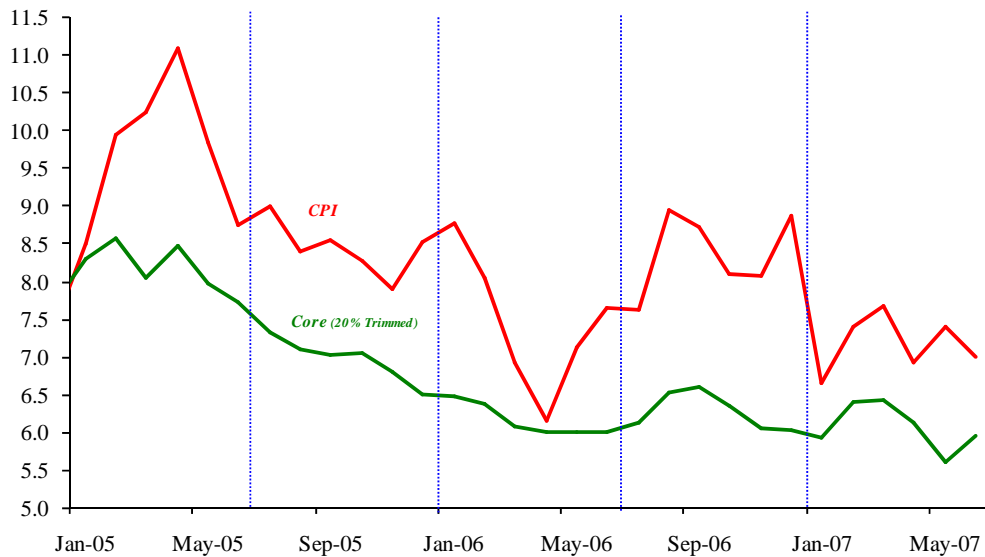


MONETARY POLICY STATEMENT

JULY – DECEMBER 2007

Year on Year CPI and Core Inflation, January 2005 - June 2007



..... indicates release of Monetary Policy Statement



STATE BANK OF PAKISTAN

CONTENTS

OVERVIEW	1
A. Recent Economic Developments	7
B. FY07 Monetary Developments	9
C. International Policy Environment	12
D. FY08 Monetary Policy Framework	13
E. Key Challenges and Risks	15
APPENDIX: Relevant Core Inflation Measures in Pakistan	18

OVERVIEW

- State Bank of Pakistan (SBP) tightened its monetary policy further in July 2006 by raising policy discount rate by 50 basis points to 9.5 percent, the Cash Reserve Requirement (CRR) from 5 to 7 percent on demand liabilities, and the Statutory Liquidity Requirement (SLR) from 15 to 18 percent, for the scheduled banks. At the same time, in order to incentivize banks to mobilize long-term deposits, SBP reduced the CRR on their time liabilities from 5 to 3 percent.

- Monetary tightening has had visible results on different fronts, as excess aggregate demand pressures in the economy were reduced. Aside from curbing import demand, which had grown to unsustainable levels in the last two years, effective liquidity management has allowed adequate growth in private sector credit but aligned it to real prevailing demand. Most importantly, FY07 monetary policy was successful in sustaining a downtrend in inflationary pressures in the economy, while facilitating the economy to record strong growth, in line with the annual target.

- If this moderation in aggregate demand pressures had not been achieved, the country's hard-won macroeconomic stability would have come under strain with consequences in terms of further widening of the current account deficit and higher inflationary pressures. All of these, in turn, would have adversely affected the country's recent success in attracting investment flows, thereby lowering economic growth, reducing employment generation and threatening poverty reduction efforts, in years ahead.

- The impact of the monetary tightening is most evident in the continued deceleration in core inflation during FY07. One measure of core inflation, the non-food non-energy CPI, continued its downtrend from 7.8 percent YoY high in October 2005, to 6.3 percent YoY at end-FY06, and to 5.1 percent YoY by the end of FY07. However, much of the gains from tight monetary policy on overall CPI inflation were offset by the unexpected rise in food inflation. Had food inflation, in FY07, remained at the average level observed in FY06 (i.e. 6.9 percent), CPI inflation would have met the 6.5 percent target for the year.

- Volatility in food inflation, that has a 40.3 percent weight in the CPI basket, meant that despite a sharp decline in non-food inflation, the fall in CPI inflation during FY07 was quite modest. Average inflation for FY07 thus remained 1.3 percentage points above the FY07 annual target. Indeed, another (and better) measure of core inflation, the 20 percent trimmed CPI, appears to capture this dynamic; while it too has declined from a trend-high of 8.6 percent YoY in February 2005 to reach 6.0 percent YoY by end-FY07, this indicator shows greater volatility in FY07 relative to the preceding year, which suggests that the underlying inflationary pressures are once again gathering momentum.

- The risk of a resurgence in inflation has also increased because unanticipated developments have resulted in substantial growth in broad money supply (M2). It grew by 19.3 percent during FY07 exceeding the annual target by 5.8 percentage points, and

was well above the 15.1 percent growth in FY06. Slippages in money supply growth principally stemmed from an expansion in net foreign asset (NFA) due to the higher than expected foreign exchange inflows. While the larger part of the NFA increase was due to a welcome rise in foreign investment flows, it is worth noting that a significant portion also comprised of external financing support for budgetary expenditures. These borrowings were a key element in the excessive reserve money growth in FY07.

- Equally stressful was the impact of Government borrowings from the central bank. The pressures from the fiscal account manifested themselves more during the course of the year as evident from the high central bank borrowings during some months of FY07. This was despite the Government diversifying its domestic debt partly through issuance of Pakistan Investment Bonds (PIBs) worth Rs 48.7 billion (net of maturities), and through net National Savings Schemes (NSS) receipts of Rs 56.4 billion, during the fiscal year. With the privatization inflows and the receipts from a sovereign debt offering, the Government managed to end the year with retirement of the central bank borrowings, on the margin. By the end of FY07, SBP holdings of government papers were still around Rs 452 billion, despite a net retirement of Rs 56.0 billion during the year.
- Another major aberration in FY07 emanated from the high level of SBP refinancing extended, for both working capital and long-term investment, to exporters. Aside from monetary management complexities, these schemes are now distorting the incentive structure in industry.
- The sharp rise in foreign capital flows and SBP refinance, coupled with continuing government borrowing through most of FY07, have resulted in exceptional high growth of 20.9 percent in reserve money in FY07; sharply higher than the 10.2 percent growth recorded during FY06. Clearly, this sharp growth in reserve money has the potential to further raise the already high inflationary pressures in the economy.

FY08 Monetary Policy Framework

- In the light of FY07 developments and expected challenges in FY08, monetary management in FY08 will be complicated and demanding. These challenges include the carry forward of the monetary stress generated from capital inflows, sizeable demand pressures emanating from fiscal and external imbalances, the distortions from SBP refinancing schemes, as well as the impact of supply-side factors (e.g., oil prices, food inflation, etc.).
- Keeping in view these challenges and allowing greater scope for private sector credit growth, SBP has introduced some strategic changes in monetary policy formulation and its conduct. Monetary policy is undergoing qualitative changes following the abandonment of the Annual Credit Plan (which prescribed targets for broad monetary aggregates) and recognition that there is need for adopting a more sustainable approach to dealing with the two principal sources of reserve money growth, i.e., the government's reliance on central bank borrowings and the refinancing operations which dilute the central bank's monetary stance.

- The monetary policy framework is based on the estimates of NFA derived from the projected foreign inflows. Given the desired monetary expansion consistent with real GDP growth and inflation rate targets, the net domestic assets (NDA) is then obtained as a residual. In line with this monetary policy framework, assuming real GDP growth target of 7.2 percent and inflation target of 6.5 percent, broad money supply growth should be 13.7 percent for FY08.
- In line with this framework and projections, applying for the first time the provisions of the State Bank of Pakistan Act 1956 (section 9A), SBP has recommended to the Government that for FY08 it would be prudent to (i) retire borrowings from SBP by Rs 62.3 billion, (ii) adopt quarterly ceilings on budget borrowings from SBP, and (iii) adopt a more balanced domestic debt strategy whereby the budget deficit is financed from long-term financing sources (that are relatively less inflationary). For this purpose, SBP has advised the Government to use Pakistan Investment Bonds, and issue *Shariah* Compliant Papers which, among others, will allow Islamic Banks to meet their SLR requirements that are kept below par because of lack of effective supply in the system of *Shariah* compliant Government securities. As Islamic bank industry grows, absence of adequate SLR coverage, could pose a systemic risk to the banking sector.
- Another significant strategic change in monetary policy is the SBP decision to gradually reduce commercial banks' reliance on refinancing facilities and encourage them to mobilize the desired level of resources to fully accommodate private sector and export credit requirements. Empirical evidence suggests that refinancing schemes have adverse economic outcomes, pose problems for effective liquidity management, and are detrimental to the transmission of monetary policy signals. Furthermore, with a captive source of liquidity, commercial banks have less incentive to mobilize deposits. SBP policy stance and communication has facilitated an upward movement in the weighted average deposit rates that have risen from 2.9 percent in June 2006 to 4.0 percent in June 2007. However, with easy availability of refinancing support under the Export Finance Scheme (EFS) at 6.5 percent and under Long Term Financing for Export Oriented Projects (LTF-EOP) at 4 to 5 percent, commercial banks have no incentive to tap deposits more aggressively.
- Better fiscal and monetary policy coordination with explicit ceilings on government borrowings from SBP and coordinated quarterly borrowings, coupled with tightening of refinancing window, should help reduce pressures on reserve money growth. Lower government demand for financing from the banking system would be a prerequisite for provision of more space, within the overall growth in broad money, to finance private sector requirements. More importantly, SBP is increasingly encouraging the banking sector through a number of development financing initiatives to cater to the credit needs of the private sector. SBP is also interacting closely with relevant stakeholders to increase financial penetration and access to finance, on a broader front.

Risks and Challenges

- The policy measures outlined above are expected to help contain monetary expansion to the target level, and reduce inflation. However, there remain a few risks and challenges to the realization of CPI inflation target in FY08:
 - (i) Current trends in food inflation are already worrisome, and recognizing the urgent need to restrain the volatility in food prices, the government has constituted a high level committee to examine the demand-supply bottlenecks and devise an action plan to address these issues. However, price volatility could be more pronounced given disruptions in production and supplies in the flood-affected areas. Also, the recent surge in oil prices and its upward trend, if passed on to the domestic economy, could fuel a further rise in domestic inflation.
 - (ii) Containment of growth in monetary aggregates during FY08 would remain a challenge in the wake of persisting trends in capital inflows, government borrowing pattern, and refinancing requirements. As inflation is sensitive to increases in money supply, curbing the growth in monetary aggregates is imperative to contain inflation to its target level in FY08. Therefore, SBP considers it essential to sterilize the liquidity impact of foreign capital inflows expected in FY08.
 - (iii) The expansionary budgetary outlay for FY08, apart from carrying high potential of monetization of the budget deficit could threaten to raise excessive demand pressures. Therefore, accommodating expansionary fiscal policy for FY08 with minimum inflationary pressures remains one of the major challenges for SBP.
- Despite these risks and challenges and the unfavorable developments of FY07, SBP is determined to achieve the CPI inflation target of 6.5 percent in FY08. Therefore, SBP would actively make use of its policy instruments to bring CPI inflation down to its target level.

Policy Measures

- Keeping in view the above risks and challenges, SBP has adopted the following policy measures:
 - (i) Effective from 1st August 2007 SBP will raise policy discount rate from 9.5 percent to 10 percent.
 - (ii) Zero rating of Cash Reserve Requirement (CRR) for all deposits of one-year and above maturity (to encourage greater resource mobilization of longer tenor) and 7 percent CRR for other demand and time liabilities.

- (iii) Recognizing the shortage of Shariah-compatible papers that are used by Islamic Banks to meet SLR requirements, their cash in hand and balances with NBP are being allowed to count towards SLR.
- (iv) **Introduction of modifications in the refinancing limits and resource sharing arrangements for EFS to reduce its consequences for reserve money growth and promote efficient utilization.** Under the revised scheme, the export finance limits of banks for the year FY08 shall be fixed at the level of outstanding amounts as of 30th June, 2007. For ensuring phased transformation of export financing regime, SBP shall allow only 70 percent refinance against such limits based on actual 100 percent draw down of export finance by the exporters with their respective banks; the balance 30 percent shall be funded by the banks out of their own resources. Exporters will continue to get the financing from banks for 100 percent of their entitlement to borrow under the existing Scheme. The banks will be required to ensure that their total outstanding refinance from SBP as of 30th June, 2007 is reduced steadily by 30 percent latest by 30th June, 2008. During the transition period as an interim support, the amount of export finance provided by banks from their own sources would be eligible for deduction from their demand liabilities for the purpose of determining their CRR. The other terms and conditions of revised EFS would remain the same. In particular, the refinance rate to banks will remain below the benchmark 6-month T-bill and similarly the banks lending rate to exporters will not exceed 7.5 percent per annum.
- (v) **The SBP is introducing a new Long Term Financing Facility (LTFF) to promote export led industrial growth in the country.** This facility will be available through approved Participating Financial Institutions (PFIs) including banks and DFIs. Under this facility, the exporters can avail financing for fresh procurement of new imported and locally manufactured plant and machinery. The facility will be available to the export oriented projects with at least 50 percent of their sales constituting exports or if their annual exports are equivalent to US\$ 5 million, whichever is lower. SBP will provide refinance up to 70 percent of the sanctioned facility and the PFIs will finance 30 percent of LTFF from their own resources. LTFF will be guided by an overall yearly limit with which PFI limits will be set based on their financial capacity and strengths. PFIs will serve exporters on a first come first serve basis subject to meeting the prescribed eligibility criteria. Lending under the facility shall be subject to compliance of the relevant Prudential Regulations and the prescribed Debt-Equity Ratio. Other terms and conditions will be released separately.
- (vi) **Simplification and Liberalization of External Commercial Borrowing (ECB).** Consistent with the growing trend in corporate sector of Pakistan to access international markets for funding requirements, SBP is issuing instructions to further liberalize and rationalize the ECB. Industry and exporter will be able to secure their foreign currency requirements based on different product structures and maturities; if within stipulated pricing range these transactions can be approved by the commercial banks/DFIs without seeking

SBP's approval. In order to liberalize hedging of exchange exposures arising out of foreign currency borrowings, forward cover facility will now be available in all categories of ECBs. Subject to the compliance of prescribed conditions, SBP is also in the process of formulating guidelines and procedures to allow Authorized Derivative Dealers to provide this facility to the exporters without seeking SBP's approval.

- (vii) **Augmenting Financial Penetration.** To encourage the public to open Basic Banking Accounts (BBAs), banks are being advised not to recover any charges from customers for operating BBA or for conversion of regular full service bank accounts. Furthermore, banks are also being advised not to recover service charges of more than Rs.50/- per month from their regular account holders on maintaining balance below the minimum monthly average balance. Further, to enhance the financial penetration of banking system, all banks will henceforth be required as a minimum to open 20 percent of their new branch network in rural / underserved areas under Annual Branch Expansion Plan (ABEP). Appropriate flexibility is being built-in to open sub-offices and other arrangements to offer the financial services to rural population.
- (viii) **Procedural Streamlining of Lending Rates.** Recognizing concerns of borrowers and in order to ensure transparency in the pricing and documentation of bank loans, SBP is issuing detailed instructions to the banks/DFIs that restrict them from making unilateral changes in the rates of fixed rate loans, recommending adhering to the specified margins in case of variable rate loans, and to clearly spell out the pricing and re-pricing frequency explicitly in the loan document. All charges including fee, repayment penalties etc., to be recovered by the banks/DFIs, should be determined and clearly disclosed to the customers at the time of the contract. In addition, a complete amortization schedule covering principal and mark up and a revised amortization plan in the case of revision in the floating rate should be provided to the customers.

A. Recent Economic Developments

1. The real GDP growth target of 7.0 percent for FY07 was not only met, the growth was actually quite broad based. While agriculture and services sectors surpassed their respective targets for FY07, growth in industrial sector accelerated compared to FY06 (**Table 1**). This high GDP growth and its composition, despite the decelerated growth in private sector credit, actually refute the argument that tight monetary conditions were stifling real GDP growth.

2. At the same time, the increased monetary tightening has helped in sustaining the downward movement in inflation. Non-food Non-energy measure of core inflation declined from average 7.1 percent for FY06 to 5.5 percent in FY07. Similarly, average non-food inflation reduced substantially from 8.6 percent in FY06 to 6.0 percent in FY07. However, headline average inflation rate in FY07 declined only slightly by 0.1 percentage point over FY06 and remained well above the 6.5 percent target for the year. This is because a sharp rise in food inflation to 10.3 percent (on average) in FY07 has restrained the downward movement in overall inflation in FY07. Another (and better)¹ measure of core inflation, the 20 percent trimmed CPI, shows greater volatility in FY07 relative to the preceding year, which suggests that the underlying inflationary pressures are once again gathering momentum.

3. The tight monetary stance also helped in curbing import demand, which had grown to unsustainable levels in the last two years. However, a slowdown in export growth led to a further widening of external current account deficit to US\$7.0 billion in FY07 compared to US\$ 5.0 billion in FY06 (see **Figure 1**). Nevertheless, this high external current

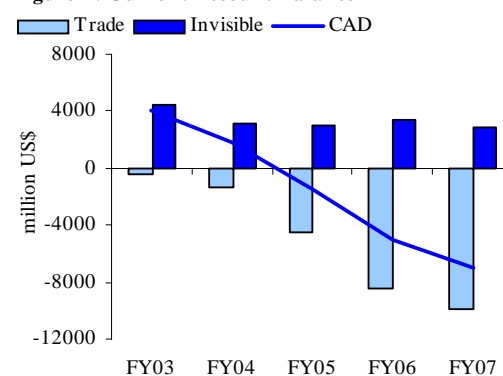
Table 1. Selected Economic Indicators

	growth rate in percent		FY07	
	FY05	FY06	Target	Actual
Average Inflation				
CPI	9.3	7.9	6.5	7.8
Food group	12.5	6.9	-	10.3
Non-food group	7.1	8.6	-	6.0
20% Trimmed	8.8	6.7	-	6.6
Non-food Non-Energy	7.0	7.1	-	5.5
YoY Inflation*				
CPI	8.7	7.6	-	7.0
Food group	9.3	7.8	-	9.7
Non-food group	8.4	7.5	-	5.1
20% Trimmed	7.7	6.0	-	6.0
Non-food Non-Energy	7.7	6.3	-	5.1
Economic Growth				
Real GDP	9.0	6.6	7.0	7.0
Agriculture	6.5	1.6	4.5	5.0
Industry	12.1	5.0	9.1	6.8
Services	8.5	9.6	7.1	8.0

*: Inflation in June for each year

Source: MoF, FBS.

Figure 1: Current Account Balance

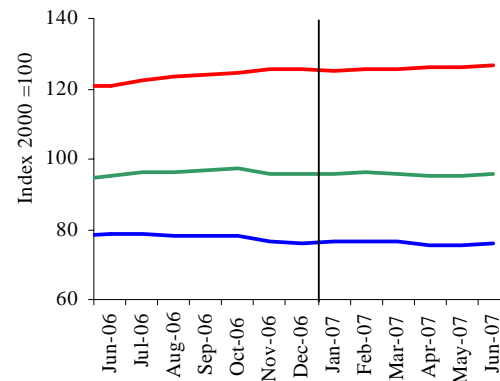


¹ See **Appendix 1** for details.

account deficit was financed comfortably through increased financial inflows, and lowered the pressures on rupee during H2-FY07. In fact, in contrast to depreciation by 1.1 percent during H1-FY07, Rupee appreciated against US dollar by 0.8 percent during H2-FY07 reducing the full year depreciation to 0.32 percent.

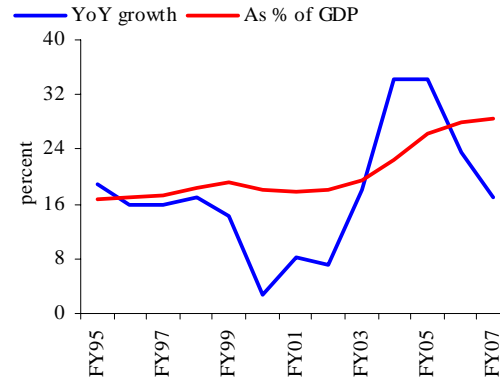
4. As US Dollar weakened relatively more against major currencies, Pak Rupee witnessed a marginal depreciation against the basket of trading partners' currencies, as reflected by 0.4 percent decline in Nominal Effective Exchange Rate (NEER) during H2-FY07; significantly lower than 3.4 percent depreciation during H1-FY07. Moreover, domestic inflation during H2-FY07 moved in parallel to general inflation trend in trading partners. As a result, Real Effective Exchange Rate (REER) appreciated only slightly by 0.2 percent during H2-FY07, against an appreciation of 0.6 percent in H1-FY07 (**Figure 2**).

Figure 2. Real and Nominal Effective Exchange
— RPI — NEER — REER



5. The credit to private sector, during FY07, posted a moderate growth of 16.9 percent as compared to 23.5 percent last year. It is important to note that this slowdown when seen in the context of robust economic growth, suggests that private sector credit growth is, in fact, converging back to its long term trend (**Figure 3**).

Figure 3: Credit to Private Sector
— YoY growth — As % of GDP



6. The two major segments that saw relatively slower growth are consumer finance and the working capital. It is encouraging to note that fixed investment has accelerated in FY07. While the decline in consumer finance largely reflects the impact of a tight monetary policy in arresting aggregate demand pressures and was desirable, a number of structural factors contributed to the slowdown in overall credit.

7. Despite liquidity in the system, commercial banks were not able to lend because of low demand for credit by corporates that had borrowed heavily in the last few years. In some cases, corporate sector was further meeting their demand either from retained earnings or foreign borrowings. In other sectors, banks had deliberately slowed down their lending activities and were focusing on developing their own capacities to lend more prudently. Furthermore, the process of mergers and acquisition in a number of

banks affected private sector credit delivery as most “acquired banks” slowed down their business.

B. FY07 Monetary Developments

Monetary Policy Stance

8. The monetary policy for FY07, formulated in the backdrop of growing macroeconomic imbalances, faced the following key challenges:

- (i) In line with Government targets, it aspired to bring down the CPI inflation to 6.5 percent, requiring a 1.4 percentage point decline over FY06 level, amid strong demand-side pressures.
- (ii) Pressures build up from the high monetary expansion of 15.2 percent (compared to target of 12.8 percent) in FY06 and even steeper monetary expansion in the preceding years when on average money supply expansion regularly slipped in the range of 18.6 percent to 19.6 percent annually.
- (iii) Pressures emanating from the expansionary fiscal policy envisaged for FY07 which continued to rely on central bank borrowing.
- (iv) Widening external current account deficit as exports slowed and oil bill remained high.
- (v) International economic environment characterized by volatile oil prices and domestic environment characterized by high food inflation.

9. Containment of demand pressures was considered imperative to rein in inflation. However, in line with its legal mandate that calls for supporting the dual objective of promoting economic growth and price stability, the challenge was to reduce aggregate demand pressures without hurting the investment demand in the economy.

10. Recognizing these pressures, in July 2006, SBP tightened its monetary policy further by raising SBP policy rate by 50 basis points to 9.5 percent, the Cash Reserve Requirement (CRR) from 5 to 7 percent on demand liabilities, and the Statutory Liquidity Requirement (SLR) from 15 to 18 percent of time and demand liabilities of the scheduled banks. At the same time, in order to incentivize banks to mobilize long-term deposits, SBP reduced the CRR on their time liabilities from 5 to 3 percent.

11. SBP continued to implement its tight monetary stance during FY07 through effective utilization of OMOs. This liquidity management mainly focused on the short end of the yield curve by mopping up the surplus funds to keep the overnight (O/N) rate tight and to reduce the volatility in short term rates.

12. To assess the effectiveness of sterilization through OMOs, SBP monitored weekly weighted average O/N rate and the volatility of overnight rates in relation to previous years. Market consistently remained within a corridor of 7.5 percent to 9.5 percent with only a few exceptions due to un-anticipated inflows. As shown in **Table 2**, the weighted average O/N rate for FY07 was 8.4 percent against 7.9

percent in the previous year accompanied with reduced volatility depicting consistency in implementation of the monetary stance. The frequency of OMO in FY07 is down as compared to FY06 mainly due to the better liquidity forecasting of SBP.

Trends in Monetary Aggregates

13. The growth in money supply (M2) during FY07 accelerated to 19.3 percent compared to 15.1 percent in FY06. The higher M2 growth in FY07 primarily stemmed from a sharp rise in Net Foreign Assets (NFA) of the banking system (**Table 3**). NFA of both SBP and scheduled banks has contributed to higher NFA growth of the banking system.²

14. Besides large foreign exchange inflows in its account, the government continued to rely on borrowing from banking systems for budgetary support during most of FY07. However, towards the end of FY07, government retired substantially its SBP borrowings. During FY07, in net terms government borrowed Rs 102.1 billion for budgetary support from the banking system against Rs120.1 billion credit plan target for FY07 and Rs 67.1 billion in FY06 (**Table 3**). Annual trends in government borrowings, however, mask the complications created by the government's over-reliance on the

Table 2. OMOs and Volatility in Overnight Rates

	OMOs		Overnight Rate	
	No.	Net Absorption	Average	Coeff. of variation
		billion Rs	in percent	
FY05	51	567	3.9	0.7
FY06	94	214	7.9	0.2
FY07	69	864	8.4	0.1

Source: SBP

Table 3. Monetary Survey (Flows)*

billion Rupees		Credit plan [#]	FY06 ^R	FY07 ^P
1	Money supply (M2) (2+3)	459.9	446.3 (15.1)	658.3 (19.3)
2	NFA (i + ii)	9.8	51.5	285.8
	i SBP		61.8	222.4
	ii Scheduled banks		-10.3	63.4
3	NDA (iii + iv)	450.1	394.8	372.4
	iii SBP		22.6	-66.5
	<i>Of which credit to:</i>			
	Export sector		-1.5	26.6
	Industrial sector		5.8	34.9
	iv Scheduled banks		372.2	438.9
	Memorandum items			
	Govt. borrowing	130.1	86.9	92.8
	<i>Budgetary support</i>	120.1	67.1	102.0
	<i>From SBP</i>		135.1	-58.6
	<i>From Sch. banks</i>		-68.0	160.6
	Private sector credit	390.0	401.8	356.3
	Reserve money		92.3 (10.2)	209.1 (20.9)

Source: SBP

Note: Figures in parenthesis are growth rates
 *: Total may not tally due to separate rounding off.
 #: for FY07
 R: Revised; P: Provisional

² Unlike in FY06, the scheduled banks have witnessed positive expansion in FY07. This expansion in NFA of scheduled banks is a result of higher inflows in financial accounts and weak demand for foreign currency loans in FY07 (for details, see SBP third quarterly report of FY07 on the State of Pakistan Economy).

banking system, which given the sizeable fiscal deficit, has been inevitable. Few important features and trends of Government borrowings are noteworthy.

- First, the Government is now highly reliant on the commercial banks.
- Second, the Government has now been able to regularly retire its obligations from the privatization-related and other foreign receipts.
- Third, the fiscal uncertainties magnify and translate into an abrupt borrowing pattern, which dilute the impact of monetary tightening even if government meets annual target or retire its obligations.

15. In anticipation of these developments, SBP continued to pursue tight management by relying on OMOs. The monetary tightening impact was however subdued by the private sector excessive reliance on export finance scheme (EFS) which grew by 24.7 percent in FY07 compared to a negative growth of 1.3 percent in FY06 and Rs 34 billion textile industry demand for debt swap of loans sanctioned since January 2003. EFS and long-term financing for export oriented project (LTF-EOP) being backed by central bank refinancing resulted in additional banking sector liquidity offsetting the impact of tight liquidity management. Refinancing of long term obligations of industry did provide interest rate relief to textile industry through swapping of high cost debt with subsidized loans at interest rate 6 to 7 percentage points below the KIBOR, but did not result in new investments. Disproportionate growth in EFS relative to export earnings in FY07 has raised renewed concerns on misallocation of EFS funds which ends up creating distortions in financial sector.

Table 4. SBP Credit for Private Sector

billion Rupees

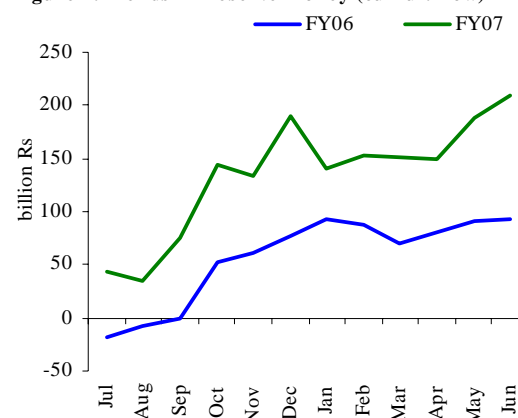
	FY06	FY07
Industrial sector	5.8	34.9
Export sector	-1.5	26.6
Others	2.6	-8.0
Total	6.9	53.5

Source: SBP

16. **Table 4** reflects that exporters and industrial sector jointly availed Rs 61.5 billion concessionary credit during FY07 compared to only Rs 4.3 billion in FY06. Liquidity generated by both working capital and long term export refinancing accounted for one-third of the reserve money expansion in FY07 and thereby contributing to growth in M2 in FY07.

17. All factors highlighted above, resulted in a sharp rise of 20.9 percent in reserve money during FY07 (see **Figure 4**); the highest level recorded in last seven years.

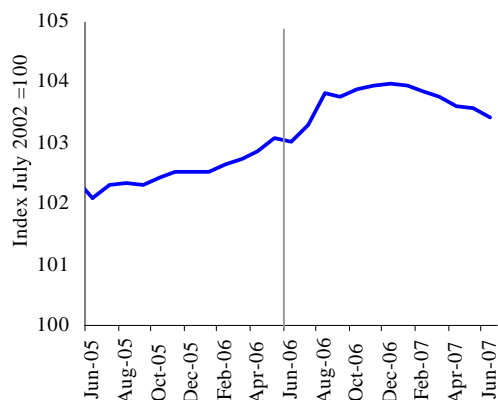
Figure 4. Trends in Reserve Money (cumul. flow)



18. In the money market, the monetary tightening measures yielded a mixed result on key interest rates in FY07. On point to point basis, KIBOR of all tenors increased

during FY07. However, it is important to note that KIBOR of 3 months and higher tenors have shown a steady downward trend during H2-FY07. Monetary condition index (MCI) of SBP reflected a similar pattern during FY07.³ In particular, MCI after rising by 0.9 percent in H1-FY07 moved downward in H2-FY07 and limited the full year increase to 0.4 percent (Figure 5). This suggests that monetary tightening witnessed during H1-FY07 partly eased off during the latter half of FY07.

Figure 5. Monetary Conditions Index (MCI)



C. International Policy Environment

19. After few years of accelerated global economic growth in the recent past inflation has also begun to surge (Table 5). Similar to Pakistan, the economies of U.S.A., U.K., Euro-zone, China, and India since 2005 are facing inflationary pressures.

Table 5. Inflation Rates of some Key Advanced and Emerging Economies

	2003	2004	2005	2006	2007
USA	1.90	3.30	3.40	2.50	2.70
Euro-zone	1.97	2.36	2.22	1.92	1.91
UK	1.30	1.70	1.90	3.00	2.50
China	1.16	3.99	1.82	1.46	4.40
India	3.95	3.56	5.70	6.94	7.56
Malaysia			3.30	3.10	1.40
Philippines	3.45	5.98	7.63	6.28	2.40
Thailand	1.80	2.90	5.80	3.50	1.90
Indonesia	6.59	7.26	7.42	15.60	6.29
Saudi Arabia	0.82	0.20	0.61	2.22	3.00
Brazil	9.30	7.60	5.69	3.14	3.18

Note: Figures for 2007 are for the month of May.

Source: Bloomberg, International Financial Statistics, The Economist

20. The unique reasons pertinent to U.S.A., U.K., and Euro-zone economies notwithstanding, the general argument for inflationary pressures in these economies is being attributed to rising commodity prices in the international markets. Leading market analysts have forwarded three main reasons behind this trend. First, supply bottlenecks in some major commodity producing countries such as Australia. Second, structural shift in the demand for soft commodities for the growing production of bio-

³ The MCI is a weighted average of interest rate and exchange rate relative to base period. It is used as an indicator of monetary stance as it tracks the combined impact of interest rate and exchange rate changes on monetary conditions. For details on the computation of MCI, see, Zulfiqar Hyder and Mazhar Khan (2007). *Monetary Conditions Index for Pakistan*. SBP Working Paper No. 11.

fuels. Third, insatiable demand for commodities in spectacularly growing China and India. Some commentators have also blamed accommodating monetary policy amid global excess liquidity of the past few years behind the recent upsurge in inflation.

21. In the foreseeable future, supply problems might not settle soon, quest for alternative energy sources would rather increase, and indeed there is no respite to demand pressure induced by China and India's economic growth. It is anticipated that there would probably be a need to tighten monetary policies in these economies for an extended period of time. The economies of U.S.A., U.K., and Euro-zone are sensitive to the anchoring of low inflationary expectations. Therefore, their central banks would not like to lose their credibility of several years as inflation-fighters. For China and India low and stable inflation is a social insurance for a great proportion of their respective population that actually lives near or below the poverty line. Therefore, their central banks would like to deliver stable prices as a matter of societal compulsion and are likely to shape their monetary policies accordingly.

22. Pakistan's current situation is largely in tandem with the global scene in general and to that of China and India in particular. Specifically, the features include high food inflation and higher foreign exchange inflows that are expected to augment the levels of net foreign assets and result in monetary expansion. Distinctively, burgeoning trade deficit and expansionary fiscal policy in FY07 are also anticipated in FY08. These challenges point towards the need to bring Pakistan's monetary stance close to that of the aforementioned global scenario.

D. FY08 Monetary Policy Framework

23. Recently, SBP has introduced a perceptible strategic shift in the monetary policy formulation and its conduct, to allow greater scope for private sector credit growth in line with the emerging developments and requirements of the economy. Monetary policy is undergoing qualitative changes. The old practice of preparing and announcing the annual credit plan with indicative targets of multiple monetary aggregates has been abandoned after the National Credit Consultative Council (NCCC) was restructured to operate as Private Sector Credit Advisory Council (PSCAC) that focuses on policy constraints impeding the sector credit delivery.

24. Targets for inflation and real GDP growth provide the basis for setting a consistent target for broad money (M2) expansion. Two major components of broad-money are the NFA and the NDA of the banking system. NFA is determined by the excess of foreign inflows over outflows, whereas NDA, which is composed of the credit extended by banking system to government and private sector and the other items (net) is determined residually (i.e. M2 minus NFA). Thus, projection of banking system's NFA is the crucial component in the monetary policy framework.

25. Central pillar of this framework is that broad money expands by a multiple of reserve money. Hence, adequate level of reserve money which is consistent with the desired stock of M2 is determined using the estimated money multiplier. While SBP-NFA is derived from the projected foreign inflows which include privatization receipts,

sovereign bond issues, project and program loans, net forex purchases, etc. SBP-NDA is obtained as a residual. Within the SBP's NDA, net lending to Government for budgetary support is determined after providing for concessionary refinance support to the private sector that includes export related financing schemes.

26. From now onwards, SBP will be announcing and pursuing only the monetary growth target, consistent with the Government's real GDP growth and inflation rate targets. Furthermore, SBP is adopting a more sustainable approach to dealing with the two principal sources of reserve money growth, i.e., the Government's reliance on central bank borrowings and the refinancing operations, which dilute the central bank's monetary stance.

27. In future, it is important that government borrowing from the banking system be on a smooth path by better management of government's cash flows to meet the continued expenditure needs. Moreover, reducing the government borrowing (ideally by further retiring SBP holding of debt) from the banking system is imperative for containing inflation.

28. In this context, SBP has adopted a proactive approach in its dealings with the Government by exercising its statutory right to determine the limits of Government borrowing for budgetary support. In line with this position, the State Bank of Pakistan (under Section 9(A) of SBP Act 1956) has recommended the government to (i) retire borrowings from SBP by Rs. 62.3 billion, (ii) adopt quarterly ceilings on budget borrowings from SBP, and (iii) adopt a more balanced domestic debt strategy whereby budget is financed from long term financing sources; that are relatively less-inflationary. For this purpose, SBP has advised the Government to use Pakistan Investment Bonds, and issue *Shariah* Compliant Papers, which, among others, will allow Islamic Banks to meet their SLR requirements that are kept below par because of lack of effective supply in the system of *Shariah* compliant Government securities. As Islamic bank industry grows, absence of adequate SLR coverage, could pose a system risk to the banking sector.

29. In addition, SBP has decided to gradually reduce commercial banks reliance on refinancing facilities and encourage them to mobilize the desired level of resource to fully accommodate private sector credit. Ceilings on government borrowings from SBP coupled with tightening of refinancing window should help reduce pressures on reserve money growth. Lower government demand for financing from the banking system could provide more space, within the overall growth in broad money, to finance private sector credit requirements. More importantly, SBP is increasingly encouraging the banking sector to cater the credit needs of the private sector. SBP is also interacting closely with relevant stakeholders to increase access to finance on a broader front.

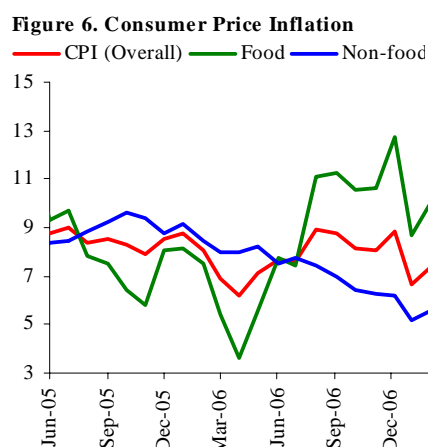
30. With continued momentum in foreign capital inflows, it will be more critical to achieve greater fiscal and monetary coordination to ensure recognition of the imperatives of monetary policy and encompassing inflationary pressures. Government borrowing from the banking system particularly from the central bank should be

aligned with the monetary policy projections to ensure continued macroeconomic stability and avoid the risk of crowding-out of the private sector credit. Concurrently, SBP will need to strictly adhere to the limits imposed on refinancing and encourage both banks and industry to rely increasingly on market based credit delivery systems.

E. Key Challenges and Risks

31. The primary challenge for FY08 remains the achievement of CPI inflation target of 6.5 percent. SBP is determined to achieve this target, but at the same time is conscious of certain factors that pose considerable challenges to achieving the desired target.

32. High food inflation, which restrained the downward movement in overall inflation in FY07, has not yet shown any sign of improvement (**Figure 6**). The twelve month moving average food inflation depicted a continuous up trend since June 2006 and in June 2007 YoY food inflation was recorded at 9.7 percent. Furthermore, the volatility in core inflation in FY07 indicates the possible inducement of second-round effects of high food inflation. In short, for the coming months, food inflation is posing a key risk for the effectiveness of monetary policy; if it persists over long period it may fuel expectations of higher inflation.⁴ SBP believes that in the short-run proper availability and distribution of food are critical in curtailing this inflation; as SBP can only impact the second round effects of high food inflation on overall wages and prices only in the medium to long run.



33. Volatility in oil price still persists and is expected to remain there in FY08. This could mainly be due to the current strong global economic growth that might result in higher demand for oil, thus pushing up its price. If higher oil prices are sustained, and pass on to the domestic economy, this would have a negative impact on domestic general price level, and calls for offsetting steps.

34. During recent months, a large part of Sindh and Baluchistan has come under floods. This may have an adverse impact on the supply of livestock and some crops, especially minor crops, limiting their supply and reflecting negatively on already volatile food prices.

35. The federal budget for FY08, while carrying positive incentives, entails an expansionary fiscal stance with a substantial increase in the total budgetary outlay. In

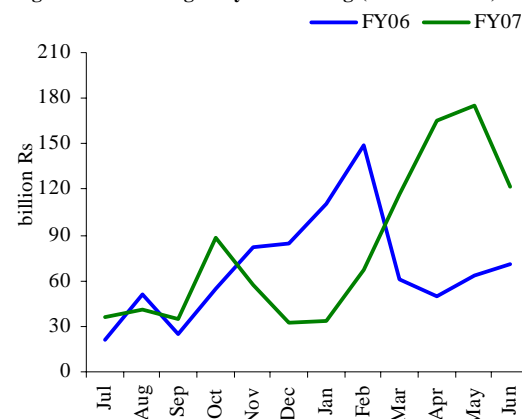
⁴ Sustained high food inflation may lead to higher wages that may put further upward pressures on inflation in second round.

addition to the initiation of investment projects particularly in housing and construction, several relief and compensatory measures have been announced that are likely to generate extra demand in the economy. This excess demand is expected to exert pressures on the general price level through two channels. On the one side, income increase due to the 15-20 percent rise in pensions and salaries and enhancement of minimum wage of unskilled labor from Rs 4000 to 4600 per month. On the other, increase in purchasing power due to subsidies and other transfer payments of Rs 114 billion, against Rs 89 billion budgeted last year. Any inflationary impact of the fiscal measures would need to be contained.

36. During FY07 the Government continued to rely heavily on bank borrowing for budgetary support and only towards the end of the fiscal year retired a considerable amount of its debt holding with the SBP (**Figure 7**).

37. With a budget deficit of 4 percent of GDP (Rs 399 billion), the government's expansionary fiscal policy for FY08 creates risks from financing requirements. To meet the financing requirements of this deficit, the budget for FY08 forecasts a huge target of net external receipts (Rs 193 billion), bank borrowing (Rs 82 billion) and privatization proceeds (Rs 75 billion). Realization of receipts under external finances and privatization proceeds would be with discrete path of time with former depending on investor confidence and latter on pace of progress of privatization; while government would need continuous financing to meet its day-to-day expenditure. This would create a temporary pressure on SBP for deficit finance. Heavy expected monetization of deficit during the course of the year would therefore generate challenging implications for the conduct of monetary policy.

Figure 7. Net Budgetary Borrowing (cumul. flows)



38. Recent and prospective trends in monetary aggregates have increased the risks of inflationary pressures in the economy making it a major source of concern for SBP in FY08. Monetary management in FY08 would be complicated and demanding due to the carry forward of the monetary stress generated especially from large capital inflows in Q4-FY07, sizeable demand pressures emanating from fiscal and external imbalances and the distortions from SBP re-financing schemes as well as the impact of supply-side factors (e.g., oil prices, food inflation etc.).

39. Larger foreign exchange inflows during FY07 have created significant demand pressure in the economy. There is an increasing trend in the inflows under workers' remittances, foreign investment, and debt financing. Benefit of large capital inflows notwithstanding, the resulting liquidity of these inflows can actually have adverse effects on macroeconomic stability and, above all, on inflation. If the current trend continues in FY08, it would indeed require effective sterilization to mitigate the risk of

its adverse implications for monetary management (see **Box**). Another aspect that calls for vigilance by the SBP is the increase in reserve money due to heavy foreign exchange inflows to the government that have been witnessed in FY07 and are expected to continue in FY08.

Box: Sterilization of Foreign Inflows

The term sterilization is commonly used to describe monetary actions in which a central bank attempts to neutralize (partly or fully) the expansionary impact of foreign exchange inflows on Net Foreign Assets (NFA) and eventually on Reserve Money (RM) by corresponding reduction in Net Domestic Assets (NDA). Typically, a central bank mops up excess liquidity by selling government securities through auctions or open market operations.

If the reserve money is not curtailed through sterilization, the money supply would expand substantially, having severe implications for the economy in terms of higher inflation and erosion in country's export competitiveness. Sterilization policy is a market-based approach and is highly effective when the capital inflows are temporary in nature.

It is important to note that sterilization affects the balance sheet of a central bank. For instance, if there are foreign exchange inflows in the economy and the central bank drains out the hot currency through foreign exchange intervention then the NFA of the central bank increases. On the liability side, the commercial banks' reserves with central bank improve, thereby leading to increase in RM. To offset this expansionary impact, the central bank may offload either its claims on government or schedule banks or both, resulting in reduction in NDA of the central bank. Consequently, the RM declines.

Such action has two important implications: (a) the central bank avoids abrupt appreciation of domestic currency by mopping up hot currency and (b) it keeps in check building up of inflationary pressure by intervening in the money market and draining out the excess liquidity. This neutralizes the monetary impact of foreign exchange inflows.

Sterilization also involves some cost which is to be borne by the central bank. It is the difference between higher earnings foregone on offloaded TBs and lower returns on central bank's investment of foreign exchange. Resultantly, it reduces the profit of central bank. In most developing countries (including Pakistan), such profit is transferable to government. In this situation, the Government would lose to the extent of reduced transferable profit of central bank.

APPENDIX: Relevant Core Inflation Measures in Pakistan

Since the main concern of the monetary policy is to stabilize the underlying (long-run) inflation rate, it may not be desirable for the monetary policy to respond to all the price changes. Rather, monetary managers should ignore the temporary (short-term) non-monetary supply side changes in inflation. Monetary framework, therefore, requires an inflation measure that can mimic a true underlying long-term inflation trend. Because of these considerations, the concept of core inflation is gaining popularity among central banks. The basic idea is to separate the transitory and permanent (core) component hidden in the headline inflation (*CPI inflation* in Pakistan). In fact, many central banks have started monitoring trends in some measures of core inflation; along with movement in headline inflation.

The concept of core inflation is also gaining popularity in Pakistan. In fact, SBP has been reporting and analyzing *core inflation* measures since 2003. There is no unique way of computing *core inflation* and various series have been estimated in Pakistan by two commonly used techniques; that is, *excluding fixed-items* approach and *trimmed mean* approach. In the former approach, the items to be excluded are presupposed and fixed; whereas, in the latter measure, the items to be excluded are those exhibiting the most volatility in a given period. Non-food Non-energy (NFNE), a commonly used estimator of core inflation in Pakistan, falls under the first category; while 20 percent trimmed mean core inflation computed by SBP is an example of the latter approach.

Recently an attempt has been made at SBP to evaluate various core inflation measures in Pakistan including NFNE and 20 percent trimmed mean series.* Idea is to test if these estimated core inflation series are exhibiting basic properties of a core inflation measure that are as follows:

- (a) Headline and core inflation must exhibit similar trends in the long term. This is a necessary condition to show that the two series are same in long-run.
- (b) Headline inflation must converge to core series in the long run; otherwise, there is no advantage of knowing if headline inflation is above or below the core inflation measure.
- (c) The third condition is to ensure that estimated core inflation does not converge to headline inflation. This is necessary for core inflation to be a reasonable predictor of the future path of the headline inflation.

Findings of the study suggest that none of the series based on *excluding fixed items* approach including NFNE passed the evaluation test. On the contrary, the estimated series based on *trim-mean* approach satisfy all the conditions of a true estimator of core inflation.

* Lodhi, M. Amin K. (2007). *Evaluating Core Inflation Measures in Pakistan*. SBP Working Paper No. 18.