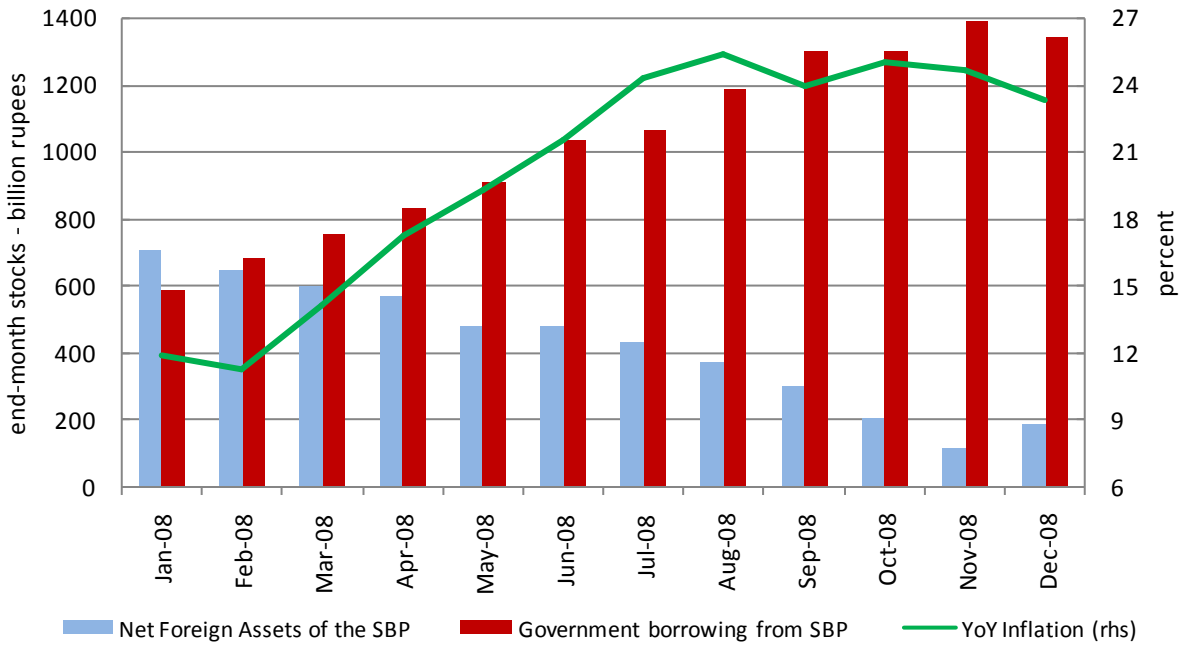
MONETARY POLICY STATEMENT

January – March 2009



STATE BANK OF PAKISTAN

This page is left blank intentionally

Contents

This page is left blank intentionally

Executive Summary

Pakistan's economy has started to show signs of the beginning to an end of a year long period of mounting difficulties and challenges, yet it has not solved all of its problems. The ensuing vulnerabilities and risks posed complex policy questions that occupied the country during most of 2008. The stress on macroeconomic stability was most visible in an unsustainable balance of payments position and the falling value of the rupee. Together with this, escalating CPI inflation, driven both by food and non-food components, and structural problems such as power shortages leading to a gradual decline in real economic activity, aggravated the pressure. The enormous size and skewed financing mix of the fiscal deficit that tilted heavily towards central bank borrowing, liquidity shortages in the money market, and strains in the overall banking system added to an already worsening situation. The domestic socio-political upheavals and rapidly changing global economic environment also contributed to these multifaceted problems.

These diverse developments entailed complex interactions and led to an increasingly intricate menu of policy trade-offs. In response, and keeping in view the economic outlook for FY09, the SBP tightened the monetary policy further by increasing the policy discount rate by 100 bps in July 2008. The final judgment categorically stated that the risks to the inflation outlook were far greater than risks to economic growth and reckoned the necessity of well coordinated stabilization measures. Given the emerging liquidity issues, SBP also took a host of measures in October 2008 to address problems related to liquidity management by banks.

In continuation of its resolve to support a return to macroeconomic stability, *Interim Monetary Policy Measures* were announced on 12th November 2008. The increase in the policy discount rate from 13 to 15 percent was taken after assessing the developments during the first four months of the current fiscal year and seeing no visible turnaround in the highlighted risks and challenges faced by the SBP. Tight monetary policy, however, was only one ingredient of the macroeconomic stabilization program; several stabilization and structural adjustments were required immediately and in the medium term to put the economy back on a stable path.

More importantly, the *Interim Measures* outlined the contours of the macroeconomic stabilization program prepared by the SBP and the government. Since the corner stone of the stabilization program was an urgent need to plug the

'financing-gap' of $4.5 billion during FY09, a Stand-by Arrangement (SBA) was signed with the IMF towards the end of November, 2008 (see **Appendix** for details).

Although it is too early to evaluate the benefits of all the measures that the stabilization program stipulates, yet by January 2009 there are early signs of improvement in the outlook for some important economic variables such as inflation, foreign exchange reserve, import growth, and government borrowings from the SBP. Two broad reasons underlie these positive developments.

First, some of the important policy measures and adjustments, which are a part of the macroeconomic stabilization package, have already been working their way through the economy and are likely to contribute towards achieving stability by the end of FY09. These include: (i) frequent and timely adjustments in the policy interest rate that resulted in a cumulative increase of 500 bps during 2008 kept the aggregate demand and inflation expectations from spiraling out of control; (ii) rationalization/elimination of subsidies, especially on petroleum products that had wrecked havoc with the government's budget of FY08. Out of a budget deficit of Rs777.2 billion in FY08, Rs395 billion were spent on subsidies; and (iii) an inevitable yet needed and market driven adjustment in the exchange rate helped in putting a dent in an otherwise unsustainable growth rate of imports. After a cumulative depreciation of 11.5 percent in FY08 and a further slide of 13.5 percent in FY09 up till 30th January 2009, the import growth has slowed down from 31.2 percent in FY08 to 15.4 percent in H1-FY09.

Second, two phenomena that had hitherto diluted the effects of the tight monetary policy have changed their direction: (i) there has been a noticeable decline in the volume of government borrowings from the SBP for budgetary support. This has been made possible because preference for subsidy took a back seat, especially after the confidence-invoking and discipline-inducing home grown stabilization package that also paved the way for successful conclusion of SBA. For example, during Q1-FY09, the government borrowed Rs264.4 billion from the SBP, while this amount reduced to Rs44.3 billion during Q2-FY09; (ii) After touching a record high of $147.3/bbl on 11th July 2008, oil prices have slumped to around $40/bbl as on 27th January 2009; a fall beyond national and international expectations and projections. This drastic fall in international prices will provide a much needed respite for the trade account and coupled with tight monetary policy and prudent exchange rate management will strengthen the balance of payments position. CPI inflation is also likely to benefit from this development.

Despite these preliminary positive indications it would be imprudent to lower the guard at this stage. A number of measures suggested in the stabilization package, especially those related with structural issues, still need to be implemented to put the economy back on a sustainable path of growth and development. Even the macroeconomic indicators that have recovered and the ones likely to post improvement in the next six months justify only restrained optimism on close inspection. Furthermore, the full impact of demand and liquidity management measures taken by the SBP during 2008 have yet to materialize.

The excessive drain of rupee liquidity from the system in October 2008, which was precipitated by falling net foreign assets, strong credit demand, and other seasonal factors, was largely addressed by a staggered lowering of Cash Reserve Requirement (CRR) and exemption of time liabilities from the Statutory Liquidity Requirement (SLR). As a consequence, however, overnight repo interest rate fell in the following weeks and continued to remain at a relatively lower level even after the increase in the policy discount rate on 12th November 2008 by 200 bps. The low levels of weekly average overnight repo rate of around 10.3 percent (for the week ending 23rd January 2009) essentially entail softening of the monetary policy stance. This was done consciously by the SBP to keep money market sufficiently liquid while remaining vigilant in draining excessive liquidity build-ups.

Two consideration prompted the SBP to remain cautious in mopping up the liquidity: (i) there were concerns about some lingering effects of liquidity problems in some segments of the market; (ii) it allowed the banks to increase their participation in the T-bill auctions and thus helped in lowering the reliance of the government on borrowings from the SBP. In the six auctions held since the *Interim Monetary Policy Measures*, November 2008, Rs482.1 billion was realized to the government against the maturities of Rs321 billion, which helped the government to meet its end-December targets under the SBA.

A prudent approach to liquidity management is necessary in the current circumstances to ensure meeting quantitative targets in the SBA. Floor on SBP Net Foreign Assets (NFA) and ceilings on SBP Net Domestic Assets (NDA) and government borrowing from SBP will ensure that softening market interest rates remain consistent with achieving macroeconomic stability. In fact, reducing government borrowing from SBP will also help entrench expectations of a sustained decline in inflation. Moreover, increased participation of banks in auctions indicates their

reluctance to extend credit to the private sector and hint towards the slowdown in economic activity. Hence, softening of market interest rates is a welcome development.

However, given a high inflation environment which induces people to hold more cash, accommodation of liquidity shocks does not bode well for pinning long-term inflation expectations. One of the reasons for increasing the policy rate in November was to strike a balance between these considerations.

Another consequence of adequate liquidity is that the Karachi Inter Bank Offer Rate (KIBOR) has remained flat after the policy rate increase and even declined in January 2009. As on 30th January 2009, both the 3-month and the 6-month KIBOR of 14.5 and 15.2 percent are lower than their respective levels of 15.4 and 15.7 percent as on 12th November 2008; just before the increase in the policy discount rate. This is partially because the market had already factored-in the imminent interest rate hike.

The result is that the Weighted Average Lending Rate (WALR) on incremental loans has eased somewhat (14.3 percent in December 2008) leading to a fall in the real interest rates. As has been argued by the SBP in previous Monetary Policy Statements, it is the real interest rate that needs to increase in order to bring the domestic savings in line with the investment requirements of the economy. Failing to do so has resulted in a continued and unnecessarily increasing reliance on foreign savings. This provided little incentive to align domestic aggregate demand with the productive capacity of the economy. Eventually, shocks to foreign resources in 2008 such as the global financial turmoil and domestic turbulence exposed the domestic vulnerabilities and resulted in a fall in reserves, considerable depreciation of rupee, and a persistent rise in inflation.

A careful analysis of monetary aggregates also expose the consequences of a widening saving-investment (or aggregate demand-aggregate supply) gap. The depreciation of rupee was mainly reflecting a sharp fall in the NFA component of money supply (M2). Similarly, stubbornness of inflation was partially because of a significant expansion in the NDA, driven largely by government borrowings from the SBP. Recent data reveals that the rate of increase of government borrowing from the SBP (and thus the NDA) has slowed down and the foreign exchange reserves (and thus the NFA) have improved. This offers a glimpse of a certain degree of stability to come by the end of FY09. However, in absolute terms, an expansion in NDA (Rs360

billion) and contraction in NFA (Rs303 billion) during 1st July – 17th January FY09) still represents a disproportionate increase in rupee liquidity relative to the availability of foreign exchange.

The expected rate of growth of M2 for FY09 consistent with the projected fiscal deficit of 4.6 percent of GDP and external account deficit of 7.0 percent of GDP turns out to be around 9.0 percent. This is the equilibrium growth of money that is consistent with the given forecasts for the fiscal and external sectors and the projected real GDP growth rate of 3.7 percent. Despite the anticipated improvements in the twin deficits and slowdown in real GDP growth, a projected average inflation rate of 20 percent for FY09 is still quite high and explains the reasons for the current high level of policy discount rate. It also highlights the importance that SBP has placed on controlling inflation.

In order to take advantage of the improvement in the composition of monetary aggregates, it is important to encourage factors for the emerging signs of stability, that is, government should continue to keep borrowings from the SBP under control and ensure the buildup of reserves. This can be achieved by bringing down the level of fiscal deficit and external current account deficit to sustainable levels; important features of the stabilization program. Elimination of subsidies, partial transfer of oil payments to the foreign exchange market, and fall in the international oil prices should help on these fronts.

The risks involved in this context are twofold. First, the target for tax revenues, in the wake of a slowing economy has begun to look a bit ambitious. During the first six month, the FBR tax revenue collection amounted to Rs543.7 billion against a (revised) Federal Bureau of Revenue (FBR) target of Rs581 billion for H1-FY09 and Rs1360 billion for FY09. To avoid a slippage in the fiscal deficit target the government will need to keep its expenditures in check. Second, expected decline in import growth to around negative 5.0 percent due to a fall in international prices and depreciation of rupee may be neutralized by a slowdown in export revenues—expected to decelerate to around 2.0 percent—because of the deepening global recession.

Lower external demand for exports coupled with energy shortages, law and order situation, and pending circular debt issue are expected to drag the growth of the domestic economy in FY09, particularly of the industrial and services sectors. The dismal performance of Large Scale Manufacturing (LSM) during the first five months

of current fiscal year and falling private sector credit are an indication of weakening real economic activity. The expected better performance of the agriculture sector may support the growth prospect to some extent. Nonetheless, the overall GDP growth is still projected to remain around 3.7 percent in FY09, which is lower than last year's growth rate of 5.8 percent but is still respectable.

Finally, it is important to stem the current level of inflation from becoming chronic since there is a risk that the current experience of higher prices may get entrenched in expectations of economic agents. Expected decline in the fiscal and external current account deficit and government borrowings from the SBP point to easing of aggregate demand pressures and would help on this front. Similarly, falling international commodity prices are an indication of slackening supply shocks, which is also helpful for the inflation outlook.

However, record high international commodity prices during 2008, especially oil, not only had a level effect on the imported component of domestic CPI but gradually spilled over to other categories. This affected both the actual and expected inflation and explains its persistence. Though the increase in CPI inflation has somewhat eased, the high level of inflation and rigidity of core inflation remain a source of concern. The YoY CPI inflation is projected to come down to 12 percent in June 2009, but the average CPI inflation for FY09 is likely to remain in the vicinity of 20 percent.

Based on these considerations, it is clear that by the end of FY09 there will be some reduction in both the fiscal and external current account deficits relative to FY08. However, not only is the expected magnitude of these deficits quite high but also there are risks of slippages. This signifies that the demand pressures have not completely dissipated and are likely to persist in H2-FY09, despite a slowdown in economic activity. Similarly, the high expected average CPI inflation of 20 percent for FY09 (significantly higher than the FY09 target of 11 percent) and its persistence, reflected by core inflation measures, clearly reflect the risk on this front. To mitigate the implications of these risks it is important to continue with the current monetary policy stance. Therefore, the SBP has decided to keep the policy discount rate unchanged at 15 percent.

In order to further strengthen and segregate the responsibilities of debt and monetary management following steps have been taken: (i) prior announcement of the auction calendar for Treasury Bills (T-bills) and Pakistan Investment Bonds (PIBs)

and a volume based approach to determine the auction result. These are positive steps in the development of a liquid government debt market; (ii) Ministry of Finance will henceforth be responsible for deciding the cut off yields of the primary auctions of T-bills and PIBs on the above premise. State Bank of Pakistan will continue to manage the operational aspect of the auctions and there will be no change in the process as far as the market is concerned; (iii) next step in the segregation of debt and monetary management would be to work toward introducing limits on the direct government borrowings from the SBP and along with a plan to eliminate the same in a phased manner over next several years.

To facilitate the banks in providing finance to the exporters and support the industry SBP has decided to further enhance banks' limits both under EFS and LTFF Schemes by Rs35 billion. As a result total limits under EFS will increase by Rs25 billion from Rs181.3 billion to Rs206.3 billion. Resultantly, cushion of Rs46.4 billion will be available with the banks over and above their current utilization of facility for meeting the requirements of the industry. Further in order to support long term investment in new plant & machinery, the limits under LTFF have also been enhanced by Rs. 10 billion from Rs9.5 billion to Rs19.5 billion.

In addition it has been decided that the SBP will issue Monetary Policy Statement (MPS) on quarterly basis. This is a significant step in current fast evolving economic environment and will enhance the effectiveness of monetary policy transmission. The MPS for the next quarter will be issued by the end of April 2009.

A. Economic Environment and SBP's Policy Response during H1-FY09

Unyielding aggregate demand pressures and stubborn inflation necessitated tightening of the monetary policy twice…

1. The precarious and unsustainable balance of payment position and heavy reliance of the government on borrowings from the SBP remained the major sources of macroeconomic instability in the initial months of FY09. High international commodity prices, global financial crisis, and slowing economic growth worldwide aggravated the domestic vulnerabilities. To address these and particularly to curb the persistent increase in inflationary pressures, SBP increased the policy discount rate by 100 bps to 13 percent in July 2008. Liquidity strains in the domestic financial markets during October 2008 added another dimension to an intricate menu of policy trade-offs.[1]

2. To ease the liquidity conditions, SBP reduced the Cash Reserve Requirement (CRR), in a staggered manner, by 400 bps to 5 percent. The SBP also exempted time deposits from the Statutory Liquidity Requirement (SLR) and took a host of other measures. In the same vein, to meet the credit requirements of the exporters, the SBP decided to provide 100 percent refinancing to banks under the Export Finance Scheme (EFS). These measures allowed the SBP to address the liquidity situation while remaining vigilant in draining excessive liquidity build-ups.

3. Seeing no visible improvement in the broad macroeconomic indicators, the policy discount rate was further increased to 15 percent on 12th November, 2008. This strengthened the earlier monetary tightening and was necessary to improve the inflation outlook and secure the long-term growth prospects. The need for coordinated policy measures and structural reforms was also emphasized.

Fiscal and exchange rate adjustments complemented the tightening of monetary policy…

4. In fact, some of the important policy measures and adjustments had already been introduced that subsequently became a part of a comprehensive macroeconomic stabilization program. For example, to bring the fiscal deficit in line with the resource envelope, government had started to rationalize subsidies. In

[1] For details, see pp 16 – 18 and Annexure: Measures Taken to Improve Liquidity and Restore Stability in the Money Market on page 27 of the *Interim Monetary Policy Measures, November 2008*.

particular, the rise in international oil prices, which peaked in July 2008, was gradually passed on to the domestic market. Similarly, the exchange rate had adjusted considerably in the wake of rising external current account deficit and depleting reserves.

5. Despite these monetary and fiscal adjustments the stabilization program projected a 'financing gap' of $4.5 billion for FY09, which prompted the government to sign a Stand-by Arrangement (SBA) with the IMF in late November to support the program. The SBA increased SBP's foreign exchange reserves and called for a gradual transfer of oil payments, made by the SBP, to the domestic foreign exchange market. The SBA also envisaged a further reduction in the fiscal deficit and the stock of government borrowings from the SBP to remain at the end October 2008 level for the remaining part of FY09 (see **Appendix** for details). These steps are expected to induce discipline in macroeconomic management and have already instilled confidence in the system; both the rate of decrease in Net Foreign Assets (NFA) and the rate of increase in government borrowings from the SBP have been dampened.

Changing economic environment is offering opportunities as well as challenges…

6. At the same time, the global economic environment has begun to change in a manner that has both favorable and adverse repercussions for the Pakistan economy. On the positive front, there has been a steep and noticeable fall in international commodity prices that is expected to reduce the import bill and moderate the rate of increase in inflation. Oil prices (WTI) fell from the highest level of $133.93 per barrel in June 2008 and are currently hovering around $40 per barrel. Similarly, wheat and rice prices that peaked in March/April 2008 at $439.7 per metric ton and $1015 per metric ton have fallen to $220.1 and $550.8 in December 2008.

7. However, the global financial crisis has led to prospects of a prolonged and deep recession in major economies and a considerable deceleration in growth in emerging markets. The crisis has squeezed the ability, and more recently, the capacity (due to rising unemployment and defaults) of the households and businesses to obtain credit from an already strained financial system. The fallout of this global slowdown and credit crisis is likely to reduce the demand for exports of Pakistani products and supply of financial flows to Pakistan's economy.

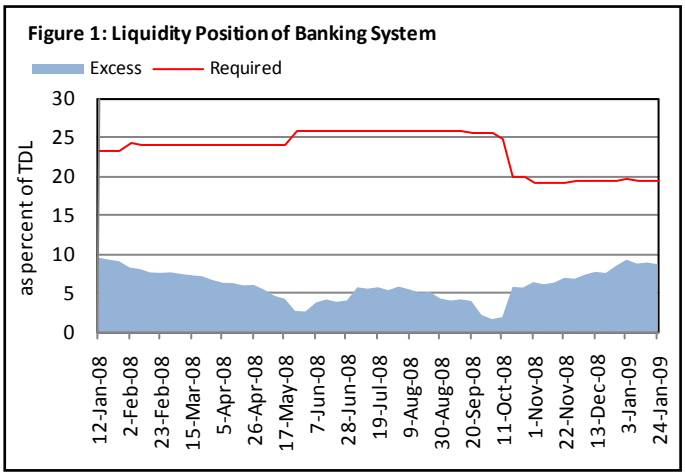
The resulting preliminary positive indications make a case for only restrained optimism…

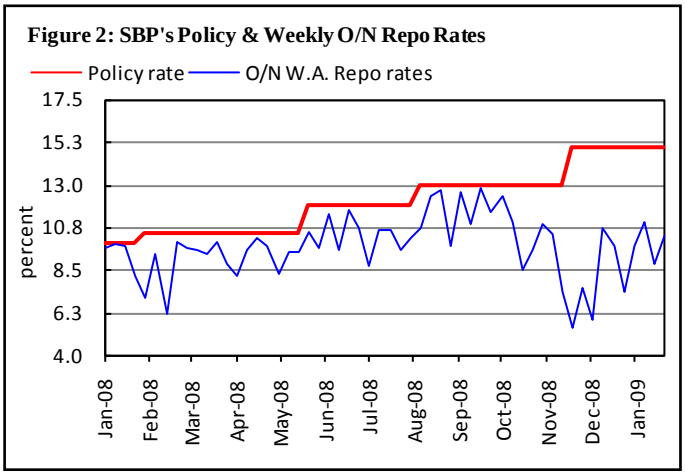
8. The net effect of monetary tightening, fiscal and exchange rate adjustment, and changing global commodity price trends is visible in a positive change in some key economic indicators. The foreign exchange reserves have increased, the falling trend in the NFA has reversed, the import growth has slowed, the fiscal position has improved, the rate of growth of government borrowing from the SBP has declined, and the persistent increase in inflation has come to a halt. Although these developments have instilled a sense of optimism regarding the near term economic outlook, yet there are considerations that call for restraint.

B. Recent Economic Developments and Outlook for H2-FY09

Liquidity issues have settled to a large extent, but new complications are emerging…

9. The easing of the liquidity by the SBP in October 2008 has helped the market conditions considerably as reflected in an improved excess reserve position of the banks. These reserves increased from an all-time low of 1.6 percent (Rs59 billion) as on 4th October 2008 to 8.6 percent (Rs325 billion) of the TDL by the week ending on 24th January 2009 (see **Figure 1**). Comfortable level of liquidity in the system is also reflected in overnight repo rate trends, which remained well below the discount rate (see **Figure 2**).

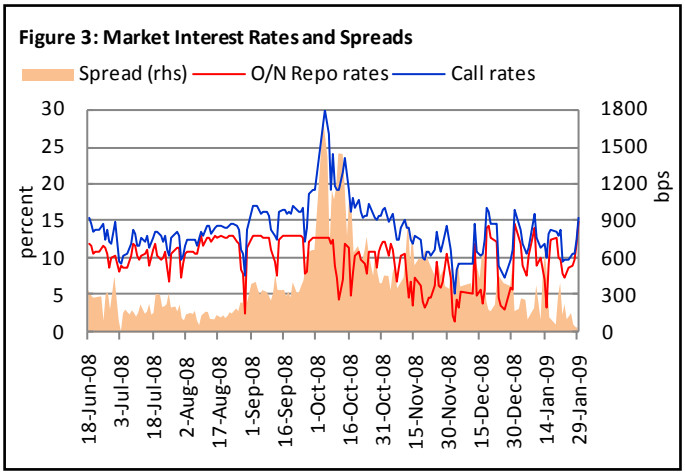




10. Other market interest rates such as call and clean rates[2] also declined from their peak levels reached during the first week of

[2] The clean rate is the weighted average lending rate on all uncollateralized transactions held between the financial institutions. The call rate is the weighted average lending rate on all uncollateralized transactions held between the scheduled banks with the option of being called by the lender at any time before the maturity.

October 2008. As a result of improved liquidity in the banking system, the liquidity spread, that is, the difference between uncollateralized rates and collateralized overnight repo rates, has narrowed down considerably. Particularly, the spread between the call and the overnight repo rate, which rose to a peak of 1720 bps on 4th October 2008, has fallen below 100 bps by 29th January 2009 (see **Figure 3**).



11. However, the net injection of liquidity through open market operations during September and October turned into net mop-up in December 2008. Against a net injection of Rs411 billion during September and October 2008, SBP absorbed Rs460 billion (on net basis) during 1st November 2008 to 26th January 2009. As a result, the overnight repo rate volatility increased considerably[3] though its level remained quite low due to the lingering effects of liquidity problems in some segments of the market. To reduce volatility and restore confidence shaken by the global liquidity crunch, it is necessary to keep domestic money market adequately liquid, while ensuring mop-ups of excessive liquidity build-ups.

12. The November 2008 hike in policy rate and the increasing liquidity in the system encouraged banks to participate in the T-bill auctions aggressively and helped SBP to shift the stock of government securities to the commercial banks. In the six auctions held since 13th November 2008, SBP has raised Rs482.1 billion (realized amount) against maturities of only Rs321 billion. As a result, scheduled banks' stock of T-Bills holding improved to 15 percent of their time and demand liabilities (TDL) as on 17th January 2009 from the lowest level of 11.5 percent of TDL reached on 8th November 2008.

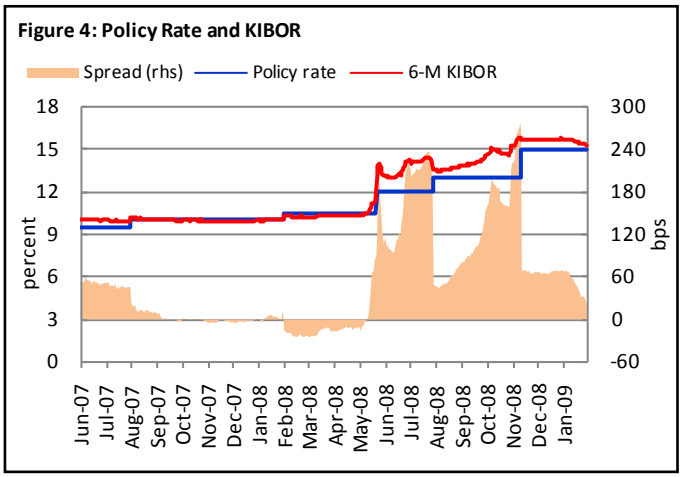
13. This trend helped the government to meet its end December targets under the SBA and bodes well for inflation expectations. However, increased participation of banks' in auctions indicates their reluctance to extend credit to the private sector and is an indication of growing risk aversion amidst a slowdown in economic activity.

[3] In September, the coefficient of variation was 14.1, which consistently rose to 23.4 in October, 36.6 in November and 60.1 in December 2008. However, it has come down significantly to 25.7 in January 2009.

Going forward, as the government's credit requirements stabilize and the confidence in the system builds up due to the implementation of a comprehensive stabilization program, both the credit demand and supply conditions are likely to improve for the private sector.

The response of KIBOR and other market interest rates to the hike in policy rate in November has been neutral, indicating rise had already been incorporated by the market…

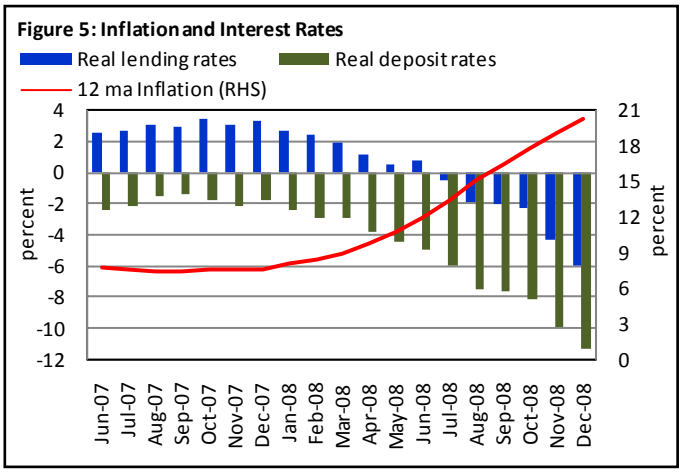
14. KIBOR of all tenors remained almost unchanged since the announcement of Interim Monetary Policy Measures until very recently when the 3-month and 6-month KIBOR recorded a slight decline. As on 30th January 2009, both the 3-month and the 6-month KIBOR of 14.5 and 15.2 percent are lower than their respective levels of 15.4 and 15.7 percent as on 12th November 2008; just before the increase in the policy discount rate. Earlier, during late October and start of November 2008, KIBOR had risen sharply due to tight market liquidity conditions and in anticipation of the policy rate hike. This indicates that the banks had already built in their expectations the need for such a hike in the wake of worsening macroeconomic situation and high inflation in the economy (see **Figure 4**).



15. Similar to trends in the interbank interest rates, the retail rates also eased during the last two months of 2008. In December 2008, the weighted average lending and deposit rates, on incremental basis, stood at 14.3 and 8.9 percent. As the decrease in lending rates was much sharper compared to a decline in the deposit rates, their spread contracted by 62 bps to 5.4 percent.

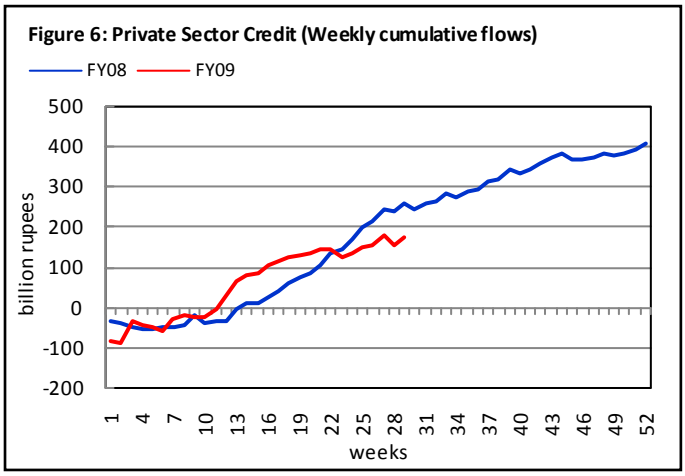
16. Consequent to a decline in the lending and deposit rates on the one hand and rising annualized inflation on the other, the real lending and deposits rates have declined further (see **Figure 5**). This decline has negative implications for the economy's dire need for increasing domestic savings that are necessary to meet investment requirements. The consequences of a widening saving-investment gap and increasing reliance on potentially volatile foreign savings to bridge this gap are

clearly evident in FY08 developments in the wake of the global financial crisis. The evaporation of foreign inflows in FY08 exposed the unsustainability of the external current account and fiscal deficits and resulted in a fall in reserves, considerable depreciation of rupee, and consequent rise in inflationary pressures.



Despite liquidity easing and falling real interest rates, credit to the private sector remains subdued…

17. In addition to these developments, the real economic activity also started to slow down becoming more evident in the trends of private sector credit from November onwards. The current fiscal year started with a substantial increase in the credit to the private sector at least up till the end of October 2008. During this period (1st July – 1st November FY09) the private sector availed Rs125.6 billion credit compared to Rs60.5 billion in the corresponding period of last year. However, it has decelerated significantly from that point onwards (see **Figure 6**). During 1st November to 17th January 2008, credit to the private sector increased by Rs47.2 billion only while in the same period of previous year this increase was Rs196.2 billion. Cumulatively, the credit during 1st July to 17th January, FY09 stands at Rs172.8 billion.



18. The deceleration in growth of overall private sector credit is most visible in a fall in demand for working capital in the textile, construction, commerce and trade, and real estate sectors. In particular, import financing has witnessed substantial decline which is in line with the recent lower pace of import growth. The credit for fixed investment, however, compensated for this decline to some extent keeping the

overall flow of advances to private businesses at almost the same level as last year (see **Table 1)**. The consumer financing and banks investment in private sector securities and shares also declined substantially contributing towards the deceleration in overall credit.

Table 1: Credit to Private Sector

billion Rupees

	H1-FY08	H1-FY09
1. Loans to private sector business	**200.5**	**194.1**
Working capital	182.4	65.8
of which		
Export finance	7.8	4.1
Import finance	30.6	-18.9
Fixed investment	18.1	128.2
2. Personal	**24.1**	**-27.2**
of which		
Consumer financing	20.7	-33.3
3. Investment in security & shares	**44.4**	**-39.8**
4. Others	**-0.94**	**-4.8**
Total credit to private sector	**268.1**	**122.3**
Memorandum Items:		
Credit to:		
Textile sector	61.7	26.3
Construction	9.6	-1.4
Commerce and trade	22.2	8.8
Real estate	21.2	2.0

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

Source: SBP

19. Weak external demand and frequent power and gas outages that disrupted production partly explain the fall in the demand for private sector credit. The rise in input costs (such as wage bill, utilities, raw material) also discouraged economic activities contributing towards a reduction in demand for credit.[4] The credit supply by banks was also hurt by the severe liquidity squeeze of October 2008. On top of it, the banks became constrained and more risk averse in extending credit due to the rising Non Performing Loans (NPLs).

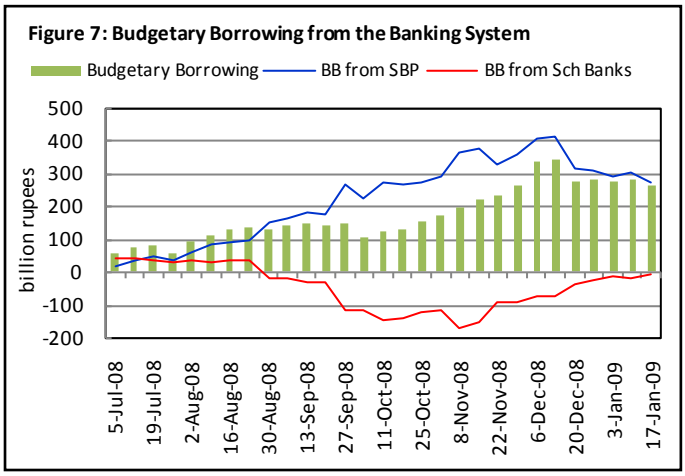
20. NPLs have reached to Rs278 billion (or 8.4 percent of gross advances) during the first three quarters of 2008 as compared to Rs205 billion (or 7.7 percent of gross advances) in 2007. Although the rise in NPLs is concentrated among few banks, most of the banks appear to have become more cautious in lending. Credit concentration among a few borrowers is also a source of concern for the banking sector. For example, textile sector being the major user of credit is relatively more exposed to the risk of global slowdown, adding to the worries of the banking sector. Despite these emerging risks, due to provisioning requirements stipulated by the SBP, the net NPLs to advances ratio at 1.9 percent lies within tolerable limits and the banking system is well positioned to withstand shocks of this nature. To avoid erosion of credit quality, banks have started to adjust the composition of their portfolios in favor of relatively risk free assets. An increase in the credit to public sector enterprises (PSEs) and government's commodity operations in addition to preference for investment in T-bills reflect this adjustment.

[4] Interest cost as percentage of overall cost of production has increased from 4.3 percent during Q4-FY08 to 5.4 percent in the Q1-FY09.

Increase in the flow of credit to the public sector enterprises and the government has more than neutralized squeeze in private sector credit…

21. Credit to PSEs (Rs59.0 billion) and government borrowings for commodity operations (Rs7.5 billion) has resulted in an expansion of Rs66.5 billion during 1st July to 17th January FY09 compared to a retirement of Rs20.7 billion in the corresponding period of last year. While most of the credit to PSEs was extended to finance the gaps due to the public sector driven circular debt issue,[5] wheat and fertilizer import by Trading Corporation of Pakistan (TCP) explains the rise in the credit for commodity operations this year.

22. Similarly, government borrowing from the banking system for budgetary support rose considerably since the beginning of FY09. However, after reaching a maximum of Rs339.4 billion on 13th December 2008, it has somewhat stabilized at Rs260 billion as on 17th January 2009. More importantly, the composition of government borrowing from the banking system also changed significantly after the liquidity easing measures announced in October 2008 (see **Figure 7**). The government has retired some of its debt to the SBP and financed its borrowing needs from the scheduled banks. Consequently, the stock of Market Related Treasury Bills (MRTBs) has come down to Rs1305 billion as on 28th January 2009 from a high of Rs1430 billion on 3rd December 2008.



23. Earlier, realizing the negative fallout of the fiscal imbalance of FY08, the government had embarked on reducing its expenditures mainly by reducing the expenditures on subsidizing oil prices by gradually increasing domestic petroleum prices. Furthermore, it curtailed its ambitious developmental budget. As a result, the fiscal deficit as a percentage of GDP has dropped to 1 percent of GDP compared to 1.5 percent in Q1-FY08. These are all positive developments and will play a critical

[5] This issue emerged because of the delay in passing on the impact of the higher international oil prices to the domestic consumers by the Government during FY08. It not only stressed the government's fiscal position due to large subsidy payouts but also fueled inflation due to the monetization of these subsidy expenditures. While subsidies have been phased out in recent months, the circular debt issue among PSE's is still lingering on and has cost the country dearly in terms of reduced power generation and lost industrial output.

role in achieving macroeconomic stability. Government should continue with this prudence while keeping a close eye on a potential slowdown in tax revenues in the wake of a slowing economy.

24. The net impact of a relative slowdown in private sector credit and significant expansion of credit to the government and non-government sector is Rs501 billion in NDA (excluding Other Items Net (OIN)) during 1st July to 17th January, FY09. In the corresponding period of last year this component of money supply was Rs474 billion. Even including the significant contraction in OIN, YoY growth in NDA accelerated to 25.5 percent till 17th January against 18.9 percent in the corresponding period of last year (see **Table 2**).

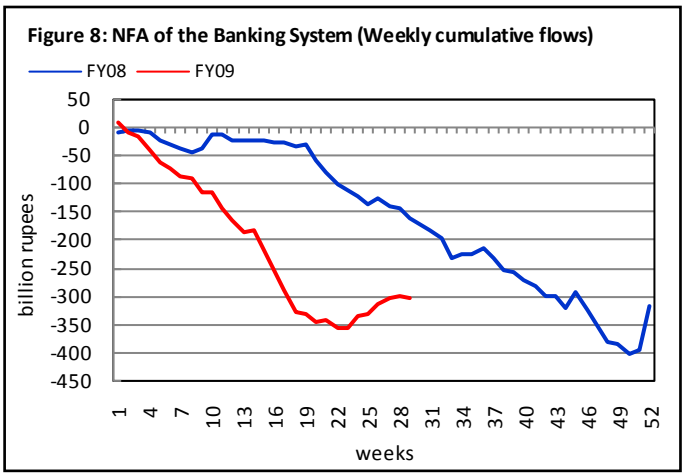
Table 2: Monetary Aggregates (Flows)
billion rupees

	FY08	FY09		
	1 July-19 Jan	1 July-17 Jan	1 July-1 Nov	1 Nov-17 Jan
NDA	400.0	359.5	234.6	124.9
of which				
Govt. sector*	210.0	268.8	179.3	89.5
Private sector credit	256.7	172.8	125.6	47.2
Credit to PSEs	6.0	59.0	62.8	-3.8
NFA	-162.3	-302.8	-327.3	24.5
SBP	-79.3	-290.5	-313.0	22.5
Sch. banks	-83.0	-12.3	-14.3	2.0
Money supply (M2)	237.7	56.7	-92.7	149.4
YoY growth	*19.6*	*9.5*	11.2	9.5
Memorandum items				
Net budgetary support	237.7	263.1	170.9	92.2
from SBP	*237.1*	*270.7*	289.6	-18.9
from Sch. banks	*0.5*	*-7.6*	-118.7	111.1
Currency in circulation	161.2	173.9	131.1	42.8
Total deposits	78.4	-117.2	-224.7	107.5
Reserve money	116.2	-10.1	-32.9	22.8
YoY growth	*13.7*	*11.7*	14.9	11.7

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

Despite expansion in NDA, money supply (M2) growth remains low due to contraction in NFA …

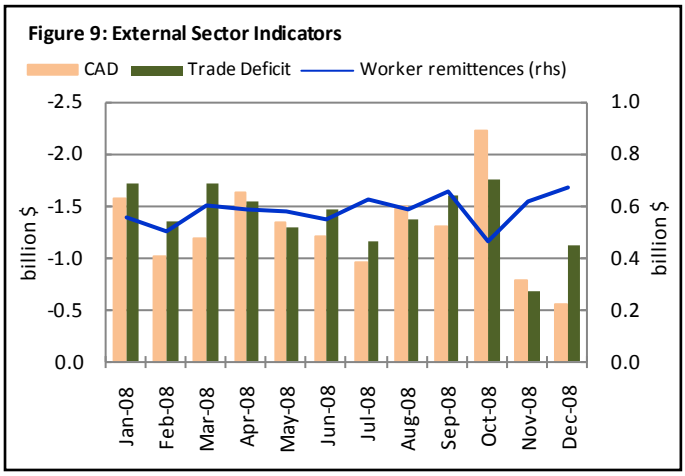
25. Contraction in NFA (Rs303 billion) has neutralized the expansion in NDA (Rs360 billion) to a large extent. This resulted in a slowdown in broad money (M2) growth to 9.5 percent (YoY) as on 17th January 2009 from 19.6 percent in the last year (see **Table 2**). This should not be considered as a healthy development as it represents a disproportionate rise in rupee liquidity relative to the foreign exchange component. Nevertheless, the contraction in NFA has been arrested and is visible in the trend reversal (see **Figure 8**). It is likely to improve further due to expected



improvement in the external current account deficit during H2-FY09 and likely inflows from bilateral and multilaterals creditors in coming months.

Balance of payments has started to improve as the reserves stabilize and import growth decelerates …

26. The pace of contraction in NFA started to ease due to the incremental slowdown in the growth of the external account deficit and the realization of financial flows since November 2008. Both the fall in trade deficit and stable inflow of workers' remittances are responsible for this decline (see **Figure 9**). However, the external current account deficit still stands at a considerably high level of $7.3 billion during H1-FY09.



27. Although the deepening global economic slowdown has impacted Pakistan's export growth, a simultaneous reduction in import bill actually lowered the trade deficit in November and December 2008 compared to the first four months of FY09 (see **Table 3**). The declining import growth (from 21.6 percent during Jul-Nov, FY09 to 15.4 percent in Jul-Dec, FY09) reflects both the reduced quantum of imports and falling international commodity prices.

Table 3: Balance of Payment Statistics (in billion US$)

		July-December	
	FY08	**FY08**	**FY09**
i. CA balance	**-14.0**	**-6.1**	**-7.3**
Trade balance	-15.3	-6.2	-7.7
Exports	20.1	9.2	10.2
Growth rate	*16.5*	*10.0*	*10.4*
Imports	35.4	15.5	17.9
Growth rate	*31.2*	*12.9*	*15.4*
Services net	-6.3	-3.3	-2.3
Income net	-3.9	-2.0	-2.4
Current transfers	11.5	5.4	5.0
Remittances	6.5	3.1	3.6
ii. Capital account	**0.1**	**0.0**	**0.1**
iii. Financial account	**7.7**	**3.8**	**2.3**
of which			
Direct investment	5.1	2.0	2.4
Portfolio investment	0.0	0.1	-0.2
iv. Errors and omissions	**0.5**	**0.5**	**-0.4**
Overall balance	**-5.8**	**-1.7**	**-5.4**

Source: SBP

28. While the decline in import quantum is quite visible on cumulative basis in a number of commodities, including crude oil and petroleum products, the price impact has yet to be realized fully (see **Table 4)**. For instance, the international oil prices are hovering around $40 per barrel currently; however, the full benefit of this

decline has not yet been realized since the average crude oil price paid in H1-FY09 is around $109 per barrel. Nonetheless, it is expected that price impact will become more evident in coming months as the current import contracts are structured at new and lower international prices.

Table 4: Major Imports with Decrease/Increase in Quantum

million US$

	Jul-Dec FY09	Abs. Change from Jul-Dec FY08		
		Total	Quantum impact	Price impact
Total imports	**19133.5**	**2182.6**		
Major items with decreases/increase in quantum				
Fertilizer manufactured	363.6	-165.2	-375.0	209.7
Iron and steel	636.2	69.4	-140.9	210.3
Iron and steel scrap	268.3	-57.8	-124.0	66.2
Petroleum crude	2572.6	677.1	-120.7	797.8
Raw cotton	354.9	-89.8	-119.9	30.1
Palm oil	721.3	52.6	-81.2	133.9
Petroleum products	3313.2	965.9	-74.3	1040.2
Plastic material	581.8	-25.5	-51.7	26.2
Soyabean oil	14.9	-30.0	-35.2	5.2
Tea	120.9	25.9	11.4	14.5
Worn clothing	52.1	20.2	21.9	-1.7
Synthetic fibre	152.6	25.2	33.2	-8.0
Wheat un-milled	707.7	627.1	715.5	-88.5

Source: Federal Bureau of Statistics

29. During H1-FY09, the financial and capital account balance showed a net inflow of $2.4 billion (compared to $3.8 billion in the corresponding period of FY08) as both public and private flows were lower than the projected volumes. Consequently, overall balance registered a deficit of $5.4 billion during H1-FY09. The stock of foreign exchange reserves, however, improved to $6.6 billion (by end December) with the receipt of first tranche of $3.1 billion under SBA. Currently, as on 29th January 2009, the stock of SBP's foreign exchange reserves stand at $6.9 billion.

30. To bring the economy back on a sustainable path, the value and need of structural transformation of the economy, as envisaged in the letter of intent to the IMF by the Government of Pakistan, must not be overlooked. These measures include de-monetization of the fiscal deficit, tax reforms to increase the tax-to-GDP ratio, and emphasis on the fact that the government should plan its expenditures in accordance with the resource envelope, and not vice versa. A tight monetary policy and fiscal reforms are anticipated to moderate excess demand pressures and lower inflationary expectations. It should be realized by all stakeholders that it is imperative to narrow the saving-investment gap to correct the external imbalance and strengthen the foreign exchange reserve position.

31. Based on this assessment, the outlook for the external current account position suggests a deficit of $11.2 billion (7.0 percent of GDP) in FY09 compared with $14 billion (8.4 percent of GDP) in FY08. Although it is an improvement on the previous year, it is still very high relative to the reserves position of the country. There is a risk that external account pressures may persist if slowdown in major economies affects export receipts and foreign inflows by more than projected.

Therefore, it is imperative to achieve a sustained decline in overall imports and thus bring the external current account deficit to sustainable levels. The decision of transferring payment of furnace oil imports to the markets goes hand in hand with these considerations.

Improvement in the external sector calmed the sentiments in the foreign exchange market …

32. The improvement in foreign exchange reserves and positive outlook of the external current account has helped in restoring confidence in the foreign exchange market. Prior to the announcement of SBA, the exchange rate depreciated significantly. This depreciation, however, was inevitable and simply reflected the market's reaction to the worsening economic situation. As soon as the macroeconomic stabilization program was announced, the exchange rate stabilized and in fact appreciated by 4.6 percent during 19th October 2008 to 30th January 2009. Recent announcement of scaling back of SBP intervention in the foreign exchange market for furnace oil payments (effective from 2nd February 2009) will facilitate the market determination of exchange rate. This increasing flexibility in the exchange rate will help in absorbing the impacts of evolving external shocks and overall augurs well for the economy (see **Table 5**).

Table 5: Trends in Exchange Rate

	End month exchange rate (Rs/US$)*	App./Dep. (%)	
		Monthly	Cumulative since end June 2008
Jun-08	68.28	-	-
Jul-08	71.49	-4.49	-4.49
Aug-08	76.25	-6.24	-10.45
Sep-08	78.04	-2.29	-12.50
Oct-08	81.62	-4.40	-16.35
Nov-08	78.78	3.61	-13.33
Dec-08	79.10	-0.40	-13.68
30-Jan-09	78.98	0.15	-13.54
1st July to 18th October 2008			-17.32
19th Oct 2008 to 30th Jan 2009			4.6

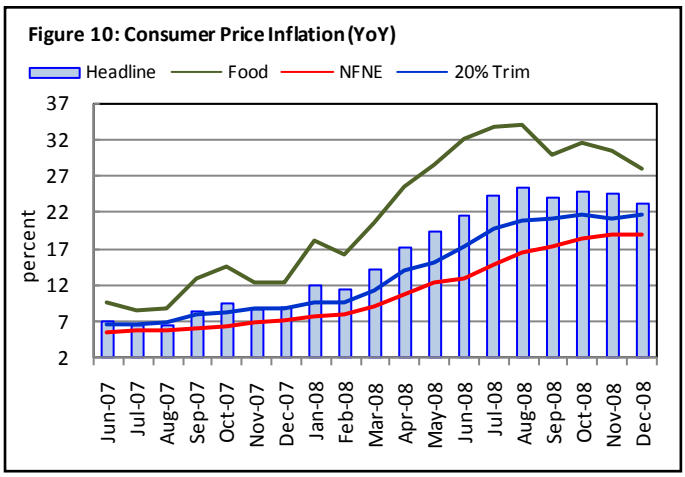
* Weighted average mid rates

33. Despite this flexibility in the nominal exchange rate, higher domestic inflation relative to the prevailing inflation in the trading partners has resulted in an appreciation of the rupee in real terms. On cumulative basis, the Real Effective Exchange Rate (REER) index has appreciated by 1.2 percent during H1-FY09. The appreciation in REER indicates erosion in the competiveness of our exports vis-à-vis the trading partners and means that the domestic prices of the imported goods and services are relatively lower than the (domestic) prices of domestically produced goods and services. This situation is a potential risk and may encourage imports and discourage exports leading to pressures on the external current account deficit and

reserves. Therefore, it is of utmost importance to bring domestic inflation down, especially in the wake of global deflationary concerns.

The inflationary pressures have started to ease yet the level of inflation remains high…

34. A tight monetary policy stance, improved fiscal discipline, and falling international commodity prices have started to ease the domestic inflationary pressures. Consumer price inflation is moderating to some extent after rising to a record high of 25.3 percent in August 2008 (see **Figure 10**). On a month-on-month basis, prices fell consecutively in November and December 2008 for the first time after January 2007. However, the YoY inflation at 23.3 percent in December 2008 is still significantly high. The average inflation during H1-FY09 has risen to 24.4 percent and is well above the target of 11 percent for FY09.



35. The marginal decline in YoY inflation during the last two months was contributed by both food and non food prices. The deceleration in inflation remained limited as the pass-through of falling international commodity prices has yet to be realized. While the direct impact of a downward adjustment in petroleum prices is partially there, the indirect benefit such as a decline in transport fares has not materialized to that extent. Moreover, depreciation of Pak rupee has also offset some of the gains from falling international commodity prices.

36. It is expected, however, that the declining trend in inflation would gain momentum in H2-FY09. The administrative measures such as ensuring the effectiveness of the price monitoring mechanism to check profiteering and passing-on of the falling international prices (including adjustment in the domestic energy prices) are steps in the right direction. Similarly, a restrained government borrowing from the SBP is also likely to influence the inflation outlook positively. A significant fall in the YoY wholesale price inflation from 35.7 percent in August 2008 to 17.6 percent in December 2008 is also a leading indicator of a fall in CPI Inflation in coming months.

Core inflation has yet to show improvement reflecting persistence of demand pressures…

37. The aggregate demand pressures, though moderating, still persist, and are being reflected in high core inflation indicators. The YoY non-food non-energy (NFNE) and 20-percent trimmed measures are relatively stable around 18 and 21 percent for the last three to four months and have shown no signs of a trend reversal yet (see **Table 6**). This means that the second round impact of high food and energy prices has become embedded and is widespread. The moderating aggregate demand might not have the desired effect of reducing inflation as capacity of the economy to meet the domestic demand has also been affected due to the structural issues such as severe energy shortages and poor law and order conditions. Therefore, the output gap is likely to remain more or less unchanged, mitigating the anticipated effect on inflation through this channel.

Table 6: Inflation Indicators

	YoY inflation		
	Jun-08	**Dec-07**	**Dec-08**
CPI	21.5	8.8	23.3
Food group	32.0	12.2	27.9
Non-food group	13.8	6.3	19.8
Non-food non-energy	13.0	7.2	18.8
20% Trimmed	17.2	8.7	21.7
	Average inflation		
	Jul-Jun	**Jul-Dec**	
	FY08	**FY08**	**FY09**
Headline CPI	12.0	8.0	24.4
Food group	17.6	11.6	31.3
Non-food group	7.9	5.4	19.2
Non-food non-energy	8.4	6.5	17.4
20% Trimmed	10.2	7.6	21.1
	12m MA inflation		
	Jul-Jun	**Jan-Dec**	
	FY08	**FY08**	**FY09**
Headline CPI	12.0	7.6	20.3
Food group	17.6	10.8	27.6
Non-food group	7.9	5.3	14.8
Non-food non-energy	8.4	6.1	13.9
20% Trimmed	10.2	7.4	16.9

Source: Federal Bureau of Statistics and SBP

38. Incorporating all these considerations, YoY CPI inflation is expected to come down to around 12 percent by end June 2009; however, due to strong inertial effect of high inflation in the first half, the average CPI inflation for FY09 is projected to remain in the vicinity of 20 percent.

Alignment of real economic activity with productive capacity bodes well for macroeconomic stability…

39. The available data reveals a mixed picture of real economic activity in FY09. The performance of large scale manufacturing (LSM) has remained dismal as shown

by a negative growth of 5.6 percent during Jul-Nov, FY09. However, the agriculture sector's performance during the *kharif* season was decent as the bumper rice crop and an improved cotton production over the last year more than compensated for the shortfall in sugarcane production.[6]

40. For the full fiscal year, the performance of LSM and thus the industrial sector is likely to be weak, affected by lower external demand for exports, decline in the availability of consumer financing, pending circular debt issues, and energy shortages. In the agriculture sector, wheat crop is expected to be significantly higher than last year as area under cultivation has increased due to better incentives (higher support prices), timely rainfall, and increased availability of credit.

41. Thus, the improvement in agriculture sector is expected to provide some respite to overall real GDP growth. The contribution of the services sector in overall GDP is also likely to remain moderate since the performance of this sector usually follows the trends in industrial and agriculture sectors. As a result, the prospects for overall growth in FY09 appear modest. The economy is expected to grow at 3.7 percent, which is lower than last year's growth rate of 5.8 percent.

C. Risks and Challenges

42. It is comforting that the extent of risks and vulnerabilities which the economy had faced during 2008 has moderated to some extent. For example, factors such as the vulnerability of the external sector due to high oil and other commodity prices; anticipated weakness in workers' remittances due to speculative sentiments; persistence of high imports and weak prospects of foreign investment, have all moderated considerably owing to improvements related to each area. International commodity prices, especially oil have declined sharply; remittances have so far shown robust growth and imports are decelerating. The financial inflows which dried up during 2008 are likely to be restored with the macroeconomic stabilization program in place. On the fiscal front, the budget deficit is on decline and government borrowing has at least stopped ascending sharply. Nevertheless, it would be naïve not to keep in view the newly emerging risks and challenges.

43. Indeed, though there are indications of an improvement in the current account balance due to falling international commodity prices and strong

[6] This is based on record rice harvest of 6.5 million tones and cotton production of 12.1 million bales.

remittances, the balance of payments position is still exposed to several risks. First, the decline in trade deficit, which is anticipated on account of a fall in imports, may prove to be less than expectations for two reasons: (i) there has been a considerable deceleration in growth of exports due to global recession and the domestic structural bottlenecks featuring intermittent power and gas supplies; (ii) the anticipated decline in oil import bill may turn out to be less than the current projections. If the water availability during the summer season is less than what is required, the pressure to increase electricity supply using thermal sources would necessitate higher fuel imports. This could reduce the benefit envisaged in the form of a lower oil import bill.

44. Second, workers' remittances face the risk of decline due to the global slowdown as is indicated by already falling remittances from the US, UK and UAE. A challenge to keep the workers' remittances flowing through official channels is not to let any incentives develop in the form of a higher kerb premium that may reroute them to the unofficial channels. This requires establishing confidence in the foreign exchange market.

45. Third, the deepening of the financial crisis and the global recession has increased the risk aversion among international investors. This increases the likelihood of a severe reduction in financial inflows to emerging market including Pakistan. These global developments coupled with domestic vulnerabilities may even increase the outflow of foreign investment in the country. A comprehensive implementation of the macroeconomic stabilization program would enhance the confidence of foreign investors in Pakistan's economy.

46. On the fiscal side, the risk of missing the full year (revised) target of tax revenues has increased in the wake of slowing economic activity. This necessitates aligning of expenditures with the resources, since otherwise a rise in fiscal deficit may increase the risks of inflationary SBP borrowing or the crowding out of private sector credit. It may also lure the government to increase its dependence on non-tax revenue through the differential between international and domestic oil prices.

47. Currently, the decline in domestic oil prices is not in line with the sharp decline in international oil prices. A regular transfer of the international oil price impact to domestic prices is instrumental in establishing confidence over government's actions. A delayed or no action by the government after a decline in oil prices not only reduces the direct trickle down impact on domestic prices but also

dissuades adjustments in inflationary expectations. As a result, the benefits of adjustments in other prices may not materialize either. The challenge, therefore, is to maintain public confidence over price mechanism and keep the reliance on these non tax revenues to a minimal.

48. Finally, though CPI inflation has eased somewhat its persistence at a high level remains a source of concern. With a sustained period of high inflation there is always a risk and tendency for inflation to take a chronic form as it becomes entrenched in public's expectations. The will of the SBP and the government to credibly commit and follow through the stabilization program and tackle the structural weaknesses would play an essential role to fight this tendency.

Annexure: Brief Overview of Quantitative Targets and Stabilization and Structural Measures in the Current IMF Program for Pakistan

In order to get support for its comprehensive program of macroeconomic stabilization and sustainable development, Pakistan has recently signed a Stand-By Arrangement (SBA) with IMF in November 2008. With economic stabilization on priority, quantitative targets for monetary and fiscal variables for FY09 are set as performance criteria under the SBA. Both the IMF and the government is of the view that achieving these targets is essential for addressing current key macroeconomic challenges in Pakistan, including high inflation and unsustainable twin deficits, and in achieving high economic growth on sustainable basis.

In addition to quantitative targets, some structural and other policy measures that aim at enhancing efficiency and effectiveness of policy formation and implementation have also been made a part of the SBA (see **Chart 1 and 2** at the end).

Performance Criteria Quantitative Targets for the SBP

Quantitative targets that pertain to SBP include a floor on SBP's NFA and ceilings on SBP's NDA, government borrowings from SBP for budgetary support and SBP's net exposure in foreign exchange swaps and forward transactions (see **Table 1**).

Table 1: Quantitative Targets for SBP

	Targets (end-period)				
	Nov-08	**Dec-08**	**Jan-09**	**Mar-09**	**Jun-09**
Floor on SBP NFA (stock, million $)	1,117	1,165	1,065	671	2,782
Ceiling on SBP NDA (stock, billion Rs)	-	1,346	-	1,412	1,314
Ceiling on net government borrowing from SBP (stock, billion Rs)	-	1,274	-	1,274	1,181
Continuous ceilings on SBP's foreign currency swaps and forward sales (billion $)	2.75	2.75	2.75	2.75	2.75

Simultaneously achieving these targets is not possible unless a substantial improvement in fiscal and BOP accounts is made. For instance, curtailing government borrowings from SBP to the targeted level will be difficult in the presence of high fiscal deficit and/or in the absence of substantially large external financing. Similarly, a significant improvement in Pakistan's external account over FY08 is necessary for achieving SBP's NFA targets.

Performance against End-December 2008 targets

As shown in **Table 2**, the SBP has comfortably met all its quantitative targets of end-December 2008.[7] Further, considering the trend and level up to the 29th January 2009, the SBP's NFA is expected to remain well above the floor target of end-month.

Table 2: Targets and Performance at End-December 2008

	Target	Adj. target	Actual
Floor on NFA of SBP (million $)	1,165	897	2,354
Ceilings on:			
NDA of SBP (billion Rs)	1,346	1,363	1,270
Budgetary borrowings from SBP on cash basis (billion Rs)	1,274	-	1,222
SBP's net exposure in forex swaps (million $)	2,750	-	1,850

Performance Criteria Quantitative Targets for the Government

Quantitative targets for the government are summarized in **Table 3**, which include a floor on fiscal balance and ceilings on the public sector external debt. The fiscal deficit target for FY09 has been revised downward to Rs562 billion (or 4.2 percent of the GDP of FY09; jointly projected by the IMF and MoF) against Rs582 billion planned in the budget in June 2008. Furthermore, it is decided to increase the social safety net spending of the government from budgeted 0.6 percent of GDP the 0.9 percent of GDP.

Table3: Quantitative Targets for the Government

	Dec-08	Mar-09	Jun-09
Floor on budget balance (cumulative flows, billion Rs)	-261	-405	-562
Ceiling on short-term external debt (stock, billion $)	1.5	1.5	1.5
Ceiling on non-concessional medium and long-term external debt (billion $)	9.5	9.5	9.5
Ceiling on external payments arrears (million $)	0	0	0

In order to limit the fiscal deficit within the targeted level, the government has planned to significantly improve its revenue and keep a strict check on the expenditures.

[7] The NFA and NDA targets, shown in **Table 1**, are based on certain assumptions and subject to adjustments if these assumptions are not met. For instance, both the NFA and the NDA targets will be adjusted for excess and shortfall in official program financing assumed for FY09 at the time of setting these targets in November 2008. Similarly, the NFA targets assume SBP's net open position under foreign currency swaps at $1.9 billion and will be adjusted for any change from this level.

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

Measures for:	Required Actions	Timelines
Changes in policy rate	Consideration of a further increase in the discount rate at the time of the monetary policy statement for H2-FY09.	End-January 2009
	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 Nov-Jan, 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-Nov, 2008
Amendments in BCO	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-Jun, 2009.
Oil support to market	Phasing out the SBP's provision of foreign exchange for oil imports according to the following schedule:	By Feb 1, 2009
	Furnace oil	
	Diesel and other refined products	By Aug 1, 2009
	Crude oil	By Feb 1, 2010
Liquidity management	Review of the current procedures for liquidity management, and adoption and publicization of a transparent liquidity management framework, including the announcement of an explicit corridor for money market interest rates	By end-Jul, 2009
Auction calendar	Issuance of a T-bills auction calendar for every quarter	One month in advance
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-Jan, 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-Dec, 2008

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 Jun, 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-Dec, 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-Dec, 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-Mar, 2009
Single treasury acc.	Existing funds held outside the SBP account will be transferred to the SBP account.	By end-Jun, 2009
Circular debt	Preparation of a plan for eliminating the inter-corporate circular debt within the fiscal deficit target.	By end-Mar, 2009
Electricity tariff adj.	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-Dec, 2009
Fuel price adj.	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	By FY13
	Increasing tax revenue by at least 3½ percentage points of GDP	