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The State Bank of Pakistan is expected to release its Monetary Policy Statement for the second half of the current fiscal year, FY 2007-08, by the end of this month. The key challenge currently facing the central bank is to stabilize prices which have reached an alarmingly high rate while keeping economic growth intact.

This report will begin by reviewing the trend in broad money growth and inflation since the beginning of FY 2007-08, when the State Bank tightened its Monetary Policy by raising the discount rate to 10%. The report will then examine the inflationary risks that the economy is likely to face in the coming months, before concluding an interest rate outlook for the second half of the current fiscal year.

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And then they tightened the Reign...

Under the Monetary Policy Statement for the first half of the new fiscal year, the State Bank of Pakistan (SBP) targeted a broad money supply growth of 13.7% for the year while assuming a real GDP growth target of 7.2% and inflation target of 6.5%.

Citing the risk of resurgent inflationary pressures emanating from high monetary growth as the biggest challenge facing the central bank, the SBP under its new policy framework addressed the two key stimulants of reserve money growth; the rising Net Foreign Assets on account of increased foreign inflows and the rising Net Domestic Assets on account of increased budgetary borrowings and refinancing activity.

Therefore in order to meet its targets, the SBP further tightened its monetary stance by raising the policy discount rate by 50 bps to 10%. In addition to this, it restructured the Export Refinancing Scheme (EFS) whereby the commercial banks were obligated to provide 30% of EFS at the existing rate of 7.5% from their own resources. The SBP also suggested a quarterly ceiling on budgetary borrowing with a greater focus on long term debt.

In the following pages we will assess how the tight monetary stance of the SBP for the first half of the current fiscal year has influenced the broad money growth and inflationary pressures in the economy.

Scores for the Tightened Reign

Broad Money Growth: A Decent Score So Far

The tightening of monetary policy enabled the SBP to manage the broad money growth at the previous levels. As of 1st Dec-07 broad money growth since the beginning of the current fiscal year is recorded at 4.22% relative to 4.2% for the corresponding period of the previous year.

As visible in Box 1, broad money is a sum of Net Foreign Assets and Net Domestic Assets of the banking system. The Net Foreign Assets have shown a decline for the period under review mainly on account of political uncertainty which curbed the foreign inflows into the economy and therefore growth in broad money is reflective of growth in the Net Domestic Assets.

The Net Domestic Assets are primarily a function of government borrowings from the SBP and credit to the private sector. The 50 bps rise in interest rate meant high borrowing costs and was thus successful in curbing the demand for private sector credit which declined by 9% from PKR 147.729 billion to PKR 133.881 billion in the current fiscal



year. However the decline in private sector credit was more than offset by the increased government borrowings resulting in a positive growth for broad money. As of 1st Dec-07 total budgetary borrowing rose to PKR 191 billion; up a 96% over the same period last year. Of this, the biggest portion was sourced directly from the SBP, while the banking sector picked up only 10% of total government debt. This is in contravention of SBP's directives given in its last monetary policy statement, which advised the government to shift the bulk of its debt financing towards the banking sector because borrowing from the central bank is detrimental to the tight monetary stance of the SBP. This is due to the fact that government borrowing from the central bank essentially means printing more money by the SBP which will eventually build demand pull inflationary pressures in the economy, diluting the impact of monetary policy.

Hence government's borrowing of PKR 169.452 billion from the SBP was the main contributor to broad money growth.

Box 1: Monetary Aggregates for the week ended 1st December, 2007

Factors Affecting Broad Money (M2)							
A	<u>Net Foreign Assets of the Banking System</u>	984,892	53,748	73,403	274,551	-99,869	-71,449
B	<u>Net Domestic Assets of the Banking System (1+2+3)</u>	3,080,263	421,404	372,857	383,699	271,281	214,476
	<i>Growth</i>		22.15%	16.05%	14.23%	8.81%	7.95%
1	<u>Net Government Sector Borrowing (a+b+c)</u>	926,530	91,141	86,879	92,844	168,023	90,437
a	<u>Borrowings for Budgetary Support</u>	810,053	67,152	67,063	102,015	191,314	97,599
	(i) From SBP	344,991	155,588	135,092	-58,575	169,452	98,577
	(ii) From Scheduled banks	465,061	-88,435	-68,029	160,590	21,862	-978
b.	Commodity Operations	98,552	21,963	19,926	-9,210	-22,034	-5,931
c.	Others	17,926	2,026	-110	39	-1,257	-1,232
2.	<u>Credit to Non-Government Sector (a+b+c+d)</u>	2,576,474	418,699	408,401	385,705	138,658	139,783
a	<u>Credit to Private Sector</u>	2,479,608	437,848	401,797	365,718	133,881	147,729
b	Credit to Public Sectors Enterprises (PSEs)	104,158	-11,083	7,154	19,942	4,484	-7,992
c	PSEs Special Account-Debt Repayment with SBP	-23,478	-1,606	489	-253	-7	-174
d	Other Financial Institutions (SBP credit to NBFIs)	16,187	-6,460	-1,038	298	301	221
3.	<u>Other Items (net)</u>	-422,742	-88,436	-122,423	-94,850	-35,400	-15,744
	Broad Money (M2)	4,065,155	475,152	446,260	658,250	171,412	143,027
	<i>Growth</i>		19.12%	15.07%	19.32%	4.22%	4.20%

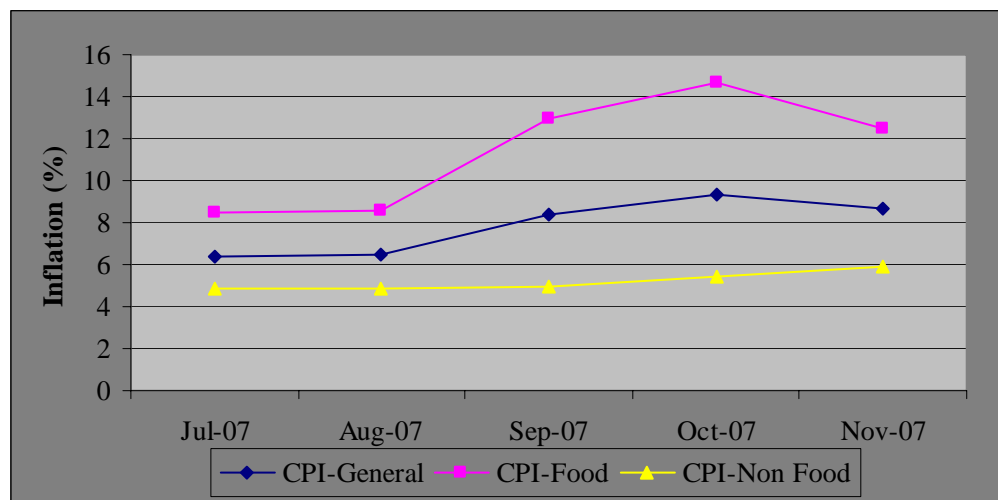
Source: SBP



Inflation: A Poor Score

Following the hike in discount rate, the current fiscal year began with a positive note with regards to inflation as average headline inflation for July and August was recorded at 6.4%. However, in the months that followed, the inflation numbers witnessed a complete rebound as inflationary pressures began to rise on the back of rising international food and oil prices. Though non-food inflation remained low, hovering around the 5% level, food inflation reached double digits in Sept-07, being the primary cause for the rising CPI. The CPI index assigns 40% weight to food inflation. Food prices are said to have accelerated during September and October particularly due to Ramadan, but one must note that food inflation persisted at high level even post Ramadan in November, showing only a slight decline from its previous level. One food item, which carries a high weight in the CPI food basket, has been a primary cause for high food prices-wheat. The wheat prices rose almost 20% in the previous month in the wholesale market, affecting the price of many processed food items.

Figure 1: Inflation Jul'07-Nov'07



Nevertheless, the tight monetary policy was successful in containing demand-pull inflationary pressures as reflected by the core (non-food and non-energy) inflation numbers. Core inflation remained low at 6.3% for the first four months of the current fiscal year.



Tug of War: Fiscal Pressures will weaken the Tight Reigns

As mentioned earlier, the government borrowing from the banking system increased by 96% in the first five months of the current fiscal year over the same period last year. The increased government borrowing witnessed during this period was primarily due to increased government expenditure. For the first quarter of FY08, total expenditures rose by 52% to PKR 469 billion. Though total revenues showed a healthy growth of 22% to PKR 313 billion, they failed to meet the rising government spending, leaving no option for the government but to incur heavy budgetary borrowings from the banking system.

In the coming months, in the wake of development of following factors, we are likely to witness a further increase in the government expenditure and thereby budgetary borrowings from the banking system.

Firstly the rising oil prices have significantly increased pressure on national exchequer. Despite spiraling global prices of oil, the government continues to maintain a strong stance on keeping the fuel prices at the same level with the approaching elections. In the previous fiscal year, FY07, the government spent approximately PKR 25 billion as subsidies granted to OMCs and Oil Refineries to shield the consumers from rising oil prices. With oil prices reaching USD 90/ barrel mark, the cost to the government is likely to double for the year if fuel prices are not changed.

Besides the cost of heavily subsidized oil price, the government faces additional cost from disbursement of subsidies to the Trading Corporation for import of essential agro goods including wheat and fertilizer. Though wheat output has recorded a healthy growth in recent months, the failure of the government to set a support price and the rising international prices of wheat has resulted in wheat supply inefficiencies. Hence the government will have to import wheat and thereby pay subsidies to prevent the consumer from facing rising wheat prices.

Lastly due to political uncertainty since Aug-07, the economy's dollar denominated debt securities have already suffered in terms of rising yield and will thus increase fiscal pressures even further. Moreover, the political turbulence will also restrict access to foreign sources of raising revenues such as issuance of Global Depository Receipts (GDRs) and global bonds.

Hence driven by rising debt servicing costs and escalating expenditures including higher subsidies disbursement we expect the government to continue to borrow from the central bank to contain the fiscal deficit which otherwise may worsen to over 4.5% of GDP. Any borrowing by the government from the central bank necessarily means printing of more money and thereby a higher broad money growth, which will stimulate demand-pull inflationary pressures.



Cheap Goods – No More!

Besides the risk of demand pull inflationary pressures emanating from increased budgetary borrowings expected in the next few months, we believe the economy will continue to face high food prices on the back of rising international commodity prices, particularly wheat, edible oil and farm inputs like fertilizer.


The world price of wheat reached a record level of USD 400 a tonne in Sept-07 as against the USD 200 level a tonne which prevailed in May, earlier this year. Similarly maize (corn) prices also reached a record high earlier this year as they exceeded USD175 a tonne, again a world record. Though since then it has fallen from its peak, as has that of wheat, but the current price of USD150 a tonne is still 50% above the average for 2006. Rice prices have also hit records this year, although their rise has been slower.

Usually high food prices are reflective of scarcity of crops but what is interesting to note of the current global trend is that food prices are increasing despite a rising output. Moreover price of wheat is having knock-on effects on other crops. This is because as the price of one crop shoots up, farmers plant it to take advantage, switching land from other uses. The global rise in prices of these crops is affecting prices in our market as well. As international prices rise, the local farmers are tempted to sell off their crop at higher prices in the international market, incurring supply shortages in the local market. Hence it is not surprising that despite a high wheat output this year, the consumers face high prices and the government intends to import wheat.

The global food inflation is unlikely to lose steam in the coming months and will continue to impact the domestic prices. At the same time a weakening currency since the imposition of emergency means even higher imported prices of wheat, fertilizer and oil. We therefore expect the food inflation to remain in double digits in coming months and keep headline inflation in the 8.0%-8.5% range.

How will SBP continue its Reign?

Given the current inflation scenario and the inflationary risks that the economy is expected to face in the coming months, we expect the SBP to maintain its tight stance, moving into the new calendar year with the discount rate at 10%. Though some analysts' foresee a further hike in the discount rate to contain the growing inflationary pressures, we would like to emphasize that any further tightening in the Monetary Policy stance of the central bank may be futile in controlling the rising price level. Instead we believe that the SBP is done with its part of controlling inflation as reflected by the significant decline in private sector credit growth.



The alarmingly high inflation which currently persists in the economy is not really demand pull but a result of rising food prices. And food prices have been on the rise for the past few months in the local market due to rising international food, fertilizer and oil prices.

It must be noted that food inflation cannot be controlled by high interest rates but currently is a function of global demand and supply scenario. Though the government has been subsidizing prices of imported essential goods like wheat and oil, it means increased expenditure for the government. Hitherto the government has been financing its spending by borrowing from the banking system, particularly the SBP. This has resulted in stimulating broad money growth. Thus what the government currently faces is a double bind situation; if the government does not subsidize prices, inflation will reach uncontrollable levels and if it continues to subsidize them as heavily by borrowing from SBP, broad money will expand and provoke demand pull inflationary pressures.

Nevertheless we strongly believe that the government will have to reduce its borrowing from the central bank and shift to other sources, say scheduled banks. However this again carries a cost in terms of crowding out private investment which is already cooling down due to high interest rates.

Another point that must be noted is that the economy may face an additional risk in terms of broad money growth besides increased budgetary borrowings; that of Net Foreign Assets (NFA). With an end to emergency, we may witness increased foreign inflows which will increase the NFA of the banking system and thereby further expand the broad money growth. In the previous fiscal year, broad money growth primarily resulted from an accumulation of NFA on account of increased foreign inflows. However since the beginning of this year, the political uncertainty has hampered growth in foreign inflows and therefore the NFA have not contributed as much to growth in broad money supply. However now the SBP must prepare itself to sterilize the increased foreign inflows which we may witness as political stability will be restored after the end of emergency and the elections.



Economic Snapshot

Fiscal year 07-08														
	Units	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov
<u>Inflation</u>														
Headline Inflation	%	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7
Core inflation	%	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9
Food inflation	%	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5
Non-food inflation	%	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05
6 month	%	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21
12 month	%	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4
<u>External Sector</u>														
Export	Mln US\$	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	n.a
Import	Mln US\$	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	n.a
Trade balance	Mln US\$	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	n.a
<u>Remittances</u>	Mln US\$	448	475	391	457	520	513	537	505	495	489	516	580	505
<u>Forex Reserves</u>	Mln US\$	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,764



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