

# Pakistan Strategy FY09

## Is the Party Over?

### Economic Outlook FY09: Negative

In line with our expectations for FY08 CPI inflation hit 12% against a target of 6.5%. We foresee persistent inflation pressures in the short term with CPI inflation hitting 19% in FY09 as there is limited fiscal space available to subdue prices. We anticipate the discount rate to follow suit with a staggered movement of 150bps a quarter in order to keep the real rate of return at par with inflation. However rate movement may face resistance from rapidly deteriorating growth indicators. Deferred payment facilities, debt waivers, stable remittances, and external assistance due to Pakistan's geopolitical significance will serve as economic buffers in FY09.

### Budget Outlook FY09: Negative

Where the previous Budget was weak, Budget FY09 is weaker in light of the much more aggressive steps required to stabilize the economy. The fiscal deficit target of 4.7% suffers from implementation constraints; while cutting the oil subsidies was a brave step it largely offset by higher debt servicing costs. PSDP spending is touted to rise by 20%, Subsidies to decline by 28% to PKR 295bn, Tax revenue is expected to increase by 24% while Bank Borrowing to fall three-fold over revised Budget figures for FY08. Given the economy will remain under stress in the short term the above targets reflect obvious constraints.

### Political variables take center stage

The federal government coalition fell apart within a few months of its formation as expected. Despite a clear democratic advantage after a decade of military intervention, Pakistan's political framework faces a challenging future with key risks although unlikely, being a PML-N walkout from the federal core and cracks within the PPP. The increasing security threat from the border with Afghanistan, deteriorating relations with the US, loosening grip on inflation and power shortage has inflamed the GoP's predicament.

### KSE 100 bottom dips further

In the hazy backdrop of deteriorating political and macroeconomic variables, the capital market's shock absorbers have weakened considerably. We estimate future earnings to decline in view of a discount rate of 18% by end FY09. Accordingly we have readjusted our 'oversold' range of 9,300-10,200 points, post the MPS of May 28'08, further downward to a range between 7,400-8,300 points for the KSE 100.

### KSE's rough terrain brings some bargains to the fore

Unanticipated rates of CPI inflation have significantly altered our stance on the economy. From an opportunist stance we recommend investors adopt a defensive strategy for the next 6-12mo. Regulatory measures, if substantial and well timed, could support the KSE 100 only in the very short term, between a 8,000-10,000 points. Underleveraged scrips protected by currency and commodity hedges or driven by dynamic demand cycles could offer attractive gains for hardy investors in the medium to long term. In the near future however diminishing foreign reserves, a wobbling PKR and increasing dependence on external liquidity signal deep fissures in the economic landscape. This is unlikely to translate into a bullish sentiment during FY09.

### Zainab Jabbar

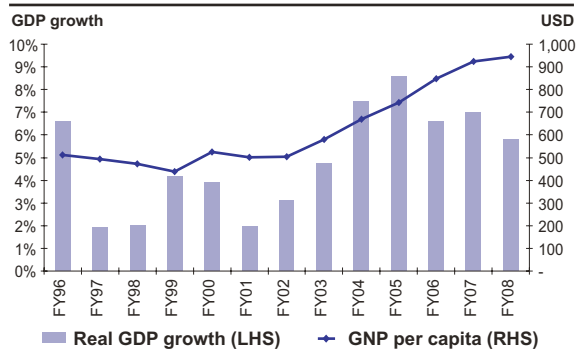
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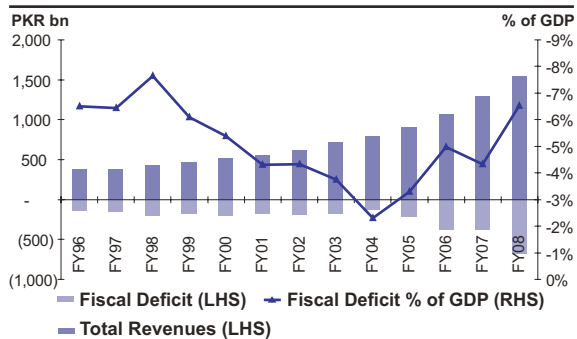
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**Chart 1: GDP growth and Per Capita Income**



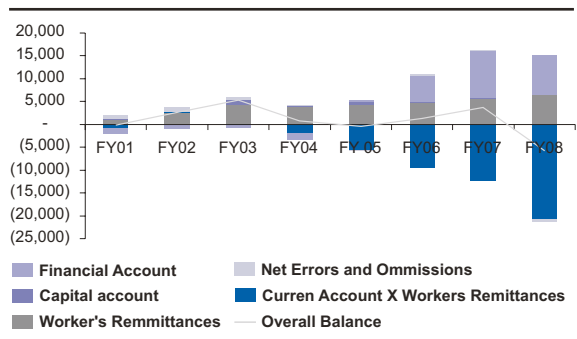
Source: Economic Survey, IGI Research

**Chart 2: Fiscal Management**



Source: Economic Survey, IGI Research

**Chart 3: Balance of Payments (US\$ mn)**



Source: SBP, IGI Research



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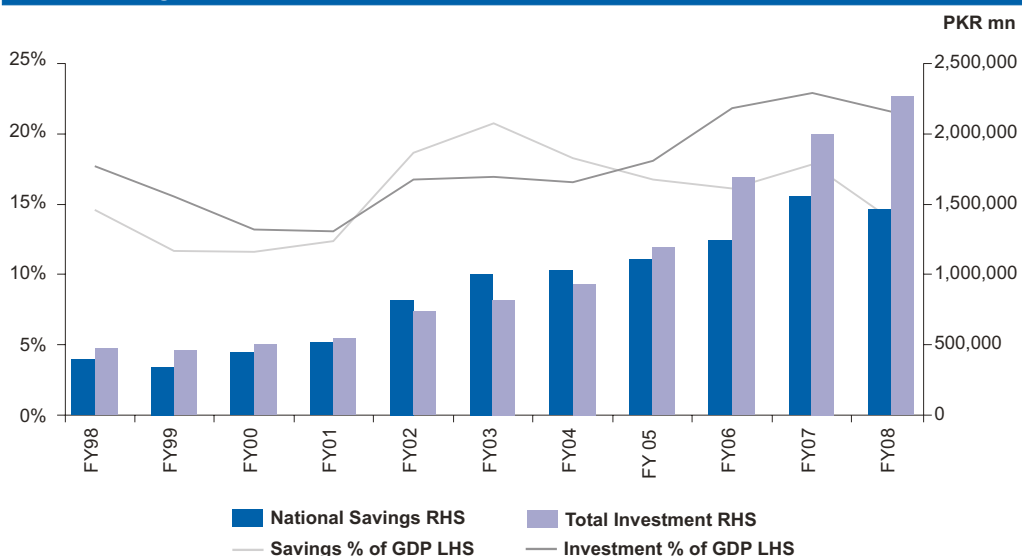
## Rough Tides

Rapidly rising inflation and deteriorating political and fiscal variables compounded pressure on the economy in FY08 and remain challenges to future growth in FY09. Given the obvious concerns it was not advisable to embark on fiscal loosening in FY07, especially when the global economy was facing headwinds and both the balance of payments and fiscal operations were substantially dependent on external liquidity. A tumultuous election year, soaring global commodity prices and spiraling inflation shook investor sentiment further; pulling the plug on growth in the short term. For now we must come to terms with a bear case for Pakistan; economic and political roadblocks are unlikely to budge in the next 6-12mo.

### Growth and Investment decline

Disappointing results fettered Pakistan's economic position, with growth descending to 5.8% while investment (GFCF) plunged back to 18% of GDP and a real growth rate of just 3% over Jun07. Savings also remained under pressure plunging to 13.9% of GDP from the 16-17% range earlier. This presents a serious constraint and reflects the urgency for rationalization of rates. Domestic demand (public & private consumption and investment) rose at a rapid pace by 23% over FY08. However this number also reflects the inflationary pressure rampant in the economy. Moving forward we expect growth to stabilize in the 3-4% range in FY09 due to demand contraction and high cost of capital and production.

Chart 4: Savings and Investment



Source: SBP

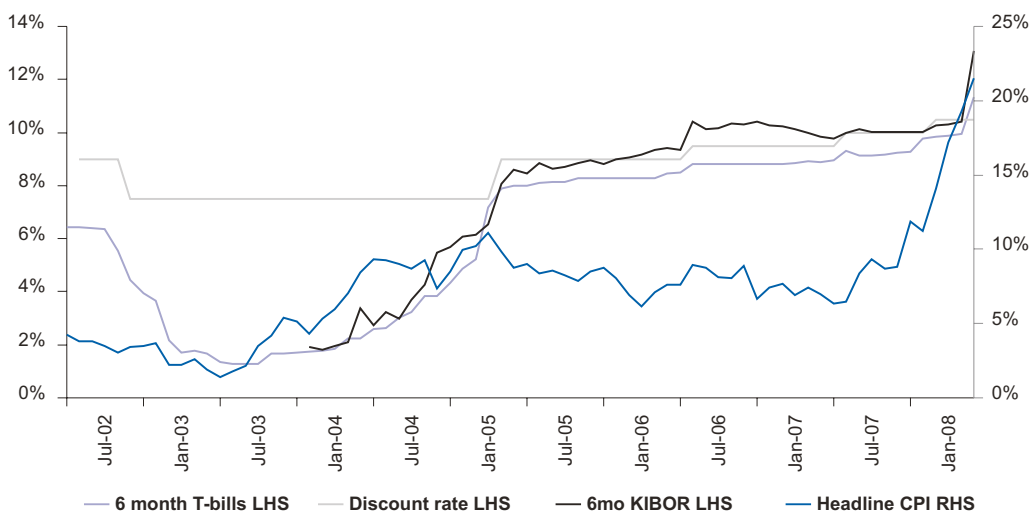
### Inflation a global problem

Inflation has rattled nerves across the globe; Eurozone inflation hit a record inflation high of 4%, China an 11yr high of 8.7% in Feb09 and India a 13yr high of 11.92% in Jul08. Central banks across the globe have been caught between slowing growth and spiraling inflation; any economic stimulus from rate cuts will be on hold until inflation is bridled.

**Domestic CPI Inflation closing in on 20% in FY09...interest rates to follow suit**

Pakistan has faced a greater challenge, being a net importer of essential food and fuel items as well as raw materials and machinery. With CPI inflation crossing 20% in Jun07 and expectations of a further increase on account of reductions in oil price subsidies we could easily foresee inflation rates as high as 25% in Jul08. Gas tariffs were raised in Jul08 by between 31-121% while oil prices were hiked by between 82% and 62% over Jul07 levels. The reverberations of this and upcoming upwards price revisions are likely to be felt late into FY09 with our expectations of average inflation in the range of 19-22%. This could be averted if regulatory bodies find the fiscal space to reduce determined rates of food and fuel; which is unlikely.

**Chart 5: Inflation and Interest Rates**



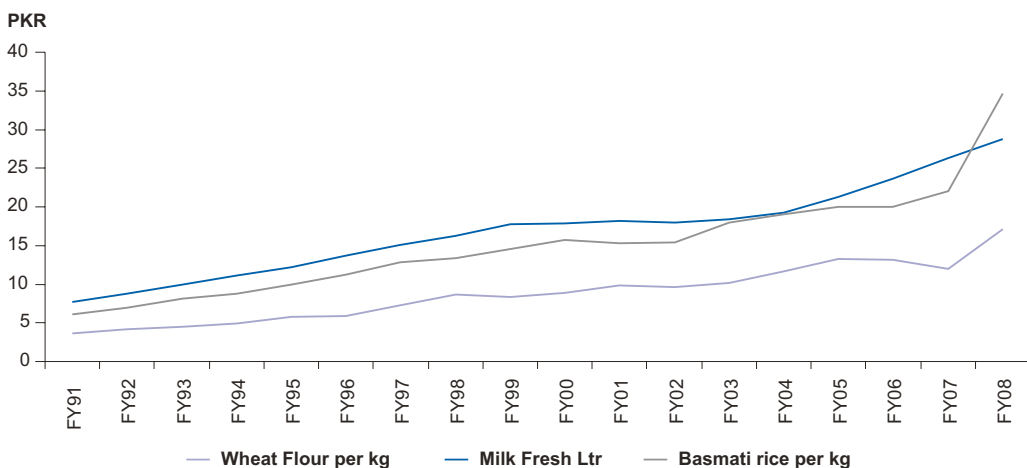
Source: SBP

Given the inflation rates are in the high double digits the real rate of return could slip to negative 6%. A negative real rate of return could severely destabilize the money market as savers and lenders preserve funds and liquidity. Consequently we expect monetary policy makers to announce a staggered rate increase of 150bps a quarter and 100bp increase in CRR and SLR in the next monetary policy announcement due Jul 29'08. We recommend monetary policy makers meet more regularly to move inline with the fast pace of inflation. A key example would be India which has aggressively responded to inflation by raising its policy and reserve rates twice in the last two months with another hike in the pipeline.

### Government in a catch 22

PASSCO, the government’s food procurement arm, purchases essential food items including wheat, rice and sugar at minimum support prices (MSPs). The MSPs work well in a price slump but serve to destabilize markets when the economy is faced with a price spiral. If the government chooses to intervene it could trigger hoarding and price manipulation leading to leakages of precious stocks. If it doesn’t intervene and raises the MSP to plausible levels it will deepen the impact of food inflation. In our view raising the MSP would be the lesser evil as domestic stocks would atleast be protected allowing supply to ease inflationary pressures.

**Chart 6: Prices of Essential Food Items**

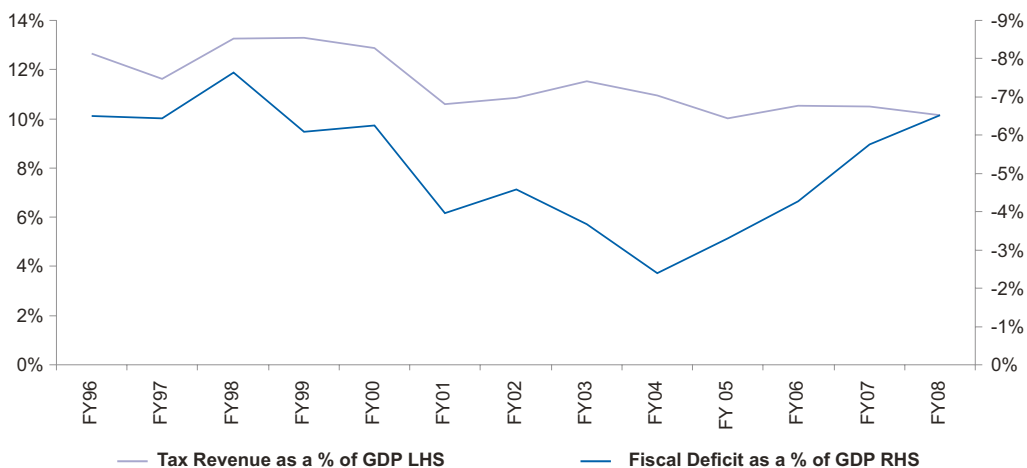


Source: Economic Survey

### Fiscal vulnerabilities

Consolidated tax revenues as a % of GDP remained in the 10% range at PKR 1,062bn and were heavily supported by Non-tax Revenues of PKR 483bn, However in an interesting development the Economic Survey FY08 published by the MoF released revised figures of Total Expenditures incurred by the government; PKR 1,799.9bn against an earlier figure of PKR 1,663.8bn. This stretches the fiscal deficit to nearly 6% of GDP against a published estimate of 4.3% for FY07. We believe a similar fiscal trend will permeate FY09 policy making, with the projected FY08 Fiscal Deficit stretching beyond government estimates of 6.5% to the 7.5% range.

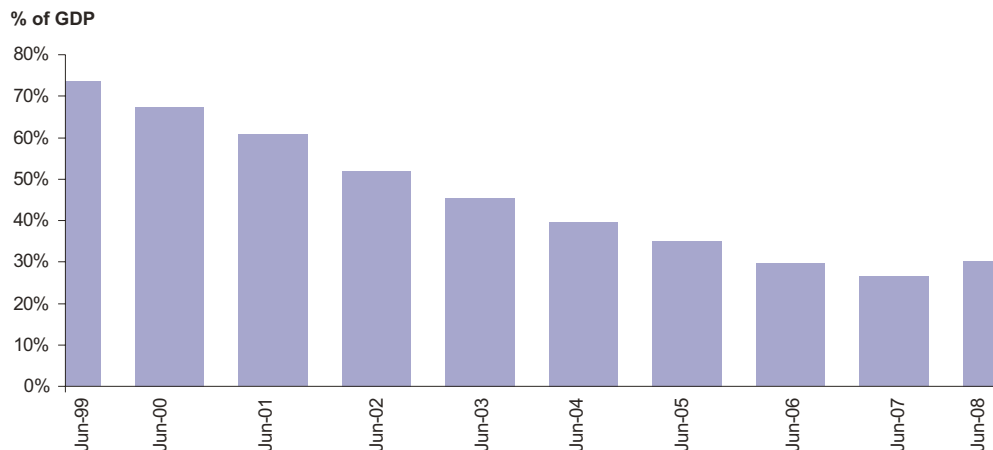
**Chart 7: Tax % GDP and Fiscal Deficit % GDP**



Source: Economic Survey

Total Public Debt as a % of GDP declined to just 57% in FY07 compared to more than double that a decade earlier. Although we don't have access to external debt data post Mar08, domestic debt figures reflect a much faster pace of debt accumulation in the 2H FY08. This increases the possibility that the debt to GDP ratio will overshoot the limitation requirement of less than 60% of GDP by a substantial margin.

**Chart 8: EDLs % of GDP**



Source: SBP

We had anticipated an increase in NSS and PIB net investment during the fiscal year, and in line with our expectations NSS schemes saw a net inflow of PKR 78bn in 11mo FY08 reflecting an increase of 25% savings mobilized the previous year. Given NSS schemes are bullet bonds that produce exponential outflows from the exchequer on redemption and maturity, increased reliance on these schemes poses a serious risk to future fiscal management. In FY05 the NSS pool saw a net outflow of PKR 39bn which created significant pressure on fiscal accounts.

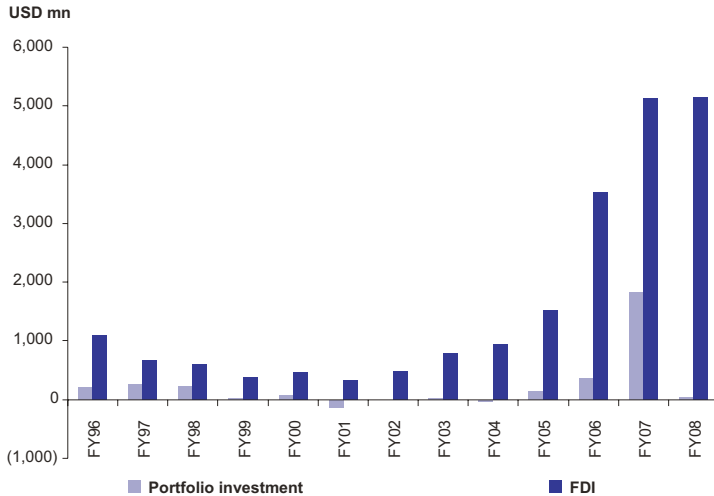
**External Imbalance takes the cake**

A massive balance of payments deficit to the tune of USD 5.8bn or PKR 400bn was realized in FY08, fueled by a trade and services deficit of above USD 25bn and limited inflows into the Financial Account of just USD 8.7bn; 14% less than the previous year. In the short term we foresee the economy facing a significant challenge from limited investment flows against the backdrop of costlier imports and a challenging exports scenario.

**Structural support from FDI and remittances to continue**

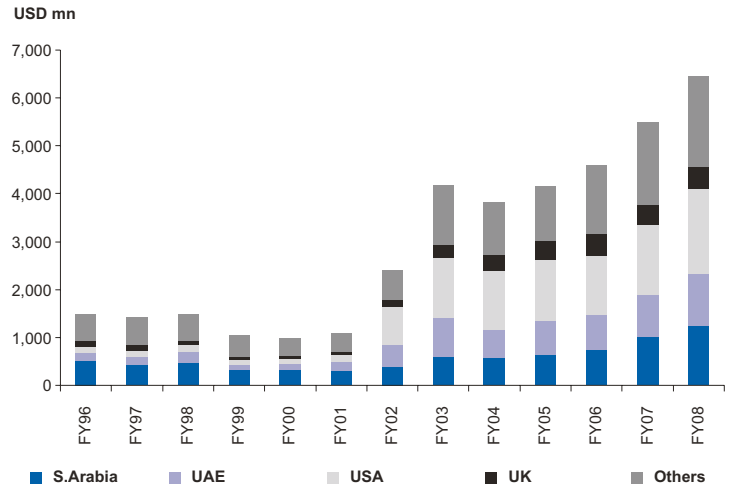
Nevertheless remittances and FDI have remained relatively stable at USD 6.5bn and 5.1bn respectively providing structural support to the economy. The trend is likely to continue in FY09 as specific sectors including E&P and Power offer attractive returns. However we are likely to see a cooling off in investment into others such as Banking, Telecom and Cements.

**Chart 9: FDI**



Source: SBP

**Chart 10: Remittances**



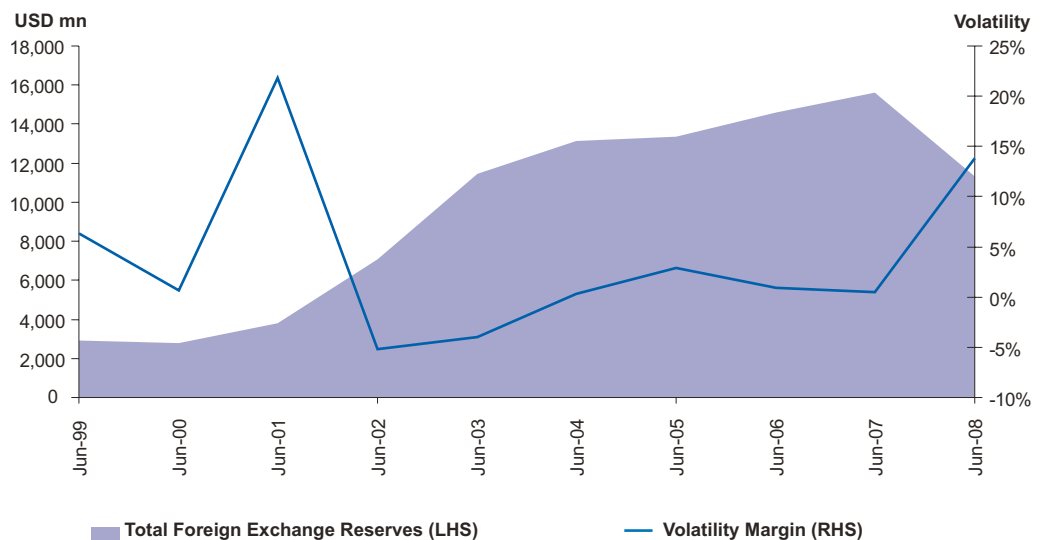
Source: SBP

**Currency instability ahead**

Pakistan's currency has nose-dived against the USD in the last couple of months, dipping 20% lower on Jul 8'08 compared to Jun07 levels. The greatest threat to the PKR is that of capital flight in reaction to the country's economic tribulations. The government must immediately address our low savings rate and high consumption spending reflected in the widening current account gap. Policy options available are further regulatory controls on imports and ofcourse higher interest rates.

In 2H FY08 it appeared currency instability would be supported by capital inflows via global bond issues and privatization deals. The new government's inability to carry these deals through reflected its particular state of fragility, which was compounded by the vulnerable state of global markets in the last quarter of FY08.

**Chart 11: Exchange Rate Volatility**



Source: SBP

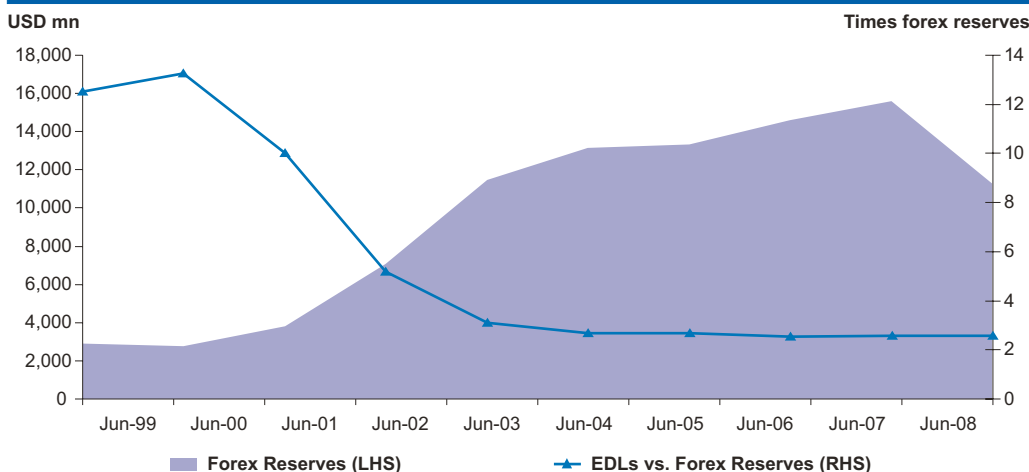
Although the Saudi oil facility might ease pressure on the current account in FY09, it only presents a short term solution to our exchange rate difficulties. Higher debt servicing costs and limited capital inflows against diminishing current account receipts will increase exposure in the current fiscal period. Let's not forget the maturing Eurobond 'PKSTAN 2009 which will suck up USD 500mn+ of liquidity in Feb09.

**A Decade of Differences**

During the mid 1990's Pakistan also went through a series of economic shocks and political breakdowns which culminated in the nuclear tests of 1998 and finally the military intervention by General Musharraf in Oct99. Compared to a decade earlier Pakistan's per capita income has nearly doubled, the value of the economy has tripled, tax revenues have nearly quadrupled and total debt as a % of GDP has halved to 57% last year. Foreign debt servicing as % foreign reserves are expected to range between 7-8% compared to 42% a decade ago, total debt servicing is less than 6% of GDP while EDLs as a % of GDP are still in the range of 28-30% and stand at 4.3x foreign reserves.

While economic variables reflect better financial management, in FY08 there has been a substantial depletion of gains made over the last 5yrs. The currency depreciation of nearly 20% since Jun07 reflects the stress the economy is undergoing at this time.

**Chart 12: EDLs % of FX Reserves**



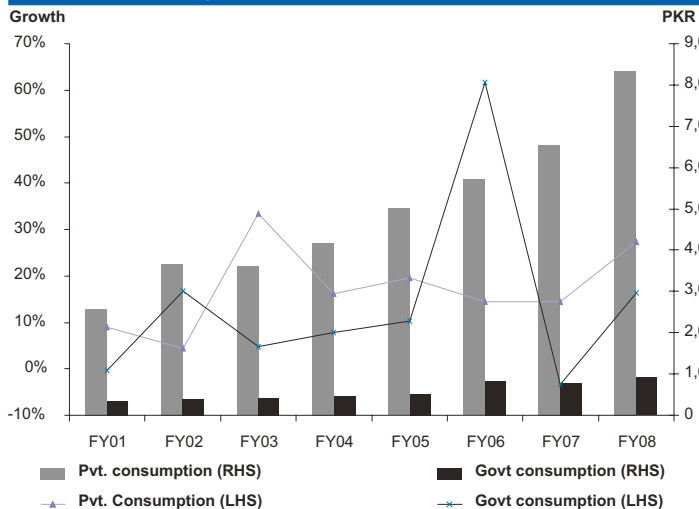
Source: SBP

Structural strengths were thought to have contributed towards sustainable growth; monetary and fiscal policy makers appeared to be making headway in the struggle for growth and investment. Infrastructure indicators including crude oil extraction, gas supplies, electricity capacity installed, road networks, telephone connections, mobile phone networks and motor vehicles on the road all signaled an improvement in production and efficiencies. So why the negative sentiment?

Much of the growth in domestic demand (private, public consumption and GFCF) has been consumption based; Gross Fixed Capital Formation (Investment or GFCF) still remains low while fiscal space to stimulate growth remains limited moving forward. Meanwhile the twin deficits reveal the widening gap between Pakistan's diminishing capacity to earn and its widening desire to spend.

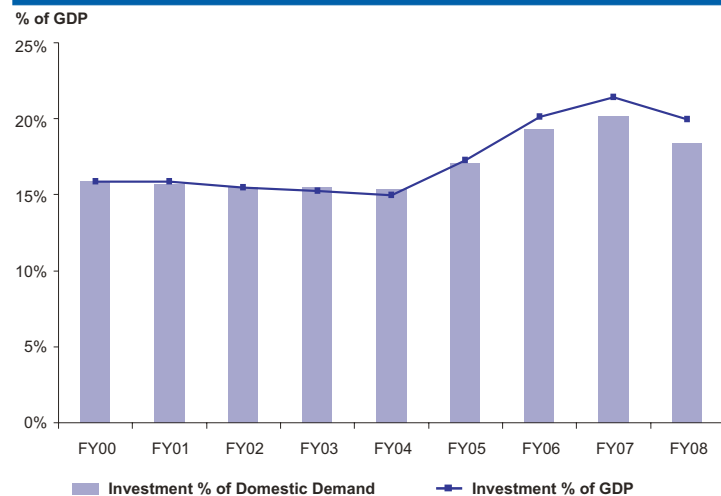
In order to convince both domestic and foreign investors that policy makers mean business we feel future strategy will aim to control aggregate demand, reduce consumption, boost savings and fund future investment in order to prevent risk ratios from deteriorating further.

Chart 13: Consumption



Source: Economic Survey

Chart 14: Investment



Source: Economic Survey

### Stagflation ahead

Pakistan's current situation presents a clear case for stagflation; the economy is slowing down while inflation is rising rapidly. For a small open economy this is more deeply felt as global economies on which we are reliant are in a similar situation. As fiscal capacity to cushion the economy shrinks, recourse to external liquidity is inevitable, at the expense of further debt at costlier rates.

Fears of a crisis are exacerbated by similarity to another era in Pakistan's economic history; the 1990s. In FY96 the Current Account Deficit reached 7.2% of GDP growth, CPI inflation tipped up to 11.8% in FY97, discount rates were in the range of 20% and the fiscal deficit reached 7.7% of GDP the following year. A decade later these variables have rolled back to similar levels. The Current Account Deficit has reached 9%, while the fiscal and external deficits are likely to cross 7% and 4% of GDP; all exceeding targets by significant margins and setting new record highs.

### Key risk: Too little too late

Pakistan is at a major crossroads, if monetary and particularly fiscal policy makers are able to divert attention from political provocations and take aggressive action to combat future challenges, we may see the country revert to the path of dynamic sustainable growth once more. If policy measures come too little, too late it will be particularly difficult for the economy to bounce back in the near term.

The present government is in the process of securing a USD 6bn deferred oil payments facility from the Saudi government which will have an immediate impact on the current account gap in FY09. The US has also pledged a staggered payment of USD 7.5bn for non-military aid. Eliminating subsidies on oil and reducing funds to defunct government organizations could all contribute towards a cleaner balance sheet by FY09 end.

The new government has declared its aim to alleviate the burden on the low income segment of our society several times. PKR 34bn in subsidies are expected to be released to low income households while the Punjab provincial government will launch a PKR 22bn food stamps program to ease the burden on the poor. Nevertheless relief to the poor remains patchy and irregular; subsidies through utility stores provide just PKR 2.7bn in price relief in FY09.

**Potential upside: global demand-led inflation spiral unravels**

At the present time the best thing that could happen for small open economies including Pakistan, would be a surprising unscrambling of demand led inflation. Oil prices could fall as fast as they rose in the last year and stabilize under an average USD 90/bbl level. The jostle for food and raw materials may also ease as inflation pressures serve as the straw to break the camels back.

Pakistan being a net importer of fuel and food such as wheat – may benefit. If so the government may be able to execute oil price cuts via OGRA to ease the burden on the economy. On the flipside it may also benefit from the differential between domestic and international oil prices on its balance sheet in the interim period. With much of the oil subsidies off its balance sheet and a deferred oil payments facility from Saudi Arabia in the pipeline the fiscal deficit picture could improve substantially.

## Fiscal Misalignments

Revised Budget estimates reveal the government's excessive reliance on Bank Borrowing, Capital Receipts and Non-Tax Revenue during FY08. Bank Borrowing rose by 3.2x Budget Estimates to PKR 424bn, while Capital Receipts merely doubled to PKR 143bn, confirming our suspicions of a resource gap of nearly PKR 500bn. Inflation and Non-Tax Revenues helped boost Gross Revenue Receipts close to the PKR 1,400bn level, supported by a significant increase in SBP Profits, PDLs and Royalties on Oil & Gas. External receipt estimates were also in line with our expectations near PKR 280bn, supported by 'Other Aid' from IDB and China of PKR 65bn.

In line with IGI estimates overall expenditures exceeded budget targets by 22% to reach PKR 1,948bn. Servicing of Domestic Debt exceeded targets by nearly 40% to reach PKR 443bn while spending on subsidies rose four-fold to PKR 407bn against the initial target of PKR 114bn. PKR 175bn for oil subsidies, PKR 40bn to TCP for the import of wheat and PKR 114bn in payments to WAPDA were the key drivers of a misaligned subsidy budget in FY07.

**Table 1: Federal Budget Revised Figures (PKR bn)**

	FY07 Budget	FY07 Revised	FY08 Budget	IGI Estimates FY08	Revised FY08
<b>Resources</b>					
<b>Tax Revenue</b>	<b>840.9</b>	<b>839.6</b>	<b>1,030.5</b>	<b>920.0</b>	<b>1,005.50</b>
Non Tax revenue	241.9	374.4	337.5	360.0	393.30
<b>Gross Revenue Receipts</b>	<b>1,082.8</b>	<b>1,214.0</b>	<b>1,368.0</b>	<b>1,280.0</b>	<b>1,398.90</b>
<b>Less Provincial Share</b>	<b>378.2</b>	<b>390.9</b>	<b>465.9</b>	<b>396.0</b>	<b>457.20</b>
Net Revenue Receipts	704.6	823.1	902.7	884.0	941.7
Net Domestic Capital Receipts	16.4	80.5	58.5	520.0	142.82
External Receipts	239.3	276.6	258.5	294.0	275.46
Self Financing of PSDP by provinces	85.6	96.0	122.7	182.0	129.75
Change in Provincial Cash Balances	53.8	22.2	51.8	16.0	32.50
Privatization Proceeds	75.0	75.0	75.0	1.7	1.65
Bank Borrowing	140.0	55.3	130.9	130.9	424.11
<b>Total Resources 1-7</b>	<b>1,314.7</b>	<b>1,428.7</b>	<b>1,600.1</b>	<b>2,028.6</b>	<b>1,948.0</b>
<b>Expenditures</b>					
<b>Current Expenditure Revenue Account</b>	<b>879.6</b>	<b>1,033.3</b>	<b>1,056.0</b>	<b>1,523.6</b>	<b>1,466.2</b>
General Public Service	504.3	634.7	641.8	705.0	881.66
Defense Affairs and Services	250.1	252.6	275.0	261.0	227.27
Public Order and Safety Affairs	22.4	22.9	24.5	25.0	26.11
Economic Affairs	74.7	91.2	78.9	102.0	293.44
Environment Protection	0.2	0.2	0.2	0.2	0.18
Housing and Community	1.0	1.1	1.0	0.7	1.14
Health Affairs and Services	4.7	4.7	5.2	5.6	5.29
Recreational and Culture	2.7	2.9	2.9	3.5	3.10
Education Affairs and Services	18.8	21.9	24.1	23.0	24.28
Social Protection	0.7	1.1	2.4	3.4	3.77
<b>Current expenditure Capital Account</b>	<b>24.6</b>	<b>31.9</b>	<b>32.1</b>	<b>42.0</b>	<b>39.20</b>
<b>Total Current Expenditure</b>	<b>904.2</b>	<b>1,065.2</b>	<b>1,088.1</b>	<b>1,565.6</b>	<b>1,505.4</b>
<b>PSDP</b>	<b>435.0</b>	<b>394.5</b>	<b>520.0</b>	<b>440.0</b>	<b>458.28</b>
Federal	320.0	279.5	370.0	255.0	289.28
Provincial	115.0	115.0	150.0	181.0	150.00
Other Development Expenditure	-	-	23.2	23.2	19.00
<b>Total Expenditure 8+9</b>	<b>1,314.6</b>	<b>1,427.8</b>	<b>1,599.2</b>	<b>1,986.8</b>	<b>1,943.5</b>
Federal Fiscal Deficit	(231.77)	(213.82)	(231.18)	(706.80)	475.62
<b>Federal Fiscal Deficit % of FY08 GDP</b>					<b>-7.1%</b>

Source: Annual Statements, Federal Budget in Brief 2008-2009, Finance Division

## Budget FY09: Outlook Negative

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Fiscal mismanagement in FY08 was exacerbated by deep fissures in the global economy, soaring international prices of food and fuel and interest rate risk. However lack of foresight was evident in Budget 2008 expectations as discussed in our Budget Preview 2009. The trend continues into 2009 albeit with greater restraint; the size of the PSDP is expected to rise by 20%, Subsidies are allocated at just PKR 295bn or a decline of 28%, Tax revenue is expected to increase by 24% while Bank Borrowing is targeted to fall three-fold over revised Budget FY08 figures.

### **Tax revenue to remain within 10% of GDP**

In Federal Budget FY09 the revenue structure of the economy has seen little change. A boost from inflation and non-tax revenues led to gross revenue receipts close to initial targets, but still leaves the tax to GDP ratio at 10%. Direct Taxation fell short of targets by 5% as did Indirect Taxes by a smaller margin. Fiscal loosening, trade liberalization and tax incentives all served to compress tax receipts. Therefore the FY09 target of a 24% increase in receipts seems unrealistic given tax revenues have historically increased by between 5%-10% during periods of economic and political stress. Shedding oil price subsidies is likely to be offset by high debt servicing costs making it reasonable to assume the fiscal deficit will remain near its current range. Tougher decisions may be in order which could include further PSDP cuts.

### **Old Dog, same tricks**

Across the spectrum of Customs duties, Income and Sales taxes the Budget FY09 hardly creates a stir. While highlighting the significance of a cash crunch and the need for relief, both revenue and relief measures appear scattered and disconnected. In light of the dire need for aggressive reform in the face of a serious economic slippage, the Budget FY09 should have incorporated a much tougher stance on revenue generating channels.

Given the scantiness of fiscal pockets, it would have been appropriate to uncompromisingly tax the asset base. However capital gains on shares of listed companies as of FY08 have been exempt from income tax till FY10, while no revenue measures were announced related to sale of property. Without economic fundamentals in place it makes little sense to give relief to the wealthiest income segment of the country. Consequences of this move are likely to be felt in the reaction of a deeply sensitive public which is bearing the greater burden of an unraveling economy in the face of higher prices of essentials.

### **Taxes on non-essential imports rise by 5-10%**

The Customs duty structure incorporates a 5-10% increase in imports of non-essential items such as dairy products, electronics, cosmetics, furniture and lighting and a 10% increase in import cost of cars/jeeps above 1800cc. At odds with this announcement is a 15% increase in duties on sewing machines and 30% on betal leaves; goods generally consumed by low income households. Mobile phone sets are now dearer by PKR 500 at the import stage, however this is unlikely to affect imports now more than USD 1bn, as it is not a progressive tax nor does it index inflation.

On the Income tax front, relief measures include exemptions on basic minimum salary which have increased by 20% in line with inflation. However proposals to tax pensioners, senior citizens and widows on returns from benefit and behbood schemes at a ceiling of 10% compared to a previous exemption, present a conflict. Although expectations of higher rates of return on most debt instruments are likely to offset this concern.

**Sales taxes remain stable**

Sales taxes and FED remain largely the same, with a marginal increase of 1% on goods and services. Highlights of the Sales tax structure were a 5% increase in withholding taxes WHT on imported and locally manufactured car sales of 850cc plus engine capacity. However this was reduced substantially in the Finance Act 2008 to between PKR 7,500-50,000 based on engine capacity.

Although capital gains on property were not targeted the amended Finance Bill has tapped into the services of property developers and promoters. This has now been subjected to federal excise duty by amendment in First Schedule of the Federal Excise Act 2005. The development of plots will now be subject to Excise duty at PKR 100/sq yard and construction of residential and commercial units shall be subject to the same at PKR 50/sq ft of covered area. The Cement sector was also taxed a marginal PKR 150/MT (fixed rate of PKR 900/MT) in sales tax. Combined, both taxation systems will have a negative impact on related industries which include, steel, glass and other construction related sectors.

Possibly the most significant waiver is the exemption on imported and locally manufactured fertilizers and pesticides from sales taxes. With prices of fertilizers rising significantly last year, consumption declined while agriculture output suffered. Relief of 16% on the final cost of fertilizers should ease the financial burden of farmers.

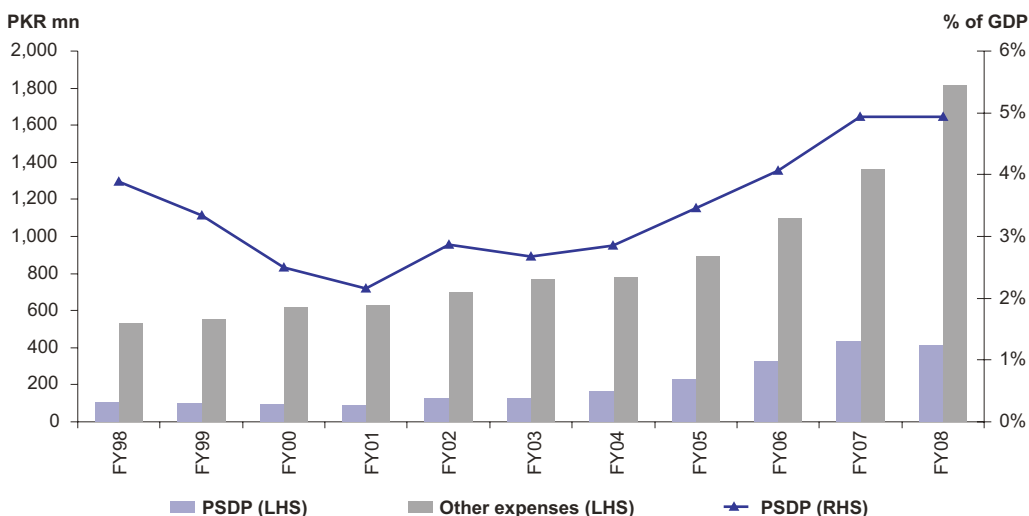
**Expenditure targets suffer from interest rate and inflation risks**

During FY08 domestic debt servicing costs escalated by 39% and inflated to 4% of GDP. Remarkably they are targeted to rise by just 3.6% in FY09. We feel this is an unrealistic expectation given the persistent pressure on the fiscal resource base and likelihood of future discount rate hikes at home and the increasing cost of liquidity abroad. Consequently we expect domestic debt servicing to remain a key driver of rising current expenditures in FY09. With the government indebted to the banking sector by PKR 424bn to plug the fiscal resource gap, or nearly 3x initial estimates, the debt servicing figures are only likely to go one way; up.

**Slippages in development spending likely**

In the new fiscal period we expect a further crunch in development spending. FY08 trend lines are likely to deepen in FY09 with cuts in key areas of health, education, planning and development. As expected the size of the Federal Consolidated PSDP slipped to PKR 411bn or 3.9% of GDP, lower than the last 2yrs. As a % of Total Expenditure PSDP spending was also lower at just 18.5% versus 24% and 26% in the preceding years. This is likely to remain static if not decline further in FY09.

**Chart 15: PSDP**



Source: Economic Survey

According to the Federal Budget in Brief, PSDP spending was trimmed in almost every Federal Ministry/Division; Defense -36%, Education -32%, Finance -32%, Industries and Production -32%, Planning and Development Division -80% and Law Justice and Human Rights Division -40% of initial budget allocations. On the flipside the Water and Power Division received funds in excess of initial allocations of PKR 64bn to reach PKR 66bn as did the National Highway Authority by 23% to reach PKR 35.7bn. Both areas provide essential infrastructure efficiencies to the economy and are likely to be the result of previous commitments and contracts. We expect the new development package to focus on the NHA and Power Division as several commitments have been made for increasing power generation. This is likely to overshadow Education, Health, Industries and Production already receiving as little as 4.8%, 3% and 2.5% of the PSDP in FY08.

#### **Subsidy package could still overshoot targets despite brave cuts**

In FY09 the oil subsidy alone made up for nearly 2% of GDP against an initial estimate of just 0.15% while the total subsidy package accounts for 4% of GDP against an original target of just 1.3% of GDP. This ratio is likely to widen in FY09 with oil prices on an upward march. The government remains liable for nearly PKR 30/ltr of HSD and LDO together accounting for just under 10bn litres of annual consumption or close to PKR 300bn.

The largest proportion of the FY07 subsidy package contributes to consumer welfare by suppressing domestic oil prices, electricity tariffs and the cost of imported wheat and fertilizer. However this has been largely lost on the public at large in the face of strengthening global and domestic inflation. Tightening fiscal space will leave little room for subsidies; reduction of which will also rationalize demand growth and increase reliance on substitutes.

Gas tariffs have already been increased as OGRA notified a 31% commercial usage increase on Jul 1'08 while a 68% increase in gas tariff for captive power plants in industrial units was also announced. Despite going to the chopping block the reduction of the subsidy package by 28% against revised estimates of FY08 if adhered to, will be a painful process, if implemented. The medium term impact is likely to be a challenge for both the economy and political framework. Consequently we feel the government may yet come under pressure to provide relief to the Power Division and keep the remaining oil subsidies intact.

#### **Externalization of debt to increase**

In FY08 externalization of debt was lower than we estimated, coming in at just PKR 20bn above initial estimates or PKR 275bn. The compressed figure may also be due to delays in transfers of loanable funds and lack of global bond issues. Although this keeps the external debt to GDP ratio within reasonable limits it increases pressure on the banking sector and the public at large. Fiscal managers are likely to suck up liquidity from these channels at high rates which have long term consequences for the public debt burden and also crowd out private sector credit.

Debt monetization through the central bank is also a persistent trend that allowed government budgetary borrowing from the central bank to reach PKR 629bn compared to a net retirement in the corresponding period last year. Currently external debt to GDP ratio is in the 30% range, indicating room for growth. However this depends on the availability of external liquidity in the backdrop of a global slowdown.

**Relief measures unimpressive**

Less than 0.5% of the subsidy package was allocated to subsidization of Ghee, Pulses and Flour through the government controlled Utility Stores catering to low income households. This number rose to just 1% of total subsidies planned for FY09 which is dismal given the substantial pressure on majority of Pakistan's population living under the poverty line. At a time when it is crucial to focus on the low income segment of the economy, the government is dragging its steps. The government's PKR 22bn relief payout package for a list of low income families compiled by NADRA, is likely to have a shot in the arm impact, rather than provide a long term solution.

The previous subsidy package focused on goods with relatively inelastic demand, such as fuel oil, power and food/agro imports. Subsequent cuts could lead to unmanageable inflation pressures on the low income segment in the interim. This is the time to tax the rich, feed the poor and add value to your economy. Monetary and fiscal policy makers must join hands and take concrete policy steps to cushion the poor via larger subsidized food supplies through current and new government distribution networks which may include utility stores, food stamps, and even poor kitchens.

**Farmer's get a break**

Federal Budget FY09 has benefitted one sector; Fertilizer. The government has doubled the subsidy on DAP and exempted sales of local and imported fertilizer from sales taxes of 16%. Prices of DAP rose by nearly 200% globally, suppressing local demand. Although the subsidy has now reached PKR 1000/bag we feel demand will remain constrained compared with urea fertilizer usage.

## Politics, politics and more politics

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In our earlier assessment of Pakistan's economy we had underestimated the increasing importance of political variables. As PPP and PML-N swept the polls in Mar08, General Pervez Musharraf adopted civilian garb as the President and the federal coalition assumed office, it appeared a strong democratic agenda would support economic indicators. We were wrong.

Politics has taken center stage; the coalition failed to agree to on the restoration of deposed Judges, resulting in a walkout by the PML-N from the Cabinet. The democratic revival succumbed to the weaknesses of this forged alliance, despite how insync they might be against their common antagonist, President Musharraf. With macrostability on the slide, it is imperative that the government diverts its attention from defensive politics and focuses on economic challenges.

### **Fragile coalition presents a key risk**

At present the political framework appears shaky; key risks are the disintegration of the federal government and a cross-floor movement of the PML-N to the Opposition bench of the National Assembly. However the potential for this is limited by the desire to maintain the coalition's strength against political opponents. PML Q and PML N would make uncomfortable partners and PML N is not likely to leave its much coveted position at the federal core. Potential risks may be exacerbated by internal rifts within the PPP.

### **Nuisance factor from militant elements to continue**

Another concern which continues to worry global allies and domestic political forces is the accelerating militant activity in border areas with Afghanistan. After the infiltration of Swat, militant elements have threatened the NWFP government to resign and surrender control to the Tehrik e Taleban Pakistan (TTP). Although military operations in Hungu and Swat areas have pushed back Taleban forces, they remain a serious nuisance factor which is unlikely to abate in the medium term.

The suspected amalgamation of Taleban forces in Afghanistan and Pakistan in the border areas will continue to present a significant drain on military resources. The obvious concern of the US government regarding the increase in offensive activity is also reflected in spooked investors withdrawing portfolio flows from Pakistan. Negotiations continue between tribal factions, the government and the military. The government has adopted a peaceful approach however the military stands prepared for a confrontation if the situation deteriorates.

Militant control of FATA and the tribal areas is largely due to an infrastructure vacuum in these areas and the substitution of an Islamic institutional framework with the existing ones. Urban areas with a substantial institutional network are less susceptible to infiltration of this kind, while the Pakistan Army is likely to push back any potential threats that challenge democratic forces in properly governed areas in NWFP.

## KSE: Tipping Point

In the last 6mo the KSE 100 has lost 23% in value over Dec07 levels beyond 14,000 points. We believe the equity market has reached a tipping point; downward momentum is inevitable as the market adjusts to new global and domestic, economic and political realities. Index levels of the KSE 100 are likely to shuttle between a narrow band of 8,000-10,000 points moving forward.

Key indicators including the exchange rate, Eurobond spreads and capital markets began to reflect deteriorating risk ratios. Major credit ratings agencies proceeded to downgrade Pakistan's local and foreign currency debt ratings resulting in a 100% decline in portfolio inflows over Jun07. However it is pertinent to note that FDI and remittance flow remained robust at USD 6.5bn and 5.1bn respectively indicating long term structural strength. Investors who remain invested will be hunting for medium to long term gains rather than short term entry and exit opportunities.

### Credit rating downgrades trigger a market dip

In FY08 deteriorating economic variables, political volatility and security slippages culminated in ratings downgrades from the major ratings agencies, Moody's and S&P. The S&P Pakistan rating declined from B+/Positive/B and B+/Positive/B on Local Currency and Foreign Currency debt respectively in FY07 to BB-/Negative/B and B/Negative/B in FY08. While Moodys Investor Services downgraded Pakistan to B2 speculative grade from B1 on its LT Foreign Currency Debt, S&P maintained its B rating on the economy but changed its outlook for the economy to Negative from Stable. The sudden turnaround was attributed to the indicated increase in vulnerability to crisis of Pakistan compared to regional peers.

**Table 2: S&P Credit Ratings History Pakistan**

	Local Currency LT/Outlook/ST	Foreign Currency LT/Outlook/ST
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 Ratings History

### Pakistan's vulnerability ratios deteriorate faster than peers

Pakistan's vulnerability ratios slid sharply in comparison with its B category peers including Indonesia and Philippines. Although some ratios have improved compared to the past decade, the general outlook of the economy has teetered on to speculation regarding the sustainability of its political process and therefore potential for capital flight; endangering external balances.

**Table 3: Sovereign Risk Indicators 2008**

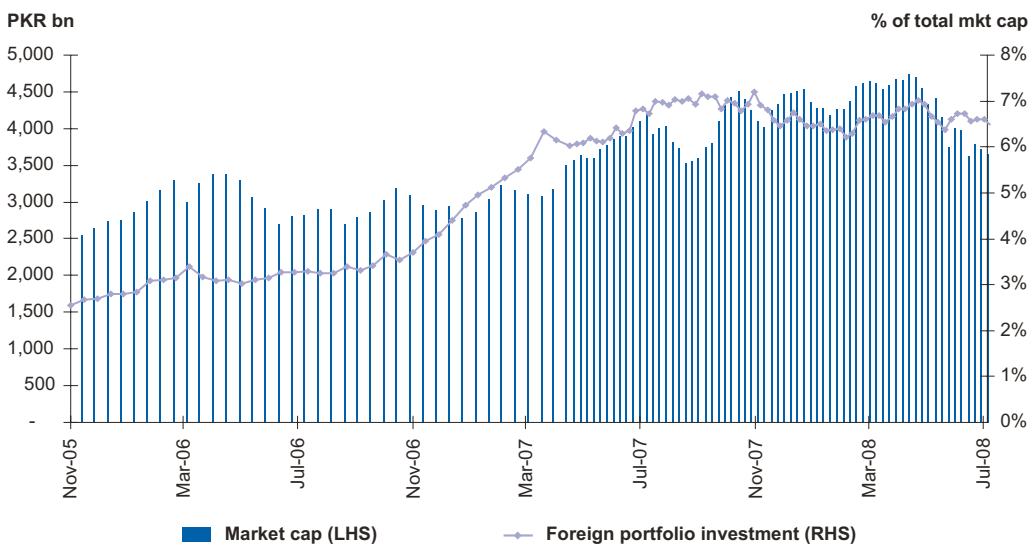
	Sovereign Risk Indicators		
	Pakistan	Philippines	Indonesia
CAD % of GDP	(9.0)	4.4	2.6
Total Debt % of GDP	66.0	53.0	39.0
Total Revenues % GDP	14.0	16.0	22.0
FDI % of GDP	3.3	1.0	0.3
Trade Balance % of GDP	(14)	(5.7)	7.7
EDLs % GDP	66.0	38.0	32.9
Debt servicing % GDP	4.0	5.1	37.5
Fiscal Deficit % GDP	(7.5)	(3.1)	(2.1)
EDLs USD bn	48.4	55.0	142.0
FX Reserves USD bn	10.0	36.2	59.5
BoP USD bn	(5.8)	8.6	8.5

Source: Bloomberg, S&P, Central Bank of Philippines, SBP, Central Bank of Indonesia

**Onus shifts to domestic market player**

A decline in foreign ownership of market capitalization of the KSE is on the cards; from a peak of nearly PKR 334bn foreign holdings of Pakistan’s equity markets through SCRA’s have declined to PKR 238bn; a drop of nearly 28%. Nervousness in global markets, worries of a US recession and concerns about Pakistan’s sustainability is likely to keep this number on the decline.

**Chart 16: Foreign Ownership of Market Capitalization**



Source: SBP

At its peak foreign ownership of market cap was 7.5% and of an estimated 30% of free float. By Jul 12’07 this had declined to 6.5% however the 1% lower lock in place had much to do with preventing a rapid slide in Jun08. Much of the push to the KSE from foreign investors took place after Dec06, with the KSE 100 ascending past the 15,000 level from just 10,000 points earlier. Domestic liquidity was also stimulated by foreign interest. However in FY09 we expect the onus of stabilizing the market to shift to the domestic investor.

### **Valuations not pricing in potential rate hikes**

According to our estimates the KSE 100 was trading at a P/E multiple of 12x earnings as of Jun 30'08. When accounting for rising interest rates, weak economic indicators and volatile politics we feel the KSE 100 could be trading at a price to earnings multiple between 8-10x earnings, as per historical stress periods suggesting an oversold area below 7,300 points and overbought area above 9,200 points

Last Twelve Months (LTM) net earnings as of Mar08 reflect a steady decline over the last few quarters for the KSE 100 companies with earnings down 4% over Mar07 levels. Post-Interim Monetary Policy Measures of May08 and following the expected rate hike of Jul08 we feel cash flows will contract substantially as the cost of capital rises and input costs remain elevated.

Corporate profitability could decline by a further 4-8% during FY09 however some of the downward push will be offset by inflation pass-through. Nevertheless this will create substantial pressure on equity investments versus alternatives such as debt securities, making plausible our argument for a KSE 100 trough of 7,300 points.

### **Let's not get hyper**

If inflation is beyond 20% there is no choice but this. Interest rates must rise, real rates must be positive to prevent capital flight, lenders and savers must be compensated, and aggregate demand must be restrained. The consequences of not doing so are greater demand pull on prices, an outflow of capital, a liquidity crunch and unmanageable strain on our exchange rate.

Policy makers must focus on the low income segment of our society for whom the inflation-interest rate spiral will be the hardest. Our policy suggestion; tax the rich and feed the poor. There is no better time to add value to our economy and sustain some level of economic equilibrium than this.

The impact of a rate hike on our valuations is a given; as rates rise, company cash flows will decline. But lagged as it may be, the balance sheets and market players that make up our equity market will adjust to the opportunity cost of demand and therefore price stability must return. In time, the cost burden of inputs will shrink and steady future cash flows to desirable levels.

### **US recession could diminish confidence in short term**

Oil at USD 146/bbl? The USD:EUR at 1.64? Who would have thought the global economy could withstand such an economic scenario? The US has been pounded with multiple shocks, the housing slump, the credit crisis and the oil price shock. The impact on the USD has been staggering and suggests cross-border liquidity flows will compress, while portfolio flows return to core markets.

So how are several emerging and frontier markets still surviving? Being a small open economy with its exchange rate largely pegged to the USD and a net importer of oil and food, Pakistan will find a US recession a painful process. Although export receipts remain a small 13% of GDP and consumption is largely fed by domestic production, the output gap is widening.

Notwithstanding the depression surrounding the US economy, we cannot bypass the influence of new economic participants; the BRICs and the Middle East. We feel in the medium-long term the resurgence of these economic agents will propel global growth in the right direction and also benefit Pakistan. External liquidity from these countries remains on the hunt for value across the globe; Pakistan may continue to be a beneficiary; geopolitical factors will sustain high remittance flows and FDI.

Key risks to this scenario are if continuing inflationary pressures prevent central banks from initiating stimulating rate cuts for these economies. This could lead global economies into a vicious slump rather than cycle which will have a negative impact on Pakistan despite its demographic advantage and geopolitical significance.

**State intervention will provide a very short term boost**

We can partially explain the KSE 100's resistance level of 10,000 points by state intervention. The Securities and Exchange Commission attempted to arrest the fall of the KSE by establishing a temporary 1% lower lock and 10% upper lock on Jun 24'08. The 10% upper lock was a sure-shot move to guarantee market buoyancy. However this was short lived as the KSE slipped into lack luster mode and the locks were later removed in the 2nd week of Jul08 to revert to the original 5% upper and lower limits.

Short selling was also prohibited in Deliverable Future Contract Market while Short Sale in the ready market with pre-existing interest against purchase, on another exchange was also prohibited. These prohibitions were enforced for one month, effective June 24'08 and were revoked on Jul 24'08 with terms and conditions attached. Bank Guarantees from "A" and above rated banks were also allowed as margin eligible securities for Margin Deposit in the Ready, Futures and CFS Market.

Following this a market stabilization fund of an initial PKR 20bn managed by NIT was introduced, which indicated several rules of procedure but is yet to be finalized by stakeholders. It was earlier announced that the Equity Market Opportunity Fund (EMOF) comprising pension funds of large public sector companies would inject PKR 50bn into the market. The fund would pick up securities according to CFS weightage and would only divest its investment when prices reached 20% in excess of the scrips weighted average price of the last 6mo. No confirmation was received of whether stakeholders approved this plan, however PKR 20bn was reportedly released during the week ending Jul 25'08.

A couple of days after the funds propped up the market, the KSE 100 again dipped into the red. State intervention into free market activity will create further instability and implausible pricing of assets. Consequently we are of the view that the government should let the market price the KSE indices freely in order to prevent a sudden price shock in the future.

# IGI

## Investment Bank

I, **Zainab Jabbar**, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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