



MCB Bank Limited
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Quid Pro Quo

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Attempting Redemption

Controversy-

The increase in reserve requirements by the SBP was indeed an unconventional means of monetary tightening. At a time of stable inflation and slowing credit off take, the move is not self explanatory. What than is the rationale behind it?

Contention-

The inflation problem is not as pervasive as it is popularly believed. In our opinion, the SBP has displayed much dissatisfaction at the widening fiscal and external deficits, and the rise in interest rates is intended to redress these growing imbalances. Furthermore, low deposit rates have been a source of much chagrin to the SBP, and the recent measure ensures that they will rise.

Market impact-

Liquidity driven KIBOR, lending and deposit rates will go up as significant liquidity is removed from the banking system. Banks will be encouraged to mobilize longer-term deposits. From a macro-economic perspective, the trade balance will be positively impacted but the budget deficit is unlikely to be curbed.

Risk-

The measure might be inadequate to meaningfully reduce the country's economic imbalances and may choke off private sector credit off take, and resultantly, economic growth.

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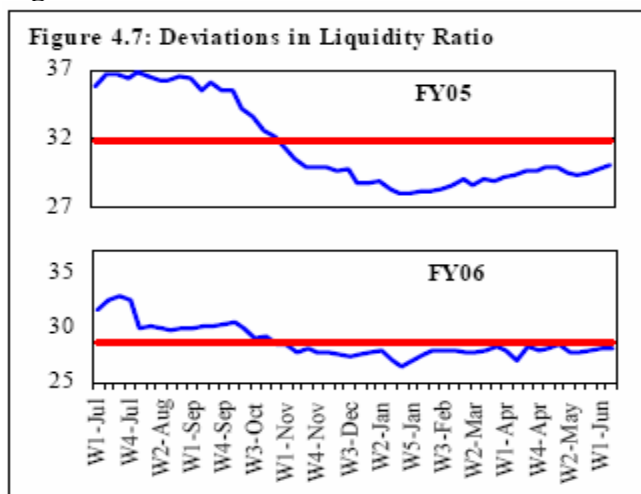
With the monetary policy statement for FY07 due on the 29th of July, financial markets wondered if a discount rate hike was in the offing. Concerns have been voiced, both from the SBP and S&P, that an expansionary fiscal budget at a time of still strong aggregate demand, inadequate anti-trust regulation, and oil prices climbing to new heights could reignite inflationary pressures. With SBP having reiterated its tight monetary policy stance on numerous occasions, a discount rate hike was a possibility.

But the central bank's recently released quarterly report and the rise in CRR and SLR requirements has put an end to that speculation. For all effective purposes, monetary policy has been tightened without using the primary tool of the discount rate, but through the combined use of OMOs and higher reserve requirements.

Circumventing Convention

SBP has received its fair share of stick regarding the uncertain nature of their OMO dependant monetary exploits. The statistics, however, indicate that OMOs have kept liquidity on a tight leash, holding inter bank rates close to the discount rate, and achieving the desired rise in lending costs. The SBP quarterly graphs the "liquidity ratio"¹ for FY05 and FY06, which we have reproduced below. It indicates that the reserves of the banking sector (CRR + SLR + excess reserves) as a % of total demand and time liabilities have declined from an average of 32% of FY05 to 29% in FY06. The variation from the mean has also decreased in FY06, indicating better and tighter liquidity management.


Figure 1



SBP Third Quarterly Report 2005-2006

¹ Liquidity ratio is defined as required reserves (CRR and SLR) plus excess reserves as percent of demand and time liabilities of banks net of inter bank time and demand liabilities and FE-25 deposits.





Now the rise in the CRR and SLR requirements will push the KIBOR and lending rates further up, making SBP's monetary policy tighter than before. Lending rates will rise because banks can give out fewer advances against the same deposit base. KIBOR, being a liquidity driven rate, will rise as the central bank sucks out liquidity from the banking sector. Moreover, the rise in reserve requirements is also likely to help raise deposit rates, something which OMO's were unable to do with any great success.

Higher reserve requirements will now allow the bank lending channel to transmit the SBP's tight monetary policy more effectively, by curbing the banking sector's ability to lend aggressively. The banking sectors ADR ratio was approximately 72% by June 2006 (the 76% vanilla figure is an overstatement because it includes export refinancing). SLR and CRR now total almost 25%, leaving little room (3% approx) for advances to grow without a corresponding increase in deposits. Of course, we are looking at a sector as a whole, and the more liquid banks (such as NBP which has an ADR of 59%) will have a greater room for maneuverability. However, the sector analysis importantly indicates that banks will now compete for deposits amongst each other. And unless fresh deposits are mobilized, the lending capacity of the banking sector as a whole will be significantly trimmed.

Not only has supply of credit been reduced, but with real interest rates well into positive territory (and set to continue moving further up), demand for credit is slowing as well. Both KIBOR and weighted average lending rates are in double digits, whilst CPI inflation is 7.92% in FY06. This combination of reduced demand and supply has led to a slowdown in private sector credit off take, and the PKR 390 billion credit target envisioned in the FY07 Credit Plan now looks increasingly unachievable.

From the point of view of inflation, this is good news. Monetary statistics indicate that tightening had started to work even before the reserves requirement was raised. For the first time in four years M2 growth of 13.13 % in FY06 (from 1st July 2005 to 17th June 2006) is less than the growth in nominal GDP. This is a trend worth noting and appreciating. Meanwhile, private sector credit off-take has been virtually stagnant around the PKR 340 billion mark for the last three months, indicating that more than just a seasonal slowdown is at play. Now, with interest rates in the economy going up further and a significant chunk of liquidity having been withdrawn from the banking sector, aggregate demand will slow down, leading to a reduction in core inflationary pressures.

The perennial rumor of a discount rate hike can now be laid to rest. It is not needed for the time being, and the upward pressure on T-bills should also abate. If yesterday's auction is anything to go by, that trend has already kicked in. The bulk of the participation was in the 12 month paper, and interestingly, no one bid above the previous cut-off, indicating market expectations of a stable discount rate.



Why Now?

We, along with many other economists in the country, have long advocated the need for further tightening of monetary policy to redress growing economic imbalances. The SBP has belatedly and unexpectedly obliged. The reserve requirement hike comes just ten days before the monetary policy statement is due to be released, which would outline the SBP's monetary stance for the first half of FY07. Even more interestingly, the tightening comes at a time when inflation by SBP's own admission is "not an immediate concern," and private sector credit off-take has slowed down significantly in the last few months.


The CRR and SLR hike could be seen as a stick intended primarily to instill greater caution and discipline within the banking sector, with the long-term aim of encouraging banks to mobilize long-term deposits. This would help correct the asset-liability mismatch in the banking sector, and raise the abysmally low deposit rates currently on offer. However, a hike in the reserve ratio requirement is a stringent measure, and will have an economy wide impact. It raises the cost of credit across the board, and while it will affect banks to the greatest degree, its intended purpose is more comprehensive.

Disturbing Deficits

We understand the central bank's tightening not as a pre-emptive measure to nip inflationary pressures in the bud but as a means to rein in the more important structural issues of deteriorating fiscal and trade discipline. A read of the SBP quarterly report sheds some light on the issue. The central bank has repeatedly underscored its deep rooted dissatisfaction at the yawning fiscal and trade deficits, displaying a growing realization that maintaining the status quo is untenable in the long term.

Much of the unprecedented rise in the "twin deficits" is owing to the GoP's contradictory desire to reduce inflation while sustaining above potential growth. The FY07 budget is similarly ambitious, projecting a 7% GDP growth and a 6.5% inflation target. The FY07 import policy also has maintained its liberal leanings. The import bill projection of US\$ 28 billion, which is less than the import bill for the outgoing fiscal year, is inexplicable with a 7% GDP growth target and in the absence of import controls. If recent history is anything to go by, trade estimates should be taken with a pinch of salt. The FY06 import bill was estimated at US\$ 21.5 billion whilst the full year actual was US\$ 28.5 billion. Even oil at US\$ 70 cannot account for that difference!!

The SBP waited patiently on the sidelines for the fiscal position to be clarified. Islamabad has shown its hand, and it's hardly reassuring from a macro economic perspective. In terms of policies, the message from Islamabad seems that they are



willing to stack up the deficits as long as the growth momentum is maintained and inflationary pressures are contained. The SBP has subsequently decided to take matters into their own hands, and assume the moral responsibility of the country's financial well-being. Their first move to cut the refinance rate by 150 basis points to 7.5% is going to help exporters compete more effectively in the international market. The second move to raise the CRR and SLR requirements raises interest rates for the rest in the economy. Consumer finance will feel the pinch particularly, and imports of many items are likely to decline as a result. More generally, higher interest rates will reduce the economy's overall aggregate demand, which in turn, will suppress import growth in the future.

Meltdown Concerns

SBP's concerns are not unwarranted. Truth be told, external receipts have allowed us to have our cake and eat it too. They have enabled us to sustain higher than potential economic growth, lower than required interest rates, having fed a remittances induced liquidity boom that has subsequently funded a consumption binge of unprecedented proportions. With a trade deficit over 9% of GDP and little devaluation in the offing, our reliance on remittances, foreign investment and privatization receipts has become absolute. If any one of these funding flows does not materialize in the quantum expected, there will be serious risks to macro-economic stability in terms of higher interest rates and a large currency devaluation.

As a thought experiment, it seems worthwhile to quantify the extent of our dependence on these foreign flows. External receipts account for almost 60% (PKR 239 billion) of our budget deficit funding plans for FY07; privatization receipts account for an additional PKR 90 billion. Meanwhile, the banking sector (SBP and commercial banks combined) are budgeted to provide PKR 120 billion. If any of the external receipts or the privatization proceeds do not materialize, and the GoP were to turn to the banking sector to bridge the gap, there would be pressure on interest rates to rise further. SBP calculations indicate that had the government not repaid borrowed monies with external receipts last year, total government borrowing from the banking sector in FY06 would have totaled PKR 220 billion!!

Also imagine the repercussions if remittances, foreign investment and privatization proceeds were unable to fund a trade deficit in excess of US\$ 12 billion. How adversely would economic growth be impacted if the import bill had to suddenly be slashed? The beating that the rupee/dollar parity would take if such an eventuality would come to pass is frightening even to contemplate.

The quantum of our twin deficits coupled with our complacency in entrenching them is truly disturbing. By tightening monetary policy further, the SBP hopes to stem some of the decline. This show of strength is encouraging from the perspective of long term stability. It might however, not be enough, specially in reducing the fiscal



deficit. The government has the option to continue funding its profligacy from abroad, and higher domestic interest rates will not affect them substantially for now. Abundant external receipts will not however, be available indefinitely. The GoP will then have to turn to the banking sector and domestic sources to fund its deficit, sending interest rates higher, and the economy in the opposite direction.



Economic Snapshot

Fiscal year 06													
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	July-May
<u>Inflation</u>													
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.96
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	7.23
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	6.88
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	8.65
<u>T-bill (Wgt Avg)</u>													
3 month	%	7.69	7.99	8.10	8.10 id rejected		8.09	8.10	8.10	8.10	8.10	8.33	n/a
6 month	%	7.97	8.12	8.14	8.14 id rejected		8.25	8.29	8.29	8.29	8.29	8.49	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	n/a
<u>External Sector</u>													
Export	Mln US\$	1,272	1,408	1,499	1,329	1,120	1,421	1,229	1,300	1,521.1	1,450.9	1,488.9	15,039
Import	Mln US\$	1,997	2,235	2,322	2,328	2,300	2,420	2,145	2,253	2,685.3	2,258.9	2,648.5	25,592
Trade balance	Mln US\$	(725)	(827)	(823)	(999)	(1,180)	(999)	(916)	(953)	(1164)	(808)	(1160)	(10,554)
Remittances	Mln US\$	313	348	341	373	309	336	391	339	444	401	507	4102
Total													
Foreign													
Investment	Mln US\$	130	161	183	208	323	458	165	347	658	744	n.a	3376
Forex reserves	Mln US\$	12613.2	12123.9	12000.3	11714.8	11320.9	11211	11504.7	11400	12905	13016	13006	n/a
<u>Key</u>													
n.a	not available												
n/a	not applicable												



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