



MCB Bank Limited  
(Formerly Muslim Commercial Bank limited)

## Treasury & FX Group

# *Quid Pro Quo*

*Issue # 1*

*Economic report*

*December 7<sup>th</sup> 2005*

## **Irrational Exuberance**

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### **Controversy-**

With our yield curve flattening, is a recession brewing in the economy?

### **Contention-**

Our yield curve is “managed” to be flat by not holding a PIB auction. With interest rates having peaked out, the risk of inversion of the yield curve is minimal. Thus, a recession is not on the cards.

### **Market impact-**

Monetary contraction should now take the form of stable nominal but rising real rates of interest. PIB auctions would be held once the monetary policy is more accommodative. We do not expect that to happen until the inflation target of 8% is achieved.

### **Risk-**

With elections approaching in 2007, political considerations may sway economic judgment. However, for the moment, the conflict of interest is not pronounced enough to debate the possibility of a reversal in monetary policy.

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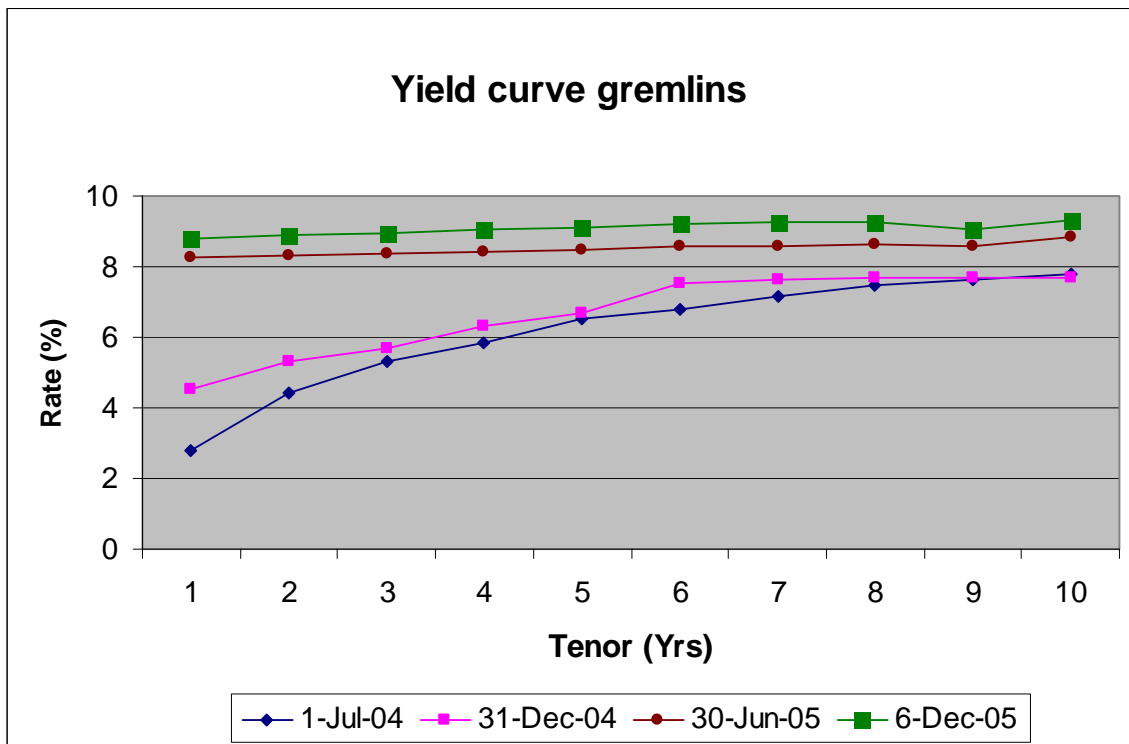
### A flat yield curve....

Economic theory suggests that a flat yield curve is usually followed by an inverted one, and an inverted yield curve leads to a recession three or four quarters later with alarmingly high probability. Infact, there is ample empirical evidence that the yield curve is the single most accurate business-cycle forecasting indicator.

Is there, then, cause for concern in Pakistan. Our yield curve is fairly flat at this point in time, and should further tightening continue, is there a real threat of inversion and an ensuing recession?

According to the pessimists, the script is familiar. The SBP has tightened, liquidity is drying up (credit boom is over), the yield curve has flattened, and growth is also showing signs of slowing. However, before submitting to prophets of doom, it is imperative to understand the how and why of yield curve flattening.

So we ask; why is our yield curve flat? Is the flatness a consequence of the tight monetary policy being pursued by the central bank resulting in gloomy future growth expectations or are inflation expectations benign? Are we in Pakistan also witnessing the conundrum that besets the US bond markets of rising short-term rates and falling long-term yields? If we are, should we too brace ourselves for the possibility of a recession in a couple of years?





**.....or a managed one**

Our yield curve is not flat for any of the above reasons. Rather, what we are witnessing today is a managed yield curve. We cannot determine the true shape of the yield structure when no long-tenor bonds have been issued since the past year and a half. Infact, the very non-existence of fresh long-term paper reveals that in reality, the yield curve is not flat. If the State Bank has a PIB auction as of today, and it yields a single-digit interest rate on 5 and 10 year government securities, then one can correctly claim that our yield structure is in reality flattening. However, one of the primary reasons why no PIB bids have been accepted since June 2004 is that the government does not want to lock itself into paying double digit interest rates. In the last successful PIB auction, which was 17 months ago, the State Bank locked itself into 20 year PIB's at 9.99%. That is the closest they came to flirting with the self-imposed double digit barrier.

The logic of the State Bank is that monetary tightening is a temporary phenomenon. Once inflationary pressures have eased off, one can expect the central bank to revert to its pro-growth bias. In essence, it is much more economical to borrow long-term during an accommodative monetary cycle vis-à-vis during tight monetary conditions.

That is not to say that the government does not need to borrow. Fiscal hemorrhaging is very much evident by the fact that the government has revised its fiscal deficit target to 4% for the year, and the actual figure could be even higher. However, given that LIBOR is around 4.6%, and there is not much expectation of a depreciation of the Pak rupee, it is more economical to borrow funds from the international market. The euro and sukkuk bonds have been issued exactly for this purpose. The international borrowing has a fringe benefit that it provides the SBP with foreign exchange. This is no small favor given the trade and current account imbalances that we are currently running. Thus, it would be reasonable to expect the government to fulfill its borrowing requirement through sources other than PIB's till such a time that inflation pressures subside and allow for a reversal in tight monetary policy.

### **Adios Dr. Hussain...Bonjour Dr. Akhtar**

Like Dr. Bernanke in the United States, our new SBP governor shall also need to signal the interest rate path to the financial markets. "First impression lasts" is more applicable to a central banker than to anyone else I can think of. However, the stability that has marked Ishrat Hussain's last two months in office would make the

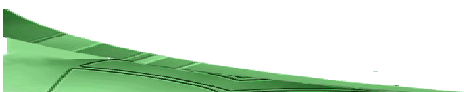
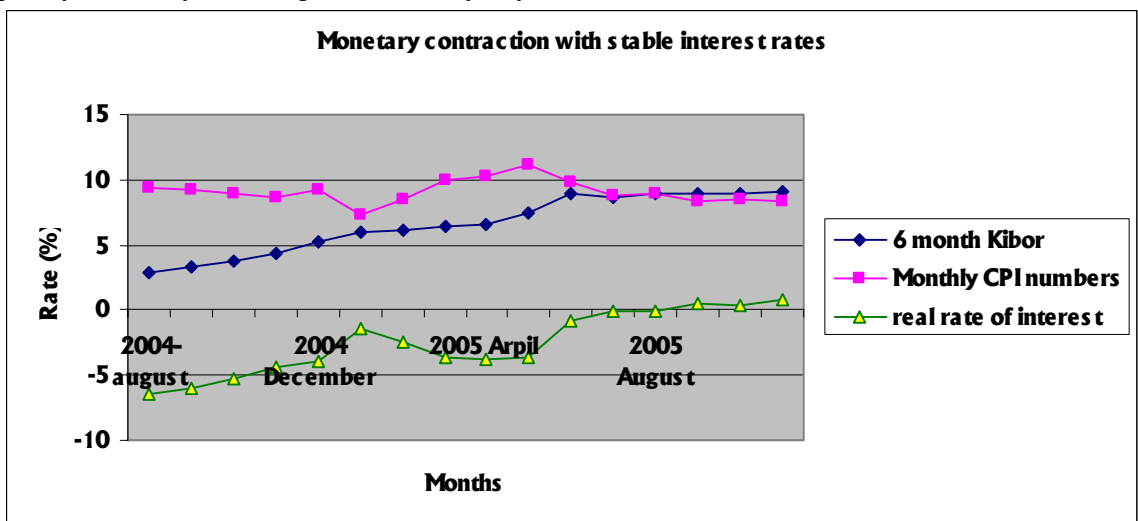
job of the next governor much easier. She can keep interest rates at current levels without risking being branded an inflation dove, a luxury that Bernanke can ill-afford. In our view, that is the most appropriate mechanism to fight inflation while not compromising on growth; in essence, to achieve a soft landing. To maintain the status



quo would also be advisable from a purely academic point of view as well. By her own admission, Dr. Akhtar has confessed her relative unfamiliarity with the recent

state of the Pakistani economy, and it would take some time for her to take stock of the macro-economic situation. In this learning period, any significant break from stability would be seen as hasty, and not appropriate in theory.

That does not mean that we are advocating a neutral monetary policy. The inflation risk is still significant enough to warrant a conservative stance. But the correct definition of monetary tightening is a positive and increasing “real rate of interest.” After all, the real interest rate is what effectively matters. One of the reasons why private sector credit off-take did not decline last fiscal year despite year-long interest rate hikes was because real interest rates continued to be negative. It made business sense to continue borrowing at 7% when inflation was between 9-10%. If we compare six month KIBOR and CPI numbers, we find that the interest rates approached zero as late as September of this year. Continued monetary tightening could now take the form of stable nominal rates but higher real rates. In other words, higher real rates of interest can be achieved by tackling inflation without having to tinker with the nominal interest rates. If recent CPI figures are anything to go by, this might very well be the case going forward. CPI headline inflation fell to 8.27% in the month of October. While some of the decrease may be attributed to base effect, one should not forget that October inflation includes the effect of Ramadan, the earthquake and rising international and domestic oil prices. Since then, these inflationary pressures have abated somewhat. The bottom-line - inflation has assumed a definite downward trend. A headline CPI of 8% for the month of November can now realistically be expected. With inflation numbers falling and private sector credit off-take also growing at a subdued pace, it would only be fair to concede that a tight monetary policy is finally working. And as they say, don't fix it if it ain't broke!!





## Political economics- Soft Landing versus Speedy Gonzalez

Political economists, however, point to the possibility of a reduction in interest rates with the 2007 elections approaching. After all, broad money has grown at an anemic 1.84% in the first three months of the current fiscal year. This is against a full year target of 13%. However, a closer analysis of the data reveals that the Net Foreign Assets, not private sector credit off-take which is resulting in a stagnating money supply. The NFA of the economy have decreased by 12% YoY. Private sector credit off-take is growing fairly close to the projected rate and has increased by 6% YoY in the first four months of FY06. It would be fallacious to believe that money supply growth has reduced so drastically owing solely interest rate hikes.

The central bank, for one, does not seem at all intent to reverse their tight monetary policy. If one reads between the lines of “SBP speak”; one can, infact, ascertain that the central bank is more inclined to lower the growth target of 7% then to exceed the inflation one of 8%. Dr. Ishrat has infact lowered the government estimate of GDP growth between 6.3-6.8%, stating at the same time that inflation should be around 8% for the fiscal year 05-06. For more on this, take a look at Box 1.

### Box1

#### *SBP SPEAK- Read between the lines*

*“While continuing to observe movements of all key variables and taking timely corrective actions, the key objective of the monetary policy would be to fight inflation and bring it down to a reasonable level during the next six months.”*

Monetary Policy Statement, July December 2005

Our Interpretation- Tight monetary policy to continue till inflation pressures have abated.

*“Inflation continues to pose a risk to our economy. The challenge going forward would be to control inflation while not hurting growth.”*

Interview with Dr. Hussain on 23<sup>rd</sup> November 2005

Our Interpretation- Inflation pressures have not abated completely. It would not be prudent to lower interest rates till inflation is under control. Inflation would be under control when the target of 8% for the fiscal year is achieved.



If the central bank is intent on achieving the inflation target, it would be appropriate to examine how that can be achieved. Simple arithmetic indicates that an average inflation rate of 7.73% has to be achieved over the next 8 months if the full fiscal year 8% target is to be met. That is a daunting task even at current interest rate levels. At lower levels, it would just not be achievable. Another revealing statistic is that with average inflation standing at 8.55% for the first four months, it would require an average of 6.9% inflation for November and December to bring the half-year inflation to the projected 8%. Even “Speedy Gonzalez” would be hard-pressed to achieve that. In all probability, inflation for the first six months of this fiscal year would be in excess of 8%. With inflation above the fiscal year target of 8% at the end of December, the monetary policy statement for January-July 2006 would find it difficult to propose and subsequently justify an accommodative monetary policy.

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<b>Projected inflation for fiscal year 05-06</b>	<b>8%</b>
<b>Average inflation for first four months (July to October)</b>	<b>8.55%</b>
<b>Average for the next 8 months so the full year target is met</b>	<b>7.73%</b>
<b>Average inflation rate for Nov and Dec so that 8% target is achieved at Dec end</b>	<b>6.90%</b>

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But it also makes political sense to restrain from interest rate cuts. It has become increasingly evident to the common man that our country faces an inflation, not a growth problem. Unemployment figures are not going up. It is not income generation per se that is the problem; rather it is the diminishing purchasing power of that income that hurts every time you make a trip to your local grocery store. Rising prices and not reduced growth numbers threaten to be a potential flashpoint in the 2007 elections. Hence, it makes both economic and political sense to continue in the present contractionary mode, with stable nominal but rising real rates fighting the inflation battle!!

What does this mean for our yield structure? If the true shape of our yield curve is not flat, then any worries about a growth setback are at best pre-mature. Actual flattening and inversion are products of excessive monetary tightening. With expectations of interest rates peaking out, it would be fair to say that excessive monetary tightening is not on the cards. In the meantime, there has been a change of guard at the helm of the State Bank. Whilst we welcome Dr. Akhtar in her new role as SBP governor, a note





of thanks is extended to Dr. Ishrat Hussain for his extremely astute stewardship of Pakistan's economy for the last six year.

## Box 2

### ***Money Matters-*** **Explaining the 12 month T-bill fetish**

Does ground reality support our stable interest rate predictions? Is our hypothesis in line with the behavior of financial markets? Our analysis is in no way an exact science, but we endeavor to make a few rudimentary calculation. These show that if an investor were to buy the six month T-bill at the November 8 auction cut-off of 8.14%, and then roll his investment over at maturity in another 6 month T-bill, to get a return equal to the 12 month yield of 8.77%, the yield on the 6 month T-bill six months from the November 8<sup>th</sup> auction would have to be 9.03%- that is 89 basis points above the 8.14% yield. Financial markets were not expecting such a significant rise in interest rates over the short to medium term; hence they primarily went into the 12 month paper.

In the November 23rd auction, however, the cut-off on the 6 month T-bill was raised. The yield rose by 12 basis points to 8.26%. Redoing our calculations with the new yield structure indicates that yield on the 6 month T-bill would have to rise by 65 basis points after 6 months for the returns on rolling over a 6 month T-bill and a 12 month T-bill to be equal. Hence, those money market players who expect a 50-100 basis points increase in the discount rate would find it attractive to invest in 6 months T-bills right now. For those who are expecting an unchanged discount rate, the 12 month T-bill is still the one to go for.

Thus, in our view, recent interest in the 12 month T-bill is indicative of its superior yield given future expectations of stable interest rates. The important point to note is that the break-down of expectations of significant interest rate hikes, rather than expectations of interest rates being revised downwards is the reason for interest in the 12 month T-bill.

We have, ofcourse, not allowed for liquidity and risk premiums but those, we feel, are not significant enough to negate the essence of our analysis.



## Key Economic Data

Fiscal year 05- 06							
	Units	July	Aug	Sep	Oct	Nov	July-Oct
<b><u>Inflation</u></b>							
Headline Inflation	%	8.99	8.41	8.53	8.27	n.a	8.55
Core inflation	%	7.62	7.55	7.58	7.81	n.a	7.64
Food inflation	%	9.73	7.82	7.52	6.41	n.a	7.87
Non-food inflation	%	8.47	8.83	8.25	9.61	n.a	8.79
<b><u>T-bill</u></b>							
3 month	%	7.69	7.99	8.1	8.1	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14	8.26	n/a
12 month	%	8.69	8.78	8.79	8.77	8.77	n/a
<b><u>External Sector</u></b>							
Export	million US \$	1272.00	1408.00	1499.00	1329.00	n.a	5508.00
Import	million US \$	1997.00	2235.00	2322.00	2328.00	n.a	8882.00
Trade balance	million US \$	(725.00)	(827.00)	(823.00)	(999.00)	n.a	(3374.00)
Remittances	million US \$	313.14	348.41	341.10	372.50	n.a	1375.15
Total Foreign Investment	million US \$	129.50	161.40	182.80	208.30	n.a	682.00
Foreign Exchange reserves	million US \$	12613.20	12123.90	12000.30	11714.80	n.a	n/a

\* n.a      not available

\*\* n/a      not applicable



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