

2 Real Sector

2.1 Overview

Initial data for FY13 suggests that the economy is likely to miss the growth target for another year due to supply disruptions. Monsoon rains and local flooding in upper Sindh, lower Punjab and Eastern Balochistan damaged the cotton and rice crops, and gas shortages disturbed manufacturing activities in the country: a significant decline in fertilizer production has more than offset the growth in many industries.

Nonetheless, some support to growth will come from the expected increase in sugar production (due to an above-target sugarcane harvest); an increase in wheat cultivation on the back of higher support price; and construction activities.

2.2 Agriculture¹

For FY13, the government has set a target of 4.0 percent for the agriculture sector, higher than the 3.1 percent growth realized in FY12 (**Table 2.1**).² To begin with, the target was challenging as this would have required a strong performance by *all*

Table 2.1: Targets for the Agriculture Sector

	% Share in VA (FY12)	Growth		FY13 Target
		FY11	FY12	
Agriculture	100.0	2.4	3.1	4.0
Major crops	31.9	-0.2	3.2	3.8
Minor crops	10.1	2.7	-1.3	4.5
Livestock	55.1	4.0	4.0	4.2
Fishing	1.8	1.9	1.8	2.0
Forestry	1.1	-0.4	0.9	2.0

Source: Planning Commission

Table 2.2: Production of Major Crops

million tons, million bales for cotton

	% Share in major crops (FY12)	Production			Max output in last 10 years
		FY11	FY12	FY13 target	
Cotton	24.6	11.5	13.6	14.6	14.3
Sugarcane	11.7	55.3	58	59	63.9
Rice	15.4	4.8	6.2	6.9	7
Wheat	39.2	25.2	23.5	25.5	25.2

Source: Planning Commission

¹ At present, as Crop Reporting Service in each province is responsible for collecting information on crops, the consolidated data for the country is not available. The Pakistan Bureau of Statistics aggregates these numbers, but only after a considerable delay.

² The prospects for a better performance are based on a recovery in minor crops, and a further boost to major crops, on top of a strong growth recorded in the previous year.

major crops (**Table 2.2**).³ This was not possible because of considerable damage to the cotton and rice crops from the monsoon rains and flash floods in September 2012. The sugarcane crop, however, performed reasonably well.

Cotton

The Cotton Crop Assessment Committee estimates the harvest at 13.3 million bales of 170 kg – below the target of 14.6 million bales and lower than 13.6 million bales realized in FY12 (**Table 2.3**).

Table 2.3: Cotton Crop for FY13 (million bales)

	Target	Assessment	Deviation from target
Punjab	10.5	9.6	-0.9
Sindh	4.0	3.6	-0.4
Baluchistan	0.1	0.1	0.0
Pakistan	14.6	13.3	-1.3

Source: Cotton Crop Assessment Committee

The area under cultivation declined compared to the last year due to: (1) shortage of water at the sowing time;⁴ (2) delays in harvesting of the preceding wheat crop;⁵ (3) lower cotton prices in the previous season; and (4) the shift in preference of farmers towards sugarcane.⁶

The cotton crop was hampered further due to late arrival of monsoon rains. The crop suffered the most from flash floods and heavy rains in Southern Punjab.⁷

Rice⁸

The plantation of the *irri* variety ends in July, but it continues till August for *basmati* rice.⁹ This year, a shortage of irrigation water delayed the crop sowing season.

³ The target for individual major crops was set either near, or above, the maximum production realized during the last 10 years.

⁴ The water availability during kharif (before monsoon rains) was 15 percent lower, compared to the corresponding period of the last year.

⁵ The extreme cold weather in *rabi* extended the ripening stage for the wheat crop.

⁶ Farmers who were expecting heavy rains this year, preferred sugarcane crop which is more resilient to floods.

⁷ The major affected areas include: DG Khan, Rajanpur, Muffargarh, Rahim Yar Khan, Bahawalpur and Bahawalnagar in Southern Punjab. These districts produced 4.9 million cotton bales in FY12. According to Suparco, heavy monsoon rains led to a loss of 0.43 million bales

⁸ Punjab is the major producer of rice, followed by Sindh and Balochistan. More than 90 percent of *basmati* rice production is concentrated in Punjab. The key districts include: Gujranwala, Hafizabad, Sheikhpura, Nankana Sahib, Sialkot, Mandi Bahauddin, and Gujrat. For *irri* rice, Sindh contributes over 60 percent of the total produce, and major districts are Shikarpur, Larkana, Qambar, Kashmore and Jacobabad.

⁹ Farmers, particularly in lower Sindh, also grow hybrid varieties, which generally provide attractive yields compared to *irri* rice. The sowing of this variety usually completes in July.

The FY13 target for rice production was set at 6.9 million tons – a 12.0 percent increase over last year.

However, initial estimates put the rice crop at 5.4 million tons (Table 2.4). Heavy rains in September 2012 damaged the rice crop in the districts of Jafferabad and Naseerabad in Balochistan; and Jacobabad, Shikarpur, Kashmore and Qambar in upper Sindh.¹⁰ The losses were more extensive in areas where the crop was still in its growing phase, since water shortages had already delayed the sowing phase.¹¹

Table 2.4: Rice Production

area in 000 hectare and production in 000 tons

	2012-13 crop		2011-12 crop	
	Area	Prod	Area	Prod
Sindh	511	1,689	636	2,260
Punjab	1,700	3,461	1,714	3,277
Balochistan	37	120	171	529
KP	52	99	50	95
Total	2,300	5,369	2,521	6,066

Source: Provincial Crop Reporting Centers

One major concern for Pakistan is the gradual reduction in the production of *basmati* rice. While a part of the decline was replaced with other varieties (mainly the hybrid rice), the overall rice production continues to fall. As shown in Table 2.5, the area growing *basmati* rice in Punjab has fallen further this year.¹² Given the higher premium on *basmati* rice, this trend is a serious concern.

Table 2.5: Rice in Punjab

area in 000 hectare and production in 000 tons

	Basmati		Other		Total	
	Area	Production	Area	Production	Area	Production
2008-09	1,548	2,602	430	1,041	1,978	3,643
2009-10	1,414	2,475	518	1,238	1,932	3,713
2010-11	1,334	2,365	433	1,019	1,767	3,384
2011-12	1,121	1,889	593	1,388	1,714	3,277
2012-13	984	1,743	716	1,718	1,700	3,461

Source: Agriculture Statistics of Pakistan, and Crop Reporting Center, Punjab

Sugarcane

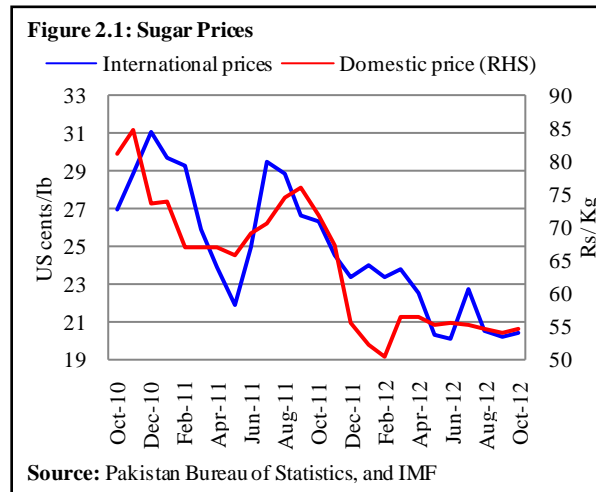
The rains have benefited the sugarcane crop this year. Preliminary indications suggest sugarcane production of 62 million tons, against the target of 59 million tons.

¹⁰ According to Suparco, heavy rains damaged around 0.4 million tons of rice, mainly in Sindh.

¹¹ The harvesting of *irri* variety usually begins in September, whereas for other finer varieties this starts in October and November.

¹² Compared to *irri* rice, the hybrid variety generally receives lower prices in the market due to higher percentage of broken rice and variation in grain size.

Farmers have, however, suffered due to the fall in domestic prices (**Figure 2.1**). Furthermore, they could not recover their investment in time since sugarcane harvesting was delayed due to the late announcement of minimum purchase prices in the provinces.^{13, 14} This also delayed the crushing season by sugar mills. There are also reports that mills have not yet fully cleared farmers' dues against the cane



procured last year. Despite these supply-chain issues, sugarcane will support agri growth and also help Pakistan's exports.

Wheat

The wheat crop is currently at its sowing stage. Although the sowing of wheat was delayed in some areas due to late harvesting of sugarcane; timely rains, relative stability in input prices, and increase in wheat support prices from Rs 1,050 to Rs 1,200 per 40 kg, are expected to help the crop.

2.3 Large Scale Manufacturing

FY13 started off with some visible improvement in large-scale manufacturing. Importantly, the key sub-sectors of *capital goods* and *building materials* posted a strong growth over the same quarter last year (**Table 2.6**). But structural and policy issues in a few important industries – namely, fertilizer, cars, and home electronics – pulled down overall growth, resulting in a *deceleration* of 2.2 percentage points in LSM growth in Q1-FY13 over the same period last year.¹⁵ However, after excluding fertilizer and automobiles, LSM growth is better than last year, which supports our view that demand conditions remain broad-based.

¹³ We have reasons to believe that sugar Mills are purchasing sugarcane cheaper than the announced price of Rs 170/40kg this year.

¹⁴ Provincial governments generally announce indicative minimum price for the purchase of sugarcane in the later half of September. This year, the announcement was delayed till end-October 2012.

¹⁵ Fertilizer, automobiles, and home appliances have an aggregate weight of 11.4 percent in the LSM.

The biggest drag on LSM growth in Q1-FY13 stemmed from the fertilizer sector.

Production during this quarter fell by 27.0 percent YoY – to nearly half of the industry's capacity – as the supply of natural gas was intermittent. The allocation of natural gas, which serves as a feedstock for fertilizer, has been a point of contention since FY11,

when the commissioning of two new plants added to demand on an already strained network – what is disturbing is that the problem appears to be getting worse. The demand-supply gap has become so large that the industry is not even receiving its pre-FY11 share of the fuel: fertilizer production in Q1-FY13 was the lowest in the past five years.

Table 2.6: LSM YoY Growth (Jul-Sep)
percent

Commodity Group	Wt.	FY11	FY12	FY13
Consumer goods	41.1	2.8	7.7	3.6
Capital goods	3.3	4.2	-31.3	14.0
Building materials	12.3	-9.9	-5.0	7.9
Other intermediates	43.3	-5.9	3.7	-5.5
Overall LSM	100.0	-2.5	3.2	1.0
<i>less fertilizers</i>	93.7	-2.3	3.0	3.0
<i>less cars & fertilizers</i>	89.7	-3.0	2.9	3.5

Source: Pakistan Bureau of Statistics; SBP calculations

Unlike the supply-side issues in fertilizer, problems in the automobiles sector – the second major hindrance to LSM growth – were more varied. Specifically, the production of cars, jeeps and motorcycles *fell* by 8.9 percent during Q1-FY13 compared to a *rise* of 8.9 percent in Q1-FY12. Accordingly, sales also declined by a 29.5 percent YoY during the quarter, compared to 26.6 percent growth last year. However, a deeper analysis reveals the contraction in sales might not be as severe if one accounts for the following three factors:¹⁶

- (1) Relaxation in the allowable age for used car imports, led to an influx of imported cars into the country. Import of used cars during Jul-Nov FY13 increased to 25,005 units, compared to only 16,203 units in the same period last year.
- (2) The Punjab government's 'Yellow Cab' scheme in FY12 accounted for 20,000 cars last year; which did not play a role in FY13. Adjusting for this one factor, the quarter's sales of domestically produced automobiles actually show 10 percent growth.

¹⁶ Adjusting for the yellow cab scheme and the discontinuation of two models in the small car segment, Q1-FY13 sales shows a decline of 5.1 percent compared to a rise of 7.9 percent in Q1-FY12.

- (3) In the small car segment, the production of two out of three models was phased out completely this year in order to comply with Euro II standards. These two cars models (Cuore and Alto) together had a 44 percent average market share during the period FY09-FY11.

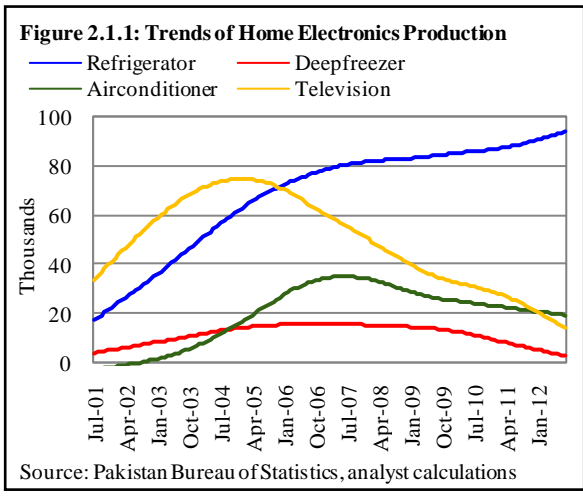
In overall terms, the contraction in automobile production should not be viewed negatively.

In the case of consumer electronics, the domestic production of major household items like air-conditioners and television sets is declining, and even while construction picks up, the production of accessories like lighting fixtures remains stagnant. Although imports have increased to meet this gap, it has not offset the decline in domestic production. **Box 2.1** discusses this anomaly in more details.

2.1: The Consumption Conundrum – the case of home electronics

Consumption demand indicators are elusive. Although imports of consumer durables, setting up of new food processing industries, and sustained growth in construction activity spell out high consumption demand, but on the other hand, we see automobile and home electronics production – arguably the most sensitive tickers of consumer demand – plummeting to negative growth.

In home electronics, the long-term production trend of three out of four large items has been declining for some years now (**Figure 2.1.1**). In fact, it appears that deep freezer and television production is almost being phased-out. Indeed, over the past decade, a few multinational manufacturers did pack up electronics business, especially as new technologies came out, because they did not want to invest further. For example, the production of television sets has been declining since early 2000s when the LCD technology was introduced, which investors rendered too expensive a production venture for a small market like Pakistan. Similarly, the import of energy saving lamps in the second half of 2000s dented the local bulb-manufacturing industry.

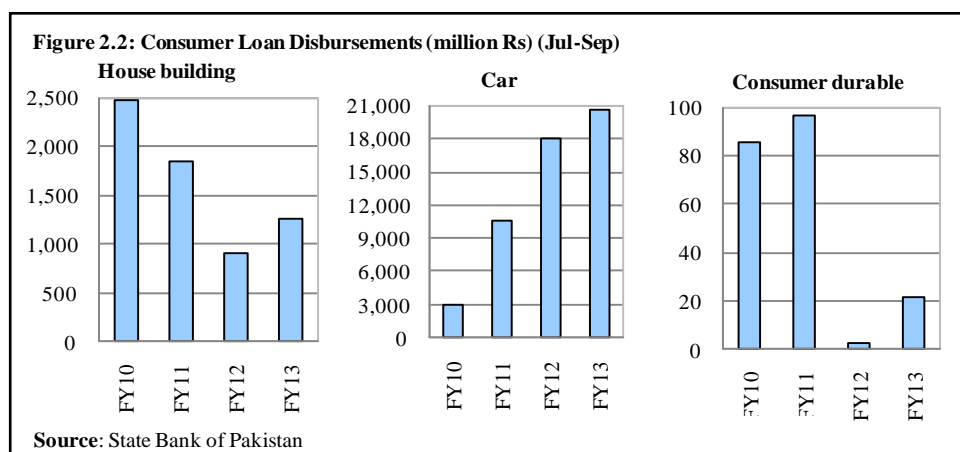


But whether household demand is declining is another story. Several indicators point otherwise. For instance, production of other consumer durables (such as vehicles and refrigerators) increased over the same time frame and imports have also been on the rise.

Import competition is cited by business owners as one reason for the decline in local electronics demand. Indeed, despite high custom duties, imports of televisions, electric fans, air conditioners,

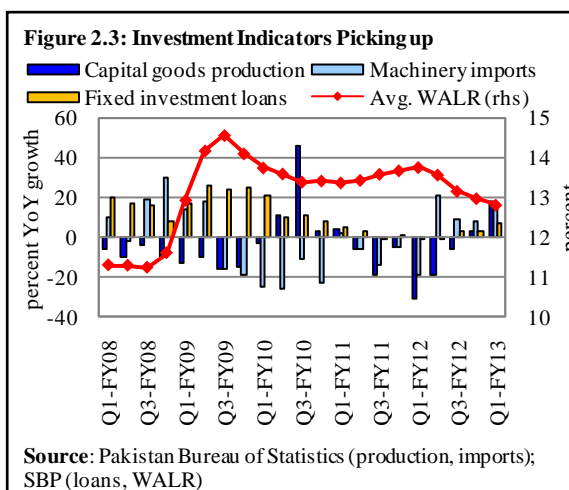
and lighting have increased over the past few years. Anecdotal evidence also points to large-scale smuggling of these goods from neighboring countries.

Finally, in the case of energy intensive items (air conditioner and deep freezer), it is possible that extensive electricity shortages together with rationalization of tariffs over the past few years have led to an enduring change in consumer behavior.



Apart from these few ‘pull-down’ factors, most other industries are showing some improvement over the corresponding quarter of FY12.

For instance, pick-up in private construction activity – evident from higher cement dispatches and import of iron and construction machinery – appears to be an important driver of Pakistan’s manufacturing growth. In particular, production of building materials (with a combined weight of 12.3 percent in LSM) has shown a rise of 7.9 percent YoY during the quarter.¹⁷ Encouragingly, this sector now seems insulated from the energy shortages: we have learnt that most plants in glass and steel have gradually shifted to self-generated power to maintain



¹⁷ While formal companies supply primary building material (e.g., cement, steel); most construction activities still fall under the informal sector.

their production volumes. It is important to recall here, that cement plants had already shifted to coal in early 2000s.

In the case of consumer goods industries, one factor that likely had some positive bearing on demand this quarter could be the monetary easing that began in August 2011. With lowering of lending rates, the decline seen in consumer financing, during the past year, particularly for house building and consumer durable, appears to be bottoming out (**Figure 2.2**).

Another positive development is a noticeable rise in investment which is reflected in higher fixed-rate loans, machinery imports, and the domestic production of capital goods (**Figure 2.3**). There are two drivers for this demand:

1. Capital goods production is mainly being led by derived demand from the agriculture sector (tractors and farm equipment), and by higher demand for commercial vehicles.

2. Lower interest rates allow firms to restructure their loan portfolio more favorably. As firms retire expensive loans, financing costs – which eat into gross profits – also decline. This creates room for new investment spending at more affordable rates. In the LSM sector, fresh investments have been concentrated in textile, paper, glass, steel, and food processing. Furthermore, arranging alternate power sources remains a priority in Pakistan’s manufacturing sector (**Table 2.7**).

Table 2.7: Selected Machinery Imports (Jul-Sep)

million US\$

Item	FY11	FY12	FY13
Textile machinery	103.3	97.0	116.2
Generators	72.8	53.2	75.7
Steel	5.2	7.2	8.7
Packaging	6.4	4.6	6.9
Boilers	1.5	5.1	6.2
Food processing	4.7	5.8	5.9
Paper-making	15.3	3.3	4.3
Transformers	6.7	1.3	3.3
Glass making	0.8	0.4	1.6

Source: State Bank of Pakistan

Going forward, a number of expected developments bode well for industrial growth:

1. The pickup in textile exports from September 2012, is benefitting cotton yarn production.
2. A stricter policy for used car imports announced in November 2012, will provide relief to domestic manufacturers. Moreover, the large car segment is

also set to benefit from a new model that will reportedly be released in Q3-FY13.¹⁸

3. A good sugarcane crop is expected this year, with sugar production expected to be 4.8 million tons – this amounts to a 4.8 percent increase over last year.
4. The commissioning of a large cold rolling steel mill and Tuwairiqi Steel Mills (which will provide raw material for rolling mill industry) in Q2-FY13, and consistent growth in ship-breaking, will enhance steel supply in the country.
5. Commissioning of a new motor cycle tyre plant in Q3-FY13, should improve local market share in the tyre market. The motorcycle industry will also benefit from a reduction in duties on imported components.

However, challenges remain: for one, the gas supply situation which generally worsens during the winter as domestic demand typically increases; sectors that could suffer include fertilizer, glass, paper, and textiles. As we had highlighted in the *Annual Report FY12*, structural reforms are needed in the energy sector, as deficiencies in this sector have become a major bottleneck to our industrial production. In addition to improving the operational efficiency of energy-related PSEs, we recommend rationalization of electricity and gas prices to encourage energy conservation. Side by side, government must continue to add capacities in both conventional and alternate fuels, for a long-term solution to energy constraints.

¹⁸ Although producers will benefit from this stricter import policy, consumer welfare will fall as their choice become limited.