MCB Bank Limited

Treasury & Investment Banking Group

Quid Pro Quo

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SLIPPERY EXCHANGE, SIMMERING INFLATION

The rupee has depreciated by around 7.0% since the beginning of the current fiscal year, breaching the PKR 64/$ mark on April 17th, 2008. In a simplistic sense local currency depreciation should mean an improvement in the current account deficit. As a weaker rupee makes the country's exports more competitive in the international markets and therefore results in increased volume of exports while on the flip side imports become more expensive and hence decline.

However, with the dollar losing its strength against all major world currencies and with international food and energy prices reaching new heights, rupee depreciation will add to the inflationary pressures by making the imports of essential commodities like oil and food more expensive, leading to imported inflation. Additionally depreciating rupee will also push up the prices of locally produced commodities via increasing incentive to export.

This report will analyze the impact rupee movements will have on domestic inflation. It will begin by examining the movements in rupee dollar parity since the imposition of emergency rule, then move on to trace global commodity prices. Finally, we will proceed to consider the impacts of rupee depreciation on the country's imports and exports linking them to domestic inflation.

EMERGENCY: ALARM BELLS

The State Bank of Pakistan has been successfully managing the economy's exchange rate, particularly the rupee dollar parity for the past few years. Since February 2006, the informal peg has been kept close to PKR 60/$. The stable rupee coupled with strong economic growth strengthened the confidence of foreign investors in the country's growth prospects, spurring meaningful foreign inflows as FDI and home remittances reached record high in previous years, resulting in a surge in the country's FOREX reserves.

However the scenario changed with the imposition of emergency in November 2007 and ensuing political turmoil in the country. FDI flows slowed down as international investors waited on the sidelines to let the political situation stabilize while the SCRA accounts witnessed significant capital outflows as reservations about Pakistan's economy grew. Subsequently FX reserves which had reached a record high at USD 16.354 bn in October 2007 dropped down to USD 13.1335 bn in March 2008. As of April 19th they stand at USD 12.7 bn.

All these changes have naturally been putting a downward pressure on the PKR/$ peg and the rupee slipped past the 64/$ mark for the first time since 2001.

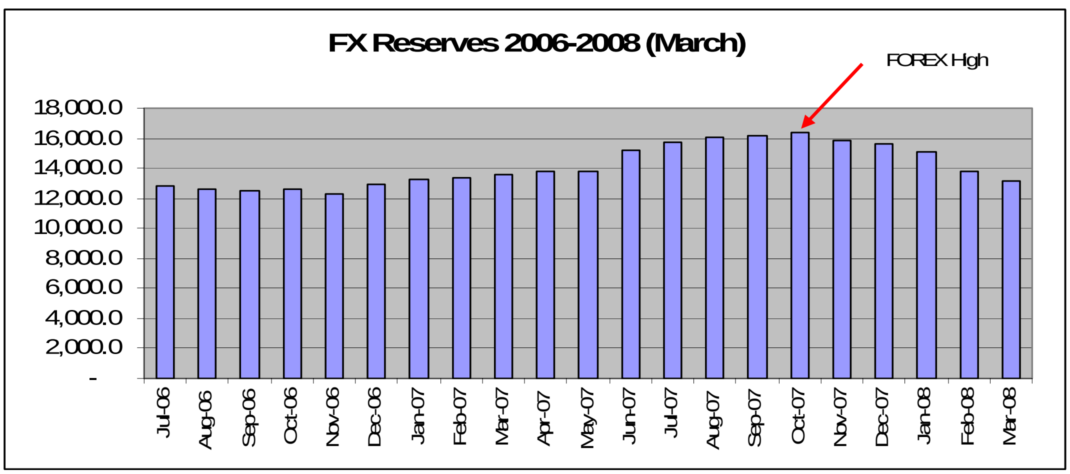

Figure 1 - Foreign Exchange Reserves 2006-2007 & 2007-2008 (Feb)

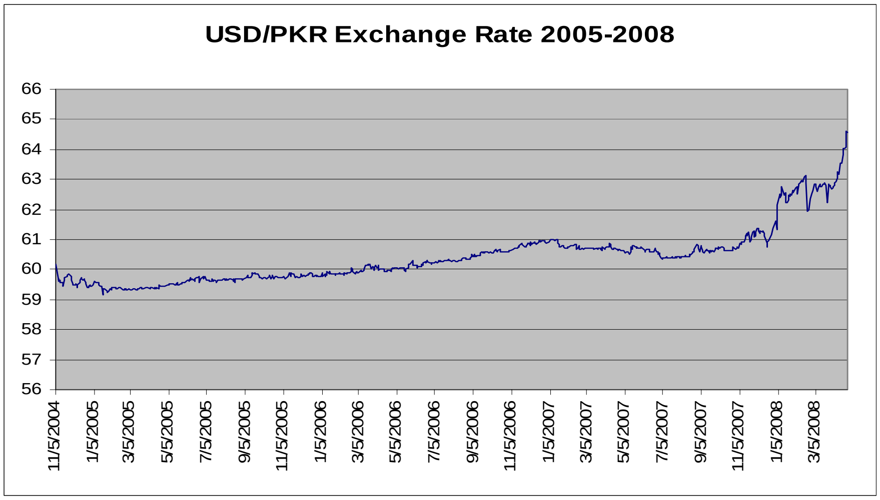

Figure 2: 2 Year PKR/$ Exchange Rate

INFLATION: A GLOBAL PHENOMENON

International food prices are continuously on the rise with countries banning export of commodities like wheat, e.g. India and Russia both banned wheat exports in February. This strains an already fleeting supply thus increasing world price. According to the World Bank, Thailand which is the world's largest rice exporter may restrict rice exports as well. This news alone resulted in a price hike, indicating the volatility of commodity markets.

Wheat and rice prices have soared this year with some varieties of wheat jumping by as much as 25% in a day. These prices have gone up not only because of the Australian drought and problems in supply but major changes in demand have also played a considerable part in increasing prices. Countries such as India and China have begun consuming more as their standards of living improve, simultaneously western bio-fuel programs have consumed a lot of produce converting it to bio-fuel.

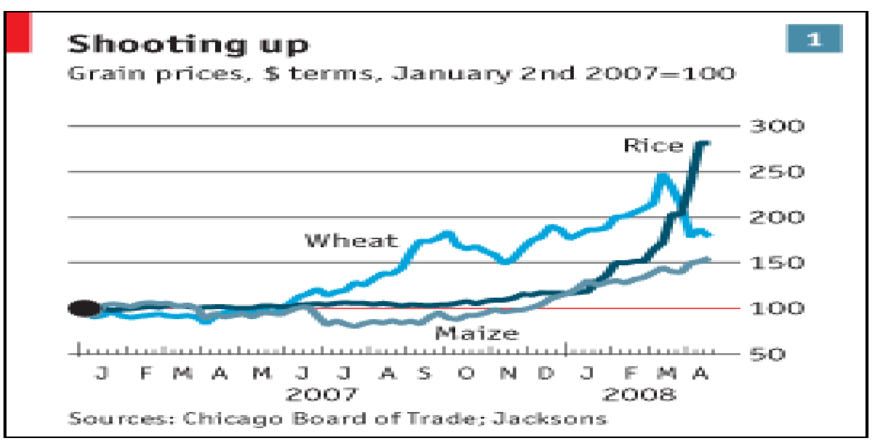

Figure 3 - World Food Prices

Similarly oil prices have also reached new heights this year. They have risen by 63.45% since April 2006, showing hardly any signs of slowing down. Demand for oil from growing economies like China and India has increased manifold while the OPEC is reluctant to increase production. Also a weakening dollar has resulted in increased demand for oil. International oil prices are quoted in dollars, so crude becomes cheaper for countries holding currencies which have strengthened against the dollar.

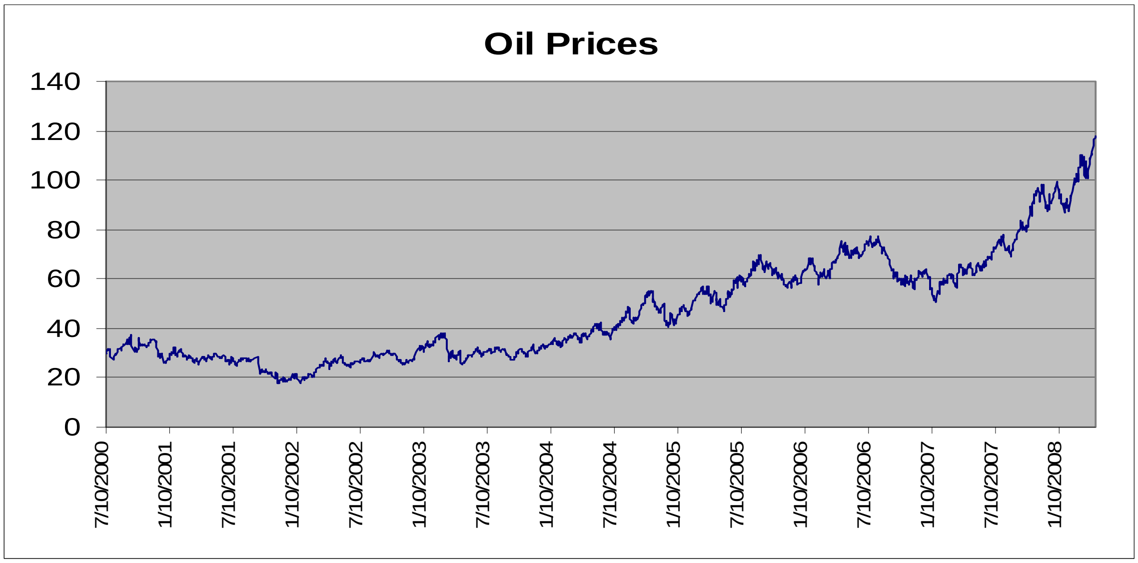

Figure 4 - Oil Prices since 2001

The sustained increases in food and oil prices in the international markets have resulted in supply disruptions and market inefficiencies in our domestic markets. Subsequently inflation has assumed high numbers as CPI inflation reached a thirteen year high at 14.12% in March. Food inflation for the same period was 20.16%.

Going forward, given the current volatility of the PKR/$ exchange rate amidst the need to import important commodities like oil and wheat, inflationary pressures are likely to further increase. For the Pak rupee/dollar parity dictates how much we pay for our imported consumption, which ultimately determines inflation.

IMPORTED INFLATION

Regardless of high prices the government has to import excess demand from international markets. The government on April 23rd cabinet meeting decided to import 1.5mn tonnes of wheat. Currently imports have climbed up by 20.25% to USD 21.463 bn in the July-Feb period compared to last year. The oil import bill has broken all previous records by reaching USD 7.4 bn, owing to high international oil prices.

With prices of commodities expected to increase further this year, the exchange rate carries amplified importance. Depreciation of the rupee against the dollar can enlarge the import bill significantly and add to inflation.

A depreciating rupee is also going to adversely impact the fiscal deficit as the government is already providing subsidies for oil, ghee and flour to shield consumers from high international prices. With oil subsidies already at PKR 84 bn and the government having paid PKR 1.3 bn per month until April on provision of flour, a weakening rupee will further increase prices and ultimately burden on the government's food support program. To cover for this price rise the government may continue to borrow from the State Bank. This will again add to inflation vis-à-vis growth in monetary aggregates.

For instance on April 23rd the Economic Coordination Committee (ECC) approved a three-phase increase in edible oil, ghee and flour prices at utility stores. In the first phase, to be started from the same day, price of edible oil would increase by PKR 13 per kg to PKR 80 from PKR 67. The price of flour would increase by PKR 20 per 20kg from PKR 260 to PKR 280. Further price increments are scheduled to take place on May 10 and June 20. By implementing this first phase alone, the government was able to cut its subsidy payments per month for flour by PKR 465 mn. The fact that all these commodities are imported in large quantities, rupee depreciation will force the government to make higher subsidy payments in order to maintain the above mentioned price levels. This will unsurprisingly increase money circulation adding to inflationary pressures.

… EXPORTED INFLATION!

In the wake of a weakening rupee domestic prices will face additional upward pressure, encouraging hoarding/smuggling and thereby creating supply inefficiencies.

The wheat crisis, which the economy has been facing for some time now, has been prompted by disparity in international and local wheat prices. Local wheat prices have always been at much lower levels than the prices that prevail in regional and world economies. Hoarders, identifying the differential, have been hoarding vast quantities of wheat hoping to sell it in the future at higher prices. In most cases the smugglers connived with the hoarders and sold wheat particularly across the border making abnormal trading profits, resulting in domestic supply shortages. Despite strict bans by the government on wheat exports.

With recent depreciation of the rupee the situation is likely to get worse. This is because a depreciation in PKR/$ parity, given other currencies in the region remain more or less unchanged, will make Pakistani wheat cheaper for international importers while smugglers will benefit more from the higher price they receive for every dollar. Hence a weaker rupee will exacerbate supply inefficiencies, creating further inflationary pressures.

Similarly in case of rice, domestic prices have been rising in tandem with international price as sizeable quantities of rice is being exported. Pakistan produces approximately 5.5 million tonnes of rice against 2.5 million tonnes of local demand thereby leaving about 3 million tonnes available for exports each year. Since there are no export restrictions in place right now the domestic consumer will have to pay the same price as the international consumer does for Pakistani rice. The weakening rupee will further intensify this impact.

REVISING ESTIMATES

In the previous Quid Pro Quo, we estimated year end inflation to be at 9.0-9.5%. However, taking into account the rupee depreciation and the arguments presented above we revise our previous estimate and expect the year end inflation to be somewhere in the 10.5%-11.0% range.

Economic Snapshot

	Units	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb
						Fiscal year 07-08								
Inflation														
Headline Inflatior	%	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3
Core inflation	%	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1
Food inflation	%	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16
Non-food inflatioı	%	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8
T-bill (Wgt Avg)														
3 month	%	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38
6 month	%	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61
12 month	%	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87
External Sector														
Export	Mln US$	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,642	1,625
Import	Mln US$	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,271	2,856
Trade balance	Mln US$	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1,231)
Remittances	Mln US$	457	520	513	537	505	495	489	516	580	505	479	557	502
Forex Reserves	Mln US$	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	15,074	n.a

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http://www.mcb.com.pk/quick_links/economic_reports.asp