MONETARY POLICY STATEMENT

JULY-DECEMBER 2004

STATE BANK OF PAKISTAN

Economic Policy Department

Monetary Policy Statement

(July-December 2004)

Macroeconomic Outlook and Monetary Policy Stance

Recent global trends point to an improved economic outlook as the US and other developed economies have exhibited significant recovery and growth that started in the later half of the last fiscal year. The developing nations have benefited from the on-going recovery in the developed world and higher capital inflows, and most of the nations including Pakistan have been able to achieve or even surpass growth targets.

Although high demand in the developed world is the driving force behind the global economic up-turn, there are risks of relatively high inflation and long-term slowdown due to higher US deficits caused by heavy tax cuts and costs associated with the war against terrorism. This has led to rising inflationary expectations worldwide and, therefore, interest rates are likely to continue to increase in the international financial markets. These developments may have, to some extent, dampening effects on investment and economic growth the world over.

Pakistan's economy has experienced broad-based economic growth during FY04. The country is estimated to have achieved a growth rate of 6.4% against the target of 5.3%. Principal factors were the intentional growth-oriented monetary and exchange rate management in a low inflation scenario, improved fiscal discipline, stable political environment and better relations with neighbors. Prevalence of low interest rates on account of easy monetary policy under less inflationary environment fueled growth helping to accelerate the pace of economic recovery. The low cost funds available to the corporate sector enabled many companies to strengthen their balance sheets, improve profitability and invest retained earnings along with bank borrowing into expansion, modernization or higher capacity utilization. On the external front, though the imports also grew more than expected, export earnings crossed the $12.0 billion mark for the first time mainly due to rising export competitiveness. Workers' remittances amounted to $3.87 billion, higher than estimated for the FY04. However, there was a decline in other net foreign capital inflows.

Pakistan's economy is, therefore, better placed in terms of achievement of medium-term growth targets in view of the momentum already gained in the last fiscal year and existing global trends that augur well for the world economy, at least in the short term. GDP growth for FY05 is projected at 6.6% with the manufacturing sector taking the lead to grow by over 10%, agriculture sector expanding at 4% and the services sector to grow at 6.2%. Due to higher increases in prices recently, the inflation is targeted to increase by 5%. To achieve these targets, the broad money expansion is targeted at 11.4% for the FY05, slightly less than the nominal growth rate target. Consistent with higher growth and development, the main thrust of monetary and credit policy would be to ensure adequate availability of bank credit to private sector while containing inflation.

The constellation of risks has changed in a perceptible manner since the issuance of last Monetary Policy Statement. On the negative side:

- International interest rates have begun to edge up and there is a fairly strong expectation that these rates will move upwards in the coming quarters. The differential between Pakistan Rupee interest rates and US Dollar, Euro, Yen and Sterling Pound interest rates should not be allowed to widen.

- Strong import demand witnessed in FY04 is unlikely to be depressed in the current fiscal year worsening the trade balance and therefore exerting a downward pressure on the exchange rate.
- Domestic private credit demand has peaked in FY04 and therefore the rate of expansion will be moderate but still a large portion of net domestic asset growth will be preempted by the private sector.
- Hike in asset prices, adjustment in wages and salaries awarded to public servants will also put upward pressure on prices.

On the positive side:

- Fiscal deficit is likely to remain at 4 percent of GDP and along with the improved financial balances of public sector enterprises the demand from the public sector, barring any unforeseen events, would not pose any serious concern.
- Lower capital inflows would moderate the monetary and reserve money growth.
- Lower world prices of raw cotton should help the textile and clothing sector in its export drive but much depends on how fast the textile export industry is able to expand its share in the post-MFA textile markets of North America and Europe.
- The continued growth of textile sector should take place with lower demand for working capital from banking system thus easing somewhat the pressure on private sector credit.

- Imports of wheat of one million tones should facilitate the government to stabilize the prices of wheat flour during the lean months effectively but the uncertainty about oil and commodity prices remains worrisome.
- The state of labour market shows high degree of unemployment in the country with very low pressure for wage rise outside the public sector. An inappropriate or more aggressive monetary policy will only aggravate the unemployment problem.

The balance of risks indicates that domestic prices may continue to increase and exchange rate may be under pressure in the coming six months. The lingering overhang from the last two years' monetary expansion has to be wrung out of the system thus lowering the inflation risk premium built into market expectations. Therefore, the State Bank will continue to exercise vigilance on the movement of key variables and make a smooth transition from an expansionary monetary policy stance to measured tightening to avert inflationary pressures and maintain stability in exchange rate. This measured response will have to ensure that the current growth and investment momentum in the country is not impaired in any significant manner, export competitiveness is maintained while inflation is kept under control. Raising interest rates rapidly or aggressively when the economic recovery is still incipient, a significant slack exists, and unemployment rates are rising, will entail real economic costs. The State Bank remains firmly committed to price stability and will use both the tools of monetary policy as well as prudential regulations to achieve this goal.

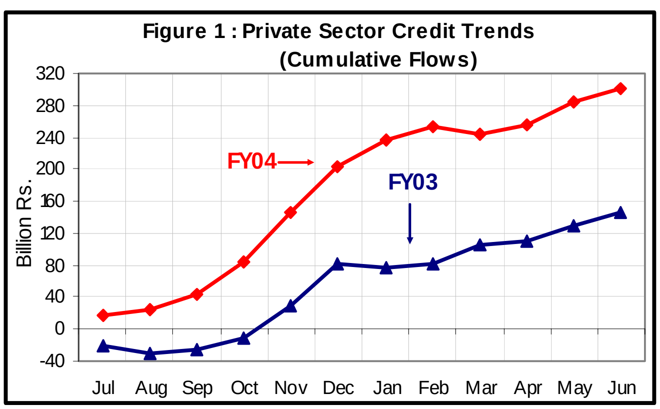
Monetary and Credit Trends (July – 26th June FY04)

The pace of monetary expansion that had substantially accelerated during the last few years continued through FY04 and showed a growth of 17.6 percent during July – 26th June FY04 (the most recent available data) compared with the full-year target of 11 percent and a growth of 17.4 percent in the corresponding period of last year. The prime source of monetary expansion in the last couple of years before FY04 was exorbitant capital inflows that increased the net foreign assets (NFA) of the banking system. However, monetary expansion during FY04 primarily resulted from the buildup in the net domestic assets (NDA) of the banking system, which amounted to Rs.324.9 billion against a depletion of Rs.4.0 billion last year. The buildup in NFA of the banking system showed a subdued rise of Rs.41.5 billion against a massive rise of Rs.310.4 billion last year. Some of the key factors that contained the growth of foreign assets included worsening trade balance, deteriorating services account, and pre-payment of expensive external debt, both by the government and the private sector. The stock of reserve money also continued to increase substantially and expanded by 23.6 percent (Rs.158.3 billion) compared with the expansion of 24.6 percent (Rs.143.7 billion) last year. Three major factors that expanded the stock of reserve money included SBP credit to the government (Rs.122.5 billion in contrast to net retirement of Rs.204.1 billion last year), SBP credit to banks under the scheme of export refinance (Rs.28.4 billion in contrast to net retirement of Rs.0.8 billion) and SBP's net foreign exchange purchases from banks ($0.9 billion equivalent to the injection of Rs.52 billion compared with $4.5 billion equivalent to the injection of Rs.263 billion).

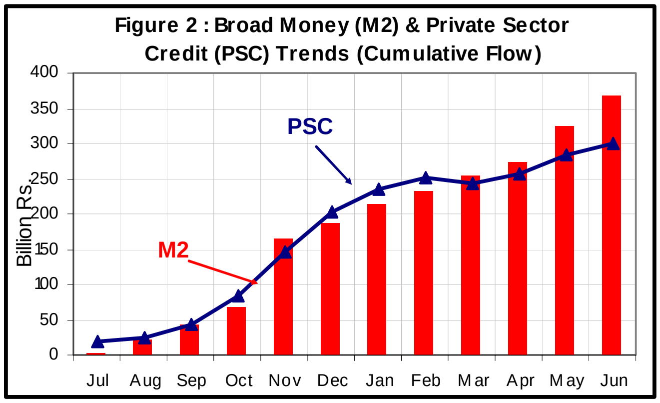
The performance of the government sector during FY04 continued to improve. Budget deficit came down to 3.9 percent of GDP against the target of 4 percent. The CBR successfully achieved its tax collection target of Rs.510 billion set for FY04 when its tax collection recorded a growth of 10.9 percent to Rs.510.6 billion. The non-tax revenues also rose to Rs.180.9 billion during FY04 and surpassed the annual target of Rs.150.8 billion by 20 percent.

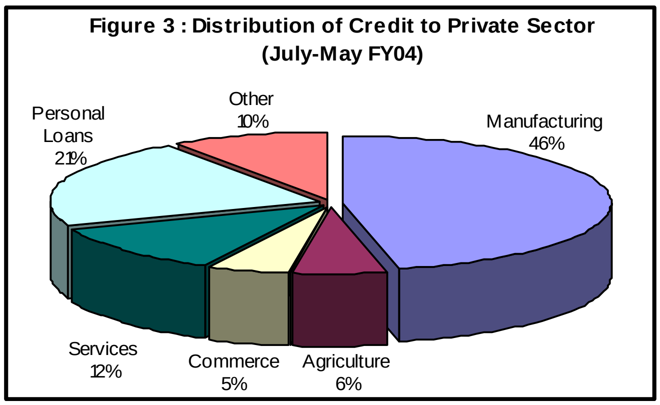
Budgetary borrowings from the banking system increased substantially during FY04 but without constraining credit flows to the private sector. These totaled Rs.68.0 billion compared to the annual target of Rs. 15.0 billion and the net retirement of Rs.44.0 billion in the corresponding period of last year. The principal reasons behind the increased budgetary borrowings were the pre-payment of expensive external debt of $1.17 billion, decline in non-bank borrowings due to low returns on national savings schemes and less-than-targeted external financing. The pre-payment of most expensive debt is expected to reduce the future debt servicing cost and create fiscal space for developmental expenditure. Government borrowings for commodity operations showed net retirement of Rs.8.6 billion due to the combined impact of improved availability of commodities and greater participation of the private sector.

The dynamic impact of low interest rates in the last couple of years gained momentum during FY04 when the bank credit to the private sector reached new highs. Monthly credit flows averaged Rs.25.0 billion and the cumulative credit flow to the private



sector during July-26 June FY04 grew by 31.7 percent to Rs.301.2 billion compared with the growth of 18.9 percent (Rs.152.2 billion) in the corresponding period of last year (***Figure 1***). The monthly trend of monetary expansion during FY04 could best be explained by corresponding rises in credit to the private sector (***Figure 2***).





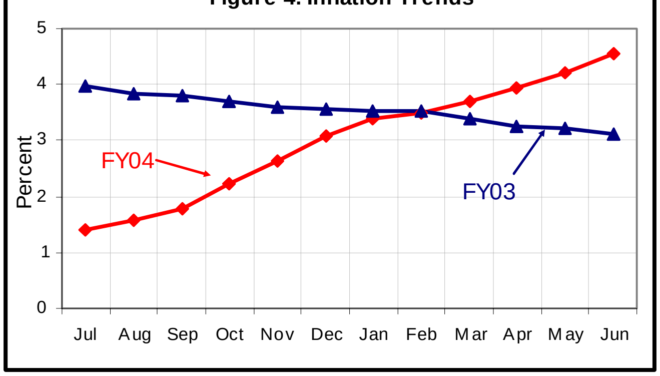
The distribution of credit utilization during July-May FY04 was broad based as all important segments of the economy showed increased utilization of bank credit (***Figure 3***). *Manufacturing sector*, as usual, took the lead and claimed a larger share of 46.7 percent in the net credit expansion during July-May FY04. Its credit utilization rose by 106 percent to Rs.133.0 billion. *Personal loans*, which accounted for 21.4 percent increase in the net credit utilization more than doubled to Rs.60.9 billion. Most of these loans (18.6 percent or Rs.11.3 billion) were availed for automobiles. Other notable sectors that contributed to substantial credit growth were *Services* (11.9 percent or Rs.33.8 billion), *Agriculture* (5.5 percent or Rs.15.7 billion) and *Commerce* (4.9 percent or Rs.14.0 billion).

Economic outlook during FY05 appears promising on the backdrop of record-high credit off-take by the private sector during FY04. CPI inflation is targeted at 5 percent while interest rates are expected to rise gradually during FY05. Foreign capital inflows are likely to continue to decelerate and delimit the buildup in the NFA of the banking system to Rs.30 billion. In view of above expectations, monetary expansion is projected at 11.4 percent (Rs.280 billion) during FY05, consistent with growth and inflation targets.

Inflation Trends

The consumer price inflation, which remained below 4 percent until April 2004, despite notable monetary expansion during the last few years, rose sharply to 4.57 percent by the end of June 2004 (***Figure 4***). The rate of marginal inflation continued to show rising trend since July 2003 primarily due to adverse supply shocks. The potential shortage of wheat, wheat flour and meat were responsible for food-price inflation, which rose to 6.01 percent from 2.82 percent in FY03 and from a deflation of 0.5 percent in July 2003. The periodic rises in world oil prices coupled with weakening exchange rates and hikes in house rents also jacked up the average price of non-food items and therefore non-food CPI inflation also rose to 3.62 percent from 3.29 percent in FY03 and 2.68 percent in August 2003.

Figure 4: Inflation Trends

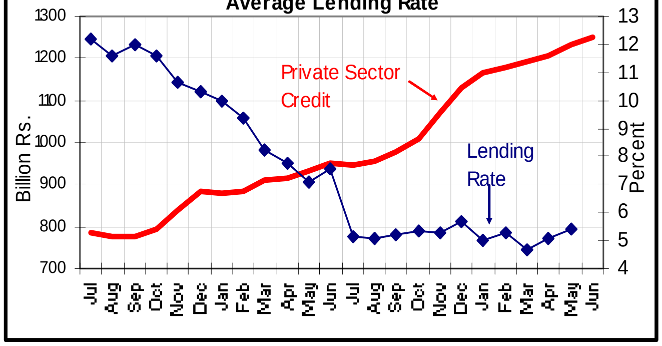


The consumer price inflation, which exceeded the annual inflation target of 4 percent towards the end of the last fiscal year is expected to behave normally during FY05 in view of rising interest rates, fast stabilizing food prices, relatively stable exchange rates, and modest inflationary expectations. However, consumer price inflation target for FY05 is set at 5 percent.

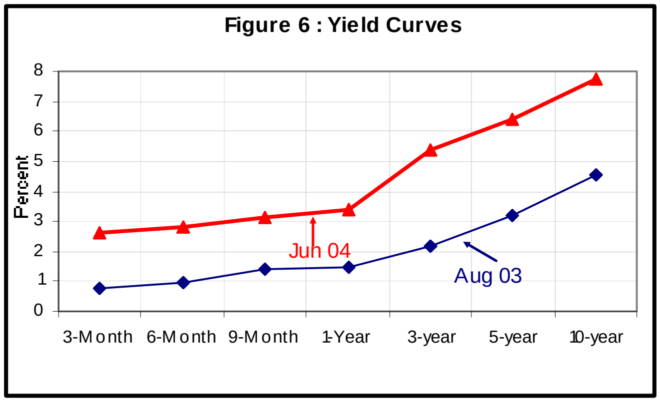
Interest Rate Trends

The easy monetary policy posture that the SBP had adopted for a couple of years paid off amply as various interest rates touched all-time lows with credit to the private sector reaching its historic highs (***Figure 5***). The low interest rate environment pushed the benchmark TBs rate as low as 1.27 percent in August 2003 and the average lending rate as low as 4.69 percent in March 2004. This led the private sector to raise its credit off-take as high as Rs.301.2 billion towards the end of the last fiscal year. This suggested the increased efficacy of the monetary policy transmission mechanism reinforced by the on-going banking and other economic reforms.

Figure 5 : Private Sector Credit Trend (Stock) and Average Lending Rate



The liquidity position of banks during FY04 was not as comfortable as it was during the last couple of years, on account of fast-dwindling net capital inflows from overseas. The inter-bank liquidity also shrunk because SBP injected Rs.52 billion on account of net foreign exchange purchases of $0.9 billion compared with the injection of Rs.263 billion (against the purchase of $4.55 billion in FY03) and record-high lending to the private sector. This eventually reversed the direction of interest rates as the cut-off yield on the benchmark 6-month TBs started to go up gradually and recorded a rise of 96 basis points to 2.23 percent during August-May FY04. Cut-off yields on other short- and long-term government papers also increased by varying magnitudes. The rising interest rates outlook is also reflected in the upward shift in the yield curve between August 2003 and June 2004 (***Figure 6***).



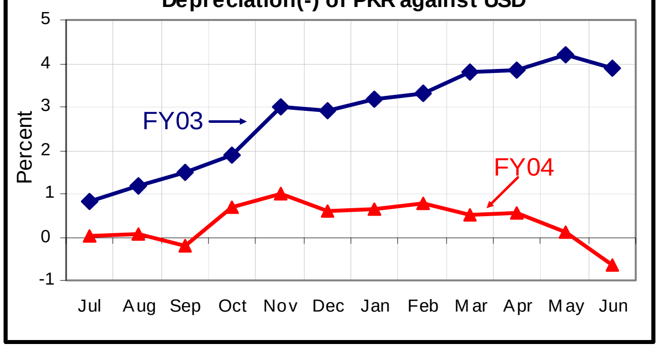
The present rising trend of interest rates is expected to continue for some time to come in view of decelerating foreign capital inflows, modest inflationary expectations, significant credit provision for the private sector (Rs.200 billion) during FY05 and also rising interest rates in the international financial markets. However, SBP will be quite vigilant and will make sure that the process of interest rate hikes is gradual and that it does not adversely impact the on-going growth momentum essential to achieve the growth target of 6.6 percent set for FY05.

External Sector Developments

One of the major external sector developments that took place last year was the export earnings, which crossed the $12 billion, mark for the first time. Export earnings increased by 9.9 percent to $12.3 billion against the target of $12.1 billion. The pace of net capital inflows, however, decelerated considerably during July-May FY04 and this trimmed the overall balance of payments (BOP) surplus by 70.7 percent to $1.2 billion over the same period of last year. The major impact came from the trade deficit (custom-based), which widened by 202.6 percent to $3.2 billion primarily on account of hefty import bill, which grew by 26.7 percent to $15.5 billion. Other developments that had significant adverse impact on the BOP position were the services account deficit, which rose by 70.3 percent to $3 billion, and the capital account deficit, which increased to $1.0 billion. Workers' remittances also dipped by 8.6 percent to $3.87 billion during FY04 but were higher than the targeted $3.6 billion. FDI inflows, however, rose by 19.0 percent to $949.4 million owing to the privatization of Habib Bank.

Exchange rates began to show the impact of fast-declining BOP surplus as rupee-dollar parity recorded a marginal depreciation of 0.6 percent during FY04 compared with an appreciation of 3.9 percent in FY03 and 6.8 percent in FY02 (***Figure 7***). SBP had to intervene frequently in the foreign exchange market starting from March 2004 to ensure the stability of exchange rates and also to stem the quick slide of rupee against dollar. SBP intermittently injected a sum of $461.8 million in the inter-bank market during March-June 2004. The gradual slide of rupee, however, improved the export competitiveness as the real effective exchange rate index showed a net real depreciation of 2.8 percent during FY04 compared with the depreciation of 1.6 percent recorded last year. The improved export competitiveness played its part as the actual export

Figure 7: Cumulative Appriciation(+) / Depreciation(-) of PKR against USD



earnings crossed the target of $12.1 billion for the first time in the history of the country.

Foreign exchange reserves which had accumulated by 66.7 percent to $10.72 billion in FY03 further increased by 15 percent to $12.33 billion despite decelerating net capital inflows and pre-payment of expensive debt.

In summary, Pakistan's economy is poised to do well during the current fiscal year in view of on-going growth momentum generated by all-time high credit off-take by the private sector during FY04. Interest rates are projected to rise gradually in response to liquidity constraints, rising interest rates in the international financial markets and inflationary expectations but their potential adverse impact on investment and growth will be minimized through better monetary and exchange rate management.

Table 1

Monetary Indicators

Targets and Actuals

Rs. in Million

SECTORS	Credit Plan		Cumulative Flows	
	FY05	FY04	01-Jul-03 to 26-Jun-04 P	01-Jul-02 to 28-Jun-03
1. GOVERNMENT SECTOR BORROWINGS (Net)	47,000	10,600	61,966	-64,781
i. Net Budgetary Borrowing	45,000	15,000	67,978	-43,997
ii. For Commodity Operations	5,000	-6,000	-8,622	-24,978
iii. Net effect of Zakat Fund/Privatization	-3,000	1,600	2,610	4,193
2. NON-GOVERNMENT SECTOR (A+B+C)	190,000	91,000	282,399	132,708
A. Credit to Private Sector (i + ii)	200,000	85,000	301,192	152,215
i. Commercial Banks			309,679	150,987
of which: (Export Finance)			28,361	-842
ii. Specilised Banks			-8,487	1,228
B. Credit to Public Sector Enterprises (PSEs)	-5,000	6,000	-12,468	-12,327
C. Other Financial Institutions (SBP credit to NBFIs)	-5,000		-6,324	-7,179
3. OTHER ITEMS (Net)	13,000	-1,600	-19,481	-71,934
4. NET DOMESTIC ASSETS (1+2+3)	250,000	100,000	324,884	-4,006
		(6.49%)	(21.11%)	(-0.26%)
5. NET FOREIGN ASSETS	30,000	130,000	41,537	310,453
6. MONETARY ASSETS (4+5)	280,000	230,000	366,422	306,447
	(11.40%)	(11.00%)	(17.63%)	(17.40%)

P = Provisional

Table 2
Monetary Indicators
Cumulative Growth (percent)

	01-Jul-03 to 26-Jun-04 [P]	01-Jul-02 to 28-Jun-03	FY03	FY02
Reserve Money	23.65	24.58	14.52	9.64
Money Supply	17.63	17.40	18.02	15.42
Currency in Circulation	18.45	15.44	14.01	15.54
Deposits	17.37	18.04	19.33	15.38
of Which:				
Demand Deposits	24.76	36.38	41.71	14.55
Time Deposits	12.93	17.29	16.40	19.10
RFCDs	13.10	-19.89	-19.89	2.14
Credit to Private Sector	31.74	18.95	20.88	6.88
Net Borrowing by Government	10.35	-9.57	-11.57	3.68
Net Domestic Assets (NDA)	21.11	-0.26	0.55	1.95
Net Foreign Assets (NFA)	7.70	134.56	133.91	727.53

P = Provisional