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A Challenging Future

With ambitious growth targets set for the coming fiscal year, FY 2007-08, the key challenge facing SBP is to maintain a balance between sustaining strong economic growth and stabilizing prices.

This report will analyze the challenges that State Bank will continue to face in the coming months; a) strong monetary growth arising from increased budgetary borrowings, excessive refinancing facilities and increased foreign inflows, and b) increasing inflationary pressures emanating from rising salaries, fluctuating food prices and rising international oil and food prices. The report will then conclude with an inflation and interest rate outlook for the new fiscal year.

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In Retrospect


With ambitious growth and inflation targets set for the current fiscal year, FY07, the key challenge facing SBP was to strike a balance between price stability and growth prospects. The inflation target for the year was set at 6.5% while the growth target was kept at 7.0%. Although the inflation for FY06 had declined with respect to the previous year inflation, it was still significantly high at 7.9%. More worrying were the demand side inflationary pressures which persisted causing the core inflation to remain at high levels.

As a response to these challenges, the SBP maintained a tight monetary stance for the first half of FY07; increasing its policy rate by 50 bps to 9.5%. Subsequently for the second half of the year, SBP declared it will continue to pursue its tight monetary policy stance; maintaining the base interest rate at its previous level of 9.5%. Though the average weekly cash reserve requirements were held at the previous levels of 3% and 7% for time and demand liabilities, the SBP raised the daily minimum cash requirement for commercial banks to 2% and 6% from the previous levels of 1% and 4%.

The impact of monetary tightening pursued throughout the current fiscal year is visible in the slowdown witnessed in private sector credit off take, mainly in textile units and consumer credit. As of Jun-9th, the bank credit to private sector stands at PKR 279.134 billion against the credit disbursement of PKR 333.725 billion during the corresponding period of the previous year. This slow private sector credit growth has largely removed excess demand from the economy without hurting the growth impetus and has slackened demand side inflationary pressures significantly, as core inflation has been recorded at 5.6% for the Jul-May period of FY07 against the core inflation of 7.2% for the corresponding period of FY06.

Nevertheless headline inflation has remained stubbornly high at 7.8% (Jul-May'07), against the year end target of 6.5%. No surprise, SBP revised its inflation target, expecting inflation to remain in the 7.5-7.8% range by the end of the fiscal year. This raises some serious questions regarding the effectiveness of the monetary policy. However it must be stressed that it is the development of certain other factors within the economy, which have disrupted the impact of monetary tightening:

- The headline (CPI) inflation remains stubbornly high mainly on account of fluctuating food prices resulting from supply inefficiencies.
- Higher fiscal pressures during the year resulted in increased government borrowings. With limited options available for external borrowings, the government resorted to finance its deficit through borrowings from the central bank, particularly in the first half of FY07. However recently the government has been retiring part of its SBP's borrowings and is relying on commercial bank's borrowings to finance its deficits.
- Excessive refinancing facilities to the textile sector by the SBP

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- Increased foreign inflows increasing the levels of Net Foreign Assets (NFA) of the banking system.

Together these factors have resulted in 20.28% YoY growth in reserve money (as on Jun-9th) against growth of 12.6 % for the previous year. This has translated into broad money supply growth of 16.07%; much beyond the original projection of 13.5%.

Though trends in key macroeconomic variables indicate that SBP monetary policy stance has proved successful in striking the required balance between curbing the demand side inflationary pressures and supporting the growth momentum, the factors highlighted above represent a new challenge for the central bank in terms of monetary management as headline inflation continues to rise on the back of food inflation and rising international oil and food prices while the growth in money supply gains pace.


New Challenges: Are we ready yet?

Inflation Outlook

The monetary impact on inflation has started to become visible already, as the demand pull inflationary pressures reflected in core inflation (Non-Food Non-Energy-NFNE) are weakening. The year on year core inflation has dipped to as low as 4.7% in May-07 from 5.2% in Apr-06 and a local crest of 7.8% in Oct-05. Nonetheless the food prices continue to fluctuate and CPI general inflation continues to hover at stubbornly high levels and is expected to breach the year end target of 6.5% by over 100 bps.

Though the SBP is largely being criticized for being unable to contain inflationary pressures, it must be recognized that food inflation is a function of supply inefficiencies rather than monetary tightening and therefore the temporary shocks in food prices are not likely to respond to monetary policy. What instead is required to contain food inflation are administrative measures by the government, aimed at improving market inefficiencies.

The government has already taken some substantial steps in the Federal Budget FY08 to control food prices by introducing fixed prices for some essential food items available through the utility stores. However weaknesses in the supply chain of some major crops like wheat persist and are likely to pose a threat in terms of fluctuating/rising food prices to the inflation monitor in the coming year. In addition to this, local food prices may also respond to internationally rising food prices likewise; as recently we witnessed the price of wheat and sugar increasing in the local market when the world price of the two commodities increased. What must be noted is the fact that the global food prices are rising at the back of rising world oil prices. So far, rising oil prices have not been fully



passed on to the local market but in the coming year we may see some domestic adjustment in this regard.

Besides food prices, another risk to inflation comes from a 15% rise in minimum wage of unskilled workers, 15% rise in salaries of government employees and a 15-20% rise in pensions of the pensioners. While these measures were announced in the FY08 Budget largely as a part of relief measures, they will necessarily translate into increased demand for food and other items and thereby increasing prices. Thus demand side inflationary pressures which were so far reduced significantly by monetary tightening are likely to be built up yet again and therefore will need to be diffused by Monetary Policy.

Fiscal Pressures: Will government crowd out private investment?

The current fiscal year witnessed increased budgetary borrowings as a result of rising fiscal pressures. As of Jun-9th the net budgetary borrowings from the banking system are recorded at PKR 176.372 billion against borrowings of PKR 133.691 billion for the corresponding period of the previous year.

Budgetary borrowings constitute borrowings from the central bank and from the commercial banks. Recognizing the inflationary impact of budgetary borrowing from the central bank, the government retired borrowings worth PKR 38.584 billion with the SBP and resorted to finance its deficit via commercial bank's borrowings. Nonetheless borrowings from commercial banks entail an additional cost in terms of reducing private investment.

The government borrows from commercial banks mainly through fortnightly auctioning of Market Treasury Bills of 3M, 6M and 12M maturities while borrows long-term by auctioning of Pakistan Investment Bonds (PIBs) of 3Y, 5Y, 10Y, 15Y, 20Y and 30Y maturities. Increased government borrowing puts upwards pressure on interest rates. The commercial banks then find it more prudent to park their money in government securities rather than lending it to the private sector. This draws the available capital away from prospective private investments to the government. As a result private investment may be crowded out.

The FY08 Budget with a total outlay of PKR 1.874 trillion envisages a fiscal deficit of PKR 398 billion or 4% of GDP and therefore is likely to build stronger fiscal pressures in the coming year. As a result we will see increased government borrowings particularly from the scheduled banks and thereby an even slower growth in private sector credit off-take. If the pressure increases further, the government may also reverse its current trend of borrowing from the commercial banks and resort to finance its deficit by borrowing from SBP once again, stimulating growth in broad money supply.



Refinancing facilities: Creating Money

During the current fiscal year, financing facilities under Export Finance Scheme (EFS) and Long Term Financing for Export Oriented Projects (LTF-EOP) have been offered to exporters for different periods of time at rates significantly below the KIBOR for relevant maturities. For e.g. currently under EFS, exporters are offered financing for a six month period at 7.5% which is approximately 3% below 6M KIBOR while financing facilities for import of eligible machinery for a three year period are offered in the range of 5% below the KIBOR of respective maturities. Subsequently in the first ten months of the current fiscal year, total gross disbursement from refinancing facility allowed to banks under EFS and LTF-EOP is estimated to be PKR 328 billion which constituted EFS flows worth PKR 284 billion. This is the highest ever disbursement under the financing schemes to the textile sector and is likely to assume a greater number in FY08 as the FY08 Budget announced the extension of LTF-EOP to the entire spinning sector. Hitherto the debt/swap facility was limited to only six sub-sectors of spinning.

What is critical is the impact of excessive refinancing on the money supply. Firstly refinancing, which necessarily implies creation of new money, stimulates growth of high-powered money. For e.g. textile refinancing of PKR 43.8 billion under LTF-EOP in the first ten months of the current fiscal year accounts for 29% of the reserve money growth. The additional liquidity generated by the excessive refinancing in turn dilutes the tight monetary stance of SBP to curb inflation. For e.g. the excess liquidity in the current year could not be retailed by the commercial banks and continued to find its way back to the government securities in T-Bills auctions and the increased number of Open Market Operations witnessed lately. This distorts the overall monetary policy implementation.

In FY08, with an additional recipient for export refinancing; the spinning sector, we are likely to witness a larger number of financing disbursements and subsequently stronger monetary growth.

Foreign Inflows: Creating More Money

Another primary source of expansion in money supply during the current fiscal year is the large foreign exchange inflow (both in the government and the private sector) that has led to a significant increase in NFA (Net Foreign Assets) of the banking system. This is because in order to prevent rupee appreciation, the SBP seeks to purchase the foreign exchange, spurring undesirable growth in reserve money in the process.

The money supply as of Jun-9th increased by PKR 548.966 billion as compared to an increase of PKR 390.784 billion for the previous year. This increase is reflected in the increase in NFA of the banking system; NFA increased by PKR 159.297 billion as compared to an increase of 20.879 billion witnessed in the previous year (Figure1).

Within the banking system, the growth in NFA stemmed primarily from scheduled banks where most of the private sector foreign exchange flows were directed.

With high growth prospects for the coming year, the expansion in NFA of the banking system is expected to continue apace though the magnitude remains uncertain.

Figure 1: Profile of Monetary Assets


	Credit Plan 2006-07	Stocks		Monetary Impact During	
		30-Jun-06	30-Jun-05	1st July 06 to 09-Jun-07 ^P	1st July 05 to 10-Jun-06
1. Net Government Sector Borrowing (a+b+c)	130,100	843,281	752,515	164,753	128,852
a. Borrowing for Budgetary Support	120,100	717,632	646,682	172,991	117,402
(i) From SBP		403,566	268,474	-23,278	112,322
(ii) From Scheduled banks		314,066	378,208	196,269	5,081
b. Commodity operations	10,000	107,762	87,836	-8,047	11,424
c. Others	0	17,887	17,997	-191	26
2. Credit to Non-Government Sector (d+e+f)	395,000	2,190,769	1,782,368	292,206	335,123
d. Credit to Private Sector (i-ii)	390,000	2,113,890	1,712,093	279,134	333,725
i. Commercial Banks		2,018,961	1,601,550	277,870	349,904
ii. Specialised Banks		94,928	110,543	1,264	-16,178
e. Credit to Public Sectors Enterprises (PSEs) (iii+iv+v)	5,000	60,991	53,348	12,715	2,663
iii. WAPDA, KESC, OGDC, PTC, PIA & Pak Steel		36,979	32,224	13,444	3,318
iv. Others		47,237	44,838	-502	-1,164
v. PSEs Special Account-Debt Repayment with SBP		-23,225	-23,714	-228	509
f. Other Financial Institutions (SBP credit to NBFIs)	0	15,889	16,927	358	-1,266
3. Other Items (net)	-75,000	-305,979	-205,470	-67,290	-94,070
4. Net domestic assets of the banking system	450,100	2,728,071	2,329,414	389,669	369,905
5. Net Foreign assets of the banking system	9,800	688,429	636,939	159,297	20,879
6. Monetary Assets (M2)	459,900	3,416,500	2,966,352	548,966	390,784
(Growth)	(13.46%)			(16.07%)	(13.17%)

Source: SBP

The Bigger Challenge

In the wake of high inflation and reserve money growth pressures downplaying effectiveness of the monetary policy, SBP's task of maintaining a balance between sustaining strong economic growth and stabilizing prices has become all the more difficult.

The recent trend of reserve money growth which primarily resulted from excessive refinancing facilities provided to the textile sector and increased foreign inflows is likely to continue apace. This is because a) we expect greater disbursements under refinancing facilities to the textile sector in the coming year because now the entire spinning sector has been listed as a recipient and b) we foresee foreign inflows rising and subsequently adding to the NFA of the scheduled banks. In addition to this we may also see the



government borrowing from the SBP to finance its deficit if the fiscal pressures increase. This will further add to the M2 expansion.


This surge in M2 expansion is a more challenging development given that this has the potential to cause resurgence in excess demand pressures in the economy. During the current fiscal year the money supply growth despite a decrease in private sector credit off take (due to high interest rates and increased budgetary borrowings), lead to an increase in liquidity within the banking sector. The increased liquidity in the banking sector exerts a downward pressure on the interest rates as visible in the recent declining trend of the 6M KIBOR. The 6 M KIBOR fell from average monthly rate of 10.55% in Jan to an average of 10.03% in June (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. Before interest rates fall enough to stimulate private sector credit expansion once again, increasing the demand and subsequently inflationary pressures, the SBP will have to speed its sterilization of foreign inflows. Moreover, excess demand pressures will also come from an increase in minimum wage level and government salaries.

Hitherto the tight monetary stance of the SBP was successful in reducing demand pull inflationary pressures effectively, as reflected in the declining core inflation and the rather slow private sector credit growth. However in the coming year the possibility of the resurgence of demand pull inflationary pressures is high. In addition to this, fluctuating food prices and the rising international food and oil prices, which though are not directly controlled by monetary tools, will also continue to reinforce these inflationary pressures.

Crystal Ball: What does it say?

In the middle of FY07, when general inflation dipped to 6.6% as a result of decline witnessed in both food and non food inflation(8.7% and 5.2%), we were amongst those several who expected the SBP to loosen its monetary stance. However for reasons argued through the course of this report, we have changed our stance now. We expect the SBP to either retain its tight stance on monetary policy by keeping the base interest rate at 9.5% or increase it marginally in order to control for not only any potential demand pull inflationary pressures but to prevent inflationary expectations from being built up as a result of rising food prices.

On the other hand, we expect the SBP to increase the reserve requirements for all commercial banks. Currently the average weekly cash reserve requirement (CRR) for time and demand liabilities is at 3% and 7% respectively while the statutory liquidity requirement (SLR) is at 18%. Since an increase in the SLR is not likely to have an impact as many scheduled already hold government securities at more than the required level of 18%, what we foresee is an increase in the CRR. The increased CRR will help SBP in its



sterilization of foreign inflows, thereby reducing level of liquidity within the banking system and containing the downward pressure on interest rates. The CRR is in fact one of the most effective tools available to the SBP for addressing the shrinking gap between the T-bills and KIBOR.



Economic Snapshot

Fiscal year 06-07														
	Units	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May
<u>Inflation</u>														
Headline Inflation	%	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4
Core inflation	%	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7
Food inflation	%	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3
Non-food inflation	%	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69
6 month	%	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9
12 month	%	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10
<u>External Sector</u>														
Export	Mln US\$	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	1536	1446	1534
Import	Mln US\$	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	2070	2159	2275
Trade balance	Mln US\$	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(741)
<u>Remittances</u>	Mln US\$	507	464	376	435	422	410	448	475	391	457	520	513	537
<u>Forex Reserves</u>	Mln US\$	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778



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