2 Real Sector

2.1 Overview

Pakistan's real GDP grew by 4.1 percent in FY14 – higher than last year's growth of 3.7 percent (**Table 2.1**).[1] Although the growth remained lower than the target of 4.4 percent, what is encouraging is that it exceeded the 4.0 percent mark for the first time after FY08.[2]

Table 2.1: Overall GDP (at Constant Basic Prices of 2005-06)

Growth in percent; contribution in percentage points

	Growth			Contribution to growth	
	FY13[R]	**FY14[T]**	**FY14[P]**	**FY13[R]**	**FY14[P]**
Agriculture (21%)	2.9	3.8	2.1	0.6	0.5
Industry (20.8%)	1.4	4.8	5.8	0.3	1.2
Services (58.1%)	4.9	4.6	4.3	2.8	2.5
GDP	**3.7**	**4.4**	**4.1**	**3.7**	**4.1**

R = Revised; T = Target; and P = Provisional
Note: Figures in parentheses are sectoral share in GDP for FY14.
Source: Pakistan Bureau of Statistics

This recovery in FY14 was led by the above-target performance of the industrial sector. Agriculture and services, on the other hand, posted lower growth compared to the previous year.

Higher growth in industry was mainly due to a sharp turnaround in *construction* and *electricity & gas distribution*, and a better showing by *large scale manufacturing (LSM)*. Within LSM, a number of factors were supportive to growth: for example, increased availability of gas for fertilizer; improved capacity utilization in steel, paper, beverages and rubber;[3] investment in alternate energy; and a higher production of sugar on the back of a healthy sugarcane crop.

A further breakup of industrial data shows a much stronger growth of 6.5 percent in LSM during H1-FY14, compared to 2.2 percent in the corresponding period of FY13. As discussed later, some industry-specific developments in H2-FY14 have dampened LSM performance: the increase in power tariffs in September 2013;

[1] The annual GDP numbers are prepared by the Pakistan Bureau of Statistics and approved by the National Income Accounts Committee. These estimates are based on information available up to March, and are subject to revision later when information for full fiscal year (i.e., Jul-Jun) becomes available.
[2] The average annual GDP growth during FY09-13 was 2.8 percent.
[3] Installation of new (coal/biomass fired) boiler allowed the Century Papers Mills to utilize capacity that was previously underutilized due to gas shortages. Similarly, Engro fertilizer received additional gas since end July 2013 from Mari gas fields, which enabled the company to operate its plants at more than 80 percent capacity. Furthermore, as the operation of Tuwairqi commenced in January 2013, it resulted in higher steel production during Jul-Dec FY14. Finally, General Tyre introduced motor cycle tyres in the last quarter of FY13, which supported LSM growth in FY14.

imposition of the Gas Infrastructure Development Cess (GIDC) from January 2014; and the two-sided volatility of the PKR against major currencies during Jul-Mar FY14, may have impacted LSM growth in the third quarter of FY14. Hence, LSM only recorded growth of 0.5 percent on a YoY basis during Q3-FY14.[4]

Notwithstanding this uneven performance of LSM, the strong recovery in both *construction* and *electricity & gas distribution*, allowed the industrial sector to surpass its target of 4.8 percent for FY14 (**Table 2.2**). In addition to a low base in FY13, the initiation of new projects in both the public and private sector helped push higher growth in *construction* during FY14.

Table 2.2: Value addition by Industry

Growth and share in percent; contribution in percentage points

	Share in FY14	Growth		Contribution to industry growth	
		FY13^R	FY14^T	FY13	FY14
Mining & quarrying	14.4	3.8	4.4	0.5	0.6
Manufacturing	64.9	4.5	5.5	2.9	3.6
Large scale	52.4	4.1	5.3	2.1	2.8
Small scale	8.0	8.3	8.4	0.6	0.7
Slaughtering	4.5	3.6	3.5	0.2	0.2
Electricity gen & dist and gas dist	9.2	-16.3	3.7	-1.8	0.3
Construction	11.5	-1.7	11.3	-0.2	1.2
Overall	**100.0**	**1.4**	**5.8**		

Source: Pakistan Bureau of Statistics

The value addition in *electricity and gas distribution* also witnessed stronger growth in FY14, mainly due to higher production in power generation companies following the settlement of circular debt in the earlier months of FY14. Hence, the industrial sector grew by 5.8 percent in FY14, compared to only 1.4 percent in the previous year. This recovery was sufficient to offset the slowdown in services and agriculture.

Lower growth in the services sector during FY14 can be traced to a slowdown in *general government services* and *finance and insurance*.[5] However, *wholesale and retail trade* posted stronger growth compared to FY14, reflecting the improved performance by major crops and large scale manufacturing (see **Section 2.4**).

[4] The recent data on LSM shows YoY growth of 4.3 percent for Jul-Mar FY14, which is considerably lower than the full-year estimate of 5.3 percent in the National Income Accounts.

[5] The value addition by general government includes services such as education, health, social work, defence and public administration provided by federal, provincial, district governments, local bodies, and cantonment boards.

2.2 Agriculture[6]

Agriculture growth remained below target for the second year in a row. However, unlike FY13 when losses in rice and cotton held back agriculture growth, it was a significant decline in *minor* crops which suppressed value addition by the agriculture sector in FY14. This was exacerbated by the livestock subsector, which posted lower growth compared to FY13 (**Table 2.3**).

Table 2.3: Value Addition by Agriculture

Share and growth in percent; contribution in percentage points

	FY14	Growth		Contribution to growth in agriculture	
	Share	FY13[R]	FY14[P]	FY13[R]	FY14[P]
Crop	40.0	2.3	1.2	0.9	0.5
Major crops	25.6	1.2	3.7	0.3	0.9
Other crops	11.6	6.1	-3.5	0.7	-0.4
Cotton ginning	2.8	-2.9	-1.3	-0.1	0.0
Livestock	55.9	3.5	2.9	1.9	1.6
Forestry	2.0	1.0	1.5	0.0	0.0
Fishing	2.0	0.7	1.0	0.0	0.0
Overall	**100.0**	**2.9**	**2.1**		
Annual target		4.1	3.8		

Source: Pakistan Bureau of Statistics

Crop sector

Better than expected growth of rice, sugarcane, wheat and maize, overshadowed the below-target cotton crop (**Table 2.4**).[7,8] At the time of finalizing the *Second Quarterly Report* for FY14, when only provisional estimates were available, SBP was positive on rice, sugarcane and wheat; but its assessment on the overall performance of major crops was bearish mainly due to the drag from cotton. The final outcome appears to be quite different, as upward revisions in the production of all major crops, led to a growth of 3.7 percent in FY14, significantly higher than 1.2 percent in the previous year.

Table 2.4: Major Crops

Production in million tons; for cotton million bales; Growth in percent

				Growth	
	FY13	FY14[T]	FY14	FY13	FY14
Cotton	13.0	14.1	12.8	-4.1	-2.0
Rice	5.5	6.2	6.8	-10.1	22.8
Sugarcane	63.8	65.0	66.5	9.2	4.3
Wheat	24.2	25.0	25.3	3.1	4.4
Maize	4.2	4.6	4.5	-2.7	7.3

Source: Pakistan Bureau of Statistics

Unfortunately, the unanticipated decline in *minor* crops offset most of the gains from *major* crops. A further breakdown identifies lower production of pulses and

[6] This section focuses on the major crops which account for 26 percent of the value addition by the agriculture sector. The livestock subsector, the largest contributor to agriculture with 52 percent share, is not covered in detail due to non-availability of sufficient information.
[7] Cotton crop recorded a decline for the second consecutive year.
[8] Rice, sugarcane and wheat together generally contribute around 65 percent of the value addition in major crops, whereas share of cotton crop is roughly 28 percent.

vegetables (especially potatoes) in FY14, mainly due to unfavorable weather conditions.

Furthermore, the growth in livestock recorded a slowdown during FY14. The value addition in this sector includes headcount and age of cattle, products (milk, wool, etc.), and poultry products (meat and eggs).

It may be noted that this sector has been experiencing a significant technological upgrade in recent years, with vertical integration in supply chain of meat and dairy products, and the focus on new processing techniques that are based on international hygiene and health standards. However, the hard data on livestock may not reflect such trends, as the share of the formal segment is still very low compared to the informal market.[9] So while official data may not reflect the higher prosperity generated by livestock, rural and semi-urban areas may be better off compared to the past.[10]

2.3 Industry

Large scale manufacturing

LSM recorded growth of 4.3 percent during Jul-Mar FY14, compared to 3.5 percent during the corresponding period of last year. However, this higher growth was largely concentrated in sugar and fertilizer (**Table 2.5**). A closer look shows industries like cotton yarn & clothing, edible oil & ghee, POL, and paper & board, which had posted decent growth in Q1-FY14, could not sustain this momentum in subsequent quarters.

Quarterly data reveals a sharp decline in YoY growth of LSM during Q3-FY14. While some slowdown in LSM growth was expected due to the high base effect from September 2013,[11] as shown below, other factors also dampened LSM growth in Q3-FY14.

- First, sugarcane crushing was concentrated in Q2-FY14, which meant lower production was realized in the third quarter. This trend stands in sharp contrast to last year, when most of the crushing was carried out in Q3-FY13.

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[9] Gross value addition in the livestock is computed on the basis of past surveys or by applying fixed parameters.

[10] Furthermore, to support livestock sector, SBP has not only issued guidelines on livestock financing, but also launched the Agricultural Lending Diversification Project (which encouraged bank lending to non-farm activities) and the Livestock Loan Insurance Scheme (which was issued in November 2013 to safeguard the interest of livestock farmers).

[11] Since most of these industries started to recover from September 2012, we were expecting some slowdown in their growth after September 2013.

Table 2.5: Growth in Large Scale Manufacturing (YoY)
percent

	wt.	FY13 Q1	FY13 Q2	FY13 Q3	FY13 Jul-Mar	FY14 Q1	FY14 Q2	FY14 Q3	FY14 Jul-Mar
Overall LSM	**70.3**	**0.6**	**3.8**	**5.5**	**3.4**	**6.6**	**6.4**	**1.0**	**4.3**
Textile	21.0	-0.5	0.9	2.4	0.9	2.4	1.2	0.9	1.5
Cotton yarn	13.0	-0.6	1.2	3.2	1.3	3.0	1.4	0.9	1.8
Cotton cloth	7.2	-0.3	0.1	0.9	0.2	0.9	0.6	0.5	0.7
Food & beverages	12.4	6.5	1.3	11.0	7.4	8.0	24.4	-0.3	7.8
Sugar	3.5	0.0	-29.0	11.0	3.0	0.0	87.2	-1.8	10.9
Vegetable ghee	1.1	-5.8	2.9	15.7	3.8	7.0	2.2	3.1	4.1
Cooking oil	2.2	6.4	20.6	17.1	14.6	8.7	-1.4	-5.9	0.2
Soft drinks	0.9	28.3	14.7	1.8	17.1	18.4	40.5	57.8	34.0
POL	5.5	3.4	18.0	19.4	13.3	12.7	4.2	5.9	7.5
Petroleum products	5.4	4.0	18.1	19.1	13.5	13.6	6.5	8.6	9.5
Coke	0.1	-17.8	16.8	28.0	6.9	-28.0	0.0	0.0	-78.4
Steel	5.4	16.1	22.8	2.8	13.2	9.4	-5.0	5.5	3.4
Pig iron	1.6	-35.6	-38.7	3.6	-25.3	-21.1	-66.7	-71.3	-53.4
Billets	1.5	-4.5	8.4	-0.8	0.9	32.5	21.5	33.8	29.2
H.R sheets/strips	2.3	72.9	78.8	4.8	45.5	7.3	-4.5	18.5	6.7
Cement	5.3	4.0	5.1	9.0	6.1	0.7	1.7	-2.0	0.1
Automobile	4.6	-1.2	-14.7	-18.2	-12.0	-5.5	3.1	2.5	0.0
Tractors	0.5	156.4	75.7	-33.5	34.5	-46.0	-26.3	-30.6	-33.6
Jeeps and Cars	2.8	-11.9	-36.3	-20.3	-22.9	-5.3	12.0	-0.3	1.3
Fertilizer	4.4	-27.0	11.2	6.6	-5.0	44.6	15.8	7.6	21.6
Nitrogenous fertilizers	4.0	-28.5	9.3	2.7	-7.3	47.4	18.9	10.8	24.6
Phosphatic fertilizers	0.4	-15.9	24.3	52.0	13.5	26.8	-2.7	-17.7	2.1
Paper	2.3	14.5	40.5	2.6	17.8	19.9	6.4	-2.4	8.0
Leather products	0.9	-10.0	-2.7	7.9	-1.7	14.0	8.5	15.8	13.0
Leather footwear	0.5	-10.3	1.1	10.9	0.3	12.8	9.8	22.8	15.7
Memorandum item									
LSM excl. sugar & fertilizer	*62.3*	*2.3*	*5.7*	*4.1*	*4.0*	*4.9*	*2.0*	*1.3*	*2.7*

Source: Pakistan Bureau of Statistics

- Second, the drag on Q3 growth came from the textile sector, especially cotton yarn. This moderation in growth was unexpected as it primarily came from a reversal in China's cotton policy. A more detailed discussion is covered in a subsequent section.

- Finally, the poor performance of Pakistan Steel Mill also pulled down LSM growth. Specifically, the production of coke and pig iron came to a halt in Q3-FY14, which at the margin had a significant impact on overall LSM growth during Q3-FY14.

Besides the above-mentioned factors, the rise in power tariffs for industrial users in September 2013, increased the production costs for almost all industries. Moreover, the imposition of Gas Infrastructure Development Cess (GIDC) in

January 2014 increased the cost for gas-dependent industries such as textiles, fertilizer, cement and paper.

Furthermore, industries which are heavily dependent on imported raw materials like POL, faced rising costs following the sharp depreciation of the PKR against major currencies during Q1-FY14.[12] Similarly, a steady increase in the price of palm oil in the international market adversely impacted the cooking oil and ghee production.[13]

Despite the subdued performance during Q3-FY14, overall LSM growth during Jul-Mar FY14 was still higher than the previous year. In fact, some of the industries (e.g., urea, leather products, soft drinks, and petroleum products) continued to show strong growth throughout the year. This is detailed below:

Sugar production rose again in FY14

Sugar production grew by 10.9 percent in Jul-Mar FY14, compared to 3.0 percent in the corresponding period of last year. As mentioned earlier, better sugarcane crop and timely crushing was the key reasons for this improved performance.[14]

The timely commencement of crushing can be traced to a better understanding between the government and sugar mills. More specifically, given that most sugar mills were facing a shortage of liquidity at the start of crushing season due to excessive carryover stocks, the government not only purchased part of this stock through TCP, it also allowed sugar exports on condition that mills in Sindh and Punjab would commence crushing on 1st and 15th of November, respectively.[15, 16]

The crushing reached its maximum in the month of January 2014, against the normal peak in February (**Figure 2.1**). As mentioned earlier, the impact of this

[12] In fact, all listed refineries have reported huge exchange loss in their financial statements for second half of 2013. However, their margins started to recover following PKR appreciation towards the end of Q3-F14.

[13] After experiencing a continuous decline since Jan 2012, international price of palm oil started to recover in October 2013.

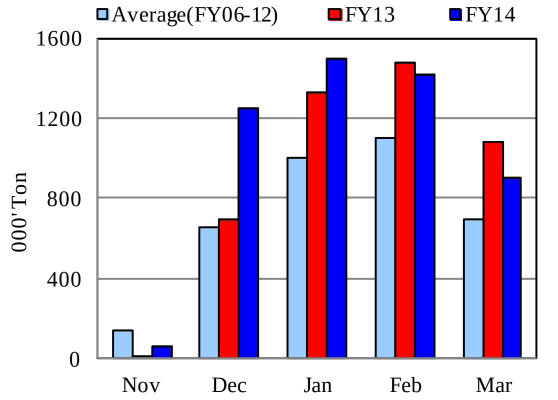
[14] According to recent estimates prepared by Pakistan Bureau of Statistics, sugarcane production during FY14 was 66.5 million tons, which was significantly higher than the final estimates of 63.8 million tons for FY13.

[15] In addition to offering rebate on sugar exports, the government reduced the sales tax from 8 percent to 0.5 percent on local supply of sugar to the extent of quantities actually exported (see SRO # 77 (1) of 7th February 2013).

[16] Delays in crushing generally reduce the water contents in the cane. This not only improves the recovery rate (which is the ratio of sugar produced and cane crushed), the resulting fall in the weight of sugarcane implies lesser payment to cane grower for the same crop.

change in the crushing cycle was reflected in later months when the YoY growth of sugar became *negative* in both February and March 2014.

Figure 2.1: Monthwise Production of Sugar



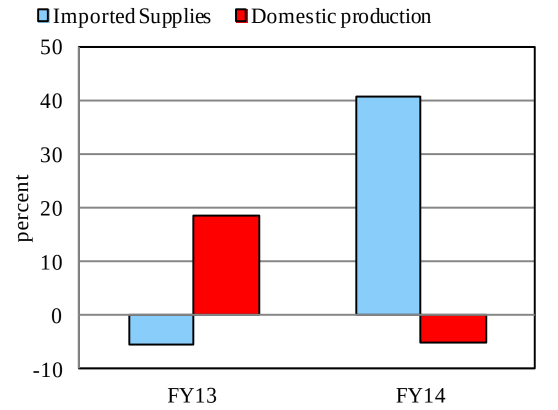
Source: Pakistan Bureau of Statistics

Fertilizer supported the LSM growth

With 21.6 percent YoY growth in Jul-Mar FY14 (compared to a *fall* of 5.0 percent in Jul-Mar FY13), the fertilizer sector alone contributed more than one-fifth of the overall growth in LSM. Better availability of gas to the fertilizer sector, and a higher off-take of fertilizer during Jul-Mar FY14, largely explain this improved performance.

The industry even survived the adverse impact of GIDC, which was raised in January 2014.[17] Manufacturers initially passed on this increase to farmers by raising retail prices from Rs 1,720 per bag to Rs 1,900. However, when the government fixed the retail price at Rs 1,786 per bag, margins of most fertilizer companies came under pressure during Q3-FY14.

Figure 2.2: YoY Growth in Production of DAP during Jul-Mar



Source: NFDC

Production of DAP, which had accelerated sharply in Q1-FY14, experienced a slowdown in the following two quarters. A steep fall in international DAP prices and the resulting widening of price differential between landed and domestic prices, led to a substantial

[17] Government increased the GIDC on feedstock gas from Rs 197 to Rs 300 per mmbtu, and on fuel gas from Rs 50 to 100 per mmbtu.

increase in DAP imports during Jul-Mar FY14 (**Figure 2.2**).[18] This dampened domestic production of DAP.

Lackluster performance by cement

Cement production only increased by 0.1 percent during Jul-Mar FY14 compared to a growth of 6.1 percent in the last year. The recent hike in power tariff and the imposition of GIDC, increased the cost of production for the cement sector. The impact was more pronounced on smaller units that generally depend on the national grid and piped gas. In comparison, larger production units are using alternative fuels (such as tyre-derived fuel) and have incorporated waste heat recovery plants to reduce their energy cost.

Nonetheless, the industry passed on the increased production cost to end-users.[19] The higher retail price and lower PSDP allocations during the nine months of FY14 reduced the domestic demand for cement.[20] The growth in local cement dispatches was only 2.1 percent in Jul-Mar FY14, compared to 6.1 percent in the previous year, while demand from international markets also remained subdued during the period. Most of the fall in external demand came from Afghanistan as subsidized Iranian cement captured that market.[21]

Some domestic cement manufacturers have announced their investment plans in Africa, and Iraq. These projects will not only diversify their product market but also provide an opportunity to grab market share in Gulf and African region. Although their additional production will not be reflected in Pakistan's cement sector, the profits repatriated may help the country's BoP, while the experience overseas may help improve production efficiencies in the country.

The outlook for the cement sector appears bright as new infrastructure projects like the Economic Corridor from Gawadar port to Khunjrab, and the construction of dams are expected to start in the coming year. From the private sector, cement demand is likely to come from construction companies that have launched mega

[18] International DAP price reached 4-year low of US $351.3/metric tons in November 2013. Although there was some uptick in December 2013 following a closure of a DAP plant in Morocco, prices soon started a downtrend from March 2014 onwards.

[19] Retial price of cement rose on average by 11.5 percent on YoY basis during Nov-Mar FY14.

[20] PSDP spending during Jul-Mar FY14 was Rs 393 billion which was marginally lower than Rs 407.1 billion during the corresponding period of last year.

[21] For their fuel requirement, Iranian cement sector is mainly reliant on the local gas, available at cheaper rates. In contrast, Pakistan's cement sector is mainly dependent on thermal energy and imported coal.

housing projects in the major cities. Finally, the real estate sector should also receive support from the relaxation in SBP prudential regulations.[22]

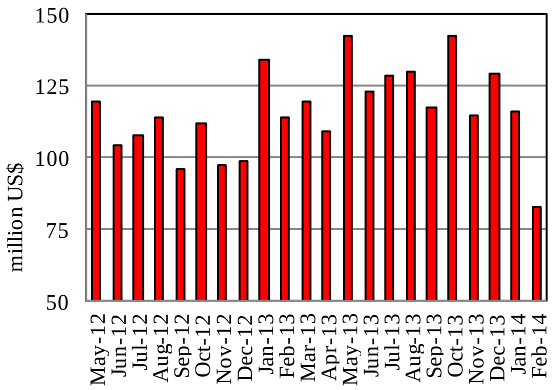
Yarn production

Although yarn manufacturing posted growth compared to the previous year, a gradual slowdown is visible in Q2 and Q3 of current fiscal year (**Table 2.6**). While external demand for yarn weakened after a change in cotton policy by China (**Box 2.1**), import of cheaper yarn from India (at zero tariffs) lowered the domestic demand.[23]

Box 2.1: Reversal of Cotton Policy by China

China has been building cotton stocks since 2011 by offering higher than competitive price to local farmers. The consequent widening of the gap between the international and the local cotton prices encouraged Chinese manufacturers to increase their import of cotton yarn and its bi-products. Hence, Pakistan's export of textile items flourished. In fact, during FY11-H1FY14, the country earned US$ 3.5 billion from the export of cotton yarn to China only.

Figure 2.1.1: Yarn Export Receipts from China



Source: State Bank of Pakistan

In March 2014, Chinese government introduced a major shift in this policy, i.e., instead of buying cotton at higher than market prices, the government would pay the price differential to farmers if market price falls from a target level, which is significantly smaller than the price at which government was earlier buying from the market.[24] Interestingly, yarn demand from China had already fallen in February 2014 in anticipation of this new policy (**Figure 2.1.1**). At the same time, this policy shift eased the pressure on yarn prices in the international market.

[22] In order to promote housing finance, SBP has issued separate prudential regulations. The key feature of new prudential regulations is the extension in the period for classifying overdue loans under the 'loss' category from one year to two years (IH&SMEFD Circular No. 03 of 2014).

[23] The import of the Indian yarn reached to US$ 86.3 million during Jul-Mar FY14 compared to US$ 58.3 million during the same period of FY13. This not only lowered the demand for local yarn, but also kept market prices down. In response, the Economic Coordination Committee of the cabinet restored 5 percent duty on yarn import from India in April 2014.

[24] The Chinese government announced a lower target price in the new cotton reserve policy relative to support price offered in the older policy.

Cotton clothing

Cotton cloth, which is the second largest segment after yarn in textile manufacturing, posted moderate growth of 0.7 percent in Jul-Mar FY14 against 0.2 percent in the corresponding period of FY13. This trend is consistent with growing domestic demand for light cotton fabric (i.e., lawn) which has impacted the cotton cloth sales.

2.4 Services[25]

FY14 growth in services remained lower than last year and also below the target of 4.6 percent (**Table 2.6**). This relatively weak performance is largely because of *finance & insurance* and *general government services;*[26] whereas *wholesale & retail trade* and *transport, storage & communication* continued to provide impetus to overall growth in services.

Table 2.6: Value Addition by Services

Share and growth in percent; contribution in percentage points

	Share in FY14	Growth		Contribution to growth in services	
		FY13^R	FY14^P	FY13^R	FY14^P
Wholesale & retail trade	31.9	3.4	5.2	1.1	1.6
Transport, storage & communication	22.3	2.9	3.0	0.7	0.7
Finance & insurance	5.4	9.0	5.2	0.5	0.3
Housing services	11.6	4.0	4.0	0.5	0.5
General govt. services	12.1	11.3	2.2	1.3	0.3
Other private services	16.6	5.2	5.8	0.9	1.0
Overall	**100.0**	**4.9**	**4.3**	**4.9**	**4.3**

P: Provisional; R: Revised

Source: Pakistan Bureau of Statistics

Strong growth in LSM, better production of major crops and the increase in trade volumes, largely explain increased activity in *wholesale & retail trade*. Furthermore, the strong credit growth to wholesale and retail trading, also bodes well for this sub-sector.

In the transportation sector, PIA struggled with operating losses; the company posted a net loss of Rs 44.5 billion during CY13, as compared to Rs 30.6 billion in CY12.[27] However, recent corporate results for Q1-CY14 reveal an improvement:

[25] A detailed analysis of developments in the services sector will be done in SBP's forthcoming Annual Report, when relevant information for the full year becomes available.

[26] Although banks' profitability increased during this period, the value addition by this sector showed lower growth. In fact, value addition in *finance & insurance* is computed by using a method called Financial Intermediation Services Indirectly Measured (FISIM) by PBS, which may not necessarily reflect the actual profitability of financial institutions.

[27] According to annual report of PIA, the company suffered losses mainly on account of (1) shortage of operational aircraft; (2) higher operational cost, and (3) the sharp depreciation of Rs against major currencies.

the net loss has fallen from Rs 8.62 billion in Q1-CY13 to Rs 1.98 billion in Q1-CY14. Stronger revenue growth could be traced to the acquisition of four narrow body aircrafts, as well as stability in the exchange rate.

The growth in *communication* came mainly from value addition in cellular segment. According to PTA, cellular companies operating in Pakistan earned revenue of Rs 440.2 billion in FY 2012-13, which is the highest recorded. The recent auction of licenses for 3G/4G spectrum is likely to boost revenues in this segment of the telecom sector.