# Government of the Punjab
# Punjab Pension Fund

Dated: 19 April 2010

MONTHLY REVIEW OF INVESTMENTS

March 2010

## FUND SIZE

- A summary of changes in fund size during the current accounting year i.e. 2009-10 is given in the following table:

Rs. millions (rounded to the nearest million)

| | Jul 2009 - Mar 2010 |
|---|---|
| Beginning fund size | 3,480 |
| Add: contribution during the period | 9,000 |
| Less: transfer to Reserve Pension Fund | 1,000 |
| Add: gain/(loss) during the period | 1,054 |
| Less: expenses during the period | 11 |
| **Ending fund size** | **12,523** |

## FUND'S PORTFOLIO

- The Fund's exposures to different investment types are summarized as under:

Amounts: Rs. millions (rounded to the nearest million)

%: as percentage of Total Fund Size

| | 30 Sep 2009 | | 31 Dec 2009 | | 31 Mar 2010 | |
|---|---|---|---|---|---|---|
| | Amount | % | Amount | % | Amount | % |
| PIBs | 0 | 0 | 4,115 | 33.9 | 4,925 | 39.3 |
| T-Bills | 0 | 0 | 0 | 0 | 3,363 | 26.9 |
| Short term bank deposits | 12,670 | 99.3 | 7,814 | 64.3 | 2,542 | 20.3 |
| Accrued interest | 41 | 0.3 | 202 | 1.7 | 66 | 0.5 |
| Cash at bank | 49 | 0.4 | 22 | 0.2 | 1,619 | 12.9 |
| Other assets* | (1) | 0 | 2 | 0 | 8 | 0.1 |
| **Total Fund Size** | **12,759** | | **12,155** | | **12,523** | |

*Other assets include prepaid expenses for management of PPF and book value of fixed assets (vehicles, computers etc.) of PPF

- PPF has been increasing its exposure to long-term fixed-rate investments which are more suitable for the Fund considering the long-term nature of pension liabilities. At the end of March 2010, long term PIBs constitute 39.3% of the Fund size;
- Also, PPF has been switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.



23-D, FCC Block, Syed Maratib Ali Road, Gulberg IV, Lahore. Tel: 042-5758138

FUND'S PERFORMANCE

- Time Weighted Return (TWR) earned by PPF until March 2010 is summarized as under:

| Period | Annualized Return for the period | |
|---|---|---|
| | Gross Return | Net Return* |
| 16 May 2008 (inception) to 30 June 2008 | 7.00% | 6.79% |
| FY 2008-09 | 15.21% | 15.00% |
| Jul 2009 – Mar 2010 | 13.88% | 13.71% |
| Mar 2010 | 12.19% | 12.08% |

*Net Return means the return after deducting expenses incurred on management of PPF

- Despite a gradual shift towards long-term fixed-rate investments (PIBs), the Fund has been invested primarily in short-term bank deposits during the current financial year therefore its return has been moving in line with market interest rates.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

Agriculture

- The share in GDP and growth of agriculture sector along with its various subsectors in the last two financial years is shown in the following table:

| | FY 2007-08 | | FY 2008-09 | |
|---|---|---|---|---|
| | Share in GDP (%) | Growth during the year (%) | Share in GDP (%) | Growth during the year (%) |
| Agriculture | 21.3 | 1.1 | 21.8 | 4.7 |
| Major crops | 6.9 | -6.4 | 7.3 | 7.7 |
| Minor crops | 2.6 | 10.9 | 2.6 | 3.6 |
| Livestock | 11.1 | 4.2 | 11.3 | 3.7 |
| Fishing | 0.4 | 9.2 | 0.4 | 2.3 |
| Forestry | 0.3 | -11.5 | 0.2 | -15.7 |

Source: Pakistan Economic Survey 2008-09 (published by Ministry of Finance)

- It is evident that the two most important agriculture sub-sectors are 'major crops' and 'livestock'.
- The performance of 'major crops' sub-sector does not seem promising in FY 2009-10. The important crops in this category include Cotton, Sugarcane, Rice and Wheat.

- For the crops harvested during FY 2009-10, area under cultivation was higher in case of Cotton but lower in case of Sugarcane, Rice and Wheat as compared with the previous year. The trend in area under cultivation was driven by prices received for the crops in the previous season and availability of water at the time of sowing.
    - Production of these crops has also followed the same pattern as area under cultivation (the final figures for wheat production have not arrived but the production is expected to be less than last year).
- Use of fertilizer increased significantly during FY 2009-10 on the back of higher farm incomes and stable fertilizer prices. A continuation of this trend has positive implications in terms of future productivity.
- Growth in credit disbursement to Agriculture sector has been slower in FY 2009-10 compared with the previous financial year. One important factor behind this slowdown is rising NPLs in the Agriculture credit.
    - A bifurcation of purpose-wise lending shows that production loans (which are of a seasonal nature) have shown a slightly higher growth over last year whereas development loans (which are meant for capital investments) have shown a negative growth.
    - A bifurcation of sector-wise lending shows that credit to Farm sector showed a higher growth over last year whereas credit to Non-Farm sector showed a much slower growth compared with last year.
- Slowdown in disbursement to Non-Farm sector (which includes livestock, dairy and poultry sub-sectors) is a source of concern considering the significant share of this sector in the overall GDP.

## Industry

- Large-scale Manufacturing (LSM) sector has been helped by rising domestic demand. As per the Quantum Index of Large-scale Manufacturing (QIM) released by Federal Bureau of Statistics (FBS), LSM sector showed a growth of 2.34% during Jul-Jan 2009-10 over the same period of last year.
    - Major sub-sectors showing a decline in production during Jul-Jan 2009-10 as compared with Jul-Jan 2008-09 include textiles, food-beverage-tobacco (especially sugar & cigarettes), petroleum products and metal industries.
    - Major sub-sectors showing increase in production during Jul-Jan 2009-10 as compared with Jul-Jan 2008-09 include pharmaceuticals, non-metallic minerals (especially cement), leather products, tyres & tubes, automobiles, fertilizers, electronics and engineering items.

- Production of consumer durables, mainly automobiles and allied industries, contributed the most to the recovery.
- Demand for cement and steel increased as construction activities revived. Cement sector also benefitted from rising global demand as exports showed a considerable increase.
- Low value-added textile sector benefitted from a good cotton crop and a simultaneous shortage of cotton globally.

- Growth of manufacturing sector will be challenging to sustain in the remaining months of FY 2009-10 because of energy insufficiency and rising costs (including energy and commodities). If manufacturers try to shift the cost burden to consumers by raising prices, the demand for goods may tumble because the consumers' purchasing power has already been weakened by a resurgence of inflation.

Services sector

- The share in GDP and growth of services sector along with its various subsectors in the last two financial years is shown in the following table:

| | FY 2007-08 | | FY 2008-09 | |
|---|---|---|---|---|
| | Share in GDP (%) | Growth during the year (%) | Share in GDP (%) | Growth during the year (%) |
| Services | 53 | 6.6 | 53.8 | 3.6 |
| Transport, Storage & Communication | 10.2 | 5.7 | 10.3 | 2.9 |
| Wholesale & Retail Trade | 17.3 | 5.3 | 17.5 | 3.1 |
| Finance & Insurance | 6.4 | 12.9 | 6.2 | -1.2 |
| Ownership of Dwellings | 2.7 | 3.5 | 2.7 | 3.5 |
| Public Administration & Defence | 5.9 | 1.2 | 6.1 | 5.0 |
| Other Services | 10.6 | 10 | 11.1 | 7.3 |

Source: Pakistan Economic Survey 2008-09 (published by Ministry of Finance)

- Services sector seems well poised to achieve its growth target of 3.9% for FY 2009-10.
  - Better than expected performance of manufacturing sector is benefitting the Wholesale and Retail Trade which is the biggest segment within the Services sector.
  - The trend in imports has implications for the Services sector through its effects on Wholesale & Retail Trade activities, port/shipping activities and inland transportation of goods. Imports have shown a positive growth during Oct-Feb

FY 2009-10 compared with a negative growth during Jul-Sep FY 2009-10. The rising trend in imports will also help the Services sector.

- Finance & Insurance sector is also expected to perform well compared with its dismal performance during the last financial year.

## FISCAL MANAGEMENT

- A summary of revenues and expenditures during the first half of FY 2009-10 and their comparison with the same period of the previous financial year is made in the following table:

Billion rupees

| | Jul-Dec | | |
|---|---|---|---|
| | FY 09 | FY 10 | Growth |
| **Total revenue** | 835 | 910 | **9.0%** |
| Tax | 607 | 659 | 8.6% |
| Non-tax | 228 | 251 | 10.3% |
| **Total expenditure** | 1084 | 1,313 | **21.1%** |
| Current | 919 | 1,059 | 15.2% |
| Development | 133 | 239 | 80.0% |
| Unidentified | 32 | 15 | -53.0% |
| **Budget deficit** | -250 | -403 | **61.5%** |
| Revenue balance (Total Revenue minus Current Expenditure) | -84 | -149 | |

Source: State Bank of Pakistan (Surcharges on POL in FY 09 have been subtracted from non-tax revenues & added to tax revenues in order to make figures comparable with FY 10 in which the Government has included petroleum levy in tax revenues)

- It is evident that the expenditures grew faster than revenues resulting in huge increase in the budget deficit.
- Revenue balance measures the capacity of the government to finance capital expenditure (development expenditure) from existing resources. Rising deficit in the revenue balance shows the inability of the government to do that.

- The composition of tax and non-tax revenue for first half of FY 2009-10 and its comparison with the previous financial year is shown in the following table:

Billion rupees

| | Jul-Dec | | |
|---|---|---|---|
| | FY 09 | FY 10 | Growth |
| **Tax Revenue** | **607** | **659** | **9%** |
| Direct Taxes | 211 | 211 | 0% |
| Taxes on Property | 2.5 | 2.8 | 12% |
| Taxes on goods & services | 273 | 301 | 10% |
| Taxes on international trade | 73 | 71 | -3% |
| Petroleum levy | 29 | 52 | 80% |
| Other taxes | 19 | 21 | 11% |
| **Non-tax Revenue** | **228** | **251** | **10%** |
| Profit of PTA/PO | - | - | |
| Interest (PSE & others) | 4 | 5 | 24% |
| Dividends | 34 | 27 | -23% |
| SBP profits | 72 | 135 | 88% |
| Defense | 30 | 3 | -89% |
| Dev. Surcharge on gas | 9 | 10 | 18% |
| Discount retained on crude oil | 6 | 3 | -58% |
| Royalty on oil/gas | 26 | 23 | -12% |
| Others | 47 | 46 | -2% |
| **Total Revenue** | **835** | **910** | **9%** |

Source: Ministry of Finance

- Tax collection has been generally unimpressive. Major areas of weakness have been collection of Direct Taxes and Taxes on Goods & Services.
- Analysis of non-tax revenues is particularly troubling.
    - Decline in non-tax revenues under the head of Defense reflects the delay in reimbursements by the US for logistic support services provided by Pakistan to the coalition forces.
    - SBP profits account for the major portion of non-tax revenues. Most of these profits have arisen because of deficit financing by the government in recent years. The interest paid by the government on T-bills sold to SBP appears as income in SBP's accounts and is transferred back to the government. This results in zero cost financing for the government with adverse implications for inflation and financial discipline. This trend is clearly unsustainable.

- In its latest Monetary Policy Statement dated 27 March 2010, SBP has highlighted fiscal problems and uncertainties as the major risk to the economy.
    - Phasing out of subsidies and imposition of Petroleum Development Levy are making it difficult to control domestic inflation
    - Uncertainty regarding non-tax revenues on account of foreign reimbursements and the extent of remaining power subsidies adds to the complications
    - Financing mix of fiscal deficit is also uncertain. External financing for budget, especially the amount pledged by Friends of Democratic Pakistan (FoDP), has not materialized yet. An amount of Rs. 93 billion has already been borrowed from IMF for a short term which has to be returned once the FoDP flows are received.
    - Towards the end of March 2010, the outstanding stock of government borrowing from SBP (on cash basis) was in excess of the quarterly ceiling limit by an amount of Rs. 110 billion.
    - Commodity operations and circular debt in the energy sector are straining domestic liquidity.
    - Banks have been lending to the government at high rates. TFCs issued during 2009 to resolve circular debt paid a spread of 1.75%-2% above KIBOR. Rates for financing commodity operations have been 2.5%-2.75% above KIBOR. Attractively priced government borrowing may lead to stagnation in private sector credit growth.

## EXTERNAL ACCOUNT

- Balance of payments during the current financial year has been compared with the balance of payment in the same period of last financial year in the following table:

Billion US $

| | Jul - Feb | |
|---|---|---|
| | FY 09 | FY 10 |
| **Current Account** | -8.0 | -2.6 |
| Balance on goods & services | -11.7 | -9.1 |
| Trade balance | -9.0 | -7.4 |
| Imports | 22.3 | 19.9 |
| Exports | 12.9 | 12.5 |
| Services net | -2.7 | -1.7 |
| Income net | -2.9 | -1.9 |
| Current transfers | 7.1 | 8.4 |
| Remittances | 4.9 | 5.8 |
| **Capital and Financial Account** | 3.4 | 3.9 |
| Direct Investment | 2.8 | 1.3 |
| Portfolio Investment | -0.9 | -0.3 |
| Other Investment | 1.4 | 2.6 |
| **Errors & Omissions** | 0.0 | -0.4 |
| **Overall balance** | -5.0 | 0.9 |

Source: SBP

## Current Account

- Current Account Deficit (CAD) has lowered significantly during Jul-Feb FY 10 compared with the same period of last year. Current Account may be divided into three major segments i.e. trade in goods & services, income-related flows and current (unilateral) transfers.

1. Trade in goods & services:
    - Deficit on trade in goods & services has lowered as a result of lower imports and a small rise in exports.
    - Major reasons for lower imports include lower prices, lower domestic demand and depreciation of domestic currency.
        - Major categories responsible for most of the decline in import-of-goods include Food (especially wheat), Machinery and Petroleum.
        - Major categories responsible for most of the decline in import-of-services include Transportation and Travel.

- Relatively better performance of exports is attributable to improvement in external demand, increase in domestic industrial production and depreciation of domestic currency.
  - Major categories responsible for relatively better performance of export-of-goods include Food and Textiles.
  - Major category responsible for relatively better performance of export-of-services is Government Services.

2. Income-related flows:
   - Deficit on Income-related flows has also lowered because of lower repatriation of profits by foreign investors and lower interest payments on foreign loans.
     - Most of the decline in repatriation of profits has occurred in Petroleum Refining, Oil & Gas and Financial sectors. This can be attributed to lower profitability of these sectors due to various factors including circular debt, lower prices of oil & gas and rising non-performing loans.
     - Lower interest payments are attributable mainly to lower interest rates on floating-rate foreign-currency-loans.
3. Current (unilateral) transfers:
   - Surplus on account of current transfers increased mainly because of higher worker-remittances.
   - Most of the increase has occurred in remittances from the Gulf region. Remittances from the entire Gulf region constitute 57% and remittances from UAE constitute 23% of the total remittances received during Jul-Feb FY 10.

## Financial Account

- Financial Account can be divided into three major segments including Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI) and Other Investment.
- For analytical purposes, however, it is better to divide Financial Account into two major segments i.e. Equity-related flows and Debt-related flows.
  - FPI includes both equity and debt components.
  - Equity-related flows would include FDI and Equity-component-of-FPI.
  - Debt-related flows would include Debt-component-of-FPI and Other Investments.
- Surplus on Financial Account has increased during Jul-Feb FY 10 over the same period of last year. But the composition of Equity and Debt within the Financial Account is shifting towards less Equity-related and more Debt-related flows. This has implications for the future when higher interest payments may create financial problems.

Change in Trend

- Most of the improvement in External Account during the period Jul-Feb FY 10 came in the first quarter i.e. Jul-Sep FY 10. The trend has changed from October 2009 onwards.
  - Since Oct 2009, CAD has been increasing on a month-on-month (MoM) basis. Imports are picking up and worker-remittances are falling on a MoM basis. The trend of rising imports is expected to continue due to improving domestic demand and higher international commodity prices. Future trend in worker-remittances remains uncertain considering the economic slowdown in UAE.
  - Most of the surplus in Financial Account also materialized during Jul-Sep FY 10. Since then financial inflows have slowed down considerably which is a reflection of our weakened ability to tap international capital markets and to finance even the smaller CADs.
- Despite improvements, External Account remains a vulnerable area of our economy.

INFLATION

- A summary of inflation rates during the current financial year is given in the following table:

| End of month | CPI Inflation (YOY) |
|---|---|
| July 2009 | 11.17% |
| August 2009 | 10.69% |
| September 2009 | 10.12% |
| October 2009 | 8.87% |
| November 2009 | 10.51% |
| December 2009 | 10.52% |
| January 2010 | 13.68% |
| February 2010 | 13.04% |

- Average CPI Inflation has been 11.08% during Jul-Feb FY 10.
- NFNE (Non-food non-energy) measure of Core inflation stood at 10.1% in Feb 2010. Trimmed Mean measure of Core inflation (which excludes 20% of the items in the CPI basket showing extreme changes in price) stood at 12.4% in Feb 2010. The significant gap between the two core inflation measures shows that inflationary pressures mainly emanated from food and energy sub-groups but, within these groups, inflationary pressures were quite broad based.

- Inflationary pressures seem to have reemerged in the economy during recent months. These can be partly attributed to second round impact of higher prices of fuels, electricity, gas and commodity prices.
- WPI (Wholesale Price Index) Inflation, which is a proxy to cost of production, increased to 19.3% in Feb 2010 from a low of 0.3% in Aug 2009. The primary reason for this uptrend is higher international commodity prices, depreciation of domestic currency and rise in domestic prices of fuel and energy.
- International commodity prices eased during Feb 2010 which can be attributed to different factors including:
    - Continuing economic problems in Euro Zone (Greece's debt crisis, poor GDP growth in Germany) & USA (high unemployment);
    - Appreciation of US dollar; and
    - Monetary tightening in China.
- IMF Commodity Price Index rose by 44.4% on YOY basis (prices compared with same month of previous year) but declined by 2.3% on MOM basis (prices compared with the immediately preceding month) in Feb 2010 compared to 41.1% YOY & 3.5% MOM in Dec 2009. The YOY changes in Price Indices of specific commodities showed
    - high inflation in prices of Metals, Energy and Raw Material;
    - lower inflation in prices of Food group; and
    - deflation in prices of Fertilizers.

## INTEREST RATES

- A summary of interest rates for the current financial year is given below:

| End of month | Yield on 1-yr T-bill (p.a.) | Yield on 10-yr PIB (p.a.) | 6-month KIBOR (p.a.) |
|---|---|---|---|
| July 2009 | 11.83% | 11.84% | 11.99% |
| August 2009 | 12.35% | 12.36% | 12.56% |
| September 2009 | 12.46% | 12.47% | 12.65% |
| October 2009 | 12.57% | 12.76% | 12.84% |
| November 2009 | 12.07% | 12.40% | 12.41% |
| December 2009 | 12.10% | 12.62% | 12.43% |
| January 2010 | 11.95% | 12.47% | 12.23% |
| February 2010 | 12.29% | 12.70% | 12.43% |
| March 2010 | 12.31% | 12.65% | 12.41% |

Source: SBP, Reuters

- Domestic demand from the private sector seems to be recovering gradually due to reasons such as higher farm incomes, higher prices of imported goods due to exchange rate depreciation etc.
- Gradually rising private sector demand combined with continued borrowing by the federal government from the domestic market at high interest rates and revival of inflationary pressures suggest that interest rates will remain high in the near future.

FUTURE STRATEGY

- Considering the high interest rates currently prevailing in the market, we continue to follow the strategy of gradually building the long-term fixed-rate bond portfolio.
- Out of the long-term fixed instruments available in the market, the Investment Sub-Committee (ISC) & the Management Committee (MC) prefer Pakistan Investment Bonds (PIBs) over Defense Saving Certificates (DSCs) because of better liquidity and regular coupon payments in case of the former.
- In-house research reports on the credit risk of eligible TFCs and their issuers are being prepared. The Operational Investment Committee (OIC) plans to start building the TFC portfolio very soon.
- There has been no breakthrough in negotiations with commercial banks for long term placement of funds. The banks are generally reluctant to take fixed deposits for periods longer than one year. The matter will be discussed in the next ISC meeting.
- The ISC is yet to make a decision on our recommendation to allocate 10% of Fund size to equity investments. This will also be discussed in the next ISC meeting.

**(Aquil Raza Khoja)**
General Manager
Punjab Pension Fund