MONETARY POLICY STATEMENT

January-June 2005

ECONOMIC POLICY DEPARTMENT

STATE BANK OF PAKISTAN

Macroeconomic Outlook and Monetary Policy Stance

The world economy has continued to show recovery that started a couple of years ago. The recovery has continued despite the fact that long-term interest rates in the US are still on the rise with the headline inflation picking up in both the US and the euro area. The growth in the US is relatively robust and has resulted from strong business investment and household spending reinforced by tax cuts. However, the pace of recovery in the euro area and Asia (excluding China) is moderately slow. The global growth momentum is expected to continue, though at a slow pace, despite oil price hikes which have occurred primarily due to relatively strong demand. The ongoing recovery in the developed world coupled with elimination of textile quotas from 2005, is expected to help many developing nations including Pakistan in their pursuit to improve their exports performance.

Pakistan's economy has continued to show solid performance despite rising interest rates in recent months. Principal macroeconomic indicators in general point to improved state of growth. Growth is strong across most of the sectors driven by both exports and domestic demand with the latter being increasingly dominant. The performance of the agriculture sector has considerably improved this year and its growth may exceed the annual target of 4.0 percent during FY05. The recovery has come about from timely rains, increase in area under wheat cultivation and cotton production, which has been estimated to cross the mark of 14 million bales for the first time in the history of the country. The bumper cotton crop would scale up the performance of the textile and clothing industry and reinforce the ongoing growth momentum. The large-scale manufacturing sector has performed strongly so far and is expected to reach the annual target of 12.0 percent. The services sector is also expected to show above-target growth.

Private sector has expanded enormously and its credit absorption in the first two quarters of the year has reached new seasonal peaks. Encouragingly, the distribution of credit is fairly broad-based with noticeable expansion in consumer loans, and shows strong consumer and investment spending during July-December 2004. Although, current account deficit has shot up (due to sharp rise in the import of machinery) but it is largely a reflection of the growing needs of the economy for further investment in capacity building and is therefore not a source of significant concern.

The consumer price inflation which remained around 4 percent for the last few years shot up to 9.3 percent in July 2004. Nonetheless, it has come down to 8.8 percent in December 2004 due to receding food inflation. The core inflation, on the other hand, is still heading upwards, though at a slow pace, and has risen to 6.8 percent in December 2004 from 6.1 percent in July 2004. The current increase in price pressures is likely to be arrested with the rising trend of interest rates. In addition, there are at least six factors that may also weaken inflationary pressures and expectations during the remaining part of the year and these are:

- Robust growth in agriculture and industry;
- Improved food supplies from additional wheat import;
- Improved fiscal performance reinforced by sustained improvement in financial performance of PSEs;
- Expectation of stable exchange rates with SBP’s commitment to provide foreign exchange for imports;

- Potential addition to exportable surplus resulting from record-high cotton production;
- Weak wage pressures in the labor market due to high unemployment.

Simultaneously, inflationary expectations are likely to remain for at least four key reasons, which include:

- Continuation of substantial monetary and credit expansion with monetary overhang from last couple of years;
- Pass-through of higher oil prices;
- Possibility of further widening of current account deficit;
- Rising trend of real assets prices.

State Bank of Pakistan would, therefore, on the basis of the balance of risks, shift from an accommodative to neutral monetary policy stance during the next six months to suppress the current accelerating trend in core and non-food inflation, wring out inflationary expectations from the system and to discourage speculative and non-productive financing while easing supply of loan-able funds to creditworthy corporations, individuals, farmers and SMEs at non-negative real lending rates.

In a low per capita income country such as Pakistan where poverty is persuasive, unemployment looms large and economic growth has remained depressed for more than a decade, it would be counter productive to dogmatically follow any single objective in formulating monetary policy. While the central bank should and would attack inflation in a central manner there is no solid empirical evidence either from Pakistan's own experience or cross-country studies that low and decelerating inflation rates in the range of 5-7 per cent have a strong pernicious effect on the economy. Fighting inflation would remain the primary objective of monetary policy but higher economic growth, productive employment and capacity expansion would neither be abandoned nor stifled. State Bank of Pakistan would, therefore, continue to tighten the monetary policy by raising interest rates but maintain a healthy balance between suppressing inflation and facilitating investment, growth and employment in a non-inflationary environment. State Bank of Pakistan would remain alert to the movements in key monetary and credit variables and take corrective measures if required to ensure price stability.

Monetary and Credit Trends

The broad-based economic growth experienced in the last couple of years put the country on the path to greater economic recovery and set the stage for speedy credit and monetary expansion. Therefore, the growth of key monetary aggregates remained strong. The broad money showed a growth of 7.8 percent (Rs.193.0 billion) during July-25 December 2004 compared with the growth of 8.0 percent (Rs.165.8 billion) in the corresponding period of last year **(*Tables 1-2*)**. The growth of broad money resulted entirely from the expansion in net domestic assets of the banking system which expanded by Rs.196.7 billion (owing primarily to substantial private sector credit off-take) against the expansion of Rs.121.5 billion in the comparable period of last year. The net foreign assets of the banking system, however, underwent a depletion of Rs.3.7 billion due to net capital outflows precipitated by above-normal oil imports, in contrast to the expansion of Rs.44.3 billion last year. The growth of the reserve money also continued unabated as it expanded by 15.4 percent (Rs.118.9 billion) during July-25 December 2004 compared with the expansion of 16.4 percent (Rs.110.0 billion) in the corresponding period of last year. The growth in reserve money was the direct outcome of shifting of some of TBs holdings of commercial banks to the SBP.

The private sector's appetite for bank credit did not weaken despite increases in nominal interest rates during July-25 December 2004. The on-going growth momentum and the attractiveness of consumer loans supported by average lending rates, still below normal levels, continued to create substantial demand for credit by the private sector. Simultaneously, the credit capacity of banks continued to expand (despite the expansion in the currency in circulation by Rs.94.7 billion) due to inflows of Rs.166.2 billion previously invested in government papers, and the growth in bank deposits by Rs.95.0 billion. Therefore the bank credit to the private sector grew by 19.2 percent (Rs.244.4 billion) during July-25 December 2004 compared with the growth of 16.4 percent (Rs.155.3 billion) experienced in the corresponding period of last year (***Figure 1***). The shift of government borrowing from commercial banks to private sector is depicted in ***Figure 2***.

Figure 1: Banks' Credit to Private Sector (Cumulative Flows)

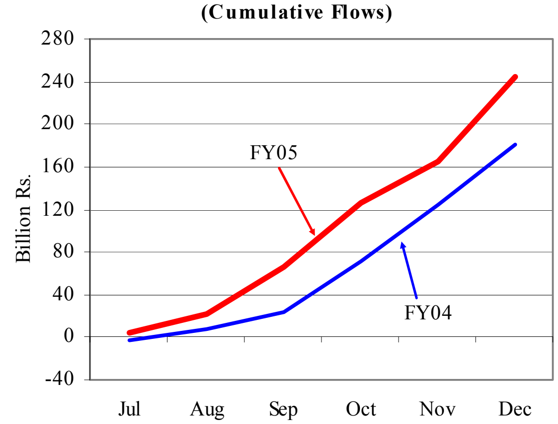
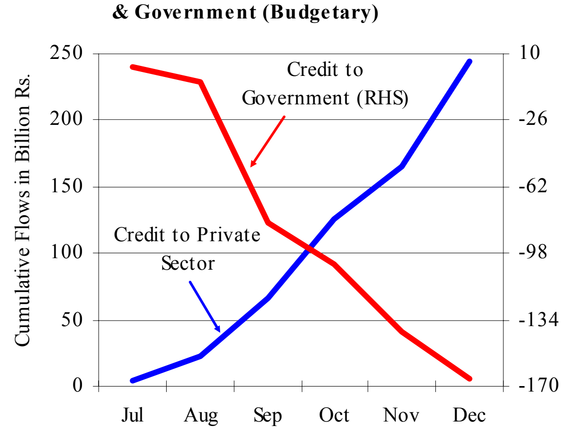
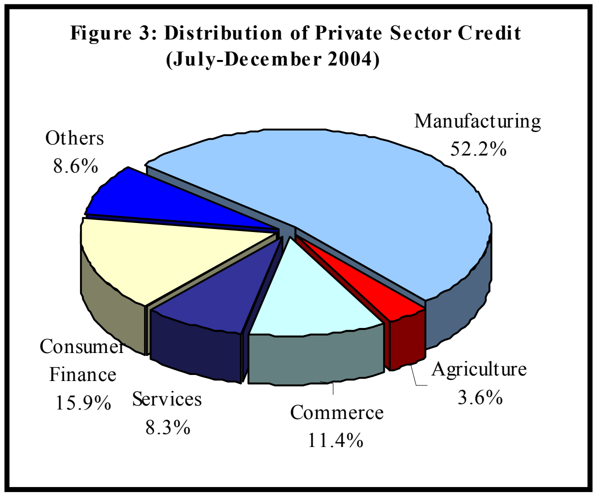


Figure 2: Scheduled Banks' Credit to Private Sector & Government (Budgetary)





The distribution of credit utilization continued to be broad-based **(*Figure 3*).** The bulk of credit went to the *manufacturing sector* (52.2 percent or Rs.127.5 billion) followed by *Consumer financing* (15.9 percent or Rs.39 billion), *Commerce* (11.4 percent or Rs.27.8 billion), *Services* (8.3 percent or Rs.20.3 billion), (*Transport, Storage and Communication* (5.2 percent or Rs.12.6 billion) and *Agriculture* (3.6 percent or Rs.8.7 billion) . *Textile sector*, the mainstay of the domestic industrial activities, continued to get upgraded through the employment of imported machinery, and its credit off-take increased by 25.4 percent to Rs.95.4 billion; it constituted 39 percent of the total credit off-take and 75 percent of the total credit utilized by the *manufacturing sector*. Within *consumer financing,* most of the consumer loans were availed for acquisition of *automobiles* (Rs.22.1 billion) followed by *housing finance* (Rs8.6 billion) and *credit cards* (Rs.3.5 billion).

One of the positive developments on the fiscal front was the ability of the CBR to surpass its half-yearly tax collection target of Rs.250.1 billion during FY05. The on-going growth momentum, substantial imports and improved revenue administration enabled the CBR to increase its tax collection by 14 percent and exceed the target by Rs.12.4 billion in the first six months of FY05. The non-tax revenues also grew considerably and showed a growth of 30.3 percent to Rs.59.7 billion during July-September 2004. The government's budgetary borrowing from banks during the first six months increased to Rs.34.8 billion against the full-year target of Rs.45 billion. This was mainly due to the shortfall in non-bank borrowings budgeted for FY05, and high foreign payments. In addition, the government also bore the brunt of oil price hikes by not passing them fully to the consumers. On the basis of expected receipts and expenditures during the next six months, it is expected that government budgetary borrowings from the banking system would remain within the annual target.

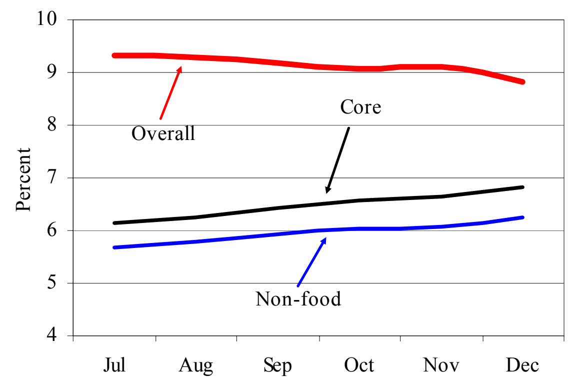
Inflation Trends

The consumer price inflation, which remained subdued at around 4 percent for almost three years despite heavy monetary expansion, rose sharply to 9.3 percent in July 2004. Inflationary pressures crept in owing to both rising aggregate demand from ongoing credit boom and supply-side factors such as shortages of various food items, especially the unanticipated shortage of wheat and an increase in its support price, and exchange rate depreciation. The flow of credit to the private sector reached new seasonal highs and contributed to the demand-pull component of inflation. Similarly, rupee depreciation raised the cost of imports adding to the cost-push component of inflation. In consequence, the consumer price inflation remained on the higher side and during July-December 2004 it was recorded at 8.8 percent compared with 3.1 percent registered in the corresponding period of last year. The constrained supplies of primary food items like mutton, chicken, eggs, milk and others, and the ongoing wheat shortages despite import of wheat (one million tons) jacked up the food price inflation to 12.6 percent during July-December 2004 from 3.4 percent in the comparable period of last year. Likewise, non-food factors such as house rent which accounts for relatively large share in consumer price index, and transportation cost raised the level of non-food inflation to 6.2 percent from 2.9

percent. It is important to notice that though food inflation is decelerating, the non-food and the core inflation are still rising (***Figure 4***).

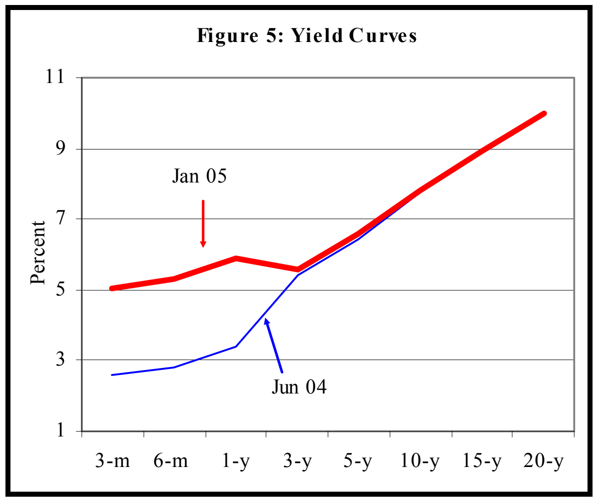
There are expectations that price pressures would ease considerably in the near future in view of favorable trends prevailing in the financial market; interest rates are continuously climbing up on account of monetary policy tightening; exchange rates have become stable once again in the wake of SBP's decision to fund oil-related imports. The prospect of declining world oil prices and improved food supplies, and additional import of wheat is expected to improve the inflation outlook. Therefore, consumer price inflation is projected to come down to around 7 percent by the end of the current fiscal year against the annual inflation target of 5 percent.

Figure 4: Inflation Trends



Interest Rate Trends

The borrower-friendly low interest rate environment which had prevailed during FY02 and FY03, was tightened gradually since the start of FY04. This was the natural consequence of rising interest rates in the international financial markets, depreciating rupee and the threat of accelerating inflation. The process of interest rates tightening gained some momentum during July-January FY05 when yield on benchmark 6-month TBs rose by 209 basis points to 4.32 percent compared with the rise of 96 basis points during August-June FY04. Yields on other government papers also rose by varying proportions. SBP did not permit yields on government papers to go up sharply in order to minimize the potential negative impact on the growth momentum. The average lending rate also moved up by 138 basis points to 6.0 percent during July-November 2004 against the rise of 20 basis points in the corresponding period of last year. The yield curve undergoing the process of gradual upward shift flattened during July-January FY05 reflecting investors' increasing appetite for short-term papers (***Figure 5***).

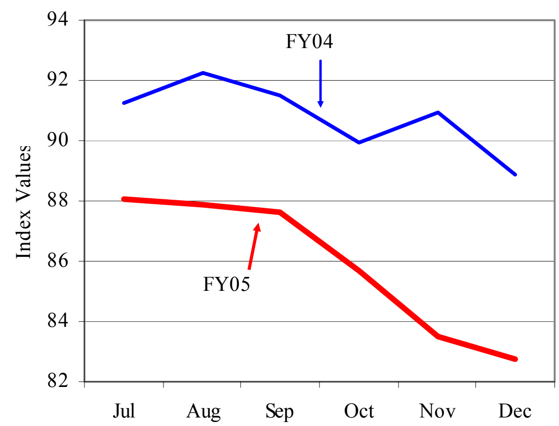


The magnitude of gradual upward shift of the yield curve during July-January FY05 reflected the upward adjustments in interest rates by the SBP. The inter-bank liquidity conditions remained comfortable despite massive rupee outflows from the banking system as a result of substantial bank credit to the private sector (Rs.224.6 billion) and widening trade deficit ($2.4 billion during July-December 2004). SBP alone had withdrawn (on a net basis) Rs.109.0 billion by selling $1.8 billion in the inter-bank foreign exchange market in contrast to the injection of Rs.52.6 billion ($0.9 billion) in the corresponding period of last year. Although interest rates are rising, at their current levels, they are still low and negative in real terms. It is for this reason that the monthly private sector credit off-take during July-25 December 2004 averaged Rs.40.7 billion against the monthly average of Rs.25.9 billion in the comparable period of last year. The prospect of persistence of rising interest rates might have been another reason pre-empting borrowers to increase their credit off-take. In short, in view of recent monetary and credit trends plus the inflation outlook, interest rates are expected to continue to rise until inflationary pressures are significantly eased off.

External Sector Trends

The external competitiveness continued to increase despite relatively high domestic inflation rate. The real effective exchange rate index showed a depreciation of 6.9 percent during July-December 2004 compared with the depreciation of 3.8 percent registered in the corresponding period of last year (***Figure 6***). This resulted from the fall of the rupee against major currencies including Euro (-12.63 percent), British Pound (-8.08 percent) Japanese Yen (-6.66 percent) and the US dollar (-2.16 percent). The exports sector, the major beneficiary of the weakening rupee, showed a growth of 10.5 percent to $6.5 billion during July-December 2004. However, exports at their current level were not enough to prevent the trade deficit from widening to $2.4 billion largely on account of oil import bill, which swelled by 93.62 percent to $2.17 billion during July-November 2004. The import of petroleum products grew in terms of both quantity and price. The country had to increase its import of furnace oil for thermal power generation in the wake of water shortages. Simultaneously, it had to pay more in the wake of higher oil price which increased the per-ton import cost by 17.7 percent during July-November 2004. Clearly, the quantity effect outweighed the price effect and that too by 38 percent. Other commodities that significantly added to trade deficit during July-

Figure 6: REER Index (2000=100)



November 2004 were the import of machinery, and various types of chemicals which rose by 32.2 percent to $1.7 billion and by 39.5 percent to $1.5 billion, respectively.

The widening trade deficit despite rising trend of worker's remittances eventually wiped out the gains that the country had made in terms of current account and capital account (including financial account) surpluses during FY03 and FY04. The overall balance of payments position recorded a deficit of $1.0 billion during July-November 2004 in contrast to the surplus of $695 million experienced in the comparable period of last year. Despite world oil price showing the tendency to move downward after hitting the peak at $52.13 per barrel in October 2004, one should expect the trade deficit to be significantly above the annual estimate of $3.0 billion by the close of FY05 because of the surge in oil import bill and higher import of machinery and industrial raw materials.

To sum up, Pakistan's economy is expected to remain on track with sustained growth and recovery. The on-going credit boom is projected to contribute more to the GDP growth than to the consumer price inflation. Monetary expansion is projected to be around 13.4 percent while the consumer price inflation is anticipated to come down to around 7 percent by the close of the year. Interest rates are expected to continue to rise in accordance with inflationary pressures and expectations. SBP would ensure through the conduct of the monetary policy that the adjustments in rates do not retard the process of economic growth.

Table 1
Monetary Indicators
Targets and Actuals

Rs. in Million

	SECTORS	Credit Plan FY05	FY04	Cumulative Flows 01-Jul-04 to 25-Dec-04[P]	01-Jul-03 to 27-Dec-03
1.	**GOVERNMENT SECTOR BORROWINGS**	**47,000**	**58,106**	**38,206**	**3,941**
	i. Net Budgetary Borrowing	45,000	63,699	34,786	24,118
	ii. For Commodity Operations	5,000	-8,174	1,873	-20,967
	iii. Net effect of Zakat Fund/Privatization	-3,000	2,581	1,548	790
2.	**NON-GOVERNMENT SECTOR (A+B+C)**	**190,000**	**315,408**	**228,058**	**125,643**
	A. Credit to Private Sector (i + ii)	200,000	325,215	244,367	155,326
	i. Commercial Banks		333,458	243,703 (19.2)	166,642 (16.4)
	of which: (Export Finance)		29,998	13,649	20,046
	ii. Specialized Banks		-8,243	664	-11,316
	B. Credit to Public Sector Enterprises (PSEs)	-5,000	-2,917	-11,696	-26,904
	C. Other Financial Institutions (SBP credit to NBFIs)	-5,000	-6,891	-4,613	-2,778
3.	**OTHER ITEMS (Net)**	**13,000**	**-9,188**	**-69,533**	**-8,103**
4.	**NET DOMESTIC ASSETS (1+2+3)**	**250,000**	**364,326** (23.67%)	**196,731** (10.34%)	**121,482** (7.89%)
5.	**NET FOREIGN ASSETS**	**30,000**	**43,526**	**-3,689**	**44,288**
6.	**MONETARY ASSETS (4+5)**	**280,000** (11.40%)	**407,852** (19.62%)	**193,042** (7.76%)	**165,770** (7.97%)

P = Provisional

Note: The figures in parenthesis are growth rates

Table 2
Monetary Indicators
Cumulative Growth (percent)

	2003-04	01-Jul-04 to 25-Dec-04 [P]	01-Jul-03 to 27-Dec-03
Reserve Money	15.44	7.76	7.97
Money Supply	19.62	15.39	16.43
Currency in Circulation	16.89	16.39	16.75
Deposits	20.61	5.15	5.23
of Which:			
Demand Deposits	30.13	6.40	10.78
Time Deposits	14.52	2.22	1.01
RFCDs	15.50	15.67	7.04
Credit to Private Sector	34.27	19.18	16.37
Net Borrowing by Government	9.71	5.82	0.66
Net Domestic Assets (NDA)	23.67	10.34	7.89
Net Foreign Assets (NFA)	8.07	-0.63	8.21

P = Provisional