2 Real Sector

Aggregate demand in the economy showed some signs of recovery in the first five months of FY10; evident from higher sales of selected industrial and agriculture raw-material as well as consumer goods (see **Table 2.1**). A strong support came from higher farm incomes during FY09[1] which helped in sustaining consumption demand. The recovery was supported further by receding inflationary pressures that stabilized consumers' purchasing power to an extent. As a result, commodity producing sector is expected to exhibit a moderate recovery in FY10. Similarly, the performance of services sector is likely to improve in FY10, supported by *finance & insurance* as well as *public administration & defense*. Consequently, real GDP growth during FY10 is likely to be in the range of 2.5-3.5 percent, slightly up from 2 percent in FY09. It is important to note that the revival in aggregate demand is the combined impact of a gradual monetary easing and expansionary fiscal policy.[2,3]

Further impetus to recovery came from relatively lower input prices during most of 2009, as international commodity prices declined due to global recession. Nonetheless, firms remained cautious in building-up inventories as the FY09 collapse of prices had already caused significant inventory losses to a number of manufacturing industries including edible oil, steel, refineries, etc. Therefore, the present recovery came without significant pressures on demand for bank credit as well as imports.

The pace of recovery, however, has remained weak so far due to uncertain domestic political and security situation which caused weakening in investment demand. Similarly from the supply side, banks through most of Jul-Oct FY10 were reluctant to finance private sector credit, which was another factor obstructing a quick recovery. A weak recovery has manifested in low real wages, slackening import demand for raw-materials, and weak tax collection during Q1-FY10. Similarly, the aggravating security situation in the country did not allow any improvement in mining activities.

[1] Three major crops (wheat, rice and sugarcane), which account for about two-third in value addition by major crops, saw record high harvests in FY09. In particular, the government also procured record quantity of wheat at a significantly high price of Rs 950/40 kg in FY09.
[2] Fiscal deficit rose from 1 percent of GDP during Q1-FY09 to 1.5 percent of GDP in Q1-FY10.
[3] Support to manufacturing sector in FY10 came from fiscal side as government reduced FED on selected domestic end-products (e.g., cement, cars) and lowered import duties on raw-material.

The continuation of economic recovery will be challenging going forward as the global commodity prices continued to rise reaching 12-month high in November 2009. The increase in oil prices, especially, which resulted in increase in domestic prices of POL in December 2009 is going to be a major challenge in cost management. Similarly, although a rise in power tariff is inevitable, this increase will enhance cost of production. Also, while it is possible that gains in productivity could be achieved by minimizing load-shedding and winter gas outages; hydel electricity generation potential will be dependent on rains, while gas shortages seem probable.

Nonetheless, a stronger than expected surge in private credit since October 2009, substantial increase in cotton arrival,[4] improvement in electricity supply in recent months, a reversal in rupee parity by end-November 2009, capacity expansions in some industries (refinery and fertilizer) and stronger export orders are promising developments from the perspective of a recovery in manufacturing activities in the economy. As a result, a recovery seen in LSM production during Jul-Oct seems sustainable in the remaining months of FY10.

Table 2.1: Indicators of Aggregate Demand

percent growth

	FY09	FY10		FY09	FY10
A. Consumption indicators			**B. Investment indicators**		
POL sales (Jul-Oct)[1]	-5.2	16.4	Credit (manufacturing) (Jul-Oct)	6.4	-1.3
Cement sales-local (Jul-Nov)[2]	-14.5	9.3	Capital goods production (Jul-Oct)	6.2	-20.5
Auto sales (Jul-Nov)[3]	-20.5	29.7	FDI (Jul-Nov)	-17.7	-52.2
Fertilizer off-take (Jul-Oct)[4]	2.7	32.2	Exchange rate (end Nov.)	28.8	6.1
Volume of cotton sold to textile[5]	2.8	37.5	WPI (12-month ma)	25.0	7.4
Value of wheat[6]	32.3	74.3	Int. comm. price (avg. Jul-Nov YoY)	17.6	-23.3
Consumer finance (Jul-Oct)	-6.0	-7.6	**C. Govt. expenditures:**		
Taxes (Q1)	27.7	0.6	Fiscal balance (Q1)	-12.8	62.4
Direct taxes (Q1)	13.8	-3.5	Total expenditure (Q1)	11.1	24.5
Sales taxes (Q1)	33.2	6.2	Development Expenditure (Q)	-48.9	92.1
Imports (Jul-Nov)	16.4	-23.0	**D. Net exports**		
CPI (Nov) (12-month ma)	19.1	14.6	Trade balance[7] (FBS - Jul-Nov)	-20.8	37.8

Source: [1]OCAC, [2]APCMA, [3]PAMA, [4]NFDC, [5]PCGA (cotton arrival statement as on 15th December)

[6] Growth in value of wheat pertains to *rabi* 2008 and *rabi* 2009.

[7] Trade balance with minus sign shows increase in trade deficit whereas plus sign shows decline in deficit.

[4] Cotton arrival at ginning factories by December 15, 2009 is up by 24.2 percent (YoY).

2.1 Agriculture Sector Performance

Initial estimates suggest that the performance of FY10 *kharif* crops would be significantly weaker than in the corresponding period last year (see **Table 2.2)**. This is mainly because of water shortages at sowing times and, more importantly, farmers' disappointment with prices received for some crops of the previous *kharif* season. The latter is particularly evident in the decline in area under rice and sugarcane cultivation. Conversely, the impact of favorable price signals is reflected in the higher acreage under cotton during *kharif* FY10; cotton prices had registered an increase for the fourth consecutive year in FY09.

Table 2.2: Performance of Major Crops

Area under cultivation (000 hectares) **Crops**	**FY08**	**FY09^{T}**	**FY09^{P}**	**FY10^{T}**	**FY10^{E}**	**% change in FY10 over FY09**
Cotton	3,055	3,220	2,850	3,200	3,020	6.0
Sugarcane	1,241	1,040	1,029	1,106	952	-7.5
Rice	2,516	2,594	2,963	2,526	2,854	-3.7
Wheat	8,550	8,610	9,045	9,045	-	-
Gram	1,107	1,012	1,092	1,022	-	-
Maize	1,037	1,001	1,062	1,039	971	-8.6
Production ('000 tons; cotton in '000 bales of 170.09 kg each)						
Cotton	11,655	14,110	12,060	13,360	12,100*	0.3
Sugarcane	63,920	56,516	50,045	56,527	48,622	-2.8
Rice	5,561	5,721	6,954	5,949	6,377	-8.3
Wheat	20,959	25,000	24,032	25,000	-	-
Gram	475	652	760	750	-	-
Maize	3,109	3,279	2,891	3,414		-
Yield (Kg/hectare)						
Cotton	649	750	720	710	710	-1.4
Sugarcane	51,507	54,342	48,635	51,109	51,074	5.1
Rice	2,210	2,205	2,347	2,355	2,234	-4.8
Wheat	2,451	2,904	2,657	-	-	-
Gram	429	644	696	-	-	-
Maize	2,998	3,276	2,722	3,410		-9.2

P: Provisional, T: Target, E: Estimates
*: Projected on possibilities of 710 kg yield per hectare
Source: MINFA

The initial estimate for cotton production does not appear to be substantially higher than the previous year,[5] and the increase in value-addition may be offset by

[5] However, the Sindh cotton crop is thought to be substantially higher than in the previous year, benefiting from increased cultivation of Bt cotton. If the Punjab crop follows this

the impact of a significant decline in rice and sugarcane production. Early signals of poor *kharif* output and uncertain livestock due to decline in non-farm agri-credit raise the risk of an overall weak performance of agriculture sector during the current fiscal year.

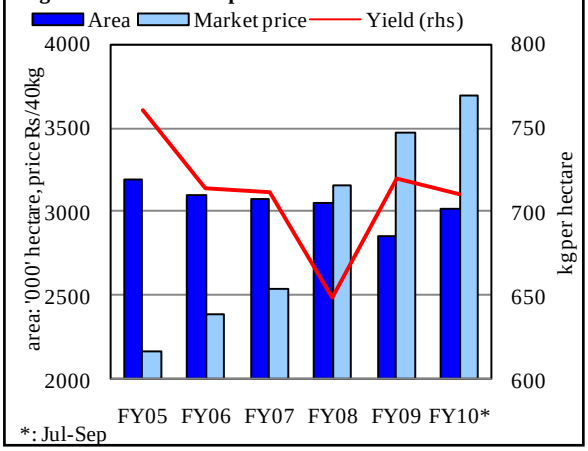
As variability in agricultural production has strong bearing on overall performance of the economy, it is extremely important to devise some mechanism that can help smoothing output in the crop sector. One such measure is the establishment of commodity futures market that can enhance information content in crop price-setting. In this context, an efficient legal and regulatory framework with crop insurance is important prerequisite for properly functional futures market.

2.1.2 Kharif Crops

Cotton

Cotton was the only important major crop to see increase in cultivated area in *kharif* FY10. But despite this increase, production is projected to remain around the preceding year's level of 12.1 million bales against the target of 13.4 million bales. Area under cotton cultivation increased by 6.0 percent in FY10 against 6.7 percent decline witnessed last year (see **Figure 2.1**). Initial estimates indicate that the shortfall in cotton output is principally from Punjab as the harvest in Sindh seems to be well above target.

Figure 2.1: Cotton Crop and Price Trends



The crop faced negative developments in the critical growth stages in August and September 2009, i.e., a) higher temperatures, resulting in excessive fruit shedding; b) incidence of pest attacks; and c) farmers unfamiliarity with Bacillus Thuringiensis (BT) cotton that led to excessive use of fertilizers. This raised the size of plant too much, which attracted multiplicity of insects.

pattern (or even remain unchanged from FY09), the FY10 cotton production could be significantly higher than suggested by initial estimates.

The cotton crop sown in normal season (May-June) also came under stress of extraordinary heat (45^0C plus against 41^0C last year), which restricted flower and boll formation. Moreover, a delay in winter arrival also damaged the crop at final stages of growth, which finally offset the impact of higher area under the crop.

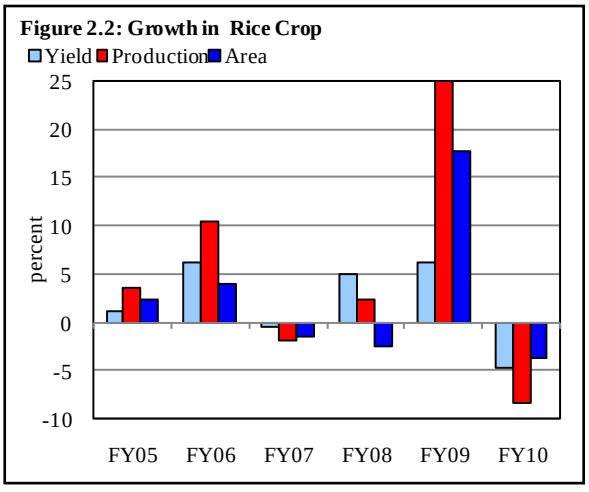
It is interesting to note that the arrival of cotton at ginning was about 24.2 percent higher than the preceding year by December 15, 2009. This was possibly because of excessive heat that forced growers to pick cotton early. Farmers were also incentivized by the prospect of sowing wheat by November, which would help increase yields and thus maximize the prospective gains due to high wheat prices and relatively low and stable fertilizer prices. If correct, this would suggest that the sharp jump in cotton arrival at ginning would likely to be sustained. However, there is a possibility that the stronger ginning arrival indicate a bigger than anticipated crop due to increased usage of early maturing high yield Bt cotton.

The view of an estimated lower annual production receives some support also from the strong demand for cotton in domestic markets that has driven local prices to record highs by early December 2009. It should also be remembered that domestic production of cotton remained lower than domestic consumption; domestic requirement for long staple is also met through imports. Thus domestic cotton prices increased due to: a) strong domestic demand with the revival of some exports, b) rising international prices, and c) a gradual weakening of rupee.

Rice

Initial estimates indicate a sharp decline in rice harvest relative to a record crop last year, though it is nonetheless higher than the target for FY10. This decline is the combined impact of lower area under rice, as well as, drop in its yield. The decline in area was anticipated due to a decline in international prices and farmers' disappointment over realized lower prices. Farmers were demanding a more active government intervention in the rice trade to stabilize the prices. However, ad-hoc measures by the government entails substantial fiscal costs and yield sub-optimum

Figure 2.2: Growth in Rice Crop



results. Therefore, improvement in market structure is an unavoidable need for the agri-commodity prices.

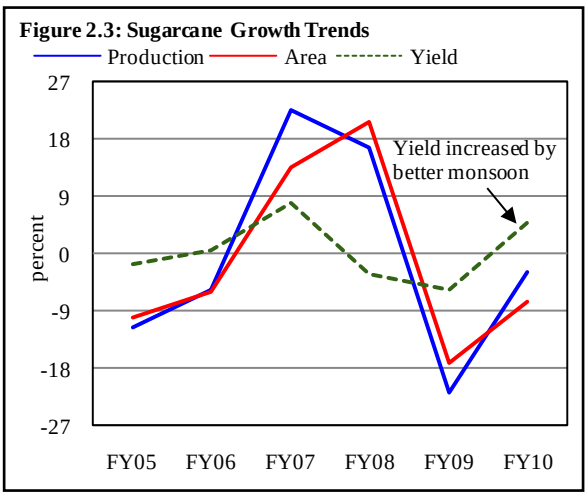
The decline in yield is mainly attributed to shortfall in irrigation water in some rice growing districts during sowing time: the impact was further compounded by dry weather, particularly in Multan and Sargodha region. Incidence of Leaf Borer also damaged crop in Punjab, resulting in decline in overall yield (see **Figure 2.2**). In addition, supply of sub-standard paddy seed was a major contributor to yield losses by 113 kg per hectare in FY10.

It is interesting to note that international rice prices are likely to resurge due to additional demand from India and Philippines. India is likely to become a net importer of non-basmati rice from a major exporter. It is also likely that people have started using basmati rice in India due to higher prices of non-basmati rice. This substitution would also put upward pressures on international prices of basmati rice due to lower exportable surplus with India. This suggests that farmers and traders may earn good price for rice in months ahead. This is not easy task, particularly for farmers especially in the absence of appropriate storage facilities. Farmers are typically forced to sale their produce to avoid wastages. Financing facilities and small investment in dry storage can make a strong impact on the motivation of the farmers.

Sugarcane

After achieving a record harvest of 63.9 million tons in FY08, domestic sugarcane output dropped for the second consecutive year during FY10 (see **Figure 2.3**). Farmers brought lower area under sugarcane due to continued dissatisfaction on marketing issues with sugar mills. Since carryover stock of 1.1 million tons from the bumper FY08 crop was substantial, sugar mills were relatively reluctant in aggressive buying and quick settlement of the payments during FY09. This discouraged farmers from sugarcane cultivation in FY10. This situation is quite frustrating as international sugar prices are on an uptrend and country has to

Figure 2.3: Sugarcane Growth Trends



import a substantial quantity to meet domestic demand. Fixation of domestic sugar price below international prices during Q2-FY10 may also go against the farmers. It is likely that sugar mills would offer a lower price than expected by the farmers since mills would like to minimize their input cost given regulatory hurdles in passing on the impact of higher cost. This would make sugarcane crop outlook further gloomy for years to come. It should also be noted that the cane pricing issue in India may also lead to contain a sizeable increase in 2010 sugarcane output; as India is a major sugar consumer that could mean international sugar prices will stay high during most of 2010.

Although sugarcane yield is expected to rise in some parts of Sindh due to higher than normal monsoon, the crop still suffers from a number of problems: a) autumn sugarcane cultivation is being substituted by wheat due to water shortages, b) power outages, as well as, c) higher electricity tariff and input rates discouraged growers, particularly in Punjab, to increase area under sugarcane. Given the prevailing uncertainty in international commodity prices and serious repercussions of 2008 commodity price shock on developing economies, a long-term and sustainable policy to resolve issues between sugarcane growers and farmers is needed.

Other Crops

Initial estimates suggest that performance of other major *kharif* crops is also not encouraging in FY10 when compared with the preceding year. However, the relative stability in market prices for minor crops, particularly perishable goods, indicates an improvement in supply of these commodities (for details see **Chapter 3** on **Prices**). These minor crops can also play an important role in earning foreign exchange, improving farm income as well as generating employment opportunities in rural areas. There is a need to invest in: a) proper transportation to market these items, b) establishment of small food processing and packaging units, as well as, c) dry and cold storage facilities. In particular, access to Middle East market at the initial

Figure 2.4: Agri-creditt Disbursement (Jul-Oct)

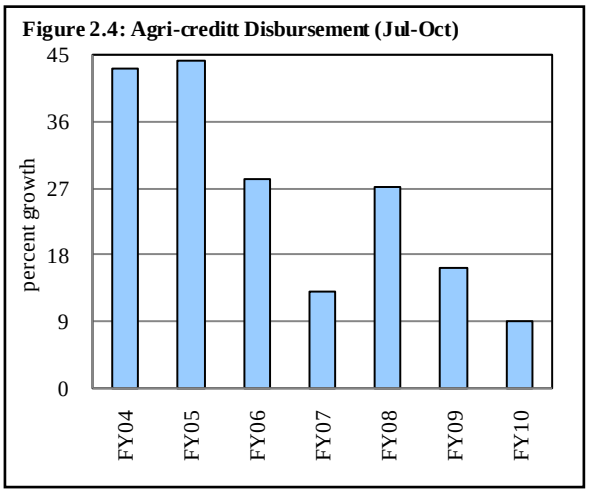


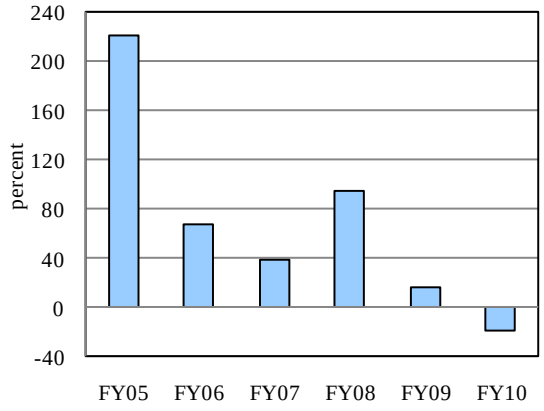
Table 2.3: Agri-credit Trends (Jul-Oct)

billion Rupees; change in percent

	Disbursement				Recoveries				Net credit		Outstanding	
	FY08	FY09	FY10	change	FY08	FY09	FY10	change	FY09	FY10	FY09	FY10
CBs	**38.2**	**44.6**	**47.6**	**6.6**	**33.6**	**44.0**	**47.1**	**7.1**	**0.6**	**0.5**	**85.4**	**81.1**
5 big CBs	26.8	31.5	36.9	17.4	24.7	30.9	35.9	16.0	0.6	1.1	58.6	56.3
DPBs	11.4	13.2	10.6	-19.2	8.9	13.1	11.3	-14.1	0.1	-0.6	26.8	24.8
Sp. banks	**11.3**	**13.0**	**15.3**	**17.8**	**8.7**	**10.8**	**10.9**	**1.0**	**2.2**	**4.4**	**87.8**	**98.8**
ZTBL	10	12.1	14.6	20.7	7.7	9.6	10.0	4.1	2.5	4.6	78.0	89.4
PPCBL	1.3	0.9	0.7	-21.3	1.0	1.2	0.9	-23.2	-0.3	-0.2	9.8	9.4
Total	**49.5**	**57.6**	**62.8**	**9.1**	**42.3**	**54.8**	**58.0**	**5.9**	**2.8**	**4.8**	**173.2**	**179.9**

stage is an advantage to Pakistan.

Figure 2.5: Growth in Agri-credit Disbursement by DPBs (Jul-Oct)



2.1.3 Agri-credit Performance

Agriculture credit disbursement growth during Jul-Oct FY10 slowed to 9.1 percent. Not only was this reduction in sharp contrast with FY09 growth of 16.2 percent, but was also the lowest in the last seven years for any Jul-Oct period (see **Figure 2.4**). The deceleration in agri-credit is attributed to both demand and supply side factors. Demand for institutional credit weakened due to: a) increased farm incomes on the back of record harvests of three major crops in the preceding season, and, b) decline in the cultivated area under three major crops during FY10 *kharif* season. Anecdotal evidence suggests that the farmers preferred to purchase inputs from their own resources.

On the supply side, commercial banks, particularly smaller banks, become risk averse due to rising NPLs and liquidity crunch. It is evident from a fall in agri-credit by the domestic private banks (DPBs) for the first time since the entry of these banks in agri-credit market (see **Figure 2.5** and **Table 2.3)**. Moreover, the opportunity to invest in government papers, given increased financing requirements of the government from domestic commercial banks, also reduced commercial banks' risk appetite.

Purpose-wise Agri-credit

A sharp fall in the agri-credit disbursement for developmental purposes by the commercial banks is in conformity with the risk-averse (cautious) agri-lending by these institutions (see **Table 2.4**), since developmental loans are settled in medium to long-run, while production loans cycle is short-term in nature. In addition, declines in disbursements for both production and developmental purposes by the DPBs are a reflection of more cautious lending by these institutions as these banks were hit hard by the squeezed liquidity conditions in money market.

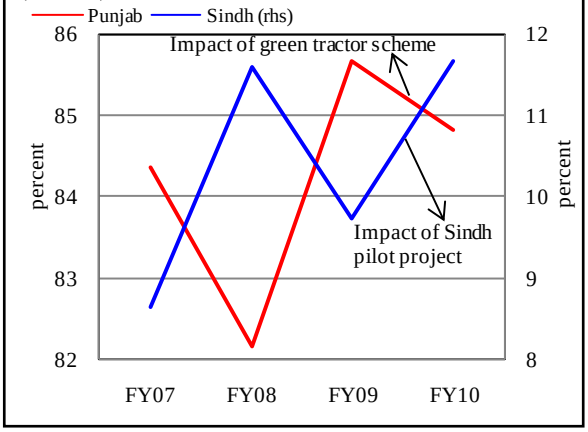
Table 2.4: Institution-wise Agri-credit

billion Rupees

	Production loans			Development loans		
	FY09	FY10	change %	FY09	FY10	change %
5-large (CBs)	27.8	35.9	29.2	3.6	1.0	-72.9
DPBs	11.8	10.2	-14.0	1.4	0.5	-64.6
Sub-total	**39.6**	**46.1**	**16.3**	**5.0**	**1.5**	**-70.7**
ZTBL	8.8	9.8	11.3	3.2	4.7	46.0
PPCBL	0.8	0.6	-18.2	0.1	0.1	-46.9
Sub-total	**9.6**	**10.5**	**8.9**	**3.3**	**4.8**	**43.3**
Total	**49.3**	**56.6**	**14.9**	**8.3**	**6.3**	**-25.0**

It should also be remembered that a major factor for high growth in the previous year was the successful implementation of a green tractor scheme in Punjab. It also increased the share of Punjab province in total agri-credit in FY09. Similarly, positive impact of Sindh Pilot Project[6] for seven districts initiated by the SBP, is evident in rising share of Sindh province in total agri-credit during FY10 (see **Figure 2.6**). It is expected that broadening the scope of this pilot project to the entire country in second phase as well as implementation of Benazir Tractor Scheme for all provinces would increase agri-disbursements in the country during the current fiscal year.

Figure 2.6: Province-wise Share in Agri-credit Disbursement (Jul-Oct)



[6] Under this initiative, it was mandatory for agri-credit disbursing banks to set up one window operation and post agriculture credit officers in their branches in 7 underserved districts of Sindh to increase agri-credit outstanding portfolio and number of borrowers. SBP will closely monitor and supervise the target achievement and implementation of the project.

Sector-wise Credit Disbursement

The slowdown in agri-credit was entirely attributed to a sharp deceleration in disbursement growth for non-farm sectors during Jul-Oct FY10 (see **Table 2.5**). This may adversely impact the outcome of FY10 livestock. While growth in agri-credit to poultry farmers decelerated, it declined sharply in the case of livestock dairy farmers and fisheries during this period.

Table 2.5: Holding-wise Agri-credit Disbursement (Jul-Oct)

billion Rupees				Growth rates	
	FY08	**FY09**	**FY10**	**FY09**	**FY10**
Subsistence	21.6	23.5	24.8	8.8	5.5
Economic	7.4	8.2	9.3	10.4	13.5
Above economic	6.8	6.2	6.5	-8.7	5.1
Farm	**35.7**	**37.8**	**40.5**	**5.8**	**7.2**
Non-farm	**13.8**	**19.8**	**22.3**	**43.0**	**12.8**
Small farms	2.2	3.6	3.7	63.7	4.7
Large farms	11.7	16.2	18.6	39.1	14.6
Total	**49.5**	**57.6**	**62.8**	**16.2**	**9.1**

Similarly, deceleration in agri-credit to farm sub-sector is emanating largely from subsistence farm holders during Jul-Oct FY10; as higher growth was registered under economic and above economic farm holders. A similar trend was observed in non-farm sector. Although, growth in agri-credit slowed for both small and large farm holders under non-farm sub-sector, the impact was more pronounced in the former. This may probably be attributed to: a) farmers used own resources due to increased farm income in FY09, as well as, b) cautious lending by the commercial banks to small farm holders. However, reduction in interest rates amid easing monetary stance of the central bank, a relative stability in commercial banks' NPLs and increasing credit requirements by the farmers for wheat crop, it is hoped that pace of institutional agri-credit disbursement is likely to improve November 2009 onwards during *rabi* season.

Table 2.6: Growth of Agri-credit and Fertilizer Off-take

	Disbursement		**Urea**		**DAP**	
	FY09	**FY10**	**FY09**	**FY10**	**FY09**	**FY10**
July	16.1	19.0	-26.7	26.3	-77.8	577.1
August	8.8	-8.7	-9.5	42.2	-68.4	737.3
September	38.8	-4.0	75.5	7.2	-2.5	160.5
October	-4.5	26.5	98.1	-3.8	24.3	-45.4

A monthly break-up of agri-credit disbursement and fertilizer off-take also support the direct relationship between the two variables (see **Table 2.6**).[7] Specifically, a rise in credit disbursement during July 2009 had positive impact on fertilizer off-take in the following month. Similarly a fall in disbursement in September 2009 had a negative impact on fertilizer off-take. Given this trend and substantial

[7] Some other factors such as fertilizer prices, water availability and prices of farm produce have influence on fertilizer off-take with agri-credit.

requirements of fertilizers for wheat on the back of farmers' optimism, due to high wheat prices and lower fertilizer prices, agri-credit disbursements are likely to see a jump in FY10 *rabi* season.

Table 2.7: Fertilizer Off-take (Jul-Oct)
(million tons)

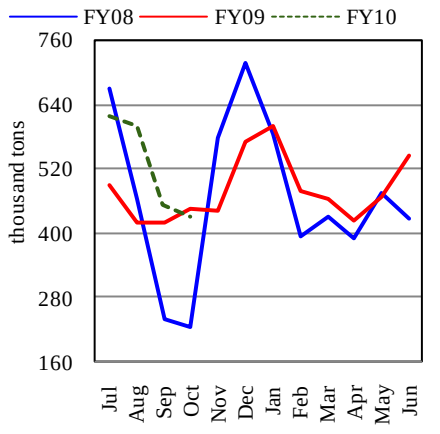
	FY08	FY09	FY10
Urea	1.6	1.8	2.1
DAP	0.5	0.4	0.8
Total	2.1	2.2	2.9
Growth (%)			
Urea		11.2	18.0
DAP		-24.3	98.2
Total		2.7	32.2
Share (%)			
Urea	76.0	82.3	73.5
DAP	24.0	17.7	26.5

2.1.4 Fertilizer Off-take

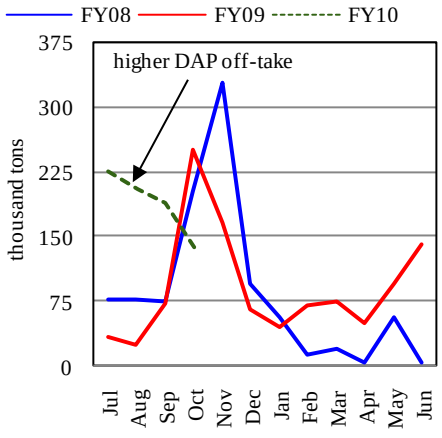
Fertilizer off-take increased sharply during the first quarter of FY10 against negative growth seen in the same period last year. This growth was attributed to a fall in the prices of both urea and DAP (see **Figure 2.7**). While, a higher off-take was observed in the first two months of FY10, it declined in September 2009. However, fertilizer off-take is likely to increase further during *rabi* season given impetus from stable wheat support price and relatively lower fertilizer prices. Anecdotal evidence suggests that fears of a resurge in fertilizer prices before wheat sowing season also encouraged growers to purchase fertilizer early. A sharp increase in DAP off-take is encouraging as a balanced use of nutrients is necessary to increase the yields, particularly for wheat (see **Table 2.7**).

Another factor, which contributed to higher fertilizer off-take, may be the market signals of higher prices of sugar in the domestic as well as in international

Figure 2.7: Urea Off-take



DAP Off-take



markets. Since sugarcane crop was cultivated on lower area, the growers may have sought to raise yield through higher application of fertilizers to maximize their gains. However, it is pertinent here to note that while a balanced use of fertilizer helps maximize the crop yields, market related issues impede farmers to apply an appropriate mix of the nutrients (see **Box 2.1**).

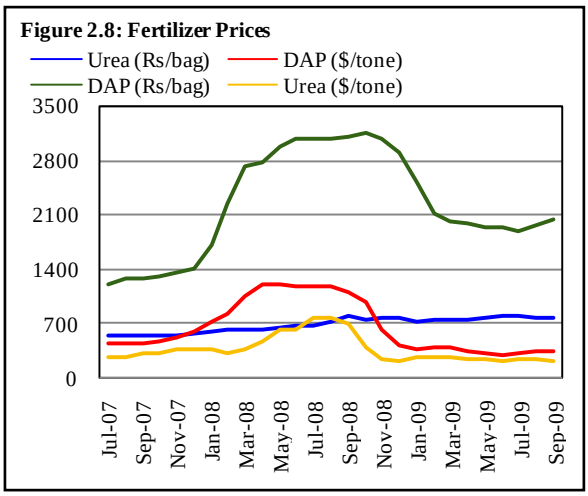
Box 2.1: Fertilizer Issues Faced by the Farming Sector

The main issues that farming sector faces today, regarding fertilizers consumption are: a) difficulties in timely availability at affordable prices, b) adulteration, and, c) imbalanced use of nutrients/fertilizers. At crucial stages fertilizers are usually missing from sale points and growers are on the mercy of traders. Efforts should be made to ensure regular supply of fertilizers. Delayed availability/application of fertilizers increases cost of production on one hand, and unable to play any active part in yield increase-resulting in misuse of resources and national wealth. Adulteration in fertilizers is common to maximize profit, which cause heavy cash and yield losses to the grower and shake their confidence. It is required to strictly impose law upon those found involved in fertilizer adulteration. Researchers/scientists agree that balanced use of fertilizers is necessary for yield maximization. Stakeholders should make efforts to educate farmers to apply balanced fertilizers. Through print and electronic media efforts should be made to inform growers regarding balanced use of fertilizers to maximize crop yields. Balanced use of fertilizers also helps to reduce various plant diseases, thus increases yield. Fertilizer is an expensive and valuable input; and should be used judiciously.

Fertilizer Prices

Domestic fertilizer prices started to ease from Q1-FY09 but a sharp declining trend since then led farmers to postpone purchases. Although prices resurged again in Q1-FY10, these are relatively stable **(**see **Figure 2.8)**.

Figure 2.8: Fertilizer Prices



International fertilizer prices registered drop at a faster pace than the domestic prices. This difference is explained by the impact of depreciation of rupee.

It may be noted that outlook of international fertilizer prices remains uncertain given rolling-coaster trend in energy prices. In addition, adjustment in the domestic utility prices may also have upward pressures on domestic prices. In case of higher variability in fertilizer prices, their off-take may slow down.

2.1.5 Water Availability

Water availability at the start of crucial *rabi* FY10 season (Oct-Mar) has improved compared to the last three years (see **Figure 2.9**). The anticipated water availability as per IRSA forecast was 23.9 million acre feet (MAF) in *rabi* FY10, up by 6.9 percent relative to the corresponding *rabi* season. IRSA estimates indicate 31.0 percent shortages in current *rabi* season against 39.0 percent shortages in the corresponding period in FY09.

Figure 2.9: Rabi Start Storage

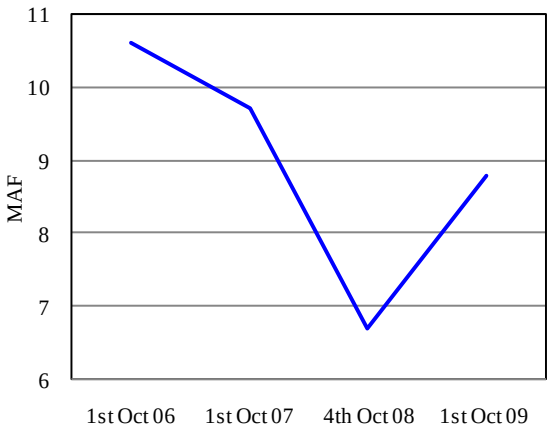
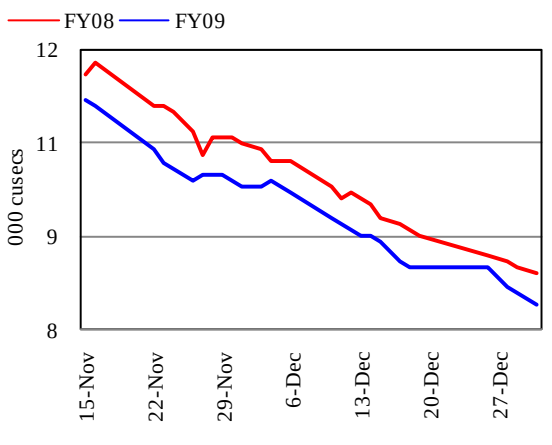


Figure 2.10: Glacial Melt

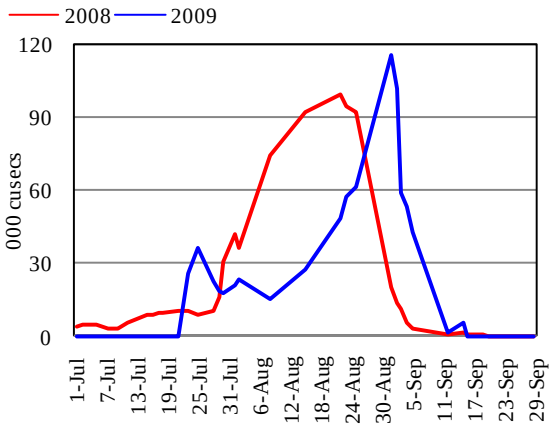


The slight improvement emanates from the combined storage at the start of *rabi* last year, which was 7.3 MAF while it was 8.8 MAF as on October 1, 2009. Late monsoon rainfall was instrumental in building-up the reservoir levels. It is pertinent to note here that the water reservoirs situation will deteriorate as winter approaches.

The water reservoirs' position at the time of clearing of irrigated area from sugarcane and cotton, when it is being prepared for wheat crop, is likely to be weak, with glacial melt discharges from Indus basin not exceeding 12000 cusecs in the month of November and likely to drop to 8000 cusecs by December 2009 (see **Figure 2.10**) due to falling temperatures. Winter rains would be a deciding factor for the final tally of the wheat sowing in the major wheat growing belts of Punjab. The positive impact of late monsoons was visible in the Kotri downstream outflows critical to the growth of mangroves in the Indus delta region

(see **Figure 2.11**). Outflows continued till end of September 2009 compared with mid September 2008. That was illustrative of the availability of water till the last stretches of the Indus canal system.

Figure 2.11: Kotri Outflow



However, they were also indicative of the water flows that remain unutilized in the world's most elaborated canal network. That calls for the construction of new reservoirs as well as rehabilitation of the canal system. Further, better water management and efficient use of water through improved land leveling is also necessary to enhance yield as well as to face the future challenges.

2.1.6 Outlook

The growth outlook for FY10 agriculture sector seems gloomy and likely to be lower than the strong growth seen in FY09. However, an aggressive wheat sowing by end-November is encouraging as a bumper wheat crop may push up agri growth. A bumper wheat crop is expected due to: a) slight improvement in water availability during *rabi* FY10, b) relatively lower and stable fertilizer prices, as well as, c) stable domestic wheat prices despite substantial drop in international prices. This may also be supported by an improvement in minor crops. However, initial estimates suggested performance of FY10 *kharif* crops was below expectations, and expected lower growth in livestock (due to decline in credit to this sub-sector during Jul-Oct FY10) may largely offset gains from a good *rabi* harvest.

2.2 Large Scale Manufacturing

The LSM sub-sector, after declining for 13 consecutive months, recorded a mild recovery in Jul-Oct FY10. The 18-month high YoY growth in October 2009 took the cumulative LSM growth in Jul-Oct FY10 to 0.7 percent; compared with a decline of 5.0 percent in Jul-Oct FY09. Almost half of the LSM sub-groups showed improvement from the previous year, mainly including industries producing consumer and intermediate goods. However, monthly production trend shows quite an erratic pattern (see **Figure 2.12**). In specific terms, while

production declined in July and September compared with the corresponding months in FY09; it increased in August and October. Furthermore, the recovery during Jul-Sep FY10 was quite weak as huge production declines in petroleum and metal sub-sectors offset production gains in many industries. The YoY growth in October, however, looks firm mainly on the back of strong ginning activities during the month and consolidating improvements in cement and automobile industries. On cumulative basis, textiles, leather, automobiles and rubber were few sectors that recorded net improvement in production in Jul-Oct FY10. In contrast, petroleum, metals, and capital goods were major industries

Figure 2.12: LSM Growth (YoY)

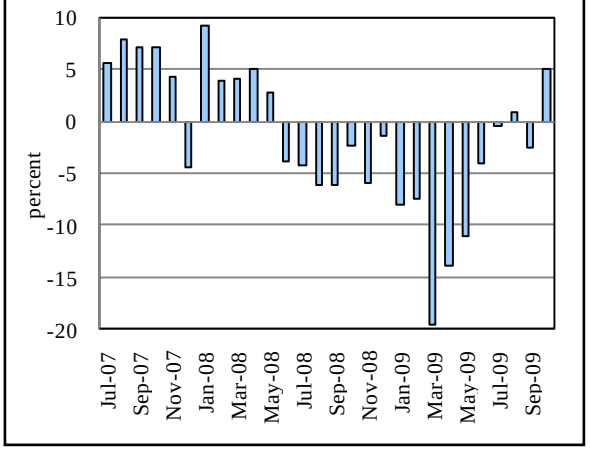


Table 2.8: Production and Trade of Major Manufacturing Goods during Jul-Oct

Growth in industries producing exportable surplus						**Growth in industries competing with imports**					
in percent		**Production**		**Exports**				**Production**		**Imports**	
	AdWt	**FY09**	**FY10**	**FY09**	**FY10**		AdWt	**FY09**	**FY10**	**FY09**	**FY10**
Textile	24.5	**-0.4**	**-0.6**			**Automobile**	5.3	**-32.3**	**7.1**		
Cotton yarn	13.1	-0.42	-2.2	-15.2	42.6	CBUs[2]	3.4			-24.7	-40.3
Cotton cloth	3.4	-0.67	-0.7	23.6	-39.8	CKD[3]				14.5	34.8
Cotton ginned		1.42	13.0	277.5	68.0	**Electronics**	3.3	**-10.4**	**-15.2**		
Leather	3.0	**1.5**	**22.4**			**Fertilizer**	4.5	**12.1**	**2.3**	-21.9	-35.2
Upper leather	1.5	0.6	12.3			**Paper**	0.8	**2.2**	**7.7**	-11.1	0.6
Sole leather		-15.8	103.1			**Rubber**	0.4	**5.5**	**26.1**	-42.9	-4.3
Footwear	0.7	24.0	-1.2	4.4	2.0	**Food**	19.1	**-5.8**	**-0.2**		
Pharma	6.7	**0.4**	**0.7**	5.3	-18.3	Edib. Oil[4]	5.7	-6.50	7.0	-13.1	6.4
Ply-wood	0.0	**45.7**	**-28.2**			**POL**	7.0	**-6.0**	**-11.4**	22.5	21.3
Non-metallic	5.6	**1.6**	**18.5**			MS[5]		-6.4	-0.9	-13.8	598.5
Cement[1]	5.5	1.4	18.8	72.9	18.0	FO		-7.4	-19.5	2.5	71.5
Chemicals	6.4	**-0.7**	**1.0**			HSD		1.2	-9.6	13.7	9.8
Engineering	0.6	**9.0**	**-14.5**			**Metal**[6]		**-13.9**	**-21.3**	-23.4	-21.2

[1] Source for cement export data is APCMA. Growth numbers presented here do not tally with FBS data.

[2,3]Dollar import value change as quantum change is not available, [4]Import of palm oil

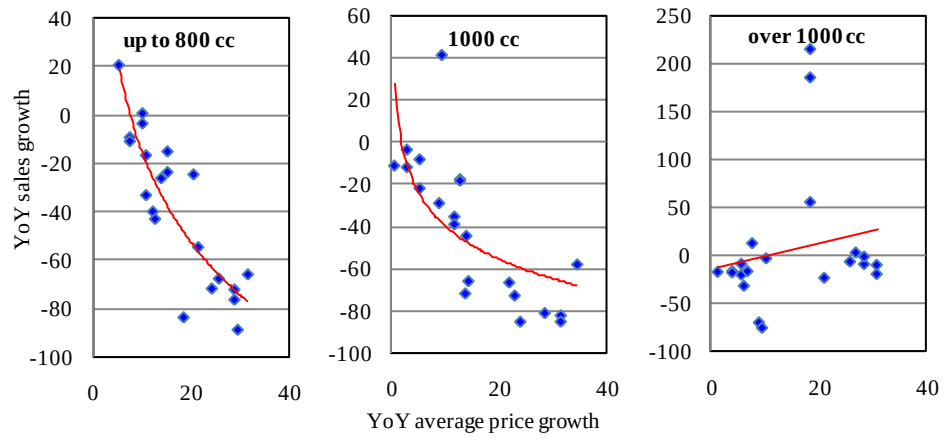
[5]Import data for all POL products is taken from OCAC website, [6] Import only includes iron & steel (incl. scrap)

showing production declines (see **Table 2.8**)

Robust growth in cement industry during Jul-Oct-FY10 emanated from higher domestic demand as well as strong export demand. Decline in local cement prices in the start of FY10, following the reduction of FED on cement in FY10 budget appears to be the major factor in higher domestic sales.[8] Moreover, higher budgetary allocations for housing and works as well as decline in other building material prices further strengthened the local demand. Cement exports, on the other hand, slowed down during Jul-Oct FY10.[9] The slowdown in exports was both broad-based as well as expected. Specifically, with new capacities coming on line in the regional economies, a slowdown in the cement exports was expected especially from India that had already imposed 20 percent duty on cement imports from Pakistan in January 2009. Moreover, with the global financial crisis penetrating into Dubai construction sector, a drastic weakening was observed in cement demand from the Gulf. Nonetheless, domestic demand for cement is likely to remain strong as a number of new housing projects are in line mainly in the private sector and government is also keen in initiating mega infrastructure projects.

Consumer durable industries showed some recovery despite the absence of bank finance. In FY09, a sharp jump in the prices of most of electronics and frequent electricity disruptions had caused a slackening demand for consumer durable

Figure 2.13: Auto Prices & Sales

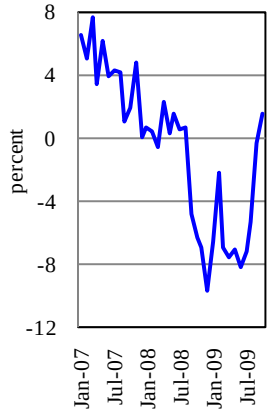


[8] Local cement dispatches increased by 12.9 percent in Jul-Oct FY10 compared with a decline of 14.2 percent in Jul-Oct FY09.

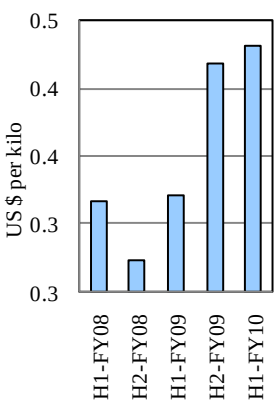
[9] Data from All Pakistan Cement Manufacturers Association shows an increase of 18.0 percent in cement exports during Jul-Oct FY10 compared with an increase of 72.9 percent in Jul-Oct FY09.

goods. Moreover, high cost and lower availability of bank finance further reduced production activities in automobiles and electronic industries. In Jul-Oct FY10 however, the automobile sub-sector, in particular, recorded higher production as the demand for cars and motorcycles increased mainly on the back of lower prices and higher agriculture incomes (see **Figure 2.13**).[10] Specifically, the government removed FED on the purchase of cars 850 cc and above in Budget 2009-10 that was imposed in the previous year to curb excess demand pressures. As global commodity prices and exchange rates were relatively stable in Jul-Oct FY10 compared with last year, automobile companies passed on the benefit of duty elimination to the consumers.

Figure 2.14: Sales in US Retail Stores (YoY growth)



Spread of Yarn Prices in Global & Lcoal Market

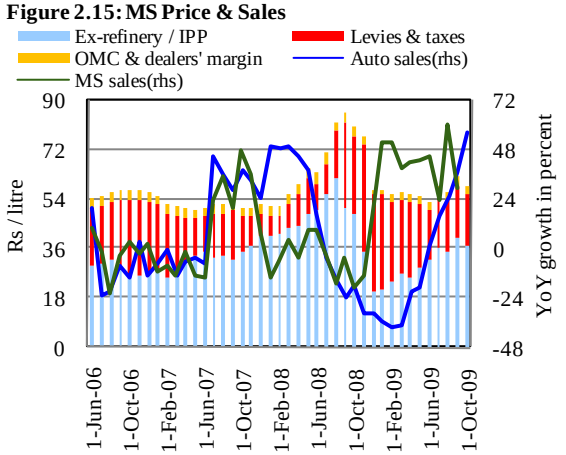


In sharp contrast to the above, the growth in textiles sector during Jul-Oct FY10 came mainly from better arrival of the new crop and increase in external demand. Specifically, the domestic textiles benefited from: a) increase in cotton crop, b) some recovery in retail sales of textiles in advanced economies (see **Figure 2.14**), and c) higher international prices of cotton and cotton yarn following the sizable shortage in Chinese cotton crop. As a result of these factors, production and exports of cotton ginning industry registered a strong growth during Jul-Oct FY10. Moreover, although the operational bottlenecks that the spinning industry has been facing for the last couple of years including higher financing cost, electricity and gas outages, as well as unfavorable domestic security situation; the increased price differential in local and global yarn prices created a viable opportunity for spinners to produce more. With higher exports of cotton and cotton yarn, the upward pressures on local cotton and yarn prices started to emerge, increasing production cost of high value added sector. As a result, domestic weaving industry suffered and reportedly a number of small power looms shut down during Jul-Oct FY10.

[10] Major car makers reduced prices in Q1-FY10.

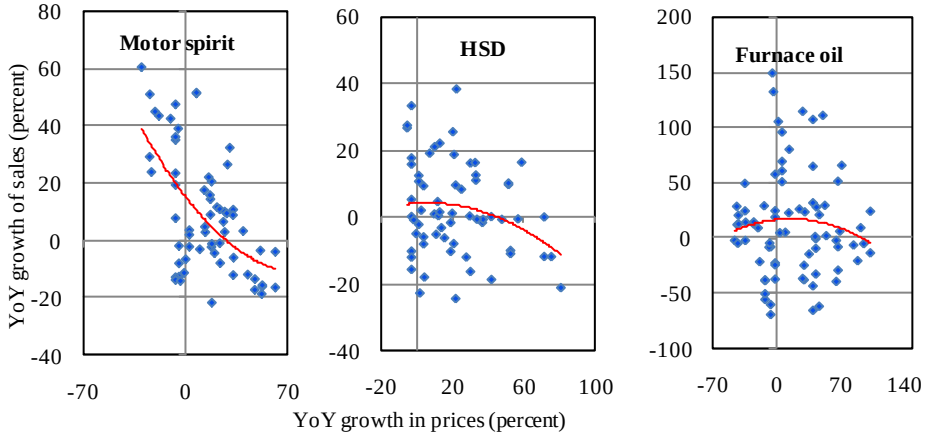
With recovery seen in major manufacturing sectors, demand for petroleum products increased. However, a large part of the demand was fulfilled through imports and domestic refineries faced severe liquidity problems in running the production processes smoothly. Specifically, the problem of circular debt in the refining sector did not allow refineries to import sufficient quantities of crude oil and operate at normal throughputs. As a result, country had to import refined petroleum products to fulfill domestic requirements.

Figure 2.15: MS Price & Sales



Pick-up in demand for motor spirits appeared first in the initial months of 2009 following the collapse of global oil prices (see **Figure 2.15**). The decline in domestic petrol prices caused petrol-CNG price differential to narrow causing substitution of motorspirit over CNG. Although in the following months global prices started inching up again, but government adjusted the domestic levy structure to stabilize prices. Later in Q1-FY10, the sales of automobiles, especially motorcycles, picked up after declining for 12 consecutive months. The higher automobile sales were mainly a response to lower prices following the duty

Figure 2.16: Price Elasticity of POL Sales



cut in Budget FY10 (see **Figure 2.16**). [11]

Going forward, LSM performance is expected to vary widely across the sectors. While the addition of new plants and further resurgence in demand tilt the scales towards a higher overall growth number, a host of uncertainties also linger in the near future.

Demand for refined POL products, mainly furnace oil and motor spirits, is likely to remain strong. While the demand for furnace oil is likely to emanate from increase in electricity generation capacity, the demand for motor spirit will remain strong as the automobile sales picked up and CNG-petrol price differentials narrowed further. Furthermore, government's decision to close CNG stations twice a week may also strengthen motor spirit demand. The refineries' response to higher demand is evident from 33.9 percent YoY increase in crude imports in Oct-Nov FY09. Production capacity of fertilizer and steel sector is likely to increase sharply with new plants coming online. Specifically, annual production capacity of nitrogenous fertilizer will increase by approximately 146 percent to 3.6 million MT by the end of the fiscal year. Furthermore, 30 percent increase in production capacity of steel sector is expected as a new steel producing unit will start commercial production in March 2010. Lastly, production of transformers is also likely to rise as demand increases, following expected up-gradation of the electricity distribution network.[12]

However, a number of downside risks also prevail that may inhibit an otherwise strong LSM recovery. If the recent uptrend in global commodity prices continues and gathers pace, the resultant increase in retail prices may hurt the demand. This is already evident in automobile sub-sector where car assemblers have increased retail prices November 2009 onwards following the increase in prices of aluminum and copper and further depreciation of rupee against yen. Moreover, domestic prices of raw material showed a year-on-year increase of 20.2 percent in November 2009.

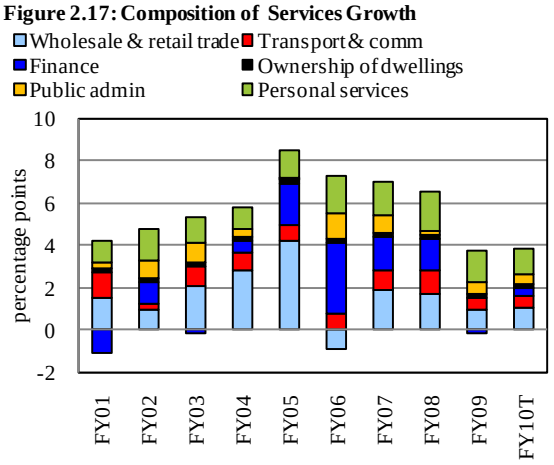
Aside from domestic demand, several other factors put downward pressures on manufacturing growth; these include a lower sugarcane harvest along with fears of late cane-crushing, which could impede growth in sugar industry (5.5 percent weight in LSM).

[11] According to an estimate, of the total motor spirit sale in the country, 55 percent is consumed by motorcycles.
[12] In October 2009, production of transformers increased by 8.4 percent YoY after declining in previous 11 months.

Furthermore, the recovery in advanced economies has been weak so far. Credit markets in the US and EU are still depressed, employment levels are low, and as a result consumption patterns are weak. The recovery in these economies is still dependent on policy support and fear of premature policy reversals adds to uncertainties in the global outlook. The domestic exporting industries of textiles (other than spinning) and leather may not see any major demand impetus and would thus need to strive to capture a larger share in stagnant demand. The export demand for cement is not likely to sustain due to tougher competition with the lifting of export ban in Saudi Arabia. It must be noticed here that the cement export growth in the previous years was driven largely by newly-captured African and Gulf markets. Saudi Arabia, having the vicinity advantage, can give a tough competition to local exporters to maintain market shares. Price competition will also toughen as coal prices increase.[13] Moreover, security crisis in the Frontier province could jeopardize cement supplies given the fact that NWFP has around 30 percent share in total cement production.

The pace of recovery in the domestic economy will also depend on the supply and costs of two key inputs: energy and finance. A tight monetary stance till Q2-FY09 had increased firms' financial costs significantly. This, coupled with squeezed operating margins in the face of depressed demand, had led to severe liquidity shortages in many industries. As a result, NPLs of manufacturing industries have increased substantially in recent years. To accommodate the slight increase in demand from private sector, the State Bank reduced the policy rate by 250 basis points on three different occasions since April 2009; lending rates have also responded, though gradually. Furthermore, a sharp increase in credit off-take by manufacturing sector during Oct-Nov FY10 bodes well for the sector's recovery.

Figure 2.17: Composition of Services Growth



2.3 Services

Services growth in FY10 was expected to maintain, and slightly surpass, the FY09

[13] Particularly, Indonesian coal prices are expected to rise as the country plans to employ the fuel for thermal energy generation. A large proportion of coal employed in local cement manufacturing is imported from Indonesia (around 50 percent).

growth mainly on the back of an expected recovery in finance and insurance sub-sector (see **Figure 2.17**). The expectation of a stable growth was reinforced by the recovery in manufacturing in Q1-FY10 which is expected to support wholesale and retail trade activities (which have one-third share in overall services value addition) (see **Table 2.9**).

Table 2.9: Indicators of Services Sector Performance in Q1

percent growth, (mentioned otherwise)

	FY09	FY10
Wholesale & retail trade		
Credit to wholesale and commission trade (Jul-Oct)	-2.1	-4.7
Credit to retail trade (Jul-Oct)	16.6	2.2
FDI in trade (Jul-Nov)	2.5	-52.8
Manufacturing growth (Jul-Oct)	-5.0	0.7
Import growth (Jul-Nov)	16.4	-23.0
Transport, storage & communication		
Cargo handling at KPT (Jul-Nov)	9.0	10.2
Tele-density (percentage of population)	60.0	62.4
Telecom imports (Jul-Oct)	69.6	33.6
Sales of commercial vehicles*	-7.6	1.5
Transport group imports (Jul-Oct)	42.1	-25.6
Transport communication inflation (Nov)	23.8	6.2
Finance & insurance		
Profits of commercial banks (Sep on Jun)	23.4	47.2
Percentage of advances at 12% or above (Oct)	72.9	77.9
Percentage of deposits held at 8% or above (Oct)	34.5	37.4
Interest rate spread – stock	7.7	7.4
Interest rate spread - incremental (Oct)	6.0	6.5

* LCVs, tractors, buses and trucks (Jul-Nov)

However, the sharp decline in external trade volume (mainly imports) may partially offset the gains from real sector recovery. Specifically, the decline of 23.0 percent in imports during Jul-Nov FY10 can have multiple implications for services sector growth: a) some slowdown in wholesale and retail trade activities, b) slowdown in import-related port/shipping activities, and c) some impact on inland freight (inland transport of imported goods). The decline in sale and production of trucks and LCVs as well as lower sales of HSD also reflect the decline in inland freight.

In addition to decline in imports, a further drag to growth in transport and communication may also come from the telecom sector. The telecom companies are operating within a highly competitive market competition which has already resulted in a significant decline in the ARPU (average revenue per user) and, therefore, the profits of these companies. In Budget 2009-10, the government reduced federal excise duties and SIM activation charges which could increase earnings, if not passed on to end users. However, it is highly likely that telecom companies would pass on this benefit to consumers in order to capture and maintain market shares. The decision to pass on the benefit to users would largely depend upon the demand for network services in months ahead. In this scenario, the government's decision to eliminate regulatory and reduce customs duties on

import of mobile sets may increase network demand. Moreover, network suppliers are reciprocating to increased demand by up-grading operations, including: a) expanding network base to remote areas, b) providing value-added services through cellular phones, e.g., mobile banking, payments of utility bills, etc., and c) technical up-gradation of existing infrastructure. A strong growth in telecom imports during Jul-Oct FY10 and slight increase in cellular density also raised optimism regarding sector's prospects.

As mentioned earlier, the finance and insurance sector is likely to benefit from favorable supervisory measures announced during the quarter. These measures include: a) ease in regulations regarding the benefit of forced sale values of collateral while computing the provisioning requirements, and b) relaxation in loan classification and resultant lower provisioning requirements. Moreover, the net interest margins have widened which resulted in increased interest earnings during Q1-FY10. In addition, a higher banking spread in Q1-FY10 is expected to further boost banks' net interest earnings during the year. The recovery in finance and telecom sub-sectors is a welcome development given its strong implications for employment generation, export potential, and overall development in the country. Moreover, rapid job creation in these sectors in the recent past means that further expansion will result in more employment absorption (see **Table 2.10**).

Table 2.10: Contribution of Services in the Economy

	GDP growth[1]		% point contribution in GDP growth		Employment growth[1]		% point contribution in employment growth		Investment growth[1]		% point contribution in investment growth	
	CPS[2]	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.
1970s	3.2	6.1	1.7	2.8	2.6	5.1	2.0	1.3	..	..	..	..
1980s	5.9	6.7	2.9	3.4	2.1	3.1	1.5	0.9	4.9	5.2	3.0	2.0
1990s	4.5	4.5	2.2	2.3	1.2	4.6	1.4	1.2	-0.3	3.1	-0.7	1.8
2000s	4.2	5.7	2.0	3.0	3.3	4.5	2.1	1.5	-0.7	8.9	-0.3	5.1

[1]Compound growth, [2] CPS refers to commodity producing sectors.

Thus, the services sector is all set to grab a growing share in the economy. With employment numbers reaching 17 million in 2008, the sector is fast outpacing the agriculture sector, the economy's largest employer (with a 21 million-strong labor force). Not only that, services has consistently outpaced the commodity-producing sector (CPS) in terms of contribution to GDP growth; and the drawing on bulk of investment expenditure in the last decade paves the way for future growth in services.