

Monetary Policy Preview

"Status quo, you know, that is Latin for the mess we're in." — Ronald Reagan

Too soon for a U-turn

Limited visibility regarding major economic variables makes the case for a policy rate reversal inappropriate at this time. CY08 was a year riddled with defining moments in Pakistan's economic history and subsequent regulatory responses that require a sufficient time span for smooth transmission. Any reversal of policy rate at this point would unhinge macroeconomic stabilization. Consequently we expect the Discount Rate to remain static at 15% till 4Q FY09 when a definitive inflation trajectory is visible.

Corrective and coordinated policy measures include;

- i staggered increase in discount rate to 15% by Nov08 from 10% a year earlier
- ii effective liquidity management via 400bp phased reduction of CRR and amendment to SLR requirements in Oct08
- iii aggressive exchange policy changes in order to enhance effectiveness of exchange rate as 'transactional price' in Jul08
- iv an uncompromising focus on resource mobilization with the imposition of a minimum deposit rate of 5% on PLS accounts in May08

Inflation downswing in early stages

In line with our expectations the short term impact of a rate hike in Jul08 was over baked. The CPI basket continued to overheat despite 4 upward rate adjustments in CY08. Supply-side constraints and global dynamics were largely to blame for record CPI Headline and Food Inflation; which soared to a record 25.3% and 34.5% in Aug08 respectively. However the medium term spill-over effects of the price spiral, unprecedented domestic demand growth of 23% in FY08 and lack of fiscal space to control prices of fuel and essential food items, necessitated the upward movement of interest rates. Core Inflation reflected the aftermath of the inflation surge with NFNE and Trimmed Mean topping 18.9% and 21.7% respectively in Nov08. Although CPI Inflation seems to have decelerated on account of domestic fuel price cuts in Sep08, the impact on Core Inflation remains unclear, justifying a firm Discount Rate for the time being.

Earnings trough to stay for CY09

We expect any equity market enthusiasm to be short lived during CY09, as earnings face the brunt of the economic downturn. Year end GDP is likely to result in 'recessionary' growth in the range of 3%. While bottom lines of the Manufacturing sector may improve on easing commodity prices, contracting demand and high cost of capital will weigh on output and inventories. Services sector, particularly Financial Services and Wholesale & Retail will feel the pinch of the shrinking economy as asset growth slows, cost of deposits rise, default risk increases and disposable income narrows. Key indicators include negative LSM output at -5.6% for 5mo FY09 on account of capacity, input and energy constraints; declining KSE 100 trailing net earnings for Sep08; and an expected steep decline in investment to GDP ratio below 20%.

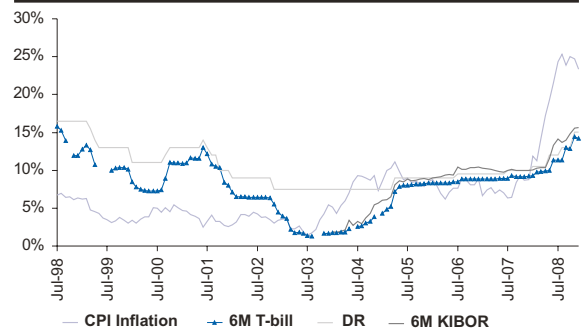
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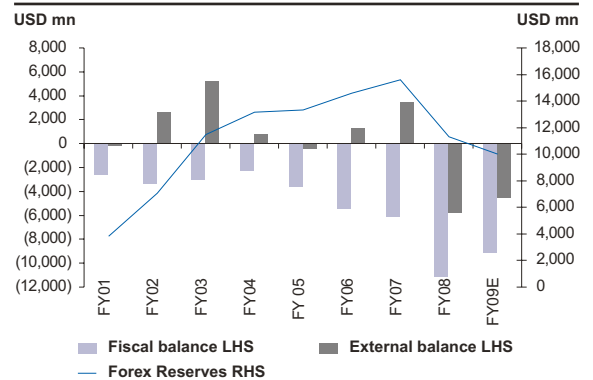
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Chart 1: Inflation and Interest Rates



Source: SBP

Chart 2: FX Reserves and Twin Deficits



Source: SBP & Economic Survey

Table 1: Monetary Statistics

| Monetary Indicators % | Date | Year ago | Latest | Chg. bps |
|-----------------------------------|--------|-----------|-----------|----------|
| Discount Rate | Dec-08 | 10.0 | 15.0 | 500 |
| 6mo T-bill average cut off yield | Dec-08 | 9.3 | 14.2 | 493 |
| 5yr PIB market average yield | Dec-08 | 10.2 | 15.1 | 490 |
| 6mo KIBOR Offer | Dec-08 | 10.1 | 15.7 | 557 |
| Headline Inflation | Dec-08 | 8.8 | 23.3 | 1450 |
| WA Lending Spread ex-zero markup | Dec-08 | 6.9 | 7.7 | 88 |
| Monetary Aggregates PKR mn | | | | |
| Credit to govt sector | FY09 | 213,822 | 288,989 | 35% |
| Credit to private sector | FY09 | 240,223 | 155,812 | -35% |
| Other Items | FY09 | (62,081) | (159,521) | NA |
| Net Domestic Assets | FY09 | 402,551 | 343,539 | -15% |
| Net Foreign Assets | FY09 | (142,583) | (299,999) | NA |
| M2 growth | FY09 | 6.40% | 0.93% | |

Source: SBP

