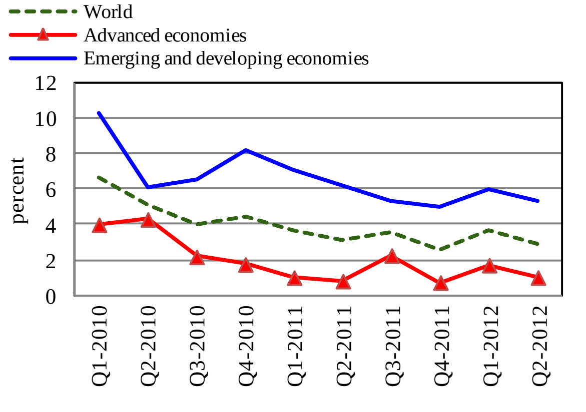
8 Balance of Payments

Since Balance of Payments is a record of all transactions made between one country and all other countries during a specified period of time, a review of global economic developments provides a useful perspective to discuss Pakistan's balance of payments. As such, first part of the chapter gives a brief overview of the global economic environment during FY12, while the rest of the chapter focuses on Pakistan's specific balance of payment developments.

Figure 8.1: Global Trends in GDP Growth
(quarter over quarter annualized)

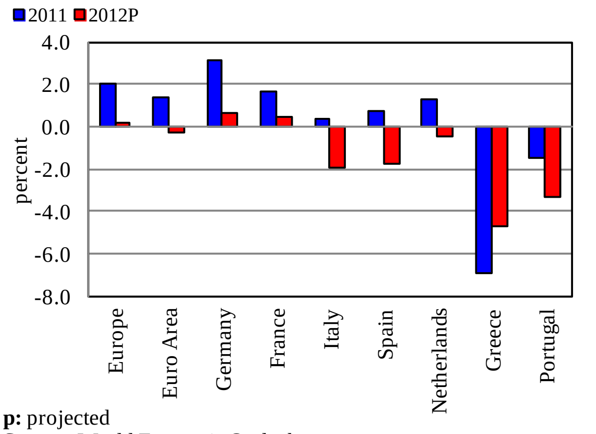


Source: World Economic Outlook

8.1 International Developments[1]

Prospects for the world economy in 2012 were not very promising to begin with (**Figure 8.1**). As the year progressed, downside risks to the anticipated recovery escalated due to the deepening Eurozone debt crisis, cuts in fiscal spending, and continued deleveraging by firms and households in the US and other advanced economies.

Figure 8.2: GDP Growth



p: projected
Source: World Economic Outlook

The epicenter of the current recession gripping the OECD, is the Eurozone. Lack of consensus among policymakers over Greece, and rumors regarding its possible exit from the currency union, has seen the crisis spillover to other larger Eurozone economies. In addition, banking sector problems in Spain have emerged as an additional threat to the economic recovery. As a result, borrowing costs in Italy and Spain are on the rise, and private credit growth is declining. Overall, the outlook for Europe remains bleak: most countries are expected to experience a contraction in GDP this year (**Figure 8.2**). Even Germany, which has so far shown resilience to the crisis, is showing signs of a slowdown as the demand for its exports declines.

The European Union has taken several measures in response, especially to ensure adequate funds to make repayments, and keep market borrowing rates affordable. Notwithstanding these efforts, the crisis continues. Perhaps this is because the solution is neither simple nor cheap. European banks are the largest holders of EU government debt. In case a problem country defaults on its debt, their balance sheets will be impacted. Given the contagion in a financial crisis, the failure of a single bank could spread across the global financial system.[2]

[1] This section is based on the data and information from IMF World Economic Outlook July 2012.
[2] IMF Working Paper No. 10/236 October 1, 2010: CFS Working Paper, No. 1999, 17th November 1999.

As far as the US is concerned, the economy is likely to grow at 2.0 percent during 2012, slightly better than last year. However, this projected recovery could stall due to a slowdown in the Eurozone, and the expected expiry of fiscal incentives in December 2012, the so-called "fiscal cliff".

In fact, even the economies of Brazil, China and particularly India, which have so far been the drivers of global growth, are also slowing. In particular, India's quarterly GDP growth declined for the eighth consecutive quarter in January-March (Q4-FY12), hitting a nine-year low of 5.3 percent.[3] Moreover, foreign capital inflows have declined, the Indian Rupee has depreciated sharply during FY12, and the government's failure to implement reforms have hurt business confidence. Growth prospects in Brazil and China are also softening, as risk aversion by global investors takes hold.

The IMF has revised downward its projections for world economic growth for 2012 and 2013. Growth rates for both advanced and emerging economies have been revised downwards since the April projections. The global economy is now expected to grow by 3.5 percent in 2012, 10 bps lower than the projection in April 2012 (**Table 8.1**).

8.2 Pakistan's External Account

Pakistan's external account posted a deficit of US$ 3.3 billion in FY12, against a surplus of US$ 2.5 billion in FY11. Given the one-off nature of developments that led to the surplus last year, it was expected that the external position would not be as comfortable in FY12.[4]

Table 8.1: Major Indicators of World Economies

percent	GDP growth			Inflation rate		
	2010	**2011**	**2012P**	**2010**	**2011**	**2012P**
World	5.3	3.9	3.5	3.7	4.8	4.0
Advanced economies	3.2	1.6	1.4	1.5	2.7	1.9
US	3.0	1.7	2.0	1.6	3.1	2.1
Eurozone	1.9	1.5	-0.3	1.6	2.7	2.0
Japan	4.4	-0.7	2.4	-0.7	-0.3	0.0
UK	2.1	0.7	0.2	3.3	4.5	2.4
Emerging and developing economies	7.5	6.2	5.6	6.0	7.1	6.2
China	10.4	9.2	8.2	3.3	5.4	3.3
India	10.6	7.2	6.9	12.0	8.6	8.2
Pakistan	3.8	2.4	3.4	10.1	13.7	12.0
Bangladesh	6.4	6.1	5.9	8.1	10.7	10.4
Indonesia	6.2	6.5	6.1	5.1	5.4	6.2
Philippines	7.6	3.7	4.2	3.8	4.8	3.4
Russia	4.3	4.3	4.0	6.9	8.4	4.8

P: Projected
Source: World Economic Outlook Database

However, the widening of the trade deficit, and fall in workers' remittances during the initial few months of FY12, led to apprehensions of a far worse external position.[5] Consequently, SBP revised upwards its projections of the current account deficit in November 2011 to US$ 5.2 billion, and an overall deficit of US$ 3.4 billion – significantly higher than the initial forecast of US$ 3.7 billion and US$ 2 billion, respectively. As such, the actual FY12 external position was relatively better than what was being anticipated after the first quarter of the year (**Table 8.2**).

[3] Data from Reserve Bank of India Bulletin: Macroeconomic and Monetary Developments Review, Q2-FY13.
[4] In FY11, large part of the increase in exports was due to one-off increase in the cotton and cotton yarn prices that increased by 106.9 and 78.4 percent, respectively.
[5] The current account deficit for Q1-FY12 alone was US$ 1.3 billion.

As in the past, the trade account was the main source of deterioration: the deficit increased by almost 50 percent compared to the previous year. This was because, prices of Pakistan's main exports fell sharply, and the price of its major imports increased.[6] In fact, the entire increase in Pakistan's import bill was due to higher prices, as the quantum of imports actually declined.

A rise in workers' remittances provided much needed support to the current account. Remittances crossed US$ 13.0 billion for the first time in the county's history, while all other heads of the current account deteriorated compared to FY11 (**Table 8.2**).

Financing of the current account deficit was very challenging as the capital & financial account surplus contracted by US$ 0.6 billion in FY12. This fall was due to a decline in both, non-debt (investment) and debt (loans) inflows. Not only did foreign direct investment decline to US$ 812 million from US$1.6 billion last year, disbursements of fresh loans were also lower than the previous year.

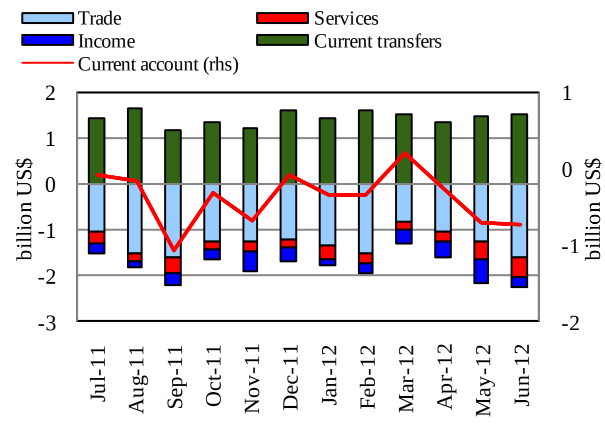
This meant that the overall deficit in the external account had to be financed from the country's foreign exchange reserves, which declined by US$ 3.8 billion during FY12 (see section on **Reserves and Exchange Rate**). The depletion in reserves, and appreciation of the US Dollar against the world's major currencies, caused the Pak Rupee to depreciate by 9.1 percent against the Dollar during FY12, compared to a nominal depreciation of 0.6 percent in FY11.

Table 8.2: Balance of Payments: Key Indicators
billion US$

	FY09	FY10	FY11	FY12
Current account balance	**-9.3**	**-3.5**	**0.2**	**-4.6**
Trade balance	-12.6	-11.5	-10.5	-15.5
Exports	19.1	19.7	25.4	24.7
Imports	31.7	31.2	35.9	40.1
Services balance	-3.4	-1.7	-1.9	-3.0
Income account balance	-4.4	-3.3	-3.0	-3.4
Workers' remittances	7.8	8.9	11.2	13.2
Financial account balance	**5.6**	**5.1**	**2.1**	**1.5**
Foreign direct investment	3.7	2.2	1.6	0.8
Portfolio investment	-1.1	-0.1	0.3	-0.2
Disbursement of loans	4.0	4.1	2.8	2.5
Amortization of loans	1.9	1.9	2.0	1.9
Overall balance	**-3.1**	**1.3**	**2.5**	**-3.3**
as percent of GDP				
Current account balance	**-5.7**	**-2.0**	**0.1**	**-2.0**
Trade balance	-7.8	-6.5	-5.0	-6.7
Exports	11.8	11.1	12.0	10.7
Imports	19.6	17.7	17.0	17.3
Services balance	-2.1	-1.0	-0.9	-1.3
Income account balance	-2.7	-1.9	-1.4	-1.5
Workers' remittances	4.8	5.0	5.3	5.7
Financial account balance	**3.5**	**2.9**	**1.0**	**0.6**
Foreign direct investment	2.3	1.2	0.8	0.4
Portfolio investment	-0.7	0.0	0.2	-0.1
Disbursement of loans	2.5	2.3	1.4	1.0
Amortization of loans	1.1	1.1	0.9	0.8
Overall balance	**-1.9**	**0.7**	**1.2**	**-1.4**

Source: State Bank of Pakistan

Figure 8.3: Components of Current Account Balance



Source: State Bank of Pakistan

8.3 Current Account

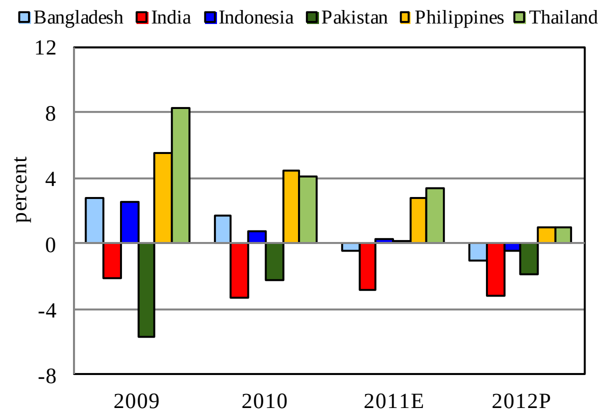
As discussed earlier, the current account reverted to a deficit after the unexpected surplus seen in FY11. Although current transfers (remittances in particular) grew by 10.2 percent, these could not offset the deficits in the trade and services account (**Figure 8.3**). As against a US$ 22.0 million surplus in H1-FY11, the current account recorded a deficit of US$ 2.4 billion in H1-FY12. This was due to a sharp increase in oil imports, and a temporary slowdown in

[6] Unit prices of cotton and cotton yarn declined by 28.8 and 23.2 percent, respectively; while that of petroleum products and crude oil increased by 19.7 and 29.6 percent.

remittances that led to a billion Dollar deficit in the month of September alone.[7] While some weakening in the current account was expected, its pace in the initial few months was indeed unsettling for policymakers. Fortunately, however, in the second half of FY12, the increase in the trade deficit was smaller, and remittances also picked up.

With exports continuing to perform poorly, the easing trade deficit during H2-FY12 was entirely on account of international oil prices. Had they continued to rise at the same pace as in H1-FY12, the FY12 current account deficit would have been much higher. The fact that Pakistan's external position is heavily dependent on two commodities – oil imports and cotton related exports – highlights its vulnerability to adverse movements in the prices of these commodities.

Figure 8.4: CAB as Percent of GDP



E: estimated; P: projected
Source: World Economic Outlook

On a positive note, however, Pakistan was not the only country to experience a worsening external position. In the backdrop of the global recession, a number of emerging economies have experienced a deteriorating external position (**Figure 8.4**).

In fact, Pakistan may be relatively less affected compared to some of the other emerging market economies due to its relative isolation from global financial markets, and the basic nature of its exports (**Box 8.1**).

Box 8.1: International Financial Recession and Its Likely Impact on Pakistan

There are two possible channels through which the global financial crisis can impact Pakistan:
1. The banking channel
2. External accounts

Pakistani **banks** are relatively safe due to limited exposure:
- Only 101 Pakistani banks branches, out of a total of 9,528, are based overseas;
- The share of overseas operations of Pakistani banks accounts for less than 10 percent of assets of the banking system;
- Investments account for less than 20 percent of overseas operations;
- Within the banking system, only three big banks dominate the overseas operations; and
- The share of foreign currency deposits in total deposits is capped at 20 percent, and the actual share is around 13.5 percent.

On the **external side,** the global financial crisis could have a possible impact on:
- Trade account
- Remittances
- Capital and financial inflows

Trade account
- Further impact of global economic slowdown on Pakistan's trade account is likely to be neutral or positive. This is because:
  - Pakistan exports are mainly low value added cotton products (e.g., gray cloth, bed sheets, towels and knitted garments etc.); intermediate cotton products (e.g., carded cotton, cotton yarn etc.); and primary commodities. Demand for these products is relatively income inelastic, making a sharp fall in exports unlikely.

[7] Dubai crude oil prices averaged US$ 106.6/bbl in H1-FY12 against US$ 79.2/bbl in H1-FY11.

- Pakistan has one of the lowest unit cost of comparable products in the region.

- Pakistan's exports to Asian countries – such as China, Afghanistan, Middle East and India – are increasing. Demand in these markets is relatively less affected by financial crisis.
- Pakistan's trade account can benefit from the fall in international commodity prices, especially crude oil, which could decline in response to falling global demand in the event of a further slowdown.
- Sixty percent of Pakistan's imports comprise of raw materials or intermediate goods. A fall in international commodity prices could substantially reduce the country's import bill
- Thus, if exports stay at the current level and import bill falls, Pakistan's external account stands to benefit.

Overseas workers' remittances

- A financial crisis may result in an increase in inward remittances. This is because:
  - Job losses for overseas Pakistani workers may force them to move back with their savings;
  - Remittances could increase as overseas Pakistanis benefit from depreciation of domestic currency
  - Some overseas Pakistanis might consider this a good time to invest in their home country.

Pakistan's financial account

Pakistan's financial account is the most vulnerable to a global financial crisis. However, since the surplus is already small, any further decline is likely to be very small. Nevertheless:

- Inflows on privatization proceeds or bond floatation on global capital markets are unlikely during a financial crisis;[1]
- Private and bilateral loans could decline as donor countries face fiscal constraints;
- However, given that financial inflows are already negligible, further deterioration is likely to be marginal, though IMF repayments would keep reserves under pressure.

Overall impact on the external sector

Trade account	Neutral/positive
Remittances	Positive
Financial account	Neutral/negative
Net overall impact	Positive

The deficit in the *trade account* increased by US$ 5 billion during FY12, compared to a decline of US$ 1 billion last year. A slowdown in external demand, and domestic supply-side constraints contributed to a decline in the country's exports. The increase in imports, as mentioned earlier, was mainly a function of higher oil prices. In addition, fertilizer imports also contributed to the increase in the import bill (see **Section 8.7** for details).

The *services account* mirrored the performance of the trade account. Imports of services increased by 3.3 percent, while exports declined by 14.1 percent during FY12. The rise in trade related services (e.g., insurance, transportation and travel) was the main reason for the increase in services, whereas the non-realization of coalition support fund (CSF) explains the contraction in inflows from services.

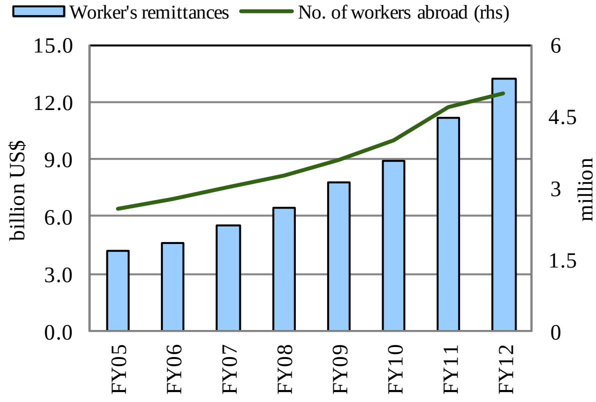
The *income account* balance deteriorated marginally during FY12, with a higher deficit of US$ 3.4 billion compared to US$ 3.1 billion last year. This was because an improvement in profitability of the domestic banking sector led to higher profit repatriation by the foreign banks. In addition, interest payments on IMF loans also widened the income account deficit.

Current transfers increased by 10.2 percent during FY12, against a 24.9 percent rise in FY11. As discussed, record remittances provided the biggest boost, and more than offset the decline seen in FE-25 deposits and cash grants. Two factors explain this consistent increase in remittances over the last few years: (i) the increase in number of Pakistanis working abroad; and (ii) efforts by the government and SBP to channel remittances via the banking system. In our view, former appears to have a larger role. Limited job opportunities within the country appear to have incentivized more skilled workers to seek employment elsewhere (**Figure 8.5**).[8]

[8] Remittances per worker per year increased from US$1,600 in FY05 to US$ 2,600 in FY12.

Other than the rise in the number of migrants, the Pakistan Remittances Initiative (PRI) – a scheme launched jointly by the government of Pakistan and SBP to channel remittances through banks – has also played an important role. For instance, after the introduction of PRI in FY09, the share of official remittances routed through banks increased from 70 percent to almost 90 percent in FY12.

Figure 8.5: Workers' Remittances



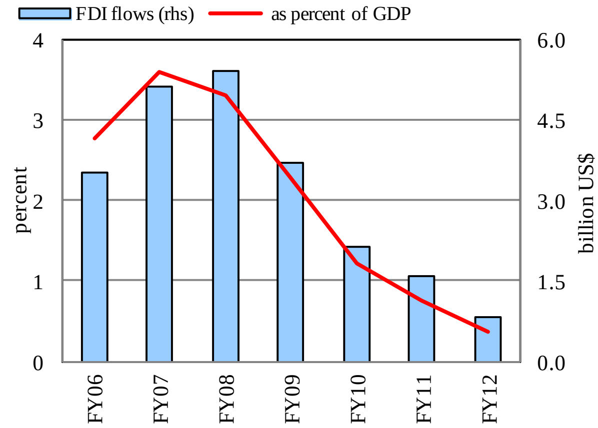
Source: State Bank of Pakistan, Bureau of Emigration and Overseas Employment

Net inflows under foreign currency accounts *RFCAs* fell to US$ 289 million in FY12 from US$ 367 million last year. A large part of this decline was the withdrawal of US Dollar deposits held with commercial banks to realize capital gains from the depreciation of Pak Rupee.

8.4 Capital and Financial Account

The capital and financial account surplus contracted for the fifth consecutive year, as both non-debt flows (investment) and debt flows (loans) continued to decline.[9] This declining trend, and not the size of current account deficit, is increasingly troubling policymakers.

Figure 8.6: Trend in FDI



Source: State Bank of Pakistan

Foreign direct investment (FDI), which supported the external sector during the past few years, fell below US$ 1 billion, and reached 0.35 percent of GDP (**Figure 8.6**).[10] Disinvestment (foreign loan repayments) by two large cellular companies was the major reason for this decline in FDI. Pakistan in recent years has struggled to attract foreign investment as shown in (**Box 8.2**).

[9] The amount of loans disbursement in the *Balance of Payments* may not tally with the numbers stated in **Chapter 7** due to definitional differences.

[10] This is in comparison with 0.8 percent of GDP last year and 3.5 percent in FY07.

Box 8.2: Regional Trend in FDI; Pakistan vis-a-vis Peers

FDI is a non-debt creating source of financing the current account deficit. The global financial turmoil of 2008-09 had an adverse impact on foreign direct investment in the emerging economies. However, with a subsequent improvement in investor confidence, FDI flows have recovered to some extent in the recent years. In the case of Pakistan, however, FDI has not yet picked up **(Figure 8.2.1)**.

The *Inward FDI Performance Index* – measures the amount of FDI that countries receive relative to the size of their economy (GDP). The index can be specified as:

$$IND_i = \frac{FDI_i/FDI_w}{GDP_i/GDP_w}$$

Where,

INDi = Inward FDI Performance Index of the ith country

FDIi = FDI inflows in the ith country

FDIw = World FDI inflows

GDPi = GDP in the ith country

GDPw = World GDP

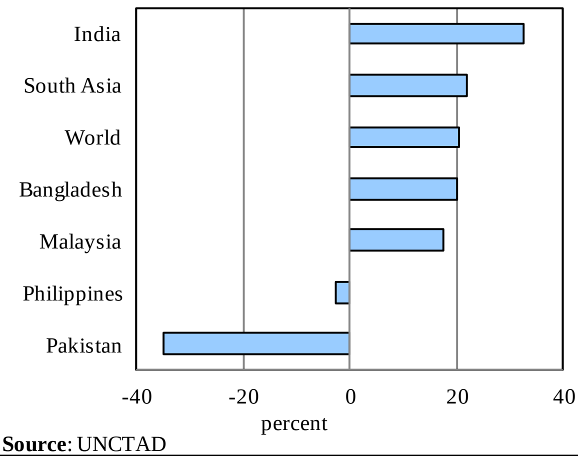
A value greater than one suggests that the economy has received more FDI relative to its economic size, while a value below 1 suggests that it received less FDI. The inward FDI performance index suggests that over the years, Pakistan has lost momentum in attracting FDI. In contrast, some of the other countries in the group have either stabilized or improved **(Table 8.2.1)**.

Table 8.2.1: Inward Performance Index of FDI

	2006	2007	2008	2009	2010	2011
Bangladesh	0.36	0.25	0.42	0.37	0.44	0.45
India	0.76	0.62	1.22	1.38	0.77	0.89
Indonesia	0.46	0.45	0.64	0.44	0.99	1.00
Pakistan	1.13	1.10	1.16	0.70	0.58	0.29
Philippines	0.81	0.55	0.31	0.57	0.33	0.27
South Asia	**0.79**	**0.64**	**1.19**	**1.23**	**0.79**	**0.80**

Source: IMF, Haver Analytics

Figure 8.2.1: FDI Inflows during 2011 (YoY Growth)

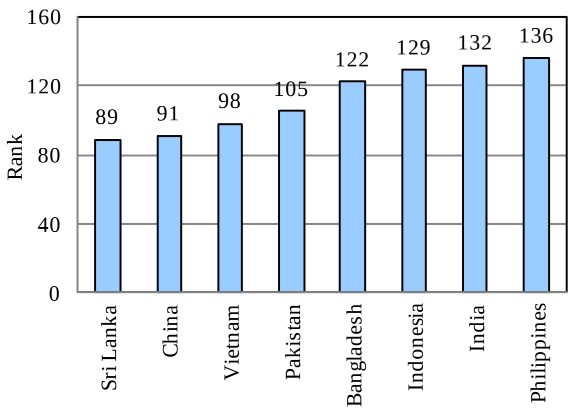


Source: UNCTAD

Initially, the fall in FDI flows to Pakistan was considered to be in line with global trend as most of the countries in the region were facing similar declines. However, while the FDI flows to number of regional countries have resumed recently, they are yet to recover in case of Pakistan. This suggests that country needs to make more efforts to attract foreign direct investment, especially when debt inflows are also low.

Interestingly, Pakistan has a better standing in terms of "*Ease of Doing Business Ranking*" compiled by the World Bank. The ranking shows that Pakistan is better placed than Bangladesh, India, Indonesia and Philippines **(Figure 8.2.2)**. The Cost of Doing Business Report assesses regulations affecting domestic firms in 183 economies and ranks the economies in 10 areas of business regulation, such as starting a business, resolving insolvency and trading across borders. [11]

Figure 8.2.2: Ease of Doing Business Ranking



Source: World Bank

On the other hand, Pakistan's standing is not as encouraging when it comes to the macroeconomic environment, quality of institutions, infrastructure facilities, human development indicators and political risk, which are considered important determinants of foreign direct investment. According to Global Competitiveness Report of 2011-12 Pakistan lags behind its peers in most of these indicators. Moreover, while, other countries have either made improvement or (remained stagnant), Pakistan has slid further down. Pakistan now ranks above 100 in all the competitiveness indicators **(Table 8.2.2).**

[11] http://www.doingbusiness.org/reports/global-reports/doing-business-2012.

Table 8.2.2: Global Competitiveness Ranking 2011-12

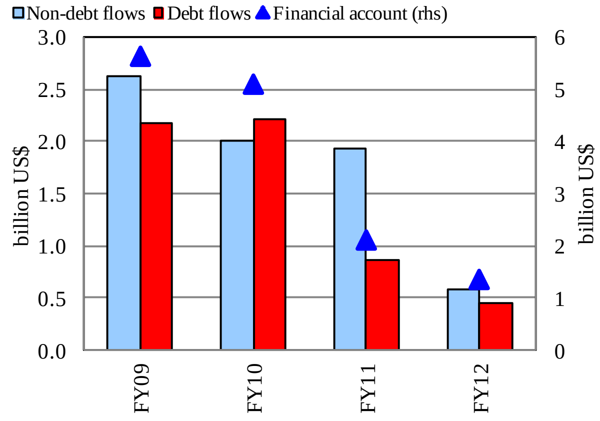
	Overall ranking	Institutions	Infrastructure	Macroeconomic environment	Health and primary education	Efficiency
China	26	48	44	10	32	26
Indonesia	46	71	76	23	64	56
Sri Lanka	52	50	60	116	45	69
India	56	69	89	105	101	37
Vietnam	65	87	90	65	73	66
Philippines	75	117	105	54	92	70
Bangladesh	108	112	134	75	108	99
Pakistan	118	107	115	138	121	100

The rankings are given out of 142 countries

Source: Global Competitiveness Report 2011-12, World Economic Forum

Portfolio investment posted net outflows of US$ 0.2 billion in FY12 in contrast to net inflows of US$ 0.3 billion last year. Both equity and debt observed outflows in FY12. As in the previous year, the fall in non-debt flows was accompanied by a contraction in debt flows*:* total loan receipts declined from US$ 2.8 billion last year to US$ 2.5 billion in FY12 (**Figure 8.7**).

Figure 8.7: Debt & Non-debt Flows (net)



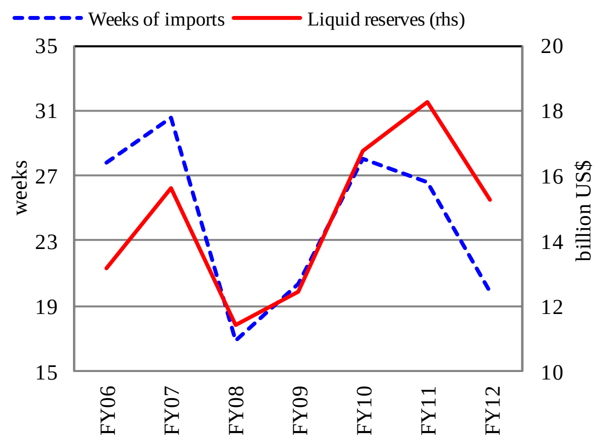
Source: State Bank of Pakistan

Compared with last year, the disbursement of program loans fell from US$ 1,440 to only US$ 80 million in FY12, while project loans increased from US$ 933 to US$ 2,049 million. Since program loans were effectively halted during FY12, the government focused on realizing as much of the pipeline *project* loans during the year. Project loans are mainly provided by ADB and the World Bank.

8.5 Foreign Exchange Reserves

Pakistan's liquid foreign exchange reserves declined to US$ 15.3 billion by the end of FY12, compared with US$ 18.2 billion a year ago. This was a consequence of the overall deficit in the external account during the year (**Flow Chart 8.1**).

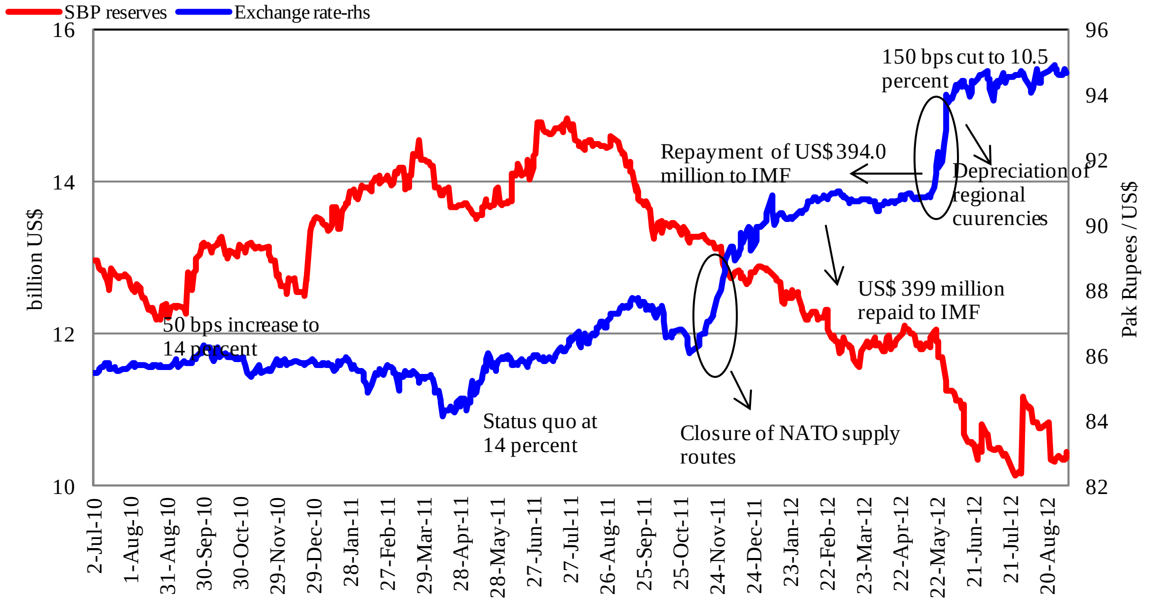
Figure 8.8: Import Coverage Ratio and Reserves



Source: State Bank of Pakistan

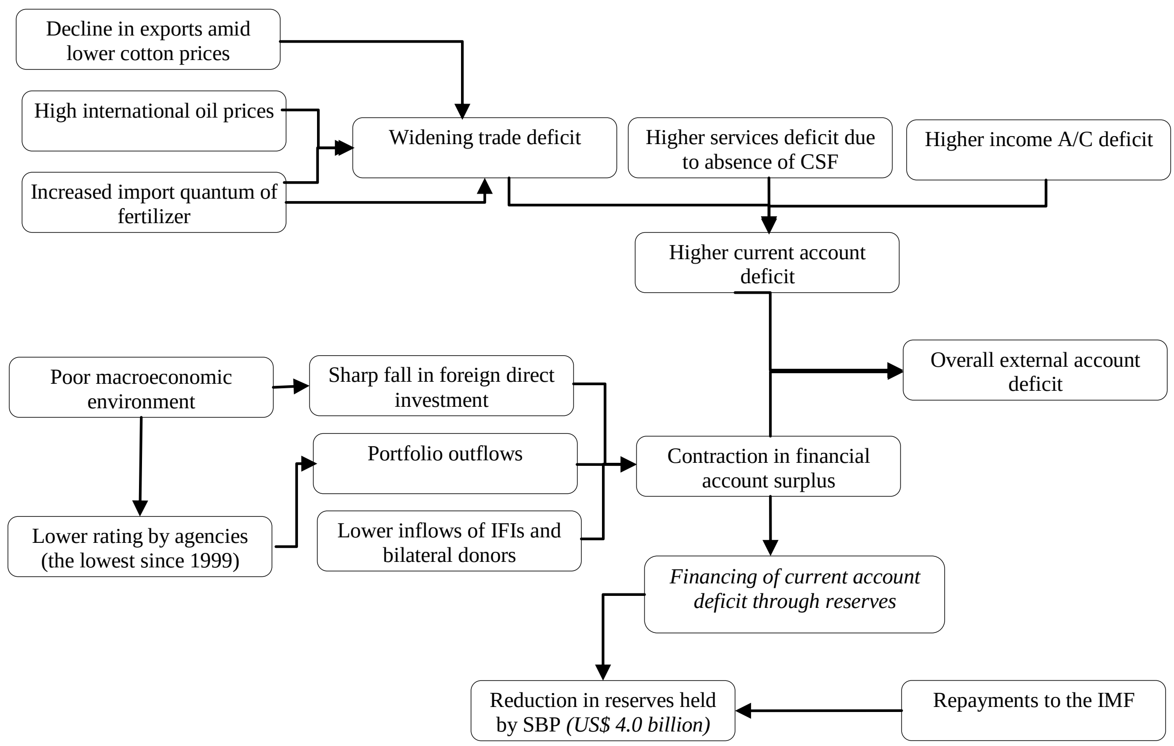
A disaggregation of FX reserves shows that the entire decline was on account of depletion in SBP's reserves, as the FX held by commercial banks increased by US$ 1 billion. Three factors explain this depletion: (i) market support by SBP, which remained a net seller during FY12; (ii) fall in multilateral inflows from US$ 5.3 to US$ 3.7 billion; and (iii) external debt servicing – Pakistan repaid US$ 5.8 billion to its lenders during FY12. It may be noted that the placement of US$ 500 million by China provided some relief to the forex reserves position.

Figure 8.9: Daily Movements in Exchange Rate and FX



Source: State Bank of Pakistan

Flow Chart 8.1: Factors leading to depletion in SBP reserves- A panoramic view



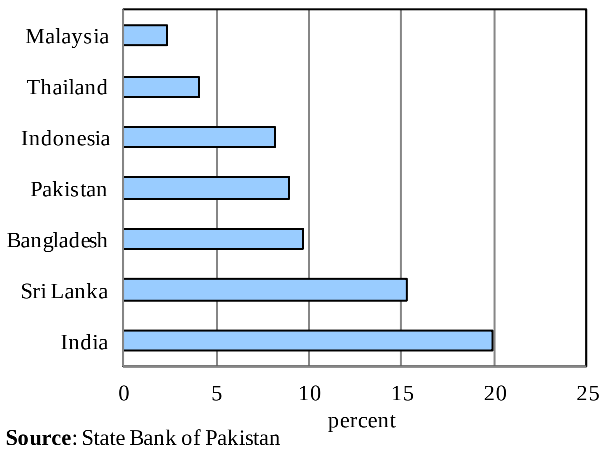
Increase in FX reserves held by commercial banks on the other hand, was mainly due to sustained growth in worker's remittances. The record level of remittances during FY12, along with market support from SBP, enabled commercial banks to cope with oil import payments without compromising their reserves. In addition, the retirement of FE-25 loans by importers also supported commercial bank holding of FX.[12]

The depletion in the country's reserves during FY12 led to a worsening of reserve adequacy indicators. In particular the import coverage ratio, which measures the ability of a country to meet its import requirements through its total reserves (in terms of weeks of imports), declined from 27.8 weeks in FY11, to 19.9 weeks by the end of FY12 (**Figure 8.8**). Unfortunately, this import coverage continues to fall in FY13.

8.6 Exchange Rate

The Pak Rupee depreciated by 9.1 percent against the US Dollar in FY12, compared to a marginal depreciation of 0.6 percent in FY11. Despite lumpy oil payments and servicing of IMF loans, the depreciation in Pak Rupee was relatively gradual through most of the year. Instead, the value of Pak Rupee seemed more sensitive to geo-political and adverse market sentiments. For instance, Pak Rupee depreciated more sharply in response to non-economic factors in November 2011 and May 2012 than at any other time during the year. **Figure 8.9** shows the movement of Pak Rupee in the context of the country's reserve performance.

Figure 8.10: Depreciation against the US Dollar during FY12



Source: State Bank of Pakistan

A part of this depreciation was also due to global economic developments: the US Dollar appreciated against most of the regional currencies throughout FY12, and Pakistan was no exception. However, when compared with some other South Asian countries, the depreciation in the Pak Rupee was relatively small (**Figure 8.10**).

NEER, RPI and REER

Pakistan's nominal effective exchange rate (NEER) depreciated by 3.9 percent in FY12 as compared to 6.7 percent depreciation recorded during FY11. The lower nominal depreciation was primarily the result of a 4.6 appreciation of the Pak Rupee against the Euro. This is to be expected given the economic weakness in the Eurozone. Nevertheless, Pak Rupee depreciated against all other major currencies (US Dollar, Japanese Yen and British Pound), which led to an overall depreciation of the Pak Rupee in nominal terms.

On the other hand, the relative price index (RPI) increased by 8.8 percent during FY12 compared with a rise of 9.3 percent in FY11, caused mainly by relatively high domestic inflationary pressures compared to Pakistan's trading partners.[13] In fact, the nominal depreciation of Pak Rupee was more than offset by a rise in RPI, which caused the real effective exchange rate (REER) to *appreciate* by 3.8 percent in FY12, in contrast to a small depreciation in FY11.

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[12] Commercial banks' reserves increase when the traders retire foreign currency loans.
[13] Relative price index is a ratio of domestic prices to the prices in major trading partners.

8.7 Trade Account[14]

Pakistan's trade deficit increased by 36.2 percent YoY to US$ 21.2 billion in FY12 (**Figure 8.11**). The widening trade deficit is attributed to both a rise in imports and a decline in exports.

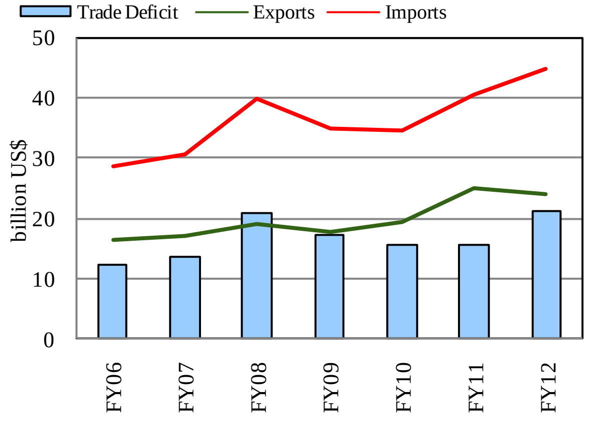
At the start of the year, weaker prospects of a global economic recovery, and trend reversal in international cotton prices when they peaked in April 2011, had already indicated a possible squeeze in export earnings in FY12. However, the supply-driven increase in international oil prices inflated the import bill beyond expectations.[15] Furthermore, gas shortages in the country had necessitated higher imports of certain petroleum products and fertilizer. Excluding these items, Pakistan's imports show a much smaller increase (**Figure 8.12**).

Detailed data shows that the imports of consumer goods are gradually building up (see **Chapter 4** and **Figure 8.13**). As a result, the share of consumer related items in total imports has increased from 56 percent in FY05, to 70 percent in FY12. This shift is consistent with the composition of aggregate demand, a large part of which is now consumption, as investment is continuously falling.

8.7.1 Exports

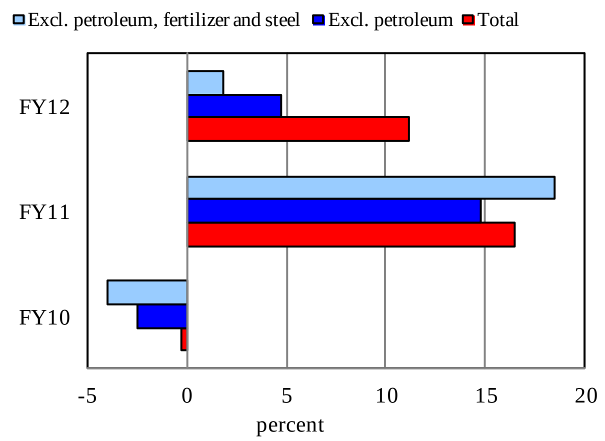
Exports declined by 4.7 percent during FY12 in sharp contrast to 28.9 percent growth last year. In terms of composition, exports of *food*, *textile*, *petroleum* and *leather & leather manufactures* recorded declines, whereas, *chemicals & pharmaceuticals*, *engineering goods* and *gems & jewelry* recorded increases during FY12 (**Table 8.3**).

Figure 8.11: Trade Account



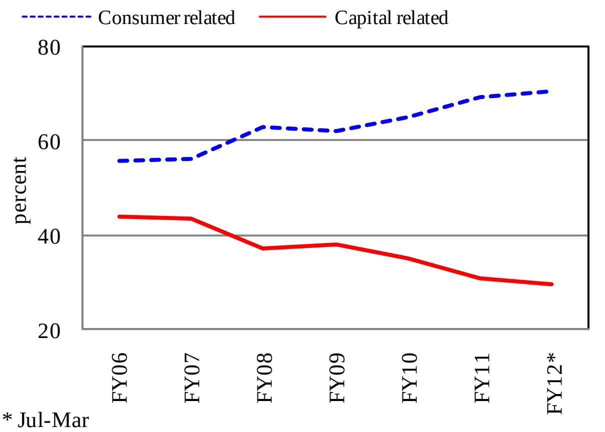
Source: Pakistan Bureau of Statistics

Figure 8.12: Import Growth



Source: Pakistan Bureau of Statistics

Figure 8.13: Imports Classification (share in total)



* Jul-Mar

Source: Pakistan Bureau of Statistics

[14] The analysis in this section is based on data from the Pakistan Bureau of Statistics (PBS), which differs from the exchange record data prepared by the SBP.

[15] The 'Arab Spring' affected oil and gas supplies—most notably the complete, albeit temporary, loss of Libyan supply—while the tragic Fukushima accident in Japan had knock-on effects for nuclear and other energy sources around the world. These shocks pushed energy prices higher in much of the world, with oil prices reaching a record average of over $100 per barrel (bbl). Source: The BP Statistical Review of World Energy, 2012 – 61st Annual Report.

Category-wise exports indicate that textile and leather exports are facing pressure from an unfavorable external and domestic environment: both declined by 10 percent (YoY) during FY12. Within the food group, while exports of rice, wheat and vegetables declined compared with the previous year, this was partially offset by growth in fish, meat, and fruits exports (**Table 8.4**).

Table 8.3: Exports Composition (YoY growth in percent)

	FY11	FY12
Food	34.6	-4.2
Petroleum	25.4	-28.0
Leather	25.3	-4.0
Chemicals & pharmaceuticals	22.6	18.1
Engineering	10.1	11.9
Gems & jewelry	-36.5	119.6
Total	**28.6**	**-4.7**

Source: Pakistan Bureau of Statistics

Rice exports, both basmati and non-basmati, declined for the second consecutive year. The fall in quantum was largely on account of the loss of Iranian market to India, which undercut Pakistani prices. According to reports, international prices of (par boil) rice rose, following Thailand's decision to introduce a support price, in a bid to ensure post-flood availability of the commodity. Against an international price in the range of US$ 200-300/MT, the Thai government was offering US$ 500/MT. This resulted in a 44 percent fall in rice exports from Thailand, which India and Vietnam capitalized on to increase their market share of rice exports. Pakistan was unable to do so as its prices were higher than those offered by both India and Vietnam.

Table 8.4: Food Exports

million US$	Abs. Δ	Quantum Impact	Price Impact
Rice	-85.8	-212.5	126.7
a) Basmati	-121.2	-188.7	67.5
b) Others	35.3	-64.6	99.9
Fish and fish preparations	19.3	-17.3	36.6
Fruits	87.7	28.0	59.7
Vegetables	-66.5	-97.9	31.4
Tobacco raw	2.2	7.8	-5.6
Wheat	-457.1	-445.7	-11.5
Spices	-0.4	-7.5	7.1
Oil seeds & nuts etc.	10.1	10.5	-0.4
Sugar	27.9	0.0	0.0
Meat and meat preparations	22.6	10.0	12.6
Food group	**-184.3**		

Source: Pakistan Bureau of Statistics

In case of ***wheat*** exports, Pakistan was unable to benefit from its record production last year (and carryover stocks), due to a fall in international prices, and the increase in domestic support price.[16] Exports of wheat in FY12 stood at 409,000 tons against 1.75 million tons last year.[17]

Exports of ***meat & meat preparation*** continued to grow for the sixth consecutive year, and reached US$ 168.3 million in FY12 compared to US$ 152.4 million in FY11. This rise is on account of higher demand from the Middle East, following an improvement in Pakistan's quality standards. Both the Punjab and Sindh governments have facilitated this trend by setting up branded *halal* units in their provinces. The sector seems to have considerable potential, as Pakistan currently holds a very small share in the global market for *halal* meat, which is estimated to be over US$ 600 billion.[18,19]

The export of ***fish and fish preparations*** grew by 6.5 percent in FY12, on account of higher unit values. This share in food exports had been stagnant at around 7.0 percent for the last five years,

[16] Pakistani wheat is priced at US$ 315 per MT compared to Indian and Russian wheat, which are priced at $280 and $250 per MT, respectively.
[17] To avoid such a situation in future, the government should set support prices after taking into account global production and price trends.
[18] Source: www.halalpakistan.com.
[19] The largest *halal* meat exporters in the world are Brazil, France, Thailand and Malaysia; whereas the Middle East and USA are the biggest importers.

which can be attributed to non-compliance with international standards.[20] This has also resulted in a shift of exports from more lucrative European markets, to the Middle Eastern market. In order to increase export earnings from this source, an improvement in quality standards at different stages (from fishing to packaging) is essential. In this regard, several EU missions have visited Pakistan and tried to set up pilot projects. In our view, the biggest hurdle seems to be lack of education, as fishermen are unable to follow complicated procedures for tracking and storing the fish.

Table 8.5: Textile Exports - FY12

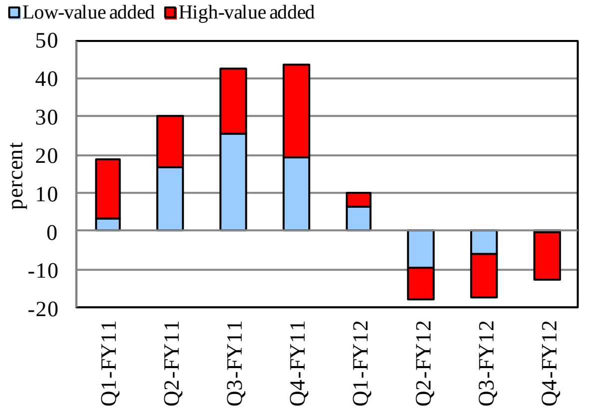
million US$	Growth (%)	Abs. Δ	Quantum impact	Price impact
Raw cotton	28.4	102.3	288.8	-186.5
Cotton yarn	-17.8	-388.2	155.6	-543.8
Cotton fabrics	-4.2	-108	-0.4	0.2
Cotton carded	-61.4	-18.7	-20.4	1.7
Hosiery	-13.9	-319.3	-560.8	241.5
Bed-wear	-16.2	-337	-394.9	57.8
Towels	-10	-75.9	-134.8	58.9
Readymade garments	-8.6	-153.6	-494	340.5

Source: Pakistan Bureau of Statistics

Textiles

Textile exports declined by US$ 1.4 billion during FY12, due to lower consumer spending in the US and EU. Other textile producers like China, India, Bangladesh and Indonesia, also faced contraction in their exports to these markets. In fact, the decline in Pakistan's exports was smaller than other countries. This may be attributed to the fact that its unit values are the lowest among peers, with buyer deciding to switch to low-price products.[21]

Figure 8.14: Contribution in Textile Export Growth



Source: Pakistan Bureau of Statistics

Furthermore, the decline in unit prices of cotton and cotton yarn in FY12, also hit our export earnings: quantity gains were completely offset by the negative price impact in yarn, and to a lesser extent in raw cotton (**Table 8.5**).[22] In addition to unfavorable global conditions, Pakistan's textile exports were also hit by domestic energy shortages, as local manufacturers could not meet delivery deadlines. This has also dented their reputation in export markets as credible suppliers.

Leather exports registered a decline of 3.6 percent during FY12, in sharp contrast to a 25.4 percent increase last year. Leather exports, including garments and footwear, declined by 15.7 and 5.8 percent, respectively. Leather products, being relatively expensive, are more sensitive to global economic conditions. Pakistani exporters are facing stiff competition from China and India, who not only benefit from economies of scale but also have much better designing and manufacturing facilities. Moreover, availability of cheaper substitutes in the global market, and rising domestic cost of production have also hurt the competitiveness of Pakistani exports. We also believe that Pakistan's branding in this sector lags behind its competitors.

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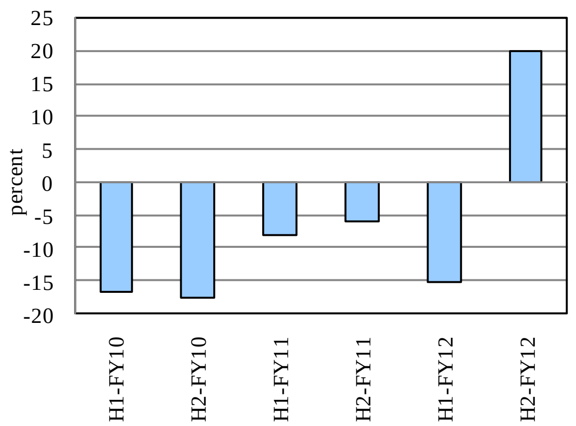
[20] Application of Sanitary and Phyto-sanitary Measures (the 'SPS Agreement') entered into force with the establishment of the World Trade Organization on 1st January 1995. It concerns the application of food safety and animal and plant health regulations.

[21] For details, please see **Annexure 1** in SBP Third Quarterly Report for 2011-12.

[22] New York average cotton prices in FY12 were 105.2 cents/lb compared to 157.9 cents/lb in FY11.

Cement exports increased by 2.1 percent in FY12, largely due to an improvement in the export of Ordinary Portland Cement (OPC).[23] In addition to higher demand from Afghanistan, OPC exports to India and Sri Lanka benefitted from improved relations with the two countries that saw a relaxation in import restrictions imposed earlier. As a result, cement exports improved in H2-FY12 (**Figure 8.15**). In contrast to OPC however, SRC exports to its main market, Iraq, declined. This was mainly due to competition from Iran and the UAE, which benefitted from closer geographical proximity to the country.[24]

Figure 8.15: Cement Exports (YoY growth)



Source: Pakistan Bureau of Statistics

Direction of Exports

The US remained the top destination for Pakistani exports, followed by UAE, Afghanistan and China (**Table 8.6**).[25] Bangladesh is also a top export destination for Pakistan, with 2.7 percent share in total exports. Exports to UAE and China increased compared with last year, whereas those to the US and Europe declined. In the case of the US and Europe, the decline was the result of financial and economic strains facing these economies. On the other hand, a 46.3 percent fall in exports to Bangladesh compared with last year, was mainly the result of high base-effect. Last year, Bangladesh imported a large quantity of raw cotton from Pakistan due to a shortage in the international market.

Table 8.6: Top 10 Export Destinations

million US$

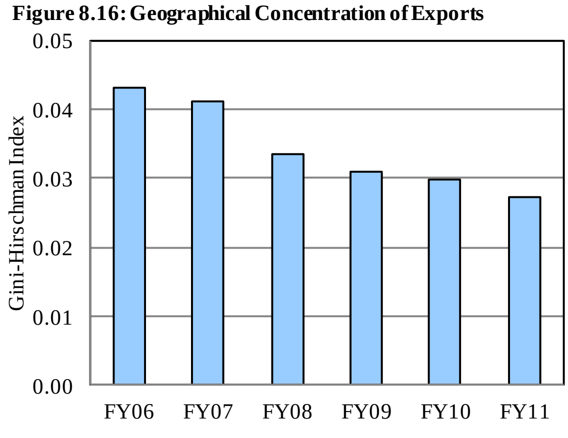
	FY11	FY12	YoY growth	% share in
USA	3,956.9	3,533.0	-10.7	15.0
UAE	1,808.1	2,303.1	27.4	9.7
Afghanista	2,335.0	2,247.6	-3.7	9.5
China	1,634.3	2,195.5	34.3	9.3
UK	1,206.1	1,184.2	-1.8	5.0
Germany	1,271.9	1,052.9	-17.2	4.5
Bangladesh	1,015.0	634.8	-37.5	2.7
Italy	790.1	580.0	-26.6	2.5
Belgium	658.9	521.8	-20.8	2.2
Spain	571.4	490.1	-14.2	2.1
Total	**2,4810.4**	**2,3631.9**	**-4.8**	**62.3**

Source: Pakistan Bureau of Statistics

Market Diversification

On a positive note, there was some improvement in market diversification. Traditionally, Pakistan's exports have been concentrated towards the US and EU markets, which makes them vulnerable to these economies. However, since FY03, Pakistan has gradually diversified its export markets; the share of exports to North America and EU has declined from around 55 percent in FY03, to 43 percent in FY11, whereas the share of Asia has increased from 39 percent to 50 percent. This is

Figure 8.16: Geographical Concentration of Exports



Source: Pakistan Bureau of Statistics; Analyst calculations

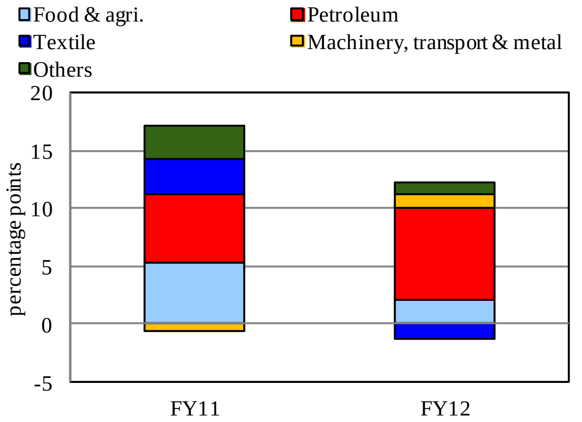
[23] Ordinary Portland Cement (OPC) accounts for 90 percent of the country's production capacity, and recovered from last year's decline growing by 3.8 percent in FY12.
[24] OPC exports to India and Sri Lanka grew by 11 percent and 41 percent respectively during Jul-May FY12, following the relaxation in export licenses and quality standards imposed by the two countries on Pakistan's cement exports.
[25] The share of Afghanistan in Pakistan's exports has surprisingly increased in recent years. However, this is mainly because the informal trade between the two countries is now being documented.

a heartening trend, as Asia is increasingly driving global economic growth. The Gini-Hirschman Index also confirms this diversification (**Figure 8.16**).[26]

8.7.2 Imports

Imports grew by 11.1 percent YoY during FY12, to US$ 44.9 billion. The increase was due to a significant increase in international commodity prices, particularly oil. Other than prices, the increased quantum imports for power, construction, transport, and agriculture, also contributed to rise in the import bill during FY12 (**Figure 8.17**).

Figure 8.17: Contribution in Import Growth



Source: Pakistan Bureau of Statistics

The increase of ***petroleum products*** during FY12 was caused by both a rise in prices, and higher demand. Gas load shedding, rising sales of automobiles, and narrowing price differential between CNG and petrol, have increased the demand for petroleum products. On the other hand, a fall in crude oil imports was the result of refineries' inability to purchase oil due to the growing circular debt problem (see **Chapter 3).**

Palm oil imports increased for the second consecutive year, growing by 20.7 percent during FY12. The increase in quantum can be attributed to a preferential trade agreement with Indonesia that was approved in September 2011, and became effective from January 1, 2012. As a result of this agreement, Pakistan lowered import duty on palm oil by 15 percent from the world's top producer.[27]

Fertilizer imports also remained strong. As gas supply to the fertilizer industry remained sporadic during the year, urea production declined, and imports became necessary. However, the government overestimated the import requirement for the *kharif* season, which led to a urea glut in the latter half of FY12. While domestic prices remained suppressed because of this excess supply, manufacturers' profitability also suffered due to the increase in operating costs, fall in output, and depressed prices. Since imports are subsidized – as domestic prices are lower than international prices – the government's subsidy bill also increased. New arrangements regarding supply of gas to fertilizer industry, and carryover stock may, however, reduce the need for imports next year.[28]

Road motor vehicles recorded a 20.6 percent increase during FY12, on account of increased imports of completely built units (CBUs) of motor cars, buses and motor bikes.

In the backdrop of rising domestic prices, locally assembled cars faced stiff competition from imports of used Japanese cars, which have increased five-fold over the last year.[29] Despite being 5 years old, anecdotal evidence suggests these cars compete quite well against their locally assembled counterparts on price dependability, as well as interior features.

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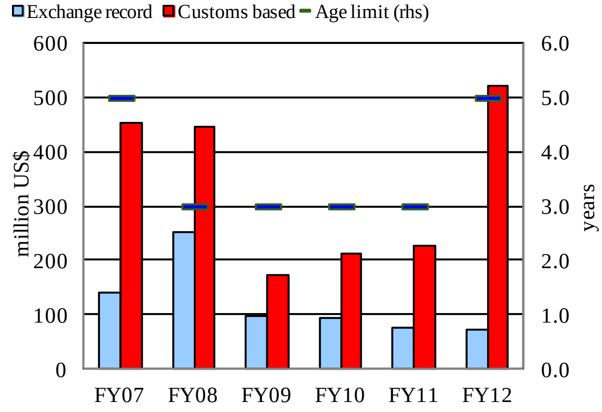
[26] The Gini-Hirschman geographical concentration Index is defined as $G = [\sum(xi/X)^2]^{1/2}$., where the annual value of exports to country *i* is represented by *xi* , while the annual value of total exports is X. Higher the value of the index, more concentrated are the country's exports. For instance, if the value is 1, it means that the country exports to a single country.
[27] Indonesia is the largest palm oil producing country in the world, followed by Malaysia. On the other hand, Pakistan is the third largest buyer of palm oil in the world.
[28] For details, see **Annexure 3 Fertilizer** in SBP's 3rd Quarterly Report for 2011-12.
[29] According to Pakistan Motor Dealers' Association, Pakistan imported around 55,700 units of used cars in FY12, compared to 11,300 units in FY11.

Interestingly, as per customs record, imports of CBUs amounted to US$ 523.0 million whereas, as per the exchange record data, this was just US$ 70.6 million (**Figure 8.18**). This clearly indicates that payments for bulk of imported used cars, are being made from outside the country.[30]

Going forward, as production of some locally assembled models is phased out to comply with Euro-II emissions standards, we believe imported used cars will continue to benefit – particularly in the under-1500cc segments.[31] However, the government's recent decision to limit the depreciation allowance, which can be claimed for duty purposes (effectively increasing customs duty), is likely to slow down the pace of imports as prices rise.[32]

Figure 8.18: CBU Imports



Source: Pakistan Bureau of Statistics

Machinery imports increased by 6.9 percent during FY12 in contrast to a 1.7 percent fall last year (**Table 8.7**). The major driver of this growth was telecom machinery, mostly cellular phones. The share of other machinery groups was relatively small, with textile machinery posting negative growth.

Table 8.7: Contribution in Machinery Import Growth

percentage points

	FY11	FY12
Power generating	-7.8	0.4
Office machinery	0.3	0.8
Textile	3.0	-0.2
Construction and mining	-0.9	0.6
Electrical and apparatus	2.2	0.4
Telecom	4.9	4.6
A. Mobile phone	3.9	3.1
B. Other apparatus	1.0	1.5
Agricultural machinery	-1.8	0.5
Other machinery	-1.6	-0.2
Total machinery	**-1.7**	**6.9**

Source: Pakistan Bureau of Statistics

Sugar imports fell by 98.0 percent compared to last year, mainly due to sufficient availability as a result of better domestic production and carryover stocks from last year (**Table 8.8**).[33] In fact, Pakistan is now in a position to export sugar, and there is an opportunity to enter into barter trade with Iran, as it is planning to buy about 1.6 million tons of sugar from the international market. Pakistan can offer at least 200,000 tons of sugar to Iran in exchange for fertilizer.[34]

Table 8.8: Major Items Recorded YoY Decline in Imports

	Abs. Δ (million US$)	YoY Growth (%)	
	FY12	FY11	FY12
Sugar	-671.6	132.2	-98.0
Air crafts, ships, etc.	-456.4	5.9	-55.4
Raw cotton	-489.9	62.0	-50.0
Jute	-19.6	12.1	-27.4
Soybean oil	-15.5	142.2	-23.2
Aluminum	-15.3	-1.3	-10.9
Insecticides	-16.7	-4.1	-10.9

Source: Pakistan Bureau of Statistics

Raw cotton imports fell compared to the previous year due to a good cotton crop. This was in contrast to FY11 when Pakistan had to import significant quantity of raw cotton to fulfill needs of the domestic textile industry. It may be recalled that Pakistan faced a shortage of cotton in FY11, after it exported this commodity to China and Bangladesh.

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[30] Importers of used cars usually have agents in the host country who collect money from the expatriates. The importers in Pakistan make the payment in Rupees to the relatives of expatriates, and the car is imported as either gift, or transfer residence scheme.
[31] These accounted for around 90 percent of used car imports during FY12.
[32] Vide Federal Bureau of Revenue's CGO 13/2012.
[33] Pakistan imported 1.65 million MT of sugar from Brazil, Thailand, India, UAE, and Saudi Arabia during last three years.
[34] Source: Pakistan Sugar Manufacturing Association