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Time to Fill the Gap!

The State Bank of Pakistan released the Monetary Policy Statement for the second half of the current fiscal year on 18th January, 2007, declaring that it shall continue to pursue a tight monetary policy. Though the governor SBP, Dr. Shamshad Akhtar stated that she was optimistic about achieving 7% growth rate in GDP by the end of the fiscal year, she expressed her concern over expecting to exceed the inflation target of 6.5% for the year by at least a percentage point due to the rising inflationary pressures. Despite these pressures the SBP decided to hold the discount rate steady citing weaknesses in the supply chain of essential food items as the primary reason of the rising CPI.

This issue seeks to analyze the causes of the current rising trends in the CPI, highlighting the inefficiency in the supply of essential food items as the primary cause. Hence it concludes that the current inflation is not *always and always* a monetary phenomenon and instead can only be controlled by rectifying the supply inefficiencies.

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Tightening to Loosen Pressures!

The State Bank of Pakistan released the Monetary Policy Statement for the second half of the current fiscal year on 18th January, 2007, declaring that it shall continue to pursue a tight monetary policy stance while remaining heedful of the developments in the economy and taking any necessary actions if required. Though the average weekly cash reserve requirement for time and demand liabilities was announced to be maintained at the previous levels of 3% and 7% respectively, the SBP raised the daily minimum cash requirement for commercial banks to 2% and 6% for time and demand liabilities from the previous levels of 1% and 4% correspondingly. Additionally the SBP announced that the base interest rate shall be maintained at its previous level of 9.5%.

In the first half of the current fiscal year, the SBP faced stern challenges in terms of monetary policy management as it was required to control existing inflationary pressures while keeping the growth prospects intact. Though the inflation for FY 06 remained within the target, it was still significantly high at 7.9%. Thus an inflation target of 6.5% for FY 07 meant that there needed to be a decline of 1.4 percentage points to meet the current year's target. Moreover the demand side inflationary pressures remained strong causing the core inflation to decline by only a small amount. As a response to these challenges, the SBP executed a tight monetary policy raising the cash reserve requirement for banks while also increasing its policy rate by 50 bps to 9.5% in July 2006.

This policy stance has proved to be successful so far as it has reduced excess demand from the economy without hurting the growth impetus and slackened inflationary pressures significantly as year on year core inflation reached its lowest level since December 2005 when it was recorded at 5.5%. However the headline inflation has been recorded at a persistently high average rate of 8.4% for the first half of FY 07. This was primarily due to high food inflation which may continue to exert additional pressure on the overall CPI and cause the average inflation for FY 07 to exceed the annual target of 6.5%.

Despite the current CPI inflation rate rising significantly, the SBP decided to hold the discount rate at the existing level citing weaknesses in the supply chain of essential food items as the primary reason of the rising CPI in the Monetary Policy Statement. SBP further emphasized that the weaknesses in the supply chain of essential food items has the *“potential to dilute the impact of monetary tightening”*.

This leads us to analyze the causes of the current inflationary trends before moving on to suggesting adequate policies required to keep the current inflation rate as close as possible to the target.



Taxation without Legislation


“Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.”

Inflation is defined as a sustained increase in the general level of prices for goods and services as measured against a baseline of purchasing power and normally calculated in annual percentage terms. The value of the rupee does not stay constant in presence of inflation as when inflation rises every rupee an individual owns buys a smaller percentage of a good or service.

The need of low and stable inflation as a prerequisite in sustaining long term economic growth has often been emphasized. This is because high and volatile inflation is detrimental to long term growth. However empirical studies have established that the relationship between inflation and growth is nonlinear. At low levels of inflation, inflation has either no impact or a positive impact on growth. Nevertheless once inflation exceeds a certain threshold it adversely influences long term growth. This opens room to a more interesting question that how much inflation is detrimental to economic growth and what is the optimal target for inflation. A few economists have focused their research in estimating this threshold level of inflation for Pakistan and their empirical findings suggest that the threshold level of inflation for Pakistan may lie within the range of 4-9%. Nonetheless it is important to note that as the economy progressively develops the threshold level of inflation shall move towards the lower end of the estimated band and it is thus safer to set the target in the range of 4-6%. Currently the SBP has wisely set the inflation target for FY 07 at 6.5%. However in the Monetary Policy Statement for 2H FY 07, the State Bank expressed concerns regarding the expectations of exceeding this target by almost one percentage point. Being significantly beyond the estimated threshold inflation, this expected inflation rate can pose serious threat to a growing economy and hence requires immediate action on part of the government that must prioritize inflation on its agenda. However it is highly critical to understand the causes of these rising prices before any measures can be taken to contain them to acceptable levels.

Money Matters and so do the Gaps

In economic literature a number of different schools of thoughts exist regarding what exactly causes inflation. Normally, the mainstream economists are classified as Monetarists and Keynesians. The former believe that the rate of inflation is determined primarily by the monetary effects that dominate all others while the latter assume that it is the interaction of money, interest rates and output that determines the prevailing inflation rate. Though in the long run inflation is undoubtedly believed to be a monetary phenomenon, in the short run it is largely influenced by the relative elasticity of wages, prices and interest rates. The root of the Monetarist-Keynesian debate lies in the question



of whether these short term effects last long enough to be significant. The Monetarists argue that prices and wages adjust quickly enough to make other factors merely marginal behavior on a general trend line while the Keynesians believe that prices and wages adjust at different rates and these differences have enough effects on real output to be long term.

Focusing on the supply and demand for money as the primary means by which economic activity is regulated, the monetarists stress on the monetary theory that sees inflation as an effect of the supply of money exceeding the demand for money. Today monetarism is associated with the work of Milton Friedman who is remembered for his celebrated words: *“Inflation is always and everywhere a monetary phenomenon.”* The monetary phenomenon of inflation is best explained as follows: The price level P is the price of goods in terms of money. Its inverse, $1/P$ is the price of money in terms of goods or the value of money. Like any other commodity the value of money; that is its price relative to other goods, is determined by the supply and demand for it. An expansion of the money supply, holding the demand for money constant, will cause the value of money to fall and the price level to rise. An expansion of the demand for money, holding the quantity constant will cause the value of money to rise and the price level to fall. All price level changes can thus be analyzed within this framework of the demand and supply of money. For this reason, inflation is taken to be a monetary phenomenon and Friedman advocated a central bank policy aimed at keeping the supply and demand for money at equilibrium to contain inflation.

However it is important to note that in the short run, inflation (especially for narrow benchmarks of inflation including few items) is not necessarily a monetary phenomenon and can be analyzed within the framework of demand and supply of commodities. For instance a good may witness significant increase in its price level if the demand for the good rises relative to its supply or the supply of the good falls relative to its demand. In either case there exists an output gap as the supply of the commodity fails to meet its demand.

The recent price hike in food items can be attributed to the insufficient supply of these goods that was unable to meet the demand of the growing population. This hike in food prices has caused the CPI inflation to reach significantly high levels. The fact that the CPI inflation reflects the short run output inefficiencies raises question regarding the extent to which monetary policy can be effective in controlling the CPI inflation while raising another interesting question; that is how reflective this consumer index is of inflation in the whole economy.



The Bigger the Picture the Better


A consumer price index (CPI) or retail price index (RPI) is a statistical time series measure of a weighted average of prices of a specified set of goods and services purchased by consumers. Providing a measure of inflation, this price index tracks the prices of a specified basket of consumer goods and services. The current CPI covers 374 items in the basket of goods and services reflecting the taste, habits and customs of the people. The basket of goods and services comprises on 10 major groups (2000-2001 base). Table 1 shows the basket of goods and services used by the Federal Bureau of Statistics to compute the CPI figures.

Table 1
CPI Basket of Goods

S.No.	Group	Weights
1	Food & Beverages	40.34
2	Apparel, Textile & Footwear	6.10
3	Fuel and Lighting	7.29
4	Household, Furniture & Equipments	3.29
5	Transport & Communication	7.32
6	House Rent	23.43
7	Recreation & Entertainment	0.83
8	Education	3.45
9	Cleaning, Laundry & Personal Appearance	5.88
10	Medicare	2.07
Total		100.00

Source: FBS

The CPI is calculated by taking price changes for each item in the predetermined basket of goods shown above, and averaging them; the goods are weighted according to their importance to the common man. Taken to be a cost-of-living index, the CPI is a fixed quantity price index. This is one of the most frequently used statistics for identifying periods of inflation or deflation, as large rises in CPI during a short period of time typically denote periods of inflation and large drops in CPI during a short period of time usually mark periods of deflation.



Every month, people ranging from economists to traders at the Stock Exchanges to the general masses await the latest announcement from the Federal Bureau of Statistics and the State Bank of Pakistan that gives the change in consumer prices from the previous month. Individuals make critical decisions after hearing this number, since it supposedly measures the rate of inflation.

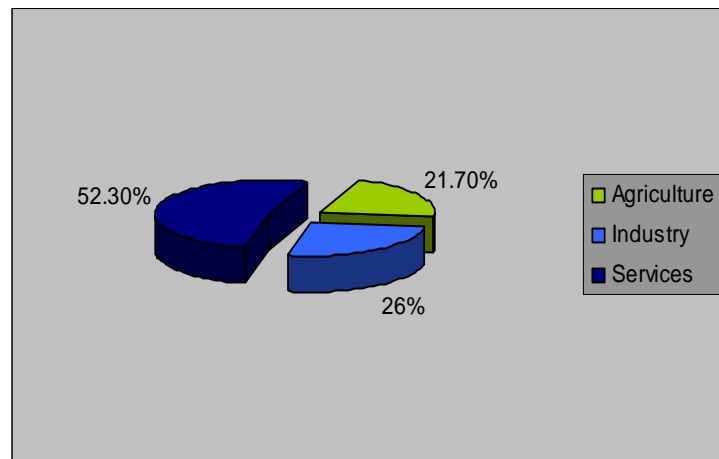
Since the CPI basket constitutes all essential consumer goods it is a reasonably good measure of the price changes affecting the common man. However the fact that it consists of specified goods and services only, and does not include all goods and services in the economy and that too not at the same weightage as their contribution towards the economy's GDP, CPI may not be an accurate price indicator for the whole economy. This is an important observation because as illustrated later, the monetary policy acts through impacting the money supply of the whole economy and hence the monetary policy's impact on CPI is through its impact on the overall economy.

At this point we must closely observe the items in the CPI basket (Table 1) to evaluate the extent to which they contribute to the total growth in the GDP. For example the food and beverages group carries the highest weight in the CPI basket. This group constitutes essential food items that have witnessed volatile and high inflation over the year. However it is interesting to note that it has a comparatively lower weightage in the overall GDP and therefore has a relatively low contribution to the total GDP growth.

Figure 1 shows how the growth in the different sectors: Agriculture, Industry and Services have contributed to the 6.6% growth of GDP in FY 06. As it can be clearly seen, the largest contribution came from the Services sector that holds a very small weight in the CPI basket of goods. Following the services sector, the industrial growth contributed 26% to the total GDP growth. This was primarily due to the growth in the large scale manufacturing. The interesting fact to note is that while manufacturing products account for a large part of GDP and the growth in this sector has contributed significantly to the GDP growth, their growth has a very little share in the CPI basket.

Conversely, the groups that are given a high weightage in the consumer basket (e.g. Food and Beverages Group) make relatively smaller contribution to the total GDP and its growth. This significant divergence in the CPI and GDP compositions implies that it is possible for CPI inflation to be high despite subsiding inflationary pressures in the overall economy.

Figure 1
Share % to GDP growth of FY 06



Aiming in the Right Direction?

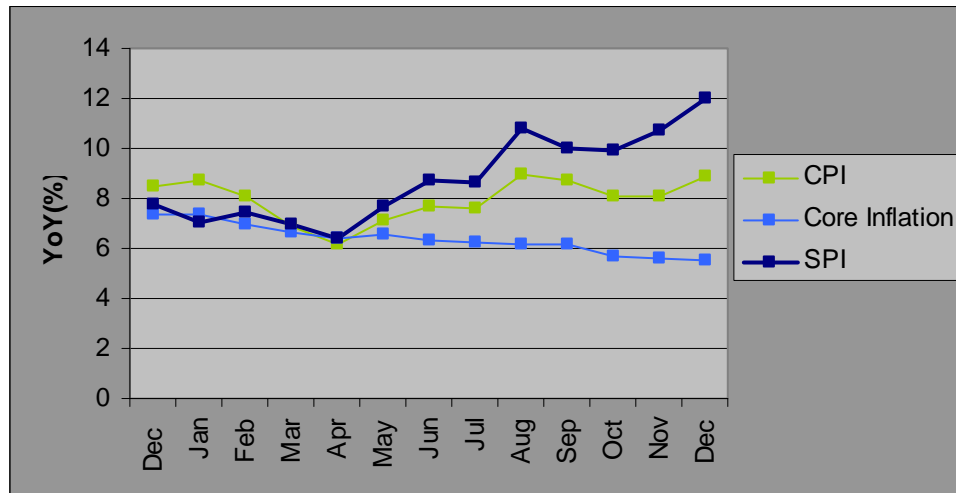
The monetary policy by means of modifying the supply of currency in the economy influences the aggregate demand and consequently the general price level. A contractionary Monetary Policy reduces the size of the money supply or raises the interest rate while an expansionary policy increases the size of the money supply or lowers interest rate. Monetary policies are said to be accommodative if the interest rate set by the SBP is intended to stimulate economic growth, neutral if it is intended to neither spur growth nor control inflation and tight if intended to reduce inflation or cool the economy. The State Bank can use several policy tools to achieve these ends. Increasing interest rates, decreasing the monetary base or increasing reserve requirements shall result in contracting the money supply while the reverse of these shall cause the money supply to expand.

A tight Monetary Policy as in the case in Pakistan contains inflation by cooling down the aggregate demand. The State Bank of Pakistan has been following a tight monetary policy stance since FY 05 when it raised the discount rate by 150 basis points to 9% and further in FY 06 to 9.5%. By slowing the growth in money supply and subsequently the aggregate demand the State Bank has managed to reduce the core inflation significantly but at the same time it has failed to bring down the monthly CPI index as shown in Figure 2.

The reason for this failure is that the rising trend in the CPI was primarily contributed by the rise in food prices as reflected by the Sensitive Price Index (SPI) that assesses the price changes of essential commodities, majority of which are food items.



Figure 2: Trends in CPI, Core Inflation and SPI (Dec 05-Dec 06)



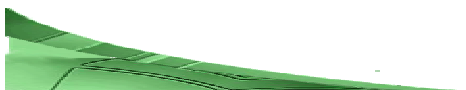
Source: SBP


This brings us to difficulties in controlling the SPI through the monetary policy. Since monetary policy targets all the goods and services produced within the economy and not specific goods, it is not a very adequate measure for targeting the SPI as this would mean slowing down the whole economy for the sake of controlling just a small part of it. Additionally the fact that the SPI basket consists of essential commodities that face an inelastic demand and a zero to negative income elasticity, a contractionary monetary policy will not necessarily bring down the demand for these essentials and consequently their prices. Hence using monetary policy to reduce aggregate demand in the whole economy to control CPI inflation that is primarily triggered by SPI is similar to using a thermonuclear device in order to kill a mosquito.

Condensing Volatility

Now that it is established that the monetary policy may not necessarily be efficient in controlling the rising CPI and SPI, we are left with the question that what is the most competent method to counter the rising trends in these price indices. In our opinion the food inflation is arising not from excess money supply but rather as a result of supply inefficiencies. Hence it is more important to target the CPI inflation by controlling for these inefficiencies rather than via monetary policy tools only.

In order to better understand the supply situation, consider the aggregate value addition by the crop sector that constitutes of two subgroups; major crops and minor crops, which declined by 2.3% during FY 06 as compared with a strong growth of 13.7% in FY 05. Table 2 shows the production of certain minor crops, which are present in the CPI basket





as significant food items, for FY 06 relative to the production of the past two years. It is interesting to note that despite the high growth in population some of the food items shown in Table 2 (at least one or more of these items are typical of every meal of each household) witnessed low or no growth at all. For example the supply of potatoes shrank by almost 18% while that of pulses (Mung, Masoor and Mash) declined by approximately 14%. These statistics clearly indicate the supply inefficiencies of these crops and their inability to meet the demand of the growing economy.

Table 2
Minor Crops Production (tones)

Crops	FY 04	FY 05	FY 06
Potato	1,855	2,025	1,663
Onion	1,449	1,853	2,050
Tomato	426	426	440
Mung	141	130	114
Masoor	31	26	18
Mash	25	18	17

Source: SBP


So in our opinion the rising CPI and SPI are a result of supply inefficiencies in essential food items, it is highly imperative for the government to rectify these inefficiencies by ensuring adequate supply to meet the rising demand of the growing population. Following are a few suggestions we propose to improve the existing supply chains.

Introducing Support Prices for Minor Crops

Currently the government uses the support price mechanism for the major crops such as wheat and sugar cane. While supporting these crops is essential to the health of the wider economy, a common man is equally affected by the fate of the minor crops which may not be significant enough to a statistician in Islamabad but is a matter of life and death to the farmer and the end consumer. The problem is the price fluctuations that occur in these items preventing the farmer to plan with any certainty the crop cycle. This results in prices for some crops sky rocketing in one season and crashing to the ground the next. Introducing support prices for these smaller items would go a long way in ensuring smooth plantations of these crops.

Establishing Storage Capacities

Besides price fluctuations, low storage capacity also contributes to lack of stable supply of some essential commodities. Due to lack of adequate storage facilities available for the agricultural sector, a bumper crop instead of providing a boon to the farmer may become his bane as it would require the farmer to immediately sell the entire crop into the market, often at ridiculously low prices. Since the private sector has not been able to develop the



required level of these storage houses, the government must step in and storage facilities for smaller crops to guarantee a smooth supply of them to the market.

Reducing the length of the Supply Chain

Since a long chain of intermediaries exists between the farmer and the final consumer the price for a crop received by the former and that paid by the latter is significantly different. These price distortions create strong inflationary pressures in terms of high prices paid by the consumer and low prices received by the farmer creating a production disincentive for him. This requires the government to effectively shorten the supply chain by reducing the number of intermediaries between the supplier and the final consumer and narrowing the difference between the prices received and paid by the farmer and the consumer respectively.

Allowing Open Trade for crops

Lastly, we suggest that the government should allow open trade for minor and major crops especially with the neighboring economies. This is because by means of developing a stable supply for these items, trade will control the volatility in their prices. For instance if in a certain season a crop is produced excessively due to favorable weather conditions, trade with neighboring countries will allow the producers to export the excess crop. Similarly in case of low production the country can import the crop and meet the demand, preventing the prices from rising to high levels.



Economic Snapshot

Fiscal year 06														
Units	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	
<u>Inflation</u>														
Headline Inflation	%	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88
Core inflation	%	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.50
Food inflation	%	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71
Non-food inflation	%	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64
6 month	%	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81
12 month	%	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00
<u>External Sector</u>														
Export	Mn US\$	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1,350	1,383	1,420	1,290	1,380	na
Import	Mn US\$	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2,370	2,292	2,450	2,191	2,773	na
Trade balance	Mn US\$	(478)	(785)	(567)	(733)	(232)	(801)	(1,114)	(1,020)	(909)	(1,030)	(901)	(1,393)	na
Remittances	Mn US\$	336	391	339	444	401	507	464	376	435	422	410	448	475
Forex reserves	Mn US\$	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,904
na=Not Available														



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