2 Real Sector

2.1 Overview

The initial months of FY12 challenged the key assumptions on which this year's growth target rested: continuation of post-flood revival, firm global commodity prices, and back-up electricity supply arrangements by industries.[6] Firstly, 2010 flood recovery was interrupted by another flood in Q1-FY12, which caused considerable damage to cotton crop in Sindh. This was followed by an outbreak of dengue fever in Punjab which disrupted economic activity for about a month. Furthermore, global prices of agricultural commodities softened significantly to the disappointment of farmers. Moreover, industries found it difficult to run gas or furnace oil based captive power plants, in the wake of gas shortages and high oil prices. With this backdrop, realizing the 4.2 percent growth target for FY12 GDP looks difficult **(Table 2.1)**.

Table 2.1: GDP Growth Targets for FY12
percent

	FY11	FY12^{T}
Agriculture	1.2	3.4
Major crops	-4.0	3.0
Industry	-0.1	3.1
LSM	1.0	2.0
Construction	0.8	2.5
Services	4.1	5.0
Wholesale, retail and trade	3.9	5.0
GDP	2.4	4.2

Source: Planning Commission, Annual Plan 2011-12

Agriculture is facing many challenges this year: flood damage to *kharif* crops; taxation on inputs (which has reduced margins); decline in global commodity prices; and low credit availability. Although the increase in support price is likely to help wheat production, we fear that low global prices may make it hard to offload stocks that are procured by PSEs and provincial governments. In this regard, there is a dire need to improve supply chains, build storage facilities for grains, and develop market-based solutions to hedge against price fluctuation.

Agriculture-related manufacturing also requires well thought out policies. For instance, the fertilizer sector needs to be monitored more carefully. High fertilizer prices coupled with low agri credit availability created liquidity constraints, which in turn led to a sharp decline in tractor sales. This liquidity impact could have

[6] In the Annual Plan FY12, one of the assumptions on which the Planning Commission has based manufacturing growth projection was that captive power plants (CPP) will make up for electricity load-shedding faced by industries. However, the CPPs are run on gas or furnace oil, neither of which seem to be viable alternate fuels in the current scenario.

been minimized had it been complemented by more liberal lending by commercial banks.

Manufacturing sector looks better placed with increase in demand for consumer and intermediate goods (food, fertilizers, POL, pharmaceuticals, consumer vehicles, and cement). However, growth may be hard to sustain. Fears of another global recession have already led to a fall in textile export demand. Furthermore, gas shortages will constrain output in many industries.

A revival in construction may also be difficult on account of sales tax on the already anemic sector in Sindh, and high building material prices. Due to irregular domestic production, steel and glass demand is largely being met via imports which are costlier. Cement prices remain inexplicably high.[7]

Investment growth is a key ingredient for economic revival. In our view, power and transport infrastructure should have top investment priority. Although there have been some encouraging developments on this front – construction plans for new dams, a gas pipeline from Iran, and some bridges and highways projects are now being more seriously considered – but in most cases, progress has been very limited. Moreover, the private sector must also upgrade their production facilities in order to become more energy efficient. In this regard, progress is being made in some manufacturing industries, for example cement manufacturers are constructing tyre-derived fuel facilities, while the country's major soda ash producer is setting-up coal fired boilers to reduce energy-related costs.

2.2 Agriculture Sector Performance[8]

The initial assessment indicates major losses to cotton due to floods in Central and Southern Sindh. However, improved water availability, introduction of better yielding variety of rice, and the increase in wheat support price, are likely to help agriculture sector achieve its target for FY12.

Cotton

The cotton crop target of 12.8 million bales was fairly conservative compared to initial estimates of around 15.0 million bales. Unfortunately, the expected gains

[7] Cement prices increased by 17.3 percent YoY during Jul-Nov FY12 despite a reduction on cement taxes and only 10.7 percent increase in local coal prices during the period.

[8] FY12 is the first performance year of this sector following the devolution of the Ministry of Food and Agriculture to provinces under the 18th Amendment. The absence of centralized planning and monitoring body has widened the information gap particularly on estimates of major crops.

from the bumper crop were lost due to the floods.[9] According to the Cotton Crop Assessment Committee, cotton production in the current season would be 12.6 million bales.[10]

Rice

The harvesting of *irri* rice in Sindh and Punjab is generally completed by mid-Oct, whereas harvesting of basmati rice continues till mid-Nov. Flood-related damage to rice is likely to be limited as most of the rice (around 70 percent of the rice in Sindh) is produced in the upper region which remained unaffected by the floods. According to the report by Suparco, the rice crop has benefitted from substitution of *irri* rice with better yielding hybrid varieties,[11] improved water availability and rich soil moisture. The expected rice production is over 7.0 million tons compared to 4.8 million tons produced last year.

Table 2.2: Growth in Agriculture
percent

	Share in agri VA	Growth in FY11	Target for FY12
Agriculture		**1.2**	**3.4**
Major crops	31.0	-4.0	3.0
Minor crops	11.0	4.8	2.0
Livestock	55.0	3.7	4.0
Fishing		1.9	2.0
Forestry		-0.4	-1.0

Source: Planning Commission, Annual Plan 2011-12

Sugarcane

Flood-related losses to sugarcane are expected to remain low, as the crop is relatively resilient to flooding. According to Suparco, the expected sugarcane production is 53.9 million tones.[12]

Table 2.3: Major crops
production (million tons; cotton in million bales of 170.0 kg each)

	Share in major crops VA	FY11[P]	FY12[T]	Estimates[1]
Rice	42.3%	4.8	6.6	7.2
Cotton	22.3%	11.6	12.8	12.2[2]
Sugarcane	11.7%	55.3	57.6	53.9
Wheat	14.2%	24.2	25.0	--

[1.] Estimates by Suparco
[2.] Estimates of Cotton Crop Assessment Committee are 12.6 mln bales
[T.] Planning Commission, Annual Plan 2011-12

However, sugarcane growers are facing problems as mills again delayed sugarcane crushing till mid-Nov 2011. Under the Sugarcane Factory Act 1950,

[9] Estimated production losses due to floods are 2.2 million bales (see SBP's Annual Report for 2010-11 for more details).
[10] The numbers on cotton arrival released by Pakistan Cotton Ginner Association show a YoY increase of 17.5 percent in cotton arrival up to 1st Jan 2012. If this trend continues, the expected cotton crop size may reach 13 million bales.
[11] The productivity of these hybrids is around 7,000-8,000 kg per ha against 3,000-4,000 kg per ha in conventional irri variety.
[12] This estimate is significantly lower than 60 million tones production estimates provided by the Pakistan Sugar Mills Association.

the crushing of sugarcane is supposed to start in Oct each year. This delay is costly for farmers as: (a) prolonged exposure of sugarcane to flood water in Sindh, deteriorates the crop quality; (b) farmers remain cash-strapped for a longer period; and (c) in some areas, farmers were unable to switch to wheat as their fields were not available.

In this context, government has allowed Trading Corporation of Pakistan (TCP) to procure 200,000 tons sugar from mills. This decision would considerably ease liquidity constraints of sugar mills.

Wheat

The most important development is the increase in the wheat support price to Rs 1,050 from Rs 950 per 40 kg. The wheat crop is currently in its sowing stage, and we expect the higher support price to encourage growers to increase yields and also bring more area under cultivation.[13] The crop outlook also benefits from better availability of water.

However, this rise in support prices only partially compensates farmers against the steep rise in the cost of inputs (including seeds, fertilizers, pesticides and electricity) during the past three years **(Table 2.4)**. Hence it will be safe to assume that this increase may not re-ignite rural demand on a scale that was observed following the price adjustment in Oct 2008.[14]

Table 2.4: Estimated Cost of Wheat Production

Rs per 40 Kg	
Average cost of FY09 crop	667.6[1]
Support price for FY09 crop	950.0
Margin (percent)	42.3
Average cost of FY12 crop	950.0[2]
Support price for FY12 crop	1,050.0
Margin (percent)	10.4

[1] Agriculture Policy Institute
[2] Assumes 13 percent increase over cost of FY11 crop

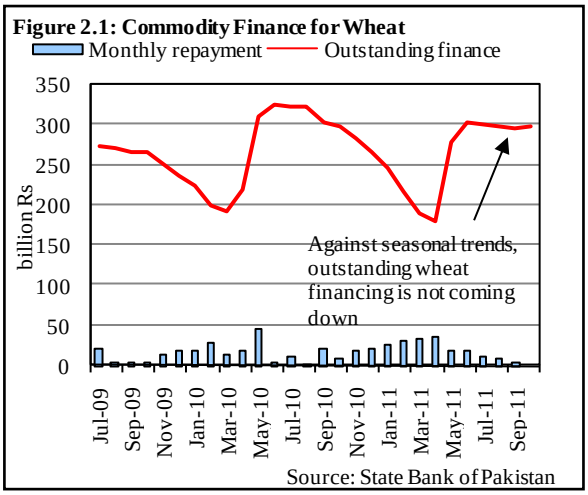
Having said this, the revised wheat support price is much higher than prevailing prices in the international market.[15] On top of this, the outlook is that global

[13] A case in point is the 2008 wheat crop when delays in the announcement of support price till end-Mar 2008 contributed to a sharp decline in the wheat production. In the next crop however, a steep rise in support prices before the sowing provided a boost to wheat production which crossed the 24 million tones mark for the first time in country's history.

[14] The size of price increase in 2008 was exorbitant (i.e., 52 percent increase from Rs 625 to Rs 950/40 kg). This not only led to a windfall gains to farmers as their profit margins rose substantially, but also provided a considerable boost to consumer demand in rural areas (as reflected in swelled demand for automobiles, motorcycles and other consumer items).

[15] After conversion in Pak-Rupee, the spot price of wheat in Chicago Board of Trade (CBOT) is around Rs 760 per 40 kg as on 8th Dec 2011.

wheat prices would remain depressed during the 2012 crop season, as global production is likely to be higher than initially thought.



In view of this, setting the procurement target for the upcoming crop would be quite challenging. Not only will the government be pressured to set a higher procurement target, on-selling the surplus wheat (either in the domestic or international markets) would not be possible without incurring fiscal losses.[16] It may be noted that the government is already struggling to settle the outstanding obligations from previous years **(Figure 2.1)**.[17,18]

2.3 Large-Scale Manufacturing

The computation methodology for the large-scale manufacturing index has been revised this year. The index has been rebased, new industries have been added, and industry weights have been revised ***(Box 2.1.)***

The LSM recorded a growth of 2.1 percent during Jul-Oct FY12 in contrast to 2.9 percent decline recorded in the corresponding period last year.

Box 2.1: The Rebased Index in Perspective

The Federal Bureau of Statistics (FBS) revises the computation methodology of quantum index of manufacturing – the index that measures movement in LSM – roughly after every decade to integrate changes in industrial trends. The changes made in the index this year include: (i) rebasing from FY00 to FY06, (ii) inclusion of nine new industries, (iii) exclusion of one redundant industry (cotton ginning), (iv) re-classification of industry sectors, and (v) reallocation of weights **(Table 2.1.1)**.

[16] Since the expected crop will be higher than domestic consumption of around 22 million tons, farmers will insist on the government to procure surplus wheat to prevent a fall in the price.
[17] Though borrowings for commodity operations are self-liquidating, the outstanding level of wheat financing is persistently high. Furthermore, against the norm when repayment of commodity loans picks up in Sept every year, the pace of repayment this year is very low.
[18] We feel that banks would be willing to fund the additional borrowing demand for wheat procurement as long as they can charge higher spreads over Kibor.

For analysts such changes sometimes create difficulties. For instance, rebasing has marginally deteriorated growth numbers for the past two years **(Figure 2.1.1)**. Major downward revisions in Q1-FY11 growth rates of some key industries – fertilizer, leather, chemicals, electronics, pharmaceuticals, and automobiles – also creates doubts about our assessment about these sectors at that time. In short, perception and reality are hard to delineate.

If last year was actually worse than earlier deemed, it implies that in absolute terms the industry is still *behind* FY10 production levels. This is corroborated by the fact that the QIM index value in Jul-Oct-FY12 is 3.1 percent lower than the value recorded in Jul-Oct-FY10. It is much further behind the pre-recession levels of FY09 and FY08.

To conclude, we believe that it would not be judicious to compare LSM performance based on the new index against the official growth target of 2.0 percent. In simple terms, target is the number obtained by setting desired production levels and computing the growth against previous year's actual production. Now, this year's target was based on the old FY11 growth number of 1.1 percent. According to the new methodology, FY11 growth was actually 0.01 percent. In our view, plugging in the earlier desired production levels in the new LSM setup may yield a higher target. In this regard, the Planning Commission may be expected to update the benchmark growth.

Table 2.1.1: Revision of LSM Weights

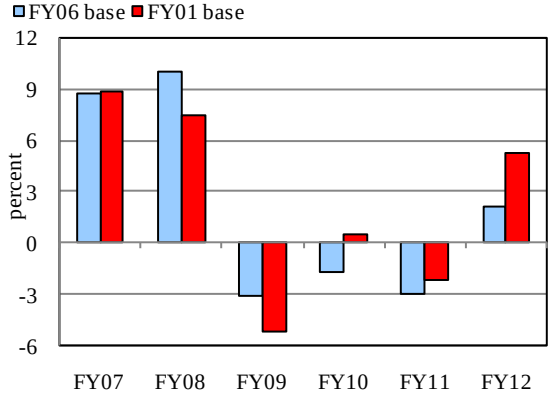
percent

Industry	Revised	Old
Textile	29.7	35.1
Food, beverages, & tobacco	17.5	19.1
Petroleum	7.8	6.9
Steel	7.6	4.6
Non-metallic minerals	7.6	5.5
Automobiles	6.5	5.2
Fertilizers	6.3	4.5
Pharmaceuticals	5.1	6.7
Paper	3.2	0.8
Electronics	2.7	3.3
Chemicals	2.3	3.8
Leather products	1.2	3.0
Wood	0.8	0.0
Engineering	0.5	0.5
Rubber products	0.3	0.4
Overall LSM	100	100

*Adjusted to 100.

Source: Pakistan Bureau of Statistics

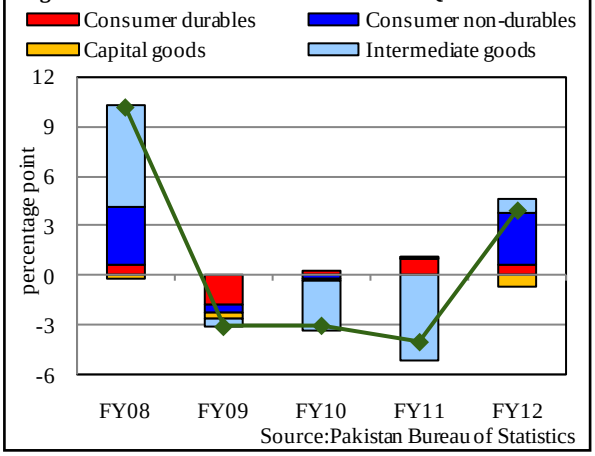
Figure 2.1.1: Comparison of Old and Rebased QIM Growth in Jul-Oct



Source: Pakistan Bureau of Statistics

Growth was mainly led by consumer goods, with food and pharmaceuticals showing the strongest contribution. Intermediate goods – building materials, fertilizers, industrial chemicals, petroleum products, and other raw material – posted a welcome recovery. However, revival is not yet seen in capital goods, which continued to post declining production for the fourth consecutive quarter **(Figure 2.2)**. In overall terms, the following factors helped LSM:

Figure 2.2: Contribution to LSM Growth in Q1



Source:Pakistan Bureau of Statistics

1. Fiscal policy was supportive. Reduction in duties on beverages, automobiles, cement, and air conditioners as well as across-the-board reduction in the sales tax, helped manufacturers absorb fluctuations in input prices.[19] The yellow cab employment scheme of the Punjab government, also contributed to vehicle sales.
2. Gross margins improved for some industries. For instance, the global refining margins for POL sector improved; textile benefitted from lower prices of raw cotton in the wake of higher arrivals this season as well as lower global prices; and a decline in global coal prices led to better profits for the cement industry. A similar trend was observed in the pharmaceutical and wheat milling.
3. It appears that vegetable oil & ghee, cigarette, tea, and tyre manufacturers may have compromised profit margins to compete with the informal sector and smuggled substitutes.
4. Rural demand fared well despite the 16 percent sales tax on agricultural inputs. Demand for fertilizers and small farm implements remained intact.[20] Anecdotal evidence however suggests resource reallocation away from investment in tractors in response to high fertilizer prices. This drift was

[19] FED on beverages was reduced from 12 percent to 6 percent; cement FED brought down from Rs 700/Mt to Rs 500/MT; 10 percent FED on deep freezers and air conditioners was slashed; 2.5 percent SED (Special Excise Duty) on automobiles was eliminated. Overall sales tax was brought down from 17 percent to 16 percent.

[20] Combined fertilizer off-take of urea and DAP grew by 13.4 percent YoY during Jul-Oct FY12, compared to 19.1 percent decline in Jul-Oct FY11, despite 62.1 percent average hike in fertilizer prices YoY during the period.

further reinforced by higher after-tax tractor prices and lower credit availability.

5. A marginal improvement in export demand for value-added textiles and leather helped these industries.

However, this growth may not be sustained as the LSM sector is expected to face many challenges in the coming months. Some of this growth is driven by a base effect, following the floods of FY11; specifically, POL, cement and leather.[21]

This phenomenon also affected other industries as rural demand fell and supply chains were damaged. In Q2-FY12, these industries will be compared to more 'normalized' production levels of last year, which is already reflecting in Oct FY12 growth.

The growth impact following the Federal Budget for FY12 must also be carefully evaluated, especially in the case of durable goods. Consumers generally hold off purchases in expectation of favorable tax adjustments, and rush to buy immediately after the budget. Therefore, Q1-FY12 sales include some carry-forward demand from last year.

Furthermore, global demand has declined amid fears of another recession, which could affect textiles. Apparently, manufacturers did not expect prices to fall by this proportion. Specifically, some textile processing mills purchased large quantities of grey cloth when prices were high in Q4-FY11 and early FY12, expecting demand for their output to remain stable. But now that cotton prices have fallen sharply, they are finding it difficult to offload inventories – this has adversely impacted the demand for upstream commodities. Reportedly, ginners are asking the government to intervene in the cotton market in order to keep prices from falling further. Fluctuations in cotton and yarn prices, coupled with rampant energy outages and uncertain global demand has made textile manufacturing an extremely challenging business lately. Therefore, investors are shying away from it; and are instead focusing on textile retailing **(Box 2.2)**.

On the supply side, the winter quarter will prove difficult for a number of industries running on natural gas, as household demand for gas will increase. Textile, fertilizer, vegetable oil & ghee, soda ash, glass, and steel will be hardest hit. Encouragingly, the soda ash industry is setting up coal-fired boilers to replace gas which will prove to be cheaper and more reliable in the long run – other

[21] The heavy monsoon in Q1-FY11 led to flooding of a major petroleum refinery, virtually complete freeze in construction, and livestock losses which affected hides and skins supply to leather industry.

industries facing gas shortages could take a cue from this sector. Lastly, automobile sector could face shortages of parts due to flooding in Thailand, which is the hub of auto parts trade in the region.

Box. 2.2: New Investments in Textile: a Shift from Manufacturing to Services

Despite adverse business conditions, investment appeal of textile sector is sustained in recent years; however, the dynamics of new investments have changed noticeably.[22] At a time when manufacturing appears an inauspicious business due to severe energy shortages and unfavorable export prospects, retailing has emerged as a promising avenue.

A small survey of a sample of textile firms registered with SECP during 2007-2011 shows that most of the new investments are self funded, smaller in size and largely concentrated in the retailing business.[23] The attractive margins in the retail business are in fact pulling in other businessmen besides manufacturers[24]

One obvious reason for the greater interest in retail business, besides low capital expenditures, is the disincentive that the textile manufacturers face due to persistent energy shortages and lackluster global demand.[25] In addition, a growing population with increasing awareness and brand consciousness is a major incentive for a thriving retail business in recent years

We must however not overlook the critical role of supply side responsiveness. In previous few years, the sector has taken major strides in the fields of product development and marketing; new products have entered market as per changing consumer preferences, new brands have flown in; and consumers got acquainted with the concept of complete textile stores.

Interestingly, the market for used textile products has also grown in recent years. Growth of clothing import increased tremendously during the period 2006-2010 – CAGR of 21.1 percent during the period compared with CAGR of 10.9 percent in 2003-2006. As a result, Pakistan has become 2nd largest importer of used/worn clothing by Dec 2010; up five notches since 2003.[26]

The higher demand for used clothing was expected from low-income segment of the society as they are burdened more due to rising inflation and escalating cost of fabrics. Surprisingly, middle to high income groups are also buying used clothing. Anecdotal evidence suggests that good quality products (mainly branded clothing and accessories) are sold in exclusive *Sunday bazaars* and other up markets.

[22] During 2007-11, 484 firms were registered with SECP. Though the number is low compared with preceding five years; we still consider it decent given tough business conditions during most of this period (we understand that of these, many firms were already existed and operating in 1990s but got registered only recently).

[23] The survey conducted by SBP is based on randomly selected 70 textile-related firms (22 in Karachi, 20 each in Lahore and Faisalabad; 4 in Multan and 2 in Sialkot) registered with SECP during 2007-2011.

[24] Around one-third of the surveyed firms were in business of retailing – importing branded clothes and selling in local market.

[25] Around 15 percent of respondents also informed us that after having registered in those years, machinery has not started production yet due to different reasons; prominent being non-availability of gas and power.

[26] Russia is the world's largest importer of this category.

With increasing penetration of textiles, complementary industries (ranging from basic textile services to local advertisers and event managers) are also flourishing.

1. We observe growth in basic textile services including dyeing and printing followed by embroidery and tailoring services. For instance, tailoring charges alone have inflated by 30 percent in previous 3 years as per FBS data that signifies strong demand. Similarly, new firms focusing exclusively on embroidery are opening up. We could identify at least 3 of such firms that got registered with SECP only in FY11.

2. Anecdotal evidence suggests that a large number of women in every segment of society have taken up dress designing as their key business, employing a large number of dyers, printers, tailors, etc. These designers supply not only in domestic market but have also found niche overseas.

3. On a more macro level, the growing liaison of textile and domestic fashion industry has added tremendous business for domestic advertising and event management industry.

Conclusions

Domestic textile industry has been reshaped in recent years with growing scope and depth in terms of products, business strategies and penetration in services industry. Given a larger employment intensity of services sector, we believe that the sector's contribution in domestic economy and employment has further increased. But no matter how obvious the growth is, we unfortunately cannot measure it since the large part of the sector is undocumented.

More disturbing is investors' disinterest in textile manufacturing which calls for drastic steps to encourage them. Certainly pessimism regarding global demand is a major issue hurting investment prospects in textiles; we believe that energy supplies is the most dominant factor in discouraging additional investments in the sector, as well as disinvestments.