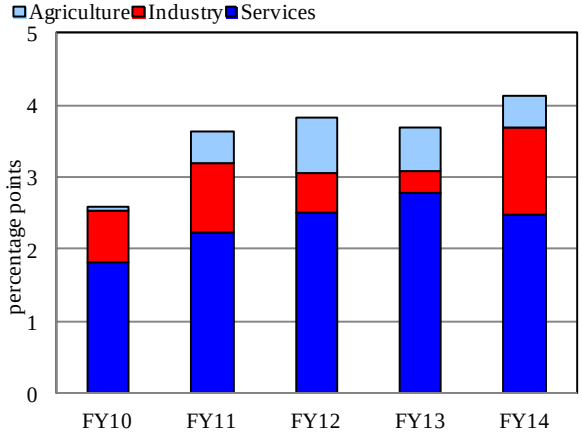
# 2 Economic Growth

## 2.1 Real GDP

Real GDP increased by 4.1 percent (PBS), which is a better and more balanced performance compared to the last year's growth of 3.7 percent, but still slightly short of the target of 4.4 percent for the year.[1] Although the major contribution to growth came from services (58 percent share in GDP), it was the sharp jump in industrial growth, which provided the much needed boost to GDP (**Figure 2.1**). Agriculture, on the other hand, remained below target on account of a slowdown in livestock subsector and losses in minor crops (**Table 2.1**).

**Figure 2.1: Contribution to GDP Growth**




Source: Pakistan Bureau of Statistics

While reviewing the performance of Pakistan's industry in FY14, we should be careful as it assumes growth of 5.3 percent in large scale manufacturing (LSM), which has been brought down to 3.9 percent with the realized data for the full fiscal year.[2] Before discussing this issue further, we should understand that data compilation in the national income accounts, involves many assumptions; and like other developing countries, this data suffers from several limitations (e.g., inadequate definition, time lags, limited coverage, non-response from reporting entity, etc.). Not surprisingly, national account estimates experience revisions every year, with some sub-components undergoing larger revisions than the others. More importantly, there is no bias in these revisions, as downward corrections often offset upward adjustments.[3]

In terms of LSM growth, a number of sectors that are showing strong performance; (for example, fast-moving-consumer-goods (FMCG) sector; plastic products; buses and trucks; and even textiles),[4] are either under reported, or not even covered. The omission of such important sectors from official data coverage, probably explains the apparent disconnect between overall economic activity in the country and the hard numbers in LSM.

The agriculture sector, missed the growth target for the year, as losses in minor crops and below target livestock growth, more than offset the improved performance of major crops. Interestingly, while all major crops (except cotton) recorded an increase in area under cultivation, this was offset by a fall in the area under a number of minor crops.[5] In fact, the challenges in agriculture sector have become more complex due to climate change; recurring extreme weather conditions; and more frequent pest attacks. Clearly, the solution lies in increasing productivity, for which farmers need to adopt better

[1] Unlike FY13 when the service sector explained more than 75 percent of the GDP growth, the performance in FY14 is more balanced as both, the service and the industry, made a significant contribution to growth.
[2] Assuming no other revision, the downward adjustment in LSM growth would bring overall GDP growth to 4.0 percent, which is still higher than last year's performance.
[3] Revisions to national income are also regularly carried out in advanced economies.
[4] The coverage of cotton cloth producers includes only those firms which are reporting to Textile Commissioner Office. Such firms cover only 10 percent of the overall cotton cloth production in the country.
[5] This suggests that the country cannot achieve higher agriculture growth simply by bringing more area under crop cultivation.

farming practices like proper irrigation; land leveling and soil testing; use of quality seeds; correct and timely sowing; and balanced use of fertilizer. As discussed in **Box 2.1**, these practices will go a long way in enhancing agriculture productivity.

Finally, the slowdown in services during FY14, was mainly due to sluggish growth in *finance & insurance* and *general government services*. The two sub-sectors, *wholesale & retail trade*, and *transport, storage & communication* (which together account for more than 50 percent of the value addition in services), posted decent growth.

**Table 2.1: Gross Domestic Product (at constant prices of 2005-06)**
share and growth in percent; contribution in percentage points

| | Share FY14 | Growth | | | Contribution to growth | |
|---|---|---|---|---|---|---|
| | | FY13 | FY14 Target | FY14 | FY13 | FY14 |
| **Agriculture** | **21.0** | **2.9** | **3.8** | **2.1** | **0.6** | **0.5** |
| Crops | 8.4 | 2.3 | -- | 1.2 | 0.2 | 0.1 |
| Major crops | 5.4 | 1.2 | 3.1 | 3.7 | 0.1 | 0.2 |
| Minor crops | 2.5 | 6.1 | 4.5 | -3.5 | 0.2 | -0.1 |
| Cotton ginning | 0.6 | -2.9 | 6.1 | -1.3 | 0.0 | 0.0 |
| Livestock | 11.8 | 3.5 | 3.9 | 2.9 | 0.4 | 0.3 |
| Forestry | 0.4 | 1.0 | 2.0 | 1.5 | 0.0 | 0.0 |
| Fishing | 0.4 | 0.7 | 2.0 | 1.0 | 0.0 | 0.0 |
| **Industry** | **20.8** | **1.4** | **4.8** | **5.8** | **0.3** | **1.2** |
| Mining & quarrying | 3.0 | 3.8 | 6.2 | 4.4 | 0.1 | 0.1 |
| Manufacturing | 13.5 | 4.5 | 4.5 | 5.5 | 0.6 | 0.7 |
| Large scale | 10.9 | 4.1 | 4.0 | 5.3 | 0.4 | 0.6 |
| Small scale | 1.7 | 8.3 | 8.2 | 8.4 | 0.1 | 0.1 |
| Elect gen & dist. and gas dist. | 1.9 | -16.3 | 4.0 | 3.7 | -0.4 | 0.1 |
| Construction | 2.4 | -1.7 | 5.7 | 11.3 | 0.0 | 0.3 |
| **Services** | **58.1** | **4.9** | **4.6** | **4.3** | **2.8** | **2.5** |
| Wholesale and retail trade | 18.6 | 3.4 | 4.0 | 5.2 | 0.6 | 1.0 |
| Transport, storage and communication | 13.0 | 2.9 | 3.5 | 3.0 | 0.4 | 0.4 |
| Finance and insurance | 3.1 | 9.0 | 6.0 | 5.2 | 0.3 | 0.2 |
| Housing services | 6.8 | 4.0 | 4.0 | 4.0 | 0.3 | 0.3 |
| General government services | 7.0 | 11.3 | 6.0 | 2.2 | 0.8 | 0.2 |
| Other private services | 9.7 | 5.2 | 6.0 | 5.8 | 0.5 | 0.6 |
| **GDP** | **100.0** | **3.7** | **4.4** | **4.1** | **3.7** | **4.1** |

Source: Pakistan Bureau of Statistics
The GDP numbers were approved by the National Accounts Committee in its meeting held on May 15, 2014.

## 2.2 Agriculture

Agriculture posted growth of 2.1 percent in FY14, which was lower than both the target of 3.8 percent, and the 2.9 percent growth realized in the previous year. Broadly speaking, the loss in *minor* crops (particularly in pulses and vegetables), and the below-target performance of *livestock*, more than offset the better performance of major crops (**Table 2.2**).

The performance of the crop sector was disappointing, even though the underlying factors were growth supporting: above-normal monsoon rains helped improve overall water

**Table 2.2: Value addition by Agriculture**
growth in percent; and contribution to growth in percentage points

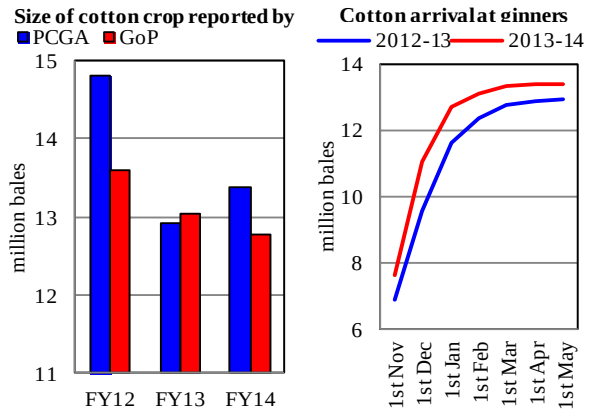
| | Share in FY14 | Growth | | | Contr. to agri growth | |
|---|---|---|---|---|---|---|
| | | FY13 | FY14 T | FY14P | FY13 | FY14 |
| Crops | 40.0 | 2.3 | 3.8 | 1.2 | 0.9 | 0.5 |
| Major crops | 25.6 | 1.2 | 2.7 | 3.7 | 0.3 | 0.9 |
| Minor crops | 11.6 | 6.1 | 4.0 | -3.5 | 0.7 | -0.4 |
| Cotton ginning | 2.8 | -2.9 | 6.0 | -1.3 | -0.1 | 0.0 |
| Livestock | 55.9 | 3.5 | 3.9 | 2.9 | 1.9 | 1.6 |
| Forestry | 2.0 | 1.0 | 2.0 | 1.5 | 0.0 | 0.0 |
| Fishing | 2.0 | 0.7 | 2.0 | 1.0 | 0.0 | 0.0 |
| **Overall** | **100** | **2.9** | **3.8** | **2.1** | **2.9** | **2.1** |

Source: Pakistan Bureau of Statistics

availability;[6] and higher domestic fertilizer production, as well as imports, ensured sufficient availability of fertilizer during FY14.[7]

The livestock sector, which accounts for 55.9 percent of value addition by agriculture, also recorded lower growth in FY14 compared to the previous year. While growth in gross output remained more or less unchanged, it was the higher intermediate consumption (specifically, fodder) that led to fall in livestock growth (see **Section 2.2.3**).

**Figure 2.2: Cotton Crop and Arrival**




Source: PCGA and Pakistan Economic Survey

### 2.2.1 Major crops

Major crops recovered strongly despite a decline in cotton production. This performance was mainly driven by an improvement in area under cultivation for some of the major crops (**Table 2.3**). A part of this increase, particularly in rice and wheat, was simply a recovery from last year's losses due to heavy rains in September 2012.[8] Moreover, the attractive market price of wheat and rice encouraged greater area under these crops, but it came at the expense of some minor crops (e.g., potato and sunflower).

**Table 2.3: Performance of Major Crops**

| | | | Growth | |
|---|---|---|---|---|
| | 2012-13 | 2013-14 | 2012-13 | 2013-14 |
| **Area in 000 hectare** | | | | |
| Cotton | 2,879 | 2,806 | 1.6 | -2.5 |
| Rice | 2,309 | 2,789 | -10.2 | 20.8 |
| Sugarcane | 1,129 | 1,173 | 6.7 | 3.9 |
| Wheat | 8,660 | 9,039 | 0.1 | 4.4 |
| **Production in 000 tons; for cotton 000 bales** | | | | |
| Cotton | 13,031 | 12,769 | -4.2 | -2.0 |
| Rice | 5,536 | 6,798 | -10.1 | 22.8 |
| Sugarcane | 63,750 | 67,460 | 9.2 | 5.8 |
| Wheat | 24,211 | 25,286 | 3.1 | 4.4 |

Source: Pakistan Bureau of Statistics

***Cotton:*** At 12.8 million bales (170 kg each), the crop not only missed the target of 14.1 million bales, but also remained below the 13.0 million bales realized last year. This poor performance was mainly due to water shortages at the crucial time of sowing,[9] and low margin in the face of depressed market prices and rising cost of inputs (e.g., quality seeds, fertilizer and pesticides). As a result, this crop is losing area to its competitors, such as maize and rice.[10] Similarly in Sindh, following the setup of four new sugar mills in Ghotki District, cotton growers have shifted away from cotton crop.

While the area under cotton cultivation has fallen, the standing crop also suffered from pest attacks (mealy bug and pink ball worm in Sindh, and whitefly and jassid in Punjab). Further damage,

[6] The country received 151.4 mm of rains during Jul-Sep 2013 which was more than the historical average of 140.8 mm. Furthermore, the overall water availability was better in FY14, compared to the previous year. In terms of crop season, water situation during kharif was more comfortable compared to corresponding period last year, mainly due to larger withdrawal of water at canal heads.

[7] The urea offtake during FY14 increased by 7 percent compared to a decline of 3.1 percent a year earlier; whereas the demand for DAP recorded a strong growth of 34.9 percent in FY14 on top of 18.9 percent increase in the previous year.

[8] Heavy rains in September 2012 damaged the rice crop in the districts of Jafferabad and Naseerabad in Balochistan; and Jacobabad, Shikarpur, Kashmore and Qambar in upper Sindh. Later on, growers in Jacobabad and Kashmore could not even cultivate wheat due to stagnant water.

[9] Under the Wheat-Cotton cropping pattern, which is more common in Punjab, cotton is sown from early-May to mid-June. This year, water shortages extended the cotton sowing period beyond June 2013.

[10] There are reports that farmers in Vehari, Lodhran, Muzaffargarh, Jhang, Faisalabad, and Pakpattan preferred maize and rice owing to their better market returns.

particularly in Southern Punjab (Muzaffargarh), came from rains in August 2013, when the crop was at the flowering and ball formation stage.
These intermittent shocks increased the uncertainty on the size of the cotton crop. Not surprisingly, the Cotton Crop Assessment Committee (CCAC) repeatedly revised its estimates for the crop during the course of the season.[11] The confusion about the crop size was compounded further as the numbers reported by the Pakistan Cotton Ginners Association (PCGA) had been showing improved cotton arrival throughout the season (**Figure 2.2**).[12] However, these numbers should be interpreted with care, as they do not follow the standard weight of 170 kg for each cotton bale.

***Rice:*** According to the second estimate, rice production reached 6.8 mln tones in FY14, compared to the target of 6.4 mln tons.[13] This was mainly due to a sharp recovery in area under cultivation in Sindh and Balochistan. Although attractive prices in FY13 induced growers to cultivate more rice in Punjab,[14] this could not translate to higher production due to heavy rains and the pest attacks in Gujranwala, Lahore and Faisalabad.[15] Fortunately, most of the damage in Punjab was limited to non-basmati varieties, as production of basmati rice recorded an increase of 17.0 percent after declining continuously since FY09.[16]

***Sugarcane:***[17] Against the target of 65.0 million tons, sugarcane production was 67.5 million tons in FY14. In Sindh, farmers preferred sugarcane as it is more resilient to heavy rains. As mentioned before, opening of new sugar mills in Ghotki, encouraged neighboring farmers to cultivate more sugarcane.

***Wheat:*** According to latest estimates, wheat production of 25.3 million tons in FY14 was marginally higher than the 25.0 million tons target and the previous peak of 25.2 million tons realized in FY11. Wheat production would have been higher, had there been no drought in the potohar region during November and December 2013. Although government support price remained unchanged this season, the higher market prices, better water situation, and the availability of fallow land due to early maturity of the cotton crop, encouraged farmers to grow more wheat. In addition, growers in Jacobabad and Kashmore, were able to cultivate more area, which was lost to heavy monsoon rains last year.

### 2.2.2 Minor Crops

These crops posted a *decline* of 3.5 percent in FY14, compared to 6.1 percent growth in the previous year. Lower production of gram, potatoes, sunflower, rapeseed, mustard and chilies, compared to the previous year, largely explains this negative growth (**Table 2.4**).

[11] CCAC estimated the cotton crop size of 13.26 million bales (170 kg each) in its initial assessment for FY14, which was subsequently revised downwards to 11.96 million bales. The latest estimates are however at 12.8 million bales.
[12] According to PCGA, the cotton arrival during 2013-14 remained at 13.4 million bales compared to 12.9 million bales in the previous season.
[13] Provincial crop reporting centers generally provides three estimates for key crops. The first estimate, which becomes available soon after the sowing, covers only the provisional numbers on area under the crop. The second estimate includes production numbers as well. The third estimate which is prepared after a lag, provides the final numbers on both area and production.
[14] By April 2013 (i.e., before the start of sowing season for the FY14 crop), price of premium basmati rice recorded an increase of 23.2 percent (on YoY basis) from Rs 102.5 to 126.2 per kg.
[15] Heavy rains hit various districts in Punjab during July-August 2013 that coincides with floods in river Indus, Sutlej, Chenab and Ravi.
[16] Gujranwala, Lahore, Faisalabad, Sahiwal and Sargodha, which are the major basmati rice producing divisions in Punjab, contributed more than 80 percent of the growth in country's basmati rice production during FY14.
[17] In Sindh, this crop is sown during September and its growing cycle runs for 12-14 months; whereas in Punjab, the sowing takes place in February and the crop matures in 10-12 month period.

Sunflower suffered in Sindh (i.e., Thatta, Mirpurkhas, Sanghar and Badin) due to water shortages. [18]

Reportedly, higher prices encouraged farmers to sell seed potato in the market for its final consumption as food.[19] In addition, the standing crop of potato suffered, first due to the heat wave, and later from frost.[20] Finally, in response to attractive market prices, growers preferred to harvest their crop prematurely.

For the gram crop, the production decline mainly came from a prolonged dry spell in December and January, particularly in Khushab, Bhakar, Layyah and Jhang (these four districts, together contribute more than 70 percent of country's gram production). In overall terms, gram experienced 36.8 percent fall in its output during FY14.

**Table 2.4: Minor Crops**

| | 2012-13 | 2013-14 | % change |
|---|---|---|---|
| ***Area in 000 hectare*** | | | |
| Gram | 992.0 | 975.4 | -1.7 |
| Potatoes | 174.4 | 161.9 | -7.2 |
| Sunflower | 196.1 | 177.2 | -9.6 |
| Rapeseed & mustard | 224.2 | 198.4 | -11.5 |
| Chilies | 63.6 | 62.5 | -1.7 |
| ***Production in 000 tonnes*** | | | |
| Gram | 751.3 | 474.6 | -36.8 |
| Potatoes | 3802.2 | 3507.1 | -7.8 |
| Sunflower | 243.4 | 230.8 | -5.2 |
| Rapeseed & mustard | 204.9 | 180.9 | -11.7 |
| Chilies | 147.2 | 145.1 | -1.4 |

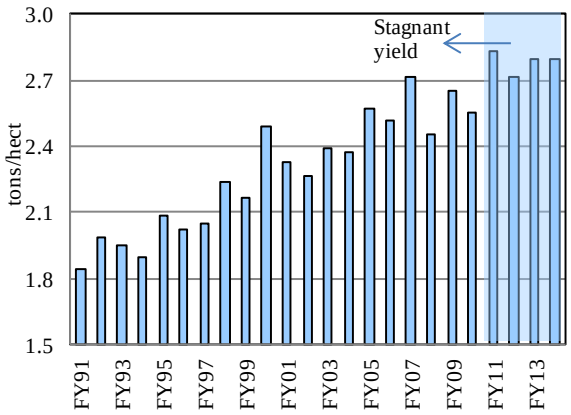
Source: Annual Plan 2014-15

**Box 2.1: Why Crop Yields are Low in Pakistan?**

Although wheat occupies a central place in Pakistan's food security policy, its average yield (hovers around 2.7 tons per hectare) is low compared to other countries, and has been stagnant for the last many years (**Figure 2.1.1 & 2.1.2**).

The country thus far has been able to meet rising demand for food, not only by bringing more land under wheat cultivation, but also by adopting intensive farming (which is characterized by low fallow ratio and increased use of input). Unfortunately, the scope for further increase in cultivable land is constrained by physical limits. In addition, one should not expect any major increase in crops yields, as Pakistan's natural resource base is already under pressure due to intensive farming and growing environmental constrains (e.g., water logging, soil salinity, shortages of irrigation water, adverse climate shocks, etc.).

**Figure 2.1.1: Trends in Wheat Yield**




Source: MNFS&R; Pakistan Bureau of Statistics

However, as crop productivity varies widely from subsistent farmers to progressive farmers, this hints at huge potential gains that can be realized by ensuring quality inputs, encouraging better farming practices, and diffusion of technology to farmers. The availability of certified seeds is still very low in Pakistan. Not surprisingly, most farmers use seeds from their own previous harvest, or buy from other farmers and small traders. Such seeds are not only contaminated with weeds, but their productivity declines over time. In addition, as the quality of seeds available in the market remains doubtful, this makes farmers skeptical of the advantages from investing in quality seeds. Institutional constraints to ensure seed standards, can be gauged from the fact that the federal Seed Certification and Registration Department, which is responsible for quality assurance, is operating with only 38 seed testing laboratories all over Pakistan.

There is also some uncertainty about the quality of fertilizer available in the market, as growers often complain about the availability of fake, adulterated and under-weight bags of fertilizer in the market. In addition, the lack of awareness about the nutrient requirement of soil, often results in excessive use of fertilizer. Although soil testing helps determine the right amount and mixture of nutrient needed, farmers do not have ready access to this facility as there are few testing laboratories

[18] There were reports of water shortages during early kharif in some parts of Sindh and Punjab due to rotation in water releases in small and medium canals.

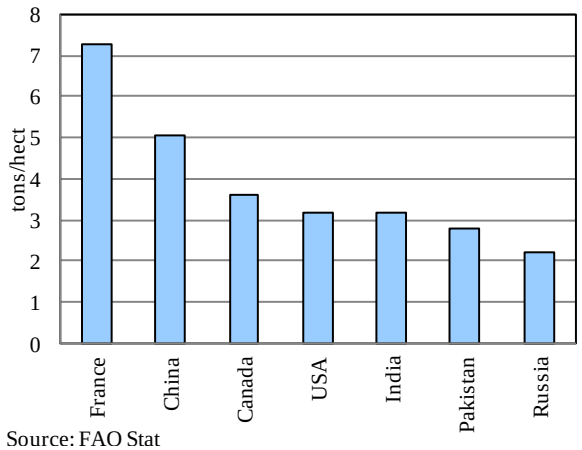
[19] Seed potatoes are healthy potatoes with a bud that grows into a new plant.

[20] The sowing season for the early crop of potato starts in September, whereas late crop is sown in November. While the heat damaged the early crop, the late crop suffered from frost conditions

in the public sector.[21] Hence, long travels (and multiple visits) to these laboratories, discourage growers from getting their soil tested. Moreover, even if farmers know the nutrient needs of their soil, they cannot purchase the specific fertilizer at the right time due to limited supply or higher prices. More importantly, farmers are often unaware of the appropriate timing and methods for the application of fertilizer.

Traditionally leveled land causes an uneven application of irrigation water where some plants remain dehydrated, while others receive too much moisture – this in turn weakens the plants. On the other hand, the use of laser-guided equipments results in more precise, smooth and graded fields, which allow for uniform application of irrigation water with negligible losses. This in turn, leads to better germination and higher yields. Despite the many advantages of precise land leveling, the use of laser leveling is limited to a few large farms. Most subsistence farmers often lack awareness and have limited purchasing power.[22]

**Figure 2.1.2: Wheat Yields in Selected Countries**




Source: FAO Stat

Although water is increasingly scarce, its supply through canals is highly unreliable (i.e., growers may not get irrigation water at critical times due to limited supply) and inflexible (i.e., farmers will get a fixed allocation of water whether they need it or not). The water distribution system works against tail-end users, who generally receive less water than those in the middle, or at the beginning of the water course. The crumbling water canal network and lack of maintenance, further add to uncertainty about water supply.[23] This deters growers from investing in seeds, fertilizers and land preparation. Furthermore, the practice of controlled flooding, the commonly used method for supplying water in Pakistan, is the least efficient as it involves significant water losses.

Lastly, it is important to control weeds in any form (i.e., seed, seedling or mature plant), so the crop could benefit from nutrients, moisture and sunlight. Controlling weeds also reduces the risk of attack from insects and disease. Generally, the use of low quality seeds and use of livestock manure encourages the high incidence of weeds.

### 2.2.3 Livestock

Livestock is the largest sub-sector of agriculture, accounting for 55.9 percent of the value addition by the sector. In overall terms, livestock contributed about 11.8 percent to Pakistan's GDP in FY14. This includes live animals, meat and meat preparation, dairy, and, poultry & poultry products. Pakistan ranks 2nd in the world in terms of the number of buffaloes, 4th in terms of goats, 7th in terms of cattle herd, and 8th in terms of the number of sheep.[24]

**Table 2.5: Livestock - YoY Growth in Percent**

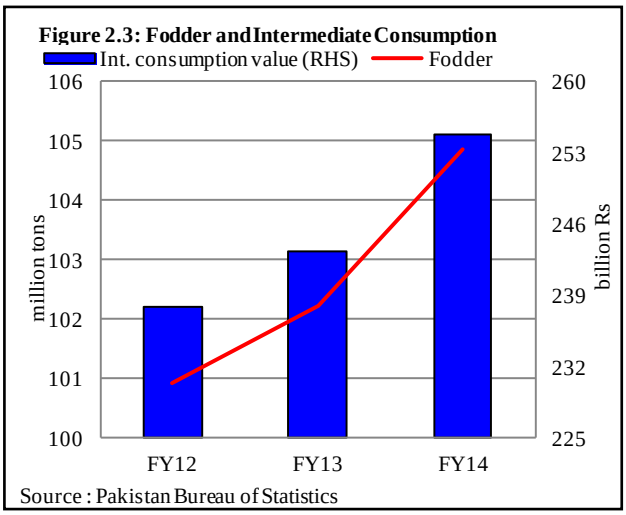
| | % share in output | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **Gross Output** | **100.0** | **3.2** | **3.3** | **3.1** |
| Net sales | 23.5 | 2.9 | 2.9 | 2.8 |
| Natural growth | 14.6 | 3.0 | 3.0 | 2.4 |
| Milk | 45.2 | 3.2 | 3.2 | 3.0 |
| Poultry & products | 8.3 | 7.2 | 7.3 | 7.4 |
| Others products | 8.4 | 1.1 | 1.1 | 1.1 |
| **Intermediate consumption** | | **-0.1** | **2.3** | **4.7** |
| **Gross value addition** | | **4.0** | **3.5** | **2.9** |

Source: Pakistan Bureau of Statistics

Despite having such a global presence, the count on live animals is done by applying geometric growth rates to the previous censuses (the last census was done in 2005-06), whereas estimates on livestock products (e.g., meat, milk and poultry) are derived by applying fixed growth parameters on the above mentioned computed livestock population. Hence, the gross output of this sub-sector follows almost a fixed growth (**Table 2.5**).

[21] Although some of the fertilizer companies in the private sector offer soil testing facility, this is usually availed by their corporate clients.
[22] Water Management Departments of some provincial governments provide laser land leveler on rental basis.
[23] Despite being a scarce input, canal distribution system results in significant losses mainly due to water seepage, evaporation, and transpiration.
[24] Source: FAO STAT (http://faostat.fao.org).

Having said this, the value addition by livestock fluctuates due to changes in intermediate inputs (the value of fodder – dry, green and concentrates) (**Figure 2.3**). While green fodder is reported under minor crops, estimates of dry fodder are obtained by applying fixed ratios.[25] More specifically, the manner in which intermediate inputs are computed, makes the growth in livestock counter-cyclical to the performance of the crop sector. More simply, higher growth in the crop sector would result in higher estimates of fodder production, which in turn, would *pull down* the growth in livestock.




In terms of by-products, the *meat* subsector is an important component of livestock products, which consists of many operations ranging from simple slaughtering to processing meat into cooked, fermented and preserved forms. The exports of meat and meat preparation are concentrated to the gulf countries, while exports to other major markets (e.g. EU) are constrained because of their high health and safety standards.

*Milk* is another important subsector of livestock, and its production has increased by 3.0 percent during FY14, which is in line with the growth seen in the last few years.[26] Despite being one of the largest milk producers in the world, Pakistan has been unable to utilize its supply base to fully cater to its domestic demand. The sector has great potential and according to industry sources, all big business groups are investing in dairy farming. Nishat group, Sharif group, Engro foods, Dairy land, etc. have already set up dairy farms using modern technology fulfilling phyto and phytosanitary conditions. Nonetheless, formal dairy farming contributes just 5 percent to total milk production.

### 2.3 Large Scale Manufacturing (LSM)

LSM posted 3.9 percent growth in FY14, compared to 4.0 percent in FY13 (**Table 2.6**).[27] Although the overall increase in LSM remained almost unchanged from last year, the underlying factors of this increase underwent a shift. More specifically, one-half of the entire increase was driven by fertilizer, sugar and beverages – after excluding them, LSM growth dips to 2.2 percent, compared to 3.9 percent in FY13.[28] This was mainly due to a slowdown in the production of textile, cement, automobiles, cooking oil, steel, POL, paper, and glass (**Figure 2.4**). The manufacturing in these sectors was constrained by a confluence of factors: (i) weak export demand for cement, particularly from Afghanistan; (ii) phasing out an old model of Toyota and the increase in GST on tractors; (iii) base effect in edible oil because of record production in FY13; (iv) suspension in the activity of Pakistan Steel Mill during the year; and (v) gas shortages, which hampered a number of Punjab based industries.[29] These factors also eclipsed the improvement in power supplies following the settlement of circular debt in June 2013, and the increased availability of credit to the private sector in FY14.

[25] For instance, wheat fodder is 100 percent of the production; whereas sugarcane fodder is 20 percent of the crop.
[26] Production is estimated by applying fixed production parameters to the projected population of livestock. Milk for human consumption is derived by subtracting 20 percent from the gross milk production of cows and buffaloes.
[27] The LSM growth number of 5.3 percent in FY14 (used in **Table 2.1**) was based on Jul-Feb data. The more recent estimate shows 3.9 percent growth in large scale manufacturing during FY14. The downward adjustment came mainly due to a strong base effect from Q4-FY13, and the lackluster performance of cement, steel and cigarette production in Q4-FY14.
[28] Fertilizer production posted 4.0 percent decline in FY13, due to gas shortages, hence its exclusion actually improves last year's growth number.
[29] The performance of *paper* and *glass* was affected by gas shortages in FY14.

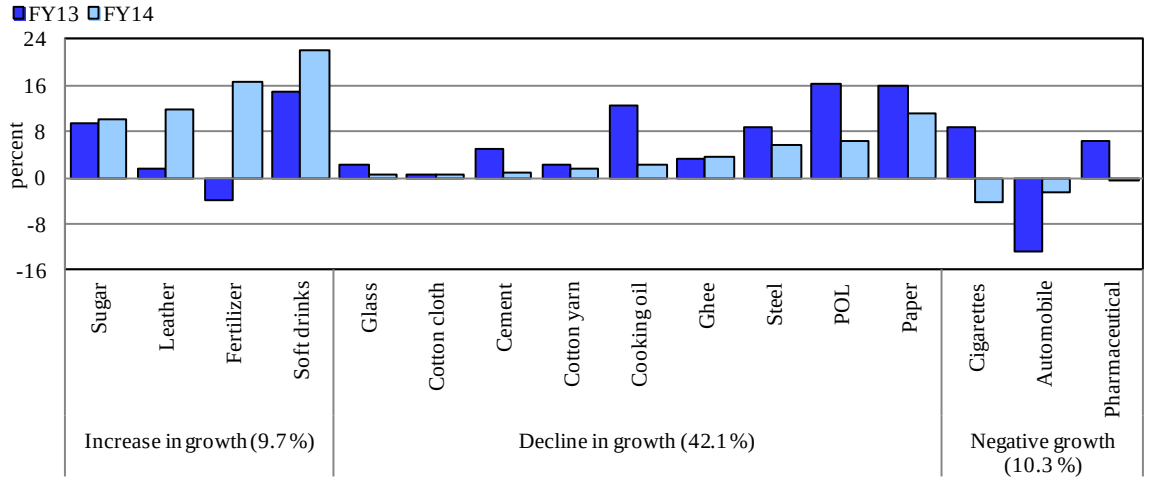
**Table 2.6: Growth Trends in Large Scale Manufacturing**

| | Weight | Growth | | | Percentage Contribution[30] | | |
|---|---|---|---|---|---|---|---|
| | **70.3** | **FY12** | **FY13** | **FY14** | **FY12** | **FY13** | **FY14** |
| Textile | 21.0 | 0.2 | 1.6 | 1.3 | 5.9 | 12.0 | 9.9 |
| *Cotton yarn* | 13.0 | 0.5 | 2.1 | 1.6 | 8.0 | 10.1 | 7.6 |
| *Cotton cloth* | 7.2 | 0.3 | 0.6 | 0.7 | 2.5 | 1.4 | 1.7 |
| Food | 12.4 | 6.0 | 9.8 | 7.2 | 94.6 | 49.0 | 38.7 |
| *Sugar* | 3.5 | 11.2 | 9.5 | 10.0 | 58.1 | 16.5 | 18.8 |
| *Cooking oil* | 2.2 | 3.7 | 12.5 | 2.4 | 10.4 | 11.1 | 2.3 |
| *Soft drinks* | 0.9 | 20.1 | 14.8 | 22.1 | 25.6 | 6.8 | 11.5 |
| POL | 5.5 | -6.7 | 16.2 | 6.2 | -32.8 | 22.1 | 9.7 |
| Steel | 5.4 | -23.3 | 8.7 | 5.6 | -71.3 | 6.1 | 4.2 |
| *Billets* | 1.5 | -0.8 | 1.4 | 29.9 | -0.6 | 0.3 | 6.8 |
| *H.R sheets/strips* | 2.3 | -22.9 | 28.1 | 11.4 | -31.1 | 8.9 | 4.5 |
| Cement | 5.3 | 2.9 | 5.1 | 0.8 | 25.0 | 13.4 | 2.2 |
| Automobile | 4.6 | 3.4 | -12.8 | -2.6 | 17.0 | -19.9 | -3.4 |
| *Tractors* | 0.5 | -32.0 | 5.6 | -32.1 | -22.5 | 0.8 | -4.8 |
| *Jeeps and cars* | 2.8 | 14.7 | -21.3 | -3.5 | 35.7 | -17.8 | -2.3 |
| Fertilizer | 4.4 | 1.0 | -4.3 | 16.5 | 0.4 | -5.4 | 20.9 |
| Pharmaceutical | 3.6 | 7.0 | 6.3 | -0.2 | 43.1 | 12.4 | -0.4 |
| Paper | 2.3 | 21.8 | 16.0 | 11.0 | 50.3 | 13.6 | 10.6 |
| Leather products | 0.9 | -1.0 | 1.5 | 11.7 | -1.5 | 0.7 | 5.1 |
| Glass | 0.1 | -1.8 | 2.3 | 0.4 | -0.2 | 0.1 | 0.0 |
| Other items | 5.0 | -6.0 | -2.8 | 1.7 | -30.7 | -3.9 | 2.3 |
| **Overall LSM** | **70.3** | **1.2** | **4.0** | **3.9** | | | |
| Excl. fertilizer, beverages and sugar | 61.4 | 0.2 | 3.9 | 2.2 | 16.0 | 82.1 | 48.8 |

Source: Pakistan Bureau of Statistics

Having said this, energy constraints have changed the dynamics of LSM in the past several years. Hard pressed by energy shortages, a large number of industries are in the process of converting to alternate energy setups.[31] However, given the high cost involved in this shift, not all firms have the resources to do so. Hence, smaller firms involved in the production of glass, paper, and textile (especially units in the informal sector) are either closing down, or are forced to curtail their operations.

**Figure 2.4: LSM Performance**




Source : Pakistan Bureau of Statistics
* Numbers in paranthesis showing respective weights of the sectors in LSM index.

[30] Contribution to growth shows the percentage that a given sub-sector contributes to the overall LSM growth. This is a combination of growth within a sub-sector and the weight it captures in overall LSM index.
[31] For details, see Special Section 1 on, "**Alternate Energy Resources**" in the *First Quarterly Report for FY14*.

Another important issue pertains to the coverage of sectors and manufacturing units, which are included in LSM by the Pakistan Bureau of Statistics (PBS). The existing LSM index is based on the Census of Manufacturing Industries (CMI) that was conducted in FY06. [32] While constructing LSM index, only those sectors were included which had significant value addition to GDP at the time of census. Our assessment is that not only has manufacturing activity in a number of sectors been enhanced, many new manufacturing units have started operating in the country in the recent past. Hence, an expanded data coverage exercise of manufacturing units and new categories is required, to present a more realistic picture of large scale manufacturing in the country. We believe the actual growth in LSM is better than what is reported by PBS (**Box 2.2**).

**Box 2.2: Coverage Issues Undermining LSM Growth**

Large scale manufacturing data is compiled across countries, according to the International Standard Industrial Classification ( ) of the United Nations Statistics Division, which has defined 22 broad categories of manufacturing.[33] In the case of Pakistan, however, the coverage of LSM pertains to only 15 sectors identified by the ISIC. Data pertaining to manufactures of wearing apparels & dressing; publishing, printing products & recorded media; fabricated metal products (except machinery & equipment); office & accounting machinery and computers; medical precision & optical instruments; and recycling of metal and non-metal waste scrap, is not included as part of Pakistan's LSM.[34] The current LSM index is based on the Census of Manufacturing Industries (CMI) conducted in FY06.

**Table 2.2.1: Coverage Issues in LSM**

| Sectors | Issues |
|---|---|
| **Textile** | (i) LSM data for cotton cloth and cotton yarn is collected by the Ministry of Textile, which only covers *mill* sector activity. The *non-mill* sector, which entails over 90 percent of overall production of cotton cloth in the country, is not included in the data set.* |
| | (ii) Textile *production* data is not classified according to different types of fabrics; yarn; fibers; and final products (such as apparel, cotton based denim, bed-wear, hosiery). This makes analysis of production trends very difficult. However, PBS coverage of *export* data is more extensive, and includes a number of categories, like: hosiery/knitwear, bed-wear, towels, tarpaulin & other canvas goods, readymade garments, and synthetic textiles. |
| **Automobiles** | PBS reports the production of units registered with Pakistan Auto Manufacturers Association (PAMA) only, which include: Pak Suzuki, Indus, Honda, Fiat, Deewan, Hinopak, Ghandhara, Sind Engg, Master and Isuzu. This leaves out some leading bus and trucks manufacturers, namely *Afzal Motors* and *Al-Haj FAW motors*. |
| **Chemicals** | PBS reports data for 11 categories of chemicals, with *caustic soda* claiming the largest share. For caustic soda, production numbers are obtained from Sitara Chemicals, ICI and Nimir Industrial Chemicals. The production of Engro Chemicals, which caters to one-third of the entire domestic demand of caustic soda, is not included in LSM data.[35] |
| **Fast Moving Consumers Goods (FMCG)** | (i) Food sector: Given the significant change in Pakistan's consumption patterns, the demand and production of a number of processed food items has grown in the past few years (e.g. packaged milk & products, dairy items, yogurt, pastas, cereals, frozen and ready to cook items, etc). The production of these items however, is not included in LSM data, which leaves out large and vibrant manufacturers like Unilever, Kolson, Nestle, Efoods and National Foods. |
| | (ii) Non-Food: Similarly, non-food FMCGs are also not captured by LSM. This includes products like cosmetics, personal care products and toiletries, which are produced by prominent brands like Unilever, Medicam, and Procter & Gamble. |

[32] PBS conducted the CMI in 2006 to collect information about industrial activity in the country. Providing this information by production units, is obligatory under Section 9 & 10 of General Statistics Act 1975, and Section 5 & 6 of Industrial Statistics Act,1942. PBS is currently engaged in conducting a fresh CMI.

[33] http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17

[34] The manufacturing data as reported by India contains all categories identified in the ISIC. Source: http://mospi.nic.in/Mospi_New/upload/iip_11_july2014.pdf

[35] Similarly in the case of glass, production of one of the leading manufacturers is not captured by LSM index.

| | |
|---|---|
| **Plastics** | The production of plastics is completely absent from the LSM data set. According to the Pakistan Plastic Manufacturing Association (PPMA), there are around 6,000 upstream and downstream units operating in the country, employing 0.6 million people. This sector is producing a broad range of products ranging from household items, industrial containers, medical & surgical items, auto parts, stationery items, PVC pipes, etc. Yet they are not covered in LSM. |

* Source: http://www.aptma.org.pk/Pak_Textile_Statistics/pedrc.asp

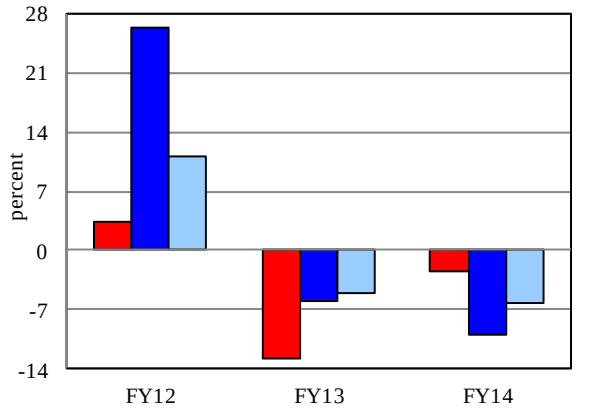
In our view, the coverage of LSM should be enhanced by including rapidly growing sectors, and manufacturing units, to provide a more realistic picture of large scale manufacturing (**Table 2.2.1)**, as discussed in the following:

- While the growth in manufacturing textiles posted a slowdown in FY14, the export quantum of almost all textile categories (with the exception of cotton yarn) posted an increase in the year.[36] In fact, the provision of GSP+ from the EU, suggests strong growth prospects of this sector. The apparent disconnect between production and export numbers can be addressed by improving data coverage of textiles. This is all the more important given the 20 percent share of textile in the LSM index;
- In automobiles, the production of buses and trucks posted a decent increase after taking into account the growth numbers of two large firms that are not covered by PAMA;
- In chemicals, while the production of caustic soda posted a 8.4 percent YoY decline in 2013 (according to LSM data), Engro Chemicals reported a 5.6 percent increase in production this year.[37] The inclusion of this company could have offset the reported decline in caustic soda;
- The sales and profit margins of almost all leading manufacturers of both food and non-food FMCGs, posted a healthy increase during FY14, which indicates strong growth in this sector;[38]
- In the case of plastics, while exports posted a decline in FY14, imports of raw materials witnessed 26.4 percent growth in this year, which indicates robust growth in manufacturing in this segment.

### *Demand led compression in growth*

*Automobiles*: Continuing with the trend observed last year, automobile production showed negative growth in FY14 (**Figure 2.5)**.[39] This was led by a slowdown in demand, which is evident from lower domestic sales volumes and imports.

**Figure 2.5: Performance of Automobile Industry (YoY Growth)**




Source: Pakistan Bureau of Statistics & PAMA

The most prominent fall was seen in the production of tractors, which could be traced to the rise in GST rates from 10 percent in FY13, to 16 percent in FY14 (**Table 2.7**).[40] Furthermore, the assembling of cars & jeeps also remained sluggish mainly because of the phasing out of a popular model by Indus Motors, and a marginal decline in production by Suzuki Motors.[41] In fact, these factors overshadowed a number of positives in FY14: (i) the introduction of a new product by Suzuki motors[42]; (ii) an 11 percent increase in production by Atlas Honda; (iii) the sharp growth in demand for LCVs, following the launch of a new model *Ravi* by Suzuki Motors; and (iv) increase in auto

[36] Cotton fabric, ready-made garments, knitwear, and bed wear posted 14.0 percent, 6.8 percent, 11.9 percent, and 20.3 percent increase in exports during FY14, respectively.
[37] Source: Company's website.
[38] Source: Companies' websites.
[39] Compared with a sharp fall of 12.8 percent during FY13, production in the automobile sector fell by 2.6 percent during FY14.
[40] The reduction in GST rate in FY13 (from 16 percent to 10 percent), and subsidized tractor schemes in Punjab and Sindh led to a surge in production and sales in FY13. Previously, the government levied 17 percent sales tax on tractors in March 2011, which was reduced to 16 percent in budget 2011-12.
[41] Toyota posted 14.5 percent fall in production in FY14, whereas Suzuki motors posted 2.8 percent decline in FY14, compared to last year.
[42] Suzuki Motors produced 2,208 units of Wagon R during FY14.

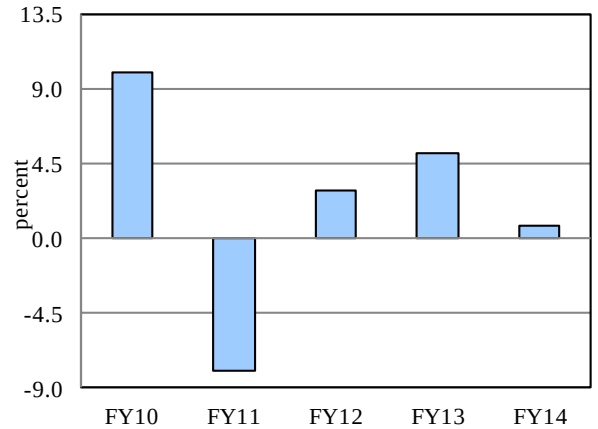
financing from Rs 5.4 billion in FY13, to Rs 13.2 billion in FY14.[43] This decline in the production of cars & jeeps took place despite the reduction in the age limit of used imported cars from December 2012, and the downward revision in most automobile prices in 2014, following the appreciation of Pak Rupee.[44]

**Table 2.7: Growth in Automobiles Assembling (percent)**

| | FY12 | FY13 | FY14 |
|---|---|---|---|
| **Automobile** | 3.4 | -12.8 | -2.6 |
| Tractors | -32.0 | 5.6 | -32.1 |
| Buses | 15.9 | -8.1 | 7.1 |
| Jeeps and Cars | 14.7 | -21.3 | -3.5 |
| Scooters/motor cycles | 0.8 | 1.5 | 3.2 |
| L.C.V.s | 9.3 | -30.6 | 20.4 |
| Trucks | -7.6 | -26.0 | 39.1 |

Source: Pakistan Bureau of Statistics

**Figure 2.6: Trend in Cement Production (YoY Growth)**




Source: Pakistan Bureau of Statistics

Having said this, the outlook for the automobile sector is likely to be positive in FY15. This is due to a number of factors: (i) the launch of Indus Motors's new model should boost the overall auto sector during FY15; (ii) tractor demand is likely to increase after the reduction in GST from 16 percent to 10 percent in the budget for FY15; (iii) the announcement of a *yellow cab* scheme by the government of Punjab;[45] (iv) the removal of 10 percent federal excise duty on 1800 cc plus cars in the FY15 Budget;[46] and (v) the government has again allowed local car manufacturers to import and fit CNG kits in their cars.

Notwithstanding, the strong growth prospects of automobiles in FY15, the long-term prospects of the industry are not optimistic. This is because of industry's inability to indigenize production despite a long period of protection. This has given rise to a number of concerns about its performance: (i) low indigenization has made the industry vulnerable to adverse movements in the exchange rate, which impacts production costs and retail prices; (ii) inability to tap economies of scale because of sub-optimal level of production; (iii) low quality of locally manufactured auto parts, raises concerns about durability and passenger safety; and (iv) high protection given to this industry over an extended period of time, has resulted in complacency and insensitivity to consumer needs. This situation is in sharp contrast with India, where consumers enjoy a wide variety of products at competitive prices (**Special Section 2.1**).

**Table 2.8: Cement Sales Dynamics**

| | Share in sales | YoY Growth | | |
|---|---|---|---|---|
| | FY14 | FY12 | FY13 | FY14 |
| **Domestic sales** | **76.3** | **9** | **4.7** | **4.3** |
| Punjab & KPK | 63.2 | 8.2 | 5.1 | 6.5 |
| Sind & Baluchistan | 13 | 12.3 | 2.9 | -5.2 |
| **Exports** | **23.7** | **-7.1** | **-2.3** | **-2.8** |
| Afghanistan | 10.7 | -0.2 | -6.6 | -17 |
| India | 2 | 2.7 | -20.4 | 40.5 |
| Rest of the World | 11.1 | -17 | 7.4 | 9.1 |
| **Total growth in sales** | | **4.2** | **2.8** | **2.5** |

Source: APCMA

[43] The total number of borrowers availing auto financing increased from 116,474 in FY13, to 123,005 in FY14.
[44] Following the appreciation of PKR during 2014, Pak Suzuki has already reduced car prices ranging from Rs 5,000 to Rs 100,000; Indus Motors has brought down the prices of its cars and pickups by up to Rs 75,000; and Honda Atlas Cars Pakistan Limited has reduced car prices by Rs 30,000-40,000.
[45] The government plans to distribute 35,000 cabs in this scheme, as announced in the provincial budget for FY15. The Punjab government announced a similar scheme in FY12 and distributed 20,000 cars.
[46] http://www.finance.gov.pk/press_releases.html.

Cement

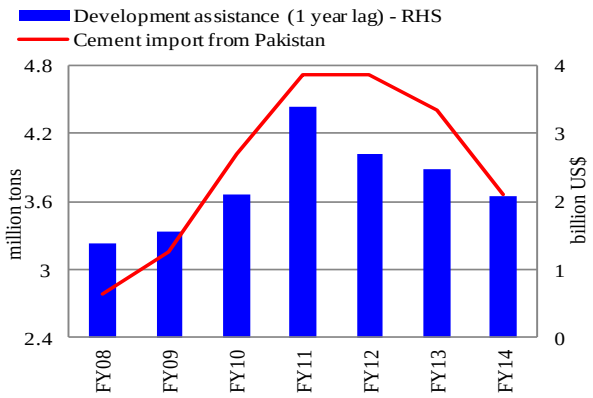
Growth of cement production declined to 0.8 percent in FY14, compared to a 5.1 percent increase in FY13 (**Figure 2.6**). This was because of weaker exports and sluggish local demand.

The composition of cement sales reveal that around two-third of the entire demand comes from domestic services, specifically from the northern region of Pakistan (Punjab and KPK-**Table 2.8**).[47]

A number of ongoing mega projects like, the Rawalpindi-Islamabad Metro bus; the widening of Khunjerab section of the Karakorum highway;[48] and the Multan-Faisalabad Motorway project, shored up demand from cement plants located in Punjab and KPK in FY14. However, sluggish construction activity in Sind & Baluchistan, suppressed overall local sales.

On the export side, Pakistan's cement is dispatched to a number of countries including Afghanistan, India, Sri Lanka, and different parts of Africa. Afghanistan became a key destination after the US and its allied partners started to rebuild the country (**Figure 2.7**). However, exports have started to fall with the withdrawal of UN troop from Afghanistan. Furthermore, Iran is also giving tough competition to Pakistani cement in Afghanistan.[49]

**Figure 2.7: Afghanistan - Development Expenditures & Cement Imports from Pakistan**




Source: APCMA; www.sigar.mil

South Africa has become the second largest importer of Pakistani cement in FY13.[50] However, cement manufacturers in South Africa have recently filed a petition in their International Trade Administration Commission (ITAC), alleging that Pakistan is dumping cement in their market.[51] This may have negative repercussions for Pakistan's exports to Africa. Going forward, most of the demand for cement is likely to come from local infrastructure projects.

Importantly, despite a slowdown in cement sales, profitability of the larger production units increased during FY14 (**Figure 2.3.1a &b**). Other than the market power enjoyed by the large brands, some of this enhanced profitability can be linked to effective cost management by these firms (**Box 2.3**). In addition, the consistent increase in cement prices in the past few years, has also helped the industry maintain a healthy stream of revenues.

[47] The average share of sale to northern region remained 82.4 percent during last five years.

[48] It involves the rehabilitation and widening of KKH (Railkou-Khunjerab Section) in Gilgit Baltistan. (Source: Planning Commission)

[49] Iran's cement industry is thriving on the back of abundant raw material and cheap energy. Iran increased its cement capacity from 42.7 million tons in 2005 to 75.0 million tons in 2013, and the industry is planning to attain the mark of 110 million tons in 2015. Source: USGS Mineral Year Book: Iran and http://www.globalcement.com

[50] According to PBS, cement export to South Africa rose to 1.3 million tons in FY14, as compared to 828 tons in same period of FY09.

[51] Dumping refers to the practice of exporting a product at a lower price than what is charged in the domestic market. Source: http://www.itac.org.za/notices.asp

**Box 2.3: Cement – Large firms dominate the market**

The classification of the cement sector by large and small production units reveals some interesting insights:[52]

- The five large firms account for 56.5 percent of local demand, and 65.0 percent of total cement exports;
- The financials position of large firms is much stronger than smaller firms. Specifically, larger firms are operating with higher profit margins, which shows stronger revenue streams and better cost management (**Figure 2.3.1a & b**);[53]
- To manage costs, big players have switched to energy efficient technologies like: Waste Heat Recovery (WHR) plants; Refuse Derived Fuel (RDF); and Tyre Derived Fuels (TDF). Given the increase in electricity tariffs and GIDC rates, these alternates have now become critical for the survival of the cement sector. In fact, half of the firms in the industry, have already converted to fuel efficient plants, thereby reducing their energy costs **(Figure 2.3.2),** while four of the remaining firms are in the process of installing these units;
- Large firms have reduced their distribution cost by 11.3 percent during Jul-Mar FY14, whereas distribution costs surged by 29.2 percent for smaller companies; [54]
- Both large and small firms have reduced their dependence on banks, and thereby reduced their financing cost by 29.2 and 50.1 percent, respectively, during Jul-Mar FY14 as compared to FY13.[55] This was helped by softening international coal prices;[56] the increase in the domestic prices of cement, and lower lending rates.[57]

**Figure 2.3.1a: Gross Profit Margin (Jul-Mar)**

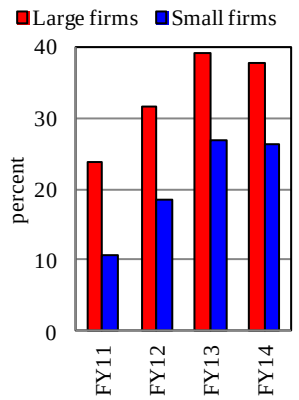
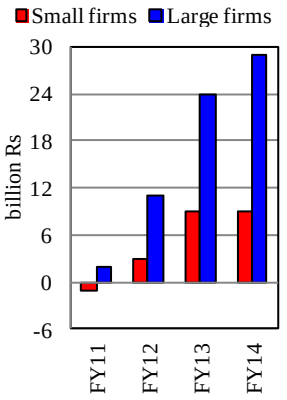
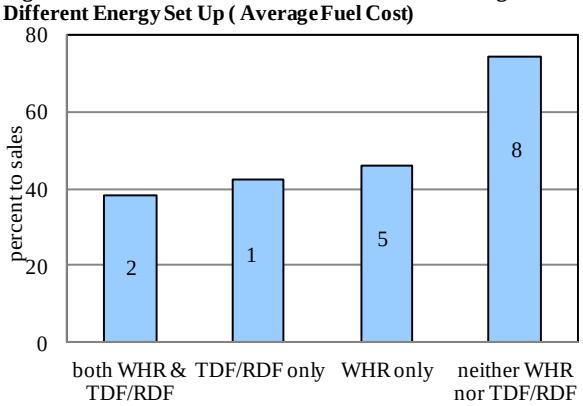



**Figure 2.3.1b: Before Tax Profit of Cement Industry (Jul-Mar)**




Source: Companies' websites

**Figure 2.3.2: Fuel Efficiencies of Cement Plants Having Different Energy Set Up ( Average Fuel Cost)**



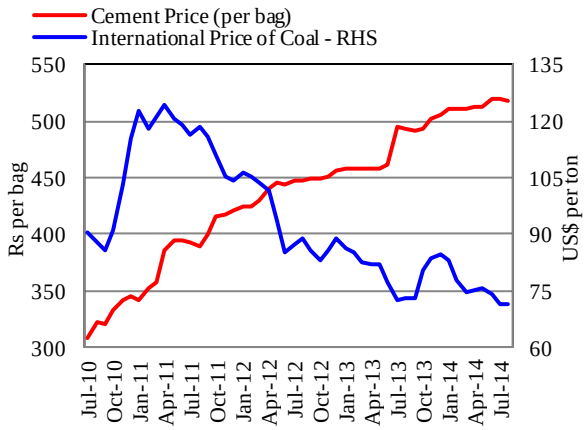

Source: Companies' websites
Figures shows number of plants having these setups

- However, it is important to mention that the impact of the improved cost structure has not translated to lower cement prices. On the contrary, cement prices have been on a rising trend over the past five years (cement price have increased by 74.8 percent after FY10).[58] This is despite a fall in international coal prices, which is a major input for the industry (**Figure 2.3.3**).

[52] Based on production and capacity statistics, Pakistan's cement industry can be divided into two groups of large and small firms: out of 16 listed companies, 5 companies have production capacities of more than 3 million tons per year and can be termed as large units, whereas remaining can be categorized as small units.
[53] Gross profit margin (GPM) of the larger firms is around 43 percent higher than smaller companies.
[54] Specifically, Lucky cement has reduced its cost by introducing its own fleet and by erection of silos at port Qasim.
[55] A steeper decline for the smaller firms is due to their higher leveraging.
[56] International coal prices posted 13.0 percent decline in FY14 compared to last year, falling from an average of US$ 95.2 US$/MT in FY13 to US$ 82.8 US$/MT in FY14.
[57] Despite the 100 bps increase in the policy rates, the weighted average lending rate fell by 19 bps in FY14. This is because banks generally offered attractive rates to the old customers, while new customers were provided credit at increased rates.
[58] Cement prices posted 19.9 percent fall in FY10.

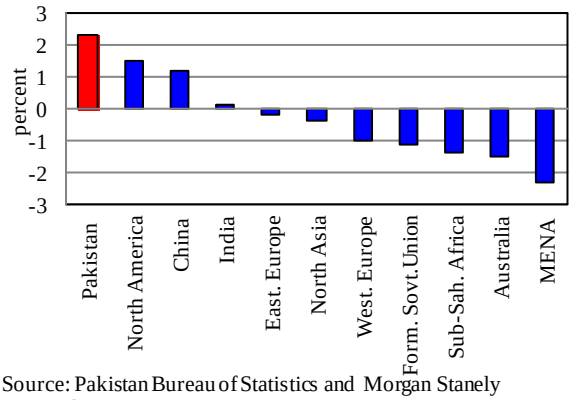
- This trend sharply contrasts with regional peers, where the inflation adjusted YoY growth in cement prices have been falling over the past two years (**Figure 2.3.4**).

**Figure 2.3.3: Cement Price Vs Coal Prices**




Source: Pakistan Bureau of Statistics and World Bank

**Figure 2.3.4: Inflation Adjusted YoY growth in Cement Prices - FY 14**

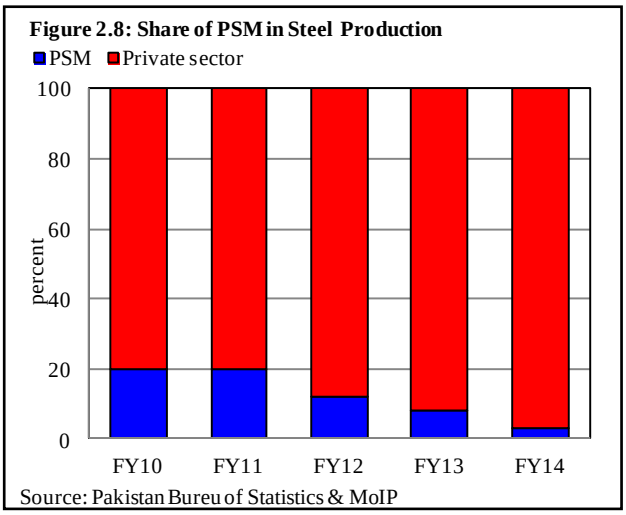



Source: Pakistan Bureau of Statistics and Morgan Stanely Research Estimates

***Suspension of operations in Pakistan Steel Mills (PSM) weighs on steel production***

The deepening liquidity crisis in PSM eventually caused its operations to come to a complete standstill in November 2013, causing its share to decline in FY14 (**Figure 2.8**). [59] It is important to state that PSM is the sole producer of pig iron in the country, which is used as an input for making various steel products.[60] Hence, the closure of PSM operations forced the steel manufacturers in the private sector to rely on imported pig iron. Led by capacity expansions, as well as rapid conversion to alternate energy sources, the privately run steel sector has positioned itself to grow strongly.[61] After excluding the production of PSM, steel manufacturing posted a 18.1 percent increase in FY14, compared to the adjusted growth of 16.9 percent in FY13.

**Figure 2.8: Share of PSM in Steel Production**




Source: Pakistan Bureu of Statistics & MoIP

***Growth in cotton yarn constrained by a host of issues***

Growth in the production of cotton yarn dropped to 1.6 percent in FY14, from 2.1 percent in FY13. This can be attributed to a number of adverse factors: (i) decline in domestic cotton output for a second consecutive year in FY14;[62] (ii) change in China's cotton policy which lowered demand for cotton yarn from Pakistan;[63] (iii) increase in the intensity of seasonal gas shortages in Punjab; and (iv)

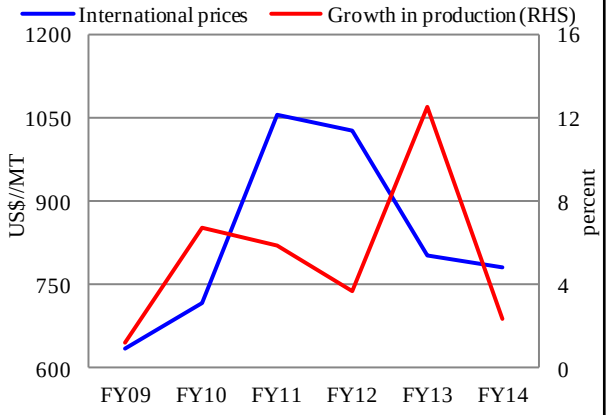
[59] However, the mill started functioning again in May 2014, after the government approved a restructuring plan for PSM amounting to Rs18.5 billion.
[60] Pig iron had 4.8 percent share in overall steel production in FY13, which fell to 1.8 percent in FY14.
[61] One of the Karachi based steel plant (*Amreli steel*) witnessed capacity addition in FY14.
[62] Cotton output fell from 13.6 million bales in FY12 to 13.1 million bales in FY13, and further to 12.8 million bales in FY14.
[63] Pakistan's cotton yarn exports to China posted 10.4 percent decline in Jul-May 2014, compared to the same period last year.

duty free import of cotton yarn from India, which gave tough competition to the local industry.[64] Explaining the last point, the import duty on cotton yarn was reduced from 5 percent to zero in FY10, to ease supply constraints.[65] Although the supply situation did improve quickly, the duty relaxation was kept in place as it suited some players. During FY14, however, the local yarn industry started feeling the negative impact of this relaxation, and was therefore withdrawn by the government in April 2014.

***Base effect from last year pulls down growth in cooking oil***

The growth in edible oil production declined from 12.5 percent in FY13, to only 2.4 percent in FY14. This is because domestic production of edible oil posted very significant growth in FY13, on the back of a sharp (18.1 percent) decline in international palm oil prices. The production of edible oil posted a 23.0 percent increase in FY13, over the past five-year average.[66] While, the production of cooking oil in FY14 was higher than the multi-year peak observed last year, growth reverted back to a normal trend in FY14 (**Figure 2.9**).

**Figure 2.9: Growth in Cooking Oil Production and International Prices**




Source: PBS & IMF

***PKR depreciation takes its toll on Pharmaceuticals***

Manufacturing of *pharmaceuticals* posted a 0.2 percent decline in FY14, compared to the 6.3 percent increase last year. This can be explained by the increase in raw material prices in the first half of FY14, following the depreciation in the PKR; and delays in announcing drug pricing policy in FY14 (**Box 2.4**). The profitability of listed pharmaceutical companies, presented a mixed picture in 2013: gross profit margins of six out of nine listed companies were squeezed in 2013, because of an increase in the cost of production.[67]

**Box 2.4: Pharmaceuticals – Regulatory Issues in Pakistan**

Drug Regulatory Authority of Pakistan (DRAP) was constituted in November 2012, after the functions of the Ministry of Health were transferred to the provinces in June 2011. DRAP is an autonomous body, which comes under the ambit of Ministry of Health Services Regulations and Coordination. Its major functions are:

(1) Pricing: To regulate issues related to the retail pricing of drugs;
(2) Licensing: To issue licenses to manufacture drugs after verification of processing plant and premises; and
(3) Drug Registration: For local manufacturing, or imported medicines;

**Regulatory Issues:**

*Drug pricing:* Pricing of medicines has become a contentious issue in Pakistan. Drug prices are controlled by the government under the Drugs Act, 1976. A numbers of medicines are on a price-freeze since 2001, with various exceptions accorded in the form of hardship allowance.[68] Furthermore, the pharmaceutical industry is demanding an across the board revision in prices to cover the impact of PKR depreciation, and the increase in taxes and power tariffs in the past many years. The formal pricing policy, however, further delayed after the fiscal devolution in June 2011. Anecdotal evidence suggests that pharmaceutical companies increased prices of a number of drugs unilaterally in FY12, after the transfer of Health

[64] Cotton yarn imports from India posted 53.3 percent increase in Jul-May 2014, compared to the same period last year.
[65] SRO 15(1)/2010 dated January 6, 2010.
[66] The international palm oil prices fell from an average of US$ 939.8 per MT in 2012 to US$ 764.2 on average in 2013. Encouraged by this fall, the import of Malaysian RBD palm oil increased from 444.5 thousand MT in Jul-May 2012 to 742.1 thousand MT in the corresponding period of FY13. The production of edible oil stood at 363.4 thousand tones in FY13, which was 23.0 percent higher than the past five-year average of 295.3 thousand tones.
[67] Since most of the companies follow calendar year, these financials do not take into account the appreciation in PKR during H2-FY14.
[68] Hardship allowance is provided to only those products where there is an essential need to increase the price for the continued availability of the drug.

Ministry to the provinces. DRAP formulated a Drug Pricing Committee (DPC) in August 2013, to review matters related to the pricing of drugs. Interestingly, the DPC announced and simultaneously withdrew price increases for a number of drugs in November 2013.[69] The association of pharmaceutical companies, filed a petition in the Sind High Court, against the said withdrawal, which restituted DPC's decision to increase drug prices.[70] We believe an early resolution of this issue, through formulation of a formal drug pricing policy, is required to eliminate uncertainty pertaining to pricing of drugs in the country.

*Import policy:* A clear import policy is required for medicines and raw materials needed for their domestic production. Specifically, medicines, where the active raw materials are produced in the country and can be manufactured locally, should not be imported. Anecdotal evidence suggests that currently, a number of drugs are being imported and sold at prices, which are higher than locally produced medicines.

*Delays in registration and licensing of drugs* have resulted in the entry of illegal medicines into the market.[71] Currently, a large number of applications are awaiting approval for registration of new drugs, and the renewal of licenses. This issue can be partly attributed to the delayed establishment of DRAP in 2012. Furthermore, with a significant backlog created, the domestic market is falling behind in term of the availability of cheaper medicines. There is also a need to strengthen the institutional capacity and resource base of DRAP to expedite the resolution of pending cases.

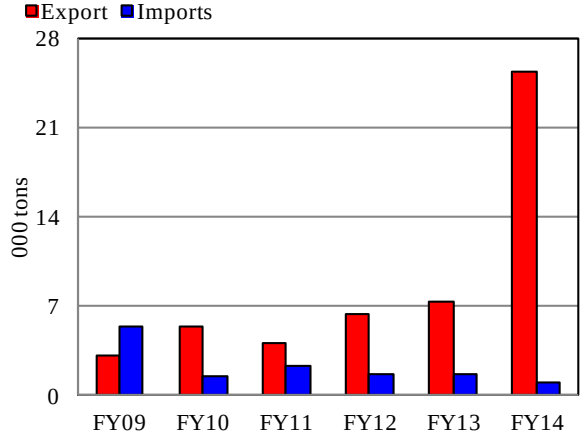
**What can be done?**

- A formal drug policy should be formulated;
- Prioritize life saving medicines in the list of drugs awaiting registration (and renewal of licenses), so that the influx of illegal medicine can be stopped;
- Anomalies in import should be removed to protect the domestic industry and consumers;
- Finally, DRAP to effectively handle issues related to manufacturing; export; import; storage; distribution; and sale of pharmaceuticals in the country.

### *Drag from gas shortages*

The production of *paper & board* posted a slowdown in FY14, compared to the same period last year. This was led by gas shortages in the third quarter of FY14. In the absence of gas, paper mills had to shift to more expensive oil fuel, which negatively impacted their production.

**Figure 2.10: Import & Export Quantum of Float Glass**




Source : Pakistan Bureau of Statistics

The glass sector was also negatively impacted by gas shortages. The overall glass production that is captured by LSM, is based on the production of only four glass manufacturers, where two of these plants faced closures in FY14, on account of non-availability of gas. It is important to note that PBS does not take into account the production of one of Pakistan's leading *float* glass[72] manufacturer, which started operations in FY12. Anecdotal evidence suggests that after adjusting for this factor, glass production may have actually improved during the course of FY14. This is also evident from a sharp increase in *float* glass exports in FY14 (**Figure 2.10**).

### *Sectors posting strong growth:*

Improved availability of gas to fertilizer was the key development of FY14.[73] This helped the fertilizer sector and hence overall LSM to post decent growth in FY14. As mentioned in previous reports, the fertilizer plants operating on Mari gas performed better than their counterparts on

[69] S.R.O.1002 (1)/2013 dated November 27, 2013.
[70] Overseas Investors Chamber of Commerce & Industry, Annual Report (2013).
[71] A legitimacy certificate is awarded for a specific period, usually two years, to the manufacturer which requires renewal after expiry for the continuity of its production.
[72] Float Glass, a crystal clear glass sheet, is different from ordinary glass sheet due to its production technology.
[73] For details see *First Quarterly Report* for FY14.

SNGPL's network (**Table 2.9**). Specifically, the diversion of gas to *Enven* (the largest plant in South Asia) from Guddu power plant, went a long way in boosting fertilizer production in FY14. Encouragingly, this improved gas supply from Mari is still continuing, which augurs well for the performance of fertilizer in FY15.

**Table 2.9 : Urea Production (000 tons)**

| | | | Production | | Share | |
|---|---|---|---|---|---|---|
| **Company** | **Gas field** | **Capacity** | **FY13** | **FY14** | **FY13** | **FY14** |
| EFERT | SNGPL &MGCL | 2,275 | 1,076 | 1,732 | 25.5 | 35.6 |
| FFC | | 2,599 | 2,684 | 2,606 | 63.7 | 53.6 |
| Fauji (Pak-Saudi) | MGCL | 718 | 840 | 810 | 19.9 | 16.7 |
| Fauji (G. Machi) | MGCL | 1,330 | 1,587 | 1,583 | 37.6 | 32.6 |
| FFBL | SSGC | 551 | 257 | 213 | 6.1 | 4.4 |
| Fatima | | 592 | 296 | 373 | 7.0 | 7.7 |
| FATIMA | MGCL | 500 | 296 | 366 | 7.0 | 7.5 |
| Pak-Arab | SNGPL | 92 | 0 | 7.0 | 0.0 | 0.2 |
| DHCL | SNGPL | 446 | 47 | 43 | 1.1 | 0.9 |
| AGRITECH | SNGPL | 433 | 113 | 106 | 2.7 | 2.2 |
| **Total** | | **6,345** | **4,216** | **4,860** | | |

Source: Various reports of National Fertilizer Development Centre

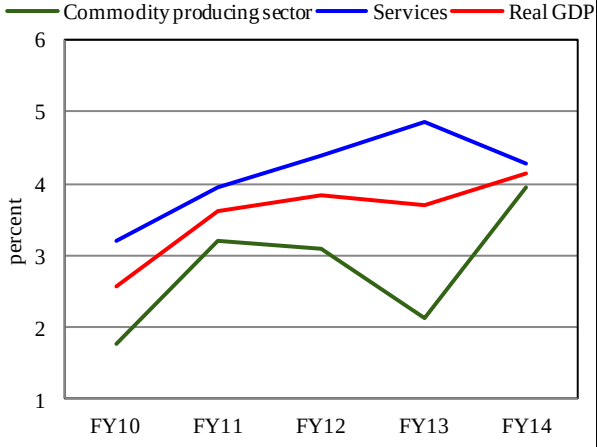
Driven by record sugarcane production, sugarcane crushing posted a 10.0 percent growth in FY14, despite higher carryover stocks from last year and depressed domestic prices (**Table 2.10**). In fact, higher production of sugar created some excess supply in the market. To counter the impact of excess supply, the government purchased sugar through TCP, and allowed sugar mills to export the surplus.[74] Surprisingly, the sugar export quota for FY14 was set at a lower level than last year. Hence, sugar exports recorded a 39.0 percent quantum decline during FY14, compared to the previous year.[75] Meanwhile, the unsold stock caused liquidity pressures for sugar mills, which restricted retirement and increased credit appetite for working capital in FY14, compared to last year.

**Table 2.10: Dynamics of Sugar Industry**

| | | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **Production** | | | | |
| Sugarcane | 000 MT | 58,397 | 63,750 | 66,469 |
| Sugar | 000 MT | 4,634.1 | 5,073.5 | 5,582.4 |
| **Exports** | 000 MT | 48.7 | 1,061.5 | 647.3 |
| **Credit** (flows) | billion Rs | -1.2 | 12.5 | 39.3 |
| Working capital | billion Rs | 2.9 | 3.5 | 28.1 |
| Fixed investment | billion Rs | -4.1 | 9.0 | 11.2 |

Source: Pakistan Bureau of Statistics; State Bank of Pakistan

**Figure 2.11: Commodities and Services Growth**




Source: Pakistan Bureau of Statistics

### *Outlook*

The performance of LSM sector is expected to improve in FY15, as some of the issues discussed earlier are likely to be resolved. More specifically, growth in *edible oil* may improve after the base effect washes out.[76]

The *automobile* sector is likely to recover with the reduction in GST on tractors in the FY15 budget; the launch of the much awaited Toyota

[74] TCP purchased 408.6 thousand MT sugar from sugar mills, in FY14.
[75] For details, see **Chapter 5.**
[76] Edible oil refining posted 7.5 percent increase in Q4-FY14, after recording negative growth in the previous two quarters, due to base effect.

Corolla will boost domestic demand; and the yellow cab scheme announced by the government of Punjab. In the case of *cement*, while exports will continue to remain depressed, domestic demand will pick up, if development projects announced in the FY15 budget are implemented (e.g., Khanki barrage, *bhasha* dam, etc). Improved gas supply to fertilizer, which was initially planned to be discontinued in April 2014, is still in place, which will also help reduce Pakistan's reliance on imports. And, still another bailout package has been announced for PSM, which will keep this entity operating.

## 2.4 Services

Although the commodity producing sectors showed a revival in FY14, the services sector could not maintain its momentum seen in the last four years (**Figure 2.11**). The slowdown was mainly due to sluggish growth in *finance and insurance* and *general government services*.[77] Resultantly, the contribution of services to real GDP growth also declined sharply from 75.4 percent last year, to 60.1 percent during FY14 (**Table 2.11**).

*Wholesale & retail trade* is the largest component of services, which shows the trading margins of commercial activities.[78] PBS estimates its value addition by applying fixed ratios of tradable surpluses and traders' margins, on domestic commodity producing sectors and imports. The growth in this sub-sector was 5.2 percent during FY14, mainly on the back of higher growth in major crops and the real increase in imports.[79]

*Transport, storage & communication* maintained its last year's growth of 3.0 percent in FY14 (**Table 2.12**). The value addition by road transport (having more than 76 percent

**Table 2.11: Growth in Services Sector**

| | | | % Contribution to GDP growth | |
|---|---|---|---|---|
| | FY13 | FY14 | FY13 | FY14 |
| Wholesale & retail trade | 3.4 | 5.2 | 16.9 | 23.0 |
| Transport, storage & communication | 2.9 | 3.0 | 10.3 | 9.5 |
| Finance & insurance | 9.0 | 5.2 | 7.2 | 3.9 |
| Housing services | 4.0 | 4.0 | 7.3 | 6.5 |
| General govt. services | 11.3 | 2.2 | 20.5 | 3.8 |
| Other private services | 5.2 | 5.8 | 13.3 | 13.4 |
| **Overall services** | **4.9** | **4.3** | **75.4** | **60.1** |

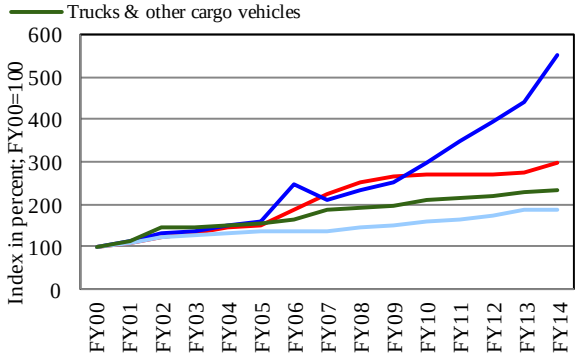
Source: Pakistan Bureau of Statistics

**Table 2.12: Growth in Transport, Storage & Communication**

| | % share | % Growth | |
|---|---|---|---|
| | | FY13 | FY14 |
| Road | 76.4 | 4.0 | 3.7 |
| Air | 4.9 | 20.3 | 6.1 |
| Water | 2.7 | 5.0 | -1.7 |
| Pipeline | 0.4 | 10.2 | 8.5 |
| Railways | 0.1 | -47.6 | 10.3 |
| Communication | 11.9 | -4.7 | -0.4 |
| Storage | 3.7 | 3.2 | 5.2 |
| **Total** | **100.0** | **2.9** | **3.0** |

Source: Pakistan Bureau of Statistics

**Figure 2.12: Trend in Road Transport**




Source: Pakistan Bureau of Statistics

[77] An analysis of past trends indicates that these two components experience major revisions in subsequent years.
[78] In fact the wholesale and retail trade is the largest sub-sector of overall GDP in Pakistan, having share of more than 18 percent. It is followed by livestock (11.8 percent of GDP) and large-scale manufacturing (10.9 percent).
[79] Import data for Jul-Mar FY14 was available at the time of compilation of National Income Accounts. During this period, imports in real terms (i.e., rupee value of imports adjusted for changes in unit value index) showed a growth of 4.2 percent, compared with -1.6 percent in the corresponding period last year.

share in this sub-sector) remained more or less stagnant. Road transportation covers only *commercial* vehicles,[80] which are showing sluggish growth. In particular, the growth in number of commercial vehicles for passengers use, which has the largest share in road transport value addition, has declined significantly (**Figure 2.12**). As only commercial vehicles are counted in this sub-sector, the increasing use of private cars and motorcycles does not directly impact GDP.[81]

Pakistan Railways, however, has shown growth of 10.3 percent, compared to negative growth last year. Revenues rose to Rs 25 billion in FY14, from Rs 18 billion in FY13 (a growth of 38.9 percent). This was made possible by increasing locomotives for cargo services (from 8 to 25); attracting more passengers by reducing fares, improving general facilities and rail timings (timeliness increased from 10 to 55 percent), and increasing fuel reserves to ensure smooth operations of trains.

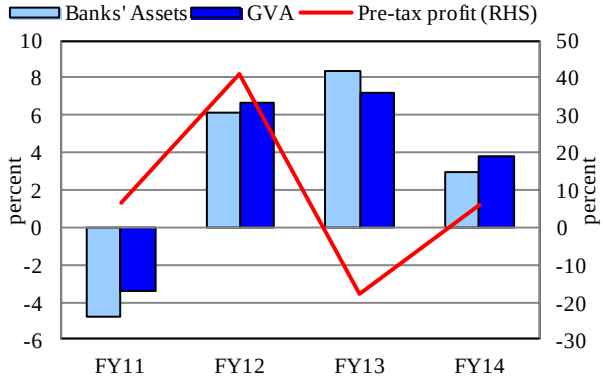
**Table 2.13: Growth in Finance and Insurance**

| | | % growth | |
|---|---|---|---|
| | % share | FY13 | FY14 |
| SBP | 3.1 | 3.2 | 6.8 |
| Banks | 82.2 | 7.2 | 3.8 |
| Leasing | 0.6 | 0.0 | -19.7 |
| Other credit granting | 0.9 | 19.3 | -2.5 |
| Insurance & pension fund | 5.5 | 34.3 | 32.0 |
| Auxiliary activities | 7.6 | 20.6 | 7.5 |
| **Overall** | **100.0** | **9.0** | **5.2** |

Source: Pakistan Bureau of Statistics

Within the aviation sector, Pakistan International Airline (PIA) was able to reduce its losses during the first half of CY2014, mainly due to higher revenues and the exchange gain from PKR appreciation against major currencies.[82] The financial support from the government, and the improved performance, facilitated the national airline to acquire three narrow-body aircrafts on dry lease.[83,84]

**Figure 2.13: Growth in Banks' Gross Value Added**




Note: Like GVA, growth in Banks' assets and pre-tax profit are also in real terms.
Source: Pakistan Bureau of Statistics & State Bank of Pakistan

Communication services, having a 11.9 percent share in this sub-sector, continued to decline in FY14 as well.[85] Several factors impacted the telecommunication sector: increased competition amongst service providers (which has pulled down average revenue per user);[86] higher tax incidence; strict regulations on the sale of new SIMS; and sluggish income growth during the last few years.

However, going forward, it is expected that telecommunications will gather pace with the launch of 3G/4G technology and introduction of new facilities like domestic fund transfer by cellular companies that is being done in collaboration with commercial banks.

[80] It includes buses, trucks, station wagons, pickups, taxis, rickshaws, and non-mechanized vehicles. The PBS has estimated benchmark value addition by each type of vehicle for the base year. For subsequent years, growth in number of vehicles is used.
[81] However, private use of such vehicles appears in private consumption.
[82] Net loss to PIA fell from Rs 18.4 billion in H1-CY2013, to Rs 10.1 billion in H1-CY2014.
[83] As a result of a package approved by the government in February 2013, PIA received a support of Rs 11.8 billion during CY13, and Rs 2.9 billion in the current calendar year.
[84] The airline is also planning to expand its fleet by seven narrow-body aircrafts, to be secured on wet-lease basis.
[85] PTCL and cellular phone service providers bag the largest share followed by courier services.
[86] According to PTA Annual Report FY13, Average Revenue Per User (ARPU) declined to Rs 211 per month in FY13 from Rs 217 a year before. Besides increased competition among service providers, addition of low income users in the subscribers' base has also affected ARPU.

Growth in *finance & insurance* has declined considerably from 9.0 percent in FY13 to 5.2 percent in FY14. The slowdown in value addition by commercial banks (the largest component in this sector), overshadowed the higher growth posted by the State Bank of Pakistan (**Table 2.13**).

Although commercial banks profitability increased during FY14, growth in their value added was lower when compared with the last year (**Figure 2.13**). PBS estimates banks' GVA by an indirect method, called Financial Intermediation Services Indirectly Measured (FISIM), which takes in to account a larger set of information than just profits. Interestingly, GVA of commercial banks appears more in line with the trend in overall assets, which grew by just 3.8 percent in FY14, in real terms, compared with 7.2 percent in FY13.[87]

Finally, the growth in value addition by *general government services* slowed to just 2.2 percent, which was considerably lower than last year's growth rate of 11.3 percent. The main component of value addition by this sector, is the compensation of government employees. Salaries of government employees recorded an increase of 10 percent during FY14, which was lower than the 20 percent rise a year before. Consequently, the growth in general government services was also lower this year.

[87] In nominal terms, banks assets showed a growth of 10.2 percent in FY14, compared with 16.6 percent in FY13.

## Special Section 2.1: Comparison with India: Where Does Pakistan Stand in Automobiles Production? [88]

Although Pakistan and India share the same vision for their automobile sectors (promotion of local technology and designs, less dependency on imports, and achieving international competitiveness), Pakistan has not been as successful in achieving these objectives. A comparison of the dynamics of the automobile industry in Pakistan and India, highlights a number of issues impeding the performance of the domestic industry.

**Table S2.1: Comparison of Car Manufacturers and Their Products (2013)**

| Pakistan | | India | |
|---|---|---|---|
| **Car Manufacturers** | **No. of Products** | **Car Manufacturers** | **No. of Products** |
| Pak Suzuki | 6 | Tata | 17 |
| Honda | 2 | Maruti | 12 |
| Indus Motors | 3 | Mahindra | 17 |
| Hyundai | 2 | Hyundai | 6 |
| | | Nissan | 4 |
| | | Honda | 6 |
| | | Ford | 4 |
| | | Toyota | 10 |
| | | Chevrolet | 9 |
| | | Renault | 6 |
| | | VW | 9 |
| | | Others | 12 |

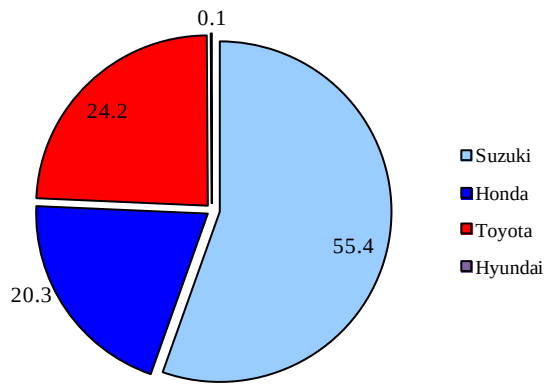
Source: PAMA and Official Websites of Indian Car Manufacturers

### *Profile of India and Pakistan's Automobile industry*

Pakistan's auto industry is characterized by a few assemblers, and a limited number of products (**Table S2.1**), whereas the picture is different in India, where a large number of manufacturers are producing a wide range of models (**Figure S2.1a &S2.1b**). The availability of more options creates tough competition in the Indian market, which increases consumer welfare.[89]

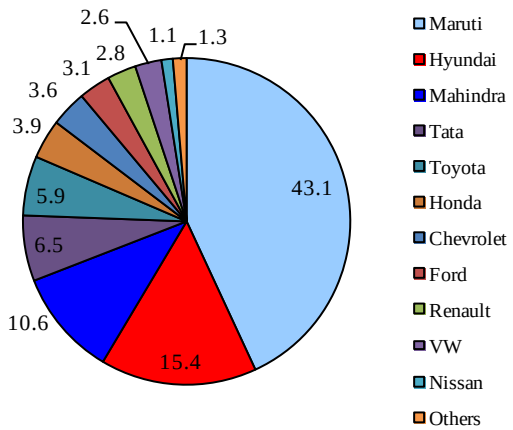
In the case of Pakistan, with only a few producers that are protected from foreign competition, producers are able to offer few products and charge high prices. A comparison of average retail prices in Pakistan and India indicates significant disparities in prices in all engine capacities (**Table S2.2**).

**Figure S2.1a: Share of Car Manufacturers in Pakistan**




Source: PAMA

**Figure S2.1b: Share of Car Manufacturers in India**




Source:Team-BHP.com

[88] Ownership of this section goes to Syed Zulqernain Hussain, Deputy Director and Sabina Khurram Jafri, Sr. Joint Director Economic Policy Review Department, SBP.

[89] As defined in microeconomic theory, any product sold in a market environment, creates welfare (utility) for both consumers and producers. In an efficient market, consumers should realize the bulk of the welfare. In Pakistan's automobile sector, producers gain at the expense of consumers.

Despite charging higher prices, the local industry in Pakistan does not provide much variety to buyers. Furthermore, as shown in the sales data, demand dynamics differ in these countries (**Table S2.3):** in India, demand for 800-1000cc cars dominates the market, while in Pakistan, larger cars (1300cc and above) are just as popular. This is very surprising as India and Pakistan have similar socio-economic foundations, and have similar demand patterns. This is perhaps because there is only one assembler in the 800-1000cc category in Pakistan since FY13. Interestingly, before the phasing out of two popular models in the 800cc category in FY12, the market segmentation was not as skewed in Pakistan.

**Table S2.2: Average Car Price in 2012**

Pak Rupees in thousands

| Engine Size | India | Pakistan | Difference |
|---|---|---|---|
| 800cc | 247.5 | 520.0 | 272.5 |
| 1000cc | 446.7 | 737.0 | 290.3 |
| 1300cc | 702.3 | 1,474.0 | 771.7 |
| 1800cc | 1,230.0 | 1,839.0 | 608.4 |

Source: Report on India-Pakistan Trade, A Case Study of the Automobile Sector by SDPI (2012)

**TableS2.3: Share in Total Sales (in percent)**

| | **India** | **Pakistan** | |
|---|---|---|---|
| | **2012** | **FY12** | **FY13** |
| 800-1000cc | 80 | 40 | 21* |
| 1000-1300cc | 18 | 21 | 30 |
| 1300cc and above | 2 | 39 | 49 |

Source: Official websites of manufacturers/Assemblers; and Report on India-Pakistan Trade, A Case Study of the Automobile Sector by SDPI (2012)

*After the phase out of two models, there is only one model in this category.

### *Capacity Utilization*

Pakistan's automobile industry is utilizing only 50 percent of its capacity (**Table S2.4**) which is much higher at 75 percent in India.[90] As mentioned earlier, the product range in Pakistan is limited compared to India and the demand of domestically produced cars is stagnant. As a result, consumers prefer imported products over domestic ones, as they offer more options.[91] If consumers in Pakistan have a wide range of domestically produced models, it would lead to an increased demand and higher capacity utilization.

**Table S2.4: Capacity Utilization (in percent)**

| | **FY12** | **FY13** | **FY14** |
|---|---|---|---|
| Suzuki | 58.8 | 44.1 | 42.9 |
| Toyota | 92.7 | 65.8 | 56.2 |
| Honda | 25 | 42.5 | 47.2 |

Source: PAMA

### *Strength of India's automobile industry*

The most important strength of India's automobile industry is greater indigenization and domestic availability of raw materials. The industry has developed the capability to produce all automotive parts, ranging from engines, transmission apparatus, suspensions, brakes, body parts and chassis parts.[92] This has made Indian auto sector not only immune from exchange rate fluctuations, but has also helped reduce its cost of production.[93] In addition, India has the advantage of economies of scale because of a large domestic market. Furthermore, competition from a number of domestic manufacturers has created more efficiency in the Indian auto sector.

*Government policies:* India has adopted a highly protectionist regime for its automobile sector. Not only are import duties kept high, the import of used cars is subject to strict restrictions: (i) import duty on cars is 100 percent; (ii) new vehicles can only be imported via the ports of Mumabi, Chinnai and Kolkata; (iii) cars older than three years cannot be imported; (iv) used cars can only be imported through the port at Mumbai; and (v) import of vehicles with engine sizes 1000 cc-2500cc, is totally banned.[94]

[90] Report on India-Pakistan Trade, A Case Study of the Automobile Sector by SDPI (2012)

[91] Used cars imports increased from 7,154 units in FY11 to 18,986 units in FY12 when the age limit of imported car was increased to 5 years.

[92] Source: http://www.dhi.nic.in/draft_automotive_mission_plan.pdf

[93] Hundayi sources 90 percent of its components locally (Hyundai Motors India Ltd). http://www.hyundai.com/in/en/AboutUs/AboutHyundai/index.html. India's Maruti Suzuki is also working on to develop its first fully 'made in India' car.

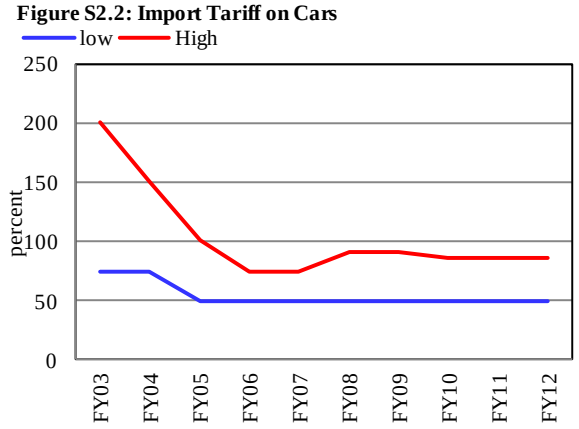
[94] Source: http://india.angloinfo.com/transport/vehicle-ownership/importing-a-vehicle/

***Downsides of Pakistan's Industry:***

In Pakistan, the deletion program (which sought to shift away from imported inputs) was introduced in 1985. Although the industry was kept heavily protected as a part of deletion program, it was unable to achieve the staggered indigenization that has been envisaged. Furthermore, this plan had to be completed by 2006 to remain compliant with WTO's agreement on Trade Related Investment Measures (TRIMs), which disallowed countries to place local content requirements on domestic manufacturing sectors.

After the deletion program, Pakistan adopted a Tariff Based System (TBS) under the Auto Industry Development Program I (AIDP-I) for the period FY06 -12. The objective was to achieve a critical mass of production by FY12, which is required to develop high value added sub-sector in the auto industry. Specifically, the auto sector was targeted to produce 500,000 cars by end-June 2012. To achieve this objective, a long-term import duty structure was announced to help local assemblers formulate their production policies (**Figure S2.2**). While the industry was kept highly protected during 1985-2006, duties were lowered in the development phase (FY06-12). However, actual production of cars stood at 132,661 in FY12, which is far below the target.

**Figure S2.2: Import Tariff on Cars**

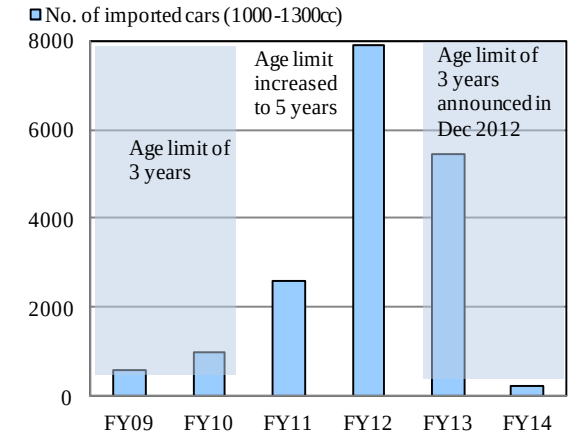



Source: Auto Industry Developemnt Program (AIDP), Ministry of Indsutires, Production & Special Initiatives, GoP

Pakistan's auto sector is still significantly dependent on imports, as indigenization is limited to the manufacturing of sheet metal parts, interior trim, seats, rubber & plastic parts, batteries, wheel rims, tyres, and lighting accessories. The more sophisticated moving parts (engine, transmission, etc.) that require precision engineering are all imported because Pakistan is unable to produce these components to their international standards. This implies that a significant part of the cost of production, is vulnerable to movements in the exchange rate, which forms the basis of frequent increases in retail prices. Pakistan currently imports 57 percent of its total auto-related raw materials from Japan, and Yen movements against the PKR, plays an important role in the final price.

The government has also been inconsistent with its import policy for used cars. In an attempt to incentivize the local industry, the government reduced the age limit for used cars from 5 to 3 years in December 2012.[95] As a result, imports of used Completely Built Units (CBUs) declined substantially (**Figure S2.3**). Such anti-competitive policies favor producers over consumers.

**Figure S2.3: Changes in Import Policy for Used Cars**




Source: Pakistan Bureau of Statistics

**What can be done?**

The above comparison highlights the inability (and unwillingness) of the domestic industry to

[95] The government had previously eased restrictions on used car imports in FY06; allowing imports aged up to 10 years. However this was lowered to 3 years by FY09. This was again eased to 5 years in FY11.

provide better quality vehicles at competitive prices. The dependence on imported components could not be phased out despite a long phase of protection. We believe a more balanced development of Pakistan's automobile sector, requires increasing the level of competition by opening up the market to imports. In this regard, we endorse the assessment of the Competition Commission of Pakistan, which has advocated the need to reduce protection of the local market and allow the import of new cars.[96] Having said this, Pakistan's automobile sector should be provided a long-term policy environment, which should focus on: (i) developing local auto parts, to reduce dependence on imports; (ii) avoiding frequent changes in the tax regime and import policy; (iii) making all efforts to attract FDI in this sector; and (iv) encouraging the production of small fuel efficient cars (with engine capacity below 1000cc).

[96] Source: Competition Impact Assessment Report on the Automobile Industry of Pakistan, February 2103, Competition Commission of Pakistan.