

2 Economic Growth

2.1 Overview

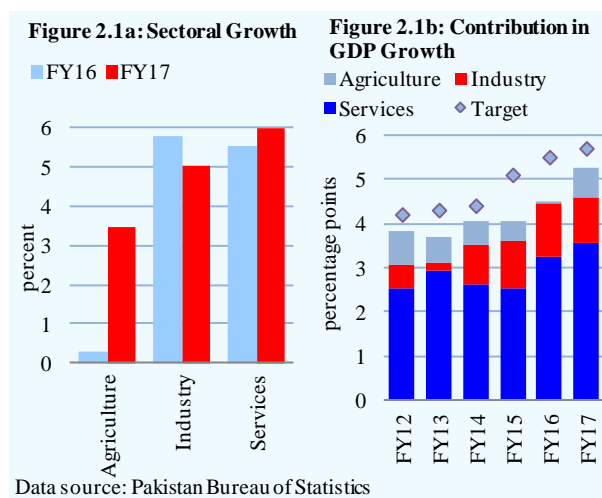
The real GDP growth gained further momentum during FY17, increasing by 5.3 percent compared to 4.5 percent last year (Figure 2.1). This growth was not only the highest over the last decade, but also broad-based. A sharp recovery in agriculture production, healthy value addition in the services sector, and continued improvement in the manufacturing sector contributed towards this encouraging performance.¹

The agriculture sector not only achieved the targeted growth rate of 3.5 percent during FY17, but also recorded its highest growth in the last five years (owing to a broad-based improvement in the production of important crops). From policy perspective, the continuation of price support on wheat and sugarcane protected growers against falling prices of these crops in the international market. At the same time, fertilizer offtake improved sharply in FY17, as the subsidy announced under Kissan package led to a decline in its prices.² This was further supported by affordable access to credit facilities. As a result, important crops segment posted a growth of 4.1 percent against a contraction of 5.5 percent experienced last year.

Revitalization of the agriculture sector also had a positive spillover into the industrial sector, particularly the Large-scale Manufacturing (LSM). A surge in sugarcane production led to record sugar output in the country, which in turn steered LSM to achieve 5.7 percent growth during FY17.³

The manufacturing activities also benefitted from the government policies. For example, support to the agriculture sector also increased the purchasing power in the rural areas. The real wages, particularly in urban households, also received support from benign inflation, rising income, and stable exchange rate. This, coupled with improved availability of electricity, had favorable spillovers in the consumer durable (e.g. electronics) and pharmaceutical segments (due to increased health spending) of the industrial sector. Moreover, the increased PSDP spending led to a widespread growth in construction and infrastructure related activities in the economy, which in effect provided support to allied industries (such as cement and steel) in the manufacturing sector. Further support to LSM came from a relaxation in import duties, and decreasing corporate taxes.⁴

The growth in the services sector surpassed both the target and the last year's level. The recovery in the agriculture sector, an increase in manufacturing output, and a rise in trade related activities largely explain the outstanding performance of services. Thus, the sector contributed around two-thirds of



¹ The GDP estimates for FY17 compiled by National Income Accounts are based on projected LSM growth of 4.9 percent.

² Although the fertilizer subsidy under Kissan package was announced in November 2015, its sale remained depressed throughout the fiscal year. This was because growers were anticipating a downward revision in fertilizer prices, whereas the actual decline came in April 2016 when the government reduced the tariffs for feedstock gas.

³ It may be noted that some of the industries could not perform well due to sector specific issues. For example, fertilizer industry suffered due to delays in the implementation of subsidy scheme; a hike in the federal excise duty led to decline cigarettes production; and a move towards sale of high quality motor gasoline slowed down its production growth.

⁴ See Box 4.1 in Chapter 4 on Fiscal Policy.

the growth in GDP observed during FY17, with *wholesale and retail and finance and insurance* leading the performance.

On the expenditure front, the high domestic consumption continued to drive the growth in GDP. Factors like fiscal expansion, subdued inflation, growing income levels, and higher demand from expanding middle class population⁵ bolstered consumer spending in the economy.

Though Pakistan's GDP growth of 5.3 percent in FY17 was notable, this still lags behind over 8.0 percent growth target as envisaged in Vision 2025 for 2018 and onwards. Furthermore, the current consumption led growth poses questions regarding the sustainability of the performance. This is because (1) the current investment rate, though improving, still remains insufficient to enhance production capacity to match the fast growing demand;⁶ and (2) the existing growth structure, particularly for industries, does not generate sufficient export earnings to ease the balance of payment constraint – one of the most binding impediment to sustainable and high economic growth. In terms of the latter point, the policy incentives do not encourage industries to look out for competition in the global markets (**Box 2.1**). At the same time, achieving sustainable growth in export earnings becomes increasingly challenging as more of the GDP growth comes from the services sector, which has limited export potential. The growth strategy should therefore focus on promoting investment in high value added exporting activities both in industrial and services sectors (**Box 2.3**).

Box 2.1: Industrial Growth in Pakistan – the Role of Liberalization Policy

The industrial sector of Pakistan has achieved encouraging and broad-based growth over the recent years. This has come on the back of an ease in policy rates and continued efforts of the government to address long-term impediments, such as inadequate energy supplies, and challenging law and order situation. Meanwhile, the growing domestic consumption bolstered the production of the manufacturing sector. Despite all these gains, the industrial growth in Pakistan still lags behind its regional competitors (**Figure 2.1.1**).

While inadequate level of investment (both in private and public sector) explains the lower industrial growth in Pakistan, the role of tariff liberalization policies cannot be overlooked. For example, a well designed liberalization policy would positively impact industries, mainly by promoting technology transfer. At the same time, the resulting gains (e.g., due to improved efficiency and larger economies of scale in production) would make industrial products competitive in the global markets. However, in actual settings, most of these gains would depend on how other countries pursue their liberalization goals. In this backdrop, we have reviewed the tariff liberalization efforts in Pakistan's industrial sector and compared our experience with regional competitors. The analysis offers some interesting insights:

Firstly, the liberalization efforts have been slower in Pakistan (**Figure 2.1.2**). This is evident from the fact that India, Bangladesh, and Sri Lanka, all significantly lowered their average tariff rates between FY92 and FY98, while Pakistan waited till the start of the new millennium to catch up. This had various implications: (a) with our industries relying on imported machinery for the production of final commodities, higher tariffs meant that the costs were high relative to other regional players – this made the goods less competitive in the global markets; (b) even when Pakistan fairly liberalized its industrial sector after FY02 (with average rates lower than India and Sri Lanka, for example), the first mover advantage was lost and market shares to a large extent had already been captured and maintained by our close competitors.

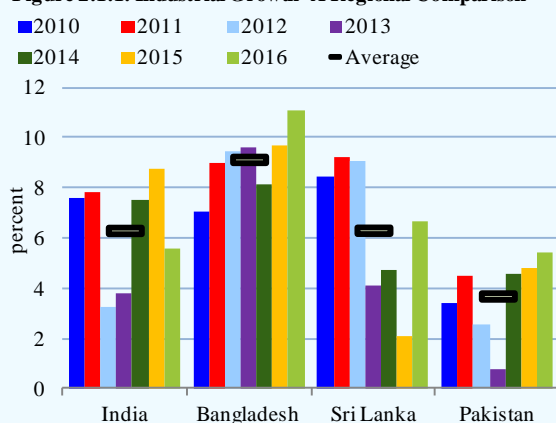
Secondly, the liberalization efforts were not implemented uniformly across the sectors (**Figure 2.1.3**), with many maintaining fairly high protection, such as textiles, automobiles, ceramics, essential oils, etc. The imposition of higher tariffs in selected industries resulted in the local market getting shielded from foreign competition. This further fueled the anti-export bias in the economy and allowed firms to earn attractive margin by tapping the strong domestic demand. It also incentivized inefficient production in the domestic market (diverting the focus away from quality control). The auto

⁵ According to the Household Integrated Expenditure Survey conducted by PBS, the second, third and fourth quartile population of the economy witnessed an increase of 14.5 percent, 12.6 percent and 16.1 percent respectively in their income, which led to a rise of 16.7 percent in per capita expenditure for three quartiles during FY14 to FY16.

⁶ FY17 saw a slight improvement in the investment figures of the economy, mainly on account of increased focus on CPEC and public infrastructure development projects. At the same time, a low interest rate environment has led to an uptick in the loans to private sector (particularly for fixed investment). Various firms are investing in capacity expansions, anticipating higher demand and better margins in the coming years. Increasing investments are a good omen for future growth; however the current level far below the regional competitors.

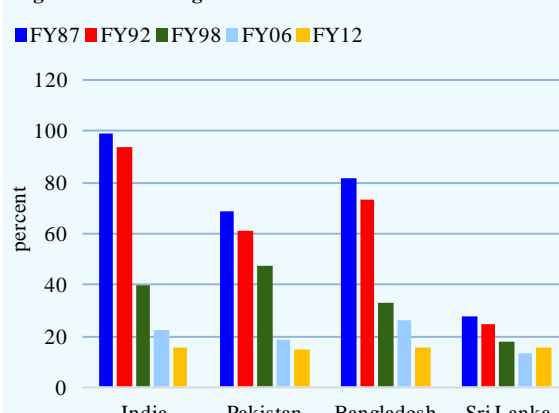
industry has been a prime example of this – with barriers to entry (until the recent announcement of the new Automotive Development Policy 2016-2021 that has enticed new players to enter the sector) and high tariffs, it resorted to manufacturing well below economic scales. This not only hurt the end users but also reduced the competitiveness, further bolstering anti-export bias amongst the manufacturers. It is pertinent to note that the trend of non-uniformity has been observed in the tariff structure of the regional competitors as well, however in case of Pakistan the degree of protection has been higher (**Figure 2.1.4**).

Figure 2.1.1: Industrial Growth- A Regional Comparison



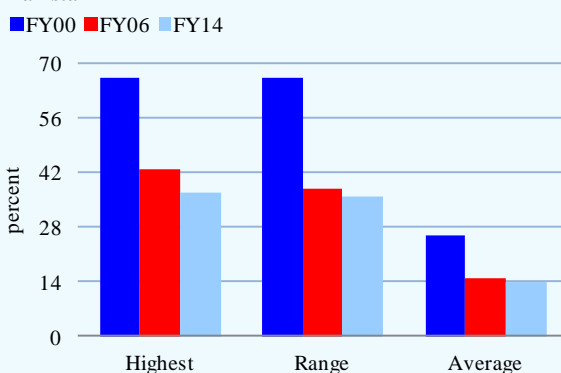
Data source: World Bank

Figure 2.1.2: Average Tariff Rates



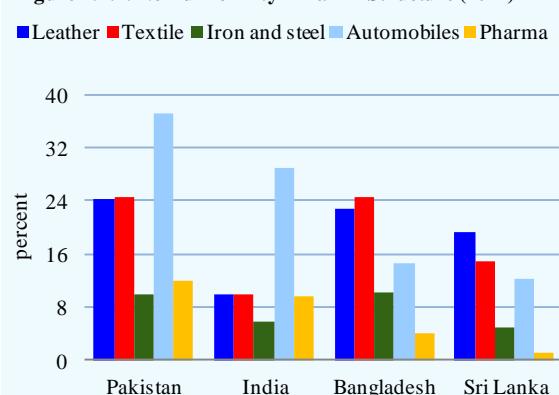
Data source: Trade Policies in South Asia (2004, WB); UNCTAD

Figure 2.1.3: Trends in Tariff Variation for Industries - Pakistan



Data source: United Nations Conference on Trade and Development

Figure 2.1.4: Non-uniformity in Tariff Structure (2014)



Data source: United Nations Conference on Trade and Development

Finally, and most importantly, the tariff structure has also been applied disproportionately; final goods faced stricter controls than raw materials and intermediates (**Table 2.1.1**). This encourages “low value-addition” in the production sectors. This is because the skewed tariff structure restricts evolution of strong backward linkages (as evidenced by the strong dependence of the industrial sector on imported intermediate capital goods), while high protection on final products restricts foreign competition. Furthermore, the escalating tariff structure was especially detrimental for the SME sector, which mainly focuses on the production of semi-finished and intermediate commodities.

In retrospect, it can be argued that the semi-liberalized, non-uniform, and escalating tariff structure not only diverted export orientation of the industrial sector but also made it import dependent by hindering the formation of strong backward linkages in the economy. This suggests that Pakistan would have to focus on developing an

Table 2.1.1: Tariff Escalation in Pakistan

percent	First Stage	Semi-finished	Final
Textile, apparel, and leather	8.9	13.1	16.4
Manufactured wood products	7.9	14.5	23.6
Paper, printing, publishing	N/A	14.2	30.9
Manufactured chemicals, petroleum, coal, rubber, plastics	7.5	19.5	18.5
Manufactured non-metallic minerals (except petroleum)	7.5	8.7	15.5
Basic metal industries, manufactured metal products	5.0	22.3	21.3
Machinery and equipment	11.2	10.7	16.6
Other manufacturing	N/A	13.5	14
Stage finished	5.0	8.8	18.7
Simple average tariff by stages of processing (percent)	9.0	11.3	17.3

Data source: World Bank (2006): Pakistan – Growth and Export Competitiveness

industrial policy that is less intrusive (selective shielding) and more facilitative so as to spur innovation for a broad based growth on a sustainable basis.

2.2 Agriculture

The overall agriculture sector rebounded strongly, as it registered a growth of 3.5 percent in FY17 compared to a nominal increase of 0.3 percent in the previous year (Table 2.1). An impressive recovery in important crops explains this performance. Indeed, this was a notable achievement given that the area under important crops had declined, and the water availability remained lower than expectations. An across the board increase in crop yields, largely driven by a considerable rise in fertilizer application and government support (e.g., subsidy on fertilizer, attractive support prices on wheat and sugarcane, and lower tax on pesticides), facilitated the important crops to post a marked recovery in production. Further support came from livestock (the largest sub-sector within agriculture) that maintained last year's growth of 3.4 percent in FY17 as well.

The price support policy is paying off as both wheat and sugarcane have shown impressive performance during the year. However, while the subsidy has also been successful in protecting growers from the impact of low international prices of their produce, this pursuing this policy would be challenging in the long run. In fact, the country is already experiencing gradual buildup of wheat and sugar stocks. This is happening when the crop yields in the country have lagged behind the global benchmarks by wide margins.⁷

Crop Sector

FY17 was the first time after 1991 that all important crops recorded a positive growth in a year. In particular, sugarcane and maize reached their record harvest, and cotton crop recovered from low output in the previous year (Table 2.2). The improved showing by the three crops, which together account for 47.2 percent of important crops, steered the impressive recovery in the crop sector. The production of other crops (mainly oil seeds, pulses, condiments, fruits and vegetable) remained below expectations however, as key crops in this group (e.g., barley, onion, and potatoes) missed their target by a wide margin.

The availability of agriculture input also remained favorable during FY17. The sizeable support from the government on urea and DAP lowered their prices in the domestic market,

Table 2.1: Performance of Agriculture Sector
share and growth in percent; contribution in percentage points

	Share in GDP FY17	Growth		Contribution to agri growth	
		FY16	FY17	FY16	FY17
Crop	7.3	-5.0	3.0	-2.0	1.1
Important crops	4.7	-5.5	4.1	-1.4	1.0
Other crops	2.2	0.6	0.2	0.1	0.0
Cotton ginning	0.5	-22.1	5.6	-0.7	0.1
Livestock	11.4	3.4	3.4	1.9	2.0
Forestry	0.5	14.3	14.5	0.3	0.3
Fishing	0.4	3.2	1.2	0.1	0.0
Overall	19.5	0.3	3.5	-	-

Data source: Pakistan Bureau of Statistics

Table 2.2: Performance of Important Crops

	FY15	FY16	FY17	% Growth	
				FY16	FY17
Area (in thousand hectares)					
Cotton	2,961	2,902	2,489	-2.0	-14.2
Rice	2,891	2,739	2,724	-5.3	-0.5
Sugarcane	1,141	1,131	1,217	-0.9	7.6
Wheat	9,204	9,224	9,052	0.2	-1.9
Maize	1,142	1,191	1,334	4.3	12.0
Production (in thousand tons; for cotton, thousand bales)					
Cotton	13,960	9,917	10,671	-29.0	7.6
Rice	7,003	6,801	6,849	-2.9	0.7
Sugarcane	62,826	65,482	73,607	4.2	12.4
Wheat	25,086	25,633	25,750	2.2	0.5
Maize	4,937	5,271	6,130	6.8	16.3
Yield (kilograms per hectare)					
Cotton	802	582	730	-27.4	25.4
Rice	2,422	2,483	2,514	2.5	1.2
Sugarcane	55,062	57,897	60,482	5.1	4.5
Wheat	2,726	2,779	2,845	1.9	2.4
Maize	4,323	4,426	4,595	2.4	3.8

Data source: Pakistan Bureau of Statistics

⁷ For example, global average yields during 2010-2014 for sugarcane, rice, wheat and maize crops exceeded those realized in Pakistan by a wide margin of more than 20 percent.

and consequently increased their sale by 15.1 and 24.1 percent respectively (**Table 2.3**).⁸ Furthermore, this policy proved quite effective in protecting growers against the rising global prices of fertilizer during the *rabi* season.⁹

The water situation, on the other hand, came under stress, particularly for *rabi* crops. The prolonged dry spell in early *rabi* season led to a significant drop of 9.8 percent in water availability compared to previous year.¹⁰ However, its adverse impact was limited to Potohar region where crops suffered due to lack of soil moisture; growers in the irrigated areas resorted to groundwater extraction to overcome supply shortages. In contrast, the situation was comforting for *kharif* crops as water supplies surged by 9 percent compared to previous year.

Keeping up with its momentum, agriculture credit increased by 17.8 percent (Rs 106.2 billion) in FY17, following 16.0 percent (Rs 82.4 billion) rise recorded in previous year. Impressive gains by Microfinance Banks and Institutions (MFIBs), mainly due to inclusion of Microfinance Institutions (MFIs) in agri finance, explains this encouraging performance (**Figure 2.2a & b**).

Another encouraging shift was the recovery in financing for development purpose (e.g., purchase of tractors, tubewell, farm machinery and land improvement). Such loans increased by 6 percent in FY17 against a contraction of 15.6 percent in FY16. Moreover, production loans, which are extended to meet short term requirements of farmers for seeds, fertilizer and pesticides, also showed an expansion of 18.8 percent, on top of 20.1 percent growth realized last year (**Figure 2.2a & b**).

Rice

Rice posted a marginal growth of 0.7 percent (6.9 million tons) in FY17, as higher yields more than offset the impact of reduced area under the crop (**Table 2.2**). This is the second consecutive year when the crop area fell. However, unlike FY16 when area under rice had declined for all varieties, it was non-basmati variety (e.g., irri), particularly in Punjab, which experienced a contraction in area during FY17.

Table 2.3: Fertilizer Off-take

million tons		Kharif	Rabi	Total
Urea	2016	2.4	4.9	7.3
	2017	2.7	5.6	8.3
	Growth	12.5	14.3	13.7
DAP	2016	0.4	1.9	2.3
	2017	0.7	2.3	3
	Growth	75	21.1	30.4

Data source: National Fertilizer Development Center

Figure 2.2a: Growth in Agri-finance

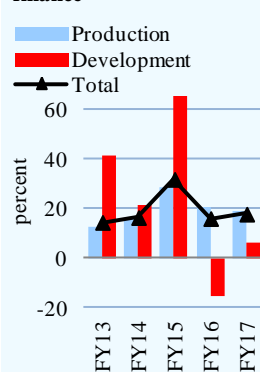
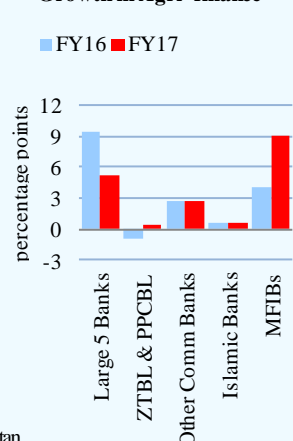


Figure 2.2b: Contribution to Growth in Agri-finance



Data source: State Bank of Pakistan

⁸ The government provided a cash subsidy of Rs 300 per 50 kg bag on DAP. In the case of urea, subsidy amounted to Rs 390 per 50 kg bag (this included the impact of Rs 50 due to voluntary price reduction by domestic manufacturers; benefit of Rs 184 on account of GST reduction from 17 percent to 5 percent; and a cash subsidy of Rs 156). These subsidies led to a decline of 21.4 percent and 23.8 percent in the prices of urea and DAP. The government also allowed subsidy on NP, NPK and SSP. Although the government allocated Rs 28 billion in the budget for this subsidy scheme, the actual expense exceeded the initial allocation.

⁹ During September 2016 to March 2017, prices of urea and DAP in the international market increased by 20 percent and 8 percent respectively. In comparison, domestic prices remained stable (in the case of urea) or declined (for DAP).

¹⁰ Water availability during *rabi* 2016-17 remained at 29.7 million acre feet (MAF), compared to 32.9 MAF during the corresponding season previous year.

The rice cultivation in Punjab has been witnessing some interesting trends. For example, the area under non-basmati rice has almost halved over last five years, whereas that of basmati has risen by 36 percent (351 thousand hectare) during the same period.¹¹ Within basmati, southern districts (e.g., Sahiwal, Multan, DG Khan and Bahawalpur) are gaining share against Gujranwala and Lahore (which traditionally have remained stronghold for basmati). The frequent setbacks with cotton crop in recent years largely explain this shifting of southern districts to rice cultivation.

Cotton

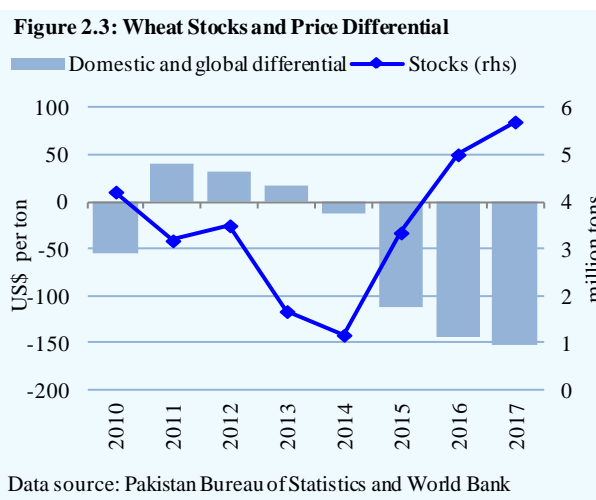
Cotton crop showed a marked recovery as the output reached 10.8 million bales in FY17, from 9.9 million bales a year earlier (when the crop suffered from pest attack). This performance is notable given a decline of 14.2 percent in area under the crop, as the high risk of infestation and low prices in early months of FY17 led farmers to go for more profitable crops (e.g., maize, rice and sugarcane). However, favorable price in the later months attracted more farmers and encouraged them to use more inputs and take better care of crop against pest attacks, which in turn helped in achieving higher yields. Nonetheless, the cotton crop still appears under stress as the output remained way below the average of 13.3 million bales for three years preceding FY16.

Wheat

Wheat production recorded a rise of 0.5 percent to reach 25.8 million tons in FY17. The crop suffered setbacks in rain-fed areas owing to scanty showers in the first half of *rabi* season. The resultant losses however were more than offset by strong performance in the irrigated regions. In particular, the attractive procurement prices not only encouraged additional area under wheat cultivation, but also induced growers to apply more fertilizer compared to previous *rabi*.¹²

FY17 was the fourth consecutive year when the wheat harvest crossed 25 million tons mark. Since the harvest exceeds the domestic consumption, this impressive performance over the years has also led to a sharp buildup of domestic wheat stocks to record 5.7 million tons by June 2017 (from just 1.2 million tons in June 2014) (Figure 2.3). We expect this stock to increase further in FY18 due to better harvest and large procurement target (7.05 million tons) for the current season.

Maintaining such high level of stocks involves certain costs. As the government has kept the procurement prices at significantly high level, particularly when the global prices are facing persistent decline over the past few years, this has made offloading surplus wheat in the global market difficult without incurring losses. In addition, as the unsold wheat reserves have been rising over time, the outstanding loans taken by the government for its procurement are also growing.¹³ More importantly, the policy challenge is likely to continue going forward, as the wheat prices in the international market are likely to remain sluggish due to better harvest in major wheat exporting countries.



¹¹ Non-basmati area fell from 716.3 thousand hectare in FY13 to 383.6 thousand hectare in FY17.

¹² The government maintained the procurement prices to Rs 1350 per 40 kg for FY17, despite a downtrend in global wheat prices.

¹³ The outstanding loan against wheat procurement has soared to Rs 600 billion in FY17, from Rs 100 billion a decade earlier.

Sugarcane

Sugarcane production grew by 12.4 percent in FY17 to reach a record high of 73.6 million tons. This was the first time in the past 6 years that sugarcane output growth reached double figures. The improvement was achieved on the back of both the larger area under crop as well as better yields. The continued low cotton prices (along with frequent pest attacks) and changing weather pattern marked by excessive rains have driven growers towards more resilient sugarcane crop that yields stable and attractive returns.¹⁴ In addition, relocation and capacity enhancement of some sugar mills spurred growers' interest in the crop.

The policy of keeping indicative prices at attractive level has led to an increase of 25 percent in sugarcane production over a period of last five years, with a corresponding increase in the sugar output by the industry. Since the domestic consumption is growing at a moderate pace, the country has been building up the unsold stock of sugar (**Figure 2.4**). This surplus sugar cannot be exported without a large subsidy from the government, as the high indicative prices of sugarcane made the industry uncompetitive in the global market.

Maize

The maize production increased to 6.1 million tons in FY17, showing a higher growth of 16.3 percent compared to 6.3 percent last year. Though the crop yields improved by 3.8 percent, the higher production was more due to larger area under cultivation (up 12 percent).

More than 80 percent of maize is produced in Punjab; of that, more than 70 percent is concentrated in the mid-eastern districts of Punjab (e.g., Kasur, Okara, Pakpattan, Sahiwal and Vehari). These districts produce 69.3 percent more maize per hectare of land than the rest of Punjab. In addition to being blessed with fertile soils, productivity differential owes much to the work of the seed research companies that have developed new seed varieties in conjunction with their work with maize growers in these areas. Companies like Cargill, Monsanto, ICI, Rafhan, and Pioneer have penetrated the maize seed market. The preference for maize in this region is a result of better farm yields bringing in higher returns. As the work of these companies expanded, more growers jumped on the bandwagon converting mid eastern Punjab into a maize stronghold.

Thus, maize is gradually replacing traditional cash crops (such as cotton and sugarcane) in these districts (**Table 2.4**). The switch away from sugarcane is understandable, as sugar mills have generally moved southwards in search of better recovery rates. Similarly, volatility of cotton prices, high sensitivity of crop towards climatic conditions and occasional pest attacks may have played a crucial role in swinging the balance in favor of the maize crop in this region.

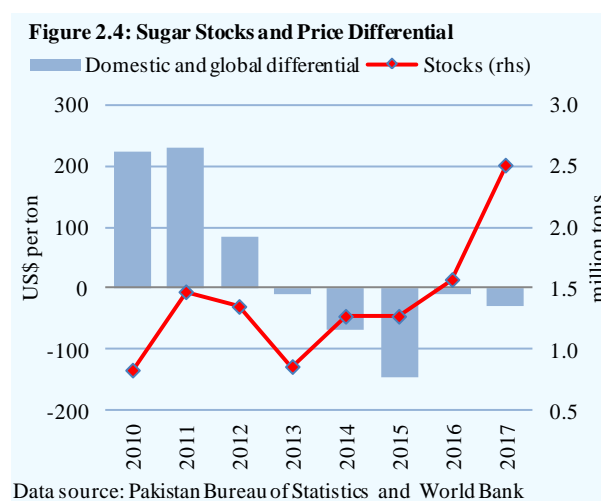


Table 2.4: Share of Area under Kharif Crops (Mid Eastern Punjab)¹
percent

	Maize	Cotton	Rice	Sugarcane
FY07	21.4	39.3	28.3	11.0
FY11	26.9	37.5	27.5	8.1
FY17	46.1	19.7	27.9	6.3

Data source: Crop Reporting Centre, Government of Punjab

¹ Mid-eastern Punjab includes districts Okara, Sahiwal, Pakpattan, Vehari and Kasur

¹⁴ The provincial governments set the indicative price of sugarcane at the start of each crushing season which serves as a benchmark for both the buyers and the sellers. The current sugarcane price of around Rs 4,500 per ton has been in place for the past three years.

2.3 Industry

The industrial sector recorded a growth of 5.0 percent in FY17, which was lower than the target of 7.7 percent for the year (**Figure 2.5**). This was mainly due to a drag from *mining and quarrying* (on the back of decline in natural gas, which has a weight of about 66 percent in the mining sector) and *electricity generation & distribution and gas distribution* subsectors (mainly due to non completion of ongoing projects) (**Table 2.5**). These subsectors had mainly driven industrial growth last year by contributing almost one-third of the industrial performance. Similarly, the growth in *construction* moderated, but this was expected as it had recorded a strong growth of 14.6 percent last year. In contrast, *manufacturing* experienced a significant improvement over last year (especially LSM, although higher sugar production dominated by contributing almost half of the growth).

Large Scale Manufacturing

The large scale manufacturing witnessed a growth of 5.7 percent during FY17, compared to 3.1 percent observed during last year – the highest growth achieved during the last 10 years.¹⁵ More importantly, this growth is broad based, as a number of industries (e.g., textile, food, POL, paper, electronics, pharmaceuticals, and steel) performed better this year. However, the dominant contribution came from sugar, which recorded a steep rise of 37.8 percent in FY17, partly reflecting a record harvest of sugarcane crop (**Table 2.6**). Excluding sugar, the LSM grew by 3.4 percent during FY17 – unchanged from last year's level.

In overall terms, manufacturing activities benefited from improved energy supplies, low interest rates, better security situation, and increased spending on construction and infrastructure. Despite the favorable macroeconomic environment, some sectors showed deceleration or contraction due to various regulatory issues (for example in leather; and cigarettes) and supply side constraints (in fertilizer; vegetable ghee and cooking oil; and chemicals).

Automobile

The automobile industry, continuing on the momentum achieved last year, grew by 11.2 percent during FY17. The performance was commendable, considering that the conclusion of Apna Rozgar Scheme led to a steep contraction of 32.3 percent in the Light Commercial Vehicle (LCV) segment (as opposed to a growth of 27.1 percent during the corresponding previous period). The healthy performance of passenger vehicles, tractors, trucks, and buses helped offset this impact of LCV production decline.

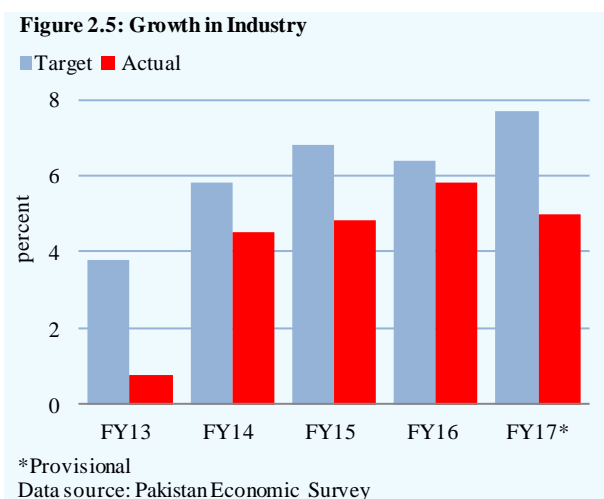


Table 2.5: Growth in Industry
growth in percent and contribution in percentage points

	Share	Growth		Contribution in growth	
		FY16	FY17	FY16	FY17
Industry	20.9	5.8	5.0	5.8	5.0
Mining & quarrying	2.9	6.9	1.3	1.0	0.2
Manufacturing	13.4	3.7	5.3	2.4	3.4
Large scale	10.7	2.9	4.9	1.6	2.5
Small scale	1.8	8.2	8.2	0.7	0.7
Slaughtering	0.9	3.6	3.6	0.2	0.2
Electricity gen. & distt and gas distribution	1.8	8.4	3.4	0.7	0.3
Construction	2.7	14.6	9.0	1.7	1.1

Data source: Pakistan Bureau of Statistics

¹⁵ The Quantum Index of Manufacturing, which has a base year of FY06, has reached 139.4 in June 2017. This means that LSM has recorded a cumulative growth of 39.4 percent over the last 11 years.

The low interest rate environment for auto financing, coupled with the introduction of new models of popular vehicles, helped maintain consumer's interest in jeeps and cars (having the highest weight in the automobile sector). Further impetus to demand for passenger cars stemmed from the launch of online cab services in major urban areas. Thus, production and sales of this segment grew by 5.4 percent and 4.0 percent respectively during FY17 (**Table 2.7**). On parallel terms, higher purchasing power of farmers, increase in agri lending and a reduction in the sales tax led to a turnaround in the production of tractors, as it recovered from a decline of 28.6 percent last year to post a growth of 54.6 percent during FY17.¹⁶ Lastly, progress in construction and infrastructure related activities bolstered the production figures of trucks and buses (the segments grew by 36.1 percent and 4.5 percent, respectively).

Going forward, both demand and supply side factors would help keep the growth momentum strong in the sector. The rising income levels; availability of affordable bank financing; and low motorization rate would help push the demand upwards.¹⁷ On the supply side, the sector would benefit from the proposed Punjab government's "Orange Cab scheme", which entails distribution of 50,000 cars to unemployed youth. Further support would emanate from the recent introduction of Corolla facelift with de-bottlenecking¹⁸ which is to ease concerns of capacity constraints. The entry of new players and the associated foreign investment would also contribute in continuing the growth momentum of the auto industry on a sustainable basis.¹⁹

Electronics

Improved availability of electricity, increasing consumer appetite for durable goods (backed by rising purchasing power) led the demand for home appliances in the country. On the supply side, stability in

Table 2.6 : Growth in LSM

growth in percent; contribution in percentage points

	Weight	Growth		Contribution in growth	
		FY16	FY17	FY16	FY17
LSM	70.3	3.1	5.7		
Textile	20.9	0.4	0.8	0.12	0.23
Cotton yarn	13.0	1.4	0.7	0.26	0.12
Cotton cloth	7.2	0.2	0.4	0.02	0.04
Jute goods	0.3	-41.3	8.1	-0.14	0.02
Food	12.4	0.6	11.5	0.12	2.33
Sugar	3.5	-0.7	37.8	-0.05	2.50
Cigarettes	2.1	-14.6	-35.8	-0.34	-0.69
Vegetable ghee	1.1	4.8	5.7	0.06	0.08
Cooking oil	2.2	3.7	3.2	0.13	0.11
Soft drinks	0.9	6.4	10.4	0.17	0.29
POL	5.5	-2.6	2.8	-0.17	0.17
Steel	5.4	-9.3	20.5	-0.36	0.70
Non-metallic minerals	5.4	10.0	4.4	1.03	0.49
Cement	5.3	10.1	4.5	1.03	0.49
Automobile	4.6	16.1	11.2	0.93	0.73
Jeeps and cars	2.8	17.6	5.4	0.52	0.18
Fertilizer	4.4	13.9	1.7	0.77	0.10
Pharmaceutical	3.6	6.7	9.1	0.54	0.76
Paper	2.3	-1.5	7.2	-0.05	0.24
Electronics	2.0	-1.8	21.6	-0.03	0.35
Chemicals	1.7	8.1	-2.3	0.19	-0.06
Caustic soda	0.4	22.5	-0.6	0.09	0.00
Leather products	0.9	6.9	-16.5	0.13	-0.32
LSM excl. sugar	66.8	3.4	3.4	-	-

Data source: Pakistan Bureau of Statistics

Table 2.7: Performance of Automobile Industry

growth	Weight	FY16		FY17	
		Output	Sales	Output	Sales
Tractors	0.5	-28.6	-27.4	54.6	61.8
Trucks	0.21	40.3	33.8	36.1	35.1
Buses	0.16	86.1	78.7	4.5	11.1
Jeeps and cars	2.82	17.6	19.4	5.4	4.0
L.C.V.s	0.33	27.1	29.3	-32.3	-33.4
Scooters/motorcycles	0.61	78.0	77.2	20.7	20.0

Data source: Pakistan Bureau of Statistics and Pakistan Automotive Manufacturers Association

¹⁶ The purchasing power of growers improved on the back of stable crop prices and lower input cost, whereas General Sales Tax on tractors was reduced to 5 percent from 10 percent in the Federal Budget for FY17.

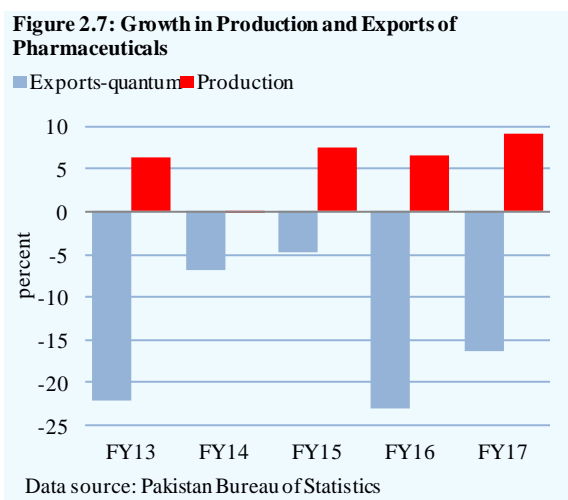
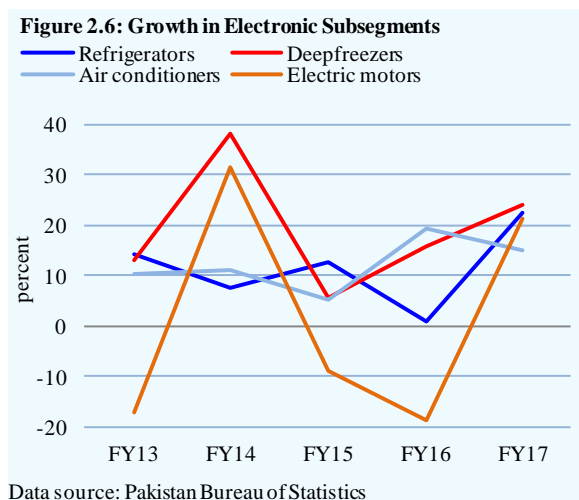
¹⁷ Pakistan has a low motorization rate of 18 vehicles per 1000 persons compared to a global average of 341 (source: Board of Investment Pakistan).

¹⁸ Indus Motors' debottlenecking is expected to add about 10,000 units annual capacity.

¹⁹ The government has allowed Kia-Lucky Motors Pakistan Limited (bringing in investment of US\$ 190 million), Nishat Group (US\$ 164 million) and United Motors Private Limited (US\$ 18.1 million), to set up units for assembly and manufacturing of vehicles under the Greenfield investment category, while renowned Swedish heavy commercial vehicles manufacturer. Scania is set to introduce its premium trucks, tractors, buses and coaches through a local distributor.

exchange rate and lower raw material prices (e.g., steel and copper) encouraged manufacturers to increase production in a favorable business environment.²⁰

Resultantly, the electronics industry rebounded strongly during FY17, growing by 21.6 percent after facing a contraction of 1.8 percent during FY16. The performance was fairly broad based amongst the consumer durable products, with refrigerators, deep freezers, and air conditioners, all posting double digit growth rates (**Figure 2.6**).



The production growth of electronics has been historically volatile in Pakistan. However, continuity in aforementioned factors – coupled with sustained rise in rural incomes on the back of better agriculture performance – could bolster sales in future and help bring stability to the segment.

Pharmaceutical

Manufacturing of pharmaceuticals posted a growth of 9.1 percent in FY17, on top of 6.7 percent observed during last year. This performance was encouraging given the steep decline in its export since FY10 (**Figure 2.7**).

A number of developments explain this acceleration in growth. For example, stable exchange rate (that reduced uncertainty regarding input prices); higher health spending under PSDP; crackdown on counterfeit and substandard products (especially in Punjab)²¹; and launch of new products (such as the introduction of Rotavirus vaccine in Punjab).

The demand for pharmaceutical products is also likely to stay strong in FY18, following an 80 percent rise in the budgetary allocation for health spending by the provincial governments.²² From the supply side, more new products are expected going forward as the local players are expanding their R&D operations following the checks on counterfeit products.

Cement

Despite continued decline in exports, the cement production managed to grow by 4.5 percent during FY17 to 37.1 million tons (following 10.1 percent rise in FY16), main aided by higher local

²⁰ Gross profit margins of the electronics industry have increased on average by about 20 percent in FY17.

²¹ The Drug Regulatory Authority of Pakistan’s (DRAP) campaign against spurious, fake and counterfeit drugs in FY17 resulted in sealing of hundreds of sales outlets, illegal and non-compliant manufacturing units throughout the country.

²² Rs 8 billion have been allocated for the Prime Minister’s Program for New Hospitals (Phase-I), Rs 1.3 billion have been marked to build 46 other hospitals, and around Rs 7.6 billion have been earmarked to fight polio under Expanded Program on Immunization.

dispatches (**Table 2.6**).

On external front, the imposition of anti-dumping duties by importing countries and stiff competition from regional players largely explain the continued decline in exports (**Table 2.8**).^{23, 24} The industry is still able to sustain growth in production due to high domestic demand and attractive margins on local sales.²⁵

The industry is benefiting from economies of scale (due to higher capacity utilization), while the international coal prices (the chief raw material) are also low.²⁶ Further efficiency is being achieved by the continuing efforts of the players to use byproducts as power source, and install waste heat recovery units (WHR), refused-derived fuel (RDF), and tyre-derived fuel (TDF) facilities.²⁷ Interestingly, manufacturers continued to earn healthy margins during the year due to robust domestic demand and some decline in the production cost.²⁸

More importantly, the manufacturers are aggressively investing in capacity expansions (by adding about 60 percent additional capacities) in anticipation of strong domestic demand (**Table 2.9**). The increase in total PSDP allocation with higher allocation for hydropower projects (e.g., Diامر, Basha, Suki Kinari); major infrastructure projects under CPEC; and ongoing mega housing projects in the private sector would keep the domestic demand strong.²⁹ At the same time, manufacturers are exploring new markets (such as Philippines, Qatar, Yemen and Sri Lanka) to boost their exports.

Steel:

Steel production recovered sharply with a strong growth of 20.5 percent in FY17, compared to a contraction of 9.3 percent in previous year. The imposition of anti-dumping duties on Chinese steel

Table 2.8: Cement Sales

	Share in sales FY17	Growth			
		FY14	FY15	FY16	FY17
Domestic sales	88.4	4.3	8.0	17.0	8.0
Punjab & KP	69.6	6.5	8.2	15.4	7.7
Sind & Baluchistan	15.3	-5.2	6.5	24.9	9.5
Exports	11.6	-2.8	-11.6	-18.4	-20.6
Afghanistan	4.3	-17	-21.4	-15.1	-29.6
India	3.1	40.5	2.8	42.5	26.3
Rest of the world	4.2	9.1	-4.7	-32.7	-30.6
Total growth	-	2.5	3.3	9.8	3.7

Data source: All Pakistan Cement Manufacturers Association

Table 2.9: Cement Industry Expansion

Company	Expansion (metric tons)	Investment (US\$ million)	Completion
Lucky	3.0	270	FY17
ACPL	1.1	120	FY17
CHCC	4.7	315	FY17-FY19
DGKC	2.6	200	FY18
Fecto	1.0	100	FY18
Gharibwal	2.4	200	FY18
Bestway	1.8	190	FY19
PIOC	2.4	245	FY19
POWER	2.5	235	FY19
MLCF	2.3	225	FY19
KOHC	2.3	125	FY19

Data source: Companies Financials/Pakistan Stock Exchange notices

²³ Slowdown in construction activities in China has forced its cement producers to resort to international markets to export their surplus. Chinese producers, with large advantage from economies of scale, are posing challenge for Pakistani manufacturers. Furthermore, lifting of sanctions has also opened up room for Iran to return to cement exports market, with ample surplus capacity available. In fact, Pakistani players have already lost a substantial share of Afghanistan market to Iranian producers.

²⁴ For example, the levy of anti dumping duties (in the range of 15-70 percent) curtailed cement exports to African countries.

²⁵ Domestic sales fetch substantially higher margins than exports sales due to 20 percent regulatory duty protection, besides freight cost savings.

²⁶ Although, higher from last year, Australian coal prices remained below US\$ 80 per MT significantly lower than the prices prevailing two years ago.

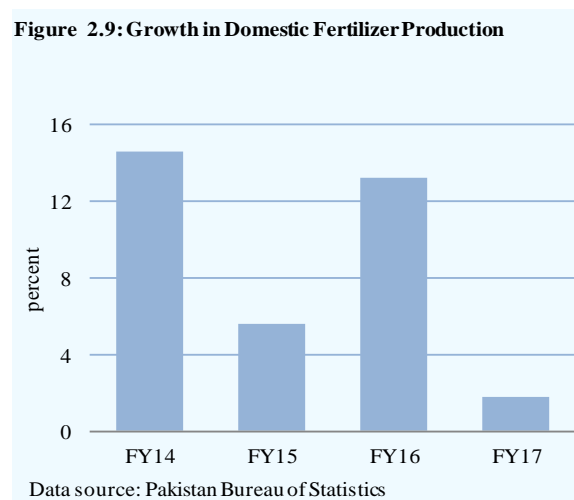
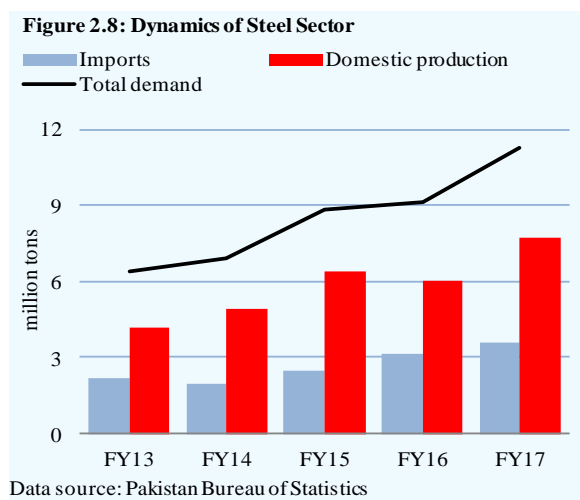
²⁷ Almost all the cement manufacturers have installed WHR Units that reduce energy cost by more than 10 percent.

²⁸ Recently, cement manufacturers in the northern regions of the country have slashed prices by around Rs 10-25 per 50 kg. This was probably the result of both, a decline in exports to Afghanistan as well as capacity expansions.

²⁹ Planned low cost housing scheme of 50,000 units has the potential to create additional demand of 0.6-0.7 million tons.

products; increasing demand (**Figure 2.8**); better availability of electricity; and favorable prices of raw material (scrap) helped enhance the economies of scale and improve margins.³⁰

The outlook for the industry remains encouraging in view of expected strong growth in the allied industries, such as automobile (especially the two/three wheelers which depend mostly on local vendors for the supply of raw materials such as steel), and construction (where a focus on higher infrastructure spending would increase the demand for steel pipes and other related construction products). Furthermore, the trend of rising income levels would have a direct impact on the sales of consumer durables (of which steel is an intermediate material). Anticipating this future demand hike (**Figure 2.8**), manufacturers are investing heavily in capacity expansion.³¹



Fertilizer

The fertilizer industry experienced a slowdown in FY17 as large inventory carried over from previous year limited the production growth to just 1.7 percent from 13.9 percent in FY16 (**Figure 2.9**). This was despite a strong recovery in domestic demand due to subsidy on domestic sales.³² Though the offtake increased by 35.8 percent from a contraction of 14.3 during last year, this was not enough to offload the excess stocks.

The industry also could not export surplus stocks as high production costs made their products less competitive in the foreign markets. Although the government offered export subsidy, the delays in its announcement and some logistic constraints (e.g., inadequate facilities for bulk loading and shipment) restricted the industry from taking advantage of the export allowance announced by the government (a quantum equating to only 14 percent of the allowance could be exported during FY17).

Going forward, the availability of imported LNG, cheap bank financing, and tariff concessions on gas supplies to some of the plants would continue to benefit the fertilizer sector. The industry would also gain from recent improvement in subsidy scheme which has been made more transparent and its

³⁰ In early February 2017, the National Tariff Commission (NTC) imposed anti-dumping duties on imports of steel products (e.g., galvanized steel coils and sheets) in the range of 6 to 40.5 percent.

³¹ International Steels is expanding its capacity by 0.4 million tons to 1.0 million tons; Aisha Steel SL is also doubling its production capacity, while Mughal Steel is replacing current re-bar facilities with 0.43 million tons plant, alongside the 0.3 million girder facility.

³² The Federal Government has reduced the rates of GST on different fertilizers to bring down their price. Furthermore, in order to keep urea prices below Rs 1,400 per bag, the government provided a cash subsidy of Rs 100 per bag. The scheme will remain in force during FY18.

implementation more effective.³³ Despite all these positives, the outlook for the industry would depend on whether the agriculture sector is able to sustain its growth momentum, as export avenues are hindered by ample logistics constraints.

Food

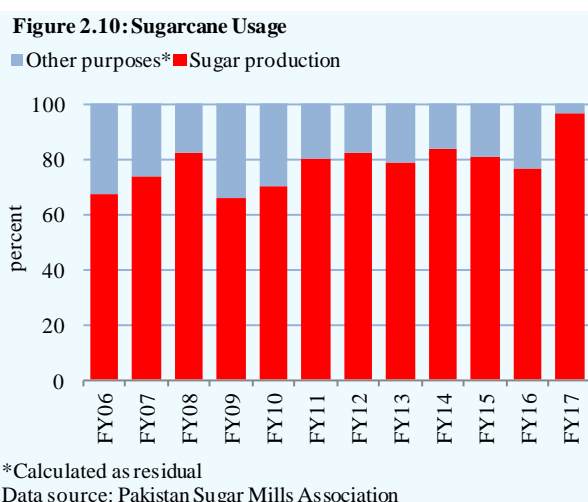
Contributing around 40 percent to the overall LSM performance, the growth in the food sector accelerated remarkably from 0.6 percent in FY16 to 11.5 percent in FY17. Sugar industry spearheaded this recovery, posting record production figures at a growth rate of 37.8 percent.

Several developments can help explain this increase in sugar production. On growers' side, the clarity on support prices encouraged them to sell more of their produce to mills for crushing.³⁴ In addition, the reallocation of some sugar mills reduced cost of transporting sugarcane for some growers. From the perspective of sugar mills, the increased availability of low cost bank financing improved their liquidity situation, and allowed them to make early payments to growers.³⁵ Furthermore, sugar recovery rates have continued to improve over the past 10 years, as growers are shifting to sugarcane varieties with higher sugar content. Despite all these positive developments, the sugar production volume is unusually high as it recorded an increase of about 38 percent, which was considerably higher than the increase of 12.4 percent in sugarcane crop.³⁶

According to Pakistan Sugar Mills Association (PSMA), a total of 71.4 million tons cane was crushed during FY17, yielding a utilization rate of about 97 percent for the year (**Figure 2.10**). This leaves only 2.2 million tons of sugarcane for other purpose (such as seeding and making gur and juices), which is considerably lower than the past trends. In fact, the use of sugarcane for purposes other than crushing has varied in the range of 10 to 17 million tons during the last 10 years.³⁷

In the beverages industry, the impact of capacity expansions during the past few years has started to materialize, as the production grew by 10.4 percent on top of the 6.4 percent increase witnessed during last year. This performance was supported by continued strong demand in the local market on the back of rising incomes.³⁸

The cigarette industry suffered when a hike in Federal excise duty under the FY17 budget (**Figure 2.11**) encouraged the sale of counterfeit and smuggled products. Resultantly, the local production recorded a contraction of 35.8 percent, in addition to 14.6 percent decline suffered during last year.



³³ Finance ministry has improved the subsidy disbursement process as the companies were facing severe delays in receipt of subsidy claims.

³⁴ Growers margins increased for sugarcane crop on the back of subsidized inputs mainly fertilizer.

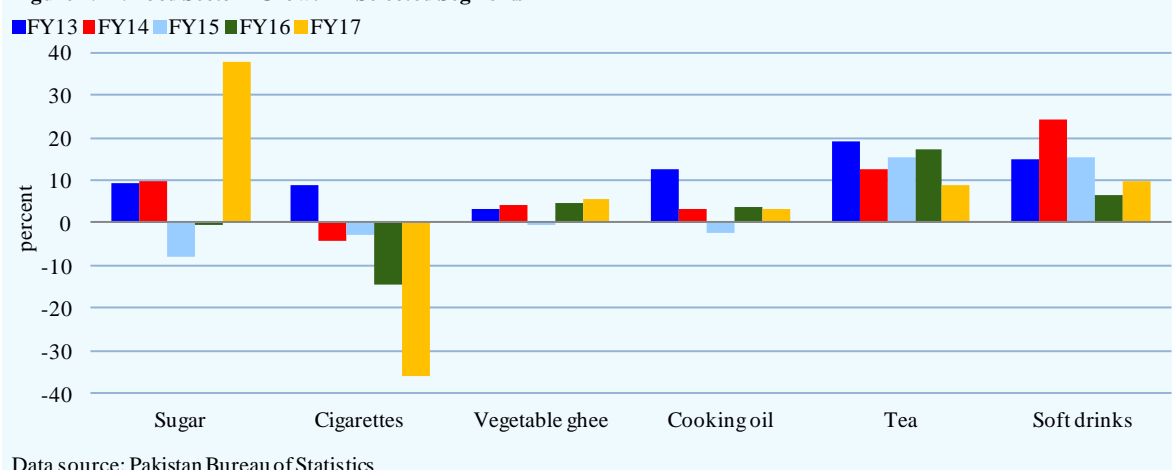
³⁵ During Nov-Apr FY17, sugar sector availed bank financing of Rs 146.4 billion compared to Rs 87.2 billion during same period last year.

³⁶ While the sugarcane crop increased by 12.4 percent to reach historic high of 73.6 million tons, sugar production rose from 5.1 million tons in FY16 to 7.1 million tons in FY17.

³⁷ The increase in gur production is also evident from a rise of 33 percent in its exports during FY17.

³⁸ According to Household Income Expenditure Survey (HIES), average expenditures on hotels and non-alcoholic beverages have increased. The share of food items in total consumption of an average household is close to 40 percent.

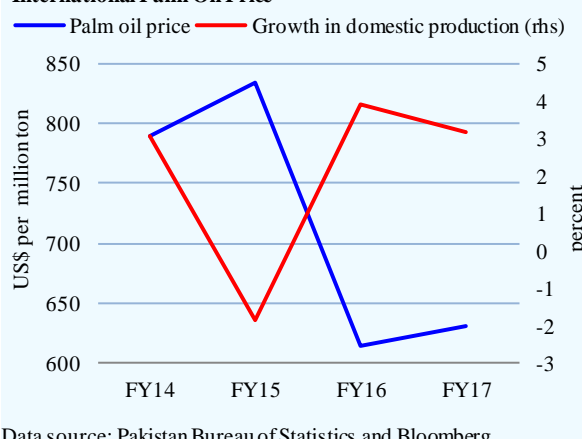
Figure 2.11: Food Sector - Growth in Selected Segments



The growth in vegetable ghee and edible oil production during FY17 remained marginally lower than last year, mainly due to large inventories accumulated over the last year. Specifically, a sharp decline in palm oil (the main raw material) prices in the international market during FY16 encouraged manufacturers to import this key input in large quantities, increase their output, and build stocks during the previous year (**Figure 2.12**).

The growth decelerated also due to volatility in the global palm oil prices during the first three quarters which added to uncertainty regarding the manufacturing decisions. The production slowed down further due to the suspension of operation units of a number of oil and ghee manufacturers.³⁹

Figure 2.12: Growth in Domestic Cooking Oil Production and International Palm Oil Price



Chemicals

Chemicals production fell by 2.3 percent during FY17 (against a rise of 8.1 percent in FY16) despite a continued strong demand for construction and its allied industries in the country. The continued absence of a Naphtha Cracker Plant (and the resulting high dependence of the industry on imported chemicals) is one major reason that hinders the sustainable growth of the sector.⁴⁰

Subdued growth in leather and textile sectors also impacted the performance of the chemical industry as manufacturers in the former segments use the products of the latter as raw materials in their production processes (e.g. use of soda ash for cleansing and treatment).

The challenge for the industry compounded in FY17 due to cheaper imports. Specifically, China's

³⁹ During November, 2016, the Punjab Food Authority (PFA) declared various cooking oil and ghee brands unfit for human consumption due to rancidity (unpleasant odour), absence of Vitamin A, and inclusion of artificial flavor and other acid values.

⁴⁰ Naphtha is an important feed used for the manufacturing of various polymers (using gasification of coal, for example), including PVC, which is mainly imported in Pakistan. According to Pakistan Chemical Manufacturers Association (PCMA) a feasibility report is under process for the establishment of first such plant in the country.

slowing construction activities is causing accumulation of large stockpiles of chlorine in the region, which is not only dragging down chemical prices across Asia, but also increasing supply in the local market through imports.⁴¹ At the same time, the slump in petrochemicals prices also discouraged production.

Textile

The textile sector managed to marginally improve its performance by recording a growth of 0.8 percent during FY17, as compared to 0.4 percent during last year. Robust domestic demand continued to compensate for the stagnant exports.⁴² The export package by the government has started to impact the performance of textile sector albeit with a slower pace than anticipated. It may be highlighted that only sufficient investment by textile players in BMR, efforts to concentrate on value-added products, and increased focus on improving operational efficiency could broaden the export potential of the products and stimulate its performance on sustainable basis. Encouragingly, the textile segment also borrowed for BMR purposes during FY17 (refer to **Chapter 3** for more details).

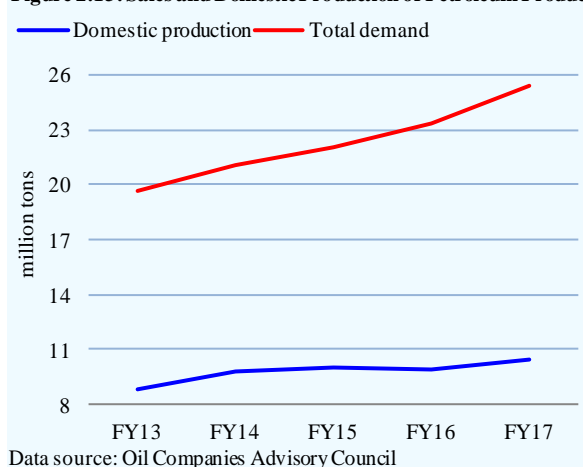
The jute subsector recorded a turnaround by showing a growth of 8.1 percent during FY17 compared to a huge decline of 41.3 percent during the previous year. The ban on the import of raw materials from Bangladesh – imposed by the country during FY16 following a setback in its own production – kept on affecting the production cycle of the Pakistani manufacturers till H1-FY17. However, with the lifting of the aforementioned ban, the sector experienced some respite in H2-FY17. Going forward, the availability of cheap alternatives, dependence on imported raw material, and inefficient technology would constrain the full recovery of domestic jute industry.⁴³ Exacerbating the problem is the fact that financial constraints have forced five of the ten remaining jute goods producing mills to suspend their operations.

POL

The POL industry could not gain from the growing demand for petroleum products in the country (**Figure 2.13**). Specifically, against a rise of 9 percent in overall sale of petroleum products in the country, the POL industry managed to increase production by only 2.8 percent. The domestic industry does not fully meet the regulation requiring RON 92 grade petroleum to be sold in the domestic market.⁴⁴ Resultantly, import dependence increased to bridge the growing demand-supply gap.⁴⁵

Encouragingly, National Refinery Limited (NRL) has already adopted higher quality fuel standards.⁴⁶ While the conversion of other

Figure 2.13: Sales and Domestic Production of Petroleum Products



⁴¹ For example, other paints and varnishes imports from China increased by about 36 percent in FY17.

⁴² Historically, the lack of sufficient R&D and reliance on low-value added products has contributed towards less than optimal level of exporting revenues, breeding stagnancy in the sector.

⁴³ Jute bags are costlier compared to their substitute (e.g., polypropylene / polyethylene), if a plastic bag is available at Rs 60, the same 100kg capacity jute bag costs more than Rs 100.

⁴⁴ Most of local refineries produce RON 90 Premium Motor Gas (PMG).

⁴⁵ During FY17, import quantum of petroleum products increased by 39.2 percent over last year (source: Pakistan Bureau of Statistics).

⁴⁶ NRL also revealed that Naphtha Isomerization (ISOM) Unit is in start-up phase whereas its Auxiliary Units (Naphtha Splitter and Naphtha Hydrotreater) have already been commissioned.

refineries to high grade POL would take some time and require a substantial investment to acquire compatible technology, the industry would see a healthy rise in production following the resumption of operations of Byco.⁴⁷

Leather

Leather manufacturing suffered a contraction of 16.5 percent during FY17, compared to a 6.9 percent growth achieved last year. Increasingly, the industry is facing pressures from the supply side which is resulting in a decline in exports as well. **Box 2.2** highlights the various issues faced by the sector and steps taken by both the government and the industry players to address the worrisome trend.

Box 2.2: Why is the Leather Industry Underperforming?

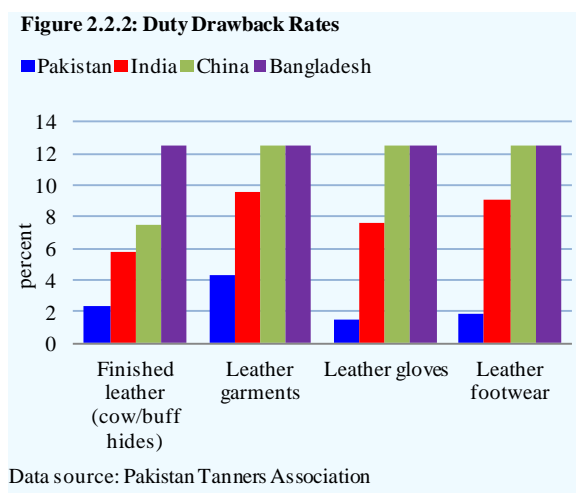
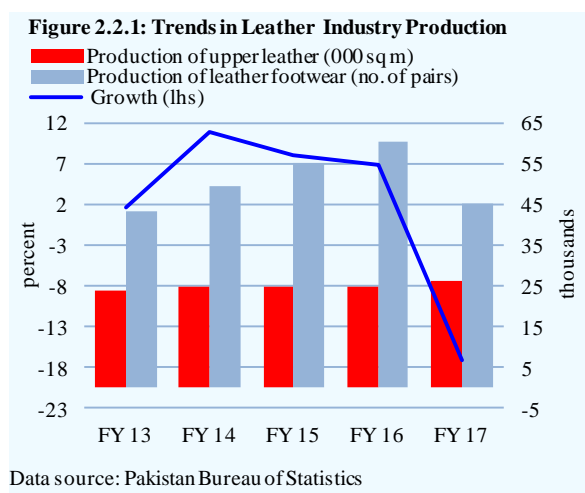
Leather industry not only fulfills the needs of domestic downstream industry, it is also a source of valuable foreign exchange earnings for the country. Despite its significance, the industry has been going through a difficult phase: the leather output fell by 17.0 percent in FY17, whereas exports have declined for the third consecutive year (**Figure 2.2.1**).⁴⁸ A host of factors explain this sharp decline:

Firstly, the high rate of smuggling of live animals to Afghanistan is not only reducing the supply of hides and skin in the domestic economy, this is also disrupting the breeding process of the livestock.

Secondly, inefficient supply chains result in wastage of raw materials, as skins and hides are to be treated in a timely manner to make them useful for tanning purposes. During the FY17 Eid season, large quantities of raw material were damaged due to high temperatures and inadequate preservation mechanisms.⁴⁹ This negatively impacted the production potential of the industry and increased its dependence on imports.

Thirdly, the absence of advance technology and shortage of semi-skilled and skilled workers (that could process the different categories of raw leather) is constraining the industry’s ability to cater to the needs of its consumers. At the same time, continued levy of custom duties on various machines (used for fleshing, stacking, shaving, tanning, and buffing, etc) largely explain the lack of modern technology in this segment.⁵⁰

Fourthly, the industry is facing high cost of doing business. For example, electricity tariffs, gas charges, and workers’ wages are higher in Pakistan relative to global competitors (**Table 2.2.1**). Furthermore, according to Pakistan Tanners Association, the rates of duty drawbacks and rebates have been considerably low in Pakistan (**Figure 2.2.2**), and the considerable delay in their payment adds to their manufacturing cost. Thus, the industry is finding it difficult to compete against exporters from India, Vietnam, and Bangladesh.



⁴⁷ One of the plants of Byco refinery with a capacity of 85,000 barrels a day has resumed its operations in July 2017 (after remaining closed for almost two years due to a fire), and is gradually improving on its capacity utilization.

⁴⁸ In particular, export quantum of leather garments, which had declined by 6.5 percent during FY16, recorded another steep fall of 16.8 percent during FY17. Similarly leather gloves showed a contraction of 5.1 percent after experiencing a decline of 28.6 percent last year.

⁴⁹ Eid season accounts for around 40 percent of the total raw material accumulated from the domestic economy.

⁵⁰ In addition to 4 percent custom duty, the machines are subjected to an average of 17 percent sales tax.

Lastly, it appears that the domestic demand has been increasingly catered to by imported low-cost Chinese products.⁵¹

In sum, the leather industry is finding it challenging to compete in the global markets due to reasons mentioned above. However, some improvement is expected in this sector as:

- (1) The federal government has announced removal of the custom duty on imports of raw materials (raw hides & skins/pickled and wet blue) in the FY18 budget.
- (2) Moreover, the government has promised to release all pending sales tax claims of the manufacturers at the earliest.
- (3) The government has announced an export promotion package that targets the export-oriented sectors of the economy, including leather. A rebate of 7 percent on selected leather products would be provided in order to stimulate the industry.⁵²
- (4) Knowledge sharing efforts have intensified in Punjab, where the tanners are running advertisements to educate the general public and hides collectors on the accurate procedures of preservation.

Table 2.2.1: Cost of Doing Business in Leather Industry

US dollar	Pakistan	Bangladesh	India	Vietnam
Electricity (per KWh)	0.1	0.09	0.09	0.08
Gas (Industrial Captive Power) (per MMBTU)	7.7	3.0	4.7	6.0
Minimum wages (per month)	135.0	68.0	115.0	113.5

Data source: Pakistan Tanners Association, and Council for Leather Exports (India).

Bangladesh's leather sector observed a healthy growth last year, and is increasingly gaining momentum in the global market. With its supply chain disturbed due to ban on cow slaughtering in India, the manufacturers in Pakistan are expecting to exploit this opportunity to provide raw and low-value added leather to Bangladesh as raw material.

2.4 Services

The growth in services sector contributed more than two-third of the increase in overall GDP. The performance of services sector was fairly broad based, with *wholesale and retail* (the dominant subsector) posting 6.8 percent increase in value addition compared to 4.3 percent in the previous year (**Table 2.10**). This was on the back of strong increase in imports (that more than offset the decline in exports) and growth in both the commodity producing sectors (agriculture and industry).

Table 2.10: Performance of Services

share and growth in percent; contribution in percentage points

	Share in GDP	Growth			Contribution to growth	
	FY17	FY16	FY17 target	FY17	FY16	FY17
Wholesale and retail trade	18.5	4.3	5.5	6.8	1.9	2.1
Transport, storage and communication	13.3	4.8	5.1	3.9	0.8	0.9
Finance and insurance	3.4	6.1	7.2	10.8	0.5	0.6
Housing services	6.6	4.0	4	4.0	0.4	0.5
General government services	7.6	9.7	7	6.9	0.8	0.9
Other private services	10.2	6.8	6.7	6.3	1.0	1.1
Services	59.6	5.5	5.7	6.0	5.5	6.0

Data Source: Pakistan Bureau of Statistics

Given the constantly rising share of services in the economy (**Figure 2.14**) and constrained merchandise exports, efforts are needed to enhance quality of services in the country to make it competitive in international markets in line with other developing economies (**Box 2.3**).

⁵¹ Leather and related items are produced in broadly four quality variants in Pakistan. With Pakistan being a low-income economy, domestic market demand is predominantly for the lower quality products, while higher quality goods serve the export markets.

⁵² Initially, the leather products included in the package did not adequately cover the manufacturing base of the local industry. In this regard, the association had asked for 8 other HS codes to be included, and they have now been made part of the package.

Finance and Insurance recorded an encouraging growth of 10.8 percent compared to 6.1 percent growth observed during FY16 (Table 2.11). Scheduled banks, the largest component, spearheaded the performance by contributing 73 percent to the segment's growth. Low interest rates affected the profitability of commercial banks, which contracted by 3.9 percent as opposed to a 2.7 percent increase observed during FY16. However, the impact of this was more than offset by a healthy rise in advances (18.1 percent) and deposits (14.1 percent). Encouragingly, not only was this increase broad-based (with intake by almost all the segments and sectors of economy, including textile, sugar, energy, cement etc), it came with decreasing infection ratios (from 11.1 to 9.3 percent) amongst most categories. Thus *finance and insurance* segment posted a 9.8 percent increase in value addition, compared to a growth of 5.9 percent in FY16.

Transport, storage, and communication also continued to grow albeit with a slower pace in FY17, registering a growth of 3.9 percent against 4.8 percent during FY16. This deceleration in growth can be mainly attributed to steep decline in gross value addition by railways and PIA, and continued contraction in water and pipeline transport (Figure 2.15).

Road transport, however, improved marginally in tandem with improvement in trade activities in the country as evident from increase in cargo handling activities. The increase in sales of HCVs (trucks and buses) in the country also point towards growing value addition by the road transport sector.

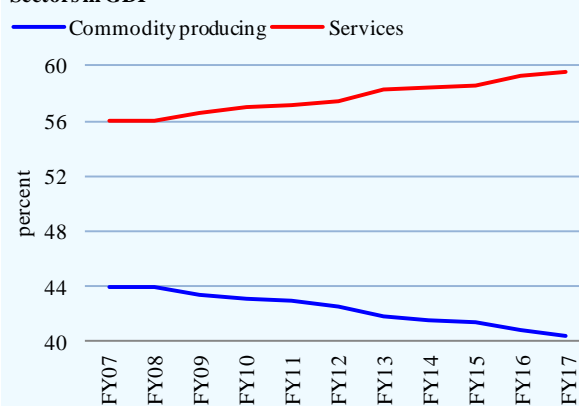
During FY17, the economy witnessed a rise in total Teledensity on top of the recovery achieved last year, after a steep decline in FY15, due to the SIM verification campaign (Figure 2.16). Similarly,

Table 2.11: Finance and Insurance
percent

	Share in FY17	Growth	
		FY16	FY17
Central banking	2.4	-3.2	8.8
Other monetary intermediation	84.9	6.9	10.6
<i>Scheduled banks</i>	82.0	6.4	9.6
<i>Non-scheduled banks</i>	2.8	31.5	50.2
Other financial services	1.5	2.3	5.0
Insurance, reinsurance and pension fund	3.3	9.7	-4.0
Activities auxiliary to financial services	7.9	-0.5	23.1
Finance and insurance	100	6.1	10.8

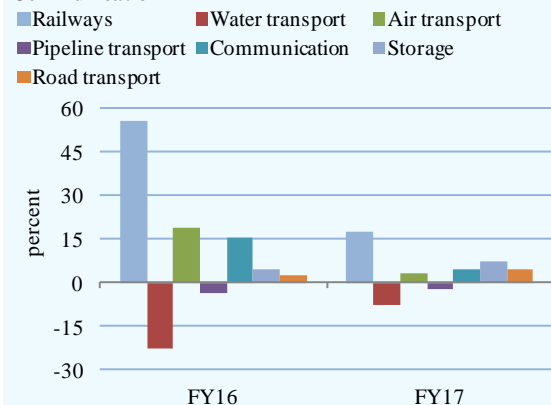
Data source: Pakistan Bureau of Statistics

Figure 2.14 : Share of Services and Commodity Producing Sectors in GDP



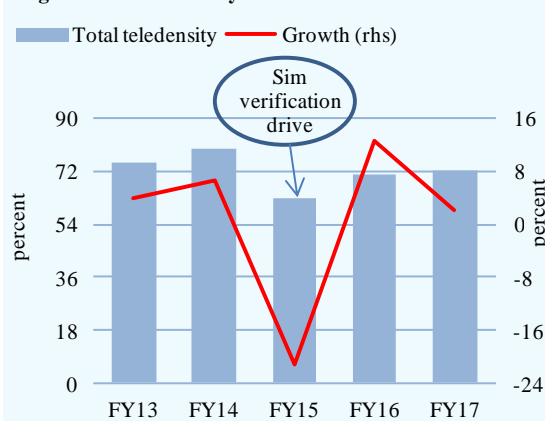
Data source: Pakistan Bureau of Statistics

Figure 2.15: Sub-sectors of Transport, Storage and Communication



Data source: Pakistan Bureau of Statistics

Figure 2.16: Teledensity in Pakistan



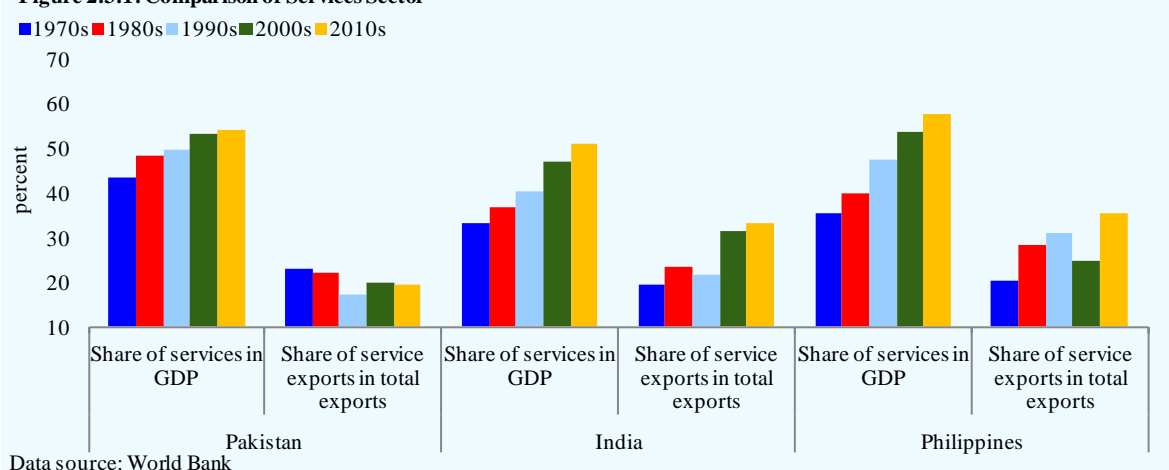
Data source: Pakistan Telecommunication Authority

the number of broadband users increased to 44.6 million; an addition of around 11 million over the course of just one year. A major increase in 3G/4G subscriptions was the most dominant contributor to this performance as the number of mobile broadband customers rose substantially while other segments (such as DSL and WiMax) showed stagnation or contraction.

Box 2.3: How to Make Services Exportable?

While the share of services in GDP of Pakistan has been on a rising trend in line with the experiences of other developing economies, the services exports have remained stagnant over time. This is worrisome as Pakistan needs exports to fund the growing import of intermediate and capital goods, which are essential for the expansion of its industrial base and achieving a sustained increase in economic growth. More importantly, services exports have a potential of generating higher and more lucrative returns in the external markets relative to the low value-added industrial goods Pakistan is currently exporting. Thus, a high share of exports from the services sector could lower the burden on already constrained merchandise industrial base.

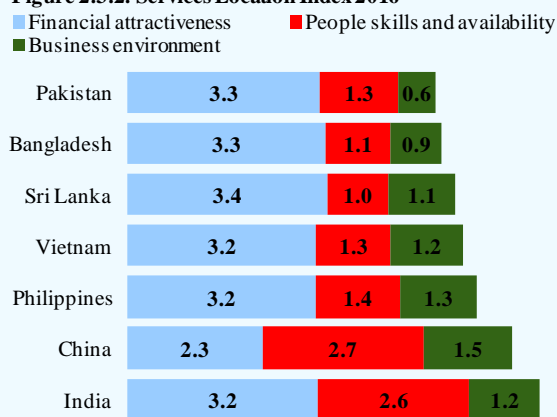
Figure 2.3.1: Comparison of Services Sector



In terms of policy initiative, the government has devised a National Roadmap in 2007 with a view to enhance the quality of services and make them exportable. The strategy not only highlighted key impediments to services exports but also assigned priority to segments like Business Process Outsourcing (BPO), IT, and consultancy in their roadmap to harness their potential competitive advantage. A decade after, however, it is fair to say that palpable gains have not been achieved. This is evident by the fact that the share of services in total export earnings of the country has shown a marginal decline over time (**Figure 2.3.1**).⁵³ The regional competitors, on the other hand, have significantly increased their exports over time, and the earnings are not concentrated in a few areas but span a variety of services.

A review of Service Location Index provides some interesting insights on major obstacles to services' exports. In overall terms, Pakistan ranks low at 28th in the Services Location Index 2016, compared to India (ranks 1st), Philippines (7th), Vietnam (11th), and Bangladesh (22nd).⁵⁴ Despite such low ranking, Pakistan fares better in terms of labor and operational costs: its financial attractiveness score is higher than that of India (**Figure 2.3.2**). In comparison, the areas where Pakistan's performance remained weak include business environment and people skills and availability. Hence, any strategy to improve services exports should focus on skill development, and (in the case of business environment) protection of intellectual property rights and ensuring policy consistency.

Figure 2.3.2: Services Location Index 2016



⁵³ Most of these inflows include foreign exchange receipts of the government on account of coalition support fund. The contribution from the private sector remained very low.

⁵⁴ Source: Survey ranking of A.T. Kearney a global management consultancy firm.

More lessons can be drawn from the success of developing countries, which have been able to increase their services exports. For example, in terms of IT exports, India has been very successful and offers some important insights:

- (1) The role of the policy support has been crucial, both in terms of design and timeliness. For example, the relaxations and exemptions that Pakistan offered for the import of software and hardware appears comparable to that of India, but these were implemented with a considerable delay, which amounted to an opportunity lost to make inroads earlier.⁵⁵ Similarly, India incentivized the exports of IT by allowing import reliefs and subsidies, whereas in case of Pakistan, such incentive structures have mostly been absent and, where available, have not reaped the desired upticks in exports.⁵⁶
- (2) The low computer literacy is another factor that placed Pakistan at a disadvantage, whereas in India, a policy focus on improving computer-related skills mainly explain the success of Software Technology Park (STP) as export growth from STP units increased at an average annual rate of 30 percent from 2000-2009.^{57,58}
- (3) The role of expatriates in boosting the IT knowledge of the domestic population also remained significant.⁵⁹ In order to tap the potential of knowledge transfer from expatriates, the government introduced various skill transfer programs such as the Transfer of Knowledge through Expatriate Nationals (TOKTEN).
- (4) The imposition of credible intellectual property laws in India has been a distinctive feature to attract foreign IT firms and nurture emerging domestic ones.⁶⁰ Though Pakistan has also introduced copyright laws against software piracy, their implementation has remained far behind the desired level.

In the field of Business Process Outsourcing, Philippines is the third biggest provider behind India and Canada. Success of Philippines came on the back of low labor costs, presence of English speaking talent pool, support from the government, and a strong role of the private sector.

- **Low labor costs:** The labor costs constitute 50 percent of the total operating expense of a BPO firm. Thus, low wages in Philippines relative to international standards has made this country attractive for outsourcing. Encouragingly, Pakistan fares even better in terms of costs of doing business, especially in the labor-intensive niche of the BPO sector. This is evident by the fact that the labor costs in the economy are lower than that of Philippines and even India.
- **Young, English proficient talent pool:** US firms are by far the largest outsourcing parties in the Philippines. A strong, English speaking pool of skilled graduates, coupled with the similarity of the countries' accounting and legal structures, has resulted in Philippines attracting service provisions such as legal transcription outsourcing and financial and accounting outsourcing. In comparison, Pakistan also has a pool of young English speaking labor supply. However, their involvement is restricted to low value added services such as conventional customer care call centers. The high value added avenues like consultancy and data keeping analysis become difficult to target due to limited technology and inadequate skills in the workforce.
- **Government support:** As of 2014, there were 300 operating special economic zones in the Philippines under the supervision of Philippine Economic Zone Authority (PEZA). The firms focusing on export-oriented service provision are offered various fiscal incentives such as exemptions from local government imports, fees, licenses, and taxes. For example, a zero duty on operations-related imports is also granted. Similarly, taxable income deduction incentives are available if a minimum capital to labor ratio (with a focus on local workforce participation) is maintained, and this deductible amount is doubled if the firm is situated in a less developed area. In comparison, Pakistan does not have a similar export-oriented focus and even the latest incentive provisions are limited. The "start-up" initiatives (see below) for instance, allow exemptions and duty free imports for three years relative to the minimum of ten years in case of Philippines.

⁵⁵ India reduced tariffs on computer and software imports for educational purposes as far back as 1970s. In 1984, this policy was enhanced to make procedures for importing related machineries easier.

⁵⁶ In India, 1984 policy allowed 50 percent of services export revenues to be used to import required associated inputs. In 1993, the Export Promotion Scheme was extended to the services sector and import duties on software were reduced to 10 percent in 1995.

⁵⁷ India initiated a program, alongside others, called Human Resource development in IT, under which it aims to make the populace computer literate, to increase access to internet, and to improve the quality of IT education.

⁵⁸ In 1986, India formed an export processing zone solely focusing on software-exporting firms. The STP aimed to promote innovation and exports by allowing duty-free imports of inputs, providing tax exemptions, and permitting repatriation of investments and royalties. By 2009, around 8455 firms were operating under the umbrella of STP. Pakistan, on the other hand, has experimented with the concept of IT parks before but has not been very successful in increasing the quality of the services and, hence, exports.

⁵⁹ The Indian diaspora constituted around 24 percent of the workers in Silicon Valley.

⁶⁰ In India, the Copyright Act was extended in 1985 to include software, and piracy was subjected to hefty fines and punishment. It further encouraged innovation in the sector by safeguarding the rights of investors and publishers.

- **The role of private sector:** The distinctive feature of the Philippines services sector has been the spearheading role of the private sector. The IT and Business Process Association of the Philippines (IBPAP) has been at the forefront of the research, analysis, and promotional activities related to the services exports. It participates in various road shows, campaigns, conferences (such as the World Congress on Information and Communication Technology and World BPO Forum). It also drafted a Roadmap 2010 to increase the share of Philippines service exports in the world and another Roadmap 2016 was drafted to highlight, among other things, the next avenues that the country could focus on to enhance its share of exports (namely, healthcare, information management, and outsourcing management). In contrast, Pakistan's private sector lags behind in such measures and is constrained by various regulatory and entrepreneurial issues, as evidenced by the very low rating in the World Bank Ease of Doing Business Report.

In sum, Pakistan can benefit from low wages and the presence of English speaking pool of workforce. However, there is a need to focus on improving labor skills, and providing the private sector with a suitable business environment where they can explore growth opportunities. This is important so that the country can take advantage from forthcoming export opportunities provided by a few positive developments under CPEC. For example, the construction of Technology and Commerce Park in Islamabad would benefit the IT firms, while the development of Special Economic Zones (SEZs) would help spur interest and competition in complementary services sectors such as accounting, consultancy, hospitality, catering, etc. Furthermore, exposure to potential export-oriented firms and competition from Chinese counterparts would encourage innovation and a focus towards value addition.

Healthcare is another area which is growing rapidly in developing countries, especially the Asian market that includes India, Thailand, Philippines, and Singapore.⁶¹ Pakistan can also strive to become a medical tourism destination. It may be noted that a number of expatriates already visit Pakistan to benefit from low cost medical services (e.g., dental checkups and surgical treatment).

The government has already been providing appropriate policy support to exploit the aforementioned opportunities. In particular, the recent introduction of incentives for start-up under the new budget is a step in the right direction as it promotes entrepreneurship and incentivizes the private sector to take initiative in shaping the export orientation of the service sector.⁶² Secondly, the establishment of various technology centers and internship programs are to ensure the minimization of prevalent skill differential between labor demand and supply.⁶³ However, such programs need time before they would materialize in the shape of increasing export revenues. This is evidenced by the fact that it has taken India's effective policy mix close to three decades to result in global dominance; similarly Philippine's export zone initiatives focused on long-term incentive structures.

Reference: Goswami, Arti Grover; Mattoo, Aaditya; Sáez, Sebastián (2012), "Exporting Services: A Developing Country Perspective" World Bank Report.

⁶¹ Over the years, due to rising cost and time restraints of the medical system in the developed countries, now, their nationals are visiting the developing countries for treatment at affordable prices in countries.

⁶² The label would, among other things, provide tax exemptions and subsidies on withholding taxes for up to three years. Importantly, these start-ups are envisaged to enter predominantly in the technology sector, hence potentially paving way for a much needed improvement in services sector.

⁶³ The government is focusing on addressing the skill building in various segments, such as FinTech (focusing on payment sector and P2P lending facilities, etc), Internet of Things Innovation Centre (to enable start-ups in the up and coming IoT domain), and Robotics Innovation centre (to encourage investment and focus on automations and capital goods enhancement) and the continued focus on training programs such as Digital Skills Training Program for Freelancing, ICT for Girls, and National ITC Internship Program.