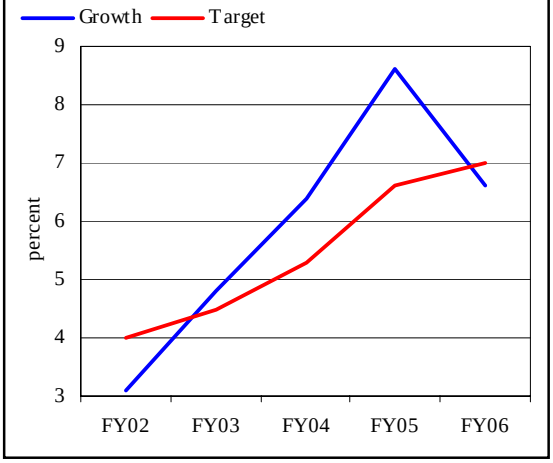
2 Real Sector

2.1 GDP

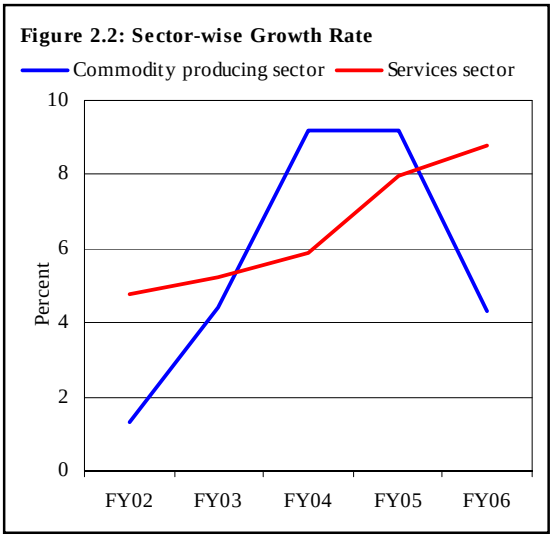
Provisional estimates show that the country's long-term growth momentum remains intact, with real GDP growth exceeding 6 percent for the third successive year (see **Figure 2.1**). While the 6.6 percent real GDP growth for FY06 is relatively weaker than the 8.6 percent growth rate for FY05 and falls marginally short of the 7.0 percent annual growth target, this achievement is impressive given the backdrop of relatively poor crop harvests, the losses due to the earthquake, the impact of high oil prices and rising domestic interest rates (**Box 2.1**).

Figure 2.1: Real GDP Growth



While sustained high oil prices, rising interest rates and persistent inflationary pressures amidst capacity constraints in major industries put pressures on industrial growth, harvests of three major crops (cotton, sugarcane and wheat) witnessed shortfall against the respective targets, these adverse developments dragged down agricultural growth significantly below target. As a result, the commodity producing sector registered 4.3 percent growth during FY06 against the annual target of 7.2 percent, and considerably below the 9.2 percent growth

Figure 2.2: Sector-wise Growth Rate



achieved in FY05 (see **Table 2.1**). In contrast, the services sector exhibited a remarkable 8.8 percent growth during FY06, higher than both, the target of 6.8 percent for the year as well as the 8.0 percent growth witnessed in the preceding year (see **Figure 2.2**).

Indeed, unlike FY05, when the economy experienced a broad based growth, a larger part of the FY06 GDP growth originates from the services sector. Nearly all the sub-sectors of commodity producing sector (except for *livestock* in agriculture and *small scale manufacturing* and *construction* sub-sectors in industry) have shown below the target performance. In contrast all the services sub-sectors showed acceleration and surpassed their respective growth targets, bringing overall share of the services sector in GDP to 52.3 percent in FY06, up from 51.3 percent in FY05.

Table 2.1: Gross Domestic Product
at constant prices of 1999-00; percent

	Growth rate		Contribution in GDP growth	
Sectors	**FY05 R**	**FY06 P**	**FY05 R**	**FY06 P**
Commodity producing sector	9.2	4.3	52.3	31.0
Agriculture	6.7	2.5	17.7	8.1
Major crops	17.8	-3.6	17.4	-4.2
Industry	11.4	5.9	34.9	23.1
Manufacturing	12.6	8.6	26.2	23.6
LSM	15.6	9.0	22.6	17.3
Services sector	8.0	8.8	47.8	69.7
GDP at Factor Cost	8.6	6.6		

P: Provisional, R: Revised
Source: Economic Survey 2005-06

Within the services sector, the highest growth of 23.0 percent was witnessed by *finance & insurance* sub-sector only a little lower than the strong 29.7 percent growth in FY05. *Wholesale & retail trade* registered 9.9 percent growth against 11.1 percent last year (mainly on the back of surge in imports). The *transport, storage & communication* sub-sector saw growth accelerate to 7.2 percent during FY06 against the annual target of 5.8 percent for the year and 3.6 percent growth in FY05. This sub-sector also witnessed US$ 1.7 billion FDI inflow, of which US$ 1.4 billion of FDI was due to the privatization proceeds of the telecommunication utility PTCL. *Community, social and personal services* sector also exhibited acceleration with growth rate moving up from 5.9 percent in FY05 to 6.5 percent during FY06.

On the demand side, private consumption expenditures remained the source of growth in GDP, as is evident in the continued strong growth in imports, even as the performance of the domestic commodity producing sector fell below target (see **Table 2.2**). The acceleration in public consumption is mainly attributed to increased earthquake relief spending during FY06.

Table 2.2: Expenditures on GDP
constant prices of FY00, percent

	Growth rates		Share in GDP (mp)	
	FY05	FY06	FY05	FY06
Consumption	11.9	7.8	83.8	85.0
Private	13.1	8.1	75.6	76.9
Public	1.7	4.8	8.2	8.0
Investment	9.3	10.3	13.9	14.4
Private	9.6	11.0	10.1	10.5
Public	8.5	8.5	3.8	3.9
Changes in stocks	9.3	6.0	1.7	1.7
Net exports	-83.2	-261.6	0.7	-1.1
Exports	9.6	12.9	18.1	19.2
Imports	40.5	23.9	17.4	20.3

Source: Economic Survey 2005-06

Also, while the growth in private sector investment expenditures witnessed an encouraging acceleration during FY06, the growth in public investment stagnated. While both consumption to GDP ratio and investment to GDP ratio increased during FY06, there was a decline in the share of net exports in GDP. Although the growth in exports accelerated relative to a deceleration in imports in real rupee terms, the share of imports in GDP increased at a faster rate than that of exports.

Box 2.1: MTDF 2005-10 and Current Status of Pakistan Economy

Maintaining an annual average growth rate of 7.6 percent is the key objective of MTDF 2005-10, to act as an impetus to poverty reduction in the economy. However, achieving it needs a high level of commitment at policy level keeping in view the performance of economy for FY06, especially the disappointing performance of agriculture as well as industrial sector, resulting in a huge deceleration in overall commodity producing sector. Following are some suggested measures to be applied in the sector, to ensure future compliance of MTDF growth target:

- Introducing reforms in agriculture sector with a focus on research and development, water management and easy credit availability to the sector. Further, information infrastructure is a must to create awareness regarding a broad based application of latest techniques in the sector.
- Enhancing the capacity of industrial units to ensure higher growth in manufacturing.
- Attracting domestic as well as foreign investment by improving policy framework as well as business environment in the economy, especially law and order situation. Secondly, transmitting the resources thus generated to priority sectors like manufacturing.

Although the Pakistan economy has accelerated strongly during the last three years, performance in FY06 suggests weaknesses in the structure of the economy which needs to be taken care of to keep the economy on the right track of higher growth rate, which would act as a first step towards a steady development path.

2.2 Agriculture

Following the disappointing performance of key *kharif* cash crops (cotton and sugarcane), the 4.8 percent agri-growth target for FY06 already looked optimistic, and hopes of nearing this growth rested firmly on the achievement of a substantially above-target wheat harvest as well as a significant improvement in value-added by the *minor* crops and the *livestock* sub-sectors. Although SBP forecasts of a substantial improvement in livestock proved correct, provisional data for the crops sub-sector indicates that the wheat harvest will likely fall short of target, and that the hoped-for-improvement in minor crops will also not materialize. As a result, agri-growth for FY06 is estimated at 2.5 percent, well below the 6.7 percent growth seen in the preceding year (see **Table 2.3**).

Table 2.3: Agriculture Value added

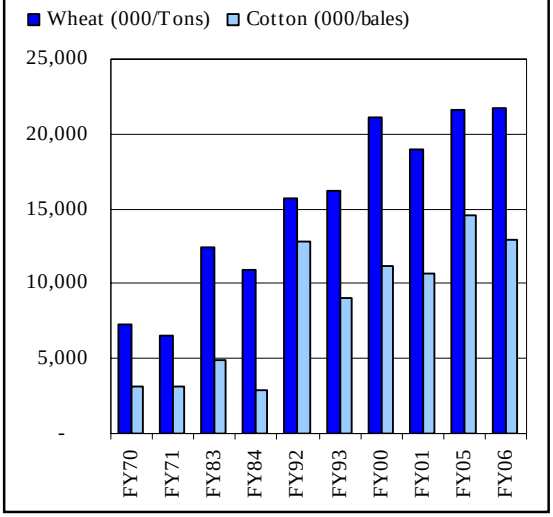
percent growth

	FY05	FY06 T	FY06 P
Agriculture	6.7	4.8	2.5
Major crops	17.8	6.6	-3.6
Minor crops	3.0	4.0	1.6
Livestock	2.3	3.5	8.0
Fishing	2.2	4.0	1.9
Forestry	-30.4	3.1	-9.7

T: Targets; P: Provisional

Source: Economic Survey 2005-06

Figure 2.3: Production Pattern of Major Crops



It is interesting to note that the cropping pattern of Pakistan shows that bumper crop harvests, based on higher yields, have never been repeated in the succeeding year. The sole exception to this trend has been the wheat harvest in 1992-93 (see **Figure 2.3**). Thus, the FY06 crop-sector performance is a repetition of historic trends.[1]

[1] It was also argued in *SBP Third Quarterly Report for FY05*.

Crops

The provisional FY06 estimates indicate that the crops sub-sector will record a 2.3 percent decline in value-addition, largely due to below-target performance of the wheat harvest and aggregate minor crops, which failed to offset the impact of decline in the cotton and sugarcane harvests (see **Table 2.4**).

Table 2.4: Production Targets and Harvests of Important Crops

(million tons, cotton in million bales)

	FY05		FY06		FY07	percent change in		
Crops	Target	Actual	Target	Actual	Target	FY06 over FY05	FY06 Actual over Target	FY07 Target over FY06 Target
Cotton	10.70	14.60	15.00	13.00	13.82	-11.0	-13.3	-7.9
Rice	5.11	5.03	5.00	5.55	5.69	10.3	11.0	13.8
Sugarcane	50.90	47.22	50.10	44.32	50.50	-6.1	-11.5	0.8
Wheat	20.80	21.61	22.00	21.70	-	0.4	-1.4	-
Maize	2.20	2.80	2.90	3.56	3.28	27.1	22.8	13.1

In particular, other important crops witnessed a decline of 3.6 percent as the production of gram and *jowar* was also badly affected due to unfavorable weather and witnessed declines of 38.2 percent and 17.7 percent respectively during FY06.

In contrast, minor crops posted a positive growth of 1.6 percent during FY06, but this was lower than the 4.0 percent growth target for the year as well as the 3.0 percent rise in production during FY05. The latest available data for FY06 shows that the impact of increases in the production of *chillies* (33.3 percent) and *onion* (10.6 percent) (see **Table 2.5**) were partially offset by the fall in the output of pulses,[2] and potatoes (down 17.9 percent). In fact, the decline in the aggregate production of these crops is explainable either by vagaries of nature or lack of incentives (lower prevailing prices of crops). Specifically, the decline in the production of pulses during FY06 is a result of a fall in the area under cultivation due to the relatively

Table 2.5: Production of Selected Crops

(thousand tons)

Crops	FY04	FY05	FY06	% change in FY06 over FY05
Gram	611	868	536	-38.2
Bajra	274	193	221	14.5
Jowar	238	186	153	-17.7
Sesamum	25	30	34	13.3
Tobacco	86	101	120	18.8
Onion	1449	1853	2050	10.6
Chillies	96	90.4	121	33.3

[2] Production of *masoor* pulse witnessed a decline of 13.5 percent, followed by *moong* (12.6 percent and *mash* (9.8 percent).

stagnant prices of pulses last year. The output of potatoes was damaged in the Punjab due to bad weather and in parts of NWFP because of the earthquake.

However, there are some encouraging developments within this disappointing performance by the crops sub-sector. Firstly, despite the under-performance on the annual target, the wheat harvest is a little higher than the 21.6 million tons record harvest of FY05. Moreover, this higher output was achieved despite a marginal decline in the area under wheat,[3] i.e. the improvement was caused by a rise in the yield, which rose by 1.1 percent to 2614 kg/hectare during FY06. The improved FY06 wheat yield was due to: (1) improved irrigation water supply, at sowing and growth period, compared to *rabi* FY05, (2) higher institutional financing, and (3) better distribution of certified seed. Thus, given favorable weather and water supply,[4] and adequate pricing, it seems likely that wheat production could be sustained at higher levels in future.[5]

Similarly, the drop in the sugarcane harvest owes mainly to the price disputes between farmers and sugar mills, rather than poor weather or inadequate inputs. Thus, if the price disputes were to be resolved, it is quite likely that production of this cash crop would bounce back in FY07. Indeed, following the sharp rise in sugar prices many farmers eventually received significant premiums over the sugarcane support price late in the crushing season, and this probably encouraged growers to enhance the planted area by 13.9 percent to approximately one million hectares for the FY07 crop (close to the target set for the year). The sowing was almost completed in time and moderate winter rains improved the crop prospects. If water availability in *kharif* FY07 is around the last year's level, then harvesting of 2.9 percent higher yield over FY06 would be sufficient to achieve the production target of 50.5 million tons for FY07.

Finally, although the cotton production was below target in FY06, it is important to note that harvests in FY05 and FY06 were significantly higher than the average

[3] The decline of 0.7 percent in area was entirely due to delayed crushing of sugarcane.
[4] The wheat yield restrained by lower than normal water supply at reproductive stage and quick day/night temperature fluctuations during Jan-Feb 2006, which lowered weight/size of grain.
[5] While the first two of these factors are substantially subject to the vagaries of nature, government policy can significantly influence the prices received by farmers. While it is true that a market determined price is very important to ensure economic efficiency, it must also be recognized that underdevelopment of a competitive market can adversely distort the returns to farmers. For example, the availability of storage facilities and access to credit could help significantly improve the holding power of farmers allowing them to improve their terms of trade. Similarly, the development of an active commodity futures market can significantly remove the informational asymmetry between intermediaries and farmers, allowing the latter to negotiate better terms for produce.

of the preceding years, principally due to higher yields. However, while it is still too early to make an assessment of the prospects for the cotton crop, there is a risk that the FY07 cotton harvest target may prove optimistic, given that farmers may switch some land from the cultivation of cotton to sugarcane in the FY07 *kharif* season.

Livestock

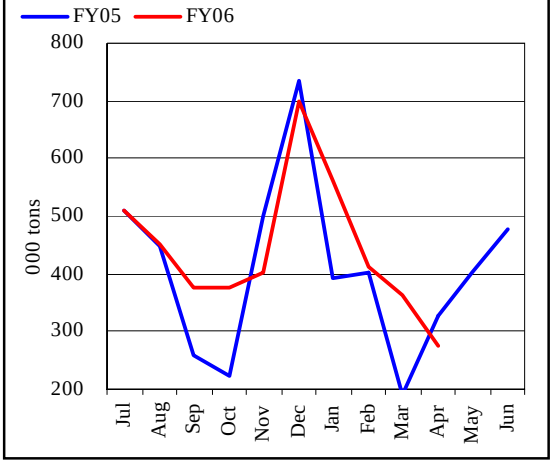
The livestock sub-sector of agriculture posted a significant growth of 8.0 percent in FY06, which is not only higher than the moderate 2.3 percent seen in FY05, but also well above the average growth rates of the 1980s (5.3 percent) and 1990s, (6.3 percent). A substantial increase in the population of animals, probably a result of concerted private and public sector efforts aided this growth. This is particularly reflected in milk production, which increased by 6.3 percent in FY06 compared with a 2.8 percent rise last year.

In recent years, the livestock sector has been recognized as an important contributor to rural incomes. Increased access to institutional credit, availability of technical support from the government and private sector initiatives, all suggest that the contribution of the livestock sector would significantly increase in the years ahead.

Fertilizer Off-take

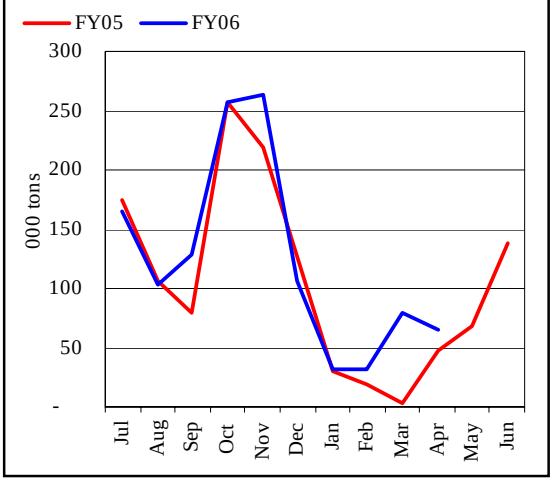
Fertilizer off-take increased strongly by 12.1 percent during FY06 compared to a moderate rise of 7.1 percent last year. The contribution of urea in total fertilizer off-take fell by 0.6 percentage points YoY in FY06, even though its off-take posted a higher growth of 11.1 percent to 4.4 million tons during Jul-Apr FY06 against a 7.7 percent rise in the same period last year (see **Figure 2.4**).

Figure 2.4: Month-wise Urea Off-take



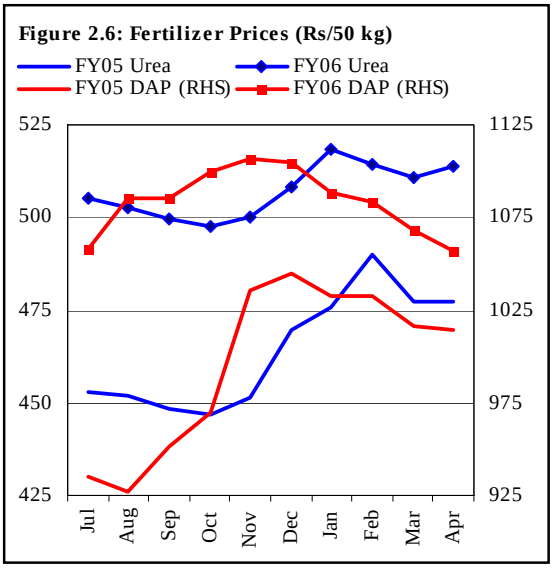
On the back of strong demand, the share of DAP in total off-take increased by 0.6 percentage points YoY during Jul-Apr FY06. Off-take recorded a healthy rise of 15.6 percent YoY to 1.2 million tons in Jul-Apr FY06. The DAP followed its usual seasonal pattern and witnessed strong off-take during July-December (*kharif* and *rabi* seasons) (see **Figure 2.5**).

Figure 2.5: Month-wise DAP Off-take



It is encouraging that the off-take of fertilizers increased sharply, despite rise in prices. The prices of urea showed a continuous rising trend through FY06 cropping seasons while the rise in the prices of DAP slowed down somewhat since January 2006, due to both an ease in demand and a deceleration in international prices (see **Figure 2.6**).

Figure 2.6: Fertilizer Prices (Rs/50 kg)



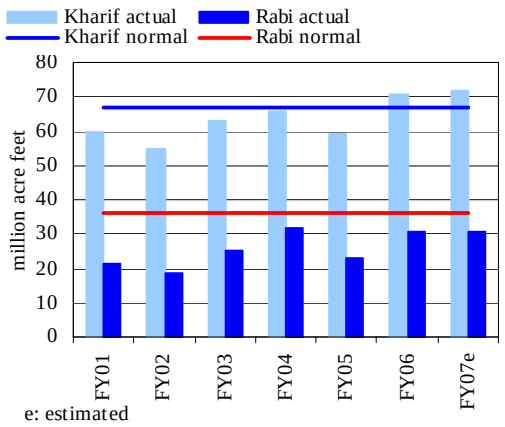
Water Availability

The winter rains during January 2006 improved the irrigation water availability at canal heads by 1.6 percent YoY to 71.86[6] million acre feet (MAF) for *Kharif* FY07. This improved water availability is estimated to be 4.8 MAF over and above the normal levels of 67.1 MAF, which significantly improves the growth prospects for the FY07 *Kharif* crops (see **Figure 2.7**).

[6] Estimated by IRSA.

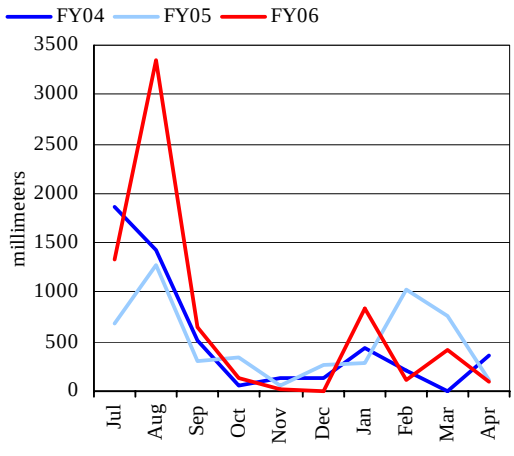
Rainfall increased by 35.6 percent YoY during Jul-Apr FY06 against only a 0.1 percent increase in the same period last year, the impact of higher rainfall during Jul-Sep 2005 was particularly notable (see Figure 2.8). These higher rains coupled with the current hot spell across the country, which enhanced the snow melt in the mountains, led to a considerable increase of water inflow in the Indus, Kabul, Jhelum and Chenab rivers.

Figure 2.7: Water Availability



Unfortunately over the years the water storage capacity in the country has declined considerably. Specifically the storage capacity of the existing water reservoirs Tarbela, Mangla and Chashma had declined to 13.48 MAF by 2005 from their original capacity of 18.37 MAF. In this background and to meet the growing challenges in water management in Pakistan, the Diamer Basha Dam has been recently inaugurated. At completion this would add storage capacity of 6.4 MAF (see **Box 2.2**).

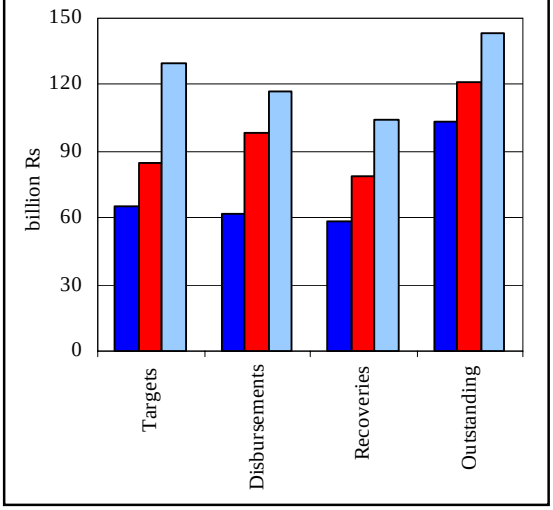
Figure 2.8: Monthly Rainfall



Credit Disbursement

The growth in agriculture credit disbursement slowed to 25.7 percent YoY (to Rs 116.96 billion) in Jul-May FY06 as against a robust growth of 50.4 percent YoY in the corresponding period of FY05. This slower growth was anticipated, as evident from the 19.6 percent growth target set for the year, following the high base set by the strong growth in the preceding two years (see **Figure 2.9**). The small underperformance till May 2006 relative to the target probably reflects the rising interest rates in the economy, but it is likely that the credit off-take for the full year will not be substantially below the target (see **Table 2.4**).

Figure 2.9: Credit to Agriculture Sector (Jul-May)



A break-up of the credit off-take for July-May FY06 reveals that the growth in disbursements slowed for almost all institutions relative to July-May FY05.

Table 2.6: Share in Agri-credit - Jul-May in percent

	FY04	FY05	FY06
CBs-5	46.3	48.0	51.1
ZTBL	41.1	34.8	33.2
PPCBL	9.0	6.6	3.9
DPBs	3.6	10.6	11.8

Moreover, the better performance of commercial banks (CBs) and domestic private banks (DPBs), meant that these institutions gained market share at the expense of specialized institutions (see **Table 2.6**). Specifically, the credit disbursement by ZTBL decelerated to 19.7 percent YoY in Jul-May FY06 compared to 27.5 percent YoY rise in the same period of FY05. The share in credit disbursement of PPCBL continued to decline, falling to 3.9 percent during Jul-May FY06 against 6.6 seen in Jul-May FY05.

Credit Recoveries

Reflecting the lower growth in loan off-take, the growth in loan recoveries also decelerated to 32.8 percent YoY during Jul-May FY06 compared with 34.8 percent YoY in the same period last year. The slowdown in recoveries, however is smaller than that in the disbursements and, as a result, recoveries as percent of disbursements have increased from 84.5 percent YoY in Jul-May FY05 to 89.3 percent YoY in Jul-May FY06 (see **Table 2.7**).

Table 2.7: Recovery as Percent of Disbursement – Jul-May

percent

	FY04	FY05	FY06
Total CB's	75.9	79.7	84.2
Specialized banks	113.8	102.4	99.5
DPBs	60.2	50.6	79.5
Total	**94.3**	**84.5**	**89.3**

Although the recovery ratio dropped in case of three commercial banks during Jul-May FY06 relative to the preceding year, in aggregate, recoveries have been strong, which is an important indicator of the sustainability of the growth in agri-credit. Indeed, the DPBs, which aggressively entered the agri-credit business market in recent years, have seen a strong improvement in their recovery ratio compared to the preceding years. The recovery ratio of the specialized banks has been particularly good (see **Table 2.7**).

Credit for Tractors

A notable development in agri-credit is the significant fall in tractor financing during Jul-Mar FY06, even as the domestic tractor production jumped by over 16 percent in the same period last year. The decline in tractor financing was probably attributable to a significant rise in interest rates. The break-up of loans by category of institutions reveals that the decline was evident in specialized banks and DPBs, while CBs increased tractor financing by 10.5 percent YoY during Jul-Mar FY06 (see **Table 2.8**).

Table 2.8: Tractors Financed by Banks (Jul-Mar)

million Rupees

	FY05		FY06	
	Tractors finance (Nos)	Amount disbursed	Tractors finance (Nos)	Amount disbursed
CBs*	6,396	2,031.6	6,526	2,245.7
ZTBL	7,414	1,888.6	6,122	1,665.9
PPCBL	1,338	580.3	322	122.7
DPBs	1,821	617.8	825	289.8
Total	**16,969**	**5,118.3**	**13,795**	**4,324.1**

* ABL, HBL, MCB, NBP and UBL

Box 2.2: Water Management Issues in Pakistan

Pakistan built dams in the sixties and seventies, which today are incapable of meeting the rising demands in the agriculture and energy sector. The Tarbela reservoir which was built in 1976 with an original storage capacity of 11.62 MAF has lost its storage capacity by 3.05 MAF. Mangla dam was constructed in 1967 with a storage capacity of 5.88 MAF. It, too, has lost 1.41 MAF and this loss would further extend to 1.51 MAF by 2010. The Chashma reservoir was completed in 1971 with a storage capacity of 0.87 MAF. Its capacity has squeezed to 0.44 MAF and it will further shrink in the years to come. The government has planned a number of large reservoirs which will increase the supply of water, manage river inflows and control floods.

Accordingly, the first reservoir under construction is the Diamer Basha Dam. It was inaugurated on 27 April 2006 and, on completion is expected to increase the irrigation water reservoir capacity, enhance water availability at farms, get and generate hydel power. It is located on the Indus River, 315 km upstream from Tarbela Dem, 163 km and 40 downstream from Gilgit and Chilas. The dam would have maximum height would be 281 meters and be 990 meters long. Its estimated cost is $6.5 billion in FY05. The dam is expected to be completed in a minimum period of 10-12 years. At the completion of the project it will increase the surface water availability by about 6.4 MAF annually to supplement irrigation supplies to the agriculture sector during shortages and also provide 4500MW of electricity. It would also help to control floods and manage river inflows.

Table B1: Irrigation Water Facts

million acre feet

Water availability in Indus River System	142
Supply of water through canals	104
Losses	42
Supply of water at farm get through canals	62
Water supply by underground water resources	44
Total supply of water at farm get	106
Total water requirement for agriculture sector	115
Shortages of water	9
Flow of water in sea annually	35
River flow in Kharif	85%
River flow in Rabi	15%
Water requirement in Kharif	60%
Water requirement in Rabi	40%

2.3 Industry

Provisional government estimates suggest that the overall value addition by industry witnessed a rise of 5.9 percent in FY06, significantly lower than both, the 9.5 percent target for the year and the 11.4 percent growth in FY05. This deceleration in industrial growth was contributed by all sub-sectors other than *small scale manufacturing* and *slaughtering* (see **Table 2.9**); while growth in the former accelerated[7] in FY06, growth in the latter was kept unchanged at 2.4 percent.

Table 2.9: Industrial Growth and Sectoral Share

percent

	FY05^{R}	FY06^{P}	FY05^{R}	FY06^{P}
	Growth Rates		Share	
Industry	11.4	5.9	100.0	100.0
Manufacturing	12.6	8.6	68.3	70.0
Large-scale	15.6	9.0	47.5	48.9
Small-scale	7.5	9.3	15.8	16.4
Slaughtering	2.4	2.4	4.9	4.8
Mining and quarrying	9.6	3.8	10.2	10.0
Construction	18.6	9.2	8.2	8.4
Electricity & gas distribution	3.5	-8.4	13.4	11.6

Source: Economic Survey 2005-06

P: Provisional R: Revised

Within industry, the highest growth of 9.2 percent was observed by the construction sub-sector during FY06. While this growth is higher than the annual target of 7.5 percent, it is nonetheless significantly lower than the robust 18.6 percent growth witnessed in the preceding year.

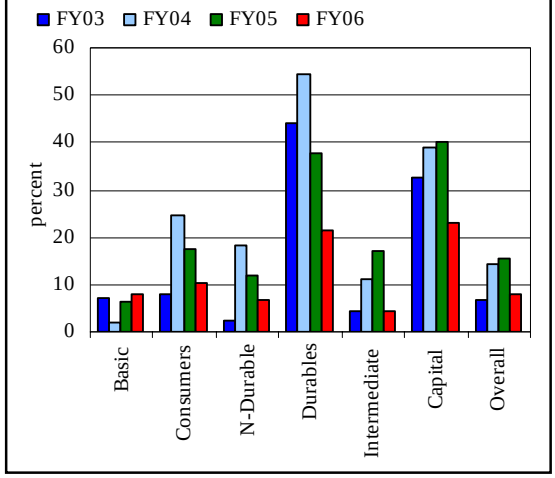
In contrast, *electricity & gas distribution* is the only sub-group of industry to register a fall in value addition during FY06. The value addition by *electricity & gas distribution* declined by 8.4 percent in FY06 in contrast to the 3.5 percent growth recorded in the preceding year. As in the previous year, the negative growth in this sub-sector mainly reflects the higher costs of inputs such as oil and gas.

[7] According to Small and Household Manufacturing Industries (SHMI) surveys, the share of cotton products manufacturing in small scale manufacturing is about 14 percent. This portion of small scale sector has been raised at the growth of non-mill cotton products (20 percent) provided by the Textile Commissioner. The overall growth rate of this sector has changed from 7.5 percent to 9.3 percent.

Analysis of Industries by End-Use (UBQI)[8]

During the first three quarters of FY06, the *User based Quantum Index* (UBQI) registered a growth of 8.0 percent, which is significantly lower than the 15.4 percent growth witnessed in the corresponding period of last year (see **Figure 2.10**). The slowdown in all sub-indices (except of *basic* sub-group) of UBQI imitates the development seen in the *LSM* and *mining & quarrying* sub-sector. The *basic goods* recorded the acceleration in output in Jul-Mar FY06, mainly due to acceleration in *electricity generation* and some industries of *mining & quarrying*, while the *consumer goods, intermediate goods* and *capital goods* industries witnessed a deceleration in growth compared to the corresponding period last year.

Figure 2.10: Growth of UBQI (Jul-Mar)



The biggest slowdown of 16.9 percentage points was observed in the capital goods industries during Jul-Mar FY06 over the same period of the previous year. The major contribution in the slowdown of *capital goods* stemmed from the decline in the production of *buses, power looms* and *electric motors* as well as deceleration in the production of *tractors, LCVs, electric transformers* and *wheat thrashers* during the first three quarters of FY06.

Similar to *capital goods*, a deceleration was recorded in the growth of *intermediate goods* in Jul-Mar FY06. Most of the slowdown in the growth of output of *intermediate goods* came from the lower production of *textile products, basic metal industry, petroleum products, fertilizers products, etc.*

Consumer goods group grew at a rate of 10.5 percent in Jul-Mar FY06 as against a growth of 17.6 percent during the corresponding period of the preceding year. This slow growth is attributed to both *durable* as well as *non-durable* sub-groups.

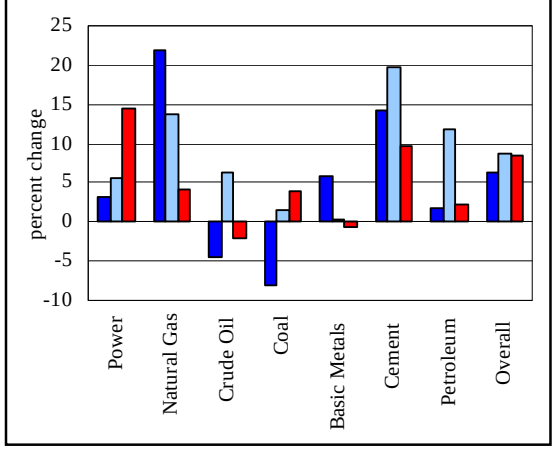
[8] Due to data constraint on *mining & electricity*, estimated production figures extrapolated using the available data (for Jul-Feb FY06,) were used for the month of March 2006.

The decline in the production of *sugar*, *vegetable ghee & cooking oil*, and in some items of the *chemical* group are the main reasons for the deceleration in the *consumer non-durables* group. Similarly, the deceleration in *electronics* products and *rubber* industry output slowed down the growth of *consumer durables goods* in Jul-Mar FY06.

Infrastructure Industries Index (III)

The overall performance of *infrastructure industries* measured by the composite index of seven infrastructure industries[9] slightly weakened during the first nine months of FY06. The III registered an increase of 8.5 percent in Jul-Mar FY06 marginally less than 8.8 percent growth during the corresponding quarters of the previous year (see **Figure 2.11**). This deceleration is mainly attributed to a fall in the production of *basic metal* and *crude oil* during Jul-Mar FY06, which was partially offset by positive contributions by *electricity generation*, *coal*, *natural gas*, *cement* and *petroleum* products.

Figure 2.11: Infrastructure Industries (Jul-Mar)



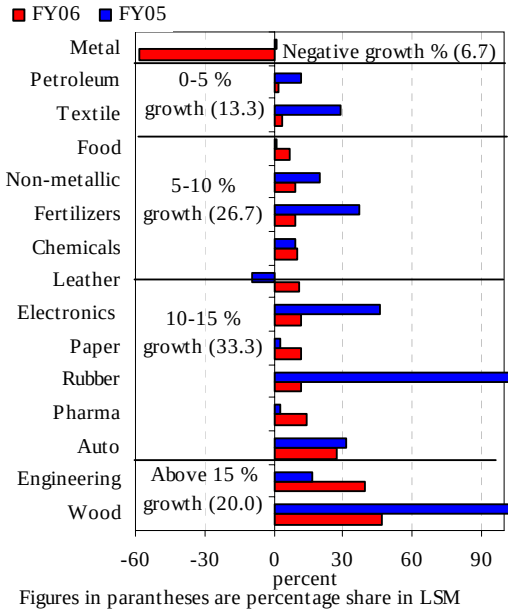
Large-scale Manufacturing (LSM)

The FY06 annual growth target for LSM was set at 13 percent, a little below the 15.6 percent growth recorded in FY05. However, provisional estimates indicate that *LSM* growth slowdown has been substantially greater than anticipated, with growth falling to approximately 9 percent. Moreover, the provisional data for July-March FY06 indicates that the deceleration is quite broad based (see **Figure 2.12** & **Table 2.10**), with only six LSM sub-groups (that have an aggregate weight of 36.6 percent in LSM) witnessing growth higher than that in the corresponding period of the previous year.

[9] These industries are electricity generation, natural gas, basic metals, petroleum products, crude oil, cement and coal.

Of these, the most significant is the *food* group (that has second highest weight in LSM), which witnessed a 7.0 percent growth during Jul-Mar FY06 as against 1.5 percent growth in the same period of FY05. This acceleration was contributed by the substantial increase in the production of *beverages* and *tea (blended)*, which was partially offset by the drag of a small slowdown in the production of *vegetable ghee & cooking oil* as well as a sharp decline in sugar production.

Figure 2.12: Growth in Selected LSM Groups (Jul-Mar)



Figures in parantheses are percentage share in LSM

The output of *beverages* increased by 42.1 percent in Jul-Mar FY06 as compared with a growth of 17.4 percent in the corresponding period of the preceding year. On the other hand, the production of *vegetable ghee & cooking oil* grew at 13.2 and 17.6 percent in Jul-Mar FY06 respectively as against 14.3 and 28.6 percent growth for Jul-Mar FY05. One driver of the sustained strong growth in the production of these two products was a significant rise in exports to Afghanistan.[10] The government has taken some measures to bring the Federally Administered Tribal Area (FATA) and Provincially Administered Tribal Area (PATA) into the tax net (see **Box 2.1**), shifting duty on *ghee* and *cooking oil* from production to import stage. This would eliminate tax evasion from the *ghee*, thus putting an end to the shortcomings/disadvantages faced by ghee manufacturing units in settled areas.

[10] During Jul-Dec FY06 the export of ghee reached to US$ 53.7 million, up by a substantial 358.8 percent over the same period of last year based on the latest commodity wise data of trade is available for Jul-Dec FY06.

Similarly, the cigarettes industry saw a drop to 4.7 percent growth in Jul-Mar FY06 in contrast to the 10.5 percent growth during the first three quarters of the preceding year. This deceleration is largely explainable by the substantial 64.8 percent decline of cigarettes export volumes during the period.

In contrast to the other food industries, sugar production actually declined for the second successive year.[11] According to the FBS data, output fell by 2.4 percent during Jul-Mar FY06 as against a fall of 21.0 percent during the corresponding period of the previous year. This reflects the smaller sugarcane harvest, and unnecessary delays in the crushing season and farmers' increased preference to making "*gur*" (*dehydrated sugar*), following continuing disputes between farmers and sugar mills owners over the pricing of sugarcane. It is interesting to note that despite low *sugar* production and *sugar* shortage in the economy, the manufacturers have been building their inventories.

Figure 2.13: Sugar Production and Sale (Jul-Mar)

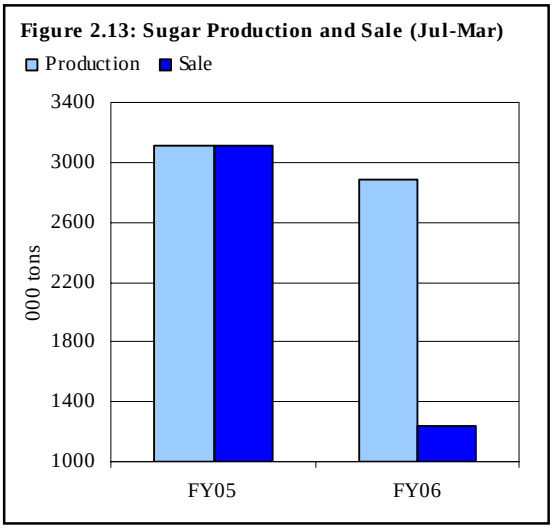


Table 2.10: Distribution of Sub-sector Growth Rates (Jul-Mar)

numbers

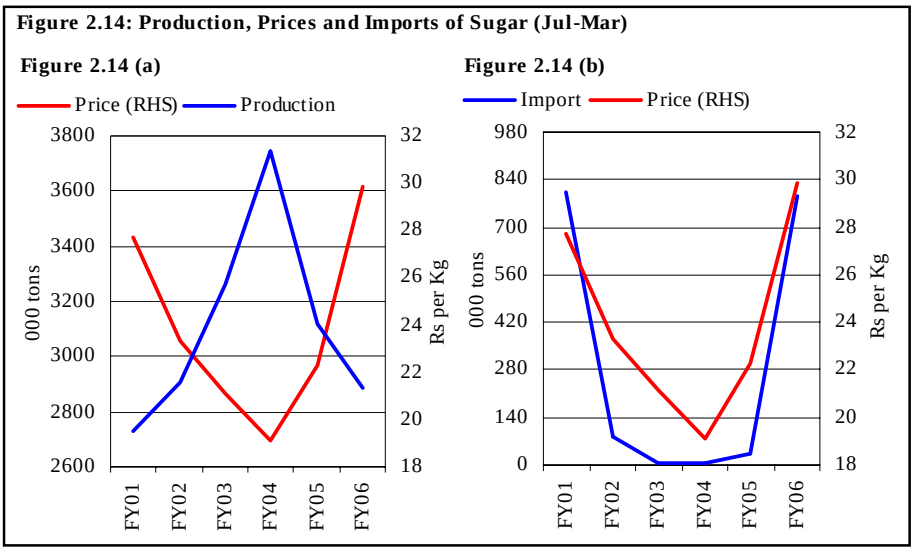
	FY06	FY05
Negative growth	1	1
0-5 % growth	2	4
5-10 % growth	4	1
10-15 % growth	5	1
Above 15 % growth	3	8

During the first three quarters of FY06, producers have sold only 43.1 percent of sugar produced, which is far less than the 99.7 percent of production sold in the same period of the previous fiscal year (see **Figure 2.13**).

[11] Pakistan Sugar Mills Association reported 7.3 percent decline during Jul-Mar FY06 as compared with 16.7 percent fall in output during the same period of last year.

The decline in sugar production as well as lower sale of sugar by manufacturers pushed up the sugar prices by 33.9 percent in the domestic market during Jul-Mar FY06 as compared with 16.6 percent increase in the same period of last year[12] (see **Figure 2.14 a**). To keep the sugar prices at reasonable level or to control the sugar price crisis in the economy, the government has encouraged sugar imports. In Jul-Mar FY01, the quantity of sugar imported was 803.3 thousand tons, the highest import of sugar in the corresponding periods of the last six years. Although the government has imported a significant amount of 789.5 thousand tons of sugar during Jul-Mar FY06, contrary to the FY01 trend, ease in the prices of sugar is yet not evident (see **Figure 2.14 b**).

Figure 2.14: Production, Prices and Imports of Sugar (Jul-Mar)



As with the food group industries, the leather industry observed remarkable acceleration in output during Jul-Mar FY06, with output rising to 10.8 percent as compared with 9.5 percent decline in production in the same period of FY05. This acceleration was contributed by all three components of the leather industry, which recovered very well from negative growth in Jul-Mar FY05 to positive growth in Jul-Mar FY06. The government has taken many measures (*see First Quarterly Report 2005-06 for details*) for the betterment of the leather industry. As a result, 44.0 percent rise of leather products export was observed during the

[12] The government has exempted the 10 percent sugar mills' stocks from sales tax that they will provide to the Utility Store Corporation (USC) for selling at its outlets at subsidized rates of Rs 29.50 per kg. At present there is about 10 percent sales tax on sugar sales. The mills were selling stocks at around Rs 36 per kg which included Rs 4 to 5 per kg sales tax.

first nine months of the current fiscal year as against a 20.6 percent rise in export in the corresponding period of last year.

The *pharmaceutical* sub-sector also saw accelerated growth. During the first three quarters of the current fiscal year, this industry witnessed 14.2 percent growth as compared with a low growth of 2.5 percent during the same period of the previous year. The high local demand (earthquake affected areas), increase in external demand, entry of new companies[13] and expansion in production capacity by existing units are the main factors for the growth of the *pharmaceutical* industry. All sub-sector of *pharmaceutical* except for *capsules* and *tinctures/spirits* witnessed acceleration in output for the period. Within *pharmaceutical*, the maximum growth of 29.9 percent was registered in *injections* production during the Jul-Mar FY06 as against 2.1 percent small growth in the first nine months of the previous year. Production of *chemicals*, which is a sign of industrial activities, grew at the rate of 9.9 percent in Jul-Mar FY06 compared to a slight low of 9.3 percent in the same period last year. The growth in *chemicals* was mainly contributed by *soap & detergents* and *toilets soap* which are the bi-products of *vegetable ghee and cooking oil*. While *textiles*-related *chemicals* such as *caustic soda, sulphuric acid* and *hydrochloric acid* had shown a deceleration trend as seen in the *textiles* sector.

In the same way, the *paper & board* sub-group also witnessed acceleration with 11.9 percent growth in output in Jul-Mar FY06 in contrast to 3.2 percent growth during the corresponding period of FY05. The increased growth in *paper & board* output during the current fiscal year was mainly due to an expansion in production capacity by some manufacturers. However, strong domestic demand was met by an increase of 15.1 percent in imports of *paper & board* products in Jul-Mar FY06 as against a 12.0 percent YoY rise in imports during the same period of the previous fiscal year.

Unlike the *papers & board* sub-sector, despite deceleration, the *automobiles* industry observed another year of robust growth. Production grew at 27.7 percent rate during Jul-Mar FY06 considerably lower than 31.5 percent growth in the same period of the preceding year.[14] Credit availability and rising incomes were the main causes for the remarkable performance of the *automobiles* industry.

[13] 10 new pharmaceutical companies have been set up in Karachi, 45 in Punjab and 10 in the NWFP in recent times.

[14] PAMA reported 27.8 percent growth up to Jul-Mar FY06 as compared with 24.3 percent rise in output during the same period of last year; the difference may be due to reporting of unit. PAMA reports only members' production while FBS reports members as well as non members' production.

Except for *jeeps & vans* and *buses*, all automobiles sub-groups recorded positive growth in output during the first nine months of FY06 (see **Table 2.11**).

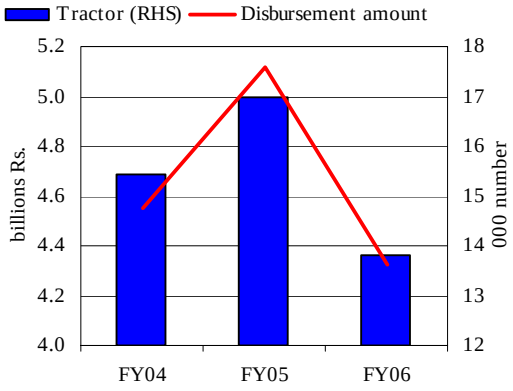
Within the *automobile*s industry, the *cars* and *trucks* sub-sectors saw acceleration in production during Jul-Mar FY06. During the first nine months of FY06, *cars* industry recorded 29.9 percent growth YoY compared with 26.1 percent YoY rise in Jul-Mar FY05 on the back of significant increase in the production capacity.[15] This acceleration is the result of a continued growth momentum in high capacity engine cars (up by 36.4 percent) and a turn around in the production of low capacity engine cars (which rose by 25.4 percent during Jul-Mar FY06, in contrast to a fall of 1.3 percent in Jul-Mar FY05).

Table 2.11: Automobile Industry During Jul-March

Numbers

	Production		
	FY04	**FY05**	**FY06**
Cars 1300cc and above	27,477	36,799	49,518
Cars less than 1300cc	50,977	50,290	62,960
Jeeps & vans	4,005	10,271	9,098
LCVs	5,839	11,294	20,564
Trucks	1,411	2,138	3,268
Buses	1026	2,282	518
Tractors	25,382	31,335	36,383
Motorcycles	213,778	302,063	381,341

Figure 2.15: Tractor Financing (Jul-Mar)



On the other hand, the production of *tractors* grew at a low pace during the first three quarters of the current fiscal year. This group recorded 16.3 percent growth in output during Jul-Mar FY06 as compared with 24.5 percent growth during Jul-Mar FY05. This slowdown was attributed to a rise in interest rates and

[15] The Land Utilization Department has issued Provisional Allotment Letter of 400 acres of land to Prime Transport Limited (PTL) to establish a car assembly/manufacturing plant at Dhabeji, which will produce the famous Black Cabs of UK in Pakistan with rated capacity of 6000 units per annum on single shift basis. The vehicles will be operated by PTL as Satellite Controlled Taxi Service in all major cities of Pakistan and would be exported to African, Asian and Middle Eastern countries from Pakistan. This car manufacturing plant would be established in the proposed industrial estate comprising of an area of 13,000 acres at Dhabeji. Mercedes Benz is also establishing their plant of assembling/manufacturing buses, trucks and cars at Karachi.

subsequently a decline in tractor financing both in terms of amount as well as numbers by the banks (see **Figure 2.15**).

The *automobiles* industry performed very well during the last three years but has been unable to meet the rising demand of *automobiles* in the economy. To fill this gap, the government has taken many budgetary measures in the recent years, which has changed the market scenario in favor of consumers with the availability of a variety of imported second-hand cars, jeeps, LCVs, pickups, vans, etc. The leasing and bank financing companies, who have boosted the buying confidence for locally assembled cars, are now also targeting used and new imported cars.

However, there is a dilemma here. Liberal import of cars adds to the pressure on the trade balance, but on the other hand, if domestic industry is protected for an extended period, the absence of competition could lower efficiency gains and reduce the consumer surplus. The one probable solution of these problems is imposition of substantial domestic taxes to discourage consumption. While this policy would add to revenues, lower addition of vehicle will lessen the problems of traffic jams and pollution as well. However, any such policy is strongly conditional upon the significant improvement in the urban transportation system.

A sharp deceleration was seen in the *petroleum* and *lubricant* products (POL), which recorded only 2.3 percent growth during Jul-Mar FY06 as compared to 11.7 percent rise in the same period of the last fiscal year. The high *POL* prices (which are up by approximately 38.8 percent in Jul-Mar FY06 over Jul-Mar FY05)[16] are the main factors behind this slowdown. During the first three quarters of the current fiscal year, the imports of *POL* products declined by 5.5 percent as against 14.5 percent rise during the same period of the previous fiscal year.

Table 2.12 shows that within *POL* sector, *furnace oil* (FO) imports recorded an acceleration with 7.4 percent growth in Jul-Mar FY06 as against 6.7 growth in output in Jul-Mar FY05, generally because of higher consumption by electricity producers. *Jet fuel* recorded the highest 14.2 percent growth in Jul-Mar FY06 as compared with 17.1 growth during the same period of last year. The rise in the production of *jet fuel* is mainly due to increasing domestic consumption on the back of the expansion in activities of domestic airlines as well as exports to Afghanistan. Contrary to *jet fuel, high speed diesel* which has the largest contribution in *petroleum* products registered 2.8 percent fall in the production during Jul-Mar FY06 in contrast with 19.4 percent growth during Jul-Mar FY05,

[16] It may be noted that even when domestic prices of key fuels are fixed, most of the industrial inputs (oils and lubricants) witnesses increases with international prices.

mainly due to 40.3 percent upward revision in the domestic prices during Jul-Mar FY06.

Table 2.12: Production of POL Products During Jul-Mar
million tons

	FY05	FY06
Jet fuel	847593	968228
Kerosene	142953	160831
Motor spirits	1013410	902817
High speed diesel	2574228	2503001
Light speed diesel (n.o.s.)	135708	94907
Furnace oil	2370051	2546107
Lubricant oil	154073	152371
Jute batching oil	4622	2864
Solvent naphtha	547295	660456
Petroleum products (n.o.s.)	502438	494040

Similar to the petroleum industry, a slowdown was also seen in the *textiles* sub-sector, which has the largest weight in LSM. During Jul-Mar FY06, the sector saw production rise by 4.0 percent, significantly lower than the 28.7 percent growth seen in the same period of last year. A substantial contribution to this slowdown was from a deceleration in the production growth of cotton yarn & cotton cloth and a decline in the production of ginned cotton. Specifically, the production of these textile items grew by 11.2 percent, 0.1 percent and -10.9 percent in Jul-Mar FY06, compared to the robust 18.3 percent, 39.6 percent and 45.3 percent growth respectively recorded during Jul-Mar FY05.

The deceleration in *textiles* mainly owes to low cotton harvest, high prices and disruption in gas supply during Dec-Feb FY06 by Sui Northern Gas Pipelines Limited (SNGPL) to about 40-42 captive power plants (CPP) in the areas of Sheikhupura, Faisalabad and Gujranwala where various textiles and chemical units are located. However, it is interesting to note that despite a slowdown in the production growth of *textiles*, the exports of textiles manufacturing increased by 18.2 percent during the first nine months of the current fiscal year as compared with a moderate 4.2 percent rise in the same period last year. The jump in exports may be a reflection of (1) aggressive marketing by the exporters in post-MFA regimes by utilization of inventories and (2) significant growth in the export related production of small-scale textiles units.

The *fertilizer* industry also saw deceleration as growth fell sharply to 9.8 percent during Jul-Mar FY06, lower than 37.2 percent growth witnessed in Jul-Mar FY05. The main contributor for this slowdown was *phosphatic fertilizer*, which grew by 12.0 percent during the first nine months of current fiscal year as against 59.7 percent growth in Jul-Mar FY05. The slowdown in *fertilizer* was mainly due to capacity constraints: the capacity utilization for urea is already over 100 percent, and rising domestic demand is increasingly being met through imports. *Fertilizer* imports rose to 1.7 million metric tons during Jul-Mar FY06, which is 49.5

percent higher than in July-March FY05. In the next few years, a significant rise in the production of *fertilizer* is expected after the completion of additional plants of fertilizers,[17] which will reduce the dependency on imported fertilizer.

Construction activities have impacted both directly on employment generation and indirectly on allied industries such as non-metal industry, iron & steel, paint & varnishes, etc. The performance of the construction industry can be judged on the basis of its performance indicators (see **Table 2.13)**, which shows that all indicators positively contributed in construction activity but it was less than last year's contribution. In other words we can say there is slowdown in the economic activities of construction sector. Construction auxiliary industries, especially non-metal industry, recorded deceleration in output with 9.5 percent growth during Jul-Mar FY06 as compared with 19.7 percent growth during the same period of last year. The immensity of this slowdown replicated from a deceleration in growth of the cement industry, where output growth declined to 9.8 percent in Jul-Mar FY06, compared to a robust 19.8 percent growth during the same period of FY05 (see **Figure 2.16**).

Table 2.13: Construction: Performance Indicators (Jul-Mar)

		FY04	FY05	FY06
Domestic Cement dispatches	000 tons	9009.7	10640.9	12192.8
Private credit for construction (flow)	million rupees	-757.0	9000.0	9015.0
Public sector development expenditure	billion rupees	85.0	137.9	204.2
Foreign direct investment *	million US$	32.2	22.0	93.0
Production of steel (Pakistan Steel)	000 tons	777.129	782.078	445.108
Import of iron & steel	000 tons	1299.6	2122.1	2938.1
Import of construction & mining machinery	million rupees	4201.5	6365.8	8447.5
Change in cement price		-1.8	2.9	13.5

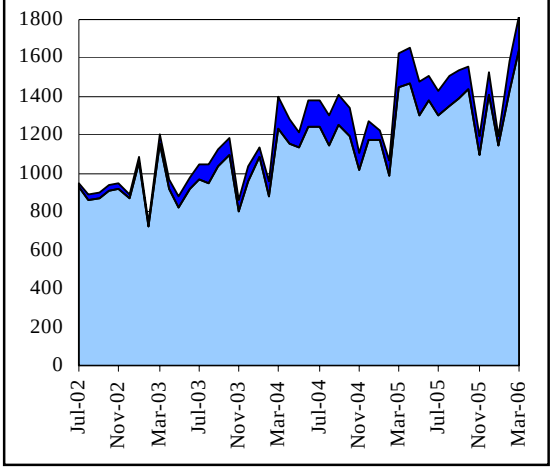
* It includes the FDI in construction, cement, metal and basic metal group.

The local cement dispatch attained 12.2 million tons during the first nine months of FY06, from 10.6 million tons in Jul-Mar FY05, mainly due to high domestic price and expansion in production capacity. Similarly, external demand reached 1.2 million tons during Jul-Mar FY06, marginally higher than 1.1 million tons during the first three quarters of the last fiscal year. To reduce the price in the domestic market, the government has announced some measures, such as: withdrawal of sales tax on cement export, temporary ban on cement export,

[17] The Fatima Fertilizer Complex (FFCL), a US$ 475 million project being built at Machi Goth, is to have a capacity of producing 1.580 million tons of urea, calcium, ammonium nitrate and phosphatic fertilizers like NP and NPK (substitute of DAP).

subsidy on cement import, allowed import from India, etc. (for details **see Box 2.3**).

Figure 2.16: Cement Consumption (000 tons)



As with the *cement* industry, the *tyres & tubes* industries also witnessed a slowdown in output with 12.2 percent growth during Jul-Mar FY06 as compared with 14.9 percent YoY growth seen in the first nine months of FY05. The major impetus to this deceleration came from a fall in the production of *motor tubes* by 42.6 percent during Jul-Mar FY06 in contrast with 20.2 percent decline during the corresponding period of the preceding year. The rising demand of *tubeless tyres* in *automobiles* is the major reason for this decline in *motor tubes* industry during Jul-Mar FY06. The continuously extraordinary performance of *automobiles* industry generates the strong domestic demand of *tyres & tubes* which was met by 11.0 percent rise in the import of rubber *tyres & tubes* in Jul-Mar FY06 as against 25.2 percent rise in imports during Jul-Mar FY05.

The production of *metal* industries witnessed a fall of 58.6 percent in the first nine months of the current fiscal year as compared with a minor increase of 1.5 percent in production in the same period of the preceding year (see **Figure 2.17**). The fall in the production of *iron & steel* sector was mainly caused by the technical problems in Pakistan Steel.[18, 19] The rising demand of *iron & steel* was met through imports, which saw an increase of 41.5 percent in Jul-Mar FY06.

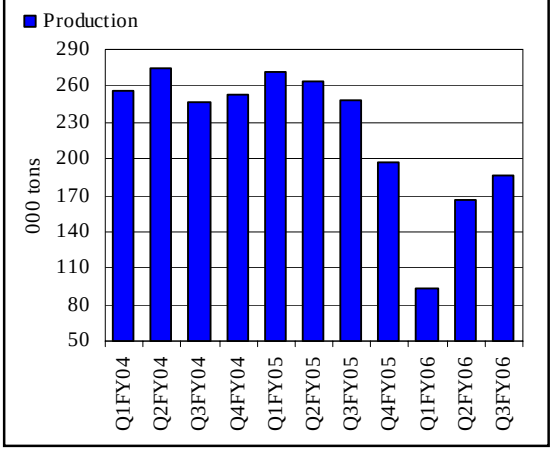
[18] Two coke oven batteries of Pakistan Steel (PS) are out of order since April 2005. The PS has given tender for their repairing work in the first week of January 2006, in which 18 months are mentioned for the completion of task. This means that PS will start working at full capacity by the end of 2007.

[19] Al-Tawairiqi Group of Companies is building a steel mill at Bin Qasim in two phases. In the first phase, direct reduced iron (DRI) plant with a capacity of 1 million tons will be completed in the next 18 to 24 months costing around US$ 130 million. In phase two, with an additional investment of US$ 170 million, the plant will start making steel billets, wire rods, heavy structures, seamless pipes and other construction material. The Tawairiqi Steel Mill project will cost US$ 300 million with production capacity of up to 1.5 million tons of iron products annually.

Capacity Utilization in LSM

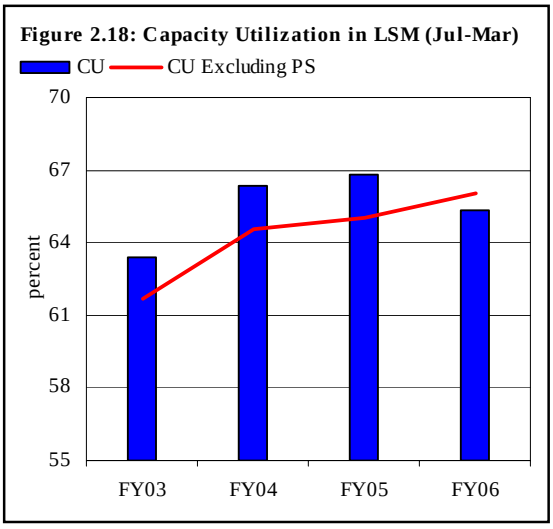
The overall capacity utilization in LSM declined by 1.3 percentage points in Jul-Mar FY06 as compared with a *rise* of 0.5 percentage points during the same period of FY05. The major contributor to this was Pak Steel Mills, where production has dropped steeply due to a major technical fault. Excluding the Pakistan Steel Mills' production, the overall capacity utilization in LSM reached 66.2 percent in Jul-Mar FY06, which is 1.1 percentage points higher than the corresponding period of last year (see **Figure 2.18**).

Figure 2.17: Pakistan Steel Performance



In the first nine months of FY06, the capacity utilization in Pakistan Steel Mills fell to 54.0 percent, which is 40.8 percentage points less than the capacity utilization during the corresponding period of preceding year (see **Figure 2.19**). Technical problem and outstanding repairable work in operational units, especially in coke oven batteries of the plants was the main reason for this lower capacity utilization, which are expected to be overcome by the end of 2006.

Figure 2.18: Capacity Utilization in LSM (Jul-Mar)



The rise in capacity utilization in LSM excluding Pakistan Steel is impressive given capacity additions seen in major industries during FY06 as a result of increase in investment (both domestic as well as foreign direct investment). The highest increase of 13.7 percentage points was recorded by automobiles, as the capacity utilization in all components of the automobile industry increased

substantially during Jul-Mar FY06. Capacity utilization in the tractors industry also rose to 98.2 percent by the end of the first three quarters of FY06, which has attracted considerable attention from investors (local as well as foreign investors).[20]

Capacity utilization in *edible oil & ghee* industry increased by 6.4 percentage points and reaching to 52.0 percent during the first three quarters of the current fiscal year. The strong domestic as well as external demand, largely from Afghanistan, was the main reason for this rise in capacity utilization.

Capacity utilization in the *electronics* industry stood at 13.3 percent during Jul-Mar FY06, marginally higher than 12.3 percent. A probable reason for this under utilization is that cheap Chinese electric items gained popularity in the domestic market, rendering some local products uncompetitive.[21]

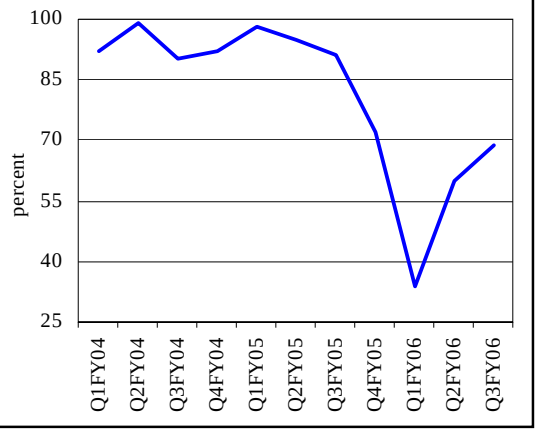
Table 2.14: Capacity Utilization in Selected Industries (Jul-Mar)

percent

Industry	FY05	FY06
Textiles	58.7	59.1
Edible oil & ghee	45.6	52.0
Sugar	65.7	59.7
Automobiles	74.6	88.3
Electronics	12.3	13.3
Cement	81.0	73.1
Steel (Pak Steel)	94.8	54.0
Industrial chemicals	89.0	94.7
Fertilizer	105.2	110.9
Petroleum refining	86.1	85.6
Paper & paper board	100.3	108.7
Overall capacity utilization	66.8	65.4
Overall capacity utilization *	65.0	66.2

* Excluding Pak Steel production

Figure 2.19: Capacity Utilization in Pakistan Steel



[20] With the assistance of foreign investors, a local company is setting up a new tractor manufacturing plant at Port Qasim with the production capacity of 8000 tractors per annum.

[21] According to market sources, more than 75 percent sales of electrical and electronic items are Chinese and only 25 per cent are locally-assembled products. Even the 25 percent of locally assembled items are dependent on the import of parts and material arriving from China.

During Jul-Mar FY06 the capacity utilization in the *cement* industry fell by 7.9 percentage points to 73.1 percent relative to 81.0 percent in Jul-Mar FY05. This drop in capacity utilization was due to the expansion in production capacity, on the back of strong domestic as well as external demand.

Box 2.3: Government's Supportive Measures for Construction Industry

The Government of Pakistan has announced a number of measures to generate economic activities in the construction sector, which are as follows:

- Ministry of Commerce has included cement in the positive list of importable items from India through an amendment in the Import Policy Order 2005.
- GOP has allowed duty and tax free import of cement and clinker from India through rail, road and sea routes with immediate effect. The cement import from India is now permissible to private and public sector entities including Earthquake Rehabilitation and Reconstruction Authority (ERRA) for reconstruction needs in Azad Kashmir and the NWFP.
- Rupees 60 per bag discount on freight rates from India to Pakistan.
- 30 per cent reduction in railway freight for cement import.
- Withdrawal of rebate of Federal Excise Duty (FED) and refund/adjustment of sales tax on the export of cement via land, air or sea routes.
- Import of iron sheets from India has been allowed, up to September this year, via land route as well, for exclusive use in the reconstruction of earthquake-affected areas.
- The government has banned cement exports for 25 days from April 2006 to control domestic prices of cement in the economy.

Government Measures for Ghee & Cooking Oil Industry

The Government of Pakistan has announced a number of measures for vegetable ghee & cooking oil industries, which are as follows:

- Introduction of uniform duty formula for ghee and cooking oil industries.
- Imposition of Rs 1,000 per ton excise duty at import stage of edible oil and vegetable ghee, including cooking oil.
- Levy of vegetable ghee to pay 15 percent general sales tax (GST) on the by-products, including carbon dioxide gas, oxygen gas, soap and oil dirt.
- If a manufacturer of vegetable ghee is producing hydrogen gas within his premises for use in the manufacture of final product, i.e. vegetable ghee, its consumption within the same premises is exempted from the sales tax.
- This exemption will not apply to such hydrogen gas, which is not manufactured within industries' own premises or is either purchased/supplied by the manufacturer of vegetable ghee.