2. Balance of Payments

In the past, the balance of payments strategy has been a prisoner of simple categorization like "import substituting industrialization'' and "export led growth''. These are misleading depictions of strategies that are far more complex and require an integrated approach for developing national technological capabilities to achieve rapid and sustainable economic development. The key to success is aggressiveness in the international market and the attractiveness of the economy for the foreign investors.

The macroeconomic stability visible today stems primarily from an improved external setting in the aftermath of the September 11, 2001 events. Many factors have affected Pakistan's economy positively. It has benefited from higher external grants and remittances, and increase in textile and clothing quota allowances. The high export growth was mainly textile driven as earnings from four major categories namely: cotton fabrics, knitwear, bed wear and cotton yarn crossed $ 1 billion each. The increase in reserves accumulation was on account of improvement in the trade and nonfactor services accounts and higher workers remittances. Higher defense receipts helped and so did increase in access to foreign markets, but also strong performance of Pakistan's export oriented industries. Large inflow of remittances partly reflects the tighter scrutiny of financial holdings of Pakistanis living in industrialized countries, providing an incentive to transfer funds to Pakistan. However, it also reflects efforts to bring informal remittances into the official net, and enhanced confidence in the Pakistani rupee and in Pakistan's financial system.

The balance of payments projections for the Medium Term Development Framework have been made keeping in view the long run objectives of reducing the external dependence by increasing those sources of external financing that are stable, sustainable and have positive effects on growth rather than traditional sources, which have been found to be volatile or less stable. The constraints imposed by the external and internal factors for these projections have also been considered.

The internal factors include overly dependence on imports of food and oil, lack of diversification of exports, faulty import substitution, changing behavior of workers' remittances, acceleration in interest payments, production structure, incentives to the external sector and unfavorable terms of trade. The external factors are falling commodity prices of exports due to global recession and limited access to foreign markets due to protectionist policies of the developed countries, increasing competition, vulnerability to exogenous shocks for example, the vagaries of weather and international demand fluctuations.

Medium Term Development Framework has been prepared to achieve the export promotion objectives within the context of technology driven economic and export growth, emphasizing the need to meet challenges of quota free textile exports under the global environment defined by the WTO regime. Exports will be promoted by reducing the cost of doing business, increasing competitiveness in international market, thus enhancing market access, diversifying exports and encouraging export-oriented foreign investment. Dissemination to the business community, commercially useful information and statistics through country economic briefs, statistical services and other publications have also become priority concern. These measures will be supported by an appropriate exchange rate policy. The market forces and economic fundamentals at home and abroad will determine the exchange rate, but the SBP will take corrective measures when so warranted.

Government will continue to provide conducive environment for the further expansion of the export sector to sustain export earnings. For prudent exchange and reserves management, the focus of SBP will be on building in-house reserve management capacity, liberalizing the capital account in a phased manner, capacity building in the area of risk management, strengthening of reporting mechanism of exchange companies and documenting of all capital flows, especially cash transactions. Concerted efforts will also be made to reduce the import bill through the active promotion of agriculture sector to meet the food requirements.

2.1. Challenges

i) Pure economic performance and well- managed competitive advantages will count more than ever before. Trade will no longer be regulated by quantitative restrictions and, as a result, there will be a large and growing market waiting to be captured.

ii) Deterioration in developing countries' terms of trade is likely to continue as the US, European and Japan textile and clothing prices have been falling continuously since 1996.

iii) Rationalization of trade in textiles and clothing will continue under complex patchwork of international trade agreements in which buying countries have been granted specific concessions.

iv) There is likely to be a rise in antidumping and countervailing duty cases, which will pose a real threat to exporters. Textile and clothing manufacturers are subject to random checks by customs officials, to ensure that trans-shipment activities are not taking place.

v) There would be more concerns about child labour, labour standards and environment.

vi) Textile and garment manufacturers from developing countries are increasingly confronted with the need to adapt to eco-labeling requirements.

During the last two years government has taken many forward looking measures such as capacity building of exporters, upgrading of productive capacity, conducive environment for all the stakeholders to meet competition requirements of the WTO regime, promoting the image of exports of Pakistani products, establishment of special export zones and three garment cities, allowing import of used/second hand machinery, reducing the cost of doing business to attain competitiveness globally, and regional market access for Pakistani goods. The Government has also focused on enlarging the export-financing base besides encouraging export-oriented foreign investment in the country.

2.2. Review

In 2004-05, there are prospects of a high trade deficit due to higher imports. The exports (fob) are estimated at $ 14.0 billion against Annual Plan 2004-05 targets of $ 13.1 billion, while imports (fob) are estimated at $ 17.6 billion during 2004-05 against the Annual Plan target of $ 14.5 billion. The growth of exports is attributed to cotton based value added textiles. The increase in imports is mainly on account of increased imports of machinery, particularly textile machinery for BMR and industrial raw materials as well as POL higher prices in the international market. The trade deficit is estimated at $3.6 billion during 2004-05 as against Annual Plan target of $ 1.3 billion. The trade deficit is however, expected to be narrowed in future on account of increased exports particularly the textile products after elimination of quota regime and market and product diversification. The balance on the invisible account is estimated at $ 1.6 billion surplus during 2004-05 as against a surplus of $ 1.7 billion projected in the (AP) 2004-05. With a significant increase in the trade deficit, the current account deficit is estimated at $ 1.9 billion (1.75 percent of GDP) as against Annual Plan targeted surplus of $ 0.33 billion (0.3 percent of GDP).

2.3. Medium Term Development Framework

The main objective of the MTDF is to reduce imbalances in the various components of the Balance of Payments. Increasing exports at a rate faster than the imports will reduce imbalance in the trade sector. Invisible balance will be improved by attracting private transfers, especially workers' remittances. Capital account will be improved by diversifying sources of financing with greater recourse to non-debt creating sources of financing.

In physical terms, the objectives and other parameters of the MTDF are as follows:

i) Exports (fob) in nominal dollar terms estimated to increase to $ 28.0 billion, (14.9 per cent ACGR), with major thrust on exports of value added products.

ii) Imports (fob) in nominal dollar terms to grow to $ 33.2 billion, (13.6 percent ACGR), with the assumption that capital goods imports will increase reflecting revival of economic activities, coupled with the increase in the POL imports due to increase in POL prices in the international market. However, imports of wheat and sugar will fall due to increase in their domestic production.

iii) Workers' remittances are estimated to increase from $ 4.0 billion in 2004-05 to $ 4.16 billion in 2009-10. Surplus on invisible balance, however, will decrease from surplus of $ 1.64 billion in 2004-05 to surplus of $ 0.30 billion in the terminal year of MTDF, largely due to the increased payments.

iv) Current account deficit on the balance of payments is to increase from $ 1.91 billion (1.75 percent of GDP) in 2004-05 to $ 4.91 billion (2.4 percent of GDP) in the terminal year 2009-10 of the MTDF.

Achievement of these objectives is a great challenge and requires determined efforts, both at the domestic and international fronts. Keeping in view the objectives, a strategy and operational plan has been evolved as given below.

2.4. The Strategy

Main elements of the strategy are:

i) Diversification of exports both commodity-wise and market-wise.

ii) Stable Exchange Rate and consistency in economic policies.

iii) Enhancing Export Competitiveness.

iv) Exports of Services

v) Trade Liberalization

vi) Enhancing workers remittances and to make them sustainable.

vii) Efficiency and Quality/Standard

viii) Increasing Market Access

ix) Creation of Export Culture

x) Brand development

xi) Establishment of Joint Ventures

xii) Image Building

xiii) Expanding the role of Export Processing Zones

xiv) Increasing total factor productivity.

xv) Tariff Rationalization.

Measures to increase exports are discussed in detail in the chapter "Exports Development". This chapter focuses on balance of payments and imports.

2.5. Structure of Imports

Pakistan's economy would be growing at an annual average rate of 7.6 percent over the MTDF. This growth will generate demand for imports for raw material, plants, machinery and equipment both for import substituting industries and those producing for exports. There would also be imports for some consumer goods to supplement their domestic production to meet the needs of a growing population. Imports therefore, have been estimated to increase from $ 17.6 billion in 2004-05 to $ 33.2 billion in the terminal year of the framework. Major imports are discussed below:-

Capital Goods: Pakistan has imported textile machinery of more than $ 3 billion during the last three years for balancing and modernization purposes. During the MTDF period there will be a change in the composition of imports of machinery with construction and mining, electrical machinery and apparatus and power generating machinery, taking higher portion of imports. Capital goods imports are therefore placed at $ 8.29 billion in 2009-10 against capital goods import of $ 5.12 billion in 2004-05 , an increase of 10.1 percent .

Table 1
Major Imports Projections

($ Million)

Commodity	2004-05 Estimate	2009-10 Projection	ACGR (%)
Edible Oils	714	1119	9.4
Crude Oil	2058	2920	7.2
Fuel Oil	218	247	2.5
Others	940	800	-3.2
Fertilizer	270	377	6.9
Capital Goods	5123	8290	10.1
Others	9969	22738	17.9
Total imports (cif)	**19291**	**36491**	**13.6**
Total imports (fob)	**17555**	**33207**	**13.6**

Edible Oils: Potential for increasing domestic production of oil seeds has always remained high. Domestic production of traditional as well as non-traditional oilseeds is projected to grow rapidly to meet the domestic consumption requirements. The import bill of edible oils is estimated at $ 1119 million in 2009-10, registering an increase of 9.4 percent . The country at present is importing around 1.4 million tonnes edible oils per year .

POL: Efforts will be made to reduce the domestic use of oil by substituting its consumption by gas, thus lowering import requirements. However, crude oil import is likely to increase by 7.2 per cent per annum in nominal terms, from $ 2058 million in 2004-05 to $ 2920 million in the terminal year of the MTDF mainly due to rise in its international price.

Fertilizers: Fertilizers import is projected to increase by 6.9 percent during the MTDF period from $ 270 million in 2004-05 to $ 377 million in 2009-10. It is expected that imports of fertilizers will be contained with the enhanced domestic production resulting from increased capacity utilization of existing plants and coming into operation of some new units.

2.6. Trade Account

Exports (fob) are projected to grow by 14.9 percent from $ 14000 million in 2004-05 to $ 27996 million in 2009-10. Projections of the exports are based on sustained increase in agricultural production and manufacturing output and improvement in the overall competitiveness of the external sector. Imports (fob) are anticipated to increase by 13.6 percent from $ 17555million in 2004-05 to $ 33207million in 2009-10. This increase will be induced by higher imports of plants, machinery and equipment required for modernizing and balancing the existing capacity as well as addition to the productive capacity required to meet the needs of a growing economy. Imports of raw material will also be increased . Higher expenditure on the import of POL due to increase in the international prices of crude oil will be another factor contributing to higher imports. As a result, the trade account is projected to be in deficit of $ 5211 million in 2009-10 against deficit of $ 3555million in 2004-05 . Details are at Annex III. Efforts however, will be made to reduce the import bill by enhancing production and reducing import of edible oils etc. and by switching over to indigenous fuels or cheaper alternatives and full exploitation of hydropower potentials. Major exports and imports are given at Annex I and Annex II respectively.

2.7. Invisibles Account

The invisibles balance will be governed mainly by the behavior of workers' remittances and other private transfers. With an integrated and technology led approach being followed in the MTDF, the foreign direct investment is likely to increase . As a result, payments for technical fees and royalties are expected to increase significantly. The workers' remittances are projected at $ 4160 million for 2009-10 against $ 4000 million during 2004-05. Workers Remittances are the most important source of foreign exchange earnings for Pakistan after merchandise exports and are also included separately in the gross national income estimates as one of the components of net factor income from abroad reflected in the current account balance. Remittances serve two purposes in our national economy: first, they supplement foreign exchange resources available to the economy and to that extent reduce the balance of payments constraints ; second, the corresponding domestic resources which are generated can be used to supplement domestic investment or consumption. During the fiscal year 2002-03 remittances reached $ 4237 million, the highest in the history of the country. For the financial year 2003-04 remittances amounted to $ 3872 million showing a decline of 8.6% over the previous year. This decline in remittances was primarily due to the continuous fall in receipt from the Gulf States, particularly UAE. The inflow of remittances (including HSS) is projected at $ 4160 million for the terminal year 2009-10 of MTDF on the following assumptions: -

i) Pakistan will gain new markets in the coming years in Malaysia and a large role in the rehabilitation of Afghanistan

ii) Position of skilled labour will improve in the coming years and will gradually replace Pakistan's unskilled labour abroad.

iii) The recent increase in the oil prices will lead to greater economic activity in the oil producing countries resulting in more demand of workers from Pakistan in the coming years.

Allowing for other invisibles receipts and payments, the surplus on invisibles account is anticipated at $ 300 million in 2009-10 against a surplus of $ 1643 million estimated during 2004-05.

2.8. Current Account

With a deficit of $ 5211 million on the trade account and a surplus of $ 300 million on the invisibles account, the current account deficit is estimated at $ 4911 million (2.4 percent of GDP) in 2009-10 against a deficit of $ 1912 million (1.75 percent of GDP) in 2004-05. The deterioration in the current account based on significant increase in the trade deficit on account of higher imports of capital goods , raw materials and increased import bill of POL due to higher prices of POL in the world market . The other major factors responsible for this worsening are increased net income outflows in the services account.

2.9. Foreign capital requirements and financing

Foreign capital requirements over the next five years will be determined by the size of the current account deficit, amortization and desired level of exchange reserves. Amortization is projected to decrease from $ 1498 million during 2004-05 to $ 1330 million during 2009-10. Given the decreased amortization and increased current account deficit capital requirements are expected to increase from $ 3985 million in 2004-05 to $ 6691 million in 2009-10. The financing of these requirements would be made through normal disbursements of medium and long-term loans, capital and foreign investment (net) and exceptional financing coming from multilateral institutions. It is envisaged that the disbursement of medium and long-term loans will decrease from $ 2246 million in 2004-05 to $ 1590 million in 2009-10. Other capital including foreign direct investment and portfolio investment (net) is anticipated to increase from $ 210 million during 2004-05 to $ 608 million in 2009-10. The gap will be financed through exceptional financing. Pakistan has entered the international capital market in February 2004 and issued $ 500 million Euro Bonds and has also mobilized $ 600 million by floating Sukuk Bond in the international market.