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ECONOMIC REPORT

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BURGEONING BURDEN

Pakistan's macroeconomic fundamentals deteriorated significantly in CY08, as the twin deficits widened, GDP growth slowed to a six year low of 5.78 % in FY08 and 2.5% projected for FY09, FOREX reserves depleted, inflation soared to above 25% YoY and the exchange rate depreciated by approximately 30% YoY.

As a result, Pakistan had to resort to external debt in order to manage its Balance of Payments (BOP) position. IMF was the most notable provider, pledging USD 7.6 bn for the second largest economy in South Asia, with an initial tranche of USD 3.1 bn. This has naturally put pressure on the country's external debt position.

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SUSTAINABLE OR UNSUSTAINABLE?

Debt is considered sustainable if the financing gap is reaching zero in the long term. Therefore, monitoring debt sustainability indicators is important to gauge long term debt sustainability.

Unsustainable levels of debt can have severe repercussions for an economy. Diverting additional resources towards debt servicing, may mean crucial development expenditure, domestic investment and poverty alleviation initiatives are crowded out and stalled.

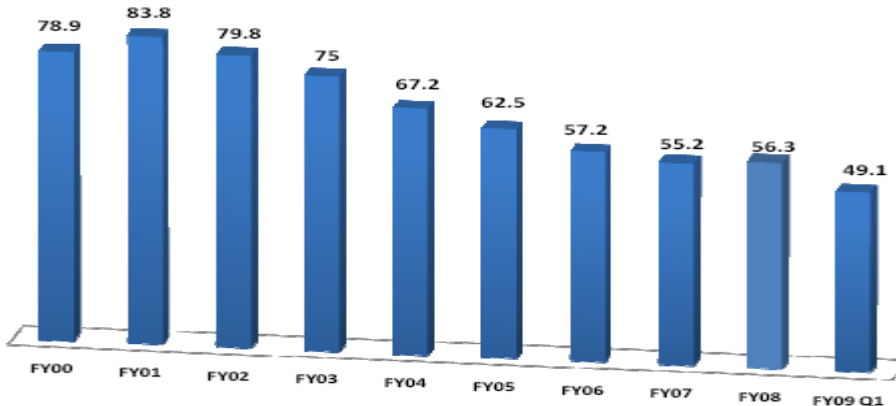
Pakistan was in considerable debt distress during FY08, hence it turned to the IMF for support under its Standby Agreement (SBA). However, joining the SBA is only a short-term fix, the economy still faces possibility of trade and other external shocks. The Latin American Crisis of 1980s was a direct result of economic mismanagement even though they had considerable IMF support, therefore the need for prudent macroeconomic management is enhanced specially considering the deepening global recession in Pakistan's main trading partners.

The GOP needs to ensure the fiscal deficit target is met, curb inflationary borrowings from the State Bank, and ease aggregate demand pressures to help narrow the current account deficit.



DEBT BURDEN & SUSTAINABILITY INDICATORS

The most common way of ensuring sustainable debt is to put limits on various debt ratios, e.g. the FRDL Act 2005 stipulated that the government reduce public debt by at least 2.5 percentage points of GDP every year. However, in in FY08 public debt instead of decreasing by 2.5% of public-to-GDP, actually increased by 1.1%.

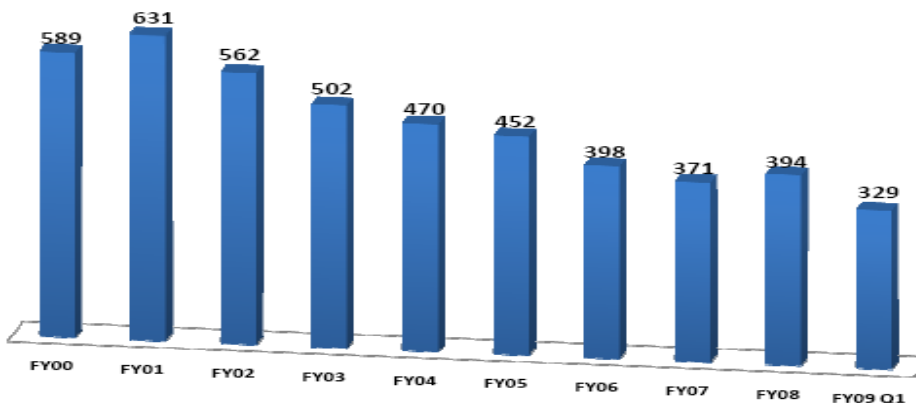


Public Debt (as % of GDP)
FY00-FY09 (Jul-Sep)

Source: Ministry of Finance

Pakistan public debt saw a considerable downward trend from FY02 onwards. However, in the outgoing fiscal year public debt increased by PKR 1087 bn, taking the total debt stock to PKR 5901 bn, an increase of 22.6%. This was the first increase in seven years. At the end of Q1FY09 the stock of total debt has already gone up to PKR 6572 bn, an enormous addition of PKR 671 bn, with total debt expected to increase further due to the government's financing needs for FY09.

Public debt as a percentage of government revenue has also gone up in FY08 breaking the seven year downward trend. This ratio had been declining by a commendable 31.1% per year from FY02-FY07 (see below).



Public Debt (as % of Govt. Revenue)
FY00-FY09 (Jul-Sep)

Source: Ministry of Finance



DEBT BURDEN & SUSTAINABILITY INDICATORS ... continued

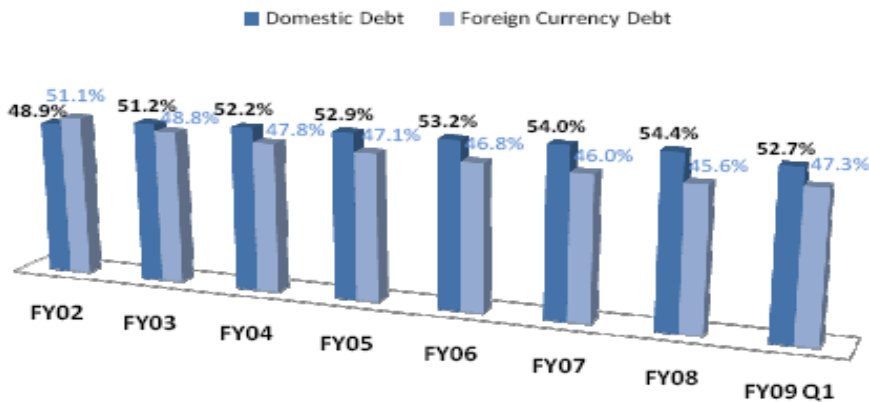
The unprecedented commodity and oil price shocks had an adverse impact on current accounts and fiscal deficits. This is because the GOP resorted to maintaining subsidies on essential commodities and financed them by borrowing from the State Bank. High commodity prices not only increased fiscal deficit but they also depleted the country's reserves to USD 6.7 bn in Oct'08. As a result, the USD/PKR parity depreciated by approximately 11% in FY08, which has had a translational impact of PKR 224 bn on public debt. In addition to this, the rupee's 15.5% depreciation in FY09 thus far, has further increased public debt by PKR 447 bn.

Stable exchange rate, sound fiscal position and a manageable current account deficit are essential for reducing public debt levels. Pakistan's current account and fiscal deficits and exchange rate are now under control. However, with oil payments planned to be shifted to interbank completely by Feb'10, the exchange rate is expected to depreciate, which will add to the translational impact on public debt.

DOMESTIC DEBT

In FY08, out of the PKR 1087 bn public debt, PKR 609 bn was accounted for by domestic debt (approximately 56%). Therefore, the remaining PKR 479 bn was foreign currency debt, however it's important to note here that out of this amount PKR 224 bn was a direct result of currency depreciation.

One significant trend witnessed since FY02 has been the change in structure of public debt and the tendency to rely more on domestic debt as compared to foreign currency debt (see below).



Structure of Public Debt
FY02-FY09 (Jul-Sep)

Source: Ministry of Finance

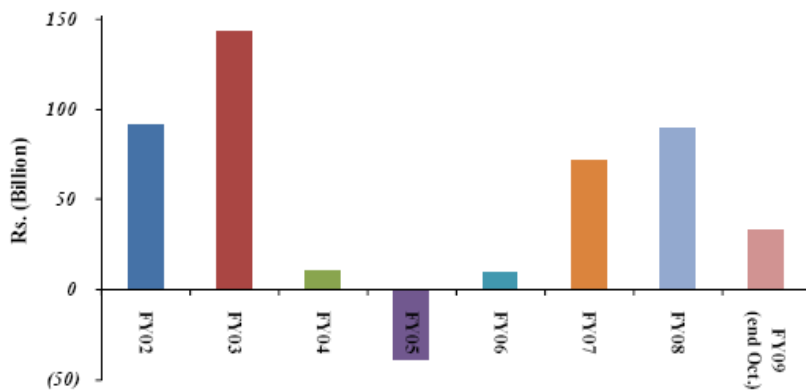
The share of rupee denominated debt has increased from 48.9% in FY02 to 54.4% in FY08. Some benefits of this are that the translation impact of a change in exchange rate is limited and liquidity is increased. On the other hand, domestic borrowing (specially from the SBP) results in build up of inflationary pressures in the economy and may crowd out private sector credit.

There are three types of domestic debt; permanent, floating and unfunded. Permanent debt includes medium to long-term instruments (e.g. PIBs), floating debt represents short-term debt (e.g. T-Bills) and unfunded debt constitutes National Savings Schemes (NSS), which are encashable on demand.

DOMESTIC DEBT ... continued

Within domestic debt, floating debt holds the lion's share, between FY04 and FY09 (Jul-Oct) the share of short-term debt has increased from 27% to 52%. Specially T-Bills purchased by SBP increased significantly from FY04 to FY09 (Jul-Oct), 10% to 39% respectively. Conversely, permanent long-term debt has seen a decline from 22% in FY06 to 18% in FY09 (Jul-Oct).

Unfunded debt has historically displayed erratic investment behaviour (see below).



Net Investment in NSS
FY02-FY09 (Jul-Oct)

Source: Ministry of Finance

Unfunded debt was a negative PKR 39.4 bn in FY05 before increasing by PKR 8.8 bn debt in FY06, PKR 71.3 bn in FY07 and PKR 89.5 bn in FY08. The recent rise in profit rates offered in FY09 is expected to increase investment in NSS schemes further. The target for this fiscal year is PKR 140 bn, which seems achievable given the high rates being offered.

If NSS participation is achieved, it will prove beneficial for the government since it will reduce the GOP's reliance on SBP borrowing, external support and side step the problem of exchange rate volatility.

EXTERNAL DEBT

External debt and liabilities (EDL) have deteriorated against all major fundamentals, reversing the seven year trend in a similar fashion to total public debt. Until FY08 Pakistan did not require external budgetary support, however the unprecedented external shocks as well as domestic turmoil and infrastructure problems forced GOP to approach IMF for support last fiscal year. Hence, external debt and liabilities of Pakistan have swelled.

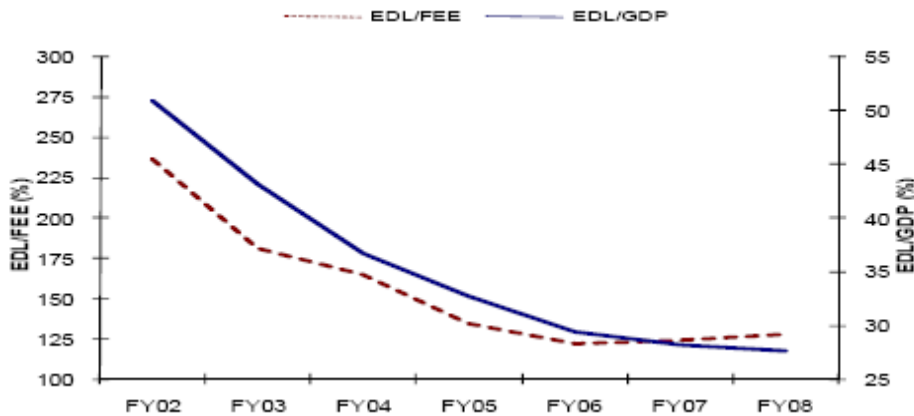
Year	EDL/GDP Percent	EDL/FEE Percent	EDL/FER Percent	STD/EDL Percent	STD/FER Percent	Interest Payments/FER Percent	Debt Service/GDP Percent	Debt Service/FER Percent	Total Public Debt/ Revenues Percent	EDL/Total Public Debt Percent
FY00	51.7	297.2	1750.3	0.3	6.0	73.0	5.1	173.8	589.0	61.8
FY01	52.1	259.5	1146.7	0.7	8.0	41.0	7.1	157.2	631.0	67.6
FY02	50.9	236.8	571.0	0.5	2.8	16.7	8.6	98.8	562.4	62.5
FY03	43.1	181.2	329.6	0.5	1.8	8.8	5.2	40.5	501.9	56.5
FY04	36.7	165.0	286.4	0.1	0.2	7.9	5.4	42.8	470.1	54.0
FY05	32.7	134.3	283.8	0.8	2.1	7.2	2.7	23.5	451.5	52.6
FY06	29.4	121.6	286.8	0.5	1.3	7.2	2.5	23.7	398.4	51.8
FY07	28.1	124.1	267.5	0.1	0.2	7.3	2.1	19.7	370.9	51.0
FY08	27.6	127.2	407.3	1.5	6.2	9.7	1.9	26.7	393.7	51.8

Trends in External Debt Sustainability Indicators FY00-FY08

Source: Ministry of Finance & SBP

Note: EDL= External Debt and Liabilities FEE= Foreign Exchange Earnings FER= Foreign Exchange Reserves STD=Short term debt

EDL to FEE ratio has deteriorated, suggesting that external liabilities of Pakistan have increased at a faster pace as compared to foreign exchange earnings. Furthermore, EDL to FER ratio has deteriorated to 407.3% in FY08 compared to 267.5% in FY07. Therefore, any corrosion of reserves will take the level of external debt dangerously close to unsustainable levels.



Trends in External Debt Sustainability Indicators FY00-FY08

Source: Ministry of Finance



IN SHORT

FY08 saw a reversal in several declining trends of public debt, as a percentage of GDP total debt increased from 55.2% in FY07 to 56.3% in FY08. Other significant ratios also deteriorated; debt servicing increased to 33.6% of government revenues in FY08 up from 30% in FY07; domestic debt increased by 23% in FY08 (primarily on account of borrowing from SBP). Therefore the IMF put a cap on the government's ability to borrow for budgetary support. Thus far, the fiscal deficit targets and government borrowing targets are being met and the government is making efforts to look for alternative sources of credit.

External debt went up by USD 5.8 bn to reach USD 46.3 bn in FY08, increasing further in FY09 to reach approximately USD 50 bn, on account of the latest IMF program. Current account deficit of nearly USD 14 bn in FY08 followed by a USD 7.3 bn deficit in FY09 so far puts additional pressure on the already strained economy. This also indicates, that the economy's BOP support requirements are persistent, a fact that can be vindicated by advisor on Finance Shaukat Tarin's statement that he is looking for a fresh USD 4.5 bn loan from the IMF.

CONCLUSION

Taking into account the current macroeconomic situation, a back to basics approach is the only way forward. With GDP growth slowing to an eight year low in FY09, the GOP should maximize developmental expenditure in order to increase long-term growth of the economy. By efficiently allocating resources, the government can ensure growth with development and improve macroeconomic fundamentals going forward.

Focusing on developing the supply side of the economy will not only help narrow the twin deficits and stabilize the exchange rate, but will also put an end to the translational impact on total debt and ensure a steady stream of foreign exchange earnings, which can begin to put a serious dent in the burgeoning public debt.

ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
<u>Inflation</u>														
Headline Inflation	%	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7	23.3	20.5
Core inflation	%	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9	18.8	18.9
Food inflation	%	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4	27.9	21.6
Non-food inflation	%	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2	19.8	19.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8	14.0	13.7
6 month	%	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0	14.0	14.0
12 month	%	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a	14.3	14.2
<u>External Sector</u>														
Export	Mln US\$	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,572	1,438	1,269
Import	Mln US\$	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,253	2,478	2,144
Trade balance	Mln US\$	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)
<u>Remittances</u>	Mln US\$	557	502	602	590	584	547	627	592	660	466	621	674	637
<u>Forex Reserves</u>	Mln US\$	14,657	14,031	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081	9,662	10,163



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