

PAKISTAN
ECONOMIC UPDATE
(JULY 2004 - MARCH 2005)

ASIAN DEVELOPMENT BANK

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Pakistan Resident Mission
Asian Development Bank

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Pakistan Resident Mission

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The views expressed in the Economic Update are those of the authors and do not necessarily reflect the views of the ADB or its member governments.

FOREWORD

The Asian Development Bank is a long-standing development partner of Pakistan, having provided a total of \$14.3 billion to the country in development assistance from 1968 to 2004. Of this amount, \$709 million were provided in 2004. The Bank will provide another \$797 million in 2005. The projected assistance for the period 2006-2008 amounts to \$3.6 billion. The major development sectors in which ADB has invested include energy, agriculture and rural development, finance and trade, transport and communications, social sectors, and governance. Under its Country Strategy and Program for Pakistan for 2002-2006, reduction of poverty is the central objective, which will be operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance, with governance being the key area of focus.

Together with this lending portfolio, the Pakistan Resident Mission (PRM) is actively engaged in Economic and Sector Work to develop an understanding of important economic policy and sector concerns, particularly with regard to poverty and governance issues. To bring this work to a wider audience, PRM published, in July 2002, a country poverty assessment titled “Poverty in Pakistan: Issues, Causes, and Institutional Responses”, after extensive consultations and dialogue with the key development partners. PRM has also started a working paper series on topical issues, and the first paper titled “Escaping the Debt Trap: an Assessment of Pakistan's External Debt Sustainability” was published in December 2002. In addition, PRM published Pakistan: Sector Assessment Review in October 2003, which provides an overview of ADB's operations in the various sectors in Pakistan. A paper titled “Industrial Competitiveness: The Challenge for Pakistan” was published in October 2004, based on a seminar organized by PRM in collaboration with the ADB Institute (Japan). Finally, the second paper in the working paper series titled “Agricultural Growth and Rural Poverty” was published in March 2005.

In 2002, PRM initiated a series to provide regular updates on the state of the national economy. The first Pakistan Economic Update was published in April 2002. The present report provides an analysis of economic trends in Pakistan in the first three quarters of fiscal year (FY) 2005, and presents an outlook of the economy for the full year. In addition, the report summarizes the findings of the ADB study on Agricultural Growth and Rural Poverty mentioned above and reviews poverty related expenditures in the first half of FY2005. The report also includes a special section on Prospects for Exports Post-MFA (Multi-fiber Agreement). We hope that the contents of this report will be of use to all stakeholders including the Government, civil society, donors, academia, media, and others. We look forward to receiving comments on the report, and also suggestions for improvement of future reports in this series.

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Strong performance of both commodity and services sectors thus far indicates that economic growth will exceed 7.0 percent in FY2005. Given sound macroeconomic fundamentals and pick up in investment, medium-term outlook looks bright. However, rising inflation is emerging as a major area of concern.

High economic growth, recorded last year, strengthened further in the first three quarters of FY2005, with both commodity and services sectors gaining further momentum. Because of strong domestic demand, shortages of essential food items, and high oil prices, inflation accentuated and external balance worsened. Poverty related public expenditure for the first half of the year showed a substantial increase, reflecting the Government's commitment to poverty reduction. This report analyses macroeconomic developments in the first nine months of FY2005 along with the outlook for the whole year in section I, and summarizes the findings of a recent ADB study on Agricultural Growth and Rural Poverty and reviews poverty related expenditures in section II. The report also includes a

special section on Prospects of Exports Post-MFA.

I. MACROECONOMIC DEVELOPMENTS

Performance of the economy improved further in the first three quarters of FY2005. Cotton, the largest cash crop of the country, achieved a record high output and the rice crop was also better than last year. Widespread winter rains have improved the prospects for winter crops. The large-scale manufacturing sector (LSM) maintained a double-digit growth, and the large increase in private sector credit and double-digit growth in exports augur well for LSM growth during the rest of the year. Rapid growth of imports, particularly of machinery and raw materials, reflects continuing high economic growth. Import growth

also exceeded export growth by a wide margin, resulting in a large trade deficit and the surplus in the current account of the balance of payments turned into a deficit. Inflation accelerated sharply in the first nine months of FY2005.

Domestic Sector

Growth: The real sectors of the economy have shown a robust growth thus far and the outlook for the rest of FY2005 looks good, despite continuing high international prices of oil. A record cotton crop of 14.6 million bales, or 46.0 percent larger than last year, was harvested. Each one million bales addition in cotton output directly adds 0.7 percentage points to the agriculture sector growth, and indirectly boosts the textile industry and exports. The actual cotton output being 4.6 million bales higher than last year, implies a 3.2 percentage points higher agriculture sector growth on account of cotton alone. Because of widespread winter rains and the timely sowing of wheat, production is expected to be 10.6 percent higher than last year.

Sustained high demand continued to boost production in the LSM

sector. LSM production increased by 14.7 percent in the first seven months of FY2005 compared with 15.1 percent increase in the same period of FY2004. Although LSM growth was somewhat less than last year, it was the second highest in last seventeen

years. The detailed data available for the first half of the year shows that growth was broad-based, with increases being particularly large in the case of cement, electronics, automobiles, fertilizers, and cotton cloth (see table 1). Production of cotton

Table 1: Growth in Production of Selected Large-scale Manufacturing Items

Items	Weights	Growth (%) in July - December	
		FY2004	FY2005
Textiles and apparel	32.6	8.0	15.9
Of which:			
Cotton yarn	17.4	1.6	7.5
Cotton cloth	10.1	20.9	21.8
Cotton ginned	4.5	-1.6	39.4
Food, beverage, tobacco	19.1	18.3	8.0
Of which:			
Sugar	5.5	23.5	18.6
Vegetable ghee	5.7	17.1	-4.9
Cooking oil	1.8	19.5	25.5
Cigarettes	4.1	16.0	7.3
Petroleum products	7.0	2.8	15.0
Pharmaceuticals	6.7	16.6	-0.7
Chemicals	6.4	16.6	3.0
Automobiles	5.3	57.6	32.9
Of which:			
Jeeps and cars	3.4	70.0	29.3
Fertilizers	4.5	31.1	45.4
Phosphatic fertilizer	2.5	65.4	84.3
Nitrogenous fertilizer	2.0	5.0	-1.4
Metal industries	4.7	19.5	-1.4
Of which:			
Pig iron	2.2	20.1	1.2
Coke	1.9	20.2	1.4
Non-metallic mineral products	5.6	15.3	21.2
Of which:			
Cement	5.5	15.5	21.4
Electronics	3.3	42.5	58.0
Leather products	3.0	46.3	-14.6
Paper and board	0.8	9.1	1.5
Engineering goods	0.6	10.5	19.9
Overall growth	100.0	17.9	16.1

Source: State Bank of Pakistan: The State of Pakistan's Economy, Second Quarterly Report 2004-2005.

cloth recorded a 21.8 percent growth and the textile industry expanded by 15.9 percent, almost twice last year's growth. The other two sub-sectors for which some indicators of growth are available are construction and telecommunications. Double-digit increases in production and sale of cement and paints and varnishes, large increases in imports of iron and steel and construction machinery, and a 45.6 percent increase in disbursement of bank loans for housing, all indicate that high growth in construction continued in FY2005. Similarly, a 76.0 percent increase in cellular telephone connections to 8.8 million in February 2005 and 160,000 WLL connections given in the first eight months of the year show that telecommunication services continued to expand at a rapid pace.

Prices: Rising demand in the economy in the face of most industries operating at or

near full capacity, shortages of essential food items like wheat, pulses, meat, and sugar, rising house rents, and high oil prices put pressure on general price level in the first nine months of FY2005 (see box). The CPI-based inflation rose to 9.1 percent in the first nine months of FY2005 compared with 3.7 percent in the same period of FY2004. Food prices increased by 12.5 percent, and house rent by 11.0 percent, significantly higher than 4.6 percent and 3.5 percent last year. Price indices for fuel and lighting and transport took an upturn following the Government's decision to lift the freeze on domestic prices of petroleum products with effect from 15th December 2004, and on a month-on-month basis, fuel and lighting index was higher by 6.0 percent and that of transport and communication by 10.7 percent in March 2005, sharply up from 1.9 percent and 4.1 percent in November 2004. The annualized CPI-based

Inflation rose to 9.1 percent in the first nine months of FY2005.

Is the Pakistan Economy Heating Up?

State Bank of Pakistan (SBP) in its latest Quarterly Report has forecast that GDP growth in FY2005 will be between 7.4 and 7.8 percent, and inflation will be above 8.0 percent. Most industries are operating at or near full capacity, and some, like petroleum refining, fertilizers, motorcycle and tractor assembly, are operating above their full capacity. On a month-on-month basis, CPI increased by 10.1 percent in March 2005, and core inflation was up by 8.1 percent. Real estate prices in major cities have increased manifold, and stock prices rose by 21.6 percent in the first half of March 2005 and then become erratic and fell by 30.9 percent in the subsequent four weeks. All these are signs of an economy that is heating up.

However, the SBP's sale of treasury bills (TBs) through fortnightly auctions in the first nine months of FY2005 were even less than maturing amounts, as it sought to keep interest rates from rising too rapidly. Interest rate on 6-month treasury bills was raised by 300 basis points to 5.2 percent, but there was only a modest increase in lending rates charged by banks, because of excess liquidity in the market. Lending rates remained negative throughout the first eight months of FY2004, resulting in record growth in credit to the private sector. In February 2005, the SBP also revised upward its target for the broad money (M2) growth for the year from 11.3 percent, set in the beginning of the year, to 14.5 percent, as part of its generally accommodative monetary policy.

Only recently has the SBP started aggressive tightening of monetary policy with the increase in discount rate from 7.5 percent to 9.0 percent, effective 11th April, 2005. Also in recent auctions of treasury bills (TBs), SBP accepted more than pre-announced amounts, resulting in a sharp increase in short-term interest rates. In the auction held on 13th April 2005, the cut-off interest rate on 3-month and 1-year TBs increased by 138 and 130 basis points to 6.39 percent and 7.25 percent, respectively. Six-month Karachi inter-bank offer rate (KIBOR) rose to 7.80 percent on 14th April 2005 from 6.83 percent on 11th April. However, the generally accommodative monetary policy pursued in the first 9 months and rapid expansion in private sector credit will continue to exert upward pressure on prices for some months to come. SBP will have to persist with its tightening of monetary policy to absorb the past monetary overhang to bring inflation down to more acceptable levels.

Until March 2005, SBP pursued a generally accommodative monetary policy.

inflation was 8.6 percent in March 2005 compared with 4.6 in June 2005 (see figure 1). Non-food, non-oil inflation increased from 3.7 percent to 6.7 percent over this period. The Wholesale Price Index (WPI) inflation remained somewhat subdued because of a sharp decline in prices of cotton, which has a large weight in raw materials. WPI excluding raw materials increased by 9.5 percent in first nine months of FY2005 compared with the same period of FY2004. The main contributors to rise in WPI-based inflation were higher prices of food items, fuel, lighting, and lubricants, and building materials (weights of 42.1 percent, 19.3 percent, and 4.7 percent, respectively), which increased by 10.7 percent, 14.1 percent, and 16.9 percent.

Monetary Developments: Despite high inflation, the State Bank of Pakistan (SBP) pursued a generally accommodative monetary policy until March 2005. Money supply increased by 12.7 percent in the first nine months of FY2005, which was higher than the 11.9 percent increase recorded in the corresponding period of FY2004 (see table 2). Monetary growth was mainly due to increase in net domestic assets of the

banking system, which accounted for more than four fifths of monetary expansion. The major source of increase in net domestic assets was the accelerated flow of credit to the private sector, which increased by Rs 347.9 billion compared with Rs 236.9 billion last year, which itself was a record. Banks continued their drive to lend to new sectors like consumer finance and agriculture. Gross disbursement of agricultural credit, at Rs 65.3 billion, in the first eight months of FY2005 was 50.8 percent larger than the same period of FY2004. The outstanding amount of consumer loans also increased by 70.7 percent to Rs 85.5 billion in the first half of the year. Net borrowing by the Government sector was only Rs 10.3 billion compared with Rs. 21.4 billion in the first three quarters of FY2004. However, there was a sharp increase in Government's budgetary borrowing from the central bank, which more than doubled to Rs 152.0 billion, the bulk of which was offset by retirement of its borrowing from scheduled banks. Government's heavy borrowing from the central bank resulted in a substantial increase (15.7 percent) in reserve money, which added further to the inflationary pressure.

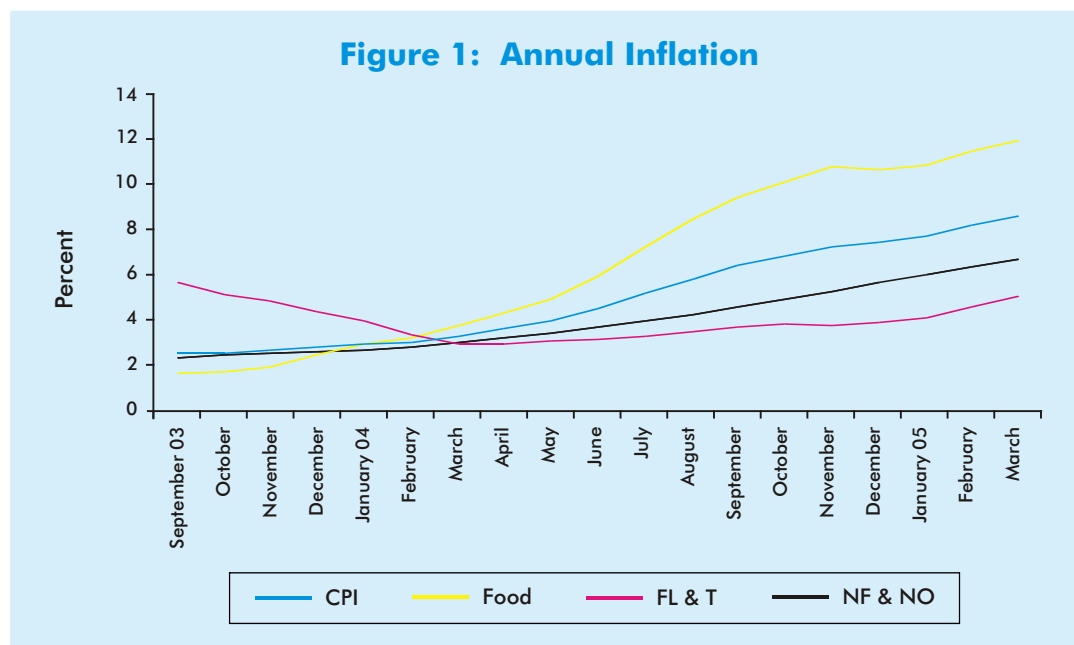


Table 2: Monetary Growth (Billion Rs)

	July-March	
	FY2004	FY2005
Monetary assets	246.6	315.3
Growth in monetary assets (%)	11.9	12.7
Net foreign assets of the banking system	56.5	51.6
Net domestic assets of the banking system	190.1	263.7
Net borrowing by government sector	21.4	10.3
Of which:		
Budgetary support	56.3	14.0
Commodity operations	-35.4	-6.0
Net borrowing by non-government sector	202.6	331.6
Borrowing by the private sector	236.9	347.9
Borrowing by public sector enterprises	-29.9	-10.3
SBP credit to NBFIs	-4.3	-6.1
Other items (net)	-33.9	-78.1

Source: SBP Website

Fiscal Situation: The overall fiscal deficit increased to 1.3 percent of GDP in the first half of FY2005 compared to 0.8 percent of GDP in the corresponding half of FY2004, as expenditure increased by 21.9 percent and revenues by only 11.8 percent (see table 3). The entire increase in the deficit took place in the second quarter of the year, when increase in expenditure accelerated to 33.9 percent (from an increase of 10.0 percent in the first quarter) and that in revenues decelerated to 3.7 percent (from an increase of 22.2 percent in the previous quarter).

The current expenditure increased by 21.3 percent to Rs 427 billion in the first half of FY2005. A large increase (33.5 percent) was recorded in non-interest, non-defense expenditures, partly due a more than two-fold increase in grants given by the Federal Government, which accounted for almost one-fourth of the increase in current expenditure. The 15 percent raise in salaries of government servants, effective from July 2004, also increased the establishment expenditure. Defense, the second largest head under the current expenditure,

increased by 15.8 percent to Rs 101 billion, presumably due to military operation on the western border of the country. The increase in defense expenditure was more than twice that shown in the budget. Interest payments increased by only 5.5 percent to Rs 104 billion, the entire increase being in interest on domestic debt, partly explained by rise in domestic interest rates.

There was also a sharp increase of 43.7 percent to Rs 82 billion in development expenditure in the first half of FY2005 compared with the same period of last year. As a percentage of GDP also, development expenditure increased from 1.0 to 1.3. Both federal and provincial development expenditures increased by more or less the same percentage. The Government succeeded in spending 40.4 percent of its annual development program compared with only 20.0 percent in the first half of FY2004, which reflects efforts being made by the Government to improve implementation of development projects.

The slow growth in revenues in the first half of FY2005 was mainly due to a sharp

Development expenditure increased by 43.7 percent in the first half of FY2005.

Table 3: Consolidated Federal and Provincial Fiscal Position (Billion Rs)

	July - December		% Change
	FY2004	FY2005	
Total revenue	379.1	423.8	11.8
Federal revenue	354.2	397.6	12.3
Taxes	230.8	267.9	16.1
Of which:	0.0	0.0	
CBR taxes	230.8	265.4	15.0
Surcharges	33.2	13.8	-58.5
Non-tax revenue	90.2	115.9	28.5
Provincial revenue	24.9	26.1	5.0
Total expenditure	412.8	503.3	21.9
Current expenditure	352.5	427.5	21.3
Federal expenditure	252.3	309.5	22.7
Of which:			
Interest	98.8	104.2	5.5
Domestic	76.3	82.9	8.6
Foreign	22.5	21.3	-5.2
Defense	87.3	101.1	15.8
Provincial expenditure	100.2	116.4	16.1
Development expenditure and Net lending	63.7	86.3	35.4
Development expenditure	56.8	81.6	43.7
Federal	35.2	50.7	44.1
Provincial	21.6	30.9	43.1
Unidentified expenditure	-3.4	-10.4	204.4
Budget deficit	33.7	79.6	136.0
As % of GDP	0.8	1.3	

decline in petroleum development surcharge, resulting from the freeze in domestic prices of petroleum products from May to 15th December 2004 in the face of their rising international prices.¹ The CBR tax collection also slowed down significantly in the second quarter, lowering the cumulative growth in collection in the first half of the year to 15.0 percent from 30.9 percent in the first quarter. The above shortfalls in revenue were partly offset by a 28.5 percent

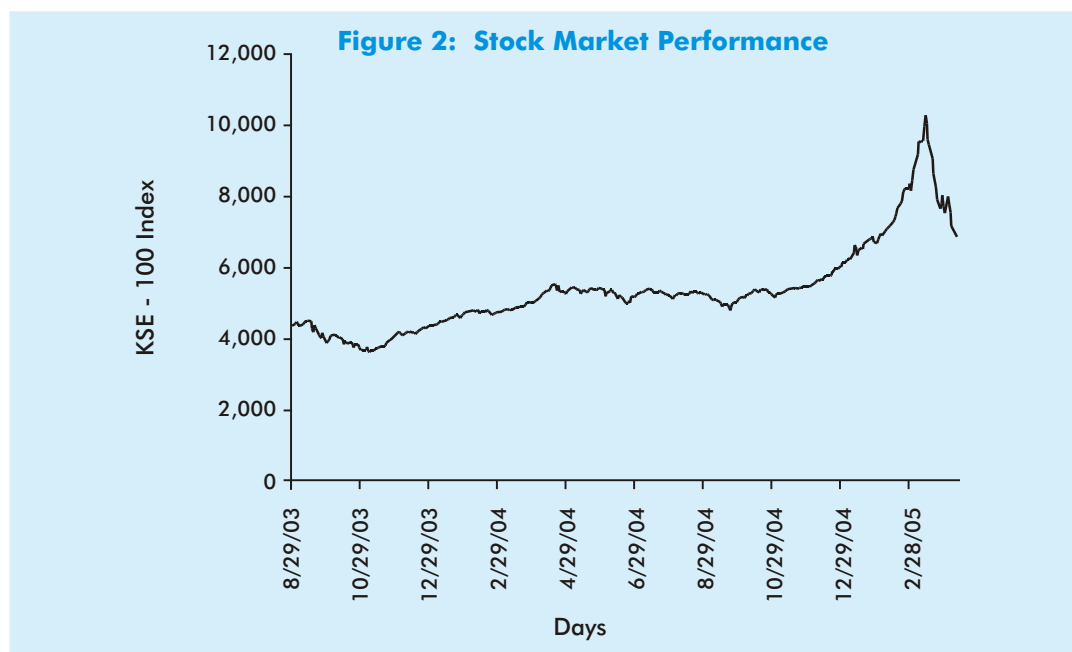
growth in federal non-tax receipts, as Pakistan Telecommunication Authority (PTA) transferred more than Rs 17 billion to the federal budget out of its receipts for issuing licenses for various types of telephone services. The receipt of dividends from state-owned enterprises also increased by 27.1 percent to Rs 32.4 billion, as profits of the PTCL, OGDC, and other SOEs increased.

1. The sharp decline in development surcharge on petroleum was partly offset by higher receipts from other taxes on petroleum, like import duty, sales tax, and excise, which together increased by 24.8 percent due to increase in oil prices.

CBR tax collection data, now available up to March 2005, shows that tax receipts picked up in the last month, and as a result, cumulative receipts in the first three quarters of FY2005 increased by 13.5 percent compared with the same period of last year. The increase in tax receipts was marginally above the target, but fell short of the projected growth in nominal GDP (14.5 percent), and unless tax collection picks up significantly in the last quarter, the tax-to-GDP ratio will decline. The largest increase was seen in customs, which accounted for more than one-third of the increase in CBR revenues. Excise, sales tax on imports, and income tax also recorded high growth. Only sales tax on domestic production declined, mainly due to the exemption for ginned cotton announced in the FY2005 budget, which contributed Rs 14.0 billion last year.² However, the decline in this tax in the third quarter was much smaller (7.7 percent) than in the second quarter (16.3 percent), and it is expected that the sales tax collection will pick up in the last quarter.

Stock Market: Shares prices, after declining in the first quarter of FY2005, increased in the subsequent two quarters (see figure 2). Particularly sharp increase was seen in the first two and a half months of calendar year 2005, when the KSE-100 index rose by 62.1 percent to 10,303 on 15th March 2005. Most pronounced increases were recorded in shares of oil and gas, telecom, and cement companies. Higher corporate earnings announcements, privatization of some state-owned enterprises through the stock market, announcement of privatization plans of some major public sector enterprises (PSEs), and large injection of foreign portfolio investment³ were the main factors behind the sharp increase in share prices. There was also 'following the herd' buying, as well as speculative buying, particularly in the first half of March 2005 when the KSE-100 index rose by 21.0 percent. Share prices had risen too high to be sustained, with excessive exposure of banks and brokers. The subsequent technical correction turned into

Unless tax collection picks up significantly in the last quarter, the tax-to-GDP ratio will decline.



- About 90.0 percent of sales tax on ginned cotton last year was collected in the second and third quarters of the year.
- The market attracted foreign investment of \$82.3 million in the first eight months of FY2005 in contrast with a divestment of \$38.5 million in the same period of last year.

a rout and the KSE-100 index declined to 7,124 on 13th April 2005.

External Sector

Merchandise Trade: High domestic demand and a sharp increase in oil prices resulted in a rapid growth in imports, putting pressure on the balance of payments. Compared with the first three quarters of FY2004, imports increased by 37.8 percent to \$14,469 million.⁴ Exports rose by 14.6 percent to \$10,207 million. Growth of imports thus far has been much higher than the target set in the Trade Policy announced in July 2004. Export growth has also exceeded the target, but only by a small margin.

There was a sharp deceleration in export growth in the second quarter of FY2005 to 3.4 percent from 16.8 percent in the first quarter (see figure 3). A particularly sharp deceleration was seen in textile exports presumably due to foreign importers withholding orders for Pakistan textile goods in anticipation of the discontinuation of the quota regime in January 2005. Textile exports declined by 15.7 percent in the second quarter compared with an increase

of 9.7 percent in the first quarter. Disaggregated export data is not available after December 2004, but aggregate data, available up to March 2005, shows a sharp increase of 33.0 percent in each of the last two months. This is presumably due to a turn-around in textile exports, which account for about two-thirds of total exports.

Item-wise break-down of exports, available only up to December 2004, shows that textile exports declined by 2.5 percent to \$3,736 million in the first half of FY2005 (see table 4).⁵ Export of bedwear suffered the largest decline (\$150 million or 23.0 percent), possibly due to the 13 percent anti-dumping duty imposed by the European Union, which is currently the largest importer of Pakistani bed linen. Art silk and synthetic textiles, readymade garments, and cotton yarn also recorded significant declines. Readymade garments had shown a robust increase of 18.1 percent in the first quarter of the year, but declined sharply by 68.3 percent in the second quarter, resulting in a cumulative decline of 20.3 percent in the first half of the year. Only knitwear and towels showed significant increases. Knitwear export increased by 41.3 percent

There was a sharp upturn in exports in February and March 2005.

Figure 3: Quarterly Growth of Exports



4. These are cif imports, which differ from fob imports discussed later under current account.

5. This is in contrast with last two years, when textiles led the growth in exports.

Table 4: Growth in Exports (Million US\$)

Commodities	July - December		% Change
	FY2004	FY2005	
Primary commodities	505	541	7.2
<i>Of which:</i>			
Rice	311	344	10.6
Fish and fish preparations	87	68	-22.3
Textile manufactures	3,832	3,736	-2.5
<i>Of which:</i>			
Cotton yarn	517	448	-13.4
Cotton cloth	768	785	2.2
Knitwear	698	987	41.3
Bedwear	654	504	-23.0
Towels	174	210	20.2
Readymade garments	489	389	-20.3
Art silk and synthetic textiles	285	155	-45.5
Made-up articles	213	14	-93.3
Other manufactures	1,056	1,126	6.6
<i>Of which:</i>			
Carpets	108	105	-3.0
Petroleum products	103	184	79.3
Sports goods	145	129	-10.9
Tanned leather	117	135	15.5
Leather manufactures	224	195	-12.8
Chemical and pharm. products	135	151	11.3
Others	488	1,092	123.8
Total	5,881	6,496	10.5

Source: Federal Bureau of Statistics (FBS) Website

to \$987 million and emerged as the largest item among textile exports. The bulk of the increase in knitwear exports was due to higher volumes. Export of towels increased by 20.2 percent, entirely because of increase in volumes.

Export of primary commodities, which had stagnated last year, picked up and increased by 7.2 percent in the first half of FY2005, solely because of large increases in export of non-Basmati rice, raw cotton, and oil seeds. Increase in the export of the last two items reflects the bumper cotton crop harvested this year. Export of non-Basmati rice increased by 33.7 percent in

the first half of FY2005, after remaining more or less constant in the last three years. However, prospects of its export have become somewhat uncertain with the imposition of a heavy import duty by Kenya, which is a major importer of coarse rice from Pakistan. Export of Basmati, which had grown rapidly in the last three years, stagnated in the first half of FY2005.

Among non-textile manufactures, export of petroleum products increased sharply by 79.3 percent to \$184 million in the first half of FY2005. Increases in both volume and price contributed to the increase. The export of other non-classified

items more than doubled to \$1,092 million and accounted for 98.2 percent of growth in total exports. However, as no breakdown of these exports is available, it is not possible to analyze them in depth.

Growth in imports in the first half of FY2005 was broad-based, with all categories showing high double-digit growth (see table 5). Petroleum and petroleum products, which increased by 37.9 percent to \$1.9 billion, led the import growth and accounted for more than one-fifth of the total increase in imports. Food imports increased by 17.2 percent. Non-food, non-oil imports also increased sharply by 35.8 percent on the back of a 38.0 percent increase last year.

Both higher prices and larger import volumes pushed up the import bill for petroleum crude and petroleum products, which emerged as the single largest item in country's import bill in the first half of FY2005. Unit values of petroleum products and petroleum crude increased by 18.2 percent and 12.2 percent, respectively, while their import volumes swelled by 14.0 percent and 25.1 percent. Higher import volumes reflected continuing robust economic growth and additional demand for furnace oil for power generation to make up for decline in hydel generation due to the water shortage. A sharp increase in automobiles sales in the last two years also pushed up demand for petroleum products.

Table 5: Growth in Imports (Million US\$)

Commodities	July - December		% Change
	FY2004	FY2005	
Food group	493	578	17.2
<i>Of which:</i>			
Edible oil	332	346	4.3
Tea	94	104	10.1
Machinery	1,288	1,742	35.3
<i>Of which:</i>			
Power generating machinery	144	172	19.4
Textile machinery	266	451	69.9
Vehicles	308	390	26.6
Petroleum group	1,356	1,870	37.9
Petroleum products	599	808	34.8
Petroleum crude	756	1,062	40.4
Textile group	133	165	24.8
Fertilizers and other chemicals	1,308	1,798	37.5
<i>Of which:</i>			
Fertilizers	174	225	29.5
Plastic materials	245	367	49.7
Metal group	317	472	49.2
<i>Of which:</i>			
Iron and steel	278	429	54.1
Others	1,403	1,890	34.7
Total	6,604	8,905	34.8
Non-food non-oil imports	4,755	6,457	35.8

Source: FBS Website

Large increases in import of machinery and raw materials and intermediate goods, observed in the last two years, continued in the first half of FY2005. Machinery imports were up by 35.3 percent. Particularly large increase was recorded in the import of textile machinery (69.9 percent), reflecting the continuing investment in textile industry to prepare for the quota-free regime after December 2004. Import of construction and mining, agricultural, and other machinery also increased by 42.1 percent, 66.9 percent, and 47.0 percent, respectively, which indicates a broad-based increase in investment. Raw materials and intermediate goods like completely knocked down

automobile kits, iron and steel, plastic materials, fertilizers, pesticides, and synthetic fiber also recorded substantial increases.

Current Account: The balance of payments position weakened significantly in the first eight months of FY2005, as the current account, excluding official transfers, turned into a deficit of \$ 0.9 billion from a surplus of \$1.5 billion in the same period of FY2004 (see table 6). The sharp deterioration in the current account was mainly due to substantial increases in the trade deficit and the deficit on the services account. There was a more than five-fold

Table 6: Balance of Payments (Million US\$)

	July - February		% Change
	FY2004	FY2005	
Trade balance	-536	-3,019	463.2
Exports	8,138	9,223	13.3
Imports	8,674	12,242	41.1
Services (net)	-599	-2,104	251.3
Income (net)	-1,389	-1,534	10.4
<i>Of which:</i>			
Interest	745	605	-18.8
Current transfers (net)	4,514	5,543	22.8
<i>Of which:</i>			
Workers remittances	2,546	2,606	2.4
Resident FCAs	438	565	29.0
Saudi oil facility	302	0	
Current account (net)	1,990	-1,114	
Current account (net) excluding official transfers	1,547	-908	
Capital account (net)	61	565	826.2
<i>Of which:</i>			
Debt forgiveness	0	495	
Financial account	-1,574	-31	-98.0
<i>Of which:</i>			
Foreign direct investment	385	599	55.6
Disbursement of foreign assistance	555	1,835	230.6
Amortization	1,993	1,169	-41.3
Errors & omissions	155	113	-27.1
Official reserves	10,820	9,852	-8.9

Source: SBP Website.

External debt decreased from 37.4 percent of GDP to 35.4 percent.

increase in trade deficit to \$3.0 billion, as imports increased by 41.1 percent, compared to 13.3 percent increase in exports. Large increase in trade-related freight charges and payments for other business services resulted in more than tripling of deficit in the services account to \$2.1 billion. In addition, the Saudi Oil facility, under which there was an inflow of \$302 million in FY2004, was no longer available.

Capital and Financial Account:

The capital account improved sharply in the first eight months of FY2005, showing a surplus of \$565 million compared with \$61 million in the same period of FY2004 -- primarily due to debt forgiveness of \$495 million by the USA. The financial account also improved substantially, and its deficit declined to only \$31 million from \$1.6 billion in the same period of last year, mainly because there was a large prepayment (\$1.2 billion) last year. Disbursement under long-term program assistance increased more than three-fold to \$1.8 billion, while short-term lending by the Islamic Development Bank rose from \$8 million to \$236 million. Mainly because of \$600 million raised through Islamic bonds in January 2005, shown under debt securities, there was an inflow of \$522 million on account of debt securities compared with \$419 million last year. Foreign direct investment also increased by 55.6 percent to \$599 million. Increases in inflows were partly offset by larger repayments by the private sector including a pre-mature repayment of \$347 million by the Pak Arab Refinery.

Foreign Exchange Reserves:

Foreign exchange reserves held by SBP declined by \$0.7 billion to \$9.9 billion in the first eight months of FY2005. At present⁶ reserves stand at \$10.2 billion, and are

sufficient to finance 6.7 months of merchandise imports. The reserves had declined to \$9.2 billion in November, as the balance of payments position worsened and SBP intervened in the inter-bank market to support the Rupee. Subsequently, inflows from the issue of Islamic bonds, increase in disbursement of foreign assistance, and foreign investment in the stock market, led to increase in reserves. The Rupee depreciated from Rs 57.92/US\$ as of end-June 2004 to Rs 59.35/US\$ in January 2005.

Pakistan's external debt and liabilities increased by 4.1 percent to \$36.7 billion in the first half of FY2005. However, a large part of the increase was due to the valuation effect, as the US Dollar depreciated vis-à-vis Euro, Pound Sterling, and Yen. As a percentage of GDP, external debt and liabilities decreased from 37.4 to 35.4.⁷

Outlook

Based on robust growth in the real sectors of the economy thus far, sharp increase in non-oil non-food imports, particularly machinery and industrial raw materials, and continuing high domestic demand, GDP is projected to grow by at least 7.0 percent in FY2005 (see table 7). The agriculture sector is expected to grow at 5.0 percent, as output of cotton, the most important cash crop, is estimated to be as much as 46.0 percent higher than last year. Also, wheat output is estimated at 22 million tons, which is 10.6 percent higher than last year. More than 60.0 percent increase in import of agricultural machinery in the first half of FY2005 and a 50.8 percent increase in gross disbursement of agriculture credit in the first eight months of the year also point to better prospects of the agriculture sector.

GDP is projected to grow by at least 7.0 percent in FY2005.

6. As of 9th April 2005.

7. Outstanding domestic debt declined from 36.3 percent of GDP as of end-June 2004 to 32.7 by 31st January 2005. Thus total public debt as a percentage of GDP declined to 68.1 from 73.7 as of end-June 2004.

Table 7: Outlook

	FY2003	FY2004	Projections
			FY2005
	(Annual changes in percent)		
Real GDP	5.1	6.4	7.0
Agriculture	4.1	2.6	5.0
Large-scale manufacturing	7.2	17.1	14.0
Other sectors	5.1	6.1	6.5
Inflation (CPI)	3.1	4.6	7.5
Merchandise exports	22.2	10.0	11.0
Merchandise imports	18.2	26.6	30.0
	(In percent of GDP)		
Budgetary deficit*	4.5	3.9	3.1
Trade balance	-0.4	-1.4	-3.9
Current account balance (including official transfers)	4.9	1.9	-1.7

* Consolidated budget deficit of Federal and Provincial Governments.
Sources: (1) Pakistan Economic Survey 2003-04, Government of Pakistan.
(2) Asian Development Outlook 2005, Asian Development Bank.

The growth in manufacturing in FY2005, while less than last year, is likely to be a robust 14 percent, given the strong recovery in investment in the sector seen last year and continuing high demand. Sharp increase in flow of credit to the private sector in the first nine months of the current year indicates that high growth of the manufacturing sector is being sustained. A large increase (70.7 percent) in consumer finance is driving growth in production of automobiles and electronics. Investment demand has gained further strength, as reflected in 35.3 percent increase in import of machinery in the first half of the year. Continuing modernization of the textile industry, cheaper and abundant availability of cotton, and the end of the quota regime in textile trade since January 2005 will boost the textile industry (see special section on Prospects of Exports Post-MFA). Increase in lending rates in the first eight months has been quite modest. Although interest rates are expected to rise more sharply in the last quarter, their impact will be generally seen next year.

The two other important sub-sectors in the industrial sector are construction and electricity generation and distribution. Expansion in construction will be sustained, supported by easy availability of housing finance from banks, particularly after the recent removal by the SBP of the ceiling of Rs 10 million on the amount of bank loan for housing to a single party. In addition, enhanced allocation for the public sector development program will boost construction in the public sector. Value-added in electricity generation and distribution, on the other hand, is likely to be adversely affected due to shortage of water in the first half of the year.

Services sector growth is also expected to increase in FY2005. The high growth in the telecommunication sector is likely to accelerate further, as companies given 193 licenses in 2004 for various types of telephone services, start their operations. One new cellular phone company, Telenor, and two WLL licensees, PTCL and Telecard, have already started their

Manufacturing is likely to grow by 14 percent in FY2005.

Inflation for full FY2005 is projected to exceed 7.5 percent.

operations. The banking sector is also expected to register robust growth, as it has been strengthened through reforms and privatization, and is expanding its lending operations in new areas. Most banks reported robust increase in their profits in the first half of the year. And the large increase in imports will boost growth in wholesale and retail trade.

With 12.7 percent increase in money supply in the first three quarters of FY2005, most industries operating at or near full capacity, and a large monetary overhang from the last three years, inflation for the full FY2005 is projected to exceed 7.5 percent, despite some dampening effect of expected good wheat crop on food prices.

With GDP growth expected to exceed 7.0 percent, imports maintaining very high growth, and tax reforms of the past several years beginning to pay off, CBR tax revenues should achieve the target of Rs 580 billion. Non-tax revenues, like dividends from Pakistan Telecommunication Company Limited and Oil and Gas Development Corporation and license fees for telephone services are expected to exceed the target. However, there will be a shortfall in receipts from surcharge on petroleum products, as the Government did not pass on the increase in international oil prices to domestic consumers until 15th December 2004. As regards expenditure, interest payments are expected to remain on target. Defense expenditure, the second largest expenditure item, may exceed the target due to army operation against foreign militants in the tribal areas. Subsidies to the two state-owned power companies will also be larger than budgeted because of their additional losses, resulting from higher fuel prices as well as substitution of high-cost thermal for low-cost hydel electricity due to water shortage. Similarly, TCP will incur large losses in its trading operations pertaining to import of wheat and urea and procurement of cotton. On balance, though, the

The fiscal deficit target is likely to be achieved in FY2005.

over-run in expenditure, due to higher subsidies and possibly defense expenditure, is expected to be offset by higher revenue receipts, and the fiscal deficit target of 3.1 percent of GDP for FY2005 is likely to be achieved.

High economic growth, sharp increase in oil prices, additional requirement of furnace oil for thermal power generation, and import of wheat and additional 100,000 tons of urea during the year will result in rapid import growth. Exports took a sharp upturn in the last two months, which is likely to be sustained in the remaining part of FY2005, given the end of textile and clothing quotas since January. However, increase in exports for the full year will fall short of that in imports by a wide margin, and the trade deficit will increase further. This, along with the expanding deficit on the services account and absence of the Saudi Oil Facility will increase the current account deficit.

With sound macroeconomic fundamentals and pick up in investment, medium-term outlook of the economy looks bright. Continuity of policies over the last four years has enhanced investor confidence. The Government's active debt management policy and tax reforms are expected, respectively, to further reduce the debt service burden and boost revenues. The resulting fiscal space will allow the Government to increase investment in physical infrastructure and allocate more resources for operation and maintenance, as well as raise allocations for basic social services, such as education, health, and safe drinking water.

The financial system, greatly strengthened by reforms implemented over the past several years, is also well positioned to support higher economic growth over the medium term. Such reforms, together with privatization, have resulted in a more resilient and efficient financial system that is

better placed to absorb macroeconomic shocks and mobilize and allocate financial resources more efficiently.

Significant improvement in Pakistan's relations with India in the last year has also enhanced the economic outlook by reducing security concerns and by improving prospects of intra-regional trade in South Asia.

To keep the economy on a high growth path, the Government will need to rigorously pursue prudent macroeconomic policies to curb rising inflation, which can undermine the stability of exchange rate, distort investment incentives, and eventually stall growth.

II. POVERTY REDUCTION

Agricultural Growth and Rural Poverty

Recently, PRM, ADB published a paper on Agricultural Growth and Poverty (Working Paper II, March 2005). Among other things, the paper attempted to explain why a reasonably high agricultural growth (4.6 percent per annum) in the 1990s did not translate into reduced levels of poverty. The two main explanations, given in the paper, are: 1) the agricultural growth rate in the 1990s was overstated; and 2) there were wide fluctuations in agricultural growth from year to year. All the growth in livestock sector revealed in the livestock survey of 1995-1996 was counted in that year, instead of being spread over the decade since the previous survey. As a result, the growth in the livestock sub-sector in that year was inflated to 26.4 percent, which raised agricultural growth for the year to 11.7 percent. Once adjusted for this spike, average annual growth rate of the agriculture sector was only 3.1 percent, which translates to only 0.6 percent in per-capita terms.

Agricultural production in the 1990s was highly erratic, particularly in the case of wheat and cotton. Crop failures and natural calamities, which pull agricultural growth down in any given year, push rural households just above the poverty line into poverty. This is particularly true in the case of Pakistan, where the incidence of transitory poverty is high. Households pushed into poverty in a bad year take many years to come out of it. This has a very important implication for policy making. While a minor shock may push households into poverty, a little assistance, say, in the form of employment, can help them escape it.

Another very interesting finding of the paper was that the incidence of poverty has been consistently lower in rain-fed rural

areas of Punjab than in any other part of the country since 1985, according to various poverty studies. This is explained by better integration of these areas with large urban centers, which give them more stable sources of income. Agriculture, which is subject to vagaries of nature, has progressively declined in importance as a source of income for households living in these areas. The incidence of poverty is the highest in those areas, which rely most on crop income. This is particularly evident in cotton growing areas of Punjab and Sindh.

The skewed land distribution is one of the major hindrances in poverty reduction. More than half of farms are smaller than five acres. Smaller farms tend to be less diversified, dependent on one or two crops, and hence more vulnerable to poverty. Dependence of small farmers on cotton, which tends to be very erratic, seems to be a major cause of poverty in the cotton belt. It is necessary to provide small farmers with technology and markets to help them diversify their sources of income.

The incidence of poverty in sharecroppers is considerably higher than even small farmers who cultivate their own land or cultivate the land of others at a fixed rent. There is no effective mechanism to monitor the implementation of existing tenancy laws. As a result, tenancy arrangements lead to exploitation of sharecroppers.

Poverty Reducing Public Expenditure

The pro-poor budgetary expenditure during the first half of FY2005, at Rs 124.7 billion, was 26.5 percent higher than the corresponding period in FY2004 (see table 8). As a percentage of the annual GDP, the pro-poor expenditure increased from 1.8 in the first half of FY2004 to 2.0 in FY2005, reflecting a continuing strong commitment of the Government to poverty reduction. Non-budgetary transfers targeting the poor,

Households pushed into poverty in a bad year take many years to come out of it.

Poverty has been consistently lower in rain-fed areas.

Table 8: PRSP Expenditure (Billion Rs)

	July - December		% Change
	FY2004	FY2005	
Access to Market and Community Services			
Roads	4.9	9.6	97.3
Water supply & sanitation	1.6	2.2	37.9
Sub-total	6.4	11.8	82.9
Human Development			
Education	43.7	50.0	14.5
Health	10.1	12.3	21.9
Population planning	1.2	1.6	27.2
Sub-total	55.0	63.9	16.2
Development of Rural Areas			
Irrigation	8.6	12.5	45.7
Land reclamation	0.8	1.1	27.8
Rural development	5.2	6.7	28.7
Rural electrification	0.5	0.4	-29.9
Sub-total	15.2	20.7	36.2
Social Safety Nets			
Social security & welfare	0.6	2.0	216.7
Natural calamities	0.4	0.2	-40.7
Food subsidies	2.0	1.1	-47.8
Food support program	1.2	2.1	64.9
Low cost housing	0.02	0.2	990.5
Tawana Pakistan	-	0.1	-
Sub-total	4.3	5.6	29.9
Governance			
Administration of justice	1.1	1.4	30.9
Law and order	16.6	21.3	28.8
Sub-total	17.6	22.7	28.9
Grand total	98.5	124.7	26.5
Total PRSP expenditure as % of GDP	1.8	2.0	

Source: PRSP Progress Report for the Second Quarter of Year 2004-05, PRSP Secretariat, Finance Division, Government of Pakistan

however, declined by 29.4 percent to Rs 2.8 billion.

Pro-poor expenditure has been grouped under the following heads: improving access of the poor to market and community services, fostering human development, accelerating development of rural areas, improving governance, and providing safety nets. Expenditures under all these

heads recorded increases in the first half of FY2005, with the sharpest increase being in expenditure on access to market and community services (82.9 percent), followed by development of rural areas (36.2 percent), social safety nets (29.9 percent), and governance (28.9 percent). Expenditure on human development showed the lowest increase of 16.2 percent.

Pro-poor expenditure on core sectors increased by 19.8 percent.

Of the 17 sectors identified for pro-poor expenditure, education, health, population planning, social security and social welfare, water supply and sanitation (WSS), and rural development may be considered core areas. Total expenditure in these sectors, at Rs 74.7 billion, represented an increase of 19.8 percent compared with the first half of FY2004, which was much lower than the overall increase in PRSP expenditure.

Expenditure on education, which accounts for 40.1 percent of the total pro-poor expenditure, increased by 14.5 percent to Rs 50.0 billion in the first half of FY2005. As a percentage of GDP, it remained more or less unchanged. It is not possible to analyze trends in expenditure on various levels of education because of classification problems. As much as 21.8 percent of total expenditure on education has been shown against other non-classified education, which also accounts for 129.1 percent of the overall increase in expenditure on education. Because of the failure to assign this large increase in expenditure to individual sub-sectors of education, all sub-sectors except secondary education show decline. Obviously, these declines are spurious and will not be there if expenditure data is properly classified.

Expenditure on health increased by 21.9 percent to Rs 12.3 billion. Growth in expenditure varied substantially between various levels of health services. Expenditure on health facilities and preventive measures increased by 44.8 percent and that on general hospitals and clinics increased by 19.0 percent. Development expenditure by the Federal Government, mainly on lady health workers, accounted for more than four-fifths of the total increase in expenditure on preventive health measures. In the case of general hospitals and clinics also, development expenditure more than tripled, the Government of Punjab undertaking the bulk of the expenditure. There was no change in expenditure on

The non-budgetary transfers decreased by 29.4 percent.

mother and child care.

Among other categories of pro-poor expenditure, the Government of Punjab spent Rs 229 million on low-cost housing in the first half of FY2005 compared with Rs 21 million in the same period of last year. None of the other three provincial governments or Federal Government spent anything on this account. In the area of governance, expenditure on law and order increased by 28.8 percent to Rs 21.3 billion and that on justice administration by 30.9 percent to Rs 1.4 billion.

The non-budgetary transfers under Zakat (an Islamic welfare fund), employees old age benefits, and microcredit in the first half of FY2005 were 29.4 percent lower than in the same period last year. The number of beneficiaries of these transfers showed an even sharper decline of 60.0 percent. Credit disbursed through the partner organizations of the Pakistan Poverty Alleviation Fund, the largest source of microcredit, declined and so did the number of borrowers. Disbursement of microcredit by the Khushali Bank, at Rs 832 million, showed a more than three-fold increase compared with the first half of FY2004. There was a more than four-fold increase in the number of female beneficiaries.

Intermediate Human Development Indicators

Data on intermediate indicators for education and health is used for assessing the impact of increased public expenditure on these services in the short run. In education, the number of functional primary and middle schools and their proportion with four basic facilities (i.e., water, latrine, electricity, and boundary wall) are used as intermediate indicators. Data on intermediate indicators for education is not available. Data on four intermediate health indicators - average utilization rate of First

Level Care Facilities (FLCF)/day, births attended by skilled birth attendants, FLCFs not experiencing stock-out, and availability of contraceptives at FLCFs - shows that

there was a deterioration in almost all these indicators (see table 9). Only the coverage of rural population by Lady Health Workers showed an improvement.

Table 9: Intermediate Indicators for Health

	FY2004	FY2005
Average utilization rate of FLCFs (Curative - -average number of cases per day per facility) ¹	130	112
LHW coverage (% of population) ²	50.0%	57.8%
Immunization coverage (% of target population) ³		
TT-I	39%	38%
TT-II+	43%	41%
Births attended by skilled birth attendants ³	13%	11%
Availability of contraceptives in FLCFs (%of FLCFs) ³	70%	61%
FLCFs not experiencing stock-out (%) ³	29%	25%

1 Also includes hospitals, data for Oct-Dec 2003 and Oct-Dec 2004 (exclusive of Punjab data for FY05)

2 Data for whole FY2004 and upto December 2004 for FY2005

3 Data for Oct-December 2003 and Oct-December 2004 (exclusive of Punjab data for FY2005)

Special Section: Prospects for Exports Post-MFA⁸

Introduction

The advent of a quota-free regime in textiles and clothing (T&C) from January 1, 2005 heralds a potentially seismic shift in global trade flows. Along with many other developing countries dependent on T&C exports, a large question mark hangs over Pakistan's textile and clothing sector after the abolition of the global quota regime. The fading out of the Multi-Fibre Agreement

(MFA), to be replaced by the prospect of free global trade, throws open a \$400 billion market to fierce competition among the world's top T&C exporting nations (see table 10).

The T&C sector exerts a disproportionately large influence on Pakistan's economy. Value-added in T&C amounts to approximately 10 percent of GDP, with the sector accounting for over 40 percent of the country's manufacturing output. In addition, almost 40 percent of industrial employment is associated with this sector.

Table 10: World's Top T&C Exporter Nations

Rank	Country	1990	2003
Textile			
Million US\$			
1	EU	50,795	58,938
2	China (incl HK)	15,432	39,985
3	US	5,039	10,917
4	Korea	6,076	10,122
5	Taipei, Chinese	6,128	9,321
6	India	2,180	6,510
7	Japan	5,859	6,431
8	Pakistan	2,663	5,811
9	Turkey	1,440	5,244
10	Indonesia	1,241	2,932
Clothing			
1	China (incl HK)	25,075	75,213
2	EU	40,782	59,947
3	Turkey	3,331	9,937
4	Mexico	587	7,343
5	India	2,530	6,459
6	US	2,565	5,537
7	Bangladesh	643	4,326
8	Indonesia	1,646	4,105
9	Romania	363	4,069
10	Thailand	2,817	3,615

Source: WTO

8. This section was prepared by Saqib Sheerani, Chief Economist, ABN Amro Bank, Islamabad.

In terms of exports, Pakistan's dependence on the T&C sector is even more skewed. For 2003 T&C exports accounted for over 70 percent of total export earnings for the country - the highest dependency ratio for any major player in the world (with Bangladesh at second -- see table 11).

It is clear from the foregoing that any impact (either positive or negative) on Pakistan's T&C exports in the post-MFA regime will have substantial second-order repercussions on the economy. While so far, indications point to the fact that Pakistan is likely to be amongst the major beneficiaries of the move to a freer trading regime, the outcome is far from assured. According to anecdotal evidence, export orders in different product categories are at elevated levels since January this year, boosting the chances of a fairly large windfall to the country's T&C industry. However, at the same time, reports also indicate that order books in certain other important categories (principally in knitwear) are not very healthy, suggesting that the impact will not be even across Pakistan's T&C sector.

Outlook

Which countries stand to gain the most from the demise of MFA? Most studies on

the likely impact of the MFA phase-out conclude that China and India stand to gain the most from the regime change in global T&C trade. In fact, between 1990 and 2003 these two nations, China in particular, have captured a larger share of world T&C exports than Pakistan has managed to - with China's global market share gaining over 23 percentage points, India's 2.3 percentage points, and Pakistan's 1.1 percentage points. As confirmation of a likely trend in the coming months, in January this year the first month since the removal of quotas China's T&C exports to the US have reportedly jumped 65% year-on-year in terms of value. Preliminary data from US customs also indicates a significant rise in export volumes in different categories from both Pakistan and India (corresponding data for the EU was not available at the time of writing).

Even relative newcomers such as Vietnam, without the benefit of being a major cotton-growing nation, or having an established textile sector, have captured a greater market share in apparel exports in the inter-decade period (table 12). This suggests the operation of certain constraints in the case of Pakistan that have prevented it from achieving its full potential as a major apparel producer and exporter.

Pakistan is likely to be among the major beneficiaries of the move to a freer trade regime.

Table 11: Share (%) of T&C in Total Exports - Selected Countries 2003

% of economy's total merchandise exports	Textile	Clothing	Total T&C
Pakistan	49	23	71
Bangladesh	7	62	70
Sri Lanka	4	50	54
Turkey	11	21	33
India	12	12	23
China	6	12	18
Indonesia	5	7	12

Source: WTO

Table 12 : Global Market Share in T&C Exports - China, India & Pakistan

	Textile Exports		Clothing Exports	
	1990	2003	1990	2003
	(Billion US\$)			
World	104.4	169.4	108.1	225.9
China ¹	15.4	40.0	25.1	75.3
India	2.2	6.5	2.5	6.5
Pakistan	2.7	5.8	1.0	2.7
	Share (%)			
World	100.0	100.0	100.0	100.0
China ¹	6.9	15.9	8.9	23.0
India	2.1	3.8	2.3	2.9
Pakistan	2.6	3.4	0.9	1.2

1. Includes Hong Kong.
Source: WTO

Two problems that come immediately to the fore are those of high business costs, coupled with low labour productivity. According to a World Bank study, various production costs such as electricity, wages, sales and general administration, and interest and rent - were all substantially higher in the case of Pakistan's apparel manufacture as compared to China, India and Bangladesh.

This finding reinforces other work which tends to show that wages in manufacturing are higher in Pakistan than in most regional countries, while productivity levels tend to be lower (barring Bangladesh). Hence, the inescapable conclusion is that Pakistan's T&C exports are significantly disadvantaged because of cost/productivity differentials. One influential study (Gherzi, 1993 as quoted in World Bank 2004) has suggested that Pakistan's efficiency in the sector was 38 percent of globally feasible levels, while for firms in China this ranged from 40 to 65 percent.

Despite these drawbacks, Pakistan has managed to gain world market share in a number of product categories over the past few years. Using a market positioning matrix, which maps the dynamism of a country's exports relative to the world, the competitive positioning of Pakistan's top 50 exports at the 4-digit SITC level (in \$, for 2002) has been evaluated. The 50 export items analysed represented 78 percent of Pakistan's merchandise export receipts for 2002.

The matrix is divided into four quadrants, each representing relative performance of a product's exports compared to the world. The four possible outcomes are defined as:

- **Rising Stars:** Exports with a rising world market share in "dynamic" products (where world exports of product are growing faster than world merchandise exports);

Production costs in Pakistan's apparel manufacture are higher than China, India, and Bangladesh.

- **Lost Opportunities:** Exports where, prima facie, competitiveness is declining represented by falling market shares in "dynamic" products;
- **Falling Stars:** Exports with rising market shares in "non-dynamic" products (ie where global growth in exports is lower than growth in world merchandise exports);
- **Retreats:** Exports that are losing market share in "non-dynamic" products, which could represent a degree of desirable restructuring of the export mix.

The results are summarised in table 13, with the top ten product lines in each quadrant listed. Broadly, there are 11 product lines at the 4-digit SITC level where Pakistan is strongly-positioned in a "dynamic" product category ie the Rising Star quadrant. This quadrant has the highest concentration of products in terms of absolute export value. Together, this classification houses almost 25 percent of Pakistan's top 50 exports by value (combined 2002 exports: \$2,425 million), representing 1.15 percent of world merchandise exports. The major product lines include home textile products (household linens, curtains and other furnishing), other woven fabrics (cotton), trousers for women, and other articles of leather.

The next highest degree of distributional concentration of Pakistan's exports is in the Falling Stars category, which

accounts for approximately 23 percent of the top 50 exports (by value). Such a large concentration in "non-dynamic" products at the world level, is obviously not desirable in the long run. The main product lines falling in this quadrant include shirts (knitted), cotton fabrics unbleached, trousers, bibs and overalls, carpets etc, knotted, and other garments, knitted.

Retreats account for 22 percent of export products studied, with a fairly high share of world exports (0.84 percent). Amongst Pakistan's principal exports by value in this category are cotton yarn, fabrics woven of synthetic filament yarn, sports goods, other woven fabrics, and shirts.

Finally, Lost Opportunities representing those product categories that are "dynamic" at the world level, but where Pakistan's market share has been declining. While this quadrant is occupied by roughly only 8 percent of exports surveyed, the magnitude of opportunity is represented by the fact that these products account for 0.64 percent of world exports, which, in absolute terms, translated into \$37.2 billion for 2002. Principal exports by value in this quadrant include leather apparel and accessories, textile made-ups, medical instruments (other than dental instruments), and goat & kid skin leather.

Comparing our results with an earlier study (Ijaz Nabi, 1997), which covered virtually the entire range of manufactured

Almost 25 percent of Pakistan's top 50 exports are in the dynamic product category.

Summary of Matrix

	World Product export growth > World total export growth	World Product export growth < World total export growth
Pakistan Product export growth > World product export growth	Rising Star	Falling Star
Pakistan Product export growth < World product export growth	Lost Opportunity	Retreat

Table 13: Competitive Positioning of Pakistan's Major Exports

Rising Stars	Falling Stars
6584 - Household linens 6525 - Other woven fabrics, 85 percent cotton 6529 - Other woven fabrics, cotton 6585 - Curtains and other furnishings 6114 - Other bovine, equine leather 8426 - Trousers, bibs, braces for women 6129 - Other articles of leather 8454 - T-shirts, singlets, other vests 5138 - Polycarboxylic acids 6583 - Blankets, travelling rugs	8437 - Shirts, knitted 6522 - Cotton fabric, unbleached 8414 - Trousers, bib, brace overalls 6592 - Carpets etc knotted 8461 - Clothing accessories, not knitted or crocheted 8459 - Other garments, knitted 8447 - Blouses, shirts, shirt-blouses 6113 - Whole bovine skin 8432 - Suits, jackets, trousers knitted 8991 - Carved and molded goods
As % of total Pakistan exports: 24.5 percent	As % of total Pakistan exports: 23.4 percent
Lost Opportunities	Retreats
8481 - Leather apparel and accessories 6589 - Made-up articles of textile materials 8722 - Other medical instruments 6116 - Goat or kid skin leather 8511 - Footwear with metal toe-cap 5799 - Dried fruit	6513 - Cotton yarn 6531 - Fabrics woven of synthetic yarn 8947 - Sports goods 6523 - Other fabrics, containing more than or equal to 85 percent cotton 8415 - Shirts 6552 - Other knitted or crocheted fabrics 8458 - Other garments, not knitted or crocheted 6577 - Wadding, wicks, textile fabrics used in machinery or plants 8422 - Suits and ensembles 5798 - Other fresh fruit
As % of total Pakistan exports: 7.8 percent	As % of total Pakistan exports: 22.2 percent
Source: Author's calculations using UN Comtrade databases	

exports and included a cross-country comparison for the period 1985-1992, the share of Rising Stars appears to have slipped quite dramatically - from 60 percent of Pakistan's total manufactured exports, to around 25 percent of the surveyed sample for 2002. This represents a substantial erosion of strongly-positioned products in the country's export portfolio, and under-

scores the vulnerabilities associated with a heavy concentration in products with a low technological and low skill base.

These findings also reinforce what can be readily observed from Table 3 - the fact that between 1990 and 2003 Pakistan has managed to gain a larger world share in the export of textiles as compared to clothing.

Prospects for Pakistan's T&C Exports

Looking ahead, prospects for Pakistan's T&C exports can be categorised as both "upbeat" as well as "clouded by a number of concerns". While a significant segment of its T&C exports is competitively positioned, an excessive concentration in the low value added segment of the T&C chain, and the fact that Pakistan has been expanding its international market share in "non-dynamic" product categories which appear to be on a secular decline globally, gives cause for concern in the long run. In addition, the sense of vulnerability on this score is accentuated by the low tech nature of its production (implying low barriers to entry) - and concentration in T&C areas which are likely to be more susceptible to trade restrictive action by developed markets such as US and EU. The ineligibility of Pakistan's T&C exports to the EU's new GSP-Plus arrangement, together with the likelihood of Bangladesh, Vietnam and Sri Lanka making it to the final list of countries that is extended this key concession, will further disadvantage the country's apparel exports.

Finally, free trade agreements (FTAs) between the US and many of Pakistan's trade competitors in apparel, or the recent inclusion of ten Eastern European countries into the EU, is likely to result in a degree of trade diversion that could erode potential gains in the post-MFA regime.

Apart from the ever-present likelihood of T&C exports from developing countries being constrained by major importing nations' trade restrictive actions (via anti-dumping/safeguard measures) to protect domestic industry, a major constraining factor for Pakistan's T&C exports appears to be on the supply-side. Despite substantial investment over the last 3-4 years in this sector, it is believed the industry is still not

geared to smoothly handle incremental high-volume orders placed by any of the larger buying houses from the EU or US. Since these firms typically place orders in large quantities in one go, and will not have the incentive in the post-quota regime to distribute their orders over a large number of producing countries, the capacity constraint in Pakistan's T&C sector could play a role in determining the future flow of orders from US and European importers till such time this issue is redressed.

Nevertheless, in the interim, Pakistan's proximity to China and India could lead to secondary orders (or outsourcing) from suppliers to the US and EU in these two countries who may not have the installed capacity to service their order books. This is one avenue which Pakistani T&C exporters can capitalise upon, especially given the thaw in relations between the South Asian neighbours. It would appear that there is enough available capacity in Pakistan's T&C sector, as a result of the investments over the last three to four years, to handle the incremental orders from Chinese and Indian firms.

Conclusion

To conclude, on balance one can be cautiously optimistic about the prospects for Pakistan's T&C exports. However, Pakistan is unlikely to be amongst the biggest gainers of the abolition of quotas, with the honours going to China and India. By most estimates, the impact will not be even across different segments of Pakistan's textile and clothing sector, with textiles likely to gain substantially, and apparel exports losing out to stiff competition from the country's Asian neighbours. However, Pakistan could leverage its strong competitiveness in certain product categories within the clothing chain where a substantial boost in export earnings can be achieved.

The ineligibility of Pakistan for EU's GSP plus arrangement will disadvantage its apparel exports.

Pakistan could get secondary orders from Chinese and Indian suppliers to US and EU.

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