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A New Shock Therapy

The State Bank of Pakistan (SBP) released the Monetary Policy Statement for the first half of the new fiscal year on 31st Jul-07, further tightening its monetary stance by raising the policy discount rate to 10% while stating the risk of resurgent inflationary pressures emanating from high monetary growth as the biggest challenge facing the Bank. Thus the new monetary policy framework aims to primarily address the key stimulants of reserve money growth.

This report will analyze the key measures taken by the State Bank in its new Monetary Policy to curtail monetary expansion and thereby demand pull inflationary pressures, and their subsequent impact on the economy as a whole.

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Lights, Camera, Action!

In line with the new monetary policy framework, assuming real GDP growth target of 7.2 percent and inflation target of 6.5 percent, broad money supply growth should be 13.7 percent for FY08.

*Monetary Policy Statement
31st July, 2007*

The State Bank of Pakistan (SBP) released the Monetary Policy Statement for the first half of the new fiscal year on 31st Jul-07. Under its new policy regime, the SBP has targeted a broad money supply growth of 13.7% for the year while assuming a real GDP growth target of 7.2% and inflation target of 6.5%.

Citing the risk of resurgent inflationary pressures emanating from high monetary growth as the biggest challenge facing the central bank, the SBP under its new policy framework aims to address the two key stimulants of reserve money growth; the rising Net Foreign Assets on account of increased foreign inflows and the rising Net Domestic Assets on account of increased budgetary borrowings and refinancing activity.

Hence in order to meet its targets, the SBP has further tightened its monetary stance by raising the policy discount rate by 50 bps to 10%. In addition to this, it has restructured the Export Refinancing Scheme (EFS) whereby the commercial banks will provide 30% of EFS at the existing rate of 7.5% from their own resources. The SBP has also suggested a quarterly ceiling on budgetary borrowing with a greater focus on long term debt.


Tightening the Reign

Effective from 1st August 2007 State Bank of Pakistan SBP will raise policy discount rate from 9.5 percent to 10 percent.

*Monetary Policy Statement
31st July, 2007.*

In the beginning of the previous fiscal year, FY07, the SBP assumed a tight monetary stance; the policy discount rate was raised to 9.5% while the CRR on demand liabilities and SLR for all scheduled banks were raised to 7% and 18% respectively. Although the monetary tightening was able to bring core inflation down to 5.1% as compared to the 6.3% level recorded in the previous year, CPI inflation remained high at 7.8% against the year end target of 6.5%.

The high CPI inflation despite a sharp decline in non food inflation was rather a result of volatility in food prices which in turn is a consequence of supply inefficiencies. Hence




monetary tightening has little to do with controlling food inflation; it instead holds the demand pull inflationary pressures down and therefore keeps non food inflation low. Thus a hike in interest rate by the SBP reflects the central bank's concern to prevent any resurgence of demand pull inflationary pressures and thereby avoid any rise in core inflation.

As mentioned earlier, the SBP cited the risk of resurgent inflationary pressures from high monetary growth as one of the biggest challenges facing the economy. Increased government borrowings from the central bank, strong growth in Net Foreign Assets on account of increased foreign inflows, and a high demand for refinance facilities contributed to a 19.3% growth in M2 during FY07 against the year end target of 13.5%. This surge in liquidity translated into a 20.9% year on year growth in reserve money which represents a more challenging development as it has the potential to cause resurgence in excess demand pressures in the economy. Now with the increase in interest rates we expect excess demand pressures to be curbed. We may witness a further slowdown in the private sector credit take off, depending on the extent to which the banks will revise their lending rates upward as a reaction to the hike. Subsequently core inflation numbers will remain intact for the new fiscal year and the CPI inflation may also decline, more so if the rate hike is complemented with improvement in supply inefficiencies.

On the other hand the impact on KIBOR depends on the degree to which the central bank is able to manage the liquidity within the banking system. We may not see any significant upward movement in the KIBOR if liquidity persists on the back of rising foreign inflows and increased budgetary borrowings. This is because KIBOR is determined more by the liquidity than by the policy discount rate. Since the beginning of 2007 KIBOR has declined significantly due to the rising liquidity within the system; the 6 M KIBOR fell from average monthly rate of 10.55% in Jan to an average of 9.97% in Jul.

Though as an immediate reaction to the rate hike we saw the KIBOR climb by approximately 30 bps in the days that followed, we believe that this sudden hike was psychological in essence. KIBOR may again assume its downtrend if the SBP does not take more aggressive measures to manage the liquidity in the banking system.

However one such measure or rather a result of a rate hike is already visible. In the T-bill auction held by the SBP immediately after the release of its Monetary Policy Statement, we saw an upward revision in the T-bill rates. The cut off yield for 6M bill was raised by 20bps to 9.09% while for 12M bill was raised by 23 bps to 9.39%. The upward revision of the T-bill rates will fuel additional participation of commercial banks in the T-bill auctions and will subsequently absorb the liquidity in the system. Under these circumstances we may then see the KIBOR rise, and this time out of no psychological reactions.



Besides a hike in discount rate, the SBP has introduced additional measures which are particularly aimed at curtailing monetary expansion and thereby liquidity within the banking system. In the following pages we will be analyzing these key measures and their subsequent impact on the economy as a whole.

Stretching the lengths

Zero rating of Cash Reserve Requirement (CRR) for all deposits of one-year and above maturity (to encourage greater resource mobilization of longer tenor) and 7 percent CRR for other demand and time liabilities.

*Monetary Policy Statement
31st July, 2007.*

In the recent past the SBP has made substantial efforts to encourage growth in longer term deposits by granting various incentives to the commercial banks to seek longer tenor deposits. In its new monetary policy the SBP has reduced CRR on all deposits of one year and above maturity to zero rating from previous requirement of 3%. At the same time it has increased CRR for other demand and time liabilities by 4% to 7%. This move is likely to prompt the commercial banks to run for longer tenor deposits relative to short term deposits. This in turn will result in higher longer tenor deposit rates. Besides affecting the deposit rates, this measure will also impact the liquidity within the banking system only marginally.


The zero rating CRR on deposits of one year and above maturity will not result in any significant surge in liquidity as only 11.6% of the total banking deposits are held in tenors of 1 Year and above. On the other hand the increase in CRR of 4% for other demand and time liabilities will absorb approximately PKR 5.6 billion. The net impact will be therefore a surge of PKR 4.5-5 billion in the banking system. .

Domestic Debt Management

SBP has recommended to the Government that for FY08 it would be prudent to (i) retire borrowings from SBP by Rs 62.3 billion, (ii) adopt quarterly ceilings on budget borrowings from SBP, and (iii) adopt a more balanced domestic debt strategy whereby the budget deficit is financed from long-term financing sources (that are relatively less inflationary).

*Monetary Policy Statement
31st July, 2007.*

Higher fiscal pressures during the year resulted in increased government borrowings. With limited options available for external borrowings, budgetary borrowings primarily constituted borrowings from domestic sources; the central bank and the commercial



banks. 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.

In the first half of FY07 the government particularly resorted to finance its deficit through borrowings from the SBP. Borrowing from the central bank necessarily implies creation of new money and therefore results in monetary expansion, thereby building demand pull inflationary pressures. Hence in order to contain monetary/inflationary pressures it is imperative to reduce the government borrowing from the central bank. In view of these risks, the SBP in its new Monetary Policy Statement has suggested a more balanced approach for domestic debt management. It not only recommended the government to retire borrowings worth PKR 62.3 billion from SBP but also suggested to the government to adopt quarterly ceilings on its borrowing from the central bank while funding the budget more from long term financing sources.

In effect, if the government does retire its borrowings from the central bank by the suggested amount and places quarterly ceilings on the amount borrowed, we are likely to witness a gradual slowdown in monetary expansion. In fact it must be noted that during FY07, particularly in the latter half of the year, the government retired borrowings worth PKR 38.584 billion with the SBP and resorted to finance its deficit by borrowing from the commercial banks. The government may continue this trend, in line with the SBP's recommendation.

However it must be noted that borrowing from commercial banks entails a significant cost in terms of reducing private investment. Increased government borrowing puts upward 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. Hence we will see increased government borrowings particularly from the scheduled banks and thereby a slower growth in private sector credit takeoff. However if the pressure increases further, the government may go against the SBP's recommendation and resort to finance its deficit by borrowing from SBP once again, stimulating growth in broad money supply.



Reorganizing the Export Refinancing Scheme

The export finance limits of banks for the year FY08 shall be fixed at the level of outstanding amounts as of 30th June, 2007. For ensuring phased transformation of export financing regime, SBP shall allow only 70 percent refinance against such; the balance 30 percent shall be funded by the banks out of their own resources.


The SBP is introducing a new Long Term Financing Facility (LTFF). Under this facility, the exporters can avail financing for fresh procurement of new imported and locally manufactured plant and machinery. The facility will be available to the export oriented projects with at least 50 percent of their sales constituting exports or if their annual exports are equivalent to US\$ 5 million, whichever is lower. SBP will provide refinance up to 70 percent of the sanctioned facility and the PFIs will finance 30 percent of LTFF from their own resources.

*Monetary Policy Statement
31st July, 2007.*

In the previous fiscal year we saw increased credit disbursement under EFS (Export Refinance Scheme) and LTF-EOP (Long Term Financing for Export Oriented Projects). Under these schemes the SBP provides export credit to industrial centers through commercial banks at subsidized rates. In the first ten months of FY07, total gross disbursement from refinancing facility allowed to banks under EFS and LTF-EOP for the textile sector alone was estimated to be Rs.328 billion of which EFS flows were Rs.284 billion. What is critical is the impact of refinancing facilities on the money supply.

Credit disbursement under refinancing facilities by the central bank, which necessarily implies creation of new money, stimulates growth of high-powered money. For example an increase of PKR 43.8 billion witnessed in refinancing (LTF-EOP) during Jul-06 to Apr-07 emanated from a corresponding creation of new money. Keeping this in view, SBP has reorganized the structure of EFS whereby the SBP will fund only 70% of the export financing requirements; the remaining 30% will be provided by the commercial banks from their own resources and therefore will not constitute money creation. However no amendments have been made to the lending and the refinance rates. The refinance rate to banks will remain below the benchmark 6M T-bill rate and the lending rate to exporters will not exceed 7.5%. Thus export oriented industries, like the textile industry, will not be impacted significantly.

On the other hand this restructuring of EFS will have a direct impact on the money supply; it is likely to absorb approximately PKR 45 billion of the excess liquidity within the banking system. In addition to this, the fact that under the new structure of EFS commercial banks will have to provide export credit off their own funds, we are likely to witness a rise in the advance to deposit ratios of the commercial banks. This in turn would mean increased competition between the commercial banks for raising additional deposits to facilitate the growth in advances; the deposit rates may thus rise putting a



downward pressure on the banking spreads. However one must not forget that this restructuring comes along with a 50bps hike in the discount rate and as an immediate reaction the banks may revise their lending rates upward. Hence initially the banking spread may widen instead. Nevertheless in the medium to longer term we expect the banking spreads to narrow slightly because the deposit rates will climb sooner or later relative to the lending rates as banks will seek to mobilize more time deposits.

Besides restructuring the EFS, the SBP has introduced a new refinancing scheme, the Long Term Financing Facility (LTFF) under which the exporters can avail financing for fresh procurement of new imported and locally manufactured plant and machinery. Though this scheme will have a similar structure (70% refinancing provided by the SBP and 30% by commercial banks) it will dilute the monetary impact of reorganization of EFS as it will nevertheless mean increased credit disbursement. Hence the additional liquidity expected to be mopped up by the revised scheme may be less than the estimate of PKR 45 billion.

The Challenges Within

Though the new monetary policy is aimed at curtailing the monetary expansion within the economy and thereby controlling for the demand pull inflationary pressures, the SBP is likely to face severe challenges in meeting its targets in the times to come. Therefore it is rather impossible to analyze the full economic impact of the new policy measures. Rising international oil and food prices will continue to exert pressure on the CPI while Strong economic performance and high interest rates will continue to attract foreign capital inflows, adding to the NFA and thereby M2 growth. The expansionary government expenditure (for e.g. rise in government salaries and minimum wage) will push aggregate demand upwards igniting demand pull inflationary pressures while also creating the need for increased budgetary borrowings.

Hence in the coming months the tight monetary stance will be effective only if it is complemented with improvement in supply inefficiencies to contain food price volatility and aggressive measures by SBP to curtail liquidity.



Economic Snapshot

Fiscal year 06-07														
Units	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	
<u>Inflation</u>														
Headline Inflation	%	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0
Core inflation	%	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1
Food inflation	%	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7
Non-food inflation	%	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69
6 month	%	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9
12 month	%	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16
<u>External Sector</u>														
Export	Mln US\$	1,533	1,334	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583
Import	Mln US\$	2,685	2,383	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373
Trade balance	Mln US\$	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)
<u>Remittances</u>	Mln US\$	464	376	435	422	410	448	475	391	457	520	513	537	505
<u>Forex Reserves</u>	Mln US\$	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182



Research Desk

Treasury and FX Group

MCB BANK LIMITED

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 111-000-111 Ext: 4420

0333-3800744

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

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