

Economics & Strategy

It's a Wrap!

2008 is about to end on a dramatic note in deep contrast to the heights and gains of the past 5yrs. The Government of Pakistan belatedly sought and received USD 7.9bn in IMF assistance in an attempt to reverse the descent into economic turmoil. However further challenges loom large; implementation challenges to the vast reform agenda, economic vulnerability, regional political friction, a young and fragile democratic framework and weakening credibility of the financial market regulator.

“The good news is we're landing....”

CPI headline inflation appears to be easing up and is likely to decelerate further in 2H FY09 although FY09 is expected to average at 20%. The trade deficit for 5mo FY09 deteriorated by 20% but YoY imports eased up by 14% in Nov08 largely on account of lower food and oil prices. Fiscal fortunes are also looking up with 1Q FY09 figures indicating the overall deficit of PKR 140bn is in line with year end targets of 4.2%.

“The bad news is we're crash landing!”

Deleveraging is likely to be the name of the game in FY09; unless ofcourse regulators freeze markets again. We feel financial market mayhem has been significantly aggravated by a weak Regulator; by intervening in the equity market and finally freezing the market for 110 days, regulators and stakeholders have placed investors at serious peril. Portfolios are significantly over-valued compared to global indexes while Pakistan's equity markets present greater vulnerabilities. Resultantly the KSE 100 sits at a trailing P/E of 11x earnings and is poised for a severe sell-off. We expect a further slide in KSE 100 net earnings in Dec08 which would translate into a target index level between a bear case at 4,700 and a bullish stance of 6800 points.

Bailout or Band-aid?

The exchange rate briefly stabilized below PKR 79 to the USD as USD 3.1bn in IMF funds were received by the GoP and reserves bolstered to USD 9bn. However as import payments, portfolio outflows and debt payments accumulate, pressure on the exchange rate is likely to mount. If official reserves drop once again to the USD 4bn level we reiterate our stance on currency at PKR 91 to the USD.

Reform to Recover

Some of the positives of the IMF program to look out for are greater independence of the central bank, full integration of foreign exchange management into monetary policy, refined interest rate management, removal of oil import payments from central banks books and ceilings on direct government borrowing from the central bank. Implementation challenges tend to be greater on the fiscal end of the policy spectrum as the program requires significant public financial management, tax administration reform and could suffer a greater than expected economic slowdown in partner countries.

Zainab Jabbar

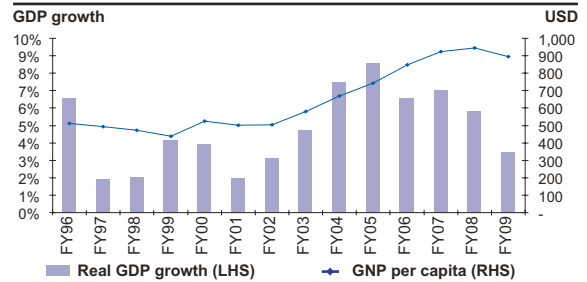
zainab.jabbar@igi.com.pk

111-234-234 Ext. 810

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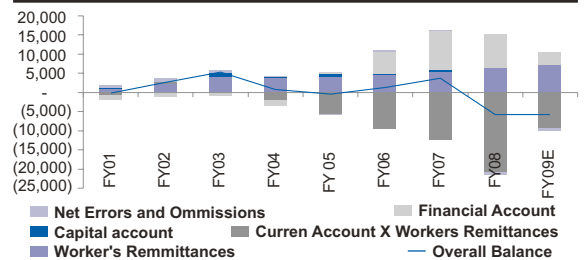
Data as of December 19, 2008

Chart 1: Growth and Income per capita



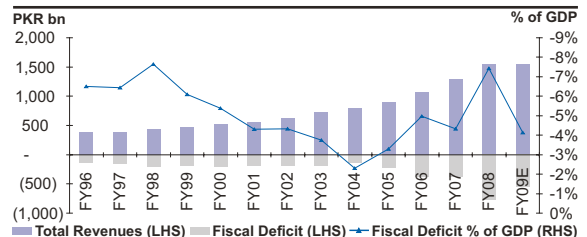
Source: SBP

Chart 2: Balance of Payments (USD mn)



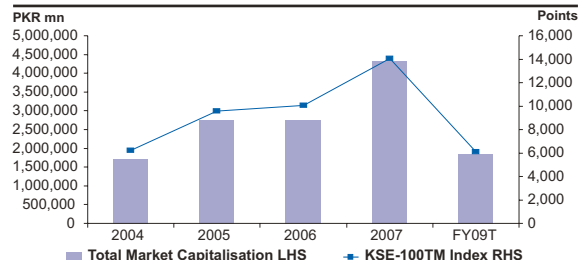
Source: SBP & IGI Research

Chart 3: Fiscal Management



Source: Ministry of Finance

Chart 4: KSE 100



Source: KSE



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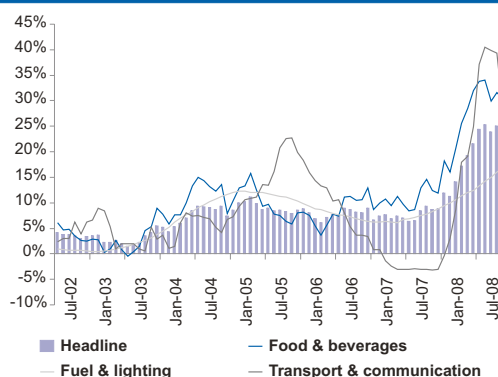
The Laws of Gravity...

Domestic inflation appears to be cooling in line with global inflation trends and the SBP's tight monetary policy. By Jan09 we expect headline YoY CPI inflation to dip below the 20% mark and descend further below 10% by the end of the fiscal period.

Nov08 CPI inflation up by 24.65%

CPI headline inflation came in at just under 25% in Nov08 while Core inflation is also expected to remain in the 21% range for the period under review. The price barometer remains supported by Food & Beverage, Fuel & Lighting and Transport & Communication inflation of between 28-32% respectively. Inflation of the Food & Beverage index, accounting for over 40% of CPI, eased to 30.4% from 34.1% earlier this year while Transport & Communication reflected a drop of 12% from historic highs in Aug08. MoM CPI inflation for Nov08 eased marginally by 0.1% for the first time since Jan07 while MoM Food prices also deflated by a wide margin of 1.5% over the same period.

Chart 5: YoY Inflation



Source: FBS

Inflation risks still loom

Despite the historic lag times between decelerating prices at home and abroad, we feel consumer prices could remain under pressure from significant supply-side constraints on the ground. News of water constraints from the Chenab River, power shortages and high costs of imported fuel and fertilizer are likely to keep up the ante on food inflation during 2H FY09. Nevertheless we expect the price impact of interest rate increases and a more flexible exchange rate scenario to exact further downward pressure food prices.

Goodbye USD 150 oil?

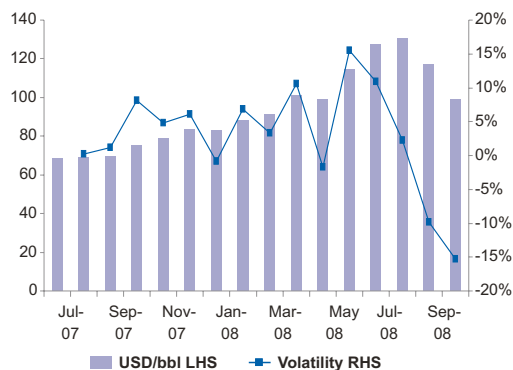
Since Sep08 we have seen significant upward pressure on the global commodity prices alleviated; the global inflation coil unraveled due to a rapid demand deceleration, global de-leveraging and recession expectations for the US and Eurozone.

On Dec 17'08 OPEC and non-OPEC oil exporters announced they would remove up to 2.6mn bpd from the market. The Saudi Arabian oil minister said the 13-nation OPEC cartel had agreed at a meeting here on a production cut equivalent to about 7% of its current output quota of 27.3mn bpd. Following the announcement international oil prices dipped to 4yr lows on growing global recession concerns; WTI Crude prices closed at USD 40.06/bbl while London Brent Light Sweet Crude closed at USD 43.09/bbl.

More oil price cuts on the horizon

During the first 6mo of its tenure the GoP was compelled to increase petroleum product prices by 40-60% over a 6mo period and reduce the subsidy burden on the fiscal account. Trade figures for 1Q FY09 revealed the country was spending an average of USD 125/bbl on oil imports compared to USD 70/bbl in the same period last year; a domestic oil price increase was inevitable.

Chart 6: MoM Average Cost of Oil Imports



Source: FBS

By Oct08 the country was importing oil products at an average USD 99/bbl however this was a substantial relief from prices of USD 130/bbl in Aug08. Accordingly the GoP announced 2 oil price cuts in the last 2mo which partially negated oil price pressures on the CPI index and should slow the pace of overall headline inflation in the coming months.

Trade deficit rises by 20% in 5mo FY09

5mo FY09 trade deficit stood at USD 8.7bn, a 20% increase over the same period last year; trade figures indicate 16.5% increase in imports and 12.7% increase in exports. However results for Nov08 indicate a 21.4% decline in imports over the previous month and a 13.8% decline over Nov07 figures.

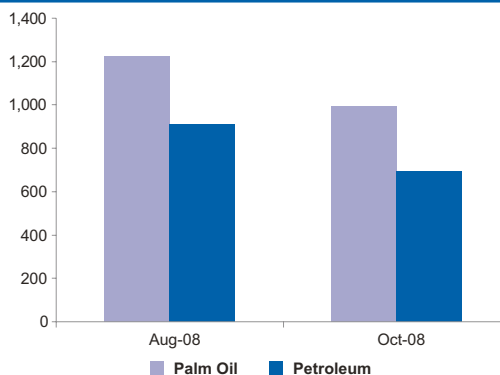
Two key import drivers lose traction

According to our analysis of 4mo FY09 trade figures, Palm Oil imports declined by 17% to 124,664MT. Palm oil accounts for 34% of the food basket and 4% of total imports and its prices have a substantial impact local edible oil prices. 4mo FY09 prices are 41% higher than the previous year however MoM prices have shown deflation in line with global commodity price easing. Prices have dropped to an average cost of USD 995/MT in Oct08 compared to USD 1,227/MT in Aug08; a decline of 19%.

Petroleum group import quantities have declined by 11% to 1.4mn MT during the same period however prices are 64% higher on average compared to 4mo FY08. MoM declines are evident however with prices now at an average USD 99/bbl in Oct08 from a high of USD 130/bbl during the same period; a decline of 24%. With Oil now dipping below USD 45/bbl we are pleased to expect a significant deceleration in the import bill with an estimated FY09 average oil price in the range of USD 70/bbl which translates into an oil import bill of just under USD 9bn.

Chart 7: Imports Easing

(USD mn)



Source: FBS

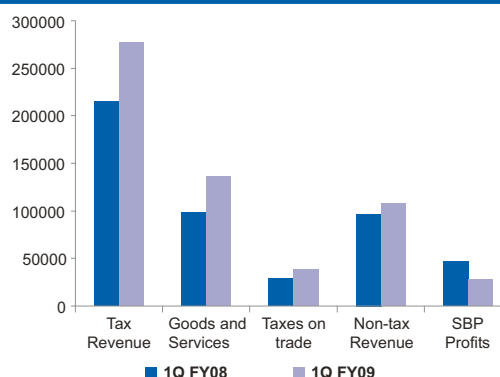
Fiscal frivolity at an end

Government officials must feel a sense of relief as the first bits of positive news were released by the Ministry of Finance on Dec 29'08. Fiscal operations for 1Q FY09 reflect a substantial decline in the budget deficit by 12% to PKR 140bn over the same period last year. This translates into an annualized rate of 4.2% however may extend further if less than expected external budget support materializes by year end or fiscal resource pools begin to dry up.

Development spending cuts to be extreme

The narrowing of the deficit was largely due to a significant decline in 'Development' expenditures which dropped by 69% to PKR 39.7bn. As a percentage of GDP development spending is likely to remain at 1.2% of GDP during FY09 which bodes ill for investment and GDP growth. However the historically inverse relationship between the fiscal deficit and development spending must be appreciated here; in the prevailing circumstances the focus of policy makers will remain on the deficit rather than development till the fiscal position is stabilized.

Chart 8: Fiscal Revenues (PKR mn)

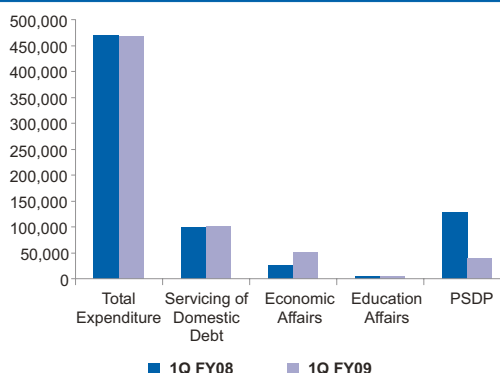


Source: Ministry of Finance

Dent from debt payments not as dramatic as expected

We had expected interest payments to lend substantial pressure to the fiscal expenditure book in FY09 however were surprised to see that interest payments on debt remained in the range of 4% of GDP. Servicing of both Domestic and Foreign Debt remained relatively stable at PKR 102bn and PKR 14bn respectively for the quarter.

Chart 9: Fiscal Expenditures (PKR mn)



Source: Ministry of Finance

Subsidies to remain in line with targets

Although Economic Affairs, which include allocations for subsidies, showed a 98% increase in spending to PKR 50.6bn, we expect the annualized figures to remain within government targets of PKR 211bn, especially since further cuts may be initiated next year. Last year the government spent PKR 175bn in PDC claims to Oil Refineries and OMCs and was estimating PKR 140bn payout in FY09. However with the reduction in fuel subsidies we may see some pressure on the overall subsidy package worth PKR 295bn in FY09 alleviated. Subsidies imports of wheat and fertilizer are also estimated at PKR 46.5bn and PKR 29.5bn respectively for FY09. However the recent unraveling of global commodity prices will likely reduce the subsidy burden substantially and therefore spending on Economic Affairs.

Regional friction likely to keep defense spending up

Despite the recent downward trend of defense expenditure we have seen a marked increase in 'Defense Affaires and Services' which rose by 44% to PKR 82bn. 'Unidentified' expenditures, often speculated to be related to Defense, also rose to PKR 56bn during the period under review.

On the revenue front 'Excise' and 'Sales' Taxes showed a market improvement by 40% to PKR 136.6bn reflecting the recent increase in GST to 16%. Although 'Non-Tax' revenues rose by 11% this was largely due to an increase in revenues from 'Defense', which brought in nearly PKR 30bn to fiscal coffers compared to only PKR 1bn in the same period last year.

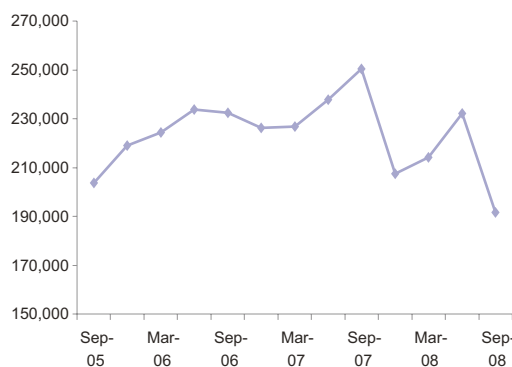
Gauging Growth

Quarterly GDP data is not available however we can use several indicators to predict the GDP slump expected in FY09/10. Indicators which adequately reflect a domestic product picture include Large Scale Manufacturing, Savings and Investment and even the KSE.

KSE 100 LTM earnings slip dramatically

How do we know growth is slipping? KSE 100 companies also function as a reasonable proxy; although the publicly listed companies lean heavily on the Oil & Gas sector in terms of market cap, their bottom lines appropriately reflect the general economic strain faced by the Services and Manufacturing sector. By Jun07 the country had been booming with a 5yr CAGR of 7% GDP and Corporates witnessing double digit net profit growth. By Dec07 however the picture began to change dramatically as net profit slipped in the negative range. But Sep08 Last Twelve Months (LTM) net profits of KSE 100 dived by 24% over Sep07 figures. This is the first time in the last 8 quarters that we have seen such a dramatic drop in earnings.

Chart 10: KSE 100 LTM Net Profit (PKR mn)

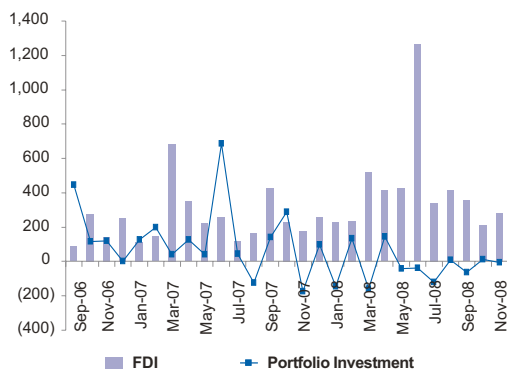


Source: Bloomberg & IGI Research

Net Foreign Investment down 21%

If Investment is taken as a proxy for growth we can safely assume that GDP will roll back to the 3% range in FY09. Investment to GDP rose as high as 24.2% in FY07 but decelerated again to 22.8% the next year. Net foreign investment, a key driver of overall investment, is down to just 1.4bn in 5mo FY09 and down 21% over the same period last year. We can expect the Total Investment figure to also decline at a similar rate leaving little steam for GDP growth.

Chart 11: MoM Foreign Investment (USD mn)

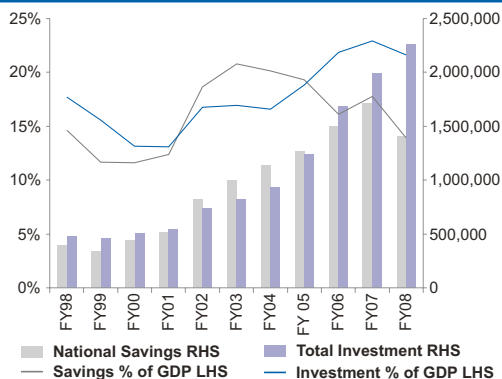


Source: SBP

Net Savings at 8yr low of 14%

SBP Annual Report reveals Savings as a % of GDP plunged a massive 600bps to 14% in FY08 from 21% the previous year. Savings are a direct reflection of the Current Account Deficit which topped 9% of GDP last year. During 5mo FY09 the CAD already stands at USD 6.8bn a 44% increase over the same period last year and an annualized expectation of 10% for FY09. With fortunes not in favour of a Savings rate improvement in FY09, a slowdown in GDP seems a more than rational expectation.

Chart 12: Savings and Investment (PKR mn)



Source: SBP

Dreaded Deleveraging: (Dump me if you can)

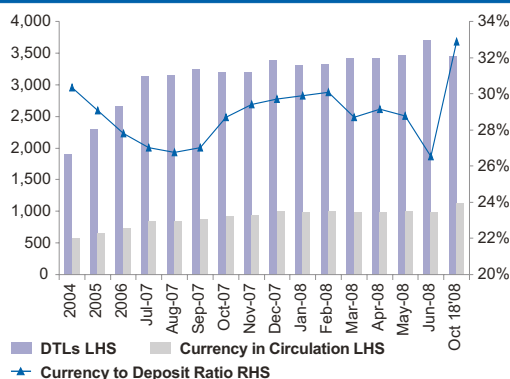
If liquidity is the panacea to all financial market evils we have only to look at monetary aggregates data to get a feel for the worst. Overall money supply declined by 0.23% as of Nov 29'09 compared to 3.98% M2 growth in the same period last year and a 5yr CAGR of above 18%. The years of monetary expansion appear to be over, largely on account of rapid Net Foreign Asset (NFA) depletion, inflation and higher interest rates.

Drawdown on deposits

Net Foreign Assets outflow amounted to PKR 356.3bn against a stock of PKR 667.5bn in Jun08. The deposit base is also showing weakness with Demand and Time Liabilities (DTLs) down by PKR 150bn against a stock of PKR 3.7tn during the same period. On the flip side monetary assets are rising; NDA rose by 9% over stock FY08, fueled by government borrowing of a staggering PKR 356.2bn and Private Sector credit of PKR 146bn. With the gap between assets and deposits/reserves widening, a liquidity crunch was inevitable; so where is the liquidity going?

Chart 13: Currency to Deposit Ratio

(PKR mn)



Source: SBP

Consumers and Companies will cut their losses

Asset dumping may seem like a harsh term, but we fear that is exactly what will dominate Pakistan's financial markets in the ST. With commodity price led inflation stripping 20% off of national income, retail spending, labour capacity, operational scales and production are all set to contract. Limited cash flows could endanger refinancing capacity and future investment, highlighting the urgent need for deleveraging. Consumers and corporates have all been looking to tighten their belts and conserve cash; this makes asset dumping a disturbing aspect of the recent past and a very real prospect for the near future.

Connecting the dots on the Market Liquidity Map

Since asset prices tend to move in conjunction with liquidity, it is naturally assumed that bourses would face the brunt of monetary tightening, a global slowdown and diminishing external inflows. Instead of preparing for a soft landing, Pakistan's financial regulators permitted a freeze of the bourses altogether. This very debatable intervention by stakeholders eventually led to the build up of immense pressure and the crippling of the KSE.

Investment channels such as the KSE, Interbank Market, TFC market and finally the CFS market have been gradually choked, eroding free market principles of price discovery, liquidity and efficiency. Co-dependent key players of the Financial Market including Commercial Banks, Investment Banks, Brokerages and Asset Management companies thereafter have become deeply constrained for liquidity.

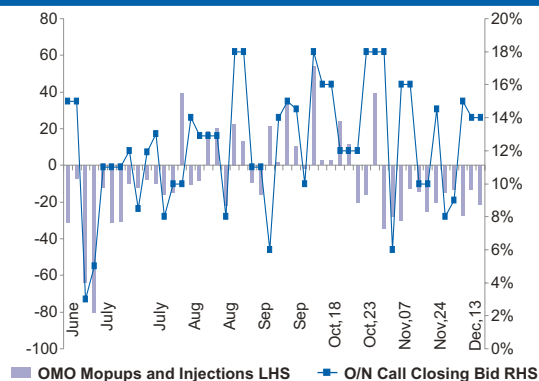
The equity market....

The first phase of asset dumping began to materialize in early May08 when consumers and corporates offloaded their equity holdings in response to soaring inflation, interest rate hikes and negative sound bytes on growth. The KSE BoDs intervened thrice between Jul08 and Aug08 before finally freezing the bourses on Aug 27'08 after the KSE 100 plummeted 42% to 9014 points from its peak in Apr08. SECP, the Regulator, did not intervene and one of three key investment channels was virtually closed for business.

The Interbank market...

Liquidity pressure shifted onto the Interbank Market and pushed up Call/Clean Lending rates to extraordinary levels past 40% in Oct08. The increased default risk resulted in a liquidity freeze; with profitability prospects weakening rapidly. Lenders preferred to conserve capital. The onus shifted onto central bank, which dramatically reduced reserve requirements by 400bps, eased SLR regulations and injected over PKR 300bn into the Interbank Market via OMOs. Market rates normalized and the O/N Repo rate corridor widened dramatically.

Chart 14: OMOs and Call Rates (PKR bn)



Source: SBP, Bloomberg & IGI Research

The Corporate Bond market...

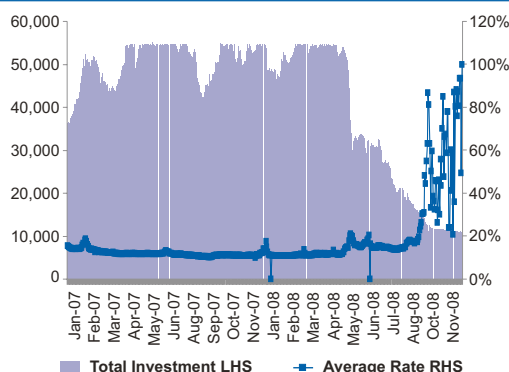
The second phase of asset dumping began in Oct08; redemption pressure which had initially hit Equity Based Mutual Funds began to creep into Fixed Income Funds. Unable to offload their equity positions the Mutual Fund industry turned to the Corporate Bond market. No respite: with inflation expectations at 20% for FY09 and an IMF program in the works, rates had to rise. In the meanwhile trading of TFCs halted and prices remained sticky, leading to severely over-valued Fixed Income portfolios.

SECP later asked asset management companies to mark down their TFC portfolios in line with an arbitrary pricing formula and rationalize unit prices. This is in spite of the Mutual Fund Association offering to submit recommendations regarding valuations to the Regulator. Panic regarding a crunch in Income Fund values set redemptions on fire. This move by the Regulator was again vociferously vetoed by the MUFAP as Open end Income funds would have been forced to temporarily suspend issuance, redemption and pricing of their units. Faced with increasing capital outflows the only avenue available for Mutual Funds was liquidation of bank deposits. Thereafter ensued a heavy depletion of the banking sector's deposit base.

Finally CFS...

In the current scenario capital was precious; some CFS Mk II financiers began to renege on their agreement to commit a minimum amount to the CFS pool of funds with the NCCPL or clearing house. Rates shot up past 63% and broker defaults on CFS margin calls were on the rise, triggering a vicious cycle of refinancing incapacity, unsustainable rates and a shrinking pool of CFS funds now standing at PKR 11bn. With distressed brokers unable to meet financial obligations and the risk of further default heightened by the removal of market floors, CFS investment also screeched to a halt on Dec 15'08.

Chart 15: CFS (PKR mn)



Source: KSE & IGI Research

On Dec 15'08 the SECP compelled the KSE BoD to remove market floors, however brokers petitioned in the Sind High Court against the floor removal. Citing 'frustration of contract' brokers claimed that CFS II financiers had reneged on their minimum commitment of funds to CFS which justified their own non payment of margin calls. By Dec 19'08 the court allowed financiers to go ahead in their bid to join the brokers/finances petition against the National Clearing house. This is a significant development as the court has accepted that the financiers and brokers are the underlying contractual party with the NCCPL as the facilitator. Initially brokers had filled the suit against NCCPL on the grounds that its contract was with the facilitator and not the financier. As a contractual party in the same suit against the Regulator and the Clearing House, the financiers now have a better chance of preventing rollover of their funds or evaporation of their capital.

The SHC on Dec 19'08 allowed NCCPL to square up the Mk-II transactions and liquidate the securities furnished by the plaintiff. The court directed securities companies to furnish PKR 7bn bank guarantee by Dec 22'08 however we expect lawyers on the plaintiffs end to file an appeal to the order in which case a stand-off in CFS might continue.

Something's Gotta Give

If contracts were reneged upon by financiers, those financiers should be penalized and the others rewarded. On the contrary if the court allows CFS contracts to become null and void, as petitioned by brokers, it stands to penalize the lender community as a whole.

The repercussions will be colossal; although financial market interventions appear to be evaporating liquidity constraints, they are ultimately creating unsustainable liquidity pressure on other investment channels. In the long term we feel this has serious consequences for Regulator credibility and investor confidence in the market.

The Year of the Terror Trap

In the very recent past Pakistan's prospects were looking very bright on account of its very obvious advantage as a key player in the war against terror. An alliance with the US, long-standing relationship with China and improving relations with India contributed to the image of a more credible, reliable and liberal Pakistan all of which initiated a new wave of investment and growth.

Fast forward to CY09 and the regional political landscape has altered dramatically. The friction on Pakistan's eastern border with India has reached a high pitch while tensions in Afghanistan have spilled over into Pakistan's Northwest. This poses continuous security challenges to the country's urban infrastructure, manifested in the rapid increase in attacks on government and security services and civilian targets such as the Marriot Hotel in Islamabad.

A more demanding ally and confrontational neighbour

Terror attacks in Mumbai and the ensuing deterioration of Indo-Pak relations maximized pressure on Pakistan. Within just 2 weeks of the attacks a barrage of US and British senior leaders including Secretary of State Condoleezza Rice Vice President Elect Joe Biden, Senator John McCain, Senator John Kerry and British PM Gordon Brown descended on both countries to cool the situation.

India has provokingly violated Pakistani airspace twice in the last week and the country's FM has stated that the Peace process is currently on 'hold' while war is not on the agenda. Meanwhile in Pakistan arrests were made and an Islamic charity linked with a militant organization was shut down and its assets frozen. Although Pakistan has sent all the right signals to both India and the US, demands from both countries are unlikely to cease in the near future.

In the backdrop are closer military linkages between long standing allies, China and Pakistan who signed a corporation pact earlier this week at the 6th round of the Pakistan-China Defence and Security Talks. On the flip side are warming relations between India and the US; in Sep08 the US House of Representatives passed a civilian nuclear pact with India that lifts a three decade-old ban on nuclear trade with New Delhi. No such treats in store for Pakistan.

When push comes to shove...

There's no denying that regional politics will come centre stage in FY09/10 much like domestic politics remained the key theme of 2008. In both cases the result is unlikely to be positive; the US war on terror in Afghanistan is expected to intensify with the Obama administration's new focus on the region. Pakistan with the Central Asian States above it and Afghanistan, Iran, India and China on its border is at the nexus of the War on Terror, Nuclear Weapons concentration and Poverty.

In the coming weeks and months, the Pakistani leadership will have to move quickly and carefully; on the one hand to keep in step with its foreign allies in Afghanistan and on the other to respond with restraint and care to its eastern neighbor as needed. Globally, confidence in Pakistan is suffering, on account of lack of capacity, lack of will and sometimes lack of credibility in its foreign policy dealings. The past 8yrs of military control have done little to improve transparency and accountability; although this might have worked in favour of the Bush administration, it may not sit well with the new leadership in America.

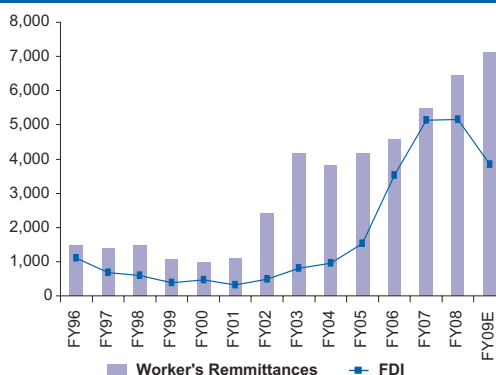
Fragile democracy at risk

Foreign policy hitches are expected and opposition to Pakistan's relationship with the US from the diverse social and political fabric of the country will emerge. The fallout of the new emphasis on performance criteria will be hardest on the fledgling Pakistani democracy. Sustained opposition could exacerbate domestic instability and political infighting and consequently cracks in the coalition government. If the PPP led coalition were to fall apart and lose control of the political steering wheel, reform agendas whether in political, economic or legislative spheres, will be put on hold, endangering future stability.

Economic vulnerabilities could deteriorate on lower external inflows

Pakistan’s economy has entered a trough in its growth cycle with expected GDP at 3.5% for Jun09 and is likely to remain in an adjustment phase in FY10. Removal of market distortions, minimization of regulatory risks and further integration of fiscal and monetary policies should activate a new growth phase. However a key challenge in the medium term is a deeper than expected global recession which will restrict cross-border flows from key partner countries. This will negatively impact both fiscal and balance of payments deficits and could sustain inflation and currency weakness. A vicious cycle may ensue with these two factors deterring future investment and financial commitments.

Chart 16: FDI and Remittances (USD mn)



Source: SBP

Ratings reflect decade-long economic and political lows

Pakistan has suffered the most rapid decline in ratings and downward outlook revisions in a decade. Pakistan’s S&P peer group has changed from the likes of Indonesia to Lebanon while its ratings declined to CCC/Negative/C for both its Foreign Currency Debt and Local Currency denominated debt. This is a major shift from a BB and Positive Outlook in Dec06. Moodys Investor services has similarly downgraded Pakistan’s country ceiling to B3 from Baa1 group earlier. The last time Pakistan faced such a loss of credibility and confidence was right after the nuclear blasts of 1998.

Table 1: Ratings History S&P

	Local Currency LT/Outlook/ST	Foreign Currency LT/Outlook/ST
Nov 17, 2008	CCC/Negative/C	CCC/Negative/C
Oct 6, 2008	CCC+/Negative/B	CCC+/Negative/B
May 15 2008	BB-/Negative/B	B/Negative/B
Jul 10 2007	BB/Stable/B	B+/Stable/B
Dec. 19, 2006	BB/Positive/B	B+/Positive/B
Dec. 28, 2005	BB/Stable/B	B+/Positive/B
Nov. 22, 2004	BB/Stable/B	B+/Stable/B
Dec. 2, 2003	BB-/Positive/B	B/Positive/B
Dec. 12, 2002	BB-/Stable/B	B/Stable/B
Dec. 21, 1999	B+/Stable/B	B-/Stable/B
Jul. 9 1999	B/Stable/B	SD/NM/SD
Jan. 29, 1999		SD/NM/SD
Dec. 3, 1998		CC/Negative/C
Oct. 12, 1998		CCC-/Negative/C
Jul . 14 1998		CCC/Watch Neg/C
Jun 1 1998		B-/Watch Neg/C
May 22 1998		B+/Watch Neg/B
Jan. 14, 1998		B+/Negative/B
Jan. 31, 1997		B+/Stable/B
Aug. 3, 1995		B+/Stable/—
Nov. 21, 1994		B+/Positive/—

Source: S&P Rating History

The above ratings reflect serious damage to Pakistan’s political and economic credibility and strength, without which investors are unlikely to be attracted to Pakistan. Pakistan needs to undergo a rigorous structural adjustment program and also rejuvenate its political framework to meet future foreign policy and internal security challenges.

Given the country is currently on IMF crutches and the new democratic government is finding its feet after 8yrs of military control, a quick rebound is highly unlikely. Although not impossible, we feel it will take much time and persuasion for Pakistan to regain its former position in the global marketplace and political landscape.

Pakistan knocked off the MSCI EM Index

During the last couple of months Pakistan has faced a barrage of downgrades and votes of no confidence. The latest nail in the coffin was the Dec 10'08 announcement by MSCI Barra (NYSE: MXB), a leading provider of investment decision support tools world wide, that it will remove the MSCI Pakistan Index from the Emerging Markets Index as of the close of Dec 31'08 The MSCI Pakistan Index will remain as a stand alone index after its removal from the MSCI Emerging Markets Index.

The press release stated that the imposition of the market floor in Aug08, and the resultant paralysis of the KSE indices had compelled the institution to take the above action. The deterioration of investability, price discovery and the following ambiguity regarding the removal of the floors made the investment decision inevitable. A day later the SECP announced the KSE BoD would lift market floors; too little too late. If regulators wanted a taste of things to come on account of heightened regulatory inefficiencies – this was a clear indication.

The total share of Pakistani companies in the MSCI EM Index was 0.18% and included JSCL, PTCL, UBL, MCB, FFC, NBP, PSO and OGDC. In May08 the investment advisor had reduced the number of Pakistani companies in its index from 13 to 8.

The Writing's on the Wall

Whether on the political front or on the economic front, the writing's on the wall: 'actions not words'. With regards to the reform agenda proposed and agreed upon with the IMF, the government is likely to face serious implementation challenges.

On a positive note the IMF agreement was preceded by bold policy moves made by the current government including;

- i. A gradual rate hike which brought the Discount Rate to 15% from pre-crisis levels of % earlier
- ii. Elimination of fuel subsidies
- III. Electricity tariff increase of an average 18%

Moving forward timely and efficient processing of performance criteria should win the confidence of the IMF team, but delays could also destabilize the refreshment of stand by facilities. The Memorandum of Understanding with the IMF team is based on the government's commitment to undertake legislative reform and ensure independence of the SBP in the areas of Banking Supervision and harmonize Tax Laws during FY09, without which future stability and IMF support will be unlikely.

Tax regime needs a revolution

The fiscal deficit target of 4.2% of GDP was set for Jun09 down from 7.4% a year earlier which will be based on cuts in subsidies and non-essential development spending but be balanced by an increase in spending on social safety nets. Although the fiscal target is likely to be achieved as is evident from 1Q FY09 figures, the impact on poverty will be dire in which case social spending at just 1% of GDP will be inadequate.

On the Revenue front the government will need to conduct a bold campaign to broaden the tax net, otherwise the PKR 1.36tn revenue target will remain unmet. Pakistan's tax to GDP ratio is also one of the lowest in the region near 10%. The fact that Agriculture Sector, which contributes more than 20% to GDP, is out of the tax net suggests a new approach to the Tax to GDP ratio is imperative.

Historical trends also loom; the average increase in tax revenues has been 5-10% in times of economic stress. However the new administration increased the FY09 tax revenue target from PKR 1.25tn to PKR 1.36tn; a 35% increase over the previous year's revenue of PKR 1.05tn

Greater Fiscal and Monetary Policy Coordination

In the IMF Lol it was also noted that an interagency committee that will be established to review technical recommendations from the IMF regarding legislative changes to ensure operational independence of SBP. Representatives from the Ministry of Finance and SBP will aim to improve policy efficiencies by removing market distortions such as excess government borrowing direct from the central bank. However the legislative change would have to be meaningful rather than superficial.

An example of such an attempt would be the Fiscal Responsibility Act 2005; although the regulations of the Act were violated there were no legal implications for the Government. The government was bound to ensure that total public debt is reduced by not less than 2.5% of GDP for any given year amongst a number of other provisions. It did not, and there was nothing the central bank, the public or the legislature could do about it. This kind of legislation or 'Acts' would be a fruitless exercise, therefore it would serve both monetary and fiscal agencies if they are able to agree and implement meaningful legislative change.

Liquidity management a priority

On the monetary policy front several positive developments are expected which will enhance forecasting of the government's cashflow. The announcement of a rate corridor to rationalize money market rates is one such positive. Rates using the SBP's reverse Repo rate as the ceiling and the standing Repo facility to absorb excess liquidity as the floor will stabilize market liquidity and send clear monetary policy signals. In the last month O/N Repo rates have slipped to 1-2% whereas the DR has been at 15%; in such a situation the SBP will be expected to step in and mop up excess funds however a rate of remuneration is unclear. Further measures include clear treasury auction volume targets, advance notice of auctions and availability of T-bills from the Treasury to the SBP, as needed, to conduct its Open Market Operations.

Integrating Foreign Exchange management into Monetary policy

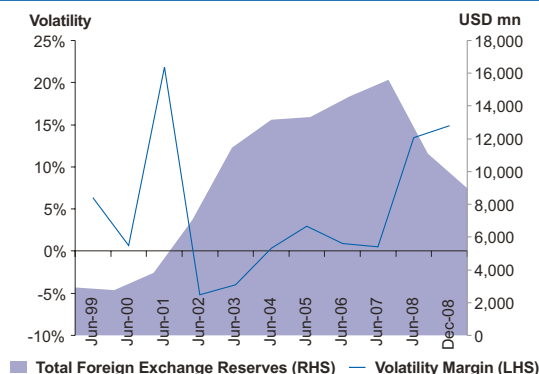
The SBP has also been instructed to phase out foreign exchange financing of the following;

- (i) Furnace oil by Feb1'09.
- (ii) Diesel and other refined products by Aug 1'09
- (iii) Crude oil by Feb 1'10.

This will integrate foreign exchange policy of the central bank fully into its monetary policy. Limiting FX market intervention will allow the exchange rate to function as it should; as a 'price' or transactional cost.

In the past the SBP has sought a desirable PKR band against the USD which has kept foreign exchange volatility at bay. In the long term however this has jeopardized currency strength; in 2008 the PKR plunged by more than 40% against the USD after nearly 5yrs in a 1-2% volatility range against the USD at PKR 60.

Chart 17: Exchange Rates and Reserves

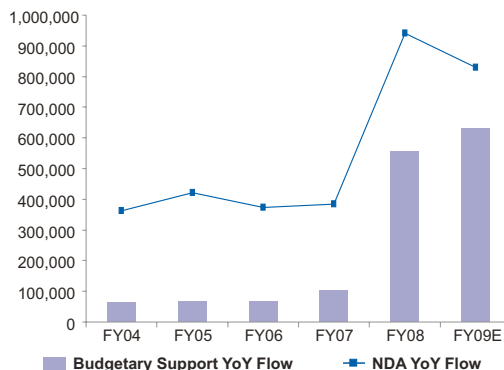


Source: SBP

NDA ceiling crucial for stability

NDA are defined as the difference between the Reserve Money and Net Foreign Assets of the central bank. With DTLs on the decline it is essential that an NDA ceiling is established for the SBP. Currently set at PKR 1.3tn and currently standing at 1.3tn and up nearly 30% over stock of the same period last year, it provides little room for maneuver. The key risk to the SBP NDA target are sources of financing for fiscal managers and a larger than expected global slowdown. If budgetary borrowing continues at these rates stock of SBP NDA may rise by a further PKR 1tn triggering crowding out of the private sector and also further inflation; not to mention the displeasure of the IMF.

Chart 18: Govt Budgetary Support and NDA (PKR mn)



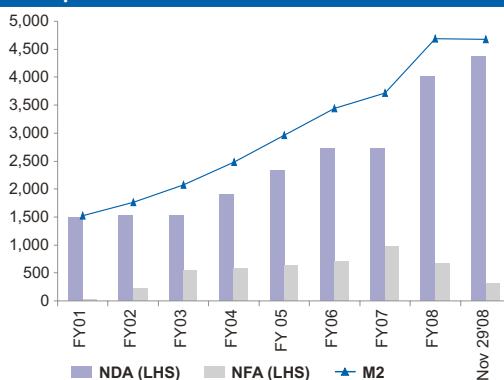
Source: SBP

NFA: the eye of the storm

The IMF team has set a floor of USD 2.8bn in SBP NFA for Jun09 and an official reserve target of USD 8.6bn. As of Dec08 the SBP holdings of NFA, defined as the difference between its foreign assets and foreign liabilities, stands at roughly USD 1.5bn. In order to double this number administrators have proposed removing oil import payments from the SBP books and exerting further vigilance on foreign exchange outflows.

However drains on Foreign Currency Assets expected in the short term are close to USD 10bn not including outflows related to trade and portfolio investment. The cumulative impact of trade related and investment outflows will create further pressure on the NFA position by Jun09 which will depress overall M2 growth during FY09.

Chart 19: M2 stalls on NFA depletion (PKR mn)



Source: SBP

Currency a definitive casualty in FY09

The PKR has to have been the greatest casualty of the year; and its woes are likely to carry over into the 2H FY09. Challenges regarding external inflows remain as we move into the new year while outflows mount. Looking at the Balance of Payments position for 5mo FY09 the numbers look worrying; at a deficit of USD 5.72bn the overall outflow run-rate comes in at an average USD 1.14bn a month. If the current pace of outflows is sustained we can expect a massive balance of payments deficit of USD 13.72bn or more than 8% of expected GDP. Against a Reserve position that has already declined by 52% to USD 6.5bn in Nov08, the balance of payments position is a worrying sign. Although the IMF fund support to Pakistan will provide a short term buffer we feel policy makers will have to take stronger action in a scenario where export receipts remain weak against sustained import and debt payment pressure. If Reserve targets are not met in FY09 the official reserve position could decline again and sustain pressure on the PKR, pushing it towards PKR 90 against the USD.

Research Team

Zainab Jabbar	Investment Strategy, Economy	Tel: (92-21) 111-234-234 Ext.:810	zainab.jabbar@igi.com.pk
Abdul Sajid	Database	Tel: (92-21) 111-234-234 Ext.:813	abdul.sajid@igi.com.pk
Mansoor Ahmed	Design, Layout	Tel: (92-21) 111-234-234 Ext.:812	mansoor.ahmed@igi.com.pk
Burhan Javaid	Research Analyst	Tel: (92-21) 111-234-234 Ext.:823	burhan.javaid@igi.com.pk

Equity Sales

Azhar Ahmed Batla	Tel: (92-21) 530-1713	azhar.batla@igi.com.pk
Sher Afgan (LHR)	Tel: (92-42) 630-0082	sher.afgan@igi.com.pk
Shafqat Ali Shah (ISL)	Tel: (92-51) 280-2243	shafqat.ali@igi.com.pk
Chaudhry Usman Javed (SKT)	Tel: (92-52) 3242689	usman.javed@igi.com.pk
Muhammad Ejaz Rana (FSD)	Tel: (92-41) 254-0854	ejaz.rana@igi.com.pk

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Head Office

7th floor, The Forum, Suite 701-713, Khayaban-e-Jami, Clifton, Karachi
Phone: (92-21) 111-234-234 Fax: (92-21) 111-567-567, 5301729

Branch Offices

Karachi (Clifton)

F-5, Block 9, Clifton, Karachi.
Phone: (+92-21) 5309258-60 Fax: (+92-21) 5309168

Karachi - KSE

Room # 70, 1st Floor, KSE Bldg. Karachi Stock Exchange Road, Karachi
Phone: (92-21) 2429601-06 Fax: (92-21) 2429607

Lahore

5-F.C.C. Ground Floor, Syed Maratib Ali Road, Gulberg, Lahore
Phone: (92-42) 5756701, 5777861-70 Fax: (92-42) 5762790

Lahore - DHA

75-T, Phase 2, DHA (near Lalak chowk), Lahore
Phone: (92-42) 5707411-33 Fax: (92-42) 5748935

Islamabad

Mezzanine Floor, Razia Sharif Plaza, 90 – Blue Area, G-7, Islamabad
Phone: (92-51) 111-234-234, 2802241-43 Fax: (92-51) 2802244

Faisalabad

9th Floor, State Life Building, 2 – Liaqat Road, Faisalabad
Phone: (92-41) 2540843-45 Fax: (92-41) 2540815

Sialkot Office

Room No: 206, Sialkot Trading floor, Cantt Plaza, Sialkot Cantt.
Phone: 052 -4566032-36 Dir.: 052 – 4566034-36 Fax: 052- 4566035

Multan Office

C-2, 1st floor, Hassan Arcade, Multan Cantt.
Phone: (92-61) 4784401-02 Fax: (92-61) 4784403

Gujranwala Office

Nasir Plaza, Main GT Road, (Adjacent to New Railway Station), Gujranwala
Phone: (92-55) 3841346-48 Fax: (92-55) 3257453

Peshawar Office

Mall Tower, 2nd floor, 35. The Mall Peshawar
Phone: (92-91) 5253980-88 Fax: (92-91) 5253989

