6 External Sector

6.1 Overview

After a sharp deterioration in Jul-Oct FY09, Pakistan's overall external account balance improved noticeably in the ensuing months, (see **Table 6.1**) aided by lower current account deficits and a modest revival of financial inflows. Consequently, foreign exchange reserves increased and rupee also recovered part of its losses suffered during the Jul-Oct FY09 period (see **Figure 6.1**). Thus the aggregate 83.9 percent growth in overall external account deficit during the first eight months of FY09 accrued essentially during the first four months of the period.

Table 6.1: Summary of External Accounts
billion US$

	FY08		FY09	
	Jul-Feb	**Nov-Feb**	**Jul-Feb**	**Nov-Feb**
A-Current A/c balance	-8.6	-5.7	-7.5	-1.5
i) Trade balance	*-9.3*	*-5.9*	*-8.9*	*-3.0*
Exports	*12.5*	*6.3*	*13.0*	*5.9*
YoY growth (%)	*13.8*	*14.3*	*4.3*	*-7.0*
Imports	*21.8*	*12.2*	*21.9*	*8.9*
YoY growth (%)	*20.8*	*37.6*	*0.5*	*-27.6*
ii) Invisible balance	*0.6*	*0.3*	*1.4*	*1.5*
Remittances	*4.1*	*2.0*	*4.9*	*2.6*
B-Financial/cap balance	4.9	1.8	2.5	1.9
i) FDI	*2.5*	*1.2*	*2.8*	*1.5*
ii) FPI	*0.1*	*-0.2*	*-0.9*	*-0.7*
iii) Other investment	*2.2*	*0.7*	*0.5*	*1.2*
C-Errors & omissions	0.7	0.9	-0.2	-0.3
D-Overall balance	**-3.1**	**-3.0**	**-5.2**	**0.1**

A significant part of the Jul-Oct FY09 deterioration in the current account owed to a steep rise in import growth mainly on account of higher import prices. The subsequent improvement owed to both, a lower quantum of imports (as demand was compressed by monetary tightening and a weaker rupee) as well as large fall in import prices (see **Table 6.2**). Specifically, the import bill registered a 27.6 percent YoY decline during Nov-Feb FY09 against an extraordinary growth of 37.6 percent in the comparable period last year (see **Table 6.1**).

The contraction in the import bill complemented the rise in remittances to contain the current account deficit. However, weakening in exports growth and lower earnings on foreign exchange reserves offset some of the gains.

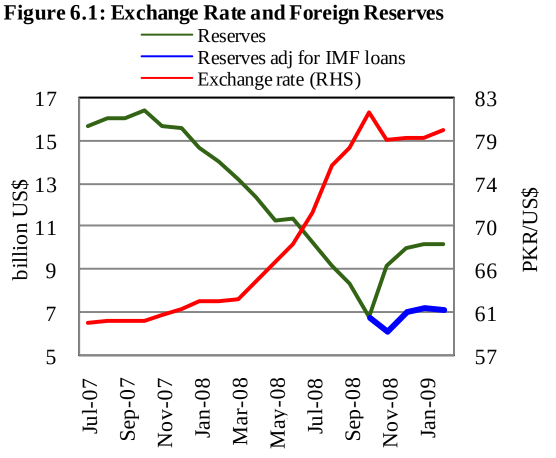
Table 6.2: Factors Behind Recent Improvement in External Accounts

	Jul-Jan			Nov-Jan	
	FY07	FY08	FY09	FY08	FY09
Private sector credit growth	10.9	9.9	5.5	8.2	1.4
Petroleum imports unit value (US$/MT)	449	508	654	529.3	412
Wheat import unit value (US$/MT)	277	463	406	460.8	377
Palm oil import unit value (US$/MT)	483	805	907	833.6	647
Pak GDP growth	6.8	5.8	2.5p	-	-
PKR/US$ app(+)/dep(-)	-0.9	-3.5	-13.6	-	-
Rice production (million ton)*	5.4	5.6	6.5	-	-
S&P foreign currency rating	B+	B	CCC+	B+	CCC+[1]

p projected * Full fiscal year

Similarly, financial inflows which had dried up in Jul-Oct FY09 period revived to some extent following the availability of IMF support for Pakistan's macroeconomic stabilization program in November FY09 (see **Figure 6.1**). IMF support encouraged the foreign inflows in two ways. On the one hand it helped stabilize exchange rate which, in turn, decelerated the retirement of FE-25 loans and discouraged holdings of outstanding export bills. On the other hand, it helped somewhat in restoring foreign investor's confidence and led to the release of bilateral and multilateral loans.[1] As a result, the surplus in the financial account increased to US$ 1.9 billion during Nov-Feb FY09 period from a meager amount of US$ 0.5 billion during Jul-Oct FY09.[2]

Figure 6.1: Exchange Rate and Foreign Reserves



Potential Risks to Future Outlook

On the flip side, falling export prices and decline demand, amid of a recession in Pakistan's major export markets compounded by the impact of domestic power

[1] S&P upgraded Pakistan's credit rating from CCC to CCC+ on December 18, 2008.
[2] Support from IMF is not included in capital and financial account inflows.

shortages have adversely impacted Pakistan's exports in the recent months. Specifically, during Nov-Feb FY09,
Pakistan's exports have declined by 7.0 percent compared with 14.3 percent YoY growth in the comparable months of the previous year.

Moreover, workers' remittances which showed impressive growth so far may be hurt by world economic recession in the medium to long term (see **Table 6.3**). For instance, sharp fall in oil prices may reduce the demand for additional migrants in the oil rich gulf region which accounts for more than 50 percent of Pakistan's overall remittances receipts. Likewise, deep recession in US, which contributes close to one third of Pakistan's remittances, could also hurt remittances flows to Pakistan in the months ahead. However, in the short run, remittances are expected to show resilience to recession in the source countries (see **Box 1)**. Similarly, notwithstanding the modest revival in foreign direct investment, overall foreign investment declined during Jul-Feb FY09 (mainly on

Table 6.3: Potential Risk for Pakistan's External Accounts

	2007	2008p	2009p
World GDP growth rate**	5.2	3.4	0.5
US**	2	1.1	-1.6
EU**	2.6	1.0	-2.0
Advance economies import growth**	4.5	1.5	-3.1
World unemployment rate*	5.7	6.0	6.1-7.1
Developed economies and European Union*	5.7	6.4	6.6-7.9
Middle East*	9.4	9.4	9.3-11.0
Sugarcane production (million ton)***	54.7	63.9	52.1
Global liquidly (TED spread)[1]	1.2	1.6	1.0

* International Labor Organization report on global employment trends January 2009
** World Economic Outlook Update January 2009
*** Fiscal Year
p projected

[1] TED spread is a measure to summarize credit strain in the financial markets. Usually the TED spread is less than 0.5%. The higher the spread, the greater the perceived credit risk.

Table 6.4: Major Inflows Vulnerable to US Recession
million US$

	Jul-Jan FY08			Jul-Jan FY09			YoY Change (%)	
	Total	US	US share (%)	Total	US	US share (%)	Total	US
Exports BOP	10.9	2.2	20.3	11.5	2.2	19.2	5.5	-0.7
Remittances	3.6	1.0	28.3	4.3	1.0	24.1	18.0	0.3
Foreign private investment	2.5	1.2	47.9	2.3	0.3	13.7	-10.6	-74.4
of which:								
Direct investment	2.6	1.0	37.5	2.6	0.5	20.2	1.3	-45.4
Portfolio investment	0.0	0.3	-	-0.3	-0.2	66.1	-	-182.9
Total Inflows	**17.0**	**4.5**	**26.1**	**18.0**	**3.5**	**19.6**	**5.8**	**-20.6**

account of net outflow from portfolio investment) in the wake of sluggish performance of stock market, euro bond payment, poor law and order situation and liquidity crunch in the international market. With more than one third of foreign investment inflows originating from US, which is worst hit by the ongoing financial crises, the chances of considerable improvement in these inflows in the coming months remain dim (see **Table 6.4**).

In this backdrop, maintaining growth in foreign exchange inflows would be challenging going forward. Therefore, there is an urgent need to devise a strategy to mitigate the downside risks to Pakistan's external inflows. For instance, efforts to raise productivity, address power shortages and trade diplomacy to get preferential market access are critical factors for protecting export market shares.

In the same way, workers' remittances can be promoted by facilitating international travel documents, providing investment advisories services at migrants' hometowns, strengthening financial sector infrastructure, and making efforts for greater labor mobility under the mode four of General Agreement on Trade in Services (GATS). Regarding foreign investment, efforts to improve law & order situation, better infrastructure

Table 6.1.1:Cross Country Comparison of Remittances Flows Stability Against Other Capital Flows

(measured by Coefficient of Variation)

	Workers' Remittances	Direct Invest	Portfolio Invest	Other Invest
	Q1-1980-Q4-2007			
Pakistan	0.55	1.76	3.43	2.28
Philippine	1.40	2.08	3.49	4.72
India[1]	0.89	0.76	1.33	1.35
Sri Lanka	0.74	1.17	4.56	1.33
Bangladesh	0.96	1.51	7.49	4.01
	Q1-1980-Q4-1989			
Pakistan	0.16	0.66	1.00	0.97
Philippine	0.49	1.50	3.70	1.74
India[2]	0.18	n.a.	n.a.	0.63
Sri Lanka[3]	0.22	0.42	n.a.	0.80
Bangladesh[4]	0.27	1.79	-13.00	0.55
	Q1-1990-Q4-1999			
Pakistan	0.21	0.57	3.04	1.01
Philippine	1.66	0.90	3.02	1.64
India	0.53	0.77	1.14	1.08
Sri Lanka	0.31	1.34	2.87	1.11
Bangladesh	0.29	1.69	-31.08	4.65
	Q1-2000-Q4-2007			
Pakistan	0.46	1.06	3.53	-16.10
Philippine	0.33	2.45	3.06	-2.91
India	0.27	0.49	1.03	1.44
Sri Lanka	0.30	0.53	3.47	1.79
Bangladesh	0.49	0.72	2.31	-3.75

[1] Indian data is available up to Q4-2006.

[2] Indian Investment data is available from Q1-1991 onward

[3] Srilankan portfolio investment data is available from Q1-1991 onward.

[4] Foreign investment data is available from Q1-1983 onward

and controlling the factors that increase start-up costs[3] may encourage foreign direct investment.

Box-6.1.1: Workers' Remittances as a Stable Source of Foreign Inflows
After exports, worker's remittances are the second largest source of foreign exchange earnings in Pakistan. In recent years, its impressive growth has moderated the widening of current account deficit as it more than offset the deficit in services and income account. However, there are downside risks to remittances growth in the wake of ongoing recession in the source countries. In this backdrop, a comparison is made between the stability of remittances and other capital inflows over the longer period of time to business cycles in home and host countries.

To conduct this exercise, quarterly data on workers' remittances, foreign direct investment, foreign portfolio investment and other investments from 1980 to 2007 is taken from IMF balance of payment statistics. The countries chosen are Pakistan, Philippine, India, Sri Lanka, and Bangladesh. The coefficient of variation is used as measure of dispersions as it is more appropriate when comparing between data sets with widely different means.

The comparison of different capital flows show that remittances are one of the least volatile sources of foreign exchange earnings in almost all of these countries. Moreover, remittances have shown remarkable stability over time (see **Table 6.1.1**). Thus, it may be argued that remittances react less violently to economic cycles (both in source and recipient countries) than the other form of capital flows.

The relative stability of workers' remittances to economic down turn in source countries may be attributed to the following factors: a) remittances are small part of the workers income and migrants continue to send remittances even hit by adverse income shock, b) if migrants return, they are likely to take back accumulated savings and c) developed countries may offer some income protection to migrant workers during economic downturns.

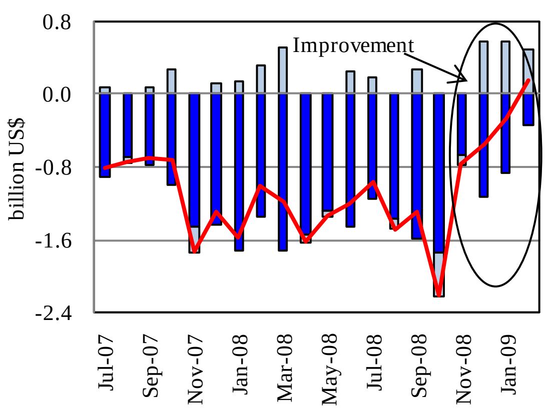
In this scenario, Pakistan's remittances flows are likely to increase in the short run. Apart from the above mentioned factors, the recent action against the informal transfer of funds may also divert a part of the informal flows to formal channel. Moreover, migrants are likely to remit more to meet the increasing cost of living of their families at home in the wake of strong inflationary pressures. Likewise, predominant proportion of remittances is intended for consumption purposes which are less volatile than those intended for investment.

6.2 Current Account Balance

In sharp contrast to extraordinary YoY expansion of 47.6 percent in the comparable period last year, current account deficit contracted by 13.8 percent during Jul-Feb FY09. This contraction entirely stemmed from the Nov-Feb FY09 period (see **Figure 6.2**), during which current account deficit declined by 74.3 percent compared with the same period last year.

[3] Doing Business Report for 2009 shows that Pakistan's ranking in starting a business has deteriorated from 64th in 2008 to 77th in 2009.

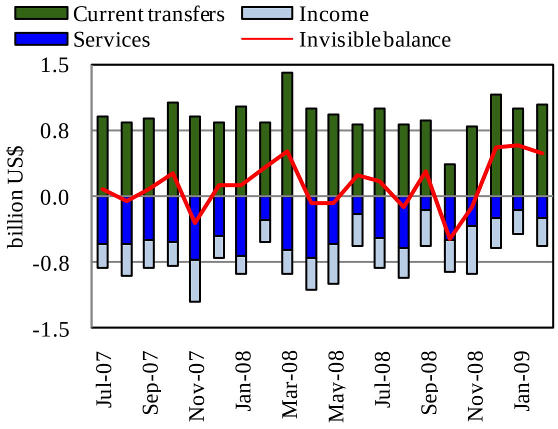
Figure 6.2: Monthly Composition of Current Account



The improvement in the current account deficit in the latter period was contributed by both, a substantial contraction in the trade deficit and a surplus in the invisibles account. The contraction in the former was mainly the result of substantial fall in import bill on the back of lower import prices, subsiding demand pressures and exchange rate depreciation while improvement in the latter emanated from decrease in freight charges, receipt of logistic support payments and impressive growth in worker's remittances (see **Figure 6.3**).

While falling global commodity prices, amid world economic recession, benefitted Pakistan in the form of lower import bill it has also lowered Pakistan's export earnings and poses risk to remittances growth in the medium to long term. In particular, if the global recession prolongs, the aforementioned risks may hamper improvement in current account deficit going forward.

Figure 6.3: Monthly Compositing of Invisible Balance



6.2.1 Trade Account[4]

Trade deficit showed YoY contraction of 4.6 percent during Jul-Feb FY09 against a 31.5 percent expansion in the comparable period of last

[4] This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS due to inclusion of freight and insurance costs in the latter imports, difference in coverage, times leads and lags involved in recording etc.

year, largely reflecting extraordinary slowdown in import growth. However, what is worrisome is the concurrent slow down in export growth which slowed to 4.3 percent during Jul-Feb FY09 from reasonable growth of 13.8 percent in the same period last year.

Slowdown in export growth during Jul-Feb FY09 period is mainly explained by decline in textile exports on the back of shrinking demand in Pakistan's major export markets as a result of ongoing global economic recession. Unfortunately, there are also signs of slowdown in non textile exports in the last four months which were hitherto showing strong growth. [5]

As mentioned earlier, YoY growth in imports slowed down to only 0.5 percent during Jul-Feb FY09 from 20.8 in the corresponding period last year.

6.2.2 Services (net)

In sharp contrast to Jul-Feb trend of last six years, the deficit in services trade declined by 36.0 percent during Jul-Feb FY09. Lower outflow from foreign exchange companies[6], logistic support receipts and deceleration in freight related

Table 6.5: Services Account Balance
million US$

	Jul-Feb		Absolute change	Nov-Feb		Absolute change
	FY08	**FY09**		**FY08**	**FY09**	
Transportation	-1,628.0	-1,625.0	3.0	-911.0	-638.0	273.0
of which freight	*-1,705.0*	*-1,752.0*	*-47.0*	*-963.0*	*-701.0*	*262.0*
Travel	-872.0	-675.0	197.0	-502.0	-137.0	365.0
of which exchange companies	*-823.0*	*-579.0*	*244.0*	*-408.0*	*-102.0*	306.0
Other business services	-1,937.0	-837.0	1,100.0	-976.0	-248.0	728.0
of which exchange companies	*-1,653.0*	*-476.0*	*1,177.0*	*-843.0*	*-92.0*	751.0
Government services	407.0	621.0	214.0	387.0	185.0	-202.0
of which logistic support	*282*	*465*	*183.0*	*282.0*	*100.0*	-182.0
Others	-207.0	-197.0	10.0	-113.0	-149.0	-36.0
Services(net)	-4237	-2713	1524	-2115	-987	1128

charges on account of slowdown in import growth were the major contributory factors behind this decline.

In this regard, close to three fourth of this decline was witnessed during Nov-Feb

[5] For detail, please see section on foreign trade.
[6] The outflows from exchange companies have been declining since May-2008 when exchange companies outflows for legal transactions were restricted to 75 percent of the home remittances mobilized by them during the preceding month (FE circular No. 04, dated May 09, 2008).

FY09 period. This relatively larger decline during this period mainly owed to significant decline in import related freight charges and sharp fall in outflows from foreign exchange companies in the aftermath of action against undocumented fund transfer (see **Table 6.5).**

Table 6.6: Current Account Balance
million US$

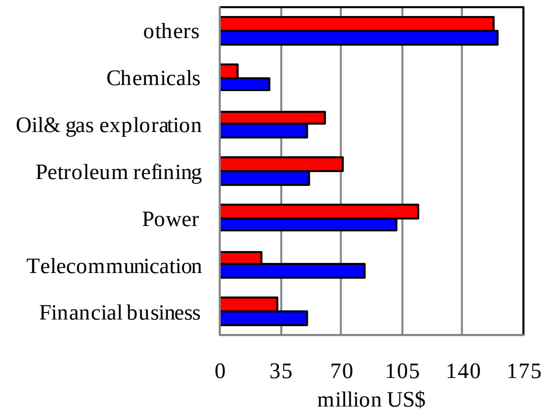
	FY08		FY09*	
	Jul-Feb	**Nov-Feb**	**Jul-Feb**	**Nov-Feb**
1. Trade balance	**-9,293.7**	**-5,938.0**	**-8,863.1**	**-3,000.0**
Exports	12,482.0	6,297.0	13,014.5	5,859.0
Imports	21,775.7	12,235.0	21,877.6	8,859.0
2. Services (net)	**-4,237.0**	**-2,115.0**	**-2,713.0**	**-987.0**
Transportation	-1,628.0	-911.0	-1,625.0	-638.0
Travel	-872.0	-502.0	-675.0	-137.0
Communication services	19.0	-4.0	-31.0	-25.0
Construction services	-13.0	-11.0	-24.0	-19.0
Insurance services	-88.0	-35.0	-48.0	-32.0
Financial services	-81.0	-63.0	-90.0	-56.0
Computer & information services	5.0	11.0	53.0	23.0
Royalties and license fees	-49.0	-11.0	-57.0	-40.0
Other business services	-1,937.0	-976.0	-837.0	-248.0
Personal & cultural & recreational services	0.0	0.0	0.0	0.0
Government services	407.0	387.0	621.0	185.0
Of which logistic support	282.0	282.0	465.0	100.0
3. Income (net)	**-2,428.0**	**-1,201.0**	**-2,923.0**	**-1,468.0**
Investment income(net)	-2,433.0	-1,205.0	-2,931.0	-1,472.0
Direct investment	-2,047.0	-982.0	-2,167.0	-1,043.0
of which: profit & dividends	-423.0	-161.0	-388.0	-165.0
purchase of crude oil and minerals	-971.0	-485.0	-1,118.0	-561.0
Portfolio investment	-149.0	-61.0	-291.0	-137.0
Of which : dividend	-134.0	-91.0	-108.0	-60.0
IMF charges & interest on off. external debt	-436.0	-294.0	-436.0	-288.0
Interest on private external debt	-115.0	-60.0	-78.0	-30.0
Others (net)	319.0	196.0	49.0	30.0
4. Current transfers (net)	**7,314.0**	**3,602.0**	**7,044.0**	**3,991.0**
Private transfers	7,259.0	3,566.0	6,928.0	3,982.0
Workers remittance	4,124.0	2,045.0	4,919.0	2,574.0
FCA - residents	287.0	84.0	-142.0	173.0
Others	2,848.0	1,437.0	2,151.0	1,235.0
of which exchange companies	1,526.0	782.0	247.0	72.0
Official transfers	55.0	36.0	116.0	9.0
Current account balance	**-8,644.7**	**-5,652.0**	**-7,455.1**	**-1,464.0**

* Provisional

6.2.3 Income (net)

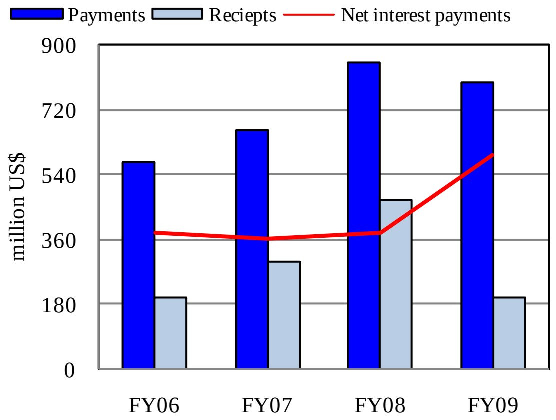
Deterioration in income account deficit accelerated to 20.4 percent during Jul-Feb FY09 from a benign growth of 3.3 percent in the comparable period of last year. While a rise in investment income outflow also contributed to this deterioration, a large part of the acceleration was driven by an increase in interest (net) payments during the period under review.

Figure 6.4: Sector-wise Repatriation of Profit & Dividends (Jul-Jan)



The modest rise in investment income outflows was entirely explained by higher purchase of crude oil and minerals whereas the repatriation of profit and dividends registered decline during the period under consideration. This latter largely reflects sharp fall in repatriation of profit and dividends by the telecommunication sector on account of PTCL's lower profits owing to its Voluntary Separation Scheme (VSS).[7] Moreover, lower profitability of banks on the back of increased non-performing loans also contributed to decline in repatriation of profit and dividend during the period under review.

Figure 6.5: Detail of Net Interest Payment (Jul-Feb)



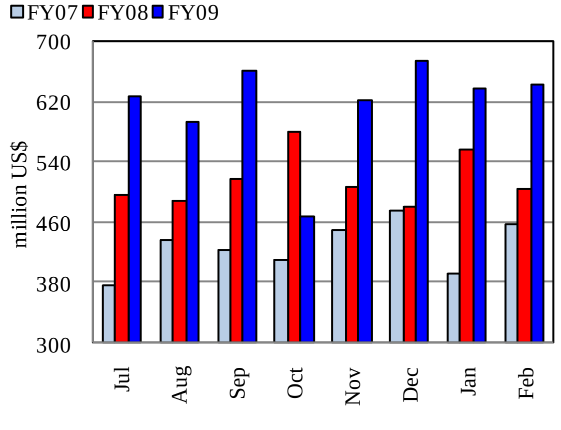
On the other hand, oil & gas exploration, petroleum refining and power sector registered small increase in repatriation of profit and dividends during the period under consideration (see **Figure 6.4**).

Unlike the previous years when growth in interest income on foreign reserves

[7] The repatriation of profit and dividends by PTCL declined to US$ 1.2 million during Jul-Jan FY09 from US$ 47.0 million during same period last year.

offset a significant part of the increase in interest payments, substantial fall in these earnings during Jul-Feb FY09 increased net interest payments (see **Figure 6.5**). Specifically, net interest payment increased by US$ 207 million during Jul-Feb FY09.

Figure 6.6: Monthly Worker's Remittances



6.2.4 Current Transfers

Against the respectable growth of 11.4 percent last year, current transfer declined by 3.7 percent during Jul-Feb FY09. With the robust growth in workers' remittances during the period, this decline was largely driven by fall in other inflows from foreign exchange companies. Moreover, outflow from resident foreign currency account also contributed to this decline (see **Table 6.6**).

Nonetheless, current transfers have registered a nominal increase of 10.8 percent during Nov-Feb FY09 period on the back of extraordinary growth (25.9 percent) in workers' remittances and inflow in resident foreign currency accounts during the period.

Worker's Remittances

As in the previous two years, workers' remittances grew remarkably during Jul-Feb FY09. Specifically, workers' remittances registered 19.3 percent growth during Jul-Feb FY09 on the top of 21.3 percent average growth in the same period of the previous two years.

During Jul-Feb FY09, channel of remittances growth can be categorized into two distinct periods i.e. Jul-Oct FY09 and Nov-Feb FY09. During the first period, more than three fourths of the increase in remittances was contributed by higher inflows in exchange companies whereas in the second period around 60 percent of

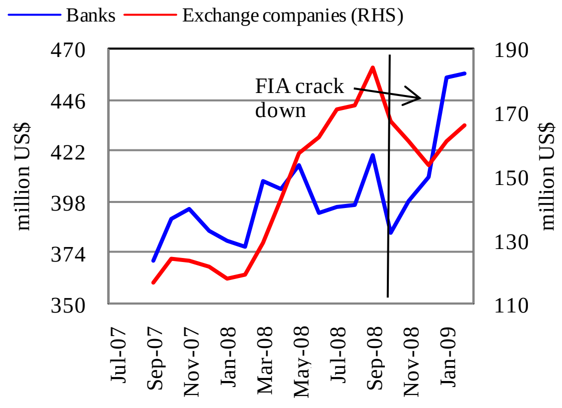
Table 6.7: Contribution (%) in Remittances YoY Growth

	FY09		
Channel	**Jul-Oct**	**Nov-Feb**	**Jul-Feb**
Banks	9.7	59.9	43.1
Exchange companies	78.3	32.5	47.8
Post offices	12.0	7.6	9.0
Overall growth	12.7	25.9	19.3

the rise in remittances growth was contributed by higher inflows in banks (see **Table 6.7**).

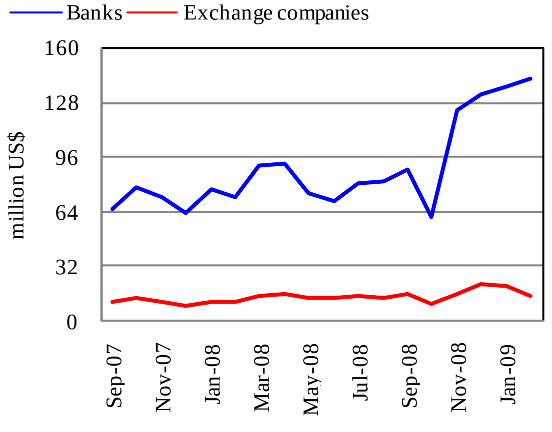
Monthly data on remittances suggests that this compositional change in remittances growth coincided with the FIA action against the undocumented fund transfers during October 2008. This coincidence gives credence to the view that a part of the remittances earlier being transmitted through undocumented channel diverted to banking channels after this action. Moreover, growth of remittances flows routed through exchange companies witnessed a deceleration suggesting that prospective customers might have withheld funds for the time being owing to the possibility of a further crackdown against other exchange companies.

Figure 6.7: Remittances Routed Through Exchange Companies and Banks (3-Months Mov.Avg)



Country-wise data on the remittances suggests that a major part of the increase in remittances through banking channel in the post FIA action period was recorded from United Arab Emirates, while slowdown in remittances through exchange companies was largely attributed to fall in remittances from United States (see **Table 6.8**), which accounted for 58.5 percent of the overall remittances routed through the companies during Jul-Oct FY09.

Figure 6.8: Remittances from United Arab Emirates



During Nov-Feb FY09, a steep rise in remittances through banking channel relative to exchange companies from UAE (see **Figure 6.8**) may be attributed to a) action against undocumented transfer of funds, b) wide network of Pakistan's banks available in the region, c) negligible differences between costs of remitting through banking channel and money transfer operators (MTOs) and d) possible reverse capital flight of some of the money earlier transferred to Dubai in the wake of recession in the real estate activities in the region.

Regarding US, it may be pointed out that remittances routed through exchange companies were continually rising while that through banking channel were continuously falling till October 2008 (see **Figure 6.9**). Specifically, share of workers' remittances routed through exchange companies in overall remittances increased to 64.7 percent in October 2008 from 48.8 in July 2007. This shift was taking place probably because of considerably low cost of remitting funds through Money Transfer Operators (MTOs) compared to banks (see **Table 6.9**) and scarce

Table 6.8: Monthly Average of Workers' Remittances
million US$

	FY08			FY09		
	Jul-Sep	**Oct**	**Nov-Feb**	**Jul-Sep**	**Oct**	**Nov-Feb**
		Total				
Banks	370.6	429.2	376.9	420.0	306.7	456.2
Exchange Companies	116.7	134.6	118.3	184.1	140.0	161.4
Post Offices	12.9	16.4	15.5	22.5	19.4	25.5
Total	500.2	580.2	510.8	626.6	466.1	643.1
		US				
Banks	77.7	95.4	75.5	59.1	44.9	60.3
Exchange Companies	62.6	74.5	66.9	107.4	82.3	72.1
Total	140.3	169.9	142.4	166.6	127.3	134.0
		UAE				
Banks	63.0	78.1	70.8	83.0	60.3	133.4
Exchange Companies	11.9	13.9	10.7	14.4	9.6	18.3
Post Offices	4.2	5.4	5.3	6.7	6.1	10.2
Total	79.1	97.4	86.8	104.1	75.9	161.9
		UK				
Banks	24.3	30.7	20.5	23.5	17.6	15.3
Exchange Companies	15.7	13.9	11.6	16.0	13.6	33.3
Total	40.0	44.6	32.1	39.5	31.2	48.6
		KSA				
Banks	88.3	84.1	81.5	112.0	80.1	96.8
Exchange Companies	5.0	5.7	5.7	11.7	9.4	11.8
Post Offices	5.1	6.2	5.5	9.0	7.3	8.3
Total	98.3	95.9	92.7	132.7	96.8	116.9

During Jul-Oct Khanani &Kalia accounted for around 19 percent of the remittances received through exchange companies
During Jul-Oct around 53 percent of Khanani &Kalia remittances were received from US alone.

availability of Pakistani banks branches in the US. The exchange companies which captured the major share of these inflows during Jul-Oct FY09 period included Zarco (28.9 percent), Pakistan's currency exchange (28.5 percent) and Khanani & Kalia (K&K) (17.0 percent). With the action against one of these exchange companies (K&K), the remittances routed through these companies fell sharply during Nov-Feb FY09 period (see **Figure 6.9**).

In addition, deepening recession in US economy may also have decelerated the remittances inflows from US. Other countries which contributed to rise in remittances during Jul-Feb FY09 included Saudi Arabia, other gulf countries and United Kingdom.

Resident FCAs

Resident foreign currency accounts registered a net outflow of US$ 142 million during Jul-Feb FY09 against inflow of US$ 287 million during the comparable period of last year. Almost all of this decline occurred during the Jul-Oct FY09 period, when individuals withdrew funds from foreign currency accounts on the back of substantial depreciation in exchange rate and rumors of bank defaults and possible freezing of foreign currency accounts during October 2008. The outflow peaked at

Figure 6.9: Remittances from United States (3-MMA)

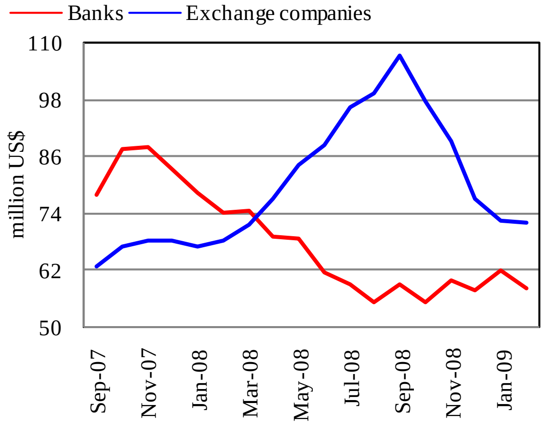
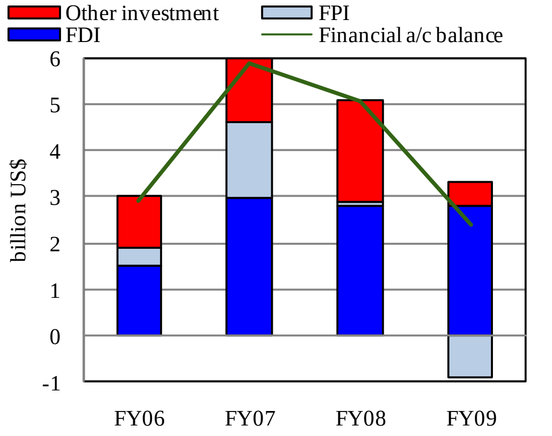


Table 6.9: Average Cost of Remitting (US$ 200) to Pakistan
amount is US$

Country	Time	Bank	MTO e	Total
United States	5-Jun-08	11.46	11.36	11.42
Saudi Arabia	1-May-08	21.7	12.66	14.3

Source: remittanceprices.worldbank.org/Remittance Costs

Figure 6.10: Sources of Financial Account Surplus (Jul-Feb)



US$ 315 million at end October, 2008. However, some of this outflow was recovered in subsequent months (Nov-Feb) with the stability in exchange rate.

6.3: Financial Account

Worsening law and order situation, large economic imbalances, sluggish performance of stock market and risk averse behavior of foreign investors amid liquidity crunch in the international market hampered capital flows to Pakistan during Jul-Feb FY09. In particular, portfolio investment and other investment[8] which are most volatile in nature (**see Box 1**) were severely impacted by these developments during the period (see **Figure 6.10**). Consequently, surplus in financial account shrunk by 52.6 percent during Jul-Feb FY09 against 14.2 percent decline in the corresponding period last year.

Encouragingly, foreign inflows have revived modestly in the aftermath of IMF support for macroeconomic stabilization program. On the one hand, stability in exchange rate decelerated the retirement of FE-25 loans and encouraged the repatriation of export proceeds, on the other hand, IMF support lowered the default risk and encouraged loan inflows from other sources. The latter was chiefly attributed to increased inflows from Islamic Development Bank, Bank of China and other private sector loans.

6.3.1 Net Foreign Investment

Overall net foreign investment declined by 34.2 percent during Jul-Feb FY09 on the top of around 25.0 percent decline in the corresponding period of last year. As in the previous year, the entire decline resulted from outflow of portfolio investment (on account of euro bond payment and outflow from stock market) as the foreign direct investment registered a nominal growth of 0.2 percent during the period under review. Substantial fall in inflows from US, which constituted more than 50 percent of the overall investment in Pakistan during Jul-Feb FY08, was the major driving force behind decline in investment inflows during Jul-Feb FY09 (see **Table 6.10**).

Foreign Direct Investment

During Jul-Feb FY09, foreign direct investment increased slightly by 0.2 percent against a decline of 6.1 percent in the corresponding period of last year. The weak FDI growth largely owes to absence of privatization proceeds, decline in reinvested earnings on account of lower corporate profitability and tighter liquidity conditions in the international market.

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[8] The major components of other investment inflows to Pakistan are the official and private loans.

Table 6.10: Net Foreign Investment in Pakistan
million US$

	July-Feb FY08			July-Feb FY09		
	FDI	**FPI**	**Total**	**FDI**	**FPI**	**Total**
I. Private investment	**2,789.1**	**113.8**	**2,902.9**	**2,794.4**	**-367.0**	**2,427.4**
U.S.A	1,009.5	458.9	1,468.4	618.3	-235.6	382.6
Mauritius	326.3	6.5	332.8	292.8	2.7	295.5
U.A.E	299.2	18.1	317.3	151.8	6.7	158.5
U.K	223.8	-83.7	140.1	188.6	-63.9	124.7
Japan	85.3	2.2	87.6	55.4	-2.1	53.3
Switzerland	113.0	-54.6	58.4	200.7	-29.0	171.7
Germany	56.9	0.2	57.1	41.4	-0.8	40.6
Netherlands	48.9	9.4	58.2	57.0	9.5	66.5
Norway	74.4	-	74.4	64.2	-	64.2
Malaysia	-3.1	-	-3.1	213.7	0.0	213.7
Singapore	22.1	-23.5	-1.5	233.9	-32.7	201.1
Hong Kong	75.2	-174.9	-99.7	86.4	-33.5	52.9
II. Public investment		**-29.5**	**-29.5**		**-535.3**	**-535.3**
Total (I+II)	**2,789.1**	**84.3**	**2,873.4**	**2,794.4**	**-902.3**	**1,892.1**

Major sectors which registered either decline or deceleration in FDI growth during Jul-Feb FY09 included communication, financial business, personal services, trade, construction and transport equipments. On the other hand, food packaging, petroleum refining, oil & gas explorations and, power sectors witnessed higher growth in investment inflows during Jul-Feb FY09 compared with the same period of last year (see **Table 6.11**). In food packaging almost the entire increase was due to investment in Tetrapak Pakistan Limited while higher investment in power was received by Uch power projects and KESC.

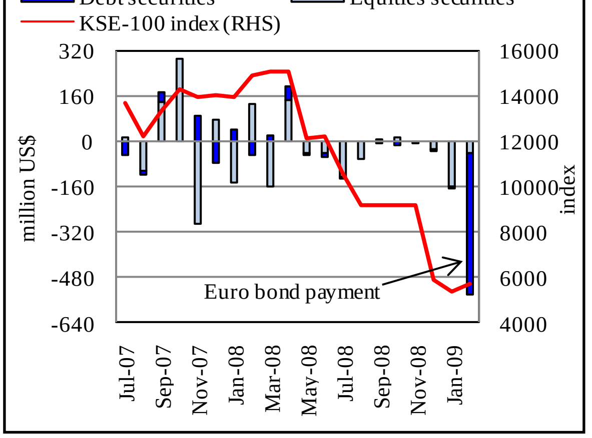
Table 6.11: Sector-wise Foreign Direct Investment
million US$

	Jul-Feb		Change (YoY)	
	FY08	**FY09**	**FY08**	**FY09**
Food packaging	6.3	100.5	5.3	94.2
Petroleum refining	56.1	74.0	-26.4	17.9
Oil & gas Explorations	399.4	471.1	46.6	71.7
Transport equipments	67.0	58.5	34.6	-8.5
Power	39.3	79.8	-74.5	40.6
Construction	54.3	42.5	-38.5	-11.8
Trade	123.9	121.5	6.7	-2.4
Communications	828.1	790.7	-453.4	-37.4
Financial business	714.8	647.2	142.1	-67.6
Personal services	68.0	63.2	3.8	-4.9
Others	431.9	345.4	172.0	-86.4
Total	**2789.1**	**2794.4**	**-181.7**	**5.3**
Total without Privatization	2655.9	2794.4	-181.7	138.5

Portfolio Investment

In line with the trend in emerging economies stock markets, foreign investors are taking their investment out from Pakistan's stock market. Outflow of the foreign investment, which decelerated with the imposition of artificial floor on prices on end August, 2008, accelerated again with the removal of this floor in mid December, 2008 as around 58 percent of the out flow from equity securities during Jul-Feb FY09 was concentrated in Dec-Feb FY09 (see **Figure 6.11**).

Figure 6.11: Portfolio Investment and KSE-100 Index



Moreover, outflow from public sector debt securities on account of euro bond payment worth US$ 500 million further added to the outflow from portfolio investment during the period under review.

6.3.2 Outstanding Export Bills

Aggregate stock of outstanding export bills declined by US$ 467 million during Jul-Feb FY09 compared with increase of US$ 156 million in the same period of last year (see **Table 6.12**). Partly, this decline may be attributed to slowdown in export growth and partly to the Central Bank tight monitoring of overdue outstanding exports bills.[9] Moreover, slight appreciation in exchange rate after the IMF support for macroeconomic stabilization program may have also encouraged repatriation of export proceeds.

6.3.3 Currency and Deposits (Assets)

In sharp contrast to decline of US$ 858 million during the Jul-Feb period of last year, currency and deposits increased by US$ 83 million during Jul-Feb FY09. This increase is largely attributed to increase in FE-25 nostros on account of retirement of FE-25 loans by exporters and importers.

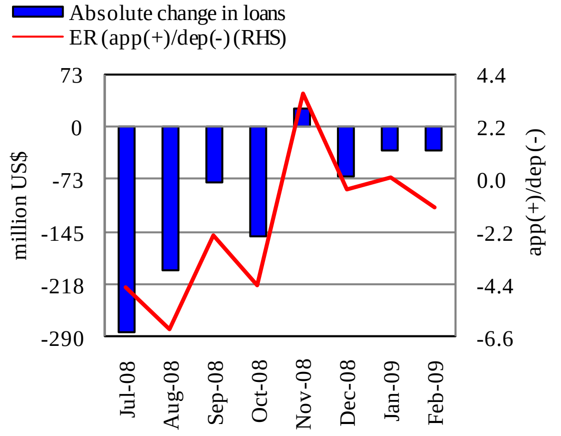
Official Long Term Loans

As a result of lower inflows and higher amortization, net inflow in long term loans worth US$ 444.4 million during Jul-Feb FY09 were considerably lower than US$

[9] From JulFY09, banks were asked to provide data on outstanding exports bills on monthly basis to the Central Bank. From August FY09, onward the frequency of reporting was increased to weekly basis.

731 million received during the corresponding period of last year. The inflows during the current year mainly reflected US$ 693 million receipts from Asian Development Bank. Relatively higher amortization, on the other hand, mainly emanated from payments of Islamic Development Bank (US$ 200 million), Asian Development Bank (US$ 116 million) and IBRD (US$ 120 million) loans during the period under review.

Figure 6.12: Changes in FE-25 Loans and Exchange Rate



6.3.4 Official Short Term Loans
The short loans recorded net outflow of US$ 114 million during Jul-Feb FY09 compared with net increase of US$ 367 million in the comparable period of last year. This net outflow mainly reflects US$ 590 million payment to Islamic Development Bank during the period. However, in the Nov-Feb FY09, short-term loans recorded net inflow of US$ 223 million on account of receipts from Islamic Development. This loan is for less than one year and would be reflected as an outflow next year.

6.3.5 Private Loans
Net inflow in the private loans increased to US$ 379.0 million during Jul-Feb FY09 from US$ 157.0 million in the comparable period of last year. This inflow largely reflects US$ 556 million loan received by Warid Telecom during the period.

6.3.6 Currencies and Deposits (liabilities)
Decline in trade financing on account of retirement against FE-25 loans led the currency and deposits to register sizable decline during Jul-Feb FY09. It may be pointed out that retirement of FE-25 loans was mainly driven by exchange rate depreciation which makes these loans costlier for exporters and imports. However, with the stabilization in exchange rate during Nov-Feb FY09, retirement of these loans slowed down significantly (see **Figure 6.12**).

Table 6.12: Financial Account
million US$

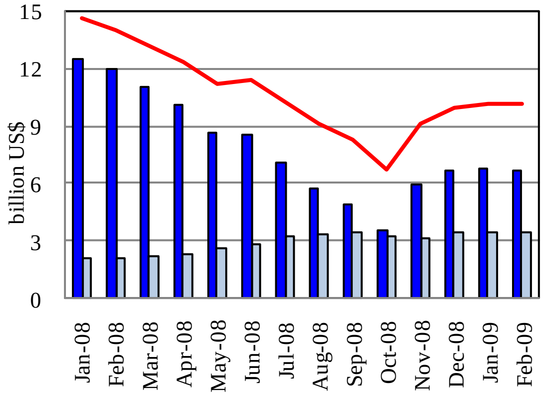
	FY08		FY09*	
	Jul-Feb	**Nov-Feb**	**Jul-Feb**	**Nov-Feb**
Financial account (net)	**4,811.00**	**1,705.00**	**2,403.40**	**1,905.40**
Direct investment abroad	**-36**	**-27**	**12**	**12**
Direct investment in Pakistan	**2,532.00**	**1,213.00**	**2,794.00**	**1,464.00**
Equity capital	1,867.00	**869**	2,205.00	1,219.00
Of which: privatization receipts	133	133	0	0
Reinvested earnings	665	344	589	245
Portfolio investment	**82**	**-229**	**-926**	**-745**
Equity securities	111	-231	-391	-226
Debt securities	-29	2	-535	-519
Net foreign investment	**2,578.00**	**957**	**1,880.00**	**731**
Other investment	**2,233.00**	**748**	**523.4**	**1,174.40**
Assets	702	291	384	68
1-Outstanding export bills (exporters)	-297	-252	189	73
2-Outstanding export bills (DMBs))	141	114	278	53
3-Currency and deposits	858	429	-83	-58
of which banks	761	400	-178	-124
Liabilities	1,531.00	457	139.4	1,106.40
1-Foreign long-term Govt loans / credits (net)	731	207	444.4	201.4
Project loans	767	243	524.4	264.4
Non- project loans	643	299	816	251
Amortization	679	335	896	314
2-Private loans	157	54	373	341
of which supplier credits	331	168	653	487
suppliers credit repayments	174	114	280	140
3-Short term capital (official)	367	303	-114	223
of which IDB (net)	483	319	-14	223
4-Currency and deposits	337	106	-469	-45
5-Other liabilities	-111	-213	-101	386

* provisional

6.4 Foreign Exchange Reserves

After a substantial fall in Jul-Oct FY09 period, foreign exchange reserves increased considerably in ensuing months. Specifically, foreign exchange reserves increased to US $ 10.2 billion by 13th March, 09 from end October 2008 level of US $ 6.8 billion. A significant part of the increase in the latter period is attributed to IMF support for Pakistan's macroeconomic stabilization program. In addition, noticeable improvement in overall external balance on the back of substantial reduction in current account deficit coupled with modest revival in capital flows also contributed to increase in the post October 2008 reserves position (see **Figure 6.13**). Improvement in reserves brought relative stability in the exchange rate and subsequent increase in foreign currency deposits, these factors in-turn further eased pressures on the foreign exchange reserves during the period.

Figure 6.13: Foreign Exchange Reserves



The breakup of foreign exchange reserves indicates that while commercial banks' reserves also increased, improvement in overall reserves during Nov-Jan FY09 period largely owed to increase in the Central Bank's reserves (see **Figure 6.14**). As mentioned earlier, increase in central bank reserves during the period mainly owed to inflow from IMF (US$ 3.0 billion) and the subsequent revival of capital inflows from ADB (US$761 million), IDB (US$ 517 million), and China (US$ 500 million) (see

Figure 6.14: SBP Reserve Flows

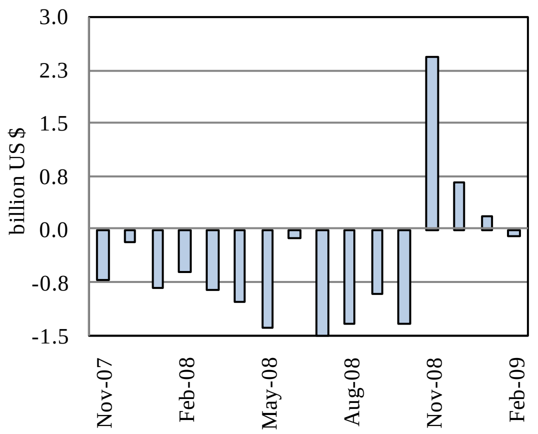


Table 6.13). However, higher payments for oil support and euro bond (US$ 517 million) exerted downward pressure on the central bank reserves.

It may be pointed out that part of the oil payment (furnace oil) has been shifted to inter-bank market with effect from February 02, 2009.[10] This step is likely to ease pressures on the SBP reserves; however, it may also bring some volatility in the exchange rate. Fortunately, fall in the trade deficit and increased inflows on account of remittances are likely to mitigate to a large extent the adverse impact of this decision on the exchange rate.

As against the SBP reserves, commercial banks' reserves recorded an increase of US $ 652.3 million during Jul-13 Mar FY09 and stood at US $ 3.5 billion.

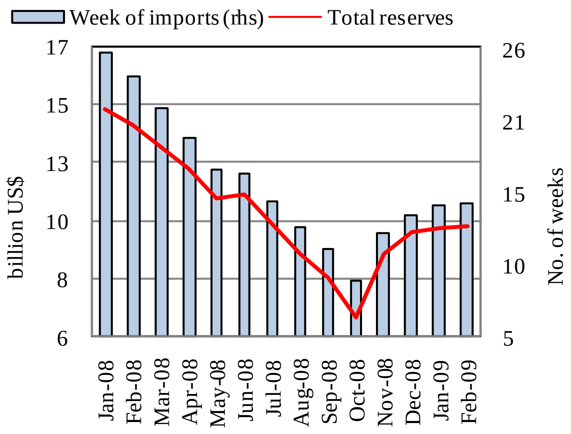
Commercial banks' reserves were recording healthy rise till September, 2008, however, adverse developments in October 2008 resulted in sharp fall in their reserves. Not only remittances fell sharply in October, but heavy withdrawals were also witnessed from the foreign currency accounts in the wake of heightened

Table 6.13: SBP Reserves
(million USD)

	Jul-Feb	
	FY08	**FY09**
Inflows	9,927.0	21,637.0
Purchases	3,676.0	4,415.0
Loans and grants	1,890.0	4,709.0
ADB	975.0	866.2
IMF	5.0	3,057.1
IDB	303.0	516.5
Others	4,361.0	12,514.0
Forward maturities	2,480.0	9,204.0
Logistic supports	281.7	466.0
Privatization proceeds	644.0	0.0
Outflows	11,697.0	23,568.0
Sales	7,021.0	8,800.0
Inter-bank sales	1,962.0	1,176.0
Oil support	5,059.0	7,624.0
Debt servicing	724.0	1,448.0
Others	3,952.0	13,321.0
Forward maturities	1,972.0	10,031.0
Wheat L/C - TCP	325.0	690.0
Net Change in reserve	-1,770.0	-1,930.0

Source: DMMD

Figure 6.15: Reserve Adequacy



[10] FE circular No. 02 dated January15, 2009.

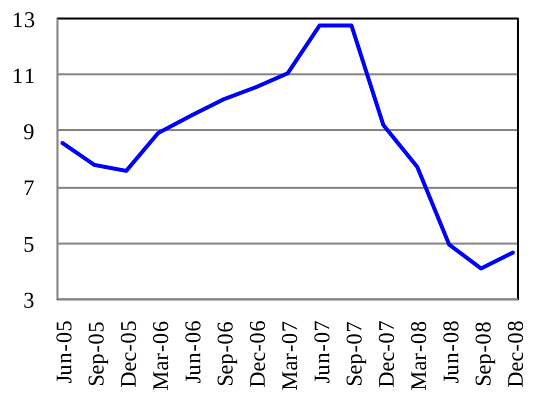
uncertainty amid sharp depreciation in exchange rate and rumors of possible freezing of foreign currency accounts.

However, as Pakistan's external position improved in the subsequent months so did the reserves of the commercial banks. By March 13 2009, commercial banks' reserves were slightly over their pre-October, 2008 level of US$ 3.2 billion.

Reserve Adequacy

Both reserve adequacy ratios; reserves to weeks of imports and reserves to short term debt and liabilities recovered slightly in Q2-FY09 after continued deterioration for almost a year (see **Figure 6.15 & Figure 6.16)**.

Figure 6.16: Reserves to Short-term Debt and Libilities

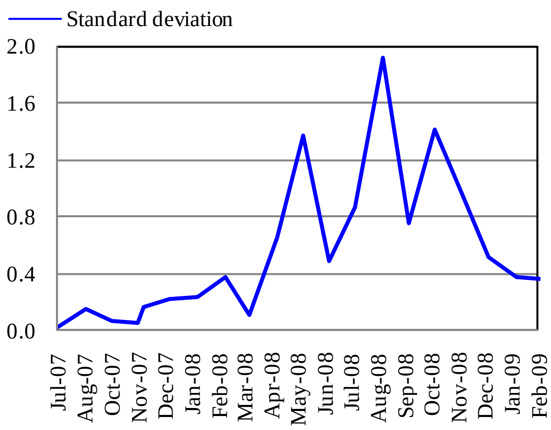


Reserves to weeks of imports ratio in particular, declined to as low as 9.1 weeks in October, 2008 before recovering to 14.5 weeks as on March 13, 2009. This owes both to improvement in the reserves as well as fall in the imports bill in Q2-FY09. Likewise, reserves to short term debt and liabilities ratio recovered to 4.6 at end December 2008, from 4.1 during September, 2008.

6.5 Exchange Rate

After falling steeply by 16.3 percent during July-Oct FY09, rupee recovered some of its lost grounds November 2008 onwards. The recovery of the exchange rate owes to improvement in Pakistan's external accounts, especially improvement in the financial account following the Stand-By Arrangement with the IMF. The inflows from the IMF not only stemmed

Figure 6.17: Exchange Rate Volitility



depletion of reserves but also improved market sentiments. In the following months, as trade deficit shrank and inflows from other sources increased, the pressure on the rupee further subsided. As a result rupee exhibited relative stability against US dollar during Nov-Feb FY09. The value of standard deviation that indicates fluctuations, also declined considerably from 1.41 in October to 0.35 in Feb FY09. (see **Figure 6.17**)

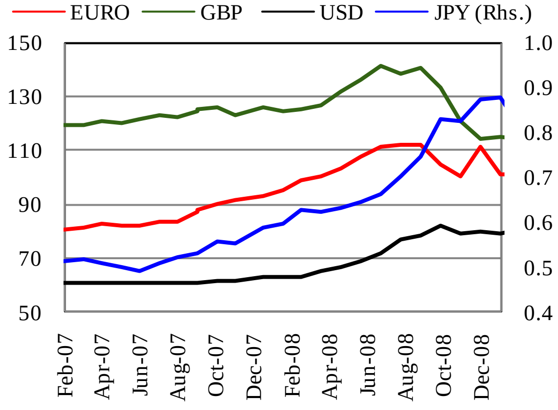
Global Recession and Exchange Rates

The recent economic turmoil not only resulted in global slowdown, but it also altered the stance of central banks; as a result massive rate cuts were witnessed worldwide. The Fed set the rate to record lows, while the Bank of Japan has the lowest rate around the globe. The European central bank and the Bank of England also changed their stance and opted for sharp rate cuts in order to foster economic growth (see **Table 6.14**). The financial turmoil and rapid rate cuts brought sharp movements in every major currency. During H1-FY09, while Dollar strengthened against its counterparts, the Euro and Pound lost ground against other currencies. Emerging-market currencies, along with commodity currencies[11] Canadian, Australian, and New Zealand dollars also lost value against the US dollar.

Table 6.14 : Interest Rates Comparison

	Jul 2007	Nov 2007	Mar 2008	Jul 2008	Nov 2008	Jan 2009
USA	5.25	4.50	2.25	2.00	1.00	0.25
UK	5.75	5.75	5.25	5.00	3.00	1.50
Euro-zone	4.00	4.00	4.00	4.25	3.25	2.00
Japan	0.50	0.50	0.50	0.50	0.30	0.10
Pakistan	9.50	10.00	10.52	13.0	15.00	15.00

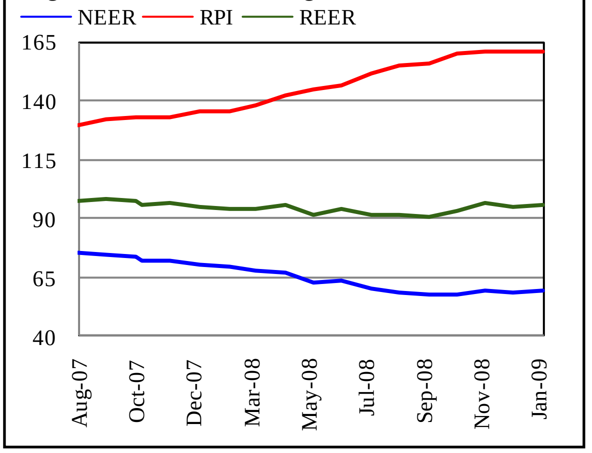
Figure 6.18: Exchange Rate- Pak Rupee vs Other Currencies



[11] Commodity currencies is a name given to currencies of countries which depend heavily on the export of certain raw materials for income. In the foreign exchange market, commodity currencies generally refer to the Australian Dollar, Canadian Dollar, New Zealand Dollar, and the South African Rand.

The rupee showed relatively better performance against other major currencies. Rupee's appreciation against the Euro and Pound was primarily driven due to the weakness in the respective currencies during H1-FY09. Both Pound and euro weakened against the US dollar due to deteriorating economic conditions in UK and Euro-zone. Owing to relative strength of Japanese yen against the US dollar, Pak rupee depreciated by 21.4 percent against its Japanese counterpart (see **Figure 6.18).**

Figure 6.19: Effective Exchange Rate Index

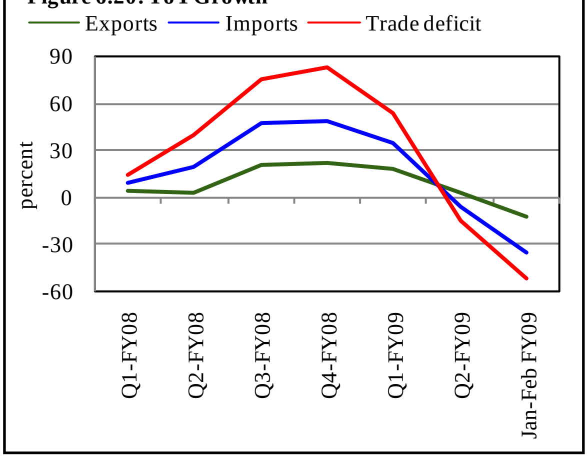


The exchange rate against basket of currencies as measured by Nominal Effective Exchange Rate (NEER) showed 7.1 percent depreciation during Jul-Jan FY09 as compared to the depreciation of 7.2 percent during the same period last year, however, due to continuous rise in inflationary pressures as evident from the 9.4 percent rise in Relative Price Index (RPI), Real Effective Exchange Rate (REER) appreciated by 1.6 percent during Jul-Jan FY09 (see **Figure 6.19).**

6.6 Trade Account

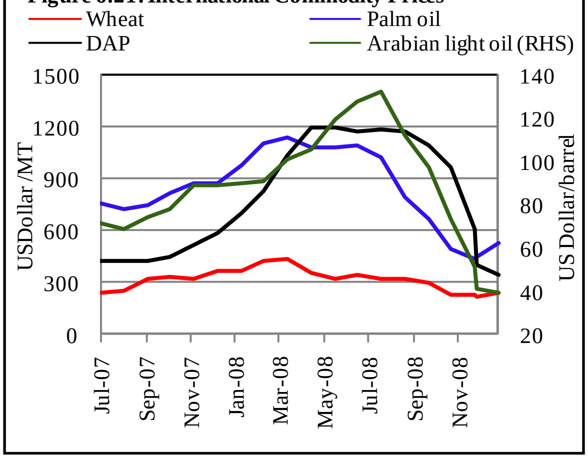
The cumulative trade deficit for the Jul-Feb FY09 was recorded at US$ 11.6 billion, down by 6.9 percent YoY – the first time in seven years that the trade deficit for the July-February period has declined. This improvement was led principally by a compression of imports. Imports recorded substantial YoY growth in Q1-FY09, but a pronounced weakening of aggregate demand, and a sharp fall in import prices November 2008 onwards caused the import bill to shrink, with a corresponding impact on the trade deficit (see **Figure 6.20**). While the resilience in exports also played a role in narrowing the trade deficit, this was small, as the modest YoY increase in Jul-Feb FY09 exports was largely concentrated in Q1-FY09.

Figure 6.20: YoY Growth



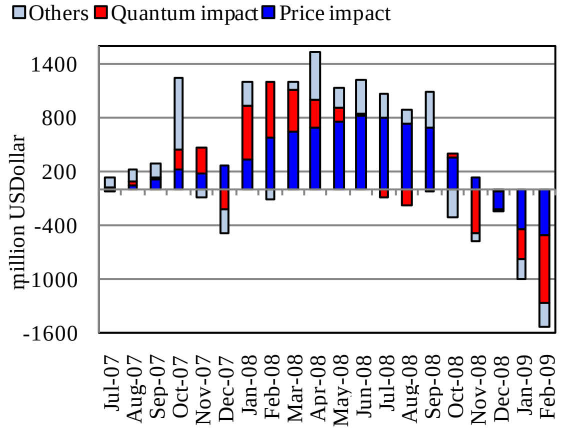
The Q1-FY09 rise in imports was almost entirely due to higher prices. International commodity prices had started to weaken since the beginning of FY09, but this was reflected in Pakistan's import prices with a lag, and the import bill saw an accelerated reduction Q2-FY09 onwards (see **Figure 6.21 & 6.22**). This trend was also helped by declines in the quantum of imports, which probably reflected the combined impact of a coordinated tightening of both monetary and fiscal policies and a sharp depreciation of the Pak rupee,[12] energy shortages, etc.

Figure 6.21: International Commodity Prices



[12] Rupee exchange rate vs. US Dollar recorded 14.5 percent depreciation during Jul-Feb FY09.

Figure 6.22: Factors of YoY Change in Imports

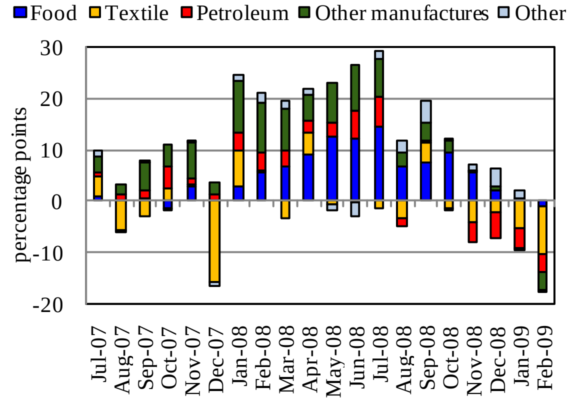


The slowdown in aggregate demand is likely to continue through FY09, while import prices are also expected to weaken. Consequently, As chances are that the trade deficit will decline further in the months ahead. However, the extent of the compression of the overall trade deficit for FY09 will depend upon the trends in export growth during Mar-Jun FY09.

So far, while exports have shown weakness, the decline has been relatively modest. In the wake of global recession and the resultant fall in international demand, slowdown in the country's export growth was expected. However, the situation has been worsened by growing domestic problems, such as the energy shortage. Moreover, export growth during Jul-Jan FY09 was narrowly based, as almost all of the increase in exports during this period came from rice and cement sectors and there is a risk to the growth momentum in both sectors.

Exports

Figure 6.23: Exports- Monthly YoY Contribution in Growth



Exports recorded a modest 4.3 percent YoY growth during Jul-Feb FY09 as compared to 7.4 percent YoY growth posted during the same period last year. In view of the long range of issues facing exporters - the continued severity of the domestic energy crisis, political uncertainty in the country and law and order issues – this performance was appreciable. However this growth pattern does not seem to be sustainable in the coming months, as from Nov-FY09 exports are recording a steady YoY decline (see **Figure 6.23**). The weakness in export performance is broad based. Not only there is a continuing decline in textile exports, there is now an appreciable weakness even in the hitherto strong performing categories of non-textile exports (see **Table 6.15**).

Table 6.15: Major Exports (Jul-Feb)
million US$

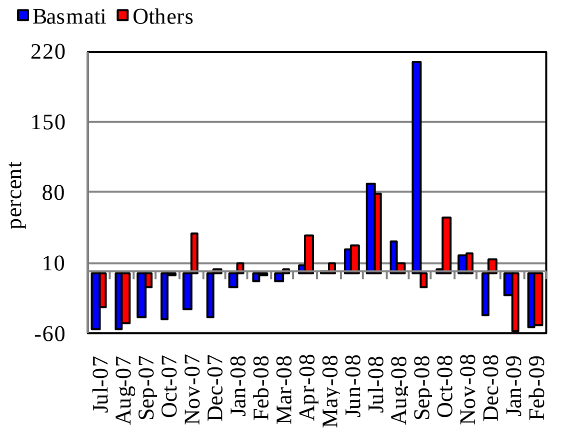
		FY08		FY09(P)			% YoY Δ		
	Units	Value	Unit value	Value	Unit value	Abs.Δ value	Qty	Value	Unit value
Food group		**1,425.1**		**2,099.3**		**674.3**		**47.3**	
of which									
Rice	MT	826.1	504.3	1,394.3	924.9	568.1	-8.0	68.8	83.4
Textile group		**6,854.0**		**6,470.4**		**-383.6**		**-5.6**	
of which									
Cotton yarn	MT	864.4	2,309.6	732.3	2,163.4	-132.1	-9.6	-15.3	-6.3
Cotton fabrics	SQM	1,248.3	1,001.5	1,317.8	985.6	69.5	7.3	5.6	-1.6
Knitwear	DOZ	1,236.4	18.9	1,203.6	17.8	-32.9	3.4	-2.7	-5.8
Bed wear	MT	1,259.7	5,736.0	1,128.2	5,271.7	-131.5	-2.6	-10.4	-8.1
Towels	MT	383.9	4,087.5	422.4	3,612.4	38.5	24.5	10.0	-11.6
Readymade garments	DOZ	935.7	37.4	819.4	39.5	-116.3	-17.1	-12.4	5.6
Synthetic textiles	SQM	287.7	912.9	220.3	854.7	-67.5	-18.2	-23.4	-6.4
Other textile made-up		332.3		331.3		-1.0	---	-0.3	---
Other textile material		177.7	---	150.6	---	-27.2	---	-15.3	---
Petroleum group		**730.8**		**589.2**		**-141.6**		**-19.4**	
Other manufactures group		**2,232.7**		**2,444.4**		**211.7**		**9.5**	
of which									
Chemicals and pharmaceuticals		367.6	---	420.9	---	53.3	---	14.5	---
Molasses	MT	23.2	59.6	72.2	94.8	49.0	95.7	211.0	58.9
Cement	MT	213.1	53.9	374.4	58.6	161.3	61.5	75.7	8.8
Others		**417.9**		**552.4**		**134.5**		**32.2**	
Total exports		**11,660.5**		**12,155.7**		**495.2**		**4.2**	

This situation needs immediate attention from government. In particular, the energy shortages need to be addressed on priority. According to APTMA sources the textile (spinning and weaving) sector was provided with only 33 percent of its total gas requirement during the winter season (Nov-Jan FY09), while during the whole of Jul-Jan FY09 this sector obtained 70 percent of its total power supply needs. In addition, the country's exports are also being affected by a variety of structural and sector specific issues in various sectors, which should be addressed aggressively.

Major non-textile exports

Rice exports were the largest contributor in the total YoY increase in exports during Jul-Feb FY09. A large share of this surge was witnessed during Q1-FY09, as the rice export growth has started to decelerate since Q2-FY09 (see **Figure 6.24**). This is attributable to a number of factors:

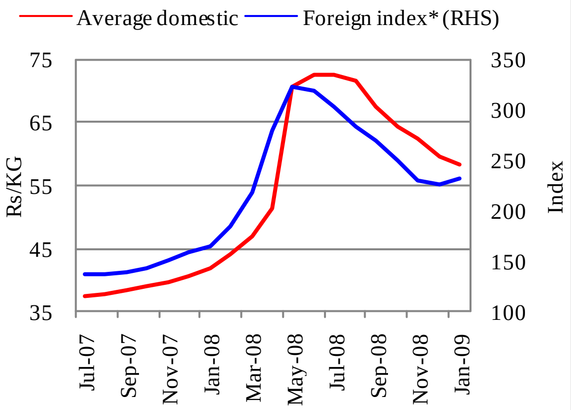
Figure 6.24: Rice Exports Quantum - YoY Growth



1) A part of this slowdown in Q2-FY09 may be attributed to problems faced by rice mills on account of frequent power shortages.

2) In the case of basmati rice, situation has been complicated by India's decision to remove duty on the export of basmati rice from January FY09, as this has increased competition for Pakistan's basmati rice export.

Figure 6.25: Trends in Rice Prices



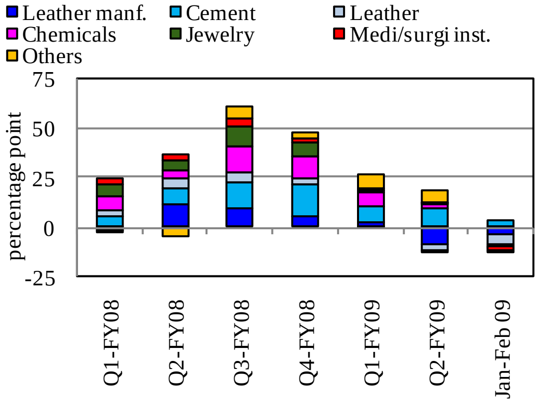
* FAO rice price index

3) The supply of new crop has led to a sharp fall in the international rice prices. In this situation despite a bumper domestic rice crop, for attracting demand, Pakistan's exporters have to be price competitive. The situation in the domestic rice market, however, is not completely in line with that in the international market, where the fall in the domestic rice prices is not as sharp as that in the international market (see **Figure 6.25**).

This could partly be attributed to the intervention of Trading Corporation of Pakistan (TCP) in the rice trade. This decision by government has caused uncertainty in the domestic market, as growers are reportedly not willing to sell their produce to exporters in the hope of getting better rates from TCP. The resultant stagnation in domestic rice prices is hurting competitiveness of the country's rice exports.

Other manufacture exports recorded 9.5 percent YoY growth during Jul-Feb FY09. Though large, this growth was substantially less than the 35.4 percent YoY growth recorded by this category during the same period last year. Almost all major export categories in this group are witnessing deceleration or fall since Q1-FY09 (see **Figure 6.26**).

Figure 6.26: YoY Contribution in Other Manufactures Export Growth



Among other manufactures *cement* was the largest contributor in overall export growth during Jul-Feb FY09. In fact this sector recorded high growth rates throughout FY08 led by increase in external demand and domestic capacity enhancements. However, recently some adverse developments in the major cement export markets, are posing serious challenges to the ability of this sector to sustain the high growth pattern witnessed in FY08. For instance;

1) From January 2009, India which is one of Pakistan's large export markets that accounts for 12-14 percent of cement exports, has imposed 12 percent duty on its cement imports.

2) The slowdown in construction activities in UAE (14 percent share) may also hamper export demand from this market;

3) An increase in Saudi Arabia's cement production capacity [13] might also divert demand from Middle Eastern countries away from Pakistan.

[13] http://www.menafn.com/qn_news_story_s.asp?StoryId=1093200542

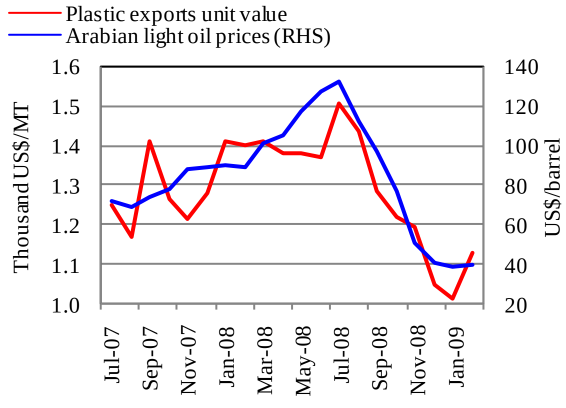
All these factors might cause some downward pressure on country's cement exports in the coming period. However, on a positive note, African countries have emerged as a potential market for Pakistani cement since FY08.

Leather manufactures exports recorded a 13.5 percent YoY fall during Jul-Feb FY09. This was caused by a fall in external demand led by global recession as well as a long range of domestic structural issues. Most of the countries' leather manufactured exports comprise luxury items such as leather jackets and articles of apparel[14], with EU, and US being the major markets, which are in the grip of economic recession. On the supply side, like other sectors, this sector is faced with the issue of power shortages, rising cost of production, unskilled labor force and obsolete machinery.

Given the availability of raw leather in the country the exports of leather manufactures have a potential to increase once the structural issues are addressed properly. However, in the coming period these problems are likely to persist, which implies slowdown in export of this category in the short run. In addition, the fall in leather manufactures demand has also reduced the *raw leather* demand from some of the major leather goods producing countries. This has resulted in a large 22.5 percent YoY fall in raw leather exports as well during Jul-Feb FY09.

Chemicals and pharmaceuticals exports also recorded a slight YoY deceleration and recorded a 14.5 percent YoY rise during Jul-Feb FY09 as compared to 41.9 percent rise witnessed during the same period last year. This was observed due to a slowdown in exports of major categories of plastics and other chemicals.

Figure 6.27: Relation Between International Oil Prices and Plastic Exports Unit Values



A large (around 55 percent) share of plastic exports comprises PET bottle grade resin, which is a derivative of crude oil. With a sharp decline in international oil

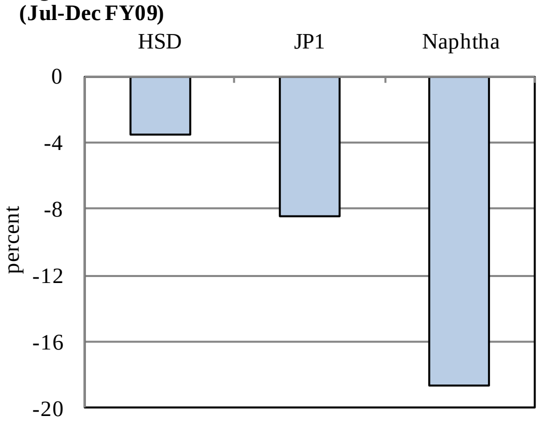
[14] Leather manufactures contain 75 percent of leather garments, and together leather jackets and articles of apparel comprise 90 percent of leather garments exports.

prices the unit values of PET are also declining since Jul-FY09 leading to falling price impact and thus deceleration in overall plastic exports (see **Figure 6.27**).

The fall in exports of ***petroleum products*** during Jul-Feb FY09 may be attributed to lingering circular debt problem that is hindering the ability of refineries to import crude and resulting in lower petroleum products export. This fact is also supported by lower production of petroleum products, such as naphtha, HSD and Jet fuel, as compared to the same period last year (see **Figure 6.28**).

Textile exports have largely witnessed a steady monthly decline since May FY08 and this trend has continued into FY09. During Jul-Feb FY09 exports from this sector recorded 5.6 percent YoY fall. In view of the ongoing global recession and resulting fall in demand for textile and apparel products, this slowdown in textile exports is not unanticipated.

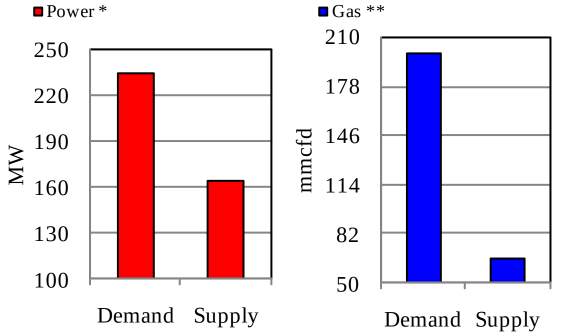
Figure 6.28: YoY Fall in Petroleum Products Production (Jul-Dec FY09)



In addition to falling international demand, domestic supply side issues, especially power and gas shortages are also affecting the export performance of this sector (see **Figure 6.29**[15]). Due to the large intensity of the adverse effects of the current energy crisis on country's largest exports sector i.e., textile, this situation demands some immediate attention from the government. In addition, this sector is also facing cash flow problems due to low credit availability from the banks. As a result of building up of large inventories on account of sluggish response from buyers, and rising NPLs in the textile sector, banks have become more conservative in extending loans to this sector. This belief is also strengthened by a deceleration in net credit flow to the textile sector from 14.1 percent in H1-FY08 to 5.1 percent in H1-FY09.[16] Further, the anecdotal evidence suggests that due to the ongoing international recession international buyers are demanding extension in payment period, which is further aggravating cash flow problems faced by the textile sector.

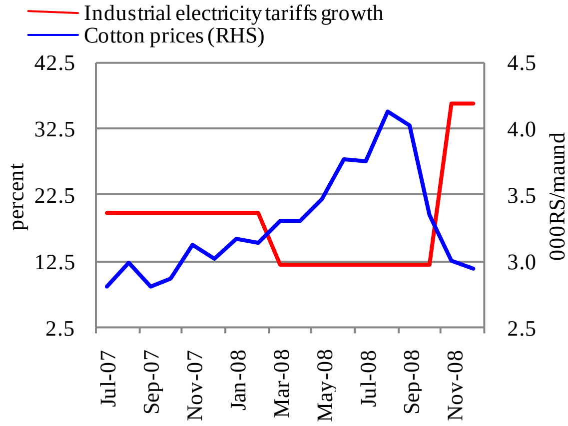
[15] Graph is based on information provided by All Pakistan Textile Mills Association.
[16] For details see Chapter 4 on Money & Credit.

Figure 6.29: Power and Gas Shortages - Textile Sector



* Data pertains to Jul-Jan FY09
** Data pertains to Nov-Jan FY09
Source: APTMA

Figure 6.30 : Cost of Textile Sector Raw Materials



This said, however, a substantial depreciation of Pak rupee[17] has increased the competitiveness of this sector vis-à-vis its competitors. This is also reflected from country's relatively better position in the major exports to EU and US in both textile and apparel categories (see **Table 6.16**). In fact in rupee terms textile exports recorded a large 19.3 percent YoY increase during Jul-Feb FY09. The large depreciation is helping textile sector in many ways; 1) this has increased the ability of exporters to quote lower prices, which is evident from falling unit prices of a number of textile products during Jul-Feb FY09.

2) Given the fact that around more than half of the raw material used by this sector is domestically produced, textile exporters are now well positioned to offset some of the impact of rising domestic cost of production. Importantly, the prices of one of the important raw material i.e., raw cotton are recording a continued decline since August FY09. Further, with the fall in international oil prices, the prices of synthetic fibre are also falling. In this situation the important rising costs to be borne by this sector are electricity tariffs and wages (see **Figure 6.30)**.

[17] Pak rupee recorded 14.5 percent depreciation against US dollar during Jul-Feb FY09.

Financial costs are also an important part of the cost structure of this sector; however, the availability of concessional financing through EFS has to some extent protected the textile industry from the effect of rising lending rates. In this connection SBP has given further incentives to textile sector which include one year extension in mark-up subsidy for spinning sector[18], provision of 100 percent financing to banks against export finance provided to exporters[19] provision of one year moratorium on loans availed under the Long Term Financing Facility (LTFF)[20] and extension in the period of refinancing under EFS[21].

Table 6.16: Textile & Apparel Export Growth - Market Analysis

in percent

	CY07		CY08	
	Textile	Apparel	Textile	Apparel
US Market (Jan-Dec)				
Pakistan	-10	4.2	-5.2	-0.5
Bangladesh	3	5.3	7.5	11.3
China	10.9	17.2	0.6	-0.8
Indonesia	-2.4	7.7	-5.5	1.1
India	2.1	-1.7	1.7	-2.7
Sri Lanka	3.1	-7	-22.5	-5.9
Mexico	5.9	-15	-15.5	-10.5
Turkey	2.4	-22.4	-9.9	-28.4
World	3.5	2.2	-4.1	-3.5
EU Market (Jul-Oct)				
	FY08		FY09	
Pakistan	7.2	-0.4	-2.7	6.2
Bangladesh	16	-4.8	1.2	4.1
China	19.7	11.4	1.3	16.1
Indonesia	5.1	-10.8	-24.7	-10.3
India	7.1	4.2	-7.5	2.7
Sri Lanka	1.6	9.8	-19.4	3.3
Mexico	3	-5	-14.9	6.8
Turkey	2.7	6.9	-9.9	-14.2
World	7	5.4	-5.7	1.3

Source: US Census Bureau & Euro stat

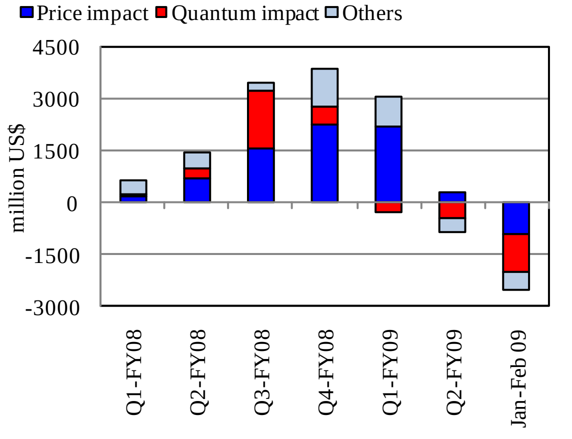
In this scenario with the persisting external demand side weakness and domestic energy shortages, the depreciation of Pak rupee is likely to stem a large fall in textile sector exports to some extent. Resultantly, textile exports are expected to record a small YoY fall in the remaining months of FY09.

[18] http://www.sbp.org.pk/smefd/circulars/2009/C5.htm
[19] SMEFD Circular No. 03 of 2008, SBP.
[20] http://www.sbp.org.pk/smefd/circulars/2009/C1.htm
[21] http://www.sbp.org.pk/smefd/circulars/2009/C4.htm

Imports

During Jul-Feb FY09, imports recorded a 1.5 percent YoY fall as compared to the 21.9 percent YoY growth witnessed during the same period last year. The deceleration in import growth has been evident since Q2-FY09, due to both, a sharp fall in international commodity prices and falling demand pressures in the economy (see **Figure 6.31 & 6.32**).

Figure 6.31: Factors of YoY Change in Imports



The contractionary impact of both these factors was more pronounced during Q2-FY09. During Q1-FY09, despite a fall in most of the international commodity prices as compared to their H2-FY08 levels, imports recorded a higher price impact due to lower base.

Demand led compression in imports

A tight monetary policy by SBP, sharp depreciation of Pak rupee, fall in domestic real income levels, increase in import duties and sales tax on luxury goods, circular debt issue and a general slowdown in the economic activity substantially compressed import demand during Jul-Jan FY09 (see **Table 6.17 & 6.18**). While the non-food and non-oil imports remained weak during Jul-Feb FY09, from Nov FY09 food & oil imports have also started to record a YoY fall (see **Figure 6.33**).

Figure 6.32: YoY Fall In International Commodity Prices

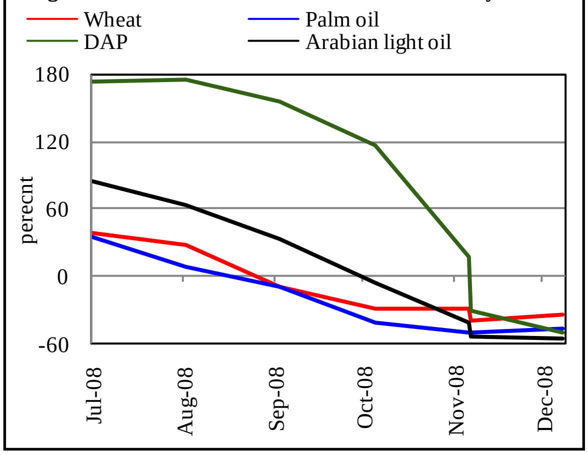
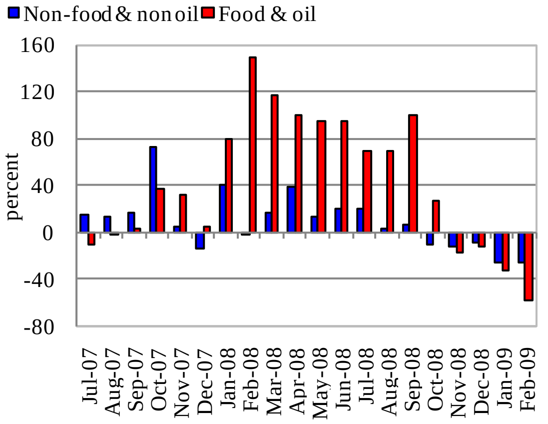


Table 6.17: Quantum impact – Top 12 import Categories
million US$

	FY08				FY09		FY09
	Q1	Q2	Q3	Q4	Q1	Q2	Jan-Feb
Fertilizer manufactured	50.4	109	73.7	-139.1	-103.4	-281	-95.1
Raw cotton	141.9	93.6	353	20	-90.6	-22	-427.8
Petroleum products	-136.9	344.2	337.9	236.2	67.4	-171.6	-7.9
Iron and steel	77.7	-26.2	6.5	113.9	-145.4	-32.3	-73.8
Iron and steel scrap	78.9	88.5	47.9	28.2	-96.8	-66.8	-10.9
Palm oil	1.8	-39.8	27.1	67.8	-57	-18.5	-4.8
Plastic material	-3.4	6	11.9	-36.3	23.5	-59.3	-42.8
Soybean oil	17.3	5.1	18.6	2.1	-16.1	-18.9	-14.9
Paper/ board & Manuf.	-9.4	1	6	10.7	-12.1	-13	-19.4
Rubber tyres & tubes	1.5	0.9	4.8	-0.9	4.0	3.0	-9.1
Wheat	0	-3.7	547.7	216	25.5	375.8	-205.4
Petroleum crude	93.4	-163.8	220.3	-40.5	55.9	-171.1	-170.0
Total	**313.2**	**414.8**	**1655.4**	**478.1**	**-345.1**	**-475.7**	**-1082.0**

Figure 6.33: YoY Import Growth



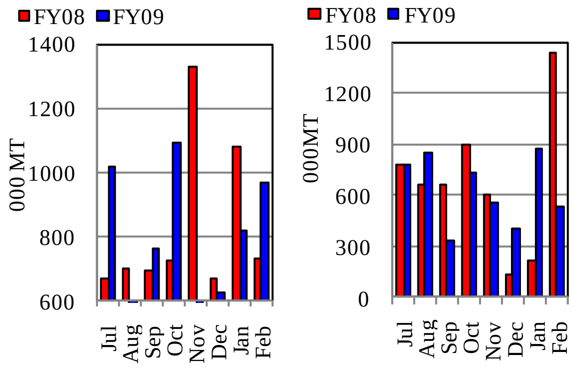
In overall terms ***petroleum group*** imports recorded a large 9.2 percent YoY increase during Jul-Feb FY09, though almost all of this increase was caused by prices lower. In terms of quantum, petroleum crude recorded a moderate increase whereas petroleum products imports continued to decline in Jul-Feb FY09 (see **Table 6.18**).

The slowdown in POL group import quantum is attributable to the circular debt issue that limited the ability of refineries and OMCs to import. In the case of petroleum crude, refineries were also facing problems in opening LCs, probably due to a deterioration in Pakistan's external account position prior to IMF support. With an agreement with IMF and a steep fall in international oil prices, this situation has improved which is also evident from a YoY quantum rise in petroleum crude import during Dec-Jan FY09. The circular debt issue, however, is still keeping petroleum product imports depressed (see Figure **6.34 A&B**).

Fertilizer manufactured imports also recorded a steep quantum decline during Jul-Feb FY09 (see **Table 6.17 & 6.18**). This fall resulted from very high domestic fertilizer prices, especially for DAP, which led to a lower DAP offtake during the period under review.[22] In addition large domestic inventories were also present from excessive imports of FY08, which also reduced the need for further imports.

Figure 6.34A: Import Quantum - Petroleum Products

Figure 6.34B: Import Quantum-Petroleum Crude



Fall in ***iron and steel*** import quantum is reflective of lower construction activity and a fall in automobiles production[23] during Jul-Feb FY09. ***Telecom sector imports*** also witnessed a large 49.8 percent YoY fall during the period of analysis. This is attributable to declining purchasing power along with higher custom and regulatory duties on mobile sets[24].

Raw cotton import recorded fall on account of good domestic cotton crop[25]. The fall in ***palm oil*** imports could be attributed to improved domestic oil seeds crops[26] during FY08 as well as falling domestic demand both from households and from industry on account of the sharp rise in prices. Falling industry demand is also evident from 4.8 percent YoY fall in cooking oil production during H1-CY09.

Wheat imports recorded substantial YoY quantum increase during Jul-Feb FY09 (see **Table 6.18**). This was done according to government's decision to import around 2.5 million tonnes of wheat during FY09 to 1) overcome domestic shortages and 2) to build one million tonnes strategic reserves of this commodity to ensure ample domestic supply on sustained basis. The wheat shortages in FY08 also made government to announce a very high support price i.e., Rs 950/40kg for

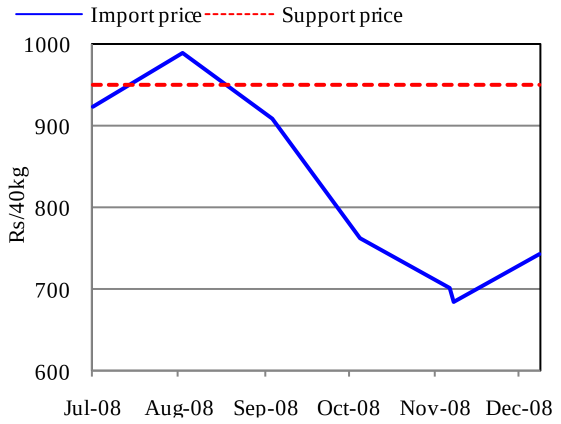
[22] DAP offtake recorded 6.2 percent YoY fall during Jul-Dec FY09.
[23] Automobiles production recorded a large 35 percent YoY fall during Jul-Dec-FY09.
[24] In the FY08 budget the federal government imposed Rs500 customs duty per set and later imposed Rs250 regulatory duty (R&D) in August 2008.
[25] Cotton production recorded 3.5 pecrent YoY rise during Fy09 reaching 14.1 million bales.
[26] Sunflower production recorded 48 percent YoY rise during FY08.

the FY09 crop. This has led to a reported increase in area under cultivation and a bumper production is expected from the current crop.

Table 6.18: Major Imports (Jul-Feb)
million US Dollar

	Units	FY08		FY09(P)		Abs.Δ value	% YoY Δ		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
Food group		**2,511.3**		**2,749.6**		**238.4**		**9.5**	
of which									
Wheat	MT	369.0	386.3	838.0	466.3	469.0	174.2	127.1	20.7
Palm oil	MT	961.8	859.9	913.2	819.2	-48.5	-9.5	-5.0	-4.7
Machinery group		**4,473.4**		**4,385.4**		**-88.0**		**-2.0**	
of which									
Power generating machinery		647.9		1,083.1		435.2		67.2	
Telecom		1,427.9		716.3		-711.6		-49.8	
Transport group		**1,500.1**		**886.8**		**-613.3**		**-40.9**	
of which									
Road motor vehicles		855.8		622.8		-233.0		-27.2	
Aircrafts, ships and boats		622.5		257.3		-365.3		-58.7	
Petroleum group		**6,340.2**		**6,921.2**		**581.0**		**9.2**	
Petroleum products	MT	3,417.6	616.8	3,929.4	540.1	511.9	0.7	15.0	-12.4
Petroleum crude	MT	2,922.7	606.3	2,991.7	541.2	69.1	-8.6	2.4	-10.7
Textile group		**1,604.7**		**1,037.4**		**-567.3**		**-35.4**	
of which									
Raw cotton	MT	912.9	1,663.6	399.2	1,395.0	-513.7	-63.3	-56.3	-16.1
Agricultural and chemical group		**3,653.6**		**3,528.9**		**-124.7**		**-3.4**	
of which									
Fertilizer manufactured	MT	625.5	563.6	365.7	374.8	-259.8	-61.1	-41.5	-33.5
Other chemicals		1,785.2		1,998.5		213.4		12.0	
Metal Group		**1,724.8**		**1,669.0**		**-55.9**		**-3.2**	
of which									
Iron and steel scrap	MT	443.9	311.8	380.2	275.5	-63.8	-24.3	-14.4	-11.6
Miscellaneous group		**467.4**		**427.3**		**-40.0**		**-8.6**	
All other items		**1,862.4**		**2,165.0**		**302.6**		**16.2**	
Total imports		**24,137.9**		**23,770.5**		**-367.4**		**-1.5**	

Figure 6.35: Comparison of Wheat Prices



However, this has also created certain issues pertaining to the handling of FY09 wheat crop. Due to sharp fall in international wheat prices[27], unit values of imported wheat have also come down significantly as compared to the support price level announced for the FY09 crop (see **Figure 6.35**). In this situation the procurement of current wheat crop at the stated support price will require large subsidies to the growers and hence, a huge financial burden for government.

The surge in ***power generating machinery import*** recorded during Jul-Feb FY09 is attributable to rising demand for generators in anticipation of large power shutdowns in the forthcoming summer season. Further, the government's decision to exempt duty on temporary imports of power generating plants by WAPDA, Pepco and KESC might also be contributing in the rise of this category's import.[28] In addition, these imports also increased due to the ongoing work on various IPPs.

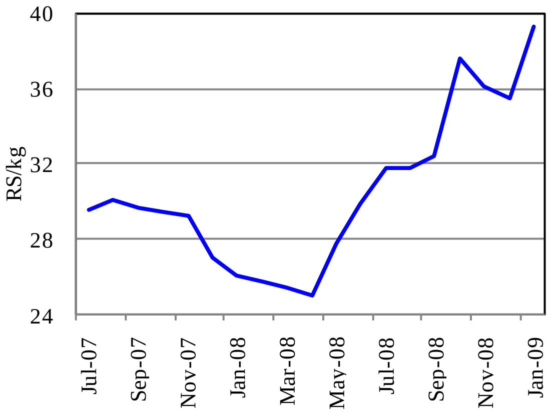
During Jul-Feb FY09 a marginal amount of ***sugar*** worth only US$ 14.1 million was imported. However, from Q4-FY09 onwards sugar import is likely to witness a surge due to a large YoY fall in the FY09 sugarcane crop[29]. Government has directed TCP to start import process to curb rise in domestic sugar prices, which are witnessing a continuous rise since May FY08 (see **Figure 6.36**). Given, the fact that FY08 crop recorded a large 14.4 percent YoY increase, the rise in domestic sugar prices might not be associated with depletion of sugar stocks in the country as early as in May 2008. In fact this points towards the possibility of hoarding and smuggling of this commodity to some neighboring countries. To curb this tendency SBP imposed the condition of 50 percent cash

[27] International wheat prices after crossing the level of US$ 440/MT in April FY08 have come down to almost US$ 240/MT in Jan FY09.
[28] From June 11, 2008 Wapda and Pepco were allowed duty free import the power plants with the condition of re-export the same. Now from January 2, 2009 KESC will also be treated like Wapda and Pepco under the same conditions (source: FBR).
[29] According to estimates sugar production recorded 18.5 percent YoY fall during FY09.

margin on sugar trade financing in February FY09 which was afterwards removed.[30]

The above discussion hints at ***a fall in import growth during the remaining months of FY09.*** This is because of the following three factors:

Figure 6.36: Domestic Sugar Prices



1) The fall in price impact in total imports that started in January FY09 is likely to continue through FY09 due to significantly high levels of international commodity prices in H2-FY08 as compared to their current levels.

2) The large quantum surge recorded in wheat is also likely to cease in the remaining FY09 with the availability of domestic wheat.

3) The general depression in imports due to a slowdown in economic activity is also likely to continue through FY09.

The imports of power generating machinery, sugar, petroleum crude and other chemicals, however, are likely to rise but the surge in these categories imports is expected to be offset by the above mentioned factors. This scenario hints at the possibility of a large YoY fall in overall imports for FY09.

30 BPRD Circular No. 02 of 2009, SBP