



MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

Issue # 44

Economic report

September 5th, 2007

Time to Shift Lanes

In an interview with a daily local, Prime Minister Shaukat Aziz stressed that in order to achieve sustainable economic growth Pakistan must enhance its trade performance by thriving on its geo-strategic location and building itself into a regional trading hub. He emphasized that in order to leverage the true potential of regional trade the economy must build energy, transportation and trade corridors.

This report will discuss how development of Services, particularly Transport and Communications, has enhanced the trade performance of global economies and the huge potential that exists in Pakistan within these segments. It will then examine the significance of employing the untapped potential of the Services sector and its sub sectors in making the economy globally competitive and achieving sustainable economic growth.

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Building New Corridors to Success

In the recent years Pakistan's economy has gained considerable strength, underpinned by good governance, comprehensive structural reforms, prudent macroeconomic policies and sound financial discipline. As a result of these proactive and consistent policies, Pakistan has been successfully transformed into a stable and resurgent economy with strong growth prospects for the coming years. Nevertheless despite holding better than ever economic prospects, the economy faces some potential threats including growing current account deficit resulting from poor trade performance, continuing high inflation and the emerging power and gas shortages.

The poor trade performance emanating primarily from weak performance of exports is often cited as the biggest challenge facing the economy, which may reverse the growth trend if left unchecked. For the FY 2006-07, the current account deficit stood at a record high level of USD 7.016 billion; an increase of 40% over the previous fiscal year. The widening current account deficit was caused in part by poor performance of the exports which failed to achieve the export target for the year, the widening trade deficit, and an increased deficit for services sector which resulted from high payments of transportation, construction, financial, computer services and royalties, and an increase in income deficit witnessed during the year. Hence in the wake of the rising current account deficit alongside the strong economic growth many economists, policy makers and international financial institutions are emphasizing on promoting trade particularly in sectors where enormous untapped potential exists to not only sustain the current growth momentum but to take the economy on a higher growth trajectory.

Similar sentiments were expressed by Prime Minister Shaukat Aziz lately in an interview with a daily local where he stressed that in order to sustain its strong economic growth and thereby usher in an era of development and prosperity for the people., Pakistan must enhance its trade performance by benefiting from its geo-strategic location which is pivotal in promoting and facilitating trade linkages between Asian countries. He emphasized that the country offers the ideal conditions in all respects, to be a regional hub for trade and in order to leverage the true potential of regional trade it must build energy, transportation and trade corridors.

For years the economy of Pakistan has concerted its efforts to boost trade via its commodity producing sectors like textiles, with little attention directed towards development of services. However one must realize that in presence of large manufacturing goods suppliers like India and China (in case of textiles) in the region, Pakistan faces tough global competition. In presence of these circumstances, this report shall discuss the significance of employing the untapped potential of the Services sector and its sub sectors instead, particularly transport and communications, in making the economy globally competitive and achieving sustainable economic growth.

A Shift in Paradigm: From Manufacturing to Services

Contrary to the historical pattern of structural change observed in what are now known as developed countries, the share of services in the GDP has grown at a faster long-term rate than manufacturing in the emerging economies and has thus come out as a more steadfast engine of growth. For example in Pakistan as shown in Figure 1, the share of Services Sector towards total GDP has increased considerably over the years relative to the share of Manufacturing. With a share in GDP of 52.3% and a share in employment of 36% for FY 2005-06, the role of Services Sector has thus become crucial in sustaining the growth of the economy.

Figure 1: Sector-Wise Share in GDP at Constant Factor Cost

	1969-70	2001-02	2002-03	2003-04	2004-05	2005-06
Commodity Producing Sector	61.6	47.9	47.1	48.4	48.7	47.7
1. Agriculture	38.9	24.1	24.0	22.9	22.5	21.6
2. Mining & Quarrying	0.5	2.4	2.5	2.6	2.7	2.6
3. Manufacturing	16.0	15.9	16.3	17.3	17.9	18.2
4. Construction	4.2	2.4	2.4	2.0	2.1	2.2
5. Electricity & Gas Distribution	2.2	3.0	2.4	3.7	3.5	3.0
Services Sector	38.4	52.1	52.3	51.6	51.3	52.3
6. Transport, Storage & Communications	6.3	11.4	11.4	10.9	10.4	10.5
7. Wholesale & Retail Trade	13.8	17.8	18.0	18.2	18.6	19.2
8. Finance & Insurance	1.8	3.5	3.3	3.4	4.0	4.6
9. Ownership of Dwellings	3.4	3.2	3.1	3.0	2.9	2.8
10. Public Administration & Defence	6.4	6.4	6.6	6.3	5.6	5.8
11. Other Services	6.7	9.8	9.9	9.7	9.5	9.5
GDP (constant factor cost)	100.0	100.0	100.0	100.0	100.0	100.0

Source: SBP

Though the impressive performance of the services sector was equally shared by all sub-sectors, finance and insurance, wholesale and retail trade, and transport and communications sectors contributed most significantly. Growth and efficiency gains witnessed in finance and insurance can be attributed to financial reforms and liberalization initiated in the 1990s. While the rise in the profits of both banks and insurance companies reflects the general improvement in the economy, the profits of the commercial bank also benefited from rising interest rate spreads. The increased profits of the insurance industry, on the other hand, came from expansion in both life and non-life insurance industries. The strong performance turned in by Wholesale and Retail Trade was underpinned by a surge in trading activities while the improved performance in transport and communications sector was backed by strong growth in value addition by road transport, railways, ports, communication and storage sub-sectors.

What is interesting to note is that despite such impressive growth in the services sector, the contribution of the sector towards trade has rather been poor. Due to this poor scale of services trade, Pakistan is not only considered as amongst the small service traders of the region where with continuing liberalization trade in services has been growing rapidly,

but also its imports of services (payments) are far above its exports (receipts) of services. For FY 2006-07 the exported services stood at USD 4.125 billion against USD 3.769 for the previous year while imports of services were recorded at USD 8.250 against imports of USD 8.198 for the previous year resulting a deficit of USD 4.125 billion. Though these numbers show a slowdown in growth of imports relative to the exports, there still exists tremendous potential within the services sector which if tapped can bring a dramatic turnaround in the export performance of the sector and thereby the whole economy.

Services are the most productive sector in many growing economies and many services are crucial inputs into products that compete in domestic and international markets. Indeed access to efficient and productive input services are an important determinant of economic productivity and competitiveness in the entire economy. Thus, liberalization of services is not just for expanding export in services trade, but also to facilitate domestic producers gain competitive advantage with access to more efficient (low cost and high quality) and diversified producer services available in world markets. Hence rather than relying solely on the commodity producing sectors for boosting our exports it is important for the economy to investigate ways by which the comparative advantage in services could be explored.

The emerging economies for quite some time have been lured by the export led growth strategies of the East Asian countries like China and have concerted their efforts to boost exports via the commodity producing sectors. Being the fastest growing economy, China has been growing approximately 8% and its technological capacity is upgraded at prodigious rates and its businesses threaten an ever greater swathe of industry in Europe and the US. However one must pay heed that such growth miracles can only work for first comers, but falls apart once all try to enter the international markets. One may argue that export led growth operates via a hierarchical process, with less developed newcomers replacing maturing export economies in which surplus labor supplies have been exhausted and wages are rising. However China has huge supplies of labor at rock bottom wages, and population growth ensures that this will hold into the future. It is therefore very difficult for any developing country to now enter the system with production costs below those of China.

In the wake of these circumstances it is therefore more critical to diversify the export base and instead of focusing only on developing manufacturing products for trade, steps must be taken towards development of Services which currently have enormous untapped potential.

Playing the Dart Game: Who are the Winners?

Now that it has been established that development of Services sector is deemed critical to the economy's trade and sustainable development, we must focus on sub-sectors that are more crucial in this aspect. As mentioned earlier the best performing sub-sectors within Services are finance and insurance, wholesale and retail trade, and transport and communications. With financial services already performing very strongly and attracting

considerable foreign investment, we believe that amongst these sub-sectors the most potential exists within the transport and communication segment which if utilized will contribute considerably towards trade.

The establishment of an efficient and well integrated transport and communication system is crucial in order to facilitate the development of a competitive economy while ensuring effective connectivity. Having direct and indirect association with all important sectors of the economy, the Transport and Communication sector covers roads, road transport, railways, ports and shipping, aviation and telecommunications.

The Clear Winner: The Transport Sector

An efficient transport system contributes to economic growth by lowering domestic production cost through timely delivery of raw materials, enhancing economies of scale in the production process, integrating markets and creating economic opportunities and communications links among people. In this fashion it enhances the competitive advantage of the economy in production of goods and thereby promotes trade. A competent transport system is likely to also encourage tourism and foreign investment. In addition to this, this sector generates a large number of employment opportunities; currently 6% of employed labor force is said to be engaged with this sector. The sector also contributes to the government revenues through taxes and duties on production and import of vehicles and parts, petroleum products, and fees on ownership and operation of vehicles.

Despite the strategic importance of the sector as outlined above, the performance of the transport system is not up to mark. There are logistics constraints, which impede competitiveness of the country's trade and industrial development. The incompetent and outdated infrastructure of the system cannot support the 7% growth which the economy aims to achieve. Since an efficient transport system is a pre-requisite for Pakistan to become globally competitive, it is thus extremely important to revamp the present structure of the transport system by increasing the level of investment in the sector with enhanced private sector participation in the provision of transport infrastructure and services.

Firstly revamping the entire structure of the transport system would require upgrading the existing infrastructure to international standards while improving the quality and management efficiencies. Secondly it is important to facilitate the coordinated use of various modes of transport and lastly it is necessary to prepare for energy efficiencies, and other modal changes which are likely to occur in the coming years.

One important sub-sector of transport which is very critical to enhancing trade is shipping and ports. Around 95% of the country's imports and exports are handled through the ports and currently there are only two national ports which handle about 40 million tons of cargo annually. The Karachi Port, handles about 30 million tons of cargo, while Port Qasim handles about 10 million tons. Therefore in order to keep pace with the rising

economic growth and enhance trade performance, it is important to build new routes for trade activities on strategic locations.

One such location is Gwadar which is a district of Balochistan, situated at a distance of about 750 km from Karachi. Gwadar is one of the very few deep seaports in the region which enjoys a significant position geographically as it is linked with the world three key points; Middle East, South Asia and Central Asian states. Hence once adequate communication links and ancillary facilities are developed in the region the Gwadar sea port will build into a rich trading hub for many Asian, African and Pacific countries.

Although it has been neglected in the past, today the development process in Gwadar is rapidly progressing at hands of government's initiatives. The government has already started various projects with local and international financial and technical assistance to develop the port to enable high volume cargo movement to and from the landlocked Central Asian states. On completion the port will not only facilitate the shipping and port sector of the country but will help generate tremendous economic activities in the economy by providing a multi-directional network of road communication within and outside the country. It would also help in reducing congestion at Port Qasim. It has been estimated that the economy would earn USD 60 billion per year on transactions of trade after completion of Gwadar Port.

Though no date has yet been fixed for Gwadar Port's formal inauguration, it is expected to come into operation by the end of this year. In order to benefit optimally from this port it is important to ensure that port operation begins smoothly under adequate law and order and management facilities so that investors at domestic and international level can optimize on the opportunities offered by the port.

The 2nd Winner: The IT Industry

In order to enhance trade performance it is important to complement development in transport system with investment in the IT industry. Pakistan's IT industry is growing at a rate much faster than ever seen before. Estimated to have an annual size of USD 2 billion, the IT industry in Pakistan currently employs a workforce of over 90,000 professionals. The most fundamental measure of IT readiness is the telecom infrastructure and the reach of network services. It is commendable to note that telecom infrastructure has grown rapidly over time and the telecom industry has evolved into a dynamic global business sector driven by mobile services, data transmission, and internet, e-government and e-commerce applications. The bandwidth consumption has increased from 800 MB in 2003 to 2500 MB. However though the telecommunication segment has done remarkably well and has aroused considerable foreign interest, the software industry falls way behind the optimal mark. Hence it is not surprising that compared to the IT industry of the neighboring economy of India that of Pakistan is far from being fully developed.

For years Pakistan has been aiming at boosting its software exports but unfortunately results have been rather disappointing. It is very important to optimize on the potential of this industry which is huge. Since the software industry faces severe global competition, the local firms must be encouraged to undertake large scale software development projects in collaboration with foreign companies. In this fashion the local firms will be exposed to the tried and tested development processes and methodologies of multinational software companies. Besides attracting large multinational businesses in the country, local entrepreneurs and investors must also be encouraged to invest in this nascent sector and thereby stimulate it to take off.

When the Others Grow, So must we!

Globally Transport and Communication is changing every aspect of human life, from trade to manufacturing, education, research, entertainment, culture and defense. Most emerging economies being aware of the strength of these services are transforming their economies towards knowledge and communications. This will equip these economies to sustain the fierce competition envisaged under the WTO trade regime and achieve sustainable economic development.

In order to keep pace with the global environment, Pakistan will also have to develop an efficient and well integrated transport and communication system. With this it will emerge as a competitive economy, enhancing its trade performance and thereby attaining sustainable growth.



Economic Snapshot

Fiscal year 06-07														
	Units	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June
<u>Inflation</u>														
Headline Inflation	%	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0
Core inflation	%	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1
Food inflation	%	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7
Non-food inflation	%	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69
6 month	%	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9
12 month	%	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16
<u>External Sector</u>														
Export	Mln US\$	1,533	1,334	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583
Import	Mln US\$	2,685	2,383	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373
Trade balance	Mln US\$	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)
<u>Remittances</u>	Mln US\$	464	376	435	422	410	448	475	391	457	520	513	537	505
<u>Forex Reserves</u>	Mln US\$	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182



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