2 Real Sector

2.1 Overview

The slowdown in real GDP growth last year was generally attributed to the policy measures taken to manage twin deficits. As a result, along with curtailed domestic demand and significant import compression, the industrial sector (especially manufacturing) came under strain. Also, costlier inputs and water shortages dented agriculture output, especially of important crops. Since industrial and agricultural output are linked to important services,[1] the deceleration in growth of both had led to a moderation in services sector growth in FY19 as well.

Table 2.1: Real Sector Performance and FY20 Target

	FY18^{R}	FY19^{P}	FY20^{T}
1. Commodity-producing	4.4	1.1	2.9
A. Agriculture	3.9	0.8	3.5
o/w: Important crops	3.5	-6.5	3.5
B. Industry	4.9	1.4	2.3
o/w: LSM	5.1	-2.0	1.3
2. Services	6.2	4.7	4.8
GDP	5.5	3.3	4.0

R=revised; P=provisional; T=target
Data source: Planning Commission

At the start of FY20, the government had set GDP growth target of 4.0 percent for the year. The achievement of this target crucially depends on the performance of the agriculture and industrial sectors, which are targeted to grow by 3.5 percent and 2.3 percent respectively (**Table 2.1**). In this regard, while the output of important *kharif* crops is expected to remain below target, there is some improvement over the last year. Meanwhile, the performance of the LSM sector in Q1-FY20 is indicative of the contraction in industrial activity.

In the agriculture sector, targets for important *kharif* crops are likely to be missed. While cotton production was hurt by pest attacks and untimely rains, sugarcane farmers cultivated less area this year, as they were not able to generate expected earnings on their investments last year. On the other hand, rice production grew appreciably, with the impetus coming from both higher demand from the Middle East and the EU and better international prices. However, it is worth highlighting that despite an improvement in water availability and higher use of other inputs, crop yields have remained low, pointing towards structural shortcomings in the sector, such as the use of older varieties of seed, low level of farm mechanization, soil erosion, etc.

[1] Such as wholesale and retail trade and transportation, storage and communication.

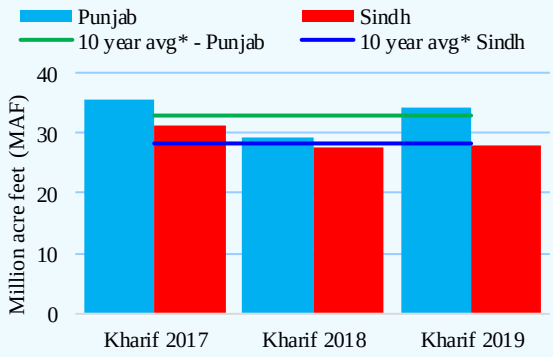
In the industrial sector, the contraction in LSM during Q1-FY20 was broad-based, with the automobile, petroleum and construction-allied firms particularly feeling the pinch from the economic downturn. Meanwhile, the rest of the LSM sector faced supply constraints stemming from expensive inputs, implementation of stabilization and revenue measures and lower domestic demand. Furthermore, the textile industry is bracing for a shortfall in cotton production in FY20 and would have to rely on imports to meet the demand from the value adding export industry. On the positive side, fertilizer and electronics have provided some relief, as the output of these industries has risen on account of better natural gas supply and high demand for water extraction equipment respectively.

As for the services sector, *wholesale and retail trade* appears to be off to a slow start, based on an assessment of proxy indicators such as the decline in LSM and imports, and lower sectoral credit offtake as compared to last year. Similarly, lower commercial vehicle sales and POL sales to the transport sector may reflect broadly sluggish activity in the *transport, storage and communication* segment. Regarding *finance and insurance*, higher quarterly profits for commercial banks compared to Q1-FY19 may represent a silver lining.

2.2 Agriculture

The major *kharif* crops presented a mixed picture during Q1-FY20, based on preliminary estimates. The outcomes for the rice and maize crops were broadly favorable. However, the revised estimate for cotton crop was significantly below the annual target as well as last year's level. In addition, early estimates of a 3.8 percent decline in the area under cultivation for sugarcane crop suggest that its performance may remain subdued. On overall basis, there are accentuated downside risks in reaching the targeted growth of 3.5 percent for agriculture during FY20, particularly given the gradually declining yields of almost all major crops.

Figure 2.1: Canal Water Withdrawals for Kharif
(Apr-Sep 2019)



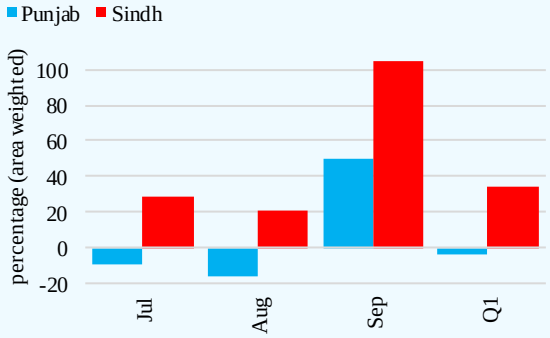
* Average of actual utilization
Data source: Indus River System Authority

Inputs

The availability of canal water in Punjab improved considerably as compared to the last *kharif* season (**Figure 2.1**). In Sindh's case, canal water availability remained similar to the last season,

as well as the 10-year average for the province. However, the overall water availability in the province improved due to ample rainfall, which helped alleviate the drought-like condition observed last year. Still, some shortage of irrigation water was recorded during the important stages of the cotton crop's development, which contributed to depressed yields in the province (**Figure 2.2**).[2]

Figure 2.2: Departure of Rainfall from Normal* during Q1-FY20



* Normal refers to area-weighted rainfall during 1981-2010
Data source: Pakistan Meteorological Department

Fertilizer offtake during the *kharif* 2019 was higher compared to last year. Specifically, urea and DAP offtake rose by 4.7 percent and 8.1 percent, compared to declines of 10.7 percent and 9.6 percent recorded in the last season respectively.

In addition, there was an uptick in agriculture credit, with disbursements during Q1-FY20 up 24.1 percent compared to last year (**Table 2.2**). Despite some deceleration, 19.5 percent of the agriculture credit disbursement target set by the government had been achieved by end-September 2019, which was higher than the 17.0 percent progress made in the comparable period last year. In the non-farm sector, the growth in credit for poultry enterprises occurred in tandem with an increase in input prices, and also coincided with the launch of the Prime Minister's backyard poultry initiative.

Table 2.2: Agriculture Credit Disbursements (Jul-Sep)

	Rupees (billion)			Growth (percent)	
	FY18	**FY19**	**FY20**	**FY19**	**FY20**
Farm sector					
A. Production	57.5	82.4	103.8	43.3	26.0
Co-operate farm	2.6	26.7	27.0	926.9	1.1
B. Development	3.3	6.0	9.3	81.8	55.0
Tractor	1.1	1.0	0.7	-9.1	-30.0
C. Total farm sector (A+B)	60.8	88.4	113.1	45.4	27.9
Non-farm sector					
Livestock/dairy	41.2	61.5	77.8	49.3	26.5
Poultry	24.7	26.6	64.3	7.7	141.7
Other	29.1	35.7	8.1	22.7	-77.3
D. Total non-farm sector	95.0	123.7	150.2	30.2	21.4
Total agri (C+D)	**155.9**	**212.1**	**263.3**	**36.0**	**24.1**

Data source: State Bank of Pakistan

[2] Source: MNFSR press release dated December 19, 2019.

Elsewhere in the farm sector credit, disbursements to corporate farmers remained high for the second year running. That said, in terms of rupee amount, the credit availed for production purposes constituted the bulk of disbursements to the farm sector, and its significant growth could partially be attributed to the rising cost of production. Increase in prices of agricultural inputs such as fertilizer[3], diesel[4] (for water extraction, tube wells and farm machinery) and tractors affected the on-farm expenditure of growers.

Crop Production

Cotton

Cotton production in the country, estimated at around 9.45 million bales, fell well short of the annual target (**Table 2.3**),[5] with both Sindh and Punjab posting lower output than last year. Adverse weather played an important role in the crop's performance. Harsh temperatures during key stages of the crop's development – including a 2-5 degree Celsius increase in September 2019 as compared to earlier years – put cotton under severe stress. In addition, the crop's performance was also impacted by an outbreak of whitefly pests and a pink bollworm attack (which lowered the boll weight).

Table 2.3: Cotton Crop Estimates

			FY20		Growth in %	
	FY18	FY19	Target	FY20^{P}	FY19	FY20
Area ('000 hectares)						
Punjab	2,053	1,888	2,145	1,860	-8.0	-1.5
Sindh	612	448	640	615	-26.8	37.3
Pakistan	2,700	2,373	2,895	2,513	-12.1	5.9
Production ('000 bales)						
Punjab	8,077	6,826	7,900	6,671	-15.5	-2.3
Sindh	3,776	2,938	4,600	2,680	-22.2	-8.8
Pakistan	11,946	9,861	12,720	9,451	-17.5	-4.2
Yield (Kg/hectares)						
Punjab	669	615	626	610	-8.1	-0.8
Sindh	1,049	1,115	1,223	741	6.3	-33.5
Pakistan	753	707		639	-6.1	-9.5

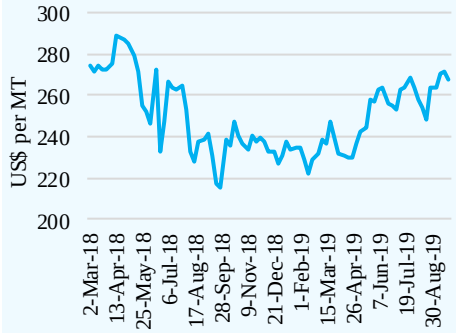
Data source: Cotton Crop Assessment Committee; Federal Committee on Agriculture; PBS; SBP calculations

Rice

Rice production grew by 6.9 percent and comfortably surpassed the annual target during the FY20 *kharif* season, as the area dedicated to the crop increased substantially (**Table 2.4**). To some extent, the impetus came from an uptick in global prices for rice compared to the same period last year (**Figure 2.3**). It is worth mentioning that exports of both basmati and other varieties of rice nearly doubled during Q1-FY20 compared to a year earlier (for details, see **Chapter 5**).

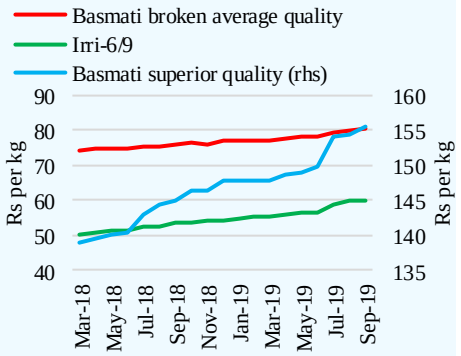
[3] The average price of urea rose by 18.0 percent in Q1-FY20 compared to previous period.
[4] The average price of diesel in Q1-FY20 registered increase of 16.0 percent over last year.
[5] The annual target for cotton was 12.72 million bales according to the Pakistan Central Cotton Committee, and 15.0 million bales according to the Annual Plan 2019-20.

Figure 2.3a: Global Rice Prices*



* Chicago Board of Trade
Data source: Bloomberg

Figure 2.3b: Domestic Price of Rice



Data source: Pakistan Bureau of Statistics

That said, there appeared to be some room for improvement in rice cultivation in Sindh. While the area under rice rose substantially, the corresponding increase in output was relatively lower. This could partly be traced to a decline in the yield for the province compared to a year earlier.

Table 2.4: Rice Crop Performance

			FY20		Growth in %	
	FY18	FY19	Target	FY20[P]	FY19	FY20
Area ('000 hectares)						
Punjab	1,841	1,904	1,869	2,029	3.4	6.6
Sindh	828	690	770	780	-16.7	13.1
Pakistan	2,901	2,810	2,877	3,036	-3.1	8.1
Production ('000 tons)						
Punjab	3,898	3,979	4,000	4,267	2.1	7.2
Sindh	2,851	2,571	2,710	2,746	-9.8	6.8
Pakistan	7,450	7,202	7,432	7,701	-3.3	6.9
Yield (kg/hectare)						
Punjab	2,117	2,090	2,140	2,103	-1.3	0.6
Sindh	3,441	3,725	3,519	3,519	8.2	-5.5
Pakistan	2,568	2,563	2,583	2,536	-0.2	-1.0

P = provisional
Data source: MNFSR and Federal Committee on Agriculture

<u>Sugarcane</u>

According to preliminary estimates, sugarcane production in the country is likely to decline during FY20 as compared to last year (**Table 2.5**).[6] The output may largely mirror the pattern of area under cultivation, with yields remaining roughly similar to FY19. Specifically, a decrease in the area dedicated to the crop may result in a corresponding fall in output in Punjab, the country's largest sugarcane-producing region, for the second season in a row. Pricing disputes and delayed payments to sugarcane growers by sugar mills in successive seasons during the last few years, have made the farmers less inclined to grow sugarcane

[6] Some revised numbers in Table 2.5 may vary from the provisional numbers published in the Annual Development Plan 2019-20 and Economic Survey 2018-19.

until the issues are resolved.

That said, a marginal decline in sugarcane production may not be a major cause for concern since output was already in surplus relative to domestic consumption. Moreover, in the past, sugar export tended to be uncompetitive without subsidies. Therefore, some rebalancing in terms of the reduction in cultivated area under sugarcane crop is optimal.[7]

Table 2.5: Early Estimates of Sugarcane Crop Performance

	FY18	FY19	Target	FY20[P]	Growth (percent)	
					FY19	FY20
Area ('000 hectares)						
Punjab	859	711	753	661	-17.3	-7.0
Sindh	333	280	310	287	-16.1	2.7
Pakistan	1,342	1,102	1,179	1,060	-17.9	-3.8
Production ('000 tons)						
Punjab	55,068	44,906	44,906	42,218	-18.5	-6.0
Sindh	20,612	16,691	18,339	16,985	-19.0	1.8
Pakistan	82,128	67,174	68,702	64,771	-18.2	-3.6
Yield (kg/hectare)						
Punjab	64,107	63,194	59,636	63,846	-1.4	1.0
Sindh	61,898	59,724	59,158	59,157	-3.5	-1.0
Pakistan	61,198	60,960	58,271	61,103	-0.4	0.2

P = provisional
Data source: MNFSR, FCA, and SBP calculations

2.3 Large Scale Manufacturing

Performance of LSM dipped further as economic downturn deepened. The sector witnessed decline of 5.9 percent in Q1-FY20 YoY, compared to a 0.6 percent drop during the same period in FY19 (**Table 2.6**). This contraction was broad-based. Construction-allied industry, petroleum and automobile industries continued on their downward trajectory, while fertilizer and electronics posted positive performances. Production of urea increased on the back of resumption of natural gas supplies to smaller units. The electronics sub-sector grew at the back of the robust demand for electric motors.

The overall downtrend can be explained by the macroeconomic stabilization policies. Contractionary monetary and fiscal policies and realignment of the exchange rate, which resulted in the sharp Pak rupee depreciation in June FY19, helped set the tone for the industry at the beginning of FY20. These developments affected the cost structure of the industrial sector in general, and particularly for industries relying more on imported inputs. Furthermore, in order to anchor inflation expectations, the SBP jacked up the policy rate by 100 bps in Q1-FY20 to 13.25 percent; the highest level since October 2011. On the demand side, low growth outcome is resulting in nominal wages not rising in line with higher level of inflation as compared to the previous few years, hurting the purchasing power

[7] It is also worth mentioning that provinces had been previously encouraged to devise their own strategies to lower the area dedicated to sugarcane, given that its production is highly water-intensive and water scarcity is already an issue in certain regions of the country. For details, refer to the minutes of the 11th meeting of the FCA for *rabi* season 2018-19.

of consumers. The increase in operational and financial costs amid low demand hampered the performance of the industrial sector during the period under review.

The trend in monthly LSM growth (12-month moving average) also remained largely subdued. Nonetheless, there is a slight improvement in this trend on 3-month moving average basis. **Figure 2.4** shows that the seasonal dip has decreased in intensity in Q1-FY20 compared to the same period in the last two years. However, it is hard to pin down if the LSM growth has bottomed out from this recent trend.

In addition to the policy measures, certain regulatory measures also helped contain excess demand in the economy. First, increase in additional customs duty increased the cost of production for some industries. Second, the introduction of statutory requirement to record CNIC number of purchaser for transactional purposes also unsettled businesses. The government's measures to bring more people under the tax net during the economic downturn has negatively affected business sentiments.

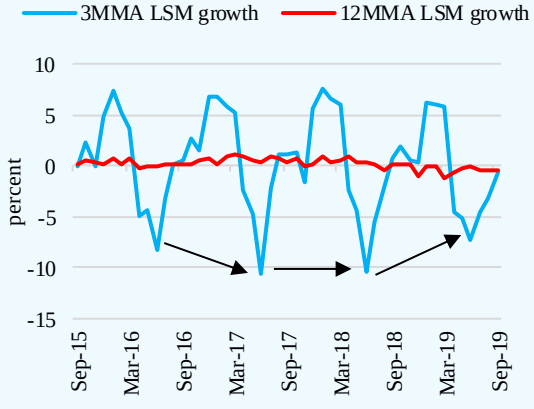
Table 2.6 : YoY Growth in LSM (Q1)

growth in percent, contribution in percentage points

		YoY Growth		Contribution to growth	
	wt.	FY19	FY20	FY19	FY20
LSM	**70.3**	**-0.6**	**-5.9**		
Textile	20.9	-0.2	0.2	0.0	0.0
Cotton yarn	13.0	0.0	0.2	0.0	0.0
Cotton cloth	7.2	0.1	0.1	0.0	0.0
Jute goods	0.3	-8.1	-14.8	0.0	0.0
Food	12.4	1.5	-8.0	0.2	-1.2
Cigarettes	2.1	4.4	-34.5	0.1	-0.7
Vegetable ghee	1.1	2.8	1.7	0.0	0.0
Cooking oil	2.2	5.7	-0.8	0.2	0.0
Soft drinks	0.9	-6.7	-8.0	-0.3	-0.3
POL	5.5	-5.4	-14.5	-0.4	-1.0
Steel	5.4	-2.9	-17.0	-0.2	-0.8
Non-metallic minerals	5.4	0.1	-0.9	0.0	-0.1
Cement	5.3	0.1	-1.5	0.0	-0.2
Automobile	4.6	-1.2	-34.1	-0.1	-2.8
Jeeps and cars	2.8	4.7	-38.6	0.2	-1.7
Fertilizer	4.4	-4.8	15.9	-0.3	0.9
Pharmaceutical	3.6	-4.8	-11.9	-0.4	-1.0
Paper	2.3	3.9	-2.0	0.1	-0.1
Electronics	2.0	16.9	5.5	0.5	0.2
Chemicals	1.7	-6.7	-8.9	-0.2	-0.2
Caustic soda	0.4	17.2	-21.4	0.1	-0.1
Leather products	0.9	0.5	4.2	0.0	0.1

Data source: Pakistan Bureau of Statistics

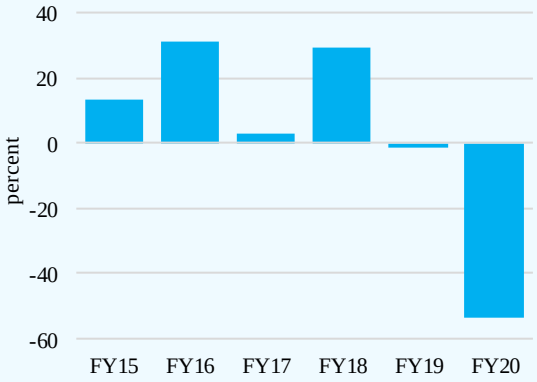
Figure 2.4: Monthly LSM Growth (Moving Average)



Data source: Pakistan Bureau of Statistics

Also, the imposition of FED on certain products, such as automobiles and cigarettes, adversely affected the output of these industries.

Figure 2.5: Automobile Sector Growth Q1



Data source: Pakistan Bureau of Statistics

Automobile

The output of the automobile sector contracted sharply by 34.1 percent in Q1-FY20, on top of a 1.2 percent dip recorded in the same period last year (**Figure 2.5**). Segment-wise production data shows that the decline was broad-based (**Table 2.7**).

Table 2.7: Automobile Sector Production during Q1

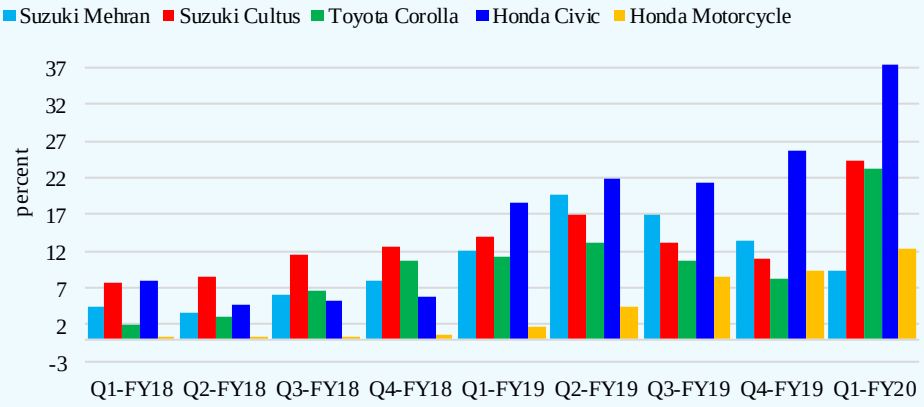
			Growth (percent)	
	FY19	FY20	FY19	FY20
All Cars	53,258	33,122	8.0	-37.8
<800 cc	12,854	11,817	8.5	-8.1
between 800-1000 cc	13,515	9,524	3.9	-29.5
>1000cc	26,889	11,781	10.0	-56.2
Sports utility vehicles	2,147	867	-22.5	-59.6
Light commercial vehicles	11,947	8,570	-6.3	-28.3
Trucks	2,049	799	-16.4	-61.0
Buses	281	157	-4.4	-44.1
Tractors	13,939	9,589	-10.8	-31.2
Motorbikes	456,521	370,771	-2.6	-18.8

Data source: PAMA

This decline can be explained by further increase in automobile prices in the country, as a result of: (i) the pass-through of 6.0 percent depreciation of Pak rupee in the month of June 2019; (ii) imposition of FED to the tune of 2.5, 5.0 and 7.5 percent on cars below 1000 cc, between 1001 and 2000 cc, and above 2000 cc respectively (**Figure 2.6**); and (iii) increase in the rate of additional customs duty on automobile parts.[8] This increase in vehicle prices came at a time when real wages of prospective customers were also subdued**.** Furthermore, prevailing high level of interest rates deterred consumers from availing financing facilities. This behavioral shift is evident from net retirements of Rs 1.9 billion recorded under auto-finance during Q1-FY20 as opposed to Rs 5.0 billion uptake in Q1-FY19. This also contributed to a subdued demand for automobiles during the quarter.

[8] FBR SRO 670(I)/2019 dated 28th June, 2019.

Figure 2.6: Increase in Automobile Prices



Data source: Pakistan Bureau of Statistics

It is important to note that new assemblers have already started their production activities, especially in the car segment. However, these newcomers as well as the incumbents face a testing period as the economy is going through a low economic growth phase. In order to integrate these entrants in the domestic market and also to insulate the automobile industry from the excessive effects of economic cycles and import compression, a number of structural improvements are needed. These include: (i) increasing the localization content in automobile assembling; (ii) providing a level-playing field in the sector by doing away with protective policies; and (iii) addressing market frictions in the auto financing business.

Construction Allied Industries

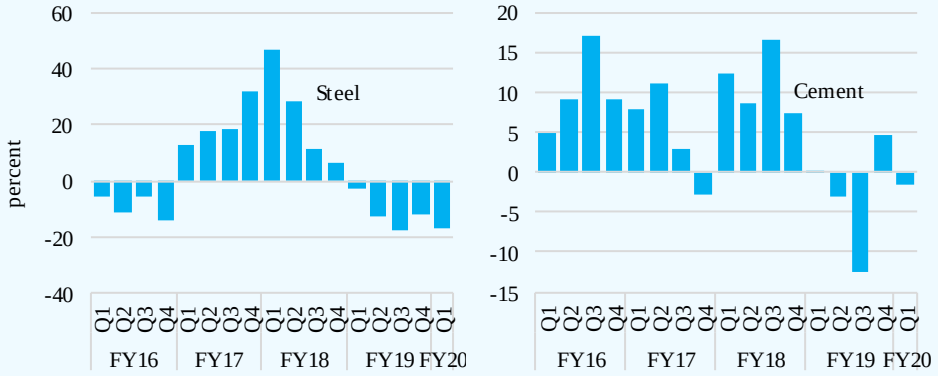
The downward trend in construction-allied industries became more pronounced in Q1-FY20 (**Figure 2.7**).

Cement

The cement industry's output declined by 1.5 percent in Q1-FY20 compared to marginal growth last year, as captured by LSM data. This outcome is owed mostly to subdued domestic demand although there are some signs of improvement since September FY20. On the other hand, exports of clinker helped offset a substantial portion of losses but were not enough to turn the overall output growth to positive in this quarter.

According to the All Pakistan Cement Manufacturers Association (APCMA), cement exports rose by 17.6 percent in Q1-FY20 compared to 30.8 percent growth

Figure 2.7: YoY Change of Construction Allied Industries



Data source: Pakistan Bureau of Statistics

last year.[9] As exports to India tapered, exports of the finished commodity to Afghanistan and clinker to mainly African countries rose sharply, to the benefit of local producers. In particular, exports of clinker, which grew 121.9 percent over last year, provided much needed boost to a sector that has undertaken extensive capacity enhancement in the last few years, and added over 20.0 percent to the overall capacity in just the past two years (**Table 2.8**).

Table 2.8: Cement Dispatches and Growth

		Dispatches (million tons)		Growth (percent)	
		Domestic	Export	Domestic	Export
FY18	Q1	9.0	1.3	21.6	-13.3
	Q2	10.7	1.1	12.6	-15.4
	Q3	11.4	1.0	17.5	11.1
	Q4	9.9	1.3	8.8	44.4
FY19	Q1	9.1	1.7	1.1	30.8
	Q2	10.6	1.7	-0.9	54.5
	Q3	9.8	1.6	-14.0	60.0
	Q4	10.9	1.4	10.1	7.7
FY20	Q1	9.1	2.0	0.0	17.6

Data source: All Pakistan Cement Manufacturers' Association

Meanwhile, domestic cement sales remained dull as public and private spending on infrastructure and housing remained subdued. High cost of construction deterred real estate developers. In addition, large-scale developers, who rely on bank borrowing to fund their operations, held back their investment owing to the increase in financing costs.

Steel

The steel industry's downtrend continued, with output contracting 17.0 percent in

[9] However, this is in contrast with the PBS' exports data, which shows a 5.2 percent YoY decline in quantum cement exports in Q1-FY20.

Q1-FY20. The production of billets, mostly used in construction activities, declined by around one-third as compared to Q1-FY19. As mentioned earlier, the high cost of construction is the primary cause of this performance.

In addition, the PKR depreciation just before the start of the year, higher financing costs, and lower utilization levels have led to higher costs for the industry's larger players, and also played a role in constraining the producers' pricing power. As demand subsided owing to higher prices, the profitability margins of the industry squeezed as well.

Food

The food sector's growth continued to remain negative due to weak performances of cigarettes, soft drinks and cooking oil segments. The increase in FED on cigarettes and uncertainty regarding the imposition of an additional tax on sugary soft drinks, affected the industry. Cooking oil processing declined as production of its close substitute (ghee) registered an increase. This is mainly due to the significant drop in the import price of palm oil (major input for ghee production) prices compared to soybean, which is a major raw material for cooking oil.

Cigarette

The output of the cigarette industry declined by 34.5 percent during Q1-FY20 as compared to a positive growth of 4.4 percent in the corresponding period last year. The primary reason was the significant increase in FED rates on two tiers and elimination of the third tier of locally produced cigarettes (**Table 2.9).**

Table 2.9: Changes in FED on Cigarettes

Timeline	Tier	(Price=P in PKR/1000 cigarettes)	FED
Jun-16	Tier 1	> 4000	3436
	Tier 2	< 4000	1534
May-17	Tier 1	> 4500	3740
	Tier 2	2925 < P < 4500	1670
	Tier 3	< 2925	800
Apr-18	Tier 1	> 4500	3964
	Tier 2	2925 < P < 4500	1770
	Tier 3	< 2925	848
Sep-18	Tier 1	> 4500	4500
	Tier 2	2925 < P < 4500	1840
	Tier 3	< 2925	1250
Jun-19	Tier 1	> 5960	5200
	Tier 2	< 5960	1650

Data source: Federal Board of Revenue

The increase in FED had negative implications for the growth of the formal cigarette industry, as it pushed consumers towards cheaper alternatives, in the shape of illicit products that remain out of the tax net. These include both locally produced counterfeits and those smuggled from abroad. In order to curb the prevalence of illegal products in the market, the government has developed a track and trace program that would track these products and penalize the illegal chain of tobacco dealers in the black market.

Petroleum

The POL industry registered a double digit contraction of 14.5 percent in Q1-FY20, which was deeper than the drop of 5.4 percent recorded last year. The shift in power generation away from furnace oil has reduced the fuel's demand and affected the industry's output. Some oil refineries are still weighing the possibility of installing diesel hydro desulphurization units that would allow them to increase their production of other POL products. However, for the time being, refineries are facing excess capacities.

Textile

The mismatch between production and export volume data for the textile sector has widened further. Domestic textile output data (as reported in LSM) is skewed towards firms making primary products; these firms exhibited insipid performance during Q1-FY20 which is reflected by the marginal growth of 0.2 percent over Q1-FY19. However, export volumes of apparel, for instance, have risen sharply during the period, supported by the realignment of the exchange rate with market fundamentals. As highlighted in previous SBP reports as well, the detailed analysis of these two datasets points toward some transition in the textile sector, from low value added (yarn and fabric) products to higher value added products (such as apparel).

This transition is a welcome boost for the industry, as firms continue to make inroads into the European and the US markets. This positive outcome, while not entirely visible in production (LSM) data, is the result of the industry regaining competitiveness after the exchange rate depreciation. To further support this, some of the large industry players have increased their capacity utilization levels as well.

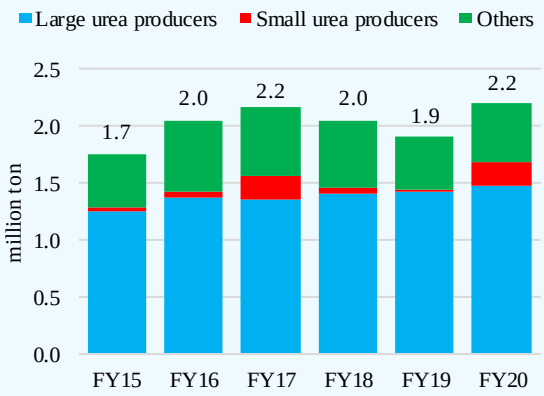
Fertilizer

The fertilizer sector's output expanded sharply by 15.9 percent in Q1-FY20 in contrast to a decline recorded last year. The impetus came from small as well as large urea producers, which led to a record high first quarter urea production. The output of small urea units expanded considerably,[10] whereas large producers also scaled up their operations by another 2.5 percent in Q1-FY20 (against a growth of 2.3 percent in the previous period), as shown in **Figure 2.8**. At this rate, the country is set to produce surplus urea for FY20.

[10] It in pertinent to recall that last year, these units had remained shut during the time due to non-availability of natural gas, a critical input, at economically feasible rates. For details, see Chapter 2 in the SBP's State of the Economy Report for Q1-FY19.

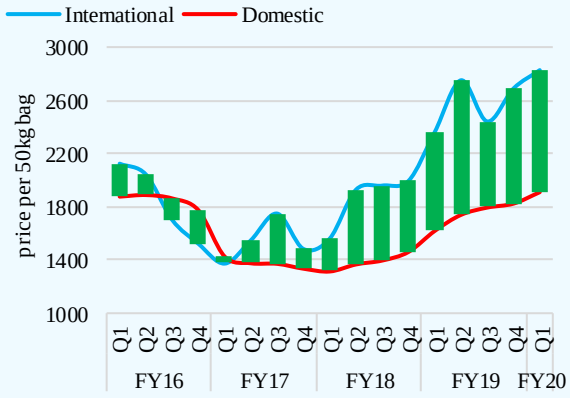
The country's absorption capacity for urea is around 6 million tons in a typical year. With production outstripping demand, the surplus supply would need to be offloaded in the international markets. The global urea prices have risen by around 19.7 percent since Q1-FY19, creating potential for the producers to export the commodity at favorable rates. The fertilizer's average domestic price was Rs 1,911 per 50-kilogram bag during Q1-FY19, while international prices averaged Rs 2,821. The sizeable price differential means that the producers can earn substantial returns on their excess stock (**Figure 2.9**).

Figure 2.8: Fertilizer Production during Q1



Data source: National Fertilizer Development Corporation

Figure 2.9: Fertilizer Prices



Data source: National Fertilizer Development Corporation

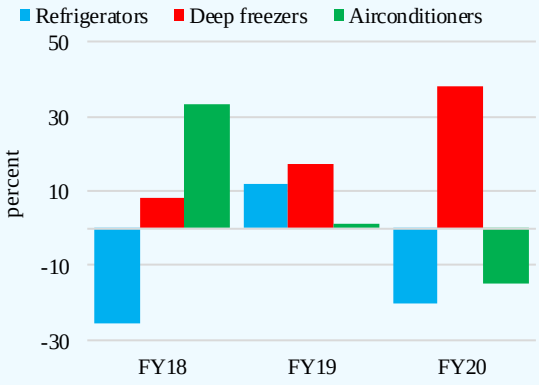
However, this export opportunity has arisen due to subsidies provided by the government to the fertilizer plants. Before making allowances for export, the government needs to recoup as much of the cost subsidy as possible. Otherwise, it makes no economic sense to subsidize consumption of fertilizer for foreign users.

Production of other fertilizers (which included DAP, NPK and SSP) also witnessed significant recovery during Q1-FY20 after 3 years of contraction. The higher production reduced the need for fertilizer imports; in fact, fertilizer (DAP) was one of the largest contributors to the decline in overall imports in the quarter (**Chapter 5**).

Electronics

The output of the electronics industry grew by 5.5 percent during Q1-FY20 as compared to the growth of 16.9 percent in the corresponding period of FY19. The major driver was the electric motor segment, which saw its growth reach 9.8 percent, against the rise of 28.8 percent recorded during Q1-FY19. One possible reason is that domestic consumers have turned away from imported motors after the exchange rate depreciation, and have started to prefer relatively cheaper domestic alternatives. The inclusion of a motor assembling firm in the LSM data is somewhat helpful in pinning down this uptick in growth.

Figure 2.10: Growth in Production of Electronics Items



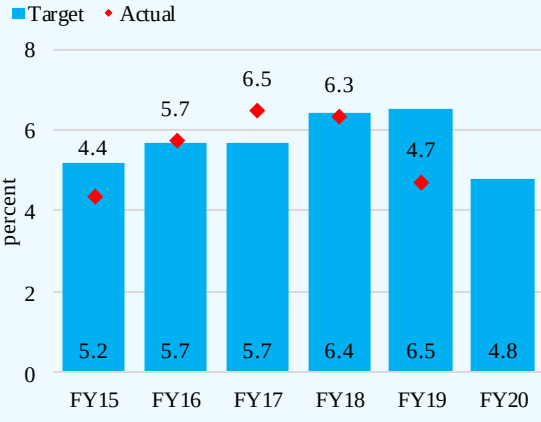
Data source: Pakistan Bureau of Statistics

Meanwhile, the increase in electricity tariffs and the Pak rupee depreciation had some bearing on a few consumer durables, such as air conditioners and refrigerators (**Figure 2.10)**. The rise in electricity rates increased the operating costs, while the Pak rupee depreciation increased the production costs of these import-intensive products.

2.4 Services

The services sector's growth target of 4.8 percent for FY20 is only marginally higher as compared to the actual growth realized last year (**Figure 2.11**). Moreover, it is fairly low compared to the annual targets in the previous five years.

Figure 2.11: Services Sector Growth



Data source: Planning Commission and PBS

To some extent, the near-term outlook of the services sector depends on the performance of its largest segment, *wholesale and retail trade*, which is

inherently linked to the commodity-producing sectors. On this note, LSM declined during Q1-FY20 (**Table 2.10**). Imports were also expected to remain on the lower side as long as macroeconomic stabilization policies remain in place. In addition, various traders' associations observed countrywide strikes during the first quarter to protest against certain documentation measures being pursued by the government; these tensions persisted till end-October 2019, when an agreement was finally reached. Taking all these factors into account, it was hardly a surprise that credit offtake to wholesale and retail traders saw a significant decline during Q1-FY20 compared to last year.

Table 2.10: Selected Services Sector Indicators (Q1)

	FY19	FY20
Wholesale and Retail Trade (18.9%)		
Sectoral credit off take*- flow	-4.9	-43.8
Imports (billion US$)	14.2	11.5
LSM (YoY growth)	-0.6	-5.9
Agriculture credit	212.1	263.3
Transport, Storage and Communication (12.9)		
POL sales to transport sector	3.6	3.4
Commercial vehicle sales	11,219	5,000
Cellular teledensity (%)	73.2	76.8
Broadband users (million)	61.6	74.0
Finance and Insurance (3.5%)		
Assets (billion Rs)*	18,118	21,655
Deposits (billion Rs)*	13,603	14,945
Profit after tax (billion Rs)	34.8	37.3
Infection ratio	8.0	8.9
General Government Services (8.4%)		
Expenses on general govt & defense*** (Rs billion)	932.8	1,009.3

Note: Values in brackets are sectoral shares in GDP, as of FY19.
* With adoption of ISIC-4 classification by SBP, the *wholesale and retail trade* and t*ransport, storage and communication* categories have been modified. Thus, one-to-one mapping of sectoral credit offtake numbers may not be possible in each case
** Stocks, as of end-September 2019
***Only Federal Government
Data source: SBP, PBS, OCAC, PAMA, PTA and MoF

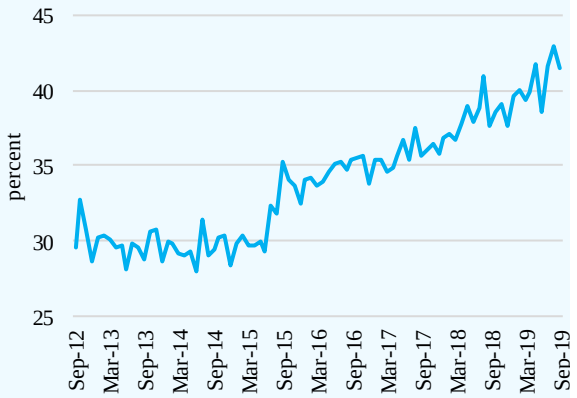
Among the *transport, storage and communication* segment indicators, there was a sharp dip in commercial vehicle sales, which more than halved compared to last year. Besides, POL sales to the transport sector were also lower during Q1-FY20. Furthermore, the proposed implementation of axle load controls faced resistance from the business community and transporters. Ultimately, in late October 2019, the government postponed the axle load implementation for a year.

Regarding the *finance and insurance* segment, the profit after tax of commercial banks showed some improvement in Q1-FY20 compared to the same quarter last year. To some extent, this may be attributed to higher net interest income. At the same time, a rising infection ratio and higher quantum of NPLs may keep the upside potential somewhat in check.

It is worth noting that there continues to be an excessive reliance on cash holdings, indicated by the persistently high currency- to-deposit ratio (**Figure 2.12**). The secular rise in cash holdings can mainly be traced to the introduction of

withholding taxes on banking transactions by the government in FY16. In addition to the lingering impact of this move, the higher inflation since FY19 may also have influenced the people's preference to keep greater cash holdings for transactions. That said, certain measures proposed by the SBP may induce a gradual shift in the public's preference away from cash-based transactions in favor of digital payments, as envisioned in the National Payment Systems Strategy (NPSS) introduced in November 2019.[11] The entry of more players into the payments space, including fintechs, may drive more innovation and financial inclusion, ultimately bringing more vibrancy to the *finance and insurance* sector.

Figure 2.12: Currency to Deposit Ratio



Data source: State Bank of Pakistan

[11] The details of the NPSS may be accessed at SBP's website.