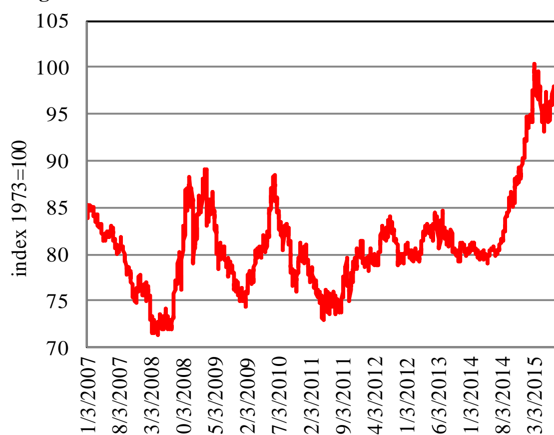
7 External Sector

7.1 Global Economic Review

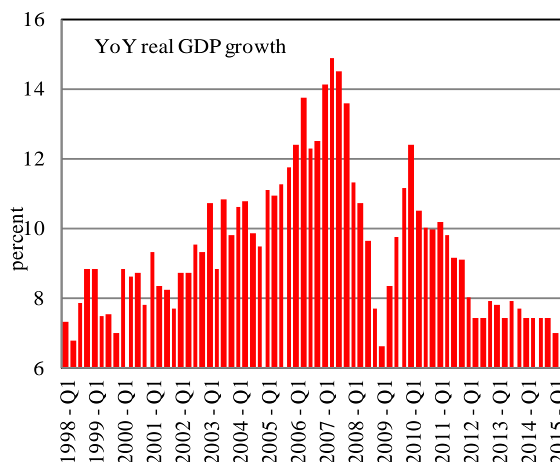
FY15 was quite an eventful period for the global economy. This period began with speculations over a rise in Federal Fund rates as the US brought its Quantitative Easing program to an end; massive capital drove into the US, appreciating the US Dollar to an 11-year high (**Figure 7.1**). Meanwhile, the economic slowdown deepened in China, where the GDP growth is fast approaching levels seen during the crisis period (**Figure 7.2**). Other emerging economies also faced hard times: sanctions on Russia were tightened; Brazil was hit by a massive corruption scandal; Malaysia and Thailand plunged into political turmoil; and regional conflicts intensified within the GCC countries. The fragile global economy led to a collapse in oil prices that touched a 5-year low in December 2014 (**Figure 7.3**). Having said that, the highlight of this period was Greece being taken over by the leftist Syriza party, which immediately demanded the abandonment of the bailout program. Much to the anxiety of Germany-led creditors, Greek bonds were downgraded to junk; Greece defaulted IMF payment in June; a poll was held to decide on bail-out conditions; and the government imposed capital controls to prevent the possible currency outflow. The Greece exit from the Euro was just round the corner, before the last-minute agreement saved the integrity of the common currency.

Figure 7.1: US Dollar Index



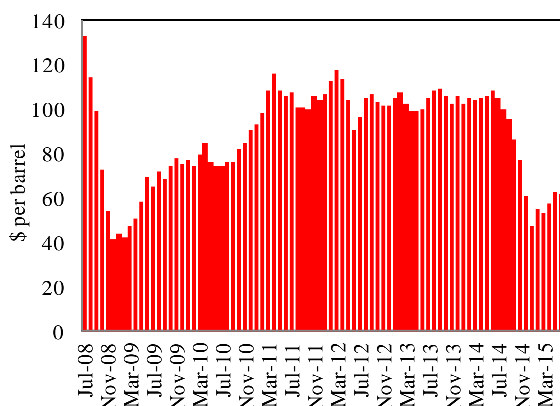
Based on weighted geometric mean of Euro (57.6%), Yen (13.6%), Sterling (11.9%), Canadian Dollar (9.1%), Krona (4.2%) and Franc (3.6%) Source: Bloomberg

Figure 7.2: China Cooling Down



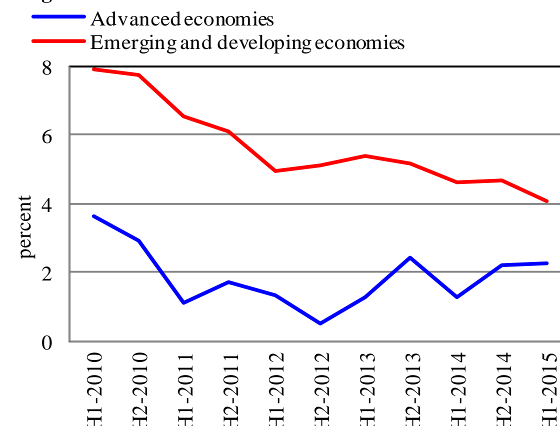
Source: Haver Analytics

Figure 7.3: Global Crude Oil Price



* Simple average of spot prices: Brent, WTI, and Dubai Fateh
Source: World Bank

Figure 7.4: World GDP Growth



Source: IMF World Economic Outlook, April 2015

Amid all the turmoil, the growth in advanced economies continued to consolidate on the back of liquidity injections by ECB and favorable financial conditions in the US (**Figure 7.4**).[1] The pace of US economic growth has been particularly impressive, as consumer confidence rebounded, and retail sales firmed up. Although net exports tumbled as the US Dollar became costlier, the overall increase in consumption spending supported the US GDP, which showed an average growth of 2.7 percent during Jul-Jun 2015.[2,3] The drag from fiscal consolidation was also absent; in fact, reversed. The government spending posted a YoY increase throughout Jul-Jun 2015, compared to consistent declines in the same period last year. More importantly, unemployment levels have dropped to a 7-year low, and a recovery in wages is visible on account of a tighter job market.

Other advanced economies posted a mixed growth, as activity picked up in some countries (like the UK, Germany, France and Spain), and stalled in others (Japan and Italy). The ECB's asset purchase program and a sharp decline in global oil prices were pivotal in lifting overall growth in the EU. Similar to the US, the growth has largely been consumption-driven, with some contribution coming from net exports as Euro weakened. However, it will take some time to restore the investor confidence that has been shaken by high real debt burdens (Greece, Ireland, Portugal and Italy); policy uncertainty; and impaired balance sheets of financial sector. In Japan, the consumption tax hikes caused a sharp contraction in GDP throughout 2014. Although the growth in the first quarter of 2015 was much stronger than expected, the economy went back into contraction in the second quarter.

In the developing/emerging world, the highlight was the continuous decline in China's growth rate. The latest quarterly data shows a 7-year low real GDP growth, primarily as fixed investments slowed down. Property investments that constitute nearly a fifth of China's GDP, are facing a slump, as unsold housing inventory remains high, and property developers are bogged down with high debt levels. Policy rates have been cut thrice since November 2014, still the money growth could not recover. Outlook of other economies depend heavily on how the Chinese economy performs going forward, as it is the second largest importing country of the world, after the US, with nearly 11 percent share in global imports.

Latin American and Caribbean region has particularly suffered from China's slowdown. The slowdown in this region was further intensified by uncertainty related to policy reforms, and low commodity prices. For instance, growth in Colombia and Venezuela was marred by lower oil prices, whereas, Chile and Peru were hit by falling prices of copper and zinc. For Brazil, the decline in iron ore prices was not the only problem: a massive scandal in the state-owned oil producer (Petrobas), had severely dented investor confidence. The country was also struck by worst-ever drought, whereas frequent power blackouts even spawned fears of rationing of electricity and water supplies in the country.

Going forward, we do not expect global economy to be much different than what it is today, at least by the end of FY16. But, how low the "new normal" level of growth in China turns out, is what to watch for.[4] Although China has embraced the path of slower but sustainable growth, it will not let growth slip further than the current levels; recent Yuan devaluation and higher fiscal spending are some desperate last-minute attempts. Notwithstanding this, a tamed China is very much an integral part of the post-crisis global economy. This brings into play two important parameters that would define the future global growth: first, the commodity boom has fizzled out; therefore, growth spurts in

[1] From March 2015 onwards, ECB increased the bond purchases from €12 billion (on average) to €60 billion per month.
[2] Import of goods and services increased by 5.0 percent YoY (on average), during Jul-Jun 2015. In the corresponding period a year ago, imports had increased by only 2.6 percent (Source: US Bureau of Economic Analysis BEA).
[3] The quarterly data between July 2014 to June 2015 shows that the seasonal adjusted real GDP has grown by an average of 2.7 percent YoY. Between July 2013 and June 2014, the US economy had grown by an average rate of 2.1 percent.
[4] The "new normal" term is referred to the state of global economy in the post-global financial crisis period. For China, this term refers to where the economy would land after experiencing an extraordinarily high growth period.

resource-rich economies of GCC, CARs, and Latin America, are probably over.[5] Second, trade volumes have peaked, which signifies tough times ahead for the export-driven manufacturing economies in Asia. For now, these economies are responding with currency management, but in the long run, productivity gains and diversification would rule the game.

India is expected to post strongest growth among major economies of the world, on the back of expected reforms in labor, agriculture, mining and power sectors can further consolidate India's growth in future. Vietnam is also emerging as a new manufacturing powerhouse of Asia. Cambodia too, is not much far behind. However, in overall terms, emerging market economies have to put up with modest growth rates for some time, before structural reforms – that reduce infrastructure bottlenecks and other supply-side constraints – improve the overall productivity.

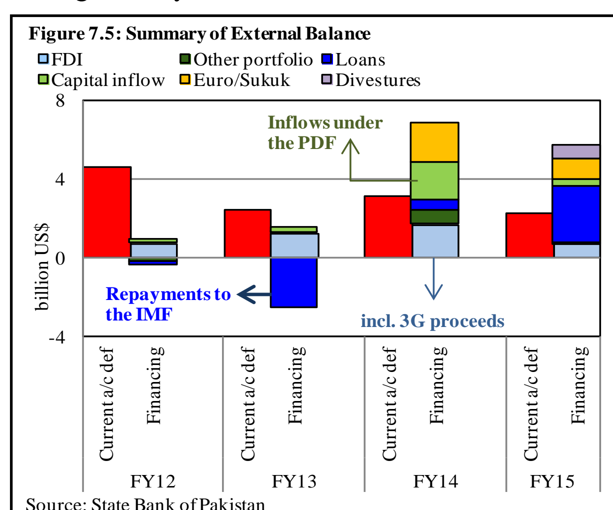
Under these circumstances, global growth will be taken forward by advanced economies of the EU and the US, which will be helped by low oil prices, and reduced drag from fiscal consolidation. EU would also gain from currency depreciation and low interest rates, but what this region requires to optimize on these opportunities, is an earlier clean up of balance sheet of the banking system; accelerated structural reforms; and further strengthening of the governance framework. In the US, some important adjustments are near like the increase in Federal Fund rates, which may be accompanied with capital influx, and responses from the currency and financial markets.

Concerns for Pakistan are not much different than most emerging economies: export revenues are declining, as demand from China tapers, and unit prices fall. EU has also begun to cutback purchases from Pakistan (and other exporters), as weak Euro has made local goods more competitive. In case of imports, Pakistan has not benefited much from low oil prices, as non-oil imports rose sharply during FY15 (**Section 7.5**). On a positive note, oil prices did not hurt remittance growth either. In fact, remittance inflow from oil-rich GCC countries grew at a faster pace than last year, thanks to significant volume of FX reserves that financed infrastructure spending in these countries.
That said, this trend may not persist for long if oil prices fail to recover.

7.2 Pakistan's External Sector: Prospects and Challenges

The improvement in Pakistan's external sector that began last year, consolidated further in FY15. The country's foreign exchange (FX) reserves posted an increase of US$ 4.6 billion during the year, to reach an all-time high level of US$ 18.7 billion at end-June 2015.[6] The net international reserves (NIR) are in much better shape than before, thanks to official inflows and SBP's spot purchases from the interbank. This comfort on the external sector was reflected in a much stable PKR parity through most of the period.[7]

Figure 7.5: Summary of External Balance



Source: State Bank of Pakistan

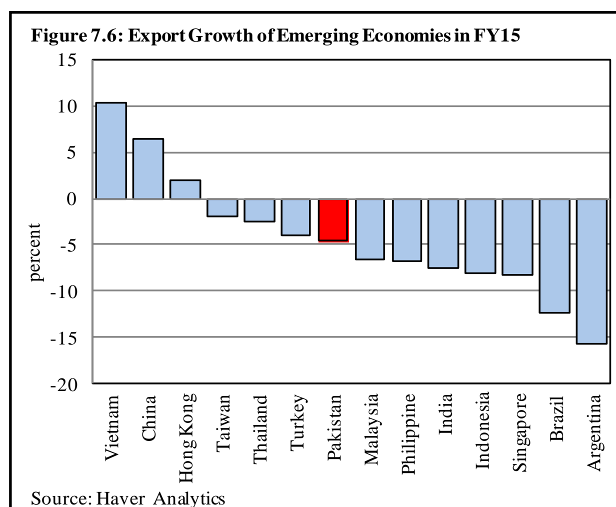
The IMF program lent major support to Pakistan's reserves position during the year. This program provided US$ 2.0 billion net FX support to the country during FY15; last year, Pakistan had retired US$ 0.6 billion to

[5] Oil and petroleum sector is the major casualty, where demand is not the only nuisance: supplies have also risen sharply due to increased production of shale gas.
[6] By end-September 2015, the country's FX reserves touched US$ 20 billion.
[7] The PKR had depreciated by 3.7 percent during the first quarter of the year. However since then, it posted an appreciation of 0.8 percent up till end June 2015.

the Fund.[8] The successful continuation of this program induced confidence among other lenders, which enabled the government to fetch US$ 1.8 billion during the year via Sukuk issuance and divestures, and gather IFI funding for various public projects. The availability of external funding made it easier to finance the current account deficit, which was already muted due to record-high worker remittances (**Figure 7.5**). IFIs and credit rating agencies have corroborated improvement in sovereign health, and overall stability in Pakistan's external sector.[9]

Two factors are critical for sustaining this stability over a longer time-period: exports and foreign direct investment (FDI). As things stand, exports have declined by 3.9 percent during FY15 (mainly in quantum), whereas FDI inflows have more than halved. In fact, it is the weakness in these two indicators over the past few years that made Pakistan increasingly dependent on external borrowings. How to boost these indicators, and build servicing capacity against fresh borrowings, therefore remains our major concern.

Figure 7.6: Export Growth of Emerging Economies in FY15



Source: Haver Analytics

In case of exports, global factors appear predominantly responsible: many emerging economies are struggling with lower export revenues, as depressed commodity prices weighed on nominal export values (**Figure 7.6**). Quantums are also stagnant as weaker Euro has made it hard for emerging economies to compete in the world's largest export market.[10] The demand from Chinese market, which is 10 percent of world's imports, is also dropping to more sustainable levels.

However, despite this commonness, there are three concerns that are distinct for Pakistan: (i) as mentioned before, in the case of other emerging economies, export volumes were mostly unhurt.[11] But in case of Pakistan, exports were pulled down primarily by quantums; this suggests that even if prices had stayed the same as last year, Pakistan's exports would have declined; (ii) Pakistan's share in world exports has begun to taper from 4th quarter onwards. Intuitively, this period has coincided with divergence in REER trend between Pakistan and other countries: while the PKR appreciated in real terms during Q4-FY15, other Asian currencies posted real depreciations (**Section 7.5**); and (iii) while the weakening in Euro has made the EU a tough market for almost every exporting country, Pakistan has failed to benefit from the booming US market. In fact, Pakistan's exports to the US have actually declined at a time when US overall imports have increased to record-high levels.

The concern on FDI is no less, as inflows have nearly halved in FY15 compared to last year. While domestic constraints persisted, global environment was also not conducive for cross-border investments in FY15.[12] Except for textiles, hydel power and motorcycle industries, all sectors of the economy received lesser FDI than last year. More importantly, multi-nationals divested from Pakistan's steel, cement and pharmaceutical sectors (**Section 7.4**). Meanwhile, the volume of

[8] After including repayment of IMF's budgetary support to the government, the overall net borrowing from the IMF stood at US$ 1.43 billion in FY15.
[9] In June 2015, Moody's upgraded Pakistan's sovereign rating from Caa1 to B3.
[10] The EU had 32 percent share in world's imports during 2014 (Source: International Trade Centre).
[11] For instance, oil prices provided a drag on exports of India, Indonesia, Malaysia, and the Philippines; Thailand suffered due to low rice and rubber prices.
[12] Global foreign direct investment (FDI) inflows fell by 16 per cent to $1.23 trillion in CY 2014, mostly because of the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. (Source: UNCTAD).

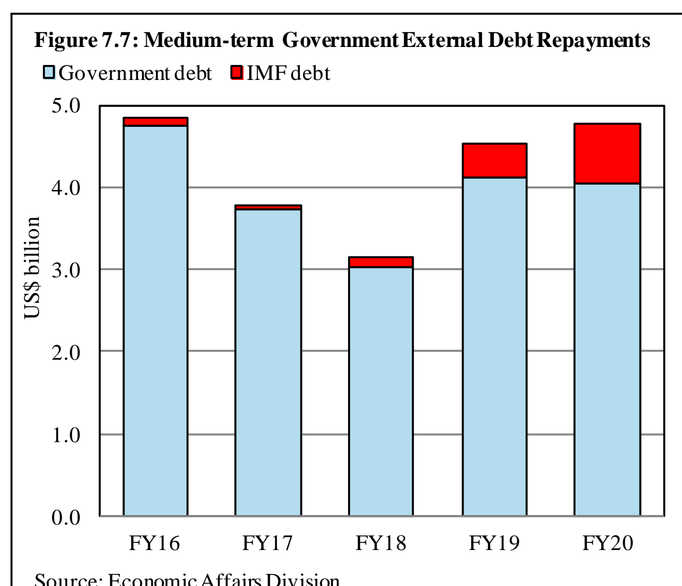
repatriations on existing FDI has reached to an all-time high of US$ 3 billion in FY15 – four times the inflow of fresh FDI.

With concerns lingering on exports and FDI, sustaining a revival in investment activity will be challenging, as this entails additional import of capital goods and raw materials; our limited FX resources may act as a constraint. Most of the growth in imports in FY15 (steel, machinery, industrial chemicals) was to supplement the domestic infrastructure spending, which is at the centre stage of recent fiscal spending in Pakistan.[13] Similarly, measures to revive the ailing public transport also implied higher imports: aircrafts for PIA; locomotives for Pakistan Railway; and CKDs to assemble cars to give away under the Apna Rozgar Scheme. Additional pressure on imports came from food sector, especially in the first half of the year. Importers rushed to book orders in this period, to benefit from soft prices (oilseeds, wheat, palm oil, etc.), whereas some impact of floods was also visible in case of higher import of important vegetables like onions, garlic, and tomatoes. These pressures died out in the third quarter: the respite came from imposition of regulatory duty on a number of items, and stability in global prices. Together, the increase in non-oil import offset most of the gains from the lower oil bill (**Section 7.5**).

The above discussion boils down to one point: economic activity in Pakistan depends heavily on imports, therefore, any measure to boost growth would increase our FX needs. In the previous few years, worker remittances were carrying this burden of financing *incremental* imports, since a meaningful growth in exports (and FDI) was not happening.[14] However, the future growth in remittances hinges significantly upon fiscal spending in GCC countries: if oil slump persists, we might have to prepare ourselves for a possible slowdown in remittances.

This situation leaves external borrowings as the *only* possible factor that may support higher growth in Pakistan. And this is exactly where the issue of sustainability props up: repayment burden adds to FX needs and reduce any space for import expansion. **Figure 7.7** shows how much *more* FX we must generate in the future to finance external debt servicing burden *alone*. Here it is important to emphasize that the fast changing dynamics of the global economy is making it increasingly difficult for Pakistan to generate FX resources. Following developments are particularly important:

Figure 7.7: Medium-term Government External Debt Repayments



Source: Economic Affairs Division

China weakens: China is the second-largest market for Pakistan, with nearly 10 percent share in exports. The recent slowdown in Asia's largest economy spells trouble for some local industries that had enjoyed strong Chinese demand in recent years. Most of the items that Pakistan exports to China are industrial raw materials like cotton yarn, fabrics, chromium ores, raw hides and skins, marbles and articles of copper. The impact of China's slowdown would most strongly be felt on cotton textile

[13] Total public investment posted an increase of 25.1 percent in FY15, compared to a decline of 1.9 percent last year. Investment in construction increased by 22.2 percent, whereas in electricity generation & distribution and gas distribution increased by 23.0 percent.
[14] In FY15, remittances financed 45 percent of Pakistan's import bill.

products, which constitute over 30 percent of our total exports to China (**Section 7.5**). Demand for other raw materials has also weakened, as overall industrial activity and export growth lose steam. China's overall export growth has shrunk to only 6.1 percent YoY in Jul-Jun 2015, compared to an average annualized growth of 12.8 percent in the post-crisis period (Jul-09 to Jun-14).

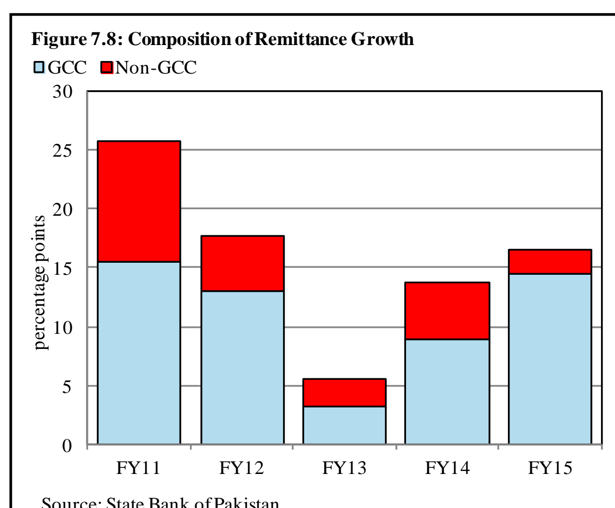
Vietnam rising: Over the past few years, manufacturing of labor intensive products like garments, footwear and furniture, had been shifting gradually from China to Vietnam. With a much younger labor force and low wages, Vietnam has lately emerged as the new manufacturing power house of Asia, now selling high value-added products like cell phones, computers, electronics, and automobile parts. Only in the previous five years, its export to the US and EU has more than doubled.[15] More recently, Vietnam has daunted many competitors including Pakistan, with its participation in Trans-Pacific Partnership agreement with the US. Similarly, a bilateral free-trade agreement between Vietnam and the EU, is also on cards. If negotiations succeed, these agreements would grant Vietnam duty-free access to the world's largest markets.

EU market and the currency war: As Euro has weakened against the US Dollar, it has become difficult for emerging economies to remain competitive in the EU market. The EU's overall imports have declined in FY15, as consumers shifted their preference towards domestic goods.[16] A cut-throat competition has begun, forcing exporters to take a hit on their margins; those countries are more desperate where growth is strongly dependent on exports. China has responded by devaluing Yuan in August 2015, which was followed by a similar measure by the State Bank of Vietnam. Even before this, some central banks were taking deliberate measures to suppress their currencies to lift exports, like Reserve Bank of India and the Bank of Thailand (**Section 7.4**).

US market and the product mismatch: Long before the threat of Vietnam had emerged, Pakistan had already started losing the US market. Reason: Pakistan is not producing what is in demand in the US, i.e., synthetic textiles. The US is the largest buyer of Pakistani products, with 15 percent share in total exports; of this, nearly 80 percent is comprised of just two items: clothing and home textiles. Together, these two items fetch US$ 3 billion from the US market. Over the last few years, the demand for synthetic textiles in the US is rising, which has taken over the market for cotton textiles: share of cotton textiles has reduced from 40 percent, to only 31 percent in just five years. Unfortunately, Pakistan is stuck in the production of cotton textiles alone, and is not able to promote the use of man-made fibers in local textile manufacturing.

Oil slump and the GCC: After rebounding in the fourth quarter of FY15, oil prices crumbled again in August 2015. While a subdued China kept a lid on demand, the battle between Saudi Arabia and the US for market share has deepened the supply glut. The news on Iran nuclear deal further intensified panic in the market: if sanctions are lifted, Iran could pump significant quantity of oil in the global market. GCC countries, which rely heavily on oil revenues for fiscal spending, would not be able to continue their spending spree if oil slump

Figure 7.8: Composition of Remittance Growth



Source: State Bank of Pakistan

[15] Vietnam's exports to the US have increased from US$ 16 billion in 2010, to US$ 32 billion in 2014. Similarly in the EU, Vietnam's exports have increased from US$ 14.7 billion in 2010, to US$ 34.74 billion in 2014. (Source: ITC).

[16] Exports of those countries have particularly suffered, with which the EU does not have a bilateral trade agreement, like India and Indonesia (**Section 7.5**)

persists. It must be recalled here that the remittance growth in Pakistan over the past five years was sourced primarily from the GCC countries, which relied heavily on migrant workers to support their booming construction industry (**Figure 7.8**).

New opportunities can defy challenges:

In addition to posing a challenge, low oil prices also provide an opportunity for Pakistan, to address structural weaknesses in its balance of payments: with less import burden for some time, Pakistan can focus on medium-to-long-term measures needed to enhance exports and investments in the country. For instance, the unfavorable state of energy and security in the country had predominantly deprived Pakistan of productive investments in the previous few years. Encouragingly, recent developments promise an early redressal of these concerns, ushering in new opportunities for the economy to recover from one of the most difficult phases in the history.

China-Pakistan Economic Corridor (CPEC): Offering opportunities to fix our chronic infrastructure and energy sector problems, CPEC involves building of roads and rail networks and telecommunications; development of Gwadar Port; and major projects for power generation and transmission.[17] Thermal generation projects would be particularly helpful especially those that use indigenous coal; the Private Power and Infrastructure Board has recently given approval for one such plant (of 1320 MW) in Thar. For FY16, the government has estimated disbursements of Rs 207 billion (around US$ 2.1 billion) from China; of this, Multan-Sukkur section of CPEC is expected to get funding of Rs 45 billion (US$ 445 million) in the form of external loan.

Iran nuclear deal: This deal would open the Iranian market to many countries, who were earlier unable to undertake financial transactions with the Islamic Republic due to UN sanctions. Presently, China, India and Turkey – who never backed restrictions against Iran, have an edge over other countries, as they managed to expand bilateral trade at a time when Iranian banks were unplugged from the SWIFT. Now with Iran's reintegration with the global economy, Pakistan eyes this market to increase export of cereal, pharmaceuticals, paper, sugar and furniture.

Growing peace: Successful military operations are going on across the country to improve security conditions, with visible positive outcomes. Number of terror attacks and fatalities have significantly reduced in 2015, compared to the previous few years.[18] Business community has shown satisfaction with the progress, as consumers' turn out and retail sales have reportedly surged in recent months. Hopefully this would help improve the country's image abroad as well, which was one of the major reasons why multinationals were reluctant to invest in Pakistan. Our exports had also suffered in the previous few years as buyers could not visit manufacturing facilities here.

Time to optimize

With changing dynamics of global economy, it has become imperative for Pakistan to assess where it stands, and set the direction for future. Long-term analysis of our trade policy divulges numerous weaknesses that had severely dented Pakistan's export potential (**Special Section 1**). Our huge dependence on imports and low FDI in the country, are also reflections of this weakness. However, we believe that Pakistan can still pull through despite global market adversities ahead.

The most essential ingredient for the future strategy is the formulation of an all-encompassing industrial policy. Due to significant overlapping in decision making for industry and trade, the government should consider assigning a single public-sector agency to take industry-level decisions, like METI in Japan; Economic Planning Board in Korea; Industrial Development Bureau in Taiwan;

[17] Source: Federal Budget 2015-16 Speech.

[18] Number of fatalities in terror attacks in Pakistan during Jan-Aug 2014 were 5,525, which has more than halved in Jan-Aug 2015 to 2,513 (Source: South Asia Terrorism Portal).

Ministry of Planning and Investment in Viet Nam; and National Development and Reform Commission in China. Planning Commission can possibly be strengthened to perform this task.

Broad objectives and strategies are well defined, but now it is high time to work on specifics. For instance, in Vision 2025, the government has promised to help the manufacturing sector access regional markets to boost economies of scale; support clusters; facilitate access to technology; upgrade labor's technical skills; ensure adequate incentives for research and development; and most importantly, encourage movement up the value chain. The next step is difficult; each one of these objectives, requires a detailed roadmap; institutional infrastructure; and consistent stream of funding. Some sector-specific measures are discussed in detail in **Special Section 1**.

In the meantime, import compression policy should be adopted. Since it will be counterproductive to curb import of essential raw materials and capital goods, the burden of this compression should fall on consumer imports. Presently, Pakistan spends nearly US$ 723 million on the import of mobile phones; over US$ 460 million on personal care items; and much more on other non-productive consumer items (**Section 7.5**). Most of this represents Pakistan's FX saving potential. It is important to recall here that local industries had started facing stiff competition from the influx of low-cost Chinese products, after the Pak-China Free Trade Agreement; many have reportedly been closed down.[19]

A positive development in this regard is the initiation of revision process for Pak-China Free Trade Agreement. A consensus seems to have built on both sides regarding the negative repercussions of this agreement on Pakistan's industry and overall balance of payments. Both sides have agreed to revise it. However, Pakistan does not need to get overly cautious in extending collaborations with other countries or regions; these should only be more measured, pragmatic and *in line with* the overall industrial policy. In fact, Pakistan should integrate further with other economies to lessen its isolation; in this context, membership of Asian Infrastructure Investment Bank (AIIB) and Shanghai Cooperation Organization, and growing proximity with the BRICS, are much welcome developments. The time is high for more strategic partnerships; this time it is the *international* media that is casting optimism over Pakistan's investment potential.[20]

In the final analysis, we want to re-emphasize that without bridging the saving-investment gap in the country, and implementing a well-integrated long-term industrial policy, it is impossible to turn trade balance in our favor, and pull in more FDI into the country. If objectives are set, roadmaps are clear, and adequate strategy is in place, Pakistan has the potential to skirt away its chronic BoP constraints and achieve high growth rates. The improving country's image has set the platform.

Table 7.1: Current Account
billion US$

	FY13	FY14	FY15
Current account balance	-2.5	-3.1	-2.6
Trade balance	-15.4	-16.6	-17.2
Exports	24.8	25.1	24.1
Imports	40.2	41.7	41.1
Services balance	-1.6	-2.7	-2.5
CSF	1.8	1.1	1.5
Primary income	-3.7	-4.0	-4.5
Repatriations on FDI	2.6	2.9	3.2
Interest payments	0.9	1.1	1.1
Secondary income	18.1	20.1	21.8
Worker Remittances	13.9	15.8	18.5

Source: State Bank of Pakistan

7.3 FY15 BoP Round-up

FY15 was a surplus year for Pakistan's balance of payments. The current account deficit of US$ 2.6 billion was easily financed via US$ 1.0

[19] Pakistan's Economic Survey for 2014-15 notes: "The imbalance of trade in favor of China is highly alarming. The FTAs signed with some of the countries appears to have been playing their role for this imbalance." It also noted that "some experts are of the view that Preferential Trade Agreements (PTAs) and Free Trade Agreements (FTAs) with trading partners which were drafted in haste are another cause of stagnant export growth."

[20] Forbes, Economists and Bloomberg have recently published positive assessments about Pakistan's economy, based on hard-earned political and economic stability in the country.

billion Sukuk issuance; US$ 754 million divestures; and US$ 1.3 billion increase in government's FX loans. The IMF support of US$ 2.0 billion also supported the build-up of FX reserves.

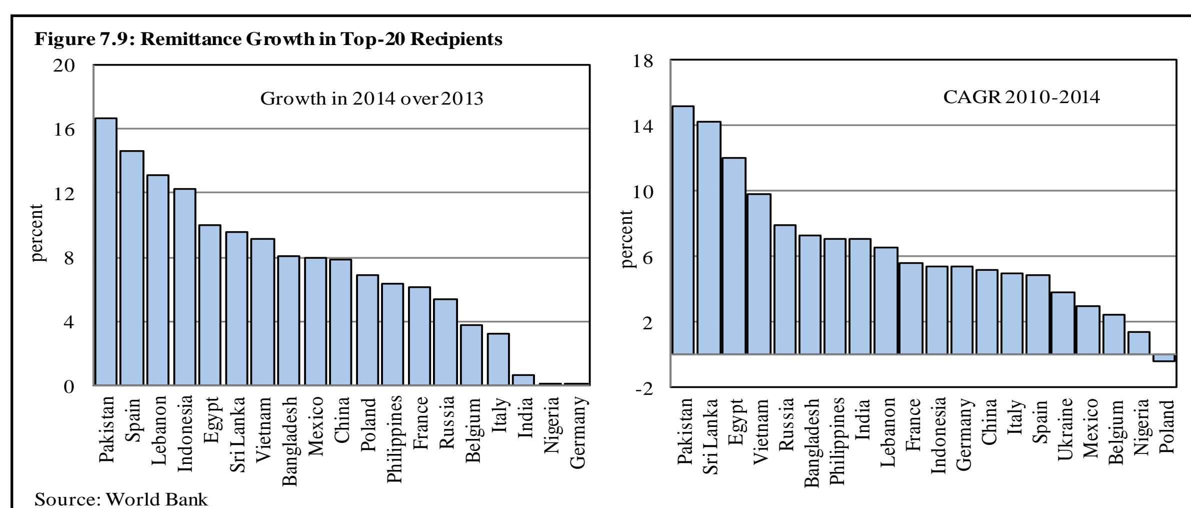
Current account

The current account deficit narrowed in FY15 compared to last year, primarily because a much higher worker remittances came into the country (**Table 7.1**). Apart from these remittances, interbank FX market remained under pressure, as trade deficit widened (despite less oil payments), and multinationals repatriated record profits overseas.

Worker Remittances

Worker remittances posted a strong growth of 16.5 percent during FY15, to reach a record-high level of US$ 18.5 billion. Making up for 45 percent of the country's import bill, and 95 percent of goods and services deficit, remittances have become an increasingly crucial source of FX earnings for Pakistan. Interestingly, the heavy influx of remittances in Pakistan is happening at a time when global remittance flows are losing steam. More specifically, in the post-crisis period of 2010-2014, global remittances have grown by 6.2 percent CAGR, which is only a third of growth seen in the pre-crisis period.[21] But in Pakistan, remittance growth has accelerated. In fact, in the last four years, remittance growth in Pakistan has been the strongest among top-20 recipients in the world; 2014 was no exception (**Figure 7.9**). Two factors explain this trend: a continuous increase in Pakistani diaspora, and *more* diversion of remittances from informal to formal channels.

Figure 7.9: Remittance Growth in Top-20 Recipients



Source: World Bank

GCC countries, which are the employment haven for Pakistani workers, have led the recent surge in remittance inflows. Nearly 88 percent of the total *increase* in remittances during FY15, was contributed by this region (**Table 7.2**). Higher inflows were expected despite a sharp fall in oil prices, as long-term infrastructure development plans – financed by large volumes of accumulated FX reserves – kept the economic activity in GCC intact.[22] Most of the GCC countries spent heavily in their non-oil sectors: activity in the UAE remained buoyant as preparations for Expo 2020 gathered pace: Dubai airport; industrial project in Abu Dhabi; Dubai Creek Harbor are some of the mega projects planned for the year 2015. Similarly, Saudi government initiated a number of road and rail projects across the Kingdom, and has also spent on developing megacities, airports and industrial estates.[23] Kuwait has been expanding its oil sector to enhance penetration of Kuwait's petroleum

[21] During 2003 to 2007, remittances had grown by 18.8 percent CAGR.

[22] Other oil exporting countries like Russia, Armenia and Georgia were heavily constrained, and depreciation of their currencies further reduced remittances from these countries (Source: World Bank).

[23] Current projects that are in focus include rail and road projects such as Riyadh Metro, Dammam Haramain rail, and Makkah railway; airport construction and upgrades; and mega cities such as King Abdullah Economic City.

products in the world market,[24] whereas Qatar has been spending on projects related to 2022 soccer world cup.

Remittances from other sources have slowed down, especially from the US and UK. As far as UK is concerned, the slowdown is entirely due to exchange rate effect: a sharp depreciation of Sterling, has lowered the US Dollar value of remittances from the Kingdom. Adjusting for this, remittances from the UK have actually gathered pace.[25] This improvement mainly reflects higher economic activity on the back of lower oil prices, rising house prices, and a relatively slow pace of public spending cuts. More importantly, UK employment has continued to rise strongly during 2014 and 2015, which may have contributed in stronger remittances.

Table 7.2: Region-wise Worker Remittances

	Values in million US$			YoY growth (percent)	
	FY13	FY14	FY15	FY14	FY15
USA	2,186	2,468	2,586	12.9	4.8
UK	1,946	2,180	2,287	12.0	4.9
Saudi Arabia	4,105	4,729	5,630	15.2	19.1
UAE	**2,750**	**3,110**	**4,207**	**13.1**	**35.3**
Dubai	1,214	1,550	2,403	27.7	55.0
Abu Dhabi	1,485	1,512	1,735	1.8	14.7
Sharjah	50	46	68	-8.5	48.5
Other	2	2	2	-2.6	0.0
Other GCC	**1,608**	**1,860**	**2,152**	**15.7**	**15.7**
Bahrain	283	319	389	12.7	22.0
Kuwait	619	681	748	10.1	9.8
Qatar	321	329	348	2.5	5.6
Oman	385	531	667	37.9	25.7
EU	**357**	**432**	**362**	**20.8**	**-16.3**
TOTAL	**13,922**	**15,838**	**18,454**	**13.8**	**16.5**

Source: State Bank of Pakistan

In case of the US, which is the third largest source country, the slowdown in remittance inflow is rather perplexing as labor market conditions in the US have visibly improved. Probably this slowdown should be seen in the context of narrowing interest rate differential, which is an outcome of normalizing monetary policy in the US, and an easy policy in Pakistan. More specifically, it is not hard to imagine that migrants are expecting a rise in interest rates and are probably holding back their savings – or at least that portion which they used to send to their families in Pakistan for investment purposes.[26] The stability in the PKR vis-à-vis US Dollar would have reinforced their decision.

As was the case in previous few years, domestic financial sector continued to promote the use of formal channels in remittance transfer. Besides banks, microfinance institutions (MFIs) are now also being tied up with global money transfer organizations. MFIs operations are more tailored, and therefore their inclusion would improve the remittance delivery mechanism. More recently, Pakistan Remittance Initiative (PRI) has initiated a drive to open bank accounts of departing worker, and his/her family members; it has also requested the Ministry of Overseas Pakistanis to make valid account numbers of outbound worker and his/her family member mandatory before leaving the country. These accounts are treated separately from conventional bank accounts, and there is close monitoring of inward and outward movement of funds.[27] Furthermore, PRI is carefully monitoring FX inflows into remittance-rich areas of Pakistan, and SBP is working closely with law enforcement agencies to curb illegal FX handling.

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[24] Kuwait National Petroleum Company has initiated work on a new refinery, which would supply low sulfur fuel to local power plants.

[25] In Sterling terms, remittances from the UK have increased by 8.7 percent in FY15, compared with 7.9 percent growth seen last year.

[26] This analysis reconciles with the available empirical findings. Kock and Sun (2011) had analyzed reasons behind phenomenal increase in remittance inflow into Pakistan during 1997-2008. In addition to Pakistan's economic conditions, exchange rates and skill set of migrating workers, the difference between investment returns in host country and Pakistan was a *highly* significant determinant (with expected signs) of remittance growth in Pakistan. For details, see Kock, Udo., and Sun, Yan. (2011). '*Remittances in Pakistan-Why have they gone up, and why aren't they coming down?*' IMF Working Paper No. WP/11/200.

[27] For instance, if fund inflows from a particular region are consistently low, this might be taken as an indication that an alternative arrangement is available there for sending money. The PRI would then be able to highlight this issue with the concerned authorities in those regions.

Services account

Services balance posted a marginal improvement in FY15, as Pakistan received steady inflows under the Coalition Support Fund (CSF). Essentially a compensation for supporting NATO activities in Afghanistan, the CSF inflows have lately become an important component of Pakistan's FX revenues. Aside from the CSF, Pakistan's deficit in the services account continued to widen (**Table 7.3**).

Table 7.3: Balance in Services Account

million US$

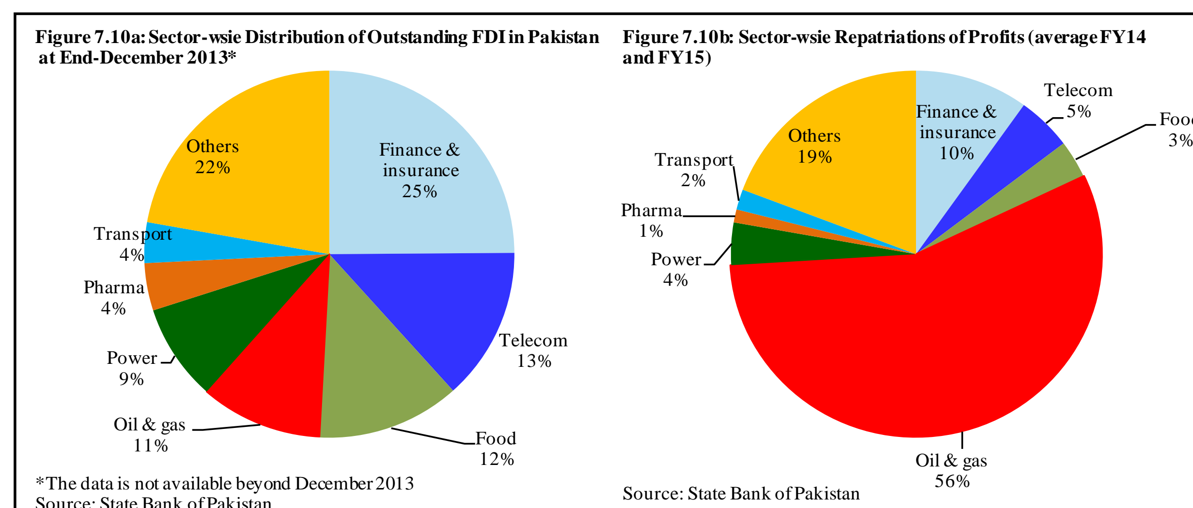
	FY14	FY15
Services balance	**-2,650**	**-2,517**
of which		
Transport	-2,559	-2,572
of which: Freight	-2,540	-2,610
Travel	-787	-1,059
Insurance and pension services	-135	-193
Financial services	-99	-152
Charges for using intellectual property	-144	-154
Telecommunications, and information	469	429
Other business services	-741	-570
Government goods and services	1,450	1,792
Coalition support fund	1,050	1,452

Source: State Bank of Pakistan

Freight deficit – the largest component in services balance, posted an increase during FY15. However, a part of this increase was offset by a reduction seen in air transport deficit.[28] As a result, overall transport deficit posted a marginal increase during the year. Furthermore, travel related deficit also increased as more and more Pakistanis are travelling abroad – only if foreigners were also visiting Pakistan in a similar manner, this deficit could have been much contained. Pakistan's tourism development authorities have much work to do in marketing Pakistan's landscape overseas, and provide tourist facilities in remote areas. Probably with better security conditions, this job will be easier.

Primary income

Record repatriations on existing FDI increased the primary income deficit during FY15. Telecom sector dominated the outflows, as earnings got a boost from data-based (internet) services. For the



last two years, multinationals had been increasing their stakes in Pakistan's telecom market envisaging a deeper internet penetration after the roll-out of 3G-4G services in the country.[29] This investment is now paying off. Data related revenues posted a startling growth of 69 percent YoY

[28] The reduction in air transport deficit attributes to strengthening fleet size of PIA, which has diverted more passengers towards the national carrier. In addition to this, a decline in airfares by foreign airlines (due to low oil prices), also reduced import of transport services.

[29] While most cellular firms started providing 3G services in FY14, FY15 marked another technological advancement in the country when 4G and LTE services were launched in September and December 2014, respectively.

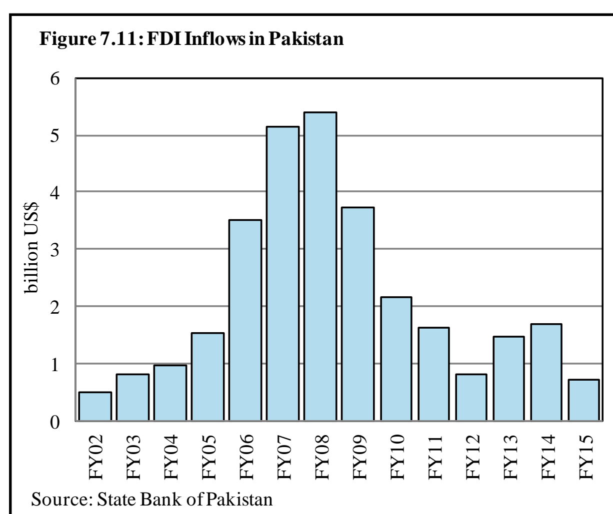
during Jul-Dec FY15.[30] This trend is likely to have continued in the remaining period of FY15, as approximately one million 3G/4G/LTE subscriptions are being added *every month* since the commercial launch of these services in the country.[31]

As it appears, telecom firms are not reinvesting much, and are repatriating most of their earnings. It is important to recall here that telecom has the second-largest share in outstanding FDI in Pakistan, after financial sector. However, its contribution in profit repatriations has generally remained much less than other sectors, as stiff competition never allowed firms to substantially raise their profit margins (**Figure 7.10**). Interestingly, it is the oil and gas sector that dominates profit repatriations from Pakistan. However, due to price slump, repatriations from this sector in FY15 remained more or less unchanged than last year.

Financial Account

Similar to last year, most of the activity in the Financial Account was driven by the public sector: the government was able to mobilize external funding via Sukuk issuance; divestures; and IFI loans (**Chapter 6**). Private transactions were minimal, as FDI inflows declined sharply (**Figure 7.11**).

Figure 7.11: FDI Inflows in Pakistan



Source: State Bank of Pakistan

As shown in **Table 7.4**, the decline in FDI was most pronounced in cement, oil & gas, telecom, metal and pharmaceutical sectors. In fact, divestments have been recorded in cement, metal and pharmaceuticals. Some of these divestments highlight policy-related constraints in Pakistan's manufacturing sector. For instance, divestment from the metal sector represents the issue of sovereign guarantee. More specifically, Tuwairqi Steel has shut down its production activity in Pakistan, mainly because of dispute with the government over gas pricing (**Chapter 2**).[32]

Pharmaceutical industry is another example of policy setback. A number of multi-nationals are pulling out of Pakistan as prices are heavily regulated; imports and smuggling of medicines is rampant; and delays exist in registration and licensing of drugs.[33] In FY15, AGP and Johnson and Johnson wound up their production facilities from the country, and their marketing/distributions businesses were acquired by local firms.[34]

Contrary to the above, the divestment in cement sector was the part of global sell down of assets by France-based Lafarge, to get clearance for its merger with Swiss building-material giant, Holcim. Together, these two firms have disposed off their assets in many countries including Brazil, Germany, Hungary, Serbia, Philippines, Romania and Austria. In Pakistan also, Lafarge sold out 87.9 percent share for an enterprise value of US$ 329 million. With a capacity of 2.5 MT per annum, this plant was taken over by the Bestway group.

[30] So far, the data up till December is available.
[31] Source: Economic Survey 2014-15
[32] According to company sources, the plant is closed since November 2013, and has now started laying-off its employees.
[33] According to industry sources, the number of MNCs in pharma industry has declined from 36 to 24 in last 10 years.
[34] Source: Competition Commission of Pakistan

Table 7.4: Sector-wise Inflow of Foreign Direct Investment in Pakistan
US$ million

	FY13			FY14			FY15		
	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI
Oil & gas exploration	565.6	5.8	559.8	511.5	9.5	502.0	250.2	2.1	248.1
Power	162.6	135.8	26.8	247.0	175.5	71.4	191.7	64.7	127.0
Telecommunication	160.8	564.9	-404.1	904.6	474.7	429.9	907.6	786.9	120.8
Financial business	388.9	74.8	314	291.4	98.6	192.8	231.1	118.7	112.4
Automobiles	27.0	2.0	25.1	55.2	2.1	53.1	56.1	0.0	56.1
Construction	51.2	3.6	47.7	37.0	8.2	28.8	37.4	2.4	35.0
Manufacturing	1,020.9	284.4	736.5	633.6	246.7	386.9	471.2	498.9	-27.7
Basic metal (steel)	1.3	-	1.3	5.2	-	5.2	4.7	59.8	- 55.2
Pharmaceuticals	20.3	6.3	14.0	17.4	1.7	15.7	9.8	58.6	- 48.8
Cement	8.4	0.3	8.1	45.1	8.5	36.6	44.3	229.5	- 185.2
Total	2,665.3	1,208.9	1,456.5	2,847.4	1,148.8	1,698.6	2,279.2	1,570.0	709.3

Source: State Bank of Pakistan

Similarly, lower FDI in the oil & gas exploration also seems to be a global phenomenon. With record decline in crude prices, most investment plans in this sector have been put on hold as high capital costs have made oil drillings unfeasible. Major oil companies are undertaking cost cutting measures to maintain profitability, by shelving new projects and reducing workforce.[35] It is hard to imagine that oil and gas companies would expand their offshore activities anytime soon, unless prices recover.

In the case of telecom sector, the decline in FDI was expected, as multinationals had borrowed from their parent companies last year to pay for the 3G/4G spectrum licenses. No such auction was expected in FY15.[36] However, the Pakistan Telecommunication Authority is in the process of hiring international consultants for the marketing of unsold spectrums, worth at least US$ 500 million.[37] If this process completes on time, more FDI in this sector may come next year.

The above discussion shows that both global and domestic environment have been unfavorable for foreign investments in FY15. However, the image of Pakistan is gradually improving abroad, with stable external sector outlook and better security conditions. In case global commodity market recovers, Pakistan should be able to attract FDI. The important task at hand is to increase the co-ordination between regulatory bodies and the corporate sector so that concerns and grievances are discussed and settled on time. Furthermore, investment policies and offers for multi-nationals, should be aligned with the country's overall growth objectives, and resource availability.

7.4 Exchange Rate and Reserves

Pakistan's FX market observed episodes of volatility during FY15; however, in overall terms, it remained relatively stable compared to last year.[38] The PKR, after posting a depreciation of 4.0 percent vis-à-vis US Dollar during the first four months, remained stable through rest of the year.[39] This stability stemmed from a comfortable balance of payment position: the country's FX reserves increased by US$ 4.6 billion, to reach an all time high of US$ 18.7 billion by the end-June 2015.

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[35] Source: (i) http://www.bloomberg.com/news/articles/2015-07-28/oil-industry-starts-new-round-of-cost-cutting-as-prices-languish (ii) http://www.reuters.com/article/2015/01/21/us-baker-hughe-results-idUSKBN0KT13720150121
(iii) http://www.ft.com/intl/cms/s/0/d6877d5e-31ee-11e5-91ac-a5e17d9b4cff.html

[36] The auction for 3G/4G spectrum license was held in April 2014. As per the government's directives, no auction could be carried out for another 18 months from the day of auction (i.e., before October 2015).

[37] The unsold spectrum includes (i) 10 Mhz in 1800 Mhz band with base price US$ 210, and (ii) 7.38 Mhz in 850 Mhz band with base price US$ 291 (Source: Economic Survey 2014-15).

[38] The coefficient of variation (standard deviation adjusted by mean) declined from 3.5 percent in FY14, to only 1.1 percent in FY15.

[39] Between November and June 2015, the PKR posted an appreciation of 1.1 percent.

From adequacy perspective, the volume of reserves looks sufficient as this can comfortably finance more than five months of the country's import of goods and services.[40] Looking at short-term drains, reserves position is much stronger than last year (**Table 7.5**).

Table 7.5 : Reserves Adequacy Indicators at End-June

US$ million

	FY11	FY12	FY13	FY14	FY15
SBP Reserves	14,784	10,804	6,008	9,098	13,532
Total Reserves	18,244	15,289	11,019	14,141	18,706
percent, mentioned otherwise					
ST Drains/ SBP Reserves	25.9	42.1	155.0	78.4	53.4
ST Drains/ T Reserves	21.0	29.7	84.5	50.4	38.7
SBP reserves as months of Import	5.0	3.2	1.8	2.6	3.9
Total reserves as months of Import	6.1	4.5	3.3	4.1	5.5
SBP reserves as months of Import G&S	4.1	2.7	1.5	2.2	3.3
Total reserves as months of Import G&S	5.0	3.8	2.7	3.4	4.5
CAD/ SBP Reserves	-1.4*	43.1	41.5	34.4	16.4
CAD/ T Reserves	-1.2*	30.5	22.7	22.1	11.9
CAD + ST Debt/ SBP Reserves	2.9	46.6	41.7	42.1	20.2
CAD + ST Debt/ T Reserves	2.3	33.0	22.7	27.1	14.6
Debt Servicing / SBP Reserves	26.7	41.7	107.9	76.9	40.0
Debt Servicing / T Reserves	21.6	29.5	58.9	49.5	29.0

*The current account was in surplus during FY11

Source: State Bank of Pakistan

If we closely analyze the trend in the PKR parity, we can trace three distinct phases of developments (**Figure 7.12**):

Phase I (Jul-Oct): debt repayments and delay in the IMF's 4th review

FX market remained under pressure during this period. SBP's FX reserves dropped by US$ 479 million, and the PKR posted 4.0 percent depreciation. The pressure came primarily from bulky debt repayment (mainly to the IMF); a sharp rise in the current account deficit; and delays in the 4th review of the IMF program that caused uncertainty in the FX market.[41] July and August 2014 were particularly stressful, but the situation started to improve September onwards, when the news about the combined 4th & 5th review in December was out. CSF inflow of US$ 364 million in September 2014, also helped bring stability in the FX market.[42]

Phase II (Nov-Dec): PKR recovers amid financial inflows

While the FX market had already stabilized with the forthcoming IMF review, the collapse of international oil prices further boosted market confidence on the PKR. The current account deficit eased in November 2014, as commodity prices softened, and worker remittances gathered pace.[43] However, the game changer during this period was the conclusion of the 4th and 5th review of the IMF that was followed by disbursement of US$ 1.1 billion in December. Equally important was the government's successful issuance of Sukuks that fetched US$ 1.0 billion from the international market. These developments had a major impact on market sentiments that helped the PKR appreciate by 2.4 percent during this period.

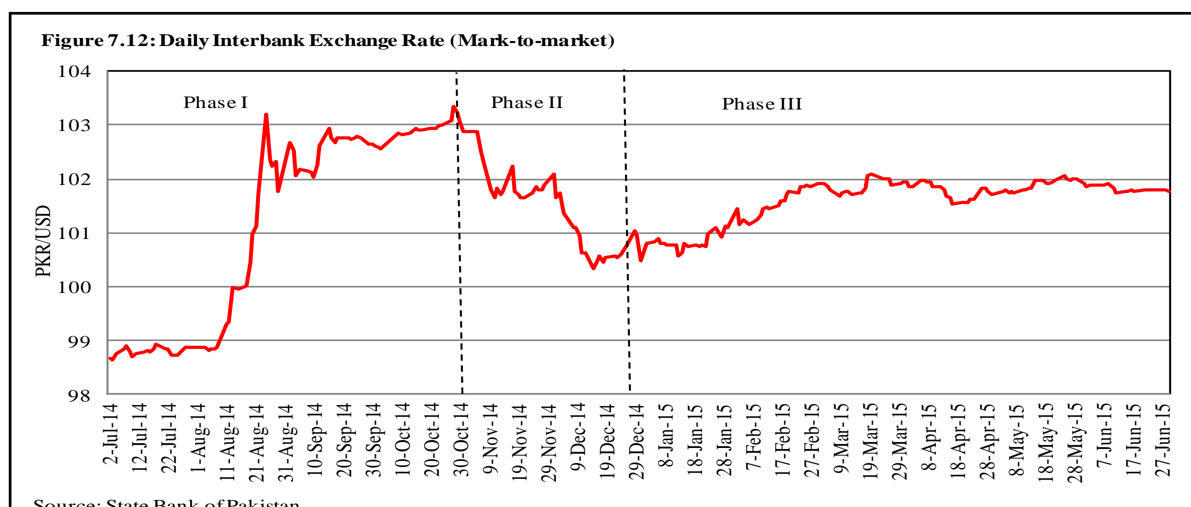
[40] Even if we look at SBP reserves alone, these are sufficient to finance more than 3 months (the benchmark) of import of goods and services.

[41] Political instability in the country, and a continuous appreciation of US Dollar vis-à-vis Euro and Yen during this period, also caused uncertainty in the FX market. The country did receive 3rd tranche of US$ 550 million of the EFF program during July 2014.

[42] There was CSF inflow of US$ 371 million in the month of August, but its impact was diluted by debt repayment pressures.

[43] The CAD during November 2014 was US$ 574 million, compared to US$ 698 million in November 2013.

Figure 7.12: Daily Interbank Exchange Rate (Mark-to-market)



Source: State Bank of Pakistan

<u>Phase III (Jan-Jun): Current account surpluses</u>

External sector conditions during the second half of the year were quite comforting. A sharp decline in oil prices from October 2014, began to reflect in Pakistan's import bill from January 2015 onwards.[44] Trade deficit narrowed by 9.2 percent YoY during H2-FY15, and was comfortably financed via heavy influx of worker remittances. As a result, the current account posted surpluses in Febraury, March and April 2015.[45] However, the PKR depreciated between January to March 2015 (**Figure 7.12**). SBP's reserves gained further strength by inflows of HBL divesture; 6th tranche of the EFF; and inflows from the World Bank.

In overall terms, external conditions are much favorable, and no major stress is in sight in the short-term. The implicit PKR stability is much welcome. However, this stability vis-à-vis US Dollar, has come at the cost of significant appreciation against currencies of other important trading partners like the EU and Japan. More specifically, Pakistan's nominal effective exchange rate (NEER) has appreciated by 6.7 percent during FY15 and the real effective exchange rate (REER) has posted an appreciation of 8.8 percent during the year. Putting this in perspective, this appreciation almost equals the benefit Pakistani products had received in the EU via GSP plus.[46]

The REER appreciation is due to an unusually strong US Dollar against major currencies of the world. As mentioned before, the all-around strength in the US Dollar has stemmed primarily from divergence of monetary policies in the US and other advanced economies: while ECB and BOJ announced more monetary easing in 2014, Fed began to unwind its asset purchase program. Anticipation of an increase in federal fund rate has caused massive capital inflows into the US that appreciated the US Dollar (**Figure 7.13**).

Table 7.6: JP Morgan Trade-Weighted Exchange Rate (deflated by CPI) ***YoY Growth Rate***

percent	FY15	
	Jul-Mar	**Apr-Jun**
Thailand	7.7	-3.6
Vietnam	8.0	-1.9
Pakistan	6.2	0.5
India	8.5	-1.9
China	14.4	-1.4
Indonesia	5.1	-1.3
Philippines	8.3	-1.5

Source: Haver Analytics

However, currencies of our export competitors were also not immune to US Dollar appreciation. As shown by JP Morgan index (**Table 7.6**), appreciation in Pakistan's REER was smaller in

[44] Since oil contracts are made 3-month advance before the shipment.

[45] On aggregate, the current account posted a surplus of US$ 137 million during Jan-Jun FY15, compared to US$ 1.1 billion deficit in the same period last year.

[46] Before the GSP plus status, Pakistani products could enter the EU at 9 percent tariff rate; after the GSP plus status, Pakistan can export to the EU at zero tariff. This benefit of 9 percent was almost entirely offset by 8.8 percent real appreciation of the PKR.

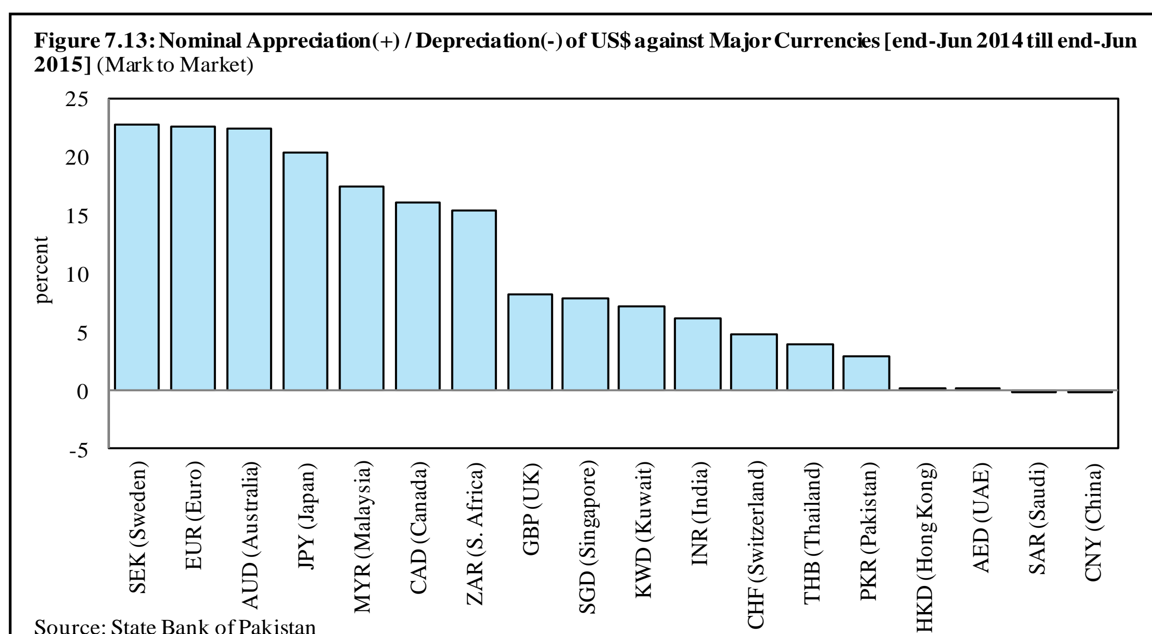


Figure 7.13: Nominal Appreciation(+) / Depreciation(-) of US$ against Major Currencies [end-Jun 2014 till end-Jun 2015] (Mark to Market)

Source: State Bank of Pakistan

comparison to China, India, Philippines, Thailand and Vietnam, up till end-March 2015. However, in the fourth quarter of FY15, currencies of most emerging economies depreciated, but the PKR continued to appreciate in real terms.

Here it is important to mention that emerging economies are deliberatly keeping their currencies low, to maintain competitiveness in the world market. In particular, East Asian economies depend heavily on their export sectors, and currency depreciation is the quickest and easiest way to lift their growth. For instance, Central Bank of Vietnam devalued Dong in January and May 2015;[47] Thailand suppressed Baht via relaxation of capital controls;[48] and the Reserve Bank of India purchased huge volume of FX from the interbank, to depreciate the Rupee (INR).[49]

7.60 These pressures in the global currency market are likely to persist in FY16 as well. On the one hand, import demand from Euro Area – the largest export market in the world – remains weak, and on the other, low commodity prices continue to suppress unit values. Emerging economies are finding it hard to lift their exports, which has been the engine of their overall economic growth. China has responded to this by lowering the Yuan Reference Rate by around 3.0 percent against the US Dollar, which jolted global currencies and stocks.[50] The three-day long currency slide in the world's second largest economy, have stoked fears of global economic slowdown. Not only this devaluation signifies serious concerns about the state of Chinese economy (and commodity outlook), it has also prompted a fresh wave of (imported) deflation in some economies.[51]

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[47] In January and May 2015, Vietnam devalued its currency by 1 percent each against the US Dollar,

[48] In April 2015, Bank of Thailand announced measures to encourage capital outflows. For instance, it increased the limit on purchase of foreign currencies (for deposit) by Thais from US$ 500,000 to US$ 5 million. Similarly, it also raised the limit for purchase of foreign property from US$ 10 million per year, to US$ 50 million per year. Source: Bank of Thailand Website (https://www.bot.or.th/Thai/PressandSpeeches/Press/News2558/n2358e.pdf).

[49] Source: http://in.reuters.com/article/2015/06/04/india-markets-rupee-rbi-idINKBN0OK13W20150604; and http://www.bloomberg.com/news/articles/2015-04-12/rajan-rupee-intervention-seen-as-wal-mart-supplier-laments-gains

[50] This decision came after the release of China's trade statistics for the month of July, which showed 8.3 percent YoY decline in its exports.

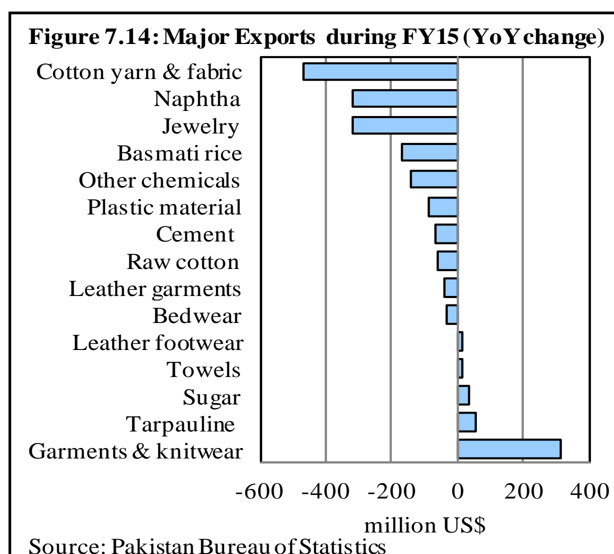
[51] Devaluation in Yuan made Chinese goods cheaper in the US, EU and other export markets.

7.5 Trade (Customs Records)

Pakistan trade deficit posted an increase of 11.1 percent during FY15, compared to a decline of 2.6 percent last year. This was contributed by both, a decline in exports as well as a rise in imports during the year.

Exports

Pakistan's exports recorded a decline of 5.7 percent during FY15, compared to an increase of 2.7 percent in FY14. Three products contributed the most to this decline, i.e., naphtha, jewelry and cotton fabrics. Export of many other items also remained lower than last year (**Figure 7.14**). As mentioned before, quantums fell short of last year's levels for most products, and the impact of commodity prices was minimal (if any).



Less fabric exports, more value-addition

Pakistan's export of cotton yarn and fabric posted a sharp decline in FY15. While yarn exports suffered from low unit values, the decline in fabric exports is attributed mainly to weakening Chinese demand.[52] Export of cotton fabrics has tapered the most, which constitutes over 30 percent of our exports to China. The important thing to note here is that Pakistan did not lose its share in the Chinese market; it is still competitive (**Figure 7.15**). Another aspect of this decline is the increase in Pakistan's export of value-added products like clothing. This means that some of the fabric that could not be exported to China, was processed locally; this helped increase the export of value-added products during the year. The demand from China is not expected to recover soon, therefore, textile exports can be increased only if Pakistan is able to process and market value-added products in the US and EU markets directly.

Naphtha and Jewelry export to remain low key

Despite higher production, Pakistan's export of naphtha declined sharply in FY15. This decline is attributed primarily to a slump in global oil market, which did not induce local refineries to sell the product in the international market. Furthermore, one of the newly installed isomerization units – that convert naphtha into petrol – began commercial operations in FY15; this also left little exportable surplus. Going forward also, we do not see a recovery in naphtha exports; some more isomerization units would commence operations in 2015 and 2016. What we expect is some reduction in petrol

[52] China's appetite for imported cotton products is plummeting as local prices have started to soften that has induced more spinning and weaving activity in the country. More specifically, China had been stockpiling cotton during 2011-13, which had put significant upward pressure on domestic prices. In effect, China's textile industry was paying premium over the world's prices and therefore lost much of its competitiveness. Therefore, instead of using local cotton, millers started importing cotton yarn and fabric from other countries to produce high-end products. With the end of this program, cotton prices in China are gradually coming down to world's average. Pakistan, India and Japan were earlier supplying yarn and fabric requirements of Chinese mills, but now they are losing orders.

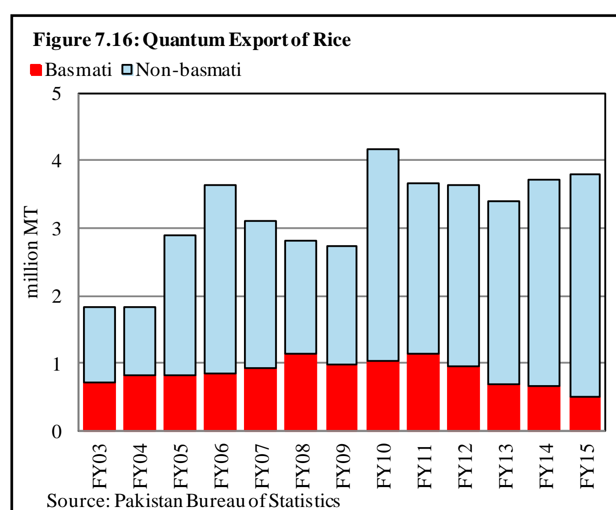
imports, as more petrol will be produced locally using naphtha. This suggests that the decline in naphtha export would have minimal impact on the overall trade deficit. Meanwhile, export of crude oil resumed after 10 years, as the government allowed oil producers to ship excess quantities. Pakistan exported nearly 474 thousand tons (equivalent to US$ 278 million) of ultra-light crude oil – also known as condensate, mainly to Singapore.

Similarly, the decline in jewelry exports also did not impact the overall trade gap significantly, as most of the value of jewelry export is comprised of imported gold. Specifically, the government allows import of gold only if it is to be converted into jewelry, and exported within 180 days. Minimum value addition (labor) required is around 13 percent, but wastage of 10 percent in the value of imported gold is also permissible.[53] Naturally, this leaves net little gain (FX) from exporting. Ministry of Commerce has placed a cap on monthly quantum imports, along with restrictions on volume per single transaction.[54] These restrictions are in place because payments for gold imports are made via exchange companies, there is always FX pressure in the kerb market whenever gold imports increase.[55]

Basmati woes continue

After showing some stability last year, basmati exports continued their downtrend, and recorded a fall of 21 percent during FY15. Pakistan's basmati is shipped mainly to the GCC countries especially UAE, Oman and Yemen; however, Indian varieties have penetrated deeply into these markets on the back of strong marketing and distribution network. It appears that Pakistani exporters have succumbed to competition from India, as quantum exports have nearly halved in the past five years (**Figure 7.16**). Farmers are also preferring other varieties over basmati, as it is a low-yield variety; more water intense; and costlier to produce. The only factor that had earlier pulled farmers into basmati, was the international demand and higher unit values compared to other varieties; now with tapering exports, it has become less lucrative to grow this variety.

Figure 7.16: Quantum Export of Rice



Source: Pakistan Bureau of Statistics

Therefore, the bulk of Pakistan's rice exports is now made up of non-basmati varieties; and their performance is consistently improving.[56] In FY15 also, export of non-basmati rice posted a quantum increase of 8 percent. The demand for broken rice remained particularly strong, especially from Afghanistan, Indonesia, Senegal and Mozambique. However, due to low unit prices, values could not recover much.

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[53] For embedded or studded jewelry, wastage of 10 percent is allowed, and value-addition of 13 percent is required. For plain jewelry, wastage of 2 percent along with value-addition of 12 percent is required. Source: SRO 760(1)/2013 of 2nd September 2013, Ministry of Commerce and Textiles Industry, Government of Pakistan.

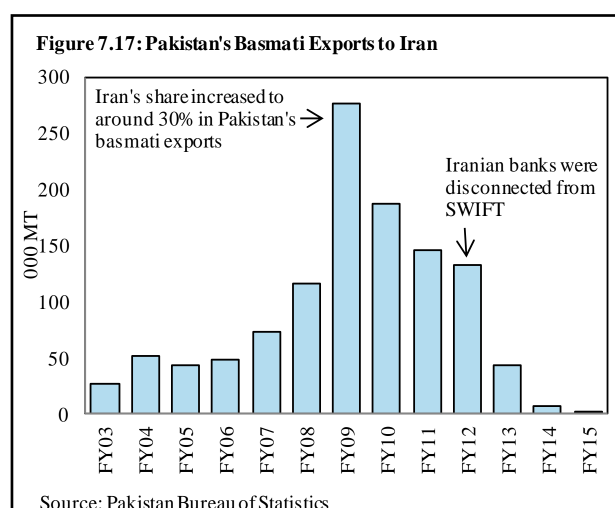
[54] Source SRO 328(I)/2014, Ministry of Commerce, Government of Pakistan.

[55] To reduce FX burden in the kerb market, the government had been imposing periodical bans on gold import throughout 2013 and 2014. For details, see SBP Third Quarterly Report for 2013-14.

[56] Since these varieties are cheaper than basmati, these are popular in low-income African countries, like Kenya, Madagascar, Mozambique and Tanzania.

Recently, two developments have improved rice export outlook for Pakistan. First is the Iran nuclear deal: it is likely that the UN will lift sanctions. Iran is the largest importer of basmati rice in the world, and presently, India supplies nearly half of its imports. Indian domination in this market is more political in nature: India never really backed sanctions against Iran and, all through the sanction period, the two countries expanded bilateral trade via structured financial transactions.[57] However, if sanctions are lifted, Iranian market would be open to many other countries, including Pakistan. Indian businesses are foreseeing tough times. Here it is important to recall that back in FY09, Pakistan was the major rice supplier in the Iranian market before sanctions put the trade between two countries to a near hold (**Figure 7.17**).

Figure 7.17: Pakistan's Basmati Exports to Iran



Source: Pakistan Bureau of Statistics

Secondly, severe drought is likely to hurt 2015 rice production in Thailand, which is the largest exporter of non-basmati varieties. Thai government has reduced rice production estimates by around 9 percent compared to the previous season, as it requested farmers to delay plantations. Thailand is already grappling with quality issues with rice the government had stockpiled in the previous few years, under the costly pledging scheme. Other producers like India, Vietnam and Pakistan are likely to benefit.

GSP+ helped despite Weak Euro

The GSP plus status in the EU continued to support Pakistan's exports. EU increased its purchases from Pakistan, and at a faster pace than last year (**Table 7.6**). Therefore, Pakistan's share in the EU import market strengthened further. While readymade garments (both woven and knitwear) were major beneficiaries, export of home textile items and leather footwear also displayed better performances than last year.

Table 7.7: EU Imports from Major Countries (Jul-Jun)

	Values (US$ billion)			*Growth rate%*		Quantities (million tons)			*Growth rate%*	
	FY13	FY14	FY15	FY14	FY15	FY13	FY14	FY15	FY14	FY15
Bangladesh	13.4	15.8	16.7	18.0	5.7	10.2	11.7	12.2	15.1	4.0
China	367.8	388.6	395.1	5.6	1.7	493.8	565.8	612.3	14.6	8.2
Indonesia	19.3	19.3	18.1	-0.2	-6.1	183.2	168.4	176.3	-8.1	4.7
India	49.3	49.3	46.9	0.0	-4.8	183.5	162.7	157.3	-11.3	-3.3
Pakistan	5.6	6.7	7.0	19.2	4.8	14.0	13.6	15.3	-3.0	12.4
Turkey	64.0	71.3	69.1	11.3	-3.1	235.9	245.5	257.0	4.1	4.7
Total	2,257.3	2,278.2	2,061.9	0.9	-9.5	16,241.3	16,378.1	16,486.0	0.8	0.7

Source: Eurostat

As shown in **Table 7.7**, EU's overall imports have declined in FY15, as weaker Euro has made local goods more competitive than imports. It appears that exporters in China and Pakistan have compromised on their margins to maintain market shares: their dollar exports have grown modestly, but quantums have jumped quite sharply. India and Turkey are finding it hard to compete. As discussed in **Section 7.5**, many emerging economies are managing currencies to stay competitive in the EU market.

[57] India was also one of those few countries that were given exemption by the US in exchange of reducing purchases of Iranian oil.

Lately, Pakistan is also finding it hard to maintain export levels in this market: after increasing in the first two quarters of the year, EU's quantum imports from Pakistan flattened in the third quarter, and posted a YoY decline in the fourth quarter (**Figure 7.18**).

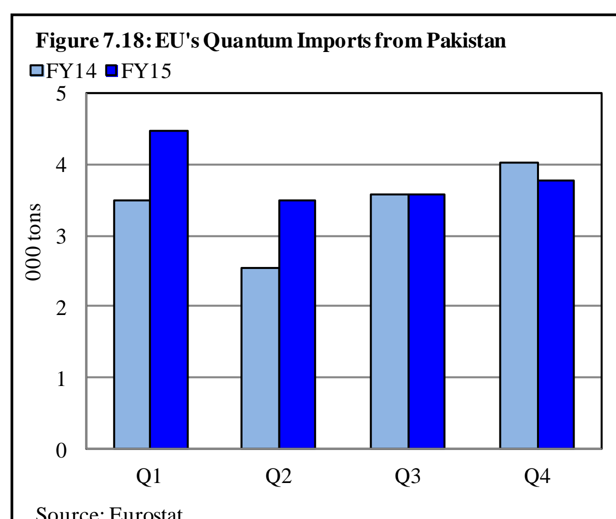


Figure 7.18: EU's Quantum Imports from Pakistan

Source: Eurostat

Imports

Imports grew by 1.7 percent during FY15, on the back of a vibrant non-oil sector. Posting a 4-year high of 13 percent, the growth in non-oil imports more than offset the decline seen in oil imports during the year (**Table 7.8**). Higher fiscal spending and dull commodity prices in FY15, primarily explains this vibrancy. More specifically, the government increased its investment in construction and electricity distribution that generated demand for related capital and intermediate goods like steel, and power generating machinery. Meanwhile, private sector was also bullish on construction that further cemented imports of allied products.

Imports in the first quarter were particularly burdensome. During this period, food imports grew strongly as domestic supplies of major fruits and vegetables were hit by floods. Onions, tomatoes, garlic, grapes, and apples were imported in large quantities, especially from India, that helped in stabilizing their prices in the domestic market. Meanwhile, import of rapeseed and wheat also strengthened as prices subsided. Interestingly, import of steel and other commodities was also extraordinarily high during this period; global prices were trending down and importers rushed to book orders in an anticipation of price reversals. These pressures died out from second quarter onwards, when domestic supplies of agricultural commodities returned to normal, and it was clear that low international prices were here to stay. Import growth of non-oil items during the second half of the year was, therefore, much modest (**Table 7.8**).

Table 7.8: Import Values (million US$)

	H1		H2		Full-year	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Overall	21,671	24,145	23,402	21,707	45,073	45,852
POL	7,537	6,947	7,324	4,748	14,861	11,695
Non POL	14,134	17,198	16,078	16,959	30,212	34,157
Steel	922	1,383	1,263	1,482	2,184	2,865
Machinery	2,927	3,644	3,531	3,774	6,458	7,418
Food	2,047	2,810	2,196	2,218	4,244	5,028
Automobiles	1,131	1,291	1,083	1,409	2,214	2,700
YoY growth (in percent)						
	H1		**H2**		**Full-year**	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Overall	-1.1	11.4	1.6	-7.2	0.3	1.7
POL	-2.2	-7.8	0.8	-35.2	-0.8	-21.3
Non POL	-0.6	21.7	2.0	5.5	0.8	13.1
Steel	-11.3	50.0	2.9	17.4	-3.6	31.1
Machinery	0.0	24.5	27.1	6.9	13.1	14.9
Food	-5.3	37.3	8.5	1.0	1.3	18.5
Automobiles	0.2	14.1	-14.4	30.1	-7.5	21.9

Source: Pakistan Bureau of Statistics

Buoyant construction activity

Higher PSDP spending through most of the year, triggered construction activity in the country during FY15.[58] As a result, import of a number of items increased during the year like steel, steel scrap, metal rolling and molding machinery, loading structures (elevators and escalators), construction machinery, and chemicals used in steel and other industries, etc.

The pick-up in steel imports was the strongest, which posted a growth of 31.1 percent. In addition to PSDP spending, pressure on imports also came from the revival of manufacturing activity in Pakistan

[58] Construction activity has increased by 7.05 percent during FY15. According to APCMA data, local cement dispatches increased by 7.9 percent in FY15.

Steel, which was bailed out by the government in the initial months of the year. Most of the demand was seen for hot rolled coils, line pipes, zinc coated plates and some semi finished products; these items are used for making vessels, storage tanks, containers and pipes for gas and water transmission, and for manufacturing of cold rolled product used in construction activity. Some import was also meant for supplies for commercial vehicles, especially trucks.

As mentioned before, higher imports were realized during the first half of FY15, when global prices began to fall. During this period, the biggest exporter – China, had flooded the global market with cheaper steel, as it grappled with overcapacities and shrinking demand at home.[59] Input costs also played an important role: price of iron ore – the principal raw material – slipped away as Australia geared up capacities.[60] Meanwhile, Russia – the fifth largest exporter of iron and steel in the world – added to the steel glut as weaker Ruble pushed down dollar price of its products. Understandably, the slump in global steel prices called for protectionism in many importing countries. For instance, India imposed anti-dumping duty on Chinese steel of various grades in January; the EU imposed tariffs of up to 25.2 percent for sheet, coil and strip imports from China in March; and Indonesia increased import duties from 5 to 40 percent in May 2015. Iran, Egypt and Mexico also turned to protect local steel industry. Pakistan did not stay behind.

As per the domestic industry view, imported raw material basically replaced low quality scrap, which is collected from ship-breaking activity. Imported steel has also priced out items produced by local steel melters. In January 2015, the government imposed regulatory duty of upto 15 percent on certain steel products to protect local industry. However, as is always the case, this decision spurred a debate among domestic stakeholders. On the one hand, domestic steel melters hailed the decision, and on the other, domestic steel re-rollers complained that the duty was also imposed on certain products (like billets), in which Pakistan is not self-sufficient.

Machinery

Machinery imports increased sharply during FY15, as public investments regained momentum in energy sector.[61] The influx of power generating machinery was the strongest, which explained nearly 30 percent of the total *increase* in machinery imports during the year. The import of power transmission machinery, metal rolling, air intake filters and compressors also remained stronger than last year. However, little investment seem to have come into textile and telecom sectors, as import of machinery used in these sectors has declined over last year.

Edible oil conundrum

Palm oil imports declined for the third straight year to reach US$ 1.8 billion in FY15.[62] Quantum import of palm oil is increasing consistently, but lower prices have reduced import values. As is the case with other commodities, falling demand from China (the second largest buyer after India) has kept downward pressure on global prices.[63]

Nonetheless, a sharp rise in the import of oil seeds more than offset the decline in import value of edible oil. Despite lower unit values, the three-fold increase in quantum imports of oilseeds chipped in an additional US$ 400 million to the import bill during the year. Most of the increase was seen in

[59] China produces more than half of the world's steel supply.
[60] Australia is the world's largest producer and exporter of iron ore. In 2014, Australia supplied half of the world's demand for iron ore.
[61] Public investment in electricity generation and distribution increased by 23.0 percent, in real terms, during the year. Last year, it posted a massive decline of 27.0 percent.
[62] Palm oil import touched the peak of US$ 2.3 billion in FY12 due to high prices. Since then, its import is declining.
[63] China's palm oil imports declined by 32.7 percent during Jul-Mar FY15 over last year (Source ITC). In addition to China factor, palm oil prices also faced downward pressures due to reduced consumption in production of biodiesels.

rapeseeds carrying low erucic acid (Canadian variety), which is considered healthier than other varieties.

As noted in **Chapter 2**, the production of refined oil and ghee has remained lower than last year. This suggests that Pakistan's edible oil industry has taken benefit of low prices, to build up inventory of crude palm oil and rapeseeds. Therefore we can expect lower imports of these products in FY16.

Transport gets fiscal push

Transport sector also benefited from fiscal spending: (i) the Punjab government distributed 19,893 cars (Suzuki Bolan and pick-ups) during the year, under the Apna Rozgar scheme;[64] (ii) PSDP allocations for Pakistan Railway were increased, to procure high capacity bogie wagons, diesel electric locomotives, and other coaches during the year;[65] (iii) the government released US$ 14.6 million to PIA to purchase aircrafts on dry lease;[66] and (iv) duties on 1800 cc plus cars were relaxed in the Federal Budget for FY15.

As a result, imports of automobiles posted a growth of 21.7 percent over last year. Most of the increase was seen in the import of CKD/SKD, as local assembling for passenger cars gathered pace. In addition to fiscal spending, a strong public liking for the new-generation Corolla was another factor causing a rise in CKD imports in the country. Influx of used cars also remained strong.

Similar to automobiles, the import of aircrafts, railway parts, also increased during FY15. The only category, which posted a decline within transport sector, was ships and other floating structures. The decline in imports under this category mainly reflects cheaper steel scrap available in the global market that hit the ship-breaking activity in the country.

Petroleum

The value of Pakistan's petroleum imports declined by US$ 3.2 billion in FY15; this is the highest ever decline in the country's import bill, all thanks to a slump in the global oil market. Intriguingly, despite lower prices, overall oil consumption in Pakistan increased by only 6.3 percent during the year, compared to 9.1 percent growth in FY14. This basically reflects lower furnace oil consumption for thermal generation during the year; excluding furnace oil, the *growth* in petroleum sales has actually doubled than last year.[67] Transport fuel was the most attractive product, as government had sharply reduced prices of petrol and high-speed diesel during the year;[68] in fact, Pakistan was among those countries where the pass-through of crude oil prices on transport fuel prices was the strongest.[69] The demand for petrol remained particularly strong as car sales bounced back, after slipping away in previous two years.[70] Low CNG availability, and narrowing price differential across fuels, is also propping up petrol demand in the country.

Most of the demand for petrol was met via imports, as domestic production increased marginally.[71] Local refineries had tough times during the first half of the year, as they faced liquidity constraints

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[64] According to the Financial Report for Jan-Jun 2015, Pak Suzuki has 19,893 units during the period under the Apna Rozgar Scheme. The company expects to meet the target of 50,000 cars by end February 2016.

[65] In FY14, PSDP of Rs 28 billion was spent on Pakistan Railway, which increased to nearly Rs 40 billion in FY15 (Source: Budget in Brief 2014-15 and 2015-16).

[66] According to PIA's First Quarter Report for 2015, the process for the acquisition of 10 narrow-body aircrafts, five ATRs, and two wide-body aircrafts on dry lease has been initiated.

[67] Excluding furnace oil, sale of petroleum products posted a growth of 12 percent in FY15, compared to 6 percent last year.

[68] According to OCAC, petrol sales increased by 20.8 percent YoY in FY15, whereas sale of HSD went up by 9.8 percent.

[69] For details, see SBP Second Quarterly Report for 2014-15.

[70] After declining by 24.5 percent and 0.6 percent in FY13 and FY14, respectively, car sales increased by 28.0 percent in FY15.

[71] Petrol production by domestic refineries increased by only 1.1 percent YoY in Jul-Jun FY15, despite a rise in conversion of naphtha into petrol.

due to circular debt. Refineries were reluctant to import crude also to avoid inventory losses, as oil prices were uncertain. In the second half of the year, refineries processed more crude as prices were stabilized, and refining margins had improved. Therefore, there has been a significant increase in the import of crude oil in the fourth quarter of the year.[72]

Consumer items

Import of consumer items has also increased in FY15. Pakistan spends millions of dollars every year on the import of consumer items like value-added food products; personal care; appliances; and other household items (**Table 7.9**). With no direct link to production activity in the country, these items stand first in line when import compression policies are to be exerted. Worryingly, Pakistan does not import these products via official sources alone; these items also enter Pakistan via the Afghan Transit Trade; sea routs from Dubai (in exchange of hawala-driven worker remittances); and/or professional travelers (*khepias*) who carry these goods as personal baggage.

Table 7.9: Import of Selected Consumer Goods

million US$

	FY13	FY14	FY15
Processed food			
Spices	67.3	92.3	109.6
Pasta/bread/ cakes/ biscuits	3.8	5.0	6.6
Tomato paste/prep/preservatives	3.7	9.1	8.2
Beverages incl. juices	23.0	24.3	26.6
Household items			
Kitchenware	9.5	11.3	16.9
Baby carriages/toys/games	43.7	50.6	74.5
Electronic appliances			
Grinders/mixers/juicers	8.0	9.9	11.2
Laptop	75.9	30.3	114.5
TVs	0.9	2.5	11.9
Cellular phones	613.2	613.3	722.9
Earphones / remote controls	7.8	10.9	14.6
Air-conditioners	13.8	20.9	23.9
Refrigerators	5.6	5.8	7.6
Electric fans	11.4	13.8	19.3
Bulbs	72.6	110.0	99.0
House building			
Ceramic tiles and bricks	15.0	21.3	16.2
Sanitary fixtures	3.3	4.7	6.2
Personal care			
Essential oil/perfume	111.2	129.3	160.8
Make-up/beauty	11.4	15.1	22.0
Hair preparations	22.7	31.9	41.8
Shampoos	16.5	25.1	33.2
After-shave/toilet preparation	5.3	7.4	10.7
Soap/ washing detergents	137.5	167.5	190.6
Total	***1,283***	***1,412***	***1,749***

Source: PBS

Most of these products require low-technology and therefore *could* have a fair degree of substitutability between local and imported ranges. However, three major factors do not allow this substitution to happen:

(i) Under-invoicing/smuggling of foreign products give an unwarranted competition to local products. Investors are discouraged to set up local manufacturing units or expand their business, which further widens the demand-supply gap. Therefore additional demand has to be met via imports. Electronic appliances, rubber tyres, and pharmaceuticals are few examples;

(ii) Local products lack variety and range, therefore high-end consumers prefer imported varieties. For instance, in household items like tableware, ceramics and sanitary fixtures, European brands have a strong customer base here due to vast variety of colors and texture;

(iii) Pakistani manufacturing units are mainly small in size, and therefore it is hard to compete with low-cost mass production of Chinese products – and nearly impossible in a zero-tariff regime. Very low technology items like plastic toys, tupperware, earphones, bulbs, handbags, stationary are being imported from China in bulk.

[72] After posting a decline of 8.5 percent YoY during Jul-Mar FY15, crude oil imports posted a growth of 7.9 percent YoY in Q4-FY15.

Both, regulatory authorities and the private sector, have a lot in their plates. At first, there is an urgent need to cut cross-border smuggling of goods, if local industry is to be kept viable. Similarly, necessary modifications should be done in trade regime and agreements, to make them beneficial for promoting manufacturing activity in the country. Secondly, manufacturers must also strategize about how to position themselves in changing market dynamics, reclaim the domestic market. Investments are essential to tailor local product range to changing styles and tastes. More important is to ramp up technological and labor capability to offer quality products to local customers – foreign collaboration could do the trick.

This all has to start from industrial policy. If sectors are identified on which future growth is to be desirably built, all other macro policies related to trade, credit, fiscal, and FDI, would coalesce to support those sectors. These sectors can then be provided with all sorts of regulatory support – be that protection under trade agreements, or incentives for investment – to ensure that they grow. Only then, Pakistan's chronic trade imbalances can be fixed, and the country can move along the growth frontier.