



MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

Issue # 54

Economic report

February 13th, 2008

Fighting Fire with Fire

In the backdrop of rising money supply, emanating from increased government borrowings, and sustained increases in commodity prices, the State Bank of Pakistan further tightened its monetary stance for the second half of the current fiscal year, FY 2007-08. Effective from 1st Feb'08, the policy discount rate has been raised by 50 bps to 10.5% while Cash Reserve Requirement has been increased by 100 bps to 8% for deposits up to one year maturity.

This report will begin by reviewing the developments in the economy since the beginning of FY 2007-08, following the hike in discount rate pursued by State Bank earlier in Aug'08. It will then proceed to critically analyze the impact of central bank's actions on prices, money supply and the broader economy.

The information contained in this publication is for information purposes only. The information contained herein has been obtained or derived from public sources believed by us to be reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Any opinions or predictions constitute our judgment as of the date of this publication and are subject to change without notice. The information contained herein is not meant to be, nor shall it be construed as, an offer by MCB Bank Limited or any of its affiliates to offer to buy or sell any financial product. Readers are expected to make their own investment decisions without undue reliance on this report and the company accepts no responsibility whatsoever for any direct or indirect consequential loss arising from any use of this report or its contents. The Bank may from time to time hold positions in, and may effect transactions in, the currencies and securities mentioned herein.

Generally, this report may only be distributed to professional and institutional investors.

This report may not be reproduced or distributed by any person for any purpose without the prior written consent of MCB Bank Limited. Please cite source when quoting. All rights are reserved. Further information on any security or financial instrument mentioned herein is available on request.



Monetary Policy Jan-Jun'08: Highlights

Citing the risks to inflation as stronger than risks to growth, the State Bank of Pakistan (SBP) on 31st Jan -08 tightened its monetary stance further by raising its policy rate by 50 bps to 10.5%. Alongside, the Cash Reserve Requirement (CRR) has been enhanced 100 bps to 8% for deposits up to one year maturity while leaving term deposits of over a year zero rated.

Additionally, in order to compensate private and public sector enterprises for losses suffered in the wake of political events of Dec-07, the central bank has announced a moratorium on payment and principal, permitting the banks to provide financing for rebuilding of damaged properties and premises. SBP has also relaxed requirements of export proceeds for the affected entities for the immediate term.

Furthermore, effective from 1st Jan'08 the SBP has already introduced a new Long Term Financing Facility (LTFF), whereby banks/DFIs are to provide long-term financing of up to 10 years to their borrowers for import of machinery as well as purchase of locally manufactured machinery. Under this scheme the borrower is entitled to borrow for three different tenors at financing rates which are locked in for the entire period; Up to 3 years at 8%, 5 years at 9% and 10 years at 10%.

*Monetary Policy Statement Jan-Jun 2008,
SBP*

A Quick Review: First Half FY 2007-08

The SBP earlier raised its policy rate by 50 bps to 10% in Aug-07 for the first half of the current fiscal year, targeting broad money supply growth of 13.7% for the whole year while assuming a real GDP growth target of 7.2% and an inflation target of 6.5%. In addition to this the SBP restructured the Export Refinancing Scheme (EFS) whereby the commercial banks were to provide 30% of EFS from their own resources. The bank also suggested a quarterly ceiling on budgetary borrowings with a greater focus on long term debt.

The increase in the policy rate and the restructuring of EFS which constituted a gradual decline in commercial bank's reliance on SBP refinancing facilities, had the desired the impact of reducing the reserve money growth. The growth in reserve money for 1st Jul-26th Jan decelerated to 7.92% against growth of 14.21% witnessed in the same period last year. While the growth in broad monetary aggregate (M2) since the beginning of the current fiscal year remained at 6.05% against growth of 6.40% for the same period last year, the broad money supply increased considerably from PKR 217.981 billion last year to PKR 245.980 billion.

It can be inferred from Figure 1 that the expansion in broad money supply was entirely a result of a rise in net domestic assets (NDA) of the banking system, as the net foreign assets (NFA) registered a decline during the period. The primary constituents of the NDA of the banking system are the government sector borrowings from the SBP and the credit to the private sector. While the increase in discount rate moderated private sector credit growth, the impact of this temperance was more than offset by persistent government borrowings from SBP for budgetary support.

Figure1: Monetary Aggregates for the Week Ended 26th Jan-08

(Million Rupees)							
COMPONENTS	Stocks at End-June 2007	Yearly Flows			Monetary Impact Since		
		FY 05	FY 06	FY 07	1st July to		
					26-Jan-08 ^P	27-Jan-07	
A	Currency in Circulation	840,181	87,785	74,489	99,790	149,064	96,948
B	Other Deposits with SBP	7,012	1,219	1,595	2,081	-1,938	-104
C	Total Demand & Time Deposits incl. RFCDs ¹	3,217,962	386,148	370,176	556,378	98,855	121,137
	of which Residents Foreign Currency Deposits (RFCDs)	207,312	34,600	15,206	11,811	20,730	4,298
	Broad Money (M2)	4,065,155	475,152	446,260	658,250	245,980	217,981
	<i>Growth</i>		<i>19.12%</i>	<i>15.07%</i>	<i>19.32%</i>	<i>6.05%</i>	<i>6.40%</i>
Factors Affecting Broad Money (M2)							
A	<u>Net Foreign Assets of the Banking System</u>	<u>984,892</u>	<u>53,748</u>	<u>73,403</u>	<u>274,551</u>	<u>-171,800</u>	<u>11,856</u>
B	<u>Net Domestic Assets of the Banking System (1+2+3)</u>	<u>3,080,263</u>	<u>421,404</u>	<u>372,857</u>	<u>383,699</u>	<u>417,780</u>	<u>206,125</u>
	<i>Growth</i>		<i>22.15%</i>	<i>16.05%</i>	<i>14.23%</i>	<i>13.56%</i>	<i>7.64%</i>
1	<u>Net Government Sector Borrowings (a+b+c)</u>	<u>926,530</u>	<u>91,141</u>	<u>86,879</u>	<u>92,844</u>	<u>216,221</u>	<u>12,357</u>
a	<u>Borrowings for Budgetary Support²</u>	<u>810,053</u>	<u>67,152</u>	<u>67,063</u>	<u>102,015</u>	<u>241,814</u>	<u>38,662</u>
	(i) From SBP	344,991	155,588	135,092	-58,575	239,516	61,440
	(ii) From Scheduled banks	465,061	-88,435	-68,029	160,590	2,298	-22,777
b.	Commodity Operations	98,552	21,963	19,926	-9,210	-24,689	-24,467
c.	Others	17,926	2,026	-110	39	-904	-1,838
2.	<u>Credit to Non-Government Sector (a+b+c+d)</u>	<u>2,576,474</u>	<u>418,699</u>	<u>408,401</u>	<u>385,705</u>	<u>263,248</u>	<u>228,290</u>
a	<u>Credit to Private Sector</u>	<u>2,479,608</u>	<u>437,848</u>	<u>401,797</u>	<u>365,718</u>	<u>245,045</u>	<u>231,162</u>
b	Credit to Public Sectors Enterprises (PSEs)	104,158	-11,083	7,154	19,942	17,124	-4,653
c	PSEs Special Account-Debt Repayment with SBP	-23,478	-1,606	489	-253	-25	-194
d	Other Financial Institutions (SBP credit to NBFIs)	16,187	-6,460	-1,038	298	1,104	1,975
3.	<u>Other Items (net)</u>	<u>-422,742</u>	<u>-88,436</u>	<u>-122,423</u>	<u>-94,850</u>	<u>-61,689</u>	<u>-34,522</u>
	Broad Money (M2)	4,065,155	475,152	446,260	658,250	245,980	217,981
	<i>Growth</i>		<i>19.12%</i>	<i>15.07%</i>	<i>19.32%</i>	<i>6.05%</i>	<i>6.40%</i>

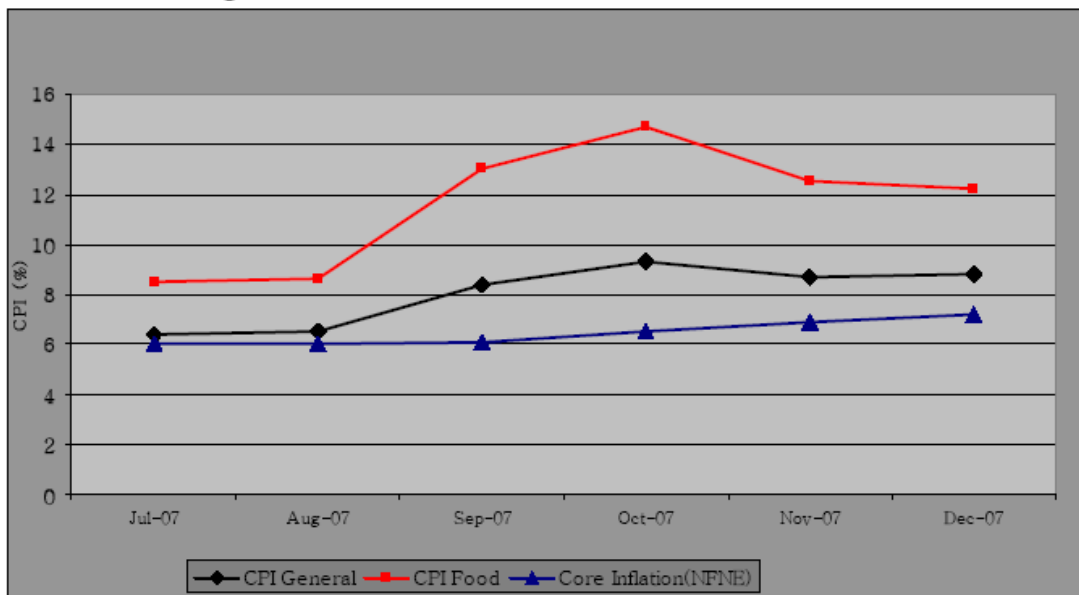
Source: SBP

Government's reliance on borrowings from the central bank has the tendency to accelerate reserve money and subsequently broad money growth as it necessarily implies printing of more money by SBP. For 1st Jul-26th Jan, total budgetary borrowing rose to

PKR 241 billion; almost six times of the borrowings made in the same period last year. This was sourced directly from the SBP, while the banking sector picked up only 1% of the total government debt. This is in direct contravention of SBP's directives given in its Monetary Policy Statement, where the government was advised to shift the bulk of its debt financing towards the banking sector.

Since increased government borrowing from the central bank increases the currency in circulation, it stimulates demand pull inflationary pressures diluting the effectiveness of a tight monetary policy. Besides these pressures, the economy faced additional inflationary pressures in the face of sustained increases in global food and energy commodity prices. Food inflation reached double digits in Sept-07 and skyrocketed to a 30 month high in Oct-07 at 14.7%. Subsequently headline CPI inflation resurged sharply to reach a 29 month high at 9.3% in Oct-07.

Figure 2: Headline, Food and Core Inflation Measures



What is interesting to note is that despite monetary tightening core inflation has also been gradually increasing since the beginning of FY08. This is particularly because prices of a broader range of CPI basket was being affected by the cost push of high commodity prices, as suppliers of goods and services increased their prices to protect margins.



SBP Holds the Ropes Tight

In the backdrop of the rising money supply, emanating from increased government borrowings, and sustained increases in commodity prices SBP has further tightened its monetary stance for the second half of FY08. With a hike in discount rate, the SBP hopes to offload central bank borrowings, roll over the maturities of the different government securities and meet the additional borrowing needs of the government from the market while strengthening the monetary policy transmission. Raising the CRR, for deposits up to one year maturity, is aimed at encouraging the banks to mobilize long term deposits.

In this section we will critically analyze the impact of SBP's actions on prices, money supply and the broader economy.


Inflation and Money Supply: Is Government dissipation to be blamed?

Additional tightening by the SBP is unlikely to have the desired impact on rising inflation. This is because the uptrend witnessed in inflation lately, is more a function of rising international prices of food and energy and the supply inefficiencies in the domestic markets for say wheat and rice, than a result of credit penetration into the economy.

As discussed in the earlier section high interest rates which essentially mean high borrowing costs maintained the private sector credit expansion at previous levels. Credit to private sector from scheduled banks grew by 10.4% relative to 10.2% last year. Hence it was the unprecedented rise in government borrowing from the SBP that led to significant increase in broad money supply.

The increased government borrowings are associated with increased government expenditure. Strong increases have been witnessed in both development and current spending by the government. The development expenditure grew by 89.5% during the first quarter alone while the current expenditure registered a high growth of 39.2 % due to an over 100% rise in debt servicing cost. Subsidy disbursements have also been well above budgetary provisions as the government continued to protect the consumers by providing substantial subsidies on essential commodities like oil and wheat while international prices of these goods fluctuated. Since the government revenue failed to match the increased government spending particularly due to decline in direct taxes, the government resorted to borrowing from the SBP to finance its expenditures.

It is interesting to note that while on one hand the government is providing subsidies to shield domestic consumers against price increases, on the other it is borrowing heavily from the central bank to finance its increased spending, thus accelerating broad money growth expansion and building additional inflationary pressures in the economy. Nevertheless in the coming months the government's reliance on the central bank to



finance its spending may ease once the privatization and GDR inflows materialize. At the same time however, the economy may experience a recovery in the NFA once the political uncertainty fades and therefore monetary expansion may accelerate on the back of foreign inflows as it did in the previous fiscal year. Hence M2 growth will remain high over remaining months of FY08.

Another interesting aspect of the current setting, whereby government expenditure is substantially high relative to private expenditure as reflected by the borrowings made from the central bank by either sector, is the classic case of increased government expenditure crowding out private investment. This setting however raises the question of efficiency of government expenditure over that of private expenditure. In our economy due to institutional weaknesses it can be stated without doubt that the efficiency of government expenditure is regrettably low when compared to that of private expenditure and therefore it is rather disappointing to see the government expenditure crowd out private expenditure.

In addition to this, increased government spending beyond budgetary provisions has substantially worsened all fiscal indicators. The government may exceed its budget deficit target of 4.0% of GDP by approximately 50 to 75 bps. It is very crucial that the government make an effort to contain the fiscal deficit target as this would send a strong signal of the government's commitment to fiscal discipline and macroeconomic stability on the global front including the international rating agencies. One way to bring the fiscal deficit under control is by cutting the PSDP spending. Nonetheless it must be noted that any corrective measures aimed at containing the fiscal deficit will automatically cool the price rise as well.

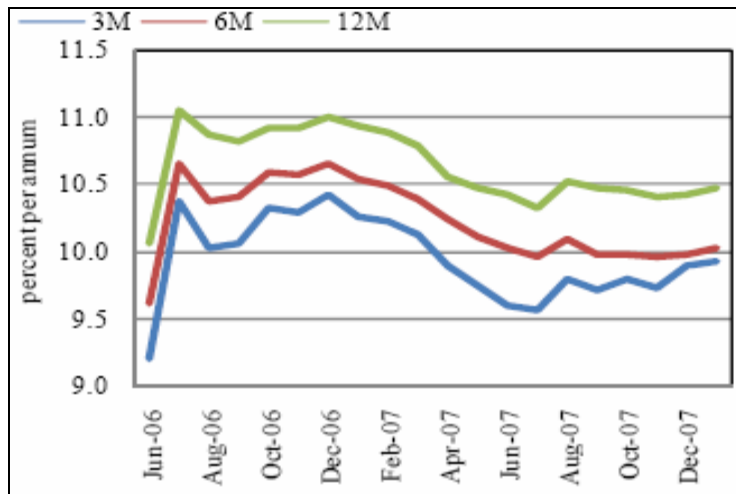
Industrial Sector: Will there be More Woes?

Since the policy measures, a 50 bps hike in discount rate and a 100bps rise in CRR, are aimed at curbing the money supply growth, we may witness a subsequent rise in the KIBOR. KIBOR is primarily determined by the extent to which the central bank is able to manage liquidity in the system. As the lending rates are pegged to KIBOR, this necessarily means an increase in the lending rates of the banks. Thus the highly leveraged industries of textiles, cement and telecom will be most affected. Additionally investment decisions of other sectors will also be affected. As mentioned earlier, private sector credit take-off since the beginning of FY08 has already been slow due to high interest rates as no substantial growth was witnessed in disbursement of credit from the banking sector to the private sector. The discount rate hike is likely to further prevent the private sector credit from taking off.

However there is always the possibility of KIBOR not rising significantly. Earlier in Aug-07 after SBP raised the discount rate, 6 months KIBOR immediately surged approximately 30 bps but later fell to the previous levels due to increased liquidity in the

banking system. The same thing may happen again if liquidity within the banking system surges on back of increased budgetary borrowings and potential rise in NFA. In that case the leveraged sectors will not be affected.

Figure 3: Trends in KIBOR




Source: SBP – MPS (Jan-Jun 08)

Nevertheless in order to ease the woes of the export oriented industries the SBP had already introduced a new Long Term Financing Facility (LTFF), effective 1st Jan-08, whereby banks/DFIs are to provide long-term financing of up to 10 years to their borrowers for import of machinery as well as purchase of locally manufactured machinery. Under this scheme the borrower is entitled to borrow for three different tenors at financing rates which are locked in for the entire period; Up to 3 years at 8%, 5 years at 9% and 10 years at 10%.

Economy still at Achilles' heel

Though the new monetary policy is aimed at curbing monetary expansion within the economy and in so doing controlling for the inflationary pressures, the SBP is likely to face severe challenges in meeting its targets in the times to come.

The expansion in broad monetary aggregates has already been above the full year target on an annualized basis and will continue to surge if government consistently finances its expenditure via central bank's borrowings. Nevertheless with privatization proceeds and GDR inflows anticipated in coming months, government's reliance on central bank is most likely to ease. Another force that may stimulate further monetary expansion will come in the form of a recovery in NFA. However this depends much on the upcoming elections which will determine the foreign investor sentiment and thus the foreign inflows



into the economy. Effectiveness of monetary policy transmission will then largely depend on the central bank's ability to sterilize liquidity.

Alongside CPI inflation has reached a new high at 11.9% for Jan-08 on the back of rising food prices; food inflation for the month reached a record high at 18.2%. It must be noted that food inflation is likely to persist in presence of domestic supply side bottlenecks and high international food prices. In the coming months therefore inflationary numbers will remain high, and will face an additional pressure once the government filters the high prices of oil and POL products on the real economy to contain its deficit.

Though we do not expect the tight monetary policy to curb industrial growth significantly, performance of industry particularly the export oriented industries will suffer at the hands of increasing global competition, the likelihood of a global slowdown and a domestic power and electricity crisis.



Economic Snapshot

Fiscal year 07-08														
	Units	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec
<u>Inflation</u>														
Headline Inflation	%	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8
Core inflation	%	5.5	5.3	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2
Food inflation	%	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2
Non-food inflation	%	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09
6 month	%	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29
12 month	%	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49
<u>External Sector</u>														
Export	Mln US\$	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500
Import	Mln US\$	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910
Trade balance	Mln US\$	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)
<u>Remittances</u>	Mln US\$	475	391	457	520	513	537	505	495	489	516	580	505	479
<u>Forex Reserves</u>	Mln US\$	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,604



Research Desk

Treasury and FX Group

MCB BANK LIMITED

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 92-111-000-111 Ext. 4420

0333-3800744

Email: sanaqureshi@mcb.com.pk

Usman Siddique, CFA

Head of Research and Structured Products

Telephone: 92-21-2270024

0333-2153438

Email: usman.siddique@mcb.com.pk

Fax: 92-21-2270094

92-21-2270109

All previous issues of Quid Pro Quo are available on the following web link:

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