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Quid Pro Quo

ECONOMIC REPORT

LOOKING AHEAD

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With FY09 coming to an end, this edition of the Quid Pro Quo seeks to provide readers with a synopsis on what to expect in the upcoming budget taking into consideration domestic constraints and a global recessionary environment.

Before the end of FY09 the economy has to achieve some vital IMF targets including NFA floor (USD 2.78 bn), NDA ceiling (PKR 1.31 bn), tax collection (revised PKR 1.18 bn) and incremental government borrowing agreed in the SBA (PKR 1.18 bn). Furthermore, we do not expect the economy to achieve the 2.5% revised growth target for FY09. Hence, all eyes are now firmly on the next budget and what challenges we face in stimulating the economy.

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FISCAL SPACE

In our last edition we concluded that given the growing investment needs of the country (in the context of a deepening global recession and slowdown in foreign inflows) the Government of Pakistan (GOP) could afford to spend at low levels on PSDP. This point was not lost on the IMF, the agency on 12th May'09 reached a preliminary understanding to relax the fiscal deficit target of the government from 3.4% to 4.6% for FY10 (approximately an additional PKR 180 bn).

The increase in government spending will boost economic growth and help sectors like manufacturing that witnessed 7.7% contraction in the first nine months of FY09 recover (sub-sectors like cement in particular will benefit from increased domestic demand). Meeting next year's growth target of 4% is now likely as the government has more fiscal space for development expenditure. However, despite this relaxation, the GOP has to make difficult choices on prioritizing expenditure, keeping in view the higher defense and debt servicing costs next year. In FY09 thus far, the government had to substantially cut the Federal component of PSDP by PKR 118 bn to PKR 219 bn, owing to dismal revenue collection.

It is unanimously agreed that Pakistan has to become prudent with its expenditures. However, cutting back on developmental expenditure will be inadequate going into FY10, as it is only a short term solution. For a developing country like ours, where infrastructure is underdeveloped and productive capacity underutilized, expenditure by the government on development projects is essential. Slashing the PSDP, education and health budget will only slow future output and GDP growth. In times of low GDP growth, spending by the government should go up and vice versa, in order to achieve long term growth.



REVENUE SIDE

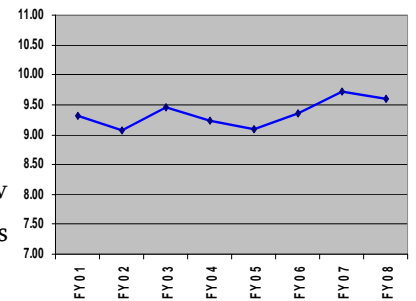
An equal emphasis needs to be put on increasing revenue through broadening of the tax base. Since some major contributors to GDP are not yet taxed (agriculture, stock market, real estate) and less than 2% of the population pays taxes, we have a good sized target market to identify new entrants.

The ideal solution is to increase sustainable revenue, which can only be achieved by increasing recurring income (i.e. higher tax-to-GDP ratio) and keep spending on development so as to achieve sustainable growth.

Tax-to-GDP Ratio

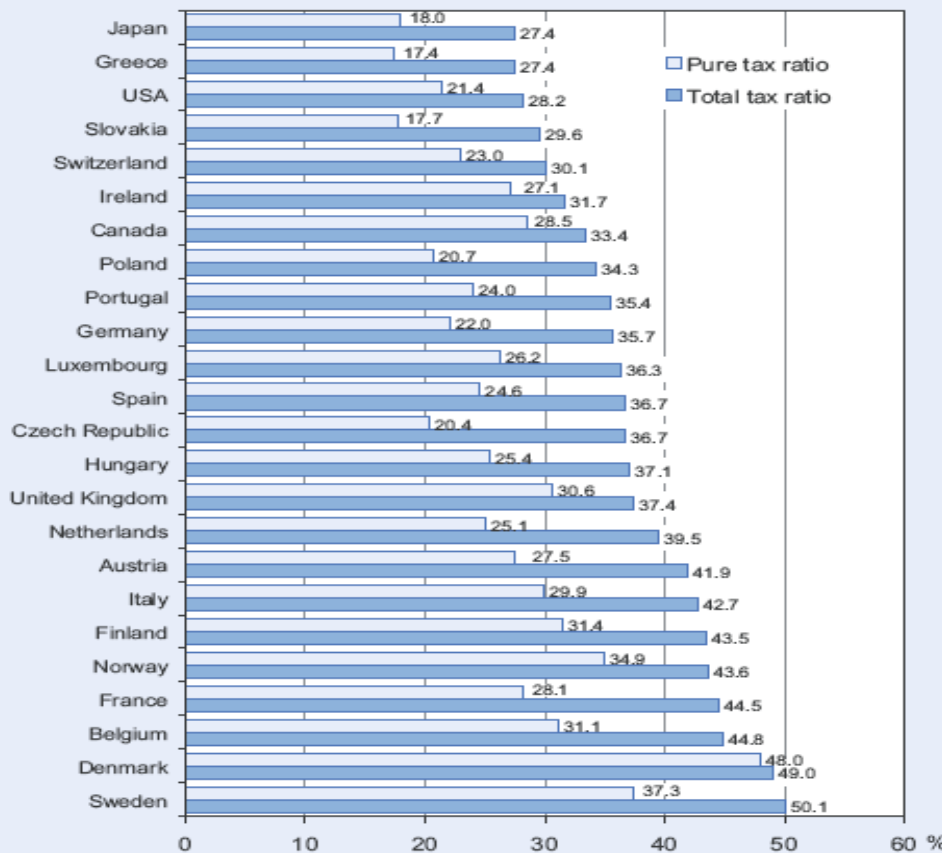
Tax-to-GDP ratio of Pakistan has hovered between 9-10% for some time now (see graph on right). This ratio is low compared to developed countries as shown below.

Tax-to-GDP ratio (%) FY01-FY08



Source: SBP

INTERNATIONAL COMPARISON OF TOTAL TAX RATIOS as % of GDP



Total tax ratio: Japan and Poland, status: 2005
Pure tax ratio: Poland, status 2005

Source: OECD
Revenue Statistics
1965-2006

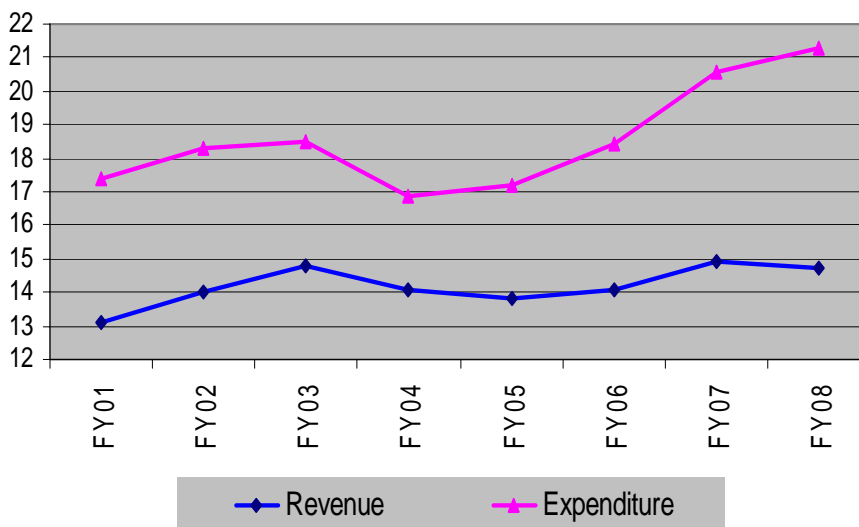
LOOKING AHEAD



TAX-TO-GDP RATIO ... continued

Pakistan's low tax to GDP ratio essentially means the government's ability to finance its expenditures in important areas (such as defense, infrastructure, social welfare and public services like transportation and water management) is hindered due to scarce resources (see graph below). Hence, in order to fill budgetary gaps the GOP is often left with no other option but to attain financing from the SBP (i.e. monetization of fiscal deficit), or borrow from the banking sector (i.e. crowd out private sector credit), as has been the case since 2HFY09, when T-Bill cut-offs came under the purview of the Ministry of Finance (MoF).

Pakistan Revenue & Expenditure as % GDP (FY00-FY08)



Source: Bloomberg



TAX COLLECTION

The IMF expressed its reservations over the dismal FY09 tax collection of PKR 898.64 bn (17.7% YoY) for Jul-Apr'09 period. This left an average monthly tax collection of more than PKR 200 bn for the remaining two months, a mammoth task even after including the PKR 73 bn collected through PDL in 9mFY09.

As a result, Advisor on Finance Shaukat Tarin on 13th May'09 announced, after negotiations with IMF staff, that the tax collection target was being slashed for the second time to PKR 1.18 bn (18.15% YoY), due to slow economic activity. Furthermore, he announced next year's tax collection target of PKR 1.4 trillion (19% YoY). He had earlier said the tax to GDP ratio would be increased to 13.5% by FY'13 and the government may add new sectors to the tax base, which may include real estate, stock market and agriculture. In addition, harmonizing income and GST taxes and reducing exemptions will undoubtedly improve the tax-to-GDP ratio and ensure the tax burden is shared by more taxpayers rather than increasing taxes for the existing tax payers (2% of population).

RIGID EXPENDITURE

While it is understood the government will actively manage fiscal deficit (under the IMF's strict supervision), GOP's hands are tied due to huge chunks of expenditure being fixed. Defense spending and debt servicing constitute nearly 50% of total government expenditure. As a result, in FY10 the government may not be able to drastically cut spending. However on the other hand, military operations in the North of the country (which do not have a timeline) and accommodating internally displaced persons (IDP), both represent an upside risk to expenditure going forward, because, because if the conflict drags on too long the likelihood of overshooting the expenditure target is high.

PSDP seems the likely victim once again as the government balances the budget next year. However, we can take some comfort from the extent of pledges made at the Friends of Democratic Pakistan (FoDP, USD 5.28 bn) and Kerry-Lugar Act being passed by the US Senate.



ROUND OF INFLATION

Policies designed to dampen aggregate demand have helped subside inflationary pressures, latest figures show an almost 200 bps decline in headline inflation to 17.19% YoY in Apr'09 vs 19.07% in Mar'09. Core inflation also showed a firm decline to 17.8% in Apr'09 after hovering in the 18.5-18.9% range for the previous three months.

With a 4% growth target and dire investment needs of the economy, the only way to stimulate growth in FY10 is to increase demand for private sector credit (PSC), which registered dismal incremental increase of PKR 49 bn as of 25th Apr'09, compared to PKR 371 bn in FY08. This gives considerable room for the SBP to aggressively cut interest rates in FY10, in order to stimulate real economic activity by increasing PSC off-take. We expect interest rates to come down swiftly next fiscal year, as falling inflation leaves regulators room to implement an expansionary monetary policy and the need to prop up flagging growth becomes the primary driver of policy.

However, increased fiscal space and higher PSC for FY10 represents a double edged sword for the government and its plans to achieve long-term growth. Higher government spending coupled with higher growth may kick off another round of inflation starting from Nov'09 when the base effect subsides. Although CPI YoY inflation is showing a declining trend, the MoM figures have been increasing gradually (see table below), mainly due to increasing food and fuel prices.

Date	Index	MoM
Jun-08	176.5	2.10%
Jul-08	182.4	3.34%
Aug-08	186.3	2.14%
Sep-08	188.1	0.97%
Oct-08	192.1	2.12%
Nov-08	191.9	-0.12%
Dec-08	190.9	-0.50%
Jan-09	190.1	-0.42%
Feb-09	191.9	0.95%
Mar-09	194.5	1.37%
Apr-09	197.3	1.41%

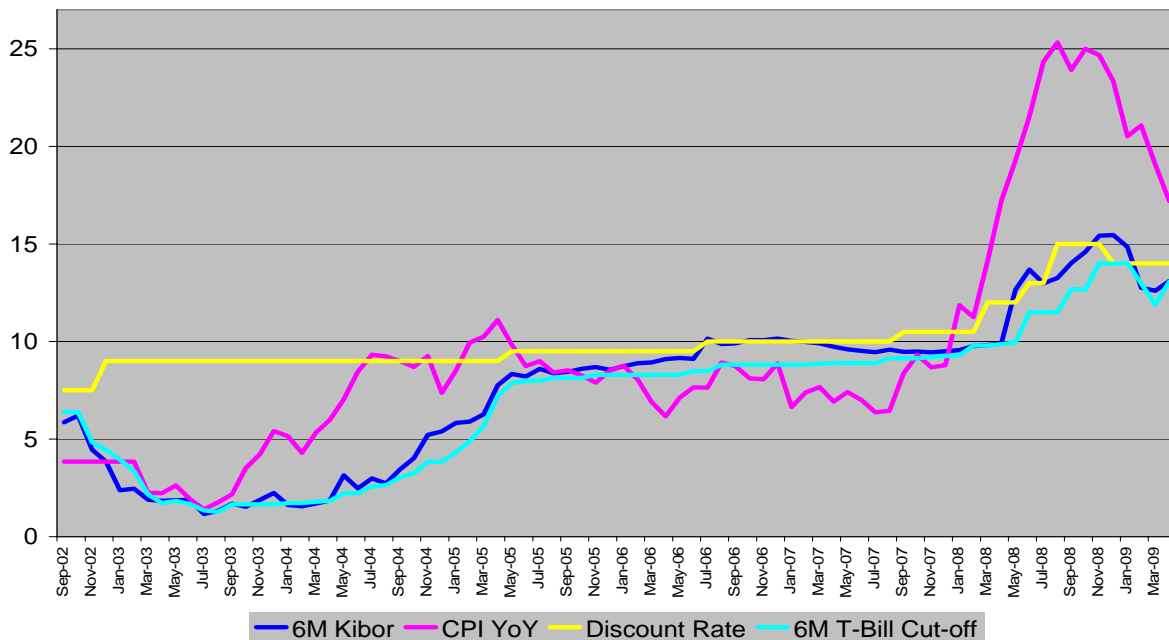
Source: FBS & MCB Research



ROUND OF INFLATION ... continued

This increasing trend in MoM inflation has perplexed IMF officials, who have reportedly aired their reservations in the recent round of meetings in Dubai, and asked regulators not to decrease the DR in next monetary policy statement (MPS) to be held in Jul'09. Officials pointed to lack of commitment on part of the government and ineffective administrative measures as the primary reasons behind high inflation. They were referring to the GOP increased support price of wheat by approximately 60% (which is inflationary in nature), and prices of commodities not moving in tandem with international prices, e.g. despite international palm oil prices crashing by approximately 66% (from USD 1144 to a low of USD 390 between 27 May'08 and 18 Nov'08), domestic prices did not change.

Lack of administrative action coupled with an expansionary monetary policy may allow inflationary pressures to gain momentum starting from 2QFY10 as economic activity picks up, and simultaneously put a limit on downside to market rates. Considering that the IMF has explicitly linked future cuts in discount rate (DR) to significant declines in core inflation, inflationary expectations may play a big role in deciding the floor on market interest rates.



6M Kibor, CPI YoY, Discount Rate & 6M T-Bill cut-off (Sep'02-Mar'09)

Source: Bloomberg, SBP & MCB Research

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CONCLUSION

FY10 is being labeled by the government and IMF as the year the economy could turn around and achieves meaningful growth of 4-4.5%. However, the government has pressing issues to address including the military operation in the North, stimulating the manufacturing sector, increasing exports in a slowing global economy, managing inflationary pressures and controlling budget deficit.

Although there is not much the government can do to curtail expenditure, it can increase tax revenue by bringing new sectors into the tax net and meaningfully increase the tax to GDP ratio.



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	1,466
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	2,095
Trade balance	Mln US\$	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)	(339)	(629)
<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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