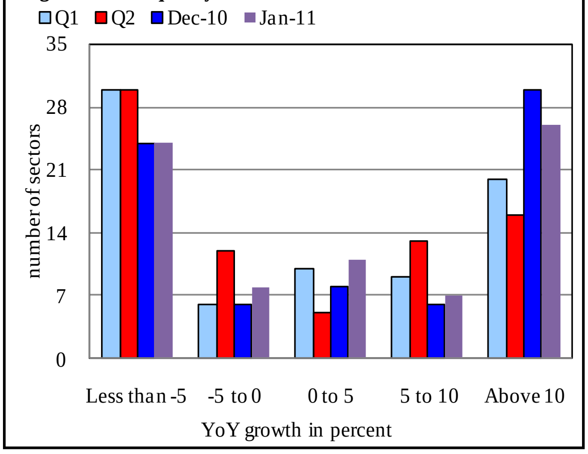
2 Real Sector

2.1 Overview

The latest available economic data indicates that the economy has fared better than expected in the aftermath of the most devastating floods in the history of Pakistan. A mild recovery is discernable, supported mainly by improvement in external demand and rise in domestic economic activity.

Figure 2.1: Frequency Distribution of Growth in LSM Sectors



Specifically, while the ongoing recovery in advanced economies brought about a revival in export industries; the rise in farm-income[1], strong growth in the remittances, higher loan disbursements and transfer payments[2] stimulated consumption demand. As a result, number of LSM sectors posted positive growth in December 2010 and January as the index increased by 2.5 percent and 0.8 percent YoY. (see **Figure 2.1**).

More importantly, it appears this recovery is sustainable given: (1) prospects of a record wheat crop; (2) increase in *phutti* arrivals at the ginning factories during Jan-Feb FY11 amid growing textile export orders;[3] (3) a sharp rise in loan disbursements to private businesses in December and January;[4] (4) expected increase in construction activities in the northern areas, March 2011 onwards; and (5) improvement in trade-related and financial services.

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[1] Due to higher prices of cotton, rice and sugarcane.
[2] For instance, Rs 31.0 billion were disbursed through *Watan cards* to flood affected families during Jul-Dec FY11 (for details, please see **Chapter 5**).
[3] Farmers are offloading cotton which they had held back in Q1-FY11 to fetch better prices.
[4] Disbursements to private business sector increased by 32.4 percent in Dec-Jan FY11 over Dec-Jan FY10.

Persistent energy shortages and escalation in global commodity prices (especially oil) are some of the threats that can suffocate this nascent recovery. Rise in oil prices and various industrial input prices due to supply disruptions and strengthening demand in emerging economies, have already generated concerns over inflation and the external imbalance. The situation becomes all the more serious as the growing fiscal deficit has precluded possibility of any government stimulus, and monetary easing is not possible because of persistence in inflationary pressures. The external imbalance could also amplify, particularly, in the absence of financial inflows that hinge on the resumption of the IMF program. With opportunities and threats more or less balanced, the SBP has maintained its initial forecast for GDP growth at 2.0 to 3.0 percent.

Table 2.1:Performance of Major Crops

Crops	FY09	FY10^{P}	FY11^{T}	FY11^{E}	YoY growth in FY11
Area under cultivation (000 hectares)					
Cotton	2,850	3,106	3,200	3,142	1.2
Sugarcane	1,029	943	1,070	1,047	11.0
Rice	2,963	2,883	2,708	2,642	-8.4
Wheat	9,046	9,105	9,045	-	-
Gram	1,092	1,050	1,122	-	-
Maize	1,062	950	1,010	-	-
Production ('000 tons; cotton in '000 bales of 170.09 kg each)					
Cotton	12,060	12,914	14,010	11,700	-9.4
Sugarcane	50,045	49,373	53,665	49,400	0.1
Rice	6,954	6,883	6,048	5,949	-13.6
Wheat	24,032	23,917	25,000	25,000^{f}	4.5
Gram	740	571	619	-	-
Maize	3,548	3,477	3,452	-	-
Yield (Kg/hectare)					
Cotton	720	707	745	633	-10.4
Sugarcane	48,635	52,357	51,000	47,182	-9.9
Rice	2,347	2,387	2,228	2,252	-5.7
Wheat	2,657	2,627	2,764	-	-
Gram	696	544	552	-	-
Maize	3,341	3,660	3,419	-	-

P: Provisional, T: Target; E: Provisional estimates; f: SBP forecast.
Source: Ministry of Food & Agriculture estimates released on November 1, 2010.

2.2 Agriculture Sector Performance

Agricultural performance during *rabi* FY11 is likely to compensate for some of the flood related losses sustained during *kharif* (see **Table 2.1**). Improved prospects for *rabi* stem from better availability of water and higher prices of most agricultural produce – particularly wheat.

The country is likely to see a record wheat crop of 25 million tons - barring unfavorable weather at the time of harvest. In addition to water, the availability of high yield certified seeds, and a bullish price outlook (that saw an increase in the area under cultivation) bode well for the outlook for wheat. The government's decision to provide seeds free of cost in the areas worst hit by the flood, further supports our positive outlook for wheat.

While a faster than anticipated recovery in agriculture is a welcome development, it does not imply that the adversities of the floods have been entirely overcome; FY11 growth in agriculture apart from wheat will still be substantially lower than the target (see **Table 2.1**).

Agriculture Credit

Agri-credit disbursement fell by 4.4 percent in H1-FY11 compared with a 6.9 percent increase in the same period last year. This fall in disbursements is largely due to a decline seen in one specialized bank[5] which more than offset the rise in disbursements made by commercial banks.

This divergence between commercial and specialized banks'agri-credit performance must be seen in the context of a sharp rise in the latter's NPLs; they increased to 18.8 percent by Dec- 2010 from 15.6 percent in Dec-2009. This reflects the exposure of specialized banks to the farm sector that was worst hit by the flooding.

Table 2.2: Sector -wise Agri-credit Disbursement Growth
percent

	FY08	FY09	FY10	FY11
Subsistence holding	-3.5	10.7	3.0	-15.1
Economic holding	1.3	6.1	14.2	-6.1
Above economic holding	84.8	-18.1	10.1	-8.7
Farm credit	***7.0***	***4.4***	***6.6***	***-12.0***
Small farm	-16.9	45.5	12.7	10.9
Large farm	333.9	21.8	6.1	13.5
Non-farm credit	***147.5***	***26.0***	***7.4***	***13.0***
Total	**25.9**	**10.2**	**6.9**	**-4.4**

More disturbingly, the decline in credit to the farm sector was stronger in the case of subsistence (small) farms (see **Table 2.2**). This is due to both demand and supply factors: rising prices of agri produce have resulted in improved cash flows for small farmers, reducing their demand for bank credit; while on the supply-side, commercial banks remain risk averse in the face of rising NPLs.[6]

[5] ZTBL posted a fall of 31.0 percent in credit disbursement during Jul-Dec FY11 compared with 9.7 percent growth in the corresponding period last year. The share of ZTBL in total disbursements also fell from 28.6 percent to 20.6 percent.
[6] See **Chapter 4**.

In addition, lower demand for bank credit, particularly in the case of sugar, is also the result of a partnership between sugar mills and farmers, whereby the former provide high yield variety seeds and in turn secure raw materials (see **Box 2.1**). This arrangement is likely to lower fluctuations in sugarcane output by lessening conflicts between growers and millers.

Looking forward, agri-credit could improve in the coming months due to expected increase in fertilizer off-take for wheat, and early sowing of *kharif* crops–as farmers are optimistic due to high prices–particularly for cotton.

Box 2.1: Private Sector and Agriculture Extension

The private sector in Pakistan is a significant source of advisory services to famers. [1] According to growers, private sector recommendations are useful, up to date, timely, accurate and consistent with their farm situation. These companies supply fertilizers and high yield varieties of seeds, as well as provide credit. This reduces farmers' demand for institutional credit. Following are a few examples:

(a) Local sugar mills provide high quality seeds, fertilizer, new growing techniques and introduce high yield varieties, with the contract that growers will sell their produce to the mill. This is not only beneficial to farmers in terms of higher output, but mills are also able to secure supplies of raw material.

(b) Some high yielding maize/corn varieties were introduced by Pioneer Seed Company. In addition, they provided training to farmers on new planting methods and provided assistance on how to control pest attacks.

(c) Dairy companies are providing not only veterinary assistance, but also training dairy farmers on fodder production, hygiene, milking practices and construction of cowsheds.

The increasing cooperation between farmers and key market players in the private sector bodes well for the agri growth in coming years.

Source: The role of private sector in agriculture extension; rural development news 2010.

Fertilizer

Fertilizer off-take for Jul-Dec FY11 declined 13.6 percent over the corresponding period of the previous year (see **Table 2.3**). This decline was entirely in Q1-FY11, due to floods and a high base set in Q1-FY10 when farmers bought aggressively owing to lower prices. Subsequently, some pick-up was seen in Q2-FY1, which is likely to continue due to the bright outlook for wheat crop.

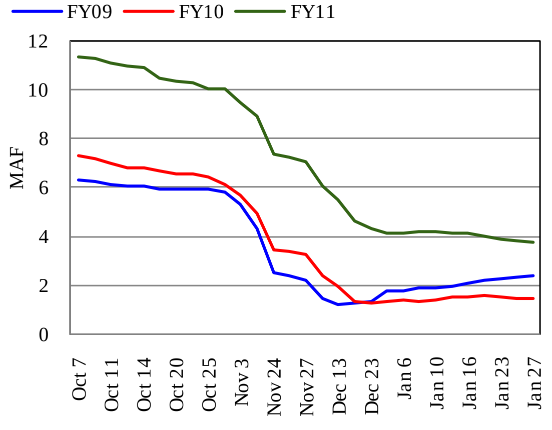
Both DAP and urea, saw lower off-takes in H1-FY11 compared with last year. In the case of DAP, this is probably due to a surge in prices. Average DAP prices rose by 41.2 percent during H1-FY11.

Water Availability

Canal headwater availability for the *rabi* season increased to its highest level since FY11 due to heavy monsoon rains. This improvement in water availability was instrumental in increasing the area sown under wheat in the canal fed areas, that accounts for approximately 87 percent of the total area under wheat cultivation.

The area under wheat also increased in non-irrigated (*barani)* areas due to enhanced soil moisture from heavy monsoon rains. Wheat yields are also likely to have benefited from winter rains throughout the country.

Figure 2.2: Water Availability Comparison



Collective storage at major reservoirs, at the beginning of *rabi* FY11 was about 4 million acre feet (MAF) higher than the corresponding period of FY10 (see **Figure 2.2**). Even by end-January 2011, water storage at major reservoirs was around 3.6 MAF as compared to only 1.4 MAF last year.

Table 2.3: Fertilizer Off-take (Jul-Dec)

million tons

	FY09	FY10	FY11	% change in FY11 over FY10
Urea				
Jul-Sep	1.33	1.67	1.15	-30.7
Oct-Dec	1.46	1.84	1.93	4.9
Jul-Dec	2.79	3.51	3.09	-12.0
DAP				
Jul-Sep	0.13	0.62	0.35	-42.7
Oct-Dec	0.48	0.60	0.64	7.7
Jul-Dec	0.61	1.21	1.00	-18.0
Total				
Jul-Sep	1.46	2.28	1.51	-34.0
Oct-Dec	1.94	2.44	2.57	5.6
Jul-Dec	3.40	4.72	4.08	-13.6

2.3 Large-scale Manufacturing

After recording flood-related production declines for four consecutive months, LSM posted positive growth in December 2010 onwards despite chronic energy shortages and weak textiles performance. Recovery in LSM was expected given the improvement in sugar[7] and robust growth in automobiles loans during Oct-Nov 2010, which had strengthened

[7] Improvement in the sugar owed to better recovery rate on account of high moisture content.

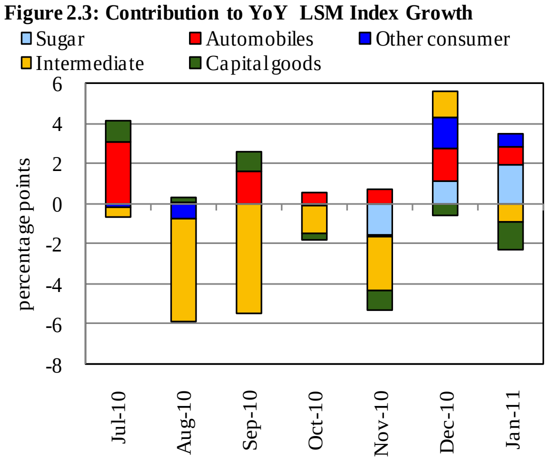
expectations of a rise in automobile production in subsequent months.[8] Not surprisingly therefore, a large part of LSM growth in Dec-Jan FY11 was contributed by these two sectors (see **Figure 2.3**).

Textiles sector suffered heavily from the loss of cotton crop while other industries that are heavily dependent on gas were adversely affected by shortages in gas supply. Fertilizer industry, in particular, could not operate at full capacity, from December to February, due to planned gas curtailments. Similarly, a large number of value-added textile units reportedly had to close down in Punjab due to severe gas shortages resulting in production and employment losses.[9]

Issue facing low value-added textile was the rise in cotton prices. Production in low value added sectors (i.e., spinning and weaving) was expected to increase October 2010 onwards, following easing of restriction on cotton exports by India. However, Indian government extended these restrictions, due to which, local textile manufacturing suffered input shortages.

Going forward, there are prospects of further improvement in some LSM sub-sectors. For instance, demand for consumer durables is likely to remain strong on the back of a potential record wheat crop and from higher wheat prices. Automobiles demand, in particular, could strengthen due to increase in rural incomes.

Figure 2.3: Contribution to YoY LSM Index Growth



Rise in automobile sales, in turn, is expected to strengthen demand for petroleum products, especially motor spirit. However, given capacity constraints, production of motor spirit cannot increase

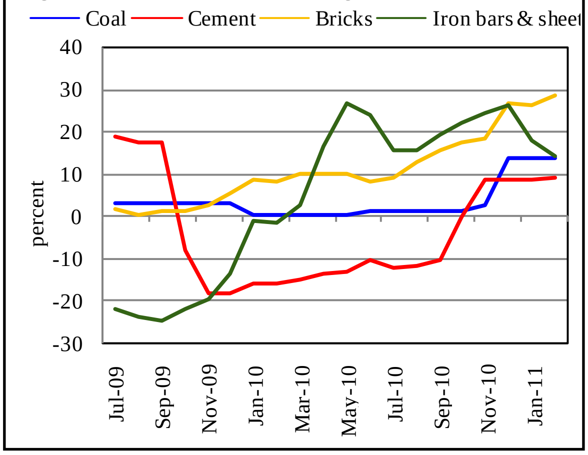
[8] During Oct-Nov FY11, banks disbursed Rs 12.4 billion for the purchase of automobiles compared with Rs 3.2 billion in Oct-Nov FY10. However, disbursements declined by 54 percent YoY during Dec-Feb FY11.

[9] Anecdotal evidence suggests that almost 30 percent of textile units in Faisalabad have closed down due to multiple crises, including gas load shedding.

significantly and the additional demand is likely to be met through imports. Production of other petroleum products, especially HSD and furnace oil, is likely to remain strong as the recovery in gross refining margins (GRMs) during FY11 has slightly improved financial conditions of local refineries. Rise in capacity utilization levels during January and February 2011 supports this argument.

As far as the cement sector is concerned, it is expected that once the construction sector resumes activities in the post-winter season, production of cement and steel (in the private sector) would increase.[10] Domestic cement manufacturers are eyeing at expected initiation of private construction projects (spring onwards) as any impetus from the public sector seems highly unlikely.[11] A key downside risk, however, is the supply-related rise in international coal and steel prices that are strengthening domestic price pressures on building materials (see **Figure 2.4**). [12]

Figure 2.4: YoY Inflation in Building Material Prices



In overall terms, demand for manufacturing goods appears to be strong in both the domestic and international markets, but supply-related commodity price pressures, can potentially weaken domestic demand. Domestic production is also vulnerable to energy shortages, which have worsened in recent months due to severe winters in the northern region.[13]

The resilience of local manufacturing sector will once again be tested in the summer when household and commercial demand for electricity will widen the

[10] Construction activities typically decline in winters, Nov-Jan, and pick up February onwards.
[11] Given fiscal limitations and cut in budgeted PSDP.
[12] Due to severe floods in Australia and coal mine accidents in other key coal producing countries, world coal supplies have declined sharply January 2011 onwards.
[13] According to news reports, textile firms in Faisalabad and adjacent areas received gas for only 3.5 days a week throughout January and February 2011 and this availability has been further reduced to only 2 days, 25th February onwards.

demand-supply gap. Production processes particularly, in metals and automobile sector depend heavily on uninterrupted power supplies.

2.4 Services

Unlike commodity producing sector, services are likely to show good performance during FY11 (see **Table 2.4**). In particular, country-wide rehabilitation and relief operations after the floods would contribute in the form of special payments to flood affectees, which will show up in *community & social services* sub-sector. The activities in *wholesale and retail trade* have remained sluggish during H1-FY11 due to decline in manufacturing and flood-related crop/livestock losses, although there is anecdotal evidence that trade activity is up in recent months. The expected record wheat production in *rabi* FY11, and modest rise in manufacturing activities during H2-FY11 point towards a recovery in the months ahead. *Finance & insurance* is also likely to show improvement over the previous year as volumetric gains coupled with wider spread have improved bank

Table 2.4: Indicators of Services Sector Performance
percent growth unless mentioned otherwise

	Q1		Q2		H1	
	FY10	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Wholesale & retail trade						
Credit to wholesale and commission trade	-4.8	-4.4	3.6	5.8	-1.3	1.2
Credit to retail trade	-3.2	5.3	13.0	-3.0	9.4	2.1
FDI in trade	-53.8	-39.6	-53.4	-37.3	-53.2 [a]	-43.9 [a]
Manufacturing growth	0.5	-2.3	4.3	-3.2	1.7	-1.6
Import growth	-29.8	19.0	1.3	20.1	-16.3	19.6
Transport storage & communication						
Cargo handling at Ports	8.7	13.3	32.5	-1.1	20.2	5.7
Telecom imports	-60.0	33.2	-25.3	68.2	-47.6	51.0
Commercial vehicles sale	-3.9	5.5	24.8	-5.4	14.7 [a]	-1.0 [a]
Transport group imports	3.7	13.9	22.2	-4.1	13.3	3.8
Communication services export	135.6	-18.3	343.6	11.7	199.2 [b]	-4.7 [b]
Finance & insurance						
Advances at 12% and above	81.4	7.7	85.9	85.0	83.6	81.3
Deposits at 8 % and above	54.7	55.3	53.5	51.8	54.6	53.6
Interest Rate Spread – stock (Dec)	7.3	6.0	7.4	7.5	7.4	7.6
Interest Rate Spread - incremental (Dec)	6.5	7.5	6.4	6.7	6.3	6.8

a. Jul-Jan; b.Jul-Nov

* Expected profit

profitability.[14] Indicators for *transport, storage & communication*, however, do not present a positive picture. Initial data received from Port Qasim and KPT shows decline in export related cargo handling of rice and cement.

[14]However, a part of the contribution of *finance & insurance* in real value addition will be sharply contracted due to higher inflation in FY11 relative to the preceding year.