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Quid Pro Quo

ECONOMIC REPORT

KEEPING SCORE

December 24th, 2008

The much awaited IMF prescription is here, widely reported in the media through various sources, the Fund cleared the air by releasing the official Letter of Intent with Pakistan on 2nd December 2008. The LOI represents the “bitter bill” that Pakistan has to swallow in order to revive the economy and hopefully emulate the average 7.09% GDP growth seen in the last five years. This paper will summarize the steps and targets agreed between GOP and IMF, and where we stand vis-à-vis to them.

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List of targets and provisions outlined in the SBA:

Date	Target
Mid-November 2008	Establishment of interagency committee
December end 2008	Elimination of oil subsidies
December end 2008	Reintroduce audits as part of a risk-based audit strategy
December end 2008	Full description of the required reforms, together with an action plan will be provided to the IMF, following a planned seminar to review tax policy and administration
December end 2008	Draft legislation for implementation of full VAT with minimal exemptions ready for debate
December end 2008	Prepare contingency plan to deal with problem private banks
December end 2008	Finalize schedule for electricity tariff adjustments during FY09, in collaboration with World Bank
January end 2009	Further increase in discount rate will be considered at time of MPS
February 1 2009	Phase out SBP provisions for Furnace Oil
March end 2009	Prepare strategy and time bound action plan for the adoption of specific measures in consultation with World Bank
March end 2009	Prepare plan for eliminating inter-corporate circular debt within the fiscal deficit target
June end 2009	Amendments to Banking Companies Ordinance submitted to Parliament
June end 2009	Elimination of electricity subsidies
June end 2009	Transition to single treasury account will be completed
June end 2009	Submit legislative amendments to parliament to harmonize the income tax and GST laws
June end 2009	20% 12-month inflation rate
June end 2009	3-3.5% Real GDP growth
June end 2009	\$8.6 bn gross official reserves
FY09	\$3.6 bn external financing gap
FY09	4.2% fiscal deficit
FY09	1% reduction in domestically financed development spending
July end 2009	Adopt and publicize a transparent liquidity management framework as part of the MPS
August 1 2009	Phase out SBP provisions for Diesel and other refined products

As quoted in the Letter of Intent published November 20th 2008.



DAMAGE CONTROL

The first target of the proposed program is to restore overall economic stability and confidence by addressing key macroeconomic imbalances – these include the wide fiscal deficit, negative real interest rates and high current account deficit (viewed by many as unsustainable).

The first step in this endeavor was to tighten monetary policy in order to curtail inflation and strengthen international reserves. The discount rate was increased by 200 bps to 15% in Nov08 the same month the LOI was finalized. The IMF is targeting 12-month CPI to come down to 20% by end-June 2009, from the current 24.6%. In other words, the IMF and SBP expect CPI by year end to be around 15% for the average to be around the mentioned target.

In a stressed economic environment the importance of a contingency plan for private financial institutions is paramount. Hence, SBP will prepare a plan by end-December 2008, details of which have yet to be announced. In our view, having a contingency plan ready is vital specially since a bailout of the stock market has largely been ruled out, this may result in some institutions being vulnerable due to direct and cross exposures. Currently KSE100 has declined to 6660 level after the floor mechanism was removed on 15th December 2008 depicting a decline of approx 51% since Jan'08.

Significant measures for improvements in liquidity management are also in the pipeline, specially forecasting the cash flow position of the government. In this regard, SBP and Ministry of Finance (MoF) have agreed to quarterly volumes of T-bill issues consistent with zero SBP financing of the government in Oct-Jul FY09. However, as of 29th November 2008, government borrowing from SBP was around PKR 80 bn against the target of net zero for the last 3 quarters of the fiscal year.



CUTTING EXPENDITURE

To help curtail inflation, decrease borrowings from SBP and meet the fiscal deficit target of 4.2% in FY09, the government will seek to increase tax revenue by 0.6% of GDP, reduce non-interest current expenditure by 1.5% of GDP mainly through elimination of oil subsidies (which was achieved earlier in FY09) and electricity subsidies by Jun'09 and reduce domestically financed development spending by approximately 1% of GDP in FY09. Schedule for the removal of electricity subsidies will be finalized by end December in consultation with the World Bank.

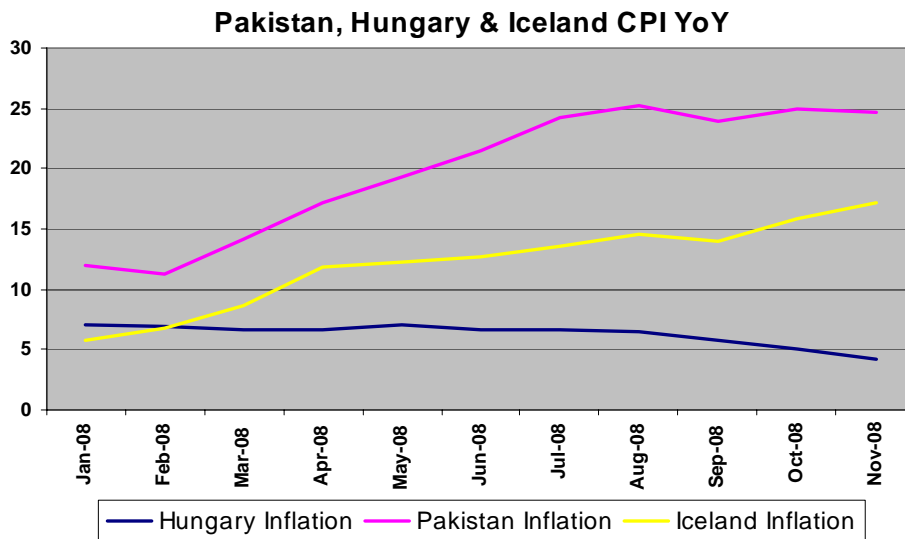
In our previous publication we highlighted the importance of increasing revenue through broadening the tax base. The SBA includes targets for tax collection, in the form of reintroducing audits as part of a risk-based audit strategy to be implemented by end-Dec'08. The government will seek to harmonize the income tax and GST laws and submit legislative amendments to parliament by end-Jun'09. Furthermore, the government will initiate a process to implement full VAT with minimal exemptions, legislation for which will be ready for debate in Parliament by the end of 2009.



INTEREST RATE OUTLOOK

The SBP has clearly stated that it shall follow a flexible interest rate policy to protect the foreign reserves position, rein in inflation and allow GOP to place T-bills with commercial banks and DFI's. As stated in the LOI, a further increase in the discount rate will be considered at the time of January MPS. However, any changes in interest rate depend on key targets including monthly floors on SBP's NFAs, T-bills subscription and inflation figures.

The inflationary trend has remained stubbornly high, as shown by Nov'08 figures, coming down slightly to 24.65% compared to 25% in Oct'09. The next set of figures (for December due in the second week of January) will be pivotal in the interest rate decision. We expect inflationary pressures to subside considerably from Mar'09 onwards. A steep decline in Dec'09 CPI may convince policy makers that increasing the discount rate is no longer necessary.



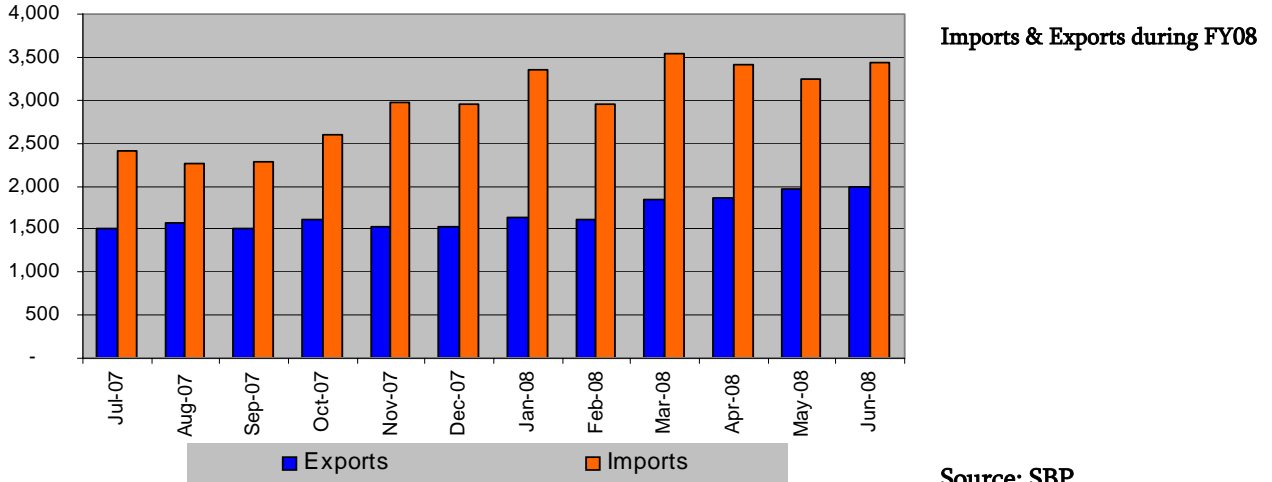
Source: Bloomberg and SBP

Even though Hungary is part of the IMF program, it was able to cut its benchmark rate twice in two weeks during December, as inflation slowed more quickly than expected, reducing risk in the recession bound economy. Looking at the graph above, Pakistan's inflation is yet to show the same kind of steep drop, therefore a sharp reduction in inflationary pressure (in December) may just convince authorities that there is no need to increase rates further in the January MPS, despite Pakistan's negative real interest rates, as monetary policy may tend to be more forward looking.

KEEPING SCORE

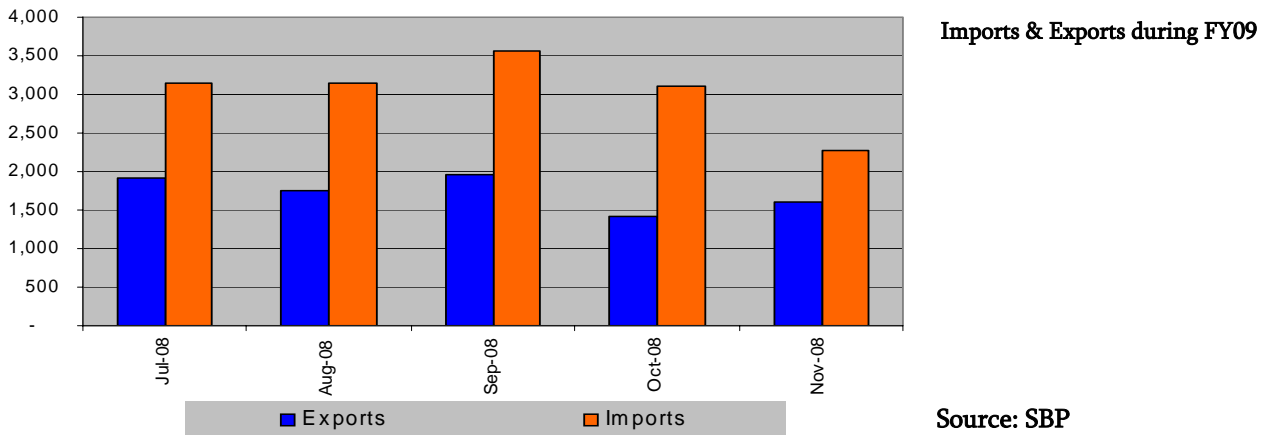
EXTERNAL POSITION

Pakistan's external position has been under stress since the beginning of FY08.



Source: SBP

However, now the trade deficit is showing signs of narrowing, as shown in the graph below:



Source: SBP

This can be attributed to a number of reasons, starting with the falling trend in global oil and commodity prices, which have helped ease pressure on the import bill. Food and energy imports constitute roughly 40% of Pakistan's import bill and thus it can be assumed they are the primary drivers of the narrowing deficit.



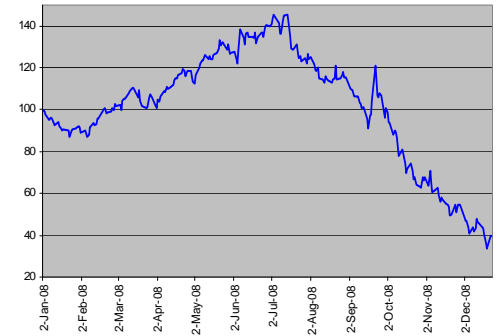
EXTERNAL POSITION ... Continued

In addition, propensity to consume in the economy has come down drastically as the rupee has depreciated by nearly 30% since Jan'08, directly adding to the cost of consuming imported items. This has had a base effect on inflation, which averaged well over 20% in FY09.

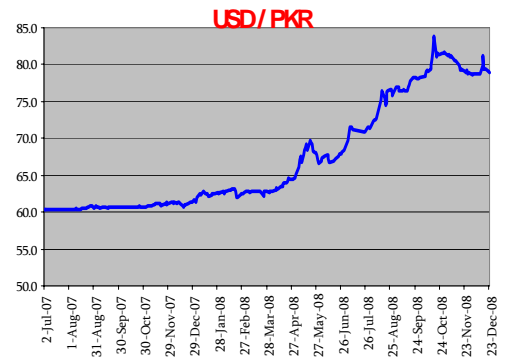
The SBP has committed to following a flexible exchange rate policy in the remainder of FY09. Any intervention would be aimed at meeting the program's reserve targets, which will be achieved in part by phasing out of SBP's provision of foreign exchange for oil imports:

February 1 2009	Phase out SBP provisions for Furnace Oil
August 1 2009	Phase out SBP provisions for Diesel and other refined products
February 1 2010	Phase out SBP provisions for Crude Oil

If the SBP does indeed maintain a flexible exchange rate, then it could result in significant gyrations in the USD/PKR parity, something we have already noted does not bode well for any currency, due to thin inter-bank volumes.



Source: Bloomberg
Oil prices since Jan'08



Source: Bloomberg
USD/PKR since Jul'07

KEEPING SCORE





SOCIAL SAFETY NET

A significant cut in PSDP and a subsequent reduction in GDP growth means that the poverty stricken classes of society will be exposed to further hardship. Therefore, the SBA is designed in a manner that ensures social stability and adequate support for the poor. The idea is that the burden of adjustment falls least on the most vulnerable classes.

Therefore, the fiscal budget will increase social net spending to 0.9% of GDP from 0.3%. This increase in social spending will be channeled, in consultation with the World Bank, through the Benazir Income Support Program (BISP) and targeted electricity subsidies. Furthermore, additional funds will be allocated to already existing programs like the Bait-ul-Mal.

PLANNING IS EASY – IMPLEMENTATION IS ANOTHER STORY

The IMF program has highlighted sustained and forceful implementation as key to the success of the program in bringing the economy back on a sustainable path by fixing macroeconomic imbalances. Therefore, strengthening public sector institutions like the SBP is high on the priority list. In this regard, amendments to the Banking Companies Ordinance will be submitted to Parliament by end-Jun'09, to enhance the central bank's ability to manage the banking sector more effectively. Legal provisions relating to the operational independence of SBP will also be reviewed.

The SBA seeks to generate widespread support and domestic consensus in order to achieve complete implementation and ensure that the steps taken are home grown and fully owned by the country.



CONCLUSION

Pakistan's economy has been battered by a mix of internal and external shocks since FY07. The domestic political upheaval compounded by the global economic slowdown and high commodity prices deteriorated the overall economy.

However, several factors that lead to the current slowdown have now subsided, including high global commodity prices (oil is trading at \$38 per barrel compared to a high of \$145 in Jul'08) and reinstatement of a civilian government. Furthermore, with the SBA now in place, the economy now has breathing space to consolidate its macroeconomic fundamentals. The inflationary expectations have largely subsided, though this has yet to manifest itself in the YoY CPI. In our opinion an increase in interest rates in the Jan'09 MPS is possible on the back of previous CPI data but this could well be the last upward revision of this interest rate cycle. We expect a declining trend in interest rates from the next FY or maybe a bit sooner.

The following months are critical and strict implementation of reforms is required in order to gain maximum benefit from the IMF program, as we did in 2004. If all goes well, and there is no apparent reason to think any differently, then subsequent to the completion of reforms our economy may once again be on track for sustainable growth.



ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
<u>Inflation</u>														
Headline Inflation	%	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7
Core inflation	%	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9
Food inflation	%	12.5	12.2	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4
Non-food inflation	%	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.1	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8
6 month	%	9.2	9.3	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0
12 month	%	9.4	9.5	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a
<u>External Sector</u>														
Export	Mln US\$	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,595
Import	Mln US\$	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,269
Trade balance	Mln US\$	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)
<u>Remittances</u>	Mln US\$	505	479	557	502	602	590	584	547	627	592	660	466	621
<u>Forex Reserves</u>	Mln US\$	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081



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