

2 Economic Growth, Saving and Investment

Despite an evident slowdown in major economies around the globe amidst a sustained rise in international oil prices, the domestic economy surpassed its growth target by a wide margin for the third consecutive year, witnessing a growth rate of 8.4 percent in FY05, the highest during the last two decades (see **Figure 2.1 & 2.2**).

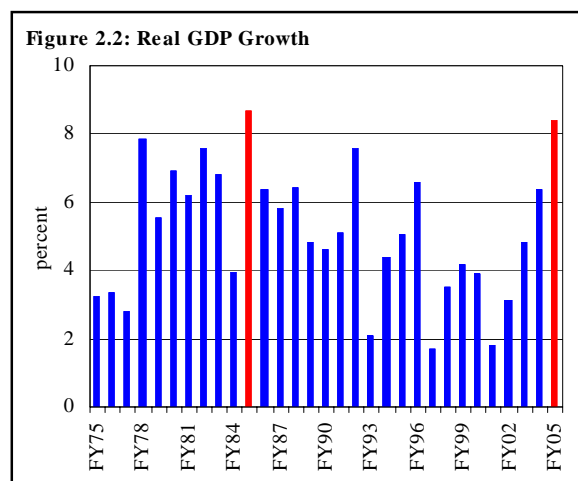
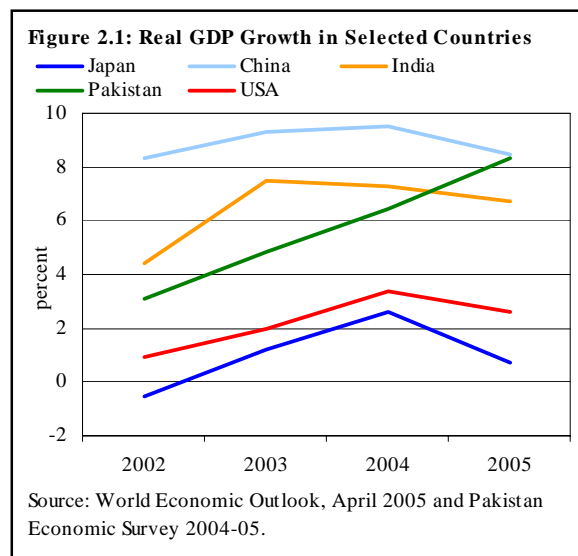
The acceleration in the domestic economic growth looks even more impressive since it was achieved despite a monetary tightening initiated to contain inflationary pressures. This exceptional growth is probably the result of a number of factors including (1) strong domestic demand (2) good luck in terms of timely winter rains (3) continuity of policies, and (4) a robust financial sector.

A glance at **Table 2.1** reveals that both the commodity producing and the services sectors achieved above-target growth during FY05. However, within the commodity-producing sector, only the *major crops* and *large scale manufacturing* (LSM) sub-sectors achieved above target growth rates during the current fiscal year.

In particular, major crops witnessed an exceptional growth rate of 17.3 percent during FY05 as against the annual target of 3.5 percent. This sharp pick up in the major crops was achieved on the back of record harvests of cotton and wheat, which registered growths of 45.5 percent and 8.3 percent respectively.

Favorable weather and greater use of inputs were major factors in this stellar performance. The considerable rise in the use of farm related equipment, improved seeds and fertilizers, reflects the ample availability of credit, which probably contributed significantly in boosting the productivity of major crops (for details see **Section 2.2**). However, the growth in other agri sub-sectors was relatively weak mainly due to heavy rains and snow fall. In fact, while the extended winter rains helped improve water availability and prospects for major crops, it significantly damaged minor crops.

As with agriculture, the growth momentum in industrial sector is solely driven by a single sub-sector (LSM), which was again facilitated by the increased availability of credit. Within LSM, the impetus to growth mainly stems from *textiles*, *automobiles*, *electronics* and *fertilizer* industries. A high base of the preceding year, coupled with huge line losses in gas field due to attacks on gas distribution



infrastructure and plant/supply lines caused a slowdown in growth of the *electricity & gas distribution* sub-sector during the year.

The services sector's share in GDP dropped marginally in FY05 due to its relatively slower growth compared to the commodity-producing sector (see **Figure 2.3**), the quality of growth is much better for the services in terms of the performance of different sub-sectors. For example, *wholesale & retail trade, transport & communication* and *finance & insurance* comfortably surpassed their respective annual growth targets.

The highest growth amongst the services sub-sectors was recorded by *finance & insurance* (21.8 percent) due the improved profitability of NBFIs, scheduled banks as well as SBP. The high profitability of the former two is attributed to the increased economic activity, while that of the latter is a reflection of rising interest rates and improved reserves management.

On the demand side, the economy experienced a sharp climb as a result of soaring private consumption expenditure in FY05 for the second year in a row. The rise in consumption expenditure reflects consumer confidence as a result of an improvement in the economy, huge capital gains in the stock exchange and real estate markets (a wealth effect) and increased remittances from abroad. Moreover, the growth in consumer credit also facilitated the rise in private consumption as is reflected in, the demand for durables.

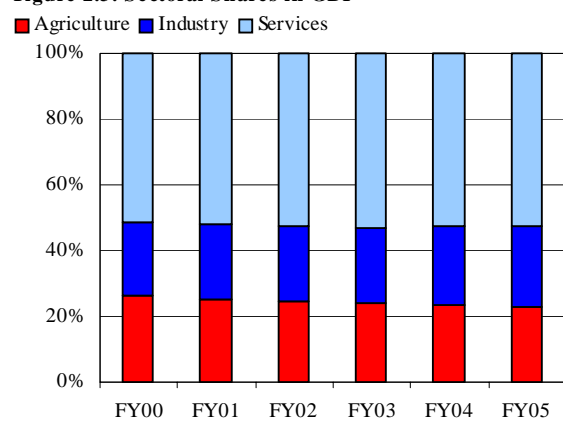
Initially, the economic uptrend of recent years was more dependent on external demand, however, the sustained rise in income contributed to the improved confidence of the consumers, and the FY05 growth is mainly driven by strong domestic demand. However, this gain is not without a cost, the exceptional rise in domestic consumption coupled with rising international oil prices as well as supply shortages of some key staples resulted in strengthening inflationary pressures (see **Figure 2.4**). In addition, not only the domestic production increased to meet the rising domestic demand, the import bill has also soared. This ultimately led to a sharp deterioration in the current account balance.

Table 2.1: Real GDP Growth
percent; at constant prices of 1999-2000

| | FY03 | FY04 | FY05 | |
|---------------------------------------|------------|-------------|------------|-------------|
| | | | Target | Provisional |
| Commodity producing sector | 4.4 | 6.9 | 7.0 | 8.9 |
| Agriculture | 4.1 | 2.2 | 4.0 | 7.5 |
| Crops | 5.5 | 2.1 | 3.5 | 13.5 |
| Major crops | 6.8 | 1.9 | 3.5 | 17.3 |
| Minor crops | 1.9 | 2.6 | 3.5 | 3.1 |
| Livestock | 2.6 | 2.8 | 4.4 | 2.3 |
| Fishing | 3.4 | 2.0 | 3.2 | 2.1 |
| Forestry | 11.1 | -5.5 | 4.0 | 0.4 |
| Industry | 4.7 | 12.0 | 9.8 | 10.2 |
| Manufacturing | 6.9 | 14.1 | 10.2 | 12.5 |
| Large-scale | 7.2 | 18.2 | 12.0 | 15.4 |
| Small, household & slaughtering | 44.5 | 6.2 | 6.4 | 6.2 |
| Mining and quarrying | 16.1 | 3.8 | 5.5 | 5.0 |
| Construction | 4.0 | -6.9 | 9.5 | 6.2 |
| Electricity & gas distribution | -11.7 | 21.1 | 10.0 | 2.1 |
| Services sector | 5.2 | 6.0 | 6.2 | 7.9 |
| Wholesale & retail trade | 6.0 | 8.1 | 8.4 | 12.0 |
| Transport storage & comm. | 4.3 | 5.5 | 4.5 | 5.6 |
| Finance and insurance | -1.3 | 4.5 | 3.5 | 21.8 |
| Ownership of dwellings | 3.3 | 3.5 | 3.8 | 3.5 |
| Public admin. & defense | 7.7 | 4.2 | 6.5 | -0.8 |
| Community, social & personal services | 6.2 | 5.2 | 5.1 | 5.4 |
| Gross domestic product (GDP) | 4.8 | 6.4 | 6.6 | 8.4 |

Source: Pakistan Economic Survey 2004-05

Figure 2.3: Sectoral Shares in GDP



The growth in private gross fixed investment this year was much lower than expectations and does not conform to the behavior of other components that form the investment goods basket. The imports of machinery and equipment and raw materials have shown very significant jumps in both FY04 and FY05; steel consumption and cement sales have expanded rapidly; public development expenditure has doubled; foreign direct investment has risen by 60 percent but the growth in investment was shown as negative in FY04 and negligible in FY05 (see **Table 2.2**). This raises serious doubts about the derivation of investment series in the national accounts. Either the coverage is incomplete and all activities are not fully reflected or the methodology of compiling the national expenditure estimates is deficient. The Federal Ministries of Finance and Planning should examine this inconsistency in depth.

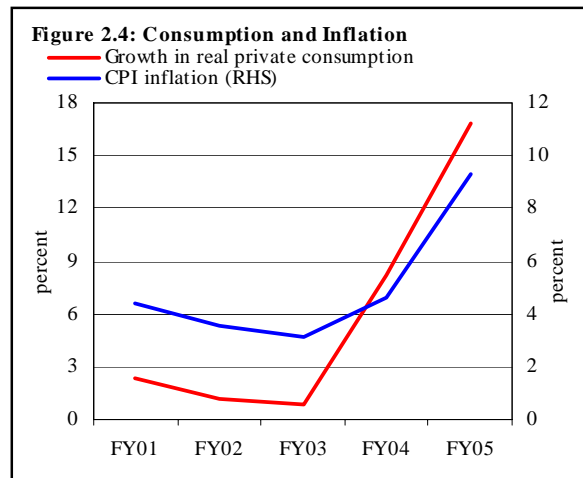


Table 2.2: Aggregate Demand

at constant prices

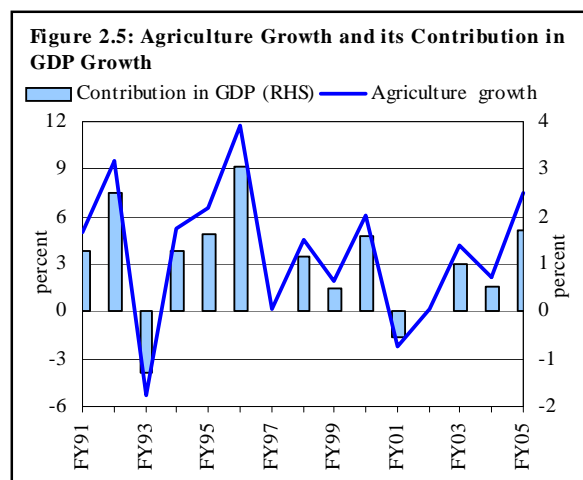
| | FY04 ^R | FY05 ^P | Growth rates | | As percent of GDP | |
|-------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | | | FY04 ^R | FY05 ^P | FY04 ^R | FY05 ^P |
| Consumption expenditure | 3,546,860 | 4,086,302 | 7.5 | 15.2 | 78.8 | 79.6 |
| Public | 3,153,903 | 3,684,438 | 2.1 | 2.3 | 9.2 | 8.8 |
| Private | 392,957 | 401,864 | 8.2 | 16.8 | 69.7 | 70.8 |
| Gross fixed investment | 628,796 | 638,538 | -3.2 | 1.7 | 17.4 | 15.8 |
| Public | 196,386 | 185,323 | 14.0 | -5.6 | 4.1 | 4.4 |
| Private | 432,409 | 453,213 | -11.0 | 4.8 | 11.6 | 9.7 |

Source: Economic Survey 2004-05; R=Revised ,P=Provisional

2.2 Performance of Agriculture Sector

The agriculture sector exhibited an impressive performance in FY05 registering a growth rate of 7.5 percent. This not only surpassed the annual target of 4.0 percent but is also well above the 2.2 percent growth recorded in FY04. In fact, the FY05 agri-sector growth is the highest recorded in the last nine years (see **Figure 2.5**).

All sub-sectors with the exception of livestock, which saw a deceleration in growth, contributed toward this improved performance (see **Figure 2.6**). However, the strongest contribution was from major crops, following the record production of cotton (14.6 million bales) and a bumper wheat crop (21.1 million tons), which pushed up the share of major crops in agricultural value addition from 34.0 percent to 37.1 percent (see **Table 2.2**) even as the share of agriculture in real GDP growth increased from 7.9 percent in FY04 to 20.6 percent during FY05. While good fortune, in the form of favorable conditions and timely rainfall were key determinants of the good

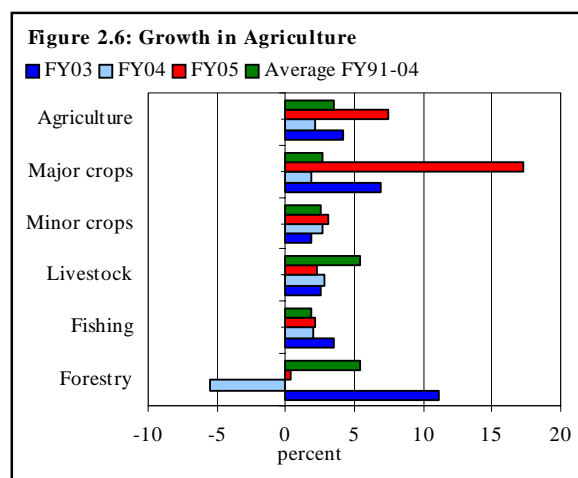


performance by major crops, the ability of farmers to take advantage of these was probably significantly augmented in FY05 by the sharp rise in the credit availability that encouraged use of improved seeds, pesticides and fertilizers (see **Table 2.3**).

Table 2.3 Agriculture Sector Performance

| | | FY02 | FY03 | FY04 | FY05 | Growth rate during | |
|----------------------------|------------------|--------|-------|-------|--------|--------------------|-------|
| | | | | | | FY04 | FY05 |
| Value addition | | | | | | | |
| Agriculture VA | billion Rs. | 904.4 | 941.9 | 962.5 | 1034.3 | 2.2 | 7.5 |
| <i>of which</i> | | | | | | | |
| Major crops | billion Rs. | 300.9 | 321.5 | 327.5 | 384.2 | 1.9 | 17.3 |
| Minor crops | billion Rs. | 117.2 | 119.4 | 122.6 | 126.4 | 2.6 | 3.1 |
| Livestock | billion Rs. | 449.0 | 460.5 | 473.2 | 484.0 | 2.8 | 2.3 |
| Crops production | | | | | | | |
| Cotton | (million bales) | 10.6 | 10.2 | 10.0 | 14.6 | -1.6 | 45.5 |
| Wheat | (million tonnes) | 18.2 | 19.2 | 19.5 | 21.1 | 1.7 | 8.3 |
| Rice | (million tonnes) | 3.9 | 4.5 | 4.85 | 5.0 | 8.3 | 3.7 |
| Sugarcanes | (million tonnes) | 48.0 | 52.1 | 53.4 | 45.3 | 2.6 | -15.2 |
| Non-crops | | | | | | | |
| Meat production | (000 tonnes) | 2072 | 2132 | 2188 | 2271 | 2.6 | 3.8 |
| Milk production | (000 tonnes) | 27031 | 27811 | 28624 | 29472 | 2.9 | 3.0 |
| Fish production | (000 tonnes) | 655 | 562 | 566 | 574 | 0.7 | 1.3 |
| Forest production | (000 cu.mtr.) | 726 | 823 | 918.0 | 912.0 | 11.5 | -0.7 |
| Inputs | | | | | | | |
| Improved seed distribution | (000 tonnes) | 177.65 | 190 | 189.0 | 196.6 | -0.5 | 4.0 |
| Fertilizer off-take | million N/T | 5.3 | 5.4 | 5.7 | 6.2 | 6.7 | 9.1 |
| Sale of tractors | (Nos) | 24311 | 17617 | 25417 | 32012 | 44.3 | 25.9 |
| Credit availability | | | | | | | |
| Credit disbursement | billion Rs. | 52.4 | 58.9 | 73.6 | 108.7 | 24.9 | 47.8 |

Specifically, the credit disbursement to the agriculture sector registered a growth of 47.8 percent YoY in FY05 to reach Rs 108.6 billion, which is also 27.9 percent higher than the target of Rs. 85 billion envisaged by Agricultural Credit Advisory Committee (ACAC) for the year. The availability of agri financing resulted in an improvement in the per hectare yield of almost all crops, possibly reflecting to the higher usage of agricultural inputs and the increased mechanization of agri-process as shown by tractor financing loans and a higher number of tractors sold during FY05 (see **Table 2.3**). As credit became available to small and subsistence farmers the use of fertilizers and other inputs was more broad based this year.



The record production of cotton, wheat, and strong maize and rice harvest probably led to a rise in farm incomes during FY05, helping spur economic activity in the rural areas, but probably also reduce rural poverty (see **Box 2.1**– Agriculture Growth and Rural Poverty).

2.2.1 Production & Area

While the crops sub-sector provided almost half of the total value addition in agriculture during FY05, it accounted for over 90 percent of the sectoral *growth* during the year. Much of this, in turn, emerged from major crops, as the contribution of minor crops grew only modestly, while growth in the other major sub-sector, livestock, decelerated (see **Table 2.4** and **Figure 2.7**).

As detailed below, the growth in aggregate value addition by crops (1) stems principally from an improvement in productivity rather than an increase in the area under cultivations; (2) it is mainly based on a significant improvement in a few major crops such as cotton, wheat, maize and gram; and (3) the switching of cultivable land during the kharif season away from sugarcane to cotton proved to be very fortuitous.

Major Crops

The aggregate value-addition by major crops grew by an exceptional 17.3 percent during FY05 – the strongest showing by this sub-sector in two decades. Interestingly, the aggregate cultivated area for important major crops witnessed only a nominal 2.3 percent YoY growth during the period, indicating that the increased output stemmed from an improvement in yields accompanied by changes in the crop mix. Particularly, the shift in the crop mix from sugarcane raised the cotton area under cultivation (see **Table 2.5**).

Relative to the targets set for FY05, the area cultivated was low for both rice and sugarcane, probably reflecting concerns over water availability prevalent during the kharif FY05 sowing season. On the other hand, cotton which is also planted during the same period is less vulnerable to water shortages, and farmers were probably encouraged by relatively strong prices (particularly given the timely increase in the support price for cotton from

Table 2.4: Sectoral Share of Agriculture Value Added
in percent

| Description | FY01 | FY02 | FY03 | FY04 | FY05 |
|-------------|-------|-------|-------|-------|-------|
| Agriculture | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Major crops | 34.1 | 33.3 | 34.1 | 34.0 | 37.1 |
| Minor crops | 13.5 | 13.0 | 12.7 | 12.7 | 12.2 |
| Livestock | 47.9 | 49.6 | 48.9 | 49.2 | 46.8 |
| Fishing | 1.6 | 1.4 | 1.4 | 1.4 | 1.3 |
| Forestry | 2.8 | 2.7 | 2.9 | 2.7 | 2.5 |

Source: Economic Survey 2004-05

Figure 2.7: Performance of Major Crops during FY05

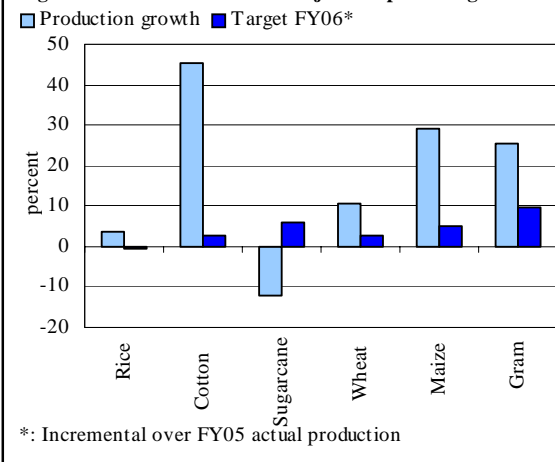


Table 2.5: Area and Production of Important Major Crops

| Crops | Area in million hectares | | % ch. In FY05 | |
|-----------|--------------------------|------|---------------|------|
| | FY04 | FY05 | FY04 | FY05 |
| Rice | 2.46 | 2.59 | 2.4 | -2.7 |
| Cotton | 2.99 | 3.14 | 8.0 | 2.9 |
| Sugarcane | 1.07 | 1.0 | -11.8 | -5.3 |
| Wheat | 8.21 | 8.29 | 1.5 | 0.5 |
| Maize | 0.94 | 0.94 | 1.1 | 1.1 |
| Gram | 0.98 | 1.06 | 6.1 | -1.9 |

| Crops | Production (cotton million' bales; other crops million' tons) | | | % ch. In FY05 | |
|-----------|---|-------|------|---------------|-------|
| | FY04 | FY05 | FY05 | FY04 | FY05 |
| Rice | 4.85 | 5.11 | 5.03 | 3.7 | -1.6 |
| Cotton | 10.05 | 10.72 | 14.6 | 45.5 | 36.2 |
| Sugarcane | 53.78 | 50.88 | 45.3 | -15.2 | -10.9 |
| Wheat | 19.5 | 20.2 | 21.1 | 8.2 | 4.5 |
| Maize | 2.15 | 2.77 | 2.77 | 28.8 | 0.0 |
| Gram | 0.61 | 0.69 | 0.77 | 26.2 | 11.6 |

Source: Ministry of Food, Agriculture and Livestock

Rs.850 per 40kg to Rs.925 by the government).¹ In contrast, the impact of the water shortages on sugarcane cultivation was probably exacerbated by the lower market prices of sugarcane in FY04, and payment delays by sugar mills for the FY04 crop.

By the rabi season however, heavy rains had considerably improved the water supply. The total area under important major crops in the season consequently rose by 1.8 percent YoY, but approximately two-thirds of this increase was captured by wheat. This probably reflects farmers' preferences (wheat is the most widely sown crop in Pakistan) as well as the impact of an increase in the support prices of wheat.

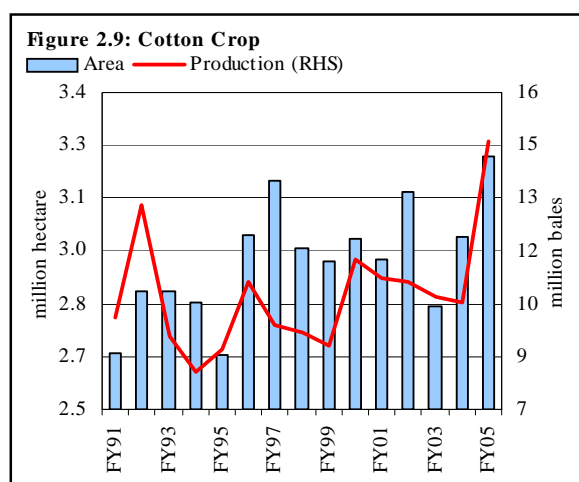
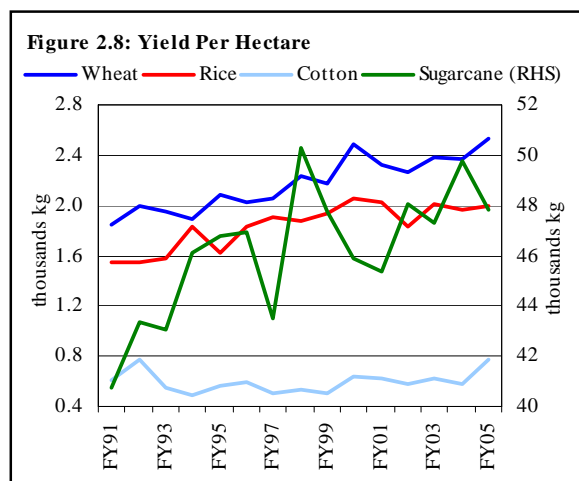
The increased emphasis on wheat and cotton crops resulted in a significant improvement in yields during FY05, while the yield of sugarcane declined (**Figure 2.8**). The FY05 yields of key major crops are analyzed below:

Cotton

The yield increase was mainly due to the favorable weather conditions at the time of sowing (see **Figure 2.9**). The relatively high median temperatures protected the cotton crop from pest attack, weeds, and viral disease while later, the lower rainfall during the monsoon season not only resulted in a lower incidence of weeds and pests, but also made the pesticide sprays more effective. Indeed, not only was there ample availability of pesticides in the market,² farmers' access to institutional agriculture credit enabled them to respond with pesticides (and fertilizers) as needed. These favorable factors improved the production and the quality of raw cotton. The latter is evident in the improved ginning outturn (GOT; the ratio of lint and seed ratio in raw cotton)³, resulting in the production of a record 14.6 million bales of cotton during FY05, an increase of 45.5 percent YoY.

Sugarcane

The area under cultivation for sugarcane declined by 11.8 percent to 947 thousand hectares during FY05 that is 5.3 percent below the sowing target for the period. The impact of this was probably compounded by a number of factors, including poor water availability during kharif FY05, and weak price incentives – not only has the support prices for sugarcane been unchanged at Rs. 42 per 40 kg FY02; but actual prices received during FY03 and FY04 were often lower. Moreover, many farmers received payments after some lag.



¹ This is generally only an indicative price, given that the government does not often undertake large cotton purchases.

Nonetheless, the hope of government intervention in the event of a price collapse does provide some comfort to farmers.

² This probably owes to the governments measures in response to poor availability and quality of pesticides in FY04 that caused significant losses to the cotton crop that year.

³ The GOT improved from 33 percent to 40 percent during FY05 as compared to last year (for reference see Cotton Plus, August 2005).

Not surprisingly, many farmers switched away from the crop to cotton in FY05 (probably including more productive lands). This lower interest in crop, together with the poor water availability, contributed to the 4 percent decline in yields, dragging down the FY05 sugarcane production (see **Figure 2.8**).

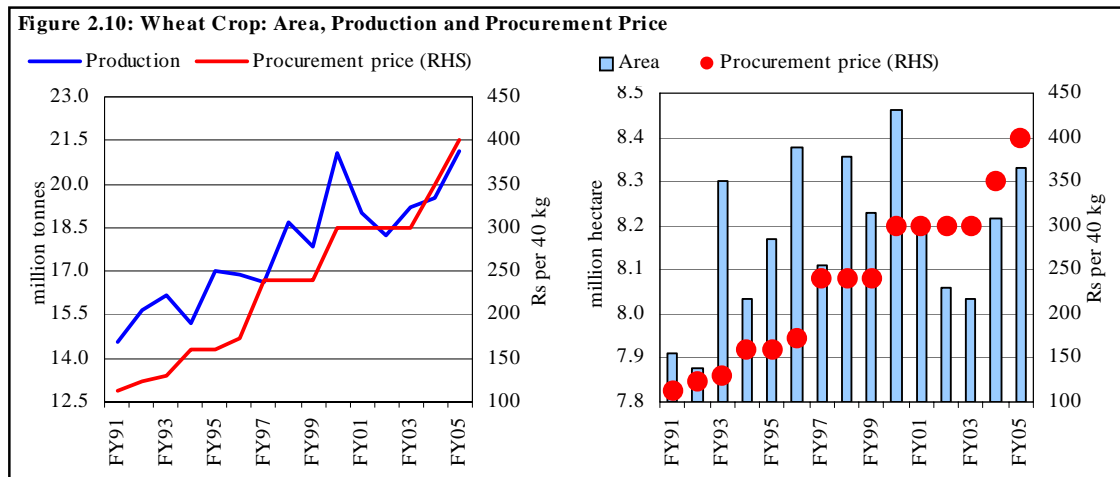
Rice

Although the area under cultivation for rice increased by 2.4 percent, it was still 2.7 percent less than the target set for FY05. This probably reflected the concern over water availability at sowing time. Fortunately, the fall in cultivated area was compensated by an improvement of 1.2 percent YoY in the yield but the actual FY05 crop slightly below the annual target.

Wheat

As discussed earlier, FY05 wheat production was 10.6 percent and 6.7 percent higher than the FY04 production and the FY05 target respectively. This good harvest was mainly attributed to; (1) the rise in procurement prices from Rs. 350 to Rs. 400 per 40 kg during FY05, which encouraged the farmers to bring more area under wheat crop; (2) ample availability of the inputs such as fertilizer and certified seeds (see **Section 2.2.2**); and (3) the wide- spread and timely winter rains (see **Section 2.2.3**).

As reflected by **Figure 2.10**, there is a strong direct relationship between procurement prices of wheat with area under wheat cultivation and thus wheat production. It is noteworthy to mention that the procurement prices remained stagnant at Rs 300 per 40 kg during FY00 to FY03, which resulted into a notable decline in its area under cultivation and therefore, production. Due to this direct relationship and wheat shortages during FY03, government decided to push the procurement prices of wheat to Rs 350 per 40 kg during FY04 and then further to Rs 400 per 40 kg in FY05 respectively.



The timing of the announcement of procurement wheat prices has a very significant impact on area under cultivation for wheat. As reflected by **Figure 2.10**, the announcement of procurement price increase before the pre-sowing time of wheat as recorded in FY93, FY00, FY04 and FY05 has a much bigger impact on the area under wheat cultivation relative to upward price announcement during the harvesting time as happened in FY94 and FY97 which had a lagged impact in the area under wheat.

In short, important major crops performed well despite water shortage during Kharif FY05 due to better crops' management by farmers, favorable weather condition, supportive policies of the government, and a record disbursement of agri credit by financial institutions.

Table 2.6: Production and Target Setting of Important Crops

| Crops | FY05p | | FY06 targets | | Target FY06 | |
|-----------|------------|-----------|--------------|-----------|------------------------------------|-----------------------------------|
| | Production | Area Sown | Production | Area Sown | % Change over actual prod. of FY05 | % Change over actual area of FY05 |
| | Cotton | 14.6 | 3,229 | 15.0 | 3,247 | -17.8 |
| Sugarcane | 45295 | 947 | 51,245 | 955 | 13.1 | 0.8 |
| Rice | 4992 | 2,502 | 5,225 | 2,533 | 4.7 | 1.2 |

Source: Ministry of Food, Agriculture and Livestock

The prospect for Kharif FY06 crops is brightened by the comfortable water availability. However, the government target for major important crops for Kharif FY06 have been kept at conservative levels despite the improvement (see **Table 2.6**); the area under cultivation targets set for sugarcane and rice are only 0.8 percent and 1.2 percent higher than actual area of FY05. As discussed earlier, the cultivated area of sugarcane and rice were lower due to the expected water shortage and lower market prices last year. Given the improved water availability and prices, the actual area brought under sugarcane and rice in Kharif FY06 is likely to exceed FY06 target.

Minor Crops

Value addition by minor crops registered a growth of 3.1 YoY during FY05, only slightly better than the growth of 2.6 percent during FY04. Even this improvement was on the back of a substantial improvement in the production of three crops i.e. Onion, chillies, and oil seeds, which increased by 13.8 percent, 25.4 percent, and 34.7 percent respectively during FY05. Other important minor crops like potatoes and pulses recorded a decline as reflected by **Table 2.7**. The weak aggregate growth in value-addition by minor crops reduced the share of this sub-sector in agriculture to 12.2 percent during FY05 from 12.7 percent in FY04.

Table 2.7: Area and Production of Other Minor Crops

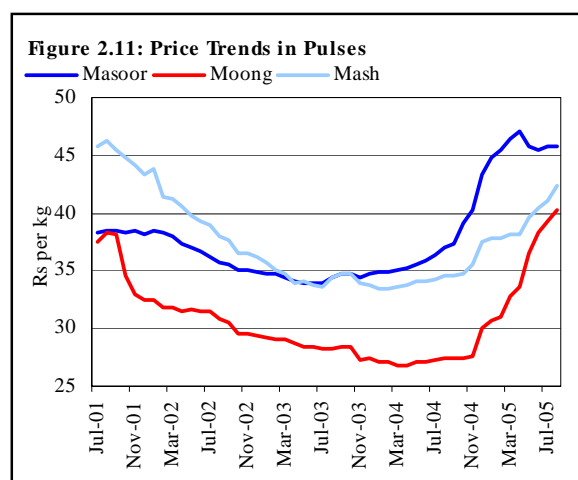
Area in 000 hectares and Production is in Tons

| | FY04 | | FY05 p | | % Change in production |
|----------|-------|------------|--------|------------|------------------------|
| | Area | Production | Area | Production | |
| Masoor | 51.0 | 31.1 | 49.0 | 28.0 | -10.0 |
| Moong | 256.0 | 140.8 | 245.0 | 130.0 | -7.7 |
| Mash | 48.7 | 24.6 | 45.0 | 18.3 | -25.6 |
| Potato | 112.7 | 1938.2 | 111.0 | 1886.5 | -2.7 |
| Onion | 106.3 | 1449.0 | 122.0 | 1817.4 | 25.4 |
| Chillies | 48.8 | 96.4 | 39.0 | 129.9 | 34.7 |

P= Provisional (July-March).

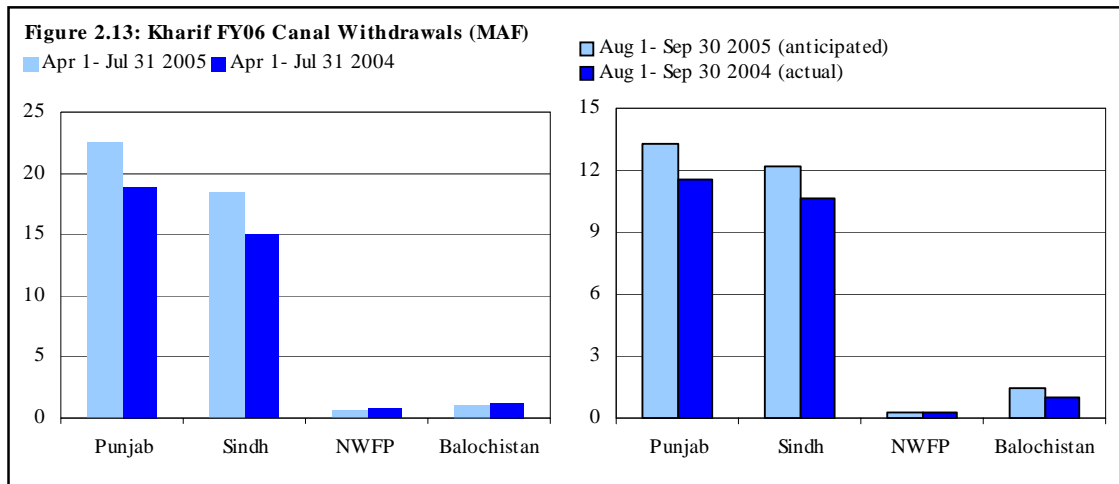
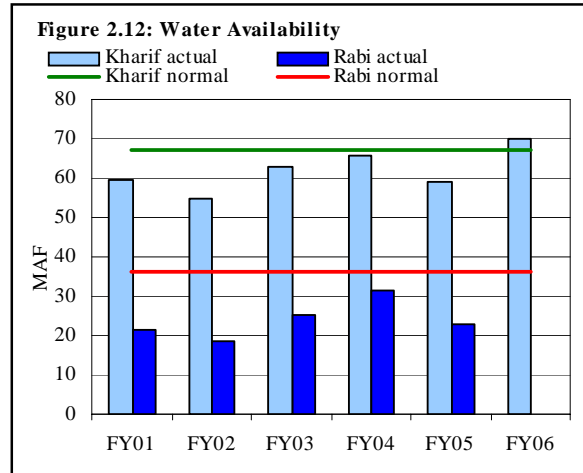
Source: Ministry of Food, Agriculture and Livestock and FBS.

The production of *mash* and *masoor* declined mainly due to; (1) weak market prices of these pulses during FY04 (see **Figure 2.11**) due to the availability of imports (which discouraged farmers, leading to a fall in the cultivated area); and (2) excessive rains during the second half of FY05 that also adversely affected the standing crop (these minor crops are quite vulnerable to the vagaries of the weather). *Moong* and *potatoes* also recorded a fall in both cultivated area and production, during FY05 as compared to FY04.



2.2.2 Water Availability

During rabi FY05, water availability initially worsened relative to the FY04 season. However, towards the latter half of the FY05 rabi season, heavy winter rains and snowfall significantly improved the water availability (see **Figure 2.12**). As a result, on aggregate, the water availability for rabi FY05 and for kharif FY06⁴ has remained above expectations and even above the normal level for the kharif season. Consequently, the situation of canal water withdrawal also improved as shown in **Figure 2.13**. This was mainly due to the timely monsoon rains and snow melt (see **Figure 2.14**).



Indeed this cause a mild flood, as dams filled to their permitted storage capacity forcing unplanned releases of water. Despite the distraction caused by the floods in some parts of the country in overall terms of water availability for irrigation purposes, the rains and heavy inflows of rivers (see **Table 2.8**). The ample water availability is also expected to help re-charge the ground water table for future consumption as well.

However, kharif FY06 crops are clouded by the impact of the mild floods and the threat of weeds growth, viral and pest attacks on the cotton crops following monsoon rains.

2.2.3 Fertilizer Offtake

Despite a substantial rise in prices, fertilizer off- take recorded a substantial growth of 14.1 YoY percent during FY05 against an 8.1 percent YoY increase in FY04. Urea consumption was up by 10.9 percent in FY05, while DAP registered a buoyant growth of 28.4 percent (see **Figure 2.15**). This high growth

| River | Aug 02, 2005 | Aug 02, 2004 | Difference (x1000cs) | Difference (%) |
|--------|--------------|--------------|----------------------|----------------|
| Indus | 284.9 | 193.4 | 91.5 | 47.3 |
| Kabul | 73.0 | 32.0 | 41.0 | 128.1 |
| Jhelum | 41.1 | 28.8 | 12.3 | 42.7 |
| Chenab | 95.4 | 48.8 | 46.6 | 95.5 |
| Total | 494.4 | 303.0 | 191.4 | 63.2 |

⁴ Actual level for first 4 months of kharif FY06, and anticipated level for last two months of the season.

rate should be interpreted with caution as the offtake of DAP in FY04 unusually below the normal trend (see **Figure 2.16**). However, this upsurge partly also reflects the higher (and relatively easier) access to agri-credit; and price incentives provided by the higher procurement and the support prices of wheat and cotton. In addition, the improved water availability during the rabi season probably encouraged farmers to use more fertilizer.

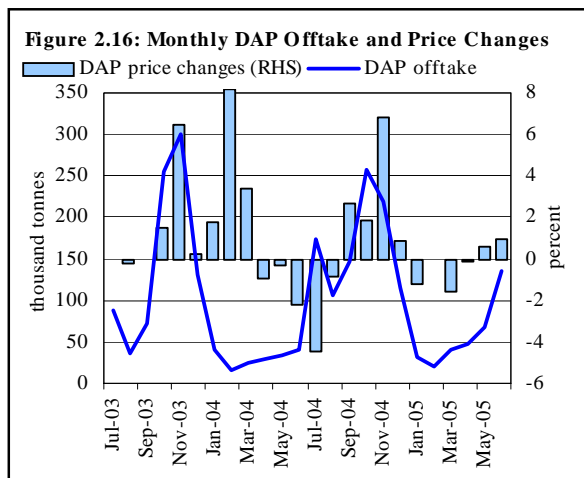
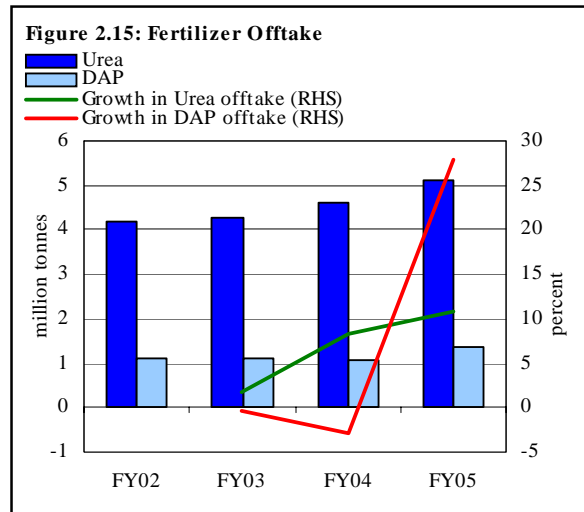
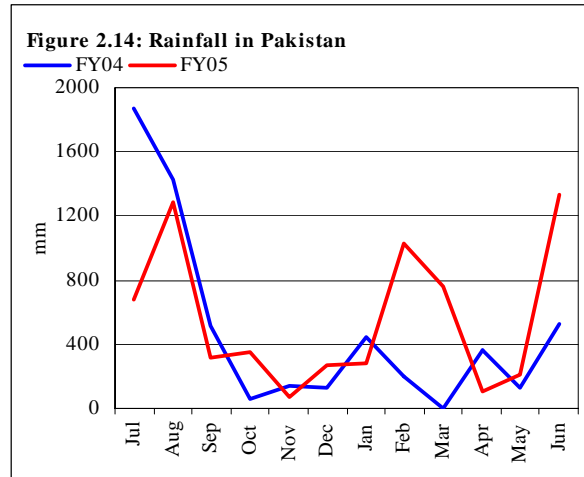
The prices of the both urea and DAP rose substantially during FY05 due to supply constraints and rising demand. The demand for both Urea and DAP could not be met

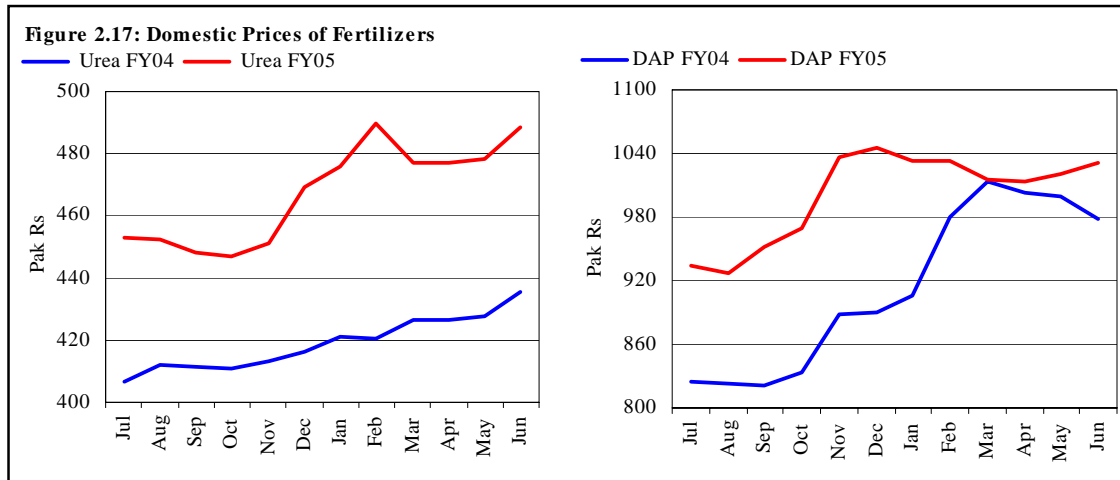
completely through local production (due to capacity constraints) and had to be supplemented by imports. The higher international fertilizers prices accompanied by upward adjustments in domestic gas prices put upward pressures on fertilizer prices in domestic market throughout the fiscal year, though the rise slowed in the latter months (see **Figure 2.17** and **Figure 2.18**).

As international prices of urea and DAP have risen very sharply in recent years, the government tried to provide relief to farmers through a Rs 100 per bag reduction in the deemed price of DAP for GST computation, accompanied by 5 percent reduction in the withholding tax on both urea and DAP at import stage. These measures did not reduce the domestic prices of fertilizer. Initially this was because the traders were unwilling to cut prices until existing stocks had been sold, but there after a surge in international fertilizer prices once again intensified pressures on domestic prices.

2.2.4 Credit Disbursement

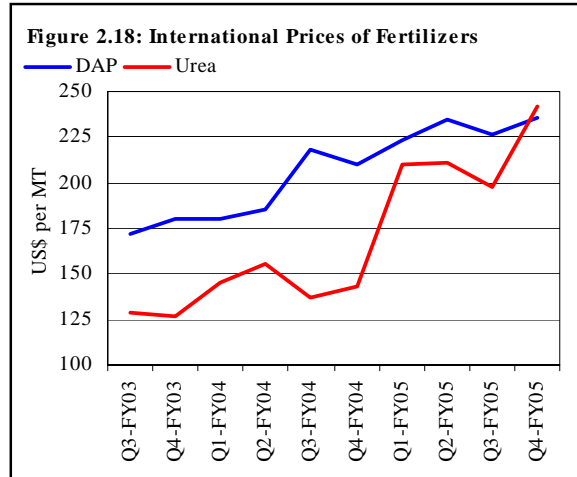
The total gross disbursement of agriculture credit increased by 47.8 percent YoY to Rs 108.7 billion during FY05 as compared to 25.0 percent YoY in FY04. This was the second consecutive year in which the gross disbursement exceeded the annual target envisaged by ACAC (see **Figure 2.19** and **Table 2.9**).





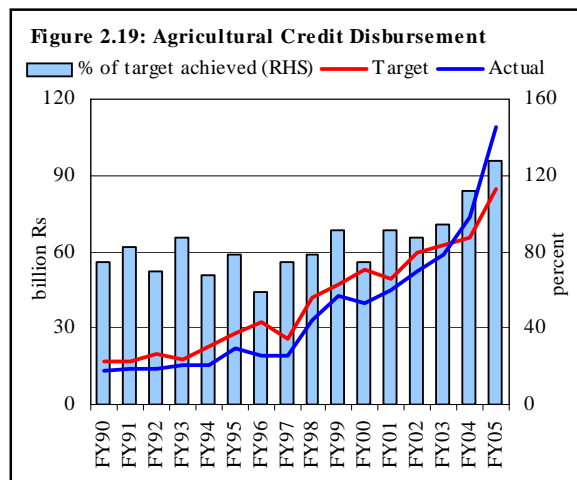
This unprecedented growth in credit extension during FY05 was led by commercial banks, which increased their share in total agri credit from 48.9 percent in FY04 to 58.5 percent (see **Figure 2.20**, and **Figure 2.21**). It is also pertinent to note that ZTBL has also performed relatively better than in the preceding year, slightly exceeding its credit disbursement target during FY05.

The increasing penetration of commercial banks in the agri-credit market as depicted in **Figure 2.21** reflects attractiveness of this market segment as relative margins were higher compared to that in the corporate sector.



The introduction of more flexible and time saving agri credit schemes such as the “Revolving Credit Scheme”⁵ also helped in gradually reducing the transaction costs.

As far as the types of these loans are concerned, the disbursement of production loans has shown a buoyant growth of 52.9 percent YoY while the development credit grew by 5.6 percent YoY during FY05. It is encouraging to note that the share of production and development loans extended by the 5 largest commercial banks and DPBs increased during FY05 (see **Figure 2.22**). ZTBL’s share in production loans declined while its share in developmental loans



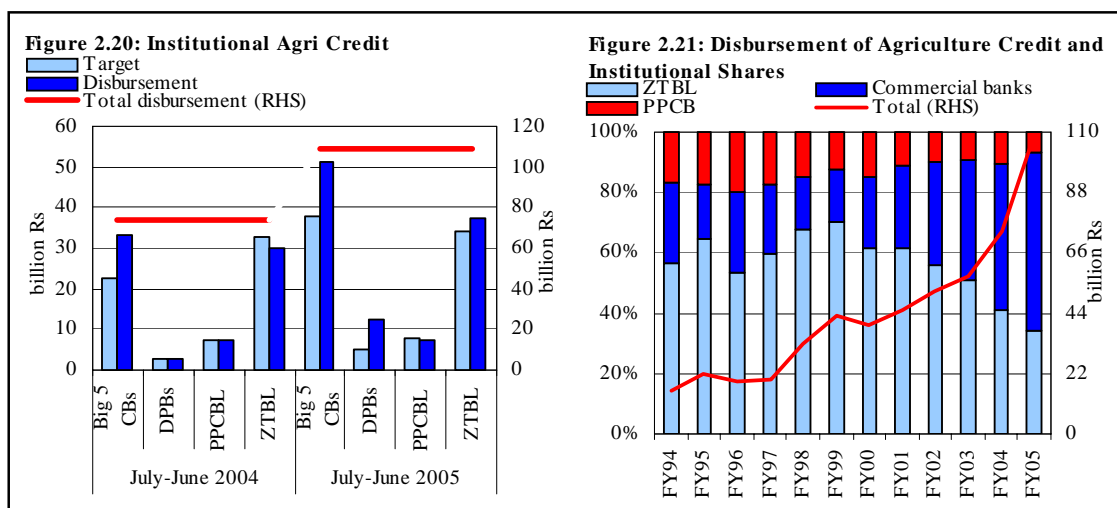
⁵ The Scheme primarily would cater to the requirements of the farmers and provide financing for working capital needs and for the production purposes to eligible farmers / growers. This scheme aims to extend credit without repeated documentations, bank visits and approvals of the limits against full repayments).

increased during FY05. However, a clear shift has taken place in case of PPCBL, from farm loans to non-farm loans.

Table 2.9: Numbers of Borrowers and Amount Disbursed
 borrowers in thousands; disbursement in billion Rupees

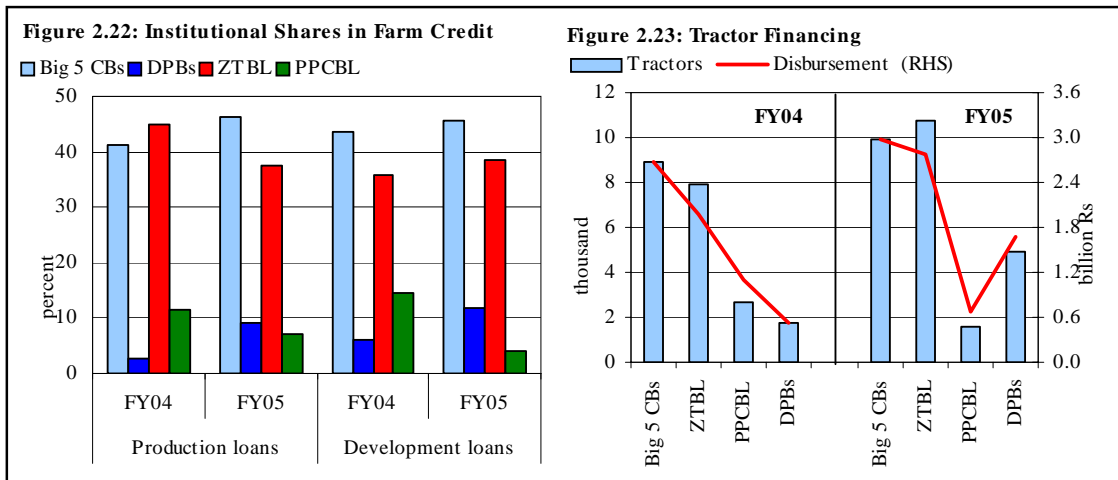
| | Numbers of Borrowers | | Disbursement | | % change in FY05 over FY04 | |
|--------------------------|----------------------|---------------|--------------|--------------|----------------------------|--------------|
| | FY04 | FY05 | FY04 | FY05 | Numbers of borrowers | Disbursement |
| Farm sector | 1081.7 | 1072.8 | 63.9 | 93.3 | -0.8 | 46.1 |
| <u>Production loans</u> | <u>1042.3</u> | <u>1027.0</u> | <u>53.6</u> | <u>81.9</u> | <u>-1.5</u> | <u>52.9</u> |
| Subsistence | 912.6 | 894.0 | 38.1 | 56.9 | -2.0 | 49.6 |
| Economic | 113.5 | 114.8 | 12.1 | 18.4 | 1.2 | 52.1 |
| Above economic | 16.1 | 18.2 | 3.4 | 6.6 | 13.1 | 91.9 |
| <u>Development loans</u> | <u>39.4</u> | <u>45.8</u> | <u>10.2</u> | <u>10.7</u> | <u>16.2</u> | <u>5.6</u> |
| Subsistence | 28.8 | 34.5 | 6.9 | 7.7 | 19.9 | 11.1 |
| Economic | 9.6 | 9.8 | 2.5 | 2.6 | 2.0 | 3.0 |
| Above economic | 1.0 | 1.5 | 0.7 | 0.4 | 48.6 | -38.5 |
| <u>Corporate farming</u> | <u>0</u> | <u>0</u> | <u>0.1</u> | <u>0.7</u> | <u>-69.2</u> | <u>447.0</u> |
| Non-farm sector | 54.7 | 69.9 | 9.7 | 15.2 | 27.8 | 57.2 |
| Small farms | 54.4 | 68.7 | 4.9 | 7.7 | 26.3 | 59.2 |
| Large farms | 0.3 | 1.2 | 4.8 | 7.5 | 259.9 | 55.2 |
| Total | 1136.4 | 1142.8 | 73.6 | 108.6 | 0.6 | 47.6 |

Approximately 80 percent of the total developments loans are to finance the purchase of tractors. All institutions but PPCBL financed the purchase of a higher number of tractors during FY05 as compared to FY04, with DPBs and ZTBL in particular posting a healthy growth of 180 percent and 35.6 percent respectively (see **Figure 2.23**).



Farm and Non-Farm Credit Disbursement

Farm sector credit disbursement includes both production and development loans while loans for the non-farm sector include disbursements for livestock, poultry, forestry, dairy farming, etc. Farm credit disbursement saw a growth of 46.1 percent YoY during FY05 but its share in total agri credit nonetheless fell slightly to 85.3 percent in FY05 from 86.6 percent in FY04, because the disbursement of non-farm credits grew even faster.



The non-farm agri-credit recorded an increase of 57.2 percent YoY during FY05, compared to a growth over 33.9 percent during FY04 (see **Table 2.8**). As depicted in **Figure 2.24**, the credit disbursement to livestock increased by 385.5 percent to Rs. 3.7 billion while the number of borrowers doubled compared to the preceding year, mainly due to new credit schemes introduced for livestock.

The number of borrowers and amounts disbursed for fisheries, poultry and dairy farming also showed an upward movement. This is a particularly positive development because livestock adds to the cash income of the farmers and helps in poverty reduction.

In terms of institutions, DPBs credit to non-farm sector has increased sharply, probably because commercial banks have introduced special products for the livestock sector during FY05. It is also encouraging to note that PPCBL also started to extend credit to non-farm sector during FY05 (see **Table 2.10**).

Number of Borrowers

A matter of serious concern this year was that the number of beneficiaries of agri-credit has remained stagnant. The overall number of borrowers recorded only a marginal increase of 0.6 percent to 1142.8 thousand during FY05. The disaggregated data suggests there is a decline of 0.8 percent in number of borrowers in farm sector, which was offset by a 27.8 percent rise in non-farm borrowers (see **Table 2.9**). In effect, the banks have only increased the relative size of the loans disbursed and has not been able to increase their customer base.

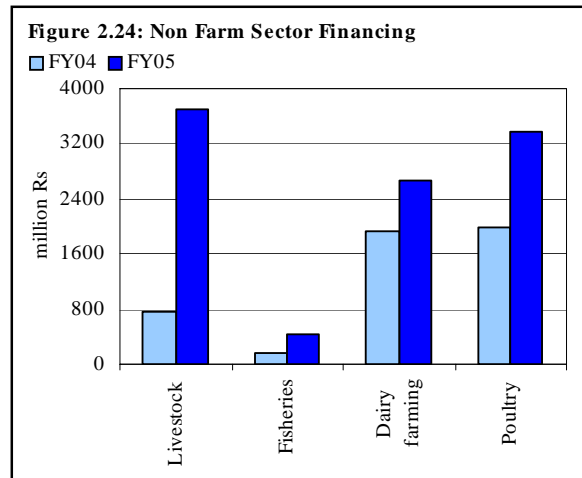


Table 2.10: Institutional Non-Farm Credit Disbursement

| | FY04 | FY05 | Growth rate FY05 |
|------------------------|------------|-------------|------------------|
| 5 big commercial banks | 6.9 | 8.4 | 21.6 |
| DPBs | 0.6 | 2.8 | 377.5 |
| ZTBL | 2.2 | 2.6 | 18.5 |
| PPCBL | 0.0 | 1.5 | |
| Total | 9.7 | 15.3 | 57.2 |

A more worrying finding is that the number of borrowers with economic and above economic land holding increased in farm and non-farm sectors, while the number of borrowers for production loans with subsistence farm holding declined by 2.0 percent during FY05 (see **Table 2.9**). However, the

share of farmers with subsistence holdings remained dominant at over 87 percent for the production related loans. Despite the slight reduction in number of borrowers, the amount disbursed for production loans to farmers with subsistence landholdings increased by 49.6 percent.

However, an encouraging development this year was the healthy growth of 205.2 percent in the number of borrowers in the livestock sector, which is one of the most important sub-sector of agri sector, contributing almost half in the total value addition in agriculture. The development of new financial products specifically for livestock sector by the commercial banks has brightened the growth prospects of this sector.

Recovery

The amount recovered during FY05 was 31.8 percent higher as compared to FY04, and as a result the overall recovery rate moved up to 68.0 percent for FY05 as compared to 66.5 percent in the preceding year.

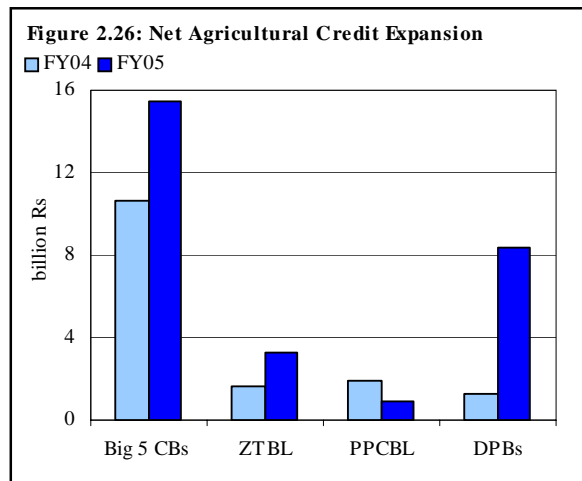
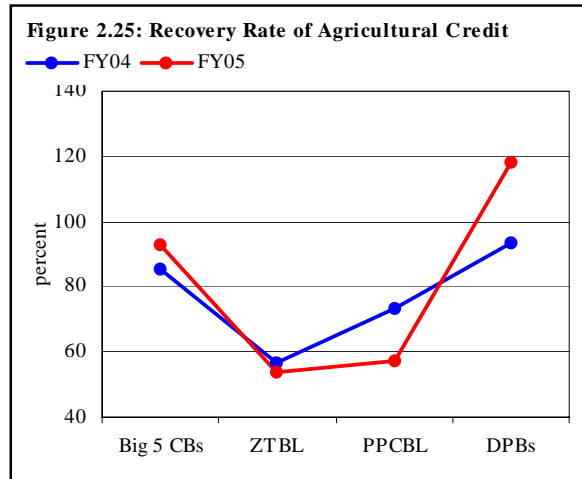
At a disaggregated level, the commercial banks recovery rate this year was 92.8 percent – an increase of 7.5 percentage points– while that of DPBs from 93.2 percent in FY04 to 118.0 percent in FY05 (see **Figure 2.25**). On the other hand, ZTBL and PPCBL recorded a decline in their recovery rate by 2.7 and 16.2 percentage points respectively.

Net Credit Expansion

The net credit expansion (disbursement less recovery of principal amount only) registered a rise of 81.3 percent to Rs 28.1 billion during FY05 as compared to Rs15.5 billion during FY04.⁶ As exhibited by **Figure 2.26** all institutions barring PPCBL participated in the net expansion, with DPBs showing the fastest growth followed by the big 5 commercial banks and ZTBL. In addition special efforts made by Agriculture Credit Department of State Bank of Pakistan for successful launch of training programs to create awareness throughout the country during the last three years also appear to be bearing fruit.

2.2.5 Livestock⁷

Livestock registered a deceleration in growth from 2.8 percent YoY in FY04 to 2.3 percent YoY during FY05. The main factor for this deceleration was a sharp reduction in the growth in the production of mutton and poultry products (white meat and eggs)-(see **Figure 2.27**).



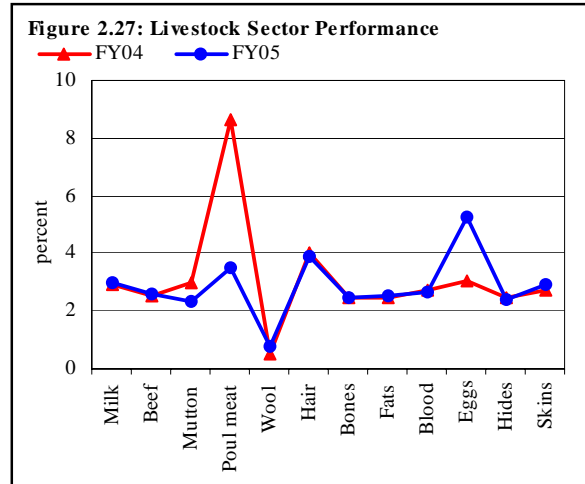
⁶ The increase in net credit expansion is a very encouraging indicator for agri financing.

⁷ Livestock sector is the most important emerging sub sector of the agri sector as reflected by its shares of 46.8 percent in agriculture and 10.8 percent share in GDP during FY05.

Livestock incomes complement crop income of the small and subsistence farmers and provide insurance against risks of crop failures arising from the vagaries of the weather. Livestock output and prices affect the cost of living for urban poor by their impact on overall affecting the food price levels.

Due to this importance, livestock has gained the attention of policy makers and scheduled commercial banks. The latter is visible in the rise of finance credit extension to livestock. The government has provided the following incentives for the promotion of the livestock sector;

- Imported plant and equipment not manufactured locally are completely exemption from sales tax and only subject to custom duty of 10 percent.
- Import of breeding stock will be allowed, subject to the import duty of 10 percent.
- Locally manufactured machinery will be provided credit.
- In order to meet Sanitary and Phytosanitary (SPS) requirements under WTO for quality assurance of livestock and livestock products exports, various steps have been taken to improve sanitary and hygiene conditions of animal casing processing units in the country and National Veterinary Laboratory has been constructed for drug residue testing in the livestock products.
- Livestock Development Board (LDB) has been established for the promotion and development of livestock sector.



Besides these measures, there is also an urgent need to strengthen the government veterinary departments and research & development activities/programs related to breeding of animals. The higher expenditure on health and R&D expenditure would be justified because these are public goods and having positive externalities.

2.2.6 Fisheries⁸

The share of fisheries in GDP is only 0.3 percent while its share in agriculture is 1.3 percent during FY05. It also has a 0.9 percent share in total exports earnings. The growth in this sector remained almost unchanged –2.1 percent during FY05 as compared to 2.0 percent in FY04. The release of larger quantity of fresh water into the sea will increase the reproduction of fishes due to the expected growth of mangrove forest in the delta. At the same time, the start of fish and fish preparations exports to EU in FY06 would most probably increase the value addition of this sector in FY06.

⁸ Fisheries have also a potential of not only meeting the domestic nutrition needs but also contributes in the foreign exchange earnings of the country. Both inland and marine fisheries are playing an important role in creating millions of job opportunities as well.

Box 2.1: Agriculture Growth and Rural Poverty

The poverty incidence in Pakistan is mainly driven by relatively higher poverty in rural areas. The economic literature on poverty suggests that higher and sustained agriculture growth can play a significant role in poverty alleviation (see Gaiha, 1993; Datt and Ravallion, 1998). However, the Pakistan version of the picture told a different and puzzling story. Despite a reasonable average growth rate of 3.6 percent during FY91-02, rural poverty incidence measured by Head Count Ratio (HCR) increased during the same period. The recent working paper of Malik J. Wohail (2005), released by the Pakistan Resident Mission of ADB, has made a significant contribution in investigating this puzzle of relatively good agriculture growth and increasing rural poverty incidence. The main findings of this study are:

The estimates of agriculture growth reported by various issues of Pakistan Economic Survey during the 1990s highly overstated the value addition in livestock, fishing and forestry due to the incorrect accounting of livestock, fishing and forestry value-added in some years. After adjusting for these overstated sub-sector growth rates, the study found the average growth rate declines to 3.1 percent during 1990s. This resulted into an average per capita income growth of only 0.6 percent assuming the population growth of 2.5 percent during 1990s. Therefore, the increase in rural poverty is not surprising with such low growth rate

- The higher variability in the growth rates of wheat and cotton crops resulted into higher variation in agriculture growth during 1990s (see **Table 1**). Given the large variability in the production of cotton and wheat, the growth in value added from these two crops over the 1990s is only 1.3% per annum, implying a negative per capita growth in value-added. Therefore, the large variability in these crops is one of the major factors in higher

Table 1: Coefficient of Variation in Cotton/Wheat Crops

| | Cotton | Wheat |
|---------------|--------|-------|
| Area | 0.05 | 0.02 |
| Production | 0.15 | 0.11 |
| Yield/Hectare | 0.14 | 0.09 |

Source: ADB PRM Working Paper Series 2

- poverty incidence in cotton/wheat growing areas of Sind and Punjab as household are pushed into transitory poverty due to bad crops of wheat and cotton. This argument seems convincing as the poverty incidence is the highest in cotton/wheat Punjab, followed by cotton/wheat Sind, and rice/other Sind in FY02.
- Cotton production is concentrated in a few districts of the country where land distribution is highly unequal: expanding the production of this crop would theoretically benefit large farmers. More than half the total farms are smaller than 5 acres in size and excessive land fragmentation and the sub-division of landholdings from generation to generation are causing a persistent decline in farm size, and, therefore, in agricultural productivity.
- There are few avenues available to small farmers for diversification within agriculture and away from agriculture. Specifically, the poor socio-economic characteristics relative to rural population living in Barani areas of Punjab which is attributed to numbers of factors such as: (i) socio-economic characteristics i.e., the lowest dependency ratio, the highest literacy ratio, and the lowest number of unpaid family workers; (ii) the rural areas of barani regions are well integrated with prosperous urban centers that have strong linkages with services sector; (iii) the region's labor force works on a large scale in both armed forces and the government sector; (iv) workers' remittances contributes a large proportion of household incomes in this region due to higher incidence of domestic and overseas migration.
- The reliance of small farmer on cotton and wheat crops with few avenues for diversification renders them more vulnerable to poverty in case of any adverse natural shock.
- The increasing mechanization in agriculture has considerably reduced the use of on-farm hired labor. Agricultural workers' real wages show a decline and this, too, has contributed significantly to the rise in poverty.

What should be done to reduce rural poverty incidence?

Multi-pronged strategy, such as envisaged in Poverty Reduction Strategy Paper (PRSP), is needed to alleviate rural poverty. Besides investing in human development, targeted intervention, expanding social safety nets and Improving governance, PRSP also called for rapid growth in agriculture and other employment generating areas such as small and medium industries, housing and construction, and the Information Technology sectors.

Since agriculture is a risky business and its growth depends on the natural shocks and good fortunes. As such, one cannot control the negative shocks emanating from vagaries of nature. However, implementation of the following measures specific to agriculture sector would help to achieve higher agriculture growth and supplements non-form income, which in turns alleviate and decrease rural poverty;

- Ensure the sustainable, agriculture credit to farmers with subsistence and economic land holdings. The recent increasing trend in institutional disbursement of agri-credit is a right step in this direction.
- The provision of improved seeds, the availability of quality pesticides, and the extension services in agriculture would improve per hectare crops' yield thus increase the income of the rural population.
- Access to Micro finance and small and medium enterprises credit, one village one product initiative, development of livestock sector and the increased public sector investment in infrastructure especially farms to market roads;

lining of water courses, etc. Would provide the employment opportunities to unpaid and disguised workers in rural areas and thus would lead to reduction in poverty incidence.

- The study by Malik (2005) also recommends a poverty reduction strategy focusing on education, skills development, job creation, and health care needs to be designed for cotton/wheat zones of Punjab and Sindh areas.

1 Cotton and Wheat crops contribute on average more than 60 percent to the value addition of crop sub-sector and nearly 30 percent in total value addition in agriculture.

References:

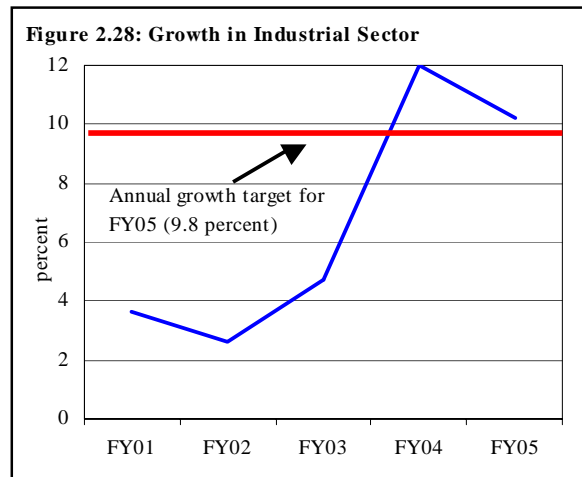
Dutt, G. and Ravallion Martin, 1998, "Farm Productivity and Rural Poverty in India," Journal of Development Studies, Vol. 34, No. 4, pp. 62-85.

Gaiha, R., 1993, "Design of Poverty Alleviation in Rural Areas", Food and Agricultural Organization, United Nations.

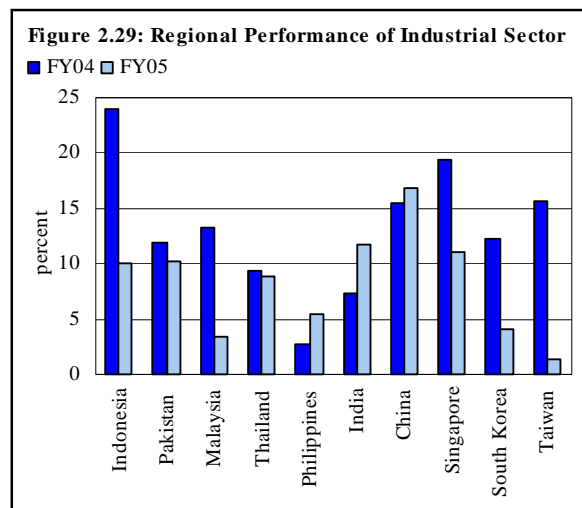
Malik, Shoail J, 2005, "Agriculture Growth and Rural Poverty; A Review of the Evidence", Working Paper No. 2, Pakistan Resident Mission Working Paper Series, Asian Development Bank.

2.3 Industry

Provisional estimates⁹, place the FY05 industrial growth at 10.2 percent YoY, down from the 12.0 percent YoY recorded during the preceding year. Despite the small deceleration, this growth is not only well above the 9.8 percent target for the year, it is also substantially higher than the growth rates witnessed in recent years (see **Figure 2.28**). In fact, Pakistan's industrial growth compares favorably with that in many countries in the region. As shown in **Figure 2.29**, with the exception of India, China and Philippines, all other regional economies registered lower growth in industrial production than Pakistan.



As in the previous year, the most significant contribution to the continued robust performance of Pakistan's industrial sector during FY05 came from *large-scale manufacturing* (LSM), which accounted for approximately three-fourth of the total industrial value addition. This was supplemented by strong performances of the *construction* and *mining & quarrying* sectors (see **Table 2.11**). The turnaround in *construction* was particularly impressive, showing a reversal in growth from a *negative* 6.9 percent in FY04 to positive 6.2 percent during FY05. Indeed, given the strong linkages with many LSM sub-sectors, this sharp recovery probably had a significant downstream impact on overall LSM growth.



In contrast, the growth rate for the *electricity & gas distribution* sub-sector slowed sharply from 21.1 percent in FY04 to only 2.1 percent witnessed in FY05. This slowdown was despite a strong rise in electricity distribution during FY05, and probably reflects the losses by the *gas distribution* sector following attacks on gas distribution infrastructure and the base effect of exceptionally higher growth in FY05.

2.3.1 Index of Industrial Production¹⁰ (IIP)

The production of the industrial sector, as

Table 2.11: Growth of Industrial Value Added

percent (at constant factor cost of 1999-2000)

| Description | FY02 | FY03 | FY04 | FY05 ¹ |
|-------------------------|------------|------------|-------------|-------------------|
| Manufacturing | 4.5 | 6.9 | 14.1 | 12.5 |
| Large-scale | 3.5 | 7.2 | 18.2 | 15.4 |
| Small & household | 7.5 | 44.5 | 6.2 | 6.2 |
| Slaughtering | 3.0 | 3.0 | 2.8 | |
| Mining & quarrying | 7.3 | 16.1 | 3.8 | 5.0 |
| Construction | 1.6 | 4.0 | -6.9 | 6.2 |
| Electricity & gas dist. | -7.0 | -11.7 | 21.1 | 2.1 |
| Industry | 2.6 | 4.7 | 12.0 | 10.2 |

Source: Economic Survey 2004-05; ¹ Data up to July-March FY05. ²: LSM grew by 15.6 percent based on production index data for Jul-Jun FY05.

⁹ Based on the data upto March 2005

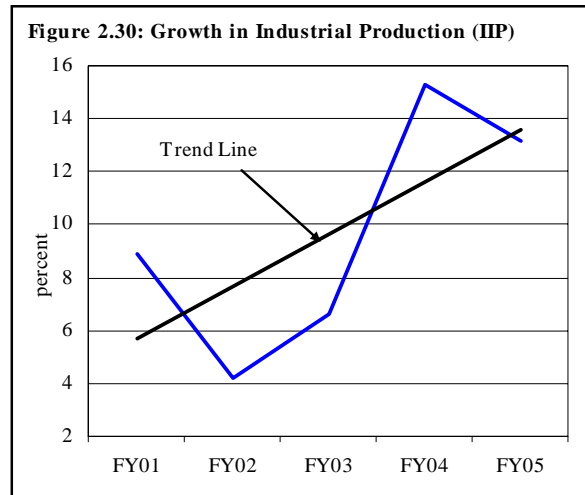
¹⁰ The change in the IIP is used to proxy the growth in the industrial sector, as the estimated growth published in the Economic Survey 2004-05 is based on data up to March 2005. The IIP is based on data that is available for the whole of the year. It covers an estimated 61.2 percent of total industrial sector in the economy, and comprises of three main components namely *LSM, Electricity Generation and Mining & Quarrying*.

measured in terms of the index of industrial production (IIP), witnessed a double-digit growth of 13.2 percent during FY05. While this is a little lower than the 15.3 percent growth recorded in the previous year, the overall growth trend remains intact, as evident from **Figure 2.30**. This deceleration in the growth rate emerged mainly from a corresponding slowdown in the *LSM* sub-sector¹¹ (that comprises 41 percent of the IIP), as well as in *mining & quarrying*.¹²

As with *LSM*, growth in *mining & quarrying*¹³ saw a modest dip, falling to 11.5 percent in FY05 as against the 12.8 percent growth witnessed during FY04. The deceleration

stemmed from weak growth in gas and a fall in coal production. Most other minerals registered strong production growth during FY05¹⁴ (see **Box 2.3.1** for details). In particular, crude oil production rose 6.1 percent in FY05, in contrast to the 3.6 percent decline noted in the previous fiscal year. Local crude oil production has increased in FY05 principally due to the 5 kbpd additional production from the Bobi and Chanda oil fields. Encouragingly, the slowdown in gas production noted earlier was caused by a one-off factor – the attacks on gas distribution pipelines in the Sui gas fields during FY05. In fact, the production from other major gas fields, e.g. Qadirpur and Uch etc. increased. Less welcomingly, the domestic production of coals continued to decline for the second successive year, falling to 6.1 percent in FY05. The decline in domestic coal production principally reflects the fall in demand from the local cement industry, which requires higher quality low-sulphur coal. Thus, even as domestic production has declined, imports have risen sharply. However, coal mining may see faster growth in coming years as several projects¹⁵ are underway for the exploration and production of higher quality coal.

The sub-sector *electricity generation* recorded a slowdown of almost 4.9 percent in FY05, as compared to the 6.8 percent growth in FY04. The main contribution came from the WAPDA which recorded growth of 7 percent on account of 24 percent growth in electricity generation by the thermal system during FY05. Unlike the thermal system, hydel recorded less growth of 17 percents due to closure of some of power units on account of water management constraints during the mid FY05.



¹¹ See section on *LSM* for details

¹² The composition of mining & quarrying differs for the definition used in the National Income Accounts (NIA) published in the Economic Survey. Therefore the growth computed in the IIP for the sub-sector will differ from that in the Section which is based on the NIA data.

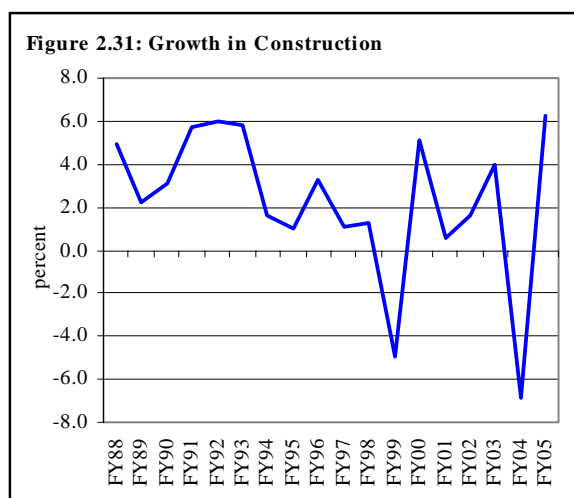
¹³ The major contribution to the growth in the sub-sector is from crude oil, gas and coal that account for more than 95 percent of this IIP sub-index. Interestingly, the growth trend recorded in the IIP is inconsistent with that reported in the Economic Survey 2004-05. While the former is recording in acceleration in growth, the latter indicates the deceleration. The disparity may be on account of value addition and quantum basis, as the national accounts data depicted growth in terms of value addition and the latter in terms of quantum only. Another reason could be the difference between the composition of national accounts data for mining & quarrying and IIPs construction with respect to the mentioned sub-sector. As it is observed that national accounts data does not include natural gas production sub-sector in the composition but it is included in the construction of mining and quarrying sub-sector of IIP.

¹⁴ see Table 2.10 & Box 2.3.1 for details

¹⁵ These projects include: Systematic Evaluation and Appraisal of Coal Resources of Four Specific Tracts in Thar Coal Field, Mithi, Sindh. Exploration and Evaluation of Coalfield of Loralai and Kohlu districts, Balochistan, Exploration of Hangu & Karak Coal Deposit, NWFP, Pakistan. Exploration for Coal in Kotli Area, Azad Kashmir

Construction

The 6.2 percent growth in this sector is the highest witnessed since FY88 (see **Figure 2.31**). This strong performance probably reflects the impact of the boom in the real estate market, rising private investment and higher development expenditures by the government. However, what is puzzling is the sharp downward revision in the FY04 figure from the provisional 7.9 percent YoY growth to a *negative* 6.9 percent, particularly when all indicators relating to construction sector (see **Table 2.12**) suggest that FY04 performance should have recorded a significant improvement over the preceding year.



At the very least, this very substantial variance in the provisional and revised FY04 estimates and inconsistency between the indicators such as cement dispatches, steel consumption etc and the value added estimates in the FY04 clearly points to the need for a possible improvement in the sectoral statistics as well as in the estimation methodology (see **Box 2.3.2**). It seems however unlikely that the FY05 estimates will also be sharply revised downward given the strength of the increase in key indicators such as cement dispatches (up 18.2 percent YoY), import of construction & mining machinery (up 42.3 percent YoY as against a decline the preceding two years), etc.¹⁶

Table 2.12: Construction -- Performance Indicators

| | Unit | FY03 | FY04 | FY05 |
|---|----------------|---------|---------|---------|
| Development expenditures | million rupees | 129,202 | 160,500 | 188,000 |
| Gross fixed investment | -do- | 6,606 | 7,919 | 12,289 |
| Import of construction & mining machinery | -do- | 5,918 | 5,845 | 8,318 |
| Private credit for construction | billion rupees | 15.80 | 18.26 | 31.36 |
| Production of steel (Pak Steel) | 000 tons | 1,001 | 1030 | 979 |
| Import of iron & steel | 000 tons | 1,444 | 1761 | 3693 |
| Cement dispatches excluding exports | 000 tons | 10,959 | 12,514 | 14,789 |

The strong recovery by the construction industry is a very welcome development indeed, both directly (as the construction sector has substantial potential for employment generation),¹⁷ as well as indirectly (through its impact on auxiliary industries). It is therefore of crucial importance that the sector be supported through policy measures. In particular, measures are required to increase access of land (in order to ease supply shortages), improve documentation of land holdings (clear titles will be crucial in allowing people to access credit, especially mortgage financing), and measures to reduce construction costs (enforcing the break-up of the cement cartel, reducing the cost of steel, etc).

Mining and Quarrying

The value addition by the *mining & quarrying* sector registered an expansion of 5.0 percent YoY during FY05 compared to a growth of 3.8 percent in the preceding year. The growth in this sector mainly stemmed from the production of chromites, gypsum, limestone, natural gas and crude oil. While the production of dolomite, coal and rock salt fell during FY05 (see **Table 2.13**).

¹⁶ The strong FY05 performance of the construction sector is also reflected through its forward and backward linkages in LSM industries such as cement, iron & steel, paints & varnishes, wood etc.

¹⁷ The employment elasticity with respect to GDP in the construction industry is 0.87. This estimate was presented in the "Poverty Reduction Strategy Paper 2003" www.finance.gov.pk/poverty/prsp_03.pdf

Surprisingly, the coal extraction fell by 6.1 percent as compared to a decline of 7.9 percent in FY04. Although the domestic demand for coal increased as most of the cement plants have started using coal as an energy source (instead of the furnace oil), the resulting demand-supply gap was filled in by better-quality imported coal.

Electricity and Gas Distribution

Growth in this sector decelerated sharply during FY05 to 2.1 percent YoY from a very robust 21.1 percent YoY during the preceding year (see **Figure 2.32**). In fact, this weak growth stemmed entirely from *electricity generation* which decelerated to 4.9 percent YoY during FY05 (against 6.8 percent in FY04). Furthermore, this performance was largely affected by *negative* contribution by the *gas distribution*.

During FY05, both gas utilities, i.e., Sui Southern Gas Company (SSGC) and Sui Northern Gas Pipelines Limited (SNGPL), expanded their network for commercial, domestic and industrial consumers by 10.8 percent YoY (see **Table 2.14**). Moreover, around 700,000 cars shifted to the use of compressed gas in FY05, up from 450,500 units in FY04. Furthermore, while growth in the domestic gas production decelerated from 21.2 percent YoY in FY04, it was still strong at 13.7 percent YoY in FY05.

Unfortunately, despite the increasing demand and rising production, *gas distribution* fell to 874.7 billion cubic feet (0.9 percent YoY) in FY05. This reflects the impact of the attacks on major pipelines that severely curtailed supplies to various regions of the country for considerable periods.

Large Scale Manufacturing (LSM)

Aided by strong domestic and external demand, growth in *large-scale manufacturing* remained well above the 12 percent annual target during FY05. This sector recorded a growth of 15.6 percent YoY in FY05 on the back of 18.2 percent YoY growth in FY04 (see **Figure 2.33**). The growth in last two years was the highest in the last two decades.

Table 2.13: Growth in Production of Selected Minerals

| Minerals | FY03 | FY04 | FY05 |
|-------------|--------|--------|-------|
| Coal | 2.76 | -7.87 | -6.1 |
| Natural gas | 7.45 | 21.17 | 13.7 |
| Crude oil | 1.13 | -3.55 | 6.1 |
| Chromites | 29.17 | -6.45 | 155.2 |
| Dolomite | 8.94 | -12.75 | -14.9 |
| Gypsum | 5.47 | 10.14 | 42.0 |
| Limestone | 9.80 | 10.69 | 11.5 |
| Rock salt | 0.21 | 15.01 | -2.0 |
| Sulphur | -14.07 | 23.04 | 6.7 |
| Baryte | 95.24 | 7.32 | 6.8 |

Source: Based on data from FBS

Figure 2.32: Growth in Electricity & Gas Distribution

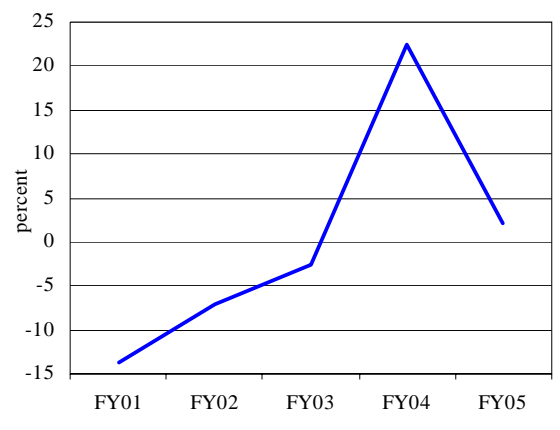


Table 2.14: Gas Distribution by Major Companies

| | FY03 | FY04 | FY05 |
|---|---------|---------|---------|
| Sui Northern Gas Pipelines Limited (Punjab & NWFP) | | | |
| Industrial Consumers | 2667 | 2881 | 3271 |
| Commercial Consumers | 37471 | 38842 | 41358 |
| Domestic Consumers | 2133554 | 2263875 | 2516795 |
| Sui Southern Gas Company Limited (Sindh & Baluchistan) | | | |
| Industrial Consumers | 2412 | 2638 | 2812 |
| Commercial Consumers | 17429 | 18152 | 19194 |
| Domestic Consumers | 1648874 | 1713153 | 1772256 |

Source : SSGCL & SNGPL

In fact, the deceleration in LSM production was not unexpected, due to the large base effect, as is evident from the relatively low target for FY05. The growth of textile sector at 24.7 percent YoY, in particular was very impressive due to its high labor intensity, share in exports and forward & backward linkages. Consumer durables industry, e.g., *automobile* and *electronics* also continued to post strong growth despite the rising interest rates, as did the fertilizer industry.

The relative weakness in the remaining sectors meant that the FY05 LSM growth is less broad-based than in the preceding year (see **Table 2.15 & Table 2.16**). This is because:

- While seven out of fifteen industrial sub-sectors of LSM registered a *deceleration* during FY05, there were only three such sub-sectors during FY04.
- In FY05, five of the fifteen LSM sub-groups observed *acceleration* in output as against eleven sub-groups of LSM during FY04.
- Three sub-sectors of LSM particularly food and beverages registered a *decline* in production in FY05 in contrast to only one group during the previous year.

Furthermore, in FY05 six sub-sectors had registered growth rates that were either negative or below 5 percent (see **Table 2.17 & 2.18**). In comparison, there were only three such sub-sectors in the previous year. Moreover, while 42.6 percent of LSM industries fell in the range of 10-20 percent growth in FY04, the share of high growth sub-sector was only 7.4 percent in the current year.

As mentioned earlier, the strongest contribution to LSM growth during FY05 came from the *textile* sector that witnessed a remarkable YoY growth of 24.7 percent compared to 6.5 percent rise in previous year. In fact, the FY05 growth rate is the highest since FY88 (see **Figure 2.34**). This extraordinary growth of textile sub-sector is mainly attributed to:

Record production of cotton: In FY05, the production of cotton crop recorded at 14.6 billion bales, which is not only 46.0 percent

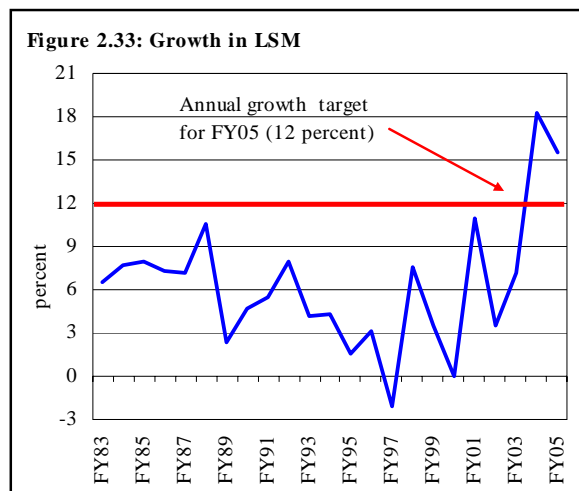


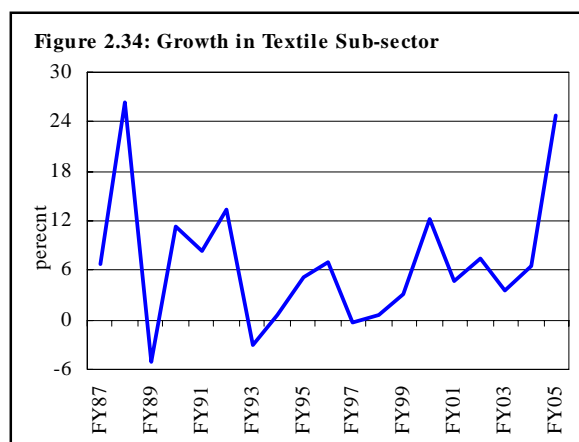
Table 2.15: Large-scale Manufacturing Growth Rates

| percent | FY03 | FY04 | FY05 |
|--|------|------|------|
| Overall | 6.8 | 18.2 | 15.6 |
| Excl. textile | 8.9 | 23.4 | 12.1 |
| Excl. automobile | 4.4 | 15.6 | 13.8 |
| Excl. electronics | 5.3 | 16.1 | 13.5 |
| Excluding fertilizer | 7.3 | 16.6 | 15.1 |
| Excluding textile, electronics, autos & fertilizer | 3.6 | 14.0 | 3.1 |

Source: Federal Bureau of Statistics.

Table 2.16: Distribution of sub-Sector Growth Rates

| number | FY04 | FY05 |
|---------------|------|------|
| Negative | 1 | 3 |
| 0-5% | 2 | 3 |
| 5-10% | 2 | 2 |
| 10-20% | 4 | 1 |
| 20% and above | 6 | 6 |



greater than in FY04, but is also the highest aggregate cotton production in Pakistan. This led to a surge in ginning as well as downstream textile industries.

Rise in foreign direct investment (FDI): During FY05, FDI in the textile sub-sector rose to US\$ 39.3 million (up YoY 11 percent) from US\$ 35.4 million during FY04.

Increase in investment: Manufacturers had greater access to bank credit for textile products; during FY05 the credit disbursement to the sector rose to Rs 88.2 billion (up YoY 12.5 percent). There was a rise of 24.2 percent in the credit disbursement under Textile Vision 2005. In fact, out of FY05 loans, 51.8 percent of the credit was given under the Textile Vision 2005 compared to 47.0 percent in FY04 (see **Table 2.19**).

Table 2.17: Growth in the Production of Selected LSM Industries in percent

| | Weights | Percentage change | |
|-----------------------|---------|-------------------|-------|
| | | FY04 | FY05 |
| Textile | 32.62 | 6.5 | 24.7 |
| Food & tobacco | 19.12 | 13.5 | -2.0 |
| Petroleum products | 6.97 | 4.4 | 9.4 |
| Pharmaceuticals | 6.70 | 14.0 | 4.0 |
| Chemicals | 6.39 | 24.5 | 3.4 |
| Non metallic minerals | 5.58 | 18.5 | 16.8 |
| Automobile | 5.27 | 50.7 | 32.6 |
| Metal industries | 4.67 | 2.4 | -5.0 |
| Fertilizers | 4.51 | 65.5 | 25.7 |
| Electronics | 3.31 | 58.1 | 44.8 |
| Leather products | 3.03 | 31.5 | -5.6 |
| Paper & board | 0.80 | 7.6 | 3.7 |
| Engineering items | 0.59 | 16.1 | 21.6 |
| Wood products | 0.04 | 87.8 | 238.7 |
| Tyres & tubes | 0.40 | 0.0 | 6.7 |

Note: The weights of the LSM industries are adjusted so as the sum of total weights become 100

Source: Based on data from FBS

Textile external demand: Post MFA the international trade in textile and clothing from January 2005 provided an opportunity to Pakistan textile manufacturers to expand their export network. In fact, export of textile manufactures that had grown by only 1.2 percent YoY during H1-FY05, surged strongly and rose 10.9 percent YoY during H2-FY05.

Table 2.18: Growth Performance of Selected Industrial Groups

| FY05 | | | FY04 | | |
|------------------------|-------------------------|------------------------|--------------------------|------------------------|-------------------|
| Acceleration in Growth | Deceleration in Growth | Decline in Growth | Acceleration in Growth | Deceleration in Growth | Decline in Growth |
| 1 Textile | 1 Pharmaceuticals | 1 Food, bev. & tobacco | 1 Textile | 1 Paper & board | 1 Tyres & tubes |
| 2 Petro- products | 2 Non metallic minerals | 2 Leather products | 2 Food, bev. & tobacco | 2 Metal industries | |
| 3 Tyres & tubes | 3 Chemicals | 3 Metal indust. | 3 Petro- products | 3 Engineering items | |
| 4 Wood Products | 4 Paper & board | | 4 Pharmaceuticals | | |
| 5 Engineering items | 5 Automobile | | 5 Chemicals | | |
| | 6 Fertilizers | | 6 Automobile | | |
| | 7 Electronics | | 7 Fertilizers | | |
| | | | 8 Electronics | | |
| | | | 9 Leather products | | |
| | | | 10 Non metallic minerals | | |
| | | | 11 Wood Products | | |

Supportive government policies: In FY04, the government announced various supporting measures for the textile sector which were probably reflected in the robust textile sector growth of FY05. One such measure was the reduction in the import duties on textile machinery, which contributed to the 50.8 percent jump in their imports and, in turn, spurred textile production.

Within the textile sector, the production of ginned cotton saw an extraordinary 45.3 percent growth (by 2,483 thousand tones, (see **Table 2.20**) as against a decline of 1.6 percent in FY04.

Similarly, the production of cotton yarn (with more than 50 percent weight in the textile sector), recorded 18.2 percent growth in FY05 in comparison with only 0.7 percent growth in the preceding year. This higher production was supported by rising export volumes (up 4.35 percent YoY) as well as higher domestic demand. The production of cotton cloth (accounting for about 30.8 percent of textile sector), contributed approximately one-third of the FY05 textile sector growth. The growth in cotton cloth production at robust 28.9 percent was substantially higher than the 17.4 percent rise witnessed during FY04 and was well supported by both, an 8.6 percent in export demand, as well as lower input costs.

Table 2.19: Textile Industry: Investment, and Expansion

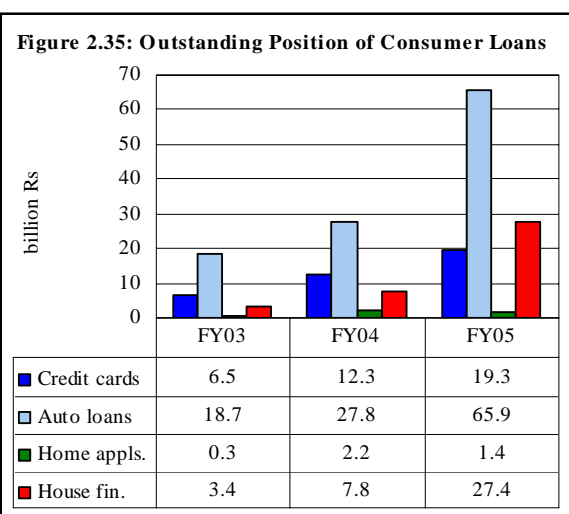
| | FY04 | FY05 |
|---|--------|--------|
| Investment | | |
| Credit under Textile Vision 2005 (billion Rs) | 36.8 | 45.7 |
| Imports of textile machinery (million US\$) | 598.0 | 901.7 |
| Expansion | | |
| No. of mills | 455 | 458 |
| Installed capacity (000 Nos) | | |
| Spindles | 9510.0 | 9957.3 |
| Rotors | 144.2 | 155.9 |
| Looms | 10.4 | 9.0 |
| Working capacity (000 Nos) | | |
| Spindles | 8192.0 | 8514.2 |
| Rotors | 65.1 | 78.4 |
| Looms | 4.4 | 4.5 |

Source: Economic Survey & Textile Commissioner Organization
Installed & working capacity data for FY04 are up to April 05.

Table 2.20: Textile Production

| Items | Units | Weights in LSM | FY | | Growth Rate |
|----------------------|----------|----------------|---------|---------|-------------|
| | | | FY04 | FY05 | |
| Cotton Yarn | Tones | 13.066 | 1929129 | 2280552 | 18.2 |
| Cotton Cloth | 000 Sq.m | 7.549 | 683392 | 880791 | 28.9 |
| Cotton (ginned) | 000Tones | 3.368 | 1709 | 2483 | 45.3 |
| Woolen & Carpet Yarn | Tones | 0.323 | 2371 | 2239 | -5.6 |
| Jute Goods(Total) | Tones | 0.174 | 103957 | 104788 | 0.8 |
| Knitting Wool | Tones | 0.012 | 3745 | 3131 | -16.4 |

In the case of *electronics, automobiles* sub-sectors, consumer financing remained a key determinant of the demand growth¹⁸ (see **Figure 2.35**). The electronics industries saw a YoY rise of 44.8 percent in production during FY05 compared to the 58.1 percent growth in the preceding year (see **Table 2.21**). Specifically, the production of consumer appliances grew by a robust 58.0 percent YoY, as compared to a 51.9 percent growth recorded in FY04.¹⁹ Indeed, the sustained strong demand for consumer electronics has led to a 33.9 percent YoY jump in FDI to these industries during the year.



In contrast, the production growth for industrial electronics was relatively moderate, with the production of electric transformers and electric

¹⁸ In fact, aggregate loans for auto purchases, home appliances and housing finance rose to Rs 94.7 billion (up substantial 37.7 percent YoY) in FY05 (see **Figure 2.34**). This is all the more impressive given that interest rates had been rising strongly during the latter half of the fiscal year.

¹⁹ This lower aggregate growth largely reflects a high-base effect due to the large increase in FY04 production. For example, in FY05 the production of ACs raised by 133,679 units, almost three times the increase of 52,377 units recorded in FY04. However, since the FY04 growth rates were computed on the low production of 12,000 units, the growth rate for FY04 appears higher (see **Table 2.21**).

meters decelerating to 7.5 and 27.8 percent YoY respectively during FY05 from 86.5 percent and 47.8 percent during FY04. This relative slowdown simply reflects the lower demand from the country's power utilities (WAPDA & KESC). Similarly, the production of electric motors and switch gear declined by 29.4 percent and 12.1 percent respectively during FY05 reflecting in part, shortage of imported components and competition from cheaper imports.

Table 2.21: Production of Electronics Consumer Durable Goods in numbers

| Items | FY03 | FY04 | FY05 |
|------------------|---------|---------|---------|
| Air conditioners | 12043 | 64420 | 198099 |
| Deep freezers | 86595 | 111059 | 178970 |
| Refrigerators | 375864 | 617439 | 784561 |
| TV sets | 764612 | 843079 | 908805 |
| Electric fans | 1258243 | 1361636 | 1445643 |

As with consumer electronics, the *automobile sector* also benefited from the rising credit disbursement in the economy. The persistent and robust demand in the economy has enticed new producers into the domestic market, and led established producers to embark on capacity expansions. As a result, the aggregate production of automobiles rose by 32.6 percent in FY05, even over the 50.7 percent YoY growth seen in FY04 (see **Table 2.22**).

Table 2.22: Production & Sales of Selected Automobiles production & sales in thousand numbers

| Items | Production | | Sales | |
|-------------------------|------------|-------|-------|-------|
| | FY04 | FY05 | FY04 | FY05 |
| Cars (1300cc and above) | 38.4 | 53.6 | 38.0 | 53.5 |
| Cars (800cc and 1000cc) | 60.1 | 72.8 | 58.7 | 73.8 |
| LCVs | 8.9 | 25.3 | 8.9 | 25.1 |
| Jeeps | 6.0 | 8.9 | 6.0 | 8.8 |
| Trucks | 2.0 | 3.3 | 1.9 | 3.4 |
| Buses | 1.4 | 1.8 | 1.4 | 1.6 |
| Tractors | 35.8 | 43.2 | 35.9 | 43.6 |
| Motorcycles/rickshaw | 302.2 | 416.2 | 297.1 | 417.1 |

Sources: Pakistan Automotive Manufacturers Association

Although, the increase in production capacity for cars has narrowed the delivery lags relative to past years, they remained significant for many popular models, leading to substantial premium for immediate delivery.²⁰ In order to reduce the consequent speculative demand for vehicles, many car producers have stopped accepting bookings directly from individuals; instead they prefer to make deliveries through financing companies or catering directly to the corporate. Furthermore, the government has started gradual easing of tariff barriers on automobiles imports during FY05, which probably led to a 48.9 percent rise in road motor vehicle imports during the year. The automobile imports have been further liberalized in the FY06 budget.

The rise in the output of *light commercial vehicles (LCVs)* registered an exceptionally strong growth, while the growth in the production of buses saw a more modest acceleration in FY05. The rise in the production of LCV and buses stems from a number of developments, including (1) start of production of LCVs by two Chinese trademarks, and expansion in capacity by other producers; (2) availability of bank credit, particularly for small and medium scale enterprises; and (3) higher demand for buses and coaches probably due to introduction & restoration of intra-city bus routes, rising sales of buses under the Urban Transport Scheme in Punjab and Sindh, and substitution away from railway transportation (in the wake of rising fares for longer destination).

The production of trucks also showed an extraordinary growth of 58.5 percent in current year compared to a modest growth of 3.7 percent FY04. While the suspension of manufacturing of Japanese brand truck by a local facility explains low growth during FY04,²¹ the exceptional growth in

²⁰ Anecdotal evidence indicates that the "own" or annualized premium charged for immediate delivery has reached as high as 17 percent for some popular models.

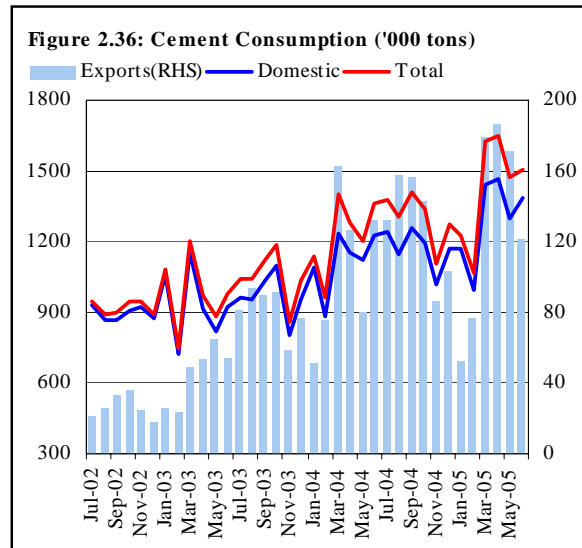
²¹ Sindh Engineering (Pvt) Limited switched over to new product line for assembly/manufacturing of Dong Feng vehicles from Mazda vehicles.

FY05 is largely due to the low-base effect and the introduction of a new Chinese brand during the year.

The production of *motorcycles & auto rickshaw* again posted an exceptional growth of 45.5 percent in FY05 even on the top of 85.4 percent YoY growth seen in FY04. The strong demand for motorcycles reflects not only the impact of the fall in prices (due to competition from low-priced Chinese motorcycles) but also the higher demand owing to rising rural incomes and the availability of consumer credit. Moreover, the rise in higher fuel prices is encouraging people to prefer motorcycles over cars.

The sustained strong growth in automobile industry has led to higher demand of *tyres & tubes* products, which was met by domestic as well as external supplies. In FY05 *tyres & tube* industries registered a growth of 6.7 during FY05 as compared with stagnation in output during FY04. Imports of *tyres & tubes* on the other hand, registered a YoY increase of 33.7 percent in FY05. Due to rise in the cost of inputs, within the *tyres & tubes sub-sector*, only motor tubes registered a production decline of 2.6 percent in FY05.

The rapid growth in housing and construction sector was the main growth driver for allied industries such as cement, iron & steel, paint & varnish, glass sheet, wood etc. The production of cement in particular recorded a 16.9 percent increase during FY05, which was marginally less than the 18.6 percent growth during FY04 and was sustained by increased domestic and external demand (see **Figure 2.36**).



The local cement dispatches placed at 14.8 million tons during FY05, showing a growth of 18.2 percent over 14.2 percent growth of FY04. Similarly, exports, mainly to Afghanistan and Iraq, during current fiscal year stood at 1.6 million tons, representing growth of 40 percent over the earlier year. In order to dampen the impact of the abnormally high demand on cement prices, the government has recently allowed the private sector to import unlimited quantities of cement from any source without any customs duty and withholding tax.

On the back of strong growth in *construction* and *automobiles* sector, the associated domestic demand for iron & steel also rose sharply. However, the rising demand was mainly met through a 109.7 percent rise in imports, as domestic production declined during FY05. The fall in domestic production reflects the continued slowdown in ship-breaking industry as well as the impact of technical problems in the production line of Pakistan Steel²². The strong domestic demand together with rising prices of steel in the international market led to significant pressure on prices in the local market. Therefore, the government sought to support the construction industry through various fiscal measures (see **Box 2.3.3**).

²² The decline in the production of Pakistan Steel was due to problems with the functioning of one of the blast furnaces and technical fault in coke-oven batteries. Consequently, the daily average production of pig iron dropped to 700 tons per day against an average of 3,500 tons per day, due to breakdown of coke oven batteries. This in turn led to around 31 percent increase in the prices of pig iron to Rs 34,000 per ton during FY05.

Box: 2.3.3: Supportive Measures for Construction Sector

| FY05 | FY06 |
|---|--|
| <ul style="list-style-type: none"> • 25 percent reduction in the CED on cement, and withdrawal of the CED on electrical wires and cables to provide boost to construction industry in the country. • Excise duty on paints has also been abolished, and import duties on number of materials, including steel & its products, and construction machinery have been reduced. • Sales tax and withholding tax on construction machinery was abolished. • Custom duty on the import of re-rollable steel scrap reduced from 25 percent to 10 percent, • Levy of 3 percent withholding tax on import of ships for scrapping and 6 percent withholding tax on the import of other raw materials and intermediary products was eliminated, and • Withholding tax was exempted on import of raw materials by Pakistan Steel Mills. | <ul style="list-style-type: none"> • Reduction in duty on scrap from 5 percent to zero for ship-breaking • House Building Finance Corporation (HBFC) to extend house building loans to people of rural areas for construction, extension and renovation of houses. • Permission to import of unlimited quantities of cement without any customs duty and withholding tax through the private sector. • Decision to allow import of clinker cement used for commercial purposes. • Decision to revitalize the dormant Public Private Infrastructure Fund (PPIF) and to create a new Khushhal Pakistan Fund (KPF) aimed at improving the infrastructure and social indicators. • Reduction on customs duty for construction/industrial vehicles from 25 percent to 10 percent. • Four raw materials and two components used for manufacture of composite doors and windows allowed at a concessionary rate of 5 percent and 15 percent, respectively as against the previous rate of 10 percent to 25 percent. • Exemption of customs duty on wood and reduction in customs duty on wood products from 25 percent to 20 percent and 10 percent to 5 percent. |

The *glass sheet* industry also witnessed a growth of 5.3 percent in FY05 compared to 13.3 percent fall in production during FY04. In contrast, the *paint & varnish* industry recorded a growth of 59.2 percent in the current fiscal year, which appears to mirror the strong growth in the construction as well as the automobiles sector. Finally, the exceptional high growth by the *wood* industry also reflects the growth in construction, the increased coverage of units in the industry and strong external demand – export of wood products rose by 19.0 percent in FY05. The direct and indirect linkages between the construction and automobile sector and a large number of manufacturing industries seem to be quite evident from the above analysis.

The *fertilizer* sector, which recorded the highest production growth among the *large scale manufacturing* industries in FY04, also performed well during FY05. While the growth decelerated to 25.7 percent during FY05, this was partly due to a high-base effect (following that 65.5 percent growth in the preceding year), and partly reflects capacity constraints (which forced a 9.7 percent jump in imports during FY05). The FY05 production growth, spurred by rising demand,²³ was mainly attributed to (1) an increase in the capacity of existing units, and (2) resumption of full commercial production of DAP by a local unit.

Similarly, the commencement of commercial production by a local refinery and increase in thermal power generation were the main factors for accelerating the domestic production of *petroleum* products, which witnessed an increase of 9.4 percent during FY05 as compared with the 4.4 percent growth in FY04 (see **Table 2.23**). Within the petroleum sector, most of the products recorded growth during FY05, except for kerosene oil, LPG and LSD. The availability of heavy stock of diesel oil probably led to a fall in the production of LSD. Moreover, the increased use of CNG as fuel in automobiles is leading to lower demand for the LPG cylinders. This fall in LPG demand is not even

²³ See **Section 2.2.3** for details on fertilizer demand.

compensated by substitution from costly kerosene oil to (cheaper and more convenient) gas cylinders in domestic usage.

Chemicals sub-sector's output showed a modest growth of 3.4 percent in FY05, compared to a remarkable rise of 24.5 percent during the previous year. The growth deceleration owed significantly to a very large drop in the production of matches,²⁴ which overshadowed an exceptional rise in the production of caustic soda and varnish & paints.

The production of *pharmaceuticals* production rose by 4.0 percent in FY05 as compared to a 14.0 percent growth recorded in FY04. This slowdown is probably due to increased market substitution of costly products of multinational companies by cheaper (generic) products of local companies, which are not included in the *LSM* survey.

Table 2.23: Production of Petroleum Products

| million liters | | | |
|----------------|------|------|------|
| | FY03 | FY04 | FY05 |
| July | 896 | 966 | 1088 |
| August | 922 | 879 | 1081 |
| September | 918 | 917 | 1069 |
| October | 747 | 910 | 1096 |
| November | 937 | 894 | 969 |
| December | 946 | 950 | 1039 |
| January | 988 | 1037 | 1093 |
| February | 911 | 947 | 958 |
| March | 947 | 943 | 1046 |
| April | 840 | 1009 | 994 |
| May | 879 | 1073 | 1073 |
| June | 893 | 908 | 1006 |

The *food, beverages & tobacco* sector, which has a 19.1 percent share in the *large scale manufacturing* industries, witnessed a 2.0 percent fall in production during FY05 as against a rise of 13.5 percent in the preceding year. This decline was mainly due to the fall in the production of sugar & beverages industries, and a lower growth recorded by the *vegetable & cooking oil* sub-sector, which together account for about 69.6 percent weight in food & beverage group.

The decline in sugar production simply reflects the weak sugarcane harvest during FY05.²⁵ In order to counter the impact of this on domestic prices, government eliminated the import duty on sugar. This led to imports of 241.5 thousand metric tones of sugar during FY05, in sharp contrast to net exports of 4.1 thousand metric tones in FY04.

Beverages industry showed a marginal YoY decline of 0.2 percent in FY05 compared to 9.2 percent growth in the previous year, probably due to rising competition from products such as lemon & soda water (informal sector products) and from units not included in the FBS survey. Recently the FBS has also expanded the coverage of this sector by including non-aerated syrups etc in this category.

The competition from the informal sector continues to impact the performance of the *vegetable & cooking oil* industry as well where the production growth by the formal sector has been decelerating since last five year. Similarly, the growth slowdown in *tea* industry is probably due to increasing usage of loose tea or unbranded tea. The deceleration in the cigarettes industry, however, mainly reflects a 6.4 percent fall in exports.

The leather products industry registered a fall of 5.6 percent in FY05 as against a remarkable 31.5 percent rise in the previous year. This decline is largely due to shortage of raw hides, whose export has recorded a rise of 13.5 percent in FY05. The output of footwear witnessed a sharp reversal from 6.4 percent rise in FY04 to a decline of 10.9 percent in the current year. Availability of imported shoes at cheaper rates as compared to locally manufactured shoes was the foremost causes of this

²⁴ The fall in the production of matches was due to both a fall in demand as well as rising costs. The former included the imposition of anti-dumping duty on matches by Egypt, and substitution with lighters, while the latter was driven by rise in the price of inputs such as poplar wood (as its exports rose).

²⁵ Market source have also claimed that some sugarcane has also been diverted to the production of '*gur*' (which is in the informal market and therefore undocumented), particularly to cater to the demand originating from Afghanistan.

decline. Recently, government has imposed a 20 percent duty on export of raw hides and skins to encourage value addition in the leather sector.

2.3.2 Public sector enterprises

The production of public sector industries witnessed a sharp recovery from a YoY fall of 9.6 percent in FY04 to a modest rise of 2.6 percent in FY05. This major contribution came from two sub-sector industries of National Fertilizer Corporation (NFC) and Sindh Engineering Corporation (SEC) which reflected 12.4 percent and 62.5 percent rise during FY05 relative to a decline of 57.7 percent and growth of 13.1 percent during FY04, respectively (see **Table 2.24**).

Table 2.24: Performance of Public Sector Industries

billion Rupees

| Corporation | Production value ¹ | | Net sales | | Pre tax profit/loss | | Employment ² | |
|--|-------------------------------|-------------|-------------|-------------|---------------------|-------------|-------------------------|--------------|
| | FY04 | FY05 | FY04 | FY05 | FY04 | FY05 | FY04 | FY05 |
| National Fertilizer Corporation(NFC) | 1.0 | 1.2 | 3.8 | 4.5 | 0.2 | 0.6 | 1961 | 2010 |
| Pakistan Automobile Corporation (PACO) | 0.3 | 0.1 | 0.3 | 0.2 | -0.1 | -0.1 | 419 | 381 |
| State Cement Corporation (SCC) | 0.4 | 0.4 | 1.1 | 1.4 | 0.0 | 0.2 | 782 | 823 |
| State Engineering Corporation (SEC) | 1.3 | 2.2 | 2.4 | 3.6 | 0.2 | 0.1 | 3828 | 4785 |
| Sub Total | 3.1 | 3.9 | 7.5 | 9.7 | 0.3 | 0.9 | 6990 | 7999 |
| Pakistan Steel (PS) | 8.0 | 7.5 | 24.8 | 30.5 | 7.1 | 9.2 | 16113 | 16525 |
| Grand Total | 11.1 | 11.4 | 32.3 | 40.2 | 7.4 | 10.1 | 23103 | 24524 |

Source: Expert Advisory Cell, Ministry of Industries and Product.

1: At constant prices of 1987-88

2: In numbers

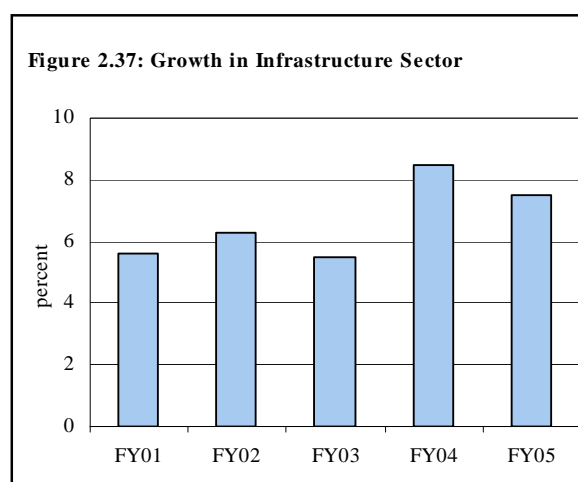
The higher production by NFC came from one of the subsidiary 'PAK American Fertilizer Limited' that recorded the production growth of 16 percent during FY05.

Similarly, the remarkable growth in SEC was backed by the contribution from Heavy Electrical Complex (HEC) and PAK Engineering Co. Ltd, which recorded exceptional production growth during FY05. The other unit of public sector industries, 'State Cement Corporation' (SCC) showed more moderate results.

In terms of profitability, Pakistan Steel (PS) was the major contributor with the dominant share of 91.1 percent in FY05 with a robust rise of 29.6 percent in its pre-tax profit. The other notable development is exceptional growth in profit of NFC and SCC during FY05. PACO was the only loss making public entity during FY04 and FY05.

2.3.3 Infrastructure Industries²⁶

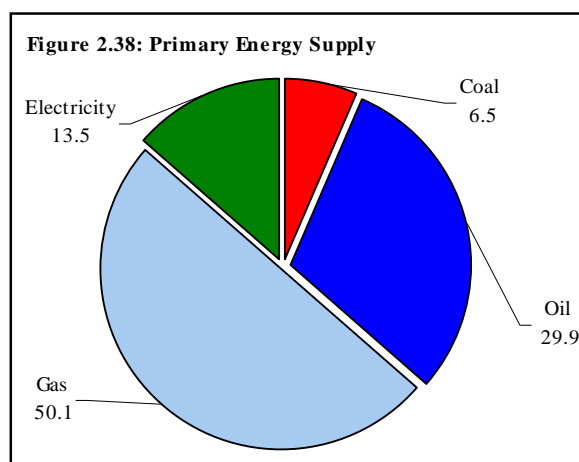
Infrastructure Industries Index, a composite of seven industrial sub-sectors (with a 26.2 percent share in IIP) rose by 7.5 percent YoY during FY05 compared to 8.5 percent in FY04 (see **Figure 2.37**). The infrastructure index reflects the position of existing primary energy production mix and the construction



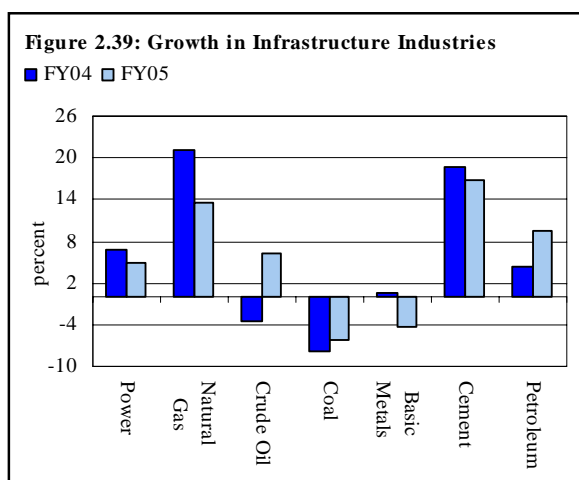
²⁶ The infrastructure industries comprise of power, coal, gas, metal, cement, crude oil and petroleum industries. These industries are almost 26 percent of total industrial sector in Pakistan.

sector in the economy. The primary energy supply mix comprises over the electricity generation, coal, oil and the gas sub-sectors (see **Figure 2.38**). Similarly, the sub-sectors of cement and basic metals can be considered as the representative of the construction sector in the economy.

The relative slowdown in growth of infrastructure industries was largely due to deceleration in the production of power & natural gas and cement sub-sectors during FY05 (see **Figure 2.39**). In the case of power production, growing consumption demand from industrial, transport and power sectors was more than offset by falling consumption by the households and agriculture sector. The lower consumption of petroleum products by households and agriculture reflects increased use of alternative and cheaper sources of energy like natural gas and LPG.



The output of crude oil on the other hand recorded a growth of 6.1 percent in FY05 relative to a decline of 3.6 percent during FY04. This mainly reflects the increased production of two companies, namely OGDCL and Orient Petroleum Inc. (OPI). The average oil production of OGDCL during Jul-Mar 2004-05 rose by 47 percent YoY basis to reach 30,939 barrels per day. The OGDCL added 34 more exploratory wells during Jul-Mar 2005.



2.3.4 Analysis of Industries by End-Use

The user based quantum index (UBQI) covers almost 61 percent of the industrial sector, with four sub-indices, namely consumer

goods (durable and non durables), intermediate goods, basic goods and the capital goods. The deceleration in growth in LSM and the IIP during FY05 is clearly reflected in the UBQI as well, with a slowdown in the production of consumer goods and basic goods offsetting the higher growth in the production of intermediate goods (see **Table 2.25**).

The major driver for the relative low growth in the production of basic goods industries was the slowdown in electricity generation (reflecting water management constraints). However, other components of basic goods such as *chemicals* and *mining & quarrying* showed encouraging growth during FY05. The higher production growth of industrial chemicals reflects the increased demand from fertilizers, paints, plastic and paper

Table 2.25: Growth of Industrial Production by End Use
percent

| Sector | Weights | FY03 | FY04 | FY05 |
|--------------------|---------|------|------|------|
| Basic goods | 26.5 | 4.9 | 5.3 | 5.1 |
| Consumer goods | 31.6 | 9.2 | 24.4 | 14.7 |
| Non-durables | 27.4 | 2.7 | 17.4 | 6.8 |
| Durables | 4.2 | 46.1 | 52.8 | 39.0 |
| Intermediate goods | 39.7 | 4.9 | 12.0 | 15.6 |
| Capital goods | 2.1 | 19.7 | 43.7 | 28.9 |

Source: Based on data from FBS

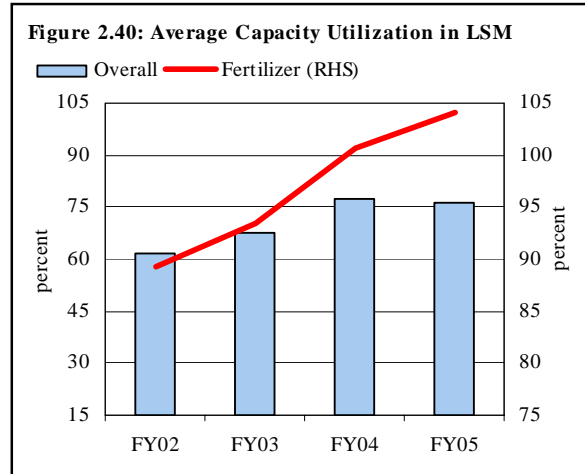
Note: The weights of industries are adjusted so as the sum of total weights become 100

industries, where these are used as raw material. The strong growth of marble and gypsum industries mirrored the healthy performance of cement industry and the construction sector.

In the group of consumer goods, *durable goods* did exceedingly well while among the *non-durables textiles, wheat & grain milling* were the better performers. The main contributors to consumer durables growth were the electronics, automobiles and rubber industries.

Intermediate goods growth witnessed a high growth than the previous year stemming largely from cotton yarn, cotton ginned, fertilizer and the petroleum sub-sectors.

While the four-year acceleration in the production of capital goods finally peaked, it was still a quite robust 28.9 percent during FY05 mainly due to growth acceleration in trucks, buses and LCVs.

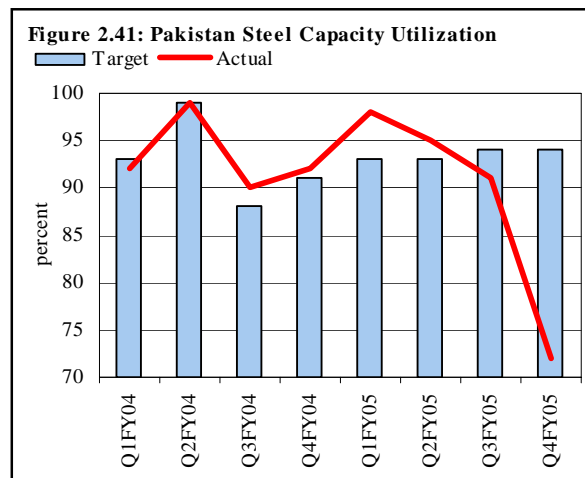


2.3.5 Capacity Utilization in Large Scale Manufacturing Industries

The continuing strength of the domestic economy was broadly reflected in the trends in capacity utilization for large scale manufacturing industries (see **Figure 2.40**). Although, the average capacity utilization²⁷ during FY05 fell marginally by 0.8 percentage points, compared to an increase of 9.4 percentage points in FY04, this drop is mainly attributed to enhanced capacity, contributed equally by domestic (private) as well as foreign direct investment. The change in capacity utilization in key industries is discussed below.

The cement industry continued to enhance the capacity utilization owing to growing domestic and external demand (see **Table 2.26**). The major contribution to the increased capacity utilization came from Lucky Cement, which increased its capacity utilization to 107.6 percent in FY05 compared to 85 percent in the previous year.

Fertilizers industries continued to operate at level more than their capacity (see **Figure 2.40**) despite a modest increase of 2 percent during FY05 in their operating capacity.²⁸ This reflects higher demand for fertilizer,²⁹ particularly owing to improved water availability, and underlines the need to enhance the installed capacity of the fertilizers industry.



²⁷ It represents the average of vegetable ghee & cooking oil, cement, automobiles, petroleum refining, industrial chemicals, fertilizer, paper & paper board and electronics sub-sector.

²⁸ The operating capacity rose from 5,636,900 metric tones in FY04 to 5,753,000 metric tones during FY05.

²⁹ The higher demand is reflected in production growth of 3.5 percent and 44.7 percent of nitrogenous and phosphatic fertilizers respectively during FY05.

The capacity utilization in the automobile industry declined marginally to 65 percent during FY05 from 67 percent in FY04 (see **Table 2.26**), mainly due to expansion in operational capacity in sub-sectors of buses and trucks, cars & jeeps and LCVs. The increase in capacity utilization of cars & jeeps from 75 percent in FY04 to 84 percent in FY05 is particularly important as it was achieved despite enhanced production capacity.³⁰

Table 2.26: Capacity Utilization in Selected Industries

| Industry | Units | Production | | Capacity Utilization | |
|------------------------------|---------------|------------|---------|----------------------|------|
| | | FY04 | FY05 | FY04 | FY05 |
| Vegetable ghee & cooking oil | million tones | 1.08 | 1.14 | 40 | 42 |
| Cement | 000 tones | 12862 | 15038 | 76 | 84 |
| Automobile | | | | 67 | 65 |
| Cars & jeeps | numbers | 100070 | 128381 | 75 | 84 |
| LCVs | numbers | 14089 | 23613 | 50 | 79 |
| Trucks & Buses | numbers | 3402 | 4966 | 24 | 18 |
| Petroleum refining | million tones | 10 | 11 | 89 | 85 |
| Industrial chemicals | | | | 89 | 99 |
| Caustic soda | tones | 187541 | 206690 | 129 | 143 |
| Soda ash | tones | 286287 | 297335 | 108 | 112 |
| Sulphuric acid | tones | 64663 | 92358 | 29 | 42 |
| Fertilizer | metric tones | 5672778 | 5989076 | 101 | 104 |
| Paper & paper board | tones | 404696 | 419823 | 97 | 101 |
| Electronics | | | | 60 | 31 |
| Airconditioners | numbers | 64420 | 198099 | 32 | 29 |
| Deep Freezer | numbers | 111059 | 178970 | 44 | 26 |
| Refrigerators | numbers | 617439 | 784561 | 103 | 39 |

Source: EAC- Ministry of Industries & Production

The sub-sector of electronics responded well to the increasing demand created through the availability of consumer financing, thus resulting into rapid increase in the production of deep freezers, air conditioners and refrigerators. In the same way, a substantial increase in the operating capacity of the electronics sector was observed in FY05, which contracted with the decline of 28.5 percentage points in capacity utilization.

Q4-FY05 the capacity utilization of the Pakistan Steel Mills production was registered at 76 percent remained at 89 percent that is five percentage points less than the annual target of 94 percent mainly due to technical fault that disturbed production in some quarter of FY05 (see **Figure 2.41**). In preceding year, the mill achieved its target of 93 percent for the capacity utilization of its production.

³⁰ The operating capacity of cars & jeeps increased from 134,000 units in FY04 to 153,000 during FY05

Box 2.3.1: Minerals¹

Pakistan has some 5,000 operational mines employing nearly 300,000 workers. It also has the world's 5th largest reserves of coal in Thar (184 billion tons), but only 4.5-5.0 million tons is mined annually, mostly for use in brick kilns. Similarly, very large reserves (over 837 million tons) of copper ores bearing gold, silver, and molybdenum have been identified in the Chaghi Volcanic Belt (Tethyan Magmatic Arc) which extends from Pakistan through Iran into Turkey. Other major metallic mineral reserves include 74 MMT (Million Metric Tones) of aluminum (bauxite, laterite), lead-zinc (46 MMT), and iron ores (600 MMT). Large reserves of non-metallic minerals are gypsum (300 MMT), Clays (134 MMT), barite (30 MMT), and phosphates (22 MMT) as well as raw material used in cement production. Pakistan also has reasonable reserves of other metallic minerals such as uranium, zirconium, titanium, chromium, and vanadium. Of the 92 known minerals in the country, 58 are commercially exploited, with an annual production of 14 million metric tonnes (MMT). Major minerals / raw materials imported are iron ores, coking coal, and phosphate rocks.

Further, it is speculated that if discoveries at Reko Diq keep emerging at the present rate, Pakistan may well be home to an ore body equivalent to Chile's fabulous Escondida deposit and emerge amongst the top five copper projects in the world. Demand for electrical/electrolytic grade copper is booming, and Pakistan can be the source of metal for the growing economies of Asia through the 21st century.

Copper and Gold

The copper deposits in Pakistan at Reko Diq and Saindak are likely to transform the face of mining industry in Pakistan. The Saindak project started commercial production (August 2005) and in the first two months produced 1,000 tons of blister copper.

Pakistan entered as an exporter in the metal market for the first time (2005) in its history with the export of 1,000 tons of blister copper, produced from the Saindak Copper-Gold Project in Balochistan. The Saindak production would export around 16,000 tons of blister copper within a year and the Balochistan government would get two per cent royalty from the total production to be valued at London Metals Exchange (LME). As such, the total export earnings out of Saindak copper would be around \$45 million per annum. In Tethyan Cooper Company's case, by the time the first production of copper is ready for export, it would have taken over 15 years from its inception to reach that stage.

One of its main industrial usages is for the production of cable, wire and electrical products for both the electrical and building industries. Demand for copper is high and world inventories are significantly diminishing.

Marble and Granite

After limestone and coal, the group of marble, granite and onyx is the most heavily mined mineral in Pakistan, with reserves of the order of 158 MMT (156 MMT lies in NWFP and 2 MMT in Balochistan), with the best mines being in FATA area. Italy is the world leader in marble, granite, and stone sector, exporting over 38% of finished material and importing 18% of the world trade. FATA has most of the high quality mines, even then nearly half the mines are closed because of antiquated mining techniques in Pakistan prevent extraction of standard blocks or large blocks, while poor infrastructure in the mining area impedes transporting of heavier blocks which carry maximum premiums. Standard quarry wastage in Pakistan is 61 – 73% compared with the world average of 50 percent of the gross produce. The marble units are unable to produce high quality products because of substandard raw materials and low skill levels of the workers.

Gypsum

Pakistan is blessed with large and high quality deposits of gypsum (5 to 6 billion tons), spread over all the provinces, with annual production of 0.5 m tons. It is planned to affect major increase in gypsum production from the present 0.5 MMT to 2.0 MMT by 2010 and 10 MMT by 2015. It is further proposed to facilitate and encourage its use in the building industry as low cost gypsum blocks for economical housing.

Pakistan also possesses sizable deposits of low grade iron ore (600 MMT) and leadzinc ores (60 MMT), besides being a major supplier of chromium and vanadium bearing ores.

In view of the growth potential of the mining industry in Pakistan, as well as the potential to become an important source of exports, the MTDf incorporates a number of proposals for the development of the sector that include:

¹ Discussion is extracted from the 'Medium Term Development Framework 2005-10' and details are available at: [http://www.pakistan.gov.pk/divisions/planninganddevelopment-division/Data/MOPD/Five%20Year%20 Plans.htm](http://www.pakistan.gov.pk/divisions/planninganddevelopment-division/Data/MOPD/Five%20Year%20Plans.htm)

- To conduct surveys in some key areas of Pakistan including geophysical and geochemical analysis.
- To enhance the capacity of the provincial directorates as well as in AJK, Northern Areas to carry out exploration, surveying and mapping as well as geochemical analysis.
- To augment provincial exploration activities through the conduct of geological surveys.
- To prepare bankable feasibilities for vendor industries such as copper wires and cables, wiring harnesses, cathodes, copper clad boards for use in electronics.
- To focus on export of finished goods based on copper and its alloys, rather than bulk ore or blister copper.
- To help in improving the value addition by local industry on gold recovered from future mining concessions in the copper belt.
- To facilitate joint ventures for mini steel mills 50-100 thousand tons capacity based on ores at Dilband, Nokkundi and Kalabagh.
- To facilitate Ferro-chrome industries so that these can add value to local chromites ores (which are all currently exported and then imported as higher value chromium compounds).

Box 2.3.2: Gaps, Weaknesses, Infrequencies and Lags in Pakistan's Statistical System

Pakistan's main sources of key economic statistics—national accounts, production of agriculture and industry, foreign trade, prices, poverty incidence, unemployment- are dependent on the Federal Bureau of Statistics (FBS). Despite several attempts to improve the statistical system suffers from a number of gaps, weaknesses, infrequencies and lags in the compilation and dissemination of data. The most controversial topics on which the public debate is more acrimonious—poverty and unemployment— are marred by the non-availability of the requisite data for over several years. The last poverty and unemployment data available is for the year 2001-02—the period of lowest growth, acute drought and other negative economic and political shocks to the economy. The data available for the period 2002-05 during which the economy recorded average annual growth of 6 percent is not yet available. Hence, the critics have a field day by citing the outdated but last officially published data pertaining to 2001-02 in support of their contention that the lot of common man has not improved despite of the high growth rates achieved by the economy. Annual publication of the data on poverty and unemployment will help in conduct of a well-informed debate on this topic.

Inflation data also suffers from some methodological problems whereby the core inflation number is difficult to extract. Some of the oil products prices are still included in the non-food non-oil index. The House Rent Index is erroneously compiled, because in actual fact it is the House Construction Price Index.

National accounts also suffer from several weaknesses. Small & medium manufacturing is estimated by applying a constant annual assumed growth rate derived from the last survey carried out five years ago. While large-scale manufacturing is growing so rapidly and has spill over effects to SMEs the value added in SME is static and does not capture this buoyancy.

Value added in construction estimates of national accounts is inconsistent with the movement of key performance indicators of the sector such as cement dispatches, steel consumption etc.

These weaknesses along with the status of the FBS, therefore, give rise to some questions about the confidence to be reposed in the data series. Efforts should be made to convert FBS into an autonomous Statistical Authority and upgrade the skills and quality of technical competence of the staff of the Authority.

2.4 Services

The services sector kept pace with the higher growth observed in the commodity-producing sectors. The growth rate of 7.9 percent during FY05 is significantly above the 6.2 percent target as well as the 6.0 percent actual growth realized in FY04 (see **Figure 2.43**). The major contribution came from *finance & insurance, wholesale & retail trade, and transport, storage & communication* sub-sectors (see **Table 2.27** & **Figure 2.44**).

The growth in *Finance & insurance* was mainly driven by a sharp increase in SBP’s profits during FY05 as well as higher volume and efficiency gains realized by the bank and non-bank financial institutions. This was well supported by insurance businesses. Similarly, the *wholesale & retail trade* sub-sector reflects the strong performance of industry, agriculture and foreign trade sectors of the economy. The value addition by road transport and communication also shows the linkage with the production and foreign sectors. For example, there is a significant improvement of 18.2 percent in the earnings of Pakistan Railway during FY05 as compared to a mere 2.3 percent in FY04. Similarly, cargo handling activities recorded 13.2 percent growth in FY05 on account of increased volume of exports and imports. Cellular penetration reached up to 5.59 percent in FY05 compared with 3.31 percent, registering 68.8 percent growth during FY05 (see **Table 2.28**).

Although, the share of the services sector in overall GDP declined marginally during FY05, it was still strong at 52.4 percent. Moreover, during FY05 this sector absorbed 37.6 percent of the employed labor force. Another significant development is the consistently rising share of foreign direct investment (FDI) in the services compared to the commodity producing sector.

2.4.1 Finance and Insurance

The finance & insurance sub sector witnessed a remarkable growth of 21.8 percent – the highest level recorded since FY73 – thereby sharply raising its contribution in the growth of the services sector to 19.4 percent during FY05 from 4.7 percent in FY04. This remarkable performance

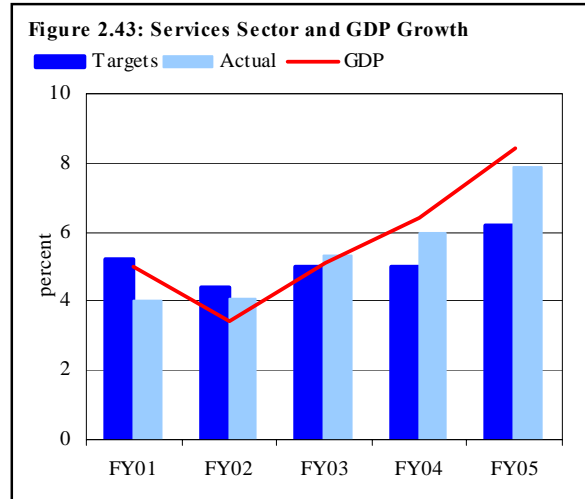
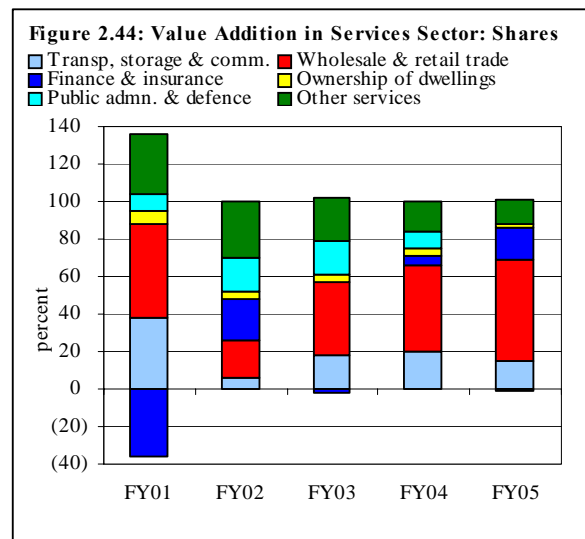


Table 2.27: Sectoral Growth and Investment in Services Sector

| percent | Growth | | GFCF Growth | |
|---------------------------|-------------------|-------------------|-------------------|-------------------|
| | FY04 ^R | FY05 ^P | FY04 ^R | FY05 ^P |
| Services Sector | 6.0 | 7.9 | 12.0 | 0.3 |
| Transport, storage & com. | 5.5 | 5.6 | 28.8 | 5.0 |
| Wholesale & retail trade | 8.1 | 12 | -0.6 | 14.2 |
| Ownership of dwellings | 3.5 | 3.5 | 5.2 | -6.3 |
| Finance & insurance | 4.5 | 21.8 | 0.9 | -11.3 |
| Public admin & defence | 4.2 | -0.8 | -- | -- |
| Other services. | 5.2 | 5.4 | 6.2 | 5.2 |

Source: Pakistan’s Economic Survey FY05



is mainly explained by a sharp rise in the central bank's profit that increased from Rs 6.2 billion in FY04 to Rs 31 billion in FY05.

Furthermore, banks and non-bank financial institutions have also been able to post extraordinary profits despite their shrinking average spread and net interest margin (see **Table 2.29**). In particular, their assets base increased by 14.4 percent during CY04 even over 15.2 percent growth realized during CY03. Since the rise in profits was even stronger than the expansion in their assets base (as evident in higher return on assets), this clearly reflects increased volume and as well as efficiency gains during this period.

The efficiency gains, in particular, point at the rising competition that has forced banks to rationalize their cost structure as well as design new financial products. The financial innovation, in turn led to a rise in profitability of their core business activities during CY05 (see **Figure 2.45**). It deemed that the economic benefits of liberalization and financial reforms initiated in early 1990s that were not much evident earlier, have now started paying dividends.

Insurance business has also witnessed a sharp rise of 15 percent YoY in their assets base during CY04, shared by both the non-life insurance sector as well as life insurance sector. The non-life insurance business in particular may have benefited from increased activities in the areas of international trade and commerce and bank borrowing that creates a sizeable demand for non-life insurance. Besides that the assets of the country's only reinsurance company also showed an improvement of 6.1 percent YoY in CY04.

As shown in **Table 2.30**, while the gross and net premium of both life insurance and reinsurance business increased during CY04, there is a decline in these premiums for non-life business during the calendar year, largely due to significantly higher claims under fire and motor insurance categories during this period. The investment income/net premium ratio improved for life and non-life insurance business while declined in case of reinsurance activities.

Table 2.28: Indicators of Services Sector

| percent | Growth | |
|---|--------|---------|
| | FY04 | FY05(p) |
| Railway revenue earning freight traffic | 2.3 | 18.2 |
| Cargo handled at major ports. | -2.2 | 13.2 |
| Cell phone penetration | 3.31 | 5.59 |
| Roads: up gradation of highways | 1.55 | 1.44 |
| Aggregate deposits | 20.9 | 19.6 |
| Non-food private sector credit | 22.1 | 36.4 |
| Credit extended to personal loans | 42.9 | 56.7 |
| Central government expenditure | 1.66 | 10.6 |

Source: SBP, PTA, Economic Survey

Table 2.29: Key Performance Indicators of Financial Sector

| percent | CY03 | CY04 |
|--|------|-------|
| Average cost of deposits and borrowing | 2.09 | 1.52 |
| Average spread | 3.5 | 3.4 |
| Net interest margin | 4.07 | 3.89 |
| Return on average assets (after tax) | 1.4 | 1.46 |
| Advance to assets ratio | 43.4 | 51.52 |
| Advances to deposit ratio | 56.5 | 65.9 |
| Assets base | 15.2 | 14.40 |

Note: Indicators are based on aggregated data of banks, Microfinance institutions and NBFIs (excluding mutual funds)

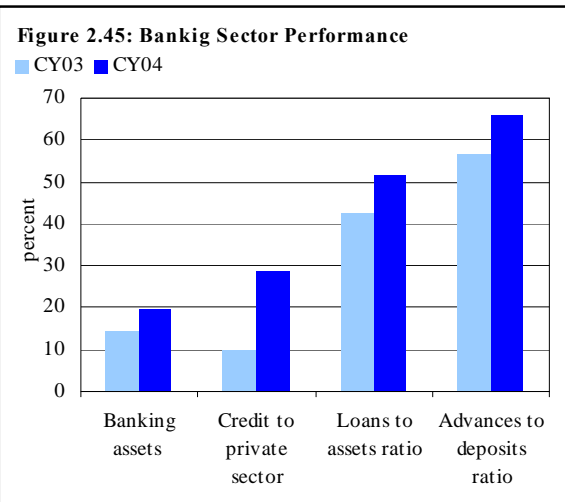


Table 2.30: Snapshot of Insurance Business

million Rupees

| | Non-Life Insurance | | | Life Insurance | | | Re-Insurance | | |
|-------------------------------------|--------------------|--------|-------|----------------|---------|------|--------------|------|-------|
| | CY03 | CY04 | % Δ | CY03 | CY04 | % Δ | CY03 | CY04 | % Δ |
| Assets | 36,209 | 42,703 | 17.9 | 107,889 | 123,676 | 14.6 | 6232 | 6613 | 6.1 |
| Gross premium | 18,853 | 16,825 | -10.8 | 12,978 | 14,632 | 12.7 | 4697 | 5241 | 11.6 |
| Net premium | 9,253 | 8,345 | -9.8 | 12,625 | 14,207 | 12.5 | 1447 | 2289 | 58.2 |
| Investment income/net premium | 28.6 | 30.9 | 8 | 82.7 | 98.2 | 18.7 | 23 | 15.8 | -31.5 |
| Investment income/investment assets | 18.3 | 16.1 | -12 | 12 | 14.2 | 18 | 17.6 | 13.3 | -24.9 |

Source: FSA 2004

2.4.2 Wholesale and Retail Trade

Wholesale and retail trade (W&R) sector with a share of 36.5 in services sector, registered a strong growth of 12 percent during FY05 on the top of 8.1 percent rise in FY04 (see **Table 2.31**). The component-wise discussion on W&R value addition is as follows:

- Higher value addition from import sub-sector on account of an exceptional growth of 32.2 percent in overall imports.
- The impact of strong growth in the manufacturing sector and consequent distribution throughout the country and overseas (see **Figure 2.46**).
- The above average production of major crops and the diversion of informal trade of cotton into formal channels after the removal of GST on cotton trading.

2.4.3 Transport, Storage and Communication

The transport head covers roads, railways, air transport, port and shipping services, while the communication comprises of telecommunication, information technology and postal services. This sub-sector registered a moderate growth of 5.6 percent in FY05 as compared to 5.5 percent during last year (see **Table 2.32**).

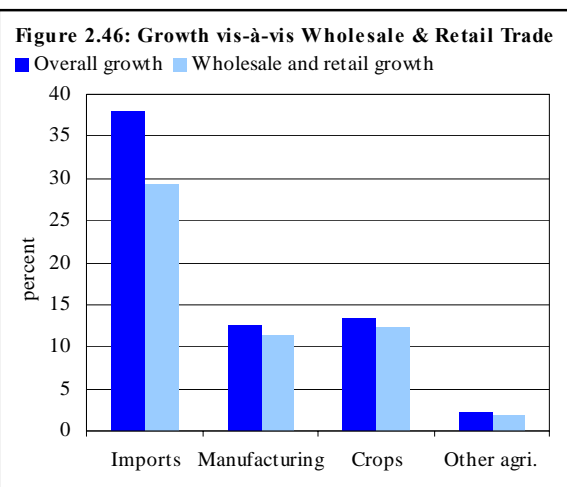
A moderate growth of 3 percent in value addition during FY05 in road transport (a heavyweight with a dominating share of 68.9 percent in transport & communication) is quite surprising given than the production of trucks, buses and LCVs rose by a significant 58.5 percent, 27.7 percent and 67.6 percent

Table 2.31: Whole sale & Retail Trade

million Rupees

| Sub Sectors | FY04 | FY05 | Growth | % Share in Value addition. |
|------------------------|----------------|----------------|-----------|----------------------------|
| Imports | 102.896 | 133.107 | 29.4 | 32.9 |
| Manufacturing | 335.962 | 374.542 | 11.5 | 42 |
| Agriculture | 141.806 | 144.474 | 1.9 | 2.9 |
| Crops | 88.453 | 99.288 | 12.2 | 11.8 |
| Hotel & restaurant | 96 | 105.12 | 10 | 10.4 |
| Total W & R | 764.688 | 856.531 | 12 | 100 |

Source: FBS

**Table 2.32: Transport Storage & Communication in FY05**

| Sub Sectors | Δ in value addition Rs million | % Share in value addition | Growth |
|--|-----------------------------------|---------------------------|------------|
| Pak railway | 638 | 2.44 | 76.7 |
| Port and shipping | (214) | (0.82) | (1.8) |
| Airlines | (711) | (2.72) | (2.5) |
| Pipelines | (80) | (0.31) | (1.6) |
| Road transport | 9,817 | 37.53 | 3.0 |
| Communication | 15,069 | 57.61 | 19.3 |
| Storage | 1633 | 6.24 | 12.2 |
| Transport, storage, communication | 26,155 | 100.00 | 5.6 |

Source: Federal Bureau of Statistics.

respectively during this period. This moderate growth even overshadowed the strong growth of 18.8 percent posted by *communication, railways and storage* components (having combined contribution of 19.6 percent during FY05 (see **Figure 2.47**)).

The strong growth in the *communication* sector, particularly in telecom is largely the result of government incentives and steps taken as part of its deregulation policy for this sector that resulted in the entry of new telecom companies in cellular phones, LDI and WLL.

As in FY04, the *transport, storage and communication* sub-sector attracted foreign as well domestic investors. This sector received FDI of Rs 584 billion (accounting for nearly 40 percent of the total inflows) in FY05. Similarly, private sector credit to *transport, storage and communication* is almost doubled to Rs 50.6 billion in FY05 from Rs 26.3 billion during FY04.

Road Networks

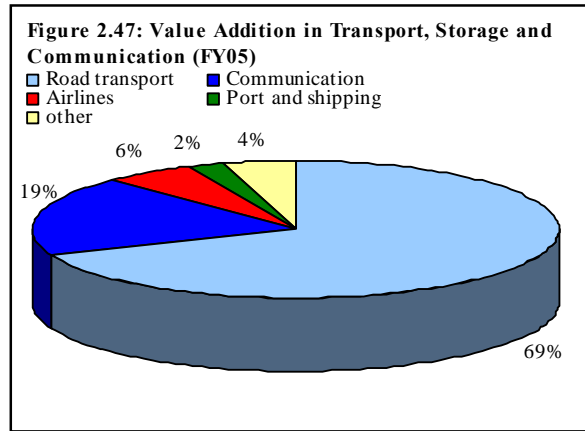
In Pakistan, road transport is the most commonly used mode of transportation. The road network covers 259,758 kilometers that includes 162,879 km (62.7 percent) high type roads and 96,879 km (37.3 percent) low type roads (see **Figure 2.48**). During FY05, while the coverage of high typed roads increased, coverage of low typed roads witnessed a decline. This probably reflects an increased focus on building major highways (see **Box 2.5**).

Pakistan Railways

The value addition by Pakistan Railways increased remarkably by 76.7 percent during FY05.

While the number of passengers carried increased by 5.5 percent, distance traveled declined by 22.4 percent during FY05 (see **Table 2.33**). The latter is mainly the impact of reduction in prices for air travel (reflecting competitive pressures from new airline companies) that diverted more passengers away from railway travel, particularly on longer routes.

The gross earnings witnessed a sharp upsurge of 18.2 percent YoY (Rs 2.7 billion) in FY05 as compared to 2.3 percent in FY04, mainly due to (1) a significant increase in fares by Rs 0.026 per KM

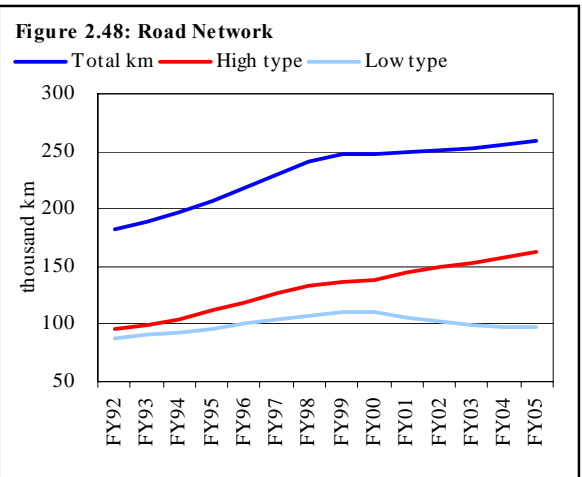


Box 2.5: Major Highways Projects

The National highway authority is sole responsible for maintenance and up gradation of Pakistan’s 19 major inter-provincial links including national highways, and motorways. These constitute only 3.5 percent of Pakistan’s entire road network but cater for about 90 percent of the commercial road traffic in the country.

Major road infrastructure projects under construction are: (1) Mekran Costal Highway (MCH); (2) Karachi Northern Bypass; (3) Lyari Expressway, (4) Islamabad–Peshawar Motorway (M-1). The work on MCH and Lyari Expressway has almost up to completion, while Islamabad–Burhan and the Rashakai-Charsadda sections are on their final phases of construction, and the entire motorway will be opened to traffic in 2007. Moreover, work on Islamabad–Murree is in process, and Mansehra-Naran road has also been completed in near future.

The expansion and smoothen of the transport system will ultimately leads to prosperity of country.



per passenger; and (2) increased freight traffic. This was supported by increased sundry earnings³¹ that grew at 97.2 percent due to fast recovery of receivables during the year (see **Figure 2.49**).

The revenue expenditures have also witnessed a rise of 6.5 percent, mainly due to an increase in operational expenses, including POL charges, and salaries & pension paid. Furthermore, the interest accrued on overdraft increased by 97.8 percent during FY05.

Since the revenue expenditures were more than the revenue receipts, it led to a deficit of Rs 3.5 billion during FY05. But this deficit was significantly less than the Rs 5 billion deficit realized in FY04. Thus, despite a considerable improvement in the performance of Pakistan Railways, this public sector entity has a long way to go towards achieving self-sufficiency and profitability (see **Figure 2.50**).

Air Transport

FY05 turned out to be a very difficult year for the aviation industry throughout the world

owing to an extraordinary increase in fuel prices. The average cost of fuel has risen from Rs 51.86 per gallon during the year to Rs 71.68 per gallon. As a result, the value addition by the airline industry fell by 2.5 percent during FY05.

Pakistan International Airlines

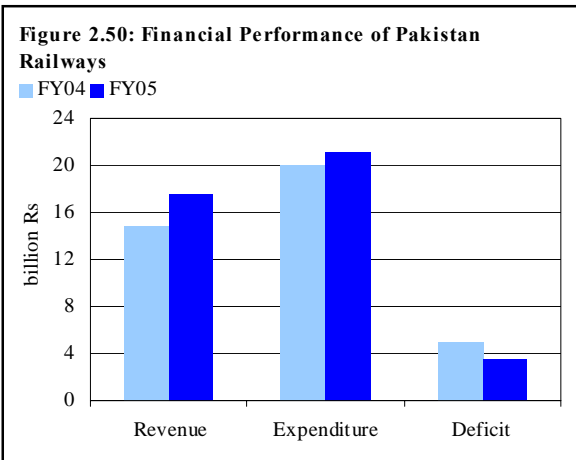
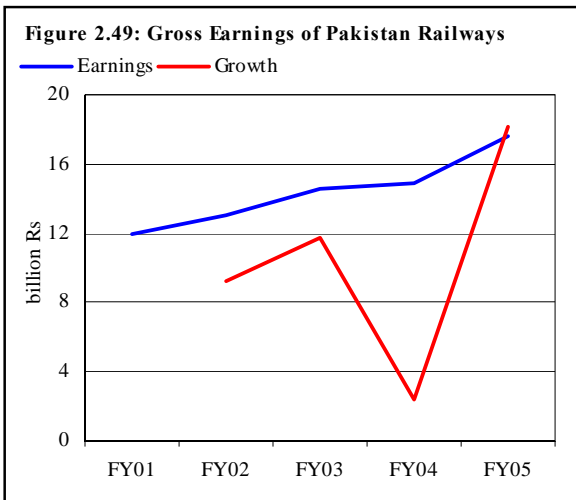
The calendar year 2004 was a momentous period in the history of PIA as the corporation inducted nine new aircraft. Furthermore, three new international destinations were added and a number of services to regional routes were restored (see **Figure 2.51**).

The addition to air fleet during 2004 positioned the airline to expand its services. Consequently, the corporation was able to increase its passenger capacity by 17.9 percent which was satisfactorily absorbed. Thus, PIA revenue reached a record Rs 61 billion in CY04, registering a growth of over 20 percent relative to CY03. This is the highest revenue growth rate in the past 20 years, which was achieved despite the competitive pressures in the domestic routes.

Table 2.33: Performance of Pakistan Railways

| | 2003-04 | 2004-05 | Growth |
|----------------------------------|---------|----------|--------|
| Passenger traffic | | | |
| Number of passenger carried | 75.7 | 79.88 | 5.5 |
| Number of passengers Km traveled | 23045.1 | 17879.92 | -22.4 |
| Avg. rate per passenger km (Rs.) | 0.34 | 1.53 | 350 |
| Freight traffic | | | |
| Number of tonnes Carried | 6.14 | 6.38 | 3.9 |
| Number of Km traveled | 5335.97 | 5005.39 | -6.2 |
| Avg. rate per ton km (Rs.) | 0.82 | 3.82 | 365.9 |

Source: Pakistan Railways



³¹ Sundry earnings are the earnings from the sources other than the core business activities.

On the expenditure side, persistent pressure on oil prices in the international market led the aircraft fuel bill of the corporation to reach Rs 21.7 billion compared to the target of Rs 15.7 billion. Furthermore, the depreciation of Pak rupee against the US dollar in 2004 adversely impacted the profitability of the corporation for the year. Thus, despite the record revenues, PIA incurred losses of Rs 2.5 billion which was in sharp contrast to the target profits of Rs 3 billion (see **Table 2.34**).

Shipping and Port Activities

The value addition through shipping and port activities fell by 1.8 percent during FY05 despite a strong rise in port activities on the back of increased trade. This fall in value addition may be the result of a significant downward adjustment in the port handling charges during the period (see **Figure 2.52**).

It may be noted that cargo handling activities witnessed a higher growth of 13.6 percent, with total cargo volume increasing to 41 million tonnes in FY05 from 36.3 million tonnes in the preceding year. This rising trends corresponds to sharp rise in Pakistan's trade volume. In fact, reflecting the structure of foreign trade, the handling of import-cargo exhibited a 14.5 percent growth (a drastic jump over the last year growth of 1.5 percent), whereas the volume of export cargo increased by 6.6 percent in FY05.

The cargo handling activities at Port Qasim increased by 46.8 percent during FY05, in contrast to a fall of 2.9 percent in handling activities at KPT. This divergence can be explained by reduction in the range of 10-15 percent in both wet and ancillary charges³² at Port Qasim.

These reductions in charges, for the first time in the port's history, have made it less expensive against most of ports in the region. It has been argued that with the reduction in port charges, the Port Qasim would be around 14 percent cheaper compared to KPT and 2 percent cheaper than Mumbai Port.

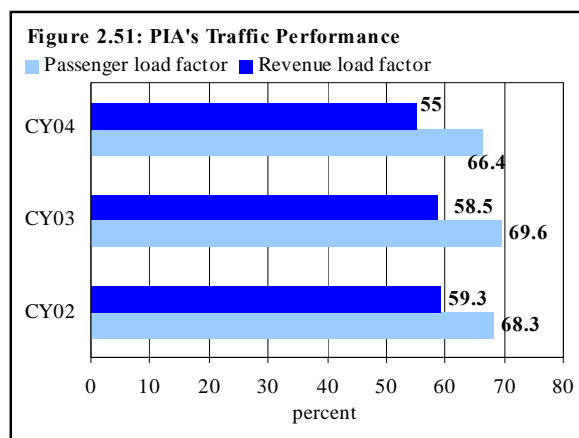


Table 2.34: PIA Financial Performance - 2004

| | Target | Actual | % change |
|---------------------------------|--------|--------|----------|
| Revenue | 59.482 | 61.002 | 2.6 |
| Expenditures | 77.519 | 89.931 | 16.0 |
| Profit & loss after direct cost | 17.425 | 12.653 | -27.4 |
| Total indirect fixed cost (IFC) | 11.925 | 12.804 | 7.4 |
| Total operating cost (TOC) | 53.962 | 62.153 | 15.2 |
| Profit & loss | 3.018 | -2.519 | -183.5 |

Source: Pakistan International Airline

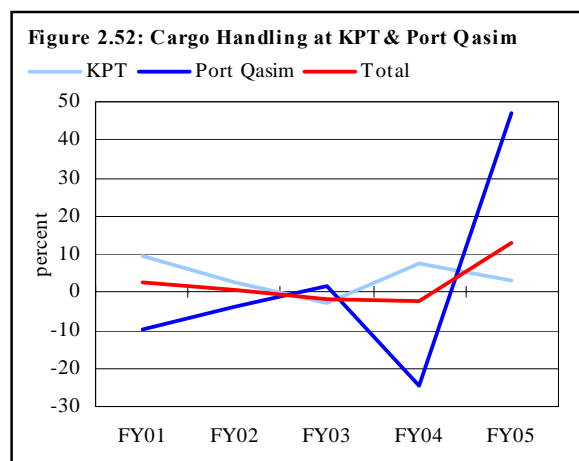


Table 2.35: Communication Sub sectors.

| | FY04 | FY05 |
|---------------------------------|-------|-------|
| Percent growth in GVA | | |
| Telecom | 11.6 | 19.3 |
| Postal & courier services. | 16.2 | 21.3 |
| Percent growth in GFCF | | |
| Telecom | 73.6 | 53.3 |
| Postal & courier services. | 125.0 | -13.5 |
| % share in communication | | |
| Telecom | 87.7 | 87.5 |
| Postal & courier services. | 12.3 | 12.5 |

Source: Federal Bureau of Statistics

³² Wet charges would mean reduction in port dues, berthing, pilot age and haulage charge.

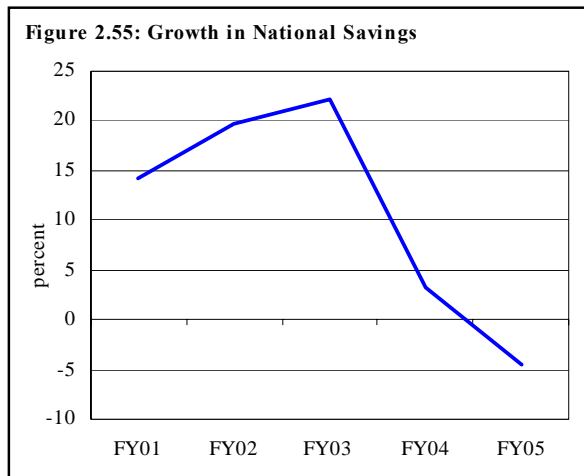
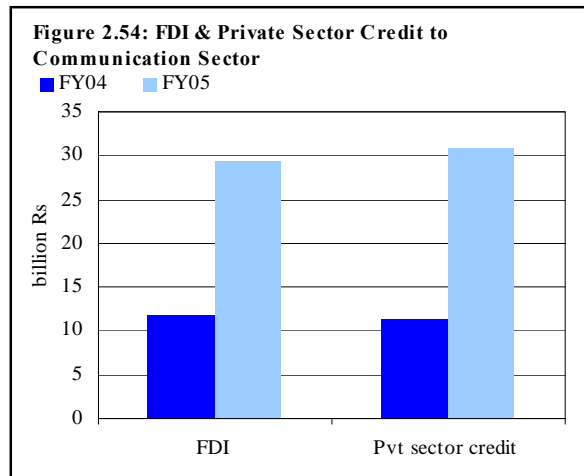
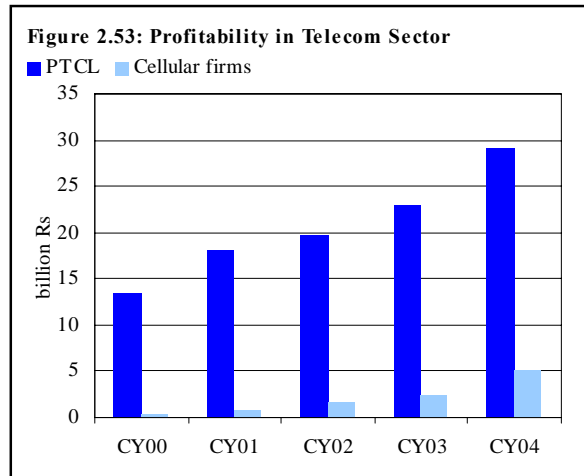
Moreover, to smooth the cargo and shipping activities, Port Qasim Authority entered into an agreement with Karachi Shipyard & Engineering Works for construction of two tugs and two Pilot boats at a collective cost of US\$ 6 million. Pilot Boats have been delivered, while delivery of tugs is expected shortly. As freight forwarding has been declared as industry, and the incentives that are available to other industries will now be available to this sector, it is expected that private sector investment in this sector will rise.

Communications

The communications sub-sector experienced a strong growth of 19.3 percent in FY05 even over the 12.2 percent increase witnessed during FY04 (see **Table 2.35**). Within communications, the telecom sector (with a share of 87.5 percent in communication sector) recorded a growth of 19.3 percent (Rs 81.5 billion) in gross value addition during FY05. Similarly postal and courier services (with a share of 12.5 percent), grew at 21.3 percent in FY05 as compared to the 16.2 percent growth recorded in FY04.

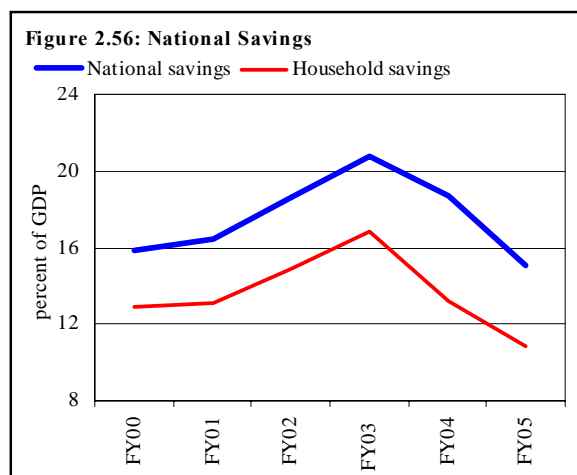
In particular, the performance of both PTCL and cellular firms is remarkable as their profitability increased by 26.4 percent and 40.9 percent respectively during CY04 (see **Figure 2.53**). The entrance of new cellular operators Al-Warid and Telenor created a tough competition among the cellular segment leading to lower tariffs and improvement in service quality. Competition in the sector could increase further if the state-owned telecom utility PTCL, is privatized.

Private sector credit extended to telecom sector increased from Rs 11.4 billion in FY04 to Rs 30.9 billion during FY05. Similarly foreign direct investment reached Rs 29.5 billion in FY05 from Rs 11.9 billion a year earlier. As a result, the number of new cell phone connections in FY05 increased from 5 million to 12 million taking the overall tele-density up to 12 percent by June 2005 (see **Figure 2.54**).

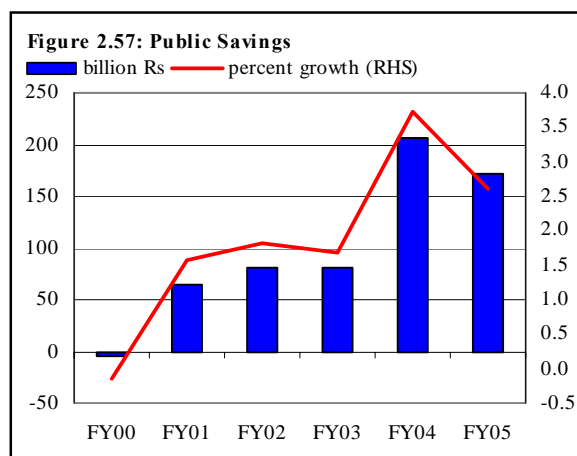


2.5 Savings

The national savings deteriorated for the second successive year, recording a 4.5 percent *fall* in FY05, after seeing growth decelerate to 3.2 percent in FY04 (see **Figure 2.55**). The FY04 deceleration in national savings was contributed by the decline in private savings, which was more than offset by an exceptionally large jump in public savings. Unfortunately, during FY05, not only have private savings continued to decline (albeit at a lesser pace), public savings also fell. As a result, national savings dropped from its FY03 peak of 20.8 percent of GDP to 15.1 percent of GDP in FY05 (see **Figure 2.56 & Table 2.36**).



As evident in **Figure 2.57**, at least part of negative growth in public savings during FY05 is a base effect i.e. FY04 had seen an unusual jump which could not be sustained in FY05. On the other hand, the decline in private savings probably stems from a number of factors including: (1) low and generally negative real interest rates on national saving scheme (NSS) instruments,³³ (2) the preference for physical rather than financial assets following rising asset prices during both FY04 and FY05; and, (3) most importantly, a sharp increase in private consumption expenditure.



At least a part of this rise in private consumption is explained by the ample availability of consumer credit at soft terms during both FY04 and FY05.

Table 2.36: National Savings

| Description | million Rupees | | percent growth | | as a percent of GDP | |
|-----------------------|-------------------|-------------------|-------------------|-------------------|---------------------|-------------------|
| | FY04 ^R | FY05 ^P | FY04 ^R | FY05 ^P | FY04 ^R | FY05 ^P |
| National Savings | 1,034,590 | 987,885 | 3.2 | -4.5 | 18.7 | 15.1 |
| a) Public Savings | 206,669 | 171,628 | 155.0 | -17.0 | 3.7 | 2.6 |
| i) General Government | 89,862 | 60,828 | 24121.6 | -32.3 | 1.6 | 0.9 |
| ii) Others | 116,807 | 110,800 | 44.8 | -5.1 | 2.1 | 1.7 |
| b) Private Savings | 827,921 | 816,257 | -10.1 | -1.4 | 15.0 | 12.5 |
| i) House-hold | 730,226 | 710,030 | -10.1 | -2.8 | 13.2 | 10.8 |
| ii) Corporate | 97,695 | 106,227 | -10.1 | 8.7 | 1.8 | 1.6 |

Source: Planning and Development Division, Government of Pakistan

³³ Net withdrawals from the National Savings Schemes totaled Rs 56.0 billion during FY05, as compared to with a net withdrawals of Rs 20.9 billion during FY04. This fall in net NSS receipts during FY05 was primarily due to (1) negative real rate of return on most of NSS schemes, and (2) possibly, the continued retirement of SSCs which were purchases for interest rate arbitrage during FY04 (see *Annual Report 2003-04* for details).

In contrast to household savings, corporate savings witnessed a positive growth of 8.7 percent during FY05 on the back of improved profitability amidst strong domestic demand. However, this small positive contribution was unable to offset the aggregate negative impact of all other components of national savings.

2.6 Investment

Nominal investment grew strongly during FY05, remaining well above the 5-year average of 10.6 percent (see **Table 2.37**), on the back of robust macroeconomic fundamentals, increased availability of credit and significant rise in foreign direct investment (FDI) (see **Figure 2.58**). Indeed, even the slowdown in investment growth

relative to FY04, is probably attributable to a high-base effect, and a sharp rise in the investment deflator, as much as the gradual tightening of monetary policy.

It may be noted that despite the rise in nominal investment during the preceding three years, the investment to GDP ratio has remained stagnant in recent year, continuing to hover around 15.5 percent in the last three years (see **Figure 2.59**).

While the decline in public investment as a percentage of GDP is consistent with the increasing importance to the private sector, the absence of a corresponding acceleration in private investment is disappointing. The growth in private gross fixed investment this year was much lower than expectations and does not conform to the behavior of other components that form the investment goods basket. The imports of machinery and equipment and raw materials have shown very significant jump in both FY04 and FY05. Steel consumption and cement sales have expanded rapidly; public development expenditure has doubled; foreign direct investment has risen by 60 percent but the growth in investment was shown as negative in FY04 and negligible in FY05 (see **Table 2.38**). This raises serious doubts about the derivation of investment series in the national accounts. Either the coverage is incomplete and all activities are not fully reflected or the methodology of compiling the national expenditure estimates is deficient. The Federal Ministries of Finance and Planning should examine this inconsistency in depth.

Table 2.37: Indicators of Investment

| | percent growth | |
|----------------------------|----------------|------|
| | FY04 | FY05 |
| Domestic cement dispatches | 14.5 | 17.9 |
| Steel consumption | 14.2 | 67.4 |
| Machinery imports | 43.4 | 40.2 |
| Private sector credit | 34.3 | 33.6 |
| Development expenditures | | |
| Foreign direct investment | 19.2 | 60.4 |
| Memo item: Real investment | -4.4 | 1.5 |

Figure 2.58: Growth in Investment

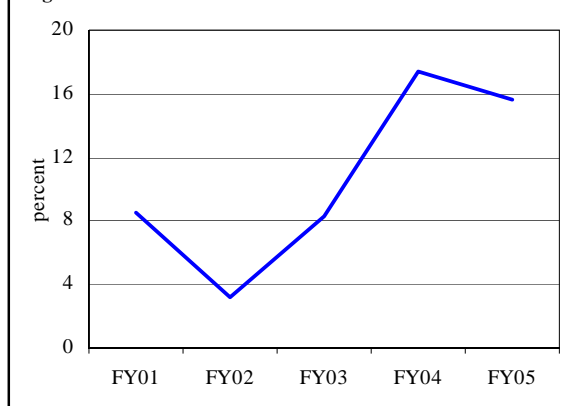
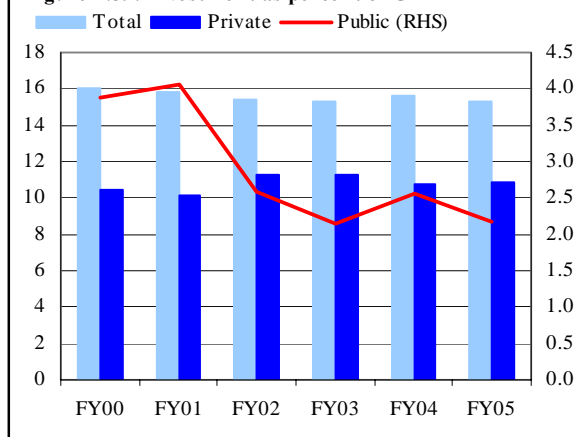


Figure 2.59: Investment as percent of GDP



| Description | FY00 | FY01 | FY02 | FY03 | FY04 ^R | FY05 ^P |
|-------------------------------|---------|---------|---------|---------|-------------------|-------------------|
| Gross Total Investment | 659,110 | 715,525 | 738,373 | 817,062 | 958,995 | 1,102,605 |
| Changes in Stocks | 51,700 | 56,200 | 58,000 | 80,629 | 94,294 | 103,299 |
| Gross Fixed Investment | 607,410 | 659,325 | 680,373 | 736,433 | 864,701 | 999,306 |
| a) Public Sector | 212,661 | 236,228 | 183,909 | 191,329 | 267,110 | 286,149 |
| b) Private Sector | 394,749 | 423,097 | 496,464 | 545,104 | 597,591 | 713,157 |
| Growth rates, percent | | | | | | |
| Gross total investment | | 8.6 | 3.2 | 10.7 | 17.4 | 15.0 |
| Gross fixed investment | | 8.5 | 3.2 | 8.2 | 17.4 | 15.6 |
| a) Public sector | | 11.1 | -22.1 | 4.0 | 39.6 | 7.1 |
| b) Private sector | | 7.2 | 17.3 | 9.8 | 9.6 | 19.3 |
| As percent of GDP | | | | | | |
| Gross total investment | 18.7 | 18.5 | 18.0 | 18.2 | 18.6 | 18.0 |
| Gross fixed investment | 17.2 | 17.0 | 16.6 | 16.4 | 16.8 | 16.3 |
| a) Public sector | 6.0 | 6.1 | 4.5 | 4.3 | 5.2 | 4.7 |
| b) Private sector | 11.2 | 10.9 | 12.1 | 12.2 | 11.6 | 11.6 |

Source: Economic Survey 2004-05; ^R=Revised; ^P=Provisional

The importance of raising investment levels is clear from **Table 2.39**, which shows that Pakistan is placed at the bottom amongst selected countries in terms of investment to GDP ratio, with an exception of crisis hit Indonesia. Interestingly, **Table 2.39** shows that most of the countries with an increasing investment to GDP ratio, were able to accelerate their growth and vice versa.

Agriculture

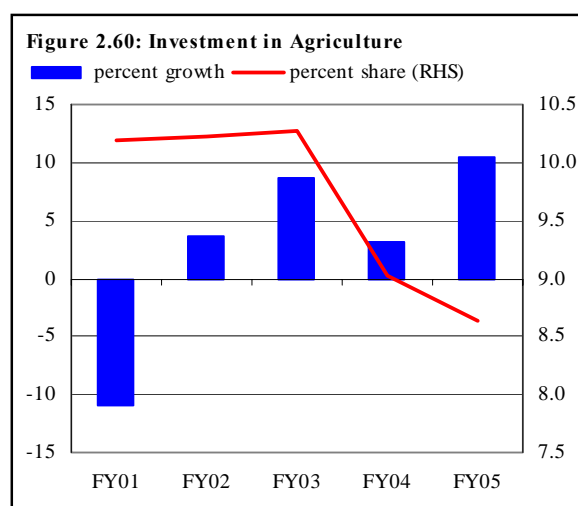
Investment in agriculture sector witnessed double-digit growth in FY05, for the first time since FY99 with both, the public and the private sectors contributing to this acceleration. While the increased availability of institutional credit for the agriculture sector helped push up private investment, a significant increase in PSDP supported the growth momentum in public sector investment during FY05

Unfortunately, even this higher growth in agriculture could not keep pace with either the rise in total investment or rise in GDP. Thus, during FY05, its share in total investment and as percent of GDP continued to decline (see **Figure 2.60**). This outcome is also not fully understandable as both private bank credit and public sector infrastructure investment were quite high in FY05. The basis on which such estimates are derived should be reviewed to assess its reliability.

Table 2.39: Investment & Growth in Different Countries

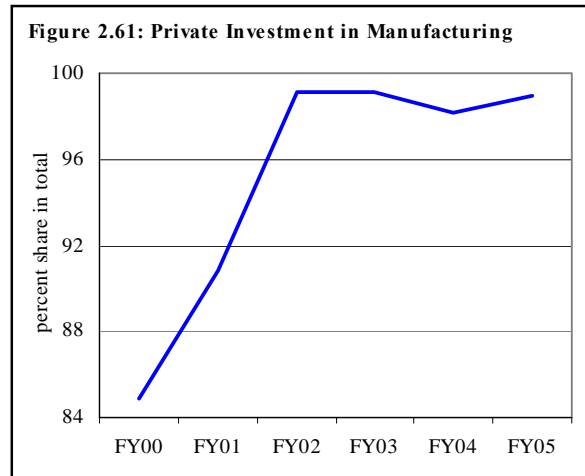
| | Investment | | GDP growth | |
|-------------|----------------|------|------------|------|
| | percent of GDP | | percent | |
| | 2000 | 2003 | 2000 | 2003 |
| China | 36.3 | 44.4 | 8.0 | 9.1 |
| South Korea | 31.0 | 29.4 | 8.5 | 3.1 |
| Indonesia | 16.1 | 16.0 | 4.9 | 4.1 |
| Malaysia | 27.2 | 21.8 | 8.5 | 5.2 |
| Thailand | 22.8 | 25.2 | 4.8 | 6.7 |
| Bangladesh | 23 | 23.4 | 5.9 | 5.3 |
| India | 24.4 | 23.3 | 4.4 | 8.1 |
| Pakistan | 17.4 | 16.7 | 4.3 | 5.1 |
| Sri Lanka | 27.9 | 24.1 | 6.0 | 5.9 |

Source: Asian Development Bank.



Manufacturing

Investment in the manufacturing sector witnessed a robust growth of 23.0 percent during FY05, compared with the 13.1 percent YoY increase in the preceding year (see **Figure 2.61**). The growth was equally shared by both LSM and small scale sub-sectors, and appears to reflect a number of factors, including: (1) strong demand on the back of rising income as well as higher resort to debt (reflecting the easy availability of consumer financing); (2) capacity constraints in some industries (that provided expansion opportunities); (3) aggressive investments by the textile sector ahead of the post-quota regime; (4) a recovery by the construction sector, etc. The resulting nexus of strong demand, rising capacity utilization, and improved credit availability allowed induced capacity expansions by many sectors, including, amongst others, textiles, automobiles, consumer electronics, and cement.



Construction

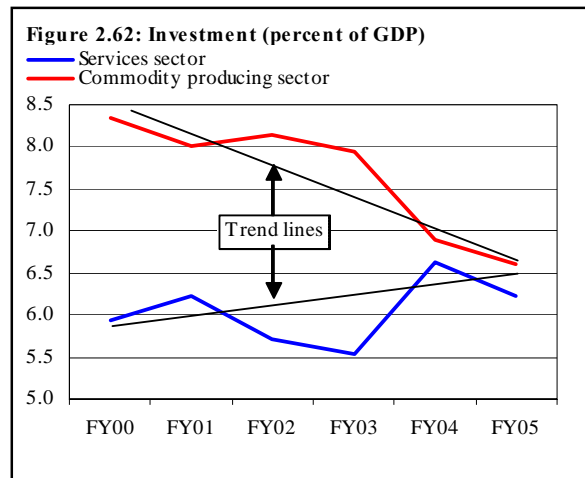
Investment in the construction sector accelerated during FY05 for the second year in a row, with an exceptional rise in private investment comfortably offsetting the small deceleration in public investment (see **Table 2.40**). While public sector investment in construction is rising due to higher allocation of PSDP, the strength of the private sector investment is driven by a number of factors, including: (1) rising incomes, (2) greater availability of institutional credit for housing, and (3) the real estate boom seen particularly in most major cities.

Table 2.40: Investment in Construction

| | Private | Public | Total |
|------|---------|--------|-------|
| FY01 | -8.2 | -18.8 | -10.1 |
| FY02 | 2.9 | 55.9 | 11.6 |
| FY03 | -64.3 | -15.0 | -53.0 |
| FY04 | 58.1 | 18.7 | 41.8 |
| FY05 | 79.9 | 14.2 | 57.1 |

Services

Investment in the services sector witnessed a growth of 11.0 percent during FY05, as compared to a much sharper rise of 37.7 percent in the preceding year. This slowdown is also evident in a decline in the *investment to GDP* ratio for the services sector in FY05. It may be noted that while the recorded *investment to GDP* ratio in the commodity-producing sector is trending downward, it is gradually rising in services sector (see **Figure 2.62**).



Transport & Communication

The contribution of private sector investment in the *transport & communication* sub-sector is increasing on the back of rising economic activities, privatizations and emerging attractive avenues in communications, correspondingly the share of public investment in the sector is declining as evident

in **Figure 2.63**. In particular, liberalization in telecommunication resulted in significant growth in private investment in this sub-sector as evident from a sustained rise of 42.2 percent in FY05 over an equally strong increase of 39.0 percent in the preceding year. The FY05 rise is mainly attributable to the PTCL privatization and the entry of two new mobile companies in the country. Indeed, even the FY04 reversal in the downtrend in investment in the sector owes to large investments by just two public sector entities, PIA and Pakistan Railways.

Wholesale & retail trade

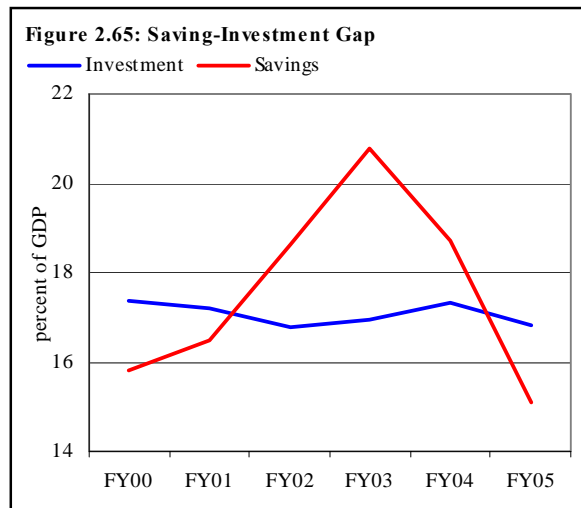
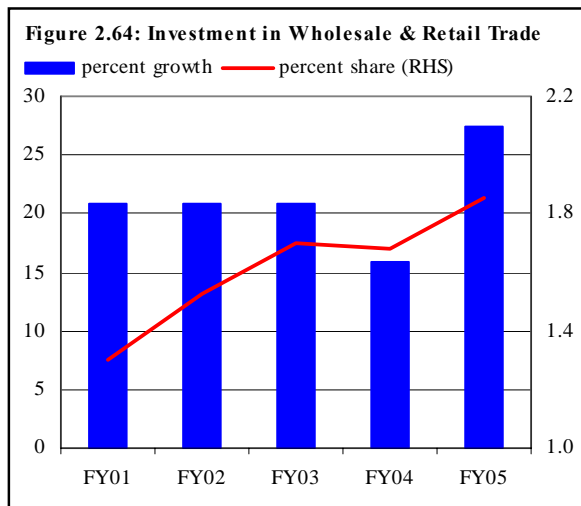
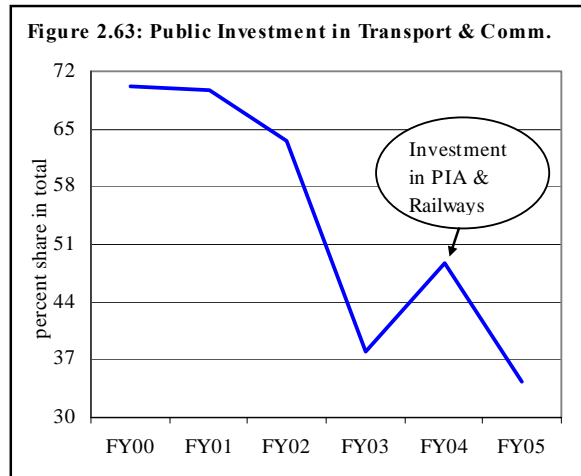
Wholesale & retail trade sub-sector witnessed a rising trend in terms of both the growth and its share in total investment (see **Figure 2.64**). The robust 27.4 growth in FY05 was result of (1) a substantial rise in economic activities with tremendous growth in agriculture and manufacturing, (2) a sharp increase in private consumption, and (3) a visible structural change in the trade business, following the increasing popularity of shopping malls and chain stores.

Finance & insurance

Public sector investment in *finance & insurance* witnessed an increase of 6.1 percent during FY05, however this rise was more than offset by a decline of 1.7 percent in private investment. The deceleration is explained by a base effect; during FY05 investment in the sector rose sharply reflecting the receipt of privatization proceeds for a large public sector bank, HBL.

Saving-Investment Gap

Although the *investment to GDP* ratio remained stagnant in recent years, the steady decline in the *savings to GDP* ratio drove the savings-investment gap into a deficit during FY05 (see **Figure 2.65**). This gap is not large by historical standard, and by itself, would not be a source of concern. However, given that the gap has emerged from a fall in savings rather than a rise in investment, even this low

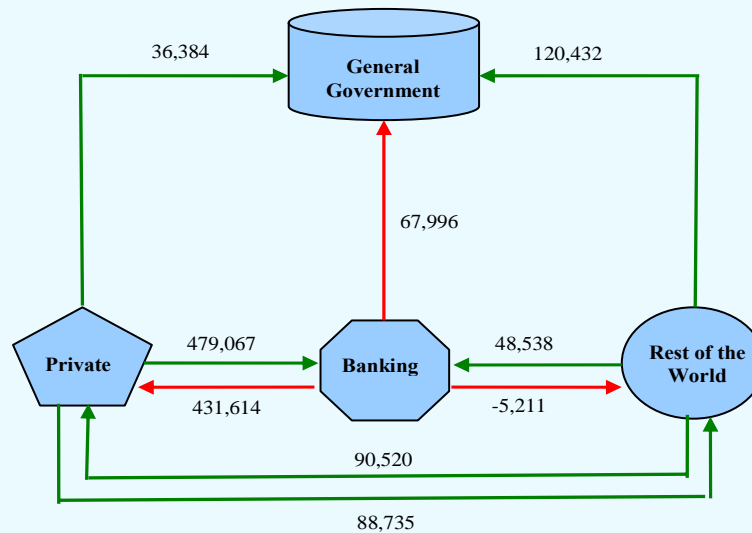


deficit is troubling.³⁴ Interestingly, the savings-investment gap entirely stems from the shortfall in private savings relative to private investment, while public sector emerged as a net saver (see **Box 2.6**).

Box 2.6 Flow of Funds Account 2004-05, At a Glance:

The flow of funds accounts measure financial flows across different sectors of the economy, tracking movement of funds from sectors having surplus capital, through intermediaries to sectors that use the capital to acquire physical and financial assets. The comprehensive framework of the flow of funds accounts is useful for analyzing economic activities; it supplements the conventional national income and product accounts which cannot show the interplay of forces between real processes and financial markets. The State Bank of Pakistan has been compiling the flow of funds accounts for the country since 1987. The accounts for years up to 2003-04 are available in the form of various reports published by the Bank. A summary account for the year 2004-05 is given in **Table 2.9** (Statistical Annexure of the Annual Report). The following chart gives a pictorial view of the flow of funds among different sectors including government, banks, private, and rest of the world.

During 2004-05, the general government had a saving-investment gap of Rs 217.0 billion which was financed by the domestic private sector to the extent of Rs 36.4 billion, banking system Rs 68 billion and the rest of the world to the extent of Rs 120.4 billion. The private sector supplied funds amounting to Rs 479.1 billion to the banks and received from them Rs 431.6 billion; thus it remained net supplier of financial resources to banking system during the year. The private sector was net recipient of funds from the rest of the world. Between banking system and the rest of the world there was a net transfer of Rs 53.7 billion to the latter.



(numbers in million rupees)

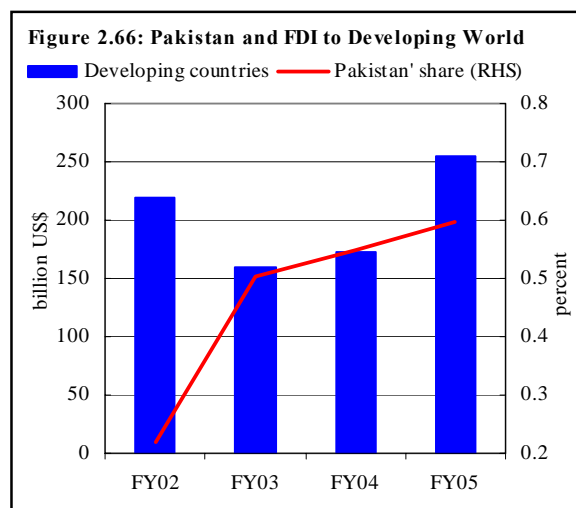
Source: Statistics Department, State Bank of Pakistan

³⁴ Indeed, it may *also* be noted that even a positive saving-investment gap is neither a healthy sign nor sustainable for a developing country. However, negative gap is either only desirable, if and only if developing country is investing borrowed resources in enhancing its productive capacity that likely to improve its repaying capacity in future.

2.7 Foreign Direct Investment

After dipping to 19.0 percent in FY04, the growth in FDI resumed its near term trend growth, rising by 60.5 percent in FY05.

While this compares favorably with the rise of only 6.0 percent in global FDI flows, it must be kept in mind that the high growth rate simply reflects a low base. In fact, despite this rise, Pakistan's share in overall flow of global FDI rose by about 0.1 percentage points, to a mere 0.25 percent during the year. Even within developing economies Pakistan's share of FDI rose only marginally, to reach 0.6 percent for FY05 (see **Figure 2.66**).³⁵



The silver lining to these dismal statistics is that in recent years Pakistan's performance in attracting FDI has improved significantly (see **Figure 2.67**), with the growth in FDI for the last three years averaging approximately 48 percent, which compares well with many countries in the region. This is a reflection of (1) successful liberal regime to attract the foreign investment; (2) improved macroeconomic fundamentals; (3) appropriate amendments in laws and regulations govern FDI; as well as (4) implementation of effective reforms to improve governance. This is reflected in the country's improved competitiveness ranking from 91 in 2004 to 83 in 2005.³⁶ Nonetheless, it is worth noting that country's ranking in terms of attracting FDI, is still quite low, and therefore Pakistan has still a lot to do, in order improve the domestic business environment. The latest Doing Business in 2006 survey published by the World Bank and IFC has ranked Pakistan 60th (out of 145 countries) in the index of ease of doing business.

This increase in FDI during FY05 was relatively broad-based, with almost all sectors witnessing an increase. But the most significant flows were due to privatization and deregulation in *telecommunications* and *financial* sectors (see **Table 2.41**). While partial receipts of the HBL privatization and expansion in Islamic Banking during FY05 pushed up FDI under financial sector, FDI in communications was attributable to the privatization of PTCL, entry of two new cellular companies, and introduction of new technologies like WLL service. Excluding these transactions the growth in FDI during FY05 was small. FDI during FY06 is likely to be much higher following the receipts on account of PTCL privatization, as well as the entry of new Islamic banks.

Table 2.41: Foreign Direct Investment

million Rupees

| | FY04 | FY05 | Share in total | Growth |
|-------------------------|--------------|---------------|----------------|-------------|
| Food & beverages | 4.0 | 16.2 | 1.1 | 305.0 |
| Textiles | 35.4 | 39.3 | 2.6 | 11.0 |
| Chemicals | 15.3 | 51.0 | 3.4 | 233.3 |
| Petroleum refining | 70.9 | 23.7 | 1.6 | -66.6 |
| Oil & gas explorations | 202.4 | 193.8 | 12.7 | -4.2 |
| Pharma & OTC products | 13.2 | 38.0 | 2.5 | 187.9 |
| Machinery & electronics | 16.9 | 16.5 | 1.1 | -2.4 |
| Transport equipment | 3.3 | 33.1 | 2.2 | 903.0 |
| Power | -14.2 | 73.3 | 4.8 | 616.2 |
| Construction | 32.0 | 42.7 | 2.8 | 33.4 |
| Trade | 35.6 | 52.1 | 3.4 | 46.3 |
| Communications | 221.9 | 517.6 | 34.0 | 133.3 |
| Financial business | 242.1 | 269.4 | 17.7 | 11.3 |
| Others | 70.6 | 157.3 | 10.3 | 122.8 |
| Total | 949.4 | 1524.0 | 100.0 | 60.5 |

Source: Statistics Department, SBP.

³⁵ In fact, more than 41 percent (US\$ 255 billion) of global FDI in FY05 was directed to developing economies.

³⁶ Source: Global Competitiveness Report 2005-06, World Economic Forum.

Another trigger for FDI in FY05 was the rise in capacity utilization in many LSM industries. The dis-aggregation of the FDI by source country also reveals interesting insights. In particular, in recent years there has been a welcome geographical diversification of FDI inflows, with the top three sources accounting for only 57.4 percent of the total FDI during FY05. In contrast, earlier, the US alone had accounted for over two-thirds of the FDI into the country (see **Figure 2.68**). Inflows from the UAE however, have continued to rise in recent years, and in FY05 this country was the biggest contributor of FDI flows into Pakistan. On the other hand, while the increased geographical dispersion of FDI flows is encouraging, the stagnation of flows from the US is a source of concern, as that country has a significant share in global FDI.

Furthermore, during FY05, the UK based FDI was largely in *oil & gas exploration*, that from the USA was also concentrated in the mining and communications, while investments from UAE were principally in the communications sector (see **Table 2.42**).

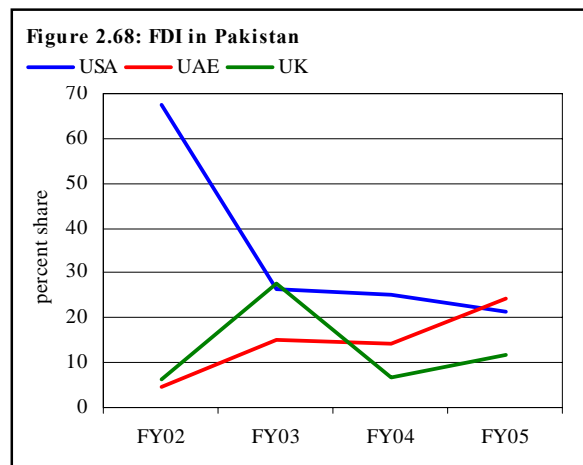
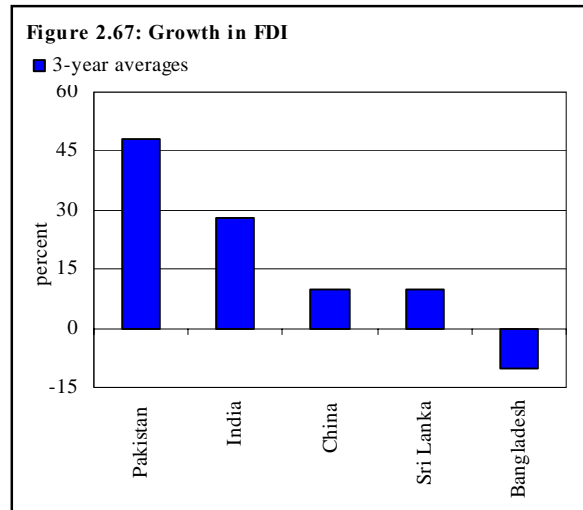


Table 2.42: Share of major contributors in FDI inflow to Pakistan

| percent | | | | | | |
|-----------------------------------|--------------|--------------|--------------|-------------|--------------|---------------|
| Sector | USA | UK | UAE | Switzerland | Others | Total |
| Food & beverages | 0.56 | 0.08 | 0.23 | 0.13 | 0.06 | 1.06 |
| Textiles | 0.72 | 0.45 | 0.79 | 0.24 | 0.37 | 2.58 |
| Chemicals | 0.67 | 1.76 | 0.12 | 0.49 | 0.31 | 3.34 |
| Petroleum refining | 0.76 | 0.87 | 0.17 | 0.00 | -0.24 | 1.56 |
| Oil & gas explorations | 5.30 | 3.15 | 0.01 | 0.01 | 4.24 | 12.72 |
| Pharmaceuticals & OTC products | 0.72 | 0.24 | 0.01 | 0.49 | 1.04 | 2.49 |
| Transport equipment (automobiles) | 0.12 | 0.00 | 0.01 | 0.00 | 2.04 | 2.17 |
| Power | 0.28 | 0.64 | 0.00 | 0.01 | 3.88 | 4.81 |
| Construction | 0.76 | 1.23 | 0.10 | 0.00 | 0.72 | 2.80 |
| Trade | 1.21 | 0.53 | 0.57 | 0.06 | 1.05 | 3.42 |
| Communications | 6.09 | 0.16 | 20.55 | 0.01 | 7.16 | 33.96 |
| Financial business | 0.51 | 1.05 | 0.83 | 7.22 | 8.07 | 17.67 |
| Personal services | 0.50 | 0.08 | 0.07 | 0.01 | 0.87 | 1.54 |
| Others | 3.19 | 1.67 | 0.67 | 0.34 | 3.99 | 9.87 |
| Total | 21.39 | 11.91 | 24.12 | 9.02 | 33.56 | 100.00 |