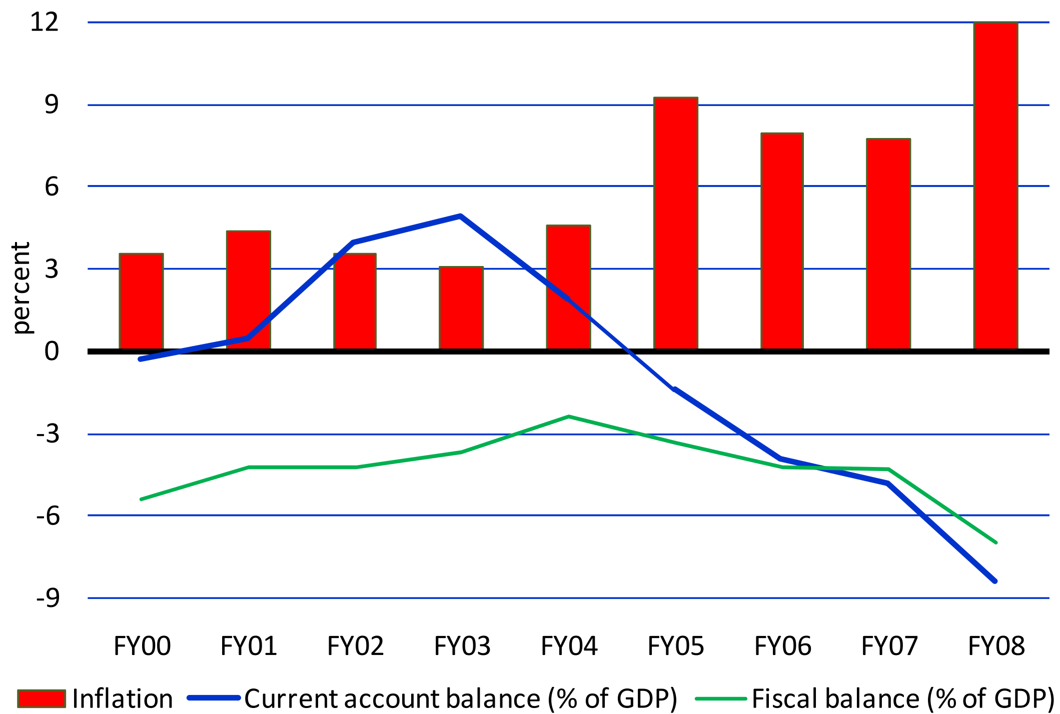
MONETARY POLICY STATEMENT

July – December 2008



STATE BANK OF PAKISTAN

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Executive Summary

2008 has been a difficult year for the global economy but more so for emerging and developing economies including Pakistan. After a relatively long period of macroeconomic stability and prosperity, global economy has faced multifarious challenges: (i) hit by the subprime mortgage crisis in U.S in 2007, the international financial markets have been in turmoil and whose impact is now felt across markets and continents; (ii) rising global commodity prices, with crude oil and food staples prices skyrocketing; and (iii) a gradual slide in the U.S dollar against major currencies. Combination of these events has now induced a degree of recessionary tendencies and inflationary pressures across developed and developing countries. Policy makers are now gripped with dual challenge of slowdown in growth and unprecedented rising inflationary pressures. Central bankers are facing demanding task of weighing the tradeoff between growth and price stability. With the exception of few developed countries, most central banks have shown a strong bias towards addressing the risk of inflation and have responded with tightening of monetary policies.

In one sense, Pakistan is no exception. Like other countries, it faced confluence of global shocks. What distinguishes Pakistan, given its political and economic vulnerabilities relative to other developing and emerging countries, is that the impact of global shocks turned out to be severe and rapid. Consequently, in Fy08, country's twin deficits magnified to unsustainable levels, which along with supply side constraints escalated inflation (see **Annexure I**). To avoid further complexities, both the Government and central bank have taken a set of fiscal and monetary policy measures over the last two months of FY08 to curb macroeconomic imbalances. While other countries have greater room to support growth at the cost of higher inflation, the trade off for Pakistan would not be affordable since inflation is already very high and above historic trends while growth is still at a respectable level.

After a careful and measured assessment of both global and domestic developments and their consequences for growth prospects and inflation outlook, during the course of FY08, the State Bank of Pakistan (SBP) had to take three rounds of corrective policy actions:

- **First,** in July 07, SBP policy rate was raised by 50 bps to 10 percent simply to allow for sterilization of excessive foreign inflows, which came in the last two weeks of FY07, and stem anticipated inflationary pressures. This measure did help in curbing the monetary pressures during July-October 2007 as real interest rates rose and monetary growth decelerated. Continued foreign inflows ensured stability in exchange rate and built up of foreign exchange reserves. More importantly, Government borrowing from the central bank was largely on track; as it borrowed only Rs23.2 billion. In short, major economic variables were showing that monetary transmission mechanism was working. However, since November 2007 onwards, monetary tightening began to lose some of its steam. Massive liquidity was injected in the system as the Government borrowed from SBP almost Rs178 billion in November and December 2007. This led to softening of key interest rates and money growth accelerated. At the same time, rising international oil and food prices impacted the inflation outlook and in absence of adjustment in domestic prices the financial burden of subsidies and high spending in other areas resulted in rising economic stress.

- **Second,** in January 2008, viewing the developments in H1-FY08 and outlook for future, SBP advocated the need for strengthening demand management and raised policy rate by another 50 bps to 10.5 percent. However, international oil and food prices continued to rise to unprecedented high levels. The burden of the subsidies and rising consumption demand widened macroeconomic imbalances and exchange rate experienced significant pressure. Rising recourse to inflationary financing of the budget (by Rs338.3 billion during January 1 to May 24, 2008), started to induce loosening monetary conditions in the economy as net domestic assets of the banking system grew sharply. Also, external current account deficit rose substantially to US$5.6 billion during January-April 2008 compared to US$2.0 billion in the corresponding period of the last year.

- **Third,** recognizing the scale and magnitude of unprecedented economy-wide pressures and urgency of the situation, SBP introduced a host of emergency interim monetary policy measures in May 2008 to restore macroeconomic stability. These measures have helped in reinstating tight monetary conditions as real interest rates moved upwards. Notwithstanding, risks facing Pakistan economy continue to be complicated by fast changing global commodity price

scenario and unwelcome domestic developments. Government's heavy reliance on SBP borrowings continued unabated with additional borrowing of Rs149.8 billion during May 25 to June 30, 2008. Budget for fiscal year FY09 estimates put the fiscal deficit at 7 percent of GDP, while financing data available to SBP for the full FY08 shows that this could be as high as 8.3 percent of GDP.[1] Within two months (May and June 2008), trade and external current account deficits as percent of GDP widened further by 1.5 percentage points each and exchange rate remained under pressure. In the same period, CPI inflation (YoY), on the back of high International commodity prices and high inflationary borrowing, increased by 4.3 percentage points. Above all, second round impact of high food inflation has become embedded in the inflation expectations.

Outcome for FY08

Most imminent challenges to macroeconomic stability now emerge in the following areas:

Growing external current account deficit. Despite record flow of worker's remittances and buoyant exports, the external current account deficit grew to US$14 billion, equivalent to 8.4 percent of GDP – which is around three and a half percentage points higher than the initial projection for FY08 and more than twice last year's level in absolute terms. This is largely because the growth in the import bill outpaced growth in export revenues. Witnessing continued surge in oil import prices from US$66.2 per barrel (Arabian Light Crude) at the beginning of the year to US$130.9 per barrel by end June 2008, Pakistan's oil import bill for FY08 rose to US$10.5 billion, which is 43 percent higher than the last year's level. Given domestic shortages and emerging political concerns for strategic reserves, the country imported US$570.1 million worth of wheat, which along with price hikes of palm oil and other products raised the food import bill by 46 percent. In FY08, oil and food imports requirements constituted around 40 percent of total import payments. With non-oil non-food imports registering a strong growth momentum (24.2 percent), aggregate growth in imports was 31.2 percent that is much higher than the last five years average of 24 percent.

[1] The revised estimate for fiscal deficit by the MoF for FY08 is 7 percent of GDP including an estimated bank financing of Rs424.1 billion. With the actual position of bank financing of Rs.555 billion and keeping all other types of financing as given by the MoF, the fiscal deficit turns out to be Rs.865 billion i.e. 8.3 percent of GDP.

Financial inflows met external current account deficit only partially. While foreign inflows did finance a large part (63 percent) of the external current account deficit, outflows in foreign portfolio investment and deferment of privatization program lowered the foreign resource availability. Financing the resource gap of external current account deficit and the repayments (both of public debt and private sector obligations) has depleted the reserves by US$6.5 billion during FY08 from all time high of US$16.4 billion along with the use of funds held in escrow accounts. At these levels, Pakistan's foreign exchange reserve coverage of import fell from 31 weeks observed at end June 2007 to 17 weeks by end June 2008.

Pressures on foreign exchange reserves strained exchange markets. After experiencing a high degree of exchange rate stability for almost five years, with the growing pressure on foreign exchange reserves, Rupee Dollar parity depreciated cumulatively in FY08 by 11.5 percent in nominal terms. However, depreciation in the Real Effective Exchange Rate was only 2.4 percent due to high domestic inflation relative to inflation in the trading partner countries. Managing exchange rate has been a challenge during the year as the investor sentiments and speculative tendencies introduced spikes in exchange rate, which dipped to lows of Rs69.73 per US$ (on May 21, 2008) compared to an average of Rs62.63 per US$ during FY08. To curb the pressures and calm the sentiments in the domestic foreign exchange market, SBP introduced two rounds of administrative and regulatory measures that helped to restore a degree of foreign exchange rate stability (see **Annexure II**).

Government's excessive recourse to SBP borrowings to finance the fiscal deficit is now unsustainable. Based on financing availed from SBP, it is estimated that fiscal deficit for FY08 is more than double the targeted level and even above the reported outcome in budget for FY09. Given free access to automatic monetization (as profits generated by SBP from interest payments on borrowings from SBP are transferred to the Government annually), the Government financed its fiscal deficit from the central bank. This was despite the SBP's repeated reminders, at the start and during the course of the year, that it has been breaching the annual and quarterly limits on government borrowings imposed by the SBP's Board of Directors. Consequently, the year has ended with the SBP's financing of Rs688.7 billion, around 80 percent of the fiscal deficit. The stock of government debt to SBP – Market Related Treasury Bills (MRTBs) – has now reached to Rs1053 billion, almost 10 percent of GDP.

Stress on fiscal account has been of high order. Budget outcome for FY08 revealed gross underestimation in several heads of recurrent expenditures including interest payments and excessive subsidization of oil and food products that grew from Rs114 billion budgeted level to Rs407 billion as the Government opted to delay the pass through of prices. Consequently, fiscal deficit grew unabatedly without due regard to the resource envelope. Rise in fiscal deficit and inability of the government to tap non-bank and external resources over and above the projected levels resulted in excessive recourse to central bank's borrowings. During the course of H2-FY08, the Government borrowed Rs204.2 billion during January – March 2008 and Rs283.9 billion during April - June 2008 – of which Rs55 billion were borrowed on the last day of the fiscal year alone.

The impact of this excess liquidity is serious for inflation outlook, as this has added to the currency in circulation and diluted the tight monetary policy stance. Moreover, substantially large borrowings requirements have inhibited Government ability to meet the additional financing requirements from commercial banks and off loading the existing stock of MRTBs to the market. Efforts to offload these Government borrowings to the market are already exerting further pressure on Karachi Inter-Bank Offer rate and other market interest rates. In fact, the market has already raised its bid prices in T-bill auctions and consequently the 3 month cut-off rate has peaked to 11.8 percent reaching close to SBP's policy rate of 12 percent.

Inflationary pressures are alarming. On average basis, headline CPI inflation, at 12.0 percent in FY08, was 5.5 percentage points above the target for the year with the underlying average food and non-food inflation rising to 17.6 and 7.9 percent in comparison with the previous year's 10.3 and 6 percent respectively. In June 2008, the headline CPI inflation reached to a 30 year high of 21.5 percent YoY, while food inflation rose to record high of 32 percent, the non-food inflation more than doubled to 13.8 percent compared with last year. Strong aggregate demand pressures combined with increased pass-through of the persistent rise in imported oil prices contributed to high domestic inflation. On the domestic front, in addition to the demand pressures, a fall in the productive capacity of the economy is also contributing to rising inflation.

In SBP's assessment, the share of structural weaknesses (like energy shortages, supply chain management issues, low productivity etc.) dominate the

supply side issues compared with the impact of monetary tightening. A common perception of some business segments is that the tightening of the monetary policy has raised the share of financial expenses within the total expenses.[2] However, the audited accounts data of non-financial companies listed at the Karachi Stock Exchange reveal that in 2007 financial expenses constituted only 2.4 percent of overall expenses compared to 4.7 percent in 2001. In growth terms, during 2007 the total expenses grew by 12.1 percent of which financial expenses increased by 0.7 percent only. This evidence confirms that the contribution of financial expense in overall rising expenses is small. Furthermore the private unlisted companies in Pakistan usually rely on internal resource generation to finance their requirements. Notwithstanding, companies have option to raise financing from stock markets provided they meet the listing requirements and other disclosure. Stock markets need to position themselves to allow companies to raise new capital – a measure that will help broaden and deepen these markets, while reducing risk exposure of the banking industry.

It has to be acknowledged that recent increases in the industry's cost of production are largely due to rise in "other" input costs. Industry is paying more for oil and other imported raw material and capital goods in line with rising international prices and utilities and transportation costs and wage costs have risen due to the rise in minimum wages. These elements constitute more substantial increase in production cost relative to financial costs. Feeling the heat on their profit margins and expecting these global shocks to be permanent, firms have been passing on this imported inflation to their customers. The result is that the pressure on prices in the economy has remained persistent. An indication of these pressures is a sharp increase in core inflation measures. The non-food non-energy indicator shows a YoY rise to 13.0 percent in June 2008, more than twice that in the last year. Similarly, the 20 percent trim measure rose to 17.2 percent in June 2008 compared to 6.5 percent in June 2007.

The danger now is that of a wage-price spiral, that is, to get compensated for the erosion in their purchasing power due to accelerating inflation, people will expect and demand higher wages, which will add to the burden of the production sector. The SBP has been pursuing a tight monetary policy stance over the last three years to stem these second round effects from getting out of control. The monetary

[2] Financial expenses include all types of markups, bank charges and exchange rate losses etc.

policy stance has had a visible impact in arresting such expectations and core inflation came down from 7.8 percent in April 2005 to 5.2 percent in May 2007. Even up to December 2007, core inflation remained contained; however, it's only during the last six months that the pace of increase rose sharply that prompted the SBP to introduce interim monetary policy measures in May 2008.

These challenges require well coordinated and immediate policy responses to further contain demand pressures in line with the economy's capacity and resources.

Outlook for FY09

FY09 ought to be a year of consolidation. New democratic Government has entered FY09 with heavy overhang of the last year's macroeconomic imbalances in the economy. At the same time, it carries the responsibility of fulfilling the aspirations and promises to the nation. The trade offs are not easy and global economic environment continues to be fraught with uncertainties though some trends are quite clear: global growth has slowed down, international liquidity squeeze persists and Pakistan sovereign rating prevents tapping international markets, and international commodity prices remain high.

Recognizing this, the Government and the central bank have taken pre-emptive policy actions together. Budget deficit for FY09 has been rolled back to 4.7 percent of GDP and Government has committed itself to achieve net zero borrowing from SBP during the course of the year, while enhancing its reliance on other nonbank sources. To reinforce further, on 10 June 2008 (ahead of the budget for FY09), SBP advised the Government that the Central Board of Directors recommend net retirement of Rs84 billion for FY09 with quarterly retirement of Rs21 billion. These limits have been worked out keeping in perspective the need for consistency with a coherent macroeconomic framework. Adhering to these commitments and targets will be vital to arrest the drift in macroeconomic imbalances. Imposing hard budgetary constraints further requires that the Government amends the *Fiscal Responsibility and Debt Limitation Act, 2005* to include provisions for recognizing the need to phase out the Government's dependence on SBP borrowings over a period. This involves adherence to limits imposed on SBP borrowings henceforth, while lowering the stock of SBP borrowings.

Fiscal framework for FY09 will need to be dynamic to incorporate necessary adjustments as economic developments evolve. Early indications are that the budget deficit target for FY09 of 4.7 percent of GDP is already coming under stress. Aside from the changing oil and exchange rate scenario relative to budgetary assumptions, SBP assessment is that the budget underestimates spending and overestimates revenues. Containing expenditure growth at 6.5 percent, given a track record of 20.3 percent average increase during the last five years, seems difficult and the subsidy bill is likely to come under strain unless political pressures are muted. Similarly, realizing the estimated growth in tax revenue at 24 percent seems challenging given the average growth of only 12.8 percent during the last 5 years. It must be kept in view that past few years benefited from the high and fairly robust GDP growth (7.0 percent on average); while for the coming year a growth of only 5.5 percent is being anticipated.

These optimistic expenditure and revenue assumptions carry the risk of fiscal slippages beyond target again. Even a one percentage point increase in fiscal deficit above the target level would require additional borrowings in the order of over Rs100 billion. What is worrisome is that there are severe external and domestic constraints which make it difficult for raising the required financing on a timely basis for the projected fiscal deficit for FY09. Generating the same amount domestically from sources other than the central bank would result in crowding out of credit availability to the private sector. Efforts should be launched to raise additional resources otherwise it risks the monetary policy stance. As is evident, during the first twenty five days of current fiscal year the government has already borrowed additional Rs32.9 billion from SBP. This pattern is not in line with SBP's recommendation to the government to retire Rs21 billion during each quarter of FY09.

The balance of payment scenario for FY09 demands further policy action. Curtailing import growth and raising the exports further are critical for narrowing the external current account deficit which is key to the macroeconomic sustainability. Additional efforts to mobilize financing to meet the external current account deficit is equally critical as the assumptions underlying balance of payment projections have changed with the rise in international oil prices. At the same time financing mobilization will need to be calibrated to restore foreign exchange reserves to a more comfortable level.

To restore macroeconomic stability there is need for additional corrective policy actions, both at the Government and central bank level. As is obvious from above analysis, the difference between the real domestic aggregate demand and supply of goods and services in the economy widened during FY08 and the rise in both the external current account deficit and the fiscal deficit are only a manifestation of this gap. The growth in real domestic demand (7.1 percent) was stronger than in real supply (5.8 percent) and was mainly driven by a sharp rise in real consumption expenditures (both private and government) in the economy; the growth in real investment expenditures remained subdued (3.4 percent). The rise in consumption expenditures also reflect a deceleration in national savings and therefore broadening of the saving investment gap in the economy. The widening of the external current account deficit is a mirror image of this difference and requires inflow of foreign savings in the country. The unsustainability of this saving investment gap is evident from the current levels of both the external current account deficit and the trends in real domestic aggregate demand and supply growth.

Assuming the domestic demand continues to grow at last five year's average of 8.1 percent and the real GDP growth target of 5.5 percent for FY09 is achieved, the difference between domestic demand and supply is expected to widen further. Therefore, it is of utmost importance to:

(i) curtail aggregate demand pressures through restraining expenditures in the short run;
(ii) increase the production capacity of the economy by addressing structural constraints; and
(iii) improve factor productivity.

These measures are necessary for ensuring price stability and long term growth on sustainable basis. While it is expected that some of the demand pressures will recede in the current fiscal year, but if the supply side issues are not addressed, the 'gap' could remain unchanged and the expected favourable impact on inflation will be diluted.

Against this backdrop, it is obvious that deterioration in macroeconomic indicators since the announcement of interim monetary policy measures is of a very steep nature. There is a grave risk of earlier measures being again diluted by the

fiscal excesses now visible more clearly. Moreover, SBP reserves have depleted further by US$ 1.6 billion during May 23 to July 25, 2008. Also, import growth is alarmingly high rising by 50.1 percent during H2-FY08 compared to 2.5 percent in the corresponding period of the last year.

Hence, considering the risk related to rising external current account and fiscal deficits and worsening inflation outlook, the SBP has decided to raise its policy rate by 100 bps to 13 percent effective July 30, 2008 to contain further aggregate demand pressures which are contributing to the inflationary pressures. Fiscal coordination with the monetary policy stance in particular commitment to scale down Government borrowings from the central bank and to contain import growth is critical to achieve the desired impact of monetary tightening.

Furthermore, considering the adverse impact of continued borrowing by the government from SBP on inflation, the SBP Central Board of Directors resolved that government should retire Rs21 billion in each quarter of FY09.

A. Economic Environment and SBP's Policy Response during H2-FY08

FY08 macroeconomic environment turned out to be challenging. Risks and vulnerabilities, highlighted in previous issues of monetary policy statements, unearthed themselves more visibly as the country was hit by a combination of global and domestic economic adversities…

1. Despite enormity of exogenous and endogenous shocks, Pakistan's economy showed a degree of resilience as it managed to register growth of 5.8 percent in FY08. After enjoying benign economic environment, global economy is now under stress. The subprime mortgage crisis induced financial market turmoil in advanced economies that has dampened global economic growth prospects. At the same time, the international oil and food prices have skyrocketed. Consequently, the world economy (especially the US economy) started to move away from the robust growth trend; goods prices increased while asset prices declined; financial markets' health weakened; and the unwinding global imbalances generated undercurrents in the currency markets.

2. The IMF's *World Economic Outlook* (WEO), released July 17, highlights that the global economy is caught between economic growth slowdown and rising inflationary pressures. Global growth has moderated from 5 percent in 2007 and is expected to be 4.1 percent in 2008 and 3.9 percent in 2009. The growth in emerging and developing economies is expected to slide from 8 percent in 2007 to 6.9 percent in 2008. Fueled by soaring commodity prices, oil and food importing emerging and developing economies are facing sharper surge in inflationary pressures (see **Table 1**). IMF states that "………..in many emerging economies, tighter monetary policy and greater fiscal restraint are required, combined in some cases with more flexible exchange rate management. In the major advanced economies, the case for monetary tightening is seen as less compelling, given that inflation expectations and labor costs are projected to remain well anchored while growth is weakening, but inflation pressures need to be monitored. The risk of second-round effects from the surge in commodity prices

Table 1: Challenging Global Environment 2008
in percent

	Jun-07	Dec-07	Jun-08
Arabian light crude oil[1]	66.2	91.0	130.9
Δ in int'l prices	Jan-Jun 07	Jun-Dec 07	Jan-Jun 08
Food index	8.5	16.5	24.0
Metal index	11.5	-17.6	14.6
Energy index	10.8	29.6	47.8
	2007	**Projection for**	
		2008	2009
Output growth			
World	5.0	4.1	3.9
Emerging & developing	8.0	6.9	6.7
Inflation			
World	4.0	4.7	3.6
Emerging & developing	6.3	7.4	5.6

[1] End-month values in US$/barrel
Sources: IMF and Bloomberg for oil prices.

complicates policymakers' response to the slowdown, particularly in advanced economies, while in emerging economies stronger action is likely to be needed to cool activity and reverse rising inflation momentum. Additional oil and food price shocks would exacerbate inflation concerns, while further weakening consumption in importing countries.”

3. Slowdown in the world economy has become quite visible and expected to continue even beyond 2008; however, the strong trends in inflation and the increased likelihood of its persistence has emerged as the sole threat to macroeconomic stability across the globe. Until the second quarter of calendar year 2008, the monetary policy responses of different countries have varied. More recently many central banks, especially in the developing countries, have raised their policy rates in order to curtail inflation and inflation expectations (see **Annexure I**).

4. Facing these global adversities, Pakistan’s macroeconomic vulnerabilities magnified in FY08. The twin deficits widened as the Government delayed pass through of rise in the international oil and food prices, growth moderated, and the combination of growing demand and reduced supply magnified inflationary pressures (see **Table 2**). Economic developments further reflect the strains of (i) growing infrastructural bottlenecks – especially the shortage of power; and (ii) political uncertainties and worsening of the law and order situation during the second quarter of the fiscal year. Together these events disrupted productive sectors and public life. This prompted a cautious approach by various economic agents leading to a holding on of major investment decisions both by domestic as well as international investors.

Table 2: Changes in Key Economic Variables

	FY07	FY08		
		Target /proj.[1]	H1	Year
Fiscal deficit (% of GDP)	4.3	4.0	3.6	8.3*
SBP financing (bln Rs)	-58.6	-62.3	201	689
C.A. deficit (% of GDP)	4.9	5.0	3.6	8.4
Trade deficit (% of GDP)	6.8	8.3	3.7	15.3
Exchange rate[2] (Rs/US$)	60.4	-	61.7	68.3
Forex reserves (bln $)	15.6	-	15.6	11.4
YoY M2 growth in %	19.3	13.7	19.9	15.4
Avg. Inflation %	7.8	6.5	8.0	12.0
YoY Inflation %	7.0	-	8.8	21.5
NFNE (YoY) %	5.7	-	7.2	13.0
20% trim (YoY) %	6.5	-	8.7	17.2
Real GDP growth in %	6.8	7.2	-	5.8

1: Projections at the start of FY08; 2: End-period values
*: Based on full year financing data.
Sources: SBP, FBS

The second half of FY08 particularly proved difficult for Pakistan’s economy…

5. The impact of these global and domestic developments became more pronounced in the second half of FY08 and has derailed hard earned macroeconomic stability. The strong aggregate demand and a rise in the international commodity prices resulted in widening of the external current account and fiscal deficits, which

are now well above their projections for FY08 and have reached to unsustainable levels, and an exceptional rise in inflation.

6. The external current account deficit grew as Pakistan ended up paying on average US$86 per barrel for FY08 (relative to projected US$65 for the year and actual US$61.2 in FY07) and picked up US$3.5 billion of food import bill when no imports were anticipated. The international oil prices, which crossed the hundred dollar mark in November 2007, remained below that level till February 2008; however, since then it has been mostly rising without stabilizing for a significant period at any level. It is now hovering around US$125/barrel. International food prices such as wheat and rice have also touched historical high levels (US$12.52 per bushels, US$23.4 per 100 pound) on March 12, 2008 and April 23, 2008, *respectively*.

7. Even though foreign direct investment reached over US$5 billion in FY08, the developments in financial account such as the outflow in foreign portfolio investment and deferment of privatization program etc. meant that capital and financial account flows could not fully finance the external current account deficit. Consequently, almost 30 percent of the FY08 external current account deficit was financed by US$4.3 billion drawdown of foreign exchange reserves; almost 100 percent of this drawdown occurred in H2-FY08. Depletion of reserves and weakening investor confidence due to political uncertainties resulted in sharp exchange rate depreciation.

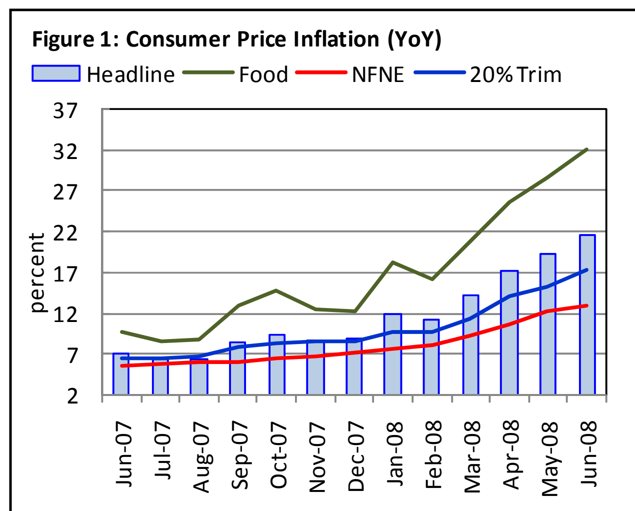
8. Balance of payments pressures were also aggravated by the growing fiscal indiscipline as the expenditures continued to rise, while revenue growth lagged. Almost 80 percent expenditure overruns can be attributed to the delay in pass through of international oil prices and other subsidies, while the remaining are due to underestimation in current expenditures. Despite repeated calls, rather than curtailing expenditures Government continued to spend by issuing Market Related Treasury Bills (MRTBs). Automatic monetization of the fiscal deficit encourages fiscal imprudence and renders monetary policy to be subservient to fiscal policy.

9. This fiscal imprudence and mismanagement is the source of macroeconomic instability. On one hand, it generated aggregate demand pressures and burdened the external current account deficits. On the other hand, unsustainable growth in fiscal deficit resulted in Government financing bulk of its deficit by central bank borrowings which is inflationary.[3] Consecutive monetary tightening efforts to bring down inflation rate from 9.3 percent in FY05 to 6.5 percent in FY08 were disrupted.

[3] Assuming fiscal deficit of 8.3 percent of GDP.

10. Alarming and continuous rise in all categories of inflation indices were observed, in particular during H2-FY08 (see **Figure 1**). Though food inflation is the major contributor to the headline inflation (consumer price index, CPI), however, the non-food group, which accounts for 59.7 percent in the CPI basket, also contributed significantly. Similarly, the core inflation witnessed a continued uptrend, which reflects the sustained aggregate demand pressures on account of the Government overspending and the second round impacts of higher food and oil prices. This suggests that inflationary expectations have now become embedded and likely to exacerbate the macroeconomic stability, inflation outlook and long-term growth prospects.

Figure 1: Consumer Price Inflation (YoY)



The weakening macroeconomic situation necessitated the interim monetary policy measures by the SBP…

11. After a careful and measured assessment of the prevailing economic conditions which confirmed that the balance of risks clearly tilted towards inflation, in January 2008, the SBP raised its policy rate by 50 bps to 10.5 percent and increased the Cash Reserve Requirement (CRR) by 100 bps to 8 percent for bank demand liabilities (including deposits of maturity up to one year). However, risks to macroeconomic stability and inflation turned out to be deeper and sharper due to higher than anticipated magnitude of global shocks and domestic weaknesses warranting further stabilization measures.

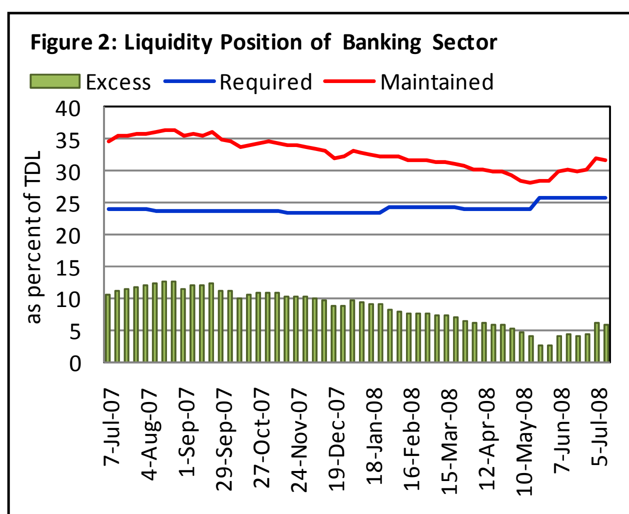
12. The SBP, therefore, augmented its efforts to address these risks and challenges by announcing multiple monetary policy measures on May 22, 2008. These included: a rise in the policy rate by 150 bps to 12 percent, increase in CRR and SLR to 9 percent and 19 percent respectively, a floor on banks' savings/PLS deposit rates at 5 percent, and L/C margin on all imports excluding oil and selected food products at 35 percent. In addition, SBP reiterated its advice to the government to reduce reliance on central bank (inflationary) borrowings and recommended amendments in the *Fiscal Responsibility and Debt Limitation Act, 2005* to incorporate appropriate provisions for restricting debt monetization in future. Even before announcing these policy measures, the SBP had taken several other measures to stabilize the foreign exchange market.

B. Recent Developments and Future Outlook

Heavy government borrowings from SBP diluted the impact of monetary measures of January 2008…

13. The monetary tightening in January 2008 helped in draining interbank market liquidity and pushing interest rates up. The impact of these measures was moderated as the Government borrowings from the SBP grew at a faster pace – SBP borrowings for financing fiscal deficit rose sharply by Rs.488.1 billion during H2-FY08, of which Rs283.9 billion occurred in the last quarter of FY08. Financing of fiscal deficit from SBP resulted in huge additional liquidity injection posing serious challenges for monetary management.[4]

14. To meet the liquidity requirements banks started reducing their surplus holdings of government securities – i.e. commercial banks' holdings of government securities over and above SLR requirement – which was close to Rs300 billion at end-January 2008. Banks did not show much interest in the T-bills auctions, held up to May 21 2008 in H2-FY08 as reflected in the amount offered of Rs325.4 billion (accepted amount was Rs 227.1 billion) against the maturities of Rs 446.0 billion. The resultant increase in interbank interest rates including Karachi Interbank Offer Rate (KIBOR) remained subdued until the further tightening of monetary policy in May 2008.



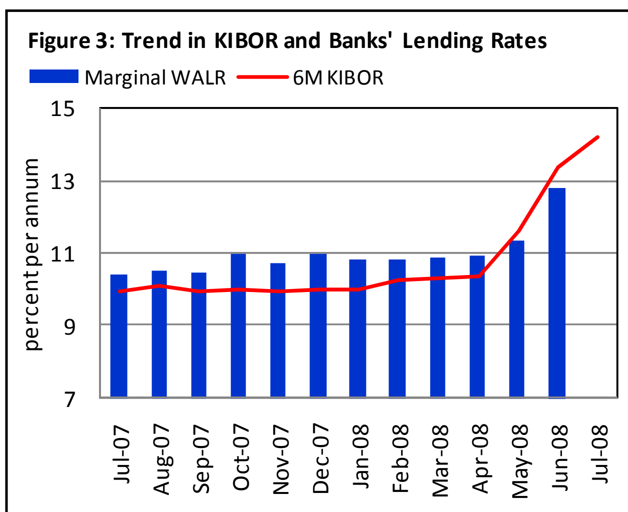
SBP policy measures in May 2008 led to tightening of monetary conditions…

15. As a result of 100 bps increase each in CRR and SLR on May 22, 2008, in addition to a 150 bps increase in the policy rate, the surplus liquidity with the banking sector fell to as low as 2.6 percent of time and demand liabilities (or Rs 81.6 billion) at end-May 2008 (see **Figure 2**). As a result of a rise in yields, banks started showing interest in T-bills allowing SBP to generate positive net funding (over and

4 Although, during February 1 – May 22, SBP managed to keep the overnight rate in a desirable range on average, its volatility increased considerably as reflected from a significant rise in its coefficient of variation from 9.3 percent 16.4 percent.

above the maturities) for the government from the market sources.[5] With the falling liquid assets to very low levels, KIBOR rates have not only increased but the KIBOR curve has also steepened. After the interim policy measurers of May 2008, 6 month KIBOR hovered around 13 percent; however, since the last week of June 2008, it has crossed 14 percent (see **Figure 3**). This increase is in spite of the fact that the surplus liquidity with the banking sector has increased to Rs.205 billion (or 5.5 percent of DTL) as of July 12, 2008. This hike is partly on account of market expectations that have been built for the July end monetary policy statement; however, SBP also feels that some of the recent increase is unwarranted given the above level of surplus liquidity. While such an abnormal increase is neither desirable nor expected in future, the SBP stands ready to quell such market behavior.

Figure 3: Trend in KIBOR and Banks' Lending Rates



Banks lending rates are expected to move up in the coming months…

16. As KIBOR is used as a benchmark for pricing most of the banks' loans, its effect is visible in the Weighted Average Lending Rate (WALR). As shown in **Figure 3**, the impact on WALR has remained muted up till April-08. The same, however, has risen to 12.8 percent in June 2008 from 10.9 percent recorded in April 2008. Notwithstanding the rate increase, it is the level of real lending rates that determines the spending decisions in an economy. Though a rise in real lending rates is necessary in curbing aggregated demand pressures and thereby in controlling inflation, real interest rates have been very low in Pakistan in recent year relative to historic trends and compared with other countries in the region (see **Table 3**).

Table 3: Lending Rates & Inflation in Regional Countries

percent

	Average Inflation	Lending rates	
		Nominal	Real
Indonesia[1]	7.4	13.7	6.3
India[1]	6.5	12.8	6.3
Philippines[1]	4.7	8.5	3.8
Malaysia[1]	2.4	6.1	3.7
Bangladesh[2]	10.5	12.7	2.2
Sri Lanka[3]	21.0	18.8	-2.2
Vietnam[2]	11.9	14.6	2.7
Pakistan[3]	**12.0**	**12.8**	**0.8**

[1]: For Jul-May FY08 period; [2]: For Jul-Mar FY08 period; [3]: For Jul-Jun FY08 period.

Source: SBP & Central banks' websites for other countries.

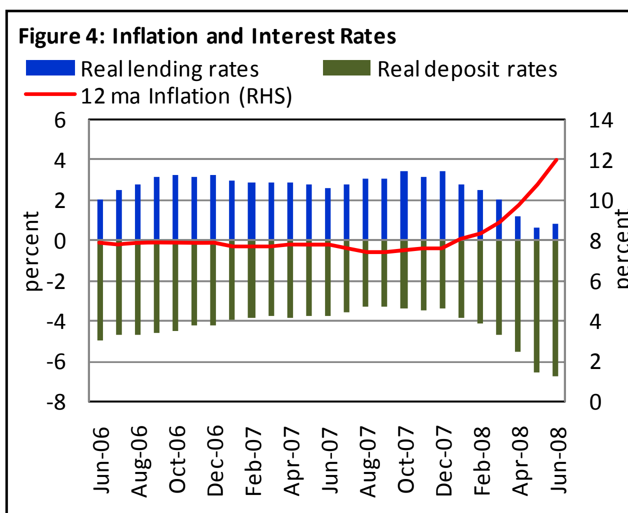
5 In the auctions held after May 23, 2008, against the total maturities of Rs 200.1 billion, SBP accepted Rs 211.1 billion.

Tight monetary conditions and setting a floor on deposit rates is expected to improve return on deposits and, therefore, savings in the economy…

17. Similarly, low real return on deposits discouraged savings in the country, increasing the saving-investment gap and dependence on external resources.[6] In the wake of liquidity crisis in the US and the EU and falling global liquidity flows, which are expected to become more acute due to increasing focus on monetary tightening around the globe, it has become difficult for Pakistan to bridge the rising saving-investment gap through foreign resources. Therefore, given the need to accelerate investment necessary to sustain economic growth, it is getting increasingly important to encourage greater macroeconomic discipline as well as domestic savings. The SBP has been highlighting the importance of lower fiscal deficit in improving national savings and reinforcing overall macroeconomic stability and remains committed to improve incentives for private savers.

18. Considering the need to increase return and share of long-term deposits, SBP introduced a differential (lower) CRR on long-term deposits in July 2006 giving incentives to banks to attract such deposits. Over time, these incentives were further enhanced by exempting over one year deposits from CRR and increasing CRR on shorter-tenors.

19. Although, this differential CRR policy along with monetary tightening did help in improving the weighted average deposit rates, the improvement was lower than public expectations for short tenor deposits, even though return on longer tenor deposits has grown. The rise in the nominal interest rates for shorter tenor PLS deposits was also not enough to make any significant change in the real deposit rates. The sharp rise in inflation, in fact, further depressed the real return on deposits (see **Figure 4**). Nonetheless the rise in nominal weighted average deposit rates (on outstanding deposits) is higher than the rise in nominal weighted average lending rates (see **Table 4**).



6 During FY08, national savings as percent of GDP decreased to 13.9 percent from 17.8 percent in FY07. At the same time investment to GDP ratio witnessed a moderate fall from 22.9 percent in FY07 to 21.6 percent.

Table 4: Banking Spread and Changes in SBP Policy Rate
in percent

	Apr05	Jul06	Jun08	Δ during (in bps) Apr 05 - Jul 06	Jul 07- Jun-08
Rates on marginal					
Loans	6.78	10.24	12.79	346	255
Deposits	2.20	5.15	6.36	295	164
Spread (bps)	458	509	470	51	91
Rates on outstanding					
Loans	7.49	10.51	11.96	302	145
Deposits	1.55	3.09	5.19	154	210
Spread (bps)	594	742	677	148	-65

Source: SBP

20. SBP's continuous moral suasion to banks to offer appropriate return to their depositors and use of incentives did generate response, albeit at a slower pace. To accelerate progress, the SBP made it compulsory for banks to pay a minimum profit of 5 percent of saving/PLS saving products with effect from June 2008. Assuming the share of saving and PLS saving deposits in overall banks' deposits in June 2008 remain roughly the same at December 2007's level (around 56 percent), the introduction of this floor alone is expected to raise the return on deposits in the range of 200 to 220 bps. Public perception on deposit rate also needs to be corrected through greater awareness and financial literacy. Public needs to appreciate that transactional accounts normally yield low return than longer tenor stable deposits. Also, savers' have options to shop around for yields as rate differentiation is now growing across banking industry as smaller banks compete for depositors.

21. Moreover the tight liquidity conditions and increased CRR on short-term deposits imply an even greater incentive to mobilize longer-tenor deposits. Recently 200 bps increase in return on National Savings Schemes (NSS) instruments[7] – a substitute of banks deposits – will augment competition and inevitably banks will need to offer higher return on bank deposits to mobilize funds. Since scheduled banks deposits constitute a significant part (around 65 percent in FY07) of overall financial savings in the economy, it is expected that the above mentioned measures would encourage savings and reduce the existing aggregate demand pressures.

The declining trend in aggregate demand did not continue…

22. The impact of a rise in interest rate is generally transmitted to a decline in aggregate demand in the economy through consumption or investment expenditure. The tightening of monetary policy stance since FY05 has had a visible impact in arresting growth of aggregate demand pressures in the country (see **Figure 5**). However, the demand for goods and services as measured by real GDP less net exports accelerated from 5 percent in FY07 to 7.2 percent in FY08.[8] In contrast, the

7 W.e.f. June 24, 2008, government has raised return on various NSS instruments in the range 190 to 350 bps. For instance, return on Defense Savings Certificate – on 10 year maturity – has been increased from 10.15 percent per annum to12.15 percent per annum.

8 Net exports are at constant market prices.

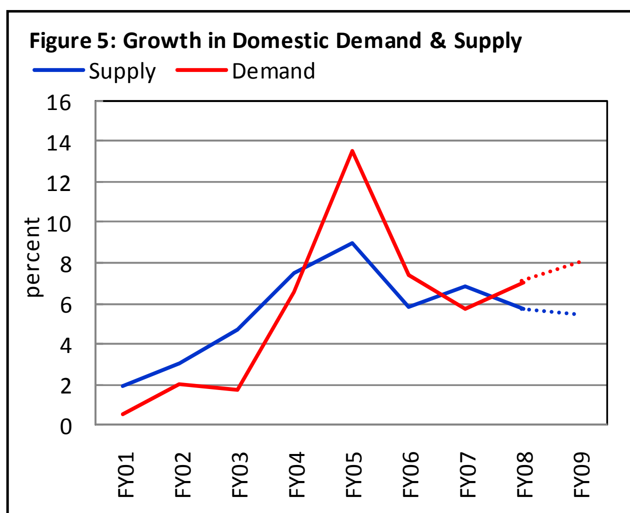
growth in overall supply of goods and services as measured by the real GDP slowed down to 5.8 percent during FY08 from 6.8 percent last year. Nonetheless, the real GDP growth during FY08 is still well above the average growth of 5.3 percent witnessed during the last four decades.

Growth sustainability demands stimulating investment as thus far consumption and not investment has been the driver of growth

23. In FY08, demand pressures mainly emanate from the real consumption expenditures (private plus government expenditures) which grew by 8.1 percent during FY08 against 2.8 percent in FY07 and an average of 6.1 percent for the previous five fiscal years. A disturbing development in FY08 is the sharp slowdown in investment expenditures that decelerated to a meager 3.4 percent as compared to a robust 16 percent growth in FY07.

24. If the domestic demand continues to grow at last five year's average of 8.1 percent and the real GDP growth target of 5.5 percent for FY09 is achieved, the difference between domestic demand and supply is expected to widen further (see **Figure 5**). Though the monetary tightening induced in FY08 is likely to dampen some of the demand pressures. Therefore, this demand-supply difference could narrow, relieving some of the inflationary pressures.

Figure 5: Growth in Domestic Demand & Supply



25. It is also worth highlighting that the level of real GDP remains well above the estimate of potential output. This means that the amount of goods and services being produced in the economy is in excess of what economy can sustain in the long run with stable inflation. Therefore, it is of utmost importance to: (i) curtail aggregate demand pressures through restraining expenditures in the short run; and (ii) increase the production capacity of the economy by addressing structural constraints and improving factor productivity. This is essential for ensuring price stability and long term growth on sustainable basis.

The excess demand in the economy is reflected in the widening of external current account deficit …

26. The rising aggregate demand pressures are reflected in widening of external current account deficit which reached to unsustainable levels of US$14.0 billion (8.4 percent of GDP). The widening trade deficit, which was partly financed by strong inflow of remittances (US$6.5 billion) was the main contributor. Merchandise imports in FY08 grew steeply by 31.2 percent in comparison with the preceding year's growth of 8.0 percent. This robust growth in import bill is reflective of not only the increased international commodity prices but also the amplified quantum due to higher domestic demand. Aside from pressure on oil and food imports, non-food non-oil imports grew strongly (see **Table 5**). This clearly indicates that the import demand is strong and broad based. Worryingly, this has more than off-set the gains from export earnings which grew by 16.5 percent in FY08.

Table 5: Balance of Payments Statistics (in billion US$)

			January-June	
	FY07	**FY08**	**FY07**	**FY08**
i. CA balance	**-6.9**	**-14.0**	**-2.2**	**-8.0**
Trade balance	-9.7	-15.3	-4.4	-9.0
Exports	17.3	20.1	8.9	10.9
Imports	27.0	35.4	13.3	19.9
Growth rate	*8.0*	*31.2*	*2.5*	*50.1*
Non-food non-oil	16.9	21.4	8.6	11.7
Services net	-4.2	-6.3	-1.7	-3.0
Income net	-3.6	-3.9	-1.8	-1.9
Current transfers	10.6	11.5	5.6	6.0
ii. Capital account	**0.3**	**0.1**	**0.1**	**0.0**
iii. Financial account	**10.1**	**8.7**	**6.2**	**4.8**
of which				
Direct investment	5.1	5.2	3.3	3.1
Portfolio investment	3.3	0.0	2.0	-0.1
iv. Errors and omissions	**0.2**	**-0.5**	**-0.3**	**-0.9**
Overall balance	**3.7**	**-5.8**	**3.8**	**-4.1**

Source: SBP

27.

28. While trade deficit was partly financed by strong inflows from remittances, financing of external current account deficit was partial as net foreign and capital receipts were close to $8.8 billion – substantially below original expectations (**Table 5**). Funding gap of imbalance in external accounts was almost US$ 5.8 billion in FY08. With rising external current account deficit and falling foreign inflows, the overall balance of payments remains vulnerable. Draw down of reserves and recent spikes in exchange rate are manifestations of this unsustainable position.

29. Going forward, to ensure sustainability of balance of payments, there is a strong need to contain external current account deficit by curtailing imports and promoting exports more aggressively. Similarly, steps must be taken to attract the much needed inflows to finance this deficit. However, containment of imports bill would be a challenge if the current trend of international oil prices persists and their full impact is not transferred to domestic consumers. Increasing prices would be the most effective way of curbing demand given the low price inelasticity of oil imports

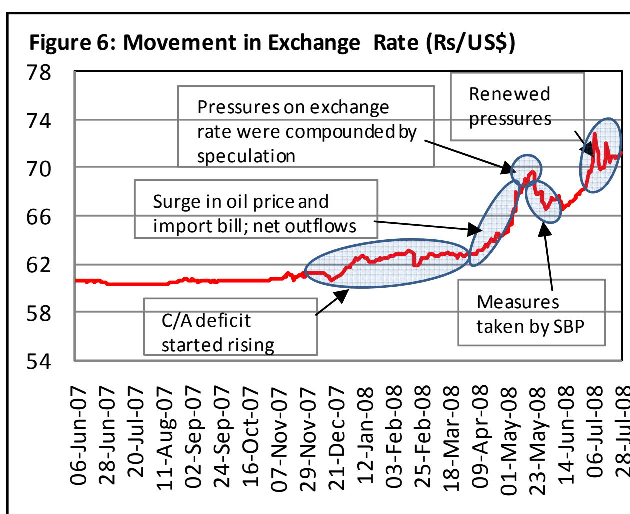
thus far. An uptrend of international oil prices, without demand curtailment, would enhance the already huge external current account deficit to unmanageable levels. This would compound pressure on the country's foreign exchange reserves and threaten macroeconomic stability further, which is already under stress.

Worsening external position reduced foreign exchange reserves and increased pressures on exchange rate considerably…

30. Emerging trends in FY08 destabilized exchange rate which had hovered around Rs/US$ 60.26 on average during the last two fiscal years with low volatility. Pressures on exchange rate increased initially due to political uncertainties, but then grew further as this was accompanied by the depletion of reserves in the second half of the fiscal year.

31. The depreciation of the Rupee against the US dollar remained subdued up till the end of March 2008 and was limited to 3.7 percent only since July 1, 2007. Since then, however, the Rupee faced extraordinary pressures and had two major spikes of depreciation – first in May 2008 and then in the first week of July 2008 with a fall in value by 8.2 percent during April 1 – June 30, 2008 and by 6.2 percent during July 1 – 8, 2008, hitting the peak of 72.79 on July 8, 2008 (see **Figure 6**). While the accelerated depreciation since end March was due to the continued stress on macroeconomic fundamentals, the two spikes were partly due to the speculative sentiments and disruption of investor confidence in the market. Excessive import advance bookings also played their role. To curb volatility SBP took several policy and administrative measures including monetary tightening on May 22, provision of foreign exchange for all oil payments, curb on forward bookings, reduction of advance payments, limit for imports, and increased reporting requirements from exchange companies etc. (**Annexure II**).

Figure 6: Movement in Exchange Rate (Rs/US$)



A large fiscal deficit is the main contributor to excess demand pressures…

32. The impact of a rise in external current account deficit on macroeconomic instability was complemented by a significant worsening of the fiscal position. The fiscal deficit rose sharply and is expected to be above 8.0 percent of GDP against a

budgeted target of 4.0 percent for FY08 (see **Table 6**). Sizeable increase in FY08 deficit is largely attributable to the rise in subsidy bill for oil and wheat prices, while expenditures on other accounts also showed slippages to a large extent. Subsidies are clearly unsustainable as they accounted for 47 percent of fiscal deficit. With such heavy subsidization the domestic consumption behavior has not adjusted to changing global and local realities. In the absence of additional financial resource from other than SBP, Government had to resort to the highly inflationary central bank borrowing for deficit financing. On the one hand, subsidies financed by central bank borrowings will exert its pressure on inflation this year, and on the other the eventual and unavoidable adjustment in domestic oil prices will also affect inflation outlook. Thus, recognizing this, the government is passing on the increase gradually to avoid painful consequences.

Table 6: Summary of Consolidated Fiscal Operations

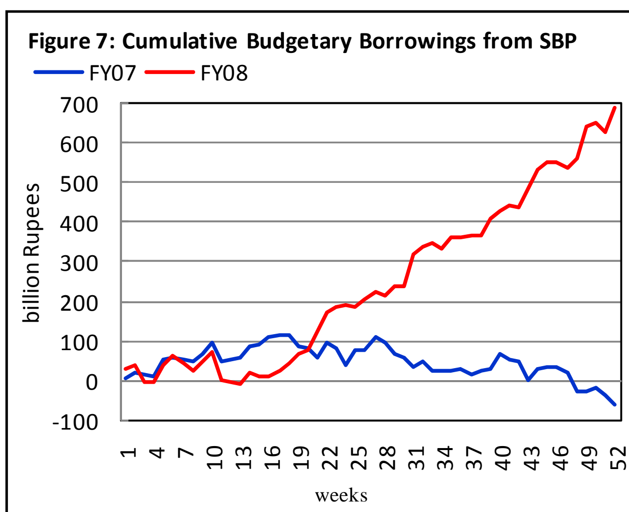
billion Rupees

	FY08 BE	FY08 RE	FY09 BE
Total revenue	1475.9	1512.0	1809.2
Tax	1095.5	1056.6	1308.5
Non-tax	380.4	455.5	500.8
Total expenditure	1874.7	2245.9	2391.5
Current	1378.2	1837.2	1875.8
Development*	496.5	408.7	515.7
Budget deficit	-398.8	-733.9	-582.2
Financing	398.8	733.9	582.2
External	193.1	192.3	165.2
Domestic	130.7	540.0	391.9
Non-bank	49.7	115.9	242.9
Bank	80.9	424.1	149.0
Privatization proceeds	75.0	1.7	25.1

*: Includes net lending to PSEs; BE: Budget Estimates; RE: Revised Estimates Source: MOF

33. Although the Government has indicated its commitment to reducing fiscal deficit, the FY09 budget estimates suggest an expansionary fiscal stance. The government would need to instill fiscal discipline to remain within the budget estimates of deficit (Rs582.2 billion).

Figure 7: Cumulative Budgetary Borrowings from SBP



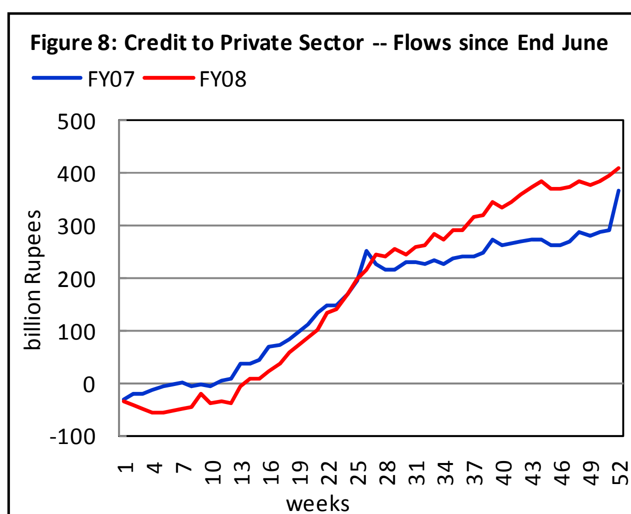
An expansionary fiscal stance was maintained through an unprecedented volume of government borrowings from the SBP…

34. Throughout the year, there was no let up in government borrowing from the SBP which reached to an historic high of Rs688.7 billion (almost 6.6 percent of the GDP) during FY08 financing bulk of deficit (see **Figure 7**). As a result, the stock of outstanding Market Related Treasury Bills (MRTBs), an instruments through which

Government borrows from SBP on tap for replenishment, has reached to Rs1053 billion by end June 2008; more than double against the last year's level of Rs452.1 billion. It is worth mentioning that the creation of MRTBs entails minimal cost to the government since the interest paid on these T-bills is transferred back in the form of SBP's profits. This is perhaps why the government finds little incentive to meet its funding requirements from other sources.

Private sector credit also remained strong and thus contributed in overall domestic credit demand…

35. The efforts to contain domestic credit expansion did not succeed due to a sharp expansion in credit to the government. This was augmented by the continued growth in credit to the private sector. Private sector credit grew by 16.5 percent and reached Rs408.4 billion close to the last year's growth of 17.3 percent (Rs365.7 billion) (see **Figure 8**).



The rise in the twin deficits changed the composition of monetary aggregates considerably and poses challenges for monetary management…

36. The unprecedented rise in the twin deficits had drastic consequences on the composition of monetary aggregates. That is, the net domestic assets (NDA) grew rapidly while net foreign assets (NFA) experienced a substantial contraction (see **Table 7**). Domestic credit was almost twice the size of last year and grew by 29.3 percent during FY08. The credit to the government sector clearly outpaced the credit to non-government sector and experienced more than a six-fold increase.

37. NFA, on the other hand, registered a decline of Rs.316.4 billion in FY08 compared to an expansion of Rs.274.6 billion in FY07. The movement in these aggregates in the opposite direction limited the overall broad money growth to 15.4 percent, which is greater than the target of 13.7 percent envisaged at the start of the year.

38. Though the actual outcome of M2 expansion is not much away from the projected growth it should not be construed in any way as a healthy development since it is a reflection of weakness in external and fiscal accounts management. In fact, the change in the composition of monetary aggregates caused a

disproportionate increase in Rupee liquidity relative to the availability of foreign exchange and explains to a large extent the pressures on exchange rate and prices.

Inflationary pressures in economy increased considerably …

39. Strong aggregate demand pressures combined with increased pass-through of the persistent rise in commodity prices in international market continue contributing to high domestic inflation. In June 2008, the headline CPI inflation jumped to a 30 year high of 21.5 percent, on year-on-year (YoY) basis. This was mostly because of food inflation (contributing 62 percent – see **Figure 9**) that rose to record high of 32 percent, due to domestic supply shortages, rising input cost, lack of administrative control and rising prices of key food items in the international market.

40. The non-food inflation, which remained fairly stable around 6 percent up to December 2007, also more than doubled to 13.8 percent in June 2008. On average basis, headline inflation at 12.0 percent in FY08 remained 5.5 percentage points above the target for the year (see **Table 8**).

41. The trend in core inflation remained persistently on the rise during FY08 and indicates that the impact of high food and energy

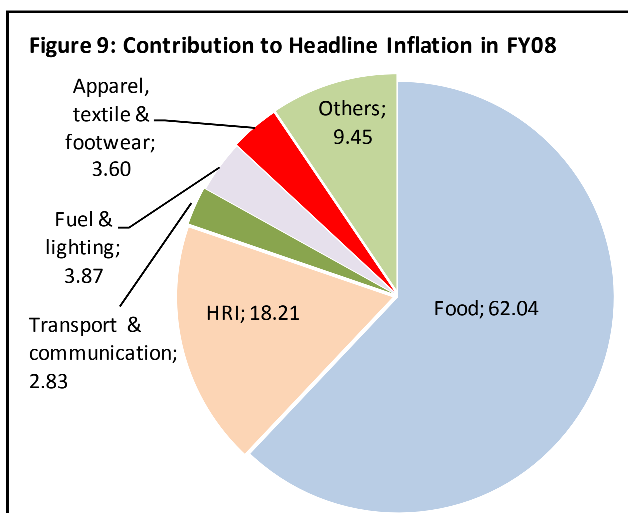
Table 7: Monetary Aggregates (Flows)

billion rupees

	FY07	FY08	Δ since Jan 19	
			FY07	FY08
NDA	383.7	940.4	174.8	544.1
of which				
Domestic credit	478.5	1025.3	240.7	555.1
YoY growth	*15.8*	*29.3*	-	-
Govt. sector*	92.8	583.6	69.3	377.3
Non-govt. sector**	385.7	441.7	171.4	177.9
NFA	274.6	-316.4	283.6	-154.5
SBP	222.7	-307.0	223.7	-227.7
Sch. banks	51.8	-9.4	59.9	73.2
Money supply (M2)	658.3	624.0	458.4	389.6
YoY growth	*19.3*	*15.4*	-	-
Memorandum items				
Net budgetary support	102.0	554.6	55.3	320.6
from SBP	-58.6	688.7	-129.5	451.6
from Sch. banks	160.6	-134.2	184.8	-131.1
Private sector credit	365.7	408.4	149.8	151.7
YoY growth	*17.3*	*16.5*	-	-
Reserve money	209.1	260.9	42.6	144.7
YoY growth	*20.9*	*21.6*	-	-

Note: Provisional numbers for FY08.
*Includes credit for commodity operations and net budgetary support; **Includes credit to private sector and public sector enterprises
Source: SBP

Figure 9: Contribution to Headline Inflation in FY08



prices has spread out to the prices of other non-food items. The non-food non-energy measure of core inflation rose to 13.0 percent in June 2008, more than twice the last year's level. Similarly, the 20-percent trim measure — that exclude items showing extraordinary increase or decrease in the prices — rose to 17.2 percent in June 2008 compared to 6.5 percent last year.

Table 8: Inflation Indicators

	YoY inflation			
	Dec06	**Dec07**	**Jun07**	**Jun08**
Headline	8.9	8.8	7.0	21.5
Food group	12.7	12.2	9.7	32.0
Non-food group	6.2	6.3	5.1	13.8
NFNE	5.7	7.2	5.7	13.0
20% Trimmed	6.3	8.7	6.5	17.2
	Average inflation			
	July-December		**July-June**	
	FY07	**FY08**	**FY07**	**FY08**
Headline	8.4	8.0	7.8	12.0
Food group	10.6	11.6	10.3	17.6
Non-food group	6.8	5.4	6.0	7.9
NFNE	6.2	6.5	5.9	8.4
20% Trimmed	6.7	7.6	6.9	10.2

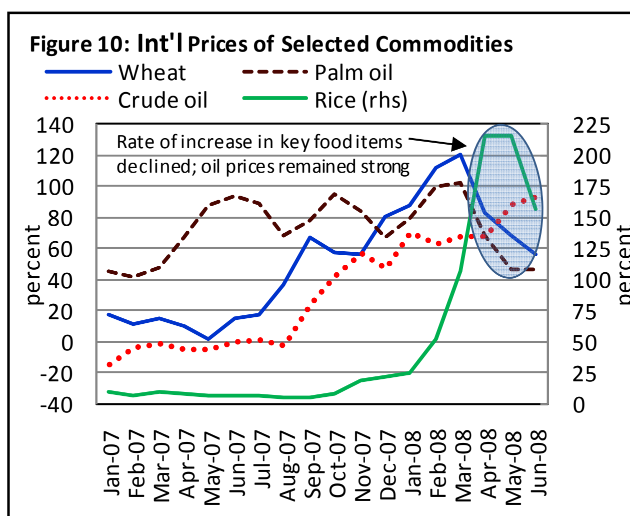
Source: Federal Bureau of Statistics and SBP

42. It is estimated that direct contribution of imported inflation is about 16 percent (on average) of the domestic inflation during FY08. Including the indirect impact, the contribution rises to one third of the headline inflation in FY08. Recent adjustment in electricity and gas tariffs is likely to further add to the production cost besides their direct contribution to inflation.

Commodity prices are expected to ease but not significantly...

43. The expected moderation in global demand and likely increase in the production of food crops suggests easing of commodity prices in international markets in near future. This is already evident from decline in the rate of increase in key commodity prices (**see Figure 10**). The demand for oil and other commodities is expected to be restrained by current high prices and increased likelihood of slowdown in global growth.[9] However, this is also important to

Figure 10: Int'l Prices of Selected Commodities



[9] In case of oil, the OPEC and Energy Information Administration predict slower growth in demand for oil during 2008. For other commodity prices, including energy, World Bank forecast shows falling trend from 2009 onwards. IMF estimates also show a decline of 0.75-1 percentage point in global demand due to high oil prices alone.

note that oil and commodity prices are not likely to fall significantly unless supply is increased on a sustainable basis for the next few years.

44. The domestic prices of key food items are also likely to stabilize due to expected higher production of key food items. Particularly, the production of rice and wheat is expected to increase during FY09 as the current high prices are likely to encourage farmers to make efforts to increase productivity.

C. Risks and Challenges

45. It is evident from the preceding discussion that the degree of risks and extent of vulnerabilities faced by the economy have increased considerably in H2-FY08. The challenges to mitigate such risks and vulnerabilities have become more pronounced and require increased vigilance and proactive response to ensure macroeconomic stability in H1-FY09 and beyond.

46. The most imminent threat to macroeconomic stability is from the precarious balance of payments position. The task at hand is to bring back the current account deficit to sustainable levels through demand management, promoting exports and ensuring smooth inflow of foreign inflows. The same, however, is vulnerable to a number of risks. First, International oil prices, though, have shown some retreat, their future trend is yet uncertain and more likely to be heading north. This could have a significant impact on the import bill straining the foreign exchange reserves and exchange rate outlook.

47. Second, the lower growth prospects of the global economy are likely to affect the demand for Pakistan’s exports. The efforts to support growth globally may dwindle as the threat of rising inflation has already cautioned central banks both in developed and developing countries. Most of them have already started pursuing a tight monetary policy stance. The IMF has recently revised its projections for 2009 world output growth downward. Nevertheless, a tightening of the policy to contain inflation offers at least one positive that it may bring some respite in the oil prices.

48. Third, workers’ remittances flowing through the banking channels have been the mainstay of containing current account deficit in the recent past. However, these flows are very sensitive to the exchange rate differential between the inter-bank and the kerb market. Speculative sentiments due to political uncertainties can potentially increase the differential significantly and therefore cause a rerouting of the workers’ remittances through informal channels. It is, therefore, of utmost importance not to let such speculative sentiments develop. SBP has taken a set of measures to curb such speculative activities.

49. Fourth, a significant part of the imports have been due to weak domestic production of the same items (e.g. raw cotton and wheat). A continuation of the same trend would not help in bringing imports demand down. It is, therefore, important to ensure that domestic supplies do not fall short of their demand and cause unnecessary import.

50. Fifth, The prospects of foreign exchange inflows looks weak given the turbulent state of global financial markets and downgrading of Pakistan's rating by international agencies such as Moody's and Standard & Poor. Moreover, investors' confidence is sensitive to the deteriorating macroeconomic outlook.

51. The fiscal outlay for FY09 proposes a reduction in overall fiscal deficit and government's commitment not to borrow from the SBP. Meeting these commitments, however, would be challenging. For instance, the past five years' growth trends of both expenditures and revenues and the fact that the targeted GDP growth is lower than the robust growth performance during these years does not support their estimates in the budget for FY09. Therefore, the risk of missing the overall fiscal deficit target of 4.7 percent of GDP is quite high. Even a one percentage point increase in fiscal deficit above the target level would necessitate resource generation of over Rs100 billion.

52. Aside from issues surrounding external resources, generating finances domestically from sources other than the central bank would result in crowding out of credit availability to the private sector. Looking towards the SBP for the same amount, which is a more likely scenario given the outcome of FY08, would only aggravate inflationary pressures.

53. The financing of the twin deficits rests with the tapping of external resources to a large extent. Given the persistence of financial and liquidity crisis in the international financial markets, generating resources through sovereign bonds, sukuk bonds or the GDRs may become more difficult. Similarly, attracting or even maintaining foreign investment with the current upheavals in the capital market and clouded political environment poses even a bigger challenge.

54. While it is expected that some of the demand pressures will recede in the current fiscal year, but if the supply side issues are not addressed, the 'gap' will remain unchanged and the expected favourable impact on inflation will be diluted. In SBP's assessment, the share of structural weaknesses (like energy shortages, supply chain management issues, low productivity etc) dominate the supply side issues compared with the impact of monetary tightening.

55. All the above factors are expected to have a snowball impact on inflationary expectation, which have already taken hold and are evident from a continuous uptrend in all the inflation indicators. People will continue to expect high inflation in future, especially after being affected by the passing on of high international oil prices, and demand wage increases. This would exacerbate the wage-price spiral.

56. Above risks and challenges point that FY09 macroeconomic outcome is likely to deviate from Annual Plan FY09 targets. While it may be possible to realize a reasonable growth in real GDP close to its target of 5.5 percent due to expected better performance of agriculture, average inflation in FY09 will exceed target of 11 percent by a wide margin. Therefore, the objective of monetary policy has to be seen in the context of macroeconomic direction for next few years. Since there is a clear need to bring inflation down, therefore, SBP's monetary framework envisages an expansion of 14.0 percent in broad money growth during FY09. Keeping money supply expansion with this target would also be a big challenge for SBP in FY09.

57. In conclusion, at present the risks to inflation and overall macroeconomic stability emanating from unsustainable twin deficits are far greater than risks to economic growth and necessitate stabilization measures.

Annexure I: Monetary Policy Rate Changes in Various Countries

	Policy Rates					Projections for 2008[6]	
	Current	W.e.f.	Prev.	Inflation*	Real Policy Rates	CAB as % of GDP	Fiscal bal. as % of GDP
Developed Countries							
Australia	7.25↑	4-Mar-08	7.00	3.20	4.05	-5.5	1.4
Canada	3.00↓	22-Apr-08	3.50	1.98	1.08	0.8	0.2
Denmark	4.25↑	4-Jul-08	4.00	2.47	1.78	0.9	3.8
Euro area	4.25↑	3-Jul-08	4.00	2.41	1.84	-0.3	-0.9
Japan	0.50↑	21-Feb-07	0.25	0.68	-0.18	4.1	-2.7
Korea	5.00↑	1-Aug-07	4.75	3.61	1.39	-0.8	1.1
N. Zealand	8.00↓	24-Jul-08	8.25	3.09	4.91	-	-
UK	5.00↓	10-Apr-08	5.25	4.12	0.88	-4.1	-3.6
USA	2.00↓	30-Apr-08	2.25	3.70	-1.70	-4.9	-2.4
Developing Countries							
Pakistan	**12.00↑**	**23-May-08**	**10.50**	**12.00**	**0.00**	**-8.6**	**-6.7**
Azerbaijan	14.00↑	10-Apr-08	13.00	-	-	-	-
Chile	7.25↑	10-Jul-08	6.75	7.24	0.01	0.5	8.9
China	7.47↑	21-Dec-07	7.29	7.10 [3]	0.37	9.3	0.4
Egypt	10.50↑	26-Jun-08	10.00	15.56 [4]	-5.06	0.2	-7.1
Ghana	16.00↑	19-May-08	14.25	18.42 [3]	-2.42	-	-
Iceland	15.50↑	10-Apr-08	15.00	7.11	8.39	-	-
India	9.00↑	29-Jul-08	8.50	6.46 [1]	2.54	-3.0	-3.4
Indonesia	8.75↑	3-Jul-08	8.50	7.87	0.88	2.7	-1.9
Malaysia	3.50↑	1-Apr-06	3.25	2.86	0.64	14.0	-3.1
Nigeria	10.25↑	2-Jun-08	10.00	10.5 [3]	-0.25	-	-
Philippines	5.75↑	17-Jul-08	5.25	5.29	0.46	-	-
Romania	10.00↑	27-Jun-08	9.75	8.61 [3]	1.39	-	-
S. Africa	12.00↑	13-Jun-08	11.50	8.99 [1]	3.01	-8.0	0.4
Tajikistan	14.75↓	3-Apr-08	16.00	8.28 [5]	6.47	-	-
Thailand	3.50↑	16-Jul-08	3.25	4.29	-0.79	-0.4	-3.0
Turkey	16.75↑	17-Jul-08	16.25	8.64	8.11	-6.4	-2.7
Vietnam	14.00↑	11-Jun-08	12.00	15.24	-1.24	-	-

* Average Inflation (July-June FY08) [1] July-May FY08 [2] July-March FY08 [3] June 2008 (YOY)
[4] Jan-Jun 08 [5] Jan-May 2008 [6] The Economist forecast

Source: Central Banks Web sites

Annexure II: Steps Taken by SBP to Stabilize Exchange Rate

SBP has taken following measures to stabilize the exchange markets since end April 2008:

- Exchange companies have been required to surrender a minimum of 15 percent, instead of earlier 10 percent, of foreign currencies received by them from home remittances to the interbank markets. (Circular Date: April 29, 2008).

- Limits on advance payments that were relaxed last year have been tightened. Now advance import payments will only be allowed against letter of credits and that too only to the extent of 50 percent. Advance payments against contracts are now not allowed. Last year advance payments against letter of credit and firm registered contracts were allowed to importers via banks to the extent of 100 percent (Circular Date: April 29, 2008).

- Exchange companies have been directed to transfer foreign currency from their nostro accounts held outside Pakistan to commercial banks in Pakistan and henceforth exchange companies will have to close all nostro accounts abroad (Circular Date: May 9, 2008).

- Exchange companies have been encouraged to focus on promoting home remittances and companies can only effect outward remittances to the extent of 75 percent of the home remittances mobilized by the respective company (Circular Date: May 9, 2008).

- In order to meet the demand of foreign currencies within Pakistan, the Exchange Companies have been directed to surrender their surplus foreign currency to State Bank – earlier exchange companies were exporting most of the foreign currency, except dollars abroad. Now exchange companies, besides dollar, will not be able to export Pound Sterling, Euro and UAE Dirham's (Circular Date: May 9, 2008).

- On July 8, 2008 SBP took the following measures with immediate impact: 1) Forward booking against all types of imports have been suspended temporarily 2) Advance payments against import Letter of credit has been

further reduced from 50 percent to 25 percent, 3) All foreign exchange for oil payments will now be made available from State Bank of Pakistan 4) Foreign exchange dealing time for customer and interbank transactions has been restricted, 5) In order to further strengthen monitoring mechanism of transactions made through Exchange Companies, all Exchange Companies will be required to take prior approval of State Bank for all transactions of US$ 50,000 or above on account of outward remittances or sale of foreign currencies to the customers.