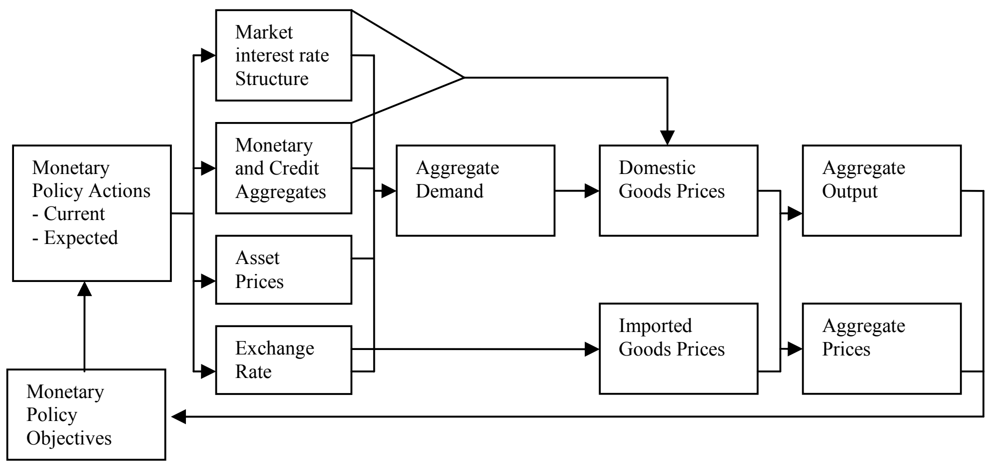
MONETARY POLICY STATEMENT

January–June 2008



STATE BANK OF PAKISTAN

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Executive Summary

Background

- State Bank of Pakistan (SBP) has now been in a monetary tightening phase since FY05. Initially, SBP raised policy rate by 150 basis points in April 2005 but persistent demand pressures in the economy required additional upward revisions cumulatively of another 100 basis points in two stages. These measures had to be complemented by adjustments in reserve ratios as well as frequent recourse to open market operations to improve liquidity management.

- The monetary stance adopted has had a visible impact. Core inflation came down during FY06 and FY07, albeit slowly and with the standard lag typically observed in developing countries. The progress achieved in reducing core inflation has to be judged in context of the (i) significant and lingering monetary overhang brought about by earlier easing; (ii) excessive growth in reserve money in FY07 due to exceptional requirements of the textile industry for re-financing and budget's continued recourse during the course of the fiscal year on central bank borrowings; and (iii) supply management problems affecting key food items and the significant rise in global commodity prices that has been generating new inflationary pressures in most economies. Due to the sizeable impact of the latter two items in particular, there has been a reversal, since May 2007, in core inflation. Trend headline inflation (Consumer Price Index) has stayed around the same level of the last two years, but this is much higher than the target of 6.5 percent.

- The Monetary Policy Statement July – December 2007 recognized that slippages of money supply growth from its target in FY07 were complicated by the bunching of heavy foreign exchange inflows in the last two months of FY07. SBP took corrective measures to prevent the impact of the FY07 developments from penetrating into FY08. The resulting monetary policy framework for FY08 envisaged broad money supply to grow by 13.7 percent, in line with the real GDP growth target of 7.2 percent and inflation target of 6.5 percent. Underlying this framework were restraints imposed on the government borrowings from the central bank, as endorsed by the SBP's Central Board of Directors, and limits on SBP refinancing for industry.

FY08 First Half Year Monetary Developments

- The developments in the first half of FY08 substantially deviated from the monetary policy framework. Most significant among these deviations is the behavior of the fiscal account, where demands for spending have far outstripped the resource envelope (defined to include current revenues and other revenue sources). Slippages from the fiscal deficit target have, and will, cause complications for monetary management during the course of the year. A gap in financing the deficit has also emerged. This was because of the delays in privatization and issuance of Global Depository Receipts (GDRs) and a Sovereign Bond, which have in past two years financed almost 41 percent of the budget deficit.

- Despite these deviations, reserve money growth slowed to 9.6 percent, as the refinancing requirements were lower and net foreign assets contracted during the first half of the year, in wake of a growing external current account deficit. Nevertheless, this reserve money growth was stronger than planned, as the budget recourse to the central bank financing grew to Rs241.6 billion with Market Treasury Bills stock reaching record levels of Rs624.6 billion by January 29, 2008.

- During the course of the year, liquidity management was challenging as the commercial banks and central bank ended up together financing almost 60 percent of the budget deficit for the July 1 - January 29, FY08 period. Notwithstanding the impact of the political uncertainty and pressures of government borrowings on the financial system, private sector credit managed to grow by 10.4 percent during July 1 -January 19, FY08 in line with the last year's trend. This was partly helped by the calibrated liquidity injections in the system and a decline in the effective Cash Reserve Requirement (CRR). Banks and SBP worked closely to ensure export financing was being provided in line with requirements. As of January 5, 2008 exporters benefited from Rs139.6 billion export credit against Rs131.6 billion at the same point in time in FY07.

- The tight monetary policy stance, especially since the previous policy rate increase, has begun to lose some of its steam. A moderate increase in KIBOR and banks' lending rates, almost flat Monetary Conditions Index (MCI), a fall in the effective CRR, and persistently high annualized M2 growth rate are all manifestations of these developments. Further, there was a reversal in core inflation trends which rose to 8.7 percent on an year on year (YoY) basis by December 2007; 2.3 percentage points above the last year level and 2.4 percentage points above the trough reached in May 2007. Headline CPI inflation reached 8.8 percent by December 2007, reflecting the undercurrents of core inflation and the food inflation (which hit double-digits, to reach 12.2 percent in December 2007).

FY08 Second Half Monetary Policy Stance

- SBP has to tighten its monetary policy further, recognizing:

(i) Developments in first half of the fiscal year and the outlook for the remaining half of the year. These underscore the need for strengthening demand management, as money supply for July 1 - January 19, FY08 grew, on an annualized basis, by 19.2 percent (relative to the 13.7 percent target for FY08).

(ii) Aggregate demand pressures are to remain high. Both the fiscal and the external current account deficits are likely to be higher than original projections.

(iii) Inflationary pressures are likely to build up further, with headline inflation projected to be in the range of 8.0 percent for the full year – higher than the target by 1.5 percentage points. In addition to the impact of reserve money growth on core inflation and difficulties in curbing food inflation, inflationary trends are likely to be impacted adversely due to the pass through of increase in international oil prices.

(iv) Though Pakistan has thus far not been significantly impacted by the global financial market turmoil led by United States subprime mortgage crisis and accompanying liquidity crunch, events are still unfolding and the second round impact on global and advanced countries' growth may bear implications as the economy is now open and fairly integrated with the international markets.

- In light of the above factors, effective from February 1, 2008, the SBP is raising its policy discount rate by 50 basis points to 10.5 percent. This will allow SBP to offload central bank borrowings, roll over the maturities of the different government securities, meet the additional borrowings needs of the government from the market, and strengthen the monetary policy transmission. Concurrently, CRR is being raised by 100 basis points for deposits up to one year maturity while leaving term deposits of over a year zero rated. This will further incentivize the banks to mobilize long term deposits.

- Effective January 1, 2008 State Bank has already introduced a new Long Term Financing Facility (LTFF) to facilitate export growth. Under the new scheme banks/DFIs will provide long-term financing of up to 10 years to their borrowers for import of machinery as well as purchase of locally manufactured machinery for setting up of export oriented projects. SBP has earmarked Rs8.0 billion for financing for the period between January to June 2008, which is well above the estimated demand received from the banks/DFIs for providing limits under the scheme. The SBP shall provide 70 percent refinance to the banks/DFIs on their disbursements under the new scheme. The borrower has the option to borrow for three different tenors, i.e., for up to 3 years, 5 years and 10 years, at financing rates of 8 percent, 9 percent, and 10 percent respectively. The financing rates for end users shall remain locked in for the entire period, once the facility has been disbursed by the banks/DFIs. However, banks/DFIs have to keep the disbursements during a year in accordance with the limits sanctioned to them.

- The events of December 27, 2007 resulted into losses to various private and public sector enterprises. In order to assist such enterprises in revival of their activities, SBP is developing a relief package which includes: (i) moratorium on payment of principal and mark up in respect of the loans availed by the affected entities under Export Finance Scheme and relaxation in the shipment period under Part-I and performance requirements under Part-II; (ii) permission to banks/DFIs to provide financing for reconstruction/rebuilding of the factory premises by the affected borrowers under the recently announced Long Term Financing Facility (LTFF); and (iii) relaxation in respect of realization of export proceeds by the affected entities on case to case basis. The above reliefs under the package shall be subject to the findings of the commission set up by the Federal Government pursuant to the events of December 27, 2007.

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

Challenging monetary policy environment towards the beginning of FY08 required more than just further tightening of monetary policy…

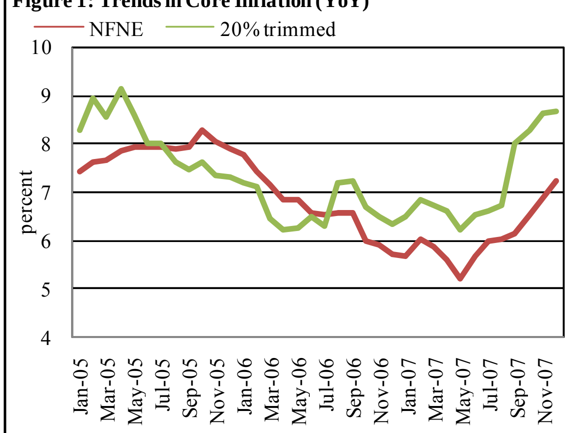
1. The State Bank of Pakistan strives to keep headline inflation, measured by the average growth in consumer price index (CPI), at its targeted level while keeping an eye on the growth prospects of the economy through its prudent and timely use of monetary policy instruments and other related measures.

2. The economy completed FY07 with growth at the targeted level of 7 percent, while average CPI inflation was 7.8 percent — 1.3 percentage points higher than the target. Prevailing demand pressures, as reflected by widening fiscal and current account imbalances, and double-digit food inflation, contributed to slippages in inflation target which could have been higher but for the success of monetary policy in keeping average non-food inflation well contained as depicted by its significant decline of 2.6 percentage points.

3. Food inflation, which kept the headline inflation above the target in FY07, was anticipated to persist and magnify in FY08 as global commodities prices continued to rise. The sustained high food inflation fueled inflationary expectations and spread out to prices of general commodities through the wage-price spiral – generally referred to as second round impact.

4. This second round effect of high food prices was already evident towards the end of FY07. Both the Non-food Non-energy (NFNE) and 20 percent trimmed measures of core inflation — used by most central banks to gauge the permanent component of price changes in a timely manner — witnessed a reversal in downward trends since May 2007 (see **Figure 1**). This suggested that inflationary pressures were not confined to few items, but were widespread and persistent.

Figure 1: Trends in Core Inflation (YoY)



5. SBP, in formulating its monetary policy for H1-FY08, anticipated and incorporated the pressures that high oil prices were to exert not only on government budget but also on overall prices in the country. Although the government has yet to pass on the increase in international prices to domestic consumers, its impact has already crept in inflationary trends as domestic price of furnace oil and various petroleum products is directly linked with international prices.

6. The risk of resurgence in underlying inflationary pressures in FY08 had also increased due to expected lagged impact of substantially high growth of 19.3 percent in money supply (M2), exceeding the FY07 target by 5.8 percentage points. The key reasons for this slippage were higher than expected foreign exchange inflows, continued government borrowings from SBP during the course of the year, and liquidity-generating and distortionary refinance schemes.

7. For FY08, the government targeted real GDP growth to 7.2 percent and inflation rate at 6.5 percent; this entails an M2 growth target of 13.7 percent. Relative to FY07, this requires a sharp deceleration in M2 growth and a 1.3 percentage point reduction in average inflation rate during FY08. Given the risks and challenges mentioned above and considering that the economy achieved its growth target for FY07, bringing down inflation in FY08 anywhere close to the target level was inconceivable without further tightening of monetary policy and introduction of other related measures.

Accordingly, SBP implemented both monetary and non-monetary measures…

8. SBP tightened its monetary policy further by raising the policy rate by 50 bps to 10 percent w.e.f. August 1, 2007. To contain excessive growth in monetary aggregates, the SBP also recommended to the government retirement of borrowings from the central bank by Rs62.3 billion during FY08, adoption of mutually agreed quarterly ceilings, and diversification of its borrowing sources. Moreover, SBP modified its refinancing scheme for banks under Export Finance Scheme (EFS). The refinancing limit to banks (under EFS) was fixed at 70 percent of outstanding amounts as of June 30, 2007. This measure alone was expected to have a dampening effect on the reserve money flows of Rs40 billion during FY08. In line with this, during July 1 - January 19, FY08 there was a net retirement of Rs35.9 billion in EFS in contrast to a disbursement of Rs25.6 billion during the same period last year. However, export credit to exporters was not affected as retirement to SBP was made-up by the greater credit expansion by scheduled banks.

9. In addition, to encourage financial sector deepening and to improve its efficiency, the SBP incentivized banks to mobilize longer-tenor deposits by zero rating the Cash Reserve Requirement (CRR) for all deposits with maturity of one-year and above.[1, 2] As banks' long-term deposits are generally more sensitive to the rate of return, this measure was expected to improve banks' deposit rates and their responsiveness to SBP's policy rate.[3] The SBP has also restricted banks from making unilateral changes in the interest rates of fixed rate loans and has recommended

1 Prior to this, banks were required to hold 3 percent CRR for all deposits of 6 month and higher maturity and 7 percent for the other demand and time liabilities.

2 Banks are allowed to deduct the component of the export credit provided from their own sources under the modified EFS from the sum total of the demand liabilities determined for the purpose of computation of CRR. The incentive is meant to keep banks liquid enough to meet required quantum of export credit.

3 Increasing maturity of banks' deposits also bodes well for the financial stability of the banking sector, as this will help in reducing rising maturity mismatches of banks' assets and liabilities. Maturity of banks' assets has seen a substantial increase in the previous five years, as banks entered into consumer financing, including auto and housing finance; extended substantial credit for project financing; and invested significant amount in long-term debt securities of both the government and the private sector. However, banks continued to finance these long-term assets with short-term deposits.

adhering to the specified margins in case of variable rate loans. This was to ensure transparency in the pricing and documentation of banks' loans and to keep a check on the banking spread.[4] One of the outcomes of all these measures is that the spread, though still high, has narrowed to 7.1 percentage points in December 2007; the lowest level since August 2005.

As required, tightening signal was followed by draining excess liquidity to ensure effective transmission…

10. In order to implement its tight monetary policy stance, the SBP continued to focus on the shorter-end of the yield curve by effectively using Open Market Operations (OMOs). These interventions in the interbank market, by draining out excess liquidity, were aimed at keeping overnight repo rates in a desired range consistent with the monetary policy stance. This was essential for effective transmission of monetary policy to interest rates structure and other key economic variables in the economy.

B. Assessment of Monetary Policy Transmission and Outlook for FY08

Impact of monetary tightening was visible more towards the short-end of the yield curve…

11. As a result of proactive liquidity management by SBP, the overnight repo rate in the interbank market remained at a higher level and showed less volatility during FY08 (see **Table 1**). Barring few exceptions, the overnight rate consistently moved between 8 percent and the policy rate of 10 percent. Consistent with monetary policy transmission, the increase in policy rate and overnight repo rate allowed SBP to raise yield on the government securities and also pushed higher-tenor repo rates up (see **Table 2**). The increase in yields on government securities helped mobilize Rs377.8 billion in T-bills during July 1 - January 29, FY08; which was significantly higher than Rs331.4 billion maturing in this period. As a result, SBP shifted at least a part of the government borrowings to the market and was able to avoid a sharp growth

Table 1: OMOs and Overnight Repo Rate

	OMOs		Policy rate	O/N rate	
	Injection	Mop-up		Avg.	CV#
	billion Rs		percent		
H1-FY06	120.9	314.1	9.0	7.8	17.2
H2-FY06	308.6	330.6	9.0	7.9	15.8
H1-FY07	47.0	586.5	9.5	8.2	14.7
H2-FY07	25.0	349.5	9.5	8.5	14.3
H1-FY08	40.9	635.0	10.0	9.1	11.0
H2-FY08*	27.5	18.0	10.0	9.2	9.5

*: Up to January 29, 2008; #: Coefficient of variation
Source: SBP

Table 2: Impact on Interbank Interest Rates
percent, change in percentage points

	Jun-07	Jan-08	Change
Auction Cut-offs			
3-m	8.69	9.09	0.41
6-m	8.90	9.30	0.39
12-m	9.16	9.50	0.34
Repo Rates			
3-m	8.88	9.49	0.62
6-m	9.00	9.60	0.60
12-m	9.09	9.61	0.52

Source: SBP

4 Banking spread is the difference between banks' weighted average lending and deposit rates.

in the reserve money.

12. The Karachi Interbank Offer Rates (KIBOR), the benchmark for banks' lending rates, also followed the increase in the policy rate.[5] However, these rates, in particular of 3-month and higher tenor, remained well below their respective peak levels observed during FY07 (see **Figure 2**). More importantly, after the increase in August 2007, KIBOR of 6-month and higher tenors declined and by the end of H1-FY08 reached back almost to their levels observed before the change in the policy rate; thus weakening the monetary policy transmission.

13. This weakening of monetary policy transmission is also reflected from trends in Monetary Conditions Index (MCI).[6] The MCI, after increasing in August 2007, have recorded a decline in the following months (**Figure 3**). Besides the fall in longer-tenor KIBOR, depreciation of Pak-Rupee against US dollar explains the decline in the MCI.

Banks' lending rates also responded to the monetary tightening measures, though impact (up to December 2007) was significantly lower than past experience…

14. Despite a relatively weak response of KIBOR, banks' lending rates did see an increase of 53 bps

Figure 2: Trends in KIBOR

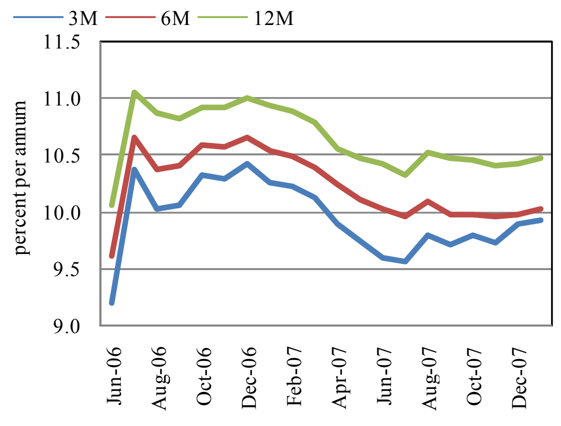


Figure 3: Monetary Conditions Index

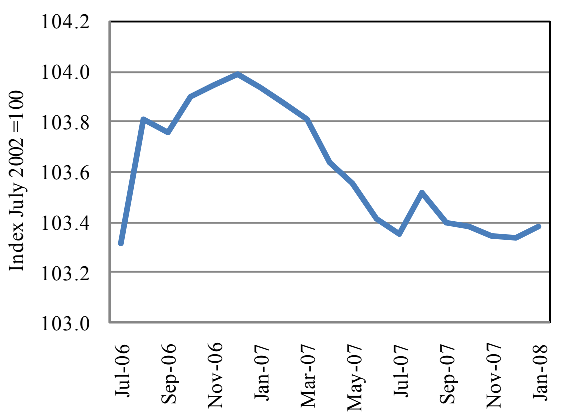
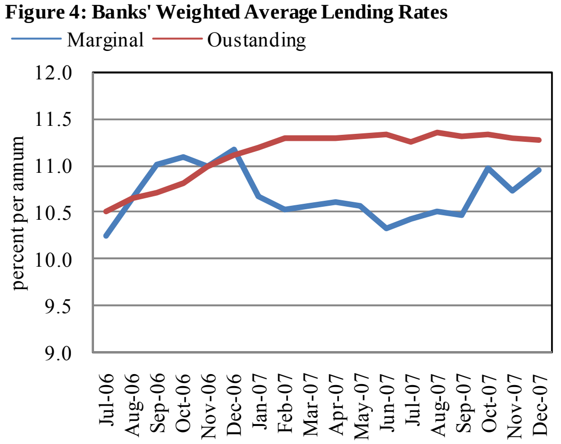


Figure 4: Banks' Weighted Average Lending Rates



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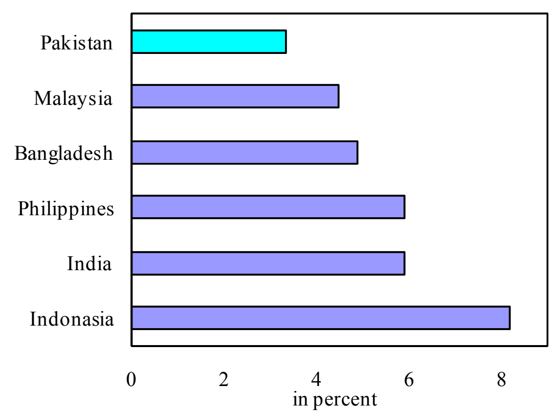
[5] Karachi Inter-bank Offer (KIBOR) rates are average ask rates used primarily to indicate participating banks' view on clean lending and borrowing rates levels in the interbank market for various tenors. All (18) participating banks are required to quote their offer (KIBOR) and bid (KIBID) prices of all the 9 existing tenors (starting from 1week up to 3 years) for a minimum sum of Rs100 million. These prices remain valid between 11: 30 am to 11:45 am on a given working day.

[6] The MCI is a weighted average of interest rate (6-month KIBOR) and exchange rate relative to base period. It is used as an indicator of monetary stance as it tracks the combined impact of interest rate and exchange rate changes on monetary conditions. For detail on the computation of MCI, see, Hyder, Zulfiqar and Mazhar Khan (2007). *Monetary Conditions Index for Pakistan*, SBP Working Paper No. 11.

since the policy change on July 31, 2007. However, two points are worth noting. First, banks' weighted average lending rate (WALR) on incremental loans, at 11.0 percent in December 2007, remains 21 bps lower than that observed in December 2006 (see **Figure 4**). Second, during H1-FY08 increase in WALR, both on incremental and oustanding loans, was significantly lower than that witnessed in the corresponding period of FY07.[7]

Figure 5: Real lending Rates in Regional Countries in 2007



15. More importantly, banks' *real* lending rates — nominal lending rates minus 12-month moving average CPI inflation – on incremental loans increased from 2.8 percent in July 2007 to 3.4 percent in December 2007. It is worth pointing out that the real lending rates in Pakistan remain siginificantly lower than those observed in other regional countries; mainly due to relatively higher inflation (see **Figure 5**). In the face of prevailing demand and inflation pressures, these marginal increases in nominal and real lending interest rates indicate a softening of the monetary policy stance.

16. Monetary tightening along with the zero rating of CRR helped in the mobilization of deposits of above one year maturity and induced banks to offer higher returns. During August 4 – December 29, 2007 share of these longer-tenor deposits in banks' total liabilities increased by 1.7 percentage points (Rs71.4 billion) to 13.7 percent. The shorter tenor deposits, on the other hand, increased by only Rs22.0 billion. This higher growth in banks' longer-tenor deposits is good for improving the transmission of monetary policy changes to banks' deposit rates, as the rising share of such deposits increases the responsiveness of deposit rates to changes in benchmark interest rates.

In addition to affecting interest rates, monetary policy actions also impacted monetary aggregates …

17. The zero rating of CRR on longer-tenor deposits, however, resulted in a decline in the effective weekly average CRR to 5.96 percent for the week of December 29 – January 4, FY08 from 6.32 percent at the time of the policy change. This 36 bps decline in CRR has added Rs12.3 billion to loanable funds with the banking sector.

18. Moreover, a fall in effective CRR coupled with a lower currency to deposit ratio resulted in a higher money multiplier value of 3.24 (on average) during July 1 - January

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7 Specifically, during July-December 2007 WALR on incremental and outstanding loans increased by 53 bps and 1 bp, respectively, compared to a sharper rise of 92 bps and 59 bps in the corressponding period of previous year.

19, FY08 compared to 3.09 in the same period of FY07.[8] Given that the reserve money stock level is substantially large (Rs1.3 trillion as of January 19, 2008), even this 15 bps increase in the money multiplier, though desirable from the financial deepening point of view, has caused a significant acceleration in M2 and underscores the need to keep a close check on reserve money growth.

19. The potential risk of a sharp acceleration in reserve money growth was mitigated by SBP's decision to increase the policy rate and gradually reduce commercial banks' reliance on SBP refinancing facilities. Indeed, the growth in reserve money for July 1 - January 19, FY08 decelerated to 9.6 percent (Rs116.2 billion) in comparison to 16.6 percent (Rs166.5 billion) in the same period last year. However, impact of these actions was partially offset by government's heavy reliance on borrowings from the SBP, which has the potential of sharply accelerating reserve money and thus M2 growth. As shown in **Table 3**, a higher annualized M2 growth of 19.2 percent has already increased the supply of broad money from Rs199.8 billion recorded last year to Rs234.4 billion this year during the period under consideration.

Table 3: Monetary Aggregates (Flows)
billion Rupees

	Actual	July 1 - Jan 19	
	FY07	**FY07**	**FY08**
Money Supply (M2)	658.3	199.8	234.4
Growth	*19.30*	*5.87*	*5.77*
Annualized growth	-	13.6	19.2
NFA	274.6	-9.1	-161.9
SBP	222.7	-1.0	-79.3
Scheduled banks	51.9	-8.0	-82.6
NDA	383.7	208.9	396.3
SBP	-66.8	112.2	240.4
Scheduled banks	450.5	96.7	155.9
Memorandum items			
Net budgetary support	102.0	46.7	234.0
from SBP	-58.6	70.9	237.1
from Scheduled banks	161	-24.2	-3.1
Private sector credit	365.7	216.0	256.7
Growth	*17.30*	*10.22*	*10.35*
Reserve money	209.1	166.5	116.2
Growth	*20.90*	*16.63*	*9.6*
Export finance scheme	26.8	25.6	-35.9

Source: SBP

20. Broad money (M2) is used as the intermediate target for monetary policy execution in Pakistan because it has linkages to the real, fiscal, and external sectors of the economy. For instance, external sector developments are reflected in changes in the net foreign assets (NFA) of the banking system while government borrowings from the banking system are indicative of the fiscal position. These interrelationships are captured in the monetary policy framework. Moreover, data on monetary aggregates is available relatively quickly. Thus, paying attention to monetary aggregates allows policy makers to form an informed view about the economy and take timely decisions regarding its policy stance.

21. In this context, a comparison of the YoY growth rate for M2 till January 19, 2008 (19.2 percent) with the same period last year (13.6 percent) suggests that attaining the target of 13.7 percent, set for FY08, will be quite challenging unless immediate corrective policy measures are taken to reduce significantly the excess central bank borrowings.

[8] During July 1 - January 19, FY08, value of currency to deposit ratio was recorded at 0.30 (on average) against 0.31 in the corresponding period of FY07.

Acceleration in M2 growth is despite a decline in Net foreign assets (NFA) …

22. NFA position of the banking system — a crucial component in the monetary policy framework — on cumulative basis saw a contraction of Rs161.9 billion during July 1 - January 19, FY08 compared to only Rs9.1 billion during the same period last year (see **Table 3**).

23. These NFA trends are reflective of the developmnets in external current account deficit, which increased by 31.2 percent despite a 9.0 percent increase in export receipts and 10.1 percent growth in the current transfers during H1-FY08. Assuming an expected slowdown in the US economy, mainly due to the still unfolding sub-prime mortgage crisis and subsequent financial distress, coupled with the recent uncertainty on the domestic front, could have implications for export performance. At the same time, high international oil prices and wheat imports together with strong import demand (12.8 percent during H1-FY08), will keep the pressure on the import bill in the near future (see **Table 4**).

Table 4: Balance of Payment Statistics (July-December)
million US$

	FY07	FY08	% change
i. Current account	**-4,679.0**	**-6,137.7**	*31.2*
Trade balance	-5,363.0	-6,368.7	*18.8*
Exports	8,343.0	9,091.0	*9.0*
Imports	13,706.0	15,459.7	*12.8*
Services net	-2,451.0	-3,281.0	*33.9*
Income net	-1,808.0	-1,931.0	*6.8*
Current transfers	4,943.0	5,443.0	*10.1*
ii. Capital account	**177.0**	**14.0**	*-92.1*
iii. Financial account	**3,964.0**	**3,690.0**	*-6.9*
of which			
Direct investment	1,873.0	2,066.0	*10.3*
Portfolio investment	1,295.0	100.0	*-92.3*
iv. Errors and omissions	**464.0**	**930.0**	*100.4*
Overall balance	**-74.0**	**-1,504.0**	

Source: SBP

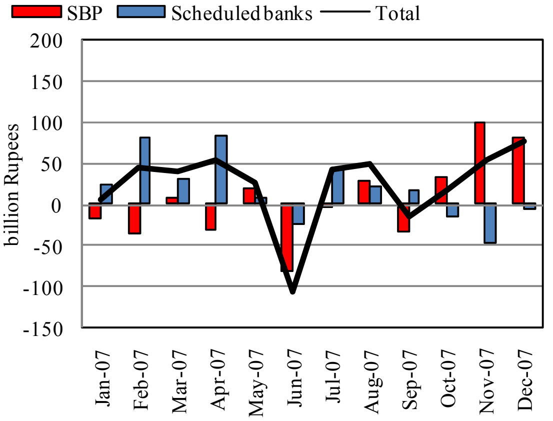
24. Similary, financial inflows necessary to finance the current account deficit have slowed down by 6.9 percent during the period under consideration. The less than expected net inflows in the portfolio investment due to uncertain domestic environment was a drag in this regard, while foregin direct investment continues to show healthy growth. The future prospects of these inflows such as GDRs, Eurobonds, privatization receipts etc, necessary for the financing of external current account deficit depend on how swiftly domestic and international environment appears conducive to launch this initiative. Government is committed to proceed with these transactions.

25. These developments may result in further widening of external current account deficit to GDP ratio to a much higher level than the targeted 5.0 percent. Pak Rupee-US dollar exchange rate has already depreciated by 3.7 percent during July 1- January 29, 2008. Apart from putting pressure on foreign exchange reserves, this will be an additional contributing factor to inflationary pressures in the coming months. Thus, there is a strong and urgent need to nurture an environment that facilitates the foreign inflows and to improve the prospects for adequate financing of external current account deficit, which has so far resulted in foreign exchange reserve drawndown of US$403.2 million.

Weakening of NFA position has implications for financing of fiscal deficit as well, and is already visible in government's substantial reliance on borrowing from SBP…

26. The likely decline in these external financing resources has and would force the government to resort to the domestic banking system for their financing requirements, especially from the SBP (see **Figure 6**). By January 19, FY08, the SBP financed Rs237.1 billion of the total net budgetary support. This is in contrast to same period last year when government borrowings from the SBP were less than one-third of this amount. If this trend continues, the government is unlikely to meet its annual target of retiring Rs62.3 billion.

Figure 6: Net Budgetary Borrowings from Banking System



27. The stock of Market Related Treasury Bills (MRTBs) through which the government borrows on tap from SBP has now touched new record high level of Rs624.6 billion (see **Table 5**), relative to the average annual Rs305 billion for last five fiscal years and is well above the target stock of MRTBs for FY08.

28. During the course of the year it is not unusual for government to borrow excessively from SBP but in the recent past it was able to pay off central bank borrowing through privatization proceeds or other flows. However with the slack in these sources of revenues, there is a continuous reliance on SBP borrowings. Breaches of SBP borrowing limits and the persisting build up in MRTBs, for replenishment, is aggravating inflationary pressures and has endangered macroeconomic stability.

Table 5: Cumulative Government Borrowings from SBP

billion Rupees

End June	Stock of MRTBs	Δ in MRTBs	Δ in net borrowing
2002	195.8	-274.9	-112.0
2003	104.6	-91.2	-249.2
2004	128.0	23.4	60.0
2005	333.0	204.9	155.6
2006	508.1	175.1	135.1
2007	452.1	-56.0	-58.6
2008*	624.6	172.5	241.6

*: Up to January 29, 2008.
Source: SBP

Higher SBP borrowings are despite a healthy support from other financing sources, suggesting fiscal deficit is increasing…

29. The higher government's reliance on banking system is over and above FBR tax collection which up to December 2007 was Rs19.4 billion higher than last year. On the financing side, the government mobilized Rs41 billion (net of maturities) from Pakistan Investment Bonds (PIBs) auction in H1-FY08; Rs19.6 billion more than that in the similar period last year. Further, it mobilized Rs26.5 billion (in net terms) through National Saving Schemes (NSS) during July - November FY08 compared to Rs20.8 billion in the corresponding period of the last year.

30. Unprecedented dependance on central bank financing is a reflection of growing fiscal imbalance. The latest available Ministry of Finance (MOF) data for Q1-FY08 indicates a widening fiscal deficit reaching at Rs158.1 billion; 82.3 percent higher than the corresponding period last year. Growth in expenditures (by 38 percent) has outpaced the growth in revenues (by 22 percent). Growing requirement for the subsidies in the wake of increasing international oil prices, higher interest payments on domestic debt which almost doubled to reach Rs111.1 billion, and the elevated development expenditures which grew by 89.5 percent to support the growing economy, are the main reasons for the escalation in these expenditures.

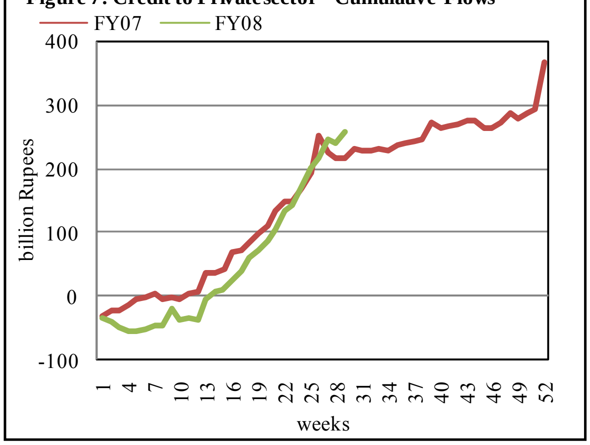
31. Expansion in borrowings from SBP is likely to induce further inflationary pressures and unless lowered significantly will complicate monetary management. Slippages in fiscal target will inevitably result in unpleasant monetary consequences. M2 growth may then exceed its target of 13.7 percent by a wide margin and pose a serious challenge for the conduct of monetary policy.

Keeping the M2 growth at indicative target of 13.7 percent would have implications for private sector credit…

32. Government borrowings during July 1- January 19, FY08 has absorbed more than half of increment (52.1 percent) of the total net domestic assets (NDA) of the banking system while private sector credit constituted the other part. Higher government borrowings have the potential of crowding out private sector credit. If government borrowings remain high in the second half of FY08 then private sector credit will be squeezed. Continued accommodation of the government borrowings from the SBP will surely result in excessive monetary growth and would perpetuate inflationary pressures.

33. Latest data (till January 19, 2008) indicates that credit to private sector from scheduled banks grew by 10.4 percent relative to 10.2 percent last year. On cumulative basis, the current year's flows exceeded last year credit by Rs40.8 billion (see **Figure 7**). Going forward, we expect the private sector disbursements to surpass the previous year net disbursement of Rs365.7 billion especially if new independent power projects (IPPs) reach financial closure and draw their disbursements during FY08.

Figure 7: Credit to Privatesector--Cumulative Flows



34. To keep M2 growth rate in the vicinity of the targeted level and encourage private sector credit, it is imperative that government borrowings be retired from the SBP and additional financing be raised through other sources of domestic debt such as PIBs, NSS, and Shariah compliant instruments. This will go a long way in bringing

down the CPI inflation and strengthening the growth prospects of the economy.

Nevertheless current high monetary expansion is leading to further inflationary pressures…

35. In the backdrop of widening external current account and fiscal deficits, and high M2 growth, YoY CPI inflation remains stubbornly high at 8.8 percent during H1-FY08 (see **Table 6**). Double-digit food inflation due to domestic supply side bottlenecks and high food prices in the international market contributed the most, however now all the inflation indicators are depicting rising inflationary pressures in the economy. For instance, non-food inflation has risen to 6.3 percent in December 2007 from 5.1 percent in June 2007 (see **Figure 8**).

Table 6: Inflation Indicators

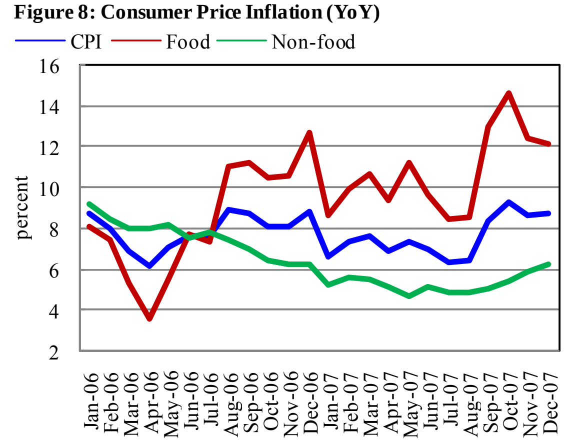
		July - December	
	FY07*	**FY07**	**FY08**
YoY inflation			
CPI	7.0	8.9	8.8
Food group	9.7	12.7	12.2
Non-food group	5.1	6.2	6.3
Non-food non-energy	5.7	5.7	7.2
20% trimmed	6.5	6.3	8.7
Average inflation			
Headline CPI	7.8	8.4	8.0
Food group	10.3	10.6	11.6
Non-food group	6.0	6.8	5.4
Non-food non-energy	5.9	6.2	6.5
20% trimmed	6.9	6.7	7.6
12 month moving average			
Headline CPI	7.8	7.9	7.6
Food group	10.3	8.5	10.8
Non-food group	6.0	7.5	5.3
Non-food non-energy	5.9	6.6	6.1
20% trimmed	6.9	6.8	7.9

* Period average and 12 month moving average inflation numbers are same for full FY07; the YOY inflation numbers for FY07 are June 2007 over June 2006.

Source: Federal Bureau of Statistics and SBP

Trends in core inflation are highlighting that the inflationary pressures are widespread…

Figure 8: Consumer Price Inflation (YoY)



36. Core inflation is a measure of underlying or persistent inflationary trends in the economy and allows central banks to respond to inherent inflation expectations and permanent demand pressures in a timely manner. The Non-Food-Non-Energy (NFNE) measure of core inflation at 7.2 percent in December, 2007 is 1.5 percentage points higher than in the same month of the previous year. This clearly points out that high CPI inflation is not just confined to rising food prices; non-food inflation is also on the rise. Inspection of core inflation measured by 20 percent trim, that excludes the most volatile items, showing extraordinary increase or decrease in prices, reveals a more alarming picture. It was recorded at 8.7 percent in December 2007 — 2.3 percentage points higher than in December 2006.

Rising food inflation is further exacerbating the CPI inflation…

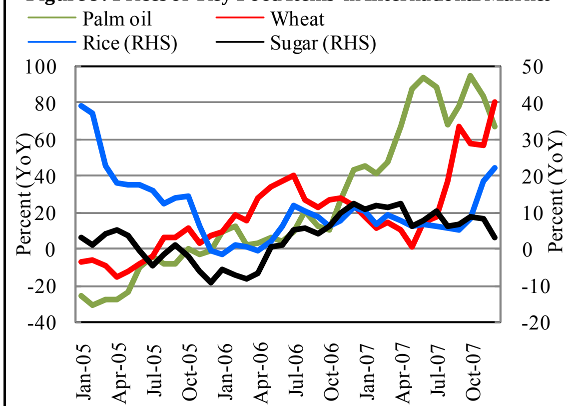


Figure 9: Prices of Key Food Items in International Market

Source: IMF

37. The sharp jump in food inflation from 9.7 percent in June 2007 to 12.2 percent in December 2007 is due to a combination of domestic and external factors. Continued supply shortages of the staple food items — that have been worsened by hoarding and rising input costs — are the key domestic factors having upward pressures on food prices. On the international front, the prices of food items continued to remain strong due to growing demand of key food crops for conversion into bio-fuel (see **Figure 9**). While diverting food crops for the production of bio-fuel will directly raise prices of corn, edible oil and possibly sugar, the wheat prices will be affected indirectly. Rise in corn prices due to growing demand from bio-fuel production, would result in substitution of corn with other staples like wheat. Therefore, wheat prices will remain under pressures despite easing of supplies.[9]

38. Both these domestic and international developments are likely to persist and continue pushing up food prices in rest of FY08.[10] Thus, expected high food inflation may continue contributing to headline inflation directly and indirectly, through fueling expectations of higher wages. Exploring the second round effects of food inflation on non-food inflation in Pakistan, our preliminary estimates suggest that a 1 percentage point temporary increase in food inflation leads to 0.2 percentage point (one-fifth) increase in non-food inflation, realized between 12-18 months.

And let's not forget the likely impact of a pass through of rising international oil prices on the domestic market …

39. So far, domestic inflation has remained broadly insulated from direct impact of rising oil prices due to government policy of not passing the price hike onto the consumers. However, recent trends in crude oil price — that has risen by 70 percent by January 23, 2008 since the last adjustment made in domestic prices in January 2007 — and growing government expenditures on oil subsidy suggest that upward adjustment in domestic oil prices is imperative. This will not only have immediate impact on headline inflation, but also indirect effects in the form of higher transportation and input costs that will continue pushing up the prices of a wide range of CPI items. Despite its negative effect on inflation, pass-through will help reducing the twin deficit.

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9 See the SBP Annual Report for 2006-07, Box 3.1: *Rising Global Food Inflation*, pp.39.

10 Food and Agriculture Organization (FAO) and OECD estimates show 20-50 percent increase in food prices in international market over the next decade from the average price levels in last ten years.

The persistence of these inflationary tendencies may have implications for the medium to long-run growth prospects …

40. Although it is too early to infer the full FY08 growth prospects due to limited information, the latest available data on large-scale manufacturing (LSM) and crop estimates can be used as a proxy instead. During the first four months of FY08, the LSM growth decelerated to 7.6 percent from 8.4 percent in the comparable period of last year; among others, this is due to higher input costs and slowdown in export of textile goods. While there is no sign of easing raw material and input prices, slowdown in exports of textile goods could be exacerbated by global recessionary tendencies, particularly in the US economy triggered by recent financial turmoil. In addition, recent events in the country coupled with power shortages are also likely to adversely affect manufacturing activities. However, higher production of sugar and construction related manufactured items are expected to bring some improvement in LSM growth.[11]

41. The latest estimates indicate that, now except for sugarcane and maize, output of other major crops witnessed either decline in production (cotton) or deceleration in output growth (rice). The production of sugarcane and maize are estimated to increase by 13.5 and 11.7 percent, respectively during FY08. Although preliminary estimates show a 3.0 percent decline in area under cultivation of wheat (as on December 10, 2007 from the same point of time last year), enhanced water availability by recent rains has improved prospects for wheat production.[12] In addition, expected good performance of livestock sub-sector is likely to provide much needed support to agriculture growth.

42. Needless to say, smooth political transition, establishment of law and order, effective enforcement of property rights and legal business contracts, and commitment in addressing energy shortages can really go a long way in creating an environment that is conducive to long-run growth prospects of the economy.

C. Key Risks and Challenges for H2-FY08

43. Emerging outlook for second half of FY08 needs to be assessed based on following considerations. *First*, monetary policy stance, since the latest policy rate increase, has begun to lose some of its steam. Expansion in M2 growth rate is above the annualized trend target for FY08 and relative to last year, MCI remained flat, and there has been a fall in the effective CRR as SBP zero rated commercial banks' financing support for exporters. *Second*, government has breached its quarterly target of borrowings which implies it is unlikely to retire Rs62.3 billion; the level needed to align M2 growth to the 13.7 percent target for FY08. *Third*, virtually all inflation indicators are showing rising trends, while the growth rate of real GDP has hovered around its target level for several years and exactly matched the target level of 7 percent for FY07.

[11] For example, higher domestic sale of cement, credit for housing finance, foreign investment in construction, cement & metals, import of steel & iron and construction machinery indicate strong construction activities in the economy.

[12] The decline in area under cultivation of wheat despite higher prices was due to delayed start of sugarcane crushing (i.e., farmers had to wait for clearing fields from sugarcane crop) and water shortages at the time of sowing.

44. Thus, the key challenge for monetary policy remains bringing down the headline CPI inflation by addressing the persistent inflationary pressures visible in the core inflation (which are on the rise since May 2007) and containing second round effects of high food inflation. Efforts on the government's part to address supply constrains of essential food items and to slash their hoarding, profiteering, and smuggling will pave the way for arresting unhealthy trends in food inflation. However, food inflation is likely to remain high during the rest of FY08 and will remain a serious obstacle in achieving the 6.5 percent CPI inflation target.

45. In addition, actual inflation outcome is also influenced by how people expect it to behave. These expectations could be forward looking – people expecting inflation looking at the future prospects of economic performance and policy stance – and they could be backward-looking, meaning that people will continue to expect high inflation if they have experienced it for some time. Managing and cooling-off of inflation expectations is a crucial and challenging task and requires timely monetary policy actions.

46. The expected increase in fuel prices and the likely effect on inflation also points in the same direction and calls for further tightening now before their full effects are realized.[13] Although it does not seem plausible to pass on the increase in international oil prices to domestic consumers in one go, doing so in installments will still have an impact on CPI inflation. The decision of not passing the oil price hike is also not without cost in terms of its implications for fiscal deficit, which ultimately has monetary consequences.

47. Widening of fiscal and external current account imbalances beyond targeted levels reflect high demand pressures in the economy, and are aggravating pressure on already high inflation. In the backdrop of domestic political noise and global developments, it seems unlikely that these deficits and their financing requirements will come close to the targets set at the beginning of current fiscal year.

48. Apart from monetary tightening, additional efforts will be useful in tackling these deficits. In particular, to meet fiscal target, the government will have to tighten its expenditures, reduce its reliance on borrowing from the SBP, and diversify its financing sources. Monetary policy stance for this second half of the year, should help offload government borrowings from SBP to the private sector by way of floating of higher levels of PIBs and NSS issuance and introduction of long-awaited Sovereign Shariah Compliant instruments. The same point was also voiced in the Monetary Policy Statement for H1-FY08. Since then, SBP in its communications to the Ministry of Finance has emphasized those recommendations to garner further fiscal-monetary coordination.

49. Continued reliance on borrowings from the SBP during FY08 on one hand leads to a contraction in available funds with banks for lending to private sector, on the other, results in accelerated monetary expansion, making monetary management difficult.

[13] Although crude oil price has slipped below the peak of US$ 100 per barrel in end December, the latest forecast shows oil prices to remain around US$ 87 per barrel during 2008, i.e., 20 percent higher than the average price in 2007. [Source: Energy Information Administration, (http://www.eia.doe.gov/emeu/steo/pub/contents.html)].

Thus, its high level and noticeable volatility (see **Figure 10**) is a risk to inflation and overall macroeconomic stability, and calls for adherence to mutually agreed amount of retirement.

50. *The main message that emerges from all this discussion is: risks to inflation outweigh the risks to growth in the near future. To address these risks and confront the emerging challenges, the SBP has decided to tighten its monetary policy further.*

Figure 10: Cumulative Budgetary Borrowings from SBP