



MCB Bank Limited

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**Treasury & FX Group**

## *Quid Pro Quo*

### ECONOMIC REPORT

#### GREEN SIGNAL!

April 30th, 2009

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The market was divided on the State Bank's April interest rate decision. A Bloomberg survey for the market revealed a 50:50 split. Hence the central bank's decision to cut the discount rate (DR) by 100 bps came as surprise to quite a few market participants.

SBP Governor Saleem Raza in the latest Monetary Policy Statement reiterated that the economy was on track of recovery and a disciplined implementation of the IMF SBA was bearing fruit. However, the deepening global recession posed a threat to external flows and home remittances, which are a vital source of Foreign Exchange for the exchequer. The report highlighted that a meaningful contraction in aggregate demand, supported by fiscal prudence, are improving the fundamentals and bringing inflation down, which gave the SBP room to cut the DR.

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## FISCAL PRUDENCE

The government under IMF's strict supervision has shown considerable fiscal discipline. Borrowing from the central bank, as of 18<sup>th</sup> Apr'09, stood at PKR 103 bn which is PKR 154 bn less than the Oct-Jul'09 net zero target (PKR 258 bn) agreed in the Stand-by Agreement. Fiscal deficit was recorded at PKR 251 bn (1.9% of GDP) for H1FY09, with a target of PKR 562 bn (4.3% of GDP) for June-end. Furthermore, as of 16<sup>th</sup> Apr'09 the stock of government borrowings from SBP were PKR 1094 bn, with a June-end target of PKR 1181 bn, the likelihood of reaching this goal is high.

As a result of successful implementation of the macroeconomic stabilization program and curtailment of fiscal deficit, GOP was able to confirm the significant scale of pledges made at the Friends of Democratic Pakistan (FoDP) forum held in Tokyo on 17<sup>th</sup> Apr'09. A total of USD 5.28 bn were pledged over a period of 2-4 years primarily to support health, education and poverty alleviation efforts; this amount will undoubtedly improve Pakistan's balance of payments position and growth going forward. However, Mr. Holbrooke didn't provide details of which pledges were loans and/or grants, hence we will have to wait and see how much of the pledged amount materializes and more crucially how long it takes to do so.

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## ULTIMATE OBJECTIVE

The government's fiscal prudence complimented the tight monetary stance, not only was government borrowing limited, the central bank's foreign exchange reserves were able to increase to a comfortable level and most importantly inflationary pressures were abated. This was not the case in FY08 when monetary tightening was made ineffective by a lax fiscal policy, which saw budget deficit climb to 7.4% last year. However, in FY09 controlling the twin deficits have helped achieve the SBP's ultimate objective of dampening aggregate demand and realigning it with the country's domestic and foreign resources.

The most notable result of containing the twin deficits has been contraction in money creation. Due to restrained government borrowing and fewer external inflows, money creation has been slow in FY09; M2 has grown by only 1.62% as of 18<sup>th</sup> Apr'09 compared to 8.04% last fiscal year. As a result the overall liquidity position of the system remains tight.

This poses problems particularly for the banking sector. First of all, it adds pressure on the banking system to meet the government's borrowing requirements. The 4QFY09 T-Bill auction target for the government is PKR 350 bn, which is PKR 97 bn over and above the T-Bill maturities. In addition to this, the wheat procurement cycle is about to begin which will require approximately PKR 60-80 bn on flow basis. However, the SBP has been managing liquidity well having injected PKR 277 bn through OMOs in Apr'09 alone. Secondly, due to declining deposits and low money creation, private sector credit will be squeezed even more; as of 18<sup>th</sup> Apr'09 incremental credit to the private sector was PKR 55 bn compared to PKR 359 bn in FY08.

As a result of high demand for credit not only by the government but by other sectors as well, short-term rates will be put under stress.



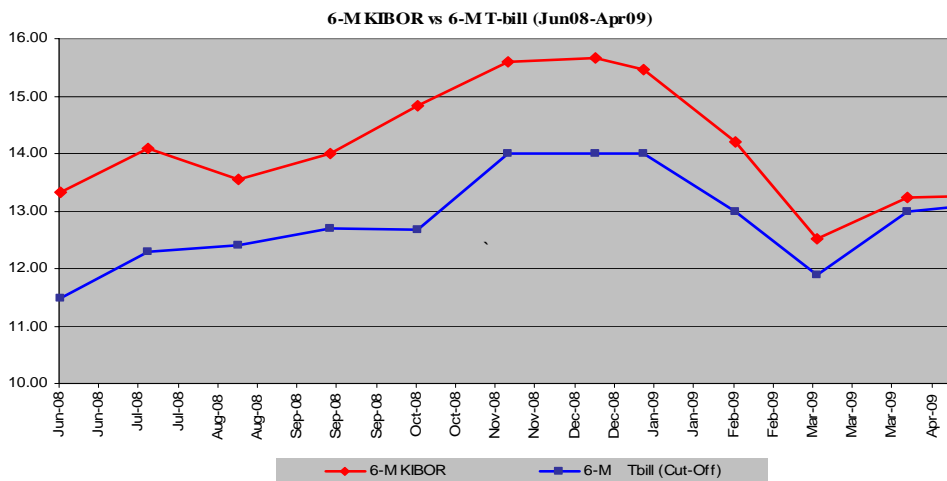
## INTEREST RATES

As mentioned above, money creation is slow due to the tight monetary stance of SBP, fiscal constraint and the banking sector's risk aversion. Consequently high demand for money from various sectors most notably the government will crowd out private sector credit.

In 3QFY09 the government picked up more than PKR 550 bn from scheduled banks with a further PKR 350 bn target for 4QFY09. Market rates had already begun moving upward towards the end of 3QFY09, (See 6M T-Bil vs 6M Kibor Graph) due to tight money market conditions. T-Bill cut-offs in the Apr 8<sup>th</sup> 2009 auction jumped by 92-154 bps (See T-Bill Auctions Table).

T-Bill Auctions				
Auction Date	Tenor	Cut-off Yield %	W.A. Yield 12M %	Change from last Cut-Off
March 25, 2009	3 M	11.74	11.65	0.05
	6 M	11.90	11.77	0.11
	12 M	11.95	11.85	0.10
April 8, 2009	3 M	12.66	12.53	0.92
	6 M	12.98	12.76	1.09
	12 M	13.49	12.97	1.54
April 22, 2009	3 M	12.98	12.89	0.32
	6 M	13.07	12.95	0.09
	12 M	13.27	13.14	-0.22

T-Bill Auctions  
Source: SBP



6M Kibor vs 6M T-Bill (Jun08-Apr09)  
Source: SBP

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### INTEREST RATES ... continued

KIBOR also went up in tandem with the cut-off rates, Kibor average for April was higher compared to Mar'09 average – See Table.

The Governor stressed that T-Bill cut-offs and volume targets are no longer under the purview of SBP and are determined by the Ministry of Finance based on fiscal considerations.

However, on its part State Bank has been vigilant in curtailing inflationary pressures within the economy and managing liquidity within the system.

Kibor Average		
<u>Tenor</u>	<u>March</u>	<u>April</u>
1W	11.63	13.30
2W	11.73	13.31
1M	11.88	13.32
3M	12.08	13.15
6M	12.53	13.27
9M	13.58	13.75
12M	14.03	14.00

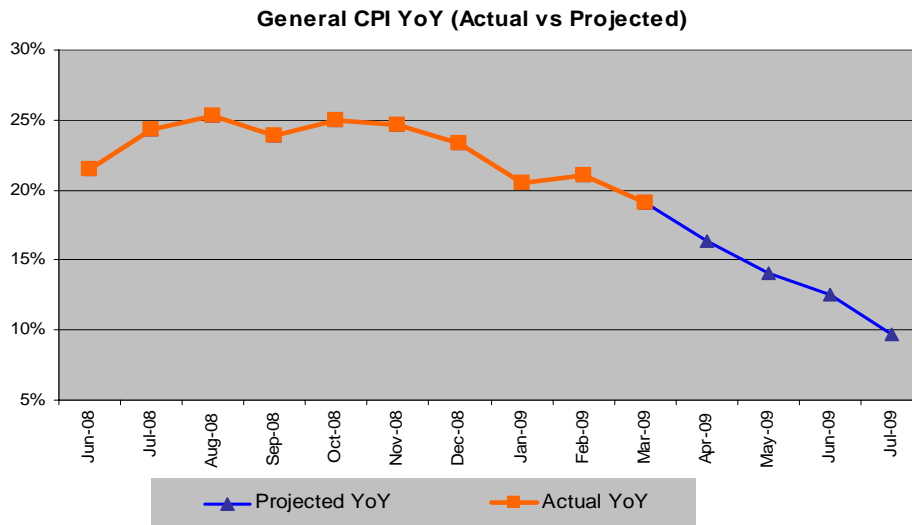
**KIBOR Average**  
**Source: SBP**



### Inflation Expectations

Policies designed to dampen aggregate demand have helped bring inflation down, latest figures show a 200 bps decline in headline inflation to 19.07% YoY in Mar'09 compared to 21.07% in Feb'09. Core inflation remained high at 18.5% in Mar'09 vs 18.9% in Feb'09, it is the third consecutive month that core inflation has remained in the narrow band of 18.5-18.9%. Despite this rigidity and relatively high CPI general index, the inflationary trend remains firmly downward. CPI is expected to come down sharply during the last quarter of FY09. We are anticipating CPI general YoY inflation around 12.5-13% by June-end'09 due to base effect kicking in.

Date	Actual			Projection		
	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09
CPI General YoY	20.50%	21.07%	19.07%	16.37%	14.11%	12.55%



Source: SBP & MCB  
Research

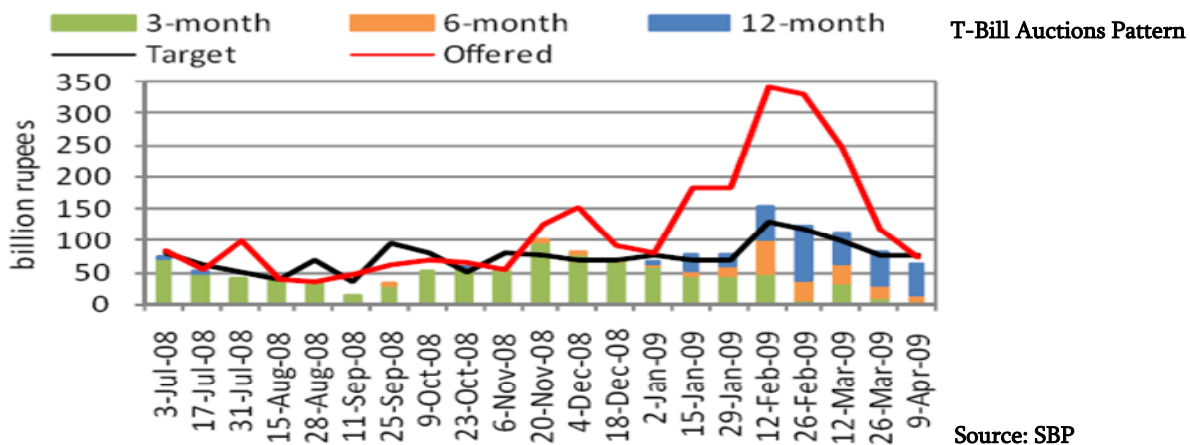
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## SBP'S GAME PLAN

The SBP Governor clearly stated that the declining trend in inflation will continue and this allows the central bank room to relax monetary policy in order to support real economic activity. The State Bank's vigilance in dampening inflationary expectations of the market going forward is the paramount reason behind the downward shift in yield curve, since markets are now expecting possible cuts in the policy rate as inflation comes down (See April 22<sup>nd</sup> 2009 auction result for 1Y tenor). Keeping this in view, the increase in T-Bill yields on 8<sup>th</sup> Apr'09 was one off and was primarily due to tight money market conditions. The State Bank's 1% cut of discount rate to 14% effective 21<sup>st</sup> Apr'09, validates the market's expectations of lower interest rates and sets the yield path downward.

Consequently, the bidding patterns of banks have changed in favour of longer tenors. There is a clear preference for the 12M tenor, as shown in the graph.



In order to facilitate banks in meeting the government's financing requirements, SBP has used its only viable monetary policy instrument and injected liquidity regularly into the system through nine Open Market Operations (OMOs) amounting to PKR 337 bn from 28 Mar-29 Apr'09, as well as mopping up excess liquidity in order to smoothen the yield curve. In addition, SBP is expecting M2 aggregate to grow 8% by June-end from 1.62% as of 18<sup>th</sup> Apr'09; amounting to approximately PKR 300 bn in reserve money growth. This should help ease liquidity within the banking system, especially since the GOP's auction target of PKR 350 bn for 4QFY09 is PKR 97 bn above T-Bill maturities and PKR 60-80 bn wheat procurement has just begun.



## GOING FORWARD

Pakistan's economy has been going through a period of stagflation (high inflation accompanied by low growth). As mentioned earlier, private sector credit (PSC) went up by an incremental PKR 55 bn as of 18<sup>th</sup> Apr'09, compared to PKR 360 bn in FY08. In addition, limiting fiscal deficit has come at a cost to developmental expenditure, the government had to substantially cut the Federal component of PSDP by PKR 118 bn to PKR 219 bn (owing to dismal revenue collection of PKR 704 bn for Jul-Feb period against a target of PKR 1.3 tr). Given the growing investment needs of the country, in the context of a deepening global recession and slowdown in foreign inflows, the government cannot keep spending at low levels.

In FY10, the State Bank is targeting GDP growth of 4.2-4.5% and 9% average inflation. This gives considerable room forward the government to increase fiscal spending and the SBP has to aggressively cut interest rates in order to stimulate economic activity. We expect interest rates to come down swiftly from the beginning of next fiscal year, as falling inflation eases leaving regulators room to implement an expansionary monetary policy.

## ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
<u>Inflation</u>														
Headline Inflation	%	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7	23.3	20.5	21.1	19.1
Core inflation	%	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9	18.8	18.9	18.9	18.5
Food inflation	%	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4	27.9	21.6	22.9	19.7
Non-food inflation	%	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2	19.8	19.7	19.6	18.5
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8	14.0	13.7	12.6	11.6
6 month	%	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0	14.0	14.0	13.0	11.8
12 month	%	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a	14.3	14.2	13.0	11.8
<u>External Sector</u>														
Export	Mln US\$	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,572	1,438	1,269	1,525	1,466
Import	Mln US\$	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,253	2,478	2,144	1,864	2,095
Trade balance	Mln US\$	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)	(339)	(629)
<u>Remittances</u>	Mln US\$	602	590	584	547	627	592	660	466	621	674	637	641	739
<u>Forex Reserves</u>	Mln US\$	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081	9,662	10,163	10,138	10,090



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