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ECONOMIC REPORT

LIQUIDITY CRUNCH, INFLATION & MARKET GROWTH

Pakistan's banking system recently faced one of the biggest liquidity crunches in recent memory. Several factors contributed to this phenomenon, including an increasing M1 synonymous with Ramadan. The SBP duly responded with relaxations in CRR and SLR eligibility requirements, re-affirming that it takes its dual mandate of ensuring price stability and promoting economic growth seriously. Though one may take preference over the other from time to time (the SBP has been accused by many of inflation phobia) our central bank now seems firmly focused on saving the financial system just like others around the world who have risen to the occasion.

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DOMESTIC LIQUIDITY CRUNCH

The money market faced a severe liquidity shortage in recent weeks, whereby overnight call rates traded as high as 45%. This surge is a reflection of banks being constrained in their SLR positions, hence to fund this SLR deficit they had to resort to borrowing from the call market (un-collateralized borrowing).

Reasons for surge in liquidity demand at the time included Ramadan coinciding with the end of the quarter tax out flows. The SBP announced printing of PKR 54 bn of new currency notes for Ramadan, a majority of which are still in circulation (out of the banking system).

Another contributing factor is the ever increasing import bill. Latest figures show our trade and current account deficits have swelled to record levels, trade deficit is approximately USD 5.5 bn from the beginning of FY09 until September, which is an increase of 52.65% compared to the same period last year. Similarly the current account deficit has widened by 63.78% to USD 2.571 bn in Jul-Aug compared to the same period last FY. Consequently, there has been a decrease in Net Foreign Assets resulting in PKR being drained out of the system. Foreign exchange reserves have halved since October 2007 when they reached a record of USD 16.48 bn, now they are at USD 8.32 bn. These expanding deficits and decreasing reserves have put pressure on the Pak Rupee, which so far has depreciated by over 30% YOY.

To exacerbate the situation, combined credit off-take to the Private and Public Sector Enterprises has increased by PKR 122 bn versus the same time last year. Since majority of these flows are adding to the circular debt there is a resultant net out flow from the system.

Deposits for the banking sector as a whole fell during the current fiscal year by approx. PKR 60 Billion mirrored in the M2 falling by 1.03%, All these factors have culminated into the present liquidity crunch.





STEPS TAKEN

The SBP took decisive steps to free up liquidity in the system by reducing the CRR requirement by 100 bps to 8% of total demand liabilities as of October 11th 2008. This action will be followed by another decrease of 100 bps, which will come into effect on November 15th 2008 (to coincide with the commodity financing season). Reduction of 1% CRR increases liquidity by approximately PKR 32 bn for the whole banking system.

According to our estimates there was approximately PKR 180 bn worth of excess liquidity in the market at June end 2008. From this an estimated PKR 60 bn was drained out through circular debt and another PKR 60 bn by increased currency in circulation. This left approximately a meager PKR 50-60 bn of excess liquidity in the system distributed between the thirty odd banks.

Taking note of this, SBP on 13th October 2008 changed HMS and Statutory Liquidity Requirements. Through this policy change the eligibility of PIB's and TFC towards SLR was increased from 5% to 10% of Time and Demand Liabilities (TDL). Furthermore, securities classified under 'Held to Maturity' category have been allowed for Repo borrowing. The cumulative effect of this policy change is to allow banks to raise liquidity against securities marked as HTM thereby reducing demand in the inter-bank call market.

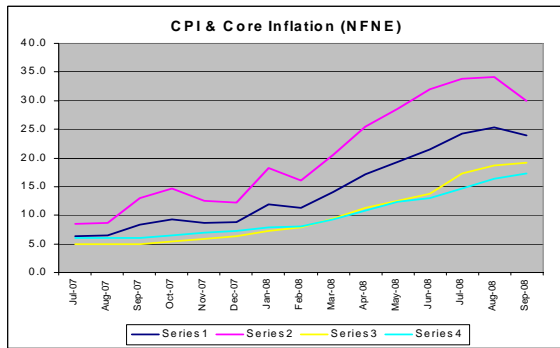
The measures outlined above will increase liquidity, a question that beckons is what effect injection of such a huge quantum of currency have on inflation? Latest inflation figures show a slight ease in price levels, inflation came down to 23.9% in Sept08 YoY, this is less than the record 25.3% YoY inflation we witnessed in Aug08.



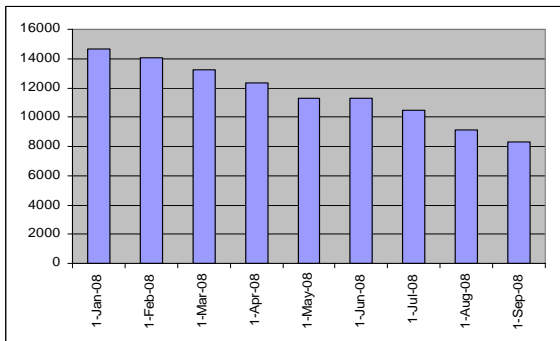
STEPS TAKEN ... Continued

Recent adjustments in SLR, CRR and HMS are likely to increase inflationary pressures in the economy, as they shall increase money supply. But the SBP had to do so in order to ensure that there is sufficient liquidity in the system so that the Financial Sector does not collapse. Juggling both inflation and economic growth simultaneously requires a delicate balance. This can be witnessed globally, where an increasing number of central banks are easing their monetary stance to ensure that sufficient liquidity is available to their financial sectors to function.

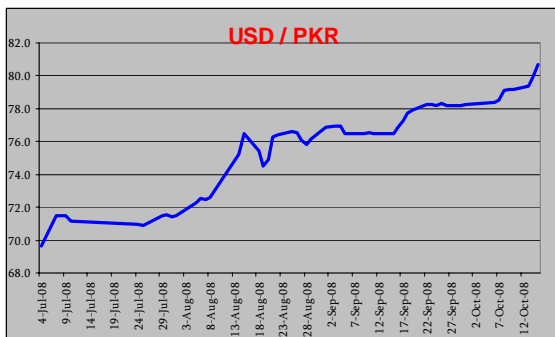
CPI & Core Inflation (NFNE) - Jul07-Sept08



FOREX RESERVES - Jan08-Sept08



USD/PKR - Jul08-Present





INTERNATIONAL – PREMIUM ON GROWTH

High interest rates and the prevailing credit crunch were slowing the world economy. In a move of unprecedented scope, the world's major central banks collaborated to lower their benchmark interest rates on 8th of October. This was a coordinated effort to halt the collapse of share prices and unfreeze credit markets that are threatening to deepen the first global recession since early 1970s.

Global reduction in interest rates will make more liquidity available to the financial sector and ease fears of depression. To add to this, on 13th October G10 governments pledged to pump unlimited dollar funds into money markets, a move that saw world stocks rally, Dow Jones in NY climbed by more than 936 points and the MSCI World Index went up 9.5%.

These steps show the dual policies employed in developed economies, where they are willing to trade off between inflation and economic growth. Due to the dramatic slowdown in the global economy, there has been a shift in paradigm from controlling inflation to rebuffing and stimulating economic growth. This may now be applied in Pakistan, where the stock market is firmly planted at its lower lock, foreign reserves are falling and investor confidence is dwindling.

Country	Cut in (Bps)	Now
US	50	1.50%
England	50	4.50%
Eurozone	50	3.75%
Canada	50	2.50%
Sweden	50	4.25%
Switzerland	25	2.50%
China	27	6.93%
Taiwan	25	3.25%
Korea	25	5.00%
Hong Kong	100	2.00%
Australia	100	6.00%



PRECARIOUS POSITION

With oil prices having dropped sharply (currently trading at USD 75.50 / barrel), the government should be able to reduce fuel prices. If it does, inflation will undoubtedly come down and pressure will mount on the SBP to cut the discount rate to help further ease the liquidity crunch in the financial sector. But the question is at what level of inflation should a prudent central bank consider such a policy shift? SBP historically has been of the opinion that in Pakistan's case, CPI of 5% is required for long-term sustainable growth. Annual inflation of 8% has resulted in the SBP raising interest rates. Bringing inflation down from its current level of 24.5% could take some time and doing. For its part, the SBP has only moderately increased the discount rate (in relation to CPI) as the real interest rates remain highly negative (10-12%), the perils of which are evident in our; current account deficit, depleting FX reserves and now Dollarization as skyrocketing inflation has lead people to loose faith in the PKR as a store of value. Empirical evidence (of not so long ago) shows that these trends will take a Herculean effort (of 9/11 proportions to put it lightly) to reverse. Therefore Pakistan simply should not follow other regional central banks and decrease its policy rate.

It would be in the economy's best interest to reduce the CRR further rather than cutting the discount rate. We simply do not have any foreign exchange reserves to pay for any consumerism driven adventurism to stimulate economic growth (if I am not mistaken that is how we got here in the first place).



ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
<u>Inflation</u>														
Headline Inflation	%	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9
Core inflation	%	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3
Food inflation	%	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5	32.0	33.8	34.1	29.9
Non-food inflation	%	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.95	11.3	12.2	12.4	12.6
6 month	%	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86	11.5	n/a	n/a	n/a
12 month	%	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.32	11.7	n/a	n/a	n/a
<u>External Sector</u>														
Export	Mln US\$	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779
Import	Mln US\$	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806
Trade balance	Mln US\$	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)
<u>Remittances</u>	Mln US\$	516	580	505	479	557	502	602	590	584	547	627	592	660
<u>Forex Reserves</u>	Mln US\$	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920	9,130	8,322

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