6 External Sector

6.1 Overview

Sustained inflow of workers' remittances and significant growth in exports together with by official and private inflows for flood relief contributed to a sharp YoY improvement in the current account during Jul-Nov FY11. The impact of this improvement on overall external account was, however, subdued due to substantial declines in capital and financial account surpluses (see **Table 6.1**).

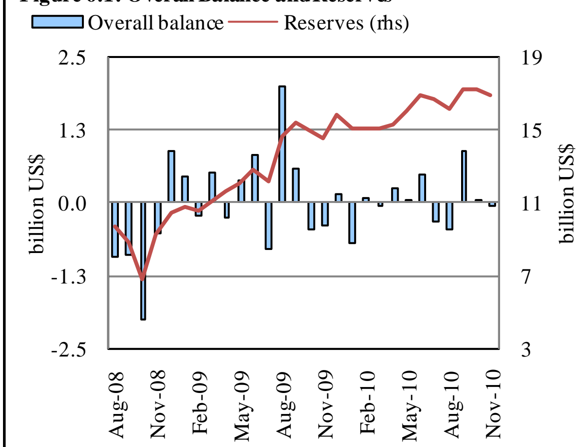
Table 6.1: Summary of External Balances (Jul-Nov)

billion US$

	FY09	FY10	FY11
Current A/C	**-7.24**	**-1.82**	**-0.50**
Trade Balance	-7.05	-4.74	-4.53
Exports	*8.65*	*7.70*	*9.03*
Imports	*15.71*	*12.44*	*13.56*
Invisible Balance	-0.19	2.91	4.03
Remittances	*2.97*	*3.83*	*4.43*
Capital& Financial A/C	**1.84**	**2.24**	**0.51**
FDI	1.62	0.73	0.57
FPI	-0.18	0.30	0.17
Other Investment (net)	0.37	1.17	-0.27
of which			
Public sector loans (net)	*-0.01*	*0.42*	*-0.04*
Private sector loans (net)	*0.10*	*-0.01*	*0.06*
Error& Omission	**-0.23**	**0.53**	**0.10**
Overall Balance	**-5.63**	**0.94**	**0.11**
Memorandum Items			
Foreign reserves (end period)	9.27	14.52	16.93
Exchange rate (end period)	78.78	83.56	85.77

Though overall external account deteriorated compared to the same period last year, it remained in surplus. As a result country's foreign exchange reserves rose to US$ 16.9 billion at end- Nov 2010 (see **Figure 6.1**). This also helped in keeping the exchange rate relatively stable, which depreciated by 0.35 percent during Jul-Nov compared to 2.6 percent in the same period last year.

Figure 6.1: Overall Balance and Reserves



Looking forward, there is risk that contraction in current account deficit may not sustain, on grounds that: (1) anticipated rise in import of sugar, palm oil, textile

machinery, pulses, and raw cotton; (2) a slowdown in export growth as gains from strong growth in high value added textile exports could be partially offset by lower exports of primary commodities (rice, raw cotton, fruits, and vegetables), cement, meat & meat preparation and pharmaceuticals; (3) current transfers could lose momentum once reconstruction activities slow down.

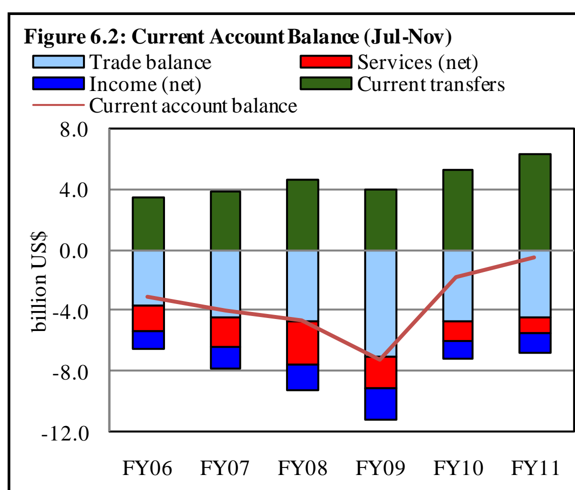
The overall external account is likely to remain under pressure because of dwindling financial account surplus despite a moderate current account deficit. Given the anticipated slowdown in global economic recovery and no improvement in the country's sovereign credit rating since 2009, chances of significant increase in foreign investment inflows is unlikely. Moreover, securing debt flows will be challenging if the IMF's Stand-By Arrangement is jepradised and if structural reforms are further delayed.

On a positive note, given the influx of liquidity in the world economy as a result of fiscal stimulus packages by different countries, Pakistan has plenty of opportunities to attract foreign capital if the economic and political problems are addressed promptly.

6.2 Current Account Balance

Current account deficit contracted sharply by 72.3 percent during Jul-Nov FY11 (see **Figure 6.2**). This contraction was contributed by trade and services accounts along with current transfers. Most notably, significant growth in exports, record inflows of workers' remittances, and private and official grants for flood relief contributed to this improvement.

Figure 6.2: Current Account Balance (Jul-Nov)



6.2.1 Trade Account[1]

During Jul-Nov FY11, trade deficit contracted by 4.4 percent compared to 32.9 percent contraction during the same period last year. Improvement in trade

[1] This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS. For detailed analysis on trade account please see section 6.7 on trade account.

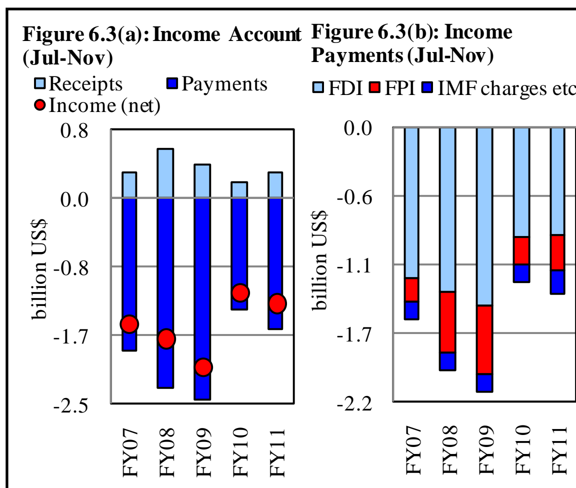
account was attributed to higher export growth (17.3 percent) rate than imports (9.1 percent). Growth in exports was broad based. In particular, textile and petroleum exports increased by 18.8 percent and 40.8 percent respectively; result of a mix of higher quantum and unit prices. The import growth, on the other hand, was mainly a result of strong growth in food and textile group's imports.

6.2.2 Services (net)

In comparison to a 40.0 percent decline during the comparable period last year, deficit in services trade contracted by 18.5 percent during Jul-Nov FY11. This improvement was mainly the result of 20.8 percent higher services exports. A sizable increase of US$ 295 million in services exports is mainly attributed to government services exports on account of logistic support fund and higher receipts by international organizations and their attached offices involved in flood relief activities. On the other hand 3.3 percent growth in services imports was mainly the result of higher freight payments under transportation on the back of rising import bill and rise in travel payments on account of Hajj related outflows (see **Table 6.2**).

Table 6.2: Services Account (Net) (Jul-Nov)
million US$

	FY10	FY11	Change
Overall Services	-1258	-1025	233
Transportation	-891	-996	-105
Travel	-275	-282	-7
Other business services	-276	-166	110
Government services	185	479	294
Other Services	-2	-60	-58

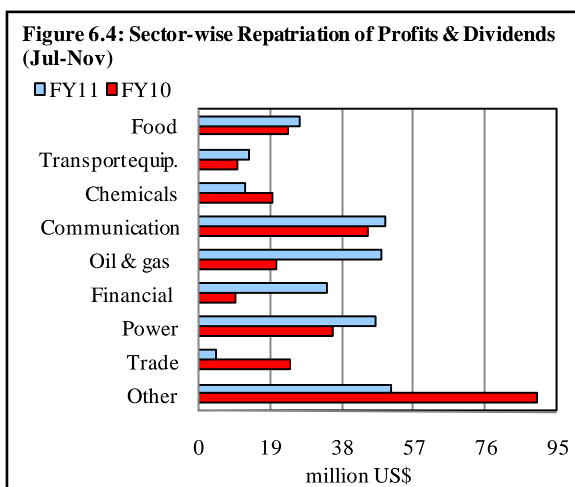


6.2.3 Income Account

Income account deficit increased by 10.5 percent during Jul-Nov FY11aganist contraction of 43.1 percent in the corresponding period last year (see **Figure 6.3**). This expansion stemmed from rise in payments largely on account of interest payments on public long term loans and IMF charges. This offset the lower outflows of profit and dividends and decline in interest payments on Eurobonds during Jul-Nov FY11.

As regards the investment income, portfolio investment payment increased by US$ 76 million that offset the decline of US$23 million in direct investment income during Jul-Nov FY11. In direct investment income, outflows under repatriation of profits and dividends did not show a significant change. This shows that companies are reluctant in expanding their businesses in Pakistan on grounds that direct investment as well as reinvested earnings declined remarkably during the first four months of FY11.

Figure 6.4: Sector-wise Repatriation of Profits & Dividends (Jul-Nov)

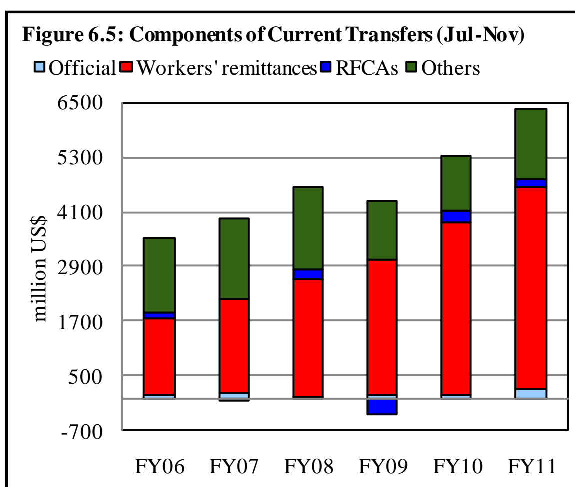


The highest amount of repatriation of profits & dividends came from *communication sector* reflecting high earnings of the telecom companies followed by oil & gas, power, and financial business sectors (see **Figure 6.4**). On the other hand, chemicals, and trade sectors witnessed lower repatriation of profits and dividends during Jul-Nov FY11.

6.2.4 Current Transfers

Record inflows of workers' remittances and significant inflows of official transfers helped improve current transfers by 18.7 percent during Jul-Nov FY11 compared to the same period last year (see **Figure 6.5**). This growth is a welcome development as it came in the presence of high base set last year on one hand, and significant decline in Residents Foreign Currency Accounts (RFCAs) on the other.

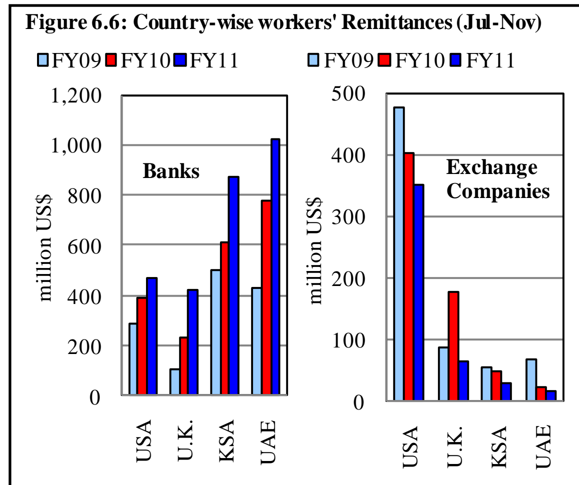
Figure 6.5: Components of Current Transfers (Jul-Nov)



Workers' Remittances

The inflow of workers' remittances remained strong with 15.6 percent YoY growth during Jul-Nov FY11 on top of 29.2 percent growth in the comparable period last year. The current increase in workers' remittances can be attributed to: (a) government and SBPs efforts to attract workers' remittances through banking channels; (b) seasonal increase because of Eid festival; and (c) expatriates' increased support to flood affected people. Country-wise data shows that all traditional sources recorded an increase in workers' remittances through banking channels. Since FY09, UAE has taken over USA as a major source (see **Figure 6.6**). The increasing remittances from Saudi Arabia can be attributed to higher demand of Pakistani workers after a ban was imposed on Bangladeshi workers by Saudi government due to some administrative issues[2]. Moreover, initiatives under PRI such as recently introduced Xpress money, incentives in the form of interbank fund transfer (IBFT) facility, and HBL's step by dedicating special time for remittances in Dubai also helped improve remittances flows to Pakistan (see **Box 6.1**).

Figure 6.6: Country-wise workers' Remittances (Jul-Nov)



Box 6.1: New Initiatives to Increase Workers' Remittances

One of the major determinants that encourage the inflow of remittances is the predictability of receiving payments by the beneficiaries. A number of new steps have been taken recently to make it more predictable in terms of time of receiving money. These initiatives include:

1. Xpress Money. Under xpress money: (i) there is no charges either on remitters or on receivers (no end to end charges), (ii) in addition to cash over counter facility express money offers cash to account facility, i.e., money is transferred in the account even if remitted in cash.

2. **Easypaisa by Telenor Pakistan** has expanded its mobile money service with the launch of international transfer service, in collaboration with xpress money, UK. The senders of funds from abroad can transfer the money through a wide network of xpress agents present in more than 80 countries including UAE, Saudi Arabia, and UK. Easypaisa user can visit any

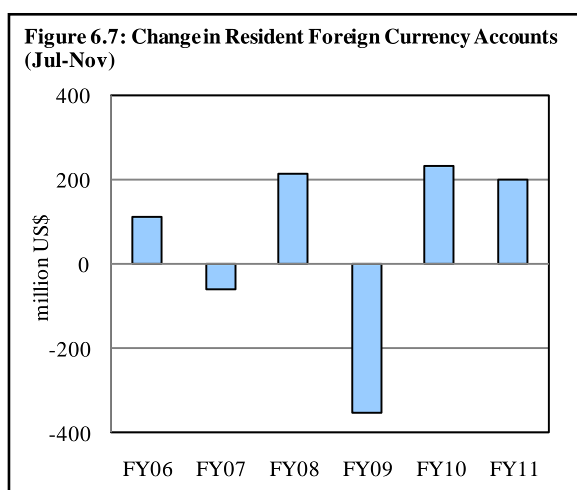
[2] According to anecdotal evidence, Saudi Arabia put a limit on Bangladeshi workers in housing and agricultural sector due to some administrative reasons. The ban was put in 2008 as the quota for Bangladeshi workers exceeded the limit of 1.5 million workers. Now Pakistani workers seem to be benefiting from this situation as their demand has increased.

Telenor service center to get money. On the remitter side they can visit any xpress money center to send money. To use these services Easypaisa or Xpress money account is not required.
3. Inter-bank Fund Transfer (IBFT) Facility. Inter Bank Fund Transfer (IBFT) initiative has made it easy to transfer funds to the third party.

Resident FCAs

Resident FCAs showed inflows of US$199 million during Jul-Nov FY11 as a result of healthy trade activity (see **Figure 6.7**). However, this inflow of RFCAs remained significantly lower than that in the same period last year. This is probably due to relative stability in exchange rate and declining weighted average lending rates on FCAs[3] that provided weak incentive to foreign currency account holders to maintain their dollar account.

Figure 6.7: Change in Resident Foreign Currency Accounts (Jul-Nov)



6.3 Financial Account Balance

In contrast to the previous year, financial account deteriorated in Jul-Nov FY11. Financial account surplus declined significantly from US$ 2150 million during the same period last year to US$ 462 million. A large part of this decline is explained by the sharp fall in other investments despite the emergency loan of US$453 million given by the IMF. This fall in other investments was expected as increase in other investment last year was due to the Special Drawing Rights (SDRs) allocation and bridge financing from IMF. As far as the other two important components of financial account are concerned, the fall in

Table 6.3: Components of Financial Account Balance (Jul-Nov)
million US$

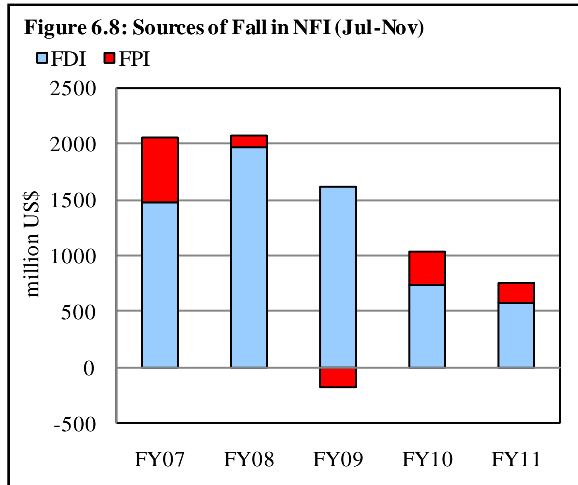
	FY08	FY09	FY10	FY11
Financial Account	4270	1796	2150	462
FDI	1969	1621	731	574
FPI	102	-182	301	173
Other investments	2209	365	1172	-270
of which:				
Loans	780	93	383	-26
SDR Allocation	0	0	1280	0

[3] Weighted average lending rate on foreign currency accounts declined gradually from 1.28 percent in Sep 2009 to 0.97 percent in Sep 2010.

foreign direct investment was the continuation of last two years trend; low investment in equity and outflows from debt securities explain the falling portfolio investment (see **Table 6.3**).

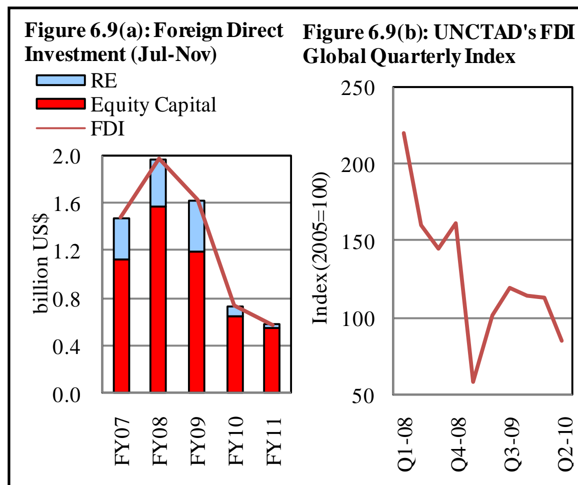
6.3.1 Net foreign investment (NFI)

Factors such as poor law & order, political uncertainty, energy crisis, and circular debt issues continued to depress NFI into the country during Jul-Nov FY11. Resultantly, net foreign investment declined for the third consecutive year. The fall was broad based. And both foreign direct investment and portfolio investment dropped during the period under review (see **Figure 6.8**). Although it was expected that with the gradual improvement in international financial market, net foreign investment would improve, volatile domestic situation and macroeconomic outlook after the floods kept investors reluctant to invest in Pakistan.



6.3.2 Foreign Direct Investment

As in the previous year, foreign direct investment remained under pressure during Jul-Nov FY11. In absolute terms, FDI dropped by US$ 157 million during the period under review. This decline was contributed by both: a fall in equity capital and reinvested earnings. However, major share was contributed by the fall in equity capital (64 percent).



This consistent decline in

Foreign Direct Investment (FDI) flows is attributed to both global and domestic conditions. On the global front, FDI flows declined sharply in Q4-FY10 after a slight recovery in the latter half of 2009. This is indicated by United Nations Conference on Trade and Development (UNCTAD's) FDI Global Quarterly Index[4] (see **Figure 6.9b**). This decline was mainly due to falling reinvested earnings and intra-company loans. It happened as parent companies repatriated a larger share of their profits instead of reinvesting and withdrew the loans to their affiliates to strengthen their balance sheets[5]. This phenomenon was more significant in the developed countries compared to developing countries where the fall in FDI flows remained relatively small. In Pakistan although dynamics of FDI flows are different from developed countries, decline in FDI was for different reasons and continued to have a declining trend in Q1-FY11 (see **Figure 6.9a**). Factors like weak economic growth, political uncertainty, poor law & order, issues like circular debt, and energy crises restricted the FDI in the economy. Adding to these factors was the recent post flood macroeconomic outlook of the country. In these circumstances, investors are reluctant to invest and hence, FDI declined significantly during the period under review.

Sector-wise analysis shows that although telecommunication, cement, and financial business recorded a YoY increase, this was more than offset by the lower

Table 6.4: Sector -wise Foreign Direct Investment (Jul-Nov)
million US dollar

	FY10			FY11		
Sectors	**Cash**	**Re-invested earnings**	**Total**	**Cash**	**Re-invested earnings**	**Total**
Chemicals	35.9	21.0	56.9	23.0	8.2	31.2
Petroleum refining	4.7	15.8	20.6	7.1	-14.1	-6.9
Oil & gas explorations	154.9	52.4	207.3	163.4	6.5	169.9
Cement	0.1	3.9	3.9	5.3	3.7	9.0
Power	50.5	13.8	64.2	26.1	25.3	51.4
Construction	44.9	-2.3	42.6	26.5	-2.8	23.7
Trade	27.3	6.0	33.3	17.6	-3.3	14.4
Telecommunications	97.9	-38.7	59.3	99.1	-16.8	82.3
Financial business	18.7	-0.7	18.0	8.3	14.2	22.5
Personal services	18.6	1.7	20.4	11.3	2.1	13.4
Others	185.1	18.7	203.8	149.4	12.6	162.0
Total	**638.6**	**91.8**	**730.4**	**537.1**	**35.7**	**572.9**

[4] This index is based on national data on FDI flows for over 60 major FDI recipients around the world.
[5] UNCTAD Global Investment Trends Monitor No.4, 14 October 2010.

investment in oil & gas exploration, chemicals, petroleum refining, and power groups (see **Table 6.4**).

An encouraging sign is the improved level of investment in the traditional groups like telecommunication and financial business. In case of telecommunication, major inflows were recorded by a single mobile telephone company (US$ 60 million) during the month of September 2010. However, anecdotal evidence suggests that negative reinvested earnings show losses of some of the companies in the telecom industry. On the other hand, reinvested earnings in the financial business turned positive from negative in the corresponding period last year. This reflects overall profitability in the financial industry, which is helpful in attracting more FDI flows in this sector.

FDI in oil & gas exploration, chemicals, power and petroleum refining sectors recorded significant declines. Specifically, petroleum refining and oil & gas exploration sector registered significant decline on account of reinvested earnings. The dismal performance of refineries and oil & gas exploration is mainly caused by the circular debt issue.

6.3.3 Portfolio Investment

Portfolio investment plummeted by 42.5 percent during Jul-Nov FY11. This was largely a function of low inflows in equity securities during the period under review. The outflows of debt securities further aggravated the portfolio investment (see **Figure 6.10**).

Figure 6.10: Foreign Portfolio Investment (Jul-Nov)

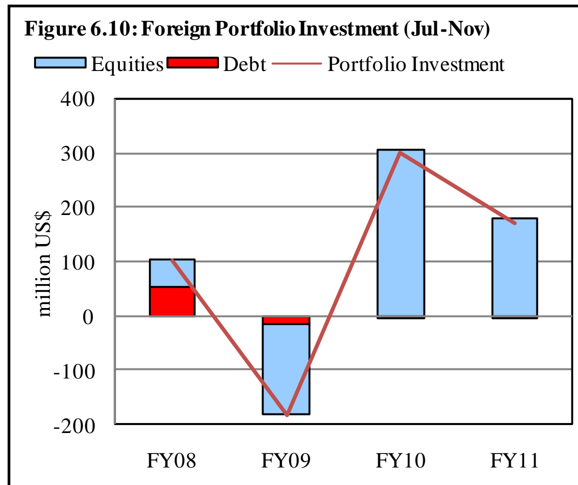
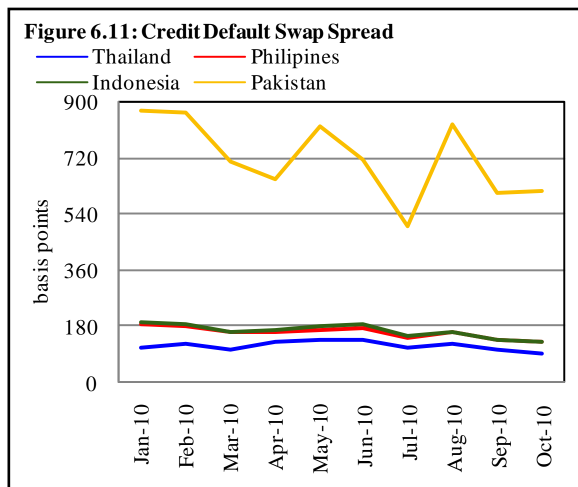


Figure 6.11: Credit Default Swap Spread



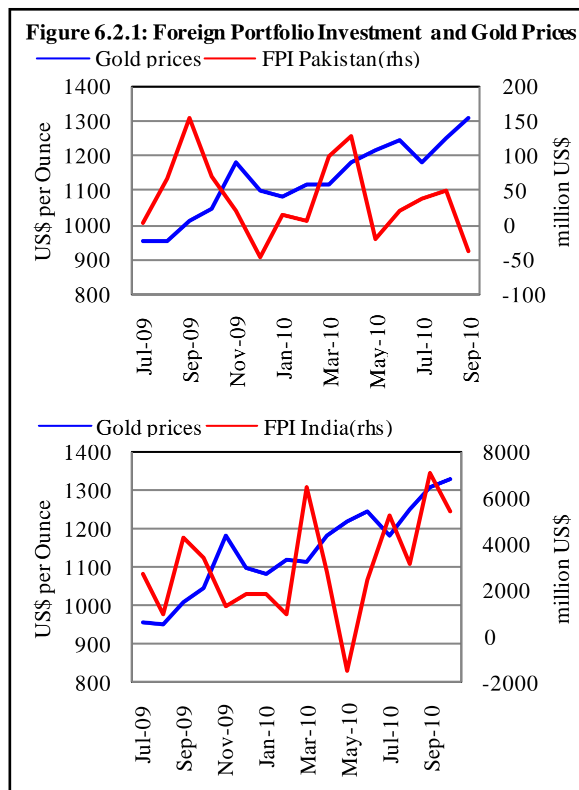
While the outflow of debt securities owed to Treasury Bills (T-bills) net payment of US$ 60 million in the month of September, low inflows in equity securities is not an encouraging sign as Pakistan's stock market remained relatively stable during the period under review. Moreover, Credit Default Swap (CDS) spread also fell significantly from January 2010 position. However, CDS spread showed erratic trend and is still higher than other regional economies (see **Figure 6.11**).

Anecdotal evidence suggests that most of the investors preferred to invest in gold rather than investing in stock markets of India and Pakistan. This is probably due to safe haven tag of gold (see **Box 6.2**).

Box 6.2: Relationship between Gold Prices and Investment in Stock Market

Investment in stock markets by foreign investors is determined by a number of factors, for instance, macroeconomic outlook of the country, stability of the stock market, rating of the country. However, with the emergence of risk averse environment after the recent financial crisis, investment in gold has increased probably due to the fact that it is considered as a hedge against inflation and risk free asset. Investors tend to buy gold due to its safe haven appeal. This has become more apparent after the recent global slowdown as investors are investing in gold, resultantly investment in equity markets are declining.

Figure 6.2.1: Foreign Portfolio Investment and Gold Prices



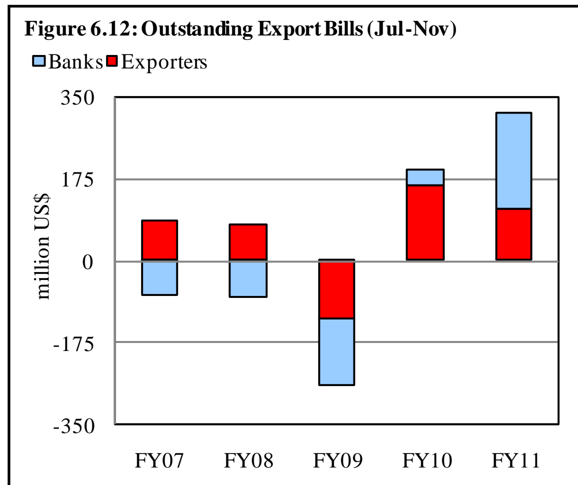
Monthly analysis of gold prices and investment in stock markets of India and Pakistan shows that there exists an inverse relationship (see **Figure 6.2.1**). Investment in stock market declines when gold prices are going up and vice versa. This inverse relationship has become even more significant/apparent during the last three to four months due to the bullish trend in gold market. Foreign investors are reluctant to invest in the stock markets of these two countries despite easing of the global financial crisis.

It is expected that as long as bullish sentiment prevails in the gold market, investment in equity markets of these two countries may not increase substantially.

6.3.4 Outstanding Export Bills

The stock of aggregate outstanding export bills has increased by US$ 316 million during Jul-Nov FY11 compared to the increase of US$ 194 million in the same period last year. Unlike last year, when the large part of increase was due to the outstanding bills held by the exporters, the increase in FY11 is explained largely by the outstanding export bills held by the banks (see **Figure 6.12**). Despite relative exchange rate stability, increase in outstanding export bills is attributed to better performance of exports during the period under review.

Figure 6.12: Outstanding Export Bills (Jul-Nov)



6.3.5 Currency and Deposits (Assets)

Currency and deposits increased by US$ 225 million during Jul-Nov FY11 compared to an increase of US$ 115 million during the same period last year. This increase is largely attributed to the rise in commercial bank FE-25 nostros.

6.3.6 Official Long Term Loans (net)

Net official long term loans recorded an outflow of US$ 44 million against an inflow of US$ 957 million during the same period last year. Despite US$ 453 million of emergency loan by IMF, net official loans recorded outflows on account of higher amortization during the period under review.

6.3.7 Private Loans

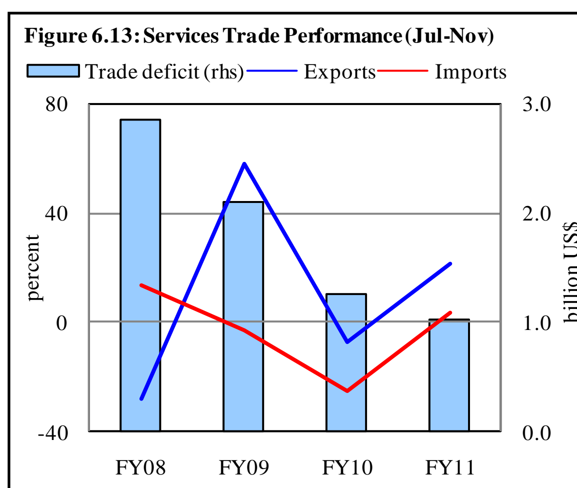
The private loans recorded net inflows of US$ 60 million during Jul-Nov FY11 in contrast to net outflows of US$ 10 million during the same period last year. It is important to mention that the level of inflows was not significantly higher; however, it was the decline in repayments of private loans that resulted in overall improvement during the period under review. The major companies that recorded loan inflows were COCA COLA BEVERAGES PAKISTAN (PVT) LTD (US$ 60

million), LARAIB ENERGY LTD ISLAMABAD (US$ 23 million), KESC (US$ 20 million) and WI-TRIBE PAKISTAN LIMITED (US$ 20 million) during Jul-Nov FY11.

6.4 Trade in Services

Pakistan's services trade deficit contracted by 18.6 percent in Jul-Nov FY11 compared to 40.0 percent in the same period last year. The fall was due to 20.8 percent YoY increase in services exports (see **Figure 6.13**). On the contrary, services import increased by 3.3 percent in Jul-Nov FY11 compared to a decline of 25.5 percent in the same period last year.

Figure 6.13: Services Trade Performance (Jul-Nov)



Expansion in services imports resulted from increase in transportation and travel services related to the religious affairs. In services exports, apart from communication services, all major heads recorded increase during the period under consideration.

6.4.1 Services Exports

Pakistan's services exports increased by 20.8 percent during Jul-Nov FY11 as against a decline of 7.7 percent in the same period last year. The major chunk of

Table 6.5: Major Services Exports (Jul-Nov)

Values in million US$, growth and share in percent

	Absolute Values		Growth		Share	
	FY10	FY11	FY10	FY11	FY10	FY11
Transportation	544.6	558.3	-5.0	2.5	34.5	29.3
Travel	110.8	130.5	-29.1	17.8	7.0	6.8
Other Business	214.3	259.6	-0.2	21.2	13.6	13.6
Communication	107.7	102.6	201.0	-4.7	6.8	5.4
Government	430.0	724.6	-24.8	68.5	27.2	38.0
Total	**1580.0**	**1908.4**	**-7.7**	**20.8**	**100**	**100**

this growth came from rise in receipts under transportation, travel, government services, and other business services sub-groups (see **Table 6.5**). During Jul-Nov

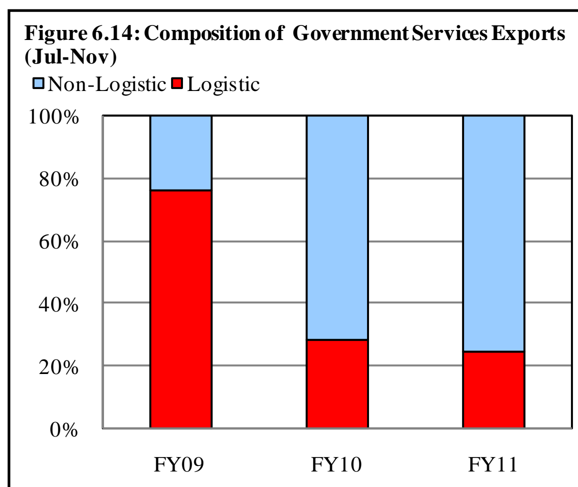
FY11, the overall services exports grew on account of improved freight earnings of national airline/shipping companies, increased disbursements of foreign transport companies domestically, and the increased funds received from international organizations.

Transportation services exports increased by 2.5 percent during Jul-Nov FY11 against a decline of 5 percent in the same period last year. The increase in exports of this category was on account of higher freight earnings, following the revival of economic activities in the international markets. This also led to increased disbursements of foreign air and shipping companies.

Travel Services exports increased by 17.8 percent on account of increased receipts through foreign tourists, indicating a revival of the tourism industry in Pakistan. On the other hand, receipts through exchange companies continued on declining trend following restrictions imposed on exchange companies by SBP.

Other business services exports witnessed increase of 21.2 percent during Jul-Nov FY11 compared to a decline of 0.2 percent in the same period last year. This rise is attributable to the increase in Arch., engineering & technical services, and the others business services head.

Figure 6.14: Composition of Government Services Exports (Jul-Nov)



Government services exports increased by 68.5 percent owing to the remarkable performance of both logistic and non-logistic sector during the period under analysis. Specifically, non-logistic support recorded healthy increase of 77.7 percent in the period under discussion. Consequently the share of non-logistic support in overall government services exports reached 75.4 percent during Jul-Nov FY11 (see **Figure 6.14**). Among the non-logistic support, funds received by international organizations recorded healthy growth of 425.5 percent during Jul-Nov FY11 compared to the increase of 224.3 percent in the same period last year. This probably reflects the increased activities of the international organizations in the flood affected areas. In addition to this, funds received by the foreign missions in

Pakistan also saw an increase, reflecting increased security of foreign embassies and consulates. On the other hand, logistic support increased by 45.4 percent during Jul-Nov FY11 by adding US$ 113.1 million in November 2010 only.

Table 6.6: Major Services Imports (Jul-Nov)

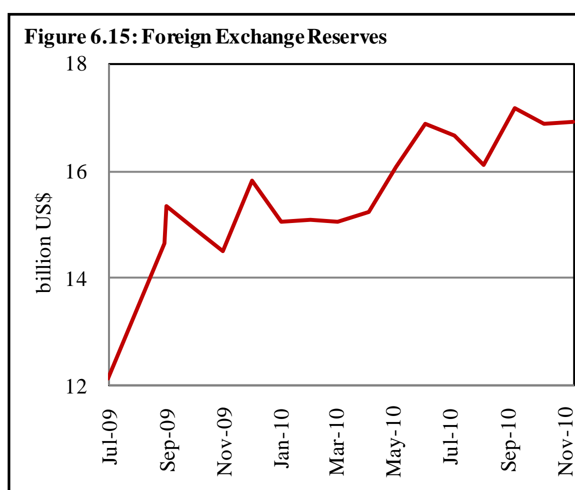
Values in million US$, growth and share in percent

	Absolute Values		Growth		Share	
	FY10	FY11	FY10	FY11	FY10	FY11
Transportation	1436.0	1554.6	-21.6	8.3	50.6	53.0
Travel	385.6	411.5	-45.0	6.7	13.6	14.0
Other Business	490.1	425.7	-42.9	-13.1	17.3	14.5
Government	244.9	246.0	71.0	0.4	8.6	8.4
Total	**2838.2**	**2932.8**	**-25.5**	**3.3**	**100.0**	**100.0**

6.4.2 Services Imports

Increased travel services imports along with robust growth in the transportation services resulted in 8.3 percent expansion in the overall services import during Jul-Nov FY11, compared with the fall of 25.5 percent in the corresponding period last year (see **Table 6.6**).

Figure 6.15: Foreign Exchange Reserves



Import of the ***transportation services***, being the largest contributor in the overall service import recorded an increase of 8.3 percent against a decline of 21.6 percent last year. This seems in line with the increase in the imports of the merchandise goods.

Likewise, ***travel services payments*** also increased on account of higher Hajj payments (under the head religious travel) which registered an increase of 17.8 percent during Jul-Nov FY11. On the other hand, outflow through exchange companies continued on declining trend on account of outflow restrictions on exchange companies by SBP.

6.5 Foreign Exchange Reserves

In November 2010, Pakistan's foreign exchange reserves reverted to FY10 position, after reaching an all time high of US$ 17.2 billion by end- October 2010 (see **Figure 6.15**). The improvement earlier in the reserve position was mainly due to the inflow of US$ 451 million from the IMF under the Emergency Natural Disaster Assistance (ENDA) for Pakistan in September 2010.

Of US$ 22 million increase in the overall reserves during Jul-Nov FY11, SBP reserves increased by US$ 113.0 million, while that of the scheduled banks declined by US$ 91.0 million. Most of the increase in the SBP reserves was on account of inflows from the IMF under ENDA. Besides these inflows, SBP reserves also benefited from lower outflows due to shifting the oil payments to inter-bank market. Consequently, SBP support for oil payments was completely phased out in the period under discussion (see **Table 6.7**). In contrast to SBP reserves, decline in the scheduled bank's reserves reflects increase in both import and export financing

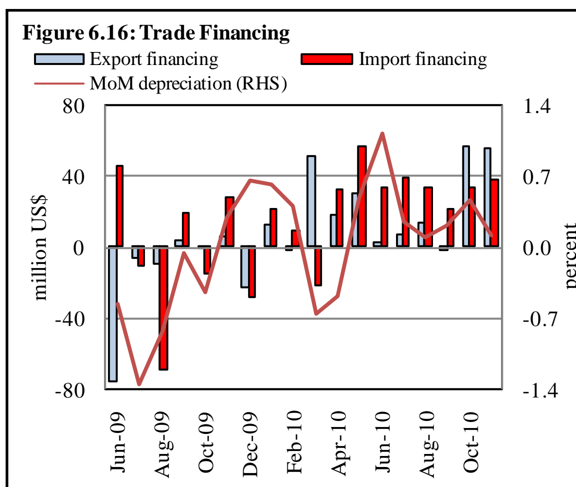
Table 6.7: SBP Reserves[6]

million US$

	Jul-Oct	
	FY10	**FY11**
Inflows	**8217**	**4630**
Purchases	1,320	315
Loans & Grants	3,022	596
ADB	216.8	60.8
IMF	2481.0	453.4
Others	2,862	2,685
Forward maturities	2,505	1,969
Interest on dep./discount	12.5	53.3
Miscellaneous receipts	182.4	558.2
Outflows	**6644**	**4369**
Inter-bank sales	20.0	90
Inter-Bank sales (Oil)	1292.1	0
Debt Servicing	405.7	365.1
Others	3,335	2,878
Forward maturities	2336.3	1,944
Defence (Army / PAF / Navy etc.)	445.3	147.9
Miscellaneous payments	138.0	197.2
Net change in reserve	**1573**	**260.5**

Source: DMMD

Figure 6.16: Trade Financing



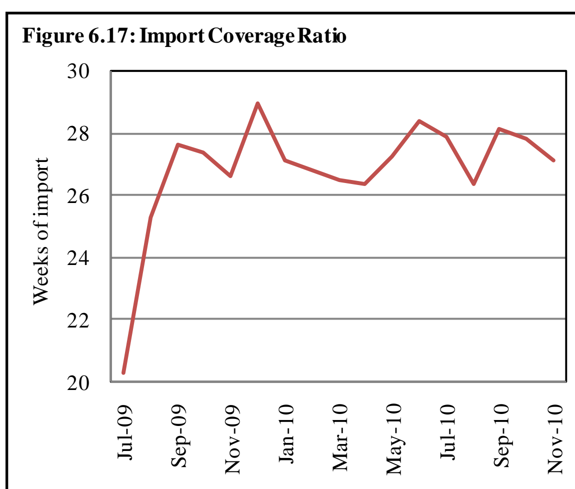
[6] Detailed data on SBP reserves pertains to October 2010.

(see **Figure 6.16**). Consequently, the volume of Foreign Exchange (FE) lending to importers increased to US$ 166.0 million during Jul-Nov FY11. The rise in EFS rate coupled with increase in the interest rate differential between Weighted Average Foreign Currency (WAFC) lending and Karachi Inter Bank Offer Rate (KIBOR) led to an increase in the FE lending to importers. Also, the escalating food and petroleum prices in the international market added pressure on the import payments during the period under discussion.

6.5.1 Reserve Adequacy

Reserve adequacy indicator in terms of weeks of imports declined from 28.4 weeks at end- June 2010 to 27.3 weeks at end-November 2010 (see **Figure 6.17**). Although the reserves increased reasonably during this period but the increase in the import bill was more pronounced resulting in fall of import coverage ratio. Monthly analysis reveals that the overall reserves depleted in the initial two months and imports increased, pushing import coverage ratio down to 26.3 weeks. However, improved reserve position in September and October 2010, with almost stable import bills with respect to previous months has pushed this ratio up again to 28.2 weeks by end- October 2010.

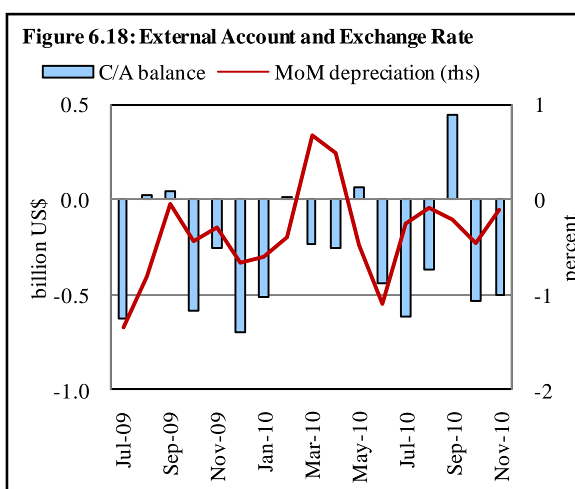
Figure 6.17: Import Coverage Ratio



6.6 Exchange Rate

Owing to improvement in the overall external accounts, Pakistan's currency vis-à-vis US dollar depreciated by only 0.35 percent during Jul-Nov FY11 compared to a fall of 2.6 percent in the corresponding period last year (see **Figure 6.18**).

Figure 6.18: External Account and Exchange Rate



Depreciation of rupee signifies pressures in the interbank forex market, as most of the inflows leading to improvement in overall foreign reserves were received directly by SBP (e.g., Emergency Natural Disaster Assistance (ENDA) disbursements by the IMF). Although, scheduled banks' reserves benefited from the rise in remittances, but the increased pressure of the oil payments on the interbank market more than offset the impact of rise in remittances. Specifically, the depreciation of Pak rupee was more evident in the second half of September 2010, reflecting heavy demand for foreign exchange by the oil marketing companies for making payments for the import of crude oil.

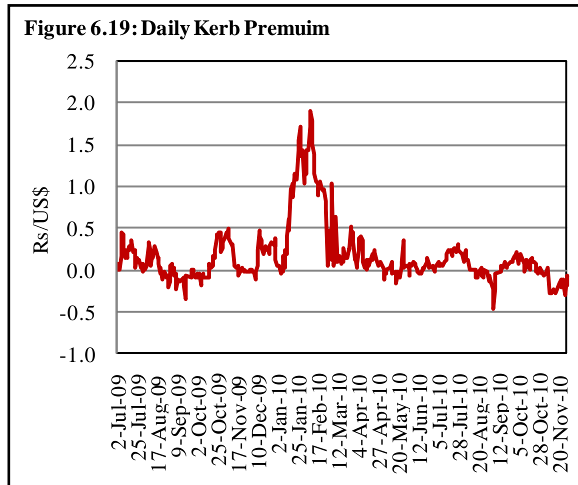


Figure 6.19: Daily Kerb Premuim

During Jul-Nov FY11, kerb market premium remained insignificant, reflecting lower demand of foreign exchange through FECs following SBP's restrictions on outflows from FECs (see **Figure 6.19**).

In nominal terms, Pakistan's currency depreciated by 4.4 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-Nov FY11. The depreciation of US dollar has caused Pak rupee to depreciate against these currencies (see **Figure 6.20**).

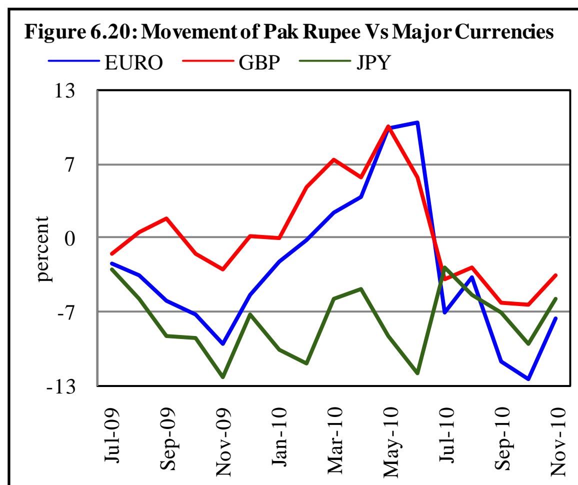
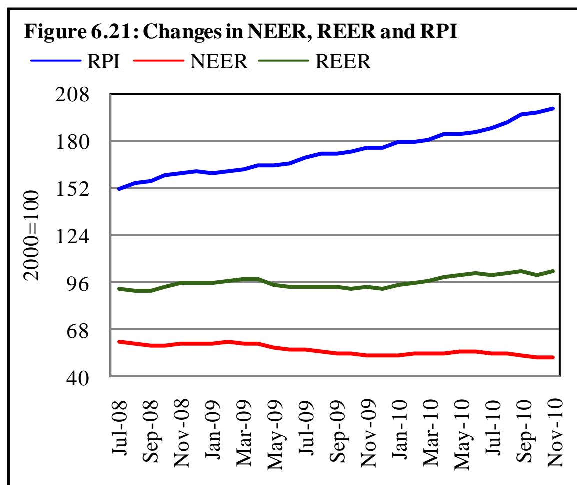


Figure 6.20: Movement of Pak Rupee Vs Major Currencies

The Nominal Effective Exchange Rate (NEER) depreciated by 4.4 percent during Jul-Nov FY11 compared to 7.0 percent during the same period last year (see **Figure 6.21**). The increase in the Relative Price Index (RPI) due to higher domestic inflation compared to the trading partner countries has caused the Real Effective Exchange Rate (REER) to appreciate by 0.88 percent compared to last year.

Figure 6.21: Changes in NEER, REER and RPI



6.7 Trade Account[7]

Trade deficit widened by US$ 938.2 million during Jul-Nov FY11 in contrast to a contraction of US$ 3220.3 million during the same period last year (see **Table 6.8**).

Unlike last year, when sharp fall in imports improved trade account, the deterioration recorded during FY11 is principally due to an increase of US$ 2288.2 million in the import bill which outpaced the rise of US$ 1350 in export earnings.

Table 6.8: Absolute Changes in Trade Account (Jul-Nov)

million US$

	FY10	FY11
Trade Deficit	**-3220.3**	**938.2**
Imports	**-3905.0**	**2288.2**
of which		
POL	-1696.8	474.5
Food	-703.5	853.6
Exports	**-684.7**	**1350.0**
of which		
Textile	-170.8	948.3
Non-Textile	-513.9	401.7

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

Analysis of import bill shows that a significant part of the rise was due to increased import quantum of food, petroleum, and textile products. Apart from higher import demand, relatively higher international commodity prices further inflated the import bill (see **Figure 6.22**).

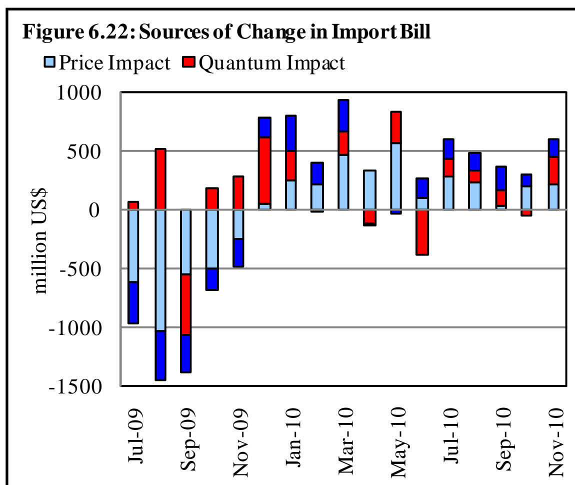


Figure 6.22: Sources of Change in Import Bill

The breakdown of the YoY change recorded in export earnings shows that main impetus came from the high-value products of the textile group. This rise can be attributed to relatively higher demand from the US market.[8] However, raw cotton exports declined in terms of quantum due to domestic shortfall.

As far as performance of non-textile export is concerned, on one hand, food exports recorded a rise primarily on the back of higher export prices as export quantum registered a decline compared to last year (see **Figure 6.23**). On the other hand, other manufactures exports fell amid subdued external demand.

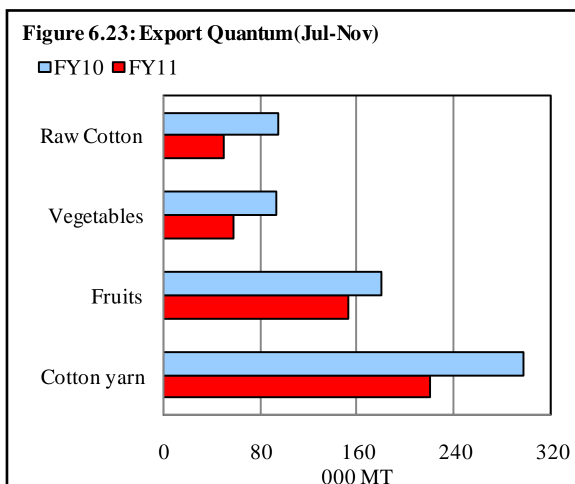


Figure 6.23: Export Quantum (Jul-Nov)

[8] US textile imports from the world increased by 17.9 percent during Jul-Aug FY11.

The import bill is likely to inflate further, going forward, on account of both, rising import price impact as well as domestic shortages of some key commodities, for instance, sugar and raw cotton. Export growth, on the other hand, may not accelerate at a sharp rate as flood impact on primary commodities[9] is likely to impede the export performance. Thus, trade deficit is likely to widen in coming months.

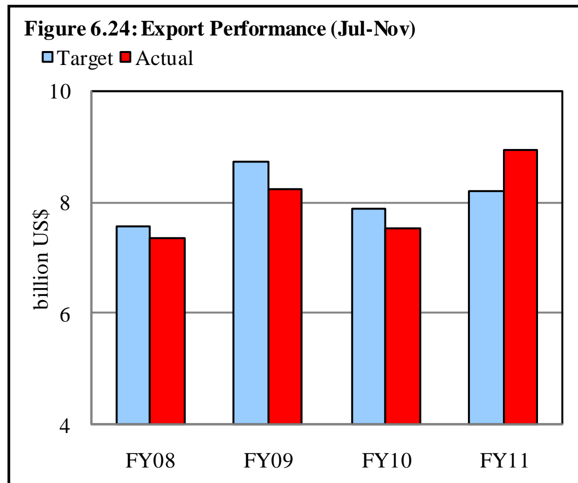


Figure 6.24: Export Performance (Jul-Nov)

6.7.1 Exports

Exports posted a growth of 17.9 percent during Jul-Nov FY11 in contrast to a fall of 8.3 percent during the same period last year. Exports performance is appreciable as this is the first time during the recent years that actual export has surpassed the target export set for the period (see **Figure 6.24**).

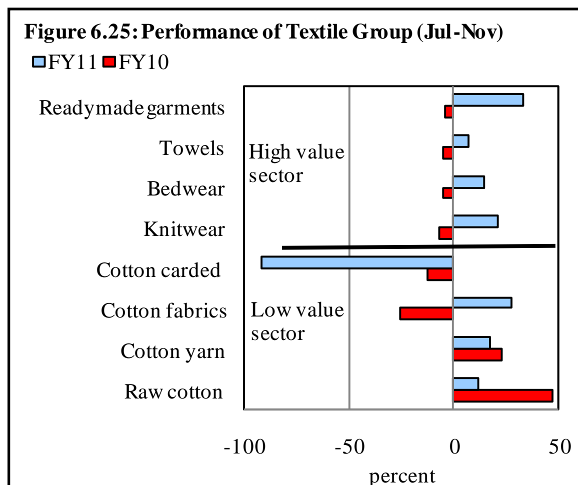


Figure 6.25: Performance of Textile Group (Jul-Nov)

Textile Exports

In case of textile exports, positive development was improved performance of the high value products such as readymade garments, knitwear, towels and bed wear (see **Figure 6.25**).

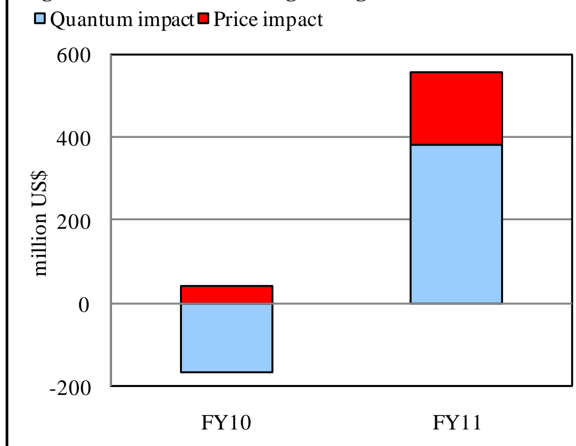
[9] It is estimated that cotton production will fall short by 2.5 million Metric Ton (MT), while rice production is estimated at 3.5 million MT compared with production level of 6.7 million MT. Similarly, loss of live animals is likely to impact meat exports.

Table 6.9: US Apparel Demand (Jul-Sep)
growth in percent

Apparel Imports	FY09	FY10	FY11
Bangladesh	12.9	-7.5	18.4
China	0.8	-3.8	23.5
India	-8.1	-3.1	6.6
Pakistan	-4.9	-11.3	15.3
World	-2.4	-14.5	17.9

Anecdotal evidence suggests that high value sector was facing two major problems in the last two years. First, compressed external demand led to low export orders. Second, supply-side issues such as liquidity constraints, shortage of raw material, and prolonged power crisis were adversely impacting the production process.

Figure 6.26: Sources of Change in High Value Products



However during Jul-Nov FY11, boosted by increased US textile and apparel imports, Pakistan's exports recorded a YoY rise during the initial months of FY11 compared to a substantial fall during the same period last year. In the presence of tough competition from regional competitors, Pakistan's performance, especially in case of apparel, is largely in line with export growth of competitors (see **Table 6.9**). Despite the shortfall of domestic cotton and pro-longed power crisis, Pakistan's competitiveness improved relatively as increased labor cost in Bangladesh, and appreciation of Chinese and Indian currencies [10] resulted in a loss of competitive strength for their exports in the US market.

On the supply side, availability of raw material such as cotton yarn improved after government imposed restrictions on export of this category. Due to these developments, export quantum of high value products registered a substantial rise. The rise in international cotton prices also kept the export price impact positive during the period under study (see **Figure 6.26**).

[10] Labor wages in Bangladesh increased by 60 percent while Chinese and Indian currencies appreciated by 2.0 and 5.1 percent against the dollar respectively.

Box 6.3: Impact of EU's trade concessions on Pakistan's textile exports

European Union (EU) offered trade concessions to Pakistan on 75-items mostly related to textile sector.[11] After legal modalities, i.e., approval from EU governments and European parliaments, tariff concession would be given for a period of three years effective from January 1, 2011. These 75-items account for approximately 27 percent of Pakistan's total exports to the EU. In 2009, export earnings from these textile-related items were around US$ 1.0 billion. Average export earnings during the last three years were US$ 1.2 billion. Pakistan's export share of these commodities in EU imports is approximately 3 percent.

Table 6.3.1: EU Clothing Imports in H1-2010 (Unit value)

US$/per kg

Woven cloths	Bangladesh	China	India	World	Pakistan
Men overcoats	11.2	15.8	18.5	17.2	9.8
Men suits	11.6	9.6	14.3	12.6	10.1
T-shirts	10.1	15.1	19.0	16.1	10.6
Knit-clothing					
Men overcoats	19.4	18.5	23.2	21.0	18.4
Men suits	12.4	15.3	19.6	18.4	12.9
Women suits	13.7	18.2	33.2	22.5	14.0

Table 6.3.2: EU Clothing Imports in H1-2010 (Volume Share)

share in percent

Woven cloths	Bangladesh	China	India	Other	Pakistan
Men overcoats	5	62	3	24	6
Men suits	11	53	5	25	5
T-shirts	35	22	8	34	1
Knit-clothing					
Men overcoats	2	77	1	19	1
Men suits	16	45	6	27	7
Women suits	8	54	7	28	3

Table 6.3.3: Analysis of EU Concession List

value in million US$, share a& tariff in percent

	Value of exports in 2009	Share	Current avg tariff
Yarn	87.4	8.3	3.2
Fabric	414.4	39.6	6.4
Knit-clothing	545.2	52.1	9.6
Total	**1047.0**	**100.0**	**6.4**

The direct benefit of this package is that it will lower the prices of Pakistani products in EU. However, analysis of EU's textile and apparel imports shows that Pakistan's unit prices in most of the categories are already much lower than competitors (see **Table6.3.1**). But still Pakistan's share in EU market is lower than its peers (see **Table 6.3.2**). Anecdotal evidence suggests that lack of modern technology; designing techniques and exporter's inability to meet large orders are the major impeding factors.

Furthermore, if low value products are exported to EU to get benefit of trade concessions, then domestic availability of raw material would be a problem and imports of these products could increase the cost of production. The shortage especially hurt the production and exports of towels and bed sheets which have not been provided any concession.

However, it is pertinent to mention that the tariff on different categories of yarn is already low, so a zero tariff on these categories would not drastically lower the unit prices. On the other hand, few categories of fabrics and knit-clothing could benefit from the trade concession as the current average

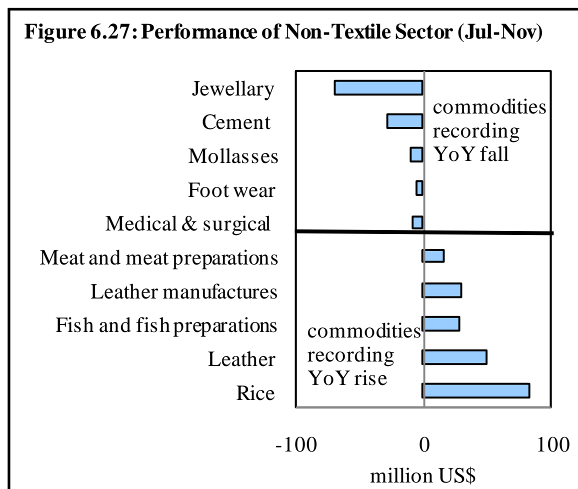
[11] Out of 75-items, 68 are related to textile sector, 6 are associated with the leather industry, while the remaining item is dried mushrooms and truffles.

tariff on these categories is relatively high (see **Table 6.3.3**). Unit prices would decrease dramatically in this case and Pakistan's price competitiveness would increase.

Non-Textile Exports

Analysis of non-textile exports shows that on one hand, exports of food group recorded a YoY rise of 7.3 percent with main contribution coming from rice, meat, fish, and vegetables. While on the other hand, exports of others manufactures marginally increased by 0.3 percent during the period under study (see **Figure 6.27**).

Figure 6.27: Performance of Non-Textile Sector (Jul-Nov)



Rice exports registered a growth of 11.9 percent with major contribution coming from non-basmati rice recording a growth of 13.4 percent during the period under study. This rise in rice exports was largely due to the carryover stocks. However, rice exports may slowdown going forward as production of rice is estimated to remain 3.5 million MT during FY11 compared with last year's production level of 6.7 million MT. However international rice prices are expected to rise due to low production in Philippines[12], which would partially offset the impact of lower export quantum.

Meat and fish exports were increased by 48.2 and 34.3 percent respectively during Jul-Nov FY11. The rise in meat exports was principally due to higher unit values. Moreover, increased demand from Saudi Arabia probably due to the ban imposed by the Saudi government on meat imports from Ethiopia facilitated the Pakistani exporters. On the other hand, rise in fish export was due to increased demand from Egypt.

Exports of *leather and leather manufactures* posted a decent rise during the initial months of FY11. The rise in this category is attributed to market diversification and increased external demand of leather jackets. A number of new markets were

[12] According to Philippines department of Agriculture, the estimated production losses (222,000 MT) as a result of Typhoon Megi represent about 3.2 percent of the projected 7.0 MMT national rice production for the last quarter of 2010.

explored, such as South Africa and Turkey. Apart from these new destinations, increased demand from European countries also encouraged the exporters.

Cement exports declined by 13.3 percent during Jul-Nov FY11. This decline in exports was in line with the compressed demand from Middle East countries. Moreover, commissioning of new cement capacities in India led to fall in exports to India during the period under review.

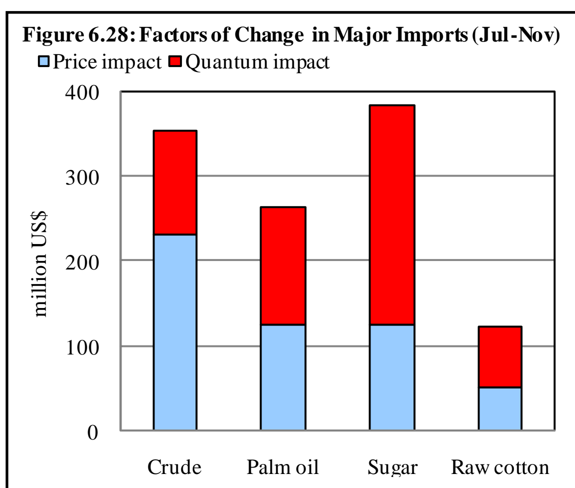


Figure 6.28: Factors of Change in Major Imports (Jul-Nov)

6.7.2 Imports

In contrast to a fall of 23.0 percent during Jul-Nov FY10, import registered an expansion of 17.5 percent during Jul-Nov FY11. This rise in import bill came due to increased import quantum of products like crude oil, palm oil, sugar & raw cotton. Relative increase in international commodity prices also played a part in inflating the import bill (see **Figure 6.28**).

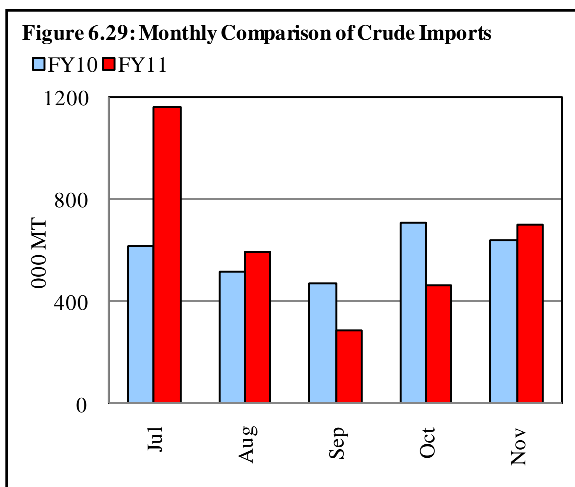


Figure 6.29: Monthly Comparison of Crude Imports

Food group imports recorded a YoY rise of 65.8 percent in contrast to a fall of 35.2 percent during the same period last year. The trend of rising sugar import which emerged during FY10 due to domestic shortages continued in the initial months of FY11 as well. Sugar imports are likely to increase further going forward due to domestic shortage.

Similarly, the dominant factor behind palm oil imports was the quantum impact amid higher domestic demand and reduction of import duty.[13]

Petroleum group imports increased by 12.6 percent during Jul-Nov FY11, as against a drop of 31.0 percent during the same period last year. The price impact in case of both crude oil and petroleum products turned positive in FY11 broadly in line with the increase in international oil prices. In case of crude oil, monthly analysis shows that import quantum substantially decreased after high imports

Table 6.10: Imports of Machinery (Jul-Nov)
million US$

	FY10	FY11	Abs. change
Textile	83.2	193.3	110.0
Telecom	242.6	377.6	135.0
Electrical Machinery and Apparatus	281.6	343.6	62.0
Agricultural	57.2	39.4	-17.8
Power Generating	623.5	459.6	-163.9
Construction and Mining	79.8	51.1	-28.7
Other Machinery	667.3	647.7	-19.6
Total	2137.6	2207.6	70.0

during the month of July (see **Figure 6.29**). [14] Suspension of work at one of the largest refineries resulted in sharp fall of crude imports during September and October.

Machinery group imports posted a growth of 3.3 percent in contrast to a fall of 27.5 percent during the same period last year. Category-wise analysis reveals that imports of textile, telecom and electricity machinery increased in absolute terms, however, power generating, construction and other machinery continued to register a fall (see **Table 6.10**).

Import of textile machinery started rising from September 2009 onwards following the elimination of import duty.[15] The trend of rising import further strengthened after the inclusion of textile machineries under the Long Term

[13] Import duty on crude palm oil was reduced from Rs8,000/MT to Rs7,000/MT
[14] This rise is also due to apparent reporting error, which resulted in oil imports of June to be reflected in July, this is quite obvious as crude imports during June were recorded zero. Avg. crude imports per month is around 600 MT, however, in July, crude imports were reported at 1200 MT.
[15] SRO 809(I)/2009 dated 19th September 09, allows reduction of import duty on textile machinery from 5 percent to zero.

Financing Facility (LTFF).[16] The demand of textile machinery is emanating from low value as well as value added sectors amid improved external demand. Anecdotal evidence suggests that some of the firms are either upgrading or increasing their capacities. The government announcement to grant 10 percent tax credit to firms under BMR would also result in further up-gradation of textile units going forward.

In case of the rise in *telecom* imports, out of the US$ 135.0 million increase, US$89.7 million was due to imports of cellular phones while rest of the increase was due to imports of apparatus. The demand of cellular phone has been on a rise since the reduction of custom duty from Rs. 500 to Rs. 250 and 50 percent reduction in SIM activation charges.

Transport group registered a growth of 7.1 percent. Main contribution in this import growth was the rising imports of CKDs of motor cars. Increased import of CKDs is a function of increased demand from the domestic auto industry. Increased demand is evident from the domestic production and sales numbers which increased by 18.7 and 12.2 percent respectively during Jul-Sep.

Import of *raw cotton* increased during the initial months of FY11 owing to both quantum as well as price impact. First, the expected shortfall in domestic production due to floods led to increased import quantum of cotton. Second, the rise in international cotton prices led to high unit values.

Revival in construction activities, low domestic capacity utilization, and delay in commissioning of a new steel mill largely explains the rising import demand of *iron and steel scrap.* Moreover, the rising demand of the re-rolling industry was also apparent in imports of ship breaking vessels, which recorded a YoY rise of 101 percent during the period under review.

[16] Small and Medium Enterprises Finance Department (SMEFD) Circular Letter No. 03 of 2010, according to which import of second hand machinery shall be eligible for refinancing under the Long Term Financing Facility.