

## 2 Real Sector

### 2.1 Agriculture Sector Performance

Information available by mid-February FY08 suggests that agriculture sector is likely to record reasonable growth during the fiscal year. Prospects of achieving the target of 4.8 percent growth for the year remain dim. The record sugarcane and maize harvests, anticipated good wheat harvest, and above-target growth in minor crops, are unlikely to overcome the drag from the disappointing performance of some major *kharif* crops (cotton and rice) (see **Table 2.1**). livestock sub-sector, hit by bird flu virus (see **Box 2.1**), may see some slowdown in growth.

**Table 2.1: Performance of Major Crops**

Crops	Area under cultivation (000 hectares)				% change	
	FY06	FY07 <sup>T</sup>	FY07 <sup>P</sup>	FY08 <sup>T</sup>	FY08 <sup>E</sup>	FY08 <sup>E</sup> /FY07 <sup>P</sup>
Cotton	3,100	3,072	3,072	3,250	3,082	0.3
Sugarcane	907	1,005	1,029	1,040	1,155	12.2
Rice	2,621	2,575	2,581	2,594	2,512	-2.7
Wheat	8,448	8,459	8,578	8,578	-	-
Gram	1,029	1,051	1,074	1,120	-	-
Maize	1,042	1,001	1,038	1,001	1,055	1.6
<b>Production</b> (000 tonnes; cotton in 000 bales of 170.09 kg each)						
Cotton	13,019	13,820	12,856	14,140	12,775*	-0.6
Sugarcane	44,651	50,500	54,871	55,871	62,300	13.5
Rice	5,547	5,693	5,439	5,721	5,490	0.9
Wheat	21,277	22,000	23,295	24,045	-	-
Gram	536	707	848	707	-	-
Maize	3,110	3,279	2,907	3,221	3,248	11.7
<b>Yield</b> (kg/hectare)						
Cotton	714	724	720	740	705	-2.1
Sugarcane	49,229	50,249	53,325	53,722	53,939	1.2
Rice	2,116	2,211	2,107	2,205	2186	3.7
Wheat	2,519	2,601	2,716	2,803	-	-
Gram	521	673	790	631	-	-
Maize	2,985	3,276	2,801	3,218	3079	9.9

\*: The size of cotton crop for FY08 is likely to be revised downward.

<sup>P</sup>: Provisional, <sup>T</sup>: Target, <sup>E</sup>: Estimates.

Source: MINFAL

Relatively weak aggregate performance of the crops, in the face of strong international prices of most agri-commodities indicates not only the sector's vulnerability to the vagaries of nature but also the urgent need to enact reforms. It should target distortions in the incentive structure for farmers and the substantial wastage due to inadequate infrastructure.

For example, the disconnect between price signals to farmers and the prevailing international market prices is, in some measure, captured by the small decline in the acreage under wheat during the FY08 *rabi* season. Wheat prices, both international as well as domestic retail prices, surged through most of the FY07, but farmers did not

appear to be capitalizing on this opportunity. Some farmers preferred to delay sowing

Wheat (continuing with late picking of cotton) or switched to alternate crops (such as sunflower). One explanation to this could be the delayed announcement of the support price, leading to uncertainty on the eventual sale prices. But given the limited scope of government purchase program (it purchased only 4.4 million tonnes out of 23.3 million tonnes of the FY07 crop). It appears that farm-gate prices are not keeping pace with international market prices. This suggests that substantial improvements in yields (and welfare gains) may be possible through reforms to improve price-signal transmission to farmers, and other reforms. An active futures market for wheat could provide some benchmark price to the farmers to help them taking timely sowing decisions.

Future market for agri-produce is even stronger in the case of sugarcane. While government announces procurement prices, sugar mills offer lower prices than the

**Box 2.1: Impact of Bird Flu**

The bout of the bird flu incidence in domestic poultry industry during January 2008 in urban Sindh caused a decrease in the output of the poultry farms with no reported culling of the grandparent and parent resources by the one day old chick producers. The impact on the otherwise stable growth of the livestock sector was expected to be partially offset as the result of the two weeks long scare. However, fears that lesser production of one day old chicks during the two weeks was likely to cause price jump in April-May 2008 due to demand and supply imbalance; with lesser supplies caused by few one day old chicks as well as traditional weather cycle impact.

Traditionally, the one day chick production process is spread over 25 months starting from the grandparent flocks laying down eggs that produce parent flocks which in turn lay down eggs for the one day old chicks. It is the one day old chick that after 40 days gains weight up to 1.60 kg to be transferred to the retail sale outlets. Any letup in the demand causes lesser production cycles with extreme situations causing culling of the parent and grandparent stock. A situation faced in spring 2006 causing the re-organization of the culled flocks. These refurbished flocks have been responsible for over production incidence in the upcountry poultry clusters forcing small players out of business.

announced benchmark prices and clear payments with significant lags. Delay in crushing season also goes against the farmers as weight of sugarcane gets reduced with each passing day due to evaporation of water content in sugarcane. In addition, farmers were unable to vacate fields for succeeding crops. However, effective implementation of regulations regarding beginning of crushing season, assurance of a minimum (rational) price to farmers that could also provide incentive to sugar mills to work at full capacity can resolve these issues. In this backdrop, delayed crushing amid price dispute between farmers and sugar mills during FY08 is likely to adversely impact FY09 sugarcane crop, which would lead to sugar shortage next year and hike in the domestic sugar prices. This reinforces the need for effective policy and regulations to resolve these issues on permanent basis.

According to a World Bank assessment, Pakistan is one of the most water-stressed countries on the globe.<sup>1</sup> The need to use water resources prudently has never been as demanding as today, when changing weather patterns make agriculture more uncertain and prone to the vagaries of nature. Timely investment in infrastructure is also required to upgrade water distribution system and to increase land productivity. In addition, efficient use of water resources should be promoted with (1) laser leveling of farms,<sup>2</sup> (2) reduction of 30-40 percent irrigation water losses between canal heads and farm gate with the improvement in water courses, (3) drip water irrigation system, and (4) evolving drought resistant seed varieties. According to World Bank report, Pakistan needs to invest US\$ 1 billion per annum for the next five years to improve its irrigation system.

Investment in farm-to-market roads, agri-storage facilities, and small processing units can also significantly reduce wastage and increase value addition in agriculture. The strong growth in dairy sector is a case in point; with support for small dairy farmers for storage units helping the milk processing industry which recorded strong growth, leading to increase investment across the value-added chain, and supporting income prospects for farmers (see **Box 2.2**).

### **2.1.1 Crops**

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<sup>1</sup> The World Bank Report on *Pakistan Infrastructure Implementation Capacity Assessment*, 2008 available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:21642194~pagePK:146736~piPK:146830~theSitePK:223547,00.html>

<sup>2</sup> Along other benefits, this may increase 20 percent crop yield: Muhammad Rafiq Akhtar, *J. Agric. Res.*, 2006, 44(3).

In the wake of relatively disappointing FY08 *kharif* crop, hopes of achieving reasonable growth in the crops sub-sector during FY08 are centered mainly on a good wheat harvest.

**Box 2.2: World Development Report 2008: Agriculture for Development<sup>3</sup>**

The World Development Report (WDR) for 2008 identifies a number of policy options to reduce poverty through agricultural productivity growth and hence provides guidance to governments and international community on designing and implementing agriculture-for-development agendas that can make a huge dent in world poverty. Countries have been classified in the report as agriculture-based, transforming and urbanized based on the share of agriculture poverty in the rural areas (using US\$ 2 a day line). Pakistan falls among the transforming countries.

The report warns that agriculture suffers from slower growth and natural resources are under growing pressure from agriculture and non-agricultural sectors. While the combination of population pressure together with declining farm size and water scarcity further exacerbate the situation, especially in South Asia. As a result, arable and permanent cropland per capita of the agricultural population is falling on one hand; and increased competition over access to scarce land and water due to rising urban population, income and demand has adversely affected the agricultural output on the other. Consequently, farm income in transforming countries lag behind the fastest growing non-farm income and results into further increase in rural urban income divide. In the same way, lack of investment and public spending besides leadership and management crisis in R&D, led to a huge knowledge gap between industrial and developing countries.

The report states that access to water is a major determinant of land productivity and the stability of yields. For that reason, soil and water quality degradation, in case of Pakistan, have negated the productivity gains from improved varieties and technical progress by one third, even then the improved varieties of seeds contributed 53 percent of total factor productivity gains, particularly in Punjab, from 1971 to 1994.

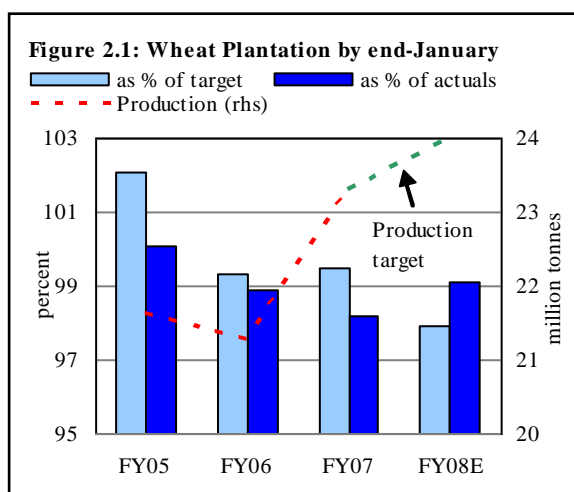
Livestock contribution in agriculture output is about 50 percent in Pakistan but the report observed that the share of Pakistani household in livestock is below 40 percent as compared to 80 percent in Albania, Nepal and Vietnam. This shows that livestock holding in Pakistan is quite low. Livestock production plays a major role in intensifying agriculture growth by diversifying risk and exploring new diverse markets. Therefore, improved animal genetics combined with improved animal health and feeding can increase productivity and lead to greater agriculture output.

Agriculture production is vital for food security since it is a source of livelihood for majority of the rural poor. The report described agriculture as a source of growth for national economy and a provider of investment opportunities for the private sector. In addition, agricultural productivity growth acts as a prime driver for stimulating growth in other parts of the economy and determines the price of food, which in turn determines wage cost and competitiveness of the tradable sectors.

Report also asserts that increasing assets may also call for affirmative action to equalize chances for disadvantaged or excluded groups, such as women and ethnic minorities. Similarly, institutional development, such as enhancing the security of property rights and the quality of land administration, health, education, access to the market and diverting remittances to farm activity will pay back heavily.

<sup>3</sup> World Development Report 2008: Agriculture for Development- prepared/published by the International Bank for Reconstruction and Development 2007, the World Bank.

The latest data on FY08 *rabi* crops indicates that area under wheat cultivation decreased by 0.2 percent (see **Figure 2.1**),<sup>4</sup> which is a consequence of delayed sugarcane crushing and extended cotton picking season. Other factors responsible for lower area under wheat cultivation are: (1) an anticipated reduction in availability of irrigation water during *rabi* FY08, (2) delay in announcement of wheat support price, (3) rising input cost particularly prices of fertilizers and (4) load shedding (that reduced water supply from tube-wells). It has been reported that growers (in Multan, Rahim Yar Khan and Khanewal) shifted planting area from wheat to sunflower and also to gram pulse.<sup>5</sup> As a result, achieving the wheat harvest target of 24.0 million tonnes for FY08 will be difficult.



However, impact of lower wheat plantation was somewhat offset by increase in water supply for irrigation purposes by recent rains and snowfall. In particular, winter rains would not only improve water supply to wheat fields but also provided sufficient low temperature levels. The low temperature would have significant effect on yield, especially at early growth stage, which has brightened the prospects of good wheat harvest. The main beneficiary of rain spell are the *barani* areas (un-irrigated land), where approximately 14.0 percent of total wheat is planted.

### Other Crops

Initial data on various minor crops suggests that in FY08, growth of minor crops will be substantially higher than previous years. Other crops like bajra, jawar, chili, moong, potatoes, etc., also performed well. Improved supply as a result of higher production is also mirrored in relatively lower prices of a number of

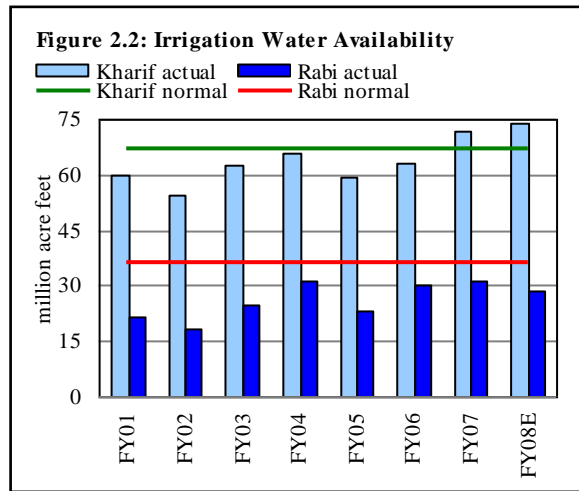
<sup>4</sup> Wheat planting area is provisionally estimated at 8400 thousand hectares by end-January 2008 compared to 8420 thousand hectares by end-January 2007.

<sup>5</sup> Print media, reported that increase in cost of wheat production (due to increase in DAP prices) growers have shifted soil to sunflower plantation; they are anticipating higher earnings, as compare to wheat.

vegetables and fresh fruits during FY08, particularly mangoes, citrus, onion and potatoes.

### 2.1.2 Irrigation Water

At the beginning of *rabi* FY08, water shortage was estimated to be around 22 percent lower than the 'normal' levels compared with a shortfall of 14.3 percent in *rabi* FY07 (see **Figure 2.2**). While the recent rains had helped allay some of these concerns, the expectations of water shortfall at the time of sowing have already hurt growth prospects.



For example, expectations of poor water availability probably contributed to the lower area under wheat, with farmers switching to sunflower and gram in some areas. Ironically, while the extended winter rains have probably helped the wheat crop, the sunflower and gram crops may have suffered some damage.

Unfortunately, the benefits of rains proved less effective and water shortage is likely to be intensified further during the remaining period of *rabi* FY08 as excessive release of water from reservoirs took place to meet the acute electricity shortages in January 2008. Therefore, prospects of water availability for *kharif* FY09 would crucially depend upon monsoon rains.

### 2.1.3 Credit to Agriculture Sector

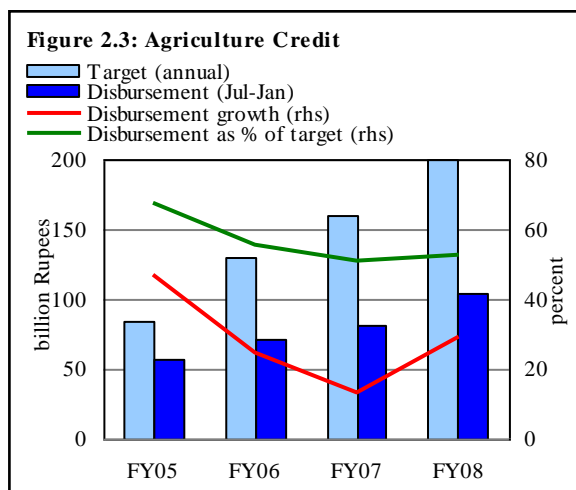
Institutional credit disbursement to agri-sector increased significantly by Rs 23.8 billion to Rs 104.8 billion during Jul-

**Table 2.2: Agri-Credit Disbursement (Jul-Jan)**

percent	FY06	FY07	FY08
<b>Growth</b>			
CBs	39.3	0.9	33.2
ZTBL	9.9	20.4	3.4
PPCBL	-29.0	22.1	-9.3
DPBs	54.0	44.3	89.7
<b>Total</b>	<b>24.7</b>	<b>13.0</b>	<b>29.4</b>
<b>Shares</b>			
CBs	52.4	46.8	48.2
ZTBL	31.5	33.6	26.8
PPCBL	4.6	5.0	3.5
DPBs	11.4	14.6	21.4

Jan FY08. The major impetus to this accelerated growth in agri-credit disbursement stemmed from aggressive lending by the commercial banks, catering to strong demand on account of rising prices of fertilizers (especially DAP), pesticides, energy, labor charges, and transportation.

A sharp jump in non-farm credit also contributed in agri-credit growth acceleration during Jul-Jan FY08. Substantial rise in commercial bank lending compensated for a contraction in lending by specialized banks during Jul-Jan FY08. As a result, the share of all commercial banks (five largest commercial banks and domestic private banks) rose to an all time high of 75.0 percent, at the expense of specialized banks (see **Table 2.2**). Credit disbursement as percent of annual target, also rose to 52.6 percent during Jul-Jan FY08 compared with 50.6 percent in Jul-Jan FY07, indicating the possibility of an above-target agri-credit disbursement for the 5<sup>th</sup> successive year (see **Figure 2.3**).



Increasing role of commercial banks in agri-credit is appreciable and points towards emergence of agri-credit market as a viable opportunity for commercial lending. Commercial banks also responded positively and have introduced new financial products for agri-credit with aggressive marketing. As a result, agri-credit disbursement by the five largest commercial banks increased significantly by 33.2 percent YoY during Jul-Jan FY08 against only 0.9 percent rise witnessed in the same period of the previous year.<sup>6</sup>

Similarly, strong performance has been shown by domestic private banks (DPBs) with 89.7 percent growth in agri-credit disbursement during Jul-Jan FY08 on top of 44.3 percent increase in the same period of FY07. Steady rise in the agri-credit market share of DPBs placed this group as one of the most important players

<sup>6</sup> A weaker growth of commercial banks lending during H1-FY07 was principally due to restructuring drive at HBL.

within few years. If continued, this group would become the second largest source of agri-credit in the country.

In contrast, weaker performance of agri-credit disbursement by the specialized banks during Jul-Jan FY08 is largely a reflection of restructuring and stress on revolving credit scheme by ZTBL. Providing the greater availability of infrastructure and skilled staff with specialized banks, slowdown in agri-credit disbursement is not a welcome development. Specialized banks must improve their agri-credit disbursement performance to maintain their market share. There is a need to restructure and revamp the operations of specialized banks on commercial basis.

It is also important to note that while agri-credit disbursement has been increasing, the number of borrowers has been declining in recent years. This trend also continued in Jul-Jan FY08. Good to see, while number of borrowers declined for production loans, number of borrowers increased for developmental and non-farm purposes. State Bank is aware of the problem that a large number of small farmers are unable to avail institutional credit. The major hindrance is non-availability of appropriate collateral for small farmers. SBP has therefore designed a financing scheme for small farmers to increase the outreach of the agri-credit (see **Box 2.3**). It is expected that this scheme would yield desired results and number of borrowers would increase in agriculture sector.

**Table 2.3: Number of Borrowers and Purpose-wise Agri-credit Disbursement (Jul-Dec)**

volume in million Rupees

Sectors	Number			% change		Volume		% growth	
	FY06	FY07	FY08	FY07	FY08	FY07	FY08	FY07	FY08
Farm sector	454,724	519317	452350	14.2	-12.9	61,345	66,191	15.7	7.9
Production*	434,558	506576	436098	16.6	-13.9	57,923	61,857	22.4	6.8
Development**	20,166	12741	16252	-36.8	27.6	3,422	4,334	-39.7	26.6
Corporate	3	14	2	366.7	-85.7	673	140	1.7	-79.1
Non-farm***	33,514	29735	33652	-11.3	13.2	9,674	23,946	9.2	147.5
Agri-sector	488,241	549,066	486,004	12.5	-11.5	71,691	90,277	14.7	25.9

\*: Include seeds, fertilizers, pesticides etc.

\*\*: Include land development, tractor, machinery etc.

\*\*\*: Livestock, poultry, forestry and fishing.

### **Purpose-wise Credit<sup>7</sup>**

While growth in farm related loans saw a slowdown during H1-FY08, agri-credit for non-farm purposes witnessed an impressive growth (see **Table 2.3**). The sharp

<sup>7</sup> Purpose-wise credit data is available up to Jul-Dec FY08.



jump in non-farm loans is a result of government's supportive policies and private sector's optimism in livestock sub-sector. Encouragingly, despite a deceleration in farm sector, development loans rose by a robust 26.6 percent, indicating farmers' enthusiasm about the prospects of this sector. However, a decline in corporate lending is disappointing, as growth in this segment is necessary to introduce modern techniques and best farm management. Introduction of best practices usually has positive spillover effects, which would likely to enhance productivity and reduce wastages.

### Agri-Credit Recovery

Since agri-credit disbursement is based on revolving credit formula, the performance of disbursements is also mirrored in the recoveries.

Despite a slowdown in agri-credit recovery growth by the five largest commercial banks and DPBs, their performance remained buoyant during Jul-Jan FY08 (see **Table 2.4**). In contrast, the recovery performance of specialized banks is relatively lackluster. This reinforces the view that specialized institutions need to streamline their operations on a commercial basis.

**Table 2.4: Agri-Credit Recovery (Jul-Jan)**

percent				
Banks	FY05	FY06	FY07	FY08
CBs	153.1	-32.9	72.0	39.7
ZTBL	16.8	-3.0	14.1	0.5
PPCBL	4.4	6.0	-3.2	10.8
DPBs	662.8	-57.0	231.9	93.5
<b>Total</b>	<b>77.1</b>	<b>-22.5</b>	<b>49.6</b>	<b>31.7</b>

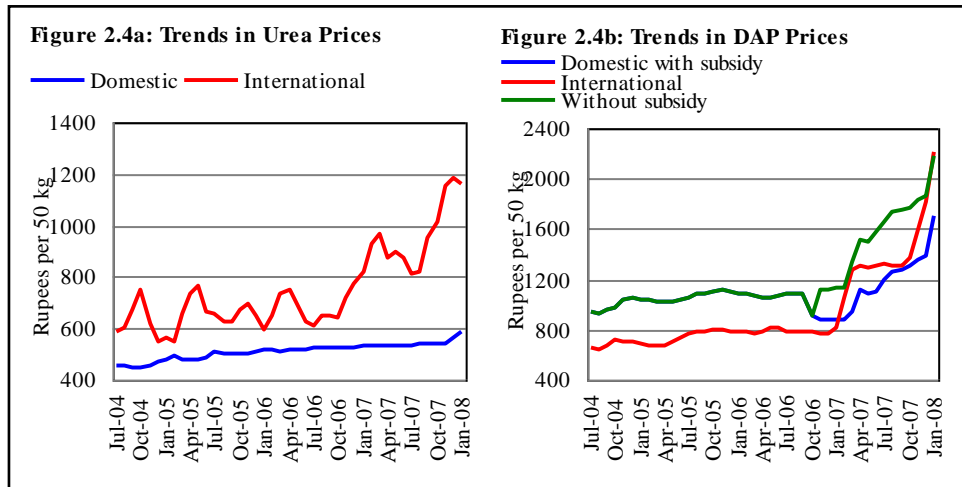
### 2.1.4 Fertilizer Off-take

Aggregate fertilizer off-take witnessed recovery during Jul-Jan FY08 in contrast to decline during the corresponding period of FY07 (see **Table 2.5**). This growth was entirely driven by significantly higher off-take of urea. Despite a significant subsidy on DAP fertilizer,<sup>8</sup> its off-take saw a sharp decline in Jul-Jan FY08 amidst continued increase in international prices.

**Table 2.5: Fertilizer Off-take (Jul-Jan)**

000 tonnes			
	FY06	FY07	FY08
Urea	3,380	3,011	3,468
DAP	1,056	1,202	961
<b>Total</b>	<b>4,435</b>	<b>4,213</b>	<b>4,429</b>
<i>Growth (%)</i>			
Urea	7.2	-10.9	15.2
DAP	-0.8	13.8	-20.0
<b>Total</b>	<b>5.2</b>	<b>-5.0</b>	<b>5.1</b>
<i>Market share (%)</i>			
Urea	76.2	71.5	78.3
DAP	23.8	28.5	21.7

<sup>8</sup> Subsidy of Rs 470 per 50 kg bag of DAP fertilizer was extended for the FY08 cropping seasons to encourage farmers to use a balanced mix of fertilizers.



The higher off-take of urea is also a result of lower domestic prices of urea compared to international prices (see **Figure 2.4a**). This difference is mainly attributed to availability of relatively cheaper natural gas which is an important input for the production of urea. In case of DAP, domestic prices have traditionally been higher than the international prices. However, subsidy on DAP resulted in relatively lower domestic prices of DAP than international prices. While, government increased the subsidy on DAP, it is unable to offset the increasing trend in international prices (see **Figure 2.4b**). A fall in DAP off-take suggests that the use of DAP is probably not feasible at this price. Low use of DAP will not only hurt the government’s campaign for farmers to implement a balanced mix of the nutrients, it would also have negative impact on wheat yield.

**Box 2.3: Small Farmers Financing Scheme-Guideline for Banks**

In order to enhance the outreach of institutional credit to small farmers having no collateral, State Bank of Pakistan introduced “Financing Scheme for Small Farmers” (FSSF). This is an attempt to resolve the root cause of market failure in agriculture credit, i.e., non-availability of collateral. This scheme offers an opportunity to small farmers in mainstream institutional credit, which is likely to impact lives of thousands small farmers. This FSSF is based on small groups of farmers and cover all areas of agriculture including farming, livestock, dairy, poultry, fisheries, horticulture etc. The salient features of the scheme are given below:

**Group dynamics**

- Banks will form Small Farmers Group (SFG) with 5-15 members through NGOs and outlets of farm input services providers etc.
- Banks will determine the eligibility for loans by on-site verification of farming activities being financed and assessment of cash flows of individual members.
- Bank staff will maintain record and facilitate group meetings, relieve/replacement of member as per eligibility criteria.
- Each Group will nominate a group coordinator amongst themselves with the consent of the concerned bank.

- The selected coordinator will prepare a tentative schedule of meetings/proceedings. He will also maintain and retain group documents/files/registers. He will also inform bank in case of misuse of funds by a member.
- Members of the group ensure that the bank receives timely repayments from individual borrower/group members. In case of default/non repayment by a member, all members should come up with a strategy/timeline for setting off the due repayments.
- Each group will submit Personal Guarantee (PG) which would be a joint liability agreement/undertaking wherein each member of the group takes the responsibility of the outstanding debt of all group members. In case of any change in the composition of group members, a fresh PG would be signed by all members of the group.

#### **Eligibility of borrower**

- In crop sector, individual should be a holder/ tenant/lessee/allottee, farmer of land up to 12.5 acres.<sup>9</sup> Individuals having sufficient knowledge of the business /activity being carried out.
- In case of non-crop sector:
  - Individual farmer involved in small scale livestock activities like goat and sheep up to 40 animals, meat cattle up to 25 animals and milch animal up to 4 animals  
or
  - Poultry farming for broiler up to 1,500 birds, layers up to 500 birds and desi up to 500 birds  
or
  - Inland fisheries with pounds up to 2 acres or marine fisheries with one boat not exceeding five gross ton capacity.
  - Should have computerized N.I.C.
  - Should be resident of same village/area at least for the last two years.
  - Bank account in the name of the intending borrower.
  - Not to be a defaulter of any bank.
  - Any other criteria as per policy of the bank(s).

#### **Financing facilities**

- Financing would not exceed Rs 200,000 per borrower to meet their financial requirement and based on individual's cash flows.
- Repayment schedule may be set as per production cycle of the crop/non-crop activities being financed or revolving credit facility for three years subject to mandatory clean up of entire liabilities (both principal and mark up) once in a year or cash flow of the borrower in case of non-crop activities.

#### **Type of Financing**

- **Working Capital:** (i) Small farm credit to be provided for purchase of inputs like: seeds, fertilizers, pesticides etc. for crops production. Production loans also include working capital finance to meet various expenses attributable to farming. (ii) Non-farm credit includes short-term financing for livestock, dairy, poultry and fisheries. These includes financing for purchase of feeds, raising and veterinary expenses, working capital for milk collection, purchase of chicks, fish seed, running charges of tube wells etc.

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<sup>9</sup> In case of Sindh and Balochistan, this limit is up to 16 and 32 acres respectively.

- **Term Financing:** Banks can provide term loan facility to small farmers for making different types of improvements in the land, construction of sheds/ ponds, development of orchards/ nurseries, purchase of livestock, farm implements, machinery, tube wells, generators etc.
- **Documentation:** The banks/DFIs may use the following standardized documents.<sup>10</sup> However, they can obtain a separate set of documents or additional documents as per their policies in order to safeguard interest of the bank/borrower.
  - Group Formation Form (GFF)
  - Loan Application Form
  - Attested copies of CNIC
  - Personal Guarantee (PG)
  - Residence Certificate from Taluka Nazim (only in case of difference in permanent address on CNIC from the place of business)
  - For the verification/confirmation of cultivation by the borrower, khasra girdawari/ lease agreements or any other document as per policy of the bank.
  - An undertaking from the landowner that neither he has availed agri-finance against his land from any institution nor he will draw such loans in future without the approval of the bank until he remained a member of SFG.

#### Other important features

- Banks would ensure disbursement of working capital/short-term financing within seven days and for term loans within 15 days from the date of completion of formalities.
- Bank shall determine mark-up on the basis of KIBOR and their cost of funds in line with their credit policy.
- Banks shall not charge any penalty on early repayment/adjustment of loan.
- Banks to arrange insurance of loan disbursed for crop and non crop activities (wherever available) and life insurance of the borrower to safeguard the interest of the borrower and the bank, in case of losses due to natural calamity or event beyond the control of the borrower.
- It would be the joint responsibility of the group members to ensure timely repayment of principal and mark up of the members. Other terms and conditions will be as per Prudential Regulations for Agriculture Financing in this regard.
- In case of non settlement of default amount, bank has the right to stop renewal/disbursement/withdrawal of loan to all members of the group till the full settlement or rescheduling by the bank. Proper mechanism should be developed by bank for recovery/follow up of the loan accounts including recovery/follow up of skip and death cases.
- Banks/DFIs to ensure that loans have been utilized for the same purposes for which they were obtained. For this purpose, banks/DFIs may consider it's prudent to make payments directly to the suppliers wherever appropriate. However, this provision will not apply on farmers who are provided loans under Revolving Credit Scheme.

<sup>10</sup> Specimen of documents is available at [www.sbp.org.pk/acd/2008/Annex-C1.pdf](http://www.sbp.org.pk/acd/2008/Annex-C1.pdf).

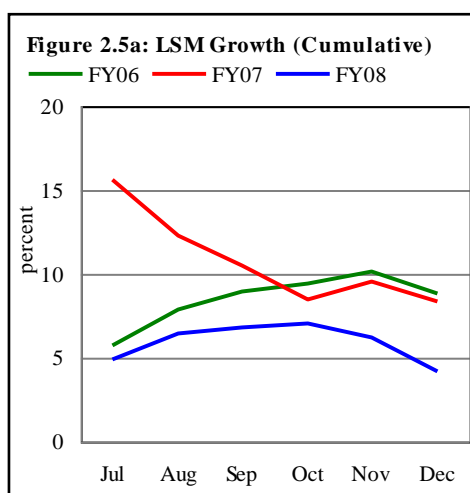
## 2.2 Large Scale Manufacturing

Pakistan's large scale manufacturing (LSM) has been encountering headwinds since the start of FY08. Domestic as well as external factors are responsible for the relatively slower growth in this sector compared to the stellar performance of preceding years (see **Table 2.6**). These factors include: the continued strong increases in the international commodity prices, domestic energy woes and dampened demand (particularly for textile exports). Economic losses in the aftermath of 27<sup>th</sup> December 2007 have further weakened the chances of meeting the annual target.

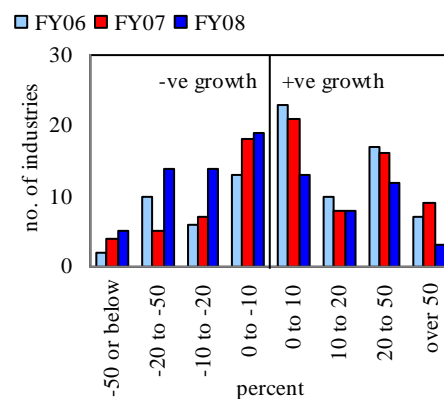
The impact of latter was complemented by intensifying energy shortages in December

**Table 2.6: Sector wise LSM Performance (Jul-Dec)**

percent	FY07	FY08
<b>Sectors showing decline in production</b>		
Paper & board	2.0	-10.4
Fertilizers	-2.9	-3.2
Metal industries	13.1	-7.2
Electronics	9.8	-7.7
<b>Sectors showing deceleration</b>		
Textiles	11.3	2.1
Chemicals	15.0	3.09
Food, beverages and tobacco	4.8	4.4
Automobile	7.9	0.5
Leather and leather products	3.1	1.8
Tyres & tubes	18.4	8.4
Non metallic minerals	19.5	17.8
<b>Sectors showing acceleration</b>		
POL	-6.0	6.2
Pharmaceuticals	4.0	36.4
Wood products	1.4	31.1
Engineering products	17.5	19.1
<b>Overall LSM</b>	<b>8.4</b>	<b>4.2</b>



**Figure 2.5b: Frequency Distribution of YoY Growth in December**



2007 leading to a substantial fall in the production of a large number of industries (see **Figure 2.5**). As a result, although the deceleration in December is a common factor in preceding three years, the decline in LSM growth during December 2007 was stronger.

Overall, the slowdown in LSM during H1-FY08 was broad based and was seen in 11 out of 15 industrial groups. Of these, paper & board, metals, fertilizer and electronics industries registered a decline in production.

Paper & board industry has done rather dismally as few plants in the sector were temporarily closed for expansion activities during the period. Similarly, the decline in fertilizer production during H1-FY08 was mainly due to the closure of a large DAP producing plant in the country for balancing, modernization and replacement (BMR) activities. As a result, the imports of non-urea fertilizer shot up during the period.

In contrast, the decline in electronics production was in response to the weakened demand. On one hand, rising inputs costs led to higher prices, while on the other, demand was also dampened by the rising cost of consumer loans (as banks priced-in the higher benchmark rates and perceptions of increased risk on these loans).

Decline in basic metals sub-sector was caused by operational bottlenecks. Specifically, the sector is facing acute energy shortages which are forcing manufacturers to operate the plants below potential and in some cases production activity has come to a halt. These energy supply constraints in local economy combined with increasing international prices have pushed up local prices and are diluting the demand for steel products from housing sector.

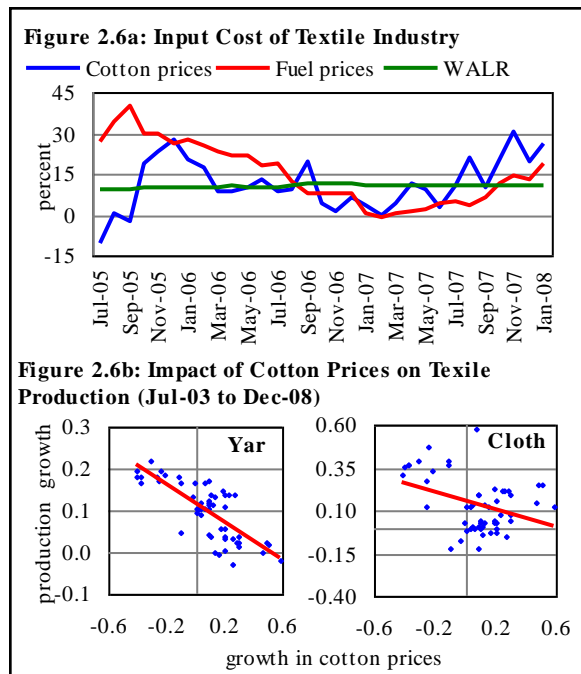
Liberal automobile import policy of the last two years has adversely affected local auto industry. Government in FY08 budget tightened the policy by only allowing imports of automobiles up to three years old. This measure has reduced the import of completely built units (CBUs); but could not spur local production. The impact of this measure has been more than offset by stronger Yen and a 2.5 percent levy on car sales (see **Table 2.7**). Moreover, the relatively costlier auto loans in FY08 also dampened

**Table 2.7: Performance Indicators of Car Industry (Jul-Dec)**

	percent growth				
	Auto loans	Auto production	Auto sales	CBU imports	CKD imports
FY05	2.8	29.1	31.2	NA	NA
FY06	25.8	28.4	24.2	NA	NA
FY07	7.7	6.1	6.7	3.7	-27.7
FY08	7.2	-2.8	-7.7	-5.8	-19.1

the demand for automobiles.<sup>11</sup> As a result, car manufacturers cut production during H1-FY08. However, robust growth in completely knocked down (CKD) imports of 14.5 percent during Q2-FY08 suggests that car manufacturing may recover in the second half of the year, when 70 percent of annual production usually takes place.

Poor performance of textile sector is mainly a reflection of sharp slowdown in its exports. Ironically, the deceleration in textile exports is despite the substantially high subsidized financing for working capital, fixed investment, and concessional export finance in recent years, and appears to be driven by structural impediments in the industry<sup>12</sup> as well as recent slowdown in US demand for textiles (for details see **Section 6.6 on Foreign Trade**). Besides this, supply and operational bottlenecks like decline in FY08 cotton harvest, electricity & gas shortages and deteriorating law and order situation in the country, further worsened the sector's weak performance during the period. Poor cotton harvest and the resultant growth in cotton prices; appears to be the most critical factor in deteriorating competitiveness of domestic textile (see **Figure 2.6**).



<sup>11</sup> On face value, though auto loans showed only marginal deceleration in H1-FY08; in the context of upward revision in car prices during the period, the slowdown is rather substantial.

<sup>12</sup> The structural impediments in the textile industry mainly include dearth of market research in designing of the products as well as quality issues (for instance, cotton contamination).

In contrast to these under-performers, pharmaceuticals, POL, cement, engineering and wood producing industries witnessed a reasonably strong growth.<sup>13</sup> While growth in cement production is mainly due to export demand (see **Table 2.8**), growth in petroleum products is driven mainly by robust domestic consumption as well as productivity gains following the overhauling of plants in two refineries in the preceding year. Sugar and pharmaceutical industries managed to perform well due to ample availability of raw materials.

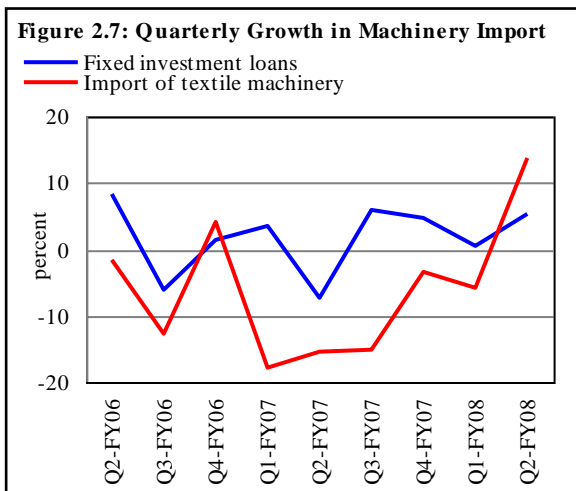
**Table 2.8: Cement Dispatches (000 tonnes)**

	Jul-Dec		Exports as % of total
	Domestic	Export	
FY06	7981	775	8.9
FY07	9979	1203	10.8
FY08	10940	2996	21.5

Pharmaceuticals recorded an unprecedented growth of 36.4 percent during H1-FY08 driven mainly by increase in the outreach of public sector health related activities in the year as well as reduction in duties on raw-material imports announced in federal budget for FY08.<sup>14</sup> Similarly, robust growth in sugar production is an outcome of record sugarcane crop during the year.<sup>15</sup> However, the food, beverages and tobacco sub-group decelerated slightly due to the decline in the production of edible oil/ghee.

Thus, it appears that the manufacturing sector needs to consolidate its gains in coming months in order to improve the muddling performance so far. However, the prospects for improvement appear low, given:

1. Short-term performance of fertilizer sector will be affected as the only DAP production plant in the



<sup>13</sup> Cement production registered a robust growth of 18.2 percent in FY08, decelerated only marginally from 18.8 percent in the preceding year. However, production of other items in *non-metallic minerals* group declined sharply.

<sup>14</sup> The latter is evident from the 34.8 percent growth in import of medicinal products.

<sup>15</sup> However, this robust sugar production could have been even better had the cane crushing started on time.



- country will remain closed during Q3-FY08 for BMR expansion.
2. Yawning gap between energy demand and supply, and resultantly, the government instructing all the steel-melting and re-rolling steel units to close down operation for 15 days to conserve energy and also instructing textile mills to reduce operation during January 2008.
  3. Slowdown in the US economy following the financial turmoil may weaken exports to USA.

On the positive end, however, mild recoveries are expected in a few sectors as:

1. Sugar production is likely to remain robust in coming months. It is also expected that in order to stabilize the declining sugar prices in domestic market, surplus sugar will be exported. It is also important to note that the international prices of sugar witnessed a rise in recent months, which may be beneficial for the domestic sugar industry.
2. Price pressures in domestic cotton market may ease somewhat once the import of raw cotton from India is realized. Moreover, sharp growth in fixed investment loans and import of textile machinery in Q2-FY08 also hints at some recovery in textiles going forward (see **Figure 2.7**).
3. Similar recovery is expected in edible oil & ghee industry January 2008 onwards when the Free Trade Agreement (FTA) between Pakistan and Malaysia comes into force.<sup>16</sup> This is also evident from 52.6 percent YoY growth in *quantum* of palm oil imports during January 2008.
4. Refining activities will get a major spurt as the new pre-flash distillation system in one of the refining companies will be taken on line during February 2008, and
5. Government deferred withholding tax (levied in the start of FY08) on auto sales for two months February to April 2008. The said measure is expected to ease prices.

Finally, however, prospects of the LSM sector will largely depend much upon the nature of political scenario, law and order situation as well as the effectiveness of government measures to mitigate the energy crisis.

### **2.3 Services Sector**

The early availability of information on growth trends is important for the modulation of policy, particularly as the impact of changes in economic policies is transmitted with variable lags. While the services sector contributes over 50 percent in annual GDP for Pakistan, an assessment of growth in the sector is

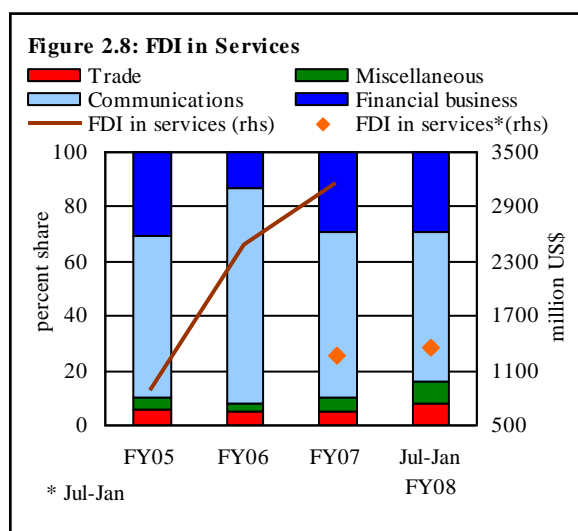
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<sup>16</sup> Specifically, the agreement requires a 15 percent cut on import tariff on palm oil which currently is Rs 9200 per ton. However, the agreement is expected to have marginal effect on the industry as palm oil prices are not likely to show any respite.

available only on an annual basis. This is in contrast to the position for the commodity producing sectors (CPS), where partial data on crops and large-scale manufacturing allows for intra-year assessments of on-going growth trends.

In light of the above, this section attempts to assess broad direction of FY08 growth trends for the services sector, based on a number of variables that may be indicative to trends in the respective area (see **Table 2.9**). Most of these growth indicators for the services sector suggest robust growth for the first half of FY08.

Wholesale and retail trade<sup>17</sup> seems likely to perform well given a significant increase in imports (which accounts for more than half of the value addition in this sub-sector). This sub-sector is also likely to benefit from expansion in the network of domestic and foreign chain stores. In particular, multinational chain stores are operational at full swing in FY08. These stores contributed substantial FDI inflows of US\$ 319.2 million during FY05-FY07



compared with only US\$ 109 million during FY02-FY04. While trade activities adversely impacted due to weakness in the growth by major crops, significant rise in the production of minor crops and imports of wheat and cotton is expected to offset this drag. Similarly, a relative weakness in transportation sub-sector could be offset by a strong growth in the electronic media and telecommunication sub-sectors on the back of government's liberal policy as well as large FDI in this sub-sector in recent years (see **Figure 2.8**). In particular, expansion in cellular services is impressive as cellular density has turned more than double during July 2006 to December 2007.<sup>18</sup> Relatively weak growth in transportation sector is reflected in growth deceleration of credit, production of LCVs and import of petroleum.

<sup>17</sup> The share of manufacturing and wholesale and retail trade is 19.1 percent each in GDP during FY07.

<sup>18</sup> The overall teledensity increased by 7 percentage points in H1 FY08 (source PTA).

**Table 2.9: Services Sector Performance Indicators**

percent growth or mentioned otherwise				
	FY06	FY07	H1-FY07	H1-FY08
<b>Wholesale &amp; retail trade</b>				
Credit to wholesale and retail trade	8.1	-62.8	15.5	10.7
FDI in trade	126.4	46.0	55.0	-0.4
Imports	38.8	6.9	9.1	13.8
Trade volume (imports & exports)	28.7	5.5	7.4	10.3
<b>Transport storage &amp; communication</b>				
Credit to transportation storage and communication	-50.9	48.3	25.9	4.6
Petroleum crude imports	76.6	-4.9	-1.8	3.6
Commercial vehicles production	16.1	7.9	4.2	1.6
Teledensity (percentage of population)	26.3	44.1	35.4 <sup>1</sup>	52.9 <sup>1</sup>
Cellular density (percentage of population)	22.2	39.9	31.1 <sup>1</sup>	48.6 <sup>1</sup>
FDI in transport storage & communication	267.8	-0.5	52.4	43.4
<b>Finance &amp; insurance</b>				
Profit of commercial banks	51.5 <sup>2</sup>	10.8 <sup>2</sup>	20.4 <sup>3</sup>	6.9 <sup>3</sup>
FDI in financial business	22.2	182.6	340.0	-32.7
<b>Ownership of dwellings</b>				
Cement	13.5	22.5	11.6 <sup>4</sup>	25.8 <sup>4</sup>
Metal production	5.3	10.7	12.8 <sup>c</sup>	-0.6 <sup>c</sup>
<b>Public administration &amp; defence</b>				
Fiscal spending on public admin. and defence	14.3	3.3	-18.5 <sup>3</sup>	26.3 <sup>3</sup>
<b>Community, social &amp; personal services</b>				
FDI in social and personal services	162.5	23.8	1.3	51.5
<b>Total FDI in services sector</b>	<b>181.5</b>	<b>27.4</b>	<b>111.7</b>	<b>7.2</b>

<sup>1</sup>: Data pertains to end-Dec. <sup>2</sup>: Data pertains to Jan-Sep.

<sup>3</sup>: Data pertains to Jul-Sep. <sup>4</sup>: Data pertains to Jul-Oct.

At glance, slower growth in profit for commercial banks and fall in FDI inflows could point to lower growth in value addition by the *finance & insurance* sub-sector. However, the impact of a likely improvement in the profitability of the central bank, coupled with some improvement in value-addition by non-bank financial institutions is expected to support the high growth momentum in this sector as well. In addition, growth in value addition by public administration & defence as well as community & social services (social services) is likely to be major contributing factors. Rise in value addition in these two sectors is principally driven by deployment of troops in various parts of the country; election related public and private spending as well as increase in social services, particularly government initiatives for health and education during the year.