



MCB Bank Limited

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**Treasury & Investment Banking Group**

## *Quid Pro Quo*

### ECONOMIC REPORT

#### THE WAITING GAME

July 31st, 2008

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State Bank of Pakistan on 29<sup>th</sup> July 2008 announced the Monetary Policy for July-December 2008. Highlighting considerable external and internal pressures on the economy the Governor Dr. Shamshad Akhtar announced the following policy change:

- Discount rate hike by 100 bps to 13%

Core inflation for June 08 YoY was 13 % while headline inflation was 21.5% for the same period. The Governor urged the government to stop borrowing from the central bank and allow this policy to have an impact.

This paper will seek to identify the reasons for disagreement against monetary tightening that came prior to the announcement and why, in our opinion, the central bank's decision is in line with market conditions. It will then stress the importance of why monetary and fiscal policies need to work in tandem for controlling inflation. Finally, by not using its complete repertoire of policy actions, the State Bank has fired a stern warning at the government to give up its borrowing habit, otherwise harsher measures may be employed in the future.

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## SCORECARD FY08

- **Current Account Deficit Jul-May FY08:** USD 14.016 bn in against a deficit of USD 6.878 bn for FY07. This is equivalent to approximately 8.4% of GDP whereas 6% was targeted.
- **Trade Deficit** has increased to \$20.7bn for FY08 or approximately 12% of GDP.

**Exports: USD 19.22 bn** vs. USD 17.120 for Jul-May FY07

**Imports: USD 39.97 bn** vs. USD 26.614 for Jul-May FY07

- **M2 Money Supply** has swelled to 13.29% YoY for the week ended June 28<sup>th</sup>, adding to inflationary pressures.

**Massive government borrowings** are the main reason for this growth, which were PKR 583,805 bn in FY08.

**Private sector credit** has grown further from PKR 376.584 bn last month to PKR 408,427 in FY08 vs. PKR 365,718 in FY07.

- **CPI inflation** has skyrocketed to 12.0% for FY08 vs. 7.8% in FY07, where as food inflation averaged 17.6% vs. 10.3%

**Core inflation** rose to 8.4% in FY08 vs. 5.9% in FY07.

- **Foreign Direct Investment** was \$5.15 bn in FY08 vs \$5.12 bn in FY07.
- **Foreign exchange reserves** totaled \$10.728.4 billion week ended July 18,

Reserves held by SBP: \$7.777.8 bn

Reserves held by scheduled banks: \$2.950.6 bn

FX Reserves reached a record peak in Oct 07 at USD 16.486 bn

- **PKR** is trading at 70.90 bid / 71.10 offer
- **Kerb Rates** 70.70 bid / 71.20 offer
- **Home remittances** reached a record in FY08, reaching \$6.451 bn vs \$5.493 bn last FY.
- **T-Bill** cut-offs on 31<sup>st</sup> July were: 3 Month: 12.1688 % 6 Month: No bids 1 Year: Bids Rejected
- **KIBOR** average in July: 3-month: 13.83% 6-month: 14.10% 1-year: 14.46%
- **PIB**  
Market rate 5 Year Bond 14.50%  
Market rate 10 Year Bond 14.75%
- **Oil Price** closed at \$126.77 per barrel on July 30<sup>th</sup>  
The highest close was at \$145.29 on 3<sup>rd</sup> July



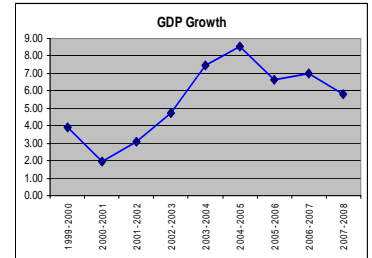
## SCORECARD

Concluding figures for the last fiscal year are here, but the scorecard is hardly encouraging. FY08 has not been a year to remember as Pakistan was marred by domestic turmoil and an international onslaught, which worked together to batter the economy. Current account deficit, trade deficit and inflation have all gone through the roof. These along with poor fiscal management were responsible for grinding economic growth down to 5.8%, whereas an ambitious 7.2% was targeted.

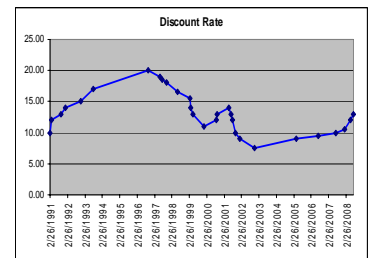
SBP's objective is to assist in bringing these broad economic indicators back in line. The Government of Pakistan (GOP) has been criticized for its role in the twin deficits and high inflation. Government borrowing from the State Bank rose meteorologically to PKR 688,724 bn in FY08, which increased M2 growth and fanned inflation. However, this was largely due to the decision to provide oil subsidies and cushion consumers from high international oil prices.

Prices of commodities went up around the world, it was not a phenomenon restricted only to Pakistan. Cost push inflation saw riots break out around the globe from Egypt to Brazil. Governments were blindsided and were ill prepared to face such a dramatic rise in prices of commodities. In our case and with other countries, the solution at the time was borrowing from the central bank to provide subsidies to the consumer. The result was detrimental if not catastrophic for the economy. It is important to understand that funds borrowed by the government essentially means the State Bank is printing more currency notes. This led to crowding out of credit available to the private sector therefore impacting its growth. In addition, utilizing this borrowing for providing subsidies and not development expenditure encouraged consumption and push prices upward.

### GDP Growth 2001-2008



### Discount Rates 2001-2008





### **SCORECARD... continued**

Alarmed by this, the Governor stated unequivocally, when she was announcing the monetary policy, that government borrowing from the central bank are totally unsustainable. It must be noted here, that the government has announced it will slowly phase out oil subsidies by the end of this year. But it remains to be seen by how much government borrowing will come down, considering that they have already borrowed PKR 32.9 bn in the first 25 days of FY09. Sizeable reduction in fiscal spending is essential to slow aggregate money supply growth and help curb inflationary pressures in the future.

In previous terms an expansionary fiscal policy outweighed the effects of a tight monetary policy. Due to this, the tight stance of the State Bank had limited impact in controlling broad economic indicators. However, the government has acknowledged the need to halt price escalation and provide relief to the increasingly agitated populace. The budget will try to roll back fiscal deficit from around 8.4% in FY08 to a target of 4.7% in FY09. If the government is able to cut expenditure, monetary and fiscal policy will work in tandem and we can anticipate inflationary pressures to begin subsiding.

An increase in discount rate was not supported by several quarters and there has been great debate about the effectiveness of a discount rate hike. Indeed the State Bank Governor herself openly debated this topic in order to listen to all sections of the economy and get their opinions before formulating the monetary policy. After careful deliberation SBP decided to hike rates by 100 bps to 13%, which in our opinion is in the best interests of the economy. In the ensuing sections, arguments against a rate rise will be presented followed by reasons why a rate rise was the need of the hour.



### NO MORE RATE HIKES

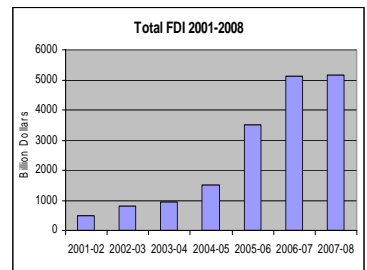
In the previous FY international food prices were continuously on the rise as countries banned export of commodities like wheat and oil price sky rocketed. Wheat soared by almost 25% in a day, while oil prices went up by nearly 50% in Jun08 YoY. Regardless of high prices the government had to import excess demand from international markets. The sustained increases in food and oil prices resulted in supply disruptions and market inefficiencies in our domestic markets, impacting inflation that soared as a consequence.

Given this scenario, depreciation of the rupee by 11.5% in FY08 increased inflationary pressure by making the import of commodities more expensive, adding to imported inflation. Thereby at present domestic inflation is highly correlated with global commodity inflation and any monetary policy adjustments by SBP will not have an impact on domestic price levels. Moreover, it seems M2 money growth is now under control, as it increased by 15.35% compared to 19.32% last FY, which should subdue pressure on prices as well.

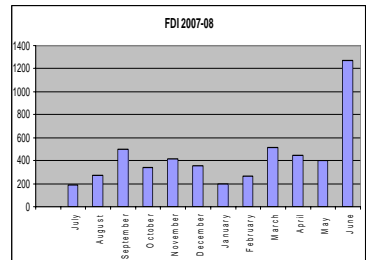
Phasing out of subsidies will increase inflation in the short run, but stopping government borrowing from SBP was necessary to quell the rising trend of price levels. The government’s decision to cut subsidies will undoubtedly help in controlling fiscal expenditure, buoyed by this some economists are arguing that a rate rise is not necessary anymore. Besides government borrowings are insensitive to interest rate hikes, hence any rise will not halt borrowing for budgetary support.

On the contrary any rate rise will increase the cost of borrowing for consumers, pinching their already depleted wallets and will also be unfavourable to businesses, who have received little help from a cash strapped government through the budget. Cost of borrowing will go up further, 6m KIBOR has averaged 14.10% in July. As a result growth will slow and force businesses to take cost cutting measures that might include worker layoffs. So essentially the rate rise might not be able to control inflation but may run businesses into the ground.

Total FDI 2001-2008



Total FDI FY08





### NO MORE RATE HIKES... continued

One of the arguments presented for increasing interest rates is that they attract more foreign portfolio investment. This is because a higher rate of return in Pakistan allows foreign investors to earn a spread by borrowing cheaply from other countries and investing in our domestic market. But due to the recessionary climate surrounding the global economy, investors are highly risk averse and Pakistan's political situation, macroeconomic indicators and reduction in credit/sovereign rating by international agencies have scared investors away. Sighting these domestic conditions and global economic climate some sections of the economy were not in favour of monetary tightening, instead they would have liked to delay a rate rise and wait for inflation to come down.

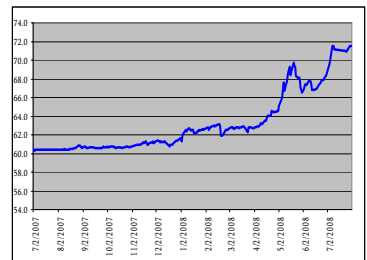
### NO MORE SUBSIDIES, NOT ENOUGH ANYMORE

The sets of arguments going around and presented by economists above are sound and do suggest interest rate hikes may not be the silver bullet for Pakistan's sick economy. However, a look at the economic indicators will explicitly show that the country is at a cross road. The risk of inflation, twin deficits and wage-price spiral can drag the economy further into recession, while on the other hand pre-emptive action by the State Bank and more importantly the government will steer the economy in the direction of recovery.

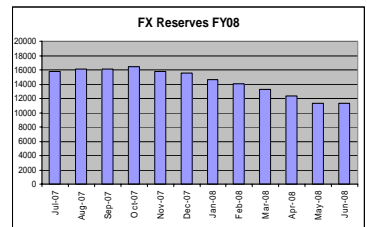
Huge current account, trade and budget deficits have put massive pressure on the exchange rate, PKR/\$ parity slipped by 11.5% in FY08. This resulted in FOREX reserves dipping sharply below \$11 bn for the first time in July, after reaching a peak of \$16.48 bn in Oct 2007, and reduced foreign reserve coverage from 31 weeks to 17 weeks.

To further bring the threat facing Pakistan's economy into perspective, according to Governor State Bank, trade and current account deficits went up by 1.5% each in the last two months of FY08 alone. Current account deficit is more than \$14 bn or 8.4% of GDP, while trade deficit is \$20 bn or 12% and fiscal deficit is close to 8.3%.

PKR/\$ Parity FY08



FX Reserves FY08





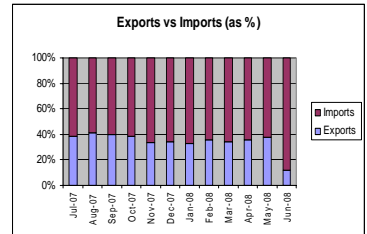
**NO MORE SUBSIDIES, NOT ENOUGH ANYMORE... continued**

Imports of essential goods such as oil and wheat have increased the import bill considerably. Food and oil constituted roughly 40% of the entire import costs. Furthermore, supply in the economy is lagging behind demand which went up significantly. Limited supply puts pressure on prices, however in addition to this, companies have also passed on higher costs to consumers by raising prices. This has drastically depreciated the purchasing power of consumers forcing workers to demand more wages, which has worsened the wage-price spiral.

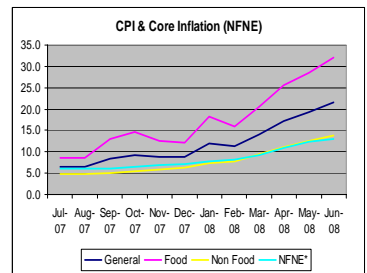
SBP has acknowledged that monetary policy will not be enough to counter the wide spread problems gripping the economy. Hence, it issued a clear message to the government that fiscal discipline and collaboration are crucial for setting the economy on a revival path. However, this does not mean the State Bank is ineffective in controlling economic indicators, according to Dr. Shamshad Akhtar's inflation is always a monetary phenomenon. High commodity prices are the economy's scourge, SPI was at 26.3% YoY and core inflation was 13% YoY in June08, core inflation has been going up due to second round inflation. To make the situation worse, GOP is not cutting back on central bank borrowing which has already reached PKR 32.9 bn in the first 25 days of the current fiscal year, against an aim of retiring PKR 21 bn to the State Bank in the first quarter. Oil subsidies to date have still not been phased out and the government is paying approximately PKR 35 per litre of diesel, a substantial amount. Therefore, huge liquidity is coming into the market because of government spending. This accelerates M2 growth which in turn raises price levels, since more money is chasing fewer goods.

Given this situation, the State Bank can be instrumental in halting the momentum and stopping inflation in its tracks. Higher rates are required, Pakistan's economy has reached a point where sole dependence on fiscal policy is inadequate, monetary and fiscal policies are like two sides of the same coin and must work together during this time of crisis.

**Exports vs Imports FY08**



**Inflation FY08**





### **NO MORE SUBSIDIES, NOT ENOUGH ANYMORE... continued**

Although rising interest rates will not be enough to bring in foreign portfolio investment, because of global economic slowdown and unfavourable domestic outlook, it can slow down the flight of domestic capital by providing higher returns. In addition, Pakistan faces a substantial real aggregate demand and supply gap, real domestic demand grew by 7.1% whereas real supply grew by 5.8%, driven mainly by a sharp rise in real consumption expenditures. In addition to this, the growth in real investment expenditures remained subdued at 3.4%. This is the primary reason for record current account and trade deficits. Therefore, aggregate demand needs to be controlled immediately to bring these gaps down to sustainable levels. This can only be achieved by tightening monetary policy to counter negative real interest rates.





## THE WAITING GAME

In the debate over inflation vs. growth the State Bank has come out strongly and reaffirmed its stance on controlling price levels. By pinning responsibility of high inflation on monetary growth, the central bank has made it abundantly clear that reducing liquidity is its main objective and will not shy away from doing so. It is now up to the government to follow suit and support the central bank in its attempt to control M2 growth and stop borrowing funds for consumption expenditure. If it is able to do so, then fiscal policy and monetary policy will undoubtedly be able to not only halt but reverse the inflationary trend, since the sum is greater than the parts.

Majority of expectations were that the State Bank would use its complete repertoire of policy tools, however by increasing only the discount rate the central bank has fired a warning at the government to get its fiscal policy in line and control budgetary borrowing. In the mean time SBP will continue to monitor government actions. Its tone suggests that if government spending continues to grow as it has done so far, the next monetary policy announcement would entail the use of much harsher policy actions, including CRR and SLR adjustments. The ball is now in the government's court, we have to wait and see if it delivers.

## ECONOMIC SNAPSHOT

Fiscal Year 2007-08																
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
<u>Inflation</u>																
Headline Inflation	%	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5
Core inflation	%	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0
Food inflation	%	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5	32.0
Non-food inflation	%	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8
<u>T-bill (Wgt Avg)</u>																
3 month	%	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.95	11.3
6 month	%	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86	11.5
12 month	%	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.32	11.7
<u>External Sector</u>																
Export	Mln US\$	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089
Import	Mln US\$	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869
Trade balance	Mln US\$	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)
<u>Remittances</u>	Mln US\$	513	537	505	495	489	516	580	505	479	557	502	602	590	584	547
<u>Forex Reserves</u>	Mln US\$	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285



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