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.

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

[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.

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

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 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.

****