

6 External Sector

6.1 Overview

Pakistan's overall external account recorded a surplus of US\$ 0.9 billion during Jul-Nov FY10 compared to a deficit of US\$ 5.6 billion in the same period last year (see **Table 6.1**). This improvement owed to both, a marked contraction in the current account deficit and an increase in the financial account surplus.

While all the components of current account recorded YoY improvement, the major impetus came from the contraction in the trade account deficit, which declined by 33.4 percent (see **Figure 6.1**). The entire improvement in the trade account was due to a 21.2 percent fall in the imports as exports continued to weaken, contracting by almost 11.3 percent YoY during Jul-Nov FY10.

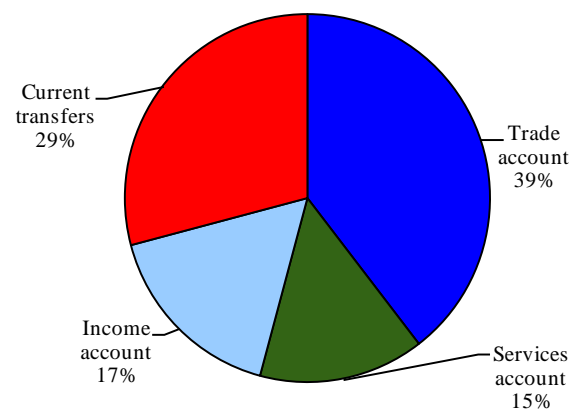
Besides the trade account, services and income account deficits also contracted significantly, reflecting lower economic activity. Specifically, services deficit fell by 40.3 percent mainly

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

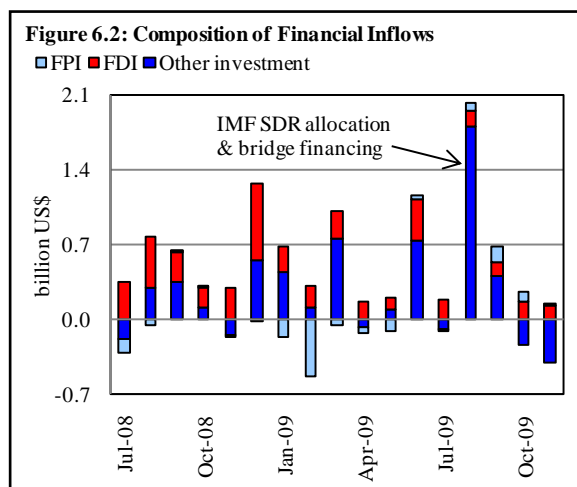
billion US dollar

	FY09	FY10
A. C/A balance	-7.3	-1.4
i) Trade balance	-7.1	-4.7
Exports	8.7	7.7
YoY growth (%)	11.2	-11.3
Imports	15.7	12.4
YoY growth (%)	25.6	-21.2
ii) Invisible balance	-0.3	3.3
Remittances	3.0	3.8
B. Financial/Capital balance	1.9	2.5
i) FDI	1.6	0.8
ii) FPI	-0.2	0.3
iii) Other investment	0.4	1.4
C. Errors & omissions	-0.2	-0.2
D. Overall balance	-5.6	0.9
Foreign exchange reserves (end-period)	9.1	13.7
Spread on Euro bond (percent)	20.0	5.9
Credit rating (end-period)	CCC+	B-

Figure 6.1: Contribution in Current Account YoY Contraction during Jul-Nov FY10



due to fall in imports related transportation charges and lower outflow from foreign exchange companies. Whereas 48.5 percent fall in income accounts deficit was the result of both lower purchases of crude oil and repatriation of profit & dividends. Current transfers on the other hand, remained robust recording 43.9 percent rise on account of both, increase in workers' remittances as well as other transfers.



Financing side also recorded marked improvement with financial account surplus rising by 34.9 percent during Jul-Nov FY10. This improvement was primarily driven by increased inflows from the IFIs (see **Figure 6.2** and **Box 6.1**). Although the net foreign investment contracted by 22.4 percent, net portfolio investment returned to positive territory, contributing US\$ 301 million during Jul-Nov FY10 against a decline of US\$ 182 million in the corresponding period last year. Foreign direct investment, on the other hand, did not show any signs of recovery and declined by 52.3 percent during the period under review.

As a result of improvement in the overall external account, Pakistan was able to rebuild foreign exchange reserves, which reached US\$ 13.7 billion by end-November 2009. It may be recalled that in the corresponding period last year, Pakistan's foreign exchange reserves were under severe stress and had declined to US\$ 9.1 billion. Foreign exchange market also exhibited relative stability and exchange rate depreciated by 2.6 percent during Jul-Nov FY10 compared to 13.3 percent in the corresponding period last year.

Although Pakistan's external position has improved considerably over Jul-Nov FY09, it remains fragile. For one, the contraction in the current account deficit is largely on the back of decline in imports, which may have bottomed out. The rising trend in the international commodity prices and likely recovery in the domestic economy would tend to widen the trade deficit as exports may not be able to stage a significant comeback in the presence of acute power shortages and poor law and order situation.

The nature of improvement in financial account is also a source of concern. Most of the improvement in financial account, as described earlier, is on account of debt creating flows. The repayments of these flows in coming years would put pressure on the current account. Thus improvement in the external position may be short-lived, and has a risk of future sustainability.

Box 6.1: IMF SDRs Allocations

In response to Group of Twenty (G-20) April-2009 call of boosting global liquidity through general SDR allocation, IMF injected SDR 161.2 billion (US\$ 250 billion) to its member countries in August 2009. This allocation was made in fixed proportion (74.13 percent) to SDR quota of member countries. As a result, IMF member countries' SDRs holdings (foreign reserves) have increased simultaneously. Apart from general allocation, IMF has also allocated SDR 21.5 billion (US\$ 34 billion) under special allocation of SDRs in September 2009.

SDR is an interest-bearing international reserve asset and can be turned into usable currencies through voluntary trading agreement with other IMF member countries. This allocation provides members with an additional method to obtain hard currencies. If a member country purchases SDR from another member it will earn interest on the amount excess of its allocation and if a member sells SDR it will pay interest on the amount short of its allocation.

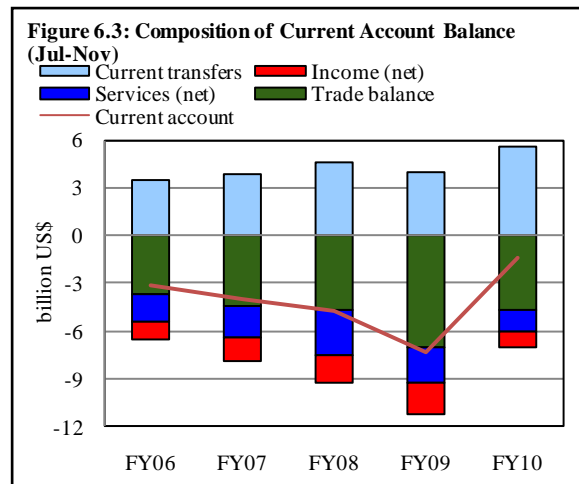
This allocation has no impact on member countries' SDR quota, however, this is broadly based on its relative size in the world economy. Thus member countries voting rights in the organization and access to IMF financing remains unaffected as these are based on SDR quotas.

Pakistan has received SDR 766.3 million (US\$ 1197 million) under general allocation and SDR 52.3 million (US\$ 83 million) under special allocation.

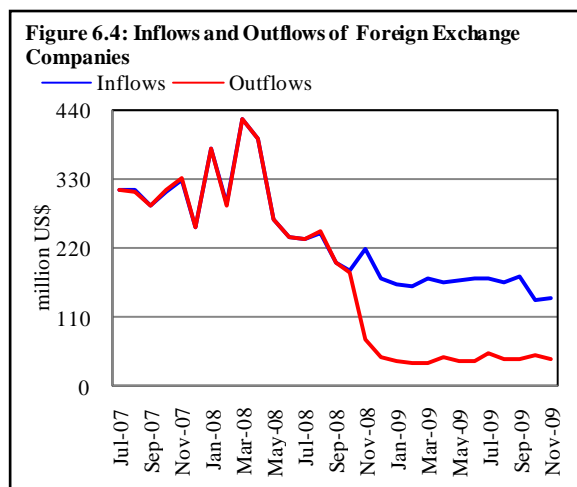
6.2 Current Account Balance

During Jul-Nov FY10, current account deficit declined to US\$ 1.4 billion compared with US\$ 7.3 billion in the corresponding period last year. This is the lowest current account deficit for the Jul-Nov period during the last five years (see **Figure 6.3**).

Contraction in current account deficit during Jul-Nov FY10 was broad based as all sub accounts, i.e., trade, services, income and current transfers recorded improvement during the period.



Decline in trade deficit entirely owed to a large fall in imports (offsetting a smaller reduction in exports), while increase in invisible surplus (services, income and current transfers) mainly reflected higher remittances and higher net inflows through foreign exchange companies (FECs). Moreover, fall in both freight charges and repatriation of profit & dividends also increased invisible surplus during the period.



It may be pointed out that transactions through FECs used to have no impact on current account balance.¹ However, outflow from FECs fell drastically in the wake of various restrictions and action against one of the company. As a result, FECs outflows fell below their inflows November 2008 onward. This, in turn, is having positive impact on current account balance (see **Figure 6.4**). Foreign exchange companies sell the surplus foreign currency in the inter-bank market.

6.2.1 Trade Account²

In sharp contrast to 49.2 percent expansion in Jul-Nov FY09, trade deficit contracted by 33.4 percent during Jul-Nov FY10. This was entirely attributed to 21.2 percent fall in imports that more than offset an 11.3 percent fall in exports during the period under review.

Decline in import growth is contributed by both falling international prices and contraction in domestic demand. The impact of former was more visible in petroleum group imports while the impact of latter was more pronounced in machinery and other raw material import.

¹ Outflows through exchange companies used to be offset by inward home remittance and contra entry as other inflows.

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**.

Similarly, there was an across-the-board decline in exports. Fall in textile exports is partly attributed to lower unit prices amid subdued demand from US and EU and partly to domestic factors such as energy shortages and poor law & order situation. Likewise, fall in non-textile exports mainly owed to falling international prices of rice and lower production of petroleum products (for detail, see section on **Trade**).

6.2.2 Services (net)

During Jul-Nov FY10, deficit in services trade fell to the lowest level in the corresponding period of last five years. Lower outflow from foreign exchange companies for travel and other business purposes along with lower import related freight payments were the main contributory factors behind this improvement. However, absence of receipts against logistic support offset a part of the gains. Encouragingly, receipts against logistic support are likely to materialize in the months ahead.

6.2.3 Income (net)

After rising continuously in the last six years, deficit in the income account declined considerably during Jul-Nov FY10 (see **Figure 6.5**).

Specifically, the deficit dropped to US\$ 1.1 billion during Jul-Nov FY10 from US\$ 2.1 billion in the same period last year. Although a large part (more than 80 percent) of this fall was contributed by lower investment outflows, fall in net interest payments also contributed positively to overall improvement. During

Figure 6.5: Income Account Deficit Trend (Jul-Nov)

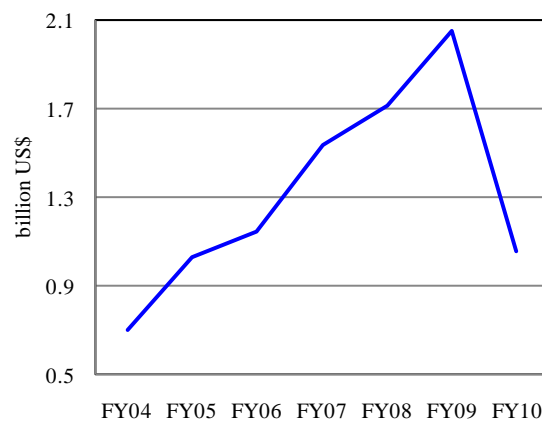
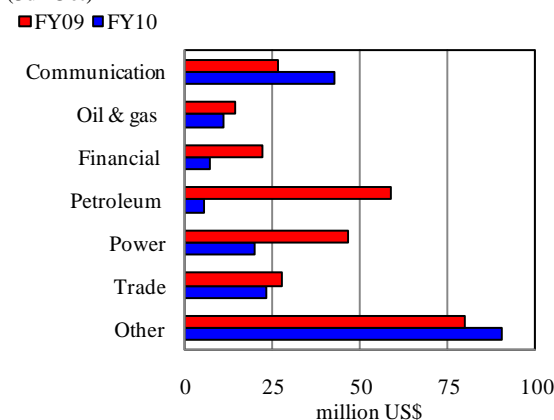


Figure 6.6: Sector wise Repatriation of Profit & Dividend (Jul-Oct)



Jul-Nov FY10, decline in investment income outflow was broad-based as all the major heads like repatriation of profit & dividends, purchase of crude oil & mineral and reinvested earnings recorded large declines. Lower repatriation of profit & dividends and reinvested earnings³ mainly owed to falling profits of most of the sectors. The profits were adversely hit by combinations of factors such as weak economic growth, fall in average prices of oil & gas, circular debt issue, energy crises and deteriorating law & order situation. Sector-wise data shows that almost all the major sectors recorded decline in repatriation of profit & dividends during Jul-Oct FY10 compared with Jul-Oct FY09 (see **Figure 6.6**).

The only exception was the communications sector, where a large privatized company returned to high profitability after successful completion of Voluntary Separation Scheme initiated last year. Likewise, decline in government's purchase of crude oil and minerals mainly showed both lower average gas and oil prices and lower extraction of oil and gas.

Fall in the net interest payment during Jul-Nov FY10 mainly resulted from lower gross payments which more than offset the fall in interest earnings on foreign exchange reserves. The decrease in interest payments, in turn, is contributed by lower payments on both the public and private external debt (see **Table 6.2**).

Decline in net interest payments partly owed to contraction in the stock of Euro bonds debt and partly to lower interest payment on floating debt (one fifth of total public sector debt) on account

Table 6.2: Details of Interest Payments and Receipts (Jul-Nov)

million US dollar

	FY09	FY10 ^P	Absolute change
Payments (I+II)	582.0	299.0	-283.0
I. Total external debt	468.0	250.0	-218.0
Public & publicly guaranteed	400.0	184.0	-216.0
Long-term	291.0	133.0	-160.0
Military	2.0	0.0	-2.0
Euro bonds	89.0	42.0	-47.0
Commercial loans/credits	2.0	5.0	3.0
IDB	14.0	4.0	-10.0
Private loans/credits	50.0	23.0	-27.0
IMF	18.0	43.0	25.0
II. External liabilities	114.0	49.0	-65.0
Foreign currency deposits	39.0	31.0	-8.0
Special US\$ bonds	1.0	0.0	-1.0
Central bank deposits	9.0	4.0	-5.0
Others	65.0	14.0	-51.0
Receipts	83.0	28.0	-55.0
Interest on reserves	40.0	6.0	-34.0
Others	43.0	22.0	-21.0
Net	-499.0	-271.0	228.0

P: Provisional

Source: State Bank of Pakistan

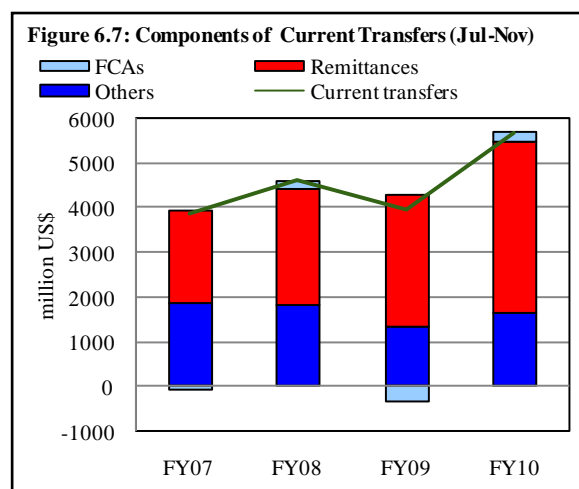
³ For discussion on reinvested earnings, see section on **Foreign Direct Investment**.

of falling LIBOR. However, increase in interest payment on IMF loans offset part of the above-mentioned gains.

6.2.4 Current Transfers

Commendable increase in workers' remittances, revival of inflows in both the Resident Foreign Currency Accounts (FCAs) and other private transfers led to a remarkable increase (43.9 percent) in overall current transfers during Jul-Nov FY10 (see **Figure 6.7**).

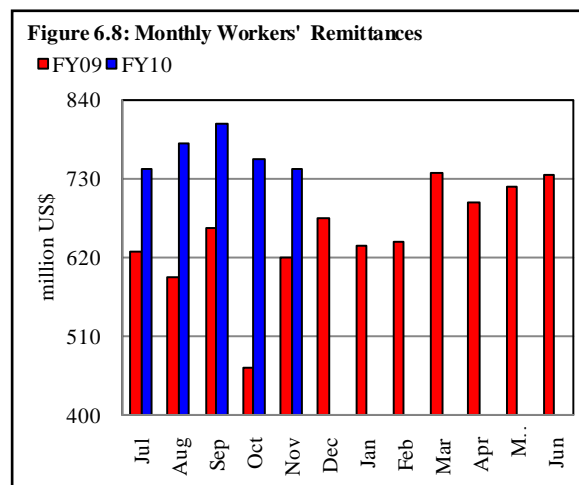
While a part of this growth is attributed to lower base set last year⁴, government and SBPs efforts to attract transfers through banking channel also paid dividends.



Workers' Remittances

Following the trend of last five years, workers' remittances showed a tremendous growth (29.2 percent) during Jul-Nov FY10. Monthly data shows that remittances remained higher than the previous year throughout the period (see **Figure 6.8**).

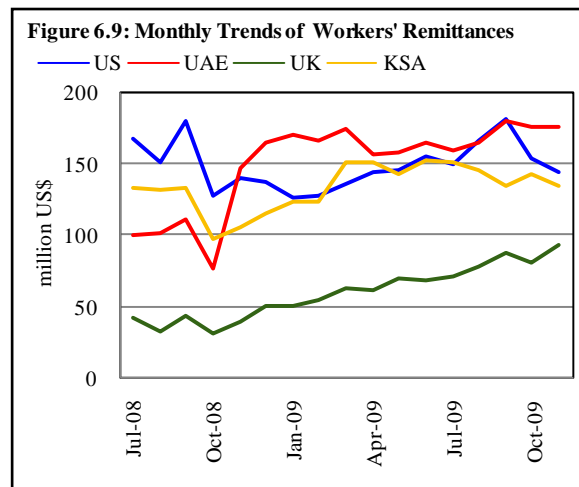
Country-wise data suggests that a large part of this growth was driven by United Arab Emirates (37.0 percent) and United Kingdom (25.4



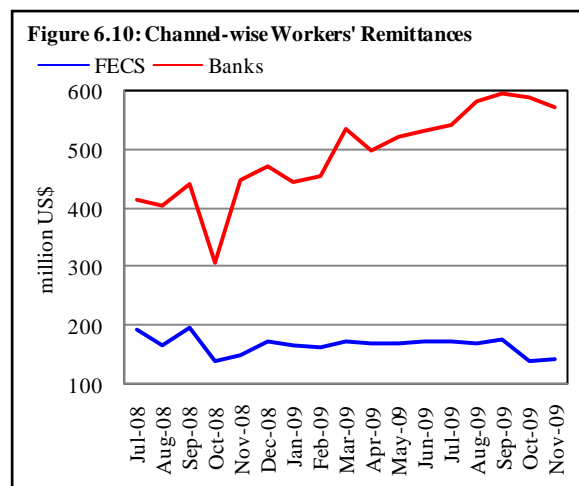
⁴ During Jul-Nov FY09, workers' remittances fell and RFCAs recorded withdrawals amid various rumors about FCAs freeze and substantial pressure on exchange rate.

percent) followed by Kingdom of Saudi Arabia (12.5 percent) (see **Figure 6.9**). The remittances from other countries like USA, Canada, Germany and Australia also exhibited moderate growth during the period under review.

The probable factors behind higher remittance from UAE are: a) diversion of a part of remittance from informal to formal channel as is evident from trend shift following the crackdown on illegal fund transfer, and b) increased outreach of banks having arrangements with overseas entities. Higher remittances from UK, on the other hand, possibly owed to expatriates shift of investment from Dubai to Pakistan in the wake of attractive asset prices here. In addition, increased outreach of banks and diversion of flows to formal channel are also playing their role. Encouragingly, remittance flow from USA is also recovering steadily.



Channel-wise data suggests that remittances routed through banking channel have increased quite significantly while through exchange companies' recorded nominal fall (see **Figure 6.10**). This is because of: a) fear of fund being stuck up in an event of action against the exchange company, as has been the case in past, b) increased competition as like exchange companies banks are also having bilateral tie-ups with the foreign entities and c) lower costs as sending funds through banks is free of charges since central bank reimburses the TT charges to the beneficiary's bank, and d) efforts, such as PRI, to attract funds through banking channel (see **Box 6.2**).



Box 6.2: Incentives for Remittance through Banks

1) Exchange Policy Department of State Bank is encouraging commercial banks to increase outreach. In this back drop, to support and facilitate banks in their diligence process, this Department will provide its input, if any, on the intended draft agreements between banks and other entities both within and outside Pakistan (FE Circular Letter No. 05. May 30, 2008).

2) To protect the beneficiary and remitter from any loss and encourage remittance through banking channel, SBP, Ministry of Finance and Ministry of Overseas Pakistanis jointly launched Pakistan Remittance Initiative (FE Circular No. 04, August 22, 2009).

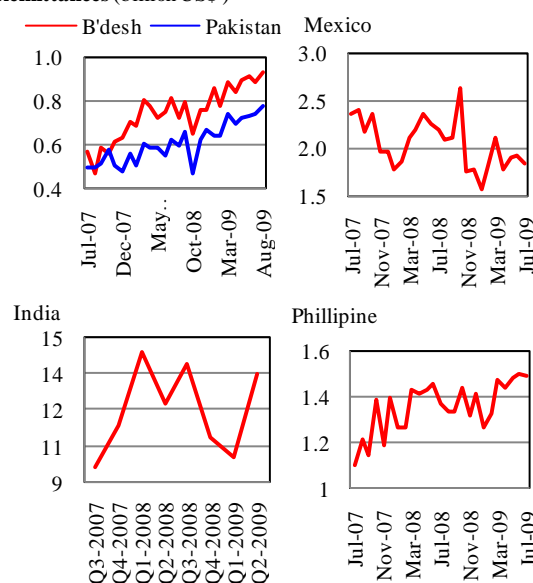
3) In order to encourage overseas entities (having specific home remittance related arrangements with banks in Pakistan) to enhance marketing effort at their end, Government of Pakistan shall reimburse marketing expenses (see **Table 6.2.1**) (FE-circular No 06, dated October 19, 2009).

Table 6.2.1: Incentives for Remittance through Banks

Remittances Mobilized by an Overseas Entity from any One Particular Jurisdiction (in Equivalent US\$)	Marketing Expenses Reimbursement (as % of Remittances Mobilized - in Equivalent US\$)
Up to 100 million	Nil
Above 100 million to 400 million	0.50 percent on incremental amount (i.e., on remittances above 100 million).
Above 400 million to 800 million	0.75 percent on incremental amount (i.e., on remittances above 400 million), plus amount calculated in the above slab.
Above 800 million to 1,200 million	1 percent on incremental amount (i.e., on remittances above 800 million), plus amount calculated in the above slab.
Above 1,200 million	1 percent on total remittances mobilized.

Impact of Global Recession

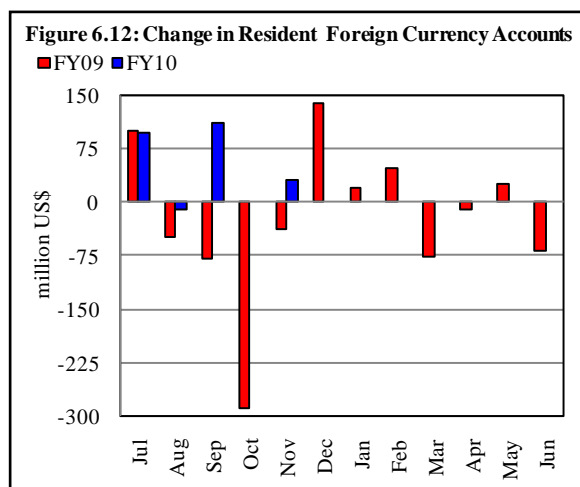
The behavior of remittances from various destinations during the current recession shows relatively higher impact on the remittances of countries with higher migrants stock in North America and Europe (see **Figure 6.11**). On the other hand, remittances to the countries with higher migrant stock in Asia (Middle East in particular) showed resilience. This is because of: a) the migrants in Middle East are low profile and on non permanent basis who remit a major chunk of their income to support their spouses and

Figure 6.11: Country Comparison of Inward Workers' Remittances (billion US\$)

families back home, and b) recession in these countries was not as severe as in the west.

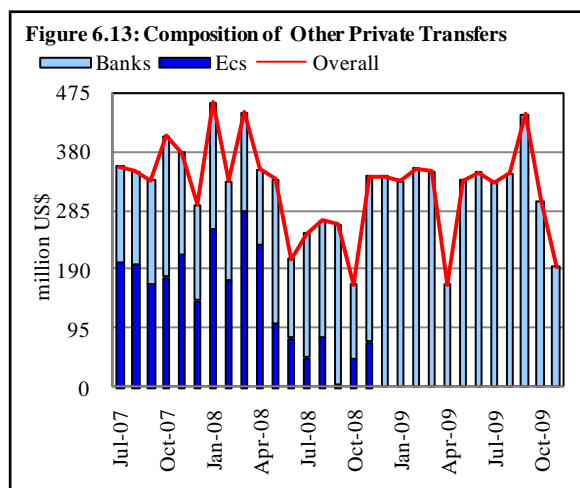
Resident FCAs

Higher enterprises inflows led to US\$ 231 million increase in RFCAs during Jul-Nov FY10 compared with net outflows of US \$ 352 million in the same period last year. Major enterprises inflows during the period included OGDC, KESC and UN mission. Monthly trend of resident FCAs suggests that most of these inflows were concentrated in July and September 2009. It may be pointed out that RFCAs recorded massive outflow during the comparable period last year on account of pressure on exchange rate. However, in the ensuing months stability in exchange rate had revived RFCAs inflows to the great extent (see **Figure 6.12**).



Other Private Transfers

After falling in Jul-Nov FY09, other private transfers recovered noticeably during Jul-Nov FY10. It may be noted that composition of the transfers has also undergone some change in the recent months. In contrast to past trend, when these transfers were routed through both FECs and banks, other private transfers were only routed through banks in FY10 (see **Figure 6.13**). Transfers through FECs fell mainly because of fall in their outflows.⁵ Increase in bank transfers, on the other hand, is



⁵ Other than home remittance inflows of FECs were recorded as contra entry of the FECs outflows in services account.

attributed to sharp increase in RFCAs conversion by other enterprises. This increase in RFCAs conversion coincided with the SBP decision to instruct FECs to close their nostros with banks abroad and shift their balance to RFCAs of banks in Pakistan (see **Box 6.3**). Thus this increase in banks' other transfers may be attributed to increased RFCAs conversion of e FECs.

Box 6.3: Steps to Route Foreign Exchange Companies Inflows through Banks

- 1) All Exchange Companies were required to close all their existing Nostros and bring back the balances held in those accounts into their FCAs in Pakistan. Moreover, all permissible inflows/outflows of exchange companies are to be routed only through FCY Accounts maintained with Commercial Banks in Pakistan (FE Circular No. 04, May 09, 2008)
- 2) Exchange Companies must bring a minimum of 25 percent of foreign currencies exported by them in their FCAs maintained with banks in Pakistan. Out of this, 10 percent is to be sold in interbank market and remaining amount must be withdrawn in cash US dollar from FCAs in Pakistan (FE Circular No. 02, April 29, 2008).
- 3) Minimum 15 percent, instead of earlier 10 percent, of inward home remittance (equivalent US dollar) must invariably be sold in interbank market (FE Circular No. 02, April 29, 2008).
- 4) Exchange companies should make arrangement with those foreign entities which has proper KYC policy, physical presence and affiliated with a regulated financial group (FE Circular No. 01, January 01, 2009).

6.3 Financial Account

Financial inflows revived to greater extent during Jul-Nov FY10, after sharp fall in the same period last year (see **Figure 6.14**). This improvement mainly resulted from increased inflows from IMF and modest revival of foreign inflows to equity market. However, foreign direct investment fell substantially during the period owing to both global and domestic recession along with increasing security risk and continued energy crises.

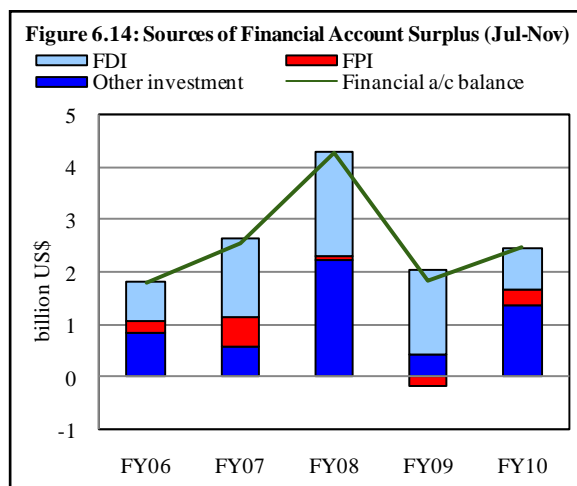


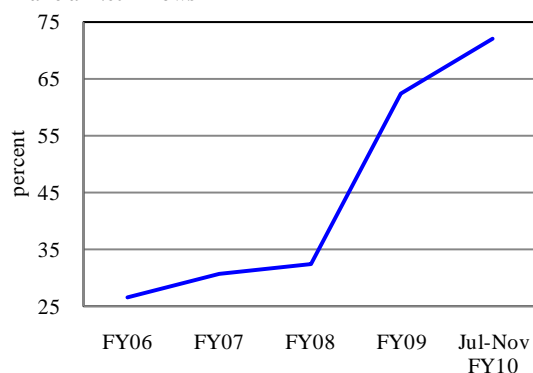
Table 6.3: Current Account Balance (Jul-Nov)			
million US dollar			
	FY09	FY10^P	Absolute change
1. Trade balance	-7,053.5	-4,697.0	2,356.5
Exports	8,651.5	7,677.0	-974.5
Imports	1,5705.0	1,2374.0	-3,331.0
2. Services (net)	-2,166.0	-1,294.0	872.0
Transportation	-1259.0	-921.6	337.4
Travel	-615.0	-273.6	341.4
Communication services	-14.0	41.0	55.0
Construction services	-14.0	-5.8	8.2
Insurance services	23.0	11.8	-11.2
Financial services	-45.0	29.0	74.0
Computer & information services	38.0	28.0	-10.0
Royalties and license fees	-24.0	-32.0	-8.0
Other business services	-644.0	-276.0	368.0
Personal & cultural & recreational services	0.0	-11.0	-11.0
Government services	429.0	178.0	-251.0
of which: Logistic support	365.0	0.0	-365.0
3. Income (net)	-2,051.0	-1,056.0	995.0
Investment income (net)	-2,056.0	-1,058.0	998.0
Direct investment	-1,433.0	-775.0	658.0
of which: Profit & dividends	-311.0	-213.0	98.0
Purchase of crude oil and minerals	-692.0	-545.0	147.0
Portfolio investment	-235.0	-60.0	175.0
of which: Dividend	-72.0	-48.0	24.0
IMF charges & interest on off. external debt	-327.0	-185.0	142.0
Interest on private external debt	-50.0	-23.0	27.0
Interest on reserves	40.0	6.0	-34.0
Others (net)	-46.0	-19.0	27.0
4. Current transfers (net)	3,953.0	5,688.0	17,35.0
Private transfers	3,868.0	5,657.0	1,789.0
Workers' remittances	2,966.0	3,832.0	866.0
FCA - residents	-352.0	231.0	583.0
Others	1,254.0	1,594.0	340.0
of which: Exchange companies	247.0	0.0	-247.0
Official transfers	85.0	31.0	-54.0
Current account balance	-7,317.5	-1,359.0	5,958.5
P: Provisional			

Importantly, this improvement in financial inflows is difficult to sustain. This is because of: (a) higher inflows from IMF mainly reflects one off SDRs allocation and, (b) inflows in equity markets are uncertain as is evident from their erratic behavior in the past.

Moreover, as a result of higher debt creating inflows, their share in overall financial inflows is on increase (see

Figure 6.15). The shift toward debt flows does not bode well for the medium to long term sustainability of external accounts.

Figure 6.15: Share of Debt Creating Flows (net) in Total Financial Net Inflows



Debt creating flows include IMF loans, SDR allocation and liabilities

6.3.1 Net Foreign Investment (NFI)

Net foreign investment continued declining for the second consecutive year. Unlike the previous year, however, when the decline was broad based; a part of fall in foreign direct investment was offset by higher portfolio inflows during Jul-Nov FY10. As a result, decline in NFI was limited to 25.6 percent during Jul-Nov FY10 against 29.6 percent fall during the corresponding period last year (see **Table 6.4**).

Table 6.4: Net Inflow of Foreign Investment in Pakistan (Jul-Nov)
million US dollar

	FY09	FY10	Growth (%)
Foreign investment	1,457.8	1,085.3	-25.6
I. Private investment	1,474.6	1,092.1	-25.9
Foreign direct investment	1,620.7	774.0	-52.2
Portfolio investment	-146.1	318.1	317.7
Equity securities	-146.1	318.1	317.7
Debt securities	0	0	0
II. Public investment	-16.8	-6.8	59.5
of which: Debt securities*	-16.8	-6.8	59.5

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

Foreign Direct Investment

As in the previous year, foreign direct investment remained under pressure during Jul-Nov FY10. With the recession at global and domestic level, a part of foreign direct investment 'reinvested earnings' was bound to weaken. The affect of recession on foreign direct investment in Pakistan was further exacerbated by

deteriorating law & order situation and energy crises. Fall in reinvested earnings accounted for 32 percent and fall in cash investment around 68 percent of the overall decline (52.3 percent) in foreign direct investment during the period under review (see **Table 6.5**).

Table 6.5: Sector wise Foreign Direct Investment (Jul-Nov)

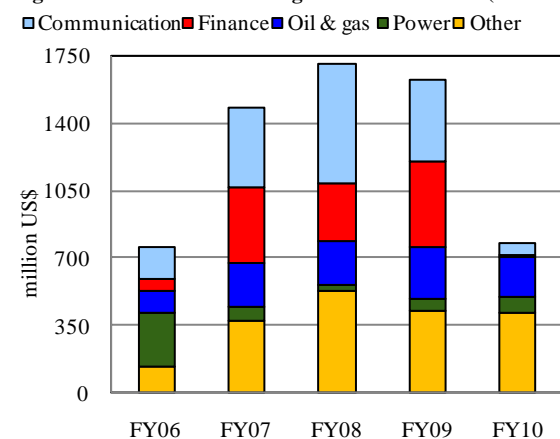
million US dollar

	FY09			FY10		
	Cash	Re-invested earnings	Total	Cash	Re-invested earnings	Total
Chemicals	-1.9	19.5	17.5	35.9	21.0	56.9
Petroleum refining	10.7	28.1	38.8	4.7	15.8	20.6
Oil & gas explorations	183.7	91.9	275.5	154.9	52.4	207.3
Cement	8.0	17.5	25.6	0.1	3.9	3.9
Power	58.3	1.9	60.2	64.0	13.8	77.7
Trade	53.1	20.1	73.1	27.3	6.0	33.3
Telecommunications	329.6	37.1	366.7	97.9	-38.7	59.3
Financial business	309.1	135.0	444.1	19.61	-0.7	18.0
Personal services	47.9	1.7	49.7	18.4	1.7	20.1
Others	192.9	76.4	269.3	260.3	16.5	276.8
Total	1,191.5	429.2	1,620.7	683.2	91.8	774.0

It may be pointed out that during the last three years (FY07-FY09) more than 70 percent of Pakistan foreign direct investment was concentrated in three sectors, i.e., communication, financial business, and oil & gas exploration. With the increase in provisioning costs of financial business and stiff competition in communication, foreign direct investment inflows in these two sectors dried up during Jul-Nov FY10 (see

Figure 6.16). Likewise, foreign direct investment in oil & gas exploration, petro chemicals, pharmaceuticals, cement, and trade also declined. However,

Figure 6.16: Sector-wise Foreign Direct Investment (Jul-Nov)



investment in power sector increased by 28.9 percent during the period. The developments in major sectors are as follows:

Communication

Lower investment in communication sector largely reflected market saturation and losses of some of the companies. Major contributory factors behind fall in profits or higher losses of the business are: a) re-registration of SIMs, b) heavy taxes and SIM activation charges, and c) higher advertisement cost due to stiff competition.

Financial Business

Absence of merger and acquisition and lower reinvested earnings on the back of increase in provisioning costs of banks were the major reasons behind fall in FDI flows to the sector. Moreover, repayment of US\$ 14 million inter-company loan of one of the banks also contributed to lower investment in the sector.

Oil and Gas Exploration

After increasing in Jul-Nov period of five successive years, FDI in oil & gas exploration recorded decline during Jul-Nov FY10. This decline is partly explained by war against terrorism that restricted the operations of OGDC in the NWFP and partly to lower reinvested earnings on account of lower average prices of oil and gas during the period.

Power Sector

Unlike the above sectors, power sector registered a significant growth mainly on account of US\$ 30 million investment in KESC 560 MV project at Port Qasim and US\$ 20 million for Uch power project.

Other major receipts recorded in Packages (Pvt) Limited (paper & pulp) US\$ 80 million and Procter & Gamble Pakistan (chemicals) US\$ 24 million during Jul-Nov FY10.

Country wise data shows that FDI flows from major contributors like USA and UK declined while from UAE and Netherlands increased during the period under review. Other major countries that witnessed decline in foreign inflows included Hong Kong, Japan and Singapore.

Looking ahead, in line with global economic recovery and expected revival in profits, foreign direct investment is likely to increase to emerging markets in the latter part of FY10. This is because of: a) the recent growth rebound is led by emerging economies, and b) relatively low interest rates in developed economies

may encourage capital flows to emerging economies.⁶ In this perspective, addressing structural problems and boosting economic growth in Pakistan is pivotal to attract foreign direct investment once international financial conditions normalize. Moreover, foreign direct investment also needs to be diversified from services sector to manufacturing sector in general and export oriented industries in particular.

Portfolio Investment

In sharp contrast to net outflow of US\$ 182 million during the comparable period of last year, portfolio investment recorded net inflow of US\$ 301 million during Jul-Nov FY10. The entire increase stemmed from higher investment in stock market (see **Figure 6.17**).

This increase was attributed to a series of positive developments like a) re-entry of Pakistan index in MSCI frontier Index, b) IMF augmentation of SBA and SDR allocation, and c) Standard & Poor's upgraded Pakistan sovereign rating from CCC+ to B- while Moody's changed Pakistan's economic outlook from negative to stable. Higher investment in Pakistan's stock market is also in line with international trend. With massive fiscal and monetary stimulus and consequent global liquidity ease, foreign flows to emerging equity markets revived

Figure 6.17: Foreign Investment in Pakistan Equity Market

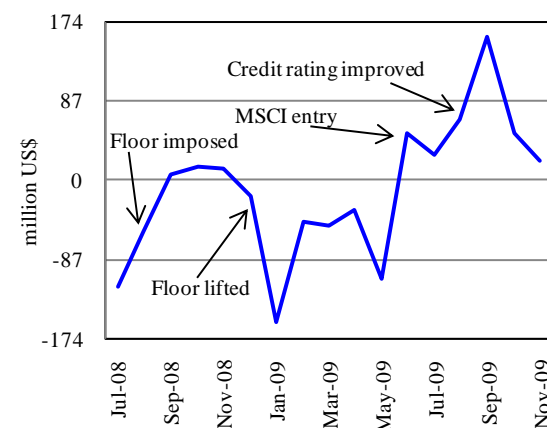
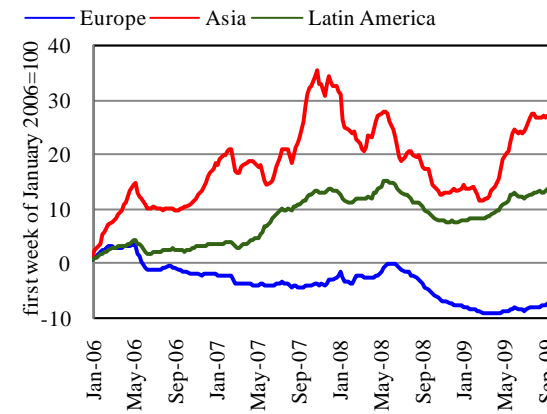


Figure 6.18: Net Foreign Flows to Emerging Economies Equity Markets



⁶ Institute of International Finance Research note on capital flows to emerging market economies (October 3, 2009).

in second quarter of CY09 and further strengthened in third quarter of CY09 (see **Figure 6.18**).

Table 6.6: Performance of Various Sovereign Bonds

value: million US dollar , yield in percent

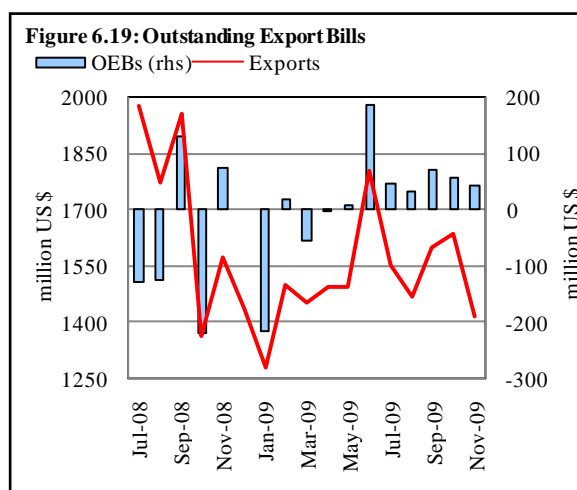
Issue Year	Bond	Tenor	Maturity	Value	Yield at issue	Yield at 30 Jun, 2009	Yield at 30 Nov, 2009
FY06	Euro	10-years	Mar-16	500	7.1	15.3	9.1
FY06	Euro	30-years	Mar-36	300	7.9	15.0	10.5
FY07	Euro	10-years	Jun-17	750	6.9	14.2	9.9
Spread Over US treasury bond							
Issuing date				30-Jun-09	30-Nov-09		
FY06	Euro	10-years	2.4	11.8	5.9		
FY06	Euro	30-years	3.1	10.7	6.3		
FY07	Euro	10-years	1.8	10.7	6.7		

Moreover, like other emerging markets, spread on yield between Pakistan euro bond and US Treasury bond has narrowed, close to the trend but above the rate at date of issue (exceptionally low pre-crisis rates) (see **Table 6.6**).

With the narrowing spreads, access of many emerging markets to international capital market has restored. Thus Pakistan may also consider tapping international capital markets, though at higher rates compared with that of previously issued bonds.

6.3.2 Outstanding Export Bills

The stock of aggregate outstanding export bills has increased by US\$ 246 million during Jul-Nov FY10 against decline of US\$ 268 million in the comparable period last year. Monthly data shows that change in stock of outstanding exports bills is in line with export proceeds (see **Figure 6.19**).



6.3.3 Currency and Deposits (Assets)

In sharp contrast to decline of US\$ 123 million during the Jul-Nov period of last year, currency and deposits increased by US\$ 111 million during Jul-Nov FY10. This increase is largely attributed to increase in FE-25 nostros during the period.

6.3.4 Official Long-term Loans

Official long term loans recorded a net inflow of US\$ 986 million during Jul-Nov FY10 against an inflow of US\$ 126 million received during the corresponding period previous year. The improvement mainly emanated from US\$ 745 million from IMF for bridge financing. Along with this, loans receipts of US\$ 151 from ADB for Punjab government efficiency improvement program and US\$ 265 from World Bank under Benazir Income Support program and higher education also contributed. On the payment side, amortizations decreased by US\$ 222 million during the period under review.

6.3.5 Official Short-term Loans

The official short term loans registered net outflow of US\$ 434 million during the period under review. This was mainly due to repayment of US \$ 334 million to Islamic Development Bank during Jul-Nov FY10.

6.3.6 Private Loans

The private loans recorded a net outflow of US\$ 11 million against net inflow of US \$ 147 million during corresponding period last year. During Jul-Nov FY10, private sector recorded an inflow of US\$ 167 million against US \$ 178 million of loans repayments. Major companies that recorded inflows were Warid Telecom (US\$ 19.7million), Wateen Telecom (US\$ 17.3 million) and Engro Energy (Pvt) Limited (US\$ 34 million) during the period under review.

6.3.7 Currencies and Deposits (liabilities)

Currency and deposits increased by US\$ 19 million during Jul-Nov FY10 compared with a decline of US\$ 142 million in the corresponding period last year. This increase was largely on account of lower retirement of trade financing compared to the corresponding quarter of last year. During Jul-Nov FY09, trade financing declined by US\$ 397 million. Nonetheless, in current fiscal year it is only limited to US\$ 41 million on account of exchange rate stability.

Table 6.7: Financial Account (Jul-Nov)

million US dollar

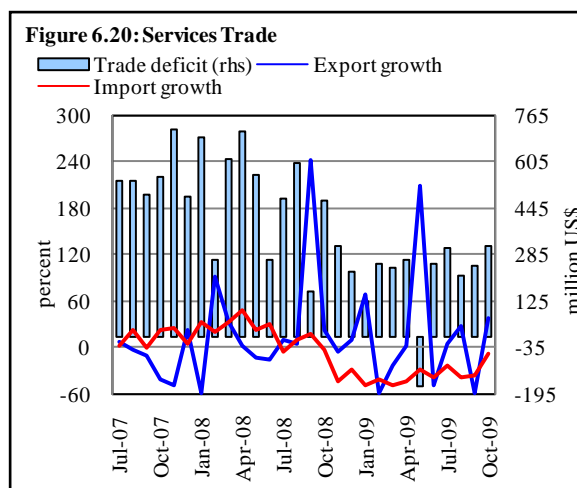
	FY09	FY10 ^P	YoY change (%)
Financial account (net)	1,845.0	2,488.0	34.9
Direct investment abroad	-8.0	36.0	-550.0
Direct investment in Pakistan	1,621.0	774.0	-52.3
Equity capital	1,191.0	614.0	-48.4
of which: Privatization receipts	0.0	0.0	0.0
Reinvested earnings	430.0	160.0	-62.8
Portfolio investment	-182.0	301.0	265.4
Equity securities	-168.0	308.0	283.3
Debt securities	-14.0	-7.0	50.0
Net foreign investment	1,431.0	1,111.0	-22.4
Other investment	414.0	1,377.0	232.6
Assets	391.0	-357.0	-191.3
1. Outstanding export bills (exporters)	123.0	-213.0	-273.2
2. Outstanding export bills (DMBs))	145.0	-33.0	-122.8
3. Currency and deposits	123.0	-111.0	-190.2
of which banks	73.0	-81.0	-211.0
Liabilities	23.0	1,734.0	7,439.1
1. Foreign Long-term govt. loans / credits (net)	126.0	986.0	682.5
Project loans	298.0	284.0	-4.7
Non- project loans	565.0	1,217.0	115.4
Amortization	737.0	515.0	-30.1
2. Private loans	147.0	-11.0	-107.5
of which: Supplier credits	254.0	167.0	-34.3
Suppliers credit repayments	107.0	178.0	66.4
3. Short term capital (official)	-137.0	-434.0	-216.8
of which: IDB (net)	-37.0	-334.0	-802.7
4. Currency and deposits	-142.0	19.0	113.4
5. Other liabilities	23.0	1,174.0	5,004.3

P: Provisional

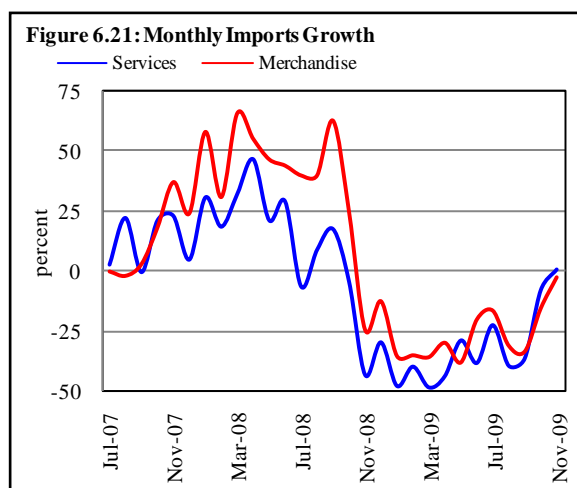
Source: Statistics Department, SBP

6.4 Trade in Services

Continuing the trend of FY09, the services trade deficit contracted considerably by 40.3 percent during Jul-Nov FY10 as compared to a 24.1 percent fall during the same period last year (see **Figure 6.20**). This welcome reduction in services trade deficit is principally due to the decline in services imports which overwhelmed the impact of decline in services exports during the period under analyses.



All major categories of services imports witnessed fall, apart from government services and construction & insurance services (share of these two is negligible in overall services imports). The overall decrease in merchandise imports (see **Figure 6.21**) coupled with the rigorous check on outflows of foreign exchange companies by SBP (see **Box 6.4**) still continued to hold down the services imports.



A part of reduction in services exports growth can be explained by factors such as decline in merchandise exports, lower seat occupancy of Pakistan Airlines, absence of logistic support receipts and fall in information technology services exports during Jul-Nov FY10.

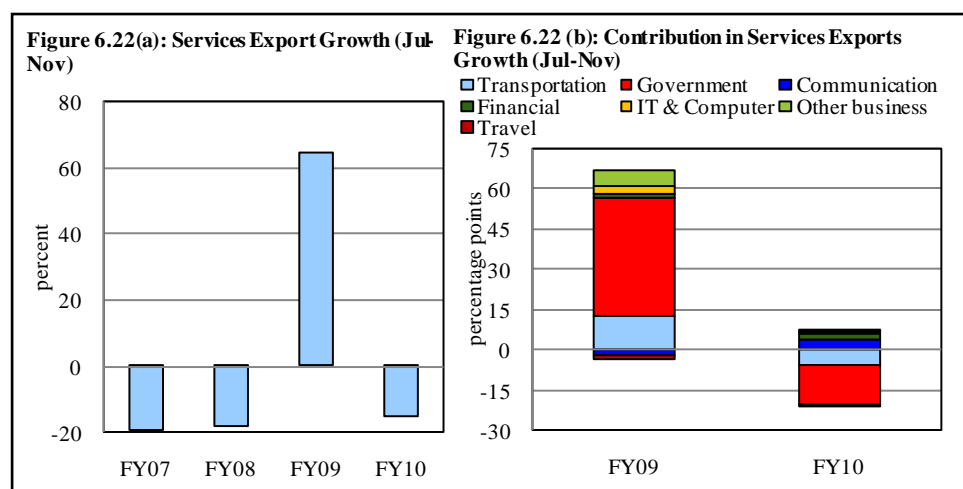
Box 6.4: SBP's Restrictions on Outflows of Foreign Exchange Companies

As a regulator, SBP introduced necessary measures to control the activities in the forex market. During the last eighteen months, SBP has taken many steps to improve monitoring of the activities of exchange companies including the following:

1. Exchange company permissible outflows were restricted to 75 percent of the home remittances mobilized by the company during the preceding month (FE Circular No. 04, May 09, 2008).
2. In addition to US dollar, exchange companies were not allowed to export cash in U.K. Pound Sterling, Euro and UAE Dirhams (FE Circular No. 04, May 09, 2008).
3. All the currency carriers must be employees of the exchange company (FE Circular No. 10, December 12, 2008).
4. It would be compulsory for exchange companies to finalize the deal with overseas entity before the shipment of each export consignment. The system generated deal ticket must be accompanied with the each request for exporting permissible FCYs (FE Circular No. 10, December 12, 2008).
5. All the Exchange companies will be required to take prior approval of State Bank for all transactions of US \$ 50,000 or above (or equivalent in other foreign currencies) on account of outward remittances or sale of foreign currencies to the customers (FE Circular No. 06, July 08, 2008).
6. Exchange companies are also required to report to SBP on daily basis, all transactions of US\$ 5000/- or above (or equivalent thereof) made by the exchange company on account of (i) sale/purchase over the counter and (ii) outward remittances with all related particulars (FE Circular No. 02 . April 29, 2008).

6.4.1 Services Exports

Overall services exports experienced a reduction of 8.6 percent during Jul-Nov FY10 against a remarkable growth rate of 51.2 percent in the corresponding period of preceding year (see **Figure 6.22a** and **Table 6.8**). The decline in the exports of transportation and government services were the primary reasons behind the fall in overall services exports (see **Figure 6.22b**). In contrast to the above mentioned



services groups, travel, telecommunication, financial services and other business services exports showed growth during the first four months of current fiscal year.

Table 6.8: Services Exports (Jul-Nov)

million US dollar

Groups	Absolute Value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	573.0	478.0	32.6	-16.6	34.9	31.8
Government services	572.0	418.0	168.5	-26.9	34.8	27.8
Other business services	215.0	214.0	36.1	-0.5	13.1	14.3
Travel	87.0	111.0	-18.7	27.6	5.3	7.4
Communication services	36.0	108.0	-39.0	200.0	2.2	7.2
Financial services	27.0	70.0	50.0	159.3	1.6	4.7
Computer & IT.	82.0	77.0	49.1	-6.1	5.0	5.1
Insurance services	31.0	16.0	138.5	-48.4	1.9	1.1
Construction services	9.0	6.0	-40.0	-33.3	0.5	0.4
Royalties and license fees	10.0	3.0	-37.5	-70.0	0.6	0.2
Total exports	1,642.0	1,501.0	51.2	-8.6		

Transportation services exports witnessed a decline of 16.6 percent during Jul-Nov FY10 against an increase of 32.6 percent during the same period last year. The reduction in exports of transportation services is attributing to lower earnings of domestic airlines, falling merchandise exports and declining payments by foreign airlines due to curtailed operations.

The major sub-category 'passage earnings' of domestic airlines which comprise more than half of the overall transportation services exports fell by 5.9 percent during Jul-Oct FY10 compared to 12.9 percent growth in Jul-Oct FY09. The fall in seat occupancy of the international flights of national airlines, probably reflecting the weakness in the global and domestic economies.

Similarly, freight earnings declined by 45.6 percent due to declining exports growth during Jul-Oct FY10. Other local disbursements of foreign airlines and shipping companies fell by 8.6 percent on account of stoppage of flight operations by six gulf-states airlines followed by terrorist attacks in the province of NWFP.⁷ As in the transportation services exports, a decline was also observed in *computer & information services* exports which fell by 6.1 percent during Jul-Nov FY10, (US\$ 3.6 million) compared to 49.1 percent strong growth in the same period of

⁷ These include Saudi Arabian Airlines, Emirates Airlines, Gulf Air, Air Arabia, Etihad Airways and Qatar Airways.

FY09. The noteworthy performance of software consultancy services (YoY growth of 95.4 percent in Jul-Oct FY10) is offset by the decline in other computer services category (YoY fall of 61.1 percent Jul-Oct FY10).

On the domestic front, IT industry is hampered by the issues such as weak enforcement of legal framework, shortage of quality human resource and financing issues. Moreover IT industry has started feeling the taste of global economic slowdown as offshore demand of exports has been declining since FY09, however exports of the category are likely to grow once the demand revives in the advanced economies (the major buyers of Pakistani IT related products).

The global economic downturn has resulted in longer sales cycle, in-sourcing and price pressure. According to CBI⁸, in the coming years, the EU market will take on off-shoring activities to a much larger extent than before the crisis. So, the developing countries service providers must be prepared to tap the upcoming opportunities.

The government on its part is trying to promote IT exports by taking some concrete steps as mentioned in SBP's Annual Report for 2008-09. In this regard, the government has formulated Information and Communication Technology (ICT) task force to promote software exports, development of domestic software/ computer hardware and telecom equipment industry, development of citizen centric applications/services especially in local language, raising quality and enrolment of IT education, make recommendations for the promotion of IT/Telecom sectors, suggest incentives; and estimate the investment requirements for the public and private sector. The ICT task force has submitted a final document on first five years Information Technology (2010-2015) to the Planning Commission. The IT policy should not only be incorporated in Trade Policy but also included in the next five year plan. The ICT task force is also making contingency planning for reducing the impact of global economic recession on Pakistan.

Like services exports, the *government* services exports experienced a decline of 26.9 percent during Jul-Nov FY10 compared to 168.5 percent growth in the corresponding period of preceding year. The volatility reflects the uncertainty in receipts from USA for logistic support to NATO forces in Afghanistan.

However, the performance of non-logistic support is remarkable; it rose by 101.9 percent YoY during Jul-Nov FY10 compared to the decline of 2.8 percent in the

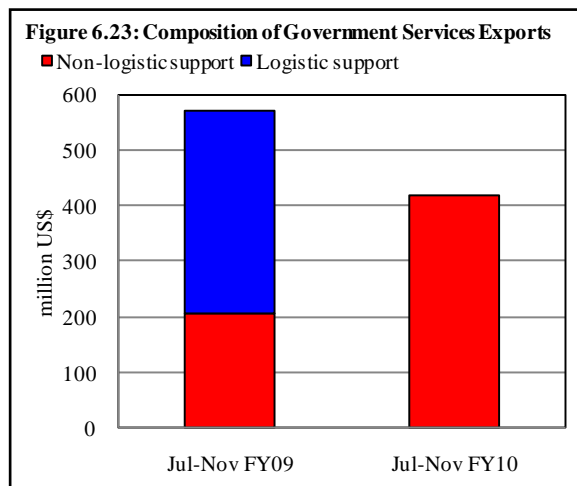
⁸ CBI stands for "Centre for Promotion of Imports from Developing Countries" in EU.

corresponding period last year (see **Figure 6.23**). The notable performance of non-logistic supports services is attributable to the increased remittances of Pak missions from abroad and higher volumes of transfers received by international organizations.

In contrast to decline in the exports of transportation, IT and government services in Jul-Nov FY10, encouraging growth was observed in the exports of communications, travel and financial services during the first five months of the current fiscal year.

Exports of *communication* services recorded an appreciable growth rate of 200 percent during Jul-Nov FY10 compared to the decline of 39 percent during the same

period previous year. The remarkable growth of this category is attributable to the rising exports of telecommunication services through the recognized telecom operators following aggressive action by Pakistan Telecommunication Authority (PTA) against illegal exchanges. As a result, the share of communication services in overall services exports increased to 7.2 percent in Jul-Nov FY10 from 2.2 percent in the corresponding period last year.



Similar to communication services, travel services export performed well in the first five months of current fiscal year. Travel services exports on account of foreign tourists (foreign tourists constitute almost 90 percent of overall travel services exports) recorded 27.6 percent growth during Jul-Nov FY10 compared to 18.7 percent decline in the same period of FY09. This growth however, shows somewhat low base as the incremental amount is only US\$ 24 million in the period under review as compared to the fall of US\$ 20 million in the same period last year. Due to global recession, tour operators have shortened the projects and multinational companies have cut back on business trips & events, which probably reduced the exports of travel services.

The travel industry depends upon its allied industries of tourism and hotel industries, in which Pakistan has a huge potential for both investors and tourists. Revenue growth in the hotel industry has dropped steeply in wake of the global recession and persistent poor law & order situation in some areas of Pakistan.

Other business services

recorded a moderate fall of 0.5 percent during Jul-Nov FY10 as compared to 36.1 percent strong growth in the same period last year. During Jul-Oct FY10, none of the categories has seen a major change apart from refunds on weight loss or claims on price which has seen a fall of 70.7 percent due to lower level of imports during the period under analysis. The gain from refunds is partially offset by declining miscellaneous items which are down by 22 percent during Jul-Oct FY10 as compared to the healthy growth of 84.6 percent in Jul-Oct FY09 (see **Table 6.9**).

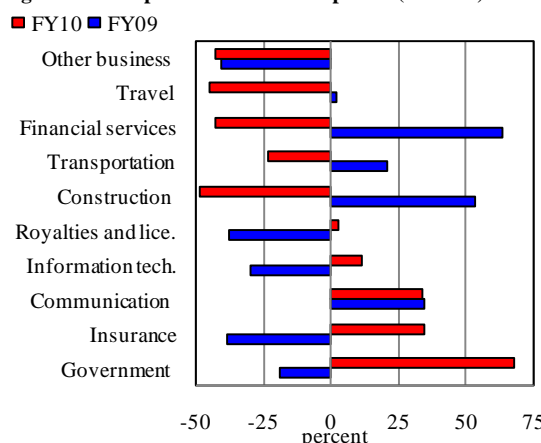
Table 6.9: Other Business Services Exports - Major Items (Jul-Oct)

million US dollar			
	FY08	FY09	FY10
Merchant. & trade related services	14.0	4.5	8.8
Bus. & manag. consultancy	18.0	26.9	29.7
Agency commission	39.6	48.0	50.3
Adv. market research & pub. opinion	6.9	8.1	6.7
Arch., engineering, & technical	7.0	21.5	12.5
Misc. other business services,	48.0	88.7	69.3
Refund	-29.1	-42.9	-12.6
Total	117.0	170.7	173.2

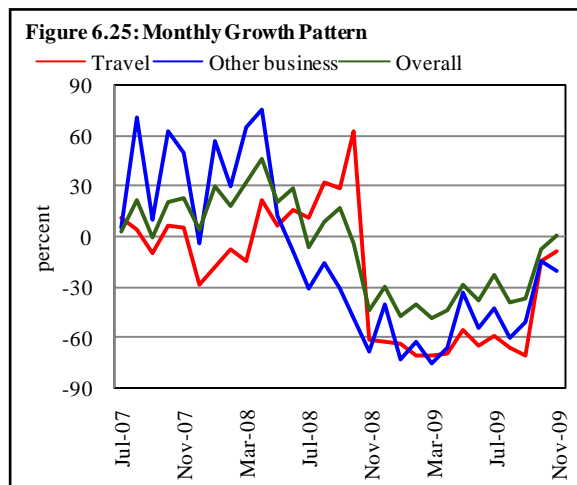
6.4.2 Services Imports

A depressed performance was shown by overall services imports in the first five months of FY10, with a decline of 26.6 percent against the fall of 3.3 percent in the corresponding period of previous year. The decline in the imports was broad based with all major groups (having more than 85 percent share in import services) experienced negative growth with the exception of government services, insurance and communication services groups having about 11 percent share in the overall services imports (see **Figure 6.24**).

Figure 6.24: Imports Growth - Group-wise (Jul-Nov)

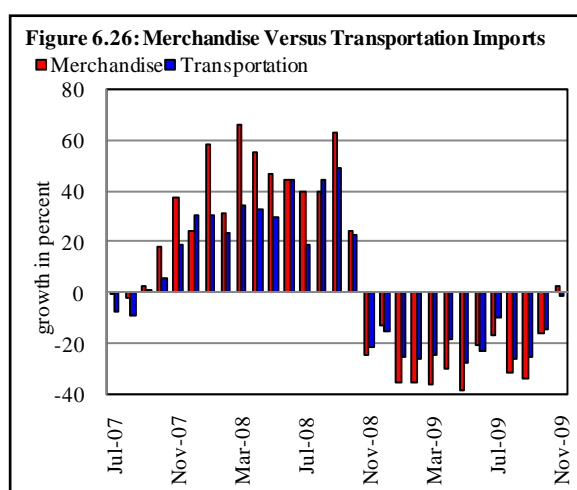


Overall services imports declined persistently since October 2008 primarily after the crackdown on the exchange companies as two of the major categories namely travel and other business captured a larger portion of import routed through exchange companies. In fact, any cash selling on the counters of foreign exchange companies used to record as for travel. The same was the case with other business services where both the categories had larger portion under the sub category 'through exchange companies'. SBP's restrictions on exchange companies (see **Box 6.4** and **Figure 6.25**) forced the transactions of foreign exchange companies to be routed through the commercial banks.



The other major factor behind the fall of overall services imports was the falling payments of freight due to declining merchandise imports during the period under analysis.

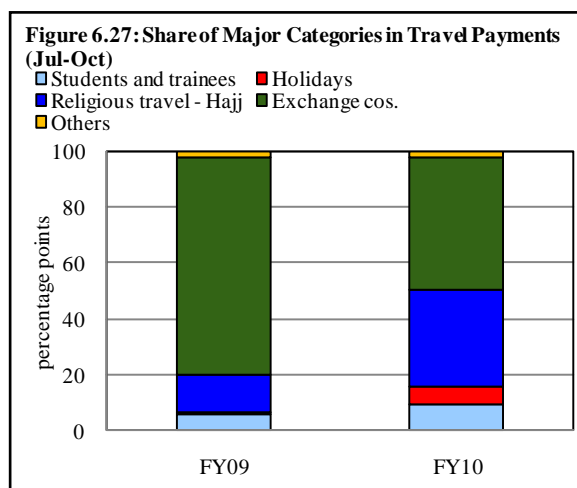
Transportation services imports fell by 23.6 percent during Jul-Nov FY10 compared to the hefty growth rate of 31.8 percent in the corresponding period last year. The decline in imports



of transportation services is attributed to decline in merchandise imports (see **Figure 6.26**) on account of lower freight payments. The payments to foreign airlines also witnessed fall of 27.2 percent during Jul-Oct FY10 compared to 49.2 percent in the same period of previous year. The suspension of flight operations by British, French and Dutch airlines continued to restrict the category's imports.

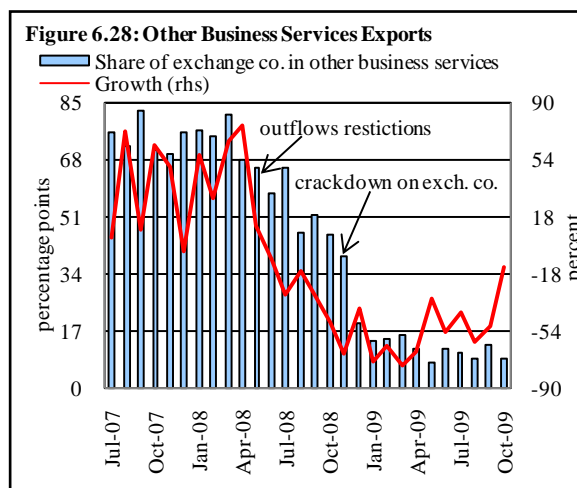
Further, the recent terrorist activities also called for the end of flight operations by six Gulf countries airlines to and from Peshawar.

Similar to transportation, *travel* services imports declined by 45.2 percent on account of outflows restrictions on exchange companies during the period under consideration as compared to the growth rate of 3.2 percent in Jul-Nov FY09. As a result, share of exchange companies in travel services imports declined to 46.5 percent in Jul-Nov FY10 from 72.7 percent in the corresponding period last year (see **Figure 6.27**).



However, payments under the religious travel (Hajj) increased by 1.0 percent during Jul-Nov FY10. A part of this increase might be due to the higher numbers of pilgrims and rise in compulsory Hajj dues.⁹

Further, the increase in the category of *holiday on recreational tours abroad* probably reflects the shifting of the local tourist from northern areas to international tourism on the back of operation against terrorist and shifting of payments through formal channel.



⁹ The number of pilgrims is estimated to increase by 5000 and compulsory Hajj dues are increased by 100 Saudi Riyals.

As in travel services imports, the *other business* services also experienced a fall of 43.0 percent during Jul-Nov FY10 compared to the decline of 38.9 percent in the corresponding period of previous year. Other business services recorded fall for 17 consecutive months. Since the outflows restrictions by SBP on exchange companies initiated from May 2008, the other business services are falling continuously. The share of exchange companies was nearly 90 percent in early 2008 in overall other business services imports which gradually came down to under 10 percent (see **Figure 6.28**).

The outflows restrictions on foreign exchange companies made them to use the formal channel through their accounts with commercial banks. Interestingly, the absolute decline in overall business services imports is explained by an equivalent decline in foreign exchange companies (see **Table 6.10**).

Going forward, services trade deficit is likely to contract further on the basis of increase in services exports and decline in services imports. The rise in services

Table 6.10: Other Business Services Imports (Jul-Nov)

million US dollar			
	FY08	FY09	FY10
Merchant services	4.2	4.1	6.1
Charter of ships without crew-operating leasing	0.1	0.0	11.7
Legal services	18.0	11.4	3.3
Business & management consultancy, and public relations	12.7	25.1	25.2
Agency commission	64.1	64.3	71.5
Adv., market res., & public opinion poll.	11.6	3.1	4.8
Research and development services	0.8	1.0	0.6
Architect., eng., and technical services	18.2	68.4	63.2
Payments to journalists	0.0	1.4	0.1
Technical fees to foreigners	176.3	209.8	212.4
Miscellaneous services, n.s.e.	35.1	63.5	68.2
Exchange companies	1,060.7	425.0	49.0
Refund	-14.2	-29.2	-26.8
Total	1,395.1	858.8	490.0
Absolute difference in total amount		-536.2	-368.8
Absolute difference payments through FECs		-635.7	-376.0

exports is expected on account of more logistic support and good performance of communication services in the ensuing months. Further services imports growth

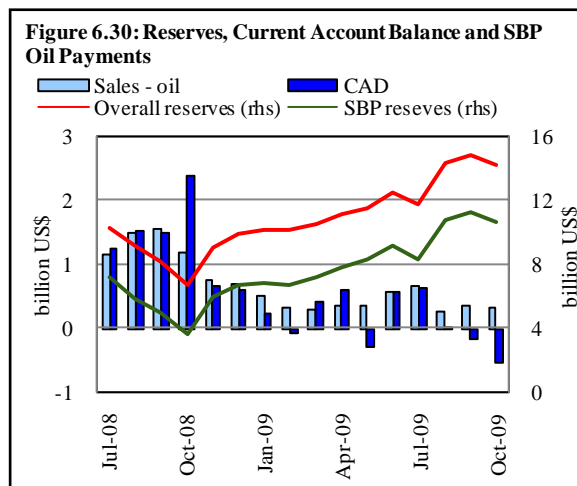
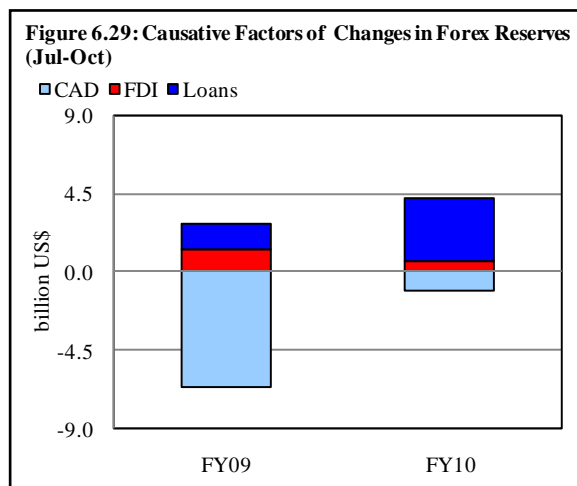
is likely to remain subdued due to outflows restrictions on foreign exchange companies.

6.5 Foreign Exchange Reserves

The reserve position during Jul-Nov FY10 benefitted from a combination of substantial increase in financial inflows and fall in current account deficit (see **Figure 6.29**). As a result, Pakistan's total foreign exchange reserves increased to US\$ 13.7 billion by end-Nov 2009.

The increased inflows and lower outflows decreased the need for SBP market interventions compared to the same period last year. Since most of the SBP interventions were oil related, the gradual shifting of the same to inter-bank resulted in marked decline in SBP's market support (see **Figure 6.30**). Specifically, market support for oil payments declined from US\$ 6.1 billion in Jul-Nov FY09 to US\$ 1.9 billion in Jul-Nov FY10.¹⁰

In contrast to SBP reserves, which increased by US\$ 1.0 billion during Jul-Nov FY10, scheduled banks' reserves increased marginally by US\$ 300 million compared to US\$ 293 million in the corresponding period last year.



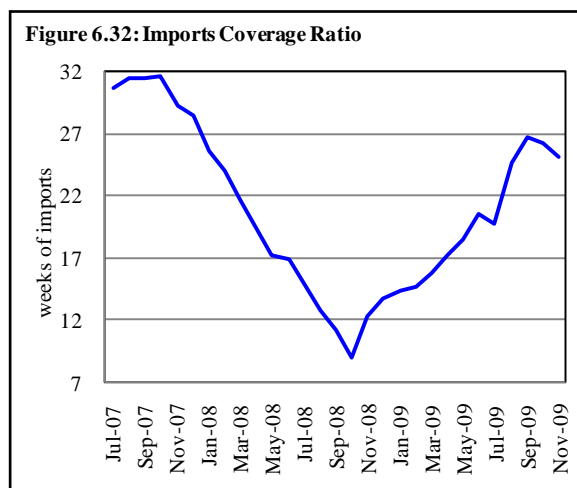
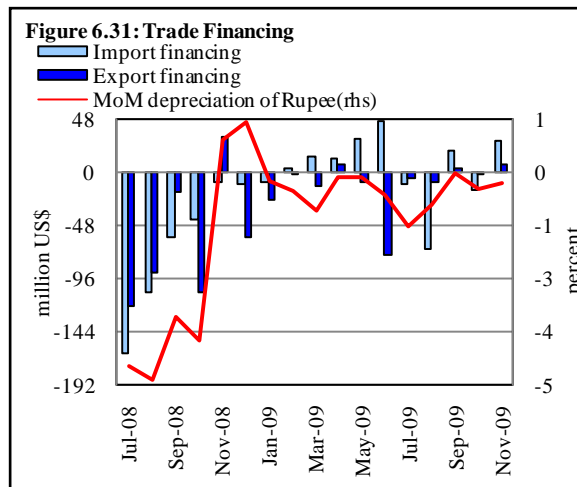
¹⁰ According to SBP F.E. Circular 03 dated July 15, 2009, with effect from August 01, 2009, in addition to furnace oil, all purchases of foreign exchange related to imports of diesel and other refined products shall be made by banks from inter-bank market. SBP further discontinued the support payments for crude oil from December 14, 2009 onwards.

Scheduled banks reserves were constrained by not only shifting of the oil payments to the inter-bank but also due to lower retirement of trade loans against FE-25 deposits.¹¹ During Jul-Nov FY09, weakening rupee along with strong expectations of further depreciation had resulted in retirement of US\$ 685.7 million. In Jul-Nov FY10, both export and import financing declined reflecting: a) fall in the economic activity, as well as, b) decline in the interest rate differential between the foreign and domestic currency lending rates. As a result, retirements also declined to US\$ 51.5 million (see **Figure 6.31**).

6.5.1 Reserve Adequacy

Fall in the import bill coupled with build-up of foreign exchange reserves substantially improved Pakistan's reserve adequacy in terms of weeks of imports coverage. Specifically, import coverage ratio

increased from 12.5 week as of end-Nov 2008 to 25.2 weeks in November 2009 (see **Figure 6.32**).



¹¹ When banks lend foreign currency loans their foreign assets fall with corresponding increase in the domestic assets, when these loans are retired it has the opposite impact.

6.6 Exchange Rate

Owing to the relative improvement in economic fundamentals, Pakistan's currency vis-à-vis US dollar depreciated by only 2.6 percent during Jul-Nov FY10 compared to the sharp decline of 13.3 percent in the corresponding period last year (see **Figure 6.33**).

Depreciation of rupee despite the improvement in the overall external account

position signifies pressures in the forex market as most of the inflows leading to improvement in overall foreign reserves were received directly by SBP (e.g., IMF disbursements). Although, scheduled banks benefited from the rise in remittances, but the impact of increase in remittances was offset by the shifting of significant part of the oil payments to the interbank market. Continued trade deficit also kept the forex market tight as is evident from the overdrawn nostros of commercial banks.

Kerb market premium, however, remained insignificant during the period of analysis (see **Figure 6.34(b)**). SBP's restrictions on outflows from FECs were the major reason behind the lower demand of foreign exchange through FECs that

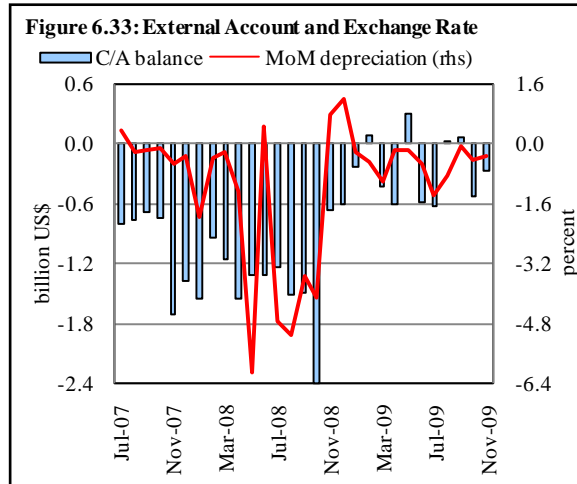


Figure 6.34 (a): Role of Expectations

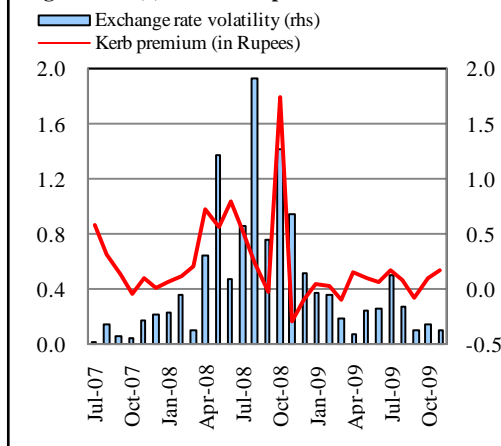
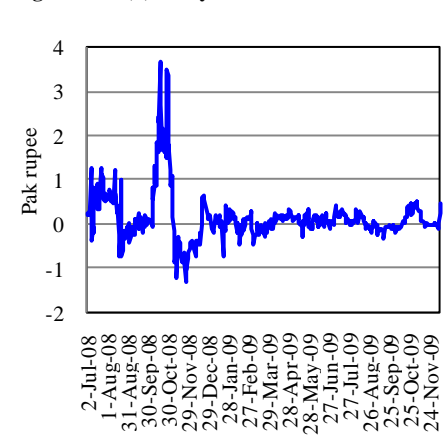


Figure 6.34 (b): Daily Kerb Premium



kept the kerb premium within a narrow band.

The rise in the kerb premium from mid October to mid November 2009 may be attributed to increased demand of hard currency for Hajj related expenses.

In nominal terms, Pakistan's currency depreciated by 5.8 percent against the basket of currencies. Higher nominal depreciation against basket of currencies compared to US dollar is attributable to the weakness of US dollar against major currencies during Jul-Oct FY10 (see **Figure 6.35**).

A large part of this gain, however, was offset by the relatively higher inflation in Pakistan compared to its trading partners and competitors, i.e., RPI rose by 4.4 percent. Consequently, real effective exchange rate (REER) depreciation was limited to 1.6 percent during Jul-Oct FY10 (see **Figure 6.36**).

Figure 6.35: Movement of US Dollar Against Major Currencies (Jul-Nov)

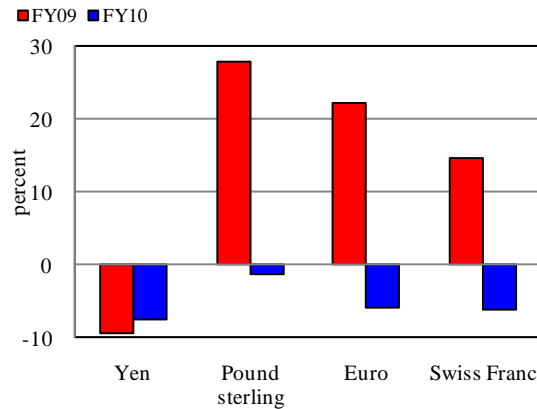
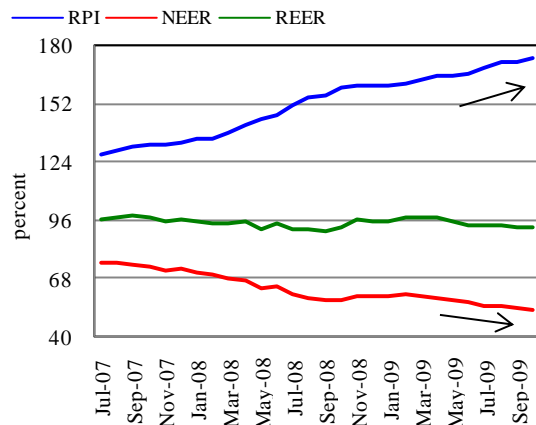


Figure 6.36: Changes in NEER, REER and RPI

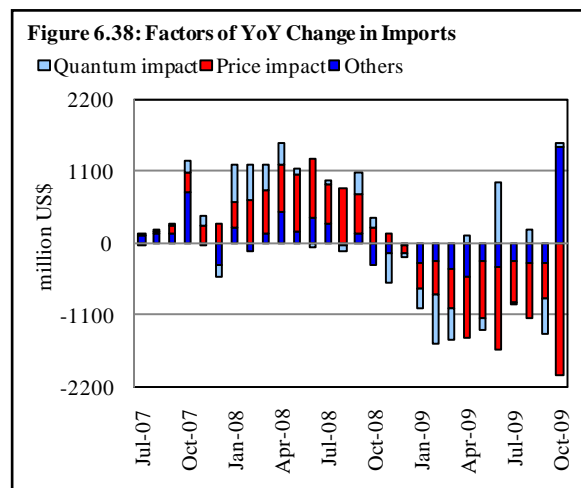
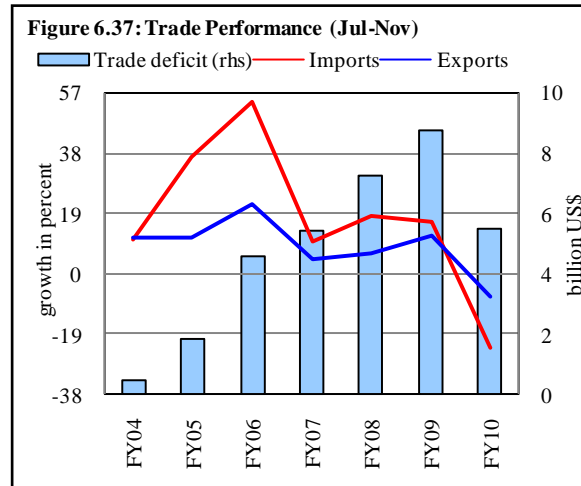


6.7 Trade Account

Pakistan's trade deficit declined significantly by 37.8 percent YoY during Jul-Nov FY10 in contrast to 20.8 percent rise in the same period last year. The decline in trade deficit was entirely due to 23.0 percent YoY fall in the import bill as exports continued to decline, recording 7.4 percent YoY fall (see **Figure 6.37**).

The contraction in imports was a result of combination of restrained demand, better domestic production of some key commodities (wheat and cotton), as well as fall in the international commodity prices. Of these, however, the impact of the fall in the international commodity prices was the strongest (see **Figure 6.38**).

Similar to imports, the fall in exports was also broad-based (see **Figure 6.39**). Growth in all the main categories either further declined or turned negative. Both the star performers of FY09, rice and cement, posted negative growth during Jul-Nov FY10. Rice exports suffered due to fall in prices as international supply conditions improved. Cement exports on the other hand declined owing to fall in demand during Jul-Nov FY10.



Although overall textile group exports declined further by 3.2 percent compared to 3.0 percent in the corresponding period last year, exports of raw cotton and cotton yarn posted significant positive growth during Jul-Nov FY10.

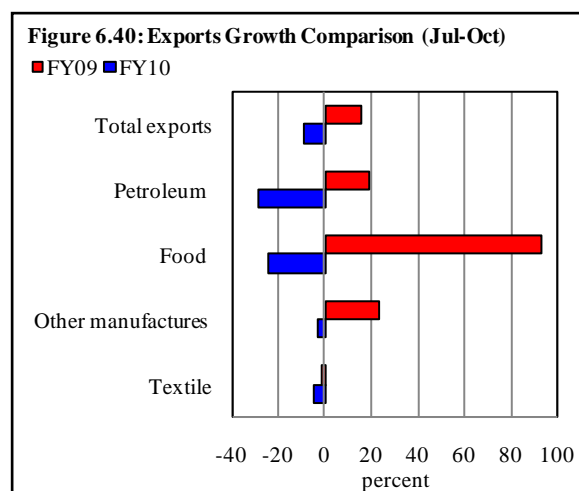
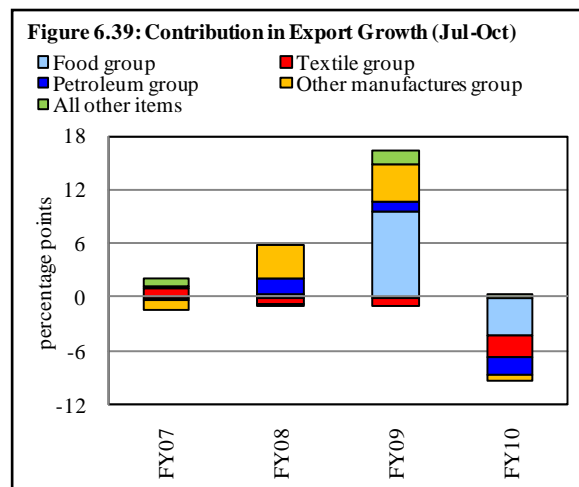
Even though there are some signs of global economic recovery, exports are likely to remain under pressure owing to persistent domestic issues like infrastructural constraints, particularly energy supply shortage and poor law & order, etc.

Imports on the other hand, are expected to increase following the rise in international commodity prices, recovery in domestic demand and shortages of some key commodities.

Thus it appears that, the fall in trade deficit has probably bottomed out, and there is a likelihood that it will start to widen again in the remaining months of FY10.

6.7.1 Exports

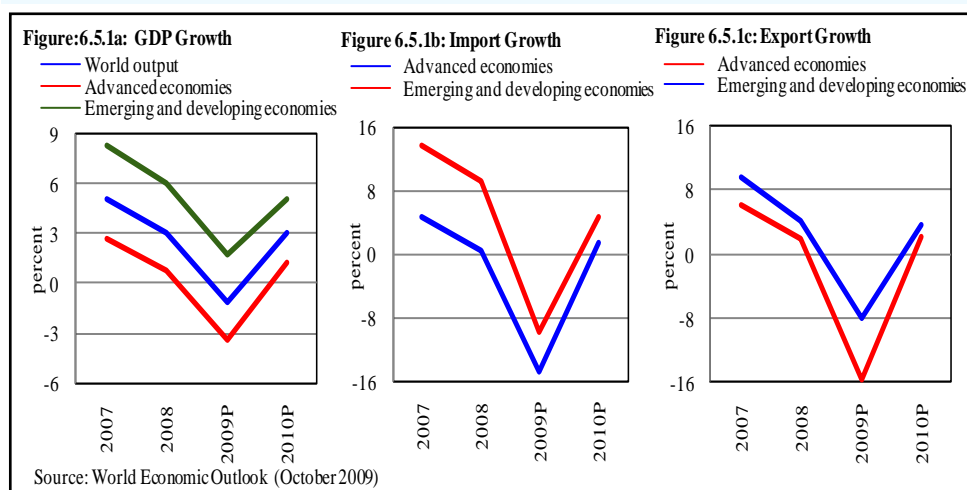
External and domestic factors that hampered export growth in the second half of FY09, persisted during Jul-Nov FY10. As a result, exports fell by 7.4 percent YoY during Jul-Nov FY10, compared to a decent growth of 12.0 percent during Jul-Nov FY09. Analysis of the export performance of major groups reveals that domestic power crisis, circular debt issue, low international prices and compression in external demand were the main factors



behind sluggish growth of exports during Jul-Nov FY10. Resultantly, exports of food, textile, petroleum, as well as other manufacturers group declined during the period under review (see **Figure 6.40**). Although external demand is expected to recover (see **Box 6.5**), timely resolution of internal constraints is imperative to foster exports growth.

Box 6.5: Prospects for Trade of Regional Economies as Global Economic Indicators Improve

Global trade recorded a significant contraction in 2008 as the world economy remained in the corridor of uncertainty. The recession that hit the world's developed countries spilled over to emerging and developing economies owing to globalization and market integration. The intensity of the impact of falling world incomes on emerging and developing economies' exports was evident in H2-CY08 and H1-CY09 as exports plummeted.



Although exports of all regional economies were battered due to slowdown in external demand, Pakistan was particularly unfortunate, as internal supply constraints further hampered exports and macroeconomic instability left little room for fiscal or monetary stimulus. Imports also contracted owing to falling domestic demand amid declining consumer and investor confidence.

The good news is that both domestic and global economic indicators are improving. The latest World Economic Outlook (October 2009) reports that the global economy is finally on the path of recovery and offers upbeat projections for the year ahead. (see **Figure 6.5.1**). Trade prospect for all, developed, emerging, and developing economies, indicate a rise in the trade volume of both imports and exports.

A lot depends on textiles

According to the Asian Development Outlook (September) 2009 Update¹², forecasts 'a modest improvement in growth during FY10'. However growth in the case of Pakistan would depend on both internal policies and global economic developments. Key determinants will be oil prices and

¹² <http://www.adb.org/Documents/Books/ADO/2009/Update/pak.pdf>

performance of the major trading counterparts. Industrial revival is imperative. The pace of growth in textile demand will be very important as the sector constitutes over 50 percent of overall exports. How Pakistani exports compete in this scenario will depend much on timely resolution of internal constraints, such as the power crisis and banks' liquidity.

Food Group exports fell by 22.5 percent during Jul-Nov FY10. The fall in rice exports, which has 60 percent share, was the main reason for the negative exports in food group. Export proceeds from *rice* fell by 30.9 percent owing to fall in international rice prices as quantity exported increased compared to the same period last year.

Table 6.11: Major Exports (Jul-Nov)

million US dollar

	Unit	FY09		FY10(P)		Abs.Δ val	% YoY Δ		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
Food group		1,453.7		1,127.6		-326.1		-22.4	
of which									
Rice	MT	1,012.2	915.8	699.2	597.3	-313.0	5.9	-30.9	-34.8
Textile group		4,343.2		4,203.8		-139.4		-3.2	
of which									
Cotton yarn	MT	498.8	2,361.7	590.0	1,971.3	91.2	41.7	18.3	-16.5
Cotton fabrics	SQM	949.6	976.0	665.7	1,061.7	-283.9	-35.6	-29.9	8.8
Knitwear	DOZ	826.7	17.1	764.5	16.2	-62.2	-2.3	-7.5	-5.4
Bed wear	MT	755.5	5,328.4	701.0	4,975.3	-54.5	-0.6	-7.2	-6.6
Towels	MT	287.9	3,790.4	270.6	3,417.2	-17.3	4.2	-6.0	-9.8
Readymade garments	DOZ	510.0	40.0	521.7	46.8	11.8	-12.5	2.3	16.9
Synthetic textiles	SQM	110.3	0.8	205.5	1.0	95.2	59.9	86.4	16.6
Other textile made- up		212.5		210.0		-2.5	---	-1.2	---
Other textile material		92.1	---	126.4	---	34.3	---	37.3	---
Petroleum group		471.8		357.0		-114.8		-24.3	
Other manufactures		1,614.7		1,521.8		-92.8		-5.8	
of which									
Chemicals/pharma		280.3	---	269.9	---	-10.4	---	-3.7	---
Molasses	MT	42.9	100.0	16.7	119.1	-26.2	-67.4	-61.1	19.2
Cement	MT	264.5	64.4	215.9	79.4	-48.6	-33.8	-18.4	23.3
All other items		334.1		399.2		65.1		19.5	
Total exports		8,217.9		7,609.5		-608.4		-7.4	

P: Provisional

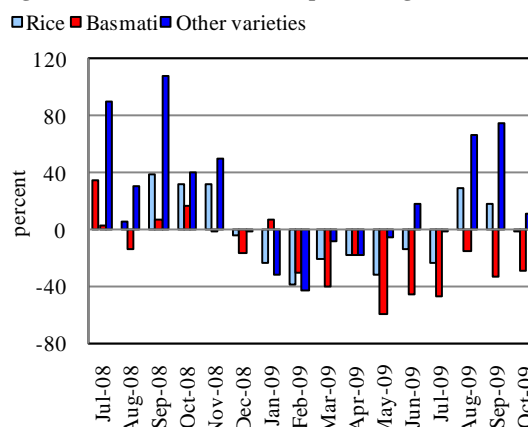
While exports of basmati and non-basmati rice declined, the fall in basmati was more prominent (see **Figure 6.41**).¹³ State Bank on its part has relaxed the financing facility available to rice exporters to ease some of their problems.¹⁴

Textile group exports declined by 3.2 percent during Jul-Nov FY10 as compared to a fall of 3.0 percent during the same period last year. The export of low value added products, i.e., raw cotton and cotton yarn showed some recovery but high value added products, except for readymade garments continued depicting a dismal performance.¹⁵

Raw Cotton and *cotton yarn* exports increased during the period under review amid early arrival of crops and better production. Pakistan Cotton Ginners Association data suggests that this season, the number of bales sold to exporters increased by 192.1 percent by end-November 2009.¹⁶ Moreover, due to ample availability of raw cotton for domestic use, import of raw cotton also exhibited a negative growth during the period under review.¹⁷

Cotton fabric exports declined by 29.9 percent YoY during Jul-Nov FY10 as Pakistan is losing its lower price advantage due to persistent rise in cost of production. High cost of production has led to increasing unit values; resultantly

Figure 6.41: Quantum of Rice Export (YoY growth)



¹³ Lower yield of basmati rice is compelling the growers to focus on production of Irri and other non-basmati rice. As a result, export of Irri and other varieties in particular rose substantially during the period under review.

¹⁴ SMEFD Circular Letter No. 16, dated November 25, 2009; the SBP has decided that rice exporters will now get financing up-to 100 percent instead of 85 percent of the value of firm export order/contract/letter of credit and will be required to make shipments equivalent to 100 percent instead of 117 percent against refinance available for 270 days from the export of eligible commodities under Part-I (pre-shipment). This relaxation will be available to rice exporters for FY10.

¹⁵ Raw cotton export surged by 107.4 percent while yarn export increased by 18.3 percent during Jul-Nov FY10.

¹⁶ According to Pakistan Cotton Ginners Association data, 25.1 percent YoY growth in number of bales was observed by end-November 2009.

¹⁷ Import of raw cotton dropped by 51.4 percent YoY during Jul-Nov FY10.

the export quantum failed to increase.¹⁸ Fabric exports, however, could revive in coming months as anecdotal evidences suggest that Bangladesh is expected to allow its garment manufacturers to import Pakistani fabric from January 2010.¹⁹

Readymade Garments exports also exhibited signs of improvement, registering 2.3 percent growth during Jul-Nov FY10 as compared to a negative growth of 15.9 percent during Jul-Nov FY09. Readymade garments were adversely impacted by compression in external demand during FY09. However, external demand is likely to revive due to higher Christmas sales in the US and EU in FY10 compared with FY09; the major importer of Pakistan's readymade garments products. Anecdotal evidence, on the other hand, indicates that exporters are facing difficulty in fulfilling these orders due to continuing power shortages and rising cost of production.

Knitwear exports declined by 7.5 percent YoY during Jul-Nov FY10 compared with a modest growth of 1.7 percent during the same period last year. *Bed wear* exports dropped by 7.2 percent YoY during Jul-Nov FY10 despite the removal of anti-dumping duties imposed by EU. Tough competition from regional economies is hampering knitwear and bed wear exports.

Towel exports declined by 6.0 percent during Jul-Nov FY10 compared to a decent growth of 22.4 percent during the same period last year. Unit value of towel is persistently declining since April 2009 as the demand for the same has not picked up in the key markets.

Although external demand from developed countries is projected to revive in upcoming months, internal issues are still hindering Pakistan's textile exporters. Similarly, although liquidity conditions have eased, but power crisis and deteriorating law & order conditions of the country is hampering the performance of the textile sector.

To foster textile exports, the government has formulated the first ever textile policy with the aim to realize the sector's true potential. A Textile Investment Support Fund has also been proposed for modernization of machinery and technology, infrastructure development, skill development, marketing and the use of information and communication technology. However realization of these proposals is yet to take effect.

¹⁸ Unit value of cotton fabric increased by 13.0 percent YoY during Jul-Nov FY10.

¹⁹ Bangladesh having the GSP-plus status from EU had the facility of duty free export to EU, but the facility was limited to exporters who were using local fabric. However, Bangladesh has agreed in principle to import Pakistani fabric.

Other manufactures group export declined by 5.9 percent YoY during Jul-Nov FY10 compared with a positive growth of 18.9 percent during Jul-Nov FY09.

Leather garments export dropped by 15.9 percent during the period under review amid low international demand and domestic issues such as lack of preservation technologies, poor infrastructure, security issues, lack of skilled labor and power crisis.²⁰ Tough competition from regional economies is also hitting the leather sector. Realizing the importance of this sector, an Export Investment Support Fund has been proposed for upgrading production, designing facilities and installing flaying machines.²¹ The incentives announced in the Trade Policy are, however, yet to be implemented.

Cement exports fell by 18.4 percent during Jul-Nov FY10 compared to a remarkable growth of 97.3 percent during Jul-Nov FY09 as export quantum fell well below the 2 year average (see **Figure 6.42**).²² Export proceeds from cement dropped amid increased competition and fall in demand in neighboring countries of Afghanistan and India. Saudi Arabia also lifted ban on its cement exports, the move is likely to

Figure 6.42: Quantum of Cement Export

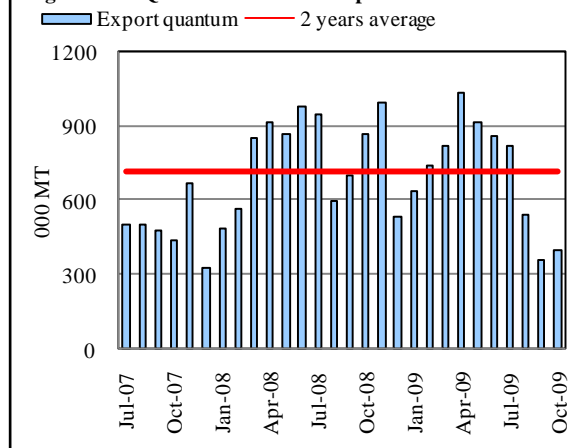
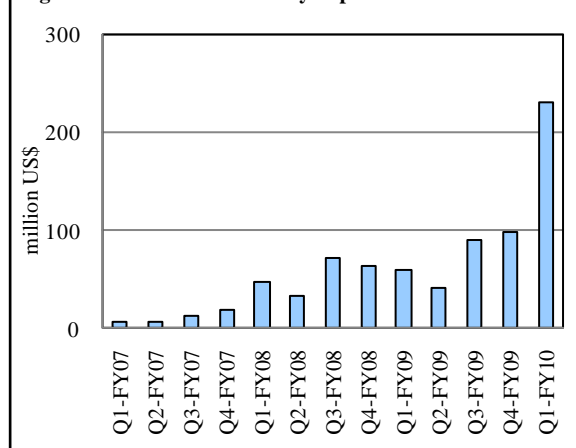


Figure 6.43: Value of Jewellery Exports



²⁰ Demand for leather gloves in particular declined owing to slowdown in global auto and steel industry.

²¹ <http://www.commerce.gov.pk/Tradepolicy.asp>

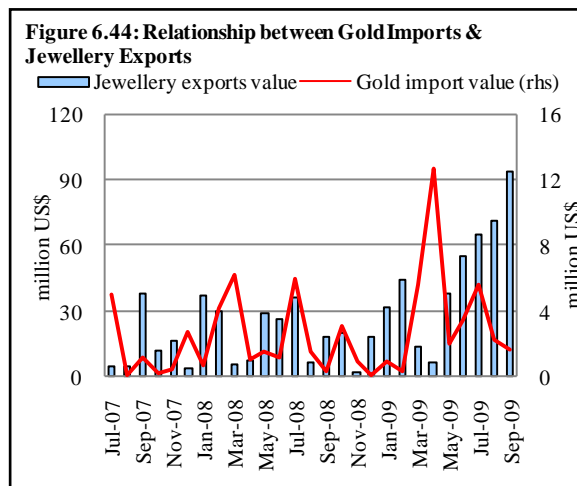
²² However, All Pakistan Cement Manufactures Association data shows 12.8 percent increase in export dispatches during Jul-Nov FY10.

give tough competition to Pakistan cement exporters as Saudi Arabia has an advantage of low transportation cost. The Middle East, with almost 20 percent share in total cement exports has remained one of the most important markets for Pakistan; however Saudi Arabia, due to its geographical proximity could capture Pakistan's share in Middle East and Africa.

Jewellery exports posted an extraordinary growth of 221.8 percent YoY during Jul-Nov FY10 compared to 9.6 percent in the corresponding period last year (see **Figure 6.43**).²³ Exemption of GST on imports and local supply of platinum, palladium, diamonds and precious stones coupled with surge in gold prices induced bullish sentiment in jewellery exporters. Moreover, Pakistan Gems and Jewellery Development Company facilitated the exporters by conducting and participating in seminars and exhibitions in order to promote and explore new markets for Pakistani products.²⁴

It is pertinent to mention that to export gold jewellery, minimum value addition in imported gold is imperative: a) 4.0 percent on plain gold bangles and chains, b) 6.0 percent on other plain jewellery, and c) 9.0 percent on studded or embedded jewellery.²⁵

However, a mis-match between the reported gold imports and jewellery exports exists. Monthly analysis shows that jewellery exports are rising but import quantum of gold is declining (see **Figure 6.44**). Anecdotal evidence suggests that part of non-value added gold export is being smuggled from a neighboring country facing trade restrictions.



²³ Strategic Trade Policy Framework 2009-12.

²⁴ PGJDC participated in Hong Kong Jewellery & Gem Fair in Wan Chai, Hong Kong dated 23-27 September 2009.

PGJDC participated in the 44th Bangkok Gems & Jewelry Fair 2009 dated 15-19 September.

PGJDC organized 7th Gem Bazaar at Gem Exchange, Namak Mandi, Peshawar dated 17th August, 2009.

²⁵ S.R.O 266(I)/2001 dated 7th May 2001, Ministry of Commerce, Government of Pakistan.

6.7.2 Imports

Falling import price coupled with decline in the quantities imported led to 23.0 percent YoY contraction in the import bill during Jul-Nov FY10, compared to 16.4 percent YoY rise in the corresponding period last year.

Fall in the prices of petroleum group was particularly sharp and alone contributed to 43.5 percent fall in the overall import bill. In overall terms, around 64 percent of the fall in import bill was on account of decline in the international commodity prices.²⁶

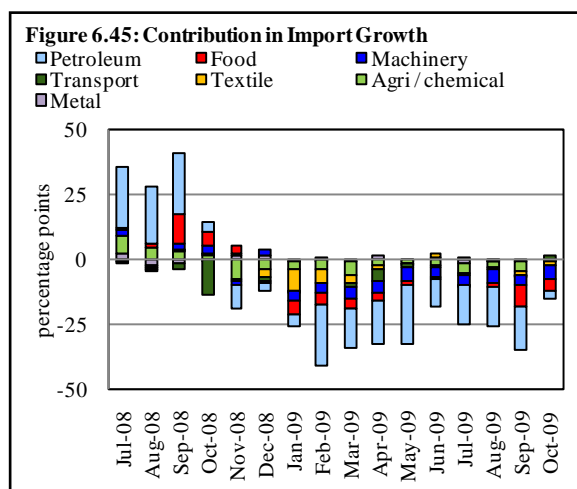


Table 6.12: Composition of Fall in Imports (Jul-Nov)

million US dollar

	FY10			FY09		
	QI	PI	Total change	QI	PI	Total change
Petroleum crude	724.5	-1,380.3	-655.8	57.7	1,036.8	1,094.5
Petroleum products	-137.4	-903.9	-1041.3	-246.8	856.7	609.9
Raw cotton	-138.3	-15.2	-153.4	-98.3	60.6	-37.7
Fertilizer manufactured	42.3	-6.5	35.9	-224.5	123.9	-100.6
Palm oil	58.9	-225.5	-166.7	-101.8	170.2	68.4
Wheat	-747.3	0.8	-746.5	884.0	-155.7	728.3
Plastic material	-16.6	-50.6	-67.2	-81.3	79.8	-1.5
Total imports	-183.0	-2,539.8	-3,905.0	2.0	2,384.0	2,389.6

²⁶ Total Price and quantum impact is calculated for 21 items of imports, which had 50 percent share in total imports during the period under review. Main categories excluded are transport and machinery group.

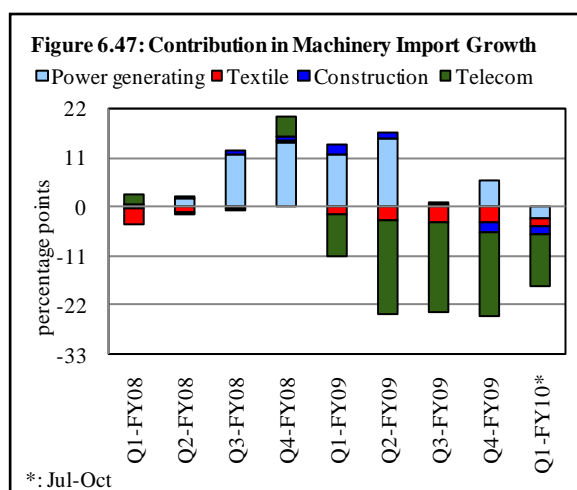
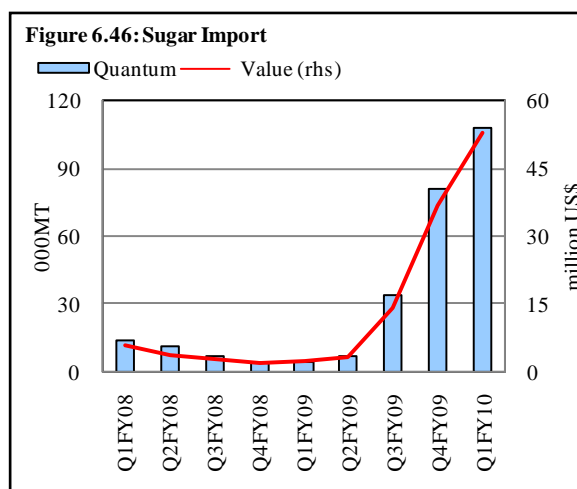
Similarly, a large number of categories witnessed compression in import demand during Jul-Nov FY10, as reflected by substantial negative quantum impact compared to last year when rise in quantity also added to the import bill (see **Table 6.12**).

Food, transport, machinery, textile, petroleum, agriculture and other chemical, metal, and miscellaneous groups showed contraction during the period under review (see **Figure 6.45**).

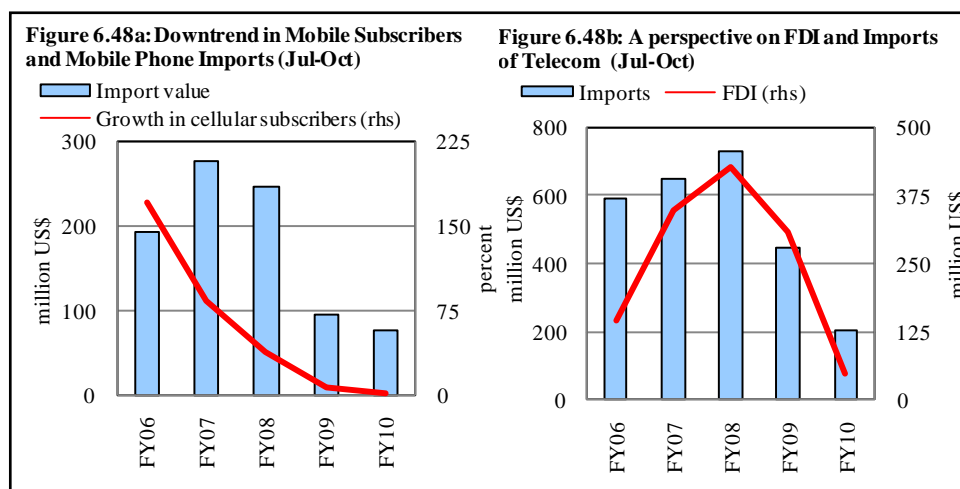
Food group imports fell by 35.5 percent YoY during Jul-Nov FY10 with largest fall recorded in wheat. Imports of wheat fell by 97.0 percent amid better domestic production of wheat. Palm oil and soya bean oil import also observed contraction of 26.2 and 77.7 percent on the back of falling international commodity prices.²⁷

On the other hand, import of sugar increased substantially during the period under review (see **Figure 6.46**). Import of sugar may continue to rise as domestic shortage of sugar is likely to persist.

Machinery Group import fell by 26.4 percent during Jul-Nov FY10 with largest fall registered by the telecom group (see **Figure 6.47**). The declining trend of telecom imports in both the categories of mobile phones and telecom apparatus



²⁷ Palm oil unit value fell by 32.5 percent during Jul-Nov FY10.

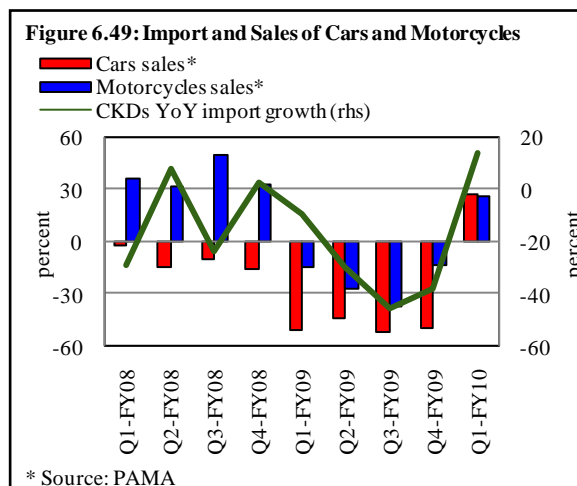


continued for the fifth consecutive quarter despite relaxation in import duties.²⁸ The fall in telecom group imports probably reflects cellular market saturation also evident from falling growth in subscriber base and FDI (see **Figure 6.48**)

Import of power generating machinery dropped by 10.1 percent during Jul-Nov FY10, due to subdued demand from both, the household and non-domestic sector. Pile-up of inventories by importers in the previous year also contributed to fall in the power generating machinery imports.²⁹

Transport group imports decreased by 4.6 percent during Jul-Nov FY10.

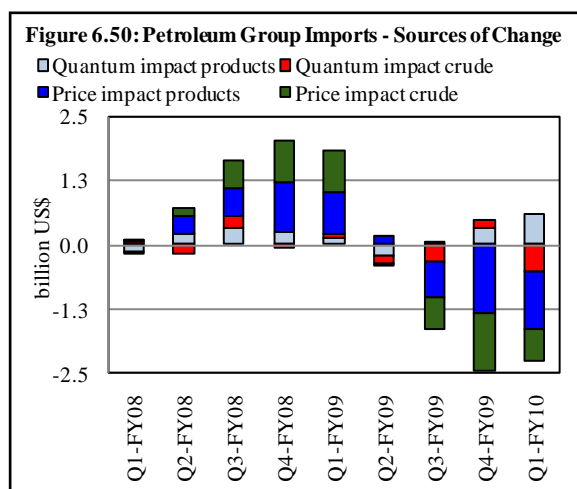
However, some signs of recovery were observed in completely knocked-down (CKDs) kits of motor cars and motor cycles as import of these categories surged



²⁸ The budget for FY10 introduced a 50 percent reduction in sim activation charges and reduction of custom duty from Rs 500/set to Rs 250/set.

²⁹ The growth of gas turbines and parts of gas turbines declined by 43.0 and 73.0 percent YoY respectively during Jul-Oct FY10.

by 35.2 and 107.8 percent during Jul-Nov FY10. The introduction of new models in CY09 and rise in agriculture income revived the demand for cars and motor cycles. As a result, the sales of motor cars and motorcycles also surged during the period under analysis (see **Figure 6.49**). Improvement in production & sales of motor cars and motor cycles also resulted in increased demand for *rubber tyres and tubes*.³⁰



Petroleum group imports dropped by 31.0 percent amid falling prices and quantity during Jul-Nov FY10 (see **Figure 6.50**). Besides the fall in international oil prices, the low import of crude oil could also be attributed to the ongoing circular debt issue, which resulted in the decline in quantity of crude oil imports.

Decline in international prices was however, the major factor for the fall in imports of petroleum products during Jul-Nov FY10 compared with the massive growth observed during Jul-Nov FY09 (see **Table 6.13**). However, petroleum products import rose in terms of quantum.³¹ Motor Spirit (MS) and furnace oil (FO) sales rose amid high domestic demand. Power crisis and dependence on

Table 6.13: Analysis of Imported Petroleum Products (Jul-Oct)

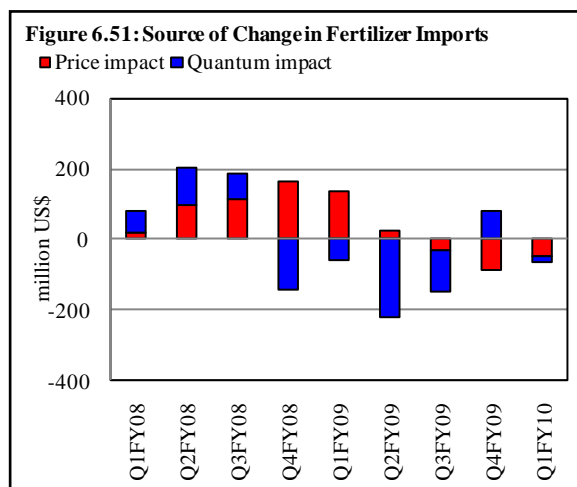
in percent							
Product	Share			Growth		Contribution in POL imports	
	FY08	FY09	FY10	FY09	FY10	FY09	FY10
Furnace oil	37.4	34.6	50.4	93.7	11.2	19.3	2.1
High speed diesel oil	38.3	46.8	37.8	156.2	-38.4	32.9	-9.8
Motor spirit	1.0	3.0	5.7	568.2	43.8	3.0	0.7
Kerosene type jet fuel (JP I)	0.6	1.2	4.2	344.9	167.4	1.1	1.1

³⁰ Import of rubber tyres and tubes posted a positive growth of 4.0 percent during Jul-Nov-FY10 as compared to a negative growth of 25.9 percent during the same period last year.

³¹ Furnace oil imports in terms of quantum increased by 71.5 percent YoY during Jul-Oct FY10.

thermal power generation resulted in increased demand for furnace oil.³² On the other hand, lower price differential between CNG and MS increased the demand for motor spirit.

Fertilizer imports increased by 10.4 percent during Jul-Nov FY10 in contrast to 22.6 percent fall during the comparable period of last year. This increase was entirely driven by higher quantum imports as fall in international prices translated into lower unit values (see **Figure 6.51**).³³ Quantum rose by 12.3 percent YoY during Jul-Nov FY10 whereas import value increased by 20.7 percent YoY during the period under review.



³² Sales of motor spirit and furnace oil increased by 37.8 and 26.1 percent YoY during Jul-Sep FY10.

³³ Domestic production of urea remained 259 (000 tonnes) while DAP production remained 323 (000 tonnes) during *Kharif* 2009.

Table 6.14: Major Imports (Jul-Nov)

million US dollar

	Unit	FY09		FY10(P)		Abs.Δ val	% YoY Δ		
		Val	Unit Val	Val	Unit Val		Qty	Val	Unit Val
Food group		2,000.5		1,290.2		-710.2	---	-35.5	-
of which									
Wheat	MT	769.5	393.9	23.0	408.9	-746.5	-97.1	-97.0	3.8
Palm oil	MT	637.2	1070.8	470.5	723.8	-166.7	9.2	-26.2	-32.4
Machinery		2,947.6		2,168.9		-778.7	---	-26.4	---
of which									
Power generating		694.2		624.0		-70.2	---	-10.1	---
Telecom		507.5	---	246.7	---	-260.8	---	-51.4	---
Transport group		556.7		531.1		-25.5	---	-4.6	---
of which									
Road motor vehicles		431.1	---	431.4	---	0.3	---	0.1	---
Aircrafts/ships,		121.5	---	98.7	---	-22.8	---	-18.8	---
Petroleum		5,475.9	772.7	3,778.8	481.2	-1,697.1	10.8	-31.0	-37.7
Petroleum	MT	3,046.4	769.1	2,390.6	487.6	-655.8	23.8	-21.5	-36.6
Petroleum crude	MT	2,429.5	777.2	1,388.2	470.7	-1,041.3	-5.7	-42.9	-39.4
Textile group		734.0		574.1		-159.9		-21.8	
of which									
Raw cotton	MT	298.4	1,743.9	144.9	1,578.8	-153.4	-46.3	-51.4	-9.5
Agricultural & other chemical		2,520.4		2,298.6		-221.8		-8.8	
of which									
Fertilizer	MT	345.2	549.0	381.0	539.9	35.9	12.3	10.4	-1.7
Other chemicals		1,393.2	---	1,090.3	---	-302.9		-21.7	
Metal group		1,033.6		912.5		-121.0		-11.7	
of which									
Iron & steel scrap	MT	226.3	311.9	170.1	280.1	-56.2	-16.3	-24.8	-10.2
Miscellaneous		299.6		248.2		-51.4		-17.2	
All other items		1,423.9		1,284.3		-139.5		-9.8	
Total imports		16,991.7		13,086.7		-3,905.0		-23.0	

P: Provisional