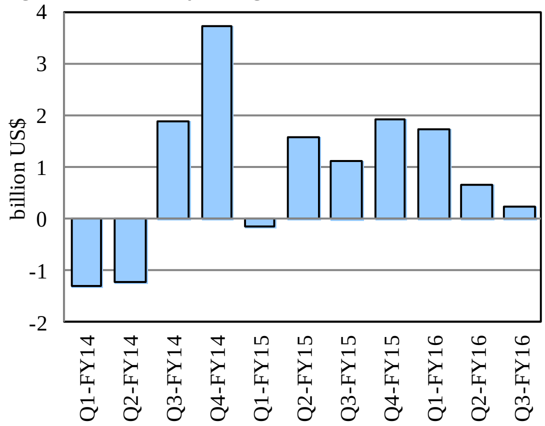
5 External Sector

5.1 Overview

Surpluses were recorded in Pakistan's external account throughout the first nine months of FY16, which led to accumulation of FX reserves (**Figure 5.1**). Contained oil payments and higher remittance inflows provided support, though FX borrowings weighed in much more (**Table 5.1**). On a cumulative basis, SBP's liquid reserves increased by US$ 2.6 billion during Jul-Mar FY16 and reached US$ 16.1 billion – this amount is sufficient to finance four months of the country's import bill, and more than twice the short-term payments. More importantly, this FX cover would help in achieving the high economic growth targets that the government is envisaging for the next couple of years. Improving the fundamentals, therefore, has become an important element to ensure that the good momentum continues.

Figure 5.1: Quarterly Changes in SBP Reserves



Source: State Bank of Pakistan

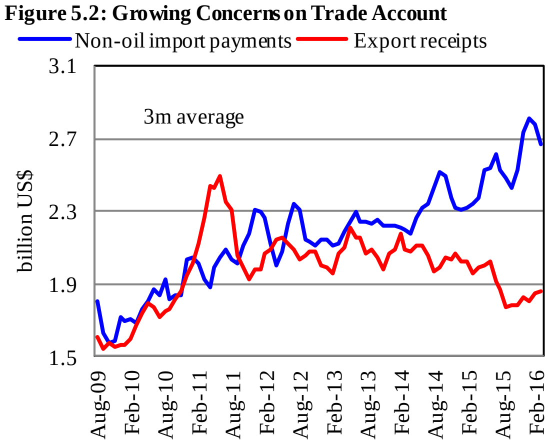
Table 5.1: Performance of Key External Indicators

million US$	Q3			Jul-Mar		
	FY15	FY16	*difference*	FY15	FY16	*difference*
Increase in SBP reserves	1,102	235	-867	2,518	2,593	75
Current account balance	518	-334	-852	-1,971	-1,717	254
Excl. CSF	-199	-334	-135	-3,423	-2,430	993
Trade balance	-3,243	-3,969	-726	-13,180	-13,277	-97
Exports	5,865	5,556	-309	18,031	16,363	-1,668
Oil imports	2,104	1,459	-646	9,702	5,944	-3,758
Non-oil imports	7,004	8,006	1,002	21,509	23,696	2,187
Remittances	4,433	4,698	265	13,595	14,385	790
FDI inflows (net)	220	291	71	832	960	128
Portfolio investment (net)	-84	-611	-527	1,041	-393	-1,434
FX liabilities (net)	27	-219	-246	696	2,005	1,309
IMF support (net)	311	503	192	1,065	1,455	390

Source: State Bank of Pakistan

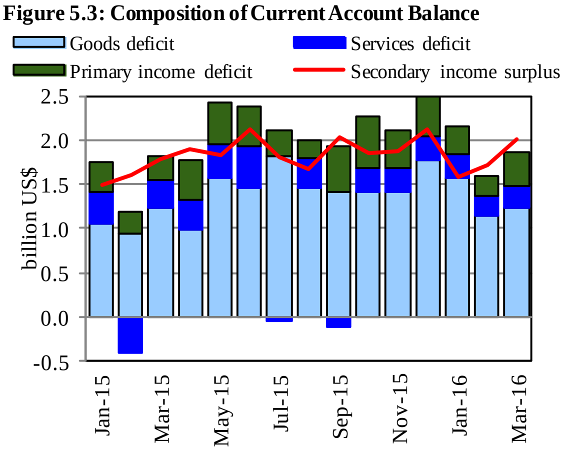
In this context, the continuous decline in the country's exports needs immediate correction. While Pakistan was already being affected by weak demand in major export markets, depressed unit prices, and high production costs, the decline in key crops this year (particularly cotton) has further steepened the export fall. This, together with a sharp increase in non-oil imports during the year (especially in the third quarter), has entirely offset the gains from a decline in the oil import bill (**Figure 5.2**); the trade deficit during Jul-Mar FY16 was slightly higher than the same period last year (**Table 5.1**).

Figure 5.2: Growing Concerns on Trade Account



Source: State Bank of Pakistan

Figure 5.3: Composition of Current Account Balance



Source: State Bank of Pakistan

FX pressures in the interbank market have been manageable so far, as the tapering in payments and receipts has largely been evened out. In fact, the current account has posted back-to-back surpluses in February, March and April 2016, helped by some moderation in trade and primary income deficits (**Figure 5.3**).

However, managing FX can become a little intricate going forward, if the non-oil trade deficit continues to widen and remittances stagnate. Here, it is also important to note that the oil prices have risen by nearly US$21 per barrel from their lowest levels in mid-January 2016.[1] Under these circumstances, three factors

[1]After falling to US$ 24.1 per barrel during the week ending 15th January 2016, price of Saudi Arabian Light has increased to US$ 45.0 per barrel by end May 2016.

will be critical in determining the external outlook of Pakistan: (i) the trend in the global economy and commodity prices; (ii) support from international financial institutions (IFIs); and (iii) how the China-Pakistan Economic Corridor (CPEC) accord unfolds.

In the case of global commodity prices, Pakistan's recent experience has been mixed: while the cut in the oil import bill has certainly been a boon, the price-driven fall in export receipts and flagging remittance growth, have been adverse spin-offs. Foreign direct investment (FDI) and equity inflows too have tightened up, partly due to uncertain global market dynamics. If commodity prices stabilize at current low levels (which is likely, given the weak recovery in advanced economies; financial stability risks in emerging market economies; and the ongoing growth rebalancing in China), then our export earnings and remittance growth may continue to remain under pressure.[2] On the flip side, any exogenous shock leading to higher commodity prices (emanating from geo-political risks) will naturally inflate our import bill, before (and probably more than) it benefits our exports and remittances.

Similarly, CPEC also appears to have mixed implications for Pakistan's external outlook. We believe that the corridor, and associated investments, is likely to have long-term positive and strong spillovers on real economic activity in the country; but in the interim period, it will contribute to a higher import bill. While Pakistan has begun receiving FDI from Chinese firms, our imports have also grown substantially in Jul-Mar FY16 (14.9 percent YoY) (**Table 5.2**); nearly 33 percent of our total non-oil imports during the period have come from China. Most of the increase in these imports comprised power generation and distribution machinery. Steel products too came into the country from China in large quantities to supplement ongoing infrastructure spending. Debt inflows from China are also inching up (for the full-year FY16, the government is envisaging US$ 3.1 billion loan disbursements from China).

Table 5.2: Pakistan's Transactions with China (Jul-Mar)
million US$

	FY15	FY16	Net change
Exports to China	1,696	1,450	-246
Imports from China	5,092	5,850	758
FDI (net)	193	518	325
Portfolio investment	11	6	-5
Loan disbursements[1]	565	601	36

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

[2] On the other hand, demand for non-oil imports in the country is likely to maintain its pace with infrastructure spending and other economic activities. Therefore, despite savings in oil imports, the trade deficit may widen further going forward.

Finally, the IMF program is ending *successfully* this September. Not only has this program helped Pakistan skirt away a looming FX stretch, it has also contributed in putting other IFIs on board.[3] It is hoped that this engagement with IFIs will continue post-Extended Fund Facility, as Pakistan's external financing needs are projected to rise over the medium-term.[4]

5.2 Current account: *Rising non-oil imports offset gains from lower oil bill*

The current account posted a deficit of US$ 1.7 billion during Jul-Mar FY16, which was smaller than the shortfall of US$ 2.0 billion recorded during the same period last year. Most of this improvement had come in the first quarter, as the windfall impact of lower oil bill has lately been absorbed by rising non-oil imports: after declining for four consecutive quarters, Pakistan's overall import bill has risen YoY in both Q2-FY16 and Q3-FY16. And while remittances continue to provide a much-needed buffer, the continued moderation in these flows means that payment pressure will switch back to the financial account. This will be at a time when non-CPEC FDI inflows may not be forthcoming.

Worker remittances: Global conditions have begun to bite

Extensive changes have been taking place in the global remittance business, particularly since the second half of CY2015. A multitude of factors seems to be at play: virtually stagnant growth and low inflation in the developed world; the drastic nature of the oil price fall and subsequent changes in labor market dynamics of GCC countries (which have included lay-offs and glitches in visa issuances); a tightening regulatory landscape governing cross-border money transfers in the US (which has increased compliance costs for banks and money transfer operators); and the migrant crisis in the EU.

As a result, volumes of global cross-border remittances have shrunk substantially in CY2015; in developing economies, these have nearly stagnated.[5] Encouragingly enough, although the growth in global remittances had begun to taper since early 2014, the impact of global conditions on inflows to Pakistan have started to become visible only recently. During Jul-Mar FY16, remittances have grown by only 5.8 percent YoY, compared to 17.3 percent growth seen last year. Certainly,

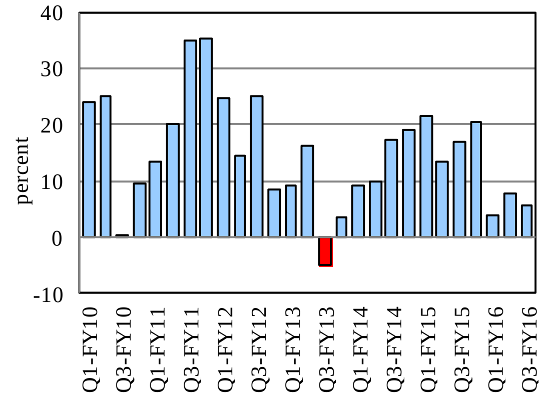
[3] Major sources of official FX inflows in Jul-Mar FY16 included the ADB (US$ 721.8 million); IDA (US$ 708.8 million) and the IDB (US$ 684.8 million) (source: Economic Affairs Division).

[4] Pakistan's annual gross external financing needs (current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period) will rise to US$ 10.7 billion in FY17 and further to US$ 13.0 billion by FY20 (source: IMF Country Report 16/94, March 2016).

[5] Global remittances declined 1.7 percent YoY in CY2015. In developing countries, the growth in inflows declined from 3.2 percent in CY2014 to only 0.4 percent in CY2015 (source: World Bank Migration and Development Brief, April 2016).

this growth looks unimpressive compared to the pace we have been observing in the recent past; but compared to other regional countries, this looks quite decent.[6]

Figure 5.4: Quarterly Remittance Growth (YoY)



Source: State Bank of Pakistan

Despite this, we believe the growth could have been slightly higher if not for the government's decision to reduce the effective subsidy on the remittance business.[7] This assessment is based on the magnitude of the *decline* in remittances that we observed exactly three years ago, when the reimbursement of telegraphic transfer (TT) charges by the government was delayed– by far, Q3-FY13 remains the worst quarter in terms of remittance inflows since the launch of the Pakistan Remittance Initiative (**Figure 5.4**).

In our view, the reduction in the subsidy, along with recent restrictions placed on per customer/per day transactions, would limit the expansion of the overall remittance business.[8] However, we expect banks to eventually introduce more cost-effective systems and delivery channels to mitigate any hit on their margins due to the lowering of rebates. The banks should also focus on establishing new alliances with global MTOs; scale up their marketing efforts; and introduce

Table 5.3: Country-wise Remittance Inflows (Jul-Mar)

million US$

	FY15	FY16	Growth (%)
GCC	8,636	9,327	8.0
US	2,008	1,857	-7.5
UK	1,747	1,807	3.5
Others	1,204	1,394	15.8
Total	13,595	14,385	5.8

Source: State Bank of Pakistan

[6] Overall remittances to India dropped 2.1 percent YoY in CY2015, while those to Sri Lanka went down 0.05 percent; flows to Bangladesh grew by only 2.5 percent during the year (source: World Bank).

[7] Effective from July 1, 2015, the government had reduced the effective subsidy from 25 Saudi riyals per remittance transaction to SAR 20, and increased the minimum transaction amount to qualify for the rebate to US$ 200 (or equivalent) from US$ 100.

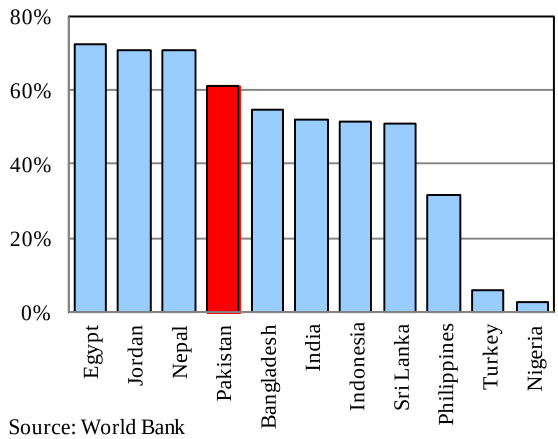
[8] In May 2016, SBP announced that banks will be reimbursed for only *one* transaction conducted between the same remitter and the same receiver on the same day, irrespective of the number of transactions conducted between them on the day (vide EPD Circular Letter No. 8 of 2016). This was done to prevent the misuse of the subsidy by splitting transactions.

innovative products. Moreover, the reduction in the subsidy itself is a step in the right direction, as banks should become more efficient in operating in a free market environment. However, the decline in remittance growth stemming from global factors highlighted in detail in the following sections, are likely to remain in play in the foreseeable future. By this, we are referring to structural issues in the two key corridors: the Gulf and the US **(Table 5.3)**.

The Gulf Corridor

Ever since bears took control over the global commodity market, fears have clouded the future of the oil-rich GCC economies. Other developing countries too have been holding their breath, especially the ones that depend heavily on FX inflows from this region. Although Pakistan relies less on this region for export earnings, it is among those countries that depends on the GCC for a big chunk of worker remittances (**Figure 5.5**). Therefore, a tapering was expected after a startling 16 percent growth per annum in flows from the region consistently over the previous decade.

Figure 5.5: Share of GCC in Total Remittance Inflows (2015)



Source: World Bank

That said, Pakistan seems to have been spared the worse: while overall remittance flows to the country from the GCC have definitely slowed down (from 22.7 percent in Jul-Mar FY15 to only 8.0 percent this year), these have not declined, as in the case of countries like India, Bangladesh and Sri Lanka. In this context, what concerns us the most is the meager growth of 4.7 percent YoY in Q3-FY16 in flows from the region:[9] if remittances from the bloc continue to grow at *this* pace, Pakistan may not uphold the FX comfort it has been enjoying over the previous few quarters. A wishful arrangement in these circumstances would be: (i) leveraging upon Pakistan's diplomatic arrangements with the GCC to shield our workers from any discriminatory action by employers in the region; and (ii) GCC governments do not cut their development spending

[9] Large variations in flows from within the UAE have been noted this fiscal year. For instance, remittances from Dubai (with less dependence on oil, as well as a relatively liberal political setup) have grown 33.1 percent YoY in Jul-Mar FY16, while those from Abu Dhabi and Sharjah have declined by 25.4 percent and 3 percent, respectively, in the same period.

(ideally for Pakistan, this should happen without a surge in oil prices – meaning that the region's economies diversify their revenue base away from oil, and generate fiscal space via cutting down non-development spending). As things stand, however, both these factors may come into play over the medium- to long-term.

Saudi Arabia has come out with broad outlines of its vision for a post-oil economy. As per the Vision 2030, designed by the Council of Economic and Developmental Affairs and approved by the Cabinet in April, the Kingdom is planning to significantly reduce the concentration of its fiscal revenues and exports from oil.[10] Nonetheless, the blueprint seems ambitious to many, and an air of skepticism prevails over its active execution: previous plans to diversify the economy too had remained unimplemented. In the short-term, reduction in fuel subsidies and increase in taxation will instead reduce savings of expatriate workers, squeezing the amount they can remit back home.

Meanwhile, in case of economies like Dubai and Qatar, remittance growth has remained strong throughout this fiscal year as work progresses on infrastructure projects related to the Expo 2020 and the Fifa World Cup 2022. Besides, according to the IMF, spending cuts announced by Oman and Bahrain are largely aimed at current (as opposed to capital) expenditures; this should leave enough fiscal space for infrastructure development projects to proceed in these countries.[11]

<u>The US Corridor</u>

As low oil prices continue to impact the fiscal position of many GCC countries and contribute to a softening in remittance growth, a different issue appears to be holding back flows from the US: money transfer operators (MTOs) are facing stringent regulations governing remittance transfers.[12] Not only have these regulations significantly increased compliance costs for banks and MTOs operating in the US, these have also created certain operational difficulties in the remittance transfer business. While banks have traditionally been more regulated, the inclusion of large MTOs under this new regime (through the so-called

[10] The key objectives of the plan include: increasing the share of the private sector in economic activity; asset sales and privatization of state enterprises (e.g., sale of around 5 percent shares of Aramco); rationalization of spending, including sizable reduction in subsidies and increase in taxation (including the introduction of VAT in 2018); and measures to increase the share of the indigenous population in a wide range of jobs.

[11] Remittances from both Bahrain and Oman have been robust this year, rising by 23.7 percent and 19.8 percent YoY respectively during Jul-Mar FY16.

[12] Remittances from the US have declined by 7.5 percent YoY in Jul-Mar FY16; most of this decline occurred in Q2-FY16.

'Remittance Rule') has had a wide-ranging effect on the remittance business. For instance, the US Consumer Financial Protection Bureau (CFPB) in October 2013, strengthened the consumer protection standards, and side by side, introduced stern measures to ensure compliance with anti-money laundering and counter financing of terror (AML/CFT) rules by money service businesses.[13] In order to comply with these rules, MTOs have had to invest sizable amounts in integrating their systems and upgrading their technological infrastructure.

The UK Corridor

The UK is the third most important source of remittances for Pakistan (after GCC and the US), accounting for 12.5 percent of overall inflows during Jul-Mar FY16. Unlike the US, remittances from the country are still up this year, having grown 3.5 percent YoY during the period. The relative robustness of these flows can be attributed to two main factors: First, SBP has been encouraging commercial banks, under the PRI, to increase their network coverage in the UK by establishing new tie-ups with MTOs (which is getting increasingly difficult in the US market due to constricting regulations); this has ensured that expats have easy access to multiple legal and affordable avenues to remit money.[14] The second reason is the size and nature of the diaspora in the country itself. As of end-2013, the UK had the second-largest Pakistani diaspora (estimated at over 1.5 million people).[15] Over the years, migrants have continued to financially support their extended families back home, in addition to contributing funds for local development initiatives.

5.3 Financial account: *Abundance of IFI inflows*

Similar to FY15, financial inflows into the country in Jul-Mar FY16 were sufficient to cover the deficit in the current account; side by side, these also contributed to reserves build-up. During the period under review, FX flows from IFIs dominated, though a marginal increase in FDI inflows was also recorded (**Table 5.4**).

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[13] An important feature of these measures was to hold remittance service providers liable even for irregularities committed by their authorized agents; if convicted, their license to engage in the money transfer business could be suspended or revoked. In its annual report for 2015, Western Union highlighted the issue very succinctly: "Regulators worldwide are exercising heightened supervision of money transfer providers and requiring increasing efforts to ensure compliance….we are experiencing increasing compliance costs related to customer, agent, and subagent due diligence, verification, transaction approval, disclosure, and reporting requirements ... that have had and will continue to have a negative impact on our business."

[14] From 2010 to 2014, the growth in overall remittance outflows from the UK has averaged 4.6 percent per annum (source: World Bank). Against this, flows from the country to Pakistan have risen by an average 22 percent per annum during the same period.

[15] Source: Ministry of Overseas Pakistanis and Human Resource Development Year Book 2013-14.

Foreign direct investment: led by China

China has lately emerged as a dominant source of FDI inflows for Pakistan, primarily due to its interest in power projects. During Jul-Mar FY16, China remained the top contributor, providing more than half of net FDI into Pakistan, followed by UAE and Hong Kong.[16] Chinese firms have been particularly interested in coal-based thermal generation, as this entails low unit cost compared to furnace oil and HSD. Excluding power, FDI inflows into the country have declined.

Table 5.4: Financial Inflows to Pakistan (Jul-Mar)
million US$

	FY15	FY16
FDI in Pakistan	**832**	**960**
Excl. power sector	694	462
Portfolio investment in Pakistan	**1,041**	**-393**
FX loans and liabilities (net)	**696**	**2,005**
Central bank	11	3
Deposit taking corporations	388	-145
General government (incl. IFIs)	590	2,196
Disbursements	2,741	4,492
Amortization	2,149	2,296
Other sectors	-293	-49

Source: State Bank of Pakistan

Portfolio investment

Massive sell-off greeted global equity markets (especially emerging markets) at the start of Q3-FY16, as investors became unnerved by oil prices hitting 13-year lows (following the lifting of international sanctions on Iran); China's stock market crash in early January; and a hike in the Federal Funds rate in mid-December 2015. Billions of dollars in market capitalization were wiped out as a result. However, some sense of calm has returned over the past few months: a rebound in crude prices from mid-February has corresponded with a recovery in major stock markets. Pakistan's equity market, which exhibited pronounced volatility during CY2015, has also been on an upward trajectory since February, as the intensity of foreign selling has eased off, and local buying has buoyed up.

However, uncertainties still abound, both on the global economic and political fronts. These include a hazy outlook for global demand; pace of further monetary tightening in the US; gradual reorientation of China's economy; and chances of the EU disintegrating with *Brexit*. That being said, the reclassification of the Pakistani stock market in the Emerging Markets (EM) Index by the Morgan Stanley Capital International (MSCI) in mid-June 2016 would provide a boost to investor sentiments.

[16] During Jul-Mar FY16, net FDI inflows stood at US$ 960 million. Of these, US$ 518 million came from China, followed by US$ 126 million from the UAE and US$ 120 million from Hong Kong.

5.4 Trade account[17]

Pakistan's trade deficit has continued to widen this year, as the decline in exports and a rise in non-oil imports have offset savings from the lower oil import bill. Nonetheless, the importance of the 37.2 percent reduction in oil imports during Jul-Mar FY16 cannot be overstated, as it helped contain the growth in the trade deficit to only 5.2 percent, against a much higher rate of 14.8 percent recorded in the same period last year **(Table 5.5)**.[18]

Table 5.5: Trade Account during Jul-Mar

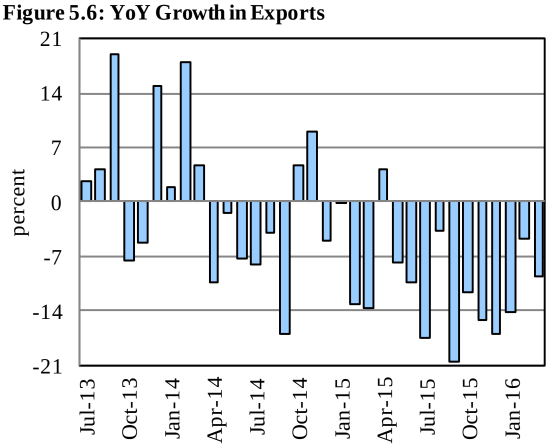
	FY14	FY15	FY16
	billion US$		
Exports	19.1	17.9	15.6
Imports	33.0	33.9	32.5
Trade deficit	-14.0	-16.0	-16.9
	Growth rate (%)		
Exports	5.9	-6.0	-12.9
Imports	0.8	2.8	-4.4
Trade deficit	-5.3	14.8	5.2

Source: Pakistan Bureau of Statistics

Exports

Pakistan's depressing export performance has been a cause of concern for quite some time now; exports declined by 12.9 percent during Jul-Mar FY16, compared to a fall of 6.0 percent in the same period last year. Lower commodity prices, subdued demand from China, a weak global recovery and high domestic production costs have all contributed to this multi-year trend (**Figure 5.6**). An *additional* irritant that surfaced this year is the decline in production of key agriculture products like cotton, rice and sugarcane. Since Pakistan's exports are mainly concentrated in resource-based products, their decline in Jul-Mar FY16 has been much more severe.

Figure 5.6: YoY Growth in Exports



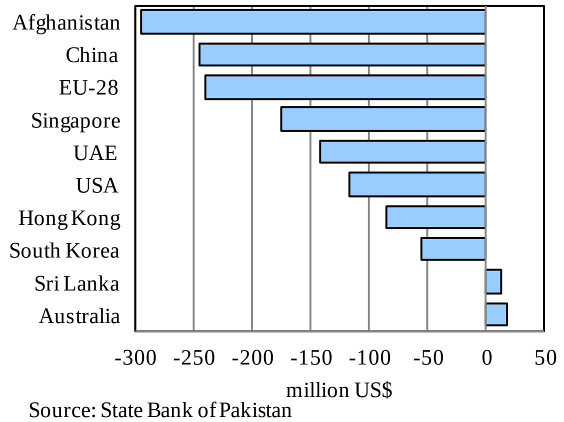
Source: Pakistan Bureau of Statistics

[17]This section is based on customs data reported by the PBS. This data set also has the advantage over payments record data for analysis purpose, since this carries information on quantums and unit values. The information in this section does not tally with the payments record data, which is reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

[18] Despite a sharp decline in oil prices, Pakistan's total imports had increased by 2.8 percent YoY in Jul-Mar FY15. This, coupled with a decline in the country's exports, had led to a 14.8 percent YoY increase in the overall trade deficit.

Nearly all markets contributed to this lackluster export performance, with Afghanistan, China and the EU figuring in more prominently (**Figure 5.7**). However, an interesting observation this time around is the difference in the nature of the export decline across markets: while quantums steered export declines in Asian markets, lower unit prices eclipsed an otherwise improved showing in advanced economies.

Figure 5.7: Pakistan's Exports to Major Countries during Jul-Mar FY16 - YoY absolute change



Source: State Bank of Pakistan

Specifically, more than a quarter of the overall decline in our exports to Afghanistan has come from lower cement dispatches, whereas fewer supplies of cotton yarn and fabric suppressed our export figures in Chinese market. In case of Singapore also, the decline in exports is explained mainly by quantums. However, it must be noted that with falling oil prices, it has become unfeasible for Pakistan to export petroleum oil and related products (like naphtha), which have a sizable share in our exports to the city-state.

In contrast, Pakistan's export of apparel and home textiles to the US and EU markets recovered noticeably during Jul-Mar FY16, but the continuous drop in unit prices held back values (**Table 5.6**). More specifically, Pakistan has been able to export larger volumes of readymade garments, towels, knitwear, and bed-wear during Jul-Mar FY16 to the EU and the US markets, as the demand in these economies recovered.[19] Our exporters were able to deliver on commitments despite a fall in domestic cotton crop, thanks to available inventories and timely import of inputs from India. Pakistan was able to maintain its share in the US market, with our textile and apparel exports to the country rising by around 7.2 percent YoY during Jul-Feb FY16. However, Pakistan's performance looks modest when compared to that of Bangladesh, which was able to increase its share

[19] For instance, in volume terms, overall imports of EU-28 increased by 1.7 percent during Jul-Mar FY16 YoY (source: Eurostat).

in the US market following the implementation of improved safety conditions at its factories.[20]

Table 5.6: YoY change in Exports during Jul-Mar FY16 over Jul-Mar FY15

million US$

	Quantum impact	Price impact	Total
Basmati	-32.5	-94.9	-127.4
Non-basmati	95.1	-161.4	-66.3
Fruits & Vegetables	-25.2	-3.3	-28.5
Sugar	-74.0	-1.6	-75.6
Meat	14.0	16.6	30.5
Raw cotton	-66.2	-0.5	-66.7
Cotton yarn	-501.9	26.9	-475.0
Cotton fabric	91.4	-281.8	-190.3
Apparel*	17.2	7.6	24.8
Bed-wear	8.4	-74.3	-65.9
Towels	37.1	-30.1	7.1
Naphtha	-233.5	-1.7	-235.2
Tanned leather	-88.1	-11.4	-99.5
Leather garments	-36.6	-3.0	-39.6
Foot wear	-18.6	-1.0	-19.6
Plastic	-100.7	36.5	-64.2
Pharmaceutical	-40.9	35.6	-5.3
Cement	-85.0	-16.0	-101.0

*: Includes knitwear and readymade garments; Source: Pakistan Bureau of Statistics

Nonetheless, competitiveness issues continued to stay in place especially in case of non-textile products like rice and cement (**Table 5.6**). In case of rice, which is the largest item in the non-textile group, the decline in exports stood at 11.6 percent YoY in Jul-Mar FY16. While the decline in export of non-basmati was entirely due to low unit prices, basmati exports declined due to further cut in demand: quantum basmati exports declined by 7.1 percent YoY in Jul-Mar FY16. Pakistani exporters have been continuously losing space to high-yielding low-cost Indian varieties (mainly PUSA) in major Middle Eastern markets like Iraq, UAE, Bahrain and Oman (**Figure 5.8a** and **5.8b**). With the lifting of international sanctions in January 2016, Iran has lately emerged as a silver lining: Pakistan's overall rice exports to the country more than doubled to 4,500 tons during Jul-Jan FY16.

[20] Pakistan quantum textile and apparel exports to the US grew by only 100 million sq. meter during Jul-Mar FY16, compared to an increase of 300 million sq. meter recorded by Bangladesh (source: Otexa). The country's share in export markets had been hit after a fire incident at a garment factory in November 2012. Bangladeshi firms have since then undertaken various initiatives to enhance security controls at their factories.

Figure 5.8a: India's Export of Basmati (Jul-Feb FY16) -YoY growth in Quantum

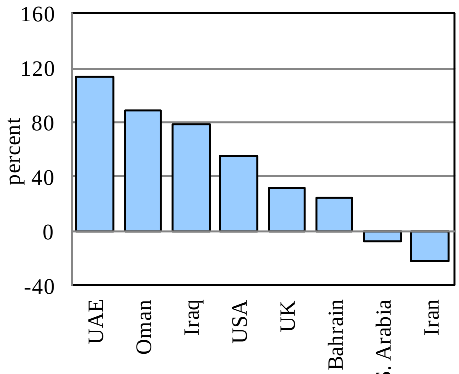
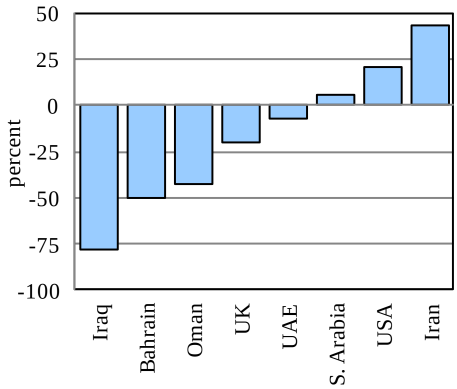


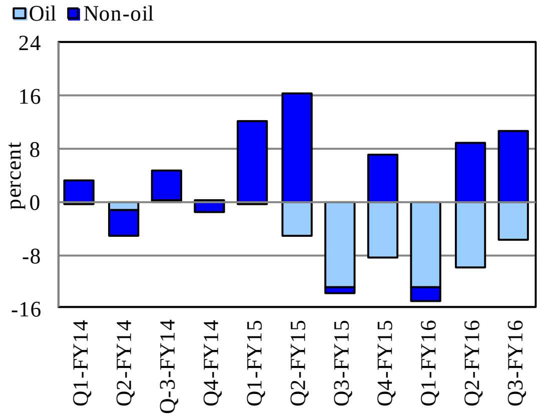
Figure 5.8b: Pakistan's Export of Basmati (Jul-Feb FY16) -YoY growth in Quantum



Source: APDEA and Pakistan Bureau of Statistics

Similarly in case of cement, the decline in exports was mainly a result of lower dispatches to Afghanistan, as Iranian varieties are providing tough competition in this market. Cement exports to Afghanistan dropped 34.2 percent YoY in Jul-Mar FY16. An added irritant has been the extension of anti-dumping duty on Pakistani cement in South African market. Specifically, the International Trade Administration Commission, which had imposed anti-dumping duty (ranging from 14 to 77 percent) on Pakistani cement products in May 2015 initially for six months, decided in December 2015 that these duties will remain in place for five years. Cement exports to the country, in terms of volume, have dropped by a sizable 70 percent YoY during Jul-Jan FY16.

Figure 5.9: Contribution to Import Growth



Source: Pakistan Bureau of Statistics

Imports

Imports declined by 4.3 percent during Jul-Mar FY16, after rising by 2.8 percent in the same period last year. The entire decline was seen in the first half of the year, when a sharp drop in oil imports more than offset a modest increase in non-oil imports. However, in Q3-FY16, overall imports posted a growth of 5.4 percent

YoY, as the import of power generation/distribution machinery and raw cotton gathered pace (**Figure 5.9**).

POL

Petroleum imports posted a further decline of 37.2 percent YoY during Jul-Mar FY16, after falling by 18.7 percent in the same period last year. The entire decline was driven by lower unit prices, as quantum imports posted an increase of 8.6 percent during the period.[21]

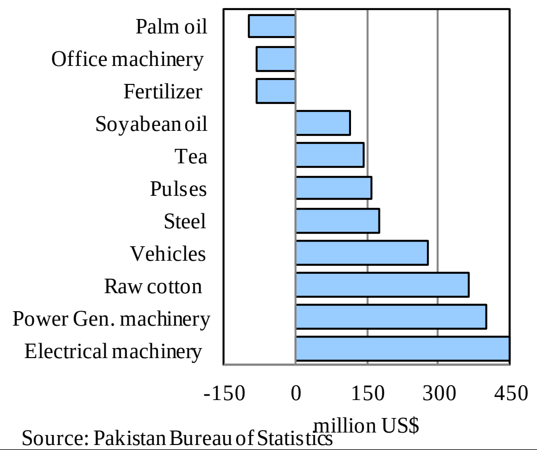
Within petroleum products, the increase in volume came from crude oil and petrol, whereas the demand for imported furnace oil (FO) and high speed diesel (HSD) remained lower than last year (**Table 5.7**). While the improvement in cash flows of local refineries explain the increase in demand for crude, a steady increase in automobile sales and lesser availability of CNG resulted in higher demand for petrol.

Table 5.7: Import of Energy during Jul-Mar

	Quantity (000MT)		
	FY14	**FY15**	**FY16**
High speed diesel	1,843	2,133	2,009
Furnace oil	4,816	4,581	4,328
Crude oil	5,776	5,916	6,642
Motor spirit	1,583	2,170	3,057
Other	43	42	78
Total POL*	14,062	14,842	16,114
LNG** (Jul-Feb)	-	-	593

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

Figure 5.10: YoY Change in Non-oil Imports (Jul-Mar FY16)



Source: Pakistan Bureau of Statistics

As far as furnace oil and HSD were concerned, the decline in imports was due to both an increase in domestic production as well as a fall in their consumption during the period.[22] The latter represents, government's decision to shift power generation away from costly FO and HSD in favor of gas (both piped and LNG).

[21] Source: Oil Companies Advisory Council (OCAC)

[22] FO and HSD production increased by 5.1 percent YoY and by 3.1 percent respectively, during Jul-Mar FY16. Besides, sales of furnace oil declined by 4.9 percent YoY in Jul-Mar FY16, while HSD sales slowed down to 3.3 percent from 8.8 percent in the same period last year.

Non-oil imports

A surge in investments in power generation and distribution infrastructure of the country, has put an upward pressure on non-oil imports, especially machinery (**Figure 5.10**). Additional pressure on imports came from a fall in domestic cotton crop, which necessitated higher imports from India. Meanwhile, ongoing construction activities on the back of higher PSDP spending have also increased the demand for imported iron and steel products. In overall terms, non-oil imports increased by 7.4 percent during Jul-Mar FY16; this rate was lower than 13.4 percent witnessed in Jul-Mar FY15. China has emerged as the largest supplier of most of these products: its share in Pakistan's total imports has increased to over 30 percent by end-March 2016.

In case of steel, most of the items that we imported this year included coils and line pipes. While the higher demand for coils (both hot and cold rolled) came from the automobile industry, the increase in import of line pipes represented investments in the gas distribution infrastructure. However, it must be noted that not all of the items that we are importing require high technical expertise: Pakistani steel manufacturers are also capable of supplying some of these items, but they have been priced out by the influx of cheap imports from China. Also, Pakistan is not the only country being impacted by this phenomenon: competition from cheap Chinese steel products[23] has been cited as one of the reasons for Indian giant Tata Steel's decision to exit the UK steel industry this year.[24]

Upon request of domestic steel re-rolling firms, the government had imposed up to 15 percent regulatory duty (RD) on certain steel and allied products back in March 2015. However, as we had feared, this rate of duty was not sufficient to close the gap between the prices of locally produced items and imported ones; therefore, the government decided to increase the same further to 30 percent in March 2016.[25] In addition to this, the government also imposed anti-dumping duty, ranging from 8.3 to 19.0 percent, on imports of cold-rolled coils and sheets from China and Ukraine; these products are mostly used in auto assembling, fabricated goods (trunks and drums), and home appliances.

[23] For instance, it costs the UK 538 Euros on average to import a ton of steel from China in 2015, as opposed to 870 Euros from EU-28 (source: Eurostat).

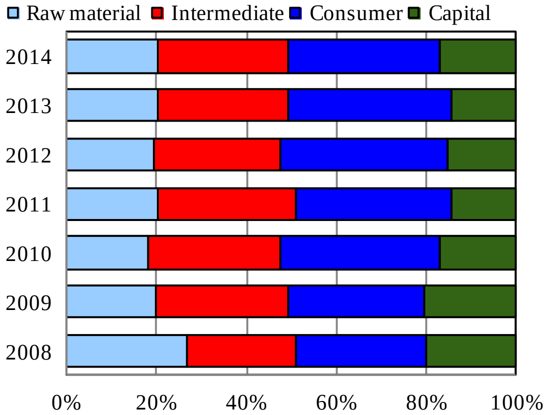
[24] Tata Steel is one of the largest steelmaking companies in the world, and operates multiple plants in the UK. However, after facing hefty losses from last year, the company decided in March 2016 to exit the UK steel market. In addition to cheap imports from China, it has cited the global steel glut, higher regulatory costs in the UK, and a stronger pound sterling, as reasons for its decision.

[25] The government increased the regulatory duty up to 30 percent via SRO 236(I)/2016 dated 21-03-2016.

Going forward

Growth in China is not projected to recover much in the short- to medium-term, as the world's second largest economy navigates its way through structural changes; this would further limit our exports. Similarly, a noticeable revival in commodity prices is still not in sight in the short run, so even if our exporters maintain their current share in major markets like the EU and the US, they would continue to fetch subdued FX earnings. Pakistani businesses should broaden their horizon and integrate with global supply chains. This has become more relevant now because as China is stepping out from this segment, Bangladesh and Vietnam are grabbing its share. Pakistani businesses need to develop networking ties with their peers in these countries so they too could benefit from the changing global market dynamics. Currently, Pakistani exporters are neither able to compete with their counterparts in Bangladesh and Vietnam, nor are they part of these countries' value chains.

Figure 5.11: Composition of Pakistan's Imports



Source: World Bank

In case of imports, there is a need to curb the influx of low-tech and unproductive goods. Presently, most of our imports comprised either of consumer goods, or semi-manufactured (intermediate) items that require very little domestic value addition **(Figure 5.11)**. Policy has to be tilted towards enhancing the value-addition in the country. This is the only way of making our high growth strategy more sustainable and inclusive.