



MCB Bank Limited

Issue # 78

**Treasury & Investment Banking Group**

## *Quid Pro Quo*

### ECONOMIC REPORT

#### TWIN CHARGES

February 18th, 2009

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The last Monetary Policy Statement (MPS) confirmed what we stated in our last *Quid Pro Quo*, that Pakistan's economy is at a crossroad where the need for prudent monetary and fiscal management is heightened. In other words, failure of policies to complement the recent improvements in macroeconomic fundamentals can easily deteriorate the economy, a point not lost by SBP which used the word 'restrained' four times in its last MPS.

Put simply the balance between controlling inflation and promoting growth is now tilting towards the latter, albeit with 'restrained optimism'.

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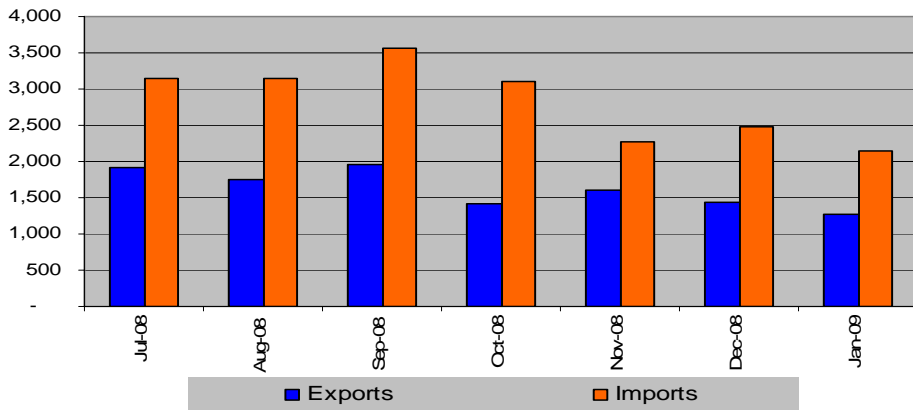
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## IMPROVEMENT IN OUTLOOK

Pakistan's economic outlook is improving slowly, as seen by recent declines in inflation, import growth and government borrowing from SBP; and increase in export growth, FOREX reserves build up and narrowing current account deficit.

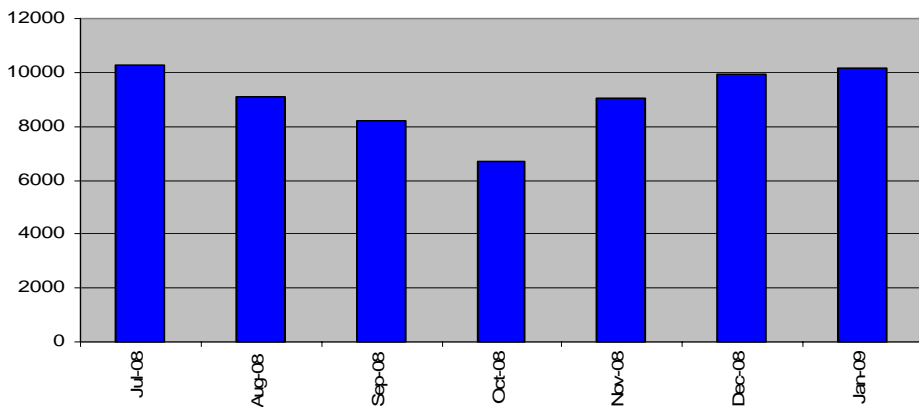
Import growth has slowed considerably, from 21.6% in Jul-Nov to 11.7% in Jul-Jan FY09, mainly due to a decline in import demand and declining international commodity prices. Simultaneously despite a deepening global recession, exports have grown by an encouraging 5.47% in Jul-Jan FY09.



Imports & Exports during FY09

Source: SBP

This has helped boost foreign reserves to USD 10.28 bn for the week ended 6<sup>th</sup> Feb'09, up from USD 9.06 bn in Nov'08. The current account deficit is also narrowing, it narrowed by 25.4% MoM in Jan'09 compared to Dec'08.



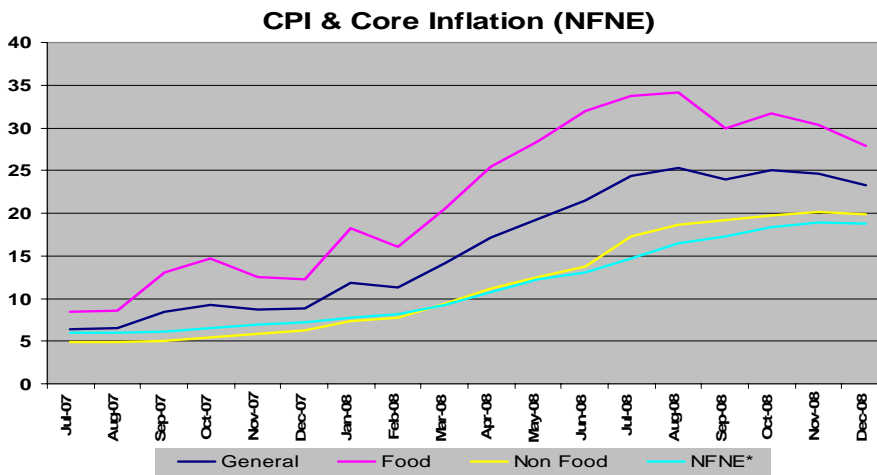
FOREX Reserves during FY09

Source: SBP



### IMPROVEMENT IN OUTLOOK ... Continued

Furthermore, government borrowing from SBP has come down sharply, from PKR 410 bn in Dec'08 to PKR 254 bn for the week ended 24 Jan'09. This along with reduced aggregate demand pressures have had a direct impact on inflationary pressures in the economy. Inflation is beginning to taper off, coming down to 20.5% YoY in Jan'09 compared to a high of 25.0% in Oct'09.



Source: SBP

Steps taken by State Bank and measures outlined in the SBA have clearly instilled confidence in their ability to manage macroeconomic variables. These steps include, frequent and timely adjustments of the discount rate, rationalizing subsidies on petroleum products, adjustments of exchange rate and significant decline in government borrowing from SBP.

## NEED FOR CONTINUATION

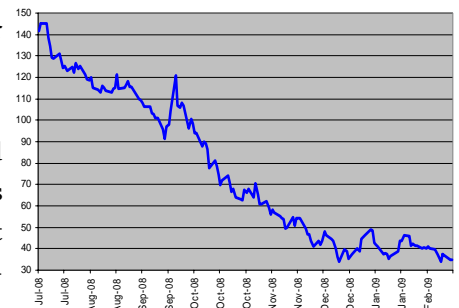
Depreciation of the USD/PKR parity was due to a reduction in NFA, similarly persistence of inflationary pressures was due to sharp growth of NDA on the back of high government borrowing. Even though government borrowings have slowed and FOREX reserves have increased, there is still a disproportionate increase in rupee liquidity, which needs to be managed. Also despite improvements in the balance of payments position and slow down in real economy, average inflation is projected to be around 20% for FY09.

Thus, there is a need to continue with the tight monetary stance as well as encourage further slowdown in government borrowing and foreign reserve build-up. This can be done by controlling twin deficits, through rationalizing subsidies (particularly electricity) and transferring oil payments to the interbank market.

However, significant risks are involved in managing the macroeconomic fundamentals. First of all, the target of PKR 1360 bn tax revenue looks ambitious in a contracting real economy. FBR collected PKR 543.7 bn for H1FY09, against a revised target of PKR 581 bn.

Although there has been a steep fall in oil prices, Nymex is trading around USD 35 per barrel down from USD 145 per barrel in Jul'08, Pakistan also has to deal with a slowing global economy, in this context achieving high export growth and FDI inflows to improve the balance of payments will be difficult. Furthermore, energy shortages and law and order situation in the country and pending circular debt issue will have a drag on economic growth. This can be gauged by the dismal LSM performance and falling growth of private sector credit. All this is happening with rigid core inflation, which indicates demand pressure will persist during H2FY09. Therefore it is important to continue with the tight monetary stance so as to moderate the impact of these risks.

**Oil Prices - Jul'08-Feb'09**



**Source: Bloomberg**



## LIQUIDITY ISSUES

In an inflationary environment, propensity to hoard cash by individuals increases, hence banks and DFIs faced a liquidity crisis in Oct'08 (accentuated by seasonal factors). In order to ease this, State Bank slashed CRR in a staggered manner by 400 bps to 5% and exempted time deposits from SLR requirements among other steps. This helped markets considerably, increasing excess reserves of banks from 1.6% in Oct'08 to 8.6% of TDL by Jan'09 end, whereas overnight repo rates, clean call rates and liquidity spreads all came down.

To control the excess liquidity SBP conducted several mop-up OMOs. In addition, with commercial banks reluctant to lend to the private sector, they were encouraged to participate in T-Bill auctions, which allowed the central bank to shift its stock of government T-Bill holdings to commercial banks. Hence the GOP was also able to meet its central bank borrowing targets, which subsequently helped lower inflationary expectations.

However, private sector credit has still not picked up, mainly due to deceleration in growth of the overall sector. A large part of private sector credit demand was derived from import financing, however, substantial decrease in imports reduced demand for working capital in the sector. In addition, weak external demand and frequent power shortages disrupted growth and discouraged activity, indicating the weakened real economic activity. Private sector activity will increase once stability measures outlined in the SBA are implemented and macroeconomic fundamentals stabilize. Nonetheless, growth target is still 3.7% for FY09, which can be achieved through continuation of prudent policies.



## SHIFTING TIDE

It is important to stem the stubbornly high level of inflation, which is at risk of becoming chronic, if the high current prices may become embedded. Inflation was 3.1% (general CPI) in FY03, before going up to 9.28% in FY05, coming back down to 7.8% in FY07, then increasing to current levels (23.9%). This fluctuation does not bode well for the economy, as it disrupts supply mechanisms, creates inefficiencies and slows growth.

Tightening of the belt by GOP to meet its fiscal deficit target by controlling inflationary borrowings from the State Bank, narrowing current account deficit and easing aggregate demand pressures are easing price expectations. However, it would be too early to call for monetary easing, since we have not yet seen a decisive decline in inflation. Also risks to the economy remain high, demand pressures are likely to persist in H2FY09, inertial impact of high inflation will continue in second half, missing the tax revenue target will hamper fiscal management efforts and deepening global recession will have an impact on export levels.

Therefore, in our opinion to control the impact of the above mentioned risks, the current policy rate should be maintained. Having said so, macroeconomic fundamentals are improving, which allows our economic managers to shift focus from inflation to growth.

## ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
Units	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	
<u>Inflation</u>														
Headline Inflation	%	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0	24.7	23.3	20.5
Core inflation	%	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3	18.9	18.8	18.9
Food inflation	%	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7	30.4	27.9	21.6
Non-food inflation	%	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7	20.2	19.8	19.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	13.8	13.8	14.0	13.7
6 month	%	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	14.0	14.0	14.0	14.0
12 month	%	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8	n/a	14.3	14.2
<u>External Sector</u>														
Export	Mln US\$	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926	1,572	1,438	1,269
Import	Mln US\$	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647	2,253	2,478	2,144
Trade balance	Mln US\$	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1,721)	(674)	(1,040)	(875)
<u>Remittances</u>	Mln US\$	557	502	602	590	584	547	627	592	660	466	621	674	637
<u>Forex Reserves</u>	Mln US\$	14,657	14,031	13,232	12,362	11,258	11,285	10,282	9,111	8,212	6,716	9,081	9,662	10,163



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