

March 29, 2010

Pakistan Market**Apr–May MPS: SBP stays cautious****MORNING BRIEFING**

KSE100 Index: Closing 10137.93 ↑ (+10.90)

SBP opted to keep the policy rate unchanged in the bi-monthly Monetary Policy Statement (MPS) released on March 27th 2010. The cautious approach by the SBP is a by-product of the uncertainty lingering around the fiscal deficit and its financing. Though not mentioned in the policy statement, we believe the delay in the IMF tranche has also stressed the central bank to stay defensive. SBP expects to strike a balance between inflation, economic recovery and financial stability with the current monetary policy, however, we believe the liquidity issue will remain circular, until the release of commodity financing by the government, in addition to the reimbursement of foreign funds. Finally, the SBP expressed its concern over the disappointing tax collection, our view, stands differed, as inflation itself is a tax being borne by the general public. SBP expects full-year inflation to come at 12.0%.

SBP's remarks on the general economy

In the policy statement SBP expresses *"Building on initial gains in macroeconomic stability the economy is looking to further its traction for sustainable recovery. Inflationary pressure have dampened but continue to persist, mainly due to alignment of energy sector prices with market factors. Large Scale Manufacturing (LSM) has consistently grown since October 2009 after contraction for almost 20 months but remain fragile. Reduction in the external current account deficit has allowed SBP to rebuild foreign exchange reserves, despite shortfalls in external financing flows. However, uncertainty has increased in some areas, particularly the fiscal sector, with implications for the rest of the economy, including the monetary policy"*.

SBP's gravest concern

As highlighted above, the SBP highlighted fiscal deficit and its financing as the real danger. Interestingly, Pakistan has been declared as a war economy, yet even then, the deficit for the full-year is likely to be in the range of 5.0-5.5%, way below than the Eastern European economies and historical figures

of other war economies. Though not budgeted, the government has incurred a huge sum in the security related operations and at the same time has achieved greater fiscal discipline through curbing subsidies on the energy sector. The SBP's concern regarding the deficit figures in the following statement:

"The key source of uncertainty, however, lies in the weak fiscal position. Burdened by significant security related expenditures and shortfall in revenues, keeping the fiscal deficit for FY10 within target would be challenging. Partial phasing out of subsidies and reduction in development expenditures have helped in containing expenditures but has lead to surge in domestic prices and is hurting crucial public sector investment. Similarly, increased Petroleum Development Levy (PDL) receipts, due to higher oil imports, have cushioned the lower tax revenues to some extent but have contributed towards inertia in domestic inflation".

Our view and recommendation

As described above, the tax collection number is not all that dismal if we incorporate an inflation tax. Room for further tax collection is limited, as the economic pie is stagnant and unlikely to procure more savings to fund the deficit. Commodity financing can only be sorted out, if the government allows this year's surplus wheat stock to be exported. The Coalition Support Fund (CSF) will eventually be disbursed, meanwhile the government should seek a waiver from the IMF and print rupee counterpart to fund the deficit. We expect full-year inflation for FY10 to range around 11% and 8% in FY11, provided oil prices hover at US\$80/bbl.

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Also in focus**FBR and E&P companies settle tax-related disputes**

The Federal Board of Revenue (FBR) and E&P companies have signed a Memorandum of Understanding (MoU) to settle tax-related disputes worth approximately Rs14bn. E&P companies are expected to pay the due amount by June 2010, while the FBR has agreed to let the de-commissioning costs amortize over a period of 10 years, or equal to the life of the field, whichever is less. To formalize the above agreement; amendments in the Finance Act would be made accordingly. This should help facilitate foreign investment in the sector, as it will help overseas companies to map out future strategies for the execution of their projects. However, Pakistan Oil Fields (POL) and Pakistan Petroleum Limited (PPL) are likely to take a one time hit of Rs1.89/share and 0.58/share, respectively.

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