A biannual publication of PIDE about performance and expectations of the business sector of Pakistan

No. 2 December, 2007

PIDE BUSINESS BAROMETER

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS

ABOUT PIDE

The Pakistan Institute of Development Economics (PIDE), a premier research institute of Pakistan, has led the field in developing quality research in social sciences and informing public policy. PIDE is an academic institution that coordinates its work plan with the Planning Division, Government of Pakistan. Granted the degree-awarding status by the Government of Pakistan since 2006, PIDE functions as a research body with an educational mission.

Through recent restructuring, PIDE has developed several new initiatives such as the *PIDE Working Papers*, *PIDE Policy Viewpoint*, and a weekly PIDE Seminars series. It has been very active in the area of opinion evolution, breaking new ground in such areas as urban issues, governance and institutions, and civil service reform.

PIDE Business Barometer of Pakistan provides biannual information about the business sector's assessment and expectations of the state of economic activity in Pakistan.

THE NEED FOR A BUSINESS BAROMETER

To provide independent biannual information about the state of economic activity in Pakistan, PIDE has launched the *PIDE Business Barometer*.

The *PIDE Business Barometer* is based on the survey of firms' assessments of the economy through their own activities. We have tried to get information from firms on their production, sales, inventories, prices, wages, employment, and investment. The survey was conducted in July.

We asked for information on the selected variables for the last six months, January–June, 2007. This information should be relatively easy to analyse since most managers will have a very real feel for events of the last six months even if they have not finally closed their books.

We then asked about their expectations of the same selected variables over the coming six months, July to December, 2007. Once again, the information provided by firms would be very useful given that they would have good knowledge of things to come from their order books and forward contracting arrangements.

We intend to repeat the survey every July and January. This simple device allows us to assess market perceptions of the economy in a very real way. And we know from global experience that market perceptions are an important source of information on the economy that both policy-makers and market participants can use.

We hope that this *Barometer* will lead to the development of a diverse set of market sentiment indicators that all economic agents as well the government will find useful as a measure of coming economic activity.

THE SURVEY

For this survey we are focussing on firms that are listed at the Karachi Stock Exchange (KSE). In that sense, we are dealing mainly with large business. While this is largely because of the convenience and management of the survey, it is also true that large firms, because of their weight in the economy, may provide us with more information on developments in the economy.

The questionnaire was sent to all the firms listed at the Karachi Stock Exchange. The respondents included the banking sector, textile sector, sugar and allied industries, cement, oil and gas exploration companies, engineering, automobile assemblers, automobile parts and accessories, fertilisers, pharmaceuticals, chemicals, banaspati and allied industries, food and personal care products, and glass and ceramics. Some 11 percent of the firms responded, which gives us a fairly good sample to generalise from. There were 13 respondents from the banking sector, which caused a separate banking section.

A common drawback of the studies involving forecasting of the variables is the authenticity or accuracy of the calculations. Since the perceptions about the future production, investment, etc., are vulnerable to any small change like a political event or shift of policy, the barometer uses a deviation factor to ensure that the firms’ behaviour in the next six months is predicted with more precision and accuracy. This deviation factor is based on the responses of the same responding units to compare expectations and actual evaluations of January–June, 2007. The deviation factor has been calculated by taking the difference between the actual evaluations and the expectations of the overlapping period of January–June, 2007. For more careful calculation, only the same responding units have been used to derive the difference between the expectations and the evaluations. The application of this percentage difference, to the most favoured category of the response, shows how much the actual evaluations deviate in reality from the expectations. The use of this deviation factor helps in analysing the behaviour of business firms with more accuracy, since the possibility of the gap between the perceived figures and the actual figures is controlled. In other words, this factor supports our argument regarding the firm's perceptions about their activities in the next six months with corrected anticipations.

Furthermore, over time, we shall improve the coverage while also ensuring that we do develop a panel of respondents to ensure comparability across semesters.

OVERVIEW

The second edition of the *Business Barometer of Pakistan* is again based on the views of the firms listed at the Karachi Stock Exchange (KSE). The first edition dealt with the firms' evaluations of the second half of 2006 and expectations about the first half of 2007. This edition consists of their opinion about the overall performance of the economy, such as growth and inflation during the first half of the year 2007 and expectations about the remaining six months of 2007. The second edition also includes an analytical comparison of the current with the previous survey. The overlapping period in the two surveys is the first half of 2007, which is used to calculate the deviation factor in the expectations and evaluations. The first attempt to disaggregate the analysis sector-wise has been made by reflecting the views of the banking sector in a separate section. There is a substantial difference in both the assessment and expectations of the banking as well as non-banking sector about the economy.

The analysis reveals that overall growth of the economy during the first half of 2007 remained stable. Further, firms also anticipate stability in growth of the economy in the next six months of 2007. Although most of the firms expect the same level of growth, yet the net balance[1] remains negative as was the case in the first edition. Since the deviation between the expectations and the evaluations is not substantial, a stable economic growth can be forecast for the next half of 2007. The banking sector is also anticipating stable growth, with the majority of banks (69.2 percent) reporting stable economic growth in the first half. Their expectations indicate the uniformity of the trend in the remaining six months of 2007.

The picture about the general price level—and the rate of inflation—is still alarming. Most of the firms reported higher prices in the first half of 2007, and their expectation is that these would be even higher in second half of the 2007. The deviation in the respondents anticipating high general price level, calculated by taking the difference between the actual evaluations and the expectations of January–June, 2007, is 20.3 percent. With this deviation added, almost all the firms will be anticipating a high general price level for the second half of 2007. The trend seems to be uniform across all the sectors since the analysis reveals that the banking sector has not experienced any fall in the general price level for the year 2007, nor is it anticipating during the year.

In summary, we can say that during July–December 2007 the analysis from the survey data reveals that the positive growth trend during January–June 2007 will continue. Overall, the broad sentiment is positive, with the banking sector fuelling the momentum, although the non-bank firms are a little sceptical about the situation and hence are framing their expectations in the "stay the same" category for the next six months. Incorporating the deviations in responses, the final picture reveals a positive sentiment during July–December 2007. This

[1]Net Balance represents the percentage of respondents indicating "higher" minus the percentage of respondents indicating "lower".

is reflected by the majority of the firms reporting an increase in the production, sales, and employment. Their future expectations about their activities are also high. However, the high current and expected prices negate the attempts of curbing of the inflationary pressure by the government since the inflationary expectations are still high, asking for harder more efforts.

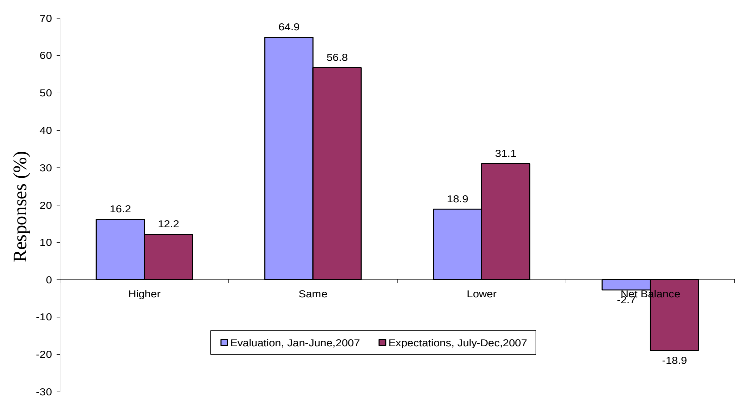
OVERALL ECONOMIC ACTIVITY

Stable Economic Growth

During the first half of 2007, a majority of firms, 64.9 percent, saw stable economic growth while 18.9 percent firms reported slower growth than in the second half of the 2006 (Fig.1). Only 16.2 percent of the respondents indicated faster growth in economy during the survey period.

In terms of perception of business firms regarding the economic growth in the next six months, 56.8 percent reported that it would grow at the same pace, 31.1 percent reported that it would grow at a slower rate, while only 12.2 percent expected that it would grow at a faster rate. The analysis shows that the majority of firms perceived that growth would remain stable in the second half of 2007. The 0.7 percent deviation confirms expectations about stable economic growth.

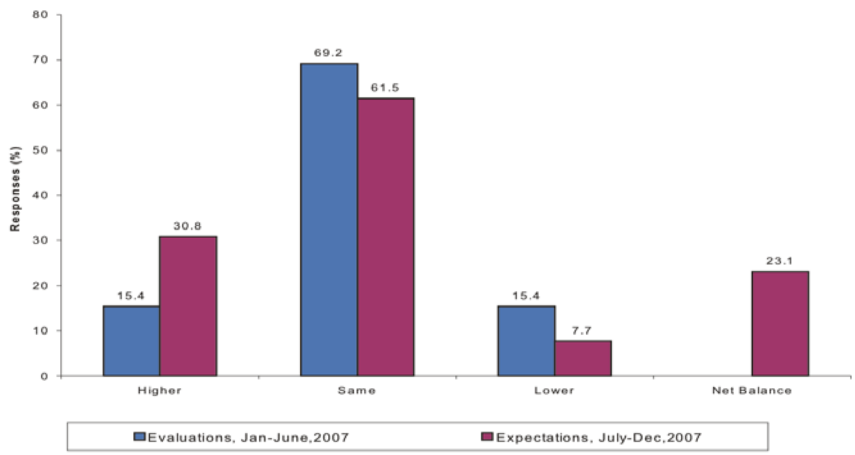
Fig. 1. Economic Growth



Looking at the first six months of 2007, a majority of banks, 69.2 percent, saw stable economic growth (Fig. 2), while 15.4 percent banks reported slower growth than in the second half of the previous year. The same percent of the respondents indicated faster growth in economy during the survey period.

In terms of their perception regarding the economic growth in the next six months, 61.5 percent reported that it would grow at the same pace, 7.7 percent reported that it would grow at a slower rate, while 30.8 percent expected that it would grow at a faster rate. In case of expected pace of growth, the majority of banks perceived that growth would remain at the same level. Interestingly, the net balance is positive while it is negative for the non-banking firms, thus indicating that the banks are optimistic about economic growth as compared to the other firms.

Fig. 2. Economic Growth of the Banking Sector



THE STATE OF FIRMS

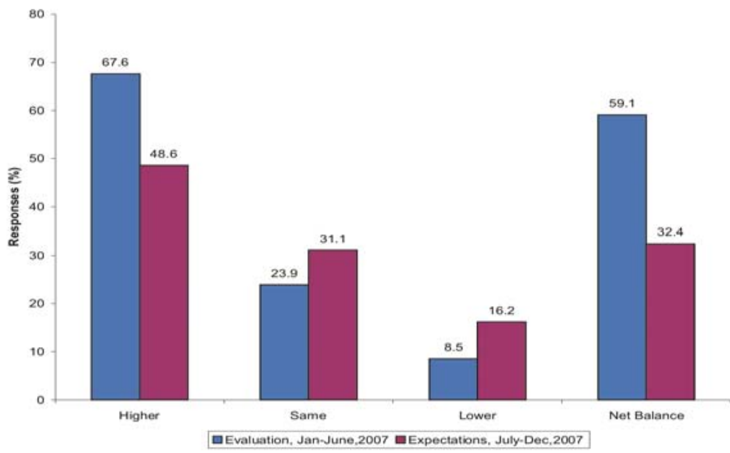
Production is Increasing

Production is increasing as the business firms are optimistic about their sales in domestic and international markets. The responses indicate that during January–June, 2007, 67.6 percent had a higher level of production as compared to the second half of

2006 (Fig. 3). While 23.9 percent indicated no change in the volume of production, a small number of firms (8.5 percent) indicated that their production was lower as compared to the second half of 2006.

In terms of the plans of business firms for the next six months, 48.6 percent responded that they expected their production/size of activity to rise, 31.1 percent expected the same level, and 16.2 percent expected a fall in their production. The analysis shows that firms are optimistic about future growth. Considering the previous experience about the expectations, production would be even higher than what is expected as deviation in the respondents favouring higher production (20 percent).

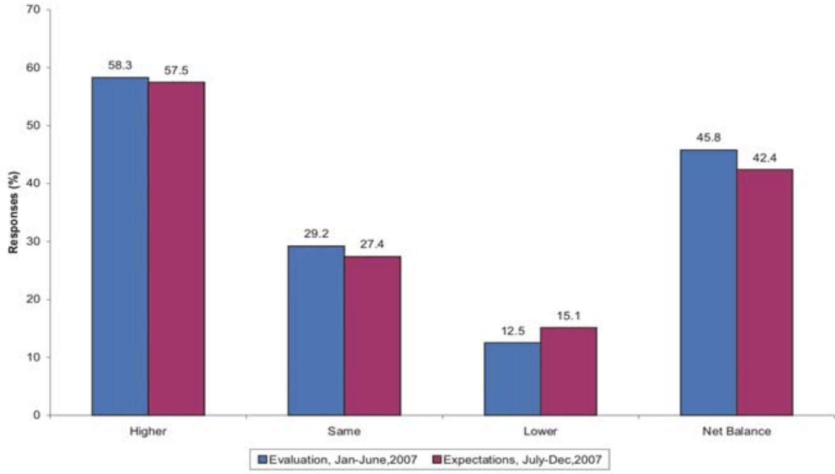
Fig. 3. Production



Sales Increased with High Expectation

The analysis shows that business firms are optimistic about their sales in the domestic market, as the majority of firms reported that domestic demand was strong and was expected to remain strong. As much as 58.3 percent of the firms indicated that their sales in the domestic market during the first 6 months of 2007 were higher than in the second half of 2006. The firms which recorded a decrease in their sales were 12.5 percent. However, there is no significant change in the sales of 29.2 percent firms (Fig. 4).

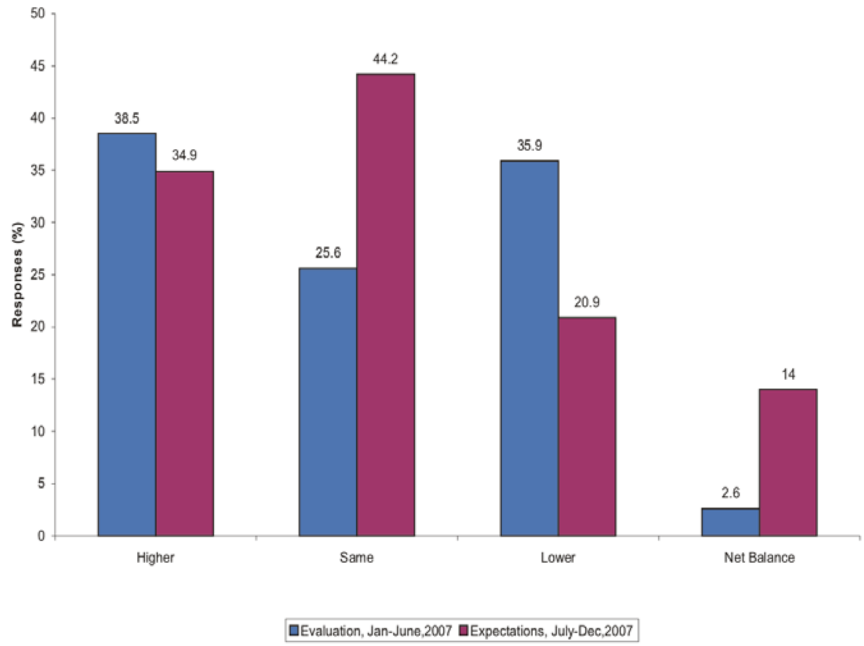
Fig. 4. Sales in the Domestic Market



The majority of firms (57.5 percent) were expecting that their sales in the domestic market would increase in the second half of 2007, 27.4 percent expected them to stay the same, while 15.1 percent expected a fall in their activity in the domestic market. Taking into account the previous experience about expectations, sales in the domestic market would exceed the expectations of business firms as deviation in the respondents favouring higher sales in the domestic market is 4.5 percent.

In the international market, 35.9 percent firms reported a decrease in the sales as compared with the previous half of the year: in July–August 2006, 38.5 percent reported an increase in the sales activity in the international market, and 25.6 percent reported no significant change (Fig. 5). The evidence shows that firms are confident about the international market as 34 percent of the firms are hoping that their sales would increase; only 20.9 percent are expecting that sales may decline, and 44.2 percent are expecting no change. Although the majority of firms are expecting the same level of sales in the international market, yet if we consider the previous experience about their expectations, then sales in the international market would be even higher. This is because the deviation in the respondents favouring higher sales in the international market is 7 percent.

Fig. 5. Sales in the International Market



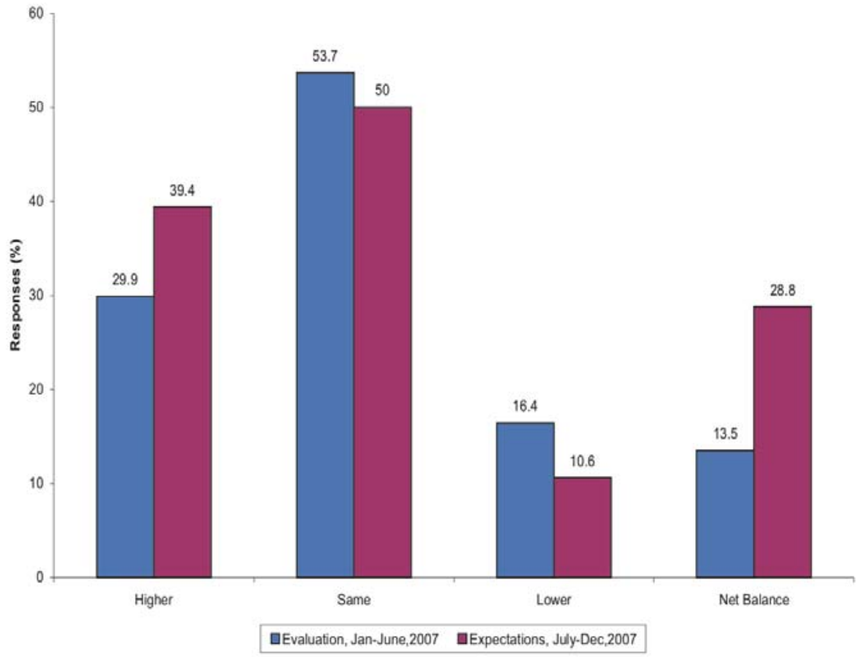
Capacity Utilisation Remains Low

The evidence shows that business firms still have the potential to expand capacity utilisation. In response to the question "Is your capacity utilisation approaching the full capacity?", only 29.9 percent firms reported that their capacity utilisation was approaching the full capacity as compared to that in the second half of 2006 while the remaining firms reported underutilisation of capacity (Fig. 6).

Regarding the future course of capacity utilisation, 39.4 percent of firms are expecting that their capacity utilisation will approach the full capacity during the next six months of 2007, while the remaining firms are expecting underutilisation of productive capacity utilisation.

The deviation of negative 23 percent in the respondents favouring higher capacity utilisation during the first half of 2007 confirms that capacity utilisation would be less than what is being expected by the firms.

Fig. 6. Capacity Utilisation

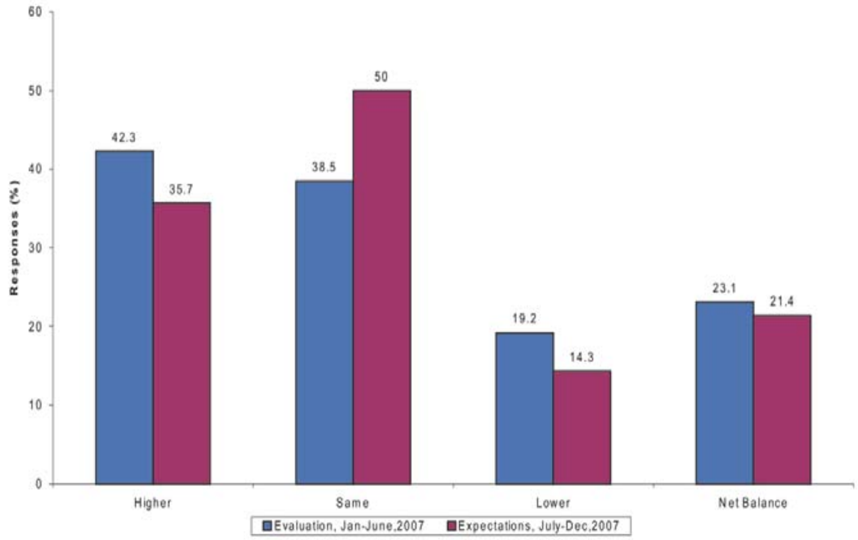


Firms Are Building Up Inventories

Inventories are building up as most of the firms are reporting an increase in growth, production, sales, and capacity utilisation. Most of the firms (42.3 percent) reported a rise in the inventories during the first half of 2007, 38.5 percent kept it at the same level, while 19.2 percent decreased their inventories in the first half as compared to the second half of 2006 (Fig. 7).

In the next six months, 35.7 percent firms expected an increase in their inventory, 50 percent expected it to stay at the same level, while 14.3 percent expected a decline in their inventory. The majority of firms are expecting no change in the level of inventories. Furthermore, considering the past experience about expectations, inventories would be even higher than what is expected as deviation and is positive.

Fig. 7. Inventories



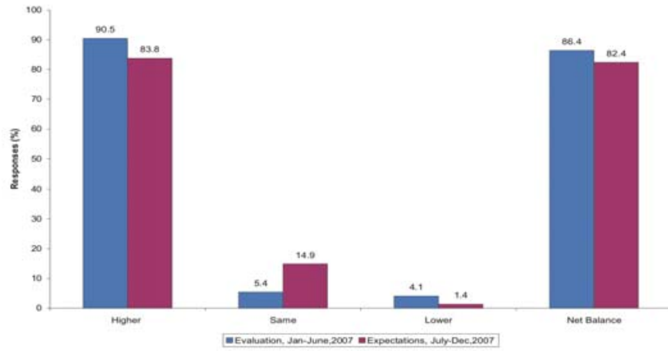
PRICES AND WAGES

Inflationary Expectations Remain High

Inflationary expectations of the firms are still very high. About 90 percent of the respondents indicated that during the first six months of 2007 the general price level increased as compared to the second half of the year 2006. Only 5.4 percent firms reported that it stayed at the same level, while 4.1 percent indicated that it declined (Fig. 8).

For the second half of the year 2007, 83.8 percent are anticipating an increase in the general price level, 14.9 percent are expecting the same level, while only 1.4 percent are anticipating a fall in the general price level. The net balance confirms that the majority of firms are holding on higher inflationary expectations for the remaining six months of 2007. The general price level would be even higher than the expectations of the business firms as deviation in the respondents favouring higher general price level is 20.3 percent.

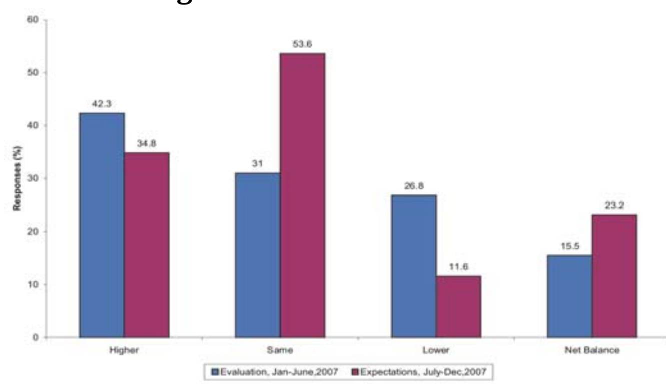
Fig. 8. General Price Level



As for the prices of final goods, 42.3 percent of the respondents experienced an increase in the prices of their product in the first six months of 2007. For 31 percent, these remained the same, while for 26.8 percent the prices fell from the second half of the 2006 level (Fig. 9). For the coming six months, 53.6 percent reported that these would stay the same, 34.8 percent firms expected the price of their product to increase, while 11.6 percent expected a fall in the price of their product.

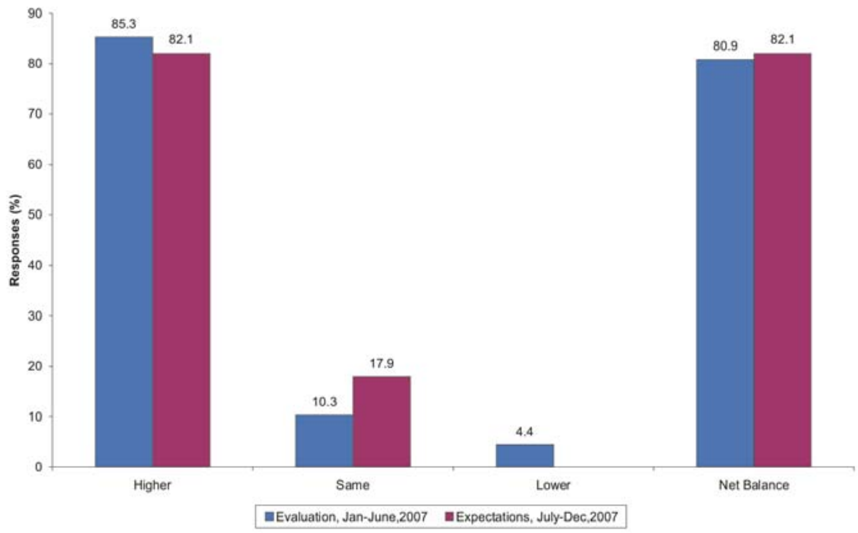
Although the majority of firms are expecting the same prices of their final products, yet the previous experience about expectations indicates that final product prices would be even higher than expectations of business firms as deviation in the respondents favouring higher final product prices is 16 percent.

Fig. 9. Final Product Prices



The majority of firms reported that prices of their inputs had increased. The increase in input prices ultimately forced the business firms to raise their own final goods prices. Only 4.4 percent of the respondents reported a decrease in the prices of their inputs (Fig. 10). A large number of them, 85.3 percent, indicated that their input prices increased in the first half of 2007, while 10.3 percent reported no change. For the current half of the year 2007, 82 percent expect a rise in the prices of their inputs, while 17.9 percent expect them to stay the same. None of the firms expect a fall in the prices of their inputs. The 13 percent deviation in the respondents favouring higher input prices confirms expectations about higher input prices.

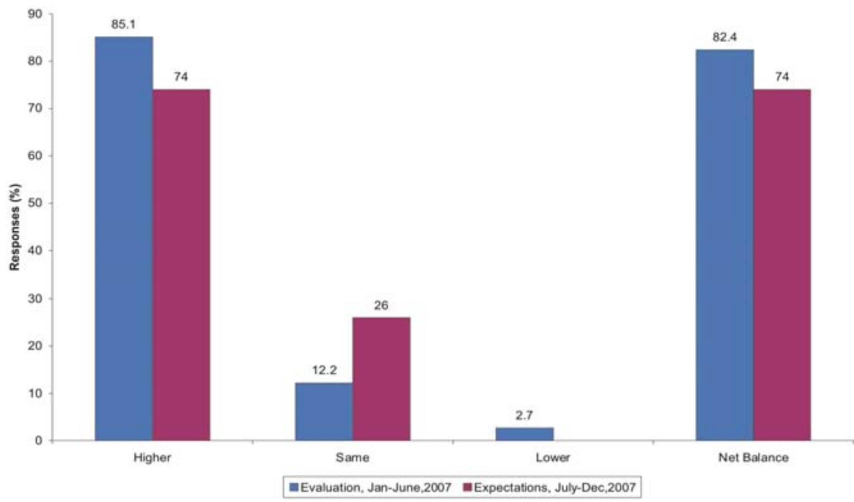
Fig. 10. Input Prices



Wage Pressure Is Also Building Up

Wage pressure is also building up along with the inflationary expectations. Only 2.7 percent of the firms experienced a wage decline in the first half of 2007 and none of them are expecting wages to decline in the coming six months (Fig. 11). 85 percent of firms reported a rise in wages in the first half of 2007, over those of the second half of 2006, while 12 percent reported that the wage level remained the same during this period. In the coming six months, 74 percent continue to expect wage inflation while only 26 percent anticipate stable wages. The 28 percent deviation confirms expectations about higher wages.

Fig. 11. Wage Level



INVESTMENT AND EMPLOYMENT

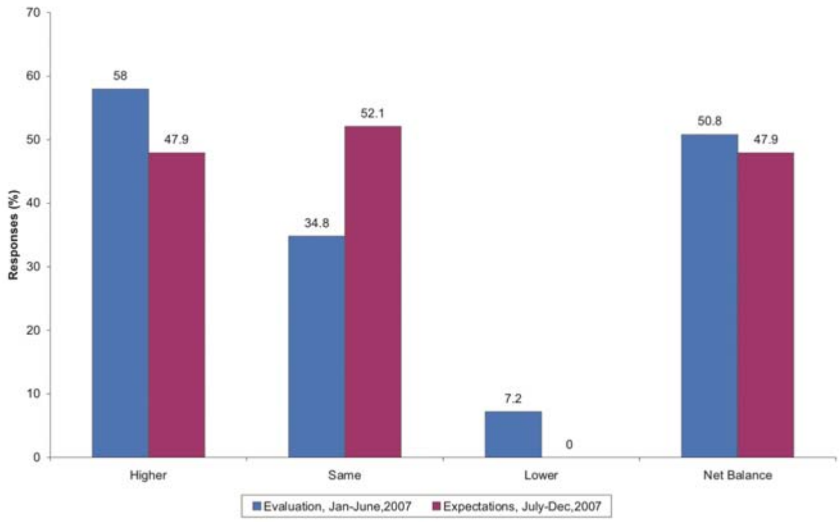
Higher Investment with Higher Expectations

The investment behaviour of the firms depicted in Fig.12 indicates that their investment plans are firmly positive as 58 percent have increased their investment in the first half of 2007 as compared to the second half of 2006, and 34.8 percent firms reported that it stayed at the same level. Only 7 percent firms reported a decline in investment.

For the second half of 2007, 47.9 percent firms are anticipating an increase in investment, 52 percent predict no change in investment behaviour, while none of the firms have plans to decrease their investment. In general, the investment situation is encouraging for the economy.

Although more firms are expecting no change in future investment, yet past experience, indicated by the deviation, leads us to conclude that the general investment situation is encouraging for the economy. The 24.7 percent deviation in the respondents favouring higher investment confirms expectations about higher investment.

Fig. 12. Investment

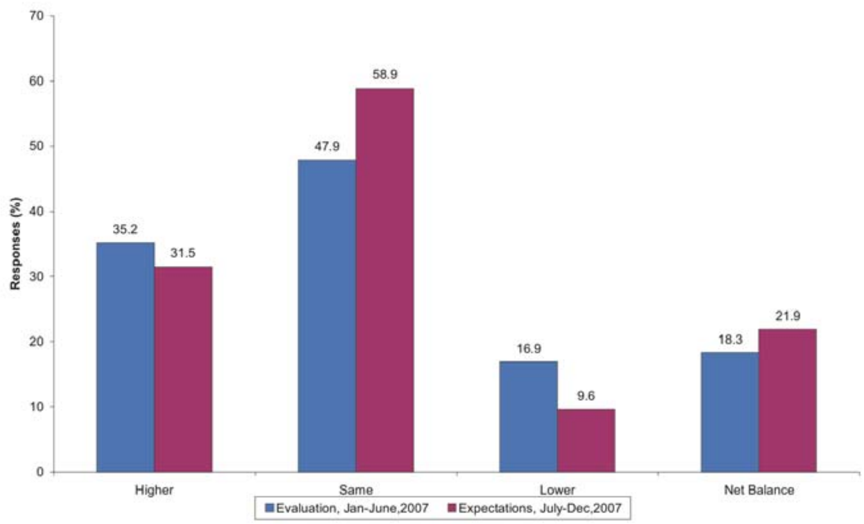


Stable Current and Expected Employment

The increase in production, sales in domestic and international markets, increase in product prices, and overall stability in growth are positively affecting employment, which is putting the pressure for an increase in wages. Most of the firms (47.9 percent) reported that their employment situation did not change in the first half of 2007 from that over the second half of 2006 (Fig. 13). No less than 35 percent reported an increase in employment, while a decline was reported by 16.9 percent of the respondents. The positive net balance indicates that, overall, there would be some increase in employment during the first half of 2007.

The increase in net balance reveals that unemployment would decrease in the future. As many as 58.9 percent firms are expecting stability in employment in the second half of 2007, 31.5 percent are anticipating that work force would increase, while 9.6 percent are expecting a fall in their employment level for the next six months.

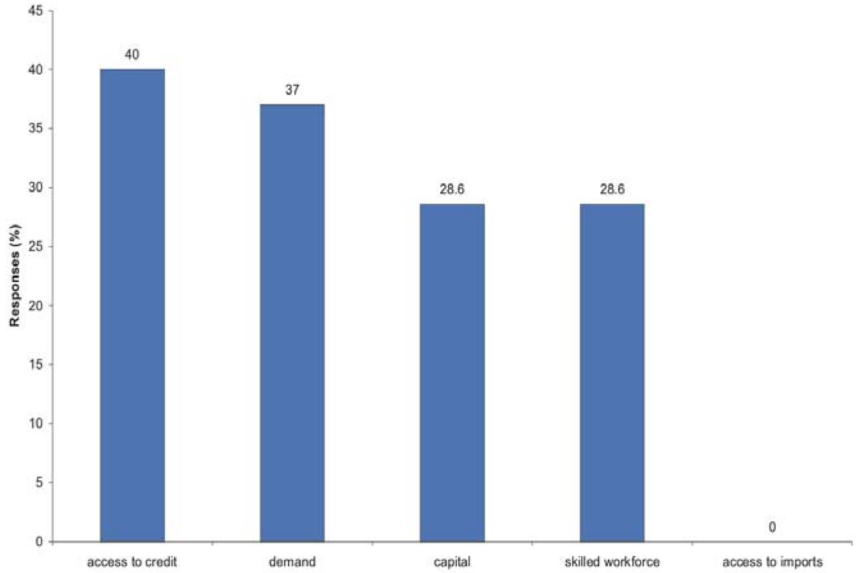
Fig. 13. Employment



CONSTRAINTS ON FIRMS' GROWTH

We also enquired about the constraints facing by the business sector of the economy. 31 percent of the firms reported that their production was constrained by different factors (Fig. 14). Out of these, 40 percent think that insufficient access to credit and its cost is the most important constraint. 37 percent of the firms identify insufficient demand to be an important constraint in doing business, while 28.6 percent feel that insufficient capital may be a problem. Shortage of skilled work force is felt by a similar number of firms as those feeling capital shortage, again confirming a well-known perception regarding the education system. None of the firms identify access to imports as a constraint, indicating that the import regime has been considerably liberalised.

Fig. 14. Constraints on Production



BANKING

THE STATE OF BANKS

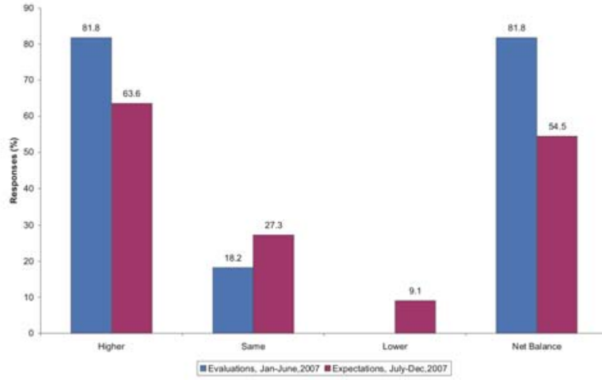
Production is Increasing

The responses indicate that during January–June, 2007, 81.8 percent banks had a higher level of volume of deposits and advances as compared to that in the second half of 2006 (Fig. 15). While 18.2 percent indicated no change in the volume of advances and deposits, and none of the banks indicated that their production was lower than that in the second half of 2006.

In terms of the plans for the next six months, 63.6 percent responded that they expected their volume of deposits and advances to rise, 27.3 percent expected the same level, and 9.1 percent expected a fall in their production.

The net balance, though declining, is positive and promising when it comes to future expectations.

Fig. 15. Production

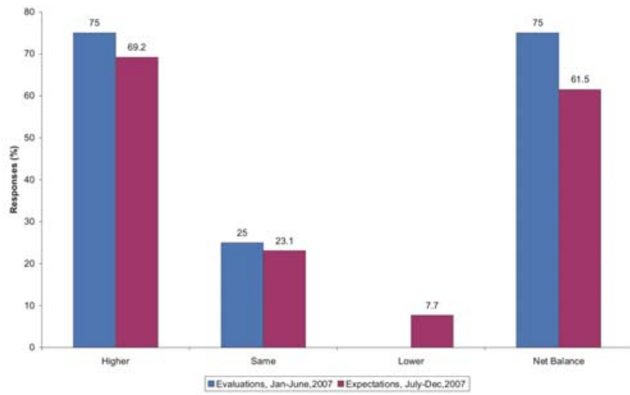


Activity Increased with High Expectation

The analysis reveals that most of the banks have expanded their activity during the first half of the year 2007 (see Fig. 16). 75 percent of the banks indicated that their activity in the domestic market during the first six months of 2007 was higher than in the previous half of 2006. Interestingly, none of the banks recorded a decrease in their activities.

Furthermore, the majority of banks (69.2 percent) are expecting that their activities in the domestic market would increase in the next 6 months of 2007, 23.1 percent are expecting it to stay the same, while 7.7 percent are expecting a fall in their activity in the domestic market.

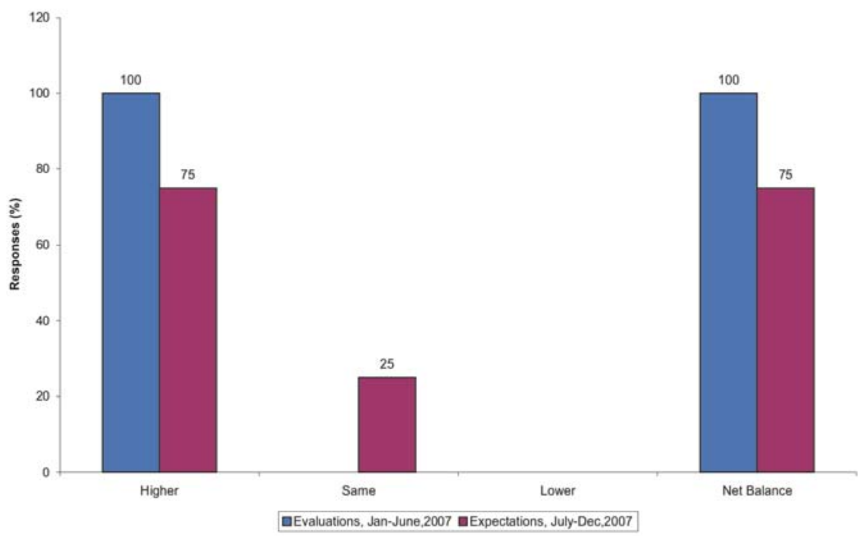
Fig. 16. Sales in the Domestic Market



Interestingly, in the international market, 100 percent of the banks reported that their activity was higher than during the last six months of 2006 (Fig. 17).

The optimistic expectations of the banks remain uniform for the second half of 2007 also. Unlike the non-bank firms, the majority of the banks (75 percent) are hoping that their activity would increase. None of the banks is expecting that its activity would decline; 25 percent are expecting that their activity would remain the same. This can be attributed to the recent reform in the money laundering laws curbing malpractices like hundi and increasing in the inflow of remittances through bank channels.

Fig. 17. Sales in the International Market



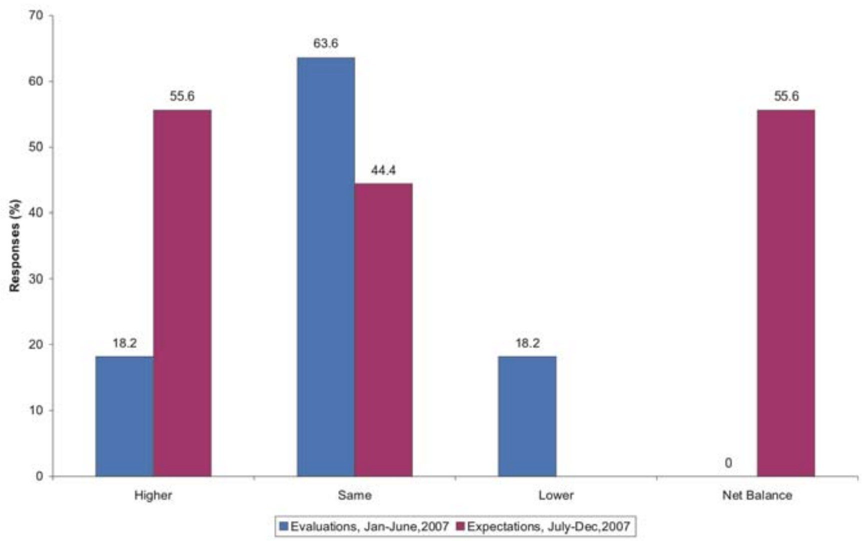
Capacity Utilisation Confirms the Picture

Only 18.2 percent of the banks reported that their capacity utilisation was approaching the full capacity. The majority of banks, 81.8 percent, reported that it remained underutilised during the first half of 2007 (Fig. 18).

Interestingly, for the second half of 2007, 55.6 percent of the banks are expecting that their capacity utilisation will approach full capacity. The net balance is sharply rising from zero in the first half of

2007 to 56 percent. This is also in contrast to the non-bank firms, where the majority are expecting that their capacity utilisation will remain underutilised for the second half of 2007. This confirms the higher expectation of activity by the banks in both the domestic and the international markets. The banking sector is now reaping the benefits of the banking sector reforms completed in 2006.

Fig. 18. Capacity Utilisation



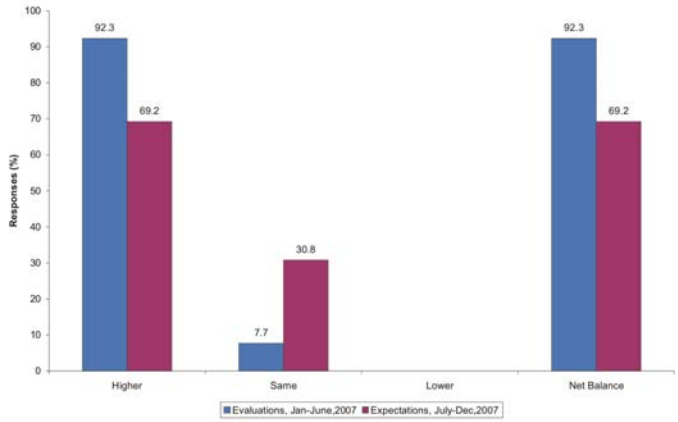
PRICES AND WAGES

Inflationary Expectations Remain Robust

About 92.3 percent of the banks indicated that during the last six months, the general price level had increased as compared to that in the last half of the year 2006 (Fig. 19). Only 7.7 percent reported that it stayed the same, while none indicated that it declined.

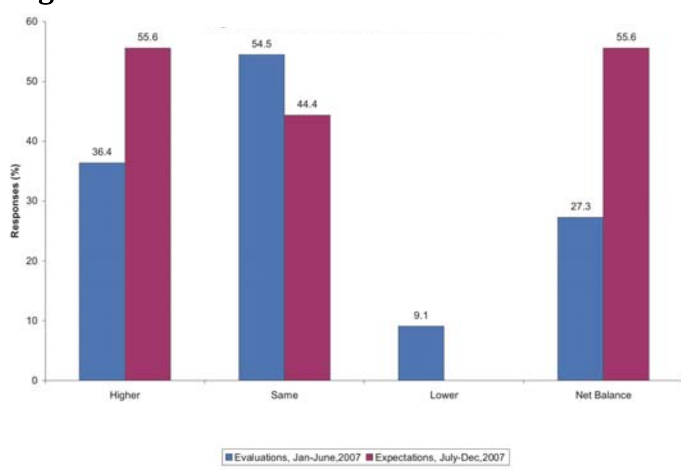
For the second half of the year 2007, 69.2 percent are anticipating an increase in the general price level, 30.8 percent are expecting it to be the same, while none of the banks is anticipating a fall in the general price level. These expectations are in line with the upward movement of the expected interest rate and wages in the banking sector.

Fig. 19. General Price Level



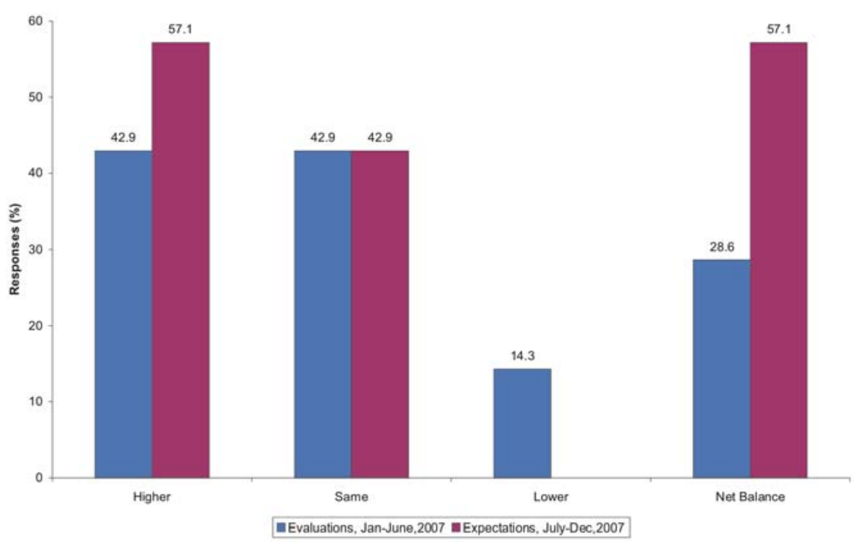
Looking at the prices of final goods (at the interest rate), 36.4 percent of the respondents experienced an increase in the prices of their product, i.e., the rate of return on advances/investment, in the first six months of 2007 (Fig. 20). 54.5 percent said that it remained the same, while for 9.1 percent the prices fell from the second half of the 2006. 44.4 percent reported that in the coming six months it would stay the same, 55.6 percent banks were expecting that the interest rate was going to increase, while none was expecting a fall in the rate of interest. Interest rate in Pakistan is linked to the international interest rate, which is moving upwards.

Fig. 20. Rate of Interest on Advances / Investment



Banks are feeling the price pressure on the input side due to an increase in the deposit rate, wages, and other expenditure, which is forcing them to raise prices on their advances. Only 14.3 percent of the respondents reported a decrease in the prices of their inputs (Fig. 21), whereas 42.9 percent indicated that their input prices increased and stayed the same in the first half of 2007. For the second half of 2007, the majority of the banks (i.e., 57.1 percent) were expecting a rise in the prices of their inputs, while 42.9 percent were expecting no change. None of the bank was expecting a fall in the prices of their inputs. The higher expectation regarding the activity, despite the increase in the general price level, the final product, and input prices, could be due to the Fisher argument that an increase in the rate of inflation is causing the lenders to demand higher interest rates on their loans while the borrowers are willing to accept this higher cost because of higher anticipated inflation.

Fig. 21. Input Prices



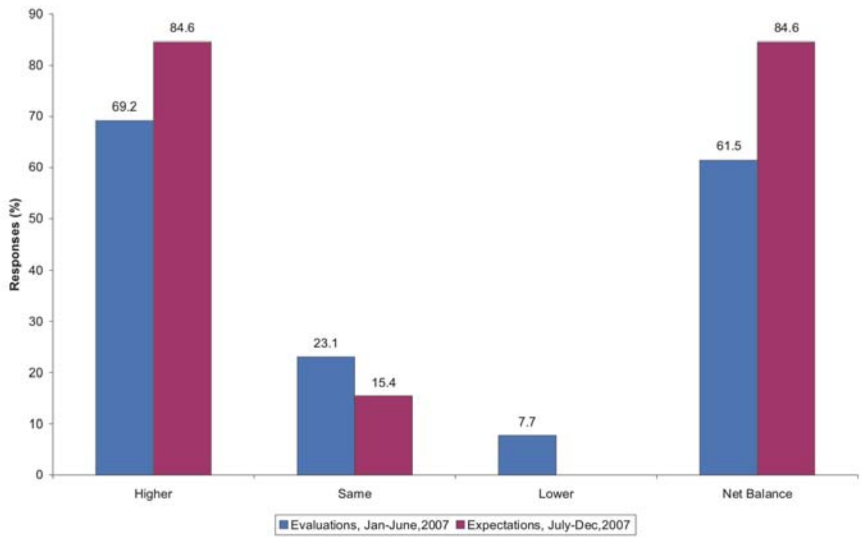
Wage Pressure is Building Up

In the process of keeping up with the inflationary expectations, wage pressure appears to be building up. Only 7.7

percent of the banks witnessed a wage decline in the first half of 2007 (Fig. 22). Whereas the majority of banks (69.2 percent) reported a rise in wages in the first half of 2007, 23.1 percent reported that the wage level remained the same in both halves.

In the coming six months, banks are overwhelmingly expecting wages to rise. Only 15.4 percent are anticipating stability. This future anticipation of higher wages in contrast to the first half of 2007 could be due to the mergers and acquisitions of the banks, and the entry of the foreign banks in the market pressurising the rest to increase this wage level in order to retain the scarce skilled labour force.

Fig. 22. Wage Level



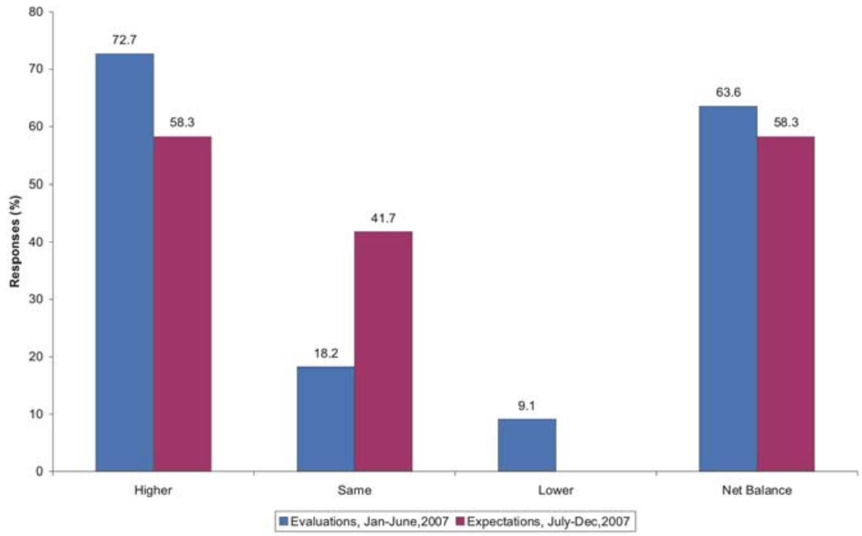
INVESTMENT AND EMPLOYMENT

Higher Investment with Higher Expectations

Stable growth and increasing investment in the economy are sustained by the investment behaviour of the banks. The majority of the banks, 72.7 percent, increased their investment in the first half of 2007 as compared to the second half of 2006, and 18.2 percent banks reported that it stayed the same (Fig. 23). Only 9.1 percent banks reported a decline in investment.

For the second half of 2007, 58.3 percent are anticipating an increase in investment, 41.7 percent plan to maintain it at the same level, while none of the banks has plans to decrease its investment. This is in contrast to the non-banking firms, where the majority are anticipating the same level of investment in the second half of 2007. However, the major chunk of the banking sector investment is flowing into the government bonds, which are less risky.

Fig. 23. Investment

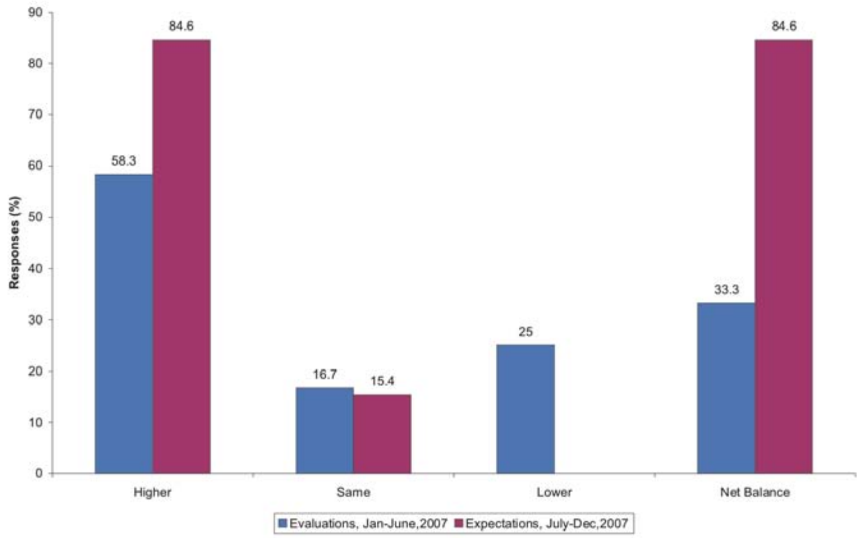


Higher Current and Expected Employment

Most of the banks (58.3 percent) reported an increase in the employment level in the first half of 2007 as against the last half of 2006. 16.7 percent reported that it stayed the same, while a decline was reported by 25 percent of the respondents (Fig. 24).

Analysis reveals that there will be employment creation in the banking sector. This is in contrast to the non-banking firms, which are expecting the same level of employment for the second half of 2007. 84.6 percent banks are expecting that work force would increase, 15.4 percent banks are anticipating that work force would stay the same, while none of the banks is expecting a fall in their employment level for the next six months of 2007. Overall, there would be some increase in the banking sector employment during the next six months of 2007 as the net balance is increasing. This is in line with the higher expectation of activities in the banking sector.

Fig. 24. Employment



CONSTRAINTS ON BANKS

More than half of the banks (i.e., 66.7 percent) reported that, currently, their production was not constrained. Only 33.3 percent reported that their activities were currently constrained. Out of the constrained banks, 50 percent think that insufficient demand, insufficient access to imports, insufficient skilled labour force, and insufficient access to credit hamper their activities. While insufficient capital is not a constraint in the case of the banking sector at all, the insufficient demand for advances signals the maturing of the cycle, since the investment activity by the non-banking firms is dwindling in the economy. The insufficient availability of skilled labour force may call for redressing this constraint since the banking sector has the potential for reducing the prevailing unemployment situation in the economy.