Economic Update

Pakistan Economics

July 2008

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KSE-100 Index
11,032.17

KSE Market Cap
PkR3,440bn (US$45,566mn)

Economic highlights	**last update**
Inflation (Jun) YoY	21.53%
Exports (Jun) US$bn	1.99
Imports (Jun) US$bn	3.44
SCRA(FYTD Jul 25) US$mn	(133.764)
Remittances (Jun) US$mn	547.41

Data Releases

For Jun 2008	**Approx. Date**
Monetary Aggregates	Jun 2008
Exports & Imports	Jun 2008
Inflation	Jun 2008

Interest rates hike - a misadvised policy and a counter productive strategy?

The world we live in is clearly being hit by an unprecedented macro event - Rising global commodity prices and faltering financial markets. Reasons stated behind these events are various, ranging from high speculative money in the global economy, misunderstood supply-demand dynamics, political instability in resource rich regions, a weakening USD and many others. These global trends have tightened the economic conditions for many emerging and even developed economies. We are beginning to see macro imbalances across the globe and policy responses from various macro managers are now kicking in. Clearly the balance between growth and inflation is the ultimate debate. How much economic growth can be sacrificed to keep inflation growth at bay? Are existing policy initiatives undertaken by the policy managers sufficient or are there more required? Incase there is more policy adjustment required then of which type is necessary and of what magnitude? Clearly these are very difficult questions to address and the risks are even more difficult to balance out. However one thing is for certain - an all out effort to address inflation alone would result in further off-balancing the economy. As a result, despite evidence of stiff inflation numbers, we continue to see central banks across many emerging markets and even the developed ones being less hawkish than what monetary data warrants.

Pakistan is facing similar problems. Even more so, Pakistan is not a text book economy owing to lack of timely critical data and a sizable undocumented economy. In line with the rest of the world, Pakistan continues to face the same macro economic headwinds. Now with the monetary policy statement announcement closing in, focus is settling on the debate whether the solution to fixing Pakistan's economic ills lies in further monetary tightening. We feel that Pakistan's economic challenges are beyond the ambit of the monetary policy where we feel further frugality in monetary policy could unwind a series of repercussions that may unnecessarily burden the ongoing economic balancing act without really addressing the core issue - inflation. Pakistan has a slippery slope to climb to reinstate economic stability. In our view, the ultimate root of our growing macro imbalances is market expectations and thus investor confidence. Any policy solution through monetary mechanics is unlikely to form part of an ultimate solution, but will rather add to existing problems and further tighten an already delicate economic corner. Capital flight, leading to a faltering currency, is a direct result of myopic growth expectations from investors.

Conditional love is not going to help Pakistan back to the economic growth track.

Recent monetary actions warrant a wait and see policy and a gradual hike, if required, after reviewing the data that emerges in the next 6 months.

Since the sources of inflation are exogenous shocks, i.e. out of the domestic economic system, the central banks of most of these countries have limited effectiveness. Realizing these limitations, so far most of the world economies have chosen to take fiscal measures to deal with inflation, while keeping the monetary policy relaxed to accommodate growth.

Our view is underpinned by the fact that demand destruction from the fiscal end in the form of phasing out of subsidies will start becoming visible across a broad spectrum and is likely to sap corporate profitability. At the same time, proposed expansion prospects and the robust growth in foreign investment flows are at risk of being shelved. If economic slowdown is prolonged in a nation of close to 160mn + population, can the damage done to medium term growth and resulting unemployment under tighter monetary conditions be reversed in time to avoid the build up of sociopolitical pressures? We think tighter monetary conditions are likely to push Pakistan back into the 3%-4% real GDP growth era, a scenario that is likely to mount severe sociopolitical pressure that would go against the mandate of the elected democratic government.

We feel that the lack of a weighted democratic process at the center of monetary policy making is likely to lead to a biased approach if not checked in time. Further concern now rises with recent statements from the IMF which has further reiterated calls for monetary and fiscal tightening. While the IMF may have us on board for further fiscal tightening, an unduly restrictive monetary policy is likely to further derail economic growth. Media reports claiming that Pakistan is in talks with the IMF over a broad economic package that could include financing by the development lender with catch on government reforms is unlikely to set the economic chess board straight. We are continuously seeing a heightened influence of multilateral agencies over monetary policy without any compensating aid or grants or the absence of support for foreign exchange reserves. Conditional love is not going to help Pakistan back to the economic growth track.

Growing imbalances have repeatedly been cited by the multilateral agencies as well as our central bank, leading them to reiterate calls for a tighter monetary stance. The key question becomes, are we going to see a genuine downturn compression in those imbalances as a result of a tighter monetary stance. We don't think so. The recent pullback in hard and soft commodity prices is expected yo ease off some pressure on Pakistan's external imbalances. With the central bank sighting a 6-12 month lag over visible impact of tightened monetary conditions, we believe further preemptive tightening is uncalled for at least for, the current time being. Recent monetary actions warrant a wait and see policy and a gradual hike, if required, after reviewing the data that emerges in the next 6 months.

The uncertainty created by spiraling inflationary expectations fuelled by the global commodity crisis is not only stalling the economic growth momentum by depressing domestic demand, but concurrently also blurring the vision for both financial and economic policies. Last month the CPI, the monthly index of the consumer goods market which the Federal Bureau of Statistics tracks, increased by a record 21.5%. The broad based global rise in commodities from agro-commodities like rice, wheat, sugar to metals (both basic and precious) and fuels (oil, gas, coal) has been hurting growth in most oil importing, current account deficit countries. Besides the direct impact on the economy, the inflationary pressure is also threatening to have a second round impact on the economy, by making the policy makers commit to contractionary policies. Indeed Pakistan is not the only country facing these tough economic decisions; in fact most countries ranging from India to New Zealand, to Egypt, Turkey and even the developed economies are facing the same dilemma. Most economies, besides the oil and resource rich regions like the Middle East, Russia and Latin America, are tackling the question of how to structure a policy response which curbs inflation while supporting economic growth. Since the sources of inflation are exogenous shocks, i.e. out of the domestic economic system, the central banks of most of these countries have limited effectiveness. Realizing these limitations, so far most

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of the world economies have chosen to take fiscal measures to deal with inflation, while keeping the monetary policy relaxed to accommodate growth. In Pakistan, this situation has been further made difficult by the transition in political system. It is imperative that the State Bank of Pakistan and the other economic planning think tanks, come up with a holistic approach to deal with the emergency like situation. We believe that the ideal response will be similar to what most central banks have done, i.e. keep the monetary policy conducive to economic growth, but compliment it with fiscal discipline, resource development and efficient social development plans as well as cash support to the poor. We have seen visible changes with the government as it settles in, taking corrective actions that signal a renewed sense of fiscal responsibility. The recent hike in POL product prices and the proposed Benazir cards scheme are steps in the right direction towards tackling Pakistan's ground realities.

Will monetary tightening be able to control rising inflationary pressures?

We think that the answer is clearly **NO**. We have time and again stressed in the past in our reports on the analysis and causes of inflation and the effectiveness of monetary policy to control inflation. It is now well established that the factors behind the ramp up in inflation are exogenous; increase in commodity prices, pushed up due to demand acceleration in China, India and other developing countries. This is pretty clear from the fact that in FY08, core inflation remained below 10% (averaging 8.5%), while headline inflation or CPI averaged 12%. Even last month, when CPI hiked up by 21.5%, core inflation was around 12%. Hence, around 40-45% of overall inflation is non-core, i.e. food prices and oil prices. Based on this structure of inflation, we advised and still continue to hold that monetary policy tools generally and discount rate tightening especially will be ineffective and rather counter productive. The rise in core inflation has mainly come from second round impact of high commodity prices.

Core inflation basket in Pakistan is mainly composed of house rents, transport and communication and prices of education, healthcare and prices of textile and apparels. Higher fuel prices have been driving the prices of transportation and of goods provided to markets by transport. Similarly, the pick up in the prices of metals like copper, steel, iron has been feeding into higher construction cost, higher transport cost and thus inputs costs of business. Consequently the margins for the industrial base are being squeezed, some of which are being passed onto the consumer in the form of higher prices.

The argument above leads us to question the effectiveness of the interest rates hike. Can raising interest rates by State Bank of Pakistan reduce global oil prices, global metal prices and global food prices? Since we believe, and economic theory and basic logic provides supports, this will not hold true; raising interest rates will not meet the stated objective of controlling inflation. Rather, it would be counter productive, as it will raise the cost of doing business, further reduce domestic demand and force the industries to pass on the rise in financial cost to the consumer in the form of higher prices. These problems can be further compounded if the rise in financial costs leads to delinquencies and defaults. Indeed a deterioration in credit quality can even cause a collapse of the financial system, which could threaten the whole economic infrastructure. The recent bear run in the financial sector stocks has indeed been triggered by such concerns by investors. We are bearers of red flags of caution.

Global problem, global solution?

Simple economic theory supports that raising interest rates and thus sacrificing economic growth are perhaps the only solution to rising inflation. However, this sacrifice of growth has to be given by the economies which have been responsible for global inflationary pressures, i.e. global economies like China, India and the developed G8 countries. If the prices of commodities have been fuelled by rising demand from these countries, then a fall in prices, can only come from either a slowdown in global demand or an increase in supply. Since supply response is inelastic and takes a long response time, demand destruction is the only solution. However, all of these economies are reluctant to hurt their own economy to reduce inflation for the rest of the world. **In economics this is called the "free rider" or "public goods problem"**. The US has been cutting interest rates, UK is reluctant to further tighten, India has been cautious with tightening and China has been stubbornly reluctant to either use currency adjustment or any other measure which slows their economy. Reduction in inflation requires a slowdown in demand from these economies, however they are all reluctant to take unilateral action and instead are providing further impetus to the economies. Instead now, the rest of the world is being pressured to reduce the growth in their economies in order to do the clean up act.

Why us, IMF?

The bigger countries, will force the less powerful to maintain policies which benefit the more powerful ones.

Today, local newspapers published policy advice from IMF, which directs Pakistan to further tighten the interest rates. We ask IMF, why us? Developing countries which can be pushed and arm twisted, are now being recommended to sacrifice their economic growth by stifling domestic demand, in order to accommodate expansionary policies in the more powerful blocs of the world. Indeed this is the same problem which prevented the creation of a unified central bank in many regions of the world and which stalled the creation of European Union for a long time. The bigger countries, will force the less powerful to maintain policies which benefit the more powerful ones. Recommendation of raising domestic interest rates in Pakistan, certainly fits this pattern.

What is the rest of the world doing?

Over the last 12 months, the US has reduced interest rates, UK and EU have relaxed their monetary policies, New Zealand has cut interest rates and even economies in the Middle East, like Oman have cut their interest rates.

What! Cut interest rates to control inflation? Why/How?

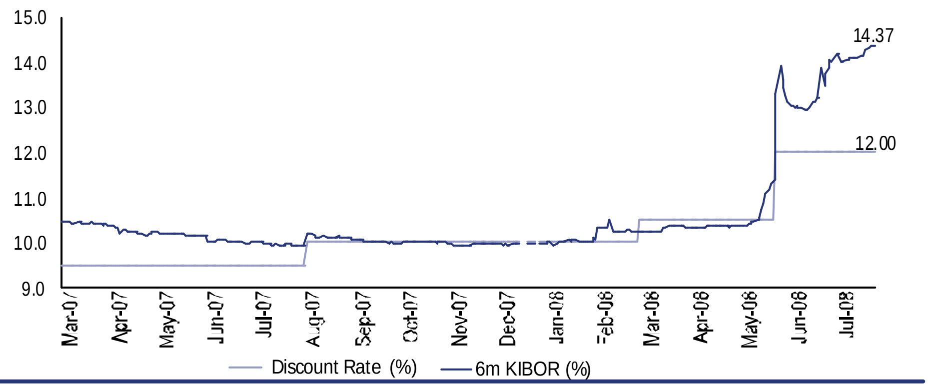
Reduction in interest rates can help urban consumer and increase disposable income.

Yes, cutting interest rates can actually help reduce inflation. In leveraged economies, financial cost is a significant part of cost of doing business. Also in economies where the consumers are leveraged through mortgages and consumer loans, interest cost is a major drain on the finances. In such a situation, reducing interest rates helps the businesses by reducing the cost of doing business, which in turn can be passed onto the consumer in the shape of lower prices. Similarly when interest rates are cut, consumers benefit as their disposable income goes up. Indeed during the last eight years, the urban populace in Pakistan has taken significant consumer loans in the form of home loans, auto loans and credit cards, however, we accept that Pakistan's consumer remains relatively underbanked with consumer lending less than 5% of GDP. That said, corporate borrowing for expansion remains and any hike in interest rates is either going to be past on to consumers or lead to a shelving of expansion plans. Furthermore the 16.5%YoY growth in Private sector credit offtake has mainly been led by higher input costs, thereby resulting in higher working capital requirements, not fresh growth per se. As a result, the Pakistani consumer is likely to face a double whammy as prices surge after a rate hike, lowering disposable income.

Repercussions of Further Tightening – Raising the Cost of Business

At present, the discount rate is 12% and the 6M KIBOR is 14.3%, implying a spread of +200bps. As the graph below shows, the effective interest rates (KIBOR) in the system have significantly overshot the discount rate. Our point of view is that there is no rationale for raising policy rates higher in the backdrop of an already-present 200+bps KIBOR-Discount Rate spread. Moreover, the government has recently started passing the burden of oil subsidies onto consumers (domestic POL prices are up 60-75% from Mar '08 onwards). Although this has resulted in an inflationary spike, we believe the situation should be read as an exercise to control further fiscal slippages. From that vantage, the Central Bank should not act on a short term spike in prices due to withdrawal of oil subsidies. Signs of fiscal austerity are now visible and with the fiscal side getting its act together, the monetary side can afford to step back.

Effective Lending Rates have already overshot the Discount Rate



Source: State Bank of Pakistan

At this point in time, further monetary tightening will likely result in demand destruction by increasing the cost of doing business. Rising KIBOR rates are already having an adverse impact on different companies as the expansion projects of different manufacturers have become unfeasible. Costs of expansion have risen exponentially due to the double whammy of interest increases as well as exchange rate devaluation. Resulting loan demand destruction will be unnecessarily exacerbated in the wake of further monetary tightening. Furthermore, latest SBP data indicates that FDI inflows have remained stable in FY08 at US$5.14bn compared to US$5.15bn in FY07 while FPI has fallen significantly to just US$40.1mn in FY08 from US$3.29bn in FY07. As such, further tightening not only entails the likelihood of subdued FPI inflows but also of dampened FDI inflows, if the cost of business in Pakistan becomes too high. This would likely go against the SBP's efforts to contain the PkR depreciation, at a time when FDI and privatization proceeds are highly needed. It is not only the private sector corporate profitability we see being sapped, but government-owned corporations are also expected to feel a substantial pinch. Ahead of an expected pickup in privatization proceeds, this risks to undermine privatization activity and overall government revenues ahead of a challenging fiscal revenue target.

Need of the hour!

Grants should be obtained from multilateral agencies and friendly countries, such as the oil facility expected from Saudi Arabia. Moreover, grants from US such as the intended US$7.5bn non-military aid over the next four years should be lobbied for. This should help ease pressure over the BOP figure going forward. We expect positive newsflow on modalities over the Saudi Oil Facility which is expected to visibly boost the BOP conditions. As a result, being proactive now on the part of the SBP may not necessarily be a wise strategy.

As international prices of oil recede from historic highs, we expect other commodities to follow suit. Specifically, as prices of food items and edible oil decrease, the Sensitive Price Index is likely to taper off in the next few weeks leaving no further rationale for a tightening stance to be adopted.

With the passing on of oil subsidies to consumers, and if bilateral grants are received, we believe the government will be in a position to retire its debts to the central bank and thereby ease inflationary pressures. Moreover, according to a SBP working paper “Transmission Mechanism of Monetary Policy in Pakistan”, the impact of monetary tools through monetary transmission channels on real sectors of the economy takes place with a lag of at least 6 to 12 months. Hence, it is important that the central bank adopt a wait-and-see policy in the MPS for the next 3 months at least.

Policy blunder or misdirection?

Is Pakistan being misdirected again by the international economic advisors, the IMF's, World Banks and ADBs of the world? Indeed the historical track record of these institutions, especially in dealing with global financial crises is a black spot. From East Asia to Latin America, numerous economic systems have come down to their knees after following the policy advice from these agencies. During the East Asian crisis, the only economy which survived the mayhem was Malaysia, which refused to toe the policy advice of these bodies and chose to follow its own strategy. Pakistan too has suffered many times in the past from misdirected policy advice. We believe that monetary policy tightening to curb inflation is another one of such bad policies.

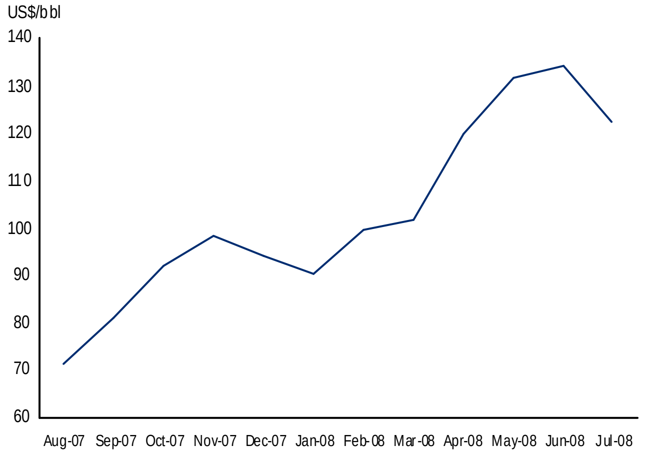
Conclusion:

We have argued many times in our reports that raising interest rates will derail the economic momentum and stall industrial growth in Pakistan by both reducing domestic demand and raising the cost of business. Both of these will further hurt domestic consumers, who will be squeezed between the double whammy of rising commodities' prices and slower economic growth. It can also lead to deterioration in credit quality and lead to defaults, which can trigger a collapse of the financial system.

In contrast, reducing interest rates can reduce domestic inflation by reducing the financial burden on industries and on the consumers. This indeed is the strategy used by most of the world.

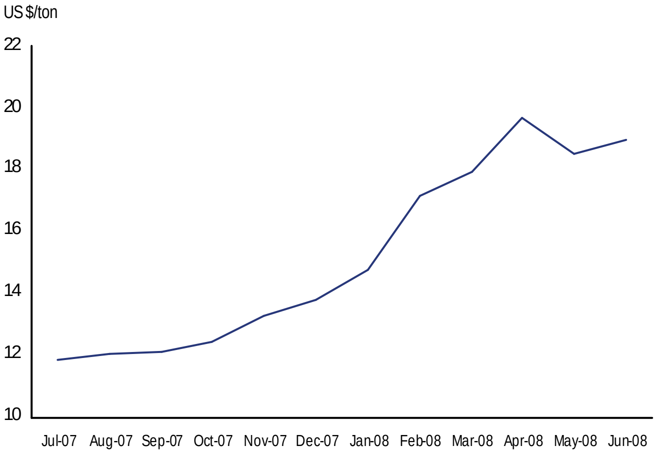
Inflation is a global phenomenon caused by few fast growing powerful economies of the world. The sacrifice of economic growth has to come from these economies, and not from the less powerful developing parts of the world like Pakistan. Taking such policy actions requires vision and courage, in our view.

International (WTI) Oil tappering off



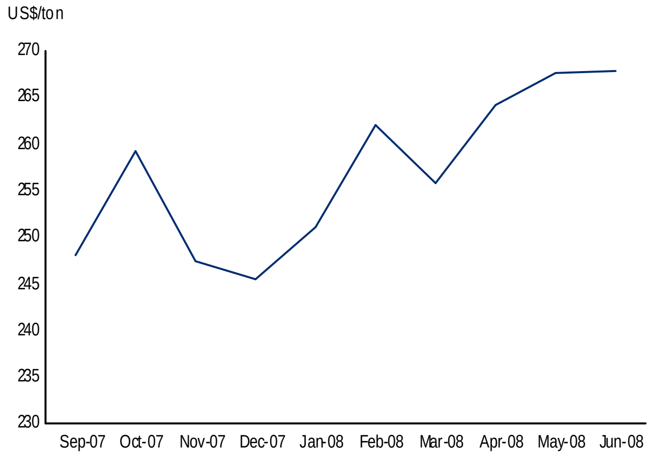
Source: Bloomberg

Rice (Rough) stablilizing



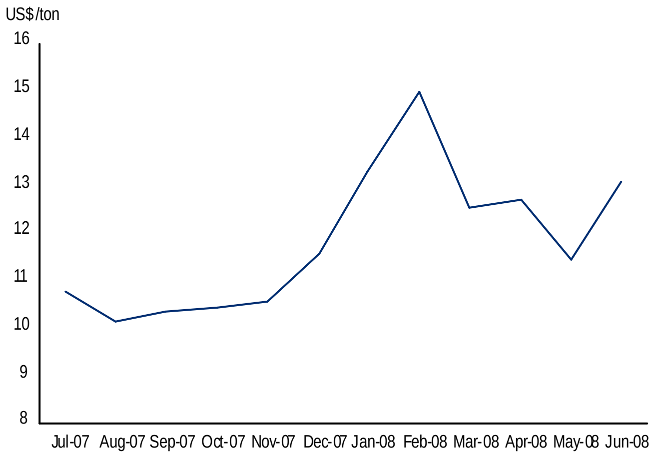
Source: Bloomberg

Wheat Price Stabilizing



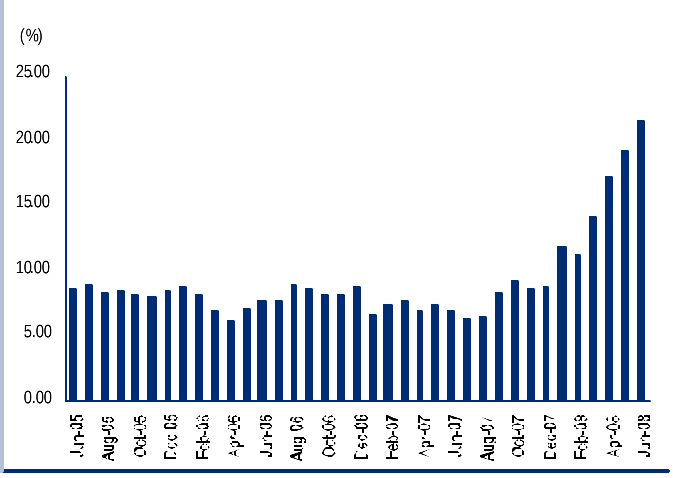
Source: Bloomberg

Sugar Price Stabilizing



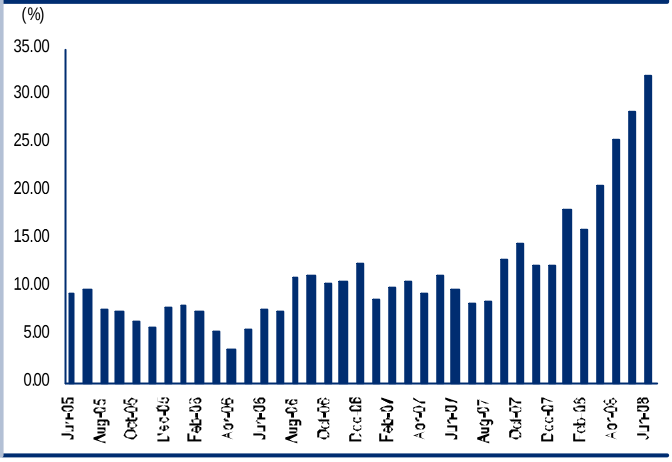
Source: Bloomberg

Headline Inflation has significantly increased since Dec 07



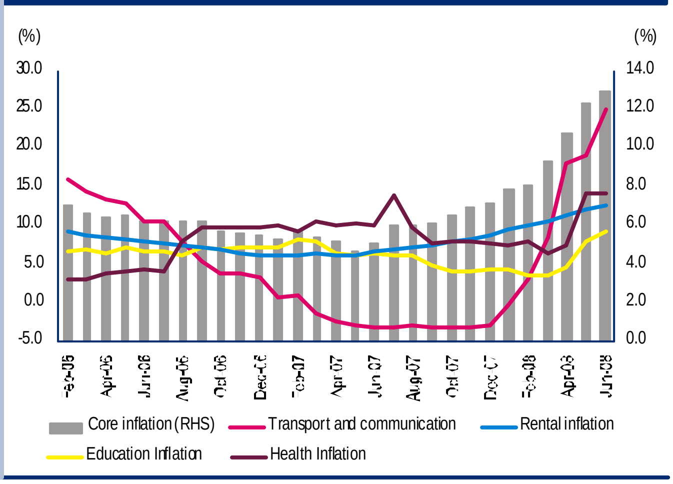
Source: State Bank of Pakistan

Sharp uptrend in food inflation is responsible for surge in headline inflation



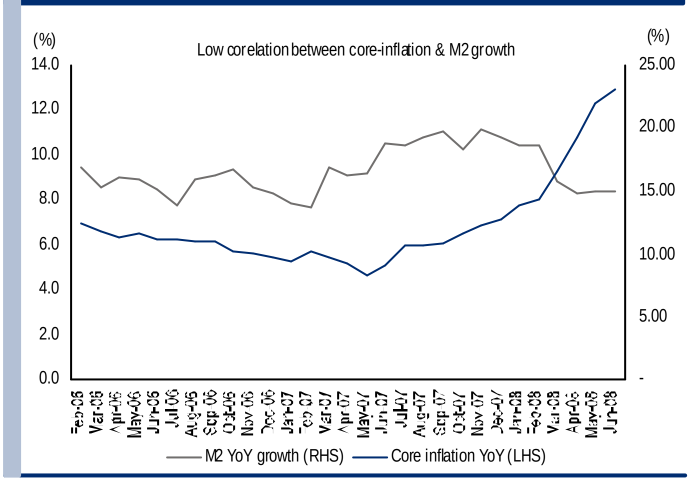
Source: State Bank of Pakistan

Trend in Core Inflation & its major components



Source: State Bank of Pakistan

Low corelation between core-inflation & M2 growth



Source: State Bank of Pakistan

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