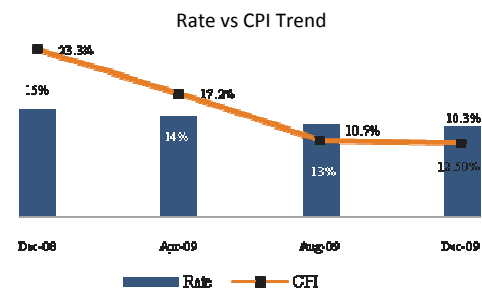


Monetary Policy and Fiscal Scarcity

REDUCTION OF DISCOUNT RATE IS LINKED WITH FISCAL DEFICIT AND INFLATION. THE CURRENT FISCAL, INFLATIONARY, BROAD MONEY AND CAD SCENARIOS SCARCELY LEAVE ENOUGH LIBERTY FOR MUCH SPECULATION.

- Surge in broad money (M2) and massive increase in CAD of 130% in 2QFY10 comparing 1QFY10 are hampering over to change in lending rate.
- The magnitude and timing of expected non-IMF foreign inflows remain uncertain and could increase the challenges of SBP's liquidity management and government's budgetary financing.

The State Bank of Pakistan (SBP) is to review the existing monetary policy by end Jan-2010. In the existing policy, discount rate was lowered by 50 bps that fixed the interest rate at 1,250 bps from 1,500 bps set in November 2008 to meet the IMF's requirement. It is unlikely if the SBP would take a quantum alter in the discount rate because there is hardly any change in the factors that constrained the SBP not to reduce discount rate in a big way. On the contrary, a few developments have taken place that point towards maintaining a status quo. Funds from the friends of Pakistan (FoP), financial assistance under the Kerry-Lugar were the chief sources decreasing the pressure on the government to bridge fiscal deficit through domestic and foreign borrowings.



FISCAL PARAMETERS:

Government's compulsion to continue with expansionary fiscal mode also persists because of fiscal expenditures. However, reduction in subsidies and increase in prices of gas and electricity will improve government finances. According to the SBP report, total expenditure during Q1-FY10 grew by 24.5 % which is considerably higher than 11.1 % recorded in the same period of last year. Within total expenditure, current expenditure increased by 14.2 %. Inflationary stress is likely to increase during 2HFY 10 because of cost push inflationary measures being taken by the government, such as 12.0 % raise in electricity tariff and another of 6.0 % in April 2010 to do away with subsidies and enhance revenue to bridge fiscal deficit. Fiscal deficit figure of 1.5 % for first quarter of current fiscal year points toward that containing fiscal deficit to 4.9 % as assured to the IMF might be complex. The government presently depends upon extensive borrowing from the commercial banks and foreign lenders to bridge the fiscal gap. Consequently, public debt is on the increase; foreign debt is around \$53.0 bn and domestic debt is more than Rs4.1 trn at present. The real issue is not about debt as a percentage of GDP that is still lower than 60.0 %, but it is about its repayment and taking the burden of its serviceability in a weak economic environment.

Sources: SBP

| | FY 09 | FY 10 | |
|--------------------------|-------|----------------|-----------------|
| | | Annual Targets | SBP Projections |
| CPI (%) | 20.8 | 9.0 | 10 - 12 |
| Monetary Assets (M2) (%) | 9.6 | - | 12 - 13 |
| GDP (%) | 2.0 | 3.3 | 2.5 - 3.5 |
| Export (US \$ in bn) | 19.2 | 19.9 | 18.5 - 19 |
| Import (US \$ in bn) | 31.7 | 28.7 | 30.5 - 31 |
| Fiscal Deficit % of GDP | 5.2 | 4.9 | 4.7 - 5.2 |
| CAD % of GDP | 5.3 | 5.3 | 3.7 - 4.7 |

Conclusion:

In the monetary policy statement announced on 24th November, 09, the SBP observed that a higher than projected fiscal deficit for FY09 has also changed some underlying assumptions for inflation outlook in FY10. In addition, the full impact of electricity and gas price adjustments, a necessary part of fiscal consolidation measures, and recent resurgence of international commodity prices, on the back of early signs of global economic recovery, remains a source of uncertainty for inflation outlook. Additionally, Surge in broad money (M2) and massive increase in CAD of 130% in 2QFY10 comparing 1QFY10 are hampering over to change in lending rate. Hence; we do not foresee any further curtail in lending rates.

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