

6 External Sector

6.1 Overview

The improvement in the overall external accounts recorded during Q1-FY10 could not be sustained in the ensuing months (Oct-Feb). Considerable YoY fall in financial inflows in the latter period together with moderation in YoY contraction in current account deficit led to a noticeable deterioration in overall external account during this period (see **Table 6.1**). Nonetheless, overall external account recorded sizeable YoY improvement for the aggregate Jul-Feb FY10 period.

Close to half of YoY contraction in current account deficit during Jul-Feb FY10 was attributed to lower imports and related freight costs.

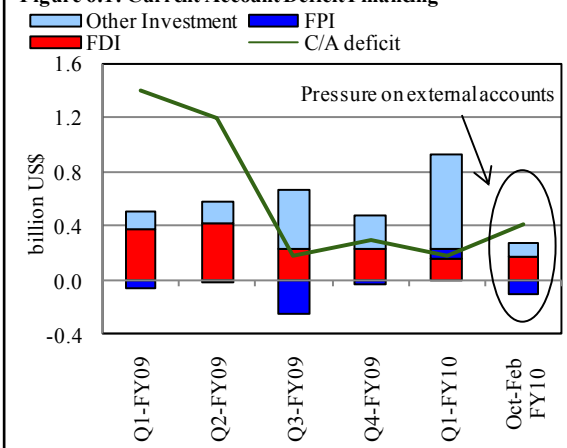
Fall in foreign exchange companies outflows, lower repatriation of dividends and strong rise in workers' remittances also contributed to the improvement in current account balance.

Fall in exports amid energy crises and subdued external demand offset a part of the above mentioned gains. Specifically, exports declined by 3.0 percent during Jul-Feb

Table 6.1: Summary of External Accounts (Jul-Feb)

billion US dollar	FY10			
	FY09	FY10	Jul-Sep	Oct-Feb
A-Current A/C balance	-8.0	-2.6	-0.5	-2.0
<i>i) Trade balance</i>	-9.5	-7.4	-2.8	-4.6
<i>Exports</i>	12.9	12.5	4.6	7.9
<i>YoY growth (%)</i>	2.1	-3.0	-19.1	10.1
<i>Imports</i>	22.3	19.9	7.4	12.5
<i>YoY growth (%)</i>	2.8	-10.8	-27.4	3.5
<i>ii) Invisible balance</i>	1.5	4.9	2.3	2.6
<i>Remittances</i>	4.9	5.8	2.3	3.5
B-Financial/Capital A/C balance	3.4	3.9	2.9	1.0
<i>i) FDI</i>	2.8	1.3	0.5	0.8
<i>ii) FPI</i>	-0.9	-0.3	0.2	-0.5
<i>iii) Other Investment</i>	1.4	2.6	2.1	0.5
C-Errors & omissions	0.0	-0.4	-0.4	0.1
D-Overall balance	-4.5	0.9	1.9	-1.0

Figure 6.1: Current Account Deficit Financing



FY10 against 2.1 percent increase in the corresponding period last year.

Most of the surplus in the financial account was also concentrated in the first quarter of FY10 (see **Figure 6.1**). Specifically of the US\$ 3.7 billion surplus during Jul-Feb FY10, US\$ 2.8 was accumulated in Q1-FY10, which included non-recurring US\$ 1.2 billion equivalent SDRs allocation by International Monetary Fund. In the later period (Oct-Feb) financial inflows fell considerably and accumulation was limited to only US\$ 0.8 billion.

Potential Risks

Oct-Feb FY10 developments in the external accounts indicate that while current account deficit has gone down compared to the same period last year, financing even this lower current account deficit is becoming difficult. The situation could become more serious in the months ahead as current account deficit has recorded month on month increase during Oct-Feb FY10.

While some part of this monthly deterioration owed to seasonal or one off factors, anticipated increase in imports led by domestic demand and high average import prices is likely to further weaken current account balance in the months ahead (see **Table 6.2**). Moreover, there is a risk that remittance inflows may further lose momentum as already evident from MoM decline.

Table 6.2: Potential Risks to External Outlook

Imports				
Commodity average prices ¹	H1-FY09	H2-FY09	H1-FY10	Jan-Feb FY10
Crude oil (US\$/barrel)	85.8	51.7	63.4	76.0
Palm oil (\$/MT)	640.8	627.5	660.6	748.2
Soybean oil (\$/MT)	966.1	769.2	804.8	839.4
DAP (\$/MT)	908.4	332.9	313.2	459.0
IMF metal price index (2005=100)	146.4	106.0	137.3	150.3
Workers' remittances				
	2007	2008	2009	FY10 ²
Kerb premium (Rupees)	0.6	0.4	0.1	0.7
	FY07	FY08	FY09	FY10 ³
Domestic GDP growth	6.8	4.1	2.0	3.3
International capital flows				
Pakistan's Euro bond yield ³	Dec-08	Jun-09	Dec-09	Feb-10
10-year bond (end period)	23.0	15.0	9.8	10.1
30-year bond (end period)	20.1	15.3	10.9	11.9

1: International Monetary Fund, 2: End Feb, 2010,

3: Bloomberg, p: projections

Table 6.3: Positive Factors for Exports Recovery

	2007	2008	2009	2010 ^p
Real GDP growth¹				
World	5.2	3.0	-0.8	3.9
Advanced economies	2.7	0.5	-3.2	2.1
United States	2.1	-0.4	-2.5	2.7
Euro Area	2.7	0.6	-3.9	1.0
Emerging & developing economies	8.3	6.1	2.1	6.0
China	13.0	9.6	8.7	10.0
Middle East	6.2	5.3	2.2	4.5
Cotton production (million bales) ²	12.9	11.7	12.1	12.7
REER (app(+)/dep(-)) ³	0.0	-0.7	-3.6	-
Average prices				
	H1FY09	H2FY09	H1FY10	Jan-Feb FY10
Cotton outlook 'A' index	147.6	126.6	149.8	173.4
Rice (\$/MT)	666.0	590.2	588.6	591.4

1: World Economic Outlook Update (January, 2010), 2: Fiscal year, 3: State Bank of Pakistan, p: projected

Current account balance is however, expected to benefit from the likely recovery in exports on account of some favorable developments (see **Table 6.3**).

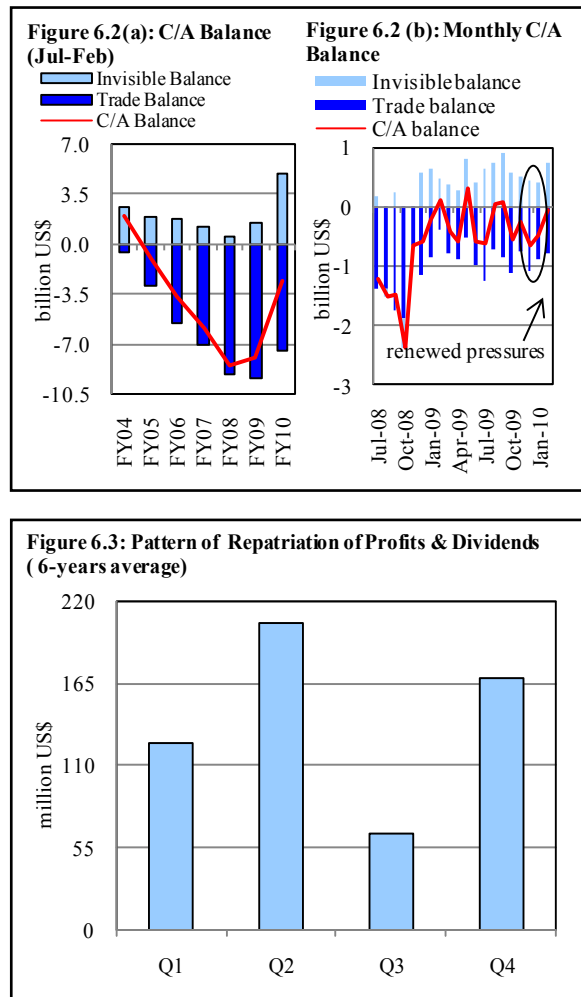
On the financing side, investment inflows are expected to remain weak amid impaired ability to tap international capital and uncertainty about realization of Tokyo pledges.

6.2 Current Account Balance

After widening continuously in the last five years, current account deficit recorded substantial YoY contraction (67.8 percent) during Jul-Feb FY10 (see **Figure 6.2a**). This improvement was largely driven by a considerable fall in imports and impressive increase in workers' remittances.

A bulk of this improvement in current account deficit was concentrated in Q1-FY10. In the subsequent months (Oct-Feb), pace of YoY improvement in current account deficit has noticeably slowed down, while month over month position is showing deterioration (see **Figure 6.2b**). Indeed, during December FY10 current account deficit reached the highest level in the last fourteen months.

While a large part of increase in monthly current account deficit is attributed to fall in invisible surplus, increase in imports also contributed. Fall in invisible surplus, in turn, was the result of both higher payments and lower receipts. The



former, mainly reflected increase in freight cost and seasonal payments of Hajj, dividends (see **Figure 6.3**)¹ and debt servicing whereas the latter largely owed to slowdown in remittances growth.

Further, the future path of imports and remittance also pose risk to current account outlook.

6.2.1 Trade Account²

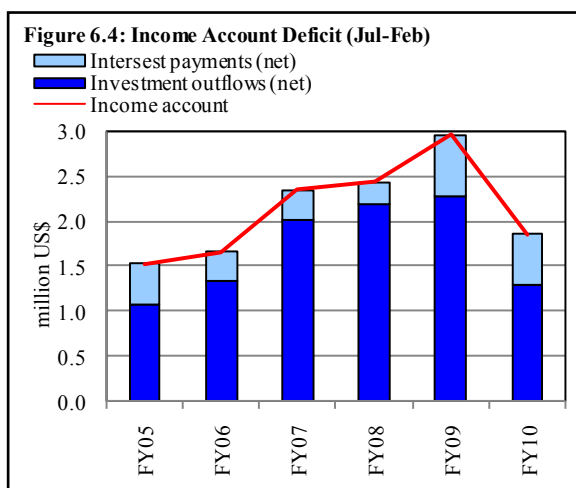
During Jul-Feb FY10, substantial fall in imports more than offset the decline in exports. As a result, trade deficit contracted by 21.3 percent during Jul-Feb FY10 against 3.7 percent expansion in the same period last year.

Lower import prices and weak economic activity were the key factors behind fall in imports during the period under review. Better cotton production and exchange rate depreciation also reduced demand for imports.

Although exports have recorded a YoY decline of 3.0 percent during Jul-Feb FY10, they have staged a comeback in October, 2009 onward. This recovery may be attributed to better cotton production amid poor international cotton crop, nascent recovery in major export markets and depreciation in real effective exchange rate. However, imports are likely to grow faster than exports in the remaining months of FY10, thus keeping trade deficit under pressure.

6.2.2 Services (net)

Services account deficit contracted by 37.4 percent during Jul-Feb FY10 compared with the same period last year. This contraction mainly reflected lower payments on account of



¹ Most of the foreign companies repatriate their profit and dividends on annual basis. As audit and other procedures take approximately three to four months, thus a major part of repatriation takes place in either second or fourth quarter depending on the financial years of the companies.

² This section is based on exchange record compiled by SBP that does not tally with more detailed custom data used in **sub-section 6.2**.

freight costs, travel expenses and other business services imports. This fall in freight costs followed a remarkable contraction in country's merchandise imports, whereas restrictions on foreign exchange companies' outflows largely explains lower payments of travel and other business services. Some of the improvement, however, was offset by seasonal increase in hajj related expenses (for details see **section on services**).

6.2.3 Income Account

Income account deficit declined by 37.3 percent during Jul-Feb FY10 against 21.6 percent expansion in the same period last year. While a larger part (88.8 percent) of this contraction emanated from fall in investment outflow (net), lower net interest payments also contributed to this decline (see **Figure 6.4**).

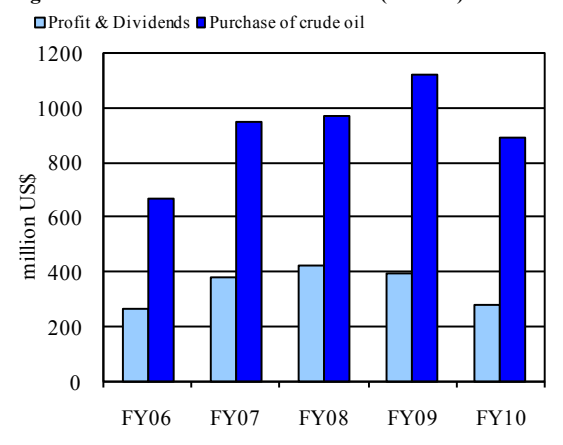
Table 6.4: Sector-wise Repatriation of Profits and Dividends (Jul-Feb)
million US dollar

	FY09			FY10		
	FDI	FPI	Total	FDI	FPI	Total
Petroleum refining	58.5	12.8	71.3	17.5	2.5	20.0
Oil & gas	20.8	39.3	60.1	6.6	19.1	25.6
Power	93.1	5.9	99.0	32.3	9.8	42.1
Trade	41.4	3.6	45.0	40.9	0.2	41.1
Communication	25.3	2.9	28.2	47.0	4.6	51.7
Financial business	16.5	16.5	32.9	7.7	10.1	17.8
Others	115.3	23.5	138.8	142.2	19.9	162.1
Total	370.9	104.4	475.3	294.3	66.2	360.5

Although a number of factors explains the fall in investment related outflows during the period under review, but most important among these are the circular debt and low average prices of oil and gas. For instance, circular debt hampered companies' operations by affecting their cash flows while low average oil and gas prices led to inventory and revenue losses.

The impact of these factors is more pronounced on purchase of crude oil and mineral (which is a function of oil & gas extraction and their prices), and dividends payments of oil and gas, petroleum refining and power sectors (see **Table 6.4**). Oil & gas extraction was also adversely affected by poor law & order situation and aging impact of oil fields. As a result, not only purchase of crude oil & minerals (which constitutes around 50 percent of overall investment related outflows) has fallen considerably

Figure 6.5: Investment Income Outflows (Jul-Feb)



(see **Figure 6.5**), but repatriation of profit and dividend of oil & gas sector has also reduced substantially.

Falling profitability of financial business amid weak economic growth is another factor behind lower repatriation of profit & dividends during the period. Moreover, nominal fall in foreign investment stock in equity markets may also have lowered repatriation of profit and dividends (see **Figure 6.6**).

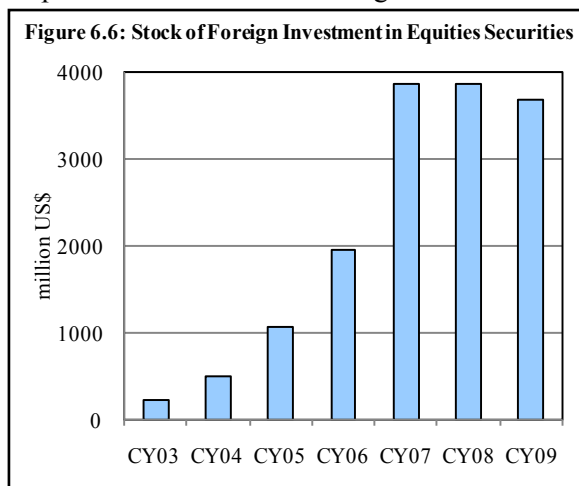


Table 6.5: Details of Interest Payments and Receipts (Jul-Feb)

million US dollar

	FY09	FY10	Q1	FY10 Q2	Jan-Feb
Payments (I+II)	807	642	213	331	98
I. Total external debt	635	559	181	296	82
Public & publicly guaranteed	527	436	144	239	53
Long-term	373	334	100	199	35
Military	2	0	0	0	0
Euro bonds	122	78	42	26	10
Commercial loans/credits	6	11	1	2	8
IDB	24	13	1	12	0
Private loans/credits	77	39	14	19	6
IMF	31	84	23	38	23
II. External liabilities	172	83	32	35	16
Foreign currency deposits	62	45	14	26	5
Special US\$ bonds	3	0	0	0	0
Central bank deposits	16	7	4	0	3
Others	91	31	14	9	8
Receipts	171	56	21	18	17
Interest on reserves	73	10	4	3	3
Others	98	46	17	15	14
Net	-636	-586	-192	-313	-81

Source: State Bank of Pakistan

The only exception to this fall in repatriation of profit & dividends was telecommunication sector which recorded an increase in repatriation of profit during Jul-Feb FY10.³

³ PTCL repatriated profit in Jul-FY10, after successful completion of its VSS scheme last year.

The decline in net interest payments, on the other hand, was entirely explained by fall in gross interest payments during Jul-Feb FY10 (see **Table 6.5**). Apart from the impact of a relatively lower international interest rate on the floating debt payments, fall in debt stock of relatively expensive IDB debt, Euro bond and private debt largely explains lower gross interest payments during the period.

Moreover, interest payments on foreign currency deposits also declined during the period under review.

However, a part of these gains was offset by increase in interest payments on IMF loan and decline in interest earnings on foreign exchange reserves.

6.2.4 Current Transfers

Led by remarkable increase in workers' remittances and higher inflows in Resident Foreign Currency Accounts (RFCAs), current transfer recorded a YoY growth of 17.8 percent during Jul-Feb FY10, compared with the decline of 2.2 percent in the same period last year (see **Figure 6.7**).

Workers' Remittances

Continuing last four years trend, workers' remittances recorded impressive growth in Jul-Feb

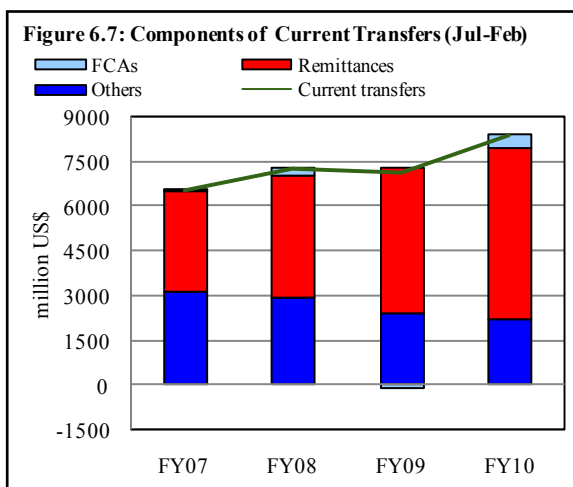


Table 6.6: Country-wise Workers' Remittances (Jul-Feb)
million US dollars

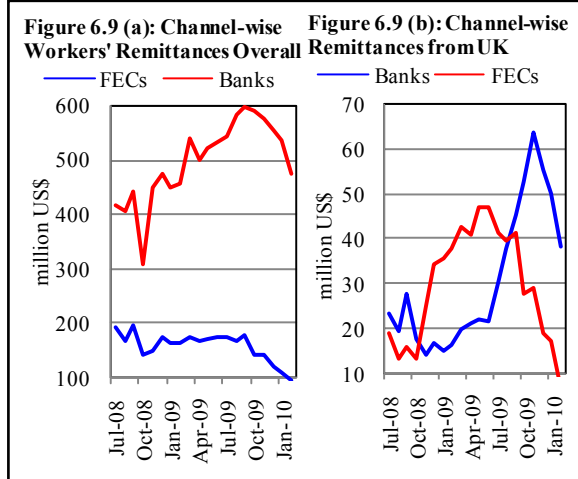
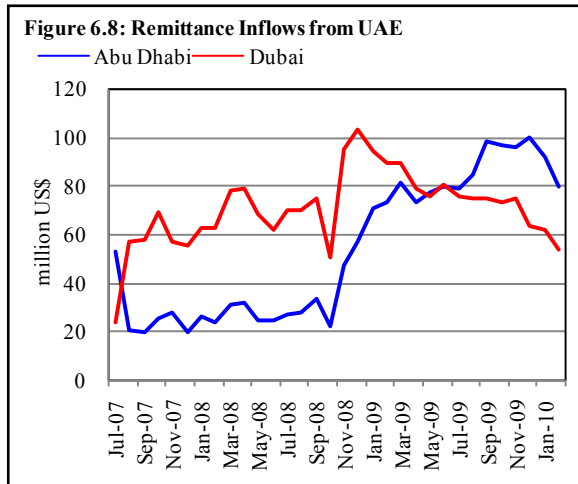
Countries	FY09	FY10	Share (%)	Contribution in growth (%age points)
Gulf region:	2781.2	3293.0	56.9	10.4
<i>Bahrain</i>	<i>99.6</i>	<i>101.0</i>	<i>1.7</i>	<i>0.0</i>
<i>Kuwait</i>	<i>287.9</i>	<i>297.1</i>	<i>5.1</i>	<i>0.2</i>
<i>Qatar</i>	<i>212.7</i>	<i>243.3</i>	<i>4.2</i>	<i>0.6</i>
<i>Saudi Arabia</i>	<i>962.3</i>	<i>1148.9</i>	<i>19.9</i>	<i>3.8</i>
<i>Oman</i>	<i>183.1</i>	<i>185.5</i>	<i>3.2</i>	<i>0.0</i>
<i>U.A.E.</i>	<i>1035.6</i>	<i>1317.2</i>	<i>22.8</i>	<i>5.7</i>
U.S.A.	1156.5	1173.4	20.3	0.3
U.K	344.1	596.3	10.3	5.1
Canada	51.6	71.6	1.2	0.4
Germany	57.5	61.8	1.1	0.1
Japan	4.3	3.0	0.1	0.0
Norway	24.8	15.8	0.3	-0.2
Others	498.6	572.2	9.9	1.5
Total	4918.6	5786.9	100.0	17.7

FY10. Specifically workers remittance increased by 17.7 percent during Jul-Feb

FY10 on the top of 17.3 percent average growth during the corresponding period of last four years.

Although a large impetus to this growth came from the gulf region and United Kingdom, USA and Canada also contributed positively (see **Table 6.6**). Within Gulf region, 55 percent of the increase was sourced from UAE and 36.5 percent came from Saudi Arabia.

Market sources suggest that Dubai (which depends on trade finance and real estate rather than oil & gas) was hard hit by recent global financial crises. As a result, the income of Pakistani migrants was squeezed amid cuts in their salaries and job losses. Thus some of the migrants facing job losses shifted to Pakistan while others sent their families back home.⁴ In the first case, migrants brought their savings with them while in the latter case the funds which were spent in Dubai are now remitted home to support their families. Some of such migrants have been successful in finding jobs in Abu Dhabi as is depicted by strong increase in remittance inflow from this state (see **Figure 6.8**). Increasing use of official channels in the wake of FIA actions against illegal fund transfer and various measures under Pakistan Remittance Initiative



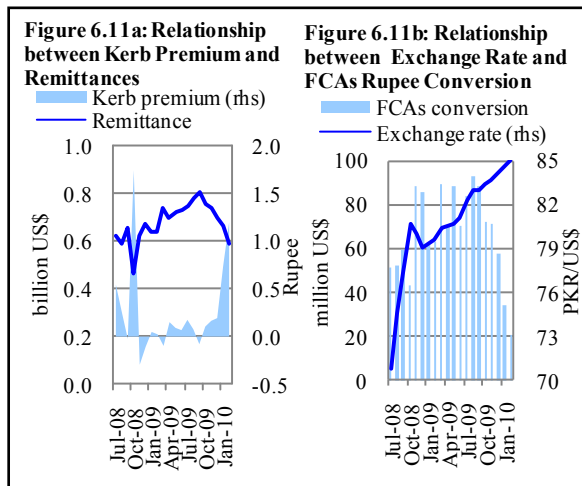
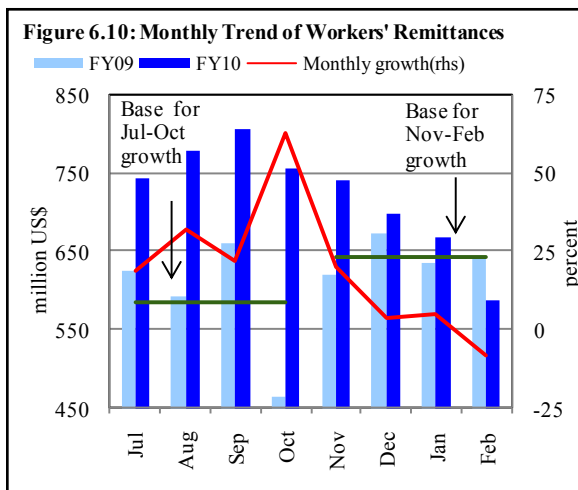
⁴ Migrants in UAE have contract based visas, so they become illegal as soon as they lose jobs. Such illegal migrants, who do not return home, face the risk of being apprehended and deported with no chance of recovering their possessions or savings. As a result, these workers send back all their income as fast as possible.

seem to be other probable reasons for surge in remittance inflows from UAE during the period under review.

Channel-wise data suggests that almost an entire increase in remittance during Jul-Feb FY10 was sourced from banking channel as remittance routed through foreign exchange companies recorded YoY fall during the period under review (see **Figure 6.9 (a)**). Higher remittances inflow through banking channel mainly reflects PRI's efforts to attract remittance through this channel. This effect is more pronounced in UK, where a large number of tie-ups are signed between banks and foreign entities (see **Figure 6.9 (b)**).

Recent Slowdown in Remittance

Monthly data shows that a large part of remittance growth was concentrated in Jul-Oct FY10, as ensuing months recorded considerable slowdown in remittance growth (see **Figure 6.10**). A combination of factors is responsible for this slowdown. On the one hand, high base set last year affected growth, and on the other hand expectations of exchange rate depreciation have slowed down remittances inflow during the period. The latter has impacted remittance in two ways: (a) it reduced FCAs rupee conversion (which is a part of workers' remittance) and (b) it led to increase in kerb market premium (see **Box 6.2**) thereby encouraging remittance inflow through informal channels (see **Figure 6.11**). Moreover, lack of processing in the last week of December 2009 on account of Ashura leaves followed by strikes against bomb blast also impacted remittances inflow

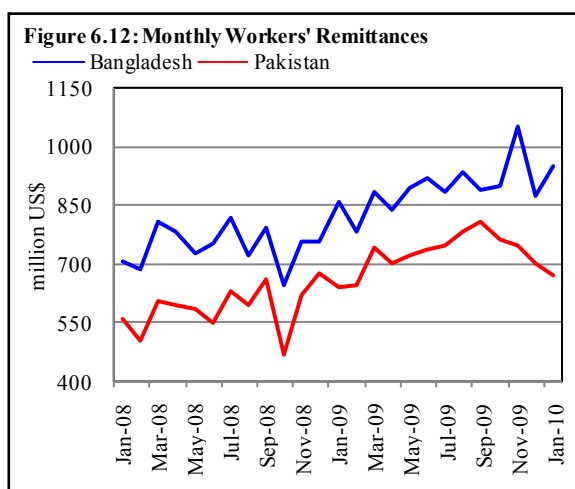


adversely.

Data analysis suggests that although slowdown in remittance growth during Nov-Feb FY10 was broad based, a large part of this slowdown emanated from fall in inflows through foreign exchange companies. Moreover, lower FCAs conversion of commercial banks (probably on account of expectations of exchange rate depreciation) and fall in remittance inflows through post offices also contributed to slow down in remittance growth during Nov-Feb FY10 period (see **Table 6.7**).

Table 6.7: Channel-wise Contribution in Remittance (YoY)			
Growth (percentage points)			
	FY10		
	Jul-Sep	Oct	Nov-Feb
Banks	24.9	60.8	12.3
<i>of which</i>			
Family maintenance	19.4	54.6	16.8
FCAs conversions	5.5	6.2	-4.5
FECs	-1.8	-0.2	-7.0
Post Offices	1.1	2.1	-0.3
Total	24.2	62.7	5.0

It may be pointed out that a part of remittance slowdown which was attributed to fall in FCAs rupee conversion is less worrisome as it has no impact on current account balance. In fact, fall in FCAs rupee conversion means increase in FCAs, which are also part of current account. However, considerable fall in remittance inflow through foreign exchange companies during Nov-Feb FY10 is worrisome as this may lead to increase in kerb market premium.



Still there is risk of downturn

Despite the fact that a considerable part of recent slowdown in remittance growth could be attributed to temporary factors, prospects of long slowdown in remittance are still there. This assessment mainly originates from possible lag response in remittance flow to slowdown in economic activities in the gulf (particularly

Dubai). This view gets some support from the fact that remittance in Bangladesh⁵ has also slowed down after strong surge in the crises period (see **Figure 6.12**).

On the positive side, with substantial recovery in oil prices in CY09, investment in huge infrastructure projects in Abu Dhabi and other oil rich gulf Emirates is expected to go on. Thus migrants losing jobs in Dubai would have an opportunity to move to these neighboring countries. This, in turn, may lower the risk of fall in remittance on account of construction slowdown in Dubai. Likewise, various measures under Pakistan Remittance Initiative (PRI) are also expected to have positive impact on remittance inflows (see **Box 6.1**).

Box 6.1: Pakistan Remittance Initiative's Strategic Alliance with Pakistan International Airlines

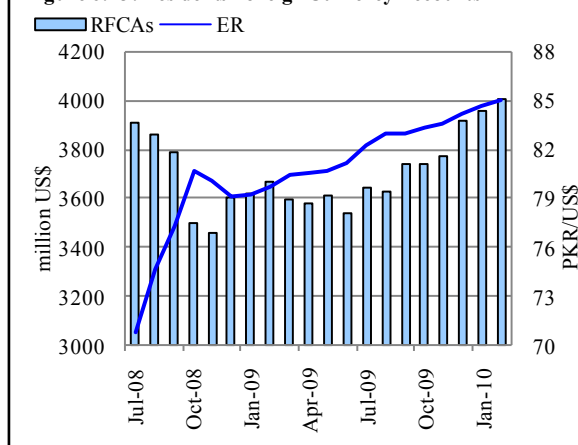
Under Pakistan Remittance Initiative, various measures are being taken to encourage and facilitate workers remittance flows through official channel. For instance, introduction of Real Time Gross Settlement (RTGS) in the major banks to enable them to transfer interbank transactions into the beneficiary account same day and increasing banks outreach by arranging their tie-ups with foreign entities had already been taken. As a part of these efforts, Pakistan's Remittance Initiative (PRI) has signed a Memorandum of Understanding (MoU) with Pakistan International Airlines (PIA) on December 29, 2009.

This strategic alliance will work in different phases. In the first phase, overseas Pakistanis will be given 100 free return air tickets through lucky draws. In the second phase, a frequent flyer card and miles program linked with the remittance transaction will be introduced. The card holders will be entitled to a number of privileges such as reserve seats and special gifts in the flights and business class services at check in counters, business class lounges and excess baggage allowance. Importantly, a small movie will also be shown in all the PIA flights to educate workers about the use and importance of remitting their earnings through official channel.

Resident FCAs

Resident Foreign Currency Accounts posted a sharp reversal during Jul-Feb FY10, from an outflow of US\$ 142 million during Jul-Feb FY09 to an inflow of US\$ 465 million during the period under review. The fall in FY09 was panic driven withdrawals following the

Figure 6.13: Residents Foreign Currency Accounts



⁵ Remittances flow to Pakistan is compared with that of Bangladesh as both have not only low profile migrants, but main source of remittance is also the same i.e. Gulf region

rumors that FCAs may be frozen in the country.

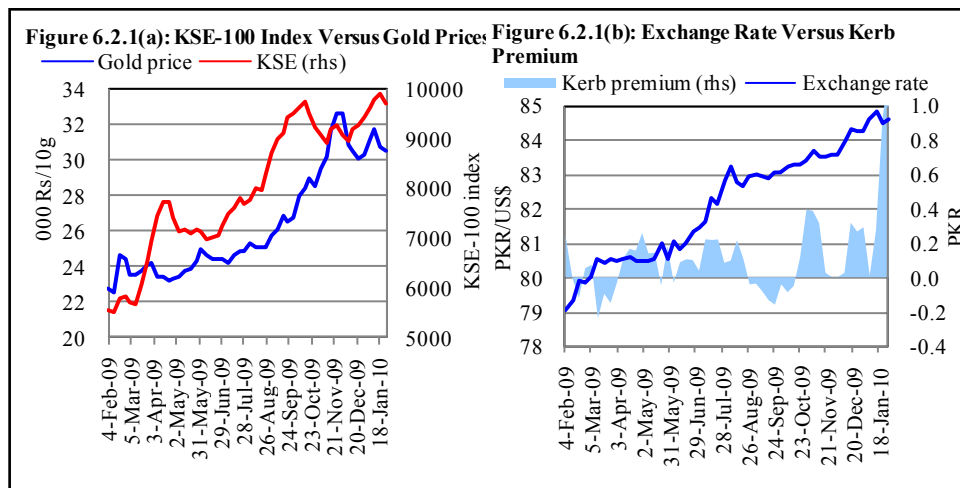
The recovery in RFCAs during Jul-Feb FY10, on the other hand, mainly reflects expectations of exchange rate depreciation and subsequent fall in rupee conversion of these accounts (see **Figure 6.13**). It may be pointed out that shifting of oil payments to interbank markets increased the exchange rate volatility; thereby some speculation. The major enterprises recording increase in their FCAs during the period include OGDC, KESC and UN mission..

Box 6.2: Short Investor's Behavior and Kerb Market Premium

Short investors in Pakistan usually invest in stock market, forex market or commodity market. As short investor behavior is also important for kerb market premium, it will be pertinent to analyze this behavior.

To study short investor behavior in three different markets, weekly average prices of US dollar, gold and KSE-100 index are plotted against kerb market premium. The data is used from Feb-2009 to Jan-2010.

The trend analysis suggests that the premium increases when increase in US dollar price is relatively higher than that of gold and stock index. Thus the magnitude of short investors influence on the premium mainly depends on price differential between US dollar and gold & stock market performance. For instance, kerb premium has increased considerably in December 2009 and January 2010 amid rising dollar price and either stagnant or declining gold price or KSE-100 index (see **Figure 6.2.1**).



This is in line with economic intuition. As when dollar price increases against other asset prices, short investor invests in dollar, thereby increasing its demand and premium. However, when price of US dollar increases less than that of gold and KSE-100 index, only a small number of short investors appears to invest in dollar, having little impact on kerb premium.

6.3 Financial Account Balance⁶

Financial account surplus recorded 10.1 percent increase during Jul-Feb FY10 compared to 40.0 percent decline in the same period last year.

During Jul-Feb FY10, financial inflows underwent a compositional change compared to the same period last year. While foreign direct investment constituted a major part of financial inflows (net) during the last year, financial inflows (net) in the current year mainly comprised of other investment (see **Figure 6.14**). Higher inflows in other investment, in turn, largely owed to one off SDRs allocation worth US\$ 1.2 billion, IMF bridge financing of US\$ 1.1 billion and realization of Tokyo pledges worth US\$ 0.2 billion.

Monthly breakup shows that financial inflows were mainly concentrated in Q1-FY10. In the subsequent months (Oct-Feb), Sukuk payments worth US\$ 600 million and IDB payment of US\$ 267 million kept the financial inflows under stress.

Net Foreign Investment (NFI)

Sharp fall in foreign direct investment along with payments of public sector sukuk bond led to a substantial decline in Net Foreign Investment (NFI) during Jul-Feb FY10. Specifically, NFI recorded 45.9 percent YoY fall during Jul-Feb FY10 compared to 33.5 percent fall in the same period last year (See **Table 6.8**).

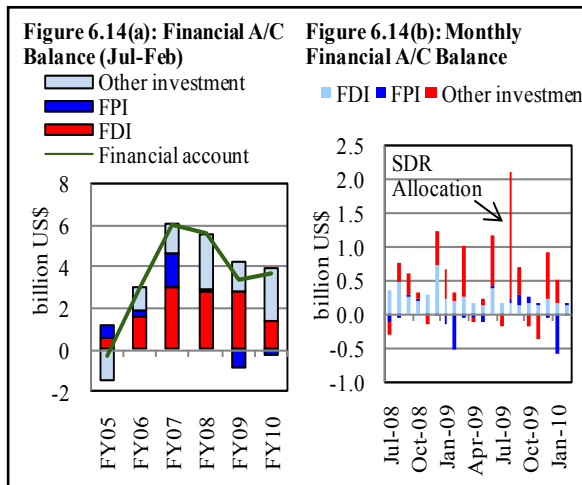


Table 6.8: Net Inflow of Foreign Investment in Pakistan (Jul-Feb)

million US dollar

	FY09	FY10	Growth (%)
Foreign investment	1,892.4	1,024.1	-45.9
I. Private investment	2,427.7	1,662.8	-31.5
Foreign direct investment	2,794.7	1,319.3	-52.8
Portfolio investment	-367.0	343.5	193.6
Equity securities	-367.0	343.5	193.6
Debt securities	0	0	0
II. Public investment	-535.3	-638.7	-19.3
of which: Debt securities*	-535.3	-638.7	-19.3

* Net sale/purchase of Special US dollar bonds, Eurobonds, FEBC, DBC, T bills and PIBs

⁶ It does not include use of IMF credit and loans (except bridge financing).

Foreign Direct Investment

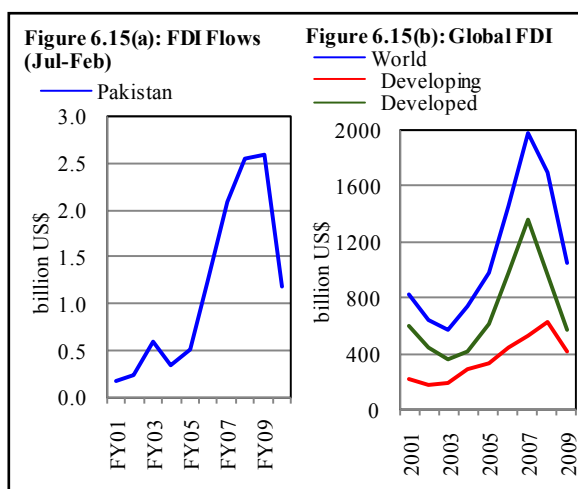
In line with global trends, Pakistan is witnessing substantive decline in foreign direct investment (see **Figure 6.15**). Globally, many companies are postponing their investments as a result of market uncertainty, contraction in their profitability and difficulty in obtaining credit.⁷ The impact of these developments on foreign direct investment flow to Pakistan was further

aggravated by hostile domestic factors such as energy crises, increasing security risk and weak economic activity. As a result, foreign direct investment recorded an extraordinary YoY decline of 52.8 percent during Jul-Feb FY10 compared to a nominal increase of 0.2 percent in the comparable period last year.

Close to one fourth of this decline was attributed to fall in reinvested earnings, which largely reflects either a fall in profitability or increase in losses. Moreover, considerable fall in merger & acquisition and decline in green field projects together contributed three fourth of the drop in overall FDI during the period.

Sector wise data shows that a large part (74.0 percent) of fall in overall FDI during Jul-Feb FY10 was driven by sharp fall in investment inflows to financial business and telecommunication. As a result, share of aforementioned sectors in overall FDI was reduced to 22.1 percent during Jul-Feb FY10 from 49.5 percent a year earlier. Apart from impact of negative reinvested earnings on account of companies' losses or lower profits, lower investment in equity in communication sectors owed to stiff competition and market saturation while investment in financial business was negatively affected by lack of mergers& acquisitions and repayment of intra-company loans.

Moreover, fall in investment in oil & gas exploration contributed around 4.9 percent of the overall fall in FDI during the period. Lower foreign investment in this sector is largely attributed to deteriorating law & order situation and circular



⁷ UNCTAD estimates show that global inflow of foreign direct investment fell by 39.0 percent during 2009.

debt issue which constrained the companies' operations. Likewise, circular debt issue also appears to be the dominant reason behind lower foreign investment in petroleum refining during the period (see **Table 6.9**).

Table 6.9: Sector -wise Foreign Direct Investment (Jul-Feb)
million US dollar

Sectors	FY09			FY10		
	Cash	Re-invested earnings	Total	Cash	Re-invested earnings	Total
Chemicals	2.4	38.6	41.0	43.5	33.7	77.2
Petroleum refining	20.5	53.5	74.0	11.0	25.4	36.4
Oil & gas explorations	321.5	149.5	471.1	315.5	83.8	399.3
Cement	9.0	21.9	30.9	0.1	6.2	6.2
Power	82.4	-8.0	74.3	93.8	22.0	115.8
Construction	45.6	-2.7	42.8	75.7	-3.6	72.1
Trade	90.3	31.2	121.5	39.3	9.6	48.9
Telecommunications	735.8	1.1	736.9	267.3	-61.9	205.4
Financial business	473.1	174.4	647.5	87.5	-1.1	86.5
Personal services	60.4	3.2	63.6	31.5	2.8	34.2
Others	364.3	126.8	491.1	207.4	30.0	237.3
Total	2205.2	589.5	2794.7	1172.5	146.8	1319.3

Sectors attracting higher FDI

Power, construction and chemical sectors, on the other hand, recorded YoY increase in foreign direct investment during Jul-Feb FY10. Higher investment in power sector was mainly routed to KESC project at Port Qasim and Uch power project, while higher investment in chemical largely channeled to a large FMCG multinational company. Likewise, higher investment in construction sector mainly channeled to road and bridges and one of the major construction companies in Karachi.

Country-wise FDI

While FDI from almost all the major sources declined during Jul-Feb FY10 compared with the same period last year, bulk of this decline (72.5 percent) was recorded from Mauritius, Malaysia, Singapore, United States and Switzerland.

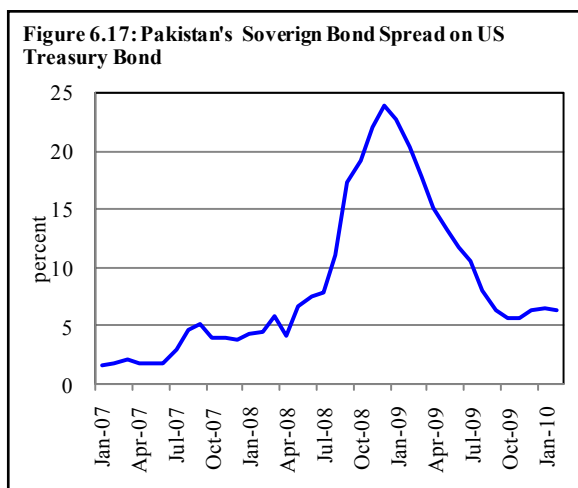
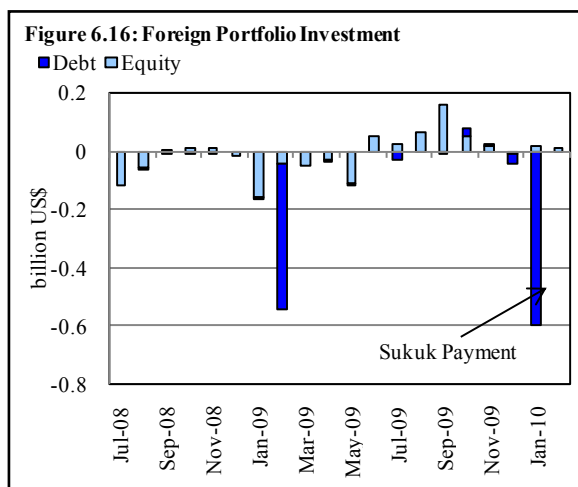
Foreign Portfolio Investment

Foreign portfolio investment recorded a net outflow of US\$ 295 million during Jul-Feb FY10 compared to net outflow of US\$ 902 million in the corresponding period last year. Although investment in equity market showed some revival, this

was more than offset by Sukuk bond payment worth US\$ 600 million during the period (see **Figure 6.16**).

It may be pointed out that revival of investment in equity market was largely concentrated in Jul-Oct FY10, when Pakistan's credit rating was improved by international credit rating agencies following its re-entry into MSCI frontier market index and considerable increase in its reserves mainly on account of SDRs allocation.

However, it slowed down considerably in the subsequent months probably on the back of lower return on stock market investment, relatively higher exchange rate fluctuation and rising security concerns. Moreover, yield spread on Pakistan's sovereign bond has also witnessed an uptick in the latter period (Nov-Feb) (see **Figure 6.17**).



Other Investment

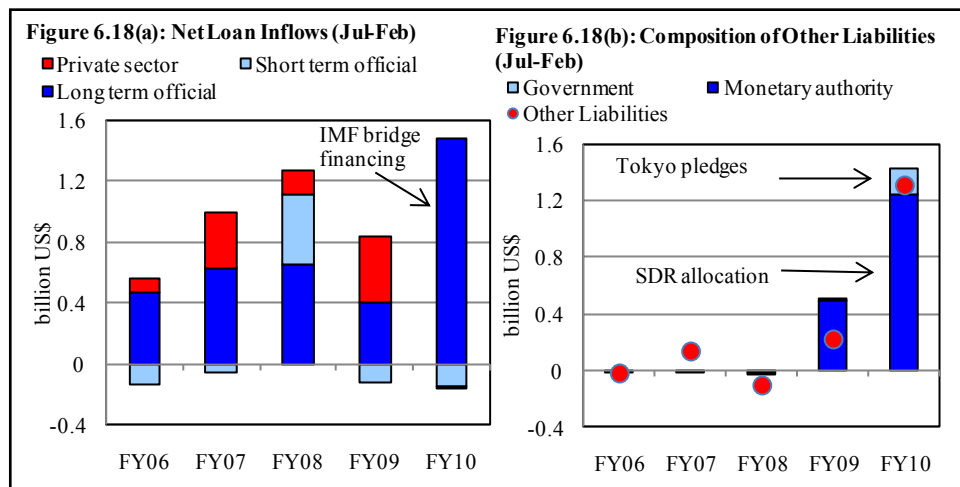
Net inflow in other investment almost doubled to US\$ 2.6 billion during Jul-Feb FY10 compared with the same period last year. Almost the entire increase was attributed to substantive increase in liabilities, while asset side⁸ had negative impact on the other investment.

Other investment assets increased by US\$ 44 million during Jul-Feb FY10 compared with US\$ 544 million decline in the comparable period last year.

⁸ Increase in assets abroad is recorded as dollar outflow and vice versa.

Relatively higher decline last year was mainly attributed to considerable fall in outstanding exports bills in the wake of weak exports. During Jul-Feb FY10, however, outstanding exports bills have increased following respectable recovery in exports. However, a large part of this increase was offset by considerable fall in commercial bank trade nostros. It may be pointed out that shifting of oil payments to interbank market is putting enormous pressure on commercial bank trade nostros.

Increase in other investment liabilities, during Jul-Feb FY10, was chiefly explained by higher net inflows of long term official loans and other liabilities (see **Figure 6.18**). The former was largely attributed to IMF bridge financing loan while latter was the result of IMF SDRs allocation (US\$ 1.1 billion) and realization of Tokyo pledges (US\$ 200 million) from Saudi Arabia.



However, net payments of short term official loan and private loans⁹ offset a part of the higher long term official net loan inflows during the period. It may be mentioned here that net payments of official short loans would have been even higher, had it not been for the rollover of IDB loan repayment (US\$ 323 million) due in December, 2009.¹⁰

⁹ Major payments Packages limited (US\$ 30 million), Pakistan mobile communication (US\$ 23 million), Pak refinery limited (US\$ 18.5 million).

¹⁰ The loan is rollover for six months.

6.4 Services Trade

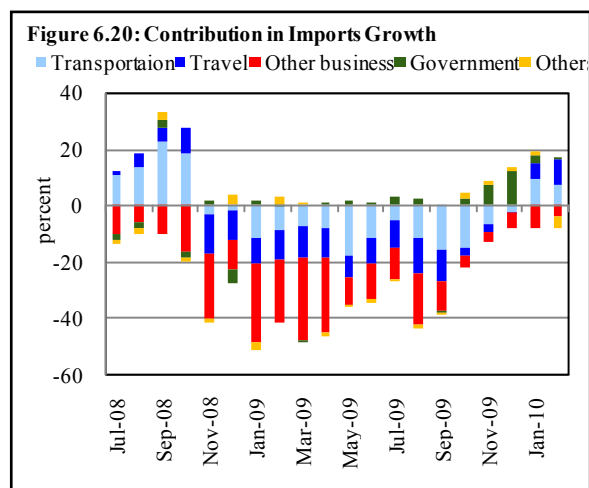
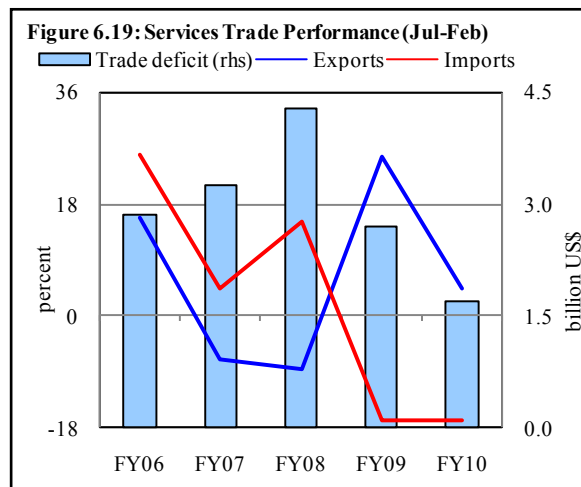
Pakistan's services trade deficit shrunk by 37.4 percent during Jul-Feb FY10 as compared to 37.3 percent contraction recorded in the same period last year. The fall in services trade deficit was due to 16.4 percent YoY fall in services imports bill and 4.4 percent YoY increase in services exports (see **Figure 6.19**).

The contraction in services imports was a result of combination of fall in transportation services which declined due to lower merchandise imports & lower passage payments to foreign airlines and outflows restrictions on foreign exchange companies (see **Figure 6.20**).

In services exports, apart from transportation, travel, computer & information services groups, all other major sub-groups including communication, financial, other business and government services recorded increase during the period under consideration.

Services Exports

Pakistan's services exports witnessed a mild increase of 4.4 percent during Jul-Feb FY10 as compared with a significant rise of 25.6 percent in the same period last year. While telecommunication, financial and government services exports recorded strong growth, the overall rise in invisible receipts was limited due to the poor export performance witnessed by the transportation and travel services sub-groups. During Jul-Feb FY09, the overall services exports grew on account of



high passage earnings of national airline, increased expenses of foreign transport companies domestically and higher travel services exports (see **Table 6.10**).

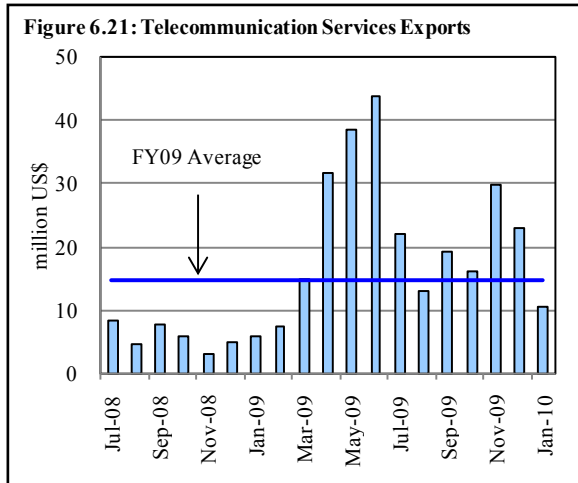
Table 6.10: Major Services Exports (Jul-Feb)
million US dollars

	Absolute value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	931	759	37.1	-18.5	35.5	27.7
Travel	227	191	27.5	-15.9	8.7	7.0
Other business	334	339	18.2	1.5	12.7	12.4
Communication	62	160	-28.2	158.1	2.4	5.8
Computer & info.	127	126	34.9	-0.8	4.8	4.6
Financial	45	77	52.8	71.1	1.7	2.8
Government	823	1038	25.1	26.1	31.4	37.9
Total	2621	2737	25.6	4.4		

Transportation services exports fell by 18.5 percent during Jul-Feb FY10 against an impressive growth of 37.1 percent in the same period last year. The fall in exports of this category was on account of lower passage and freight earnings and reduced local operations of foreign transport companies. However, some recovery in transportation services exports is evident in the last couple of months.

Communication services exports posted remarkable increase of 158.1 percent during Jul-Feb FY10 as against 28.2 percent decline in the corresponding period of last year. The growth in the groups' exports was an outcome of Pakistan Telecom Authority (PTA) efforts to eliminate illegal traffic (grey telephony) in the country.¹¹

PTA has taken number of steps both regulatory and technical with the coordination of LDI stakeholders curb illegal traffic, which has led to increase in country's exports (see **Figure 6.21**).



Other business services

exports witnessed decline of 1.5 percent during Jul-Feb FY10 as compared to the

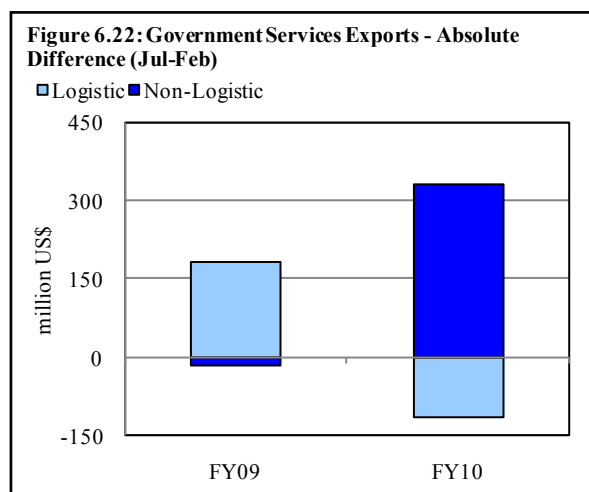
¹¹ Grey telephony is a term referred to the illegal telecom traffic in which calls from foreign countries are brought in the country as local calls while using illegal means.

strong growth of 18.2 percent in the same period of last year. This decline is attributable to the fall in *agency commission, architect & technical services* and *miscellaneous items*.

Government services exports increased by 26.1 percent owing to the remarkable performance of non-logistic sector during the period under analysis.

Logistic support declined to US\$ 349 million during Jul-Feb FY10 as compared to the US\$ 465 million in the same period last year. The entire inflow under this head was recorded in February 2010.

On the contrary, non-logistic support recorded healthy increase (see **Figure 6.22**). Among the non-logistic support, *remittances received by foreign missions in Pakistan* increased by 36.3 percent during Jul-Jan FY10 as compared to the decline of 16.5 percent in the same period last year. Foreign missions had curtailed their activities last year due to worsening of law & order situation. During Jul-Jan FY10, a part of the rise could be attributed to increase in the diplomatic operations of the US. Reportedly US has stepped up its operations in Pakistan for which it has been spending on securing its embassies and consulates.



Services Imports

Falling transportation services imports coupled with SBP's stringent check on foreign exchange companies' outflows led to 16.8 percent contraction in the invisible import bill during Jul-Feb FY10, compared with the fall of 16.7 percent in the corresponding period of last year (see **Table 6.11**).

Fall in the foreign exchange companies' outflows was particularly pronounced and contributed 73.1 percent to the fall in the overall services import bill during Jul-Jan FY10. Lower merchandise imports and reduced passage earnings of foreign airlines also contributed 40 percent to the fall in overall services imports.

Table 6.11: Major Services Imports (Jul-Feb)

million US dollar

	Absolute Value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	2608	2234	10.8	-14.4	49.0	50.5
Travel	827	580	-21.2	-29.9	15.5	13.1
Other business	1165	708	-47.4	-39.2	21.9	16.0
Government	230	413	-16.4	79.6	4.3	9.3
All others	489	493	-1.3	0.8	9.2	11.1
Total	5319	4427	-16.7	-16.8		

Among the **transportation services**, the largest decline was recorded in freight payments on merchandise imports, which contracted by US\$ 204 million followed by the US\$ 116 million fall in passage earnings of foreign airlines during Jul-Jan FY10.

Likewise, **travel services payments** and **other business services payments** declined on account of outflows restriction on foreign exchange companies during Jul-Feb FY10. The fall in the travel services payments was also due to lower Hajj payments (under the head religious travel) which fell by 16.0 percent during Jul-Jan FY10 as compared to an increase of 10.4 percent during the same period last year. This was attributed to decline in the number of pilgrims by 5000 compared to the year before.

Monthly data reveals that the pace of decline in invisible imports has slowed down, which suggests that services imports are likely to pick up in the remaining months of FY10 on account of recovery in merchandise imports.

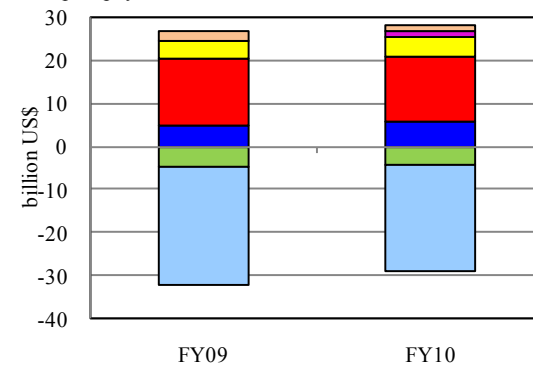
6.5 Foreign Exchange

Reserves

Pakistan's foreign exchange reserves improved significantly during Jul-Feb FY10, reaching US\$ 15.1 billion against US\$ 10.6 billion in the same period last year. With current account deficit declining considerably compared to the last year, the pressure on the country's reserves was visibly lower. Thus despite lower loan inflows and FDI, Pakistan was

Figure 6.23: Reserves Inflows and Outflows (Jul-Feb)

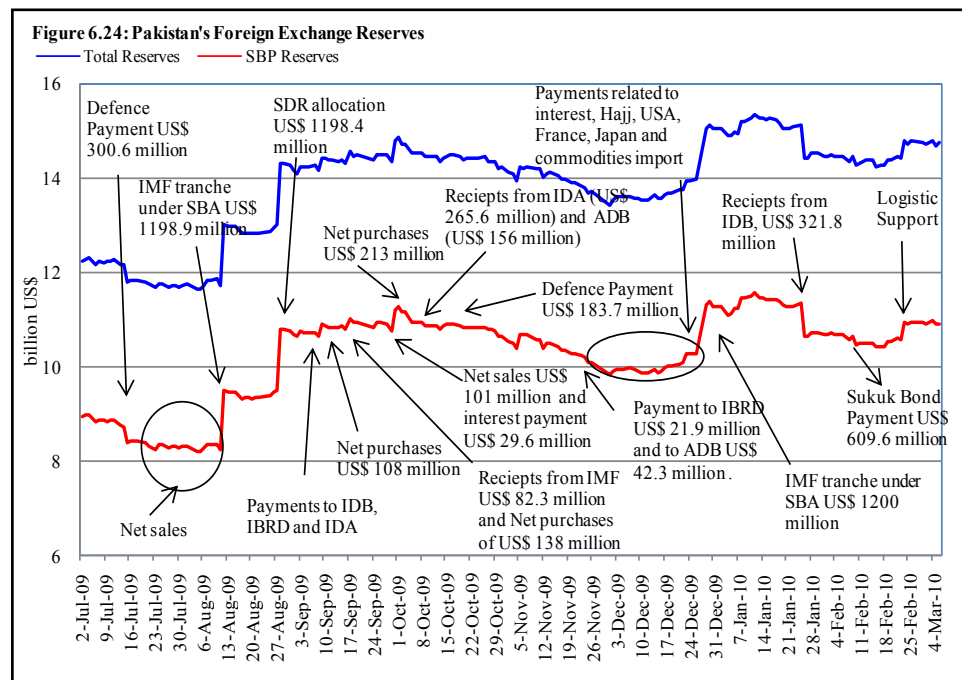
■ Remittances ■ Export proceeds ■ Loans
■ SDR allocation ■ Foreign investment ■ Debt servicing
■ Import payments



able to add US\$ 2.3 billion to its reserves during Jul-Feb FY10 (see **Figure 6.23**). A part of the rise in reserves was however, due to enhancement of SDR allocation equivalent to US\$ 1.2 billion by the IMF.

Of the US\$ 2.3 billion increase in the overall reserves, SBP reserves increased by US\$ 1.7 billion, while that of the scheduled banks increased by US\$ 525 million.¹²

Major inflows to SBP reserves during Jul-Feb FY10 came from IMF disbursements under Stand-By Arrangement and one-off SDR allocation. Shifting of oil related payments to interbank market also contributed to accumulation of reserves. **Figure 6.24** illustrates impact of major inflows and outflows on SBP reserves.

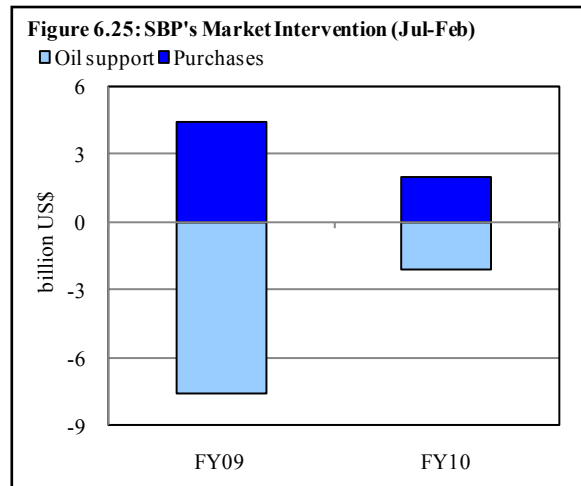


It may be recalled that in Nov-2004 to curtail speculative pressures on the domestic currency SBP had committed to provide foreign exchange to interbank market for oil related payments. Following this decision Pakistan recorded healthy buildup of forex reserves. This measure was continued as it ensured stability in exchange rate. However, starting Q2 FY08, the forex inflows started

¹² The methodology of calculating SBP reserves has changed on the recommendation of IMF. Claims on RBI are now excluded and cash foreign currency is included.

to dry up, putting domestic currency and SBP reserves under severe stress. Political pressures however, restrained SBP from rolling back what was essentially a temporary arrangement. Consequently, SBP reserves depleted sharply; over US\$ 10 billion of SBP's reserves depleted between Oct 07 and Oct 08.

Finally, as a part of the structural adjustment program in Nov-2008, SBP was allowed to gradually withdraw from its market support arrangement. The phased withdrawal was completed in December 2009 ahead of the schedule. This has had two fold benefits: (1) it allowed the exchange rate to become more responsive to market conditions and (2) it has stopped the drain of SBP reserves (see **Figure 6.25**).¹³



The commercial banks' foreign exchange reserves principally comprise of their foreign currency deposits after adjusting for outstanding FE-25 loans. During Jul-Feb FY10, commercial banks' reserves recorded US\$ 525 million rise as compared to the rise of US\$ 599 million during the same period of FY09.

This rise in the reserves of the commercial banks during Jul-Feb FY10 was largely on account of: (1) increase in foreign currency deposits; and (2) retirements of foreign currency loans.

Foreign currency deposits of the commercial banks largely reflect the rise in the deposits of OGDC, KESC, Pak Arab Refinery, BP Pak Explorations, UN Missions etc. This increase in foreign currency deposits was due to the lower US\$ conversions into Pak Rupee probably in anticipation of exchange rate depreciation. This argument is further strengthened by the overdrawn nostro accounts of commercial banks despite the 17.7 percent increase in workers' remittances. Both the workers' remittances and foreign currency deposits

¹³ SBP has shifted oil payments to interbank market vide three circulars in 2009 e.g. FE circular No.2 dated January 15, 2009, FE circular No.3 dated July 15, 2009 and FE circular No. 9 dated December 05, 2009.

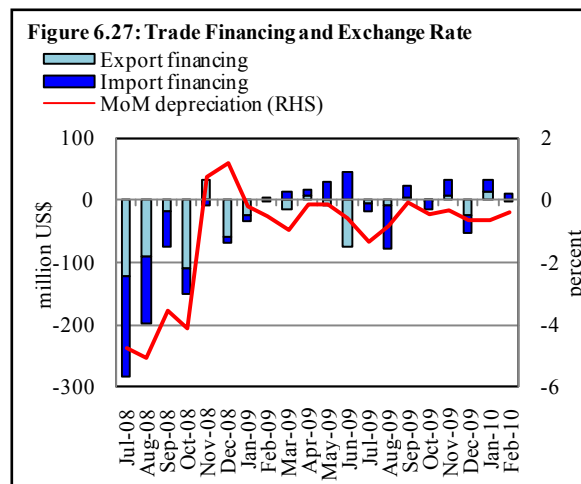
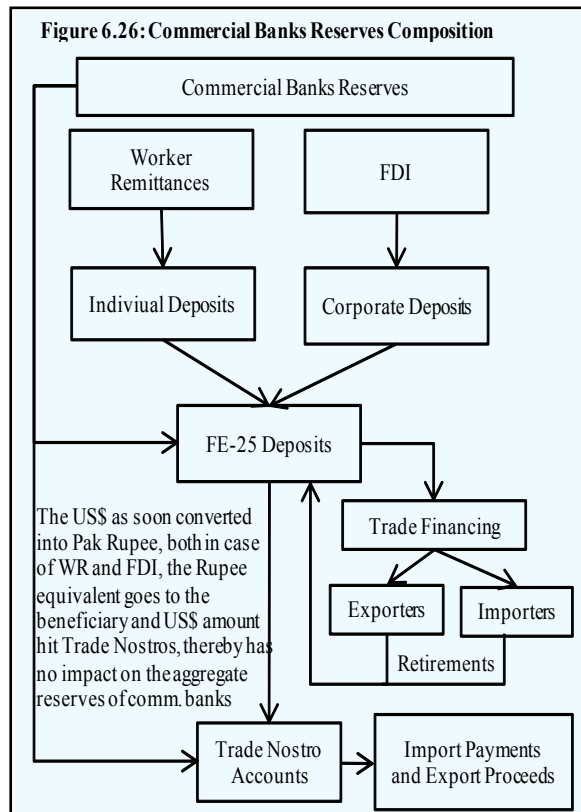
ultimately hit the trade nostro accounts of scheduled banks at conversion to local currency (see **Figure 6.26**).

Another factor which contributed in the increase of commercial banks' reserves was the retirement of foreign currency loans availed by the traders during Jul-Feb FY10. The pressures on the exchange rate first in July 2010 and later in December 2010 proved to be a disincentive for availing foreign currency loans (see **Figure 6.27**). Both importers and exporters opted to retire FC loans. This is also reflected in the rise in EFS disbursements during Jul-Jan FY10.¹⁴

Adequacy of Reserves

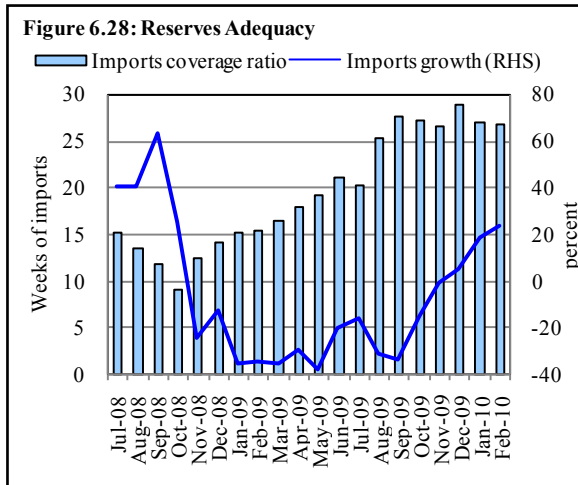
The adequacy of reserves in terms of weeks of imports increased considerably from 9 weeks at end Oct-2008 to 26.7 weeks at end-Feb 2010 (see **Figure 6.28**).

A combination of the rise in reserves and fall in the import bill led to this rise in the import coverage ratio. Interestingly, imports started to decline from November 2008, the same month when



¹⁴ EFS disbursements in Q2-FY10 have increased for commodities like rice, bedwear, readymade garments, towels, cement etc.

Pakistan entered into Stand-By Arrangement with IMF and received the first tranche of US\$ 3.0 billion. With imports declining continuously improvement in the import coverage ratio was quite significant, however Oct-09 onwards the imports have started to rise again whereas the built up of reserves has also slowed down. As a result the import coverage ratio has more or less stabilized at around 27 weeks.



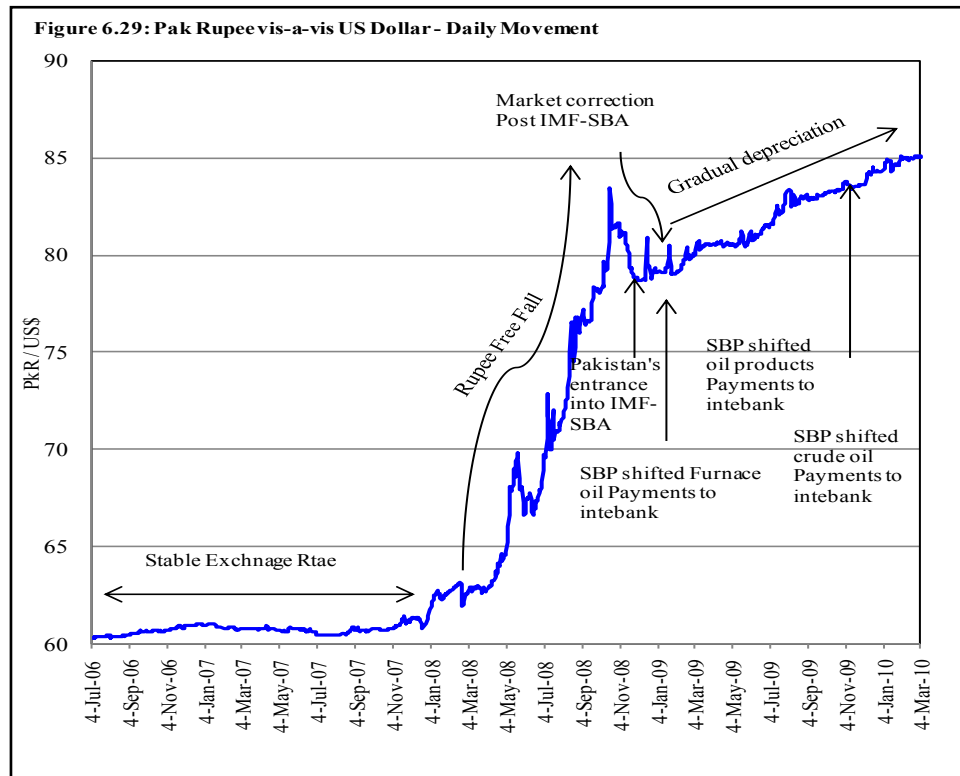
6.6 Exchange Rate

Flexible exchange rate plays an important role in correcting the external imbalances, however, excess volatility in the exchange rate is undesirable as it inhibits investment decisions and gives rise to speculative activities.

Notwithstanding the benefits of a flexible exchange rate regime, the general public perception regarding depreciation of domestic currency is almost always negative. As such the decision to let the currency freely float is politically difficult and governments usually tends to avoid such moves especially when its impact on the external accounts is also ambiguous.

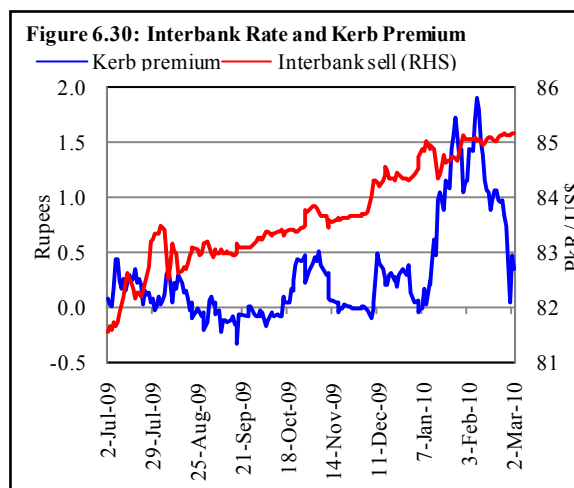
Exchange rate is a sensitive issue in Pakistan also, as it is perceived to be an indicator of performance of the government and its economic managers. Thus even as Pakistan's external position started to deteriorate rapidly from Nov 2007 onwards; necessary adjustments in the exchange rate required to correct external imbalances were avoided. However, by Jan 2008 market pressures were able to dictate the value of exchange rate causing exchange rate to depreciate rapidly.

Market conditions and Pakistan's entry into structural adjustment program paved the way for adaptation of a more flexible exchange rate regime. The gradual depreciation of Pak rupee post November 2008 is essentially a reflection of shift in the exchange rate regime (see **Figure 6.29**).



Relatively lower depreciation of 4.3 percent during Jul-Feb FY10 as compared to 14.5 percent depreciation last year was a function of lower trade deficit and robust workers' remittances.

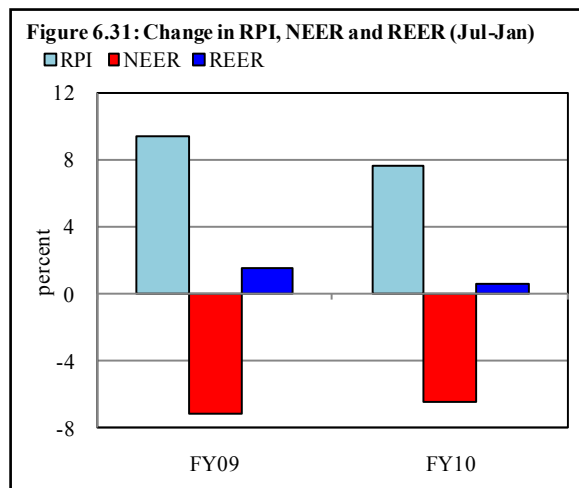
Although in overall terms the depreciation of Pak rupee during Jul-Feb FY10 was gradual, market did react to shifting of oil payments (see **Figure 6.29**). Speculative pressures were evident as reflected by the rise in kerb premium prior to preannouncement shifting date. Perhaps this prompted SBP to shift the remaining oil payments in December ahead of the scheduled date in February.



The rise in the kerb premium in January 2010 was therefore surprising as there were no apparent market pressures (see **Figure 6.30**).

While the nominal depreciation of the Pak rupee during Jul-Jan FY10 was lower than the corresponding period last year, the relatively lower inflation translated into higher gains in real terms.

Specifically, Pakistan's relative prices increased by 7.6 percent during Jul-Jan FY10, against 9.4 percent rise during the same period last year. This rise was little higher than the nominal depreciation of 6.5 percent thus causing the real exchange rate to appreciate by 0.6 percent (see **Figure 6.31**). The real appreciation of the domestic country could have adverse impact on the country's exports.



The value of Pak rupee against the major currencies i.e., Euro, Pound and Yen is determined indirectly after conversion of these currencies in US dollars. Thus their rates against Pak currency depends on the performance of these currencies against the US\$ and the parity of Pak rupee against the US\$.

The recovery of US dollar against Euro and Pound (in Jan-Feb 2010) and relatively lower depreciation of Pak rupee against the dollar caused the domestic currency to appreciate against Pound and depreciate only slightly against Euro (see **Table 6.12**). Euro has lost its value vis-à-vis US dollar due to sovereign debt problems surrounding Greece and other peripheral euro zone economies.

Table 6.12: Dep(-)/App(+) Against Major Currencies
percent

	Jul-Jan FY09	Jul-Jan FY10	Jul-Feb FY10
US Dollar vis-à-vis			
Yen	-15.8	-6.4	-4.2
Pound	39.3	2.6	7.6
Euro	23.0	1.2	4.5
Pak Rupee vis-à-vis			
Yen	-26.7	-9.8	-8.5
Pound	18.6	-0.2	3.1
Euro	6.4	-2.3	-0.5

However as dollar remained relatively weak against yen because lower US dollar interest rates have kept the dollar unattractive, the depreciation of Pak currency against yen was significant.

6.7 Trade Account¹⁵

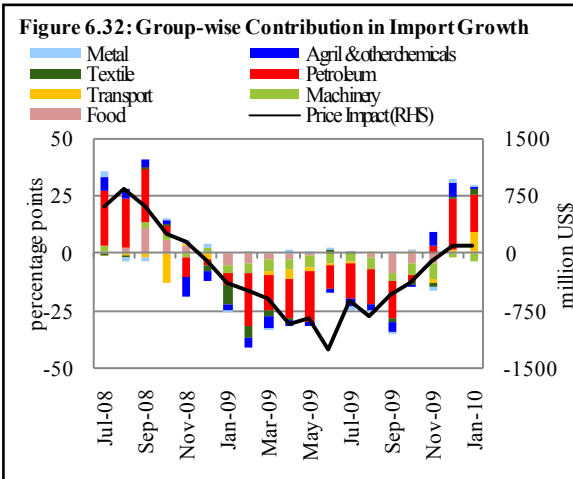
Pakistan's trade deficit contracted by 19.5 percent YoY during Jul-Feb FY10 as compared with the decline of 6.2 percent YoY in Jul-Feb FY09. The main contributor in contraction of trade deficit was the 8.2 percent YoY fall in import growth which was complemented by a small improvement in exports during the period under review.

The compression in import bill is attributed to a decline in both POL as well as non-POL imports (see **Table 6.13**). Group-wise contribution in import growth shows that fall was broad-based (see **Figure 6.32**) through most of the period under review owing to a significant negative price impact which overshadowed the impact of rising import quantum.¹⁶

Recovery in exports was observed both in textile as well as non-textile sectors

Table 6.13: An Anatomy of Trade Deficit (Jul-Jan)

changes in million US dollars;			
	FY08	FY09	FY10
Trade deficit (bln US\$)	10.3	10.8	8.5
Exports (bln US\$)	10.1	10.8	10.8
Imports (bln US\$)	20.4	21.6	19.3
Change in exports	539.4	697.7	50.7
of which change in			
<i>Textiles exports</i>	-185.9	-242.8	131.9
<i>Non-Textile exports</i>	725.2	940.4	-81.2
Change in imports	3255.8	1165.5	-2330.3
of which change in			
<i>POL imports</i>	782.3	1468.1	-828.7
<i>Non-POL imports</i>	2473.5	-302.6	-1501.6



¹⁵ The analysis is based on provisional data provided by the Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section on *Balance of Payment*.

¹⁶ During Jul-Jan FY10, the price impact was US\$ -2340.7 million, whereas quantum impact was 721.9 million US\$. Price and quantum impact encompass 54 percent of the total imports as quantum data for the rest of import items is not published.

particularly in Q2-FY10 (see **Figure 6.33**). Revival in textile's external demand coupled with good production of cotton¹⁷ resulted in high exports of low value added products.¹⁸ In the non-textile sector, food group quantum growth in particular was remarkable during the period under review with major contribution coming from rice and fruits.

Improved external demand,¹⁹ recovery in industrial production and depreciation of domestic currency bode well for exports. However structural issues like power shortages and tough competition from regional economies, particularly in textile sector, may impede export growth. On the other hand, import growth seems to have rebounded from Q2-FY10. Recovery in international commodity prices coupled with revival in domestic demand is likely to increase the import bill during the remaining months of FY10.

Exports

Exports posted modest growth of 2.7 percent YoY during Jul-Feb FY10 in contrast to a slightly higher growth rate of 3.5 percent during the corresponding

Figure 6.33: Contribution in Export Growth

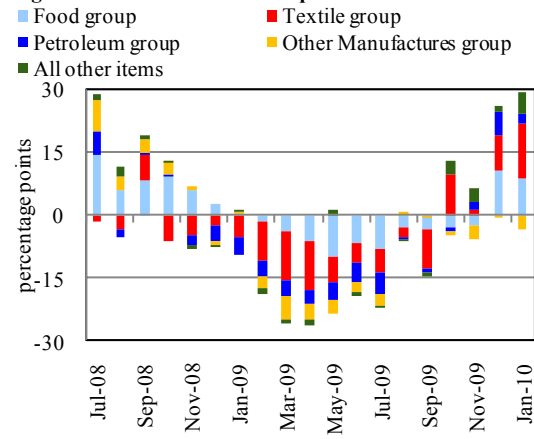
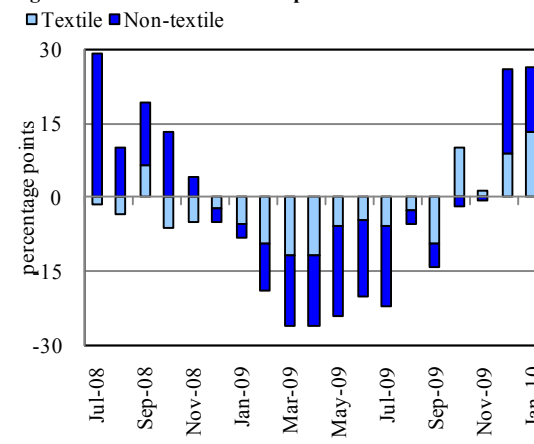


Figure 6.34: Contribution in Exports Growth



¹⁷ Production of cotton in FY10 is estimated at 12.7 million bales in contrast to production of 12.1 million bales during FY09.

¹⁸ Export growth of raw cotton and cotton yarn grew by 142.0 and 38.0 percent YoY during Jul-Jan FY10.

¹⁹ GDP growth of US and EU improved from -2.3 to 0.1 and -4.1 to -2.1 percent in Q2-FY10.

period last year. The gradual improvement observed from the start of Q2-FY10 is attributed to a rise in export quantum of rice, fruits and raw cotton. Revival in global demand, especially for textile products²⁰, also kept textile's contribution in exports growth positive (see **Figure 6.34**)

Non Textile Exports

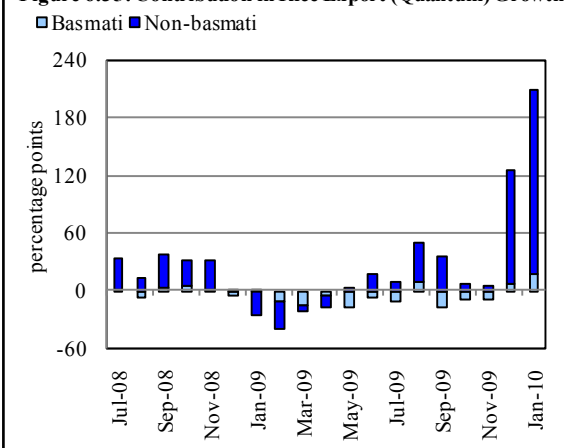
Food group export growth during Jul-Jan FY10 fell by 11.6 percent YoY despite quantum growth in most of the categories of food group (see **Table 6.14**). *Rice* exports rose in terms of quantum amid better-than-targeted production²¹ and demand from major importers. The contribution in rice export is primarily coming from non-basmati rice (see **Figure 6.35**).

In terms of market share, positive development was the rising share of Pakistani non-basmati rice exports to African countries (see **Figure 6.36(b)**).²² Kenya being a major importer of Pakistani Irri-6 rice extended the preferential duty for Pakistani

Table 6.14: Food Group Exports (Jul-Jan)

	Abs Δ (million US\$)	Growth in value (%)	Growth in quantity (%)
Rice	-104.29	-8.25	50.93
<i>of which</i>			
Basmati	-241.30	-34.94	-7.40
Non-basmati	137.01	23.91	83.70
Fruits	59.28	65.34	52.37
Vegetables	24.58	88.92	81.64
Fish	-12.92	-10.01	-5.96
Tobacco raw	-1.77	-29.46	-14.48
Spices	3.65	21.09	19.64
Oilseeds	-2.49	-14.22	-24.08
Meat and meat preparation	14.80	36.21	43.22
Total	-75.20	-4.00	N.A

Figure 6.35: Contribution in Rice Export (Quantum) Growth



²⁰ Due to low production of cotton in China, exports of raw cotton and cotton yarn increased.

²¹ The target of rice production for FY10 was 5.9 million tons, while the estimated production is 6.3 million tons, last year production was 6.9 million tons.

²² African countries imported 9.6 million tons of rice from the world, accounting for 32 percent of global trade. Suspension of the import duty on rice estimated to have facilitated a 37 percent increase in imports. Source: FAO Rice Market Monitor – December 2009

rice in June 2009 for one year.²³ As a result, the share of non-basmati rice exports to Kenya rose further in FY10 (see **Figure 6.36(b)**). Demand from Iran and Saudi Arabia also proved beneficial for rice exporters as these countries have a major share in overall rice exports of Pakistan.

The record export of fruits was primarily led by higher exports of mangoes, dates, edible nuts and kinos.²⁴ Improved market access to Iran, establishment of food irradiation plant for fruit in FY09, better harvest, coupled with improved marketing strategies led to an impressive growth of fruit exports.

Other manufacturers' group export declined by 6.7 percent YoY during Jul-Jan FY10 compared with a positive growth of 13.0 percent during Jul-Jan FY09. Decline in other manufacturers' group was broad based (see **Table 6.15**).

Garments, having the largest share in the leather group, saw exports drop by 15.8 percent YoY during the period under review. Weak global demand led to subdued exports of this group. *Cement* exports declined on account of

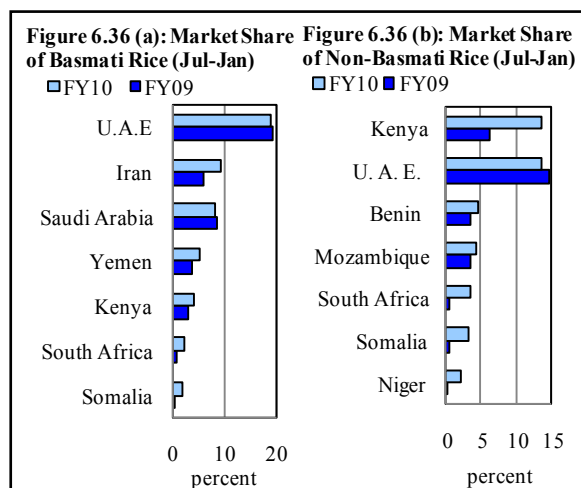


Table 6.15: Other Manufactures Exports (Jul-Jan)

	Abs Δ (million US\$)	Growth (%)	Share in other manuf. (%)
Carpets, rugs & mats	-12.7	-13.5	4.2
Sports goods excl. toys	-18.5	-11.3	6.8
Leather exc. reptile leather	-28.0	-14.8	7.6
Leather manufactures	-95.6	-25.9	13.3
Foot wear	-11.9	-17.2	2.8
Medical & surgical instruments	-14.2	-9.6	6.4
Chemicals and pharmaceuticals	2.2	0.6	18.2
Engineering goods	-10.8	-6.8	7.2
Molasses	-41.5	-68.4	0.9
Cement	-49.9	-14.9	14.1
Total	-143.7	-6.7	100.0

²³ Pakistani rice exports are being charged 35 percent import duty while others are charged 70 percent.

²⁴ Mangoes, dates, edible nuts and fresh kino exports posted growth of 34.0, 29.0, 450.0 and 28.0 percent respectively.

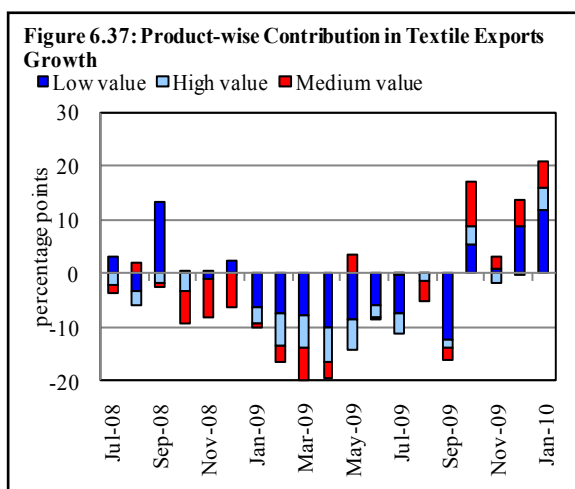
declining export quantum²⁵ due to low demand from major importers i.e. Afghanistan and India. Export orders from countries like U.A.E, Oman, and Qatar have also dropped owing to lower construction activities.²⁶ Moreover, Pakistan can lose its share in markets of Middle East and African countries, as Saudi Arabia has lifted ban on its cement exports.

Although cumulative export proceeds from engineering goods declined, the export growth of *electric fans* was remarkable i.e. 51.7 percent YoY growth during the period under review amid high demand from markets like Africa, Middle East, and South Asia.

Export of *molasses* was already declining since the government imposed 15 percent duty on this category in a bid to support ethanol production. Since molasses is a by- product of sugar, low production of sugar has severely impacted the exports of molasses.²⁷

Textile export is showing signs of recovery on account of better cotton crop and revival in global demand.²⁸

As a result, textile exports posted a modest growth of 2.3 percent YoY in Jul-Jan FY10 compared to a 4.0 percent decline in Jul-Jan FY09. Monthly data reveals that textile export growth after remaining in the negative territory during FY09 and initial months of FY10 is now posting positive figures. Product-wise contribution analysis indicates that low value products have remained the dominant contributors in



²⁵ The data of APCMA (All Pakistan Cement Manufacturers Association) data shows an increase of 14.0 percent YoY during Jul-Jan FY10.

²⁶ Share of Qatar in Pakistan exports declined from 22 to 14 percent, while share of Oman and UAE declined from 10 to 6 and 15 to 4 percent, respectively, during the period under review.

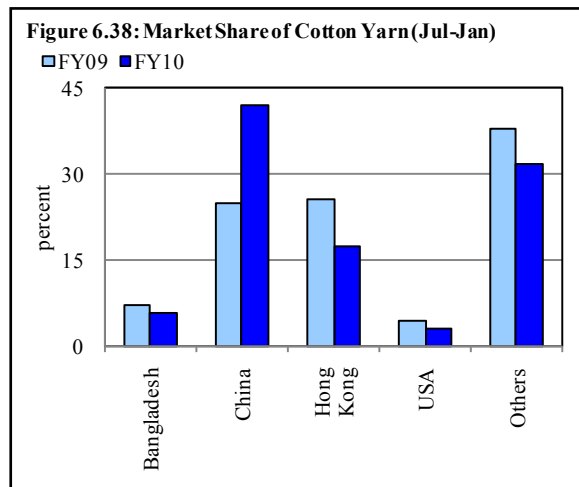
²⁷ Production of sugarcane is estimated to be 48,622,000 MT during FY10 against the official target 56,527,000 MT.

²⁸ Revival in global demand is estimated by US imports of textile and apparel products. Since the data of EU is available till October 2009, the analysis of EU market has not been incorporated.

overall textile exports growth (see **Figure 6.37**).

Raw Cotton and *cotton yarn* exports increased by 142.0 and 38.1 percent YoY during the period under review amid early arrival of crops and better production. Revival of demand²⁹ from major importers of raw cotton and yarn was an encouraging sign for exporters of these items. In case of cotton yarn, export quantum rose by 45.9 percent

YoY during Jul-Dec FY10. In terms of market share, China has emerged as the major importer of cotton yarn during the period under review. Low cotton production in China resulted in high imports of cotton yarn from Pakistan. The share of other markets subsequently declined during the period under review (see **Figure 6.38**).



However, the government's decision to cap cotton yarn export³⁰ is likely to have mix effects on the textile industry. For instance, on one hand, it would stabilize yarn prices, which is good for downstream industry. While on the other hand, the government action is likely to hit the spinning sector as the increased export demand provided much needed-relief after the industry suffered serious losses during FY09 on account of low international prices, liquidity constraints and energy shortages. It may also be pointed out that unlike the value added sector, spinning sector is not provided any subsidized credit facility.

Although exports of bed wear and towel rose in terms of quantum, probably reflecting improvement in the external demand but due to lower unit values, the value of exports during Jul-Jan FY10 was less than the last year earnings (see **Table 6.16**).

²⁹ China's total cotton yarn imports grew by 74.0 percent YoY during CY09, while imports from Pakistan grew by 136.0 percent YoY. Production of cotton in China declined by 14.0 percent YoY during Jul-Nov FY10, however consumption rose by 6.0 percent during the same period.

³⁰ S.R.O 26 (I)/2010, dated 14 January 2010, Ministry of Commerce

Table 6.16 : Major Textile Exports Price & Quantum Impact (Jul-Jan)

million US\$

	FY09			FY10		
	Total Change	Due to		Total Change	Due to	
		Quantum	Price		Quantum	Price
Textile Group	-242.8			131.9		
<i>Of which</i>						
Raw cotton	49.1	49.6	-0.5	102.2	83.8	18.4
Cotton yarn	-113.9	-100.3	-13.7	202.8	302.1	-99.3
Cotton fabrics	158.5	177.6	-19.1	-249.4	-290.0	40.6
Knitwear	-5.4	166.1	-171.5	-64.8	-106.6	41.8
Bedwear	-96.2	-11.8	-84.4	-50.8	7.0	-57.7
Towels	49.0	84.3	-35.3	-4.7	60.0	-64.7
Readymade garments	-102.0	-156.6	54.6	23.3	-78.8	102.1
Art silk and synthetic textiles	-0.1	-0.1	0.0	116.3	79.1	37.2

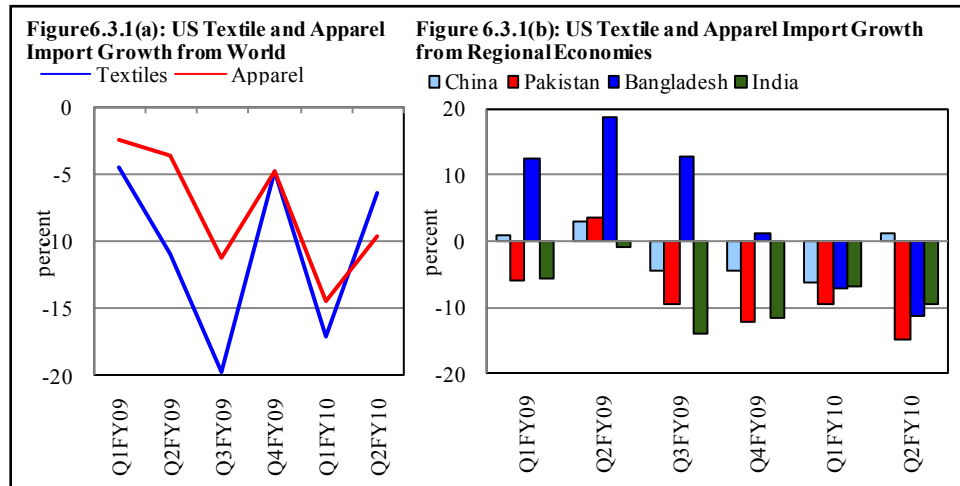
On the other hand, quantum impact of readymade garments and knitwear declined in FY10. Initially, low external demand and domestic issues were hampering the exports, but lately tough competition from regional countries like China and Bangladesh is taking its toll on the local exporters (see **Box 6.3**).

Box 6.3 Comparison of Regional Competitors Amid Revival in US Textile Market³¹

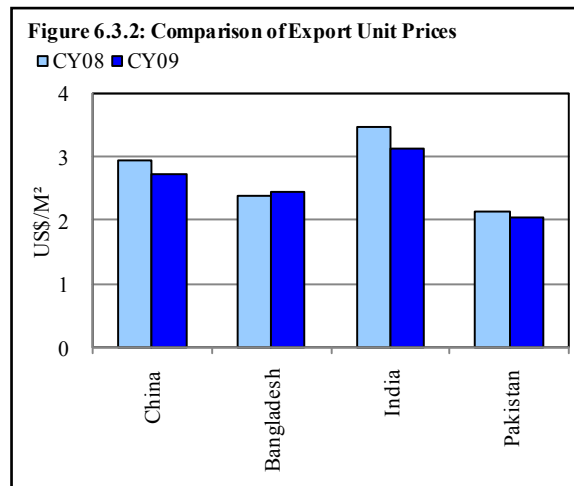
The impact of global recession was quite visible in the declining textile imports of the developed countries, which resulted into falling textile exports of Pakistan and its regional competitors. However, as the global economy is on the path of recovery³², the demand for apparel and textile products has also rebounded in the US. The regional textile exporters are now eyeing this recovery in order to capture major share in US apparel and textile market. However, comparison of regional economies indicates that textile and apparel exports performance of Bangladesh, India and Pakistan is lagging behind China (see **Figure 6.3.1(b)**).

³¹ US is the largest importer of textile and apparel products with 18 percent share in overall textile imports of the world

³² World Economic Outlook, 2009



It is interesting that despite higher unit prices than Bangladesh and Pakistan, (see **Figure 6.3.2**) China managed to capture lion's share in the US apparel market. The share of China in US apparel market in particular has almost doubled in some of the categories since the removal of quota in US market.³³ Economy of scale, labor efficiency, good quality, production of market specific products, availability of latest textile machinery³⁴, established infrastructure and technological readiness are positive contributors to China's progress.³⁵ In addition, increase in the tax refund rate for exported textile and clothing to 17 percent from 16 percent coupled with the introduction of a comprehensive 3-year Textile Plan to aid the textile and clothing industry also facilitated the exporters.



The textile sector of Bangladesh was relatively less affected by the global recession owing to lower unit values, incentives and duty free exports access to countries like US and

³³ Share of China rose from 15 to 30 percent in US imports of cotton knit shirts, whereas China's share increased from 13 to 26 percent in case of cotton trousers during CY09

³⁴ China is the largest producer of textile machinery.

³⁵ According to GCI 2009-10, China is ranked at 29th position compared to Pakistan at 101 and Bangladesh at 106th place.

EU.^{36,37} India's apparel exports remained subdued due to high export prices and tough competition from Bangladesh. Anecdotal evidence suggests that Indian textile firms are setting up their units in Bangladesh in order to gain the benefits of duty free access.

On the other hand, Pakistan textile sector was confronted with issues like power shortages, low investment, lack of latest technology and liquidity problems that hampered the textile exports during CY09. However, with the aim to foster textile exports, a Textile Investment Support Fund has been proposed by the government for modernization of machinery, infrastructure development, skill development, marketing and use of technology. However this proposal has not been implemented yet.

Imports

Import growth contracted by 8.2 percent during Jul-Feb FY10 as compared with 1.5 percent YoY fall during the same period last year.

However, monthly analysis of imports show that after posting negative growth for 13 consecutive months, imports moved into positive territory from December 2009 (see **Figure 6.39**).

During most of FY10, the price impact had offset the rise in quantum, however with price impact also turning positive, imports recorded positive growth in December and January (see **Figure 6.40**).

Figure 6.39: Monthly Analysis of Imports YoY Growth

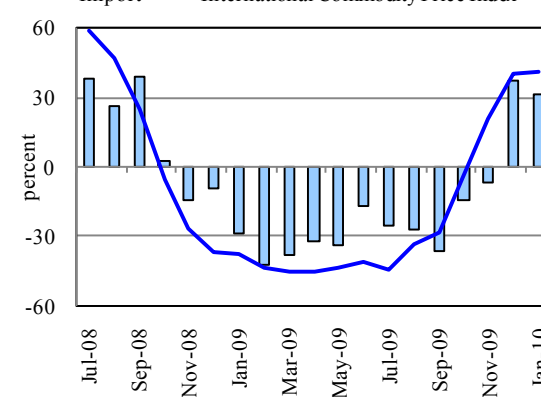
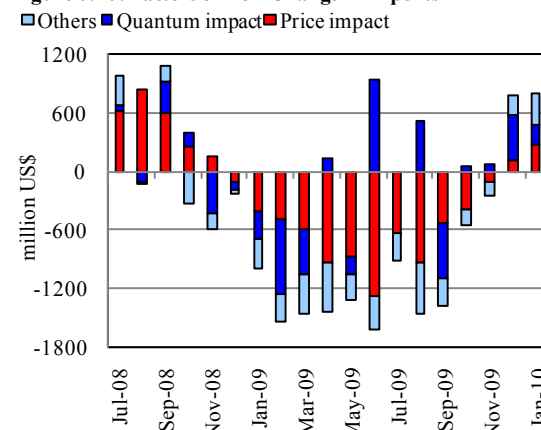


Figure 6.40: Factors of YoY Change in Imports



³⁶ The government of Bangladesh initiated a 150 million US dollar Export Development Fund facility based on revolving funds. This measure will provide liquidity to scheduled banks for financing the exporters' raw material imports.

³⁷ Bangladesh enjoys the Most Favored Nation status in the US import market and it also gets benefits from the Generalized System of Preferences in the US and EU.

Cumulative data reveals that fall in import growth is broad-based except for road motor vehicles and fertilizer (see **Table 6.17**). However, a large number of categories are showing a gradual revival as reflected by positive quantum impact.

Table 6.17: Major Categories of Imports (Jul-Jan)

million US dollars, growth and share in percent

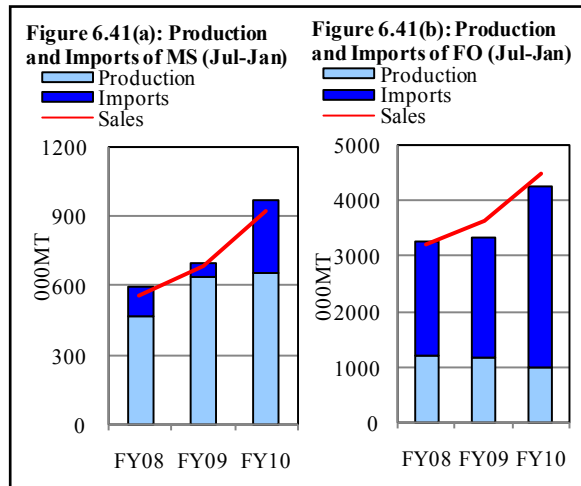
Commodity	Import bill	Absolute change	Quantum impact	Price impact	Growth	Share
Petroleum products	3620.1	1.0	1328.7	-1327.7	0.0	18.7
Petroleum crude	2014.4	-829.6	-145.1	-684.5	-29.2	10.4
Power generating Machinery	871.8	-112.0	N.A	N.A	-11.4	4.5
Palm oil	673.1	-142.0	27.3	-169.3	-17.4	3.5
Iron and steel	681.8	-82.2	-96.1	13.9	-10.8	3.5
Fertilizer manufactured	486.9	77.7	108.0	-30.3	19.0	2.5
Telecom	395.3	-273.2	N.A	N.A	-40.9	2.0
Road motor vehicles (CKD)	322.4	101.1	N.A	N.A	45.7	1.7
Total	9065.7*	-1259.2	721.9	-2340.7	-10.8	N.A

* import of all these items had 47 percent share in total imports

Petroleum Group

Petroleum group imports, having the largest share (30 percent) in the import bill, contracted by 12.8 percent YoY during Jul-Jan FY10 in contrast to a healthy growth of 29.4 percent YoY during the same period last year. The compression in POL import bill is entirely attributed to falling import prices.³⁸

Within petroleum group, petroleum products import quantum increased

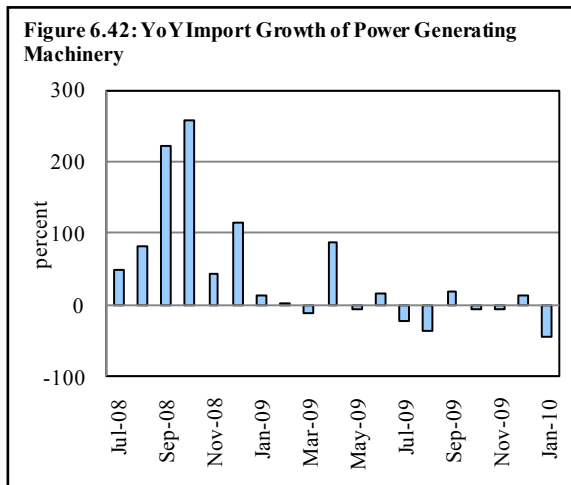


³⁸ Price impact of petroleum group imports for the period Jul-Jan FY10 is US\$ (-) 1978.7 million, compared to positive price impact of US\$ 6463.0 million during Jul-Jan FY09.

substantially as operations of the refineries were hampered by ongoing circular debt issue. Low crude imports resulted in high imports of refined products in order to meet the rising domestic demand (see **Figure 6.41(a & b)**).

Power generating machinery

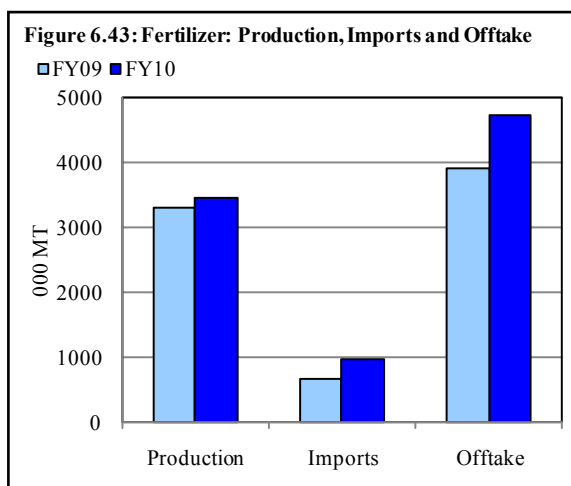
having the largest share in machinery group posted negative growth of 11.4 percent during the period under review (see **Figure 6.42**). Anecdotal evidence suggests that keeping in view the prolonged energy crisis, a large quantum of generators were imported during FY08 and FY09. However, the domestic demand for generators was not as strong as anticipated and sale of second-hand generators resulted into accumulation of large inventories.



Demand-Led Recovery in Some Categories

Fertilizer Manufactured imports recorded a growth of 19.0 percent YoY amid high demand. Fertilizer imports rose by US\$ 108 million due to quantum impact. Aggressive off take of fertilizers by the farmers resulted in high production and imports during the period under review. Analysis of Jul-Jan period show that production, imports and off take increased during FY10 in contrast to the same period last year (see **Figure 6.43**).

Road Motor Vehicles imports after posting negative growth for three consecutive years, increased by 10.8 percent YoY during the first seven months of FY10 (see **Figure 6.44**). The trend reversal in imports of road motor vehicles is attributed to demand led



recovery.³⁹ The imports of CBUs and in particular CKDs increased during the period under review (see **Figure 6.44**).

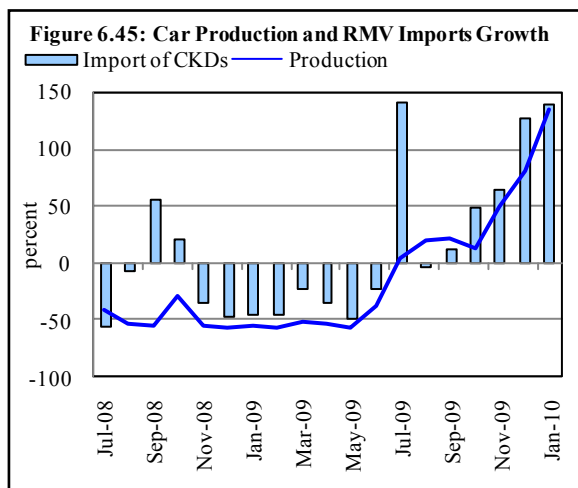
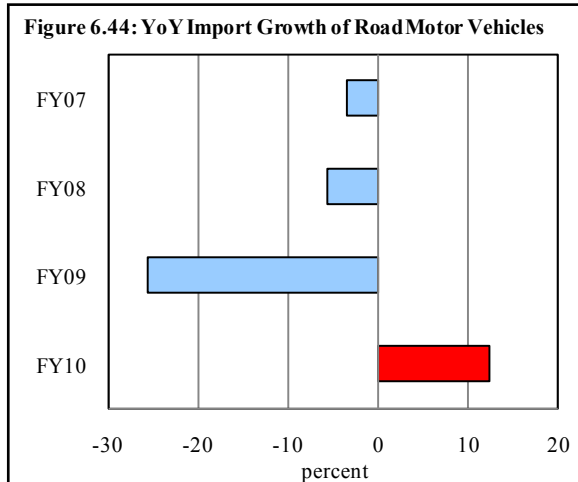
Monthly analysis of car production shows that production process started picking up since the start of FY10 leading to rising imports of CKDs (see **Figure 6.45**). Improved production and sales of road motor vehicles also led to demand for *rubbers tyres* and *tubes*. As a result, the imports of this category increased by 14.9 percent YoY during the period under review.

Agriculture Machinery

imports recorded a growth of 74.8 percent YoY during Jul-Jan FY10. The impressive growth is attributed to high imports of tractors and parts of tractors. Sixty six percent of total agriculture machinery imports originated from

tractors and its parts.⁴⁰ Projects like Benazir Tractor Scheme and Green Tractor Scheme resulted in high demand, imports and sales of tractors.

Sugar imports increased during the period under review amid acute shortage of sugar in the country. Although the surge in sugar import bill is attributed to quantum and price impact, the contribution of the former is much stronger.⁴¹



³⁹ Sales of cars and motor cycles increased by 63.0 and 66.0 percent respectively, during Jul-Jan FY10. Sales are being made on cash and 75 percent demand is originating from individuals according to anecdotal evidence.

⁴⁰ Parts includes CKDs/SKD's which are used in production process.

6.8 External Debt

The acceleration in the accumulation of external debt and liabilities (EDL) witnessed during the last two years continued in H1-FY10 as US\$ 4.7 billion were further added to the stock of EDL. As a result, the stock of EDL reached US\$ 55.8 billion by the end of H1-FY10 (see **Table 6.18**).

Table 6.18: Pakistan's External Debt and Liabilities (Jul-Dec)

value and absolute change in million US dollars

ITEM	FY08	FY09	FY10	Absolute change		Percentage change	
				FY09	FY10	FY09	FY10
1. Public and publically guaranteed debt	37,836	41,626	43,295	3,790	1,669	10.0	4.0
<u>A. Medium and long term(>1 year)</u>	37,235	40,963	42,973	3,728	2,010	10.0	4.9
Paris club	13,430	14,523	14,330	1,093	(193)	8.1	-1.3
Multilateral	19,912	22,207	23,791	2,295	1,584	11.5	7.1
Other bilateral	1,063	1,410	2,453	347	1,043	32.6	74.0
Euro bonds/saindak bonds	2,653	2,650	2,150	(3)	(500)	-0.1	-18.9
<u>B. Short Term (<1 year)</u>	601	663	322	62	(341)	10.3	-51.4
IDB	601	663	322	62	(341)	10.3	-51.4
2. Private nonguaranteed debts (M&LT:>1 yr)	2,122	3,234	3,266	1,112	32	52.4	1.0
3. Private non-guaranteed bonds	250	276	137	26	(139)	10.4	-50.4
4. IMF	1,332	4,352	7,494	3,020	3,142	226.7	72.2
Total external debt (1-4)	41,540	49,488	54,388	7,948	4,900	19.1	9.9
5. Foreign exchange liabilities	1,196	1,574	1,422	378	(152)	31.6	-9.7
Foreign Currency Bonds (NHA / NC)	66	44	22	(22)	(22)	-33.0	-50.0
Central Bank Deposits	700	1,200	1,200	500	-	71.4	0.0
NBP/BOC Deposits	400	300	200	(100)	(100)	-25.0	-33.3
Total external debt and liabilities (1-5)	42,736	51,062	55,810	8,326	4,748	19.5	9.3

It may be pointed out that Pakistan's stock of EDL had remained almost stagnant at around US \$37.0 billion from FY00-FY06, in contrast, it has grown on average by more than 12 percent during the last three and a half years. This rise in EDL owes to sharp deterioration in both the current account deficit and fiscal deficit FY07 onwards (see **Figure 6.46**). The rapid rise in the stock of EDL and falling output has raised serious concerns over the debt sustainability. The debt sustainability (measured as debt to GDP ratio) worsened further in the first six months of the current fiscal year. IMF in its recent country report has carried out a

⁴¹ Sugar imports surged by US\$127 million, out of which quantum impact is US\$ 101 million and the rest US\$ 26 million is price impact.

debt sustainability exercise which indicates that Pakistan's debt sustainability indicators can deteriorate significantly in case of exogenous shocks (see **Box 6.4**)

While the inability of the country to generate resources to finance its expenditures remained the main cause of rise in the EDL, the currency composition of its stock of EDL has also contributed to rise in its debt stock.

The major part (75 percent) of Pakistan's external debt is denominated in currencies other than US dollar. Thus, as the debt is reported in US dollar terms, the weakness of dollar against other currencies (see **Figure 6.47**) results in a significant increase in the debt stock on account of valuation change. In H1-FY10, almost 25 percent of the net increase in the EDL (see **Figure 6.48**) owed to the depreciation of US dollar against major currencies.

Figure 6.46: Average Current A/c Balance and Fiscal Balance

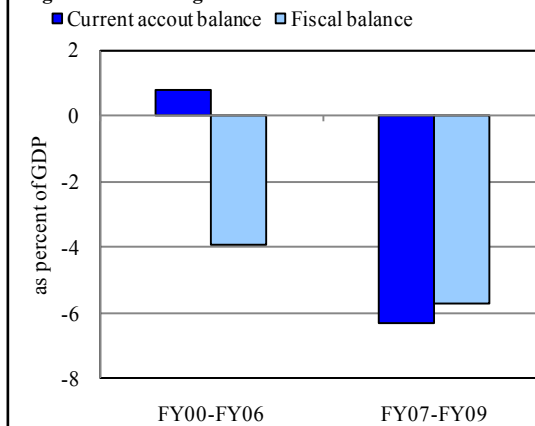
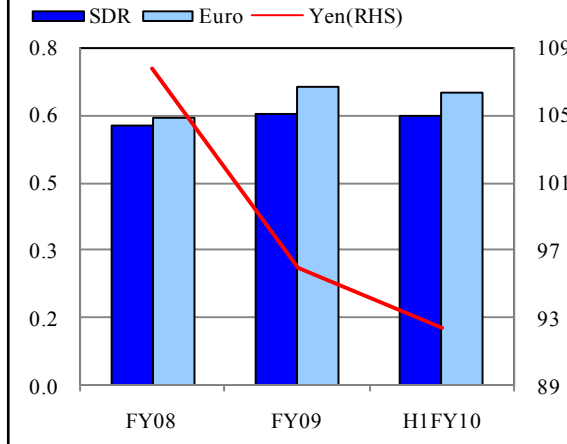


Figure 6.47: Exchange Rate vis-a-vis US Dollar



The increase in the stock of outstanding debt was on account of loans contracted from the IMF under the Stand-By Arrangement (SBA). As a result, the share of IMF loan in total debt of Pakistan increased significantly during H1-FY10.

Structure of External Debt and Liabilities

Public and publically guaranteed debt increased by US\$ 1.7 billion during H1-FY10 compared to US\$ 3.8 billion in corresponding period last year. The lower increase in H1-FY10 was on account of US\$ 1.0 billion repayments of euro bonds, paris club and short term debt.

Within public and publically guaranteed debt, multilateral debt increased by US\$ 1.6 billion during H1-FY10 compared to US\$ 2.3 billion in the corresponding period last year. These loans were provided mainly by IDA and ADB. Most of the additional loans were in the form of project loans (see **Table 6.19**).

The debt stock of bilateral donors (both Paris club and

Figure 6.48: Valuation Losses/Gains

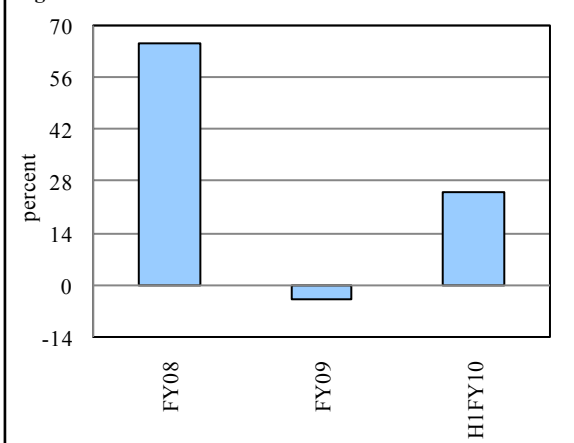


Table 6.19: Disbursement of External Resources during H1-FY10

million US dollar

Serial No.	Donors	Particulars/purpose	Amount
1	ADB	Earthquake emergency assistant	339.7
		Improvement in government efficiency program	
		Baluchistan road development	
		NWFP road development	
		National highway sector development	
2	IDA	Power system transmission enhancement	407.4
		Higher education commission-DPL	
		Social protection/safety program	
		Poverty alleviation fund	
		Highway rehabilitation	
3	Saudi Arabia	Public sector capacity building	200.0
		Partnership for polio	
4	China	Friend of Democratic Pakistan under Tokyo Conference	104.6
		Rural infrastructure development package-I AJK	
		Rural infrastructure development package-II AJK	
5	USA	Improvement of Karakorum Highway	82.8
		Chashma Nuclear Power Plant-II	
		SOGA governance III-IV	
6	UK	SOGA economic growth	48.4
		NWFP police elite force	
		Budget support for poverty reduction	

other bilateral) rose by US\$ 0.9 billion during H1-FY10 compared to an increase of US\$ 1.4 billion in the same period of the preceding year which was largely contributed by Japan, Saudi Arabia and China.

Lower inflows from the multilateral sources coupled with higher inflows from IMF resulted in the decline in the share of public and public guaranteed debt in total debt from 83.3 percent at end-June 2009 to 79.7 percent as of end December 2009 (see **Figure 6.49**).

It may be mentioned that around 75 percent of Pakistan's public and publically guaranteed loans are on fixed rates, and as such, Pakistan could not benefit much from the prevailing low interest rate environment. However, contracting loans at fixed rates is beneficial to the extent that it not only eliminates the risk of higher payments if the interest rates were to rise, but it also brings certainty in budgeting.

The outstanding stock of IMF loan increased by US\$ 3142 million in H1-FY10 on

account of third and fourth tranches under the SBA. Pakistan received US\$ 1198.9 million in August 2009 of which, about 62 percent was allocated for budgetary support as bridge financing following delays in the realization of flows from FoDP. Similarly, 31 percent of the fourth tranche of US\$ 1200 million received in Dec 2009 was for budget financing. The additional debt from IMF increased the share of IMF loan in Pakistan total debt from 10.1 percent in FY09 to 13.2 percent at end December 2009 (see **Figure 6.50**).

Figure 6.49: Public & Public Guaranteed Debt in Total Debt

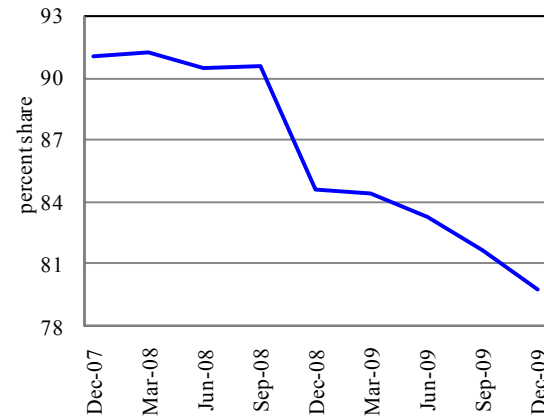
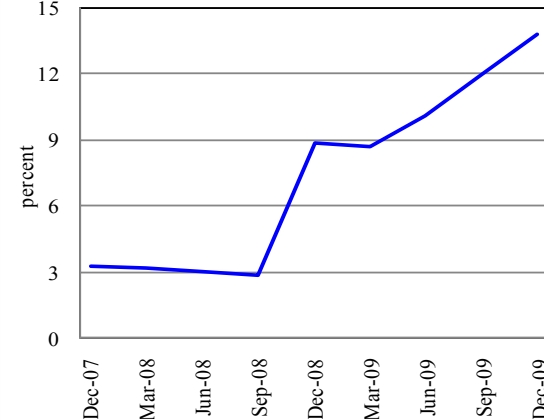


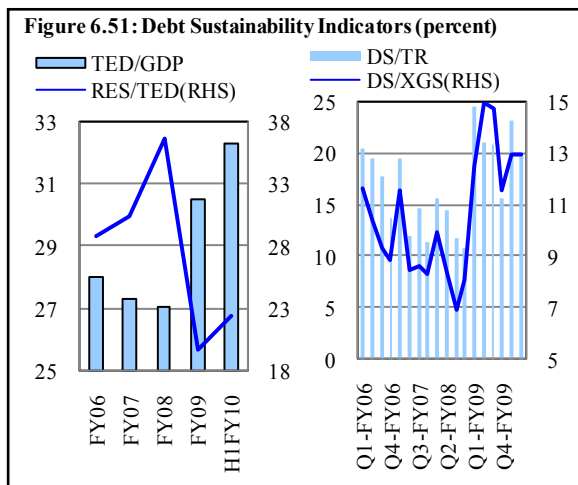
Figure 6.50: IMF Share in Total Debt



Debt Sustainability Indicators

The steady rise in the stock of EDL coupled with stagnant foreign exchange earnings and slowdown in economic growth led to further deterioration in most of the debt sustainability indicators of Pakistan in H1-FY10. Both, total external debt as a percent of GDP (TED/GDP), and debt servicing to exports earnings ratio (DS/XGS) deteriorated during H1-FY10. The

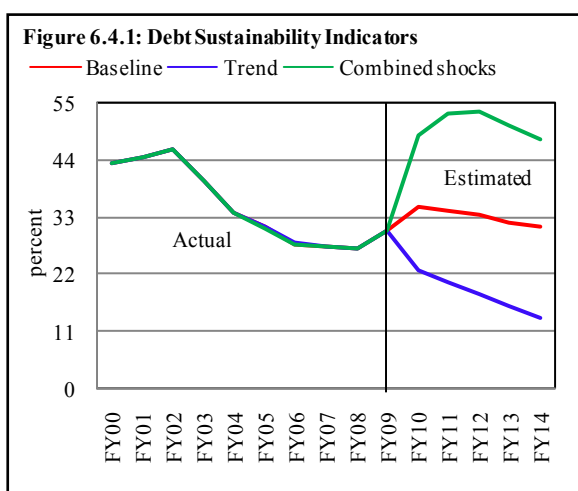
increase in TED/GDP ratio is a continuation of trend seen since FY08 (see **Figure 6.51**). The RES/ TED ratio, DS/TR and DS/XGS ratios however, after showing some improvement have again come under stress in Q2FY10.



Box 6.4: Debt Sustainability in Pakistan

IMF external debt sustainability analysis⁴² shows that debt to GDP ratio would increase from 30.5 percent in FY09 to 34.3 percent in FY12, after which it would start to decline during next two years and drop to 31.0 percent in FY14 mainly on the basis of reasonable growth of 5-5.5 percent and no change in other factors. Similarly, the debt services to exports of goods and services is estimated to rise from 13.2 percent in FY09 to 20 percent in FY14 period largely on account of repayments of IMF loans. This future outlook is based on the assumption of higher noninterest current account deficit, slower growth, larger depreciation, higher interest rate and lower FDI inflows.

In this country report, IMF also analysed the combined impact of different shocks on the debt sustainability of Pakistan. These comprises⁴³ shocks to growth, current



⁴² A complete country report about Pakistan can be seen on the following address:

<http://www.imf.org/external/pubs/cat/longres.cfm?sk=23517.0>

⁴³ The assumptions for combined shocks are; (1) current account deficit higher than baseline scenario by half of ten year standard deviation, (2) net flows of direct investment are fifty percent lower than

account, foreign direct investment and real depreciation. The combined impact of these shock would increase the debt stock to GDP ratio to 49 percent at the end of current fiscal year (see **Figure 6.4.1**).

External Debt and Liabilities Servicing

Pakistan's external debt servicing reached US\$ 2648 million at the end of H1-FY10, which is 9.7 percent higher than debt servicing of corresponding period of the preceding year (see **Table 6.20**). This increase in debt servicing is due to repayment to bilateral creditors, multilateral donors (IMF and IDB) and private non-guaranteed debt. Similarly, the increase in servicing of foreign liabilities was on account of the repayments of Bank of China deposit and NHA bonds. In debt servicing payment, the share of principal payment significantly increased to 79.7 percent in H1-FY10 (see **Figure 6.52**).

Table 6.20: Pakistan's External Debt and Liabilities Servicing
million US dollar

	H1-FY8	H1-FY9	H1-FY10	H1-FY8	H1-FY9	H1-FY10
	Actual Paid			Rescheduling/rollover		
1. Public and Publicly guaranteed	1,022.6	1,844.0	1,490.5	100.0	100.0	323.0
Principal	599.3	1,400.0	1,087.9	100.0	100.0	323.0
Interest	423.3	444.0	402.6	-	-	-
2. Private non-guaranteed	255.0	301.0	264.9	-	-	-
Principal	170.2	215.0	220.9	-	-	-
Interest	84.8	86.0	44.0	-	-	-
3. IMF	86.6	115.0	171.1	-	-	-
Principal	83.2	93.0	109.0	-	-	-
Interest	3.4	22.0	62.1	-	-	-
4. Total debt servicing (1+2+3)	1,364.2	2,260.0	2,472.9	100.0	100.0	323.0
Principal	852.8	1,708.0	1,957.4	100.0	100.0	323.0
Interest	511.4	552.0	515.5	-	-	-
5. Foreign liabilities	181.9	155.0	175.2	550.0	750.0	-
Principal	132.9	122.0	151.9	550.0	750.0	-
Interest	49.0	33.0	23.3	-	-	-
6. TOTAL (4+5)	1,546.1	2,415.0	2,648.1	650.0	850.0	323.0
Principal	985.7	1,830.0	2,109.3	650.0	850.0	323.0
Interest	560.4	585.0	538.8	-	-	-

in the baseline scenario, (3) one time real depreciation of thirty percent occurs in FY10 and (4) slowdown in growth

Given that repayment of IMF loans received in FY09 would start in FY11, the share of principal payment would increase further next year. As far as the debt servicing indicators such as debt servicing to XGS ratio and debt servicing to TR are concerned, deterioration was seen in both indicators, particularly in debt servicing to TR ratio during H1-FY10 (see **Figure 6.51**) on the back of deceleration in tax revenues.

