



MCB Bank Limited  
Formerly Muslim Commercial Bank limited

Treasury & FX Group

## *Quid Pro Quo*

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### **Budgeted to Develop**

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#### **Controversy-**

The FY07 federal budget is widely trumpeted to have been a common man's budget, keeping in mind the elections in 2007. However, does it offer macroeconomic stability in the form of lower inflation, higher potential growth, and lower twin deficits?

#### **Contention-**

In our opinion, this is more of a "development budget" rather than an expansionary budget. Current expenditures, apart from defense, have not been raised substantially. The targeted budget deficit of 4.2% of GDP is high, and given that current expenditures may be higher than targeted, there is potential for it to move up further. This fiscal stimulus in an overheating economy is bound to create inflationary pressures and worsen the current account deficit.

#### **Market impact-**

Whilst the majority of the deficit is likely to be funded through external financing, the target for bank borrowing is also relatively high at PKR 140 billion, an increase of 43% from the FY06 target. If borrowing is exclusively from the SBP, inflation will result. If the GoP does finance part of its requirement from commercial banks, private sector credit will be crowded out due to higher lending rates.


#### **Risk-**


If the government keeps a check on its current expenditures, inflation can be contained without a rise in interest rates.

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We missed much of the discussions regarding the pro-business, pro-poor, pro-Pakistan upcoming FY07 budget, which have frequently been aired on various TV channels because of prolonged electricity outages. Print media, however, came to the rescue and enabled us to keep ourselves updated. We read about Pakistan hoping to become an 8% a year economy, hoping to attract FDI on a massive scale, hoping to continue successfully privatizing government entities, and in general, hoping to lift the boat that would in turn lift the whole nation with it. However, as we experience unabashed load-shedding from the privatized KESC almost on a daily basis, and get stuck for hours on end in traffic jams, we cannot help thinking that the country's priorities need redressing.

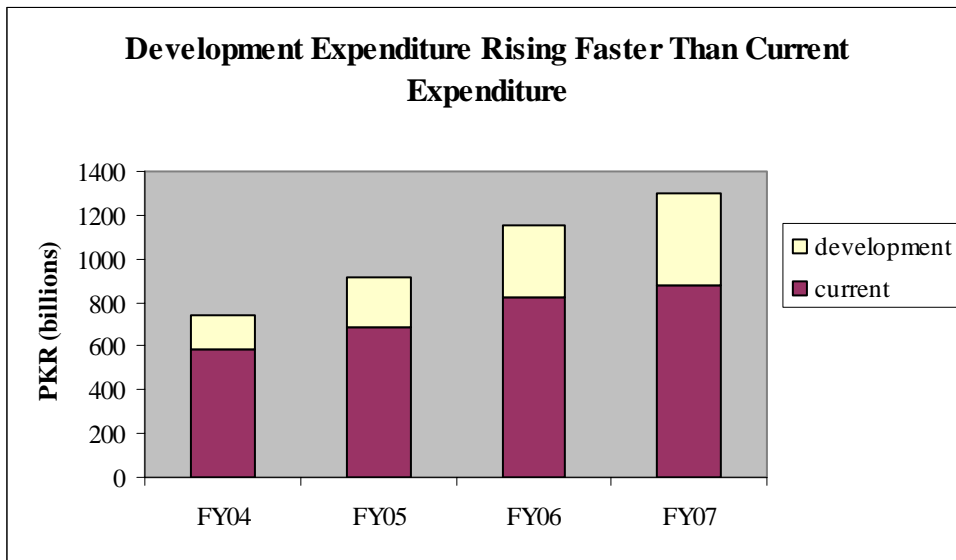
To be honest, federal budgeting is usually more of an art than a science; the art of making the "worse appear the better reason." Every year we get a self-admittedly pro-poor and pro-business budget, with promised relief for all. In truth, most of the targets are ambitious and unlikely to be met. There are always gainers and losers; distribution of economic gains is hardly zero-sum. As the year draws to a close, few people notice that somehow government spending went wildly above budgeted targets, or that much less was spent on health and education than initially promised. Because by the time economic data confirms the failures of last year's planning, the nation's attention has already shifted to next year's budget. As we sift through the details of this year's budget, one should not forget that GDP growth in FY06 was 6% below target, the budget deficit was 11% above initial expectations, the export target is likely to be missed, and the current account deficit is expected to be 33% above the initial target.

Of course, this traditional problem of official insincerity takes a severe turn for the worse as general elections draw closer. Government expenditures tend to spiral as "winning the hearts and minds" of the nation becomes the short-term agenda. For a change, everyone matters. The universal franchise of one man, one vote ensures that the budget is expansionary.

This budget is however, slightly different. While it has popularly been dubbed as an election budget, it is expansionary only in terms of development expenditure, but not with regards to current expenditures. While development expenditure has gone up by 26%, current expenditure has only increased by 6.5%, less than even the increase in nominal GDP. Whilst the enhanced development expenditure is highly desirable and shall go a long way in bridging the infrastructure deficit that the country faces, it remains to be seen if the GoP can maintain current expenditures on such a tight leash. FY07 will after all, precede the election year. Additionally, rising global interest rates promise to increase external debt servicing costs.

The graph below depicts that the proportion of development expenditure in the FY07 budget has increased substantially vis-à-vis current expenditure. This is indeed an encouraging sign, and we hope it continues.

**Figure 1**



On the revenue side, we believe that the 7% GDP growth target is ambitious. More importantly, we believe that the decline in the growth rate of Large Scale Manufacturing (LSM) sector stems primarily from structural constraints, and is not a one-off setback. Given that the manufacturing sector contributes the most to tax collection, its performance is instrumental in achieving the revenue target. Meanwhile, whilst the services sector is expected to continue growing strongly, a high base effect promises to keep a lid on growth numbers. The widening of the tax net and other tax reforms in the budget are expected to yield the CBR PKR 8.4 billion in net additional revenue. However, the revenue target of PKR 840 billion for FY07 is an 18% increase YoY from the revised CBR target of PKR 710 billion for the current fiscal year. And unless LSM growth can grow at the ambitious 13% target it has been set for FY07, revenues are likely to fall slightly short of target.

We do however acknowledge that not reducing corporate tax rates was a good idea. Reduction of taxes would result in little more than an improvement in corporate bottom-lines. The investment it primarily hoped to attract would not be forthcoming; remember, investors look for super-normal profits and first mover advantage while making business decisions, not a marginal reduction in the tax rate.

However, we believe that on the balance of risks, the budgeted fiscal deficit of 4.2% of GDP is understated. Given the upside risk to current expenditure, and the downside risk to revenue collection, our initial estimates are that a fiscal deficit of 4.5% of GDP is on the cards. On a short-term basis, this profligacy will have limited impact. The risk is that long-term fiscal health is likely to be compromised. Government expenditures, once enhanced even for a temporary event such as an election, are difficult to cut back. Duty exemptions, instituted for a specific purpose are similarly unpalatable to withdraw.



## **Of Demand and Deficits**

Of course, running budget deficits is not a bad thing per se. Keynesian economics has long argued that running budget deficits in times of economic downturns is not only permissible, but desirable. This theory advocates that the government should run counter-cyclical demand management policies. What this means is that in lean times, aggregate demand should be boosted by higher fiscal spending and in the good times, aggregate demand should be contained by running budget surpluses.

For an economy already running near full capacity, however, this fiscal stimulus is harmful. From an economic point of view, a budget deficit in a time of near-potential output, on balance does more bad than good. It might marginally improve economic growth by raising output above potential, but it shall exacerbate inflationary pressures. Of course, in times of a recession, the opposite logic applies. Fiscal deficits will lead to employment of hitherto unutilized resources, improving output and growth, without resulting in higher prices.

Importantly, the source of funding the deficit does not alter this analysis. Even if the fiscal gap is bridged through external borrowing, privatization receipts, or printing money (which will not crowd out private investment), the higher fiscal spending will result in the government and the private sector competing for scarce resources such as land, labor, and capital. This will bid up wages, rent, and prices, creating a fresh round of inflation. One can argue that for an overheating economy like Pakistan's, running a budget deficit entails inflationary costs even if the fiat (paper) money to finance it grows on trees!! We shall engage in a more detailed discussion regarding the implications of deficit financing later in the piece.

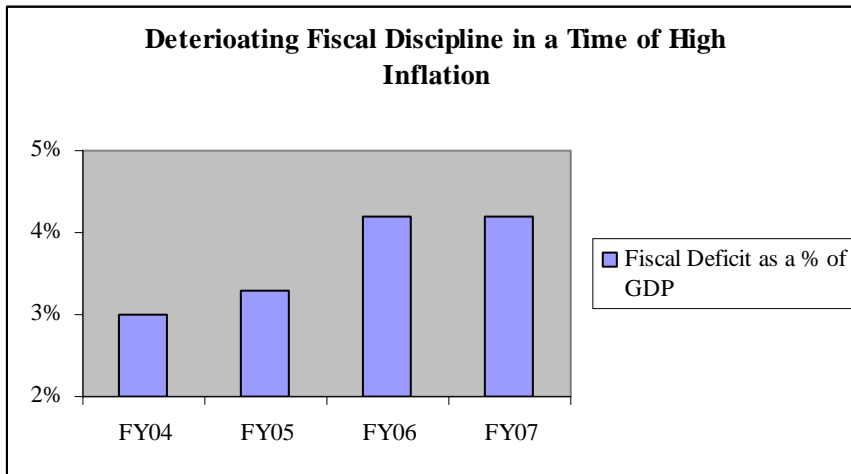
The conclusion is this; in times of an economic boom (with the economy working at near capacity), any additional government expenditure deemed necessary or desirable should be financed by a corresponding increase in taxes. Equitable taxation will not only prevent inflation, but also spread the real cost of collective government action among society in a fair manner. It will shift resources from private to public use, without changing aggregate demand. Running a high fiscal deficit in these times of overbearing aggregate demand will inevitably result in inflationary pressures.

Pakistan is currently in the midst of an economic boom, coupled and reinforced by strong aggregate demand. It is not surprising that our overheating economy has led to demand-pull inflation. And while monetary policy has been tightened to mitigate the inflationary impact, the fiscal policy continues to remain lax. The budget deficit has actually been increasing, from 2.4% of GDP in FY04 to 4.2% of GDP in FY06. Like monetary policy, we need fiscal policy to lean against the "prevailing economic wind" to quell inflationary pressures completely.



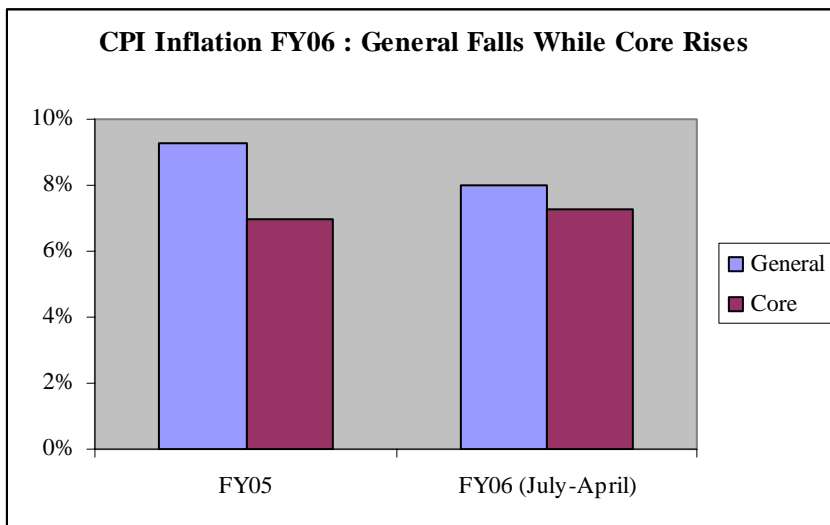


**Figure 2**




The effect of this lax fiscal policy can be seen in core inflation numbers. While the CPI headline inflation has decreased from the 9.28% in FY05 to 8.03% in the first ten months of FY06, core inflation, the portion which is directly governed by aggregate demand has gone up from 6.95% to 7.27%. And while food imports have brought down food-heavy CPI figures this year, core inflation continues to remain high

**Figure 3**



SBP and MCB Research





## **Booming Deficits**

To understand the full extent of our fiscal indiscipline, it is important to bear in mind that the budget deficit as a % of GDP has gone up in a period of record high economic growth. While GDP has expanded substantially, fiscal spending has easily outdone it. The full realization of our fiscal indiscipline will become more apparent when economic growth slows down, and revenue receipts start tapering off. We must remember our consumption led GDP growth has increased both direct and indirect taxes substantially through a combination of higher income and higher consumption. In the four years from FY02 to FY06, CBR tax collection has gone up by 76% despite the tax base having hardly been widened. Still, less than 1% of the country pays direct taxes; collection has simply gone up on account of higher income of the salaried class, record corporate profits, and significantly greater commodity consumption. Our stagnating tax to GDP ratio (9.2% in FY06) is evidence of the lack of success in reforming the tax policy. When a cyclical slowdown in economic growth occurs, the fiscal deficit will move higher.

As an interesting thought experiment along these lines, we decided to test our fiscal position by assuming that revenue receipts will rise by a six year average of 10.34% as our GDP growth slows to 5%. That translates into an alarmingly high fiscal deficit of 5% of GDP, assuming expenditures as budgeted. Whilst we have taken FY07 as the hypothetical year for such a cyclical downturn to occur, we are only assuming it as a matter of convenience. Growth is more likely to slow down in 2008 or 2009, and the fiscal scorecard promises to look much worse at that time.

## **Revisiting Deregulation**

Ironically, deficit concerns are surfacing at a time when a smaller government is being touted as the panacea for many of our economic ills. Deregulation, privatization and private sector liberalization are the watchwords of our “New Economy.” A high fiscal deficit in this era when the “frontier of the state” is being rolled back is an anomaly, unless someone can reconcile the divergent objectives of small government and substantially higher fiscal spending. It seems like a flashback to the supply side “Reaganomics” of the 1980s, which amongst other fancy claims, sought to lower corporate taxes and reduce the role of the government. Its only lasting legacy, however, has been a permanent and almost incomprehensible growth in the US budget deficit.

The government justifies its increased expenditures on a number of grounds. Commodity imports to curb the inflationary impact of hoarding, subsidizing oil imports, and implementing the political process of decentralization are but a few of them. However, if such justifications hold water, this concurrently implies that the potential of failure and abuse in the unfettered exercise of market power is immense. When deregulation is advocated, we risk overemphasizing the positive impacts of greater competition and efficiency and understate the perils of permitting monopolistic tendencies to emerge. Given the backward legal and physical infrastructure prevalent in the country, there is still plenty of potential for abuse in the industrial and services sector. History bears testimony that deregulation is not the unmitigated blessing that its advocates claim it to be.



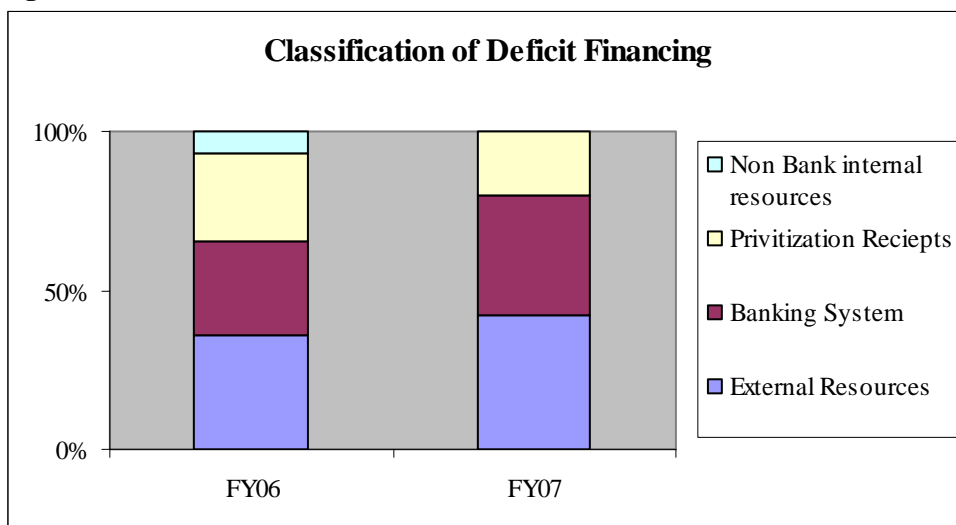
We wish to clarify any leftist inclinations. Capitalism has a better track record than communism at achieving economic growth; that much even China has implicitly conceded. But Adam Smith's "invisible hand" theory has not bore the test of time. His "greed is good" philosophy is best summed up in the following famous quotation. "It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest." Well, we have found that we cannot expect our dinner from the benevolence of the sugar mill owner, the cement manufacturer, or the banker. Pakistan kick-started the process of privatization and market liberalization only to realize midway through it the complete impotence of the Monopoly Control Authority (MCA). While we embrace capitalism with cautious optimism, it is important to realize that deregulation is difficult to do well. It is crucial in such circumstances to have a strategic vision, and at no time should myopic considerations such as the funding of a current account deficit hasten a policy decision.

### **"Kashkol" Is No More**

The source of funding of the budget deficit also has macroeconomic implications. The FY07 budget indicates that PKR 140 billion will be borrowed from the domestic banking sector. We believe the bulk of this borrowing shall be in the form of T-bill borrowing from the SBP. The PIB target has been set ridiculously low; while the rise in NSS rates is also insignificant. Meanwhile, privatization receipts are targeted at PKR 75 billion. However, the bulk of the budget financing (PKR 239 billion) is expected to be from external sources. Included in this is a US\$ 500 million (PKR 30 billion) Eurobond and PKR 50 billion of foreign aid for earthquake reconstruction. Part of the recently approved World Bank loan for infrastructure development is also included in the external receipts.

The figure below gives the break up of deficit financing in the last fiscal year and the expected funding break up for FY07 as well. It shows an increasing reliance on external receipts and borrowing from the SBP to fund an increasing budget deficit.

**Figure 4**



SBP, MOF, and MCB Research





## Taxing Through Inflation

It is a well-documented fact that government borrowing from the SBP is inherently inflationary in nature. The specific term given to this form of deficit financing—printing money, is known in economics as seigniorage. However, even external borrowing and privatization receipts can put an upward pressure on prices, to the extent that the money is spent on acquiring local goods and services. If the foreign funds are used to make oil payments or importing other commodities, there shall be an increase in the current account deficit but not in prices. The implications are familiar, so long as a budget deficit is funded without reducing aggregate private demand, it will either lead to higher inflation or a higher trade deficit.

The awkward truth is that inflation is a mighty tax collector, and a hidden and regressive one at that. The hidden tax of higher prices has helped the GoP finance some of its fiscal deficit, without having to overtly impose a politically suicidal regressive tax. However, the poor of Pakistan have disproportionately borne the burden of the GoP's fiscal indiscipline without even having realized it.

The biggest problem of our public finance has been the prolonged inability to bring speculative activities such as stock market and real estate investment into the tax net. Although a token Capital Value Tax of 2% has now been imposed on real estate, the procedure of implementation is still unsure. For example, the CVT on real estate is based on the registered value of the property, which is lower than the market price. Thus, the effective CVT is less than 2%. Furthermore, because property dealers have three months to register their acquisition, the CVT is thus unlikely to curb the speculative activity in real estate. At any rate, the jury is out on whether the CVT would raise prices or lower prices. Given the strong pricing power in the real estate market, the tax is most likely to be passed onto the buyer rather than depressing prices. Thus, while the government sees the imposition of CVT as a baby step in the direction of more stringent measures for the future, for the moment, its impact, if it has any, promises to be diluted.

However, with a low savings rate (estimated at 14% of GDP in FY06), it becomes increasingly important to channel available resources to productive uses. Even after the token gesture of taxing the real estate and stock market investments, they still are grossly under taxed relative to other business activities. Much of the eagerly awaited foreign direct investment is also keen to tap the extremely lucrative residential and real estate projects. The GoP needs to clearly define industrial investment as its priority. Rising property and equity investments are less of a sign of the country's economic progress and more an indication of a gross misallocation of scarce resources. The country's recent asset price bubbles have made many rich beyond their dreams; and it is surely not overbearing to expect them to share a small percentage of their gains to help sustain the country's development. One need only ask, what kind of a message is our tax structure sending to the country's young generation when the salaried class keeps shouldering more and more of the tax burden while capital gains continues to remain untaxed? The message to us seems this; you are better off making your living by speculation rather than by working. Talk about misaligning incentives!!



## **Sustaining Private Sector Credit Off Take**

Meanwhile, we have also conducted a preliminary monetary analysis for FY07. The nominal growth is targeted at 13.5% (real GDP growth rate + expected inflation rate). Assuming that M2 is targeted to equal the growth in nominal GDP, and the government borrowing from the banking sector estimated at PKR 140 billion, we find that credit to the private sector should be around PKR 378 billion, 15% above this year's target of PKR 330 billion.<sup>1</sup> The only worry on that front is an involuntary credit contraction on account of less liquidity within the banking sector (ADR upto April 2006 stands at 77%) and lower demand for loans due to rising lending rates (April lending rates were 10.25%). From the perspective of sustaining economic growth, it is imperative to continue the trend of robust credit expansion that we have witnessed over the last few years. Our savings and investment gap of 6% of GDP translates into a difference of approximately PKR 500 billion. Some of this difference is bridged by FDI, but the greater portion is financed by private sector credit off take.

In conclusion, we believe that the development oriented budget for FY07 lived up to its promise of promoting growth with dignity, atleast on paper. However, a high fiscal deficit promises to worsen our problems of inflation and current account imbalances. In the backdrop of upcoming elections, the growth momentum is also an extremely important variable in determining the future path of interest rates.

With the GoP putting fiscal austerity on hold, the risks are two-fold. First and most importantly is the tainting of the confidence game. A high fiscal deficit will only add to the country's growing list of macroeconomic imbalances, and if the IMF makes good of its threat of an unfavorable report under Article IV, the country's ratings can be downgraded. The long-term risk is that fiscal indiscipline might become a deeply-entrenched habit, continuing well beyond 2007. We may find that the oft cited rhetoric of having broken the "kashkol" may be only that; rhetoric.

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<sup>1</sup> Assuming Net Foreign Assets and Other Items to be as per the Credit Plan for FY06

## 2006-2007 Budget at a Glance

Receipts	PKR billions	Expenditure	PKR billion
<b>A Tax Revenue</b>	841	<b>A Current Expenditure</b>	880
<b>B Non Tax Revenue</b>	242	General Public Services	504
Gross Revenue Receipts	1083	Defense Affairs and Services	250
Less Provincial Share	378	Public Order and Safety Affairs	22
I Net Revenue Receipts	705	Economic Affairs	75
II Net Capital Receipts	16	Environment Protection	0
III External Receipts	239	Housing and Community Amenities	1
IV Self Financing of PSDP by provinces	85	Health Affairs and Services	5
V Change in Provincial Cash Balance	54	Recreational, Culture Services	3
VI Privatization Proceeds	75	Education Affairs & Services	19
VII Bank Borrowing	140	Social Protection	1
		<b>B. Development Expenditure</b>	435
		Provincial Government	115
		Federal Government	320
<b>Total</b>	<b>1315</b>	<b>Total</b>	<b>1315</b>

Source: Associated Press of Pakistan

## Economic Snapshot

Fiscal year 06												
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	July-April
<b><u>Inflation</u></b>												
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	8.05
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	7.30
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	7.01
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.70
<b><u>T-bill (Wgt Avg)</u></b>												
3 month	%	7.69	7.99	8.10	8.10 id rejected		8.09	8.10	8.10	8.10	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14 id rejected		8.25	8.29	8.29	8.29	8.29	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	n/a
<b><u>External Sector</u></b>												
Export	Mln US\$	1,272	1,408	1,499	1,329	1,120	1,421	1229	1300	1521.1	1450.9	13,550
Import	Mln US\$	1,997	2,235	2,322	2,328	2,300	2,420	2145	2253	2685.3	2258.9	22,944
Trade balance	Mln US\$	(725)	(827)	(823)	(999)	(1,180)	(999)	(916)	(953)	(1164)	(808)	(9,394)
Remittances	Mln US\$	313	348	341	373	309	336	391	339	444	401	3596
<b>Total</b>												
<b>Foreign</b>												
Investment	Mln US\$	130	161	183	208	323	458	165	347	658	744	3376
Forex reserves	Mln US\$	12613.2	12123.9	12000.3	11714.8	11320.9	11211	11504.7	11400	12905	13016	n/a
<b><u>Key</u></b>												
n.a	not available											
n/a	not applicable											



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