

March 19, 2010

Pakistan Market**Why is SBP cautious despite the macro reversal?**

KSE100 Index: Closing 10007.87 ↑ (+18.06)

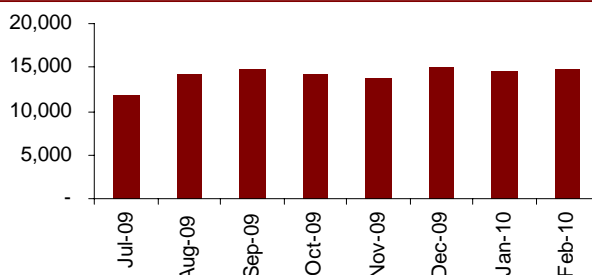


The reversal of macro economic imbalances is clearly evident by the much contained current account deficit, enhanced foreign exchange reserves and exchange rate stability. Although inflation remained in double-digits and is relatively higher in comparison to its trading partners, exchange rate stability is pointing towards strength achieved off late through structural reformation. So what is stopping SBP from easing its monetary stance? Our answer is liquidity and the risk of resurgence in global inflation. The solution to the liquidity issue is the reimbursement from the Coalition Support Fund, the Friends of Democratic Pakistan fund, and Kerry-Lugar arrangements. The sum of these flows arrives at Rs382bn or US\$4.5bn - enough to finance the deficit and resolve inter-corporate debt. Our inflation call for the full-year still stands at 10-11% and we expect inflation to taper off in the months to come on account of stability in food and other commodity prices. In the upcoming policy, we are not ruling out monetary easing by 50-100bps, but by and large we expect 250bps cut in 2010.

Liquidity; a grave concern

As highlighted above, SBP's priority to increase liquidity has stopped it from easing its stance. In addition to the delay in foreign inflows, SBP is also worried about commodity financing; carry over balances from last year, which is persistently raising the risk of dearth of liquidity for the upcoming wheat crop season. The commodity financing for FY09 was recorded at Rs210bn, compared to the meager retirement of Rs56bn as of Mar 6, 2010. This can be gauged from the frequency of SBP's Open Market Operations over the last 3 months. SBP reported 16 injections since January, with an average injection amount of Rs69bn. Interestingly, after encountering a delay in foreign inflows, government is exploring other possibilities to ease liquidity, one option is the issuance of convertible bonds of OGDC worth US\$500mn. The government is also pushing Etisalat to release US\$800mn on account of PTCL's privatization. Moreover, we

expect the release of the next IMF tranche will also improve the liquidity situation. However, it is very important for the government to assume its responsibility and retire the commodity financing through selling its wheat stock.

Foreign exchange reserves (US\$m)

Source: SBP

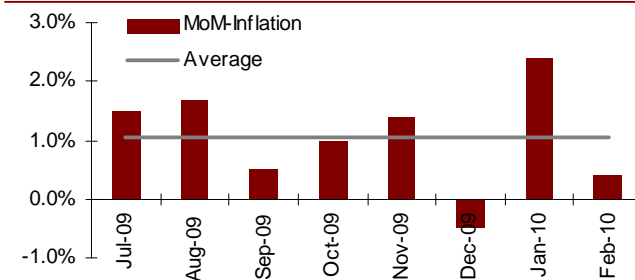
Recent macro economic data roundup

Current account deficit: Pakistan's current account deficit for the first eight months was reported at US\$2.56bn compared to US\$7.9bn in the corresponding period last year. The improved deficit was primarily led by the reduced trade deficit and higher remittances. The deficit for the full-year is expected to be around US\$5.0bn compared to US\$9.25bn in FY10.

Fiscal deficit: The MoF reported the first half fiscal deficit at 2.7% of GDP compared to the full-year target of 4.9%. We believe, the subsidy rationing coupled with reduced security expenses in 4QFY10 will help to discipline the short fall by year end. This along with expected external inflows will ease the pressure of deficit financing.

Inflation: The risk of drought in India has eased and thus stemmed the soft commodity price hike globally. We believe, the sufficient stock availability of wheat and timely sugar imports will stem inflation in Pakistan. The inflation in the remaining part of the year is expected to average around 11% with the full-year figure to arrive at 11% as well. This support

our call of an interest rate cut in the upcoming monetary policy.

MoM inflation FY10 to date

Source: SBP

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Also in focus**Cotton arrival stands put at 12.7mn bales**

According to the latest numbers released by Pakistan Cotton Ginners Association (PCGA), as of March 15, 2010, cotton arrivals stood at 12.68mn bales versus 11.30mn bales last year, translating to a growth of 12% and the fortnightly cotton flows translating in 27.3k bales. Overall, these figures are encouraging for Pakistan and are in line with our arrivals expectations of 12.7-12.8mn bales during the current season. We will still have to import 2.0-2.5mn bales, as our total demand stands at 15mn bales.

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