



MCB Bank Limited

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**Treasury & Investment Banking Group**

## *Quid Pro Quo*

### ECONOMIC REPORT

**SIZE SHOULDN'T MATTER**

July 2nd, 2008

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**Budget FY09 introduced numerous policies to incentivize the manufacturing, agriculture and power sectors. However in doing so, the government did not give due consideration to the Small and Medium Enterprise (SME) sector, which constitutes an important part of the economy. Consequently, manufacturers in this sector are facing difficulties not only because of government policies such as increased taxes but also because of inflation and the rising cost of doing business.**

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## BUDGET

*General Sales Tax (GST) increased from 15% to 16%*

*FED on bank, insurance and franchise services increased from 5% to 10%*

*In case of small company, if turnover exceeds PKR 250 mn, the income attributable to the turnover exceeding the said limit, is proposed to be charged at progressive slab rates of 25%, 30% and 35%.*

*Increase in minimum wages from PKR 4600 to PKR 6000, a more than 30% increase.*

*In order to incentivise the investment in domestic manufacturing industry, the government allows import of raw materials, parts and components etc. either at zero or reduced rate of duty provided these are not manufactured locally.*

*Budget Speech 2008-2009*

SIZE SHOULDN'T MATTER



## OVERLOOKED

The government in this year's budget has singled out the manufacturing, agriculture and power sectors for reforms.

Efforts have been made to reduce input costs and stimulate these sectors. For instance, the agriculture sector will receive more than double the subsidy on DAP fertilizer from PKR 470 to PKR 1000 per bag, and a higher support price of wheat from PKR 510 to PKR 625 per 40 kg 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 also been granted to fertilizer and pesticides, whether imported or supplied locally. Development expenditure has been set aside to improve availability and efficient use of water by constructing dams and revamping existing irrigation systems. The agriculture sector has also been given exemption from 5% FED on crop insurance and a 23% increase in loans amounting to PKR 160 bn.

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

However, these policies aimed at stimulating the overall industrial sector are selective in nature which will chiefly benefit the textile, fertilizer and chemical industries and not the Small and Medium Enterprise (SME) sector.





## WRONG SIZE

Pakistan's SME sector is quite large in terms of consumer base and employment. This sector plays a vital role in our economy, providing employment and boosting the middle class. According to Economic Consensus of Pakistan 2005 there were approximately 3.2 million business enterprises in the economy, out of which over 99% were SMEs. This sector also employed an estimated 78% of industrial labour and contributed around 30% towards GDP.

Even so these SMEs often operate with limited financial resources, this makes them vulnerable to political and economic shocks which often leads to cessation of business. This is highlighted by the fact that 19% of SMEs are less than 5 years old and only 4% make it to their 25<sup>th</sup> year.

Rising costs due to inflation have already driven SME's profit margins to the edge. While large enterprises can withstand the ups and downs of economic turmoil, SMEs due to their small size and limited resources are less capable of adjusting to shocks, making it difficult for them to survive. Therefore, treating LSM and SME sectors equally is discriminating since the size of firms creates a wedge between them.

LSMs are able to use their size to form sector wide unions to voice opinions and policy suggestions to the government. By creating this platform the government pays heed to them allowing large manufacturers to dictate terms for the benefit of their respective organizations. By continually voicing their problems these manufacturers stay in the government's focus, hence they are also able to negotiate better terms for their businesses.

Hence taking into account the recent turbulence and inflation in the local economy, either due to endogenous or exogenous shocks, it was important for the government to come out and support SMEs. However, the budget released on June 11<sup>th</sup> did not do enough to facilitate them.



So as to help reduce the cost of doing business for the manufacturing sector import duties on raw materials were decreased to slabs of 5% and 10%. In theory, this would be the logical trade policy to employ if the government wanted to rouse industrial sector growth as a whole, however, most of the duty reductions have been customized for the large scale manufacturing sector and may not benefit SMEs. For example, the government has attempted to give pinpoint support to the textile and chemical sectors by providing import duty cuts on items such as PTA, calcium carbide, caustic soda, printing screens, buckram, and bitumen, which are all raw materials used by these sectors. Such moves will only be able to help in a very limited way, the wider and more diversified SME sector.

Given that the LSM sector received sizeable benefits from budget 2008-09, when the government moved to take more money from manufacturers vis-à-vis, large manufacturers were not entirely at loss, whereas SMEs with already depleted pockets and no specific policy supports were on the losing end.

SIZE SHOULDN'T MATTER





## TAXED TO THE BRINK

If rising costs of doing business were not enough businesses now have to pay more taxes as well. An ambitious tax target of PKR 1.25 trillion has been set for FY09. The government instead of expanding the tax base, notably exempting the stock market from CGT until 2010, has decided to collect more taxes from existing sources. Numerous tax and FED increases for next fiscal year have been implemented in this regard.

Taxes on turnover above PKR 250 million are being increased at progressive slabs rates of 25%, 30% and 35%. This will inevitably reduce profitability for manufacturers and reduce their scope of investment and growth. Aside from directly taxing company revenue, the government has increased sales tax across the board from 15% to 16%. Although this is an indirect tax and is theoretically passed onto consumers, SMEs in Pakistan are not always able to do this for a number of reasons. First and foremost, the majority of consumers targeted by small industries belong to low income groups who have small disposable incomes and subsequently high price elasticity of demand, meaning a small change in price for them brings about a large change in demand. Therefore, if the increase in GST is passed onto consumers, demand for products will fall by a greater margin than the increase in price, harming profitability of SMEs. Another option for manufacturers is to withstand this increase in GST and not pass it onto consumers, however, this will be detrimental to business profitability maybe even more so than increasing prices. Finally, businesses might be forced not to report sales in an attempt to maintain revenue and profitability as well. This has often been employed in Pakistan by small manufacturers who have small profit margins and are hit hard by GST. If this were to happen it would be against the government's objective of increasing revenue.

Another change in policy which impacted businesses was the increase in FED on bank, insurance and franchise services from 5% to 10%, increasing the cost of day to day operations for all SMEs overnight. Also enhancing FED on telecommunications from 15% to 21%, introducing 0.75% tax on electric goods and increasing taxes on electricity bills, have overall raised the cost of doing business.

To add to this, soaring inflation due to macroeconomic instability has made the situation critical. Manufacturers next fiscal year may find their bottom lines in red because of soaring costs.



## INFLATION

As dust settles on the budget one thing is clear, the gloom hanging over Pakistan's economy has not been lifted. The government targeted masses, agriculture and LSM sectors as they are the engine of any economy, but have not adequately addressed the problem of inflation, which is threatening to spiral out of control.

SMEs face ever higher input and running costs because of rising prices, CPI inflation for the month of May was at an all time high of 19.3% YoY. This upward trend is set to remain strong because of the government's announcement to phase out oil subsidies by the end of this calendar year. Removing subsidies although necessary from a macroeconomic point of view, will most certainly increase inflationary pressure because any increase in energy prices specially diesel, has a significant impact on overall price levels.

In addition, to provide assistance from rising inflation the government increased minimum wages by 30% from PKR 4600 to PKR 6000, which mean higher input costs for small manufacturers. Also salaries of government employees have been raised by 20%, pension by 20% and PKR 54 bn has been set aside for cash payouts to the poorest strata under Benazir Income Support Program. This is welcome relief to the poor and salaried class, however such policies should be taken with a pinch of salt. This is because they will increase currency in circulation, hence stoking the inflationary fire.

Reigning in inflation has been left largely to monetary policy, with the Finance Minister stating emphatically that monetary policy will be tightened further to control rising price levels. However, it remains to be seen how effective a tightening monetary policy will prove to be, specially considering that the fiscal policy is not in tandem.



## **TIGHTENING THE NOOSE**

The State Bank of Pakistan is expected to increase discount rates over the course of FY09. The idea is simple, removing excess currency from the market will stop prices from rising further. Whether tightening monetary policy proves successful or not remains to be seen, but it will have a definite impact on all businesses.

Increasing input costs, taxes, and duties and imposing the 35% L/C margin required for opening import L/Cs means businesses are short of working capital, forcing them to turn to financial institutions for lending. However on the other hand, high discount rates in light of monetary tightening have increased costs of borrowing. Taking this into consideration the State Bank released a list of items exempted from the L/C margin requirement, but it constituted mainly of raw materials used by the LSM sector. SMEs requiring greater assistance due to their small size were left out, worsening their working capital position. This will most certainly lead to slow growth and a greater number of closures in the SME sector.

Tightening monetary policy creates a climate of low investor and consumer sentiment. High inflation coupled with high borrowing also means diminished buying power of consumers, which drives sales down. The government needs to pay more attention and lend policy specific support to the SME sector to counterbalance the negative effect of small size and remove dogmatic policy burdens.

## **CONCLUSION**

Currently the SME sector is stuck in a quagmire of problems, where high operating costs, high taxes and inflation are the order of the day. Profit margins have shrunk drastically and unless the government provides determined support this essential sector will suffer.





## ECONOMIC SNAPSHOT

Fiscal Year 2007-08															
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
<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	19.3
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	12.3
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	28.5
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	12.5
<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	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	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	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	1,833	1,862	1,954
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	3,549	3,406	3,241
Trade balance	Mln US\$	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)
<u>Remittances</u>	Mln US\$	513	537	505	495	489	516	580	505	479	557	502	602	590	584
<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	12,362	11,258

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