MCB Bank Limited
Formerly Muslim Commercial Bank limited

Treasury & FX Group

Quid Pro Quo

Issue # 7 **Economic report** *March 1sh 2006*

Retail Therapy doesn't work

Controversy-
India and Pakistan have trodden vastly different paths to economic revival. Is India's indigenous growth inherently more sustainable?

Contention-
Pakistan's falling savings rate and a historically high consumption to GDP ratio are indicative of a spendthrift culture. India, meanwhile, is starting to consume after more than two decades of tight-fisted economic growth.

Market impact-
With our indigenous savings base inadequate, the future of our investments continues to ride the crest of an unpredictable geo-political climate. Meanwhile, liquidity addicted consumers should realize that the punch bowl will have to be taken away from the party at some point in the future.

Risk-
Pakistan's strategic position as a key ally in the war against terror seems cemented for the moment. External assistance might last long enough for the nation to be able to clean up its act in a less painful manner.

The idea for this article came to me in the most unlikely of places, at the National Stadium Karachi where I had gone to watch the fifth and final ODI between Pakistan and India. It is very possible that had Pakistan won, or even put in a more competitive performance, the idea would never have entered my mind. I would have just enjoyed the cricket, without undertaking a mental exercise in sociology. As it happened, Pakistan delivered yet another below par performance, and I have Inzi and his boys to thank for this issue of the Quid Pro Quo.

There was a large group of Indian supporters in the stand I was in; university students from Delhi. At the outset, I felt a certain hatred for the whole lot, based on socially acquired pre-conceived notions. I soon realized that if I was erring, I was erring in a majority. Most of the people in the stand had no love lost for the Indians, and made no secrets of their emotions, jeering at them throughout the day. A fair degree of such banter can be overlooked in the name of competitive spirit. However, the Indians did not return us the favor, even while Dhoni took the Pakistani bowlers to the dry cleaners. They cheered, and cheered vociferously, but for their team, not against Pakistan. We on the other hand, missed no opportunities to taunt the Indians. Admittedly, though, such opportunities were few are far between.

The Twin Nation Theory flatters to deceive

What that indicated to me was that our youth is much self-assured than theirs. The school bully mentality that we exhibited was a text-book case of insecurity and self-doubt. The Indian youth seemed a whole lot more self-confident, despite being on historically enemy territory. They felt no need to resort to taunts when their team was doing well, as their sense of patriotism seemed to entail more than wishing other people badly.

Cultural and social differences were also on discernable. For instance, the Pakistani supporters displayed a vulgar quantity of PDAs and I Pods. The pronounced attention to attire was also something distinct to our youth. In itself, that is not a bad thing. However, the dynamic of the day indicated a definite underlying superficiality.

People on both sides of the border regularly point out the similarities between the populace of the two countries; India in particular is keen to highlight the “twins separated at birth” argument. I used to concur. We share both history and geography. However, observing the Indians at close quarters has made me a disbeliever. The twins have lived apart 58 years, and have gone down vastly different paths. The new generation of Indians is notably different from the young Pakistani population, and contentions of similarity flatter to deceive.

Two roads diverged in the wood and I…….

Changes have not taken place overnight. India has been undertaking a broad range of reforms for the last two decades. In terms of producing qualified professionals, India is definitely up there with the best. Education, and more generically, the spread of skills, has made the Indians more tolerant of competition- human capital equips you with a chance in a competitive world. The new generation of Indians can compete with the best, so there is no need for them to be afraid of them.

Their economic revival has been gradual and piecemeal, but most importantly, it is indigenous. They have faced up to their numerous domestic problems, and developed homegrown solutions. Having built up resources internally, they are now looking to unleash their true potential on a global platform. Companies such as Tata and Reliance reflect the emergence of the Indian muti-national. And while comparisons with China may be slightly premature, they are indicative of the depth of the Indian recovery.

Our economic upturn seems much more upstartish in comparison. Being the fortunate beneficiaries of a change in the geo-political climate, the economic growth that we are currently experiencing in the country is a windfall from those external events. Admittedly, the Pakistani government has made the most of its good fortune, but the economy as a whole continues to be still excessively dependant on external assistance, both in the form of remittances and FDI. Our recovery is not indigenous, and till such time, it is imperative that we strive to achieve self-reliance.

A History of Over-Indulgence

Trouble is, as a nation we have a notorious history of living beyond our means. Quaid-e-Azam Mohammad Ali Jinnah, just before his death in Ziarat in 1948 made this judgment.

"We Musalmans in general and young men in particular do not know the value of money. A paisa saved today is two paisa tomorrow and four paisa the day after that and so on and so forth. Because of our addiction to living beyond means and borrowing money we have lost our sovereignty over this sub-continent."

Pakistan's average consumption to GDP ratio of 84% over the last six years is indicative of the continued relevance of those words of wisdom. What this means is that, on average, we have consumed 84% of our income. A high consumption to GDP ratio might be justifiable when per capita income is low. Third world countries with low per capita incomes typically suffer from this problem. In the middle to lower classes, incomes are so low that nothing can be saved. A high consumption to GDP ratio is the inevitable by-product.

But, then, as a country expands and its per capita income rises, the consumption to GDP ratio should fall. More specifically, as GDP per capita increases, marginal propensity to consume should fall. Marginal propensity to consume measures the proportion of incremental GDP that is spent on additional consumption.

$$\textit{Marginal propensity to consume} = \frac{\textit{Change in consumption}}{\textit{Change in GDP}}$$

In Pakistan, the post 9/11 years (2002-2005) have seen the economy rebounding and GNP per capita has risen steadily from US$ 500 in FY01 to US$736 at the end of FY05. True to script, marginal propensity to consume in FY02 fell to 74% from 84% a year earlier. And for three fiscal years, it stayed at 74%. Because GDP was rising, even a constant marginal propensity to consume resulted in a rising savings rate.

FY05- a Year of Getting and Spending

This happy equilibrium, however, reversed sharply last year. Marginal propensity to consume rose from 74% to 121%, as the savings rate fell to a five year low of 15.1%. What does a marginal propensity to consume of 121% mean? For example, GDP between FY04 and FY05 increased by PKR 1015 billion. Consumption increased by PKR 1233 billion, more than the rise in GDP. This translates into a marginal propensity to consume of 121%. Bottom-line; in a period of record high growth of 8.4%, the nation as a whole consumed more than it earned, it dis-saved. A very generic interpretation of this is that the benefit of the GDP growth was exhausted completely within the year and no benefit is carried forward to future years.

Such a high marginal propensity to consume is extremely worrying. It is indicative of a spendthrift culture, a "make hay while the sun shines" kind of attitude. Instead of boosting savings, and in turn, investments, much of the nation decided to simply cash in on the economic revival. GDP is rising, but so is our consumption. Evidence is all around us; new cars, housing projects, mobile phones, fancy restaurants and consumer durables in general have taken centre stage in many of our lives. Granted, this is the age of consumerism globally and we are no contrarians in that regard. However, comparisons only hold relevance and meaning when circumstances are similar. For a country only skin-deep into economic revival, it is surely extravagant to spend so much, so soon.

Our historical addiction to pleasure living, which took a turn for the worse in FY05, seems to be continuing into FY06 as well. Case in point, a friend of mine wanted to book a Daihatsu Cuore recently. On calling up a car dealer, he was informed that due to an unmanageable back-log, booking for the car was closed. Forget about the wait-time, you just could not book the car at all! A few weeks later, another dealer informed him that booking had re-opened, but delivery would be in December, a wait of 10 months. The "on" premium, if immediate delivery was desired, amounted to PKR 100,000. That's more than 20% of the value of the car. Yet people actually pay the premium, it is not such a huge deal anymore.

Even more problematic is the fact that much of the new consumption is being imported from abroad. Pakistan's economy has already overheated; the sudden remittance injected liquidity boom had resulted in too much money chasing too few goods. The proper way of dealing with the liquidity would have been to direct those funds to profitable investment expenditure that would increase the productive capacity of the economy. To some extent, that did happen. Balancing, Modernizing, and Restructuring (BMR) in key industries like textiles and construction did take place. But much of the new-found liquidity was deployed in consumption and speculative activities, such as stock and real estate investments. This resulted in, and re-enforced, inflationary pressures in the economy. And when inflation reached untenable double-digits, policy makers were left with few options but to deregulate imports. Voila…it should come as no surprise that the trade deficit is soaring. And the frustrating part of importing consumption from abroad is that it adds nothing to GDP; there is no possibility of consumption-led growth.

Import Liberalization- Coming Back to Haunt Us

And for those of us who suffer from selective amnesia, a look back to the “golden decade” of the 1960’s, under Field Marshall Ayub Khan, is needed. With a rapid process of import and economic liberalization, Pakistan’s growth story was applauded by the West. Turned out, Ayub Khan had put the cart before the horse and Pakistan’s golden decade was followed up by three decades of economic wilderness. There are many analogies to draw between the growth experiences of then and now. Both episodes developed economic and political superstructures without building a corresponding base. Imports were liberalized when protectionist measures might have been more appropriate. Both episodes yielded benefits in the form of short-term economic growth that was lauded by Western sponsor nations. In both cases, the country had put all its eggs in the western basket. The excesses of the 1960’s back-fired in a big way. The fate of the current growth momentum still hangs in the balance.

India’s Austere Road to Party Time

One can argue that consumerism is catching on in India as well, and consumption is now a key driver of economic growth. Yes, it is true that the Indian consumer is spending more and more these days. But that is after averaging growth of over 6% over the last 25 years. Few countries have grown so fast for such a prolonged period of time. And for most of those years, Indians have lived simply and well within their means. They have a history and reputation for being keen savers. India is not Bollywood, a point that should be understood in no uncertain terms. Their consumption to GDP ratio averages 75%, a full 10% less than ours. And if Indians are opening up their purses now, it is because they can afford to so.

For a more complete analysis, we take a look at the two countries saving and investment figures. India’s recent consumption binge has not been at the expense of savings, its savings to GDP ratio has gone up substantially from 15.1% in 1987 to 26.5% in 2005. Pakistan’s savings rate, meanwhile, has gone up from 13.85% in 1985 to 15.1% in 2005, a little more than a percentage point increase in 17 years. Even more worrying is that our savings rate reached a peak of 20.8% in FY03 but has been falling since.

Correspondingly, India’s investment to GDP ratio is also higher than that of Pakistan’s. India’s average investment to GDP ratio for the last six fiscal years is 25.43%, relative to Pakistan’s 18.33%. One cannot attribute such a large difference to infrastructure and institutional issues alone. India has numerous infrastructure issues of its own. The primary reason for their consistently higher investment to GDP ratio is that their savings rate is higher, and that provides a reliable and sustainable source of investment funds. Foreign investment is certainly desirable but it can never be completely trusted. To engineer a growth plan on such “hot money” is not advisable. FDI should be welcomed not so much for the funds it brings, but for the technological innovations that are its inevitable by-products.

Figure 1

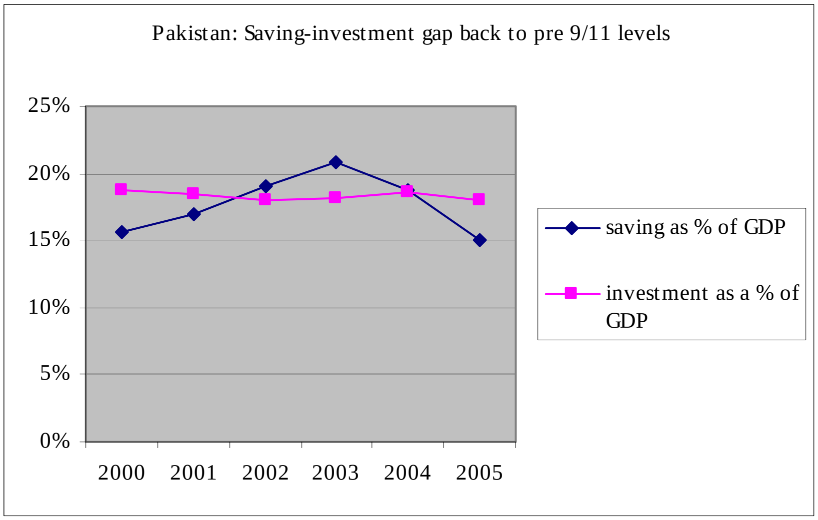
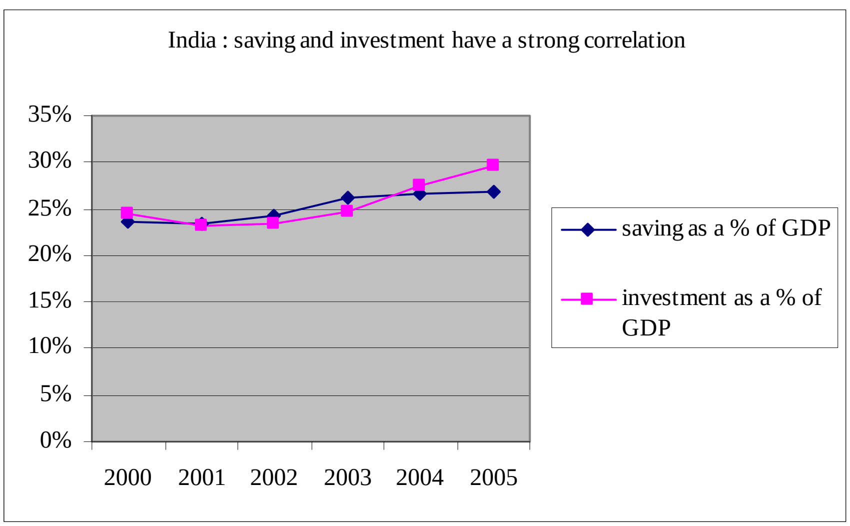


Figure 2



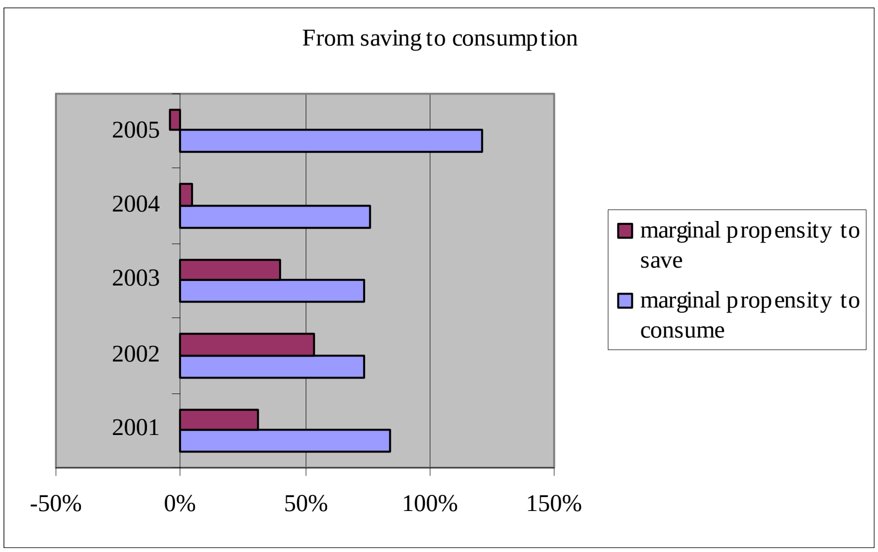
The question arises; why has the savings rate dipped so precipitously in FY05? The dip in the savings rate is typically attributed to a combination of low interest rates and high inflation. With real rates of interest well into negative territory, savings did not make intuitive sense. The saving rate in FY 05 fell drastically from 18.7% of GDP in FY 04 to 15.1% of GDP in FY05. Marginal propensity to save in FY05 was -4.5%. What this means is that savings were reduced to the tune of 4.5% of the increase in nominal GDP. A negative marginal propensity to save implies that not only did the savings to GDP ratio fall, but the absolute level of savings actually fell from PKR

1035 billion to PKR 988 billion. The nation, in a record year of economic expansion, actually dis-saved.

Marginal propensity to save = $\dfrac{\textit{Change in national savings}}{\textit{Change in GDP}}$

One reason for the fall in the savings rate, along with negative real rates of interest, was the upturn in economic and industrial activity has generated a feel-good factor in the country. This new-found economic optimism directly resulted in a reduced level of precautionary savings. With the economy expected to be robust in the foreseeable future, fewer people felt the need to save for a rainy day.

Figure 3



The negative real rate of interest along with the reduced need for precautionary savings provides a valid line of reasoning the fall in the savings rate. But not only was marginal propensity to save negative, the marginal propensity to consume was 121%. Even if we net-off the marginal propensity to save and the marginal propensity to consume, their total comes out to be a 116% of GDP. The nation financed some of the increased consumption (more precisely 4.5% of it) by running down savings. However, 16% of the increased consumption was financed through different sources, not by dis-saving. Thus, negative real rates of interest do not tell the whole story. We examine some of the alternate reasons why savings rate has fallen by less than the rise in consumption.

Leveraging Like Its Going Out of Fashion

Important in explaining this saving-consumption dilemma is the permanent income hypothesis. What this theory contends is that consumption (and savings) are a function of life-time wealth, not just the current stream of disposable income. Thus, if citizens are optimistic about the economy and their own job prospects in the future, they might decide to consume more than their current income by borrowing funds. The phenomenal rise in consumer loans in Pakistan during the last two years indicates that such leveraging is taking place. Loans have to be paid back in installments, and citizens are confident that future income shall rise, making installment payments easier on the pocket.

Another factor in Pakistan's latest consumption binge is the positive wealth effects emanating from the stock market and real estate boom. To the extent that household wealth has increased due to capital gains in equity and real estate investment, the need to save is less pressing. After all, the purpose of savings is to increase wealth. If a household's wealth increases by virtue of windfall capital gains, all else equal, its incentive to save should reduce.

An example from the US would make this point clearer. From 1995 to 2000, when the US stock market indices tripled, nearly US$ 12 trillion was added to the wealth of US households. Over the same period, savings dropped from 6.5% of disposable income to around 1%. Currently, the US housing bubble has had an even more pronounced effect, pushing the savings rate into negative territory.

The permanent income hypothesis along with the positive wealth effects help explain the apparent dilemma of consumption increasing by more than the fall in savings. That was made possible by leveraging household balance sheets and financing consumption through capital gains on investments. In that regard, the current fiscal year provides scant comfort. While real estate prices seem to have taken a breather, stock prices are still at record highs. Private sector credit off-take, meanwhile, is close to the full year target in just seven months. More importantly, the proportion of consumer loans in the total advances portfolio is rising. Marginal propensity to consume thus promises to be high for at least another year.

And while a return to positive real rates of return in NSS has halted the outflow from this government saving scheme, the government's unwillingness to jack the rates up further make it unlikely that NSS shall regain its former position as a primary source of saving. Bank deposits have grown by 8.8% in the first seven months of FY06, and while many banks are offering decent deposit rates now, these competitive rates are not on plain vanilla deposits. The average return on fresh deposits as of December 2005 was a paltry 3.17%, and returns on savings accounts are still abysmally low. Thus, on the balance of risks, while the savings rate might rebound slightly from the 15.1% of FY05, do not count on it to rise by much.

The recent bout of economic growth has not resolved these structural problems, it has merely sidelined them. As recently as 2001, the Asian Development Bank attributed Pakistan's poor economic performance, relative to elsewhere in South Asia, to its low saving and investment rate, which were the lowest in the sub-region. As the table below indicates, our ratio of saving to GDP still remains the lowest. The investment to GDP ratio has picked up primarily due to remittances and foreign investment. In FY06, remittances of USD 4.2 billion and foreign investment of USD

3 billion is expected. Political events could dry up those flows overnight. Where would our economy stand then? And with inadequate indigenous savings, will the investment to GDP ratio also recede to its previous anemic levels?

Table 1

	Savings rate	Access to credit	Inflation
Pakistan	88	8	84
India	38	1	57
Sri Lanka	80	93	92
Bangladesh	41	52	78

Ranking out of 117 countries in The Global Competitive Report 2005-2006

Complacency certainly has its perils. If and when the stock market and real estate prices adjust, leveraged and liquidity addicted consumers would face a hard landing. We should be in the consolidation phase of our growth cycle, and continued investments need correspondingly high savings. For now, Pakistanis seem unwilling to make the sacrifices to secure long-term sustainable growth. For a population that frequently laments the lack of fiscal discipline, it would do well to look at the lack thereof in the private sphere as well.

Inviting Trouble

How can domestic savings be boosted and consumption reduced? The traditional answer is to increase interest rates, which increases the incentive to save and reduces the incentive to consume. Not only does the opportunity cost of not saving, (in the form of interest foregone) go up, but the cost of credit to finance consumption also increases. The domestic-saving investment equilibrium can be achieved in this manner.

If interest rate hikes are deemed to be counter-productive to the growth momentum, then exchange rate depreciation can also yield the desired austerity. Exchange rate depreciation would increase the price of imports. Imported consumables, which due to their elastic demand, are the most price sensitive would be most directly hit by this terms of trade re-adjustment. By discouraging imports of non-essential consumer items, higher savings can be force-fed to the nation. Unfortunately, exchange rate depreciation is not consistent with the SBP’s inflation fighting plans.

However, inaction on both the interest and exchange rate fronts only heralds a much more painful re-adjustment in the future. As private sector credit off-take and the current account deficit continue to spiral, a collective reality check is only a matter of time.

Economic Snapshot

	Fiscal year 06								
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	July-Jan
<u>Inflation</u>									
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	8.76	8.48
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	7.34	7.55
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	8.17	7.66
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	9.18	8.93
<u>T-bill (Wgt Avg)</u>									
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
<u>External Sector</u>									
Export	Mln US$	1,272	1,408	1,499	1,329	1,120	1,421	1229	9,278
Import	Mln US$	1,997	2,235	2,322	2,328	2,300	2,420	2145	15,747
Trade balance	Mln US$	(725)	(827)	(823)	(999)	(1,180)	(999)	(916)	(6,469)
Remittances	Mln US$	313	348	341	373	309	336	391	2,411
Total Foreign Investmen	Mln US$	130	161	183	208	323	458	164.6	1,627
Forex reserves	Mln US$	12,613	12,124	12,000	11,715	11,321	11,211	11,505	n/a
<u>Key</u>									
n.a	not available								
n/a	not applicable								

MCB BANK LIMITED

(Formerly known as Muslim Commercial Bank Limited)

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Farrukh Karim Khan

Kamran Parekh

Telephone:	**92-21-2270024**
Fax:	**92-21-2270094**
	92-21-2270109
Email:	farrukh.karim@mcb.com.pk
	kamran.parekh@mcb.com.pk
Website:	www.mcb.com.pk