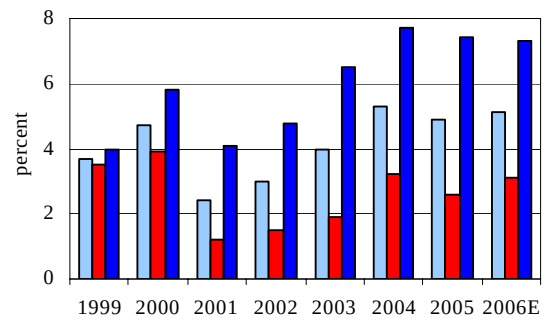
7 Balance of Payments

7.1 International Economic Situation[1]

The biggest challenge to the world economy during 2006 was sustaining the growth trend in the face of an unprecedented increase in the oil prices. Fortunately, the oil shock came at a time when the world economy was in an upswing, interest rates in many countries were at their lowest and inflation well within comfort zones. Therefore, it is not surprising that the world economy showed much more resilience to the current oil shock compared to the previous ones'. Major world economic regions still continue to show strong growth, and world output is projected to grow by a healthy 5.1 percent in 2006 (see **Figure 7.1**).

Figure 7.1: GDP Growth Rates



Source: World Economic Outlook, September 2006

However, some risks of a slowdown in economic growth are emerging. In particular, the strengthening pass-through of high oil prices and high non-fuel commodity prices (due to strong world demand and some supply shortages). As a result, inflation has started to pick up globally. Other threats include expectation of an abrupt slowdown in the U.S. housing market; slowdown in advance economies; and doubts about emerging economies, for sustaining their current growth momentum. Furthermore, burgeoning US twin deficit and gap in the external accounts of oil importers and exporters are some major economic imbalances; global markets have to come to terms with the risks to global growth posed by the possibility of a disorderly adjustment of these imbalances.

Rising inflation has already prompted most central banks to tighten monetary policy and indications of further rise in interest rates are evident. The U.S. Federal Reserve Bank continued to raise interest rates through June 2006, the European Central Bank has also raised interest rates further in recent months, and Bank of Japan ended its zero interest rate policy in July 2006. The era of easy money seems all but over.

In the United States, after a strong growth of 5.6 percent during first quarter of 2006, the growth has decelerated to 2.6 percent in second quarter. The overall growth for the full year is expected to be around 3.4 percent in 2006. Despite the recent slowing of growth, inflationary pressures have not letup, reflecting rising energy prices and diminishing excess capacity in product and labor markets.

In Euro region, too growth is projected to slowdown to 2.0 percent in 2007 against projected 2.4 percent in 2006. The growth prospects are marred by possible appreciation of Euro, which could shrink exports and investment in the traded goods sector, and impose capital loss on holders of U.S. dollar assets. In contrast to Europe and United States, emerging Asia, with China and India in the lead are likely to continue to be the main drivers of world growth in 2007. In China, real GDP grew by 11.3 percent in the second quarter of 2006, with a renewed acceleration in investment and surging net exports. In Japan, after a solid first quarter, real GDP growth eased in the second quarter of 2006.

[1] The discussion in this section is based on World Economic Outlook by IMF for September, 2006, and Development Report 2006 by UNCTAD.

However, indications are growing that after seven years of falling prices, Japan has finally escaped from entrenched deflation.

Although world trade is projected to slowdown in 2007, the performance in 2006 would most likely be an improvement over 2005. The world trade volume is projected to grow by 9.6 percent during 2006 against 7.4 percent in 2005. The world merchandise exports, which grew by 7.3 percent during 2005 is expected to grow by 9.5 percent during 2006 while the world import growth is likely to be higher at 9.7 percent against 7.4 percent during 2005. The growth in world exports is likely to be contributed by advanced economies in particular the euro area while major part of increase in import volumes is likely to be contributed by Asian economies particularly China. The rise in world trade prices is expected to moderate from 5.5 percent during 2005 to 2 percent during 2006. The major issues in the world trade are stalled negotiations on the Doha Development Agenda on account of lack of consensus on the agricultural sector's market access and domestic support and new restraints on China's textile and clothing sales to EU and USA markets. [2]

Concerns over the rising inflationary pressures, high oil, metal and other commodity prices, the weakening of the US dollar, and geopolitical tensions, kept the world equity and bond markets volatile during the first half of 2006. The rise in the interest rates by major central banks in US, EU and Japan made equity markets relatively less attractive for the typically risk averse investors. Furthermore, the decision by the bank of Japan to end zero interest rate policy also impacted the major equity market adversely by reducing carry trade (borrowing in yen and investing in equities). As a result, all the major equity markets and especially those in the emerging economies witnessed significant withdrawals of investment during May and June 2006. Going forward too, as returns on the bonds improve further, the flow of funds to emerging economies markets are likely to remain constrained.

In conclusion, the global output both in developed and emerging economies has performed well in recent years, but risks of slower future growth are emerging. The most notable risks are that inflationary pressures could intensify, requiring further tightening of monetary policy; that limited spare capacity and geopolitical uncertainties may further push oil prices ,that the U.S. housing market could cool more rapidly than expected, triggering a more abrupt slow down of the U.S. economy. Further, the depth and sophistication of the U.S. financial markets has facilitated the financing of recent large current account deficits. However, there remains some risk of a disorderly adjustment of global imbalances, which could impose heavy costs on the global economy.

7.2 Overview

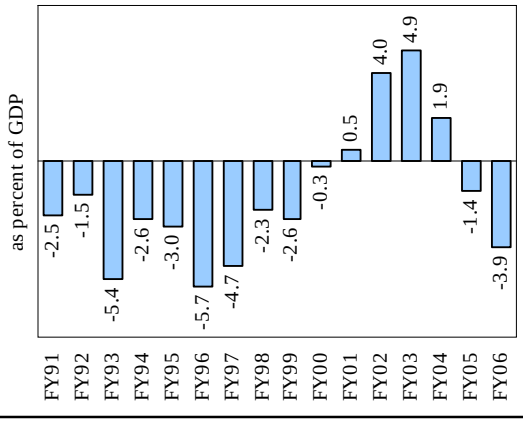
Pakistan's real GDP growth averaged 7.6 percent during the FY04-FY06 period compared to a 3.3 percent average growth for the preceding three years. Given the rapid acceleration in growth, and as capacity utilization increased, it was evident that the demand for imports would increase to cater the needs of the growing economy, both to fill in capacity constraints and to add new capacities.

It is precisely this dynamic which is evident in the sharp acceleration in imports during both FY05 and FY06. However, the actual increase in imports in FY06 was significantly higher than anticipated due to a confluence of factors including an unusual increase in the international oil prices and other commodity prices, larger food imports (following below target harvests of key crops), and strong machinery imports (particularly during H1-FY06). Consequently, Pakistan recorded its highest-ever trade deficit of US $ 8.4 billion in FY06. The deficit would have been worse had it not been for the strong 14.0 percent growth in exports.

[2] Association D'Instituts Europeens de Conjonture Economique, Working Group on Foreign Trade: ***World Trade in 2006 and 2007,*** Report submitted at the AIECE Spring General Meeting Rome, 11th-12th May 2006

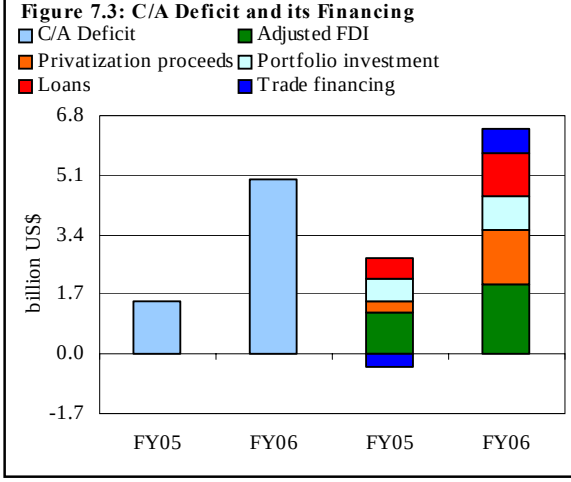
The exceptional imports and accompanying rise in services account payments (principally for freight payments for imports), contributed to a sharp widening of the country current account deficit, from a relatively manageable 1.4 percent of GDP in FY05, to a more threatening 3.9 percent of the GDP in FY06 (see **Figure 7.2**).

Figure 7.2: Current Account Balance



Fortunately, Pakistan has been able to finance the FY06 current account deficit relatively easily. This happened because Pakistan's robust macroeconomic performance in the recent years helped the country access the international debt market on relatively favorable terms, even as the improved investment climate and aggressive privatization program resulted in higher FDI and portfolio inflows (see **Figure 7.3**). In fact, due to these flows, Pakistan's overall balance of payments moved from a deficit in H1-FY06 to a surplus of US$ 1.3 billion for the full year (see **Table 7.1**). The surplus in the overall external balance, that led to a net US$ 520 million increase in the country forex reserves (to reach US$ 13.137 billion by end-June 2006) during FY06 also helps explain, in part, the relative stability of the rupee during the year. The rupee traded within a narrow band of 74 paisa for most part of FY06 and depreciated merely by 0.87 percent during the period, to close at Rs 60.2138/US$.

Figure 7.3: C/A Deficit and its Financing



However, due to comparatively higher domestic inflation in relation to the trading partner countries and relative stability of the domestic currency, rupee appreciated in real terms by around 1.9 percent. This relative stability of the rupee in the inter-bank market was helped by SBP's market interventions (particularly to improve the market liquidity comfort in meeting lumpy oil payments).

However, this reasonably good FY06 external account performance should not engender complacency. Sustained large external imbalances typically introduce vulnerabilities in the economy, reducing credibility of economic polices for international investors. It may be recalled that such imbalances throughout the 1990s had played an important role in raising the country's debt burden, contributing to Pakistan's entry into a debt trap. While ample forex reserves, a strong economy, and reasonably good macroeconomic fundamentals leave Pakistan reasonably well placed to sustain large external deficits in the short run, this cannot be continued in the medium term without incurring high costs.

Table 7.1: BOP Summary

million US Dollars

	FY05	FY06	Change
Current account	-1534	-4999	-3465
Capital account	685	191	-494
Financial account	446	5897	5451
Errors and omissions	-7	244	246
Overall balance	-410	1333	1743
SBP reserves (net)	9,805	10,765	960

Even in the short run, it would be preferable that external deficits be financed principally from stable non-debt sources, rather than debt. Amongst the former, foreign direct investment (FDI), would be the key source, given these flows are typically long-term and often contribute positive technology and management spillovers. While Pakistan has had considerable success in attracting FDI in FY06, much can be done to improve on this performance in years ahead. In particular, it should be kept in mind that a large part of the FY06 FDI, US$ 3.5 billion, comprised receipts from privatization of public sector assets (US$ 1.5 billion). Given that the stock of such assets is limited by definition, and that Pakistan has only a very small share in global FDI flows, there is considerable scope for improvement here.[3]By contrast, while portfolio investments can be substantial these can often be volatile.

Financing persistent large current account deficits by acquiring debt is generally a more risky strategy, as evident from the aftermath of Pakistan's borrowing binge of the 1990s, where the build-up of foreign currency debt led the country into a debt trap. Moreover, the ability of emerging markets (such as Pakistan) to access global bond markets is also dependent on the global developments and its own economic and political situation. Global economic slowdown, lower liquidity in the global financial markets, together with rising domestic macro imbalances have increased the level of uncertainty for investors who typically have limited apatite for risky environment. The rise in risk aversion among investors is captured by the rising sovereign spread between US T-bills and emerging market sovereign yields. The rising spread suggests that the environment will be less favorable to emerging economies' borrowers in the near future, So far, Pakistan's debt strategy has been prudent. Firstly, external debt as a percentage of GDP has continued to fall, even in FY06. Secondly, most of the net increase in debt in recent years has been on relatively concessional terms. Indeed, even the increase in commercial debt has essentially been through sovereign Eurobonds, where the relatively higher cost is offset by the use of the sovereign yields as a gauge of Pakistan's economic performance and as a benchmark rate for Pakistani companies seeking funding from international capital markets Here too, if large external imbalances persist, the cost of funding the deficits could rise significantly.

In short, the country needs to focus on narrowing the current account deficit, and focus on financing even the smaller deficits through non-debt flows or concessional debt.

Since the growth of the current account deficit in recent years is largely due to an extraordinary rise in the trade deficit, this is obviously a starting point for corrective policy, with options revolving around a mix of reducing import growth and fostering strong export growth. The most direct option would be to impose tariffs on imports growth. However, given the country's porous borders this could have perverse consequences, increasing smuggling (and reducing import-based taxes), strengthening the informal forex markets, etc.

The practical import-reduction options include substantially raising interest rates (to reduced aggregate demand), or encouraging a depreciation of the rupee (reducing the demand for domestic good relative to imports). Both of the measures would, in the medium term, help exports by either reducing inflation (i.e. the cost of producing goods), or reducing the cost of local goods for foreign buyers. In the short run however, both have significant costs.

On the one hand, given the prevailing tight monetary policy, a further rise in interest rates in FY06 risked considerably slowing the growth momentum of the economy, and on the other hand, a sharp rupee depreciation could lead to self-fulfilling expectations that could de-stabilize the economy. This dilemma was worsened by SBP projections that the extraordinary import growth was likely to be short-lived, [4] falling to "normal" levels towards the end of FY06[5] suggesting the extraordinary policy

[3] See Box on Doing Business in Pakistan 2006.
[4] For example see SBP Third Quarterly "State of Pakistan's Economy" report for FY06

responses were not required to correct the external imbalance. Specifically, the growth in the oil imports bill was likely to ease as international oil prices stabilized (or declined) and imports of machinery which, mainly reflected capacity expansions were also expected to slow, after capacity addition and BMR projects were completed. Similarly, a one-off import surge due to economic liberalization (e.g. the in telecommunications and media) was also expected to weaken.

The substantial slowdown in the imports growth during H2FY06 and the continuation of this trend in the initial months of FY07 indicates that this premise may have been correct. In fact by the end of FY06, the share of machinery imports in total imports *growth* has fallen steeply, with oil remaining as the only major contributor. Going forward too there are sufficient grounds to believe that import growth may remain weak, particularly given the continuing tight monetary posture.

Unfortunately, this may not be enough to substantially reduce the trade deficit in FY07, given the unwelcome deceleration in exports growth that has accompanied the slowdown in imports H2-FY06 onwards. Clearly, given the increasingly competitive exports market, there is need to provide greater support to exporters.

Given that the provision of direct subsidies, as provided in some countries, carry significant economic costs in the long run , it seems desirable that the policy thrust be on reducing the cost of doing business, improving infrastructure (including removing transportation bottlenecks to lower delivery lags, and costs), enhancing labor skills, strengthening managerial capacity, and reducing unit labor costs.

7.3 External Sector Indicators

Many of the key balance of payments indicators witnessed an improvement in FY06, although some weakness is evident in others (see **Table 7.2**).

Specifically, the *trade openness* indicator further improved to 32.2 percent in FY06 from 30.2 percent last year. Given the strong linkages between trade openness and growth, the rise in trade openness is a welcome development. However, this development would be more encouraging if it stemmed from exports, as export oriented companies, facing strong international competition, are often more efficient. Unfortunately, the FY06 improvement stems essentially from an exceptional rise in imports.

During FY06 exports grew by a healthy 14.0 percent. The resulting higher export earnings were able to outpace substantial increase in interest payments owed to official creditors. As a result ratio of *interest payment to export earnings* in FY06 improved marginally. Improvement in this ratio indicates greater ability of paying interest on external debt through export earnings.

The greater role of imports in the rise of the trade openness ratio is also reflected in the *current account deficit to GDP* ratio, which can be used to gauge the sustainability of current account deficit. Due to the exceptional rise in imports, the ratio deteriorated for a second successive year to 3.9 percent in FY06 form 1.4 percent in the previous year.

The sharp improvement in the ratio of *FDI as percent of exports* in FY06 is a clear reflection of the improvement in Pakistan's economy in recent years. While the extent of the improvement in FY06 owes to the substantial receipts from the successful privatizations of large government enterprises, it should be kept in mind that this investment would not have emerged without an improvement in Pakistan's relative attractiveness for investment. This view is also reinforced by the fact that even

[5] As stated earlier, a large part of the sharp rise in imports in FY05 and FY06 was drive by a steep rise in international oils prices, machinery imports to increase domestic industrial capacity, as well as a one-off surge due to economic liberalization (e.g. the in telecommunications and media)

after adjusting for the privatizations receipts the ratio continues to depict an improvement, rising from 8.0 percent in FY05 to 12.0 percent in FY06.

Lastly, a crucial external sector indicator is the reserves adequacy i.e., *imports- coverage ratio*, which is used to assess the country's ability to withstand economic shocks, as measured by the economy's ability to meet its import (of goods and services) requirements through its reserves. While this ratio has declined from 4.6 months in FY05 to 3.9 months during FY06, this is still a quite comfortable level.[6]

7.3.1 Current Account Balance

The trend deterioration in Pakistan's current account balance continued into FY06, with the current account deficit rising substantially to 3.9 percent of GDP from a modest 1.4 percent of GDP in FY05 (see **Figure 7.4**). This deterioration is largely due to the continued extraordinary growth in imports (and accompanying rise in shipment freight charges), that overshadowed the reasonably strong growth in exports, remittances and other government receipts.

Table 7.2: Balance of Payments : Key Indicators

percent

	FY04	FY05	FY06
Trade			
Exports/GDP	12.72	13.06	12.81
Imports/GDP	14.02	17.13	19.36
Trade openness	26.74	30.20	32.17
Services account			
Services (Net)/GDP	-1.34	-2.97	-3.42
Interest payment to EE ratio	8.48	6.48	6.15
Interest payment to FEE ratio	4.97	3.51	3.28
Transfers			
Net transfers to GDP	6.8	7.8	8.2
Remittances/GDP	4.3	3.8	3.6
Current account			
Current receipts / GDP	22.5	24.4	24.6
Current receipts growth	7.0	22.7	17.2
External debt to GDP ratio	36.4	32.4	27.2
FEE (US$ mlns)	21,267	26,740	30,930
Growth of FEE	9.2	25.7	15.7
Non-interest CAB (US$ mlns)	2,702	(819)	(4,366)
NICAB/GDP	2.8	-0.7	-3.4
CAB/GDP	1.8	-1.4	-3.9
Capital account			
FDI/GDP	1.0	1.4	2.7
FDI/Exports	7.6	10.5	21.3
FDI*/Exports	6.0	8.0	12.0
Others			
Reserves imports cover (in months)	7.2	4.6	3.9

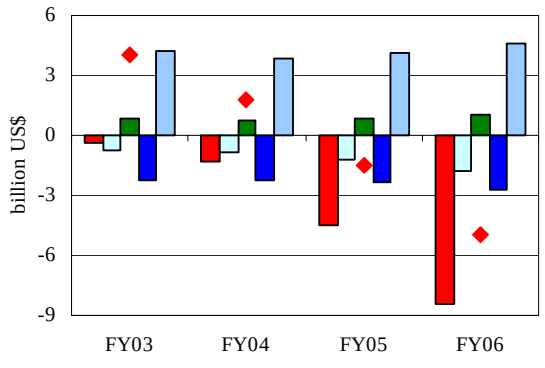
*Adjusted FDI for privatization proceeds

Trade Balance[7]

The deficit in the trade account worsened sharply to US$ 8.4 billion in FY06 as compared to a FY05 deficit of US$ 4.5 billion. This expansion was primarily due to a significant 31.3 percent YoY growth in imports that outpaced the 14.0 percent growth in exports. The sharp rise in imports bill in FY06 derived principally from a large jump in the oil imports bill, as well as higher machinery imports, which together accounted for 67 percent of the total annual growth in imports.

A cursory look on the FBS data reveals that around 87 percent of rise in import bill of petroleum products during FY06 was due to rising oil prices,[8] while the strong growth in

Figure 7.4: Components of Current Account Balance



[6] There is no specific criterion; depending on circumstances, reserves covering 3-6 months of imports are considered adequate.

[7] This section is based on exchange records data from the SBP, which will not tally with more detailed customs data used in the Trade sub-section.

[8] For detail please see section on ***Foreign Trade***.

machinery imports reflects a number of factors, such as the high capacity utilizations in industry to the persistent strong demand in recent years, BMR in the textile industry as it prepared for increased competition in the export markets post-MFA phase out, and investment in the telecom industry.

Interestingly however, there is a significant slowdown in the non-oil imports growth during the later half of FY06, largely due to a slowdown in machinery imports. This slowing trend is expected to be reinforced in FY07 by a fall in global oil prices. However, this will only help reduce the trade deficit if exports continue to grow strongly. Unfortunately, initial FY07 data suggests that export growth has also weakened significantly.

Services (net)

Services account deficit widened by US$ 1.1 billion to US$ 4.4 billion in FY06, primarily due to increased trade activity as well as the continued expansion in the coverage of foreign exchange transactions routed through foreign exchange companies.[9] Moreover, the outflow under travel also accelerated sharply, while inflow in the communication services witnessed a fall during FY06. Finally, an unusual rise of US$ 155 million in *other outflows* reflects the deffered payments for the construction of Ghazi Brotha Dam. These outflows were however compensated to an extent by the receipt of US$ 1.1 billion on account of logistic support provided by Pakistan to coalition forces.

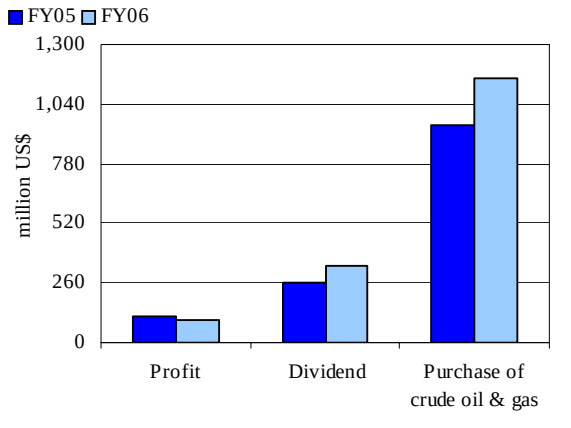
Travel

The net travel outflow inched up by US$ 190 million during FY06 as compared to FY05. Within total travel payments, the large proportion is explained by personal travels i.e., 96.4 percent; the contribution of business travel is marginal. The larger part of the travel outflows during FY06 was routed through the exchange companies.

Income (net)

During FY06, the net income deficit further expanded by12.0 percent YoY to US$ 2.7 billion. This was mainly due to higher *direct investment* outflows. Within the investment income all three heads, i.e., direct investment, portfolio investment and other investment recorded net outflows.

Figure 7.5: Direct Investment Income



Direct investment outflows recorded increase due to rise in payments made by the government to foreign oil and gas exploration companies (for their share in domestic production of crude oil and gas), as well as the higher repatriation of profits and dividend by foreign banks and companies operating in Pakistan (see **Figure 7.5**).

The increase in the payment to oil and gas exploration companies was entirely on account of the rise in the oil prices as quantum did not witnessed any significant change from last year. The rise in the profits and dividends is a result of continuous rise in the banking sector profitability. The only difference is that while in FY05, the outflows were on account of repatriation of profits, in FY06 the outflows are due to dividends repatriation.

[9] It has been mentioned in the earlier reports that these outflows have no impact on the overall current account balance as it is matched by the receipts of the FECs (appearing as current transfer inflows under *private transfers*).

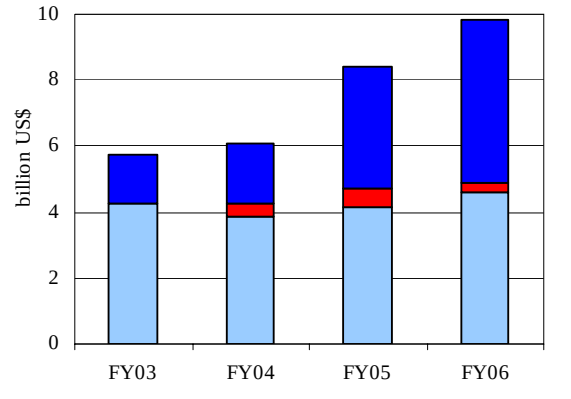
Table 7.3: Current Account Balance

million US Dollar

Items	FY04	FY05	FY06	YoY change FY06
1. Trade balance	**-1,279**	**-4,514**	**-8,442**	**-3,928**
Exports	12,459	14,482	16,506	2,024
Imports	13,738	18,996	24,948	5,952
of which mineral fuels, oils & their products	2,475	3,900	6,209	2,309
2.Services (net)	**-1,316**	**-3,293**	**-4,402**	**-1,109**
Transportation	-890	-1218	-1790	-572
Travel	-1034	-995	-1,185	-190
Communication services	166	272	97	-175
Other business services	-332	-2,217	-2,552	-335
Government services	905	1,041	1,359	318
Of which logistic support	754	831	1070	239
Other	-131	-176	-331	-155
3. Income (net)	**-2,207**	**-2,386**	**-2,671**	**-285**
Investment income(net)	-2,208	-2,387	-2,676	-289
Direct investment	-1,215	-1,622	-2,076	-454
Of which: profit & dividend	-338	-376	-433	-57
Purchase of crude oil & minerals	-678	-951	-1,149	-198
Portfolio investment	-201	-154	-95	59
Of which: profit & dividend	-109	-146	-89	57
IMF charges & interest on off. external debt	-708	-656	-664	-8
Interest on private external debt	-131	-108	-85	23
Others	47	153	244	91
4. Current transfers (net)	**6,614**	**8,659**	**10,516**	**1,857**
Private transfers	6,102	8,409	9,837	1,428
Workers remittance	3871	4168	4600	432
FCA – residents	367	521	312	-209
Others	1864	3720	4925	1,205
Official transfers	512	250	679	429
Saudi oil facility	302	0	0	0
Cash grants	202	231	464	233
Current account balance	**1,812**	**-1,534**	**-4,999**	**-3,465**

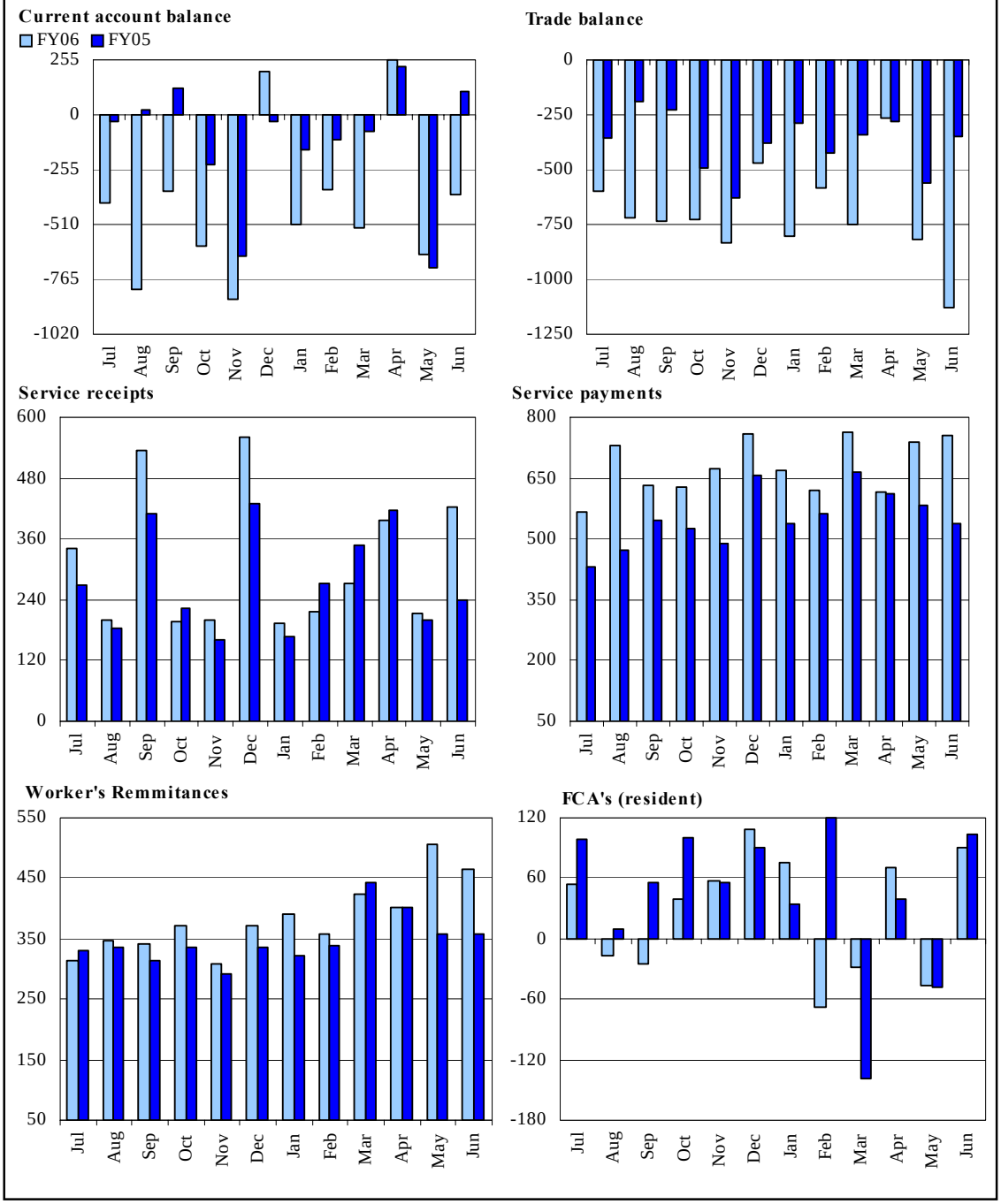
Other investment outflows reflect payments on external debt and liabilities and returns on investment of official forex reserves. During FY06 despite the rise in *interest payments* on external debt and liabilities, net payments decreased by US$ 82.0 million (see **Table 7.4**). The main factor responsible for this net saving was high interest receipts on official forex reserves on the back of rising international interest rates and substantial stock of official reserves

Figure 7.6: Composition of Private Transfers



During FY06, interest payments on external debt increased by US$ 15.0 million. This was mainly due to high interest payments on

Figure 7.7: CAB at a Glance (million US$)



sovereign bonds, final payment of the foreign currency bonds rescheduled in 1999[10] and payments on IDB loans.

In fact, in view of rising stock of sovereign bonds besides the rise in the short term IDB loans, the increase in interest payment on account of these two heads was expected. However, the lower

[10] A total of US$ 7.7 million final coupon payment was made in December 2005 for the foreign currency bond that was rescheduled in 1999

payments on IMF and private loans partly offset the impact of these outflows and thus allowed the interest payments on external debt to rise only marginally during FY06.

Table 7.4: Details of Interest Payments and Receipts
million US Dollars

	FY04	FY05	FY06	Savings
Payments (I+II)	**1056**	**939**	**1015**	**-76**
I. Total external debt	879	825	840	-15
Public & publicly guaranteed	722	694	739	-45
Long-term	657	614	618	-4
Military	14	12	9	3
Euro bonds	40	61	91	-30
Commercial loans/credits	7	7	7	0
IDB	4	0	14	-14
Private loans/credits	131	108	85	23
IMF	26	23	16	7
II. External liabilities	177	114	175	-61
Foreign currency deposits	23	15	23	-8
Special US$ bonds	31	31	28	3
Central bank deposits	17	21	35	-14
Others	106	47	89	-42
Receipts	**166**	**224**	**382**	**158**
Interest on reserves	117	155	268	113
Others	49	69	114	45
Net payments	**-890**	**-715**	**-633**	**82**

Source: SBP

In contrast to the previous year, interest payments on external liabilities recorded 54.0 percent increase during FY06. This rise in payments was observed due to increasing foreign currency loans extended to traders[11] coupled with interest payments made by the foreign companies for the working capital requirements.

Current Transfers (net)

Current transfers increased by 21.4 percent to US$ 10.5 billion during FY06. Flows in this head are typically dominated by changes in remittances flows (see **Figure 7.6**). However, in FY06, remittances inflows were complemented by a jump in *official transfers* (for budgetary support and earthquake relief).

FCAs

During FY06, resident FCAs registered lower inflows of US$ 312 million as compared to the US$ 521 million seen in FY05. The higher inflow in pervious year was mainly due to some one-off inflows in government deposits and rising expectations of rupee depreciation. In the absence of these factors in FY06 the level of inflows remained lower.

Monthly analysis of FCA inflows shows abnormal rise in December 2005. This rise is again attributable to some one-off rise in deposits of a government agency and a foreign bank which were with drawn subsequently. As a result, FCAs showed a rise in the first half of FY06.

Workers' remittances

Remittances have more than quadrupled since FY00 averaging US$ 4.2 billion since 2003. As a result, they have gained substantial importance as a non-debt creating source of financing the trade deficit. Furthermore, worker's remittances have also played an important role in poverty reduction directly and through its spillover effects.

Remittances initially grew at a slower pace in FY06, increasing by only 5.6 percent YoY in H1-FY06. However, H2-FY06 witnessed accelerated growth of 14.5 percent YoY, pushing the annual remittances to US$ 4.6 billion, up US$ 431 million from the FY05 annual receipts (see **Figure 7.7**).

The improvement largely came from Saudi Arabia, UK, Canada, Qatar and Kuwait, which was offset to an extent by the lower inflows from the USA (see **Table 7.5**). It would be pertinent to mention, that the growth in remittances from an important source, i.e., UAE, also decelerated sharply from 19 percent in FY05 to 0.5 percent during FY06. Anecdotal evidence suggests that fall in remittances may have been caused by the rising investment opportunities in the real estate market in Dubai. Moreover,

[11] Outflows under this head are equally off set by the inflows in the *other receipts*.

the increasing cost of living in UAE could be another factor responsible for slowing of the growth in remittances.[12]

Notwithstanding the decrease in the remittances from UAE, remittances from the remaining of the Gulf regions increased, possibly reflecting higher support to relatives in the wake of earthquake disaster in October 2005. In addition, rising remittances from non-traditional source i.e. Canada is also encouraging, indicating diversification of remittance inflows.[13]

Interestingly, during FY06 the reported remittances also included a significant portion of rupee encashment from the resident FCAs i.e. US$ 735 million which was US$ 214 million higher than the last year. In fact, the lower encashment from the resident FCAs in FY05 was the reflection of improved data reporting by banks. Prior to FY05 the rupee encashments from residents FCAs were inflated, as the amounts that should have been included in other private transfers were being reported as remittances

Table 7.5: Workers' Remittances
million US Dollar

	FY04	FY05	FY06	Change
I. Gulf region	**1614**	**1852**	**2,063**	**211**
Bahrain	81	91	101	9
Kuwait	177	215	247	32
Qatar	89	87	119	32
Saudi Arabia	565	627	750	123
Sultanat-e-Oman	105	119	130	11
U.A.E.	597	713	716	4
II. U.S.A.	**1225**	**1294**	**1242**	**-52**
III. Other than Gulf & US	**987**	**1006**	**1282**	**276**
Canada	23	48	82	33
Germany	47	54	59	5
Japan	5	7	7	0
Norway	10	18	17	-1
U.K.	334	372	439	67
Other	568	507	680	173
Total	**3826**	**4152**	**4,588**	**436**
of which: Exchange companies	141	392	623	231
Withdrawal FCAs (residents)	688	521	735	214
Withdrawal FCAs (non-residents)	39	41	24	-17
Encashment of FEBCs & FCBCs	45	17	12	-4
Grand total	**3872**	**4169**	**4,600**	**431**

Higher rupee encashment from these deposits compared to last year may also have been influenced by the relatively stability of the exchange rate during FY06. In contrast, there were strong expectations of rupee devaluation till the first half of FY05 which could have prompted the investors to hold on to their dollar assets.

Other Private Transfers[14]

During FY06, other private transfers (credit) reached US$ 5.0 billion, recording 31.1 percent growth YoY (see **Table 7.6**). The major portion of the other private transfers; US$ 3.0 billion was on account of the exchange companies. It may be recalled that in June 2004, the State Bank of Pakistan required informal moneychangers to convert into and register as foreign exchange companies by August 30, 2004. This directive was aimed at better monitoring and documentation of the private moneychangers. Consequently, FY05 witnessed 130 percent jump in private transfers on account of the exchange. However inflows on this account witnessed a rise of only 3.7 percent in FY06, by exchange companies contribution in private transfer is nevertheless second only to remittances. Besides

Table7.6: Other Private Transfers (credit)
million US Dollar

	FY03	FY04	FY05	FY06*
Private donation	113	115	150	402
Private transfers n.s.e.	742	479	587	1,046
FCAs withdrawal		47	105	189
Exchange Co.	273	1,273	2,932	3,040
SBP purchases	429			
Other	14	11	38	321
Total	**1,571**	**1,926**	**3,813**	**4,998**

* Provisional

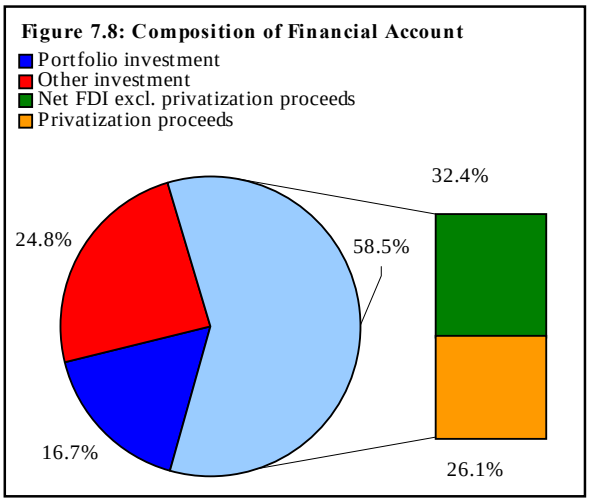
[12] http://www.ameinfo.com/74538.html.
[13] Although in absolute terms the US$ 81.7 million remittances are only 2.0 percent of the total, these are growing strongly, nearly doubling from the US$ 22.9 million recorded in FY04.
[14] This head mainly comprises of unclassified private transfers, private donation, withdrawal from the residents FCAs and receipts of exchange companies.

remittances and exchange companies, other private transfers and private donations contributed US$ 1046 and US$ 402 million each. The rise in the private donations in FY06 to US$ 402 million from US$ 150 million last year probably reflects contribution for earthquake relief activities.

7.3.2 Financial Account

The improvement in the financial account witnessed during FY05 continued in FY06. Resultantly the surplus increased substantially from a meager US$ 0.4 billion in FY05, to a sizeable US$ 5.9 billion in FY06. The improvement in financial account was quite broad based, contributed by higher FDI (including privatization proceeds); rise in portfolio investment on account of floatation of Euro bond and other receipts (see **Figure 7.8**). In addition to this, higher receipts of long-term concessional loan from ADB and World Bank, and net inflow of supplier's credit also helped in swelling the financial account surplus.

Figure 7.8: Composition of Financial Account



Net Foreign Investment (NFI)

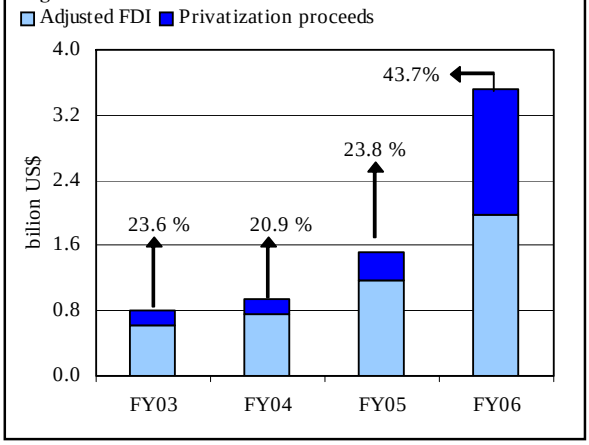
The overall net foreign investment recorded a substantial YoY rise of US$ 2.4 billion in FY06, reaching US$ 4.4 billion. This was mainly due to higher Foreign Direct Investment (FDI) and issuance of Euro bonds in March 2006. The increase in former also includes the privatization proceeds of PTCL, KESC and HBL. Importantly, even after adjusting for privatization proceeds the FDI still depicts a rising trend during the last three years.

Foreign Direct Investment

The FDI increased to US$ 3.5 billion in FY06, up by US$ 2 billion from the preceding year. Out of this, US $ 1.2 was on account of the privatization proceeds (see **Figure 7.9**). [15] FDI excluding privatization receipts was mainly concentrated in telecommunication, financial business, and oil & gas exploration.

Encouragingly, the reinvested earning also increased substantially, by US$ 223.0 million in FY06 as compared to the previous year. The higher reinvested earnings probably reflect increased confidence of the foreign investor in the domestic economy.

Figure 7.9: FDI Flows



Portfolio Investment

Portfolio investment increased substantially to US$985.0 million during FY06, rising by US$ 365.0 million YoY. This increase primarily reflects the rising confidence of the foreign investors on the

[15] It is a standard practice to account privatization proceeds in FDI inflows. However, it does have different implications for the economy than other FDI (See details in Third Quarterly Report, FY06). Even excluding privatization proceeds, FDI recorded 70 percent growth in FY06 as compared to FY05.

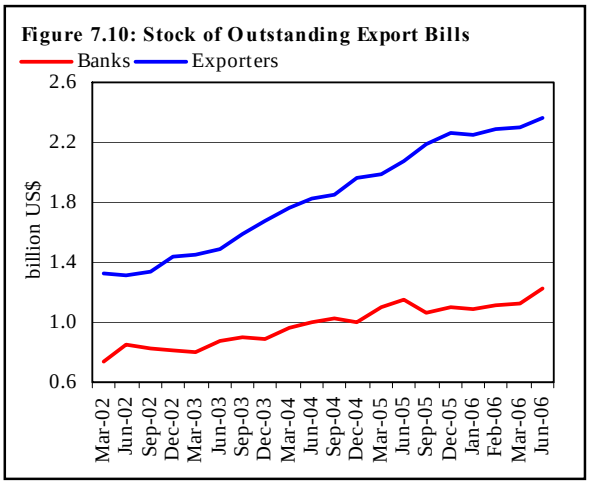
economy, as captured by the higher foreign investment in the stock market especially from USA, UAE and Hong Kong, and by the successful issuances of two new Eurobonds.

The larger part of the FY06 inflows in portfolio investments reflects the proceeds under two sovereign Eurobonds totaling US$ 800 million issued by Pakistan in FY06 – the offerings included a 10-year US$ 500 million bond issue maturing in 2016 and a 30-year US$ 300 million bond maturing in 2036. The coupon rate fixed on these bonds was 7.125 percent and 7.875 percent respectively to be paid semi-annually. The impact of these receipts was supplemented by increased portfolio investments in the country's equity markets.

Outstanding Export Bills (OEBs)

During FY06, the stock of OEBs witnessed a rise of US$ 363 million as against US$ 397 million in FY05 (see **Figure 7.10**). Out of these US$ 283 million were held by exporters while remaining OEBs were held by the banks. It may be pertinent to note that the discounting of export bills by banks recorded a fall during H1-FY06 probably due to higher realization of export bills by banks, which offset the discounting of OEBs by exporters.

Figure 7.10: Stock of Outstanding Export Bills



Currency & Deposit[16]

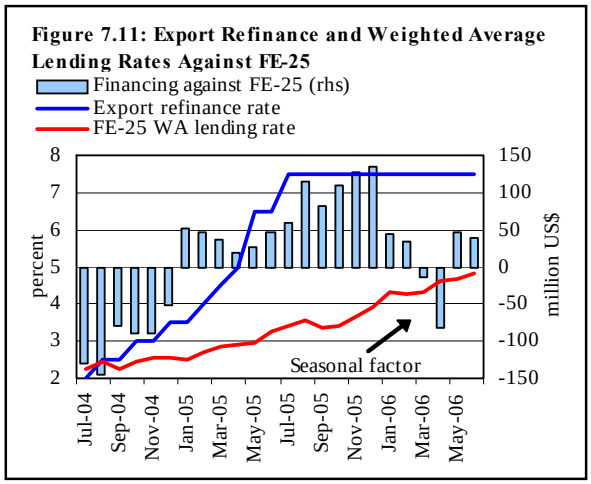
In contrast to the previous year, the currency and deposit assets recorded a fall of US$ 559 million in FY06 which was observed on account of decline in the Nostro accounts of banks during this period. The deceleration in the growth of foreign currency deposits and net rise in the outstanding stock of FE-25 loans; both of which are a function of exchange rate stability, explain the fall in Nostro holding during FY06.

Foreign Long-term Loans

The net inflow under this head increased by US$ 519 million in FY06 to reach US$ 977 million. However, the net inflow during FY05 was inflated by one-off payment of US$495 million-adjusting for this payment; the actual net foreign long-term loans show only a marginal rise of US$ 24 million.

During FY06, country received long-term loans of US$ 2.0 billion, largely form the World Bank and ADB. Of these, US$ 673 million were disbursed on account of earthquake assistance from the ADB (US$ 120 million), and the World Bank (US$ 553 million).[17]

Figure 7.11: Export Refinance and Weighted Average Lending Rates Against FE-25



[16] This head mainly comprises on commercial banks' FE-25 Nostro deposits.
[17] For detail please see Chapter on External debt.

Table 7.7: Financial Account

million US Dollar

Items	FY04	FY05	FY06	YoY change FY06
Financial account (1 through 4)	**-1,335**	**446**	**5,897**	**5,451**
1. Direct investment abroad	**-45**	**-66**	**-70**	**-4**
2. Direct investment in Pakistan	**951**	**1,525**	**3,521**	**1,996**
of which: Equity capital	763	1,208	2,925	1,717
Reinvested earning	183	314	537	223
3. Portfolio investment	**314**	**620**	**985**	**365**
of which: (stock markets)	-28	151	351	200
Special US Dollar bonds	-137	-130	-174	-44
Euro bonds	496	596	796	200
Net foreign investment	1,220	2,079	4,436	2,357
4. Other investment	**-2,555**	**-1,633**	**1,461**	**3,094**
Assets	-670	-1,352	196	1,548
i. Outstanding exports bills (Exporters)	-335	-248	-283	-35
ii. Outstanding exports bills (DMBs)	-120	-149	-80	69
iii. Currency & deposits	-215	-955	559	1,514
of which :Banks	-100	-837	461	1,298
Liabilities	-1,885	-281	1,265	1,546
I. Foreign long-term loans / credits (net)	-1,449	458	977	519
of which: Project Assistance	434	591	663	72
Food aid	-	-	-	-
Non-food aid	536	1,301	1,373	72
Amortization	2,419	1,434	1,059	-375
ii. Private loans	-109	-351	238	589
of which: Suppliers credits/MNCs	503	20	552	532
Supplier credits repayments	612	371	314	-57
iii. ST capital, (official)	-317	147	-193	-340
of which: Commercial banks (net)	-133	-116	-116	-
IDB (net)	-184	263	-77	-340
iv. Currency & deposits	-26	-302	326	628
of which: Trade financing	-210	-356	696.75	1,053
v. Other liabilities	16	-233	-83	150

Source: Statistics Department, SBP

Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

Private loans/Short-term Loans

During FY06 the net inflows of private loans depicts a sharp YoY rise of US$ 589 million. This increase was primarily due to higher inflows of US$ 189 million in the communication sector, and US$ 332 million by PIA to finance the purchase of two new aircraft. On the other hand, the short-term IDB loans witnessed a net retirement of US$ 77 million in FY06 as against of net inflow of US$ 263 million in FY05.

FE-25 Related Trade Financing

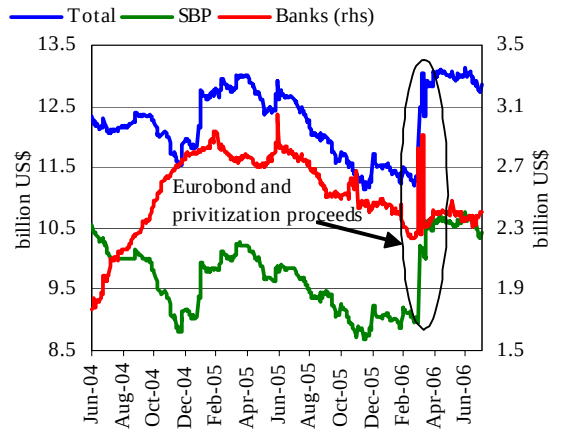
Trade financing against FE-25 deposits registered a substantial rise of US$ 697 million during FY06 as compared to net retirement of US$ 356 million during FY05. The main reason for this rise in loans is lower cost of borrowing against FE-25 deposits as compared to export finance scheme (see **Figure 7.11**). In addition, the stability in the exchange rate may also have led to the rise in net lending against these deposits during FY06.

The detailed monthly analysis depicts that these disbursements were mainly concentrated in H1-FY06 as compared to H2-FY06. The lower disbursement in H2-FY06 probably depicts the seasonal fall in the disbursement of these loans.

7.4 Foreign Exchange Reserves

After remaining under pressure during the better part of FY06 due to a burgeoning trade deficit, Pakistan's overall foreign exchange reserves rose by US $ 520.0 million in FY06. The rise in the country's reserves during FY06 was entirely attributable to a US $ 969.0 million increase in the SBP reserves, which was partially offset by a decline of US $ 449.0 million in the commercial bank reserves (see **Figure 7.12**).

Figure 7.12: Foreign Exchange Reserves



During FY06 SBP injected around US$ 9.0 billion in the forex market, 67.4 percent of which was for accomodating lumpy oil payments. A substantial portion of this market support was met through SBP inter-bank purchases which stood at US$ 6.1 billion at end June 2006 (see **Table 7.8**).[18] Resultantly, the net market support amounted to US$ 2.0 billion.

Table 7.8: SBP's Intervention

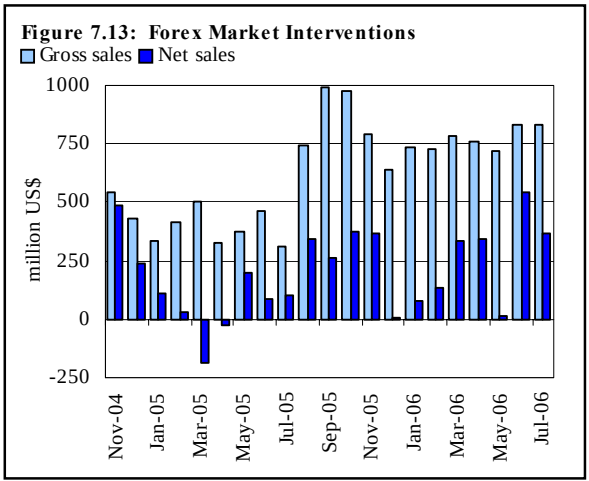
million US Dollars

	FY05	FY06	Change (%)
Net sales	1,125	103	-90.8
Net purchases	2,787	4,173	49.8
Net intervention	1,662	4,070	144.9
Oil support	2,917	6,066	108.0
Net market support	-1,255	-1,996	59.0

It may be recalled that in FY05, realizing that much of the pressure on the exchange rate was arising from mismatch of receipts and payments in the inter-bank, the SBP had committed to accommodate lumpy oil payments. Thus SBP purchased from the inter-bank when the market was long and sold when it was short. This strategy has till now, proved successful in removing untoward pressures on the exchange rate.

However, there is a downside to this approach, as extended induced stability of the exchange rate can distort incentives and encourage excessive risk taking. Further, with domestic inflation significantly higher than that off trading partners countries, this stabililty has caused rupee to appreciate by 1.9 percent in real terms.

Figure 7.13: Forex Market Interventions

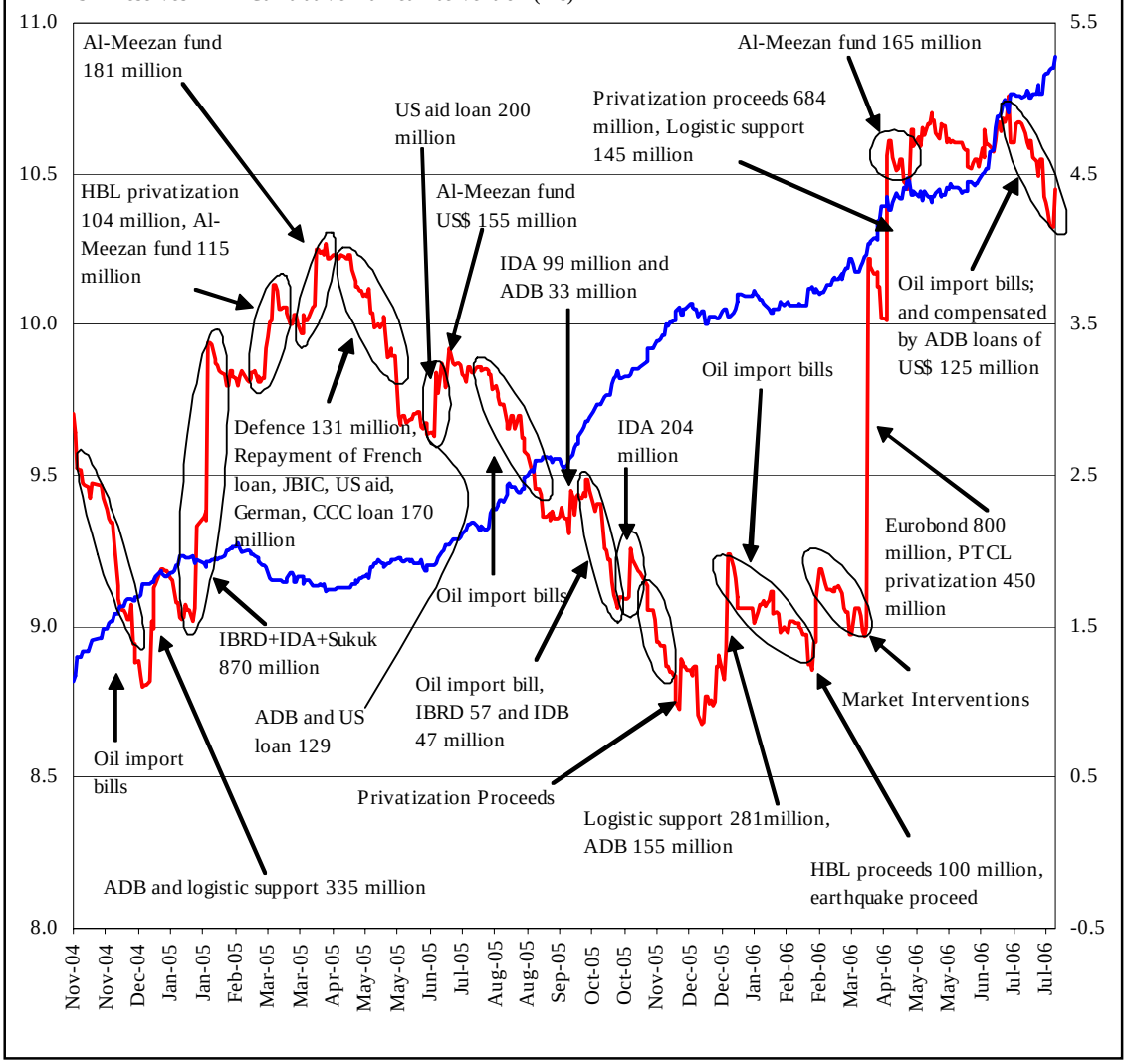


While the volume of SBP interventions in the inter-bank was much higher in FY06 compared to FY05, in net terms the market support was slightly higher in FY06 (see **Figure 7.13**). Nevertheless, heavy SBP interventions caused significant depletion of

[18] Inter-bank purchases & sales are inclusive of swap.

reserves in the first half of FY06. It was only due to some major inflows, particularly on account of privitization proceeds, and floatation of Euro bond that reserves climbed back to surpass the end-June FY05 level.

Figure 7.14: SBP Reserves and Intervention (billion US$)



In contrast to the SBP reserves, commercial banks' foreign curency reserves decreased by US $ 449 million during FY06. This fall was mainly due to the rise in trade loans against FE-deposits resulting on account of both exchange rate stability and rise in the domestic interest rates. Both of these factors also led to decline in the growth of the fresh FE -25 deposits from 19.4 percent in FY05 to 6.1 percent in FY06.

7.4.1 Reserves Adequacy

Conceptually, reserve adequacy is the level of reserves that ensures smooth balance of payments and macroeconomic adjustment in unpredictably changing economic environment, e.g. external price shocks, reversals in short-term foreign capital flows. Although, there is no common approach for estimation of reserve benchmark level, various ratios such as; reserves to imports, to money aggregates and external debt have been adopted to judge reserve adequacy. The most, widely used

Table 7.9: Overall Reserves as per BOP- BPM-5
million US Dollar

	FY05				Total	FY06				Total
Items	**Q1**	**Q2**	**Q3**	**Q4**	**FY05**	**Q1**	**Q2**	**Q3**	**Q4**	**FY06**
Opening balance	**12,389**	**12,458**	**12,141**	**12,855**	**12,389**	**12621**	**12,061**	**11,707**	**12,635**	**12,621**
Inflows	**7,391**	**8,137**	**8,447**	**8,363**	**32,338**	**8,789**	**9,706**	**10,757**	**11,256**	**40,508**
Exports of goods	3393	3555	3750	3752	14,450	3870	4042	4116	4478	16506
Exports of services	860	804	787	824	3,275	1075	960	683	1030	3748
reimbursement logistic support	280	168	202	181	831	474	282	0	314	1070
Income	57	58	77	137	329	142	195	195	229	761
Workers' remittances	983	963	1104	1118	4,168	1002	1053	1173	1372	4600
Foreign direct investment	159	252	246	439	1,096	339	527	457	658	1981
Foreign portfolio investment	21	38	48	44	151	145	214	47	-55	351
Euro / Sukuk bonds	0	0	600	0	600	0	0	800	0	800
Loan disbursements	828	745	527	331	2,431	737	511	745	789	2782
Official	*818*	*743*	*519*	*331*	2,411	*570*	*511*	*409*	*740*	*2230*
Long-term loans	*721*	*743*	*382*	*294*	2,140	407	*505*	*409*	*715*	*2036*
Program loans	*596*	*521*	*300*	*140*	1,557	*246*	*345*	*237*	*545*	*1373*
IMF	255	0	0	0	255	*0*	0	0	0	0
IDA/IBRD	310	115	300	140	865	*96*	200	107	545	948
ADB	31	406	0	0	437	*150*	145	35	0	330
Project & food loans	125	222	82	154	583	*161*	160	172	170	663
Short-term including IDB	97	0	137	37	271	*163*	6	0	25	194
Private un-guaranteed	10	2	8	0	20	*167*	0	336	49	552
Privatization proceeds	0	0	103	260	363	*0*	255	664	621	1540
Official grants	39	60	64	235	398	*38*	240	215	372	865
Others	39	60	64	235	398	*38*	240	215	172	665
Other receipts	1051	1662	1141	1223	5,077	*1441*	1709	1662	1762	6574
Outflows	**7,322**	**8,454**	**7,733**	**8,597**	**32,106**	**9349**	**10,060**	**9,829**	**10,594**	**39,832**
Imports of goods	4175	5048	4800	4942	18,965	*5926*	*6073*	6261	6688	24948
Imports of services (excluding interest)	1441	1662	1763	1726	6,592	*1931*	*2057*	2054	2108	8150
Interest payments	225	279	152	281	937	*258*	*376*	244	355	1233
Amortization of official loans	361	365	258	353	1337	*345*	*319*	242	296.36	1202.36
IMF	107	139	68	85	399	*48*	*42*	10	43	143
IDA/IBRD	124	86	134	92	436	*126*	*78*	133	78	415
ADB	41	80	50	71	242	*46*	*70*	48	69.36	233.36
Others actual paid	89	60	6	105	260	*125*	*129*	51	106	411
Profit and dividends	163	246	138	287	834	*234*	*317*	202	302	1055
Purchase of crude oil /gas	196	225	258	272	951	*231*	*269*	284	365	1149
Principal repaid on private loans	103	70	111	88	372	*94*	*73*	77	70	314
Foreign exchange liabilities liquidated	27	50	27	50	154	*115*	*51*	205	90	461
PTMA & commercial loans-actual paid	*0*	*16*	*0*	*0*	16	*0*	*16*	*0*	*0*	*16*
IDB (short term)	*0*	*8*	*0*	*0*	8	*97*	*0*	*137*	*37*	*271*
Special $ bonds	*27*	26	27	50	130	*18*	*35*	68	53	174
Other payments	631	509	226	598	1,964	*0*	*0*	-5	-16	-21
Gross reserves at end of period	***12,458***	***12,141***	***12,855***	***12,621***	***12,621***	***12061***	***11707***	***12,635***	***13,297***	***13,297***
CRR	587	637	645	682	682	680	743	702	706	706
Sinking fund	235	0	0	200	200	45	0	0	0	0
Net SBP reserves	10,079	9,182	10,062	9,792	9,805	9,504	9,226	10,282	10,760	10,760
DMB reserves without sinking fund & includes CRR	2,144	2,959	2,793	2,616	2,616	2,512	2,481	2,353	2,537	2,537

indicator of reserve adequacy has been reserves expressed in months of imports of goods and services with three months imports deemed appropriate. However, this level of reserves has proved to be insufficient in weathering financial crisis in the past, thus prompting for a measure that is more appropriate.

While some countries have opted to increase the 3-month benchmark to 4 or 6 months, countries with significant but uncertain access to international capital markets have opted to use the so-called Guidotti rule for assessing adequate level of their reserves. According to this rule, the reserves must cover all short - term debt with the remaining maturity of one year or less. Yet some other emerging markets countries, where confidence of resident investors in the domestic currency is not very high and there is risk of resident capital flight the important indicators of reserve adequacy are ratios of reserves to base money or other money aggregates.[19]

Table 7.10: Reserves Adequacy Ratios

	FY01	FY02	FY03	FY04	FY05	FY06
Liquid reserve (million US dollar)	3,219	6,432	10,719	12,328	12,618	13,137
Reserve to GDP share (%age)	4.96	8.77	14.62	14.77	11.44	10.26
Import coverage (months)	1.6	4.5	8.1	7.2	4.6	3.9
Reserve to external debt	0.10	0.19	0.32	0.37	0.37	0.37
Reserve to STDL	1.00	3.27	7.59	10.09	8.58	9.41
Reserve to M2	0.14	0.22	0.30	0.29	0.25	0.23
Reserves to reserve money	0.39	0.66	0.94	0.93	0.83	0.77

In this background, although all reserve adequacy indicators deteriorated by end-June FY06, they are nevertheless remain at comfortable levels (see **Table 7.10**). Reserves adequacy in terms of imports of goods and services has declined from 4.6 months in FY05 to 3.9 months in FY06, it is still by any standards in comfort zone. Reserve to short-term debt and liabilities (STDL) ratio has also deteriorated slightly from last year mainly due to inflow of US$ 194 million from IDB in FY06, it is still quite low. Reserve to GDP ratio declined slightly due to relatively higher growth in GDP than the growth of foreign exchange reserves. The reserves to M2 and Reserve Money ratio has continued its declining trend in FY06 due to significant growth in money supply and reserve money during the last three years compared to increase in the foreign exchange reserves.

[19] Foreign Reserve Adequacy: Case of Russia by Mr. S. G. Shcherbakov Bank of Russia. Fifteenth Meeting of the IMF Committee on Balance of Payments Statistics Canberra, Australia, October 21–25, 2002.

7.5 Trade Account[20]

The continued divergence between the import and export growth for the third successive year widened the trade deficit to a record US$ 12.1 billion during FY06, nearly twice the US$ 6.2 billion seen during FY05 (see **Figure 7.15**). Specifically, the unusually high import growth of 38.8 percent during the period outpaced the 14.3 percent increase in exports. The trade gap was also at the highest level (9.4 percent) even when compared to the size of the economy (see **Figure 7.16**).

Figure 7.15: Divergence in Exports and Imports

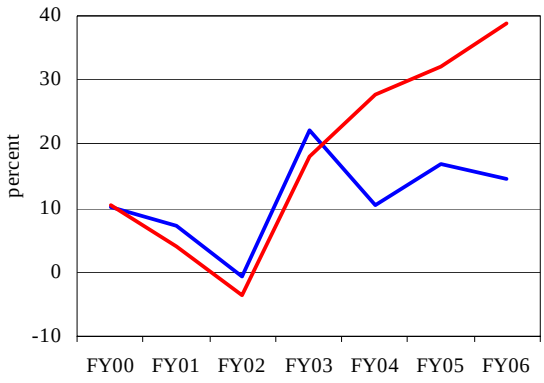
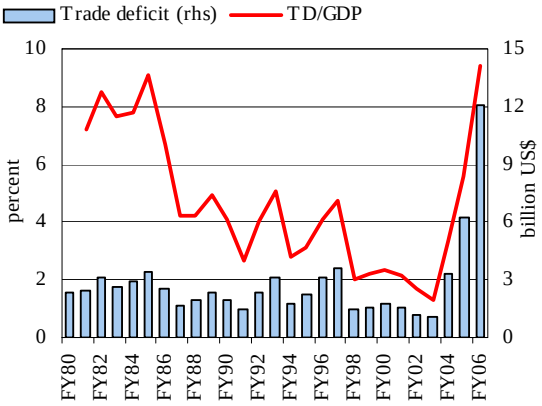


Figure 7.16: Trade Deficit- a Historical Perspective



Given the high elasticities of Pakistan's imports with respect to GDP growth, both in the short and long run, the rise in the imports was to be expected as economic activity accelerated.[21] However, during FY05 and FY06 imports also swelled due to the need of the textile industry readying for the higher competition post-MFA, demand arising from capacity constraints and for the addition of new capacity, as well as a record rise in the international oil prices. Specifically, while import of machinery and raw material together contributed almost 46 percent to the FY06 growth in the import bill, oil imports alone accounted for 33.5 percent or one third of the rise in imports (of which, around 87 percent was due to rise in the oil prices). As a result, the increase in the FY06 trade deficit proved far greater than anticipated (see **Table 7.11**).

Table 7.11: Components of Rise in Trade Deficit in FY06

billion US Dollars

Exports		**Imports**	
Primary commodities	0.2	Food	0.7
Textile manufactures	1.4	Machinery	2.4
Other manufactures	0.5	Petroleum	2.7
Others	0.0	others	2.3
Total rise	**2.1**	**Total rise**	**8.0**

However, as anticipated, the extraordinary rise in import was already moderating, as evident in the H2FY06 data. Specifically, imports growth slowed to 27.8 percent in the latter half of FY06 from 53.1 percent during the first half of the year. The slowdown is more pronounced in the non-oil imports growth, particularly, in the machinery group, where the growth has slipped from 66 percent during H1-FY06 to 25.5 percent during H2-FY06.[22] This trend seems to be continuing in Q1-FY07 as well.

The slowdown in the machinery import was most visible in the telecom and road motor vehicle imports, which together constituted almost half of the machinery imports (see **Figure 7.17**). The slow

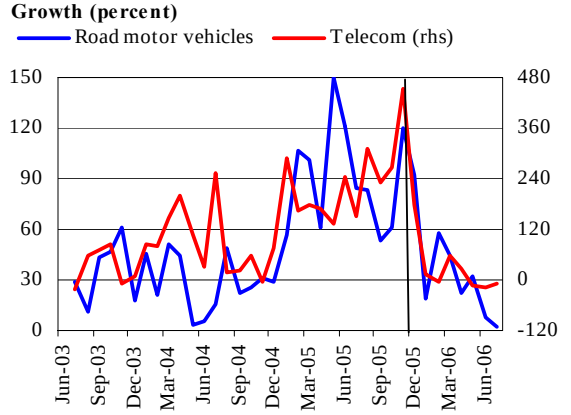
[20] The discussion in this section is based on custom data provided by the Federal Bureau of Statistics (FBS) which may vary from trade numbers complied by the SBP.

[21] For more detail, see the box on trade elasticities in the trade section of Annual Report for FY05.

[22] The machinery group adjusted for one time aircraft import increased by only 17.1 percent during the H2FY06.

down in the telecom, media equipment and road motor vehicles could be an indication of adjustment of the group's imports to new levels after an initial surge due to liberalization measures.
With the diminishing growth in the machinery, food, and Agri chemical imports, oil imports have emerged as the most important factor behind the overall import growth in the second half of FY06 (see **Figure 7.18**). With oil prices declining substantially in recent months, and aggregate demand being constrained by the tight monetary policy, it is hoped that import growth will decelerate significantly in FY07.

Figure 7.17: Telecom and Road Motor Vehicles Imports Growth (percent)

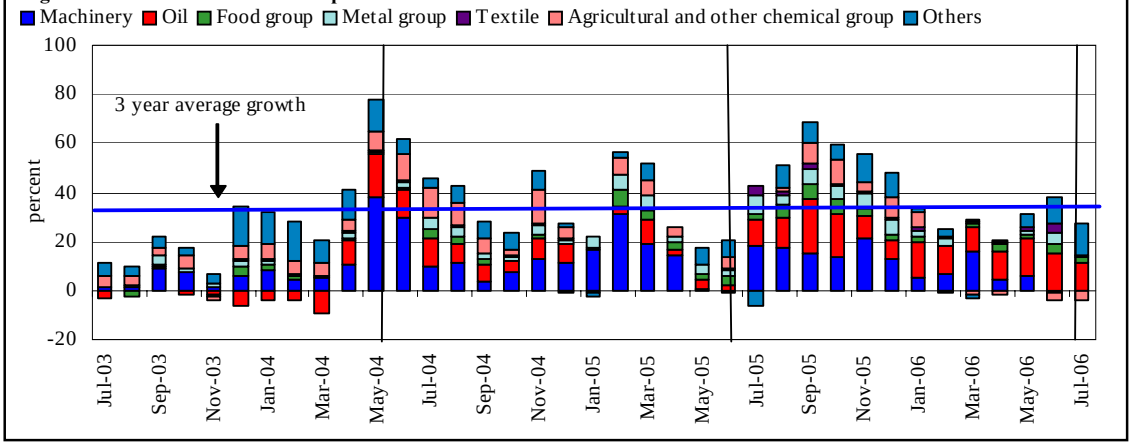


Unfortunately, this may not help reduce the trade deficit very substantially. Although the annual FY06 exports performance appears to be commendable, particularly given the adverse impact of anti-dumping duty and withdrawal of concessions under GSP by the EU and increased competition in the post MFA regime, some weakness in export growth is already evident.

Specifically, a significant part of the strong FY06 export growth was seen mainly in H1FY05, where pre-MFA (quota constrained) exports were being compare to post MFA (no quota) exports. However, this volume dependent rise was soon curtailed by increased competitive pressures (which also lowered margins). Moreover, it should be kept in mind that Pakistan's exports also benefited from the time-bound restrictions on the China's textile exports by EU and US market in FY06. Finally, there appears to be very limited progress with regard diversification of export base (vis-à-vis product and markets). Thus it would be a significant challenge to maintain strong exports growth in this environment, as evident in the deceleration in the export growth witnessed in H2FY06 and Q1FY07 data.

Given this scenario, it is important to provide greater support to the exporters (see **Box 7.1**). Government has already taken a number of steps to enhance exports, including negotiations with the EU to bring down antidumping duty on bed linen exports from 13.1 percent to 5.8 percent, and signing number of bilateral and regional trading agreements to gain the preferential or free market

Figure 7.18: Contribution in Import Growth



access. The new trade policy has also been formulated to provide maximum benefits to the exporters. However, it remains to be seen how this impact the country's export performance (see **Box 7.2**).

Exports

The overall export recorded a fairly healthy growth of 14.3 percent during FY06 against the strong growth of 16.9 percent in the preceding year (see **Figure 7.19**). In absolute terms the increase of US$ 2.1 billion in exports during FY06 and FY05 each is the highest ever in a single year in Pakistan. Moreover, the export growth is still higher than the five year moving average growth of the last sixteen years (see **Figure 7.20**). Nonetheless, the exports of US$ 16.45 billion fell short of the target of US$ 17 billion for the year by US$ 0.55 billion.

Figure 7.19: Exports

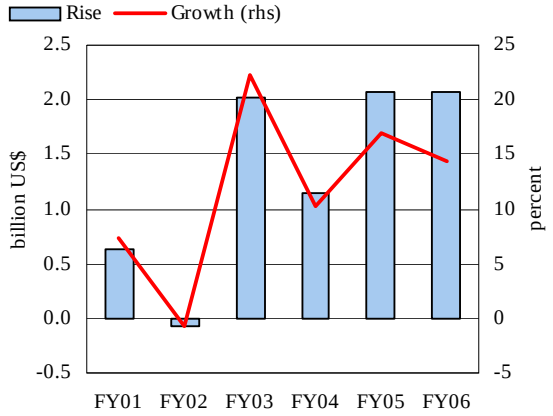
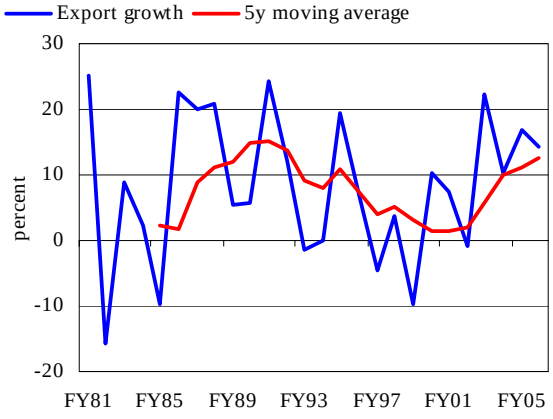


Figure 7.20: Export Growth - A Historical Perspective



The export performance is commendable given the strong competitive pressure from China, India and Bangladesh in textile and clothing items, adverse impacts of anti damping duty and loss of preferential access under Generalized System of Preference (GSP) in the European Union (EU) market, appreciation of exchange rate in real terms against the trading partner currencies and relatively lower growth in the textile sector production.[23,24]

The half yearly trend, however, reveals a slow down in the export growth from 23.4 percent in the first half to 6.8 percent in the second half of FY06. This deceleration in growth was evident in almost all the major categories of exports. However, in absolute terms the value of almost all the categories were greater than that of the first half of FY06 which implies that a major part of the explanation of slow down in exports growth probably lies in the high-base effect (see **Table 7.12**). The deceleration in textile manufacture exports was the most significant due to the large share of these in the country's total exports. The major reason behind this deceleration appears to be the increasing internal competition in the post-MFA period, leading to a fall in export prices (see **Figure 7.21**). This suggests that sustaining a high growth in FY07 would be a challenging task.

Table 7.12: Effect of High Base on the Export Growth

Value in US$ billion; Growth in percent

	Value		Growth (YoY)	
	H1-FY06	H2-FY06	H1-FY06	H2-FY06
Primary commodities	0.91	0.99	21.8	7.2
Textile manufactures	4.93	4.96	27.6	7.4
Other manufactures	1.33	1.49	32.3	10.7
Others	0.87	0.96	-3.4	-1.7
Total exports	8.05	8.40	23.4	6.8

[23] During FY06, Pak rupee appreciated in real terms against the trading partner's currencies as is depicted by 1.71 percent rise in the Real Effective Exchange Rate Indices (REER).

[24] Textile sector grew by 4.2 percent during FY06 against 24.7 during FY05.

Box 7.1: Measures to Increase Exports

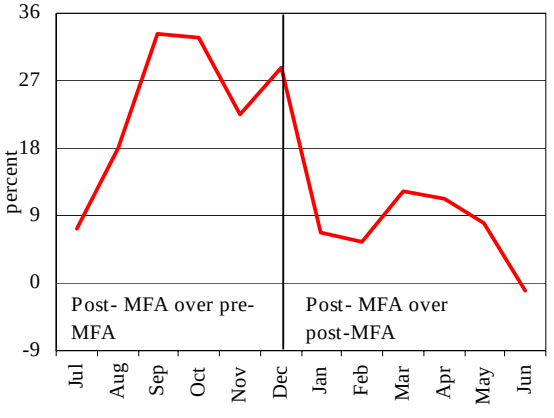
Followings are the major recommendations to raise the exports in the medium to long run.

- Pakistan exports are concentrated in the few items. More than 75 percent of the exports are originating from the cotton, leather, rice and sport goods. There is need to diversify our exports by moving progressively to the exports of steel, electronics, chemicals and other engineering goods. The Asian economies like Japan, Taiwan, Hong Kong and Korea started with the sharp increase in the exports of textile and then gradually shifted to the capital intensive production of electronics and other light and heavy engineering goods.
- Foreign Direct Investment in the export sector plays an important role in export promotion. The foreign investors are integrated into the marketing, distribution and supply management networks of their home countries thereby helping to capture the international market. China's clothing industry, through large inward FDI is heavily integrated into the global distribution systems and has direct involvement of OECD retailers which give it a comparative edge over its competitors. Today FDI in Pakistan is concentrated in the oil and gas sector, telecommunication and financial sector. The attraction of FDI in the export sector can be beneficial in terms of technology transfer, skill development of the local labor and marketing.
- The Government should provide the strong infrastructure to the exporters like transport and communication, roads highways, powers and well functioning ports. The weaknesses in the infrastructure like the transportation failures and frequent power break down interrupt the production processes making it difficult for the exporters to meet their delivery time lines.
- The imposition of punitive antidumping duty on bed wear exports together with loss of GSP in the EU market has affected our exports adversely. The Government has an important role to play in this regard by providing the exporters a level playing field in the major countries and regions through effective trade diplomacy.
- The countries across the world are engaging themselves in the different regional and bilateral trading agreements to get the preferential or free market access. The Government should also enter into such Preferential Trade Agreement (PTAs) and Free Trade Agreement (FTAs) along with successful implementation of the agreements already entered.
- The increase in the per capita productivity has become necessary in the textile and clothing sector to compete with China and India in the Post Multifiber Arrangement (MFA) period. The increased education facilities, on-the-job training, skill up gradation and dissemination of new knowledge and techniques go a long way in this regard.
- The reluctance of Pakistan's exporter to ensure compliance with environmental standards and labor standards agreed under international codes and agreements also hits their exports adversely particularly in the areas of fish and fish preparation. They should become fully compliant with the requirements of the advanced economies buyers and governments.
- The anecdotal evidence suggests that cost of doing business in Pakistan is relatively high as compared to its major competitors mainly on account of the high utility charges. In particular the high value added textile items have started showing signs of slow down in the international market on account of tough competition from China and India. According to the market sources Pakistan's competitor countries are subsidizing their exports at the rate higher than that of Pakistan. Pakistan should also simplify the tax and tariff regime for exporters and consider other subsidizing measures to provide level playing field to its exporters.
- The Small and Medium enterprises (SMEs) in Pakistan are playing a key role in production of exports. They performance can further be improved by integrating them into an organized production network for exports. The formal sector, through strategic alliances, subcontracting, and outsourcing can help the SMEs to materialize productivity gains.

Major Export Markets

The US and European Union markets remained the major destinations for Pakistan's exports during the last four years. More than 50 percent of Pakistan's exports were directed to these two markets. Likewise, UAE remained the third major market capturing 7-9 percent of Pakistan's total exports. This suggests that Pakistan's efforts to diversify exports markets have not materialized significantly (see **Table 7.13**).

Figure 7.21: Monthly Export Growth during FY06



However, though very small in magnitude, there was some evidence of export market diversification in the countries where Pakistan

Box 7.2: Highlights of Trade Policy for FY07

The salient features of the trade policy for FY07 are as follow;

1) The export target of US$ 18.6 billion and import target of US$ 28 billion is set for FY07.
2) The Export Promotion Bureau (EPB) is replaced with Trade Development Authority of Pakistan (TDAP).
3) The carpet cities would be established in Lahore and Karachi to promote carpet exports while Dazzle Park would be set up to promote export of Gem and Jewellery.
4) To facilitate the exports of perishable products, , first 6% of the mark up for any credit obtained for the setting up cool chain and cold storage by any company would be picked up by the Export Development Fund (EDF).
5) For the export diversification, all the items except those notified separately will now be able to avail 25 percent freight subsidy, provided they are exported to Africa, Pacific Islands, Eastern European countries that are not included in EU and Central Asian Republics. Moreover, exports of developmental category would be entitled to 25 percent subsidy even if they are going to top 20 export destinations. However, any individual exporter, firm or company will not be entitled to a freight subsidy in excess of 5 million rupees in a single year.
6) The Textile Skill Development Board which is assisting in the training of garment workers will also assist in the training of terry towel and bed linen workers.
7) The 6 percent Research and Development Support to the readymade garments and knitwear would continue up to the end of FY07.
8) In the face of growing importance of standards certification and quality concerns, four additional kind of certification i.e. ISO-22000, Eco-Labeling, Conformity Europe and Organic Food Product Certificates are included in the facility of 50 percent subsidy for the cost of obtaining a certification.
9) In order to increase the exports of Small and Medium Enterprises (SMEs), a specialized SME export house will be established as a corporate entity with public and private partnership and run by professional management.
10) In order to facilitate the export of cement, a specialized coal, clinker and cement terminal is planned to be set up in Port Qasim Karachi.
11) It has been decided to provide 6 percent subsidy to the footwear industry on the pattern of Readymade garments subsidy.
12) Halal meat export zones will be established in Quetta, Karachi, Lahore and Peshawar, to promote exports of Halal meat to Islamic countries.
13) Following steps are decided to be taken to finance the long term export projects.
    a) The banks will be entitled to a maximum spread of 2 percent instead of 3 percent thereby reducing the cost of borrowing by 1 percent.
    b) The banks will be allocated separate limits aligned to their demand rather than linking them with disbursement under the export refinance scheme.
    c) The allocation of separate amounts for SMEs and non-SMEs has been dispensed with. However, banks will give preference to the needs of SMEs.
    d) The SMEs borrowers have been allowed to purchase plant, machinery, equipments and accessories through commercial importers.
    e) The borrowers can import plant and machinery required for their projects irrespective of whether it is being locally manufactured or not.
14) The banks and DFIs have been authorized to sanction and disburse loans without prior approval of the State Bank of Pakistan. To promote exports of potential sectors, custom duty on some marble and granite machinery, and on horticulture and floriculture machinery has been reduced to zero percent and the duty on horticulture raw material is reduced from 25 percent to 5 percent, on complete rice par boiling plant from 25 percent to zero percent, on pharmaceutical ventilation air-conditioning units from 25% to 5%, and on imported raw material for footwear from 10% to 5%.
15) Subject to certain conditions, the import of used machinery is allowed in the construction and petroleum sector, used parts and accessories in construction, mining and petroleum sectors. Likewise import of used parts and accessories in the various industries is also allowed.

Reference: Trade Policy for FY 2006-07

entered into preferential or free trading agreements. For instance, share of Pakistan's total exports to China, Iran and SAARC countries has increased gradually during the period under review.

On the positive side, according to World Bank's ease of trading across the border ranking, Pakistan is placed in a comfortable position as compared to its major regional competitors indicating comparative advantage for Pakistan (see **Table 7.14**).

Table 7.13: Pakistan's Major Export Markets (million US$)

Value in million US Dollars, share in percent

	FY06		FY05		FY04		FY03	
	Total	Share	Total	Share	Total	Share	Total	Share
Total	16451.2		14,391.0		12,313.3		11,160.2	
USA	4192.6	25.5	3,444.5	23.9	2,943.8	23.9	2,618.8	23.5
EU	4217.6	25.6	4072.6	28.3	3726.8	30.3	3148.3	28.2
UAE	1312.7	8.0	1096.1	7.6	943.1	7.7	1037.6	9.3
Afghanistan	1063.6	6.5	748.0	5.2	493.1	4.0	314.5	2.8
Hong Kong	679.2	4.1	558.1	3.9	582.0	4.7	517.0	4.6
China	463.9	2.8	354.3	2.5	288.1	2.3	244.8	2.2
Saudi Arabia	329.2	2.0	352.8	2.5	348.6	2.8	476.4	4.3
Belgium	321.8	2.0	312.8	2.2	262.4	2.1	239.8	2.1
Turkey	304.5	1.9	258.5	1.8	218.8	1.8	146.1	1.3
India	293.3	1.8	288.6	2.0	93.7	0.8	70.5	0.6
Bangladesh	268.5	1.6	206.0	1.4	194.9	1.6	114.2	1.0
South Africa	260.8	1.6	196.8	1.4	122.4	1.0	111.3	1.0
Canada	209.0	1.3	194.0	1.3	181.6	1.5	206.1	1.8
Iran	188.1	1.1	147.1	1.0	92.5	0.8	63.2	0.6
Korea	191.2	1.2	185.2	1.3	201.9	1.6	219.5	2.0
Sri Lanka	159.2	1.0	156.0	1.1	97.8	0.8	76.1	0.7
Others	1995.9	12.1	1819.7	12.6	1521.9	12.4	1556.0	13.9

However, cost to export and import per container is relatively high chiefly because of high inland transportation and handling charges.

Table 7.14: Cost of Doing Business in Pakistan for 2006

		Trading Across Borders						
Country	Ease of doing business rank	Rank	Documents for export (number)	Time for export (days)	Cost to export (US$ per container)	Documents for import (number)	Time for import (days)	Cost to import (US$ per container)
Bangladesh	88	134	7	35	902	16	57	1,287
Bhutan	138	150	10	39	1,230	14	42	1,950
China	93	38	6	18	335	12	22	375
India	134	139	10	27	864	15	41	1,244
Maldives	53	91	8	15	1,000	9	21	1,784
Nepal	100	136	7	44	1,599	10	37	1,800
Pakistan	74	98	8	24	996	12	19	1,005
Sri Lanka	89	99	8	25	797	13	27	789

Source: World Bank

Moreover, the reduction of antidumping duty on bed wears exports to EU from 13.1 percent to 5.8 percent towards the end of FY06 and restoration of some Generalized System of preference (GSP) benefits are likely to have favorable impacts on textile exports.

Primary Exports

The primary group exports grew by 13.7 percent during FY06 as compared to a relatively higher growth of 31.4 percent in the preceding year. The lower cotton production and relatively increased consumption of raw leather domestically contributed in the deceleration of the group exports[25]. As a result the group's contribution in total exports growth has fallen from 19 percent during FY05 to

[25] The cotton production declined from 7.279 million bales during FY05 to 6.336 million bales during FY06 while leather industry recorded 5.8 percent growth during FY06 as compare to decline of 5.3 percent during FY05.

around 11.2 percent during FY06. The major contributors in the primary group exports were rice, fish and fish preparation and dry fruits.[26]

Rice

A bumper crop helped aggregate rice exports reach US$ 1.13 billion during FY06. The 20.3 percent compared to FY05 exports was a consequence of higher prices for basmati rice exports as well as extraordinary increase in exports of other varieties.

Indeed, as a result of the 37 percent rise in exports of exports of non-basmati rice, their share in total rice export has increased from 53 percent during FY05 to 59 percent during FY06. The intermediate and low quality long grain milled rice was largely exported to developing countries, such as Cote d, Ivoire, Togo, Iran, Mozambique and Afghanistan (see **Table 7.15**). The exports growth may have been strong were it not for the pressures on prices due to increased exports Vietnamese long-grain rice to Africa and the Middle East.

The basmati rice, which sells at a substantial premium in the high income markets, recorded 9.2 percent export increase during the period, essentially due to high prices; unit values of exports are higher in almost all of Pakistan's major export markets (see **Table 7.16**). The big markets of the basmati rice remained UAE, EU and other Middle East countries. However, the rice exports to Saudi Arabia declined significantly probably because of the relatively cheaper Indian rice exports to the market. The Mexico's ban on all varieties of rice imports from Pakistan under the Sanitary and Phyto-sanitary (SPS) measures since last six years has reduced the rice exports to the market[27].

Table 7.15: Rice Export Market

(Value in million US Dollars; Quantity in 000 MT)

	FY06		FY05		YoY growth in unit values
	Quantity	Values	Quantity	Values	
Rice other varieties	**2850**	**678**	**2015**	**480**	**0**
Co,te d,Ivoire(Fr.Iv)	316	68	130	32	-12
Togo	238	53	128	29	0
Iran Islamic Republic	252	68	163	45	-3
Mozambique	227	51	115	27	-5
Afghanistan	203	37	153	28	0
Madagascar	121	27	22	5	-5
Dubai	103	33	29	9	-2
Kenya	166	33	141	27	4
South Africa	86	19	130	30	-4
Guinea	88	19	51	11	-3
Saudi Arabia	51	18	38	13	-1
Ghana	55	12	52	12	0
Cameroon	68	15	138	32	-7
Russian Federation	45	11	24	6	-3
Malaysia	36	11	25	7	10
Yemen	29	12	22	7	18
Oman	25	9	17	5	14
Mauritius	34	9	20	5	8
Philippines	57	13	9	2	-13
Qatar	25	9	17	6	1
Iraq	41	11	4	1	-17
Sierra Leone	41	9	15	3	11
St.Kitts and Nevis	26	5	-	-	
Ukraine	21	5	15	4	-3
Other countries	495	120	557	132	2
Broken rice			**62**	**14**	**-**

Textile Manufacture Exports

The *textile manufactured* exports witnessed remarkable increase of 16.6 percent during FY06 in contrast to the 4.9 percent growth recorded in the preceding year. As a result, the group's share in total exports has increased from 59 percent last year to 60 percent.

It may be noted that FY05 export growth in this category had been hurt by the uncertainty due to the scheduled removal of the global textile quotas under MFA from January 2005 onwards. The higher growth figure for FY06, is therefore partly explained the absence of this uncertainty in FY06, compounded by the increase in market access for Pakistan's exports post-MFA. However, the increasing competition is now pressuring exports prices, adversely affecting export growth prospects.

[26] The rice production increased from 5.025 million ton during FY05 to 5.547 million ton in FY06.

[27] Mexico is not a major market for Pakistan rice but it gives a wrong signal to the world market about the quality of rice.

This is evident in the shifts in unit values. Over the years the share of the high value added textile items in the group had witnessed a gradual increase. However, on account of pressure on the unit values of high value added textile items, their share has stagnated in FY05 and FY06 (see **Figure 7.22**).

The unit values of almost all the high value added textile products remained under pressure during the period under review (see **Figure 7.23**). The fall in the unit values of the knitwear exports was more evident which restricted its growth to only 7.1 percent during the year.

Moreover, the entire increase in the growth was contributed by US market as the exports in EU market declined by four percent probably on account of loss of the special preference under GSP. As a result, more than 60 percent of the knitwear exports were directed to the US market.

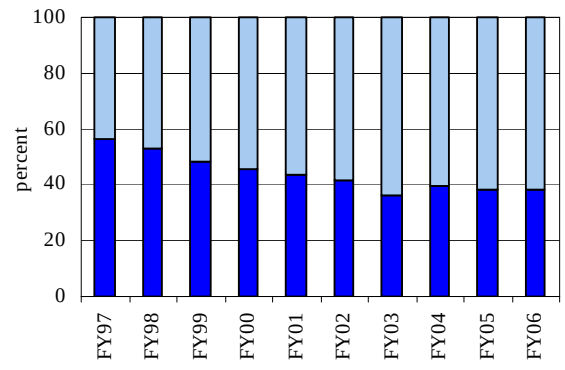
Despite the adverse effect of antidumping duty, the bed ware depicted remarkable growth of 40.4 percent during FY06 in contrast to nominal growth of 4.1 percent during the last year. The increase of exports in the US market was greater than EU market mainly on account of antidumping duty in the EU market. Almost the entire increase in bed wear export was contributed by quantum.

The towel depicted 12.6 percent growth during FY06 as compared to 28.8 percent growth in the preceding year. Despite the fall in unit values in the US market, export growth was greater to US market as compared to EU market (see **Table 7.17**). The contributory factor behind the low growth in EU market may also be loss of GSP access.

Table 7.16: Rice Export Market
Values in million US Dollars; Quantity in 000 MT

	FY06		FY05		YoY growth in unit values
	Quantity	Values	Quantity	Values	
Rice basmati	**839**	**480**	**815**	**439**	**6.1**
UAE	81	49	90	50	9.0
EU	359	201	150	83	1.3
Oman	55	30	56	29	4.1
Iran (Islamic R.)	48	29	43	24	9.3
Saudi Arabia	45	25	64	31	12.7
Kuwait	33	19	31	16	13.3
Qatar	32	18	27	15	0.2
North America	16	13	20	12	24.4
Mauritius	20	11	20	11	2.2
Yemen	22	12	35	17	10.2
Australia	12	7	10	5	8.3
Afghanistan	21	12	2	1	31.7
Malaysia	8	4	9	5	6.6
South Africa	4	2	2	1	5.2
Others	83	48	256	138	5.6

Figure 7.22: Share of Low Value Added and High Value Added in Textile Exports

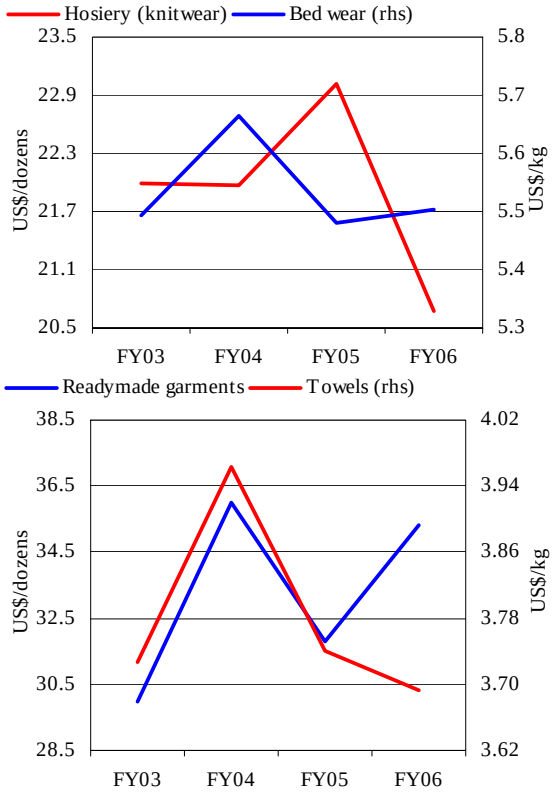


The readymade garments were able to register a relatively higher growth of 21 percent during FY06 against 9.3 percent growth during the last year on the back of higher unit values.

The 6 percent subsidy to the sector might have given some additional support to readymade garments exports[28]. However, the closer look at the data suggests that the category exports have decelerated in the second half of FY06[29]. The ready made garments exports increased to both the US and EU markets but the increase was relatively higher in the US market.

Within the low value added textile product, despite the fall in its unit value, cotton yarn recorded 32.4 percent increase in contrast to decline of 6.4 percent in preceding year whereas the cotton fabrics grew by 13.8 percent against 8.6 percent increase in the last year (see **Figure 7.24**). Interestingly, this may have been helped by the greater focus of two important competitors, China and India, on the high value added textile products.

Figure 7.23: Unit Values of High Value Added Textile Products

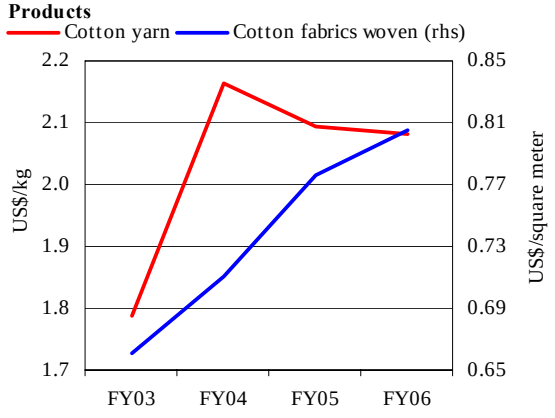


Textile Sector performance under post-MFA regime

US market

Despite tough competition from China, India and Bangladesh, Pakistan has been successful in gradually expanding its share in the US market. However, the increase in market share is relatively more pronounced during the first seven months of CY06 (see **Table 7.18**). Moreover, unlike CY05 where the slight expansion in share was almost entirely contributed by the Textile mill products, the expansion during Jan-Jul CY06 was textile & fabrics and apparel& accessories.

Figure 7.24: Unit Values of Low Value Added Textile Products



China remained the major beneficiary of the quota free regime capturing more than one fourth of the US market share. However, the surge of China's exports has cooled off after safeguard measures and subsequent restrictions in the US markets. The growth of China's exports to the US market in selected categories have been capped during 2006,2007 and 2008 to 10 percent, 12.5 percent and 16 percent respectively. As a result its market share slightly shrunk to 27.4 percent during Jan-Jul CY06 against 27.6 percent during CY05.

[28] The government is providing research and development support to the textile garment units manufacturing and exporting textile garments to EU and USA subject to certain conditions.

[29] The anecdotal evidence suggests that increased cost of doing business and lower subsidy level in Pakistan as compared to China, India and Bangladesh is the key factor behind the slow down.

Table 7.17: Market Analysis of Major Textile Items

YoY growth in percent; percentage share in the item export

	Growth			Share	
		FY06		FY05	FY06
	Quantity	Value	Unit Value	Value	Value
Towels	**14.1**	**12.6**	**-1.3**		
EU	7.2	7.0	-0.2	27	29
USA	29.3	27.4	-1.5	55	49
Others	-11.4	-11.8	-0.5	17	22
Bed wear	**39.9**	**40.4**	**0.4**		
EU	23.5	21.4	-1.7	35	40
USA	79.5	75.3	-2.3	51	41
Others	5.5	5.0	-0.5	14	19
Garments	**8.9**	**20.9**	**11.0**		
EU	17.1	29.4	10.5	47	44
USA	28.0	38.4	8.2	40	35
Others	-30.9	-27.3	5.2	13	22
Knit wear	**19.3**	**7.1**	**-10.2**		
EU	1.3	-1.1	-2.4	31	33
USA	33.2	17.2	-12.0	62	57
Others	14.6	-21.8	-31.8	7	10

Table 7.18: Percentage Share of Selected Countries Exports in US Textile Imports

	Total textile imports			Textile and fabrics		
	CY04	CY05	Jan-Jul CY06	CY04	CY05	Jan-Jul CY06
Pakistan	3.0	3.2	3.7	6.8	5.5	5.9
China	20.6	27.6	27.4	9.3	13.4	14.8
Bangladesh	2.4	2.6	3.1	0.2	0.2	0.2
Sri Lanka	1.8	1.8	1.8	0.2	0.1	0.1
India	4.7	5.5	6.3	3.6	4.1	4.7
Vietnam	3.0	3.0	3.5	0.2	0.2	0.3
Thailand	2.5	2.3	2.3	1.8	1.7	1.5
Total US textile imports	100	100	100	100	100	100
	Textile mill products			Apparel and accessories		
Pakistan	7.9	9.3	10.6	1.8	1.9	2.0
China	38.3	42.8	43.8	18.8	26.2	25.3
Bangladesh	0.8	0.7	0.8	2.9	3.2	3.9
Sri Lanka	0.3	0.2	0.3	2.2	2.3	2.4
India	12.6	12.5	12.6	3.5	4.3	5.2
Vietnam	0.4	0.3	0.4	3.7	3.7	4.5
Thailand	2.0	1.4	1.2	2.6	2.5	2.6
Total US textile imports	100	100	100	100	100	100

Source: US Census Bureau

On the back of impressive performance in the quota free regime, India's share in the US market increased from 4.7 percent during CY04 to 6.3 percent during Jan-Jul CY06. The increase in the market share of high value added apparel and accessories was more prominent as compared to low value added textile & fabrics and textile mill products. Likewise, commendable export performance of apparel and accessories by Bangladesh and Vietnam increased their share in the US market during Jan-Jul CY06 to 3.1 percent and 3.5 respectively.

The data suggests that Pakistan has a comparative advantage in the middle value added textile mill0 products, where its market share is continuously increasing in comparison with stagnant or nominal increase in the market share of its major competitors. Regarding high value added textile exports; Pakistan is facing competitive pressure from China, India and Bangladesh. Moreover, the earlier US limits on the China's exports has benefited mainly India, Bangladesh and Vietnam.

EU Market

Pakistan's textile exports share in the EU market has declined from 3.6 percent during CY04 to 3.0 percent during CY05. Both textile and clothing contributed in the over all market loss. However, the decline in share of textile exports was more prominent on account of antidumping duty on the bed wear exports. Nonetheless, a marginal recovery in the market share was witnessed during Jan-May CY06 on the back of 21 percent growth of clothing exports to the EU market during the period (see **Table 7.19**).

Table 7.19: Percentage Share of Selected Countries Exports in EU Textile and Clothing Imports

	Textile and clothing			Textile			Clothing		
	CY04	CY05	Jan-May CY06	CY04	CY05	Jan-May CY06	CY04	CY05	Jan-May CY06
China	23.0	30.2	26.9	18.7	22.9	25.3	24.4	32.4	27.4
Turkey	15.2	14.8	14.6	16.1	16.4	16.1	14.8	14.3	14.0
India	6.8	7.5	8.7	11.5	11.6	11.2	5.3	6.2	7.9
Bangladesh	5.6	5.0	5.9	1.0	1.0	1.1	7.0	6.2	7.5
Pakistan	3.6	3.0	3.1	8.3	7.1	6.9	2.1	1.7	1.9
Indonesia	2.6	2.2	2.3	2.4	2.2	2.3	2.6	2.2	2.3
Thailand	1.9	1.7	1.7	1.6	1.6	1.7	2.0	1.7	1.8
Sri lanka	1.3	1.2	1.3	0.1	0.1	0.1	1.6	1.5	1.7
South Korea	1.9	1.4	1.2	4.2	3.8	3.1	1.2	0.6	0.6
Malaysia	1.0	0.9	1.0	0.8	0.7	0.8	1.1	1.0	1.1
Egypt	0.9	0.8	0.9	1.6	1.6	1.5	0.6	0.6	0.6
Philippines	0.5	0.3	0.4	0.2	0.2	0.3	0.6	0.4	0.4
Myanmar	0.5	0.3	0.3	0.0	0.0	0.0	0.7	0.3	0.4
Iran	0.3	0.2	0.2	1.2	1.0	0.9	0.0	0.0	0.0
Mexico	0.2	0.1	0.1	0.3	0.3	0.3	0.1	0.1	0.1
Others	34.9	30.5	31.2	31.9	29.4	28.4	35.8	30.8	32.1
Total	100	100	100	100	100	100	100	100	100

Source: Eurostat

In contrast, India continued capturing EU market additional share during the post-MFA period. Specifically, its share in the EU market increased from 6.8 percent during CY04 to 8.7 percent during Jan-May CY06. Almost all the increase in the EU market share was explained by the impressive performance of the high value added clothing exports.

The restrictions on China's exports to EU market under the safeguard measures have lead to a market loss to China during Jan-May CY06. The effect of the restrictions is well reflected in the 500 basis points decrease of market share in EU Clothing market.

Bangladesh lost its market share in EU market both in the low value added and high value added products during CY05. However, limitations on China's exports and decisive support from EU's duty free access under the Everything But Arms (EBA) provision of its GSP program have enabled Bangladesh to increase its market share in EU market from 5 percent during CY05 to 5.9 percent during Jan-Mar CY06.

Moreover, the price pattern of different countries exports to the EU market suggests that China, India and Bangladesh are concentrating on quality rather than volume, consequently their exports are fetching good price from the market (see **Table 7.20**). The prices of Pakistan exports in the EU market remained under significant pressure during 2005; however the prices recovered to the greater extent during the first five months of CY06.

Table 7.20: EU Textile and Clothing Imports

Percentage change in the unit prices in Euro

	2004	2005	2006
Pakistan	2.6	-7.7	7.9
China	1.3	4	14.3
Bangladesh	2.1	-3.9	23.4
India	2.2	11.7	18.2
Sri Lanka	1.1	7.5	13.5
Vietnam	11.6	3.2	-12.6

Source: www.emergingtextile.com

Other Manufactures

The strong growth in exports other manufactures stemmed from an increase in exports of L*eather Garments and Sport goods* and of petroleum products (see **Table 7.21**). The former was on account of increased export of football due to the event of world cup, while the latter was on account of increased exports of Petroleum top Naptha and kerosene type jet fuel. Consequently, the group's share in the overall exports has increased to 17 percent during FY06 from 16 percent during FY05. In contrast, the medicinal instruments and pharmaceutical products exports declined on the back of increased domestic consumption due to earthquake in the northern areas of Pakistan and molasses exports declined on account lower sugar production. The increase in the export of items like steel, electronics, transport equipments, auto parts and other engineering goods is necessary for the diversification of exports. However, despite the strong growth in exports of such engineering goods over the last five years, their share is still negligible in the total exports (see **Table 7.22**).

Table 7.22: Export of Engineering Goods

	Growth (%)	Share in total exports (%)
FY00	-	0.31
FY01	62	0.48
FY02	17	0.56
FY03	45	0.66
FY04	35	0.81
FY05	82	1.26
FY06	17	1.29

Imports

The combination of soaring oil prices in the international market, strong domestic economic growth, economic liberalization measures, and imports of key food items to improve their domestic supply, was the driving force behind the exceptionally high import bill of US$ 28.6 billion during FY06 (see **Table 7.23**). Imports increase by 38.8 percent during the period, even on top of the top of 32.1 percent growth recorded in the preceding year.

Table 7.23: Import Supporting Indicators

	FY01	FY02	FY03	FY04	FY05	FY06
Average tariff rate	24.8	20.4	17.3	17.1	16.8	14.4
GDP growth rate (%)	2.0	3.1	4.7	7.5	8.6	6.6
Arabian light oil prices	-	-	27.01	33.73	52.93	67.9
REER app(+)/dep(-)	-	3.27	-3.57	2.57	2.03	1.71

Primarily as a result of the rising oil prices in the international market, the petroleum group contributed almost one third of the total import growth. Whereas, almost 87 percent of the increase in the petroleum group import was caused by high oil prices. The increased import of furnace oil on the back of higher consumption by electricity producers also inflated the petroleum group imports.

The increase in the import of machinery and raw material to cater for the needs of the growing domestic economy contributed almost 46 percent to overall import growth (see **Figure 7.25**).

Table 7.21: Major Exports

value: million US Dollar; Unit value in US Dollar

			FY05		FY06P		Absolute	Change (percent)		
		Unit	Value	Unit value	Value	Unit value	Δ in value	Qty	Value	Unit value
A.	**Primary commodities**		**1,674.3**		**1904.2**		**229.8**		**13.7**	
1	Rice	MT	932.5	322.5	1130.4	306.4	197.9	27.6	21.2	-5.0
2	Raw cotton	MT	110.0	939.1	68.6	1095.1	-41.3	-46.5	-37.6	16.6
3	Raw wool (excluding Wool Tops)	MT	1.0	1,126.5	1.9	2172.1	0.9	0.0	92.8	92.8
4	Fish and fish preparations	MT	138.9	6.1	194.7	9.0	55.8	-5.3	40.1	47.9
5	Leather	SQM	303.6	16.5	289.1	16.6	-14.5	-5.7	-4.8	1.0
6	Guar and guar products	MT	26.5	1,177.9	18.0	1120.1	-8.5	-28.5	-32.0	-4.9
7	Fruits	MT	91.2	309.9	125.5	279.7	34.2	52.3	37.5	-9.7
8	Vegetables	MT	32.8	305.1	48.1	301.4	15.3	48.5	46.6	-1.2
9	Crude animal material	MT	16.2	3,757.0	16.9	2984.5	0.7	31.7	4.6	-20.6
10	Oil Seeds & nuts etc.	MT	21.6	773.7	11.0	632.0	-10.6	-37.8	-49.2	-18.3
B.	**Textile manufactures**		**8,482.8**		**9891.0**		**1408.2**		**16.6**	
1	Cotton yarn	MT	1,056.5	2,093.3	1398.4	2081.9	341.9	33.1	32.4	-0.5
2	Cotton fabrics (woven)	SQM	1,862.9	0.8	2119.6	0.8	256.7	9.8	13.8	3.6
3	Hosiery (knitwear)	DOZ	1,635.0	23.0	1751.7	20.7	116.6	19.3	7.1	-10.2
4	Bed wear	MT	1,449.5	5,481.5	2035.5	5503.1	586.0	39.9	40.4	0.4
5	Towels	MT	520.5	3,739.9	586.3	3692.6	65.8	14.1	12.6	-1.3
6	Cotton bags and sacks	MT	14.1	4,094.5	12.8	3879.9	-1.2	-3.8	-8.8	-5.2
7	Readymade garments	DOZ	1,088.0	31.8	1315.3	35.3	227.4	8.9	20.9	11.0
8	Tarpaulin & other canvas goods	MT	66.6	2,518.1	34.9	2033.9	-31.7	-35.1	-47.6	-19.2
9	Tule, lace embroidery etc.	(-)	12.3		8.2	---	-4.1	---	-33.3	---
10	Synthetic textiles	SQM	300.3	0.7	202.6	0.7	-97.7	-28.0	-32.5	-6.2
12	Other textile made-up	(-)	466.0	---	412.6	---	-53.4	---	-11.5	---
13	Waste material of tex. fibers/fabrics	MT	11.2	629.7	13.0	760.0	1.9	-3.4	16.6	20.7
C.	**Other manufactures**		**2,356.0**		**2825.3**		**469.3**		**19.9**	
1	Carpets, carpeting rugs & mats	SQM	277.8	55.7	252.1	59.6	-25.7	-15.1	-9.3	6.9
2	Petro. and petroleum products	MT	476.1	395.0	803.7	531.4	327.6	25.5	68.8	34.5
3	Sports goods	(-)	307.1		345.5	---	38.3	---	12.5	---
4	Leather manufactures	(-)	526.8	---	722.6	---	195.8	---	37.2	---
5	Surgical and medical instruments	NO	182.9	---	159.8	---	-23.1	---	-12.6	---
6	Cutlery	GR	34.3	19.4	32.9	20.7	-1.4	-9.9	-3.9	6.6
7	Onyx manufactured	MT	8.7	1,716.4	13.5	1639.7	4.8	62.9	55.7	-4.5
8	Chemicals and pharmaceuticals	(-)	452.6	---	426.6	---	-26.0	---	-5.7	---
9	Molasses	MT	72.4	62.9	43.6	87.7	-28.8	-56.8	-39.8	39.4
10	Sugar	MT	17.3	313.1	25.0	409.8	7.7	10.3	44.4	30.9
D.	**Others**		**1,878.0**		**1,830.7**	---	**-47.2**	**---**	**-2.5**	---
	Total exports		**14,391.0**		**16451.2**		**2060.1**		**14.3**	

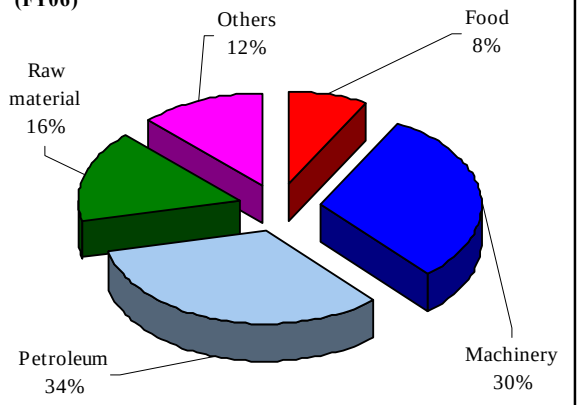
Source: Federal Bureau of Statistics

However, a closer look at the data suggests that there is a considerable deceleration in the non-oil imports growth from 50.5 percent during H1FY06 to 18.3 percent during the second half of FY06 (see **Table 7.24**).

The increase in import of sugar and pulses as a part of Government effort to deal with the price pressures was another contributor to the already strong import growth.[30]

Lastly, the appreciation of local currency in real terms against the trading partner's currencies might have increased the demand for relatively cheaper imported goods asserting additional pressure on the import bill.

Figure 7.25: Contribution to Additional Import Bill (FY06)



Machinery Group

The machinery group imports posted an annual growth of 40.7 percent during FY06 on the top of 40.2 percent growth during the corresponding period last year. Road motor vehicles, electrical machinery and apparatus, Telecom and sound recording equipments, power generating machinery and other machinery were the major contributors in the group imports. During the year, the machinery group imports can be divided into two distinct phases. In the first phase from Jul-Dec FY06, the group imports registered a strong growth of 66 percent while the import growth in the second phase from Jan-June FY06 significantly slowed down to 25.6 percent (see **Table 7.25**). The group import growth in the second phase is further lowered to 17.1 percent if adjusted for the one time air craft import. The sharp decline in the import growth of telecom and sound recording equipments, electrical machinery and apparatus, road motor vehicles and other machinery were the explanatory factors behind the lower machinery imports in the second phase.

Table 7.24: Import Growth

percent

	FY05	FY06	H1-FY06	H2-FY06
Food group	36.3	46.2	57.6	37.8
Machinery group	40.2	40.6	65.9	25.5
Petroleum group	26.3	66.9	62.7	70.6
Textile group	21.8	72.0	64.3	80.7
Agricultural and other chemicals group	28.8	10.9	26.1	-4.8
Metal group	77.2	52.1	88.0	27.6
Miscellaneous group	27.6	23.5	27.8	19.7
Others	19.7	24.2	44.4	9.8
Total imports	32.1	38.8	53.1	27.8
Non oil import	33.6	32.0	50.5	18.3

- The surge in the telecom and sound recording equipments imports since last couple of years driven by the opening up of the telecommunication sector has slowed down during FY06. The group imports, with the highest share in the total machinery imports, rose by a 63.5 percent during FY06 as compared to extraordinary increase of 146.2 percent during the last year. The substantial slow down in the group import was witnessed during the second half of FY06 where the group imports has increased by a nominal amount of US$ 140 million as compared to US$ 610 million in the first half of FY06. The deceleration in the group import was driven by both the mobile phones and other transmission apparatus imports (see **Table 7.26**). The slow down in group imports might be indicative of the fact that the economic agents have absorbed the impact of the policy changes in the sector.

[30] The lower sugar production of 29.6 million ton during FY06 as compared to 31.2 million ton during FY05 was another factor behind high sugar imports.

Table 7.25: Analysis of Machinery Import

percent

	FY06		H1-FY06		H2-FY06	
	Growth	**Share**	**Growth**	**Share**	**Growth**	**Share**
Power generating machinery	30.3	6.1	38	6.7	24	5.7
Office machinery	7.3	3.5	15	3.7	2	3.4
Textile machinery	-12.0	9.8	-7	11.4	-17	8.6
Construction & mining machinery	35.3	2.3	-1	2.1	79	2.5
Electrical machinery & apparatus	43.1	6.1	69	6.2	27	6.0
Railway vehicles*	91.5	0.9	126	1.3	53	0.6
Road motor vehicles	57.9	20.3	83	19.7	43	20.7
Telecom and sound recording equipments	63.5	23.2	238	23.5	15	22.9
Aircraft, ships and boats	173.7	5.6	89	1.7	195	8.6
Agricultural machinery & implements	91.6	1.7	261	1.9	30	1.5
Other machinery	31.6	20.4	50	21.7	19	19.4
Total machinery imports	**40.7**		**66**		**25.6**	
Machinery imports(excluding air crafts)	**35.4**		**66**		**17.1**	

- Import growth of road motor vehicles has also decelerated from 63.7 percent during FY05 to 57.9 percent during FY06. Interestingly, the slowdown in the group import is again clearly visible in the second half of the outgoing fiscal year. The slow down was contributed by almost all the categories of the road motor vehicles. What is encouraging is the increase in share of CKDs/ SKDs in the total road motor vehicles imports from 40 percent during FY05 to 45 percent FY06. Within the group, the share of CKDs/ SKDs in the small cars imports has increased to 61 percent during FY06 from 55 percent during the last year. The increased import of CKDs/SKDs suggests increased assembling taking place in Pakistan thereby promoting the allied industries. The increased imports of the group may have been caused by the opening up of the sector, capacity constraints of the domestic automobile industry and higher demand fueled by the bank car financing facilities. Moreover, the imports under transfer of residence, personal baggage and gift schemes also increased the group imports[31].

Table 7.26: Rise in the Telecom Group Imports

million US Dollars

	H1-FY05	H2-FY05	H1-FY06	H2-FY06
Telecom group	96	605	610	140
Mobile phones	-10	194	243	146
Other apparatus	106	412	367	-6

- The electrical machinery and apparatus recorded 43.1 percent growth during FY06 as compared to 37.7 percent growth during the preceding year. The major imports in the group included electronics integrated circuits, electrical appliances switching circuits and parts, energy saving lamps, color televisions pictures tubes other UPS and other automatic circuit breakers.

- The power generating machinery depicted 30.3 percent import growth on the back of imports of air craft engine, other generator set /combustion piston engines, other parts for engine of road motor vehicles, AC motors and other parts of gas turbines and steam turbines.

[31] According to CBR overseas Pakistanis imported around 43292 vehicles during FY06 under these schemes as against 2297 vehicles imported the previous year.

- The other machinery import registered 31.6 percent growth during FY06. The slow down in the other machinery was also evident in the second half of the period under consideration. The major contributor in the other machinery imports were crush and grinding machines for cement industries, parts of air condition machines, machinery for paper and boards and other printing machines.

Table 7.27: Analysis of the Petroleum Group Imports

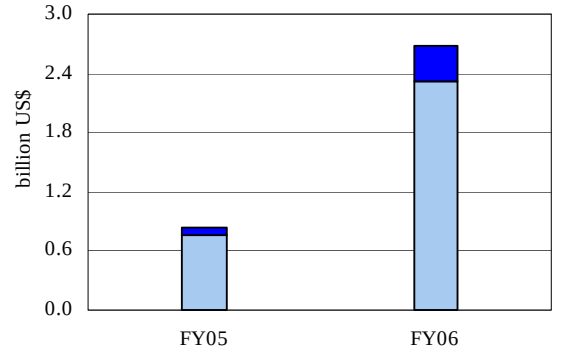
YoY growth in percent

	FY05			FY06		
	Value	Quantum	Unit value	Value	Quantum	Unit value
Petroleum group	26	2	23	66.7	9	53
Petroleum products	32	6	25	55.3	6	46
Petroleum crude	22	0	22	76.6	11	59

Petroleum Group

Driven by the 53 percent increase in annual average prices, petroleum group imports rose by 66.7 percent during FY06, substantially higher than the growth of 26 percent during the preceding year (see **Table 7.27**). As a result, the group's share in the total imports has increased from 19 percent during FY05 to 23 percent during FY06. Within the group, the increase in the unit values of petroleum crude was greater than that of petroleum products. Along with the dominant impact of prices (87 percent), the increase in quantum of petroleum crude and petroleum product also contributed in the additional petroleum import bill (see **Figure 7.26**)[32].

Figure 7.26: Contribution to Additional Petroleum Group Imports



Metal Group

The metal group imports continued to increase at a high growth rate of 52.1 percent during FY 06 on the top of 77.2 percent increase during FY05. Iron and Steel imports alone contributed almost 76 percent of the increase in the metal group imports. The contributory factors behind the increased iron and steel imports are fall in the production of domestic metal industries mainly caused by the technically problems in Pakistan Steel. Moreover, the strong growth in the automobile industry and consumer durables also increased the demand for iron and steel.

Agriculture and Other Chemical Group

During FY06, the group witnessed 10.9 percent increase mainly on account of increase in the import of fertilizer and plastic material. The growth in the fertilizer import was mainly explained by capacity constraints and higher demand. The lower import growth of other chemical is explained by the slow down in textile industry.

Other Imports

The significant increase in the import of gold (monetary and non-monetary), oil seeds and oleaginous fruits, manufactures of metal necessities, synthetic and regenerated fiber and coal, coke & briquettes led to 24.2 percent increase in the other import bill during FY06 as compared to relatively lower growth of 17.1 percent during FY05 (see **Table 7.28**).

[32] The cured oil import might have increased due to lower local crude oil extraction during FY06. The local crude oil extraction declined from 18.136 million barrel during Jul-Mar FY 05 to 17.91 million barrel during Jul-Mar FY06.

Table 7.28: Major Imports

Value in million US Dollars; Unit value in US Dollars

			FY05		FY06		Absolute	Change in percent		
		Unit	Value	Unit value	Value	Unit value	Δin value	Qty	Value	Unit value
A.	**Food group**	**---**	**1,408.8**		**2059.1**	**---**	**650.3**	**-**	**46.2**	**---**
1.	Milk &cream incl. milk food for infants	MT	34.2	2,000.0	61.4	1892.4	27.2	89.9	79.6	-5.4
2.	Wheat unmilled	MT	93.0	217.9	132.8	162.6	39.8	91.3	42.8	-25.4
3.	Dry fruits	MT	43.6	575.5	53.6	518.6	10.0	36.3	22.8	-9.9
4.	Tea	MT	222.6	1,653.3	222.8	1753.2	0.2	-5.6	0.1	6.0
5.	Spices	MT	47.4	764.8	52.8	608.7	5.4	39.9	11.4	-20.4
6.	Edible oil	MT	757.7	472.2	738.7	435.6	-19.0	5.7	-2.5	-7.8
	Soya bean	MT	54.5	743.5	21.5	658.5	-33.1	-55.5	-60.6	-11.4
	Palm oil	MT	703.2	459.2	717.3	431.3	14.1	8.6	2.0	-6.1
7.	Sugar	MT	87.9	329.5	623.3	408.2	535.4	472.5	609.3	23.9
8.	Pulses	MT	122.5	336.5	173.8	375.8	51.3	27.1	41.9	11.7
B.	**Machinery group**	**---**	**5,918.2**	**---**	**8323.2**	**---**	**2405.0**	**-**	**40.6**	**---**
1.	Power generating machinery	---	392.6	---	511.6	---	119.0	-	30.3	---
2.	Office machinery	---	273.5	---	293.6	---	20.0	-	7.3	---
3.	Textile machinery	---	928.6	---	817.2	---	-111.4	-	-12.0	---
4.	Construction & mining machinery	---	140.5	---	190.1	---	49.5	-	35.2	---
5.	Electrical machinery & apparatus	---	355.5	---	508.7	---	153.2	-	43.1	---
6.	Railway vehicles	---	41.1	---	78.8	---	37.7	-	91.7	---
7.	Road motor vehicles	---	1,068.8	---	1687.1	---	618.3	-	57.8	---
8.	Aircraft, ships and boats	---	169.2	---	462.6	---	293.4	-	173.4	---
9.	Agricultural machinery & implements	---	73.8	---	141.4	---	67.6	-	91.7	---
10.	Other machinery	---	2,474.4	---	3632.1	---	1157.6	-	46.8	---
C.	**Petroleum group**	**---**	**3,999.7**	**293.9**	**6674.9**	**450.1**	**2675.2**	**9.0**	**66.9**	**53.1**
1.	Petroleum products	MT	1,850.9	323.5	2880.9	472.9	1030.0	6.5	55.7	46.2
2.	Petroleum crude	MT	2,148.8	272.5	3794.0	434.2	1645.1	10.8	76.6	59.4
D.	**Textile group**	**---**	**317.2**	**---**	**545.8**	**---**	**228.6**	**-**	**72.0**	**---**
1.	Synthetic fiber	MT	146.9	1,806.0	260.7	1613.2	113.9	98.8	77.6	-10.7
2.	Synthetic & artificial silk yarn	MT	130.2	1,832.7	237.4	1696.3	107.2	97.0	82.3	-7.4
3.	Worn clothing	MT	40.2	327.7	47.7	335.8	7.5	15.8	18.7	2.5
E.	**Agricultural and other chemicals**	**---**	**3,604.7**	**---**	**3996.7**	**---**	**392.0**	**-**	**10.9**	**---**
1.	Fertilizer	MT	416.9	252.1	681.7	278.8	264.7	47.8	63.5	10.6
2.	Insecticides	MT	139.7	3,362.1	113.8	3254.6	-26.0	-15.9	-18.6	-3.2
3.	Plastic materials	MT	792.9	1,160.9	1020.2	1245.2	227.2	19.9	28.7	7.3
4.	Medicinal products	MT	292.2	27,703.5	335.8	32238.2	43.6	-1.3	14.9	16.4
5.	Others	---	1,962.9	---	1845.3	---	-117.6	-	-6.0	---
F.	**Metal group**	**---**	**1,218.3**	**---**	**1852.7**	**---**	**634.4**	**-**	**52.1**	**---**
1.	Iron and steel scrap	MT	222.1	226.7	363.2	248.2	141.2	49.5	63.6	9.4
2.	Iron and steel	MT	890.2	475.7	1367.1	501.6	477.0	45.6	53.6	5.4
3.	Aluminum wrought & worked	---	106.1	---	122.4	---	16.3	-	15.3	---
G.	**Miscellaneous group**	**---**	**482.9**	**---**	**596.2**	**---**	**113.3**	**-**	**23.5**	**---**
1.	Rubber crude	MT	86.0	1,073.3	104.1	1227.4	18.1	5.8	21.0	14.4
2.	Rubber tyres & tubes	Nos	133.8	24.7	155.3	21.4	21.5	34.2	16.1	-13.5
3.	Wood & cork	---	28.9	---	37.6	---	8.6	-	29.9	---
4.	Jute	MT	39.0	303.7	42.4	379.2	3.4	-13.0	8.6	24.9
5.	Paper and paperboard & manufactures	MT	195.1	649.7	256.8	708.4	61.7	20.7	31.6	9.0
H.	**Others**	**---**	**3648.3**		**4532.3**		**884.0**	**-**	**24.2**	**---**
	Total imports		**20598.1**		**28580.9**		**7982.8**		**38.8**	
	Total imports excluding aircrafts		**20428.9**		**28118.3**		**7689.4**		**37.6**	

Source: Federal Bureau of Statistics

Box 7.3: Explanation of Differences in the SBP and FBS Trade Deficit Data

The trade deficit for FY06 is reported at US$ 12.3 billion by the Federal Bureau of Statistics (FBS), while the State Bank of Pakistan data based on IMF Balance of Payment Manual 5 (BPM5) reports it at US$ 8.4 billion. Thus, there is a difference of US$ 3.6 billion in the data from the two sources.

This inconsistency primarily arises due to the difference in the data compilation procedure and as such, essentially, both data sets are correct. Furthermore, the difference in the two data sets is not unique to Pakistan and almost all countries have similar differences. For instance, there is difference of US$ 12.0 billion in the trade deficit figures compiled by the Director general of commercial intelligence and statistics and BPM5 in India, Similarly, difference of US$ 1.7 billion exists in the two data sets in Philippines and US$ 12 billion in Thailand. Interestingly in case of Thailand, the BPM5 data indicates surplus in the trade balance while the customs data show a deficit.[1]

SBP in its various earlier reports [2] has already explained the reasons for the discrepancy in the two data sets and has also reconciled the two data sets. Nevertheless, given that misconceptions still exist, the reasons for the discrepancy between the FBS and SBP trade data are once again explained.

- The trade data compiled by SBP is based on actual realization of export proceeds and payments for goods imported in the country through banks. While, FBS recorded the trade data on the physical movement of goods crossing the country's custom boundary via sea air, land and post.

- The export proceeds and import payments reported by banks are a mixed of free on board (f.o.b) and cost, insurance & freight (c.i.f) basis. [3] On the other hand, FBS import data contains the components of c.i.f.

- The variation in the trade data from the FBS and SBP also arises due to difference in coverage of various items. In fact, some trade transactions are recorded in the FBS data but are not included in the data reported by banks. Such data are added to trade numbers reported by authorized dealers to arrive at the SBP trade data. For instance, land borne trade, [4] exports for which payment are not yet received, unclassified imports and imports under foreign economic assistance.

To sum up, the differences in the trade data reported by SBP and FBS differ primarily due to the differences in timing, valuation, and coverage of the transactions.

[1] Data: RBI website, Comtrade (UN) and IFS. Data for India pertains to Apr-Mar 2006 and CY2005 for others.

[2] Special Section 1, SBP Second Quarterly Report on the state of the economy for FY06 and Special Section 3rd Report SBP Third Quarterly Report on the state of the economy for FY01

[3] These include payments/receipts on account of freight and insurance of the goods being shipped.

[4] Goods carried over Pakistan's borders from Afghanistan are classified as *land borne imports,* which do not directly enter the data reported by banks, as cash payments made in Rupees do not go through authorized dealers.