



MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

Issue # 34

Economic report

April 18th, 2007

Heads We Loose. Tails We Loose Again!

The economic progress made by Pakistan under the current leadership has strengthened the confidence of foreign investors in Pakistan's future economic growth prospects, increasing foreign currency inflows significantly in the previous months. Though these inflows make the country's balance of payments outlook positive, they pose a new challenge for the SBP in terms of exerting upward pressures on money growth.

This report will examine the monetary impact of foreign inflows and how it makes liquidity management ever more challenging for the SBP. After analyzing the risks of this impact, the report will evaluate the steps that may be taken by the SBP to mop up excess liquidity in the market.

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.



A Tight Stance

The SBP of Pakistan in its Monetary Policy Statement for the second half of the current fiscal year, declared that it will 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%. 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 quite successful as it has effectively contained the private sector credit growth as seen in Table 1. As of 24th March 07 the private sector credit grew at 11.67% against a growth of 19.87% for the corresponding period of the previous year. The rather slow private sector growth has reduced excess demand from the economy without hurting the growth impetus and has slackened inflationary pressures significantly as core inflation has been recorded at 5.74% for the July-March period of the current fiscal year as against the core inflation of 7.37% for the corresponding period of the previous year. Though headline inflation is still recorded at a persistently high average rate of 8.0% for the same period of FY 07, it is expected to meet the revised target of 7.5% as it has been prevented from reaching unacceptably high levels.

Nevertheless the success of the SBP in controlling the money growth has so far been limited as seen in Table 1. The reserve money growth as of 24th March 07 stands at 16.97% which is in sharp contrast with growth of 10.99% for the corresponding period of previous year. This is largely owing to the huge inflows of foreign exchange since November 2006.



Table 1: Monetary Aggregates (Growth Rates)

(Percent)

Indicators	2005-06	2004-05	1st July	
			Upto	
			24-Mar-07 P	25-Mar-06
Broad Money	15.18	19.30	9.94	8.99
Reserve Money	10.16	17.62	16.97	10.99
Currency in Circulation	11.19	15.18	13.81	13.62
Deposits	16.28	20.50	8.89	7.65
<i>of Which:</i>				
Demand Deposits	14.69	20.67	116.37	3.50
Time Deposits	18.81	19.87	-75.26	11.55
RFCDs	8.43	23.75	0.89	4.49
Bank Credit to Private Sector	23.47	34.36	11.67	19.87
Net Bank Credit to Government Sector	12.06	14.59	8.65	14.57
Net Domestic Assets (NDA)	17.11	22.38	9.81	15.32
Net Foreign Assets (NFA)	8.08	9.22	10.47	-14.18

p= Provisional


Source: Monetary Policy Department

Though these foreign currency inflows make the country's balance of payments outlook positive, they pose a new challenge for the SBP in terms of exerting upward pressures on reserve money growth. Additionally the high reserve money growth has resulted in increasing the broad money (M2) growth considerably, from 8.99% in July-March 06 to 9.94% in Jul-March 07 (Table 1), making liquidity management by the SBP ever more challenging.

Creating Money

The economic progress made by Pakistan under the current leadership has strengthened the confidence of foreign investors in Pakistan's future economic growth prospects, as reflected by the increased foreign investment in the previous months. Foreign inflows surged by 147% to USD 4.6 billion during July-Feb 2007 and are expected to expand further to USD 6 billion by the end of the current fiscal year. The most distinguished of these investments include acquisition of Union Bank by Standard Chartered, GDRs of Oil and Gas Development Corporation Limited (OGDCL) and The MCB Bank, acquisition of Paktel Mobile by China Mobile while some prominent transactions like the privatization of Pakistan State Oil (PSO), launching of GDRs of the United Bank Limited (UBL) and Eurobond offerings are in pipeline, expected to further increase the future foreign inflows.





Interestingly such huge foreign currency inflows under a flexible exchange rate regime where exchange rate is determined by market forces essentially result in appreciation of the local currency. For example excess dollar inflows will increase the supply of dollar in the market, exerting a downward/upward pressure on the dollar/rupee. However in Pakistan the exchange rate is rather actively managed by the SBP which manages the rupee dollar parity very closely, allowing it to fluctuate only within a narrow band.¹ What we will address here is the monetary impact of the huge foreign inflows in Pakistan, given that it follows a Managed Regime.

Since under the Managed Regime the SBP is responsible for maintaining the exchange rate within the target band, this essentially means that it has to absorb the additional supply of dollars resulting from foreign inflows which otherwise will result in appreciation of the rupee. The SBP therefore moves to buy these dollars, in turn increasing the level of its foreign exchange reserves. Though these reserves present a constructive balance of payments outlook in the short to medium term, making it a more than welcome development, it presents a challenge to the monetary management. This is because SBP's purchase of dollars, in an attempt to prevent the rupee from appreciating, inevitably results in an increase in money supply as it buys dollar in exchange for the Pakistani rupee which it essentially has to create.

Table 2 depicts this existing trend of foreign inflows and the subsequent rise in monetary assets. The M2 supply has increased by PKR 339 billion for the July-March period of the current fiscal year as compared to the increase of PKR 266 billion for the last year (Table 2: 6). This increase in broad money supply growth can be traced to the increase in net foreign assets of the banking system which increased by PKR 72 billion for the July-March period as compared to a decline of 90 billion witnessed in the corresponding period of the previous year.

History repeats Itself ?

It has been clearly established that the huge foreign inflows have resulted in significant expansion in reserve and broad money growth. Under this strong monetary assets growth the slow private sector credit takeoff as seen in Table 2, implies that the excess money supply is not absorbed by the private sector and rather has resulted in creating excess liquidity in the banking sector.

Therefore, given the existing trend of high money growth and the increased liquidity, it is crucial that monetary policy has to be necessarily kept tight in order to mitigate the risks of excessive expansion in the domestic liquidity.

¹ We have already addressed the question of Managed Exchange Rate Regime versus Floating Exchange Rate Regime in Quid Pro Quo 24 – Rational Resolution



Table 2: Profile of Monetary Assets

	Credit Plan 2006-07	Stocks		Monetary Impact During	
		30-Jun-06	30-Jun-05	1st July 06	1st July 05
				to	to
				24-Mar-07 P	25-Mar-06
1. Net Government Sector Borrowing (a+b+c)	130,100	843,281	752,515	72,971	109,636
a. Borrowing for Budgetary Support	120,100	717,632	646,682	117,694	143,157
(i) From SBP		403,566	268,474	25,708	173,992
(ii) From Scheduled banks		314,066	378,208	91,987	-30,835
b. Commodity operations	10,000	107,762	87,836	-44,559	-33,165
c. Others	0	17,887	17,997	-164	-356
2. Credit to Non-Government Sector (d+e+f)	395,000	2,190,769	1,782,368	244,414	339,801
d. Credit to Private Sector (i-ii)	390,000	2,113,890	1,712,093	246,587	340,232
i. Commercial Banks		2,018,961	1,601,550	244,552	340,204
ii. Specialised Banks		94,928	110,543	2,036	28
e. Credit to Public Sectors Enterprises (PSEs) (iii-iv+v)	5,000	60,991	53,348	-2,930	875
iii. WAPDA, KESC, OGDC, PTC, PIA & Pak.Steel		36,979	32,224	2,642	2,410
iv. Others		47,237	44,838	-5,352	-2,190
v. PSEs Special Account-Debt Repayment with SBP		-23,225	-23,714	-221	655
f. Other Financial Institutions (SBP credit to NBFIs)	0	15,889	16,927	757	-1,306
3. Other Items (net)	-75,000	-305,979	-205,470	-49,834	-92,465
4. Net domestic assets of the banking system	450,100	2,728,071	2,329,414	267,552	356,973
5. Net Foreign assets of the banking system	9,800	688,429	636,939	72,113	-90,326
6. Monetary Assets (M2)	459,900	3,416,500	2,966,352	339,665	266,647
(Growth)	(13.46%)			(9.94%)	(8.99%)

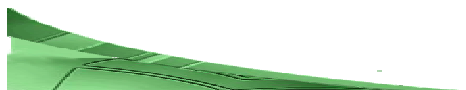
p= Provisional

Source: Monetary Policy Department

This is because if no vital steps are taken to mop up the excess liquidity, we will witness the same scenario that prevailed in the economy right after 9/11 in FY 02.

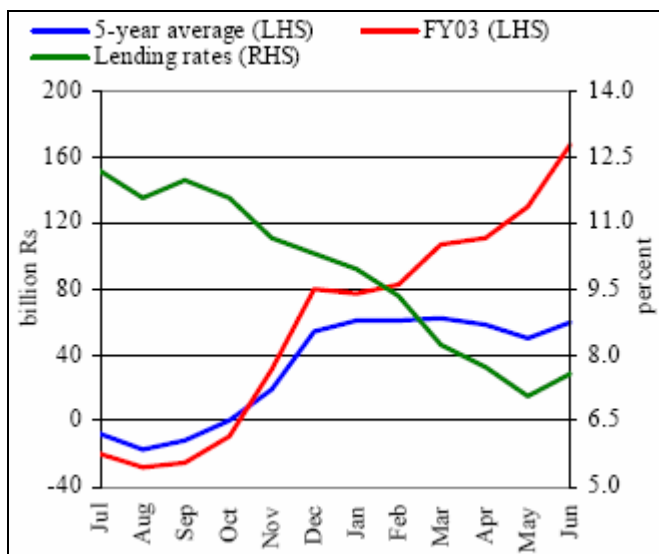
During FY02 the current account surpluses flushed the market with liquidity, changing the dynamics of the banking spread altogether. The SBP cut the discount rate by 150 basis points in Nov 2002, signaling easing of monetary policy. As a result, the increased competition among banks to productively deploy the excess liquidity led to a sharp decline in banking spread. Though private sector credit take off remained weak in FY 02, it picked up significantly in response to SBP's decision to increase market liquidity by substantially reducing the sterilization of its rising foreign exchange market purchases.

Thus as a result of the increased market liquidity and the SBP's prudent policy signals, domestic interest rates plunged to all-time lows. This strongly supported economic activity and eventually contributed to the stunning PKR 167.7 billion net private sector



credit expansion during FY03, which underpinned the monetary expansion during the year. Additionally the SBP relaxed its control on the exchange rate and as a result the period saw the rupee appreciate significantly which reduced the need for sterilization.

Figure 1: Private Sector Credit



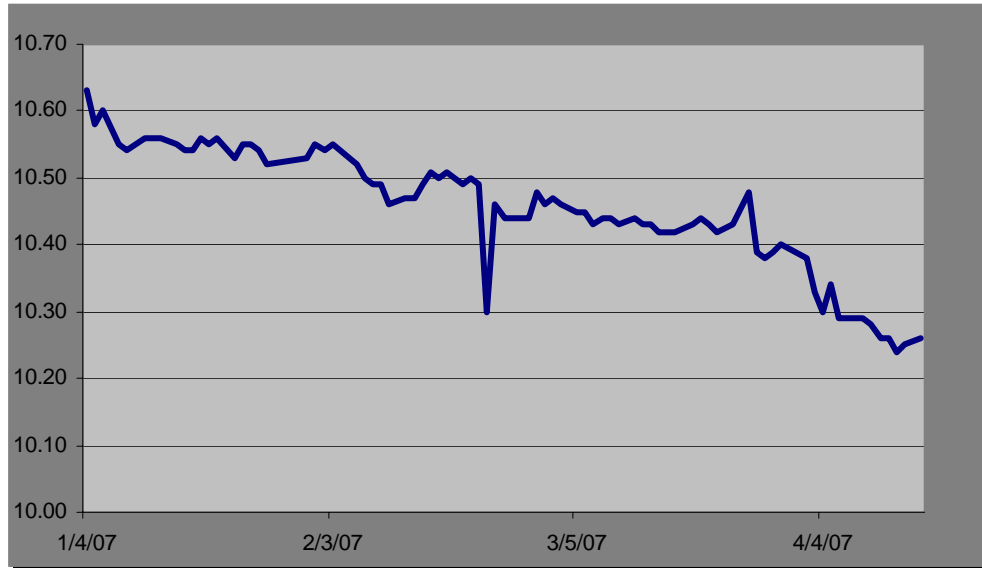
Source: SBP Annual Report FY03

SBP's policies back then, when economic growth was fairly low, proved to be highly favorable as the economy picked up momentum. However under the current ambiance of an overheating economy and rising inflation, the SBP cannot afford to execute the same stance it did in FY 02. Since FY 02 when headline inflation was recorded at a mere 3.54%, inflation now poses a much bigger challenge to the economy at 8.0% (Jul-Mar FY07). This essentially implies that allowing excess liquidity to drive down interest rates is an option that SBP will not exercise, as it has clearly indicated in its latest Monetary Policy Statement that it gives inflation the highest priority and therefore will continue to pursue a tight monetary policy stance while remaining heedful of the developments in the economy and taking any necessary actions if required

However the increase in money supply despite a decrease in private sector credit growth points towards rising liquidity in the banking sector. This is already exerting a downward pressure on the interest rates as reflected by the declining trend of the 6 M KIBOR (Figure 2). The 6 M KIBOR fell from average monthly rate of 10.55% in Jan to an average of 10.29% in April (to date). This has resulted in narrowing the gap between KIBOR and the yield on T Bills, fuelling participation of commercial banks in T Bill auctions.



Figure 2: 6 Month KIBOR (Jan 07- April 07)



Source: Bloomberg

Before interest rates fall too drastically and stimulate private sector credit expansion, increasing the demand and subsequently inflationary pressures, the SBP will have to speed its sterilization of foreign inflows.


Taking Action and some More!

As mentioned earlier, the growth in monetary expansion resulting from foreign currency inflows poses new challenges to the SBP, requiring it to mobilize tools available to it to sterilize the foreign inflows.

Selling Treasury Bills in the open market, the SBP can use OMOs as one of the principle tools for sterilization of foreign inflows. Though highly effective in the short run, it must be noted that this strategy does not come without costs in the long run. This is primarily because it involves SBP effectively swapping high yielding local debt for low yielding foreign debt. Thus the fiscal impact of OMOs makes them fairly expensive in the long run.

Another point that needs to be noted is that in order to mop up the excess liquidity via OMOs, the SBP may tend to keep interest rates high which may attract more foreign inflows in the economy. In this way OMOs contradict with the motive for which they were conducted in the first place.






Besides OMOs, another effective method to sterilize the excess money supply is by increasing the reserve requirements for all commercial banks. These are the amount of funds that commercial banks must hold in reserve against specified deposit liabilities as cash or in form of acceptable securities. Currently the average weekly cash reserve requirement for time and demand liabilities is at 3% and 7% respectively while the statutory liquidity requirement is at 18%.

Though this tool is more cost efficient than conducting OMOs for the government, the cost reduction is merely an illusion as it instead transfers the costs to the commercial banks, reducing their profit margins. Moreover it is rather a blunt tool for sterilization of excess money supply since increasing reserve requirements may not have the desired impact on the money supply as some banks may already be holding reserves greater than their requirements. Additionally changes in the reserve requirements are undesirable as they decrease the bank's ability to provide efficient financial intermediacy services which is their purpose in the first place.

The SBP can also employ Foreign Exchange (FX) Swaps as a potent tool to implement its sterilization policy. It can use a sell buy swap, selling dollars with a commitment to buy it back at a future date. This will absorb rupee out of the market, reducing the money supply while increasing the dollar holdings in the economy. The commercial banks have the choice of either issuing dollar loans against these dollars or investing them in their Nostro accounts abroad. FX Swaps are thus a very accurate and effective tool for sterilization of excess money supply as they work at the root of the problem: the dollar demand mismatch.

However FX swaps like other tools for sterilization do not come without costs. In order to make the swaps attractive the SBP will need to price them as such that it is attractive for the commercial banks to forgo KIBOR and invest the dollars at LIBOR instead. This means a high cost of sterilization in terms of an adverse fiscal impact in the long run as in the case of OMOs. Additionally if the commercial banks use the dollars to issue dollar loans, there is a high possibility that the loans will be converted back to rupee, making the whole exercise futile.

Another option at SBP's disposal is to reduce the need to sterilize money supply by gradually shifting the focus from a strictly pegged exchange rate regime to a more market oriented regime. This is because as mentioned earlier, the principle reason behind the excess money supply resulting from foreign currency inflows, is the prevalence of pegged regime in Pakistan. Pegging the rupee to the dollar creates an imbalance between demand of rupee holding by foreign investors and demand for dollar holdings by domestic investors. By allowing an appreciation of the rupee, the SBP can increase the demand for dollar holdings and subsequently reduce the need for sterilization. This calls for the SBP to reduce its intervention in the foreign exchange market allowing the market



forces to balance the dollar inflows by the existing rupee stock. This will leave the money supply unchanged. However at the same time this would mean deregulating the foreign exchange markets. Allowing the rupee to appreciate in the existing economic ambience of the ever rising current account deficit is counter intuitive and frankly laughable! No surprise, SBP has wisely stayed away from this path.


Calculating Future

As mentioned earlier, interestingly there exist commonalities between today's economic scenario and the one that prevailed post 9/11. However it may not be so prudent to draw parallels as the landscape of the economy has changed considerably over these five years. The most important distinction between the two periods lies in the fact that the buzz word back then was *growth*, while today when Pakistan is already on a growth momentum, containing inflation and the current account deficit has become the central agenda. Therefore if then SBP placed sterilization on the back burner and dropped interest rates to stimulate growth, it cannot afford to do so currently as the inflation may reach unacceptable heights.

Hence considering the current economic scenario, we expect the SBP to sterilize foreign inflows more aggressively in the near future, possibly through a combination of three tools available to it. We already see the SBP conducting OMOs frequently, and it may inch the rates higher to address the falling KIBOR, if excess liquidity persists. But we anticipate the tool of choice to be increasing the reserve requirements. Increasing reserve requirements has one major advantage which other options for sterilizations do not offer. It is a low cost strategy where the SBP accounts are concerned. All the disadvantages aside, its low cost alone makes it one of the most favored tools worldwide, (especially for developing countries) to sterilize foreign inflows. And ultimately when push comes to shove, this is the tool the SBP would rely upon.

In terms of interest rate directions, the current state of money supply should put to rest any speculation of SBP relaxing its monetary stance, at least anytime soon. However this may not necessarily mean a significant hike in the existing rates. Instead the SBP would look to address the shrinking gap between T-bill rates and KIBOR through changing the reserve requirements without increasing the T-bill rates significantly. Small upward adjustment to T-bill rates which took place in the previous three auctions may continue.

In the end, we would like to emphasize one issue that often receives no attention when trumpeting foreign investments; the crowding out of domestic investment by the foreign inflows. Sterilization often reduces the relative investment pool available to the domestic investors. Completely addressing this issue is beyond the scope of this paper, but to put it briefly the question whether this is justified or not ultimately depends upon the nature of the inflows. If these inflows are short term and are speculative in nature, their benefits are



questionable. Only if the flows lead to long term value adding projects and eventually GDP growth, can the short term monetary problems be justified. What's the nature of the foreign inflows in Pakistan's case? Only time will tell.



Economic Snapshot

Fiscal year 06-07

	Units	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March
<u>Inflation</u>														
Headline Inflation	%	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67
Core inflation	%	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42
Food inflation	%	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74
Non-food inflation	%	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65
6 month	%	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82
12 month	%	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01
<u>External Sector</u>														
Export	Mln US\$	1,536	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	n.a
Import	Mln US\$	2,269	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	n.a
Trade balance	Mln US\$	(733)	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	n.a
<u>Remittances</u>	Mln US\$	444	401	507	464	376	435	422	410	448	475	391	457	520
<u>Forex Reserves</u>	Mln US\$	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624
n.a = Not Available														



Research Desk

Treasury and FX Group

MCB BANK LIMITED

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 92-21-2270025

0300-3915027

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