

2 Real Sector

Data for the initial months of FY10 reinforces the view that a moderate economic recovery is in progress aided by a recovery in external demand as well as strengthening domestic sales. Evident from gradually improving export growth, increase in external demand was probably helped by continued stimulus policies in US and European countries. The recovery in domestic demand was supported by a number of factors including relatively easy monetary policy higher fiscal spending and a rise in rural incomes on the back of improved prices for agri-commodities. The sustained demand recovery is also evident from increase in input requirements. Specifically, while Q1-FY10 saw a modest increase in demand for key inputs, Q2-FY10 was marked by a sharp rise in domestic energy requirements, import of raw-materials as well as bank loans (see **Table 2.1**).

Table 2.1: Indicators of Aggregate Demand

YoY growth in percent

	Q1		Q2			Q1		Q2	
	FY09	FY10	FY09	FY10		FY09	FY10	FY09	FY10
HSD sales ¹	1.8	-6.5	-12.1	9.3	Comm. auto sales ⁶	3.0	-3.9	3.7	24.8
FO sales to power ¹	-2.3	25.0	3.9	21.5	Steel sale ⁷	6.1	-34.9	-33.3	7.6
FO sales to industry ¹	-24.1	36.3	-21.0	13.4	FDI	-11.5	-57.8	16.3	-56.2
Gas sales to industry ²	-1.1	-7.4	-9.3	6.8	Non-food exports	9.3	-12.0	-6.5	11.6
Gas sales to power ²	-7.0	-2.9	-5.4	-6.6	Non-food imports	32.8	-29.1	-10.6	5.4
Hydel generation ³	-4.0	1.9	-4.6	3.9	Gov. expenses ⁸	4.0	4.3	4.3	4.4
Electricity sales to industry ⁴	-6.2	-8.1	-10.5	6.1	Fiscal deficit ⁸	1.0	1.5	0.9	1.2
Local cement sales ⁵	-14.6	11.1	-12.7	10.0	Pvt. sector credit	3.1	-2.6	3.8	7.0
Consumer auto sales ⁶	-19.9	24.6	-28.2	55.2	Disbursement FII	59.3	-29.8	-36.5	8.0

Source: ¹OCAC; ²SSGC & SNGPL; ³WAPDA; ⁴FBS (for Jul-Nov period); ⁵APCMA; ⁶PAMA; ⁷Pakistan Steel Mill; ⁸percent of GDP

This assessment of aggregate demand corresponds to a small recovery seen in industrial sector. In particular, the LSM sub-sector staged a strong rebound and grew by 2.3 percent in Jul-Jan FY10 compared with a decline of 5.4 percent in the same period last year. More importantly, the LSM growth of 4.0 percent seen in Q2-FY10 was the highest in the previous 7 quarters. Construction sector also seem to have recovered on the back of lower building material prices as well as higher fiscal spending. Mining activities however, could not recover due to unfavorable security situation as well as natural decline in key oil and gas fields.

The pace of industrial recovery, however, will be challenging to sustain in H2-FY10 as domestic energy imbalances are likely to inhibit production processes. In particular, a modest increase in power sector investments means that existing capacities may not be sufficient to support a stronger recovery. Furthermore, near-stagnant gas supplies in recent years have also resulted in frequent gas outages for industrial units. Similarly, due to circular debt problem, local production of petroleum products has declined sharply in H1-FY10 resulting in burgeoning import dependence.

Another challenge for local producers is the rising global commodity prices in recent months that have already transmitted to domestic prices of major energy items (electricity and gas), industrial metals and fertilizers. Resultantly, domestic inflation witnessed a trend reversal in November 2009 onwards and started inching up again. Furthermore, rise in import demand during Dec-Jan FY10 and transfer of oil payments from SBP to interbank market put significant pressures on exchange rate, which compounded the impact of rising international commodity prices.

The SBP concerns over rising inflation were one of the factors considered in MPC decision of keeping discount rate unchanged. Moreover, realizing the key challenges for the industrial revival, the SBP has maintained its earlier forecasts, indicating that FY10 real GDP growth is likely to be in the range of 2.5-3.5 percent. In addition to the industrial sector, the forecast also incorporates expected improvement in services sector in FY10, supported mainly by *finance & insurance* as well as *public administration & defense*. Improving manufacturing and import growth in Q2-FY10 is also likely to benefit *wholesale & retail trade* activities. The GDP estimates could have been higher if not for weakening seen in agriculture growth. Specifically, lower rice and sugarcane production and expected fall in wheat harvest will more than offset the gains from a higher cotton production in FY10.

2.1 Agriculture Sector Performance

Growth prospects for agriculture sector remain weak in contrast to the strong growth seen last year. Negative contribution by the two major crops of FY10 *kharif* (rice and sugarcane) and expected decline in wheat harvest are mainly responsible for this gloomy outlook.

Although cotton output rose by 5.3 percent in *kharif* FY10, its impact was more than offset by the decline in production of other major crops (see **Table 2.2**). The major contributory factors for lower area under cultivation and dismal performance by major crops were: (a) water shortages; and (b) realization of lower prices in the preceding season for rice and sugarcane.

An overall decline in area under major crops, conservative lending by domestic private banks (DPBs) and weakness in demand for credit by the non-farm sector led to slowdown in agri-credit disbursement during Jul-Jan FY10. On the positive side, relatively lower prices of fertilizer and impact of higher farm income in FY09 encouraged farmers to use fertilizers aggressively. Fertilizer off-take also increased due to government support in terms of maintaining a higher support price for FY10 wheat, despite a substantial decline in international prices of the grain.¹

Table 2.2: Performance of Major Crops

Area Under Cultivation (000 hectares)					% change
	FY08	FY09 ^P	FY10 ^T	FY10 ^E	FY10
Cotton	3,055	2,850	3,200	3,040	6.7
Sugarcane	1,241	1,029	1,106	952	-7.5
Rice	2,516	2,963	2,526	2,854	-3.7
Wheat	8,550	9,045	9,045	8,873	-1.9
Gram	1,107	1,092	1,022	-	-
Maize	1,037	1,062	1,039	971	-8.6
Production (000 tons; cotton 000 bales of 170.09 kg each)					
Cotton	11,655	12,060	13,360	12,700*	5.3
Sugarcane	63,920	50,045	56,527	48,622	-2.8
Rice	5,561	6,954	5,949	6,377	-8.3
Wheat	20,959	24,032	25,000	-	-
Gram	475	760	749	-	-
Maize	3,109	3,548	3,414	3,344	-5.7
Yield (Kg/hectare)					
Cotton	649	720	710	711	-1.3
Sugarcane	51,507	48,635	51,109	51,074	5.0
Rice	2,210	2,347	2,355	2,234	-4.8
Wheat	2,451	2,657	2,764	-	-
Gram	429	696	733	-	-
Maize	2,998	3,341	3,410	3,444	3.1
P: Provisional, T: Target, E: Estimates					Source: MINFA
*: Pakistan Central Cotton Committee					

¹ DAP prices down by 52.6 percent YoY and international wheat price dropped by 16.2 percent YoY in October 2009.

Crops sector

Cotton

Cotton harvest witnessed an increase for the second consecutive year in FY10. Initial lower estimates for FY10 cotton crop were based on the situation in Punjab; however, a strong growth of 50.0 percent in Sindh drove overall cotton harvest to 12.7 million bales (see **Table 2.3**).² Despite higher acreage (6.7 percent) in Punjab, cotton production decreased by 8.3 percent during FY10 mainly due to severe virus attack.

The extraordinary growth of cotton production in Sindh was achieved due to: (1) increase in cultivated area; (2) aggressive sowing of Bt cotton; (3) supportive weather - low rains and desired temperatures; (4) no major incidence of disease or insects strike (no attacks of mealy bug); and (5) extended picking season.

Table 2.3: Province-wise Cotton Harvest

thousand bales

	FY08	FY09	FY10
Punjab	9062	9160	8400
Sindh	2536	2800	4200
Balochistan	57	99	100
NWFP	0.5	1.0	0.5
Total	11655.5	12060.0	12700.5

In particular, disappointed growers of rice and sugarcane (due to lower realized prices last year) switched to cotton cultivation and area under cotton rose by 6.7 percent in FY10. Recovery in cotton production in FY10 crop is a welcome development, but despite the rise, the FY10 production is still lower than the record crop of 14.3 million bales registered in FY05. The cotton consumption in the country is estimated at about 16.0 million bales which suggest that Pakistan may need to import the deficit quantity.

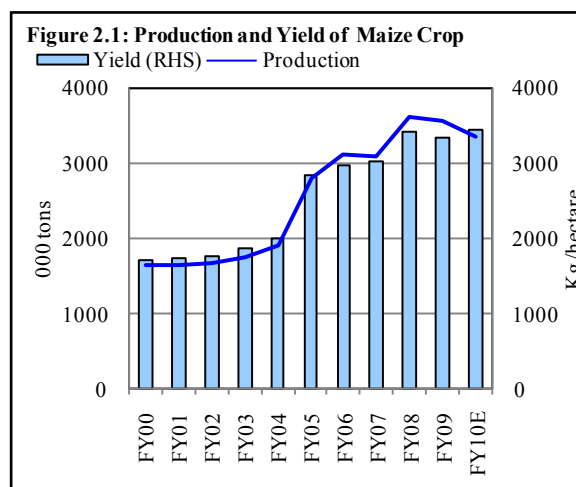
Rice

Rice production fell by 8.3 percent to 6.4 million tons in FY10 relative to FY09, but was still substantially higher than the target for FY10. A decline in area under rice (and harvest) was anticipated due to a sharp slide in rice prices during the preceding season. However, it appears that some support from the government in FY09 made rice crop attractive. Recent surge in international rice prices, due to supply shortages in India and Philippines, would also help motivate farmers to cultivate more rice in coming *kharif* season (Apr 2010).

² Due to extended picking season cotton output may increase further during FY10.

Maize

Maize harvest declined by 5.7 percent in FY10 entirely due to decline in the area under cultivation. However, it is notable that the country has seen substantial gains in maize harvest and yields in the last five years (see **Figure 2.1**). Maize is the third most important cereal after wheat and rice. It provides major portion of feedstock for livestock and poultry sector. In recent years, demand for maize has increased in the country.



Wheat

The impact of water shortages on the crop was further compounded due to lower rains during Nov-Dec 2009 – sowing period for wheat. As a result, area under wheat cultivation dropped by 1.9 percent YoY in FY10. In particular, acreage declined by 18.4 percent in non-irrigated³ (*barani*) areas during FY10 crop compared with a rise of 5.0 percent last year. However, wheat sowing in canal regions increased by 2.5 percent in FY10 mainly in response to better incentives. The prospects for wheat harvest improved somewhat with healthy fertilizer off-take in *rabi* FY10 and reasonable rainfall in February 2010. However, the impact of lower acreage and water shortages will take its toll and wheat harvest is likely to be significantly lower than the FY10 target of 25.0 million tons.

A spatial break-up reveals that area under wheat cultivation increased by 0.9 percent in Punjab during FY10 relative to the last year (see **Table 2.4**). In contrast, area under wheat declined by 1.0 percent in Sindh mainly due to lower availability of irrigation water. Similarly, poor winter rains are responsible for lower acreage in NWFP and Balochistan during FY10.

Table 2.4: Province-wise Wheat Cultivation

million hectares

Provinces	FY09	FY10 ^E	% change
Punjab	6.836	6.897	0.9
Sindh	1.031	1.021	-1.0
NWFP	0.769	0.665	-13.5
Balochistan	0.409	0.290	-29.1
Total	9.045	8.873	-1.9

^E estimated

³ Pertain to Punjab and Sindh as data for NWFP and Balochistan is not available.

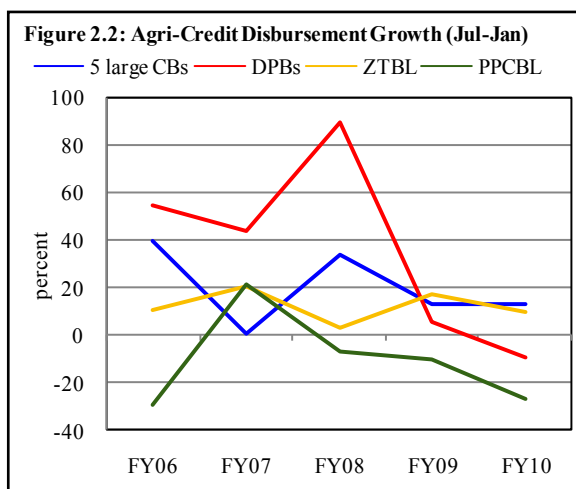
In addition, decline in wheat acreage was also caused by late harvesting of rice, delayed sugarcane crushing season and extended cotton picking on account of rising price.

Minor crops

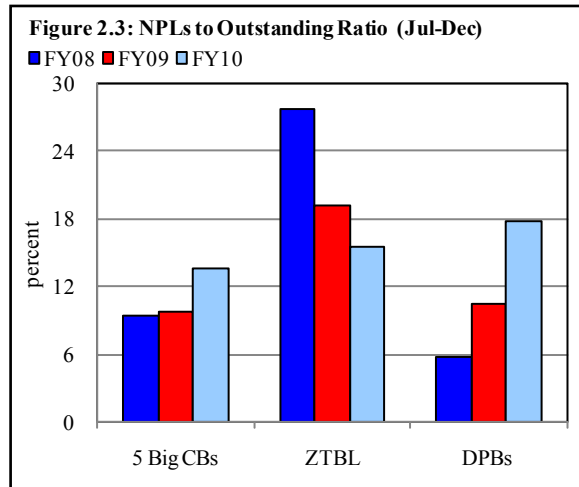
Driven by strong demand and higher prices, growers increased acreage and production of minor crops i.e., potato, tomato, onion, chilies etc. Warming weather helped early harvesting of most of the minor crops. Some of the minor crops, such as onion, also received the benefits of strong external demand, e.g. the Indian harvest was hit by a drought. Therefore, despite bumper crops, prices of most of the minor crops did not see a seasonal decline in FY10. One exception was tomatoes where a supply glut resulted in extremely low prices with some farmers were unable to cover costs. As a result area under the crop is expected to decline next year and consequent supply shortages will push its prices up. The intensity of this boom-bust cycle may be reduced with investment in cold storage, processing and packaging units in rural areas. It would not only help stabilize prices of minor crops, but will also generate most needed employment opportunities for the landless farmers in rural areas.

Agriculture credit

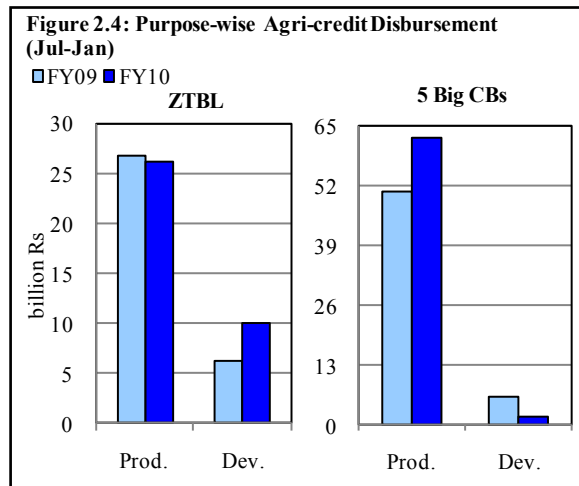
Growth in agri-credit disbursement slowed to 6.3 percent during Jul-Jan FY10 compared with 11.5 percent in the same period last year. This slowdown is largely attributed to a decline in the disbursements by the DPBs and PPCBL (see **Figure 2.2**). The main factors affecting the pace of growth in agri-credit are: (a) decline in both overall area under cultivation and number of borrowers; (b) rising NPLs in agri-credit, particularly for DPBs and five large commercial banks (CBs) (see **Figure 2.3**); as well as, (c) improvement in farm income on the back of bumper crops and better prices of most of the agri-produce in FY09.



The lending behavior of different institutions also reveals their priority in an environment of rising NPLs. CBs extended higher financing for short-term production related loans and cautiously contracted their exposure in development lending, whereas ZTBL concentrated on medium to long-term developmental loans (see **Figure 2.4**). A sharp jump of 61.9 percent in developmental loans by the ZTBL was probably due to financing of Benazir Tractor Scheme.



Among purpose-wise lending, total production loans increased by 8.5 percent in Jul-Jan FY10 compared with 7.8 percent increase seen during the same period last year. This improvement is principally driven by CBs as production loans by these institutions grew by a strong 22.7 percent during Jul-Jan FY10 compared with a rise of 6.7 percent in the same period last year. The rise in production loans was



attributed to higher fertilizer off-take following lower prices and efforts of the farmers to increase yield of wheat. However, production related loans by ZTBL and DPBs declined in Jul-Jan FY10, mainly due to weaker recovery by these institutions than in the same period of the preceding year.

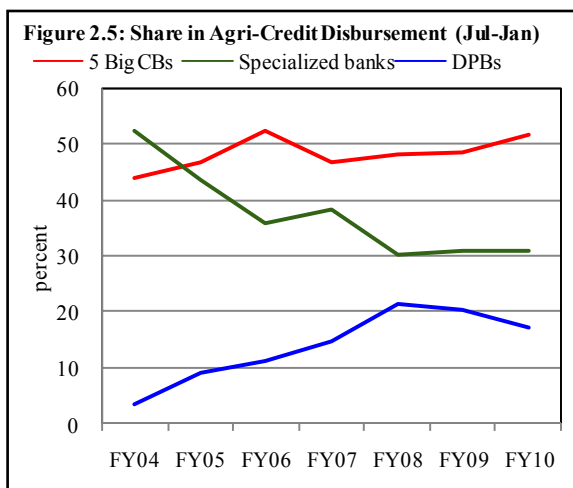
In contrast with the production loans, disbursements for developmental loans declined by 9.4 percent during July-Jan FY10, despite a healthy growth by ZTBL.

This was mainly caused by slower lending for developmental loans by CBs and DPBs.

The structure of agri credit market appears to have become stable in recent years after a distinct transformation during FY01-FY07.

The share of 5 large commercial banks is gradually increasing, improving their leading position in the market on the back of extensive branch network. The share of specialized banks seems

to be stabilized while the share of DPBs contracted somewhat (see **Figure 2.5**). Given bright prospects for investment in agriculture due to strong domestic and external demand as well as reasonable prices of agriculture commodities, the share of commercial banks (including DPBs) is likely to increase in coming years.



Sector-wise Disbursement

Agri-credit for farm sector increased by 6.7 percent during Jul-Jan FY10 compared with 4.6 percent rise seen in the same period last year. Improvement in farm credit was recorded by the economic and above economic holding groups. It appears that subsistence farmers (having a share of about 60.0 percent in total disbursements to farm sector) relied more on their own resources on the back of increased farm income in FY09 and growth in disbursement

Table 2.5: Borrowers and Credit Disbursement (Jul-Jan)

Number of borrowers (000)			
	FY08	FY09	FY10
Farm	595.2	850.2	567.3
Non-Farm	38.0	47.7	63.1
Growth (percent)			
Farm	31.6	42.8	-33.3
Non-Farm	12.9	25.5	32.4
Amount (billion Rs)			
Farm	77.2	80.7	86.1
Non-Farm	27.5	36.1	38.1
Growth (percent)			
Farm	16.3	4.6	6.7
Non-Farm	15.2	30.8	5.6

slowed under this category.

Despite fall in number of borrowers in Jul-Jan FY10 in farm sector, growth in credit disbursement improved by 2.1 percentage points due to higher growth under economic farm holders and above economic (large) farm holders. On the other hand the number of borrowers improved by 6.9 percentage points in non-farm sector, however growth in disbursement slowed during Jul-Jan FY10, owing principally to a deceleration in disbursements to large borrowers, which in the past availed about 80.0 percent of the total loans to non-farm sector.

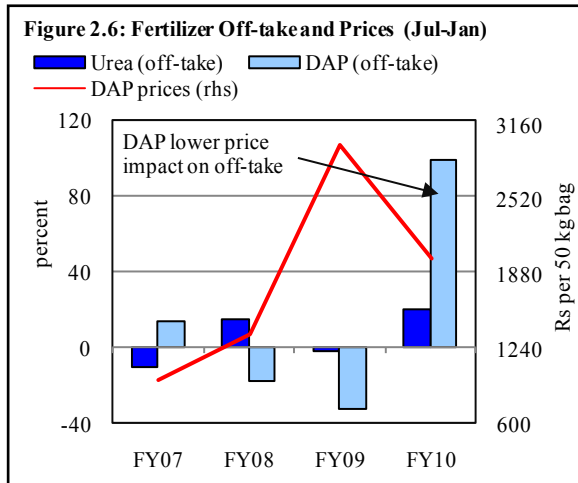
In contrast to farm sector, growth in disbursement to non-farm sector decelerated during Jul-Jan FY10 (see **Table 2.5**). A slowdown in disbursement to livestock and poultry sector is a source of concern as country needs heavy investment in these two sectors to improve domestic supply of dairy and poultry products as well as to increase exports.

Fertilizer off-take

Despite slowdown in irrigation water availability and less winter rains, fertilizer off-take registered a strong growth of 32.6 percent during Jul-Jan FY10 in contrast to a decline of 9.2 percent witnessed in the same period last year. This growth is attributed to: (1) lower prices of DAP and stable prices of urea; (2) better prices of most of the agri produce; and (3) farmers efforts to improve yield (on the face of good prices for produce) to offset the impact of water shortages.

In particular, DAP off-take substantially increased by 98.5 percent in Jul-Jan FY10 against a fall of 33.0 percent in the same period last year (see **Figure 2.6**). The record DAP off-take of 1.3 million tons is attributed to better inventories, timely imports and, more importantly, lower prices. Consequently, share of DAP in total fertilizer off-take rose by 8.1 percentage points during Jul-Jan FY10 compared with the same period last year.

Generally, growers prefer to purchase major share of DAP in the second quarter of financial year, however, as prices bottomed out in Q1-FY10, a large portion of



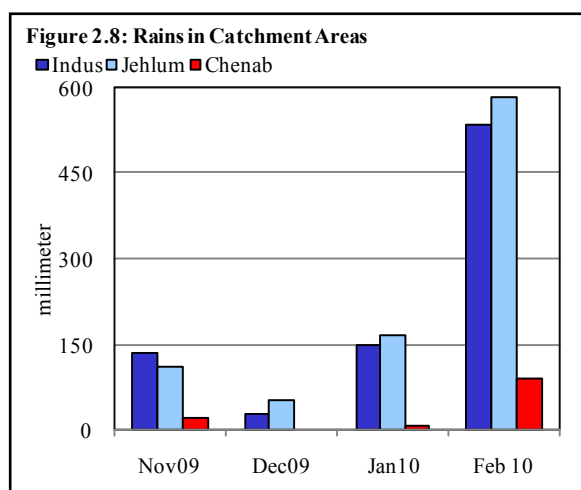
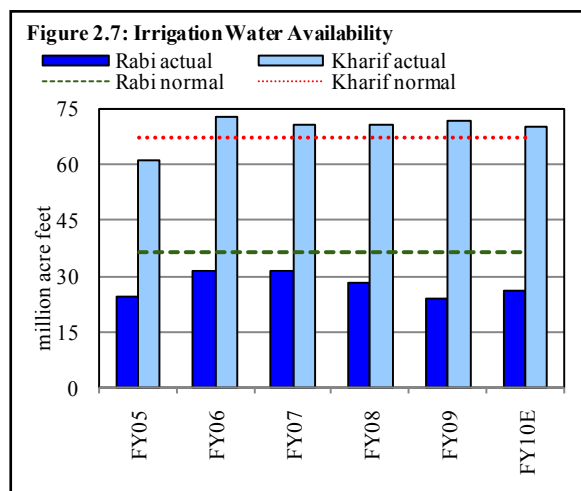
(51.0 percent) was lifted by the farmers as against only 21.0 percent in the same period last year. Similarly, urea off-take rose by 19.8 percent during Jul-Jan FY10 as against 2.4 percent fall seen in Jul-Jan FY09. An aggressive DAP off-take with substantial rise in urea is likely to impact FY10 wheat yield with a more balanced mix of the nutrients that would somewhat mitigate the impact of water shortages.

Irrigation Water

Canal water availability was initially estimated to increase by 7.7 percent YoY in *rabi* FY10 as against 13.7 percent decline in the corresponding season last year (see **Figure 2.7**). Inadequate water inflows in four major rivers, however, resulted in substantial decline in water availability for *rabi* FY10. The collective reservoir water availability dropped to 1.4 MAF by 30th Jan 2010 as against 2.6 MAF last year.

Availability at farm gate declined further due to poor water management. This adversely affected the area under wheat cultivation the most, which declined by 1.9 percent despite announcement of an attractive procurement price and lower fertilizer prices.

Lower winter rains also discouraged farmers to cultivate wheat in the non-irrigated areas. Rains in February 2010, however, provided much needed relief as the rains not only improved inflows in the reservoirs but also improved water availability in barani areas (see **Figure 2.8**).



Water shortages are likely to become more frequent and acute in years to come due to the combined impact of environmental changes and construction of new dams by India. This situation requires efficient management of water resources, as well as, improvement and construction of new dams on priority basis.

2.3 Large Scale Manufacturing

The LSM subsector continued its uptrend in Q2-FY10 largely in response to rising domestic demand. Production of consumer durables contributed most to the recovery as automobiles and allied industries increased production sharply despite the QoQ increase in prices (see **Table 2.6**). Furthermore, the demand for cement and steel increased sharply as local construction activities revived. Cement sector benefited also from rising global demand as exports to North African countries showed a considerable increase. Finally, the resource based industries presented a mixed picture. Textile sector (low value-added) benefited from a good cotton crop and a simultaneous shortage of cotton globally; whereas, local sugar industry suffered from lesser sugarcane production as well as increasing use of cane in gur manufacturing.

Major recovery was seen in consumer vehicle sector in Jul-Jan FY10. This recovery was despite the non-availability of consumer finance by banks; as a result, most of the transactions were cash-based. This was possible due to improvement in rural incomes (in case of motorcycles), as well as

Table 2.6: Performance of Selected Industries
percent growth

	FY09		FY10	
	Q1	Oct-Jan	Q1	Oct-Jan
Overall LSM	-5.9	-4.9	-1.0	4.8
Resource-based				
Cotton ginning (PCGA)	32.7	-3.8 ⁱ	24.6	10.3 ⁱ
Cotton yarn (TCO)	0.6	1.5 ⁱ	1.1	1.6 ⁱ
Cotton cloth (FBS)	-0.9	-0.1	-0.2	-0.1
Sugar	N.A.	-18.3	N.A.	-8.8
Edible oil & ghee	-9.1	-8.8	2.2	-0.1
Consumer durable				
Consumer autos (cars/M-cycles)	-43.7	-43.0	11.2	51.4
Consumer electronics	-15.6	-19.8	-9.6	17.4
Rubber	-2.3	-6.0	24.5	36.7
Construction based				
Cement	0.4	9.2	15.1	16.8
Steel (billets & coils only)	-35.8	-42.8	-24.0	10.2
Paints	27.8	9.5	-13.2	6.3
Other intermediate				
Commercial vehicles	15.6	-9.8	-18.4	10.4
POL	-5.4	-10.2	-11.0	-2.6
Fertilizers	8.0	36.2	2.4	14.8

ⁱ Oct-Feb ; ^j Oct-Jan

For details, please see FBS data on www.statpak.com

favorable price adjustments; first in April 2009 in response to depressed demand, and later in July 2009 following the removal of 5 percent FED in 2009-10 Budget (that was imposed last year). The demand for local cars was further strengthened by lesser availability of imported cars as customs duty on CBU imports was already increased by 10 percent in Budget 2009. On the supply side, two of the over 1000 cc cars were going through production phase-out process in FY09 which was the major factor in production decline in this category last year; in FY10, newly introduced models were received well by the near-captive customers.

Two features make the Oct-Jan FY10 growth more peculiar: (1) the demand for consumer vehicles remained strong in this period despite the quarter-on-quarter increase in prices;⁴ and (2) a strong recovery was seen in commercial vehicles category (as production and sales of consumer vehicles had already picked up in Q1-FY10). Tractors sales mainly reflected the generous agri-spending by Punjab government as well as increase in tractor financing by banks. On the other hand, the growth in sales of LCVs and trucks coincided with the growth in trade volume in Dec-Jan FY10 period. Moreover, larger transport of different POL products also increased the use of heavy vehicles.

The growth in textile manufacturing emanated mainly from, (1) good cotton crop; (2) export opportunities emanating from cotton and yarn shortages globally due to weaker crop in US and China; and (3) recovery in textiles related sales in advanced economies. However,

it appears that the growth in textile industry could have been higher if not for the shortages of raw-material in the country. Specifically, poor international crop and demand recovery in advanced economies put upward pressures on international cotton prices. Thanks to a better domestic crop, local ginners and spinners could offer cheaper prices in the region and thus fetched a large number of export orders mainly from China. The resultant increase in yarn exports appears to have caused a supply constraint for high value-added sector (see **Table 2.7**). At least partly as a result, local production of fabrics and exports of other high value-added items declined through most of Jul-Jan FY10. However, it must be noted that despite relatively higher yarn prices, China was able to increase its share in value-added

Table 2.7: Yarn Availability (Jul-Jan)
(000 tons)

	Production	Export	Available for local market
FY08	1,654	334.5	1,319
FY09	1,672	291.1	1,381
FY10	1,695	424.4	1,271

Source: Textile Commissioner's Organization

⁴ However, it must be noticed that although prices increased over the previous quarter; these still remained low compared with the peak seen in H2-FY09.

export to advanced economies. It must be noted that the exports of local high-value added categories has remained low in FY09 also due to structural weakness, removal of quotas in china recession etc. Nonetheless, the increase in China's share in exports to advanced economies in FY09 and FY10 appears to be driven by liberal export packages announced by the government. This was almost the reverse in case of Pakistan. Specifically, value added sector in Pakistan felt the burden of 100 bp increase in EFS rate and a rise in energy tariffs at a time when competitors were provided with liberal textile stimulus packages to circumvent stagnant export demand.⁵ The lower availability of electricity was also a key constraint for the value-added textile sector.

In sharp contrast to textile sector, sugar industry suffered heavily from raw material shortages for the second consecutive year. The shortage was an outcome of serious management problems in sugar sector whereby no proper mechanism is in place to ensure timely payments to the cane growers. Delayed payments in FY08 bumper crop year by the sugar mills discouraged sugarcane growers as they became extremely uncertain regarding future liquidity. As a result, farmers not only switched to other crops but also looked for other markets to sell their product. With better market mechanisms in place, gur making is now becoming an increasing attractive option for cane growers. The resultant decline in sugar production not only caused increased import of sugar in the country but has also hit other sugar-dependent industries like pharmaceuticals and beverages.

Going forward, the growth seen in Jul-Dec FY10 period will be challenging to sustain in the remaining months of FY10 given the inadequate energy balances in the country. For instance, the increase of 0.5 percent in gas exploration during Jul-Nov FY10 period does not seem sufficient to fuel a quick recovery. It must be noticed here that gas constitutes more than 50 percent of total energy consumption by industries. Similarly, scanty power investments in recent years allowed only a small increase in electricity generation capacity; which too often remains under-utilized due to water shortages or insufficient provision of gas and/or furnace oil. For instance, as winter rains remained low in FY10, the Hydel generation capability declined sharply in January 2010. Similarly, gas sales to power sector also declined during H1-FY10. Consequently, the use of furnace oil (FO) for thermal generation,⁶ increased.

⁵ Under the Stand-By Arrangement with IMF, the SBP is required to rationalize its refinancing schemes, and as a first step, the interest rate for both the EFS and LTFF schemes has been increased.

⁶ Unfortunately, due to circular debt problem, local refineries could not provide required FO quantity to power generation companies. As a result, import burden has increased significantly for FO provision.

Besides energy insufficiency, another challenge for local manufacturers is the continuing increase in cost, as prices of almost all energy items including electricity, gas increased January 2010 onwards. Moreover, the rise in global commodity prices Q2-FY10 onwards has already put significant pressures on production costs. Furthermore, the sharp increase in food inflation January 2010 onwards has weakened consumers' purchasing power. In this scenario, the demand for manufactured goods may tumble again if manufacturers tend to shift the cost burden to consumers by raising the retail prices. Realizing this, a number of firms are taking measures to circumvent cost pressures.

For instance, car and electronics assemblers at present are trying to indigenize the production process as much as possible to avoid vulnerability to import prices and adverse exchange rate movements. This was necessary as in previous quarter, rising input prices coupled with weakening rupee has already started translating in domestic prices of automobiles and electronics. So far, sale of automobiles has remained strong but given the non-availability of bank finance, so it is possible that demand for these items become more sensitive to prices. Anecdotal evidence also suggests that the sales of used cars have increased in recent months.

Similarly, a few cement firms have started looking for local and cheaper sources of energy for their production. For instance, where one of the top two companies has inked an accord for local provision of coal from Thar coal fields and the other has decided to use Municipal Solid Waste as Refused Drive Fuel (RDF) as an alternative to coal. This will not only reduce the rising cost of production but also will reduce volatility in input cost emanating from global price fluctuations. Besides, there is an additional possible positive for local cement industry in the months ahead. Metal prices are likely to remain stable (if not easing) in global and local market as China has become quite wary of the real estate boom and it appears that most of the possible tightening measures would be directed towards construction industry. Export prospects also seem steady as African and some middle-eastern countries, major export market for local cement, are expected to increase infrastructure spending in months ahead.

Fertilizer production is likely to remain strong in remaining months of FY10 with two new plants coming on line by the year-end. One of these plants was scheduled to commence commercial production by end-January 2010 but due to technical problems and gas shortages, timelines could not be met. Nonetheless, the technical problems have been resolved and it is expected that the plant will start operation by the start of March 2010. Gas pressure should also improve once the winter season is over.

2.3 Services Sector

On the back of recovery seen in manufacturing sub-sector, rebound in trade volumes Q2-FY10 onwards and a modest growth in agriculture sector, services sector appears well geared to achieve the annual target of 3.9 percent. In particular, wholesale & retail trade activities are likely to benefit from recovery seen in commodity producing sector as well rising imports (see **Table 2.9**). Transport sector also benefited from domestic and international trade of

Table 2.9: Indicators of Services Sector Performance in H1

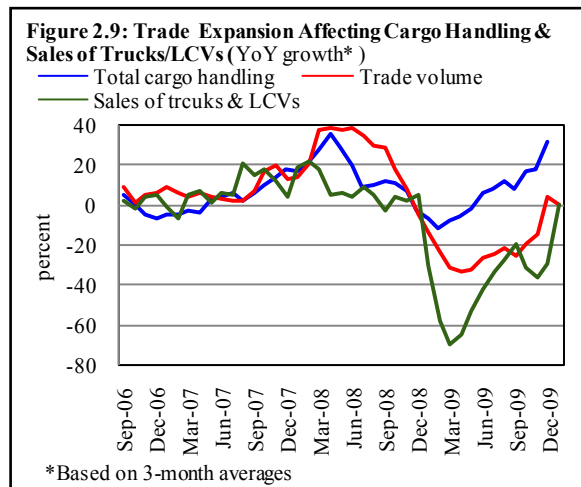
percent YoY growth unless mentioned otherwise

	FY09		FY10	
	Q1	Q2	Q1	Q2
Wholesale & retail trade (33.6)				
Credit to wholesale and commission trade	11.3	2.6	-16.0	-15.3
Credit to retail trade	45.4	32.5	1.8	5.0
FDI in trade	-11.2	0.4	-53.8	-53.4
Manufacturing growth	-5.9	-3.7	-1.0	3.8
Import growth	34.2	-6.7	-29.8	1.3
Transport (16.0)				
Cargo handling at ports	12.1	-3.0	8.7	32.5
Commercial vehicles sale	-10.6	-24.9	-1.4	37.2
Transport & communication price index	39.2	31.2	-5.8	1.6
PIA profit/loss after tax (Rs. bn.) Sep latest	547.8	..	-73.7	..
Communication (2.9)				
Telecomm imports	-29.3	-60.9	-60.0	-23.4
Communication services exports	-28.1	-45.7	138.6	277.7
Finance & insurance (10.6)				
Transfer of SBP profit to government (Rs. bn.)	28.0	16.0	70.0	65.0
Profits of commercial banks (YoY) Sep (Rs. bn.)	53.8	59.9	41.9	..
Percentage of advances at 12% or above - inc	86.9	78.2	81.4	85.8
Percentage of deposits held at 8% or above - inc	57.1	54.9	55.2	55.0
Interest Rate Spread - incremental	6.8	7.4	8.0	7.3
Gross NPLs to loans ratio	8.4	9.1	12.4	12.2
Government Services (11.5)				
Government borrowing	27.8	93.6	176.7	121.6

Values in parenthesis are 5-year average percentage shares in services value-addition.

commodities. Within the transport sub-sector, the burden of both passengers and freight has now largely shifted to road transport (89.4 percent average share in transport value-addition). It is also evident from pick up in commercial vehicles sales November 2009 onwards. Cargo handling also gained from increasing trade volumes Q2-FY10 onwards (see **Figure 2.9**). However, any major improvement

in air transport is unlikely as earnings of Pakistan International Airlines may be hurt by rising oil prices. Specifically, the first quarter result has shown a sharp decline in net losses from Rs 20.4 billion in Q1-FY09 to only Rs 5.4 billion in Q1-FY10. However, it appears that this improvement came entirely from lower oil prices in Q1-FY10 compared with Q1-FY09. Aside from that, the turnover of the company declined slightly, administrative expenses increased and financial costs remained high. Thus a rise in oil prices Q2-FY10 onwards is likely to constrain earnings of the company in remaining months of FY10.



Finance & insurance sub-sector is likely to rebound following the recovery in loan demand from private sector. Initial financial reports of few banks for H1-FY10 shows an improvement in earnings attributed to increase in volumetric expansions coupled with widening margins. However, a part of earnings growth will be offset by higher provisioning. Moreover, a sharp increase in transfer of SBP profits to government account in H1-FY10 also points towards positive financial sector earnings.

Telecom earnings are expected to gain from improved earnings of PTCL as well cellular companies. Specifically, the earnings of PTCL showed an increase of 1 percent in profit after tax compared with net decline in the previous year. The cellular companies, benefited mainly from, (a) increase in cellular subscribers H1-FY10 by 3.4 percent which resulted in higher turnover in H1-FY10; and (b) growth in telecom export services.