Monetary Policy Statement

January-June 2006

January 26, 2006

Economic Policy Department

State Bank of Pakistan

MONETARY POLICY STATEMENT

Despite the impact of earthquake and constraints imposed by rising energy prices, the economy continued to expand at a solid pace from July to December 2005, but real gross domestic product (GDP) is likely to be modestly below target in FY06. Large-scale industry and agriculture outperformed expectations last year and will continue to grow from a high base, but both are expected to record below target performances.

With a solid economic expansion underway and upward pressure on inflation early in the calendar 2005, the SBP removed policy accommodation at a convincing pace during the first half of 2005, raising the cut-off yield in the six-month T-bill auction by 414 basis points by the end of June 2005. As a result, inflation slowed down in recent months despite the run-up in energy costs. The year on year (YoY) headline consumer price index (CPI) inflation declined from 9.0 percent in July to 8.5 percent in December 2005. However, the YoY change in the CPI excluding food and energy, a widely watched indicator of core inflation, decreased only marginally from 7.6 percent to 7.4 percent in the same period. Nevertheless, the decline in food prices has been even more significant in recent months, primarily due to concrete steps taken by the Government in first half of FY06 to ease supply constraints of essential food items.

As a result of the lingering cumulative monetary overhang from the last few years interest rates adjustments have continued since July 2005 but at a measured pace, with the six-month T-bill rate increasing by only 30 basis points in the second half of 2005. Although the impact of SBP policy measures over 2005 has proved to be robust in containing inflation, there is a clear need to continue the tight monetary policy in view of persisting pressure on core inflation. SBP will therefore continue to monitor inflationary pressures and if needed, consider tightening as required to achieve price stability and ensure continued sustainable growth.

The fundamentals that supported growth in the second half of 2005 should sustain the economy over the first half of 2006 as well. Aggregate demand has remained strong with consumer and business spending expanding. In addition, government recourse to SBP borrowings rose as the Government had to accommodate spending related to rescue and relief efforts as well as urgent rehabilitation requirements for the earthquake-hit region. Manufacturing continued to dominate the surge in private credit growth. Consumer lending expanded to Rs 38.7 billion in July-November 2005, a significant jump over the corresponding period last year. The credit growth, which reached almost Rs 300 billion in the second half of 2005, has been supported significantly through remittances, which are playing an increasingly important role in financing economic activity.

Private sector credit growth combined with strong Government borrowing led to a sharp expansion in net domestic assets by 12.9 percent in the second half of 2005. Counterbalancing this surge in credit growth has been the decline in net foreign assets, which limited broad money (M2) growth to a moderate 8% during the period. The net foreign asset position has been impacted by exceptional growth in the trade deficit that reached $3.8 billion[1] during July-December 2005. This is an increase of 66 percent over the corresponding period in the previous

[1] This figure is based on the SBP exchange record. The customs data, which is presented by the Federal Bureau of Statistics, shows a trade deficit of US$ 5.58 billion.

year. The deficit reflects the impact of high international oil prices and rising imports of industrial and office machinery as well as automobiles and a variety of raw materials for making consumer and capital goods.

SBP will continue to monitor inflationary pressures. Additional policy firming may be considered as required in pursuit of maintaining the dual objectives of price stability and economic growth. In that respect SBP will remain prudent in responding to changes as needed to foster these objectives. Macroeconomic stability would also be helped by a continuation of fiscal discipline. Also, lower the reliance on short term funding by the government, by raising its requirements from the longer tenor Pakistan Investment Bonds (PIBs) will aid in strengthening government debt management, while offering a long-term reference rate to the market and pushing out and shaping the yield curve.

Macroeconomic Outlook

1. Despite the impact of the earthquake and constraints imposed by rising energy prices, Pakistan's economy is expected to remain on a high growth trajectory during FY06. The real GDP growth could be modestly below target due to a slowdown in agriculture and a relatively weak performance by large-scale manufacturing (primarily owing to capacity constraints and a high base effect). The services sector, however, is likely to continue performing better than anticipated due to expansion in the telecommunications and financial industries.

2. Despite areas of relative slowdown, economic activity seems solid on the back of broad-based expansion of bank credit to the private sector, which reached Rs.298 billion during July-December 2005 compared with the credit off-take of Rs.285 billion in the corresponding period of last year. The continued expansion of bank credit by the private sector in recent years is a reflection of positive business sentiments and sustained industrial recovery, and augurs well for future GDP growth prospects.

3. Despite the strong expansion of bank credit to government and the private sector, broad money has shown a growth of 8 percent against the full-year target of 12.8 percent. This is the result of a considerable reduction in net foreign assets (NFA) of the banking system (Rs.64.6 billion) precipitated by a high trade deficit (exchange-based), which reached of $3.8 billion during July-December 2005. The depletion of NFA served to sterilize NDA growth and kept reserve money growth largely in check, which helped price stability. This also explains part of

the rationale behind the smaller cumulative increase of 30 basis points in the benchmark 6-month T-bill rate during July-December 2005.

4. On average, the external sector has performed relatively better this year. The BOP position during July-November 2005 reflects a lower overall deficit of $0.9 billion (despite a high trade deficit) against the deficit of $1.5 billion in the corresponding period of last year. The trade deficit grew because of rising oil import prices and higher imports of machinery and raw materials. It is expected that this will result in a higher exportable surplus and value-addition and potentially greater import substitution in the future years.

5. The improvement in the overall BOP position has been due to a turnaround in the capital and financial account of *BOP,* which has recorded a surplus of $1.8 billion (relative to $1.0 billion in the preceding year) due to significant inflows of foreign investment and loans from multilateral institutions. This surplus has helped to offset the impact of a *current account deficit* of $2.8 billion (compared with the deficit of $0.8 billion in the comparable period of last year), and contributed to the relative stability in exchange rates for the period.

6. Headline inflation declined to 8.50 percent in December 2005 after hitting a peak of 11.1 percent last year, supported by declining food inflation. This continuing deceleration in headline inflation is likely to contain the longer-term inflationary expectations. Core inflation, nevertheless, has not shown any visible deceleration and has fluctuated around 7.6 percent. Persistence of core inflation together with substantially higher growth in domestic credit as reflected in NDA may fuel short-run inflationary tendencies. In short, inflationary pressures are expected to remain in view of the following factors:

- Large fiscal imbalance and widening trade deficit
- Risk of sustained high energy prices
- Risk of upward pressure on wages due to high growth in recent years

7. However, there are factors that are expected to improve the inflation outlook. These include:

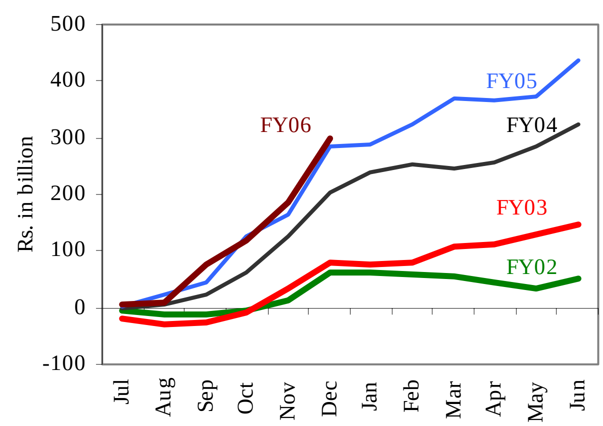
- Real lending rates becoming positive
- On-going deceleration in reserve money growth
- Improved food supplies through import of essential goods
- Capacity expansion, and BMR in key industries

8. The relative assessment of risks and gains based on the above factors favors the continuation of the on-going tight monetary policy to contain inflationary pressures and expectations. The State Bank of Pakistan will continue to closely monitor inflationary pressures and may consider additional policy firming, if required to achieve price stability with sustainable economic growth. Key interest rates will be changed at appropriate times and in accordance with the speed and magnitude of inflationary pressures. In addition, efforts would be made for issuance of long-term instruments such as Pakistan Investment Bonds (PIBs), which will help deepen the sovereign yield curve, allow appropriate pricing of risk, and also provide the requisite benchmark for the development of the capital market. Simultaneously, SBP will ensure that sufficient bank credit opportunities are available for all segments of the economy, including the SME sector and agriculture, thereby encouraging capacity expansion, and contributing to employment growth and poverty alleviation.

Monetary and Credit Trends

9. The massive expansion of bank credit to the private sector, which had started a few years ago on the back of substantial foreign inflows, continued in the first half of FY06, despite the gradual rise in interest rates, which have now helped achieve positive real lending rates, towards the end of 2005. This is reflective of changing dynamics of private sector credit demand and the strength of business sentiments, heralding better prospects for GDP growth in the near future. Total bank credit consumed by the private sector during July-December 2005 grew by 17.4 percent (Rs.297.7 billion) compared with the credit growth of 22.3 percent (Rs.284.7 billion) in the corresponding period of last year (**Figure 1**). Banks had additional loan-able funds to offer to the private sector due to a decline in their holdings of government securities by Rs.64.1 billion. This constrained the government to heavily borrow from the central bank; these borrowings from SBP totaled Rs.142.4 billion during July-December 2005 (**Tables 1-2**).

Figure 1: Credit to Private Sector (Cumulative Flows)

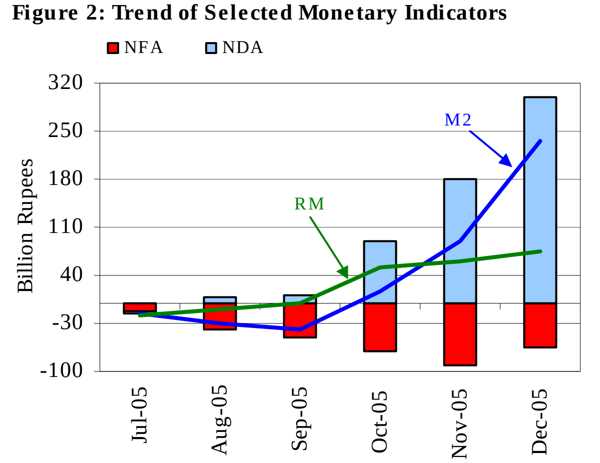


10. While private sector credit absorption reached new highs, bank credit to the government for budgetary support rose to Rs.78.3 billion compared to Rs.25.4 billion in the comparable period of last year. Government recourse to SBP borrowing was inevitable given the unforeseen spending requirements, related to rescue and relief efforts as well as urgent rehabilitation requirements, in

the aftermath of the earthquake. Reliance of government on borrowings from the banking system grew because non-bank borrowing were low (Rs.5.0 billion up to November 2005 against the full-year target of Rs.55.5 billion) and marginal external financing (Rs.5 billion realized in the first quarter against the full-year target of Rs.121 billion). The massive credit flows to both, private sector and the government, raised the NDA of the banking system by Rs.300.9 billion against the expansion of Rs.241.2 billion in the comparable period of last year.

11. Although the accumulation in NDA was above-normal, its impact on monetary expansion was subdued as the NFA of the banking system contracted due to a large trade deficit. Therefore, broad money grew by 8 percent (Rs.236.3 billion) against the full-year target of 12.8 percent (Rs.380 billion) **(Figure 2)**.

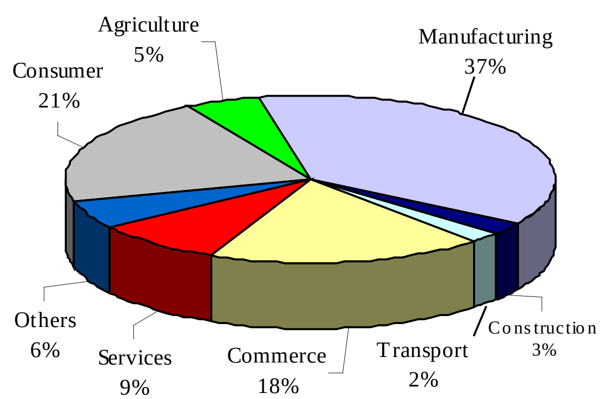
Figure 2: Trend of Selected Monetary Indicators



12. The growth of reserve money also remained within tolerable limits at 8.4 percent (Rs.76.1 billion), during July-December against 15.9 percent (Rs.123.1 billion) in the comparable period of last year. This was the outcome contraction in the NFA of SBP (due to outflow of foreign exchange committed for oil and other essential imports), which again restrained the expansionary impact of the considerable government borrowing from SBP on the NDA of SBP.

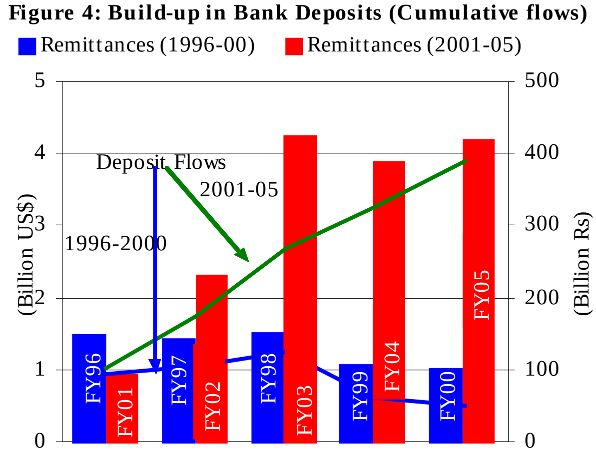
13. The distribution of credit to the private sector continued to show broad-based utilization (**Figure 3**). The *manufacturing sector* continued to dominate the consumption of bank credit and its consumption rose by 16.2 percent to Rs.68.9 billion during July-November 2005 over the comparable period of last year. *The textile industry* continued to be the largest recipient of manufacturing loans (Rs.59.2 billion) followed by *the cement industry* (Rs.8.5 billion) and *the fertilizer industry* (Rs.1.7 billion). The credit off-take of the *construction industry* rose by 82.4 percent to Rs.5.0 billion. *Commerce-related* activities picked up strongly as their credit absorption rose by 188.0 percent to Rs.34.3 billion. The growth of *consumer loans* continued unabated, and their scale expanded by 61.2 percent to Rs.38.7 billion. Most of the consumer loans were acquired to finance a range of products including automobiles (Rs.13.0 billion). Other consumer loans included personal loans (Rs.12.2 billion), credit cards (Rs.6.5 billion) and house building loans (Rs.5.9 billion).

Figure 3: Distribution of Credit to Private Sector (July - November 2005)



14. To sum up, the on-going credit expansion clearly indicates increased credit consumption capacity of the economy in recent years primarily supported by the sustainable level of workers' remittances (**Figure 4**).

Figure 4: Build-up in Bank Deposits (Cumulative flows)



Therefore, the ongoing credit boom is likely to continue with some deceleration resulting from rising lending rates in the remaining part of the year.

Inflation Trends

15. The inflation pressures (and outlook), that caused concerns until last year, at last began to ease, potentially in response to both, tight monetary policy pursued by SBP, which arrested the uptrend in core inflation, and better supply management of essential food items by the Government of Pakistan, which helped a fall in broad inflation (**Figure 5**). Core (NFNE i.e. non-food non-energy) inflation declined marginally from its peak of 7.9 percent in April 2005 to 7.4 percent in December 2005, whereas core inflation (20% trim) declined from its peak of 8.6 percent in February 2005 to 6.4 percent in December 2005. The fall in core inflation together with the significant decline in year-on-year food inflation (from its peak of 15.7 percent in April 2005 to 8.1 percent in December 2005) resulted in a decline in annualized consumer price inflation to 8.4 percent in July-December 2005 from 8.8 percent in corresponding period of 2004 (**Figure 6**).

Figure 5: Core Inflation (YoY)

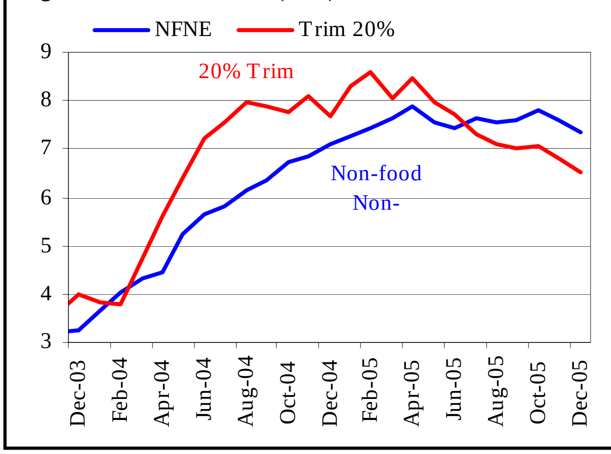
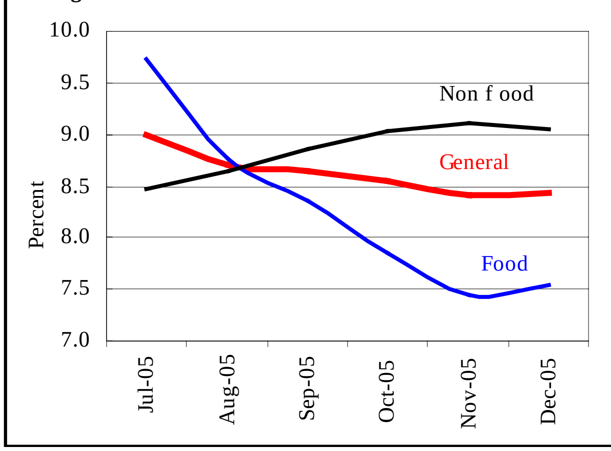


Figure 6: Inflation Trends



16. Prospects of deceleration in inflation appear to be promising because the pressures from major sources of consumer price inflation are expected to continue to ease. Food inflation is expected to further decline in the remaining months of the year as the wheat price, the major source of food inflation last year, is likely to continue to decelerate due to: (1) 50 percent higher wheat stocks with the government agencies as on 27 November 2005; (2) permission of duty-free import of wheat; and, (3) prospects of a good wheat crop. Rice prices are also likely to remain lower on the expectations of a good rice crop. Moreover, prices of other essential food items, such as sugar and pulses, are also expected to ease on account of cheaper imports.

17. Similarly, house rent inflation is also expected to continue to show deceleration on account of a high-base effect and decreases in the prices of construction inputs thereby reducing non-food inflation.

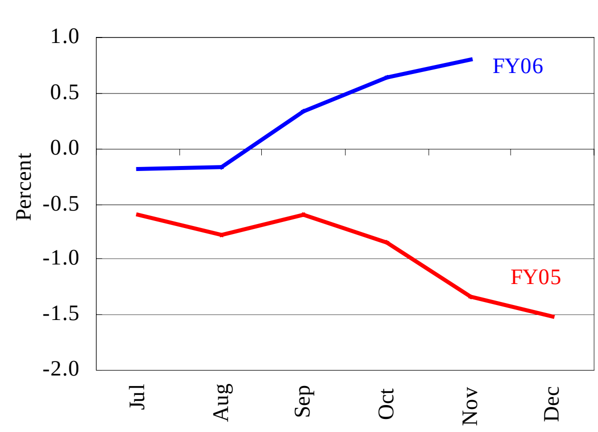
Interest Rate Trends

18. The pace of increase in interest rates that had been seen last year significantly slowed down this year. Since July 2005, yields on 3-month, 6-month, and 12-month T-bills were raised only by 59 basis points, 30 basis points, and 34 basis points compared with 577 basis points, 576 basis points and 620 basis points raised last year, respectively. The key factors that reduced the need to raise interest rates in a big way were the significant deceleration in the growth of reserve money and the on-going deceleration in inflationary pressures. The effective use of OMOs with flexible tenors not only minimized banks' reliance on the SBP discount window but also kept the overnight market rates high enough to slow excessive credit off-take, in line with the monetary policy

stance.

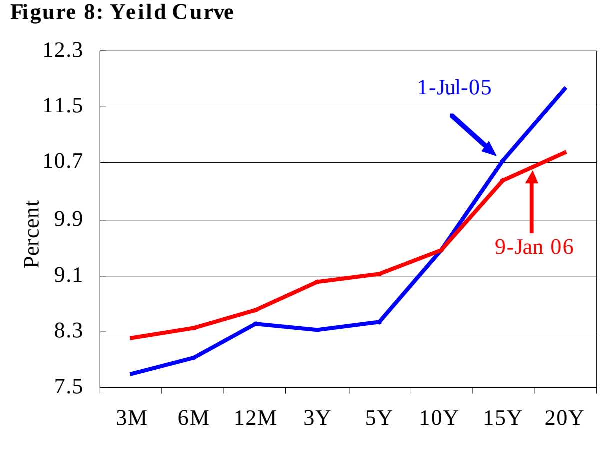
19. The lagged impact of monetary tightening in recent years continued to unfold when average lending rates moved up significantly recording a further rise of 156 basis points to 9.77 percent since June 2005 compared with a rise of 316 basis points last year. The pace of rise in average deposits rates remained slow as it registered only a 52 basis points rise during July-November 2005. In consequence, the banking spread rose further by 104 basis points to 7.4 percent since July 2005. It is for the first time in many years that the inflation-adjusted average lending rate has turned positive (**Figure 7**) and therefore, one should expect the private sector community to be more selective and prudent in terms of availing bank credit.

Figure 7: Inflation-Adjusted Lending Rates



20. While short-term interest rates continued to edge up, long-term interest rates remained stable during July-December 2005 because banks continued to hold on to their stocks of PIBs in an effort to redeem them at maturity while the government did not raise funds by auctioning additional PIBs.

Figure 8: Yeild Curve



Consequently, the yield curve continues to be non-representative in absence of fresh supply of long-term paper. The flattening yield curve mirrors lack of supply and the illiquid nature of the domestic long-term debt market (**Figure 8**).

21. Issuance of long-term papers would strengthen the secondary market and aid in strengthening government debt management, while offering a long-term reference rate to the market and pushing out and shaping the yield curve.

External Sector Trends[2]

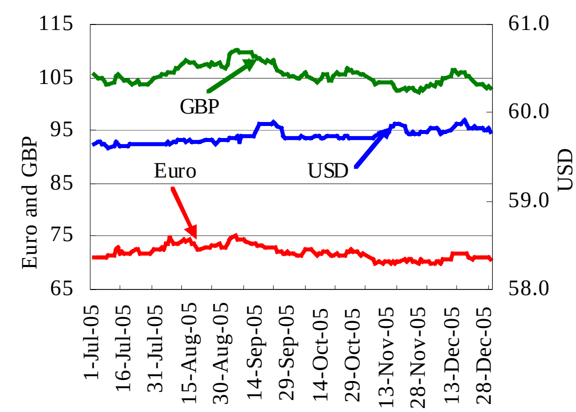
22. The external sector showed considerable improvement from last year as it restricted the BOP deficit to $0.9 billion during July-November 2005 from a deficit of $1.5 billion in the comparable period of last year. This occurred despite a massive trade deficit of $3.8 billion (exchange based) during July-December 2005. On the exports side, the recovery of textile exports (which grew by 26 percent) was impressive given the higher competitive pressures in the post-quota regime, and the additional challenges exporters had to face in the EU market in the form of antidumping duty on key exports and loss of preferential treatment. Indeed, overall exports grew by 23.8 percent despite the loss of external competitiveness by around 4 percent. Worker's remittance continued to be buoyant, with a monthly average of $342 million during July-December 2005. The rising inflows of foreign investment (around $1 billion) and long-term external loans ($211 million) drove the *capital and financial account* into the surplus zone ($1.8 billion). These large inflows helped contain the decline of foreign reserves to only $976 million against the unprecedented import bill, which swelled by 54 percent (YoY) to $11 billion. The extraordinary growth in

[2] Trade analysis is based on customs data.

imports principally resulted from oil imports (due to high energy prices), which accounted for 23 percent of the total import bill, and the import of machinery (excluding transport equipment), which also rose sharply, up 57 percent during July-November 2005 compared to 49 percent in the comparable period of last year.

23. Exchange rates, on average, showed a stable trend despite the widening of the trade deficit **(Figure 9)**. Though SBP continued to provide support for oil and commodities to the foreign exchange market, with a net cumulative injection of $ 1.4 billion during July-December 2005, this net support was 35.1 percent lower on a YoY basis. This shows signs of depth returning to the foreign exchange market, with the market mostly managing its flows in line with demand and supply factors, which is manifesting itself in healthy volatility rather than one-sided pressures on the exchange rate.

Figure 9: Exch. Rate Trends against Major Currencies



24. The growth momentum of imports is expected to continue in view of increased demand for oil, raw material and industrial machinery. Exports are also expected to sustain their impressive growth due to increased production activities resulting from the on-going capacity expansion drive and continuing modernization and upgradation of key industries. Furthermore, it is expected that worker's remittances and other inflows would be available (such as proceeds of privatization of strategic companies and international financial commitments for

earthquake relief operations are realized. Therefore, the foreign exchange position of the country is likely to remain comfortable, in view of sizable foreign reserves ($11.7 billion as on 31 December 2005). SBP is expected to remain an active player in the foreign exchange market to ensure effective monetary and exchange rate management.

25. To conclude, Pakistan's economy is likely to do well despite some slowdown in agriculture and industry during FY06. Credit consumption capacity of the economy is expected to remain strong due to strong business sentiments, and strong bank deposit base built up on the back of sustained inflows of workers' remittances in recent years. Broad money expansion is expected to be close to the target of 12.8 percent in view of a continued tight monetary policy to check inflationary pressures and expectations. SBP would also ensure that changes in interest rates do not significantly weaken the ongoing growth momentum.

Table 1

Monetary Indicators

Targets and Actuals

(Million Rupees)

Sectors	Credit Plan 2005-06	Monetary Impact During 1st July 05 to 31-Dec-05 P	Monetary Impact During 1st July 04 to 31-Dec-04
1. Net Government Sector Borrowing(Net)	**120,000**	**62,350**	**30,549**
I Barrowing for Budgetary Support (a+b)	98,000	78,301	25,421
(a) From SBP		142,427	205,376
(b) From Scheduled Banks		-64,125	-179,955
ii Commodity operations	20,000	-15,123	3,797
iii Net effect of Zakat Fund/Privatization proceeds etc.	2,000	-829	1,331
2. Non-Government Sector (A+B+C)	**320,000**	**294,145**	**268,907**
A Credit to Private Sector (i+ii)	**330,000**	**297,651**	**284,703**
i. Commercial Banks		295,864	284,581
ii. Specialised Banks		1,787	122
(i) Zari Taraqiati Bank Limited		4,494	919
(ii) IDBP		-2,654	-1,739
(iii) PPCB		-139	942
(iv) SME		85	
B Credit to Public Sectors Enterprises (PSEs) (iii+iv+v)	**-10,000**	**-1,994**	**-11,183**
C Other Financial Institutions (SBP credit to NBFIs)	**0**	**-1,512**	**-4,613**
3. Other Items (net)	**-75,000**	**-55,595**	**-58,265**
4. Net domestic assets (1+2+3)	**365,000**	**300,901**	**241,191**
5. Net Foreign assets	**15,000**	**-64,572**	**3,302**
6. Monetary Assets (M2) (4+5)	**380,000**	**236,329**	**244,492**
(Growth)	(12.81%)	(7.97%)	(9.83%)

p= Provisional

Table 2
Monetary Indicators
Cummulative Growth

(Percent)

SECTORS	2004-05	2003-04	1st July Upto 31-Dec-05 P	1st July Upto 31-Dec-04
Money Supply (M2)	19.30	19.62	7.97	9.83
Reserve Money (RM)	17.62	15.44	8.37	15.93
Currency in Circulation	15.18	16.89	9.89	13.35
Deposits	20.50	20.61	7.43	8.60
Bank Credit to Private Sector	34.36	34.27	17.39	22.34
Net Bank Credit to Government Sector	14.59	9.71	8.29	5.31
Net Domestic Assets (NDA)	22.38	23.67	12.92	12.67
Net Foreign Assets (NFA)	9.22	8.07	-10.14	0.57
Money Multiplier	3.26	3.22	3.25	3.05

p= Provisional

1: Also includes other deposits with SBP and RFCD