2 Real Sector

2.1 Overview

Early indicators suggest that Pakistan's economy is well positioned to meet the GDP growth target of 6.0 percent in FY18. All three sectors of the economy, viz. agriculture, industry and services are expected to contribute to the improving performance.

In the agriculture sector, enhanced yields, better output prices, and government support (such as Khadim-e-Punjab Kisan Package) helped in augmenting the performance of the crop sector. All the major *kharif* crops (except cotton) either achieved or surpassed the target for FY18.[1] Although the expected water shortages during the *rabi* season would have some unfavorable impact on wheat production, the strong showing witnessed during *kharif* season, coupled with government support measures, would help the crop sector post a healthy growth during FY18.[2]

On the industrial front, low interest rates, stable exchange rate, improved law and order situation, and better energy supplies provided much needed impetus to the sector.[3] Moreover, higher income and improving purchasing power are driving demand up for both consumer durables and non-durables; the impact is particularly strong in rural areas where a healthy harvest for the second consecutive year is providing boost to consumption. In the construction segment, infrastructure undertakings (under both PSDP and CPEC) have led to higher demand for cement and steel. Resultantly, large-scale industries registered a strong growth of 10.0 percent during Q1- FY18, compared to 1.8 percent in the corresponding period of FY17.

The services sector is also poised to take advantage of the healthy growth shown by the commodity producing sectors–two heavyweights of the services sector, i.e., *wholesale and retail trade* and *transport, storage and communication* would be the main beneficiaries. Further stimulus to services would come from increasing trade activities and advancement in tele-density.

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[1] Although cotton production remained below target, this still exceeded last year's level.
[2] Better availability of basic inputs like fertilizer, seeds, pesticides, alongside affordable bank credit and government support prices would provide the needed support to *rabi* crops.
[3] The increase in import of coal, LNG and petroleum products, and higher generation of electricity are indications of improved energy availability.

A benign inflationary environment for some time now is also behind the current growth momentum. As noted in **Box 2.1**, empirical evidence suggests that for Pakistan an inflation rate below 6 percent is conducive for economic growth. Indeed, among other factors, low and stable prices by providing a certain degree of certainty, facilitate in making economic decisions. This is also reflected in a number of investment initiatives which have now started to materialize. Encouragingly, manufacturers in cement, steel, automobile, food, and home appliances, have announced new investments during the first quarter of FY18. We expect this trend would gain further traction as the key bottlenecks (e.g., energy shortages, security situation) to growth have eased to a large extent. A sharp increase in investment is critical to meet the growing consumption demand, reduce reliance on imports, and produce quality products which are competitive in the global markets.

Box 2.1: Inflation and Growth – What is the Threshold Level of Inflation in Pakistan?[4]

The relationship between inflation and economic growth has been always an area of interest for policymakers. Typically, the relationship between these two variables is considered to be of a non-linear nature, that is, a certain level of inflation is necessary for an economy to grow but beyond this threshold level, inflation starts to hurt economic growth. The level of threshold inflation has thus remained an important research question, on which few empirical studies have been conducted specifically on Pakistan. Since the economy has experienced a number of shocks and undergone structural changes, determining the threshold level of inflation needed a fresh look.

Pakistan has experienced the highest inflation of 30 percent in 1974, followed by 26.8 percent in 1975 and 17.0 percent in 2009. An examination of trends in growth and inflation points out some episodes of very high inflation which had adversely affected growth. However, there are a few years of co-existence of high inflation and high growth as well as low inflation and low growth. Therefore, getting an estimate of threshold inflation for Pakistan is not a straightforward task.

Arby and Ali (2017) recently employed two approaches to estimate threshold inflation: a quadratic equation with inflation and its square term as key explanatory variables; and a special case of a regression kink model with unknown threshold (the method was developed by Hansen (2017)[5]).

The models comprised four variables: economic growth, inflation, real investment growth and a dummy to capture years with double digit inflation. There were 19 out of 67 years in the country's history when inflation was in double digits – all of these years were characterized by some sort of cost push/supply side shocks. These shocks emanated from at least one of these factors: rise in global commodity prices (including oil), floods, pest attacks, crop failures/decline in production, exchange rate shocks, increase in input prices, rise in administered prices (such as of petrol and household utilities), increase in support prices of wheat and rice, supply disruptions of essential food items, withdrawal of subsidies on food items or utilities, and enhanced taxes on consumption items.

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[4] This box is based on Arby, M. F. and A. Ali (2017). *Threshold Inflation in Pakistan*. *SBP Working Paper No. 94*. State Bank of Pakistan. [http://www.sbp.org.pk/publications/wpapers/2017/wp94.pdf]

[5] Hansen, B. E. (2017). "Regression Kink with an Unknown Threshold", *Journal of Business & Economic Statistics*, 35: 228-240.

The study estimated threshold level of inflation on data for the period 1976 to 2017. The first method, quadratic equation, gave an estimate of 6.05 percent for threshold inflation. The second method, kink model, worked out the level at 5.67 percent. The second method [Hansen (2017)] also incorporates a testing procedure to check the threshold model against a non-threshold model, confirming the validity of threshold effect of inflation on economic growth.

Keeping in view these close estimates, the authors concluded that inflation below 5.67 percent may be favorable for economic growth and inflation above 6.05 percent can hurt growth. Historically, average real GDP growth rate has been more than 5 percent during the low inflation periods (i.e., below 6 percent), and below 5 percent during very high inflation periods (i.e., above 6 percent). There was only one year (FY1990) when inflation was exactly at 6 percent and average real GDP growth was recorded at 4.6 percent – lower than its historical average. Therefore, a more careful policy is required when inflation crosses the threshold level.

Finally, while the growth outlook for the economy appears promising, one major concern stems from the resurgence in international commodity prices especially of oil and metal products. If sustained, this trend might have implications for overall macroeconomic stability. Thus, a prudent policy response would be needed to navigate the economy safely in forthcoming quarters and to sustain the growing momentum.

2.2 Agriculture Sector

Latest estimates on the major *kharif* crops show significant improvement on last year's performance: not only that all the major crops (except cotton) surpassed their targets, a number of crops (e.g., sugarcane, rice and maize) posted record production level. Higher fertilizer offtake and sufficient water availability contributed towards this performance.

Similarly, agricultural credit disbursement has shown an impressive YoY increase of 50.1 percent in Q1-FY18 (6.6 percent in Q1-FY17) , which is encouraging, as the central bank has set a higher target of Rs 1 trillion for FY18 compared to Rs 700 billion for FY17. Encouragingly, in addition to traditional formal channels, disbursements through microfinance banks and institutions are also picking up pace, as these witnessed a YoY increase of Rs 14.5 billion.

An encouraging development this year is the increase in yields of a number of crops. However, these yields are still low mainly due to lack of growers knowledge on best farming practices, usage of low quality seeds, and incurrence of significant post-harvest losses. While the use of machinery and tools can be useful in addressing such concerns, the application of simple tele-communication technology has a potential to bring about a transformation in the agriculture sector.

Acknowledging the penetration of cell phones in rural areas, one of the mobile network operators has developed an innovative model to share vital information with growers with an objective to improve their farm management practices, reduce post-harvest losses, and enhance crop yields (**Box 2.2**). Such initiatives, applied on a larger scale, hold the potential to enhance the efficiency of the agriculture sector.

Box 2.2: Khushaal Zamindar and Mobile Agriculture:
In early 2015, the Department for International Development (DFID) UK, together with Telenor, initiated the Khushaal Zamindar project. The principal objective of the project was to disseminate through mobile communications network the technical know-how and modern cultivation methodology amongst local farmers via following means:

- ***Daily weather forecast***. Farmers not only wanted to know the exact daily temperatures, but also relative weather updates (e.g. "hotter than yesterday", "dryer than last week", etc). Such forecasts are sent early in the morning as farmers get ready for work.
- ***Expert Opinions and Interviews***. The helpline also features "podcast" type interviews of local elders and progressive farmers who guide fellow workers about the latest trends and techniques of sowing, harvesting, etc.
- ***Harvesting and Storage Techniques***. The helpline also informs farmers about the latest and effective preservation and post harvest processing methodologies in order to increase productivity and lower losses.

Various techniques were adopted to make the service easy to use and informative. For example, a one-click process was introduced to make the registration simple. Secondly, the service was offered in regional languages. Furthermore, advertisements were offered and customized to different farmers, which not only helped them in the procurement of agri input, but also kept the service free of charge.

The results over the two years have been impressive:[6]

- A total of 2.9 million farmers use the service in Punjab, of which 65 percent are "power users", i.e., they use the helpline at least twice a month.[7]
- 77 percent of such power users reported making at least one change to their on-farm methodology. Changes in planting practices led the transition (42 percent), followed by changes in post harvest and storage techniques (20 percent).
- 53 percent of the power users experienced increase in income.
- The dial number "7272" for accessing this service became the second most reliable source of information amongst users, after "family and neighbors".

However, the implementation was not without challenges. For instance, poor literacy rate makes user-centric interface unfeasible. Resultantly, operators auto assign the main crop of the area to farmers. This affects the program's adoption rate. Furthermore, the adoption rate was even lower for female users who were around 20 percent of the tapped population (of the total interaction carried out through the helpline, only 3 percent involved female participants). Recognizing this disproportionate participation, Telenor, in collaboration with Punjab Livestock and Dairy

[6] Data Source: mAgri Unit of GSM Association, London.
[7] This project covers 35 districts in Punjab, which, according to agriculture censes 2010 by Pakistan Bureau of Statistics, have 7.3 million agriculture households.

Development Board (PLDDB), has recently initiated a new service dedicated to female clientele. Accessed through a separate helpline, the "Khushaal Aangan" service would channel female-only talk shows and interviews to disseminate information regarding livestock rearing, family health, nutrition, and sanitation activities.

Despite these challenges, mobile agriculture holds a promising future. Going forward, avenues such as digital payments, e-marketplaces, access to finance, etc. can be tapped to enhance farmers' financial awareness and make supply chains of the sector smoother and more effective. Telenor already has plans to make use of its microfinance channel to expand mAgri operations. Other players are expected to follow suit. However, it is important to realize that supportive government policies (such as pursuing of National Financial Inclusion Strategy) to initiate dedicated trainings and awareness programs and to encourage private sector involvement would be the key enablers in this regard.

Reference: "Khushaal Zamindar – A mobile agriculture service by Telenor Pakistan"; Case Study July 2017; GSMA.

Cotton:

Cotton benefited from stable domestic prices, which ensured growers' interest in the crop. A shift in cotton policy pursued by China has resulted in global cotton prices experiencing a slight slowdown.[8] However, the domestic players remained relatively insulated from this development, as regulatory duties on imported cotton made the domestic produce attractive for the consumers.

The price effect was evident in expansion of both area and yield that helped to push cotton production to reach 12.6 million bales from 10.7 million bales last year (**Table 2.1**). Major gains were realized in Punjab, facilitated by persistent efforts by government supervisory agencies (through technical advice, weather information dissemination, pest scouting and awareness campaign) and subsequent care and investment by cotton growers.

Sugarcane:

Another record season is expected for the sugarcane crop as latest estimates point towards a production of around 79.3 million tons, exceeding the target by a significant margin (**Table 2.1**). This output would reflect an increase of 7.7 percent over last year. Similar to last year's trend, this season's enhanced area coverage in Punjab would be the major contributor towards gain in sugarcane crop.

[8] China has started exporting from its cotton reserves, while subsidizing local prices to make imported yarn unattractive in the domestic market. All this is resulting in an increased supply in the global market, putting downward pressure on cotton prices.

Table 2.1: Estimates for major *Kharif* crops

	Share in major crops (FY17)	FY16	FY17	FY18 Target	FY18 Estimates	*Growth (percent)*
Production (million tons)						
Cotton (million bales**)**	21.7	9.9	10.7	14.0	12.6	*17.5*
Punjab		6.3	7.0	10.0	8.8	*26.1*
Sindh		3.5	3.8	4.0	3.7	*-2.3*
Rice	12.4	6.8	6.8	6.8	7.4	*7.3*
Punjab		3.5	3.5	3.5	3.6	*5.0*
Sindh		2.6	2.7	2.6	2.9	*9.5*
Sugarcane	14.3	65.5	73.6	68.5	79.3	*7.7*
Punjab		42.0	49.6	44.0	55.0	*10.9*
Sindh		18.0	18.3	19.0	18.7	*1.7*
Maize	11.2	5.3	6.1	5.6	6.1	*0.2*
Area (million hectares)						
Cotton (million bales)		2.9	2.5	3.1	2.8	*10.7*
Punjab		2.2	1.8	2.4	2.1	*18.2*
Sindh		0.6	0.6	0.7	0.6	*-4.4*
Rice		2.7	2.7	2.8	2.9	*5.8*
Punjab		1.8	1.7	1.8	1.8	*5.0*
Sindh		0.7	0.8	0.8	0.8	*9.5*
Sugarcane		1.1	1.2	1.2	1.3	*7.7*
Punjab		0.7	0.8	0.7	0.9	*10.9*
Sindh		0.3	0.3	0.3	0.3	*2.7*
Yield (kilograms per hectare)						
Cotton (million bales)		581	733	767	778	*6.2*
Punjab		481	654	702	697	*6.7*
Sindh		952	1,012	1,046	1,035	*2.2*
Rice		2,486	2,514	2,447	2,526	*0.4*
Punjab		1,967	2,002	1,944	2,001	*0.0*
Sindh		3,574	3,546	3,467	3,546	*0.0*
Sugarcane		57,898	60,478	58,854	60,509	*0.1*
Punjab		59,435	63,819	60,440	63,786	*-0.1*
Sindh		57,457	57,204	59,375	56,660	*-1.0*

Data source: Planning Commission; Ministry of National Food Security & Research; Cotton Crop Assessment Committee; and CRS Punjab and Sindh

With record production on the cards again, the growers may have to face long delays in receiving payment for their produce from the sugar mills flush with sugar stockpile. Elevated support prices have kept sugarcane crop profitable relative to other crops but this has resulted in considerable buildup of sugar stocks that the mills are unable to offload in the international market without subsidies and under quota restrictions.[9] While the government has provided export subsidy to the tune of US$ 102 per ton on 0.6 million tons of sugar, quota restrictions would not significantly reduce sugar stocks in the country, which have reached 2.4 million tons at start of the FY18 crushing season.

[9] The country is producing sugar at a higher cost compared to its counterparts; therefore, it is difficult to export sugar stocks without substantial subsidies.

Rice:

The first estimate of rice crop shows production at 7.4 million tons (7.3 percent higher over FY17 crop), above the target of 6.8 million tones. Area sown under rice has increased by 5.8 percent in FY18 compared to last fiscal year, when the area had actually contracted. Higher domestic prices (as a result of increased exports) and subsidy on input made rice cultivation attractive for growers. Exporters were able to export more quantity of irri rice at a relatively better price in Q1-FY18 compared to Q1-FY17. Breakdown at the provincial level shows Sindh as a major contributor to this performance.

While the *kharif* crops have performed well, the overall growth of the crop sector hinges on the performance of the wheat crop – the largest crop of the year. The target of 26.5 million tons for the wheat crop may face some challenges due to expected shortfall of 40 percent in water availability according to IRSA.

2.3 Large Scale Manufacturing (LSM)

LSM registered a healthy broad-based growth of 10 percent during Q1-FY18, which is 8.1 percentage points higher compared to the same period last year (**Table 2.2**). This performance is also the strongest since the manufacturing index was rebased in FY06.[10] Significant contribution came from construction and consumer durables industries.

Table 2.2: YoY Growth in LSM

Percent

		YoY Growth		Contribution in Growth	
	wt.	FY17	FY18	FY17	FY18
LSM	70.3	1.8	10.0		
Textile	20.9	-0.1	0.8	0.0	0.2
Cotton yarn	13.0	0.3	0.1	0.1	0.0
Cotton cloth	7.2	0.2	0.0	0.0	0.0
Jute goods	0.3	-52.8	98.1	-0.1	0.1
Food	12.4	-1.5	12.3	-0.2	2.1
Sugar	3.5	-	-	0.0	0.0
Cigarettes	2.1	-42.8	92.0	-0.6	1.0
Vegetable ghee	1.1	-0.9	9.8	0.0	0.1
Cooking oil	2.2	0.5	9.6	-0.1	0.2
Soft drinks	0.9	18.4	2.6	0.6	0.9
POL	5.5	-3.4	13.6	-0.2	1.1
Steel	5.4	13.0	47.0	0.4	1.7
Non-metallic minerals	5.4	7.5	12.3	1.0	1.5
Cement	5.3	7.8	12.4	1.1	1.5
Automobile	4.6	2.9	29.3	0.3	2.1
Jeeps and cars	2.8	-3.4	31.4	-0.1	1.2
Fertilizer	4.4	6.4	-5.8	0.3	-0.7
Pharmaceutical	3.6	6.9	1.6	0.6	0.3
Paper	2.3	6.8	9.0	0.1	0.3
Electronics	2.0	15.1	79.7	0.2	1.2
Chemicals	1.7	-6.0	5.6	-0.1	0.1
Caustic soda	0.4	-20.5	18.1	-0.1	0.1
Leather products	0.9	-16.6	0.1	-0.4	0.0

Data source: PBS

[10] The quantum index of manufacturing (QIM) of 133.1 for Q1-FY18 is the highest since FY06.

A number of developments explain this performance, for example, better energy supplies (as reflected in increased availability of LNG[11] and electricity), strong domestic demand, rising purchasing power and improved security situation.

Automobile

The auto industry gained momentum in Q1-FY18 by registering a growth of 29.3 percent against 2.9 percent during same period last year. The demand for automobiles remained strong as rising income levels, together with low interest rates, led to a significant uptick in auto financing.[12] Moreover, a positive reception of newly introduced variants,[13] coupled with rapidly growing ride-hailing services like Careem and Uber (especially in the metropolitan areas) further fueled consumer interest in the car and jeeps segment. In response, producers increased their work hour durations to match customer requirements. Notably, capacity utilization for 3 big players of the segment reached over 100 percent. Thus, all these factors allowed the industry to produce a record 54.9 thousand cars in the first quarter of the year.

Table 2.3: Vehicles Production and Sales

	Q1-FY17		**Q1 -FY18**		**Growth** (percent)	
Units	Production	Sales	Production	Sales	Production	Sales
Passenger Cars	43,659	41,405	54,873	50,640	25.7	22.3
Trucks	1,798	1662	2,452	2,230	36.4	34.2
Buses	372	331	294	216	-21.0	-34.7
LCVs, Vans & Jeeps	7,237	6,251	9,947	9,829	37.4	57.2
Farm Tractors	7,237	7,858	15,618	15,710	115.8	99.9
Motorcycles & Three-Wheelers	364,536	364,135	468,771	471,109	28.6	29.4

Data source: PAMA

Tractor sales more than doubled as the impact of last year's impressive harvests and sales tax relaxation continued into FY18 as well. The former factor was also at play behind higher sales of motorbikes. Robust construction activities and enhanced transportation and trade, meanwhile, continued to drive demand for heavy commercial vehicles up; as a result, the sale of such vehicles grew by 22.7 percent in Q1-FY18 on top of 61.9 percent in Q1-FY17 (**Table 2.3**).

In light of ongoing infrastructural undertakings in the country, the auto sector looks primed for another healthy performance. Recent imposition of regulatory

[11] LNG imports almost doubled from US$ 40 million previously to US$ 74.8 million in Q1-FY18.
[12] Disbursements under consumer auto-finance surged by 50.1 percent in Q1-FY18 compared to a marginal 5.4 percent rise in Q1-FY17. Aggressive marketing by the banks sparked interest amongst the buyers.
[13] Examples include new model of Suzuki Cultus and introduction of Honda BR-V.

duties on the automobile sector is expected to create a favorable situation during the year as it may further enhance domestic production. It is pertinent to note, however, that these measures undermine the rudiments of Automotive Development Policy 2016-21 (**Box 2.3**).

Box 2.3: Fallout of Regulatory Duty on Automobile Industry

In order to curb ballooning import bill, the federal government has imposed regulatory duties on consumer durables. Car imports would also face higher tariffs in the range of 15 to 80 percent. As a result, the effective protection available to local manufacturers, reflected as the price differential between imported and local cars, has increased further. In response to higher import cost, a part

Table 2.3.1: Increase in Prices of Imported Cars after RD

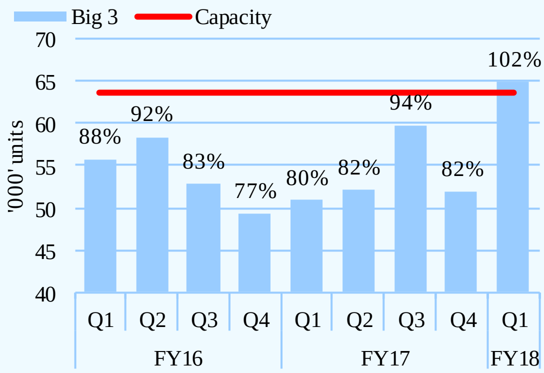
USD	<800 cc	801-1000 cc	1001-1300cc	1301-1500cc
Assessed value of vehicle	4,400	5,500	11,000	15,400
Custom Duty @1% per month[1]	3,080	3,850	7,700	10,780
Regulatory Duty-RD @15%	462	578	1,155	1,617
Sales Tax @17%	602	753	1,505	2,107
Withholding Tax @5%	207	259	518	725
Total Taxes	4,351	5,439	10,878	15,230
Without RD				
Sales Tax @17%	524	655	1,309	1,833
Withholding Tax @5%	184	230	460	644
Total Taxes	3,788	4,735	9,469	13,257
Taxes Differential	564	705	1,409	1,973
Price Differential (Rs)	**60,309**	**75,387**	**150,774**	**211,083**

[1]Assuming the car is 30 months old (depreciation @1 percent per month)
Data source: FBR and Author's calculations

of the demand for automobiles would shift away from imported models to local brands (**Table 2.3.1**). However, given that the local manufacturers are already operating at near capacity, this additional demand would result in lengthening the waiting time for the car delivery (**Figure 2.3.1**).[14]

Furthermore, the growing demand and limited supply means that the local manufacturers would now have greater pricing power in the market. Thus, the imposition of regulatory duties is against the essence of the Automotive Development Policy 2016-21 that explicitly outlines efficiency and productivity improvement through *policy of tariff reduction to improve local*

Figure 2.3.1: Car and Jeep Production and Capacity Utilization



Data Source: PAMA

[14] Consumers currently wait for 6 to 9 months for the car delivery depending on variant.

competition. Such deviation from a cornerstone of the policy would hurt the long-term prospects of the industry envisioned in the document.

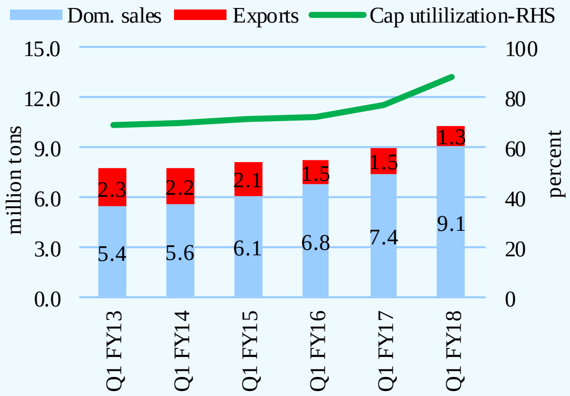
Electronics

The performance of electronics sector is largely dependent on global raw material prices (e.g., steel and copper), which makes the sector vulnerable to external dynamics. This correlation was more evident during Q1-FY18 when the surge in international prices of metals constrained its growth to 2.7 percent (15.1 percent a year earlier)[15]. While the contribution from electric motors remained strong, the substantial decrease in refrigerator production (25.9 percent in Q1-FY18 against 27.1 percent growth in Q1-FY17) contained the overall performance.

Construction Allied Industries

Progress on CPEC related projects, increased PSDP spending on infrastructure projects,[16] and continued private investment in housing schemes were the primary drivers of growth in the construction allied sectors like steel and cement.

Figure 2.1: Cement Sales, Exports and Capacity



Data Source: APCMA

Cement

The growth in cement production gained momentum as it increased by 12.4 percent during Q1-FY18, compared to 7.8 percent during the same period last year. Strong domestic dispatches (21.9 percent higher) were the major contributor to this growth, though the industry witnessed a slide in exports (down by 16.7 percent). Robust domestic demand and attractive margin on local sales also explain this significant fall in exports (**Figure 2.1**).[17]

Another development worth mentioning during this period was an increase in the cost of production and industry's response. Specifically, the government raised

[15] Overall, impressive growth in electronics (79.7 percent) was mainly due to improved reporting of electric motors (which grew by 258.7 percent).
[16] PSDP releases for Q1-FY18 increased to Rs 169.2 billion compared to Rs 110.2 billion for the same period last year.
[17] However, with new capacities coming on line soon, it is expected that the sector will not only cater to domestic demand but will also facilitate exports.

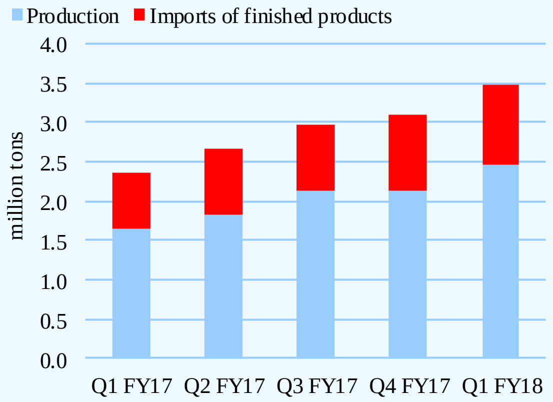
FED by 25 percent in the federal budget FY18, and the price of key input, i.e., coal increased by 10.6 percent in the global market. Both developments were anticipated to push up cement prices. Interestingly, players in the north behaved differently to their southern counterparts: while prices increased slightly in the south, northerner producers reduced the price of their product. This was the result of competitive pricing as major players vied for market share ahead of forthcoming capacity expansions. This led to some weakening of gross margins from 42.6 percent in Q1-FY17 to 33.4 percent in the Q1-FY18 amid healthy capacity utilization of around 90 percent.

Steel

The production growth of the steel sector accelerated during Q1-FY18, reaching about 47 percent, compared to 13 percent during the same period last year. Steel demand gained traction from an increase in automobile production, besides the ongoing construction activities. Interestingly, so strong was the demand for steel that even a sharp growth in domestic production was not enough to curtail imports (**Figure 2.2**).

A favorable development for the industry was the imposition of Anti Dumping Duties (ADD) on imports emanating mainly from China. Responding to the concerns of local manufacturers, National Tariff Commission has levied ADD for 5 years on steel imports from China that had

Figure 2.2: Steel Production and Import



Data Source: Pakistan Bureau of Statistics

Table 2.4: Increase in Imported Price of Steel Products After Anti-Dumping Duty (ADD)

USD per metric ton	**Rebars**	**Galvanized**	**Billets**	**Cold Rolled Coils**
Price in China (end September 2018)	590	665	541	591
Freight cost	50	50	50	50
C&F price	640	715	591	641
Excise duty	1%	1%	1%	1%
Custom duty under FTA with China	12%	11%	5%	15%
Regulatory duty	30%	18%	15%	5%
Price before sales tax excl ADD	913	929	715	776
Price after 17% sales tax excl ADD (A)	**1069**	**1087**	**837**	**907**
ADD	19%	47%	24%	19%
Price before sales tax incl ADD	1036	1264	857	898
Price after 17% sales tax incl ADD (B)	**1212**	**1479**	**1003**	**1050**
Increase in price after ADD (A-B)	**143**	**392**	**166**	**143**
Additional impact of Sales Tax	21	57	24	21

Data Source: Bloomberg, NTC and Author's calculations been undercutting the domestic market. These duties apply on a broad range of steel products and are in addition to the excise, custom, and regulatory duties **(Table 2.4)**. On top of it, the imposition of sales tax on the final price will create a multiplier effect. In essence, ADD will improve the viability of domestic steel business in the country in the short and medium term. A healthy price differential gives local manufacturers the level playing field and gives them the opportunity to improve industrial efficiency by modernizing their plants.

Earlier, steel producers (especially minor players) suffered as a result of cheap Chinese imports and energy shortages. Now they have the opportunity to bounce back, as the situation on both fronts has improved. Furthermore, large manufacturers have responded to these measures with further capacity expansion plans that will come on-line in the years ahead.[18]

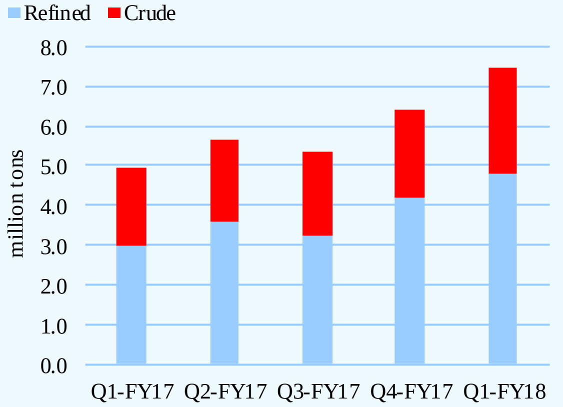
Other Construction Allied Sectors

However, other allied sectors like chemicals (especially paints and varnishes), glass plates & sheets and wood sectors could not benefit from the robust construction activities in the country.[19] Unavailability of basic raw materials, fragmented and small production units, and an influx of cheap imported products in the market are key impediments to sustainable production in the country.

Petroleum Products

Production of petroleum products rebounded strongly during Q1-FY18 by registering a growth of 13.6 percent compared to a contraction of 3.4 percent during same period last year. Resumption of operations of the largest petroleum refining installation (which had remained dormant for the last two years), together with an increase in the capacity utilization of the industry as a whole, helps explain this turn around.

Figure 2.3: Imports of Petroleum Products



Data Source: Pakistan Bureau of Statistics

[18]Companies like, Amreli Steel, Aisha Steel, Mughal Steel and Dost Steel have announced significant expansionary plans.

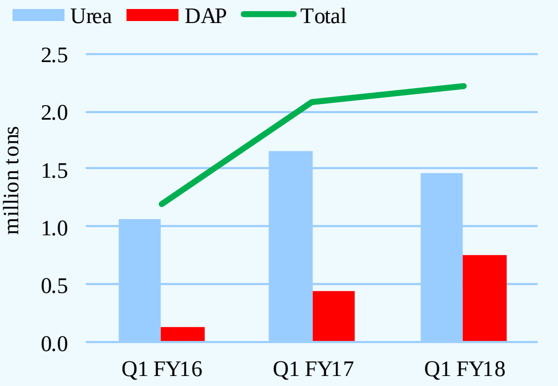
[19] Only caustic soda production took advantage of its vertical link-up with leather and textile industries to stage a relative recovery.

Encouragingly, local refineries are also managing to gradually comply with the new policy that required higher quality fuel to be sold in the domestic market. The move holds the potential to ultimately reduce marketing companies' reliance on imports (**Figure 2.3**). Improving trade and transportation activities coupled with increase in power generation capacity and industrial production were also at play in enhancing demand for petroleum products.

Fertilizer

Fertilizer remained the only sector within the LSM that recorded a contraction (5.8 percent) during Q1-FY18 compared to an increase of 6.4 percent during the same period last year. This was largely due to lower gas supply to some plants, owing to diversion of gas to the power sector.[20]

Figure 2.4: Trends in Fertilzer Offtake



Data Source: NFDC

Various supply side factors and policy uncertainty also led to a decline in the production of urea, which accounts for more than 70 percent of installed capacity of the sector. For example, despite exports and healthy domestic offtake, the inventories remained high (**Figure 2.4**).[21,22] In addition, hike in coal prices, uncertainty regarding the extent and mechanism of the subsidy (and then subsequent delays in subsidy payments to the manufacturers during last few quarters) hindered fertilizer production.

The sector's sustainable performance is dependent on the continuous gas supply from the domestic sources, as it is cheaper relative to the imported LNG. Increase in LNG imports (at affordable prices), however, could improve the overall gas

[20] Fatimafert, Pak Arab Fertilizer and Agritech Fertilizer companies with cumulative capacity 0.9 million tons had shut down production due to divergence of domestic gas and increase in LNG prices.

[21] The industry has exported 0.55mn tons of urea during 2017 so far, which is close to allocated quota of 0.60mn tons.

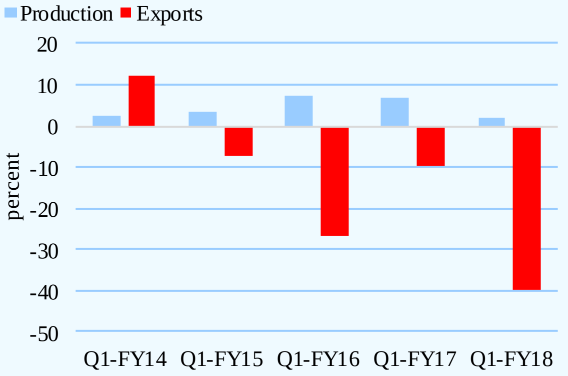
[22] Urea stocks stood at 0.7 million tons at end September 2017 compared to 1.7 million tons at same time last year.

availability in the network, benefiting the fertilizer industry to ensure production around the year.

Pharma

Pharmaceutical sector's growth decelerated to 1.6 percent during Q1-FY18 compared to a growth of 6.9 percent during same period last year. This slowdown is understandable, given a steep decline in exports during the period (**Figure 2.5**).

Figure 2.5: Production vs Export Growth in Pharmaceutical Sector



Data Source: Pakistan Bureau of Statistics

The industry, however, continues to reap the benefits of favorable government policies like higher PSDP spending on health and clarity on drug regulatory policy in the domestic market. Both federal and provincial governments have announced a substantial increase in their respective health sector expenditures. Moreover, initiatives like Prime Minister's National Health Program[23] at the country level and Sehat-Insaf-Card in KPK province [24] helped boost pharmaceutical demand to some extent in the country. Moreover, rising income levels and greater health awareness among the masses would help keep the demand strong.

Textile

The performance of the sector remained subdued during Q1-FY18. Multitier concessionary schemes in form of a mix of custom duty/sales tax relaxation and duty drawback incentives on export have not brought the expected returns from the production side. The government has recently revised the export package by further relaxing performance parameters. It remains to be seen how these measures draw a positive response from the local producers.[25]

[23] A total of Rs 8 billion have been allocated for the Prime Minister's Program for New Hospitals (Phase-I), Rs1.3 billion have been marked to build 46 new hospitals.
[24]KPK government has allocated Rs 7.0 billion under this scheme.
[25] Textile exports have surged by 7.9 percent in value (that translates into a marginal rise of US$ 238.8) in Q1-FY18. The growth is too modest keeping in perspective that hope was pinned on this sector to arrest the deteriorating trade balance.

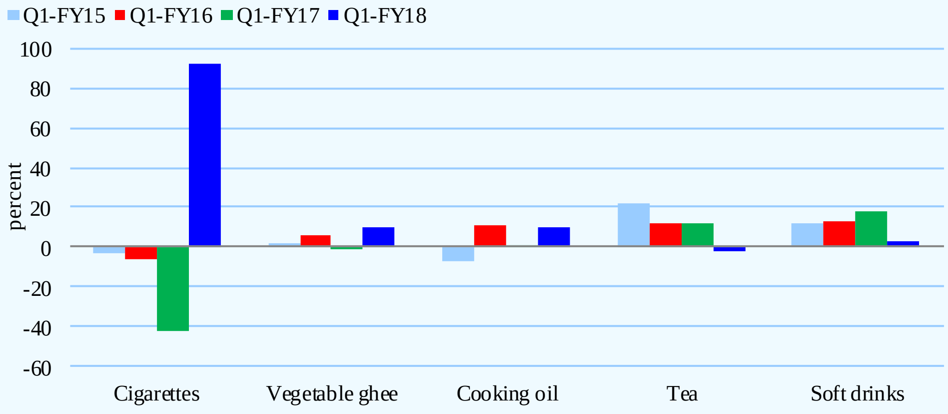
Food

Food industry experienced a growth of 12.3 percent during Q1-FY18, against a marginal contraction of 1.5 percent during the corresponding period last year. Major thrust came from the tobacco industry which more than doubled its production (92 percent) in Q1-FY18. A combination of stricter border controls, crackdown on counterfeits, and a low base effect is likely to have contributed to this uptick in cigarette manufacturing.

Edible oil and vegetable ghee segments witnessed a revival during Q1-FY18, growing by 9.6 and 9.8 percent respectively against a stagnation (0.5 percent) and contraction (0.9 percent) observed during Q1-FY17. Anticipation of an increase in prices of palm oil and soybean in the coming months is encouraging manufacturers to import the raw materials in bulk, the batch processing of which is the principal reason behind this turnaround. Successful drive against producers of substandard ghee and oil in black market was another factor that created room for formal producers (**Figure 2.6**).

Moving forward, the growth of the sector would largely depend on the sugar industry, which is expected to provide a major push to the food sector activities as once more, a bumper sugarcane harvest is expected. However, a number of factors (such as sugarcane price, weather conditions, timing of commencement of crushing season and payment settlement) would largely determine the production of sugar in the upcoming season.

Figure 2.6: Food Sector - Growth in Selected Segments

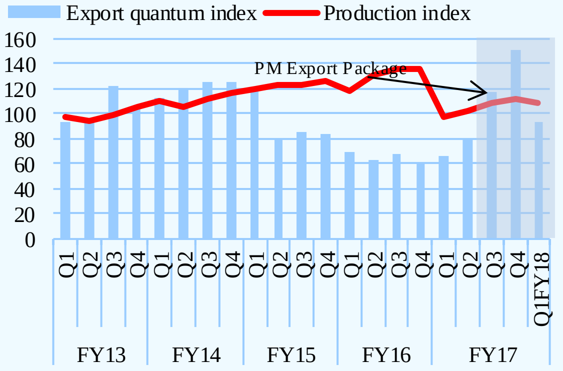


Data Source: Pakistan Bureau of Statistics

Leather

Leather industry also managed to stem the slide by posting a marginal growth of 0.1 percent during Q1-FY18, against a contraction of 16.6 percent during the same period last year. Producers' efforts to revive the industry like improving supply chains for smooth availability of raw material and exploring export markets have started to bear results (**Figure 2.7**). Favorable policies like Prime Minister's Export Package and healthier margins under the terms of the scheme also helped in boosting production. Improvement in power supply was another important determinant of this quarter's output.

Figure 2.7: Impact of PM Package on Leather Exports and Production



Data Source: Pakistan Bureau of Statistics

Moreover, the industry received extra incentives in the form of rebates on machinery imports. This would facilitate the leather industry in its transformation from outdated production methods towards modern ones.

2.4 Services:

The leading indicators pertaining to the services sector paint an overall encouraging picture (**Table 2.5**). The *wholesale and retail trade* segment benefitted from a healthy growth in manufacturing alongside a rise in import volumes. Further stimulus would come from the agriculture sector, which seems poised to perform in line with the rebound witnessed last year.

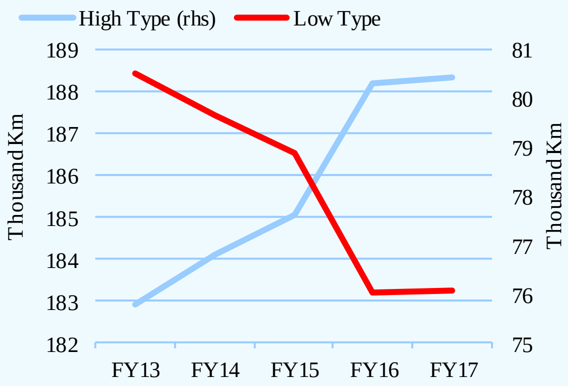
Table 2.5: Services Sector Indicators (Jul-Sep)

	FY17	FY18
Wholesale and Retail (18.5%)		
Credit off take- flow (Rs billion)	-0.6	5.9
Imports (Rs billion)	11.7	14.3
LSM (YoY growth)	1.8	8.4
Petrol and Diesel Sales (million MT)	3	3.5
Agriculture Credit (disbursements –Rs billion)	103.9	155.9
Transport, Storage and Communication (13.3%)		
Credit off take - flow (Rs billion)	-5.3	3.6
POL sales to transport sector (million MT)	3.4	4.1
Commercial Vehicle Sales (units)	12,778	14,223
Cellular Density (%)	70.9	71.8
Broadband Users (million)	44.6	48.1
Finance and Insurance (3.4%)		
Assets (Rs billion)	15,134	17,560
Deposits (Rs billion)	11,092	12,609
Return on Assets (After Tax)	1.30%	0.90%
Return on Equity (After Tax)	14.20%	10.90%
Profit After Tax (Rs billion)	139	112
General Government Services (7.6%)		
Expenses on general govt & defense* (Rs billion)	703.3	783.7

Note: Values in brackets indicate contribution to GDP in FY17
*Only Federal Government
Data Source: SBP, PBS, OCAC, PAMA, PTA and MoF

With respect to *transport, storage & communication*, a recovery in credit offtake shows confidence of the players, while increase in sales of commercial vehicles and petroleum products indicates an uptick in transport activities. Similarly, the on-going expansion and upgradation of road networks under CPEC is complementing the performance, especially considering that much of the growth observed is in the high-type road category, signaling a focus toward building major highways (**Figure 2.8**).

Figure 2.8: Trends in Road Network



Data Source: PBS

High cellular density and increasing broadband users, meanwhile, continued to push the telecom sector up during Q1-FY18. A direct beneficiary of these developments has been the e-commerce sector in Pakistan, which has consistently been growing in both usability and performance (see **Special Section 2.1**).

On the other hand, increases in assets and deposits of commercial banks indicate that the *finance and insurance* sub-sector is off to a healthy start. While decreasing margins of the banking sector remain a cause of concern amidst a low interest rate environment, this quarter an additional hit to the profitability came from a one-off provisioning expense incurred by a large bank.