

## 2 Economic Growth

### 2.1 Overview

The overall domestic economic activities gained further momentum in FY16, as energy and security situation improved (**Figure 2.1**). Specifically, real GDP growth reached 8-year high of 4.7 percent, despite global headwinds. While visible gains in industry and services contributed the most to this better growth performance, the agriculture sector recorded a decline due to severe losses to the cotton crop.

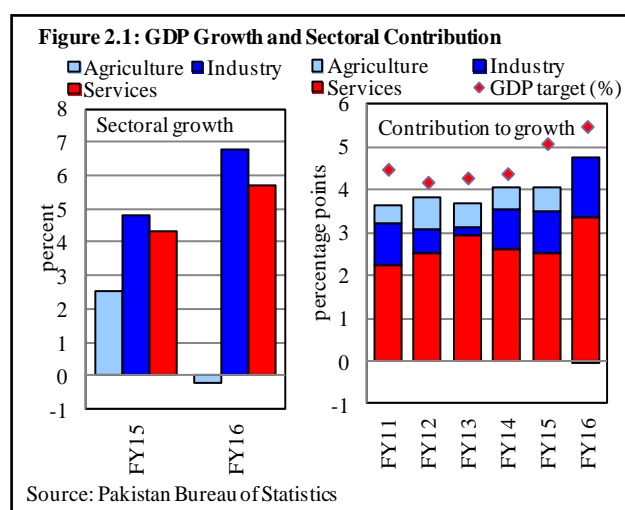
The continuing robust construction activities (both in public and private sector), better availability of gas, persistent increase in the demand for consumer durables (particularly for automobiles) and fall in prices of key raw materials in the global market, contributed to industrial growth of 6.8 percent this year. More importantly, this higher growth was realized despite global economic slowdown and resulting weakness in demand, which also pulled down the country's exports during the year.

This upsurge in industrial performance also had a significant spillover on *wholesale & retail trade* – one of the major components in the services sector. Meanwhile, other sub-sectors in services, such as *general government* and *finance and insurance*, also showed higher growth than the last year. Thus, services registered a growth of 5.7 percent in FY16, compared to 4.3 percent in the previous year.

Agriculture, on the other hand, faced a major setback this year as well. Yet, unlike past years when adverse weather inflicted damages, this year's stress stemmed from insects and pest attacks on cotton crop in Punjab. The crop losses were compounded by the slump in domestic cotton prices, particularly during Jul-Sep 2015 period, which prompted growers to vacate their fields earlier from cotton for next *rabi* crop sowing. Therefore, the cotton output declined by 29 percent over the last year. The performance of other key crops was also not encouraging. The value addition by the crop sector therefore fell by 6.3 percent in FY16. However, a growth in livestock contained the decline in overall agriculture to 0.2 percent.

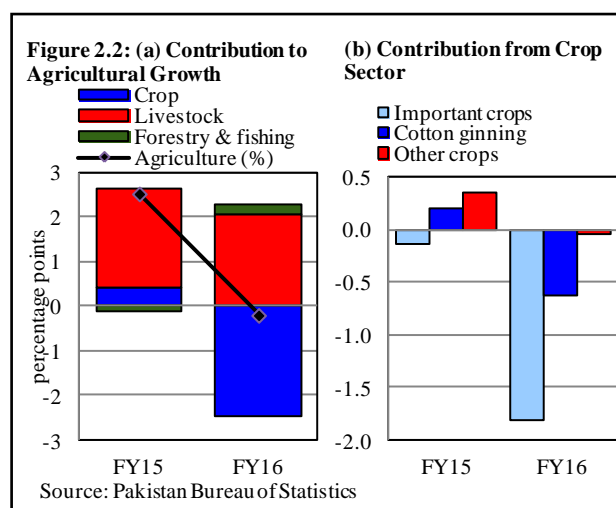
While the GDP growth benefited from improved macroeconomic stability (e.g., low inflation, contained fiscal deficit, largely stable exchange rate and rising FX reserves) and better security situation, the support from public policy was also visible. For example, increased focus on infrastructure projects drove growth in construction and related industries; Apna Rozgar scheme created demand for passenger cars and commercial vehicles; LNG imports improved gas availability to several industries and the power sector; and low interest rates helped businesses.

Focusing on energy, the availability of both gas and power remained higher than the previous year. The power sector in particular benefited from LNG imports and increased hydel-based generation. That said, the vulnerability of the transmission and distribution network continued to be a major constraint.



## 2.2 Agriculture

The agriculture sector has been under stress for the past several years due to frequent weather-related shocks and depressed commodity prices.<sup>1</sup> FY16 was no different, as erratic and heavy rains (mainly reflecting the impact of El Niño weather pattern) adversely impacted the *kharif* crops, particularly cotton in Punjab.<sup>2</sup> The losses to cotton crop were compounded by insect and pest attacks. Thus, the overall production of cotton could reach only 9.9 million bales, which was 29 percent lower than the level realized last year. In fact, cotton-related losses were large enough to offset the gains from better wheat and sugarcane crops and growth in livestock.<sup>3</sup> Hence, the value addition in the agriculture sector registered a decline of 0.2 percent, against a growth of 2.5 percent last year (Figure 2.2).



The input utilization was not encouraging either, particularly during *kharif* when urea off-take fell by 10.7 percent and water availability went down by 5 percent over the corresponding season last year. In addition, a further decline in global agriculture commodity prices during FY16 added to difficulties faced by both growers and policymakers.<sup>4</sup> The government support on output prices largely protected wheat and sugarcane growers from the impact of subdued commodity prices in the international markets.<sup>5</sup> But rice and cotton growers faced greater challenge when the fall in domestic prices of these commodities squeezed their incomes. In order to support such growers, the government announced a relief package of Rs 341 billion for agriculture, which included direct cash support and provision of soft agriculture loans.<sup>6</sup> As a part of this package, the government also announced several tax concessions for the agriculture sector, and set up a fund to reduce the price of fertilizer in the country.

<sup>1</sup> Since the floods of July 2010, the most devastating in recent history, the country has been facing small but punitive weather-related shocks, practically every year. In August 2011, floods in central and lower Sindh damaged the cotton crop. The monsoon rains in 2012 adversely affected rice and cotton crops in southern Punjab and peripheral Balochistan. In August 2013, floods again destroyed the rice crop in central Punjab. The September 2014 floods proved detrimental to cotton, rice and sugarcane, particularly in the districts of Jhang, Muzaffargarh, Multan and Sargodha. Later on, the wheat crop suffered particularly in KP and Punjab from hailstorm in April 2015.

<sup>2</sup> El Niño brings powerful effect on the weather around the world. The last El Niño (which was formed in mid-2014 and continued till mid-2016) was one of the strongest on record that led to extreme global temperatures (the American Meteorological Society has declared 2015 as the warmest year in the recorded history of planet earth). According to National Oceanic and Atmospheric Administration (USA), El Niño delayed the onset of monsoon in the Indian Ocean, and caused unpredictable rain pattern in the subcontinent.

<sup>3</sup> Adjusting for cotton crop, the agriculture sector shows a growth of around 2 percent, almost at par with last year.

<sup>4</sup> The World Bank price index for agriculture commodities has fallen by over 23 percent during the past 5 years ending June 2016.

<sup>5</sup> For example, the government maintained the wheat support price for the 2015-16 crop at Rs 1,300 per 40 kg, which comes to around US\$ 312 per metric ton. At this level, the domestic procurement price was way above the average of US\$ 170.8 during FY16 for wheat at Chicago Board of Trade. Similarly, provincial governments of Sindh and Punjab announced indicative sugarcane price at Rs 172 and Rs 180 per 40 kg respectively, which let the domestic market price for sugar to average at Rs 62.5 per kg (or US\$ 600 per metric tons). Again, this price was significantly higher than the average of US\$ 418.9 for FY16 in the global market. Such price support was not available for cotton and rice.

<sup>6</sup> The direct cash support included a subsidy of Rs 40 billion for those rice and cotton growers who hold up to 12.5 acres land. For details, see **Box 2.1** in SBP's First Quarterly Report on *The State of Pakistan's Economy* for FY16.

Another policy challenge pertained to gradual build-up of wheat and sugar stocks over the years.<sup>7</sup> Specifically, the attractive support prices for wheat and sugarcane crop increased their production to levels that exceeded even their domestic consumption. Although the government offered high rebate on the export of surplus stocks, this was not sufficient to boost exports due to wide margin between domestic and international prices (**Chapter 3**).

### 2.2.1 Crop sector

In FY16, cotton production missed the target of 15.5 million bales by a wide margin, as the crop of 9.9 million bales during the year represented a decline of 29 percent over last year (**Table 2.1**).<sup>8</sup> The untimely and excessive rains, mainly related to El-Niño weather pattern, inflicted direct damages to crops, and also washed away fertilizer and pesticides applied earlier. Meanwhile, moist season and moderate temperatures attracted white fly and boll-worms (especially pink boll-worm) attacks, thereby resulting in significant crop damages.

The growers faced setback when cotton prices declined significantly (by 17.8 percent) in the domestic market, particularly during Jul-Sep 2015. Sufficient domestic stocks and higher import of cheaper (and better quality) cotton kept market prices low.<sup>9</sup> This slump in cotton prices induced growers to vacate their fields early from cotton to minimize losses (instead of waiting for third or fourth picking), leading to a further decline in crop productivity.

An early recovery of land from cotton cultivation, however, allowed timely sowing of wheat and sugarcane crops. In addition, as mentioned earlier, high support price provided considerable financial incentive for wheat growers. As a result, not only the area under wheat reached a record high level for the third successive year, the production also increased to 25.5 million tons – very close to the highest-ever output of 26.0 million tons realized in FY14. Interestingly, this was yet another year when wheat production exceeded domestic consumption, resulting in a further build-up of wheat stocks in the country.<sup>10</sup> Disposing off this excessive stock has now become a major policy challenge for the government (**Box 2.1**).

**Table 2.1: Performance of Important Crops**

	FY14	FY15	FY16	Growth (%)	
				FY15	FY16
<b>Area (in 000 hectares)</b>					
Cotton	2,806	2,961	2,902	5.5	-2.0
Rice	2,789	2,891	2,740	3.7	-5.2
Sugarcane	1,173	1,140	1,132	-2.8	-0.7
Wheat	9,199	9,204	9,260	0.1	0.6
Maize	1,168	1,142	1,160	-2.2	1.6
<b>Production (in 000 tons; for cotton 000 bales)</b>					
Cotton	12,769	13,960	9,917	9.3	-29.0
Rice	6,798	7,003	6,801	3.0	-2.9
Sugarcane	67,460	62,826	65,482	-6.9	4.2
Wheat	25,979	25,086	25,483	-3.4	1.6
Maize	4,944	4,937	4,984	-0.1	1.0
<b>Yield (kilograms per hectare)</b>					
Cotton	774	802	581	3.6	-27.6
Rice	2,437	2,422	2,482	-0.6	2.5
Sugarcane	57,560	55,111	57,846	-4.3	5.0
Wheat	2,824	2,726	2,752	-3.5	1.0
Maize	4,233	4,323	4,297	2.1	-0.6

Source: Pakistan Bureau of Statistics

#### Box 2.1: Growing Domestic Wheat Stocks

The wheat stock at early-May 2016 reached 5 million tons, which was almost 50 percent higher than the May 2015 level. This growing wheat stock poses one of the major policy challenges for the government. During FY15, federal and provincial authorities announced a combined subsidy amounting to US\$ 90 per ton for exports of 1.2 million tons of wheat. Despite this incentive, only 7 percent of the export target was met. The situation remained more or less unchanged during FY16, when the government maintained the export subsidy at the FY15 level, but set the export target at 0.6 million tons.<sup>11</sup> The actual exports reached only 8,000 tons (1.3 percent of the target).

<sup>7</sup> Wheat stocks with procuring agencies reached 5.0 million tons as of May 1, 2016 from 3.4 million tons a year earlier (Source: Pakistan Economic Survey 2015-16). Similarly, carryover stock of sugar, which reached 1.3 million tons by October 2015, is likely to rise further to 1.6 million tons by October 2016 (Source: Pakistan Sugar Mills Association).

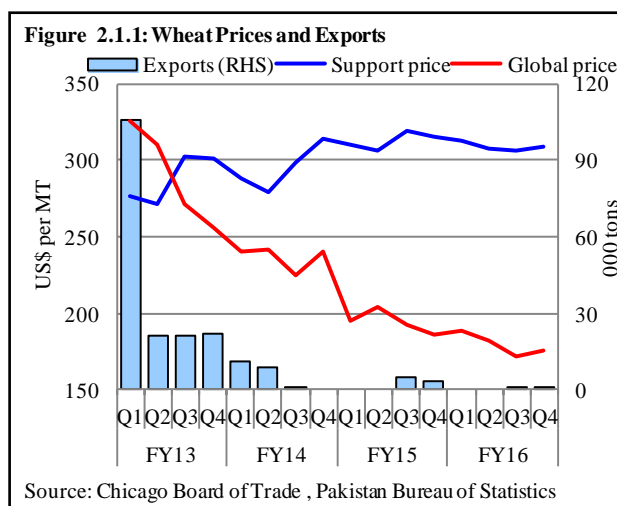
<sup>8</sup> The last time cotton recorded such a massive decline was in FY93 when production dropped by 29.4 percent.

<sup>9</sup> Import of raw cotton reached 0.43 million tons in FY16 from 0.15 million tons last year.

<sup>10</sup> US Department of Agriculture (USDA) estimates annual domestic consumption of 24.5 million tons in Pakistan.

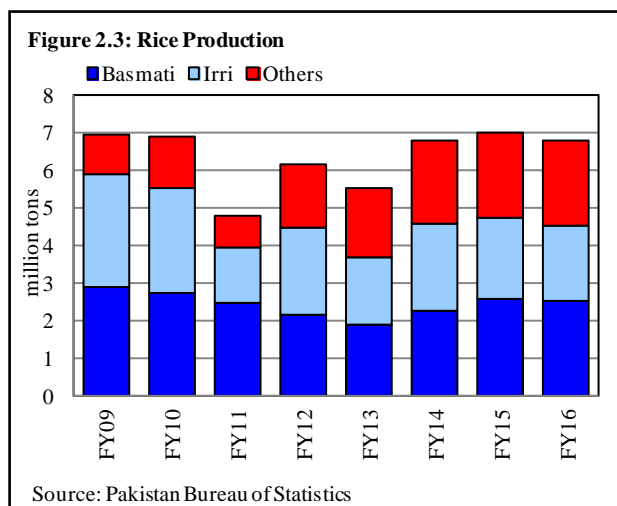
<sup>11</sup> Source: Ministry of Finance Press Release No. 1467, January 2016.

This year, the wedge between the domestic and international prices has grown even wider (**Figure 2.1.1**). Although the government maintained the wheat procurement price at Rs 1,300 per 40 kg, subdued global prices further enlarged its premium to more than 70 percent, from 65 percent last year.<sup>12,13</sup> Moreover, the global wheat price is not expected to rebound anytime soon, as global stocks, already at record level, are expected to grow further due to better crop harvest.<sup>14</sup> In this situation, the government is finding it difficult to dispose of the growing stocks, despite hefty export subsidy. The inability to get rid of this large stock also entails costs, e.g., escalation in funding expense, pilferage, and quality deterioration because of pest and fungus infestation. This means, the desire to protect wheat growers from falling global prices has led to a policy tradeoff where both maintaining or selling wheat stocks entail substantial costs.



The sugarcane crop, despite missing the target of 68 million tons for the year, still posted a respectable growth of 4.2 percent to reach 65.5 million tons. Encouragingly, this growth stemmed from better productivity, as the area under sugarcane cultivation was reduced slightly. More importantly, market price of sugarcane crop largely remained in favour of growers which shored up their margins as well.<sup>15</sup> Meanwhile, some sugar mills facing cash flow problems delayed paying farmers.

Rice production fell by 2.9 percent in FY16, mainly due to a decline in the area under cultivation. While some correction in the output was expected (as the crop had achieved the highest ever level of 7.0 million tons last year), the fall in market prices may also have discouraged farmers.



The price for rice remained soft owing to continuing surplus in the domestic market. The crop has experienced a substantial increase in output over the past several years (**Figure 2.3**).<sup>16</sup> However, a subdued growth in domestic consumption and tough competition from India in the export market (particularly for basmati variety), led to excess supplies in the domestic market, thereby exerting downward pressure on prices.<sup>17</sup> Further strain came from softening of rice prices in the global market.

<sup>12</sup> The wheat procurement price of Rs 1,300 per 40 kg translates into US\$ 310 per ton (at exchange rate of Rs 104.4 per US\$). In comparison, the US Hard Red Winter Wheat was traded at an average rate of US\$ 179 per ton in FY16 (source: CBOT).

<sup>13</sup> The government, through its designated agencies, procured more than 5.9 million tons of wheat this year. Last year, these agencies were able to procure 5.3 million tons.

<sup>14</sup> Source: US Department of Agriculture.

<sup>15</sup> Although the provincial governments of Punjab and Sindh announced the indicative price of cane at Rs 180 and Rs 172 per 40 kilograms respectively, the market prices remained higher than the benchmark level.

<sup>16</sup> Rice production has recovered from severe damages during the 2010 floods (the average production of 6.87 million ton during FY14-16 is 25 percent higher than that realized during FY11-13). However, the production of high-yielding 'other varieties' has been replacing both 'basmati' and 'irri' rice.

<sup>17</sup> The average price of basmati varieties fell by 13-16 percent in the domestic market.

The value addition from ‘other crops’ fell by 0.3 percent, compared to a growth of 3.1 percent last year. The decline was broad-based, as most segments (pulses, fruits, oil seeds, and green fodder) experienced a fall in production over last year.<sup>18</sup> In particular, gram crop (in pulses) and sunflower crop (in oil seeds) continued their falling trend – both area and yields experienced decline (**Figure 2.4**). Gram crop always had an unpredictable yield trend mainly due to weather effects. On the other hand, higher profitability margins on wheat have played a major role in curtailing area under the sunflower crop.

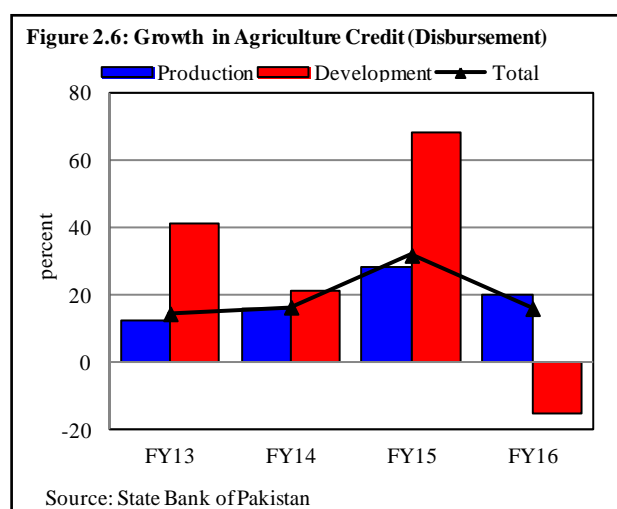
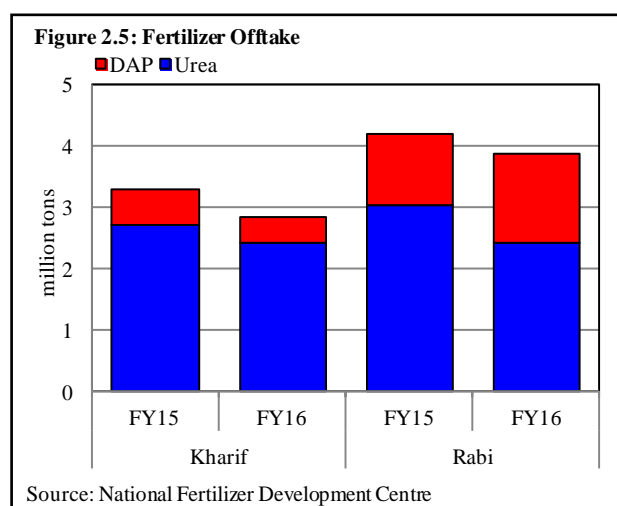
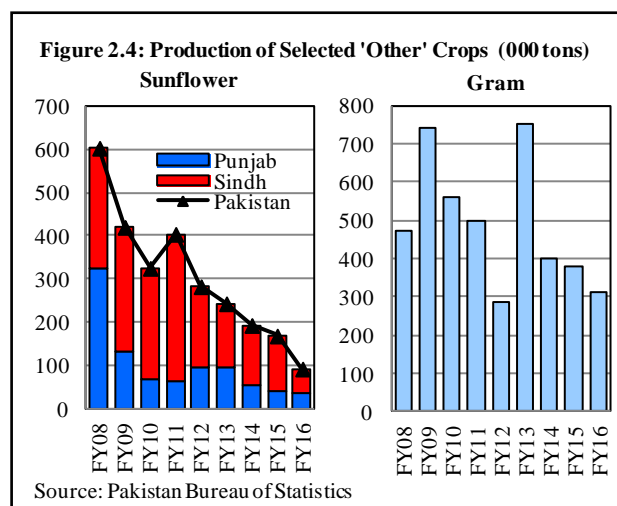
### Input situation

Despite sufficient domestic supplies because of higher production and timely imports, overall urea utilization went down by 15.6 percent (**Figure 2.5**). As mentioned earlier, the growing pressures on rural incomes largely explain this steep fall in the demand for urea.

The contraction in overall fertilizer usage was more prominent in *kharif* season – the demand for both urea and DAP was down 10.7 percent and 26.2 percent, respectively, compared to same period last year. While the demand for urea fell further by 20.0 percent during *rabi*, the DAP off-take recovered by 26.6 percent on YoY basis. The availability of subsidized imports explain this surge in DAP demand during *rabi*.

The overall water availability, another major agriculture input, was also down compared to the previous year (5 percent less during *kharif* and another 1 percent in *rabi* season).

The gross disbursement of agriculture credit grew by 16 percent in FY16, touching Rs 0.6 trillion mark. More importantly, this high growth was achieved on top of 31.8 percent increase recorded last year. That said, development loans declined 15.6 percent compared to an increase of 68.2 percent last year (**Figure 2.6**).<sup>19</sup>



<sup>18</sup> Fruits and green fodder, which represent around 55 percent of the value addition by other crops, recorded a decline of 1.6 percent during the period under review.

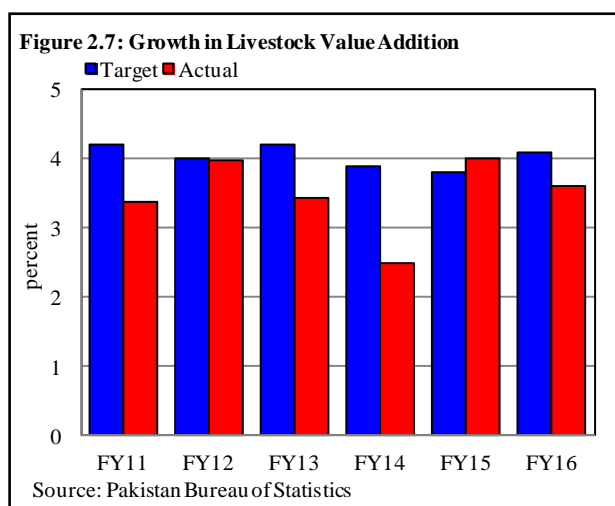
<sup>19</sup> A decline of 28.6 percent in tractor manufacturing during FY16 largely explains the drop in development loans during the year.



### 2.2.2 Livestock<sup>20</sup>

Livestock is crucial for developing economies like Pakistan. Being one of the major sources of livelihood, it generates income and employment opportunities for the farming community; acts as a safety net against adverse shocks; provides manure and draught power; and works as an important source of nourishment.<sup>21</sup> This sub-sector contributed 11.6 percent of the value addition in the overall GDP of the country during FY16, which is even higher than large-scale manufacturing’s 10.9 percent share in GDP.

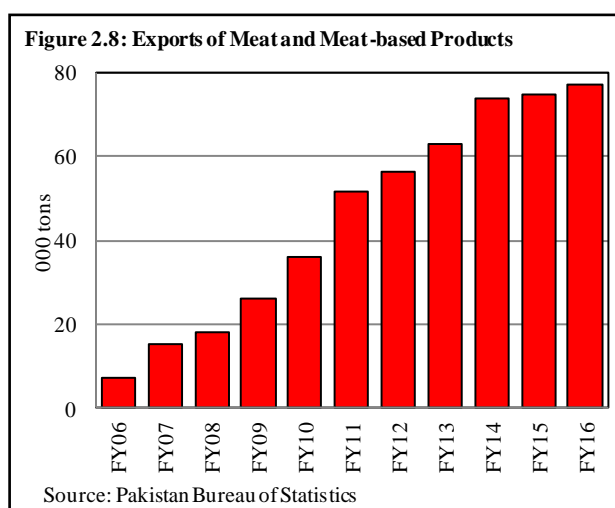
During FY16, livestock recorded a growth rate of 3.6 percent, compared with 4.0 percent in FY15 (**Figure 2.7**). The demand for value-



added livestock products is growing due to a number of factors, like population growth, income growth, urbanization and changing diets. This shift receives support from new and improved retailing, distribution and marketing techniques; opening of upscale stores; and better facility for transportation of high-value refrigerated products under hygienic conditions. Such new trends have enhanced the shelf life of many products, cut down wastages, and provided convenience to customers, particularly urban consumers.

The government also announced a 4-year tax exemption in the federal budget for FY15 for companies setting up halal meat production plants. This incentive helped in the creation of Fauji Meat Limited (FML) – a subsidiary of Fauji Fertilizer Bin Qasim Ltd – providing *halal* abattoir and meat processing facility in the country. In addition, Al-Shaheer Corporation, the leading meat exporter and retailer, listed its IPO at the stock market in June 2015.

In another important development, the government also established the Pakistan Halal Authority to promote trade and commerce in halal food products. In particular, the introduction of regulatory mechanism would strengthen the certification standards for halal food, and would go a long way in pushing exports of halal meat and meat-based products. Pakistan currently exports live animals and meat products to Gulf and East Asian region (mainly Thailand and Vietnam). Not only are these exports stagnant for the past many years (**Figure 2.8**), the share of low valued added items (e.g., carcasses) remains dominant. We expect the implementation of halal standards to also help food processing firms achieve quality standards applicable in EU and US markets.



<sup>20</sup> Livestock sector includes headcount of animals (cattle, buffalo, sheep, goat, camels, horse, asses, and mules) and their products (milk, meat, hides and skins, bones, eggs, wool & hair, etc).

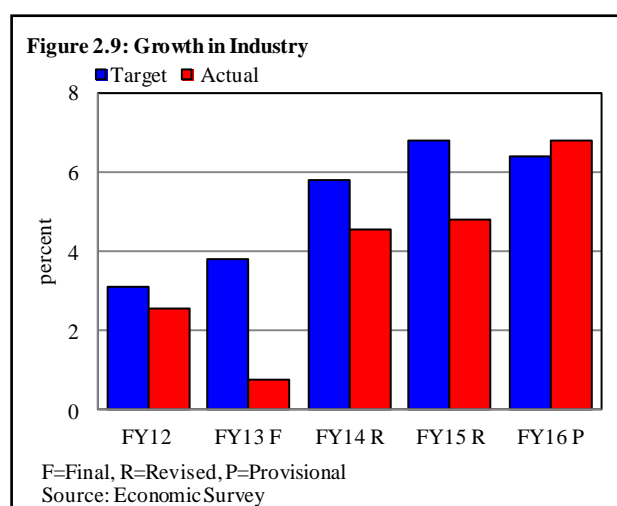
<sup>21</sup> More than 8 million families in Pakistan are engaged in raising animals (Source: Pakistan Economic Survey 2014-15).

Finally, the livestock sector is also likely to benefit from the recent decline in customs duty on machinery imports used in the processing of meat.

### 2.3 Industry

The overall industry registered a strong growth of 6.8 percent in FY16, compared to 4.8 percent realized last year (**Figure 2.9**).

Besides recording the highest growth since FY08, industry surpassed the target set in the Annual Plan for the first time in past 12 years (**Table 2.2**). But this growth may experience some downward revision, as the performance of large-scale manufacturing for the full year came out weaker than expected.<sup>22</sup>



More importantly, industrial growth improved despite continued uncertainty in the global economy and subdued external demand. Several factors, such as supportive economic policies (low interest rates, stable exchange rate, increased PSDP spending), macroeconomic stability (low inflation, build-up in FX reserves), better law and order situation, and improved availability of energy, helped in realizing this healthier performance.

This performance may gain further momentum going forward due to investments under CPEC. The direct impact of construction and energy related projects under CPEC is often highlighted, but what is overlooked is the planned development of Special Economic Zones (SEZs) across the country. These SEZs may prove to be a turning point for the industrial sector in the country, as economic zones have played a key role in industrial development in many Asian economies. So far, Pakistan has lagged behind even its South Asian peer countries in exploring the option of SEZs for attracting FDI, promotion of industrialization and economic growth (**Box 2.2**).

**Table 2.2: Growth in Industry**

growth in percent and contribution in percentage points

	Share	Growth		Contribution to growth	
		FY15	FY16	FY15	FY16
<b>Industry</b>	<b>20.9</b>	<b>4.8</b>	<b>6.8</b>	<b>4.8</b>	<b>6.8</b>
Mining & quarrying	3.3	4	6.8	0.6	1.0
Manufacturing	13.8	3.9	5.0	2.6	3.3
Large scale	11.7	3.3	4.6	1.8	2.4
Small scale	1.2	8.2	8.2	0.7	0.7
Slaughtering	0.9	3.4	3.6	0.2	0.2
Electricity gen. & distt and gas distribution	1.4	12	12.2	0.9	1.0
Construction	2.4	6.2	13.1	0.7	1.5

Source: Pakistan Bureau of Statistics

#### Box 2.2: Special Economic Zones and Economic Development

The government has planned 29 special economic zones (SEZs) under the China-Pakistan Economic Corridor (CPEC). For this purpose, the federal government has asked provinces to identify locations for these SEZs in their respective territories under CPEC. Once implemented, these SEZs could enhance the country's productive capacity; expand its exports base; and provide a major impetus for economic and social development through their backward and forward linkages with the rest of the domestic economy.

The idea of SEZs is not new, as the first such experiment was implemented in 1937 by the US.<sup>23</sup> The concept was attractive for other countries as well, as it allowed them to enhance their competitiveness, attract foreign investment, and diversify exports. More importantly, countries were still able to maintain protective barriers and create jobs. Many developing countries, especially in East Asia, used this framework as a policy tool to promote industrialization and economic growth.

<sup>22</sup> The increase of 6.8 percent in the industrial sector during FY16 assumes LSM growth of 4.6 percent. This estimate on LSM growth was based on partial information available at the time of compilation of national income accounts. The growth in LSM for FY16, on the basis of full year information, came out at 3.2 percent.

<sup>23</sup> The very first economic zone was established in New York in 1937 following the passage of the Free Trade Zone Act by the United States Congress in 1934.

Pakistan has also adopted this strategy by creating various industrial estates and export processing zones.

A review of country experiences, however, shows that not every economic zone has been successful in delivering on its objectives. While the most successful zones are found in East Asia and Latin America, the majority of African zones could not replicate this success, despite the technical assistance and funding from donors. Economic zones in Pakistan also remained largely ineffective in boosting industrial growth, investments, and exports.<sup>24</sup> In this backdrop, the renewed emphasis on this strategy under CPEC is a welcome development, as this would allow Pakistan to learn from the successful experience of China.<sup>25</sup>

In Pakistan, the SEZ Act 2012 provides the governing structure, which allows both the federal and provincial governments to set up economic zones under various administrative frameworks. Specifically, SEZ can be entirely led by the government, or can work in collaboration with the private sector (under different modes of public-private partnership), or even operate exclusively through the private sector. Whatever the arrangement, it is important that both regulatory and administrative bodies should have necessary power, autonomy and available funding. Often, weak administrative bodies established to develop, operate and regulate zones result in lacklustre performance by SEZs.

At the same time, adequate coordination and effective partnership between governments (local, provincial and federal) and private zone developers is essential. Given that provinces are now formulating their own investment and industrial policies following the 18<sup>th</sup> Amendment, the need to collaborate for designing coherent policies has become more vital.

Deciding location of SEZs is equally important. The government often has to balance between growth and social development objectives. The first objective favours those SEZ sites that offer easy availability of input (raw material, energy, labour, etc) and access to road and transportation network. However, selection of already developed areas results in congestion, over-crowding and social unrest. On the other hand, the government can pursue social development objectives by selecting remote areas. The development of such areas requires heavy capital expenditure by the government, and private firms also expect generous incentive packages to offset their location disadvantage.<sup>26</sup>

In this context, designing unique incentive structure to attract firms becomes more challenging as benefits offered by SEZs are almost similar.<sup>27</sup> In any case, since tax incentives impose significant costs on budgets (and they are hard to withdraw), focus should be on regulatory and administrative incentives. For example, SEZ authority can enhance the scope of facilities by establishing skill development centres or constructing residential complexes near economic zones. Wherever tax incentives are necessary, they should come with sunset clauses.

The design of incentives also determines the type of industries eligible for inclusion in the economic zones. Applying a general set of incentives allows inclusion of a range of activities, both commercial as well as manufacturing. In any case, industries which already enjoy strong presence in the country (e.g., textiles, household appliance, cement & building material, food processing, sports, leather and surgical items, mineral resources, etc.) would be the most likely candidates for such SEZs. However, if the country wants to use SEZs as a tool to diversify its industries and exports, the incentive structure should be tailored accordingly. While designing incentives, we should consider that China is in the process of upgrading its industrial base. This means, not only that some industries could potentially relocate to Pakistan, China would also need semi-processed material for its new and high-tech industry.

### 2.3.1 Large scale manufacturing (LSM)

Although the key manufacturing sectors performed better during FY16 (e.g., automobiles, fertilizer, chemicals, pharmaceutical, rubber, cement, and construction-related industries), the overall performance of LSM remained subdued mainly due to suspension of activity in Pakistan Steel Mill (PSM) during the year. Excluding PSM, LSM growth was higher in FY16 compared to the previous year (Table 2.3).

<sup>24</sup> For example, Hub Industrial & Trading Estate in Balochistan (established in 1982) and Gadoon Amazai Industrial Estate in KP (set up in 1990) could not prosper because of lack of necessary infrastructure. Similarly, Sundar Industrial Estate, established in 2007 in Punjab, also could not start its activities due to unavailability of gas and power.

<sup>25</sup> This optimism stems from the fact that China has successfully experimented with the SEZ model to reshape its economy. For example, the Shenzhen Special Economic Zone has transformed Shenzhen from a small village into a booming industrial hub.

<sup>26</sup> In some cases, the government compels firms to hire a certain portion of workers from the local labour force.

<sup>27</sup> This point further underscores the need for close coordination between provinces; otherwise, competition among provinces to attract recognized industries would only increase their fiscal cost.



### Automobiles

The automobile sector continued to grow strongly in FY16 as well (Table 2.4). Except for tractors, all segments registered an exceptional growth during FY16.

With the squeeze in farmers' income in FY16 and uncertainty regarding the subsidy scheme announced by the government leading to a sharp reduction in tractor manufacturing,<sup>28</sup> a commendable showing from other segments helped the auto sector record a strong growth. For example, manufacturers of trucks and buses benefited from improved construction and transportation activities in the country.<sup>29</sup> Similarly, the assembling of cars & LCVs grew owing to continued demand for new car models launched in FY15; higher sales under the Apna Rozgar Scheme introduced by the Punjab government in January 2015; and the availability of auto financing.<sup>30</sup> Interestingly, this rise in the production of cars and jeeps was realized despite a higher growth in the import of used cars.<sup>31</sup> The healthier performance from the auto sector also had positive spillover for other segments, such as manufacturing of rubber tyres and tubes.<sup>32</sup>

More importantly, the outlook for the auto sector appears promising, because of: (i) likely recovery in tractor demand following the support measures announced by the Punjab and Sindh governments, and the reduction in sales tax on tractors in the federal budget for FY17;<sup>33</sup> (ii) the launch of new models by leading car manufacturers in FY17;<sup>34</sup> (iii) continued progress on developmental projects and the resulting increase in transport and construction activities; and (iv) potential entry of new players post Automotive Development Policy (ADP 2016-21). The long-term prospects of the industry are optimistic but contingent on implementation of the ADP 2016-21 and industry's ability to

**Table 2.3: Large Scale Manufacturing Index (YoY Growth)**  
growth in percent and contribution in percentage points

	Weights	Cumulative growth		Percentage contribution	
		FY15	FY16	FY15	FY16
LSM	70.3	3.4	3.2		
Textile	21	0.9	0.4	8.1	3.9
Cotton yarn	13	1.1	1.4	6.3	8
Cotton cloth	7.2	0.1	0.2	0.2	0.6
Food	12.4	-1.3	0.9	-8.2	5.9
Sugar	3.5	-7.7	-0.7	-17.5	-1.4
Vegetable ghee	1.1	0	4.5	0	1.8
Cooking oil	2.2	-2.4	5.3	-2.7	5.9
Soft drinks	0.9	15.2	6.3	10.8	5.3
POL	5.5	8.5	-2.6	15.5	-5.2
Steel	5.4	35.4	-9.3	30.9	-11.2
Private	4.1	27	6	16.3	2.5
PSM	1.3	117.3	-100	14.6	-13.5
Non-metallic mineral	5.4	2.3	10	6.9	32.2
Cement	5.3	2.4	10.1	7.4	32.2
Automobile	4.6	23.5	16.1	33.5	29
Jeeps and cars	2.8	30.8	17.6	21.1	16.2
Fertilizer	4.4	4.6	13.8	7.4	23.9
Pharmaceutical	3.6	7.6	6.5	17.2	16.3
Paper	2.3	-9.5	-1.6	-11.2	-1.7
Chemicals	1.7	8.8	8.2	5.8	6
Caustic soda	0.4	9.8	22.5	1.1	2.9
Leather products	0.9	8	7.8	4.3	4.6
<i>LSM excl. PSM</i>	69.1	3	3.7		

Source: Pakistan Bureau of Statistics

**Table 2.4: Growth in Automobile Assembling**  
percent

	FY12	FY13	FY14	FY15	FY16
Tractors	-32	5.6	-32.1	41.6	-28.6
Trucks	-7.6	-26	39.1	51	40.3
Buses	15.9	-8.1	7.1	2.9	86.1
Jeeps and cars	14.7	-21.3	-3.5	30.8	17.6
LCVs	9.3	-30.6	20.4	61.3	27.1
Scooters/motor cycles	0.8	1.5	3.2	2.8	16.5
<b>Overall</b>	<b>3.4</b>	<b>-12.8</b>	<b>-2.6</b>	<b>23.5</b>	<b>16.1</b>

Source: Pakistan Bureau of Statistics

<sup>28</sup> The sales of tractors fell during the year, as growers kept on waiting for the formal execution of the subsidy scheme announced by the provincial governments of Punjab and Sindh in their budgets for FY16.

<sup>29</sup> High type road network in the country increased from 182,900 km in FY13 to 187,807 km in FY16.

<sup>30</sup> Auto financing increased from Rs 21.0 billion in FY15 to Rs 26.8 billion in FY16.

<sup>31</sup> The import of used cars jumped from 32,100 units in FY15 to 53,600 units in FY16 – showing an increase of 67.0 percent (source: Pakistan Association of Automotive Parts and Accessories Manufacturers).

<sup>32</sup> Motor tyre manufacturing registered a growth of 7.1 percent and motor tubes 12.3 percent in FY16.

<sup>33</sup> The provincial governments renewed their commitment to release subsidy on tractor sales committed in the previous budget. The federal government also reduced the sales tax on imported and locally-manufactured tractors to 5 percent from 10 percent, which will bring down prices by Rs 35,000-Rs 80,000 per unit, depending on the power of the engine.

<sup>34</sup> While one leading manufacturer has already launched a new car model in August 2016, other firms are likely to do so later this year.

indigenize production (**Box 2.3**).<sup>35</sup>

**Box 2.3: Salient Features of Automotive Development Policy 2016-21**

In March 2016, the government announced the much awaited Automotive Development Policy (ADP) 2016-21.<sup>36</sup> The new policy is geared towards attracting investment, ensuring more competition, and encouraging affordable and high quality products in compliance with environmental and safety standards.

For instance, the policy offers incentives to new investors, who are not only allowed duty-free import of plant and machinery for setting up the assembly and manufacturing facility on a one-time basis, but also offered concessionary tariffs (at 10 percent, against the prevailing 32.5 percent) on import of auto parts for an extended period of 5 years (**Table 2.3.1**).<sup>37</sup> Similarly, the investment for the revival of a closed assembling facility would get 3-year concessional tariff.

This new policy also addresses issues related to affordability and quality of products. At present, customers have to pay the full amount at the time of booking of cars inclusive of duties and taxes, whereas the cars are delivered to customers after several months. Furthermore, any price escalation before the delivery is also passed on to the customers. According to ADP, advance payment has been capped at 50 percent of the total price. Moreover, price and delivery schedule would be confirmed at the time of booking, and any delay in delivery over two months would result in the discount from the final payment.

**Table 2.3.1: Summary of Tariff Incentives**  
percent

	Existing duties	Next 5 years
<b>Auto parts</b>		
<b>CKDs</b>		
Non-localized	32.5	30
Localized	50	45
<b>CBUs</b>		
Upto 800cc	50	40
801-1000cc	55	45
1001-1500cc	60	50
1501-1800cc	75	65
<b>New investment-Greenfield</b>		
CKD-non-localized		10
CKD-localized		25
<b>Dormant plants-Brownfield</b>		
		<b>Next 3 years</b>
CKD-non-localized		10
CKD-localized		25

Source: ADP 2016-2021

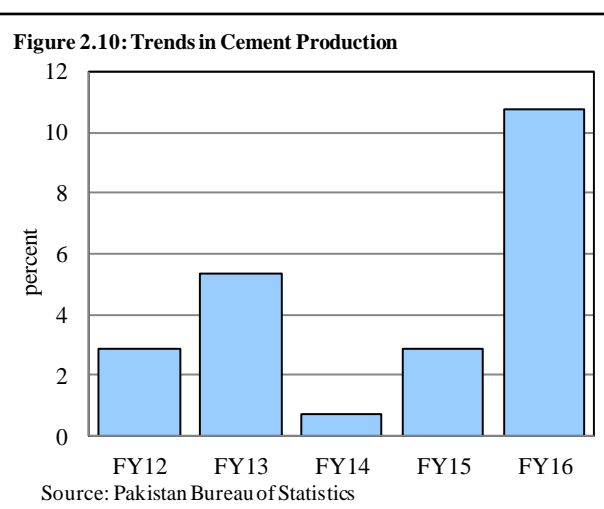
The existing regulation on vehicle safety and environment protection are not in line with global standards. The ADP therefore emphasizes on the need to review national regulations. Hence, Pakistan will seek membership for the World Forum for Harmonization of Vehicle Regulations (also called WP 29) – a body under institutional framework of the United Nations – which helps countries in formulating regulations on road safety, environmental protection and trade.

The government also aims to establish Pakistan Automotive Institute (PAI). This institute will help the industry in research and education; provide technical guidance relating to quality improvement, safety inspection and environmental preservation; and develop a database covering technical information relating to the automobile industry.

**Cement**

The strong domestic demand led cement production to grow by 10.1 percent in FY16 (compared to 2.4 percent in FY15), despite a significant decline in exports (**Figure 2.10**). Key factors explaining this strong demand include: higher public spending on mega infrastructure projects, rapid urbanization, and robust private construction activities. Most of this demand was met by manufacturing units in the northern region, i.e., Punjab and KPK (**Table 2.5**).<sup>38</sup>

On the export side, cement dispatches to a number of countries, including Afghanistan,



<sup>35</sup> Low indigenization has made the industry vulnerable to adverse movement in the exchange rate, which impacts production costs and retail prices.

<sup>36</sup> The previous policy, named ‘Auto Industry Development Program’, had ended in 2012.

<sup>37</sup> During this five-year period, new entrants are expected to catch up with the existing players in terms of indigenization and related infrastructure.

<sup>38</sup> The average share of sale to northern region remained around 81 percent during last five years.

Sri Lanka, and South Africa continued to follow a declining trend. Exports to Afghanistan suffered due to slowdown in development activities following the withdrawal of UN troops and tough competition from Iran.<sup>39</sup> Similarly, the levy of anti dumping duties (in the range of 15-70 percent) curtailed cement exports to South Africa.

From the supply side, the market power even allowed firms to increase the local retail prices, despite a slump in global market for raw material (e.g., POL and coal) and historic low domestic interest rates (Figure 2.11).<sup>40,41</sup> It may be noted that these firms were already benefiting from economies of scale.

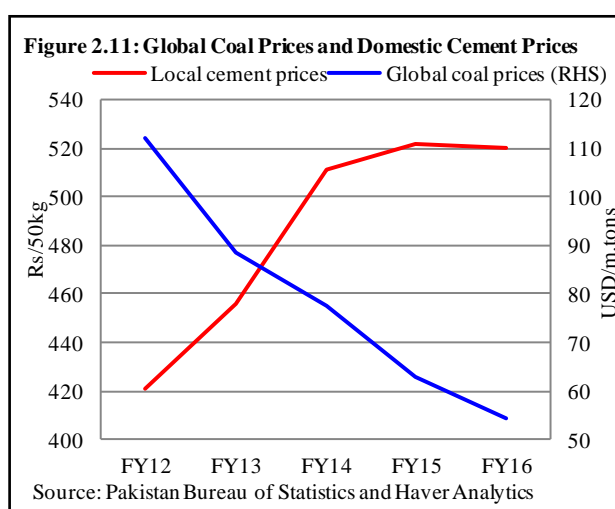
The increase in construction activities also benefited allied industries. For example, the FY16 growth of 8.2 percent in chemicals (on top of 8.8 percent during FY15) mainly came from caustic soda (showing a growth of 22.5 percent), paints and varnishes (10.1 percent) and sulphuric acid (6.8 percent). In addition, Cherat Packaging Limited (CPL) – a leading producer of cement bags – expanded its capacity by 50 million bags by installing the world's first ever European-made polypropylene plant.<sup>42,43</sup>

The outlook for cement and construction related industries, appears positive in view of upcoming development projects and thriving housing sector.<sup>44</sup> Specifically, hydel power plants (Kohala Hydel and Soki Kinari projects) and transport infrastructure projects would stimulate demand in the country. Further impetus to demand would come from rapid urbanization and the related development of mega housing projects.<sup>45,46</sup> More importantly, the demand pressures may continue going forward due to persistent housing shortages (bridging this gap would require huge quantity of cement and related construction materials). Finally, low per capita cement usage in the country also

**Table 2.5: Cement Sales Dynamics**

percent	Share in sales FY16	YoY growth				
		FY12	FY13	FY14	FY15	FY16
<b>Domestic sales</b>	<b>84.9</b>	<b>9.0</b>	<b>4.7</b>	<b>4.3</b>	<b>8.0</b>	<b>17.0</b>
North zone	69.6	8.2	5.1	6.5	8.2	15.4
South zone	15.3	12.3	2.9	-5.2	6.5	24.9
<b>Exports</b>	<b>15.1</b>	<b>-7.1</b>	<b>-2.3</b>	<b>-2.8</b>	<b>-11.6</b>	<b>-18.4</b>
Afghanistan	6.3	-0.2	-6.6	-17	-21.4	-15.1
India	2.6	2.7	-20.4	40.5	2.8	42.5
Other	6.2	-17	7.4	9.1	-4.7	-32.7
<b>Total</b>		<b>4.2</b>	<b>2.8</b>	<b>2.5</b>	<b>3.3</b>	<b>9.8</b>

Source: All Pakistan Cement Manufacturers Association



<sup>39</sup> The success of the Iranian cement industry is based on abundant raw material and cheap energy. Iran increased its cement capacity from 42.7 million tons in 2005 to above 100 million tons in 2015 (source: US Geological Survey Mineral Year Book).

<sup>40</sup> Global prices of coal (which contributes one-third of the total cost of cement production) experienced a YoY decline of around 18 percent during FY16.

<sup>41</sup> The government reduced the power tariff for all industries (by 20 percent). In addition, a fall in global oil prices not only lessened the cost of own power generation through furnace oil (by 45 percent), it also pulled down selling and distribution costs (by about 17 percent). In addition, all time low interest rates reduced financial costs (by 43 percent).

<sup>42</sup> The increase in production of caustic soda mainly reflects the impact of capacity addition.

<sup>43</sup> Polypropylene bags improve shelf life as they are strong, durable, low-weight, and provide adequate protection against weather and contamination.

<sup>44</sup> The government has allocated Rs 1,675 billion for PSDP in FY17, which is 20 percent higher than last year.

<sup>45</sup> The rural-urban mix for the country has shifted from 65:35 in 2005 to 60:40 in 2016 (Economic Survey 2015-16).

<sup>46</sup> For example, Bahria Town, DHA City, Fazaia and ASF Housing Schemes and other numerous private housing projects in different cities across the country.

adds upside to cement demand (**Figure 2.12**).<sup>47</sup> Hence, major cement producers have announced expansion plans for 9.7 million tons, which would enhance total capacity to 55.3 million tons per annum.<sup>48</sup>

### Pharmaceuticals

Pharmaceutical industry witnessed a growth of 6.5 percent in FY16 on top of 7.6 percent in FY15. Yet, this decent performance conceals some underlying issues, such as strict regulation, unpredictable price structure, lack of patent protection, abundant supply of counterfeits, and lack of US Food and Drug Administration (FDA) approved plants. Hence, not only is the size of the industry in Pakistan small (despite having large population of 200 million), its exports are also low (**Table 2.6**).

It may be noted that the country's pharmaceutical industry used to be the most modern in this region during 1960s. However, it could not keep pace with the developments taking place in other countries of the region. Currently, Pakistan does not have any plant that complies with the standards prescribed by US-FDA (**Table 2.6**). In comparison, Bangladesh has five and Jordan has three FDA approved plants.<sup>49</sup>

### Fertilizer

Better gas availability helped the fertilizer sector post a decent growth of 13.8 percent in FY16, compared to 4.6 percent in FY15.<sup>50</sup> Specifically, the uninterrupted supply of 60 million cubic feet of gas per day to Engro Fertilizers from the Genco-2 power plant, along with the addition of LNG as source of feed to three plants of Pak Arab Fertilizer Company since March 2015, provided a much needed boost to the fertilizer sector in FY16.<sup>51</sup> Higher domestic production also reduced the import demand (**Figure 2.13**).<sup>52</sup> Encouragingly, the industry is likely to benefit from improved gas supplies in FY17 as well.

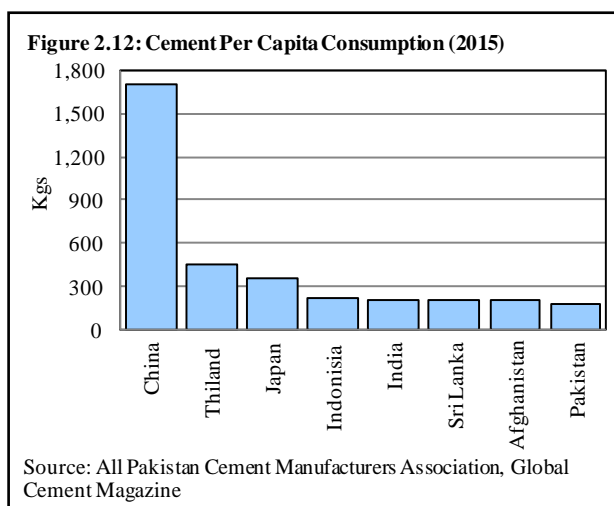
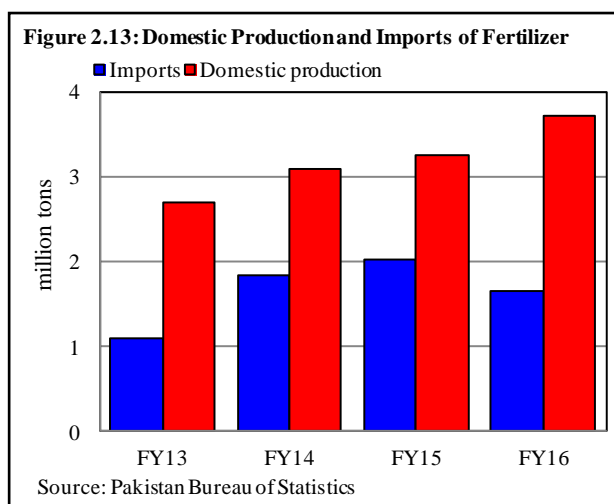


Table 2.6: Comparison of Pharmaceutical Industry (2015)

Country	Population (million)	Industry Size (US\$ billion)	US-FDA approved Plants	Exports (US\$ million)
Pakistan	200	2.0	--	208
Jordan	17	1.5	3.0	1,000
India	1,311	26.0	201	12,450
Bangladesh	170	1.5	5.0	70

Source: Country reports and global pharmaceutical industry report (2015)



<sup>47</sup> According to estimates, the housing shortage in the country stood at 9 million units in 2014 (source: SBP Housing Finance Review, September 2014). Bridging this gap would require huge quantity of cement and related construction materials.

<sup>48</sup> Cherat, Attock, Lucky, DG Khan Cement, ACPL and Pioneer Cement have all formally announced plans to enhance their annual manufacturing capacity by 1.3 million tons, 2.3 million tons, 2.6 million tons, and 2.7 million tons, 1.1 million tons and 2.3 million tons, respectively.

<sup>49</sup> FDA approved plants allows firms to make inroads into markets of advanced economies.

<sup>50</sup> Fertilizer sector is the fourth largest consumer of gas.

<sup>51</sup> Fertilizer sector received 150-200 mmcf additional gas during FY16, compared to the same period last year.

<sup>52</sup> Present installed production capacity of 6.3 million tons of urea fertilizer is more than national demand of about 6 million tons.

Fertilizer off-take, on the other hand, remained sluggish during FY16, mainly because of depressed farmers' incomes and an increase in domestic prices in response to a hike in feed gas tariffs.<sup>53</sup> The demand for fertilizer, however, is likely to recover in FY17 given a reversal in feed gas price rise, more clarity with respect to fertilizer subsidy, and promotional discounts offered by domestic companies.

### **Steel**

The overall steel production witnessed a contraction of 9.3 percent in FY16, compared to growth of 35.4 percent in the previous year. The suspension of PSM's operations overshadowed the notable performance of private steel manufacturers (**Table 2.3**).<sup>54</sup>

The steel industry mainly faced two key challenges during the year which constrained domestic private manufacturers from effectively utilizing their capacity expansions.<sup>55</sup> First, the deepening liquidity crisis in PSM caused its operations to come to a complete standstill from July 2015. PSM contributes 10-15 percent of the total steel production in the country and it is the sole producer of pig iron, which is used as an input for making various steel products.<sup>56</sup> Hence, the suspension of PSM's operations forced steel manufacturers in the private sector to rely on imported pig iron.

Second, the unprecedented decline in international steel prices, coupled with the influx of cheap Chinese steel under the free trade agreement (FTA), squeezed the profit margins of domestic firms.<sup>57</sup> In fact, low-cost steel products from China have posed a threat to many steel manufacturers around the globe.<sup>58,59</sup> Hence, the import of both steel scrap and steel products increased by 35.6 percent and 30.1 percent respectively during FY16. The imports posted extraordinary growth despite the imposition of anti-dumping duties on import of cold-rolled coils and sheets from China and Ukraine.<sup>60</sup>

### **Food products**

Weak performance of sugar industry and cigarettes (which add up to 46 percent of the total food industry), weighed heavily on the overall performance of the food sector. The decline in sugar production, despite better sugarcane crop in FY16, can be attributed mainly to a lower recovery in sugar content compared to the last year and severe liquidity crunch faced by sugar mills. Specifically, mills could not offload their large carryover stock in the local market owing to low domestic prices.<sup>61</sup> The export of sugar was not viable due to depressed prices in the international market.

<sup>53</sup> While announcing the *Kissan Package* in September 2015, the government called on fertilizer manufacturers to reverse the price hike announced earlier in response to higher gas tariffs. This prompted growers to wait for the announcement of the subsidized price for fertilizer. See **Box 2.1** in the Third Quarterly Report on *The State of Pakistan's Economy* for FY16.

<sup>54</sup> Private steel manufacturers posted an increase of 6.0 percent in FY16, on top of 27.0 percent last year.

<sup>55</sup> International Steel Limited has doubled its capacity with the installation of a 2<sup>nd</sup> galvanizing plant with a capacity of 250,000 tons in 2015; Mughal Steel has enhanced its melting capacity to 72,250 tons per annum from 48,000 tons and re-rolling capacity to 229,688 tons from 187,500 tons per annum in 2015; and Amreli Steel witnessed capacity addition in FY15 and expected to double its capacity in FY17-18 (source: companies' financial reports).

<sup>56</sup> Pig iron had 4 percent share in overall steel production in FY15, which fell to 0 percent in FY16.

<sup>57</sup> Local steel makers argue that Chinese manufacturers have resorted to dumping their steel products in other countries by relying on government subsidies, tariff concessions through FTA and marginal cost pricing mechanisms.

<sup>58</sup> Countries such as Bangladesh, Mexico, Brazil, US and India have countered this threat by imposing countervailing duties, regulatory duties and other non-tariff barriers to protect their local steel industries. Because of concessions given through the FTA and mis-declaration of non-alloy steel goods as alloy steel, the appropriate tariff barriers are not in place to protect Pakistan's steel industry.

<sup>59</sup> The G7 countries agreed to take steps to tackle a global glut in steel that many blame on excess production by Chinese producers of steel products used in construction and cars (Reuters).

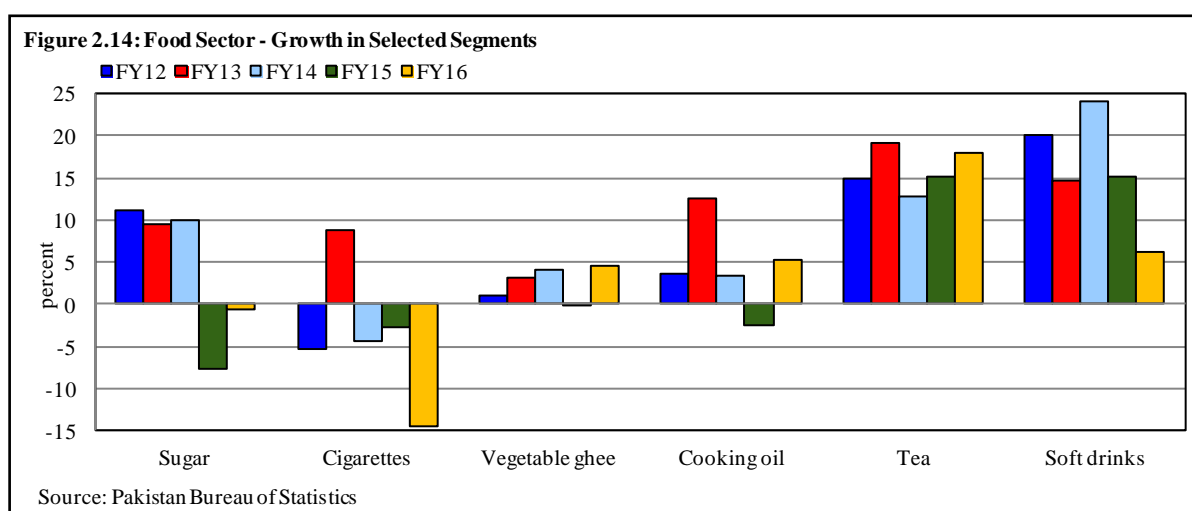
<sup>60</sup> These import duties, which were imposed in January 2016, varied in the range of 8.3 to 19.0 percent.

<sup>61</sup> As mentioned earlier, the carryover stock with sugar mills is expected to reach 1.6 million tons by October 2016 (source: Pakistan Sugar Mills Association).



In the case of cigarettes, the price increases over the years (mainly driven by imposition of excise taxes) have created a huge price gap against illicit (non-duty paid, smuggled and counterfeit) cigarettes.<sup>62</sup>

Edible oil and tea manufacturers performed better during FY16. Favourable operating environment (stable currency, low cost of borrowing, and cheaper energy and transportation) supported growth in the edible oil industry.<sup>63</sup> Manufacturers also benefited from a cut in import duty (from 6 percent to 3 percent since July 2015) on soybean.<sup>64</sup> Finally, profit margins for the industry also became attractive, as manufacturers did not fully pass on the benefit from lower cost of production to consumers.<sup>65</sup> All these factors helped edible oil segment to grow by 5.6 percent during FY16, after contracting 1.2 percent during FY15 (**Figure 2.14**).



### Textiles

The performance of textile, the largest subsector in LSM, remained sluggish during FY16. Lower demand, particularly of basic textiles, from China and Europe adversely affected the sector, whereas reduced cotton production aggravated the situation (**Chapter 6**).<sup>66</sup> Resultantly, the sector could not fully exploit the benefits from GSP Plus status in the EU; declining cotton and energy prices; and lower cost of borrowing.

That said, the domestic demand for textile products remained robust. Further support came from the imposition of anti dumping duty on cotton yarn imports from India, reduction in power tariff for industrial consumers, and gas (LNG) supply to textile mills in winter.

<sup>62</sup> In 2014, 17.3 billion local tax-evaded (LTE) cigarettes were sold in the country, which was 21.1 percent of the total cigarette market in Pakistan. These LTE cigarettes are extremely cheap. The average selling price of LTE brands in Pakistan is Rs 27.0 per packet, which is far below the minimum tax per packet of Rs 33.8. Furthermore, nearly one billion cigarettes are added every year into the black market (source: Nielsen report titled “The challenge of illicit trade in cigarettes: Impact and solutions for Pakistan-2015”).

<sup>63</sup> Although palm oil prices in the global market continue to remain sluggish, its imports remained lower this year. Probably manufacturers have been using inventories of the past year.

<sup>64</sup> The demand for semi-processed soybean oil is also on the rise as it is used in the poultry feed industry.

<sup>65</sup> According to financial statements of leading firms, margins of the edible oil industry increased by 12 percent YoY during FY16 compared to a minor decline in FY15.

<sup>66</sup> Meanwhile, following the addition of more efficient spindles by India, China and Bangladesh, it is not possible for our textile sector to compete internationally. To catch up with competitors, Pakistan’s textile industry needs to invest heavily in balancing, modernization and replacement. Broadly speaking, the textile industry has to focus more on value-added items.

Moreover, value added products provided some respite. For example, the exports of readymade garments witnessed an increase of 4.8 percent during FY16, from 1.1 percent last year.<sup>67</sup> Hence, on overall basis, the textile industry managed to record a marginal growth of 0.4 percent during FY16 – though still lower than 0.9 percent growth observed last year.<sup>68</sup>

Going forward, continuing uncertainty in the global economy would be a major challenge, especially for spinning and weaving sub-sectors; yet, the recent recovery in cotton prices would provide some relief. International cotton prices have jumped 14 percent since the beginning of July 2016 to a two-year high of US cents 85.10/lb, on the back of lower forecast by US Department of Agriculture of global cotton stocks during the upcoming season of 2016-17.<sup>69,70</sup>

### Other sectors

Availability of low cost imported petroleum products and weak outlook of prices restrained domestic POL production, which witnessed a marginal decline in FY16. The production of *paper & board* posted a slowdown yet again in FY16, compared to the same period last year. This was led by gas shortages, along with availability of low-cost imported products in the market. In the absence of gas (the cheapest energy source), paper mills had to shift to more expensive energy resources, which negatively impacted their competitiveness.

The glass and wood sector also faced similar challenges. The influx of low-cost Chinese products (under the umbrella of FTA) weighed heavily on electronics and especially engineering products, which showed a steep decline for the last few years. The state of the art technology, skilled labour, inexpensive energy, smooth raw material availability, transportation facilities, and economies of scale available to Chinese producers, are making it difficult for these segments to compete.

## 2.4 Services

The services sector recorded an exceptional performance in FY16, growing at 10-year high of 5.7 percent, which was significantly higher than 4.3 percent in the previous year. With this high growth, the services sector contributed over 70 percent of the overall GDP growth. Although all subsectors performed well, major contribution came from *wholesale and retail trade* and *general government services* (Table 2.7).

While the share of services sector in overall GDP has gradually increased from 56.9 percent in FY10 to 59.2 percent in FY16, the export of services has stagnated at US\$ 5.5 billion for the past 5 years. This highlights a major structural

**Table 2.7: Performance of Services**  
share and growth in percent; contribution in percentage points

	Share in GDP FY16	Growth		Contri. to services growth		
		FY15 <sup>R</sup>	FY16 <sup>T</sup>	FY16	FY15	FY16
Wholesale & retail trade	18.3	2.6	6.1	4.6	0.8	1.4
Transport, storage and comm.	13.3	4.8	5.5	4.1	1.1	0.9
Finance and insurance	3.3	6.5	6.5	7.8	0.3	0.4
Housing services	6.7	4.0	4.0	4.0	0.5	0.5
General govt services	7.6	4.8	6.0	11.1	0.6	1.4
Other private services	10.1	6.0	6.4	6.6	1.0	1.1
<b>Services</b>	<b>59.2</b>	<b>4.3</b>	<b>5.7</b>	<b>5.7</b>	<b>4.3</b>	<b>5.7</b>

Source: Pakistan Bureau of Statistics  
T: Target; R: Revised

<sup>67</sup> The export demand for readymade garments remained largely immune from the global commodity price slump.

<sup>68</sup> Leading textile manufacturers are also expanding their outlets in different parts of the country to capitalize on increasing domestic demand (with improved purchasing power of domestic consumers).

<sup>69</sup> Pakistani cotton prices have increased in tandem by 16 percent in July to a two-year high of Rs 6,650 per maund. Domestic cotton harvest last year was down by 28 percent due to pest attacks and untimely rainfall, resulting in lower yield. This has created price pressure in the local market.

<sup>70</sup> The global stocks are now projected at 91.3 million bales by end-FY17 – a reduction of 9 million bales from the starting level.

imbalance, i.e., the dominant sector which has been growing strongly is not adding to export receipts for the economy. The country needs to focus on areas such as information and communication technology and tourism to enhance services exports (**Chapter 6, Box 6.1** on services exports).

Large scale manufacturing also contributed to the growth in *wholesale and retail trade*.<sup>71</sup> While trading activities partly suffered owing to 6.3 percent decline in the crop sector output, this loss was more than offset by a strong performance from the non-crop segment of the agriculture sector, and increase in import quantum.<sup>72</sup> The growth in *general government services*, on the other hand, came from an increase in the salaries of government employees.<sup>73</sup>

*Finance and insurance* subsector posted an encouraging 7.8 percent growth in FY16 – the highest growth since FY07. Scheduled banks, the largest component within *finance and insurance*, led this growth (**Table 2.8**). Despite low interest rates in the economy, the profit of the banking sector continued to increase, reaching Rs 320 billion in FY16 – an increase of Rs 15 billion over last year.<sup>74</sup> More importantly, the recent trend suggests an improvement in core banking activities, reflected by a higher growth in advances in FY16 (**Table 2.9**). In particular, gross loans have visibly improved mainly at the back of increase in fixed investment with a high concentration in the energy sector.

In FY16, *transport, storage and communication* registered a slowdown (**Table 2.10**). The value addition by road transport – the heavyweight in this segment – was decelerated despite a continuous increase in the production and sale of commercial vehicles, encouraging cargo handling activities at various Pakistani ports, and the initiation of different infrastructure projects in the country.<sup>75</sup>

Telecom sector recorded a sharp improvement, mainly due to recovery in the operations of cellular companies. It may be noted that the

**Table 2.8: Finance and Insurance**  
percent

	Share in FY16	Growth		Contribution to growth	
		FY15	FY16	FY15	FY16
Central banking	2.6	-0.6	6.8	0.0	0.2
Other monetary intermediation	84.9	7.1	8.6	5.9	7.2
<i>Scheduled banks</i>	82.9	6.6	8.3	5.4	6.9
<i>Non-scheduled</i>	2.0	37.9	20.6	0.5	0.4
Insurance, reinsurance and pension fund	3.6	4.2	8.7	0.2	0.3
Other	8.8	4.1	1	0.4	0.1
<b>Finance &amp; insurance</b>	<b>100</b>	<b>6.5</b>	<b>7.8</b>	<b>6.5</b>	<b>7.8</b>

Source: Pakistan Bureau of Statistics

**Table 2.9: Performance of Banking Sector**  
growth rates in percent, unless mentioned otherwise

	FY13	FY14	FY15	FY16
Deposits	14.0	13.1	13.6	10.6
Advances-net of provision	4.3	12.4	8.7	13.8
Advances to deposits ratio	48.1	47.7	45.7	47.0
Investments-net	29.9	6.1	37.6	26.0
Profit/loss before tax (billion Rs)	170.4	195.5	305.0	320.1
Total assets	16.6	10.2	19.2	16.1

Source: State Bank of Pakistan

**Table 2.10: Transport, Storage and Communication**  
Gross output in billion rupees; contribution in percentage points

	Gross value addition		Growth		Contrib. to growth	
	FY15	FY16	FY15	FY16	FY15	FY16
Road transport	1,042.3	1,070.9	4.6	2.1	3.3	2.8
Communication	211.8	235.0	2.6	10.9	0.4	0.3
Air transport	86.2	94.8	20.9	10.1	1.1	0.9
Water transport	51.9	50	-2.8	-3.4	-0.1	-0.1
Storage	35.3	36.9	2.4	4.9	0.1	0.1
Railways	4.5	3.6	42.2	-19.2	0.1	0.1
Pipeline transport	2.1	1.8	-2.1	-16.8	0	0
<b>Total Services</b>	<b>1,434.3</b>	<b>1,493.0</b>	<b>4.9</b>	<b>4.1</b>	<b>4.9</b>	<b>4.1</b>

Figures for FY16 are provisional

Source: Pakistan Bureau of Statistics

<sup>71</sup> The performance of manufacturing sector has a significant influence on trading activities, as it contributes more than 50 percent of the value addition by wholesale & retail trade. This is followed by more than 20 percent contribution from trading in agricultural (both of crop and non-crop) produce, and around 15 percent on account of imported products.

<sup>72</sup> Non-crop segment of the agriculture sector recorded a marginally higher growth of 3.8 percent in FY16, compared to 3.5 percent last year.

<sup>73</sup> Source: Pakistan Economic Survey 2015-16.

<sup>74</sup> From September 2014 to August 2016, policy rate has been reduced by around 375 bps.

<sup>75</sup> Cargo handling at Karachi Port and Port Qasim showed a higher growth of 12.2 percent (on YoY basis) during Jul-Mar FY16, compared to a rise of 8.3 percent during the corresponding period of FY15.

SIM verification campaign launched in FY15 posed a major challenge to the telecom industry. Besides reducing the number of subscribers and increasing cost to mobile operators, this campaign also overshadowed the rollout of newly introduced 3G/4G services.<sup>76</sup>

Hence, a recovery in total teledensity and growing broadband subscription are some of the encouraging signs for the industry.<sup>77</sup> The mobile operators are also partnering with leading banks in the provision of financial services to unbanked population (Table 2.11).<sup>78</sup> The SIM verification campaign also had some positive spillover as availability of Biometric Verification System at agent locations allowed real-time, paper-less account opening facility across the country. Thus, both the number of accounts and the volume of transactions have been increasing gradually over time.<sup>79</sup>

**Table 2.11: Performance of Branchless Banking**

	No. of active agents in '000	Deposits as of end June (Rs millions)	Transactions	
			Average per day in '000	Value for the Quarter (Rs billions) <sup>1</sup>
2013	77	2,391	497	173
2014	141	6,219	791	326
2015	194	8,553	1,105	506
2016	236	13,734	1,319	544

<sup>1</sup> This pertains to end-June quarter every year.

Source: State Bank of Pakistan

Despite these positive developments, the telecom industry has to go a long way in catching up with achievements in other developing and regional countries. For example, the density of mobile phone subscribers is not only low in Pakistan, it has been falling behind other countries over the years (Table 2.12). In terms of ICT Development Index, which is a more comprehensive performance measure, the country ranked 143 out of 167 countries.<sup>80</sup> In fact, Pakistan belongs to a group of countries which have seen their rankings fall during the last five years.

**Table 2.12: Global Comparison**

Cellular subscriptions per 100 inhabitants	Cellular subscriptions			ICT Development Index Ranks (out of 167 countries)	
	2005	2010	2015	2010	2015
Malaysia	76	120	144	<b>Who gained in ranking</b>	
Indonesia	21	88	132	Brazil	73 61
Chile	65	116	129	Indonesia	109 108
Brazil	46	101	127	Kenya	126 124
Sri Lanka	17	84	113	Zimbabwe	132 127
Egypt	19	91	111	Nepal	140 136
Nepal	1	34	97	Bangladesh	148 144
Turkey	64	86	96	<b>Who lost in ranking</b>	
Zimbabwe	5	59	85	Malaysia	61 64
Bangladesh	6	45	83	Turkey	67 69
Kenya	13	61	81	Egypt	98 100
India	8	62	79	India	125 131
Pakistan	8	57	67	Pakistan	138 143

Source: International Telecommunication Union

In order to accelerate growth, telcos need to further enhance networks and work closely with banks to introduce more customer oriented services beyond remittances, such as insurance, savings, credit, etc.<sup>81</sup> From the policy side, rationalization of tax structure is imperative as its high incidence both on operators and consumers, acts as one of the major barriers to affordability and penetration of the mobile services.

<sup>76</sup> During FY15, the government launched a massive campaign for biometric verification of SIMs. As a result, around 26 million active SIMs were blocked, which not only restricted teledensity in the country but also led to revenue losses for the services providers. Cellular companies also incurred expenses on the procurement of verification devices, mobilization and training of staff, and running consumer awareness campaigns.

<sup>77</sup> Specifically, the number of 3G/4G subscribers has almost doubled to 29.5 million by end-June 2016. The total teledensity, which had dropped to 62.9 in end-June 2015 from 80.0 percent a year earlier, has now recovered to 70.8 percent (source: Pakistan Telecommunication Authority).

<sup>78</sup> The low penetration of formal banking system puts the telecom operators in a better position to capitalize on the geographical coverage and plays a key role in extending the outreach of financial services, particularly to rural areas.

<sup>79</sup> The number of branchless banking accounts has risen from 10.9 million at end-June 2015 to 13.7 million by end-March 2016.

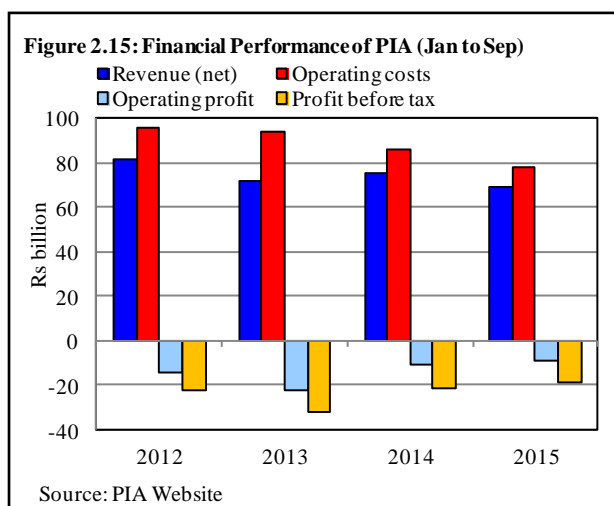
<sup>80</sup> International Telecom Union compiles ICT Development Index after five years. This index covers performance of the telecom services under various dimensions, including access, use and capability of users.

<sup>81</sup> Currently, most of the transactions are done over-the-counter, and mainly aimed at fund transfer and utility payments.

The government policy of broadening the tax base also has some bearings on financial inclusion. Specifically, the imposition of the transaction tax on the withdrawal of more than Rs 50,000 per day from bank accounts is also applicable on branchless banking agents, who use their bank accounts to facilitate customers' transactions. These agents now have incentive either to refuse customers once they reach the threshold of Rs 50,000 per day, or pass on this additional tax to their consumers. Early resolution of such conflicts is needed to promote financial services in the country.

Meanwhile, a decline in operating cost helped Pakistan International Airline (PIA) further contain its losses during Jan-Sep 2015 despite falling revenues and depreciation of the exchange rate (Figure 2.15).<sup>82</sup> Its revenues declined by 8.7 percent because of limited available capacity and operations. On the expenditure side, fall in global fuel prices pushed down total cost from Rs 86.7 billion in 2014 to Rs 78.2 billion in 2015.

In fact, fuel cost now accounts for 28 percent of the total cost compared to around 44 percent in the previous two years. Other costs increased at a slower pace (7.7 percent) during Jul-Sep 2015, compared to 11.6 percent during the corresponding period of the previous year.<sup>83</sup>



Yet, other performance indicators showed a mixed picture: the increase in fleet is an encouraging sign, but decline in the load factors is a source of concern (Table 2.13). Going forward, fleet modernization and improved efficiencies would play a vital role in improving services quality, image and competitiveness of PIA.

Finally, the decline in value addition by railways may also be due to a reduction in the passenger fare and freight charges – an effort to improve Pakistan Railways' (PR) competitiveness.<sup>84</sup> We expect further

improvement in the financial position of PR because of contained expenditures and expansion in business volume (Box 2.4 on Pakistan Railways).

Table 2.13: PIA Performance Indicators

Indicators	Units	2013	2014	2015
PIA fleet	No. of planes	34	34	38
Route	Kms	411,936	389,445	367,251
Available seat	million Kms	17,412	16,536	16,666
Passenger load factor	in percent	70	72	70.3
Distance flown	000 Kms	63,144	61,389	67,630
Revenue hours flown	Hours	106,476	101,556	111,455
Revenue per passengers carried	000 nos.	4,449	4,202	4,393
Revenue passengers	million Kms	12,237	11,903	11,711
Revenue tonne	million Kms	1,351	1,241	1,191
Revenue load factor	in percent	55	52	48.9
Available tonne	million Kms	2,471	2,396	2,435

Source: Civil Aviation Authority and Pakistan Economic Survey 2015-16

#### Box 2.4: Pakistan Railways on the Path of Improvement

Pakistan Railways (PR) has recently recorded an uptick in business operations, improvement in revenues, and some reduction in operating expenses (Figure 2.4.1). This recovery is encouraging given PR's persistent weak performance during the last several years.

As evident from historical trends shown in Figure 2.4.2, revenues earned by PR were barely sufficient to meet the operating

<sup>82</sup> Losses declined to Rs 19.0 billion compared to Rs 21.6 billion and Rs 31.6 billion in 2014 and 2013 respectively. PIA also lost Rs 2 billion due to PKR depreciation during the year.

<sup>83</sup> Other costs include salaries, wages, and allowances, welfare and social security, retirement benefits, repair and maintenance, flight equipment rental, landing and handling, communication, depreciation etc.

<sup>84</sup> During the first nine months of FY16, PR earned Rs 26.4 billion – an increase of Rs 3.2 billion when compared with its earnings for the corresponding period of FY15.



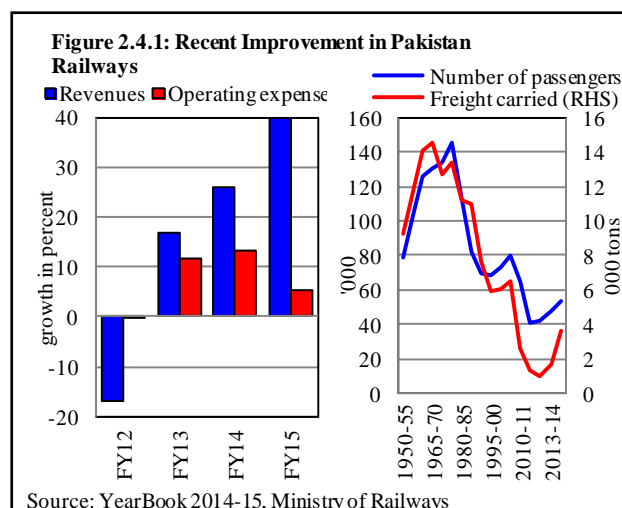
cost. One of the major reasons was the growing competition from road transport, which had started affecting business volumes of PR in early 1980s (Figure 2.4.1).<sup>85</sup> Another setback came in early 1990s, when low-yielding passenger operations began to receive priority over high-yielding freight business.<sup>86,87</sup> Thus, more resources (e.g., locomotives) were devoted to cater to needs of passenger traffic.

The financial stress on PR became more acute when the sharp increase in fuel prices in 2008 drove up expenses (as most of the locomotives run on diesel), whereas revenues fell due to shrinking operations (Table 2.4.1).<sup>88</sup>

In the meantime, the continued financial constraints did not allow room for investment in PR infrastructure. Thus, the rolling stock (i.e., number of locomotives, passenger coaches and freight wagons) kept on declining over time.<sup>89</sup> With no notable replacement and modernization, the maintenance cost of this old infrastructure increased to unsustainable levels (Table 2.4.1). The quality and scope of services also fell when the track length and number of routes was slashed. Although PR raised average prices to shore up revenues, the poorer and costlier services led to a sharp decline in both passenger and freight traffic.<sup>90,91</sup>

The staffing needs of PR also did not adjust to falling business volumes. Hence, salary and related expenses kept on consuming a major share of shrinking revenues (Table 2.4.1). Though the government provided several ad hoc bailout packages, such support could not bring any major financial improvement in PR.

In this backdrop, the recent improvement in the operations of PR is heartening. A number of initiatives helped in realizing these gains. For example, (i) repair of existing locomotives and procurement of new ones have allowed PR to expand its operation with greater reliability; (ii) tariffs have been adjusted downward to improve occupancy;<sup>92</sup> (iii) focus on freight business has increased;<sup>93</sup> and (iv) greater participation of private sector in train operation and management of terminals has improved revenues.



**Table 2.4.1: Ordinary Working Expenses to Gross Earnings**  
percent

	Total	Repair and maintenance	Fuel	Administration	Staff	Others
1975-80	80.3	33.7	20.6	10.5	11.1	4.4
1980-85	95.7	38.6	29.0	11.9	11.3	4.9
1985-90	90.5	40.6	19.8	12.3	11.7	6.1
1990-95	83.6	38.5	14.0	12.2	11.7	7.2
1995-00	101.2	45.5	17.4	14.2	12.8	11.4
2000-05	85.1	33.9	22.4	12.1	9.7	7.0
2005-10	113.8	40.0	40.2	15.6	11.7	6.3
2010-11	169.0	63.6	53.3	25.9	20.8	5.4
2011-12	203.6	77.6	55.1	35.1	29.4	6.5
2012-13	194.4	70.1	48.2	35.2	28.4	12.4
2013-14	174.5	59.1	48.2	31.0	24.6	11.8
2014-15	131.5	46.3	34.7	22.1	19.5	8.9

Source: Year Book 2014-15, Ministry of Railways  
Figures for 1950-55 to 2005-10, are 5-year averages

<sup>85</sup> The expansion in road network has remained on priority since late 1970s. The total road length, which had recorded an increase of 4,842 km during 1965-1975, expanded by 37,848 km in 1975-85 and further 81,402 km during 1985-95 (source: Pakistan Economic Survey). Thus, fund allocations under PSDP were also significantly higher for road construction. For example, during FY08-F15, the realized PSDP to PR was Rs 140.3 billion, whereas National Highway Authority (NHA) received Rs 453.7 billion during this period.

<sup>86</sup> Passenger traffic is low-yielding (compared to freight business) because of lower fares for commuters; higher maintenance cost of passenger wagons; and more burdens on support services.

<sup>87</sup> The long geographical stretch for country from south to north, offers PR a natural advantage in freight operations. Not surprisingly, by 1980, freight earning was already contributing 64 percent of PR revenues. The significance of freight however fell over time, reducing its share in total revenues to just around 16 percent during 2010-15.

<sup>88</sup> For example, the number of total freight trains operated declined to 1,782 in 2011-12 compared to over 20,000 in 1995-2000. Now, this number has improved, with 5,442 trains running in 2014-15.

<sup>89</sup> At the end of 2014-15, there were 446 diesel locomotive compared to 545 in 1995-2000.

<sup>90</sup> Currently the 11,881-kilometer long track that serves 7,791 long routes is 1,350 kilometers shorter compared to its length in 1950-55. This includes abandoning of 600 kilometer of meter gauge and dismantling of around 750 kilometer of the narrow gauge track. In fact, the dismantling of the narrow and meter gauge track is a result of abandoning of the steam engines, which used to operate on these tracks.

<sup>91</sup> In fact, a large part of the population, especially in Balochistan and KP, are left with no train services.

<sup>92</sup> The average rate charged on freight has declined from Rs 4.16 per ton per km in FY13 to Rs 2.44 in FY15.

<sup>93</sup> The number of freight trains operated by PR which has declined to 1,414 (or 0.7 million km in terms of distance travel) in FY13 has reached 5,442 in FY15 (or 4.7 million km). This is still way below the maximum number of freight trains of 92,071 (or 14.4 million km) managed by PR during 1960-65.

At the same time, drastic fall in POL prices in global markets considerably reduced the gap between operating revenues and cost (Figure 2.4.2). However, the overall losses are still high at Rs 27.3 billion in FY15, reflecting the need to introduce much wider structural reforms in this public sector entity.

Encouragingly, the outlook is also positive as the up-gradation of mainline (Karachi-Lahore-Peshawar) railway track, construction of dry ports and cargo handling facilities would significantly improve PR's capacity to handle large traffic volume. At the same time, greater connectivity with China, upcoming coal-based power projects, and the expected development of special economic zones across the country would boost both passenger and freight business. The government has already envisaged enhancing the share of railways in transportation from current level of 4 percent to 20 percent by 2025.

