2 Real Sector

2.1 Overview

The most encouraging development in the real sector, is the 6.8 percent growth of the large scale manufacturing (LSM) in H1-FY14, compared to 2.3 percent in the same period last year. While the factors underpinning LSM growth include the improved energy supplies; capacity enhancement in some of the sectors (in steel, paper, fertilizer, and beverages) in the past few years; construction activity; and availability of credit; a significant impetus came from the rise in sugar production during Q2-FY14 due to early start of crushing compared to last year.[1] As discussed later, the full year LSM growth will be lower than what was posted in H1-FY14.

As regards the performance of agriculture, wheat is likely to post a recovery due to the prospects of a better harvest, compared to the last year. Specifically, growth conditions have been favorable for wheat in all regions, except for Potohar, where the crop is under water stress.[2] However, the overall improvement in wheat may not be sufficient to offset the drag from the kharif season.[3] We therefore expect agriculture to record below target growth in FY14.

The available indicators on the services sector, present a mixed picture. We expect an uptick in value addition by *wholesale & retail trade,* as suggested by higher credit off-take by this sub-sector, and the increase in LSM growth – this will also have a positive spillover on road transport. Moreover, the decline in profitability of commercial banks is likely to contain growth in value addition by *finance & insurance* in FY14.[4]

Table 2.1: Production Estimates of Kharif Crops

million tons, except for cotton which is in million bales

	FY13		FY14	
	Target	**Actual**	**Target**	**Estimates**
Rice	6.9	5.5	6.2	6.4
Sugarcane	59.0	62.5	65.0	63.0
Cotton	14.5	13.0	14.1	12.3

Source: Planning Commission, and Ministry of National Food Security and Research

In overall terms, while a strong rebound in LSM and an expected increase in wheat production are key positives;

[1] Sugar production more than doubled during Nov-Dec 2013, compared to the same period last year.
[2] Source: Crop situation reports by Suparco.
[3] During kharif, the decline in the production of cotton compared to last year is likely to offset the improvement in rice and sugarcane production.
[4] The lower profits during H1-FY14, compared to corresponding period of last year, were mainly led by one large bank, and do not reflect the overall performance of the banking system.

the full-year GDP growth will depend on the performance of services.

2.2 Agriculture

The *kharif* season (April 2013-September 2013) suffered a setback due to a fall in the production of cotton, which was led by lower area under cultivation compared to the target (this reflects water shortages at the sowing period).[5] In addition, pest attacks and heavy rains before the harvest led to significant crop losses (**Table 2.1**).[6, 7] Although the sugarcane and rice crops were better compared to the previous year, this may not be sufficient to compensate for the damage to the cotton crop.[8]

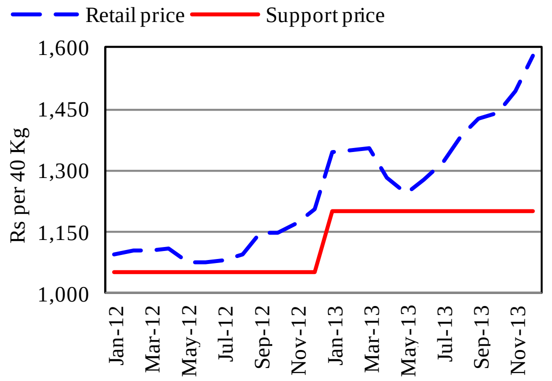
Table 2.2: Area under Wheat Crop
000 hectare

	2011-12	2012-13	2013-14	
			Target	Actual
Punjab	6,483	6,511	6,693	6,778
Sindh	1,049	1,058	1,100	1,118
KPK	729	727	750	749
Balochistan	388	363	400	398
Pakistan	8,650	8,660	8,943	9,044

Source: Ministry of National Food Security and Research

On a positive note, the *rabi* season that began in November 2013, has been showing encouraging signs. The area under wheat cultivation, registered an increase of 4.4 percent over last year (**Table 2.2**). Although, the government decided to keep wheat support prices unchanged at Rs 1,200 per 40 kg, market prices proved attractive for growers (**Figure 2.1**). More importantly, farmers were able to complete the sowing

Figure 2.1: Wheat Prices in Domestic Market

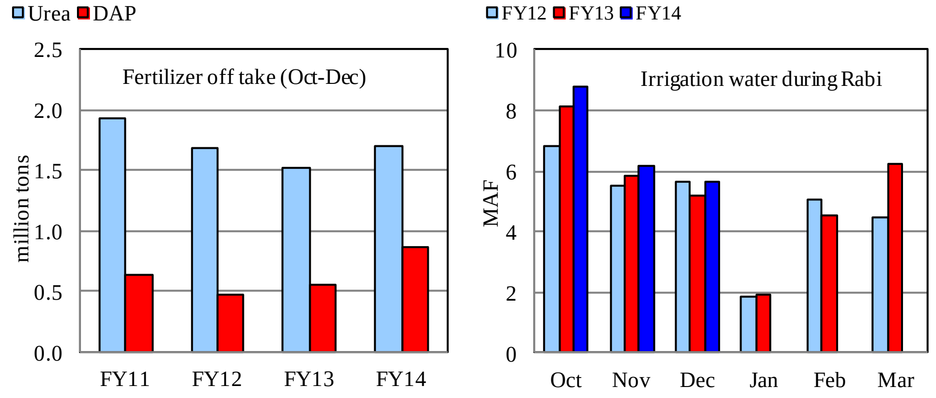


Source: Pakistan Bureau of Statistics and Pakistan's Economic Survey

[5] The area under cotton crop in FY14 was 2.7 million hectare, which was lower than the target of 3.1 million hectare.
[6] For details, see **Chapter 2** of SBP's 1st *Quarterly Report for FY14.*
[7] The cotton crop yield remained at 772 kg per hectare in FY14, which was almost unchanged from 774 kg per hectare in the previous year.
[8] Cotton contributes 27.9 percent of the value addition by major crops. This is greater than the combined share of 23.4 percent, from rice and sugarcane.

stage well in time owing to improved water availability (**Figure 2.2**) and the early harvest of the cotton crop which allowed for timely sowing of wheat.[9]

Figure 2.2: Availability of Key Agri Inputs



Source: NFDC

Source: Suparco

Furthermore, growing conditions for wheat have remained favorable. For example, the cold wave in mid-December that swept across the plains of Punjab was good for the crop yield, while fertilizer off-take during the *rabi* season remained higher than the corresponding period last year (**Figure 2.2**).[10]

Despite these positives, realizing the wheat production target of 25.0 million tons appears challenging, as this would require substantial improvement in the crop yield.[11] There are already reports that lower rainfall in Potohar has suppressed the crop growth in this region.[12]

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[9] Around 30 percent of the wheat is sown under cotton-wheat cropping system. The wheat crop under this system is generally vulnerable to late sowing due to delays in cotton picking. This year, early maturing of cotton due to warmer conditions allowed sowing of wheat as early as in November, which is beneficial for seed germination and plant growth.

[10] The urea off-take increased to 1,702 million tons in Oct-Dec 2013, compared to 1,514 million tons in Oct-Dec 2012. Similarly, the demand for DAP rose from 559 million tons last year to 868 million tons in Oct-Dec 2013.

[11] The Annual Plan had set the wheat target of 25.5 million tons. This target was later revised downward to 25.0 million tons by the Federal Committee on Agriculture. The government aimed to achieve this target through the use of quality seeds; timely availability of fertilizer and promotion of its balanced use; and increase in loan facilities.

[12] Potohar region (that includes districts of Attock, Rawalpindi, Islamabad, Jhelum and Chakwal) produces on average around 650 thousand tons of wheat annually.

As mentioned earlier, the government has kept wheat support price unchanged at Rs 1,200 per 40 kg, which is significantly lower than the current market price of around Rs 1,600 per 40 kg. Going forward, if the existing gap between domestic market prices and the support price remains high even at the time of harvest, farmers will be reluctant to sell to the government. However, it is important to emphasize here that the country has been maintaining its strategic reserves of wheat to ensure domestic food security.

2.3 Large Scale Manufacturing

Growth in LSM rebounded to 6.8 percent during H1-FY14, compared to 2.3 percent in the same period last year. As mentioned earlier, a number of factors helped in this recovery, e.g., improved supply of power to industry; availability of private sector credit; and higher export demand. Furthermore, fertilizer sector benefited from diversion of gas to one of the urea manufacturers. In addition,

Table 2.3: Growth in Key Sectors of LSM (H1)

percent

		YoY Growth		Percentage Contribution to Growth	
	Weights	**FY13**	**FY14**	**FY13**	**FY14**
Textile	21.0	0.2	1.7	3.0	8.0
Cotton yarn	*13.0*	*0.3*	*2.2*	*3.0*	*6.3*
Cotton cloth	*7.2*	*-0.1*	*0.8*	*-0.5*	*1.2*
Food	12.4	3.4	18.3	26.2	44.5
Sugar	*3.5*	*-25.3*	*78.0*	*-37.4*	*26.2*
Beverage	*1.1*	*23.0*	*29.8*	*21.6*	*10.5*
Petroleum products and coke	5.5	10.4	8.3	29.2	7.8
Steel	5.4	19.3	2.3	24.7	1.1
Pig iron	*1.6*	*-37.0*	*-41.5*	*-13.3*	*-2.9*
Billets	*1.5*	*1.9*	*26.7*	*0.8*	*3.6*
Automobile	4.6	-8.2	-2.3	-22.4	-1.8
Tractors	*0.5*	*102.5*	*-34.5*	*16.4*	*-3.4*
Jeeps and cars	*2.8*	*-24.5*	*2.3*	*-36.6*	*0.8*
Fertilizer	4.4	-10.0	28.8	-27.7	21.9
Urea	*4.0*	*-11.8*	*31.8*	*-28.7*	*20.8*
Paper	2.3	26.6	17.5	41.8	10.6
Leather products	0.9	-6.6	9.6	-5.7	2.4
Overall LSM growth		2.3	6.8		
Memorandum items					
Excluding fertilizer	4.4	2.9	5.7		
Excluding sugar	3.5	3.0	5.2		
Excluding fertilizer and sugar	7.9	3.9	3.9		

Source: Pakistan Bureau of Statistics

early sugarcane crushing this season compared to last year provided a further stimulus to growth. However, if we adjust for fertilizer and sugar (as their impact is likely to dissipate over the course of the year), LSM grew by 3.9 percent (YoY) during H1-FY14, which is unchanged from H1-FY13 (**Table 2.3**). Having said this, the overall LSM growth for the full year is likely to exceed the target of 4.0 percent set by the government.

Sugar production

Sugar production recovered strongly in December 2013, recording an increase of 78.0 percent (YoY), compared to a fall of 25.3 percent in December 2012. To put this in perspective, higher sugar production explains 26.2 percent of the LSM growth in H1-FY14. This can be traced to early start of sugarcane crushing this year, which means subsequent production in the remaining part of FY14 is likely to be lower compared to the first half.

Urea continued to drive LSM

As mentioned in the 1st *Quarterly Report for FY14*, the availability of gas on temporary basis from Mari led to a sharp recovery in urea production during Q1-FY14 – this continued in the second quarter.[13] In fact, most of the fertilizer plants operating on Mari gas functioned at their full capacity during H1-FY14 (**Table 2.4**). However, these manufacturers are likely to face production declines if the gas supply reverts back to previous levels.[14]

Table 2.4: Urea Production – Gas Allocation vs. Capacity Utilization

	Gas field	Production as % of installed capacities during H1	
		FY13	**FY14**
EFERT		40.3	77.8
EFL	MGCL	NA	NA
Enven	SNGPL & MGCL	NA	NA
FFC		87.0	102.3
Fauji (G. Machi)	MGCL	100.5	120.9
Fauji (Pak-Saudi)	MGCL	98.7	115.6
FFBL	SSGC	38.9	40.1
FATIMA		36.7	71.5
Fatima	MGCL	43.4	83.8
Pak-Arab	SNGPL	0.0	4.9
AZGARD (Pak- Amer)	SNGPL	14.2	57.2
DHCL	SNGPL	5.0	11.0

Source: NFDC and Companies' reports

At the same time, urea off-take remained strong in anticipation of an increase in Gas Infrastructure Development

[13] In April 2013, supply of Mari gas from Engro's base (old) plant was diverted to the Enven plant The Enven plant of Engro Chemicals (the largest in South Asia), was earlier connected to the SNGPL network that was unable to provide the contracted volume of gas from Qadirpur fields. For details, see SBP's 1st *Quarterly Report* for FY14.

[14] The temporary shutdown of Guddu power plant allowed more gas to fertilizer plants on the Mari network. This means production of urea may likely to suffer declines as soon as Guddu power plant resumes its operation.

Cess (GIDC) and gas tariffs from January 2014 onwards. As a result, urea production posted strong YoY growth of 31.8 percent in H1-FY14, compared to 11.8 percent fall in H1-FY13. It may be noted that the production of urea contributed 20.8 percent of the growth in LSM during H1-FY14.

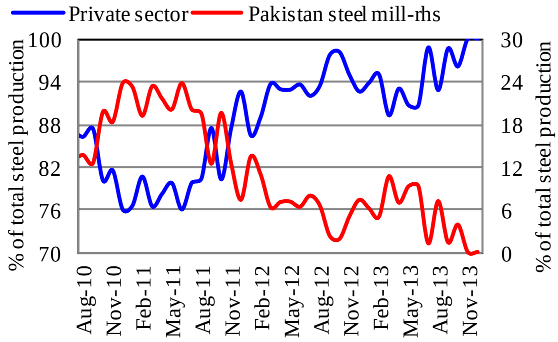
Improved demand for exports

Cotton yarn, cloth and leather continued to post strong growth led by increased demand. Specifically, leather exports to European countries increased as our major competitor – China – has moved into high value-added products. The production of cotton yarn and cloth appears to have benefited from increased demand from both domestic and external markets (particularly, bed-wear and readymade garment). It may be noted that not only the credit growth for the procurement of cotton remained strong, the weaving sector has utilized fixed investment loans for BMR (balancing, modernization and replacement) to take advantage from GSP plus.

Strong growth in beverages

Beverages that include juices, squashes and soft drinks, have been growing in double digits since FY12. In fact, 10.5 percent of the entire increase in LSM growth in H1-FY14 was contributed by beverages alone. This can be attributed to capacity enhancements by one of the leading beverage manufacturers last year, and FDI inflows in the past three years.[15] In addition, credit demand from the food sector remained higher in H1-FY14, compared to corresponding period last year.

Figure 2.3: Market Share of PSM & Private Sector in Steel Production*



*Include hot rolled and cold rolled strips and galvanized sheets
Source : Pakistan Bureau of Statistics

Capacity enhancement boosted steel production

The steel sector consists of private manufacturers and the state owned Pakistan Steel Mill (PSM) (**Figure 2.3**). This sector saw a major change in mid-2012, when

[15] Beverages witnessed US$ 25 million FDI inflows in H1-FY14, compared to US$ 5.1 million outflows in the same period last year. In overall terms, FDI inflows in beverages stood at US$ 9 million in FY11, US$28 million in FY12, and US$ 20 million in FY13.

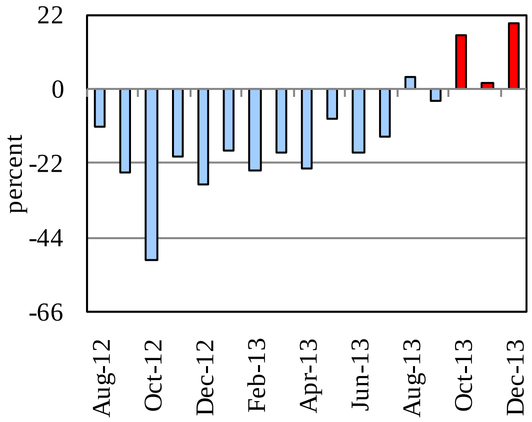
most of the new capacities in the private sector came online.[16] Thus, steel production posted a YoY growth of 19.3 percent in H1-FY13. However, this pace is now tapering off as the base-effect comes into play. Nonetheless, we expect some recovery in H2-FY14, given the increased focus of the government on infrastructure projects which may further boost steel production.

However, the prospects for Pakistan Steel Mill (PSM) are not encouraging. PSM shows a negative equity, and is unable to repay its existing loans, or secure new working capital lines. Hence, its production came to a complete standstill in October 2013. As a result, the share of PSM in total steel production dropped to *zero* in October 2013 (**Figure 2.3**).

Revival in car production

After its poor performance in FY13, car manufacturing (having more than 60 percent share in auto industry) is showing signs of recovery in H1-FY14 (**Figure 2.4**). This may be explained by a reduction in the age limit of imported reconditioned vehicles from five to three years in December 2012,[17] and the introduction of a new model of passenger car.

Figure 2.4: Production of Jeeps & Cars (YoY Growth)



Source : Pakistan Bureau of Statistics

2.4 Services

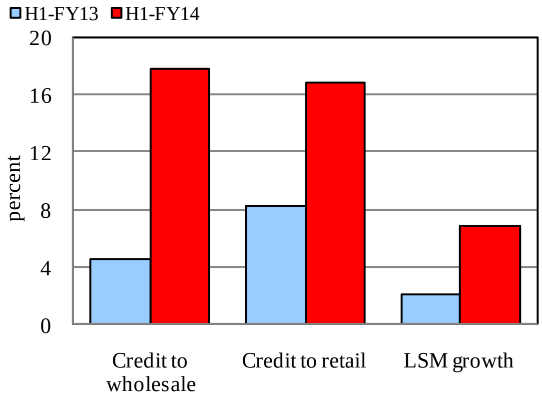
Hard data on value addition by services is not yet available; however key indicators present a mixed picture in H1-FY14. Our analysis suggests an uptick in value addition by *wholesale & retail trade*, and *telecom*, whereas *finance & insurance* is likely to post lower growth in FY14, compared to the previous year.

[16] Three new steel plants commissioned in Karachi during 2012 (one in H2-FY12, and two in H1-FY13).

[17] The imports of cars reduced to 10,776 units during H1-FY14, compared to 29,153 units in corresponding period of FY13.

Wholesale and retail trade, which was 31.5 percent of overall value addition by services in the previous year, is likely to post a decent increase in FY14. This can be seen from LSM growth and an increase in credit off-take by wholesale and retail trade during H1-FY14, which shows an increase in trade activity in the country (**Figure 2.5**). The lackluster performance of agriculture, however, creates a downside risk to this outlook.

Figure 2.5: Wholesale & Retail Trade Indicators



Source: State Bank of Pakistan & Pakistan Bureau of Statistics

The *telecom sector* posted encouraging performance in H1-FY14. Strong telecom imports, an increase in the subscriber base, and an improvement in telecom revenues, helped this sector (**Table 2.5**).

Transport sector showed a mixed performance. The operating losses of PIA increased to Rs 13.6 billion in Q1-FY14, compared to Rs 4.4 billion in the same period last year. However, the anecdotal evidence suggests an improvement in PIA's financials during Oct-Dec 2013, on account of an expansion in its fleet size.[18] Furthermore, the government also plans to disinvest 26 percent of PIA's shares by end-December 2014, which bodes well for the financial performance of this airline.[19] Pakistan Railways (PR) witnessed a marginal improvement by posting smaller losses, compared to the same period last year (**Table 2.5**). Going forward, the

Table 2.5: Indicators for Value addition in Transport & Communication during H1

	Units	FY13	FY14
Telecom			
Tele density (Jul-Nov)	% population	72.1	77.1
Telecom imports	million US$	429.3	662.1
Telecom investments (Jul-Sep)	million US$	108.2	120.9
Telecom revenues	billion Rupees	105.6	109.9
Transport			
Pakistan Railway losses [P]	billion Rupees	-15.0	-13.8
PIA losses (Jul-Sep)	billion Rupees	-4.4	-13.6

Source: PTA, SBP, PR, PIA website, P: provisional

[18] Reportedly, PIA has added four aircrafts in its fleet during Oct-Dec 2013, which led to an improvement in its flight operations.
[19] IMF Country Report No. 14/1, January 2014.

operations of PR are likely to improve due to an expansion of its fleet size.[20] Although this entity is not included in the list of PSEs which are to be disinvested by the government, the authorities have hired new board members for PR, who are in the process of preparing a medium-term restructuring plan.

The value addition by *finance & insurance* is likely to remain subdued. This is due to a decline in the profitability of commercial banks, which as stated earlier, can be attributed to one large bank.

[20] A total of 22 locomotives have been made available for freight operations during the last six months, while another 10-15 locomotives are added for passenger operations.