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## *Quid Pro Quo*

### ECONOMIC REPORT

#### SLOW & STEADY

April 15th, 2009

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SBP's second quarterly reiterated that the economy was on track of recovery and disciplined implementation of the SBA was bearing fruit. It highlighted that a meaningful contraction in aggregate demand, supported by fiscal prudence, has helped bring fundamentals towards a semblance of normality.

However, the economy is still not out of the woods, it has been in limbo since Nov'08 when inflation started retracting and fiscal policy was tightened (Oct-Jul net zero target for government borrowing). LSM sector has been affected the most, but on the other hand the real sector has shown encouraging signs of growth. Determined implementation by the Government of Pakistan (GOP) and other regulators is required to stimulate growth going forward.

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## FISCAL DIFFICULTY

The government under the IMF's strict supervision has been successful in limiting its borrowing from the central bank, as of 4<sup>th</sup> Apr'09 borrowings from SBP stood at PKR 114 bn which is PKR 144 bn less than the Oct-Jul'09 net zero target (PKR258 bn) agreed in the SBA. The GOP was able to achieve this by utilizing domestic sources to fund the budget deficit, as stated in the Letter of Intent (LOI). In this regard, PKR 150 bn have been borrowed from the Central Directorate of National Savings (CDNS). As a result, fiscal deficit for H1FY09 was recorded at 1.9% by SBP, compared to 3.4% in the same period of FY08. Although, this does not solve the government's financing needs, borrowing from domestic sources, opposed to printing new currency from the central bank is non-inflationary in nature and will not stoke inflationary pressure in the economy.

Although, limiting borrowing was essential in the short run, to halt inflation in its tracks, limiting fiscal deficit has come at a cost to developmental expenditure and is unsustainable in the long run. The government has had to substantially cut the Federal component of PSDP by PKR 118 bn to PKR 219 bn. Given the growing investment needs of the country in the context of a deepening global recession, foreign investment inflows are expected to slowdown considerably, therefore the government cannot keep spending at low levels. The Institute of International Finance estimates that private capital inflows to emerging markets will likely fall to just USD 165 bn in 2009 versus USD 929 bn record of 2007. Furthermore, defense spending and debt servicing payments comprise a significant part of government expenditure (approximately three fourths) and are rigid in nature, which increases the need to expand the revenue base.

The IMF recently highlighted that the slowing economy has affected the government's revenues and will likely result in a shortfall of overall tax revenue. In Jul-Mar'09 FBR tax collection stood at PKR 810 bn compared to PKR 680 bn last FY. Although tax collection is higher in FY09, the revised target of PKR 1.3 trillion for FY09 looks ambitious at best. The government's efforts to broaden the tax net have not materialized, as a result advisor on finance Shaukat Tarin criticized FBR for its tax reforms. Under the SBA Pakistan is required to reach a tax-to-GDP ratio of 15%, it is currently 9.6% below international standards according to the Fund.

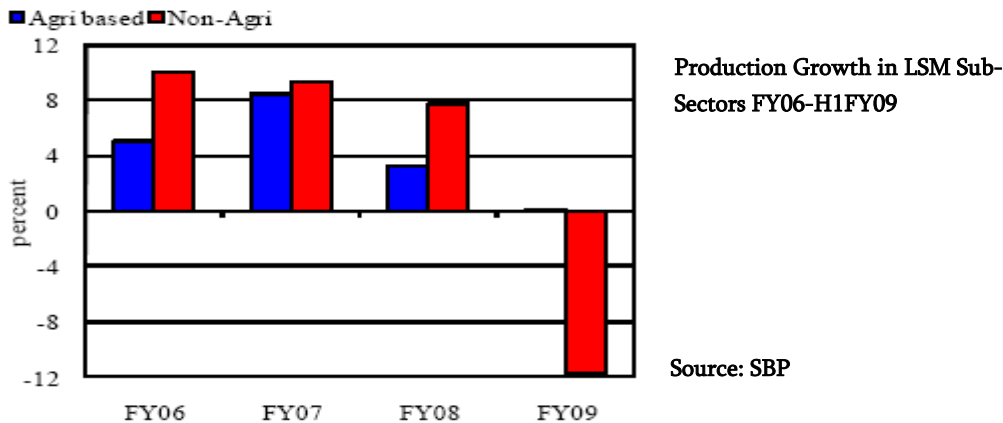
Limited revenues and fairly rigid expenditures mean the government has to turn to foreign and/or domestic sources to plug the deficit. Financing this gap using domestic sources crowds out private investment, this has been detrimental to the LSM sector.

## INDUSTRIAL SLOWDOWN

The LSM sector has been the hardest hit sector during the current recession, production contracted 4.7% during Jul-Dec'09 compared to a 5.2% increase in same period of FY'08. Several factors have contributed to this massive contraction including energy shortages, rise in input costs, low internal and external demand, poor law and order situation and high cost of refinancing. Due to a mix of tight monetary policy and high liquidity, banks started charging high risk premiums as FI's looked for the best investment in a slowing economy (i.e. government paper).

Nearly all sub-sectors have taken a hit, including automobile, metal, sugarcane, vegetable ghee, oil refinery, cement and textile industries. In the face of slowing global demand, especially from the Middle East and suppression of domestic demand, development spending was the only viable source of vital demand for some sub-sectors. In addition, rupee depreciation has not only increased input costs but increased volatility for businesses, which could not plan for the future, impacting their growth negatively.

Any improvement in LSM growth in the future requires a supportive increase in development spending. Infrastructure needs to be developed like power, transportation, etc. The agri based subsector of LSM relies heavily on the agriculture sector, however, due to poor storage and transportation mechanisms has suffered during H1FY09.



## AGRICULTURE

Performance of the agriculture sector suggests it will be the main driver of growth during FY09. A record wheat harvest is anticipated in the fiscal year, above target performance of minor crops and good performance of livestock.

Government policies to support the sector helped farmers make significant gains. These policies included complete exemption from sales tax and other duties for fertilizer and pesticides whether imported or supplied locally, doubling of subsidy on DAP (from PKR 470 to PKR 1000) to encourage greater fertilizer off-take and increase yields and output. These policies and price signals by the government were so effective, that farmers worked hard to offset the impact of water shortages and non availability of urea at subsidized prices.

The agriculture sector recorded its highest rice production of more than 6 million tons and wheat harvest is also expected to post a record produce. Both crops were able to reach higher output due to increases in area under cultivation and yields. Domestic demand of rice is 2.5 million tons, which means nearly 3.5 million tones of rice maybe available for export. Cotton area under cultivation fell by 6.7% during FY09, however, output increased by 3.5%, due to a 10.9% increase in cotton yield. One reason for this was the substantial increase in plantation of BT cotton in current fiscal year.

Performance of Major  
Crops  
Source: SBP

Area under cultivation (000 hectares)						
Crops	FY07	FY08 <sup>T</sup>	FY08 <sup>P</sup>	FY09 <sup>T</sup>	FY09 <sup>E</sup>	% change in FY09 over FY08
Cotton	3,075	3,250	3,055	3,220	2,850	-6.7
Sugarcane	1,029	1,040	1,241	1,040	1,044	-15.9
Rice	2,581	2,594	2,516	2,594	2,916	15.9
Wheat	8,578	8,578	8,550	8,610	9,053	5.9
Gram	1,052	1,120	782	1,012	-	-
Maize	1,017	1,001	1,037	1,001	1,062	2.4
Production (000 tons; cotton in 000 bales of 170.09 kg each)						
Cotton	12,856	14,140	11,655	14,110	12,060	3.5
Sugarcane	54,742	55,871	63,920	56,516	52,071	-18.5
Rice	5,438	5,721	5,561	5,721	6,543	17.7
Wheat	23,295	24,045	20,959	25,000	24,000 <sup>F</sup>	14.5
Gram	838	707	554	652	-	-
Maize	3,088	3,221	3,109	3,279	3,326	7.0
Yield (Kg/hectare)						
Cotton	711	740	649	750	720	11
Sugarcane	53,199	53,722	51,507	54,342	49,876	-3
Rice	2,107	2,205	2,210	2,205	2,244	2
Wheat	2,716	2,803	2,451	2,904	2,651 <sup>F</sup>	8
Gram	797	631	708	644	-	-
Maize	3,036	3,218	2,998	3,276	3,132	5

P: Provisional; T: Target, E: Estimates, F: Forecast,  
Source: Ministry of Food & Agriculture



## INFLATION SIMMERING DOWN

Latest inflation figures show a moderate decline in headline YoY inflation to 19.7% in Mar'09 compared to 21.7% in Feb'09. More worryingly, core inflation has remained high at 18.5% in Mar'09 vs 18.9% in Feb'09, this is the third consecutive month that core inflation has remained in the narrow band of 18.5-18.9%, dashing hopes of monetary easing in the Apr'09 MPS. SBP Governor Saleem Raza stated that 'we should not be obsessed with the discount rate', on two occasions, and was reiterated by Shaukat Tarin. IMF has highlighted core inflation as key to monetary policy decision, and keeping in mind its stickiness we do not expect a cut come the Apr'09 monetary policy.

Subsequently, market interest rates, which had stabilized in third quarter of FY'09, have jumped due to a combination of negative inflation data, statements from regulators and tight money market conditions (Table on Right). T-Bill cut-offs in the Apr 8<sup>th</sup> 2009 auction jumped by 92-154 bps (See Table Below) and KIBOR also went up in tandem with the cut-off rates; 3M jumped from 12.86 to 13.36, 6M from 12.93 to 13.52 and 12M from 13.89 to 14.17, the next day of the auction.

KIBOR Average		
Tenor	March	April
1 Week	11.63	13.56
2 Week	11.73	13.38
1 Month	11.88	13.22
3 Month	12.08	12.99
6 Month	12.53	13.10
9 Month	13.58	13.65
12 Month	14.03	13.98

Auction Date	Tenor (Months)	Cut-off Yield (%)	Change from last Cut-Off (bps)
March 11, 2009	3	11.6908	-0.9183
March 11, 2009	6	11.7845	-1.1983
March 11, 2009	12	11.8518	-1.1526
March 25, 2009	3	11.7367	0.0459
March 25, 2009	6	11.897	0.1125
March 25, 2009	12	11.9522	0.1004
April 8, 2009	3	12.6552	0.9185
April 8, 2009	6	12.9828	1.0858
April 8, 2009	12	13.4928	1.5406

Source: SBP

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## CONCLUSION

The economy is showing signs of bouncing back, a lot is dependant on the agriculture sector's performance and ability of the government to keep fiscal deficit under control. Once core inflation shows a decisive downward movement, the central bank will have more freedom to focus on the growth.

Going forward growth prospects are attractive, however, sustained efforts from the government are required to ensure the economy moves from a stability program toward one which focuses on growth. As of now the economy is in a hangover, recovering from external price shocks, severe domestic demand contraction, slow foreign flows, broken price bubbles in several markets, collapsed equity markets and high inflation.



## ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
<u>Inflation</u>														
Headline Inflation	%	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7	23.3	20.5	21.1	19.1
Core inflation	%	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9	18.8	18.9	18.9	18.5
Food inflation	%	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4	27.9	21.6	22.9	19.7
Non-food inflation	%	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2	19.8	19.7	19.6	18.5
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8	14.0	13.7	12.6	11.6
6 month	%	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0	14.0	14.0	13.0	11.8
12 month	%	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a	14.3	14.2	13.0	11.8
<u>External Sector</u>														
Export	Mln US\$	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,572	1,438	1,269	1,525	n/a
Import	Mln US\$	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,253	2,478	2,144	1,864	n/a
Trade balance	Mln US\$	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)	(339)	n/a
<u>Remittances</u>	Mln US\$	602	590	584	547	627	592	660	466	621	674	637	641	739
<u>Forex Reserves</u>	Mln US\$	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081	9,662	10,163	10,138	10,090



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