MCB Bank Limited

Treasury & Investment Banking Group

# *Quid Pro Quo*

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## THE GREEDY, THE BAD & THE UGLY

In its 2nd quarterly report, the SBP has projected GDP growth in the range 6.0% - 6.5% against the year end target of 7.2%, pointing out the outcome of *kharif* harvests and the deceleration in LSM growth, particularly after the events of Dec 07, as the primary drag on the year's growth. Meanwhile strong performance of the services sector is expected to lend support to the economy.

However the growing macroeconomic imbalances - the widening fiscal and current account deficit- and rising inflation pose the biggest challenge to the economy today. This report will lay out in detail the challenges currently facing the economy while critically analyzing the economic performance for the first eight months of FY08.

## FISCAL DEVELOPMENTS

"Too often in recent history liberal governments have been wrecked on rocks of loose fiscal policy"

Franklin D. Roosevelt

A sound fiscal position is a vital qualification for achieving macroeconomic stability. Cautious fiscal management can mobilize domestic savings, enhance resource allocation and help achieve development goals. Conversely a lax fiscal policy, can lead to higher inflation, higher interest rates and crowding out of private investment, all of which obstructs growth and poverty reduction.

### Federal Budget FY 2007-08

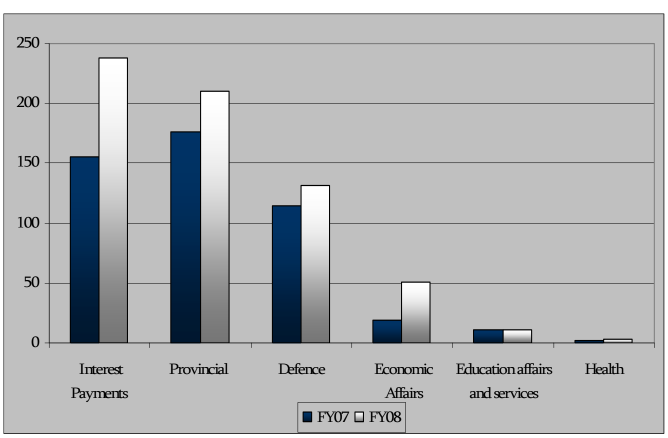
The FY08 budget, with a total outlay of **Rs.1.874 tr**, envisaged a revenue target of Rs.**1.48 tr** including a tax collection target of Rs.1.025 tr and subsequently a fiscal deficit of **Rs.398 bn** or **4% of GDP**. The budget outlay of Rs.1.874 tr was up 19.8% relative to the previous year's outlay of Rs.1.565 tr while the government had set the tax collection target 49% above the last year's target. Taking the cue from its predecessor, the FY08 budget continued to prioritize Public Sector Development Projects (PSDP) allocations as it proposed worth Rs.520 bn allocations for PSDP as compared Rs.435 bn allocated in the previous year, FY07.

All key fiscal indicators have deteriorated during the first half of FY08. Revenue growth has been slow failing to keep up with the sharp rise in expenditures: Total revenue collections have posted a meager year on year growth of 1.8% while expenditures have increased by over 25%. As a result fiscal imbalance has surged, with the deficit reaching a five year high at Rs.356.3 bn or 3.6% of GDP for the 1H-FY08, much higher than the fiscal deficit of 1.9% of GDP recorded for the same period last year. This is only Rs.41.7 bn or 10% short of the full year target.

### Expenditures

Total government expenditures for 1HFY08 have posted a year on year growth of 25.3% to Rs.981.9bn. Both current and development expenditure recorded significant increases.

Figure 1: Composition of Current Expenditure
Billion Rs.




Current expenditure constituted over 75% of the total expenditures incurred, amounting to Rs.775.1 bn against expenditure of Rs.581.4 bn noted for the previous year.

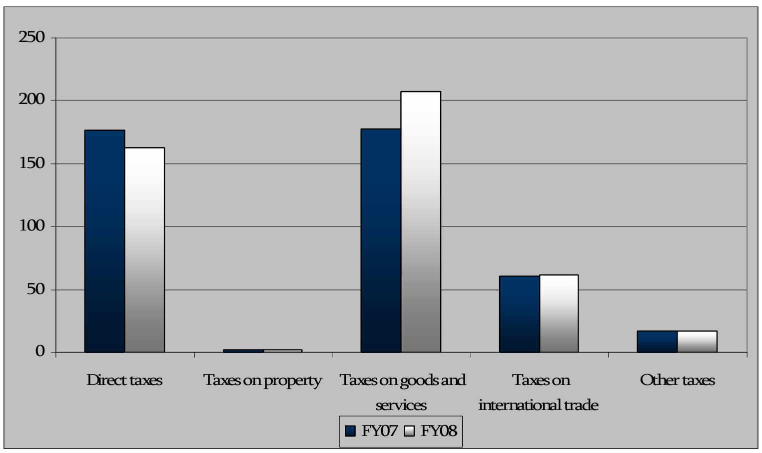
Interest payments, provincial, defense and economic affairs expenditure recorded strong year on year growth.

Expenditure on economic affairs touched Rs.50.9 bn growing by 174% while interest payments increased by over 50% Rs.237.7 bn. Expenditure on education and health services remained almost unchanged over the previous year. Development expenditures increased by over 15% reaching Rs.225.8 bn or 2.3% of GDP against 1.7% last year. As opposed to the provincial government, the federal government accounted for a larger share of development spending.

## Revenues

The poor growth in revenue receipts resulted from slow growth of 4% in tax revenues and a decline of 3.6% in non tax revenues.

Figure 2: Composition of Tax Receipts
Billion Rs.

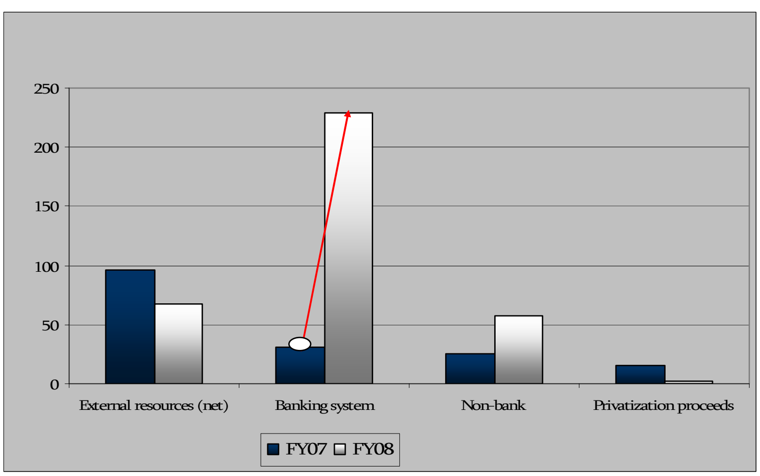



Within the tax receipts, direct tax collection declined by Rs.13.8 bn as the largest contributor of this segment – the corporate sector, reported low profitability. In the non tax receipts the rise in SBP profits and interest income was more than offset by a significant decline is defense and surcharge receipts on oil and petroleum.

## Bridging the GAP

As the expenditure revenue gap continued to widen, the government turned to domestic sources of budgetary financing as support from external resources declined in the 1HFY08 by almost 30%.

Figure 3: Sources of Budgetary Financing
Billion Rs.




Within the domestic resources, the government sourced 80% of its borrowings from the banking system while the remaining came from privatization proceeds and non banking resources. In the wake of growing political uncertainties, privatization proceeds were delayed while financing from non banking sources increased by 129.2% over the previous year due to improved performance of the NSS (National Saving Scheme) instruments. On the other hand the other non bank resources, PIB and T bills witnessed a decline in their receipts.

On a year on year basis, budgetary financing from the banking system recorded a growth of 625.7% from Rs.31.5 bn in 1HFY07 to Rs.228.6 bn this year. In the banking system the commercial banks provided only 14% of total budgetary financing, meaning major portion was sourced directly from the SBP. This is in direct contravention of SBP's directives given in its early Monetary Policy Statement in Aug 07 where the government was advised to shift the bulk of its debt financing towards the banking sector and instead retire borrowings from the SBP by Rs.62.3 bn during FY08. For government borrowings from the central bank are the most inflationary form of financing the deficit.

The widening fiscal deficit has thus more complex implications than widely comprehended. Sharp increases in government expenditure have stimulated aggregate demand pressures while government borrowings sourced directly from the central bank have resulted in growth of monetary aggregates

## EXTERNAL ACCOUNT

"Nothing, however, can be more absurd than this whole doctrine of the balance of trade."

Adam Smith

The key challenge facing the country's external account is the widening current account deficit. Alongside decline in the financial and capital account balance added further pressure to the country's overall external account. As a result the rupee failed to hold against US dollar, depreciating by 3.5% during the first eight months of FY08 against a depreciation of 0.8% recorded for the corresponding period of the previous year. This is the highest depreciation that the country has witnessed in over two years.

### Current Account

The current account deficit widened for the fourth consecutive year touching USD 7.5 billion for Jul-Jan period of FY08 against a deficit of USD 5.1 billion in the same period last year. Worsening in current account deficit was primarily driven by a widening trade deficit, services deficit and decline in net incomes.

The trade deficit recorded a growth of 25% over the previous year, reaching USD 7.8 billion. Imports surged sharply as the petroleum imports grew on the back of increased demand and rising international oil prices. Alongside imports of wheat in presence of prevailing wheat crisis, and fertilizers increased substantially. Export growth remained weak as industries suffered at the hands of a severe power crisis. Global economic slowdown resulted in decreased demand for exports while political uncertainty and strong regional competition in textile exports further added to deceleration of exports. It must be noted that textile items form a major share of the country's total exports and therefore any fall in textile export growth will substantially suppress the by and large export growth. For the Jul-Jan period textile exports recorded a fall. This decline was mainly a result of disruption in the economic activity in Dec

FY08. Nevertheless excluding this month the textile exports posted a meager growth of only 0.6% during the period under review.

In tandem with the trade deficit for goods, the services account deficit worsened primarily due to delay in the receipts of logistic support. Investment income outflows also surged driven mainly by higher repatriation of profit and dividends on FDI particularly in the thermal power, telecommunication, oil and gas exploration, and financial business sectors.

Overall, decline in trade deficit for goods and services and net incomes overshadowed the strong growth in worker's remittances. Remittances witnessed a growth of 22.4% percent during period under review while remaining higher than the corresponding months of FY07 through the entire Jul-Jan period of FY08.

## Financial Account

The financial account surplus declined during Jul-Jan FY08 by a small level of 2% or USD 95 mn over the previous year, reaching USD 4.5 bn. The fall resulted from a substantial decline of USD 1.4 bn in portfolio investment. Substantial outflows from the equity markets in the wake of increased political uncertainty and delays in GDRs due to global financial turmoil accounted for the decline in portfolio investment. A rise in FE 25 NOSTROS and short term loans at least partially alleviated the impact of these outflows on net portfolio investment.

On the other hand FDI witnessed a growth of 9.6% during the period. This however was significantly lower than the extraordinary growth of 68.5% witnessed in the same period of the previous year. FDI inflows were concentrated in oil producing sectors and well as telecommunications and financial sectors.

A source of concern in the rapidly changing composition of net financial inflows as witnessed during this period compared to the previous two years. The inflows were mainly in form of debt creating inflows reflecting the country's increased reliance on short term debt, in contrast to the capital inflows in the previous years which resulted from equity securities and concessional debt.

## Foreign Exchange Reserves

The country's foreign exchange reserves after reaching a peak in Oct FY08 at USD 16.5 bn have declined to USD 14.1 bn by end of Feb 08. The depletion in the country's foreign exchange reserves since Nov mirrors the adverse political and economic scenario of the country. It is almost entirely reflective of the sharp increase in the current account deficit as the decline in the financial account surplus was very small. Nevertheless even at the current levels, the reserves are higher that the average level of foreign exchange reserves recorded in FY07.

## MONETARY DEVELOPMENTS

"We make money the old fashioned way. We print it"
Art Rolnick – Former Chief Economist, Minneapolis Federal Reserve Bank

**Monetary Policy Framework FY 2007-08**

The Monetary Policy Statement released on 1st Aug 07 for the 1HFY08 envisaged M2 growth of 13.7% for the year in line with GDP growth target of 7.2% while aiming to keep inflation at 6.5%.

The broad monetary aggregate (M2) has posted a year on year growth of approximately 15% for the period 1st Jul -22nd Mar FY08. As of 22nd Mar 08, M2 aggregate is recorded at Rs.4341.399bn compared to a stock of Rs.3753.285bn in the corresponding period of the previous year.

Changes in the broad monetary aggregate are determined by the Net Foreign Assets (NFA) and the Net Domestic Assets (NDA) of the Banking System.

During the period under review the NFA contracted owing to a couple of factors including rising political uncertainty which led to outflows of foreign assets from the country and delays in the privatization proceeds. Alongside a global economic slowdown following the US subprime mortgage crisis coupled with a domestic power crisis caused the export performance to deteriorate while growing pressures on international commodity prices further exacerbated the whole scenario. On the whole the decline in NFA reflected weaknesses in country's external account, in turn having a negative impact on the monetary aggregates worth Rs.253 bn. This is in sharp contrast to what happened in the previous year when increased foreign inflows resulted in a surge in the NFA of the banking system, stimulating strong monetary expansion. For the same period last year the NFA recorded a growth of Rs.64.754 bn.

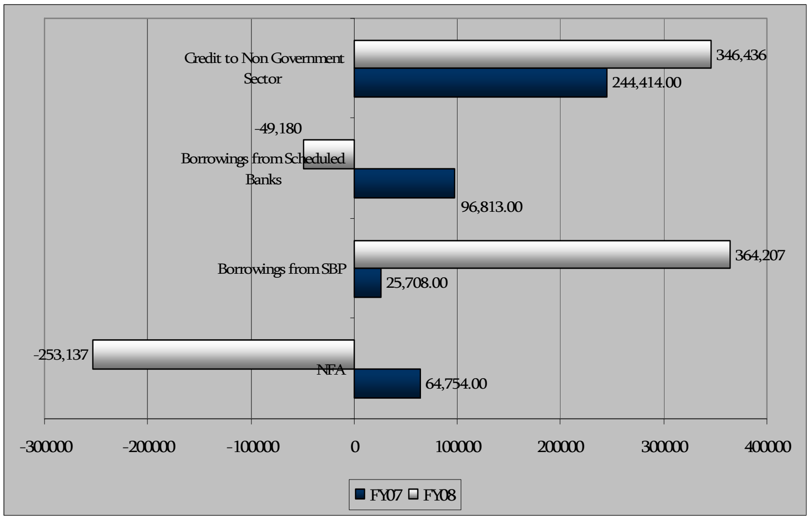
This year, however the Monetary Policy Framework has faced severe challenges due to a growth in NDA of the banking system which has more than offset the impact of the decline in NFA on monetary aggregates.[1] The total NDA surged by Rs.529.382 bn or 17.19% for the period 1st Jul-22nd Mar 08 against an expansion of 10.37% recorded for the previous year.

Within the NDA the strongest impact on monetary expansion has come from the phenomenal increase in government borrowings from the central bank for budgetary support.

Figure 4 depicts that the major driving force behind the high annualized M2 growth has been the increased budgetary borrowings made from the SBP. Budgetary financing from the central bank during this period had an impact of Rs.364.207 bn on M2 aggregate against an impact of Rs.25.708 bn recorded for the same period last year.

[1] NDA of the Banking System = Net Government Sector Borrowings + Credit to Non-Government Sector + Other items (net)

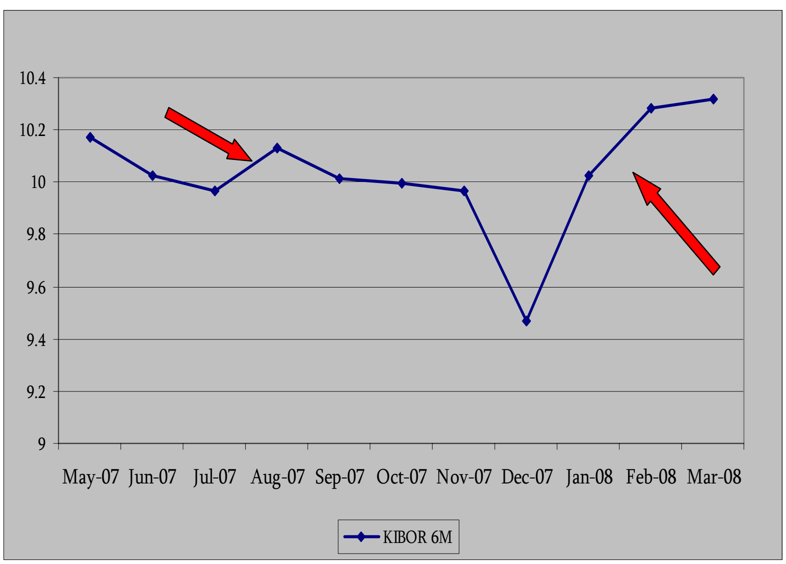
Figure 4: Factors Affecting Broad Money (M2) –Monetary Impact as of 22nd March 08
Million Rs




Increased budgetary borrowings from the central bank have also made liquidity management by the SBP difficult as reflected in frequent fluctuations of overnight rates, while unanticipated liquidity injections from government borrowings have softened the KIBOR, weakening the transmission of the policy discount rate hike by 50 bps first in Aug 07 and again in Jan 08.

Movements in KIBOR are determined more by the extent to which the SBP manages liquidity in the markets than by the discount rate. Any immediate impact on KIBOR of a discount rate hike is rather a psychological phenomenon and therefore short lived.

Figure 5: Trends in 6-Month KIBOR
(%)




As an immediate impact of a discount rate hike to 10% in Aug 07, KIBOR jumped immediately. The 6-M KIBOR increased from 9.97% in Jul to 10.13 in Aug but began to decline in the months that followed, reaching 9.4% in Dec.

Similarly after the discount rate was further raised to 10.5% in Jan 08, KIBOR jumped in Feb but has again been showing signs of softening.

Increased credit to the Non Government sector has also contributed towards current monetary expansion. Credit to non government sector surged by Rs.346.436 bn as opposed to Rs.244.414 bn noted in the previous year. Off the non government sector, the credit expansion came almost entirely from private sector credit expansion which surged by Rs.320 bn. The increase in demand for private sector credit is said to be at least to some extent a result of a surge in prices of raw materials in domestic as well as international markets. This is reflected in the rise in demand for working capital loans by most industries like cement, construction, rice processing and edible. On the other hand demand for fixed investment loans moderated. This however may not be looked upon as an indication of an economic slowdown. Instead decline in demand for fixed investment loans is a result of other financing alternatives available to the expanding industries. These include foreign investment, foreign currency loans and flotation of debt instruments in the domestic markets.

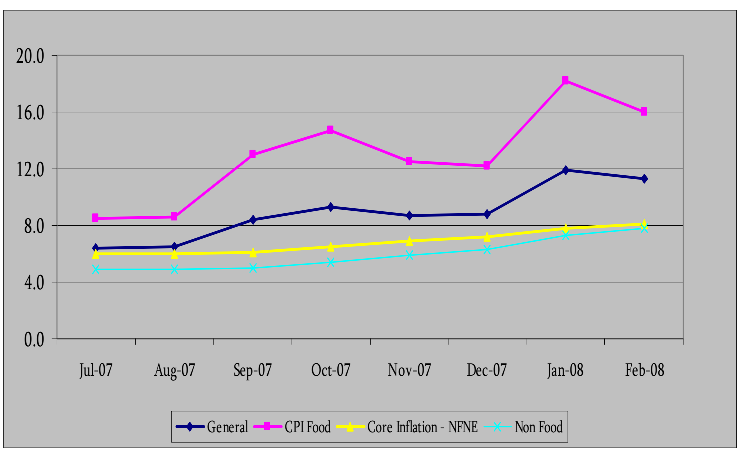
## PRICES

*Inflation is like sin; every government denounces it and every government practices it.*
Sir Frederick Leith-Ross, Observer 1957

Despite SBP's tight monetary stance, inflationary pressures in FY08 have persisted, rising sharply particularly in the latter months of the year.

Most distressing has been food inflation which has surged on the back of sustained increases in food and energy prices in the international markets and supply disruptions and market inefficiencies in the domestic markets. Global food inflation has largely been a result of weather fluctuations and increased production of bio fuels in the wake of rising energy prices.

Figure 5: CPI General, CPI Food and Core Inflation Measures
(%)




Food inflation has remained in double digits since Sept 07, peaking at 18.2% in Jan; the highest level since Apr 95. Food inflation for the first eight months was recorded at 13%.

Alongside non food inflation has also increased over the months reaching 7.8% in Feb from 4.9% in Jul 07. The rise in non food inflation has been due to an increase in non-food sub-groups including house rent, fuel and lighting and household furniture and equipment. It must be noted that this recent rise in non food inflation was despite the government's freeze on prices of key POL products as it was not until March that the government adjusted the prices of these commodities upward.

Thus as a result of stubbornly high food inflation coupled with rising non food inflation, general CPI remained strong. CPI inflation rose to 11.3% in Feb 08 from 7.0% in Jun 07.

Core inflation has also been rising consistently and has touched a 27 month high at 8.1% in Feb. Rise in core inflation numbers can be traced to the fact that since prices of a broader range of CPI basket is now being affected by the cost push of high commodity prices the suppliers of goods and services have increased their prices to protect margins. This in fact represents the second round effects of cost push inflation.

## ECONOMIC OUTLOOK

In line with the review of the country's economic performance for the first eight months of FY08, based on SBP's 2nd Quarterly Report, we project a GDP growth rate of 6.0%. Though a 6.0% growth rate reflects that the growth momentum of the past five years shall persist, it is much lower than the year end target of 7.2%.

General inflation will also exceed its target substantially and we expect it to remain in the 9.0-9.5% range. Food inflation will remain high as global food prices continue to rise and supply inefficiencies mark the domestic markets. Prices of key staples like wheat, rice and milk have not shown any signs of softening. With an upward adjustment in key POL product prices followed in March the non food inflation as well as food inflation will worsen. In the light of these developments the SBP has recommended the government to restructure the targeted food subsidy program for low income groups and has called for private sector's participation. In order to contain food prices what is most critical for the government is to ensure domestic supply. This in turn would require strong fiscal and administrative measures. Rising core inflation is indicative of cost push inflationary pressures already generating second round inflationary cycle.

In terms of macroeconomic imbalances we do not expect any miraculous rebound.

The fiscal deficit is likely to be at 5.5% of GDP, given that it has already reached 90% of its year end target of 4.2% of GDP in the 1HFY08. In the coming months the tax receipts will remain low on account of slow industrial growth in the wake of ongoing power crisis and rising input costs while non tax revenue may increase as aid inflows are expected to cover the widening deficit. On the expenditure side, with the government intending to rationalize its PSDP allocations by delaying the projects in the pipeline for 2HFY08 into FY09, development expenditures may subside. Current expenditure will however remain high as the government will continue to provide subsidy on energy prices which have been rising in the international markets. In a meeting of Economic Coordination Committee on 8th Apr, the Finance Minister clearly indicated that any withdrawals in energy subsidy will be staggered and not sudden. An increase in debt servicing and probable increases in defense spending in view of current law and order scenario in the country will further increase current expenditures. Due to the widening expenditure revenue gap the government will continue to borrow from the central bank, spurring further monetary expansion.

The widening current account deficit is not likely to show any drastic improvements unless the prices of imported commodities soften. Exports will remain weak on account of global economic slowdown and weak performance of domestic industries. Meanwhile, with the advent of democracy and whole political scenario improving, we may see a surge in foreign inflows. This will certainly lend support to the country's external account.

All in all, we feel that the two issues which will need immediate attention of the new government are sustained increases in food prices and a rising fiscal deficit. It is very crucial that the government make an effort to contain the fiscal deficit target as this would send a strong signal of the government's commitment to fiscal discipline and macroeconomic stability on the global front including the international rating agencies. Any corrective measures aimed at containing the fiscal deficit will automatically cool the price rise as well.

Lastly, we would like to point out that long term prospects will depend upon the interaction of evolution in political and social developments, economic policies to be pursued by the new ministry, the quality of governance and institutions, and investment in the human capital. Sustained economic growth and poverty reduction, thus, cannot take place merely on the strength of economic policies. Political stability, supporting institutions, and good governance are equally important ingredients coupled with both external environments for achieving economic success.

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## Economic Snapshot

| | Units | Feb | March | April | May | June | July | Aug | Sep | Oct | Nov | Dec | Jan | Feb |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fiscal year 07-08** | | | | | | | | | | | | | | |
| Inflation | | | | | | | | | | | | | | |
| Headline Inflatior | % | 7.39 | 7.67 | 6.9 | 7.4 | 7.0 | 6.4 | 6.5 | 8.4 | 9.3 | 8.7 | 8.8 | 11.9 | 11.3 |
| Core inflation | % | 5.72 | 5.42 | 5.2 | 4.7 | 5.1 | 6.0 | 6.0 | 6.1 | 6.5 | 6.9 | 7.2 | 7.8 | 8.1 |
| Food inflation | % | 9.99 | 10.74 | 9.4 | 11.3 | 9.7 | 8.5 | 8.6 | 13 | 14.7 | 12.5 | 12.2 | 18.2 | 16 |
| Non-food inflatioı | % | 5.59 | 5.54 | 5.2 | 4.7 | 5.1 | 4.9 | 4.9 | 5 | 5.4 | 5.9 | 6.3 | 7.3 | 7.8 |
| T-bill (Wgt Avg) | | | | | | | | | | | | | | |
| 3 month | % | 8.64 | 8.65 | 8.69 | 8.69 | 8.69 | 8.69 | 9.05 | 9.05 | 9.05 | 9.05 | 9.09 | 9.09 | 9.38 |
| 6 month | % | 8.81 | 8.82 | 8.9 | 8.9 | 8.9 | 8.9 | 9.12 | 9.12 | 9.12 | 9.21 | 9.29 | 9.29 | 9.61 |
| 12 month | % | 9.01 | 9.01 | 9.08 | 9.10 | 9.16 | 9.16 | 9.39 | 9.39 | 9.39 | 9.4 | 9.49 | 9.44 | 9.87 |
| External Sector | | | | | | | | | | | | | | |
| Export | Mln US$ | 1,421 | 1,536 | 1,446 | 1,540 | 1,583 | 1,434 | 1,475 | 1,463 | 1,593 | 1,524 | 1,500 | 1,642 | 1,625 |
| Import | Mln US$ | 2,103 | 2,070 | 2,159 | 2,190 | 2,373 | 2,423 | 2,206 | 2,150 | 2,555 | 2,864 | 2,910 | 3,271 | 2,856 |
| Trade balance | Mln US$ | (682) | (534) | (713) | (650) | (790) | (989) | (731) | (687) | (962) | (1340) | (1410) | (1637) | (1,231) |
| Remittances | Mln US$ | 457 | 520 | 513 | 537 | 505 | 495 | 489 | 516 | 580 | 505 | 479 | 557 | 502 |
| Forex Reserves | Mln US$ | 13,378 | 13,624 | 13,661 | 13,778 | 15,182 | 15,723 | 16,106 | 16,145 | 16,354 | 15,807 | 15,589 | 15,074 | n.a |

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