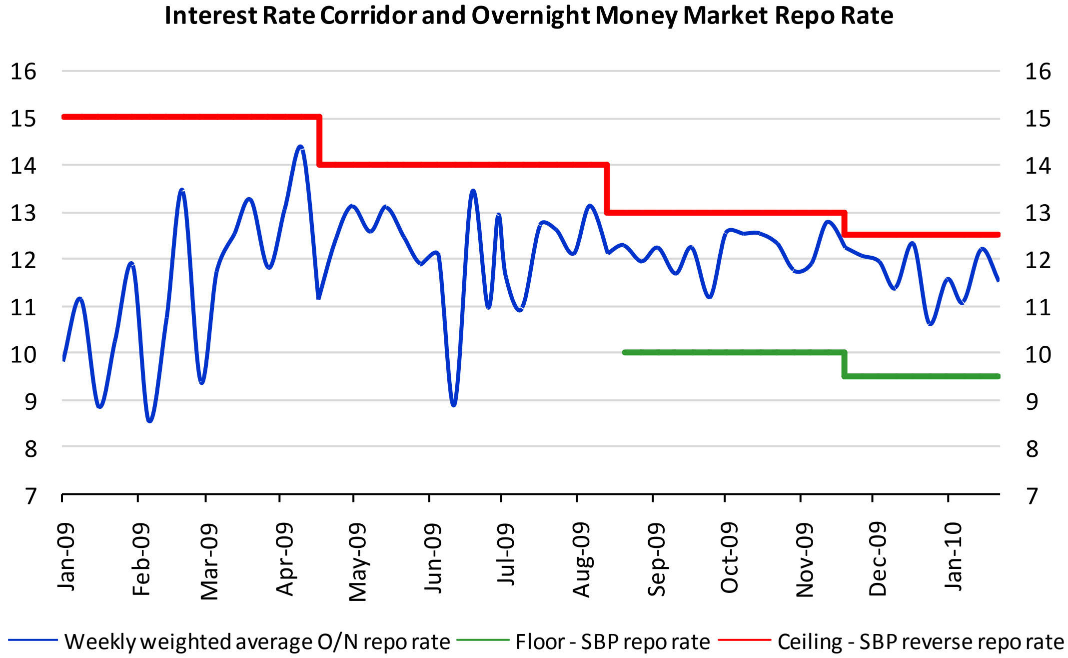
MONETARY POLICY STATEMENT

January 2010



STATE BANK OF PAKISTAN

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Executive Summary

Striking a balance between positive macroeconomic developments and ongoing economic challenges, in the first half of FY10, SBP eased the policy rate by a cumulative 150 basis points. In addition, SBP has introduced important reforms to strengthen operating framework for monetary policy. The most important of these was the introduction of a corridor structure for the overnight money market repo rate, which has helped in anchoring the short-term market rates. Increase in the frequency of monetary policy decisions, from four to six times a year, and formation of Monetary Policy Committee of the Central Board to include external members were also part of the efforts to improve monetary management. These measures, together with the quarterly limits on government borrowing from SBP and transfer of oil import payments to the market, are expected to enhance effectiveness and transparency of monetary policy objectives and operations over time.

Macroeconomic stability has proceeded apace, as evident in the considerable decline in average CPI inflation - the primary objective of monetary policy. For H1-FY10 it stands at 10.3 percent compared to 24.4 percent during H1-FY09. This decline is fairly broad based and visible in almost all the sub groups of CPI. Managed moderation of aggregate demand, and thus contraction in output gap, has clearly had a dampening effect on inflation. Simultaneously the number of commodities in the CPI basket with historical double-digit inflation has come down substantially.

The inflation outlook for full FY10, nevertheless, remains somewhat susceptible to fiscal consolidation efforts and to incipient international commodity price pressures. These include already announced and planned increases in electricity and gas prices. Added to these developments are the difficult-to-assess negative impact of law and order situation and power shortages on the productive capacity of the economy. These factors influence people's expectations of future price level trends and impart stubbornness to inflation. The likelihood of an uptick in inflation in the remaining months of FY10 thus seems quite plausible. Based upon these considerations, SBP expects the average CPI inflation for FY10 to remain between 11 and 12 percent.

Looking at the real economy, it may be observed that the agriculture sector is showing some improvement. For example, the cotton crop is higher than last year and its effects are permeating to other sectors as well, particularly the textiles and its exports. Modest but consistent recovery in Large-scale Manufacturing (LSM) is also encouraging. It grew by 0.7 percent in November 2009 compared to a low of negative 20 percent in March 2009. Pick up in private sector credit and increase in demand for exports by our trading partners, in the wake of better than expected global economic recovery, could further support domestic economic activity.

Thus, for FY10, overall real GDP growth is expected to be 3 percent compared to a 2 percent growth recorded in FY09. Key factors holding back real GDP growth forecasts are persistent power sector problems and a very challenging security environment. Water shortages may also affect agricultural productivity.

Progress in the external sector is also encouraging. The external current account deficit has declined to $2 billion during H1-FY10 from $7.8 billion in H1-FY09. The decline in imports mainly reflects the moderation in aggregate demand and benefits of lower interational commodity prices. The fall in exports, on the other hand, has been restrained by a gradual global economic recovery, availability of exportable surplus due to better cotton crop, and higher international prices of some exportable commodities. The sustained flow of workers' remittances, $4.5 billion during H1-FY10 has further contributed towards the reduction of the external current account deficit. Notably, this improvement is despite the delay in foreign reimbursements and shortfall in grants from 'Friends of Democratic Pakistan' (FoDP).

Revival of growth in major industrial and emerging economies, however, may push up international commodity prices, which are already rising. Similarly, recovery in the domestic economy may also increase demand for imports. Incorporating these factors, exports are expected to reach close to $19 billion, a reduction of 1 percent by the end of current fiscal year compared to a fall of 6.4 percent in FY09. Import bill, on the other hand, is projected to be around $30.7 billion for FY10; a contraction of 3.2 percent compared to a decline of 10.3 percent in FY09. This trade outlook combined with projections of other components, such as current transfers, leads to a projected external current account deficit of 3.4 percent of GDP for FY10.

Helped by contraction in the external current account deficit, the overall balance of payments has posted a surplus of $1.4 billion during H1-FY10 compared to a deficit of $4.8 billion in H1-FY09. A modest increase in foreign portfolio investment, SDR allocation, and SBA flows from IMF compensated the decline in foreign direct investment. Consequently, SBP's foreign exchange reserves have reached to $10.6 billion as on 27th January 2010 and are projected to be close to $15 billion by the end of FY10.

Sustained improvement in the balance of payment position would depend significantly on the timing and scale of projected foreign inflows, especially the official flows pledged by the FoDP. The actual disbursements are slightly behind schedule and thus the original $2.5 billion projected disbursements for FY10 have been revised to $1.5 billion.

On the fiscal front, government continued its efforts of rationalizing expenditures, such as phasing out subsidies and adjustment of administered energy prices. It has also taken organizational and other measures to bolster tax administration and revenue collection. Showing fiscal discipline, government has kept its borrowing from SBP within agreed limits and adhered to announced targets in T-bill auctions. Increase in borrowing from non-bank sources has also helped the government in financing the fiscal deficit.

On the other hand, shortfall or delay in projected foreign inflows and non-tax revenues on account of foreign reimbursements, could have implications for the management of fiscal deficit target at 4.9 percent of GDP or Rs740 billion. To meet the stated deficit target, Ministry of Finance (MoF) would have to increase its borrowings from the banking system and non-bank sources. This could tighten market liquidity and strain monetary management of SBP. Government has already experienced a slippage of 0.3 percent in fiscal deficit target of Q1-FY10. Given the significant pressures on expenditures, keeping the full fiscal year deficit at the targeted level seems quite difficult. The absence of budgeted external financing will also create challenges in release of ear-marked development expenditures.

It is not only the budget aspect of fiscal position that seems difficult but substantial amount of outstanding credit for commodity operations of the government, Rs316 billion as on 23rd January 2010, and the coming wheat financing season are posing risks to the monetary forecasts. Continued flow of credit to Public Sector Enterprises (PSEs) and lingering inter-agency circular debt is only adding to the pressure on the available funding sources of the banking system. Government borrowings over and above maturities also strained market liquidity. Moreover, slowdown in NFA accumulation since the beginning of Q2-FY10 limited the availability of liquidity in the system.

A substantial improvement in total deposits of the banking system, an increase of Rs265 billion in Q2-FY10 compared to a contraction of Rs71 billion in Q1-FY10, has supported rise in credit to the private sector. Recovering from a contraction of Rs75 billion in Q1-FY10, private sector credit increased by Rs199 billion during Q2-FY10. These are very positive trends and, given the current economic situation, every effort should be made to ensure their sustained improvement. In this context, the role of a clear strategy on commodity financing that brings down the outstanding stock positions from very high to more usual levels should not be discounted. An early and complete resolution of the circular debt would also be helpful.

Against this backdrop, SBP has effectively managed liquidity to support smooth functioning of the market and ensured consistency with the monetary policy stance. As a consequence, volatility in the interbank overnight money market repo rate – the operational target of SBP – has come down substantially and market interest rates have gradually eased in line with reduction in the policy rate.

Integrating the projections of balance of payments, fiscal accounts, and credit extension to various sectors and their interrelationships with inflation and real GDP projections, the equilibrium M2 growth is forecasted to be around 14.5 percent for FY10.

In conclusion, it can be stated with confidence that much has been gained on the macroeconomic stability front despite a very challenging economic and security environment. A lot of difficult decisions and adjustments have been introduced to tackle a host of structural constraints. However, much work remains to be done to consolidate this stability and set the stage for sustainable recovery. After carefully evaluating improvements in numerous macroeconomic variables and sifting through their underlying dynamics and associated uncertainties, SBP has decided to keep the policy rate unchanged at 12.5 percent.

A. Economic Environment and SBP's Policy Response: H1-FY10

Improvements in key macroeconomic indicators were significant despite some uncertainties…

1. The improvement in macroeconomic variables, beginning in the second half of FY09, strengthened further during FY10. The YoY headline inflation, maintaining its downtrend, fell to a single digit level whereas Large-scale Manufacturing (LSM) output grew by 5.6 percent in October 2009. The decline in imports due to moderation in aggregate demand, and an increase in workers' remittances resulted in a significant improvement in the external current account balance. Supported by foreign flows from the IMF under the Stand-By Arrangement (SBA), SBP's foreign exchange reserves also increased considerably. This helped in improving liquidity and instilling stability in the domestic money and foreign exchange markets. Another encouraging development was the revival of private sector credit along with a rise in total deposits of the banking system since the beginning of Q2-FY10.

2. Containment of government borrowing from SBP within quarterly limits and broad adherence to the pre-announced T-bill auction targets reflects improved fiscal discipline. These overall improvements helped SBP in achieving its end quarter targets for Net Domestic Assets (NDA) and Net Foreign Assets (NFA) stipulated under the SBA.

3. The prospects of sustained improvement in these macroeconomic variables, however, were clouded by uncertainties in the domestic and global economic environment. The sources of uncertainty holding back economic growth and an even more pronounced decline in inflation primarily emanated from persisting electricity and gas shortages and a very challenging security environment. The upward revisions in power tariffs, partial settlement of circular debt, and timing of official foreign inflows also played their part in diluting the optimism vis-à-vis macroeconomic stability.

4. In particular, fiscal management became increasingly challenging. Not only were there pressures on the expenditure side, but financing the targeted deficit also seemed difficult. Nonetheless, the government continued its fiscal consolidation efforts such as phasing out subsidies and adjustment of administered energy prices. These, in turn, lead to expectations of higher inflation resulting in volatility and persistence in monthly inflation figures.

5. Even the improving prospects of global economic recovery had both positive and negative implications for Pakistan's economy. The positives encompassed better prospects for exports and foreign investment, while negatives included resurgence in international commodity prices, particularly oil prices, with rising risks for increase in the import bill and domestic inflation.

SBP, therefore, pursued a cautious monetary policy stance by gradually lowering the policy rate…

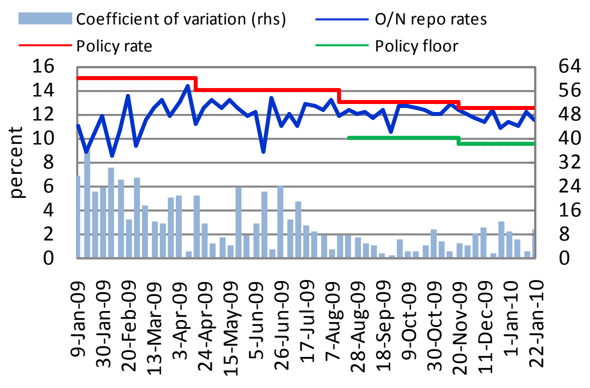
6. In this backdrop, SBP eased the policy rate by a cumulative 150 bps during H1-FY10; 100 bps in August and 50 bps in November 2009. The policy rate was kept unchanged in the September 2009 monetary policy review. To contain excessive volatility in the overnight money market repo rate and strengthen effectiveness of monetary policy, SBP introduced an interest rate corridor. It also constituted a Monetary Policy Committee with external experts as members and increased the frequency of monetary policy reviews from four to six times a year. These reforms were aimed at addressing rapidly evolving economic conditions and ensuring stability in the conduct of interest rate corridor framework.

B. Recent Economic Developments and Outlook

New liquidity management framework effectively reduced volatility in the overnight money market repo rate…

7. Since the introduction of interest rate corridor in August 2009, volatility in the overnight money market repo rate has declined considerably. The coefficient of variation of the overnight money market repo rate has fallen to 6.5 since 17th August 2009, from 19.1 during 1st January to 15th August 2009. However, the overnight money market repo rate has mostly remained within the upper half of the corridor (see **Figure 1**).[1] This reflects relatively tight liquidity

Figure 1: Policy and Weekly WA Overnight Repo Rates



[1] On average, the spread of the overnight money market repo rate from the policy rate (i.e. SBP reverse repo rate) narrowed down to only 87 bps since the introduction of the corridor compared to an average of 271 bps during 1st January to 15th August 2009.

conditions in Q2-FY10 compared to Q1-FY10.

SBP increased liquidity injections as market conditions gradually tightened…

8. The main reasons for the strained market liquidity conditions in Q2-FY10 were decline in the NFA of the banking system and substantial improvement in private sector credit (see **Table 1**). The NFA of the banking system in Q1-FY10 had increased by Rs34 billion (excluding special SDR allocation) mainly due to budgetary support of $745 million (approximately Rs62 billion) from the IMF. In Q2-FY10, however, relatively lower budgetary support of $374 million (around Rs31 billion) and other foreign inflows resulted in a net contraction of Rs30 billion in foreign assets. On the other hand, in line with the modest recovery in real activity, private sector credit increased by Rs199 billion in Q2-FY10 compared to a contraction of Rs75 billion in Q1-FY10, adding pressure on available market liquidity.

Table 1: Liquidity Conditions

billion rupees, unless stated otherwise

	Q1-FY10	Q2-FY10
NFA of the banking system	141.1	-30.1
NFA excluding SDR allocation	34.0	-30.1
Private sector credit	-74.6	199.2
Total deposits	-70.8	265.4
T-bill auctions (net of maturities)	148.3	66.1
Net OMO injections		
Outstanding amount (last week of quarter)	*80.2*	*110.2*
Average outstanding amount	*23.6*	*72.6*
Excess cash (last week of quarter)	9.0	7.3
Overnight money market repo rate (%)		
Last week of quarter	*10.5*	*11.4*
Average of daily rates	*12.2*	*12.0*

Source: SBP

9. To some extent, market liquidity conditions in Q2-FY10 were helped by a significant increase in total banking system deposits. However, public sector's borrowings from the banking system continued to constrict liquidity in the system, not least because of government borrowings through T-bills to meet its budgetary requirements. Less than expected retirement of commodity financing and continued borrowings by the Public Sector Enterprises (PSEs) also strained market liquidity.

10. Given these trends in private and public sector credit, together with a PIB auction target of Rs30 billion, market liquidity conditions are likely to remain relatively tight in the remaining part of the fiscal year. Thus, retirement of commodity financing, complete resolution of circular debt, and realization of projected foreign inflows will play a crucial role in improving market liquidity conditions.

11. To manage liquidity conditions and align the money market repo rate with the easing monetary policy stance, SBP made heavy injections into the banking system

through Open Market Operations (OMOs). As shown in **Table 1**, consistent with changing macroeconomic conditions, the extent of liquidity injections increased considerably in Q2-FY10. On average, during Q2-FY10, the outstanding amount of net OMO injections stood at Rs72.6 billion compared to Rs23.6 billion in Q1-FY10. As a result, the daily overnight money market repo rate has declined to an average of 11.5 percent since the last monetary policy decision of 24th November 2009, from an average level of 12.2 percent during 17th August to 24th November 2009.

Despite tight liquidity conditions, market interest rates and their volatility have declined …

12. Moreover, reduced volatility in the overnight money market repo rate is being transmitted to longer tenor market interest rates. As shown in **Table 2**, the secondary market repo rates of 3-month and higher tenors have stabilized considerably since the introduction of the corridor compared to the previous period. Similarly, the rates on various tenors have also responded to easing of monetary policy and gradual reduction in overnight money market repo rate.

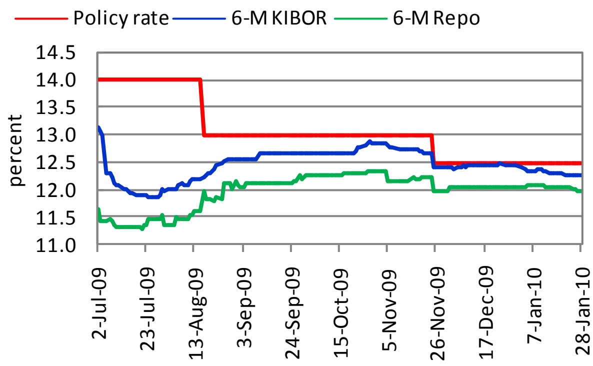
Table 2: Volatility in Market Interest Rates

Tenor	Post corridor (17th Aug 2009-22nd Jan 2010)		Pre corridor (1st Jan-15th Aug 2009)	
	Avg.	CoV	Avg.	CoV
Overnight repo rate	12.0	6.5	11.7	19.1
Secondary market rates				
3 month	12.1	1.1	12.4	6.5
6 month	12.1	1.0	12.5	7.2
12 month	12.2	1.0	12.7	7.6
3 year	12.4	1.1	12.6	8.8
5 year	12.5	1.0	12.7	9.6
10 year	12.5	1.1	13.0	11.1
20 year	13.2	0.9	14.3	9.5

Avg.: Average; CoV: Coefficient of variation
Source: SBP

13. Despite gradual tightening of the liquidity conditions, other market interest rates, such as KIBOR, have also declined. For example, the 6-month KIBOR has decreased by 40 bps, up to 28th January 2010, against a reduction of 50 bps in the policy rate effective from 25th November 2009 (see **Figure 2**). This decline in KIBOR partly reflects the changing market expectations due to lower than expected fall in inflation and uncertainties regarding the fiscal position. Thus the likelihood of a further decline in market interest rates is contingent upon inflation outlook and prospects of financing mix of the budget deficit.

Figure 2: Policy and Market Interest Rates



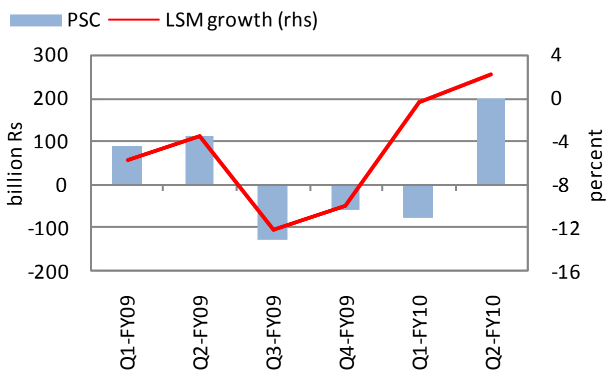
14. The decline in the weighted average lending rates (WALR) has also been smaller; 66 bps compared to 250 bps reduction in the policy rate since April 2009. One of the reasons for this slower pace of decline in WALR is the issuance of high priced government-guaranteed Term Finance Certificates (TFCs) by the power sector. The first issuance in March 2009 was priced at KIBOR plus 1.75 percent, while the second issuance in September 2009 was at KIBOR plus 2 percent. This has adversely affected the lending rates charged by the banks to other relatively more risky corporate borrowers.

15. Lack of alternative borrowing avenues for the corporate sector, other than banks, also explain this downward rigidity in lending rates. The launch of the electronic bond trading platform (E-Bond) by SBP on 11th January 2010 is an important initial step in facilitating the development of the corporate debt market. The development of an active, transparent, and liquid secondary market would encourage the corporate sector in tapping financial resources directly and reducing their reliance on bank borrowings, leading to a gradual reduction in banks' lending rates.

Softening of market rates is supporting pick up in private sector credit…

16. In congruence with reviving economic activity and supported by declining interest rates, credit to the private sector picked up substantially in Q2-FY10, expanding by Rs199 billion after a contraction of Rs75 billion in the previous quarter (see **Figure 3**). Most of this expansion was for working capital purposes and, encouragingly, broad-based. Manufacturing, commerce and trade, and electricity, gas and water sectors were the major recipients in this regard (see **Table 3**). This credit off-take would have a positive impact on the growth of these sectors in coming months. Availability of energy, however, remains a crucial missing element in the likely sustainability of these trends.

Figure 3: Private Sector Credit and LSM Growth (quarterly)



17. Banks' apetitite for lending to the private sector has also improved gradually due to a slowdown in accumulation of Non-performing Loans (NPLs) since March

2009. Although the outstanding stock of NPLs has increased to Rs422 billion by the end of September 2009, the increment of Rs18 and Rs24 billion during Q4-FY09 and Q1-FY10 were much smaller compared to an increase of Rs65 billion during Q3-FY09 (see **Figure 4**). As the real economic activity gains momentum, the likelihood of a decline in NPLs and expansion in private sector credit increases further in the coming quarters.

Table 3: Private Sector Credit
billion rupees

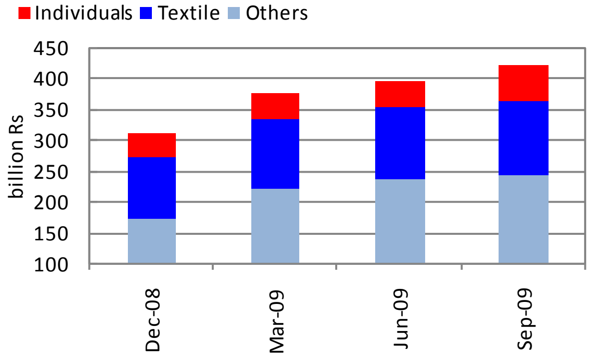
	Flows during		
	H1-FY10	**H1-FY09**	**FY09**
Total credit to private sector	**124.6**	**203.1**	**18.9**
1. Loans to private sector businesses	**124.7**	**194.1**	**49.2**
By type			
Working capital	81.3	65.8	-112.7
of which: Export finance	23.5	4.1	15.4
Import finance	-3.9	-5.4	-7.6
Fixed investment	43.4	128.2	161.8
By sectors: *of which*			
Agriculture	6.1	11.0	3.3
Manufacturing	85.3	130.5	27.4
of which: Textiles	52.2	26.3	-33.4
Electricity, gas and water	27.3	36.6	43.4
Construction	-1.6	-1.4	-8.7
Commerce and trade	5.9	8.8	-16.2
2. Personal	**-24.3**	**-27.2**	**-54.8**
of which: Consumer financing	-28.4	-34.3	-62.5
3. Investment in security & shares	**2.4**	-0.6	3.2
4. Others	**21.8**	**36.9**	**21.3**

Source: SBP

Less than expected retirement of commodity financing and continued borrowing by the Public Sector Enterprises is reducing space for private sector credit…

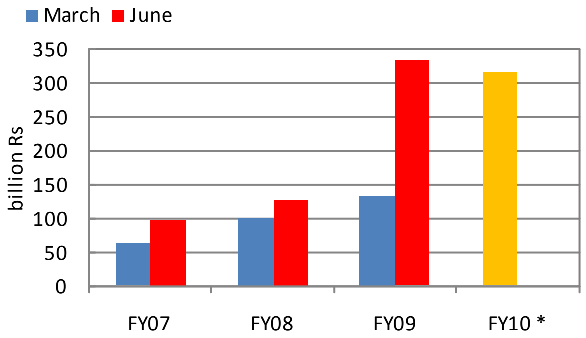
18. However, substantial outstanding stock of credit availed by the government for commodity operations and the significantly lower pace of its retirement is a drag on banks' capacity to lend to the private sector. By end-June 2009, the outstanding stock had already reached Rs336 billion, of which Rs277 billion was due to wheat procurement alone (see **Figure 5**). Compared to an average end-June stock of Rs120 billion over the last 10 fiscal years, this is abnormally high and must come down to create room for other sectors, in particular the private sector.

Figure 4: Stock of Banks' Non-performing Loans



19. Contrary to expectations, only Rs20 billion has been retired in the current fiscal year up to 23rd January 2010. Thus, it is important that the government devises a clear strategy on its commodity financing and bring down

Figure 5: Commodity Financing (end period stocks)

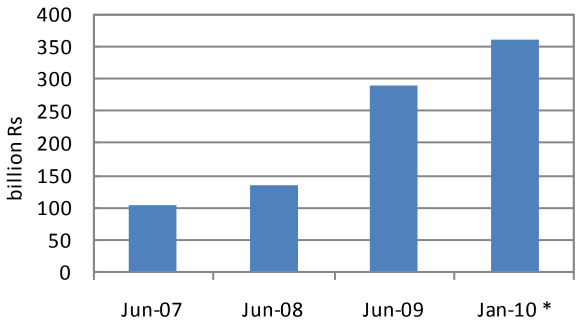


* Up to 23rd January 2010

the outstanding stock positions to normal levels before the next wheat financing season begins in Q4-FY10.

20. Similarly, continuation of credit utilization by the PSEs is also limiting banks' capacity to lend to the private sector. For example, the outstanding stock of PSEs credit stood at Rs137 billion at the end of June 2008. By 23rd January 2010, it has increased by approximately three times, reaching Rs363 billion (see **Figure 6**). In particular, credit to power sector entities has risen sharply after the issuance of TFCs worth Rs80 billion in March 2009 and another worth Rs85 billion in September 2009 for the partial settlement of circualr debt. Although these issuance lead to an immediate net contraction in the private sector, it relieved pressure on banks' balance sheets and created room for further lending.

Figure 6: Credit to PSEs (end period stocks)



* Up to 23rd January 2010

21. Thus, a complete resolution of the circular debt issue would be extremely helpful in many respects. Most importantly, it will alleviate constraints impeding the production of electricity in the country thus paving the way for sustainable economic recovery.

Government borrowing for budgetary support has also contributed in expansion of Net Domestic Assets…

22. In addition to PSEs and government's commodity operations, a significant amount of credit was also extended to the government for its budgetary finance. Against the pre-announced targets of Rs325 billion for Q1-FY10 and Rs145 billion for Q2-FY10, the government raised Rs333 billion and Rs148 billion through its T-bill auctions. This includes maturities of Rs181 billion and Rs75 billion (see **Table 4**). Thus, the total amount realized by the government through T-bill auctions, net of

Table 4: T-bill Auction Summary

billion rupees; percent

	3-Month	6-Month	12-Month	Total
Q1-FY10				
Realized amount	28.2	48.7	256.3	333.2
Cut-off Yield	12.5	12.6	12.5	-
Q2-FY10				
Realized amount	35.7	45.2	66.8	147.7
Cut-off Yield	12.06	12.10	12.09	-
Q3-FY10*				
Realized amount	4.60	38.52	45.45	88.6
Cut-off Yield	11.87	11.90	12.02	-

* Up to 27th January 2010

Notes: (1) The total realized amounts include both competitive and non-competitive bids.

(2) The cut-off yields correspond to the last auction held in the quarter.

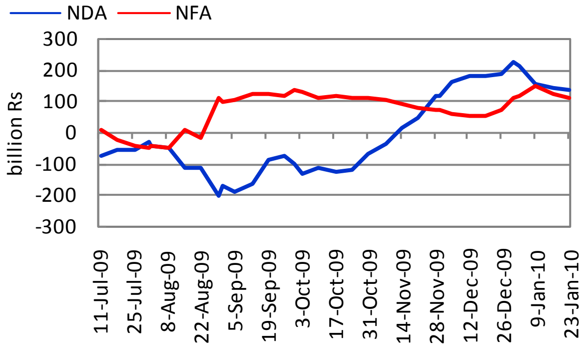
maturities, was Rs225 billion during H1-FY10. Despite these substatial borrowing requirements of the government, the T-bill rates, set by the Ministry of Finance, have fallen consistently.

23. The announced target for Q3-FY10 is Rs430 billion against maturities of Rs402 billion. In the two auctions held so far in Q3-FY10, government has realized Rs89 billion. Given the substantial remaining amount and a PIB auction target of Rs30 billion for H2-FY10, the pressure on banking system resources will remain considerable. Continuation of increases in total banking deposits, in line with Q2 trends, along with realization of projected foreign inflows would be helpful in improving funding sources of banks and creating fresh money in the system.

24. After taking account of other parameters, such as government deposits, the net budgetary borrowing from the schedule banks was Rs 181 billion during 1st July – 23rd January 2010. An ecouraging factor is that government borrowings from SBP remained within the quarterly limits stipulated by the IMF’s SBA, though it did borrow higher than the limit during the quarters. The stock of government borrowing from SBP (on cash basis) at end-December 2009, Rs1066 billion, remained well within the target of Rs1130 billion. Similarly, the target of NDA was also met successfully.

25. With the pick up in private sector credit and continued borrowings by the government and PSEs, overall NDA of the banking system have accelerated sharply since November 2009 (see **Figure 7**). Apart from the seasonal retirement in private sector credit, the earlier contraction in NDA was primarily due to the accounting adjustment of special SDR allocation by the IMF in August 2009.

Figure 7: NDA and NFA of the Banking System (cumulative flows since end June)



Foreign inflows have increased the Net Foreign Assets and thus broad money expansion…

26. While there is no overall impact on broad money expansion, the SDR allocation did increase the NFA of the banking system quite sharply. The disbursement of $745 million or Rs62 billion in August by IMF to the government for

budgetary support also caused an increase in the NFA of the banking system. Since the beginning of Q2-FY10, however, NFA accumulation has been broadly stable while NDA continues to increase. Incorporating the expected private sector credit growth together with projections of other components of NDA and assuming the realization of expected foreign inflows, the overall monetary expansion is projected to register a growth of 14.5 percent for FY10 (see **Table 5**).

Table 5: Monetary Aggregates
billion rupees

	June 2009 Stocks	Flows during		
		Jul 1-Jan 24, FY09	Jul 1-Jan 23, FY10	FY10 Proj.
NDA	4619.9	328.6	138.4	552
of which				
Net budgetary support	1681.0	257.2	167.2	-
Commodity operations	336.2	8.8	-19.8	-
Private sector credit	2906.9	165.1	113.3	-
Credit to PSEs	266.3	60.4	72.8	-
NFA	517.3	-297.3	114.6	193
Money supply (M2)	5137.2	31.3	253.0	745
growth		*0.7*	*4.9*	*14.5*
Memorandum items				
Net budgetary support				
from SBP	1164.6	254.5	-13.9	-
from Sch. banks	516.4	2.7	181.1	-
Currency in circulation	1152.2	158.3	164.4	-
Total deposits	3980.4	-127.1	86.9	-
Reserve money	1507.6	-24.1	154.8	-
growth		*-1.6*	*10.3*	*16.0*

Source: SBP

Despite consolidation efforts, fiscal position remains under pressure…

27. Apart from banking system borrowings, the government also managed to raise Rs108 billion during Q1-FY10 from the non-bank sources to finance its budget defict. This compensated to some extent relatively lower borrowings from external sources. Out of Rs77 billion external financing, Rs62 billion were on account of IMF flows for budgetary support. However, due to a very challenging security environment, fiscal expenditures exceeded their earlier estimates. Together with lower than anticipated tax revenues, the total budget deficit for Q1-FY10 turned out to be Rs224 billion (see **Table 6**). This represents a slippage of 0.3 percent of GDP from the quarterly target of Rs194 billion.

Table 6: Summary of Consolidated Fiscal Operations
billion rupees

	FY10 * Revised BE	FY10 Q1	FY10 Proj.**
Total revenue	**2156**	**427**	**2187**
Tax	1593	299	1600
of which FBR tax revenue	*1380*	*263*	*1396*
Non-tax	563	128	588
Total expenditure	**2877**	**651**	**2927**
Current	2261	521	2403
Development@	616	116	510
Unidentified expenditure	0	14	14
Budget Deficit	**-721**	**-224**	**-740**
Financing	**721**	**224**	**740**
External	377	77	301
Domestic	344	147	415
Non-bank	246	108	240
Bank	97	39	175
Privatization	0	0	23

* Revised budget estimates that show consolidated position of federal and provincial budget.
** Projections prepared by MOF and agreed with IMF in December, 2009 at the time of third SBA review.
@ This includes net lending to PSEs

28. The revised consolidated fiscal position, as agreed with the IMF in December 2009, reveals two main changes: development expenditures have been revised downward and financing from domestic sources has been increased. The former may hurt the economic growth prospects while the latter has implications for domestic liquidity. Nonetheless, the government has continued efforts for rationalizing efforts such as phasing out subsidies and adjustments in administered prices. It has also taken other measures to bolster tax administration and revenue collection. Given the significant pressures on expenditures, meeting the budget deficit target of 4.9 percent of GDP (or Rs740 billion) for FY10 seems quite difficult.[2]

29. A key challenge in meeting this target will be the realization of projected tax collections of Federal Board of Revenue (FBR) and timely foreign reimbursements. During the first five months of the current fiscal year, FBR has collected taxes of Rs460 billion against the full year target of Rs1396 billion. On the financing side, importance of external sources of budgetary support, such as flows from multilaterals and Friends of Democratic Pakistan (FoDP), cannot be overemphasized. The absence of budgeted external financing will create challenges in release of earmarked development expenditures.

Helped by contraction in the external current account deficit, the, overall balance of payments has improved…

30. Despite the shortfall in foreign flows, a significant reduction in the external current account deficit to $2 billion during H1-FY10 lead to an overall surplus of $1.4 billion in the balance of payments (see **Table 7**). A broad-based decline in imports, supported by strong workers' remittances, explains the considerable contraction in the external current account deficit. Notably, this improvement is despite the delay in foreign reimbursements and shortfall in grants from FoDP.

Table 7: Summary of Balance of Payments

billion US$

		Jul-Dec		FY10
	FY09	**FY09**	**FY10**	**Proj.**
i. Current account	**-9.3**	**-7.8**	**-2.0**	**-6.1**
Trade balance	-12.6	-8.2	-5.8	-
Services net	-3.4	-2.3	-1.6	-
Income net	-4.4	-2.4	-1.5	-
Current transfers	11.2	5.1	6.8	-
Remittances	7.8	3.6	4.5	-
ii. Capital and Financial A/c	**6.1**	**3.1**	**3.8**	
Of which:				
Direct investment	3.7	2.4	1.0	-
Portfolio investment	-1.1	-0.2	0.3	-
Long term loans	1.5	0.4	1.8	-
iii. Errors and omissions	**0.2**	**0.0**	**-0.4**	**-**
Overall balance	**-3.1**	**-4.8**	**1.4**	-

Source: SBP

[2] The difference between the revised budget estimates of Rs721 billion and latest projections of Rs740 billion is due to minor changes in the projections of nominal GDP.

31. The decline in imports mainly reflects the moderation in aggregate demand and the benefits of relatively lower interational commodity prices. The decline in exports, on the other hand, has been restrained by a gradual global economic recovery, availability of exportable surplus due to better cotton crop, and higher international prices of some exportable commodities. This has helped in limiting the trade balance to $5.7 billion during H1-FY10 (see **Table 8**).

Table 8: Exports and Imports (BoP)
billion US$

	FY09	Jul-Dec FY09	Jul-Dec FY10	Growth in H1-FY10	Growth in FY10 Proj.
Trade Balance	**-12.6**	**-8.2**	**-5.7**		
Total Imports	**31.7**	**18.3**	**15.1**	**-17.6**	**-3.2**
Food	3.6	2.0	1.4	-32.5	-
Petroleum	10	6.8	5.1	-24.4	-
Others	18.1	9.5	8.6	-9.6	-
Total Exports	**19.1**	**10.1**	**9.3**	**-7.6**	**-1.0**
Food	2.8	1.4	1.4	-1.2	-
Textile	9.8	5.2	5.0	-4.4	-
Others	6.6	3.4	2.9	-15.1	-

Source: SBP

32. The current trends in global output growth and price changes are indicating better than expected economic recovery and are reflected in improved forecasts of key economic indicators. Global output is now expected to grow over 3 percent with relatively higher contribution from Asian economies. Similarly, international commodity prices are anticipated to be higher in 2010, indicating renewed global demand pressures. Trade volumes are also projected to post positive growth in the current year (see **Table 9**).

Table 9: Global Economic Outlook*

Outlook	**2009 Estimates WB**	**2009 Estimates IMF**	**2010 Forecast WB**	**2010 Forecast IMF**
World GDP	-2.2	-0.8	2.7	3.9
USA	*-2.5*	*-2.5*	*2.5*	*2.7*
EU	*-3.9*	*-3.9*	*1.0*	*1.0*
China	*8.4*	*8.7*	*9.0*	*10.0*
Consumer Prices				-
Advance economies	-	*0.1*	-	*1.3*
Emerging and developing economies	-	*5.2*	-	*6.2*
Oil prices (US$/bbl)**	61.8	62.0	76.0	76.0
World Trade Volumes	-14.4	-12.3	4.3	5.8

* Estimation and forecast made by World Bank and IMF in January 2010
**Simple average of Dubai, Brent, and West Texas Intermediate.
Sources: International Monetary Fund (IMF), World Bank (WB).

33. While global output growth and rising trade volumes would help Paksitan's economy, rise in commodity prices could have a negative impact. The rise in energy as well as metal prices are significant and any acceleration in them can potentially result in a more than anticipated increase in the import bill and domestic inflation. Thus, the gains emanating from the earlier sharp decline in imports may fade away during the remaining months of the current fiscal year.

34. The overall decline in imports during FY10 is, therefore, anticipated to be 3.2 percent compared to a decline of 10.3 percent during FY09. Similarly, better than expected global economic recovery could increase the demand for our exports as

well. With this anticipated pick up, a decline of 1 percent in exports is projected for FY10, which is a relative improvement over FY09 when exports registered a decline of 6.4 percent.

35. This trade outlook combined with projections of other components, such as current transfers, leads to a projected external current account deficit of 3.4 percent of GDP for FY10. This represents significant improvement over last year's deficit of 5.6 percent and earlier projections of close to 5 percent. However, this improvement should be interpreted carefully. The reason FY10 projections look so benign is because of much smaller deficits in the first two quarters. Even prior to this, the external current account deficit shrank drastically in Q3-FY09 to around $0.5 billion after crossing $4 billion in Q1-FY09. Since then, it has been gradually increasing in every subsequent quarter and is expected to follow this trajectory in the remaining two quarters of FY10. Thus, a forward looking assessment indicates incremental increases during H2-FY10.

36. The capital and financial account balance also improved significantly during H1-FY10 due to a modest increase in foreign portfolio investment, SDR allocation and SBA flows from IMF, despite a fall in the foreign direct investment. Though the higher financial inflows appear impressive, one needs to be cautious in interpreting this improvement. Out of a total financial inflows of $3.8 billion, $1.1 billion consist of IMF credit for budgetary support, part of which is required to be retired in Q4-FY10. Thus, not only are one-third of the financial inflows debt creating, but they also indicate potential pressure on country's resources for debt repayments in the coming years.

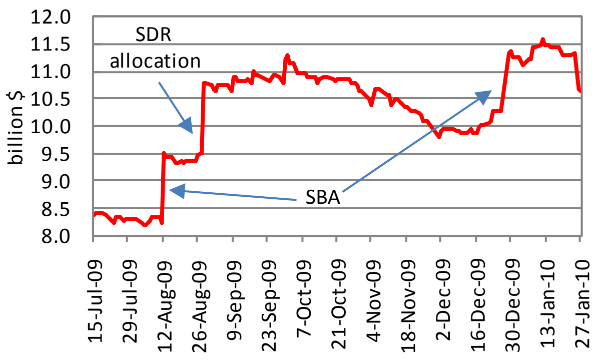
37. Most of the debt sustainability indicators are showing deterioration since FY08. For example, debt servicing to exports of goods and services ratio has increased from 8.6 percent in FY08 to 13.2 percent in FY09. With a decline in exports and rise in debt servicing for FY10, this ratio could deteriorate further. However, better global growth prospects complemented with improved domestic economy could help in tapping international capital markets, enabling Pakistan to diversify its external borrowing sources. The better image of the economy is already evident in improved credit ratings and a decline in risk premium on Pakistan's sovereign bonds from 11.0 percent in June 2009 to 6.4 pecent in November 2009.

38. Sustained improvement in the balance of payment position would depend significantly on the timing and scale of projected foreign inflows, specially the

especially the official flows pledged by the FoDP. The actual disbursements are slightly behind schedule and thus the original $2.5 billion projected disbursements for FY10, have been revised to $1.5 billion. Thus, despite improvements in the external current account, the external sector outlook seems uncertain.

39. Nonetheless, smaller external current account deficit together with foreign exchange provided by the IMF under SBA and an additional one-time allocation of SDRs has helped in improving the foreign exchange reserves of SBP (see **Figure 8**). These are projected to reach close to $15 billion by the end of FY10.

Figure 8: SBP's Foreign Exchange Reserves



Foreign exchange market is broadly stable due to improved balance of payments and buildup of foreign exchange reserves…

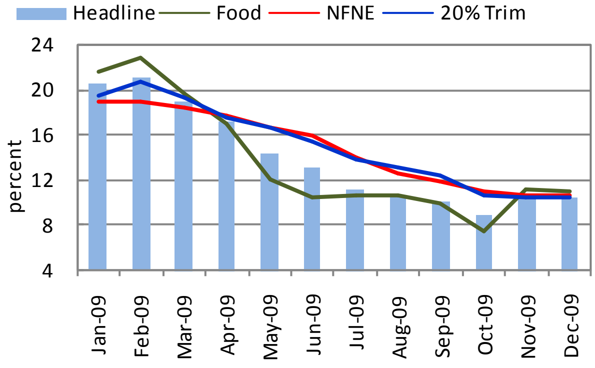
40. In line with overall improvement in macroeconomic fundamentals the foreign exchange market has remained broadly stable with rupee witnessing a marginal depreciation of 3.7 percent against the US dollar during 1st July 2009 – 28th January 2010. This relative stability in rupee has emanated from the improved flows in the interbank foreign exchange market. In fact, during December 2009, market conditions helped SBP in completing the transfer of oil payments to the market earlier than planned. Though this transfer may have caused some volatility the interbank market continues to operate smoothly.

41. It is important to highlight that it is normal for the exchange rate to exhibit healthy volatility in both directions as is the case with other international currencies. Flexibility in the exchange rate is consistent with SBP's new corridor-based liquidity management framework. Moreover, the market determined exchange rate would also insulate the real exchange rate from unwarranted misalignment, which in turn, protects the external competitiveness.

Inflationary pressures are easing yet the decline in inflation is below expectations…

42. Moderation in aggregate demand, evident in the decline of external current account deficit, has resulted in a substantial decline in CPI inflation. Year-on-Year

Figure 9: Consumer Price Inflation (YoY)



(YoY) CPI inflation has fallen to 10.5 percent in December 2009 from a high of 25.3 percent in August 2008 (see **Figure 9**). Similarly, the 12-month moving average inflation has dropped to 13.6 percent by December 2009 compared to 20.3 percent a year earlier (see **Table 10**). The role of tight monetary policy stance adopted earlier and constraints on the monetization of the fiscal deficit should not be under-estimated in bringing inflation under control.

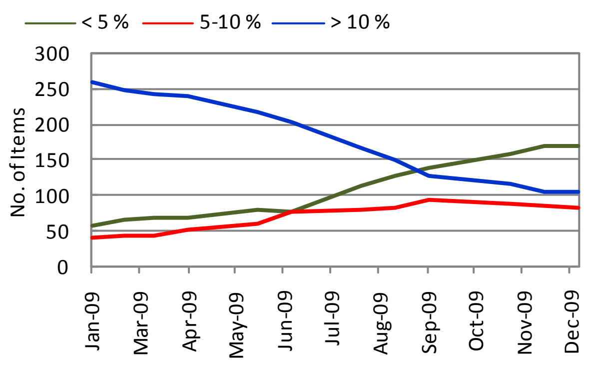
43. The fall in inflation has been contributed by all the sub groups of CPI and is also broad-based in terms of individual commodities. Moreover, the number of commodities in the CPI basket, exhibiting double-digit inflation, has come down drastically. For example, in June 2009, 205 commodities, out of a total of 374, were experiencing year-on-year inflation of more than 10 percent. This number has dropped to 107 by December 2009 (see **Figure 10**).

Table 10: Inflation Indicators

	YoY	12-month moving average	
	Dec-09	Dec-09	FY10 Projections
CPI Headline	**10.5**	**13.6**	**11.0-12.0**
Food group	10.9	13.3	-
Non-food group	10.2	13.9	-
CPI excl. HRI	9.5	12.6	-
Core Measures			-
NFNE	10.7	14.6	-
20% Trimmed	10.5	15.0	-
20% Trimmed excl.HRI	9.2	14.0	-
NFNE excl. HRI	7.4	12.0	-

Source: FBS and SBP

Figure 10: Distribution of Items in CPI Basket for YoY Changes



44. The inflation outlook for full FY10, nevertheless, remains somewhat susceptible to fiscal consolidation efforts and to incipient international commodity price pressures. These include already announced and planned increases in electricity and gas prices. Added to these developments are the difficult-to-assess negative impact of law and order situation and power shortages on the productive capacity of the economy. The likelihood of an uptick in inflation in the remaining months of FY10 thus seems quite plausible. Based upon

these considerations, SBP expects the average CPI inflation for FY10 to remain between 11 and 12 percent.

45. Volatile and higher than expected month-on-month inflation, around 1.0 percent on average during H1-FY10, and very gradual decline in core inflation measures reflect rigidity of inflation. These trends, along with aforementioned factors, could influence people's expectations of inflation. Given that monetary policy decisions affect inflation dynamics with a lag, there is a need to carefully evaluate expected trajectory of inflation for the remaining months of FY10 as well as FY11.

46. Looking at the real economy, it may be observed that the agriculture sector is showing some improvement. For example, the cotton crop is higher than last year and its effects are permeating to other sectors as well, particularly the textiles and its exports. Modest but consistent recovery in LSM is also encouraging. It grew by 0.7 percent in November 2009 compared to a low of negative 20 percent in March 2009. Pick up in private sector credit and increase in demand for exports by our trading partners, in the wake of better than expected global economic recovery, could further support domestic economic activity.

47. Key factors holding back real GDP growth forecasts are persistent power sector problems and a very challenging security environment. Water shortages are also likely to affect agricultural productivity. Thus, for FY10, overall real GDP growth is expected to be 3 percent compared to a 2 percent growth recorded in FY09.

C. Risks and Challenges

48. The most prominent risk to macroeconomic stability is the uncertainty regarding availability of external financial inflows, which has the deep effects on both fiscal accounts and the external current account sustainability. It also has implications for future trends in both the accounts and other sectors of the economy. As already explained elsewhere in the document, less than required inflows or a mix of financial inflows skewed towards debt creating flows, particualrly of short term nature, would reduce fiscal space and jeopardise financing of the current account deficit. The challenge, in the first place, is to address the underlying causes for such uncertainties and build capacity to forestall its ramifications. The ideal solution is to increase the economy's resource envelope to meet the requirements of a growing economy. The second best solution, however, is to live

within the resources available. In absence of adequate resources, the onus of macroeconomic stability also falls on timely adjustment of relative prices i.e. interest rate and the exchange rate. These prices should be allowed to adjust in time since a delayed adjustment only tends to waste resources.

49. Second most prominent risk to the economy is the extent of impetus received from the global economic recovery. The fruits of growth in the global economy cannot be reaped fully if the increase in domestic productive capacity and the depth of financial markets is not commensurate with the demand created for exports or to absorb fiancial inflows, respectively. These require removal of bottlenecks related to the improvement of law and order situation, infrastructure development, continuation of reforms process and increase in financial sector depth.

50. Linked with the global recovery, recurrence of rising international commodity prices trend poses another risk to the economy. Given its widespread impact on the economy, the real challenge is to ensure a tranparent pass-through of its effect to the economy so that it adjusts to them in full and in time. Absence of transparency and any artifical delay in adjustment would impair pass-through and bring complacency among economic agents.

51. The circualr debt issue poses a threat to the stability of institutions both in the power sector and financial sectors. Moreoever, it is distorting the pricing of assets in the banking sector, and weakening the pricing mechanism and transmission of monetary policy changes. There is need to address the root cause of this issue, which is timely generation of resources by institutions and payments by the government, in its entirety and without delays.