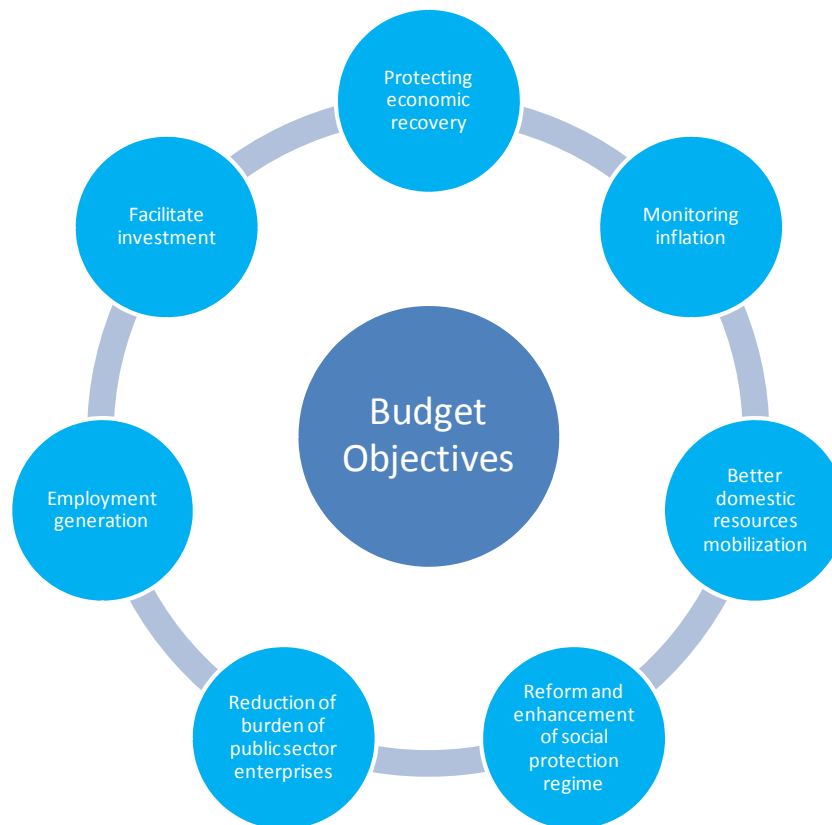
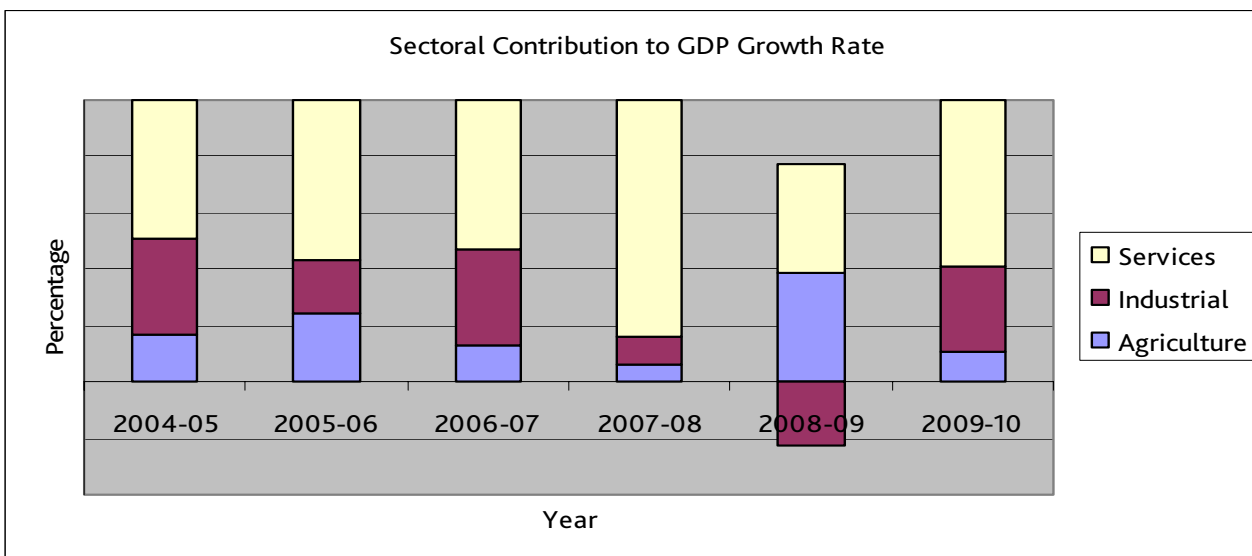


**OVERVIEW**

The Federal Budget 2010 with an outlay of Rs. 3.259 trillion and a budget deficit of Rs. 685 billion was articulately presented by the recently appointed Minister of Finance, Dr. Abdul Hafeez Shaikh in the National Assembly. In the backdrop of a perceived moderate and “fragile” economic recovery, a fiscal consolidation oriented budget has been presented given the reality of constraints, rather than adopting an expansionary fiscal policy at this juncture. The policy makers have several key objectives set out in the context of this reality which is a fundamental basis of this budget.

***Growth***

Pakistan's economy measured through real GDP has grown at a modest rate of 4% as compared to the corrected 1.2% in the previous year. The revision of previous year's growth rate has provided additional support to the headline growth rate for the current year with an additional effect of more than one percentage point. To understand the growth achieved and its momentum, a perusal of the components would provide useful insight.



### Agriculture

A cursory review of the agriculture sector reveals that the agricultural sector has not met the growth target and has made a paltry contribution of 11% to the GDP growth rate. Besides contributing to 45% of the total employed labour force, the sector also has several downstream and upstream linkages and added importance with respect to global commodity shortages. Major crops segment, accounting for 32.8% of agriculture value added registered a negative growth of 0.2% as compared to a healthy growth of 7.3% in the previous year. It is interesting to note that major crops which is the sub-sector with most incentives in terms of output prices and input subsidies has not performed well. Unfortunately the lackluster performance of this sector also feeds to the poverty issues which are a key challenge for policy makers. It appears that agriculture lobbies continue to succeed in deferring the ephemeral reference to bring the politically sensitive agriculture sector within the tax net.

### Industry

The manufacturing sector has posted a modest growth rate of 5.2% despite challenges from energy shortages, deterioration in domestic law and order and volatile export markets. Large Scale Manufacturing (LSM) which accounts for 66% of the sectoral share turned positive in August 2009 after a dismal 2008-09, with consumer discretionary products and export markets for textile leading recovery and subsequent momentum. More than half of the sub groups depicted improvements from the prior year productivity. Besides the repeated references to reforms in the energy sector, which have a direct bearing on the performance of this sector, there appear to be few policy initiatives which would allow for expansion of the LSM in the ensuing year.

***Development***

The development expenditure is largely unchanged at an estimated Rs. 787 billion and the focus is to ensure that all projects which have been started achieve a state of completion. With significant uncertainties over external receipts, the fate of the PSDP spending cannot be determined with any degree of certainty, however, reportedly the budget for this component has been set realistically to facilitate timely transfers to the various project implementing agencies.

***Investment and Savings***

The investment to GDP ratio has continued to decline from 19.0% to 16.6% in 2009-2010. Domestic savings have also continued to decline from 15.6% in 2006-07 to 9.9% in 2009-10. Resultantly, the investments-saving gap is being financed by net foreign resource inflows. This dependency on net foreign inflows is particularly concerning given the contraction in portfolio investment manifested through the capital markets and contraction in foreign direct investment by 45% year over year. A concerning statistic is the decline in gross fixed capital formation by 0.6% which was driven primarily by the decline in fixed investment by the private sector.

***Balance of payments***

The external current account deficit has improved significantly during the year to 2.8% on account of steep decline of imports, restoration in demand for exports by 8% in the nine months period end March 2010 and continued increase in workers' remittances reportedly linked to the Pakistan Remittance Initiative. The improvement in trade deficit is expected to continue in the wake of collapse in the global commodity prices emanating from the Euro zone. This has also eased some pressure on the exchange reserves which have recovered to \$15 billion from the November 2008 levels of \$6.4 billion; albeit, the recovery has been largely led by releases from the IMF.

***Monetary policy***

A neutral monetary policy stance in the context of relatively high and persistent headline inflation has been in place to combat the persistently high inflation. There has been a phased reduction consistent with policy decisions made in 2008 in the discount rate with two successive reductions in August 2009 and November 2009.

### ***Inflation***

Inflationary pressures have increased after subsiding in 2008-09 with the CPI increasing by 13% year on year. The increase has been largely led by a sharp increase in global commodity prices including food and energy coupled with other factors such as a lower comparative base effect, weakening of the rupee and increase in domestic procurement price for wheat.

While the monetary stance is no longer considered tight, this tool shall be a critical arsenal in ensuring that the contagion of inflationary pressures does not seep further into the household inflation rates.

### ***Economic reforms***

The Government's key economic reforms are outlined as follows:

1. Raising tax to GDP ratio through VAT
2. Improving tax administration and reinstating tax audits
3. Launch of Benazir Income Support Program with an allocation of Rs. 70 billion
4. Restructuring initiatives for key public sector enterprises
5. Reform of the power sector
6. National Finance Commission Award which is historic in terms of transfers to provinces.

The success of the above reforms shall be critical in ensuring that the objectives set out by the Government are met, particularly safeguarding the nascent economic recovery.

### ***GST reforms***

The Budget rhetoric was unequivocally clear that the present GST system was not a fair and efficient means of taxation besides being plagued with several administrative issues. A commitment has been made to complete the reforms to the VAT system by October 1, 2010. The historic NFC award which provides for significant increases in transfers to the provinces would facilitate stakeholder consensus building and timely completion and implementation of the reforms.

### ***Taxation measures***

The significant measures provided for in the Finance Bill are directed towards:

- Broadening the tax net through a uniform rate of tax for small companies and AOP's
- Implementation of reforms to the GST in the form of VAT with a target date of October 2010

- Relief measures in relation to custom duties which provide targeted incentives to sectors requiring a growth catalyst
- Relief measures relating to economic revival of Khyber Pakhtunkhwa, FATA and PATA regions
- Tax incentives for foreign and direct investment.

### *Looking ahead*

The year ahead would best be charted with a sense of cautious optimism in view of the universally accepted “fragile” recovery of the economy. While the Government’s stated commitment to complete existing development projects and focus on key economic reforms which meet the practicality test are sound thinking measures, the success of the reforms would depend largely on focus, commitment and consensus building between the Federation, Provinces and International financing community at large which remains a significant stakeholder in the process. Unless the key structural challenges to the economy are addressed with a sense of urgency, the fixed capital formation, tax to GDP ratio and stimulus to the economy will remain unfettered resulting in continued sub-par economic performance.

**BDO EBRAHIM & CO.**

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