INTERIM MONETARY POLICY MEASURES

May 2008

STATE BANK OF PAKISTAN

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Executive Summary

The last Monetary Policy Statement (issued on January 31st, 2008) tightened monetary policy keeping in perspective the trends and developments surfacing in the first two quarters of FY08. SBP had also enunciated clearly in the MPS the growing domestic vulnerabilities and risks facing Pakistan's economy given the disruptions in 2007 both on economic and political front. Renewed pressures are visible in the country as the domestic and international economic environment and outlook has changed significantly. Multidimensional global developments including the growing liquidity crunch and the rising global commodities prices as well as the rising domestic twin deficits reflect the significant aggregate demand. Together these developments are now manifesting themselves into heightened inflationary pressures which unless curbed is expected to magnify further.

The unfolding events on both international and domestic front have enhanced the economic stress – worldwide as well as in Pakistan. Most countries, developed or developing, are likely to register a slowdown, and have witnessed exceptional rise in inflation, which is now emerging as the biggest challenge facing the global economy. Central banks are and will be expected to play a key role in the current global scenario to strike a balance between growth and price stability. On the balance it is being acknowledged across all economies that managing domestic demand pressures is critical in avoiding further and steeper rise of inflation; current rate of inflation has already started to impact economic growth and has induced fresh threats to economic stability.

Pakistan's macroeconomic outcome for FY08 has deviated considerably from the original projections. This has necessitated re-examination of the monetary policy framework that was based on different assumptions related to fiscal and external current account deficit as well as output growth and inflation. The slippages in twin deficits and borrowings of the government from the SBP have grown persistently every month. Equally concerning is steady rise, but now a sharp spike in year-on year indicator of food inflation. These trends have reached a proportion that are now unsustainable and without corrective actions carry risk of creating more macroeconomic complications.

Few developments stand out and reflect the unprecedented economy wide pressures and highlight the urgency of an immediate monetary policy tightening.

First, external current account deficit has increased at a pace that is difficult to sustain given the slowdown in financial inflows. The rising external current account deficit owing to widening trade deficit indicates that, despite a decent export performance, significant import demand pressures exist in the economy. Underlying this alarming trend, most worrisome is the acceleration in import demand during the first four months of 2008 that has been rising unabated over the entire fiscal year. During this period, import bill has increased by US$13.4 billion while export revenues grew by only US$6.9 billion resulting in an increment of US$6.5 billion in trade deficit. Most distinct is the extraordinary growth in the non-oil and non-food imports running at 42 percent during the same period. Consequently, the external current account deficit is projected to range between 7.3 – 7.8 percent of GDP, which is much higher than the initial projection of 5 percent for FY08. This is clearly unsustainable and calls for taking urgent corrective actions.

Second, **original projections of balance of payments were casted assuming growth in foreign exchange inflows in line with the results of FY07. However, liquidity constraints in global financial markets and the domestic political uncertainty have impacted the net foreign inflows position.** Burgeoning external current account deficit along with slowdown in foreign direct investment and foreign portfolio outflows has resulted in drawdown of reserves by US$3.7 billion over July 1- May 16 FY08 and by US$4.6 billion relative to end-October 2007.

Third, complications on financing of external current account deficit coupled with speculative positions in the domestic foreign exchange market have put enormous pressure on the exchange rate. Since end-June 2007, the Pak Rupee has depreciated by 14.9 percent up to May 21, 2008 and most of this depreciation is concentrated in the last six weeks or so. Up to end March 2008, the Rupee depreciated by only 3.9 percent and since then it has depreciated by 10.8 percent. The effects of this depreciation on domestic inflation will emerge in the coming months. Recognizing the prevailing pressures on exchange rate, SBP is committed to maintaining macroeconomic stability which should help further stabilize exchange markets. The monetary tightening along with the structural changes to limit central bank borrowings for budget should help infuse exchange rate stability. In tandem, SBP has launched structural reforms of exchange companies which are intended to incentivize them to augment inflows, while maintaining strict discipline and proper disclosure.

Fourth, given substantial slippages, budget deficit is projected to be significantly higher relative to the original budgetary estimates for FY08. By December 2007 (latest available data), it had reached Rs356 billion against the full year budgeted estimate of Rs399 billion and since has exceeded the budgeted target by a wide margin. The aggregate demand pressure from fiscal module compounded as the government opted to rely excessively from central bank borrowings which, being inflationary, have fuelled considerable inflationary pressures. Rather than retiring its borrowings from central bank, as mutually agreed at the beginning of FY08, government's borrowing during July 1- May19, 2008 reached Rs544.1 billion. Stock of outstanding Market Related Treasury Bills (MRTBs), an instrument through which government borrows from SBP on tap for replenishment, has reached Rs945.9 billion (almost 9.4 percent of GDP); highest ever in Pakistan's history and more than double of last year's level of Rs452.1 billion. The borrowings from the SBP are leading to enormous expansion in reserve money and overall money supply in addition to seriously complicating monetary policy management. This trend has reversed the decline in core inflation which had come down to 5.2 percent by May 2007 -- a success achieved as a result of few rounds of monetary tightening over the preceding 18 months.

Fifth, despite monetary tightening in January private sector credit has grown consistently and has outpaced last year's growth. Credit to manufacturing, particularly textile sector that benefited from additional incentives, has been steady. One plausible explanation for strong private sector credit growth is the fall in real lending rates. As a result of persistent increase in domestic inflation, real interest rates have fallen from 3.4 percent in December to a meager 1.9 percent in March 2008. Real lending rates in Pakistan has been low now for quite some time. To suppress the aggregate demand pressures and rising inflationary trends, it is imperative for real lending rates to increase.

Finally, combination of these developments has raised the headline inflation to an alarming level. On year on year (YoY) basis, it has almost doubled in just four months; moving from 8.8 percent in December 2007 to 17.2 percent in April 2008. More disturbing is the trend of food inflation, which has also doubled spiking to 25.5 percent from 12.2 percent during the same period. Although the importance of administrative supply side measures cannot be undermined in taming food inflation, the urgent need for further tightening to address their second round impact on headline inflation cannot be ignored either. Core inflation measures, depicting persistent and mounting demand pressures, also portray worrying trends. Non-food non-energy measure of core inflation has jumped from 7.2 percent in December 2007 to 10.8 percent in April 2008. Similarly, 20 percent trimmed measure of core inflation has peaked to 14.1 percent. These trends have undermined the past few years of monetary tightening which had significantly curbed by mid 2007. With oil price in the international market now hovering around US$130 per barrel, there is likely to be additional consequences for macroeconomic imbalances and inflation.

Significant slippages in domestic and external deficit for FY08 and the complications of its financing mix and requirements, particularly borrowings from the SBP, have reached unsustainable levels. Based on current macroeconomic trends, the average headline inflation for the entire FY08 is forecasted to be over 11 percent -- almost double the target of 6.5 percent. To manage and cool-off inflation expectations and to tame the underlying dynamics, SBP has decided to introduce following policy actions:

(i) **Increase in the SBP policy discount rate by 150 bps to 12.0 percent w.e.f. May 23, 2008.** This increase has been necessitated by the persistent and excessive government borrowing from SBP to meet the financing requirement of the budget deficit. Stock of government borrowing from SBP is more than double of last year's level. In order to offload this huge debt to the scheduled banks, this increase will act as a critical measure to induce scheduled banks to participate actively in T-bill auctions, which have been mostly unsuccessful in mobilizing receipts for the government in recent past. This will also help in pushing up the low and decline real lending rates necessary to curb the demand pressures and decelerate the current rapid rise in inflation. An increase in interest rates is necessary to encourage savings in the economy, importance of which cannot be over emphasized given the state of fiscal and external current account deficits. The increase in the policy rate will also calm down the sentiments in the domestic foreign exchange markets and make it attractive to lure more foreign inflows. It will also curb the second round impact of food inflation and oil price increase to headline CPI inflation going forward.

(ii) **Increase in the Cash Reserve Requirement (CRR) for all deposits up to one year maturity by 100 bps to 9.0 percent while keeping the CRR for deposits of over one year maturity unchanged at zero percent. In addition, the Statutory Liquidity Requirement (SLR) is increased by 100 bps to 19 percent of the total time and demand liabilities.** The increase in the CRR is supposed to have an immediate impact on interbank interest rates by drying up excess liquidity; this can be ensured at present only with a concomitant rise in the SLR since the banks are already keeping government papers over and above the current requirement of 18 percent. In case, the CRR is increased in isolation, banks are likely to liquidate their investments to make up the liquidity shortages due to CRR increase, thereby diluting the impact of policy measures. The net impact of the rise in both the CRR and the SLR would then be translated into an increase in market interest rates. An additional positive impact of this measure is likely to be on deposit mobilization as the banks would be forced to generate more deposits to cope with liquidity requirements for their operations.

(iii) **Effective 1 June 2008, all Banks are required to pay a minimum profit rate of 5 percent of Saving/PLS saving products.** The saving deposits category account for more than 43 percent of all bank deposits and constitute 63 percent of the total number of countrywide deposit accounts. While on the margin deposits rates have risen, given the stock of deposits on which returns remain low the average return on all saving accounts is at 2.1 percent. The inelasticity of the deposit rates to the monetary policy signals of SBP makes the transmission of the monetary stance less effective. Impact of any increase in the discount rate by SBP is immediately transmitted through advances; however, there is little impact on the deposit rates and hence, there is no incentive for the currency in circulation to move into bank deposits. SBP has been relying on moral suasion and competition among banks to encourage rise in returns on deposits. While this has facilitated greater awareness in banks and differential and higher returns by smaller banks, but by and large increment on deposit rates has happened principally for large deposit holders. In 2008, given the low returns, the growth of deposits has been impacted thereby affecting the capacity of the system to service growing economy wide requirements. This measure is also necessitated by the slower growth in overall deposits. The rise in deposit rate will help bring in high level of currency in circulation into the financial intermediation process and allow banks to have higher level of resources to serve the credit requirements of the economy.

(iv) **Effective 23 May, the L/C margins on all imports except for oil and selective food imports is being imposed at 35 percent.**

(v) **The Government is well advised to sterilize the expected foreign inflows by using the foreign resources to settle its obligations to SBP. Rather than use fresh foreign inflows to finance new expenditures, retirements of MRTBs will help reduce the reserve money pressures.**

(vi) **The Government is being further advised to amend the *Fiscal Responsibility and Debt Limitation Act, 2005* to incorporate appropriate provisions to restrict the debt monetization.** Most countries have disallowed government to borrow from central banks to allow smooth monetary transmission, while averting the inflationary consequence of debt monetization. Currently, the Government has kept borrowings from the central bank outside this legislation which has eroded the fiscal discipline and diluted the impact of the Fiscal Responsibility Act. In FY08, it is estimated that up till now the Government will have financed around 80 percent of its fiscal deficit from SBP borrowings. Excessive borrowings from the central bank has also resulted in rise in floating debt (that comprise of short-term instruments such as T-bills), raising its share in GDP from 11.1 percent at end-June 2007 to 14.7 percent by end-April 2008. On margin this heavy reliance on debt monetization helps the government reduce its financial cost. However, real economic costs of central bank borrowings cause enormous inflationary pressures, whose burden falls on businesses, industry and public at large. So the government is best advised to launch a program of scaling the SBP borrowing by reducing its stock of borrowing from the central bank over next few years, while not relying anymore on central bank financing. This will infuse greater fiscal discipline as the real hard constraints are imposed on the budget**.**

These tightening measures along with the government's consolidated fiscal program for the medium-term would bring the desired macroeconomic stability enabling the country to escape a structural downward shift and brightening the long term growth prospects. Moreover, this would enhance exchange rate stability for which the SBP has already taken several measures during the last three weeks including:

- Exchange companies have been directed to transfer foreign currency from their Nostro accounts held outside Pakistan to commercial banks in Pakistan and henceforth exchange companies will have to close all Nostro accounts abroad.

- Exchange companies have been encouraged to focus on promoting home remittances and companies can only affect outward remittances to the extent of 75% of the home remittances mobilized by the respective company.

- In order to meet the demand of foreign currencies within Pakistan, the Exchange Companies have been directed to surrender their surplus foreign currency to State Bank – earlier exchange companies were exporting most of the foreign currency, except dollars abroad. Now exchange companies, besides dollar, will not be able to export Pound Sterling, Euro and UAE Dirham's.

- Exchange companies have been required to surrender a minimum of 15%, instead of earlier 10%, of foreign currencies received by them from home remittances to the interbank markets.

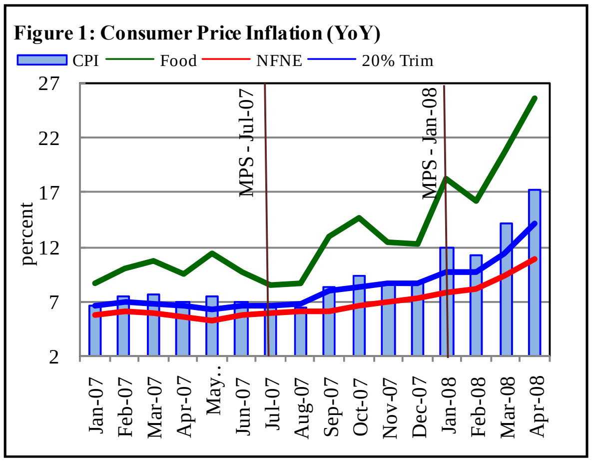
- Limits on advance payments that were relaxed last year have been tightened. Now advance import payments will only be allowed against letter of credits and that too only to the extent of 50%. Advance payments against contracts are now not allowed. Last year advance payments against letter of credit and firm registered contracts were allowed to importers via banks to the extent of 100%.

- Some reforms of the forward hedging mechanism available to importers / exporters have been introduced to ensure that there is no misuse of the facility other than true hedging.

- State Bank of Pakistan has increased the frequency of ‘surprise inspections’ on banks and exchange companies in relation to their compliance of all foreign exchange related regulations.

A. Economic Environment at the Start of H2-FY08 and SBP's Policy Response

Anticipating inflationary pressures to persist, the SBP had to take tightening measures in January 2008 …



1. A visible uptrend in the persistent high inflation (see **Figure 1**) and risks of a further broadening of inflationary pressures underpinned State Bank of Pakistan's (SBP) decision to accentuate monetary tightening in January 2008. The Monetary Policy Statement issued at that time had particularly pointed out that a combination of demand-pull (rising fiscal and external current account deficits and high money growth) and cost push (rising international oil and food commodity prices) factors have increased the risk of a further acceleration in domestic inflation.

2. The evolving inflation expectations were clearly visible in the acceleration in core inflation by December 2007. Managing inflation expectations – arguably a crucial first step towards fighting inflationary pressures – would have been extremely difficult without further tightening of monetary policy.

Thus, citing the dominant risks to inflation and in order to strengthen the monetary policy transmission mechanism, the SBP increased the policy discount rate and the cash reserve requirements…

3. Increase in the policy rate by 50 bps to 10.5 percent w.e.f. February 1, 2008 was the fourth consecutive increase since April 2005. This measure was expected to reduce aggregate demand, thereby helping contain the growth in inflationary pressures, and offset some of the impact of rising food prices and the expected increase in pass-through of international oil prices. To complement the increase in policy discount rate and to keep the market liquidity conditions tight, Cash Reserve Requirement (CRR) for all deposits of maturity of up to one year was increased by 100 bps to 8 percent. The SBP once again recommended that the government reduce its reliance on borrowings from the SBP, tighten its expenditure belt, and seek alternative financing sources.

4. The implementation of tight monetary policy through Open Market Operations (OMOs) was challenging due to heavy government borrowing from the SBP. Though the SBP managed to keep the overnight rate in a desirable range on average, its volatility increased considerably. Specifically, during February 1 to May 20, 2008 the average overnight rate remained at 9.1 percent (same as H1-FY08) while its co-efficient of variation rose to 16.4 percent, compared to a much lower 9.3 percent observed in the same period last year. The Repo rates of higher tenor and the Karachi

Interbank Offer Rates (KIBOR) – the benchmark for banks' lending rate – also followed the increase in the policy rate but its impact was somewhat diffused with the growing excess liquidity. By May 21, 2008, with the changing sentiments and borrowing pressures of both the government and the private sector, the 6-month KIBOR has experienced an increase of 130 bps and it now stands at 11.36 percent.

5. However, mounting domestic aggregate demand pressures, especially since the release of last monetary policy statement, and changing international economic enviornment are making it quite difficult to have the desired impact of these tightening measures on key macroeconomic indicators, in particular inflation. These developments, discussed below, reveal that the macroeconomic stability of Pakistan has been disrupted and requires immediate policy response to halt the situation from deteriorating further.

B. Developments and Outlook

Inflationary outlook has worsened dramatically since January 2008 due to a confluence of extraordinary adverse developments...

6. To appreciate urgency and the need of bringing forward the announcement of monetary policy measures, it is instructive to highlight upfront the key developments (see **Table 1**) before analyzing them in detail.

- Continued fiscal profligacy, post-January 2008 financed essentially by an unprecedented increase in highly inflationary borrowings from the central bank, has completely offset all the repeated attempts by SBP to contain inflationary pressurs in the economy.

- Despite previous tightening measures, a sharp acceleration in import demand has occured during the first four months of 2008. This has been rising unabated over the entire fiscal year.

Table 1: Inflationary Pressures have Worsened

Percent growth (YoY)	**29-Dec-07**	**10-May-08**
Govt. borrowings from SBP	13.6	104.4
As percent of GDP	Jul-Dec	Jul-Apr
Trade deficit	3.7	7.6
Current account deficit	3.6	7.3
Fiscal deficit	3.6	N.A
Rupee against US dollar (%)	**Jul-Dec**	**Jan-May 21**
Exchange rate depreciation	2.7	10.8
percent growth	**Jul-Dec**	**Jan-Apr**
Import growth	12.9	55.5
Change in int'l commodity prices		
Food index*	16.5	18.7
Metal index$	-17.6	22.4
Energy index#	29.6	23.0

* Commodity Food Price Index, 2005 = 100, includes Cereal, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices
$ Commodity Metals Price Index, 2005 = 100, includes Copper, Aluminum, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices
# Commodity Fuel (energy) Index, 2005 = 100, includes Crude oil (petroleum), Natural Gas, and Coal Price Indices

- Exchange rate has depreciated sharply during the last two months in the face of rising external current account deficit, slowing foreign finanical inflows, high fiscal pressures, and prevailing uncertain political environment.

- A continuation of extra-ordinary run-up in international oil and food prices are compounding an already accelerating domestic headline inflation. Moreover, domestic food inflation trend has not shown any respite and its second round impact is already visible in continiously rising core inflation.

7. Strong domestic aggregate demand and the pass-through of high international prices to the domestic economy (particularly of energy and food) appear to have embedded strong inflationary expectations. It is therefore imperative that corrective policy actions be instituted immediately, **if the country is to escape a strcutrual downward shift in the long-term growth prospects**.

Expected slowdown in domestic government and non-government credit, and therefore aggregate demand, did not materialize…

8. Despite the tighter monetary stance, domestic credit to both government and non-government sectors continued apace; accelerating to Rs837.4 billion (24.6 percent YoY growth) during July 1 - May 10 FY08, compared to Rs459.8 billion (18.4 percentYoY growth) in the same period last year. Out of this huge expansion in the total domestic credit, government sector accounted for Rs423 billion, registering an exceptional growth of 32.4 percent. The remaining Rs414.4 billion was availed by the non-government sector that includes private sector and public sector enterprises (see **Table 2**). The fact that year-on-year (YoY) domestic credit growth is the strongest in almost three decades, testifies to the continued robust aggregate demand in the economy.

Table 2: Monetary Aggregates (Flows)

billion rupees

	July 1-May 10		Change since Jan 19	
	FY07	**FY08**	**FY07**	**FY08**
NDA	395.5	656.7	186.6	260.4
of which				
Domestic credit	459.8	837.4	222.0	367.2
YoY growth	18.4	24.6	-	-
Govt. sector*	185.8	423.0	162.3	216.6
Non-govt. sector**	274.0	414.4	59.7	150.6
NFA	84.6	-289.8	93.7	-127.9
SBP	61.5	-221.7	62.5	-142.4
Sch. banks	23.1	-68.1	31.1	14.5
Money supply (M2)	480.1	366.9	280.3	132.5
YoY growth	*16.9*	*14.0*	-	-
Memorandum items				
Net budgetary support	212.4	362.1	165.7	128.1
from SBP	34.8	551.0	**-36.1**	**313.9**
from Sch. banks	177.5	-188.9	201.7	-185.8
Private sector credit	263.4	369.8	47.4	113.1
YoY growth	*15.9*	*19.9*	-	-
Reserve money	201.5	174.9	35.0	58.7
YoY growth	*17.7*	*15.2*	-	

*Includes credit for commodity operations and net budgetary support; **Includes credit to private sector and public sector enterprises
Source: SBP

9. This extraordinary growth in domestic credit is leading to enormous expansion in reserve money and overall money supply. The trend of government borrowing from the SBP is alarming in particular and is seriously complicating monetary policy management. On annualized basis, up to the May 10, 2008, the reserve money and broad money grew by 15.2 percent and 14.0 percent (relative to the indicative target of 13.7 percent for FY08) respectively.

10. These numbers, however, portray a diluted picture. Given the significant contraction in net foreign assets of Rs289.8 billion (against expansion of Rs84.6 billion in the same period last year) and retirement of budgetary borrowings from the commercial banks to the tune of Rs189 billion, the government borrowings from SBP alone are responsible for more than 100 percent (150.2 percent to be precise) of money

creation in the system. It is sobering to consider that the M2 growth would have been even stronger were it not for the contraction in NFA.

The impetus to aggregate demand from fiscal expansion was exceptionally strong …

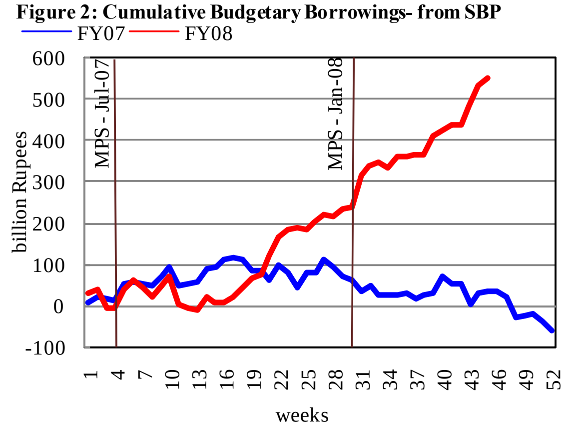
11. The FY08 budgetary fiscal deficit target was 4.0 percent of GDP (or Rs399 billion). The latest available fiscal data (July-December FY08) reveals a deficit of Rs356 billion, thus clearly pointing towards a huge slippage from the announced fiscal deficit target. At that time, current expenditures had grown significantly by 33.3 percent while development expenditure grew by 48.2 percent over the same period of FY07. On the other hand, revenue growth had not kept pace, with siginificant short-falls in both tax and non-tax receipts.

12. The tax collection data avaialble for July – April FY08 reveals that for the first 10 months, the growth in receipts remains weak. The July-April tax receipts have grown by 14.7 percent YoY, as compared to a rise of 20 percent YoY for the same period last year. Both the lower than anticipated growth in revenues and the continued increase in the governemnt financing requirements indicate that the expansionary fiscal stimulus remains significant. Based on available data, SBP forecasts that the annual FY08 deficit will fall in the range of 6.5 to 7.0 percent of GDP.

The inflationary impact of fiscal stimulus was further exacerbated by the rising reliance on financing from SBP…

13. The susbtantial growth in the fiscal deficit has largely been financed by the central bank (see **Figure 2**). This was partly forced by a shortfall in external financing receipts as well as by a lower appetite of scheduled banks for government securities. The latter is because of tight liquidity conditions in the inter-bank market and strong credit demand from the private sector (which offers higher returns). As a result, government has been unable to mobilize substantial amounts in treasury auctions. In fact, against the cummulative target of Rs373 billion and maturities (of earlier auctions) of Rs316 billion during February 1 to May 22, 2008, only Rs180.5 billion was accepted.

Figure 2: Cumulative Budgetary Borrowings- from SBP



14. As of May 19, 2008, the net government borrowings from SBP stands at Rs544.1 billion compared to the previous year's level of Rs35.9 billion. The stock of outstanding Market Related Treasury Bills (MRTBs), an instrument through which Government borrows from SBP on tap for replenishment, has reached Rs945.9 billion; highest ever in Pakistan's history and more than double of last year's level of Rs452.1 billion (see **Table 3**). These extremely high levels of government's borrowings from

SBP need to be checked as it complicates monetary management and pose a serious risk in the containment of inflationary pressures going forward.

Table 3: Cumulative Government Borrowings from SBP

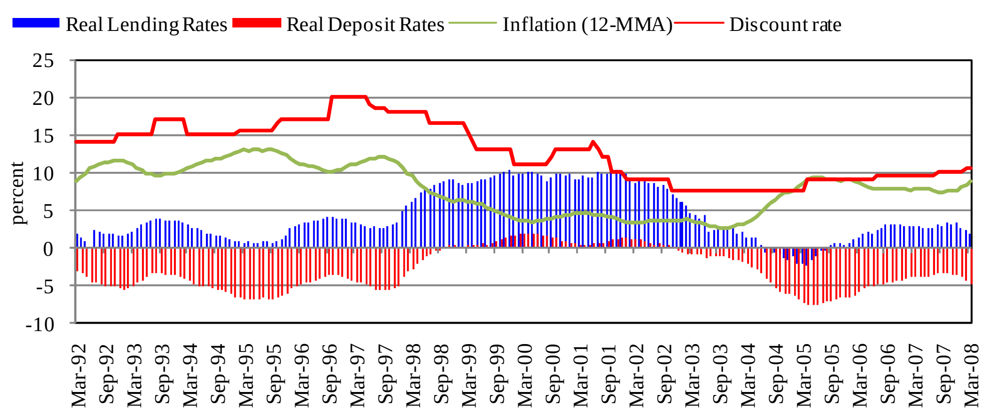
billion Rupees

End June	Stock of MRTBs	Δ in MRTBs over end June FY07	Δ in net borrowing over end June FY07
2005	333.0	205	155.6
2006	508.1	175.1	135.1
2007	452.1	-56.0	-58.6
2008 (Jul 1 - Jan 29)	624.6	172.5	241.6
2008 (Jul 1 - May 19)	945.9	493.8	544.1
Δ since Jan 29, 2008	**321.3**	-	-

The private sector credit has also remained strong, spurred by very low real interest rates …

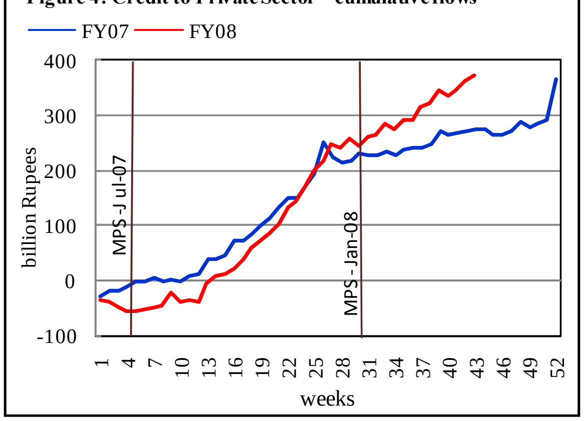
15. The increase in nominal lending rates have not kept up pace with persistently increasing domestic inflation. As a result, the real weighted average lending rate (WALR) on incremental loans stands at a meager 1.96 percent for March 2008 down from 3.4 percent in December 2007. Moreover, the real weighted average deposit rate (WADR) on incremental deposits has also slipped from -1.8 percent in December 2007 to -2.86 percent in March 2008 (see **Figure 3**). This has serious consequences for the effectiveness of monetary policy.

Figure 3: Interest Rates and Inflation



16. To control inflation through monetary policy measures it is important that aggregate demand is curbed which, in turn, depends on the level of real interest rates. It is the real interest rate that determines the spending decisions in an economy. Low and falling real interest rate essentially serve as a disincentive to save. The benefits of increasing savings, private and public, in tandem with the investment requirements of a growing economy, cannot be overemphasized in these difficult times.

Figure 4: Credit to Private Sector --cumulative flows



17. The private sector credit, which had been growing at a slower pace till January 2008 compared to previous year, gathered momentum thereafter (see **Figure 4**). Up to May 10, 2008 it has grown by 19.9 percent and stands at Rs369.8 billion – Rs106.4 billion higher than the same period of previous year. The main causative factors contributing to this recent acceleration in private sector credit growth were an increase in working capital requirements due to higher input costs and the higher fixed investment (visible in a few sectors, e.g. textile, refineries and power) in the month of March 2008.

The rise in demand-led inflationary pressures was compounded by unexpected strength in international commodity prices…

18. In addition to strong domestic demand, historic high prices of some of the key commodities in the international market (such as petroleum products, rice, wheat, palm and soybean oil etc.) are exerting an upward pressure on the overall domestic prices. It is likely that the pass through of international high prices has increased in recent years as prices of many commodities in the domestic market are now more reflective of trends in the global markets (especially in fuel commodities, iron, selected food items, fertilizer sectors etc.). The impact on domestic inflation has recently become more pronounced as the government, due to budgetary considerations, began to gradually pass-on the rise in cost of key fuel items (petrol and diesel), which were earlier kept unchanged for the domestic consumers.

19. More adjustments in domestic oil prices are expected, as the international oil price has already crossed US$130 per barrel. The imminent increase in domestic oil prices will continue contributing to inflation both directly and indirectly by affecting the cost of production across the board and imparting a lingering effect on inflation well into FY09.

Rising import prices along with strong domestic demand forced a widening of the already-high current account deficit…

20. The impact of both the rising international commodity prices as well as the widening of fiscal deficit is being reflected in the overall worsening of balance of payments accounts. The external current account deficit has increased sharply to US$11.6 billion during Jul-Apr, FY08; up by about 75 percent from the same period last year. This sharp increase has primarily come in the first four months of 2008 when the trade deficit widened considerably. Despite a decent export performance, the rising trade deficit indicates considerable import demand pressures in the economy. Import demand which has been rising throughout the fiscal year, has accelerated further since January 2008. During this January-April 2008 period, import bill has increased by US$13.4 billion while export revenues grew by only US$6.9 billion. This resulted in an increment of US$6.5 billion in trade deficit in just four months.

21. Most distinct is the extraordinary growth in the non-oil and non-food imports running at 44.5 percent during January-April 2008. Of the total import bill of US$28.9 billion during Jul-Apr, FY08, US$17.9 billion is on account of non-food and non-oil

imports. Thus it is not only the rise in international oil and food prices which have contributed to the sharp increase in the import bill, the strong overall import demand is also contributing significantly, which needs to be checked through tightening measures. Concurrently, oil import bill has also surged to US$7.9 billion during July-April, FY08 compared to US$6 billion last year owing to both increase in volume and prices In addition, food import bill stands at US$3 billion – 44 percent higher than last year.

22. This deterioration of the external account has implications for monetary management because: (i) it has put an upward pressure on the exchange rate of Pak rupee against major currencies that will add to the pass-through of imported inflation to the domestic economy; (ii) a part of deterioration in external current account deficit is due to delays in the availability of external financing, it has resulted into increased reliance of the government sector borrowings on the central bank, which is adding to the inflationary pressures; and finally (iii) it has the potential to adversely impact overall macroeconomic stability and economic growth.

The external account woes were compounded by a decline in net capital and financial account receipts, that pressured the country's foreign currency reserves and the exchange rate…

23. The external current account deficit is increasing at a pace that is difficult to sustain given the slowdown in financial inflows. During July-April, FY08, the financial inflows stood at US$6.0 billion declining by 16.7 percent over the same period of last year (see **Table 4**). The decline in these inflows mainly reflects net outflow from foreign portfolio investment on account of outflow from stock market and delay in floatation of Global Depository Receipts (GDRs) and euro bonds. This stress on the economy has been compounded by the continuing problems in the international financial markets. While the country has largely been unaffected by the direct impact of these disruptions, investors are increasingly risk averse, resulting in a reduction in liquidity flows to emerging economies. This makes financing the twin deficits more challenging. Moreover, downward revision in the sovereign credit rating would raise risk premium making external financing more expensive.

Table 4: Balance of Payment Statistics in billion US$

	July-April		January-April	
	FY07	**FY08**	**FY07**	**FY08**
i. Current account balance	**-6.6**	**-11.6**	**-2.0**	**-5.6**
Trade balance	-8.3	-12.7	-3.0	-6.5
Exports	14.0	16.2	5.6	6.9
Imports	22.3	28.9	8.6	13.4
Non-food non-oil	14.2	17.9	6.0	8.6
Services net	-3.9	-5.6	-1.4	-2.3
Income net	-2.9	-3.1	-1.1	-1.1
Current transfers	8.4	9.8	3.5	4.3
ii. Capital account	**0.3**	**0.1**	**0.1**	**0.0**
iii. Financial account	**7.2**	**6.0**	**3.3**	**2.1**
of which	**0.0**	**0.0**	**0.0**	**0.0**
Direct investment	4.2	3.5	2.3	1.4
Portfolio investment	1.8	0.1	0.5	0.0
iv. Errors and omissions	**-0.1**	**0.3**	**-0.5**	**-0.1**
Overall balance	**0.8**	**-5.2**	**0.8**	**-3.5**

Source: Statistics Department, State Bank of Pakistan

24. Not surprising, the country's overall foreign exchange reserves declined to US$ 11.9 billion by May 16, 2008 from US$ 16.5 billion at end-October 2007. Similarly,

the rupee too came under pressure depreciating by 14.9 percent against US dollar during July-May 21 FY08. Most of this depreciation is concentrated in the last couple of months. Up to end March 2008, the Rupee depreciated by only 3.9 percent and since then it has depreciated by 10.8 percent (see **Table 5**).

Table 5: Changes in Exchange Rate

	End month exchange rate (Rs/US$)*	% App./Dep.	
		Month end to month end	Cumulative since June 2007
Jul-07	60.40	-0.04	-0.04
Aug-07	60.62	-0.37	-0.41
Sep-07	60.69	-0.12	-0.53
Oct-07	61.73	-0.06	-0.59
Nov-07	61.24	-0.84	-1.44
Dec-07	62.00	-1.24	-2.70
Jan-08	62.64	-1.03	-3.75
Feb-08	62.45	0.30	-3.45
Mar-08	62.73	-0.44	-3.90
Apr-08	64.60	-2.99	-7.01
21-May-08	**69.42**	**-7.45**	**-14.98**
Period-wise app./dep. during			
30-June-07 to 31-January-08			-3.75
31-January-08 to 21-May-08			-10.82

* Inter-bank rates

25. It is important to note that, although external current account has been experiencing deficit since FY05, the pressures on exchange rate were offset by strong remittances growth. The main difference in case of the recent pressures on exchange rate is the shrinking foreign inflows. This situation was further complicated by an anticipation of acceleration in trade deficit owing to rising oil import and wheat procurement coupled with speculative positions in the domestic foreign exchange market (as is evident from rise in kerb market premium). The protracted political uncertainty did not help either, though with the new government now in office, this should settle market sentiments.

26. Since Pakistan is following a floating exchange rate regime (like several other developing countries), not a fixed exchange rate regime, the value of Pakistani Rupee is determined by the supply and demand conditions in the foreign exchange market and by the macroeconomic fundamentals at large. However, like other central banks, SBP does intervene in the foreign exchange market, in a calibrated manner, to ensure stability. For example, to reduce the recent excess volatility and prevent the emergence of destabilizing speculative activities the SBP has taken several administrative measures and remained highly vigilant regarding the activity in the domestic foreign exchange market.

The slide in the value of Rupee depreciation will further add to the already high inflation pressures in the economy…

27. The effects of this depreciation on domestic inflation will emerge in the coming months. This is because fall in the value of the Rupee will result in higher domestic prices of the imported goods that would ultimately result in higher consumer prices. It will also impact the cost of production in the economy, further fueling the inflationary pressures.

28. Recognizing the prevailing pressures on exchange rate, SBP is committed to maintaining macroeconomic stability which should help further stabilize domestic foreign exchange market. The monetary tightening along with the structural changes to limit central bank borrowings for budget (highlighted in the Executive Summary)

should help infuse exchange rate stability. In tandem, SBP has launched structural reforms of exchange companies which are intended to incentivize them to augment inflows, while maintaining strict discipline and proper disclosure (for details see **Appendix**) . Moreover, combined with the SBP's continued commitment in the form of calibrated support for significant commercial transactions, while curbing any excessive day to day volatility and speculative activities, would help infuse exchange rate stability.

At the same time, strong demand pressures and supply shocks continue driving inflation to record high levels…

29. Combination of aggregate demand pressures emanating from rising twin deficits and strong domestic credit growth, exchange rate depreciation, and rising oil and food prices have raised the headline inflation to an alarming level. On YoY basis, it has almost doubled in just four months; moving from 8.8 percent in December 2007 to 17.2 percent in April 2008 (see **Table 6**). Although high food and energy prices continue to remain main contributors, more worrying are trends in non-food and core inflation. The non-food inflation more than doubled to 11.2 percent in April 2008 from mere 5.2 percent in last year, reflecting the impact of upward adjustment in oil prices, rising housing cost and second round effect of the persistently high food and energy prices. Besides, the pass-through of high commodity prices in international market has increased, compounded by depreciation of exchange rate.

Table 6: Inflation Indicators

	YoY inflation			
	Dec-06	Dec-07	Apr-07	Apr-08
CPI	8.9	8.8	6.9	17.2
Food group	12.7	12.2	9.4	25.5
Non-food group	6.2	6.3	5.2	11.2
NFNE	5.7	7.2	5.6	10.8
20% Trimmed	6.3	8.7	6.6	14.1
	Average inflation			
	July-December		July-April	
	FY07	FY08	FY07	FY08
Headline CPI	8.4	8.0	8.0	10.3
Food group	10.6	11.6	10.3	15.0
Non-food group	6.8	5.4	6.5	6.8
NFNE	6.2	6.5	6.1	7.5
20% Trimmed	6.7	7.6	6.7	9.2

Source: Federal Bureau of Statistics and SBP

30. Core inflation measures, depicting persistent and mounting demand pressures, also portray similar trends. Non-food non-energy measure of core inflation has jumped from 7.2 percent in December to 10.8 percent in April; more than double from 5.2 percent in April 2007. Similarly, 20 percent trimmed measure of core inflation has peaked to 14.1 percent in April 2008, rising from 6.6 percent in same month last year. With oil price now hovering around US$130 per barrel, there is likely to be additional consequences for macroeconomic imbalances and inflation.

31. The food inflation has spiked to 25.5 percent in April 2008. Constraints in domestic supplies of key food items and record increase in food prices in the international market continued to contribute significantly to domestic price hike. The domestic supplies have been affected by lower production of key food crops and have been worsened by hoarding and smuggling. Rising transportation and input costs are also playing their role in escalating already high prices. The rise in the international food prices is on account of lower global production, bans on exports of a few items

(such as rice) by some countries, and growing demand of key food crops (especially corn) for bio-fuel.

32. Since longer term structural price changes[1] are the major contributor to global inflation, the impact on inflationary expectations is likely to be more lasting. There are evidences that the erosion in purchasing power and squeeze in profit margins due to sustained increase in food and commodity prices is contributing to second round of inflationary pressures. The core inflation measures, which are reflective of underlying inflationary pressures in the economy, reached their historic highs in April 2008. Further, there is increasing risk that without continued monetary tightening, the inflationary pressures may turn into a wage-price spiral.

C. Risks and Challenges

33. The above discussion of existing trends in major macroeconomic indicators and an assessment of the outlook of the economy reveal that the macroeconomic stability of Pakistan is under severe pressure and require immediate policy actions. These pressures are likely to exacerbate the existing vulnerabilities and make macroeconomic management quite challenging going forward. Thus, it is critical that a timey policy response is implemented, taking into account the risks the challenges enumerated below.

34. **First**, the aggregate demand pressures represented by strong import demand and rising fiscal deficit are putting an enormous pressure on domestic inflation. Given the projections of external current account deficit to be in the range of 7.3 to 7.8 percent of GDP (against an original target of 5 percent) and fiscal deficit to be in the range of 6.5 to 7.0 percent of GDP (against the budgetary estimate of 4.0 percent), these demand pressures are unlikely to diminish in the near future unless addressed by tightening measures using both monetary and fiscal policy tools.

35. **Second**, productivity in the eocnomy suffered due to the continuing power shortages, other infrastructural problems and political instability. These and other related requirements, such as strengthening of physical and social infrastructure, necessary to boost productivity of the economy, are urgently needed and will determine the long-term growth prospects of the economy. In the near future, the gap between rising aggregate demand and the capacity of the economy to produce more is expected to widen and will remain a challenge, if the contrainsts on productivity growth go unaddressed.

36. **Third**, the supply shocks constituting of rising food and oil prices in the international markets have and will put further pressure on the domestic inflation.
As the current high prices in international markets are likely to persist well above their historical averages for the foreseeable future, any effort by the government to absorb

[1] Rising bio-fuels production in the US and EU accounts for almost half of the increase in consumption of major food crops in the past year. Growth in per capita income in emerging economies has brought robust demand growth. Higher energy and fertilizer costs have also contributed to higher prices for all agricultural commodities. Most of these factors are likely to be permanent (source: IMF Survey Magazine, March 2008).

the pass through of rising global prices to domestic consumers, would soon become unsustainable due to limited fiscal space. The full impact of this on headline inflation has yet to be experienced by the economy. Also, given the international trends of food inflation and a sharp rise in the domestic economy, a wage-price spiral will invitably kick-in, further exacerbating the inflation situation. Although the importance of supply side measures can not be undermind in taming food inflation, the urgent need for further tightening to address their second round impact on headline inflation can not be ignored either.

37. **Fourth**, all the above factors have and will surely affect the expectations of inflation. Having experienced rising inflation so far in FY08 (especially in the last four months), people will continue to expect high inflation for some time. This inertial effect of inflation will have a strong influence on the headline inflation in the next fiscal year. More disturbing perhaps are the future expectations of inflation that are being formed on the basis of present performance of the economy and the policy stance. Since the current fiscal year's economic outcome is to the left of average performance of the last five years, it is important to give clear signals through a further monetary tightening to curb the expectations spiriling out of control.

38. **Fifth**, it must also be realized that the current demand pressures in the economy do not fully incorporate the impact of the monetary overhang of recent months. In other words, the lagged impact of current high growth in monetary aggregates will continue driving up inflation in months ahead. In case, the current falling NFA trend is reversed, which is quite likely because of the expectations of foreign inflows, the reserve money could expand sharply. Thus, looking at the reserve money trends (and even the broad money trends) alone could be deceptive because of the sheer size of government borrowings from the SBP.

39. **Finally**, at least a part of the slowdown in domestic production during FY08 stems from transient factors specific to this year. In particular, it is likley that agri-production will recover strongly next year (weather favoring) as farmers are incentivised by strong agri-commodity prices. Similalry, LSM growth in FY08 was hit by one-off developments, that are unlikley to be repeated in FY09. Thus, FY09 aggregate demand could be stronger than in the current year, unless policy is modulated to contain excessive demand pressures.

40. **In conclusion**, while SBP is maintaining a tight monetary policy stance, there is a need to further increase the effectiveness of monetary policy transmission by limiting the government borrowings from the banking system, especially from the central bank. To this end, government must follow the international best practices to limit the government borrowings from the central bank and resort to other non-bank financial sources of deficit financing.

41. Many countries have already banned or levied ceilings on the government borrowings from their respective central banks and/or limited government's options of having large debts by adopting the fiscal responsibility laws (see **Table 7**). For example, India, Argentina, Brazil, Australia, and New Zealand have implemented both these steps to ensure fiscal dicipline. Pakistan seems to be the rare example where

Fiscal Responsibility and Debt Limitation (FRDL) law has been adopted without any restriction on debt monetization.

Table 7: A Survey of Practices for Containing Government Borrowings from Central Bank

Country		Year		Year
Argentina	Government borrowing from the central bank has been banned since	1992	In addition, there are Fiscal Responsibility Laws in place since	2004
Brazil		2000		2000
India		2003		2003
Australia		1979		1998
New Zealand		1989		1994
U.K	Can borrow from central bank	1998	Limited by the provisions of Maastricht Treaty	
Euro Area	Government borrowing from the central bank has been banned since	1998	There is no explicit Fiscal Responsibility Law	
Turkey		2001		
Chile		1989		
Bulgaria		1997		
Croatia		1991		
Estonia		1993		
Hungary		2001		
Kyrgyz Republic		1998		
China		1995		
Indonesia		1999		
Latvia		1992		
Lithuania		1994		
Poland		1997		
Russia		1995		
Israel	Government can borrow from the central bank, however, **there are limits in place**; there is no Fiscal responsibility Laws enacted	1954	Up to 1.6% of budgeted expenditures for a maximum of 30 days	
Canada			Up to 1/3 of estimated revenue for that fiscal	
Mexico		1985	Up to 1.5% of authorized expenditures for a maximum of 3 months	
Malaysia		1994	Up to 12.5% of estimated receipts	
Philippines		1993	Up to 20% of government income of last 3 years; for a maximum of 6 months	
Pakistan	**Neither banned**	**Nor any limit**	Fiscal Responsibility Law is in place since 2005 but there is no limit on debt monetization	

Sources: Report on the Observance of Standard and Codes (ROSC) compiled by the IMF; Central Bank Acts; Fiscal Responsibility and Budget Management Bill 2003; BIS Paper #20 titled 'Fiscal issues and central banking in emerging economies'