2 Real Sector

2.1 Overview

Data for the first half of the year supports our initial assessment that the economy is unlikely to meet its target in FY13. We maintain a forecast of real GDP growth at 3.5 – 4.0 percent, but expect a slight shift in the composition of growth, with greater contribution from industry. This assessment is based on the revival in construction; an improvement in LSM during the 2nd quarter; and the capacity additions in steel, petroleum, tires, and chemicals.

However, this improvement is expected to be offset by a decline in cotton production, which weighs on our agriculture forecast for the year. The reported increase in area under wheat cultivation seems insufficient to achieve the target of 25.5 million tons. We also expect growth in services to remain below target, mainly due to lower earnings in the financial and telecom sectors.

2.2 Agriculture

As highlighted in the First Quarterly Report, flooding caused by heavy monsoon rains in September 2012, in Southern Punjab and Northern Sindh, adversely impacted *kharif* crops, leading to a decline in cotton and rice production (**Table 2.1**). However, rainfall across the country during the same period benefitted minor crops, and compensated for lower irrigation water in Punjab for the sowing of wheat.[1]

That is one of the reasons for the expected increase in wheat production compared to last year: the increase in area under

Table 2.1: Production of Major Crops

million tons, million bales for cotton

	Share in Major Crops	FY12	FY13 Target	FY13P
Cotton	24.6	13.6	14.5	13.3
Sugarcane	11.7	58	59	62
Rice	15.4	6.2	6.9	5.4
Wheat	39.2	23.5	25.5	NA

Source: Planning Commission; Provincial crop reporting centers, Cotton Crop Assessment Committee

Table 2.2: Irrigation Water (Oct-Dec)

million acre feet

	2011	2012	% change
Punjab	11.4	10.7	-5.9
Sindh	5.7	7.8	37.0
Balochistan	0.4	0.4	12.5
KP	0.6	0.3	-50.3
Total	**18.0**	**19.2**	**6.5**

Source: Suparco

[1] In overall terms, the availability of irrigation water was better during the current *rabi* season compared to the previous year (see **Table 2.2**).

cultivation, higher fertilizer offtake (particularly in the month of December),[2] and a relatively moderate winter,[3] are some of the other reasons (**Table 2.2**). The increase in fertilizer offtake can be traced to the increase in wheat support price (by Rs 150 per 40 kg), which has also increased the area under cultivation. That is significant as cultivated area had been declining after peaking in 2009-10. Having said this, the increase may be insufficient to meet the government's wheat production target of 25.5 million tons, even if we assume record yields that were realized in 2010-11 (**Table 2.3**).[4]

Table 2.3: Performance of Wheat Crop

area in 000 hectare; production in 000 tons; yield tons/hectare

	Punjab			Sindh			Pakistan
	Area	**Production**	**Yield**	**Area**	**Production**	**Yield**	**Total**
2004-05	6,379	17,375	2.72	887	2,509	2.83	21,612
2005-06	6,483	16,776	2.59	933	2,750	2.95	21,277
2006-07	6,433	17,853	2.78	982	3,409	3.47	23,295
2007-08	6,402	15,607	2.44	990	3,411	3.45	20,959
2008-09	6,836	18,420	2.69	1,031	3,540	3.43	24,033
2009-10	6,914	17,919	2.59	1,092	3,703	3.39	23,311
2010-11	6,691	19,041	2.85	1,144	4,288	3.75	25,214
2011-12[P]	6,486	17,702	2.73	1,049	3,664	3.49	23,517
2012-13	6,537[P]	--	--	1,061[P]	--	--	25,500[T]

T: Target; P: Preliminary

Source: Agriculture Statistics of Pakistan; and Provincial crop reporting centers

Preliminary data suggests that minor crops have performed well during the *Kharif* season primarily due to timely rains in September 2012. In particular, adequate rainfall improved the yield of pulses, bajra, jawar and corn. The prospects for the *Rabi* season, particularly for gram and masoor, are also positive due to soil moisture and rains in February 2013.

2.3 Large Scale Manufacturing

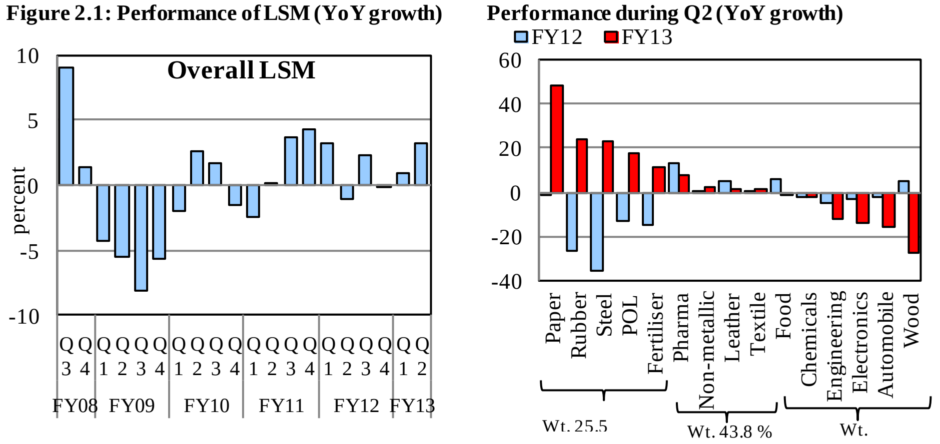
LSM grew by 3.3 percent on a YoY basis in Q2-FY13, mainly on the back of a turnaround in intermediate goods like rubber, POL, steel, fertilizers and paper (**Figure 2.1**). These industries witnessed capacity enhancements, as well as greater capacity utilization. Cement production accelerated, as construction

[2] Fertilizer off take saw a YoY increase of 25.5 percent in December 2012, compared to 14.2 percent growth in December 2011.

[3] Extended harsh winter (with temperature below 4^{o}C) slows crop growth.

[4] During FY13, total area under wheat crop increased by 0.6 percent to 8.7 million hectare in FY13.

Figure 2.1: Performance of LSM (YoY growth)



Source: Pakistan Bureau of Statistics

gathered pace on the back of an increase in public works during the quarter (see **Section 2.4**).[5] In contrast, consumer durables continued to struggle with import competition, which led to a large production decline in automobiles and electronics. As a result, overall LSM growth during Jul-Dec FY13 reached 2.1 percent, compared to 1.0 percent last year.

The following factors explain the recovery of intermediate goods:

(i) Three new steel plants were commissioned in Karachi during 2012 (one in H2-FY12, and two in H1-FY13), which improved steel production in the country.[6]

(ii) New capacity was added in the paper, rubber and steel industries during FY07-09. However, despite the import of the required machinery, these projects faced delays due to financial constraints, and only became fully functional this year (**Table 2.4**).

(iii) Improved gas supplies to fertilizer manufacturers lifted the industry's

Table 2.4: Import of Machinery

million US$

	FY04-06	FY07-09	FY10-12	H1-FY12	H1-FY13
Steel rolling	21.1	44.6	41.8	3.8	2.2
Stone and glass	16.0	17.0	5.5	2.2	2.6
Rubber	140.4	156.1	197.2	43.2	34.0
Construction	228.7	418.3	138.1	15.6	23.1
Paper	100.6	141.3	101.5	8.3	10.2

Source: State Bank of Pakistan

[5] In terms of YoY growth, cement sales in the local market accelerated from 5.4 percent YoY in Q1-FY13, to 9.6 percent in Q2-FY13.

[6] New plants are joint ventures with Saudi Arabia, Japan and International Finance Corporation. Two of the steel plants are running on captive power and are also contributing to the national grid.

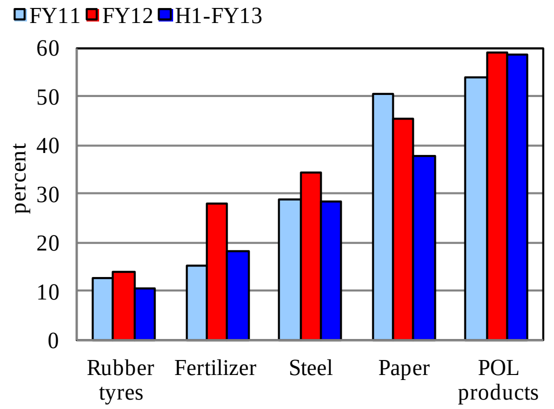
capacity utilization from 55.4 percent in Q1-FY13, to 69.5 percent in the second quarter;[7]

(iv) In the petroleum refining sector, higher margins, and a better product mix, (a shift towards high value added products such as petrol and diesel), improved the cash flows of local refineries.[8] Furthermore, the partial resolution of the circular debt situation, also enabled firms to import more crude oil, and increase capacity utilization, and[9]

(v) Improved energy management (at the firm level) also contributed towards easing production constraints. The paper and steel industries are two cases in point;[10] anticipating a reduction in natural gas supplies, these industries invested in alternate energy arrangements (e.g., coal and furnace-oil fueled plants) [11].

As a result, the production of these intermediate goods also reduced dependence on imports (**Figure 2.2**).

Figure 2.2: Imports as percent of Total Product Supply



Source: Pakistan Bureau of Statistics

Having said this, LSM growth was contained by the decline in the production of consumer durables, especially automobiles, which fell by 25 percent during H1-FY13. A part of the reduction can be explained by the sales of cars under the yellow cab scheme during the same period last year, which inflated the production during H1-FY12. Imported used cars have also

[7] Source: National Fertilizer Development Corporation

[8] Composition of refining has changed in favor of petrol and diesel, which typically incur higher margins, especially compared with the furnace oil.

[9] Crude oil imports during H1-FY12 grew by 19.1 percent YoY, compared to a decline of 21.1 percent in H1-FY12.

[10] It must be recalled that cement plants had already shifted from gas-fired plants to coal-fired plants back in mid-2000.

[11] Although alternate fuels are expensive and raise production costs significantly, domestic goods are still fairly price competitive. For example, shifting to coal or furnace oil reportedly increases paper production costs up to 30-40 percent; and domestic paper prices increased by approximately 30 percent YoY during Jul-Nov FY13 compared to a 2 percent decline in imported paper prices (in Rupees). But per kilogram average price of domestic paper prices in November 2012 was only one Rupee higher than the imported variety.

priced out local competition in the small car category (defined as 1000cc and below) and established a niche in that segment, adding to the drop in local production (**Table 2.5**). Furthermore, this decline also reflects the discontinuation of non-Euro II compliant models, as noted in our previous quarterly report.[12]

Table 2.5: Consumer Car Market

units	H1 FY12	H1 FY13
i. Local car sales	63,038	45,022
ii. Used car imports	20,953	29,263
Total (i+ii)	83,991	74,285

Source: Pakistan Bureau of Statistics and All Pakistan Motor Dealers Association

Going forward, LSM growth is likely to pickup in H2-FY13, as domestic automobile production increases to make-up for the stricter import policy on used vehicles.[13] Sugar production should also improve over last year because of a good sugarcane crop. Millers have estimated sugar production at 5.0 million tons realized during FY13, which is 7.9 percent higher than 4.6 million tons in FY12. Finally, new capacities and improved production processes, are expected to come online during the remaining part of FY13:

1. The single largest refinery in the country has already entered its pre-commissioning phase in H1-FY13. This refinery will increase Pakistan's crude oil refining capacity by around 47 percent;[14]
2. A new plant for the manufacturing of motorcycle tyres is expected to start production by the end of Q3-FY13; and
3. The largest soda ash manufacturer in Pakistan is shifting its fuel composition from gas to coal, which will help improve its capacity utilization.

2.4 Construction

A sharp increase in public sector development spending in the second quarter – a disbursement of Rs 183.2 billion, compared to Rs 127.8 billion in Q2-FY12 – was one of the major drivers for the growth in construction activities. Anecdotal evidence suggests that private construction is also strong, on the back of robust

[12] As mentioned in *SBP Third Quarterly Report for FY12*, production of an 800cc and a 1000cc car has been phased out. Together, these two had a share of around 15 percent in total cars production in Pakistan.

[13] Ministry of Commerce, via SRO 1441 (I) / 2012 dated 12th December 2012, has reduced the age limit on imported used vehicles from five to three years, which means only newer used cars would be imported.

[14] With a refining capacity of 120,000 barrels per day, this newly commissioned plant will increase Pakistan's refining capacity from existing 12.3 million tons to 18.0 million tons per year. However, there are some concerns whether commercial banks would be willing to increase their exposure to the oil and gas sector.

Table 2.6: Construction Indicators

percent growth	Q1		Q2	
	FY12	**FY13**	**FY12**	**FY13**
i. Local cement dispatches	11.8	5.4	4.5	9.6
ii. Steel products	17.3	-13.5	-8.2	10.9
iii. Construction & mining mach imp	-23	45.6	15.6	32
iv. Building manufacturing index	-5.4	4.7	-8.6	3.7
BMI excl PSM	-5	7.9	-4.8	5.6
v. Development spending	39.7	-14.6	-1.2	41.6
vi. Price of bricks	16.4	10.1	18.4	3.7
vii. Price of cement	19.7	16.5	13.2	19.7
viii. Price of steel bars/sheets	17	6.4	17.3	1.5

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

growth in remittances, and the price stability of bricks and steel.[15] As a result, the quantum of cement sales increased by 9.6 percent YoY in Q2-FY13, up from 4.5 percent in Q1-FY13 (**Table 2.6**).

Services

Preliminary data indicates that the services sector will miss the 4.6 percent growth target set by the government for FY13. This assessment is based on the slowdown in agriculture, the decline in import volumes and falling banking spreads.

In the *finance and insurance* subsector, the policy rate cuts have reduced banking spreads, which has kept net interest income under pressure (**Table 2.7**). As a result, commercial bank profits, which had grown by over 100 percent in H1-FY12, have *declined* by 3.1 percent this year.

The trend in *wholesale and retail trade* depends mainly on the margins earned through domestic and imported goods. We have mixed signals on the performance of this sector: although the increase in domestic manufacturing (with a 44 percent share in wholesale and retail trade) is likely to support trading activity,[16] the contribution from major crops and imports (especially palm oil) is likely to remain weak.

[15] Increased domestic production of steel, and softer international prices, explain the trend in steel prices. Brick prices rose sharply last year due to the imposition of a 17 percent sales tax, which has not happened in FY13.

[16] During the last three years, manufacturing had an average share of 44 percent in the gross value addition of wholesale and retail activities.

Table 2.7: Financial Performance of the Banking Industry

	Billion Rupees			Percent growth	
	H1-FY11	**H1-FY12**	**H1-FY13**	**H1-FY12**	**H1-FY13**
Interest earned	321.3	386.6	409.0	20.3	5.8
Interest expenses	173.9	212.1	237.6	22.0	12.0
Net interest income	**147.4**	**174.5**	**171.4**	**18.4**	**-1.8**
Net interest income after provision	**108.0**	**152.7**	**150.1**	**41.4**	**-1.7**
Fees, commission & brokerage income	22.1	23.6	27.8	6.7	17.6
Dividend income	3.8	7.5	10.8	97.4	43.4
Income from dealing in foreign currencies	11.2	12.7	10.5	13.6	-16.8
Other income	12.9	12.6	24.2	-2.2	92.6
Total non - interest income	**50.0**	**56.4**	**73.3**	**12.9**	**30.0**
Total non-interest expenses	105.4	117.1	135.3	11.1	15.5
Profit after tax	**29.5**	**59.6**	**57.7**	**101.9**	**-3.1**

Source: State Bank of Pakistan

Meanwhile, an improvement in the financial performance of PIA bodes well for the *transport, storage and communication* sector (**Table 2.8**). The airline has posted a gross profit of Rs 0.8 billion in the first quarter of FY13 (due to lower fuel costs), but ended up incurring an overall loss of Rs 4.4 billion on account of higher finance and distribution costs. Nonetheless, this loss is only half of what the airline incurred last year. More encouragingly, the airline has been reporting an operating surplus since October 2012.[17]

Table 2.8: Financial Performance of PIA during Q1

billion Rs.

	FY12	**FY13**
Revenue	27.8	27.8
Cost of services	28.7	27.0
Aircraft fuel	15.8	14.9
Gross profit	**-0.9**	**0.8**
Distribution cost	1.3	1.7
Administrative expenses	2.0	1.9
Other provisions	0.3	0.1
Exchange losses - net	1.4	0.3
Other operating income	0.1	1.9
Loss from operations	**-5.8**	**-1.3**
Finance cost	2.5	3.0
Loss after tax	**-8.6**	**-4.4**

Source: Pakistan International Airlines

However, the performance of *telecommunications* will largely depend on earnings of cellular service providers, as the largest telecom firm (PTCL) has so far posted a significant loss this year; an operating loss of Rs 0.7 billion during Jul-Dec FY13, compared to a profit of Rs 2.8 billion in the same period last year. This was mainly due to a

[17] During November 2012, the corporation earned an operating profit of Rs 738 million as against the loss of Rs 1.3 billion last year.

one-off cost incurred under the voluntary separation scheme, which alone accounted for a Rs 9.8 billion loss in Q1-FY13.[18,19]

[18] PTCL has offered the second Voluntary Separation Scheme (VSS) to its employees, the first one been implemented in 2008. The objective of this scheme was to optimize human resources in line with the current business needs by offering attractive package.
[19] However, a large part of this loss was compensated by a record profit (of Rs 8.6 billion) earned in Q2-FY13.