NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Capital Markets and the Growing Economic Risks

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Pakistan is exposed to two key economic risks: (i) high budget deficit, meaning government expenditures exceed government revenues (tax and non-tax); and (ii) growing current account deficit. Current Account Deficit occurs as Pakistan's cash outflows related to total imports of goods, services and transfers are greater than cash inflows on account of total export of goods, services and transfers.

In Pakistan's context the current account deficit is a bigger problem than the budget deficit as it cannot be managed by printing of notes. As can be seen in Figure 1, large current account deficits led to depleting foreign exchange reserves and declining import cover (foreign exchange reserves divided by monthly imports) in 2008, and resulted in an economic turmoil, substantial jump in the interest rates, flight of capital, freezing of the stock market, downgrading of Pakistan's sovereign rating to CCC+ from B by Standard & Poor's, severe liquidity shortage, and substantial decline in corporate profitability. The situation improved when the currency was depreciated by around 30% in 2008, which helped in the reduction of imports and exports growth.

Since November 2008, the current account has improved remarkably and even showed a surplus of US$ 542 million in FY2011. However, during the first four months of FY12, the current account deficit has grown to US$ 1.55 billion, and peaked at US$ 1.03 billion for the month of September. One of the key reasons for this rise in current account deficit is that our currency stands overvalued considering that cumulative inflation has been about 40% over the last 3 years, whereas the devaluation of the rupee versus the US dollar has been 14% during the same period. Substantial growth of remittances from the West and inflow from donor agencies also seem a low probability at present considering the geo-political scenario. In case the current account deficit widens, foreign exchange reserves may deplete sharply. This will result in loss of investors' confidence and a flight of capital. To avoid this scenario, the most viable and doable solution left with the government is devaluation of currency. We believe that so far the government has resisted such a step and that the State Bank of Pakistan has also intervened to support the currency. However, a gradual devaluation of the rupee will make imports expensive and exports competitive, thus improving the current account balance and having a positive impact on the foreign exchange reserves. Consequently, this will make the investment climate conducive for the investors.

Pakistan's stock market has a significant positive correlation with the current account balance as can be seen from Figure 2. We expect that the future direction of the stock market and interest rates will be shaped by the current account situation of the country. We are closely monitoring the current account situation while making our investment decisions.

Figure-1: Current Account Balance vs Import Cover

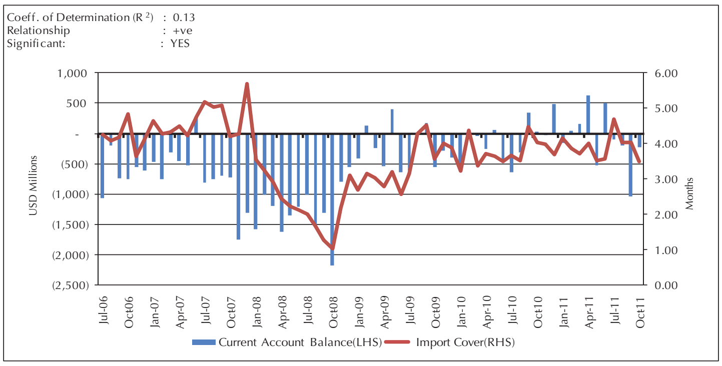

Figure-2 : Current Account Balance vs Stock Market