9MFY14 review & Outlook

Economy rebounds as government takes action on multiple fronts

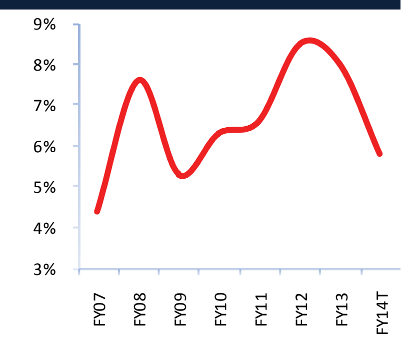
Economic indicators during 9MFY14 are gradually showing improvement with LSM and GDP showing a positive uptick, fiscal deficit remaining within the budgeted target and Forex reserve now finally improving after hitting a multiyear bottom. The current government has a clear cut mandate for five years (lasting up to CY18), and with its majority, it is now in a better position to deliver on its manifesto. As a start, PML-N has undertaken the painful economic reforms which were absent in the previous government's tenure. However, the pace of reforms has been on the lower side as highlighted by IMF in its latest quarterly report. While electricity tariffs & gas levy has been raised reluctantly, other measures such as gas tariff hike, broadening of tax revenue (SRO's removal) and SOE's restructuring & privatization are on the agenda in the near term.

Revenue collection remains below target, while PSDP suffers to keep fiscal deficit under control

FBR has provisionally collected PKR1,573bn during 9MFY14 showing a growth of 16% over the CPLY. However, the collection was PKR210bn short of the target, on the basis of PKR2475bn budgeted target. Current pace of collection shows that it will be impossible to reach the target especially after the recent PKR appreciation trend. IMF has already downward revised the annual target to PKR2345bn. PSDP allocation will likely face the axe due to stringent deficit reduction requirement of IMF, in case the government is unable to execute its Non-tax revenue target of 3G auction and CSF receipts. In order to offset the impact of low collection on the budget deficit, the IMF has also shown current year's development budget at PKR430bn as against Parliament's approved budget of PKR560bn. In 1HFY14, fiscal deficit stood at 2.1% of GDP compared to CPLY's deficit of 2.7%, which is impressive given the limited CSF inflow during the period. As per media reports, the country's fiscal deficit in 8MFY14 amounted to PKR832 billion or 3.2% of GDP compared to 4.2% in the CPLY.

Due to lower than expected external flow in FY14TD, the government's reliance on SBP borrowing has increased despite quarterly SBP borrowing retirement targets set by the IMF. Budgetary borrowing till March 21, 2014 had reached a whooping PKR680bn as opposed to only PKR139bn in CPLY. However the PIB auction of March 26, 2014 saw record participation of PKR540bn by banks against the target of PKR60bn. With the government now getting this extra funding from the commercial banks, the Mar-14 quarterly SBP borrowing retirement target given by IMF will likely be met.

Fiscal deficit as % of GDP



As a % of GDP	1HFY13	1HFY14
Total revenue	6.38%	6.48%
Tax	4.42%	4.51%
Total Expenditure	9.11%	8.56%
Current expenditure	7.52%	7.26%
Budget deficit	**2.73%**	**2.08%**

	Shares outstanding	To be sold	Method	Shares to be sold	Market Price	Possible Transaction size in USD
OGDC	4,301	10%	International/Domestic	430	259.15	1,115
PPL	1,972	5%	Domestic	99	232.15	229
UBL	1,224	20%	Domestic	245	168	411

Privatization yet to pickup pace

Due to opposition parties/ labor union issues the government has initially decided to take the easy route of offloading some of its holding in profitable entities rather than going for full fledged privatization of loss making entities. As a start, SPO of OGDC, PPL, UBL, HBL and ABL will be done.

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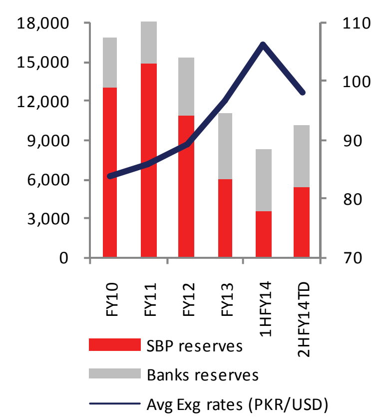
Later on, the privatization of PIA, FESCO, Steel Mills and other State Owned enterprises will be taken up. The initial three heavy weights (OGDC, PPL and UBL) shares offering size can fetch USD1.75bn at current market price.

External account review & outlook

8MFY14 current account deficit number stood at USD2.0bn as opposed to USD0.8bn, witnessed in the CPLY. The main cause for this higher CAD is the shortfall in CSF receipt which stood at USD1.8bn during 8MFY13 versus only USD0.7bn this year. Both exports and imports grew by 4% during 8MFY14, leading to 5% rise in trade deficit. Remittances continued its growth phase, augmenting by 11% to help bringing the deficit under control which was created by trade and income deficit.

Reserves breakup (USD mn) and PKR/USD trend



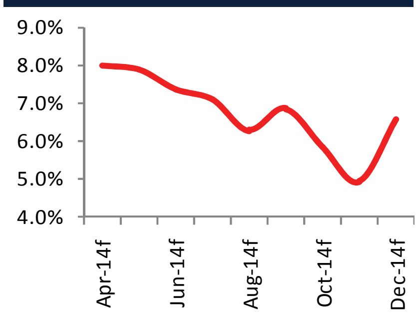
The heartening news on the external front is the rise in Capital and Financial account during FY14TD. Capital account during 8MFY14 stood at USD0.96bn versus USD0.16bn in the CPLY, mainly due to USD0.75bn received under PDF head, as a grant. Another USD0.75bn will be witnessed in March external account number. Similarly, financial account remained positive by USD0.3bn in 8MFY14 versus negative USD0.1bn in the CPLY, thanks to higher bilateral financing.

4QFY14 CAD number is projected to remain benign due to higher CSF inflow and 3G auction. We expect FY14 CAD of ~USD2.5bn which will be the same as last year. In GDP terms, a 1% CAD is well below the norm, and can easily be financed going forward by higher multilateral funding. IMF's nod was critical for reviving the assistance from multilateral agencies, which is now visible and project based lending from World Bank, IDB, IFC and ADB now ramping up. The good thing is that bulk of repayments to IMF from the previous SBA loan has also been made, and going forward, receipts from current EFF loan will more than cover the projected repayments. If the government is able to fulfill its reforms commitment with IMF, the size of EFF loan will likely be enhanced as well.

Monthly inflation dips after touching double digits

After touching a multiyear trough of 5% in May-13, the monthly CPI again moved up swiftly to 11% in November-13 due to reversal of low base effect, electricity tariff hike and overall rise in food prices. However, a gradual dip in Food price and flat electricity & gas tariff since then has brought the monthly CPI number down to 8.5% in Mar-14. Core inflation further dipped in Mar-14 to 7.6%.

CPI expected to decline from Apr-14

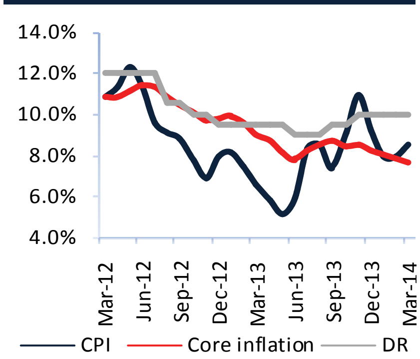


Cumulative 9MFY14 CPI numbers now stand at 8.6%. We project inflation during the 4QFY14 to clock in at ~7.8%, with FY14 average projection of around 8.4%. SBP has also decreased its FY14 inflation estimate to remain between 8.5-9.5%, compared to previous estimate of 10-11%. Positive impact of PKR appreciation has been witnessed in petroleum prices from April, and eventually on other items, later on. Moreover, gas price hike decision is still pending, but from the CPI's vantage, the government has stated that it will not change the domestic gas tariffs. Thus, YoY CPI is expected to gradually decrease going forward till November.

Monetary policy review and outlook

After ending its monetary easing policy in June 2013, the central bank went for raising discount rates in September and November 2013 by 50bps each, due to hike in inflationary trend and external account issues. In January and March' MPS review, SBP kept the discount rate unchanged at 10.0%, highlighting that while the economic indicators have improved, especially the foreign exchange reserves of SBP, the economy still faces many challenges and a pro-active policy effort is required to continue to maintain the momentum.

DR vs. Inflation measures

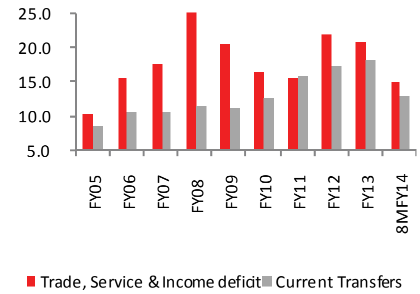


Our base case is for 50bps dip in the next monetary policy of May-14, however we feel that chances of status quo are also present. With inflation expected to dip going forward, the key swing factor for the Central bank would be the external side position in May. By then, clarity over further receipts under PDF head, Euro bonds/GDR, possible Oil credit facility, dollar proceeds portion of telecom auction would be much more visible. Thus, decision over whether to go for monetary easing will be much more apt depending on the outlook at that point.

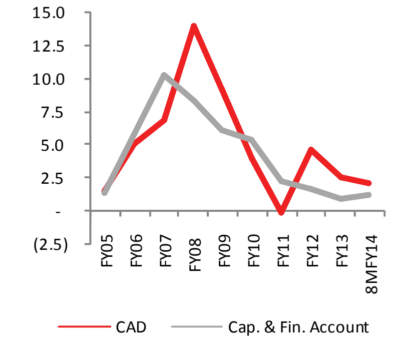
Currency review & outlook

After devaluing by around 6% against USD in the 1HFY14, PKR has surprisingly appreciated by a hefty 7% in 3QFY14TD, making it one of the best performing currencies in the world during CY14. After the SBP forex reserve touched a multiyear low of around USD3bn in February, things seem to be finally improving with an unexpected USD1.5bn received under the Pakistan Development Fund (PDF) head contributed by a friendly nation. The surprise addition in reserves has had a knock on effect on different speculators and exporters who were storing USD in anticipation of further rupee decline. These developments are game changers, so if they do materialize, we for see that PKR will remain range bound at current level throughout the calendar year. Absence of development on this front, however will likely result in rupee devaluation. While not denying the positives from recent PKR appreciation, we are of the view that negatives outweigh the positives given the structural deficit issue which the country faces. Compared to USD6.0bn forex reserves of SBP in June 2013 (USD11bn in June 2012), these reserve currently stand at USD5.4bn, despite the USD1.5bn grant. Thus, to show no devaluation on FY14TD basis is a bit questionable. If this trend continues, then the trade deficit will render further pressure on precarious forex reserves.

Higher trade deficit leads to current account deficit (USD bn)



Higher CAD compared to Cap. & Fin. account balance leads to reserves drawdown (USD bn)



Saudi and Chinese interest in Pakistan rising

The recent aid of USD1.5bn from a friendly county (Saudia Arabia) under the head of PDF has helped in improving the dwindling forex reserve position and leading to PKR appreciation. Whether the current PKR trend is sustainable or not is difficult to answer because of lack of clarity over further quantum of receipts under the PDF. Government circles are hinting towards oil deferral payment agreement to be signed with Saudi Arabia and Kuwait. These are game changers, if they do materialize. Whether it is just a goodwill gesture by the Saudi Monarchy or is there a quid pro quo remains the key question mark.

Talk of Chinese investment of up to USD30bn is being highlighted from the government side as well. While the proposed investment seems to be on the higher side, given the current economic scenario, a decent inflow from Chinese businesses is very much in the pipeline. Three areas where we have seen keen interest from the Chinese government and businesses are on 1) Energy side (Coal and Nuclear Power Plant), 2) Gwadar Port (along with related road infrastructure to connect with Western China) and 3) in the Textile Industry. Work on multiple coal projects have been finalized from the government's side with frequent contact by the Prime Minister and C.M. Punjab with Chinese companies to find a viable solution for the energy crises. If all the projects that have been talked about from Chinese side do materialize, the total quantum does easily add up to around USD30bn, but all these proposed investment will be visible over the next 1-6 years. While from Pakistan's perspective, USD30bn looks like a huge amount, but given China's economic muscles and reserve situation this is a paltry sum, especially given the synergies of trade from Pakistan's side with China's western provinces which are behind the curve on the economic growth cycle.