Pak Eco News

Economic trends: a review

By Ali Farid Khwaja

Nature has been particularly kind to Pakistan's economy. A few years back when we were starved for foreign reserves, 9/11 happened and remittances poured in the country. Now, when the water reserves were drying up, nature sent rainfall across the country and snowfall in the northern regions. According to IRSA, timely rains have reduced the expected water shortage in the season to 38 per cent from an earlier expectation of 47 per cent. The reservoirs at Tarbela and Mangla are also above their expected levels. The economic planners have all the reasons to do a rain dance.

The SBP has raised the growth target in FY05 to 7.1 per cent from an earlier 6.6 per cent and it expects agriculture growth to surpass the target of 4 per cent. Already the estimates for cotton crop are indicating a bumper crop this year. Agriculture has a strong impact on the overall economic growth. Although its direct share in the gross domestic product (GDP) has fallen to 23.1 per cent (from 31 per cent in 1981), the agricultural sector has strong backward linkages with the industrial sector and positive synergies with services growth. Pakistan's industrial base is agri-based and the textiles sector constitutes 24 per cent of total manufacturing. A bumper cotton crop, along with depressed cotton prices bodes well for the textile sector and we expect greater growth in large scale manufacturing (LSM) in the second half of the current fiscal year.

In FY05, we expect the economy to continue on its high growth path and expect the GDP growth rate to touch 6.5 per cent. The momentum in the economy would be driven by the buoyant large-scale-manufacturing sector, which has grown by around 15 per cent YoY during 1HFY05. The spectacular growth in telecommunications would boost services growth to around 6 per cent. However, in the frenzy of incentives to provide uplift to the sector. However, the responsiveness of agriculture sector to fiscal incentives is relatively low due to the strong influence of natural forces. Last year, the sector could only grow by 2.7 per cent below the target of 4.5 per cent set by the government. This year, the government announced a target of 4 per cent but once again water scarcity threatened to constrain the growth. IRSA chose to allocate maximum water supplies in the kharif season in order to boost cotton production. During the rabi season, IRSA expected a water shortage of around 47 per cent.

The timely rains in the current season have been useful in this respect. We expect the sector to grow at 3.8 per cent, slightly below the government target of 4 per cent.

Cotton record

Last year, cotton prices touched peaks of as high as PkR3160 per maund and consequently these high prices gave incentives to farmers to increase the area under cultivation of cotton in the current year. Once again fortune favoured the sector as this year the cotton crop remained free from pest attacks, weather remained suitable and water was available. According to most estimates, the cotton output is expected to cross the record level of 14 billion bales. We expect it to reach around 14.7 billion bales while some analysts even expect it to be as high as 15 billion bales! The increase in cotton output originates from both an increase in area under-cultivation and improvement in yields. The area under-cultivation has increased due to the slide in the price level and the government needs to intervene to ensure stable cotton production next year (otherwise farmers would shift to producing sugarcane next year due to the high sugar prices prevailing in the market).

Although cotton has only 26 per cent weight in the 'major crop' category, this year's bumper crop would uplift the growth in the sector. Also the industrial sector of the country is strongly dependent on cotton and the bumper crop this year would also have a strong complementary effect on the industrial and services sectors.

Agriculture sector and GDP

There was a time not long ago, when Pakistan's economy was totally dependent on the agriculture sector. By 1981 the agriculture sector contributed to around 31 per cent of the total GDP directly. Over the last two decades, the industrial and services sectors have outgrown agriculture however, the economy is still strongly influenced by the fortunes of the agriculture sector. Around 67 per cent of the population of Pakistan is based in the rural areas with family income dependent on agriculture. Growth in the agri-sector leads to an improvement in purchasing power and promotes services growth. The industrial sector is mainly agri-based, dependent on the cotton and sugar crops.

Overall GDP growth seems to move concurrently with agriculture sector growth. According to our estimates, a 1 per cent increase in agri-growth leads to a 0.28 per cent growth in the GDP.

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with a 24 per cent weight in large-scale-manufacturing is based on the cotton crop, while other industries like sugar (3.4 per cent weight in LSM), tobacco (3.05 per cent of LSM) and fertiliser (8 per cent of LSM) also have strong linkages with the fortunes of the agricultural sector.

The fall in cotton prices is expected to increase the gross margins to around 18 per cent from 16 per cent last year, an improvement in the bottom-line of textile companies like Nishat Mills. Already, the textile sector has purchased around 10 billion bales in the current year. During 1HFY05, large-scale-manufacturing sector grew by 14 per cent higher than the target of 12 per cent. However, growth in the textile sector was only around 2.4 per cent YoY (below 8 per cent achieved in FY04). In the second half of the fiscal year, we expect the sector to rebound and grow by around 6 per cent YoY on the back of: (a) easy and cheap availability of inputs; and (b) increase in demand after December 2004. This would boost the overall LSM sector growth to around 15 per cent.

Agri-growth and the services sector

Most analysts tend to ignore the strong impact of agricultural sector growth on the services sector. Around 67 per cent of the total population is based in the rural sector. Consequently, agricultural sector growth improves rural income and leads to an improvement in purchasing power. This leads to a positive correlation between services growth and growth in agricultural sector.

Regression analysis reveals that an increase (decrease) in the growth in agricultural sector by 1 per cent leads to a 0.32 per cent improvement (reduction) in services sector growth. We have used data from 1981-2003 for our analysis.

Agricultural sector and household savings

Growth in agricultural sector can help solve one of the biggest impediments of our economy, a low savings countries. Countries like Korea and Malaysia have savings rates as high as 31 per cent of GDP. The empirical estimation done by Dr. Khan and Dr. Nasar shows that farm workers in Pakistan have the highest savings rate, as high as 27 per cent. Their study using data from Pakistan Integrated Household Surveys (PIHS) shows that income is the biggest determinant of household savings. A 1 per cent increase in the income level of farm workers would lead to a 0.23 per cent increase in the savings level. Household savings is the biggest component of national savings with a 67 per cent share and consequently any increase in household saving would improve the overall savings rate in the economy.

Policy conclusions

In the frenzy of recent high growth in the manufacturing sector and increased investors interest in the services sector, most analysts seem to be ignoring the significance of agricultural sector. The agriculture sector has strong inter-linkages with all major sectors of the economy and hence plays a critical role in determining the overall GDP growth. It is not surprising then that around 40 per cent of the volatility of GDP is explained due to the fluctuations in agriculture. Water availability remains the biggest challenge facing the agricultural sector.

This year, the bumper cotton crop has been extremely propitious for the economy. Higher cotton prices last year, and no pest attacks in the current year have been the major factors behind the increase in cotton production. Cotton yields in the country, although comparable to India but much lower than the yields in China, are around 1100 kg per hectare. Boosting long run growth would require improvements in yields, which can come through from more research in agriculture. During the rabi season, we believe that the water shortage would keep wheat production below the target. The sector's growth is critically dependent on the mercy of favourable would boost services growth to around 6 per cent. However, in the frenzy of growth in these two sectors the government should not neglect the agricultural sector. The country needs a new agricultural policy focusing on water management and conservation reforms.

Water scarcity

The agricultural growth in both India and Pakistan has been strongly influenced by rainfall, especially the monsoons. In the budget for FY05, the government announced many fiscal in-

tion and improvement in yields. The area under-cultivation has increased from 1.8 million hectares in 1975 to 3.14 million hectares this year. The yields, though lower than regional levels, have also improved by 20 per cent from 613 kg per hectare in FY03 to 736 kg per hectare in FY05. As of 1st February 2005, around 14.01 billion bales of cotton have already been harvested.

The increase in cotton production has also led to a fall in its price, which bodes well for the textile industry. However, the farmers would lose out

leads to a 0.28 per cent growth in the GDP.

Agriculture sector and GDP growth

A 1 per cent increase in agriculture growth leads to a 0.28 per cent growth in GDP. Around 40 per cent of the total volatility (as measured by the standard deviation) is contributed by the agricultural sector.

Linkages with the manufacturing

The industrial base of the economy is strongly linked with the agricultural sector. Textiles, the largest industry

Growth in agricultural sector can help solve one of the biggest impediments of our economy, a low savings rate. According to work done by Dr. Ashfaque Hasan Khan, the current Chief Economist of Pakistan and Dr. Zafar Moeen Nasar of Pakistan Institute of Development Economics, for a World Bank working paper, improvement in the incomes of farm workers can lead to an improvement in the overall savings rate in the economy. Currently, Pakistan has a savings rate of around 18 per cent of GDP, which is way below the averages for developing

keep wheat production below the target. The sector's growth is critically dependent on the mercy of favourable natural outcomes.

Pakistan can learn water management techniques from India, where in Indian Punjab, water losses are much lower and many more techniques like sprinklers are used for irrigation. The country needs a new agriculture policy and to prioritise agriculture sector in order to improve the living standards of the majority of the population and also reduce the volatility in the economy.