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June 9th – A New Saga Unfolds

The Federal Budget 2007-08, released ahead of the upcoming elections has been popularized as a populist budget, aimed at luring the voting community by providing relief in various forms to the larger part of the population. However amid this debate, focus has been lost from the impact that some of the measures announced in the budget FY08 will have on the economy. This report will concentrate on analyzing the measures that going forward will significantly affect the economy and thereby the future economic growth.

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A Populist Screenplay....and What Else?

Our government has allocated Rs.520 bn under PSDP which will be spent on development and welfare of people. Out of this, 52% will be spent on infrastructure development and 48% on welfare of people and on social sector.

Salaries of government employees are being increased by 15%.

Minimum wage of unskilled workers is being increased from Rs.4000 per month to Rs.4600 per month.

Pension of government pensioners will be increased by 15-20%. Increase in pension is being given in two tiers: old pensioners will get 20% raise while new pensioners will get 15% rise.

Ministry of Housing and Works to immediately construct 37,000 houses for the low paid employees and give it to them on ownership basis.

A per kg relief of Rs.10, Rs.5 and Rs.5 on tea, sugar and rice respectively.

Price of cooking oil at utility stores fixed at Rs.67 per kg against the market price of Rs.80 per kg.

The subsidy on DAP fertilizer will increase from Rs.400 per bag to Rs.470 per bag. As a result of this, the price of each bag of DAP will reduce by Rs.70.


The government has allocated Rs.336 million for production of better seeds. 15 new seed testing laboratories will be set up.

Budget Speech 2007-08.

The Federal Budget 2007-08, with a total outlay of Rs.1.874 tr, envisages a revenue target of Rs.1.48 tr including a tax collection target of Rs.1.025 tr and subsequently a fiscal deficit of Rs.398 bn or 4% of GDP. The gap is expected to be bridged by raising money externally and through government borrowings. The budget outlay of Rs.1.874 tr is up 19.8% relative to the previous year's outlay of Rs.1.565 tr while the government has set the tax collection target 49% above the last year's target.

Taking the cue from its predecessor, the FY08 budget continues to prioritize Public Sector Development Projects (PSDP) allocations and is reflective of the expansionary stance of the government. The budget proposes PSDP allocations of worth Rs.520 bn as compared Rs.435 billion allocated in the previous year.

Total subsidies worth Rs.113.9 bn have been announced with major chunk allocated to WAPDA, KESC, textiles, and petroleum and refinery companies. In addition to this, some other significant relief measures in terms of increased pension payments, increased



salaries of government employees and various subsidies on food and non food item have been announced.

A quick glance at the expansionary/relief measures announced in the Federal Budget largely explain why the FY08 budget released ahead of the approaching elections, is being looked at as a populist budget, aimed at luring the voting community. However amid this debate, focus has been lost from the impact that some of the measures announced in the budget FY08 will have on the economy. In this report we will concentrate on analyzing the measures that going forward will significantly affect the economy and thereby the future economic growth.

Money Money!

The facility of debt/swap to spinning sector is granted.


R&D facility will also be available to fiber manufacturers @ 3.5%, which will be availed through SBP.

*Budget Speech 2007-08.
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Acknowledging the contribution of the textile industry to the industrial output, exports, employment generation and its by and large strategic significance, the federal budget FY08 announced various measures to boost the textile industry. One important measure that has been announced is the extension of Long Term Financing for Export Oriented Projects (LTF-EOP) to the entire spinning sector.

For the current fiscal year financing facilities under Export Finance Scheme (EFS) and LTF-EOP have been offered to exporters for different periods of time at rates significantly below the KIBOR for relevant maturities. For e.g. under EFS, exporters are offered financing for a six month period at 7.5% which is approximately 3% below 6-Month KIBOR while financing facilities for import of eligible machinery for a three year period are offered in the range of 5% below the KIBOR of respective maturities. Subsequently in the first ten months of the current fiscal year, total gross disbursement from refinancing facility allowed to banks under EFS and LTF-EOP is estimated to be Rs.328 bn of which EFS flows were Rs.284 bn. This is the highest ever disbursement under the financing schemes to the textile sector which is likely to go even higher in the coming fiscal year, considering that financing facilities will be extended to the entire spinning sector as well. Hitherto the debt/swap facility was limited to only six sub-sectors of spinning.

Such excessive refinancing by the SBP results in reducing the central bank's profits and thereby government revenue since recently SBP's profits have been an important source of revenue for the government. The reduction in profits mainly results from huge



payments made in terms of interest rate subsidy to the commercial banks. SBP has already paid Rs.2 bn to the banks and thereby witnessed an equivalent reduction in its profits. In addition to this, in the FY08 budget, Research and Development (R&D) facility has been made available to fiber manufacturers at 3.5% and like the current year's budget, this is also channeled through the SBP. This incurs an additional cost to the central bank. Currently Rs.16.4 bn subsidy on textile R&D has been made available, reducing profits even further.

Apart from the fiscal impact of financing facilities under EPS and LTF-EOP in terms of increased government costs, it is also important to consider the impact of such financing on the money supply. Firstly refinancing, which necessarily implies creation of new money, stimulates growth of high-powered money. For e.g. textile refinancing of Rs.43.8 bn under LTF-EOP in the first ten months of the current fiscal year accounts for 29% of the reserve money growth. This together with government borrowings of Rs.173 bn for budgetary support from the banking system has resulted in money supply growth of 16.5% on an annualized basis; much beyond the annual money supply target of 13.5%. Now with an additional recipient for export refinancing; the spinning sector, we can expect a bigger number for financing disbursements and subsequently an even stronger money growth.


Moreover, the additional liquidity generated by the excessive refinancing in turn dilutes the tight monetary stance of SBP to curb inflation. For e.g. the excess liquidity in the current year could not be retailed by the commercial banks and continued to find its way back to the government securities in T-Bills auctions and the increased number of Open Market Operations witnessed lately. This distorts the overall monetary policy implementation. Excess liquidity also distorts the measures taken by the SBP for deposit mobilization of commercial banks. The enhanced cash-reserve requirement for current and saving deposits (which are low yielding relative to long-term deposits) and a rise in deposit rates on margin by the SBP though has resulted in significant growth in deposits, could have resulted in much higher deposit growth if refinancing disbursement for textile sector had not assumed such huge numbers.

The Right Step in the Right Direction

1% special surcharge is levied on all imports with the exception of petroleum products, edible oil, fertilizer, medicine and necessary food items (vegetable and pulses). Furthermore, the already exempted items will continue to be exempted from this levy.

*Budget Speech 2007-08.
Pg 34; 87*

The FY08 budget acknowledges the growing trade deficit as one of the biggest challenges facing the growing economy. Though the rising imports are rather reflective



of industrial development and the improved consumption expenditure by the individuals, their adverse impact on the trade deficit cannot be ignored. During the first eleven months of the current fiscal year, imports grew by 8.4% to USD 27.74 bn while exports showed a rather sluggish growth. As of May the trade deficit for the current fiscal year stands at USD 12.62 bn; an increase of 15.10% against the trade deficit of USD 10.63 bn for the corresponding period of the previous year while exceeding the year end deficit target of USD 9.4 bn by 34%.


Recognizing *conspicuous consumption* as one of the primary culprits for the rising imports and thereby the widening trade deficit, the federal budget announced a 1% special surcharge on all imports with the exception of some essential food and non food items to prevent the consumers from facing rising prices. While the 1% surcharge is not likely to impact the quantum of imports significantly, we would like to emphasize that it is a sensible move considering that the alternative strategy of rupee devaluation offered from most circles to control for the widening trade deficit is not the most feasible choice for our economy. The Ministry of Commerce had proposed 9% rupee devaluation in a recently held National Security Council meeting, as a tool to stimulate exports which was prudently refused by the Council on grounds that any significant rupee devaluation may cause the events of 1990s to repeat themselves. Repeated devaluation of the rupee in the previous decade had resulted in widespread uncertainty and speculation with economic agents from all sectors locking huge sums of capital in dollars both as a hedge, and as a speculative bet to optimize on dollar appreciation; a concept often known as unofficial dollarization. Moreover with the regional economies of China and India exercising local currency's appreciation, a sudden depreciation of the rupee becomes all the more an imprudent choice. Besides devaluation would mean increased prices for industry as most industrial activity is dependent on imported raw material for value addition and other industrial inputs.

Hence considering the consequences associated with currency devaluation and subsequently the government indicating clearly that in the near future there will be no sudden rupee depreciation and if any, would be very gradual, the decision to levy a surcharge on imports is a wise step taken in the right direction.

Small is Beautiful

The Private Equity Fund has been made tax exempt till 2014

In case assets or shares of private companies are sold to Private Equity and Venture Capital Funds, the rate of Capital Gains Tax has been reduced from 35% to 10%.



The profit of REITs (Real Estate Investment Trust) will be exempt from taxation up to 90%, upon distribution. The most important tax concession for REITs is that under this scheme, sellers of property will be exempt from tax up to 2010.

Budget Speech 2007-08.

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Private equity refers to the holding of stock in unlisted companies and includes forms of venture capital where professional, institutionally-backed investors provide capital to new growth businesses. In this fashion, venture capital not only facilitates access to finance for small and growing companies which otherwise would not qualify for receiving substantial credit but improves the corporate governance and accounting standards of the companies and generates employment.

The FY08 budget has exempted the private equity funds from tax payments for the next seven years. In addition CGT resulting from sale of asset/companies to private equity forms has been reduced from 35% to 10%. As a result of these measures, we are likely to witness increased number of private equity transactions in the coming year which will eventually play a significant role in business start-ups, existing small and medium enterprises (SME) and subsequently in overall economic growth.

Likewise REITs have also been exempted from tax. REITs are corporations that invest in Real Estate; they provide similar structure for investment in real estate as mutual funds provide for investment in stocks. REITs allow individual investors to enjoy the benefits of owning an interest in the securitized real estate market. The best benefit being that of fast and easy liquidation of investments in the real estate market unlike the traditional way of disposing real estate. With a tax exemption on REITs, we will see increased small investor participation in the real estate market which will subsequently stimulate the economy.

Strengthening the Roots...Not Enough?


The DTRE (Duty and Tax Remission on Exports) system is being revamped whereby the import of PSF (polyester staple fiber) will be allowed through DTRE.

For exporter the WHT (Withholding Tax) rate of 0.75% to 1% is being rationalized and 1% rate of WHT is being proposed.

Budget Speech 2007-08.

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The Textile Sector 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 government has consistently lent support to the textile industry.

In the FY08 budget, some significant measures were announced to boost the textile industry. In addition to the extension of LTF-EOP to the entire spinning sector and availability of R&D via SBP, the budget has also allowed import of PSF through DTRE whereby PSF can be imported free of duties and taxes. PSF is an important raw material for yarn manufacturing which was hitherto subjected to a 6.5% duty. This step is likely to support export of value added products in the textile chain in particular.

However the impact off the support lent by the government in the federal budget to the textile industry is likely to be neutralized by some other measures that have been implemented. The imposition of 1% surcharge on all imports except some essential food and non food items will necessarily apply to imports of raw cotton and textile machinery spares, implying increased costs for the textile industry. Besides this, the 33% increase in minimum wages to Rs.4600 per month will also add to the costs of the industry. Hence in the wake of these measures, together with below expected incentives in the first place for the textile industry, we expect the budget to have a rather neutral impact on the sector. However it still may be too early to form an opinion regarding this sector as the textile relief package is yet to be announced later this month.

Wait and Watch

Focusing on social and development spending, the Federal Budget 2007-08 is a reiteration of the government's expansionary fiscal stance. In fact it is the five years of prudent economic management by the current government which has enabled it to set PSDP allocations as high as Rs.520 bn. In addition, some key measures aimed at stimulating the capital markets and reforming the industry structure have also been announced. Though this expansionary budget is likely to build inflationary pressures, the impact of the budget on the economy, particularly in terms of inflation largely depends on the success of the SBP's Monetary Policy.

In terms of revenue, an ambitious tax collection target has been set to finance the government spending. Though several tax relief measures have been announced, the economy is likely to witness a significant increase in tax revenue collections on account of prospects of sound economic growth and thereby increased profitability and incomes.



Economic Snapshot

Fiscal year 06-07														
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April
<u>Inflation</u>														
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
<u>T-bill (Wgt Avg)</u>														
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
<u>External Sector</u>														
Export	Mln US\$	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	1536	1446
Import	Mln US\$	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	2070	2159
Trade balance	Mln US\$	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)
<u>Remittances</u>	Mln US\$	401	507	464	376	435	422	410	448	475	391	457	520	n.a
<u>Forex Reserves</u>	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



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