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Quid Pro Quo

ECONOMIC REPORT

PICKING UP THE PIECES

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The Federal Budget 2008-09, released last week has been popularized as a populist budget, with '*roti, kapra and makan*' its main slogan and is aiming to relieve the hardships our nation is facing. However, focus has been lost from the impact that some of the measures announced in the budget FY09 will have on the economy. This report will concentrate on analyzing the measures that will significantly affect the economy and its future growth.

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FEDERAL BUDGET 2008-2009

Receipts	
a. Tax Revenue	1251.5
b. Non-Tax Revenue	427.8
Gross Revenue Receipts	1679.2
Less Provincila Share	568.3
1. Net Revenue Receipts	1110.9
2. Net Capital Receipts	221.3
3. External Receipts	300.2
4. Self Financing of PSDP by Provinces	124.4
5. Change in Provincial Cash Balance	78.9
6. Privatisation Proceeds	25.1
7. Bank Borrowing	149.0
TOTAL RESOURCES (1 to 7)	2009.8
Expenditure	
A. CURRENT	1493.2
General Public Service	929.5
Defence Affairs & Services	296.1
Public Order Safety Affairs	26.8
Economic Affairs	201.2
Environment Protection	0.2
Housing and Community	1.4
Health Affairs and Services	5.5
Recreational, Cultural Services	3.2
Education Affairs Service	24.6
Social Protection	4.8
B. DEVELOPMENT	516.6
PSDP	549.7
Federal Government	399.7
Provincial Governement	150.0
Est. Operational Shortfall	-77.0
Other Dev. Expenditure	43.9
TOTAL EXPENDITURE (A+B)	2009.8



POPULIST RHETORIC - PEELING BACK THE LAYERS

The National Economic Council has approved a development plan of PKR 549.7 bn under PSDP for the year 2008-2009. This represents an increase of nearly 5% over the budgetary target from last fiscal year.

Basic pay for all Federal Government employees and defence services is being raised by 20% increase.

Net pension for all civilian and defence pensioners is being increased by 20% increase.

Conveyance allowance for government employees is being increased by 100%.

Minimum wage is being increased from PKR 4600 to PKR 6000 per month.

Keeping with the slogan of 'Roti, Kapra and Makan' one million housing units will be added to the country's housing stock, for low income groups and government employees.

Government will recruit 100,000 more LHWs (Lady Health Workers) during the year.

'Benazir Income Support Program' will give a cash grant of PKR 1000 to the poorest of the poor. PKR 34 bn to PKR 50 bn is being allocated for this purpose.

An allocation of PKR 66 bn is proposed for a number of power sector projects. It is estimated that 2200 MW of power will be brought on stream by early next year and we will not face the same situation as during this year.

Support price of wheat is being increased from PKR 510 to PKR 625 per 40kg bag.

Government will more than double the subsidy on DAP fertilizer from PKR 470 per bag to PKR 1000 per bag.

Complete exemption from sales tax and other duties on imported and local supply of fertilizers and pesticides, so that farmers can get these at much cheaper prices.

To enhance supply of quality seeds to farmers, a National Commercial Seed Production Program is being prepared. Negotiations have been started for fast track, formal release of BT cotton seed varieties in Pakistan.

Budget Speech 2008-2009



The Federal Budget 2008-2009 has proposed a total outlay of PKR 2.01 trillion and envisages a revenue target of PKR 1.679 tr, including a tax collection target of PKR 1.25 tr to be collected by FBR. Subsequently a fiscal deficit of 4.7% is targeted, up from the estimated 4% last fiscal year. This gap will be bridged by raising money externally and internally, with an emphasis on reducing government borrowings from the State Bank, which crossed PKR 560 bn in the first 11 months of current fiscal year.

The government has put stress on the importance of public investment to maintain growth, which has been set at 5.5% of GDP. Funds available for PSDP are approximately PKR 550 bn an increase of only 5% compared to last year. This is a sign of the tight fiscal situation and the government's commitment to bring deficit down. The government is also aiming to control inflation at 12% for next term. Subsidies worth approximately PKR 50 bn have been allotted to WAPDA and National Highway authority, whereas PKR 62.5 bn have been assigned for Special Programmes including People's work program and Income Support Program. In addition, minimum wages, pensions, basic pay and transport allowance have been increased to bring relief to the working class.

Even a quick overview of the budget shows the government's commitment to bring economic and fiscal indicators under control while maintaining a semblance of its populist, '*roti, kapra and makan*' and '*social justice*' ideology. In this report we will concentrate on analyzing the measures that will significantly affect our economy and future economic growth.





THE ELEVENTH HOUR - AGRICULTURE

Agriculture is the backbone of the economy which remained neglected and sidelined during the last 8 years. Numerous measures and policy directions are being put in place to ensure relief and motivation to farmers as well as incentives to the agriculture sector.

Budget Speech 2008-2009

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The new government has duly recognized the importance of a strong agriculture sector for sustained economic growth. Therefore numerous policy actions and measures are being taken in the upcoming budget to stimulate and lift this sector.

One vital step has been to increase support price of wheat from PKR 510 to PKR 625 per 40 kg bag. This is because even though food prices went up in the country, farmers were not able to sell at these price levels due to low procurement prices set by the previous government. Furthermore, farmers have had to endure high input prices as a result of inflation, e.g. heavy diesel oil price crossed PKR 50 per liter. Facing these costs the natural step was to increase procurement prices, to help farmers earn more and to encourage cultivation for FY09. In addition to this the government will review procurement price levels before the next sowing season in August-September.

Another significant policy was the government's announcement to more than double subsidy on DAP fertilizer from PKR 470 to PKR 1000 per bag. Last fiscal year expensive fertilizer deterred farmers from using it, thereby reducing crop yield drastically. Also complete exemption from sales tax and other duties has been granted to fertilizer and pesticides whether imported or supplied locally. Doubling of subsidy on DAP and this exemption will encourage greater fertilizer off-take and favourably impact the agriculture sector by increasing yields and output.



Pakistan's dairy and livestock sectors have shown tremendous potential for growth in recent years, by taking Pakistan from a milk deficient country to an almost self sufficient one. In the process we have become the fifth largest milk producer in the world with an estimated 33 billion liters of annual milk production, from approximately 50 million animals. However, vast room for improvement exists as the gap between potential yield and actual yield is very high. Recognizing this potential for growth the Prime Minister under his Special Initiative has allotted PKR 1.5 bn for '*White Revolution*', through PSDP. This will hopefully, boost output and yield significantly and allow export of milk abroad. Demand for milk has slowly risen in international markets as the standard of living around the world, specially Asian countries, has risen.

Apart from these policies, the government has planned budgetary support to improve availability and efficient use of water by constructing dams and revamping existing irrigation systems. A National Commercial Seed Production Program has been prepared to provide high quality seeds to farmers, including BT cotton varieties. Establishment of cold chains across Pakistan, import of bulldozers for cultivation, exemption from 5% FED on crop insurance and 23% increase in loans to PKR 160 bn for the agriculture sector have also been proposed.

These steps look set to revamp the agriculture sector in FY09, and we think the government can achieve its agriculture growth target of 3.5% for the same period. Steps have been taken to try and bring down input prices for farmers and at the same time increase profits by raising procurement prices. Aside from farmers the sector as a whole will benefit from the numerous tax/duty exemptions and favourable economic environment. If the policies prove successful, a bumper crop will benefit the country by reducing trade deficit allowing us to benefit from the prevailing high international commodity prices.





POWERING UP

We are undertaking numerous measures in the short term, medium term and long term to relieve the people, industry and agriculture from the menace of electricity shortages.

Government is attaching highest priority to reduce the demand supply gap for power.

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The demand supply gap at peak hours has been recorded at approximately 4500 MW. To overcome this shortage, some of the government's short term steps include conserving energy and improving efficiency to save up to 1500 MW of electricity. Also in line with this strategy, round the clock electricity has been promised to the textile industry, 18 hours electricity for flour and ghee mills and 10 hours continuous electricity for agriculture tube wells.

Moreover in FY09 the government is embarking on an '*Energy Saving Incentives*' strategy. In this the customs duty on import of energy saver lamps, generators and deep cycle batteries for use in solar panels will be exempted. It is believed use of energy lamps alone will save up to 1000 MW of energy.

WAPDA is temporarily being allowed to import power generation plants free of the 5% customs duty it would normally pay. This will help increase investment in the power sector. The government in addition wants major investment from the private sector through its Energy Policy of 1994. This policy restricts public sector to providing supportive infrastructure, policy making and regulatory responsibilities. But keeping in perspective the urgency of the situation PKR 66 bn has been allocated for a number of power sector projects, which will start providing 2200 MW of energy by early next year.

Given the almost 9% annual increase in energy demand during the past 4 years, the previous government's failure to invest in the energy sector has led to a severe energy crisis. However, these policies portray a positive outlook for FY09. A combination of import exemption and limit on public sector investment in accordance with the 1994 policy, will encourage investment from the private sector. Private investment may prove key to the success of the government's policies. Not only will it boost investment and increase energy output but it will also help the government control expenditure.



GIVING FROM ONE HAND, TAKING FROM THE OTHER

Main plank of democratic government's economic policy will be human development and poverty reduction.

A number of far reaching steps have been taken to control the expenditures so that the burden on budget is reduced. However, such measures are not enough... Accordingly the rest of the burden will have to be shared by carrying out a more diligent and concerted effort on revenue mobilization.

The objective is to convert Tax Administration into a modern, progressive, effective and credible organization... increasing the tax to GDP ratio, broadening the tax base... promoting compliance with tax laws.

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Due to rising commodity prices and skyrocketing inflation, low income workers have been forced to live hand to mouth, while a large stratum of population has been pushed below the poverty line. The government has deployed a 'multi-pronged strategy' to tackle poverty and increasing hardship. The plan includes enhancing expenditure for poverty reduction, increasing incomes of low income workers and providing low cost housing.

For the hardest hit people, the government has introduced a number of programmes, one of which is the Benazir Income Support Program, that will pay a cash grant of PKR 1000 to PKR 1500 per month, to eligible households. PKR 34 bn have been appropriated for this program and will help subdue the upward trend on poverty. The People's Works Program, with an allocation of PKR 28.4 bn, has been introduced to improve access of low income groups to basic necessities of life. Other than this, special consideration for development of women has been taken, by implementing a 10% quota for women in all government departments and the announcement that 100,000 Lady Health Workers (LHW) will be employed in FY09.

Even though budget allocation has been denied for Khushal Pakistan Program, these policies will help fight poverty at grass root level. Giving cash grants is not the ideal policy tool from a purely economic standpoint, however 19.3% CPI infla-



tion YoY in May along with 28.5% YoY food inflation for the same period, has left little choice for the government but to give payouts. Whether this payout actually exacerbates the problem remains to be seen, since now there will be more money chasing fewer goods.

Apart from targeting the poorest of the poor, the government has also stepped up to provide relief to the salaried class. Minimum wages have been increased from PKR 4600 to PKR 6000 per month, salaries of government officials have been increased by 20% and pension has been increased by 20%. Although due to escalating price levels it was necessary to aid the buying power of fixed income individuals, these steps will contribute to inflation in the economy. Coupled with cash grants under the Benazir Program, this higher buying power could prove costly to the economy.

On the one hand, the government is aiming to boost income and provide relief to the poor, and on the other it intends to increase revenue generation and curtail consumption through taxation and duties.

Pinching Pockets – Strap Your Belts ‘Tightly’

Withholding tax on cash withdrawals from banks has been increased to 0.3% from 0.2%, also FED has gone up from 5% to 10% on banking, insurance and franchise services. This will assist GOP in reaching its ambitious tax collection target of PKR 1.25 tr, without significantly impacting bank earnings. To add to this, small companies with turnovers exceeding PKR 250 mn will be taxed at 25%, 30% and 35% slabs, above this amount. On the retail side, GST has been increased to 16% up from 15%, which will have the immediate affect of fanning inflation. Higher GST combined with increased buying power of the salaried and lower classes will add significantly to inflationary pressure, since propensity to save for low income individuals is very low.

To reduce trade deficit, imported inflation and domestic consumption, import duties on 300 non-essential luxury items (from 15%, 20% and 25% slabs, to 30% and 35% slabs), duty on cars above 1800cc (from 90% to 100%), FED on telecommunication services (from 15% to 21%), FED on cement (from PKR 700 PMT to PKR 900 PMT), have all been increased. Although this is a move away from the trade liberalization policy, increasing subsidies will remove hot air from the import consumption bubble. However, with greater money supply in the market, this may again add to inflation and directly impact the current account.



The risk of inflation spiraling out of control coupled with contractionary fiscal policy may give rise to stagflation. To add to this, the Finance Minister stated unequivocally that monetary policy will be used to reign in inflation in FY09. Therefore, rising inflation and tightening monetary policy is a real possibility in FY09, a situation that will adversely affect the services sector. Even removing excess liquidity through launching Government Commercial Papers and PIBs may not be enough to reduce this pressure.





WEAVING OUR WAY THROUGH

Pakistan has to make important strategic choices to ensure sustainable growth in the manufacturing sector in a rapidly changing and challenging international competitive environment.

Our industry is losing its competitive edge, which is most notably reflected in the slow down in all categories of textiles, which is the mainstay of exports.

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Pakistan's industrial sector suffered during FY08, mainly due to 'procedural irritants' which increased inefficiencies and input costs for businesses. In budget 2008-09, numerous policies have been made to fuel the manufacturing sector.

Import duties on raw materials have been reduced to lower slabs, along with reduction of duties on several products such as PTA, PSF (Polyester Staple Fibre), printing screens and calcium carbide. A number of industrial estates and export processing zones are being established to attract domestic and foreign investment. To make these zones feasible to investment major infrastructure developments are planned to enhance communication links, in the form of roads, railways, ports and terminals. PKR 37 bn has been allocated for development of roads all over Pakistan. This is a step in the right direction as infrastructure improvement will not only provide jobs but will also stimulate investment in manufacturing.

The proposed subsidies in budget 2008-09 will in particular benefit the textile and chemical sectors. This is because custom duties on many of their inputs have been slashed. Leading to reduction in production costs making the prices of our products competitive in international markets.

Although reduction in custom duty will lead to higher imports, these are selective cuts which will promote the waning LSM sector, restoring investor confidence and bring back foreign investment. However, export surplus is essential to help counter balance the higher import bill. Failure of the manufacturing sector to contribute meaningfully to exports will worsen trade deficit.



CONCLUSION - JUGGLING ACT

Budget 2008-2009 is attempting to tackle several key issues simultaneously. It aims to restrict inflation and consumption, while providing relief to the poor, ensuring enough development to stimulate agriculture, manufacturing and energy sectors, all the while trying to maintain fiscal discipline.

The envisaged targets of 4.7% fiscal deficit, 6% current account deficit and maintaining inflation under 12%, are ambitious. Effective implementation will be key if the government is to pull off this juggling act come July next year.



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

Cell: 92-321-2345300

Email: shan.husain@mcb.com.pk

Fax: 92-21-2270094

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