



MCB Bank Limited

Issue # 62

Treasury & Investment Banking Group

Quid Pro Quo

ECONOMIC REPORT

GREAT EXPECTATIONS

June 4th, 2008

The Federal Budget for the fiscal year 2008-2009 is going to be presented on June 10th 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 08-09.

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 performance of the agricultural and industrial sector. In the light of the strengths and weaknesses for FY08, the report will then present recommendations to the government for the new budget for different segments of the economy.

The information contained in this publication is for information purposes only. The information contained herein has been obtained or derived from public sources believed by us to be reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Any opinions or predictions constitute our judgment as of the date of this publication and are subject to change without notice. The information contained herein is not meant to be, nor shall it be construed as, an offer by MCB Bank Limited or any of its affiliates to offer to buy or sell any financial product. Readers are expected to make their own investment decisions without undue reliance on this report and the company accepts no responsibility whatsoever for any direct or indirect consequential loss arising from any use of this report or its contents. The Bank may from time to time hold positions in, and may effect transactions in, the currencies and securities mentioned herein.

Generally, this report may only be distributed to professional and institutional investors.

This report may not be reproduced or distributed by any person for any purpose without the prior written consent of MCB Bank Limited. Please cite source when quoting. All rights are reserved. Further information on any security or financial instrument mentioned herein is available on request.



ECONOMIC REVIEW – FY08

This fiscal year witnessed a notable turnaround in Pakistan's economic performance compared to the previous year. GDP growth rate is set to miss the 7.2% target by a huge margin. In our estimation it will most certainly be below 6%, which is in line with SBP's revised estimation of 5.5-6%. This slowdown can be attributed to a number of issues not least the global economic slowdown which has resulted in exports dwindling in comparison to surging imports. The government also has a monumental task of collecting PKR 140 bn for June in order to meet its revised tax revenue target of PKR 990 bn, not an easy feat to achieve. FDI has dipped greatly to \$3.5 bn in Jul-Apr compared to \$4.2 bn in the same period last fiscal year. The upside has been worker remittances which continued to show strong growth until April, rising by nearly 20% in the Jul-Apr period YoY.

However, this is essentially where the good news ends. The agriculture and manufacturing sector have both registered dismal growth rates. The agriculture sector is set to miss its growth target on the back of disappointing production of the two major crops cotton and wheat. Large Scale Manufacturing (LSM) has slowed significantly to 4.8% in Jul-Mar compared to 9% last fiscal year. The services sector on the other hand is poised to achieve its targeted growth rate.

In the next few pages, this report will look at the performance of the economy more closely, focusing on the agriculture and manufacturing sectors before moving towards budget expectations.





EXPENDITURE AND REVENUE ACCOUNTS

The Central Board of Revenue has collected an estimated PKR 850 bn thus far, leaving it with a PKR 140 bn target for June 2008. Direct taxes since December have failed to reach expected targets resulting in a huge decrease in direct taxes. They grew by 8.3% compared to 55.7% increase last fiscal year.

To add to this, incremental government borrowing has reached PKR 551 bn, pushing outstanding treasury bills with the State Bank to PKR 940.6 bn. This increase in borrowing can be attributed to higher international oil prices and subsequent subsidy payouts. With import costs and subsidies increasing on one hand and negative growth in external receipts on account of political uncertainty, the government had little choice but to turn to the State Bank for financing. This stimulated strong growth in monetary aggregates, boosting inflationary pressures in the economy and pushing it towards macroeconomic instability.

AGRICULTURE—BAD BACK OF THE ECONOMY

Pakistan has been hit hard by the poor performance of the agriculture sector. The sector will not be able to reach its target because of poor performance by major cash crops which, despite strong livestock and minor crop performance.

Sugarcane turned in a record harvest and large bumper crop, but a decrease in value addition from *kharif* crops and wheat will undermine this. What is worse is the fact that Pakistan was not able to benefit from high international prices for these crops. Pakistan is predominantly an agrarian country being able to produce crops like wheat and cotton cheaply. However, due to low productivity and output, Pakistan could not benefit from the unusually high international prices.

Production (000 tons; cotton in 000 bales of 170.09 kg each)						
Crops	FY06	FY07 ¹	FY07 ²	FY08 ¹	FY08 ²	over FY07
Cotton	13,019	13,820	12,856	14,140	11,655	-9.3
Sugarcane	44,651	50,500	54,871	55,871	62,300	13.5
Rice	5,547	5,693	5,439	5,721	5,559	2.2
Wheat	21,277	22,000	23,295	24,045	-	-
Gram	536	707	848	707	-	-
Maize	3,110	3,279	2,907	3,221	3,248	11.7

Source SBP Third Quarterly Report—Production

GREAT EXPECTATIONS



MANUFACTURING—GRINDING TO A HALT

The manufacturing sector suffered during the fiscal year, mainly due to the energy crisis, international commodity price hikes and domestic political unrest. Due to a blend of these factors the LSM sector recorded a growth of only 4.8%, nearly half of the 9% growth witnessed in the same period last year.

The power crisis in particular caused operational headaches, as large machines and industrial units could not run at optimum levels, adding to operational costs of manufacturers. The metals sub-sector, textiles and chemicals industries, which all showed strong growth and promising results in the previous year were hit hard showing poor growth this term.

Upon closer inspection, a major part of the growth in Jul-Mar period for this fiscal year has been the sharp rise in sugar production. As mentioned earlier sugarcane production turned in a record harvest growing by 13.5%. Excluding sugar production LSM growth falls by 1.5%, from 4.8% to 3.3%, an astonishing figure.

	Real value addition (billion rupees)		percent growth
	FY07	FY08	
Rice	55.6	56.8	2.2
Cotton	93.8	84.8	-9.7
Sugarcane	44.5	50.6	13.9
<i>Kharif</i> sub-total	193.9	192.2	-0.9
Assumed wheat harvest (million tons)	Value addition in FY08		Growth by 4- major crops
	Wheat	Major crops	
22	147.5	339.7	-3.3
23	154.2	346.4	-1.4
24	160.9	353.1	0.5

**Source SBP Third Quarterly Report—
Estimation of Value Addition by Four
Major Crops**



GREAT EXPECTATIONS—FY09

Needless to say, everyone in the private sector as well as public sector, are likening the budget to the light at the end of the tunnel. This fiscal year has been harsh for all consumers who have had to endure record price increases in ghee/edible oil, food items, electricity, petrol, CNG etc. Throwing soaring exchange rate and near political anarchy into the mix, has left the populace hapless and drained. Therefore, high expectations of a great many people are attached with the forthcoming budget on June 10th.

The government needs to instill immediate public confidence by planning and implementing sound policies. The elected government has come on popular mandate and there is general consensus the budget will address the most dire problems people are facing.

RATIONALIZING EXPENDITURE

As mentioned earlier, a major problem this year has been excessive government borrowings, which increased money supply, negating the tight monetary policy stance of the State Bank, hence increasing inflationary pressures on the economy. To add to this, imported inflation and high international commodity prices pass through, have also added to demand push inflation.

A decrease in excess fiscal spending, transfer of high international oil prices to consumers and continued monetary policy tightening are all necessary to rein in inflation.

It is expected the government will decrease PSDP by approximately 5%. According to the Planning Commission Deputy Chairman, PSDP will make a sharp change in direction for immediate relief to the poor and also focus on physical and social infrastructure projects for sustainable and equitable growth.



Development in the power sector is absolutely crucial for the upcoming budget because power shortages have been crippling for the LSM sector. A sizeable amount of development funds should be devoted towards coal generated power. Pakistan has one of the largest coal reserves in the world but coal power generation is only 5% of total power output compared to regional averages of above 50%.

Similarly, hydel power plants currently generate only 33% of total electricity consumed in the economy. However, the country has vast hydel resources which have the capacity to yield over 42,000 MW of electricity according to various studies while barely 15% of the country's hydel resources have been tapped in the last six decades by constructing reservoirs, barrages and dams. Hence there still exists huge potential for enhancing electricity generation from hydel resources. In order to tap these hydel resources the government does not necessarily need to invest in more projects like Kalabagh and Bhasha Dam, which require huge capital investment and time to complete. Instead hydel resources can be utilized effectively by developing micro hydel plants over several of the small and large rivers located particularly in the Mountainous Northern half of the country. There is abundance of perennial streams, waterfalls and canals in these areas which can be successfully exploited to generate electricity and mechanical electricity by developing micro hydro electricity plants. The technology needed for the process is fairly simple and needs low capital investment. These plants will not only produce low cost hydel electricity but can be utilized for development and uplift of far-flung, isolated and remote areas of the country.

Investing in these sectors will help ease pressure on the huge import bills inflated by high international oil prices, trimming trade deficit in the future.





SOWING NEW SEEDS—AGRICULTURE

Recent data points to growth rate substantially below the annual target. There was hope of a strong wheat harvest towards the end of FY08, however, there are fears the crop will fall below estimates. Due to this the major crops will offset high productivity of minor crops and livestock and drag growth into negative.

World commodity prices are expected to remain high, therefore it is important for the government to design policies and devote a sizeable portion of the budget to this sector's development and productivity. We recommend policies to boost wheat and cotton production. Policies should include subsidies on fertilizer, developing irrigation methods to reduce water wastage, and establishing forward markets which will strengthen the present procurement price system to give market prices to farmers.

The government needs to rationalize commodity prices by offering a higher price to farmers. This will provide an incentive for them to increase production and help reduce the occurrence of production shortfalls, which is the root cause of price increases. To protect the consumers on the other hand, the government must rationalize its current subsidy programs, introducing targeted subsidies.

This implies that the government will have to streamline its current broad based subsidies. One way of achieving this is via distribution of ration cards. Nonetheless, any such approach has always fallen prey to corruption in our economy. Therefore it is critical that the government puts in place a transparent selection process before developing targeted subsidies. Alongside or in place of the distribution of ration cards, the government can place mobile distribution units whereby mobile units, say trucks, can distribute wheat to the inhabitants of a targeted area at a subsidized price.





In addition, a number of measures and policy decisions can be put into place to combat production short falls. Such as, allowing the private sector to import commodities when supply is low. This policy will help stabilize market prices at no cost to the government, as deficit commodities will be imported.

Maintaining a constant presence through delivery of consistent commodity supply is essential for penetrating international markets. Given the recent trend of high international prices, agricultural exports can help Pakistan lessen its trade deficit and ensure food security and spur economic growth.

LEADING A HELPING HAND—MANUFACTURING

The LSM sector posted dismal performance this year, with major sectors showing negative or poor growth in the Jul-Mar period. The textile, fertilizer, automobile, chemicals, paper, tyre and metal industries all posted dull growth figures. However, we can take heart that most of these industries were affected by short term events rather than longer term problems hampering growth. Weak cotton harvest, political unrest, power shortage and closure of certain sectors for up-gradation are among some of the factors which affected growth.

The cement industry in particular performed well, driving the manufacturing sector exports along with garments and pharmaceutical products. This is the second year running when the cement sector has posted positive growth, despite operational disruptions throughout the year. Increased productive capacity and high regional demand by countries like Afghanistan and Sri





Lanka have helped cement exports swell. The sugar sector showed stalwart growth, on the back of a bumper crop, accounting for nearly 1.5% of the 4.8% growth in LSM. Hence the government must mobilize idle capacity in these sectors, providing relief to the domestic market and improving exports. Given the remarkable resilience and still strong demand in the economy the government should be able to stimulate growth with the right policies. By removing import duties on raw materials, components and machinery in the upcoming budget, the government can stimulate LSM growth.

REVENUE SIDE OF BUDGET

Tax collection, which is a major source of government income, remained dreary in the first two quarters of the current fiscal year. However, revenues are expected to improve third quarter onwards, as tax receipts have increased and there is disbursement of budgetary support grants.

Nonetheless the government is expected to miss its PKR 990 billion revised target, needing around PKR 140 bn for the month of June 2008. Even so, it is expected next year's revenue collection target will be above the PKR 1 trillion mark. This is because the government is planning to broaden its tax base and also introduce new taxes on luxury items. There are also indications the government is seeking other avenues of financing and curb expenditure growth, which should ease pressure on public borrowings from the State Bank.

The tax collection target is ambitious but achievable, keeping in mind the government's commitment to stimulate the manufacturing and agriculture sectors during the next fiscal year. A drastic fall in direct taxes was a major reason for revision of the tax target, because direct taxes contribute nearly 40% towards the annual target. This fall in direct taxes has largely been due to low profitability of important sectors like banking, telecommunication and oil and gas. If the government is able to stimulate growth in these two major sectors then a tax target of PKR 1 trillion and above can be realized.



CONCLUSION

Taking into consideration recent international and more importantly domestic developments the government needs to step up and take the bull by the horns. It has a colossal task of appeasing an increasingly distressed populace, badgered by inflation and political crisis. At the same time, the government must look after the interests of agriculture and manufacture sectors, which have displayed tremendous potential for growth and profitability.



ECONOMIC SNAPSHOT

Fiscal Year 2007-08														
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
<u>Inflation</u>														
Headline Inflation	%	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2
Core inflation	%	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8
Food inflation	%	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5
Non-food inflation	%	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59
6 month	%	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86
12 month	%	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13
<u>External Sector</u>														
Export	Mln US\$	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,816	n.a
Import	Mln US\$	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,458	n.a
Trade balance	Mln US\$	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1637)	n.a
<u>Remittances</u>	Mln US\$	513	537	505	495	489	516	580	505	479	557	502	602	590
<u>Forex Reserves</u>	Mln US\$	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,255



Research Desk

Treasury and Investment Banking Group

MCB BANK LIMITED

20th Floor, MCB Tower, I.I Chundrigar Road.

Karachi

Contact

Shan Husain

Research Analyst

Telephone: 92-111-000-111 Ext. 4420

0321-2345300

Email: shan.husain@mcb.com.pk

Sana Qureshi

Senior Economist

Telephone: 92-111-000-111 Ext. 4420

0333-3800744

Email: sanaqureshi@mcb.com.pk

Fax: 92-21-2270094

All previous issues of Quid Pro Quo are available on the following web link:

http://www.mcb.com.pk/quick_links/economic_reports.asp