



MCB Bank Limited  
Formerly Muslim Commercial Bank limited

Treasury & FX Group

## *Quid Pro Quo*

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### **Jan 26<sup>th</sup> didn't matter?**

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#### **Controversy-**

The monetary policy statement recently issued by the SBP reiterated that the tight monetary stance shall continue for the rest of FY06. Does it mean that a rise in the discount rate or issuance of fresh PIBs is on the cards?

#### **Contention-**

While there is a theoretical possibility of interest rate hikes, the growth-inflation trade off promises to result in a stalemate. It seems that the current policy mix shall be faithfully replicated for atleast the next couple of months.

#### **Market impact-**

Unless CPI numbers take a significant turn for the worse, the discount rate should remain unchanged. Meanwhile, a change of heart by the Ministry of Finance (MoF) on PIB issuance seems unlikely.

#### **Risk-**

Aid inflows could result in a higher than expected surplus of the Capital Account, resulting in a rise in Net Foreign Assets (NFA), pushing up M2 growth. The need for additional policy firming shall become urgent and the SBP may respond by raising the discount rate.

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As expected, surprises were few and far between in the monetary policy statement issued by the SBP for the second half of FY06. We had secretly hoped that the central bank would spring a few surprises; as it turns out, it was too much to expect. The statement seemed in many ways just a matter of protocol and the existing policy mix promises to be faithfully replicated for at least the next couple of months.

### **Core Concerns**

There was frank admittance in the monetary policy statement that despite significant monetary tightening, core inflation decreased only marginally from 7.6% in July 2005 to 7.4% in December 2005. The SBP concedes that core inflation continues to be a concern, and might fuel short-term inflationary expectations. However, falling food inflation, in their view, shall help achieve the full year inflation target and also reduce inflationary expectations going forward.

SBP seemed willing to revise the GDP forecast downwards; on the basis of below- target performances in large-scale manufacturing (LSM) and agriculture. While the economy is expected to record economic growth of above 6%, the target of 7% in their view would “modestly” be missed. However, the central bank is not willing to significantly miss the growth target, as is evident from this statement from the monetary policy.

**“SBP would also ensure that changes in interest rates do not significantly weaken the ongoing growth momentum.”**


This to us was the single most important sentence in the whole monetary policy statement. It meant that that inflation is no longer the over-riding consideration of monetary policy. As soon as you start talking about the growth-inflation trade-off, the policy stalemate that we are currently witnessing becomes inevitable.

We expect 6% to be a growth floor, the minimum acceptable growth rate for FY06. This relative slowdown in itself is not cause for concern. By and large, the growth momentum has not been derailed and business sentiment regarding the economy continues to be positive.

### **Window Dressing**

With regards to monetary statistics, the central bank expressed satisfaction that both M2 growth at 8% and reserve money growth at 8.4% were both within tolerable limits. However, the reason for that is a run-down in Net Foreign Assets (NFA), which has fallen due to a balance of payments deficit of USD 0.9 billion. The report admits that private sector credit off-take has been surprisingly strong, but that has been primarily seen as a reflection of greater optimism regarding the economy and enhanced “credit





capacity.” Agreed -- that is part of the reason for particularly strong borrowing by the private sector. However, the impact of so much credit disbursement in fuelling inflationary pressures should not be overlooked. Given that consumer loans have risen by 61.2% YoY to PKR 38.7 billion in 1HFY06 (making up 21% of total credit-off take), consumption driven inflationary pressures will persist. Small wonder that core inflation continues unabated!

Much debate has taken place regarding private sector credit off-take. Some analysts predict credit off-take of close to PKR 500 billion in FY06. After all, PKR 297 billion has already been realized from July to December 2005, and the full year target of PKR 330 billion will most certainly be exceeded. However, some of the credit demand is definitely seasonal, as the cotton ginning season has arrived. To estimate the seasonality factor, we analyzed last fiscal year's, i.e., FY05, credit off-take numbers. In the first half of FY05, credit off-take stood at PKR 285 billion, which was 73% of the full fiscal year's (FY05) number. If we assume the 73% distribution to hold this fiscal year as well, credit off-take for FY06 should be around PKR 407 Billion, exceeding the target by around 23%.


### **Parity Paralysis**

Admittedly, the trade gap is huge and should range between USD 10-11 billion for FY06. The SBP reports the trade gap for July-December 2005 at USD 3.8 billion. As they themselves clarify, this is exchange based -- meaning that both imports and exports have been calculated on a free on board (fob) basis. However, both logic and convention dictate that imports should be calculated including carriage, insurance and freight (cif), because that reflects the true cost of importing. If one calculates the trade deficit in that manner, it comes up to USD 5.58 billion for just the first six months of FY06. Given that statistic alone, SBP's claim in the monetary statement that the external sector has performed relatively better this year is at best, controversial.

### **NFA Reduction... Saving grace of a tight monetary policy**

In fact, reduction in NFA has been the saving grace of a tight monetary policy, and we are witnessing one of the rare cases in which exchange rate intervention is resulting in a more effective monetary policy. External disequilibrium (in the form of a high trade deficit) has resulted in relative domestic stability of M2 growth. And as long as this situation continues, exchange rate rationalization shall not be a priority.

However, the process of depletion in NFA could reverse in the next six months with the launching of the Eurobond, potential privatization receipts, enhanced flows of remittances, foreign investment and earthquake aid. Incidentally, foreign investment figures for both November and December were released on the 26<sup>th</sup> as well; total foreign investment in July-December 2005 stood at USD 1.462 billion. Around USD 781 million




of this, more than 50%, came in just the two months of November and December, and is part of the reason why exchange reserves have halted their downward trend of late. Below, we make some rough projections for the current account, capital account and balance of payments in FY06. The current account deficit is estimated at USD 5.8 billion, while the capital and financial account surplus is projected at USD 4.9 billion, resulting in a balance of payments deficit of USD 0.9 billion. That is approximately the balance of payments deficit that was witnessed in 1HFY06, and exchange reserves had been run down to cover that position. These estimates indicate that we shall see no further worsening in the balance of payments position in the next six months, and reserves at June-end 2006 should be above USD 11 billion. Of course, short-term fluctuations shall persist but over the course of the rest of FY06, those are expected to balance out.

in billion USD	
<b><u>Current Account</u></b>	
Imports	27
Exports	<u>17</u>
Trade Balance	-10
Workers Remittances	4.2
Current Account Balance	<b>-5.8</b>
<b><u>Capital and Financial Account</u></b>	
Foreign Investment excl. Privitizations	3.0
Privitization Receipts	0.7
Eurobond Issue	0.7
External Aid	<u>0.5</u>
	<b>4.9</b>
<b><u>Balance of Payments</u></b>	<b>-0.9</b>

### **Soft measures don't make hard currencies**

Thus, as we had also predicted in an earlier report, exchange rate rationalization will not take place as long as inflation continues to be a threat. There are large external imbalances; however, the SBP seems to have them covered for the time being. The capital account is set to finance much of the current account deficit and we expect very little movement in the rupee-dollar parity in the short to medium term. However, this



situation is not tenable in the long-run, and is only a temporary solution to a structural problem. Soft measures don't make hard currencies!!

### **Interest Rate Outlook**

The monetary policy statement did make some seemingly bold statements regarding the future path of interest rates. It claimed that the central bank shall vigilantly watch inflation, and if it believes inflationary pressures are building up, key interest rates will be raised. In the Pakistani context, "key interest rates" would mean the discount rate. However, in the same report, the SBP assesses that on the balance of risks, inflation should continue its downward trend. Taken together, these two statements imply that unless we see a sharp and sustained upturn in CPI numbers, the discount rate is unlikely to be changed.


The SBP also stated that the government should reduce its dependence on short-term debt and issue longer term Pakistan Investment Bonds (PIBs). This would serve the dual purpose of better debt management by the GoP and make the longer end of the yield curve more representative. We had previously argued that issuing PIBs shall help to better transmit the SBP's tight monetary policy through the bank credit channel, claiming that the banking sector's demand for T-bills was both limited and saturating, and issuance of new long-term government debt would help curb the explosive growth in private sector credit off-take.

### **SBP and MoF...divergent objectives**

However, it is one thing for the SBP to stress the need for PIB issuance and quite another for the Ministry of Finance (MoF) to actually issue PIBs in a tight monetary cycle. The reluctance that the MoF has shown in issuing PIBs carrying double-digit interest rates has been well documented. The MoF is by functionality growth oriented; inflation worries are the domain of the central bank. MoF's logic of not issuing PIBs in a high interest rate environment is still intact; they can borrow funds from the international market at cheaper rates.

### **Eurobond versus PIBs**

And while we do not wish to concoct conspiracy theories, it seems like a strange coincidence that the MoF announced on the 26<sup>th</sup>, just hours before the monetary policy statement was released, that it plans to launch a Eurobond in excess of USD 500 million by the end of March. The tenor of the bond could range between 5-10 years, with greater probability of it being in the upper end of this range. By the looks of it, the Eurobond issue seems to be a substitute for PIB borrowing. It is relatively long-term in nature, something that is desired by the government; given that the T-bill glut along with PIB



non-issuance has resulted in government debt becoming disproportionately front-loaded. The Eurobond has the additional advantage over PIBs that it shall provide foreign exchange to cover the current account deficit as well. And at a rate of 200 basis points above LIBOR, even accounting for exchange rate risk, external borrowing should be more economical than PIBs.


### **Discount rate and PIBs...a catch-22 situation**

From that point of view, PIB issuance, despite its theoretical desirability, seems unlikely. In fact, SBP's assertion that key interest rates may be raised, in case further policy firming is required, will actually push the interest rate demanded on fresh issues of PIBs even higher. Markets would discount the possibility of further hikes in the discount rate when pricing longer tenor PIBs, and the resulting risk and liquidity premiums sought would become even greater. In essence, this catch-22 situation is leading to policy helplessness. PIBs are not being issued because the discount rate is too high, and could go up further. On the other hand, part of the reason why the discount rate is high and needs to be raised further is because PIBs are not being issued! Quite the conundrum, as they say. In essence, reiteration of a tight monetary policy and the possibility of further tightening by the SBP mean that a change of heart by the MoF on the non-issuance of PIBs has become even more unlikely.

Suffice it to say, if the SBP raises the discount rates further, the MoF shall not be over eager in restarting the PIB bandwagon. Thus, presumably, the central bank will first allow the MoF a window of opportunity to issue PIBs. If the finance ministry resists, only then shall the SBP consider raising the discount rate.

### **Cut-off yields going nowhere**

It is for this reason that we predict unchanged cut-offs in the next few T-bill auctions. The market is expected to test the SBP on the higher side, with treasuries looking to pressurize the central bank into raising cut-offs. But in our view, the central bank will resist. Any rise in cut-offs, especially in the 12 month T-bill, shall exert immediate pressure on the discount rate. And as we have argued above, we do not think SBP is willing to raise the discount rate just yet. Cut-offs are likely to be maintained, and hence, the most eagerly awaited data in the upcoming months will be the CPI numbers. They will give the clearest indication regarding the future path of interest rates. Based on current market conditions, inflation is set to fall down due to further decline in food inflation and a high base effect. However, it would be interesting to note the central bank's response if there is another spike in oil prices, an eventuality that becomes more and more probable as the nuclear tensions with Iran continue, and Hamas prepare to assume power in Palestine.



With regards to the importance of the bank credit channel in transmitting monetary policy, something which we had stressed upon in the previous Quid Pro Quo, the SBP (in the monetary policy statement) said two things. Firstly, they hope that with real lending rates having become positive towards the end of 2005, borrowers will become more selective in accepting bank loans. Secondly, they explained that high credit off-take, despite a tight monetary policy, has been supported by a high and sustainable level of worker remittances. Being an exogenous inflow, remittance flows are unaffected by domestic monetary tightening. The continuous deposit growth (due to worker remittances) has provided banks with the financial muscle to continue widespread lending.


Agreed - lending rates have become positive and the marginal borrower may abstain from obtaining credit. However, given bright economic prospects, demand for loans will not decrease substantially. Disappointingly, the monetary policy statement has not attacked the source of credit -- rising real lending rates would make lending more attractive from the banks' point of view. We still feel that the SBP needs to force the banking sector into raising their deposit rates, and squeeze spreads. This shall lead to an immediate credit contraction, and quell consumer driven inflationary pressures.

### **OMO Fetish**

In the interim, OMOs shall rule the roost, as they have been doing since the past few months. This seems to be the preferred mechanism to manage liquidity by the SBP. The problem with OMOs is that they are external stabilizers. The central bank reacts to inflows and then conducts OMOs, either injecting or mopping up liquidity. The OMO mechanism entails a fair degree of second-guessing by the central bank, which as the name suggests, is not an exact science and can lead to policy mishaps.

Recently, the SBP has been conducting OMOs with religious regularity; both mopping up and injecting funds into the financial system, depending on the requirement. Mop-ups are part and parcel of a tight monetary policy. However, the logic of injections is more ambiguous. If the financial system is short of funds, it always has recourse to borrow from the SBP discount window. After all, that is what the discount window is there for, to serve as a lender of the last resort. But OMO injections are gradually rendering the discount window irrelevant. When the market is short of funds, SBP injects money through OMOs, at rates below the discount rate of 9%. In essence, over-extended banks are allowed to cover their positions at a lower cost. With talks of a potential discount rate hike, would it not make sense to first make the current discount rate more relevant to banks' lending decisions?

Once again, the monetary policy has a reactive bias. The hallmark of effective central banking is pre-emptive action; staying ahead of the curve. If the SBP raises the discount rate in response to rising inflation, it shall once more be playing catch-up. That, we have already found, is both notoriously hard and unrewarding.



On a more forgiving note, the monetary policy statement atleast did well to reiterate a tight monetary policy stance. The central bank has reconfirmed the statement made by the former SBP governor Dr. Ishrat Hussain that the days of cheap credit are over. It seems, monetary easing is nowhere on the horizon, and borrowers are well advised to get used to double digit lending rates.

### **Present mirth hath present laughter**

In conclusion, we feel that it might be a refreshing change to talk about positives regarding real developments in the national economy. Total FDI has shown a rise of 190% YoY to reach USD 1.462 billion in the first six month of FY06. The most remarkable thing is that this does not include any privatization receipts. Investors, the world over, are looking towards Pakistan with new-found economic respect. Standard & Poor's has recently raised the country's sovereign foreign currency ratings. The Economist has initiated coverage of Pakistan's data in its emerging market indicators, on the back of impressive growth prospects. The World Bank and Asian Development Bank have also underscored Pakistan's impressive growth momentum on more than one occasion. And while analytical pessimism is part and parcel of our job description, it seems only fair for the nation to enjoy its moment of glory under the sun. Consistent political and economic policies and reforms are bearing fruit, and at times, it seems almost wasteful to be critical in the face of plenty. Here's to Pakistan, as the great William Shakespeare put it, "Present mirth hath present laughter, What's to come is still unsure...."

## Economic Snapshot

Fiscal year 06									
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	July-Dec
<b><u>Inflation</u></b>									
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	n.a	8.43
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	n.a	7.59
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	n.a	7.57
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	n.a	8.89
<b><u>T-bill (Wgt Avg)</u></b>									
3 month	%	7.69	7.99	8.10	8.10	bid rejected	8.09	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14	bid rejected	8.25	8.29	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	n/a
<b><u>External Sector</u></b>									
Export	Mln US\$	1,272	1,408	1,499	1,329	1,120	1,421	n.a	8,049
Import	Mln US\$	1,997	2,235	2,322	2,328	2,300	2,420	n.a	13,602
Trade balance	Mln US\$	(725)	(827)	(823)	(999)	(1,180)	(999)	n.a	(5,553)
Remittances	Mln US\$	313	348	341	373	309	336	n.a	2,020
Total Foreign Investment	Mln US\$	130	161	183	208	323	458	n.a	1,463
Forex reserves	Mln US\$	12,613	12,124	12,000	11,715	11,321	11,211	11,525	n/a
<b><u>Key</u></b>									
n.a		not available							
n/a		not applicable							



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