# State of Economy

*August 20, 2009*

*Executive Summary*

**Review of the trade policy:** Focus on deepening and diversification of exports
Trade policy (2009-12) was announced by Makhdoom Amin Fahim, Minister for Commerce on 27th July, 2009. The Policy focused on diversifying our export basket and expanding across the value chain.

**IMF Review:** Stand by Agreement (SBA) Augmented to US$11.3bn from US$7.6bn
On August 7, 2009, in conjunction with the Board's second review of the program, IMF augmented its support to US$11.3bn for a period of 25-month.

**Textile Policy eyes export of US$ 25bn:** Export of Processed fabric encouraged
The new textile policy (2009-14), approved by a special session of the federal cabinet, has set up an ambitious export target of US$25bn. Policy to promote value addition in textile export along with offering 1% additional drawback on taxes for exporters who are able to increase their exports by 15% (YoY).

**Monetary Policy Statement (MPS):** Central bank decreased the principal rate (Discount rate) by 100bps to 13%, effective from 17th August 2009

Factors leading to a cut in key policy rate are:

- The CPI inflation declined by a hefty 7.9 percentage points from 19.1 percent in March 2009 to 11.2 percent in July 2009
- The core measure of Inflation, that is NFNE and Trimmed both stood at 14.0% and 13.9%, respectively.
- Current account deficit shrunk to US$ 8.9bn (5.3% of GDP) as compared to US$ 13.9bn in the same period last year
- SBP's foreign exchange reserve position strengthened to US$ 9.1bn as of June 2009

**Impact on Equity and Money market:** Nothing to bring about buoyancy in the markets
At the prevailing risk free rate (10 year PIB) of 12.0% and growth rate of 10%, we believe that at current the KSE-100 Index is fairly valued at PE of 6.96x. Using the Gordon growth model the market should trade at a PE of 7.15x (Index level of 8,084)

**Quarter on Quarter (QoQ) NPLs data:** Incremental growth in NPLs seems to be a going…. going gone case
The incremental growth in the NPLs has further slowed down to Rs. 18.8bn after touching a high of Rs. 68.6bn on Dec-08. The total NPLs have reached Rs. 410.7bn mark

**Conclusion:** Needs further cut before thinking of growth
The reduction in the key policy rate although is a step in the right direction however the quantum is not sufficient enough to provide the much needed impetus to our Large Scale Manufacturing (LSM) sector. A decrease of (200-300bps) would have moderated the finance cost of our manufacturing sector, making it viable to increase their production to cater for the higher demand. This would have in turned helped the Banking sector in improving the NPLs situation, giving them the needed confidence to start lending to the private sector and kick start the economy.

*PKIC Research*

# State of Economy: IMF commends the stability in-spite of some chronic issues

No country today can live an isolated life; sooner or later all countries have to assimilate into and become a part of the global economic engine. Pakistan like wise has opened it economy as reflected by the increasing share of trade in its GDP (from 25.8% in FY00 to 31% in FY09). Exports can serve as an important source of precious foreign exchange, substituting Pakistan's dependence on foreign loans and grants.

**Review of the trade policy**

Strategic objectives sought from the trade policy (2009-12)

- Growth with Equity
- Greater Opportunities for Gainful Employment
- Sound Marco-economic Framework for Trade Environment
- Concern with Poverty Eradication and Environmental Protection
- Investing in Human Resource
- Targeting Poverty Alleviation
- Promoting Private Sector as Engine of Growth
- Focus on Small Scale Sector Particularly Agriculture

**Trade policy is framed to:**

- Enhance the competitiveness of Pakistan's exports
    - Increase the sophistication level of Pakistan's exports by increasing the technology component and value addition.
    - Trade Facilitation
    - Process Improvement
    - Aligning Tax Reform with Trade Facilitation with the aim to reduce the cost of doing business
    - Address supply side constraints – power shortage & high financial cost
    - Reduce anti-export bias
- Reducing Cost of Doing Business
- Protection and promotion of SMEs
- Focus on products with higher sophistication potential
- Promote agricultural development through exports
- Enable Pakistani exporting companies overcome the
- negative effects of global demand contraction

| Sector to Focus on: | |
|---|---|
| Pharmaceuticals | The limit for physicians' samples may be enhanced to 20% from the current limit |
| Leather | Sharing 25% financial cost of setting up labs in the individual tanneries |
| | To provide matching grant for setting up of effluent treatment plants in individual tanneries |
| Gems & Jewelry | Support for opening exporters offices and retail sales outlets abroad |
| Engineering Goods | A special Fund of Rs 2.5bn is being created for product development & marketing for light engineering sector |
| | It has been decided to allow the import of specialized machinery and transport equipment by actual users in used condition provided they fulfill emission standards and have sufficient productive life irrespective of the age |
| Surgical. Medical, Dental, Beauty careinstruments | The govt has decided that surgical instruments, sports goods & cutlery sector would be granted 25% support on brand development activities |
| Agriculture & food | To grant 25% freight subsidy if live seafood products are exported by air |
| Halal Products | To setup a Halal Certification Board and the government would support the cost of Certification by 50% |

**Performance Parameters**

| Indicators | Targets (2012) |
|---|---|
| Merchandise Exports (US$ Billion) | From 17 8 to 23 5 |
| Competitiveness Ranking | From 101 ≤ 75 |
| Engineering Sector Export-Share | From 1.5% ≥5% |
| Value – addition of Cotton | From US$ 1000/bale to 1500/ bale |
| Expansion of Regional Trade | From 17% ≥25% |
| FTAs | EU, USA |
| Operational ROZs | 7 |

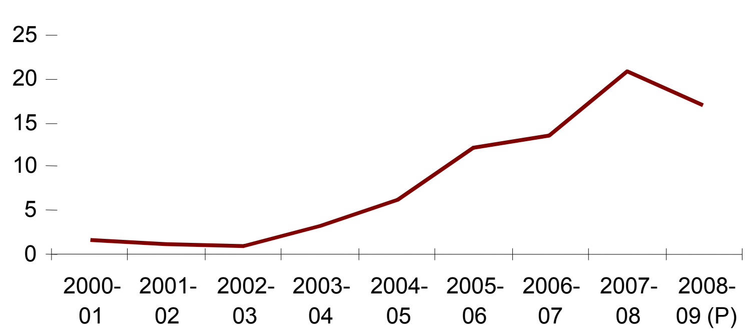
**Historical account of our trade:**

| Export | | |
|---|---|---|
| Year | Value (FOB $ Bn) | Change (%age) |
| 2000-01 | 9.2 | - |
| 2001-02 | 9.1 | -0.7 |
| 2002-03 | 11.2 | 22.2 |
| 2003-04 | 12.3 | 10.3 |
| 2004-05 | 14.4 | 16.9 |
| 2005-06 | 16.5 | 14.3 |
| 2006-07 | 17 | 3.2 |
| 2007-08 | 19.2 | 13.2 |
| 2008-09 | 17.8 | -6.7 |

| Imports | | |
|---|---|---|
| Year | Value (FOB $ Bn) | Change (%age) |
| 2000-01 | 10.7 | 0 |
| 2001-02 | 10.3 | -3.6 |
| 2002-03 | 12.2 | 18.2 |
| 2003-04 | 15.6 | 27.6 |
| 2004-05 | 20.6 | 32.1 |
| 2005-06 | 28.6 | 38.8 |
| 2006-07 | 30.5 | 6.9 |
| 2007-08 | 40 | 30.9 |
| 2008-09 | 34.8 | -13 |

**Deficit history:** The trade deficit of Pakistan peaked in FY08 at US$ 20.9bn; however the falling international commodity prices have helped correct this mammoth deficit. The Trade deficit for FY09 registered a decline of 18.5% at US$ 17bn.

**Trade Deficit**



## IMF Review: Augmented to US$11.3bn from US$7.6bn

Pakistan came under the IMF program of US$7.6 billion Stand-By Arrangement (SBA) which span over a period of 23-month, originally approved by the IMF's Executive Board on November 24, 2008. On August 7, 2009, in conjunction with the Board's second review of the program, IMF augmented its support to US$11.3bn for a period of 25-month.

### Signs of stability

Pakistan current account deficit has sharply declined by more than US$5bn (3.2 percentage point of GDP) in 2008/09 due to a significant decline in imports, higher workers' remittances, and increased support from the United States.

Inflation is hovering around 13 percent (June' 09) from a high of 25 percent last year. IMF official Adnan Mazarei further added "And, so, that allows for some consideration for rate cuts."

The IMF official concluded by saying "Despite the political and security problems and some policy slippages, the government of Pakistan has managed to stabilize the economy—the exchange rate has been broadly stable in recent months and the international Forex reserves position has strengthened to $8.3 billion in July compared to $3.5 billion at end-October 2008."

### Reform agenda to be implemented

- To improve tax administration, restore financial viability to the electricity sector, strengthen the social safety net, while at the same time maintaining fiscal discipline by eliminating non-priority investment spending

- Introduction of a broad-based value-added tax (VAT) to correct the structural shortcomings in the tax system, which relies on a very narrow tax base. Introduction of a broad-based VAT in mid-2010 is a key pillar for our fiscal strategy

- The authorities should aim to address the problems in the electricity sector. A plan has been prepared to eliminate the stock of "circular" debt in the energy sector. The government has agreed with World Bank and Asian Development Bank staffs on a schedule to increase electricity tariffs in the course of 2009/10 and eliminate tariff differential subsidies in 2010/11

## Textile Policy: eyes export of US$ 25billion

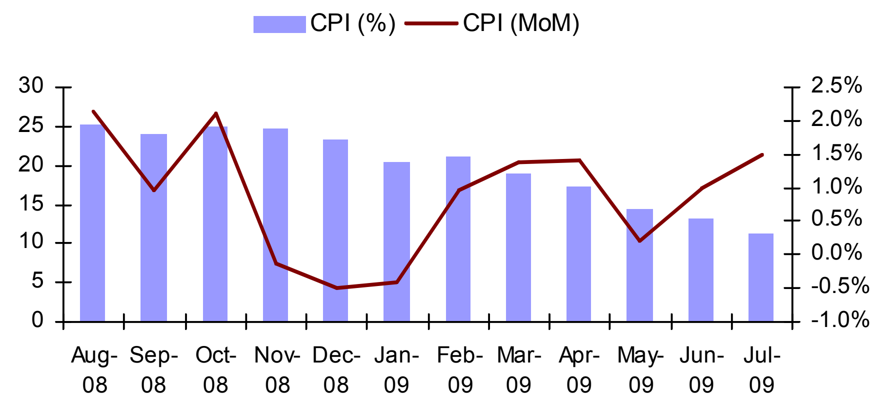
The new Textile Policy (2009-14), approved by a special session of the federal cabinet, has set an ambitious export target of $25 billion, Federal Minister for Textile Rana Muhammad Farooq Saeed Khan presented the policy.

**Following are the incentives announced in the textile policy:**

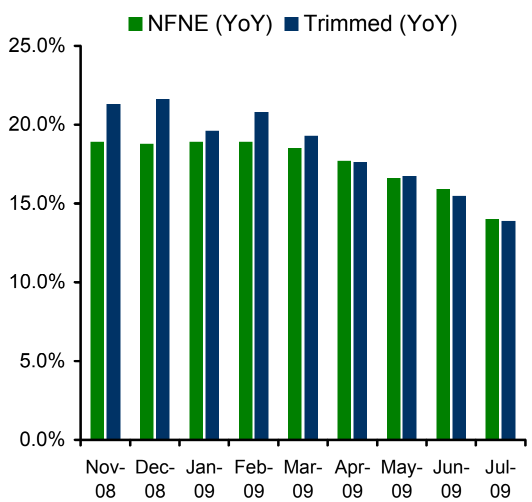
| |
|---|
| Export refinance will be available at 5 per cent. The cost of Rs2.5 billion will be borne in the budget |
| Long-term loans will be converted on the same pricing as applicable to LTTF scheme and it would entail a support of Rs5 billion |
| On drawback of local taxes, the new policy proposed new scheme as: processed Fabric (1 per cent of the FOB value of exports), home textiles (2 per cent of the FOB value of exports), and garments (3 per cent) of the FOB value of exports |
| All those who will achieve an increase of 15 per cent in exports relative to last year will be given 1 per cent additional drawback. The scheme will cost Rs17 billion during the current fiscal year (2009-10) and Rs27 billion for the next fiscal year (2010-11) |
| To settle past claims under R&D scheme of 2007-08, the government is allocating Rs5.44 billion |
| Setting up of the Textiles Investment Support Fund, Technology Up-gradation Fund (TUF), Infrastructure Development and Skills Development in the next policy |
| An amount of Rs2 billion has been budgeted for the current year for export house scheme |
| Along with these the policy also announced, Zero-rating of exports, tax-free import of machinery, rationalization of tariff structure, removing regulatory bottlenecks, market access, marketing support, export house scheme and marketing insurance scheme |

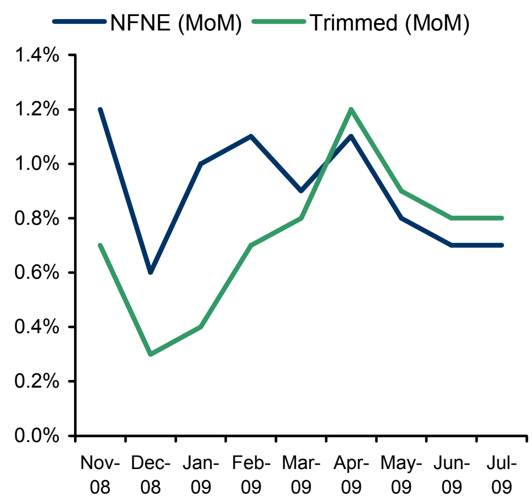
**Monetary Policy statement (MPS):** Key policy rate (Discount rate) has been reduced by 100bps to 13%, effective from 17th August 2009

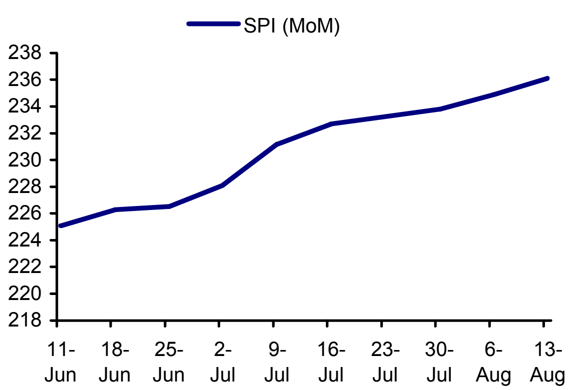
The CPI inflation has followed a downwards spiral consistently as the inflation declined by a hefty 7.9 percentage points from 19.1 percent in March 2009 to 11.2 percent in July 2009.




The core measure of Inflation, that is NFNE and Trimmed core both stood at 14.0% and 13.9%, respectively. NFNE and Trimmed core stood at 18.5% and 19.3%, respectively on March 2009.




**Sensitive Price Index (SPI):** On the rise

The SPI has been on the rise for consecutive 10 weeks in a row. Last week garlic and sugar prices contributed to this recent spike in SPI. The Garlic prices shoot up by 10.79% on week on week basis. Sugar price increased by 5.36% in a week to Rs. 54.05. Chicken prices also jumped by 5.06% in the last week to Rs. 135.07.

On the external front the current account deficit shrunk to US$ 8.9bn (5.3% of GDP) as compared to US$ 13.9bn in the same period last year. SBP's foreign exchange reserve position strengthened to US$ 9.1bn as of June 2009.

Moreover the government was successful in meeting all the three critical performance indicators. The stock of budgetary borrowing from SBP stood at Rs. 1,130bn and Net Domestic Assets (NDA) of SBP was recorded at Rs. 1,183; both were below the given target of Rs. 1,181bn and Rs. 1,321bn, respectively. While the Net Foreign Assets (NFA) of SBP stood at US$ 3.98bn well above the floor set by the IMF of US$2.37bn.

The above mentioned performances lead the central bank to decrease the principal rate (Discount rate) by 100bps to 13%, effective from 17th August 2009. Along with reducing the key policy rate, SBP has taken a variety steps to strengthen the monetary policy frame work.

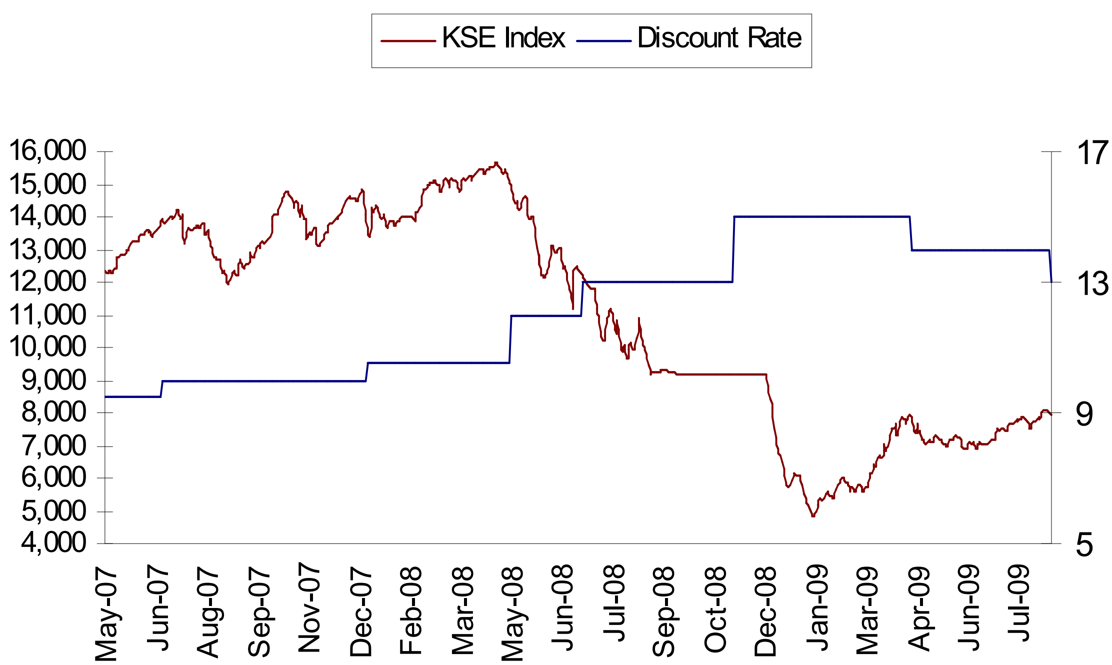
| SBP Measure | Expected Impact |
| --- | --- |
| Frequency of Monetary policy decision is being increased from four to six times a year. Thus MPS will be announced in the last week of September, November, January, March, May and July. The policy announcements of January and July will be accompanied with detailed MPS, while on the other four occasions decision will be communicated through a brief press release only. | This would help the central bank to manage the dynamic economic scenario in an proactive manner. |
| An independent monetary policy committee (MPC) will be formed that would consist of external experts in addition to the SBP representatives | This would help the SBP to extract maximum benefits from experts through their valuable and independent view. This would further ensure transparency and lend credibility to the monetary policy formulation. |
| SBP will introduce an interest rate corridor. The central bank would make available a standing deposit and lending facility, called overnight reverse repo (13%) and overnight repo (10%). | This would improve liquidity management, enhance effectiveness of market signals and foster stability |

**Impact on Equity and Money market:** Nothing to bring about buoyancy in the markets

| Growth Rate | 12.60% | 12.10% | 11.60% | 11.10% | 10.60% | 10.10% | Growth Rate |
|---|---|---|---|---|---|---|---|
| 8.0% | 6,178 | 6,483 | 6,821 | 7,196 | 7,614 | 8,084 | 8.0% |
| 8.5% | 6,483 | 6,821 | 7,196 | 7,614 | 8,084 | 8,616 | 8.5% |
| 9.0% | 6,821 | 7,196 | 7,614 | 8,084 | 8,616 | 9,223 | 9.0% |
| 9.5% | 7,196 | 7,614 | 8,084 | 8,616 | 9,223 | 9,922 | 9.5% |
| 10.0% | 7,614 | **8,084** | 8,616 | 9,223 | 9,922 | 10,735 | 10.0% |
| 10.5% | 8,084 | 8,616 | 9,223 | 9,922 | 10,735 | 11,693 | 10.5% |
| 11.0% | 8,616 | 9,223 | 9,922 | 10,735 | 11,693 | 12,840 | 11.0% |
| 11.5% | 9,223 | 9,922 | 10,735 | 11,693 | 12,840 | 14,235 | 11.5% |
| 12.0% | 9,922 | 10,735 | 11,693 | 12,840 | 14,235 | 15,971 | 12.0% |
| 13.0% | 10,735 | 11,693 | 12,840 | 14,235 | 15,971 | 18,190 | 13.0% |
| 14% | 11,693 | 12,840 | 14,235 | 15,971 | 18,190 | 21,123 | |
| | 12.60% | 12.10% | 11.60% | 11.10% | 10.60% | 10.10% | |

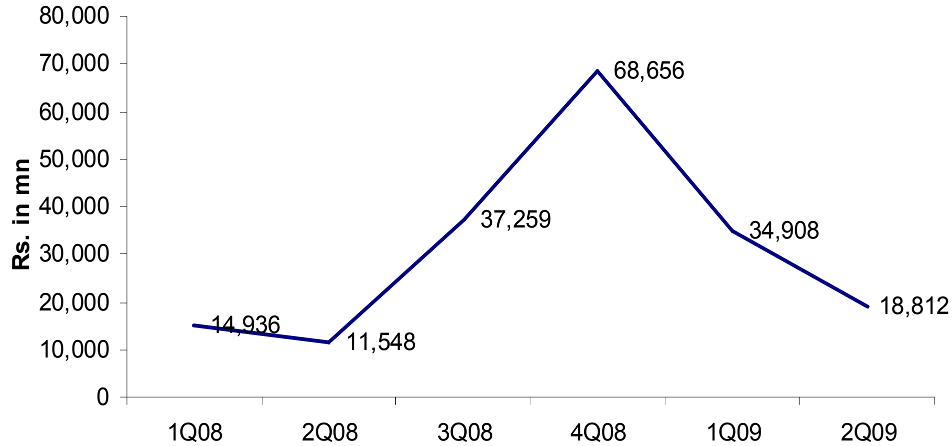
Risk Free Rate

At the prevailing risk free rate (10 year PIB rate) of 12.0% and growth rate of 10%, we believe that at current levels the KSE-100 Index is fairly valued at PE of 7x. Using the Gordon growth model the market should trade at a PE of 7.15x. At the justified PE of 7.15x the KSE-100 Index targets comes out to be 8,084, which is very close to the current Index levels of 7,950. Thus until further downward drift in the PIB yields, we do not anticipate any significant upwards movement in the capital market.




On the money market front the corridor established has defined the trading limits of the over night market. However the recent OMO's have been around 12.15%, showing that the central bank is comfortable with the overnight rate hovering around the 12% mark.

**Quarter on Quarter (QoQ) NPLs data:** Incremental growth in NPLs seems to be a going…. going gone case




The latest NPLs data released bode as a good omen for the banking system in particular and the manufacturing sector at large. The incremental growth in the NPLs has further slowed down to Rs. 18.8bn after touching a high of Rs. 68.6bn on Dec-08. The total NPLs have reached Rs. 410.7bn mark. However as the economic stabilization further deepens its roots in Pakistan, companies interest paying capacities is expected to further improve.

**(Rs. In million)**

| BANKS/DFIs | 31-Dec-07 | 31-Mar-08 | 30-Jun-08 | 30-Sep-08 | 31-Dec-08 | 31-Mar-09 | 30-Jun-09 |
|---|---|---|---|---|---|---|---|
| All Banks & DFIs | 224,629 | 239,565 | 251,113 | 288,372 | 357,028 | 391,936 | 410,748 |
| All Banks | 216,447 | 231,432 | 241,853 | 278,151 | 345,305 | 379,259 | 397,938 |
| All Commercial Banks | 183,702 | 199,200 | 212,884 | 245,086 | 316,161 | 349,721 | 370,804 |