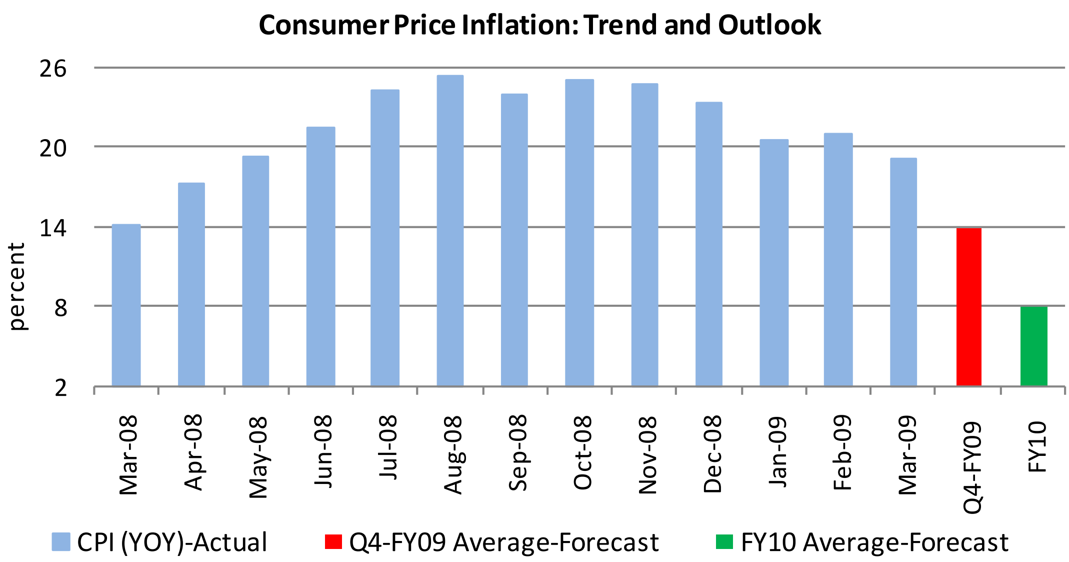
MONETARY POLICY STATEMENT

April-June 2009



STATE BANK OF PAKISTAN

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Executive Summary

Pakistan's economy has made reasonable progress on its path towards macroeconomic stability. CPI inflation (YoY) declined to 19.1 percent in March, 2009 from a high of 25.3 percent in August, 2008 though it is still much higher than the desired level. Persistent demand pressures, as depicted by core inflation measures, have also eased to some extent; 20-percent trimmed core inflation has come down by about 2.4 percentage points from its peak in October, 2008. Although the projected average CPI inflation for FY09 is around 21 percent, the expected inflation of around 14 percent for Q4-FY09 and 8 percent for FY10 illustrates a positive outlook.

Improved fiscal discipline and contraction in the external current account deficit is also indicating that aggregate demand is trending downwards. This will help in narrowing the output gap and strengthening the positive inflation outlook. Fiscal deficit of Rs251 billion (1.9 percent of projected GDP) for H1-FY09 and commitment of the government to keep it up to Rs562 billion (4.3 percent of projected GDP) target for the entire FY09 is a significant improvement over the recent past. Similarly, the external current account deficit has narrowed down to $172 million in March, 2009 compared to a deficit of $2.2 billion in October, 2008, strengthening the external sector position considerably. Cumulatively, the external current account deficit for the first nine months of FY09 stands at $7.6 billion and is projected to be $9 billion or 5.5 percent of the GDP for FY09.

SBP's tight monetary policy together with the rationalization of fiscal subsidies and expenditure controls are the key policy actions that contributed towards improvement in these deficits. The efforts of the SBP and the government to achieve macroeconomic stability got further support by market induced adjustments in the exchange rate and fall in the international oil prices.

These necessary and coordinated policy measures and favorable developments not only contained government borrowings from the SBP and allowed the build-up of foreign exchange reserves but also helped in improving inflation expectations. Consistent with the spirit of the macroeconomic stabilization program, which is supported by a Stand-By Arrangement (SBA) with the IMF, the stock of government borrowings from the SBP has remained well within the target of Rs1274 billion for end-December, 2008 and end-March, 2009. Given the level of this stock at

Rs1094 billion as on 16 April, 2009, the likelihood of meeting the end-June target of Rs1181 billion is quite high. Similarly, strengthening of SBP's foreign exchange reserve by $4.3 billion during 31 October – 17 April, FY09 and projections that this level will increase to $9.1 billion by end-June, 2009 is a key indicator of emerging macroeconomic stability.

Containment of these twin deficits indicates a fall in demand pressures and has helped in aligning, to some extent, the investment capacity of the economy with the limited availability of foreign and domestic savings. The impact of these adjustments is quite visible in monetary aggregates. More specifically, the prudent measure of restricting government borrowing from the SBP has severely restricted reserve money creation in the system given the low albeit gradually improving foreign exchange reserve position. Consequently, the overall liquidity (M2) position in the economy remains tight. The equilibrium growth rate of M2, consistent with projections of fiscal and external current account deficits, is expected to be around 8 percent.

The deceleration in monetary aggregates poses two interrelated challenges looking into the remaining months of the fiscal year. First, the burden on the banking system to cater to the needs of various sectors, including government, has increased. This would test the ability of scheduled banks to match the incremental credit demand coming from the government to meet budgetary requirements and finance the commodity operations. The Q4-FY09 calendar for the fortnightly T-bill auctions shows that the fiscal authority plans to raise an additional Rs97 billion (over and above the maturing T-bills) in six T-bill auctions. Also, the wheat procurement cycle has begun and preliminary estimates indicate that there would be new credit demand of approximately Rs60 to 80 billion, on flow basis, for this purpose by the end-June, 2009.

Second, as the growth of the banking system deposits remain weak and the injection of fresh reserve money is constrained, the already dwindling credit to the private sector might be squeezed further. Cumulative flow of private sector credit, which peaked in January, 2009 at Rs179 billion has consistently declined since then and stands at only Rs48 billion for the 1 July – 11 April, FY09 period. Similarly, the total deposits with the banking system are still Rs69 billion lower than their end-June, 2008 level, though they have recovered to a large extent after experiencing a sharp fall during the early period of FY09.

The likely impact of these developments would be an upward pressure on interbank and other market interest rates such as KIBOR and T-bill yields. In fact, the recent adjustments in these rates are already reflecting this trend. The weekly weighted average overnight repo rate, which averaged at 11.25 percent during Q3-FY09, has moved upwards reaching 12.86 percent during Q4-FY09 up to the week ending on 17 April, 2009. Similarly, the 6-month KIBOR and 6-month T-bill yields, for example, have inched upwards, 13.51 percent and 12.98 percent respectively in April, 2009 after hitting lows of 12.43 and 11.79 percent seen earlier in the previous quarter. However, improved inflation expectations, as revealed by a downward shift in yield curve, are indicating that the market is anticipating lower interest rates in the near future. Therefore, it seems likely that the market will continue to operate smoothly.

It is pertinent to mention that T-bill cut off rates in auctions along with the volume targets are no longer under the purview of SBP and are determined by the Ministry of Finance and thus reflect the fiscal authority's considerations. Therefore, any interpretation of monetary policy stance through movements in T-bill cut off rates would be misleading.

On its part, SBP closely monitors market's liquidity position and, keeping in view system's requirements, calibrates its injections and mop-ups of liquidity through open market operations (OMOs). For example, to ease the stress that emerged towards the end of Q3-FY09, SBP injected Rs228 billion, on net basis, during 28 March – 18 April, 2009. Earlier, SBP was gradually mopping up the liquidity that had been consciously left in the market to address the effects of October, 2008 liquidity shock.

The positive inflation outlook provides an opportunity to revive the economy; however, the real challenge in this regard is to improve the investment climate. In this vein, the importance of private sector credit (PSC) cannot be overemphasized. The difficulty is that not only the demand for credit by the private sector has fallen but the supply of credit by banks has also remained subdued, and the two are difficult to disentangle.

Slowdown in domestic economic activity exacerbated by power shortages, decline in external demand due to the global recession, and SBP's tight monetary policy stance necessary for overall macroeconomic stability are responsible for the fall in demand for credit by the private sector. Negative wealth effect transmitted through a fall in asset prices also played its part in this decline. On the other hand, rising Non Performing Loans (NPLs) and availability of alternate avenues to extend credit, such as government and Public Sector Enterprises (PSEs), allowed the banks to be risk averse and shy away from private sector in a high risk and uncertain environment. Easing the monetary policy stance to some extent will send a positive signal in this context but may not be sufficient under the current uncertain economic environment to fully revive the PSC and thus the growth prospects.

Notwithstanding the structural issue of excessive reliance on the banking system to channel private savings to multiple sectors, there are other immediate concerns that call for caution. In the backdrop of falling economic activity there is a risk of slippage in the tax revenues. Against a target of Rs1300 billion for FY09, Federal Board of Revenue (FBR) has collected Rs810 billion during July-March, FY09. This means that Rs490 billion or Rs163 billion per month needs to be collected in the remaining three months of the current fiscal year, which appears difficult. The expected shortfall, if any, will likely be compensated by non-tax revenues, in particular, through the differential between international and domestic oil prices. However, government is cognizant of the need to enhance tax revenues and is planning to take administrative measures, such as tax audits, and broaden the tax base across all sectors of the economy.

Moreover, outlook of the external sector remains prone to uncertainty. The deepening global recession would negatively affect Pakistan's exports. Against an actual export growth of 0.2 percent during the first nine months of FY09, the projected export growth of negative 6.5 percent for the entire FY09 is quite a somber reflection of the fast changing global economic environment. The projected import growth of negative 14 percent though provides some respite for the outlook of external account. More worrying, perhaps, are the prospects of foreign inflows – remittances as well as the financial account inflows. Up till March, 2009, the worker's remittances at $5.7 billion and FDI at $3 billion though look fairly stable but their outlook is uncertain. Also, the portfolio investment inflows have reversed and stand at negative $1 billion. Given the weak prospects of tapping international financial markets, the reliance on International Financial Institutions (IFIs) and bilateral loans to improve the overall balance of payment position has increased.

Despite improvement in the outlook of many important economic indicators, the path to sustainable medium term economic recovery remains fraught with uncertainty. There are many structural issues that need to be tackled but, most importantly, the severe domestic power shortages and deteriorated law and order conditions have created an environment that is least conducive for productive activity in the economy.

Keeping in view these factors as constraints, at least in the short run, the focus of the SBP remains on fully capitalizing the emerging signs of macroeconomic stability. The assessment that the declining trend in inflation will continue shows that the SBP can now afford to relax its monetary policy stance in favor of supporting real economic activity. **Therefore, SBP has decided to lower the policy discount rate by 100 bps to 14 percent effective 21 April, 2009.**

A. Economic Environment and SBP's Policy Response: Nov-Jan, FY09

Despite improvement in some macroeconomic indicators, the SBP remained cautious and kept the policy rate unchanged in January, 2009 …

1. Continued monetary policy tightening, fiscal consolidation, market induced exchange rate adjustments, and retreat of international commodity prices led to an improvement in Pakistan's key economic indicators from November, 2008 onwards. These were manifested in restrained government borrowings from the SBP, moderation in import growth, buildup of foreign exchange reserves, and improved inflation outlook to some extent. These positive developments together with the initiation of the stabilization program, supported by the IMF, helped in reducing the confidence deficit caused by earlier deterioration in economic conditions.

2. Notwithstanding these improvements, risks of slippage in the fiscal deficit on account of an ambitious FBR tax revenue target and uncertainty in the external sector due to deteriorating global economic conditions, persuaded SBP to keep the tight monetary policy stance unchanged in January, 2009. Moreover, in the wake of October, 2008 liquidity shock, inter-bank market was kept sufficiently liquid to calm the market sentiments and help the government in meeting their borrowing requirements through T-bill auctions. While this reduced the extent of inflationary borrowing from the SBP, there were concerns about pinning long-term inflation expectations. Leaving the policy discount rate unchanged at 15 percent was an attempt to balance these considerations.

Fast changing global economic environment reinforced the need for vigilance…

3. Moreover, outlook for the world economy changed drastically between November, 2008 and January, 2009. IMF, in its *World Economic Outlook* report of November, 2008, was projecting a world GDP growth rate of 2.2 percent, but revised it downwards to 0.5 percent in January, 2009. This deepening global recession adversely affected prospects of Pakistan's exports and much needed foreign inflows. As a result, not only the domestic manufacturing sector was hurt but the external financing for both the external and fiscal accounts also became uncertain. Although the concurrent fall in international commodity prices provided some respite but the overall balance of payments position was deemed vulnerable.

Given the overall liquidity position, meeting the credit requirements of various sectors was an emerging challenge…

4. Shortfall in external financing for budgetary support together with a prudent restriction on the government to limit its borrowings from the SBP meant that the government had to rely on the scheduled banks to finance its fiscal deficit. Helped by pro-active liquidity management of the SBP, banks did adequately subscribe to the T-bills in the fortnightly auctions and the IMF's quantitative targets for end-December were successfully met.

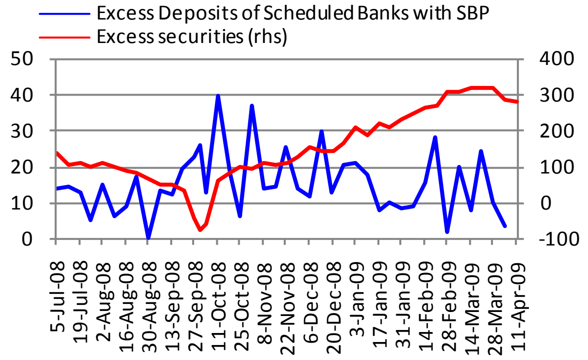
5. However, as the position of the banking system deposits remained relatively weak compared to their end-June level and the injection of fresh reserve money was constrained, the room to extend credit to the private sector was limited. Weak economic outlook and rising NPLs also had a bearing on the inclination of scheduled banks towards relatively more secure lending. The ample demand from government and PSEs helped them in this regard and as a result the credit to private sector declined.

6. Besides contracting private sector credit, the impact of unwinding fiscal and external current account deficit was also felt on monetary aggregates as both reserve money and M2 growth remained insipid. Slow and gradual improvement in SBP's reserve position (and thus the Net Foreign Asset (NFA) component of SBP's balance sheet) and limits on government borrowing from the SBP (and thus the Net Domestic asset (NDA) of SBP) explain this low growth in monetary aggregates.

B. Recent Economic Developments and Outlook for Q4-FY09

Calibrated liquidity management ensured smooth functioning of interbank market…

Figure 1: Banks' Excess Deposits and Securities (billion rupees)

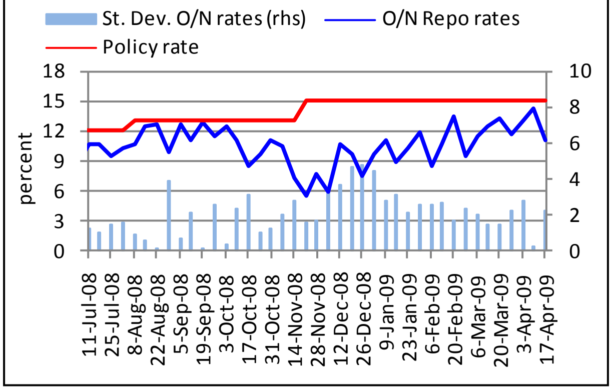


7. The acceleration in government borrowing requirements from the scheduled banks translated into an increased subscription of T-bills. This is evident in the excess of banks' holdings of securities over and above the Statutory Reserve Requirement (SLR) (see **Figure 1**). This, accompanied with

deceleration in the banking system deposits, squeezed the liquidity in the market and is also apparent in the declining trend of excess deposits of scheduled banks with the SBP over and above the Cash Reserve Requirement (CRR).

8. Consequently, the overnight interest rate started to rise and became more aligned with the policy discount rate. This rationalization of overnight interest rate and reduction in its volatility depict the success of SBP's calibrated liquidity management. Not only SBP managed to cater to the multiple needs of market, but also prudently mopped up excessive liquidity to remain consistent with the monetary policy stance. For instance, during 1 January – 24 March, FY09 SBP mopped-up Rs392 billion through Open Market Operation against Rs608 billion offered by the market, whereas the weekly weighted average overnight repo rate moved from Q2-FY09 average of 8.74 percent to 11.25 percent during Q3-FY09 (see **Figure 2).**

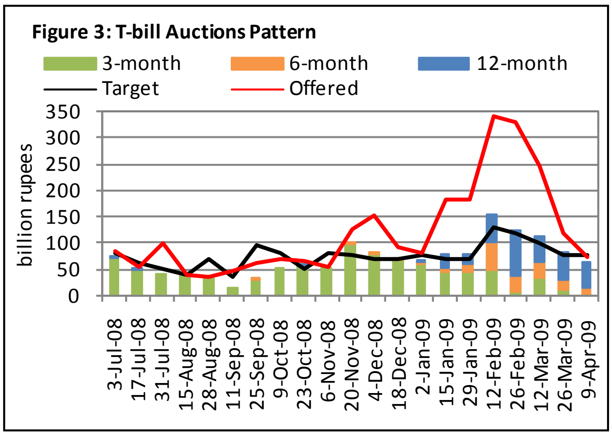
Figure 2: Policy and Weekly Average Overnight Repo Rates



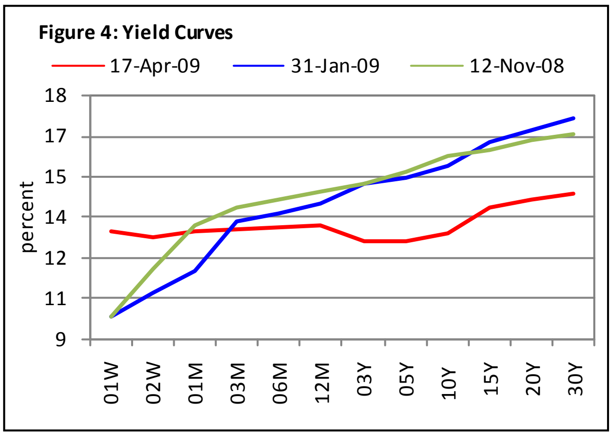
9. In the same spirit of pro-active liquidity management, SBP injected Rs228 billion, on net basis, during 28 March – 18 April, FY09 to address the liquidity concerns arising from government's efforts to meet the SBA's end-March quantitative targets. Furthermore, keeping in view the expected liquidity demand in Q4-FY09 emanating from various sources and remaining fully cognizant of the weak growth in banking system deposits and slow reserve money growth, SBP stands ready to play its part in ensuring smooth functioning of the domestic market.

Positive outcome of auctions and preference for longer tenor T-bills reflect fall in expected inflation…

10. SBP's prudent liquidity management also played its part in facilitating the T-bill auctions held in Q3-FY09. Unlike the earlier part of FY09, the banks offered substantially higher face value amounts, Rs1609 billion, in these auctions during Q3-FY09 compared to the announced target of Rs565 billion and maturity of Rs542 billion. Broadly respecting the sanctity of volume based actions, the Ministry of Finance accepted Rs684 billion and managed to raise additional Rs119 billion from the market.



11. Notably, the bidding pattern of banks for T-bills auctions changed considerably altering the composition of T-bill holdings in favor of longer tenors. As shown in **Figure 3**, there is a clear preference for the 12-month T-bill compared to the 3-month paper. For example, for the auction held on 8 April, 2009, the share of 12-month T-bill in total T-bills has increased to 78 percent compared to a paltry 4 percent on 2 January, 2009. This bodes well for the market's ability to roll over the maturing T-bills in Q4-FY09 and indicates market's expectations of a decline in inflation and thus a possible cut in policy rate.



12. The visible downward shift in the yield curve for market interest rates also reflects that the market is factoring in lower inflation premium for its medium to long term transactions (see **Figure 4**). The Pakistan Investment Bond (PIB) auction of 15 April, 2009 validates this point. Not only the participation was very healthy (Rs49 billion against a target of Rs20 billion) but the yield for all tenors declined considerably. For instance, the cut-off rate for the 10-year bond declined by 170 bps.

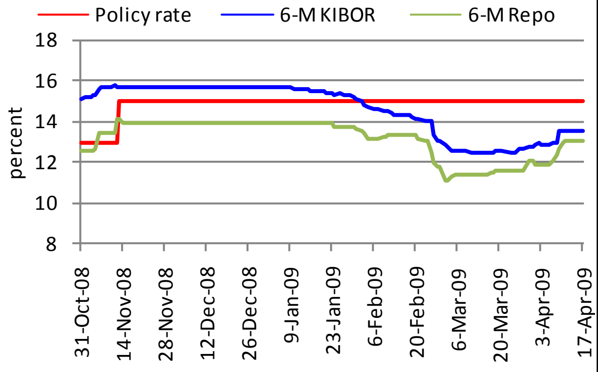
13. The Q4-FY09 T-bill auction calendar shows that government will require an additional Rs97 billion (over and above the maturing amount) from the scheduled banks to finance its fiscal deficit. In the first auction of this quarter held on 8 April, 2009, the government managed to roll-over the maturing T-bills, though the face value amount of Rs70 billion fell marginally short of the target of Rs75 billion. The T-bill yields on all tenors increased considerably relative to their fall in earlier auctions indicating tighter liquidity conditions and realignment of sentiments. However, this was probably a onetime increase and did not capture the trend. Moreover, it is important to note that change in T-bill yields reflect fiscal authority's financing considerations interacting with market dynamics in the short-term and not the overall macroeconomic outlook and thus the monetary policy stance.

Trends in market interest rate are consistent with current macroeconomic conditions and outlook…

14. Nevertheless, given the needs of the government and the emerging financing requirements for wheat procurement operations, estimated at approximately Rs60 billion, on flow basis, the liquidity conditions of the market could tighten in Q4-FY09. This may put some pressure on market interest rate and further restrain credit to the private sector. Such considerations have been incorporated in SBP's decision to cut the policy discount rate. Essentially, the decision validates market's expectations of lower interest rates in the coming months and thus would help in setting the path for market interest rates.

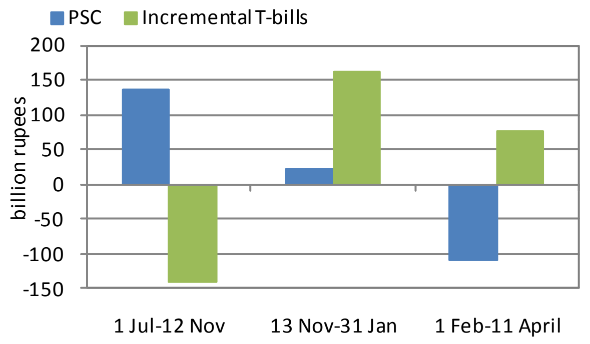
15. Similar to T-bill yields, other market interest rates, such as KIBOR, also inched up after showing a declining trend since end-December 2008 and are now moving sideways (see **Figure 5**). For instance, 6-month KIBOR increased by 66 basis points during 31 March - 17 April, FY09 after showing a decline of 285 basis points during Q3-FY09.

Figure 5: Policy and Market Interest Rates



16. In line with the reduction in KIBOR and repo rates during most of Q3-FY09, the retail market interest rates fell by 107 bps on lending and 88 bps on deposits in March 2009 over January 2009 even though the credit to private sector continued to decline. This is reflected in banks' changing preference in favor of risk-free government securities against credit extended to private sector, particularly in the face of rising NPLs (see **Figure 6**).

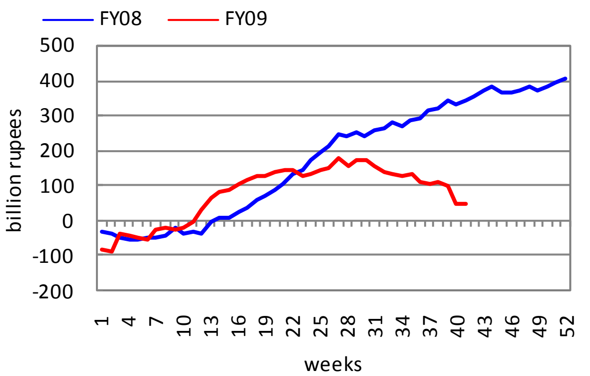
Figure 6: Private Sector Credit (PSC) and Incremental Government Borrowing in T-bill Auctions



Fiscal and quasi-fiscal credit requirements and weak economic activity are affecting private sector credit expansion…

17. The credit to private sector that picked up quite sharply as the fiscal year began, lost its pace significantly since January 2009 (see **Figure 7**). Cumulatively, the credit during 1 July -11 April, FY09 stands at only Rs48 billion, compared to Rs346 billion in the same period last year.

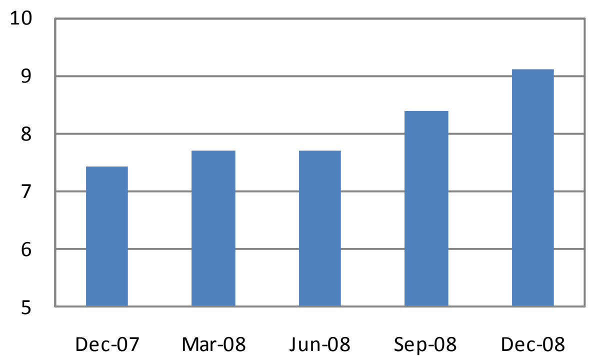
Figure 7: Private Sector Credit (cumulative flows)



18. The sharp fall in private sector credit during FY09 is a combination of both reduced demand and a reluctance of scheduled banks to extend credit. Slowdown in domestic economic activity exacerbated by power shortages, decline in external demand due to the global recession, and SBP's tight monetary policy stance necessary for overall macroeconomic stability are responsible for the fall in demand for credit. In addition, speculative demand for credit also diminished due to falling commodity prices and relatively higher interest rates.

19. On the other hand, scheduled banks' ability to lend became limited due to low deposit generation and heightened risk due to rising NPLs, especially in textiles and consumer finance sectors. NPLs have reached to Rs313.7 billion (or 9.1 percent of gross advances) by end-December 2008 as compared to Rs241 billion (or 7.7 percent of total loans) in June 2008 (see **Figure 8**). Specifically, NPL to loan ratio for textile sector has worsened sharply to 15 percent. With this sector's share of around 20 percent in total loan disbursed, it has significantly dented banks' ability to lend.

Figure 8: NPL to Loan Ratio



20. The impact of deceleration in external trade and slow domestic economic activity is quite visible in the fall in demand for working capital by the private sector. For the period July-March, FY09, the private sector retired Rs47 billion of the credit availed for working capital, with a substantial decline of Rs14.6 billion in import

financing. The consumer financing and banks investment in private sector securities and shares also declined substantially (see **Table 1)**.

Table 1: Credit to Private Sector
billion rupees

	July-Mar	
	FY08	**FY09**
1. Loans to private sector businesses	**304.7**	**105.0**
Working capital	267.0	-46.8
of which		
Export finance	14.6	13.7
Import finance	48.9	-14.6
Fixed investment	37.7	151.8
2. Personal	**21.2**	**-47.1**
of which		
Consumer financing	16.6	-52.4
3. Investment in securities and shares	**42.2**	**7.7**
4. Others	**-0.6**	**-6.3**
Total credit to private sector	**368.0**	**57.1**

Note: This data is not comparable with monetary survey data due to its coverage and reporting time difference.
Source: SBP

21. The credit for fixed investment compensated for this decline and expanded by Rs152 billion during July-March FY09 compared with a Rs38 billion in the same period of FY08. The main drivers of this expansion are the power and fertilizer sectors which are undertaking large investments to meet the shortages in their production capacities. However, most of this credit is the result of commitments made by banks in the past. It is expected that this acceleration in fixed investment will continue for some time to come as some of the projects are still in the pipeline.

Table 2: Loans to Private Sector Businesses
billion rupees

	Jul-Mar	
	FY08	**FY09**
Total loans to private sector businesses	**304.7**	**105.0**
Of which		
Agriculture	**12.1**	**8.5**
Manufacturing	**193.1**	**89.4**
Of which		
Textiles	94.2	2.4
Food products & beverages	23.4	33.5
Chemicals & products	17.3	26.0
Non-metallic mineral products	3.8	10.2
Wearing apparel, readymade garment	2.4	3.6
Electricity, gas and water	**37.3**	**22.7**
Construction	**15.0**	**-6.8**
Commerce and trade	**28.5**	**-7.5**
Transport, storage and comm.	**4.0**	**2.9**
Services	**10.0**	**-0.8**
Of which		
Real estate/renting & business activity	9.2	0.2

Source: SBP

22. Though the decline in credit is quite broad based it is more pronounced in the textiles, construction, commerce and trade, and real estate sectors. Nevertheless, there are sectors such as food products and beverages, chemicals and products, non-metallic minerals, and electricity, gas and water in which credit utilization has been significant (see **Table 2)**

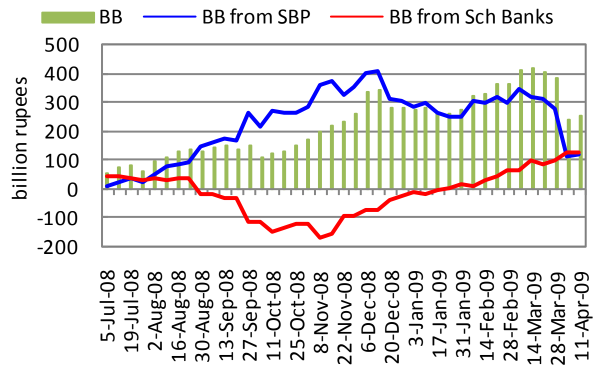
Domestic credit is largely propelled by requirements from government sector and public sector enterprises …

23. Credit of Rs141.9 billion to Public Sector Enterprises (PSEs) and government borrowings worth Rs20.37 billion for commodity operations have contributed Rs162.3 billion in domestic credit during 1 July - 11 April, FY09 compared to an

expansion of Rs53.1 billion in the corresponding period of last year. Most of the credit to PSEs was extended to finance the gaps due to the public sector driven circular debt issue. However, government has recently resolved this issue partially by negotiating with the banks to convert these loans into Term Finance Certificates (TFCs). As a result, credit to PSEs jumped by Rs78.7 billion during the first week of April, 2009 as Rs80.2 billion worth of TFCs were issued to the scheduled banks. Consequently, the credit to private sector decreased during that week. Resolution of the circular debt would allow banks to extend fresh lending which was constrained both due to exhaustion of exposure limits of PSEs/Independent Power Producers (IPPs) and their own Advances to Deposits Ratio (ADR) limits.

24. The composition of government budgetary borrowing from the banking system has changed considerably since the committed implementation of the macroeconomic stabilization program in November, 2008. The government has retired some of its debt to the SBP and financed its additional borrowing needs from the scheduled banks (see **Figure 9**). Consequently, the stock of Market Related Treasury Bills (MRTBs) has come down to Rs1094 billion as on 16 April, 2009 from a peak of Rs1430 billion on 3 December, 2008. Moreover, the end-March receipts of $500 million from the World Bank, $500 million deposits of the Bank of China, collection of advance taxes from the corporate sector have allowed government to retire Rs170 billion of the SBP borrowing in last week of March, 2009. This has also helped in meeting the end-March quantitative targets regarding government borrowings from SBP envisaged in the SBA.

Figure 9: Budgetary Borrowing (BB) from the Banking System



25. To meet one of the most important SBA performance criteria of containing the fiscal deficit to Rs562.0 billion for FY09, the government has cut development as well as current expenditures. As a result, the fiscal deficit target of Rs261 billion for H1-FY09 was successfully met. The development expenditures during H1-FY09 have only been 32 percent of the revised target for FY09. Given the constraint of fiscal deficit, these expenditures are likely to be squeezed further as the FBR tax revenue collection struggles to meet the stipulated target. Against a target of Rs1300 billion, FBR has collected Rs810 billion in the first nine months of FY09. This means that Rs490 billion or Rs163 billion per month needs to be collected in the remaining three

months of the current fiscal year, which seems quite challenging given the slow economic activity.

26. Despite the fact that government sector borrowed Rs268 billion during 1 July - 11 April, 2009 from the banking system, the slow expansion in PSC has dragged the growth in NDA of the banking system (see **Table 3**). This slow growth is shared both by NDA of SBP and the scheduled banks. While the former bodes well to meet the end-June, 2009 performance criteria and arrest the inflation inertia, the slowdown in the later is a source of concern as it shows less liquidity available to facilitate economic activity.

Table 3: Monetary Aggregates (Flows)

billion rupees

	FY08	FY09		
	1 Jul-12 Apr	1 Jul-11 Apr	1 Jul-17 Jan	17Jan-11 Apr
NDA	**622.4**	**314.8**	**359.5**	**-44.7**
of which				
Govt. sector*	359.2	268.0	268.8	-0.8
Private sector credit	345.9	47.9	172.8	-124.9
Credit to PSEs	36.4	141.9	59.0	82.9
NFA	**-281.2**	**-220.7**	**-302.8**	**82.1**
Money supply (M2)	**341.2**	**94.0**	**56.7**	**37.3**
YoY growth	*15.8*	*8.6*	*9.5*	*8.6*
Memorandum items				
Net budgetary support	342.3	249.6	263.1	-13.5
from SBP	*440.3*	*123.9*	270.7	-146.8
from Sch. banks	*-98.1*	*125.7*	-7.6	133.3
Currency in circulation	175.0	162.5	173.9	-11.4
Total deposits	169.1	-68.6	-117.2	48.6
Reserve money	141.5	-11.6	-10.1	-1.5
YoY growth	*14.8*	*8.6*	11.7	8.6

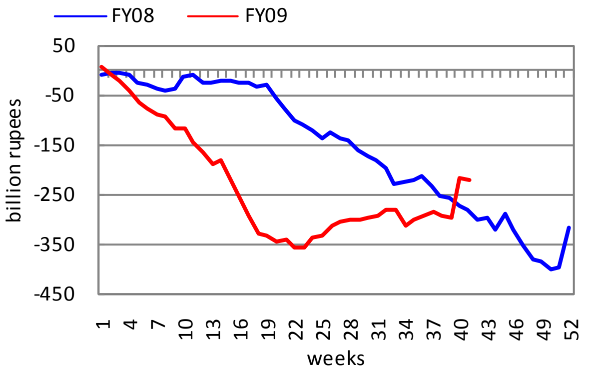
*Includes credit for commodity operations, net budgetary support and net effect of zakat fund etc.

Source: SBP

Contracting, though improving, NFA and slower expansion in NDA have constrained money supply growth …

27. In contrast to NDA, the NFA of banking system has been improving gradually since the first week of December, 2008 owing to both improved external inflows and reduction in external outflows. After contracting by Rs357 billion up till 6 December, 2008, the NFA has improved by Rs136.5 billion as on 11 April, 2009. Most of this improvement (Rs82.6 billion) came towards end-March, 2009 as the government received $500 million each from the World Bank and the Bank of China (see **Figure 10**). Cumulatively, however, there is a contraction of Rs220.7 billion in NFA of the banking system till 11 April, 2009, which is still a major source of drain for domestic liquidity.

Figure 10: NFA of the Banking System (cumulative flows)

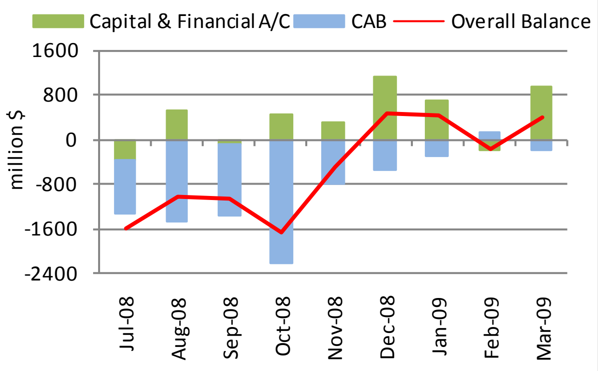


28. Nevertheless, the contraction in NFA of SBP is well within the floor set under the SBA performance criteria for end-June, 2009. While the outlook for NFA remains positive the risk of any shortfall in external budgetary flows would not only put the meeting of end-June, 2009 targets in jeopardy but also increase pressure on banking system to meet government budgetary requirements. This could exacerbate the already strained composition of rupee liquidity in the system.

29. The offsetting impact of contracting, though improving, NFA is still quite visible in a slowdown of broad money (M2) growth to 8.6 percent (YoY) as on 11 April, 2009 (see **Table 3**). This expansion is much lower than the expected nominal GDP growth, which augurs well for inflation expectations in the medium term; however, it is a source of stress in the short term.

The balance of payments position has strengthened due to an improving external current account balance…

Figure 11: Balance of Payments



30. The trend reversal in NFA was largely contributed by a steady improvement in external current account deficit, which stands at $7.65 billion for the first nine months of FY09. Incremental increase in this deficit in the five months after October, 2008 is only $1.7 billion, which is much lower than the accumulation of $6 billion deficit in the first four months of the fiscal year (see **Figure 11**). This is an encouraging development and depicts falling demand pressures in the domestic economy. The external current account deficit even turned into a surplus of $128 million in February, 2009. Similarly, the fall in trade deficit, which began in November, 2008, has become more pronounced since January, 2009. This is being supplemented by a steady rise in workers' remittances, helping in improving the external current account deficit.

31. The recession in the US and Euro-zone and slowdown in some parts of Middle East has had an impact on Pakistan's exports as almost 60 percent of the total exports are destined to these regions. As a result, export growth has fallen to 0.2 percent during July-March, FY09 and is projected to be around negative 6.5 percent for the entire fiscal year. However, helped by a substantial decline in international

oil prices and market induced rupee depreciation, imports registered a negative growth of 5.2 percent (see **Table 4**). For the entire fiscal year, import growth is expected to decelerate further and may turn out to be lower than negative 14 percent. Incorporating the likely moderation in worker's remittances due to the impact of the global recession, the external current account deficit is projected at 5.5 percent of the GDP.

Table 4: Balance of Payments Summary
billion US$

		Jul-Mar	
	FY08	FY09	FY08
i. Current account	**-13.7**	**-7.6**	**-9.6**
Trade balance	-15.0	-9.5	-10.9
Export	20.4	14.5	14.5
Growth rate	*18.2*	*0.2*	*15.4*
Import	35.5	24.0	25.3
Growth rate	*31.4*	*-5.2*	*25.6*
Services net	-6.3	-3.0	-4.8
Income net	-3.9	-3.3	-2.7
Current transfers	11.5	8.1	8.7
Workers' remittances	6.5	5.7	4.7
ii. Capital and Financial accounts	**8.3**	**3.7**	**5.8**
Of which:			
Direct investment	5.3	3.0	3.3
Portfolio investment	0.0	-1.0	-0.1
Long term loans	1.3	0.8	0.6
iii. Errors and omissions	**-0.1**	**-0.5**	**0.4**
Overall balance	**-5.5**	**-4.4**	**-3.4**

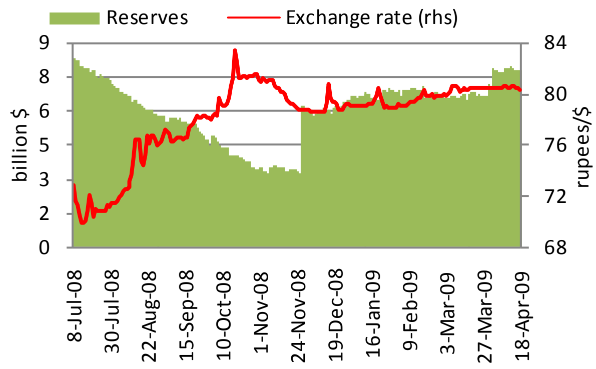
Source: SBP

32. Net inflow in the capital and financial account during Q3-FY09 was relatively lower than Q2-FY09 mainly due to lower Foreign Direct Investment (FDI) inflows and higher Foreign Portfolio Investment (FPI) outflows. This was despite the increased disbursement of long-term loans. Cumulatively, for the July-March, FY09 period, the capital and financial account balance stands at $3.7 billion. Given the external current account deficit of $7.6 billion, this still entails an overall balance of payments deficit of $4.4 billion. However, this deficit was partially offset by the first tranche of $3.1 billion from IMF under SBA in November, 2008. This resulted in the SBP reserve depletion of only $1.5 billion for the July-March, FY09 period.

Build up of foreign exchange reserves is a sign of emerging macroeconomic stability as reflected in relatively stable exchange rate…

33. With the improvement in balance of payments and foreign exchange inflows from the IMF, the SBP managed to replenish its foreign exchange reserves from a low of $3.5 billion on 31 October, 2008 to $7.8 billion on 17 April, 2009 (see **Figure 12**). This reserve build up has restored confidence and instilled a sense of stability in the foreign

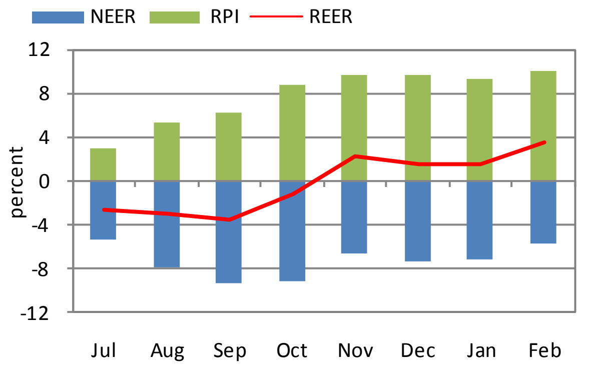
Figure 12: SBP's Foreign Exchange Reserves and Exchange Rate



exchange market. SBP managed to partially transfer the foreign exchange support for oil purchases (furnace oil) to the market without any pressure on exchange rate, which has recorded only a gradual depreciation of 1.7 percent up till 18 April, 2009 since 31 January, 2009.

34. Although the rupee depreciated by 5.7 percent in nominal terms against the basket countries' currencies between July-February, FY09, a high domestic inflation relative to the trading partner countries eroded Pakistan's export competitiveness. The rupee appreciated by 3.6 percent in real terms during the same period (see **Figure 13**). With the continuation of current trends in international exchange rates and relative stability in rupee, the importance of achieving low domestic inflation remains the most important objective.

Figure 13: Changes in REER, NEER and RPI (since Jun-08)



Inflationary pressures are easing and are expected to come down in coming months…

35. Reduced domestic demand pressure, as evident in shrinking twin deficits, are expected to narrow the output gap and reduce inflation. However, supply shocks such as power shortages and worsening law and order situation may delay the eventual fall in inflation. In fact, the persistence in inflation is largely due to these factors and is evident in various inflation indicators (see **Table 5**). Nonetheless, other supply side factors like falling international commodity prices and improved food supply coupled with strong expectations of low inflation in the near future will have a beneficial impact on current inflation.

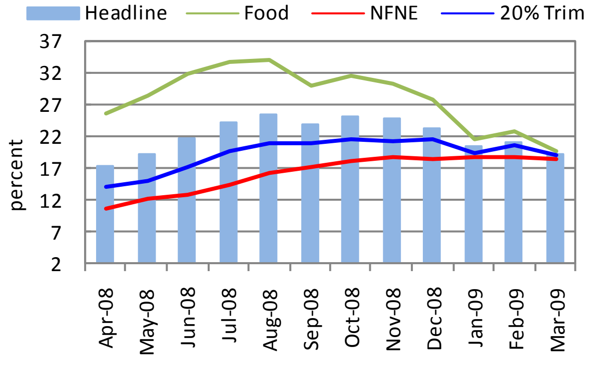
Table 5: Inflation Indicators

		Year on Year	
	Jun-08	Mar-08	Mar-09
CPI	21.5	14.1	19.1
Food group	32.0	20.6	19.7
Non-food group	13.8	9.4	18.5
Non-food non-energy	13.0	9.3	18.5
20-percent trimmed	17.2	11.3	19.3
		Period average	
	Jul-Jun	Jul-Mar	
	FY08	FY08	FY09
Headline CPI	12.0	9.5	23.0
Food group	17.6	13.8	27.8
Non-food group	7.9	6.3	19.2
Non-food non-energy	8.4	7.1	17.9
20-percent trimmed	10.2	8.7	20.4
		12-months moving average	
	Jul-Jun	Apr-Mar	
	FY08	FY08	FY09
Headline CPI	12.0	8.9	22.1
Food group	17.6	13.0	28.0
Non-food group	7.9	6.0	17.6
Non-food non-energy	8.4	6.7	16.5
20-percent trimmed	10.2	8.4	22.6

Source: Federal Bureau of Statistics and SBP

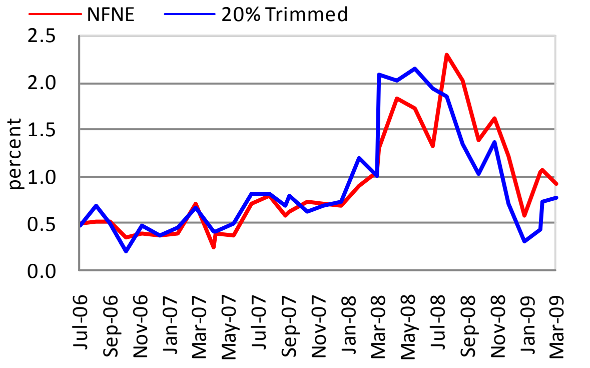
36. The declining trend in inflation now appears robust as headline CPI inflation (YoY) has come down to 19.1 percent in March, 2009 from the peak of 25.3 percent in August, 2008 (see **Figure 14**). This trend is likely to continue as indicated by an expected average inflation of around 14 percent in Q4-FY09 and 8 percent for FY10. Nonetheless, due to strong inertial impact, average CPI inflation for FY09 would remain around 21 percent.

Figure 14: Consumer Price Inflation (YoY)



37. Core inflation, measured by 20-percent trimmed mean, which remained firm around 21.7 percent since October, 2008, declined to 19.3 percent in March, 2009. Similarly, non-food non-energy (NFNE) measure has also eased to some extent. On month on month basis, both core inflation measures, have reverted to levels prevailing in FY07 (0.5 percent) after rising above 2.0 percent during earlier month of FY09 (see **Figure 15**). This provides further support to expectations of falling inflation in the coming months.

Figure 15: Core Inflation Trend (monthly changes)



Global recession, severe power outages and deteriorated law and order condition have taken their toll on domestic economic activities…

38. Dismal performance of large scale manufacturing (LSM) in July-February, FY09 with negative growth of 5.7 percent, and weaker than target growth of agriculture sector points towards the weaker real economic activities of commodity producing sector for FY09. In tandem with weak performance of commodity producing sector, services sector is also likely to show a weaker growth in FY09 relative to FY08.

39. The agriculture sector is expected to register a growth of 3.0 percent due to better output of major crops in *kharif season* (particularly of rice and cotton) and expected bumper crop of wheat of around 23.5 metric ton. This will provide some grace to overall real GDP growth, though agriculture performance will be lower than the original target of 3.5 percent.

40. LSM sector growth, in particular, the performance of export driven industries (particularly, textiles) has been negatively affected amid energy outages, deteriorated law and order condition, and most critically, weaker external demand due to the recessionary tendencies in most of the major trading partner countries. The domestic demand for automobile, electronics and other consumer durables has also remained weak which is attributed to high interest rates on consumer financing and increased risk averseness of commercial banks' about consumer financing due to rising NPLs in this sector.

41. Services sector is also expected to register a slower growth than the target of 6.1 percent for FY09. As a result, the prospect of overall growth remains modest and the economy is expected to register a growth of 2.5 to 3.5 percent in FY09.

C. Risks and Challenges

42. Despite considerable improvements in the external sector, its outlook remains a major source of concern. Not only the export performance is expected to suffer but any deviation from the expected financial inflows could send tremors to the rest of the economy. The risks for such deviations mostly emanate from the deepening global recession and domestic politico-economic environment.

43. It is now certain that the global economy is bound to see a contraction in 2009. What is more important is to assess the extent of this decline, particularly in the major economies such as US, UK, euro-zone, and Japan, and speed of economic recovery. Although unprecedented monetary and fiscal stimuli have been announced, there benefits have not yet materialized. If response of the real economy in these countries remains muted and if financial intermediation does not pick up to normal levels, the impact on the global economy could be much higher. Consequently, the adverse effect on Pakistan's economy through trade, remittances and financial inflows could be much more than expected today.

44. The persistence of the global recession and credit market imperfections are likely to impact firms' capacity and propensity to invest globally. This might reduce the chances of future investments in Pakistan and retrenchment in existing business activities. With increased risk averseness of foreign investors, the adverse impact on financial flows may turn out to be much higher than expected earlier. Despite some modest improvement in the perceptions of Pakistan's sovereign debt, the risk premium is still very high. This curtails Pakistan's ability to tap foreign debt markets

to finance its external current account deficit. With the aforementioned constraints on foreign private flows, Pakistan is depending almost entirely on sovereign bilateral and international financial institutions for financing needs.

45. The immediate implication of adverse external developments is likely to be reflected in domestic financial markets. Reduced flows in both the markets could put pressure on domestic interest rates and exchange rate. It also increases the risk of reducing the availability of credit for private sector. Moreover, the dependence of the government on domestic financial markets could increase significantly.

46. In the wake of a considerable slowdown in domestic real economic activity, tax revenues are likely to fall short of the stipulated target, which may lead to fiscal slippages in the absence of rationalization in current expenditures. Missing the revenue target may affect development spending and does not bode well for country's considerable needs for investment in infrastructure.

47. A related risk, given that further expenditure cuts may not be possible, is of a rise in the budget deficit and its financing through domestic borrowings. This may translate into crowding out of the private sector credit with renewed risk of inflation persistence.

48. Furthermore, weakening of domestic and global environment can also increase the stress on Pakistan's banking system. With higher credit concentration among few sectors, particularly textile, any sharp setback to textile sector may result in further rise in NPLs.

Annexure: Performance against the IMF Quantitative Targets

The Stand-By Arrangement (SBA) with the IMF entails some structural and other policy measures during the course of the 23-month program (see **Chart 1** and **Chart 2**). For monitoring the implementation and to assess the performance towards achieving the desired objectives, SBA has also set quarterly quantitative targets.

Coordinated monetary and fiscal policy measures helped in meeting all the quantitative targets set for Q2-FY09 (see Table 1). [1]

Table 1: Stand-By Arrangement (SBA)- Quantitative Targets and Performance

	End-Dec 2008			End-Mar 2009[1]			End-Jun 09 Program Targets
	Targets		Actual	Targets		Actual	
	Program	Adjusted		Program	Adjusted		
Targets for SBP							
Floor on NFA of SBP (million $)	1,165	882	2,355	671	502	3,214	2,782
NDA of SBP (billion Rs)	1,346	1,356	1,270	1,412	-	1,195	1,314
Budgetary borrowing from SBP[2] (billion Rs)	1,274	1,274	1,222	1,274	-	1,071	1,181
Continuous ceiling on SBP's foreign currency swaps and forward sales (million $)	2,750	-	1,850	2,750	-	1,835	2,750
Targets for Government							
Ceiling on cumulative budget deficit (billion Rs)	261	262	253	405	-	-	562
Ceiling on short-term external debt (million $)	1,500	-	813	1,500	-	-	1,500
Cumulative ceiling on non-concessional medium- and long-term external debt (million $)	9,500	-	1,000	9,500	-	-	9,500
Ceiling on external payments arrears (million $)	0	-	0	0	-	-	0

1: Provisional numbers for end-March 09. 2: On cash basis

Note: except budget deficit, all numbers shows stock or outstanding positions at the end of each quarter.

Note: Except fiscal deficit all numbers shows stocks or outstanding position.

Similar to end-December, 2009, provisional estimates suggest that SBP has successfully met all its quantitative performance criteria targets for end-March, 2009 (see Table 1). In fact, end-March, 2009 numbers of all the four monetary variables are within their respective targets for end-June, 2009.

[1] The NFA and NDA targets, shown in **Table 1,** are based on certain assumptions and subject to adjustment if

Chart 1: Matrix of SBP's Actions Required by IMF in Memorandum of Economic and Financial Policies

Measures for:	Required Actions	Timelines	Status
Changes in policy rate	Consideration of a further increase in the discount rate at the time of the monetary policy statement in Jan 09.	End-January 2009	Analyzing overall macroeconomic situation, SBP did not raise the policy discount rate.
	An earlier increase in discount rate if the actual reserves for end-November and end-December 2008 fall short of the program monthly floors on the SBP's net foreign assets.	During November-January, FY09	
Operational independence of SBP	Formation of an interagency committee for review and recommend changes in the legal provisions relating to the operational independence of the SBP.	By mid-November, 2008	A committee has been formed.
Amendments in Banking Companies Ordinance	Submission of necessary amendments in the Banking Companies Ordinance to the parliament for strengthening SBP's ability to (i) change management in banks; (ii) impose losses on shareholders by writing down their capital; (iii) intervene and take ownership of banks; (iv) appoint administrators to operate banks; and (v) restructure banks.	By end-June, 2009.	Underway
Oil support to market	Phasing out the SBP's provision of foreign exchange for oil imports according to the following schedule:		
	1. Furnace oil	By 1 February, 2009	Target achieved
	2. Diesel and other refined products	By 1 August, 2009	-
	3. Crude oil	By 1 February, 2010	-
Liquidity management	Review of the current procedures for liquidity management. Adopting a transparent liquidity management framework, including the announcement of an explicit corridor for money market interest rates and making it public.	By end-July, 2009	-
Auction calendar	Issuance of a T-bills auction calendar for every quarter	One month in advance	The procedure has been adopted.
Advance import payments	Elimination of the exchange restriction on advance import payments against letters of credit (subject to a marked improvement in the balance of payments position)	By end-January, 2010	-
Plan for problem banks	Preparation of a contingency plan to deal with problem private banks, containing criteria for SBP liquidity support, assessment of bank problems, and intervention procedures.	By end-December, 2008	Target achieved

Chart 2: Matrix of Government's Actions Required by IMF in Memorandum of Economic and Financial Policies

Measures for:	Actions	Timelines
Fiscal consolidation during FY09	To achieve the FY09 deficit target, the government will increase tax revenue by 0.6 percentage points of GDP and reduce non-interest current expenditure by about 1½ percentage points of GDP, mainly through the elimination of oil subsidies by December 2008 and electricity subsidies by June 2009. At the same time, domestically-financed development spending will be reduced by about 1 percentage point of GDP through better project prioritization.	By end June, 2009
Borrowing from SBP	SBP financing of the budget will be reduced to Rs165 billion on a cumulative basis.	In FY09
Measures to increase tax revenue	An integrated tax administration organization on a functional basis will be established at the Federal Board of Revenue (FBR).	During rest of FY09
	Audits will be reintroduced as part of a risk-based audit strategy.	By end-December, 2008
	A full description of the required reforms, together with an action plan will be provided to the IMF, following a planned seminar to review tax policy and administration.	By end-December, 2008
	Preparation of draft legislation for the VAT for public debate.	By end-2009
	Harmonize the income tax and GST laws, increase excises on tobacco, and reduce exemptions.	FY10 budget
Spending for social safety net	An increase in social safety net spending from budgeted 0.6 percentage points of GDP to 0.9 percent of GDP	During FY09
	In close cooperation with the World Bank, preparation of a strategy and a time-bound action plan to put in place a comprehensive and well-targeted social safety net.	By end-March, 2009
Single treasury account	Existing funds held outside the SBP account will be transferred to the SBP account.	By end-June, 2009
Circular debt	Preparation of a plan for eliminating the inter-corporate circular debt within the fiscal deficit target.	By end-March, 2009
Electricity tariff adjustments	Electricity tariff differential subsidies will be fully eliminated. In this regard, the average base tariff will be further increased during FY09 according to a schedule to be agreed with the World Bank.	By end-December, 2008
Fuel price adjustments	Moreover, fuel prices will continue to be adjusted to pass through changes in international prices.	Continuous
Coordination for budget framework	Coordination between the Planning Commission and the MoF will be strengthened in the context of the implementation of the medium-term budget framework.	
FY10 fiscal deficit	A further reduction in the fiscal deficit to 3.3 percent of GDP is envisaged for 2009/10.	During FY09
Fiscal consolidation in medium-term	Reduction in the fiscal deficit to 2–2½ percent of GDP. Increasing tax revenue by at least 3½ percentage points of GDP.	By FY13