

MONETARY POLICY STATEMENT

JANUARY-JUNE 2007



STATE BANK OF PAKISTAN

Monetary

Policy

Statement

January-June 2007

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HIGHLIGHTS

- Monetary policy measures adopted in July 2006 augmented earlier tightening and reduced YoY core inflation (Non-Food Non-Energy – NFNE) to 5.5 percent by December 2006 from 7.4 percent a year earlier. However, the headline inflation remained stubbornly high at 8.9 percent by December 2006.
- Although non-food inflation declined to 6.2 percent, acceleration in food inflation to double-digit levels offset the downtrend in headline inflation.
- The impact of monetary tightening is visible from an upward movement in Monetary Conditions Index (MCI) during H1-FY07.
- In line with its dual objective of balancing growth and price stability, monetary policy has also supported economic growth by ensuring effective liquidity management as well as providing adequate and timely concessional credit to priority sectors. Specifically, the liberal access of concessional Long-term Financing for Export Oriented Projects (LTF-EOP) offered by SBP and reduced rates on Export Finance Scheme (EFS) were helpful in keeping the textile industry's growth prospects intact.
- Concessional financing by SBP, nevertheless, has contributed significantly to growth of reserve money during H1-FY07. The reserve money increased by 19.0 percent during H1-FY07 compared to the 8.4 percent growth recorded in the corresponding period last year; credit under EFS and LTF-EOP together explained around 54 percent of the absolute change in reserve money in H1-FY07 over H1-FY06. As a result, risks of emerging day-to-day excess liquidity seem to have increased in the money market.
- Another source of reserve money expansion has been the build up in Net Foreign Assets (NFA) during H1-FY07 in contrast with a depletion during H1-FY06. Hence, a policy action to help smooth out liquidity management by scheduled banks is in order.
- While keeping the average weekly cash reserve requirement same as before (3 percent for time and 7 percent for demand liabilities), SBP is increasing daily minimum requirements to 2 percent and 6 percent for time and demand liabilities (from earlier levels of 1 percent and 4 percent) respectively.
- Key challenges facing the Pakistan economy remain the same as were at the beginning of FY07. In particular, (a) while inflation is likely to ease-off further it may remain above the 6.5 percent target for FY07 unless some additional administrative measures are taken to reduce food inflation; (b) international commodity prices may exert pressure on domestic inflation; (c) reserve money growth is increasing, among others because of textile sector support which is backed by SBP refinancing; (d) expansionary fiscal stance coupled with occasional upsurges in borrowings from SBP and the uncertainty created by financing mix of the deficit is posing difficulties for the conduct of monetary policy; and (e) burgeoning external imbalances also continue to pose a challenge.
- SBP will continue to pursue its existing tight monetary policy stance during the remaining half of FY07. It will, however, remain vigilant of the developments in the economy and take corrective actions, if warranted.

1. Overview

1. Since the issuance of the monetary policy statement in July 2006, State Bank of Pakistan (SBP) has been closely monitoring developments in the economy and has remained vigilant about the risks and challenges identified in the statement. These challenges were: (a) high inflation, (b) strong growth in monetary aggregates, (c) expansionary fiscal stance pushing up aggregate demand, (d) widening external account deficits, and (e) challenging international environment characterized by oil price hike and its volatility, possibility of disorderly unwinding of global imbalances, and deceleration in world economic growth.

2. In response to these challenges, SBP raised the cash reserve requirement (CRR) for banks, together with further increasing its policy rate by 50 bps to 9.5 percent in July 2006.

3. Initial evidence for FY07 suggests that *SBP's monetary tightening undertaken so far has been successful in reducing excess demand from the economy, without hurting the growth momentum*. In particular, while the GDP growth rate is expected to be close to the target of 7 percent for FY07 and above the FY06 level,¹ the underlying inflationary pressures have been easing off during the first six months of FY07. YoY core inflation (Non-Food Non-Energy – NFNE) has come down to as low as 5.5 percent in December 2006 from 7.4 percent for December 2005 and a local peak of 7.8 percent in October 2005.

4. However, the headline inflation has remained stubbornly high at an average 8.4 percent during H1-FY07,² which is well above the annual target of 6.5 percent for FY07. In this regard, the continuing high food inflation is the key driver for pressure on the overall CPI; and has a potential to dilute the impact of monetary tightening by strengthening inflationary expectations in the economy, if not addressed timely. While the role of administrative measures to improve supplies of essential food items has become more important, the monetary policy has to continue focusing on further containing the *excessive* demand pressures in the economy. Inflation outcome for FY07 is likely to be higher than the annual target for the year.

5. Focus on reducing domestic inflation is also required to help contain the cost of doing business in Pakistan, which is essential in improving the country's external competitive position. This is particularly important as the July-November 2006 trade gap has worsened on the back of an unexpected slowdown in export growth. The deceleration in exports indicates the presence of increased global and regional competition in addition to the existing structural weaknesses.

¹ This is expected on account of some recovery in the agriculture and large-scale manufacturing sectors, as well as expected strong performance of the services sector.

² 8.4 percent inflation is based on changes in average CPI for H1-FY07 over H1-FY06. In fact, YoY inflation in December 2006 is 8.9 percent.

6. It may be pointed out that SBP has allowed liberal access to concessional Long-term Financing for Export-Oriented Projects (LTF-EOP) and has lowered the financing cost of eligible items under the Export Finance Scheme (EFS). In fact, real lending rates on EFS and LTF-EOP are negative and even lower than the rates prevailing in regional countries. However, these incentives are also posing difficulties for effective monetary management due to their significant contribution in reserve money growth, which translates into overall monetary expansion.³

7. An additional challenge to growth in monetary aggregate emanates from large foreign exchange inflows during H2-FY07. While the foreign exchange inflows through privatization and GDR floatation were anticipated at the beginning of the year, other FDI inflows are accelerating. Although such inflows help in keeping the exchange rate stable by offsetting the foreign exchange drain due to the current account deficit and turning the overall outlook of balance of payments positive in the short to medium-term – making it a more than welcome development; their counterpart contribution in accelerating the net foreign assets brings a challenge to monetary management. Given the existing trend of reserve money growth, large foreign exchange inflows would also imply that monetary policy has to be necessarily kept tight in order to mitigate the risks of excessive expansion in the domestic liquidity.

8. The pattern of government borrowings, especially in the wake of a pro-cyclical expansionary fiscal policy and the slowdown in import-related tax revenues (if not offset by other sources of revenues), pose another challenge to the conduct of monetary policy. In particular, the government borrowings and its increasing reliance on the central bank are major sources of concern. Diversifying the government's sources of borrowing, adopting a judicious mix of short-term and long-term borrowings and maintaining the sanctity of the overall yield curve would, therefore, appear to be a better policy option for the government in the given environment. In this respect, recent issuance of PIBs is a welcome development.

9. While there is an overwhelming influence of domestic events on the overall economic performance of Pakistan, SBP also takes into account key developments in global and regional economies. The robust growth in the last few years and the resulting inflationary pressures prompted various central banks, including the central banks in the region, to raise their key policy rates in 2006. This will help their economies to reduce excess demand pressures and easing off inflation.

10. In sum, while most of the risks and challenges identified in the monetary policy statement for H1-FY07 still persist (except for the threat of continued acceleration in international oil prices), the key challenge for SBP is to keep the FY07 inflation outcome as close to the target as

³ Financing under EFS and LTF-EOP together contributes around 54 percent change in reserve money in H1-FY07 over H1-FY06.

possible. So far, the current monetary policy posture appears to be striking the balance of gradually reducing the excess demand pressures from the economy, without prejudice to the high-growth prospects. SBP also realizes that the policy measures taken earlier this year would have a further dampening effect on borrowing and spending in due course. Thus, SBP will be closely monitoring the economic developments and outlook for FY07 and will take appropriate actions as and when required in pursuit of maintaining the objective of price stability without prejudice to economic growth.

2. POLICY ASSESSMENT

Macroeconomic environment and SBP response in H1-FY07

The macroeconomic environment at the beginning of FY07 warranted aggregate demand moderation.

11. While the earlier monetary tightening did help in bringing down inflationary pressures in FY06, a further moderation in aggregate demand during FY07 was required as: (a) inflation at 7.9 percent in FY06, though remained within target for the year, was still high; (b) core inflation witnessed a relatively smaller decline in FY06, reflecting that demand-side inflationary pressures remained strong; (c) the FY07 inflation target of 6.5 percent required a decline of 1.4 percentage points over FY06, which would have been highly ambitious without further monetary tightening; and (d) external account pressures were expected to increase further in FY07, as current account deficit was envisaged to widen from the already high level of FY06.

Real GDP growth target of 7 percent, with high inflation and expansionary fiscal policy made monetary policy management very challenging.

12. However, the responsibility of moderating the aggregate demand fell on monetary policy given that (a) the exchange rate is market determined; and (b) the federal budget for FY07 clearly signaled an expansionary fiscal policy stance. In fact, the pro-cyclical fiscal policy made the monetary policy environment more challenging given that SBP had to strike a balance between the oft-conflicting objectives of growth and inflation (see **Box 1**). On the one hand, policy measures were required to curb existing inflationary pressures; and on the other, it was equally essential to ensure the availability of credit for exporters and long-term industrial investment to keep growth prospects intact. The task of achieving a balance between inflation and growth was difficult also because by the end of FY06, some of the key industries were working at near-full capacity. The resulting capacity constraints, in the presence of strong aggregate demand, had been contributing towards high inflation in the country, besides limiting economic growth prospects beyond its realizable potential. Thus, prudence required that monetary tightening should not adversely impact the continuing investment demand in the economy and the long-run growth momentum. In this backdrop, SBP not only focused on further monetary tightening but also allowed the export sector liberal access to concessional credit.

Box 1: Inflation-Growth Nexus

The importance of low and stable inflation in sustaining long-term economic growth requires no emphasis. The empirical research on the existence and nature of inflation-growth nexus suggests that high inflation is detrimental to long-term growth. These findings lead to more interesting policy questions that how much inflation is detrimental to economic growth and what should be the optimal target for low inflation. Khan and Senhadji (2001) found different threshold levels of inflation for industrial and developing countries. Specifically, they noted that higher than 1-3 percent level of inflation for industrial countries significantly slows their economic growth. The range for developing countries was estimated between 7-11 percent. These findings clearly indicate that threshold level of inflation is substantially different for industrial and developing economies. In these settings, one can expect that the threshold level of inflation may be different for each country depending on the level of its economic development.

In the recent literature, efforts have been made to estimate threshold level of inflation in case of Pakistan. Mubarik (2005) estimated threshold level of inflation at 9 percent, above which inflation negatively affects growth. In another study, Hussain (2005) suggested that “targeting inflation exceeding a range of 4-6 percent will be deterrent to economic growth”. Beside these studies, Singh and Kalirajan (2003) used annual time series data of Indian economy and concluded that increase in inflation at any level negatively affects economic growth and the country can benefit by focusing on price stability. However, they argued that “the band to be targeted should be between 4 and 7 percent for Indian economy”.

The above empirical findings suggest that threshold level of inflation for Pakistan may be somewhere in the range of 4-9 percent and price stability will have favorable long-run effect on economic growth. Given that these studies are based on historical data and over time, structure of the economy, in particular financial sector has undergone substantial changes; the threshold level of inflation in Pakistan is more likely to be on lower side of this range. Moreover, as country progresses gradually to become more developed, present threshold level of inflation will also decrease towards the lower end of the estimated range. Hence, it is better to set the target for inflation towards the lower side of the band, i.e. close to 4-6 percent. Clarida et al. (1999) found that output/inflation trade-off is highly sensitive to degree and nature of the persistence in inflation. He suggested that central banks should highly prioritize inflation in case of its persistent rise.

It should also be noted that monetary policy in Pakistan should focus more on the objective of keeping inflation on the lower side, rather than actively promoting growth. There is consensus in the literature that monetary stimulus can only promote growth in the short-run, with added risks both to future inflation and long-term trajectory of growth. The economists also agree that the central bank’s growth objective should be made subservient to inflation objective. This conclusion is lucidly stated by Rogoff (1985) that central bank should place larger weight on inflation stabilization, in order to increase welfare of the society.

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SBP raised CRR for banks and also increased its policy rate to 9.5 percent in July 2006.

In doing so, SBP signaled a further tightening of monetary policy by first raising the cash reserve requirement for banks (see **Box 2**),⁴ and then increasing its main policy rate, the SBP 3-day Repo rate,⁵ by 50 bps to 9.5 percent with effect from July 29, 2006.⁶

Liquidity management by SBP kept the overnight rates close to the discount rate.

13. Moreover, in order to reinforce its tight monetary stance, SBP continued to focus on the short end of the yield curve by resorting to frequent open market operations (OMOs) to drain

Table 1: OMOs and Volatility in Overnight Interest Rates
percent

	No. of OMOs	Overnight interest rate		
		Average	Standard deviation	Coeff. of Variation
H1-FY05	20	3.1	2.5	82.1
H2-FY05	31	4.4	2.7	61.5
H1-FY06	44	7.8	1.3	17.2
H2-FY06	49	7.9	1.2	15.8
H1-FY07	43	8.2	1.2	14.7

excess liquidity from the inter-bank market. This proactive liquidity management not only kept the overnight rates close to the discount rate, but the volatility in the short-term interest rates also reduced during H1-FY07 (see **Table 1**).

SBP also provided liberal incentives for the industrial and export sector to keep up the growth momentum.

14. At the same time, in order to ensure credit availability for industrial sector investment, SBP also allowed liberal access to concessional long-term financing for export related projects and lowered the interest cost of eligible items under the export refinance scheme (see **Box 3**). This was done to neutralize the adverse effects

Table 2: Growth in Reserve Money during H1
billion Rupees

	FY06	FY07	Δ over FY06	% share in Δ
Reserve money	76.3	190.4	114.1	-
<i>of which</i>				
Government sector	141.6	77.9	-63.7	-55.8
Private sector	2.7	59.5	56.8	49.8
EFS	-3.1	23.8	26.8	23.5
LTF-EOP	1.8	36.5	34.7	30.4
LMM	4.0	-0.7	-4.7	-4.1
NFA	-32.3	4.6	36.9	32.3

of monetary tightening on investment and export growth which are vital for the economy. It may be noted that this support has resulted in a significantly higher growth of reserve money during H1-FY07 compared to

H1-FY06 (see **Table 2**). Specifically, reserve money increased by 19.0 percent during H1-FY07 compared to the 8.4 percent growth recorded in the

⁴ SBP simultaneously raised the Statutory Liquidity Requirement (SLR) for banks from 15 to 18 percent with effect from July 22, 2006.

⁵ This is used to provide overnight lending (collateralized mainly by T-bills) to scheduled banks as a last resort.

⁶ SBP also increased the cut-off yield on T-bills in the subsequent auction, held on August 2, 2006, by 32, 33 and 21 bps for 3, 6 and 12-month tenors, respectively. Since then the interest rates in the primary market have remained almost unchanged.

Box 2: Changes in Cash Reserve Requirements

With effect from July 22, 2006, SBP required banks to maintain CRR of 7 percent on demand liabilities (DL) and 3 percent on time liabilities (TL). Prior to this, CRR for both DL and TL was 5 percent of total time and demand liabilities (TDL). In addition, SBP has also changed the definitions of DL and TL for the purpose of calculating CRR and SLR.¹ Thus based on new definition, the effective CRR turned out at 6.52 percent for week during July 22- 28 2006, which was significantly higher than 5 percent level (applicable prior to the change).

This change in CRR policy has helped in monetary tightening by reducing the interbank liquidity. For instance, for the week during July 22-28 2006, banks were to hold Rs 177.3 billion per day on average. This required amount would have been lower at Rs 136.0 billion per day, had the CRR remained unchanged at 5 percent of TDL. This shows an additional reserve requirement of Rs 41.2 billion on average per day.

Besides monetary tightening, an important objective of the increase in CRR was to provide banks with incentives to mobilize time deposits. This was primarily aimed at: (a) reducing the maturity mismatches that emanated from banks' substantially large investment in long-term government bonds and rising share of advances of relatively longer maturity in FY02 onwards; and (b) improving the return on banks deposits, as deposits of longer-term maturities are relatively more sensitive to interest rates.

As expected, the share of time liabilities (mainly deposits) in overall liabilities has depicted a rising trend since the changes in CRR in July 2006 (see **Table 2.1**). A point to point comparison suggests that share of TL in TDL has improved from 12.1 percent as on July 22, 2006 to 16.5 percent as on December 22, 2006, indicating a rise of 4.4 percentage points. It is pertinent to note that this relatively faster growth in TL has helped banks to reduce the effective CRR from 6.52 percent for the week ending July 28, 2006 to 6.42 percent for week ending December 22, 2006.

The changes in CRR together with other measures of monetary tightening have also helped in improving the return on banks deposits rates. During July-November 2006, banks weighted average deposits rates on marginal and stock definition have improved by 83 bps and 70 bps, respectively; which was nevertheless lower than the increase in 6-month KIBOR (97 bps) and weighted average lending rates (106 bps) during this period. As a result, spread between weighted average marginal lending and deposits rates has increased by 23 bps during July-November 2006.

Going forward, if share of TL in overall TDL continues to improve, this would help not only in increasing the return on deposits, but also bringing structural improvement in monetary policy transmission mechanism to banks' deposit rates. This is because, in general longer-term deposits are relatively more sensitive to return on deposits.

¹ As per new definition for the purpose of implementing CRR by banks and monitoring by SBP, all savings deposits have been classified into demand liabilities. Other notable changes include the reclassification of special notice deposits and time deposits of less than 6 month from the time liabilities to demand liabilities.

Table 2.1: Trends in Effective CRR

Week ended	Share in TDL		Effective CRR*	
	DL	TL	Required	Actual
	percent			
21-Jul-06	-	-	5.00	5.22
28-Jul-06	87.9	12.1	6.52	10.36
4-Aug-06	87.5	12.5	6.50	6.80
11-Aug-06	86.5	13.5	6.46	6.57
18-Aug-06	86.6	13.4	6.46	6.72
25-Aug-06	86.3	13.7	6.45	6.67
1-Sep-06	85.8	14.2	6.43	6.65
8-Sep-06	85.4	14.6	6.42	6.77
15-Sep-06	85.1	14.9	6.40	6.70
22-Sep-06	85.0	15.0	6.40	6.64
29-Sep-06	85.1	14.9	6.40	6.70
6-Oct-06	85.2	14.8	6.40	6.78
13-Oct-06	84.9	15.1	6.38	6.68
20-Oct-06	84.8	15.2	6.38	6.70
27-Oct-06	84.7	15.3	6.37	6.88
3-Nov-06	84.6	15.4	6.37	6.69
10-Nov-06	84.4	15.6	6.36	6.64
17-Nov-06	84.4	15.6	6.36	6.63
24-Nov-06	84.4	15.6	6.36	6.62
1-Dec-06	84.4	15.6	6.36	6.72
8-Dec-06	84.9	16.1	6.43	6.70
15-Dec-06	84.5	16.5	6.41	6.69
22-Dec-06	84.6	16.5	6.42	6.93

*: On weekly average basis.

corresponding period last year; credit under EFS and LTF-EOP together explained around 54 percent of the absolute change in reserve money in H1-FY07 over H1-FY06.

Box 3: Incentives for Industrial and Export Sector

As the key policy rate was moved upward to further tighten the monetary policy in July 2006, various concessional elements were introduced to limit the cost of borrowing for the industrial sector as well as exporters. The major developments on this front are summarized, as follows:

In July 2006, the maximum margin/spread for banks/DFIs on loans under Long Term Financing for the Export-Oriented Projects (LTF-EOP) was reduced from 3 percent per annum to 2 percent per annum. This 100 bps decline in spread was designed to reduce the cost of borrowing by the same percentage points. Besides this reduction in cost, the credit limits for participating financial institutions (PFIs) were also increased to match the growing financing requirements under this scheme. Specifically, separate limits for LTF-EOP and export finance schemes (EFS) were introduced in place of earlier arrangements of 'allocating LTF-EOP limit as sub-limit of EFS'. The scheme was further liberalized by withdrawing initial restriction of at least 50 percent of credit limit to be disbursed for SME sector.

Besides concession through LTF-EOP, SBP also reduced the refinance rate under EFS by 100 bps to 6.5 percent in July 2006 and capped the maximum margin/spread of banks at 1 percentage point from 1.5 percentage points earlier.¹ In other words, exporters are facilitated to borrow at 6.5 percent plus some margin (maximum 1 percent allowable to banks) under EFS in contrast with the weighted average lending rate hovering near 11 percent. The outstanding amount of refinance reached Rs 131.5 billion by end H1-FY07. More importantly, the exporters have availed net credit of Rs 23.6 billion during H1-FY07 under this scheme against net retirement of Rs 3.0 billion in H1-FY06. Furthermore, both exporters and importers can also avail FX loans, as banks are allowed to extend trade loans against FE-25 deposits.

The above concessions for industrial sector were further enhanced in September 2006 by allowing the textile sector (other than spinning but including six sub sectors of spinning) to swap their outstanding fixed term loans for import of plant and machinery with LTF-EOP scheme, if certain conditions specified by the SBP are met.² This concession allowed the textile industry to avail long-term loans of worth Rs 43.1 billion from banks/DFIs by end H1-FY07. Further break up of these loans indicate that the SBP allowed refinancing of Rs 34 billion under its debt-swap option and Rs 9.1 billion as fresh borrowing under new LTF-EOP refinance scheme. Importantly the mark-up under the scheme (a) remains fixed for the tenor of the loan; and (b) is significantly lower than the market rate.

The above SBP efforts were further supplemented by Research & Development Support to garments, home textiles and fabrics offered by the Ministry of Commerce and Ministry of Textile Industry. The data shows that the SBP has settled 91,061 cases totaling Rs 10.2 billion from July 2005 to December 19, 2006. The break-up indicates that 87,299 cases were related to the garment sector, while the remaining cases pertained to the textile and fabric sectors.

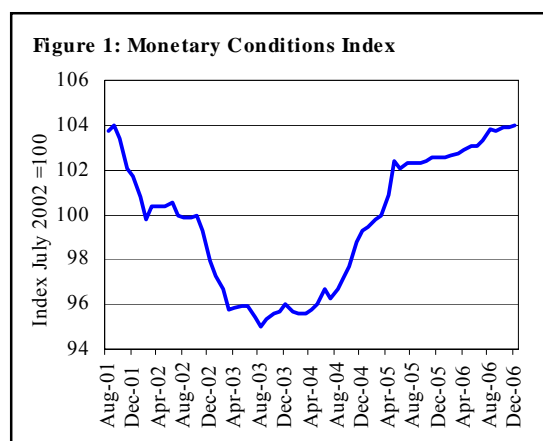
¹ For details, please see State Bank of Pakistan Press Release dated July 14, 2006.

² See SMED Circular No. 19 dated September 4, 2006.

Impact of SBP policy actions and recent trends

Monetary tightening has impacted on the Monetary Conditions Index significantly.

15. The impact of monetary tightening is clearly visible in rising interest rates and a deceleration in monetary aggregates (M2) during H1-FY07. For instance, 3- and 6-month KIBOR increased by 114 bps and 97 bps, respectively during H1-



FY07. The Monetary Conditions Index (MCI), worked out on the basis of KIBOR, clearly shows the impact of increased monetary tightening during the period under review (see **Figure 1**).⁷ In specific terms, during H1-FY07 the index has registered a growth of 0.9 percent against a significantly smaller rise of 0.4 and 0.5 percent in H1 and H2 of FY06, respectively.

M2 growth has decelerated to 7.6 percent in H1-FY07.

16. Tightening of monetary policy is also reflected in a slight deceleration in M2 growth during H1-FY07 to 7.6 percent against 7.9 percent during the corresponding period of FY06. It is pertinent to mention that M2 growth would have been even lower had the Net Foreign Assets (NFA) of the banking system

Table 3: Monetary Survey (Flows) during H1
billion Rupees

	Credit Plan FY07	FY06	FY07
M2	459.9	235.5	258.7
	(13.5)	(7.9)	(7.6)
NFA	9.8	-66.7	11.5
SBP		-32.3	2.8
Scheduled banks		-34.4	8.7
NDA	450.1	302.2	247.1
<i>of which</i>			
Government borrowing	130.1	68.9	10.9
<i>For budgetary support</i>	120.1	84.9	28.3
SBP		142.4	79.3
Scheduled banks		-57.5	-51.0
Credit to non-govt sector	395.0	294.1	244.2
Private sector	390.0	297.7	243.6

While NFA of the banking sector expanded substantially, NDA witnessed a massive decline.

not built up during the period (see **Table 3**). Specifically, the NFA of the banking system expanded by Rs 11.5 billion during H1-FY07 against a substantial contraction of Rs 66.7 billion in the corresponding period of FY06. On the other hand, NDA of the banking system decelerated to 9.1 percent in

⁷ The MCI is a weighted average of the short-term interest rate and exchange rate relative to a base period and tracks the combined impact of interest rate and exchange rate changes on monetary conditions. Details can be seen in Hyder and Khan (2006), Monetary Conditions Index for Pakistan, SBP Working Paper No. 11. SBP is internally monitoring the MCI on a regular basis.

H1-FY07 from 13.0 percent in H1-FY06. This was mainly on account of lower government borrowings (net) from the banking system and deceleration in credit off-take by the private sector (see **Table 3**).

17. Growth in credit to private sector (CPS) dipped from 17.4 percent in H1-FY06 to 11.5 percent in H1-FY07. Although the net CPS fell slightly short of the monthly estimates (see **Figure 2**), the YoY growth at 17.3 percent is still strong. More

importantly, causative factors for the slowdown do not raise any serious concern at this point in time. In fact, the distribution of banks' advances during July-November 2006 indicates that: (a) consumption-oriented

demand for credit has dampened, which is a welcome development; (b) credit demand for long-term fixed investment has remained intact (see **Table 4**); (c) the slowdown primarily stemmed from lower credit off-take by the business sector for working capital, and more importantly, was not broad based.⁸ The deceleration in the working capital loans during FY07 relative to the preceding year was expected, as most of the industries are operating at near full capacity; unless additional capacity becomes operational, one should not expect a significant rise in the demand for working capital.⁹

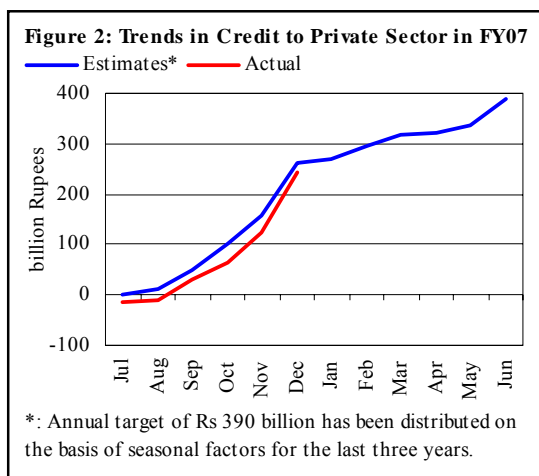


Table 4: Advances to Private Sector (Net flows)

billion Rupees	July-November		
	FY05	FY06	FY07
<i>Business sector</i>	135.7	144.0	106.2
Working capital	101.5	95.7	39.6
Fixed capital	26.7	37.3	37.4
Trade loans	7.7	11.3	29.4
Others	-0.2	-0.3	-0.2
<i>Consumer finance</i>	23.7	37.9	29.6
<i>Others</i>	-0.5	-3.7	-1.0
Total	158.9	178.2	134.8

⁸ The deceleration in banks' advances for working capital was primarily because of net retirement by cotton spinners and sugar manufacturers, explaining over 70 percent of absolute decline in working capital in July-November FY07 over July-November FY06.

⁹ It may be noted here that expansion in the fertilizer, cement and paper & board industries is expected during H2-FY07. Moreover, new plants and further expansion in a number of industries is expected to come on-line in FY08. This suggests that demand for CPS is likely to pick up going forward.

During H1-FY07 SBP monetary policy has been successful in containing demand side inflationary pressures, without hurting growth.

LSM growth accelerated during Q1-FY07.

18. Encouragingly, the trends in key macroeconomic variables during H1-FY07 indicate that SBP monetary policy measures proved successful in striking the required balance between curbing the demand side inflationary pressures and supporting the growth momentum. Indications are that the economy continues to grow at a robust pace on account of acceleration in Large-scale Manufacturing (LSM) and agriculture, and the persistently strong performance of services sector.

19. As shown in **Table 5**, growth in the LSM has accelerated during Q1-FY07 to 9.7 percent against 8.8 percent in the first quarter of FY06. Higher production in the textile, electronics, chemicals and metal industries have mainly contributed to the improved performance during the period. In the agriculture sector, despite the disappointing performance of three major *Kharif* crops (i.e. cotton, rice and maize), the value addition of the sector is likely to improve over FY06; however realization of the FY07 agricultural growth target will be possible only if the livestock sub-sector and wheat crop perform well above their targets.¹⁰

20. More importantly, core inflation, which had registered a sluggish decline in FY06, has already witnessed a substantial deceleration during H1-FY07. By December 2006, YoY core inflation has come down to as low as 5.5 percent, which is 1.9 percentage points lower than the 7.4 percent level recorded during the corresponding period last year, 0.8 percentage points less than the level

Table 5: Selected Economic Indicators

Data for July-November, unless mentioned otherwise

		FY05	FY06	FY07
Growth rates in percent				
CPI (YoY)	Dec	7.4	8.5	8.9
Non-food non-energy (YoY)	Dec	7.8	7.4	5.5
10 % trimmed based (YoY)	Dec	7.7	6.5	6.0
Large scale manufacturing	Jul-Sep	26.9	8.8	9.7
Exports (FOB)		13.6	13.8	7.3
Imports (FOB)		51.5	33.2	13.9
Amount in billion US\$				
Total liquid reserves ¹	End-Dec	9.8	11.6	12.9
Home remittances	Jul-Dec	1.9	2.1	2.6
Foreign private investment		0.4	1.0	2.1
Foreign direct investment		0.3	0.8	1.5
Of which:				
Privatization Proceeds		0.0	0.3	0.1
Portfolio investment		0.0	0.3	0.6
As percent of GDP²				
Fiscal deficit	Jul-Sep	0.4	0.5	1.0
Trade deficit		1.5	2.8	3.1
Current a/c deficit		0.6	2.4	2.7

Note: Total may not tally due to separate rounding-off

¹ With SBP & commercial banks.

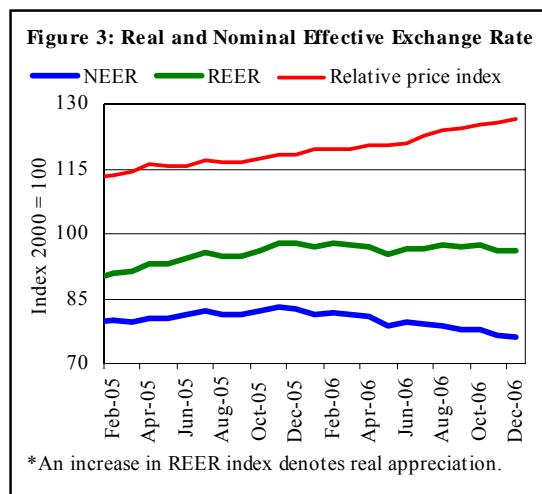
² Based on full-year GDP in the denominator.

¹⁰ Given the supporting factors such as: (a) higher water availability during *rabi* crop over last year; (b) timely announcement of increase in support price for wheat (of Rs 10 per 40 kg); and (c) distribution of new high-yielding varieties of wheat seeds; wheat crop is likely to achieve 22.5 million tons target for FY07.

The hard-won containment of core inflation was however marred by the double digit food inflation.

observed in June 2006, and 2.3 percentage points less than the nearest peak of 7.8 percent recorded in October 2005.¹¹ This comforting decline in core inflation, however, is eclipsed by the persistently high food inflation stemming principally from supply side disturbances. In totality, the average consumer price index (CPI) saw a rise of 8.4 percent during H1-FY07, which is well above the annual target of 6.5 percent for FY07.

21. Moreover, the inflation in Pakistan is relatively higher compared to its competitors and trading partners. Specifically, the Relative Price Index (RPI) increased by 4.5 percent during H1-FY07. In fact, this higher domestic inflation has offset the gains emanating



from nominal depreciation (see **Figure 3**) and the real exchange rate, measured in terms of the real effective exchange rate (REER) index, appreciated slightly by 1.0 percent during H1-FY07.

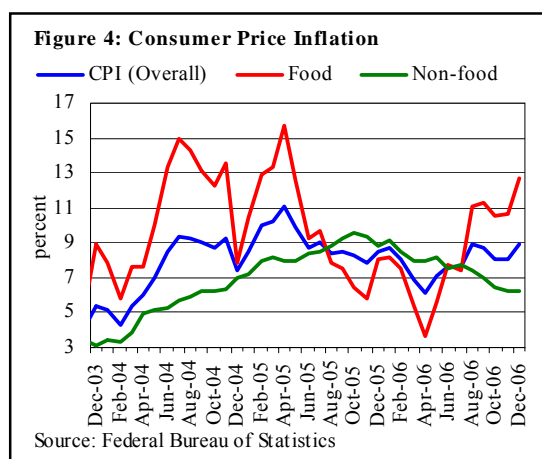
¹¹ Similarly, the 10 percent trimmed-based core inflation, measure at 6.0 percent in December 2006 also declined by 0.5 percentage points since December 2005.

2. KEY CHALLENGES FOR MONETARY POLICY DURING H2-FY07

Headline inflation will remain above the annual target for FY07

While inflation is likely to ease-off further, it will remain above the 6.5 percent target for FY07.

22. Containing the headline inflation close to the target for FY07 will be the foremost challenge for SBP. As pointed out earlier, despite a visible decline in non-food inflation during H1-FY07 (see **Figure 4**), the headline inflation remains significantly above



the target of 6.5 percent. This is principally due to the double-digit food inflation during August-December 2006 mainly reflecting the impact of heavy rains in August and November 2006, and demand escalation during the month of *Ramadan*.

23. Looking ahead, it is expected that the headline inflation would slowdown as: (a) monetary policy tightening measures taken earlier this year and the recent downward revision in petroleum prices by the government would have a further dampening effect on non-food inflation,¹² and (b) the double-digit food inflation is anticipated to ease off due to improving supply condition of key food items,¹³ and generally favorable weather conditions for the wheat crop. However, there is a risk to this outlook as higher international prices¹⁴ for cereal products (particularly wheat) may create incentives for hoarding in domestic markets as well as to export. Thus, the effective management of domestic supply conditions will remain critical for containing food inflation.

24. In overall terms, despite the downward revision in domestic oil prices, recent trends clearly suggest that the inflation outcome for FY07 is likely to be

¹² The Oil and Gas Regulatory Authority (OGRA) has cut petroleum prices with effect from January 16, 2007.

¹³ It is interesting to note that double-digit food inflation in December 2006 is significantly boosted by only two kitchen items. Specifically, price of onions and tomatoes witnessed substantial YoY increases in December 2006. Excluding the impact of these two items, food inflation would reduce to single digit, as the weighted contribution of these two items stood at 36.9 percent in YoY food inflation in December 2006.

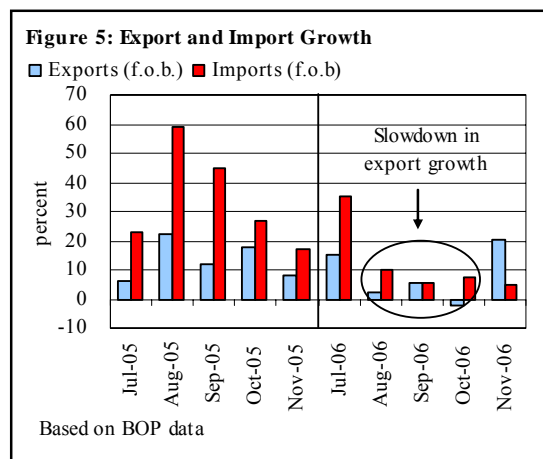
¹⁴ The international prices for wheat and rice may remain under pressure due to lower estimated world production, strong global demand, increases in input costs and reduction in global stocks.

higher than the annual target for the year because of the high food inflation. The key challenge will be to keep the inflation as close to the target as possible. Consequently, the role of administrative measures to improve supply of essential food items remains vital. In the meanwhile, SBP has to maintain its tightening stance so that inflationary expectations do not worsen.

Recent deceleration in exports is worrisome

Slowdown in export growth remains an area of concern

25. In contrast to previous years, the worsening of trade deficit during July-November FY07 was caused by a larger deceleration in exports growth in comparison with growth in imports (see **Figure 5**). Despite substantial support from the government and SBP (see **Box 3**), this



deceleration in exports indicates the presence of increased global and regional competition in addition to the already existing structural weaknesses. As explained earlier, the domestic inflation in Pakistan is higher compared to its trading partners and competitors; the continuation of SBP's focus on containing inflation is crucial for improving Pakistan's competitive position.

High reserve money growth is a concern

Reserve money growth is increasing, primarily because of liberal access to EFS and LTF-EOP.

26. Being a leading indicator of future monetary expansion and inflation outlook, the sharp rise in the reserve money (M_0) growth in H1-FY07 is a major concern for SBP. Liberal access provided to exporters under EFS and LTF-EOP has been the primary contributory factor to this sharp rise in reserve money. It is expected that the absolute contribution from these two contributory sources will continue during the second half of FY07.¹⁵

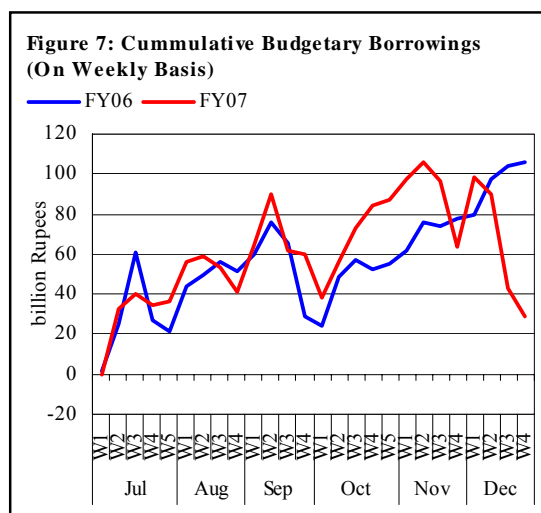
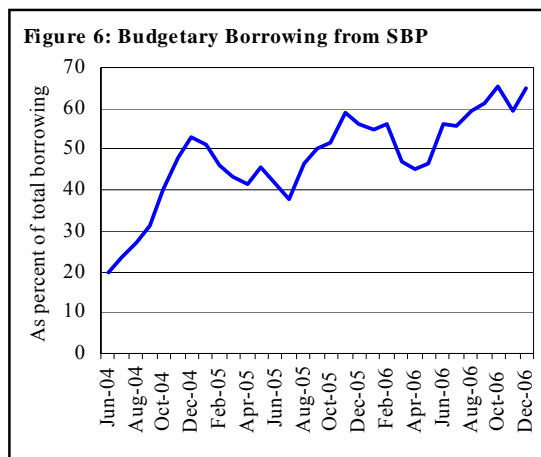
27. An additional risk to growth in reserve money emanates from the expected large foreign exchange inflows during H2-FY07 mainly from privatization proceeds and planned inflows on account of GDR floatation. While

¹⁵ The demand for credit under EFS and LTF-EOP is expected to remain strong due to considerably higher interest rate differential between the prevailing market rates and the rates on these schemes.

the realization of these inflows projects a positive balance of payments outlook for FY07, such inflows would also exert upward pressures on reserve money growth.

28. The third risk to the reserve money growth comes from the rising dependence of the government on SBP borrowings (see **Figure 6**). At the end of H1-FY07, cumulative budgetary borrowings from the banking system at Rs 28.3 billion remained well below the Rs 120.1 billion target for the year. However, the government borrowed a sum of Rs 79.3 billion from SBP during this period. Besides dependence on SBP borrowings, the volatility in government borrowings is also adding to difficulties in liquidity management by SBP (see **Figure 7**).¹⁶

Government borrowing showed high volatility during H1-FY07...



29. Given the existing trend of reserve money growth, this would also imply that monetary policy has to be necessarily kept tight in order to mitigate the risks of excessive expansion in domestic liquidity.

¹⁶ Government borrowings from the banking system as on December 30, 2006 stood at Rs 10.9 billion, significantly lower than Rs 106 billion recorded on November 11, 2006. This sharp fall in government borrowing to the current low level can largely be explained by improved inflows to government on account of: (1) Rs 24.3 billion SBP profits were transferred to the government on November 21; (2) Rs 44.5 billion were received from the OGDCL GDR in December; and (3) Rs 19.7 billion borrowed through PIBs in December 2006.

Annexure 1

INTERNATIONAL ECONOMIC ENVIRONMENT¹⁷

Global economy is likely to moderate in 2007...

30. Activity in the global economy remains robust but a benign moderation is expected in 2007 (see **Table 6**). The US economy, which expanded at a strong pace during the last few years, is likely to moderate marginally in 2007 due to a variety of factors including a decline in consumer spending, low investment in the housing market, slowdown in the industrial sector and

Table 6: Key Indicators for World Economy
percent

	2004	2005	Forecast	
			2006	2007
World Output	5.3	4.9	5.1	4.9
Advanced Economies	3.2	2.6	3.1	2.7
United States	3.9	3.2	3.4	2.9
Japan	2.3	2.6	2.7	2.1
Euro Area	2.1	1.3	2.4	2.0
Developing Asia	8.8	9.0	8.7	8.6
China	9.7	10.2	10.3	10
India	7.2	8.2	8.3	7.3
Middle East	5.5	5.7	5.8	5.4
ASEAN-4	5.8	5.1	5	5.6
Consumer prices				
Advanced economies	2	2.3	2.6	2.3
Euro Area	2.1	2.2	2.3	2.4
Developing Asia	4.1	3.5	3.8	3.6
ASEAN-4	4.6	7.5	8.6	4.5
World Trade Volume	10.6	7.4	8.9	7.6

Source: IMF, WEO, September 2006
ASEAN-4 includes Malaysia, Indonesia, Philippines, and Thailand.

widening of twin deficits. The Japanese economy, which experienced an upturn during the first half of 2006, is also expected to exhibit deceleration in 2007. While the growth recovery in Euro area has decelerated slightly, the performance of China and India remained solid. Despite remarkable performance by some of the major economies, there are certain risks to world economic growth which include a more than expected weakening of the U.S. housing market; inflation hikes, if energy prices take an upturn again; and disorderly unwinding of global imbalances.¹⁸

Global inflation is expected to slowdown in 2007 in the backdrop of reduction in demand and deceleration in oil prices.

31. During 2006, world inflation remained high mainly due to the rise in oil prices which not only caused a hike in inflation but also strengthened inflationary expectations. However, the global inflation outlook for 2007 is encouraging particularly in the backdrop of an expected reduction in global demand and deceleration in oil prices.

¹⁷ The discussion is based on IMF report on "World Economic Outlook" for September 2006, OECD reports, and policy statements/ reports of central banks.

¹⁸ Disorderly correction in global imbalances could lead to undesirable movements in exchange rates, disruptive capital flow reversals and negative effects on investor confidence. For more details, see "Annual Report on the Euro Area 2006", by European Commission, Directorate-General for Economic and Financial Affairs, pp 42-44.

32. The robust global demand, which remained a key driving force behind the strong performance of the world economy during the last few years, is likely to witness slight moderation in 2007. Factors including the ripple effects of imbalances in the US economy, and monetary tightening by a majority of central banks have resulted into dampening of the world demand pressures. Low consumer demand from major economies also signals caution for future export performance of Asian economies including Pakistan. The reduced export growth together with relatively high imports in resource deficient economies may exert additional pressures on the external account, which may lead to aggravation in global imbalances.¹⁹

33. An upshot of global economic imbalances is the creation of excess liquidity in the international financial markets, which has been used for the financing of trade gaps of resource deficient economies. In the short to medium term, the opportunities for raising funds through floatation of GDRs, issuance of bonds, privatization proceeds, etc. are likely to remain available to resource deficient countries as long as the prevailing economic conditions do not change significantly. To avoid adverse implications of reversal of such capital inflows, the governments of respective economies may devise policies that could help increase private and public savings, which is a big challenge, and could be achieved through an improved coordination of fiscal and monetary policies. Moreover, shifting from export-led to domestically-generated growth is also a feasible solution for Asian economies that are depending heavily on performance of key economies driving world economic growth.

Most central banks pursued aggressively tight policy stance in 2006.

34. Robust global growth witnessed in the last few years also caused upward inflationary pressures. To contain inflation and inflationary pressures, various central banks raised their key policy rates in 2006.

- In view of moderation in economic activity and expected deceleration in prices of international commodities, the US Fed has left the key policy rate unchanged since June 2006 (see **Table 7**).
- The Reserve Bank of Australia raised its policy rate in November 2006 mainly to curb inflation emanating from capacity constraints.

¹⁹ While the external account surpluses of countries like China, India and oil producing countries are rising, the deficit of other countries including USA are widening simultaneously.

- The European Central Bank has raised its key policy rate mainly to contain inflationary pressures which emanated from strong growth in euro area.

Table 7: Changes in Key Monetary Policy Rates
percent

- The U.K economy faced upward inflationary pressures due to money and credit growth at elevated rates, increase in wages and capacity constraints. To control inflation, the Bank of

	Current Rates	Changes since January 2006
Pakistan	9.50 ↑ (Jul 06)	50 bps
United States	5.25 ↑ (Jun 06)	100 bps
Euro area	3.50 ↑ (Dec 06)	125 bps
Japan	0.25 ↑ (Jul 06)	25 bps
United Kingdom	5.25 ↑ (Jan 07)	75 bps
Canada	4.25 ↑ (May 06)	75 bps
Australia	6.25 ↑ (Nov 06)	75 bps
Korea	4.50 ↑ (Aug 06)	75 bps
India	6.00 ↑ (Jul 06)	50 bps
Malaysia	3.50 ↑ (Apr 06)	20 bps
Bangladesh	6.50 ↑ (Nov 06)	100 bps
Indonesia	9.50 ↓ (Jan 07)	325 bps
Sri Lanka	11.50 ↑ (Dec 06)	125 bps

Source: Central banks websites, Bloomberg

Note: Figures in parenthesis denote last change occurred in policy rates of central banks.

England has raised its key policy rate on January 11, 2007.

- The Bank of Japan has kept its key policy rate unchanged since July 2006 mainly due to a decline in domestic demand in the wake of low consumption spending and subdued inflation.
- The Chinese economy continued to grow strongly despite monetary tightening.

35. As regards other Asian economies, a mixed behavior has been observed in terms of central bank policy actions. Some central banks have kept their policy rate unaltered due to moderation in their economies in an environment of subdued inflation, slowdown in exports and the manufacturing sector, while others continued to pursue monetary tightening until recently.

Annexure 2

Regional Economies - Performance and Policy Response

36. Regional economies continued to exhibit robust growth over the last few years, supported by strong aggregate demand and rising exports. Although the strong GDP growth in these economies helped improve overall living conditions of the masses, it led to inflation and inflationary expectations, as the robust domestic

High growth in regional consumption has built up inflationary pressure.

demand exceeded the productive capacity of these economies. To meet enhanced demand, these economies relied heavily on costly imports (consumer and capital goods) which deteriorated external as well as internal position of the economies.

Regional central banks are also tightening monetary policy.

37. To contain inflation and restrict demand, majority of the central banks in the region pursued a tightening stance and raised key policy rates (see **Table 7**).

However, some of them maintained a status quo on interest rates during the last four months of 2006 due to the expected ease-off in

Real lending rates in Pakistan are relatively low.

inflation in the backdrop of improved supply conditions, and expected decline in prices of international commodities. Aggressive monetary tightening by various central banks led to a rise in the lending rates of commercial banks which caused a slowdown in private sector credit off-take. It may be noted that contrary to the perception, Pakistan has the lowest lending rates in real terms

Table 8: GDP Growth of Asian Economies
percent

	2004	2005	2006(p)	2007(f)
ASEAN-4	5.8	5.1	5.0	5.6
China	9.7	10.2	10.3	10.0
India	7.2	8.2	8.3	7.3
Thailand	6.1	5.2	4.5	5.0
Malaysia	7.1	5.2	5.5	5.8
Indonesia	5.1	5.2	5.5	6.0
Philippines	6.2	5.0	5.5	5.4
Bangladesh	6.1	6.2	6.7	6.5-6.8
Sri Lanka	5.5	5.3	5.6	6.0
Pakistan	7.4	8.6	6.6	6.6-7.2
Developing Asia	8.8	9.0	8.7	8.6

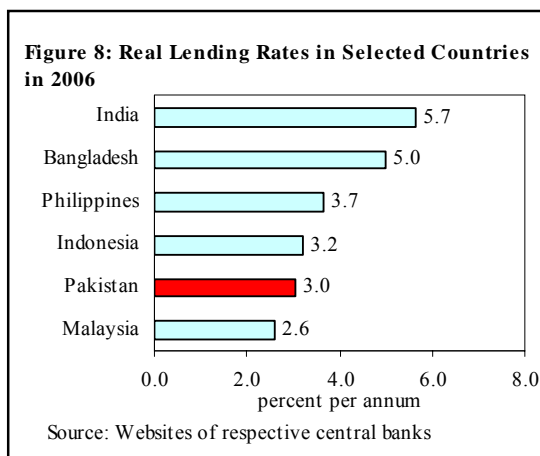
Sources: IMF, WEO for Sep- 2006, central banks websites
ASEAN-4 includes Malaysia, Indonesia, Philippines, and Thailand.
p: Provisional, f: Forecast

Table 9: Inflation in Asian Economies
Percent

	2004	2005	2006(p)	2007(f)
ASEAN-4	4.6	7.5	8.6	4.5
China	3.6	0.6	1.5	2.2
India	3.3	4.3	4.4	5.0-5.5
Thailand	3.6	5.1	4.9	2.6
Malaysia	2.0	3.3	3.8	2.7
Indonesia	7.8	11.3	6.6	6.0-7.0
Philippines	6.0	7.6	6.7	5.0
Bangladesh	6.1	7.0	7.2	6.8-7.0
Sri Lanka	10.2	9.0	8.0	7.0
Pakistan	4.6	9.3	7.9	6.7-7.5
Developing Asia	4.1	3.5	3.8	3.6

Sources: IMF, WEO for Sep- 2006, central banks websites
ASEAN-4 includes Malaysia, Indonesia, Philippines, and Thailand.
p: Provisional, f: Forecast

compared to India, Bangladesh, Indonesia and the Philippines. The low real lending rates in turn could facilitate achieving the high investment target (see **Figure 8**). Although the growth prospects of regional economies still remain positive, their



overall performance is expected to moderate slightly in 2007.

38. Within the Asian region, growth performance of East Asian economies remained robust, influenced mainly by the investment boom in China along with the high demand for electronic products from overseas economies. The Malaysian economy is projected to continue a steady growth path. The Philippines economy grew by 5.5 percent in 2006. Like other economies in the region, sharp increases in oil prices fueled inflation in the Philippines, which reached 6.7 percent in 2006. To contain inflation and inflationary expectations, the central bank of the Philippines raised its key policy rates in 2006. The Indonesian economy grew by 5.5 percent in 2006 on the back of strong export and consumer spending. Although the CPI inflation remained at 6.6 percent in 2006, it is likely to remain within the targeted range of 6+1 percent in 2007 due to administered prices and decline in food inflation. To boost-up economic activities, the Bank of Indonesia has lowered its key policy rate by 25 bps to 9.5 percent in January 2007.

39. South Asian economies are also expected to maintain the growth momentum. The Indian economy, which achieved 8.3 percent GDP growth on the back of expansion in manufacturing & services sectors, and rising private investment in 2006, is likely to moderate slightly in 2007. The headline inflation, measured by wholesale price index (WPI), has risen to 5.5 percent by end-December 2006. To contain rising inflation and to restrain demand, the RBI has raised the CRR for banks by 50 bps to 5.5 percent in December 2006. The headline inflation is expected to remain within the targeted range of 5.0-5.5 percent in 2007. The Bangladesh economy grew by 6.7 percent in 2006 because of a strong expansion in the export-oriented manufacturing sector,

besides continued buoyancy in services. The economy is expected to sustain the current growth momentum in 2007. The annual CPI inflation, which peaked at 7.2 percent in 2006, is likely to decelerate in 2007 in the wake of a restrained monetary policy stance pursued since the second half of fiscal year 2005. The Sri Lankan economy has shown a respectable growth over the last few years, with 5.6 percent growth in 2006 due to the strong performance of the textile and telecom sectors. In order to contain inflation, the central bank continued to pursue a tight monetary stance in 2006. As a result of continued tightening by the central bank, the CPI inflation fell to 8.0 percent in 2006 compared with 9.0 percent a year earlier. The central bank of Sri Lanka has raised its key policy rate to 11.5 percent in December 2006 mainly to keep inflation under control and dampen demand pressures.