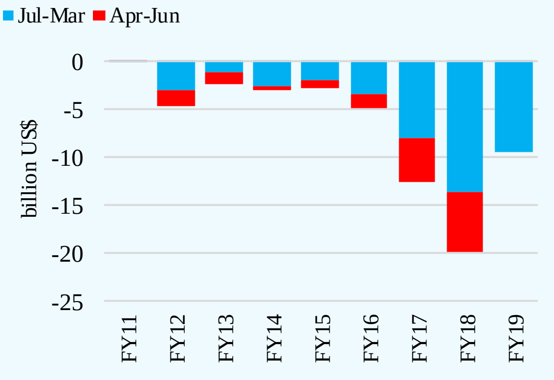
5 External Sector

5.1 Overview

The improvement in Pakistan's current account balance gained further momentum in Q3-FY19 as a significant decline in imports more than offset the stagnancy in exports and resulted in the shrinking of the merchandize trade deficit. Further support came from a substantial recovery in the services balance and healthy growth in workers' remittances. However, despite the contraction, the current account deficit (CAD) still remains at a higher level from the external account's stability perspective. The average CAD between FY11-15 was US$ 2.6 billion only, while this number is

Figure 5.1: Yearly Trend in Current Account Deficit



Data source: State Bank of Pakistan

Table 5.1: Pakistan's Balance of Payments
million US$

	Q3			Jul-Mar		
	FY18	**FY19**	***change***	**FY18**	**FY19**	***change***
Current account balance	-4,560.0	-2,022.0	2,538.0	-13,589.0	-10,345.0	3,244.0
Trade balance	-7,886.0	-5,820.0	2,066.0	-23,095.0	-21,813.0	1,282.0
Exports	6,463.0	6,170.0	-293.0	18,254.0	18,020.0	-234.0
Imports	14,349.0	11,990.0	-2,359.0	41,349.0	39,833.0	-1,516.0
Services balance	-1,299.0	-693.0	606.0	-4,320.0	-2,776.0	1,544.0
Primary income balance	-1,103.0	-1,237.0	-134.0	-3,683.0	-3,872.0	-189.0
Secondary income balance	5,728.0	5,728.0	0.0	17,509.0	18,116.0	607.0
Remittances	4,939.0	5,065.0	126.0	14,803.0	16,095.0	1,292.0
Financial account balance	-2,060.0	-5,486.0	-3,426.0	-9,395.0	-11,720.0	-2,325.0
FDI inflows (net)	709.0	478.0	-231.0	2,622.0	1,274.0	-1,348.0
Portfolio investment (net)	14.0	21.0	7.0	2,332.0	-398.0	-2,730.0
Eurobond/Sukuk	0.0	0.0	-	2,500.0	0.0	-2,500.0
FX liabilities (net)	1,456.0	5,539.0	4,083.0	4,673.0	11,234.0	6,561.0
SBP reserves (end-period)	11,602.0	10,492.0	-1,110.0	11,602.0	10,492.0	-1,110.0

Data source: State Bank of Pakistan

US$ 10.3 billion in Jul-Mar FY19 (**Figure 5.1**).[1]

The macroeconomic stabilization measures undertaken earlier resulted in a slowdown in economic activity in the country. The sizable decline in machinery imports following the conclusion of early phase of CPEC, lower quantum energy imports (excluding LNG) amid lower power generation in Q2 and Q3, and a temporary softening in global oil prices, all contributed significantly to improvement in the CAD by lowering of import payments.

Specifically, import payments dropped quite sharply in Q3-FY19 (**Table 5.1**). In percentage terms, it was the largest drop in almost 10 years, and was more than sufficient to offset a marginal contraction in exports in the quarter. Specifically, declines in both energy and non-energy import payments contributed to the sharper decline in overall imports in the third quarter. Energy imports had peaked in Q1, and then actually declined in Q3 for the first time in over two years. A sizable reduction in crude oil import payments, a moderation in LNG imports in the wake of lower power generation, and a temporary dip in global oil prices contributed to this decline in energy imports (**Section 5.5**). Meanwhile, the drop in the non-energy import payments, specifically machinery and transport, became more pronounced as the year progressed.

At the same time, workers' remittances registered a significant increase, particularly from the US and UK, on the back of improved macroeconomic conditions and wage rises in these countries. Moreover, increased efforts by the Pakistan Remittance Initiative (PRI) also helped attract higher remittances from the Pakistani diaspora.

Nonetheless, despite the improvement in the CAD, its management remains challenging, especially when exports and foreign investments did not show corresponding increases. In Jul-Mar FY19, foreign investments were unable to pick up, partially due to the looming uncertainty regarding the exchange rate adjustment and the finalization of the IMF program, which may have dented the investors' confidence. Besides, the lowering of Pakistan's credit rating by Fitch in December 2018, due to the country's external financing risk and deteriorating fiscal position, further exacerbated the situation.

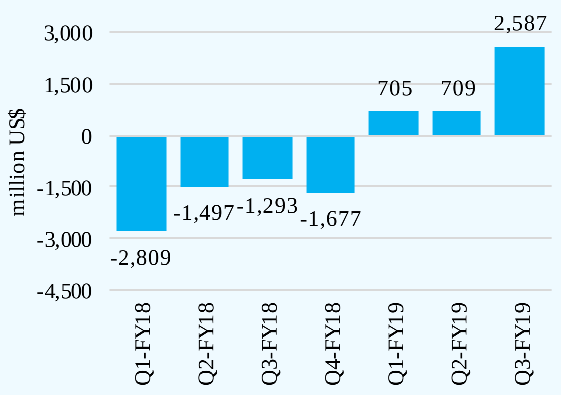
In particular, foreign direct investment declined both in Q3 and Jul-Mar FY19.

[1] FY11-15 was relatively more stable period for Pakistan's external sector after the global financial crisis. In terms of GDP, current account was 1.1 percent between FY11-15 and 4.7 percent during Jul-Mar FY19.

The drop was more pronounced in power and telecommunications; the former, being the flagship of the CPEC, was the key recipient of FDI in recent years. Similarly, private portfolio investment also witnessed a higher net outflow in Jul-Mar FY19.

While foreign investment was insufficient to bridge the current account gap, the external financing from bilateral (China, Saudi Arabia and the UAE) and commercial sources not only plugged the current account gap, but also provided some support to Pakistan's FX reserves in the third quarter. Resultantly, SBP's FX reserves jumped by US$ 3.3 billion in Q3-FY19. As a result, the Pak rupee remained relatively stable not only in the interbank market, but also in the open market during Q3.

Figure 5.2: YoY Change in Quarterly CAB



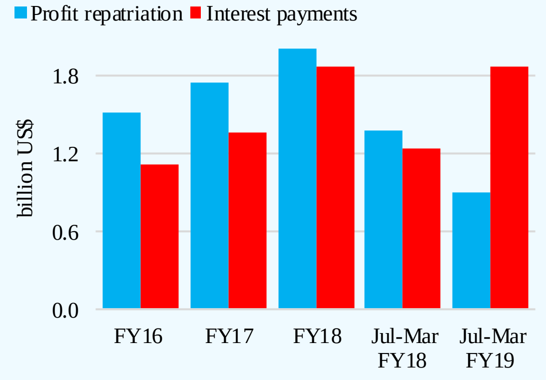
Data source: State Bank of Pakistan

5.2 Current Account

The current account deficit narrowed substantially to US$ 10.3 billion in Jul-Mar FY19, declining by US$ 3.2 billion from the same period last year. Importantly, the third quarter witnessed a pronounced improvement; the deficit fell to US$ 2.0 billion from US$ 4.6 billion, resulting in an improvement of US$ 2.6 billion in Q3-FY19, as both merchandize and services import payments declined (**Figure 5.2**).

The pressure on the primary income account continued to persist due to interest payments. The primary income deficit increased to US$ 3.9 billion in Jul-Mar FY19 from US$ 3.7 billion in the same period last year (**Figure 5.3**).

Figure 5.3: Profit Repatriation and Interest Payments



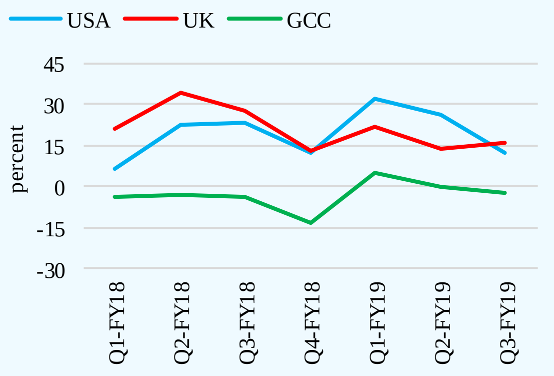
Data source: State Bank of Pakistan

While the repatriation of profit declined to US$ 0.9 billion from US$ 1.4 billion last year, it was more than offset by an increase in interest payments that climbed to US$ 2.3 billion in Jul-Mar FY19 from US$ 1.8 billion realized in the same period of FY18. This increase was driven by payments on short-term commercial borrowings. As the commercial borrowings are largely benchmarked with LIBOR, increase in the global interest rates contributed to the higher interest payments by Pakistan.

5.2.2 Workers' Remittances

Increased inflows in the workers' remittances further supported the CAB, which maintained its rising trajectory. Despite a slowdown in Q3 from key corridors, the momentum gathered in the previous two quarters propelled cumulative remittances to a record US$ 16.1 billion in Jul-March FY19 (**Figure 5.4**). Inflows were up 8.7 percent YoY in the period, almost double the growth rate of last year. Meanwhile, the growth in Q3-FY19 remained subdued at 2.6 percent on YoY basis.

Figure 5.4: Growth in Remittances from Key Corridors



Data source: State Bank of Pakistan

Pakistan Remittance Initiative (PRI) has intensified its efforts by launching campaigns in local and destination specific foreign media to encourage overseas Pakistanis to remit through legal means. Moreover, PRI facilitated local exchange companies to increase their tie-ups with the international money transfer operators. This may be supporting the higher remittances inflows in the ongoing fiscal year.

Table 5.2: Workers' Remittances to Pakistan
million US$

	Q3			Jul-Mar		
	FY18	**FY19**	**Abs. Change**	**FY18**	**FY19**	**Abs. Change**
Total	**4,939**	**5,066**	**127**	**14,803**	**16,096**	**1,293**
GCC	2,825	2,732	-92	8,616	8,704	88
S. Arabia	1,160	1,180	20	3,691	3,748	57
UAE	1,113	1,066	-47	3,277	3,415	137
Others	552	487	-65	1,648	1,542	-106
Non-GCC	2147	2333	187	6,187	7,392	1,205
US	697	784	87	2,037	2,517	480
UK	714	828	114	2,117	2,476	358
Malaysia	319	351	32	820	1,139	318
EU	164	125	-39	481	438	-43
Others	252	245	-7	732	823	91

Data source: State Bank of Pakistan

The country specific data suggests that the major impetus came from the non-GCC corridor, specifically the US, the UK and Malaysia (**Table 5.2**), as inflows from these countries increased by 23.5 percent, 17.0 percent and 39.0 percent respectively.

In fact, remittances from the US crossed the US$ 2.5 billion mark for the first time. The sharp increase from the US was primarily driven by higher economic activity. Tax reforms enacted by the US authorities have stimulated investment activities in the economy and resulted in low unemployment and increase in wages.[2] The unemployment rate in the US fell to 3.8 percent in March 2019, the lowest in the last 49 years.

Meanwhile, uncertainty in the UK over Brexit is fueling labor demand, as the firms are cautious on committing for long-term investment in case Britain crashes out of the European Union without any deal.[3] This situation is powering the labor wages in the UK, and leading to higher remittance outflow from the country.[4]

On the other hand, remittances from the GCC witnessed a marginal recovery of 1.0 percent in Jul-Mar FY19, after declining 3.2 percent in the same period last year. Nevertheless, the GCC remains the largest source of remittances for Pakistan. The moderate recovery in inflows from the GCC could be attributed to increased government spending in the Kingdom of Saudi Arabia (KSA). The Saudi government announced 7.0 percent increase in the state spending in 2019.[5]

5.3 Financial Account

Foreign investments in Pakistan failed to show improved picture in Jul-Mar FY19. While inflows in FDI remained substantially lower than the last year, the portfolio investment actually witnessed an accelerated outflow. Uncertainty regarding the exchange rate adjustment and finalization of IMF program, country's vulnerable external and fiscal position, and downgrading of Pakistan's credit rating by Fitch in December 2018 may have dented the investors' confidence.

[2] Source: Bloomberg available at, https://www.bloomberg.com/news/articles/2019-02-28/u-s-gdp-grows-above-forecast-2-6-as-business-spending-picks-up

[3] Source: Bloomberg available at, https://www.bloomberg.com/news/articles/2019-04-16/u-k-labor-market-remains-robust-as-employment-surges

[4] During March 2019, the UK's wage growth rate was 3.3 percent (source: Office for National Statistics, UK).

[5] Source: Reuters, available at https://www.reuters.com/article/us-saudi-arabia-budget-instant-view/saudi-2019-state-budget-boosts-spending-idUSKBN1OH1SG

Despite the unfavorable condition, Pakistan managed to finance its current account gap by the substantial external financing from friendly countries and commercial banks. Most of this financing was realized in the third quarter, which supported the country's depleting FX reserves.

Foreign direct investment

The net foreign direct investment in the country dropped 32.6 percent in Q3-FY19 over the same period last year. Cumulatively, net FDI plunged by 51.4 percent to US$ 1.3 billion in the first nine months of this fiscal year, from US$ 2.6 billion realized in the same period of FY18 (**Table 5.3**).

Table 5.3: Sector-wise Net FDI in Pakistan
million US$

	Q3		Jul-Mar	
	FY18	**FY19**	**FY18**	**FY19**
Construction	176	97.6	527.3	385.4
Oil & gas explorations	122.2	95.9	295.4	253.2
Financial business	85	45.4	361.2	247.6
Electrical machinery	2.9	1.9	13.8	126.6
Chemicals	-3.4	33.1	27.6	113.9
Beverages	-2.4	23.1	-7.2	86.3
Transport (automobiles)	10.1	29.9	11.6	84.3
Food	69	-20	82.9	-16.2
Telecommunications	3.2	-20.1	-12.1	-157.4
Power	108.1	35.7	929.1	-293.7
Others	138.9	155.5	392.1	443.8
Total	**709.6**	**478**	**2,621.7**	**1,273.8**
o/w: CPEC	69.7	27.5	829.1	-307.1
Non-CPEC	639.9	450.5	1,792.6	1,580.8

Data source: State Bank of Pakistan

The power sector, which remained the single largest recipient of the CPEC-related FDI over the last few years witnessed an outflow of US$ 293.7 million during Jul-Mar FY19. This was due to the repayment of an intercompany loan of around US$ 530.0 million by a power entity to its parent company in October 2018.

With regards to non-CPEC FDI, an outflow from telecommunications dragged down the overall investment during Jul-Mar FY19, as telecom firms operating in Pakistan made principal loan repayments to their parent companies abroad.

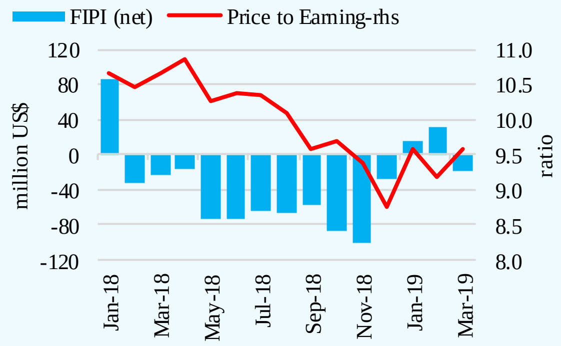
On a positive note, some other sectors, including chemicals, beverages and automobiles, were on the investors' radar during the period under review. A few automakers have now started investing in Pakistan, following the incentives announced under the Automotive Development Policy 2016-21.

Foreign portfolio investment

During Jul-Mar FY19, overall portfolio investment witnessed an outflow of US$ 398.0 million against an inflow of US$ 2.3 billion in last year, when the government had raised US$ 2.5 billion from Eurobond and Sukuk.

Pakistan's macroeconomic situation in FY19, specifically external, made it challenging for the government to raise capital from the global financial market. Instead, the government had launched US dollar denominated Pakistan Banao Certificates (PBCs) in January 31, 2019, to attract the overseas Pakistani investors.[6] However, initial response from investors was not very encouraging; in Q3-FY19, the PBCs attracted US$ 9.3 million only. Uncertainty regarding the country's external account and probably weak marketing strategy could have had been the factors behind the lukewarm response.

Figure 5.5: Foreign Portfolio Flows to Pakistani Equities and P/E ratio

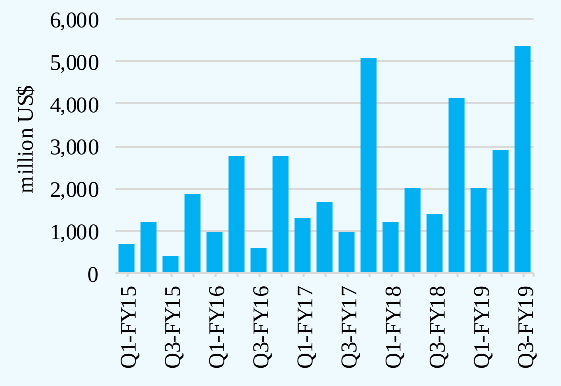


Data source: National Clearing Company of Pakistan Limited and Bloomberg

In the absence of these official inflows, the outflow of US$ 408.0 million in private equity investment in Jul-Mar FY19 set the tone of the overall portfolio investment. In Jul-Mar FY18, outflows in private equity were relatively lower at US$ 118.6 million.

In contrast, the foreign selling pressure eased in Q3-FY19, as private portfolio investment recorded an inflow of US$ 10.3 million. Pakistani equities, after declining by almost 5,000 points between Jul-Dec FY19, became attractive for investors as the price-to-earnings ratio was bottoming out by the end of 2018 (**Figure 5.5**).

Figure 5.6: Net Incurrence of Liabilities



Data source: State Bank of Pakistan

<u>Other investment</u>

During Jul-Mar FY19, the net inflow of FX liabilities more than doubled to US$ 11.2

[6] PBCs provide opportunity to overseas Pakistanis to safely invest their savings at higher profits. PBCs are offered for 3 years and 5 years maturity having profit rates, payable semiannually, of 6.25 percent and 6.75 percent, respectively. Moreover, minimum investment amount is US$ 5,000 or higher in the integral multiple of US$ 1,000 with no maximum limit.

billion compared to US$ 4.7 billion recorded last year (**Figure 5.6**). The major inflows came from commercial and bilateral sources, namely China (US$ 6.3 billion), Saudi Arabia (US$ 3 billion) and the UAE (US$ 2 billion). Most of these inflows were realized in Q3-FY19.

In net terms, the government loans increased substantially by US$ 1.4 billion during Jul-Mar FY19. Most of the activity was observed in the long-term loans, where the government had realized US$ 4.9 billion, against retirement of US$ 2.5 billion. While in the short-term, retirements exceeded disbursements, as the government retired US$ 1.4 billion, against an inflow of US$ 819 million last year.

Table 5.4: Pak Rupee vis-à-vis Major Currencies
percent change*

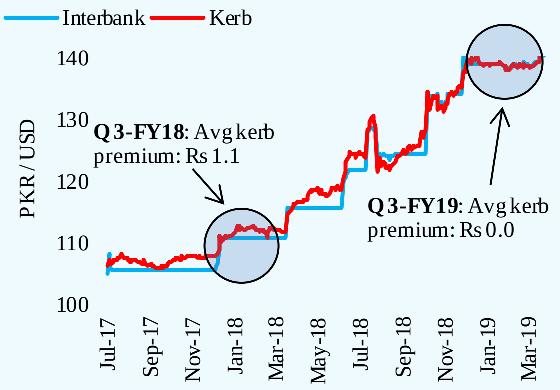
	FY18				FY19		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
US dollar	-0.5	-4.5	-4.4	-4.9	-2.2	-10.5	-1.4
Euro	-3.8	-6.0	-7.1	0.6	-1.8	-9.2	0.5
Japanese yen	0.0	-4.5	-9.9	-0.9	0.2	-13.2	-0.8
British pound	-3.4	-5.4	-8.2	1.5	-1.4	-8.3	-3.5

*Mark-to-market exchange rate;
Data source: State Bank of Pakistan

5.4 Exchange rate

The mounting pressure on the Pak rupee-US dollar exchange rate over the past few quarters seemed to have eased in Q3-FY19, owing to the external hefty FX inflows received during the quarter (**Table 5.4**). As a result, SBP's FX reserves jumped by US$ 3.3 billion in Q3-FY19.

Figure 5.7: Rupee-Dollar Parity



Data source: State Bank of Pakistan

Resultantly, the local currency remained relatively stable not only in the interbank market, but also in the open market during Q3-FY19 (**Figure 5.7**). The latter was partially due to the SBP's efforts to strengthen the AML/CFT regime for exchange companies in order to control market speculation and discourage US dollar hoarding.[7]

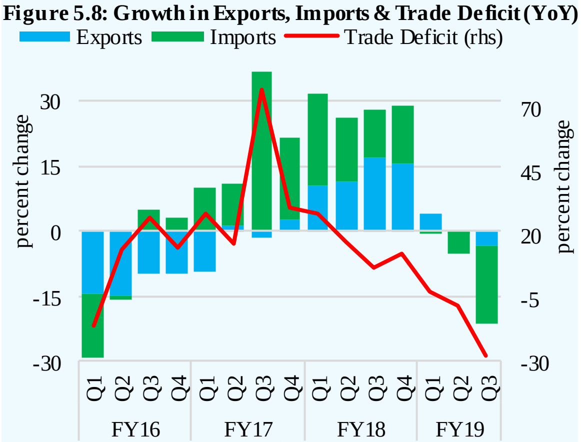
[7] The SBP, via FE Circular No. 15, dated 12 December 2018, standardized the monitoring mechanism for exchange companies by mandating the installation of CCTV cameras at company outlets.

In real terms, the PKR slightly appreciated by 2.1 percent during Q3-FY19, against a huge depreciation of 6.3 percent witnessed during the same period last year. The appreciation was mainly driven by a higher relative price index (RPI), as the local currency's NEER slightly depreciated during Q3-FY19. Most of the other emerging market currencies, including Chinese yuan, Thai baht, Indonesian rupiah, Malaysian ringgit and the Indian rupee, also appreciated in Q3-FY19, helped by the temporary easing in the US-China trade dispute and a pause in interest rate hikes by the Fed.

5.5 Trade Account[8]

The trade deficit declined by 13.1 percent to US$ 23.6 billion in Jul-Mar FY19; in comparison, the deficit had risen by 16.9 percent in the same period last year. The entire improvement in the deficit came from the import side, as exports stagnated at last year's levels.

Figure 5.8: Growth in Exports, Imports & Trade Deficit (YoY)



Data source: Pakistan Bureau of Statistics

Most of the deficit reduction during Jul-Mar FY19 was recorded in Q3, when imports dropped quite sharply in response to a deepening decline in purchases of foreign power generation machinery, aircraft and railway locomotives; technical and administrative hiccups in LNG imports (and power generation); and a temporary softening in global oil prices.[9]

Further support came from regulatory and macro stabilization measures taken earlier, which impacted industrial performance and reduced demand for imported raw materials (such as iron and steel), and also curtailed consumers' demand for cars (thereby lowering imports of CBUs). In percentage terms, the 18.1 percent decline in the overall imports in Q3-FY19 was the largest drop in a quarter in

[8] This section is based on customs data reported by the PBS. The information in this section may not tally with the SBP data reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

[9] Arab light crude oil prices were, on average, 2.1 percent lower in Q3-FY19 than in Q3-FY18. Quantum crude oil imports declined by a much higher 26.4 percent YoY in Q3-FY19, as compared to drops of 11.2 percent and 8.2 percent recorded in Q1 and Q2 respectively.

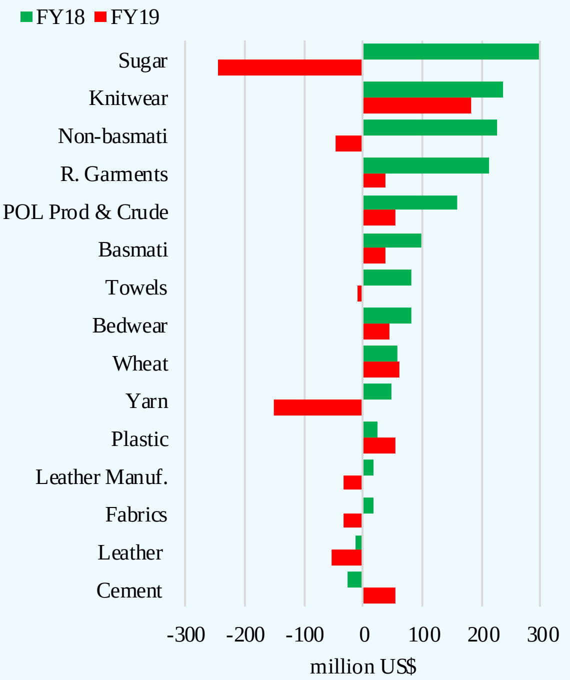
almost 10 years. It was more than sufficient to offset a 3.3 percent contraction in exports in the quarter, and led the trade deficit to drop by a sizable 27.6 percent (**Figure 5.8**).

On the other hand, the overall export values stagnated during Jul-Mar FY19 and actually declined in Q3 on YoY basis. This lackluster performance can be attributed to: (i) a drop in dollar-based unit prices of readymade garments and knitwear, which offset healthy increases in their quantum exports; (ii) lower quantum yarn exports amid stagnant domestic production and strong domestic demand; and (iii) the phasing out of export subsidies on sugar and wheat, which led to lower quantum exports of both commodities from Q2 onwards.

Exports

Pakistan's exports were recorded at US$ 17.1 billion during Jul-Mar FY19, unchanged from the same period last year (when they had grown by 13.0 percent). The broad-based slowdown in growth originated from quantum-led drops in sugar and non-basmati rice exports, tepid overall textile exports amid generally falling unit prices, and sluggishness in exports of other items, such as leather and sports goods (**Figure 5.9**).

Figure 5.9: Absolute YoY Change in Export Values (Jul-Mar)



Data source: Pakistan Bureau of Statistics

Textile exports

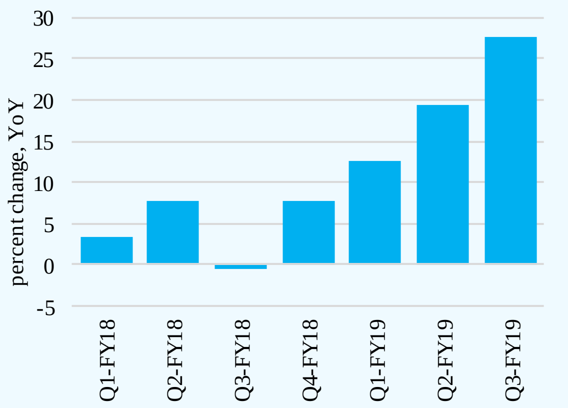
Pakistan's textile exports amounted to US$ 10.0 billion during Jul-Mar FY19, unchanged from the same period last year.

The stagnation in overall textile exports stemmed from a slowdown in export growth (in value terms) of readymade garments and knitwear items, and YoY declines in cotton fabric and yarn exports. Except for yarn, export values of all these major products suffered from a drop in unit prices, as quantum exports grew appreciably. The drop in dollar-based unit prices was mainly owed to exchange rate adjustments, as exports rose significantly in PKR terms.[10]

(i) Apparel exports

In case of apparel, quantum exports have been rising consistently at a higher pace (**Figure 5.10**). Especially in Q3-FY19, both the US and the EU contributed to the uptick in quantum exports. Interestingly, in the EU, despite a slowdown in the bloc's import demand for clothing, Pakistani exporters managed to ship 4.3 percent more clothing items in Jul-Feb FY19 than they did last year.

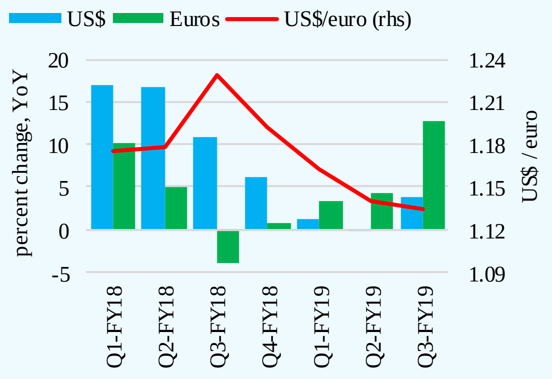
Figure 5.10: Growth in Pakistan's Quantum Apparel Exports



Data source: Pakistan Bureau of Statistics

Meanwhile, export values had also risen 4.7 percent YoY in euro terms. However, in dollar terms, the uptick dwindled to just 0.4 percent YoY (**Figure 5.11**), as the dollar appreciated against both the euro and the PKR during most of FY19. This is in contrast to last year, when the dollar was weakening against the euro, and Pakistan's apparel exports to the EU had risen more strongly in dollar terms (17.2 percent) than in euro terms (6.4 percent).

Figure 5.11: Growth in the EU's Apparel Imports from Pakistan & US$/EUR Exchange Rate



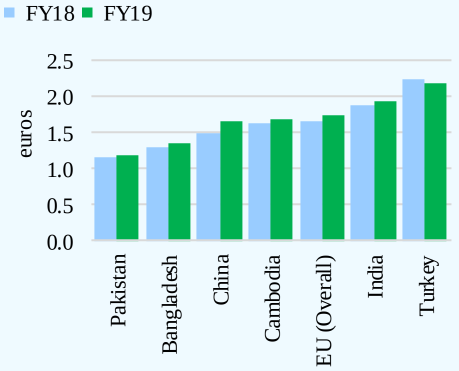
Data sources: Eurostat & Bloomberg

With regards to quantum apparel exports to the EU, Pakistan, Bangladesh,

[10] In PKR terms, overall textile exports have grown 23.1 percent YoY during Jul-Mar FY19, as compared to a 0.1 percent growth recorded in US dollar terms. PKR export values for knitwear and readymade garments have grown even more strongly, by 34.4 percent and 25.7 percent respectively during the period. The substantial increase in PKR export values has allowed textile firms to comfortably retire their borrowings to banks (**Chapter 3**).

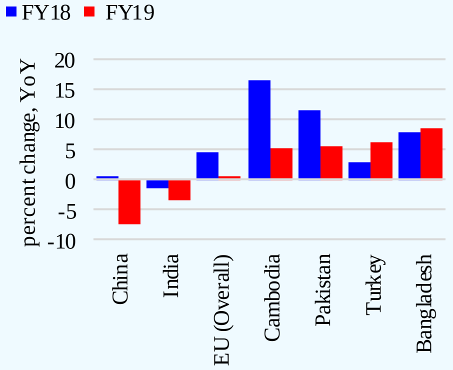
Cambodia and Turkey, all witnessed decent growths this year. Duty-free access to the bloc, along with heavy currency depreciations against the euro (in case of Pakistan and Turkey) kept the unit prices (in euros) of apparel exports of these countries in check, and contributed to higher shipments. This was despite a slowdown in demand from the bloc (**Figure 5.12 a,b**).[11] The brunt of this slowdown was faced by India and China, which could not effectively compete in the bloc. Instead, these two countries deepened their presence in the US market.

Figure 5.12 a: Unit Value of the EU's Clothing Imports (Jul-Mar)



Data source: Eurostat

Figure 5.12 b: Growth in EU's Quantum Apparel Imports from Major Suppliers (Jul-Mar)



Data source: Eurostat

The US' quantum apparel imports have risen quite significantly as compared to last year amid higher real GDP growth, falling unemployment and rising retail sales.[12] Exports of almost all major clothing suppliers to the US rose in quantum terms, including Pakistan's.

However, Pakistan could not benefit to the extent that China, Bangladesh and Vietnam did during the year. In China's case, most of the growth in its exports was realized in Q2-FY19, as the US importers rushed their purchases before Chinese textile and clothing products also came in the crosshairs of the ongoing

[11] That said, most of the growth in Bangladesh's exports came during the first (7.9 percent) and second quarters of FY19 (11.3 percent), before the minimum wage hike kicked in early 2019, raising production costs. As a result, quantum clothing exports grew by a lower 4.7 percent during Jan-Feb 2019 (source: Eurostat).

[12] Real GDP growth in the US averaged 3.1 percent in Jul-Mar FY19, up from 2.5 percent in Jul-Mar FY18. At the same time, the unemployment rate fell to 3.8 percent by March 2019, from 4.0 percent in June 2018 (source: Haver Analytics). Retail clothing sales in the US grew at a higher rate of 3.0 percent YoY during Jul-Mar FY19, as compared to 2.0 percent growth recorded last year (source: US Census Bureau).

US-China trade war.[13] At the same time, US importers also shifted some of their demand to other countries, such as Vietnam and Bangladesh, which saw an upsurge in their clothing shipments to the country.

(ii) Cotton yarn

Pakistan's cotton yarn exports declined 15.4 percent to US$ 835.7 million in Jul-Mar FY19. The decline was almost entirely driven by a 15.9 percent drop in shipments, as unit prices rose marginally. Both domestic and foreign factors played a role in the lower quantum exports during the period. On the domestic front, yarn production was basically unchanged from last year, at 2.3 million MT. However, demand for yarn by spinners has been rising in response to higher demand by local garment manufacturers (including exporters). The stagnant production amid higher demand boosted domestic yarn prices by an average of 21.0 percent YoY during Jul-Mar FY19.[14] As a result, it made more business sense for domestic spinners to cater to the local demand instead of going for exports.[15]

Internationally, exports became unviable amid a challenging situation in the primary market, China. According to Chinese customs data, cotton and yarn imports by China had dropped by a sizable 17.2 percent in CY18, as the country imposed additional retaliatory tariffs on its top yarn supplier, the United States (in July 2018). To make up for the resultant shortfall, China started unloading the sizable stockpile of cotton it had built up over the years to its ginning industry.[16] At the same time, China diverted some of its import demand for higher count yarn to Brazil, Australia and India, which managed to increase their market shares, according to the USDA. However, due to a product mismatch, Pakistani exporters could not benefit from this shift in Chinese demand, as Pakistan's ginning industry mostly produces low-count yarn, which is not widely used in apparel-making.

Food exports

Overall food exports declined 2.4 percent to US$ 3.3 billion during Jul-Mar FY19,

[13] The continued uncertainty created by the US-China stand-off on trade has interfered with US importers' timing decisions and led to frontloading of purchases from China during Q2-FY19. As of end-June 2019, both the US and China had raised tariff rates on imports that they had already targeted in CY-18.

[14] Data source: Emerging Textiles.

[15] While the PKR's depreciation also raised Pakistan's yarn export prices in PKR terms (by an average of 28.1 percent during Jul-Mar FY19), industry players said they preferred to sell to local buyers at good prices as they wanted to avoid undertaking the procedural requirements entailed in exporting the material.

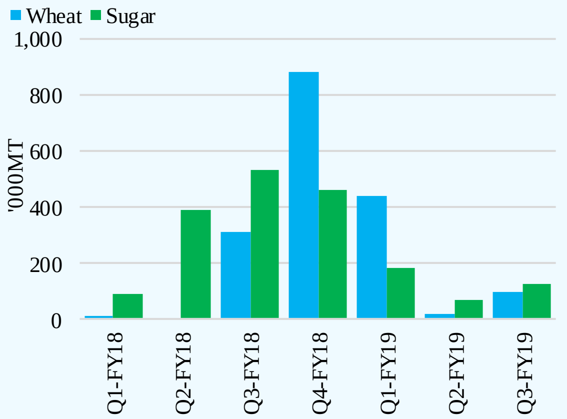
[16] Between August 2018 and July 2019, the USDA is estimating the ending stock of cotton in China to decline by 13.0 percent (from 8.3 million tons to 7.2 million tons).

compared to a sizable 28.0 percent increase recorded last year.

(i) Sugar and wheat

The major drag on food exports was sugar, whose exports dropped by a hefty 68.2 percent to US$ 115.1 million this year. In the wake of a 12.4 percent drop in average international sugar prices during Jul-Mar FY19, exporting sugar became unfeasible for Pakistani exporters in the absence of subsidies. Once the subsidies and the export quota (of 2.0 million MT announced in H1-FY18) had expired by Q1-FY19, the quantum sugar exports tapered (**Figure 5.13**).

Figure 5.13: Trends in Quantum Wheat and Sugar Exports



Data source: Pakistan Bureau of Statistics

Then in December 2018, the Economic Coordination Committee (ECC) allowed the export of 1.1 million MT of sugar; however, it left the decision regarding the scale and disbursement of any export subsidy to the provincial governments Subsequently, by end-January 2019, the Punjab government announced a sliding-scale subsidy of Rs 5.35/kg for sugar mills in the province, up to an expenditure cap of Rs 3 billion and a quantum cap of 0.572 million MT.[17] Mainly as a result of this measure, some sugar exports were recorded in Q3-FY19. However, these were quite low as compared to Q3-FY18, when a much higher federal subsidy was in place.[18]

Similarly, in case of wheat, while the overall exports more than doubled to US$ 121.9 million during Jul-Mar FY19, most of the exports were realized in the first quarter, when subsidies were in place (**Figure 5.13**). Their culmination led to a tapering in wheat exports in Q2-FY19. In Q3, quantum exports picked up slightly,

[17] Via Punjab Finance Department's notification No. FD (W&M)2-3/2018 dated January 31, 2019. Also see EPD Circular Letter No. 04 of 2019 dated February 22, 2019, on the same subject.
[18] A total of 377,678 MT of sugar was exported during Q3-FY19, down 62.6 percent from Q3-FY18. Last year, the federal government had announced an export subsidy of up to US$ 97 per MT, which worked out at around Rs 10.65 per kg (at FY18's average exchange rate of 109.84). Against this, only the Punjab government has announced an export subsidy in FY19, and that too of a lower amount of Rs 5.35 per kg.

in response to the ECC's November 2018 decision to allow exports of 0.5 million MT, with the quota split between PASSCO and the Sindh and Punjab governments. The federal and provincial governments were responsible for subsidizing exports by PASSCO and private exporters, respectively.

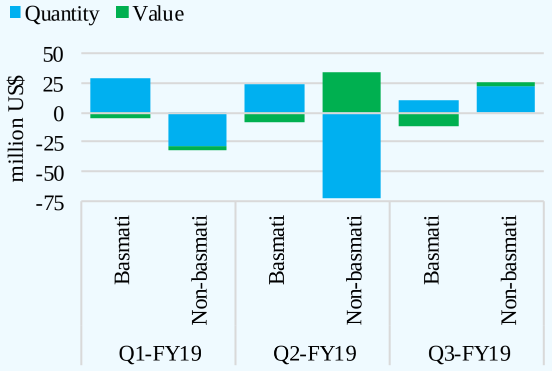
From Pakistan's perspective, the global environment appears favorable, as international wheat prices have risen in response to lower production in major exporters (the EU, Russia and China), and record demand from the Philippines.[19,20]

(ii) Rice exports

Overall rice exports stayed almost flat at US$ 1.5 billion during Jul-Mar FY19, with a 4.2 percent decline in non-basmati exports overshadowing a 10.0 percent increase in basmati exports during the period. In fact, non-basmati rice has been driving the overall trend in rice exports throughout the year, as steep declines in its quantums during the first and second quarters had more than offset healthy performance by basmati during the period.

However, the trends reversed in Q3-FY19, with an uptick in quantum non-basmati exports countering the drag from a price-led decline in basmati rice exports (**Figure 5.14**). Non-basmati rice exports to Afghanistan and China have risen significantly in Q3.[21] In case of Afghanistan, according to the industry sources, repeated border closures during Jul-Dec FY19 had curtailed exports, and the reopening of

Figure 5.14: Contribution of Quantum & Price Effects to Abs. YoY Change in Rice Exports



Data source: Pakistan Bureau of Statistics

[19] International wheat prices were, on average, up 16.4 percent during Jul-Mar FY19 as compared to the same period last year (source: World Bank).

[20] The Philippines is projected to import a record 7.0 million MT wheat in the 2018-19 year, up from around 6.0 million MT imported last year, in response to continually rising consumption and a typhoon that impacted domestic production (source: Grain: World Markets and Trade Report, USDA April 2019). However, Pakistani exporters have yet to tap this demand, and have mostly focused on Afghanistan and Indonesia so far this year.

[21] Pakistan's quantum non-basmati rice exports to Afghanistan rose 22.9 percent YoY during Q3-FY19, while those to China increased by a sizable 113.5 percent.

the crossing in January 2019 led to the resumption of normal trade activities.

Cement exports

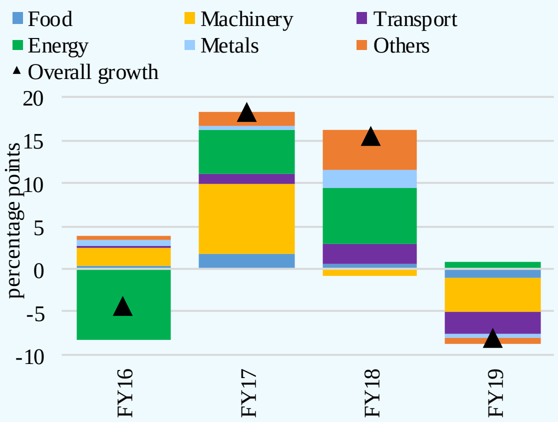
Cement exports grew 32.8 percent YoY to US$ 221.3 million in the period. A hefty 55.5 percent increase in quantum exports offset the drag from lower unit prices. Facing continuously rising surplus capacity and declining local sales amid the slowdown in domestic economic activity, cement manufacturers have diverted their attention to mostly African markets.[22] That said, the lower unit prices reflect the shift in the exporting product mix: Pakistani manufacturers are exporting more of the low-value clinker (used as a raw material) than finished cement.

Imports

The overall imports declined by 8.1 percent to US$ 40.7 billion in Jul-Mar FY19, after rising by 15.4 percent in the same period last year. The entire decline came from the non-energy group, which contracted by 11.5 percent; this offset the marginal 3.8 percent uptick in energy imports during Jul-Mar FY19.

With regards to energy imports, most of the increase was realized in Q1, with imports actually dropping by 16.9 percent YoY in Q3 – the first such decline since Q1-FY17. The curtailment in quantum imports of both LNG and crude oil led to declines in their import values, and contributed to the decline in overall energy imports in the quarter. Further relief came from the temporary dip in global oil prices, which were on average down 2.9 percent during Q3-FY19 as compared to Q3-FY18. With negative contribution from energy, overall imports dropped more steeply in Q3 than in previous quarters of FY19 (**Figure 5.15**).

Figure 5.15: Contribution to Growth in Imports (Jul-Mar)

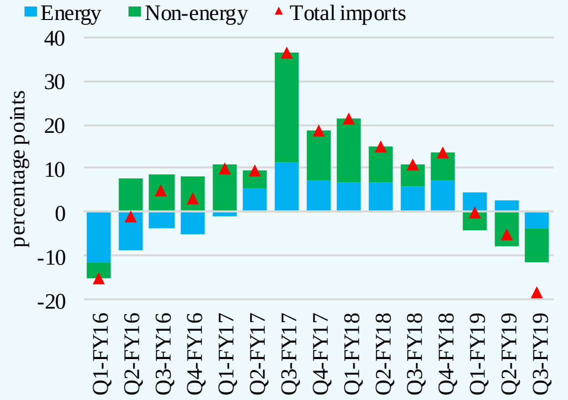


Data source: Pakistan Bureau of Statistics

[22] According to the All Pakistan Cement Manufacturers Association, domestic surplus capacity increased from 7.55 million tons in FY18 to 8.27 million tons by March 2019. Local cement dispatches declined 6 percent during Jul-Mar FY19, after rising 15.9 percent in Jul-Mar FY18.

At the same time, the drop in machinery imports, led by power generation (following the conclusion of early phase of CPEC), became more pronounced as the year progressed, and contributed sizably to the YoY drop in overall imports in Jul-Mar FY19 (**Figure 5.16**).[23] Major support also came from the normalization of imports of aircraft and related parts, which had inflated transport imports last year.

Figure 5.16: Contribution to YoY Change in Imports



Data source: Pakistan Bureau of Statistics

Some support also came from the macro adjustment policies undertaken since December 2017, including exchange rate adjustments, cuts in development spending, policy rate hikes and regulatory measures, which have subdued the performance of multiple sectors (particularly construction and auto industries), and lowered their demand for imported raw materials. As a result, imports of items like iron and steel (scrap, old ships for ship breaking, and finished products), transport fuel for heavy commercial vehicles (diesel), and cars (CBUs), all dropped in the year.

Energy imports

During Jul-Mar FY19, energy imports rose by 3.8 percent YoY to US$ 10.6 billion, as compared to the 31.8 percent increase recorded in the same period last year. The entire increase in import values came from higher international oil prices, as quantum imports of both crude oil and POL products declined significantly during the period.[24]

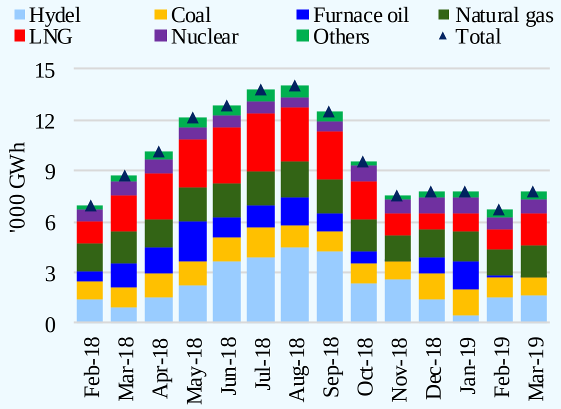
The growth in energy imports had peaked out in Q1-FY19, and actually dropped by double digits in Q3-FY19. The main factor was related to administrative and technical issues that lowered quantum LNG imports in the period.[25] As per energy

[23] Machinery imports declined by a hefty 24.7 percent YoY in Q3-FY19, as compared to drops of 17.9 percent and 19.3 percent recorded in Q1 and Q2 respectively.
[24] Arab Light crude oil prices were, on average, 19.3 percent higher in Jul-Mar FY19 as compared to the same period last year.
[25] The growth rate of quantum LNG imports fell from 44.3 percent YoY in Q1-FY19 to 19.1 percent in Q2. These imports then declined by 6.3 percent in Q3-FY19 – the first such drop since the

industry sources, the government had curtailed LNG purchases during the winter months (especially during December 2018 and January 2019). Given that LNG is now a major fuel source for power generation in the country, the government compensated for the lower LNG supplies to the power sector during these months by shifting some of the generation to furnace oil (FO) and coal (**Figure 5.17**).

This had a two-fold effect: on one hand, the country saved forex by importing lower LNG; on the other, the excessive FO stocks built up with oil refineries (which was now constraining their throughput and therefore impacting production of essential transport fuels) was utilized. That said, power generation from FO could only *partially* compensate for the decline in generation from LNG.

Figure 5.17: Source-wise Power Generation



Data source: National Electric Power Regulatory Authority

On the technical side, two LNG power plants could not operate at full capacity during Q2 and Q3, owing to low LNG supply and their inability to immediately shift to FO.[26] As a result, total power generation dropped 6.5 percent during Q3-FY19.[27] Since LNG was the top contributor to rising imports, a slowdown in its purchases contributed significantly to the curtailment in overall as well as energy imports from Q2-FY19 onwards.[28]

Meanwhile, coal imports followed a trend largely similar to that of LNG, at least until December 2018.[29] Its import values had surged in Q1-FY19, led by hefty

country started importing LNG in FY16. A 27.3 percent decline in average spot LNG prices during Q3-FY19 also contributed to its lower import values in the period.

[26] The summary of Nepra's meeting to decide on fuel price adjustment for March 2019 mentioned that "certain efficient power plants remained on forced outages during March 2019". Such underutilization of capacities is also referenced in summaries of meetings in other months as well.

[27] Moreover, anecdotal evidence suggest that the lower LNG imports also led to lower gas supplies to household consumers during the winter months.

[28] In value terms, LNG imports grew 136.3 percent YoY in Q1-FY19, with the growth then slowing down to 60.8 percent in Q2. Finally, imports declined 5.3 percent YoY in Q3.

[29] Coal is classified under the "All other items" category in the import data of both PBS and SBP.

rises in both import quantities and unit prices, and then began to moderate in Q2.[30] The slowdown in quantum imports also reflected lower demand from cement manufacturers, which were facing lower capacity utilization and slumping overall dispatches. However, quantum coal imports surged again during Q3-FY19, as it partially compensated for lower LNG supply to the power sector during the period.

Table 5.5: Growth in Quantum Import of Energy Products
percent change, YoY

	Q3		Jul-Mar	
	FY18	**FY19**	**FY18**	**FY19**
HSD	-2.8	-15.4	8.8	-29.9
Furnace oil	-82.5	-100.0	-36.0	-91.1
Petrol	2.3	7.8	4.2	2.1
Total Products	-31.0	-12.3	-11.2	-36.5
Crude oil	31.7	-27.3	24.1	-13.9

Data source: Oil Companies Advisory Council

On the POL product side, import values declined 15.3 percent YoY in Jul-Mar FY19 to US$ 4.6 billion, after rising 12.6 percent in Jul-Mar FY18. The ban on FO imports (imposed in January 2019) brought their imports to zero in Q3 (**Table 5.5**). Even though local FO production also declined, existing stocks with refineries and fresh production were sufficient to cater to already lower demand for FO from power producers.

Among other products, high speed diesel (HSD) imports dropped amid lower demand from the transport sector; overall sales declined 18.9 percent in Jul-Mar FY19, after rising 10.2 percent in Jul-Mar FY18. This is understandable, given the overall slowdown in construction activity (including the building of new power plants), which has curtailed the movement of heavy commercial vehicles (which primarily run on diesel). In contrast, petrol imports rose 2.1 percent YoY during Jul-Mar FY19, with most of the increase coming in Q3. This corresponding with a decline in its local production in the quarter.[31]

The lower petrol production was in response to a rebuilding of FO stocks with refineries from Q2-FY19 onwards, amid declining power generation from the fuel. As per industry sources, refineries curtailed their throughput to avoid producing even more FO, which they were already unable to sell to power producers. This, in turn, led to a drop in refineries' demand for crude oil as well. As a result of these issues, quantum crude oil imports declined by double digits; nonetheless higher oil prices (during H1-FY19) completely offset its impact and led to a 15.2

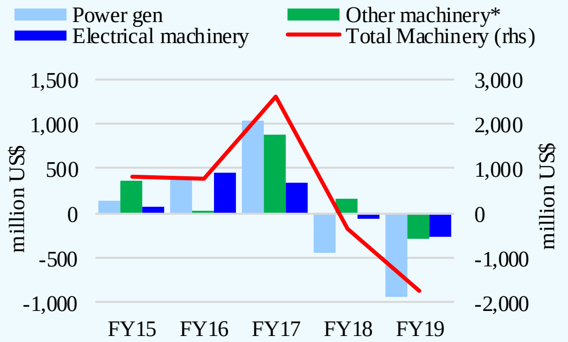
[30] The growth in quantum coal imports peaked in Q1 at 70.8 percent YoY, before reaching 13.5 percent in Q2 and 14.3 percent in Q3-FY19. International coal prices were, on average, 22.0 percent higher in Q1-FY19 on YoY basis; these grew by a much contained 3.5 percent in Q2, and declined 6.7 percent in Q3 (source: Bloomberg).
[31] Petrol production declined 1.7 percent in Q3-FY19, after rising 13.1 percent in Jul-Dec FY19.

percent growth in import values, which reached US$ 3.4 billion in Jul-Mar FY19.

Non-energy imports

During Jul-Mar FY19, non-energy imports declined 11.5 percent YoY to US$ 30.1 billion, after rising 11.2 percent in the same period last year. Power generation machinery was the single largest drag on imports, with its import values declining by almost US$ 1.0 billion during Jul-Mar FY19 (**Figure 5.18**), and accounting for a quarter of the YoY decline in non-energy imports during the period. The conclusion of the initial phase of CPEC power projects largely explains this trend. Other items related to CPEC power projects, captured under electrical and 'other machinery' categories, have been following a similar trend, and also contributed significantly to the decline in non-energy imports.

Figure 5.18: Absolute Change in Machinery Imports (Jul-Mar)



Data source: Pakistan Bureau of Statistics
*mostly comprises parts and components related to power generation and electrical machinery

The transport group emerged as the second-largest drag, with its imports declining 35.8 percent YoY to US$ 2.1 billion during the nine-month period. As indicated in **Table 5.6**, a large chunk of the decline came from aircraft- and railway-related parts, whose imports had spiked last year and have normalized this year. Car imports (both CBU and CKD) declined 13.8 percent during Jul-Mar FY19, after growing by 23.5 percent last year. Lower CBU imports accounted for a large proportion of this slowdown, and reflected tightening of regulations regarding used car imports.[32] Furthermore, multiple price hikes by auto manufacturers in the wake of the PKR depreciation, lower auto financing amid rising interest rates (**Chapter 3**), and the ban on non-filers from purchasing new vehicles, also

[32] In January 2019, the Ministry of Commerce, via SRO No. 52(I)/2019, reintroduced a restriction on used car imports under the gift and personal baggage schemes, where the importer has to pay applicable duties and taxes on the import in foreign exchange and provide documentary evidence that this foreign exchange was received from abroad. A similar restriction was in place during October 2017 to February 2018 as well.

impacted domestic new car sales.[33,34] Faced with rising inventory, auto manufacturers had to curtail production; this, in turn, lowered their CKD imports.[35]

Among other products, palm oil imports contracted by 10.2 percent YoY to US$ 1.4 billion, with the entire decline coming from lower unit prices, as import quantums had risen 9.5 percent. International prices of the commodity were, on average, down 18.7 percent in Jul-Mar FY19 over the same period last year, encouraging edible oil mills to build up their inventories. That said, international prices have bounced back from the trough hit in December 2018, and may exert upward pressure on imports going forward. Domestic palm oil consumption is expected to increase five percent and reach a record 5.0 million MT next year (as per USDA estimates).

Table 5.6: Composition of Transport Imports (Jul-Mar)
million US$

	FY18	FY19	Abs. change
Aircrafts, ships and boats	**757.5**	**222.0**	**-535.5**
Tankers*	281.6	0	-281.6
Aircraft (complete)*	52.3	5.2	-47.1
Aircraft (parts)*	47.8	48.7	0.9
Ships for shipbreaking*	350.5	135.5	-215.0
Cars	**951.3**	**820.4**	**-130.9**
CBU	358.6	209.0	-149.6
CKD	592.6	611.4	18.7
Buses & trucks	**464.9**	**370.0**	**-94.9**
CBU	195.4	108.5	-86.9
CKD	269.5	261.5	-8.0
Other transport equipment	**332.4**	**50.4**	**-282.0**
Railway locomotives*	337.2	53.7	-283.5
Transport group	**3,245.0**	**2,083.2**	**-1,161.8**

*For Jul-Feb
Data source: Pakistan Bureau of Statistics

In the case of iron and steel, cumulative imports (of both scrap and finished products) declined by 8.0 percent to US$ 2.8 billion, with most of the decline coming from lower imports of finished products. Lower quantum led the way for both these categories, reflecting the slowdown in demand from construction and automobile sectors.[36]

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[33] New car sales by PAMA members stagnated in Jul-Mar FY19, dropping 0.7 percent YoY, after growing 15.6 percent in Jul-Mar FY18. In response, car production rose by just 2.4 percent YoY in the period, against the rise of 15.9 percent recorded last year.
[34] However, by end-March 2019, non-filers were again allowed to purchase new locally manufactured vehicles, via the Finance Supplementary (Second Amendment) Bill 2019.
[35] CKD car imports declined 6.6 percent in Q3-FY19; this was the first such decline since Q2-FY16.
[36] Domestic steel production declined 12.3 percent YoY during Jul-Mar FY19, after rising 27.9percent last year. However, production of steel sheets (commonly used by the auto industry) rose 3.1 percent; but this increase was more than offset by a 24.7 percent decline in billet (steel bar) production.