

2 Real Sector

2.1 Agriculture Sector Performance

The prospects of a strong FY07 *rabi* harvests have brightened significantly. The extended rainy season (and snowfall) means that water availability is the best seen since FY00, and the impact of this has been complemented by the continued access to credit and the availability of other inputs (fertilizer, credit, etc. - see **Table 2.1**). The *rabi* crops are also expected to benefit from supportive government policies such as the subsidy on non-urea fertilizers, the media campaign to educate farmers about the use of a balanced mix of urea and DAP, as well as a rise in the support price of wheat.

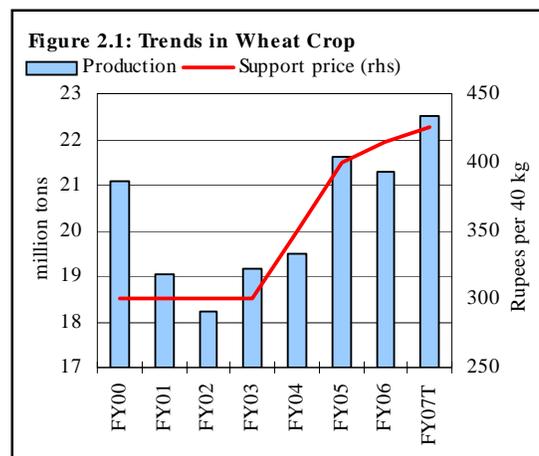
Table 2.1: Availability of Inputs (Jul-Dec)

	FY05	FY06	FY07
Rain fall (cm)	296.8	549.3	673.9
Water availability at canal heads (MAF)	82.2	93.1	103.5
Credit disbursement* (billion Rs)	57.5	71.7	81.0
Fertilizer off-take (million tons)	3.8	3.8	3.8

* Jul-Jan

Sources: 1. Planning & Development Division
2. IRSA
3. Agriculture Credit Department, SBP

It is important to note that timely announcement of support policy measures is a crucial factor for yielding effective results. **Figure 2.1** illustrates that during the period (FY00-FY03) when support price for wheat was left unchanged; production of wheat remained around 19 million tons. In contrast, a major stimulus to production was evident due to the continued rise in the support price of wheat since FY04 as an effective incentive to farmers. As a result, the realized harvest of wheat exceeded 20 million tons each year.



It is hoped that a good performance of *rabi* crops would also help to compensate, in part, for the disappointing performance of three major *kharif* crops (cotton, rice and maize) during FY07. While the decline in the harvests of all these crops was principally driven by a fall in the area under cultivation,¹ the cotton crop also suffered due to viral attacks (see **Table 2.2**). In aggregate, however, the growth of crops sub-sector will likely remain below the FY07 target, although it will still represent an improvement over the FY06 performance. Meeting the agriculture growth target in FY07 would therefore require the livestock sub-sector to grow well above target.

Table 2.2: Major Crops – Area, Production and Yield
Area Under Cultivation (000¹ hectares)

Crops	FY05	FY06T	FY06P	FY07T	FY07E	% change in
						FY07 over FY06
Cotton	3,229	3,247	3,100	3,250	2,951	-4.8
Sugarcane	967	955	907	1,005	1,017	12.1
Rice	2,520	2,533	2,621	2,575	2,475	-5.6
Wheat	8,358	8,415	8,355	8,459	8,420	0.8
Gram	1,109	1,113	1,066	1,051	-	-
Maize	945	971	1,030	1,001	1,027	-0.3
Production (000 tons; cotton in 000 ¹ bales of 170kg each)						
Cotton	14,600	15,000	13,000	13,820	12,500	-3.8
Sugarcane	47,224	50,095	44,651	50,500	51,444	15.2
Rice	5,025	5,000	5,547	5,693	5,400	-2.7
Wheat	21,612	22,000	21,708	22,000	22,500	3.6
Gram	766	853	536	610	707	31.9
Maize	2,520	2,905	3,560	3,279	2,918	-18.0
Yield (Kg/hectare)						
Cotton	769	785	713	723	720	1.0
Sugarcane	48,836	52,455	49,229	50,249	50,584	2.8
Rice	1,994	1,974	2,116	2,211	2,182	3.1
Wheat	2,586	2,614	2,598	2,601	2,672	2.8
Gram	691	766	503	580	-	-
Maize	2,667	2,992	3,456	3,276	2,841	-17.8

P: Provisional; T: Target; E: Estimates

Note: Wheat and Gram production targets were revised to 22500 and 707 thousand tons respectively for FY07.

Source: MINFAL

¹ The area under cotton and rice was principally hit by flooding, while the lower cultivation of maize mainly reflected the substitution with sugarcane.

Crop Sub-sector

Wheat

Encouraged by higher support prices, increased irrigation water availability, the subsidy on the purchase of non-urea fertilizers, and favorable weather conditions, growers increased the cultivated area for wheat. Latest available data (for January 23, 2007) indicated that this had risen by 0.7 percent YoY (or 56 thousand hectares),² achieving the cultivation area target for the year.³ Clearly, in effect, the delayed beginning of the sugarcane-crushing season has not had a materially adverse impact on the area under wheat, though it can be argued that the area under wheat may have been even higher were it not for this delay.

Furthermore, the crop is also expected to benefit from significant and widespread rains during December 2006 and February 2007; the rains at this stage are likely to lead to heavier wheat kernel and reduce pest incidence. While the unseasonal rains have also caused minor damage in some areas, in net terms Pakistan is expected to record yet another bumper wheat harvest, if conditions remain favorable.

In anticipation of a bumper wheat harvest, the SBP has proactively moved to allow ample credit lines to the private sector for the purchase of wheat, in order to ensure the timely off-take of wheat stocks by traders (see **Box 2.1**).

This said, effective policy measures for other crops are also required to assure incentives to farmers. For example, continued dispute on the pricing for the sugarcane crop is not only hurting farmers, it is also damaging for the future growth prospects of the crop as well as agriculture. Price disputes resulted in delays in crushing, thus area under the crop remained occupied. To avoid such issues, effective regulations may be helpful. Though, regulations generally create distortions, however if market failures do not permit the efficient outcome then regulations can indeed help to achieve better results.

² Pertain to 8th-23rd January 2007.

³ It is possible that final data will show that cultivated area was above target.

Box 2.1: Financial Support for Wheat Marketing

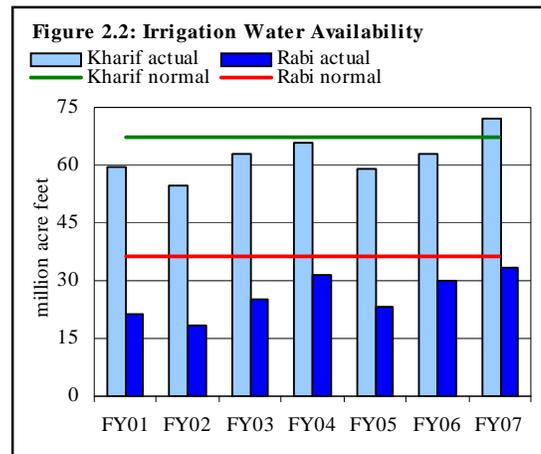
In order to strengthen wheat marketing, banks will extend funds to flour mills and licensed traders for procurement of indigenous wheat for FY07 crop, subject to the following terms:

1. Banks will determine the rate of mark-up on lending to the private sector for the purpose of wheat procurement depending upon the risk profile of each borrower. Though lending to the government agencies for wheat procurement is secured against the government guarantee, it is expected that the relative mark-up rate would be competitive in comparison to the rate charged to their borrowers in the private sector;
2. Banks may fix minimum margin requirement of 10 percent of the value of the wheat stock. However, banks shall not provide any financial facilities (funded or non-funded) to enable borrowers to meet the margin requirements;
3. Loans provided to the private sector will be for the procurement of indigenous wheat only and shall be repayable on or before January 31, 2008 positively;
4. Banks are also allowed to provide facilities for wheat procurement by the seed processing plants, in line with their lending policies and the capacity/production plans of the seed processing plants;
5. Banks shall ensure that the loans provided under the wheat procurement policy 2006 have been adjusted as per terms of SMED Circular No. 05 dated 14-03-2006. Fresh financing to the eligible borrowers for procurement of wheat during 2007 shall start from commencement of wheat procurement season 2007 in respective provinces, on arrival of new crop in the market;
6. Banks will continue to submit a weekly statement in respect of financing to private sector for wheat procurement as per the prescribed format already in use; and
7. The lending shall be in compliance with the Prudential Regulations and other instructions of SBP issued from time to time.

Agriculture Inputs

Irrigation Water

Higher than normal monsoon rains in 2006 together with the winter rains in December 2006 and February 2007 have pushed up water availability for *rabi* crops to the highest levels since FY00 (see **Figure 2.2**). In particular, the higher rains in February 2007 raised the irrigation water availability approximately by 1.8 MAF⁴ for the *rabi* FY07 season, 11.3 percent higher over *rabi* FY06.



⁴ IRSA revised irrigation water availability from 31.6 MAF to 33.4 MAF for FY07 *rabi* season.

The rains in February 2007 would particularly benefit the wheat crop, which is in the reproduction stage. In addition, these rains would also lead to increase production of vegetables and fruits. This spell of rainfall may prove to be exceptionally beneficial for Balochistan province, the *Cholistan* desert and its adjacent areas, as it will encourage growth of natural fodder for animals, increase foliage and improve water resources. Further, these rains also diluted the impact of the acute shortage of irrigation water in Punjab's southern regions⁵ due to the on-going execution of the project for the modernization and rehabilitation of *Taunsa* Barrage.

The widespread rains and snowfalls in February 2007, in the Northern areas have also improved the water storage in *Tarbela* and *Mangla* dams, with prospects of adequate supply of irrigation water for the coming *kharif* crops.

Fertilizer off-take

Despite higher farm incomes, better irrigation water availability and higher credit disbursement by banks, fertilizer off-take declined in H1-FY07.

This was mainly because farmers delayed purchases in anticipation of a subsidy on non-urea fertilizers. As evident from **Table 2.3**, the entire net decline in fertilizer off-take during Jul-Dec FY07 was due to a fall in sales during July-October FY07 ahead of the November 2006 subsidy announcement. Subsequently, off-take has risen very substantially. In fact, significant increase of 30.9 percent during Nov-Dec FY07 almost offset the impact of decline in fertilizer off-take during Jul-Oct FY07.

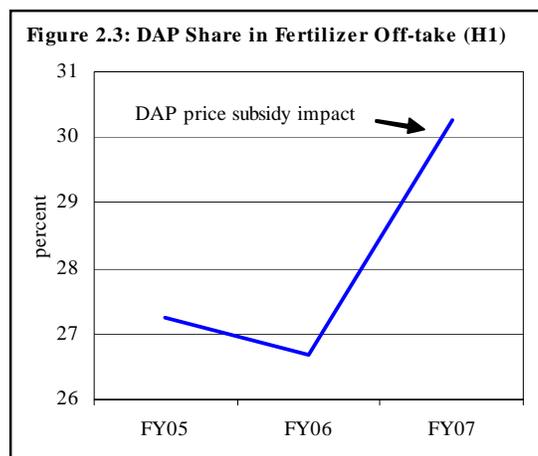
percent	FY06	FY07
Urea		
Jul-Dec	2.1	-6.1
Jul-Oct	12.7	-23.4
Nov-Dec	-11.0	20.9
DAP		
Jul-Dec	-0.8	12.1
Jul-Oct	-4.6	-15.4
Nov-Dec	6.7	60.7
Total		
Jul-Dec	1.3	-1.2
Jul-Oct	7.4	-21.2
Nov-Dec	-7.1	30.9

Interestingly, while no subsidy had been expected for urea, off-take of this had also dipped along with that of DAP. This correlation is explained by the fact that

⁵ Muzaffargarh, Rajanpur, Jampur, Kot Mithan, Fazilpur and Dera Ghazi Khan.

hitherto urea (which has an implicit price subsidy) had been used excessively in Pakistan, at the expense of DAP (the domestic price of which follows international trends). Thus, as the promised subsidy on non-urea fertilizers promised to bring down DAP prices to more affordable levels, farmers held back on excessive use of urea as well, ahead of the subsidy announcement.

Thereafter, while the sales of both types of fertilizers witnessed a significant increase during Nov-Dec FY07, reflecting the more balanced fertilizer usage, the share of DAP fertilizer off-take is now higher (see **Figure 2.3**). This trend was also helped by greater awareness of the farmers following an aggressive media campaign launched by the government.



Agriculture Credit⁶

The agri-credit disbursement during FY07 was expected to decelerate from the exceptional levels in the past three years. This is implicit in the 16.4 percent YoY disbursement growth target for the year, as compared to the 26.4 percent rise in FY06. However, the 13.0 percent rise seen during Jul-Jan FY07 is much weaker than anticipated (see **Table 2.4** and **Figure 2.4**).

Table 2.4: Credit to Agriculture Sector (Jul-Jan)

billion Rupees

Banks	Disbursement			Recovery			Net Credit ¹	
	FY06	FY07	Growth	FY06	FY07	Growth	FY06	FY07
Big 5 CBs ²	37.6	37.9	0.9	20.6	35.4	72.0	17.0	2.5
ZTBL	22.6	27.2	20.4	22.7	25.9	14.1	-0.1	1.3
PPCBL	3.3	4.0	22.1	3.5	3.4	-3.2	-0.2	0.7
DPBs	8.2	11.8	44.3	2.9	9.6	231.9	5.3	2.2
All banks	71.7	81.0	13.0	49.7	74.3	49.6	22.0	6.7

¹ Net Credit = disbursement minus recovery

² Includes: NBP, HBL, MCB, UBL, and ABL

This deceleration is principally due to a decline in the disbursement of the loans for development purposes, which fell by 19.9 percent YoY during Jul-Jan FY07. In contrast, the disbursement of production loans rose by 19.8 percent YoY in the same period.

Moreover, the relative deceleration in aggregate disbursement of loans by banks is largely contributed by a single commercial bank that was undergoing an organizational restructuring (see **Table 2.5**).⁷ This would suggest that the pace of agri-credit disbursement may pick up in following years. While this is possible that the disbursement would gather pace in H2-FY07, it must be kept in mind that the larger portion of agri-credit disbursement generally occurs during H1-FY07, and that the restructuring of another large development finance institution could also hamper agri-credit growth in FY07. Finally, growth in disbursement by domestic private banks (DPBs) is also slowed probably due to a relative weakness in their recovery ratio in Jul-Jan FY07.

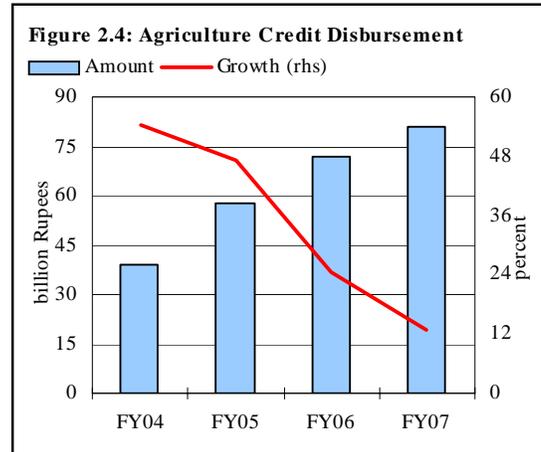


Table 2.5: Growth in Agriculture Credit (Jul-Jan)
percent

	FY05	FY06	FY07
ABL	45.8	50.7	9.7
HBL	97.1	47.9	-22.2
MCB	46.8	4.3	35.6
NBP	51.2	29.4	13.5
UBL	14.5	83.5	-3.9
Sub-total 5-big CBs	56.8	39.3	0.9
<i>5-Big CBs excl. HBL</i>	<i>43.2</i>	<i>35.2</i>	<i>12.7</i>
ZTBL	26.1	9.9	20.4
PPCBL	10.9	-29.0	22.1
DPBs	281.9	54.0	44.3
Grand total	94.1	27.2	12.9

In addition, a significant increase in disbursement for production purposes and a decline in development loans is also reflecting relative interest rate sensitivity for

⁶ Analysis of trends in overall agri-credit is based on data for Jul-Jan FY07; however, detailed analysis (number of borrowers and purpose-wise credit) is based on data for Jul-Dec FY07.

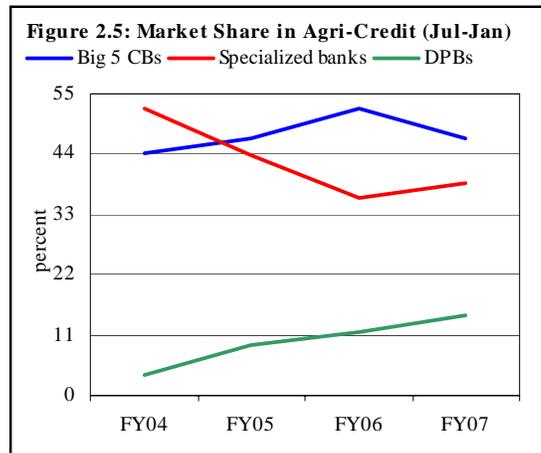
⁷ Excluding HBL, the agri-credit disbursements are seen to increase by 20.6 percent YoY.

long-term agri-loans. It should also be noted that while higher number of tractors sold during Jul-Dec FY07, the share of the number of tractors financed by the institutions to total sale declined from 44.0 percent in H1-FY06 to 29.9 percent in H1-FY07. This suggests that the farmers opted to utilize their own resources mainly due to improved farm incomes.

Institutional Performance

Agri-credit disbursement by big 5-commercial banks (CBs) witnessed a rise of only 0.9 percent during Jul-Jan FY07, well below the 39.3 percent growth seen in the same period of FY06. Adjusted for the decline by HBL, the growth in disbursement reached double digits. Although, the growth in disbursement by DPBs decelerated, it is nonetheless a strong 44.3 percent in Jul-Jan FY07. The major support to agriculture credit during this period also came from an improved performance of specialized banks (ZTBL and PPCBL).

The performance of different groups is also mirrored in their respective shares in agri-credit market (see **Figure 2.5**). The rising share of CBs saw a decline for the first time since FY00 while DPBs consistently and gradually increased their share in agriculture credit market. It appears that the specialized banks are also making efforts to maintain their effective presence in the agriculture market. However, given the increasing competition with the innovative and aggressive commercial banks, specialized banks have to broaden their deposit base amidst increased operational efficiency through organizational restructuring and introduce innovative new attractive financial products for the farmers.



Credit Recovery

Credit recovery, as a percentage of disbursements, increased by 22.4 percentage points during Jul-Jan FY07 in contrast to a 42.1 percentage point decline seen in the same period of FY06. The improvement is attributed to commercial banks only, as a moderation in recovery ratios of both specialized banks partially offset the gains by commercial banks (see **Table 2.6**).

Number of Borrowers

The number of agri-credit borrowers reached 536.3 thousand by H1-FY07, up by 0.8 percent over H1-FY06 (see **Table 2.7**). The increase is entirely attributed to 1.7 percent rise in the number of borrowers in the farm sector, which more than offset the decline of 12.1 percent in the number of borrowers from non-farm sector during H1-FY07. In particular, despite a relatively weak performance of CBs, increase in their number of borrowers is encouraging.

Though, the disbursement to the non-farm sector rose during H1-FY07, the number of borrowers declined by 12.1 percent (see **Table 2.8**).

While, the number of large non-farm borrowers saw a significant rise during H1-FY07, it was more than offset by a sharp decline in the number of small borrowers in this period. This is despite the government's efforts to reduce poverty through providing credit access for the improvement of livestock sub-sector. In fact, rise in the number of large borrowers is also encouraging given their ability to implement modern techniques to increase productivity.

Purpose-wise Credit Disbursement

The credit disbursement for the purchase of tractors declined by 31.1 percent during H1-FY07 compared with a rise of 8.9 percent in H1-FY06 (see **Table 2.9**). Surprisingly, despite a slowdown in fertilizers off-take, credit taken for fertilizers purchase saw an increase of 17.8 percent in H1-FY07. The significantly higher disbursement for fertilizer would probably accelerate the fertilizer off-take in months ahead.

Table 2.6: Credit Recovery Pattern (Jul-Jan)

Banks	Recovery as % of disbursement	
	FY06	FY07
Big 5 CBs ¹	54.8	93.4
ZTBL	100.6	95.3
PPCBL	105	83.2
DPBs	35.3	81.1
All banks	69.3	91.8

¹ Includes: NBP, HBL, MCB, UBL, and ABL.

Table 2.7: Number of Borrowers - Agri-Sector (H1)

000 number			
Banks	FY06	FY07	% Change
Big 5 CBs ¹	210.8	216.1	2.5
ZTBL	217.6	211.4	-2.8
PPCBL	83.7	89.9	7.4
DPBs	19.8	19.2	-3.2
All banks	531.9	536.3	0.8

¹ Includes: NBP, HBL, MCB, UBL, ABL

Table 2.8: Borrowers in Non-farm Sector

numbers			
	Small	Large	Total
H1-FY06	33313	940	34253
H1-FY07	28732	1390	30122

The credit disbursement slowdown is principally driven by a decline in development loans in H1-FY07 compared with 17.1 percent rise seen in the same period last year, mainly on account of lower credit taken for the purchase of tractors.

		FY06	FY07	% change
Tractor	000 number	10.5	7.4	-29.6
	billion Rs	3.3	2.3	-31.1
Fertilizers	billion Rs	19.5	23.0	17.8
% Share in total credit disbursement				
Tractor		5.2	3.1	
Fertilizers		31.2	32.1	

Encouragingly, corporate farming is getting increasingly popular as amount disbursed for the corporate farming rose sharply to Rs 1.9 billion in H1-FY07 compared with only Rs 0.7 billion in H1-FY06.

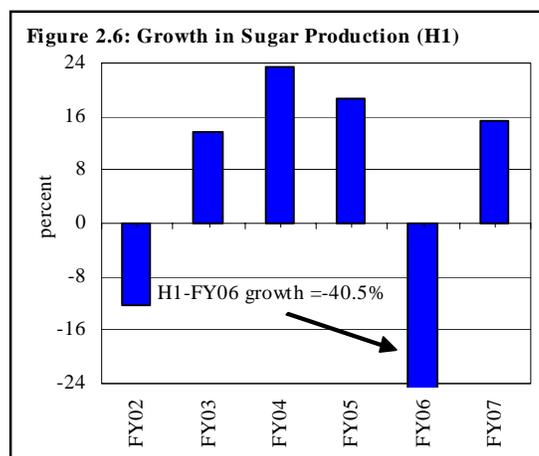
2.2 Large Scale Manufacturing

In the absence of any indicators of aggregate manufacturing⁸ the following analysis focuses essentially to production trends in individual large scale manufacturing industries, based on limited data received from various industrial associations and committees.⁹ Therefore, this analysis may not be representative of developments in overall LSM, and it may also not be consistent with the trends reported in the preceding SBP reports. This said, the LSM data for Q1-FY07 and limited information for Q2-FY07 suggests that LSM growth is slightly higher during H1-FY07 compared with the corresponding period of FY06.

Sugar

According to PSMA data, the *sugar* industry, which has about one third weight in food group, recorded 15.5 percent growth in H1-FY07 as against a fall of 40.5 percent in H1-FY06 (see **Figure 2.6**). This increase in production is mainly attributed to a 15.2 percent rise in the sugarcane harvest during FY06. Farmers cultivated sugarcane with greater enthusiasm in FY07 due to record high prices realized during FY06 season.

However, significant inventories with the mills, a liberal import policy and a decline in international prices of sugar resulted in a fall in the domestic prices of both sugarcane and sugar, finally causing the government to impose duties¹⁰ on sugar imports.



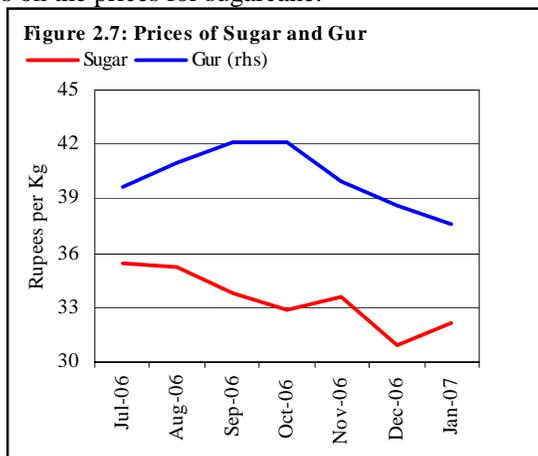
⁸ Delay in release of usual monthly data set (of about 100 items) on large scale manufacturing by the Federal Bureau of Statistics after September 2007, make it impossible to make any assessment of industrial performance. The failure to provide timely data is quite troubling, not only for the implications for macroeconomic decision-making but also for the damage to the credibility of the institution (and official statistics).

⁹ These associations/committees included Pakistan Automobile Manufacturing Association, All Pakistan Cement Manufacturers Association, National Fertilizer Development Corporation, Oil Companies Advisory Committee and Pakistan Sugar Mills Association.

¹⁰ According to the S.R.O. 1074 (1) 2006, issued by government of Pakistan, the 5.0 percent regulatory duty levied on the import of raw cane sugar, raw beet sugar, white crystalline cane sugar and white crystalline beet sugar with effect from 14th October, 2006.

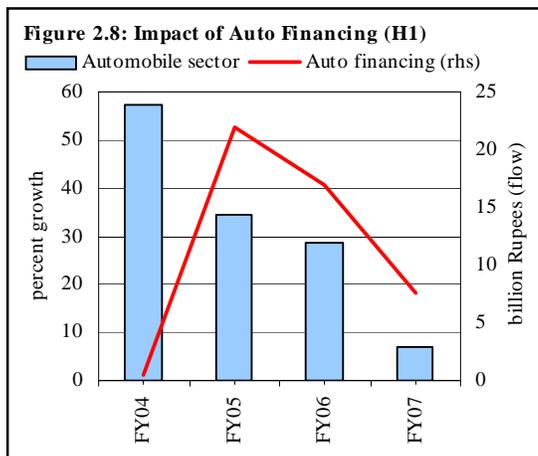
It may be noted that FY07 growth for the production of sugar may have been even higher were it not for the delays in the commencement of the crushing season¹¹ mainly due to continuing differences between the Pakistan Sugar Mills Association (PSMA), and farmers on the prices for sugarcane.

The sugar industry is also facing competition from the rapidly emerging cottage industry of *gur* manufacturing. The farmers now have the choice to sell their produce either to sugar mills or to the *gur* contractors, they bring their mobile *gur* manufacturing plant in the field and often pay higher *cash* price for sugarcane to the farmers than offered by sugar mills. The recent surge in *gur* prices enables the *gur* manufacturers to pay higher price for sugarcane crop (see **Figure 2.7**).



Automobile

The *automobiles* sector recorded a single digit growth of 6.8 percent during H1-FY07, which is not only lower than the strong growth of 28.6 percent in the same period of the preceding year but also the lowest during the last five years (see **Figure 2.8**).¹² While, the capacity constraints restricted the growth in the production, weakening demand and



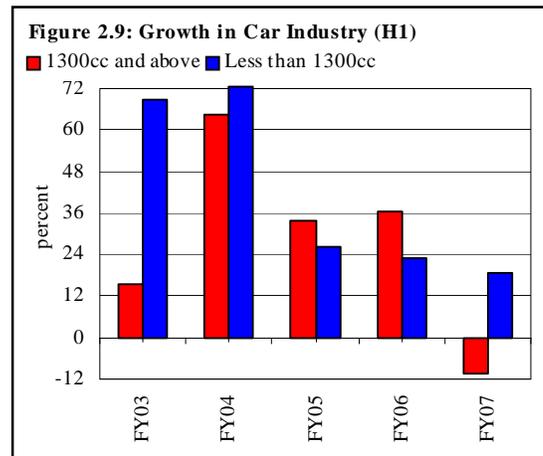
¹¹ According to Sugar Factories Controlling Act 1950, the crushing season in Pakistan start from 1st October every year. Due to environmental and seasonal changes, on 9th October 2006 the government and PSMA agreed to start the crushing season in Sindh from the mid November and both in Punjab and NWFP from 1st December.

¹² This analysis is based on the classification and information provided by PAMA for July-December, which is quite different from the FBS classification.

import of used vehicles are responsible for a relatively muted growth in demand for domestic automobiles. In light of continued delivery lags and premium on domestic automobiles, the Government has announced an auto policy to fill the demand and supply gap and overcome the problems facing by auto sector (see **Box 1**).

The surge in the growth of automobile industry in recent years was mainly attributed to increased income as well as easy access to auto financing. In particular, a declining trend in auto financing is also impacting growth of the automobile sector since more than 70 percent automobiles are financed by commercial banks and the cash sales are relatively quite low.

Within the *automobile* industry, the growth in the production of *cars & jeeps* decelerated to 8.4 percent in the first six months of the current fiscal year as compared with a substantial 30.5 percent growth in H1-FY06. In particular, the production of high capacity engine *cars*¹³ (1300cc and above) declined by 10.4 percent in H1-FY07 as against a strong growth of 36.6 percent during the same



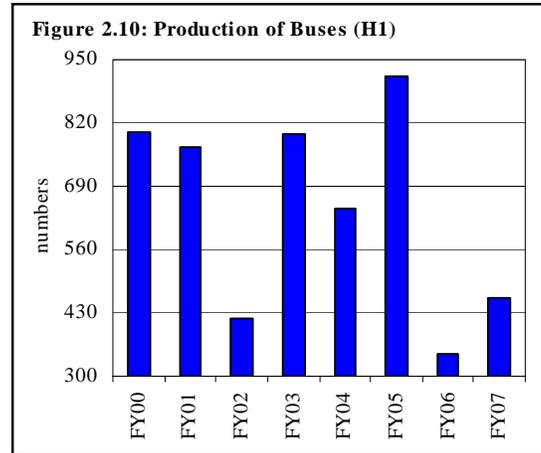
period of the previous year (see **Figure 2.9**). Stiff competition from imported used cars, poor response of customers regarding the newly introduced models, relatively higher prices of domestic cars and higher interest rates are the main reasons cited for the weaker performance of this category of automobiles.

Similarly, a slowdown of 3.4 percent was observed in the production of *tractors* during H1-FY07, which is lower than the 14.5 percent growth seen in the same period of preceding year. The capacity constraints and the government decision to allow the import of tractors are the main causes of deceleration in tractor production. However, the local manufacturers claim that since the permission of

¹³ Within the high capacity engine cars, Toyota corolla brand is the only one which has registered a higher growth of 20.9 percent in H1-FY07 as compared with 17.9 percent during the same period of last year. While the production of all other assemblers declined during this period.

government to import tractors to help the farming community has not hit the booking of local manufactured tractors. It is also claimed that farmers prefer to buy from those producers who provide after-sales service in rural areas and dealers of imported tractors have no such services.

The recovery in the output of buses was mainly due to government's institutional buying, (about 80 percent of the total sale of buses), 15 percent fall in the prices of local manufactured buses after the issuance of a notification¹⁴ by CBR regarding zero-rated sales tax on local supply of dedicated CNG buses and other buses meant for transportation for passengers. It is interesting to observe from **Figure 2.10**



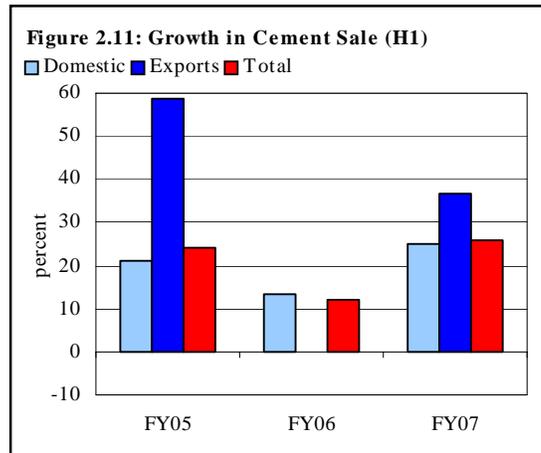
that the output of the buses generally has a very short cycle due to a narrow base, impacting largely from government policies as well as initiatives by the private sector.

The major drag to automobile industry growth was from the decline in the production of motorcycles/scooters, down by 13.5 percent during H1-FY07 compared with 34.3 percent strong growth. The production of motorcycles declined for the first time since FY00. The production of motorcycles in the reported sector remained depressed during H1-FY07 mainly due to rising market share of non-members of PAMA (Chinese bikes assemblers) on the back of lower prices. Moreover, decline in cotton and rice harvests (as well as lower realized prices for cotton) also made a direct impact on the sale of bikes in the rural areas, where farmers used to purchase new bikes after a better crop.

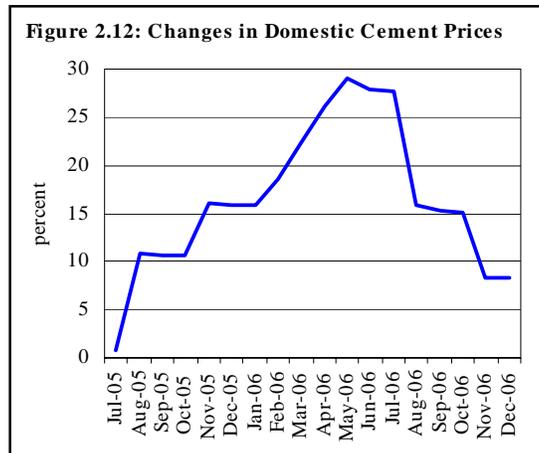
¹⁴ According to SRO.1270 (I)/2006, sales tax zero-rating would be on import and local supply of dedicated CNG buses and all other buses meant for transportation of 40 or more passengers, whether in CBU or CKD condition covered under the Pakistan Customs Tariff (PCT) Heading 8702. Sales tax would also be charged at the rate of zero-per cent on the import and local supply. Purpose-built taxis, whether in CBU or CKD, built on girder chassis and have following features: Attack resistance central division along with payment tray; wheelchair compartment with folding ramp and taximeter and two-way radio system, notification added.

Cement

The cement industry performed well during H1-FY07 with total sales rising 26.0 percent YoY, significantly higher than 12.1 percent growth seen in the H1-FY06. The remarkable performance of cement sector is attributed to the (1) enhanced installed capacity¹⁵ during the last five years, (2) rise in local demand as well as (3) strong external demand (see **Figure 2.11**).



The local cement dispatches rose by a remarkable 25.0 percent in the first six months of FY07 compared with 13.4 percent growth in the same period of FY06. The rise in local demand mirrored the rising activity in the construction sector amidst relatively low domestic prices in H1-FY07 (see **Figure 2.12**). Similarly, export demand for cement registered a robust increase of 36.8 percent during H1-FY07 as against a fall of 0.2 percent during H1-FY06. Major markets for Pakistani cement exports are Afghanistan and the UAE. Government decisions regarding restoration of duty drawback on cement exports,¹⁶ exemptions from federal excise duty & sales tax on exported cement and lower domestic prices in H1-FY07 are the key factors for the rise in cement exports during the first six



¹⁵ The installed capacity in cement industry is more than doubled during the last five years.

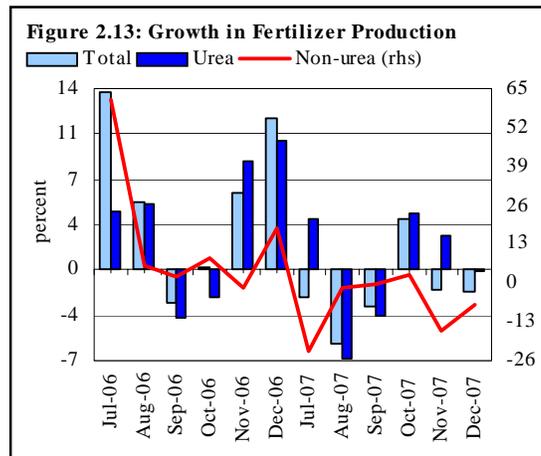
¹⁶ The Central Board of Revenue (CBR) has allowed duty drawback at the rate of Rs 25.08 per ton on export of cement through a customs notification by amending the SRO 840 of 2006. The facility is effective, from September 27, 2006.

months of FY07.

Fertilizer

The Fertilizer industry is facing capacity constraints after seeing rapid growth in production in recent years. In H1-FY07 some other factors also contributed for a decline in the production of fertilizer, these include: (1) temporary shutdown of plant by one producer for a capacity expansion and revamping of another plant, (2) slowdown in demand due to untimely rains and decrease in fertilizer demand in expectation of a subsidy announcement by the government, and (3) a sustained rise in the prices of urea amidst subsidy on non-urea as well as greater awareness to use a balanced mix of the both of which reduced the urea demand.

The slowdown in demand of fertilizer during H1-FY07 is also reflected in lower imports, which fell by 58.1 percent as compared with 69.1 percent growth in import during H1-FY06. As a result of softening demand as well as capacity issues, the output of fertilizer declined by 1.7 percent in H1-FY07 as against 5.5 percent growth during the same period of the preceding year (see **Figure 2.13**). The decline however was more pronounced in the production of non-urea fertilizer, which suggests that the impact of the delay in the purchases of fertilizers by the farmers in anticipation of subsidy announcement was stronger.



Petroleum Products

As in fertilizer, petroleum production also declined by 6.6 percent in the first six months of the current fiscal year as against a moderate growth of 2.5 percent in the corresponding period of the preceding year (see **Table 2.10**). The slowdown was mainly attributed to the mismatch in production mix and the demand growth patterns (see **Figure 2.14**). While refining operations produce various products in broadly fixed ratios, the demand growth has centered principally on diesel (as it is cheaper relative to petrol) and furnace oil (as demand for thermal electricity surged following a drop in hydro-electricity production). The consumption

growth of petrol is also weakened due to substitution with CNG. Thus in order to avoid surpluses in other products, refineries chose to operate at lower capacities.

Indeed, while the domestic production of POL fell (as reflected in a 12.1 percent YoY drop in imports of crude oil in H1-FY07), the sale of petroleum products recorded a growth of 18.9 percent during H1-FY07. Moreover, imports of specific refined petroleum products rose in the same period. Specifically, import of furnace oil and high speed diesel witnessed robust increase of 63 percent and 33 percent respectively during Q1-FY07.¹⁷

Table 2.10: Production of POL Products (H1)

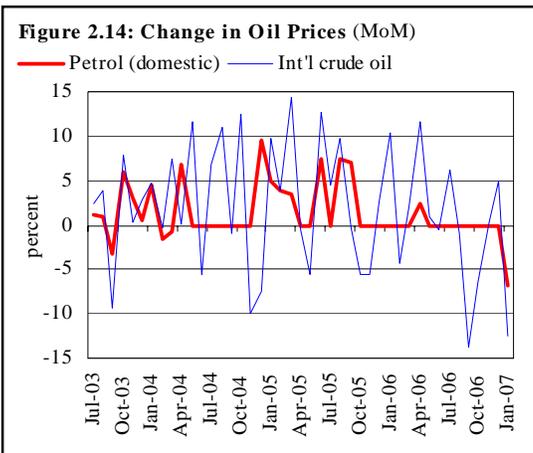
000 metric tons			
	FY05	FY06	FY07
Jet fuel	536	646	610
Kerosene	88	104	102
Motor spirits	692	627	618
High speed diesel	1,807	1,728	1,555
Light speed diesel (n.o.s.)	103	63	77
Furnace oil	1,546	1,701	1,543
Lubricant oil	113	102	104
Jute batching oil	3	2	2
Solvent naphtha	347	423	420
Petroleum products (n.o.s.)	352	332	318
Total POL	5,588	5,727	5,348

Electricity generation

Electricity generation is not part of the LSM. This analysis is based on the information received from FBS.

Electricity generation recorded a growth of 9.7 percent during H1-FY07 as compared with 12.9 percent growth during the same period of last year.

Despite deceleration, first half year growth of current fiscal year is the second highest since FY03 (see **Figure 2.15**). Despite high growth, country is facing acute energy shortages, which further augmented due to sustained high growth. In this background, the government of Pakistan has announced a “policy for development of renewable energy for power generation” to overcome the energy shortage in the economy.

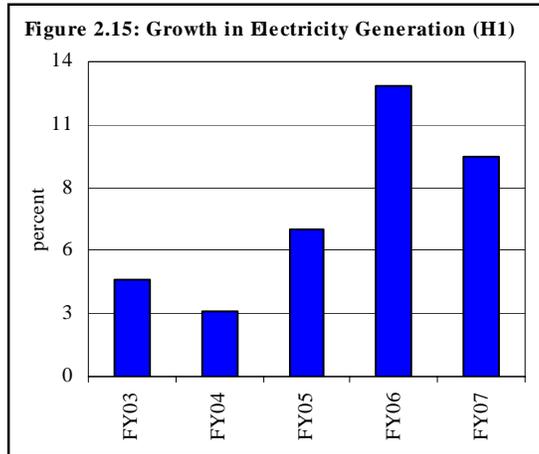


¹⁷ Latest detailed item-wise data on trade is available upto Q1-FY07.

Box 1: Auto Industry Development Program (AIDP)

Due to its multiple affect and strong backward linkages (material such as steel, copper, , aluminum etc., plastics, glass, paints, electronics, capital equipment, trucking, warehouse and logistics) and forward linkages (dealership, credit & financing, advertising, repair & maintenance, petroleum products, goods station, insurance, services parts), the auto industry is considered as the key industry. The government has approved the five years auto policy (Auto Industry Development Program AIDP), designed in such a way that it

should not hurt local industry but attract new investment. However, the government has decided not to change current import policy so that consumers' interests could also be protected. Cars import policy will continue in its existing shape and if premium becomes a public issue again, the government will take appropriate measures to protect the consumers' interest.



Salient features of AIDP are:

1. By FY12, the annual production of new cars would reach to 0.5 million as against a total of 0.2 million cars currently manufactured.
2. Five local auto manufacturers have assured the government that they will increase their total production of units up to 0.5 million by FY12 as shown in **Table 2.11**
3. Total investment in car manufacturing would reach Rs 225 billion by 2011-12 as compared to Rs 98 billion in FY06.
4. Reduction in tariff from 50 percent for localized parts of cars in FY07-FY09, followed by 47.5 percent in FY10, 45.0 per cent in FY11 and 45 percent in FY12.
5. A reduction in tariff is also proposed in the program. Tariff for non- localized parts has been proposed by 35 percent in FY07-08, followed by 32.5 percent in FY09-10 and 30 percent in FY11-FY12.
6. For Completely Built Unit (CBU), the tariff rate will be as follow:
 - a. Up to 1500cc there will be 50 percent duty till FY12.
 - b. From 1500cc to 1800cc 65.0 percent duty till FY09, followed by 60.0 percent duty till FY12.
 - c. 1800cc and above, 75.0 percent duty till FY09 and 70.0 percent tariff till FY12.
7. For LCVs (CKD kits) the tariff rate will be as below:

Table 2.11: Car Production Capacity

000 numbers		
	FY06	FY12
Honda	30	100
Suzuki	90	250
Indus	44	100
Dewan	44	48
Nissan	13	18

- a. For localized parts duty rate will be 50.0 percent upto FY09, 47.5 percent for FY10 and 45.0 percent for FY11-FY12.
8. For non-localized, the duty rate will be 20.0 percent till FY12.
9. Tariff for CBU condition LCVs would be 60 percent till FY12.
10. Two automotive parks will be established; one each in Karachi and Lahore.
11. Auto engineering department in the universities and polytechnic institutes will be established.
12. In-house factory schools for the training of employees from within the entity and from the auto industry including the vendors will also be established.
13. Tax incentives in the form of deductions equivalent to 125 percent of the net expenses from the annual taxable income of such entities operating factory school.
14. For the tax incentives, duration of each course will not be less than eight months out of which half training will be imparted at the classroom level and rest at the shop floor, laboratories and at various areas of production/dispatch/stores etc.