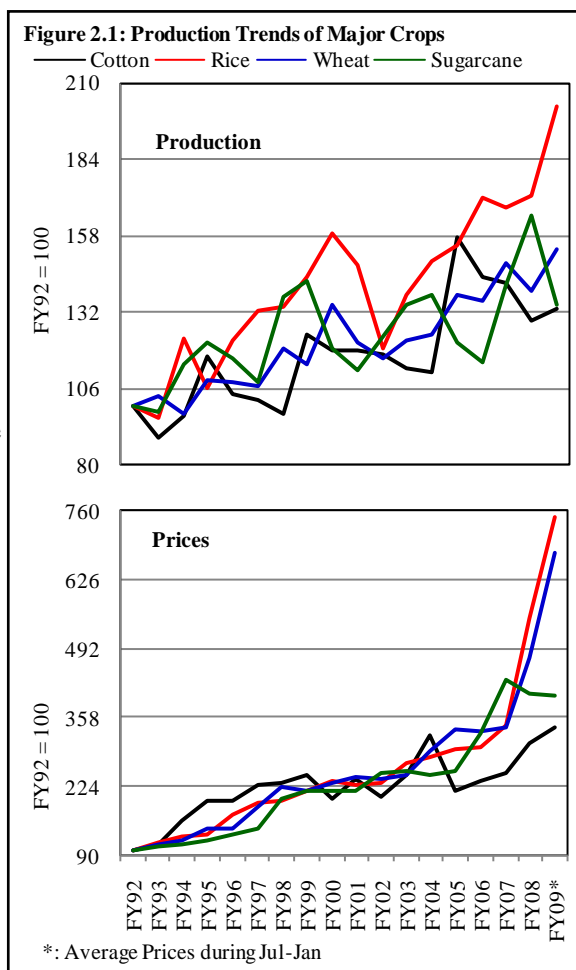


2 Real Sector

2.1 Agriculture Sector Performance

All indications are that agricultural growth will be reasonably good during FY09, despite 18.5 percent decline in sugarcane output during *kharif* FY09. This assessment is based on an anticipated record wheat harvest (that would significantly improve the contribution by major crops), above target performance of minor crops and a reasonably good outturn by the livestock sub-sector.

Improvement in the crops sub-sector appears to be helped by the significant gains to farmers in the previous cropping season; amidst high commodity prices, as well as supportive government policies.¹ The price signals were so clear in FY09 (see **Figure 2.1**) that farmers worked hard to offset the impact of water shortages and non-availability of urea at controlled prices. These efforts were also supported by favorable weather conditions. This was particularly true for the *rabi* crops, which were helped by timely winter rains. The limited available data suggests that growth in minor crops



¹ In federal budget for FY09, some measures were announced including increase in subsidy on DAP fertilizer to promote balanced mix of fertilizers, exemption of excise duty for fertilizers and pesticides, increased allocation for maintenance of reservoirs and improve water network, for further details see Box 2.2.2, SBP Annual Report for 2007-08.

and livestock sub-sectors is also likely to improve during FY09 over the preceding year.

2.1.1 Cropping Sector

Despite many adversities in FY09, the country has already recorded its highest-ever rice production and wheat harvest is also expected to reach a record high. Both these bumper harvests resulted from increases in the area under cultivation as well as higher yields (see **Table 2.1**), amidst expectations of higher prices. This effect is most visible in the wheat crop, where the government announced a 52 percent increase in the support price, well ahead of the sowing season.

Table 2.1: Performance of Major Crops

Area under cultivation (000 hectares)						
Crops	FY07	FY08 ^T	FY08 ^P	FY09 ^T	FY09 ^E	% change in FY09 over FY08
Cotton	3,075	3,250	3,055	3,220	2,850	-6.7
Sugarcane	1,029	1,040	1,241	1,040	1,044	-15.9
Rice	2,581	2,594	2,516	2,594	2,916	15.9
Wheat	8,578	8,578	8,550	8,610	9,053	5.9
Gram	1,052	1,120	782	1,012	-	-
Maize	1,017	1,001	1,037	1,001	1,062	2.4
Production (000 tons; cotton in 000 bales of 170.09 kg each)						
Cotton	12,856	14,140	11,655	14,110	12,060	3.5
Sugarcane	54,742	55,871	63,920	56,516	52,071	-18.5
Rice	5,438	5,721	5,561	5,721	6,543	17.7
Wheat	23,295	24,045	20,959	25,000	24,000 ^F	14.5
Gram	838	707	554	652	-	-
Maize	3,088	3,221	3,109	3,279	3,326	7.0
Yield (Kg/hectare)						
Cotton	711	740	649	750	720	11
Sugarcane	53,199	53,722	51,507	54,342	49,876	-3
Rice	2,107	2,205	2,210	2,205	2,244	2
Wheat	2,716	2,803	2,451	2,904	2,651 ^F	8
Gram	797	631	708	644	-	-
Maize	3,036	3,218	2,998	3,276	3,132	5

P: Provisional; T: Target, E: Estimates, F: Forecast,
Source: Ministry of Food & Agriculture

The increase in cotton output was more modest. Though the FY09 production increased, it remained significantly lower than the high FY05 levels, when farmers were encouraged by the record prices offered during FY04. A relative

improvement in cotton prices during recent months would probably provide some stimulus to farmers to increase cotton production in the next cropping season as well.

Rice

The rice harvest surpassed 6 million ton-mark for the first time during FY09. This output is significantly higher than estimated domestic rice consumption of about 2.5 million tons. It mainly reflects that farmers were encouraged by the sharp run-up in international prices in the previous year, when price stability concerns had led to the imposition of export restrictions by some major rice producing countries.

The attractive prices and lower competition in the international markets led to a surge in exports and a healthy 15.9 percent YoY increase in the cultivated area in FY09. Not only was area previously under sugarcane and cotton substituted with rice, the aggregate area under cultivation increased by 3.2 percent under major crops during FY09. Good luck, in the form of favorable weather² also supported the rice crop during FY09. In addition, in some parts of Sindh, farmers cultivated rice twice during FY09 (in early *kharif* and again in late *kharif*),³ which is encouraging and indicates huge potential of the country to increase rice production going forward. Moreover, plantation of hybrid rice⁴ on approximately 122 thousand hectares also helped better yields.

It is important to note that farmers could not realize gains at the scale anticipated, from bumper rice harvest due to an unexpected sharp fall in international rice prices. This disappointment may lead to a smaller crop size in FY10. However, recent move by Thailand and Vietnam (two major rice exporters) to fix export price is likely to help stabilize rice prices in international market. Stable prices would help farmers to make cultivation decision with some certainty.

Cotton

A 6.7 percent fall in cultivated area⁵ had initially raised expectations of a substantial decline in cotton output during FY09 cropping season but the output instead rose by 3.5 percent. Here too, it was an improvement in cotton prices that encouraged farmers to put extra efforts, resulting in a 10.9 percent gain in cotton

² In particular, extended monsoon and winter rains.

³ Farmers took the advantage of smaller duration of crop as some varieties of rice matured in 90 days.

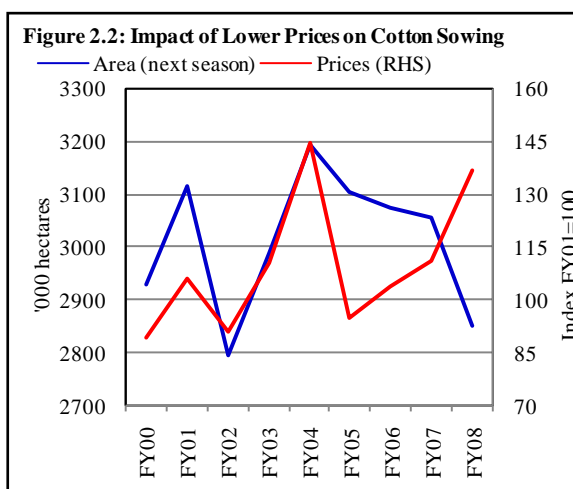
⁴ Plantation of IRRI and coarse varieties.

⁵ Besides lower cotton prices in the preceding season, water shortages at sowing period also led to drop in area under cotton during FY09.

yield which more than offset the decline in acreage. Another important reason for the substantial gains in yield is the increased plantation of Bt cotton⁶ during FY09. These results are promising and suggest that cultivation of Bt cotton should be encouraged in the country.

The broad continuing decline in cotton plantation since FY05 however, remains of concern. The trend is mainly attributed to

relatively lower prices, which are remained below the levels seen in FY04 (see **Figure 2.2**), and inadequate increase in yields.



Wheat

The wheat production target was been revised⁷ upwards to 25.0 million tons for FY09, on the expectation that farmers would respond to a 52 percent increase in support price. An immediate impact of this was seen, as despite irrigation water shortages, wheat plantation target for the year was surpassed by 5.1 percent. This change was also helped by: (1) a switch from sugarcane crop to wheat, as price

disputes between growers and sugar mills intensified last year, (2) early picking of cotton this year,⁸ as well as, (3) the westerly rain bearing systems encouraged farmers to sow more wheat in the major wheat producing districts of the country.

Table 2.2: Wheat Plantation Growth - Punjab

percent growth end Dec 2008 over last year

Regions	Irrigated	Non-irrigated	Total
Rawalpindi	6.5	8.0	7.3
Sargodha	4.5	9.7	5.1
Faisalabad	8.3	-	8.5
Gujranwala	5.2	10.3	5.9
Lahore	10.2	66.7	10.4
Sahiwal	13.9	-	13.9
Multan	10.9	15.4	11.0
D.G khan	2.1	23.0	3.0
Bahawalpur	5.6	10.5	5.7

Source: Crop Reporting Department. Government of Punjab.

⁶ Bt cotton is genetically modified by using a foreign gene (bacillus thuringiensis). This variety is resistant to diseases and pest attacks.

⁷ Earlier target was 24.0 million tons.

⁸ Cotton sowing has been completed earlier in the FY09 season (relative to customary trends) and as a result the crop matured earlier.

Area under wheat rose by 7.3 percent in the Punjab, 3.7 percent in Sindh, 0.7 percent in NWFP, and 0.2 percent in Balochistan during FY09,⁹ over the preceding year. According to the crop reporting estimates, the sowing was 8.0 percent more in rain fed and 7 percent higher in irrigated areas of the Punjab (see **Table 2.2**). In addition, extended winter rains are also likely to have a positive impact on the wheat yield. It is important to note that while favorable weather and relatively lower fertilizer prices were supportive for FY09 wheat crop, better availability of urea at controlled prices would have helped further gains in yields.

Sugarcane

A sharp decline in the sugarcane harvest during FY09 was not surprising given the disappointment of farmers in materializing benefits from a record 63.9 million tons output in FY08. Not only purchase of sugarcane was delayed by mills it is alleged that, payments to farmers were also not made in time. As a result, area under sugarcane dropped by 15.9 percent and production fell by 18.5 percent (to 52.1 million tons) in FY09. This is also reflected in rising sugar prices, due to shortages of the commodity. The government needs to formulate an effective sugarcane policy by taking all stakeholders in confidence, which covers all the dynamics of the commodity (e.g., beginning of crushing season, credit requirements of sugar mills for working capital, payments to farmers, settlement of a market based price (since it has been observed that procurement price is unable to resolve marketing issues). One sustainable long-term solution of these problems lies in the introduction of effective futures market, with crop insurance¹⁰ and contract enforcement.

Minor Crops

A shortfall in domestic production relative to consumption was embedded in FY09 production targets for most of the minor crops (see **Table 2.3**). In addition, substitution of area under

potatoes for wheat and damage to onions was due to unfavorable weather, and would probably lead to below target production of these two important vegetables in current season. However, overall performance of minor crops is likely to be

Table 2.3: Production and Consumption of Minor Crops
thousand tons

Crops	FY08		FY09 ^T		Surplus/ deficit
	Prod	Cons ^E	Prod	Cons ^E	
Potatoes	2,539	2,280	2,458	2,308	150
Onions	1,902	1,816	2,059	1,839	220
Chillies	96	164	105	166	-62
Mung	178	174	140	176	-36
Mash	17	116	17	117	-100
Lintel (Masoor)	18	116	21	117	-96

E: Estimated on the basis of Household Economic Survey FY05 by FBS. T: Targets, E: Estimates

⁹ Source: Ministry of Food and Agriculture.

¹⁰ Crop insurance scheme is in its initial stages and likely to become popular among the farmers.

reasonable during FY09 given substantial improvements in plantation of oil seeds, mung pulse and other vegetables and fruits.

The surge in international prices of edible oil not only attracted farmers to reap the benefits of high prices, it also reinforced the need to raise the domestic output given burgeoning trade deficit. Initial reports suggest a substantial expansion in area under canola and sunflower has taken place in FY09 (see **Table 2.4**). In addition, Pakistan Oilseed Development Board is also making efforts to promote cultivation of palm oil and olives in the country. It is expected that these efforts will help sustain growth in minor crops and help reduce dependence on imported edible oil in future.

	FY08	FY09 ^T
<i>Area in thousand hectares</i>		
Canola	10.3	105.2
Sunflower	397	505.9
<i>Production in thousand tons</i>		
Canola	8.8	134.4
Sunflower	603.9	755

T: Target

Source: Ministry of Food & Agriculture

It is important to note that prices of most of the minor crops increased at a slower pace relative to rise in the grain prices in recent months. This is partly explained by rise in domestic output and partly by a substantial increase in the quantum of imports (see **Table**

thousand tons			
Commodities	FY08	FY09	% change
Onions and shallots	70.1	112.7	60.7
Tomatoes	8.8	24.4	177.3
Potatoes	8.2	108.8	1,220.8
Chilies	0.5	2.4	408.3
Mash pulse	0.0	4.7	-

2.5) of these items at relatively lower prices, from neighboring countries. For example, despite a possible decline in domestic potato output, country would have been able to produce more than domestic consumption requirement. However, as potato prices collapsed in India due to a bumper crop, a hefty rise in imports caused domestic prices to drop, despite imposition of import duty in January, 2009.

Agriculture Inputs

There was a remarkable improvement in the crops sub-sector despite lower water availability and urea shortages. Decline in urea off-take also led to deceleration in agri-credit disbursement during Jul-Jan FY09.

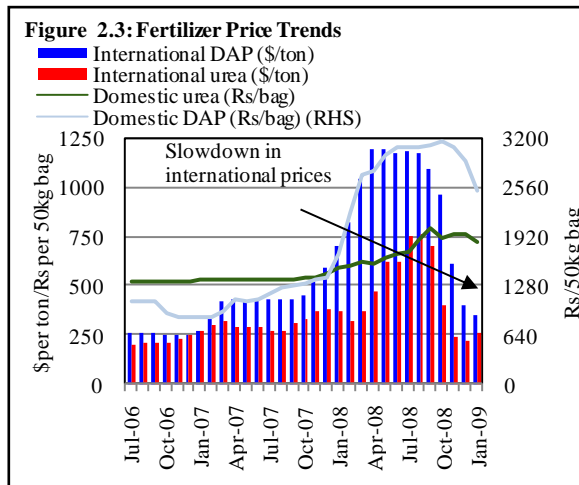
Fertilizers off-take

Aggregate fertilizer off-take declined by 10.1 percent during Jul-Jan FY09 compared with 5.6 percent increase in the corresponding period last year (see **Table 2.6**). This decline is attributed to market structure issues as well as prices of the fertilizers. DAP and urea registered decline of 33.0 percent and 3.6 percent respectively during this period. Farmers adopted a cautious approach in buying DAP due to a downtrend in DAP prices during the first quarter of FY09. This is evident from a sharp fall in DAP off-take in this period (see **Figure 2.3**), and a subsequent recovery.

Table 2.6: Fertilizer off-take (Jul-Jan)

million tons			
	Urea	DAP	Total
FY06	3.4	1.1	4.4
FY07	3.0	1.2	4.2
FY08	3.5	1.0	4.5
FY09	3.3	0.7	4.0
Growth (%)			
FY07	-10.9	14.0	-5.0
FY08	15.2	-18.3	5.6
FY09	-3.6	-33.0	-10.1
FY09 Quarterly growth (%)			
Jul-Sep	-20.8	-36.4	-25.4
Oct-Dec	-1.6	14.6	3.1

A substantial increase in off take of DAP in Q2-FY09 followed ease in domestic prices and the fixation of a 52 percent higher wheat support price. Unfortunately, while international urea prices peaked off in August 2008, the benefit of this was not passed on to the farmers.¹¹ Domestic urea prices witnessed a dip in October 2008, but then resurged amid strong demand and 6.0 percent rise in area under wheat cultivation. The rise in area under wheat was a clear indication of a strong demand for fertilizers during *rabi* FY09 season. However, it is alleged that, speculative hoarding created artificial supply shortages of urea in some parts of the country. The strong demand for fertilizer



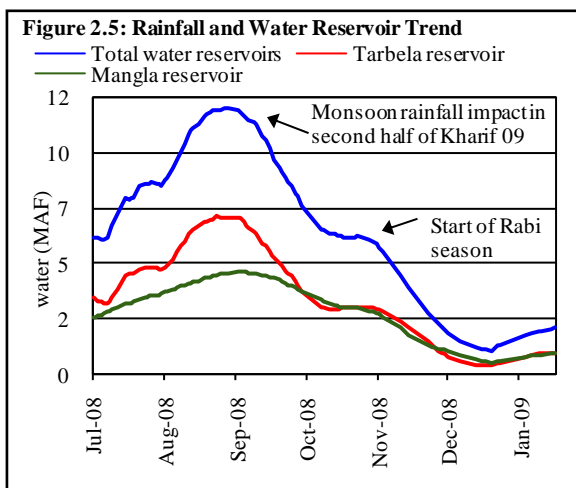
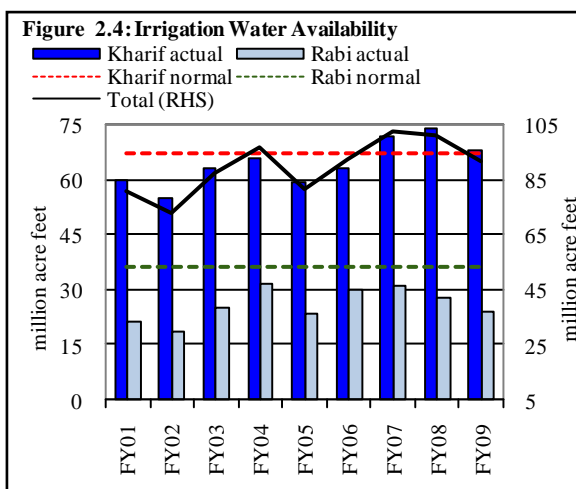
¹¹ A slight up-tick in international urea prices during January 2009 may reverse a modest downtrend in domestic prices of the nutrient going forward.

should have been foreseen given a substantial increase in the wheat support price and adequate supply planned. In addition, government has to take administrative measures to discourage hoarding and ensure smooth supply of farm inputs.¹²

Water Availability

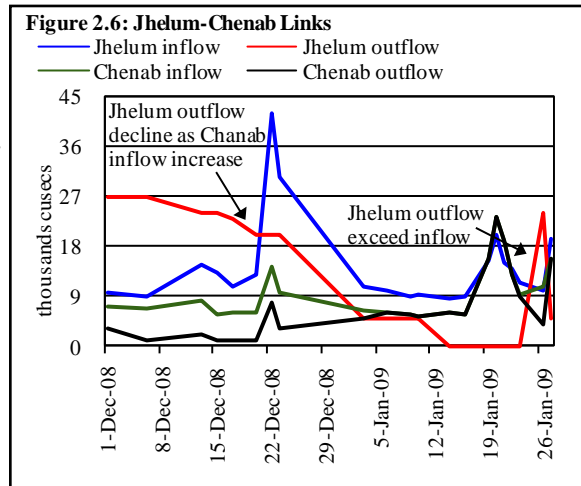
In recent years, aggregate irrigated water availability continued to decline, mainly due to shortfalls in rabi season. Fortunately, above normal water availability during *kharif* FY09 supported rice and cotton crops and extended winter rains compensated the impact of 33.8 percent shortfall of irrigated water during *rabi* FY09.

It is important to note that the water shortages for *rabi* FY09 season were initially estimated at up to 39.0 percent, however, successive rain bearing systems in the major crop growing plains in Punjab, Sindh and NWFP during Dec-Jan FY09 helped improve water availability during the season. The overall reservoir level at the start of the *rabi* FY09 season decreased at 7.1 MAF against 9.7 MAF in the corresponding FY08 season (see **Figure 2.5**). The rain bearing systems have been instrumental in recent improvement in reservoirs' water levels as well as share of un-irrigated (*barani*) cultivation in the key wheat crop sowing period.



¹² Provincial Agriculture Departments may ensure availability of fertilizer at controlled prices. Dealerships of hoarders may be canceled. Supply of fertilizer through Utility Stores at district level is another option to discourage speculative hoarding.

Water shortfall during *rabi* FY09 was aggravated by the fact that the year-end average for Chenab was down to only 6,000 cusecs inflow during Dec-Jan FY09 against an average of 10,000 cusecs in Dec-Jan FY08. The retention of water resources upstream at *Baglihar* dam was probably responsible for the progressive cuts in the water inflows into the Chenab command areas. As a consequence, the deficit water has to be channeled through the Jhelum-Chenab link canal at Rasul downstream to make up for the inflow losses. Greater outflow of the Mangla reservoir have been thus triggered by the ‘Baglihar reservoir’ to supplement the Chenab and Ravi command areas in central and South Punjab (see **Figure 2.6**).



The westerly systems impact has been helpful in keeping the water inflows at the 2.0 MAF benchmark during the concluding months of the *rabi* FY09 season. The current situation calls for speedy completion of the dams along the major water courses, especially Indus; which is the major source of water resources for the irrigated canal systems in the country.

Agri-credit

Agriculture credit

disbursement decelerated to 11.5 percent during Jul-Jan FY09, lowest in the preceding five years (see **Table 2.7**). At first look, this slowdown appears to be surprising given that increase in aggregate area under cultivation during FY09. A number of factors explain this apparent anomaly; (1) farmers delayed purchase of nutrients due to a declining trend in fertilizer prices, (2) relatively lower fertilizer prices in recent months led to lower

Table 2.7: Agriculture Credit Disbursement (Jul-Jan)
billion Rupees

Banks	FY06	FY07	FY08	FY09
Commercial banks (CBs)	45.8	49.7	73.0	80.6
Five large commercial banks	37.6	37.9	50.5	56.9
Domestic private banks (DPBs)	8.2	11.8	22.4	23.7
Specialized banks	25.9	31.2	31.8	36.2
ZTBL	22.6	27.2	28.1	32.9
PPCBL	3.3	4.0	3.7	3.3
Total	71.7	81.0	104.8	116.8
Growth (percent)	24.6	13.0	29.4	11.5

financing requirements, (3) farmers were not able to buy urea (at least at controlled prices) due to artificial shortages that also reduced their demand for financing, and (4) on the supply side, a temporary liquidity crunch during Q2-FY09 and rising overall NPLs also hindered extension in agri credit disbursement. The latter point is reinforced by the evidence that slowdown in agri-credit growth is entirely contributed by commercial banks as ZTBL witnessed a strong growth of 17.1 percent during Jul-Jan FY09 as against 3.4 percent increase seen in the corresponding period of FY08.

The drag in the performance of DPBs is also evident from the agri credit disbursement to annual target ratio, which dropped from 63.2 percent during Jul-Jan FY08 to only 45.1 percent in Jul-Jan FY09. It is in sharp contrast to an average of over 60 percent during the last five years.

It is also important to note that while growth in agri-credit disbursement for production purposes decelerated, growth in disbursements for developmental purposes accelerated during H1-FY09 (see **Table 2.8**). Major impetus to growth in developmental loans was from subsistence and above-economic farm holders. This probably reflects the farmers' willingness and ability to undertake developmental work on the back of higher farm income amid better prices of most of agri produce.

In the non-farm sector, credit disbursements rose by a remarkable 68.5 percent YoY during Jul-Jan FY09 in the livestock, dairy & meat sub-sector. The number of borrowers in livestock sector also grew by 25.7 percent YoY during the first seven months of FY09 from 29 thousands to 37 thousands. This rise in disbursement and number of borrowers in livestock sub-sector indicates the success of small loans for the purpose. This would not only help to improve supply of dairy and meat products, but also help reduce poverty. The other major non-farm head, poultry, although registered almost the same growth in the number of borrowers, its share in disbursement dropped from 70.1 percent in Jul-Jan FY08 to 63.2 percent during Jul-Jan FY09 (see **Table 2.9**). A relatively slower growth

Table 2.8: Agriculture Credit Disbursement (Jul-Jan)

billion Rupees

	FY07*	FY08	FY09
Farm	62.0	77.2	80.7
<i><u>Economic classification</u></i>			
Subsistence	40.8	46.5	51.3
Economic	14.6	17.2	18.3
Above economic	6.6	13.5	11.1
Corporate	0.7	--	1.6
<i><u>Purpose-wise</u></i>			
Production	57.9	71.8	73.4
Development	4.2	5.3	5.7
Non-farm	9.7	27.6	36.1
Small farms	5.1	4.8	6.9
Large farms	4.5	22.7	29.2

*: Data for FY07 pertains to Jul-Dec. (--) Negligible

in disbursement in the poultry sector is probably a reflection of a conscious investment approach due to heavy losses in preceding seasons on account of recurrent episodes of bird flu virus. In this backdrop and significantly higher prices of poultry products, it is expected that the disbursement for poultry sector are likely to accelerate in the remaining months of FY09.

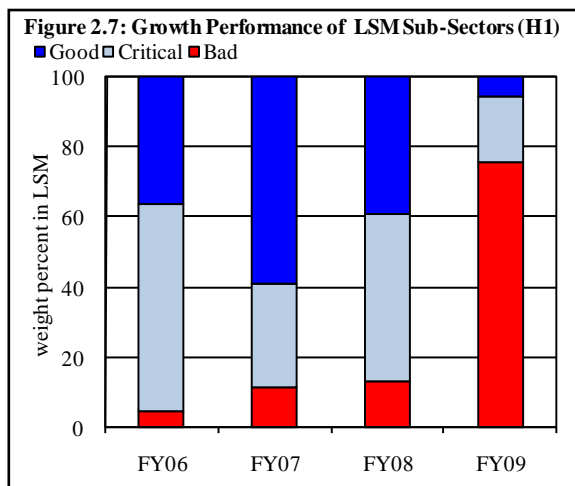
Table 2.9: Non-farm Sector (H1)

	FY08	FY09
<u>Number of borrowers</u>		
Livestock	33,403	41,977
Poultry	955	1,172
<u>Amount disbursed-Rs billion</u>		
Livestock	7.6	12.9
Poultry	17.8	22.1

2.2 Large Scale Manufacturing

Production in large scale manufacturing (LSM) saw a broad-based decline of 4.7 percent during Jul-Dec FY09¹³ as against 5.2 percent rise during the same period last year (see **Figure 2.7**).¹⁴ A number of factors including intensified energy shortages, rise in input cost, as well as lower domestic and external demands are responsible for this decline.

First, both interruptions in energy supplies and upward adjustment in the prices of electricity, gas and diesel lowered the productivity and raised the cost of production in domestic industry. Second, though international commodity prices started to ease somewhat from July 2008 onwards, domestic prices of many industrial inputs remained relatively higher. Similarly, depreciation of rupee with a greater volatility also increased the cost of imported inputs. Third, global recession has also taken its toll; export driven industries (particularly textiles) suffered due to weakening external demand. Export-led industries also faced marketing problems as foreign buyers are avoiding travel to Pakistan due to security situation and country image, with attendant concerns over Pakistani producers' ability to meet delivery deadlines. Fourth, dampening domestic demand, particularly of consumer durables, also contributed to a lackluster performance of the industry. The ease in consumer demand is attributed to both; high interest rates on consumer financing and commercial banks' reluctance in providing consumer financing for consumer durables due to rising NPLs under this head (see **Table 2.10**),¹⁵ which has direct consequences for automobile and electronics industries.



¹³ Excluding automobiles, electronics and sugar LSM growth comes to be 0.1 percent.

¹⁴ Industries with negative growth are considered as *Bad*; those with growth in the range 0-5 percent are categorized as *Critical*, while those with growth higher than 5 percent are labeled as *Good*.

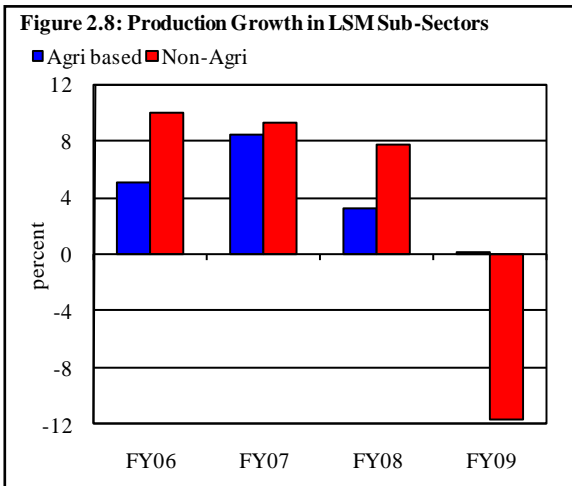
¹⁵ The NPLs ratio (NPLs as percent of outstanding amount) at 7.2 is the highest for consumer durable by end September 2008 (for which the latest data is available). As a result, banks raised their credit risk premium for consumer financing for durables.

The uptrend in commodity prices was unprecedented and most of the analysts believed that it will continue for about a decade. Thus most of the firms which built inventories eyeing gains due to the expected rise in commodity prices; are now facing problems, as international commodity prices have plummeted. As a result, these domestic are unable to reduce prices with the same pace, resultantly facing stiff competition from relatively cheaper substitutes (either imports or produced by informal sector).

Table 2.10: Consumer Durables: Trends in Credit and Production
percent growth

	FY06	FY07	FY08	FY09
Credit				
	Jul-Dec			
Car	25.5	7.7	7.2	-12.2
Consumer durables	16.7	8.2	0.3	-11.1
Production				
Cars & jeeps	29.1	15.8	-1.3	-45.4
Electronics	17.6	8.2	-0.9	-13.9

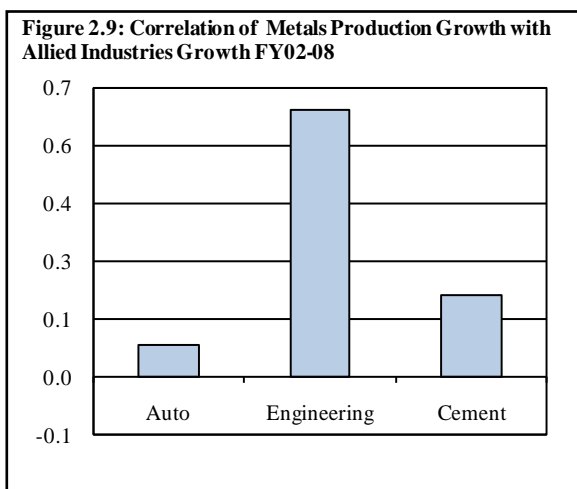
Due to these developments, the smaller sub-sectors (consumer durables, cement, metal, etc.), that were witnessing sustained growth (against volatile production behavior of agri based industries that form 66 percent of LSM) in recent years (see **Figure 2.8**), came under severe stress. The slowdown in these smaller industries is also attributed to their pricing policies and structural weaknesses (see **Box 2.1**). In particular, despite a substantial decline in international prices for metal, oil, chemicals, etc., July 2008 onwards, domestic prices of automobiles and electronics are showing a secular uptrend. Underutilization of production capacity is a major reason of the premium (own) being charged for immediate delivery of vehicles.



The automobile industry, all over the world, largely depends on institutional financing for sustained demand of its products. In Pakistan, consumer financing was relatively a new market segment in early 2000s and initially grew sharply. However as the economy slowed, NPLs in this market surged. Thus banks reduced lending; further pressuring demand for consumer durables. Furthermore,

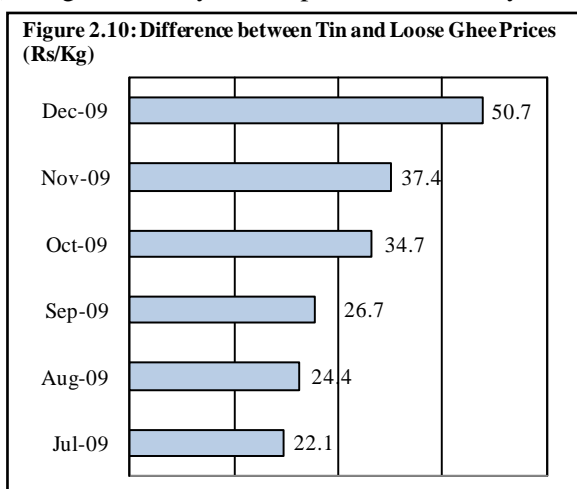
local assemblers raised the prices of their products manifold, making it more difficult for middle class (already under stress of food and fuel inflation) to buy the new products.

Demand for vehicles is not picking up even with decline in prices of fuel. Electronics industry performed below potential, principally due to severe shortages of electricity and increased cost of financing.



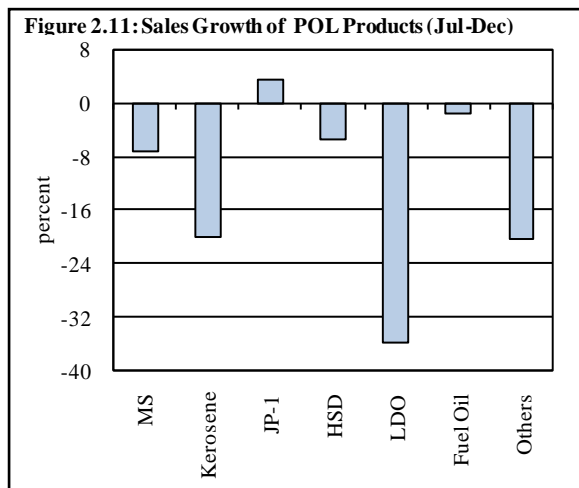
Metal industry also registered a production decline of 10.6 percent during H1-FY09. This industry is suffering from the lagged impact of (high past) international commodity prices besides sluggishness in domestic construction activity amid lower public sector spending under PSDP. Capital flight towards once lucrative Middle East real estate as well as increased cost of construction due to high inflation also led to decline in domestic construction activities. Cement dispatches to the local market, which decreased by 14 percent during H1-FY09, also support the view that construction activity has slowed; hence metal production is facing paucity of demand. Energy shortages are also hindering growth in metals (see **Figure 2.9**). High inventory build up with the industry owing to slowdown in key demand generating industries is also contributing to sluggishness in production activity of metal sub-sector.

Sugar production, which had registered a record growth during FY08, is in doldrums this year due to an 18.5 percent decrease in sugarcane production. Gur making is also posing a challenge to sugar mills for procuring sugarcane. An ongoing conflict between farmers



and sugar mills over price and payments forced cane farmers to shift to *gur* making instead of selling their produce to sugar mills. At the same time, information from market sources suggest that farmers are getting good prices for *gur* on spot, and in some areas they are not even required to bear transportation cost as the middleman is ready to lift the produce where it is processed (the fields of farmers) on cash payment. While supplying sugarcane to mills even on increased rates involves transportation cost and delay in payment in many cases.

Vegetable ghee industry is also struggling to compete with the informal sector on prices as per kilogram difference between loose and tin packed ghee has increased in FY09 reaching to the level of Rs 50/kg (see **Figure 2.10**). Such a high price differential seems to have created a significant substitution effect especially in rural areas where people are more price sensitive.



POL is another sub-sector of LSM that recorded a decline in production during H1-FY09 (see **Figure 2.11**). Here, the widely discussed issue of circular debt is contributing to the problem as refineries are financially constrained. The fact that PSO owes about Rs 38 billion to different refineries, and it has receivables of about Rs 85 billion against IPPs, marks the severity of the problem. In addition, due to relatively high prices of POL and overall slowdown in economic activities, sales of POL dropped by 4.8 percent (YoY) during Jul-Dec FY09.

Textile sector, an export oriented industry of Pakistan, and thus more prone to international demand shocks, is under severe stress amid a global recession. Although textile production has declined slightly (0.4 percent) during Jul-Dec FY09, its exports recorded an increase of US\$ 219.4 million, on a quantum basis during Jul-Dec period. A part of rise in exports may be on account of depreciation of rupee during 2008 (see **Table 2.11**). Recent decision of removal of antidumping duty on Pakistani bed wear is an encouraging development and increased the possibility of a modest recovery in domestic textiles industry. Textile sector, however, needs to find innovative ways of marketing, vertical integration,

mergers, product diversification, and maintain high quality of its products, for long-term survival, in an increasingly competitive international market.

Motor tyres & tubes industry is showing signs of resilience as it recorded a production growth of 11.2 percent when automobiles industry (the main demand creator) is in a bad shape. In fact, the number of automobiles has tremendously increased during the last six years, adding to the demand for replacement of tyres. The rising demand was met by mainly from BMR conducted by the General Tyres last year that has improved the quality of its products besides the capacity. In addition, a disproportionate higher increase in the prices of imported tyres also helped the domestic industry.

Table 2.11: Basis of Exports Earnings in Jul-Dec FY09

million US\$	Quantum	Price
Raw cotton	43.8	-2.5
Cotton yarn	-104.6	-10.7
Cotton fabrics	87.4	-35.5
Cotton carded or combed	-5.6	3.2
Yarn other than cotton yarn	-10.7	-0.4
Hosiery (Knitwear)	111.5	-103.9
Bed wear	12.1	-118.3
Towels	73.8	-23.4
Tarpaulin & other canvas goods	-5.9	-4.8
Readymade garments	-50.7	-24.9
Art silk and synthetic textiles	68.3	-23.0
Total	219.4	-344.3

Fertilizer is the only industry, having considerable weight in LSM (4.5 percent), that has registered a double digit growth of 23.9 percent during Jul-Dec FY09 owing to strong demand and low base effect due to last year's closure of a phosphatic fertilizer plant for BMR and expansion purposes. Nonetheless, this sector still requires investment for capacity expansion as the existing capacity of both phosphatic (production of which depends on phosphate rock not available in Pakistan in abundance) and non phosphatic fertilizers (the production of which mainly depends on consistent supply of gas) is less than the domestic demand

Box 2.1: Structural Issues Faced by Industrial Sector:¹⁶ A Recent Report

Industrial sector in Pakistan faces many of the problems faced by developing economies around the world especially Asia. This set of problems can be categorized into; those prolonged by the negligence of industries themselves (R&D) and those where government support was insufficient (infrastructure) and others where collaboration was required but missing (skill base development). The comparative status of 25 developing economies around the world, based on these factors is ranked by Global production consultancy annually (see **Table 2.1.1**). According to which Pakistan's potential for sustainable growth among all assessed economies is at the lowest as judged by R&D

¹⁶ This heavily draws from www.global-production.com. Global-production.com, Inc. is a business economics consultancy, based in Switzerland, which specializes in research and advice on emerging economies as locations for global production activities.

abilities, level of skills developed in different fields, infrastructure development and government functionaries' support for business activities.

Similarly selected performance indicators that reflect on the level of industrial value addition are not very encouraging. Pakistan's export growth has remained lower than its competitors as was the share of high tech exports in total. The only hope is textile industry where we are ranked at the top for export specialization, irrespective of our export growth has remained comparatively low. This shows that policy makers and industrialists have to work really hard to maintain the competitive edge where we have, along with diversification of the industrial base. A special attention is required towards the basic industries like chemicals, electronics and machinery that are the base of modern day development of economies.

Table 2.1.1: Pakistan's Ranking in Different Areas of Development and Industrial Advancement for 2008

Industrial capability score value (0.000 – 1.000)	Pakistan		Indonesia	India	Philippines	China	Thailand	Malay
	Score	Potential - rankings						
Skill base	0	23	21	22	16	19	10	15
R+D capacity	0	25	24	21	22	10	20	11
Infrastructure	0.083	19	21	20	23	13	11	8
Government	0	24	23	19	21	16	15	10
All indicators	0	25	24	23	22	18	14	12
Avg. annual growth in exports (0.0 – 30.0%)								
Export growth	7.9	23	24	7	21	1	9	17
High-tech share in exports (0.0 – 80.0%)								
Hi-tech share	0.7	25	12	18	1	7	6	2
Export specialization index value (0.00 – 5.00)								
Automotive	0.01	25	16	15	18	19	12	20
Chemicals	0.4	22	10	5	25	21	11	17
Electronics	0.01	25	10	20	1	7	5	2
Machinery	0.07	25	20	16	17	19	11	21
Text+cloth	9.09	1	6	4	9	7	8	19

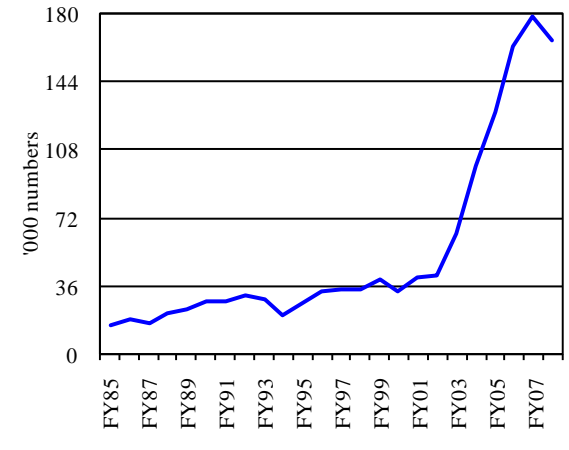
Source: www.global-production.com

Box 2.2: Cars and Jeeps Production

A significant rise in production of cars and jeeps witnessed FY02 onwards on the back of rising income and low interest rate on newly introduced consumer financing (see **Figure 2.2.1**). Similar to other consumer durables, growth in automobile industry across the world depends heavily on economic growth and availability of financing from financial institutions at favorable terms. Increased demand for automobile in Pakistan is also a reflection of this phenomenon. In response to surge in demand, automobile production units expanded their capacity and production touched new heights by FY07.

However, production of cars & jeeps registered a slight decline; dropping from 179,314 units in FY07 to 166,300 units during FY08. Importantly, this trend further worsened in FY09. The production of cars & jeeps reported at 49,553 units during Jul-Jan FY09 compared with 92,018 units in the corresponding period of FY08, is down by 46.1 percent. The production data reveals strong monthly seasonality (see **Figure 2.2.2**). If we take into account the seasonal factors of the preceding years when demand pressures were not strong, production of cars & jeeps is estimated to be around 92000 units during FY09 compared with 166,300 in FY08, a fall of about 44 percent. This decline is principally due to a number of factors including (1) increased cost of consumer financing amid tight monetary stance of SBP; (2) commercial banks cautious lending due to rising NPLs under consumer financing; (3) a surge in the prices of domestically produced automobiles, which increased in tandem with international prices of metal and chemicals but not adjusted downward as input cost lowered since July 2007 onwards; (4) continued premium (own) on immediate delivery, which shows that manufacturers are not utilizing their capacities to maintain demand-supply gap, (5) slowdown in income growth is also more pronounced in FY09.

Figure 2.2.1: Historical Production of Cars & Jeeps



In view of the above, ease in inflationary pressures and subsequent monetary easing will partly help in revival of automobile sector. However, to achieve earlier levels of production and to grow further, availability of institutional credit for consumer durables, appropriate pricing of domestic automobiles and waiving off of full advance and own money are some pre-requisites. Industry has to increase its productivity to be competitive and realize the dream of exporting Made in Pakistan cars in near future.

Figure 2.2.2a: Production of Cars & Jeeps (3mma)

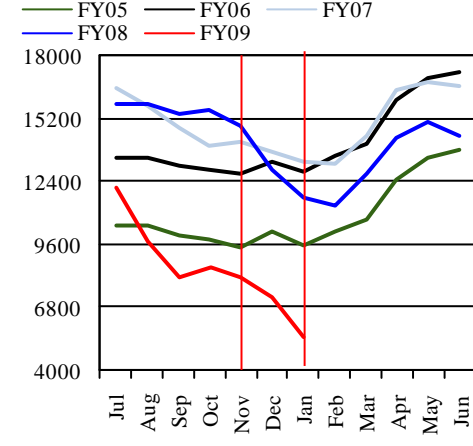
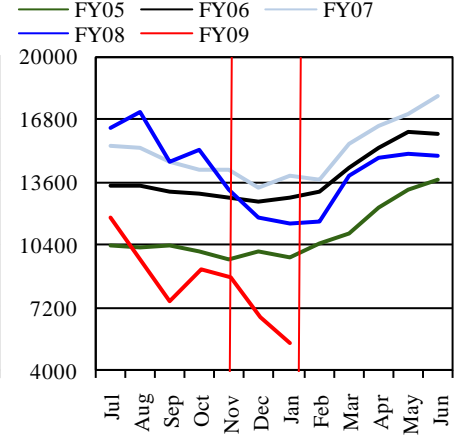


Figure 2.2.2b: Sales of Cars & Jeeps (3mma)



2.3 Services

It is evident from half yearly data on key indicators of the services sector that though FY09 growth has decelerated, it is still likely to remain higher than the growth in the commodity producing sector for the year. Deceleration in services sector is not a surprise, as seen from the fact that the 6.1 percent FY09 target growth had been set substantially lower than the 8.2 percent achieved in the previous year. The expectations of a slowdown were based on a

sharp decline in import growth and weakness in the domestic economy during FY09. These expectations have been realized during H1-FY09 with a decline in LSM growth, deceleration in import growth and lower profitability of commercial banks. However, a positive outlook of transport sector, increased profitability of the central bank, as well as, higher expenditures on defense provide a modicum of support of growth prospects in the services sector.

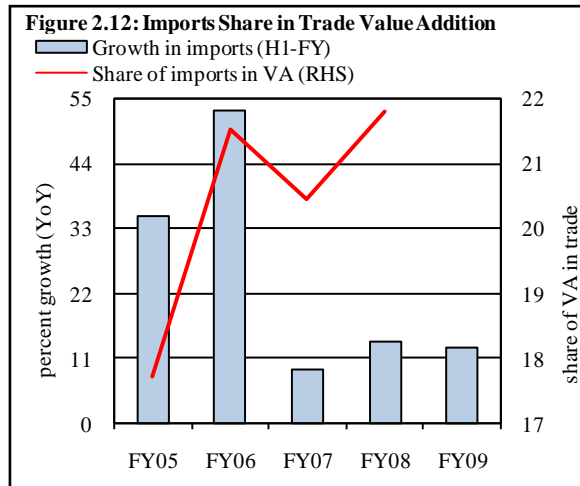


Table 2.12: Private Sector Credit to Services Sector (H1)
percent growth

	FY06	FY07	FY08	FY09
Commerce and trade	32.7	15.5	10.7	3.5
Hotels & restaurants	7.4	38.8	2.6	5.4
Transport, storage & communication	12.4	25.9	4.6	6.9
Real estate	30.9	11.5	23.4	1.9
Education	-11.9	19.7	11.4	15.1
Health and social work	-21.0	38.9	-2.8	16.9
Social and personal services	65.6	-0.8	16.8	1.6
Other private business	25.4	40.0	-27.5	-7.6
PSC in services	26.8	19.0	8.3	3.3

Source: SBP

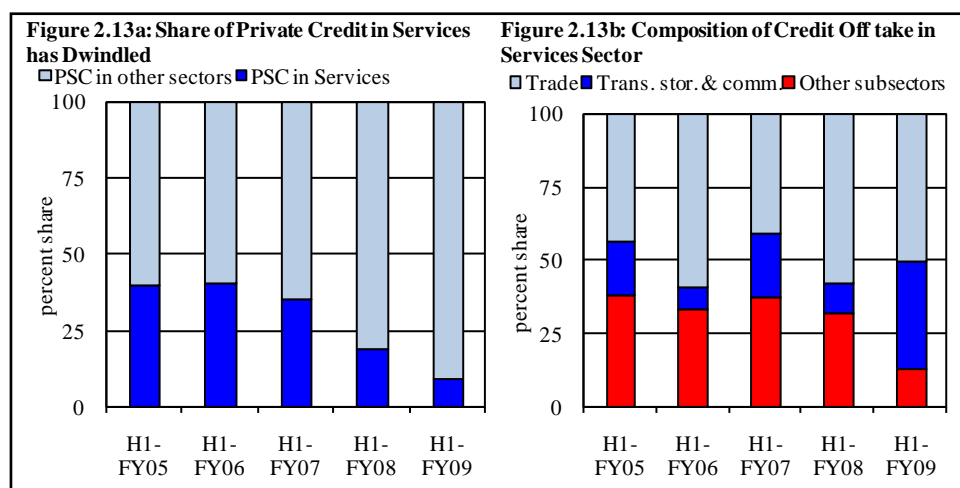
Sectoral analysis reveals that the strongest impact of domestic economic slowdown is more pronounced in *wholesale & retail trade* sub-sector during the first half of FY09. Lower growth in imports is a major drag on the contribution of *wholesale & retail trade*, since imports contribute about a quarter of the value addition in this sub-sector (see **Figure 2.12**). Similarly, a decline in LSM

production also has negative consequences for the trade sub-sector. In addition, a slowdown in credit off-take (see **Table 2.12** and **Figure 2.13**) and decline in FDI¹⁷

¹⁷ FDI dropped by 7.8 percent in trade during H1-FY09.

also point towards a deceleration in the contribution by trade sub-sector in GDP growth during FY09. However, a bumper rice harvest, a slight improvement in cotton output and an expected record wheat crop during FY09 are likely to offset some of the adverse impacts.

Unlike the trade sub-sector, most indicators suggest that the *transport, storage & communication* sub-sector is likely to exhibit an improvement in growth performance during FY09 relative to FY08 (see **Table 2.13**). This sector is expected to benefit primarily from a sharp decline in oil prices, increased production of light commercial vehicles (LCVs), higher storage activities amidst continued strong imports, and record high harvests of some major crops. The positive outlook of *transport, storage & communication* sector is also reflected in an increased credit off-take as well as a positive growth in FDI, despite global recession. Communications, on the other hand, exhibited signs of consolidation in H1-FY09. Mobile communications, for the first time, in December 2008 showed a slight contraction in subscriber base;¹⁸ this is primarily attributed to closure of undocumented cellular connections on account of PTA campaign. Encouragingly, despite the contraction in the subscriber base, revenue generation from mobile and WLL services is still increasing, indicating that most of the closed undocumented cellular connections were inactive ones.



Finance & insurance sector also demonstrated mixed performance during H1-FY09. While profitability of commercial banks decelerated during H1-FY09, central bank's profits (transferred to government) increased by 52 percent in this

¹⁸ Cellular density fell from 55.9 percent in Q1-FY09 to 55.8 percent by end-December 2008.

period. Moreover, performance of commercial banks is likely to improve in later half of the fiscal year due to: (1) the issue of liquidity crunch, faced by commercial banks in H1-FY09, has been resolved through effective and appropriate measures by the central bank, and (2) SBP's directive of providing the benefit of 30 percent cushion of forced sales value (FSV) of credit collateral to the commercial banks. These measures, as well as, increased FDI in financial sector in H1-FY09 may lead to increase in profitability of the financial institutions in general and commercial banks in particular.

Despite fiscal consolidation efforts, *administrative & defense* related spending during the current fiscal year has increased on account of unrest in the northern areas of the country and increased movements of troops along the Indian border in final months of 2008. Similarly, value addition by *community & social services* is expected to benefit from increased public spending towards social safety nets in terms of Benazir income support program during the final quarter of FY09. The budgetary allocations for the program doubled the federal government's spending on social safety nets to 0.6 percent of GDP in FY09. Resultantly, this sub-sector is expected to exhibit strong growth in FY09.

Table 2.13: Services Sector Performance Indicators						
percent growth or mentioned otherwise						
				H1		
	FY06	FY07	FY08	FY07	FY08	FY09
Wholesale & retail trade	-2.4	5.4	6.4			
FDI in trade	126.4	46.0	1.3	55.0	-0.4	-7.8
Imports	38.8	6.9	30.9	9.1	13.8	12.9
Trade volume (imports & exports)	28.7	5.5	24.2	7.4	9.9	12.1
Transport storage & communication	4.0	6.5	4.4			
Petroleum crude imports	76.6	-4.9	44.8	-1.8	3.6	35.7
Commercial vehicles production	16.6	-5.5	1.8	-6.7	1.6	7.7
Teledensity (percentage of population)	26.3	44.1	59.7	-	52.9	60.0
Cellular density (percentage of population)	22.2	39.9	54.7	-	48.6	55.8
Telecomm imports	-	15.2	4.0	22.3	2.2	-45.1
Transport group imports	-	9.2	-6.4	22.1	21.2	-46.2
FDI in transport storage & comm.	267.8	-0.5	-11.0	52.4	49.2	4.2
Finance & insurance	42.9	15.0	17.0			
SBP profit	119.6	59.5	51.6	905.1	20.7	52.0
Profit of commercial banks	76.4 a	24 a	-1.8 a	75.9	12.9	1.3
FDI in financial business	22.2	182.6	72.4	340.0	-32.7	77.2
Ownership of dwellings	3.5	3.5	3.5			
Cement Production	13.5	22.5	17.6	18.9	17.1	0.8
Metal production	5.3	10.7	-12.7	13.1	-3.3	-31.9
Public administration & defense	10.1	9.1	10.9			
Defense	14.3	3.3	14.1	-3.4	14.7	12.1
Public order and safety services	32.8	8.8	17.8	18.4	8.7	17.5
Economic affairs expenditure	-7.7	46.9	226.1	-24.5	173.3	46.2
Community, social & personal services	9.9	8.8	9.4			
FDI in social and personal services	162.5	23.8	16.3	1.3	51.5	13.7
Total FDI in services sector	181.5	27.4	13.5	111.7	8.3	24.0

a: data pertains to Calendar Year
b: quarterly data relevant to Calendar Year
c: Including light commercial vehicles, buses, trucks and tractors. Growth rate computed by using relative weights in LSM.