



MCB Bank Limited

Issue # 80

**Treasury & FX Group**

## *Quid Pro Quo*

### ECONOMIC REPORT

March 28th, 2009

### REFOCUSING

---

Pakistan in preceding weeks witnessed an upsurge in political noise, originating from the judiciary movement, supported by opposition parties and culminating in the long march. The country came to a standstill as the capital was shut down and containers put on roads to block protesters in various cities. However, Prime Minister Yousuf Raza Gillani's 6:00 a.m. (16th Mar'09) announcement of the reinstatement of the judiciary and Chief Justice Iftikhar M. Chaudhry instantly diffused tensions and averted political standoff and street agitations.

Even though some sticking points remain, like Governor Rule and ineligibility case of Sharif brothers, the political climate is calmer compared to earlier weeks. The country is now recovering and there is optimism that the government can finally focus on the much beleaguered 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.

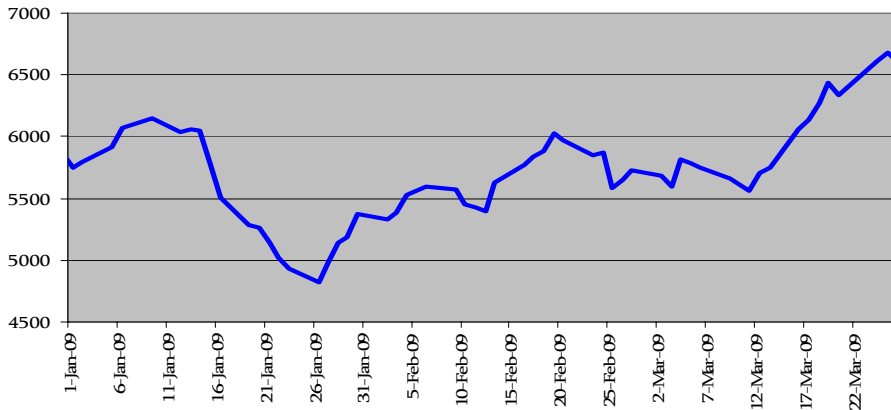
Generally, this report may only be distributed to professional and institutional investors.

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.



## OPTIMISM & RELIEF ALL ROUND

Markets have been buoyed following dissipation of political uncertainty. KSE100 index has surged approximately 12.20% since the PM's announcement on 16<sup>th</sup> March (6063 to 6803 as of 27<sup>th</sup> March).



KSE100 Index: Jan-Mar'09

Source: Bloomberg

Markets have been buoyed following dissipation of political uncertainty. KSE100 index has surged approximately 12.20% since the PM's announcement on 16<sup>th</sup> March (6063 to 6803 as of 27<sup>th</sup> March).

The surge was supported by MSCI Inc. announcing that it would reclassify MSCI Pakistan index in the MSCI Frontier Markets index in May'09, until then Pakistan will continue to operate as a standalone.

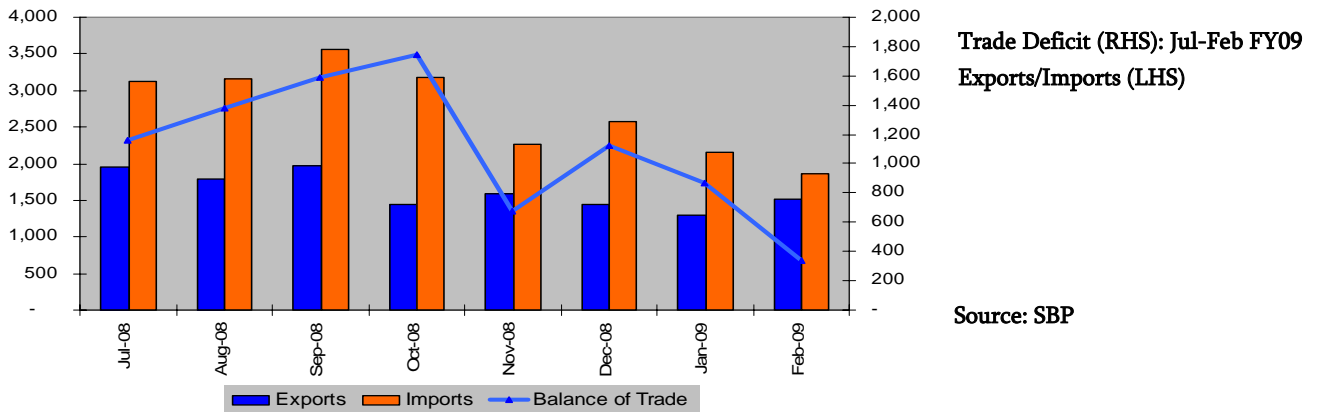
Political stability results in confidence in domestic markets, which bodes well for the USD/PKR parity. We can expect the rupee to remain stable in the PKR 80-81 range and with narrowing trade deficit and expected aid inflows; the rupee's short-term outlook carries an appreciatory bias. Upgrade by international rating agencies now also seems a possibility, currently S&P rates Pakistan's sovereign at CCC+ and Moody's B3. The last change was an upgrade by both agencies in Dec'08 after the arrival of USD 3.1 bn first IMF tranche. We can anticipate another upgrade after the second tranche is released next month.



## IMPROVING FUNDAMENTALS

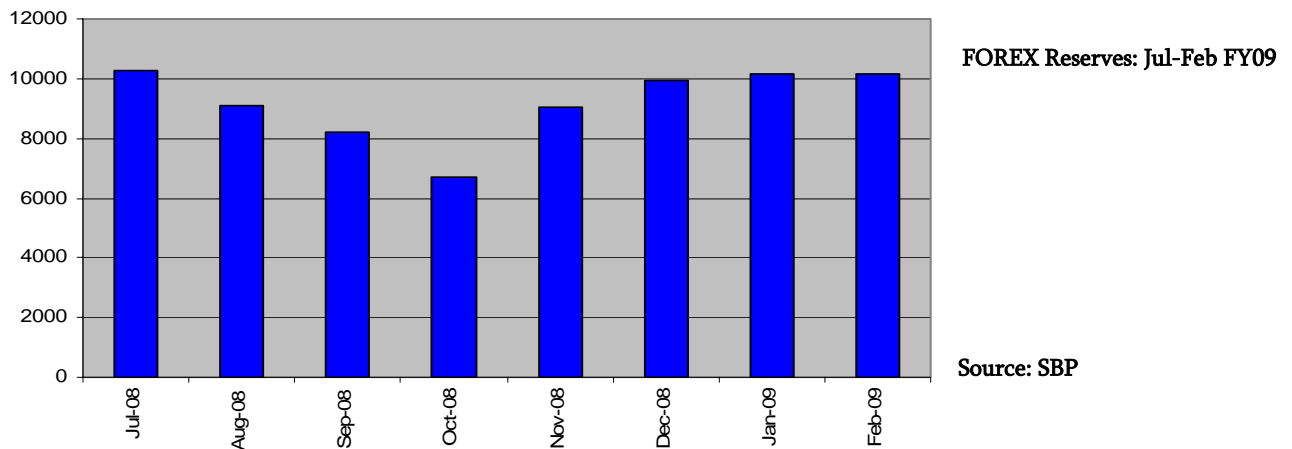
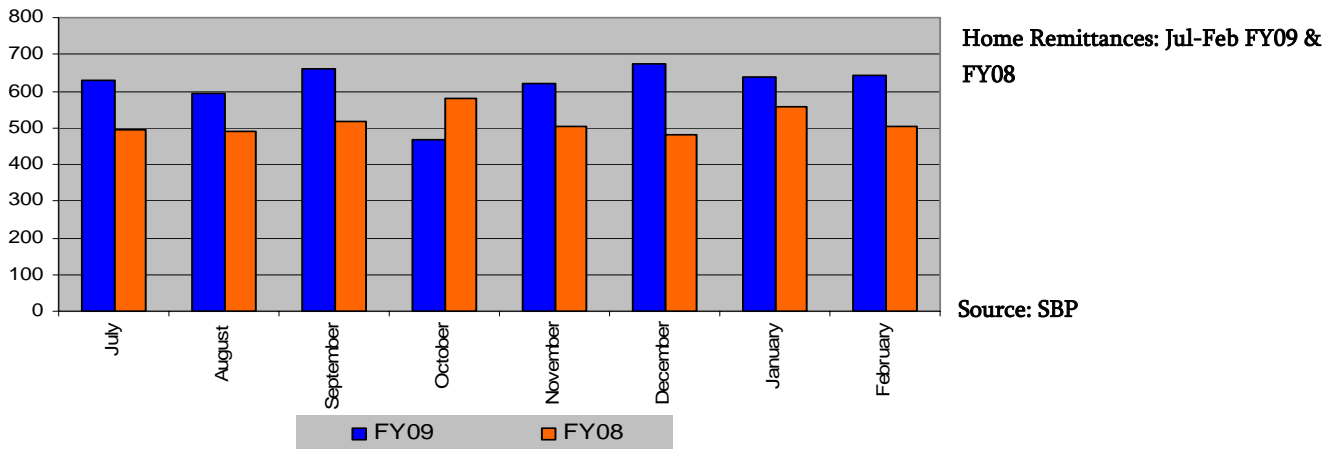
Macroeconomic fundamentals are improving slowly. The trade deficit has narrowed since the beginning of FY09, Jul-Feb'09 deficit is USD 8.86 bn vs USD 9.29 bn compared to same period FY08, this is 4.64% lower. The reason for this declining trend is slower growth of imports compared to exports. Imports for Jul-Feb period have grown 0.47% YoY, whereas exports have grown 4.27% YoY. Curb on luxury items and cheaper international commodity prices are the main reason for reduced growth in imports.

Shrinking trade deficit and balance on goods and services (9.15% YoY) helped narrow current account deficit by 13.76% YoY (USD 7.46 bn for Jul-Feb'09 compared to USD 8.65 bn in same period of FY08). Home remittances sent by Pakistanis living abroad have been a major source of FOREX for the national exchequer. Home remittances increased 19.12 % YoY in Jul-Feb'09 to USD 4.92 bn vs USD 4.13 bn in the same period of FY08. However, a major portion of this figure constitutes savings brought back by Pakistanis who have lost jobs in the ongoing global recession, specially from the Middle East.



## IMPROVING FUNDAMENTALS

FOREX reserves have been stable ever since the IMF first tranche arrived, currently USD 10.161 bn for the week ended Mar'09. SBP Governor Saleem Raza said on 12 Mar'09 that Pakistan was in a strong position to meet its NFA targets set for end June'09. He stated that at present Pakistan's reserves were USD 1.5 bn above the March end target, and only half a million dollars less than the June end target. IMF is expected to release the second tranche around USD 800-850 mn to Pakistan soon; once this tranche arrives, reserve requirements will be met easily.

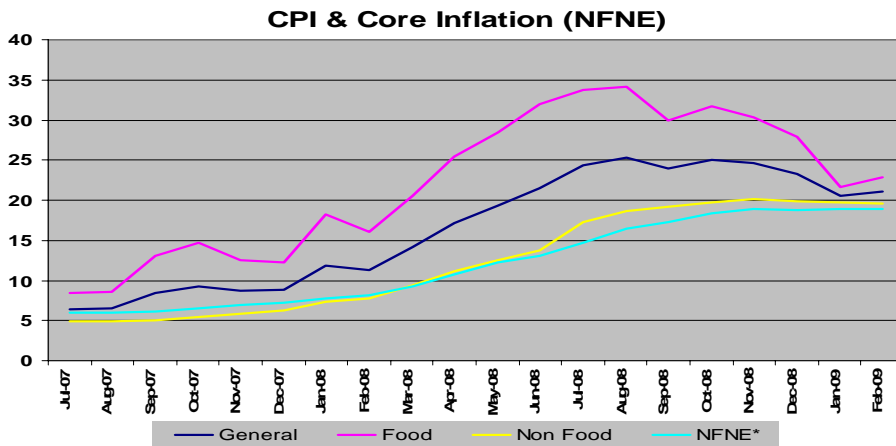




## MARKET INTEREST RATES

Market interest rates have stabilized in recent weeks, 6M KIBOR has averaged 12.53% in Mar'09 vs 14.20% in Feb'09 and 15.46% in Jan'09. Reason for this is that markets have already factored in a discount rate cut in the April 2009 Monetary Policy Statement (MPS).

Feb'09 inflation figures were slightly higher, as expected, due to an increase in prices of some staple commodities – 21.07% in Feb'09 vs 20.52% in Jan'09. But CPI inflation has already peaked at 25% YoY in Oct'08, in addition, due to base effect of inflation, stable USD/PKR parity and declining global commodity prices, inflation is expected to come down at a faster pace from Mar'09 onwards.



Inflation: Jul-Feb FY09

Source: SBP

Rigidity of core inflation still remains a concern; Feb'09 figure was 18.9%, which is the same as Jan'09. The increase in prices of steel products, medicare and house rent are the reasons behind persistence in core inflation. Going forward, core inflation will take some time to taper off due to the house rent index. This has prompted the SBP Governor Saleem Raza to state that he favours a gradual ease in monetary policy versus aggressive cuts in the discount rate (DR). He said, "The risk of too sharp a cut is to convey the feeling that the battle against inflation has been won and unfortunately, that's not true."

Taking this into account and the downward trend of inflation, we can anticipate a 50-100 bps cut in DR in the Apr'09 MPS. Following this, we expect more aggressive cuts in coming months due to the base effect.



## FISCAL MANAGEMENT

Government borrowing from SBP has gone up in recent weeks; for the week ended 14<sup>th</sup> Mar'09, GOP budgetary borrowing was PKR 320.476 bn (which is PKR 62.476 bn excess of the Oct-Jul'FY09 net zero target). GOP has been flirting with the cap on budgetary support since beginning of Feb'09, borrowings have average PKR 58 bn in Feb-Mar thus far. However, Advisor Finance Shaukat Tarin reiterated the government's commitment to control fiscal deficit and said the government would retire excess borrowing above the PKR 258 bn cap soon. Achieving this target is critical for GOP, if they are to receive the second IMF tranche.

Managing the fiscal deficit means the government is unable to spend on development project. However, GOP has been negotiating with the World Bank (WB) and Asian Development Bank (ADB) for a USD 500 mn and USD 200 mn loan respectively, which maybe approved soon. These loans will be aimed at reducing poverty and creating employment opportunities for the most impoverished classes.

In addition, the government ended petroleum subsidies last year and reduced subsidies on electricity by 31% to help meet the fiscal deficit targets agreed with the IMF. A new Petroleum Exploration & Production Policy was introduced on 20<sup>th</sup> Mar'09, which is based on the 2001 policy. A profit sharing initiative has been initiated by the government, in which the Federal Government may share excess revenues that do not affect the profitability of E&P companies. This will undoubtedly help GOP meet its revenue target of PKR 1.3 tr for FY09, Jul-Feb'09 tax collection has reached PKR 704 bn vs PKR 585 bn in same period FY08. In our opinion, reaching the PKR 1.3 tr mark is ambitious, considering the contracting real economy specially the LSM sector (which contracted 5.35% in Jul-Jan'09 period).



## CONCLUSION

With the major hurdle of judiciary out of the way, we can anticipate the government's focus to shift towards the economy, which will undoubtedly improve investors' confidence and speed up recovery. The timing could not have been more critical. Inflation is showing signs of subsiding and trade deficit registered its first surplus in Feb'09 (according to FBS trading account was surplus by USD 146 mn in Feb'09), consorted government policies to keep the economy on track of recovery and eventually growth are vital.

## ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
<u>Inflation</u>														
Headline Inflation	%	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7	23.3	20.5
Core inflation	%	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9	18.8	18.9
Food inflation	%	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4	27.9	21.6
Non-food inflation	%	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2	19.8	19.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8	14.0	13.7
6 month	%	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0	14.0	14.0
12 month	%	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a	14.3	14.2
<u>External Sector</u>														
Export	Mln US\$	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,572	1,438	1,269
Import	Mln US\$	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,253	2,478	2,144
Trade balance	Mln US\$	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)
<u>Remittances</u>	Mln US\$	557	502	602	590	584	547	627	592	660	466	621	674	637
<u>Forex Reserves</u>	Mln US\$	14,657	14,031	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081	9,662	10,163



## Research Team

Treasury and Investment Banking Group

MCB BANK LIMITED

20<sup>th</sup> Floor, MCB Tower, I.I Chundrigar Road.

Karachi

## Contact

Shan Husain

Research Analyst

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

Email: [shan.husain@mcb.com.pk](mailto:shan.husain@mcb.com.pk)

Haider Ali Jafri

Telephone: 92-111-000-111 Ext: 3220

Email: [haider.jafri@mcb.com.pk](mailto:haider.jafri@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](http://www.mcb.com.pk/quick_links/economic_reports.asp)