

January 13, 2010

Pakistan Market**SBP's 1HFY10 economic assessment****MORNING BRIEFING**

KSE100 Index: Closing 9778.36 ↓ (-18.64)

The balance of economic indicators is heading towards stability, while the drop in trade volume, disappointing tax receipts and a rise in deficit still remain lingering concerns for the country's macro economy is what SBP has expressed in the recently released half-yearly assessment. SBP projects a slight recovery in the GDP growth to 3.3%, reappearance of the inflationary pressure, and slippage in the fiscal deficit due to discretionary spending on military operations. On the monetary front, the SBP expressed its limited ability to stimulate liquidity and cut in the policy rate due to the IMF led conditionality on government and lower than anticipated external receipts. The IMF conditions bar the government from borrowing directly off of the central bank.

The interpretation of SBP's report

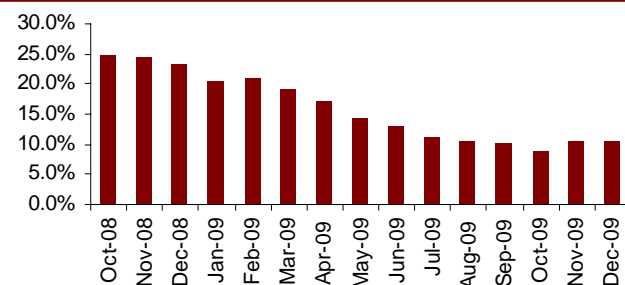
The SBP's recently released half-yearly report is highlighting the risk-averse stance in the back drop of higher commodity prices and lowers than expected external receipts. This is also reflected in SBP's projections of the key macro economic indicators, SBP expects the GDP to be in the range of 2.5-3.5%, CPI 10-12%, fiscal deficit 4.7-5.2% and C/A deficit 3.7-4.7%. The wide ranged expectations for the key macro economic indicators is highlighting SBP's uncertainty on the commodity prices and the external disbursements (from FoDP, Kerry-Lugar Bill, and coalition support fund) in the remaining part of the year. However, the recently held round table meetings between 40 country delegates in Abu-Dhabi, the arrival of Mr. Holbrooke (US special envoy to Pakistan), and David Miliband's visit to Pakistan will definitely reduce the uncertainty surrounding the external fund disbursement. This coupled with the recent tightening by China of a 50bp hike in the Reserve Ratio, deposit and lending rates will reign in the commodity price hike. This should help SBP ease its policy stance further, in the forth coming policy review due January 30th, 2010.

Our interest rate outlook – above consensus

We expect another 100bps cut in the DR in the forthcoming

January review, keeping in mind the following justifications:

- Pakistan's headline and core inflation is expected to be around 10% for FY10. The low base effect will diminish January 2010 onwards. (Refer to the graph below).

Graph: CPI inflation trend

Source: SBP

- The twin deficit is likely to be contained further, on the back of improved remittances, and a higher electricity cost pass through.
- The US\$400mn IMF disbursement for budgetary support should stimulate NFA and curtail GoP's borrowing in turn. Additionally, disbursements from the Kerry-Lugar Law and Friends of Pakistan will create additional room for GoP to fund its budget deficit.
- On the back of improved inflationary expectations and government finances, we expect the SBP to ease its stance to Accommodative (neutral) from Aggressive.

SBP report's key takeaways

- SBP expects FY10 GDP growth to be around 3.3%, the major impetus for this growth is expected to come from the services sector. Within the commodity producing sector, an improvement in the industrial output is expected to be partially offset by weaker agriculture growth.
- Similarly, the current account deficit is likely to improve further in FY10, though some expected revival in demand for imports from the manufacturing sector and rising

commodity prices may possibly contain improvement, going forward.

- The adjustment in administrated prices of key fuels amid rising international oil prices and a cut in electricity subsidies, are important factors behind the expected strengthening of the inflationary pressure.
- A major challenge in the economy is to improve the tax-to-GDP ratio. The 0.6%YoY increase in tax collection during Jul-Nov FY10 is a source of concern.

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Also in focus**CCP recommends liberal policies for car imports**

Competition Commission of Pakistan (CCP) during the National Conference on Competition Regime in Pakistan has recommended the government to liberalize car imports in order to promote competition within the industry. CCP highlighted the late delivery of cars despite under capacity utilization, higher prices and a slow transfer of technology. We believe liberalization of car imports by the government would bode negative for the local auto assemblers.

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