Investment Outlook

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Excessive Government Borrowing and Capital Markets

Government borrowing has increased drastically over the last couple of years. In FY07, the budget deficit was Rs 377 billion, which crossed Rs 777 billion in FY08. This was brought down by the Government to Rs 582 billion in FY09 by drastically cutting the development spending, but is expected to cross the Rs 800 billion mark in FY10 if the first quarter of FY10 is any indicator of things to come. Government borrowing from July 1 to mid-September, 2009 from the State Bank of Pakistan, commercial banks and national savings schemes is over Rs 200 billion versus Rs 146 billion in the same period last year – an increase of over 37%.The economy is expected to grow at a moderate rate of 3% in FY10, and revenue collection is not expected to grow by more than 12% in FY10.

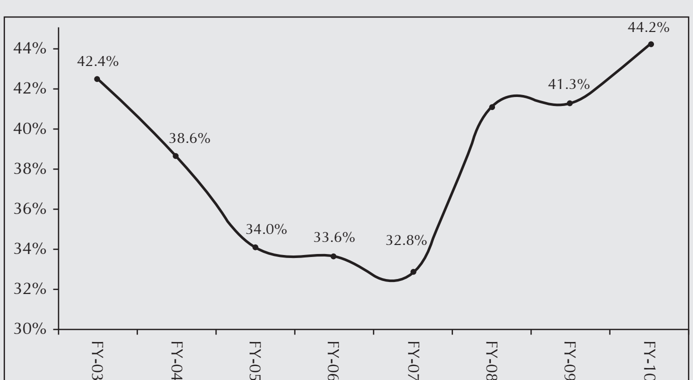
Pakistan's debt servicing to total Government Revenues ratio had declined from around 42% in FY03 to 33% in FY07. However, this ratio rose to over 41% in FY08 and FY09 (Chart-01), and is expected to cross 44% in FY10 if the present excessive borrowing trend continues. If the Government does not take the difficult decisions to increase taxes and cut its non-productive spending, almost half of total government revenues will be consumed by debt servicing in the next couple of years, leaving very little to be spent on the human and physical infrastructure of the country.

Government spending in Pakistan and other emerging countries is not very efficient due to waste and corruption. Private sector is considered more productive and efficient than the Government. Yet Government spending has started crowding out the private sector (see Chart 2), which will make it very difficult for the economy to revert back to its historical growth rate. In FY08 the private sector borrowed Rs 408 billion from the banking sector, which declined substantially to Rs 19 billion in FY09. During July – mid September period of FY10, the private sector has paid back Rs 69 billion to the banking sector instead of borrowing, which is a matter of concern. A key reason of this negative trend is that the private sector is reluctant to borrow at the prevailing higher rates, which may have been lower had the Government not borrowed so excessively. Another reason is that banks prefer to lend to the Government due to attractive rates and risk aversion.

Successive governments in the 1990s followed the policy of excessive borrowing and spending, which led us into to a debt trap where the total debt to GDP ratio reached around 100%. Businessmen preferred to simply put their money in national saving schemes and earn very attractive returns instead of investing in new businesses. The economy, employment and exports suffered as a result. We seem to be heading towards the same path again. If the Government will borrow at 14% from national savings schemes, the private sector will be forced to borrow at even higher rates, where it may not be possible for it to be profitable, especially considering the state of the economy.

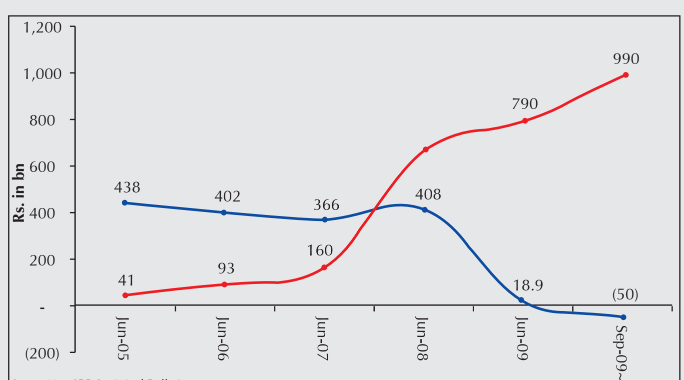
In the event that Government continues with its policy of excessive borrowing, interest rates will continue to be high, which is good for fixed income investors. However, higher interest rates reduce profitability of companies and result in investors preferring investing in fixed income versus equities. The Stock Market is fairly priced now at a price-to-earnings ratio of 8.5x, based on a 16% expected growth in corporate earnings in FY10. From here onwards, the rise in the Stock Market will be in line with corporate earnings growth.

Private Sector Credit Vs. Net Govt. Borrowing (Chart-01)



Source(s): Economic Survey of Pakistan
Govt. Budget Documents
The FY-10 estimate is that of NAFA

Debt Servicing as % of Total Govt. Revenues (Chart-02)



Source(s): SBP Statistical Bulletin
National Savings Organization Website
* Includes borrowing through National Saving Schemes (NSS)
~ From Jul-08 to Sep 12, 2009