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ECONOMIC REPORT

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STATE OF REALITY

Recently the SBP released its first quarterly report for FY09 on the state of Pakistan's economy. It gives a detailed account of how the real sector performed and what we can expect come the end of this financial year. This report will concentrate on analyzing the facts in light of latest data in order to determine the economy's trajectory.

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AGRICULTURE SECTOR

The newly elected government announced their key objective was to revitalize the agriculture sector and become a net exporter. Hence they approved an agriculture centric budget, with numerous policy actions and measures outlined in budget'09 to stimulate growth.

The first vital step was to increase support price of wheat from PKR 510 to PKR 625 per 40 kg bag (at time of budget'09). Currently the support price is at PKR 950 per 40kg bag even though international prices are approximately PKR 640. Secondly, in order to stimulate growth, agri-credit target was increased by 25% for FY09 compared with the FY08 target, with enhancement in indicative per acre credit limit for major and minor crops. Thirdly, subsidies on DAP (fertilizer) was increased, from PKR 470 to PKR 1000 per bag (at time of budget'09). Fourthly, crop insurance scheme was initiated to reduce risk farmers faced, thereby encouraging greater sowing. Finally, fertilizers, pesticides and other farm inputs were exempted from GST to reduce costs and encourage greater yields through increased profitability.

In lieu of the above mentioned policies, some improvement in growth has been witnessed. There was a record rice harvest of 6.5 million tones and marginal improvement in cotton production during kharif FY09, supported by a possibility of a record wheat harvest, target for FY09 is 25.0 mn tones vs 21.9 mn tones harvested in FY08.

However, a domestic supply glut (of rice) has coincided with falling international prices, which will put downward pressure on prices and the value of exports to come down (even if quantum of exports increase). Cotton harvest grew by a marginal 3.5% in FY09 compared to FY08. Cotton crop for FY09 was recorded at 12.1 million vs 11.6 million last FY, and has missed its target of 14.1 million bales. This is disappointing because cotton has the strongest forward linkages to the LSM sector, therefore moderate improvement in its cultivation will result in marginal or moderate growth in manufacturing.



AGRICULTURE SECTOR ... continued

Wheat harvest grew by an encouraging 9.3% in FY09 vs FY08, mainly on the back of policy measures taken in the budget. However, final output in wheat and all other crops depend significantly upon availability of irrigation water, inputs (specially DAP, other fertilizers, pesticides etc.), credit availability and weather. Thus far, scarcity of water and high prices of DAP/urea represent major threats to crop yields. High prices of urea can be attributed to hoarding and the recent liquidity crunch witnessed by the banking sector; due to scarce financial resources there was a delay in opening of LCs for urea import.

Minor crops contributed approximately 2.4% to GDP growth in FY08. Targets for FY09 have been fixed at higher levels, due to the high prices in markets and optimism farmers will be tempted to grow more minor crops. Data so far suggests a favourable outlook, however, no major impetus can be expected from this sub-sector.

Livestock is a major contributor to GDP growth, contributing approximately 10.9% in FY08. Pakistan's dairy and livestock sectors have shown tremendous potential for growth in recent years, however, vast room for improvement exists as the gap between potential yield and actual yield is very high. Recognizing this potential for growth the Prime Minister under his Special Initiative allotted PKR 1.5 bn for 'White Revolution', through PSDP. However, recent cuts in the PSDP are sure to have reduced this amount, as the GOP tightens its belt to reduce fiscal deficit.

Major crops contributed 7.1% to GDP growth in FY08, for an agrarian country like Pakistan this is a worrisome statistic. Looking at preliminary data, it is difficult to imagine the agri-sector being a driver of growth in FY09. Water shortage, high prices of DAP/other inputs and disruption of price transmission mechanism by hoarders preventing benefits from reaching farmers, are problems yet to be addressed by the government. Further data will help determine performance of this important sector more accurately, however data so far is less than encouraging.



INDUSTRIAL SECTOR

LSM performance has been disappointing in FY09, it registered a negative growth of 6.2% in Q1FY09 as against a growth of 7.3% in same period last fiscal year. Seven major sub-sectors which constitute 72.4% of LSM out of fifteen showed negative growth.

Several reasons can be identified for the dismal performance, most significant are the severe energy shortages that have hampered manufacturing massively. To add to this, deterioration in the law and order situation, pass through of high international prices (higher input costs), PKR depreciation (higher costs for importers) and weak external demand due to global slowdown have had a telling impact on LSM.

As mentioned earlier, manufacturing has strong backward linkages to the agriculture sector. Agri-based sectors are unable to achieve significant growth without good performance in agriculture, since they use several intermediate goods. These (intermediate) goods accounted for more than 50% of LSM growth in FY08, which translates into 2.6% GDP growth.

All major LSM sub-sectors registered negative growth in Q1FY09. In particular consumer durables growth declined 31.2%, without this the overall decline in LSM for first quarter comes down to only 0.8%. In addition, sales of local automobiles have declined severely; food, beverages and tobacco sector growth has declined; metal industry showed 16.6% negative growth; cement production dropped to 0.7% in Q1FY09 vs 23% growth in same period last FY as construction and real estate activities slowed considerably.

Structural weaknesses like energy constraints, capacity constraints, input constraints (agri-based industries), will continue to impact growth in FY09. In addition, USD/PKR trading close to 80.0 has removed the advantage of falling international prices of inputs for the manufacturing sector and added to their costs. This has increased prices passed through to consumers, reducing their demand further. Hence, the declining trend in LSM is likely to continue in coming months. This will reflect negatively on GDP growth since the industrial sector contributed nearly 26% to growth last fiscal year.



SERVICES SECTOR

Services sector has provided much needed stability amid the current crisis. FDI inflows have remained strong despite the global economic downturn, reaching USD 1.60 bn Jul-Nov'09 vs 1.71 bn in same period last year. Strong performance from this sector is critical as it accounted for more than 52% of total GDP growth in FY08 and contributed about three-fourth of the total value addition.

Services sector in FY08 grew by 8.2% against a target of 7.2% on account of substantial growth in imports, high government and private sector credit and military and election expenditure throughout the year. Aside from military expenses for the fight against terrorism, the other factors are likely to be reduced significantly. This is because the GOP in consultation with the IMF is seeking to cut aggregate demand for imported items and non-development related expenditure to control the twin deficits problem of Pakistan.

Furthermore, the commodity producing sector is highly correlated with the services sector. In FY09 the government's aim is to cut aggregate demand, this will have a direct impact on services sector. For instance, an important reason of 6.4% growth in the wholesale and retail trade last FY (32% of total services sector growth) was increase in imports, growth in food and retail chains. This financial year, with a strong rupee and erosion of middle class income due to inflation, the wholesale and retail trade is expected to display weak growth. However, if the agriculture sector achieves record harvests, this sub-sector will get a boost.

Transport storage and communication sector has seen steady growth for the past few years. Last FY within this sector the transport sub-sector accounted for nearly 70% of growth rates. However, this FY during the first five months transport was the biggest loser on account of huge transport payments, travel and government services. As a result the services sector as a whole posted a deficit of USD 2.06 bn (out of which transport deficit alone stood at USD 1.16 bn) for the first five months of FY09 vs USD 2.84 bn last FY.



SERVICES SECTOR ... continued

On the contrary finance and insurance sector is expected to register strong growth this FY, due to the expected rise in SBP profits, improved insurance sector, FDI flows and ease of liquidity for commercial banks by SBP (despite the fact that incomes of banks impacted because of non-performing loans, rising inflation and low appetite for consumer loans). This is because the majority of growth in finance and insurance sector (approximately 66% in FY08) was contributed by the central bank. Public administration and defense is expected to show strong growth this year due to the increased activities against terrorism and ongoing relief operation in earthquake affected areas of Balochistan.

Overall it is difficult to see how the services sector will achieve its target of 6.1% compared to last year's performance of 8.2%. Wholesale and retail trade as well as the transport storage and communication sectors are both displaying weak performance. This is a worrying sign, since these two sectors combined contributed 27.1% of GDP growth in FY08. It is essential that the services sector achieves its target if not more, as it represents a sizeable chunk of GDP growth.





CONCLUSION

Pakistan unlike many emerging markets, was not directly impacted by the international financial turmoil. However, it was faced with the challenge of withstanding indirect repercussions, like high international commodity prices. This represented an opportunity for Pakistan to rise above its peers, but it was let down by political turmoil, a series of structural problems (law and order situation, water shortage, energy shortage to name a few) and weak agriculture sector performance.

As a result, Pakistan became a net importer of commodities during record high prices and was unable to benefit from the extraordinary price levels. This affected the external account position severely in FY08 and we were left with no other option except to turn to the IMF to plug the gap. FY09 has so far been a continuation of this downward trend and it remains to be seen when the economy begins to turnaround.



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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