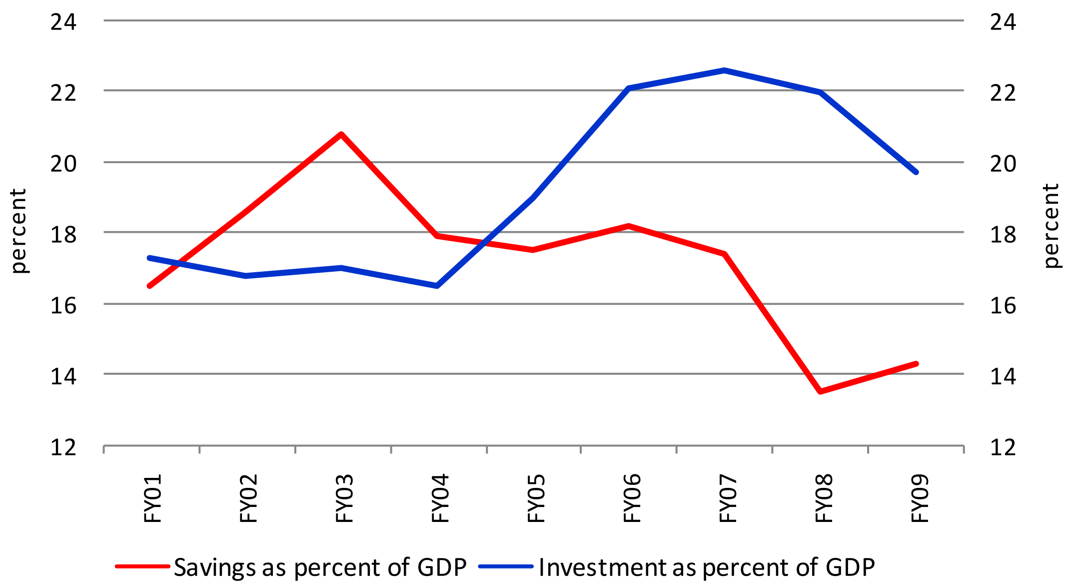
MONETARY POLICY STATEMENT

July-September 2009

Pakistan's Saving Investment Gap



STATE BANK OF PAKISTAN

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Executive Summary

The continued implementation of the macroeconomic stabilization program is showing improvements in key macroeconomic indicators. CPI inflation continues to fall, government borrowing from the central bank remains within the quarterly limits, and SBP's foreign exchange reserves show a rising trend. These positive indicators, in turn, reflect contraction in aggregate demand, much-needed fiscal consolidation, and improved balance of payments position. Consistent with the gradual strengthening of these macro fundamentals, inter-bank money market is functioning smoothly, foreign exchange market is exhibiting stability, and deposit growth in the banking system has picked up.

However, these positive signs are not without costs. Exacerbated by electricity shortages and security issues, real GDP growth has decelerated to 2.0 percent in FY09, down from 4.1 percent a year earlier. Large-scale manufacturing activity has already seen a record run of consecutive declines for eleven months up to May 2009, together with almost a nil growth in credit to private sector. Given the numerous structural constraints faced by the country in economic, social, and political spheres, recovery could be slow and painful.

While the solutions of structural impediments take place in the backdrop, monetary policy can take the lead in nurturing expectations of declining inflation and improving macroeconomic imbalances, simultaneously supporting real economic activity. A 7.9 percentage point decline in CPI inflation (YoY), from 19.1 percent in March 2009 to 11.2 percent in July 2009, is reassuring and infusing confidence in the economy. However, the year-on-year (YoY) non-food non-energy (NFNE) and 20-percent trimmed measures of core inflation at 14.0 and 13.9 percent in July 2009, though having declined from their peak levels, are still at a relatively high level. Nonetheless, projected average inflation of around 10 percent for FY10, though slightly higher than earlier projections, reflects considerably improved inflation outlook compared to the 20.8 percent average inflation of FY09.

Contraction in the external current account deficit to $8.9 billion (5.3 percent of GDP) for FY09 and strengthening of SBP's foreign exchange reserve position to $9.1 billion by the end of June 2009 provides further impetus to the increasing confidence. SBP's foreign exchange reserves have increased further to $9.4 billion as of 13th August 2009. Given the severity of global recession and slowdown in domestic economic activity, both exports and imports, after declining by 5.9 and 10.5 percent in FY09, are unlikely to pick up substantially. They may still end up with negative growth in FY10. As a result, the external current account deficit is projected to fall below 5.0 percent of GDP. Provided the projected foreign inflows are realized, including the augmented loan from IMF, the SBP's foreign exchange reserves could improve further to over $12 billion in this fiscal year.

The ability of the government to control its borrowings from the SBP in cumulative terms and raise the targeted amounts in T-bill auctions, since the inception of Stand-By Arrangement (SBA) with IMF, is another sign of success of the stabilization program. In fact, yields on government paper of different tenors have broadly followed a falling trend despite increased borrowing requirements from banks. This reflects the actual retrenchment of fiscal deficit, transparency regarding its financing from the banking system, sharp decline in credit to the private sector, and expectations of further decline in market interest rates amidst declining inflation.

Although the final consolidated fiscal deficit during first three quarters of FY09 was within target, higher expenditure related to Internally Displaced Persons (IDPs) and security in the fourth quarter of FY09 has resulted in more than targeted fiscal deficit. Despite the likely slippages from the budget estimates, the fiscal deficit for FY09 is expected to be lower than the 7.6 percent deficit of the previous year, which indicates reduction in demand pressures. Moreover, given the total revenue target of Rs2175 billion, continuation of partial electricity tariff subsidies due to staggered adjustment in electricity prices, and an ambitious development budget, delivering a Rs722 billion fiscal deficit in FY10 could be a challenging task for the fiscal authority.

Containment of external current account deficit and relative improvement in the fiscal accounts helped limiting monetary expansion; money supply grew by 9.6 percent in FY09. The equilibrium projected money growth for FY10, consistent with the projections of external account and announced federal budget, turns out to be 13 percent. Moreover, SBP has successfully met the three main end-June 2009 performance criteria. Both the stock of budgetary borrowings from the SBP at Rs1130 billion and Net Domestic Assets (NDA) of SBP at Rs1183 billion were below their respective targeted ceilings of Rs1181 billion and Rs1321 billion. Similarly, the Net Foreign Assets (NFA) of SBP at $3.98 billion was higher than its targeted floor of $2.37 billion.

In line with the reduction in fiscal and external current account deficits, the growth in domestic aggregate demand fell to 0.6 percent in FY09 compared to 3.6 percent in the previous year. Similarly, the saving-investment gap narrowed by 3.1

percentage points mainly because of the fall in investment expenditures. Although this narrowing gap reflects improving macroeconomic imbalances, the fall in investment means lower capital stock and infrastructure per worker. This does not bode well for the production capacity of the economy.

The revival of private sector credit is critical for facilitating increase in investment and capital formation in the economy. Currently, decline in economic growth, preemption of banking system resources by the government, and rising Non-performing Loans (NPLs) is hampering the private sector credit growth. Expected GDP growth of 3.3 percent in FY10 together with continuation of fiscal consolidation, further increase in total deposits in line with Q4-FY09 growth trend, and gradually recovering confidence in the economy could improve the private sector credit growth.

Despite this considerable progress on the macroeconomic stability front, it is important to recognize that even if some of these trends continue, they do not by themselves herald a sustainable medium term economic recovery. Likely increases in the oil prices and upward revision of public sector wages may lead to renewed inflationary pressures. Similarly, the pressures on the fiscal position remain substantial given the higher spending requirements, low economic growth, and uncertain external financing sources. Moreover, the prospects of global economic recovery and thus the revival of international investors' sentiments remain weak leading to uncertainty for Pakistan's balance of payments position.

More importantly, the country is facing serious electricity shortages that have hurt economic growth and productivity of factors of production, which, in turn, is adversely affecting the potential output of the economy. Apart from capacity issues, insufficient electricity tariff increases to recover the costs and non-payment of tariff differential subsidies by the government — the circular debt issue — have exacerbated the electricity problem. While the government has shown resolve to address these issues in this fiscal year, their likely positive impact on the economy may take some time. In the interim, the cost of delayed adjustments will be absorbed in the budget with consequent repercussions for inflation and thus the monetary policy stance in future.

Similarly, the country's limited resource envelope, reflected in the stagnant tax to GDP ratio, remains under severe pressure while the requirements for spending on security-related issues, social and economic infrastructure, and IDPs are on the rise. While the reinvigorated efforts on reforming the tax policy and administration provide a long term solution, the additional donor support pledged in Tokyo in April 2009 and increased access to IMF resources provides only a short term respite to the fiscal position. There is likelihood, however, that the fiscal and external debt sustainability is adversely affected in the coming years.

At the core of macroeconomic stabilization program is the balance of payments. Even its position, despite reasonable progress, seems vulnerable due to a combination of domestic structural issues and global factors. Almost two-thirds of Pakistan's exports are textile related and half of the exports are destined for the US and European markets. This limited diversification of products and markets coupled with the ongoing global recession strains the ability of the economy to generate valuable foreign exchange. The recent upsurge in oil prices in international markets, together with the fact that around one third of Pakistan's imports are oil related, could hurt external account and increase domestic prices. Moreover, uncertainty related to the size and timing of foreign inflows can potentially put pressure on fiscal operations and the fragile foreign exchange reserves.

SBP is cognizant of these domestic structural constraints and global developments and their likely adverse impact on the economy. The challenge is to strike a balance between stabilization and sustainable recovery in an environment of nascent 'positives' on the one hand and complex structural 'negatives' on the other. To give further impetus to the 'positives', SBP has decided to cut the policy rate by 100 basis points to 13 percent, effective 17th August 2009.

Moreover, to strengthen the monetary policy framework, SBP has decided to take a number of additional steps.

First, the frequency of monetary policy decisions is being increased from four to six times a year. Henceforth, monetary policy decisions will be announced in the last week of September, November, January, March, May, and July. Moreover, the January and July policy announcements will be accompanied with a detailed monetary policy statement and a press conference. On remaining four occasions monetary policy decisions will be communicated through a brief press release only. This will help in addressing the uncertain and rapidly changing economic conditions.

Second, an independent Monetary Policy Committee (MPC) is being constituted that will have external experts as members in addition to SBP representatives. The inclusion of external members is designed to ensure that SBP benefits from the expertise and independent views related to monetary policy. This will enhance transparency and credibility of monetary policy formulation process.

Third, SBP will adopt a new framework for its monetary operations by introducing a corridor for the money market overnight repo rate, effective 17th August 2009. While the SBP policy rate will serve as a 'ceiling', the repo rate on the new overnight deposit facility, 300 bps below the SBP policy rate, will provide a binding 'floor'. This facility will allow banks to deposits their surplus funds with SBP against T-bills (see **Annexure** for details). The introduction of this framework will improve liquidity management, enhance effectiveness of market signaling, and foster stability and transparency in the money market operations. It will also improve transmission of monetary policy signals, strengthening its role in fostering price stability.

A. Economic Environment and SBP's Policy Response: Feb-Apr, 2009

Emerging signs of macroeconomic stability allowed SBP to lower the policy rate by 100 bps to 14 percent in April 2009…

1. The early signs of improvement in key macroeconomic imbalances started to emerge by the beginning of 2009 indicating progress towards macroeconomic stability in the medium term. The two root causes of instability – i.e. high and unsustainable fiscal and external current account deficits – were addressed by a committed adherence to the macroeconomic stabilization program of the government followed under SBA with IMF. Supported by SBP's active monetary management, confidence in the economy strengthened as foreign exchange reserves replenished and inflation continued to fall.

2. These developments and an emerging positive economic outlook led to declining inflation expectations. These were reflected in the downward shift of yield curve and change in the bidding pattern observed in T-bills auctions. The subsiding of upside risks of inflation provided SBP the opportunity to ease monetary policy in April 2009.

The economy continued to face resource constraints despite these improvements…

3. The challenge, however, was to revive the falling private sector credit and economic activity given the relatively tight liquidity position of the system and increased risk aversion of banks. Contraction in NFA of the banking system, though gradually improving, and subdued deposit growth limited money creation in the economy. At the same time, higher government borrowing requirements for budgetary support and commodity financing preempted a large share of available resources.

4. The continued contraction in global output and trade volumes and stressed international financial markets added to the difficulties in managing the domestic economy. The April 2009 revision in global output growth projections by the IMF, from 0.5 to -1.3 percent for 2009, increased uncertainty for Pakistan's external sector.[1] These global developments played their part in increasing the risks to

[1] IMF in their April 2009 World Economic Outlook projected trade volumes to contract by 11 percent and net outflows of capital from emerging and developing countries to be $190 billion for 2009.

already dwindling exports and financial inflows. This, in turn, had implications for domestic productive activity, balance of payments position, and budgetary support.

5. Another risk from the monetary policy perspective was the likely shortfall in tax revenues with three implications. First, an increase in reliance on non-tax revenues, resulting in non-transfer of the benefit of fall in international oil prices to the domestic consumers and persistence in inflation. Second, a cut in development expenditures to meet the fiscal deficit target, hurting the productive capacity of the economy. Third, pressure on market liquidity and interest rates due to higher government borrowing from banks, given the uncertainty of external flows.

B. Recent Economic Developments and Outlook

Liquidity concerns were adequately met and the money market overnight repo rate remained close to the policy rate…

6. The expected pressure on money market interest rates in Q4-FY09, however, remained muted for a number of reasons. First, reserve money expanded by Rs54.2 billion providing the much needed fresh liquidity injection in the system. Using the scope available under the SBA, government met some of its requirements by borrowing Rs49.4 billion from SBP. Whereas SBP’s decision to provide hundred percent refinancing to banks under EFS and enhancement in the borrowing limits added Rs9.9 billion to reserve money creation. Similarly, the NFA of SBP increased significantly by Rs72.2 billion due to a relatively improved balance of payments position.

7. Second, total deposits with the banks expanded considerably, increasing by Rs295.3 billion, in Q4-FY09. Third, the demand for credit by the private sector declined sharply and there was net retirement of Rs57.2 billion. The improved liquidity due to these factors facilitated the banking system in meeting government’s borrowing requirements for budgetary support and commodity financing without putting pressure on market interest rates.

8. Though market liquidity improved significantly, much of the inflows were concentrated in later half of Q4-FY09. To ensure smooth functioning of the market, SBP conducted its Open Market Operations (OMOs) in a measured manner; injecting a net amount of Rs399.7 billion during 1st April to 16th May 2009 and Rs124.8 billion

in the remaining quarter (see **Table 1**). As a result, the weekly weighted average overnight repo rate moved in a relatively narrow range close to the policy rate. Similar trend in the money market overnight rate has continued in Q1-FY10 so far (see **Figure 1)**.

Table 1: OMOs and Repo Rates

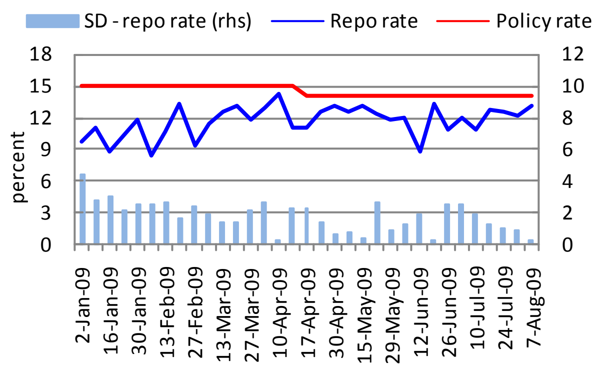
	OMOs (billion rupees)			Weekly WA O/N Repo Rate	
	Mop-up	**Injection**	**Net mop-up**	**Avg.**	**SD**
Q1	436.1	254.6	181.4	11.0	1.6
Q2	384.3	237.9	146.4	9.0	2.2
Q3	392.3	60.0	332.3	11.0	1.6
Q4	155.0	679.5	-524.5	12.3	1.3
FY09	**1367.7**	**1232.1**	**135.6**	**11.0**	**2.0**
Q1-FY10*	**153.3**	**132.2**	**21.1**	**12.4**	**1.0**

* Up to 13th August 2009. SD = Standard Deviation.
Source: SBP

Improved market liquidity and expectations of low inflation induced reduction in market interest rates...

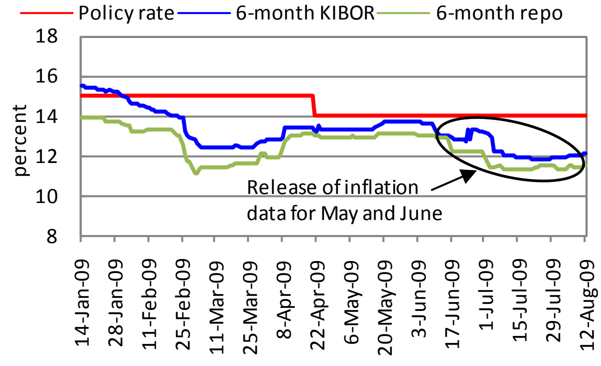
9. Consistent with the liquidity position and change in SBP's monetary policy stance, the repo rates and KIBOR of different tenors stabilized, which had inched up before the issuance of last MPS. Following the release of inflation data on 11th June 2009 for the month of May, these rates started to decline noticeably. This tendency continued after the release of June inflation figures. Cumulatively, since the release of last MPS on 20th April 2009, the decline in 6-month repo rate and KIBOR has been 158 and 132 bps up to 12th August 2009 (see **Figure 2**). The decline in these rates reflects market's expectations of low inflation and easing of monetary policy.

Figure 1: Policy and Weekly Average Overnight Repo Rates

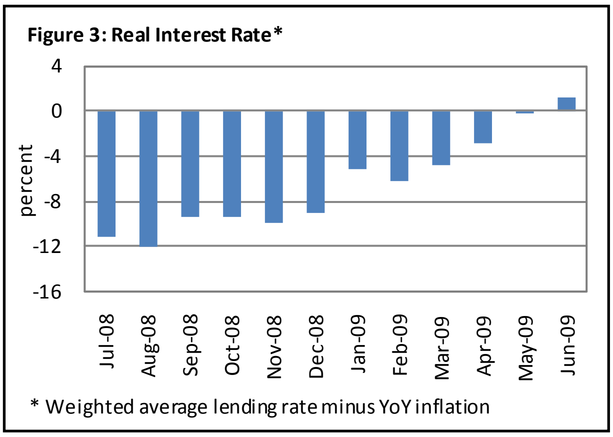


10. The nominal lending rates have also followed the falling trend in KIBOR. Gradually, banks' Weighted Average Lending Rates (WALR), on incremental loans, have declined to 14.3 percent in June 2009 from a high of 15.5 percent in October 2008. However, the fall in inflation in recent months has resulted in a steady increase in lending rates in real terms. After remaining in the negative territory for the first eleven months of FY09, the real WALR has become positive in June 2009 (see **Figure 3**). Expectations of low inflation may push this rate even higher in FY10.

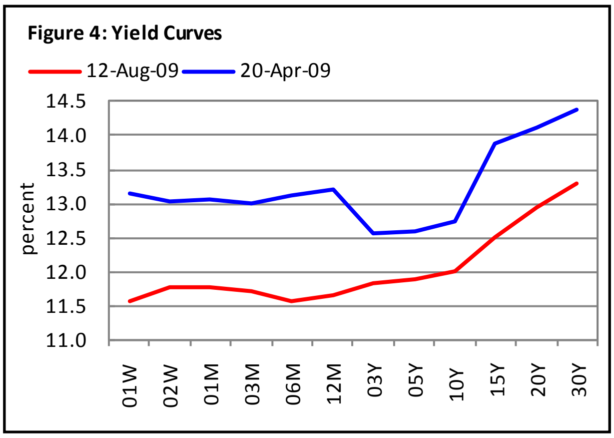
Figure 2: Policy and Market Interest Rates



11. Low inflation sentiments are also reflected in the downward shift of the yield curve (see **Figure 4**), fall in the difference between yields of long-term and short-term government papers, and noticable change in banks' bidding pattern in T-bills auctions in favor of the 12-month paper.

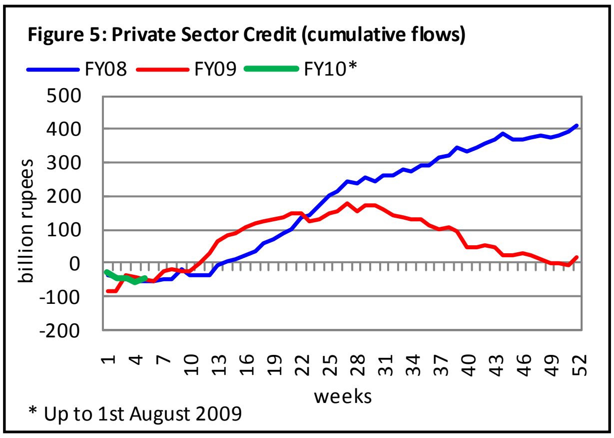


12. In Q1-FY10 market liquidity is expected to remain comfortable for the following reasons. First, the retirement of credit availed for commodity operations will begin in this quarter. Second, the demand for credit by the private sector is typically low in the first quarter. Third, if the current trends in deposit growth continue, it will augment liquidity in the system. Under these circumstances, and provided the projected external financial inflows are realized, the market is expected to function smoothly while meeting the government borrowing requirements in this quarter. In fact, recent data for Q1-FY10 up till 1st August 2009 reveals that these factors are broadly in line with expectations.



Despite falling market interest rates private sector credit continued to decline…

13. The FY09 trends in private sector credit show a steep fall relative to last year; the private sector borrowed Rs18.9 billion only compared with Rs408.4 billion in FY08. The Q4-FY09 alone shows a contraction of Rs57.2 billion (see **Figure 5**). Significant slowdown in the economy, domestic as well as global, is the most prominent reason for the fall in demand for private sector credit. While the global recession affected external demand for Pakistan's exports, serious power sector problems stymied domestic economy and credit demand by the private sector.



14. Risk aversion on the part of banks in an environment of rising NPLs, driven by the decline in economic activity, also affected the supply of credit. Large borrowing requirements of the government for budgetary support and commodity financing and significant credit demand of the Public Sector Enterprises (PSEs) gave an incentive to banks to avoid relatively high risk private sector lending. Thus the public sector effectively elbowed out the private sector given the limited available resources in the system. The partial settlement of circular debt in March 2009 (Rs 80.2 billion), though well-intentioned, also played its part in the contraction of private sector credit.

15. Consistent with slowing domestic economy and falling exports and imports, loans for working capital have experienced massive and broad based contraction, which is visible in almost all sectors of the economy. In contrast to an expansion of Rs321.2 billion in FY08, it contracted by Rs112.7 billion in FY09 (see **Table 2)**. While global recession is largely responsible for lower export finance, severe electricity shortages did not help the domestic productive activities either contributing towards a significant decline in the demand for import finance.

Table 2: Private Sector Credit
billion rupees

	Flows during	
	FY08	**FY09^P**
Total credit to private sector	**408.4**	**18.9**
1. Loans to private sector businesses	**385.4**	**49.2**
By type		
Working capital	321.2	-112.7
of which: Export finance	19.0	15.4
Import finance	37.3	-7.6
Fixed investment	64.2	161.8
By sectors: of which		
Agriculture	12.1	3.3
Manufacturing	201.0	27.4
of which: Textiles	78.1	-33.4
Electricity, gas and water	68.6	43.4
Construction	24.7	-8.7
Commerce and trade	41.8	-16.2
2. Personal	**20.1**	**-54.8**
of which: Consumer financing	8.3	-62.5
3. Investment in security & shares	**-0.4**	3.2
4. Others	**3.3**	**21.3**

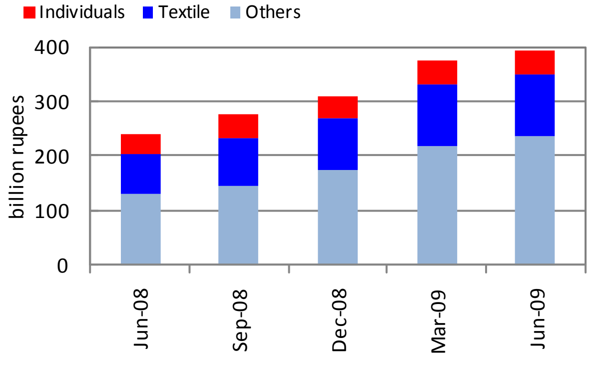
^{P} Provisional
Source: SBP

16. In addition, continued monetary tightening during H1-FY09 discouraged consumer financing and the demand for import related credit. The later was, however, also affected by the market induced adjustments in exchange rate and falling international commodity prices. In contrast, loans for fixed investment purposes, especially in the power and fertilizer sectors, witnessed a sharp growth reflecting continued investment in these sectors.

17. The rise in NPLs and the consequent banks' reluctance also explains the low credit extension to the private sector. Total stock of NPLs rose by Rs19 billion during Q4-FY09 and has reached Rs398 billion by the end of June 2009. This incremental increase is smaller than the increase in NPLs in Q3-FY09, which was Rs65 billion (see **Figure 6**). Driven largely by individuals and the textile sector, the NPLs to loans ratio

has increased to 11.5 percent by the end of June 2009 and remained unchanged since end-March 2009. Increase in NPLs in other sectors such as automobiles and electronics and transmission of energy are also significant. Weak growth in textiles and sharp decline in the demand for and production of automobiles (-40.4 percent) and electronics (-36.0 percent) during July – May FY09 explain the rise in NPLs and fall in credit utilization of these sectors.

Figure 6: Stock of Banks' Non-performing Loans

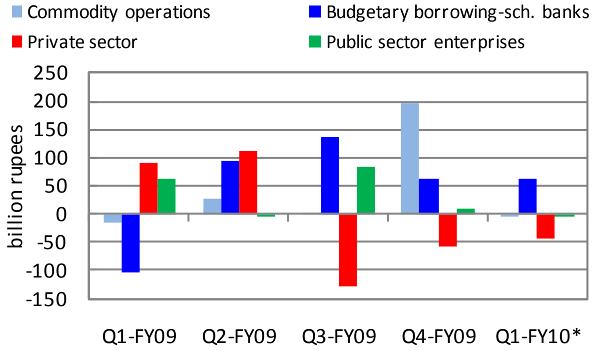


18. It is evident from the above discussion that resolving power sector problems is going to be the key for reviving the economy and thus credit utilization by the private sector in FY10. Expected credit requirements of Independent Power Projects (IPPs) and Oil Marketing Companies (OMCs), and government plans for higher development spending could help in this regard. Projected improvement in the global economy towards the beginning of 2010 and falling market interest rates are also likely to support private sector credit during the current fiscal year.

Fall in private sector credit was offset by credit extended to the public sector, leading to a significant monetary expansion…

19. In contrast to contracting private sector credit, government borrowed Rs258.3 billion from commercial banks for budgetary support and commodity financing during Q4-FY09 and Rs58.4 billion during 1st July – 1st August FY10 (see **Figure 7**). With regard to commodity financing, in particular for wheat procurement, not only the minimum guaranteed price was 52 percent higher than last year but the government also procured over 9 million tons against the initial target of 6.5 million tons. As a result, the total credit extended for commodity operations, during Q4-FY09, was substantially higher at Rs195.9 billion than Rs26 billion in the corresponding period of previous year.

Figure 7: Domestic Credit Expansion



* Upto 1st August 2009

20. To finance its deficit, the government continued to borrow successfully from banks for budgetary support. Against the pre-announced target of Rs350 billion, including maturities of Rs250.5 billion, for Q4-FY09, the government raised Rs339.7 billion in the six T-bill auctions held during the quarter. Similarly, the government raised Rs181.1 billion in the three auctions held in FY10 so far against the Q1-FY10 target of Rs325 billion and maturities of Rs180.8 billion. Despite substantial borrowing requirements of the government, the T-bill rates have broadly followed a falling trend though they inched up slightly in the last two auctions (see **Table 3**).

Table 3: T-bill Auctions Summary

billion rupees; percent

	3-Month	6-Month	12-Month	Total
Q1-FY09				
Realized amount	283.4	0.3	5.4	289.2
Cut-off yield	12.6	12.7	11.8	-
Q2-FY09				
Realized amount	410.5	8.0	0.4	418.9
Cut-off yield	13.9	14.0	12.8	-
Q3-FY09				
Realized amount	253.7	157.3	288.3	699.3
Cut-off yield	11.7	11.9	12.0	-
Q4-FY09				
Realized amount	7.0	31.3	301.4	339.7
Cut-off yield	13.0	12.4	12.2	-
Q1-FY10*				
Realized amount	10.2	11.3	159.6	181.1
Cut-off yield	11.4	11.5	12.2	-

* Up to 13th August 2009

Note: The cut-off yield corresponds to the last auction held in the quarter.

21. Meeting these heavy government borrowing requirements from the commercial banks was possible due to adequate deposit generation in the system. During Q4-FY09, total deposits witnessed a sharp increase of Rs295.3 billion in contrast with the net depletion of Rs16.1 billion in the nine months of FY09. Not only was fresh money created but bank's intermediation also improved with the recovery of confidence in the system and substantial commodity operations of the government. However, the total deposits in the banking system have declined in the first month of FY10 due to seasonal factors. These are likely to improve as the year progresses.

22. Moreover, the end-March 2009 net government borrowing from the SBP was lower by Rs110 billion than the stipulated SBA target of end June, FY09. Utilizing this scope and remaining within the quarterly borrowing limits, the government also borrowed Rs49.4 billion from SBP during Q4-FY09. However, during 1st July – 1st August FY10, the government has borrowed a significant amount, Rs76 billion, from the SBP, which will have to be retired to meet the end-September 2009 SBA target. Nonetheless, stock of government borrowing from the SBP (on cash basis) at end-June 2009, Rs1130 billion, remained well within the target of Rs1181 billion. Similarly, the target of Net Domestic Assets (NDA) of SBP was also met successfully. The total expansion in NDA of the banking system during this quarter was Rs278.2 billion. This, together with an improvement of Rs 54.8 billion in the NFA of the

banking system, accelerated the pace of overall monetary expansion significantly (see **Table 4**).

Table 4: Monetary Aggregates (Flows)
billion rupees

	Flows during			
	Q4-FY09	FY09	Q1-FY10*	FY10 Projections
NDA	278.2	599.2	-27.1	680.0
of which				
Net budgetary support	111.7	317.4	136.6	-
Commodity operations	195.9	209.0	-2.3	-
Private sector credit	-57.2	18.9	-45.4	-
Credit to PSEs	9.3	152.6	-6.5	-
NFA	54.8	-150.2	-37.0	-12.6
Money supply (M2)	332.9	449.1	-64.1	668.0
YoY growth	*6.9*	9.6	11.3	13.0
Memorandum items				
Net budgetary support				
from SBP	49.4	130.9	75.9	-
from Sch. banks	62.3	186.5	60.7	-
Currency in circulation	37.6	169.8	19.5	-
Total deposits	295.3	278.8	-83.8	-
Reserve money	54.2	27.5	-12.7	-
YoY growth	3.7	1.9	5.1	12.8

* Up to 1st August 2009
Source: SBP

23. Despite continued government borrowings, seasonal retirement in private sector credit and other factors have resulted in NDA retrenchment during the first month of FY10. Similarly, contraction in NFA of the banking system, albeit at a slower rate, has led to a contraction in overall monetary assets. Nonetheless, total money supply in FY10 is projected to grow by 13.0 percent on the basis of an expected revival in the private sector credit. Moreover, higher financial inflows comprising bilateral and International Financial Institutions (IFIs) loans are also likely to improve NFA and contribute in monetary expansion.

Relative improvement in fiscal operations contributed toward falling demand pressures…

24. In addition to borrowings from the banking system, the government raised Rs144 billion and Rs84 billion from the non-bank and external sources during the first three quarters of FY09 to finance its budget deficit (see **Table 5**). Although the final consolidated fiscal deficit during first three quarters of FY09 was within target, higher expenditure related to IDPs and security in the fourth quarter of FY09 has resulted in more than targeted fiscal deficit. Approval of the waiver for non-observance for the end-June quantitative performance criterion on the fiscal deficit, by the IMF's Executive Board on 7th August 2009, confirms higher than targeted fiscal deficit for

Table 5: Summary of Consolidated Fiscal Operations
billion Rupees

	$FY09^{BE}$	FY09 (Jul-Mar)	$FY10^{BE}$
Total revenue	1809	1301	2175
Tax	1309	849	-
Non-tax	501	452	-
Total expenditure	2392	1707	2897
Current	1876	1416	-
Development *	516	291	-
Budget deficit	-582	-405	-722
Financing	582	405	722
External	165	84	265
Domestic	392	320	458
Non-bank	243	144	-
Bank	149	176	-
Privatization	25	1	-

*This includes net lending to PSEs and statistical discrepancy;
^{BE} Budget Estimates
Source: Ministry of Finance

FY09. This slippage is because of the shortfall of Rs93 billion in FBR's tax revenues for FY09 against the budget estimate of Rs1250 billion and significantly unanticipated expenditures on security and IDPs. Nonetheless, the fiscal deficit for FY09 is expected to remain lower than the deficit of 7.6 percent in the previous year, indicating moderating demand pressures.

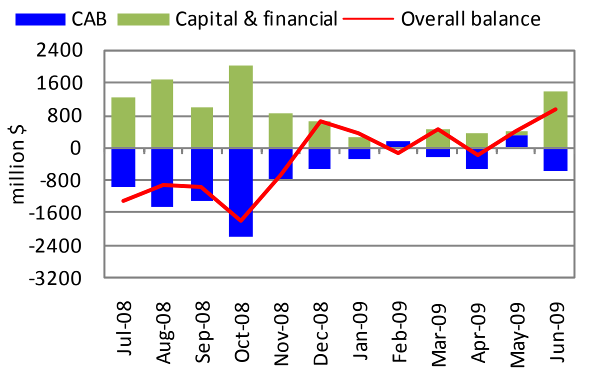
25. Given an ambitious total revenue target of Rs2175 billion in the wake of slowing economy, continuation of partial electricity tariff subsidies due to staggered adjustments in electricity prices, and a sizeable development budget, delivering a Rs722 billion fiscal deficit in FY10 will be a challenging task for the fiscal authority. The financing of this sizeable fiscal deficit is also going to be quite challenging given the uncertainty regarding external sources, in particular, the estimated flows pledged by the Friends of Democratic Pakistan in Tokyo in April 2009.

26. Although part of additional amount of approximately $3.2 billion, approved by the IMF's executive board, will be available to meet the priority spending requirements in FY10, the need to remain vigilant regarding fiscal operations will be of utmost importance. In case of non-realization of the Tokyo pledges, there could be serious implications for the economy, including need for substantial additional borrowings from domestic sources and pressure on foreign exchange reserves.

Contraction in current account deficit also reflects moderation in aggregate demand…

27. Along with relative improvement in the fiscal accounts in FY09, the external current account balance has been showing sustained improvement since October 2008 (see **Figure 8)**. With an external current account deficit of only $0.8 billion during Q4-FY09, the external current account deficit for the entire FY09 remained contained to $8.9 billion (see **Table 6**). In terms of GDP, the current account deficit improved from 8.5 percent in FY08 to 5.3 percent of GDP in FY09.

Figure 8: Balance of Payment



28. Although global recession has had a dampening effect on Pakistan's exports, which fell by 5.9 percent, the broad based reduction in imports by 10.5 percent limited the trade deficit to $12.5 billion. The most significant fall in imports has been in the non-food and non-oil groups, which fell by 15.6 percent. The fall in the quantum of petroleum group imports during FY09, also indicates low demand in the country.

Table 6: Balance of Payment Summary
billion US$

	Q4 FY09	FY09	FY10 Projections
i. Current account	**-0.8**	**-8.9**	**-8.6**
Trade balance	-2.5	-12.5	-11.6
Services net	-0.4	-3.3	-
Income net	-1.0	-4.3	-
Current transfers	3.1	11.2	-
Remittances	2.2	7.8	-
ii. Capital and financial account	**1.5**	**5.5**	**8.0**
Of which:			
Direct investment	0.7	3.7	-
Portfolio investment	-0.1	-1.1	-
Long term loans	0.9	2.2	-
iii. Errors and omissions	**0.5**	**0.0**	**-**
Overall balance	**1.1**	**-3.3**	**-0.6**

Source: SBP

29. Given the severity of global recession and slowdown in domestic economic activity, both exports and imports are unlikely to pick up substantially. They may still end up with negative growth (see **Table 7**). Moreover, the current trends in workers' remittances may not continue in FY10 though the July 2009 figure of $747 million is consistent with last year's trend. The net effect of these developments, however, is expected to result in an external current account deficit of below 5.0 percent of GDP in FY10 reflecting further easing of demand pressures in the economy. The uncertainty regarding international commodity prices and prospects of recovery in advanced economies could lead to deviations in these projections.

Table 7: Exports and Imports (BoP)
billion US$

			Growth	
	Q4-FY09	FY09	FY09	FY10 Projections
Trade Balance	**-2.5**	**-12.5**	-	-
Total Imports	**7.2**	**31.7**	**-10.5**	**-3.7**
Food	0.8	3.6	1.7	-
Petroleum	1.9	10.0	-4.4	-
Others	4.6	18.1	-15.6	-
Total Exports	**4.8**	**19.2**	**-5.9**	**-2.0**
Food	0.7	2.8	8.1	-
Textile	2.3	9.8	-5.6	-
Others	1.8	6.6	-11.3	-

Source: SBP

SBP's reserves build up and foreign exchange market stability also shows external sector strengthening …

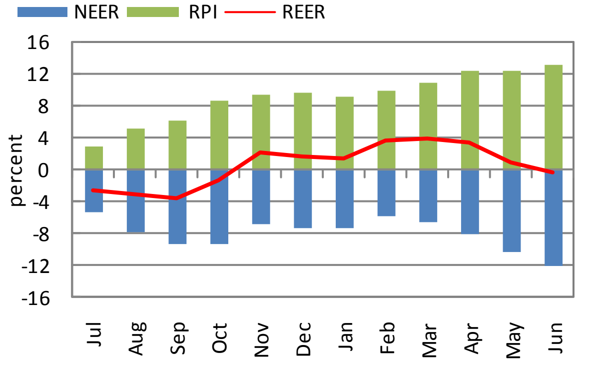
30. Foreign investment in Pakistan declined in FY09 to half of its level in FY08. This was partially compensated by an increase in long term loans. Though this did help in financing the external current account deficit, the overall balance of payments remained in deficit amounting to $3.3 billion. The fall in reserves that would have happened due to this deterioration was, however, offset by the $3.9 billion received from the IMF. The net result of this was accumulation of SBP reserves to $9.1 billion

by the end of FY09. SBP's foreign exchange reserves have increased further to $9.4 billion as of 13th August 2009. Going forward, SBP's foreign exchange reserves are likely to improve to over $12 billion in FY10. This includes the recently received third tranche from IMF of $1.2 billion and assumes that the other projected foreign inflows are realized.

31. With the improvement in external current account balance and availability of adequate reserves, the exchange rate volatility declined and its depreciation against the US dollar was limited to 1.2 percent during Q4-FY09. As of 12th August 2009, exchange rate has depreciated by another 1.8 percent since end-June 2009. Capitalizing on the stability in the foreign exchange market, SBP has already transferred all payments related to imports of diesel and other refined petroleum products to the interbank market from 1st August 2009. This would further strengthen the market determined exchange rate mechanism, enhancing its ability to absorb external shocks along with exhibiting healthy volatility in the foreign exchange market.

32. Since the exchange rate has also depreciated in real terms compared to its end-March 2009 position, exports are expected to benefit from this improvement in competitiveness (see **Figure 9**). This depreciation in the Real Effective Exchange Rate (REER) is expected to increase even more with the current declining trends in domestic inflation.

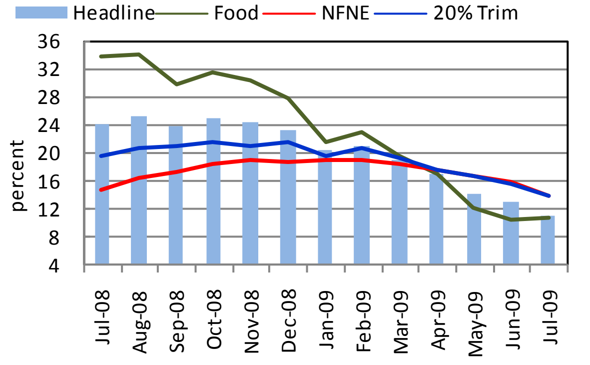
Figure 9: Changes in REER, NEER and RPI (since Jun-08)



Consistent with contracting twin deficits, Inflationary pressures have continued to ease…

33. Inflationary pressures eased further since March 2009 with CPI inflation (YoY) declining by 7.9 percentage points to 11.2 percent in July 2009 (see **Figure 10**). In fact, the pace of decline in inflation increased noticeably in Q4-FY09 compared to the

Figure 10: Consumer Price Inflation (YoY)



previous quarter and in the first month of FY10. Similarly, the YoY non-food non-energy (NFNE) and 20-percent trimmed measures of core inflation, also declined from their peak levels to 14.0 and 13.9 percent. However, core inflation is still at a relatively high level and recent trends in monthly inflation indicators are showing a degree of stickiness in inflation.

34. Despite the significant decline in inflation in recent months, average CPI inflation of 20.8 percent for FY09 is much higher than the initially announced target of 11 percent (see **Table 8**). Moreover, the average inflation during Q4-FY09 turned out to be 14.9 percent, which is higher than the 14 percent projected in the last MPS. Smaller than expected decline in the House Rent Index (HRI) inflation and imposition of fixed Petroleum Development Levy (PDL) on administered oil prices in June 2009 explain this deviation.

Table 8: Inflation Indicators

	YoY		Average	
	Jul-09	**Jun-09**	**FY09**	**FY10 Projections**
CPI headline	**11.2**	**13.1**	**20.8**	**10.0**
Food group	10.7	10.5	23.7	-
Non-food group	11.6	15.4	18.4	-
Core Measures				
Non-food non-energy	14.0	15.9	17.6	-
20% Trimmed	13.9	15.5	19.2	-

Source: FBS and SBP

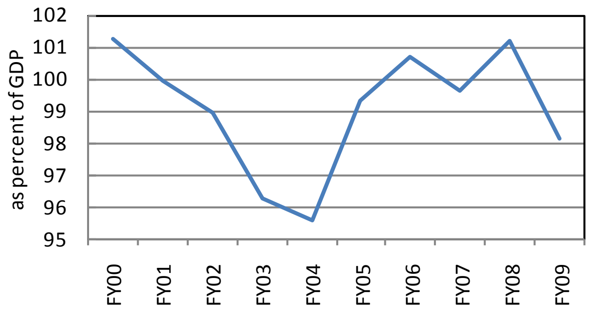
35. A number of factors explain persistence in inflation. First, the benefits of falling international commodity prices, in particular oil prices, were not fully transferred to the domestic economy. Second, even when the domestic administered prices were adjusted, other prices did not respond accordingly due to structural downward rigidities in the system. Third, nominal exchange rate depreciation during the first four months of FY09 diluted some of the gains of falling international commodity prices. Fourth, fiscal consolidation measures, such as elimination of subsidies, adjustment in power tariffs, revisions in GST and import duties, added to the existing price pressures. Fifth, loss in productivity due to severe electricity and gas shortages is another reason why the gains of contracting demand pressures could not be fully realized.

36. In FY10, the moderation in aggregate demand pressures is likely to continue contributing towards further decline in average inflation, expected to be around 10 percent, and macroeconomic stability. More importantly, the decline in inflation could be accelerated if the structural reasons of inflation persistence are addressed diligently. The benefit will not only be in terms of improved inflation expectations but also for the real economic activity. However, likely increases in the oil prices and upward revision of public sector wages may lead to renewed inflationary pressures.

Reduction in domestic investment expenditures narrowed the Saving-Investment gap…

37. Marred by power sector problems and deteriorating security conditions, the real economy grew by a meager 2 percent in FY09 against a target of 5.5 percent. The industrial sector, with a share of almost 25 percent, was the major casualty and registered a decline of 3.6 percent. Looking from the expenditure perspective, this contraction in real economic activity is being reflected in slowing growth in domestic aggregate demand, which fell to 0.6 percent in FY09 compared to 3.6 percent in FY08. As a result, the domestic demand pressures, defined as total domestic consumption and investment as a percent of GDP, declined in FY09 after showing an upward trend since FY04 (see **Figure 11**).

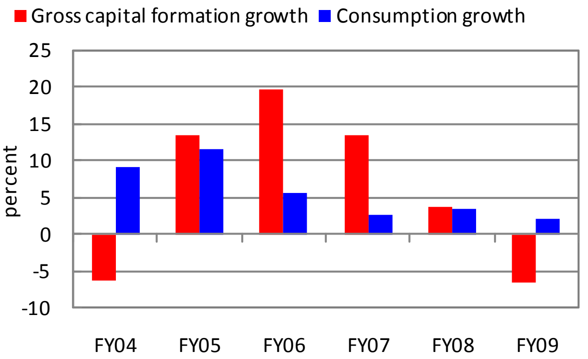
Figure 11: Domestic Demand*



* Domestic demand is the sum of real consumption and investment expenditures at market parices

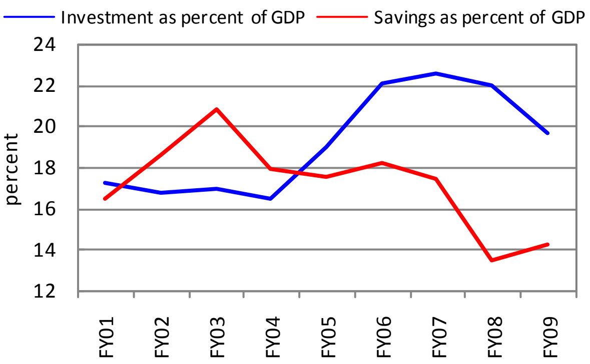
38. The contraction in aggregate demand, however, was disproportionate. While investment expenditures declined by 6.5 percent, consumption expenditures grew by 2.2 percent (see **Figure 12**). The decline in investment, both in public and private sectors, does not augur well for medium term growth prospects as lower capital stock hurts the productive capacity of the economy. In this regard, the revival of private sector credit is critical for facilitating increase in investment in the economy.

Figure 12: Gross Capital Formation and Consumption Growth



39. Reduced investment and relatively higher domestic savings due to a slow consumption growth narrowed the domestic saving-investment gap, as percent of GDP, by 3.1 percentage points (see **Figure 13**). Although this is encouraging, it still shows the need for substantial foreign

Figure 13: Pakistan's Saving Investment Gap



savings required to finance this gap. In the current global environment, it would be very difficult to attract non-debt creating foreign savings through private sources. This means that Pakistan's economy has to rely more on debt-creating flows, putting pressure on external debt sustainability in the medium term. In conclusion, the strategy needs to stay focused on increasing national savings while putting a floor under the falling investment.

C. Risks and Challenges

40. Power shortages have emerged as one of the most critical factors hampering economic activity in the country. Any failure to bring respite from the current situation would increasingly diminish the chances of economic recovery and create systemic risks for the financial sector as well. Reduced economic activity increases the risks of acceleration in NPLs, which may proliferate risk aversion by banks, limiting the flow of credit to the private sector further. The complete resolution of the circular debt issue is also of prime importance as the heightened financial stress for some of the OMCs is bringing their operations close to a halt. The repercussions of these developments may become severe affecting the efforts to bring stability and create incentives for boosting economic activity.

41. To resolve the power sector issues, removing subsidies and concurrent transfer of international oil price changes is also likely to risk a further slowdown in economic activities, at least in the near future. Though these steps would help the government in fiscal consolidation, high cost power would increase the cost of production, reducing competitiveness for exporters. It also increases the incentives for power theft offsetting the impact of improving financial health of the power sector through price hikes. Moreover, the frequent changes in power tariffs for adjusting international oil prices could cause price volatility and expose the consumers to uncertainty, particularly the low income earners and small scale businesses. The challenge to the government, therefore, is not only to resolve the power generation problems but also to arrive at a solution that does not distort the incentives for promoting economic activities.

42. The impact of a slowing economy could permeate to deteriorate the fiscal position of the country for next year as well. The foremost effect could be on tax revenues making it difficult for the government exchequer to meet annual revenue and fiscal deficit targets. The financing of the deficit is also likely to be challenging. The delay in receipts of Tokyo pledges could result in higher domestic borrowing

requirements, putting strain on the domestic money markets. With an already low tax to GDP ratio, the need to broaden the tax base is of prime importance especially to ensure higher development spending for capacity building.

43. Prospects of a global recovery in 2010 and a relatively milder recession in 2009 have improved. However, the initiation of debate on exit strategies indicates that fiscal as well as monetary stimuli have peaked. In the absence of any further significant stimulus growth impulse is likely to weaken and recovery might become slow and uneven. Moreover, while signs of recovery have increased for the US, the recovery of euro area is still engulfed in uncertainty. The trade induced positive impact on Pakistan therefore hangs in balance due to slow recovery and heavy dependence for trade on both areas.

44. Global financial conditions are also improving but yet to show complete recovery. Swift restoration of confidence in the financial sector and an orderly adjustment in asset prices in the wake of diminishing public policy support is necessary, since otherwise their positive feedback effect would remain weak. The risks of capital outflows, particularly from emerging economies, have not yet subsided. Therefore, Pakistan's external as well as fiscal accounts remain vulnerable. The imbalance between the debt and non-debt creating external inflows in favor of the former poses risks to long term external debt sustainability. The negative fallout of unsustainable external debt is massive as it risks external as well as fiscal sustainability, increases negative risk perceptions among international investors and leads to more stringent conditions from IFIs.

Annexure: Interest Rate Corridor Framework for Liquidity Management

Effective 17th August, 2009, State Bank of Pakistan (SBP) will adopt a new framework for its monetary operations by introducing a corridor for the money market overnight repo rate. The introduction of this framework will enhance effectiveness of market signaling, improve liquidity management, and foster stability and transparency in the money market operations. The new framework will reduce volatility in short term market interest rates thus improving the transmission of monetary policy signals and strengthening its role in fostering price stability.

In its money market operations, SBP implements decisions of SBP's Central Board of Directors on the monetary policy stance, signaled through changes in its policy rate. The adjustments in policy rate affect money market interest rates, banks' lending and deposit rates, and prices of other financial assets including exchange rate. The consequent changes in financial markets combined with the impact on expectations influence the spending decisions of the economic agents and thus inflationary pressures in the economy. The implementation of monetary policy focuses on the first link in this transmission mechanism i.e. impact of changes in the policy rate on money market overnight repo rates. Introduction of the new framework is intended to strengthen this link.

SBP's Current Liquidity Management Framework

SBP's main focus under the current operating framework is to keep the weighted average overnight repo rate[2] stable and close to the policy discount rate. To achieve this objective, SBP uses Open Market Operations (OMOs) to manage liquidity in the money market in a manner that there are no unwarranted pressures on the overnight repo rate.[3]

In case of upward pressure on the repo rate, due to shortage of liquidity in the system, SBP injects money in the system by purchasing government securities from banks with the agreement of selling the same on a future maturity date.[4] On the contrary, if there is excess liquidity available with the banks which is putting

[2] This is the weighted average interest rate on overnight repos against treasury bills/PIBs in the interbank market, using share of respective transactions in total amount as weight.

[3] The other tools that are only sparingly used include changes in Cash Reserve Requirements (CRR), Statutory Liquidity Requirements (SLR), and foreign exchange swaps.

[4] This is called reverse repo transaction which is affected through two simultaneous transactions: spot purchase of the government with an agreement to sell (forward) the same.

downward pressure on overnight repo rate, SBP mops up this surplus liquidity usually by selling government securities to banks with the agreement to purchase the same on the maturity date.[5]

In addition, SBP has a Standing Lending Facility i.e. 3-day repo or discount facility to provide financing to banks as a lender of the last resort. The facility is available to all banks and Primary Dealers (PDs) for overnight (extendable to 3-days) lending against eligible securities as collateral and the interest rate charged is the prevailing SBP policy rate.[6]

Limitations of the Current Framework

In the current system, OMOs are aimed at managing liquidity in the short-run with the tenor of repo or reverse repo agreements ranging, on average, from overnight to one week. Although there is no restriction on the duration of OMOs, these are confined to shorter tenors only because of SBP objective of managing only the very short end of the yield curve for its monetary policy signals. However, the uncertainty over future liquidity levels in the system does complicate the implementation of monetary policy. This uncertainty stems largely from various autonomous factors that are not in control of SBP. These include on-tap government borrowings from SBP; refinance provided by SBP to banks under EFS/LTFF schemes at subsidized rates; government borrowing requirement for commodity operations; government deposit flows in the banking system; etc. These factors make the assessment of liquidity and determining the timing as well as tenor of the OMOs extremely difficult.

The deviation in liquidity from its forecasted levels leads to excessive volatility in the overnight repo rate.[7] While discount rate serves as a 'ceiling' on the upward movement of overnight repo rate, there is no 'floor' on its downward movement. Besides excessive downward movement of the overnight repo rate, excess cash in the system may also lead to increased pressure on the exchange rate.

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5 This is called repo transaction and is a mirror image of the reverse repo transaction i.e. spot sale of government securities with agreement to purchase (forward) the same.

6 The eligible securities for discounting are T-bills and PIBs.

7 This is different compared to other central banks that usually operate with two standing facilities: one for lending to banks as the lender of last resort (standing lending facility or discount facility) and the other for absorbing surplus liquidity as absorber of last resort (standing deposit facility).

Rationale for the New Framework

The key reason for changing the existing operating framework is to avoid excessive volatility in money market overnight repo rates (see **Figure A and Table A**). Although limited volatility in the overnight rate is desirable with the perspective of creating trading opportunities that promotes interbank market activity; however, excessive volatility in the short end of the yield curve may have some undesirable spillover impact on the medium/long term yield curve. Excessive volatility in the overnight rate also discourages the development of other financial instruments and markets as most of them rely on the overnight interbank rate as benchmark. More importantly, excessive volatility in the overnight repo rate distorts the term structure of interest rates by creating disconnect between short and long term rates. While the long-term rates could move in line with market expectation of future changes in the economy, short-term interest rates themselves might not move in tandem with this due to the volatility in the overnight repo rate.

Figure A: Weekly Weighted Average Overnight Repo Rate

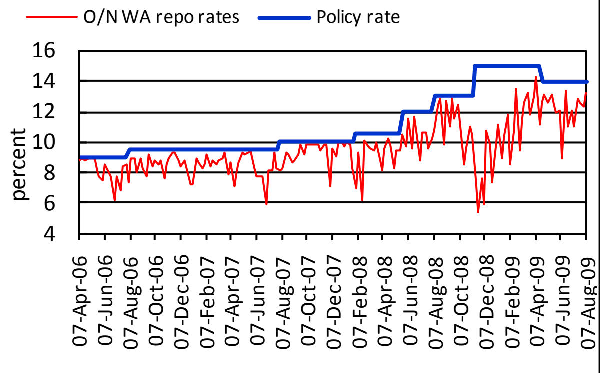

Table A: Variation in Weekly Weighted Average Overnight Rate

	Average	Standard Deviation	Coefficient of Variation
FY06	8.1	0.8	9.9
FY07	8.4	0.7	8.7
FY08	9.4	1.0	10.7
FY09	11.0	2.0	19.0
FY10*	12.4	1.0	8.3

* Up to 7th August 2009
Source: SBP

International Best Practices

Essentially, almost all of the central banks have standing facilities in place for providing liquidity to the financial institutions at the penalty rate (discount rate, bank rate plus some basis points, etc).[8] Recently, several central banks have also introduced (or are in process of doing so) standing facilities for absorbing excess liquidity from the system.[9] Therefore, there are normally two standing facilities in place in most of the countries: (1) collateralized marginal lending facility (similar to discount facility of the SBP) that serves as a ceiling of the corridor, and; (2) standing

[8] For example, Bank of Indonesia had only deposit facility and introduced lending facility in 2005.
[9] Some of these have adopted deposit facilities very recently: Malaysia in April 2004; Singapore in June 2006; Thailand in January 2007 and; Korea in March 2008.

deposit facility, where the rate on standing deposit facility serve as a 'floor' to the interest rate corridor.

Changes in SBP's Existing Framework for Money Market Operations

In this context, SBP has decided to introduce following changes in its framework for operations in the money market:

1. Introduction of Standing Deposit Facility: SBP Overnight Repo Facility

SBP will introduce an overnight standing deposit facility, "SBP Overnight Repo Facility", where the banks would be allowed to deposit their end-of-day surplus funds with SBP in the form of an overnight repo against T-bills at the 'floor' rate. This 'floor' rate will be 300 bps below the discount rate. The facility will be limited for overnight placement of excess funds left with the banks by the end of day. This implies that banks would not go in the market to lend these excess funds at a rate below the 'floor' under the standing deposit facility.

Some of the operational details are given below:

a. Only scheduled banks and primary dealers will be eligible to avail the deposit facility;
b. This facility will only be available at the end of the day when it can be ascertained that the market has excess funds;
c. The time for informing SBP about availing the facility (on a specified format) will be between 2:30 pm to 3:30 pm from Monday to Friday and between 12:00 noon to 1:00 pm on Saturday;
d. The minimum amount for the overnight standing repo facility will be Rs100 million, and in multiples of Rs50 million thereof;
e. The T-bills acquired under the Standing Overnight Repo Facility from SBP will be SLR eligible.

2. Renaming of Existing SBP 3-day Repo Facility as "SBP Overnight Reverse-Repo Facility"

The existing SBP 3-day Repo Facility will be renamed as "SBP Overnight Reverse-Repo Facility" and the tenor of the facility will be overnight. The procedure for availing the end-of-day financing facility from SBP will continue to be in accordance with the existing practices.

3. Interest Rate Corridor

While the policy discount rate, the rate on "SBP Overnight Reverse Repo Facility" will continue to serve as a 'ceiling' on the upward movement in the money market repo rate, introduction of the overnight repo facility will provide a binding 'floor' on its downward movement. This will limit the movement of the overnight repo rate within the corridor. Through its operations, SBP will ensure that the repo rate does not hit the 'ceiling' and 'floor' of the corridor too frequently, thereby, minimizing the probability of banks' using either lending or deposit facility.

As the 'floor' or rate on the SBP Overnight Repo Facility is linked to the policy rate, it will be adjusted automatically with the changes in policy rate as decided by the SBP's Central Board of Directors at the start of each quarter or as and when deemed necessary. Similarly, the width of the corridor may also be reviewed and changed by SBP according to the prevalent market conditions. Initially, this relatively wide corridor would provide the flexibility that might be useful particularly in unusual circumstances requiring large movements in the overnight repo rate without a change in the policy rate. On the other hand, narrow corridor under the current market conditions might reduce the incentive for market players to trade among themselves or circulate funds in the market as they might choose to transact more with the SBP, which may hinder market development.