Monetary Policy Statement

July-December 2005

Economic Policy Department

State Bank of Pakistan

Macro Economic Outlook and Monetary Policy Stance:

The world economy on average showed sustained growth over the last year despite slowdown in Japan and the euro zone. The US economy continued to show strong growth in consumption and investment giving rise to inflation prospects. Widening of twin deficits also created doubts about the sustainability of foreign capital inflows into the US. The Fed had to raise its key policy rate periodically in the recent past not only to prevent acceleration in inflation but also to attract foreign capital flows to bridge the savings-investment gap and to encourage domestic savings. The Asian economies including Pakistan also performed well on the back of moderate global performance. The Chinese economy continued to register robust growth on the back of large exports based on low-cost industrial production. Their performance, however, could have been even better had Japan and euro zone shown moderate growth.

Pakistan's economy performed exceptionally well during FY05 with a record growth estimated at 8.4 percent in two decades. The growth is broad based as all segments of the economy contributed significantly to GDP growth. Manufacturing sector showed a growth of 12.5 percent against the target of 10.2 percent while Agriculture sector expanded by 7.5 percent against the target of 4 percent. Services sector also exceeded its performance target by 1.7 percent to show a growth of 7.9 percent. Credit absorption by the private sector has been in the region of Rs.400 billion for the first time in the credit history of the private sector despite rising interest rates. The SME sector also significantly benefited from record credit expansion as its credit absorption has risen to Rs.71.4 billion during July-May FY05.

The performance of the external sector has been satisfactory despite a record trade deficit of $6.2 billion (custom based) during FY05. Trade deficit may not be taken as a source of concern because it has primarily emanated from production-oriented imports like oil, machinery and raw materials. It has been the sustainability of worker's remittances at around $4 billion a year that has contained the overall balance of payments deficit to mere $933 million during FY05 and thereby has prevented foreign reserves from depletion. Exchange rates on average have remained stable and the loss of external competitiveness has been negligible as the impact of relatively higher inflation was to a large extent offset by the nominal depreciation of Rupee against other currencies in the basket of trading partners and competitors.

The consumer price inflation has been a source of concern throughout FY05. It has fluctuated around 9 percent with some deceleration in the middle of the year. The increase in inflationary tendencies was also evident in the rising trend of core inflation despite periodic interest rate hikes throughout FY05. It is for this reason that discount rate was raised to 9 percent in April 2005. Following the substantial increase in interest rate, inflation is expected to decelerate and come down to 8 percent this year.

To sum up, Pakistan's economy is projected to perform well during FY06. The growth momentum built up last year is expected to continue with economic growth projected at 7 percent and inflation targeted at 8 percent. Manufacturing sector is projected to grow by 11 percent, while agriculture sector is expected to expand by 4.8 percent. To achieve these targets, monetary expansion is targeted at 13 percent with the credit to the private sector growing at 20 percent (Rs.330 billion). Monetary expansion has been kept marginally below the nominal GDP growth target to reduce monetary overhang and bring inflation down to a reasonable level. The acceleration in interest rates since April 2005 is expected to depress inflationary pressures and help achieve the inflation target of 8 percent by the end of the current fiscal year. Other factors expected to help contain inflation include:

- The increased supply of domestically produced goods and services as a result of continued and rapid GDP growth;
- Capacity expansion and BMR in key industries;
- Improved food supplies from substantial growth of 17.3 percent in the production of major crops last year supplemented by duty-free imports of 11 essential food/commodities from neighboring countries;
- Further improvement in fiscal discipline through the enactment of *Fiscal Responsibility and Debt Limitation Law* along with sustained improvement in financial position of PSEs and decline in revenue deficit;
- Expectation of stable exchange rates on the back of sizable foreign reserves and sustained annual inflows of workers' remittances and FDI;
- Increased productivity and efficiency of textile industry and ongoing expansion in automobile, electronics and cement industries;

Despite the above-mentioned moderating influences, inflationary expectations are likely to continue for a number of reasons:

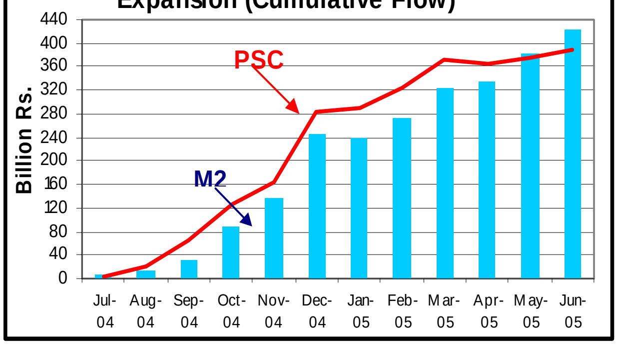
- Capacity constraints in key industries like Fertilizer, Paper and Paper Board, and Steel;
- Potential adverse impact of recent floods and heavy rains on essential food supplies;
- Outlook of upward pressure on world oil prices;
- Substantial expansion in consumer loans.

The balance of risks indicates that domestic prices may continue to remain under pressure on account of high world oil prices, widening trade deficit, and rising interest rates in the world financial markets during July-December 2005. While continuing to observe movements of all key variables and taking timely corrective actions, the key objective of the monetary policy would be to fight inflation and bring it down to a reasonable level during the next six months. The monetary policy stance of a tightened monetary expansion would, therefore, continue until inflationary pressures are eased off. The State Bank of Pakistan would also continue to ensure stability in exchange rates. The extent of the interest rate changes will be determined by the magnitude, direction and speed of inflationary pressures. Nevertheless, the State Bank of Pakistan would also ensure that the credit expansion is targeted to support SME and Agriculture sectors that generate most of the employment in the economy, further capacity expansion of vital industries, and BMR initiatives.

Monetary and Credit Trends

The monetary expansion continued unabated despite periodic rises in interest rates during FY05. SBP continued to facilitate growth initiatives as it ensured interest rate hikes at a gradual pace through to March 2005. The policy of gradual interest rate hike substantially added to the stock of reserve money as it expanded by 16.6 percent (Rs.128.5 billion) during July-25 June FY05, in part due to shifting of some of the government debt away from banks to the SBP. Therefore, the stock of broad money also expanded by 16.5 percent (Rs.411.3

Figure 1: Monetary Expansion Vs. Credit Expansion (Cumulative Flow)



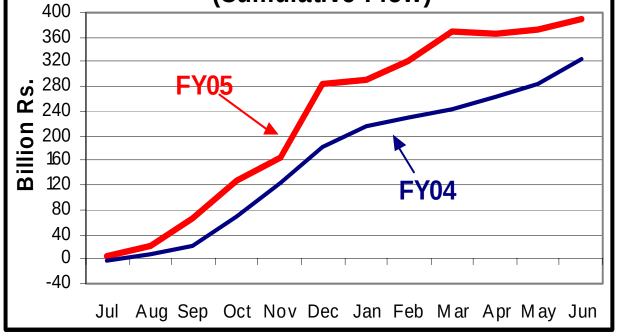
billion) as the net domestic assets (NDA) of the banking system grew by 19.5 percent (Rs.371.2 billion) largely due to record credit distribution to the private sector (**Figure 1**). The share of NDA in monetary expansion stood at 90.3 percent while net foreign assets (NFA) of the banking system increased moderately by Rs.40.1 billion (**Tables 1-2**).

The balance sheets of banks continued to expand substantially during July-25 June FY05. This primarily occurred on the back of substantial growth of deposits by 15.9 percent (Rs.303.9 billion). Other factors that made the liquidity position of banks even more comfortable included a shift of some of the TB holdings by banks to SBP (Rs.67.0 billion), and retirement of bank credit by PSEs (Rs.17.9 billion). Therefore, the total liquidity of banks rose roughly by Rs.411 billion and this improved the credit performance of banks substantially as the private sector credit off-take rose to an historically high level of almost Rs.400 billion.

The fiscal performance remained satisfactory despite considerable loss of revenues on account of the government decision to buffer the impact of a substantial rise in the world oil price on the domestic economy. This loss of revenues was partially offset by more than targeted Federal non-tax revenues (Rs.249 billion against the target of Rs.141.5 billion). Therefore, fiscal deficit as a percentage of GDP remained within the safe limit of 4 percent. The CBR tax collection rose by 13.6 percent during July-May FY05. The government borrowings from the banking system during July-25 June FY05 remained marginally on the higher side with Rs.68.8 billion borrowed to bridge budgetary gap and Rs.21.8 billion borrowed to support commodity operations against the targets of Rs.60 billion and Rs.5 billion, respectively.

Private sector continued to benefit from relatively low real interest rates, which remained in the negative zone as inflationary pressures outpaced ongoing interest rate hikes recorded in the first three quarters of FY05. This spurred the demand for cheap bank credit by the private sector and in consequence commercial banks created history by providing ample liquidity to the private sector. Bank credit to the private sector during July-25 June FY05 grew by 30.6 percent (Rs.390.3 billion) compared with the growth of 30.7 percent (Rs.291.6 billion) in the corresponding period of last year (**Figure 2**).

Figure 2: Credit to Private Sector (Cumulative Flow)



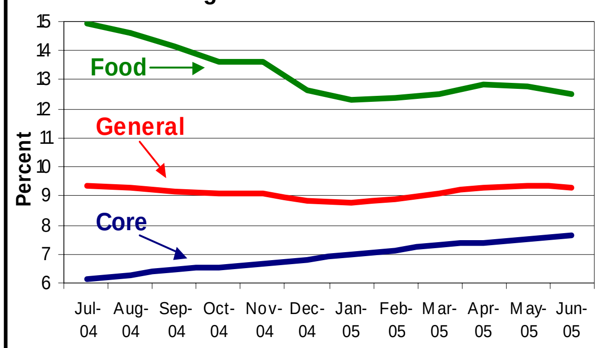
The distribution of credit to the private sector continued to be broad-based during July-May FY05. The *manufacturing sector* as usual led the credit utilization and its credit absorption rose by 41 percent to Rs.153.2 billion. The largest recipient of manufacturing loans was *textile industry* (Rs.91.8 billion) followed by *cement industry* (Rs.11.3 billion) and *petroleum refining industry* (Rs.4.7 billion). The scale of consumer loans expanded by 93.1 percent to Rs.80.3 billion and their distribution showed concentration towards auto loans (Rs.37.4 billion) and house building loans (Rs.17.5 billion). Credit absorption by *Construction industry* rose to Rs.10.6 billion from mere Rs.331 million last year. *Wholesale and retail trade* also picked up strongly and loans involved in these rose by 78.2 percent to Rs.30.7 billion. The credit absorption of *transport, storage and communication* rose by 164.7 percent to Rs.21.1 billion.

The ongoing credit boom is likely to ease with expected monetary expansion decelerating to around 13 percent during FY06 because of the prospect of rise of interest rates triggered primarily by rising core inflation. However, it is expected that credit to the private sector will still expand by around 20 percent (Rs.330 billion) during FY06 due to substantial rise in the bank deposit base due to record economic growth of 8.4 percent during FY05 and likely continuation of significant inflows of workers' remittances in FY06.

Inflation Trends

The consumer price inflation fluctuated around 9 percent last year despite interest rate tightening throughout the year. It was encouraging to see the food price inflation decelerating to 12.5 percent in June 2005 from 14.9 percent at the start of year but it remained on the higher side primarily due to excessive rises in the prices of eggs, pulses, sugar, milk and potato. Major sources of inflation from the non-food basket were the groups of *house rent* and, *fuel and lighting*: they recorded increases of 11.3 percent and 3.7 percent from 9 percent and 2.7 percent, respectively. The major source of concern remained the rising core inflation, which ended at 7.6 percent in June 2005 up from 6.1 percent at the start of the year **(Figure 3).**

Figure 3: Inflation Trends

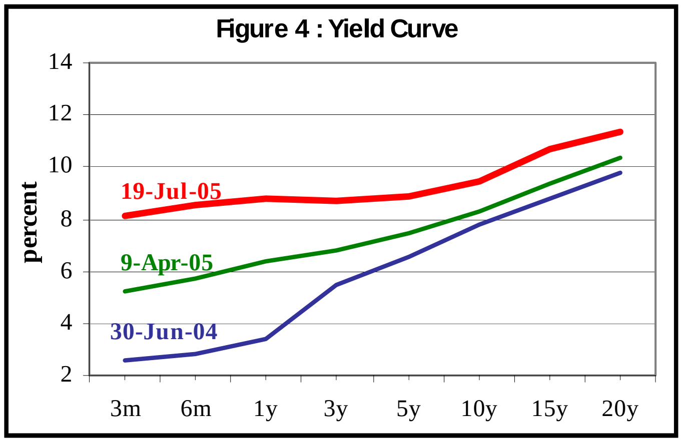


Inflationary pressures are likely to ease during FY06. Food supplies are expected to improve on account of better food crops in FY05 and permission of duty-free import of some essential food items from neighboring countries. Therefore, food inflation is likely to decelerate further. Core inflation is also likely to come down on account of slowdown in aggregate demand due to higher interest rates. Exchange rates are expected to remain stable on the back of substantial workers' remittances, FDI inflows and foreign reserves and thereby contribute to contain the price inflation of imported goods. Therefore, consumer price inflation is projected to come down at least to 8 percent in FY06.

Interest Rate Trends

International financial markets remained subject to interest rate hikes during FY05. The Fed raised the Federal Funds Rate eight times during the year by 25 basis points each to 3.25 percent since July 2004. The 6-month LIBOR also continued to edge up and showed a rise of 263 basis points to 3.84 percent. The European Central Bank however kept interest rate unchanged in view of weak economic condition in that region. On the domestic front, the inflationary pressures continued to mount with some deceleration in the middle of the year. In consequence, SBP had to take corrective measures to stay aligned not only with the international financial markets but also to ensure domestic price stability. In the first three quarters of the year, SBP took recourse to the policy of gradual interest rate hikes to avoid its adverse impact on economic growth. However, in April 2005 SBP changed its discount rate policy after a period of two years, and increased its discount rate by 150 basis points to 9 percent and thereby setting the stage for high yields on various government papers and their impending expansionary impact on the bank lending and deposit rates. The increase in the discount rate added momentum to the process of interest rate hikes and in the space of roughly three months, yields on 3-month, 6-month, and 1-year TBs increased quickly by 268 basis points to 7.69 percent, by 230 basis points to 7.99 percent and by 275 points to 8.7 percent, respectively. Prior to the change in the discount rate policy, it took almost nine months for yields on 3-month, 6-month, and 1-year TBs to rise by 326 basis points to 5.01

percent, by 346 basis points to 5.69 percent and by 370 points to 5.95 percent, respectively. The rapid upward change in the interest rates since April 2005 is also reflected by a large shift in the yield curve (**Figure 4**).



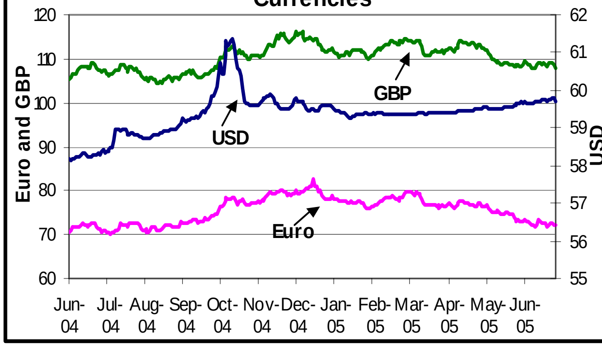
The inter-temporal impact on core inflation of recent rises in key policy rates is expected to unfold in the near term. The average bank lending rate which had risen by 152 basis points to 6.57 percent between July-March FY05 is likely to pick up speed as it has already shown a rise of 109 basis points between April-May FY05. The ongoing upward pressure on lending rates is expected to continue in view of efforts to eliminate significant monetary overhang and the lagged impact of discount rate change in April 2005.

External Sector Trends

One of the most encouraging developments in recent years which continued to prop up and gave a sense of protection to the domestic economy was the sustainability of considerable inflows of workers' remittances which continued to exceed annual targets since 2001-02. Workers' remittances during FY05 rose by 7.7 percent to $4.2 billion over the corresponding period of last year. FDI inflows also continued to show rising trend and recorded a growth rate of 60.5 percent to $1.5 billion. These inflows helped contain the overall balance of payments deficit to mere $933 million during July-May FY05 despite a record-high trade deficit of $4.3 billion, and thereby protected foreign reserves from depletion. Export earnings did grow by 14.6 percent to $13 billion. However, these were not sufficient to contain trade deficit on account of substantial imports, which grew by 40.6 percent to $17.3 billion. The phenomenal growth of imports resulted from high value of petroleum products, industrial machinery and raw materials, which were absolutely essential to reinforce the ongoing growth momentum through capacity expansion and BMR.

Exchange rates remained stable through the year despite weakening of rupee against major world currencies (**Figure 5**). This was the natural outcome of the pro-active approach of the SBP which continued to make timely and adequate interventions in the financial market to ensure stability and external competitiveness. SBP took full advantage of sizable foreign reserves and intervened quite frequently to pre-empt any adverse impact on exchange rates stemming from rising demand for foreign exchange. The weakening rupee did show a depreciation of 3.28 percent against a basket of 15 currencies. However, this gain in external competitiveness was not sufficient to neutralize the adverse impact of high domestic inflation, which raised the relative prices by 5.45 percent. Therefore, the external competitiveness showed a meager loss of 2 percent during FY05.

Figure 5: Exchange Rate Trends against Major Currencies



The performance of the external sector is likely to remain satisfactory primarily on account of sustained workers' remittances during FY06. The foreign reserves position is likely to remain strong because workers' remittances projected at $4 billion and other net inflows would be more than sufficient to finance the large trade deficit. Therefore, exchange rates are likely to remain stable during FY06 with their potential positive impact on inflation and external competitiveness.

In short, Pakistan's economy is expected to fare well once again this year and sustain the growth momentum built up last year. Capacity expansion and BMR is likely to continue with well-supported credit flows to the private sector expected to grow around 20 percent (Rs.330 billion). Monetary policy would remain tight until inflationary pressures are reasonably eased off. Monetary and exchange rate management is expected to support growth initiatives aimed at alleviating poverty in a relatively low inflationary environment.

Table 1

Monetary Indicators

(Targets and Actuals)

(Rs. in million)

SECTORS	Credit Plan		Cumulative Flows	
	FY05 (Revised)	FY 06	01-Jul-04 to 25-Jun-05 P	01-Jul-03 to 26-Jun-04
1. GOVERNMENT SECTOR BORROWINGS (Net)	**65,000**	**120,000**	**92,668**	**53,027**
i. Net Budgetary Borrowing	60,000	98,000	68,784	59,039
ii. For Commodity Operations	5,000	20,000	21,816	-8,622
iii. Net effect of Zakat Fund	0	2,000	2,068	2,610
2. NON-GOVERNMENT SECTOR (A+B+C)	**330,000**	**320,000**	**366,377**	**282,399**
A. Credit to Private Sector (i + ii)	350,000	330,000	390,317	291,560
i. Commercial Banks			388,991	300,047
ii. Specilised Banks			1,326	-8,487
B. Credit to Public Sector Enterprises (PSEs)	-15,000	-10,000	-17,876	-2,837
C. Other Financial Institutions (SBP credit to NBFIs)	-5,000	0	-6,064	-6,324
3. OTHER ITEMS (Net)	**-65,000**	**-75,000**	**-87,844**	**-22,331**
4. NET DOMESTIC ASSETS (1+2+3)	**330,000**	**365,000**	**371,201**	**313,096**
			(19.50%)	(20.34%)
5. NET FOREIGN ASSETS	**30,000**	**15,000**	**40,072**	**44,486**
6. MONETARY ASSETS (4+5)	**360,000**	**380,000**	**411,273**	**357,582**
	(14.48%)	(13.05%)	(16.54%)	(17.2%)

P = Provisional

Figures in parenthesis are growth rates

Source: State Bank of Pakistan (Economic Policy Department)

Table-2

Monetary Indicators
Cumulative Growth (percent)

Sectors	1-Jul-04 to 25-Jun-05 P	1-Jul-03 to 26-Jun-04	FY04	FY03
Money Supply(M2)	16.54	17.20	19.62	18.02
Reserve Money	16.63	23.65	15.44	14.52
Currency in Circulation	18.36	18.45	16.89	14.01
Deposits of which:	15.94	16.94	20.60	20.32
Demand Deposits	*13.88*	*23.28*	*30.13*	*41.71*
Time Deposits	*17.76*	*12.59*	*14.52*	*16.40*
RFCDs	*15.02*	*15.50*	*15.50*	*-19.89*
Credit to Private Sector	30.63	30.72	34.27	20.88
Net Borrowing by Government	14.11	8.86	9.71	-11.57
Net Domestic Assets (NDA)	19.50	20.34	23.67	0.55
Net Foreign Assets (NFA)	6.87	8.24	8.07	133.91

P: Provisional