2 Real Sector

2.1 Overview

By the end of the second quarter, prospects of a better wheat harvest and the expected recovery in minor crops, are likely to offset the weak performance of FY15 *kharif*. At the same time, the steep decline in oil prices should provide some impetus to growth in large scale manufacturing (LSM). Furthermore, there are signs of robust activity in the construction sector as evident from higher production of cement, steel and paints. In services, though heavyweight sub-sectors, like, *wholesale & retail trade* and *transport*, *storage & communication* may not be able to achieve their target growth, we expect *finance & insurance* and *general government services* to perform strongly. Thus, in overall terms, real GDP growth is likely to remain slightly higher than the last year.

2.2 Agriculture

Most of the major *kharif* crops performed below expectations in FY15. For example, cotton and sugarcane (together accounting for nearly 40.0 percent of the total value of major crops) missed their production targets (**Table 2.1**),[1] whereas sugarcane could not achieve last year's production level.

Table 2.1: Production Estimates of Kharif Crops

million tons, except for cotton which is in million bales

	FY14		FY15	
	Target	**Actual**	**Targets**	**Estimates**
Rice	6.2	6.8	6.8	6.9
Sugarcane	65.0	67.5	65.5	63.9
Cotton	14.1	12.8	15.1	13.5

Source: Targets are from Annual Plan prepared by the Planning Commission, whereas actual crop size for FY14 and estimates for FY15 are sourced from Pakistan Bureau of Statistics.

In the case of *minor* crops, though we do not have hard numbers, the significant decline in the prices of perishable food items (e.g., potatoes, onion) during the second quarter of FY15, suggests better supplies in the market and lower transportation cost. While a part of the easing in prices could be due to higher imports (and restricted exports) for stabilizing supplies amid flood related losses, preliminary reports from provincial crop reporting centers, suggest a healthier growth in minor crops this year.[2]

[1] For details, see **Chapter 2** of SBP's 1st *Quarterly Report for FY15.*
[2] A better growth in minor crops is also expected due to a low base effect of the previous year; specifically, minor crops had posted a *decline* of 3.5 percent in FY14.

Within *rabi* crops, the Federal Committee on Agriculture has set a target of 26 million tons for this year's wheat crop – around 3 percent higher than the output realized last year.[3,4] Achievement of this target is contingent on improved crop yields from better availability of quality seeds, fertilizer and water, among other factors. The target for area under cultivation, on the other hand, was almost unchanged at last year's level. Perhaps this was in view of expectations that the steep decline in global prices in recent months would discourage farmers from increasing area under cultivation.

Table 2.2: Area under Wheat Crop

000 hectare

	2013-14		2014-15	
	Target	**Actual**	**Target**	**Actual**
Punjab	6,693	6,778	6,600	6,909.9
Sindh	1,100	1,118	1,150	1,108.9
KPK	750	749	760	777.5
Balochistan	400	398	400	383.2
Pakistan	**8,943**	**9,044**	**8,910**	**9,179.5**

Source: Ministry of National Food Security and Research

Specifically, according to the US Department of Agriculture (USDA), wheat prices fell sharply from US$ 334.7 per MT in May 2014 to US$243.7 in September 2014, showing a comfortable supply situation in the global markets.[5] This price decline became an immediate policy concern for the government, as it hits growers' income and their capacity to invest on productivity enhancing technology. The financial difficulties faced by wheat growers increased due to higher input costs.[6] For example, price of DAP rose to Rs 3,800 per 50 kg in Dec 2014 (from Rs 3,430 a year earlier), whereas the price of urea increased from Rs 1,850 per 50 kg to Rs 1,940 during the same period.

Responding to growers' concerns, in early November 2014, the government announced an increase in wheat support price to Rs 1,300 per 40 kg (from Rs

[3] Wheat alone contributes 40 percent of the value of major crops.
[4] The Annual Plan for FY15 had initially fixed the wheat target at 25.8 million tons, which was revised upward to 26 million tons by the Federal Committee on Agriculture in its meeting held on 14th October, 2014.
[5] Not only that the world wheat stock continued to grow for the second consecutive year in 2013-14 (reaching its highest level in over a decade), the recent projections for 2014-15 crop indicate that the global output would even exceed the record production level realized in the previous year.
[6] The cost of wheat production shows an increase over the year on account of higher cost of seeds, fertilizer and electricity. For example, according to estimates prepared by Agriculture Policy Institute, per acre cost of seeds was up by 5 percent; fertilizer cost, which accounted for 1/5th of the overall production cost, increased by 4 percent; and cost of irrigation by private tubewell grew by a substantial 17 percent (probably the extended load shedding compelled farmers to run their tubewell on diesel).

1,250) for the upcoming crop – further widening the gap between domestic wheat prices and those prevailing in global markets. However, due to limited storage capacity and fiscal cost, this requires the government to run down its existing wheat stocks before the arrival of the fresh crop.

Table 2.3: Agri Input Availability (Oct-Dec)

	FY14	FY15
Fertilizer (000 tons)		
Urea	1,702	1,614
DAP	868	832
Water (MAF)	20.6	21.9

Source: Monthly Bulletin on Crop Situation by Suparco

Table 2.4: Purpose-wise Disbursement of Agri Credit
billion Rupees

	Q2-FY14	Q2-FY15
Production loans	79.4	108.5
Of which		
Crops	39.8	48.7
Livestock & dairy	12.8	12.5
Poultry	17.6	14.7
Developmental loans	9.2	12.9
Of which		
Crops	4.5	3.7
Tractors	2.7	2.2
Livestock & dairy	4	7.1
Grand Total	88.6	121.4

Source: State Bank of Pakistan

So far, the assessment of wheat production is encouraging. Not only has the area under wheat cultivation improved slightly (**Table 2.2**), the timely availability of water and agri credit are expected to improve yields. More specifically, canal water availability during Oct-Dec FY15 was higher by 6 percent compared to the previous year (**Table 2.3**). Similarly, agriculture credit disbursement remained strong, showing a growth of 37 percent during Q2-FY15 on YoY basis. Production loans continue to account for the bulk of agri credit disbursements (**Table 2.4**).

As a result, wheat may repeat last year's production of over 25 million tons.[7] Furthermore, the recent rains in Punjab at the growing stage are beneficial, as more water and prolonged low temperature would help raising the crop yield further.

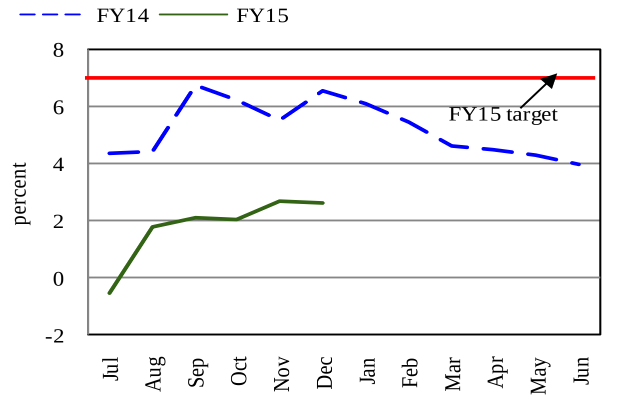
[7] However, the fertilizer off-take during Oct-Dec FY15 declined by 5 percent as compared to the previous year. This was expected given the financial constraints faced by growers as the prices of FY15 *kharif* crops experienced significant decline, and the cost of agri inputs continued to increase persistently.

This large (expected) crop would further add to the surplus wheat in the country.[8] Furthermore, with low export prospects due to excess supply in the global markets, it is feared that government may not be able to offload the surplus wheat before the arrival of the next crop (see **Special Section** at the end of this Report). This not only increases the cost of financing the wheat procurement, there is a risk of wheat losses due to insufficient storage capacity. One way to avoid such situation in future is to strengthen market based instruments (e.g., warehouse receipts, crop insurance, commodity exchange, etc.) for protecting farmers against fluctuations in the market prices.[9]

2.3 Large scale manufacturing

Most of the industries which contributed to slowdown during Q1-FY15 (e.g., fertilizer, cotton yarn, cotton cloth, edible oil, POL, paper, and wood), continued to show weak performance in the second quarter as well.[10] Furthermore, the delay in sugarcane crushing this season caused sugar production during Nov-Dec 2014 to decline to 1.1 million tons from 1.3 million tons in comparable months of 2013.[11] As a result, the overall LSM growth fell sharply to 2.3 percent in H1-FY15, compared to 6.6 percent in the corresponding period of last year (**Figure 2.1** & **Table 2.5**).

Figure 2.1: LSM Growth (Cumulative)



Source:Pakistan Bureau of Statistics

This slowdown in LSM (which is mainly concentrated in agri based industries), more than offset the strong performance by the construction-related industries and automobiles – both benefited from the

[8] The depressed prices in the international market encouraged the private sector to import 0.68 million tons of wheat during Jul-Dec FY15.

[9] Recently, the government has approved the Credit Guarantee Scheme for small farmers who do not have any collateral to offer against loans.

[10] For a detailed discussion on LSM performance during Jul-Sep 2014, see SBP's First Quarterly Report for FY15.

[11] Hence, LSM growth during H1-FY15 improves to 3.45 percent, if we exclude sugar from our sample.

softening global prices of key raw materials (e.g., coal and iron & steel).[12]

Table 2.5: Performance of Large Scale Manufacturing during H1
In percent

		YoY Growth		Percentage Contribution	
	Wt.	**FY14**	**FY15**	**FY14**	**FY15**
LSM Index	70.3	6.6	2.3	100	100
Cotton Yarn	13.0	2.2	0.7	6.6	5.7
Cotton Cloth	7.2	0.8	0.0	1.2	0.2
Fertilizer	4.4	28.8	-1.6	22.8	-4.2
Sugar	3.5	78	-17.5	27.4	-28.7
Vegetable Ghee	1.1	5.4	-0.3	1.2	-0.2
Cooking Oil	2.2	3.7	-0.5	2.3	-0.8
POL	5.5	8.3	2.7	8.2	7.5
Steel	5.4	2.3	31	1.1	40.6
Cement	5.3	1.3	4.4	2.1	19.7
Jeeps and Cars	2.8	2.3	18.5	0.8	17.9
Electronics	2.0	13.5	10.2	3.1	7.0
Paper	2.3	12.7	-2.8	8.0	-5.3
Chemicals	1.7	5.7	6.3	2.1	6.4

Source: Pakistan Bureau of Statistics

Going forward, the manufacturing activity is likely to benefit from a steep decline in global oil prices.[13] Though the immediate gain would accrue to manufacturing units, which rely on oil for their energy needs, other firms would save on transportation and distribution expenses. Even with these gains, the LSM is unlikely to achieve the target growth of 7.1 percent for FY15. This is mainly because (1) the continuing gas shortages are hitting industries such as textiles, paper, leather, glass; (2) the production of sugar may fall this year in line with lower production of sugarcane crop; and (3) fertilizer production which recorded a substantial growth of 16.5 percent in FY14 due to improved gas availability, may not repeat this performance in FY15.

More importantly, the manufacturing sector may not experience any major relief in load management, as according to Nepra report, the power deficit (defined as the difference between peak demand and the generation capability) would remain more than 4,000 MW till 2016-17.[14] The power sector continued to be burdened by serious issues, such as expensive energy mix, high cost of generation, inefficient power plants, weak distribution infrastructure, growing liquidity constraints (mainly due to line losses and unpaid electricity bill), etc.

[12] The production of passenger cars was high also because of the increased demand following the launch of new models by Toyota and Suzuki.
[13] The crude oil prices fell from US$115/ barrel in June 2014 to $50/barrel in January 2015.
[14] In FY14, this gap was 4,406 MW.

Furthermore, Nepra considers the centralized role of Pepco and relevant ministries as the root cause of failure of the power sector.

Sectoral performance

As mentioned earlier, weak performance of most of the sectors in Q1-FY15, extended into the second quarter. Since SBP's First Quarterly Report for FY15 provides a detailed assessment on their performance, the following discussion focuses on selected industries.

Weak performance of agro-based industries pulled down LSM growth

Delays in crushing dampened sugar production

Sugar production fell during H1-FY15 mainly due to the late commencement of the sugarcane crushing season following the stand-off between cane growers and sugar mills over support prices. For 2014-15 sugarcane, the Punjab and Sindh governments fixed the support price at Rs 180 and Rs 182 per maund respectively. However, farmers were demanding even higher prices in view of rising cost of production, whereas sugar mills (particularly in Sindh) were reluctant to pay this price in view of large carryover stocks with them. The resulting dispute led to delay in crushing.

To ease financial constraints of sugar mills, government has allowed exports of 0.65 million tons of sugar. More importantly, this export will attract an inland freight subsidy of Rs 2/Kg and a cash subsidy of Rs 8/Kg. In addition, the government has also imposed a regulatory duty of 20 percent on the import of raw and beet sugar.

Mills have already started cane crushing, and we expect sugar production to gain momentum in coming months. The overall sugar production for the full year is, however, likely to remain lower than the last year's level, largely due to a decline in sugarcane crop.[15]

Large inventories from previous year lowered production of edible oil

The ghee manufacturing declined during H1-FY15 primarily in response to large inventories from last year's production. According to industry sources, responding to weak global prices, manufacturers had imported large quantities of palm oil from Indonesia and Malaysia last year, and converted it into edible ghee. Hence, some decline in production was already expected this year.

[15] As mentioned earlier in this chapter, sugarcane crop posted a decline from 67.5 million tons in FY14 to 63.9 million tons during the current season.

Meanwhile, ghee supplies to Afghanistan also remained low, due to availability of cheaper ghee from Iran and central Asian states. This reduced the export demand for our ghee in Afghanistan.

Construction related industries continued to maintain their momentum

Construction related industries experienced a healthier growth during H1-FY15. The falling international prices of key inputs (e.g., coal, iron and steel), and an increase in construction activities in both private and public sector, explain the higher production of steel, cement and paints.[16]

The overall growth in steel production remained strong. In fact, some of the steel manufacturers are expanding their existing capacities, and introducing new product lines. This probably reflects a huge potential for growth as Pakistan still lags behind other countries in the region in terms of per capita steel usage (**Table 2.6**).

Table 2.6: Per Capita Steel Use (in Kg)

	Crude steel	Finished steel products
Pakistan	19.1	15.3
India	63.9	57.8
Sri Lanka	29.8	28
Bangladesh	16.4	15.3
Thailand	291.4	250.6

Source: Steel Statistical Year Book, World Steel Association

In the cement sector, local sales grew by 9.1 percent in the first half of FY15 – the highest level achieved in last five years. Cement demand remained intact owing to ongoing mega construction projects of Metro and Motorways in the northern region of the country. The export quantum however declined mainly due to lower demand from Afghanistan. In contrast, exports to India, and some African countries, continued to show a healthy growth in H1-FY15.

Strong demand for new car models kept on supporting growth in auto manufacturing

In the auto industry, the growth momentum of the first quarter continued well into the subsequent months on the back of new models of Corolla and Suzuki Wagon R. Going forward, demand for passenger vehicles would likely to increase further as the Punjab government plans to distribute 50,000 vehicles under the Apna Rozgar Scheme.[17] Moreover, the industry (OEM and their vendors) are anxiously waiting for the next auto policy to have clarity on government policy on imports

[16] For details see the Chapter 2, State of Pakistan's Economy First Quarterly Report for FY15.
[17] There are also reports that new firms are planning to enter the market.

of new and used cars, fair competition and support measures for the new investors.[18]

2.4 Services

The Annual Plan for FY15 envisaged a growth of 5.2 percent for the services sector – significantly higher than the past five-year average growth of 3.6 percent (**Table 2.7**). The Plan envisaged that the revival in agriculture and industry would support a better performance by the services sector.

Table 2.7: Services Sector – Past Performance & Targets
Percent

	Share	Average growth (FY10-14)	FY15 target
Wholesale and retail trade	31.9	2.8	6.1
Transport, storage & communication	22.3	3.2	4.5
Finance & insurance	5.4	1.7	5.8
Housing services	11.6	4.0	4.0
General government services	12.1	9.3	4.3
Other private services	16.6	6.0	5.8
Services		**3.6**	**5.2**

Source: Annual Plan 2014-15, Planning Commission

While there are signs of strong performance by *finance & insurance* and *general government services*, other sub-sectors, like, *wholesale & retail trade* and *transport, storage &communication* may not be able to achieve their target growth.

Table 2.8: Wholesale & retail trade (Jul-Dec)

		FY14	FY15
Credit to wholesale & commission trade	mln Rs	17,839	9,283
Credit to retail trade	mln Rs	16,770	-698
FDI in trade	mln US$	-1.5	26.8
LSM growth	percent	6.6	2.7
Import growth	percent	1.1	11.5

Source: State Bank of Pakistan and Pakistan Bureau of Statistics

The *wholesale and retail trade* (which contributes around one-third of the value addition by services) is likely to miss its target, due to weak performance of the LSM.[19] The expected record wheat crop and a stronger growth in imports would partly compensate for the below target production by the kharif crops and a slowdown in LSM growth (**Table 2.8**).

Within *transport, storage and communication*, road transport (primarily the commercial vehicles) has the largest share of over 75 percent in the value addition. According to recent estimates, YoY growth in both the production and sale of commercial vehicles has been lower during Jul-Dec FY15 (**Table 2.9**). In

[18] The new auto policy, which was due in 2013, is still under the review process.
[19] The FY15 target of 6.1 percent for *wholesale and retail trade* appear optimistic, as this sector has grown by 2.8 percent per annum during the last five years.

addition, despite some improvement, both PIA and Pakistan Railways are expected to post losses in FY15 as well.[20]

Table 2.9: Commercial Vehicles (Jul-Dec)

Growth in percent

	Production		Sales	
	FY14	**FY15**	**FY14**	**FY15**
Trucks	25.2	65.9	39.1	58.5
Buses	2.1	1.7	3.4	-7.6
Light comm. vehicles	29.1	-0.4	17.2	2.8
Other	13.2	1.4	17.8	2.0
Total	**21.3**	**4.5**	**18.4**	**5.9**

Source: Pakistan Bureau of Statistics and Pakistan Automotive Manufacturers Association

The second largest component in this head is the communication. Here, the services providers have started rolling out a range of new products to their customers following the spectrum auction of 3G/4G licenses in April 2014. Firms have been investing in upgrading their systems and network, which is reflected in an increase in foreign direct investment and a surge in telecom imports.[21] As a result, the number of subscribers to 3G/4G services has increased from 1.9 million in Jul 2014, to 7.7 million in Dec 2014.[22, 23]

Government also provided some relief to communication sector in the Federal Budget by reducing the advance income tax on telecom services from the 15 percent to 14 percent, and cutting GST/FED from 19.5 percent to 18.5 percent.[24] Furthermore, the 2015 ICC World Cup could boost revenues of telecom operators as they have offered various products from real-time score updates to live streaming of cricket matches.

The key challenge for the telecom sector is the recent drive by the government to carryout biometric verification of all SIMs in the country. This means all un-verified subscribers will be blocked after the expiry of the deadline. In other

[20] PIA recorded losses of Rs 10.6 billion during Q1-FY15 which was marginally lower than Rs 13.4 billion recorded in Q1-FY14 (this improvement was mainly due to fall in fuel cost). In the case of Pakistan Railways, government has already allocated Rs 37 billion in the federal budget for FY15 to meet expected losses.

[21] Foreign direct investment in telecom during Jul-Dec FY15 increased to US$ 81.9 million against a disinvestment of $ 184.9 million during H1-FY14. In addition, telecom imports during H1-FY15 grew by 21.3 percent on YoY basis, against a *decline* of 27.5 percent during the corresponding period of FY14.

[22] This also includes existing customers who have converted to packages offering high speed data usage.

[23] At the same time, the launch of 3G/4G services is also supporting the broadband services in the country.

[24] This tax reduction is applicable to Islamabad, Balochistan, FATA, AJK and Gilgit Baltistan – these are the regions which have not imposed GST on services.

words, companies will lose some of their customers as a result of this campaign.[25] At the same time, this re-verification drive adds to financial burden of telecom companies. For example, instead of marketing new SIMs, telcos are focusing more on re-verification of existing subscribers; and this required investment to procure devices and systems used in the biometric verification.[26]

The performance of PTCL also remained weak during H1-FY15. Additional cost incurred on voluntary separation scheme brought down the operating profits from Rs 8.6 billion at end-Jun 2014 to Rs 4.5 billion by end of the calendar year 2014.[27]

Within *finance and insurance*, performance of the banking sector improved remarkably during H1-FY15, in terms of growth in asset base, robust earnings and stronger solvency conditions (**Table 2.10**). The asset base of the banks expanded by 8.9 percent during Jul-Dec FY15, as opposed to 4.4 percent in H1-FY14, largely due to government borrowings (mainly in PIBs), policy rate cuts, and lending to the textile, food and energy sector.

Table 2.10: Financial Soundness Indicators

	Jun-13	Dec-13	Jun-14	Sep-14	Dec-14
NPL to total loans (gross)	14.8	13.0	12.8	13.0	12.3
NPL to total loans (net)	4.4	3.1	2.9	3.2	2.7
ROA (before tax)	1.7	1.7	2.1	2.2	2.2
ROE (before tax)	18.5	18.4	23.5	24.2	24.3
Advances to deposits	48.1	48.6	47.7	48.2	48.2

Source: State Bank of Pakistan

With improved credit conditions and more investments in risk-free, high yielding government securities, the pre-tax profits of the banking sector surpassed Rs 134 billion during H1-FY15, showing a robust increase of 119 percent over H1-FY14.[28] As a result, the profitability indicators (e.g., NIM, ROA before tax) showed considerable improvements.

Finally, we expect a higher growth in *general government services* reflecting recent mobilization of resources under operation Zarb-e-Azb against militants groups.

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[25] It may be noted that the number of cell phone subscribers has already declined by 0.45 million during Jul-Dec 2014 period.
[26] NADRA is also charging telcos for the verification of the each record, but telcos are recovering this cost from their customers.
[27] PTCL recorded the operating profit of Rs 16 billion for the calendar year 2013.
[28] On full year basis, the banking sector's (pre-tax) profits reached 246 billion rupees in 2014, making it second highest performing sector after oil and gas.