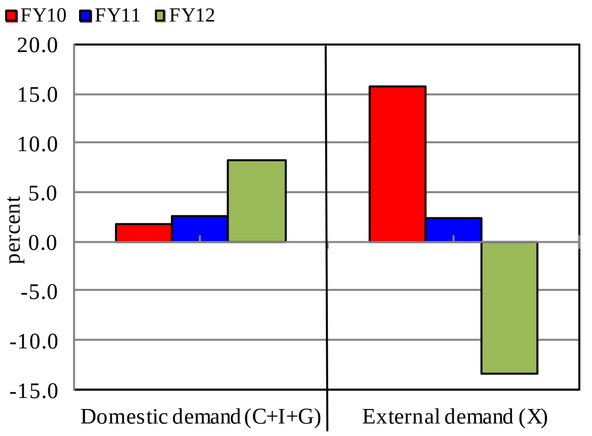
4 Aggregate Demand

4.1 Overview

Aggregate demand showed a moderate increase of 3.7 percent during FY12. The domestic market was responsible for the increase, as external demand faltered substantially during the year (**Figure 4.1**).[1] Factors including higher remittance inflows (so far immune to the global crisis), a vibrant informal economy, and a surge in fiscal spending, appear to have underpinned domestic demand.

Figure 4.1: Growth in Aggregate Demand

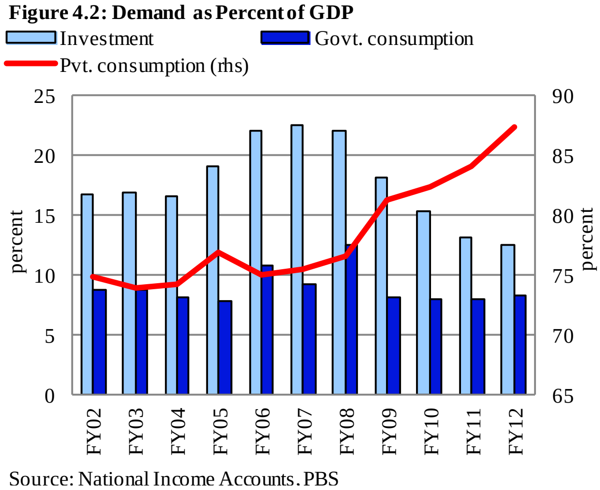


Source: National Income Accounts, PBS.
Domestic demand includes consumption (both public and private) and investments. External demand is gross export of goods and services.

Indeed, given the bearish outlook of the global economy, domestic demand is indispensible for Pakistan's economic growth. However, the current demand structure is not conducive for sustaining the growth momentum: while consumption – especially private consumption – continues to remain strong, investments fell for the fourth consecutive year. The investment-to-GDP ratio has reached a low of 12.5 percent (**Figure 4.2**). Behind this trend were investor apprehensions regarding the current state of law and order, and the issue of energy availability (see **Section 4.2.2** for details).

In our opinion, this composition of domestic demand was also an outcome of the government's fiscal strategy over the previous few years: while public investment has declined since FY09, pro-consumption fiscal measures have increased that include higher spending on untargeted subsidies, income support programs, increase in pensions and public salaries, and duty cuts on consumer items (see **Chapter 6**). In addition, we also know that worker remittances are typically channeled into household consumption and construction.[2]

Figure 4.2: Demand as Percent of GDP



Source: National Income Accounts. PBS

[1] We consider continuous weakening in the global economy and domestic competitiveness issues as the major reasons for the decline in external demand for our goods and services. Here, it is important to mention that the exports, shown in the national income accounts, also reflect some impact of supply-side constraints (including energy shortages).

[2] For example, Nishat and Bilgrami (1991). This study has concluded that in Pakistan, remittances have the largest impact on consumption, and smallest on private investment. (Complete citation: 'The Impact of Migrant Workers' Remittances on Pakistan Economy', Mohammed Nishat and Nighat Bilgrami, Pakistan Economic and Social Review , Vol. 29, No. 1 (Summer 1991), pp. 21-41). Similarly, using the data for 84 countries for the period 1970-2004, the IMF Working Paper No. WP/09/153 'Do Workers' Remittances Promote Economic Growth?' (2009) by Adolfo Barajas, Ralph Chami, Connel Fullenkamp, Michael Grapen and Peter Montiel has concluded that the remittances are not intended to serve as investments, but rather as social insurance to help family members finance the purchase of life's necessities. Therefore, although remittances lift people out of poverty, but they do not typically turn their recipients into entrepreneurs.

4.2 Consumption

Real consumption grew by 11.1 percent during FY12, compared to 3.9 percent a year earlier.[3] Although sales data is not available for most consumer items, there are indications of buoyancy in consumer spending:[4] for example, revival in construction and ancillary industries; higher production and import of consumer goods (**Table 4.1**); increase in sales tax collection by 15 percent despite a 100 bps reduction in tax rate;[5] strong public interest in retail exhibitions; new shopping malls and growing sales volumes; restaurants; increase in overseas travelling; and leading global brands opening their outlets in the country. Furthermore, the impressive performance of fast moving consumer goods (FMCGs) also supports this trend.[6]

Table 4.1: Import of Selected Consumer Durable Goods

import quantity in units given; growth rate (of import quantity) in percent; import value in million US$

	Units	Import quantity				Growth rate	Import value
Items		**FY09**	**FY10**	**FY11**	**FY12**	***FY12 over FY11***	**FY12**
Grinders/mixers/juicers	No.	605,326	782,332	397,089	439,481	10.7	6.5
Ovens/grillers/roasters	No.	7,436	10,681	16,994	23,234	36.7	0.5
Coffee/tea makers	No.	42,246	31,871	53,369	56,621	6.1	0.8
Complete dinner sets	dozens	92,946	2,872,98	440,873	577,598	31.0	8.3
Plates/dishes/teacups	dozens	234,112	173,080	226,938	330,099	45.5	1.4
Other table/kitchenware	No.	44,310	69,085	138,585	191,067	37.9	2.8
Electric iron	No.	177,850	294,780	282,081	290,377	2.9	1.1
Laptop	No.	40,385	83,462	82,565	282,559	242.2	72.1
LCDs	No.	11,480	6,294	1,912	4,934	158.1	1.3
Cellular phones	million nos.	3.8	11.0	12.3	29.2	137.0	688.4
Earphones	million nos.	1.0	0.9	1.3	2.2	77.6	5.6
Footwear	million pairs	11.8	13.2	21.6	23.0	6.8	77.6
Worn clothing	million kg	263.4	252.9	353.8	403.1	13.9	148.0
Handbags	No.	550,983	590,305	1,245,948	1,519,344	21.9	5.4
Remote controls	million nos.	2.0	4.8	8.8	11.3	28.2	4.5
Digital cameras and recorders	No.	17,296	27,385	28,072	36,903	31.5	1.0
Air-conditioners	No.	74,952	56,885	38,474	58,042	50.9	15.4
Refrigerators	No.	20,390	23,832	14,571	26,172	79.6	7.3
Electric fans	No.	283,701	526,378	607,193	715,185	17.8	8.6
Ceramic tiles and bricks	million kg	17.8	13.1	5.3	10.4	96.1	16.9
Sanitary fixtures	No.	260,605	251,983	274,618	336,373	22.5	3.4
Energy saving bulbs	million gram	1.4	1.8	1.1	4.7	316.5	72.7
Rubber tyres and tubes	million nos.	4.0	3.7	5.4	6.0	12.0	229.5

Source: Pakistan Bureau of Statistics

Within a high-inflation-low-growth environment, floods in last 2 years, and sluggish employment conditions in the country, the trend in consumer spending appears anomalous.[7] In our view, it was the income generated mainly from *outside* the domestic formal economy, i.e., remittances and the

[3] Consumption is calculated by Pakistan Bureau of Statistics as a residual in the national accounts identity: $C = Y - I - NX$; where C is consumption, Y is GDP, I is investment and NX is net exports. Conceptually, this method allows errors in the measurement of GDP, or other components, to creep into the consumption estimates.

[4] Sales data is available only for domestically produced cars and cement, which shows a growth of 18 percent and 8.8 percent in FY12, respectively. Although POL sales information is also available, but it is not meaningful given the prevailing gas shortages, and forced substitution of petrol/furnace oil over gas.

[5] This includes sales tax collected only on domestic goods.

[6] The net profits of FMCGs listed on the Karachi Stock Exchange grew by over 20 percent in FY12. Here it is important to mention that the FMCGs' bottom-line has been growing this rapidly since last 5 years, and the sector has outperformed the KSE-100 index with a wider margin.

[7] This was unlike the consumption boom in 2003-08, when the economy was on a high growth trajectory and the inflationary pressures were low. This boom was driven mainly by monetary activism that led to an unprecedented growth in private credit, especially to the consumer sector.

informal sector, which has helped support economic growth.[8] At the same time, we also believe that fiscal measures to support household incomes and expenditures over the previous years, proved effective.

We consider remittance growth as the prime stimulant for consumer spending in the country. This additional income has lifted household demand for various necessities and luxuries, and has also triggered private construction activity. In this context, it is not surprising to see a number of residential projects initiated across the country for overseas Pakistanis alone. In fact, Pakistan is not the only country where consumption growth is associated with inward remittance flows, there is sufficient empirical evidence that in most developing economies, remittance income is used for consumption and financing real estate activities.[9]

Similarly, we believe that a vibrant parallel economy is also seeping into consumption demand in the formal sector. Findings of the Household Integrated Economic Survey (HIES) 2011, show that the incomes derived from business activities (including services industry in the informal sector) posted the highest real increase amongst all the income sources during FY08-11 (**Box 4.1**).[10]

In addition to these factors, fiscal spending has also buoyed consumer sentiments: (i) subsidized energy and food has contained household expenditures on these items, which has encouraged other spending; (ii) cut in federal excise duty on electronics, and elimination of special excise duty on automobiles, have propped-up sales; and (iii) increased government spending on pensions, income support programs (e.g., Benazir Income Support Program) and other transfers, have shored up household incomes and consumption.

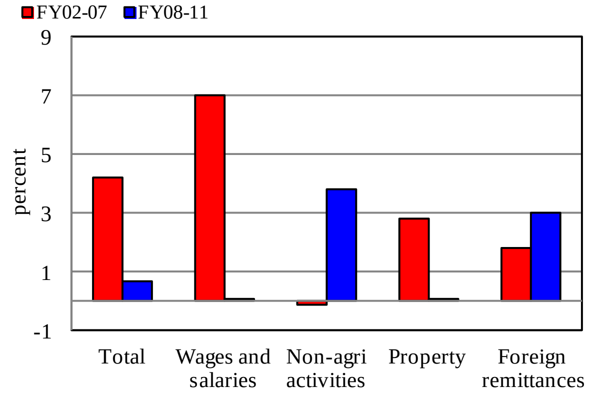
Box 4.1: Key Insights from the Household Integrated Economic Survey 2008 and 2011

HIES data provides useful insights about real consumption patterns of urban households, especially regarding the disparity in consumption trends across various income groups during FY08-FY11.[11]

At first, the survey results show that the increase in real incomes and real consumption of households was smaller in FY08-11, compared with FY02-07.

During FY02-07, household sector had enjoyed significant increase in wages and salaries, as well as house rents. In contrast, the highest increase during FY08-11 was seen in incomes derived from business activities (including, services and small-scale manufacturing in the informal sector), which have risen by 4 percent annually in real terms (**Figure 4.1.1**).[12] Given their record increase in recent years, foreign remittances are a close second. Real incomes from other sources have remained, more or less, unchanged during this period.

Figure 4.1.1: Change in Real Incomes of Urban Households by Source (CAGR)



Source: HIES, Pakistan Bureau of Statistics

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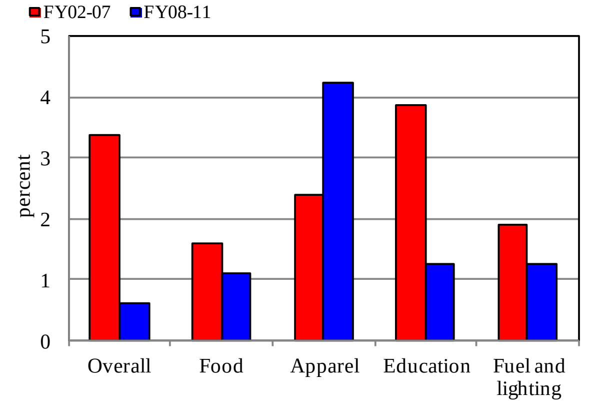
[8] We believe that the informal economy in Pakistan is growing much faster than the formal economy. Therefore, GDP growth understates the actual economic growth in the country.
[9] See for example, IMF Working Paper No. WP/03/189 'Are Immigrant Remittance Flows a Source of Capital for Development' (2003) by Ralph Chami, Connel Fullenkamp and Samir Jahjah.
[10] HIES survey is conducted after every four years. Therefore, survey results for 2007 and 2011 are compared.
[11] Real consumption is calculated after adjusting for change in prices using changes in the CPI. Since the CPI (like other available price indices) is a survey of prices in urban centers, and, due to the prevalence of barter trade and sustenance farming in the rural sector, there is no appropriate price benchmark for calculating real incomes and consumption in the rural or aggregate economy.
[12] This is classified as "other non-agri activities" in the survey.

It is important to mention here that the increase in real incomes and consumption of urban households is concentrated only in the upper-class and upper-middle class (i.e., the top 40 percent of households by income). Other income groups have actually witnessed a fall in both their real incomes, and in their real consumption.

Household consumption patterns are even more revealing. As **Figure 4.1.2** illustrates, the urban population is spending *more* on food and clothes in real terms than it was four years ago. Interestingly, food's share in household consumption basket is not just the largest, but has also increased from 44.2 percent in FY08 to 48.9 percent in FY11. Anecdotal evidence also suggests an increase in demand for processed food, dairy products and beverages; in fact, investors have been positioning themselves to take advantage of this opportunity.[13]

Figure 4.1.2: Change in Real Consumption of Urban Households for Selected Commodity Groups (CAGR)



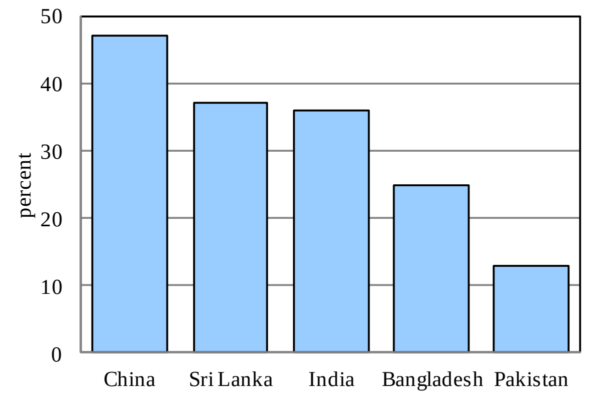
Source: HIES, Pakistan Bureau of Statistics

Compared to FY02-FY07, a period often associated with the consumption boom, spending on apparel in real terms has actually been rising faster in FY08-11. SBP's 3rd Quarterly Report for 2010-11 elaborated on the paradigm shift in domestic textile and textile-related industries, towards branding and designing, which is supported by mass-media campaigns and changing consumer preferences. Almost all the income groups have increased their expenditures on apparel; however, once again, it has been the upper and upper-middle income brackets that have led this increase.

4.3 Investment

Investments continued to taper for the fourth consecutive year after the crisis of 2008. In FY12, the investment-to-GDP ratio reached 12.5 percent, which is the lowest amongst major Asian countries (**Figure 4.3**). Presently, both domestic as well as foreign investment is weak due to an unfavorable investment climate, characterized by idle capacities; security concerns; energy shortages; low public investments; unfocused trade policies; and governance issues (**Figure 4.4**).

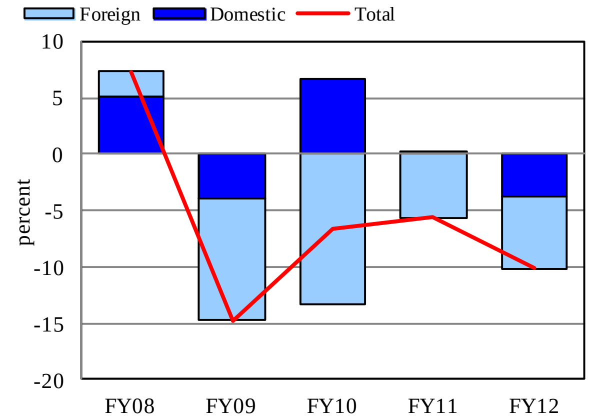
Figure 4.3: Investment-to-GDP Ratio in Regional Countries (2011)



Source: World Bank databank.

FY12 was also the fourth consecutive year that saw a decline in FDI. Here it is important to mention that FDI has bounced back in a number of emerging and transition economies to surpass the pre-crisis average;[14] but in Pakistan, it is still waning (see **Chapter 8**).

Figure 4.4: Composition of Investment Growth



Source: Pakistan Bureau of Statistics, SBP

Low capacity utilization

During FY12, most large-scale manufacturing units utilized less than 50 percent of capacity (**Table 4.2**). Energy constraints and law and order conditions, are the most frequently cited factors in explaining this trend, especially in fertilizer, steel and glass. However, there are other explanations as well.

[13] The increase in fixed investment loans for animal farming and feeding, grains milling products, processing of food & vegetables, manufacturing of beverage, and dairy products, etc., during FY12, supports this view.
[14] 3-year average level for 2005-2007. Source: UNCTAD World Investment Report 2012.

In our view, the macroeconomic environment has become challenging for the investors. We must recall that investments in Pakistan peaked in FY07, when the macroeconomic environment was easier: interest rates were lower; energy prices were stable as demand-supply gap was benign; and the global economy was booming. However, just a year later, the situation changed significantly. The global economy entered a recession, and Pakistan (which was facing large macroeconomic imbalances) had to adopt demand compression policies that necessitated an increase in interest rates and partial withdrawal of energy subsidies. From our discussion with key manufacturing sectors, a number of newly established businesses became unfeasible within 2 years – most business projections were off-target due to the global recession, and a substantial increase in domestic fuel and financial costs. Cement manufacturers had increased capacities, expecting a continuation in the real estate boom in the GCC. The outcome was different than expected.

Business uncertainties

In addition to the challenging macroeconomic environment, investors are also mindful of changes in the sector-specific policies (e.g., fertilizer and CNG) and about the direction of Pakistan's trade policies. In terms of the latter, many investors remain skeptical about the current drive for trade liberalization with India, and are reluctant to take any firm position. Furthermore, certain business groups are apprehensive that they may be priced out of the market by Indian products, especially those who are enjoying a near-captive market. In addition, there is a possibility that Pakistan will get the generalized system of preference-plus (GSP+) from the European Union.[15] If this happens, Pakistani firms will be able to export at zero duty to the EU, which can boost investment in the exporting sectors.

Table 4.2: Capacity Utilization in Selected Industries

percent

Industry	weight	FY10	FY11	FY12	Industry	weight	FY10	FY11	FY12
Sugar	5.0	46.1	36.3	40.4	Fertilizer	6.3	99.7	93.6	72.5
Cigarettes	3.0	67.9	68.0	64.4	Bicycles	0.1	63.9	48.5	37.4
Vegetable oil & ghee*	4.8	31.1	31.7	32.6	Diesel engine	0.1	85.0	37.3	11.9
Wheat milling	1.4	16.6	18.1	18.9	Caustic soda	0.6	41.9	39.5	40.8
POL	7.7	74.6	73.9	69.6	Soda ash	0.2	80.6	74.4	72.3
Coke	0.1	35.3	31.1	19.9	Refrigerator	0.3	35.6	33.2	35.4
Cars & jeeps	4.0	44.7	49.0	56.3	Deep freezer	0.2	24.4	10.9	7.0
LCVs	0.5	38.9	47.9	52.3	Air conditioner	0.1	34.6	25.5	24.0
Trucks and buses	0.2	16.2	13.2	12.7	TV	0.2	13.7	17.6	10.8
Tractors	0.7	95.6	94.5	64.2	Paper & products	3.3	47.5	48.6	57.6
2-3/wheelers	0.9	76.8	55.8	56.1	Chip board	0.8	5.1	4.3	5.2
Pig iron	2.3	39.3	35.2	20.3	Glass sheet	0.1	23.3	18.8	19.9
Billets/ingots	2.2	39.1	38.2	37.9	Cement	7.5	69.6	69.6	66.6
Re-rolled products	3.2	55.6	47.0	36.3					

Sources: Economic Survey, Punjab Bureau of Statistics, PSMA, PVMA, PEMA, OCAC, NFDC, and APCMA (please see list of abbreviations at the end of the report).

[15] GSP is a facility given by the developed countries under which, imports from developing countries are allowed at lower duties. In addition to this, there is a facility called 'Everything but Arms' (EBA) only for least developed countries (LDC), which allows LDCs to export their products to the EU duty-free and quota-free. The objective of this facility is to support LDCs to increase exports and promote growth. Being a developing country, Pakistan is presently not eligible to avail benefits under the EBA. Therefore, LDCs (e.g., Bangladesh and Cambodia) get a competitive edge in the EU market over other countries. However, effective from 1st January 2014, EU is introducing a revised GSP plus scheme, under which, some developing countries will be eligible to export to EU duty-free and quota-free, depending upon whether they fulfill 'vulnerability criterion'. Pakistan is most likely to get through. For details, see 'GSP and EPAs key issues' by Isabelle and Ramdoo, European Center for Development Policy Management; and also visit European Commission website.

Low public investments
Sluggish public sector investment also explains the low investment rate in the country. As discussed earlier, the government is spending more on current expenditures than investment. Instead of crowding-in private investment, the government appears to be crowding-out private investment, as it borrowed excessively from commercial banks to finance its fiscal deficit (for details, see **Chapter 5**).

Governance indicators
Among other factors, Pakistan's inability to attract FDI can also be traced to governance issues in the country. The World Bank's *Governance Indicators* show that Pakistan has not performed well compared to regional peers including India, Sri Lanka and Indonesia. For instance, in terms of 'political stability/absence of violence' indicator, Pakistan has not fared well. In our view, Pakistan's poor global image could be one of the reasons that the country has not been able to share the rising FDI into our peer countries.

Sector-wise investment
The decline in investment has been broad-based, and is evident in almost all the sectors. For instance, investment in the agriculture sector declined by 7.6 percent in FY12, compared to slightly positive growth in FY11. This is despite the growth potential in areas such as corporate farming, dairy products, storage, food processing, supply chain, etc.

International investors and local business groups have shown keen interest in investing, and exploiting the potential in our agriculture sector. The increase in fixed investment loans for a number of agro-based industries, also substantiates this observation. Specifically, fixed investment loans (for these activities) jumped from Rs 3.1 billion in FY11 to Rs 10.5 billion in FY12. Supportive public policies for necessary infrastructure in rural areas, would go further in attracting private investors.

Within industrial groups, only the construction sector displayed positive investment (12.3 percent) growth in FY12, primarily on the back of developmental work in the public sector and worker remittances. Other sectors, including large-scale manufacturing, mining & quarrying, and electricity & gas distribution, experienced a decline in investments in FY12. In fact, real investment in the industrial sector has been declining for the last five years, and, as a result, the investment-to-GDP ratio in this sector has come down from 19.9 percent in FY07 to 9.3 percent in FY12.

Table 4.3: FDI Inflows in Pakistan – Sector-wise
million US$

	FY08	FY09	FY10	FY11	FY12
Food	66.5	195.3	108.2	68.1	40.7
Textile	30.1	36.6	27.8	25.0	30.3
Chemical	105.4	99.2	121.0	30.7	112.8
Petroleum refining	74.5	132.1	104.5	-18.4	14.7
Oil & gas exploration	634.8	775.1	740.6	512.2	612.8
Cement	102.5	32.6	-1.2	65.2	-11.0
Machinery	24.2	18.2	15.9	6.2	3.1
Electronics	27.6	22.6	23.5	15.9	22.8
Automobile	184.5	175.6	33.2	113.4	31.6
Power	70.3	119.8	-120.6	155.8	-84.9
Construction	88.5	92.5	101.6	60.8	71.8
Trade	175.5	165.7	117.0	53.0	25.3
Communication	1625.3	879.1	291.4	-34.1	-315.3
Finance	1607.6	707.4	163.0	246.9	56.4
Miscellaneous	335.5	269.9	424.9	272.9	201.5
Total	5152.8	3721.8	2150.8	1573.6	812.6

Source: State Bank of Pakistan

The most worrying development is the net outflow of FDI from the power and communication sub-sectors (**Table 4.3**). In particular, telecommunication had been a promising avenue to attract foreign direct investment; however, with market saturation, and the delay in the auction of 3G licenses, there is now a net outflow on account of repatriation of profits and retiring external loans.