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Enhancing Trade in Services between Pakistan and Central Asia

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Acronyms

ALI	Air Liberalization Index
APTTA	Afghanistan-Pakistan Transit Trade Agreement
ASA	Air Services Agreement
ASEAN	Association of Southeast Asian Nations
ASX	Australian Stock Exchange
AUB	Asia Universal Bank
BEEP	Business Environment and Enterprise Performance
BOT	Build Operate and Transfer
CAGR	Compounded Annual Growth Rate
CAR	Central Asian Republic
CAREC	Central Asia Regional Economic Cooperation
CBTA	Cross Border Transport of Persons, Vehicles and Goods Agreement
CMT	Cabinet of Ministers of Tajikistan
EBRD	European Bank for Reconstruction and Development
ECO-TTFA	Economic Cooperation Organization Transit Transport Framework Agreement
ESE	Employing Skilled Expatriates
EU	European Union
FDI	Foreign Direct Investment
FSA	Financial Supervision Authority
GATS	General Agreement on Trade in Services
GVC	Global Value Chain
ICT	Information Communication Technology
IFRS	International Financial Reporting Standards
KASE	Kazakhstan Stock Exchange
KSE	Karachi Stock Exchange
KKH	Karakoram Highway
MoF	Ministry of Finance
MTS	Mobile Tele Systems
NBK	National Bank of Kazakhstan
NBP	National Bank of Pakistan
NBT	National Bank of Tajikistan
NPL	Non-Performing Loans
PIA	Pakistan International Airline

PMEX	Pakistan Mercantile Exchange
QTTA	Quadrilateral Traffic in Transit Agreement
RCA	Revealed Comparative Advantage
ROE	Return on Equity
SAARC	South Asian Association for Regional Cooperation
SBP	State Bank of Pakistan
SCRA	Special Convertible Rupee Accounts
SECP	Securities Exchange Commission of Pakistan
SGX	Singapore Exchange Limited
SME	Small and Medium Enterprise
SMEDA	Small and Medium Enterprise Development Authority
SOE	State-owned Enterprise
TAE	Trans Asia Europe
TAPI	Turkmenistan Afghanistan Pakistan India Natural Gas Pipeline
TASIM	Trans Eurasian Information Superhighway
TCI	Trade Complementarity Index
TIR	Transports Internationaux Routiers or International Road Transport
TSE	Tajikistan Stock Exchange

Executive Summary

Services are the leading driver of world Gross Domestic Product (GDP) growth, contributing to 70 percent of the world's GDP and generating more than 60 percent of jobs worldwide. Developing countries' share in world services exports has trebled over the last two decades to more than 30 percent. Services have evolved to be a critical instrument in forming global value chains (GVCs); the average agricultural or manufactured good contains roughly 35 percent of services value-added, with the percentage even higher for hi-technology goods.[1] Consequently, no country can become part of regional production networks, even in the goods sector, if it does not have an efficient services sector.

Pakistan's inclusion in the Central Asia Regional Economic Cooperation (CAREC) Program in 2010 opened the country to the potential of becoming a trade and energy corridor between the energy-rich landlocked Central Asian Republics[2] (CARs) and the Middle East/South Asia. Given the importance of services to regional connectivity, this paper examines the current levels of services trade between Pakistan and the CARs. It also proposes recommendations to develop a services-driven regional integration strategy within a broader trade policy framework.

Services play an important role in the economies of the CARs and Pakistan. The share of services in GDP for Pakistan and the CARs, with the exception of Turkmenistan, is near or above 50 percent. Furthermore, exports of services from Pakistan and the CARs from 2003 onward have increased rapidly at a compounded annual growth rate (CAGR) of 9.21 and 14.3 percent, respectively. CARs' imports of services globally have risen sharply over the last decade at a CAGR of 16.5 percent. Pakistan's proximity to the CARs provides it with an opportunity to tap into the emerging Central Asian market and expand trade in services.

Despite the growing importance of the services sector, the contribution of the CARs and Pakistan to the global services trade is relatively low; their combined share of exports of services constitutes only 0.42 percent of the world's export in services. This highlights the need for policymakers to take economy-wide and sector-specific measures to ensure effective reforms and liberalization in the services sector.

This paper presents an assessment of the potential for and barriers to trade in services between Pakistan and Central Asia, with a focus on backbone services including transport, financial, and telecommunications sectors. Backbone services sectors have the greatest potential to generate economic activity, and liberalization in these sectors is highly correlated with inward foreign direct investment (FDI).[3] The research examines the status of trade liberalization and current levels of regional engagement in these sectors, and suggests reforms to enhance regional integration.

Financial services facilitate the flow of funds between economies and encompass a wide range of services including banking, insurance, and capital markets. The first sectoral report evaluates Pakistan's potential for provision of banking and insurance services in the CARs. With relatively undeveloped capital markets, the banking sector dominates the financial sector of most CARs. Pakistan's banking sector is dominated by the private sector. With the exception of Kazakhstan, in CARs the banking sector is predominantly state-owned.

The study indicates potential for Pakistan's banks to provide financial services, including credit, to small and medium enterprises (SMEs) in the CARs. Analysis reveals that access to finance, especially for SMEs, is a key constraint in the Central Asian market. The state-owned National Bank of Pakistan (NBP)

[1] ITC, 2014
[2] The Central Asian Republics (CARs) for the purpose of this report include Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan
[3] Services Policy Reform and Economic Growth in Transition Economies, 1990-2004, Hoekman and Eschenbach, WPS3663

is successfully operating in all CARs and has been able to create a niche in provision of loans to SMEs. There is potential for other banks in Pakistan to provide similar services in the region; however, considering the state interference and extensive bureaucratic hurdles observed in the smaller CAR economies, it is suggested that the Government of Pakistan (GoP) may facilitate Pakistani banks that wish to provide services in Central Asia.

The findings suggest that there is considerable potential for Pakistani institutions to provide insurance services in CARs. Pakistan is already providing insurance services in Afghanistan, Kyrgyzstan, and Kazakhstan. In 2013, Pakistani insurance companies insured more than USD 200 million in these countries and generated a premium income of around USD 2.3 million. Given the steady growth of the insurance sector in Pakistan and the substantial increase of exports of insurance services over the last decade (CAGR 10.2 percent), there is potential to further increase the provision of insurance services by Pakistani companies in the region.

A comparative assessment of capital markets in Pakistan and the CARs reveals that with the exception of Pakistan and Kazakhstan, capital markets in the region are relatively rudimentary and volatile. Kazakhstan attracts significant portfolio investment in debt securities which have grown rapidly in recent years, attracting an investment of USD 58 billion in 2012. There is pervasive state control in all CARs, with the exception of Kazakhstan, where the securities market is regulated by a semi-autonomous body, the Financial Supervision Authority (FSA).

The patterns of portfolio investment in the region suggest that there is potential for investment between Pakistan and Kazakhstan; Pakistan may explore the opportunity to invest in debt securities in Kazakhstan. Moreover, Pakistan has invested USD 4 million in treasury bills in Tajikistan through a subsidiary of the NBP and may also expand this investment in Kazakhstan and other CARs. Pakistan may consider establishing a co-trading scheme with the well-functioning stock market in Kazakhstan. There is also potential for Kazakhstan to invest in the equity market in Pakistan; however, Pakistan's current security situation and perceived political instability are considered major barriers.

The second sectoral report evaluates the potential for trade in transport services in the region. Efficient transport services are essential for reaching world markets and strengthening regional and global integration. GVCs can only be developed when logistics services are reliable and cost-effective; as goods cross borders multiple times during the production process, the impact of transport services compounds.

Pakistan provides the CARs with the shortest access to sea; however, negligible exports of rail and road freight services suggest that Pakistan has failed to leverage its geostrategic location as a transit corridor. Pakistan's global exports in the transportation sector are concentrated in air transport of passengers, which constitutes over 50 percent of transport services exports. Strict visa regimes in the CARs restrict the movement of people. This reduces the business feasibility of direct flight services between Pakistan and the CARs. At the time of this report there were no exports of air transport of passengers from Pakistan to the CARs. Air freight is the preferred mode of cargo for the main exports of Pakistan to the CARs, which include high cost and low weight surgical and pharmaceutical goods. There are currently no direct cargo flights to the CARs from Pakistan.

The study makes a case for effective liberalization of the transportation sector to spur trade in transport services. Reforms such as allowing entry of new carriers and promoting policies to attract investment would address the issue of lack of capacity in Pakistan's aviation sector. Easing of visa regimes may also improve the feasibility of direct flights in the region. Implementation of transport and transit agreements and Pakistan's accession to the International Road Transport (TIR) convention would significantly facilitate the movement of vehicles in the region and enable it to function as a transit corridor. The CARs

can access Pakistani seaports via China, Afghanistan, and Iran. Pakistan currently provides CARs with the shortest route to sea along the Karakoram Highway (KKH) through the Chinese corridor; however, development of the Kashgar-Gwadar rail and road infrastructure could provide the CARs with the shortest route, and year-round access.

The study highlights the importance of telecom connectivity between Pakistan and Central Asia. With improved intra-regional connectivity, the Central Asian countries and Pakistan can not only improve telecom integration within the region, but also address the lack of reliable and cost-effective Europe-to-Asia bandwidth - a pressing concern of the international telecom industry. The situation presents an opportunity for Pakistan to become a regional telecom transit hub. Findings reveal that international bandwidth and optic fiber connectivity in the region is suboptimal. Consequently, IP transit and broadband subscription costs are prohibitively high in all CARs except Kazakhstan. This is a major impediment to the growth of telecom and digitally-enabled services. Pakistan has limited connectivity with the CARs via Afghanistan. The fiber optic link between Afghanistan and Pakistan is underdeveloped.

The report recommends that Pakistan improve its optic fiber connectivity with Afghanistan for better integration with the CARs. It also suggests that an optic fiber terrestrial network be developed along rail and road infrastructure projects under CAREC to integrate the Corridor 5 countries. Estimates indicate that the additional cost of fiber network installation during such open road construction would be less than 1 percent of total project costs.

The report also studies patterns of trade in services in the region via mode 3 (commercial presence) and mode 4 (movement of natural persons), and highlights the importance of labor mobility and FDI in services in the region.

Chapter Overview

Chapter 1 Highlights the growing role of services in the global economy and their important spill over effects, including their importance in forming global value chains, increasing productivity, facilitating rural development, and increasing overall macroeconomic growth.

Chapter 2 Examines the contribution of services sector and trade in services to the economy of the region. Services sector growth and its contribution to GDP of the economies are observed and major services at a sub-sectoral level are identified. Sectoral and sub-sectoral patterns in services trade of Pakistan and the CARs are also examined, including patterns in a shift from traditional to emerging segments and diversification of the import/export basket.

Chapter 3 Estimates the potential for growth in trade in services between Pakistan and the CARs. Competitiveness of CARs and Pakistan in global and regional services trade are determined based on sub-sectoral Revealed Comparative Advantage (RCA), trade complementarity index, and analyses of imports and exports statistics. The chapter also identify the specific sectors that hold the highest potential for trade in services in the region based on the analyses.

Chapter 4 Presents the first sectoral report. It provides an assessment of the banking sector in CARs and Pakistan and provides a cross regional comparison on indicators of financial access, financial soundness, and restrictiveness to entry of foreign banks. The section also highlights the potential for Pakistan's banking and insurance sector to provide services in the CAR region.

Chapter 5 Examines the market structure, performance, and regulatory environment of the capital markets of the CARs and Pakistan, and evaluates the potential for portfolio investment. It examines a number of sources including IMF AREAER to highlight the regulatory barriers, such as excessive state control and restrictions on national treatment for non-domestic participants, that may hinder greater capital market integration in the region.

Chapter 6 Examines the transport sector of the CARs and Pakistan and evaluates Pakistan's potential to act as a transit corridor by comparing Pakistani ports to its main competitive ports, evaluating the various corridors through which Pakistan can provides access to the CARs, and analyzing the road, rail, air, and marine transport in the region. Transport is one of the most important backbone services for trade. The chapter also recommends the reforms needed in the transport sector to increase trade and integration in the region.

Chapter 7 Highlights the importance of telecommunication connectivity between Pakistan and Central Asia, especially for Information Communication Technology (ICT) enabled services. It analyzes the existing status of regional connectivity, and current bandwidth and transit costs. The chapter proposes establishment of a terrestrial fiber optic network that would improve economic integration and connectivity between the CARs.

Chapter 8 Identifies labor mobility and worker migration (services mode 4) patterns in the region and identifies potential for Pakistani labor exports to the CARs.

Chapter 9 Focuses on FDI (services mode 3) to study patterns of investment in the region's services sector.

Chapter 10 Consolidates the report's findings, provides policy recommendations, and conclusions.

Chapter 1 Role of Services in Global Economy

Services are the leading driver of global economic growth; services on average account for 50 percent of developing countries GDP and generate more than 60 percent of jobs worldwide. Trade in services is also a fast growing component of the world trade with export of services growing from USD 1.6 trillion in 2002 to USD 4.3 trillion in 2012, a 166 percent increase.[4]

Developing countries' share in world services exports has trebled over the last two decades to more than 30 percent. With improvements in telecommunications and digital technology, a modern class of services has emerged. In 2010 alone, services outsourcing activities generated USD 250 billion in global export revenues, employing 4 million people globally, with developing countries being key participants in these new business opportunities.

Despite strong growth, CARs and Pakistan together account for only 0.42 percent of global services exports, compared with their 0.75 percent share in world merchandise exports.[5] Service reform and liberalization are crucial for any trade development strategy in the region for the following reasons:

1. Services are a critical instrument in forming GVCs. The manufacturing and agriculture sectors have undergone "servicification"; the average agricultural or manufactured good contains roughly 35 percent of services value-add with the percentage even higher for high-technology goods.[6] Thereby no country can be competitive or join GVCs, even in the goods sector, if it does not have efficient domestic services sector or is closed to their importation.

2. Research suggests that gains from global trade liberalization can be enhanced by 80 percent if services are included in the reform package. Empirical evidence also shows that economic gains from a 50 percent reduction in services rates of protection produce income gains at least equivalent to those from elimination of tariffs on manufactured goods.[7]

3. Since services are an important input into many production processes elsewhere in the economy, service liberalization reduces cost of doing business. One example is the logistics and distribution sector. An efficient telecommunications sector also makes it possible for other service providers in areas such as finance and business services to achieve higher levels of productivity.

4. Productivity in manufacturing can be increased as a result of gains in efficiency in service sector which in turn leads to improved export competitiveness. According to an estimate, on average a 10 percent increase in services trade is associated with a 6 percent increase in goods trade.[8] Literature also suggests that the strongest gains for manufacturing exports come from improved efficiency in transport and communication services.

5. Research shows strong evidence that the quality of service availability is an important determinant of rural income due to the linkages mentioned above. This is particularly true for road quality as an indicator of transport sector performance, electricity provision, availability of markets, and ability to access credit markets. The spill overs from service sector performance are not only good for the economy as a whole, but also for poor people in rural areas.

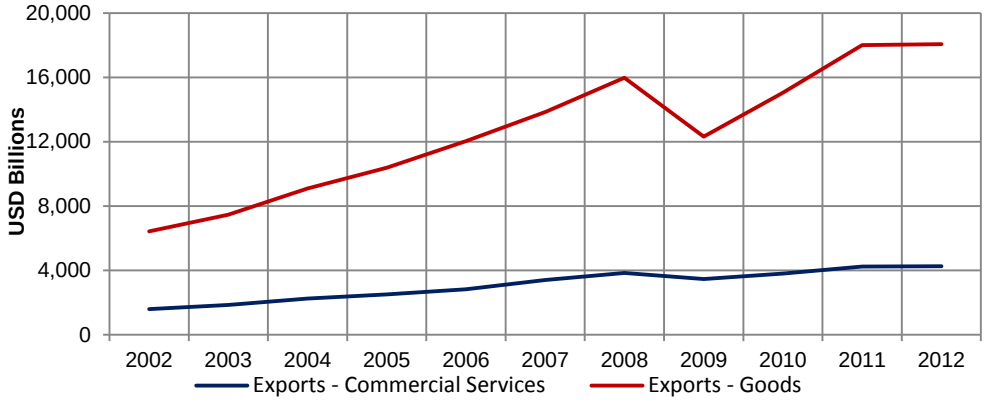
[4] UN Comtrade, 2012
[5] Ibid
[6] ITC, 2014
[7] APEC Policy Support Unit - Trade in Services in the APEC Region: Patterns, Determinants, and Policy Implications
[8] Ibid

6. Additional benefits from trade in services relate to the important role played by FDI and trade via General Agreement on Trade in Services (GATS) Mode III (sales by foreign affiliates). There is ample empirical evidence that foreign-owned companies tend to be larger and more productive than their domestic counterparts, particularly in developing economies. There are substantial technology spill overs from FDI, as well as skill upgrading in labor markets. Since FDI is an important vehicle for services trade, this dynamic is suggestive of an additional set of productivity gains that can be achieved.

7. At the macroeconomic level, there is evidence that these spill over effects matter for subsequent economic growth. The liberalization of backbone services such as finance, infrastructure, telecommunications, and transport, is highly correlated with inward FDI and therefore a strong macroeconomic growth. The economies with open telecommunications and finance sectors tend to grow about 1.5 percentage points faster than other economies.[9]

In the last decade, the direction of exports of services has been analogous to that of exports of goods, with both more than doubling in value. This underlines the important characteristic of services in facilitating trade in goods. Improved trade in services can help create synergies for merchandise trade through cooperation on transport, logistics, telecom, finance, and various other infrastructure services.

Figure 1: Worlds exports of goods and services



Data Source: UN Comtrade

Travel, transportation, and business services dominate the world trade in services. In 2012 they contributed about 70 percent to global exports in services. Major exporters of services are United States of America, United Kingdom, Germany, and France; the combined share of these four countries in 2012 represented 32 percent of the total world exports.[10]

[9] APEC Policy Support Unit - Trade in Services in the APEC Region: Patterns, Determinants, and Policy Implications
[10] UN Comtrade, 2012

BOX 1: Definition of Services Trade and Modes of Supply

International supply of services is difficult to analyze as unlike trade in goods where there is a cross-border movement of merchandise, services can be supplied through various means.

At the end of the Uruguay Round, GATs established a multilateral legal framework and negotiating forum for trade in services. The GATS uses four core analytical tools to capture the supply of services, referred to as "modes of supply."

- Mode 1 (cross border trade): Service is supplied from the territory of one member into the territory of another member. It is similar to the traditional notion of trade in goods where both consumer and supplier remain in their respective countries when the product is delivered. An example is engineering drawings, where an engineering company in Pakistan provides oil-platform services to a petroleum exploration company in Turkmenistan through the internet. Another example is tele-medicine, where a doctor in Pakistan provides consultancy services via video telephony to a patient in Turkmenistan

- Mode 2 (consumption abroad): Consumption abroad occurs when a consumer moves outside his or her territory and consumes services in another country. An example is tourism services, where a tourist from Pakistan visiting Lake Issyk-Kul in Kyrgyzstan stays in a hotel.

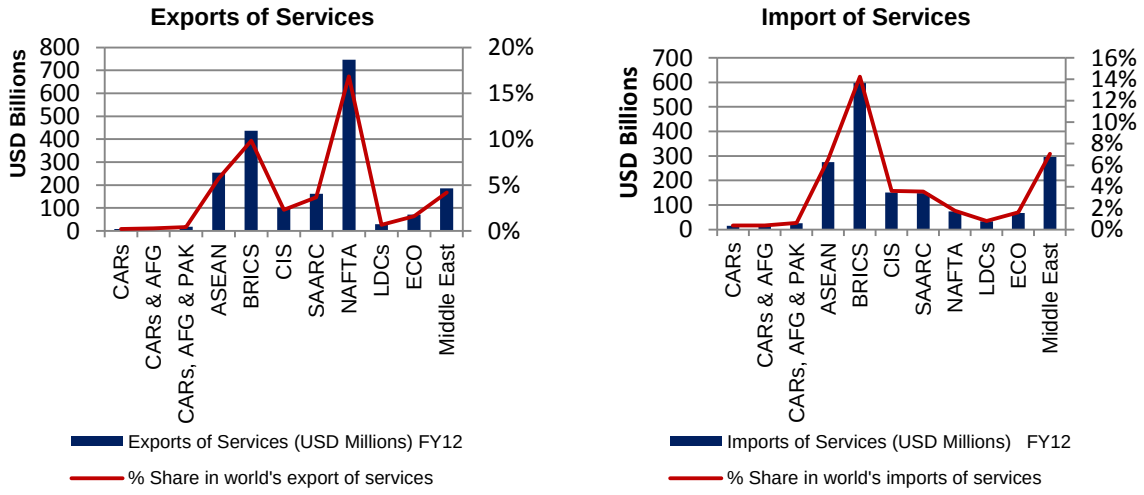
- Mode 3 (commercial presence): Services are supplied by one member, through commercial presence, in the territory of any other member. An example is the establishment of a branch by a bank in Pakistan, such as NBP in Kazakhstan to provide banking services.

- Mode 4 (Presence of natural persons): Service is supplied by an individual who moves into the territory of consumer to provide a service. An example is of an auditor from a Pakistani audit firm who goes to Uzbekistan to provide auditing services.

Chapter 2 Role of services in the economies of Pakistan and CARs

The contribution of CARs and Pakistan to the global trade in services is relatively insignificant, with their combined share of exports of services constituting only 0.42 percent of the world's export in services. Other trading blocs in Asia such as South Asian Association for Regional Cooperation (SAARC) and Association of Southeast Asian Nations (ASEAN) fare considerably better in global trade in services with services exports of 5.73 and 3.66 percent, respectively.[11]

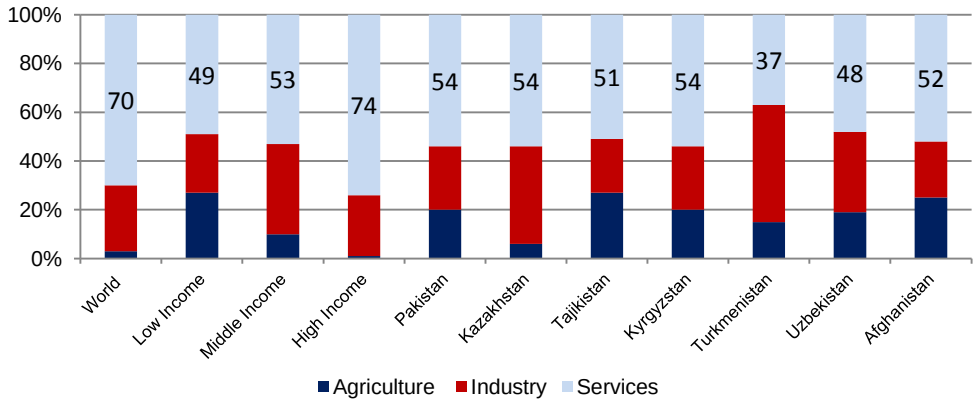
Figure 2: Export and Import of services for different regions



Source: UN Comtrade

Despite relatively low trade in services, services have been a key driver of economic growth for CARs and Pakistan. This is reflected in the sector's prominent contribution to the GDP of the respective countries. With the exception of Turkmenistan, the share of services in GDP for all CARs and Pakistan is more than or near 50 percent.[12]

Figure 3: Sectors contribution to GDP, 2012



Source: World Bank Indicators

[11] Calculated from UN Comtrade, 2012
[12] World Bank Indicators

Patterns in services sector and its contribution to the economy of the region are as follows:

1. Kazakhstan is the largest economy in Central Asia. The services sector is an important component of its national economy and accounts for 54 percent of total GDP.[13] The largest segments within services sector are: retail trade, transport, information and communication technology, real estate, and professional services.[14] Despite the rise in services sector, exports are largely concentrated in oil related extraction, construction, and pipeline transport services.[15]

2. The services sector is also the biggest sector in Kyrgyzstan, having overtaken agriculture as the main contributor to the GDP. At an average growth rate of over 8.1 per cent from 2000 to 2010, it is the fastest-expanding sector in the Kyrgyz economy. Much of the sector's contribution comes from retail trade and restaurants and hotels. A substantial extent of such services can be equated with tourism services. Lake Issyk-Kul is one of the largest alpine lakes in the world and a prominent destination for international tourists in Kyrgyzstan. Other major service categories in Kyrgyz economy are electricity supply and education.

3. The services sector has been providing a steady support to Pakistan's economic growth and its share in GDP now stands at 54 percent. Within the services sector the most important segments are: public administration and defense, wholesale and retail trade, and transportation.[16] In 2012 the services sector registered a growth rate of 3.7 percent, trailing behind the overall GDP growth of 4.0 percent.[17] The performance was mainly driven by finance and insurance, government services and transport, storage, and communication services.

4. In Uzbekistan the service sector constitutes about 48 percent of the GDP and has contributed more to growth than either industry or agriculture in the last decade.[18] From 2007 to 2010 the services sector in Uzbekistan grew by 13.3 percent, well above the 8.7 percent of overall economic growth rate. The growth was driven by strong performance in financial and telecommunication services which posted a combined growth of 24 percent in 2011.

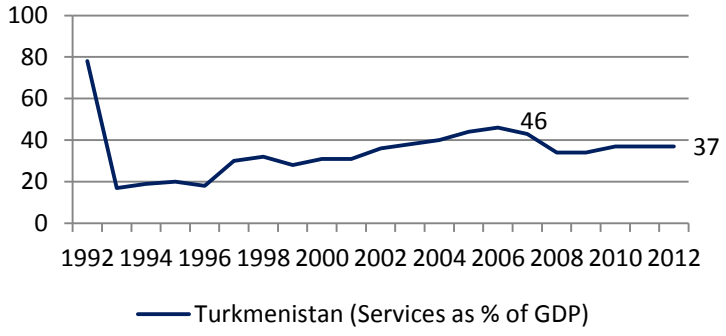
   Because of its rich culture and heritage, Uzbekistan also has enormous potential to develop its tourism sector. Even though the country possesses various tourism attractions and resources and leads the region in the number of UNESCO-designated world heritage sites, tourism accounts for only 0.2 percent of the service sector output and has seen little growth over the past 5 years. This is due to an underdeveloped air transport market, strict visa regime, and an unorganized tourism sector.[19]

5. Turkmenistan's economy is dominated by large, state owned companies. Initially, after independence from the Soviet Union, the emphasis was given to heavy industry and more recently to oil and gas industry. Services sector remains neglected in the country and unlike other post-communist countries in the region, the percentage of workers in the services sector has decreased since the breakup of the Soviet Union. Services contribution to the national output is also the lowest in comparison with other countries in the region. Moreover, unlike other CARs, Turkmenistan share of services has fallen sharply after 2006. This can be attributed to the increasing role of hydrocarbon economy in Turkmenistan and inadequate macro-economic

[13] World Bank Indicators
[14] http://www.tradingeconomics.com/kazakhstan/gdp-growth-annual
[15] Kazakhstan and the World Economy, an assessment of Kazakhstan's trade policy and pending accession to wto
[16] http://www.tradingeconomics.com/kazakhstan/gdp-growth-annual
[17] http://finance.gov.pk/survey/chapters_13/HGHLIGHTS%202013.pdf
[18] http://www10.iadb.org/intal/intalcdi/PE/2013/11857.pdf
[19] UNDP Uzbekistan, http://www.undp.uz/ru/download/index.php?type=publication&id=74&parent=1849&doc=7979

reforms to increase the role of private sector in the economy. Despite relatively less importance of services sector, it grew by 13.9 percent in 2013 which was well above the 7.3 percent growth in industry and 10 percent in agriculture.[20]

Figure 4: Services contribution to Turkmenistan's economy - % of GDP



Source: World Bank Indicators

International Trade in Services

Among the CARs, Kazakhstan is the largest exporter of services with a share of 54 percent in total CARs exports. Transportation, predominantly freight transport and travel services constitute a major proportion of services exported by Kazakhstan. Kazakhstan's exports of services have been increasing over the past ten years with a CAGR of 12.5 percent. In 2009 and 2010, the exports witnessed a slight decrease which was primarily due to the decrease in merchandise trade, especially exports of mineral fuels, oils, distillation products, and iron and steel. Kazakhstan is also the largest market constituting 80 percent of total services imports in CAR's, with a significant demand for business, professional, technical, construction, and transportation services.

Table 1: Share of respective countries in CARs exports and imports of services

Countries	Exported Value FY12 (USD Million)	% Share in CAR's exports	Imported Value FY12 (USD Million)	% Share in CAR's imports
Kazakhstan	4,951,814	54.2%	12,692,424	79.9%
Uzbekistan	2,151,895	23.5%	658,971	4.1%
Kyrgyzstan	1,219,554	13.3%	1,533,841	9.7%
Tajikistan	817,184	8.9%	1,008,622	6.3%
Source: UN Comtrade				

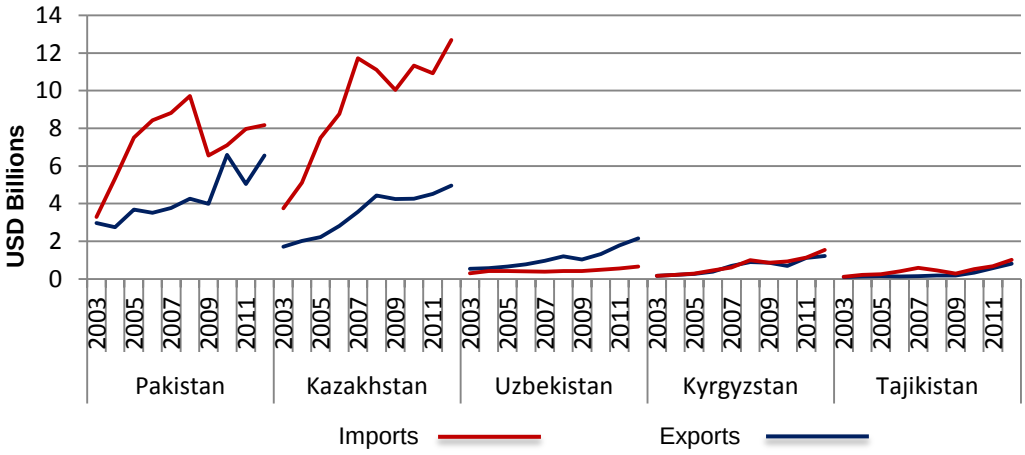
Uzbekistan is the second largest exporter of services among the CARs. Uzbekistan's trade in services, especially exports, has increased prominently over the past ten years. The positive trade balance in services has grown from USD 620 million in 2009 to USD 1.5 billion in 2012. Imports and exports in the 2012 amounted to USD 659 million and USD 2.1 billion, respectively.[21] This increase in services trade is attributable in part to the increased merchandise trade; transportation services related to trade in goods account for a large portion of trade in services. As Uzbekistan's merchandise trade with Russia and China expanded rapidly from 2001-2010, so did trade in services.

[20] http://www.adb.org/sites/default/files/ado2014-turkmenistan.pdf
[21] ITC Trade Map

The share of exports of services to Russia in total exports of services rose from 9.9 percent in 2000 to 25.8 percent in 2010, and Russia became the top export market for services. The share of exports to China in total exports of services also increased significantly, although from a low base.

The imports of services for Uzbekistan have increased over the past four years, albeit at a slower rate than the exports. As with exports of goods, Uzbekistan's imports of services from China and Russia grew on the back of increased merchandise trade. Uzbekistan's share of imports of services from CARs has declined due to decrease in services imports from Kyrgyzstan and Tajikistan. The contraction in merchandise trade with these countries led to the decrease in services imports.[22]

Figure 5: Pakistan and CARs trade in services



Source: UN Comtrade

Kyrgyzstan exports have increased considerably over the past ten years at a cumulative annual growth rate of 28.6 percent with all major services sectors exhibiting positive export growth. The major export oriented service sector for Kyrgyzstan is travel and tourism which has grown at a CAGR of 35 percent from 2003 onwards. The Kyrgyz authorities have also selected tourism as a major service subsector to be promoted. Kyrgyzstan's mountains and lakes make the country an attractive tourist destination; Lake Issyk-Kul and the Tian Shan Mountains are among the most popular. Presently, Kyrgyzstan attracts most of its tourists from nearby countries such as Kazakhstan, Uzbekistan, and the Russian Federation.[23] Diversification of tourist base and improvement of infrastructure can further enhance the sector's contribution to the country's economy and trade.

Tajikistan's trade in services has also seen dramatic improvement in the last five years with both exports and imports of services increasing significantly. The increase is mainly attributable to increased export of transport and business services including mining services in which Tajikistan has a comparative advantage.[24] Export of services in the 2012 amounted to approximately USD 817 million whereas imports stood at approximately USD 1 billion.[25] This increased importance of trade in services is reflected by the percentage of trade in services to the GDP for Tajikistan which has risen from 12.3 percent[26] in the 2008 to 24.5 percent in 2012.[27]

[22] Uzbekistan: Trade Regime and Recent Trade Developments - Working Paper No.4, 2012
[23] National Services Policy Review – Kyrgyzstan, UNCTAD, 2013
[24] World Bank, 2014
25 ITC Trade map
26 World Bank - Indicators
27 World Bank - Indicators

The services sector occupies a pivotal position in Pakistan's economy and has strong backward and forward linkages with commodity producing sectors. Pakistan exports of total services have been growing from 2003 onwards with a CAGR of 9.21 percent. Exports of business management, consultancy and public relations services, and computer and information services have displayed tremendous potential growing at a CAGR of 31.6 and 26 percent respectively from 2003 onwards. Over the same period, construction services have also grown considerably with a CAGR of 27 percent, albeit from a low base.

There was a sharp increase in exports of services in 2010. This was due to increase in exports of government services, especially military units and agencies. Pakistan imports have also increased prominently from 2003 to 2008 with imports in other business services and transportation increasing visibly. In 2009 however, the imports witnessed a sharp decline and business services, travel, and financial services declined substantially. This can be attributable to the significant decrease in the merchandise trade in the aforementioned year.

Figure 6: Sectoral Composition of Services Exports of CARs and Pakistan - 2002 (%)

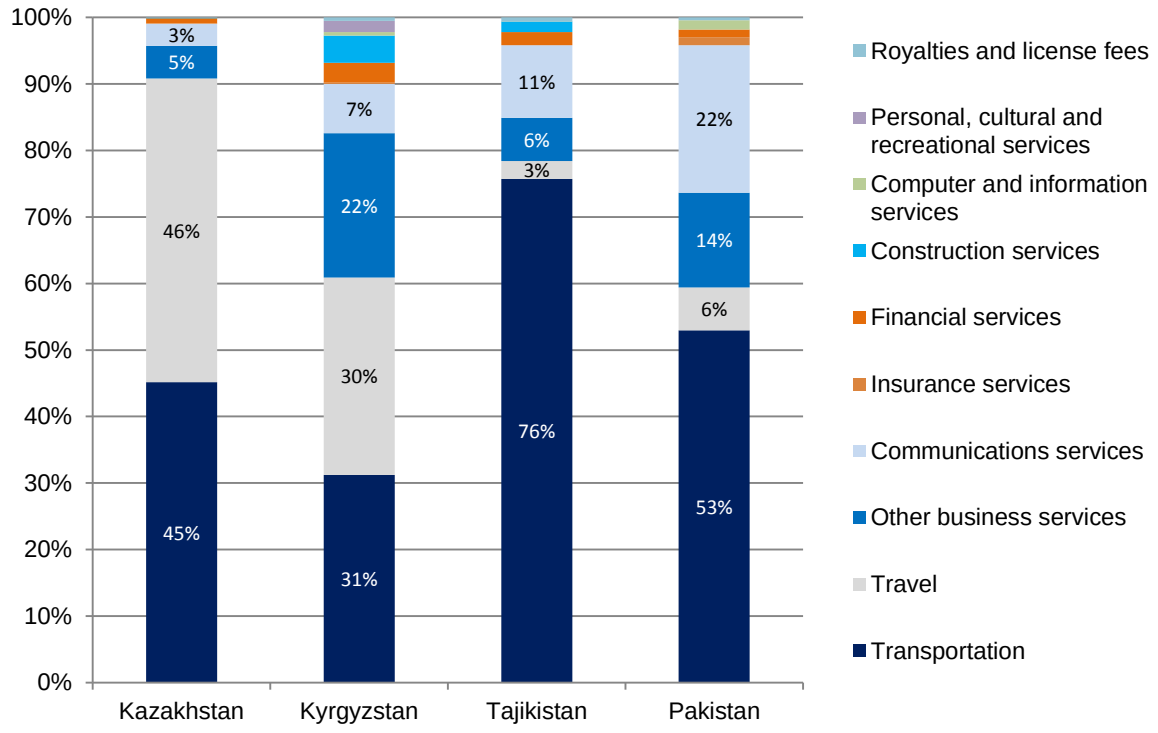
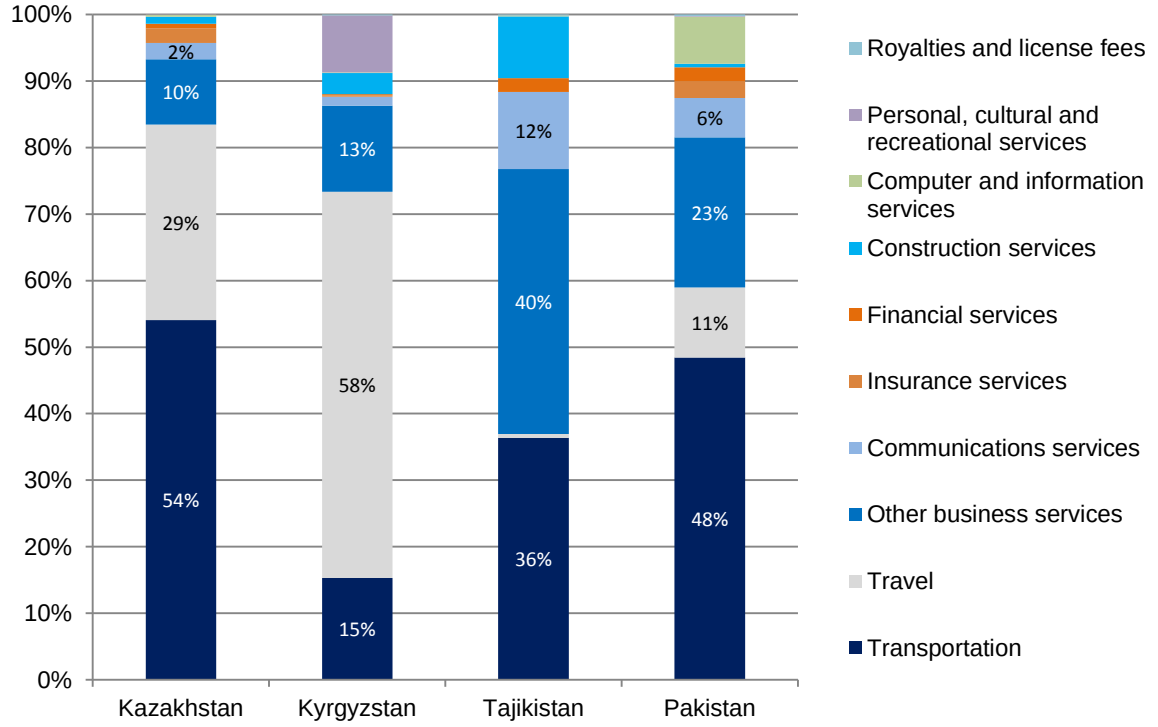


Figure 7: Sectoral Composition of Services Exports of CARs and Pakistan - 2011 (%)



Source: UN Comtrade

Figure 8: Sectoral Composition of Services Imports of CARs and Pakistan - 2002 (%)

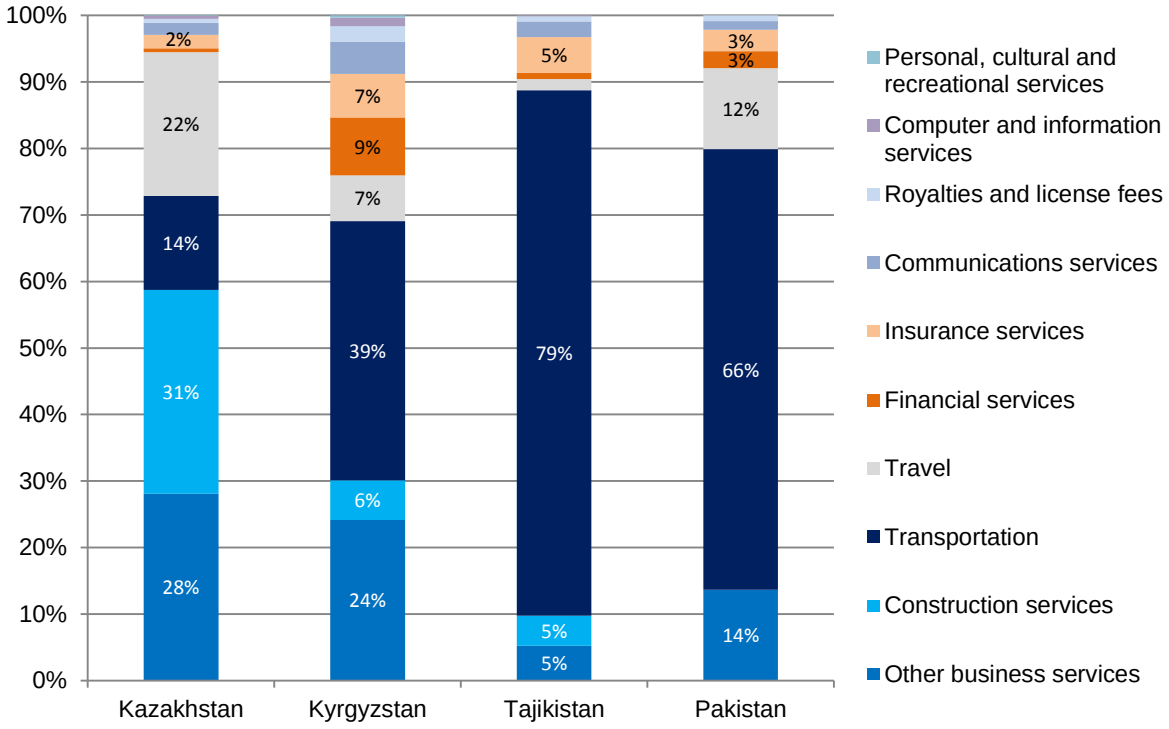
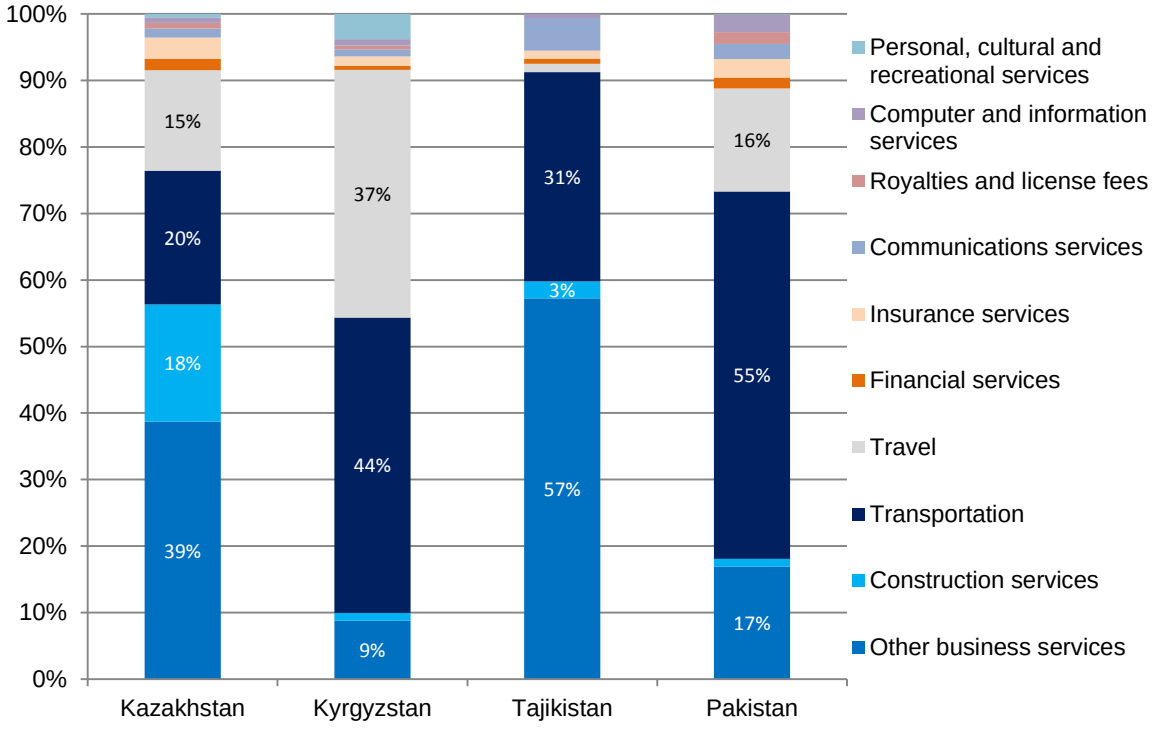


Figure 9: Sectoral Composition of Services Imports of CAR's and Pakistan - 2011 (%)



Source: UN Comtrade

Chapter 3 Potential of Trade between Pakistan and Central Asia

The CARs gained their independence from Russia in 1991 and since then have attempted to liberalize their economies. Being landlocked and remote from most global economic centers, CARs require effective transit corridors and improved integration with regional economies to leverage their valuable resources to promote economic development in the region.

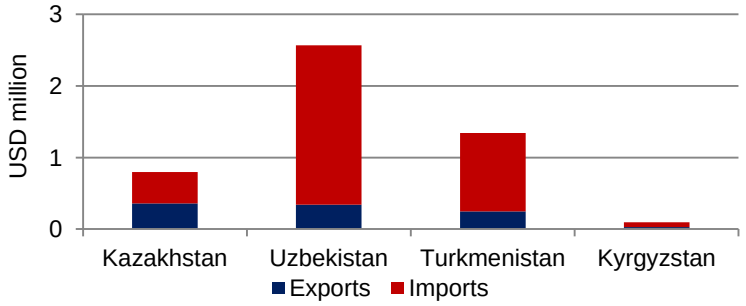
Pakistan also requires new markets to expand its exports of goods and services. Collectively, the CARs and Afghanistan have a population of almost 95 million, a GDP of USD 324 billion,[28] and offer considerable potential for trade. Proximity to the CARs provides Pakistan with an immense opportunity to tap into the emerging Central Asian market and expand its export base. Improved integration among CARs, Afghanistan, and Pakistan would be favorable to all stakeholders and be a step in the direction of enhanced integration between the Central Asian and South Asian region.

Table 2: Central Asia, Afghanistan and Pakistan: Population and GDP estimates, 2012

Countries	Population (USD millions)	GDP (USD billions)	GDP Growth
Afghanistan	29.8	20.5	14.4%
Kazakhstan	16.8	203.5	5.0%
Uzbekistan	29.8	51.1	8.2%
Turkmenistan	5.2	35.1	11.1%
Kyrgyzstan	5.6	6.5	-0.9%
Tajikistan	8.0	6.97	7.5%
Pakistan	179.2	225.1	4.0%
Source: World Bank			

Currently the bilateral trade in services between Pakistan and CARs is negligible. Pakistan's exports to CARs aggregate to approximately 0.02 percent of its total exports. Pakistan's imports of services from CARs depict a similar picture and contribute only 0.048 percent to its total imports. The merchandise trade between Pakistan and CARs is relatively insignificant; trade with CARs is less than 1 percent of Pakistan's trade with the world. This reflects difficulty in accessing CARs.[29] Services, especially transport, finance, and telecommunication can be a key facilitator in improving greater integration in the region.

Figure 10: Pakistan's trade in services with CARs

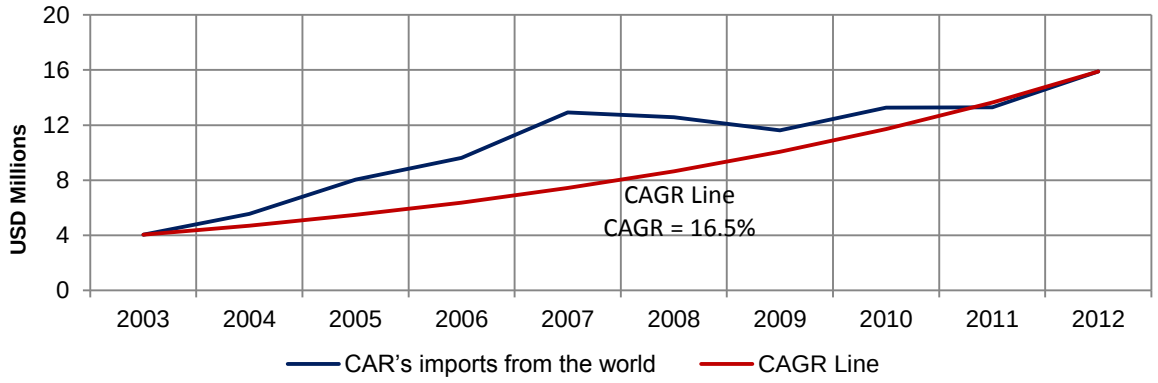


Source: UN Comtrade, 2012

[29] UN Comtrade, 2012

The CARs offer significant potential for trade in services for Pakistan. CARs imports have risen sharply over the last decade. Since 2003, CARs imports have increased by 294 percent with a CAGR of 16.5 percent. In 2012, CARs imported almost USD 16 billion of services from the world, of which only 0.008 percent was imported from Pakistan. Pakistan's total exports amounted to USD 6.6 billion in 2012.[30]

Figure 11: CARs imports of services from the world



Source: UN Comtrade

Trade Complementarity Index (TCI)

This section measures the trade complementarity index (TCI) between Pakistan and CARs trade in services. TCI measures the extent to which two countries are natural trading partners in the sense that what one country's exports overlaps with what the other country's imports. The index ranges from 0 to 1; the index is 0 when no goods are exported by one country and imported by the other country and 1 when export and import shares exactly match.

Methodology

The Trade Complementarity index is calculated as follows:

$$TCI_{ij} = 1 - \tfrac{1}{2} \sum_{k=1}^{n} \; | Xik - Mjk |$$

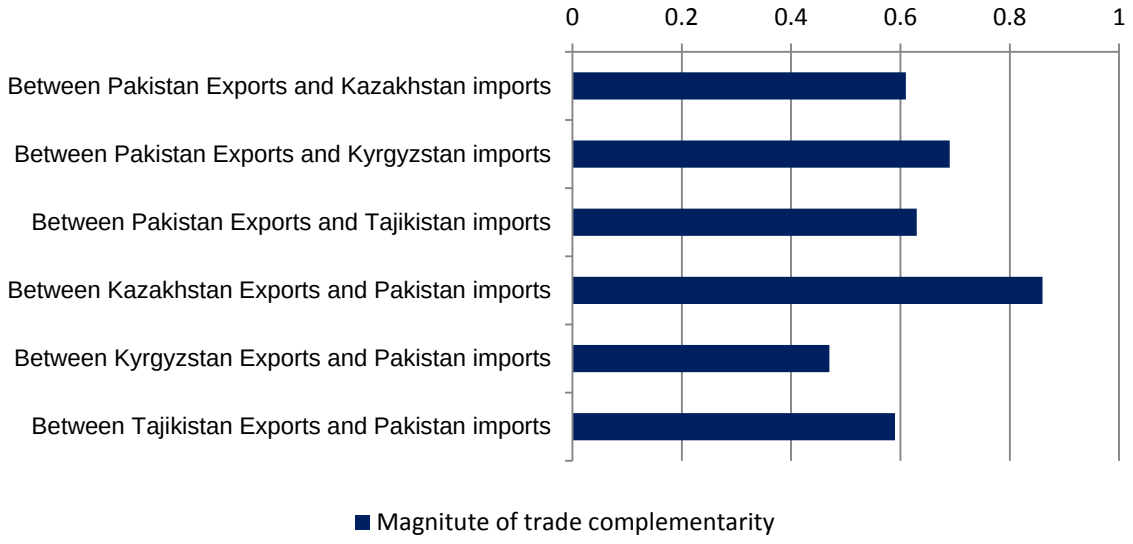
Where,
TCIij = Index of trade complementarity between exports of country *i* and imports of country *j*.
Xik = Share in total exports of product group *k* in country *i*
Mjk = Share in total imports of product group *k* in country *j*

Estimates of TCI

The results of the Trade Complementarity are presented in figure 12. The trade complementarity between Pakistan's exports and CARs including Kazakhstan, Kyrgyzstan, and Tajikistan imports is high at 0.61, 0.69, and 0.63 respectively.

[30] UN Comtrade, 2012

Figure 12: Trade Complementarity Index for services trade between Pakistan and CARs, 2012



Source: Author's calculation based on UN Comtrade Data

Revealed Comparative Advantage (RCA)

This section proceeds to determine the RCA of Pakistan and CARs. RCA is an index which measures the comparative advantage a country holds for export of any particular good. If RCA is greater than 1, the country is considered as having a comparative advantage in the particular service.

Methodology

The RCA is calculated as follows:

$$RCA = X_{ij} / X_i \;/\; X_{wj} / X_w$$

Where,

X_{ij} = exports of ith country of jth commodity

X_i = total exports of country i

X_{wj} = global exports of jth commodity

X_w = total global exports

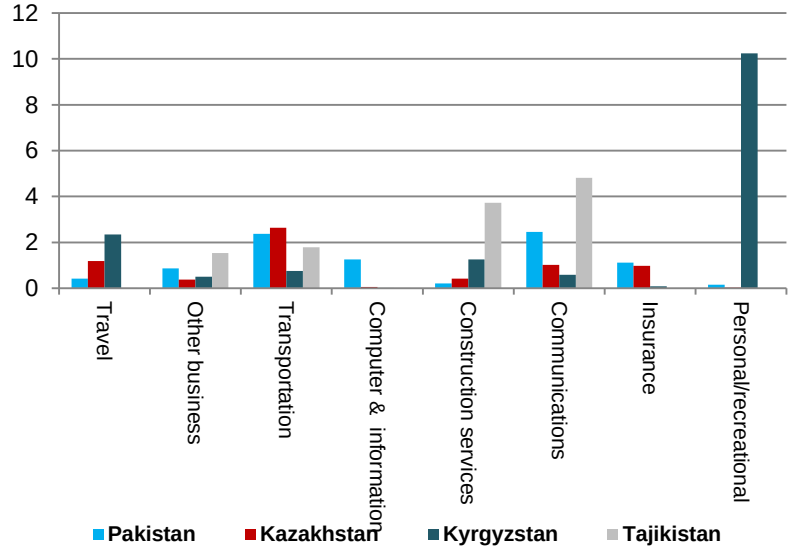
The classification of services used in the study is based on IMF Balance of Payments Manual 5 (BPM 5).

Estimates of RCA

The results of the RCA are presented in figure 13. The results indicate that in transportation and communication services, Pakistan's magnitude of RCA is substantially greater than unity, reflecting Pakistan's comparative advantage in these services. Pakistan also has RCA of greater than unity in insurance services and its RCA in finance, though not too high, has risen prominently from 0.16 to 0.28 between 2001 and 2012. Currently Pakistan's RCA in financial services is significantly higher than most CARs including Kazakhstan.

The previous section indicated that the complementarity between Pakistan exports and CARs imports is high. In the event of effective liberalization of service sectors, there is potential for Pakistan to increase its exports in transportation, telecommunication, and finance sectors.

Figure 13: Pakistan and CARs RCA in Services based on 2001 to 2012 data



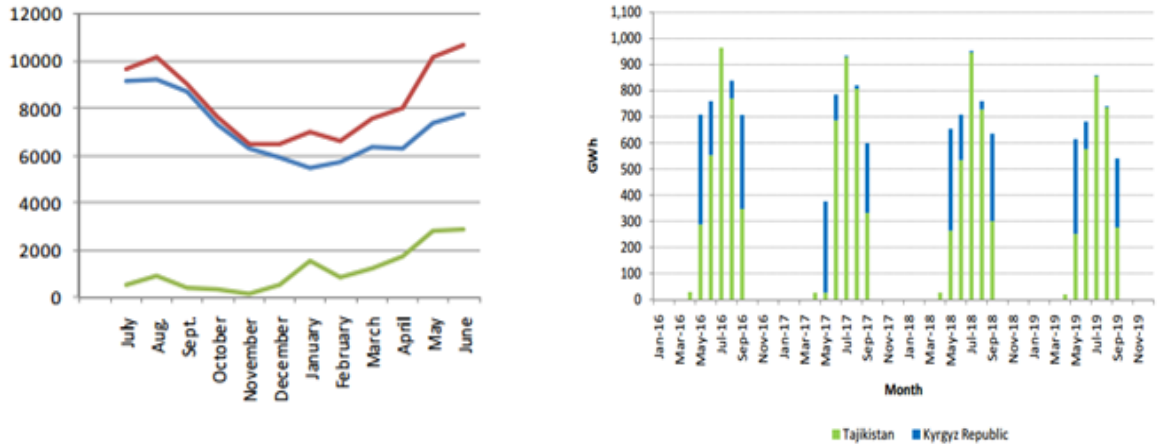
Source: Author's calculation based on UN Comtrade Data

BOX 2: Trade in Energy Services between Pakistan and Central Asia

The classification of services used in the study is based on IMF Balance of Payments Manual 5 (BPM 5) which does not classify energy services as a separate category and hence the analysis has not been able to capture the large potential of trade in energy services between CARs and Pakistan. Two notable initiatives in energy services in the region are as follows:

CASA 1000 Afghanistan, the Kyrgyz Republic, Pakistan, and Tajikistan aim to establish a Central Asia - South Asia Regional Electricity Market. The proposed CASA-1000 project is the first phase of this program. The project supports trade of up to 1,300 megawatt of clean electricity between the two regions, and will be setting the stage for a greater degree of energy trade between Central Asia and South Asia. Besides alleviating electricity shortages in Afghanistan and Pakistan, it will help establish Afghanistan's role as a transit country. CASA-1000 will also ensure a steady source of revenue from power exports of summer surplus for Tajikistan and Kyrgyz Republic and could help support the economies of these countries. The techno-economic feasibility studies have been completed. Project implementation is planned to start from 2014.The two countries have close to 6,000 GWh of surplus, almost entirely available in the summer. Figure 12 shows the monthly distribution of the exportable surplus through the CASA line for the first 4 years. The surplus patterns complement Pakistan's increase in shortfalls in the summer season.

Figure 13: Exportable electricity surplus through CASA 1000



Source: Technical Feasibility Report, CASA 1000, 2011

TAPI The Turkmenistan-Afghanistan-Pakistan-India Natural Gas Pipeline (TAPI) Project aims to export up to 33 billion cubic meters of natural gas per year through a proposed approximately 1,800-kilometer pipeline from Turkmenistan to Afghanistan, Pakistan and India. An initial USD 5.0 million capital injection has also been approved for each of the parties to provide as an initial investment into TAPI Ltd. which is a special purpose consortium company (SPCC) that will operate TAPI. The transit fees are under negotiation. Certain estimates show that Pakistan would annually earn a royalty of USD 500 million.[1] TAPI will provide an opportunity to land-locked Turkmenistan to diversify its gas exports and gain access to alternative waterways

Chapter 4 Sectoral Report: Financial Services - Banking and Insurance

Introduction

This section presents an assessment of the banking sectors of the CARs and Pakistan and evaluates the potential for Pakistani banks to provide services in the Central Asian market. The study also assesses the prospects for emerging services in the region including small and medium enterprise banking, Islamic banking, and insurance services.

The banking sector dominates the financial sector in all CARs.[31] The level of sector's development varies from country to country. Kazakhstan has a comparatively advanced banking sector, although the high percentage of non-performing loans (NPLs) remains an issue of concern. Financial intermediation in Tajikistan, Turkmenistan, and Kyrgyzstan is low and leaves considerable scope for improvement. Moreover, the strong influence of state in the banking sector, especially in case of Uzbekistan, Tajikistan, and Turkmenistan has stifled its growth.

Pakistan initiated banking sector reforms in early 1990's to encourage participation of the private sector. The reforms process intensified during 1997 to 2003. This transformed the sector into an efficient, strong and sound banking system with a more competitive market structure and expanding market share of private banks.

Access to finance is one of the key constraints in the Central Asian market. This has particularly limited the creation and growth of small and medium enterprises (SMEs)[32] defined by Small and Medium Enterprises Development Authority (SMEDA) of Pakistan as having employment up to 250 with paid up capital of Rupees 25 Million. Pakistan's SME sector constitutes 90 percent of the total enterprises with 40 percent contribution to GDP and engaging 80 percent of non-agricultural labor force.[33] In addition to the state controlled banks, the commercial banks also prefer lending to larger organizations as compared to SMEs. NBP is successfully operating in all CARs, and its most profitable service is provision of loans to the SME sector.[34] The study analyzes the success of NBP in the region and highlights the potential for other banks in Pakistan to offer similar services.

Islamic banking is on the rise in Central Asia and its importance in the region has gained significance after the financial crisis. Kazakhstan is taking the lead in Islamic banking. Kazakhstan's comparatively strong banking sector and government's success in incorporating both the Islamic Development Bank and other private Islamic banks into the banking sector have made it a model for Islamic banking and finance in the region. Given Pakistan's recent growth in Islamic banking, there is a potential for local banks to cater to the Central Asian market. Moreover, the skilled human resources from Pakistan are contributing to the development of Islamic banking all over the world, especially in Middle East, and could contribute significantly to the growth of Islamic banking in the CARs.

Although there is potential for banks in Pakistan to provide services in the CARs, there are significant challenges, especially in countries with strong state influence in the banking sector. The study analyzes the major barriers than may be encountered by foreign banks in the region.

[31] Banking in the Eastern Neighbours and Central Asia, European Investment Bank, 2013
[32] *Ibid.*
[33] *Busines Recorder,* SMEs can be engine of economic growth, May 02, 2013
[34] General Manager, NBP, Tajikistan

Methodology

The study aims to assess the potential for Pakistan's banks to provide services in the Central Asian market based on the following:

- Current state of the financial sector development in CARs and Pakistan including the level of financial intermediation
- A cross regional comparison of indicators of financial access, financial soundness, and restrictiveness to entry of foreign banks.
- A case study on the performance of NBP in CARs based on interviews and primary data.
- An assessment of potential impediment to Pakistan's financial service providers in the region.

In light of above, the study identifies potential services including SME loans and Islamic finance that can be provided by Pakistan's banking sector. In addition other services such as insurance and trade finance which are important for supporting intra-regional merchandise trade.

Overview of the Banking Sector in CARs and Pakistan

Kyrgyzstan

The financial sector in Kyrgyzstan is dominated by a banking sector which accounts for more that 70 percent of the total financial assets.[35] The Kyrgyz economy and the banking sector is one of the most open and liberalized in the region. There are no restrictions on foreign banks providing lending and deposits services, and limitations on entry of foreign banks are also minimal.

In 2010, a popular uprising followed by ethnic tensions[36] caused an economic downturn and the Kyrgyz economy contracted by 0.5 percent. The crisis also led to significant financial sector instability and caused a large and immediate deposit outflow. The largest bank, Asia Universal Bank, was declared insolvent and nationalized. Action was taken against several other banks.

Despite the adverse effects of political upheavals in 2010, the Kyrgyz banking system managed to avoid systemic risk through timely interventions by the National Bank of Kyrgyzstan. In 2011, an increase in the main indicators of the banking system including loans, deposits, and profitability was observed. The Kyrgyz financial sector also displayed a steady growth in 2012 with a Return on Equity (ROE) at 17.9 percent, one of the highest in the region.

With about 24 commercial banks including the NBP, the Kyrgyz banking system is considered underdeveloped with a potential for significant growth. The level of concentration in Kyrgyzstan's banking sector is moderate, with the largest three banks (RSK, Unicredit, and KICB) accounting for 42 percent of Kyrgyz banking system's total assets.

The level of financial intermediation in Kyrgyzstan is limited, especially in the rural areas. Moreover, in the latest round of Business Environment and Enterprise Performance (BEEP) surveys, access to finance is identified as one of the major obstacles for growth of firms. The low level of financial intermediation and minimal restrictions on entry provide an opportunity for Pakistani banks to establish their operations in the country and provide services, especially SME loans in the rural sector.

[35] Banking in the Eastern Neighbours and Central Asia, European Investment Bank, http://www.eib.org/attachments/efs/economic_report_banking_enca_en.pdf

[36] In 2010, chaotic protests started following the rise in energy tariffs. The protests soon became intense and led to the ousting of Kyrgyz president Kurmanbek Bakiyev. This was followed by increased ethnic tensions between Kyrgyz people and Uzbeks in the south of the country. The violence led to the consolidation of a new parliamentary system in Kyrgyzstan

Kazakhstan

The Kazakhstan financial and banking system is relatively advanced and integrated with the international markets. The Kazakh banking system's asset to GDP percentage is also considerable at 43.6, indicating importance of the sector to the economy.[37] Due to increasing competition the share of top five banks in the corporate sector declined in 2012. The profitability of the banking sector is positive however, it is considerably affected by the increase in expenses for formation of reserves for NPLs accumulated after the financial crisis in 2009.

The global financial crisis hit Kazakhstan's financial system and economy harder than most of the Commonwealth of Independent States (CIS) countries. One of the reasons was that the banks of the country heavily borrowed from countries such as Netherlands, Great Britain, United States, and others to provide credit to the growing customer base in Kazakhstan.[38] The crisis however, affected the Kazakh bank's ability to borrow on external debt capital and equity markets which decreased their lending capacity. Lack of lending had a negative impact on the loan dependent sectors such as construction, small and medium size business, and trade of the national economy.

The tighter global credit conditions due to financial crisis and lower oil prices led to a burst in lending and real estate bubbles in Kazakhstan resulting in large accumulation of the non-performing loans. NPLs still remain one of the biggest concerns for the banking sector of Kazakhstan and have yet to come down; as of 2012, the ratio of NPLs to total gross loans was 19.4[39] percent. The recent devaluation of the Tenge by almost 20 percent[40] in early 2014 may lead to further increase in non-performing loans.

Kazakhstan is a major player in the Central Asian region and the impressive growth recovery after the financial crisis has increased the demand for credit. This provides an opportunity for banks in Pakistan to provide financial services in the country, especially in rural areas where access to credit is limited. NBP was one of the first foreign banks to start its operations in Kazakhstan and has now expanded its network to three subsidiary branches. NBP plans to open two more branches in Kazakhstan, one in Shymkent, a major industrial and cultural center and the other in Atyrau, which is the center of the oil extracting industry.

Tajikistan

The banking system dominates Tajikistan's financial sector and accounts for about 90 percent of the financial system's assets. Tajikistan banking sector grew rapidly until 2008 and financial system loans as a percentage of GDP almost doubled between 2005 and 2009; however, the global economic slowdown in 2009 affected the Tajik banking system adversely. Furthermore, the interference of the government in lending to agriculture sector via direct lending programs has led to an increase in nonperforming loans in the sector.

The Tajik financial system consists of 16 commercial banks and more than 120 micro credit organizations and funds[41] including Pakistan's NBP and First Micro Finance Bank. The financial system is relatively small and is highly concentrated with the three largest banks by asset size (Agroinvestbank, Orienbank, and Amonatbank) accounting for over 70 percent of the system's assets.[42]

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[37] Committee for the control and supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan, current state of the banking sector of the republic of Kazakhstan, http://www.afn.kz/attachments/105/269/publish269-1058858.pdf

[38] The Impact of the Financial Crisis on the Banking System of Kazakhstan, Valeriya Anichshenko, Central Asia Business Journal, Vol. 2, November 2009, http://www.kimep.kz/files/BCB/cabj2/pp_66-70_Anichshenko.pdf

[39] IMF, Financial soundness indicators

[40] http://www.ft.com/intl/cms/s/0/5a30f3e4-931a-11e3-b07c-00144feab7de.html

[41] http://www.imf.org/external/country/TJK/rr/2013/021413.pdf

[42] Banking in the Eastern Neighbors and Central Asia, European Investment Bank, http://www.eib.org/attachments/efs/economic_report_banking_enca_en.pdf

Financial intermediation in Tajikistan is limited, and credit and deposit penetration is low compared to other countries in the region. The majority of the country's SMEs do not use the banking sector for either deposits or financing. Only a third of all firms in Tajikistan had a loan or line of credit, as compared to 44 percent in the Europe and Central Asia Region. This highlights potential for banks in Pakistan to offer their services in the country; NBP was able to convert its subsidiary in Tajikistan into a profit-generating unit within one year of its operations. Considering the prevalence of micro finance in the country, Pakistan may also explore the opportunity to provide micro finance services.

Turkmenistan

The banking system in Turkmenistan is predominately state owned. After the regional financial crisis caused by the devaluation of the Russian ruble in August 1998, the sector was restructured by presidential decree which further reinforced the state's control.[43] The majority of the lending and services are provided to the state-owned enterprises with the government sector accounting for 85 percent of the total credits. The financial crisis has little impact on the Turkmen banking sector as it is dominated by state-owned banks that are insulated from the global financial system.

The total assets of Turkmenistan's banking sector represent only 22 percent[44] of the GDP, highlighting the lack of development in the financial sector. Currently there are eleven commercial banks operating in the country including two foreign banks; the National Bank of Pakistan and Bank Saderat of Iran. The commercial banks are not allowed to provide services to the state enterprises which are primarily provided credit on subsidized terms by the state banks. Foreign investors are only able to secure credit on the local market through the Pakistan National Bank and European Bank for Reconstruction and Development (EBRD) equity loans.[45]

Turkmenistan's banking sector has experienced significant growth in recent years and the total loans increased by 43 percent in 2010. Moreover, the requirement for all banks to use International Financial Reporting Standards (IFRS) as of 2009 has led to initial improvements in accounting. The central bank has lifted a ban on international banking operations of commercial banks.[46]

Despite recent improvements in Turkmenistan's banking system, financial intermediation is low compared to international standards. Financial sector development is in the early stages and access to finance to private enterprises remains limited. This provides an opportunity for banks in Pakistan to enter the Turkmen banking sector and take advantage of the recent reforms.

Uzbekistan

Uzbekistan's banking system dominates the financial sector and accounts for over 95 percent of the financial sector assets. The state has a strong influence on the economy and the banking sector of Uzbekistan. The state owns approximately two thirds of the economy and almost 80 percent of the banking system.[47] Due to the government's multiple injections of capital into the banking system since the beginning of the international financial crisis, the state ownership of the banking system has further increased during the recent years and is expected to go even higher.

[43] Turkmenistan Country Report, BTI 2012, http://www.bti-project.de/fileadmin/Inhalte/reports/2012/pdf/BTI%202012%20Turkmenistan.pdf
[44] Banking in the Eastern Neighbors and Central Asia, European Investment Bank, http://www.eib.org/attachments/efs/economic_report_banking_enca_en.pdf
[45] http://turkmenistan.usembassy.gov/ics.html
[46] http://www.ebrd.com/downloads/research/economics/turkmenistan.pdf
[47] Banking in the Eastern Neighbours and Central Asia, European Investment Bank, http://www.eib.org/attachments/efs/economic_report_banking_enca_en.pdf

The Uzbek banking system is comprised of 31 commercial banks including eleven private banks and five banks with foreign capital participation. In addition to having a major stake in the banking sector, the Government of Uzbekistan also requires banks to perform many non-bank functions including control over accounts receivable and accounts payable of bank clients, registration and control over export and import operations, and calculation and distribution of wages and salaries. There is also excessive government control on foreign exchange transactions.[48] The excessive role of government in the financial sector has limited its growth. NBP established a representative office in Uzbekistan with the intention to convert it into a branch, but has been unable to do so as a result of Uzbekistan's closed economy and prevalent bureaucratic difficulties.

Pakistan

Pakistan's financial system has grown in the last decade and was one of the most profitable sectors for the most part of the 2000s. Pakistan initiated banking sector reforms in late 1990's to encourage participation of the private sector. The reforms have transformed the sector into an efficient, strong, and sound banking system. The privatization of nationalized commercial banks has also brought about a culture of professionalism and service orientation in place of bureaucracy. The number of scheduled banks operating in Pakistan was 44 at the end of 2011, including twelve foreign banks.

Islamic banking is also on the rise in Pakistan. Starting from almost scratch in 2001, the Islamic banking industry now represents 10 percent of the overall banking system with nineteen banking institutions offering Islamic products and services.[49] Given the more developed Islamic banking sector in Pakistan and the recent emergence of Islamic banking in Central Asia, there is potential for banks in Pakistan to provide services in the Central Asian Market.

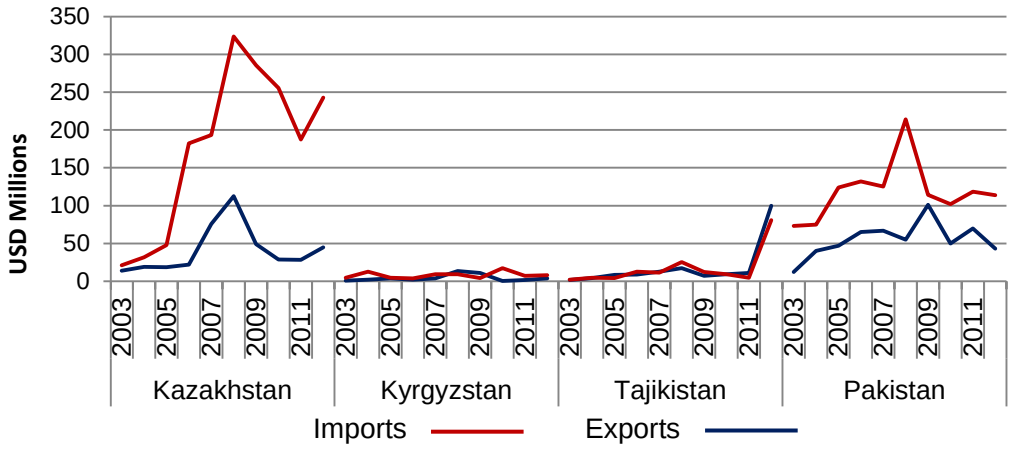
Cross Regional Findings

1. Financial intermediation is low in most of the CARs and the geographic penetration of banking services is limited. Although banking services are relatively well provided in the major urban centers, even in the more developed economies such as Kazakhstan, there are remote regions where banking services are extremely limited.
2. The bank profitability as measured by ROE for most of CARs and Pakistan is positive.
3. Kazakhstan's financial sector is constrained by NPLs as a result of the recent financial crises (2008-09.)
4. The financial crisis of 2008-09 had a significantly negative effect on the trade in financial services of CARs and Pakistan; however recently the trade in financial services has started to gain momentum.
5. Within the CARs, Kyrgyzstan has the most liberalized financial services sector for foreign investors while Pakistan has a relatively more regulated environment for foreign investors.

Kazakhstan is the largest importer of financial services and has a significantly negative trade balance that has grown over the past decade. In 2012, the negative balance amounted to USD 198 million. Among CARs and Pakistan, Tajikistan is the only country with a positive trade balance in financial services and its exports and imports increased at a very fast rate of 807 and 1612 percent in 2012. The financial crisis in 2008-09 negatively affected the trade in financial services, especially for Kazakhstan and Pakistan, and both countries witnessed a sharp decline in their exports and imports. Pakistan has had a negative trade balance in financial services over the years; however its exports increased in 2013 by 63 percent showing resurgence after the witnessing a declining trend since 2009.

[48] Banking in the Eastern Neighbours and Central Asia, European Investment Bank, http://www.eib.org/attachments/efs/economic_report_banking_enca_en.pdf
[49] http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf

Figure 15: Pakistan and CARs exports and imports of financial services

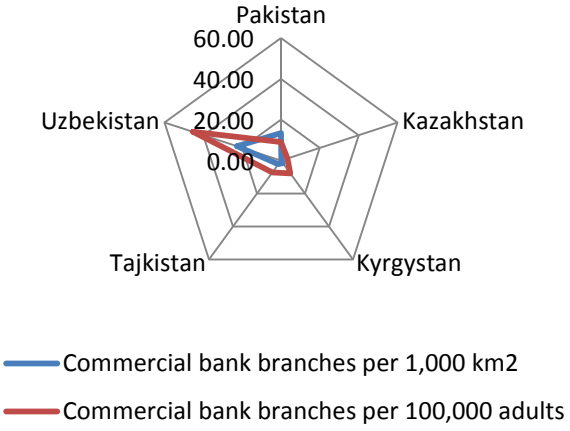


Source: UN Comtrade

Financial Services Access

Banking intermediation is weak in most CARs. Moreover, there are important sectoral and regional differences within the economies themselves. Although there is extensive access to banking services in major urban centers, even in the more developed economies such as Kazakhstan, there are remote regions where banking services are extremely limited. Similarly, the national financial access aggregates, particularly for the resource rich countries like Kazakhstan, are skewed by the prosperous sectors which face few financial constraints while access to finance is more problematic in other sectors such as SMEs. As a result of strong government patronage, access to financial services in Uzbekistan is the highest in CARs at 45 branches per 100,000 adults. This indicator is below 10 for the other CARs. Pakistan also does not perform well in the geographic outreach of financial services and the commercial bank branches per 1,000 km^2 at 13.4 are significantly less than those of its neighbor, India (33.17).[50]

Figure 16: Geographic outreach of financial services, 2012



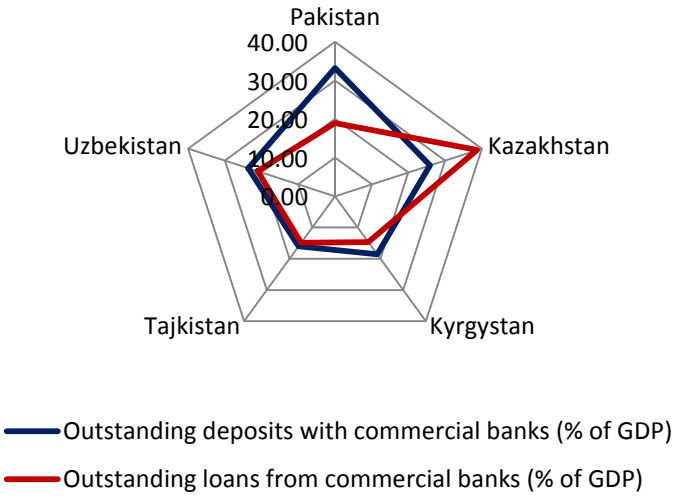
Source: 2012 Financial Access Survey, IMF

The use of banking services is also limited in the CARs. The outstanding deposits with commercial banks were less than 30 percent of the GDP for all the CARs during 2012. Other countries in the region with

[50] http://fas.imf.org/

relatively advanced banking system like Russia and Ukraine have higher percentage of deposits with commercial banks at 33.87 and 38.72 percent respectively.[51]

Figure17: Use of financial services, 2012



Source: 2012 Financial Access Survey, IMF

Financial Soundness

The banking profitability of most of CARs and Pakistan is positive; the return on equity for Pakistan, Kazakhstan, and Uzbekistan is significant at 14.8, 13.7, and 16.3 percent respectively. Banks from other regions such as Korea have established their presence in the CAR region due to high profitability; the return on equity for banks in Korea is 8.2 percent, almost 50 percent lower than the return in some of the CARs.

As mentioned earlier, the asset quality of Kazakhstan's banks has deteriorated significantly due to the accumulation of NPLs after the financial crisis. This is reflected in Kazakhstan's high percentage of NPLs net of provisions to capital indicating capital inadequacy and a decreased capacity of banks to withstand losses from NPLs. Moreover, the liquidity of the Kazakh banks is relatively low, further increasing the inherent risk in the banking sector to withstand shocks.

Table 3: Financial Soundness Indicators

Measure	Financial Soundness Indicators	Kazakhstan	Pakistan	Uzbekistan	Tajikistan
	Core FSI for Deposit Takers	**2012 Q4**	**2012 Q4**	**2012 Q4**	**2012 Q4**
Capital Adequacy	Regulatory Capital to Risk-Weighted Assets	17.5	15.4	24.3	25.9
	Non-performing Loans Net of Provisions to Capital	44.6	19.4	1.0	3.7
Asset Quality	Non-performing Loans to Total Gross Loans	19.4	14.5	0.5	9.5
	Sectoral Distribution of Loans to Total Loans	...	...	...	...
	Residents	95.9	92.6	...	100.0
	Deposit-takers	0.2	-	...	1.4
	Other Financial Corporations	2.1	1.1	...	0.5
	General Government	0.0	19.1	...	-
	Nonfinancial Corporations	69.0	57.8	...	57.9

[51] http://fas.imf.org/

Measure	Financial Soundness Indicators	Kazakhstan	Pakistan	Uzbekistan	Tajikistan
	Other Domestic Sectors	24.5	14.6	...	40.3
	Nonresidents	4.1	7.4	...	-
Earnings and Profitability	Return on Assets	1.9	1.5	1.9	0.2
	Return on Equity	13.7	14.8	16.3	0.7
	Interest Margin to Gross Income	63.8	71.1	36.4	33.2
	Non-interest Expenses to Gross Income	45.2	54.0	65.6	75.8
Liquidity	Liquid Assets to Total Assets (Liquid Asset Ratio)	18.6	44.7	31.8	30.0

Source: IMF

Regulatory Environment for Foreign Financial Service Providers

The services trade restrictions database is developed by the World Bank and captures policies and regulations that discriminate against foreign services or foreign-service providers. The database covers 103 countries and for each country provides a restrictiveness index for five major service sectors including finance, telecommunication, retail, transportation, and professional services. The index ranges from 0 to 100 with 0 representing complete openness to foreign services providers. An index below 25 is indicative of minor obstacles.

This index covers banking and insurance services under mode 1 and mode 3. At a disaggregated level, trade restrictiveness for banking encompasses regulations for bank lending and deposits, and for insurance the index is based on automobile insurance, life insurance, and reinsurance.

Figure 18: Services trade restrictiveness index - financial services, 2012

Source: World Bank Services Trade Restrictiveness Index

Banks are allowed to enter CARs and Pakistan subject to certain conditions. Pakistan has placed foreign equity limits and listing requirements for foreign banks. Uzbekistan has also placed foreign equity requirements and Kazakhstan does not allow entry through a branch. While there are no major restrictions placed by Kyrgyzstan, all CARs have employee quota requirements.

Market entry for foreign insurance service providers is allowed by all countries, subject to certain restrictions. In most CARs and Pakistan, entry through a branch is not allowed. While there are no quota requirements or foreign equity limits in Pakistan, foreign insurance providers need to invest minimum USD 4 million in foreign exchange.

Most CARs allow foreign-service providers established outside its territory to lend and accept deposits and have no major restrictions on these services. Pakistan however, does not allow acceptance of

deposits by foreign banks and lending is subjected to State Banks approval. Provision of auto mobile and life insurance under mode 1 is only allowed by Kyrgyzstan.

All CARs score less than 25 in the restrictiveness index indicating that they have not placed any major restrictions in the financial sector.

Table 4: Key restrictions for cross border trade of financial services

Services	Pakistan	Kazakhstan	Kyrgyzstan	Uzbekistan
Lending by Banks	This is allowed, subject to State Bank approval.	Allowed	Allowed	Allowed, subject to registration with central bank
Acceptance of deposits by banks	This is allowed, subject to State Bank approval. USD 1,000 may be held in any country (except Afghanistan, Bangladesh, India, and Israel) in foreign currency accounts	Allowed	Allowed	Allowed.
Automobile Insurance	Not allowed.	Not allowed	Allowed	Not allowed.
Life Insurance	SECP approval for reinsuring abroad,	Not allowed	Allowed	Not allowed.
Reinsurance	This is allowed, subject to State Bank approval. USD 1,000 may be held in any country (except Afghanistan, Bangladesh, India, and Israel) in foreign currency accounts	Allowed	Allowed. Cession requirement is 5% of reinsurance to domestic reinsurers	Allowed. The cession requirement is 5% of reinsurance to domestic reinsurers.
Source: World Bank – Services Trade Restrictiveness Index				

Table 5: Key restrictions on entry of Foreign Service providers - financial services

Services	Pakistan	Kazakhstan	Kyrgyzstan	Uzbekistan
Lending and Acceptance of Deposits by Banks	Foreign ownership limit is 50 % for greenfield investment. Minimum 50% of shares must be offered to public. The bank must be a public limited company, listed in the stock exchange in Pakistan or complete its listing within two years of commencement. Restrictions may apply for branching.	Entry through a branch is not allowed. Restrictions on employees may apply. The government determines the quota annually; in 2008, foreign specialists with high and middle professional education could not exceed 0.35 percent of the total active population.	There are no restrictions, except annual quota on employees	If a foreign bank acquires more than 35 percent of a local bank it needs to obtain the approval of the antitrust authority. Foreign banks are not allowed to open subsequent branches.
Automobile Insurance	Entry through branch is not allowed. No limit on foreign ownership. Minimum investment of USD 4 million in foreign exchange required. To reinsure outside, approval of SECP required.	Entry through a branch and/or acquisition of state-owned insurers is not allowed. For employees, a ratio of one foreign employee per five national employees applies.	Entry through a branch is not allowed. The quota on foreign employees is determined annually, and differs by region.	Entry through a branch is not allowed. In practice, 80 percent of employees must be nationals.
Life Insurance	Entry through branch is not allowed. No limit on foreign ownership. Minimum investment of USD 4 million in foreign exchange required. To reinsure outside, approval of SECP required.	Entry through a branch and/or acquisition of state-owned insurers is not allowed. For employees, a ratio of one foreign employee per five national employees applies.	Entry through a branch is not allowed. The quota on foreign employees is determined annually, and differs by region.	Entry through a branch is not allowed. In practice, 80 percent of employees must be nationals.

Services	Pakistan	Kazakhstan	Kyrgyzstan	Uzbekistan
Reinsurance	Entry through branch is not allowed. No limit on foreign ownership. Minimum investment of USD 4 million in foreign exchange required. To reinsure outside, approval of SECP required.	Entry through a branch and/or acquisition of state-owned insurers is not allowed. For employees, a ratio of one foreign employee per five national employees applies.	There are no restrictions, except that the quota on foreign employees is determined annually, and differs by region.	Entry through a branch is not allowed. Minimum requirement towards the charter capital of USD $3 million. 80 % of national employees
Source: World Bank – Services Trade Restrictiveness Index				

Recommendations

Given the low level of financial intermediation in CARs and strong state influence in the banking sector of certain economies, access to finance is one of the major limitations for small business. This provides an opportunity for international banks to enter the emerging markets of CARs. NBP has a presence in all CARs and has made a niche for itself in SME lending. This section makes a case for Pakistani banks to provide conventional and Islamic banking services in CARs by highlighting the success of NBP and emergence of Islamic banking in CARs. The section also gives an overview of the insurance sector of Pakistan and its potential to facilitate the trade between Pakistan and CARs.

SME Banking

The recent economic growth in most of CARs has led to an increase in SMEs; however access to credit remains one of major impediments in their growth. NBP is successfully providing credit to SMEs in most of the CARs, and its success augers well for other banks in Pakistan to provide similar services in the region.

National Bank of Pakistan (NBP)

National Bank of Pakistan is one of the largest commercial bank in Pakistan with a presence in all of the CARs. NBP has branches in Turkmenistan and Kyrgyzstan, subsidiaries in Kazakhstan and Tajikistan, and a representative office in Uzbekistan. NBP's largest investment is in Kazakhstan (USD 30m) followed by Tajikistan (USD 10.5m), Turkmenistan (USD 3 -4m), and Kyrgyzstan (USD 2-3m)

NBP's large overseas network and agency arrangements with 500 international banks enables it to facilitate its customers to meet their international banking needs at competitive rates in addition to the domestic banking services. NBP is in the process of opening a subsidiary in Moscow, Russia. This would further increase NBP's footprint in Central Asia as most of the CARs have substantial trade relations with Russia.

Operations in Kazakhstan

NBP was one of the first foreign banks to start its operations in Kazakhstan through a decision of the inter-governmental joint Pakistan - Kazakhstan commission for development of economic relations between the two countries. NBP's banking operations in Kazakhstan is through a fully owned subsidiary of NBP.

- As per policy of National Bank of Kazakhstan, NBP was initially issued a restricted banking license in 2002 which confined the bank to deal with legal entities and international organizations only.
- After fulfilling certain mandatory requirements, the regulators issued NBP a full-fledged banking license in 2005, enabling it to offer banking services to the physical persons and legal entities.
- To promote banking in rural and underdeveloped areas of Kazakhstan, the government increased the minimum capital requirement for the banks in Astana and Almaty to USD 67 million while the requirement for regional banks was lower at USD 27 million. Using this opportunity NBP opted to

become a regional bank and expanded its operations in rural areas where financial penetration was minimal. The bank was able to create a niche for itself in SME lending in rural areas.

- In 2008-2009, the international financial crisis adversely affected Kazakhstan. Some of the large banks faced liquidity issues and questionable credit portfolios. The two large international banks - HSBC and RBS - either curtailed their operations drastically or closed down their branches. NBP was able to avert the crisis due to its prudent lending policy with a mandatory collateral requirement.
- As a result of recording consistent profits, the bank expanded its network to three subsidiary branches. The performance of the subsidiary bank for the last five years is depicted in the figures below:

Figure 19: NBP profitability Kazakhstan

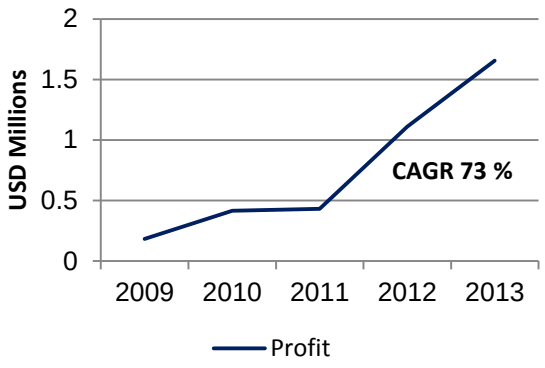
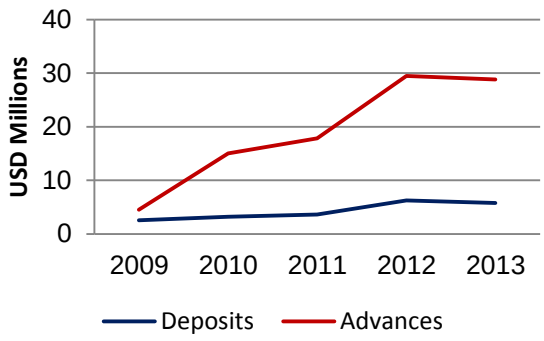


Figure 20: NBP deposits and advances



Operations in Tajikistan

NBP established a subsidiary bank in Tajikistan in 2012. Until now the NBP subsidiary has opened 866 accounts. The bank was converted into profit generating unit from June 2013 (within one year of its operations). The profit of the subsidiary in Tajikistan was around USD 0.056 million as of February, 2014.

- Loans
  - Within two years of operations, NBP has extended credit to 61 clients. The advances made till February 2014 exceeded USD 5 million, an increase of 66 percent over the previous year.
  - The NPLs are 0 percent against the credit portfolio of USD 5.1 million, ensuing from prudent lending policies with a mandatory collateral requirement.

- Deposits
  - The deposits of the NBP exceeded USD 4 million in 2014, showing an increase of 924 percent over the previous year.

- Remittances
  - In Tajikistan, remittance contribution in GDP is more than 47 percent. 93 percent of total emigrants of Tajikistan are working in Russian Federation and only 7 percent are working in rest of the world. The amount remitted by the Tajik workers from Russia to Tajikistan is approximately USD 4 billion annually. In order to get due share of remittance business, NBP has introduced a Western Union facility in the bank. NBP is expecting to increase its remittance business in the near future. The bank handled remittances amounting to USD 4.8 million within the first two months of 2014.

Expansion Policy of NBP

NBP plans to open another branch in Khujand, Tajikistan. The bank also plans to open two more branches in Kazakhstan, one in Shymkent, a major industrial and cultural center and the other in Atyrau,

which is the center of oil extracting industry. Opening of another branch in Turkmenistan is also under consideration.

Barriers

Despite the potential for foreign banks to provide services in the CAR region there are significant barriers:

- The banking sector, especially of smaller CARs is under strong state control. The state control and the bureaucratic intrusion associated with it create hindrances for private foreign companies. NBP has government patronage and is able to deal with bureaucratic impediments at a government level; however private companies might find it hard to manage the interference.
- The visa policies of the CARs are very stringent.
- The exchange arrangement of Kazakhstan is a managed float and the Central Bank intervenes in the market to smooth out the demand supply functions. The Central Bank also interferes in the market to adjust the currency as per its policy objectives. In February 2014, the Central Bank of Kazakhstan devalued the Tenge by 19 percent. One of the reasons was to ensure that exchange rate is in line with the country's biggest trading partner – Russia; Russian rouble depreciated more against dollar than Tenge since 2013. The devaluation of currency has a negative effect on the foreign investor as the dollar value of their investment falls significantly.

Micro Finance

Financial inclusion is important for economic growth of developing countries where about 70 percent of the adult population have no access to formal financial services.[52] Micro finance can provide an alternative source of financial services for entrepreneurs and small business.

Pakistan has a robust micro finance sector with about ten privately owned micro finance institutions operating in Pakistan. In 2013, Pakistan's micro finance registered a 36 percent growth. The potential for micro finance in CARs is high as the region has low financial intermediation (especially in the rural areas) and a growing SME sector. Despite Tajikistan having more than 100 micro finance institutions including First microfinance which has equity contributions from NBP, Agha Khan and EBRD, the country has one of the highest levels of financial exclusion in Europe and Central Asia, as well as low levels of financial literacy. According to the 2012 Global Findex survey, only 2.5 percent of people over the age of 15 have an account at a formal financial institution. The high level of financial exclusion in CARs offers opportunities to micro finance operators in Pakistan to provide services in the region.

Islamic Banking

Following the global financial crisis, the Central Asian countries felt the need to diversify sources of capital. Since the crisis was made up of accumulated debts of western states and NPLs in western banks, a door opened for Islamic finance. This was especially true in case of Kazakhstan whose banking sector was severely affected by the crisis.

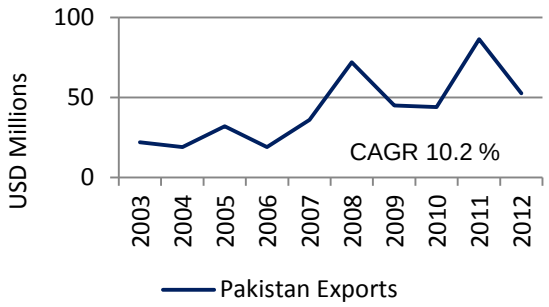
Pakistan's Islamic banking industry is growing at a fast pace, with a CAGR of 53 percent since 2003, and has acquired about 10 percent market share of the country's banking system with presence in more than eighty districts across the country.[53] Given CARs renewed interest in the Islamic Banking and Pakistan relatively well developed sector, there is potential for Islamic Banking institutions from Pakistan to provide services in the region

[52] ADB – Special Evaluation Study 2012, 'Microfinance Development Strategy 2000: Sector performance and Client Welfare
[53] http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf

BOX 3: Insurance Services

Insurance services play a key role in merchandise trade. The insurance sector in Pakistan has witnessed healthy growth rates in recent years; in 2012 it grew by 17 percent. Pakistan's exports of insurance services have also grown considerably at a CAGR of 10.2 percent over the last decade. The total exports in 2012 amounted to USD 52 million.

Figure 21: Pakistan's exports of insurance services



Source: UN Comtrade, 2012

Among CARs, Pakistan's major exports of insurance services are in Afghanistan, Kyrgyzstan, and Kazakhstan. In 2013, Pakistani insurance companies insured more than USD 200 million in these countries. During the same period, the premium income generated by the Pakistani insurance companies in the mentioned countries was around USD 2.3 million.

Major types of risks insured by Pakistani companies in CARs

- Fire and Allied Perils Insurance
- Public and Products Liability Insurance
- Workmen's Compensation and Employers' Liability Insurance
- Third Party Liability Insurance (Mining Risks)
- Motor Insurance

Pakistan is already providing insurance services in the CAR region and given the recent growth of the sector in Pakistan, there is potential to further increase the provision of insurance services by Pakistani companies in the region. As insurance constitute a key component of international trade, this would also facilitate merchandise trade between Pakistan and CARs.

Chapter 5 Sectoral Report: Financial Services - Capital Markets

Introduction

This section presents a comparative assessment of capital markets in Pakistan and CARs and evaluates the potential for portfolio investment. The study also evaluates the prospects of harmonization and integration of capital markets in the region to facilitate transactions in capital and money market instruments.

Regulatory harmonization and market integration reduce barriers to the movement of capital and the provision of capital market services; an investor in one country is able to invest in another country in the region, an issuer from one country is able raise capital in another country in the region, and suppliers of investment services are able to operate throughout the region.

There are several models for integration. Other regions including ASEAN and the European Union (EU) are also making progress toward harmonization. Singapore and Australia have also established a co-trading system. This study proposes a co-trading system between Pakistan and Kazakhstan to facilitate capital market transactions.

Data reveals that capital markets in CARs, with the exception of Kazakhstan, are in their initial development stages. Portfolio investment patterns suggest that Pakistan has the potential to invest in debt securities in Kazakhstan, which have grown rapidly in the recent years; Kazakhstan attracted USD 58 billion in debt securities in 2012. Pakistan has invested USD 4 million in treasury bills in Tajikistan through a subsidiary of the NBP and can expand this investment to Kazakhstan and other CARs. There is potential for Kazakhstan to invest in the equity market in Pakistan; however the current security situation and the perceived political instability in the country are considered major barriers.

Methodology

The study identifies the potential for portfolio investment between CARs and Pakistan based on:

1. Market structure and performance.
2. Market regulation.
3. Inward and outward portfolio investment patterns.

The report also highlights barriers to portfolio investment including:

- Regulatory and structural barriers such as excessive state control, restrictions on national treatment, and unequal treatment of nondomestic participants.
- Information barriers such as lack of transparency in trading or corporate disclosure and language issues

In the light of above analysis, the research identifies investment opportunities and assesses the potential for harmonization of capital markets to facilitate investment between CARs and Pakistan.

Overview of Capital Markets in CARs and Pakistan

The primary role of the capital market is to raise long-term funds for governments, banks, and corporations while providing a platform for the trading of securities. The member organizations of the capital market may issue stocks and bonds in order to raise funds. Investors can then invest in the capital market by purchasing those stocks and bonds. The capital market therefore, functions as a link between savers and investors. It plays an important role in mobilizing the savings and diverting them in productive investment.

The capital market includes the stock market (equity securities) and the bond market (debt). Capital markets may be classified as primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors via a mechanism known as underwriting. In the secondary markets, existing securities are sold and bought among investors or traders, usually through a securities exchange or over-the-counter.

The capital markets in Central Asia developed following the dissolution of the Soviet Union when CAR governments initiated privatization and floated shares of state-owned enterprises (SOEs) to generate funds and reduce the national budget deficit. The study shows that capital markets in CARs, with the exception of Kazakhstan, are in their initial development stages. Moreover, foreign market participation remains limited as the governments were mainly focused on developing domestic investors rather than attracting foreign investors in a bid to retain control over the SOEs.

Strong state control is pervasive in the stock market in the smaller economies. Market infrastructures are relatively advanced; with the exception of Tajikistan, stocks in all CARs are electronically traded. The security product range is not well developed and is focused on short term government bonds. With the exception of Kazakhstan, the derivative market is non-existent in the region.

Market capitalization[54] varies across the region, ranging from about 2 percent (Kyrgyzstan) to over 41 percent (Kazakhstan) of GDP. The capitalization in Kazakhstan is still small relative to developed economies such as UK, USA, and Canada where the capitalization is over 120 percent of the GDP.[55] Stock market capitalization of about 50 percent of GDP and more is an indication of a well-developed stock market.[56] Market performance of CARs and Pakistan is summarised below:

- Kazakhstan's has the largest and most developed stock market in Central Asia. The market has shown a strong upward trend since the Russian economic crisis[57] in 1998. The market value grew rapidly from about USD 1.3 billion to over USD 60 billion within a decade, from 2000 to 2010, increasing its share in the GDP from 7 percent to 41 percent. However, the stock market is volatile and has recently declined from over USD 60 billion to about 22 billion in 2012.[58] In 2013, the total trading volume of KASE (Kazakhstan Stock Exchange) was USD 164.2 billion, out of which the corporate securities represent only 1.6 percent. Over 40 percent of market turnover was in government securities and repossession transactions.[59] Due to volatility of the Tenge, KASE still remains mainly a currency exchange which accounts for over 50 percent of turnover. A majority of listed companies are in the energy and finance sectors.

- Market capitalization in Kyrgyz Republic remains relatively low at USD 165 million in 2012 (less than 1 percent of Kazakhstan's stock market). Nonetheless, there has been a steady growth with a temporary decline as a result of massive capital flight in 2009-2010 due to the domestic political crisis.[60] Following demutualization of Kyrgyz Stock Exchange in May 2000, Istanbul and Kazakhstan Stock Exchanges acquired over 5 and 10 percent shares respectively.

[54] Market capitalization is calculated as a product of the number of shares traded on the stock exchange and their prices. It is a measure of the size of the stock market in the country
[55] www.theglobaleconomy.com
[56] www.theglobaleconomy.com
[57] The Russian crisis erupted in August 1998 resulting in Russia defaulting on its debt and the ruble losing almost 70% of its value. This crisis had far reaching effects not only in Russia but also many other countries surrounding Russia. Though it is called the "Russian crisis", it was the smaller countries surrounding Russia that bore the brunt. Kazakhstan instituted strong fiscal and monetary reforms following the crisis which resulted in economic recovery.
[58] World Bank Indicators
[59] Repo is form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day.
[60] Regional Economic Outlook, Middle East and Central Asia, IMF, 2012

- The capital market is very volatile in Uzbekistan. Market capitalization had reached USD 715 million in 2006 accounting for over 4 percent of GDP.[61] The Korea exchange is expected to become a shareholder of Tashkent Republican Stock Exchange in 2014 by acquiring 25 percent in the equity capital.[62]

- The Tajikistan Stock Exchange (TSE) is relatively inactive. It was established in 1994 by eight Tajik banks with the purpose of handling the trading, clearing, and settlement of securities issued by private sector entities. More than 800 companies now have their shares listed in the TSE. To date however, there have been no transactions in the secondary market.[63]

- The capital market in Pakistan is well developed and has registered a strong upward trend. Since 2009, it has surged by over 450 percent. Market capitalization reached USD 51 billion in 2013 accounting for over 21 percent of the GDP. There are three stock exchanges in Pakistan. Karachi Stock Exchange (KSE) is the largest followed by Lahore and Islamabad Stock Exchanges.

Figure 22: Market capitalization of Kazakhstan

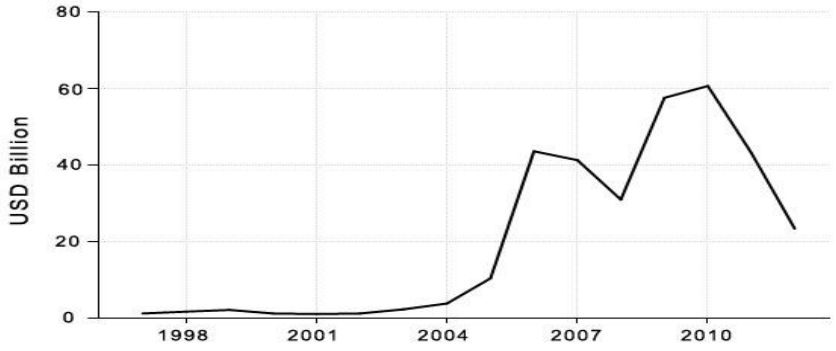
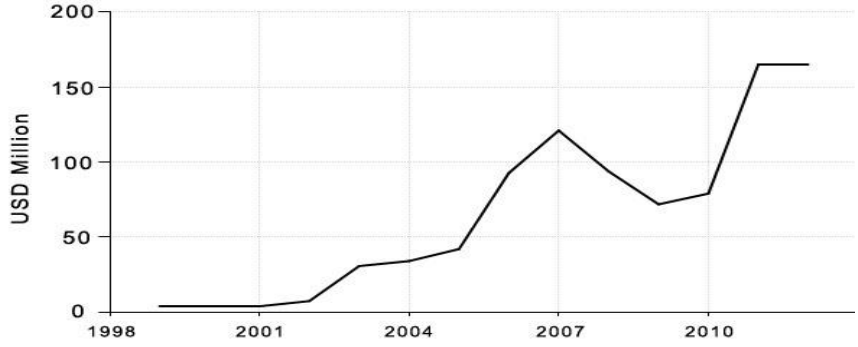


Figure 23: Market capitalization of Kyrgyzstan



[61] World Bank Indicators, 2006
[62] Presidential decree dated March 19, 2012
[63] Report on the Observance of Standards and Codes, Republic of Tajkistan, World Bank, 2009

Figure 24: Market capitalization of Uzbekistan

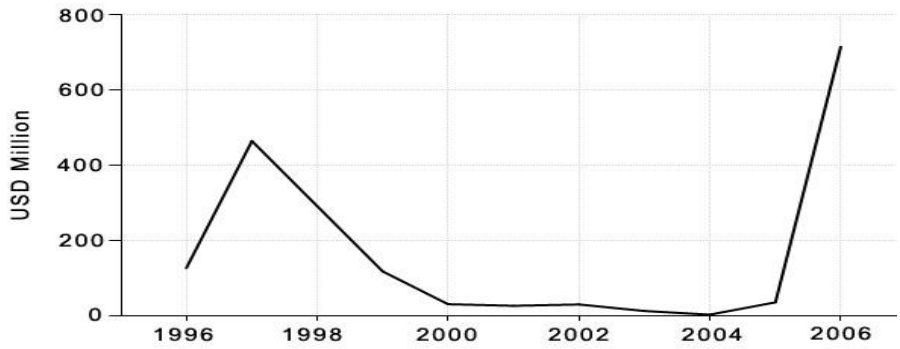
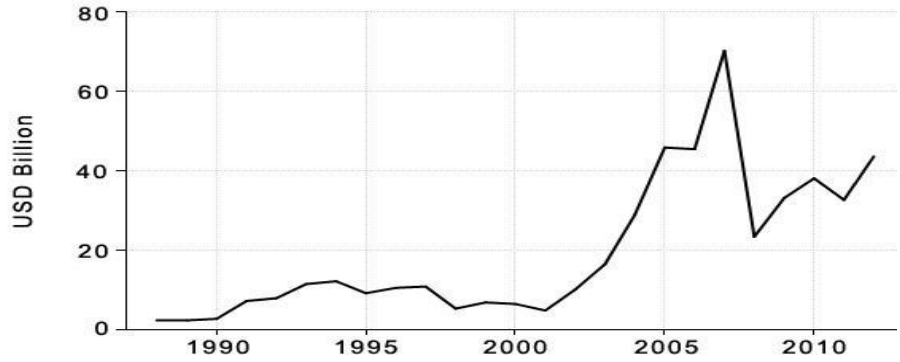


Figure 25: Market capitalization of Pakistan



Cross Regional Findings

1. Market capitalization is low. The largest in the region is Kazakhstan which peaked at USD 60 billion in 2010. This is considerably smaller compared to developed markets such as capitalization in the US at USD 17 trillion.

2. Market infrastructures are relatively advanced. All CARs, with the exception of Tajikistan, have computer assisted order routing and execution systems which enable investors to place buy or sell orders electronically. In Kazakhstan, more than 90 percent of the total trades are electronically traded. In Kyrgyz Republic, the electronic trading system handles all the transactions from trading to clearing and settlement. In Uzbekistan, there is an electronic trading system for small investors.[64]

3. The number of companies listed on the stock exchanges is fairly small, less than 90 companies on average with the exception of Kazakhstan. The KASE currently has 131 listed companies, less than one third of KSE and less than one tenth of the New York Stock Exchange (2366 in 2002).

4. The range of securities is narrow. Products and are concentrated in short-term securities products with short-term government bonds being the flagship products in the region. In Kazakhstan, the repurchase agreement or REPO market has developed rapidly. Equities and corporate bonds remain relatively insignificant in the Central Asian region. There is no corporate bond in Tajikistan.

5. The derivatives market is either non-existent or limited. The derivative market exists in Kazakhstan and Pakistan but is very small; the only product is futures and these instruments exist in limited volumes.

[64] Overview of Securities Markets in Central Asian Countries, Azerbaijan and Mongolia, 2004

Table 6: Capital Market Structure

	PAK	KAZ	KYR	TAJ	UZB	TUR
Number of Stock Exchanges	3	1	1	1	1	n/a
Number of Companies Listed	559[a]	131[b]	20[b]	800[c]	117[b]	n/a
Market Capitalization	US 51.5 billion [a] (2013)	US 60 billion [b] (2012)	US 160 million [b] (2012)	-	US 600 [b] m (2006)	n/a
Equity	Common stock, Preferred stock shares	Common stock, Preferred stock, State block of shares	Common stock, Preferred stock	Shares, Registered and bearer common stock, Preferred stock	Common stock, Preferred stock	n/a
Corporate Bonds	Most bonds are issued as private placements	Corporate bond, IFO bond	Short term bond, Long term bond	n/a	Corporate bond	n/a
Government Bonds	Short/Medium/Long term Pakistan Investment Bonds (PIBs) issued in PKR, 3/6/12 month T bills, Eurobond	Municipal bond, T bond, Short/Medium/Long term T bill, Eurobond	Short term T bill, Long term T bill	T bill, Finance Ministry bonds, National bank bonds	Short term T bill, Long term T bill	n/a
Derivatives	Up to 3 month futures	Undelivered 6 month futures	n/a	n/a	n/a	n/a
Others	Promissory note, Foreign exchange	REPO, Promissory note, Foreign exchange	n/a	n/a	n/a	n/a

a: Karachi Stock Exchange b: World Bank Indicators c: World Bank Report on Observance and Standards of Codes, 2009
Source: OECD and State Bank of Pakistan

Regulatory and Supervisory Structures for Securities Markets

There is extensive government control on the regulatory bodies in CARs. In Kazakhstan and Pakistan, the FSA and Securities Exchange Commission of Pakistan (SECP), respectively regulate and supervise the securities market and are semi-autonomous from government control. The state remains the main regulatory authority in the smaller CAR economies, suggesting impediments to any viable investment in these regions as a result of bureaucratic hurdles and uncertainties.

Table 7: Regulatory and Supervisory Structures for Capital Markets

	Single Regulator	Multiple Regulator	Level of Autonomy
TAJ	Securities and Foreign Investment Office		Low. Under the Ministry of Finance.
KAZ		FSA , National Bank of Kazakhstan (NBK), Ministry of Finance (MoF)	Medium. FSA was separated from NBK to regulate securities market and banking and is semi-autonomous. National Bank and Ministry of Finance regulate government securities.
UZB		Center for Coordination and Control of the Securities Market Ministry of finance, Central Bank	Low. While the Center supervises securities market, it remains under state control; the Ministry of Finance regulates the securities market. Ministry of Finance and the Central Bank regulate and supervise government securities market.
KYZ		State Commission on the Securities Market, Ministry of Finance and National Bank	Low. State Commission on the Securities Market regulates and supervises the securities market while the Ministry of Finance and the National Bank take responsible only for the regulations and supervision of government securities.
PAK		SECP and State Bank of Pakistan (SBP).	Medium. SECP supervises and regulated the capital market,

			including mutual funds, insurance, and private pensions. Banks, which are regulated by the central bank, also have some capital market activities. SECP has legal independence, but there is a strong perception that there is external influence, evidenced by the length of time taken to appoint commissioners. SECP staff has legal immunity.

Controls on Capital Market and Money Market

The regulatory environment in Kazakhstan is relatively liberal. The NBK plays a monitoring role and records transactions of non-residents locally or residents abroad exceeding certain limits for statistical purposes. Special permits are also required for sale or issue of securities and derivatives abroad.

There is extensive state intervention in the stock market in the smaller economies; transactions involving foreign investors are determined by quotas set by authorities (e.g., cabinet of ministers) in Uzbekistan and Turkmenistan.

Pakistan's regulatory environment is fairly restrictive. All transactions conducted by non-residents are routed via special convertible rupee accounts. SBP approval is required for purchase abroad by residents and also for sale or issue securities abroad. Proceeds from sales of these securities must be repatriated to Pakistan.

Pakistan

The capital market is regulated by the SBP and the SECP. Non-residents are allowed to trade equity securities, bond and debt securities, and money market instruments through special convertible rupee accounts (SCRAs) with designated banks. Dividends and capital gains may be credited to these accounts for remittance abroad without SBP approval. Residents are allowed to sell or issue securities abroad albeit with SECP approval only. The proceeds of these securities must be repatriated to Pakistan.

Non-residents are allowed to purchase derivative instruments listed on the stock exchanges and the Pakistan Mercantile Exchange (PMEX) through SCRAs with designated banks. Non-residents are allowed to sell derivative instruments listed on the stock exchanges and PMEX through SCRAs and are required to solicit SECP approval for issuance of derivatives. Banks are also permitted to enter into derivative transactions abroad to cover their positions for permissible categories without SBP approval.

Table 8: Capital Market Regulation: Controls on Securities

	PAK	KAZ	KYR	TAJ	UZB	TUR
Are foreign investors allowed to purchase securities?	Yes. Through special accounts.	Yes. NBK must be notified.	Yes. Regulatory authority to be notified in 3 days. Strict regulation of issuers.	Yes. National Bank of Taikistan (NBT) must be notified when stakes exceed certain limits in lending institutions. No restrictions for non-financial institutions	Yes. Shares of resident banks are not allowed to be purchased.	Yes. All transactions are subject to quotas by Government of Turkmenistan.
Are foreign investors allowed to issue and sell securities?	Yes. Through special accounts.	Yes. NBK must be notified.	Yes. Same as above. Registration of foreign investors is required for bonds and debt securities	Yes. Approval from MoF and NBT for equity securities.	Yes. Cabinet of ministers issues quotas for circulation of securities of foreign issuers. Securities may	Yes. All transactions are subject to quotas by Government of Turkmenistan.

					only be sold in local currencies	
Are local investors allowed to purchase abroad?	Yes. SBP approval required.	Yes. NBK must be notified.	Yes.	Yes. NBT must in notified when stakes exceed SM 5 million	Yes. Cannot exceed legislated amount.	Yes. All transactions are subject to quotas by Government of Turkmenistan.
Are local investors allowed to issue or sell abroad?	Yes. SECP approval required.	Yes. NBK must be notified. Permit required	Yes	Yes. Registration with MOF and approval of NBT required.	Yes. Subject to quotas by Cabinet of Ministers	Yes. All transactions are subject to quotas by Government of Turkmenistan.
Source: IMF, 2013						

Table 9: Capital Market Regulation: Controls on the Derivatives

	PAK	KAZ	KYR	TAJ	UZB	TUR
Are foreign investors allowed to purchase derivatives?	Yes. Through special accounts.	Yes. NBK must be notified.	n.r.	Yes	n.r.	n.r.
Are foreign investors allowed to issue and sell derivatives?	Yes. Through special accounts.	Yes. NBK must be notified.	n.r.	Yes	n.r.	n.r.
Are local investors allowed to purchase abroad?	Yes. SBP approval required except for banks under certain conditions	Yes. NBK must be notified.	n.r.	Yes. NBT must in notified when stakes exceed SM 5 million	n.r.	n.r.
Are local investors allowed to issue or sell abroad?	Yes. SBP/SECP approval required.	Yes. NBK must be notified. Permit required	n.r.	Yes. NBT must in notified when stakes exceed SM 5 million	n.r.	n.r.
n.r. implies not regulated *Source: IMF, 2013*						

Kazakhstan

NBK monitors all transactions in securities and derivatives for statistical accounting purposes. Sale to non-residents of securities issued by residents must be notified to NBK if the transaction amount exceeds the equivalent of USD 500,000. For the sale or issue locally by non-residents, the transaction amount limit for notification is USD 100,000. An appropriate permit is required for the issuance or placement of issued securities abroad by a domestic resident of Kazakhstan.

Kyrgyzstan

The issuers are strictly regulated; after purchase of capital market instruments, issuers must notify the authorized regulatory body within three business days. The issuers are required to report various changes such as any updates in the list of those who own 5 percent or more of the securities (or stakes) as well as variation in the percentage of those who own 5 percent or more of the securities (or stakes) etc. There is no derivate market in Kyrgyz Republic.

Tajikistan

This market is regulated by the MoF and the NBT. The NBT must be notified when stakes exceed certain limits in lending institutions. Non-residents may carry out purchase transactions only after receipt of notification from the NBT, a prerequisite for the swift execution of payments and settlements related to the transaction. Securities may be issued and circulated in Turkmenistan after registration with the MoF. The

transactions are subject to quotas by Cabinet of Ministers of Tajikistan (CMT). There is no derivatives market.

Uzbekistan

Non-residents may purchase, in foreign currency, any securities in Uzbekistan, unless their terms of issue prohibit non-residents from holding these securities. There are restrictions on the acquisition of shares of resident banks by non-residents or legal entities registered in offshore zones.

The issuance and circulation of securities in Uzbekistan are allowed only for registered securities, unless otherwise stipulated by the law. The Cabinet of Ministers establishes quotas and the procedure for circulation of securities issued by non-residents. Securities acquired by non-residents must be sold in the exchange market in domestic currency.

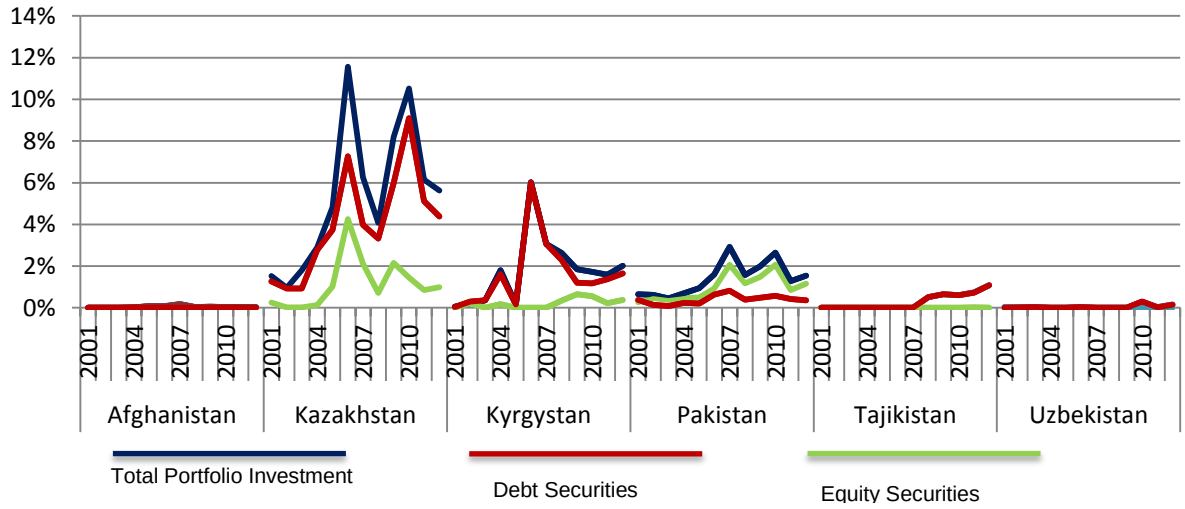
The placement of assets by legal entities outside Uzbekistan is governed by foreign exchange regulation law. Procedures governing the purchase of foreign currency securities by residents are established by the government agency for regulation and coordination of the securities market jointly with the Central Bank of Uzbekistan. The Cabinet of Ministers establishes quotas and procedures for the circulation of securities issued by residents outside Uzbekistan.

Patterns in Portfolio Investment

Kazakhstan attracts a large foreign investment in debt securities; Kazakhstan attracted USD 58 billion in long term debt securities in 2012. Kazakhstan also invests abroad in government issued securities in the US, EU, and Japan.

Pakistan's attracts portfolio investment in equities. Its portfolio investment abroad is focused mainly on equity securities in the Middle East.

Figure 26: Total Portfolio Investment Inwards (Liabilities as % of GDP)



Source: IMF, 2013

There is potential for Pakistan to invest in debt securities in more developed economies like Kazakhstan. Pakistan has the potential to invest in debt securities in Kazakhstan which have grown rapidly in recent years. Kazakhstan attracted USD 58 billion in debt securities in 2012. Pakistan has invested USD 4 million in T bills in Tajikistan through a subsidiary of the NBP. There is potential for Kazakhstan to invest in the equity market in Pakistan.

Figure 14: Kazakhstan Portfolio Investment Outward

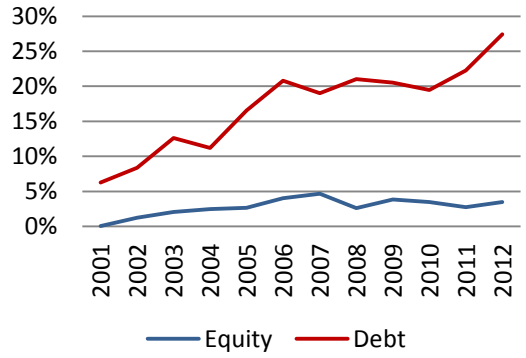
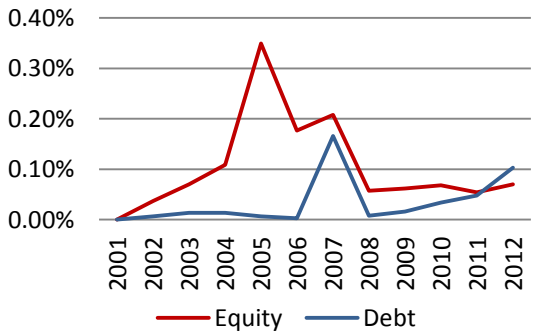


Figure 15: Pakistan's Portfolio Investment Outward



Source: IMF, 2013

Recommendations

1. Given Pakistan's advanced capital market and recent growth of the stock market in Kazakhstan, the two counties may explore bilateral investment opportunities. Pakistan may invest in debt securities in Kazakhstan which attracted a foreign investment of over USD 58 billion in 2012. There is also potential for Kazakhstan to invest in Pakistan's equity market.
2. To facilitate the flow of funds between Pakistan and Kazakhstan, a co-trading scheme may be considered. Prerequisites for an integrated trading system are adequate regulatory harmonization and advanced electronic infrastructures. Capital markets in both Kazakhstan and Pakistan are regulated by semi-autonomous regulatory and supervisory authorities (FSA and SECP) with minimal oversight of the central banks which augurs well for the possibility of regulatory harmonization. Moreover, both markets are developed and have advanced electronic trading infrastructure. It is proposed that an integrated framework along the lines of the well-functioning co-trading scheme between Australia and Singapore may be considered.
3. The research shows that capital markets in smaller CAR economies are rudimentary and state controlled. This impedes portfolio investment and makes the possibility of increased harmonization between the capital markets challenging. Nonetheless, Pakistan has invested in government issued treasury bills in Tajikistan through NBP. NBP has a presence in all CARs and may also explore the opportunity to invest in similar financial products in other CARs.

BOX 4: ASX-SGX Co-trading linkage

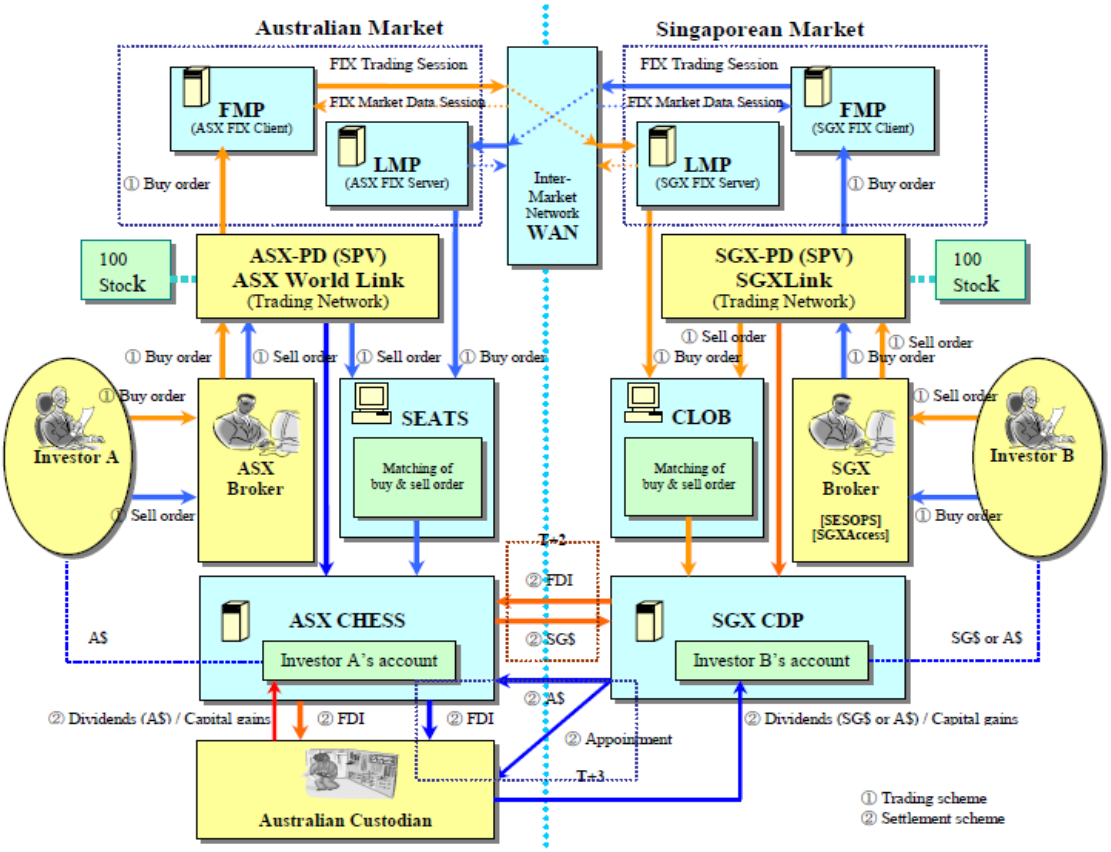
A successful case of co-trading is ASX (Australian Stock Exchange)-SGX (Singapore Exchange Limited) linkage.

This electronic linkage allows investors in Australia and Singapore to co-trade selected stocks in each other's market directly, through brokers in their own countries.

The benefits of co-trading system are expected to reduce transaction costs and to enhance service quality for investors (e.g., speedy dealings and diversified investment portfolios).

This system is well received by investors from both markets. In fact, the number of stocks available for co-trading is currently over 100 stocks in respective markets in response to growing market demand.

According to an expert in ASX, "*The main feature is that it allows domestic investors to order purchases and sales of foreign listed stocks in almost the same environment as they deal with domestic stocks.*" This is the core concept of co-trading system.



Source: OECD

Chapter 6 Sectoral Report: Transport Services

Introduction

Efficient transport services are essential for reaching world markets and strengthening regional and global integration. GVCs can only form when the transport sector provides reliable and cost-effective services. As goods cross borders multiple times during the production process, the impact of transport services compounds.

Sea-based connections provide the most economical means of international transport. The distances of CARs from the sea ports are vast. To a certain degree this geographic position constrains the ability of CARs to expand their economies through trade and to take part in global patterns of specialization.

Pakistan provides CARs with the shortest access to sea. Research shows (Figures 27 and 28 below) that transportation services feature prominently among the CARs and Pakistan's services trade. However, negligible exports of rail and road freight services suggest that Pakistan has failed to leverage its geo-strategic location as a transit corridor. Pakistan's exports in transportation sector are concentrated in its air transport of passengers which constitute over 50 percent of transport services exports. As result of inadequate liberalization of the transport sector and lack of implementation of international transit and transport agreements, Pakistan's has so far eluded the opportunity to become a transit corridor.

This study makes a case for effective liberalization of transportation sector to spur development of transport infrastructure through public private partnership. Pakistan can provide CARs with access to sea via China, Afghanistan, and Iran. Through the Chinese corridor, Pakistan provides CARs with the shortest route along the KKH and after the completion of the Kashgar-Gwadar rail and road infrastructure; this route would provide CARs with the shortest and round the year access to the sea. The distance of CARs to Pakistani seaports via the Afghan corridor also compare considerably better than with other competitive ports in the region. Distances from Tashkent to Istanbul and Dushanbe to Poti are almost twice their distances to Karachi. Pakistan's accession to TIR convention would considerably facilitate the movement of vehicles in the region and enable it to function as a transit corridor.

Pakistan's main exports to CARs include high cost and low weight surgical instruments and time sensitive pharmaceutical goods. Given that air freight is the preferred mode of cargo for such goods, direct air transport can greatly boost Pakistan's exports to the region. There is a need to address the issue of lack of capacity in Pakistan's aviation sector by allowing the growth of existing and entry of new carriers, and promoting policies attracting domestic investment and FDI into Pakistani airlines.

Methodology

The study aims to assess Pakistan's potential to enhance transport services trade by leveraging its geo-strategic position to become a transit corridor for CARs. The study evaluates Pakistan's competitiveness in terms of its capacity, and the time and cost of transit via Pakistan based on the following:

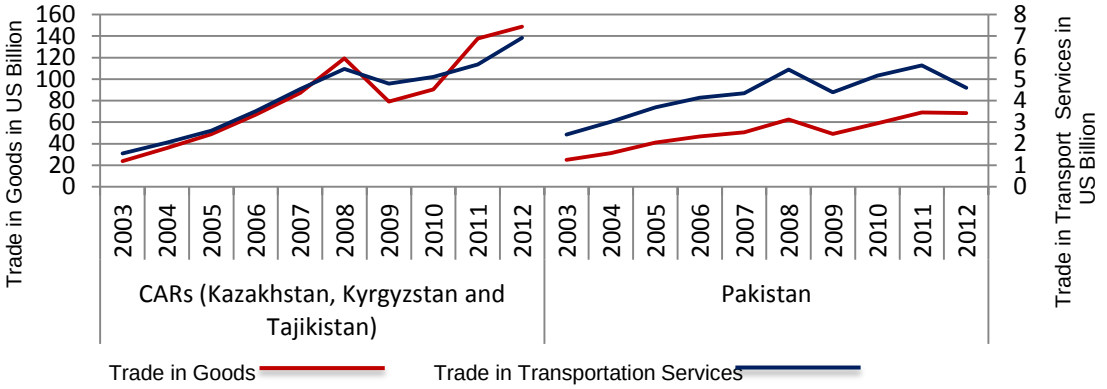
- Comparison of Pakistani ports with other ports used by CARs.
- Evaluation of corridors through which Pakistan can provide CARs with access to sea ports.
- Analysis of sub-sectoral export and import patterns to assess the performance of transport services in the region and identify potential subsectors for growth.
- Assessment of the role of railway, road, marine, and air transport services in the region.
- Evaluation of service trade restrictiveness against foreign service providers.
- Assessment of the role of transit agreements in trade facilitation in the region.

Based on the above analysis, the study makes policy recommendations for reforms for Pakistan to realize its potential role as a transit corridor for economies that lie along the Silk route.

Overview of Trade in Transport services of CARs and Pakistan

In both the CARs and Pakistan, trade in transport services strongly corresponds with trade in goods, underlying the importance of transport services as a facilitator for merchandise trade. In this respect, efficient transport services can prove to be vital in integrating Central Asia with South Asia, South East Asia and the Middle East via Pakistan.

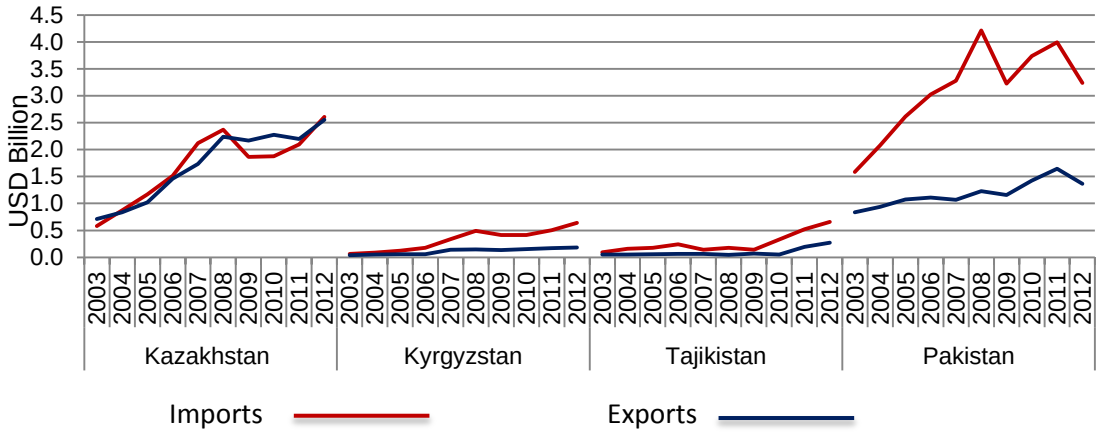
Figure 29: Trade in Goods and Transportation Services



Source: UN Comtrade, 2012

Transportation services feature prominently in global services trade of CARs and Pakistan, and constitute over 30 percent of total services trade in the region.[65] Over the years Pakistan, Kyrgyzstan, and Tajikistan have had a negative balance in trade in transportation services, while Kazakhstan's trade balance has fluctuated.

Figure 30: Exports and Imports of Transportation Services



Source: UN Comtrade, 2012

Patterns of trade in transport services in the region are as follows:

1. Pakistan is the second largest exporter of transportation services in the region, after Kazakhstan. Its exports are concentrated in air transport of passengers which constitute more than 50 percent of its exports. While auxiliary services related to sea transport have gained share in overall exports of Pakistan, the export structure has remained largely the same over the last decade.

[65] UN Comtrade, 2012

2. Freight services do not contribute much to Pakistan exports, except air freight services which have contracted from 8 percent to a little over 5 percent in share since 2004. Negligible rail and road freight suggests that Pakistan has failed to leverage its geo-strategic location as a transit corridor. Research indicates that Pakistan has a comparative advantage in air transport services in South Asia.[66] Pakistan's main exports to CARs include high cost and low weight surgical instruments and time sensitive pharmaceutical goods. Given that air freight is the preferred mode of cargo for such goods, effective air transport can greatly boost Pakistan's exports to the region.

3. Pakistan has a trade deficit in transportation services as a substantial portion of its merchandise trade in using external transportation, such as international shipping companies. Its imports of transportation services were more than USD 3 billion in 2012, with over 68 percent of imports in sea freight services. Pakistan can increase its exports of transportation services and reduce its deficit in transport service if it realizes it potential to become a transit corridor. The planned road and railway infrastructure along the KKH from Gwadar to Kashgar, would provide the shortest route to sea for CARs and western China. This corridor could be instrumental in increasing the role of rail and road services in Pakistan.

4. Kazakhstan is the largest exporter and importer of transportation services among the CARs. This importance of transportation services is due to Kazakhstan's central position as a transit country between the southern Central Asian countries and their major trading partners, Russia, Europe, and China.[67] Moreover Kazakhstan occupies a large territory, but the population density is low. This makes transport an important factor in the entire economy.

5. Transport accounts for more than 50 percent of total services exports of Kazakhstan. Over 80 percent of transport services are based on freight. Pipeline transport also contributes significantly to its exports as oil and gas industry is a major industry in Kazakhstan. Kazakhstan also acts as a transit country for pipeline exports of Turkmenistan and Uzbekistan. Rail transport features prominently in Kazakhstan's transport services trade. It is the most important mode of transport in Kazakhstan; providing up to 70 percent of cargo and 50 percent of passenger turnover in the overall transport operations in Kazakhstan.[68]

6. Freight transport services account for a large percentage of trade in services of Uzbekistan and have expanded with increasing merchandise trade with Russia and China. As a result of strong state control and a monopolized structure of the transport sector, Uzbekistan's trade and transport policies remain restrictive towards its neighbors. Uzbekistan's share of exports of services to CARs has declined. Exports of services to Turkmenistan contracted sharply because Turkmenistan has curtailed using Uzbekistan's transport companies since 2001, when political relations between the two neighbours deteriorated.

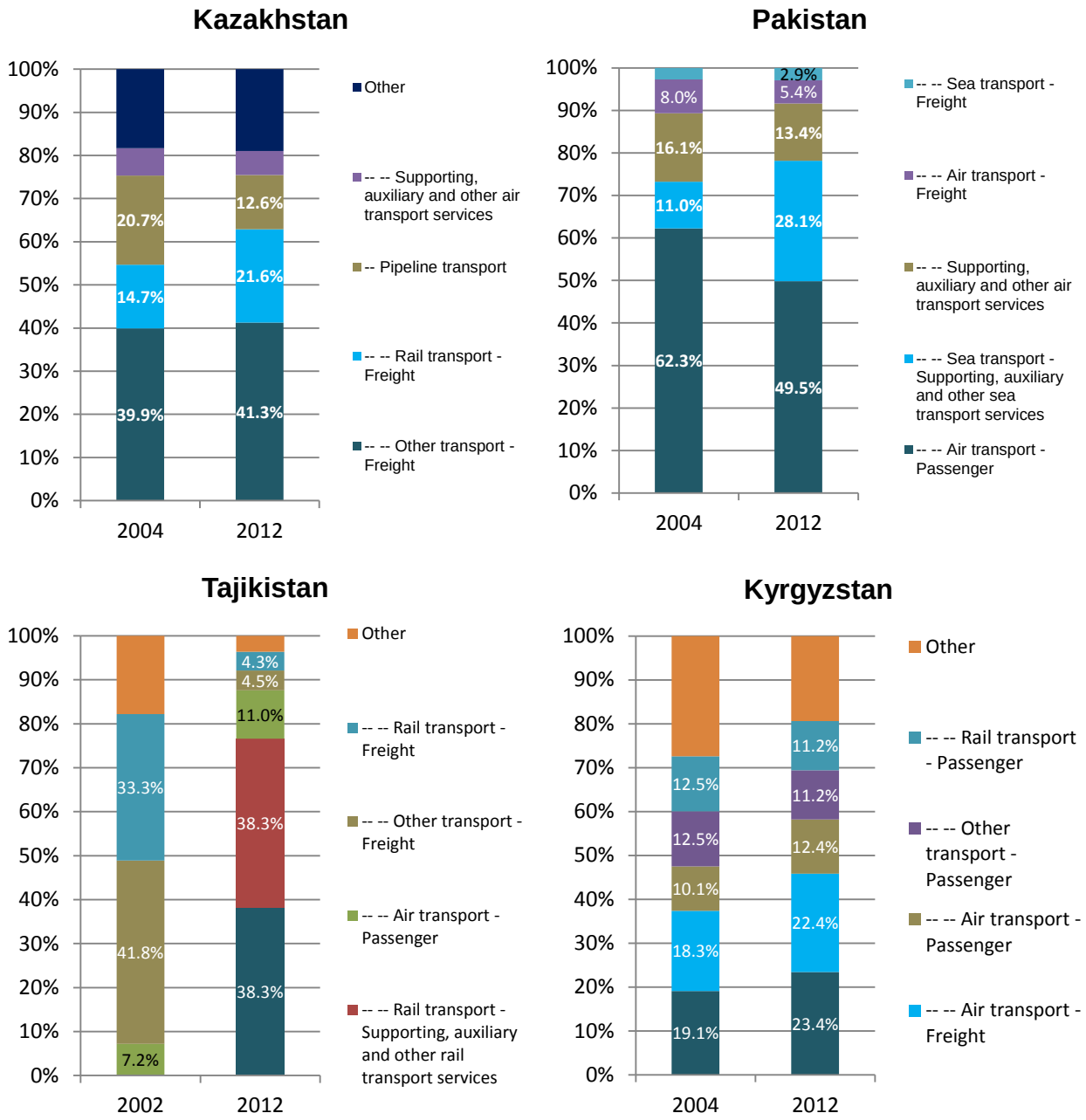
7. Tajikistan's transportation services trade increased significantly after 2009. A possible reason could be the use of Tajik territory for supply routes of US-led coalition forces to Afghanistan following the deterioration of the security situation in Pakistan. Both Uzbekistan via its stable rail networks, and Tajikistan via its road networks, are now involved in supplying fuel and other materials to US military bases in Afghanistan.

8. Air transport services are the main exports of Kyrgyzstan and account for more than 50 percent of its total exports in transport. This is because gold, pearls, and precious stones are the main exports of Kyrgyzstan, and these high cost and low weight products are usually

[66] http://trtapakistan.org/wp-content/uploads/2012/04/Pakistan%E2%80%99s-Export-Potential-in-Transport-Services.pdf
[67] International transport in Central Asia: Understanding the Patterns of (Non-) Cooperation, Elena Kulipanova, Working Paper No.2, 2012
[68] http://www.kazakhembus.com/page/transport-and-communications

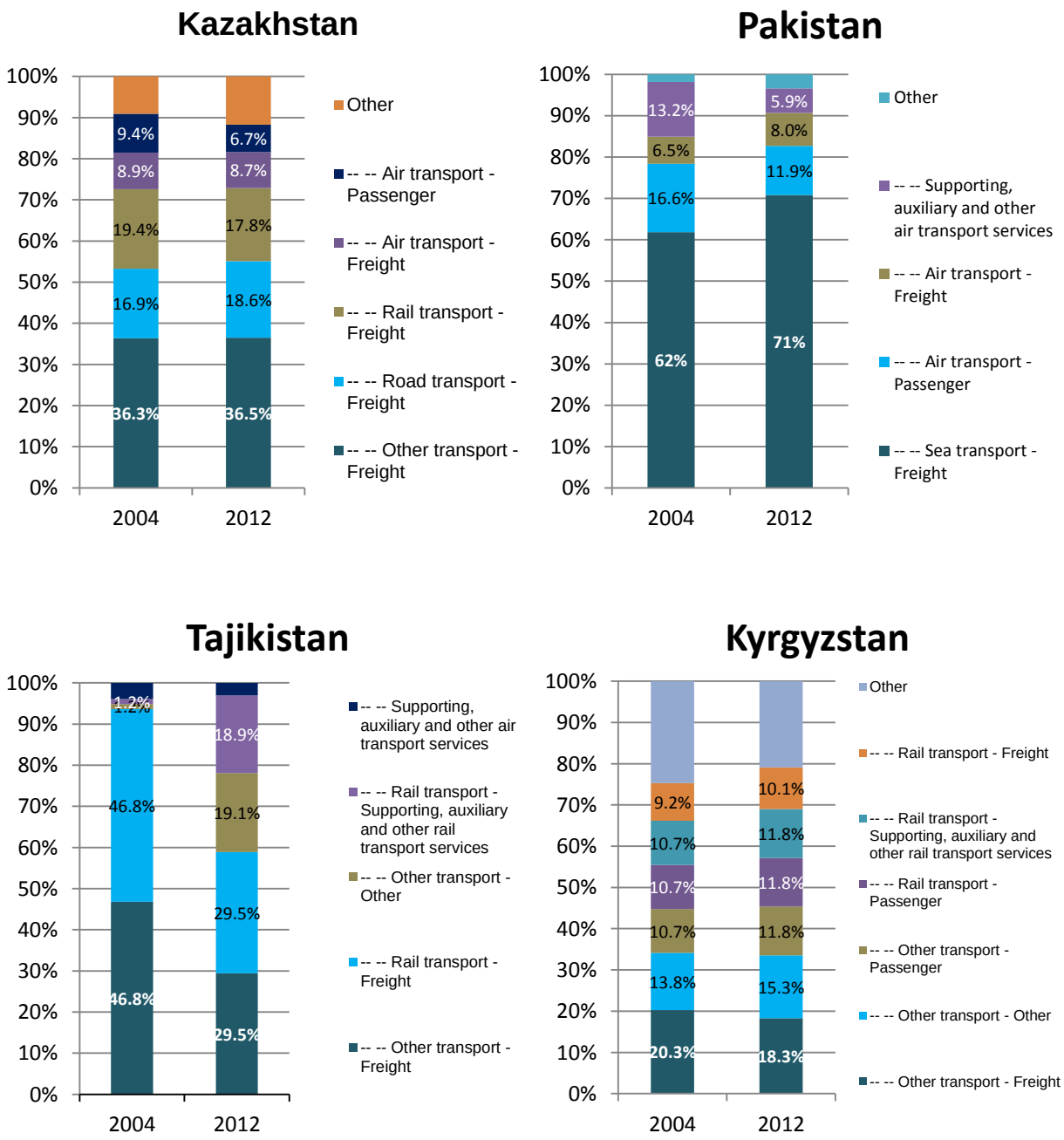
transported via air. The export and import composition of Kyrgyzstan transport services have largely remained the same over the past decade.

Figure 31: Exports Composition – Transportation Services



Source: UN Comtrade, 2012

Figure 32: Imports composition – Transportation services



Source: UN Comtrade, 2012

Pakistan's Potential to be a Transit Corridor for Central Asia

The five CARs are among the thirty-one landlocked developing countries, and Uzbekistan is one of the two double-landlocked countries in the world where more than one country must be crossed. The vast distances of CARs from the sea ports result in high transport costs for merchandise trade.

Access to the sea is critical because land transport is comparatively more expensive, especially in countries with inadequate road and rail infrastructure. Shipping goods over one additional kilometre of land costs as much as shipping them over seven extra kilometres of sea (Hausmann, 2001; Limao and Venables, 2001). As a result, the use of international rail and road routes for transcontinental

transit is limited. Some 98 percent of goods traded between the EU and the Asia Pacific are transported by sea, while overland transport through Central Asia and Russia accounts for only 1 to 2 percent.[69] This auger's well for Pakistan to become a transit hub for CARs and provide them with a gateway to the Arabian Sea and beyond.

Shortest Access to the Sea for CARs

Pakistan's ports of Karachi, Port Qasim, and Gwadar provide the shortest link to sea to the main population centers of Tajikistan, Uzbekistan, Kyrgyzstan, and Kazakhstan. This makes Pakistan a very suitable country for transit of goods, especially perishable items to and from CARs. There is significant potential for Pakistan to facilitate the transportation needs of these markets exports of food products, fresh fruits, minerals, raw cotton, aluminium, energy, and a variety of other items to Pakistan and global markets.

The main competitive ports to Pakistan's three ports are:

1. Bandar Abbas (Iran)
   The Bandar Abbas port caters to Afghanistan, Turkmenistan, Uzbekistan, and West Kazakhstan. Due to the current sanctions, ocean freight to Bandar Abbas is higher than normal.

2. Chabahar Port (Iran)
   Iran is also using the port of Chabahar to cater to traffic to and from South Afghanistan. The Iranian port of Chahbahar at the mouth of the Persian Gulf is only 200 km away from Gwadar. Chahbahar may not be directly competitive with Gwadar due to relatively shallow waters of the Persian Gulf.

3. Istanbul and Izmir (Turkey) and Poti (Georgia)
   The ports of Izmir and Istanbul are catering to Azerbaijan, Turkmenistan, Uzbekistan, and Kazakhstan. The distances of these ports from Kyrgyzstan, Kazakhstan, and Tajikistan are very long. The distance between Almaty and Izmir is approximately 1.5 times more than its distance to Gwadar.[70] Tashkent to Istanbul is also almost twice its distance to Karachi. Similarly the distance between Dushanbe and Poti is approximately twice its distance to Karachi. There is potential to divert the traffic to Pakistan's ports. Importers in Kazakhstan, Kyrgyzstan, and Tajikistan may prefer to use Pakistani ports due cost effectiveness and short transit time.

Pakistan can provide CARs with access to sea routes via China, Afghanistan, and Iran. The shortest route is via China along the KKH. After completion of the Kashgar-Gwadar rail and road infrastructure, this route would provide CARs with the shortest and with round-the-year access to the sea. All CARs have acceded to the TIR convention which allows free movement of trucks within the territory of TIR signatories. Pakistan's accession to the convention would further enable it to function as transit corridor.

[69] Michael Emerson and Evgeny Vinokurov, "Optimization of Central Asian and Eurasian Trans-Continental Land Transport Corridors," *Europe-Central Asia Monitoring Working Paper*, no. 7 (Brussels: FRIDE, 2009).
[70] Googlemap

Figure 33: Corridors

Source: Based on information from Pak Caspian

Table 10: Analysis of corridors

Corridor	Description	Advantages	Disadvantages	
Chinese Corridor	The Chinese corridor uses the historic Karakoram Highway (KKH) through China as a transit corridor to connect Pakistan with CAR's. Pakistan China, Kyrgyzstan and Kazakhstan are already signatories to the QTTA which facilitates the free movement of transit goods among the respective countries	• It is the shortest route. • The road conditions are relatively good, especially in the Chinese territory. • This is the only route where Kazak , Kyrgyz and Chinese trucks are allowed to go up to Pakistani Ports • After the completion of the planned Kashgar to Rawalpindi railway, this route will be open all year round.	• KKH is currently not an all-weather road. • System of unified seal is required. TIR Carnet can be a good solution. • Procedures regarding issuance of permits and visas under QTTA and customs inspections at border posts need to be streamlined	
Afghan Corridor	Afghan corridor provides Pakistan with access to CAR's and vice versa through the territory of Afghanistan. Pakistan has signed APTTA with Afghanistan which provides it with access to the three CARs – Uzbekistan, Tajikistan and Turkmenistan – bordering Afghanistan.		• It is the second shortest route after the Chinese corridor. • Afghanistan is now a signatory to the TIR Convention. All the CAR's have also acceded to the Convention	• High cost of fuel in Afghanistan • Perceived law and order situation in Afghanistan and Uzbekistan's requirement to open all trucks even if TIR is certified

Corridor	Description	Advantages	Disadvantages	
Iranian Corridor	Iranian corridor is the longest route among the three corridors and uses the territory of Iran for transit to and from Central Asia.		• Low cost of fuel in Iran and Turkmenistan • All weather route • Good roads within Iran	• Longest route if consignment are destined for Almaty, Bishkek, Dushanbe or Tashkent • Heavy road usage charges by Iran on foreign trucks. This is to promote local transport companies. • Axle weight restrictions within Iran

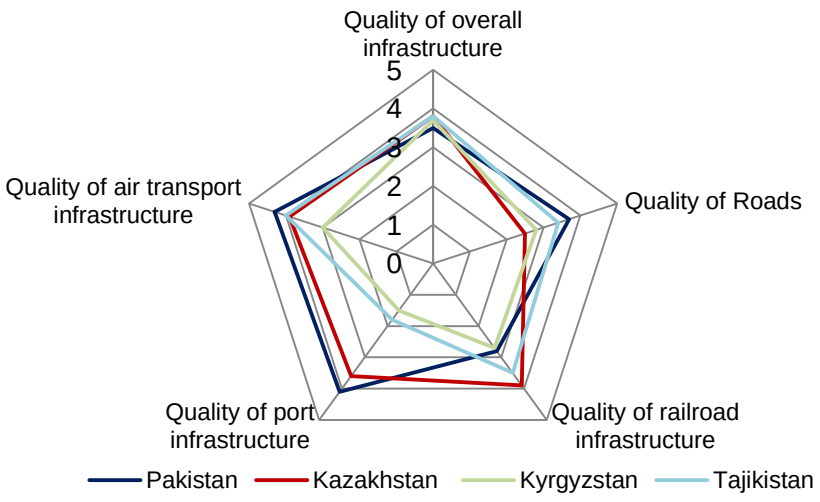
Cross Regional Findings

Transport Infrastructure in CARs and Pakistan

Being landlocked, the two most dominant modes of transport in CARs are road and rail. Regional traffic in Central Asia is predominantly carried by rail. As per World Bank indicators all CARs, particularly Kazakhstan and Tajikistan have relatively developed rail infrastructure. Uzbekistan also has a well-developed rail infrastructure. Pakistan ranks better than CARs in quality of roads, ports, and air infrastructure; however its railway infrastructure leaves significant room for improvement.

Infrastructure development is a pre-condition for growth of transit business and cheaper transport costs. This section presents an overview of the different modes of transport in CARs and Pakistan.

Figure 16: Quality of Infrastructure in Pakistan and CARs



[71]

Source: World Bank

Railway Services

During the Soviet Union, rail transport was considered as a major unifying factor in the economic activity and accounted for most of the total freight transport. The importance of railway for international freight transport in the region is still significant with its share ranging from over 60 percent in Kazakhstan, including domestic transport, to 90 percent in Tajikistan and Uzbekistan.[72]

[71] 1 = extremely undeveloped; 7 = extensive and efficient by international standards
Source: World Economic Forum - http://www3.weforum.org/docs/GCR2011-12/14.GCR2011-2012DTIIInfrastructure.pdf
[72] International Transport in Central Asia: Understanding the Patterns of (Non-)Cooperation, Elena Kulipanova

This importance is also reflected by the prominence of rail transport in CARs services trade. Kazakhstan and Uzbekistan have the most developed railway infrastructure.

Pakistan's railway importance as a means of transportation for merchandise has progressively declined. At its peak between 1955 and 1960, railways handled 73 percent of the freight traffic. Currently it handles less than 4 percent of the total freight traffic.[73] Railway transport also does not feature prominently in Pakistan services trade. The planned Gwadar – Khunjerab - Kashgar rail network will connect the CARs with the Arabian sea and provide them with an all year round, cost effective and shortest access to the sea. This would increase the importance of rail freight services in Pakistan.

Road Services

The share of international transport by road is lower in comparison to rail in all CARs except Kyrgyzstan in which over 97 percent of the goods are transported by truck.[74] Uzbekistan is a major country for road transit in Central Asia. The most heavily used routes via Uzbekistan run in a north-south direction through Kazakhstan and Turkmenistan, while the rest go from Tajikistan, Kyrgyzstan, and Afghanistan. [75]

The condition of the road network in CARs is poor. The roads in Kazakhstan and Tajikistan require rehabilitation. The roads in Uzbekistan are comparatively better, but the pavement is often severely distressed due to overloading of vehicles and lack of preventive measures.

In Pakistan, road network is the most important means for freight transport within the country and to neighboring countries. Although Pakistan's quality of road infrastructure is comparatively better than CARs, it still has severe capacity constraints that limit the facilitation and efficient movement of goods. If Pakistan is to act as a transit corridor for CARs there is a need to make significant improvements in the road infrastructure and modernize the trucking industry.

Maritime Services

Pakistan has three operational sea ports. The Karachi port and Port Qasim are already operating at international standards. Gwadar port has been recently handed over to the Chinese. About 95 percent of Pakistan's international trade is sea borne and handled at the Karachi port and Port Qasim. The port at Gwadar is also handling a small volume of public sector bulk cargo.

The terminals at Karachi port and Port Qasim were established on a build operate and transfer (BOT) basis and their ship to shore performance is comparable to any efficient port in this region.

Aviation

International air transport in general and international passenger transport in particular play a crucial role in the process of international integration, and also affect the development of other sectors of an economy.

Pakistan aviation sector has the potential to expand greatly. Air transport of passengers features prominently in Pakistan's exports and accounts for almost 50 percent of its exports of transport services. However, there is a need to increase the freight transport via air.

Presently there are no direct flights between Pakistan and CARs; the flights from Pakistan to CARs and vice versa are routed via the Gulf. Uzbekistan airline was the only operator that provided direct weekly flight between Tashkent and Lahore, but they discontinued their service in early 2014. This is

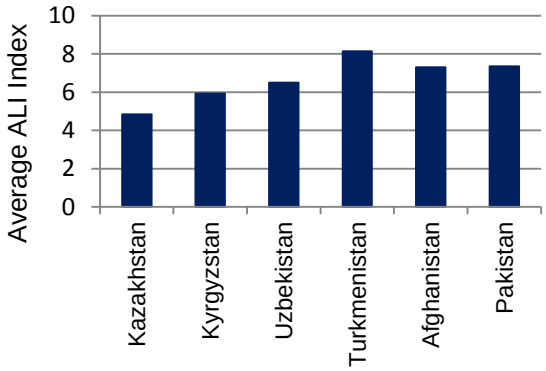
[73] Greening Growth in Pakistan through Transport Sector Reforms, World Bank
[74] UNECEC / UNESCAP, 2008
[75] International Transport in Central Asia: Understanding the Patterns of (Non-)Cooperation, Elena Kulipanova

of significant consequence given Pakistan's main exports to CARs are pharmaceutical and surgical goods which are normally transported via air.

BOX 5: Impact of Air Transport Liberalization on Trade

Liberalized air transport environment can reduce transaction costs and boost merchandise trade. Using the Gravity Model and Air Liberalization Index (ALI) developed by the WTO, Geloso Grosso and Shepherd (2009) show that more liberal air services policies are positively associated with higher bilateral trade in merchandise. Furthermore, air transport policy matters more for some sectors than for others, particularly manufactured goods, time sensitive products, and parts and components. Estimates imply that a one point increase in the ALI is associated with an increase of 4 percent in bilateral parts and components trade, indicating the importance of air transport liberalization on GVCs.

Figure 17: Air Liberalization Index



Source: WTO

The ALI index captures the impact of provisions in air services agreements (ASAs) on market access between country pairs. It ranges between 0 and 50, where 0 is associated with the most restrictive agreement and 50 denotes the most liberal regime. Pakistan and CARs have an average ALI below 10, indicating a fairly restrictive air transport regime.

Air freight is the preferred mode of cargo for the main exports of Pakistan to CARs which include high cost and low weight surgical and time sensitive pharmaceutical goods. Pakistan may consider negotiating an ASA with CARs to boost its exports and achieve greater integration in GVCs.

Regulatory Environment for Foreign Service Providers

In Uzbekistan, railway infrastructure is under exclusive state ownership, and market entry is not allowed to foreign providers. Similarly in Kyrgyzstan, the state-owned railway company, Kyrgyz Temir Joldory, is by law the monopoly provider of railway passenger and cargo transportation. With respect to Pakistan and Kazakhstan, market entry is allowed in rail freight with no restrictions.

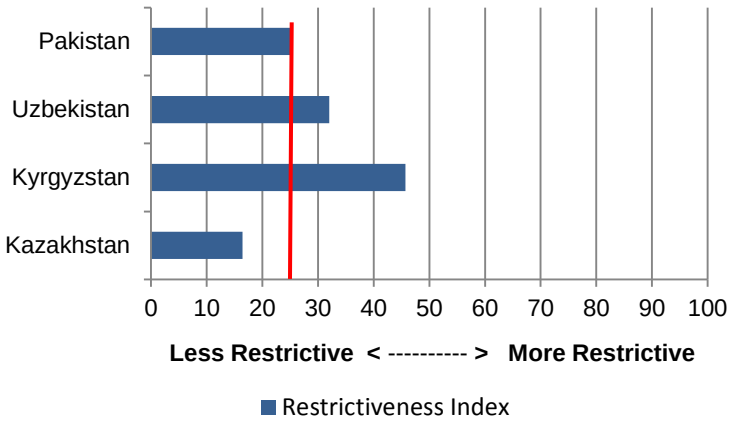
Road Freight is relatively more liberalized and has fewer restrictions across the counties. In all the countries market entry is allowed. For green field subsidiary and acquisition of a domestic private entity the maximum ownership allowed is 100 percent. However for Uzbekistan, for joint ventures with statutory capital of at least USD 150,000 and at least 30 percent foreign capital participation, special privileges and state guarantees apply.

Being landlocked, CARs do not have maritime shipping. Pakistan is the only country with access to sea ports. Pakistan has allowed market entry in both maritime shipping and maritime auxiliary

services. Although the maritime auxiliary services are open to foreign suppliers, they cannot provide the auxiliary services for ships of other firms.

Market entry in air passenger domestic and air passenger international is allowed by all the countries, though Pakistan and Kyrgyzstan have placed equity limits on foreign ownership at 49 percent. Otherwise, there are no differences in licensing criteria for foreign and domestic applicants. There are also no limits on the number of licenses available and no nationality requirements for board of directors.

Figure 18: Services trade restrictiveness index - Transport services, 2012



Source: World Bank

Table 11: Key restrictions on entry of foreign service provides - Transport services

MODE 3	Pakistan	Kazakhstan	Kyrgyzstan	Uzbekistan
Air Passenger Domestic	Foreign equity participation limit of 49 percent.	The limit on foreign ownership in a state-owned entity to be determined by the state authority.	Limit on foreign ownership for both greenfield and M&A is 49 %.	No equity restrictions; 80% of employees must be nationals.
Air Passenger International	Limit on foreign ownership is 49 % in a subsidiary and/or acquisition.	-do-	Limit on foreign ownership for both greenfield and M&A is 49 %.	-do-
Maritime Shipping International	No equity restrictions.	N/A. Landlocked.	N/A. Landlocked.	N/A. Landlocked.
Maritime Auxiliary Services	Foreign suppliers can only provide cargo handling and container auxiliary services for ships of other firms.	N/A. Landlocked.	N/A. Landlocked.	N/A. Landlocked.
Road Freight Domestic	No restrictions.	Open to foreign investors.	Open to foreign investors.	No restrictions.
Rail Freight Domestic	No restrictions.	No restrictions.	Closed (under state monopoly).	Closed (under state ownership).
Source: World Bank				

Recommendations

To become a transit corridor Pakistan must address regulatory and infrastructure challenges present in the transport sector. This section provides policy inputs on implementation of transit agreements and reforms needed in the four modes of transport to ensure that Pakistan has the required capacity to meet the transportation needs of the CARs.

1. Effective implementation of transit agreements
   - Transit facilitation agreements can improve Pakistan's connectivity with Central Asia and ease the movement of vehicles, goods and, persons in the region. Important policy instruments include Afghanistan-Pakistan Transit Trade Agreement (APTTA), Cross Border Transit of Persons, Vehicles and Goods Agreement (CBTA), Quadrilateral Traffic in Transit Agreement (QTTA), and the Economic Cooperation Organization Transit Transport Framework Agreement (ECO-TTFA). The following table provides limitations associated with the agreements and makes recommendations that can ensure better movement of goods among the contracting parties of the agreements.

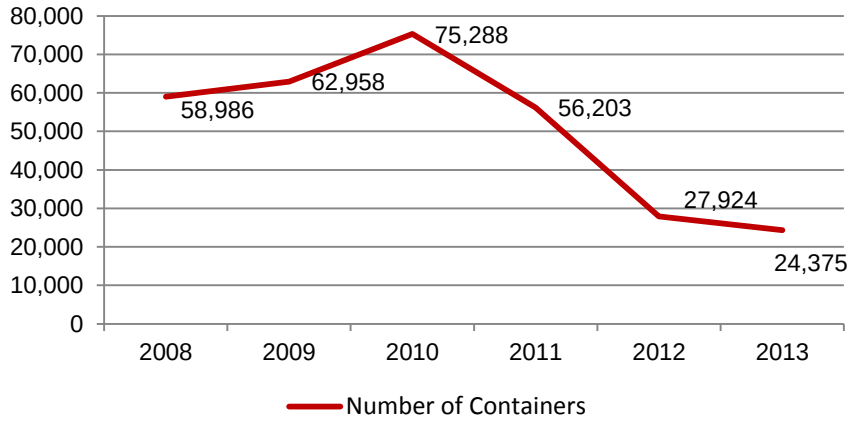
Table 12: Transit facilitation agreements

Agreement	Limitations	Recommendations
APTTA	• Excessive layers of security provisioned in the agreement • Excessive checks on transit consignments • Lack of harmonization and inadequate communication between the Pakistan and Afghanistan customs departments	• Effective mechanism to ensure smooth functioning of Electronic Data Interchange (EDI) • Accession to Customs Convention on Containers (1972) • Fast-tracked implementation of the Single Business Window • Accession to TIR convention
CBTA	• The CBTA relies heavily on international conventions in facilitating traffic in transit. Pakistan has not been very forthcoming in acceding to these international conventions	• Accession to TIR Convention • Accession to International Conventions • Establishment of Electronic Data Interchange (EDI) / Single Window • Representative Offices of Registered Transport Operators
QTTA	• Delays in issuance of permits, required for transit under QTTA. • No comprehensive procedure in QTTA for issuance of visas to drivers • Inadequate facilities at Sust border station • Routine customs examination of goods including unloading of heavy cargo	• Streamlining the procedure for issuance of permits • Developing consensus among stakeholders to introduce a robust risk management system under QTTA • Development of all-weather land routes via KKH
ECO-TTFA	• Excessive documentation required by CAR's and Afghanistan • Delay in nomination of authorized bodies to endorse visa applications of persons engaged in international transport	• Pakistan's accession to TIR Convention • Streamlining the process for issuance of visa to personal engaged in transit • Electronic Data Interchange (EDI) / Single Window (SW)

2. Accession to TIR Convention
   - For goods in transit, a financial mechanism is needed to provide assurance to the transiting country that the goods will not be diverted for local consumption without paying the required taxes and duties. The financial security model under APTTA has been a source of anxiety for Afghan traders and has been instrumental in diverting trade from Pakistani ports to Iranian ports. The figure shows that the number of Afghan containers transiting via Pakistan decreased significantly because of the financial security mechanism. TIR provides an alternative to APTTA's model of financial security. The International Road Transport Union provides the TIR contracting parties an online web base system to track the movement of the transit consignments thus providing a simple system for the discharge of the TIR Carnets as soon as goods leave the transit territories. All the CARs and Afghanistan are signatories to

the TIR convention. There is a need to expedite the process of Pakistan's accession to the TIR Convention.

Figure 19: Number of Afghan containers transiting via Pakistan



Source: Pakistan Customs

3. Trucking Sector Reform
   - The Pakistani trucking sector comprises a large number of single vehicle owners operating underpowered trucks which do not have the capacity to negotiate steep gradient in mountainous terrain. Three is a need to modernize the trucking industry to ensure that the significant volume of transit trade via road network is handled in a timely manner.

4. Reform in Aviation
   - Initiate direct flights between CARs and Pakistan to boost trade and tourism.
   - Allow entry of new carriers to create competition and address the shortage of capacity in the aviation sector and lower airfares.
   - Attract FDI into the aviation sector to address the issues of lack of capacity and need for fleet regeneration. Pakistan International Airlines's (PIA) fleet of aircraft has an average life of 13 years as compared to 5 to 6 years for Emirates and Singapore airlines. Moreover, over half of PIA fleet is older than 23 years.

5. Reform in Railways
   - Implementation of the planned Kashgar-Gawadar railroad should be expedited.
   - Public private partnerships should be encouraged. The main benefit of investing in rail transport is to reduce road traffic, and if the necessary reforms are taken, provide a fast and economical way of transporting goods domestically.

Chapter 7 Sectoral Report: Telecommunication Services

Introduction

This section highlights the importance of telecommunication connectivity between Pakistan and Central Asia. Based on an assessment of the existing status of regional connectivity and current bandwidth and transit costs, the study builds a case for the establishment of terrestrial fiber optic network which would not only improve economic integration and connectivity between CARs and Pakistan but would also address the lack of reliable and cost effective Europe to Asia bandwidth which is a pressing concern of the international bandwidth industry. The situation presents an opportunity for Pakistan to become a regional telecom transit hub.

The last decade has shown the critical importance of the telecommunications sector, not only as a growth industry itself, but also as an enabler for other economic activities .Telecommunication services, like transport, are an important set of backbone services. Without high quality and cost-effective means of communication it is difficult for other service providers and manufacturers to access foreign markets. Moreover, participation in international production networks and formation of global value chains become difficult without effective communication connectivity.

Improvement in telecom connectivity in the region would become the backbone for cross border trade in digitally enabled services. These include communications, insurance, financial services, computer and information services, other business services and recreational services. Health and education may also be traded digitally.

ICT enabled services ride on telecommunication and broadband network which runs on the optic fiber cable network.[76] Optic fiber connectivity in the region is suboptimal and resultantly IP transit and broadband subscription costs are prohibitively high in all CARs except Kazakhstan. This is a major impediment to the growth of telecom and digitally enabled services. Pakistan has limited connectivity with CARs via Afghanistan. The fiber optic link between Afghanistan and Pakistan is underdeveloped.

The report recommends that Pakistan improve its optic fiber connectivity with Afghanistan for better connectivity with CARs. It also suggests that an optic fiber terrestrial network be developed along rail and road infrastructure projects under CAREC to integrate the corridor 5 countries. Estimates reveal that the additional cost of fiber network installation during such open road construction is less than 1 percent of project total.

Methodology

The study aims to assess the potential for Pakistan's telecom sector to supplement the regional economic integration through fiber optic connectivity. The study focuses on:

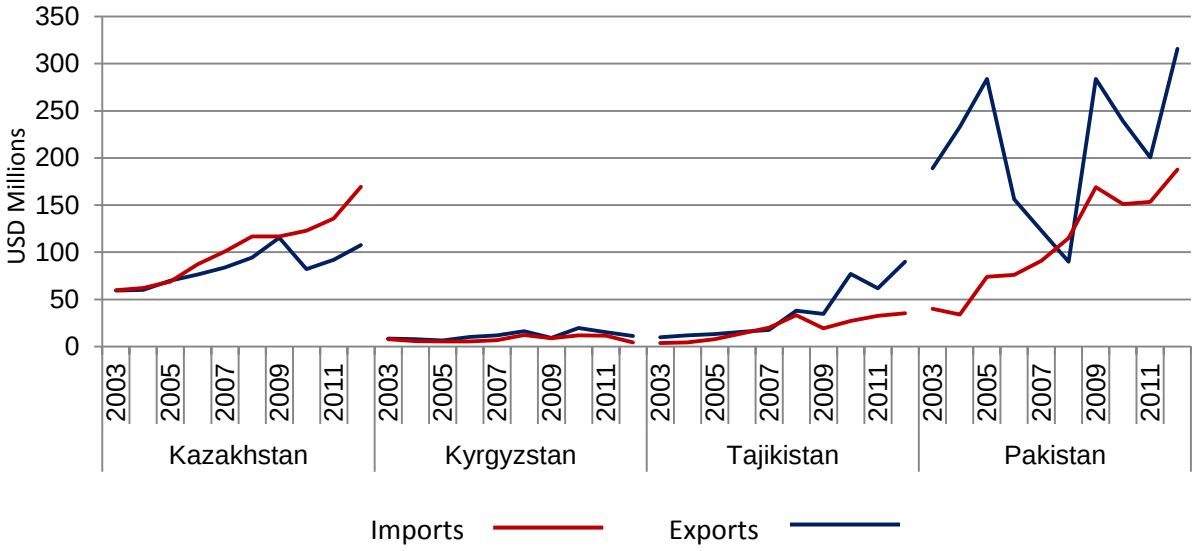
- The current status of international telecom infrastructure of Pakistan, Afghanistan, and CARs.
- The level of connectivity established between these countries and their neighbors.
- The cross regional comparison on key indicators including international band-width per capita (Kbps), international connectivity, IP transit price, competitiveness of telecom market, fixed Mobile Broadband infrastructure, fixed and mobile broadband Infrastructure, Annual 1 Mbps Broadband subscription plus Installation as a percentage of GDP per capita etc.
- The study presents a business case for the development of a terrestrial fiber optic network between CAREC corridor 5 countries.
- It highlights the bottlenecks in achieving the telecom regional connectivity.
- It further proposes set of recommendations to increase telecom integration by leveraging regional institutions.

[76] Optical fiber is used for long-distance and high speed communication, as light propagates through the fiber with little attenuation compared to electrical cables. This allows long distances to be covered without data loss providing terabits of capacity.

Overview of Telecommunication Services in CARs and Pakistan

Services trade patterns reveal that Pakistan is the largest exporter and importer of telecom services in the region followed by Kazakhstan. Pakistan is a net exporter while Kazakhstan is a net importer. Telecom exports in Tajikistan are on the rise.

Figure 20: Trade in Telecommunication Services



Source: UN Comtrade, 2012

- Kazakhstan's strong telecom sector growth is the resultant of a growing economy, positive regulatory reforms, and improved international connectivity. Legislation adopted in 2004 laid the foundation for liberalization of telecom industry and put an end to the monopoly enjoyed by Kazakh Telecom, the state-controlled telecom operator. Following the reforms, Kazakhstan's trade in services has witnessed an upward trend. Mobile penetration[77] in the country has reached 175 percent and 50 in 100 people are internet users. International connectivity and bandwidth in Kazakhstan is the highest in the CARs at 275 Gbps; however, it remains sub-optimal and is approximately 10 percent of the international bandwidth of Russia.[78]
- Kyrgyzstan suffered a restrained economic growth in 2010 due to civil unrest; however the country has emerged with a strong recovery. In 2012, the country ICT services market amounted to USD 500 million. While the mobile penetration is reasonable at 108 percent, the broadband market remains small due to lack to affordability and limited deployment. Nonetheless, following the partial privatization of Kyrgyz telecom, there has been a decrease in consumer prices. [79]
- Tajikistan has an ICT market of approximately USD 40 million. The mobile phone penetration in the country is 90 percent and internet usage is approximately 25 percent of total population. There was a sharp rise in exports of telecom services after 2009 following the completion of Tajikistan-Afghanistan optic fiber links; Tajikistan provides transit capacity to Afghanistan. Tajikistan-Kyrgyzstan optic fiber link was also completed in 2009.[80]
- Turkmenistan has poor international connectivity and a considerably restrictive telecom regime. The country has a mobile penetration of 80 percent. There are two major telecom players including the Government and Mobile Tele Systems (MTS). The MTS had 85 percent mobile market share in 2010 when its license was revoked. The government owned Turkmen Telecom. Its subsidiary Altyn Asyr gained market control but could not meet the demand

[77] Percentage of mobile owners compared to total population
[78] Terabit Consulting, 2013
[79] Artyom Zozulinsky, 2007
[80] Terabit Consulting, 2013

which grew from 400,000 subscribers in 2010 to 1.5 million subscribers in 2012. In mid-2012, MTS signed an agreement to return and agreed to pay 30 percent of net profits to Turkmen Telecom.[81]

- The estimated worth of Uzbek ICT market is over USD1 billion. It has seen mobile phone penetration of 90 percent. The international internet bandwidth increased from 10 Gbps in 2011 to 40 Gbps in 2012. Fiber optic has been laid down nationwide having a good rural coverage. The state owned Uzbek telecom accumulates monthly revenue of USD 442 through transit service provision. The country has 3 major mobile operators. In 2013 however, the MTS license was withdrawn, their assets were seized, and the top executives were sentenced.[82]
- Mobile penetration in Pakistan is at 73.2 percent with cellular coverage of 92 percent across the country.
  Broadband subscriber base increased by 30 percent growth in 2012 with more than 600,000 new subscribers have joined the broadband platform. However, broadband penetration remains low at 1.52 percent. The broadband service is approximately 7 percent of GDP per capita.[83]

Cross Regional Findings

The study shows that the telecommunication sector in Pakistan and Kazakhstan is relatively well developed. The remaining CARs have poor international connectivity and have restrictive telecom regimes, with the exception of Kyrgyzstan. Key cross regional finding are as follows:

1. Pakistan and Kazakhstan have moderate international telecom connectivity through optic fiber networks whereas the rest of the CARs have very weak connectivity. All CARs except Kazakhstan have international bandwidth below 1 percent per capita[84] which is considered a serious obstacle to development. The international bandwidth per capita is relatively higher for Kazakhstan and Pakistan.
2. IP transit[85] prices (cost for internet service providers to connect to the internet) in CARs are prohibitively high, with the exception of Kazakhstan. IP transit prices are declining around the world, falling below USD 1 per Mbps for high volume transactions in major markets,[86] however , the cost in all CARs except Kazakhstan are over USD 100 per Mbps per month; Uzbekistan's cost is USD 347 per mbps per month. This is very high as compared to developed countries such as Russia and USA where costs are below USD 5.[87]
3. Low international bandwidth and poor international infrastructure lead to higher consumer broadband prices.[88] Consequently, the overall broadband penetration remains very low. The annual mbps broadband subscription and installation cost is very high in the region except for Pakistan and Kazakhstan where it is reasonable due to better international connectivity and competitive market structure.
4. The telecom regime is liberalized and relatively competitive in Pakistan in comparison with CARs. In CARs the environment is moderately competitive in Kazakhstan and Kyrgyzstan, whereas in Turkmenistan and Uzbekistan there are major obstacles due to strong state influence.[89]
5. The fixed and mobile broad band infrastructure is very limited in Tajikistan and Turkmenistan while for Uzbekistan it is slightly better. In Pakistan and Kazakhstan the presence of such

[81] http://www.mtsgsm.com
[82] http://www.uztelecom.uz/en/
[83] PTA, Annual Report, 2013
[84] Terabit Consulting, 2013
[85] IP transit is connecting a smaller internet service provider with the larger internet
[86] TeleGeography
[87] Terabit Consulting, 2013
[88] Terabit Consulting, 2013
[89] World Bank- STRI

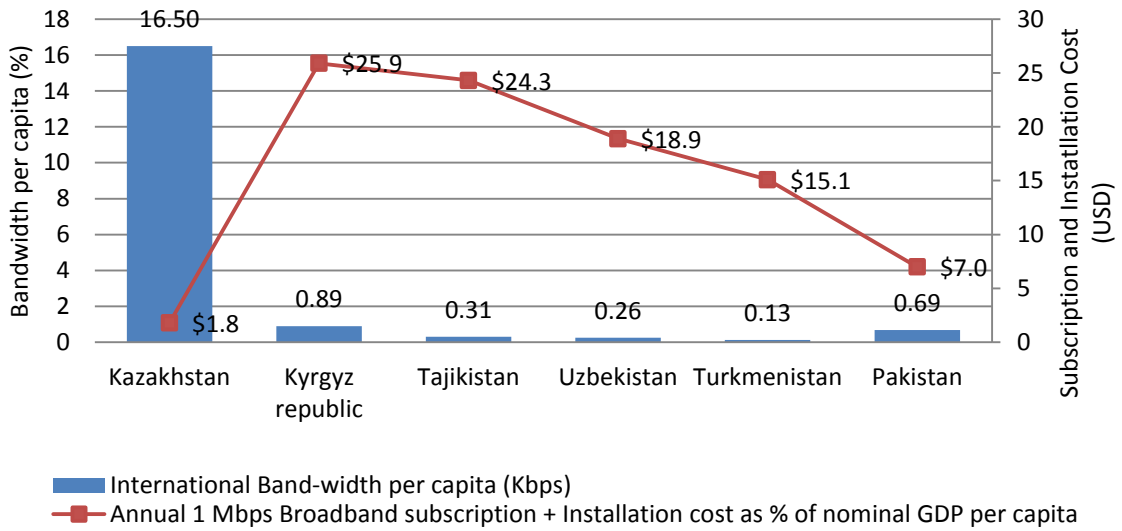
infrastructure is quite strong; broadband service provision is mainly via high speed services in urban centers.[90]

Table 13: Indicators of Telecom/Broad band infrastructure in CAREC Corridor 5 countries

Countries	Int'l band-width per capita (Kbps)	Int'l connectivity	IP transit Price	Competitive-ness of telecom market	Fixed and Mobile Broadband Infrastructure	Annual 1 Mbps Broadband subscription + Installation cost as % of GDP per capita
AFG	Not Available	Very weak	Very Expensive	Less competitive	Very Limited	Very Expensive
KAZ	16.5	Moderate	Reasonably Priced	Less competitive	Relatively strong	Reasonable
KYZ	0.893	weak	Very Expensive	Less competitive	Limited	Very Expensive
PAK	Not Available	Moderate	Reasonably Priced	competitive	Relatively Strong	Reasonable
TJK	0.313	weak	Very Expensive	Less competitive	Very Limited	Very Expensive
TUR	0.125	weak	Very expensive	Not competitive	Very Limited	Very Expensive
UZB	0.259	Weak	Very expensive	Less competitive	Limited	Very Expensive

Source: Terabit Consulting and PTA

Figure 21: Broadband Penetration and Cost in CARs and Pakistan, 2013



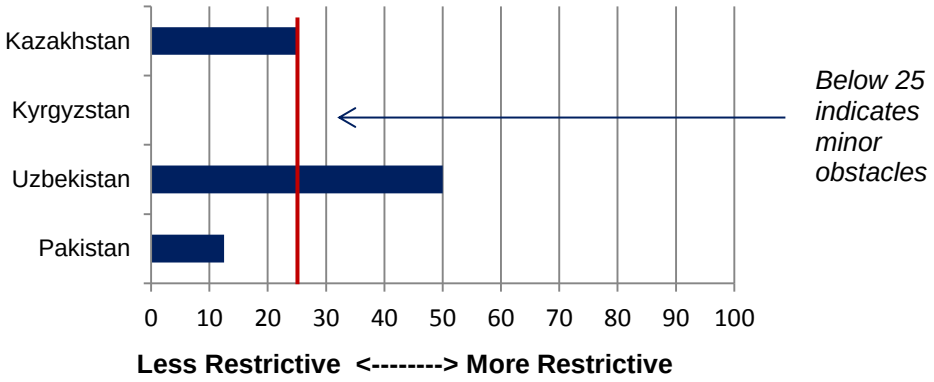
Source: Terabit Consulting and PTA

Regulatory Environment for Foreign Service Providers

Service Trade Restrictiveness Index reveals that Kyrgyzstan is the most liberal among corridor 5 countries and its policy regime is completely open for mobile and fixed–line telecommunications with minor quota restrictions on foreign employees. Pakistan's telecom regime is virtually open with no restrictions on foreign ownership while there are foreign ownership restrictions and government approval requirement for large investments in Kazakhstan. In Uzbekistan, the sector regulation is under state control with license allocation determined by the Cabinet of Ministers.

[90] ADSL, FTTx and WiMax

Figure 22: Service trade restrictiveness index - Telecom services, 2012



Source: World Bank

Table 14: Key restrictions on entry of foreign service providers - Telecom services

Mode 3	Pakistan	Kazakhstan	Kyrgyzstan	Uzbekistan
Fixed Line Communication	No limit on foreign ownership. The number of licenses is not fixed. The regulator is independent from the Ministry.	Limit on foreign ownership is 49 % if the supplier provides intercity and/or international telecom services, owning the infrastructure. 100 percent of voting shares may be held in a telecom entity that is not an operator. Gov approval required for Investment in excess of USD 150 million. Quotas for foreign employees	No restrictions except quota for foreign employees	A limit on licenses applies. The number of licenses and the method of allocation are determined by the Cabinet of Ministers. Employment of foreign nationals is subject to LMT and up to 20 percent of employees can be foreign nationals.
Mobile Communication	No limit on foreign ownership. Licenses allocated are subject to spectrum availability. IG: allowed only to operators; the license fee is USD 500,000 and a performance bond of USD 10 million, payable to the Government. Repayment of the bond is contingent upon the establishment of 14 points of presence in Pakistan by the licensee.	No Restrictions	-do-	Award of a license is subject to a decision by the Cabinet of Ministers and to the availability of radio spectrum. Employment of foreign nationals is subject to LMT and up to 20 percent of employees can be foreign nationals.

Source: World Bank

International Connectivity

International bandwidth and optic fiber connectivity in the region is suboptimal. With improved intra-regional connectivity, the CARs and Pakistan can not only improve telecom integration within the region, but will also address the lack of reliable and cost effective Europe to Asia bandwidth which is a pressing concern of the international bandwidth industry. The optical fiber cable holds the key for regional telecom connectivity. The situation presents an opportunity for Pakistan to become a regional telecom transit hub.

Pakistan has limited connectivity with CARs via Afghanistan. Pakistan can form a link with Uzbekistan and Tajikistan via Afghanistan, which established a link with the two countries in 2009. A link with

Turkmenistan is also being developed at Khushka in Afghanistan. Uzbekistan and Tajikistan are further interconnected with Kazakhstan and Kyrgyz Republic through the Trans Asia Europe (TAE) network.[91]

The fiber optic link between Afghanistan and Pakistan is underdeveloped. Pakistan's fiber optic network can be connected to Afghanistan's optic fiber cable ring at two points; one is via Khyber Pass route which would connect Islamabad to Kabul, and the second passes through Quetta and connects to the Afghan ring at Qandahar. It is also suggested that a terrestrial network be developed along rail and road infrastructure project under CAREC to integrate the corridor 5 countries. Estimates reveal that the additional cost of fiber network installation during such open road construction is less than 1 percent of project total.

A detailed analysis of regional connectivity between Pakistan and CARs follows:

Pakistan's International Telecom Connectivity

Due to its strategic location, Pakistan can become a key telecom transit point in the region. The Government of Pakistan plans to install an optic fiber cable as a part of the Kashgar to Gawadar trade corridor being established with China.[92] Pakistan can also establish fiber links through and for Central Asia, India, and Iran that will make it a communication hub and a key strategic player in the region.

Figure 23: Potential for Pakistan's fiber optic connectivity with neighbouring countries

Source: www.pta.gov.pk

Pakistan's connectivity to other countries mainly the Central Asia, Middle East, Africa and European region depends largely on two channels. The first are three submarine cables[93] that link Karachi to the outside world[94] and the second channel is Pakistan's connectivity to the Central Asian Region via Afghanistan. While the latter is relatively under developed, it carries a strategic importance. Connectivity to Central Asia has the potential to improve business opportunities and also act as redundant link (or based on requirements can even act simultaneously) alongside the submarine channels.[95]

[91] This TAE network project aims to provide fibre optic connectivity within 20 countries including China, Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan, Turkmenistan, Iran, Turkey, Ukraine, Belarus, Poland, Romania, Hungary, Austria, Germany, Georgia, Azerbaijan, Armenia, Afghanistan and Pakistan.
[92] www.pta.gov.pk
[93] Currently, three submarine links are functional which include SEAMEWE-3& SEAMEWE-4and Flag
[94] www.pta.gov.pk
[95] www.pta.gov.pk

Central Asian Republics' Regional Telecom Connectivity

The CARs are linked to each through Trans Asia Europe (TAE) fiber optic Network. Current status of connectivity among CARs is as follows:

Kyrgyz Republic is connected to Kazakhstan via TAE since the completion of its installation in 2000. The Kyrgyz telecom remains a major international transit provider as it provides links to Tajikistan and Uzbekistan. A new international fiber optic connection between southern Osh province of Kyrgyz Republic and Xingjian, China has been developed recently. This link intends to reduce reliance on Kazakhstan and Uzbekistan transit. An internet service provider named ELC is installing fiber optic to China, Kazakhstan, and Tajikistan. The Tajikistan-Kyrgyzstan (Isfara-Batken) cable was completed in 2009. Currently Kyrgyz Republic is not connected to Uzbekistan through the TAE network.[96]

Kazakhstan is connected with China, Kyrgyz Republic and Uzbekistan through TAE Link. Kazakhstan benefits from numerous trans-border fiber crossings within the region which include transit from Russia, Kyrgyzstan, China, Uzbekistan, and Tajikistan.

Tajikistan is connected with Uzbekistan via TAE. Tajikistan also provides transit capacity to Afghanistan through fiber optic cable that became operational in 2009. Recently, an agreement with China Telecom for Tajikistan-China cable also materialized. Tajikistan has also made progress in developing international telecom infrastructure since the Dushanbe satellite earth station started operation in 1994.

Uzbekistan has trans-border fiber optic connectivity with Kazakhstan, Turkmenistan, and Tajikistan via TAE. The Afghanistan-Uzbekistan cable used as part of Rostelecome's[97] "Europe Afghanistan" network was installed in 2009. Uzbekistan is doubly landlocked, making its continued reliance on trans-border links impractical and makes it dependent upon at least two transit operators. The cost of IP Transit has over the years reduced from USD 1,510 in 2010 to USD 347 in mid-2013.

Turkmenistan has major international connections via TAE with Iran. Most international transit to Turkmenistan is provided by Rostelecom, Turk Telecom, and Tata. The Trans Eurasian Information Superhighway (TASIM) links Turkmenistan across Caspian Sea to Azerbaijan. Presently the terrestrial link to Afghanistan at Kushka is also under consideration. Turkmenistan has seen restrained network development due a restrictive regulatory environment; internet service provider license revocations were revoked in 2010.

Our analysis shows the existing situation of Afghanistan's connectivity with its Central Asian neighbors including Tajikistan, Uzbekistan, and Turkmenistan. Since 2009, Tajikistan provides transit capacity to Afghanistan via fiber optic cable. The Afghan-Uzbekistan cable which is part of Rostelecom's Europe Afghanistan Network was also installed in 2009. From Turkmenistan, the terrestrial link to Afghanistan at Kushka is presently under consideration. Therefore, Afghanistan is currently connected to Tajikistan through a fiber optic cable and Uzbekistan through Europe Afghanistan network, while there seems to be no connectivity with Turkmenistan.[98]

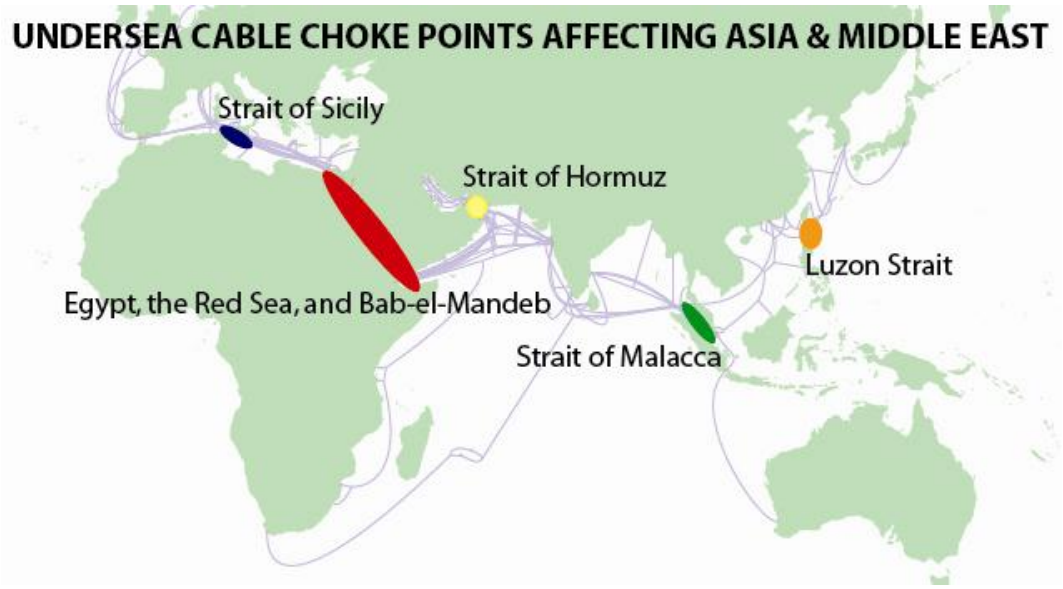
[96] Terabit Consulting, 2013
[97] One of the largest national telecommunications operators in Russia and Europe.
[98] Terabit Consulting, 2013

Barriers

This study identifies the following stumbling blocks towards the telecommunication integration among CAREC corridor 5 countries:

1. Pakistan and CARs rely on a submarine cable network to connect with other parts of the world. The submarine cable is considered both expensive and unreliable in comparison with terrestrial fiber optic network. While the terrestrial networks are accessible by highway and can be quickly repaired at low cost, faults in submarine networks take weeks to repair and incur heavy costs including ships running costs of USD 50,000 per day. Moreover, the long haul in submarine network is limited to 8 fiber pairs as the submerged electronics pose limitation. The submarine cable network also has a very high cost of installation as compared to terrestrial network; a 3-fiber pair cable costs USD 12,500 per km and marine services incur USD 20,000 to USD 40,000 per kilometre in comparison to terrestrial network cost of around USD 1250 per km with marginal fiber costing as low as USD 60 per kilometre. [99]
2. In terms of risk and reliability there seems to be no viable alternative to bottlenecks present at Egypt, the Red Sea and Bab-el-Mandeb, Strait of Sicily, Strait of Hormuz, Straits of Malacca, and Luzon Strait. With an increasing demand the global telecommunications industry is desperate for cost effective redundant links that would avoid these undersea bottlenecks. As a result, terrestrial networks are gaining more importance.
3. There is a lack regional regulatory harmonization in the region and regulatory policies in some countries are restrictive.
4. The IP transit and broadband subscription costs are high in CARs.

Figure 24: Undersea cable choke points



Source: Terabit Consulting, 2013

[99] Terabit Consulting, 2013

Recommendations

Through the analysis completed in this study several recommendations for increasing the telecom integration between CAREC corridor 5 countries emerge.

1. Coherent pan-Asian terrestrial fiber optic infrastructure needs to be developed that would benefit markets across corridor 5 countries and help address one of the international bandwidth industry's most pressing concerns, namely the lack of reliable, cost effective Europe to Asia bandwidth. For this purpose, regional cooperation is pivotal and there needs to be a forum where stakeholders can consult and harmonize telecom master plans with other countries. The CAREC organization can provide such platform and its intervention (by government or international organizations) is required to ensure the implementation of a pan Asian terrestrial fiber optic network between corridor 5 counties.
2. The proposed terrestrial fiber optic network shall aim to connect CAREC corridor 5 countries with the other regions and sub-regions. For example, capturing even a small portion of bandwidth demand between East Asia and Western Europe would increase the financial viability of such a project.
3. A fiber optic network shall be planned to be laid down simultaneously with the upcoming infrastructure highway projects in corridor 5 countries. Many of the countries in the region will be upgrading existing highway infrastructure and installing new links. Simultaneous installation of high capacity fiber and ducts would incur a negligible marginal cost in most projects making them economically viable. In the US (high labor cost market), conduit and fiber installation during open road construction costs between USD 6,000 and USD 18,000 per kilometer. The cost of fiber network installation during such open road construction is much less than 1percent of project total.
4. It is proposed that the regional cooperation shall be leveraged to pool in and utilize private-sector resources which are disparately insufficient. In order to cater for investment needs this study suggests certain option of Public Private Partnership for diverting investment in large telecom projects such terrestrial fiber optic long loop network.

Chapter 8 Patterns in Movement of Natural Persons (mode 4) in Pakistan and Central Asia

This section presents an overview of worker migration patterns in Central Asia and Pakistan and evaluates the potential for labor mobility (mode 4) based on remittance patterns and labor regulatory environments.

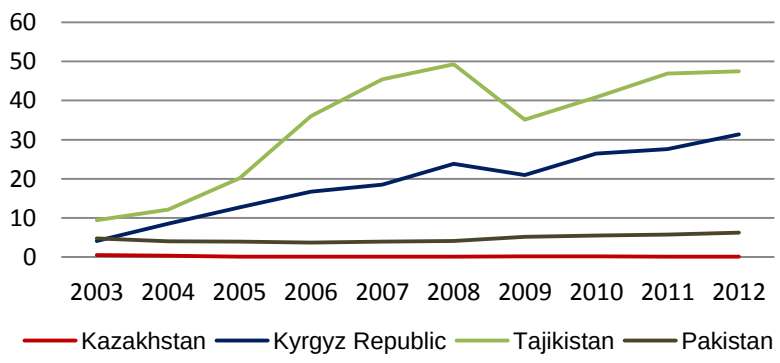
Labor mobility plays an important role for growing economies. Unskilled outward migration is an important source of remittances for developing countries. Ease of hiring skilled expatriates has been shown to spur FDI inflows; moreover, skilled expatriates contribute to the host economy's productivity, competitiveness, technology transfer, and GDP. The effect of skilled migration for sending economies is less beneficial due to possible brain drain. However, this effect may be offset by remittances and investments in the home country.

Patterns suggest a potential for unskilled migration from Pakistan to Kazakhstan especially in construction and oil and gas exploration related projects. In addition, skilled Pakistanis may seek jobs in textiles, agriculture, and Islamic banking sectors. However, language, taxes and restrictive work permit regimes may pose a barrier to effective labor mobility in the region.

Patterns of Labor Mobility and Remittances

The importance of mode 4 exports for Central Asia is reflected in the absolute size of remittances as well as their share in these economies. All countries with the exception of Kazakhstan recorded a consistent increase in remittances over the last decade; with remittances increasing at a CAGR of nearly 50 percent for Kyrgyz Republic and Tajikistan. With inward remittances at USD 14 billion in 2012, Pakistan is the largest recipient of remittances in absolute value.

Figure 25: Inward Remittance Flows (as % of GDP)



Source: World Bank

In Tajikistan remittances accounted for more than 47 percent of GDP in 2012. The poorest among the CARs, Tajikistan does not possess natural resources. The terrain is mostly mountainous, making agricultural production difficult as well. There is very little manufacturing base present in Tajikistan as well, requiring the country to import many of its basic necessities. Though World Bank data is not available for Turkmenistan and Uzbekistan, both countries contribute to the labor force in Russia through their migrants. Other destinations for workers from these countries are Kazakhstan and Europe.

In the Kyrgyz Republic the reliance on remittance has increased sharply from 4 to over 31 percent from 2003 to 2012. Kyrgyzstan is the third-most remittance-reliant country in the world after Tajikistan and Liberia. The ease of going to Russia, which allows entry to the nationals of CIS countries, along

with lack of opportunities at home, propel low skilled workers to migrate to Russia which has a great demand for cheap labor.

For Kazakhstan, the contribution of remittance to the GDP was less than 1 percent in 2012 although many Kazakh migrant workers go to Russia in search for work each year; over 2.6 million individuals left Kazakhstan for Russia to seek employment in 2010 alone. Kazakhstan's investments in its oil and gas sector, minerals extraction, and agricultural sector suggests a broad-based economy that is not overly reliant on remittances of migrant labor.

On the contrary, Kazakhstan's economic growth in recent years has created a great demand for cheap labor. In 2008, a study of 61 economies, the Global Migration Barometer ranked Kazakhstan's "Need for Migrants" at 49. The same study ranked Kazakhstan favorably for accessibility and attractiveness for migrants. Kazakhstan both sends and receives a large number of migrant workers to and from Russia. Foreign workers in Kazakhstan remitted USD 570 million to Germany in 2010. Ethnic Germans have been employed in the oil fields of Kazakhstan in the Soviet era.

Contribution from remittances to Pakistan's GDP was 6.22 percent for 2012. The remittances have grown at 15 percent per annum over the last decade. The main destination markets for Pakistan's migrants are the Gulf countries and the English-speaking OECD countries, namely Canada, the United Kingdom and the US. While Pakistani migrants to the west are largely skilled, the trend is opposite for Gulf countries; the bulk of unskilled migrant labor goes to the oil-rich Gulf States to work primarily on infrastructure projects; around 90 percent of Pakistani temporary contractual workers to these countries are engaged in semi- and low-skilled jobs. The Middle East destination is an attractive destination for Pakistani workers as there is no income tax, allowing for higher remittances.

Barriers

Employing Skilled Expatriates (ESE) index ranks 93 economies including Kazakhstan, Kyrgyz Republic, and Pakistan according to their skilled workers immigration regime.

Table 15: Employing Skilled Expatriates index, 2013

	Kazakhstan	Kyrgyz Republic	Pakistan
Average number of calendar weeks to get work permit	10	9	6
Are quotas applicable?	Yes	Yes	No
Is there a path to citizenship?	Yes	Yes	Yes
Is there a Spousal Work Permit available?	No	No	No
Does the current skilled migration regime represent a minor, moderate or major obstacle?	Moderate	Minor	Minor
Source: Employing Skilled Expatriates: Benchmarking skilled immigration regimes across economies			

The ESE Index rates the skilled immigration regime of Kazakhstan to be a moderate obstacle while Pakistan and Kyrgyzstan's immigration regimes are rated as relatively liberal. Pakistan is not a quota economy hence there is no limit on the number of foreigners that can be issued work permits. To facilitate the process, Pakistan has established one-stop-shops for the issuance of temporary work permits, and the process takes 6 weeks on average.

Key barriers to employment of foreign workers in each country are as follows:

Kazakhstan

- Kazakhstan has a quota on work permits and employment permits issued in any given year.
- In Kazakhstan only 30 percent of the workforce in any enterprise can be foreign.
- The employer must prove that the foreign worker will not be taking a job from a local worker.

Kyrgyzstan

- In order to employ foreign workers, the employer must first obtain a permit to hire foreign workers. Once the permit has been issued, work permits for employees can be procured.
- There are quotas on the number of foreign workers and work permits are valid for one year.
- Foreign nationals must also obtain a visa in addition to the work permit.
- The main problems are delays in obtaining permits and a lack of coordination between durations of visas and work permits. Employers must also demonstrate the need for a foreign worker.

Tajikistan

- The work permit is issued for the duration of one year and work visa can be renewed on its basis. Tajikistan is also a quota economy. Citizens of CIS countries are given a priority.
- Foreigners may be employed by obtaining both work permits and work visas. The process of obtaining a work visa is complicated and time intensive.
- Local content rules mandate that foreigners can at most make 30 percent of workforce in any company.

Uzbekistan

- Foreign workers need to have valid visas and must register with the Ministry of Labor.
- For employer, labor costs are particularly high as payroll taxes are highest in the region.
- In order to hire foreign employees, a company must first obtain a license from the Agency on Foreign Labor Migration and then obtain work permits for each foreign employee. The process is significantly costly; with a work permit being subject to a state duty of approximately USD 421.
- Quotas are placed on the number of foreign workers and employers must demonstrate that the job could not be performed by an Uzbek national.

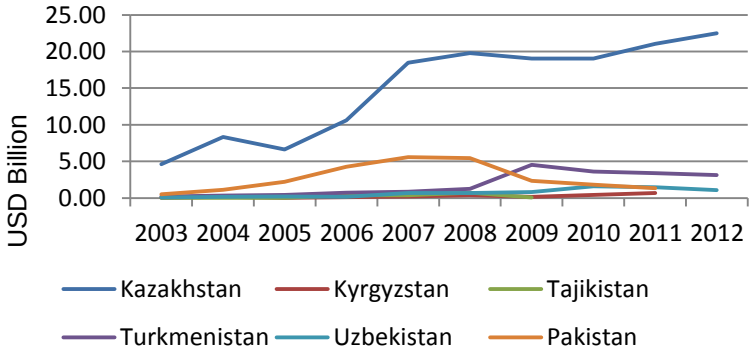
Pakistan

- No limit on the number of foreigners that can be issued work permits.
- Pakistan has established one-stop-shops for the issuance of temporary work permits.
- Process takes 6 weeks on average.
- Nationals of Azerbaijan, Kyrgyzstan, Tajikistan, and Uzbekistan are prohibited to be members of the Board of Directors in Pakistan.

Chapter 9 Patterns in Investment

FDI holds special significance for developing countries. Not only does FDI add to investible resources and capital formation, but it is also a means of transferring production technology, skills, and organizational and managerial practices as well as accessing international marketing networks. Patterns in FDI in the services sector (mode 3) in CARs and Pakistan are as follows:

Figure 26: Total FDI Inflows CARs and Pakistan



Source: Investment Map, 2012

1. *Among CARs, Kazakhstan and Turkmenistan attract the largest foreign investment*.
   Kazakhstan and Turkmenistan have a rich oil and gas resource base and have succeeded in attracting FDI despite being landlocked. The remaining CARs received less than or close to USD 2 billion with Tajikistan attracting only USD 77 million in 2009.

2. *The services sector is a significant recipient of FDI in Central Asia and Pakistan*
   The FDI in Kazakhstan's services sector is particularly significant and accounted for approximately 74 percent of the total investment at USD 16.7 billion in 2012. Major investment is in architectural, engineering, and other technical activities relating to mining and energy sectors. Kazakhstan also attracts significant amount of FDI in communications, finance, and retail trade sector.

   In Pakistan over the last decade, the services sector received the most FDI as result of extensive reforms in financial and telecommunication sectors. In 2008 about 77 percent of the total FDI was in the services sector. The international financial crises resulted in a significant contraction of FDI in the services sector which plummeted from USD 4 billion in 2008 to less than USD 1 billion in 2009.

3. *Kazakhstan is the only country among CARs and Pakistan with a significant outward investment.* More than 70 percent of Kazakhstan's outward FDI is in services sector with major investments in legal, accounting, and business and management activities.

Policy Recommendations

To form global value chains transnational corporations source inputs from the most competitive suppliers around the world. High transport costs impede formation of trade linkages and discourage transnational corporations seeking to use landlocked countries as export platforms. This factor inhibits the attractiveness of land locked countries for FDI that is part of global production networks. Nonetheless, by adopting policies aimed at strengthening regional economic integration and ICT infrastructure, CARs can offset some of the adverse effects of geography. Some policy recommendations are as follows:

- The services sector, in particular ICT enabled services, is not distance sensitive and therefore greater efforts should be directed towards attracting FDI in this sector.

- Economic integration with neighboring countries can also increase the attractiveness of landlocked countries for FDI. Some landlocked countries in the region have a narrow resource base and a small domestic market. In the absence of critical size they suffer from diseconomies of scale. By being more economically integrated CARs can become attractive offshore production locations for transnational corporations to serve large neighborhoods.
- FDI in transport and energy sectors should be encouraged to transform the region into a transport and energy corridor.

Figure 28: Inward FDI - Kazakhstan and Pakistan

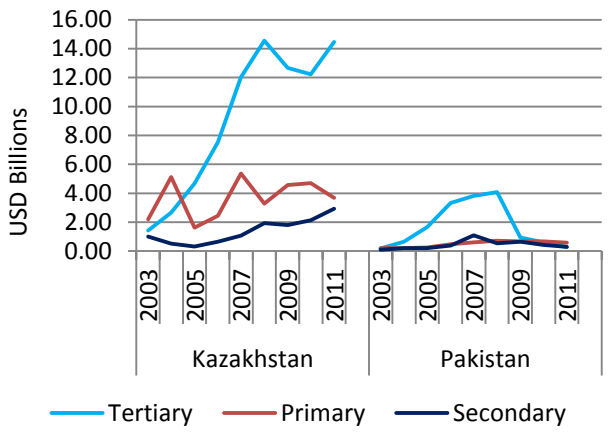
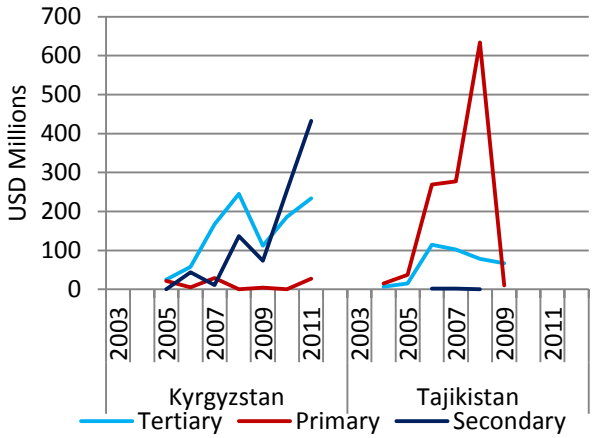


Figure 27: Inward FDI - Kyrgyzstan and Tajikistan



Source: Investment Map, 2012

Chapter 10 Conclusion

Services have emerged as a powerful engine for improving trade and are a critical instrument in forming GVCs. Trade in services demonstrated relatively more resilience than goods trade in recent global financial crises in terms of lower magnitude of decline, and earlier recovery from the crises.[100] Such resilience has led many countries to incorporate services trade into their post-crisis national trade and growth strategies. However, positively integrating developing countries and in particular landlocked developing countries in global and regional services trade remains a major development challenge.

In Central Asia there is no regional trade agreement on trade in services and only Kyrgyzstan is a member of the GATs.[101] Total services trade of this region and Pakistan constitutes less than half a percent of global services trade.

To enhance trade in services and transform the region into a trade and energy corridor, the governments of Central Asia, Afghanistan, and Pakistan may consider negotiating a framework for trade liberalization in services. This would allow the landlocked Central Asian economies with small domestic markets to effectively integrate and form larger economic regions, and also get shorter access to sea ports via Pakistan. Such an initiative may be backed by adequate service sector reforms and regulatory, institutional, infrastructural, and human resource capacity at the individual country level. Visa procedures may be simplified to facilitate the cross country mobility of persons for service delivery and consumption. The governments may identify selected bilateral and sub-regional projects to develop fiber optic, road and rail transport links, and arrange for joint investment in these projects to facilitate connectivity. The private sector may also provide an impetus by highlighting the opportunities and benefits of cooperation and costs of non-cooperation. The private sector can also expedite the process by building regional production networks and supply chains and lobbying for removal of regulatory barriers.

Recently there have been some important services driven initiatives for regional integration. CAREC program has made investments in the transport and energy services sectors to improve regional connectivity. China has committed huge resources for revival of the Silk Route; in Pakistan, work is underway for a North-South trade corridor which will also provide the CARs with shorter access to seaports and consequently, global trade. The formation of CASA 1000 will address the energy shortages in South Asia and also help support the economies of these two poorest countries in the Central Asia region, namely Tajikistan and Kyrgyzstan. TAPI will enable Turkmenistan diversify its gas exports and find access to new water ways via Pakistan's ports. A regional agreement on trade in services, with a focus on backbone services, will further enhance such efforts and pave the way for effective economic integration in the region.

[100] Borchert, I., & Mattoo, A., 2009. *The crisis resilience of services trade*. Policy Research Working Paper No. 4917, the World Bank.
[101] Tajikistan has an observer status in GATS

Appendix

The classification of services used in the study is based on IMF Balance of Payments Manual 5 (BPM 5)

Services	Code
1. Transportation	205
1.1 Sea transport	206
1.1.1 Passenger	207
1.1.2 Freight	208
1.1.3 Other	209
1.2 Air transport	210
1.2.1 Passenger	211
1.2.2 Freight	212
1.2.3 Other	213
1.3 Other transport	214
1.3.1 Passenger	215
1.3.2 Freight	216
1.3.3 Other	217
Extended classification of other transport (1.3)	
*1.4 Space transport	218
*1.5 Rail transport	219
*1.5.1 Passenger	220
*1.5.2 Freight	221
*1.5.3 Supporting, auxiliary, and other services	222
*1.6 Road transport	223
*1.6.1 Passenger	224
*1.6.2 Freight	225
*1.6.3 Supporting, auxiliary, and other services	226
*1.7 Inland waterway transport	227
*1.7.1 Passenger	228
*1.7.2 Freight	229
*1.7.3 Supporting, auxiliary, and other services	230
*1.8 Pipeline transport	231
*1.9 Other supporting and auxiliary transport services	232
2. Travel	236
2.1 Business	237
*2.1.1 Expenditure by seasonal and border workers	238
*2.1.2 Other	239
2.2 Personal	240
†*2.2.1 Health-related expenditure	241
†*2.2.2 Education-related expenditure	242
†*2.2.3 Other	243
3. Communications services	245
*3.1 Postal and courier services	246
*3.2 Telecommunication services	247
4. Construction services	249

*4.1 Construction abroad	250
*4.2 Construction in the compiling economy	251
5. Insurance services	253
*5.1 Life insurance and pension funding	254
*5.2 Freight insurance	255
*5.3 Other direct insurance	256
*5.4 Reinsurance	257
*5.5 Auxiliary services	258
6. Financial services	260
7. Computer and information services	262
*7.1 Computer services	263
*7.2 Information services	264
8. Royalties and license fees	266
9. Other business services	268
9.1 Merchanting and other trade-related services	269
*9.1.1 Merchanting	270
*9.1.2 Other	271
9.2 Operational leasing services	272
9.3 Miscellaneous business, professional, and technical services	273
†*9.3.1 Legal, accounting, management consulting, and public relations	274
*9.3.1.1 Legal services	275
*9.3.1.2 Accounting, auditing, book-keeping and tax consulting services	276
*9.3.1.3 Business and management consultancy and public relations services	277
†*9.3.2 Advertising, market research, and public opinion polling	278
†*9.3.3 Research and development	279
†*9.3.4 Architectural, engineering, and other technical	280
†*9.3.5 Agricultural, mining, and on-site processing	281
*9.3.5.1 Waste treatment and depollution	282
*9.3.5.2 Other	283
†*9.3.6 Other	284
*9.3.7 Services between affiliated enterprises, n.i.e.	285
10. Personal, cultural, and recreational services	287
10.1 Audio-visual and related services	288
10.2 Other personal, cultural, and recreational services	289
11. Government services, n.i.e.	291
*11.1 Embassies and consulates	292
*11.2 Military units and agencies	293
*11.3 Other	294