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ECONOMIC REPORT

THE INCONVENIENT TRUTH

September 17th, 2008

CPI soared by 25.3% in August08 – the highest YoY increase in decades. This comes despite the SBP having raised the policy rate 3 times in the last 8 eight months as part of aggressive monetary tightening. Yet inflationary pressures are showing no signs of subsiding and now public criticism of interest rate hikes is gaining momentum; most noticeably within the Stock Exchange and Textile lobby who hold that it is stifling growth. So the question beckons, is monetary policy relevant to our current bout of inflation or is it simply exacerbating the macroeconomic problem?

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UNDERSTANDING INFLATION

Inflation is defined as a general rise in price levels of goods and services over a specific period of time. Thereby, it is a relative change in prices compared to a base year. Most economists agree that an economy functions efficiently if inflation is low, with macroeconomic policy aiming for stable price levels.

To keep inflation low one needs to know what causes it. Economists have plenty of theories but no absolutely cast-iron conclusions. Milton Friedman who revived Monetarism in the 1970's once said, 'inflation is always and everywhere a monetary phenomenon'. This is a view echoed by SBP governor in her last Monetary Policy Statement.

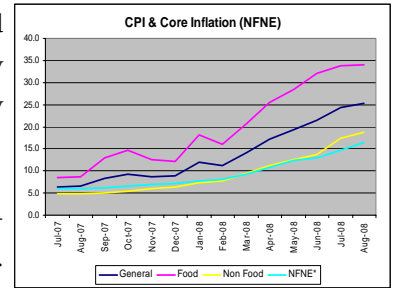
Monetarists reckon that to stabilize prices the rate of M2 growth needs to be carefully controlled, this will stimulate the rest of the economy by reducing volatility. Other schools of thought point to developments in real supply of the economy in order to explain inflation. They argue that supply constraints drive up prices of goods independent of monetary conditions, and may have wider repercussions on overall price levels.

Here it would be apt to make the distinction between inflation and relative price changes. The former is a loss of purchasing power that's caused or at least exacerbated by overly lax monetary policy, the latter are price changes driven primarily by fundamental shifts in supply and demand.

Latest figures show inflation at 25.3% in August YoY compared to just 6.5% last fiscal year, food inflation for the same period was 34.1%, both figures are the highest in Pakistan's history. In addition, core inflation has also gone up adding to woes of the population, August figures were at 16.4% compared to 6% last fiscal year. This means that average CPI for the remaining 10 months has to average around 9.50% for the SBP to adhere to its cherished mandate of maintaining price stability. This will require a Herculean effort specially in light of the recent increases in prices of diesel, kerosene, electricity and wheat.

WHY INFLATION IS DAMAGING

Inflation would not do much damage if it were predictable, as everybody could build into their decision making the prospect of higher prices in the future. However, its unpredictability causes market irregularities and economic inefficiency, not least because people take fewer risks to minimize the chances of suffering too severely from a price shock. The faster the rate of inflation, the harder it is to predict future inflation. Indeed, this uncertainty can cause people to lose confidence in a currency as a store of value. It simply creates broader economic distortions.





SNOWBALL EFFECT

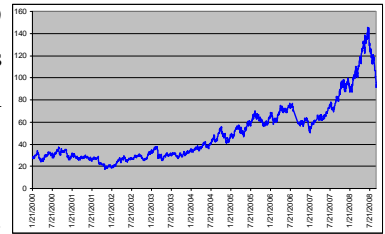
Many reasons can be cited for the increase in inflation. First and foremost, price levels increased dramatically on the back of skyrocketing international commodity prices. World food prices went up consistently last year, with some varieties of wheat jumping by as much as 25% in a day. Similarly oil reached a record \$145.29 per barrel in July08. The end result of this sustained increase in food and oil prices was disruptions in supply and market inefficiencies in our domestic market, which fuelled inflation.

Cost push inflation saw riots break out around the globe from Egypt to Brazil. Governments were blindsided and were ill prepared to face such a dramatic rise in prices of commodities. In our case and with other countries, the solution at the time was borrowing from the central bank to provide subsidies to the consumer. The result was detrimental if not catastrophic for our economy. It is important to understand that funds borrowed by the government essentially means the State Bank is printing more currency notes. Also borrowing from commercial banks leads to crowding out of credit available to the private sector, therefore impacting its growth. In addition, utilizing this borrowing for providing subsidies and not development expenditure encourages consumption and pushes prices upward. Alarmed by this, the Governor State Bank stated unequivocally, that government borrowings from the central bank are totally unsustainable.

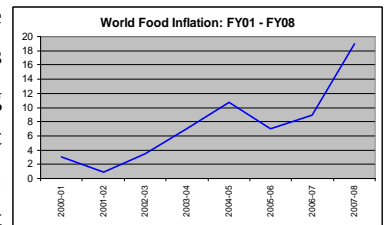
As a result, in order to halt the momentum of prices, the government had to slash subsidies on fuel with an aim to ending them by the end of 2008, increase electricity tariff by 65% to PKR 10 per unit and increase procurement prices from PKR 425 to PKR 510 in February then to PKR 625 in March, with a further increase to PKR 900 expected later this year.

But imperial evidence has shown time and again that increase in commodity prices spurs inflation in the short run rather than long run, because markets adjust fairly quickly to higher prices. Since inflation is a relative measure, once the cost no matter how steep has been built in, it does not tend to have a recurring effect.

Oil Prices 2000-Present



WPI Food: FY01-FY08



THE INCONVENIENT TRUTH



Wage Price Spiral

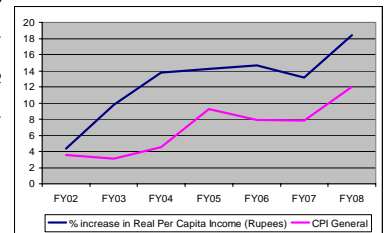
Due to high commodity prices, producers' input costs increased drastically slashing their profit margins. Hence leaving them no choice but to transfer these costs onto consumers, adding further to price levels. In addition to this, costs of living went up, prompting workers to demand higher wages.

Increasing the real income of workers makes more disposable income available for consumption. This consumption increases pressure on prices, which in turn erodes the purchasing power of individuals who again demand higher wages to compensate for loss of higher prices. This is called the wage-price spiral and represents the much dreaded second round effect of inflation. It is by far the most dangerous aspect of the inflationary cycle as it tends to create an income hangover.

Since FY02 real per capita income has increased at a higher rate than CPI. Therefore, individuals have had more disposable income to spend, which has only added to inflation. This can be seen in the graph, which shows inflation as being directly proportionate to real wages, i.e. when wages go up so does inflation and vice versa.

To reverse the cycle, SBP resorted to hiking interest rates in an effort to increase the propensity to save and slow down consumption. But so far increasing discount rates has not had the desired impact.

% Increase in Real Income vs CPI General





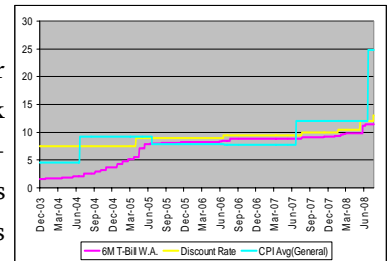
THE ROLE OF MONETARY POLICY

Monetarism is based on the belief that inflation has its roots in government printing too much money. It is closely associated with Milton Friedman, who based on the quantity theory of money argued that governments should keep the money supply fairly steady, to allow for natural growth of the economy. If it did this, market forces would efficiently solve the problems of inflation, unemployment and recession.

Excessive Money Supply growth simply results in more money chasing fewer goods. Therefore, in order to discourage demand pull stimulus the central bank subsequently tightens its policy stance in order to divert more funds towards savings and away from consumption. The question is how high should the SBP hike its policy rate in order to combat inflation? This argument is especially relevant as supply side economists argue that monetary policy by itself is too blunt a tool for managing inflation – it has a sledge hammer effect instead of a chisel.

Savings have an upward sloping supply curve, where more is saved at a higher interest rate. But the equation gets complicated when we look at the concept of real interest rates (adjusted for inflation), where negative interest rates typically increase the propensity to consume irrespective of the numerical value. This demand stimulus in an economy like Pakistan’s with supply side restrictions and an artificially strong currency puts pressure on the current account. FY07 was a text book example, M2 growth was 19.32% which resulted in CPI for the following fiscal year (FY08) to escalate to 12% versus a target of 6.5%. This further exacerbated the demand supply gap in the economy and put pressure on the trade account, trade deficit for FY08 was approximately USD 21 bn. This in turn necessitated a steep decline in the value of the PKR, which has already depreciated by 25% over the last year.

6M T-Bill vs Discount Rate vs CPI





CONCLUSION

Commodity prices have indeed been the cause of most of the increase in total inflation and probably also core inflation, which rose with a lag as producers passed higher input costs onto consumers. The effects of passed-on energy costs, withdrawal of subsidies, as well as higher import prices stemming from a weaker rupee, have probably not run their course, so inflation may edge higher in the months to come. But then both it and total inflation will probably head down. Provided the GOP adheres to restricting money supply growth, this may be as bad as it gets. Not only have international commodity prices come down drastically (oil is flirting with USD 90 per barrel), but Pakistan's state of near-recession means that it will be hard for workers to secure wage rises that match, let alone exceed, the current inflation rate. Hence a wage price spiral is unlikely in the current scenario, which is an unavoidable result of our changed economic circumstances.

If we produced more of the oil and other commodities that we consume (trade deficit for FY08 was USD 21 bn), the benefits of higher prices would flow to Pakistani firms who could thus pay higher wages. But the benefits instead flow primarily to overseas producers. High inflation and low wage growth, painful as they are, are necessary for us to adjust to the fact that we are facing a 'terms of trade' shock: relative to our trading partners our standard of living must go down.

Is monetary policy still relevant? Yes, simply because monetary hangover has a recurring impact, instead of short term gyrations caused by energy and food prices. A host of examples stretching back over the centuries, including our own, bear witness to the long-term link between monetary growth and inflation. Money still matters - as it always has.

ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
<u>Inflation</u>														
Headline Inflation	%	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3
Core inflation	%	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4
Food inflation	%	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5	32.0	33.8	34.1
Non-food inflation	%	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.95	11.3	12.2	12.4
6 month	%	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86	11.5	n/a	n/a
12 month	%	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.32	11.7	n/a	n/a
<u>External Sector</u>														
Export	Mln US\$	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726
Import	Mln US\$	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153
Trade balance	Mln US\$	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1427)
<u>Remittances</u>	Mln US\$	489	516	580	505	479	557	502	602	590	584	547	627	592
<u>Forex Reserves</u>	Mln US\$	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920	9,130



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