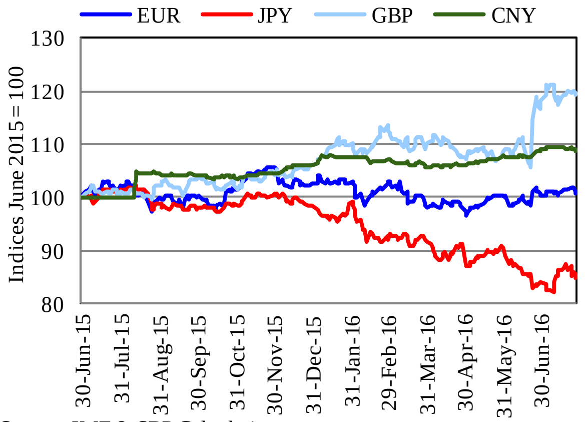
6 External Sector

6.1 Global economic review

FY16 saw the world economy continue on its tepid growth trajectory, with the fall in oil prices failing to jump-start global economic activity in a meaningful way. Volatility in financial markets, primarily driven by divergent monetary policies in the developed world, and increased market uncertainty, were the hallmarks of the global economy in FY16. These developments, along with low primary commodity prices and sporadic trade-restrictive actions (including competitive devaluations) by a number of countries, contained the growth in international trade volumes to 2.7 percent in 2015; making it the fourth consecutive year of sluggish growth in global trade (i.e. less than 3 percent). Even this small growth in trade volumes was overshadowed by the fall in international commodity prices, which led to 14 percent YoY decline in the value of world merchandise exports.[1] A sharp depreciation of major currencies against the US dollar (especially during second half of 2015), which has its roots in divergent monetary policies in advanced countries, also contributed to this decline in exports (**Figure 6.1**).

Figure 6.1: Major Currencies-per US$



Source: IMF & SBP Calculations

In FY16, the US economy witnessed the end of a prolonged and extraordinary era of monetary easing: the federal funds rate was increased by 25 bps in mid-December 2015 for the first time in nearly a decade, and a little over a year after the end of the quantitative easing (in October 2014). Economic activity in the US continued to expand at a modest pace, and the unemployment rate gradually declined to near 5 percent - the upper limit of the long-run normal rate of unemployment. Inflation, which remained well below the long term target of 2 percent, inched up to 1.1 percent during the first half of 2016; the country registered a deflation of 0.1 percent during the same period last year. The modest improvement in the US economy is being led by growing consumer spending, with jittery businesses continuing to cut back on their investment spending.[2] Weak external demand, along with sharp appreciation of the US dollar, has kept US exports in check.

In stark contrast to the US Fed, the European Central Bank (ECB) slashed its main policy rate to a historic low of zero percent in March 2016, and pushed the deposit facility rate to negative 0.40 percent.[3] These unprecedented low rates are being further supported by unconventional monetary policy measures: the ECB has introduced a new Corporate Sector Purchase Program (CSPP) as a part of the existing Euro system's asset purchase program, under which it would continue its monthly asset

[1] Specifically, a 15 percent decline was recorded in global export prices (source: World Trade Statistical Review 2016).
[2] This is little surprising as consumers are upbeat, housing sector is shaping well, and there is a visible improvement in the labour market; yet businesses are containing their capital spending. Understandably, the mining industry is on top of the list, as the continuation of lower oil prices is forcing exploration companies to reduce their capital spending.
[3] The ECB introduced negative interest rate on its standing facility for the first time in June 2014. Specifically, the deposit facility rate was set at negative 0.1 percent at that time, and it was made further penalizing in subsequent monetary policy decisions. Policy rates in countries like Denmark, Sweden and Switzerland are also in the negative zone.

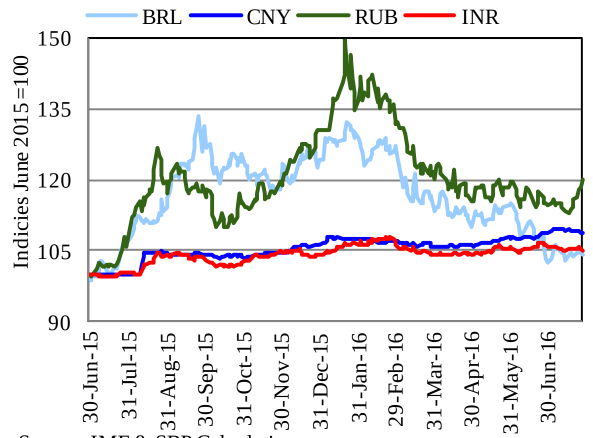
purchases worth € 80 billion for an extended period.[4] These measures are primarily aimed at providing adequate monetary stimulus to bring inflation close to the ECB's medium-term target of nearly 2 percent.[5] In fact, headline inflation for the Euro area was zero in 2015; and it was negative for three of the first six months of 2016. Moreover, measures of core inflation are yet to show a clear sign of building up of inflationary pressure in the Euro area.

Notwithstanding low inflation, economic recovery in the Euro area is in progress. A modest rise in investment activity, coupled with healthy domestic demand, led to higher than expected growth in real GDP during first quarter of the year. This looks all the more impressive as real GDP in the Euro area grew by 1.7 percent in 2015, which was almost double the level seen a year ago. The recent monetary easing has pushed the lending rates for the private sector and households to historic lows, and there has been a small increase in net credit flow, though the level of credit offtake still remains low. While the increase in offtake would support economic activity, the risks to the Euro area's economic outlook have substantially increased following the *Brexit* vote in June 2016. In addition, high level of indebtedness continues to restrain investment activity in EU countries.[6]

Following the ECB's footprint, the Bank of Japan (BoJ), in January 2016, also introduced negative return on current deposits of financial institutions held with the bank. The prime objective of the BoJ's "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" is to end the decades-long slump in prices and bring inflation close to the target of 2 percent.[7] The impact of these measures is yet to materialize, as current inflation numbers provide no comfort: headline CPI inflation averaged 0.8 percent in 2015, and the country recorded a small deflation during the first half of 2016. This could be one of the reasons behind a notable appreciation of the Japanese yen against the US dollar in spite of unprecedented monetary easing. Besides, economic growth not only continued to be low, but switched between positive in one quarter and negative in another.

Among other advanced countries, the UK economy expanded at a modest rate in 2015 and during the first half of this year; inflation also remained well below the target. Nonetheless, the success of the *Brexit* vote in June 2016, took many by surprise, especially global currency and equity markets. The British pound plunged to 31-year low against the US dollar in June 2016, rattling the forex markets. Banking stocks were hit particularly hard, and many have yet to recover to pre-June 23 levels. While the full impact of *Brexit* is likely to unfold over the next two years, it has created uncertainty for UK, EU and other advanced economies. Global economic outlook has worsened, and the IMF has revised

Figure 6.2: BRIC Currencies-per US$



Source: IMF & SBP Calculations

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[4] The ECB Governing Council, in its meeting held on 21st July 2016, decided to continue with monthly asset purchases till March 2017, or even beyond, if deemed necessary.

[5] Source: Economic Bulletin, Issue 5/2016, European Central Bank.

[6] While a high level of indebtedness constrains firms and households from making new investments, it also undermines the governments' ability to pursue counter-cyclical policies. For example, Greece and Spain are already running sizeable deficits along with relatively high debt levels; this situation undermines their ability to take further measures to support economic activity.

[7] It has been suggested that three pillars of Abenomics - i.e. fiscal stimuli, monetary easing, and structural reforms – to end the deflationary slump and to put the economy back on a growth trajectory, have yet to provide tangible results.

its forecast downward for UK and advances economies for 2016.

In the emerging world, the BRIC countries, which had been major contributors to global economic growth, showed a mixed performance. Commodity-exporting countries like Brazil and Russia plunged into severe economic downturns due to the collapse of international commodity prices, and their currencies tumbled (**Figure 6.2**).

China, which is one of Pakistan's biggest trading partners, is pursuing a structural transformation from an export-led economy to a domestic consumption-driven one. Real GDP growth gradually eased to 6.7 percent in the second quarter of 2016 from its peak level of nearly 12.0 percent in the first quarter of 2010. In fact, this structural transformation has indirectly impacted the export performance of commodity-exporting countries, as tapering demand from China is one major reason behind the sharp fall in prices of international primary commodities. Meanwhile, India was able to buck this trend, as its reform process started bearing fruit: it emerged as the fastest growing economy in Developing Asia in 2015.[8]

Among other regions, the Gulf countries, especially Saudi Arabia and United Arab Emirates (UAE), are of great importance for Pakistan. Being the biggest exporter of oil, Saudi Arabia was adversely affected by the sharp fall in oil prices: its budget deficit surged to 13.5 percent of GDP in 2015 (this was 4.7 times the deficit recorded in the previous year) as oil revenues fell; its current account recorded a deficit of 8.3 percent of GDP, against a healthy surplus last year. However, the impact of these developments on economic growth remained subdued till 2015, as the country relied on its deep reserves to finance these deficits. This led to a US$ 105.4 billion reduction in the country's FX reserves during a year. To ease the pace of the FX reserve decline, Saudi Arabia mobilized US$ 10 billion from the international market in April 2016 for the first time in a decade. Still, the economy is expected to witness a slowdown this year as austerity measures kick in, and an early recovery in external oil demand remains elusive.[9]

On the other hand, the UAE, which is among the most diversified economies in the Gulf Cooperation Council (GCC), has been relatively less affected so far. Its current account was in surplus in 2015, though it narrowed to 3.3 percent of GDP (from nearly 20 percent two years back). But its fiscal balance turned into a deficit for the first time since the real estate bubble burst in 2009. The real GDP growth remained intact in 2015, as the negative impact of a reduction in public investments is likely to be felt from 2016 onwards.[10] Moreover, there is tremendous variation across emirates within the UAE, as Dubai, which is less dependent on oil, has announced an increase in its budgetary spending for this year. This is in sharp contrast to oil-dependent Abu Dhabi, which has cut its spending.

In sum, the above-mentioned developments at the international level present a challenging economic environment for a developing country like Pakistan. The sluggish growth in advanced countries has translated into weak demand for imports; this is already impacting Pakistan's exports. Remittances, which had been growing at a healthy pace, have slowed down as the austerity measures in the GCC are kicking in. Sharp swings in international currencies entail implications for Pakistan's forex market, as was the case during the first half of FY16. In addition, exchange rate volatility also constrains investment flows, which are already low in case of Pakistan.

[8] Being a net importer of oil and other primary commodities, the Indian economy appeared to have benefited strongly from the fall in international commodity prices.
[9] Economic activity is likely to pick up from 2017 onwards in Saudi Arabia, as oil prices gradually recover. However, the benefits of implementing reforms envisaged under the Vision 2030 and the National Transformation Program to diversify the economy will take some time to emerge.
[10] Real GDP growth is projected at 2.4 percent for 2016, against 4.0 percent in 2015.
http://www.imf.org/external/pubs/ft/scr/2016/cr16251.pdf

Figure 6.3a: Prices of Major Import Items

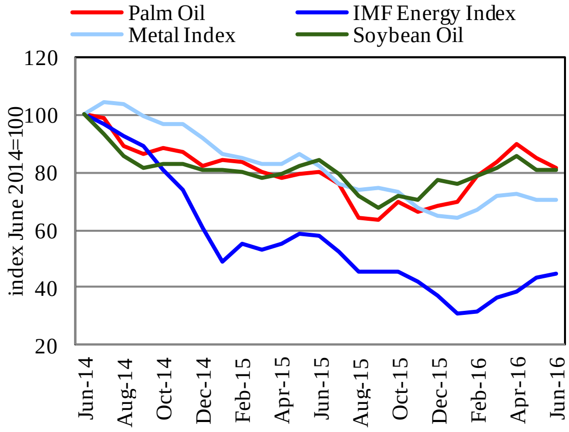
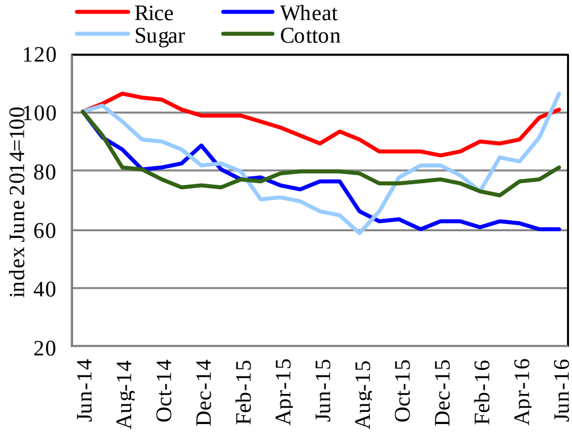


Figure 6.3b: Prices of Major Export Items



Source: IMF&World Bank

The silver lining for Pakistan is the fall in international commodity (particularly oil) prices. Being a net importer of oil and other primary commodities, Pakistan has the opportunity to utilize the benefit of the lower oil import bill to finance essential non-oil imports (like machinery and steel etc.) for infrastructure development to facilitate economic activity. It is encouraging to note that prices of Pakistan's major imports have declined by a larger magnitude as compared to the prices of our exports: i.e., a favourable change in terms of trade (**Figure 6.3a** and **6.3b**).

6.2 Pakistan's BoP

FY16 marked the third straight year in which Pakistan's external account was in surplus. While the current account deficit widened over last year, it was comfortably financed by the surplus in the financial account. A doubling in net FDI, as well as IMF disbursements and the government's external borrowings, all contributed to the financial account surplus. As a result, the country's FX reserves increased by US$ 4.4 billion in FY16 to US$ 23.1 billion (**Table 6.1**). Apart from ensuring stability in foreign exchange market, these reserves provided import coverage of over seven months.

Table 6.1: Pakistan's Balance of Payments
Billion US$

	FY14	FY15	FY16
Current account balance	-3.1	-2.7	-3.3
Trade balance	-16.6	-17.2	-18.4
Exports	25.1	24.1	22.0
Imports	41.7	41.3	40.3
Services balance	-2.7	-3.0	-2.9
CSF	1.1	1.5	0.9
Primary income	-4.0	-4.6	-5.3
Repatriations on FDI	2.9	3.3	3.8
Interest payments	0.9	1.1	1.3
Secondary income	20.1	22.0	23.3
Worker remittances	15.8	18.7	19.9
Capital account balance	1.9	0.4	0.3
Financial account balance	-5.6	-5.0	-5.5
Direct investment in Pakistan	1.7	0.9	1.9
Portfolio investment in Pakistan	2.7	1.8	-0.3
Other investment	-1.2	-2.3	-4.1
Net incurrence of liabilities	1.0	2.2	4.2
SBP liquid reserves (end-period)	9.1	13.5	18.1
Total liquid reserves (end-period)	14.1	18.7	23.1

Source: State Bank of Pakistan

Here, it is worth noting that Pakistan has *successfully* completed the three-year IMF program, which has been a key element of the country's BoP comfort.[11] On a net basis (disbursements net of repayments to the Fund), Pakistan received US$ 1.9 billion from the IMF during FY14-16.[12] In addition to this direct support, the program helped Pakistan re-enter the international bond market and secure funding from other IFIs. For instance, the rise in FX reserves along with improvement in other macro indicators, made

[11] The final review of the Extended Fund Facility was completed in September 2016, leading to the release of the residual loan tranche of around US$ 102.1 million.
[12] During the program period, gross IMF disbursements to Pakistan amounted to US$ 6.3 billion. Repayments to the Fund (for previous loan disbursements) came out to US$ 4.4 billion.

the country eligible for low-cost funding from the International Bank for Reconstruction and Development.

These inflows had been critical in keeping reserve growth on a high trajectory, as the current account deficit increased in FY16. The trade account continued to be the major contributor, as the deficit grew by 6.9 percent in FY16 on top of 3.6 percent in FY15. The benefit of lower oil payments was largely offset by an increase in non-oil imports, particularly of heavy machinery for power and construction sectors and industrial raw materials (mainly steel and raw cotton). Granted that these non-oil imports were essential for growing economic activity, they also contained the drop in overall imports to only 2.3 percent in FY16.

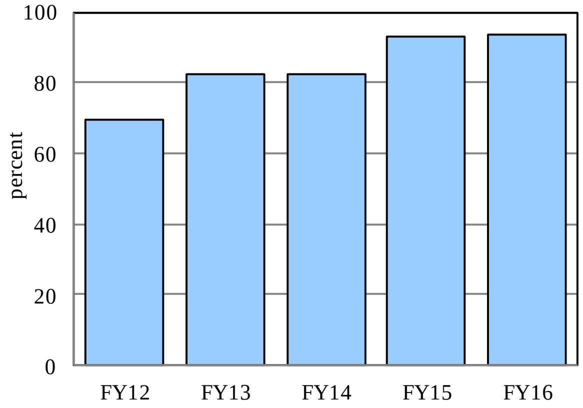
This small reduction in overall imports was insufficient to outweigh the 8.8 percent decline in exports, which fell to US$ 22.0 billion. In fact, the export decline deepened in FY16: while exports were pulled down primarily by lower volumes last year, the price effect played a dominant role this year. Factors affecting quantum exports were largely the same as in FY15, and included: (i) subdued global demand in the wake of tepid economic growth; (ii) structural shifts in China's economy, which has reduced its demand for low value added textile products; and (iii) long-standing competitiveness issues in the domestic economy. An additional factor in FY16 was the sharp decline in cotton production, which not only led to a visible drop in exports of cotton yarn and raw cotton, but also necessitated hefty imports of the raw material.[13]

Meanwhile, the services deficit improved marginally, despite lower CSF inflows during the year. The improvement was mainly a result of lower freight charges, which reduced the transport deficit by 28.3 percent to US$ 2.0 billion.

On the other hand, higher profit and dividend repatriations by foreign firms led to a 16.3 percent increase in the primary income deficit, which reached US$ 5.3 billion in FY16; this was almost three times the net FDI received by the country in the year. That said, reinvested earnings were also responsible for the higher primary income deficit this year.[14] Sectors witnessing notable increase in reinvested earnings included finance, power and telecom.

It is worth noting that worker remittances remained a key offsetting factor within the current account, and the country's reliance on these flows has increased appreciably since FY12. Even in FY16, the modest growth of 6.4 percent in remittances was enough to offset 93.9 percent of the trade deficit (both in goods and services) (**Figure 6.4**). As mentioned earlier, the remaining deficit was easily financed through strong financial inflows.

Figure 6.4: Percentage of Trade Deficit Covered by Worker Remittances



Source: State Bank of Pakistan

It is encouraging to note that non-debt creating

[13] Exports of raw cotton dropped 49.5 percent YoY in FY16, while those of cotton yarn went down 30.4 percent. Simultaneously, imports of raw cotton surged 151 percent to US$ 1.1 billion during the year.

[14] Reinvested earnings of foreign firms operating in the country basically represent their retained earnings; i.e., the part of their profits that they did not distribute to their shareholders as dividends. Yet, from a country's BoP perspective, these earnings are considered to have been repatriated abroad (thus counting as an outflow from the primary income account) and then being reinvested into the company by its foreign parent (thus treated as a FDI inflow, in the financial account). Therefore, in net terms, this has zero impact on the country's FX reserves.

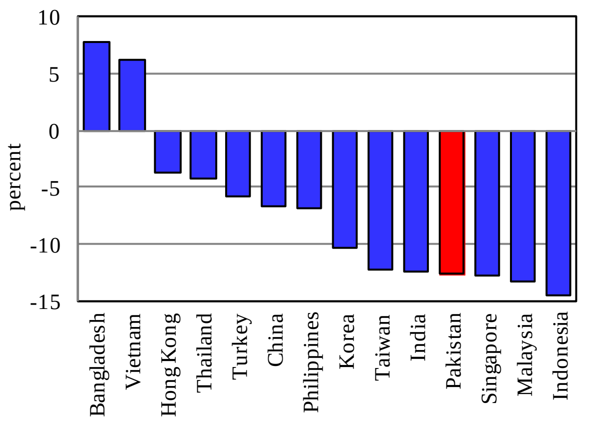
private investment flows (net FDI) more than doubled in FY16 to US$ 1.9 billion. China had a dominant share in net FDI, with most of the flows from the country going into CPEC-related power projects. FDI inflows from other countries also picked up, with flows from Norway, UK and UAE rising prominently over FY15. However, FDI inflows into Pakistan's oil & gas exploration and production (E&P) and petrochemical sectors suffered as the fall in oil prices forced global energy giants to curtail their capital spending and pushed the industry into a consolidation mode. In fact, the share of the E&P sector in net FDI declined from 32.4 percent in FY15 to only 13.1 percent in FY16. Its share was captured by the power sector, especially due to CPEC-related inflows.[15]

Here, two developments are important. First, gross FDI inflows have been either declining (in FY14 and FY15) or only marginally increased (in FY16); therefore, improvements in net FDI are more a result of lower gross outflows than a pick-up in inflows. And second, the share of reinvested earnings in net FDI has been rising over the past three years: from 12.0 percent in FY14 to 39.1 percent in FY16. It implies that existing foreign investors are shoring up their stakes, leaving the need for fresh FDI to flow into manufacturing and exporting sectors of the economy.

In the final analysis, there has been an improvement in Pakistan's external account during FY14-16. This progress has been recognised by IFIs as well as foreign credit ratings agencies, and formed the basis of the country's re-entry into international capital markets. The benchmark PSX-100 index's reclassification as an emerging market by MSCI will put the country more clearly on foreign investors' radars. At the same time, it has become imperative to effectively utilize the comfort provided by high FX reserves and low oil prices to tackle the challenges that continue to face the external sector.

Falling exports remain a key challenge: In order to ensure adequate financing for imports of capital goods and raw material, there is a need to enhance export revenues, which have contracted for the second year in a row. This decline primarily seems to be a function of global developments, as most emerging markets (EMs) have witnessed a drop in their exports (**Figure 6.5**). Some of these countries actually fared worse than Pakistan; Vietnam and Bangladesh were exceptions to this trend.

Figure 6.5: Export Growth in Emerging Economies in FY16



Source: Haver Analytics

However, the role of domestic factors must not be overlooked, as Pakistan's export performance has remained lacklustre over the last few years, even before the commodity recession set in.[16] Concrete steps are needed to enhance competitiveness and ease of doing business; promote investments in R&D and innovation, and a culture of entrepreneurship; institute a vigorous legal system to protect intellectual property rights; and improve the quality of labour, etc. In addition, given the multitude of regional and even intercontinental trade pacts that are under process or deliberated upon, Pakistan ought to improve its trade competitiveness, as FTAs signed among other countries could put Pakistan in a disadvantageous position.[17]

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[15] From just 4.2 percent in FY14, the power sector's share in net FDI increased to 23.8 percent in FY15 and further to 39.5 percent in FY16.

[16] For details, please see Special Section 3: "What has Caused Stagnation in Pakistan's Exports", in SBP's Annual Report on the *State of Pakistan's Economy* for FY15.

[17] For instance, Vietnam – which has emerged as a major competitor for Pakistan in the US and EU's textile market – concluded FTA negotiations with the EU, which has granted it duty-free access to a wide range of products, essentially

Nevertheless, there have been some encouraging developments of late.[18] The government has partly settled the refunds of exporters. This, coupled with record-low interest rates, should ease the exporters' cash-flow constraints. Moreover, in the FY17 budget, the government has restored zero-rating tax regime for five major export sectors: textiles, carpets, leather, surgical and sports goods. That said, these measures should not leave any room for complacency.

The structural issues afflicting the export industry also need to be addressed. Pakistani exporters need to keep pace with changing consumer preferences in their key markets, and adjust their product mix accordingly; the textile sector in particular should start focusing on synthetic fibre-based ones that are in demand in the US. Moreover, the SME sector, which has a major share in producing electrical products like fans,[19] light bulbs and surgical equipment etc., continues to largely operate on the fringes; its share in export financing is minimal.

In addition to exports, a policy response is needed to curb non-essential imports. In this context, the imposition of regulatory duties on non-essential consumer items in FY16 is a step in the right direction. There is also a need to evaluate the utility of hefty automobile imports (i.e. cars and motorcycles). On the other hand, imports of productive items, like power generation and distribution machinery, should not be put off. But financing even these incremental imports to support CPEC projects could be challenging if non-debt FX earnings do not pick up pace.

Pakistan yet to gain from uptick in global FDI flows: Despite an improvement in global investment flows in 2015, FDI flows are yet to pick up pace in a real way for Pakistan.[20] Pakistan could not capitalize on this improvement, mainly due to terrorism and inadequate power supply. But these are being gradually worked on: there has been a notable improvement in the law and order situation as a result of Zarb-e-Azb and intelligence-based operations.[21] On a similar note, better energy management and incremental addition to power generation capacity has improved power supplies to businesses, in general.[22]

Despite these favourable developments, the country has seen *divestments* from multiple sectors over the past two years, especially from steel and pharmaceuticals. This has happened as other countries are actively courting foreign investors by easing localization rules and expanding the limits on foreign ownership of domestic companies, etc.[23] Besides, Pakistan continues to rank behind most of its peers in terms of ease of doing business and competitiveness.

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putting it at par with Pakistan's GSP Plus status. Moreover, 12 Pacific Rim countries – accounting for 40 percent of global trade – have concluded negotiations over the Trans Pacific Partnership (TPP).

[18] The government has unveiled the Strategic Trade Policy Framework (STPF 2015-18) to promote regional trade particularly with Afghanistan, Central Asian Republics, Iran and China. The STPF aims to enhance annual exports to US$ 35 billion, improve export competitiveness, transition from factor-driven to efficiency-driven and innovation-driven economy, and increase in regional trade by June 2018. The STPF identifies four pillars including product sophistication and diversification, market access, institutional development, and trade facilitation, to achieve the target by 2017-18.

[19] Pakistan exported electrical fans worth US$ 25.0 million in FY16, down from US$ 31.5 million in FY15 (source: Pakistan Bureau of Statistics).

[20] Global FDI flows grew 38 percent and reached US$ 1.8 trillion in 2015, after declining 10.5 percent in 2014. Most of this increase was an outcome of higher cross-border mergers and acquisition activity and corporate reconfigurations; excluding large-scale corporate reconfigurations, the growth in FDI flows was around 15 percent in 2015. Flows to Developing Asia grew 15.6 percent. But this growth was not shared equally among all nations (source: World Investment Report 2016, UNCTAD).

[21] After reaching 5,496 in 2014, casualties from terrorism-related incidents in Pakistan dropped to 3,682 in 2015, and to 1,273 during Jan-Aug 21, 2016 (source: South Asia Terrorism Portal).

[22] Fertiliser is one industry that has benefitted from regular gas supplies; the sector has been a major beneficiary of LNG imports. Better energy supply during the winter allowed fertiliser companies to continue production (unlike previous years); reducing the country's need to import fertilizer in H2-FY16 (Section 6.4).

[23] In June 2016, India significantly relaxed rules governing FDI flows and foreign ownership in sectors like aviation, defense, and pharmaceuticals, in addition to providing a grace period for foreign firms to comply with localization requirements. Foreign investors can now own 100 percent of domestic airlines, up from the previous limit of 49 percent.

Cognizant of these issues, the government has implemented various measures in the recent years. First, an Action Plan for improving Pakistan's business environment was developed in October 2014 after an in-depth consultation with the stakeholders. The plan outlined time-bound reform measures focusing on 6 indicators of Doing Business. Second, a high power committee was constituted in May 2015, to develop a strategy for improving Pakistan's rating on Ease of Doing Business and overall investment environment. A Doing Business Report Strategy 2016 has been developed, and is in process of implementation. The business climate is expected to improve further in the coming years.

With regards to CPEC, while there has been a noticeable pick-up in FDI inflows from China, imports from China have also increased in FY16 (**Table 6.2**). Further, the *pace* of FDI flows from China eased as the year progressed: most of the investment from China had arrived in H1-FY16, with flows moderating in the second half of the year.[24]

Table 6.2: Pakistan's FX Transactions with China
Million US$

	FY15	FY16	Net change
Exports to China	2,321	1,905	-416
Imports from China	7,005	8,127	1,122
Trade balance	-4,684	-6,222	-1,539
FDI (net)	257	626	369
Portfolio investment	11	6	-5
Loan disbursements[1]	980	962	-18

Source: State Bank of Pakistan, [1]: Economic Affairs Division

Remittance may continue to grow, albeit at a slower rate: This is because the factors behind the slump will remain in the short- to medium-term. In case of the GCC, even if oil prices recover, it is unlikely that the Arab states will scale up their infrastructure spending immediately. Second, if the localisation drive in these countries picks up pace, it may affect demand for migrant workers. In case of the US, anti money laundering and counter financing of terrorism (AML/CFT) regulations are likely to be strengthened further. That being said, innovation in payment systems and launch of new and attractive savings and investment products for the diaspora are some measures that might keep remittance growth intact at current levels.

Here, it is essential that the government leverages diplomatic channels to proactively identify trouble spots and approach relevant government and private sector authorities in host countries to deal with the problems before they mushroom. Simultaneously, it needs to be ensured that the cost of remitting funds stays within the means of migrant workers, particularly those in major corridors like the GCC and the US.

Uncertainty with regards to the EU post-Brexit: Arguably the most potent outcome of Brexit has been the massive bout of uncertainty that has been unleashed into the global economy. Economists continue to differ about whether the British economy will plunge into a recession or not, with potentially adverse consequences for its trading partners.

It should be realized that the UK will naturally readjust its trade relationships with EU member states before it comes round to other countries. For Pakistan's BoP perspective, the UK is an important partner: (i) it accounted for 7.4 percent of the country's overall export receipts in FY16; (ii) it had the highest share in outstanding FDI in the country (18.5 percent, as of end-CY14);[25] and (iii) remittance inflows from the country remained noticeably strong during FY16, against the trend noted from other major remittance corridors. It is necessary to evaluate the potential for drop in FX inflows through all these channels, yet the job is made difficult by the uncertainty surrounding the UK's actual disengagement from the EU.

Foreign companies can now also take up to 74 percent stake in brownfield pharma projects without prior government approval. Also in June 2016, US e-commerce giant Amazon announced it will invest US$ 3.0 billion in the country to better compete with local rivals.

[24] More than 70 percent of net FDI received from China in FY16 had arrived in H1-FY16.

[25] That said, the UK had a meager 6.2 percent share in net FDI received in FY16. Net flows from the country dropped a sizable 52.9 percent YoY in the year.

In the backdrop of these challenges, it has become imperative to sustain the gains made in macro stability over the past two years, and simultaneously fix the long-term structural issues highlighted above. With official FX reserves at an all-time high, Pakistan is in a much better position to withstand disturbances stemming from abrupt global commodity and currency market shifts. That said, any abrupt and sizable increase in crude prices will pose a risk to Pakistan's external account.

6.3 Current account

Despite a modest rise in worker remittances, the current account balance deteriorated in FY16 owing to worsening trade (both goods and services) and primary income balances. The trade deficit increased as the benefit of marginally lower imports was offset by a visible drop in exports, while the primary income deficit deteriorated due to relatively higher repatriations and interest payments.

Services account

The services account posted a deficit of US$ 2.9 billion in FY16, which was 3.8 percent lower than the deficit recorded last year. This small improvement was entirely driven by a reduction in the freight deficit (which is the largest component in the country's services trade profile) as a result of the big decline in oil prices.[26] The extent of this decline was such that it completely offset the impact of lower Coalition Support Fund (CSF) receipts during the year (**Table 6.3**).

Table 6.3: Balance in Services Account
Million US$

	FY14	FY15	FY16
Services balance	**-2, 650**	**-2,963**	**-2,850**
of which			
Transport	-2,559	-2,838	-2,036
o/w: Freight	-2,541	-2,628	-1,614
Air transport (passenger)	-111	-258	-440
Travel	-787	-1,217	-1,514
Insurance and pension services	-135	-195	-201
Financial services	-99	-123	-92
Charges for intellectual property	-144	-154	-163
Telecom, computer and information	469	425	407
Other business services	-741	-590	-574
Government goods and services	1,450	1,768	1,471
Coalition support fund (CSF)	1,050	1,452	937
Services balance excluding CSF	**-3,700**	**-4,415**	**-3,787**

Source: State Bank of Pakistan

Here, it must be noted that there are two areas that have been offsetting Pakistan's services deficit over the past few years: export of government services and telecom services. Unfortunately, export of ICT services has been on a declining path over the last three years, and government services are driven by non-economic factors. This is one reason why Pakistan's services exports have stagnated in the range of US$ 5.0-6.0 billion over the past few years. On the contrary, the share of services in global exports has been rising rapidly over the same period (**Box 6.1**).

Meanwhile, the export of air transport services for passengers – basically the revenues earned by domestic airlines by flying on foreign routes – continued on its downward path, dropping by 23.4 percent YoY in FY16. Yet, lately there are hopes that the national airline's performance might improve in the future: on August 14, 2016, PIA launched PIA Premier, a luxury airline that claims to offer superior quality services to its customers. Four relatively new planes were acquired from Sri Lankan Airlines on wet lease, exclusively for PIA Premier; the airline is currently operating six flights to London – three each from Islamabad and Lahore.

Box 6.1: Services Exports: A Brief Review

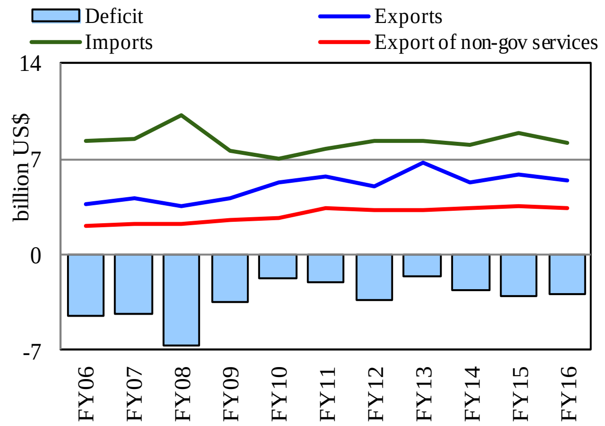
With rapid developments in information and communication technologies (ICT) and transportation, services are emerging as the most dynamic segment of international trade.[27] The global export of services grew at a higher pace as compared to the export of goods over the last decade.[28] As a result, the share of services exports in total world exports (of goods and

[26] A benefit for import bills of oil-importing countries, the fall in oil prices has severely affected the financial performance of shipping companies across the globe. After-tax profit of A.P. Moller-Maersk, the world's largest shipping container company, dropped 87 percent YoY in Jan-Jun 2016 (source: company financial statements).
[27] Trade in services is governed by the WTO's General Agreement on Trade in Services, which has been in force since 1995.
[28] Global export of services recorded a compounded annual growth rate (CAGR) of 6.7 percent during 2005 to 2015, compared with 4.7 percent for export of goods over the same period.

services) increased from 19.3 percent in the year 2005 to 22.7 percent in 2015. Even this share is grossly underestimated, as it does not take into account the services provided by foreign affiliates (i.e., foreign-owned subsidiaries/branches).[29]

Domestically, the services sector contributed 59.2 percent to Pakistan's GDP in FY16; its share in the economy has gradually increased from 50 percent in FY00. This gradual shift in the structure of the economy should have led to a slipover to services exports, but that appears to not be the case: Pakistan exported services worth US$ 5.4 billion in FY16, with a deficit of US$ 2.9 billion recorded in the year. Past data suggests that services exports have stagnated around this level since FY10 (**Figure 6.1.1**).[30]

Figure 6.1.1: Services Exports



Source: State Bank of Pakistan

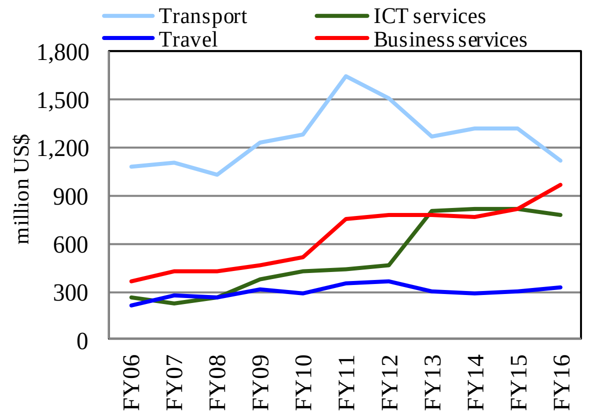
Here, it is important to realize that the commodity producing sector, which has been growing at a slower pace as compared to services, may not be able to generate sufficient exportable surpluses to meet the country's growing FX needs. This implies that services exports must play an important role in the country's overall trade. In this backdrop, Pakistan's services exports are briefly reviewed here.

Inflows under government services – primarily CSF and other military services – account for more than one-third of the country's total services exports. This is substantially higher than the share of government services of only 2 to 3 percent in the world trade in services. Given the *non-economic and one off* nature of government services, the high share does not bode well for long-term stability of export receipts. Incidentally, flows under CSF dropped drastically in FY16. As these receipts are linked with foreign troops' presence in Afghanistan, the continuity of these flows is uncertain, at best. Yet, non-CSF government services exports have recorded a sizable growth over the last two years; if this trend continues, it may cushion any further fall in FX receipts under CSF.

The export of commercial services, which is obtained by adjusting overall export of services for government services, have remained almost flat at US$ 3.4 billion since FY11 (**Figure 6.1.1**). These were only 1.2 percent of GDP in FY16, which is far below the global average level of 6.0 percent of world GDP. These exports are concentrated in transport, ICT, travel, and business segments. These four (out of 11 major categories) have a combined share of more than 90 percent in overall export of commercial services.[31] Within these categories, business services account for a quarter of commercial services exports, and have maintained a steady rise over the last decade; they reached US$ 962 million in FY16 (2.7 times the amount realized in FY06). Major contributions to this rise came from legal, accounting, management consulting, technical, and other business services segments. It is encouraging to note that the small reduction in trade-related business services was easily offset by a healthy increase in other services.

ICT services exports, which continued to increase up to FY13, have stagnated since then (**Figure 6.1.2**). This stagnation is largely stemming from telecommunication services, as revenues from foreign network operators (for calls that originate from outside Pakistan) are declining. This drop has come about as internet-based messaging and voice services, like *Skype*, *Viber* and *Whatsapp*, have gained tremendous traction locally.

Figure 6.1.2: Major Categories of Services Exports



Source: State Bank of Pakistan

However, the negative impact was largely offset by the growing export of computer services. Exports of both software consultation services and of computer software, have maintained an upward trajectory since FY06. While this is a welcome development, the export volumes are still very low. Specifically, Pakistan exported computer services worth US$ 488 million in FY16, which were only 9.1 percent of overall services exports.

[29] According to the World Trade Organization, more than 50 percent of total services are delivered by foreign affiliates.
[30] The only exception was FY13, which was attributed to one off factor related to military services.
[31] The same categories account for three-fourth of the global trade in services.

In sharp contrast to ICT and business services, exports of transport services plummeted from the peak level of US$ 1.6 billion in FY11 to US$ 1.1 billion in FY16 (**Figure 6.1.2**). This sharp reduction over the last few years is primarily driven by a fall in bulk freight rates; decline in the country's exports; and the squeezing operations of the main Pakistani air carrier.[32] In effect, the Pakistan International Airlines (PIA) fleet saw a visible depletion in the recent past (though there has been some improvement lately), which forced the airline to close some of its international operations. This, together with the fall in airfares, reduced export earnings from the air transport sector.

In short, the current level of Pakistan's services exports does not reflect the country's true potential. Concerted efforts are needed to facilitate services exports by strengthening the regulatory framework; well-thought liberalization of trade in services; investment in human resource development (especially in education and training for select services); improving access to finance for service-oriented industries; encouraging the private sector to form services coalitions and enterprise networks; promoting specialization in financial services; and improving data availability.

In effect, focus on human resource development must take the priority, as it serves the base for both manufacturing and services sectors. Given the inextricable nature of the services and commodity producing sectors (industry and agriculture), cautious trade liberalization in services would enhance the capacity of the commodity producing sectors to enhance their exports. In this context, the "Services Exports-National Roadmap for Pakistan" – developed in 2007 with the help of the European Union (as part of an EU-funded Trade Related Technical Assistance program) – should be revamped and implemented in its true spirit to promote trade in services.

Primary income

The primary income deficit widened by 16.3 percent YoY in FY16, mainly as a result of higher repatriation of profits and dividends on foreign investment, and higher interest payments.[33] Specifically, the repatriation of profits and dividends on existing FDI (excluding oil and mineral proceeds) grew 14.8 percent in FY16 to US$ 1.5 billion, reflecting strong profitability of the corporate sector (**Table 6.4**); including oil and mineral proceeds brings total repatriation to US$ 3.8 billion. The increase was broad-based: 26 out of 36 sectors witnessed higher repatriation during the year. Most of the increase (95.5 percent) in repatriations came from financial businesses, power, transport and chemical sectors; repatriations by the auto sector more than doubled in FY16.

Table 6.4: Sector-wise Repatriation of Profit and Dividend on FDI
Million US$

	FY14	FY15	FY16
Total repatriations	**2,932**	**3,327**	**3,807**
of which			
Oil and mineral proceeds	1,711	1,734	1,546
Profit & dividends	1,000	1,315	1,510
Oil and gas	53.6	79.0	103.5
Financial business	273.6	336.7	364.2
Telecom	38.9	254	174.5
Power	129.3	100.3	158
Food	92.4	111.9	129
Pharmaceutical	36.7	34.1	35.6
Others	375.5	399.0	545.2

Source: State Bank of Pakistan

On the other hand, telecom and petrochemical sectors recorded notable declines in profit repatriations. This is understandable, as the telecom industry's revenues have been under pressure from second half of FY15 because of two main factors.[34] First, there has been tremendous growth in the usage of internet-based voice and messaging services over the past few years, which have eaten into voice and text messaging revenues of cellular firms. Second, the government's nationwide biometric SIM verification drive resulted in the blocking of 26.1 million active SIMs. Apart from hitting telecom firms' revenues, the drive also led to a temporary drop in teledensity.[35] However, the tremendous growth in data revenues of cellular firms has partially compensated for the falling revenues from voice and instant messaging segments.

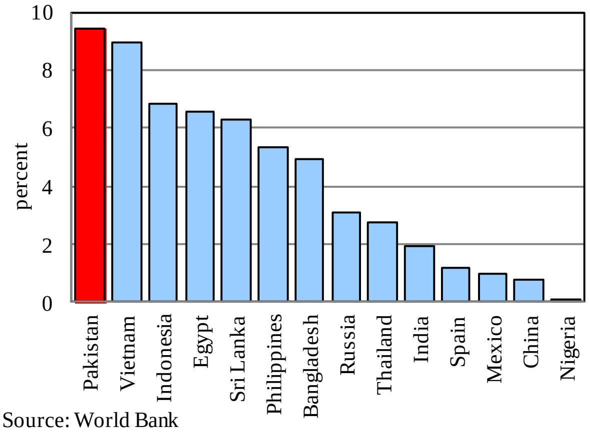
[32] Income from shipping business of the Pakistan National Shipping Corporation (PNSC) in FY16 was Rs 12.4 billion, against Rs 15.4 billion in FY15.
[33] Though nominal in overall terms, interest payments on short-term government loans grew more than three times during the year and reached US$ 68 million in FY16, against US$ 22 million in FY15.
[34] After reaching a peak of Rs 463.5 billion in FY14, revenues of the telecom sector declined to Rs 449.6 billion in FY15, and had reached Rs 333.2 billion during Jul-Mar FY16 (as per latest available data). Source: Economic Survey of Pakistan 2015-16.
[35] After reaching 79.9 percent by end-June 2014, teledensity had dropped to 70.9 percent by end-June 2016 (source: Pakistan Telecommunication Authority).

As said earlier, relatively higher reinvested earnings (which have a net zero impact on reserves position due to offsetting inflows recorded in the financial account) were also responsible for inflating the primary income deficit. Specifically, reinvested earnings of foreign firms grew almost *three times* in FY16, to US$ 744 million.

Worker remittances

External developments have been largely unfavourable for cross-border remittances over the past two years. These mainly include: (i) worsening in fiscal profiles of Gulf governments in an era of low oil price;[36] and (ii) tepid economic growth in the developed world (which has translated into subdued inflation and stagnant wages),[37] as well as tightening regulations governing international fund transfers.

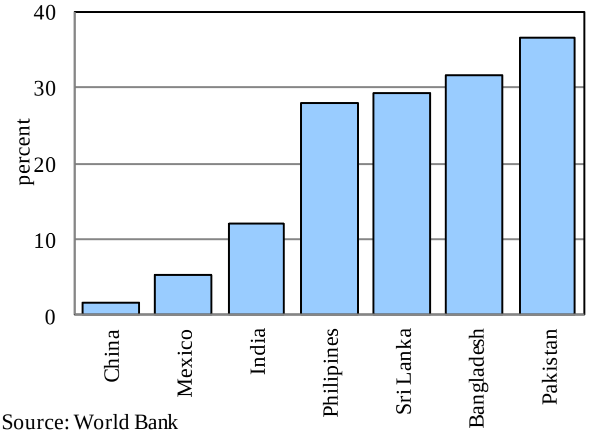
Figure 6.6: Growth of Remittance Inflows (2011-2015)*



Source: World Bank
* Compound annual growth rate

In this challenging global environment, remittances into Pakistan passed their target for FY16 and reached almost US$ 20 billion. Besides, Pakistan continued to be among those countries where remittances posted a YoY increase in 2015.[38] This should not be entirely surprising, as remittance growth in Pakistan has been exceptionally strong over the past 5 years (**Figure 6.6**). As a result, the country's dependence on these inflows has gradually increased over the last five years, and is relatively high among regional and developing countries (**Figure 6.7**).

Figure 6.7: Remittances as Percentage of Current Account Receipts (2015)



Source: World Bank

Looking at major remittance corridors for Pakistan indicates that the steep fall in oil prices has pushed many GCC states into a fiscal consolidation mode. While most GCC states responded by drawing down on their sizable FX reserves, reducing subsidies, and cutting down their overall spending, some also resorted to international capital markets and issued sovereign debt. At the same time, they have resorted to reigning in their spending, with the axe falling heavily on infrastructure spending. For instance, Saudi Arabia has reduced its budgetary allocation for infrastructure and transportation by a massive 62.1 percent YoY in CY2016 (to SAR 23.9 billion from SAR 63 billion); its overall expenditures have been slashed 13.8 percent.[39]

From Pakistan's perspective, the slowdown in inflows from Saudi Arabia is obviously worrisome. While there was ample anecdotal evidence earlier on that Pakistani workers were facing delayed

[36] The fiscal balance of the GCC region went from a surplus of 10.2 percent of GDP in 2013 to a deficit of 9.9 percent in 2015 (source: IMF Regional Economic Outlook: Middle East and Central Asia).
[37] For instance, average weekly private earnings in the US increased at a CAGR of just 2.1 percent between July 2011 and June 2016 (source: US Bureau of Labor Statistics).
[38] Some major remittance recipients, like France, Germany, India and Russia, recorded YoY declines in remittance inflows in 2015.
[39] Source: Ministry of Finance, Saudi Arabia.

salaries and visa-related issues, it has recently been confirmed officially that thousands of workers, employed at two Saudi companies, are stranded in that country.[40] Granted that the number of affected workers might appear quite small when compared with the size of the Pakistani diaspora living in the country,[41] the *extent* of slowdown in remittances from Saudi Arabia indicates that there might be more Pakistani workers who are also facing similar challenges.

Table 6.5: Region-wise Worker Remittances

	Values in million US$			YoY growth (percent)	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
USA	2,468	2,703	2,525	9.5	-6.6
UK	2,180	2,376	2,580	9.0	8.6
GCC	9,699	12,035	12,756	24.1	6.0
Saudi Arabia	4,729	5,630	5,968	19.1	6.0
UAE	3,110	4,232	4,365	36.1	3.2
Abu Dhabi	1,513	1,751	1,418	15.7	-19.0
Dubai	1,550	2,412	2,878	55.6	19.3
Other GCC	1,860	2,173	2,423	16.8	11.5
EU	432	364	418	-15.7	14.8
Total	**15,838**	**18,720**	**19,917**	**18.2**	**6.4**

Source: State Bank of Pakistan

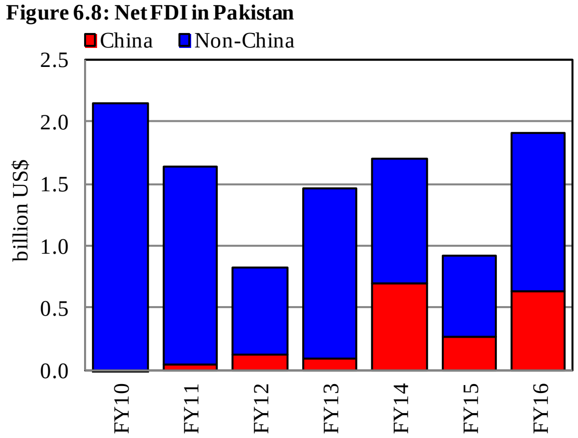
A similar slowdown was noted in inflows from the UAE, with Abu Dhabi almost entirely responsible for this deceleration (**Table 6.5**).[42] In fact, Abu Dhabi is one of only two emirates in the entire GCC from where remittances have declined on a YoY basis in FY16 (the other being Sharjah).[43]

This can be explained by oil's relatively high share in Abu Dhabi's overall revenues.[44] Like Saudi Arabia, it has resorted to international creditors to shore up its FX reserves,[45] and instituted cuts to its overall spending. In contrast, remittances from Dubai remained strong, rising 19.3 percent YoY in FY16. Given its low dependence on oil, Dubai has been largely insulated from the oil recession.

6.4 Financial account

Despite a notable increase in private inflows, activity in financial accounts was dominated by public sector debt flows. Higher disbursements of project and program loans; borrowing from the IMF; issuance of Eurobond; and commercial borrowings, pushed these inflows to US$ 5.9 billion in FY16, which were exactly double the amount of loans availed in FY15.[46] In aggregate, the surplus in the financial account was more than sufficient to finance the current account deficit and to keep the country's FX reserves on high growth trajectory.

Figure 6.8: Net FDI in Pakistan



Source: State Bank of Pakistan

[40] On August 4, 2016, Prime Minister Nawaz Sharif approved a relief package worth Rs 500 million for the families of the Pakistani workers at two Saudi companies, who were stranded in the Kingdom; each family is to be provided Rs 50,000. The government is also undertaking efforts to provide food and medical supplies to Pakistani workers stuck in labour camps in Saudi Arabia.

[41] By end-December 2013, a quarter of all overseas Pakistanis (numbering over 1.9 million) were living in Saudi Arabia (source: Ministry of Overseas Pakistanis and Human Resource Development Yearbook 2013-14).

[42] Remittance growth from the UAE slowed to 3.2 percent in FY16, from 36.1 percent in FY15.

[43] Remittances from Sharjah declined 1.7 percent YoY in FY16, after rising 48.5 percent YoY in FY15.

[44] Oil accounted for 93 percent of overall Abu Dhabi government revenues in 2013 (source: Abu Dhabi Economic Report 2014, Department of Economic Development). In contrast, oil accounted for a lower 78.6 percent of overall government revenues for the entire UAE (source: IMF Staff Report Country Report No. 14/187).

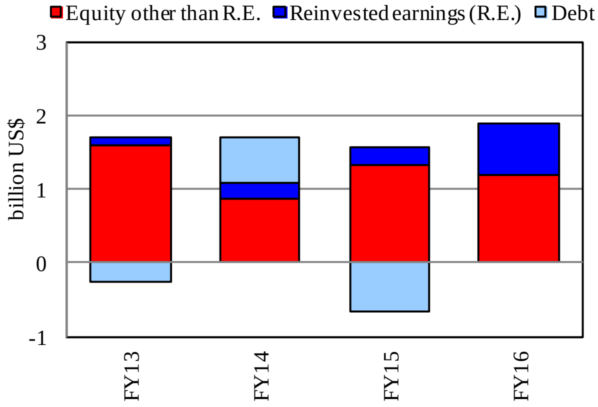
[45] Abu Dhabi raised US$ 5 billion in May 2016 by issuing 5- and 10-year sovereign bonds, to partly finance its expected budget deficit of US$ 10.1 billion for 2016.

[46] For detailed discussion on debt, please see **Chapter 5**.

Foreign direct investment

Net FDI in Pakistan was dominated by China, with investments from the country primarily arriving in CPEC-related power projects. As net inflows from the US, UAE and UK dropped significantly, China contributed 32.9 percent to net FDI flows in FY16 (**Figure 6.8**). This, together with higher net investment from some other countries, led to a sizeable increase of US$ 978.3 million in net FDI over the last year; pushing the level to US$ 1.9 billion in FY16. Having said that, the level of net FDI is still very low – less than one percent of GDP. Moreover, 39.1 percent of the net FDI was financed by retained earnings, which surged to US$ 744 million in FY16 – three times the amount recorded in the previous year (**Figure 6.9**).

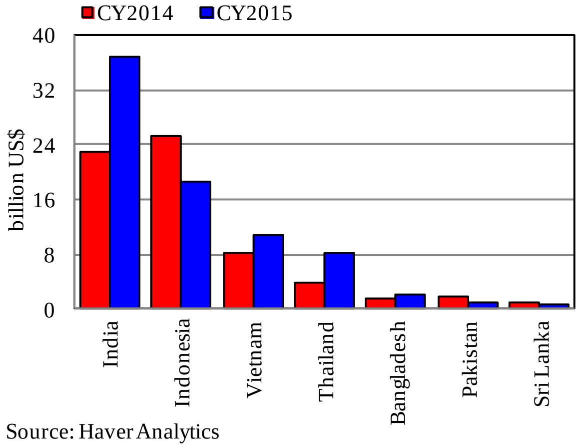
Figure 6.9: Composition of Net FDI in Pakistan



Source: State Bank of Pakistan

On the other hand, regional economies remained the most attractive destination for foreign investors, and witnessed a significant increase in their net FDI inflows (**Figure 6.10**). This could be attributed to their relatively strong economic performance, and favourable macroeconomic and business environment, which is visible from their higher ranks on the Global Competitiveness Index (GCI) and the Ease of Doing Business. These indices generally play an important role in attracting foreign direct investment into the country.

Figure 6.10: Net FDI in Regional Economies



Source: Haver Analytics

Among other factors, the fall in international oil prices also undermined FDI flows to the oil and gas industry, as oil majors (like BP Plc, Chevron and ExxonMobil) cut their capital spending in 2015.[47] Pakistan's oil and gas E&P industry was not an exception: net FDI flows contracted for the third year in a row. In addition, divestment by California-based Chevron Corporation, which decided to dispose-off its downstream petroleum assets (like lubricants, fuel stations, etc.) from Pakistan, Egypt and Australia, contributed to net outflows from the petrochemical sector in FY16. Though this transaction had notable implications for FDI flows, there was hardly any impact on real economic activity, as Chevron's Pakistan operations were acquired by Total Parco Pakistan Ltd in July 2015.

In contrast to oil and gas sector, net FDI into the power sector surged to US$ 751.3 million in FY16 – i.e. 3.4 times the net flows received in FY15 (**Table 6.6**). China emerged as the top investor in Pakistan's coal-based power projects. Among other sectors, net investments in telecom posted a

[47] Chevron has already announced further cuts in its capital spending for the years 2017 and 2018.

strong recovery in FY16; yet, this was mainly due to a one-off inflow into an MNC by its parent company (in June 2016) so it could acquire a Next Generation Mobile Services spectrum license.[48]

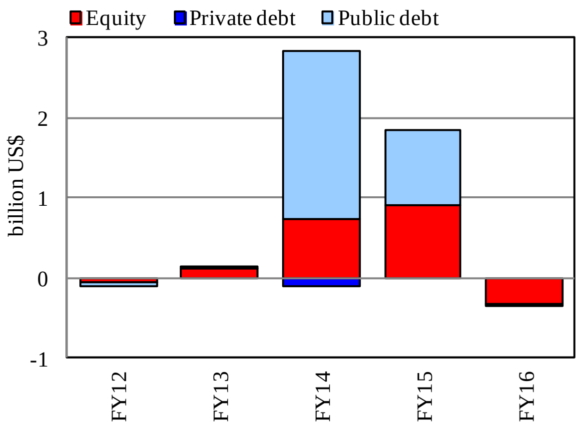
Table 6.6: Sector-wise Inflow of Foreign Direct Investment in Pakistan
Million US$

	FY14			FY15			FY16		
	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI
Power	247	-175.5	71.4	270.1	-50.8	219.3	809.1	-57.8	751.3
Financial business	291.4	-98.6	192.8	407	-150.7	256.4	391.9	-102.9	289.0
Oil & gas exploration	511.5	-9.5	502	303.8	-4.8	299.0	266.6	-17.7	248.9
Telecommunication	904.6	-474.7	429.9	948	-882.2	65.7	377.9	-131.1	246.8
Chemicals	128.5	-33.6	94.9	94.1	-38.7	55.3	106.0	-17.4	88.5
Transport equipment	55.2	-2.1	53.1	64.3	0	64.3	46.6	-0.4	46.2
Beverages	25	-2	23	96.6	0	96.6	41.9	0	41.9
Construction	37	-8.2	28.8	56	-2.4	53.5	40.3	-3.4	36.8
Textiles	11.2	-11.4	-0.2	49.6	-5.7	43.9	25.9	-5.9	20.0
Metal products	10.9	-2.3	8.6	4.7	-59.8	-55.2	1.6	-0.9	0.8
Food	111	-27.7	83.3	48.6	-50.6	-2	32.9	-88.9	-56.0
Petro chemicals	0	-0.5	-0.5	0	0	0	0.2	-136.3	-136.1
Others	514.1	-302.7	211.5	389.2	-563.4	-173.9	620.1	-297.2	322.9
Total	2,847.4	-1,148.8	1,698.6	2,732.0	-1,809.1	922.9	2,761.1	-859.9	1,901.2

Source: State Bank of Pakistan

In sum, net FDI flows in FY16 were a function of both international developments and country-specific factors. While the international scenario is less likely to see a visible improvement in the foreseeable future, positive developments on the domestic front could serve as a major pull factor. China is likely to remain the top investor in Pakistan, with power sector the main recipient of FDI – through inflows under CPEC projects. Beverages and auto sectors are also well placed to fetch new investments owing to strong domestic demand.[49] In addition, the planned divestment of Pakistan Steel Mills, PIA and Kot Addu Power Company Ltd. (KAPCO) will bring in FDI inflows.

Figure 6.11: Composition of Portfolio Investment



Source: State Bank of Pakistan

Portfolio investment

Unlike FDI, portfolio investment in Pakistan is dominated by public sector flows. Compared to the previous two years, public sector investments dropped significantly in FY16 (**Figure 6.11**).[50] In effect, inflows from the Eurobond issued in September 2015 were offset by an almost equal outflow as a result of another Eurobond's repayment in March 2016.

[48] In FY15, bulk of telecom outflow was due to China Mobile converting a 'loan' into 'equity', which it had granted to its local subsidiary (Zong) in May 2014 to acquire 3G and 4G licenses. The loan was repaid (an outflow) by turning it into corresponding equity (an inflow).
[49] Coca-Cola (a leading US investor in Pakistan) plans to further invest US$ 350 million in the country (Source: Ministry of Finance, press release No. 1334, October 8, 2015).
[50] During FY16, around 98 percent out of the total inflows in Special Convertible Rupee Account (SCRA) were received as equity, with almost negligible amount going into T-bills and PIBs.

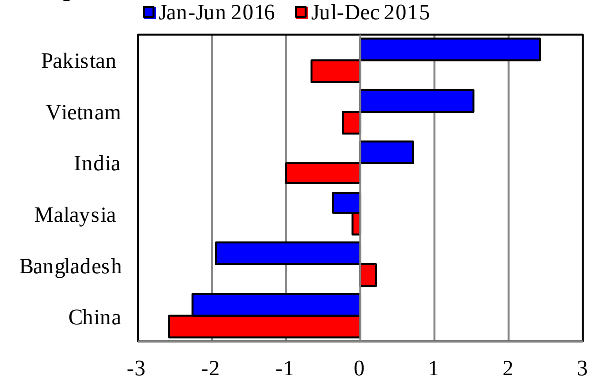
Equity flows also turned negative in FY16. This was primarily a function of global developments, as equity markets across the world witnessed episodes of volatility due to several factors: (i) Chinese yuan's devaluation in August 2015; (ii) federal funds rate hike in December 2015; (iii) China's stock market crash in January 2016; (iv) oil prices dropping below US$ 27 a barrel in mid-January 2016; and (v) Britain's vote to leave the EU in June 2016.

Pakistan's equity market – with an average return of 0.9 percent in FY16 – was amongst the least affected markets in the region (**Figure 6.12**). Though it exhibited pronounced volatility during the first three quarters, the local bourse has been on an upward trajectory since the rebound of global oil prices in February 2016.

The market gained further momentum when the Morgan Stanley Capital International (MSCI) decided to reclassify Pakistani stock market in the Emerging Markets (EM) Index in mid-June 2016, tempting foreign investors to go long on Pakistani equities amid volatile global market conditions (**Figure 6.13**).[51]

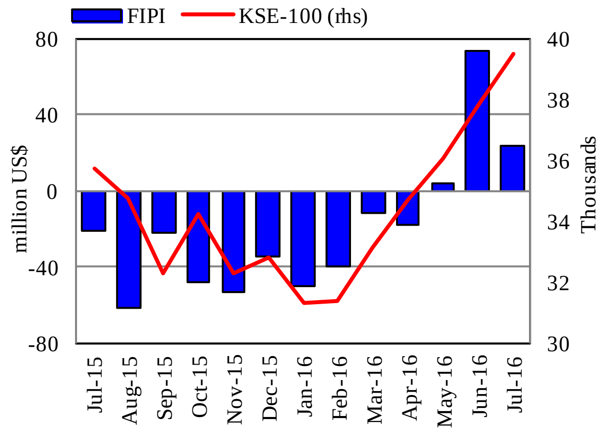
Although uncertainties still abound, Pakistan is expected to stay on foreign investors' radar considering the improvement in macro indicators and the MSCI upgrade.

Figure 6.12: Regional Economies' Equity Market Performance during FY16*



Source: Haver Analytics; *: average percent growth in stock index points

Figure 6.13: Pakistan Equity Market in FY16

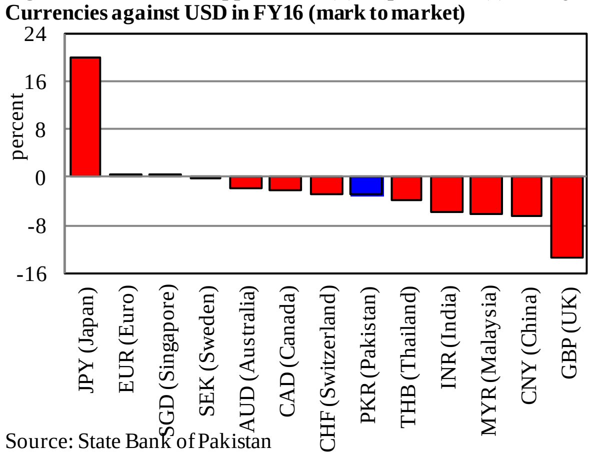


Source: State Bank of Pakistan, NCCPL

6.5 Exchange rate and reserves

Despite huge volatility in international currency markets, Pakistan's FX market remained largely stable in FY16. In fact, currencies of commodity exporting countries, especially Brazil and Russia, came under pressure during the first quarter due to the continuous fall in prices of primary commodities. China also adjusted its reference rate in the wake of falling exports and decelerating economic activity. This paved the way for depreciation of other regional currencies, including those of India, Sri Lanka, and Pakistan in August 2015.

Figure 6.14: Nominal Appreciation (+)/Depreciation (-) of Major Currencies against USD in FY16 (mark to market)



Source: State Bank of Pakistan

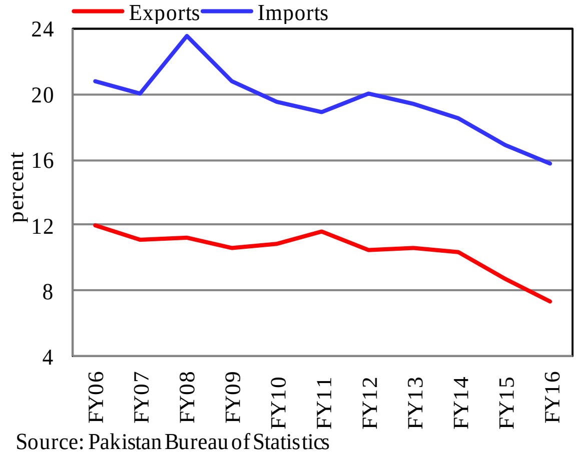
[51] Net buying by foreign investors rose to US$ 74 million in June 2016 (source: National Clearing Company of Pakistan Limited).

The second quarter was more eventful as the USD appreciated against major currencies (like Euro and Pound Sterling) in the run up to the hike in the federal funds rate, which occurred in December 2015. At the same time, the EU and Japan were contemplating the implementation of negative interest rates. This divergence in monetary policies in advanced economies also kept the currency market under pressure.

The second half of FY16 was equally challenging. Two main currencies reflected extreme movements against the greenback: the Japanese yen gained 14.6 percent (when the USD fell sharply in February 2016 owing to slumping oil prices and global equities, pushing investors into safe-haven currencies like the JPY); and the British pound depreciated 7.7 percent in June 2016 following the *Brexit* vote. This further pushed up the Japanese yen (**Figure 6.14**).

In the midst of this volatile environment, the PKR remained largely stable following a small depreciation during the initial months of FY16.[52] This stability came from a comfortable balance of payments position. Specifically, the external sector started to improve from November 2015 onwards, when a sharp decline in oil prices contained the import bill. In fact, the current account posted surpluses in February and March 2016. The resultant FX savings were supplemented by higher IFI inflows. As a result, the country's FX reserves increased by US$ 4.4 billion during the year, to reach an all time high of US$ 23.1 billion by the end-June 2016.

Figure 6.15: Pakistan Trade Performance (as % of GDP)

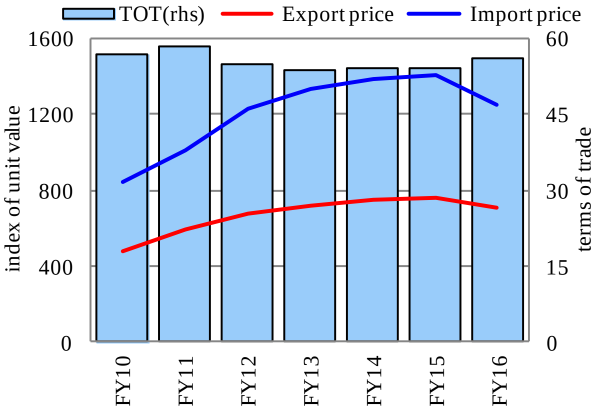


Source: Pakistan Bureau of Statistics

6.4 Trade account (Customs records)[53]

Despite favourable terms of trade, Pakistan's trade deficit expanded by 7.9 percent and amounted US$ 23.9 billion in FY16; in terms of GDP, it reached 8.4 percent. This deterioration was entirely driven by a sharp fall in exports, as imports contracted marginally during the year (**Figure 6.15**). Dropping by double digits in percentage terms, exports reached US$ 20.8 billion, missing their target for the sixth year in a row. Similarly, imports also shot passed their target; besides, the minor reduction in imports was insufficient to contain the trade deficit.[54] The persistence of such deviations from targets undermines policy formulation by increasing uncertainty about the economic outlook.

Figure 6.16: Pakistan's Terms of Trade



Source: Pakistan Bureau of Statistics

[52] Between July and November 2015, the PKR depreciated 3.7 percent against the US dollar.

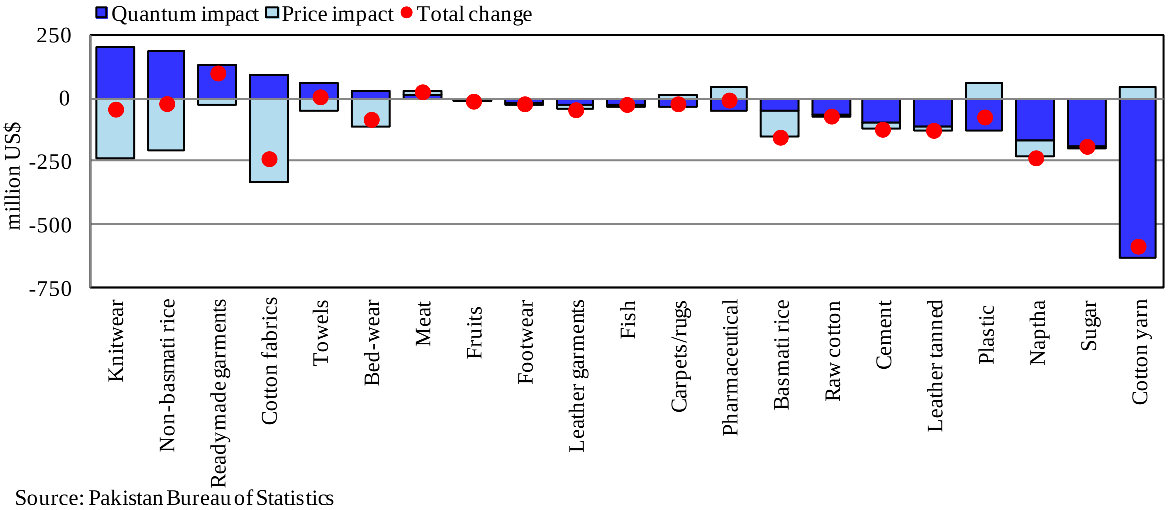
[53] This section is based on customs data reported by the PBS. The information in this section does not tally with the payments record data, which is reported in **Section 6.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

[54] Exports missed their target of US$ 25.5 billion, while imports exceeded their target of US$ 43.3 billion for the year. In fact, Pakistan's imports have been consistently higher than their respective targets since FY10.

The trade performance in FY16 appears more uncomfortable, as the fall in international commodity prices entails positive implications for Pakistan. A relatively sharp fall in the unit value of imports as compared to the unit value of exports, led to a 3.7 percent improvement in Pakistan's terms of trade during FY16 (**Figure 6.16**). However, the decline in export volumes for the second consecutive year, and a surge in import quantums, offset the benefits of lower import prices. Moreover, the US$ 3.2 billion in savings on POL imports were largely offset by a surge of US$ 3.0 billion in non-oil imports.

<u>Merchandise exports</u>
Pakistan's exports contracted 12.2 percent in FY16, after falling by 5.7 percent in FY15. The reduction was broad-based as it was contributed by almost all major product categories; key exceptions were meat, readymade garments and surgical instruments (**Figure 6.17**). Both international and domestic factors were at play: weak external demand because of sluggish global economic activity and lower domestic production of major crops (especially cotton) hit export quantums; simultaneously, the fall in international commodity prices resulted in lower unit receipts for exporters. The impact of these factors was exacerbated by the relatively high cost of production, as well as long-lasting competitiveness issues.

Figure 6.17: Breakdown of Change in Key Exports in FY16 over FY15



Source: Pakistan Bureau of Statistics

Textile: Lack of diversification remains the key issue
Pakistan is heavily dependent on textile for its exports, with the sector contributing 60 percent to overall merchandise exports. At a time when exports are down at a global level, the concentration of Pakistan's exports (in terms of both products and markets) makes it much more vulnerable to adverse developments affecting these countries or products (**Box 6.2**).

In FY16, textile exports fell 7.5 percent, after declining 2.0 percent in FY15. For the past few years, Pakistani exporters have suffered from a loss in market share in the key US market. This is mainly because they have not been able to capture the shift in US consumers' preference from cotton to synthetic fiber (**Figure 6.18a** and **6.18b**).[55] Pakistan's share in the US' import of textile has been gradually declining; yet, in FY16, the country's share in the US' cotton imports has slightly increased. Specifically, cotton apparel accounted for more than 90 percent of total US apparel imports from Pakistan in FY16.

[55] The share of man-made fiber apparel imports in total US imports have gradually increased from 58 percent in FY06 to 70 percent in FY16 (source: OTEXA).

Figure 6.18a: Share of Pakistan in Total US Textile Imports

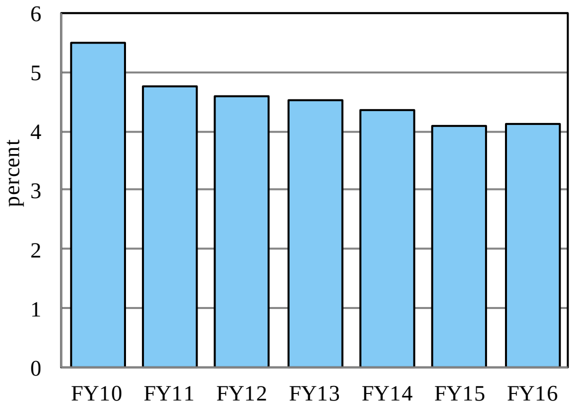
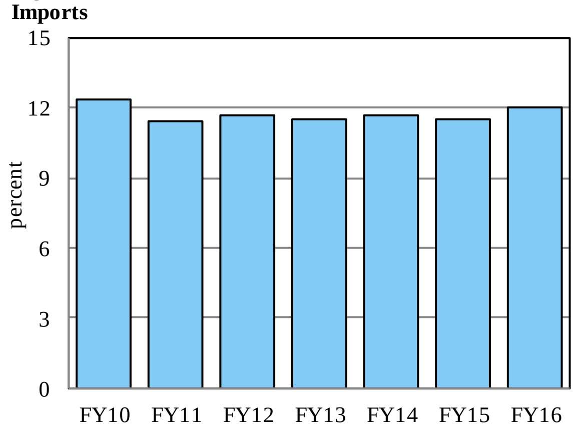


Figure 6.18b: Share of Pakistan in US Cotton Textile Imports



Source: Otexa

These changes in US consumer preferences cannot be ignored. The situation demands that our textile exporters conduct a holistic analysis of the shifts taking place in the US market, and appropriately re-adjust their product lines. Yet, even here, they have to be watchful. For example, if Pakistani exporters focus on high value added cotton apparels that are especially designed for the US market, a potential downside risk could be a declining share of cotton apparel in US markets. Another option is to introduce policies for the development of synthetic textile industry; but this will entail a long gestation period.

Meanwhile, exports of low value-added items (i.e. raw cotton, cotton yarn and fabric) fell, largely due to subdued demand from China. Despite being the largest exporter of high value added textiles to the US and EU– China's share in these two markets has been declining.[56] This, in turn, has lowered its demand for low value added products (yarn and fabric) from source countries, including Pakistan.

Table 6.7: EU's Textile &Clothing Import from Major Countries

	Value in billion US$			*Share in percent*		
	FY14	**FY15**	**FY16**	**FY14**	**FY15**	**FY16**
China	41.2	40.3	36.5	39	38.7	36.1
Bangladesh	14.7	15.4	16.2	13.9	14.8	16
India	7.3	7.2	6.9	6.9	6.9	6.8
Pakistan	3.7	4.2	4.3	3.5	4.0	4.3
Turkey	13.7	12.3	12.2	13	11.8	12.1
Vietnam	2.9	3.2	3.5	2.7	3.1	3.5
Total EU-28	105.6	104.3	101.2	100	100	100

Source: Eurostat

In the case of EU market, textile exports from a number of countries (including India and China) contracted in FY16. However, countries like Pakistan and Bangladesh, which have preferential access to the EU market, saw their textile exports rise marginally during the year.[57] Pakistan's share in the EU's textile imports has also increased from 4.0 percent in FY14 to 4.3 percent in FY16 (**Table 6.7**).

Though this is a welcome development, the need for utilizing this preferential status to further consolidate Pakistan's position can hardly be overemphasized. Textile exporters must better position themselves to face increasing competition in the EU market. In addition, with the significant drop in imports from China, buyers in the EU are gradually shifting to the next cheapest option. Pakistan should redouble its efforts to gain from these changes in global market dynamics.[58]

[56] The US' imports from China decelerated to 1.3 percent in FY16 as compared to 8.1 percent in FY15 (source: OTEXA). In the EU market, China's share in total clothing and textile decreased to 36.1 percent in FY16, from 38.7 percent in the same period last year (source: Eurostat).
[57] Pakistan has been granted the *GSP Plus* status, and Bangladesh enjoys the *Everything But Arm* (EBA) facility with the EU.
[58] Though the trade implications of *Brexit* are yet to unfold, Pakistan must prepare itself for trade negotiations with the UK and hope to get an agreement in line with the EU's GSP Plus status.

Box 6.2: Export Diversification in Pakistan

The change in the composition of a country's export destination or product mix is broadly considered as export diversification. It can be also described as the progression from traditional to non-traditional exports, or the spread of production over different sectors. Export diversification is necessary for an effective trade policy, mainly because it reduces a country's vulnerability to external shocks, i.e. price and demand fluctuations in the international market, market saturation, and, more importantly, shifts in a major market's economy, by lowering dependency on specific exports. It is worth noting that while the impact of an economic shock will be reflected through a drop in export earnings, the *magnitude* of this drop will depend on the country's export composition and major trading partners. Hence, countries with a lower level of export diversification often face difficulties in maintaining their export share in the international market.

Table 6.2.1: Export Diversification by Markets
average percent share

	FY01-05	FY06-10	FY11-15
EU-28	27.7	25.8	25.7
UK	6.9	5.3	5.6
Germany	5.0	4.2	4.6
Spain	2.1	2.5	2.5
Netherlands	2.6	2.5	2.3
Italy	3.2	3.5	2.7
USA	24.1	21.2	15.1
UAE	7.9	8.8	7.3
China	2.6	4.0	9.1
Afghanistan	3.1	6.6	8.6
Bangladesh	1.3	1.9	3.1
Saudi Arabia	3.2	2.1	1.8
India	0.9	1.7	1.4
Others	29.3	27.9	27.9

Source: Pakistan Bureau of Statistics

Market diversification

Pakistan's overall exports have increased from US$ 9.2 billion in FY01 to US$ 23.7 billion in FY15. Although exports are important for growth and economic envelopment, Pakistan has been struggling to expand and diversify its export basket for a long time. Yet, there has been some improvement on this front during the last 15 years (FY01 to FY15) (**Table 6.2.1**). The European Union (EU-28) has remained the dominant export market, and its share in Pakistan's overall exports has risen over the past five years, to around 32 percent currently. This rise is mainly explained by rising shipments to the UK, Germany, Spain, Netherlands and Italy; in fact, these five markets captured more than 70 percent share in Pakistan's total exports to EU.

Some diversification was also noted in other export destinations. The US' share in Pakistan's exports went down from 24.1 percent, on average, during FY01-05 to 15.1 percent in FY11-15. In contrast, China has emerged as the third largest export destination for Pakistan. Going forward, as subdued global economic growth keeps import demand from major markets in check, it has become imperative that Pakistan diversify its export destinations.

Product diversification

In the past 10 years, more than 70 percent of Pakistan's total exports remained concentrated in three major categories: textile manufactures, rice, and leather products (**Table 6.2.2**). Within these products, the textile group alone had a 54.6 percent share in overall exports, on average, during FY11-15. Whereas, textiles' share in overall exports had been declining between FY06-FY13, this trend reversed from FY14. The shift occurred as Pakistan was granted the GSP Plus status by the EU, and corresponded with the country's rising share in the EU's textile imports. The increase came about as the share of high value added items, i.e. knitwear, readymade garments, home textiles and towels etc., began rising; between FY13 and FY16, the share of these products in overall textile exports rose from 32.5 percent to 42.7 percent. This trend bodes well from export diversification perspective within the textile group. Meanwhile, the share of rice exports has decreased, with diversification noted from basmati to non-basmati variety. The share of leather and leather manufactures has also gone down during the period.

Table 6.2.2: Export Concentration by Products (percent share)

	FY06-10	FY11-15
Rice	9.2	8.5
Basmati	4.5	3.1
Non basmati	4.7	5.4
Textile	57.6	54.5
Low value added	19.2	20.0
High value added	38.5	34.5
Other manufactures	18.4	18.5
Leather	5.2	4.3
All others	14.8	18.5

Source: Pakistan Bureau of Statistics

In conclusion, although there is some degree of export diversification with respect to destinations and products, Pakistan's major exports are still concentrated in a few markets and products. Policymakers need to develop a strategy that promotes innovation, R & D, and trade diversification. This would help domestic industries to improve its production base and integrate with global businesses.

Food group: A victim of lower international commodity prices

Food sector exports, which account for 19.0 percent of Pakistan's merchandise exports, were severely impacted by the fall in international commodity prices.[59] Rice, which has an outsized 45 percent

[59] Overall food exports dropped by 12.6 percent YoY in FY16, after falling by 1.3 percent in FY15.

share within food exports, was especially hit by lower prices, as volumetric exports (mainly non-basmati) recorded healthy growth; although export receipts from rice dropped 8.6 percent YoY in FY16.

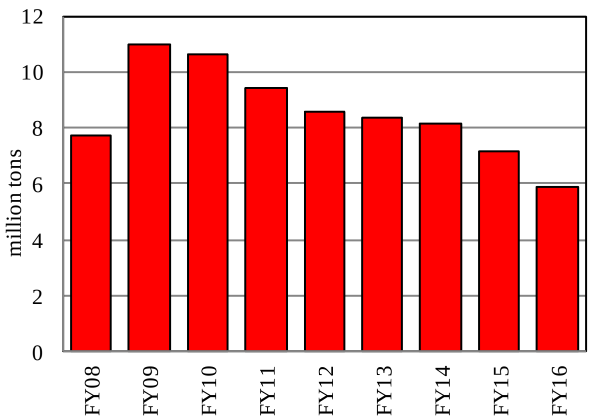
Among rice varieties, basmati exports have been gradually declining since FY12 (in terms of quantity). Pakistani traders have been facing stiff competition from India in exporting this premium variety to some countries, particularly those in the Middle East (Bahrain, Iraq, UAE, and Oman). Despite having an exportable surplus, the loss of market share is a reflection of waning competitiveness, which may have its roots in lower productivity and higher cost of production. In addition, exports of fragrant rice (a low-value product) to Iran have yet to pick up pace despite earlier expectations after the lifting of international sanctions on that country.

As far as non-basmati rice is concerned, the fall in export receipts was driven by lower international prices, as demand for the product, especially from Benin, Madagascar, Tanzania, Afghanistan and China, remained strong.[60] However, shipments to Mauritania, Kenya and Mozambique were lower mainly due to imposition of import duties/trade restrictions by these countries. Besides, Thailand – a major non-basmati rice exporter – has also firmed up its supplies to African countries. Pakistani traders should take this challenge seriously and explore other markets/destinations to enhance their exports, as Thailand may price out Pakistan in the African market.

Cement: A tale of two markets

The downward trend in cement exports, which had set in from FY09, continued into FY16. Export volumes dropped 22.3 percent to 6.0 million tons, from 7.7 million tons in the previous year (**Figure 6.19**). The relatively large decline in FY16 is mainly attributable to weak demand from Afghanistan, and the imposition of anti-dumping duty by South Africa. These two countries accounted for 22.5 percent of the reduction in cement exports in FY16. In case of Afghanistan, two factors were responsible: (i) a slowdown in development work as a majority of NATO forces have exited the country; and (ii) the influx of cheap Iranian cement into Afghanistan, which gave tough competition to Pakistani cement exporters.

Figure 6.19: Pakistan's Cement Exports



Source: APCMA

Meanwhile, South Africa, the second largest market, had imposed an anti-dumping duty in May 2015, ranging from 14 to 77 percent, on Pakistani cement. Despite a major local cement-maker challenging the duty in the International Trade Administration Commission of South Africa, the duty would remain in place for five years.

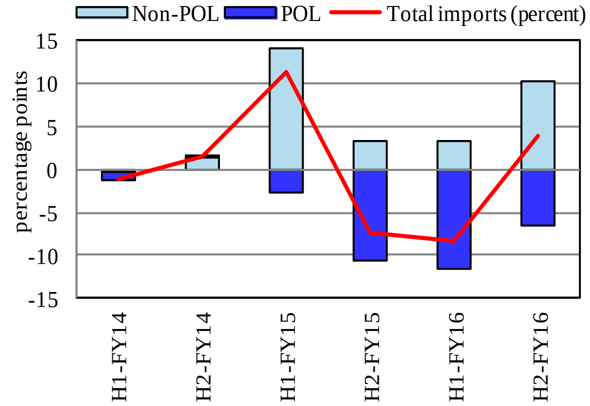
On the other hand, cement exports to India increased 42.5 percent YoY to almost 1.0 million tons. State-led investment in road infrastructure and higher spending on housing and construction increased the demand for cement in the neighbouring country. Yet, owing to its small share in Pakistan’s cement exports (17 percent in FY16), the notable rise in shipments to India could not offset the decline from other countries. On a positive note, cement demand from India is likely to remain strong

[60] Quantum exports of non-basmati rice rose 12.6 percent in FY16, after rising 9.5 percent in FY15.

going forward, as the government pushes for large infrastructural projects announced in its 12th five year plan (2012-17).

Here, it is important to note that vibrant domestic construction, progress on mega infrastructure projects, and growing activity under CPEC, seem to have reduced the exportable cement surplus. Domestic cement sales are growing at a healthy pace, and demand for the material is likely to remain strong.[61] In fact, domestic sentiment is so strong that multiple cement companies have announced capacity expansions.

Figure 6.20: POL and Non-POL Contribution to Import Growth



Source: Pakistan Bureau of Statistics

Import of Goods

Low international commodity prices, particularly of oil, provided some breathing space to Pakistan's import payments, which declined 2.5 percent in FY16. But the decline in overall imports was noted in the first half of the year, with imports recording a 3.9 percent increase in H2-FY16; reflecting a modest recovery in oil prices as well as higher demand for capital goods to support growing economic activity (**Figure 6.20**).

Table 6.8: Import of Energy

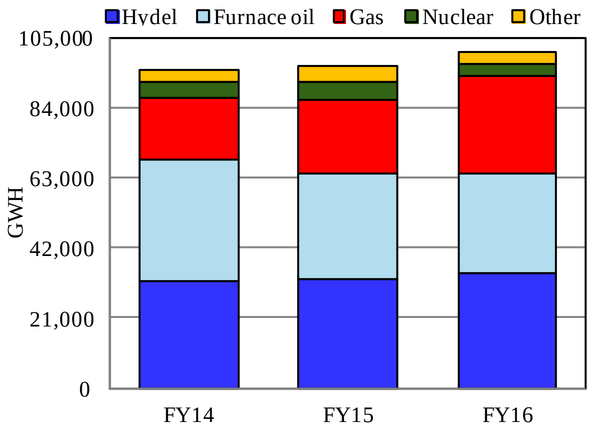
	Quantity (000MT)			Growth rate (%)	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
High speed diesel	2,647	3,185	3,081	20.3	-3.3
Furnace oil	6,584	6,170	5,990	-6.3	-2.9
Crude oil	7,945	8,254	8,492	3.9	2.9
Motor spirit	2,193	3,125	4,193	42.5	34.2
Other	130	49	118	-62.4	141.8
Total*	19,499	20,782	21,874	6.6	5.3
LNG **	-	189	1,235	-	-

*Sources: Oil Companies Advisory Council; ** Pakistan Bureau of Statistics

Petroleum imports

Petroleum imports contracted by 35.3 percent in FY16 to US$ 7.6 billion, against US$ 11.8 billion in FY15. This reduction was entirely driven by the slump in global oil prices, as quantum imports grew by 5.3 percent YoY (**Table 6.8**).[62] Within POL products, the demand for motor spirit was the strongest, which led to a 34.2 percent rise in its import volumes. According to the OCAC, petrol sales grew by 22.7 percent in FY16, after rising 21 percent in FY15. This higher demand stemmed from: (i) 18 percent reduction in petrol prices in FY16 over FY15; (ii) vehicles switching from CNG to petrol; and (iii) increase in car and motorcycle sales.[63]

Figure 6.21: Use of Various Fuels for Power Generation



Source: NEPRA

In the case of furnace oil, a small decline of 2.9 percent in import volumes was noted, reflecting the change in the country's energy mix. Demand for furnace oil eased as power

[61] Domestic cement dispatches recorded an increase of 17 percent YoY in FY16 and reached 33 million tons (source: All Pakistan Cement Manufacturers Association).
[62] Source: Oil Companies Advisory Council.
[63] According to PAMA, car sales grew 20 percent YoY in FY16.

generation companies, which are the major consumers of FO, utilized more gas for thermal generation. In addition, demand for FO was also suppressed by rising LNG imports (**Figure 6.21**).[64] As far as crude oil is concerned, lower petroleum production by local refineries mainly caused a deceleration in its imports during the year.[65]

Non-oil imports
In sharp contrast to POL, non-oil imports grew by 8.9 percent in FY16, after rising by 12.6 percent in FY15. However, most of this increase was noted in capital goods, which tend to support economic activity. Three products – machinery, raw cotton and motor vehicles – contributed 5.6 percentage points to the *increase* in non-oil imports.

LNG, which helped ease energy shortages to an extent, emerged as one of the important imported commodities in FY16.[66] LNG imports increased from US$ 128.4 million in FY15 to US$ 566.8 million in FY16. With the development of LNG import infrastructure, and the country's growing energy requirements, LNG imports are going to be a recurring feature on the country's import bill.

Machinery imports: Reflecting growing investments in power
Machinery imports, a leading indicator of economic activity, recorded double- digit growth for the third consecutive year (**Table 6.9**). In fact, import of power generation and electricity distribution machinery accounted for more than 90 percent of the *rise* in machinery group imports; this corresponds with higher investment flows in the power sector, especially CPEC-related power projects.[67] Gas turbines, heavy generators and transmission-related items, were in high demand. Besides, the rise in import of construction and mining machinery tallies with healthy growth recorded by these sectors (**Chapter 2**).

Table 6.9: Imports of Major Categories

	Billion US$		Percent growth	
	FY15	**FY16**	**FY15**	**FY16**
POL	11.8	7.6	-20.6	-35.3
Non-POL	34	37.1	12.6	8.9
Food	5	5.4	18.5	7.2
Machinery	7.4	8.6	14.9	15.6
Transport	2.7	3.0	21.9	9.7
Textile	2.6	3.1	-4.3	22.8
Agri & chemical	7.5	7.2	11.8	-3.6
Metal	3.7	4.1	20.3	11.2
Others	5.1	5.6	6.1	11.3
Total imports	45.8	44.7	1.7	-2.5

Source: Pakistan Bureau of Statistics

Textile and telecom sectors have also traditionally been major importers of machinery items. In FY16, the modest rise in the import of textile machinery was offset by the decline in import of telecom equipment. Yet, cell phone imports rose by US$ 31 million in FY16 and reached US$ 753 million – a level last seen before 2007. Given the rapid growth in 3G/4G subscribers, imports of cell phones (particularly high-cost smart phones) are likely to stay elevated.

Transport sector: Imports enable auto sector growth
Given the lower *deletion* level, Pakistan's auto industry still heavily relies on imported components. This is amply evident from higher imports of both completely built-up and semi knocked down units (CBUs and SKDs) of motor cars and commercial vehicles; these imports allowed the auto sector to post a healthy growth in FY16.[68] In absolute terms, transport group imports increased by US$ 262.6 million and reached US$ 3.0 billion (**Table 6.9**). That said, we can take some comfort from the fact

[64] Sales of furnace oil declined by 3.0 percent YoY during FY16.
[65] Domestic petroleum production dropped by 0.6 percent YoY during Jul-May FY16.
[66] Interestingly, PBS reported LNG imports under the "all other" category, which is not classified elsewhere. However, from July 2016 onwards, PBS started classifying LNG imports under petroleum group imports.
[67] In absolute terms, fixed investment in construction and electricity & gas supply rose by Rs 31.2 billion and Rs 38.7 billion respectively in FY16.
[68] Sales of pickups and LCVs rose 29 percent YoY in FY16 (source: PAMA). The import of mini vans and cars (>800cc) increased from 17,069 units in Jul-May FY15 to 22,998 units in Jul-May FY16 (source: PBS).

that half of these imports involved heavy vehicles and air transport, which would help promote economic activity.

Steel

Higher PSDP spending and vibrant private sector construction activity led to a strong demand for steel and allied products. And the modest growth in domestic production of finished and semi-finished products, like hot rolled coils, line pipes, boiler tubes and other items, meant that their demand was largely met through imports. Suspension of production at Pakistan Steel Mills also contributed to higher imports, as the Mills had more than 15 percent share in total steel production.

China has emerged as the largest supplier for most of the steel products imported by Pakistan; its share in Pakistan's total imports has also been gradually increasing. In order to protect domestic producers from the influence of cheap imports, the government imposed regulatory duty (RD) on a number of steel and allied products, especially on those items that can be manufactured by the local industry.[69] Specifically, the government increased RD on billets, bars and rods, which are mostly used for construction material;[70] the import of finished products that are used in oil & gas exploration and distribution, and power infrastructure, are exempt from RD.

Food

Food imports grew by 7.2 percent in FY16, with major increase coming from soybean, tea and pulses. After declining in H1-FY16, imports of edible oil – which has the largest share in the food group – increased 11.0 percent YoY in H2-FY16 (mainly because of higher imports of soybean oil).[71] This increase can be traced to a shift in preference by ghee manufacturers away from canola/mustard oil to cheap soybean oil.[72,73] The import of palm oil declined, largely because of lower global prices, as quantum imports rose in FY16. Meanwhile, lower domestic production of minor crops led to higher imports of pulses. In case of tea, higher global prices were largely responsible for the uptick in import values. Kenya – a major exporter – experienced a prolonged dry spell in 2015-16, which reduced its tea production and pushed up international prices of the commodity.[74]

Raw cotton: Fall in production necessitated hefty imports

Cotton imports more than doubled in FY16 and reached US$ 750.4 million (from US$ 344 million in FY15). This was primarily due to a significant fall in domestic production. In addition, higher demand for long staple and quality cotton – which are typically imported to produce high-count yarns (which, in turn, are used in the manufacturing of high value-added textile products) – also contributed to higher overall cotton imports.

Improved gas supply, high inventories contained fertilizer imports

In sharp contrast to a 30 percent rise in FY15, fertilizer imports declined 20.5 percent in FY16 (to US$ 726 million). This deceleration was attributed to: (i) higher domestic production, owing to sufficient gas supplies to fertilizer plants; (ii) comfortable inventories of both urea and DAP; and (iii) lower urea off-take in FY16. The entire decline came in the second half of FY16, as the government had imported fertilizer during H1-FY16 to avoid shortages during *Rabi* season (which runs from October to March). It is also worth noting that in previous years, fertilizer plants were forced to

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[69] The government initially imposed 15 percent RD, which was revised up to 30 percent in March 2016 vide SRO 236(I)/2016 dated 21-03-2016.

[70] The government also imposed anti-dumping duty, ranging from 8.3 to19.0 percent, on the imports of cold-rolled coils and sheets from China and Ukraine. These products are mostly used in the auto industry, fabricated goods, and home appliances.

[71] The share of palm oil, which was 97 percent in FY15 in edible oil imports, came down to 90 percent in FY16. Conversely, the share of soybean oil went up during the period.

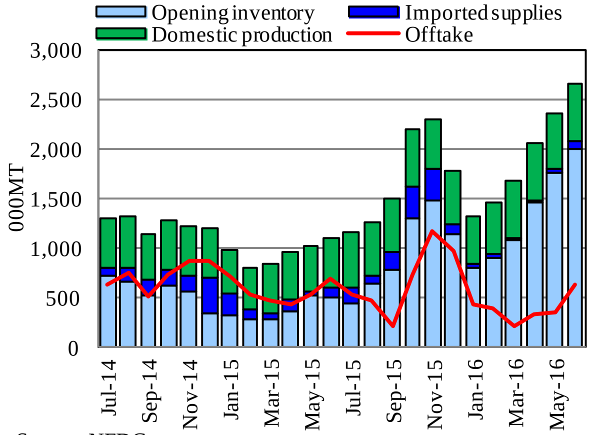
[72] The price of soybean declined by around 10 percent on average in FY16; this was much sharper than the 2.0 percent drop in the price of rapeseed (source: United States Department of Agriculture).

[73] Local production of vegetable ghee rose 4.5 percent in FY16, after declining 0.04 percent in FY15.

[74] On average, international tea prices increased by 24 percent YoY in FY16.

reduce (or halt) their operations in the winter due to lower (or non-availability) of natural gas – a key raw material. But adequate availability of gas throughout the year, supported domestic production.[75] As far as domestic demand is concerned, it remained subdued in FY16 because of depressed farm incomes; in the last couple of months of FY16, farmers delayed purchases as they awaited announcement of agri subsidies in the FY17 budget (**Figure 6.22**).

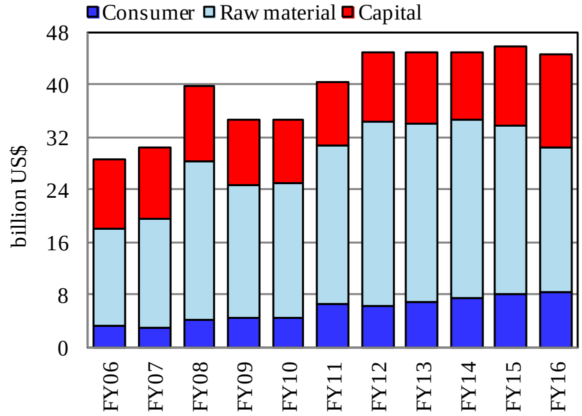
Figure 6.22: Domestic Fertilizer Situation



Source: NFDC

Finally, a brief review of major import commodities suggests that over the past three years, a pro-growth change in import composition, i.e. a shift towards capital goods, has been underway.[76] In fact, FY16 was the third consecutive year, where the share of capital goods in overall imports increased. In addition, the share of raw materials for the production of capital goods in overall imports also increased during the last three years (**Figure 6.23**). It is pertinent to note that Pakistan spends a large amount of FX to import raw material for consumer goods as well as finished consumer goods; many of these can be produced locally. For example, the country needs to invest more in agri-sector R&D to produce high-yielding crop varieties so that domestic production is able to meet local demand.[77] Such favourable developments would play a key role in improving productivity and export competitiveness of the country.

Figure 6.23: Composition of Pakistan's Imports



Source: Pakistan Bureau of Statistics

[75] The fertilizer sector grew by 13.8 percent in FY16, which was over three times the growth noted in FY15.
[76] Capital goods and raw material for capital goods mainly comprise electrical machinery, energy products, aluminum alloys, phosphoric acid, etc.
[77] Within consumer items, fruits and vegetables (like peas, garlic, ginger, apples and grapes etc) have the highest share in consumer goods imports.