports on the back of high global oil prices and increased domestic demand, import of wheat in the wake of flour crises and rise in fertilizers imports. The low export growth, on the other hand, was mainly attributed to severe power shortages, increased political unrest and stiff regional competition in textile exports.⁸

⁷ This section is based on exchange record data compiled by SBP that does not tally with the custom data compiled by FBS.

⁸ For detail, see **section 6.6 on Foreign Trade**.

Table 6.2: Current Account Balance

million US\$

	Jul-Jan			YoY Change	
	FY06	FY07*	FY08*	FY07	FY08
1. Trade balance	-4903	-6228	-7844	-1325	-1616
Exports	9166	9578	10985	412	1407
Imports	14069	15806	18829	1737	3023
2. Services (net)	-2452	-2631	-3968	-179	-1337
Transportation	-1066	-1227	-1404	-161	-177
Travel	-731	-844	-784	-113	60
Communication services	48	24	26	-24	2
Construction services	-118	-18	-10	100	8
Insurance services	-67	-74	-86	-7	-12
Financial services	-47	-53	-76	-6	-23
Computer & information services	15	7	1	-8	-6
Royalties and license fees	-57	-48	-44	9	4
Other business services	-1307	-1173	-1710	134	-537
Personal & cultural & recreational services	-3	1	0	4	-1
Government services	881	774	119	-107	-655
<i>Of which logistic support</i>	756	723	0	-33	-723
3. Income (net)	-1497	-2050	-2176	-553	-126
Investment income(net)	-1500	-2053	-2180	-553	-127
Direct investment	-1135	-1679	-1819	-544	-140
<i>of which: profit & dividends</i>	-254	-355	-398	-101	-43
<i>purchase of crude oil and minerals</i>	-577	-830	-853	-253	-23
Portfolio investment	-86	-118	-118	-32	0
<i>Of which : profit & dividend</i>	-46	-111	-130	-65	-19
IMF charges & interest on off. external long-term debt	-347	-376	-384	-29	-8
Interest on private external debt	-47	-70	-98	-23	-28
Others (net)	118	193	243	75	50
4. Current transfers (net)	5471	5803	6468	332	665
Private transfers	5242	5574	6433	332	859
<i>Workers' remittance</i>	2444	2959	3619	515	660
<i>FCA - residents</i>	295	51	294	-244	243
<i>Others</i>	2542	2594	2574	52	-20
<i>of which exchange companies</i>	1586	1462	1353	-124	-109
Official transfers	229	229	35	0	-194
Current account balance	-3381	-5106	-7520	-1725	-2414

* provisional

Box: 6.3 Pakistan's Exports Are Less Vulnerable to a US Recession

More than one quarter of Pakistan's total exports were destined to US market in 2006. In this situation, it is important to analyze the relationship between US economic activity and Pakistan's exports to US.

The breakup of Pakistan's overall exports to US market suggests that more than 90 percent of Pakistan's overall exports to US market consist of textile exports. Therefore textile exports to US have been used as the close proxy of the total exports to US market. The following analysis is based on two data sets: (a) UN comtrade data base and (b) US Office of Textile and Apparel (OTEXA).

Detailed data reveals that more than one third of Pakistan's total textile exports are directed to US market. Within textile group, US accounts for more than one quarter of Pakistan's low value added textile, yarn & fabrics exports and close to one half of the high value added clothing and accessories exports. With almost half of the total high value added being destined for the US market, it is likely that these exports would be more vulnerable to slow down in US economy than the low value added textile exports which are relatively more diversified.

Before analyzing the impact of US economic growth on textile imports from Pakistan, it would be relevant to know whether slow down in US economy is correlated with its overall textile imports from the world. The trend analysis (1990-2006) suggests that US economic growth and its textile imports growth are positively correlated (see **Table 6.3.2** and **Figure 6.3.1**). However, this relationship is stronger in case of high value added apparel imports than the low value added non-apparel imports (see **Table 6.3.2**).

In case of Pakistan, though the US economic growth and textile imports growth from Pakistan are positively correlated but the magnitude of the correlation is very low (see **Table 6.3.2a** and **Figure**

Table 6.3.1: Share (%) of Pakistan's Exports to US to its Total Exports

	Total	Textile, yarn & fabrics	Clothing and accessories	Textile (total)
2001	22.6	23.1	46.3	30.5
2002	24.4	25.2	44.0	31.2
2003	23.1	24.0	42.4	29.8
2004	23.3	25.6	42.4	31.2
2005	24.8	29.6	45.4	34.9
2006	25.7	29.7	47.2	35.7

Source: UN comtrade

Figure 6.3.1: Growth in US GDP and Textile Imports (3-month moving average)

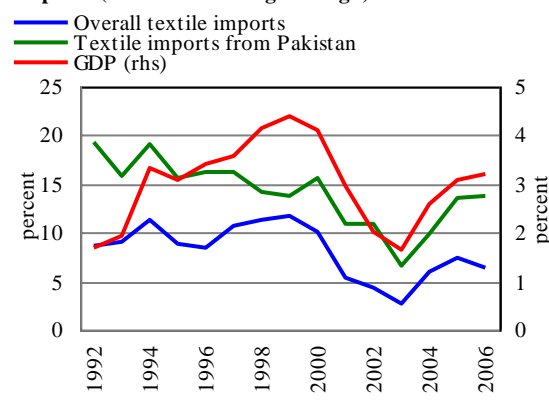


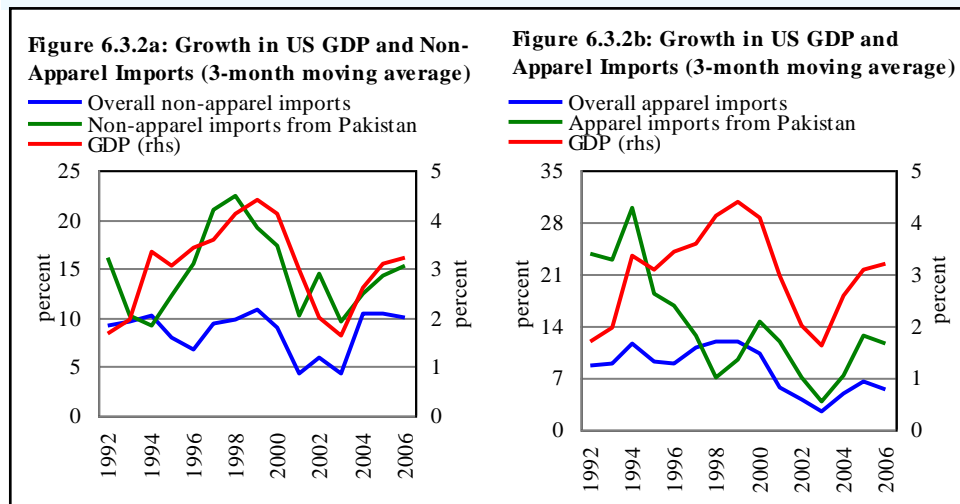
Table 6.3.2: Correlation with US GDP Growth (1990-2006)

	World	Pakistan
Total textile imports growth	0.64	0.33
Apparel imports growth	0.64	0.32
Non-apparel imports growth	0.48	0.18

Source: OTEXA

6.3.2b). With the fall in income, the possible shifting of US buyers to relatively low priced textile products from Pakistan may be the probable reason behind this low correlation. Moreover, the correlation is even weaker in case of low value added textile imports from Pakistan.

Thus, it may be argued that, (a) effect of US economy slow down is likely to be limited on Pakistan's overall textile exports to US and (b) the adverse effect is expected to be even lower in low value added textile exports (which constitute around 68.0 percent of Pakistan's total textile exports) relative to high value added textile exports.



6.2.2 Services (net)

Continuing four years trend, the services account deficit widened further in Jul-Jan FY08 (see **Table 6.3**). However, unlike the previous years, the largest contribution was not reflective of the rising imports. Rather, the dominant contribution to the year-on-year deterioration was from the delays in the receipts of logistic support. This accounted for approximately 54.1 percent of the rise in the overall services deficit during Jul-Jan FY08.

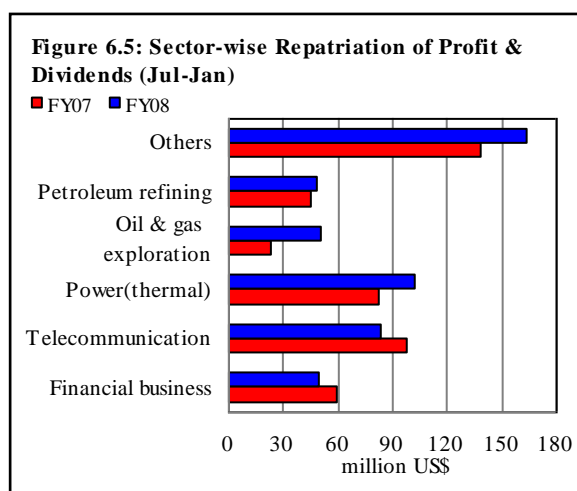
Table 6.3: Services Account Balance

million US\$			
	Jul-Jan		
	FY07	FY08	Change
1. Transportation	-1227.0	-1404.0	-177.0
of which freight	-1224.0	-1476.0	-252.0
2. Other business services	-1173.0	-1710.0	-537.0
a) Architect, eng, technical	-7.2	-37.3	-30.1
b) Technical fees to foreigners	-158.3	-291.4	-133.1
3. Government services	774.0	119.0	-655.0
Of which logistic support	723.0	0.0	-723.0
4. Others	-1005.0	-974.0	31.0
Services (net)	-2631.0	-3968.0	-1337.0

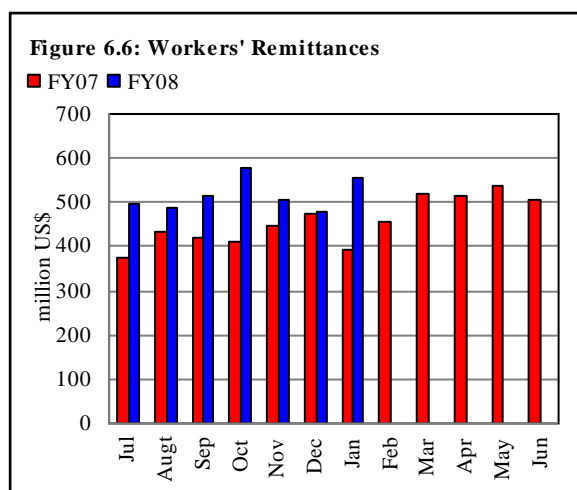
Followed by delay in logistic support, the outflows from other business services, mainly reflecting the increased coverage of foreign transaction routed through exchange companies.⁹ Increase in payments of import related freight charges on the back of higher import growth also contributed significantly in the overall rise in services account deficit during the period under review.

6.2.3 Income (net)

Income account deficit deteriorated further during Jul-Jan FY08, by 6.0 percent. This is in sharp contrast to the 37.0 percent deterioration in the same period last year on the back of higher purchases of crude oil and minerals (see **Table 6.2**). This deterioration is mainly explained by the higher investment income outflows as the interest income payments (net) were lower during Jul-Jan FY08 compared with the same period last year.



Increase in investment income outflows, in turn, was mainly driven by the higher repatriation of profit & dividends on Foreign Direct Investment (FDI). The major contribution in repatriation of profit and dividend came from the fast growing sectors, i.e., thermal power (20.0 percent), telecommunication (16.1 percent), oil and gas exploration (10.0 percent) and financial business (10.0 percent) (see **Figure 6.5**).



⁹ As mentioned in the earlier reports, these outflows have no impact on the overall current account balance as these outflows are matched by the receipts of foreign exchange companies.

Table 6.4: Details of Interest Payments and Receipts

million US\$

	Jul-Jan			Change	
	FY06	FY07	FY08	FY07	FY08
Payments (I+II)	575	660	734	-85	-74
I.Total external debt	479	559	563	-80	-4
Public & publicly guaranteed	422	475	462	-53	13
Long-term	330	355	377	-25	-22
Military	7	7	3	0	4
Euro bonds/Sukuk	74	98	62	-24	36
Commercial loans/credits	5	7	18	-2	-11
IDB	6	8	2	-2	6
Private loans/credits	47	70	98	-23	-28
IMF	10	14	3	-4	11
II. External liabilities	96	101	171	-5	-70
Foreign currency deposits	10	17	65	-7	-48
Special US\$ bonds	19	6	4	13	2
Central bank deposits	21	16	23	5	-7
Others	46	62	79	-16	-17
Receipts	198	299	423	101	124
Interest on reserves	132	228	335	96	107
Others	66	71	88	5	17
Total payment (net)	377	361	311	16	50

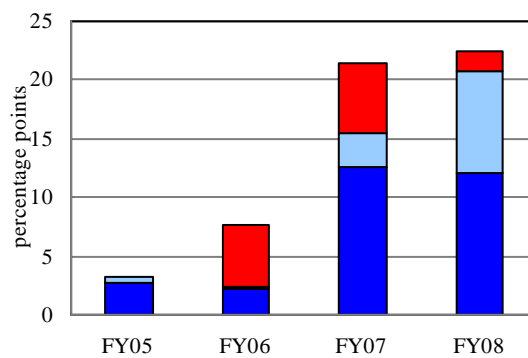
On the other hand, the lower interest payments (net) entirely emanated from higher earnings on the foreign exchange reserves (see **Table 6.4**). However, the interest payments on the external liabilities increased on account of higher payments on the foreign currency deposits.

6.2.4 Current Transfers

The 11.5 percent rise in the current transfers during Jul-Jan FY08 on the top of 6.1 percent growth in the same period last year mainly

Figure 6.7: Contribution in Remittances Growth (Jul-Jan)

■ Gulf ■ USA ■ Others



reflects the strong growth in private transfers. Within private transfers, robust growth in remittances was the major contributor followed by higher inflows in the resident foreign currency accounts (FCAs).

Workers' Remittances

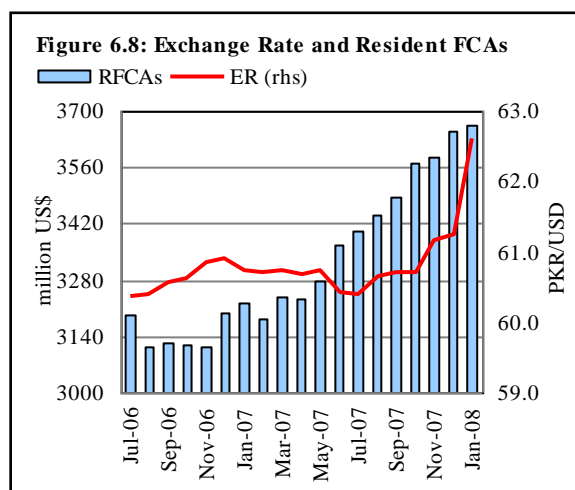
Workers' remittances continued to grow strongly for the second successive year. Remittances growth accelerated to 22.4 percent during Jul-Jan FY08 from strong growth of 21.1 percent in the same period last year. More encouragingly, the remittances remained higher than the corresponding months of FY07 through the entire Jul-Jan period of FY08 (see **Figure 6.6**).

As in the previous years (FY05-07), the remittances flows routed through Foreign Exchange Companies (FECs) registered extraordinary growth of 67.8 percent during Jul-Jan FY08. As a result, the share of remittances routed through FECs in overall remittances increased to 23.2 percent during Jul-Jan FY08 from 17.0 percent in the same period last year. The network expansion (establishment of payments booths and arrangements with western union) of Zarco and Wall Street exchange companies, which together constitutes more than 50 percent of total remittances routed through FECs, was the most probable factor behind this strong growth in remittances flows through FECs.

During the current year, the main contribution in remittances growth came from Gulf States and US (see **Figure 6.7**). As mentioned in the First Quarterly Report for FY08, the higher contribution of Gulf States probably reflects the higher oil prices and consequential prosperity there. The increasing share of remittances from the US (see **Box 6.4**), on the other hand, may reflect the fact that Pakistani migrants to US do not want to hold their savings there.

Resident FCAs

Inflow in the resident FCAs increased to US\$ 294 million during Jul-Jan FY08 as compared to the nominal inflow of US\$ 51 million in

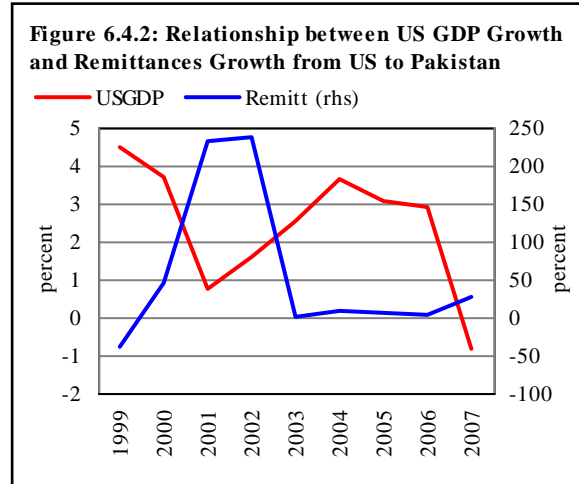
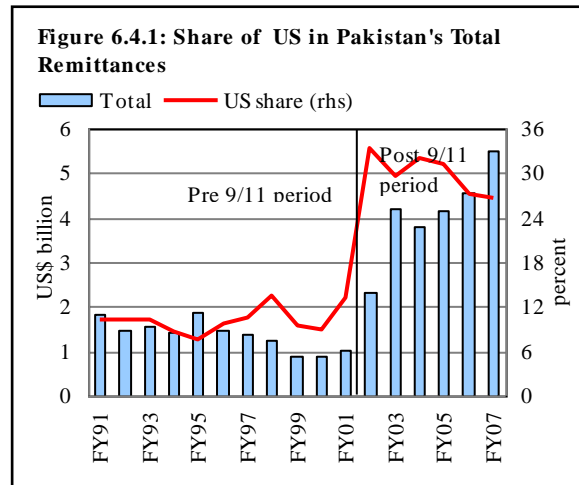


the same period last year. A part of this increase may be attributed to Rupee depreciation against US dollar which makes these deposits attractive (see **Figure**

Box 6.4: US Economic Growth and Remittances to Pakistan

Workers' remittances to Pakistan have grown rapidly in the recent years particularly in the post 9/11 period (see **Figure 6.4.1**). In the aforementioned period US emerged as one of the major sources of remittances flows to Pakistan. Specifically, US share in Pakistan's overall remittances has increased from 10.1 percent (average during FY91-FY01) to around 30.0 percent (average during FY02-FY07). The shifting trend has increased the importance of US economic conditions for maintaining stable remittances flows to Pakistan.

With the recession in the US economy it may be pertinent to analyze the influence of US economic growth on remittances flows to Pakistan. The trend analysis suggests that US GDP growth and growth in remittances flows to Pakistan seems to have very weak relationship (see **Figure 6.4.2**). This relationship is not surprising as similar results are found in empirical work of Lianos (1997) on remittances flows to Greece, Sayan (2004) on remittances flows to Turkey and Shaun K. Roache & Ewa Gradzka (2007) on remittances flows to Latin America.



The literature on the remittances provides hosts of factors for the missing or weak link between the remittances and host country economic activity. For instance, like consumption, the migrant workers may smooth their remittances flows thereby making remittances flows less volatile than the income fluctuations. Secondly, the low profile migrant workers attach more weight to being employed than to wage received and are therefore less likely to be unemployed.¹⁰ Thirdly, the diversion of remittances flows from informal to formal channels may have increased the remittances flows

¹⁰ In case of Pakistan, the anecdotal evidence suggests that around 40 percent of Pakistanis in US possess low profile jobs.

despite the fluctuations in the income of host country.¹¹ Besides these factors, home country income, socio-demographic profile of migrants, relationship of the emigrants to the household members, numbers of the years the migrant spend in the host country and the stock of migrants also influence the remittances flows.

References

Lianos, Theodore P. (1997), "Factors Determining Migrant Remittances: The Case of Greece," *International Migration Review*, Vol 31, No.1. (Spring, 1997), pp.72-87

6.8). Moreover, depreciation of US dollar against major currencies may also have increased the US dollar value of resident FCAs during the period under review.

6.3 Financial Account

After recording sharp increase in Jul-Jan period of last two years, the financial account surplus witnessed modest decline during Jul-Jan FY08 (see **Figure 6.9**). This nominal fall in the financial account surplus is entirely explained by the substantial fall in the portfolio investment. In contrast, the FDI and other investment continued to grow at a reasonable pace during Jul-Jan FY08 (see **Table 6.5**).

Composition of net financial inflows has also changed significantly in FY08 compared to the previous two years. Unlike the previous years, when capital flows mainly emanated from equity securities and concessional debt, the capital flows during

Figure 6.9: Financial Account Balance (Jul-Jan)

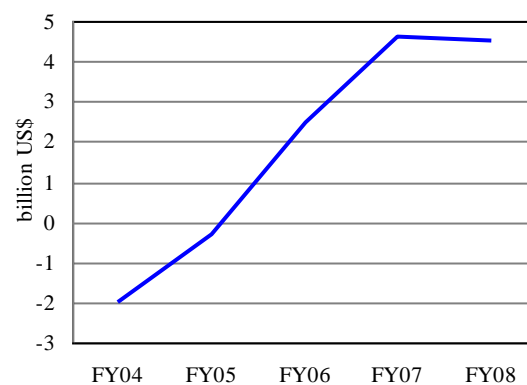
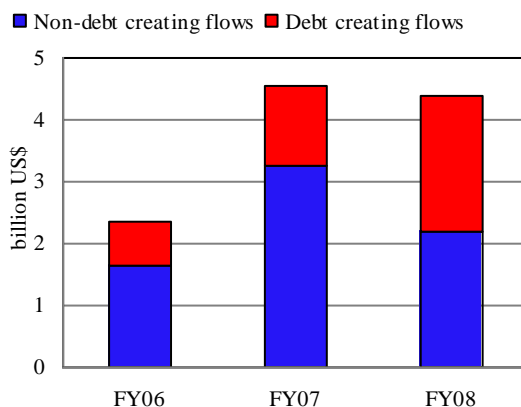


Figure 6.10: Sources of Financing CAD (Jul-Jan)



¹¹ For example, the breakdown of *hundi* channel, followed by 9/11 incident, diverted the remittances flows by expatriate Pakistanis from informal to formal channel.

FY08 were mainly in the form of debt creating flows (see **Figure 6.10**). For instance, the government borrowed short-term debt worth US\$ 508 million from Islamic Development Bank (relatively expensive source) during Jul-Jan FY08

Table 6.5: Financial Account

million US\$

	Jul-Jan			YoY change	
	FY06	FY07	FY08*	FY07	FY08
Financial account (net)	2456	4597	4502	2141	-95
Direct investment abroad	-19	-49	-35	-30	14
Direct investment in Pakistan	1244	2096	2298	852	202
Equity capital	931	1585	1719	654	134
Reinvested earnings	313	508	579	195	71
Portfolio investment	311	1370	-2	1059	-1372
Equity securities	414	1227	-24	813	-1251
Debt securities	-103	143	22.0	246	-121
Net foreign investment	1536	3417	2261	1881	-1156
Other investment	822	1119	2136	297	1017
Assets	373	30	527	-343	497
1-Outstanding export bills (exporters)	-173	-144	-225	29	-81
2-Outstanding export bills (DMBs))	62	113	138	51	25
3-Currency and deposits	483	60	614	-423	554
of which banks	454	-23	529	-477	552
Liabilities	449	1089	1609	640	520
1-Foreign long-term government loans / credits (net)	332	657	793	325	136
Project loans	340	496	602	156	106
Non- project loans	591	692	776	101	84
Amortization	600	531	585	-69	54
2-Private loans	-28	191	127	219	-64
of which supplier credits	166	401	282	235	-119
suppliers credit repayments	194	210	155	16	-55
3-Short-term capital (official)	-61	-58	467	3	525
of which IDB (net)	55	58	467	3	409
4-Currency and deposits	315	183	328	-132	145
Other liabilities	-11	177	-1	188	-178

* provisional

as against cumulative amount of US\$ 394 million in the same period of last two years. The continuous increase in current account deficit and the emerging trend

in the composition of net financial inflows is a source of concern, particularly the increased reliance on the short-term debt.

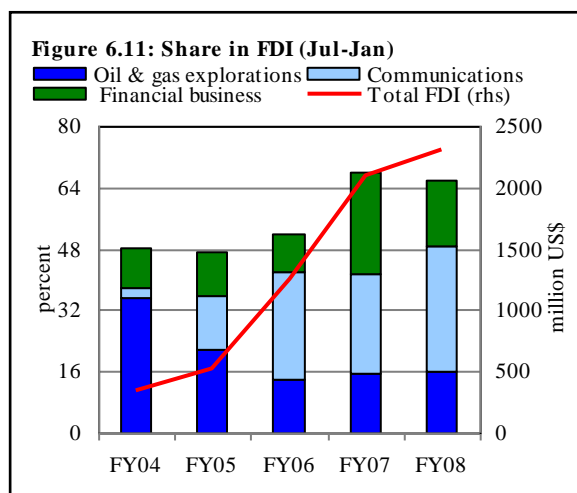
6.3.1 Net Foreign Investment

Overall net foreign investment declined by 33.8 percent during Jul-Jan FY08 as compared to exceptional growth of 122.4 percent in the same period last year. This was mainly because of lower inflows in both the private and public sector portfolio investment (see **Table 6.6**).

Foreign Direct Investment

FDI registered double digit growth for the fourth successive year. However, the growth of 9.6 percent during Jul-Jan FY08 was substantially lower than the extraordinary growth of 68.5 percent in the same period of the previous year.

It may be pointed out that FDI inflows which were traditionally concentrated in oil producing sectors have now been diversified to some extent.¹² The liberalization of telecommunication and financial sectors has played important role in attracting the foreign inflows in the preceding five years. Specifically, the share of the former sector in the total FDI has increased from 3.0 percent during Jul-Jan FY04 to 32.6 percent during Jul-Jan FY08, while the share of latter in total FDI has increased from 10.1 percent during Jul-Jan FY04 to 17.2 percent during Jul-Jan FY08 (see **Figure 6.11**).



FDI in these two sectors created competitive environment for the benefit of consumers in the form of variety of products and lower prices. Moreover, FDI driven strong growth in the aforementioned sectors also contributed significantly in the overall GDP growth through expansion of services.

¹² During Jul-Dec FY02-Jul-Dec FY04, the average share of oil and gas exploration sector in total FDI was around 31 percent which is reduced to 16.0 percent during Jul-Dec FY08.

Cash and reinvested earning breakup of the FDI suggests that both the segments contributed positively in the overall FDI growth (see **Table 6.7**). Major sectors which recorded increase in reinvested earnings include *Telecommunication, financial business, oil & gas exploration, trade and cement*. The higher reinvested earning reflects the profitability of these sectors. Moreover, the rising reinvestment by the foreigners may also be considered as a proxy for the foreign investors' positive outlook for the domestic economy in the long run.

Table 6.6: Net Flows of Foreign Investment in Pakistan

million US\$			
Jul-Jan			
	FY06	FY07	FY08
Foreign private investment	1658	2493	2192
Foreign direct investment	1244	2096	2298
<i>of which privatization proceeds</i>	255	133.2	133.2
Portfolio investment (net)	414	687	-24
Equity securities	414	489	-24
<i>of which GDRs</i>	0	150	90.5
Debt securities	0	198	0
Foreign public investment	-103	683	22
Portfolio investment	-103	683	22
Equity securities	0	738	0
<i>of which GDRs of OGDC</i>	0	738	0
Debt securities *	-103	-55	22
Total net foreign investment	1536	3417	2261

* Net sale/purchase of Special US\$ bonds, FEBC, DBC, T-bills and PIBs

Portfolio Investment

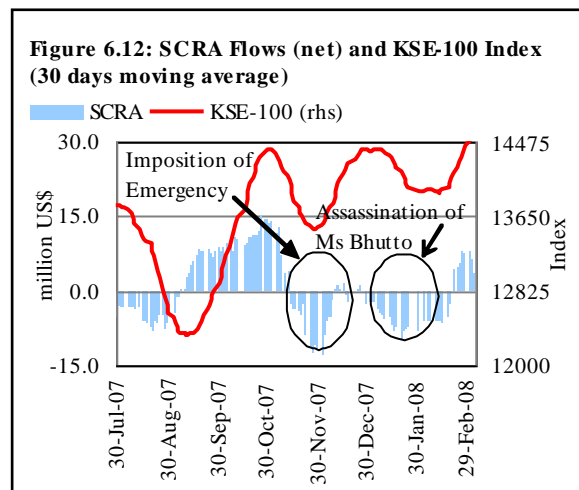
In sharp contrast to last year's robust performance, the portfolio investment recorded net outflows during Jul-Jan FY08 (see **Table 6.6**). This poor performance is attributed to delay in floatation of GDRs, lower floatation of debt securities and outflow from the equity and fixed income market. This dismal

Table 6.7: Sector wise Foreign Direct Investment (Jul-Dec)

million US\$						
	FY07			FY08		
	Cash	Reinvested earnings	Total	Cash	Reinvested earnings	Total
Chemicals	-10.1	28.6	18.6	27.4	25.5	52.9
Petroleum refining	9.2	57.4	66.6	9.8	39.4	49.1
Oil & gas explorations	255.5	74.5	329.9	245.1	122.5	367.6
Cement	1.1	12.5	13.7	58.3	24.6	82.9
Trade	94.5	11.6	106.1	83.5	27.9	111.4
Telecommunications	472.0	40.2	512.3	614.9	51.0	665.8
Financial business	420.2	133.4	553.6	239.3	187.9	427.3
Personal services	50.9	1.5	52.4	59.6	2.5	62.1
Others	292.0	150.9	442.9	380.9	98.2	479.2
Total	1585.3	510.7	2096.0	1718.8	579.5	2298.3

performance is attributable largely to global financial turmoil and domestic political unrest. On the one hand, this made it costlier to raise funds from the international capital market and on the other hand, led to capital flight from the equity market. As a result, during Jul-Jan FY08, Pakistan received only US\$ 90.5 million of United Bank Limited's GDRs as compared to receipts of Oil and Gas Development Company Limited (OGDCL) GDR worth US\$ 738 million and MCB bank GDR worth US\$ 150 million in the same period last year.¹³ Likewise, debt securities witnessed lower inflow of US\$ 22.0 million (in T-bills and PIBs) during Jul-Jan FY08 compared with investment in Mobilink's Term Finance Certificate (TFC) worth US\$ 50 million and international bond issuance worth US\$ 250 million during the same period of the preceding year.¹⁴

Outflows from the equity market are reflected in the Special Convertible Rupee Account (SCRA) position (see **Figure 6.12**). The net outflow from the SCRA is more pronounced in the time of political uncertainty, e.g., imposition of emergency and assassination of Ms Bhutto. Encouragingly, the SCRA position improved during February 2008 (as is evident from net inflow of US\$ 154.8 million during the month).



Moreover, peaceful and transparent election is likely to restore the foreign investor confidence to some extent. Karachi Stock Exchange Index has responded positively to this development. Moreover, given Pakistan's equity market relative stability in the recent turmoil, foreign investors seeking to diversify their risk may want to invest in Pakistan's equities (if new government focused on macro stability).

¹³ UBL floated GDRs worth US \$ 650 million during June FY07. However, part of the proceeds (US\$ 90.5 million) was realized in July FY08.

¹⁴ Out of US\$ 250 million private bonds, US\$ 101 million was utilized in loan repayment of the company.

6.3.2 Outstanding Export Bills (OEBs)

Aggregate stock of outstanding export bills held by exporters and commercial banks increased by US\$ 87 million during Jul-Jan FY08 as compared to increase of US\$ 31 million in the same period of FY07. As in the previous year, almost all increase in the total stock of OEBs during Jul-Jan FY08 stemmed from increase in OEBs held by exporters as the OEBs held by the commercial banks declined during the period. Interestingly, more than three-fourth (US\$ 180 million) of the total increase (US\$ 225 million) in OEBs held by the exporters was witnessed in the last two months (Nov-Jan FY08) probably reflecting the exporters' expectation of exchange rate depreciation.

The OEBs held by the commercial banks, on the other hand, declined by US\$ 138 million during Jul-Jan FY08 as compared to US\$ 113 million decline in the same period of the previous year.

6.3.3 Currency & Deposits

During Jul-Jan FY08, the banks' FE-25 nostros declined by US\$ 529 million as against US\$ 23 million increase in the comparable period of FY07. The decline in the FE-25 nostros mainly reflects the increased FE-25 lending during the period.

6.3.4 Official Long-term Loans

The net inflows in the official long-term loans reached US\$ 793 million during Jul-Jan FY08 against US\$ 657 million in the comparable period of FY07. This increase in inflows stemmed from US\$ 133 IBRD loans receipts during the period under review.

6.3.5 Official Short-term Loans

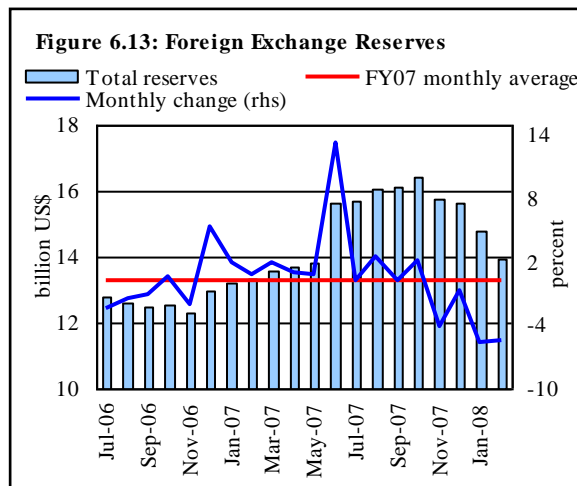
The net inflows under short-term official loans increased sharply by US\$ 467million during Jul-Jan FY08 as compared to net retirement of US\$ 58 million in the same period of the preceding year. This increase in net inflows was entirely contributed by Islamic Development Bank loans amounting to US\$ 467 million during the period.

6.4 Foreign Exchange Reserves

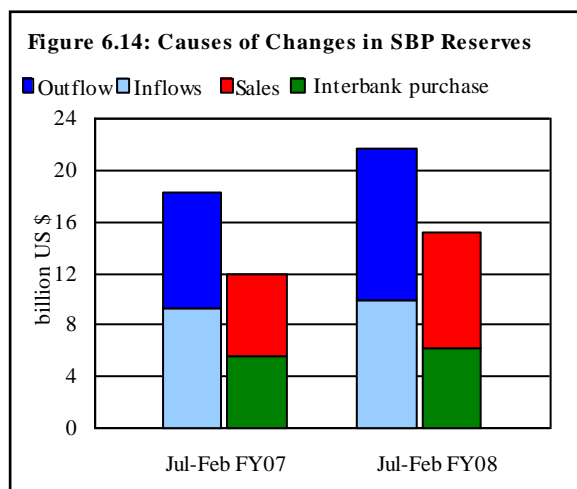
Changes in Pakistan's foreign exchange reserve position during Jul-Feb FY08 largely mirrored the developments in the country's current account. Pakistan's foreign exchange reserves declined from US\$ 15.6 billion as at the end of June 2007 to US\$ 14.1 billion by end of February 2008. The decline in the reserves was, however not consistent during this period. In the initial months (Jul-Oct) due to relatively benign current account deficit and substantial disbursement of program loans, Pakistan's foreign exchange reserves reached historical peak of

US\$ 16.5 billion. However, adverse developments in the subsequent months coupled with sharp rise in the trade deficit led to steep fall in reserves.

While the country's foreign exchange reserves have fallen quite steeply from November onwards, at US\$ 14.1 billion, these are still higher than the average level of foreign exchange reserves in FY07 (see **Figure 6.13**).



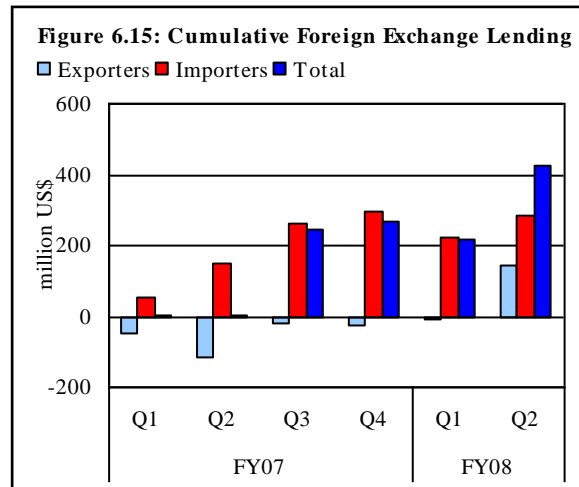
On disaggregated basis, reduction in both the SBP and commercial bank reserves added to the decline in overall reserves during Jul-Feb FY08. Major factors for decline in the level of reserves during last three months are mounting current account deficit, which is mainly a result of rise in trade deficit, outflows from portfolio investment through SCRA accounts following 3rd November 2007 events and increase in FE lending to importers as well as exporters.



SBP liquid reserves¹⁵ moved concurrent to overall reserves, rising during Jul-Oct FY08 period by US\$ 0.9 billion and falling subsequently by US\$ 2.3 billion during Nov-Feb FY08. Although, the inflows remained strong on the back of program loans and inter-bank purchases, 16.3 percent depletion in SBP reserves

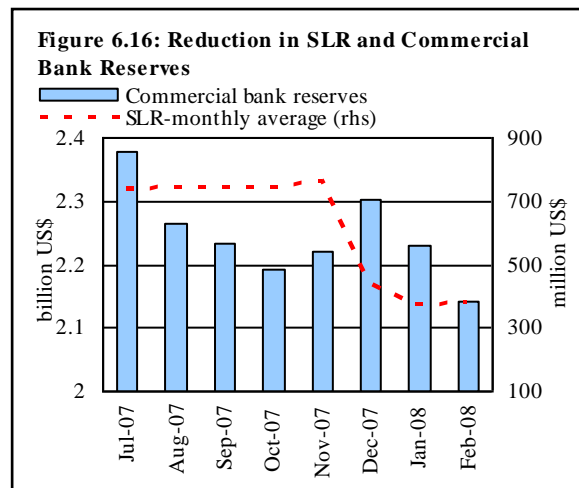
¹⁵ Excluding CRR.

during this period owed to heavy outflows on account of oil support¹⁶ as well as direct market intervention to reduce excess market volatility (see **Figure 6.14**). Besides, intervening in the market SBP also eased Special Cash Reserve Requirement (SCRR) on foreign currency deposits from 15.0 percent to 5.0 percent in order to provide liquidity comfort to forex market.¹⁷



Commercial bank reserves also registered a decline during Jul-Feb FY08 period, falling by US\$ 144.2 million to US\$ 2.2 billion as at the end of February 2008 down from US\$ 2.3 billion at end June 2007. Initially, during Jul-Oct FY08 commercial banks' forex reserves witnessed an outflow of US\$ 100.0 million, primarily due to outflows of portfolio investment during the month of August.¹⁸ Surge in FE lending to

importers also put pressure on commercial bank reserves during this period. Afterwards, during Nov-Feb FY08, reserves held by commercial banks depleted but at a slower pace than pre-November period falling by US\$ 44.2 million, despite pressure emanating from outflows from portfolio investment, soaring current account deficit, and higher FE lending to both, importers and exporters during Nov-Jan



¹⁶ Despite SBP withdrawal of oil support for furnace oil imports, the amount of oil support remained almost at the same level, although slightly lower, mainly due to rise in international oil prices, as imports of petroleum products has gone down by 0.4 percent during Jul-Dec 2007.

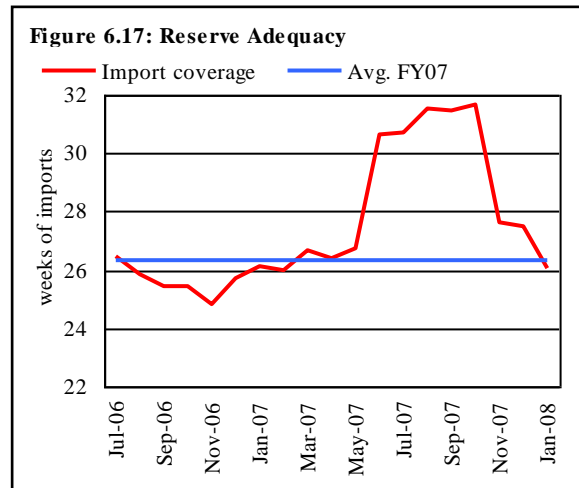
¹⁷ As per BSD Circular No.09 of 2007, this is a temporary arrangement to provide liquidity to the market.

¹⁸ During August, commercial banks' reserves fell by US\$ 112.0 million.

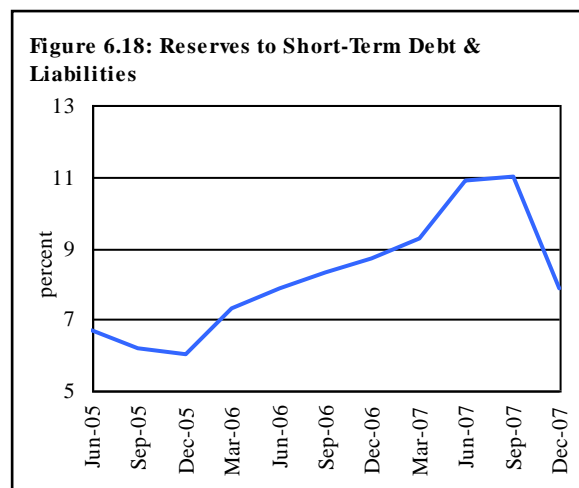
FY08 (see **Figure 6.15**). Decline in commercial bank reserves was contained due to higher SBP forex market interventions and easing of SCRR (see **Figure 6.16**).

6.4.1 Reserve Adequacy

Adequate level of foreign exchange reserves is necessary but not a sufficient condition for external sector sustainability of a country as it is an indicator of economy's ability to meet its external obligations. Most widely used measures of gauging the adequacy of reserves are (1) import week coverage ratio and (2) reserves to short-term debt and liabilities ratio. On account of recent depletion in Pakistan's foreign exchange reserves coupled with surge in imports, Pakistan's reserve adequacy in terms of import week coverage has eroded to 24.8 weeks as in February 2008¹⁹, against its recent peak of 31.7 weeks witnessed in October 2007. Due to this sharp decline, the ratio has even slid down its average level in FY07 (see **Figure 6.17**).



Other measure of external sector vulnerability in terms of reserve adequacy, ratio of reserves to short-term debt and liabilities also decreased during Jul-Dec FY08 (see **Figure 6.18**), mainly on account of rise in short-term debt obligations during last two quarters coupled with depletion of foreign exchange reserves.²⁰



¹⁹ Ratio is calculated by using sum of 12-month moving imports.

²⁰ Data on external debt is available only on quarterly basis. Latest data is available up to December 2007.

6.5 Exchange Rate

Pak Rupee suffered significant losses against the US dollar during Jul-Feb FY08, depreciating by 3.5 percent during the period. Movements in the Rupee/US\$ exchange rate largely followed the same pattern as the reserves. During the first four months of the current fiscal year Pak Rupee remained more or less stable and depreciation in the value of Rupee against the US dollar was only nominal. In contrast, Nov-Feb FY08 period saw steep decline in the value of Rupee, mirroring pressures in the foreign exchange market which arose October, 2007 onwards (see **Figure 6.19**). Besides, the steep depreciation to the extent of 3.0 percent on end period basis, during Nov-Feb FY08, the exchange rate also remained much more volatile, particularly mid December 2007 onwards.²¹ This prompted SBP to intervene in the market aggressively, helping reduce the day to day volatility in the exchange rate. However, these interventions were not aimed at arresting the fall in the value of Pak Rupee against the US dollar.

While deteriorating economic and political environment may have been responsible in large part for the steep fall in the value of Rupee, a portion of the decline seems to be driven by speculative activity in the forex market. This is evident from the rising FC deposits and export bills outstanding in the second quarter of FY08.

Figure 6.19: Exchange Rate Trend

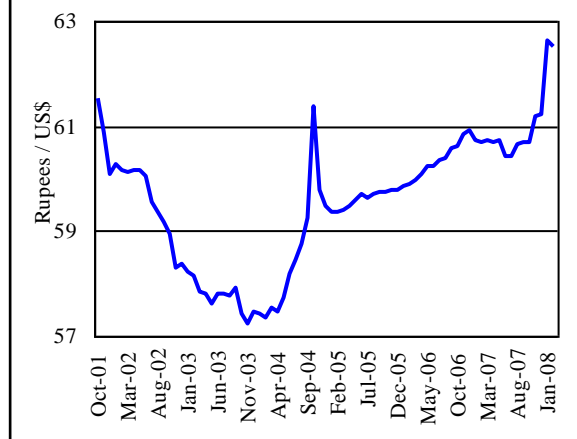
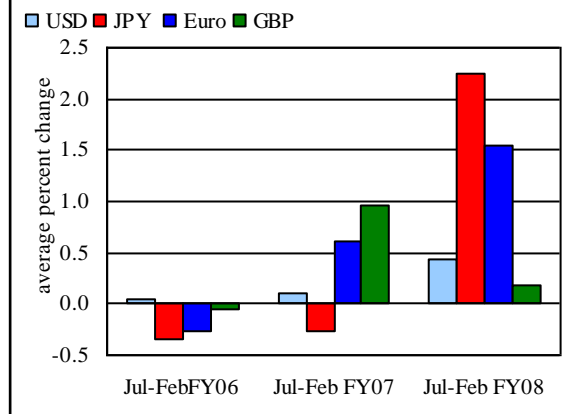


Figure 6.20: Rupee Movement against Major Currencies



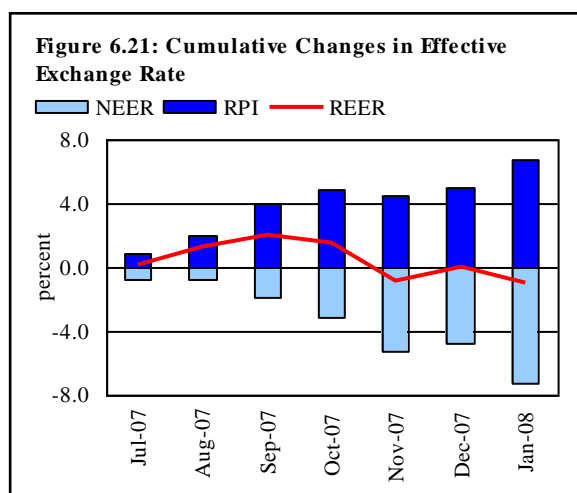
²¹ Monthly standard deviations of Rupee-dollar exchange rate were 21.7 percent and 22 percent, during December 2007 and January 2008, respectively.

Furthermore, strengthening of the Pak Rupee following peaceful elections also lends credence to the argument that speculators were attacking the currency to make quick gains. In fact SBP had to intervene in the market to arrest steep appreciation immediately following the elections on 19th February 2008. Apparently strong reserves coupled with SBP's prompt actions to maintain calm in the forex market has been successful in arresting even steeper fall in the value of Rupee.

The situation in the forex market is likely to improve with expected inflows of FDI in the coming months²², besides proceeds from issuance of eurobonds and GDRs²³ during the current fiscal year. All these factors would help in stabilizing the exchange rate. This would in turn discourage the exporter and others to hold repatriation and importers from buying forward.

Due to the steep depreciation of Pak Rupee against US dollar, coupled with dollar depreciation in international markets, Rupee lost its value against major currencies as well. During Jul-Feb FY08, monthly Rupee depreciation against JPY averaged to 2.3 percent. Against Euro and Pound sterling, Rupee depreciated by 1.5 percent and 0.2 percent on average (see **Figure 6.20**).

While the recent surge in exchange rate has negative implications in terms of appreciation in the value of liabilities of the economy, it can have positive impact on the trade front by improving the country's competitiveness especially given the depreciation of dollar in international markets. This seems further eminent if the appreciation in currencies of Pakistan's major competitors is viewed (see **Box 6.5**).



²² These expected FDI inflows include inflows worth US\$ 193 million from Omantel (Oman Telecommunication Co.) for purchase of Worldcall Telecom.

²³ During current fiscal year, flotation of NBP, HBL and KAPCO GDRs worth US\$ 1.3 billion are planned.

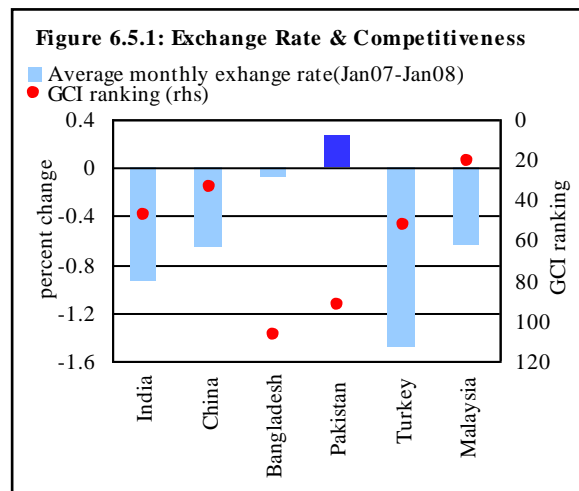
During Jul-Jan FY08, the Real Effective Exchange Rate (REER) of Pak Rupee depreciated by 1.0 percent against a basket of currencies, pointing towards an improvement in competitiveness of the economy against its major trading partners. This depreciation in REER is clear reflection of steep depreciation of Pak Rupee against the basket of currencies in nominal terms, which is also evident in depreciation in Nominal Effective Exchange Rate²⁴ (NEER) by 7.3 percent during Jul-Jan FY08. Resultantly, despite 6.7 percent rise in Relative Price Index (RPI), REER depreciated (see **Figure 6.20**).

Box 6.5: Recent exchange rate movements and competitiveness of Pakistan:

Global competitiveness of an economy is a major factor impacting the level of its exports. It is a relative phenomenon and any country's competitiveness is based on its position against other trading economies, especially its direct competitors. Exchange rate movements are a very important component of country's competitiveness as these have a direct bearing on the relative price of the country's exports against others. Depreciation in the country's currency has a favorable impact on the competitiveness of a country.

Pakistan ranked 92 among 131 countries on Global competitiveness index²⁵ for 2007-08, down one rank from last year. Besides, the country's ranking is lower against its major competitors, save only for Bangladesh. In this context, the recent Rupee depreciation coupled with dollar depreciation against other currencies could act as a source of improvement in country's competitiveness ranking, since the GCI also takes into account the impact of country's REER. The improvement in exchange rate competitiveness against major competitors especially in the area of textile exports, e.g., China, India, and Bangladesh among others can

have a positive impact on the trade balance of the country. As could be seen from the **Figure 6.5.1**, currencies of all these countries have appreciated against dollar during the last year. Although this bodes well for the comparative position of country against its rivals, it is not a sufficient factor for improvement in the exports of country, which depends on a host of other factors as well. With reference to Pakistan these include improving the allocative as well as productive efficiency of the country by lowering costs of production, skill enhancement, improving the governance and overcoming the infrastructural bottlenecks. Besides, inflationary tendencies need to be curbed as these can erode the relative prices, resulting in negative repercussions on the competitiveness of the



²⁴ Depreciation in NEER as well as REER remained more prominent in November 2007.

²⁵ Global competitiveness index is published by World Economic Forum on annual basis.

country, which is also evident in steep rise in relative price index for Pakistan during Jul-Jan FY08, by 6.7 percent.

Data Source: Bloomberg and World Economic Forum website.

6.6 Foreign Trade^{26,27}

Rising international commodity prices coupled with domestic supply constraints of some key commodities resulted in 21.9 percent YoY rise in imports growth during Jul-Feb FY08 that outpaced 7.9 percent growth in exports during this period. Resultantly, the trade deficit recorded a sharp US\$ 3.5 billion YoY increase during the period (see **Figure 6.22**). With this expansion, the ratio of trade deficit to GDP worsened from 6.2 percent in Jul-Feb FY07 to 7.9 percent in Jul-Feb FY08.

In contrast to FY05 and FY06, the sharp surge in import growth during Jul-Jan FY08, was not due to any structural shift in demand as around half of the total increase in the import bill was contributed by rising international commodity prices: oil, fertilizers, palm oil,

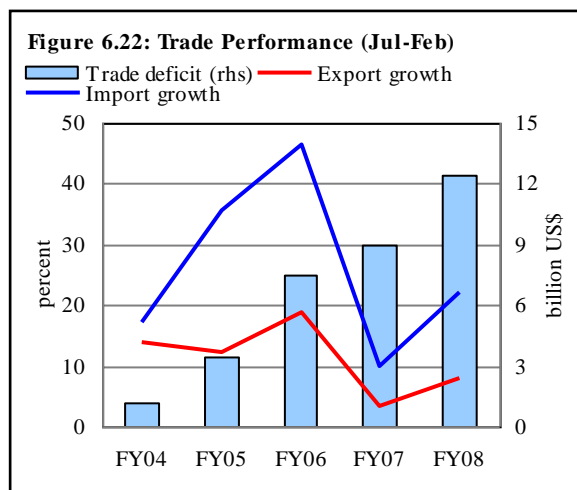


Table 6.8 :An Anatomy of Trade Deficit (Jul-Jan)

abs changes in billion US\$; shares in percent

	FY05	FY06	FY07	FY08
Trade deficit (bln US\$)	2.9	6.5	7.6	10.3
Abs. Δ in exports	0.7	1.6	0.3	0.6
<i>Shares in exports absolute Δ</i>				
Textiles exports	8.7	76.3	120.5	-37.6
Non-textiles exports	91.3	23.7	-20.5	137.6
Abs. change in imports	2.6	5.3	1.4	3.3
<i>Shares in imports absolute Δ</i>				
<i>Of which</i>				
<i>Price impact</i>				
Oil price impact	14.0	25.4	11.7	21.7
Non-oil price impact	13.3	4.8	17.0	27.6
Wheat & raw cotton imports	2.1	1.2	0.4	18.5

²⁶ This analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.

²⁷ The broad analysis of trade deficit is based on Jul-Feb FY08 data. However the detail exports and imports trends are discussed for the period Jul-Jan FY08, since detail monthly data is not available for February 2008.

etc (see **Table 6.8**).²⁸ In addition, imports of wheat and cotton were necessitated due to supply shortages. The import bill was further inflated due a large one-off import in the category of *aircrafts, ships and boats*. In the absence of all these factors import growth and thus the trade deficit would have been significantly lower than the current level.²⁹ The significant slowdown in the imports after adjusting for these factors represents a deceleration of the real demand for imports, which can in part be attributed to the tight monetary policy being pursued by the SBP.

The composition of export growth on the other hand does represent a structural shift. The growth in exports during Jul-Jan FY08 was on account of a rise in *non-textile* exports – mainly *other manufactures* and *petroleum group*; whereas *textile* exports recorded 3.4 percent YoY fall during this period. The decline in the textile exports was broad based with only the exports of synthetic textiles, ready-made garments and textile made-ups registering growth.

Fall in the textile exports can be attributed to both supply and demand factors. On the supply side, textile exports were adversely affected by the rising cost of production due to increase in domestic cotton prices and tariff rates, as well as by the frequent power shortages and political unrest. On the demand side, textile and apparel products exports appear to have suffered from the slowdown in the US economy.³⁰ In this scenario, the growth in the non-textile exports is all the more encouraging.

Going forward, textile exports are expected to recover, once political environment in the country improves and importers become confident with regard to timely fulfillment of export orders. Having said this, the recovery may not be sharp due to acute power shortages and rising domestic cost of production. The overall export growth is nevertheless, likely to pick up on the back of rising non-textile exports.

Imports, on the other hand, are expected to continue to rise, as the current trend of rising international commodity prices is unlikely to reverse in the short-term. Apart from the price impact, the import bill is also likely to increase on account of rising demand. Particularly, the import of wheat, agriculture & chemicals group,

²⁸ The price impact for the 50.2 percent imports for which price and quantum data was available was around 49 percent of the total rise in the import bill during Jul-Jan FY08.

²⁹ In the absence of these factors, the import growth for Jul-Jan FY08 would have been mere 4.6 percent, which implies a trade deficit of US\$ 7.9 billion for this period.

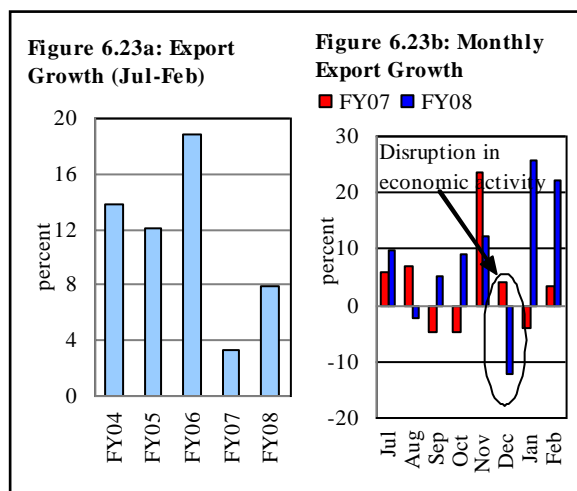
³⁰ Around one-third of country's total textile and apparel exports were directed to the US market during FY07.

raw cotton and metal group along with power generation machinery is likely to increase. This implies a substantial widening of the trade deficit through the remaining FY08.

6.6.1 Exports

Pakistan's exports stood at US\$ 11.7 billion during Jul-Feb FY08 period. Though slightly better than last year, the 7.9 percent YoY export growth was significantly lower than 11.6 percent target envisaged for Jul-Feb FY08 (see **Figure 6.23a**). Analysis of monthly data reveals that export growth recorded a significant fall on account of large-scale disruption in economic activity in the month of December FY08.³¹

In the absence of this abnormal decline, export growth for Jul-Jan FY08 could have been higher than the current recorded level (see **Figure 6.23b**).



The modest increase in exports during Jul-Jan FY08 was recorded on the back of *non-textile* exports, whereas *textile* exports growth recorded a fall during this period (see **Table 6.9 & 6.10**). Among the non-textile group, the major impetus to growth came from rising *other manufactures* exports that included cement, chemicals & pharmaceuticals, jewelry and leather. In addition, export of *all other items* also recorded large increase during this period.

Table 6.9: Category-wise Growth in Exports (Jul-Jan)

percent	FY07		FY08	
	Shares	Growth	Shares	Growth
Food group	11.3	-3.1	11.1	4.8
Textile manufacturers	65.1	6.4	59.4	-3.4
Petroleum group	4.7	3.3	6.0	34.0
Other manufactures	15.1	-8.1	18.2	27.7
Others	3.8	30.4	5.3	49.4
Total exports		3.6		5.9

³¹ In the month of December 2007, economic activity remained largely subdued firstly on account of Eid-ul-Azha holidays and later due to political turmoil in the country.

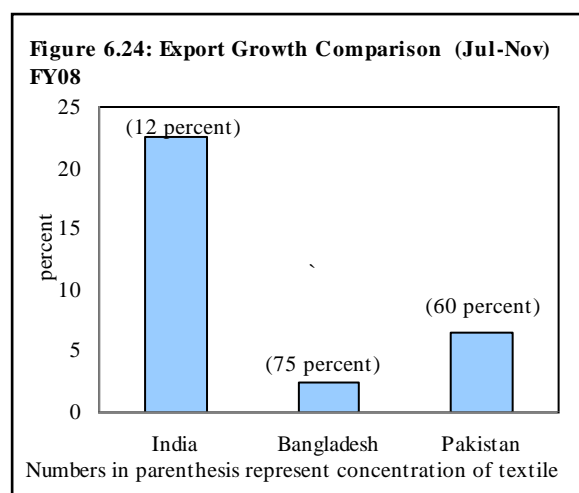
Table 6.10: Major Exports (Jul-Jan)

million US\$

		FY07		FY08(P)		Abs.Δ		% YoY Δ		
		Value	Unit value	Value	Unit value	value	Qty	Value	Unit Value	
A Food group		1,079.9		1,131.6		51.7		4.8		
<i>Of which</i>										
Rice	MT	622.4	344.7	628.7	481.8	6.3	-27.7	1.0	39.8	
Fish and fish preparations	MT	107.1	1611.6	105.8	1666.7	-1.3	-4.5	-1.2	3.4	
Fruits	MT	71.5	324.0	83.9	423.4	12.4	-10.2	17.4	30.7	
Vegetables incl. roots and tubers	MT	19.8	383.5	29.1	409.2	9.3	37.6	46.8	6.7	
Oil Seeds & nuts etc.	MT	8.8	719.6	23.0	822.5	14.2	129.1	161.9	14.3	
Meat and meat preparations	MT	22.8	2666.5	29.0	2891.3	6.2	17.3	27.2	8.4	
B Textile group		6,242.6		6,028.2		-214.4		-3.4		
<i>Of which</i>										
Cotton yarn	MT	813.0	2135.0	764.1	2195.7	-48.9	-8.6	-6.0	2.8	
Cotton fabrics	SQM	1148.3	875.1	1053.5	1001.8	-94.8	-19.9	-8.3	14.5	
Hosiery (knitwear)	DOZ	1180.1	20.9	1047.9	21.8	-132.1	-15.1	-11.2	4.6	
Bed wear	MT	1158.3	5361.0	1086.3	5518.1	-72.0	-8.9	-6.2	2.9	
Towels	MT	352.0	3907.4	328.4	3918.3	-23.6	-7.0	-6.7	0.3	
Readymade garments	DOZ	809.8	32.6	868.1	37.8	58.3	-7.5	7.2	15.8	
Art silk and synthetic textiles	SQM	241.3	0.7	302.0	0.9	60.8	5.6	25.2	18.5	
C Petroleum group		452.7		606.6		153.9		34.0		
D Other manufactures		1,447.2		1,847.7		400.5		27.7		
<i>Of which</i>										
Sports goods excl. toys	---	154.4	---	162.5	---	8.1	---	5.2	---	
Leather excl. reptile leather	SQM	167.8	16.7	230.7	17.5	62.9	31.1	37.5	4.9	
Leather manufactures	---	325.6	---	371.2	---	45.6	---	14.0	---	
Foot wear	PAIR	64.9	7.5	63.4	18.2	-1.5	-59.7	-2.4	142.0	
Chemicals and pharmaceuticals	---	218.6	---	318.3	---	99.7	---	45.6	---	
Engineering goods	---	121.2	---	109.5	---	-11.7	---	-9.7	---	
Jewelry	---	13.6	---	99.1	---	85.5	---	628.2	---	
Cement and cement products	MT	73.5	54.2	174.0	56.3	100.4	127.8	136.6	3.8	
E All other items		360.6		538.7		178.1		49.4		
Total exports		9,583.0		10,152.8		569.8		5.9		

As far as *textile* exports are concerned, this group largely recorded a broad-based decline during Jul-Jan FY08. Dismal performance of the textile sector is attributable to rising domestic cost of production that is hampering country's competitiveness vis-à-vis its competitors. In addition, the slowdown in the US economy (see **Table 6.5**) and political unrest in Pakistan also affected the export performance of this sector.

Since Pakistan's total exports have a large (around 60 percent in Jul-Jan FY08) concentration of textile items, the fall in textile export growth suppressed the overall export growth during Jul-Jan FY08. This effect is also visible in other regional economies. For instance, Bangladesh that had a higher concentration of textile exports as compared to Pakistan witnessed even lower growth of total exports during the period under review, largely due to falling textile exports. On the other hand India, which has a lower concentration of textile products, recorded a substantial export growth during Jul-Nov FY08 despite a deceleration in textile exports growth (see **Figure 6.24**).³²



In order to improve country's exports and reduce export market and products concentration, a number of steps have been taken in the last few years. These include provision of freight subsidies for the exploration of new export markets as well as exporting new products.³³ These measures have helped improve export performance to some extent. Another step in this direction is the conclusion of preferential trade agreements with a number of countries namely China, SAARC countries, Sri Lanka, Iran, Mauritius and Malaysia (see **Box 6.6**). These agreements are concluded with the aim to increase trade flows between countries. However care should be taken at the time of concluding such agreements, since the desired objective of exports increase can only be achieved if the country has

³² India's textile exports recorded a marginal 1.3 percent growth in the period of Apr-Nov 07 as compared to the 11.6 percent growth in the same period last year.

³³ Trade policies for FY00 to FY08.

the export potential for the goods for which preferential access is acquired from these countries.

Box 6.6: Preferential trade agreements and trade performance Agreements

In an effort to diversify export markets and get improved market access Pakistan has entered into preferential trade agreements with a number of countries in the last few years (see **Table 6.6.1**).

In terms of volume of trade the FTAs signed with China and the SAARC countries are the most important. Pakistan's overall trade volume with China has increased from US\$ 2.2 billion in FY05 before the start of any preferential arrangements to US\$ 4.1 billion in FY07. Similarly among the SAARC countries Pakistan's trade volume with India rose from US\$ 0.8 billion in FY05 to US\$ 1.6 billion in FY07 (**Table 6.6.2**).

In fact countries from around the world are entering into such preferential arrangements as a prelude to the start of free trade world envisioned by the WTO. The major theoretical support for such arrangements comes from the possibility of an increase in trade flows between countries after entering into such preferential arrangements.

Table 6.6.1: Status of Trade Agreements

	Effective from	Full implementation
FTAs		
China	July 2007	2012
Sri Lanka	June 2005	Fully implemented
Malaysia	January 2008	2012
SAFTA	January 2006	2016
PTAs		
Iran	September 2006	Fully implemented
Mauritius	November 2007	Fully implemented
Early harvest programmes		
China	January 2006	Fully implemented
Malaysia	January 2006	Fully implemented

Table 6.6.2: Trade Performance after Trade Agreements

million US\$, growth: percent

	FY05			FY07			Growth		
	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Imports	Trade balance
China	354.1	1846.0	-1491.9	575.9	3532.4	-2956.5	62.6	91.3	98.2
Sri Lanka	155.8	44.9	110.9	200.6	63.4	137.2	28.7	41.2	23.7
Iran	147.1	242.8	-95.7	167.5	405.8	-238.2	13.9	67.1	149.0
SAARC countries									
<i>of which</i>									
India	288.1	548.1	-260.0	342.9	1235.9	-893.0	19.0	125.5	243.5
Bangladesh	205.8	61.2	144.6	261.9	58.3	203.6	27.3	-4.7	40.8
Maldives	2.6	3.4	-0.9	3.6	0.0	3.6	42.4	-99.0	-507.1
Nepal	2.7	3.8	-1.0	1.6	3.2	-1.5	-40.6	-15.9	50.1
Bhutan	0.1	0.5	-0.4	0.0	0.1	0.0	-68.4	-88.2	-93.5

Theoretical underpinnings: The expected increase in the trade flows comes both from trade creation – the flow of trade that would not have existed between countries in the absence of preferential trade arrangements – and trade diversion – the flow of trade from a trading partner outside the FTA to a trading partner within the FTA. On the whole, net welfare from such trading

arrangements is expected to rise if the gains from trade creation are greater than the (possible) losses from trade diversion.³⁴ In this theoretical perspective, the impact of the preferential trading arrangements concluded with China and India, given their importance as reflected in the volume of trade with these countries, is discussed below.

Trade performance: The trade pattern with these countries after the implementation of trade agreements highlights a significant rise in the volume of bilateral trade. Specifically, exports to China have undergone large expansion over the period of two years. On the other hand, imports from both China and India have also increased substantially leading to large expansion in trade deficits with these countries.

Analysis of the expansion in exports to these countries (see **Table 6.6.3**) reveals that increase in exports is largely a result of creation of new trade opportunities. For example Pakistan's chromium ore export averaged at US\$ 28 million in FY05 and FY06. However, after obtaining preferential treatment from China, the export of this category reached US\$ 57.7 million mainly due to a US\$ 32.7 million rise in chromium ore export to China. While, in case of synthetic cotton yarn the rise in export to China and a fall in overall export of this category does give some evidence of trade

Table 6.6.3: Analysis of Increase in Trade from PTA Partner Countries

million US\$, unit value 000 Rs/unit

		Abs. change in FY07			Unit values FY07	
		Country wise	Largest alternate destination	Total	Country wise	Largest alternate destination
Units						
Exports						
China						
Chromium ores	Mt	32.7	-0.5	32.2	12.9	16.4
Synthetic cotton yarn	Kg	12.6	1.6	-0.8	0.1	0.1
Cotton yarn	Kg	12.4	-1.2	39.9	0.1	0.1
India						
Petroleum naphtha	Mt	61.5	321.1	118.3	32.3	34.4
Wheat	Mt	15.7	21.0	97.0	13.1	12.9
Unrefined led and alloys	Kg	7.6	0.8	8.8	0.1	0.1
Imports						
China						
Cell phones	No	148.2	-128.0	104.6	3.2	4.4
Coke of coal	Mt	50.3	17.7	80.1	10.2	10.8
Other transmission app.	No	108.0	98.6	339.9	21.7	32.0
India						
Para-Xylene	Kg	135.4	-7.4	105.5	0.07	0.06
Polypropylene	Kg	44.5	7.4	43.1	0.07	0.08
Oil cake	Kg	27.6	0.1	27.2	0.0	0.0

³⁴ Source: <http://internationalecon.com/Trade/Tch110/T110-2A.php>

diversion. Comparison of the unit values with the other largest partner shows that this diversion was not inefficient in terms of price obtained from China.

Similarly, the rise in cotton yarn export to China was less than the total increase in export of this commodity, implying creation of new trade opportunities. Since the increase in export of these three commodities constitutes more than half of the YoY increase in exports to China during FY07, these results can be extended for the total export growth to this market during this period. Similarly, the export of the top three commodities to India in FY07, also presents evidence of trade creation. Since the rise in export of these categories to India was accompanied by a general rise in their export as well.

In case of imports from China the import of cell phones presents clear evidence of trade diversion. However this diversion is efficient since the unit values offered by China are significantly below the unit values offered by the alternate supplier of this category. Further, the imports of the other two major categories are also less costly from China as compared to the alternate sources. Imports from India also show some signs of trade diversion; however this diversion is not inefficient in terms of unit values.

Conclusion: This analysis shows that the rise in trade as a result of these trading agreements is largely efficient both in case of exports and imports. The provision of improved preferential access in different countries is likely to help in diversifying country's export markets. The ability to take benefit from this opportunity, however, depends on the available exportable surplus. Currently the trade performance reveals increasing lack of competitiveness in the textile sector on account of rising costs. Also the elimination of quota regime has made it difficult for the country to face the competition from China, India and Bangladesh in the major export markets.

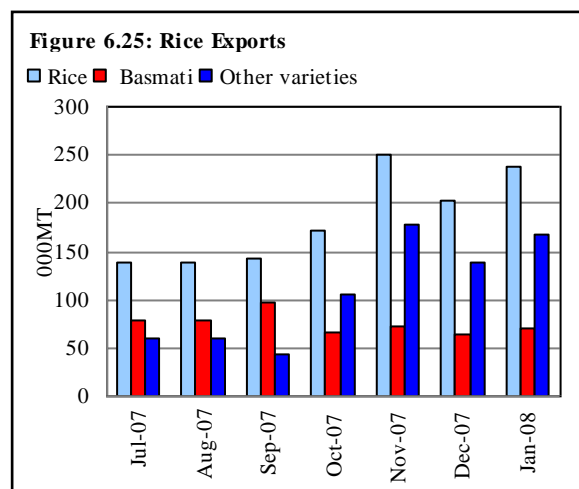
In this scenario provision of duty free access in other markets might help in slowing the current trend of deceleration witnessed in the textile exports. The availability of preferential access can provide incentives for increasing exports of other non-textile products as well. Therefore, government should focus on obtaining duty free access for both textile and non-textile goods. This can act as an incentive for diversifying country's overall export base. As regards imports, as a result of these trading arrangements imports are expected to divert to suppliers within the preferential arrangements. Apparently as the analysis reveals this diversion is expected to be efficient. Especially China is known as a low cost producer of goods in the world, therefore the diversion of imports from other suppliers to China is likely to help in improving country's trade balance.

The preferential trading agreements with large countries are thought to be more welfare enhancing as they provide less opportunities for inefficient trade diversion because the relative prices in large countries are more in line with the world prices. Secondly, preferential arrangements with natural trading partners – neighboring countries – are also more beneficial. This is because, these countries provide more opportunities for trade creation on account of reduced transportation cost and similar economic needs and potentials.

Food Group

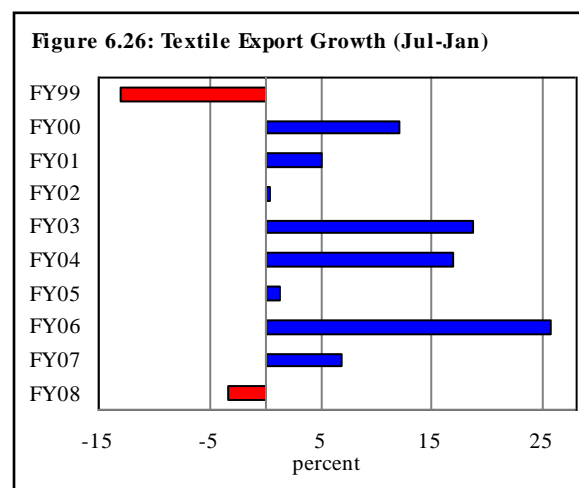
The small 4.8 percent YoY expansion in the food group exports during Jul-Jan FY08 is encouraging when seen against 3.1 percent fall registered in this group in the corresponding period of FY07. Importantly, the rise in the exports of this group was achieved despite a fall in the major categories of *other varieties of rice* and *fish* exports. In fact with the exception of these two commodities almost all

other categories in this group recorded reasonable growth during Jul-Jan FY08. Most notable of these are increasing *oilseeds, fruits, vegetables* and *meat & its preparations* exports. The increase in the exports of these categories is attributable to rise in production, higher international prices and various incentives given by the government for the growth of these non-traditional sectors



The marginal increase in the *rice* exports was recorded on account of increasing basmati rice exports, whereas *other varieties of rice* recorded a large fall during Jul-Jan FY08. However, from October FY08 the export of other varieties of rice has started to increase with the marketing of the FY08 crop (see **Figure 6.25**). Also the production of other varieties of rice was higher during FY08 as compared to the same period last year.³⁵ This fact points towards availability of higher exportable surplus during this year and thus a possibility of increase in export of this variety, going forward.

Rice exports are however faced with certain issues in Iran which captured around 18 percent share in total rice exports during FY07. Anecdotal evidence suggests that on account of political issues in the region and also reported shortage of dollars in this market some of the local banks are not accepting the letters of credit from Iranian importers. However this issue is likely to be resolved, as



³⁵ The production of other varieties of rice recorded a 10 percent YoY rise during FY08.

reportedly, the Iranian importers have opted for trading in Euro, which could revive rice exports to this market.

Textile group

For the second time in last ten years, textile exports recorded a fall during the Jul-Jan period (see **Figure 6.26**). This fall mainly represents the impact of disruption in the economic activity in December FY08. Excluding this month the YoY textile exports growth for Jul-Jan FY08 stands at 0.6 percent.

Fall in the textile exports was largely broad based and exports of all textile categories except readymade garments, synthetic textiles and other textile made-ups witnessed decline during this period (see **Table 6.11**).

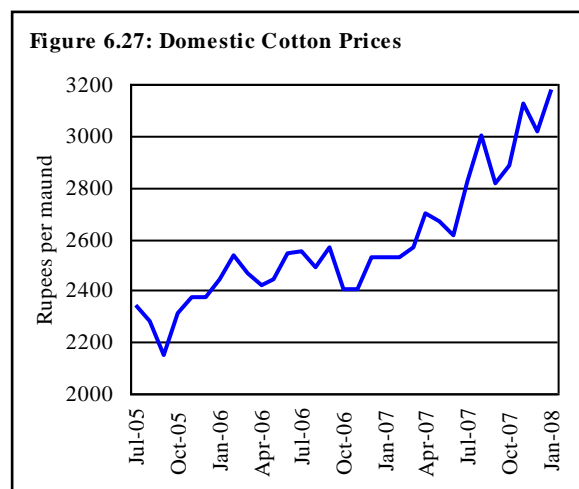
Table 6.11: Major Textile Exports Price & Quantum Impact (Jul-Jan)

million US\$						
	FY07			FY08		
	Absolute change	Due to		Absolute change	Due to	
		Qty	Price		Qty	Price
Textile Group	374.9			-214.4		
<i>Of which</i>						
Raw cotton	-13.1	-13.5	0.4	-3.5	-5.1	1.6
Cotton yarn	56.9	13.3	43.6	-48.9	-70	21.1
Cotton fabrics	-69	-198	129	-94.8	-228.1	133.2
Knitwear	158.3	214.3	-55.9	-132.1	-178.1	46
Bed wear	-32.3	-16.2	-16	-72	-102.9	30.9
Towels	21.6	6.6	15	-23.6	-24.6	0.9
Readymade garments	43.4	94.7	-51.3	58.3	-60.4	118.7
Art silk and synthetic textiles	129.8	109.1	20.7	60.8	13.6	47.2
Other textile made-ups (excl. towels & bed wear)	5.0			49.6		

Largest decline was observed in the category of knitwear exports followed by cotton fabrics. Synthetic textile was the only category that witnessed growth both in terms of quantum and unit values during Jul-Jan FY08. Unit values of all the categories recorded increase with the exception of carded or combed cotton during Jul-Jan FY08. Yet on account of large quantum decline their overall exports recorded fall.

This lackluster performance of the textile sector is attributable to the loss of country's competitive strength, which is also reflected by the rising unit values of

almost all textile exports. Apparently rising cost of production due to increase in domestic cotton prices,³⁶ (see **Figure 6.27**) higher electricity tariffs as well as rising power shortages in the country kept exporters from quoting lower prices. This is reflected in the falling export quantum. In addition to this, political uncertainty in the country also led to the diversion of export orders to other suppliers.



While the government's decision to allow imports of short staple cotton from India through land route would help in controlling rising cost of production to an extent,³⁷ other problems faced by this sector are essentially structural in nature. Especially the issues of high power tariffs and power shortages are affecting the overall industrial growth and need formulation of effective strategies to avert a long-term slowdown in this sector. On the other hand, textile sector has displayed its inability to translate huge support given to it in the form of R&D subsidies, into productivity gains.

Market Analysis³⁸

Broader market analysis reveals that Pakistan's textile exports faced tough competition in the US market during Jul-Nov FY08. On the other hand country's apparel exports fared relatively better in this market, nevertheless growth recorded in this category during Jul-Nov FY08 was lower than the past three years' average growth. In the EU market the situation was reverse, and apparel exports recorded a slight fall during Jul-Oct FY08, whereas textile exports to this region recorded a reasonable rise (see **Table 6.12**).

³⁶ The size of cotton crop during FY08 was recorded at 12.775 million bales as compared to the 12.856 million bales recorded during FY07.

³⁷ India harvested a largest ever crop of 21 million bales during FY07. According to the Agricultural Outlook Forum 2007, during the current year (2007-08) also India's cotton production is expected to surpass the previous level with India becoming the 2nd largest cotton producer.

³⁸ The analysis is based on US Census Bureau and Eurostat data that is available up to November and October respectively.

Textile apparel exports:

Pakistan faces tough competition from China, Bangladesh, Turkey and India in the EU market for textile apparel. Especially Bangladesh, which is a large garments' exporter, enjoys preferential access to this market not available to it in the US market so far. Turkey is also at an advantageous position because of its close proximity to the EU that reduces the lead time involved for fulfilling the orders, which is an important factor in case of apparel exports. All these factors reduce Pakistan's competitiveness in apparel exports segment to EU.

In the US market Pakistan is still able to compete as is shown by a small growth in

Pakistan's apparel exports during Jul-Nov FY08. However with the end of the textile safeguard measures against China in the EU market from January 2008 and in the US market from January 2009 Pakistan's textile apparel exports are likely to come under further pressure.

Textile fabrics exports

In case of textile exports especially bed wear, Pakistan seems to be inherently in a stronger competitive position in the EU market, which is a factor that has led to the repetitive imposition of anti-dumping duty on this category in this market. Pakistan's bed wear exports to this region recorded 15.5 percent YoY rise during Jul-Oct FY08.³⁹ Bed wear exports to EU are rising after the reduction of antidumping duty on this category from the previous level of 13.1 percent to 5.8 percent from May 2006.

Table 6.12: Textile and Apparel Export Growth to the Major Markets

percent				
US Market*				
	Textile		Apparel	
	Avg. CY03-CY06	Jul-Nov CY07	Avg. CY03-CY06	Jul-Nov CY07
World	9.6	5.5	5.5	0.3
B.desh	-1.9	7.9	11.9	-2.4
China	28.1	11.4	25.3	10.0
India	14.1	6.0	13.0	2.3
Pakistan	13.9	-6.6	11.2	0.7
Vietnam	70.8	25.5	47.9	41.1
EU Market (Jul-Oct)**				
	Textile		Apparel	
	CY06	CY07	CY06	CY07
World	8.7	6.4	8.2	4.2
B.desh	35.0	15.1	28.3	-6.5
China	10.4	18.9	7.8	10.0
India	10.3	6.7	2.3	3.5
Turkey	10.6	2.2	-0.5	4.9
Pakistan	12.4	6.4	4.7	-1.9

* Source: US Census Bureau

** Eurostat

³⁹ Source: Eurostat

In the US market, this category faces tough competition in terms of prices especially from China. During Jul-Nov CY07, this category recorded a substantial 44.8 percent YoY decline in the US market, in terms of quantum.⁴⁰ Hence despite the increase observed in the EU market, the overall bed wear exports registered a decline during Jul-Jan FY08.⁴¹ Bed wear export performance is expected to improve further in the EU market from next calendar year with the complete elimination of anti-dumping duty from March FY09.

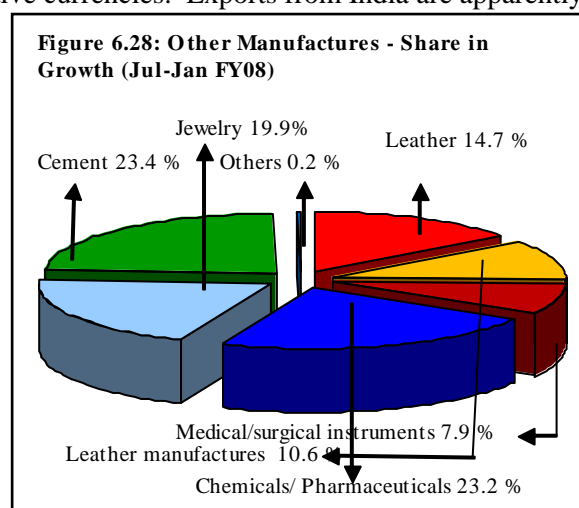
Competitors' position

The export performance of other regional competitors shows that there has been a general deceleration in the textile and apparel exports growth to these two major markets in the period under review. After the end of quota regime from January 2005, textile exports were expected to stabilize, in general, after undergoing an immediate expansion. In the US, this is also partly attributable to falling demand resulting from economic slowdown in this large market.

Apart from the demand side factors, the analysis of the individual performance of some of the competitors also highlights weaknesses in their respective competitive strengths. Bangladesh performed weakly in the category of textile apparel in both the US and the EU markets. This might be a result of the political turmoil in the country as well as natural calamities during this period. Similarly India and China face appreciation of their respective currencies. Exports from India are apparently under pressure in both these markets on account of this factor.

Other Manufacturers

Rising cement, chemicals & pharmaceuticals, jewelry and raw leather exports led the *other manufactures* sub-sector to record a remarkable growth during Jul-Jan FY08 (see **Figure 6.28**) against an 8.1 percent YoY decline recorded during the comparable period of last year.



⁴⁰ The data is obtained from the website of US Office of Textile and Apparel which provides quantum data for preliminary analysis.

⁴¹ US occupied 47.2 percent share in Pakistan's bedwear exports during FY07, as compared to 38.7 percent share occupied in the EU market in the same period.

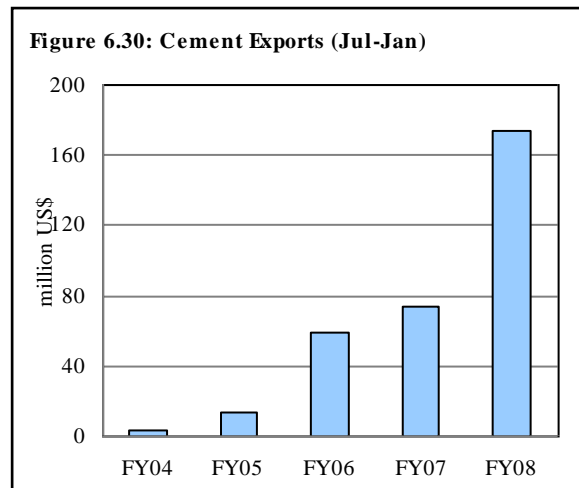
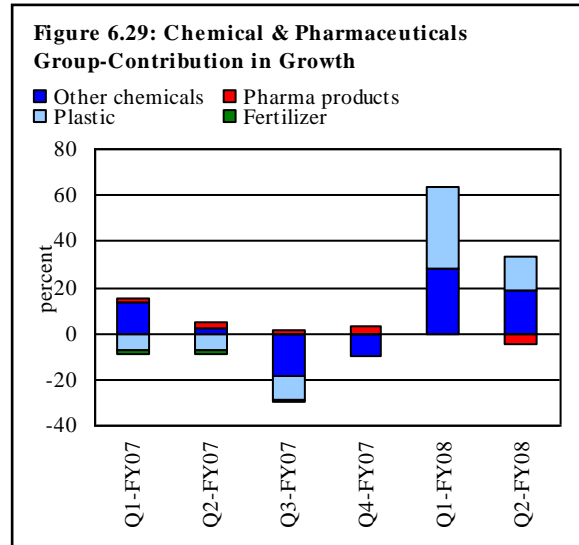
The expansion in the *chemicals and pharmaceuticals* group exports was recorded on account of rising plastic materials exports followed by other chemicals (see **Figure 6.29**).

Plastic materials exports are exhibiting rising trend since last fiscal year mainly due to rising exports of Polyethylene terephthalate (PET) resin (48 percent to EU) and plastic kitchen ware articles (largely to Afghanistan).

Manufacturing and export activity in this sector is increasing on the back of rising demand. While the rising export of kitchen-ware articles is a positive development, this sector should attempt to produce and export higher value added items.

For example, PET is the basic raw material used in the manufacturing of bottles, jars, etc. There is a need to expand the production activity by attempting to export manufactured products that can earn more value.

The largest share in the increase of other chemicals exports came from ethanol exports. The growth in ethanol exports is attributable to higher sugar production during FY08⁴². Further, the reported increase in the production capacity for



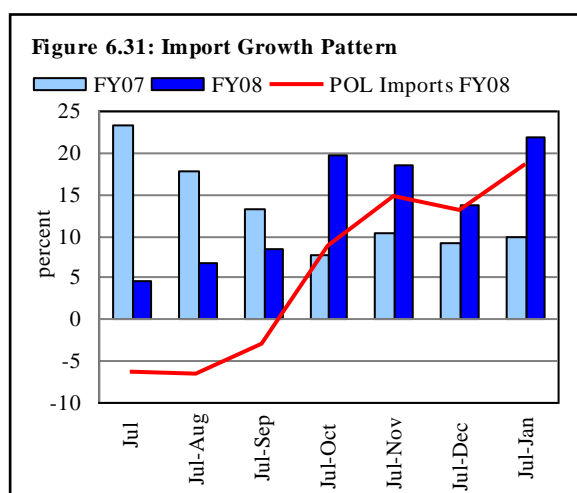
⁴² Sugar cane production reached 62.33 million tonnes during FY08 as compared to 54.9 million tonnes during FY07.

ethanol over the last few years also represents improved potential for exports in this sector.

Cement and cement products exports reached the highest ever level, recording US\$ 100 million YoY increase during Jul-Jan FY08 (see **Figure 6.30**). Detailed data for Q1-FY08 show Afghanistan as Pakistan's largest cement export market. The prospects for cement exports seem bright in the medium term due to supportive supply and demand side factors. Rising domestic as well as regional cement demand has led the cement sector to increase the operating production capacity over the last few years (especially in FY07). Further, Pakistan also achieved improved access to India after the complete removal of the 12.5 percent custom duty on Portland cement imports in this country from January 2007. The current growing pace of the Indian economy coupled with cement shortages suggest this measure to last at least in the medium-term, which implies improved export opportunities for Pakistan.

6.6.2 Imports

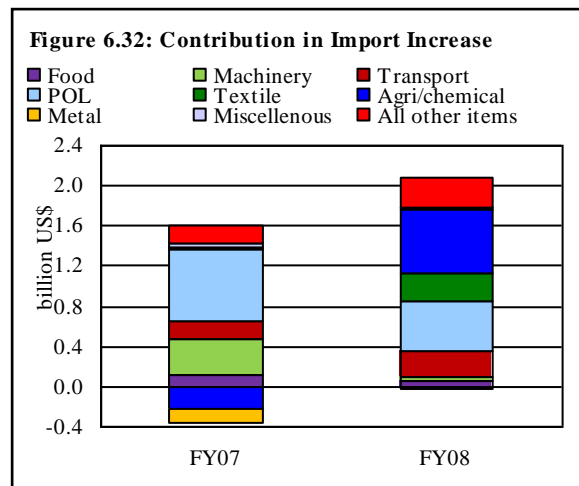
After experiencing a deceleration in FY07, import growth recorded a large 21.9 percent YoY expansion during Jul-Feb FY08. This rise however, was more an outcome of international supply constraints than a shift in demand. The international supply constraints resulted in rising international commodity prices – particularly of oil. This is evident from the import growth pattern that started to soar from October FY08 with the increase in international oil prices (see **Figure 6.31**).



Apart from the oil prices, the international DAP fertilizer and palm oil prices also witnessed a sharp surge during CY07. In overall terms, around 49.3 percent of the

total increase in the import bill during Jul-Jan FY08 was caused by increase in international commodity prices.⁴³

In addition to the dominant role played by prices, the rising demand for raw cotton, chemicals, and iron and steel scrap also contributed in import growth. Further, the transport group also recorded a large one off *ship* import in the month of October FY08. All these factors led to a significant broad based hike in the import bill during Jul-Jan FY08 (see **Figure 6.32**).



The import bill is likely to maintain the current trend of expansion through FY08 on account of both, rising tendency in the international commodity prices as well as domestic shortages of some key commodities. Especially the food import bill is likely to undergo considerable jump due to the forthcoming wheat imports.

Food Group

Food group imports experienced a small increase during Jul-Jan FY08. Thanks to a substantial fall in the *sugar* imports that helped in offsetting the impact of sharply increasing *palm oil* and *wheat* imports during this period (see **Table 6.13**). Fall in the *sugar* imports was brought about by increased production during FY08.⁴⁴

Surge in the *palm oil* import bill was completely a consequence of rising prices, since the import quantum registered fall during the period under review. The international palm oil prices are witnessing a rising trend since CY07 due to increased international demand.^{45,46}

⁴³ The price impact for the 51 percent imports for which price and quantum data was available was 49.3 percent of the total rise in the import bill during Jul-Jan FY08.

⁴⁴ Sugar production recorded 13.6 percent YoY rise during FY08.

⁴⁵ A part of the rising demand came from China which has abolished palm oil import quota from CY06.

⁴⁶ International palm oil prices averaged at US\$ 804 per MT as compared to the level of US\$ 447.1 per MT.

Table 6.13: Major Food Imports (Jul-Jan)

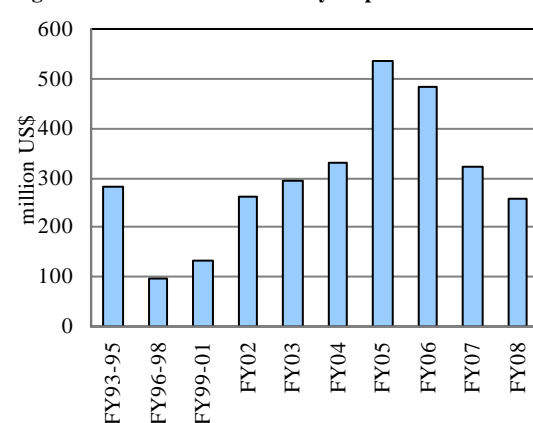
value: million US\$, growth: percent

		Value		Δ in	% Δ FY08 over FY07		Unit Value
		FY07	FY08	Value	Quantity	Value	
Food group		1,731.9	2,046.2	314.3		18.1	
<i>Of which</i>							
Palm oil	MT	437.4	671.0	233.6	-6.8	53.4	64.7
Pulses	MT	133.9	88.8	-45.0	-52.6	-33.6	40.1
Tea	MT	110.5	95.0	-15.5	-6.4	-14.0	-8.2
Sugar	MT	248.7	9.7	-239.0	-95.8	-96.1	-7.5
Wheat un-milled	MT	32.6	57.0	24.3	27.7	74.7	36.8

Besides, during H1-CY07 Malaysia's palm oil production also witnessed (8.0 percent YoY) fall, which⁴⁷ might also have added to pressures on the international palm oil prices. This trend is expected to continue to inflate country's palm oil import bill in the remaining FY08.

In addition to that *wheat* imports are also likely to undergo a major expansion going forward. The Trading Corporation of Pakistan has floated tenders for around 1.25 million tones of wheat, slightly more than one-third of which was imported till end of Jul-Jan FY08. This is worth mentioning that the international wheat prices are also witnessing a rising trend since H2-CY07 on account of lower world wheat stocks, implying a higher price impact in this category as well.^{48,49}

Figure 6.33: Textile Machinery Imports



⁴⁷ Source: <http://www.palmoilprices.net/news/?p=280>

⁴⁸ The average international wheat prices recorded 52.6 percent rise during H1-FY08 as compared to the same period last year.

⁴⁹ According to the Food and Agriculture Organization of the United States, world stock to utilization ratio of wheat fell to 22.6 percent for 2007/08 as compared to 25.4 percent in 2006/07.

Machinery Group

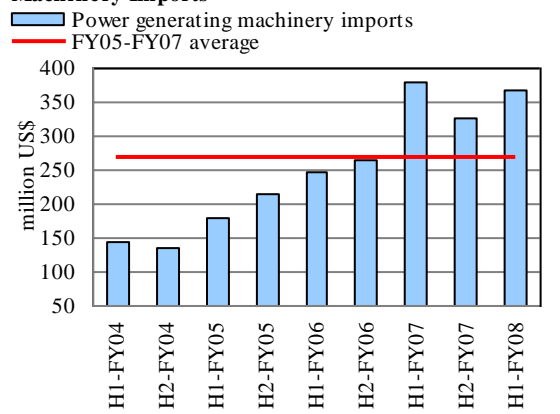
Falling *textile machinery* and *cellular mobile phones* imports caused suppression in the machinery import growth during the period under review as compared to the 12 percent growth in Jul-Jan FY07 (see **Table 6.14**). *Textile* machinery import is representing a mean reverting situation, where after remaining significantly higher for BMR activities in the past few years the import level is reverting back to the historic average level (see **Figure 6.33**). The underlying cause might be the overall slowdown in the textile exports.

Table 6.14: Machinery Group Imports (Jul-Jan)

million US\$				
	FY07	FY08	Abs Δ	% YoY Δ
Machinery group	3749.3	3897.5	148.2	4.0
Power generating machinery	428.6	517.7	89.1	20.8
Office machinery	182.2	176.0	-6.2	-3.4
Textile machinery	323.8	259.4	-64.4	-19.9
Construction and mining machinery	101.6	108.2	6.7	6.6
Electrical machinery and apparatus	373.7	394.5	20.8	5.6
Telecom	1241.8	1282.4	40.5	3.3
a. Mobile phone	480.2	441.0	-39.2	-8.2
b. Other apparatus	761.6	841.4	79.8	10.5
Agricultural machinery	86.7	86.9	0.1	0.2
Other machinery	1010.6	1072.5	62.0	6.1

Power generating machinery on the other hand continued the rising trend. This category is experiencing a gradual rise since FY05 due to ongoing work on various power projects in the country. During Jul-Jan FY08, the import in this head was substantially higher than the FY05-FY07 Jul-Jan average import level (see **Figure 6.34**). Going forward, the power generating machinery import is likely to further increase given that some eight

Figure 6.34: Trends in Power Generating Machinery Imports



Independent Power Projects have reached financial closures during the current fiscal year while agreements for further six have been signed.

Transport Group

The hefty increase in the transport group was a result of a one-off rise in the *aircrafts, ships and boats* category during Jul-Jan FY08. In the absence of this one-off element transport group would have recorded a 17 percent YoY fall during this period. This is due to falling *road motor vehicle* imports (see **Table 6.15**). Demand for new cars has witnessed some decline during the current fiscal year due to rising cost of borrowing in the country. This is also evident from the deceleration in automobiles manufacturing during H1-FY08.^{50,51}

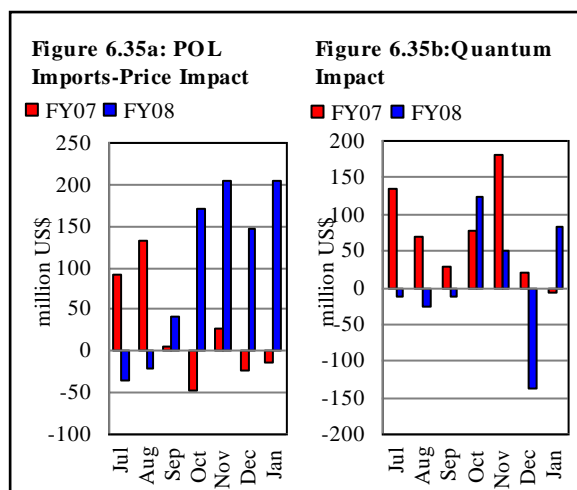
Table 6.15: Price and Quantum Impact of Petroleum Group Imports (Jul-Jan)

million US\$	FY07			FY08		
	Change in value due to			Change in value due to		
	Abs Δ	Quantity	Price	Abs Δ	Quantity	Price
Petroleum group	679.2	1153.3	-474.1	779.5	73.0	706.5
Petroleum products	747.5	1193.2	-445.7	837.3	342.7	494.7
Petroleum crude	-68.4	39.2	-107.6	-57.8	-277.7	219.9

Petroleum Group

Given the record increase in oil prices, the petroleum group import bill witnessed a substantial expansion during Jul-Jan FY08.⁵² This is evident from the rising price impact on the POL import bill from the month of October FY08 (see **Figure 6.35**).

The increase mainly came from petroleum products imports, whereas crude



⁵⁰ The average weighted average lending rates during H1-FY08 witnessed 7.5 percent rise over the level in Jun FY06.

⁵¹ Automobiles production decelerated from the level of 11.4 percent in H1-FY07 to 5.1 percent in H1-FY08.

⁵² The average oil prices during H1-FY08 reached US\$ 78.2 per barrel as compared to the level of US\$ 60.3 per barrel during H1-FY07.

imports witnessed decline in quantum. In terms of import quantum however; there is a visible deceleration in the products imports also (see **Table 6.15**).

Table 6.16: Domestic Consumption of Petroleum Products

volume: 000MT, growth: percent

	Volume			Growth	
	FY06	FY07	FY08	FY07	FY08
Furnace oil	1937.1	3440.5	3662.7	77.6	6.5
HSD	3706.3	3588.8	3929.5	-3.2	9.5
Motor gasoline	607.4	577.7	740.2	-4.9	28.1

This slow down in the products' import quantum was caused by falling furnace oil consumption⁵³ (see **Table 6.16**).⁵⁴ It may be recalled that during Jul-Jan FY07 a large quantity of furnace oil was imported for thermal power generation to supplement hydel generation that had declined due to water shortages.⁵⁵ These thermal units have been running on operational capacity due to acute power shortages, however, since no new thermal power generation units have been added, the growth in the furnace oil has not shown any substantial increase. As against furnace oil, both HSD and motor gasoline consumption recorded increase during H1-FY08 compared to the same period last year.

Increase in the motor gasoline consumption is particularly interesting given the falling demand of automobiles and their conversion to CNG. Apparently the rise in the domestic consumption of motor gasoline is the result of curtailment of large scale smuggling of this product from Iran.⁵⁶ The impact of this restriction can be seen in the form of higher domestic sales of this commodity during H1-FY08. Going forward the motor gasoline imports are likely to increase in order to fulfill the gap created by the elimination of smuggling possibilities. Crude oil imports, however, declined firstly on account of a temporary closure a large refinery during November FY08. Secondly refineries were also working below operating capacities from December FY08 due to their inability to market the product mix presently available with them.

⁵³ Consumption includes both imports and domestic production.

⁵⁴ According to H1-FY08 data, domestic production of petroleum products constituted 45.9 percent, 44.8 percent and 89.3 percent of the total domestic consumption of furnace oil, HSD and motor gasoline respectively.

⁵⁵ Thermal power generation was 13.2 percent higher during Jul-Mar FY07 as compared to the same period in the preceding year, whereas hydel power generation recorded a small 1.2 percent fall during the previous year.

⁵⁶ The Iranian government imposed restrictions on the sale of petrol in the border areas by starting a system of consumption permits from July 2007 for elimination of smuggling possibilities.

Textile Group

A sharp surge in *raw cotton* imports resulted in a wide expansion in the textile group imports (see **Table 6.17**). Cotton imports were necessitated due to a fall in the domestic cotton production during FY08.⁵⁷ Going forward, the import of raw cotton is likely to rise since the government has allowed the import of short staple cotton through land route from India from December FY08.

Table 6.17: Textile Group Imports (Jul-Jan)

value: million US\$, growth: percent

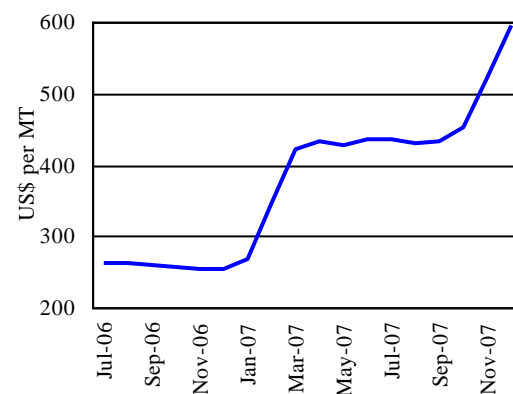
		Value		Δ in	% Δ FY08 over FY07		
		FY07	FY08	Val.	Qty.	Value	Unit Value
Textile group		824.6	1337.8	513.2		62.2	
Raw cotton	MT	298.4	726.6	428.3	122.9	143.5	9.3
Synthetic fiber	MT	136.3	164.7	28.4	6.3	20.8	13.7
Synthetic and artificial silk yarn	MT	136.7	172.2	35.5	13.4	26.0	11.1
Worn clothing	MT	31.8	37.2	5.5	13.5	17.2	3.2
Other textile items		221.3	237.0	15.8	---	7.1	---

Agricultural and other chemicals group

Agriculture and other chemicals imports increase and had the highest (around 24 percent) share in the total imports increase during Jul-Jan FY08. Higher *fertilizers* and *other chemicals* imports were chiefly responsible for inflating import bill in this group.

The large increase in *fertilizer* imports was resulted both by rising quantum and prices, with the impact of the latter

Figure 6.36: DAP Fertilizer International Price



Source: World Bank

⁵⁷ Cotton production during FY08 was recorded at 12.8 million bales as compared to the 12.8 million bales recorded during FY07.

being greater. The international fertilizer prices are witnessing an expansion since CY07 on account of lower supplies from Russian, African and Lithuanian markets, which are major DAP suppliers to Pakistan (see **Figure 6.36**).⁵⁸

As far import quantum, the rise was seen despite a 20 percent YoY fall in the domestic DAP off-take during Jul-JanY08. This is because, around 70 percent of the domestic DAP requirements are met through imports. Therefore, the impact of decline in the use of DAP did not translate into a fall in import quantum. Besides, domestic production of DAP also suffered from December FY08 due to closure of the single largest DAP fertilizer plant near Karachi which had to be supplemented through imports.⁵⁹

Other chemicals imports increased to cater the needs of textile and plastic sectors. The imports in the agriculture and other chemicals group could expand further on account of the rising activity in plastics and other industries. However, the fertilizer import might possibly go down after the capacity improvements which are currently underway in the DAP fertilizer plant.

Metal Group

Rise in metal group imports was mainly contributed by *iron and steel scrap* imports (see **Table 6.18**). Import in this category recorded a large increase due to higher iron and steel demand in the country originating from construction sector. This increased demand has led to the revival of the ship breaking industry, which at one time used to be second largest in the world.⁶⁰

A substantial share of the increase in iron and steel scrap imports was offset by the falling gold imports. This fall which resulted from lower import quantum is attributable to record high level of gold prices.

⁵⁸ Source: <http://mercermilling.com/>

⁵⁹ The DAP production fell from the level of 202.6 thousand tonnes in Jul-Nov FY07 to 197.7 thousand tonnes in Jul-Nov FY08.

⁶⁰ According to the Association of Ship Breakers, during Jul-Jan FY08 various private concerns have imported 25 vessels weighing 213.8 thousand light displacement tonnage (LDT) as compared to the 19 vessels weighing only 34.5 thousand LDT in the same period last year.

Table 6.18: Agricultural & Other Chemical Group and Metal Group Imports (Jul-Jan)

value: million US\$, growth: percent

		Value		Δ in Value	% Δ FY08 over FY07		Unit Value
		FY07	FY08		Quantity	Value	
Agricultural & other chemical group		2442.0	3224.5	782.5		32.0	2442.0
Fertilizer manufactured	MT	248.4	588.8	340.3	50.1	137.0	57.9
Insecticides	MT	59.9	57.7	-2.2	-20.7	-3.7	21.5
Plastic material	MT	655.3	726.4	71.2	4.8	10.9	5.8
Medicinal products	MT	224.2	296.1	71.9	21.5	32.1	8.7
Other chemicals		1253.9	1555.6	301.6		24.1	1253.9
Metal group		1458.3	1519.1	60.8		4.2	
Gold	KG	151.2	10.5	-140.7	-93.1	-93.0	1.7
Iron and steel scrap	MT	181.3	381.2	199.9	76.9	110.2	18.9
Iron and steel	MT	676.7	705.0	28.4	2.1	4.2	2.1
Aluminum wrought & worked		100.8	83.1	-17.7		-17.5	
All other metals articles		348.0	339.2	-8.8		-2.5	

