MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

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A New Beginning

In an interview with a local daily the State Bank Governor, Dr. Shamshad Akhtar revealed the central bank's intention of restructuring the export refinance scheme. In the process the State Bank will extricate itself from export refinancing and the export credit will be provided at subsidized rates by the commercial banks from their own funds while the government will pay the interest rate differential to the lenders. Though this restructuring is not likely to affect the industrial sector significantly, it will have widespread implications for the economy in terms of curtailing monetary expansion and subsequently controlling inflationary pressures.

This report will analyze the factors which have prompted the State Bank to consider this move before examining the impact on the economy of restructuring of the export refinance scheme.

If the shoe does not fit, must we change the foot?

Many emerging economies, in order to stimulate exports and thereby economic growth have had competent Export Finance Schemes (EFS) in place for many years. Under this scheme, credit is disbursed through the central or commercial banks at subsidized rates to export oriented industries under specified terms and conditions. For example in India, under EFS credit is available at approximately 9% against the commercial lending rate of 12% while in Bangladesh export credit is provided at subsidized rate of 6.7 % against the commercial rate of 11.14%.

Likewise in Pakistan, EFS was introduced with an aim to boost exports particularly of non-traditional items. The scheme is bifurcated in two parts; Part I and Part II. Under Part-I, the credit is given on pre as well as post shipment basis for export of eligible commodities. Under Part-II, an exporter may avail the export finance limit, based on the previous year's export performance. Over the years the sectors which have remained the major recipients of credit under these schemes are the telecommunication, IT, electronics, leather and most importantly the textiles.

Since its inception in Pakistan, the process of disbursement of credit under EFS has been operationally carried out through the State Bank of Pakistan (SBP): Hitherto the SBP has provided export credit to industrial centers through commercial banks at subsidized rates. However this process has the potential to build inflationary tendencies within the economy by stimulating reserve and broad money growth. Keeping this in view, the SBP Governor Shamshad Akhtar in an interview with a local daily revealed the central bank's intention of restructuring the export refinance scheme in order to restrict its impact on inflationary tendencies while retaining its potential for export promotion.

However a restructuring of the EFS does not mean that borrowing rates for exporters will increase. In fact the change in policy would not affect the industrial sector significantly as industries will continue to get export credit on the same terms and conditions. This is because commercial banks will continue to provide credit on low rates for refinancing of exports but this time from their own funds and the difference in interest rates will be paid by the government. The SBP will determine the spread that will be paid to the lenders. Nevertheless, this restructuring will have widespread implications for the economy in terms of curtailing monetary expansion and therefore controlling inflationary pressures.

What happens next door must happen at home?

Like most emerging economies, India is lured by the export led growth paradigm and therefore in order to stimulate exports several initiatives have been taken by Reserve Bank of India (RBI) and the Government of India. One such initiative has been the provision of export credit at rates lower than the commercial lending rate. The availability of export credit at subsidized rates enables exporters to efficiently execute their export orders at lower costs.

The EFS was initially introduced in India by the RBI in 1968 under which short-term export finance was made available to exporters at internationally competitive interest rates. In view of the importance of export credit in maintaining the pace of export growth, RBI has made many modifications to the structure of EFS ever since to ensure timely and hassle-free flow of credit to the export sector. Currently commercial banks provide short term export finance mainly by way of pre and post-shipment credit from their own resources while the RBI pays only the interest rate differential. For both types of shipment financing, RBI sets a ceiling on the interest rate that banks may charge to borrowers under the scheme. Since RBI fixes only the ceiling rate of interest for export credit, banks are free to fix lower rates of interest for exporters on the basis of their actual cost of funds, operating expenses and the track record and risk perception of the borrower/ exporter.

Presently the RBI has directed all the commercial banks to offer export refinancing at 4.5% less than the prime lending rate, which is in the range of 12%. Earlier, the difference was 2.5%. The additional subsidy of 2% which is applicable till the end of 2007 will be borne by the central government. It has been introduced to provide the exporters a cushion against the appreciating rupee. The RBI will continue to pay the remaining margin to the commercial banks.

By examining the structure of export credit facilities prevalent in India, it is clear that the decision of the SBP to revamp the structure of EFS is in line with that of our neighboring economy. There may be some confusion with regards to who will be responsible for paying the interest rate differential; the government or the SBP. However this is rather insignificant since recently central bank’s profits has been an important source of revenue for the government and therefore irrespective of who pays the differential, it will be eventually financed by the government expenditure.

Why the shoe fails to fit?

Before evaluating what impact the restructuring of export refinancing policies will have on the economy, it is more critical to examine the rationale behind this shift.

The SBP governor argued for reorganization of EFS mainly on grounds that increased credit disbursement under EFS by the SBP has been diluting the impact of its tight monetary stance as in recent months it has contributed excessively towards monetary expansion and subsequently inflationary pressures. In order to better understand this argument we will evaluate the monetary impact of the current export refinancing policies.

Currently export credit under EFS and LTF-EOP (Long Term Financing for Export Oriented Projects) is offered to exporters for different periods of time at rates significantly below the KIBOR for relevant maturities. For e.g. under EFS, exporters are offered financing for a six month period at 7.5% which is approximately 3% below 6-Month KIBOR while financing facilities for import of eligible machinery for a three year period are offered in the range of 5% below the KIBOR of respective maturities. Subsequently in the first ten months of FY 2006-07, total gross disbursement from refinancing facility allowed to banks under EFS and LTF-EOP for the textile sector alone was estimated to be Rs.328 billion of which EFS flows were Rs.284 billion. This is the highest ever disbursement under the financing schemes as a whole which is likely to increase further in the coming months as the budget for the new fiscal year has announced an additional recipient for the export credit, that is the entire spinning sector. Until now the debt/swap facility was limited to six sub-sectors of spinning.

What is critical is the impact of excessive refinancing on the money supply and thereby on interest rates and inflation. Firstly refinancing, which necessarily implies creation of new money by the central bank, stimulates growth of high powered money. For example an increase of PKR 43.8 billion witnessed in refinancing (LTF-EOP) during Jul-06 to Apr-07 emanated from a corresponding creation of new money. Thus excessive refinancing in recent months generated additional liquidity which could not be retailed by commercial banks and therefore continued to find its way back to the government securities in T-Bills auctions and was one of the reasons for the increased number of Open Market Operations witnessed lately. As a result strong reserve money growth has been witnessed; as of 23rd Jun reserve money growth is recorded at 20.08% against growth of 12.27% for the previous year. This has translated into broad money (M2) expansion which recorded a growth of 16.07% for FY 2006-07 against the year end target of 13.5%.

The surge in M2 expansion is a more challenging development given that this has the potential to cause resurgence in excess demand pressures in the economy. During the current fiscal year the money supply growth despite a decrease in private sector credit off take (due to high interest rates and increased budgetary borrowings), has lead to an increase in liquidity within the banking sector. The increased liquidity in the banking sector exerts a downward pressure on the interest rates as visible in the recent declining trend of the 6M KIBOR. The 6 M KIBOR fell from average monthly rate of 10.55% in Jan to an average of 10.03% in June (to date). This has resulted in narrowing the gap between KIBOR and the yield on T Bills, fuelling participation of commercial banks in T Bill auctions. Before interest rates fall enough to stimulate private sector credit expansion once again, increasing the demand and subsequently inflationary pressures, the SBP will have to speed its process of curtailing the reserve money growth. Planning to restructure the export finance scheme, the SBP has taken just the right step in the right direction. By extricating itself from the credit disbursement and shifting the costs to the government, the SBP with this move will be able to restrict monetary expansion significantly and thus prevent the subsequent development of inflationary tendencies.

Figure 1: Monetary Aggregates (Growth Rates)

Percentage

Indicators	2005-06	2004-05	1st July Upto 23-Jun-07	1st July Upto 24-Jun-06
Broad Money	15.18	19.30	16.70	12.23
Reserve Money	10.16	17.62	20.08	12.70
Currency in Circulation	11.19	15.18	15.73	13.70
Deposits	16.28	20.50	16.94	11.75
of Which:				
Demand Deposits	14.69	20.67	131.84	5.79
Time Deposits	18.81	19.87	-72.35	17.17
RFCDs	8.43	23.75	3.74	8.43
Bank Credit to Private Sector	23.47	34.36	13.78	20.58
Net Bank Credit to Government Sector	12.06	14.59	15.30	9.88
Net Domestic Assets (NDA)	17.11	22.38	13.34	13.80
Net Foreign Assets (NFA)	8.08	9.22	29.99	6.50

Source: Monetary Policy Department, SBP

Restructuring the EFS: The Series of Events that will follow…

As explained earlier, the SBP intends to reorganize the current structure of export refinancing facilities whereby the commercial banks will have to offer export credit from its own funds at subsidized rates. The government will compensate the commercial banks with the interest rate differential while the SBP will step back completely from export refinancing. In this fashion, export refinancing will not result in creation of money; reserve and broad money expansion will be controlled by the government thereof. This will subsequently curb effective demand in the economy which in turn will help in softening the price pressures.

Moreover as monetary expansion will cool down, the excess liquidity will be mopped up and we may see an upward pressure on the shrinking gap between the T-Bills and KIBOR as exporters will start competing for the funds along with other sectors of the economy. This however will mean an increased cost of borrowing to the export oriented industries, particularly the textile sector which remains the primary recipient for export credit. This is because the export refinance rate is pegged to the KIBOR and therefore an increase in KIBOR would mean an increase in the borrowing rate.

In addition to this, the fact that under the new structure of EFS commercial banks will have to provide export credit off their own funds, we are likely to witness a rise in the advance to deposit ratios of the commercial banks. This may in turn mean increased competition between these banks for raising additional deposits to facilitate the growth in advances.

The bigger question: When? Not, Why?

In view of the implications that are likely to result off this move, we reiterate that this is the right step aimed in the right direction by the State Bank. However what is more critical of the issue is the time this is likely to take place. There are indications within the banking circles that SBP is looking to expedite the process but there may not be any immediate progress as there is likely to be some reluctance from within the government on moving too quickly due to budgetary implications of the move.

Economic Snapshot

Fiscal year 06-07	Units	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June
Inflation														
Headline Inflation	%	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0
Core inflation	%	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1
Food inflation	%	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7
Non-food inflation	%	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1
T-bill (Wgt Avg)														
3 month	%	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69
6 month	%	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9
12 month	%	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16
External Sector														
Export	Mln US$	1,533	1,334	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583
Import	Mln US$	2,685	2,383	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373
Trade balance	Mln US$	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)
Remittances	Mln US$	464	376	435	422	410	448	475	391	457	520	513	537	505
Forex Reserves	Mln US$	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182

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