MCB Bank Limited

<u>Treasury & FX Group</u>

Quid Pro Quo

Issue # 37 **_Economic report_** ***June 1st, 2007***

The Ideal Tomorrow

The Federal Budget for the fiscal year 2007-08 is going to be presented on June 08 2007 before the National Assembly. In this Quid Pro Quo, we will look back at the year that was, and what do we have to look forward to in the budget 07-08.

The report will begin with a detailed review of the economy for the first ten months of the current fiscal year, concentrating on the fiscal developments and the performance of the agricultural and industrial sector. In the light of the strengths and weaknesses for FY07, the report will then present recommendations to the government for the new budget for different segments of the economy.

The Economic Saga – FY07

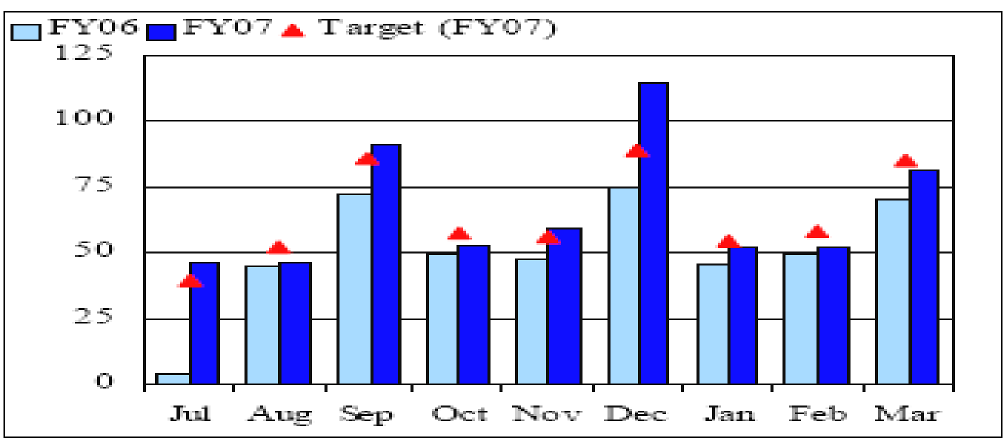
The strong performance of the economy for the first ten months of the current fiscal year promises robust economic growth for the fourth successive year. While GDP growth is expected to marginally exceed the set target of 7%, a close observation of few economic indicators and sectors leaves a rather ambiguous picture. While tax revenue collection exceeds target, government borrowing remains a concern. Remittances and foreign direct investment are creating new records while due to rising trade gaps the current account deficit is emerging as one of the biggest challenges facing the economy. Growth in the agricultural sector is expected to exceed its growth target for FY07 owing to strong performance of the wheat crop but industrial growth though higher than that recorded in the previous fiscal year is not likely to reach its target growth mark. Similarly, the services sector is expected to continue with its growth momentum for yet another year; while growth in the wholesale and retail trade sub-sector is expected to slow somewhat.

Revenue Side of the Saga

The Central Board of Revenue (CBR) has collected tax receipts (which are the primary source for government revenue) worth PKR 647 billion for the first ten months of the current fiscal year against a target of PKR 645 billion. This represents an achievement on part of CBR and is reflective of the consistent efforts of the government to improve and enhance revenue collection.

Figure 1 shows how tax collections over the course of the year FY07 have exceeded their respective target and recorded an improvement relative to FY06. This growth has been contributed primarily by growth in direct tax receipts which not only remained above the target in all months, but recorded an increase of more than 55% against the corresponding period of the previous year.

Figure 1: Monthly Tax Collections (FY07 vs. Target)



Source: SBP Third Quarterly Report FY07

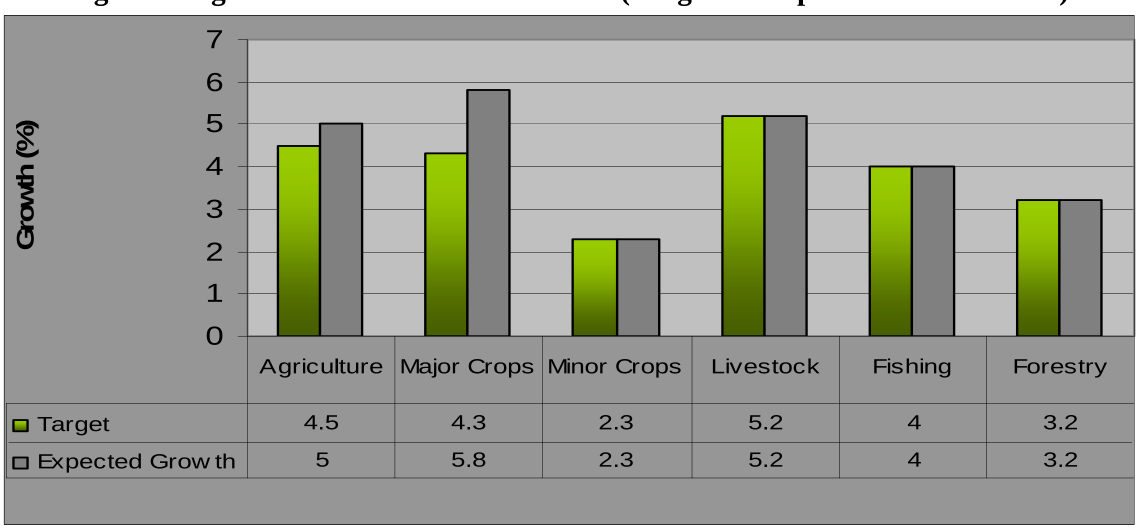
However the relative slowdown in the total tax collections since Jan 07 is a concern that calls for attention towards the expenditure side. Nevertheless the strong growth in tax collections in the first half of FY07 ensures that CBR will achieve its full year target of PKR 835 billion easily.

What presents itself as a bigger challenge is the sharp increase witnessed in government borrowings. The aggregate government borrowings for deficit financing from domestic sources stood at PKR 190.5 billion during Jul-Mar FY07; nearly four-times as high as that in the corresponding period of the previous year. The higher growth in domestic debt seems to be the result of significantly lower availability of external sector financing, which forced the government to rely more on domestic sources.

We Reap what We Sow

The agriculture sector performance during the course of the current fiscal year has been satisfactory and is expected to exceed its year end target. Notwithstanding the disappointing performance of three major *Kharif* crops (cotton, rice and maize), the aggregate growth of the crops sub-sector is likely to record an improvement over FY06 performance, on account of prospects of strong FY07 wheat harvests. Currently wheat harvests are recorded at 23 million tons (an all-time high), already above the year end target of 22.5 million tons. The exceptionally sound performance of wheat harvest can be attributed to a rise in the area under cultivation for wheat, availability of irrigation water, policy support as well as efficient use of inputs and lastly favorable weather conditions.

Figure 2: Agriculture Value Added Growth (Target vs. Expected Growth FY07)



The Machine Stops….At least Slowing Down

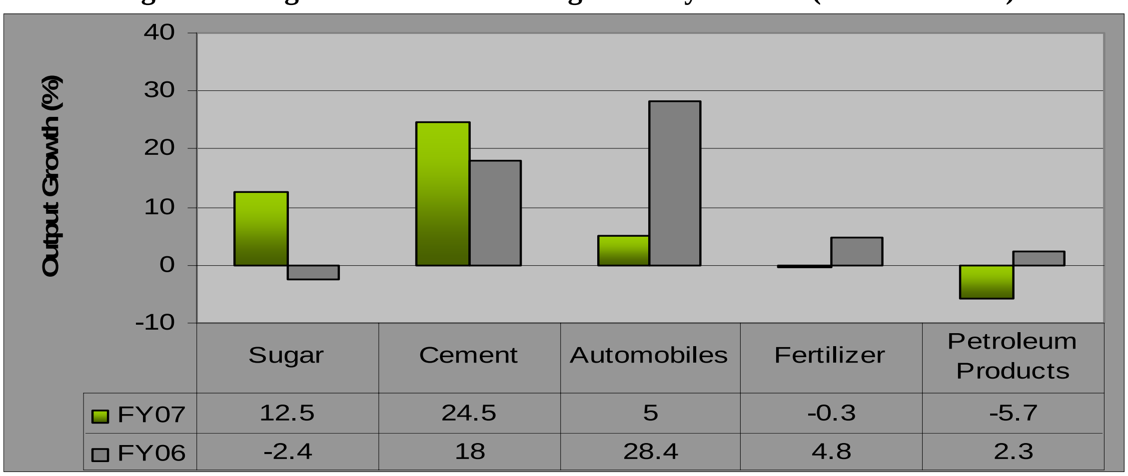
Based on the (limited) data available for this segment of the economy, we expect industrial performance to show improvement over previous year's numbers but it is unlikely that industrial growth will achieve its year end target.

Textiles, sugar, cement and basic metals industry will contribute positively to industrial growth. The textile industry though showed relatively poor performance to begin with in the current fiscal year, gained momentum in the past five months recording an average growth of 11.63%. Sugar production witnessed a growth of 12.5% for the first nine months of FY07; a strong turnaround from 2.4% recorded for the same period last year and much above the full year target of 3%.

On the other hand the slowdown witnessed in the automobile industry is likely to mute the impact of these positive stimulants. Moreover due to weak demand and temporary shut down for maintenance and expansion, fertilizer, paper, board and engineering industries recorded a decline in production relative to the previous year.

Figure 3 shows the production growth levels for the first nine months of FY07 relative to the corresponding period of the previous year for some major industries. The lackluster performance of the Automobile and Fertilizer Industry is obvious and likely to prevent the industrial sector from achieving its growth target.

Figure 3: Large Scale Manufacturing Industry Growth (FY07 vs. FY06)



	Sugar	Cement	Automobiles	Fertilizer	Petroleum Products
FY07	12.5	24.5	5	-0.3	-5.7
FY06	-2.4	18	28.4	4.8	2.3

Ideal Screenplay for the New Saga?

The federal budget for FY08 is expected to be presented before the National Assembly on 8th June. There exists widespread consensus in the country that, with the general elections approaching, the upcoming budget will have a strong political essence. According to the media the government has already set a growth target of 7.2% while a target of PKR 520 billion for Public Sector Development Program (PSDP) and PKR 1 trillion for revenue collection has been finalized. These targets however await approval from the National Economic Council.

The Expenditure Side

In the current fiscal year, in which the fiscal deficit target of 4.2% of GDP was criticized to begin with, the fiscal deficit is likely to exceed the stated target. Expansion in expenditure has generally been accused of building further inflationary pressures by stimulating demand and putting an upward pressure on the interest rates by increasing the government's funding requirements. Currently the public debt remains a large burden on the budget and the balance of payments, with the interest bill alone absorbing around one third of tax revenue. Hence some quarters are arguing for a reduced fiscal deficit target (around 4% of GDP) in the coming budget.

Instead we believe that the government has the room to keep the target for fiscal deficit at 4.2% of GDP yet again. This is because fiscal deficit for a growing economy like ours is not bad per se as long as it results from fiscal spending aimed at utilizing idle resources within the economy. Mobilization of these resources will stimulate output and growth without necessarily increasing prices. As a result higher income and higher savings will be generated. A corollary of this view is that if the government expenditure expands to generate employment of unutilized and underutilized resources then an equivalent amount of savings would accrue in private hands. This shall result in an increase in tax revenues and in this fashion the fiscal deficit will finance itself. Thus it is clear that as long as the government increases its spending in employment of inactive resources, the subsequent deficit is in fact beneficial in the medium and long term.

Target for PSDP is widely expected to be beyond PKR 500 billion and we advocate that it will be ideal to allocate the funds towards development of mega projects involving exploration and absorption of idle resources. Since earth-quake related spending will come down substantially relative to previous year, this year major portions of funds can be used for building dams in ideal locations. We also argue for additional funds to be allocated towards projects for development of coal as the country has one of the largest coal reserves in the world. Currently Pakistan's coal power generation is hardly 5% of total power production as compared to regional averages of above 50 %(in India's case it is above 70%). It is primarily the imports of furnace oil that accounts for a large proportion of power production and represents a significant portion of our import bill. This means that if the government develops its coal reserves by a significant amount every year, it will trim its oil import bill tremendously since it has been estimated that by using only 2% of the existing coal reserves, we can generate around 20,000 megawatts for almost 40 years. Acknowledging that projects for development of coal reserves would mean tremendous direct costs and hence a higher fiscal deficit, we would argue that the benefits generated off this project are tremendous and the resulting fiscal deficit is acceptable as it would be mean utilization of idle coal reserves.

The Revenue Side

On the revenue side there is widespread consensus that with the tax collections exceeding the target for first ten months of the current year and widely expected to meet and/or exceed the year end target comfortably, the government will set ambitious tax collection target in the coming budget. There are already rumors that revenue collection target has been finalized at PKR 1 trillion. We believe that the government can conveniently achieve this target without necessarily increasing tax rates as long as the economy is stimulated in the right direction. For example as argued above, the fiscal deficit can finance itself if fiscal spending generates growth. Therefore in order to achieve its ambitious revenue collection target instead of increasing taxes, what the government needs rather is generation of productive growth. This has been the emphasis of the government in the past and we are confident that the government would stick to its policy of increasing revenue not through tax increases but increased growth and inclusion of more tax payers into the tax net.

Sowing new Seeds

Though the agriculture sector is likely to meet its year end target or even exceed it marginally, it is critical to pay heed to the underperformance of major crops like rice, maize and particularly cotton.

Cotton production indicators indicate reduced production this year; below the set target. Agriculturists have predicted import of at least 3 million bales cotton to meet the requirement of domestic industry’s consumption. This is largely due to unavailability of quality inputs and inadequate technology transmitted to cotton growers. In addition to this, it has been estimated that Pakistan is almost ten years behind the major cotton producing economies in the commercial use of BT cotton. This is because the BT varieties of cotton in Pakistan have not received the deserved focus and there have been continuous delays in developing bio-safety regulations for this particular variety. India has succeeded to get as many as 40 BT cotton varieties on local level with the assistance of multinational companies while Pakistan yet needs to introduce these varieties to enhance the cotton yield in the country as it has locally developed only two BT cotton varieties. Hence there is a significant potential to enhance cotton yields in the coming year. The government must allow the agriculture sector to introduce BT gene in cotton varieties and provide the growers with adequate technology and assistance.

Within the agriculture sector another area where the government must focus to further stimulate agricultural and subsequently economic growth is the livestock. Though the livestock industry is likely to meet its year end target for FY07, the yield off this sector, particularly the milk industry, has significant potential to be increased.

Worldwide, the dairy farmers have failed to keep pace with growing demand for milk which is said to be rising at approximately 3% annually. As a result milk prices are increasing at the fastest rate ever and are not expected to fall anytime soon because of the growing demand in China and Latin America and dwindling government supplies. In this environment of rising milk prices, it is critical to develop our local livestock industry enough to guarantee consumers a comfortable supply of milk in the future and subsequently provide them with food security. In addition, this would provide a much needed impetus for growth in the agriculture sector. For this, additional expenditure needs to be allocated to livestock for deploying new technologies and providing the required resources to the sector.

Lubricating the Machine

The performance of the large scale manufacturing sector, though relatively better than previous year's, has been disappointing and is likely to stay below the year end target. The underperformance of the automobile industry in particular, muted the positive performances shown by other industries. High interest rates environment is speculated to be the primary reason behind this slowdown. In fact with globally high interest rates, intense global competition amid the WTO rules coming into play, the automobile industry's future may not be so strong globally and therefore it might be difficult for this industry to be the engine of LSM growth in the coming year. On the other hand, we believe the economy can get a stronger stimulus from other industries like textiles.

The Textile Sector in Pakistan occupies a significant position in the growing economy, as it contributes a substantial portion to the national income while constituting approximately 60% of merchandise export earnings and employing 40% of the industrial labor force. Acknowledging the strategic significance of the sector and realizing the intense international competition that it faces, the SBP has consistently lent support to the textile industry. For example, in the current fiscal year the SBP decided to provide higher level of interest rate subsidy on export financing and long-term financing for exports under the Export Finance Scheme. Subsequently textile exports witnessed positive growth during the year, 10.3% for the first nine months of FY07. Though textile industry performance has been satisfactory, there is still a lot of scope for the industry to further grow and stimulate economic growth. The government therefore must focus on the textile sector generously yet again in the new budget and enhance its productivity and competitiveness.

Closely following the growth in the economy, the cement industry revealed strong performance during the year recording a 24.5% growth in production during the first nine months of the current fiscal year. We believe that the recent growth in installed capacity of cement plants leaves the sector in a very comfortable position for the coming year. This idle capacity in combination with regional shortages of cement may lead the cement sector to be the engine of LSM growth in the coming years. Hence government must encourage mobilization of this idle capacity which will not only provide relief to domestic consumers but will also allow the economy to export to neighboring economies like India.

Surprise, Surprise?

In the light of the strong performance for the current fiscal year, the government may be tempted to set ambitions growth, revenue and investment targets in the budget. However like always the new budget may bring several surprises with it going against expectations of many analysts. In our next Quid Pro Quo we will present a detailed post-budget analysis and implications on the economy.

Economic Snapshot

Fiscal year 06-07														
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April
Inflation														
Headline Inflation	%	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9
Core inflation	%	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2
Food inflation	%	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4
Non-food inflation	%	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2
T-bill (Wgt Avg)														
3 month	%	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69
6 month	%	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9
12 month	%	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08
External Sector														
Export	Mln US$	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	1536	n.a
Import	Mln US$	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	2070	n.a
Trade balance	Mln US$	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	n.a
Remittances	Mln US$	401	507	464	376	435	422	410	448	475	391	457	520	n.a
Forex Reserves	Mln US$	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661

n.a = Not Available

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