2 Real Sector

2.1 Overview

The highlight of the second quarter for FY17 was the recovery in large-scale manufacturing (LSM) growth to 5.8 percent, from 4.0 percent in the corresponding period of FY16. As a result, LSM growth for H1-FY17 reached 3.9 percent – the same level as last year.

In agriculture, healthier crop production would help the sector rebound from the decline recorded last year. Meanwhile, we expect the services sector to maintain last year's growth momentum, based on an encouraging picture of *wholesale and retail trade* and *transport*. Thus, in overall terms, the GDP growth for FY17 is set to exceed last year's level.

2.2 Crop sector

While a better harvest of sugarcane and cotton (compared to the last year) provided a much-needed impetus to the crop sector during the *kharif* season, initial reports on the wheat crop suggest its production would remain close to last year's level of 25.4 million tons – slightly lower than the target of 26 million tons for FY17 (**Table 2.1**).[1]

Table 2.1: Wheat Targets for FY17

	Area (000 hectare)		Yield (kg per hectare)		Production (000 tons)	
	3-Year avg	**FY17 target**	**3-Year avg**	**FY17 target**	**3-Year avg**	**FY17 target**
Punjab	6,940	6,800	2,813	2,868	19,520	19,500
Sindh	1,128	1,150	3,372	3,652	3,802	4,200
KP	765	760	1,726	1,842	1,321	1,400
Balochistan	373	400	2,344	2,250	873	900
Pakistan	**9,205**	**9,100**	**2,772**	**2,857**	**25,516**	**26,000**

Source: Pakistan Agriculture Statistics; and SUPARCO

Notwithstanding water shortages witnessed during the early part of the rabi season (**Box 2.1**), the situation eased considerably in January 2017 after prolonged and widespread rains throughout the country. This, coupled with extended spells of low temperature and better availability of other inputs (fertilizer and credit), is likely to have a positive effect on wheat output.[2,3]

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[1] The Annual Plan 2016-17 set the wheat production target at 27.4 million tons, which was later revised down to 26 million tons by the Federal Committee on Agriculture. This target assumes a crop yield of 2,857 kg per hectare, which is higher than the average yield of 2,772 kg per hectare recorded during the past 3 years.

[2] In the Federal Budget 2016-17, the government had announced a cash subsidy of Rs 156 per bag on urea and Rs 300 per bag of DAP, at an estimated cost of Rs 27.16 billion (Rs 17.16 billion for urea

Box 2.1: Water Availability in Early Rabi

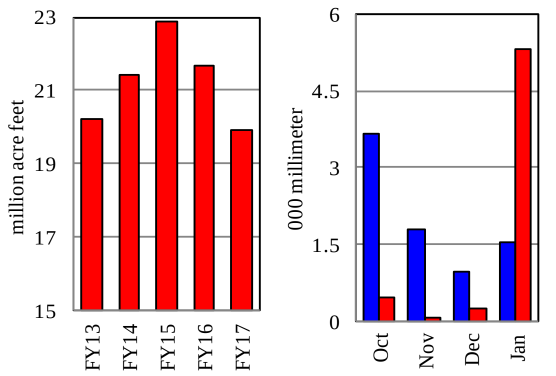
The irrigation water shortages and prolonged dry spell during the early rabi season led to some decline in the sowing area under the wheat crop (particularly in rain-fed regions of the country).

Specifically, irrigation water supply to Punjab and Sindh, which together account for more than 85 percent of the area under wheat, contracted by 8.1 percent during Oct 2016-Jan 2017 (**Figure 2.1.1**). This was on top of the 5.2 percent YoY decline recorded during the corresponding period of the previous year.

In the meantime, low precipitation in the country further stressed water resources.[4] The rain-fed areas under wheat account for 13.2 percent of total area under the crop, and contribute 6 percent to the total output (**Table 2.1.1**).

That said, the subsequent heavy rainfall in January 2017 provided a major relief to the crop sector.

Figure 2.1.1: Irrigation Water in Punjab & Sindh(oct-Jan) **Aggregate Rainfall**



Source: SUPARCO Source: IRSA

Table 2.1.1: Wheat Performance for Rain-Fed Areas
(Average 2010-11 to 2014-15)

	Rain-fed area under wheat (as % of total area under crop)	**Output from rain fed area** (as % of total production)	**Yield of rain-fed area** (as % of yield for irrigated land)
Punjab	10.2	4.7	42.9
Sindh	4.7	1.2	24.8
KP	55.9	43.0	59.4
Balochistan	7.9	4.7	57.1
Total	**13.2**	**6.0**	**42.1**

Source: Agriculture Statistics of Pakistan, Ministry of National Food Security & Research

With the expected output reaching last year's level, FY17 may be another year when domestic wheat production would exceed domestic consumption. This, in turn, would further augment wheat stocks available with government agencies.[5] This situation has arisen at a time when the Food and Agriculture Organization (FAO) is already expecting record global wheat output this year. As a result, the wheat glut in the

and Rs 10.8 billion for DAP fertilizer). This cost was to be shared equally by the federal and the provincial governments. In addition, the government also reduced the GST on urea from 17 percent to 5 percent. These measures pulled down urea and DAP prices by 28 and 27 percent respectively.

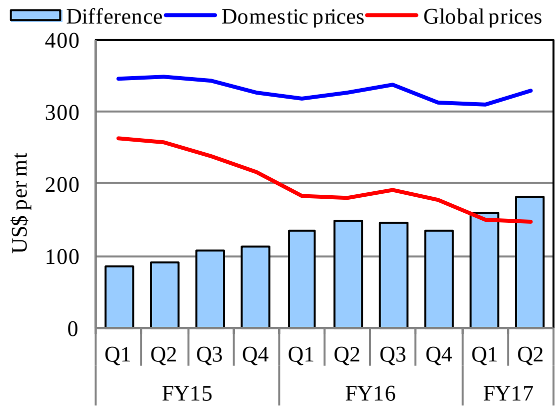
[3] Gross credit disbursement to agriculture sector grew by an impressive 32 percent in the ongoing Rabi season – both development and production loans contributed to this increase.

[4] In Q2-FY17, the country recorded nearly 90 percent less rainfall as compared to the same period last year.

[5] It may be noted that wheat stocks with government agencies have been rising consistently over the past few years, and reached 8.0 million tons by end-January 2017, from 3.75 million tons at end-January 2014.

international market is likely to deepen further, with stocks projected to reach a record 248 million tons by year-end. The resulting downward pressures on international wheat prices will pose a challenge for Pakistan as well, as this will make it difficult for the country to export the surplus wheat, even in the presence of sizeable government subsidies (**Figure 2.1**).[6]

Figure 2.1: Wheat Prices

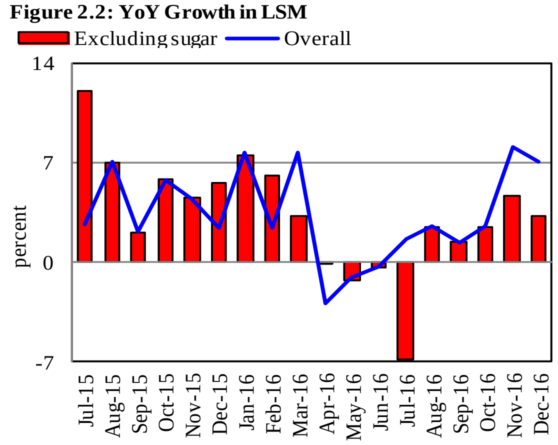


Source: Pakistan Bureau of Statistics and World Bank

2.3 Large-scale manufacturing (LSM)

LSM recorded a growth of 3.9 percent during H1-FY17, the same level realized last year (**Table 2.2**). After a dull first quarter (**Figure 2.2**), the recovery in LSM growth in Q2-FY17 came from food, steel, cement, pharmaceutical, automobiles and electronic industries.

Figure 2.2: YoY Growth in LSM



Source: Pakistan Bureau of Statistics

Going forward, multiple factors are likely to provide further impetus to LSM growth. These include supportive economic policies (low interest rate and higher PSDP spending); recently announced incentives for export industries;[7] improved energy supplies;[8]

[6] The government has permitted the export of 0.9 million tons of wheat, with a subsidy of US$ 120 per ton. So far, no significant exports have taken place, as Pakistan's FOB wheat price (even after adjustment for export subsidy) is still significantly higher than its closest competitors.

[7] The government recently announced an export stimulus package of Rs 180 billion (for H2-FY17 and FY18). This package offers several incentives, including removal of duty and taxes on some raw material and machinery, and rebate on exports, etc.

[8] LNG imports increased to 1,004 MT during H1-FY17 against 400 MT during the same period last year. The new Chashma Nuclear Power Plant (Unit-3) has added 315 MW electricity to the system.

strong domestic consumer demand;[9] and an uptick in private sector credit for fixed investment purposes.[10] Furthermore, the constraints that inhibited the growth of some industries in Q1-FY17, are expected to dilute in the future.[11]

Table 2.2: YoY Growth in LSM (Jul-Dec)

		YoY growth		Contribution in growth	
	wt.	**FY16**	**FY17**	**FY16**	**FY17**
LSM	70.3	3.9	3.9		
Textile	21.0	1.0	0.1	0.30	0.04
Cotton yarn	13.0	1.8	0.4	0.36	0.08
Cotton cloth	7.2	0.7	0.2	0.06	0.02
Jute goods	0.3	-22.6	-38.6	-0.08	-0.10
Food	12.4	-0.1	6.9	-0.01	1.16
Sugar	3.5	-14.2	52.4	-0.43	1.32
Cigarettes	2.1	-10.6	-31.0	-0.23	-0.58
Vegetable ghee	1.1	4.9	2.3	0.07	0.03
Cooking oil	2.2	6.4	-0.5	0.24	-0.02
Soft drinks	0.9	4.0	18.8	0.11	0.52
POL	5.5	6.8	-1.3	0.45	-0.09
Steel	5.4	-8.6	15.6	-0.33	0.53
Non-metallic	5.4	7.1	9.3	0.75	1.02
Cement	5.3	7.1	9.6	0.75	1.03
Automobile	4.6	32.4	6.7	1.73	0.45
Jeeps and cars	2.8	47.2	-2.7	1.22	-0.10
Fertiliser	4.4	15.1	3.5	0.90	0.23
Pharmaceutical	3.6	7.2	7.9	0.60	0.68
Paper	2.3	-15.6	5.7	-0.64	0.19
Electronics	2.0	-8.2	14.5	-0.14	0.22
Chemicals	1.7	10.8	-2.7	0.27	-0.07
Caustic soda	0.4	26.1	-6.3	0.11	-0.03
Leather products	0.9	6.2	-18.9	0.12	-0.38
LSM excl. sugar	66.8	4.4	2.6	--	--

Source: Pakistan Bureau of Statistics

Having said this, a sharp revival in LSM might be constrained by a number of factors:

(1) Most of the industries that have shown steady growth over the past few years (e.g., cement, autos, steel and pharmaceutical), have already achieved high levels of capacity utilization – further growth would therefore require capacity expansions;[12]

(2) In the textile sector, the recovery in global commodity prices (particularly cotton) and the recently announced export package are positive developments. But fully capitalizing on these favorable developments would require a well-

Going forward, 1,320 MW coal fired power projects at Sahiwal and the 118 MW Port Qasim power project in Karachi would further ease the energy constraints.

[9] Several indicators show rising consumer demand in the country, like: (i) a rise in consumer financing; increase in the sale of consumer durables (automobiles, electronic goods); sharp growth in fuel consumption, etc. Furthermore, the IBA-SBP Consumer Confidence Index (CCI) recorded its highest-ever level of 174.9 points in January 2017, showing an increase of 17 points from July 2016.

[10] During H1-FY17, the manufacturing sector availed Rs 82.7 billion in fixed investment loans, against Rs 21.8 billion in the same period last year.

[11] Some of these include: withdrawal of the increase in Federal Excise Duty on cigarettes (announced in the federal budget FY17, which led to a decline in production during Q1-FY17); and the lifting of a temporary ban on jute exports by Bangladesh (which had adversely affected the local jute industry). Similarly, the post-Apna Rozgar Scheme drag on car production would fade away after February 2017 (as car production under this scheme had continued till February 2016).

[12] While several firms in cement, steel, automobiles and beverages industries have already planned capacity expansions, it may take time for them to materialize.

thought out strategy and concerted efforts to resolve the endemic issues afflicting the sector;[13] and

(3) Global prices of key raw materials are increasing, which may squeeze margins for manufacturing firms in cement, automobiles, and cooking oil/ghee sectors (**Table 2.3**).

Table 2.3: Key International Raw Material Prices

Commodities	US$*	Change over (percent) 3-months	6-months	12-months
Coal (mt)	87.2	28.9	45.2	76.9
Palm oil (mt)	711.8	2.8	21.8	36.7
Soya bean Oil (mt)	800.3	10.7	19.5	18.2
Cotton (lb)	71	3.1	8.3	8.7
Copper (mt)	251	12.9	12.3	16.1
Steel (lb)	633	27.6	2.9	61.9
Iron (mt)	79.7	40.7	41.0	101.4
Rubber (kg)	200	43.9	54.8	69.9
Crude oil				
Brent (bbl)	52.6	16.8	19.0	43.9
WTI (bbl)	54.9	21.5	22.9	47.5
Arabian light (bbl)	52.6	23.3	21.6	56.4

* As of 31st December, 2016

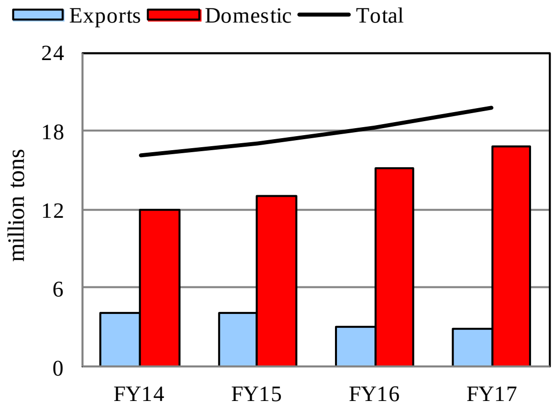
Source: Bloomberg, IMF and WB

Sectoral review

Cement

The growth in cement production increased to 9.5 percent during H1-FY17 from 7.1 percent in H1-FY16. This was mainly a result of robust domestic demand, as exports to Afghanistan fell due to strong competition from cheaper Iranian cement and some supply-related issues (**Figure 2.3**).[14] During H1-FY17, overall cement sales grew 8.7 percent and reached a record level of 19.8 million metric tons.[15]

Figure 2.3: Cement Sales (Jul-Dec)



Source: All Pakistan Cement Manufacturers Association

[13] Efforts are needed to address the issues, like low investment on R&D, product development, innovation, branding and tapping of new markets; lack of skill upgradation and resulting low labor productivity; use of obsolete technology; and high export concentration in low value added products.

[14] Due to implementation of border management system and some other issues, the resultant delays in transportation of cement (which has limited shelf life) has forced Afghan buyers to switch to Iranian cement.

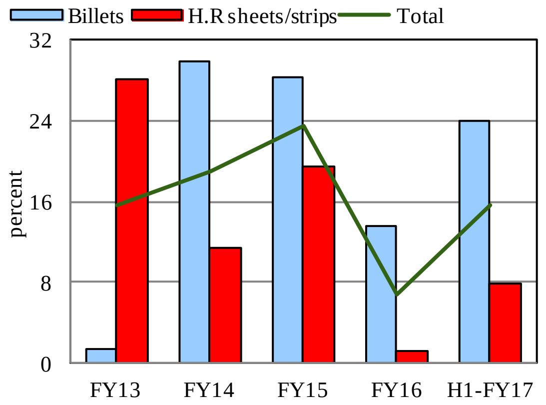
[15] Domestic sales recorded a double-digit growth of 11 percent and reached 16.9 million tons in H1-FY17. Cement exports, on the other hand, declined by 4 percent during this period.

The sizable domestic demand actually allowed manufacturers to enhance their capacity utilization to over 80 percent. The resulting economies of scales also improved their margins. The outlook of the industry appears encouraging, as many cement producers have announced capacity expansions in anticipation of firm demand (from private housing schemes, rising development spending and increased focus on CPEC-related projects).[16]

Steel

Robust construction activities in the country also led to an increase in demand for steel and allied products. The production of steel grew by 15.6 percent during H1-FY17 (**Figure 2.4**). More importantly, this growth was achieved despite the dumping of cheaper Chinese imports (which squeezed margins for the local industry).

Figure 2.4: Trend in Private Steel Production



Source: Pakistan Bureau of Statistics

That said, the industry gained some comfort when a recovery in global prices offered local players a room to increase their prices as well.[17] At the same time, improved energy supply helped the industry improve its capacity utilization.

Expecting strong domestic demand going forward, the industry is gearing up for expansions as well. For example, some large steel producers are doubling their production capacities, in addition to diversifying their energy mix and minimizing their dependence on imported raw materials. The outlook for the local industry has further improved following the imposition of anti-dumping duties on imports of steel products from China.[18]

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[16] The establishment of the proposed infrastructure finance bank (in partnership with international financial institutions to finance mega infrastructure projects in the private sector) could prove instrumental in ensuring the sustainability momentum of construction activities in the country.

[17] Following rising international prices, domestic steel prices also increased by Rs 3,000-5,000 per ton.

[18] In February 2017, the National Tariff Commission (NTC) imposed anti-dumping duties on imports of steel products (galvanised steel coils and sheets), in the range of 6 percent to 40.5 percent. Other countries have also imposed anti-dumping and countervailing duties on steel imports from China.

Automobiles

The automobile sector registered a YoY growth of 6.7 percent in H1-FY17, compared to an increase of 32.4 percent in the corresponding period last year. Higher production of vehicles under the Apna Rozgar Scheme last year explains this slowdown in growth.[19] Adjusting for this scheme, the auto industry showed a reasonable growth of 11.0 percent YoY during H1-FY17 (**Table 2.4**). This was largely enabled by higher sales of commercial vehicles (i.e., tractors, trucks and buses).

Table 2.4: Vehicles Production and Sale

					%Growth			
	H1-FY17		**H1-FY16**		**H1-FY17**		**H1-FY16**	
Units	**Output**	**Sale**	**Output**	**Sale**	**Output**	**Sale**	**Output**	**Sale**
Passenger Cars	90,222	85,901	92,514	89,824	-2.5	-4.4	48.0	53.0
Exc. Apna Rozgar Scheme	79,803	76,288	72,847	70,308	9.5	8.5	31.5	35.1
Trucks	3,806	3,304	2,326	2,194	63.6	50.6	31.8	34.7
Buses	669	577	499	451	34.1	27.9	65.8	76.9
LCVs, Vans & Jeeps	12,548	11,427	21,423	21,474	-41.4	-46.8	144.6	164.2
Exc. Apna Rozgar Scheme	2,829	2,533	2,552	2,522	10.9	0.4	20.0	39.9
Farm Tractors	21,336	20,933	13,064	12,375	63.3	69.2	-45.9	-40.7
Motorcycles & Three-Wheelers	790,240	789,879	657,283	651,338	20.2	21.3	86.2	84.1

Source: Pakistan Automotive Manufacturers Association

The robust growth in tractors was mainly due to an improvement in the purchasing power of growers due to better prices of rice and cotton; cash disbursement on account of kissan package; subsidy on basic inputs like fertilizer; and a reduction in sales tax on tractors. Similarly, the production of trucks and buses segment has responded to expansion in road infrastructure, and growing trade and economic activities.

Going forward, the industry is also expected to benefit from the launch of new models (e.g. Celerio, Alto 660cc, Revo, Fortuner, Ciaz and Vitara) by existing manufacturers; the revival of dormant players Kia Motors and Hyundai; and the entry of new players.

Steel manufacturers have also been able to persuade China to cut down its production. As a result, Chinese steel exports fell during CY-16, providing support to prices in the international market.

[19] The effect of the Apna Rozgar Scheme, which had inflated last year's growth number for the passenger car segment, is going to end in February 2017. This will help normalize the segment's growth going forward.

Fertilizer

The buildup of large urea inventories last year took its toll on domestic production this year, as output grew by 3.5 percent during H1-FY17, significantly lower than the 15.1 percent rise witnessed in H1-FY16.

Despite some recovery in sales during Q2-FY17 (due to lower prices), urea stocks were still quite elevated at about one million tons by end-December 2016.[20] Going forward, domestic demand is expected to remain strong in response to the government's decision to maintain subsidy on fertilizer.[21] Moreover, production would also benefit as the industry is getting adequate gas supplies.

Pharmaceuticals

The pharmaceutical industry continued its growth momentum from last year, rising by 7.9 percent during H1-FY17. A number of factors helped the industry's growth, like price hikes last year; a decline in raw material costs (due to the euro's depreciation); and ongoing consolidation in the sector.[22,23] Multiple factors, including the current state of health facilities and the government's increased focus on the sector; higher population growth; more clarity after the drug pricing policy; and the launch of new products (like the dengue vaccine) can further fuel the industry's growth.

Electronics

This segment witnessed a sharp turnaround during H1- FY17, recording a growth of 14.5 percent, against a contraction of 8.2 percent during the same period last year. Consumer durables like refrigerators (up 25.0 percent) and deep-freezers (up 54.4 percent) mainly contributed to this improved performance.

Further rise in energy supply in the coming months, increase in consumer financing in a low interest rate environment, better market access for the rural population, expansionary plans of leading players, and foreign investment, all indicate a sustainable trajectory for the industry's growth going forward.[24]

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[20] Urea inventories reached 1.3 million tons by end-September 2016.

[21] Although the government has allowed the export of 0.3 million tons of urea in FY17, its higher cost makes exports challenging: domestic prices are still at a premium of 6 percent to international prices).

[22] ICI Pakistan Limited is in the process of acquiring the assets of Wyeth Pakistan Limited, a multinational pharmaceutical company operating in Pakistan since 1949. And Martin Dow Ltd has acquired the Pakistani operations of Merck KGaA.

[23] The gross margins for the industry crossed 30 percent in H1-FY17 (source: listed companies' financial reports).

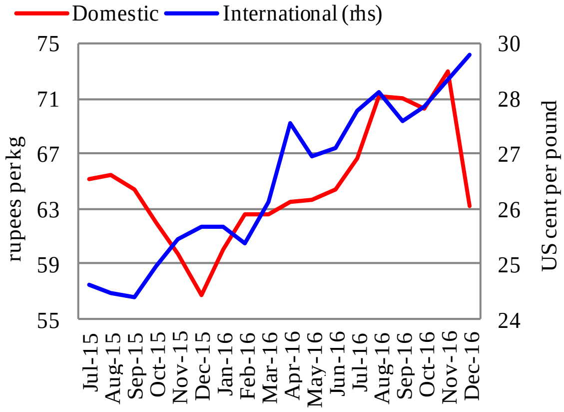
[24] Turkish firm Arcelik has recently acquired the home appliance company Dawlance Pakistan for US$258mn.

Food

During H1-FY17, the food sector grew by 6.9 percent, after contracting by a marginal 0.1 percent in H1-FY16. While cigarette-manufacturing continued to decline (in response to the levying of FED in the FY17 budget), a sharp increase in sugar production supported the overall growth in the food industry.

A better sugarcane crop, and rising domestic prices of sugar, led to an increase in cane crushing.[25] In addition, the government has allowed the export of 0.225 million tons of sugar.[26] These exports have now become increasingly feasible, given the rise in global sugar prices during H1-FY17 (**Figure 2.5**). In addition, manufacturers have increased their focus on power generation through by-products (mainly bagasse and ethanol).

Figure 2.5: Trend in Sugar Prices



Source: Pakistan Bureau of Statistics and World Bank

The soft drink category grew by 18.8 percent during H1-FY17 – higher than the average growth of 16 percent realized in the last five years. A major soft drink firm recently made a US$ 200 million investment to expand its production and distribution capacities. On the other hand, volatility in international cooking oil prices and the drive against hazardous and low quality oil, constrained the production of vegetable ghee and cooking oil.

Textile

The growth in the textile industry remained subdued at 0.1 percent during H1-FY17, compared to 1.0 percent in the corresponding period last year. The export decline and structural bottlenecks constrained the performance of the sector. While the government has recently announced a generous export package for the

[25] While sugarcane output is likely to reach an all-time high of 71 million tons, domestic sugar prices have risen by 11 percent YoY during Jul-Jan FY17.

[26] An inter-ministerial committee would meet in the first week of every month to review the price and stock/export situation of sugar. In case domestic prices exceed their level on December 15, 2016, the committee would recommend to the ECC to stop further exports of the commodity.

sector, it would take some time to make a significant impact on the sector's performance.

Other sectors
During H1-FY17, POL products witnessed a decline of 1.3 percent, compared to an increase of 6.8 percent in H1-FY16. The impact of the policy shift towards upgraded quality petroleum products is holding back growth in this sector. Wood, engineering, and leather industries are finding it difficult to compete with cheap imported products.

2.4 Services
As evident from the partial information available so far, the performance of the services has largely remained on track. For example, the expected recovery in agriculture, steady growth in large-scale manufacturing and strong growth in imports, all suggest an encouraging outlook for *wholesale and retail trade* – the largest subsector in services.

Similarly, in the transport segment, the demand for buses and trucks surged by 27.9 and 50.6 percent in H1 FY17 over the same period in the previous year; this partially offset the impact of culmination of the Apna Rozgar Scheme. At the same time, fuel consumption increased sharply in the country: sale of petrol increased by 20.1 percent YoY in H1-FY17, whereas diesel uptake grew by 15.1 percent – both of these suggest an uptick in commercial activities in the country.

On the other hand, most indicators related to the communications remained subdued, with the exception of the subscription base for 3G/4G services (which increased by 27 percent during H1-FY17). Furthermore, consolidated accounts of PTCL show higher net losses (Rs 1.5 billion) during the period, compared to Rs 1.3 billion last year. This was mainly due to losses posted by PTCL's cellular subsidiary, and additional costs incurred from the voluntary separation scheme.

Within *finance and insurance*, the profits (before tax) of the banking sector remained lower than the last year (**Table 2.5**). That said, advances to the private sector have recovered strongly this year.

Table 2.5: Performance of the Banking Sector (Jul-Dec)
million rupees

	2015	2016
Profit/loss before tax	157.8	151.8
Investments(net)	671.6	-312.2
Advances(net of provision)	263.7	319.0
Deposits	419.3	773.7

Source: State Bank of Pakistan

Therefore, in overall terms, we expect the services sector to grow at the same pace as last year.