

## 2 Real Sector

### 2.1 Real GDP

Preliminary estimates for FY12 GDP (based on Jul-Mar data) indicate that the economic growth improved over last year, but still fell short of target.<sup>8</sup> At the very onset of FY12, the economy faced headwinds in the form of floods and a persistent energy crisis which had diluted hopes of achieving

the targeted growth rates. Further down the year, growing uncertainty over the global economic outlook saw a fall in external demand, and FDI inflows remained weak. Furthermore, volatility in global commodity prices – particularly for energy-related products led to a sharp growth in imports. Given these challenges, the 3.7 percent growth in GDP this year is reasonable.

This growth was supported by a better harvest, pick up in construction and increase in value addition from the *finance and insurance* sub-sector. Specifically, despite losses to the cotton crop; decline in wheat production; and lower fertilizer usage, growth in major crops exceeded the target. Similarly, construction was more active as post-flood reconstruction and infrastructure building became priorities.

FY12 GDP growth was led mainly by consumption expenditure, which was stimulated by supportive government policies,<sup>9</sup> as well as higher remittance inflows. Consumption expenditures in FY12 are estimated to have grown by 8.2 percent (in real terms), compared to just 2.6 percent in FY11. On the upside, this invigorated production in consumer goods and the construction industry.

**Table 2.1: GDP Growth (at 1999-2000 base)**

In percent

	Growth			Contribution to growth	
	FY11	FY12 <sup>T</sup>	FY12	FY11	FY12
Agriculture	2.4	3.4	3.1	0.5	0.7
Industry	0.7	3.1	3.4	0.2	0.9
Services	4.4	5.0	4.0	2.3	2.1
<b>GDP (factor cost)</b>	<b>3.0</b>	<b>4.2</b>	<b>3.7</b>	<b>3.0</b>	<b>3.7</b>

T: Target

Source: Pakistan Bureau of Statistics

<sup>8</sup> The official growth numbers are in line with SBP's projections of 3.0-4.0 percent growth, as stated in Second Quarterly Report for FY12.

<sup>9</sup> This includes higher subsidies, and consumption-promoting policies, such as relaxation of import age of used cars and lower taxation.

However, a significant portion of this demand is being met by imports, especially in the case of sophisticated manufactured goods. Reportedly, local manufacturers are facing high energy-related costs, which make it difficult to beat import prices.

Although some investments are being made to improve energy efficiency, these remain sporadic and concentrated in a few large scale industries. In fact, investment spending in the economy is insufficient across all sectors. Overall, investment declined by 10.2 percent this year – for the fourth straight year since the recession of FY08. We believe that, although surplus capacities exist in some sectors (particularly LSM), there is still large potential for efficiency-boosting investments in all areas.

## 2.2 Agriculture

The agriculture sector performed better this year. Livestock, with the highest share in agriculture GDP, remained the largest contributor to growth (Table 2.2).<sup>10</sup>

Major crops, mainly the *kharif* crops (e.g., rice, cotton, sugarcane, maize) also

contributed to agricultural growth. The yields of the minor crops, on the other hand, suffered from multiple shocks: first due to rains in July 2011, and then from exceptionally low temperatures in February 2012.

Since the discussion on *kharif* crops has already been covered in the Second Quarterly Report for FY12, the focus of this section is on wheat, which is the largest crop of the *rabi* season.<sup>11</sup>

### Wheat

Wheat contributes 13 percent of the total value addition by the agricultural sector, and is cultivated over 37 percent of the total crop area. At end-March 2012, the

**Table 2.2: Growth in Agriculture (at 1999-2000 base)**

	In percent				
	share in Agri	Growth		Contribution to agr. growth	
		FY11	FY12	FY11	FY12
<b>Agriculture</b>		<b>2.4</b>	<b>3.1</b>		
Major crops	31.9	-0.2	3.2	-0.1	1.0
Minor crops	10.1	2.7	-1.3	0.3	-0.1
Livestock	55.1	4.0	4.0	2.1	2.2

Source: Pakistan Bureau of Statistics

<sup>10</sup> The livestock sub-sector includes the value of livestock and its products (milk, meat, eggs, hides and skins, wool & hair). The output estimates of livestock and their products are based on fixed inter-census growth rates; the last census was conducted in 2006.

<sup>11</sup> The *rabi* season begins in October and continues till April. Other *rabi* crops are gram, tobacco, rapeseed, barley and mustard, which altogether account for less than 0.5 percent of value addition by agriculture.

crop has reached its maturing stage and preliminary estimates suggest total production of 23.5 million tons, compared with 25.2 million tons realized in the previous year (**Table 2.3**). Not only was the area under wheat cultivation lower this year, but crop yields also declined because of lower fertilizer use and water shortages.<sup>12</sup> Therefore, even the incentive of higher wheat support prices fell short in enhancing production towards achieving the target of 25 million tons. More specifically:

**Table 2.3: Major Crops**

production in million tons (for cotton in million bales);

	% share in value addition			%
	in FY11	FY12	FY11	growth
Wheat	14.2	23.5	25.2	-6.7
Rice	42.3	6.2	4.8	29.2
Cotton	22.3	13.6	11.5	18.3
Sugarcane	11.7	58.0	55.3	4.9
Maize	2.25	4.3	3.7	16.2

Source: Pakistan Bureau of Statistics

1. *Farmers were cash strapped:* Due to a steep fall in the prices of the cotton crop, and inordinate delays in payments from sugar mills, farmers were short of liquidity. Furthermore, liquidity was constrained by high fertilizer prices. As a result, off-take of urea and DAP dropped significantly below *rabi* 2011 levels<sup>13</sup> – the year when alluvial soil had curtailed the need for fertilizer use to some extent.

2. *Water shortage:* The wheat crop was also struck by a water shortage, particularly in Sindh, during this season (**Table 2.4**). Not surprisingly, production declines were concentrated in Sindh. The total water availability was even lower than the minimum level projected by Indus River System Authority (IRSA).<sup>14</sup>

**Table 2.4: Water Situation During Rabi**

million acre feet

	Rabi 2012	Rabi 2011	% change
Punjab	17.6	18.7	-6.0
Sindh	10.1	14.5	-30.2
Khyber Pukhtunkhwa	0.6	0.5	16.7
Balochistan	1.1	0.9	27.8
<b>Total</b>	<b>29.4</b>	<b>34.6</b>	<b>-15.0</b>

The receding level of irrigation water was due to dry conditions in the country, and a longer spell of low temperature that reduced river flows during the *rabi*

<sup>12</sup> Area under wheat cultivation dropped by 3 percent because (a) some parts of Southern Sindh remained inundated due to floods of June 2011, (b) delays in the harvesting of sugarcane, and (c) some farmers in Southern Punjab opted for early sown cotton variety instead of wheat.

<sup>13</sup> The off-take of urea and DAP showed declines of 14.2 percent and 31.2 percent respectively over the last *rabi* season. The *rabi* season extends from October till March.

<sup>14</sup> IRSA states the minimum water availability for the two agriculture seasons. IRSA projected minimum water availability of 29.8 MAF for *rabi* 2012.

season. Demand, on the other hand, continued to grow. Hence, Tarbela and Mangla – the largest water reservoirs – reached their dead level by 12<sup>th</sup> March 2012, which was several weeks earlier than their normal depletion date.

Encouragingly, despite lower production, overall wheat availability is adequate; domestic consumption is around 22 million tons, whereas the country already has a carryover stock of 3.9 million tons from the previous crop.<sup>15</sup> However, this situation may create a potential challenge for the government. Specifically, the government has set a wheat procurement target at 7.7 million tons for the current crop, which is higher than actual procurement of 6.2 million tons last year. Hence, with the currently high levels of carryover stock, the settlement of commodity loans for the new season may not be possible without incurring an additional fiscal cost, as current international prices of wheat are considerably lower than the government's support price.<sup>16</sup> In case procurement remains below target, the domestic price of wheat may fall further, thereby squeezing farmers' margin.

### Minor crops

Minor crops (which represent 11 percent of the value addition in agriculture sector) suffered multiple shocks, particularly in Sindh: firstly, the July 2011 floods damaged chilies, onion, and tomato crops; this was followed by another setback, when exceptionally severe winter conditions resulted in losses to banana, chilies and tomatoes. As a result, minor crops posted a decline of 1.3 percent in FY12, compared to growth of 2.4 percent in the previous year.

### 2.3 Industrial Sector

Industrial sector surpassed its growth target of 3.1 percent for FY12, mainly due to higher-than-targeted growth in mining and construction industries. LSM production, on the other hand, remained below-target, mainly due to severe energy shortages (Table 2.5). Interestingly,

Table 2.5: Growth in Industry (at 1999-2000 base)

	In percent		Contribution to indus. growth		
	share in Ind.	Growth		FY11	FY12
		FY11	FY12		
<b>Industry</b>		<b>0.7</b>	<b>3.4</b>		
Large scale	46.9	1.1	1.8	0.5	0.8
Small scale	21.0	7.5	7.5	1.4	1.5
Mining & quarrying	9.4	-1.3	4.4	-0.1	0.4
Construction	8.5	-7.1	6.5	-0.6	0.5
Elec. & gas distt.	8.6	-7.2	-1.6	-0.7	-0.1

Source: Pakistan Bureau of Statistics

<sup>15</sup> Carryover stock is of end-March 2012.

<sup>16</sup> See Section on Commodity Operation in Chapter 3.

although the small-scale industries also suffered from energy shortages – perhaps more severely than the large scale sector – their growth contribution remains the highest.<sup>17</sup>

### **Large Scale Manufacturing**

The better performance of LSM was surprising as it came against the backdrop of continued energy shortages that constrained growth in a number of industries (e.g., textile, fertilizer, leather, soda ash, caustic soda, steel, and glass) and increased competition from imported substitutes. We believe that spillover benefits from improved agriculture, higher construction activities, and strong demand for consumer goods led to some recovery in LSM.

### Sector-wise developments:

Key developments in specific sectors (textiles, auto, fertilizer, and construction materials) are discussed in annexures at the end of this chapter. However, trends in other major sectors are covered in the following paragraphs.

The *food, beverages and tobacco industry* has performed well on the back of a better harvest, strong domestic demand, and greater exports to Afghanistan (Table 2.6).

Over the past year, five new beverage plants have opened in Khyber Pukhtunkhwa.<sup>19</sup> Similarly, oil and ghee exports to Afghanistan have also been higher. Furthermore, the demand for wheat flour increased as the government allowed formal export to Afghanistan in Q4-FY11.

**Table 2.6: Selected Indicators of Food, Beverages and Tobacco Industry (Jul-Dec)<sup>18</sup>**

Item	Share in food index	Export to production ratio (%)		Export share of Afghanistan (%)	
		FY11	FY12	FY11	FY12
Veg. oil & ghee	27.3	5.9	10.6	97.4	99.9
Cigarettes	17.2	0.0	0.1	0.0	0.0
Wheat flour	8.2	6.1	18.1	98.9	91.1
Beverages	7.3	1.6	2.7	98.0	96.8
Tea	3.1	1.0	1.6	0.0	32.2
Juices, syrups, squashes	1.7	..	..	82.1	91.7

Source: Pakistan Bureau of Statistics

<sup>17</sup> The small scale manufacturing consists of informal activities which are difficult to measure on annual basis. PBS has therefore assumed a *constant* annual growth rate of 7.5 percent in value addition from this sector. This growth number is based on surveys of Small and Household Manufacturing Industries. The last survey was conducted in 2006-07.

<sup>18</sup> Export data was extracted from HS-code level files (sourced from PBS). Following are the reference codes: Vegetable oil & ghee: 1516.2010,2020 & 1517.1000; cigarettes: 2402.2000; wheat flour: 1101.0010; beverages: 2201.1020, 9000 & 2202.1010-9000; tea: 902.1000, 2000, 3000, 4010, 4020, 4090; and juices, etc.: 2009.1100-2009.9000, & 2106.9020.

<sup>19</sup> The government also reduced excise duties on beverages in FY12 Budget.

In the *pharmaceutical industry*, the government reduced the custom duty on raw material imports (in most cases from 10 percent to 5 percent) which made exports more competitive.<sup>20</sup> In the domestic market, an upward revision of some medicine prices also led to improved margins.

It is widely held that the import of consumer durables is impeding the domestic industry (**Table 2.7**). In the case of *home electronics*, smuggling of Korean and Indian TV sets (via the Dubai-Afghan Transit Trade route) and under-valuation and under-invoicing of Malaysian and Chinese air conditioners have put the local industry under stress.<sup>22</sup> In the lower-end of the market, the demand for fans has fallen substantially because of extreme load-shedding in Punjab.<sup>23</sup>

*Leather footwear* and allied industries posted a YoY decline in Q3-FY12 on account of power shortages and increasing competition from imports. We expect production to remain under pressure because the footwear industry is largely based in Punjab which appears to be facing the brunt of the power shortage.<sup>24</sup>

**Table 2.7: Consumer Durables Demand Indicators<sup>21</sup>**

	Share in QIM	YoY Production (Jul-Mar) Growth in %		Imports to production ratio (Jul-Dec) in %	
		FY11	FY12	FY11	FY12
<b>Transport</b>	5.4				
Car	4.0	16.1	8.8	..	27.2*
Motor cycle	0.9	20.1	3.4	..	..
Bicycle	0.1	-23.1	-30.0	50.5	86.8
Motor tyre	0.4	9.6	-25.4	42.3	72.1
<b>Electronics</b>	0.8				
Refrigerator	0.3	-2.4	6.8	1.3	2.1
Air cond.	0.1	-11.9	4.3	19.9	26.7
TV	0.2	28.6	-25.9	0.0	0.0
Fans	0.1	-9.5	-13.5	18.9	22.0
<b>Other</b>	0.8				
Footwear	0.7	21.1	6.2	30.0	25.7
Sew. mach.	0.1	-3.4	-10.3	257.8	207.9
<b>Overall</b>	<b>6.9</b>	<b>14.6</b>	<b>3.2</b>		

Source: Pakistan Bureau of Statistics. \*Jul-Nov.

<sup>20</sup> Although a drug scandal in Q3-FY12 did lead to some scepticism in Afghan and Tajik export markets, the industry believes that the impact would be limited.

<sup>21</sup> Import data was extracted from HS-code level files (sourced from PBS). Following are the reference codes: Bicycle: 8712.0000; Motor tyre: 4011.1000-4000; Refrigerator: 8418.2100-2900; Air conditioner: 8415.1010-1020; Television set: 8528.7211-7212; Fans: 8414.5110-5990; Footwear: 6403.2000, 6403.5900, 6404.2000, and 6405.1000; Sewing machine: 8452.1090-2900.

<sup>22</sup> It may be noted here that the electronics industry is highly protected as the average import duty on CBUs is 35 percent.

<sup>23</sup> Chinese rechargeable fans appear to be a better substitute under the circumstances, and are rapidly making way in the domestic market. Such fans are not being manufactured locally.

<sup>24</sup> The data for leather footwear provided by the PBS covers Punjab's production only.

Soda ash and caustic soda suffered on account of natural gas shortages in winter. These industries are rapidly converting to coal-based power, which will run on local coal. We expect a recovery in Q4, as some of these arrangements become effective.

**Construction**

According to preliminary estimates for FY12, the construction industry reported 6.5 percent growth compared to a 7.1 percent decline in FY11. This growth was well above the target of 2.5 percent.

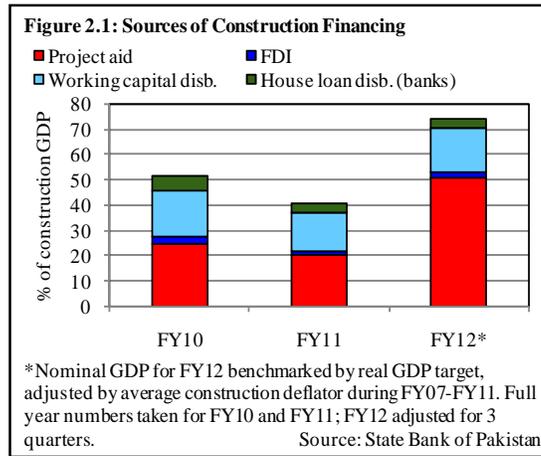
With the end of winter, construction activity gained further momentum, particularly in March. As a result, cement sales reached a record high of 2.6 million MT in March 2012 – showing a YoY growth of 10.6 percent over March last year. Moreover, some building material producers, whose production had been declining until the last quarter, posted positive growth in Q3-FY12 (Annexure 4).

Higher inflows of project aid and larger fund releases under the public sector development program, suggest greater activity in public sector projects (Figure 2.1).<sup>25</sup>

However, the sustainability of private sector construction activities is doubtful, as the financial sector continues to maintain a cautious stance towards both residential mortgages and commercial construction.<sup>26</sup>

**2.4 Services Sector**

The 4.0 percent growth in the services sector was lower compared to 4.4 percent in the previous year – it was also below the target of 5.0 percent. Improved performance of *finance and*



<sup>25</sup> During H1-FY12, PSDP releases were higher by 65.6 percent YoY, compared to -28.9 percent decline seen in H1-FY11. Q3-FY12 data is not yet available.

<sup>26</sup> While disbursements for working capital to construction industry and for house-building loans posted positive YoY growth in Q3-FY12, the growth seems anemic when adjusted for around 19 percent average inflation in construction costs this year.

insurance and transport, storage and communication sub-sectors was more than offset by weaker growth in public administration and defence (Table 2.8)

**Table 2.8: Growth in Services (at 1999-2000 base)**  
In percent

	share in services	Growth			Contribution to services growth	
		FY11	FY12 <sup>T</sup>	FY12	FY11	FY12
<b>Services</b>		<b>4.4</b>	<b>5.0</b>	<b>4.0</b>		
Transport, storage & communication	18.0	0.9	4.5	1.3	0.2	0.2
Wholesale & retail trade	32.0	3.5	5.0	3.6	1.1	1.1
Finance & insurance	8.9	-1.4	0.2	6.5	-0.1	0.6
Ownership of dwellings	5.1	1.8	3.5	3.5	0.1	0.2
Public admin. & defence	12.4	14.2	6.0	2.6	1.6	0.3
Social & community services	23.6	6.9	7.0	6.8	1.6	1.6

Source: Pakistan Bureau of Statistics

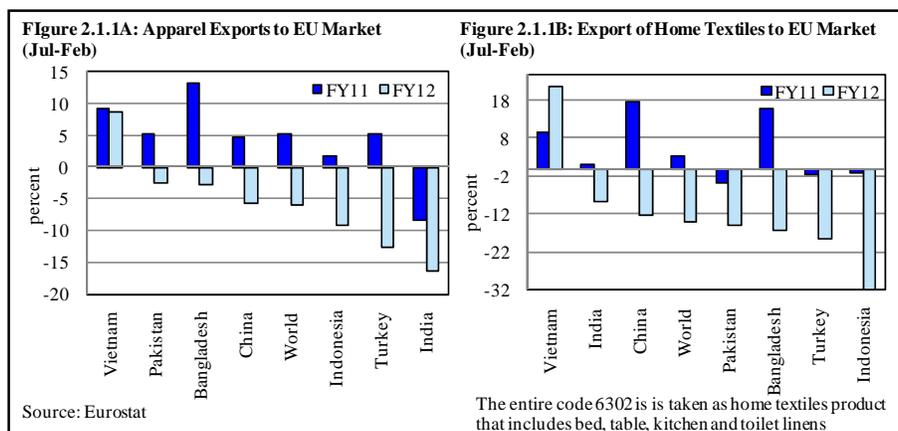
In overall terms, the banking sector and mutual funds have posted strong profits, which is driving growth in FY12. We expected stronger growth in transport as corroborated by higher fuel consumption, as well as increase in domestic sales of vehicles. However, an offsetting factor to this could be the continual losses being run by PIA and Pakistan's Railways.

Weaker growth in the public administration and defence is probably due to lower flood-related spending this year, compared to FY11. The FY11 was also characterized by a substantial increase in salaries for public sector employees.

### Annexure 1: Understanding the Decline in Textile Exports<sup>27</sup>

The global economic slowdown struck Pakistan’s textiles industry once again in FY12, following the modest recovery in the previous two years. Consumer sentiments in US and EU remained bearish, causing a decline in textile related purchases as buyers switched to low-end products. Up till March 2012, global textile exports declined by 9.4 percent. Seen in context of the 7.6 percent decline in FY09 – the worst of the global recession – the FY12 decline is indeed enormous. In addition to this global slump, anecdotal evidence suggests that shortage in energy is not allowing local manufacturers to meet delivery deadlines, which undermines the future relationship with these export markets.

Nevertheless, the decline in Pakistan’s apparel exports was modest compared with key competitors like Bangladesh, India and Turkey that also export to the EU (see **Figure 2.1.1**)<sup>28</sup>.



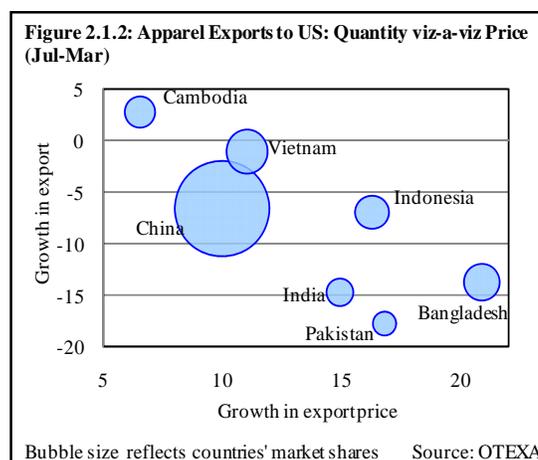
Garment exports from India and Turkey which entail higher value-added products faced double-digit declines. The demand for Pakistan’s low value-added exports was less adversely affected, as consumers switched from high-price to low-price products. In the home-textile market too, the decline in Pakistan’s exports was smaller than the overall decline in EU imports.

<sup>27</sup> The section has been authored by Ms Asma Khalid ([asma.khalid@sbp.org.pk](mailto:asma.khalid@sbp.org.pk)).

<sup>28</sup> Due to worsening debt crisis and low consumer confidence through most of the period, sales and import of textile & clothing declined sharply; most notably in France, Netherlands and Germany.

US imports for textiles also remained depressed throughout the period Jul-Mar FY12, with declines evident in both apparel as well as home textiles. In home textiles, Pakistan's exports fared better compared to China, Turkey and Bangladesh.

In contrast, however, Pakistan's garment exports to the US suffered a strong blow compared with almost all our major competitors. This was mainly because of a sharp increase in unit prices (see **Figure 2.1.2**); and the fact that the fall in apparel demand in the US was concentrated in cotton products.<sup>29</sup>



Looking specifically at fabric exports, the entire decline is explained by the imposition of safeguard duties by Turkey effective from July 2011<sup>30</sup>. Excluding Turkey, Pakistan's fabric exports actually increased, thanks to a sharp increase in demand from Bangladesh.<sup>31</sup>

<sup>29</sup> Overall US demand for apparel (quantity) declined by 7.8 percent during Jul-Mar FY12; import of cotton apparel declined by 16.9 percent, whereas import of non-cotton apparels *increased* by 3.9 percent.

<sup>30</sup> During Jul-Dec 2011, fabric exports to Turkey declined by 66.0 percent.

<sup>31</sup> As mentioned in the Annual Report 2010-11, this was due to revision in rules of origins by EU for availing the generalized system of benefits (GSP) that now allows Bangladeshi garment manufacturers to use Pakistani fabric.

## **Annexure 2: Automobiles<sup>32</sup>**

An apparent pickup in sales of passenger cars provided a boost to the auto industry. However, while growth in sales of locally assembled cars has accelerated in the current fiscal year, we believe this is due to one-off factors (e.g. tax incentives, and the Punjab Government's 'Yellow Cab' Scheme). Excluding the impact of these developments, growth during the first three quarters of FY12, in fact, has slowed compared with last year.<sup>33</sup>

In our opinion, this deceleration is due to supply-side developments in the overall market for cars (both, imported and local): (1) competition from an increase in the supply of used cars imported from Japan (this has implications for the demand for locally assembled cars); and (2) a disruption to the global supply-chain of auto parts due to recent floods in Thailand.

### ***One-off factors boost sales***

- (1) *Government demand*: Pak Suzuki Motors saw the largest increase in production and sales; with demand under the 'Yellow Cab' scheme playing a significant role.<sup>34</sup>
- (2) *Tax incentives*: growth in car sales was also supported by a cut in General Sales Tax (GST) from 17 to 16 percent, and the elimination of Special Excise Duty (SED) for FY12. This held off car purchases in the latter stages of FY11.<sup>35</sup>

### ***Supply-side factors in the market for cars***

- 1) *Imports of used cars*: in the backdrop of rising domestic prices, locally assembled cars faced stiff competition from imports of used Japanese cars; these have increased six-fold over the last year.<sup>36</sup> Despite being up to 5 years old, anecdotal evidence suggests that these cars compete well against their locally assembled counterparts on price, as well as interior features.
- 2) *Shortage of imported parts*: the recent floods in Thailand disrupted the global supply-chain of Completely Knocked Down (CKD) kits. This affected local

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<sup>32</sup> This section has been authored by Mr Bilal Khan ([bilal.khan@sbp.org.pk](mailto:bilal.khan@sbp.org.pk)).

<sup>33</sup> Sales of locally assembled cars during the first three quarters of FY12 were 15.3 percent higher than the same period last year; the corresponding figure for FY11 was 13.1 percent. However, excluding the impact of the 'Yellow Cab' Scheme and tax incentives, our estimates show a slowdown in sales growth to less than 2 percent this year.

<sup>34</sup> Over the course of FY12, 20,000 units are to be sold under this scheme.

<sup>35</sup> Consumers held off on buying cars till Jul 11 to benefit from the tax relief; we estimate the impact of this to be around 3,500 units.

<sup>36</sup> Almost 34,500 used cars were imported during the first three quarters of FY12; primarily as a result of relaxations of restrictions on age from 3 to 5 years.

assemblers like Honda Atlas. After suspending production for the past few months, the firm has partially resumed operations.

***Outlook***

The local car industry is likely to undergo additional changes on the supply-side, as some models are to be phased out by the end of this fiscal year to comply with Euro-II emissions standards. Furthermore, as the government has imposed a ban on imports of CNG kits due to safety concerns, assemblers are currently operating on inventories.

We believe imported used cars will continue to benefit from these developments, particularly in the under-1500cc segments.<sup>37</sup> Nevertheless, we expect some pickup in sales of locally assembled cars - particularly as Honda Atlas returns to pre-flood levels of production.

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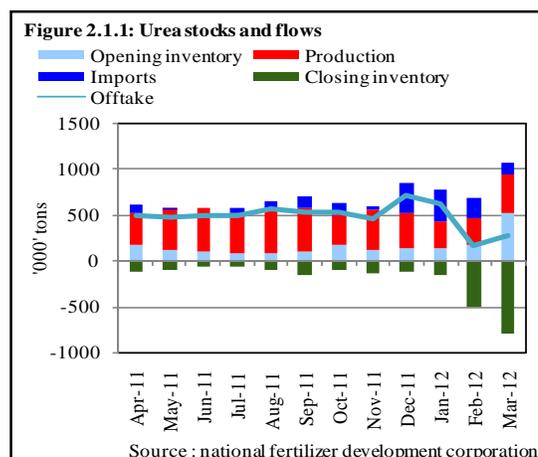
<sup>37</sup> These accounted for around 90 percent of used car imports during the first three quarters of FY12.

**Annexure 3: Fertilizer<sup>38</sup>**

There has been a strange turn of events in the fertilizer industry over the past nine months. The shortage of urea in the kharif season of 2011 has morphed into a glut, with the opening inventory for April 2012 at around 800,000 tons, which is more than a month of sales for the entire industry (**Figure 2.1.1**).

Another 300,000 tons of urea is due to be imported for this year's kharif season, while domestic manufacturers struggle to sell their produce

(i.e. if they manage to produce at all, given the ongoing gas shortages).



The progression of events that led to this scenario deserves mention. Firstly, the cost of natural gas to old fertilizer plants rose by around 200 percent, after the imposition of the gas infrastructure development cess (GIDC) in December.<sup>39</sup> Manufacturers partially passed on this increase in cost in the form of higher prices. This, in itself, did not affect demand initially. However, following the collapse in cotton and potato prices, and the expected reduction in wheat prices,<sup>40</sup> farmers held off on buying fertilizer at the end of this rabi season, and the demand for urea has fallen.<sup>41</sup>

For the rabi season, the government had also authorized the import of a total of 1.2 million tons of urea. The import itself was ill-timed, with the shipments starting to come in at the end of December, the month during which demand for fertilizer has historically been the greatest. Furthermore, the government's official sale price for urea was Rs 1,300 per bag earlier in the year,<sup>42</sup> which effectively undercut the

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<sup>39</sup> The only plants exempt from this increase were fertilizer plants with fixed price contracts. These were Engro's and Fatima's new units.

<sup>40</sup> Despite the increase in support price, smaller farmers fear that they will have to sell their produce at a lower price due to the expected excess of wheat in the market.

<sup>41</sup> Urea sales declined by 61 percent for the month of February and by 38 percent for the month of March.

<sup>42</sup> The government's official sale price was raised to Rs1,600 per bag in mid-March 2012.

local industry. With a Rs 500 per bag difference between the price of imported urea and domestically produced urea, two things happened: (i) domestic manufacturers were priced out of the market at the end of the rabi season; and (ii) the price arbitrage created incentives for black marketing and market manipulation. Therefore, as we have indicated in our previous reports, this price gap needs to be eliminated.

In the middle of April 2012 (and in the middle of this glut), the government authorized the import of another 300,000 tons of urea for the kharif season, much to the frustration of the fertilizer industry. The commodity is supposed to be sold at Rs 1,600 per bag, which could cannibalize the sale of domestic manufacturers yet again. Domestic manufacturers cannot cut their prices too sharply due the increase in the cost of gas, and uncertainty regarding gas supplies. Furthermore, the government has refused to allow urea exports.

The import of urea is expected to have a fiscal impact of Rs 11 billion;<sup>43</sup> a foreign exchange impact of \$150 million; and will add to the surplus of urea stock in the country. Thus, without a rebound in crop prices, which can revive the demand for fertilizer, the outlook for the industry is not heartening.

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<sup>43</sup> The actual subsidy passed on to the farmers is expected to be Rs5 billion if the entire stock of imported urea is sold at the official price of Rs1600 per bag. Since it is more likely that farmers will purchase this urea at Rs1800 per bag, the amount of subsidy passed on to farmers is expected to be less than Rs4 billion out of the total subsidy bill of Rs11 billion.

#### **Annexure 4: Building Material Industries<sup>44</sup>**

Following a strong pick-up in construction activity, a demand-led increase in building material prices is driving growth and fresh investments. After declining continuously since October 2010, building materials industries are finally showing signs of a fragile but broad-based recovery. Although overall building materials index (BMI)<sup>45</sup> is still reporting decline, adjusting for the now near-defunct PSM yields more optimistic results: for four straight months, the non-PSM BMI index has posted positive YoY growth.<sup>46</sup> The key developments are summarized below:

1. Higher demand is pushing up prices, which in turn is driving production. Such price adjustments were much needed in some cases, where firms had been facing a high-cost, low-demand situation.<sup>47</sup>
2. Restructuring is taking place in many industries which is expected to improve production in the medium- to long-run. The following factors are driving the structural change:
  - (a) The steel sector is adapting to the shrinking role of Pakistan Steel Mills and a growing ship-breaking industry (see **Box 4.1**).
  - (b) In energy intensive industries (glass, steel, and cement), old and inefficient units are facing closures, while new investments in large-scale production facilities as well as integration of production processes (in steel) are taking place.<sup>48</sup>
  - (c) Consumers are becoming more aesthetically aware, which has increased competition in wood and paints industry. Chipboard is substituting plywood because of its multiple color and design options, as well as lower

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<sup>45</sup> The building materials index is computed by the SBP using Pakistan Bureau of Statistics data. BMI includes cement, steel, glass-sheet, chipboard, plywood, and solid and liquid paints. BMI has 16.7 percent share in overall LSM index –making it the second largest industry group, after textiles.

<sup>46</sup> YoY growth in non-PSM BMI in Dec-Mar FY12 averaged at 1.5 percent (overall BMI: -2.4); compared to average 6.0 percent decline in Jul through Nov FY12 (overall BMI: -7.9).

<sup>47</sup> Higher energy-related costs were the major reason. For example, glass-sheet manufacturers had to use furnace oil during gas-outages, which nearly doubled production cost. Due to the resulting financial difficulties, one glass plant temporarily shut down last year.

<sup>48</sup> *Cement*: 3 million MT capacity added in FY12; whereas during FY10-FY11, smaller, inefficient plants of nearly equal combined capacity shut down. *Glass-sheet*: two new plants are set to come online. *Steel*: some rolling mills are setting up their own melt shops. One cold-rolling and galvanization plant came online in 2011, while another cold-rolling mill is set to be commissioned in 2012. Tuwairiqi Steel Mills have also reached financial close and will start producing soon.

price. In decorative paints, increasing value-addition is allowing for price increase,<sup>49</sup> despite the enhanced competition. High prices are attracting new investors.<sup>50</sup>

**Box 4.1: Re-organization in private steel industry**

The steel industry is undergoing a huge transition, necessitated by changing economic dynamics: (i) Financial meltdown of the Pakistan Steel Mills created a gap in billets and hot-rolled steel market, leading to imports. (ii) Ship-breaking industry grew rapidly over the past two years, supplying cheaper raw material amid high global steel prices.<sup>51,52</sup> Because most of the ship scrap (70-90 percent) is used by the rolling industry, the intermediate steel melting industry is facing low demand. (iii) Frequent outages of electricity and gas have badly affected business. While financially strong units manage to bear the cost of alternate power arrangements, smaller mills find it difficult to survive.

The industry is making adaptive investments. Firstly, integrated plants are coming online, which are more energy efficient. Secondly, the private sector is entering high-value market segments, such as cold-rolled and galvanized products, which were previously dominated by the PSM.

Given the high cost of setting up a business and uncertainty of electricity and gas supply, this is a difficult transition for the industry. Thankfully, some hope appeared in March 2012 when the government made a long overdue adjustment in the tax structure of the industry, which will ease effective steel products prices.<sup>53</sup> This in turn, will hopefully provide some demand stimulus.

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<sup>49</sup> Value-added services include color creation at point-of-sale and professional color advice, etc.

<sup>50</sup> Over the past two years, at least two new players entered the market. More cautious investors are testing the market by initially importing products.

<sup>51</sup> A large number of ships were discarded globally in FY10 when global trade hit a nadir. 836 vessels were imported for scrapping that year. Although scrap ships import has declined since FY10 (142 ships imported in FY11; 33 ships in Jul-Dec FY12), a large stock of scrap ships is still available with the industry.

<sup>52</sup> World Bank data shows that global steel prices have risen almost consistently since FY10. March 2012 hot-rolled prices are 33.3 percent higher than June 2009 prices; while rebar prices are higher 34.7 percent.

<sup>53</sup> SROs 332 and 333(I)/2012 dated March 31, 2012, revised the amount in sales tax payable on purchase of steel products from Rs. 5,960/MT to Rs. 6,306/MT. The steel industry pays sales tax at a rate of Rs. 6 per unit of electricity consumed. In 2008, the FBR revised the tax rate from Rs. 4.75 to Rs. 6, but left the reimbursable amount unchanged. As a result, while upstream users were charged Rs. 6,306/MT by the steel industry, the reimbursable amount was 5.5 percent lower. This anomaly has now been addressed.

**Special section: 3G Mobile Spectrum Auction - Issues & Prospects<sup>54</sup>**

In the absence of external inflows, the revenues to be generated from the auction of 3G licenses were highly awaited for financing Pakistan's external and fiscal deficits. According to the schedule announced by PTA, during January 2012, the auction for 3G mobile spectrum had to be held on March 29, 2012. However, the auction has been postponed and is not likely to be held during FY12.

In the absence of the sense of urgency to secure the receipts during the fiscal year, PTA now has enough time to improve the terms and conditions of the auction to solicit more interest and to optimize the future stream of revenues for the government. In this regard, the main findings of our analysis, concerning the rollout of 3G mobile services in Pakistan, are discussed in the following points:

- The auction of 3G mobile spectrum, has the potential of generating significant revenues for the government.<sup>55</sup> At the base price of US\$ 210 million, the minimum amount that could be generated from the auction is US\$ 630 million.
- Growth in cellular revenues could be declining due to intense price war amongst cell companies. There is a need to break this trend by introducing value added services via 3G technology, in the form of high speed internet access and video streaming.
- Although demand for mobile internet – the key feature of 3G – is low in Pakistan and the revenue from internet usage contributes a small share in total cellular revenues, the 3G business case for firms has two other components: (a) The possibility of losing high valued customers by cell companies, who opt out of 3G (b) Gaining market share from companies that are unsuccessful in the auctions. These factors together make a strong business case for 3G despite low internet demand at this stage.
- Cell companies have already upgraded their infrastructure and the rollout of 3G will not require much additional investments, except for the payment of license fees.
- 3G is technically more efficient, hence cell companies will be able to provide services to existing subscribers and increase demand for such services (supply creates its own demand).

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<sup>55</sup> Discussions with cell companies and financial sector suggest that most of the companies have made their business plans and have lined up funds for the roll out of 3G mobile services. The foreign ownerships of the domestic mobile companies also reflect the ability of some of the companies to arrange funds for investing in 3G technology from their parent companies.

- In view of the low mobile internet demand in the country, the success of 3G depends upon a competitive environment in the industry. In the absence of competition, we believe firms will not have incentives to offer competitive services at affordable prices.
- Cheap 3G handsets and availability of mobile applications in *Urdu* is necessary for the pickup in demand for 3G services.
- The demographics of Pakistan's population, with a large share of young adults hints at the possibility of strong demand for 3G services for infotainment purposes. This, however, depends upon the pricing policies of the firms that introduce new applications, the quality of service, and the pace of marketing of 3G services.
- The stimulation of cellular revenues is likely to be gradual as firms are currently focusing on retaining their subscriber base and improving the quality of services.

### **Conclusion**

In view of the low mobile internet demand in the country, the success of 3G depends upon a competitive environment in the industry. In the absence of competition, firms may not have the incentive to offer services at affordable prices. In this context, the provision in the Information Memorandum issued by PTA, allowing one firm to bid for two licenses (out of three that will be auctioned), appears to be against the spirit of competition in the industry.

In addition, to generate more and consistent stream of revenues from the auction, the payment for licenses may be staggered (after an initial payment of 50 percent of bid price), instead of the one-time upfront fee as mentioned in the information memorandum.