National Fullerton Asset Management Limited

The State of the Economy

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The Positives

- Pakistan's large scale manufacturing index started rising again in October 2009, after continuous decline of 20 months (see chart 1). Sectors such as auto, textile, fertilizer, construction are showing signs of recovery, and as a result Pakistan's economy is expected to rise by 3% in FY10 versus 2% in FY09.

- Pakistan's current account deficit exceeded US$ 2 billion in October, 2008, but has since shown a drastic improvement and has averaged US$ 304 million per month since then (see chart 2). This has helped stabilize the Pakistani rupee against the US dollar and other foreign currencies.

- Pakistan has achieved significant success in the war on terror, and the law and order situation has improved substantially in the previous months.

- The approval of the Baluchistan package and NFC award will help improve inter-provincial harmony.

The Negatives

- Pakistan's energy crisis is taking a heavy toll on the economy with no short-term solution in sight. Reliance on thermal power generation and our inability to quickly shift to alternative energy sources such as coal, hydel, nuclear, wind, etc is a huge risk that Pakistan's economy faces in the coming years.

- Pakistan's federal tax revenue collection at 8.8% of GDP is very low. Of this, 5.4% of GDP is collected in indirect taxes and only 3.4% of GDP is collected in direct taxes. India's federal tax revenue collection is 11.4% of GDP, of which 5.1% is collected in indirect taxes and 6.3% of GDP as direct taxes. Excessive reliance in Pakistan on indirect taxes, especially via rise in utility and oil prices, is one of the reasons why inflation has not subsided in the previous months. There is a need to increase reliance on direct taxes from those who earn whether in the form of agriculture income, real estate gains, or profits on service provided.

- Pakistan's non-productive expenses have grown substantially in the last couple of years, and social sector spending such as education, health care and infrastructure has been stagnant. This does not bode well for the future economic growth and stability.

- The budget deficit has widened as a result of (i) slow growth in taxes; (ii) substantial rise in government expenditures; and (iii) slow materialization of foreign assistance. This has forced the government to borrow heavily from foreign agencies, national savings schemes and the banking sector. The resultant liquidity crunch is a major reason that the private sector has been crowded out and interest rates have not declined significantly. This in turn has slowed down the pace of economic recovery.

Implications for Capital Markets

- We expect that foreign assistance to the government will rise substantially in the coming months, especially from disbursement of Coalition Support Fund of around US$ 2 billion and Kerry-Lugar Package of around US$ 1.5 billion. This will help reduce government reliance on domestic borrowing and indirect taxes, which in turn will help bring down inflation and interest rates in the coming months.

- The stock market will be affected by uncertainty over capital gains tax over the next three months. However, once this uncertainty is removed in the next budget and inflation and interest rates start to subside, we expect the stock market to perform well in the second half of the current calendar year.

Chart 1

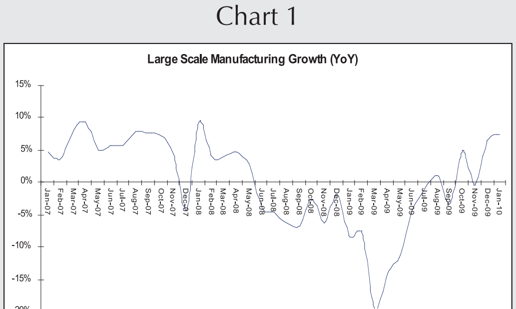

Chart 2