



MCB Bank Limited
Formerly Muslim Commercial Bank limited

Treasury & FX Group

Quid Pro Quo

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Economic report

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Money Matters!!

Controversy-

Does the forecasted decrease in CPI inflation signal an easing of inflationary pressures or is it a case of statistics flattering to deceive?

Contention-

Inflation will fall in the next few months due to a high base effect. However, underlying price pressures in the real economy continue to persist as four successive years of monetary overhang has not been removed and insufficient monetary tightening has led to a credit boom and asset price inflation.

Market impact-

Policy firming in the form of a rise in the discount rate is not expected in the medium-term, and that might provide further impetus to an already overvalued real estate and equity market. The inevitable correction is only a matter of time, but in the interim, wealth effects shall continue to fuel demand-pull inflation.

Risk-

Banking sector Advance to Deposit Ratio (ADR) has become uncomfortably high and in the absence of fresh deposits, there might be an involuntary slowdown in private sector credit off-take. Monetary discipline may thus be force-fed to the nation.

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Lies, Damn Lies, Statistics.....

As mentioned in our earlier report “Irrational Exuberance” (21st Dec 2005), base effect calculations indicate that CPI numbers for March and April shall be relatively subdued. Thus, despite milk, sugar and cement prices going up, inflation calculated on a YoY basis will be going down.

One need only look at the WPI to realize that double-digit inflation is still very much a reality. However, with the SBP governor recently stating that inflation is showing a decelerating trend, it seems naïve to look any further than base effect calculations. Additional policy firming, in the form of a rise in the discount rate, is thus highly unlikely.

Despite the fall in consumer price inflation, we see scant reason for comfort on the inflation front. There is no denying that headline inflation, calculated on a Year on Year (YoY) basis will fall in the next couple of months. Table 1 below gives our projections for the inflation rate over the next four months, given an assumed 0.65% average Month on Month (MoM) inflation level. Our calculations indicate that inflation shall remain below the 8% mark for the next three month of the fiscal year, and should dip below even 7% in April.

Table 1

FY05-06			
Assuming Month on Month inflation be be 0.8% from March 06 to June 06			
	CPI FY05-06	CPI index	CPI Inflation
	<i>MoM(%)</i>	<i>FY05-06</i>	<i>YoY (%)</i>
Jul-05	1.62	128.13	8.99
Aug-05	0.04	128.18	8.41
Sep-05	0.50	128.82	8.53
Oct-05	0.94	130.03	8.27
Nov-05	0.76	131.02	7.89
Dec-05	-0.28	130.66	8.51
Jan-06	1.2	132.23	8.76
Feb-06	0.33	132.66	8.05
Mar-06	0.65	133.52	7.36
Apr-06	0.65	134.39	6.21
May-06	0.65	135.26	7.38
Jun-06	0.65	136.14	7.97
FY05-06 inflation			8.03

Figures in bold are projection. The rest are actuals.

FBS, SBP, and MCB Research





Perils of Unrestricted Capitalism....

The anomaly is that evidence of this dip in inflation shall be extremely hard to find in the real economy. Prices of essentials such as sugar and milk continue to spiral. Recently, cement has also joined the fray. People advance various arguments justifying the price hikes; for us, as economists, the reality at the end of the day is that producers have acquired an uncomfortable amount of pricing power. Take the example of cement. Cement manufacturers have recorded impressive profits over the past year, a combination of strong pricing power in a tight demand/supply situation. However, the cartel is so strong that they are aspiring to achieve even greater profits going forward. And while their high prices have irked policy-makers for some time now, the situation has not been remedied. Infact, rather than cutting prices, cement manufacturers have actually raised them. The Monopoly Control Authority (MCA) has officially been rendered impotent, providing a small (yet significant) measure of the perils of unrestricted capitalism.

Worryingly, inflation seems to have been reduced without fighting the monster within. Last year, when inflation reared its ugly head, the GoP decided to pursue the most viable strategy of liberalizing imports. It had the desired impact; food inflation went down, dragging food-heavy CPI to more acceptable levels. It, however, also had the undesirable impact of pushing the trade deficit for the first eight months of FY06 (upto February) to US\$ 7.5 billion. This trend cannot continue indefinitely, and the inflation strategy shall soon have to be revisited and revised.

Exclusive reliance on CPI is a classic case of the central bank treating the symptoms, not the causes of inflation. For that matter, even WPI does not depict the full picture. Both indices represent a basket of goods, and by dint of construction, are more attuned to measuring actual inflation rather than accurately anticipating inflationary pressures.

The central bank may argue that it is after all consumer prices that matter. There is no disagreement on that count. But to conduct an effective and pro-active monetary policy, it is not only today's consumer prices that are relevant, but future prices are also important, and should influence monetary decisions taken today. By making the CPI larger than life, SBP runs the risk of internalizing the reactive bias that has hampered the effectiveness of its recent monetary forays. The risk of over-complacency cannot be exaggerated when winning a battle is equated with winning the war.

In theory, central banks have three options to tackle inflation. They can undertake inflation targeting, under which interest rates are adjusted to keep present and future inflation within an acceptable limit. Monetary policy is governed not only by current inflation figures, but also by future projections. Inflation targeting has been the latest fad at many central banks across the world, and is the single most popular method of tackling inflation.

The second option is to use the exchange rate as a nominal anchor. Tie in the local currency with a larger economy, and slide into cruise control, allowing the larger economy's monetary policy to automatically determine the domestic one. Unfortunately, speculative currency attacks in the post Bretton Wood's world have meant that "driving with the brakes on" is a safer option.





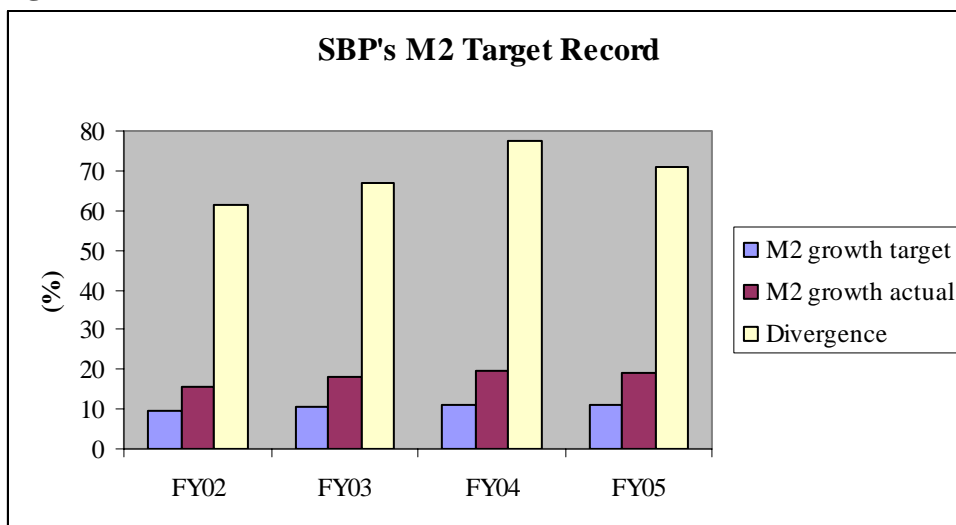
The final option is to resort to money supply targeting to control the price level in the economy. This strategy finds its roots in the doctrine of monetarism, which dictates that inflation is, always and everywhere, a monetary phenomenon. It negates the very concept of cost-push inflation, as it has been typically portrayed. Monetarism's most prominent advocate, Milton Friedman argued that the only kind of inflation in the long-term is demand pull, and cost and wage pressures have no meaningful impact on long-run. His proposition was that inflation is a direct result of a rise in the money supply over and above the growth in nominal GDP. In economic jargon that means that inflation is solely caused by monetary overhang. The trick to controlling inflation was to increase the money supply by the amount of the increase in nominal GDP. Such a strategy would ensure that no inflationary or deflationary pressures developed in the economy.

$$\text{Monetary overhang} = \text{Growth in money supply (M2)} - \text{growth in Nominal GDP (real GDP growth + inflation rate)}$$

Money Don't Matter!!


Currently, the SBP is using a crude amalgamation of an inflation and exchange rate target. Some features of an inflation target (such as the overriding objective of achieving a projected CPI inflation number) are present. Characteristics of the nominal exchange rate anchor are also present, such as the managed rupee-dollar parity. Monetary targets are also projected in the annual credit plan, but they are not the primary concern of the central bank. Exceeding the monetary aggregates, be it in the form of reserve money (M0) or broad money supply (M2) is of lesser concern as long as the inflation target is met. SBP's recent record in that regard is depicted in Figure 1 below. Evidently it's not about the money!!

Figure 1



SBP and MCB Research





For its part, the SBP can argue that money supply targeting has gone out of fashion around the world, with the exception of Germany's Bundesbank and to a lesser extent, the European Central Bank (ECB). Monetarist theory- the view that inflation is always and everywhere a monetary phenomenon does not hold much sway anymore, and the economic consensus is that money supply targeting is both illogical and impractical in today's dynamic and fast changing world. Breathless innovations in plastic money have meant that pursuing a broad money target such as M2 or M3 may be an exercise in futility. After all, central banks can only control high-powered money, also known as M0. If the money multiplier becomes unpredictable in the face of financial innovations, a given level of M0 shall lead to unexpected level of M2.

In the 1970 and 80s, however, the relationship between money and inflation was more stable, and most central banks did have active monetary targets. Since then, the link between money and inflation in the industrialized countries has become weaker. The value of the money multiplier fluctuated so widely due to innovation and new technology, that money supply targeting became an exercise in futility. In the words of a Canadian Central Bank governor, "we did not abandon monetary aggregates, they abandoned us."

From then on, money supply targeting has not been at the forefront of monetary policy with the high-profile exception of Germany's Bundesbank, which has continued to target money. Somewhat ironically, the Bundesbank has enjoyed the best inflation record amongst all central banks in the world. Its former chief economist, Otmar Issing, who is now the chief economist of the ECB, maintains that all past inflations have been preceded or accompanied by rapid monetary growth. The argument goes something like this- rapid monetary growth leads to asset price bubbles and a credit boom, which with a lagged impact (through wealth effects), exerts an upward pressure on prices. ECB's recent interest rate hikes are widely thought to be a response to higher than expected growth in the money supply, which Issing feels shall feed into higher asset prices, unless rates are raised.

On the global platform, the debate continues to rage on amongst central bankers on whether monetary policy should respond to asset price bubbles. It basically asks the question; should monetarism be allowed back into monetary policy-making? The wide consensus is that it should not. As long as consumer prices are unaffected, central banks should care little about the level of stock and real estate prices. Yet history is littered with examples of bubbles leading to runaway inflation, and eventual recessions. By taking our eyes completely off the money meter, we risk throwing "the baby out with the bath-water." While pure monetarism is no more be practical, the logic of completely ignoring systemic and sustained imbalances in monetary aggregates is less compelling.

Infact, the argument for ignoring asset price bubbles may be more personal, than economic. The awkward reality is that bubbles are popular, and busting them, while beneficial for the economy, might be harmful to personal interests. This argument has empirical backing, with central banks known to respond asymmetrically to asset prices. When the underlying economic growth is anemic, reflating the economy through asset price inflation is touted as a desirable option; and when markets crash, policy-makers are keen to inject liquidity to stop asset markets from affecting the underlying economy. However, when markets reach unsustainably heady heights, they are averse to the idea of raising rates to stop the bubble from inflating further.



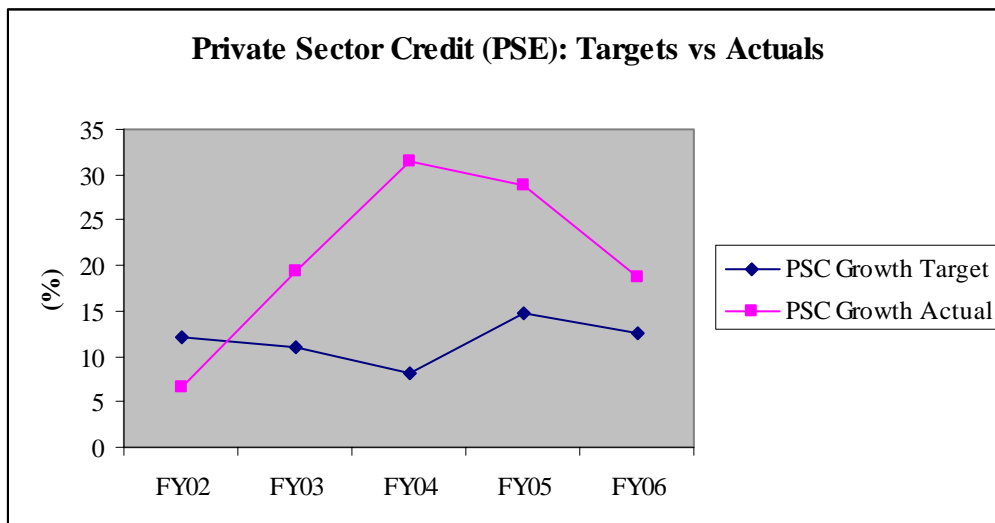
The Dangers of Casino Capitalism

However, this “cure is better than prevention” strategy does not always work. Shielding the economy once bubbles burst is painful and expensive. The biggest problem (from an economic point of view) with asset price bubbles is that they are invariably fed by an even more massive credit bubble. And when they burst, not only is the general investor community at risk but so is the entire financial system.

Look at Pakistan’s case specifically. Banking sector Advances to Deposits ratio (ADR) has gone from 66% at the beginning of 2003 to 78% as of February 2006. The rise in ADR becomes all the more staggering given that deposits themselves have risen by 74% in the last three years. Advances in the same period have gone up by more than 104%. The credit boom and rising asset prices have been mutually reinforcing. Credit off-take provides liquidity which allows asset prices to appreciate. Higher asset prices, in turn, enhance ability and willingness to take on more loans. And while a rise in loans is seen as a prerequisite to economic growth, the exponential growth in private sector credit off-take is worrying because of what it hides, i.e. a housing and stock market bubble and the risk of over indebtedness of households.

Figure 2 below plots target growth in private sector credit off-take (PSC) versus actual growth in PSC. In FY02, the target was greater than actual, but since then, private sector credit disbursement has substantially exceeded the initial target. Calculations for FY06 have been made by annualizing the data available.

Figure 2



SBP, MoF and MCB Research

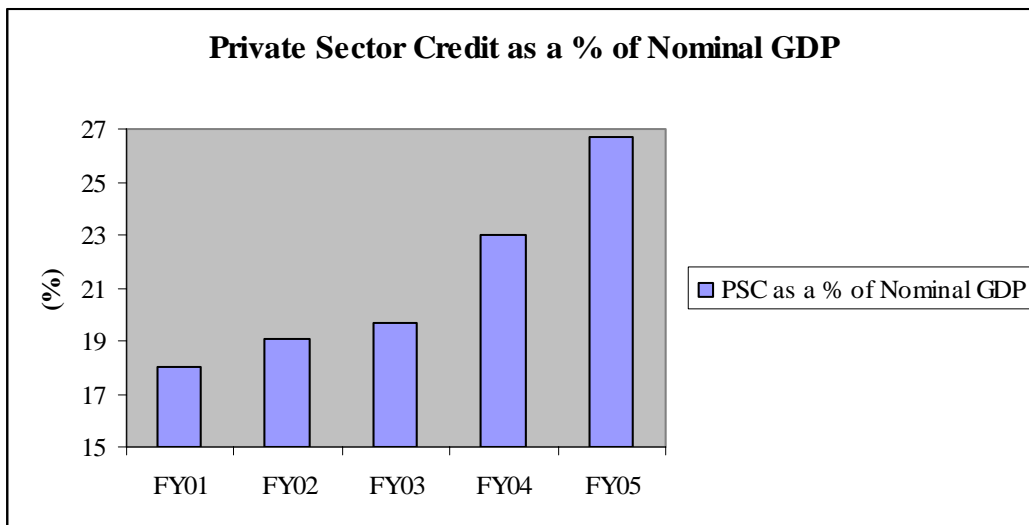
Figure 3 meanwhile portrays the rising PSC/GDP ratio, which has risen from 18% from FY01 to over 26% at the end of FY05. This ratio is set to rise even further in FY06. The danger





exists of over-shooting the fine line between enhanced credit capacity and over-indebtedness of businesses and households.

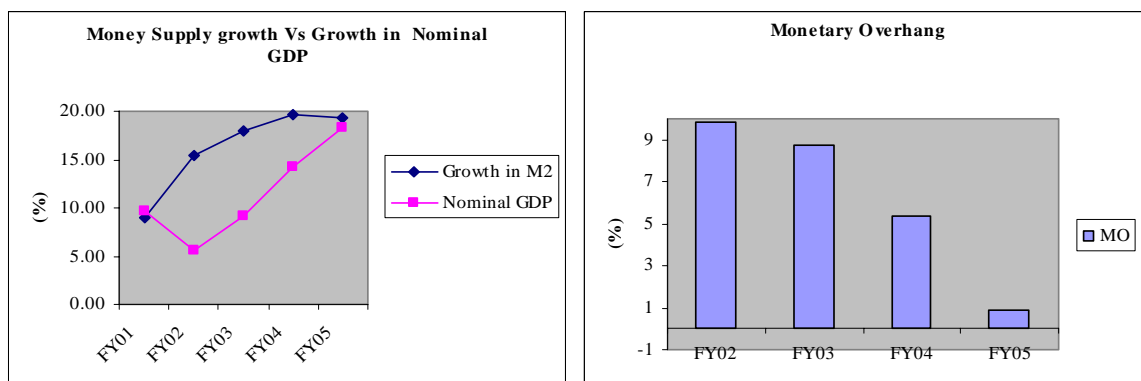
Figure 3



SBP, MoF, and MCB Research

On a macro-economic level, the problem has been four consecutive years of monetary overhang where the money supply (M2) has risen faster than the rise in nominal GDP (real GDP + inflation). The excess money has to be employed somewhere, and much of it has been channeled into equity and real estate investment. The figure below plots growth in money supply versus growth in nominal GDP. Their difference, which is plotted in the second figure, indicates the level of monetary overhang in the economy over the last four fiscal years.

Figure 4



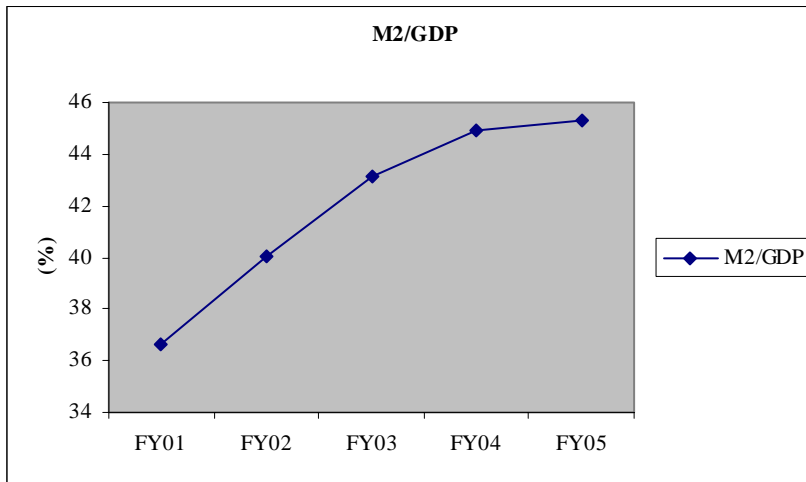
MCB and SBP Research





And as Figure 5 below shows, the ratio of M2/GDP has also risen substantially from 36% at the end of FY01 to over 45% at the end of FY05. This again is indicative that the money supply is growing faster than the underlying economy. What is interesting to note is that this ratio is not rising due to a substantial increase in the money multiplier. The primary source of the increase has been a rise in the demand for money.

Figure 5



SBP and MCB Research

To understand this further, we can use the IS-LM framework, pioneered by Sir John Hicks. The LM curve depicts all point of equilibrium in the money market, i.e. where the money supply equals the money demand in the economy. The LM framework states that money demand is a function of income (Y) and the level of interest rates (r). Money demand is directly proportional to Income (Y) as a rise in income leads to a rise in money demand. However, money demand is inversely proportional to the level of interest rates (r) in the economy. After all, interest rates represent the opportunity cost of holding money so a higher interest rate should depress money demand.

LM money market equilibrium:

Money Demand (Md)

$$Md(Y, r) = Ms/P$$

Money Supply (Ms)


Price Level (P)

GDP (Y)

Interest rate (r)

What happened in Pakistan was that interest rates (r) were pushed extremely low back in 2002-2003 to help stimulate economic growth. And when economic growth did bounce back, a combination of high income and negative real rates of interest pushed up money demand. To achieve equilibrium in the money market, the SBP had two options. It could either depress





money demand by raising the real rate of interest till the money market equilibrium was achieved. Or it could bump up money supply to meet the higher demand. SBP did a bit of both; having raised interest rates and increased the money supply. However, the rise in interest rates was insufficient (real interest rates have only recently turned positive), and much of the rise in money demand of a growing economy has been met with a corresponding increase in money supply.

And while M2 growth in FY06 has been relatively subdued, owing to the well-documented fall in Net Foreign Assets (NFA), this slow-down was involuntary, and should be treated as a one-off. Moreover, receipts from Etisalat and the dollar bond mean that this trend might well reverse in the near future. A more representative statistic in our view is private sector credit off-take, which has gone up by 19% in the first eight months of FY06, and is almost at the full year target already. And if we take NFA growth according to the credit plan, M2 growth is estimated to be at 12.77%. The full year target is 12.81%. Bottom-line, if not for falling NFA, FY06 would have been another year of monetary overhang.

Of course money is not an end in itself. Similarly, tracking and targeting monetary aggregates is also a means to an end. The end is a stable and decreasing long-term inflation path. Money supply targeting helps in that regard by mitigating the wealth effects of asset price bubbles, and the role of the central bank as the economic conscience of the nation should entail identifying bubbles when they are forming and “lean against the wind” as and when needed.

Which brings us to the more specific line of reasoning, should the SBP respond to the current stock and real estate market bubbles that are forming in Pakistan?


Some will argue that the record high stock and land prices do not signify an unsustainable bubble, but reflect real improvements in the country’s economic potential. Yes, economic growth has rebounded in Pakistan, but does that justify the quantum of the increase in asset prices? As a point of reference, we calculated that Nominal GDP has grown by 87% since FY02. The KSE-100 index, meanwhile, has gone up by 323% since that time. What this means is that corporate earnings are not the only drivers of the stock market surge. A whiff of irrational exuberance is most certainly in the air.

The Game of the Greater Fool

The fact is that markets are mean reverting, and over the long-term, the stock market oscillates between levels of over-valuation and under-valuation. What this means is that the more overvalued a market gets, the further it must move in the opposite direction once the mean reversion process gets under way. And there are hardly any instances in history where a government has been able to stop an over-valued stock market from following this mean reversion process to its logical conclusion.

At the time of tech boom in 1999, Tony Jackson of the Financial Times correctly pointed out:

“No serious investor supposes, for instance, that US internet stocks are sensibly valued. The Game is rather of the Greater Fool. Buy e-stocks at 100 times revenue; sell immediately to



the Greater Fool at 120 times; and in bear in mind that, if the game stops in the middle, the Greater Fool is you.”

Joseph Kennedy (father of John F. Kennedy and a financial wizard in his own right) said in 1929 before the infamous Wall Street crash that he got out of the market because even shoe-shine boys were offering stock tips. Our present-day equivalents are the housewives who are glued to the stock channels all day. Almost everyone these days seems to have a great stock tip....its no surprise; the bull market has made geniuses of almost all of us!! However, for the Joseph Kennedys amongst us, the writing is on the wall.

Interestingly, those who argue that no bubble exists are invariably people who are benefiting from the rising asset prices, and have no desire to see the status quo changing, however untenable it may be. So the next time someone says that the KSE-100 shall go upto 15,000 points, rest assured that they hold a sizeable stock portfolio!!

We acknowledge that our argument might not find popular appeal. The reality is that while inflation in goods and services has been universally accepted as bad, rising stock and land prices are usually regarded as a good thing. Unfortunately, for that very reason, from a macro-economic perspective, rising asset prices may be much more harmful than rising goods prices. Just ask Japan....

In a nutshell, our argument is that interest rates should move higher to quell harmful asset price inflation. Unfortunately, CPI reliance indicates that this will not happen anytime soon. In such a scenario, while base effects and falling food inflation might provide temporary relief in terms of reducing cost-push inflation, demand pull inflation is here to stay. From a long-term perspective, falling inflation might just be the medicine that we do not need.

Economic Snapshot

Fiscal year 06										
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	July-Feb
<u>Inflation</u>										
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.05	8.43
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.00	7.48
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.48	7.63
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.44	8.87
<u>T-bill (Wgt Avg)</u>										
3 month	%	7.69	7.99	8.10	8.10 bid rejected		8.09	8.10	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14 bid rejected		8.25	8.29	8.29	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	8.78	n/a
<u>External Sector</u>										
Export	Mln US\$	1,272	1,408	1,499	1,329	1,120	1,421	1229	1300	10,578
Import	Mln US\$	1,997	2,235	2,322	2,328	2,300	2,420	2145	2253	18,000
Trade balance	Mln US\$	(725)	(827)	(823)	(999)	(1,180)	(999)	(916)	(953)	(7,422)
Remittances	Mln US\$	313	348	341	373	309	336	391	339	2751
<u>Total Foreign</u>										
Investment	Mln US\$	130	161	183	208	323	458	165	347	1974
Forex reserves	Mln US\$	12,613	12,124	12,000	11,715	11,321	11,211	11,505	11,400	n/a
<u>Key</u>										
n.a		not available								
n/a		not applicable								



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