

2 Economic Growth, Saving and Investment

2.1 Overview

Pakistan's economy overcame adverse pressures to achieve strong growth for the third successive year in FY06. Despite unexpectedly weak harvests of some key crops (cotton, sugarcane and wheat), the impact of the October 2005 earthquake, a tight monetary policy and an unprecedented rise in oil prices, real GDP growth remained strong at 6.6 percent during FY06 (see **Figure 2.1**).¹ While this is lower than the 7.0 percent target for the year and 8.6 percent expansion seen in the preceding year, the growth is nonetheless commendable given the negative pressures mentioned above. Indeed, if not for the significantly adverse impact of poor weather towards the end of *rabi* FY06, it is quite possible that the annual target may have been met. Moreover, it should be kept in mind that the FY06 growth rate is still above the long-term growth trajectory of 6.0 percent that is required to assist a sustained reduction in poverty.

However, there was a visible deterioration in the quality of the economic performance, in the sense that the FY06 growth was more narrowly based as compared to preceding years. In contrast to a broad based growth in FY05, the impetus to the high growth in FY06 was principally from the above-target performance of the services sector, as both the key commodity-producing sectors, agriculture and industry saw growth fall well below the respective annual targets (see **Table 2.1**).

In particular, growth in the value addition by agriculture decelerated, as below target harvests for a number of key crops (especially cotton, sugarcane and wheat), led to a fall in the value addition by the crops sub-sector. Indeed, even the modest 2.5 percent growth in agriculture was made possible only by an exceptional showing by the livestock sub-sector, which offset the negative value addition by crops (see **Figure 2.2**).

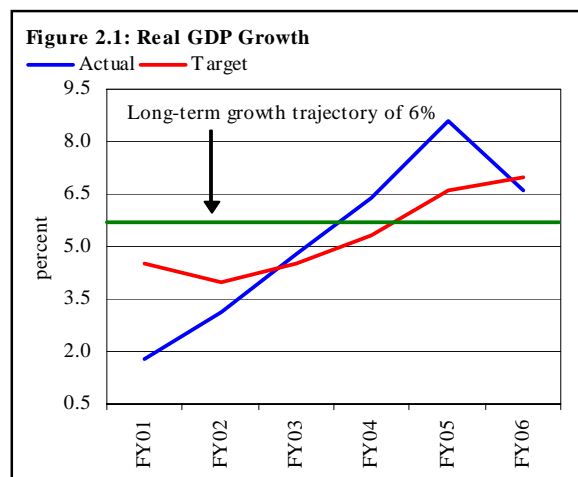


Table 2.1: Real GDP Growth

percent; at constant prices of 1999-2000

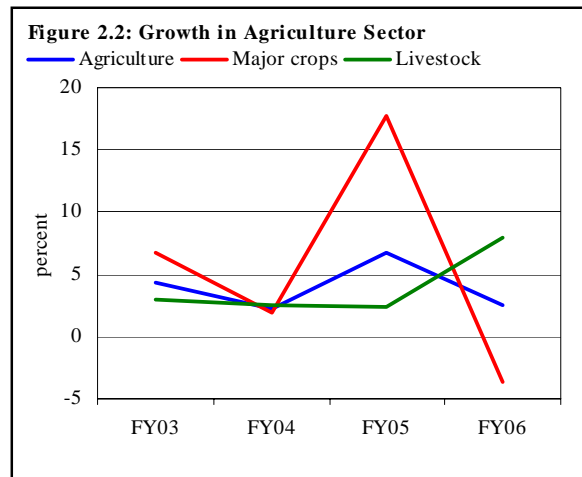
| | Growth rates | | FY06 | |
|---------------------------------------|--------------|------|-----------|--------|
| | FY05 | FY06 | Share (%) | Target |
| Commodity producing sector | 9.2 | 4.3 | 47.7 | 7.2 |
| Agriculture | 6.7 | 2.5 | 21.6 | 4.8 |
| Crops | 13.7 | -2.3 | 10.3 | - |
| Major | 17.8 | -3.6 | 7.6 | 6.6 |
| Minor | 3.0 | 1.6 | 2.7 | 4.0 |
| Livestock | 2.3 | 8.0 | 10.7 | 3.5 |
| Fishing | 2.2 | 1.9 | 0.3 | 4.0 |
| Forestry | -30.4 | -9.7 | 0.3 | 0.4 |
| Industry | 11.4 | 5.9 | 26.0 | 9.5 |
| Manufacturing | 12.6 | 8.6 | 18.2 | 11.0 |
| Large-scale | 15.6 | 9.0 | 12.7 | 13.0 |
| Small-scale & others | 6.2 | 7.6 | 5.5 | 6.4 |
| Mining and quarrying | 9.6 | 3.8 | 2.6 | 5.2 |
| Construction | 18.6 | 9.2 | 2.2 | 7.5 |
| Electricity & gas distribution | 3.5 | -8.4 | 3.0 | 3.5 |
| Services sector | 8.0 | 8.8 | 52.3 | 6.8 |
| Wholesale & retail trade | 11.1 | 9.9 | 19.2 | 9.3 |
| Transport storage & communication | 3.6 | 7.2 | 10.5 | 5.8 |
| Finance and insurance | 29.7 | 23.0 | 4.6 | 6.7 |
| Ownership of dwellings | 3.5 | 3.5 | 2.8 | 3.6 |
| Public admin. & defense | 0.6 | 4.7 | 5.8 | 3.5 |
| Community, social & personal services | 5.9 | 6.5 | 9.5 | 5.8 |
| Gross domestic product | 8.6 | 6.6 | 100.0 | 7.0 |

Source: Economic Survey 2005-06

¹ If data on large scale manufacturing up to June 2006, released by Federal Bureau of Statistics, is incorporated, the GDP growth revised upward to 6.8 percent for FY06.

Provisional data shows that growth in the sector jumped to 8.0 percent in FY06, appreciably higher than the 4.0 percent annual target and in sharp contrast to annual average growth of just 3.0 percent for the preceding 5 years.

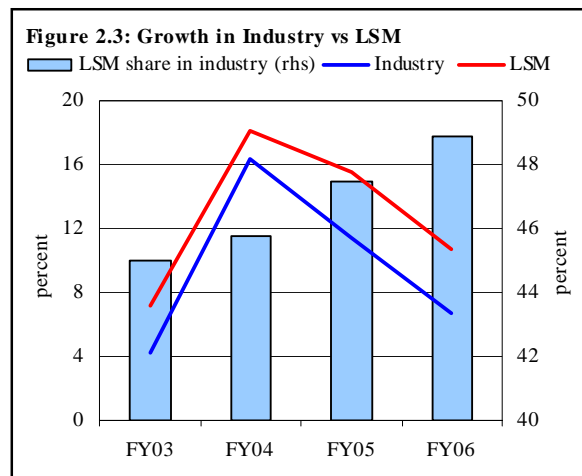
The only silver lining to this weak performance is that much of the poor performance by the crops sub-sector in FY06 was due to factors that may not repeat in FY07. Specifically, it is likely that the wheat, cotton, and sugarcane targets be achieved in FY07 in light of the improved prospects for water availability, and the continued supportive government policies and access to credit. Moreover, high FY06 prices and better water availability is likely to contribute to a bumper sugarcane harvest in FY07.



Indeed, an encouraging element of FY06 agri-sector developments was the visible increase in fertilizer off-take,² above target credit disbursement,³ increased supply of certified seeds and improved availability of irrigation water. Thus, given favorable weather conditions and supportive pricing policies there is a strong likelihood that agricultural performance will improve in FY07.

As with agriculture, it was the deceleration in growth of a key sub-sector – large-scale manufacturing (LSM)⁴ – that pulled down the aggregate industrial growth during FY06. Growth in LSM production dropped from 15.6 percent in FY05 to 9.0 percent⁵ (see **Figure 2.3**) in FY06 and, as a result, industrial growth dropped to 5.9 percent during FY06, substantially lower than both, the 9.5 percent target for the year, and the 11.4 percent growth achieved in the preceding year. The deceleration in LSM growth is attributable to a number of factors, including the impact of the relatively poor cotton harvest, capacity constraints being faced by some major industries, as well as a small slowdown in demand amidst rising interest rates.

Most of the remaining industrial sub-sectors also witnessed below target performance. Growth in *small scale manufacturing* stood at 9.3 percent against 7.5 percent, which indicates revision of data for the sector to include the contribution of cotton products,⁶ which constitutes 14 percent of small-scale production. *Mining & quarrying* sub-sector also witnessed deceleration, registering 3.8 percent



² 13.5 percent rise in urea and 14.5 percent in DAP off-take.

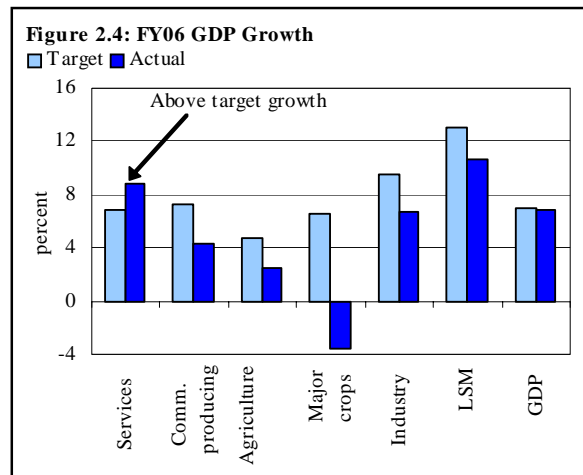
³ Credit disbursement to the sector was Rs 137 billion against a target of Rs 130 billion.

⁴ Share of *LSM* in overall industry is 48.8 percent for FY-06 higher than previous period. Share of *mining & quarrying* and *electricity & gas distribution* has gone down.

⁵ Revised provisional estimate for FY06 LSM growth is 10.7 percent according to data upto Jul-Jun FY06 released by FBS.

⁶ According to FBS sources, this portion of small scale sector has been raised at the growth of non-mill cotton products (i.e., 20%).

growth, which is lower than the targeted 5.2 percent as well as impressive growth of 9.6 percent seen in FY05. This could be attributed to fall in the production of crude oil during FY06. *Construction* sector also witnessed deceleration, registering 9.2 percent growth which is significantly lower than the previous year's 18.6 percent, although still very high keeping in view the base impact, and as compared to the targeted 7.5 percent. In fact, the *construction* sector is the only sub-sector in industry that exhibited an above-target performance. This impressive growth could be attributed to the boom in the real estate market, significant increase in public sector development program (PSDP), reconstruction activities in northern areas and higher FDI in the sector. *Electricity & gas distribution* sector witnessed a negative growth for FY06, which points towards a very serious issue of huge operating expenses in the sector in the form of increased input costs of gas and oil, and large line losses being incurred due to the security situation in Balochistan.



In contrast with the commodity-producing sector, the services sector maintained its growth momentum during FY06, registering an impressive 8.8 percent growth, which is not only much higher than the 6.8 percent annual target, but also higher than the high growth of 8 percent seen in FY05 (see **Figure 2.4**).

As a result, the share of the services sector jumped back to the 52.3 percent seen in FY03, after declining for two successive years. All services sub-sectors contributed to this remarkable performance. Although growth in the *wholesale & retail trade*⁷ and *finance & insurance* sub-sectors weakened a little from the previous year, this appears to be a high-base effect and performance of both of the sectors is quite strong. In particular, *wholesale & retail trade* sub-sector witnessed a rise in activity mainly on the back of higher trade volume in the form of higher imports as well as exports from the economy, a surge in domestic demand boosted by high consumption, and high domestic as well as foreign investment in the sector, all of which compensated for the drag due to relatively weak performance of the commodity-producing sectors. *Finance & insurance* also witnessed a significant growth for yet another year mainly on the back of improved profitability of financial as well as insurance business during the year. The profitability of the banking sector, in particular, gained due to the rising spreads as a result of increasing lending rates and lagged adjustment of deposits rates, as well as strong credit demand. Another very strong contribution to the performance of this sector was from the rising profits of SBP. *Transport, storage & communication* sub-sector witnessed a huge climb in growth rate from 3.6 to 7.2 percent mainly reflecting the strong growth in the telecommunication sub-sector in the country.

Aggregate Demand

Despite a deceleration due to a tight monetary policy, aggregate demand remained strong in FY06, on the back of higher consumption as well as investment demand. The strong aggregate demand, together with relatively poor performance of key crops and the capacity constraints of domestic

⁷ Wholesale & retail trade registered 9.9 percent growth against a target of 9.3 percent falling down from 11.1 percent for FY05. Finance & insurance grew by 23 percent, which is lower than 29.7 percent for last year, and significantly higher than its target of 6.7 percent.

industry, and rising oil prices contributed directly to a widening of the country's current account deficit.

Specifically, in terms of demand, private consumption expenditure has yet again proved to be the main source of growth in GDP, with its share in GDP rising to 76.9 percent from 75.6 percent for FY05 (see **Table 2.2**), although its growth rate was in single digits for the first time in three years. The strong demand by household was probably supported by a number of factors including: (1) higher income level achieved as a result of sustained growth in the economy for last couple of years, (2) wealth effect of gains in real estate market and capital gains in stock exchange, (3) availability of cheaper imports as a consequence of globalization, (4) higher credit flow to private sector in the form of consumer financing despite rising interest rate, and (5) higher remittances being transmitted to economy. Acceleration in public consumption expenditure is also visible in the rising budget deficit, reflecting the re-construction needs of the economy in the wake of the October 2005 earthquake.⁸

Table 2.2: Aggregate Demand

percent of GDP; at constant prices of 1999-2000

| | FY03 | FY04 | FY05 | FY06 |
|------------------------|------|------|------|------|
| Private consumption | 69.7 | 71.7 | 75.6 | 76.9 |
| Public consumption | 9.2 | 8.6 | 8.2 | 8.0 |
| Gross fixed investment | 15.7 | 13.6 | 13.8 | 14.3 |
| Net exports | 3.7 | 4.4 | 0.7 | -1.1 |
| M2 | 43.1 | 44.1 | 45.1 | 44.2 |
| Fiscal deficit | -3.7 | -2.4 | -3.3 | -4.2 |

Fiscal deficit adjusted for earthquake expenditure (3.4 % of GDP)

Not surprisingly, given the strength of domestic demand, and rising capacity utilization in LSM, and the government focus on improving infrastructure, investment spending also accelerated, growing by 10.3 percent in FY06 compared with a rise of 9.3 percent for FY05. As a result, investment expenditure as a percent of GDP has also gone up to 14.3 percent from 13.8 percent. Both public and private sector have contributed to this higher investment spending. Public sector investment was mainly on account of higher PSDP spending and has resulted in externalities for private investment, which grew by 11 percent during FY06 against 9.6 percent for FY05.

⁸ Rs 65.8 billion were spent in lieu of earthquake related activities.

2.2 Performance of Agriculture Sector

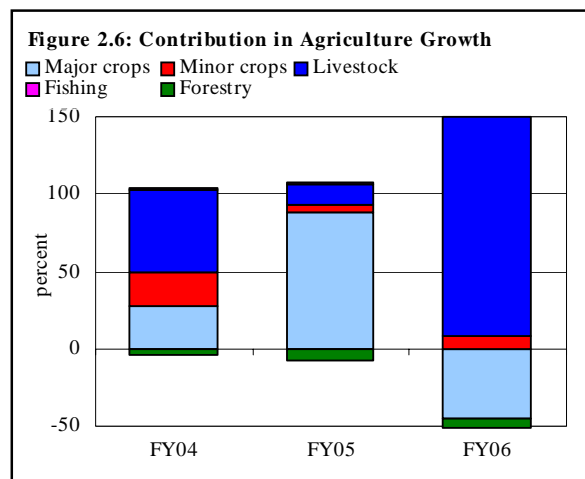
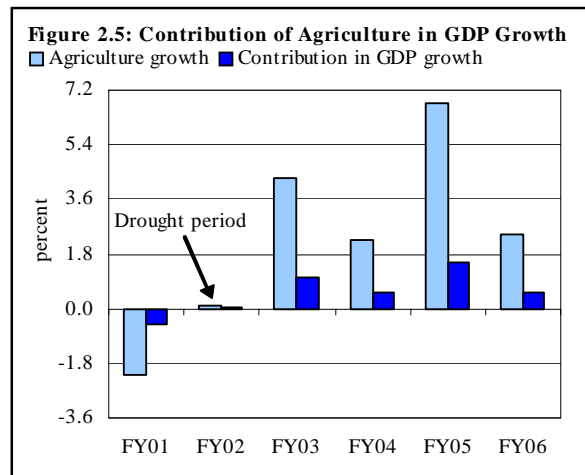
Improvements in the availability of irrigation water, inputs, and credit, in comparison to the preceding year, had initially raised hopes that FY06 would see sustained high agricultural growth. While growth was certainly expected to decelerate from the exceptional 6.7 percent recorded in FY05 (see **Figure 2.5**), it was hoped that reasonably good performance of major crops together with improved growth in the livestock sub-sector would support a growth target of 4.8 percent in FY06.

Unfortunately, these expectations received a jolt early into the year, with disappointing *kharif* harvests for cotton and sugarcane more than offsetting the impact of strong rice and maize harvests. However, despite this setback, there was still a possibility that the FY06 agricultural growth could be achieved if the wheat harvest was substantially above target, the harvest of minor crops improved significantly, and if the growth in value-addition by the livestock sub-sector proved to be well above target. In the event, only the latter expectation proved correct. In fact, the wheat harvest decreased by 1.4 percent in FY06 to 21.3 million tons, which was also 3.6 percent below the annual target for the year.

The decline in the FY06 production of sugarcane, cotton and wheat were the principal reasons for the net 3.6 percent decline in the value addition by *major crops*, in sharp contrast to the 17.7 percent growth in the preceding year. The impact of this on the growth of the crops sub-sector was compounded by the below target value-addition by *minor crops*. The 1.6 percent growth by minor crops during FY06 was lower than the 3.0 percent rise in output seen during FY05 and consequently the aggregate production of the crops sub-sector fell by 2.3 percent in FY06, compared to the growth of 13.7 percent in FY05. Similarly, the value-addition by forestry and fishing, both remained below target during FY06, but since each of these sectors has a very small share in agriculture, the net impact of these is not significant. Thus, the aggregate growth in agriculture during FY06 was contributed almost entirely by the exceptionally strong growth recorded by the livestock sub-sector (see **Figure 2.6**), handsomely rewarding the increased policy focus in the area in recent years. The 8.0 percent growth recorded by the sub-sector in the period is the strongest for the last decade, substantially outstripping the 2.3 percent growth seen in FY05 (see **Table 2.3**).

The disappointing performance of the crops sub-sector in FY06 serves to highlight important problems in the sector, including: (1) high vulnerability of crops to the vagaries of nature, and (2) rather weak market signals available to farmers to guide their sowing decisions.

The first of these is clearly evident in the unexpected below target harvests of cotton and wheat, both of which saw damage from untimely rains and unfavorable temperatures. However, it is encouraging



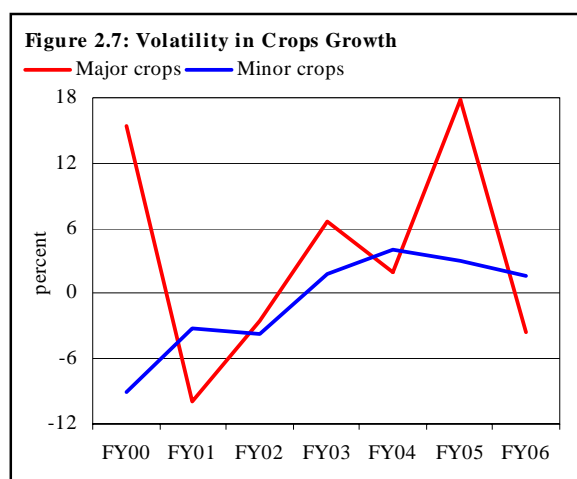
to note that in both cases, the eventual annual production remained substantially higher than the averages for the preceding decade, suggesting the increased reliance on market prices, better availability of credit, improved supply of certified seeds, etc. have helped significantly enhance yields of domestic crops.

Table 2.3: Agriculture Sector Performance

| Value addition | Unit | FY03 | FY04 | FY05 | FY06 ^P | Growth rate during | |
|----------------------------|---------------|--------|--------|---------|-------------------|--------------------|-------|
| | | | | | | FY05 | FY06 |
| Agriculture VA | billion Rs | 943.2 | 964.8 | 1,029.8 | 1,055.2 | 6.7 | 2.5 |
| <i>of which</i> | | | | | | | |
| Major crops | billion Rs | 321.0 | 327.1 | 385.1 | 371.1 | 17.7 | -3.6 |
| Minor crops | billion Rs | 119.4 | 124.1 | 127.8 | 129.9 | 3.0 | 1.6 |
| Livestock | billion Rs | 462.3 | 473.7 | 484.7 | 523.5 | 2.3 | 8.0 |
| Crops production | | | | | | | |
| Cotton | million bales | 10.2 | 10.0 | 14.3 | 13.0 | 43.0 | -9.1 |
| Wheat | million tons | 19.2 | 19.5 | 21.6 | 21.3 | 10.8 | -1.4 |
| Rice | million tons | 4.5 | 4.8 | 5.0 | 5.5 | 4.2 | 10.0 |
| Sugarcane | million tons | 52.1 | 53.4 | 47.2 | 44.7 | -11.6 | -5.3 |
| Non-crops | | | | | | | |
| Meat production | 000 tons | 2,132 | 2,185 | 2,238 | 2,419 | 2.4 | 8.1 |
| Milk production | 000 tons | 27,811 | 28,624 | 29,438 | 31,295 | 2.8 | 6.3 |
| Fish production | 000 tons | 562 | 566 | 574 | 581 | 1.4 | 1.2 |
| Forest production | 000 tons | 823 | 819 | 519 | 444 | -36.6 | -14.5 |
| Inputs | | | | | | | |
| Improved seed distribution | 000 tons | 172.1 | 178.8 | 213.8 | 311.1 | 19.6 | 45.5 |
| Fertilizer off-take | 000 tons | 5,346 | 5,746 | 6,346 | 6,790 | 10.4 | 7.0 |
| Sale of tractors | numbers | 26,742 | 35,900 | 43,578 | 48,802 | 21.4 | 12.0 |
| Credit availability | | | | | | | |
| Credit disbursement | billion Rs | 58.9 | 73.6 | 108.7 | 137.5 | 47.7 | 26.5 |

P: Provisional

The second of these problems is clearly reflected in the boom-bust cycles evident in both major crops (especially sugarcane) and minor crops (see **Figure 2.7**). For example, a key factor for the uncertain performance of the sugarcane crops in recent years is the disconnect between expectations of sugarcane farmers and sugar mills. Price disputes between the two often lead to delayed commencement of the crushing season by sugar mills (which also contributed to lower yields of succeeding crops), as farmers demanded higher prices. In the succeeding year, the area under sugarcane would drop, leading to higher prices, provides incentives to farmers to increase cultivation of the crop. This boom-bust cycle is expected to repeat in FY07, as high prices towards the end of the FY06 season probably led farmers to increase efforts. SBP projections suggest that a bumper sugarcane crop, together with the recent decline in sugar prices may substantially force down sugarcane prices in FY07.



Each of the problems discussed above has important policy implications. Firstly, the government appears to be on the right track with policies aimed at improving farm productivity, as supportive policies can lead to a substantial increase in agricultural value-addition by improving yields. Secondly, the use of market-based policies can lead to substantial improvements in productivity. Here, the presence of a vibrant commodity futures market could play an important role in improving the pricing signal to guide farmers' investment decisions. This would improve the farmers' investment decisions and smooth their income streams.

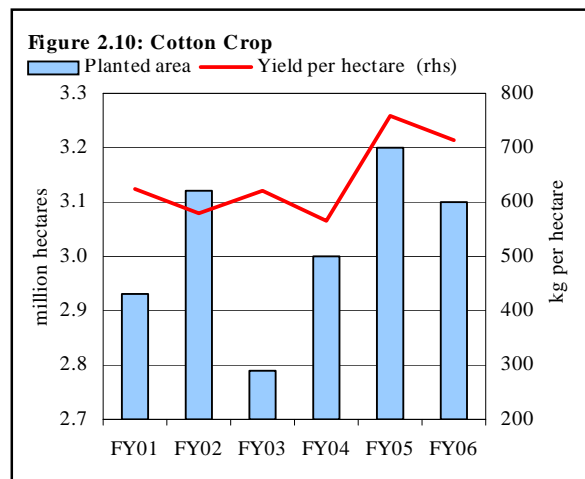
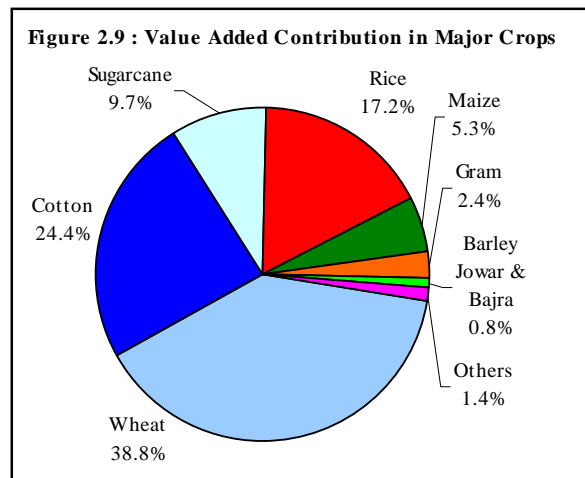
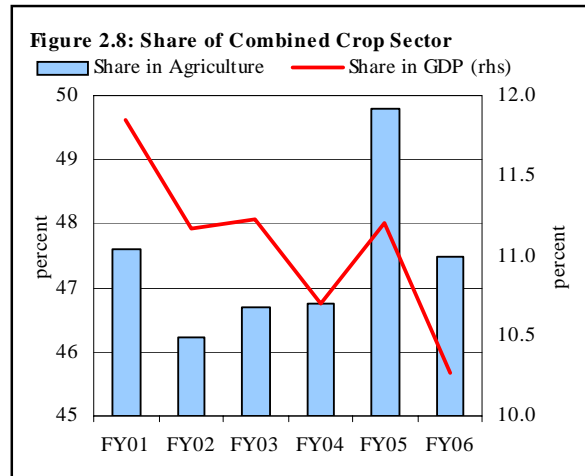
2.2.1 Crop Sector

Aggregate value addition by the crop sector, comprising of two sub-groups, *major crops*⁹ and *minor crops*,¹⁰ declined by 2.3 percent during FY06, compared with a strong growth of 13.7 percent in FY05. Major and minor crops both contributed to the disappointing FY06 performance, which mainly reflected adverse weather conditions that led to a reduction in planted area and lower yields for many important crops (see **Figure 2.8**).

Major Crops

Cotton

An important *kharif* cash crop, cotton, holds a key position in the agriculture sector as well as in the economy. It directly contributes 8.6 percent to agriculture value addition and 1.9 percent to GDP (see **Figure 2.9**). It is also a major industrial input and contributes to the larger part of the country's exports. Thus, in short, the cotton harvest has a significant impact on the economy. Although the 13.0 million bales¹¹ output in FY06 is the second largest cotton crop harvest in Pakistan's history, it was 9.1 percent lower than the record output of 14.3 million bales seen in FY05. This decline in the cotton production was due to the combined impact of a fall in planted area and yield per hectare (see **Box**



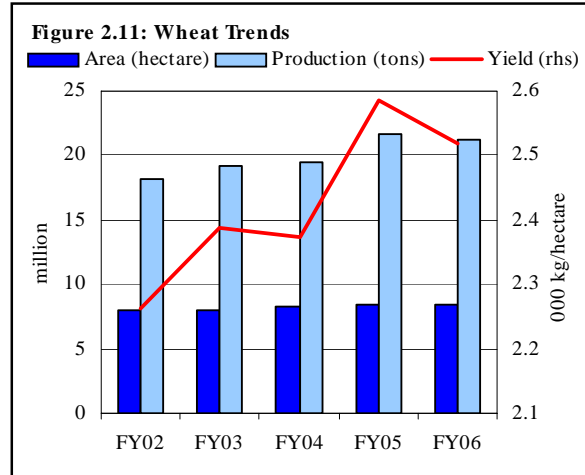
⁹ Wheat, cotton, rice, sugarcane, maize, gram, jowar, bajra, barley, oilseeds, tobacco and sasamum.

¹⁰ Pulses, potato, onion, chillies, tomato, pulses, spices, garlic etc.

¹¹ The third largest cotton output was 12.822 million bales in FY92

2.1). The 4.0 percent YoY decline in the area under cotton probably reflected the lower prices received by the farmers in the preceding year (see **Figure 2.10**).

The impact of this was then worsened by a fall in yields due to a number of factors, including (1) pest incidences in some cotton planting districts due to higher moisture levels on the back of heavy winter rains during FY05, which led to a swift growth in cotton plant size, followed by weed growth, resulting in descent flowers and weakened boll-bearing capacity of the plant, and finally (2) large variations in day/night temperature that adversely impacted the FY06 cotton crop, by lowered its weight. In addition, (3) the delayed sowing of cotton also lowered its yield (see **Box 2.1**). As a result, cotton yield dropped by 38 kg/hectare to 713 kg/hectare in FY06 relative to 751kg/hectare in FY05.

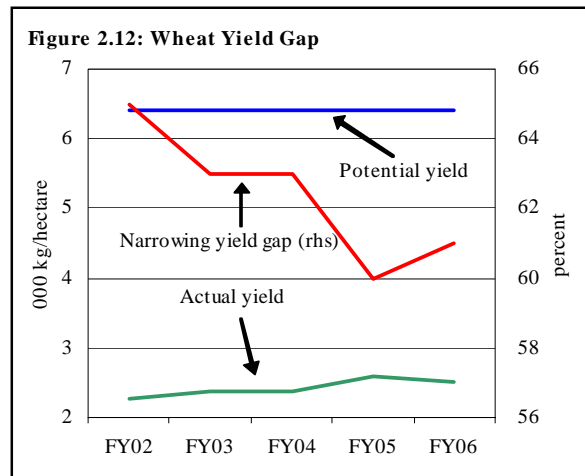


Wheat

Provisional estimates suggest that the wheat harvest fell by 1.4 percent in FY06 in contrast to a remarkable 10.8 percent increase in FY05. The decline was mainly attributed to a 2.6 percent fall in the wheat yield during FY06 (see **Figure 2.11**). At first glance, the decline in the wheat yield is surprising given (1) usage of higher inputs amidst availability of institutional credit, (2) 56 percent rise in distribution of certified seeds among the growers, (4) rains during Jan-Feb 2006 and (3) higher support prices (Rs 415 per 40 kg for FY06 from Rs 400 per 40kg in FY05) announced by the government.

However, decline in yield is a function of (1) delayed sowing of wheat crop due to the late crushing of sugarcane and extended cotton picking season and (2) adverse weather conditions during the period of formation and maturity of the grain.

It may be noted that the per hectare yield of wheat remains 61 percent below the potential level¹² (see **Figure 2.12**). Clearly, continued focus on availability of key inputs (water, improved seeds, fertilizer etc.), better farm management practices, improved infrastructure (road, silos etc), increased use of technology and appropriate pricing policy could help achieve significant improvements in yields in years ahead. This is important from the point of view of the growing domestic needs for this key staple. It should also be kept in mind that an increase in wheat yield would also help improve farm incomes and help reduce poverty.



¹² John Millors, *et al* "Intuitional reforms to accelerate irrigated agriculture", Agri Statistics Pakistan 2001-02.

Box 2.1: Field Study on Cotton Yield - Appropriate Sowing Time

The season and timing of sowing is a vital factor for the achieving better level cotton yield. A field study “Effect of Different Sowing Dates on Cotton (*Gossypium hirsutum* L.) Cultivars” was conducted at the Cotton Research Station, Multan and Pakistan Agronomic Research Station, Khanewal, Pakistan. The study assessed the effects of sowing date on two cotton varieties MNH-552 and MNH-554 grown on 1st April, 15th April, 1st May, 15th May, 1st June, 15th June, 1st July and 15th July during 1998 and 1999 under Multan conditions. 15th May and 1st June sown cotton displayed significantly maximum seed cotton yield of 2998 and 2883 kg/hectare in 1998 and 4027 and 3894 kg/hectare respectively in 1999 as compared to 595 and 253 kg/hectare (1998) and 1269 and 223 kg/hectare (1999) from crop sown on 1st and 15th July respectively. Increase in both sowing dates in seed cotton yield was associated with boll weight and bolls per plant. On average of two years data, 15th May produced highest seed cotton yield of 3513 kg/hectare, whereas the lowest figure was 238 kg ha (15th July). Comparing varietal performance, MNH-552 (2310 kg/hectare) yield was higher as compared to MNH-554 (2288 kg/hectare). However, two cultivars declined the yield in late planting. It can be concluded from the study that for getting better cotton yield, the optimum sowing time under Multan condition is 15th May [with the period range may start from 1st May and can be extended up to 1st June].

Note: The study was conducted by Hassan, Mahmood-ul, et al, (2003) “Effect of Different Sowing dates on Growth (*Gossypium hirsutum* L.) Cultivars”, Asian Journal of Plant Science, 2(6), pp: 461-3

Rice

Rice is the second major domestic food crop after wheat. It is also a cash crop that holds a key position in the agro-economy of Pakistan. Its value added contribution stood at 6.1 percent of the agriculture sector and 1.3 percent of GDP during FY06. A significant part of the domestic rice crop is consumed locally although a substantial quantity of long grain (Basmati) and IRRI types of rice is also being exported.

The domestic production of rice rose by 10.0 percent in FY06 to a record level of 5.55 million tons. This improvement was well supported by both, the 4.0 percent increase in area under cultivation and a 6.1 percent rise in yield (see **Figure 2.13**). The continued improvement in rice harvests since FY02 was achieved mainly due to (1) use of better seed varieties, (2) improved soil management, (3) efficient use of fertilizers & pesticides, and (4) improvements in the use of irrigation water from available resources.

However, as with wheat, the rice yields in Pakistan remain far below potential. It is therefore important to sustain efforts to improve rice yields (see **Table 2.4** and **Box 2.2**).

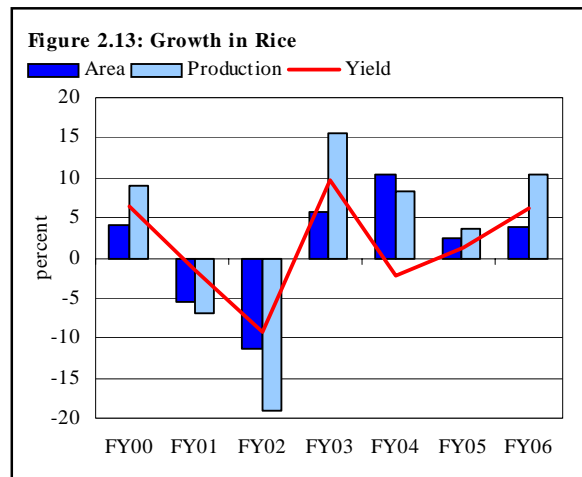


Table 2.4: Rice Yield Gap
Kg/hectare

| Crops | Potential yield FY02 | Actual yield FY06 | Yield gap (%) |
|--------------|-------------------------|----------------------|------------------|
| Rice (paddy) | 9,849 | 2,116 | 78.5 |

Sources: 1) Institutional reforms to accelerate irrigated agriculture, John Millors et al, Agri Sta. Pak. 2001-02
2) Pakistan Economic Survey 2005-06

Box 2.2: Rice Yield Gap Causes in Major Producing Countries.

The factors causing yield gaps can be classified according to their nature and the degree to which they contribute to the gaps as under:

- Biophysical: climate/weather, soils, water, pest pressure, weeds.
- Technical/management: tillage, variety/seed selection, water, nutrients, weeds, pests, and post-harvest management.
- Socio-economic: socio-economic status, farmer’s traditions and knowledge, family size, household income/expenses/investment.
- Institutional/policy: government policy, rice prices, credit, input supply, land tenure, market, research, development, extension.
- Technology transfer and linkages: the competence and facilities of extension staff; integration among research, development and extension; farmers’ resistance to new technology; knowledge and skills; weak linkages among public, private and non-governmental extension staffs.

Yield Enhancing Procedures:

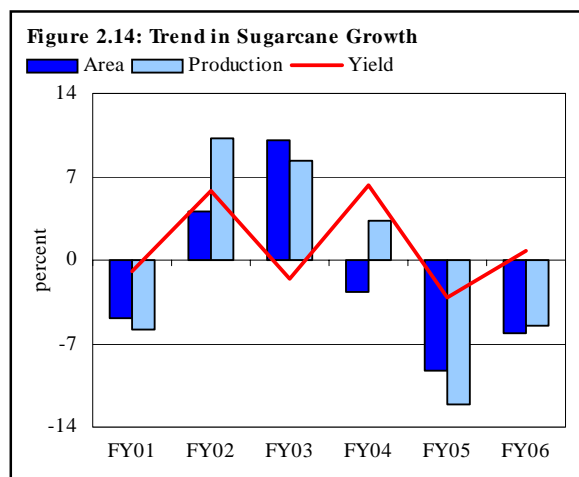
- i) government policy support;
- ii) the identification and classification of yield gaps at a particular location;
- iii) promotion of integrated crop management in rice cultivation;
- iv) deployment of new proven technologies;
- v) assurance of adequate input and farm management.

Source: FAO

Sugarcane

Sugarcane¹³ was the other major *kharif* crop that witnessed a decline in area under cultivation during FY06 (the third year in a row) (see **Figure 2.14**). This was mainly due to the disappointing prices received by farmers in the preceding two years as well as a fall (at sowing time) in availability of irrigation water.

As a result, sugarcane production witnessed a fall of 5.3 percent to 44.7 million tons during FY06, compounding the impact of the significant 11.6 percent fall in the preceding year. However, the yield of sugarcane rose by a marginal 0.9 percent in FY06 in contrast to a 2.5 percent decline in the previous year.



Maize

The maize harvest witnessed a sharp jump during FY05 and FY06 on the back of significant gains in yield. In particular, the FY06 growth in maize output accelerated due to the combined impact of a rise in area under maize crop and further improvement in yield. The farmers’ interest in maize is attributed to strong domestic demand with relatively stable prices (see **Figure 2.15**).

Minor Crops

The value-added by minor crops sub-sector rose by 1.6 percent during FY06, nonetheless lower than the 4.0 percent growth target for the year as well as 3.0 percent rise seen during FY05.

¹³ Sugarcane is a full year crop and growers cannot shift between the crops in short spell. The long-term policy decisions required to stream line the price and payment system which would be helpful to prevent any future shortages.

The higher growth in the output of fruits, vegetables, fodder crops, onion, tomato and chillies was partially offset by a decline in the production of pulses and potato during FY06 (see **Table 2.5**).

Specifically, the decline in the production of pulses during FY06 is a reflection of fall in the area under cultivation due to relatively stagnated prices in FY05, the potato crop was damaged in the Punjab due to bad weather and in parts of NWFP because of the October 2005 earthquake.

2.2.2 Livestock

The livestock sub-sector witnessed a sharp jump in the growth rate, which accelerated to 8.0 percent during FY06. This was the highest growth by this sub-sector in a decade as well as substantially higher than the 2.3 percent seen in FY05. The improvement is mainly a result of (1) higher availability of fodder following rains last year, (2) supportive policies, (3) a low base effect, particularly in poultry (4) rising trend in the prices of most of the livestock products, and (5) improved documentation of the milk production due to the greater role of formal sector marketing companies. The impact of this development is also evident in persistent increases in milk prices on the back of strong demand from the formal sector.

In fact, rising prices of milk motivated dairy farmers to put extra efforts for marketing their produce to formal companies. Government also provided support in terms of subsidized loans for livestock, chillers etc. The result of effective public-private partnership is increase in the production, reduction in wastage and thus improved income of dairy farmers. However, the focus should switch towards efforts to increase the production of milk by improving animal breeding and husbandry, to meet the growing demand.

Indeed, increase in the activities in livestock sector has important consequences for poverty reduction in the country, since a little support enables a landless farmer to generate his income stream. The growth in livestock sector is also necessary to meet the growing domestic as well external demand for the livestock products.

In terms of disaggregated data, the improvement in the livestock sector is quite broad based. All major components of the livestock sector exhibited a higher growth

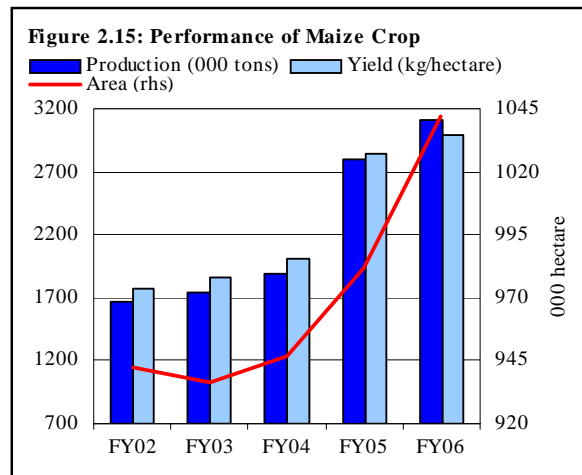


Table 2.5: Production of Minor Crops

| Crops | FY04 | FY05 | FY06 P |
|------------|--------|--------|--------|
| Potato | 1,855 | 2,025 | 1,663 |
| Onion | 1,449 | 1,853 | 2,050 |
| Tomato | 426 | 426 | 440 |
| Chillies | 96 | 90 | 121 |
| Mung | 141 | 130 | 114 |
| Masoor | 31 | 26 | 18 |
| Mash | 25 | 18 | 17 |
| Vegetables | 3,028 | 3,048 | 4,741 |
| Fruits | 5,692 | 6,637 | 7,174 |
| Fodder | 56,324 | 54,403 | 56,519 |

P: Provisional

Table 2.6: Livestock Production
percent growth

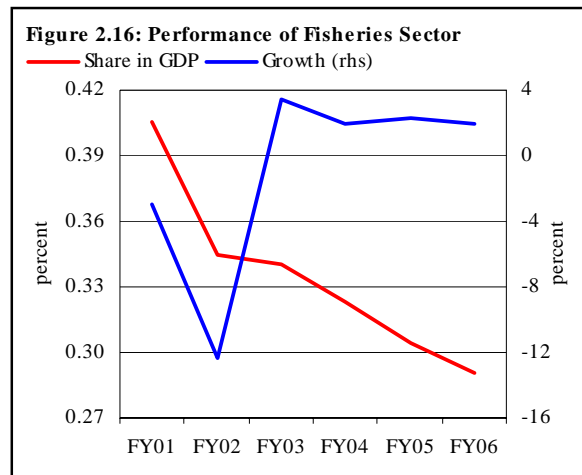
| Items | FY04 | FY05 | FY06 P |
|--------------|------|------|--------|
| Milk | 2.9 | 2.8 | 6.3 |
| Poultry meat | 2.2 | 1.6 | 20.6 |
| Wool | 0.5 | 0.3 | 1.8 |
| Hair | 4.0 | 0.0 | 12.1 |
| Hides | 2.4 | 0.0 | 8.3 |
| Skins | 5.2 | 0.5 | 6.1 |
| Fat | 2.5 | 2.6 | 5.3 |
| Blood | 2.7 | 0.0 | 8.4 |
| Bones | 2.5 | 2.5 | 5.2 |
| Eggs | 3.1 | 5.3 | 6.2 |

P: Provisional

during FY06 relative to FY05 and FY04 (see **Table 2.6**). This suggests that the role of this sector could be enhanced substantially with the efforts of the private sector and supportive public policies.

2.2.3 Fisheries

Fisheries is considered one of the important sub-sector of agriculture in terms of fulfilling domestic food requirements and earning significant foreign exchange by exporting fish and related products. However, this sub-sector is not growing in tandem with the overall economy. For example, despite a continued positive growth during last 4 years (see **Figure 2.16**), real value added by fisheries at Rs 14.2 billion during FY06 is less than Rs 15.2 billion in FY00 (down by 6.4 percent).

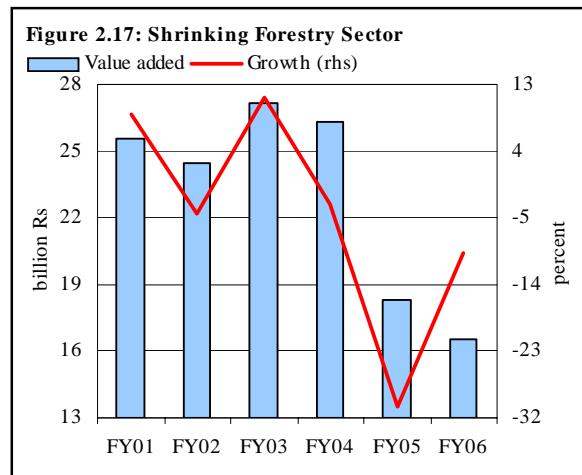


In contrast to the rapid development in the fishing sector around the globe, this sector is performing far below its potential in Pakistan, mainly due to lack of infrastructure and deficiencies in technology. Pakistan has been blessed with vast natural resources included a huge coastal range with massive fish and other sea stuff and a range of farm fishing potential along with Indus river banks. In addition, opportunities are also available at natural and man-made water reservoirs in some parts of Punjab, NWFP, Sindh and Balochistan. A campaign to improve awareness, together with appropriate extension services and investment could help to enhance the quantity and quality of fish and related products.

2.2.4 Forestry

Similar to fisheries, the role of the forestry sector is also shrinking in the overall economy. As a result, forestry sub-sector witnessed fall in the value added by 9.7 percent and 30.4 percent during FY05 and FY06 respectively (see **Figure 2.17**).

Concrete efforts are required to increase the forest area, which presently accounts for only 5 percent of the total land. Increased forestation would not only supply inputs to various industries (e.g. construction, paper & board etc.), it will also improve the environment of the country.



2.2.5 Agriculture Credit

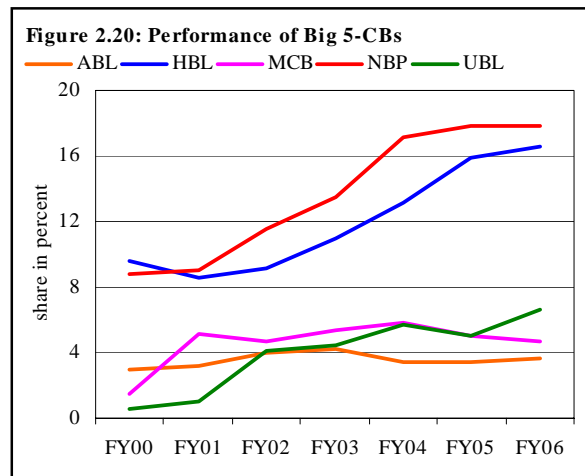
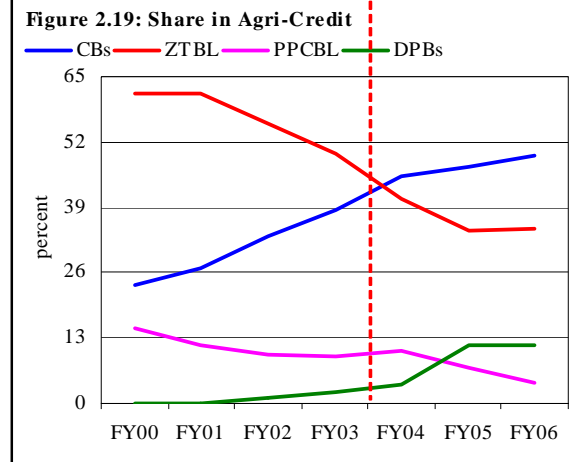
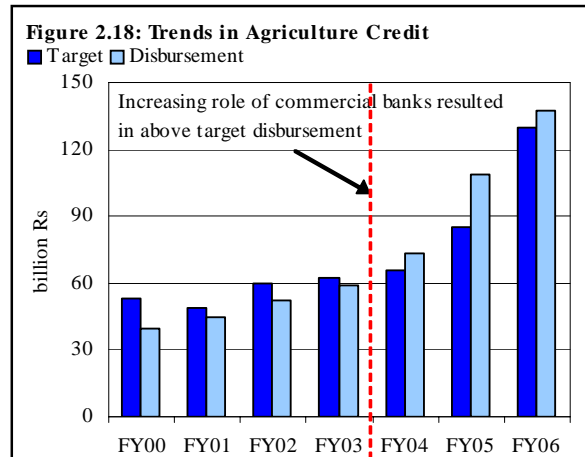
The growth momentum in agriculture credit disbursement remained strong in FY06 although it appeared to be weaker than in the preceding year. Specifically, disbursement to agriculture witnessed a remarkable increase of 26.6 percent during FY06 which is lower than the 48.0 percent rise seen in FY05, but is significantly higher than the annual growth target of 19.7 percent for FY06 (see **Figure 2.18-19**). The deceleration is evident in both production and development related agri-credit, but it is more pronounced in the case of latter. Disaggregated data reveals that while growth in disbursement decelerated by the specialized banks, commercial banks' disbursement accelerated during FY06.

It is important also to note that the number of borrowers in agriculture sector fell significantly in FY06, mainly due to rising interest rates amidst monetary tightening through the year. In particular, as a consequence of rising interest rates, small farmers may have relied more on their own resources on the back of increased farm income in the preceding years or postponed their development plans for the time being.

In terms of institution-wise performance, all major players in agri-credit market improved their shares at the cost of PPCBL during FY06 (see **Figure 2.20**). In particular, the commercial banks improved their market share by 2.2 percentage points during FY06, followed by DPBs (0.3 percentage points) and ZTBL (0.2 percentage points).

A glance at **Figure 2.20** reveals that both, the big five commercial banks and domestic private banks, are gradually increasing their presence in the agriculture credit market. This is very encouraging as increased competition would not only improve the farmers' access to institutional credit, it would also force the institutions to introduce innovative and attractive financial products. Consequently, the depth of the agri-credit market would increase further. It is also interesting to note that role of the both, the big five commercial banks and domestic private banks increased significantly since FY04, this resulted in above target disbursement for the last three successive years compared with a below-target disbursements earlier.

Within the big five commercial banks, NBP and HBL remained the market leaders with more than one-third (almost equivalent to ZTBL) share of the overall agri-credit market (see **Figure 2.21**). While the share of ABL and MCB in this growing market segment stagnated, UBL is gradually increasing its outreach. Given the continued expansion in agri-credit market, it is important for all financial institutions to participate actively in this market as it offers relatively higher returns and provides an opportunity to diversify their asset portfolio.



Purpose-wise Credit

Bank credit to the agriculture sector comprises of production loans (short-term) and development loans (long-term). Production loans are given for the purchase of inputs like seeds, fertilizer and pesticides and development loans are provided for the purchase of tractors, tube-wells and other farm related equipments. Generally, the distribution of credit to the agriculture sector has remained concentrated towards production loans (see **Table 2.7**).

This is also evident from the recent credit data as the share of production loans further increased by 3.0 percentage points to 85 percent during FY06. The decline in the share of development loans is largely attributed to fall in the purchase of tractors and tube-wells¹⁴ mainly on account of relatively higher interest rates during FY06.

Interestingly, the growth in development loans accelerated in the case of commercial banks during FY06. In sharp contrast, specialized banks and DPBs witnessed a reversal, from a significant positive growth to a decline in the disbursements for developmental loans during this period. In the case of production related loans, all banking groups saw a deceleration in loan growth during FY06. However, the seasonal pattern remained unchanged from FY05, with the bulk of disbursements being concentrated in the sowing periods for the wheat and cotton crops (see **Figure 2.22**).

In terms of farm and non-farm sector credit distribution, the farm sector received a dominant share of 84.0 percent in total agri-credit during FY06, a little lower than the 86.0 percent in FY05 (see **Figure 2.23**). The decline in the share of farm sector in agri-credit is a reflection of (1) fall in development related farm loans as well as (2) higher credit extension under specialized credit schemes for non-farm sector. In particular, disbursements to dairy farmers witnessed a substantial rise of 121.6 percent (YoY) during FY06 as a result of introduction of specialized credit schemes and priority to this important sub-sector. Moreover, newly emerging sector

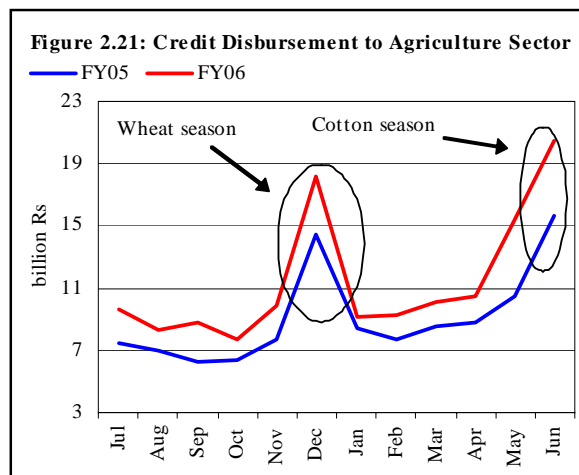
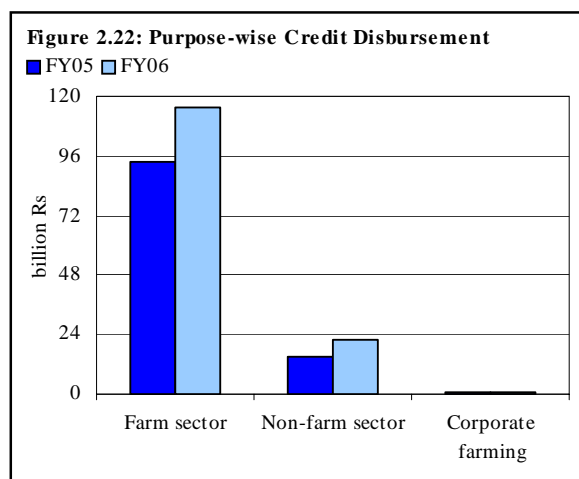


Table 2.7: Purpose-wise Credit Disbursement
percent

| | FY05 | | FY06 | |
|--------------|---------------------|-------|-------|-------|
| | Prod. | Devl. | Prod. | Devl. |
| | <i>Growth rates</i> | | | |
| 5 Big banks* | 57.8 | 39.7 | 30.6 | 41.1 |
| ZTBL | 27.4 | 14.1 | 37.0 | -22.7 |
| PPCBL | -7.2 | 35.0 | -15.1 | -45.4 |
| DPBs | 538.2 | 129.9 | 40.7 | -11.9 |
| Total | 50.7 | 37.1 | 31.0 | 5.7 |
| | <i>Shares</i> | | | |
| 5 Big banks* | 47.6 | 45.5 | 47.4 | 60.8 |
| ZTBL | 35.1 | 31.1 | 36.7 | 22.8 |
| PPCBL | 6.4 | 9.6 | 4.2 | 4.9 |
| DPBs | 10.9 | 13.8 | 11.7 | 11.5 |

* NBP, MCB, ABL, HBL and UBL



¹⁴ Tractor financing declined by 13.5 percent (YoY) and loans for tubewells fell by 12.1 percent (YoY) in FY06.

of corporate farming also registered an increase of 23.4 percent during FY06.

Number of Borrowers

The number of institutional borrowers fell by 3.8 percent to 1.1 million in FY06 as against a decline of 0.7 percent in the preceding year. In particular, this was evident in all categories of institutional borrowers during FY06 (see **Figure 2.24**).

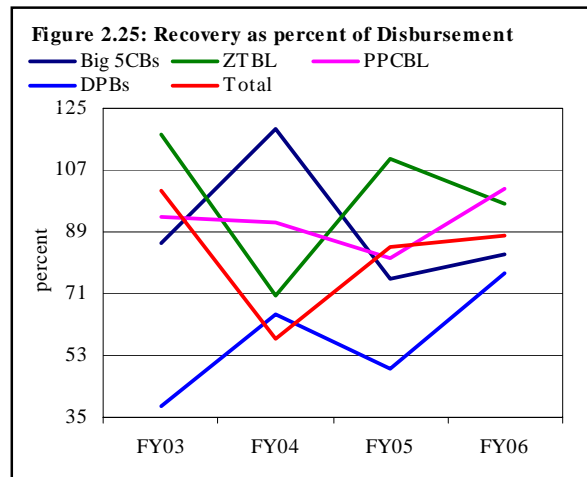
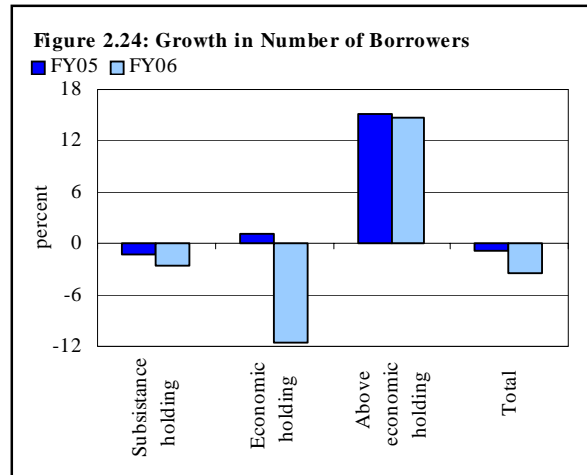
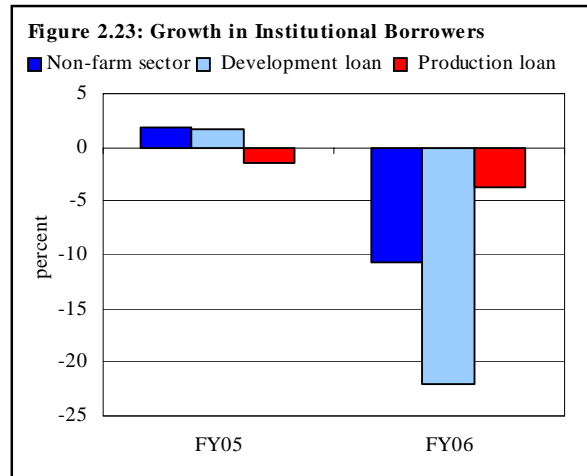
Specifically, in the category of production loans borrowers, a decline was registered in the number of borrowers for crops (-3.8 percent) vegetable (-0.9 percent) and others (-87.8 percent) during FY06. The fall in the number of development loan borrowers was mainly due to lower number of borrowers for tractors (-17.1 percent), storage (-55.1 percent), machinery (-39.5 percent) and tube-well (-30.4 percent) during this period. Surprisingly, despite a significant growth in the amount disbursed, the number of borrowers in non-farm sector declined by 10.6 percent during FY06. The major declines in the number of borrowers witnessed under livestock (-17.3 percent), dairy (-12.4 percent) and poultry (-9.9 percent) in FY06.

The fall in the number of borrowers, and rise in the amount disbursed, implies that the average size of the loans is increasing. One possible explanation is that small farmers may have been discouraged by rising cost of credit.

Credit by Land Holding

Despite decline in the number of borrowers since FY04 the land holding-wise farm sector disbursement patterns showed that a major portion of credit is being availed by subsistence holding farmers (67.4 percent), followed by economic holding farmers (10.6 percent) and above economic holding (9.3 percent) during FY06.

The growth of farm sector credit disbursement decelerated to 24.6 percent in FY06 compared to 45.3 percent increase seen last year. The major decline was reported by the *subsistence holding farms*, which fell by 23.2 percentage points, followed by a reduction of 15.4 percentage points in *economic holding* and 17.6 percentage points decrease in *above economic holding* during FY06 over FY05. Though, number of borrowers from the *above economic holding* witnessed a continued robust



growth, it was more than offset by the fall in number of borrower under *subsistence and economic holdings* (see **Figure 2.25**).

Similarly, while number of borrowers increased in the case of large farms during FY06, fewer small farm holders availed financing facilities during this period (see **Table 2.8**). As a result, the share of non-farm credit which was equally distributed between these two groups in FY04, tilted more towards large farm holders by FY06. Credit to large farms is also beneficial in terms of higher chances of applications of modern techniques and technology, however, flow of credit towards small farms is equally important to create employment opportunities, poverty reduction and to eliminate the causes of market failure.

Table 2.8: Non-Farm Sector Credit Disbursement

| Years | Number of borrowers | | | Credit disbursement | | |
|-------|---------------------|------------|-------|---------------------|------------|-------|
| | Small farm | Large farm | Total | Small farm | Large farm | Total |
| | Growth (%) | | | | | |
| FY05 | 26.3 | 259.9 | 27.8 | 59.2 | 55.2 | 57.2 |
| FY06 | -11.5 | 34.3 | -10.6 | 26.1 | 63.3 | 44.5 |
| | Share (%) | | | | | |
| FY04 | 99.4 | 0.6 | | 50.0 | 50.0 | |
| FY05 | 98.2 | 1.8 | | 50.7 | 49.3 | |
| FY06 | 97.3 | 2.7 | | 44.2 | 55.8 | |

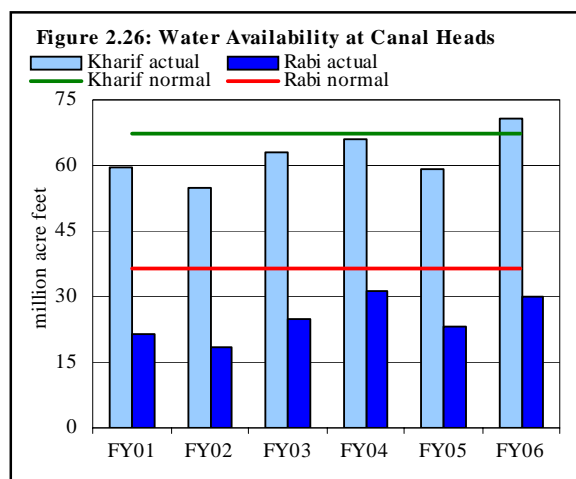
Credit Recovery

The growth rate of credit recovery also decelerated to 30.9 percent in FY06 compared to 36.7 percent in FY05. However, as a result of stronger growth of recoveries relative to disbursements, the credit recovery rate as a percentage of disbursements improved to 87.7 percent during FY06 compared with 84.7 percent in FY05. A decline in the recovery rate by ZTBL from 110.1 percent in FY05 to 97.2 percent in FY06 partially offset the gains in the recovery rates by other institutions (see **Figure 2.26**). As a consequence of better recovery, growth in the amount of credit outstanding slowed to 14.4 percent in FY06 compared with a rise of 22.4 percent seen in FY05.

The enhanced repayment of credit by the farmers is an encouraging sign for the banking sector as this can enhance their confidence to increase lending to the agriculture sector. The situation will further improve if banks should provide a buffer period of three months for credit repayment, to enable farmers to acquire full benefits of prices¹⁵, especially in case of wheat and rice crops.

2.2.6 Irrigation Water

The availability of irrigation water significantly improved during FY06 on the back of a better monsoon and winter rains, which enhanced the under ground and surface water levels.



¹⁵ The prices of most crops fall in the harvesting period, which begin to move up after 2-3 months after harvesting. The enhanced holding capacity of these commodities may provide gains to the growers, especially to the small farmers whose repayment/holding capacity is limited.

As a result, water availability at canal head rose by 22.6 percent to 100.8 MAF during FY06, the highest level in the last six years (see **Figure 2.27**). In particular, water availability in *kharif* FY06 increased by 19.7 percent in contrast to a fall of 10.3 percent in the corresponding *kharif* season of FY05. Encouragingly, the *kharif* FY06 water availability was also 3.7 MAF over and above the normal *kharif* levels. In addition, water availability at canal head in *rabi* FY06 season posted a strong 29.9 percent growth to 30.1 MAF, however water availability during *rabi* FY06 remained below normal level. Nonetheless, the improved water availability also helped to increase the water distribution among the provinces during FY06 seasons (see **Table 2.9**).

The monsoon rains in Jul-Sept 2005, although below normal levels, were significantly better than in the corresponding season of FY05 (see **Figure 2.28**). Similarly, the winter rains during Jan-Feb 2006 were also higher than seen in the corresponding period last year. Further, rains during March- June 2006 were above normal levels, which helped improve the overall water availability in the country relative to the preceding year.

Despite a relative ease in FY06 due to increased rains, water management is still an important issue in the national economy. The rising cropping density, lower snowfall and rains in the recent past, increased the reservoir requirements in the country. Moreover, other than irrigation needs, building new dams needs to be a key national priority in view of rapidly growing demand for electricity (especially given the volatile international oil prices). In this backdrop, the government has started a long-term strategy to raise the old dams and build new small and medium reservoirs in years ahead to fulfill the future water and energy requirements of the country.

2.2.7 Other Inputs

Seeds

The sowing of better seeds is a vital segment of crop technology for the achievement of higher production. The PARC scientists are of the view that the use of improved seed could increase yield by 20 percent.

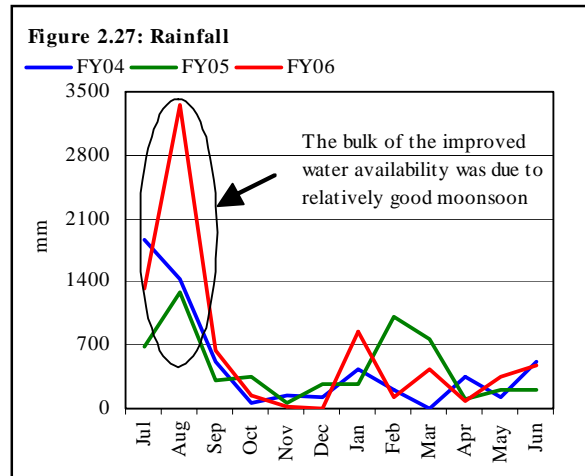
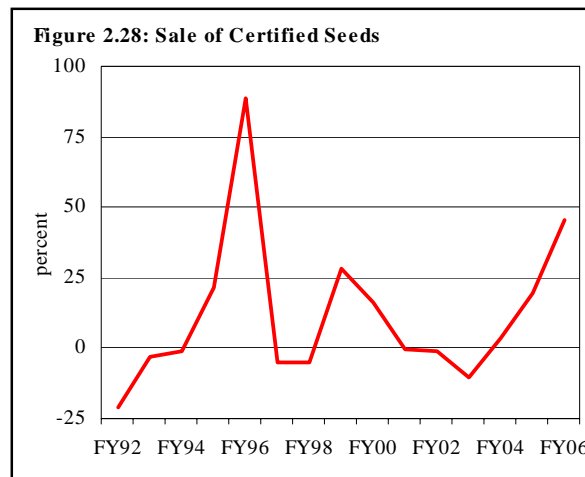


Table 2.9: Province-wise Irrigation Water Distribution

| million acre feet | | | | | | |
|-------------------|-------|--------|-------|-------|-----------|-------|
| Season | Years | Punjab | Sindh | NWFP | B'chistan | Total |
| Kharif | 2004 | 30.33 | 25.65 | 0.96 | 2.18 | 59.1 |
| | 2005 | 36.43 | 31.18 | 0.99 | 2.16 | 70.8 |
| Rabi | 2004 | 11.54 | 10.41 | 0.48 | 0.72 | 23.2 |
| | 2005 | 16.40 | 12.13 | 0.64 | 0.89 | 30.1 |
| percent growth | | | | | | |
| Kharif | FY05 | 20.11 | 21.56 | 3.13 | -0.92 | 19.69 |
| Rabi | FY06 | 42.11 | 16.52 | 33.33 | 23.61 | 29.85 |



Despite a moderate progress in improving seed technology, current seed industry is unable to meet the rising demand for certified seed.¹⁶

Nonetheless, the sale of certified seed increased sharply by 45.5 percent in FY06 compared to 19.6 percent during FY05 (see **Figure 2.29**). Significant improvement was witnessed in the sale of certified seed for wheat (55.9 percent), maize (28.3 percent), cotton (19.6 percent) and rice (11.8 percent) during FY06. However, declines were reported in the sale of certified seed for gram and oilseed (see **Table 2.10**).

There is a significant shortage in the supply of certified seeds for almost all major crops (see **Table 2.11**). Thus, given the significant gains that could potentially be realized by using improved seed, it is necessary to fill the gap between demand and supply urgently.

Fertilizers

Despite a rise in farm income, and credit availability, growth in the fertilizer off-take decelerated to 7.0 percent in FY06 compared with 10.4 percent rise in FY05. This was mainly due to higher prices of fertilizer.

The growth in urea off-take decelerated to 7.3 percent during FY06 from 8.1 percent rise seen last year. The major reason behind slower off-take of urea is an average increase of Rs 42 per 50kg bag (8.8 percent) in the prices during FY06 over last year. It may be noted that though the seasonal pattern of urea off-take during FY05 and FY06 remained the same, urea off-take during the FY06 wheat season was lower mainly due to a decline in area under cultivation. In contrast, urea off-take during FY06 cotton season was higher despite a decline in area under the crop. A double digit increase in the prices of urea at the time of wheat season and a visible deceleration at the time of cotton season largely explains the difference in the farmers' attitude in these two seasons (see **Figures 2.30** and **Figure 2.31**).

¹⁶ Pakistan Agricultural Research Council.

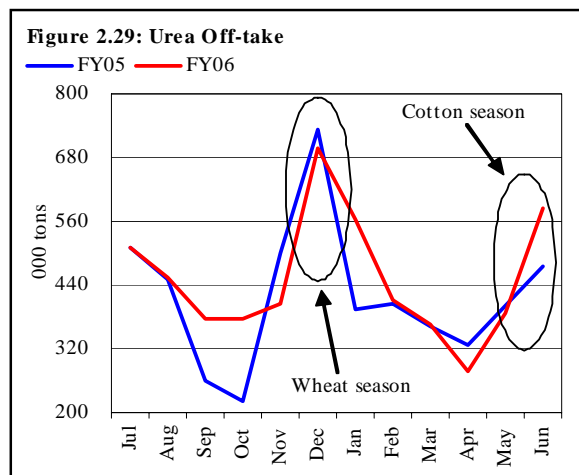


Table 2.10: Certified Seed Distribution

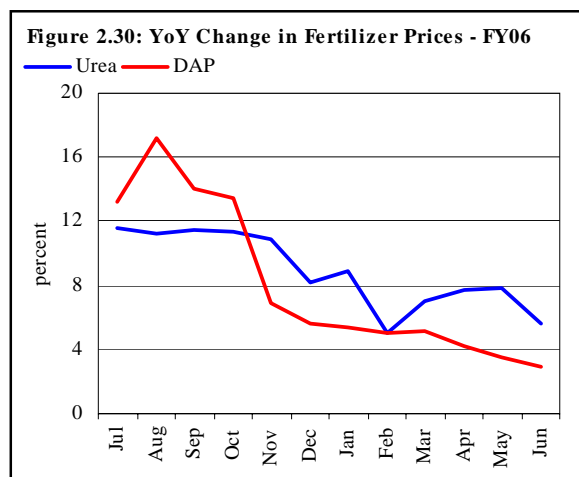
| Crops | FY05 | FY06 | YoY change (%) |
|----------|-------|-------|----------------|
| Wheat | 171.2 | 266.9 | 55.9 |
| Cotton | 24.5 | 29.3 | 19.6 |
| Rice | 6.8 | 7.6 | 11.8 |
| Maize | 5.3 | 6.8 | 28.3 |
| Gram | 0.57 | 0.29 | -49.1 |
| Oilseeds | 1.78 | 0.25 | -86.0 |

Source: Federal Seed Certification and Registration Department

Table 2.11: Availability of Certified Seed in FY06^E

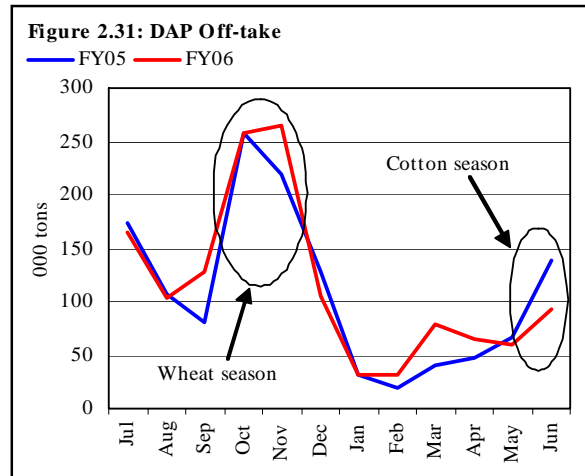
| Crop | Area sown (000 ha) | Av. seed rate (kg/ha) | Seed requirement (000 tons) | Supply of certified seed (000 tons) | Certified seed gap (%) |
|----------|--------------------|-----------------------|-----------------------------|-------------------------------------|------------------------|
| Wheat | 8307 | 124.0 | 1030.1 | 266.9 | 74.1 |
| Rice | 2621 | 10.0 | 26.2 | 7.6 | 71.0 |
| Maize | 1030 | 14.0 | 14.4 | 6.8 | 52.8 |
| Cotton | 3100 | 25.0 | 77.5 | 29.3 | 62.2 |
| Gram | 1066 | 22.0 | 23.5 | 0.3 | 98.7 |
| Oilseeds | 564 | 6.2 | 3.5 | 0.3 | 92.9 |

E: Estimated



Similar to urea, the growth in DAP off-take also decelerated to 5.8 percent during FY06 compared with a strong growth of 20.4 percent in FY05. The deceleration in DAP off-take is a result of a continued rise in the prices, which rose by 7.9 percent (or Rs 70 per 50kg) during FY06 over the prices of the previous year.

As the limited domestic production is inadequate to meet the growing demand, DAP is mainly imported. Thus, a rise in the domestic prices of DAP is mainly a function of a persistent increase in the international prices of DAP on the back of higher energy cost during FY05 and FY06.



Similarly, the country needed to import urea as domestic industry continued to face capacity constraints. As a result, the share of imports in total availability of fertilizer nutrient increased from 22.4 percent in FY05 to 25.8 percent in FY06. This suggests that a new fertilizer policy is needed which could attract fresh investment in this important sector.

2.3 Industry

The provisional numbers for FY06 indicate that industrial growth¹⁷ stood at 5.9 percent YoY, substantially lower than the 11.4 percent YoY growth recorded during the preceding year. As in the previous year, most of the sub-sectors of industry witnessed a deceleration in growth, but the deceleration in FY06 was much sharper (see **Table 2.12**).

However, the industrial growth estimate based on full year data is expected to be a little higher than the provisional number. In particular, available information suggests that the growth in large-scale manufacturing (LSM), which contributes about half of industrial value-addition, could reach 10.7 percent. While this would still be lower than the 13.0 percent annual growth target for the year, it would nonetheless significantly boost overall real GDP growth, bringing it very close to the 7.0 percent annual target.

Construction

Growth in the construction sector dropped sharply to 9.2 percent in FY06, compared to the record 18.0 percent growth seen in FY05, but the FY06 growth was nonetheless substantially higher than the growth rates recorded in the preceding 15 years (see **Figure 2.32**). This strong growth probably reflects a number of developments, including the impact of the boom in the real estate market, availability of housing finance, higher development expenditures by the government and greater foreign direct investment (FDI) in the sector.

As shown in **Table 2.13**, the reported growth of the construction sub-sector is clearly reflected in allied industry indicators. While the growth has strengthened in some cases, in others the growth has slowed (but not very significantly). Only the domestic steel production saw a considerable fall in

Table 2.12: Growth of Industrial Value Added
percent at constant factor cost of 1999-2000

| | FY03 | FY04 | FY05 | FY06 ¹ |
|-------------------------|------------|-------------|-------------|-------------------|
| Manufacturing | 6.9 | 14.0 | 12.6 | 8.6 |
| Large-scale | 7.2 | 18.1 | 15.6 | 9.0 |
| Small & household | 7.5 | 7.5 | 7.5 | 9.3 |
| Slaughtering | 2.9 | 2.4 | 2.4 | 2.4 |
| Mining & quarrying | 6.6 | 15.6 | 9.6 | 3.8 |
| Construction | 4.0 | -10.7 | 18.6 | 9.2 |
| Electricity & gas dist. | -11.7 | 56.8 | 3.5 | -8.4 |
| Industry | 4.2 | 16.3 | 11.4 | 5.9 |

Source: Economic Survey 2005-06; ¹ Data up to Jul-Mar FY06

Figure 2.32: Growth in Construction

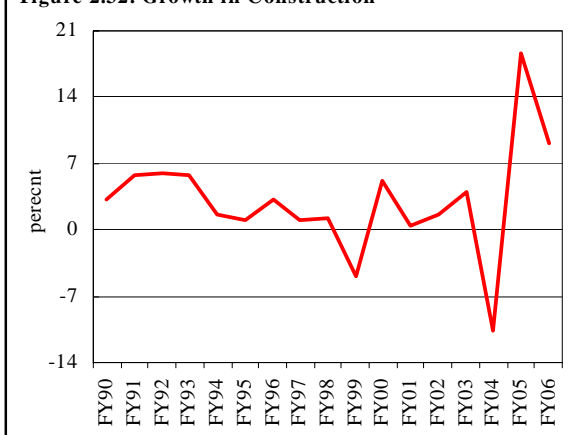


Table 2.13: Construction -Performance Indicators

| | Unit | FY04 | FY05 | FY06 |
|---|----------------|--------|--------|--------|
| Value added by construction industry | billion rupees | 82.8 | 98.2 | 107.2 |
| Development expenditures | -do- | 160.5 | 227.7 | 365.0 |
| Gross fixed investment | -do- | 7.9 | 13.2 | 14.0 |
| Private credit for construction | -do- | 18.3 | 31.4 | 42.3 |
| Foreign direct investment * | million US\$ | 35.4 | 58.7 | 136.0 |
| Production of steel (Pak Steel) | 000 tons | 1,030 | 979 | 685 |
| Import of iron & steel | 000 tons | 1,810 | 2,851 | 3,962 |
| Import of construction & mining machinery | million rupees | 5,845 | 8,340 | 11,144 |
| Cement dispatches | 000 tons | 13,663 | 16,353 | 18,412 |

* It includes the FDI in construction, cement, metal, basic metal and ceramics groups.

¹⁷ Based on the data upto March 2006

FY06 but that was due to technical problems in the country's major steel producer, Pakistan Steel. Indeed, as demand for iron & steel remained strong, 295 thousand tons YoY fall in the production of Pakistan Steel was offset by high imports of iron & steel (these rose by 340 thousand tons during FY06).

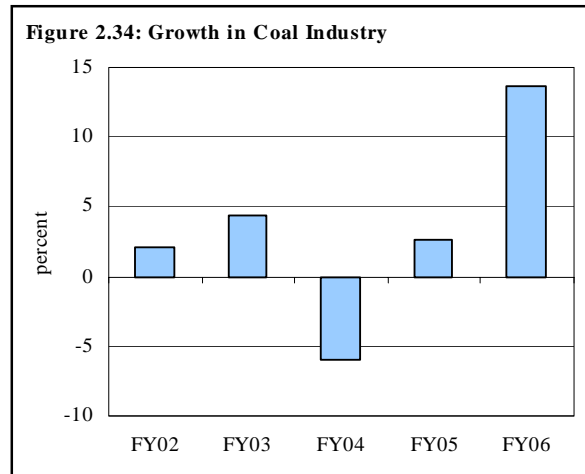
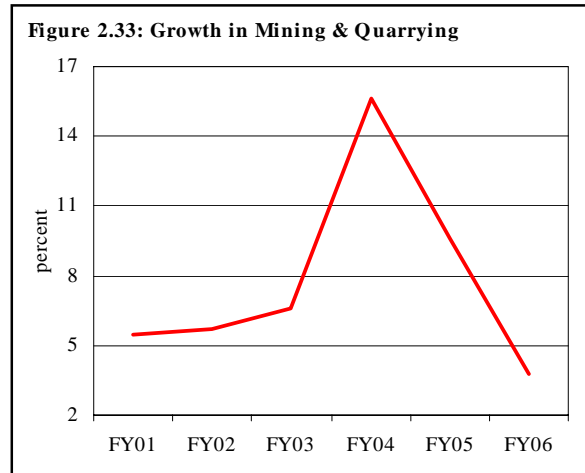
Box 2.3: Government's Supportive Measures for Construction Industry during FY06

- Inclusion of cement in the positive list of importable items from India.
- Import of cement and clinker from India without duty and taxes with immediate effect.
- Private and public sector entities including ERRA are now permitted to import cement from India for reconstruction needs in Azad Kashmir and the NWFP.
- Rupees 60 per bag discount on freight rates from India to Pakistan.
- 30 per cent reduction in railway freight for cement import.
- Withdrawal of rebate of Federal Excise Duty (FED) and refund/adjustment of sales tax on the export of cement via land, air or sea routes.
- Import of iron sheets from India has been allowed, up to September this year, via land route as well, for exclusive use in the reconstruction of earthquake-affected areas.
- The government has temporarily banned cement exports in April 2006 to stabilize domestic prices of cement.

The activities in construction industry have spillovers (directly) on employment generation as well as (indirectly) on construction related industries, and on employment (particularly in relatively low-to-medium skill segments). Recognizing the potentially large impact of this sector on growth and income distribution, the government has taken many steps to stabilize the prices of key inputs to the industry (cement, iron & steel etc.) (see **Box 2.3**).

Mining and Quarrying

The *mining & quarrying* sector witnessed an increase of 3.8 percent¹⁸ YoY in value addition during FY06, which is not only significantly lower than 9.6 percent growth recorded in FY05 but also lower than the 5.2 percent FY06 growth target (see **Figure 2.33**). The moderate FY06 growth in this industrial sub-sector was mainly contributed by the acceleration in the production of coal as well as inputs for construction, such as marble and salica sand. The impact of the strong production growth in these was partially offset by declines in the production of crude oil, chromites, dolomite and sulphur.

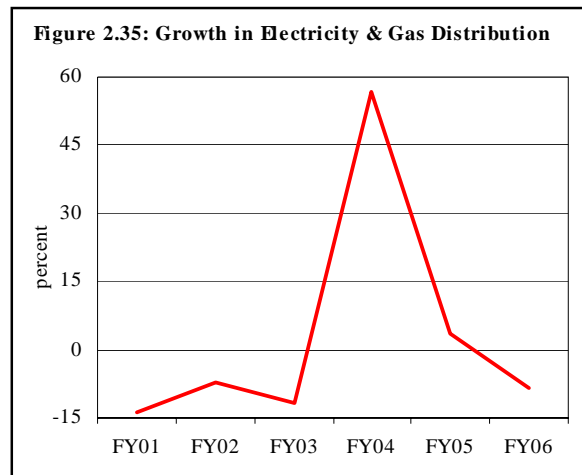


Within the *mining & quarrying* sub-sector, the coal industry recorded 13.7 percent growth in FY06 as against a 2.6 percent growth in last year. The growth of FY06 is the highest during the last five years

¹⁸ The estimated data for full fiscal year FY06 for mining and quarrying sector show the 4.2 percent growth for FY06 as compared with 3.8 percent growth based on Jul-Mar FY06.

(see **Figure 2.34**). The rise in the production of coal was mainly due to high demand by cement producers and the initiation of the production of Ferroalloys¹⁹ in Karachi, using a mixture of local as well as imported coal for energy. The rise in coal demand from the cement sector, reflected declining prices of coal in the domestic markets and rising prices of alternative energy sources, most of the cement plants used coal for firing system following a 15.5 percent upward adjustment in the gas prices for commercial consumers.

As with coal, the marble industry registered a remarkable 35.5 percent growth in FY06 even over a high 30.9 percent growth in FY05. This continued strong growth was mainly due to strong domestic demand from construction sector as well as a rise in exports. The growth in the marble industry is important, as it would generate employment opportunities in Balochistan and NWFP,²⁰ where most of the processing units are installed.



Electricity and Gas Distribution

This was the only sub-group of industry to record negative growth during FY06, with value addition declining by 8.4 percent, in contrast to the 3.5 percent rise registered in the preceding year (see **Figure 2.35**). This fall was partly because the increased cost of electricity generation due to higher prices of oil and gas reduced the profitability of the power utilities WAPDA and KESC during FY06. Moreover, losses incurred by the gas distribution companies amidst unrest in Balochistan also offset the impact of expansion in the distribution network of these companies during FY06.

Specifically, the two public sector gas utilities Sui Southern Gas Company (SSGC) and Sui Northern Gas Pipelines Limited (SNGPL) continued to see an increase in their commercial, domestic and industrial consumers during FY06 (see **Table 2.14**). Moreover, the use of the relatively cheap and environment friendly compressed natural gas (CNG) in cars accelerated in FY06. In fact, more than one million cars shifted to the use of CNG in FY06 and more than 80.0 percent new assembled cars had company fitted CNG. Not surprisingly, as seen in **Table 2.14** by 30th June 2006 the number of CNG filling stations rose to 969, with the addition of 175 gas stations in FY06 alone. It may be noted that on average 60.0 percent CNG filling station are located in seven major cities (Karachi, Lahore, Islamabad, Peshawar, Rawalpindi, Faisalabad and Gujranwala), with more than 80.0 percent transport load on the road. Production of gas also increased in FY06, rising 4.1 percent YoY compared with 11.8 percent in FY05.

Unfortunately, despite the increasing demand, expanded network and rising production, *gas distribution* fell to 874.7 billion cubic feet (0.9 percent YoY) in FY06. This reflects the impact of rise in the gas charges as well as the attacks on major pipelines that severely curtailed supplies to various parts of the country for considerable periods.

¹⁹ The first plant in Pakistan to commercially produce 'Ferroalloys' using 100 percent local raw materials and captive electric power generated from mixture of domestic and imported coal. This plant has started production in the Dhabeji Industrial Estate and would cater to the needs of Pakistan Steel and other steel manufacturing units. Until now, all quantities of Ferroalloys used in the steel industry for degassing and alloying purposes had to be imported. The production of the two products locally would save the country's substantial sum in foreign exchange.

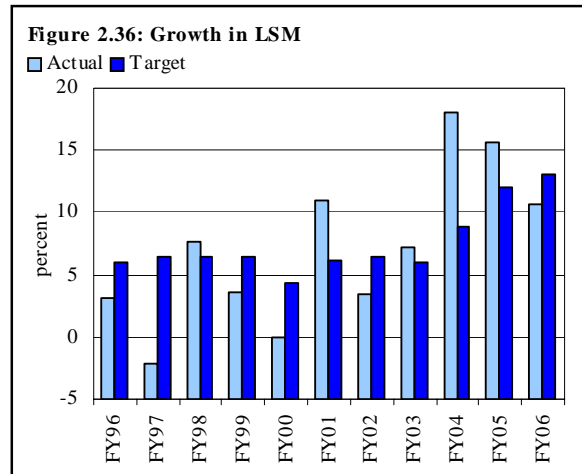
²⁰ Pakistan Economic Survey 2005-06.

Table 2.14: Gas Distribution

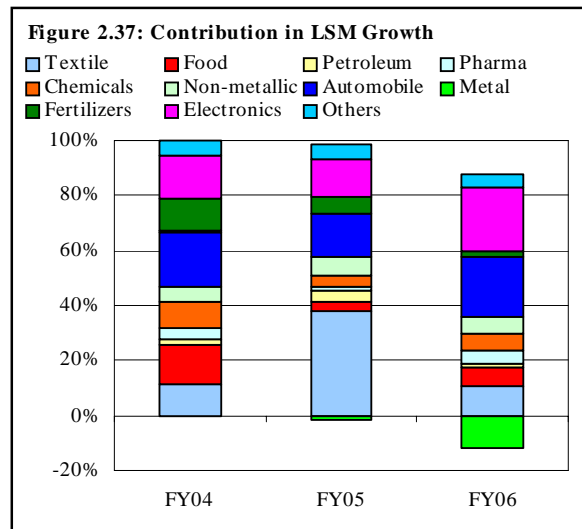
| number | FY04 | FY05 | FY06 | FY04 | FY05 | FY06 | Total as on 30 th June 2006 | |
|---|------------------|------------------|------------------|---------------------------------------|------------|------------|--|------------|
| <i>By major companies</i> | | | | <i>By CNG station in major cities</i> | | | | |
| <i>Sui Northern Gas Pipelines Limited (Punjab & NWFP)</i> | | | | Faisalabad | 4 | 14 | 7 | 37 |
| Industrial Consumers | 2,881 | 3,271 | 3,773 | Gujranwala | 7 | 7 | 11 | 38 |
| Commercial Consumers | 38,842 | 41,358 | 43,919 | Islamabad | 7 | 3 | 4 | 34 |
| Domestic Consumers | 2,263,875 | 2,516,795 | 2,641,274 | Karachi | 26 | 26 | 17 | 144 |
| <i>Sui Southern Gas Company Limited (Sindh & Baluchistan)</i> | | | | Lahore | 21 | 24 | 28 | 141 |
| Industrial Consumers | 2,638 | 2,812 | 2,978 | Peshawar | 20 | 10 | 2 | 65 |
| Commercial Consumers | 18,152 | 19,194 | 19,938 | Rawalpindi | 25 | 34 | 32 | 159 |
| Domestic Consumers | 1,713,153 | 1,772,256 | 1,837,450 | Others | 78 | 83 | 80 | 351 |
| Total | 4,039,541 | 4,355,686 | 4,549,332 | Total | 188 | 203 | 175 | 969 |

Large Scale Manufacturing (LSM)

The growth in large-scale manufacturing remained below the annual target during FY06, for the first time during the last four years (see **Figure 2.36**). The 13.0 percent target for FY06 was already lower than the 15.6 percent growth recorded in FY05 in recognition of: (1) the capacity constraints facing by some industries; (2) the impact of an expected rise in international oil prices, and; (3) continued monetary tightening. In fact, FY06 growth targets for a number of industries, having an aggregate weight of 41.5 percent in total LSM, were either negative or zero (see **Table 2.15, Figure 2.37**).



Unfortunately, the rise in oil prices proved to be higher than anticipated, negatively impacting the growth in value-addition by the petroleum industry, while growth in two other key industries, textiles and sugar, was badly hit by relatively poor cotton and sugarcane harvests respectively. Given that these three sub-groups account for 50.1 percent of LSM, and that these performed well below expectations, the deceleration in LSM growth to 10.7 percent YoY in FY06 is not surprising.



In fact, it was better-than-anticipated performance of some of the smaller sectors that offset part of the drag from the poor performance of the sugar, textiles and petroleum product industries. These

industries included the *food, beverage & tobacco* sub-sector industries (excluding sugar), *electronics, automobiles* and the *leather, paper and board, chemicals* and engineering industries.

Table 2.15: Growth Performance of Selected Industrial Items

| percent | | | | | | | | |
|------------------------|--------|--------|------------------------|--------|--------|-------------------------|--------|--------|
| Items | Target | Actual | Items | Target | Actual | Items | Target | Actual |
| Cotton yarn | -1.0 | 11.7 | Paints & varnishes (s) | 20.9 | 14.1 | Nitrogenous fertilizers | -5.8 | 4.2 |
| Cotton cloth | 22.3 | 0.6 | Soda ash | -4.3 | 7.2 | Electric transformers | 32.4 | 21.0 |
| Jute goods | -17.6 | 0.6 | Cement | 6.7 | 13.0 | Refrigerators | 23.8 | 9.8 |
| Vegetable ghee | 7.1 | 9.4 | Jeeps & cars | 7.1 | 27.1 | T.V. sets | 0.2 | 6.3 |
| Sugar | -3.2 | -5.0 | Tractors | -1.4 | 13.0 | Electric meters | -20.6 | 56.5 |
| Cigarettes | 7.9 | 5.0 | L.C.V.s | 11.6 | 25.3 | Air conditioners | 85.3 | 99.8 |
| Cooking oil | 32.2 | 13.4 | Buses | 3.8 | -53.2 | Electric motors | -28.2 | -4.8 |
| Tea | -2.5 | 5.1 | Trucks | -15.3 | 41.0 | Paper & board | -3.2 | 13.2 |
| Petroleum products | 5.7 | 2.2 | Pig iron | 1.8 | -30.7 | Bicycles | 0.7 | -0.1 |
| Liquid/syrups | -20.3 | 12.0 | Coke | -1.8 | -76.8 | Power looms | 0.0 | -15.1 |
| Ointments | 0.0 | 7.4 | Billets | -3.3 | 29.2 | Shuttles & bobbins | 0.0 | 24.4 |
| Caustic soda | 6.1 | 6.1 | H.r sheets/strips | -3.0 | 12.6 | Motors tyres | 0.7 | 11.8 |
| Paints & varnishes (L) | -26.6 | 13.5 | Phosphatic fertilizers | 30.4 | 5.5 | Motors tubes | -2.4 | 14.1 |

Source: Annual Development Plan 2005-06

For example, within the food sector, *tea blended* is the only industry that observed an acceleration in growth during the current fiscal year, with production rising by 5.1 percent as compared with 2.1 percent growth in FY05. The reduction in duty on tea import is probably the main factor for the growth in tea industry despite the rise in international tea prices during FY06. The reduction in the import duty on tea was probably an important factor in discouraging smuggling, thereby helping the growth of the formal sector.

The *cooking oil* and *vegetable ghee* industries (with a 39 percent share in the food group) also registered reasonable growth rates of 13.4 percent and 9.4 percent respectively during FY06 even over the high growths of 19.1 percent and 18.0 percent respectively in FY05. The main reasons for sustained performance by these two industries included (1) increased exports to Afghanistan²¹ (2) high domestic prices amidst relatively subdued international prices of edible oil and (3) supportive measures taken by the government for *vegetable ghee* and *cooking oil* sub-sector.²²

The strongest performance in the food group, however, was by the *beverages* industry. Although the growth decelerated in FY06, it was nonetheless quite strong at 34.5 percent compared with 37.0 percent growth in FY05. This robust increase in production was underpinned by continuing strong demand, and a consequent increase in the pricing power of the industry. Indeed, average prices of beverages saw an increase of 14.2 percent on YoY during FY06. In addition to the strong demand, the rise in the production figures probably also included (1) improvement in reporting of production data, and (2) a shrinking role of the small informal sector producers (mainly due to their inability to compete amidst increasing prices of inputs such as sugar).²³

²¹ During Jul-Mar FY06 the export of ghee up by a substantial 195.5 percent over the same period of last year based on the latest commodity wise data of trade is available for Jul-Mar FY06.

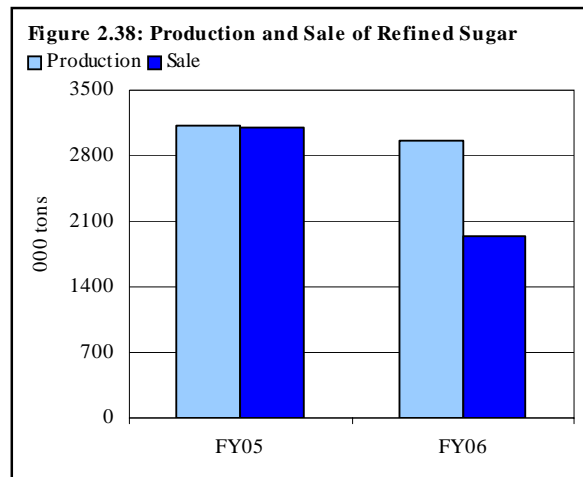
²² For details see Box 2.3 of *Third Quarterly Report for FY06*.

²³ This growth may yet be understated, as data is unavailable for a number of local brands that were introduced recently.

Thus, amongst the food industries, sugar is the only sub-sector that recorded a decline in the production (for the second consecutive year). During FY06, the production of sugar declined by 5.0 percent as against the targeted decline of 3.2 percent for the year. It may be recalled that production had already fallen by 22.5 percent in FY05, following of the diversion of some of the crop to alternative uses due to dispute between growers and millers over prices. This dispute continued into FY06, not only leading to a drop in the sugarcane crop, to 44.7 million tons in FY06 from 47.2 million tons in FY05, but also to a further drop in sugar production due to significant delay in the crushing season and farmers' consequent preference for making gur.

The relative decline in FY06 production and higher international prices prompted sugar mills to hold back sugar sales in order to obtain better prices. This is evident in the fact that by June 30, 2006, the stocks outstanding with mills was 34.3 percent of the annual production. To put this in perspective, during the comparable time in FY05, sugar mills had sold their entire stock, even though demand had been lower, and production had been higher that year (see **Figure 2.38**).

As a result of the FY06 fall in sugar production, the high stock retained by the millers and relatively high international prices, average domestic prices rose by about 33 percent during the year. In response, the government allowed sugar imports, which reached to 1387.2 thousand tonnes in FY06. The imported quantum of sugar in FY06 is higher than the aggregate quantum of sugar imported during the last five years (FY01-FY05). As a result of large imports and signs of easing in international sugar prices, domestic prices have also finally started to move downwards in recent months. It is expected that FY07 sugarcane crop would be substantially higher than that in FY06 on the back of favorable weather conditions. This would help improve the sugar production and subsequently ease prices in months ahead. Moreover, growth in production would also accelerated due to the start of operations by six new and one old sugar mills in FY07.



Another LSM sub-group that performed well during FY06 was the leather industry, which also saw an acceleration in growth during FY06. During FY06 the output of leather sub-group rose by 5.8 percent as against a decline of 5.3 percent in last fiscal year. This acceleration was added by all three components of the leather industry (upper leather, sole leather and leather foot wear). The 33.6 percent rise in leather and leather products export was seen during FY06, appears to reflect the number of measures taken by the government²⁴ to facilitate the domestic leather industry.²⁵

In the same way, the *paper & board* sub-sector also recorded an acceleration with 13.2 percent growth in production in FY06, which is significantly higher than 3.2 percent growth during the preceding year. The growth in *paper & board* output in FY06 is largely because of expansion in production capacity by some producers, strong sustained demand by *construction* sector and improvement in the packaging standards of some exportable commodities. The acceleration in *paper & board* industry was entirely contributed by paper board and chip board with 20.4 percent and 9.8

²⁴ See *First Quarterly Report 2005-06* for details

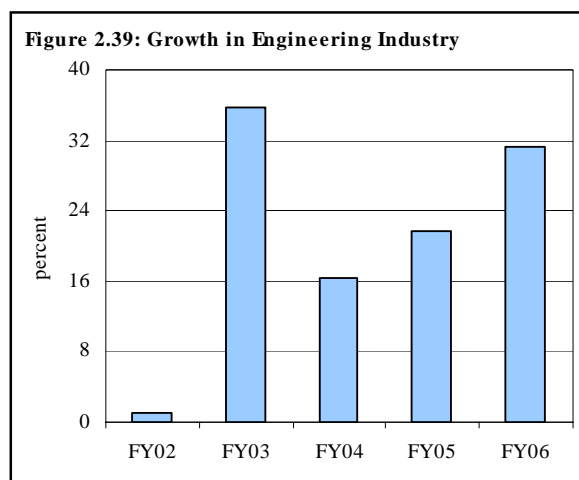
²⁵ Ministry of trade has issued SRO 871(1)/2006 and Sate bank of Pakistan has also issued a circular regarding Research & Development allowance for leather manufacturers and exporters. According to SRO and circular, the 6.0 percent Research & development (R&D) allowance will be given to leather manufacturers and footwear on the Freight on Board (FOB) value of shipment.

percent growth respectively in FY06 as against a growth of 4.7 percent and a decline of 7.8 percent respectively in FY05. The growth in the paper board demand is often a good proxy for the growth of the formal economy (which typically has a high consumption of packaging material compared to the informal sector). In particular, in recent years, demand for tetra packs has increased tremendously due to the rising market share of packaged juices, milk and other products.

However, a part of the rising domestic demand was met by the strong 19.3 percent in imports of *paper & board* products in FY06 as against a 14.0 percent rise in imports during FY05. This suggests bright prospects for additional investment in this sector.

Another sub-sector that witnessed acceleration in output is pharmaceutical, where 12.9 percent growth during FY06 relative to 4.1 percent growth in FY05. Resultantly the contribution of pharmaceuticals in LSM growth reached to 6.6 percent in FY06 from a negligible 1.1 percent during the preceding year. The entry of new companies, expansion in production capacity by existing manufacturers, and a rise in domestic demand due to the earthquake in northern areas of Pakistan, as well as an increase in exports, were important factors for the strong performance. Almost all components of the pharmaceutical sub-group witnessed an acceleration in output during FY06.

Production in the *chemicals* industry also witnessed acceleration, with growth rising to 11.2 percent during FY06, which is slightly higher than 10.4 percent growth seen in FY05. This was largely due to increases in capacity utilization (possibly reflecting a rise in FDI that reached to US\$ 62.9 million in FY06). Within the chemicals sub-group, the matches industry witnessed the highest growth of 38.0 percent in FY06 as against a negative growth of 8.7 percent in FY05. The expansion in the production capacity and rise in exports on the back of Duty & Tax Remission on Export (DTRE)²⁶ scheme are the contributory factors to this growth. However, the impact of the strong growth in matches industry is partially offset by a slowdown in textile related chemical industry,²⁷ which is mirrored the deceleration of growth in the textiles industry.



As with the chemical industry, growth in engineering industry accelerated to 31.2 percent during FY06 relative to 21.7 percent in the preceding year (see **Figure 2.39**). Within engineering, the production of diesel engine witnessed a robust growth of 96.7 percent during FY06 compared with 40.0 percent growth in FY05. The sustained growth of the diesel engines is mainly attributed to its increasing use in tube-wells at farms. Moreover, use of diesel engines for water extraction in urban areas has also increased.

In contrast to the acceleration in growth in the above mentioned sub-groups, production in textiles sub-group (with the highest weight in LSM), saw a deceleration during FY06.

²⁶ The Duty and Tax Remission on Export (DTRE) Rules allow the import or local procurement of all inputs goods needed for export production, without the payment of customs duty, central excise duty, advance income tax and sale tax. Such duty free imports or local procurement are available to both direct as well as indirect exporters. The indirect exporters are those who provide input goods or services to direct exporters for the purpose of export production.

²⁷ Synthetic resins, caustic soda, sulphuric acid, and *hydrochloric acid*.

The textile industry recorded a lower growth of 4.3 percent during FY06 as against a strong growth of 27.1 percent in the preceding year. This is partially due to high base effect, smaller cotton crop and disruption in gas supply particularly in Dec 2005 to 40-42 captive power plants (CPP) in the areas of Punjab where various textiles units are located. This weak performance was the major factor for a fall in the contribution of textiles sub-sector in LSM sector to 13.7 percent in FY06 from 39.1 percent during FY05 (see **Figure 2.40**). Within the textiles sector, production of the cotton ginning industry fell by 12.3 percent in FY06 as compared with the 45.3 percent robust growth during FY05 (see **Table 2.16**).

Encouragingly however, textile exports continued to perform well in the current fiscal year with 16.1 percent rise as against a modest 5.7 percent growth in the previous year. It is interesting to note that this growth has been achieved despite rising financial cost, high energy prices, higher prices of cotton relative to FY05, a fall in exports prices amidst intense competition, loss of preferential access and disturbances in gas supply. This raises hopes that with higher cotton output, increase in investment (both foreign as well as domestic investment), sufficient credit availability and expansion in capacity utilization, the performance of the sector will improve in the coming year. However, competition pressures remain strong, as evident in the deceleration in growth of exports in recent months.

As with textiles, the *automobiles* industry also witnessed a deceleration in growth during FY06, but this was marginal and the industry growth remained healthy (at 28.4 percent) for yet another year. Rising incomes, availability of consumer financing and expansion in production by manufacturers are the main contributory factors for the strong growth of *automobiles* industry, which was muted mainly by the impact of a rise in interest rates.

Within the automobiles industry, *cars & jeeps* is the only sub-sector which saw an acceleration in production during FY06 (see **Table 2.17**), registering a growth of 29.6 percent, which is marginally higher than 28.0 percent growth seen in FY05. The significant increase in the production capacity (by 15.2 percent) is the main reason for the acceleration in cars production. The rising purchasing power as a result of growing economy and improved access to consumer credit are probably key factors for the rising sales of larger cars. Consequently, the share of high capacity engine *cars* rose in overall sale of the *cars* as against the decline in the share of low capacity engine's cars (see **Figure 2.41**).

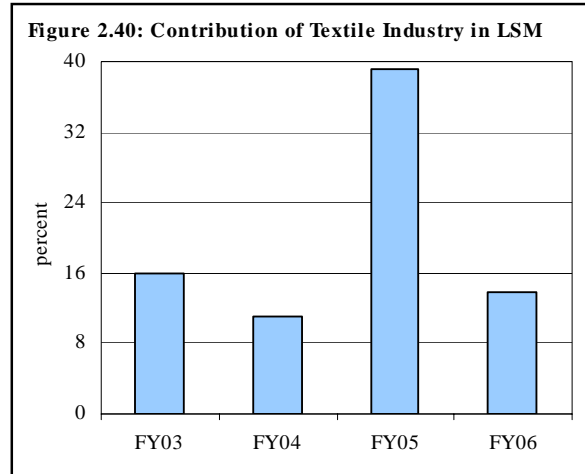


Table 2.16: Production of Selected Textile Items

| Items | Units | Weights in LSM | FY05 | FY06 | Growth rate |
|----------------------|--------------|----------------|-------|-------|-------------|
| Cotton yarn | 000 tons | 13.07 | 2,281 | 2,546 | 11.7 |
| Cotton cloth | million sq.m | 7.55 | 925 | 930 | 0.6 |
| Cotton (ginned) | 000 tons | 3.37 | 2,483 | 2,177 | -12.3 |
| Woolen & carpet yarn | 000 tons | 0.32 | 2.3 | 2 | 4.6 |
| Jute goods (total) | 000 tons | 0.17 | 105 | 105 | 0.6 |
| Knitting wool | 000 tons | 0.01 | 3 | 3 | 0.2 |

Source: FBS

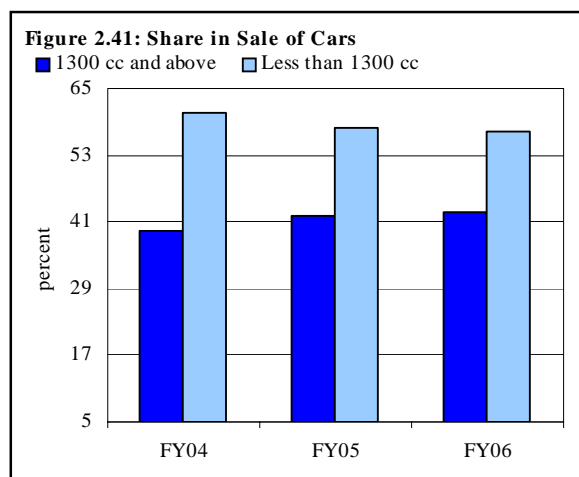
Table 2.17: Automobiles Industry

| numbers | Productions | |
|-----------------------|-------------|---------|
| | FY05 | FY06 |
| Cars 1300cc and above | 53,568 | 69,867 |
| Cars less than 1300cc | 72,820 | 90,775 |
| Jeeps & vans | 7,524 | 12,901 |
| LCVs | 23,928 | 32,053 |
| Trucks | 3,292 | 4,518 |
| Buses | 1,763 | 825 |
| Tractors | 43,200 | 48,887 |
| Motorcycles | 416,189 | 519,427 |

Source: Pakistan Automotive Manufacturers Association

Interestingly, the demand for local as well as imported cars remained high during FY06. While the import of used cars stood at 45,479 units in FY06 as compared to 11,877 units in FY05, it failed to significantly reduce the high demand of locally assembled cars. However, the rising imports of used cars led to a reduction in high premiums and delivery period.

In contrast with acceleration in the production of cars & jeeps, a deceleration was observed in the tractors sub-group of the automobiles industry during FY06. The production of tractors slowed to 13.2 percent during FY06 compared with a 20.8 percent growth seen in the preceding year. The slowdown in the production of tractors was mainly attributed to capacity constraints (capacity utilization had reached 97.8 percent in FY06) and a rise in interest rates. To meet the rising demand at reasonable cost, the government has exempted the custom duty on the import of ten thousand tractors to three companies. These firms are expected to setup three tractor plants in Pakistan.



Similarly, a slowdown is evident in the production of trucks, which decelerated to 37.2 percent growth in FY06, lower than the 62.8 percent growth recorded during the preceding fiscal year. Increased economic activity, resulting in cargo movement of imports and exports in the country, and expansion by a manufacturer has pushed up production as well as sales of trucks in FY06.

The outlook for automobiles sector production remains robust for FY07. Even though the leasing rates have started to edge up due to rising interest rates, the demand and supply gap still remains large enough for auto assemblers to enhance the production capacity in coming year. The government has announced many measures for the development of auto industry such as reduction in taxes and duty on imports of multi-axles truck (see **Box.2.4**).

As with automobiles, consumer financing also plays an important role in the growth of the electronics sub-sector. Thus, despite a deceleration during FY06, growth in the production of electronics industries is still a robust 36.5 percent, slightly lower than 41.3 percent growth seen in the preceding year (see **Table 2.18**). The main contribution for the growth of electronics sub-group came from the significant rise in FDI during FY06 and increased credit availability for consumer durables in the current fiscal year.

Table 2.18: Production of Electronics Consumer Durable Goods
numbers

| Items | FY03 | FY04 | FY05 | FY06 |
|------------------|-----------|-----------|-----------|-----------|
| Air conditioners | 12,043 | 64,420 | 181,820 | 363,247 |
| Deep freezers | 86,595 | 111,059 | 178,970 | 185,684 |
| Refrigerators | 375,864 | 617,439 | 784,561 | 861,604 |
| TV sets | 764,612 | 843,079 | 908,805 | 966,468 |
| Electric fans | 1,258,243 | 1,361,636 | 1,419,951 | 1,450,112 |

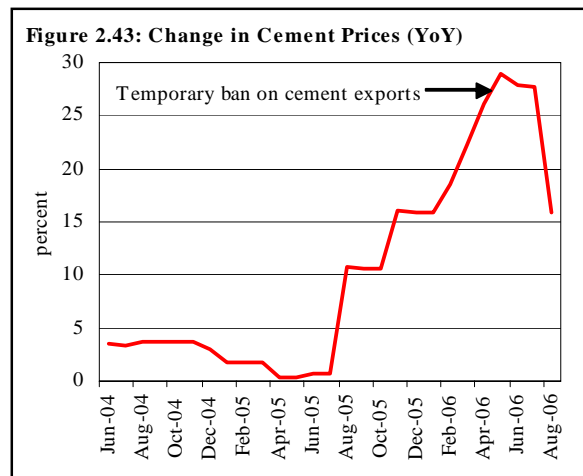
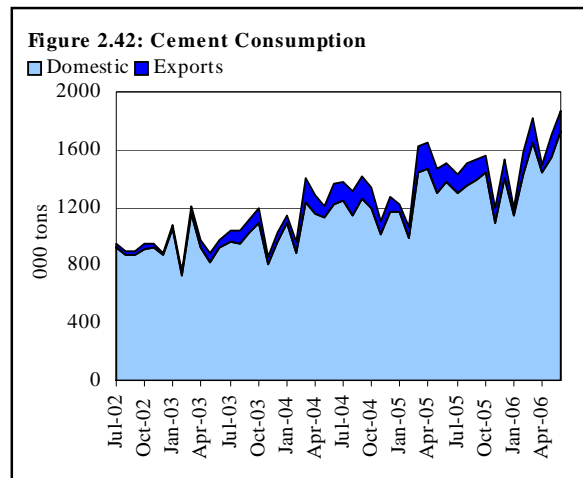
Amongst the electronics items, the highest growth of 99.8 percent was observed in air conditioners industry in FY06 even over a high growth of 182.2 percent in FY05. This spectacular performance is mainly a result of the increasing popularity of split type air conditioners on the back of reduction in prices of split ACs.

Another important industry that witnessed a lower growth in FY06 relative to FY05 is the non-metals industry. In particular, cement production registered a lower growth of 12.6 percent during FY06 compared with a 19.7 percent rise seen in production during FY05. This deceleration was due to a

slowdown in local demand on the back of high domestic prices and a decline in external demand (see **Figure 2.42**).

The slowdown in the growth of cement production is also reflected in the cement dispatches. The local cement dispatches rose by 14.3 percent to 18.4 million tons in FY06, compared with an increase of 17.9 percent in FY05. The major factor responsible for this slowdown is the continued rise in domestic prices of cement through most of FY06, until cement manufactures and government agreed on a temporary ban on export of cement in April 2006 (see **Figure 2.43**). Resultantly, domestic supply improved and prices also started to ease somewhat. Government also took many other measures to stabilize the rising domestic prices in the market (see **Box 2.4**). In order to dampen the impact of the abnormally high demand on domestic cement prices, the government has recently allowed the private sector to import unlimited quantity of cement from any source without any customs duty and withholding tax.

In contrast to growth in local demand for cement, a decline was recorded in the export of cement in FY06, dropped to 1.5 million tons as against 1.6 million tons in FY05; this was largely due to a temporary ban on cement export.



Box 2.4: Measure for Automobile Industry

Government has announced a new Tariff Based System for the import of completely built-up units (CBUs) and completely knocked-down units (CKD) effective from July 1, 2006. According to the new Tariff Based System (TBS):

- Import duty of 50 percent would be applicable to such components/parts which were manufactured locally and were imported for the assembly by the original equipment manufacturer (OEM) or by the commercial importers as a replacement parts for vehicle plying in the country including such motor vehicles, which were not manufactured locally.
- Similarly, 35 percent duty would be levied on all other indigenized replacement parts, irrespective of the type and category of the vehicle, and for such indigenized parts identified separately as were meant for vehicles (CBU) having less than 35 percent of duty.
- The existing rate of duty for vendors on import of raw materials and components of cars, buses, trucks and motorcycles was 5 percent and 10 percent, which was proposed to be reduced to zero percent and 5 percent respectively.
- However, the existing rates on components for assembly, manufacture of vehicles in any kit form, imported by the local manufacturers of automobiles, which have not been indigenized to continue through an exemption notification.
- According to the CBR documents, the rate of customs duty on prime mover from multi axle trucks having 280 HP and above in both CKD and CBU condition had been reduced from existing 10 percent and 30 percent to zero percent and 15 percent respectively.
- The duty structure on off highway dumpers and other trucks of 5 tons and above capacity had been rationalized. The existing CKD and CBU rates on these trucks, which were 20 percent and 60 percent, have reduced to 10 percent and 30 percent, respectively.
- The duty on CKD on trailers had been reduced to 10 percent on CKD from 60 percent and 30 percent on CBU.

- The import of black cabs has allowed on the pattern of tractors' scheme. Their import will be exempted from customs, other duties and taxes.
- Approval of diversify the auto-manufacturing to create competition as the existing market was dominated by Japanese manufacturers.
- The new entrants would be required to have an overseas annual manufacturing capacity of 500,000 units besides possessing sufficient resources to set up their plants in Pakistan and a significant presence in the world market.
- The new entrant will be allowed to import 100 percent completely-knocked down kits (CKD) and components at existing duty rates, which are applicable for parts not manufactured locally, for three years from start of operations.
- A number of incentives for the import of completely-knocked down and completely built units of the big trucks had been announced.

As with cement, higher prices cause slower growth in the *petroleum* and *lubricant* industry during FY06 that witnessed a 2.2 percent rise in production compared with a 12.9 percent growth in FY05. Moreover, a decline in domestic production of crude oil and conversion of over one million vehicles on CNG are also contributed in the slowdown in the production of petroleum products.

The production performance of different POL products can be seen from **Table 2.19**. The decline in the production of *high speed diesel* is mainly a function of a fall in demand, following a 21.9 percent rise in its domestic prices during FY06 amidst persistent increase in international oil prices. *Furnace oil* (FO) output recorded an acceleration of 7.8 percent growth in FY06 as against a fall of 0.1 percent in FY05, principally due to higher consumption by electricity producers.²⁸ *Jet fuel* also witnessed 11.7 percent growth in output during FY06 in contrast with a 9.4 percent fall in the preceding year. Increasing domestic consumption of jet fuel on account of expansion in activities of domestic airlines and exports to Afghanistan are the major factors for this encouraging performance.

Table 2.19: Production of POL Products

| thousand metric tons | FY05 | FY06 |
|-----------------------------|---------|---------|
| Jet fuel | 1,127.2 | 1,259.1 |
| Kerosene | 204.8 | 219.2 |
| Motor spirits | 1,333.0 | 1,195.4 |
| High speed diesel | 3,440.5 | 3,300.2 |
| Light speed diesel (n.o.s.) | 163.1 | 135.6 |
| Furnace oil | 3,132.7 | 3,377.3 |
| Lubricant oil | 189.7 | 203.6 |
| Jute batching oil | 6.1 | 3.9 |
| Solvent naphtha | 724.4 | 883.6 |
| Petroleum products (n.o.s.) | 655.7 | 650.0 |

Despite strong domestic demand on the back of improved farm income and availability of institutional credit in FY06, the fertilizer industry could not repeat its remarkable performance of recent years in FY06. This was primarily due to capacity constraints. In FY06, the fertilizer industry registered a growth of 5.1 percent, which is significantly lower than 25.7 percent growth in the preceding year. The main contribution to this slowdown stemmed from a lower growth in the production of *phosphatic fertilizer*, up by only 5.5 percent during FY06 as against 37.9 percent growth in FY05. The deceleration in *fertilizer* was largely a function of capacity constraints, and this industry is already operating at over 100 percent of the installed capacity. Given growing domestic demand and capacity constraints, Pakistan is required to import a substantial quantity of fertilizer. As a result, *fertilizer* imports rose by 38.4 percent during FY06 as compared to 22.7 percent growth in FY05. However, with the expansion of FFBL and commencement of production by a new plant, installed capacity in the fertilizer industry is expected to increase by 36 percent by the end of December 2008.

²⁸ WAPDA generate 12.5 percent electricity from the source of furnace oil, while KESC generate 16.2 percent from the same source. In overall economy, 13.1 percent electricity is being generated from furnace oil.

In fact, it is difficult to analyze a trend growth in metal industry due to non-availability of comparable data for FY04 and earlier. The available information suggests that metal industry grew by 3.6 percent during FY06, appears to be on lower side due to a sharp fall in the production of Pakistan Steel Mills on account of some technical problems.²⁹

Specifically, FY06 production of Pakistan Steel is about 31 percent below than the targeted production for the year (see **Figure 2.44**). During FY06, the contribution of Pakistan Steel in *LSM* growth fell further from (-) 1.3 percent in FY05 to (-) 15.7 percent. Consequently, the rising demand of *iron & steel* by the construction, automobile and engineering sectors was met by a 39.0 percent increase in imports during FY06. **Figure 2.44** shows the actual as well as the expected quarterly position of Pak Steel. During the first three quarters of FY06, the production of *iron & steel* was at low level due to technical problems, while Pak Steel has completed its indigenous capital repair of coke oven batteries in the last quarter of FY06. As a result, the production of steel has started increasing in Q4-FY06. It appears that the production of metal industry will regain its position and contribute positively to industrial growth FY07 onwards.

2.3.1 Infrastructure Industries Index (III)

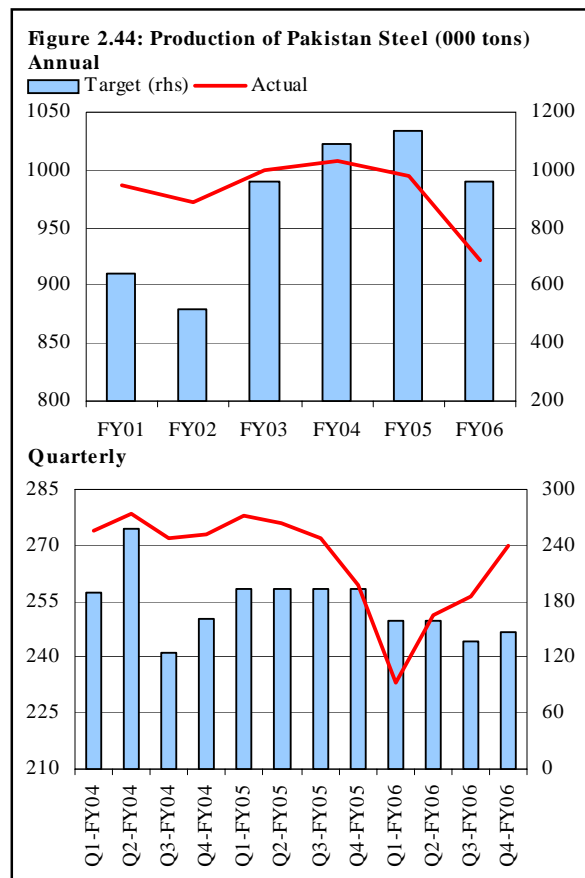
The Infrastructure Industries Index measures the performance of infrastructure industries, which consists of seven industries³⁰ having a 26.2 percent weight in industrial sector of Pakistan. The index is composed of energy related industries (83.5 percent share) and construction allied industries (16.5 percent share) (see **Figure 2.45B**), which is a leading indicator of the performance of industrial sector. The index recorded 6.2 percent growth in FY06 as against 11.3 percent growth of FY05. The production of electricity and coal accelerated to 12.8 percent and 13.7 percent during FY06 compared with 10.3 and 2.6 percent growth respectively last year. The positive impact of these two industries was offset by the deceleration in the production of natural gas, cement and petroleum products and fall in the production of basic metal and crude oil production.

Table 2.20: Growth of Industrial Production by End User

| Sector | Weights | FY04 | FY05 | FY06 |
|--------------------|---------|------|------|------|
| Basic goods | 26.5 | -0.8 | 9.5 | 7.9 |
| Consumer goods | 31.6 | 24.4 | 19.3 | 13.3 |
| A. Non-durables | 27.4 | 17.4 | 12.3 | 6.0 |
| B. Durables | 4.2 | 52.8 | 40.8 | 31.3 |
| Intermediate goods | 39.7 | 12.1 | 16.8 | 4.9 |
| Capital goods | 2.1 | 43.8 | 28.9 | 26.9 |

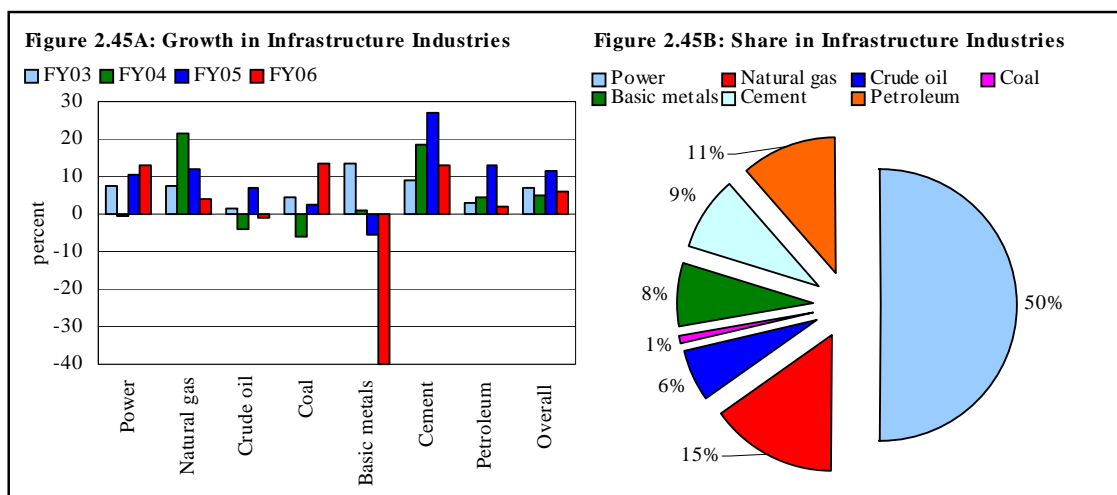
Source: Based on data from FBS

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



²⁹ Due to non-functioning of one coke oven battery at the Pak Steel Mills.

³⁰ These industries are electricity generation, natural gas, crude oil, petroleum products, basic metal, cement and coal.



2.3.2 Industries by End-Use

In terms of end-use categorization of industrial production (*basic, consumer, intermediate and capital goods*), a deceleration is evident in all categories during FY06 (see **Table 2.20**). Encouragingly, *capital goods* group witnessed a marginal slowdown and grew by a strong 26.9 percent during FY06. This relatively strong growth came from higher production of electronic items such as transformers, meters, and engineering products e.g. diesel engine, shuttles & bobbins. Strong growth in *capital goods* suggests that growth momentum in other categories is also likely to accelerate in FY07.

The second highest increase was registered under the category of *consumer goods* in FY06 for yet another year, on the back of a sustained rise in income, declining prices of electronics as well as availability of consumer financing. In particular, despite a slowdown in *consumer durable goods*, this group recorded a strong growth of 31.3 percent in FY06 as compared 40.8 percent growth in FY05. This strong growth in *consumer durable* is mainly contributed by electronics and automobiles industries on the back of consumer financing and an evident weakening is entirely owed to rising interest rates on consumer financing. Given still strong aggregate demand and private spending, growth in *consumer goods* is likely to remain reasonably good.

The *Basic goods* category showed some resilience, witnessing a deceleration of only 1.6 percentage points in FY06. Within *basic goods*, electricity generation (by both WAPDA and KESC), marble, coal etc. witnessed higher growth rates during FY06 relative to FY05. The impact of these was offset by slowdown in the output of some chemicals e.g. hydrochloric acid, sulphuric acid and fall in the production of crude oil and coke.

In FY06, the growth rate of 4.9 percent in the output of *intermediate goods* is lower than 16.8 percent growth in the corresponding year, mainly on account of a fall in the production of metal industry and cotton ginning. Moreover, growth in production of textile related chemicals and natural gas also witnessed deceleration during FY06. Although, *intermediate goods* showed a dismal performance, it is likely that growth would pick up in FY07 since the declines in both metal and cotton ginning appears to be temporary.

2.3.3 Capacity Utilization in Large Scale Manufacturing Industries

The overall capacity utilization during FY06 rose marginally by 0.1 percentage points as against an increase of 0.3 percentage points in FY05 (see **Figure 2.46**). However, excluding the steel industry (when capacity utilization fell sharply due to temporary technical faults), the overall capacity

utilization rose to 66.6 percent, exhibited an improvement of 1.8 percentage points during FY06 over FY05 (see **Table 2.21**).

In particular, the highest increase of 15.1 percentage points was observed in automobiles, where capacity utilization reached to 97.8 percent in FY06. The substantial increase in capacity utilization was seen in all components of the automobile industry in the current fiscal year. In particular, capacity utilization in cars & jeeps and LCVs reached over 100 percent in FY06 compared with below 85 percent in FY05. Thus, there is a need for additional investment in these industries to meet the growing domestic demand.³¹ Capacity utilization in the tractors industry also rose to 97.8 percent in FY06, which has attracted considerable attention from investors (local as well as foreign investors).³²

Similarly, capacity utilization in *paper & board* sub-sector was already above 100 percent in FY05, which was further improved by 9.8 percentage point in FY06 to reach 110.7 percent, despite rise in the production capacity by some existing mills due to growing domestic demand. Similarly the capacity utilization in *ghee & cooking oil* industry increased by 4.8 percentage points and reached to 52.0 percent during the current fiscal year. The strong domestic as well as external demand, largely from Afghanistan, was the main reason for this rise in capacity utilization.

Capacity utilization in textile industry increased by 0.8 percentage points in FY06 compared with 2.3 percentage points rise seen in the preceding year. The marginal increase was entirely due to the expansion in spinning sector, which consist of spindles & rotors that also offset the decline in the capacity utilization in weaving sector on account of low cotton crop during the current fiscal year.

Similarly, fertilizer industry also showed a remarkable rise of 2.8 percentage points in capacity utilization during FY06 even from the significantly high level of 105.7 percent capacity utilization in

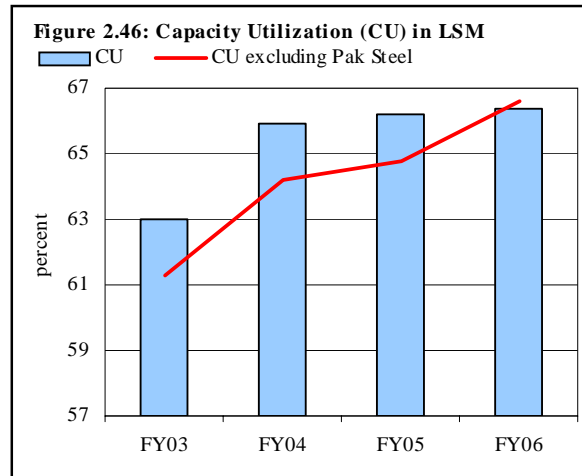


Table 2.21: Capacity Utilization in Selected Industries

| Industry | FY03 | FY04 | FY05 | FY06 |
|---------------------------------------|-------|-------|-------|-------|
| <i>Textiles</i> | 56.3 | 55.9 | 58.2 | 59.0 |
| Edible oil & ghee | 33.9 | 39.9 | 47.2 | 52.0 |
| Sugar | 64.5 | 67.2 | 49.4 | 46.3 |
| <i>Automobiles</i> | 59.6 | 75.7 | 82.7 | 97.8 |
| Electronics | 20.6 | 32.5 | 14.2 | 16.1 |
| Cement | 69.9 | 79.1 | 91.3 | 87.9 |
| Steel (Pak Steel) | 91.0 | 93.6 | 89.0 | 62.2 |
| <i>Industrial chemicals</i> | 107.0 | 88.8 | 90.1 | 95.7 |
| Fertilizer | 92.1 | 100.4 | 105.7 | 108.5 |
| Petroleum refining | 93.4 | 88.8 | 85.2 | 85.6 |
| Paper & paper board | 91.4 | 97.2 | 101.0 | 110.7 |
| Overall capacity utilization | 63.0 | 65.9 | 66.2 | 66.3 |
| Overall capacity utilization * | 61.3 | 64.2 | 64.8 | 66.6 |

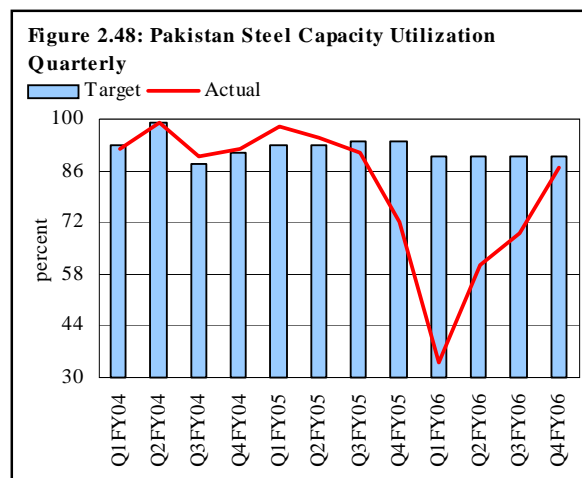
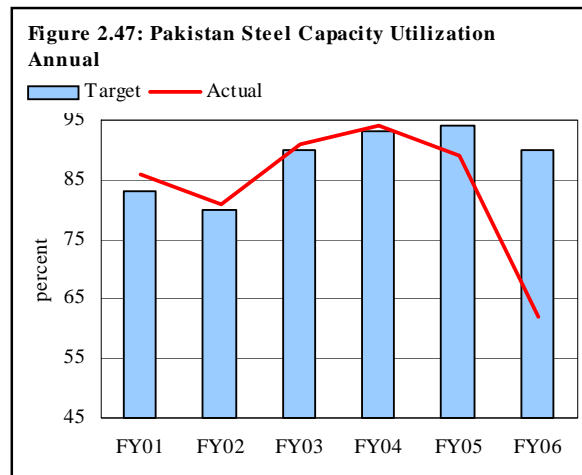
* Excluding Pak Steel production

³¹ Prime Transport Limited (PTL) car assembler/manufacturer of famous Black Cabs of UK is establishing a plant in Karachi. Mercedes Benz is also establishing their plant of assembling/manufacturing buses, trucks and cars in same city. The Indus Motor Company Limited and Suzuki Motor Limited had made expansion in production capacity, while Adam Motor Limited and master Motor Limited have commenced the production.

³² A local firm is setting up a new tractor manufacturing plant at Port Qasim with the collaboration of foreign investor, which has the production capacity of 8000 tractors per annum. More companies are expected to establish tractor plants in future to enhance the production capacity.

the preceding year. The sustained rise reflects strong domestic demand and therefore significant expansion likely in the near future.³³

In contrast, the capacity utilization in Pakistan Steel Mills fell to 62.2 percent in FY06, which is 26.8 percentage points less than the capacity utilization during the preceding year and 28.0 percentage points lower than the annual target for the year (see **Figure 2.47 & 2.48**). This was due to delays in undertaking capital repairs, which restricted the capacity utilization of Pakistan Steel at low level during the first three quarters of FY06. However, Pak Steel has completed its domestic capital repair work of coke oven batteries by the fourth quarter of FY06 and consequently, the capacity utilization for production of steel has started increasing and reached 87.0 percent in Q4-FY06. It is expected that with the completion of repairing work of Pak steel and commencement of US\$ 300 million cost Tawairiqi Steel Mill project with production capacity of up to 1.5 million tons of iron products annually will increase the production of steel going forward.

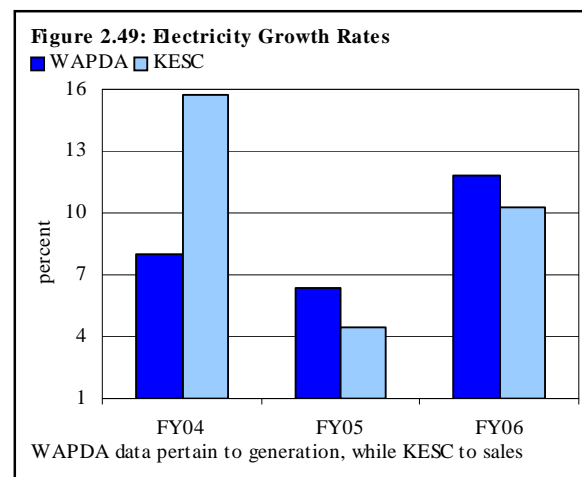


Box 2.4A: Index of Industrial Production¹ (IIP)

Industrial production output measured by the Index of Industrial Production, recorded a single digit growth of 9.4 percent in FY06 in contrast with 16.3 percent growth during previous year. This largely reflects the slowdown in the LSM² as well as in mining & quarrying sub-sectors, which comprise 48.7 percent of the IIP. The slower growth in these two components was partly offset by the accelerated growth in the energy generation sub-sector (comprises of 13.1 percent of IIP).

As in LSM, the deceleration of 4.2 percent was seen in mining & quarrying production in FY06, which is significantly lower than 10.8 percent growth in the last year. The slowdown was mostly contributed by the weak growth of natural gas and gypsum, which have more than 65 percent share in mining & quarrying sub-group and fall in the production of crude oil, dolomite and chromites.

Contrary to LSM and mining & quarrying, the electricity generation sub-sector showed an increase of 12.8 percent



³³ The Fatima Fertilizer Complex (FFCL), a US\$ 475 million project being built at Machi Goth, is to have a capacity of producing 1.580 million tons of urea, calcium, ammonium nitrate and phosphatic fertilizers like NP and NPK (substitute of DAP). The expansion plans in production capacity by FFBL (both in DAP and Urea plant) FFC and Engro (in Urea) are in the final process.

in FY06 as compared with 10.3 percent growth in the preceding year. WAPDA³, which has 86 percent share in total electricity generation, was the main contributor in this growth, registered 11.8 percent growth in FY06, compared with 6.4 percent growth during the last year (see **Figure 2.49**). Similarly, KESC witnessed 10.3 percent growth in sales during FY06, 5.9 percent higher than the rise in sale seen in the preceding year.

¹ The IIP is used as a proxy to judge the performance of industrial sector based on the monthly data for whole year regarding three components namely LSM, Electricity Generation and Mining & Quarrying, which cover about 62 percent of the industrial production in the economy. ² For details see section on LSM. ³ WAPDA data pertain to generation while KESC data show sale because of non-availability of generation information.

2.4 Services

The services sector performed remarkably well during FY06, registering an impressive 8.8 percent growth, a little higher than the 8.0 percent seen in FY05, thereby surpassing its annual target (6.8 percent for FY06) for the fifth consecutive year (see **Figure 2.50**). This robust growth was mainly contributed by *wholesale & retail trade*³⁴, *transport & communication* and *finance & insurance* sub-sectors (see **Table 2.22**). The acceleration in the services sector growth coupled with the unsatisfactory performance of the commodity-producing sector meant that the share of the services sector in GDP increased in FY06 after a gap of two years.

The impressive performance of the services sector was equally shared by all sub-sectors. Although growth in both *wholesale & retail trade*, and *finance & insurance* slowed during FY06, it was nonetheless well above the target for both sectors. On the other hand, the *transport, storage & communication* sub-sector has witnessed an acceleration, with growth rising to 7.2 percent during FY06 (see **Figure 2.51**) against 3.6 percent in FY05, mainly on the back of improved performance of *road transport* and *communication*, which was supplemented by the double-digit growth in *railway transport*. Similarly, growth in *public administration & defense* also accelerated to 4.7 percent in FY06, higher than the 3.5 percent target for the year and only 0.6 percent in the preceding year. Finally, the accelerated growth in *community, social & personal services* was probably a reflection of the increased social service activities in Pakistan's Northern areas in the wake of the October 2005 earthquake.

2.4.1 Finance and Insurance

The *finance & insurance* sub-sector continued its remarkable performance, registering 23 percent growth in FY06. While this is a little lower than the 29.7 percent for FY05, it is still quite impressive. The FY06 mainly reflects the significant improvement in the profitability of commercial banks and insurance companies, as well as the significant rise in the profits of the central bank.

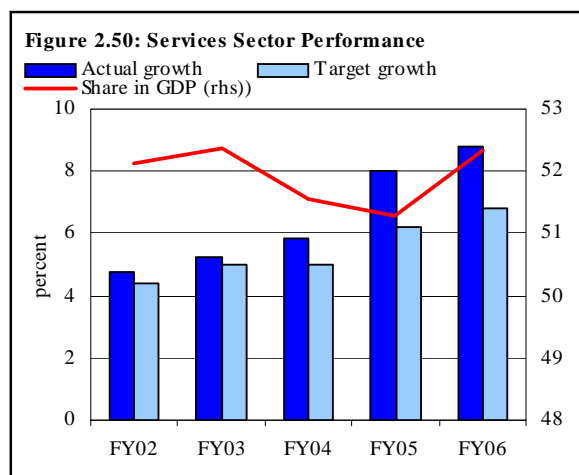
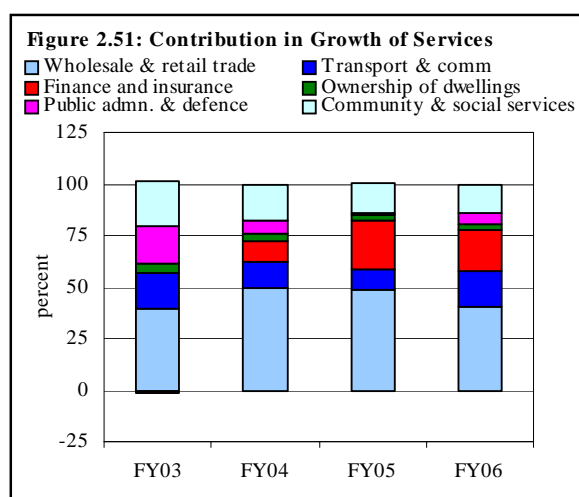


Table 2.22: Performance of Services Sector

| | Growth rate | | Share in services | |
|---------------------------------------|-------------|------------|-------------------|--------------|
| | FY05 | FY06 | FY05 | FY06 |
| Wholesale & retail trade | 11.1 | 9.9 | 36.3 | 36.6 |
| Transport storage & communication | 3.6 | 7.2 | 20.3 | 20.1 |
| Finance and insurance | 29.7 | 23.0 | 7.8 | 8.9 |
| Ownership of dwellings | 3.5 | 3.5 | 5.6 | 5.3 |
| Public administration & defense | 0.6 | 4.7 | 11.5 | 11.0 |
| Community, social & personal services | 5.9 | 6.5 | 18.5 | 18.1 |
| Services sector | 8.0 | 8.8 | 100.0 | 100.0 |

Source: Economic Survey 2005-06



³⁴ Contribution of *wholesale & retail trade* in growth of services sector has gone down to 41.2 percent in FY06 from 50.4 percent last year, nonetheless it still remains the highest in comparison to other sub-sectors.

While the rise in the profits of both banks and insurance companies reflects the general improvement in the economy, the profits of the commercial bank also benefited from rising interest rate spreads. While the tight monetary policy in FY06³⁵ was reflected in rising lending rates, banks' deposits moved up only with considerable lags, and these increases were also well below those in lending rates (see **Figure 2.52**). Hence, unlike the preceding two years, the FY06 profitability of banks' emanates mainly from higher interest rate spreads rather from an increase in the asset base. This is also evident from the rise in banks' interest related income, which grew by 66.5 percent for CY05,³⁶ significantly higher than the 13.6 percent increase in CY04.

The increased profitability of the insurance industry stems from the expansion in business by both life and non-life insurance industries, (as reflected in the aggregate rise in net premium income) and a fall in the claims ratio. This resulted in a profit of Rs. 6.9 billion for the overall industry in CY05, as compared to Rs 4.0 billion in the preceding year (see **Table 2.23 and Figure 2.53**).

In particular, non-life insurance is expanding as a result of (1) a surge in industrial and trade activities, (2) a rise in auto-sales on the back of higher credit availability to private sector resulting in higher *motor* insurance, (3) the boom in the real estate market resulting in higher *fire* insurance, and (4) higher involvement of multinationals and private firms in business. The latter has particularly improved health insurance statistics, although this concept is new in Pakistan and presently its share is negligible. Resultantly, net premium income of non-life insurance industry witnessed a 27 percent growth, with all the major areas registering double-digit growth.

The life insurance sector also benefited from a rise in demand for both individual and group insurance. Resultantly, net premium income for life insurance registered a 26.2 percent rise. Despite a 20.6 percent fall in the gross premium as a result of competition faced from foreign firms, domestic reinsurance sector registered higher profits for CY05. The sharp rise of 82.9 percent during CY05 in

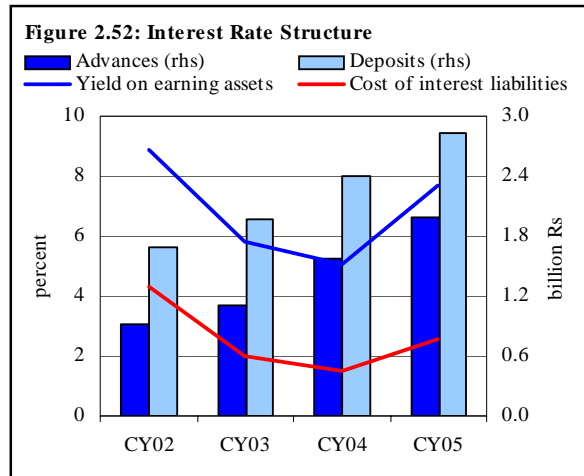
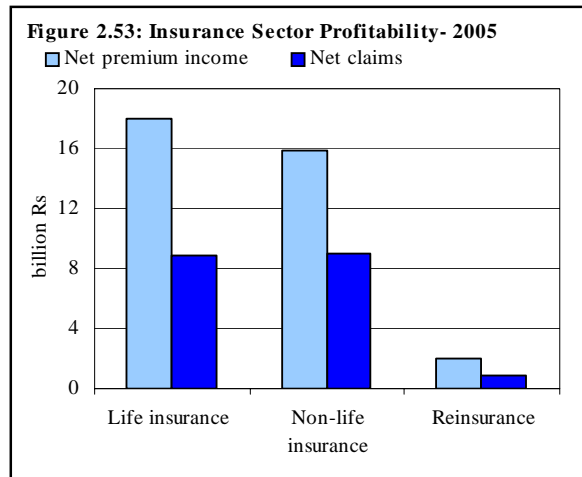


Table 2.23: Performance Indicators for Insurance Industry
billion Rupees

| | 2003 | 2004 | 2005 | 2004 | 2005 |
|----------------------|------|------|------|------|------|
| Net profit after tax | 3.5 | 4.0 | 6.9 | 15.7 | 71.1 |
| Gross premium | 37.3 | 42.0 | 50.4 | 12.5 | 20.1 |
| Net premium income | 23.8 | 28.3 | 35.9 | 18.6 | 27.0 |
| Net claims incurred | 12.6 | 15.8 | 18.7 | 24.8 | 18.2 |
| ROA (percent) | 2.4 | 2.3 | 3.4 | -4.2 | 48.1 |



³⁵ 6-monthly KIBOR has increased by 100 basis points from 8.9 to 9.9 percent during Jul-05 and Jul-06. Similarly, SBP Repo rate (6-monthly) has gone up to 8.3 to 8.64 during the same period.

³⁶ All the data pertaining to *finance & insurance* sub-sector is being reported on CY basis.

profits of reinsurance is mainly attributed to a significant increase in investment income as well as a fall in the claims ratio.

2.4.2 Wholesale and Retail Trade

Although the growth in value addition by *wholesale & retail trade*³⁷ decelerated to 9.9 percent during FY06 compared with 11.1 percent in FY05, its contribution is the highest in the FY06 growth of the services sector. The slower growth in *wholesale & retail trade* is a reflection of under performance of commodity producing sector. However, a part of this deceleration is partially offset by a surge in trading activities under imports and livestock sub-groups during FY06.

2.4.3 Transport, Storage and Communication

Value addition in the *transport, storage & communication* sub-sector grew by 7.2 percent during FY06, higher than the 5.8 percent annual target for the year as well as 3.6 percent growth seen in FY05. This improved performance was backed by strong growth in value addition by *road transport, railways, ports, communication and storage* sub-sectors. However, value addition by *airlines* declined due to the unprecedented rise in international oil prices, while the *pipelines* sub-sector also showed a negative growth due to the repeated damage to gas pipelines in Balochistan (see **Table 2.24**).

2.4.3.1 Transport

Efficient means of transportation are essential to ensure fast and cost effective movement of trade related goods as well as passengers resulting in higher activity in the economy. In Pakistan, the transport sub-sector includes the road networks, rail networks, airlines, ports/shipping and pipelines. During FY06 sub-sector groups of transport (road, port and rail transport) grew by 5.5 percent compared with 3.4 percent in FY05.

Road Transport

In Pakistan roads are the most important means of transportation, catering to almost 90 percent of the flow of goods and passengers within the country. The value addition through *road transport*³⁸ registered a rise of 8.1 percent during FY06, up from 3.9 percent last year. This reasonably good performance is mainly a result of rise in the number of vehicles on road by 14.7 percent during Jul-Mar FY06 (to 6.8 million) on the back of sustained robust growth as well as improved infrastructure as a result of higher public investment in recent years.

Table 2.24: Value-added in Transport & Communication
million Rupees

| | FY04 | FY05 | FY06 |
|-------------------|---------|---------|---------|
| Pak Railway | 837 | 2,779 | 3,165 |
| Port and shipping | 11,234 | 12,985 | 14,053 |
| Airlines | 29,002 | 25,351 | 22,449 |
| Pipelines | 4937 | 4449 | 3772 |
| Road transport | 326,297 | 338,983 | 366,530 |
| Communication | 75,547 | 78,064 | 84,947 |
| Storage | 13,422 | 14,933 | 16,409 |
| | 46,1276 | 477,544 | 511,325 |

Source: Federal Bureau of Statistics.

Box 2.5: Private Sector Participation in Road Projects

Road network in Pakistan has lagged behind its demand for past ten years, thanks to huge fiscal deficits resulting in lack of resource allocation from public sector. Overall this has created a severe shortage of road infrastructure and resultantly cost of business has gone up giving rise to inefficient markets.

Recently, the Government of Pakistan is trying vigorously to promote the concept of Public Private Partnerships in road sector mainly through BOT concept. Although this concept is not new; but it was not being implemented on large scale in the past. Hence it would help finance major road projects which could not be undertaken in the past due to lack of resources.

Major projects under this scheme include Faisalabad-Multan motorway (M-4) with a projected cost of US\$ 24.5 billion, periodic overlay of M-2 & realignment of salt range with cost projected at US\$ 11.8 billion among others and Karachi-Hyderabad motorway (M-9) with projected cost at US\$ 105 million.

³⁷ Share in overall sector stood at 36.6 percent marginally up from 36.3 percent last year.

³⁸ Computed as value added of all the vehicles on road.

The improvement in infrastructure is also evident from a 1.8 percent increase in length of the high type road network during FY06. However, the rise in overall length of the roads rose by only 0.05 percent in this period mainly due to a decline of 2.9 percent in low type roads (which have been showing a continued deterioration for the last 6 years). This exhibits the substitution between the two types of roads over time, which is reflective of the government's greater focus on building major road networks in the country, relative to low type farm-to-market roads.

Table 2.25: Length of Road Network
thousand km

| | Total | Growth | High type | Growth | Low type | Growth |
|---------|-------|--------|-----------|--------|----------|--------|
| 2001-02 | 251.7 | 0.7 | 148.9 | 2.9 | 102.8 | -2.4 |
| 2002-03 | 252.2 | 0.2 | 153.2 | 2.9 | 98.9 | -3.7 |
| 2003-04 | 256.1 | 1.5 | 158.5 | 3.5 | 97.5 | -1.4 |
| 2004-05 | 258.2 | 0.8 | 162.8 | 2.7 | 95.4 | -2.2 |
| 2005-06 | 258.3 | 0.0 | 165.8 | 1.8 | 92.6 | -2.9 |

Source: Economic Survey 2005-06

Currently, the total road network in Pakistan comprises of (a) motorways, (b) highways i.e. main or national roads, (c) secondary or regional roads, (d) urban roads and (e) rural roads. While the first two³⁹ categories comprise of only 3.5 percent of the country's entire road network, these cater to almost 80 percent of commercial traffic in the country. Although government has shown commitment towards building major road networks, their constant deterioration remains a major issue. According to pavement condition surveys conducted in 2005 by NHA, 43 percent of the national highways have poor to very poor condition, suggesting the need to invest in the maintenance of the roads as much as in their construction.

Pakistan Railway

Pakistan railway has remained a very poor performer in the past facing huge losses due to inefficient management under public sector ownership. However, restructuring of the organization⁴⁰ in the past few year lead to an improved governance of *Pakistan railway* along with introduction of modern business practices. Although there is still a lot to be done, the performance of the sector has improved over time, which is also evident in the 13.9 percent growth in value addition during FY06, even over a significant 232 percent rise registered in FY05. Importantly, this growth was achieved despite a significant increase in fuel prices.

Table 2.26: Performance of Pak Railways

| billion Rupees | | | |
|------------------|------|------|----------------|
| | FY05 | FY06 | percent change |
| Gross earning | 17.6 | 18 | 2.4 |
| Passengers KM | 22.1 | 25.6 | 16.2 |
| Cargo KM | 5.1 | 5 | -2.1 |
| No. of carriages | 1.9 | 1.9 | 1.6 |

Source: Pakistan Railways

A glance at **Table 2.26** reveals that the number of passengers traveled rose significantly by 16.2 percent during FY06, however the impact of this rise was partially offset by the increased fuel cost as well as decline in the cargo operations. As a result, gross earnings rose by only 2.4 percent in FY06. It may be noted that a decline in cargo operations is disappointing in the wake of huge cargo transported in connection with earthquake related relief efforts.

Unfortunately, information on expenditure for the whole year data is not available yet. However, data upto Jul-Mar FY06 exhibited a sharp jump in interest on overdraft (259.0 percent YoY) and cost of POL (72.2 percent YoY). The significantly high increase of 21.7 percent during Jul-Mar FY06 in

³⁹ There are 18 major road networks including highways and motorways in Pakistan.

⁴⁰ Restructuring process included promulgation of a new railway act, and changing the management.

aggregate expenditure suggests that the full year losses of Pakistan Railways would see a sharp increase relative to FY05.

Air Transport

An unprecedented rise in fuel prices continued to be the main dampening factor for the profitability of the major airlines. Pakistan's airline industry also suffered from the surge in international oil prices, as the jet fuel prices rose sharply, registering a 42.4 percent YoY rise. Consequently, a fall in profitability of airline industry was witnessed, resulted in a decline of 11.4 percent in the value addition by the industry during FY06.

However, despite the lower profitability, the domestic air-transport continued to expand, with all major local airlines benefiting from a rise in activity on the back of improved economic environment and higher level of income ensuing from sustained growth in recent years. This is evident in a stronger rise in domestic passenger traffic, which has grown by 7.1 percent mainly reflecting the strength of the economy. International traffic witnessed a relatively smaller rise of 5.7 percent. Another highlight of the year is a rise in cargo traffic, which possibly reflects usage of cargo services for relief activities for the earthquake-affected areas.

Pakistan International Airlines

Apparently, the performance of the national flag carrier airline for FY06 exhibits a disappointing situation (see **Table 2.27**). However a detailed analysis reveals that the losses incurred was mainly on account of a single head i.e. fuel costs, which experienced an unprecedented rise due to surge in global oil prices⁴¹ and resultantly wiped out the profits of the industry. On the revenue side, however the airline achieved record level of Rs 69.2 billion with expanding business being the main factor. During FY06, PIA added two new international destinations.⁴² In addition, two long range aircraft were inducted into PIA fleet which resulted in improvement in the operational efficiency of the airline.

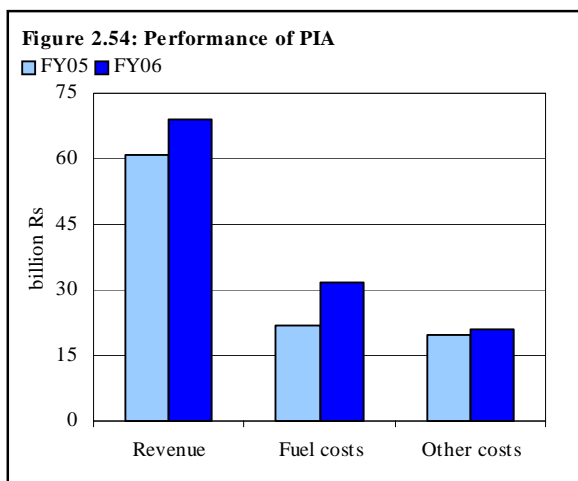
Specifically, passenger revenue registered a 14.1 percent rise for FY06 and remained well above the target set for the year, despite the tight competitive environment especially on domestic routes which compelled the national airline to drop its fares in order to retain its market share which dropped drastically in the past years. While, non transport as well as cargo revenues also registered a rise, cargo revenue fell short of target marginally, possibly a result of free of charge relief activities carried out in the wake of October 2005 earthquake.

On the expenditure side, as mentioned earlier, fuel and oil expenses remained the main dampening factor registering a 42.4 percent rise (see **Figure 2.54**). Resultantly fuel bill of

Table 2.27: Performance Indicators - PIA

| | 2003 | 2004 | 2005 | % change (2005 over 2004) |
|----------------------------|--------|--------|--------|---------------------------|
| Revenue km flown (000) | 68,851 | 80,087 | 82,550 | 3.1 |
| Passenger load factor | 69.6 | 66.4 | 69.7 | 5.0 |
| Revenue load factor | 58.5 | 55 | 55.7 | 1.3 |
| Profit (loss) (billion Rs) | 1.3 | 2.3 | -4.4 | -291.2 |
| Net worth (billion Rs) | 6.7 | 13.4 | 10.4 | -22.4 |

Source: PIA- Annual Report 2005



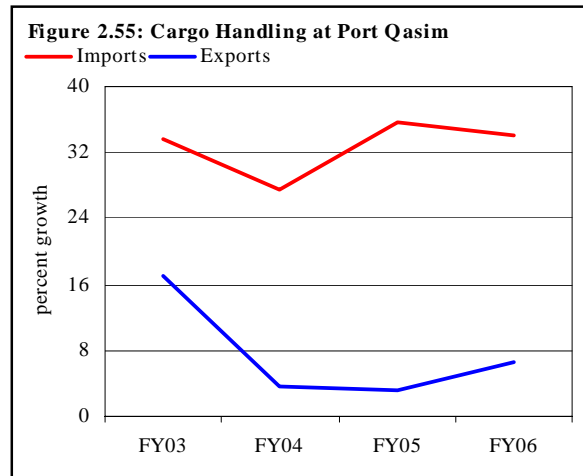
⁴¹ Arabian light oil prices (end period) for FY06 stood at US\$ 67.9 per barrel against US\$ 52.9 per barrel for FY05.

⁴² Nairobi and Urumqi (China).

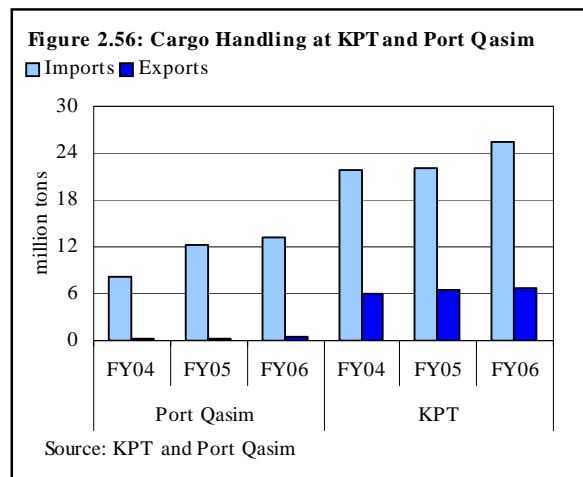
the airline reached Rs 31.8 billion during FY06, significantly above the Rs 22.3 billion target for the year. Other operating expenses⁴³ including landing/overlying expenses, maintenance, salaries of the staff, and other expenses registered a marginal increase of 6.3 percent during the year.

Shipping and Port Activities

Total cargo handling at KPT and Port Qasim amounted to 45.8⁴⁴ million tonnes during FY06 registering a rise of 11.7 percent, lower than 13.2 percent growth seen in FY05. This is consistent with the trend in the value addition through port and shipping activities, which recorded an increase of 8.2 percent during FY06 witnessing a deceleration relative to the growth of 15.6 percent in FY05. It may be noted that a greater rise in cargo handling for imports is evident at both the ports, as total cargo handling for imports amounted to 38.7 million tonnes, while that for exports at 7.2 million tonnes. This is consistent with the trends in imports and exports for the year, as FY06 imports grew strongly for yet another year on the back of strong domestic demand reaching an unprecedented level of US\$ 28.8 billion. On the other hand, in the same period exports amounted to US\$ 16.4 billion, falling a little short of the US\$ 17.0 billion target for the year.



Disaggregated data reveals that cargo handling at Port Qasim amounted to 13.6 million tonnes, which accounted for 29.8 percent of the total cargo handling at both the ports, lower than the last year’s contribution of 30.3 percent. The fall in Port Qasim’s share is mainly a function of a drop in imports by Pakistan Steel Mills (see **Figure 2.55**).



KPT witnessed acceleration in cargo handling registering a rise of 12.5 percent against 2.9 percent last year (see **Figure 2.56**). Total cargo handling amounted to 32.1 million tonnes, of which 25.5 million tonnes accrued to imports related cargo while cargo handling for exports amounted to 6.6 million tonnes.

⁴³ Excluding fuel expenditure.

⁴⁴ Cargo handling at KPT was 70.2 percent of total cargo handling at both the ports amounting to 32.1 million tonnes.

2.5 Investment

The total nominal investment-to-GDP ratio rose to 20.0 percent during FY06 up from 18.1 percent in the preceding year and an average of 17.1 percent in the last five years (see **Figure 2.57**). Importantly, this is the highest level of the investment to GDP ratio in over a decade. The rise in their ratio is mainly attributed to (1) improved confidence of local as well as foreign investors on the back of good showing of the economy, (2) a robust 22.3 percent growth in credit to private sector despite increasing interest rates and (3) rising public investment.

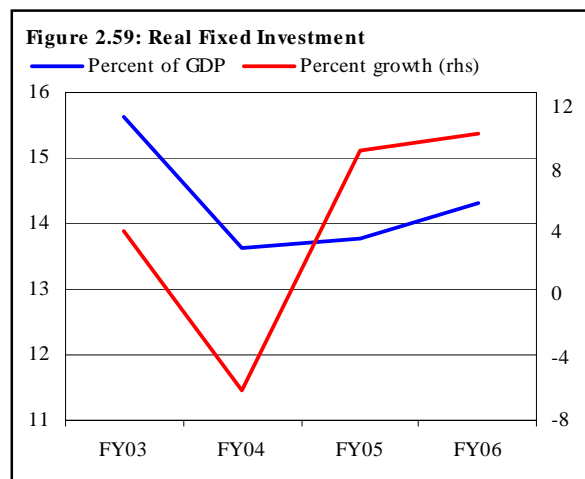
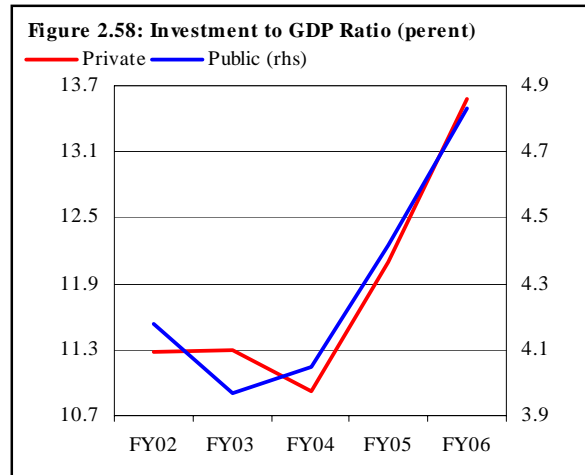
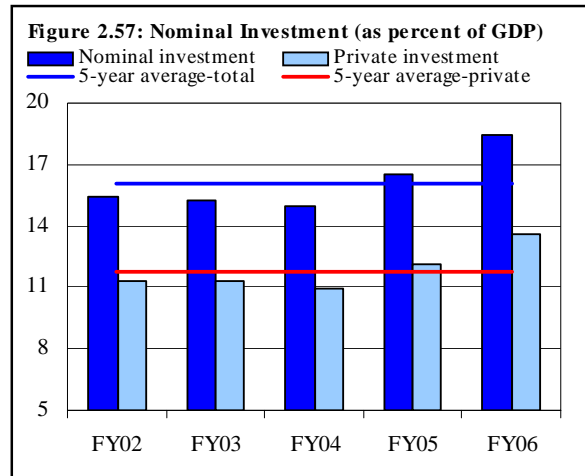
Both public and private investment contributed to the rise of total investment during FY06, but the increase in the latter was more pronounced. It is important to note that a significant rise in public investment in infrastructure during past three years also resulted in a trend reversal in private investment (see **Figure 2.58**).

Specifically, the private investment to GDP ratio rose by 1.5 percentage points to 13.6 percent during 2006. Public investment also saw a rise of 0.6 percentage points to reach 4.8 percent of GDP in FY06 after bottomed out at 4.0 percent of GDP in FY03 and FY04.

In addition to investing in infrastructure, the government is taking various additional measures to enhance investor confidence and reduce the cost of doing business in the country. Some of these measures are (1) rationalization of tariffs (2) improvement in the tax refund process (3) removal of procedural bottlenecks (4) review of tax laws and tax machinery and (5) provision of efficient and reformed banking sector. However, deliberated efforts are also needed to provide low cost and efficient energy with other utilities, amend regulation to make labor market more flexible and improve the law & order situation. The importance of an improved governance and effective contract enforcement with speedy settlement in case of dispute very important to sustain the high growth in investment.

2.5.1 Real Fixed Investment

Growth in overall real fixed investment accelerated to 10.3 percent during FY06 compared with 9.3 percent in FY05. Although, the real investment to GDP ratio rose from 13.8 percent in FY05 to 14.3



percent in FY06 (see **Figure 2.59**), it is still low relative to historical levels and the current growth momentum of the economy.

Encouragingly, the rise in real fixed investment is largely contributed by the growth in private investment that accounted for more than three-fourth of the rise during FY06 (see **Figure 2.60**).

It is noteworthy that the increase in the cost of investment, measured by percent change in investment deflator,⁴⁵ witnessed a sharp rise during the last three years (see **Box 2.1**). The sharp increase in investment deflator has also overshadowed the rise in real investment.

Agriculture

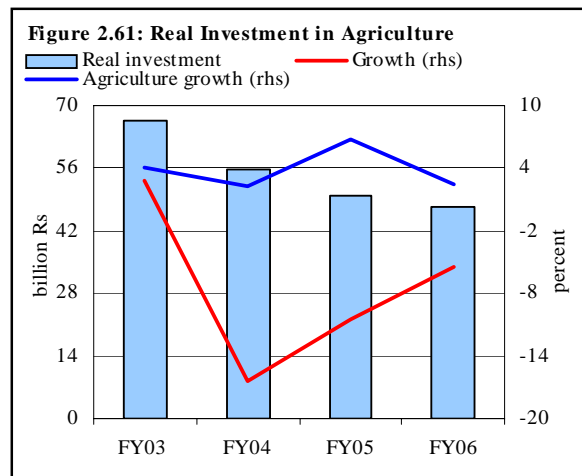
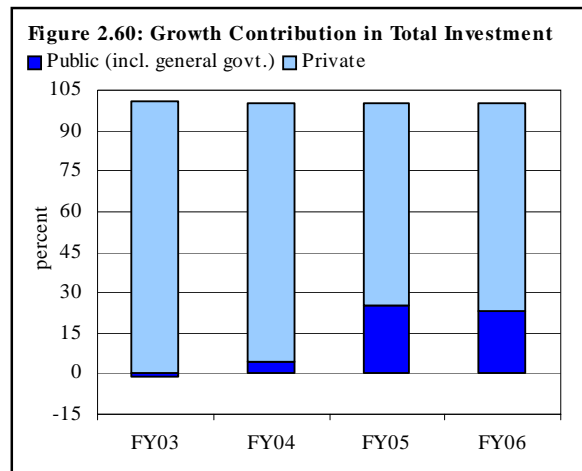
Real fixed investment in the *agriculture* sector witnessed a decline for the third year in a row (see **Figure 2.61**). As a result, the share of real fixed agricultural investment in total real fixed investment fell to 6.3 percent in FY06 from 7.4 percent during FY05. This decline is largely attributed to (1) rising interest rates, as well as (2) farmers tendency to utilize financial resources for production purposes, as evidenced by a declining share of development loans to total loans in recent years. Moreover, a large part of investment needs were probably met from farmers' own (unreported) resources due to increased farm income during the last few years amidst better prices of most crops.

Mining and Quarrying

The trend of real investment in the *mining & quarrying* sector remained volatile in recent years. Real investment in this sector witnessed a growth of 9.0 percent during FY06 compared with a fall of 22.2 percent for FY05; the FY06 rise is entirely driven by private investment. *Mining & quarrying* sector is important for the economy as it is the main supplier of key inputs and energy to industry. There is a need to exploit the natural resources of the country to sustain and diversify the growth momentum. Progress in the development to exploit large copper deposit at Riko-Dik in Chagai district of Balochistan is a positive move in this direction; success in this project could encourage more investment in the mining sector.

Manufacturing

A significant decline in private real investment under LSM more than offset the impact of increased public investment in LSM and a rise in private investment in the small scale manufacturing during FY06 (see **Figure 2.62**). The decline in private investment is, in part, a function of the tight monetary stance of SBP, as well as a slowdown in textile industry during the year. The deceleration in private sector credit growth to 24 percent in FY06 compared with a strong 34 percent rise in the preceding

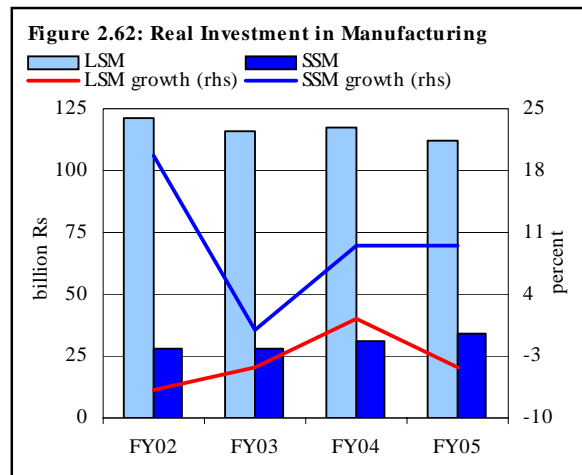


⁴⁵ Ratio of nominal investment to real investment.

year also contributed to lower investment in LSM. The decline in real investment in LSM is disappointing as major key industries are facing capacity constraints and there is a need of fresh investment in *paper & board, fertilizer, automobiles and metal industries.*

Electricity & Gas Distribution

Private sector investment in *electricity & gas distribution* has registered tremendous growth during FY06. However due to a negligible rise in public sector investment, growth in real investment in *electricity & gas distribution* was contained to 25.6 percent during FY06 relative to a remarkable 53.4 percent in FY05. The rise during the last three years is mainly attributed to an unprecedented increase in FDI in the sector which stood at US\$ 633 million,⁴⁶ including US\$ 255 million received on account of privatization proceeds of KESC.



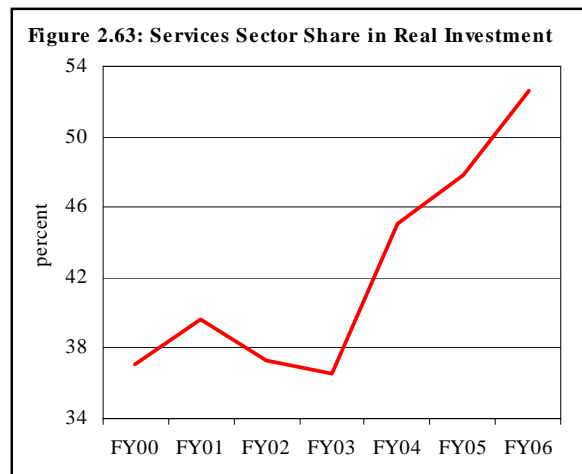
It may be noted that despite strong growth during the last two years, real investment in this sector is significantly lower than levels prior to FY04. However, it is likely that this sector would be able to grow at a fast pace due to private sector participation under a liberal energy policy of the government.

Construction

Real investment in the construction sector decelerated to 6.2 percent in FY06 compared with an exceptional 66.1 percent rise in the preceding year. The main factors behind this deceleration could be the higher base effect of last year and a fall in credit flow to the sector due to rising interest rates.⁴⁷ Importantly, FDI in the sector witnessed a sharp surge mainly due to higher interest of investors from Middle-East in residential as well as commercial projects in the country.

Services Sector

The share of the services sector in total real investment has been persistently increasing since FY03 (see **Figure 2.63**). The share of the services sector in total real investment reached 52.6 percent during FY06, registering a robust growth of 21.1 percent compared with a rise of 14.2 percent in FY05. This notable performance of the services sector has been contributed by nearly all the sub-sectors with *transport & communication* sector at the top, followed by *wholesale & retail trade* and *finance & insurance* sub-sectors.



Transport & Communication

Transport & communication sector has emerged as the highest recipient of investment during FY06, attracting 26 percent of total investment and registering a 40.7 percent YoY growth. Although, private real investment growth saw a marginal

⁴⁶ Out of this \$ 320 million accrued to power sector and \$ 312 million to oil and Gas exploration.

⁴⁷ Credit to construction sector has witnessed a decline of 16.5 percent while house building related credit has also declined by 24.3 percent.

deceleration during FY06, it remained a significant 46.1 percent compared with 47.2 percent in FY05. By contrast, public investment in the sector is volatile; FY06 acceleration is mainly attributed to fresh addition of aircraft in PIA (see **Figure 2.64**). Importantly, FDI in the sector⁴⁸ including privatization proceeds could be attributed as main factor behind the stellar growth in private real investment in this sector.

Wholesale & retail trade

Investment in *wholesale & retail trade* accelerated to 17.9 percent in FY06 mainly on the back of higher FDI and higher credit flow to the sector (see **Figure 2.65**). This surge in real investment in the sector is largely due to (1) a rise in trade activities in the economy as a result of higher imports, (2) rise in consumption, as well as (3) changing consumption patterns of the population.

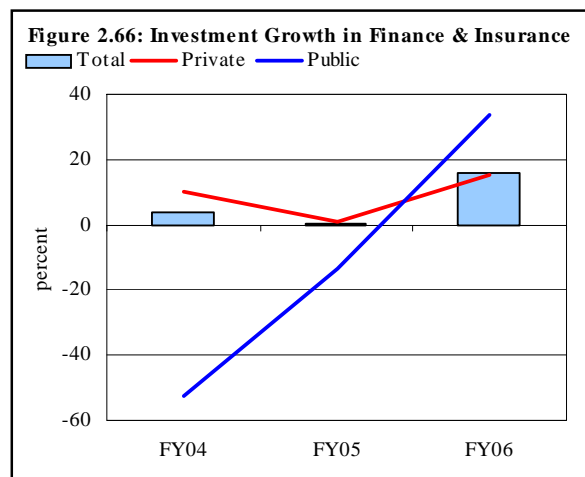
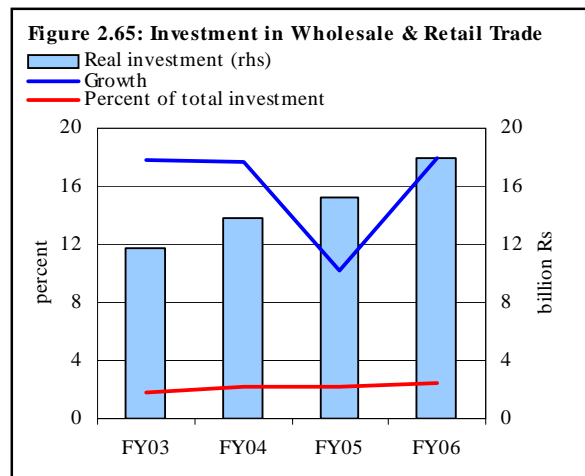
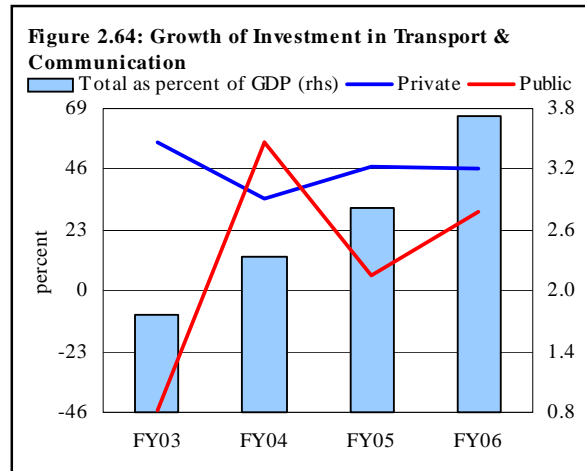
Finance & Insurance

Private real investment has principally accelerated the growth in *finance & insurance* sub-sector during FY06 (see **Figure 2.66**). As a result, real investment in this sub-sector registered an overall 16.0 percent growth during FY06 against a negligible 0.4 percent last year. This rise is principally driven by both (1) higher FDI,⁴⁹ including investment due to incorporation of a new Islamic bank, (2) higher domestic investment as a result of improved profitability of the sector during the last two years as well as (3) privatization proceeds.

2.6 Foreign Direct Investment

The flow of foreign direct investment (FDI) is an important indicator of economic performance as well as the economic prospects of an economy; on the one hand, FDI reflects the investors' confidence in an economy, and on the other it provides the required funds to capital deficient economies.

More importantly, FDI, in most cases, is



⁴⁸ Transport sector attracted US\$ 18.4 million against US\$ 10.6 million, while communication sector attracted US\$ 1.9 billion of which US\$ 1.1 billion received on account of privatization proceeds for PTCL sale to a UAE based company.

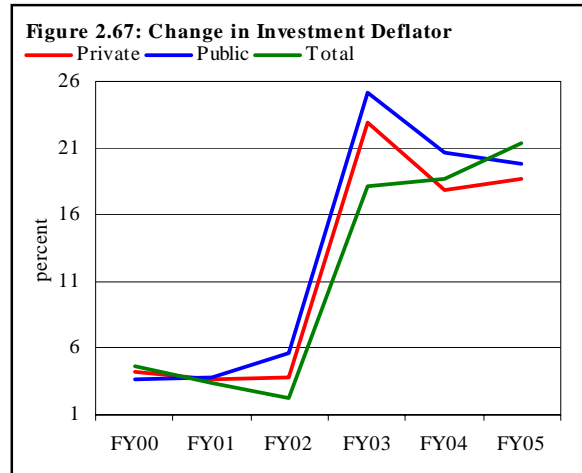
⁴⁹ Including privatization proceeds for HBL amounting to US\$ 99.3 million.

typically also accompanied with the introduction of advanced technologies, improvement in management practices as well as greater employment opportunities. Therefore, FDI appears as a win-win situation for the socio-economic progress. In this background, attracting as much FDI as possible is important for Pakistan's economy in order to help sustain (and accelerate) the growth momentum.

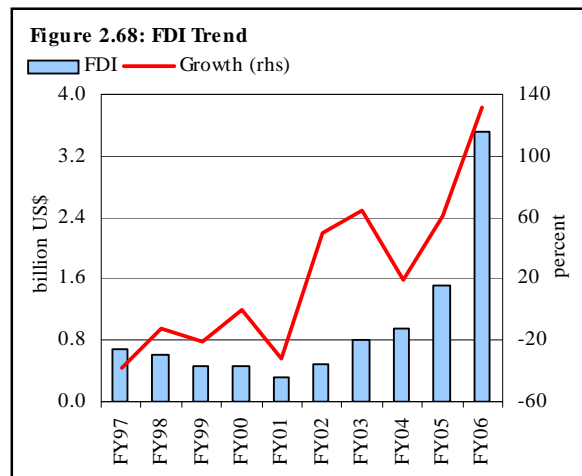
Box 2.6: Investment Deflator

It is interesting to note that investment deflator witnessed a sharp rise during the last three years (see **Figure 2.67**). Although a part of this rise is understandable, this sharp increase is puzzling. The possible explanations for an increase in investment deflator including others (1) high level of inflation in FY05 and FY06 (2) jump in real estate prices (3) significant rise in international prices of metal (4) sustained rise in the cost of construction and (5) strong demand of investment goods and machinery on the back of improved macroeconomic fundamentals.

However, above factors do not explain a sustained rise of about 20 percent in investment deflator during FY05 and FY06. More puzzling is an unacceptable increase of 345 percent rise in investment deflator in the case of wholesale & retail trade. Moreover, the reported figures in Economic Survey 2005-06 have been checked and reveal no discrepancy.



During FY06, FDI flows into Pakistan more than doubled from the preceding year, sustaining a 5-year trend (see **Figure 2.68**). This reflects the improved macroeconomic fundamentals and relative policy stability, which underpinned investor interest (particularly in major privatizations). In fact, even adjusting for the privatization transactions, FDI flows in FY06 amounted to US\$ 2.0 billion, registering a sharp rise of 70.6 percent over the preceding year. During FY06 privatization proceeds have registered an unprecedented rise to US\$ 1.5 billion (see **Figure 2.69**) mainly on account of (1) PTCL sale to a UAE based company, (2) sale of 73 percent share of KESC to a Saudi group and (3) receipts for Habib Bank privatization.



Importantly, since marketable public assets are limited, the component of privatization proceeds in FDI cannot be sustained for a longer period. This suggests the need for comprehensive improvement in the cost of doing business in Pakistan to attract investment in the country (see **Box 2.7**).

Disaggregated FDI data reveals that sectoral distribution is narrow during FY05 and FY06. In particular, the *telecommunications* sub-sector fetched more than half of the FDI during FY06 compared with about one-third FDI under this head in FY05. While during FY05 dominance of *telecommunication* in total FDI was mainly attributed to liberalization and rapid expansion in the cellular network in the country, the FY06 acceleration is principally driven by the privatization of PTCL. This also suggests that FY07 FDI is likely to be lower than the levels achieved in FY06.

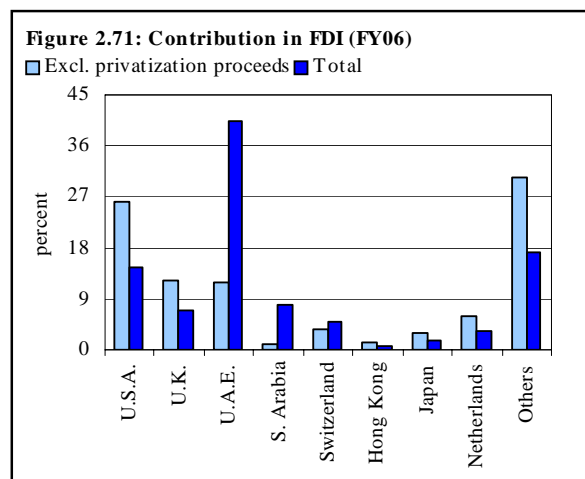
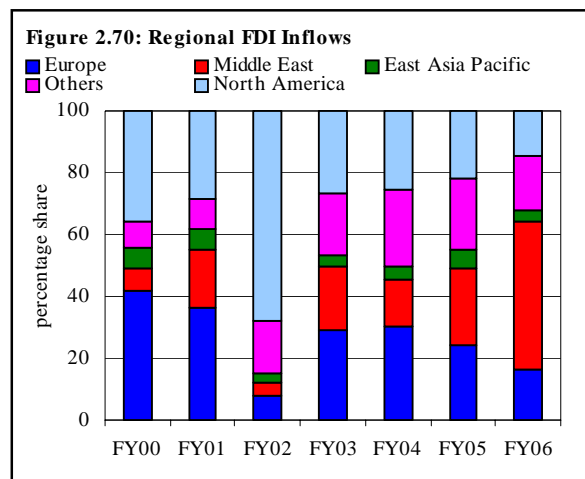
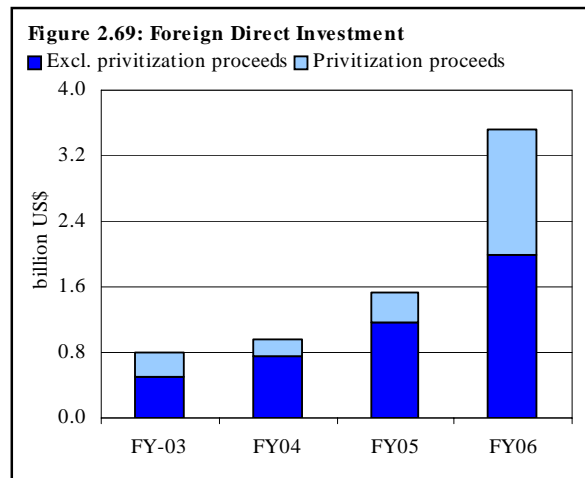
The other major sectors that attracted significant FDI inflows during FY06 were *power, finance & insurance* and *oil & gas exploration*. Each of these sectors received a little over US\$ 300 million during FY06. In the case of the power sector, privatization receipts on account of KESC as well as government’s liberal policy of power generation by the private units helped to achieve a relatively big amount of FDI by this group. Similarly, privatization proceeds on account of the privatization of a large public sector bank (HBL) and the opening of insurance sector were main contributory factors for a sustained good showing of finance & insurance group during FY06.

Interestingly, a favorable success ratio of 1:3.6 in Pakistan compared with global average of 1:10 in oil & gas exploration made this sub-sector attractive for FDI inflows. During FY06, about 40 percent of FDI inflows in oil & gas exploration originated from US based B.P. Pakistan Exploration and Production Inc.

In addition, FDI inflows rose significantly in the trade group from US\$ 52.1 million in FY05 to US\$ 118.0 million during FY06. This reflects wide interest of investors in the trading business including retail chain stores in Pakistan. A rapid expansion of big shopping malls and large departmental stores is evident in the country on the back of attractive rate of return. Similarly, historically FDI in food group was negligible, however FDI inflows witnessed a sharp jump from US\$ 10 million during FY05 to US\$ 51.3 million in FY06. The rise in FDI in food group mainly reflects investment in food marketing by a UAE based company and in edible oil processing business by a US based firm.

The impact of the above increases was partially offset by a significant decline of FDI in the fertilizer industry. A dis-investment of US\$ 107.6 million was registered during FY06, which is entirely owed to the sale of a foreign fertilizer entity to a local group.

In terms of geographical origin of FDI, a significant shift in favor of Middle East is evident in recent years (see **Figure 2.70** and **Figure 2.71**). Notably, the share of North America (mainly USA), Europe (mainly UK) and East Asia Pacific (mainly Japan) regions



shrunk considerably since FY03. It is important to make a distinction that in absolute terms, FDI inflows increased from all of these regions during FY06, however their shares in total FDI in Pakistan fell due to extraordinary rise in FDI inflows from Middle East (particularly UAE).

It is also important to note that not only about half of the FDI originated from the Middle East, FDI from different countries and regions is also concentrated in a specific sector. For example, 95.5 percent of FDI from the Middle East is only in communication sector during FY06. Similarly, Saudi investors invested about 95.1 percent in power sector, FDI from Switzerland mainly flew (81.6 percent) towards finance & insurance, and finally about 40 percent of FDI from UK and USA focused in telecommunication and oil & gas exploration sectors during FY06.

Table 2.28: Country/Sector wise FDI–FY06

million US Dollar

| | USA | UK | UAE | S. Arabia | Switzerland | Others | Total |
|------------------------------|--------------|--------------|----------------|--------------|--------------|--------------|----------------|
| Food group | 25.5 | 6.4 | 26.3 | 0.1 | 4.1 | 4.6 | 67.0 |
| Textiles | 9.5 | 7.6 | 10.6 | 0.1 | 6.0 | 13.2 | 47.0 |
| Chemicals | 9.4 | 4.6 | 2.0 | 0.2 | 9.2 | 37.5 | 62.9 |
| Petroleum refining. | -1.3 | 14.1 | 17.7 | 0.0 | 0.0 | 0.7 | 31.2 |
| Oil-gas & mining & quarrying | 200.3 | 16.2 | 0.1 | 0.0 | 0.0 | 96.1 | 312.7 |
| Pharmaceutical group | 1.3 | 9.4 | 3.9 | 0.0 | 1.8 | 18.1 | 34.5 |
| Metals | 2.7 | 2.4 | 1.5 | 0.0 | 0.0 | 0.6 | 7.2 |
| Machinery | 0.8 | 0.2 | 0.2 | 0.0 | 0.0 | 1.7 | 2.9 |
| Cement | 30.5 | 9.9 | 3.4 | 3.5 | -2.0 | 0.0 | 39.0 |
| Electronics | 4.4 | 0.0 | 0.7 | 0.0 | 0.0 | 12.9 | 18.1 |
| Transport equipment | 1.1 | 0.5 | 2.5 | 0.0 | 0.0 | 29.1 | 33.1 |
| Construction | 19.5 | 2.0 | 36.1 | 0.3 | 0.1 | 31.6 | 89.5 |
| Trade | 36.4 | 10.3 | 9.1 | 1.3 | 7.2 | 53.5 | 118.0 |
| Power | 18.8 | 21.8 | 0.3 | 264.1 | 0.2 | 15.4 | 320.6 |
| Communications | 81.6 | 101.5 | 1,360.5 | 0.4 | 0.0 | 393.8 | 1,937.7 |
| Financial business | 17.9 | 28.9 | 37.3 | 5.1 | 139.2 | 100.7 | 329.2 |
| Others | 58.3 | 8.3 | -87.5 | 2.8 | 4.6 | 77.9 | 70.6 |
| Total | 516.7 | 244.0 | 1,424.5 | 277.8 | 170.6 | 887.5 | 3,521.0 |

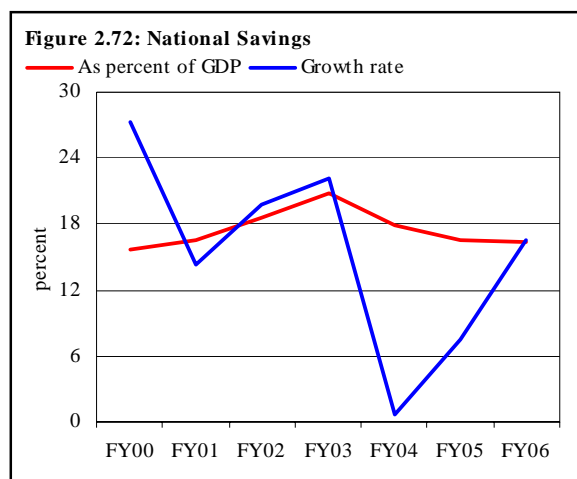
Note: Sums may not tally due to separate rounding off.

As a positive note in terms of origin of FDI, the Netherland emerged as a leading investor in the chemical sector during FY06 (see **Table 2.28**), however here too FDI is concentrated in a single company (ICI).

2.7 National Savings

Although national savings rose sharply by 16.5 percent during FY06 compared with 7.5 percent growth in the preceding year, nonetheless this increase is lower than the rise in nominal GDP (see **Figure 2.72**). As a result, national savings to GDP ratio slightly dropped by 0.1 percentage points to 16.4 percent of GDP during FY06, the lowest level of national savings since FY01.

In fact, despite rising interest rates, national



savings to GDP ratio did not improve mainly due to (1) prevailing negative real returns on deposits being offered by the banks (see **Figure 2.73**), (2) rise in NSS rates was not in line with the expectations, (3) continued ban on institutional investment in NSS (which has been relaxed recently during FY07), and (4) continued consumption boom in the economy.

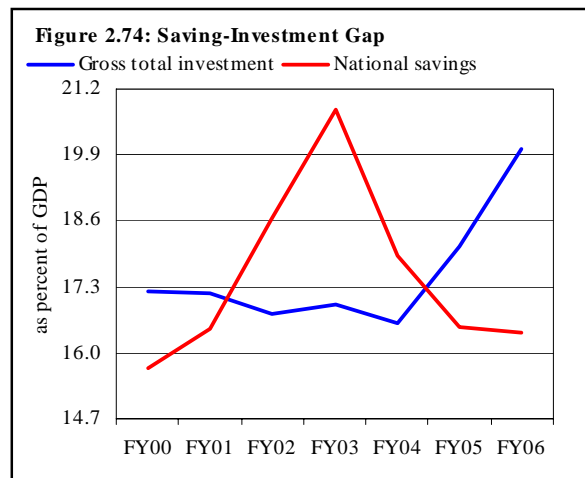
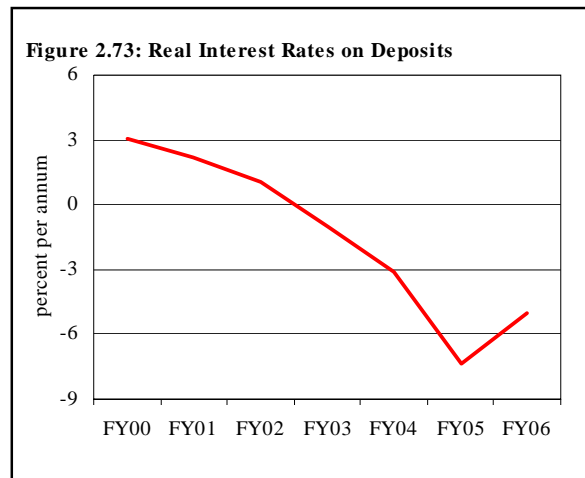
In particular, the strength of aggregate demand supported by both an expansionary fiscal policy as well as rising private consumption in recent years deteriorated the savings rate in the economy.

Saving-Investment Gap

As a result of the combined impact of an improved investment to GDP ratio and deterioration in savings to GDP ratio, the saving investment gap widened to 3.6 percent of GDP during FY06, up from 1.6 percent seen in FY05 (see **Figure 2.74**). Historically, a high saving-investment gap had adverse implications for the macroeconomic stability. However, the present widening in this gap is not an immediate concern since economy is able to finance this resource gap through higher FDI and remittances. Moreover, country's level of foreign exchange reserves is also sufficient relative to the 1990s, when saving-investment gap was quite high.

However, given that a significant part of the FDI consists on privation proceeds, a sustained saving-investment gap could pose serious threat to macroeconomic stability. Thus, there is a need to improve domestic savings through institutional arrangements and conducive policies.

An expansion in the network of banks, microfinance institutions, and postal savings to the far flung areas is needed with a friendly atmosphere for the small depositors. In addition, savings schemes for school/college students could also help inculcate savings behavior from the early age. Admittedly, there should not be regulatory intervention in the determination of rate of return on deposits. However, if financial institutions form a cartel to artificially suppress the returns on deposits, they should be treated accordingly through regulations.



Box 2.7: Cost of Doing Business Indicators

According to the World Bank's Cost of Doing Business 2007, in sharp contrast with the rising FDI trend in Pakistan, country ranked at number 74 out of 175 nations in 2006, falling from 66 in 2005. The major deterioration in ranking is attributed to a worse performance in terms of (1) closing a business (2) registering property (3) starting a business and (4) getting credit. These findings probably a result of inclusion of 20 new countries in the ranking as no major change in regulations or in practice has been witnessed that could lead to a deterioration in the above criteria in Pakistan. Moreover, it may also be noted that Pakistan in almost all of the above dimensions is much better of as compared with regional countries. For example, the time required for close of a business is 2.8 years in Pakistan with a cost of 4 percent of the estate value compared with 3.6 years in the region, with a cost of 6.3 percent of the estate value. Similarly, registering property required 50 days in Pakistan with a cost of 4.4 percent of the value of the property as against 118.6 days and 5.3 percent cost in the region. However, number of procedures to get property registered in Pakistan are 6 compared with 5.8 in the region.

A relatively better performance in the region is also reflected in a better ranking relative to other countries in the region. For example, Bangladesh ranked 88, Sri Lanka 89, China 93, Nepal 100, and India 134.

However, the statistics also pointed out some areas where Pakistan needs more efforts to improve further relative to other countries in the region. The most striking ranking of 163 out of 175 in terms of contract enforcement necessitates comprehensive reforms in legal and judiciary system. Contract enforcement should be improved that investors' can enter into an agreement confidently that in case of dispute they will be able to get their right fairly, quickly and at a negligible cost.

Another area where country needs immediate reforms is paying taxes. According to Cost of Doing Business 2006, a medium size company is required to make 47 different payments, spending 560 hours and paying 43.4 percent of the total profit in taxes. In addition, Pakistan ranked at 126 in terms of ease in employing workers, both hiring and firing costs (12 percent of salary and 90 weeks of wages respectively) are very high relative to the region. Moreover, Rigidity of Employment Index value for Pakistan is 43, shows rigid regulations and labor market. It is important to note that hiring a worker is more difficult in Pakistan than firing a worker, as the respective indices values are 78 and 30, mainly reflecting shortage of trainable/skilled workers.

The above findings may be a little exaggeration on account of some passive responses of survey. However, there is a need to improve in the areas identified in the report. A positive response with sound strategy would open new avenues of FDI on sustainable basis.

Source: Cost of Doing Business 2007 How to Reform, World Bank, available at http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf