April 20, 2009

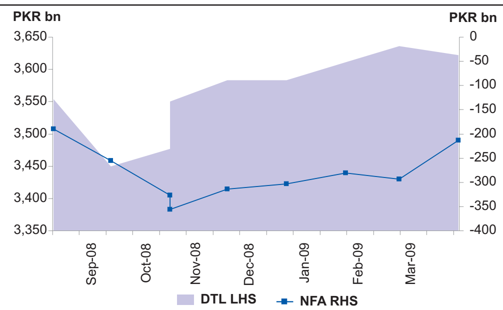
Monetary Policy Preview

Making the Cut

Structural vulnerability limits scope for a Rate cut

Fundamentals supporting the PKR and Savings Rate remain weak; necessitating an aggressive stance on the policy rate. Therefore we re-iterate our stance on No Change in the Discount Rate of 15%, with regards to the Monetary Policy to be announced on April 20'09. CRR and SLR are also likely to remain static at 5% and 19% respectively on account of the drawdown in the deposit base, Net Foreign Asset (NFA) outflow and sustained heavy Money Demand from the Government.

Chart 3: NFA and DTLs

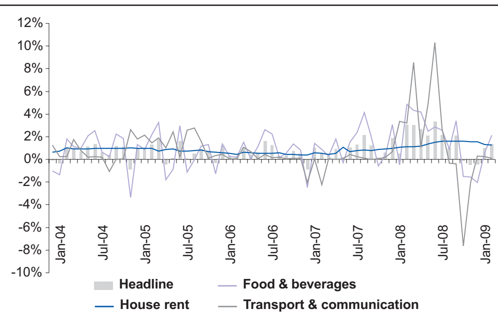


Source: SBP

Real interest rates matter

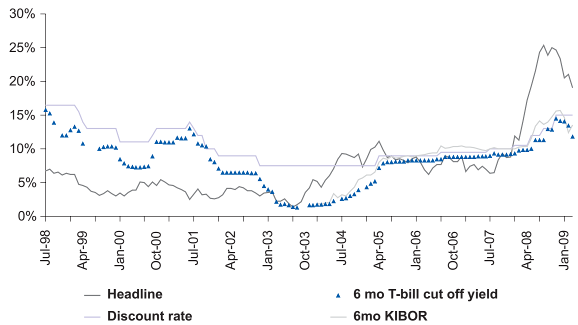
Although Headline CPI inflation variables appear to be loosening up significantly with Mar09 numbers already down by 200bps to 19.1% over the previous month, Core inflation figures remain sticky in the 18.5% range suggesting price indices still have some steam to let off. MoM CPI inflation has also increased by 1.4% in Mar09 compared to an average 0.3% decline since Nov08.

Chart 4: MoM CPI Inflation



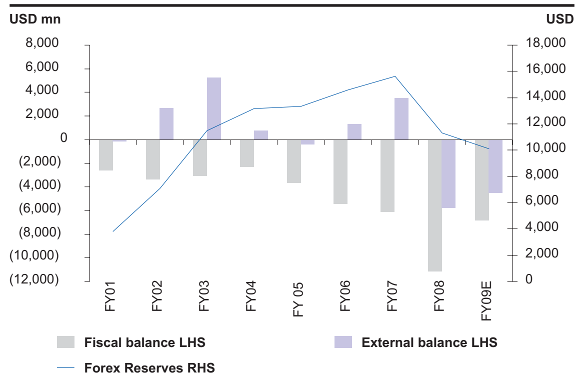
Source: FBS

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	Apr-09	10.0	15.0	500
6mo T-bill average cut off yield	Apr-09	9.9	13.0	311
5yr PIB market average yield	Apr-09	10.2	12.9	265
6mo KIBOR Offer	Apr-09	10.1	13.5	340
Headline Inflation	Apr-09	17.9	19.7	178
WA Lending Spread ex-zero markup	Apr-09	6.9	7.7	88
Monetary Aggregates PKR mn				**%**
Credit to govt sector	Apr 5'09	333,683	226,961	-32%
Credit to private sector	Apr 5'09	369,888	189,789	-49%
Other Items	Apr 5'09	(102,308)	(128,683)	NA
Net Domestic Assets	Apr 5'09	601,553	288,067	-52%
Net Foreign Assets	Apr 5'09	(271,559)	(212,594)	NA
M2 growth	Apr 5'09	1.61%	8.12%	

Source: SBP

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This leaves the Real Interest Rate still in steeply negative territory against the 12mo Average CPI Inflation expectations of 21% for FY09. The Balance of Payments also reflects high exposure to the global meltdown; with cross-border flows on the decline the overall external deficit could remain in the USD 4bn range if external financing targets remain unmet. Financial Account inflows are down by over 40% in 9mo FY09 although the rising proportion of debt inflows have buoyed the overall deficit at USD 4.4bn for now.

Wide PKR:USD interest rate differential required to support currency

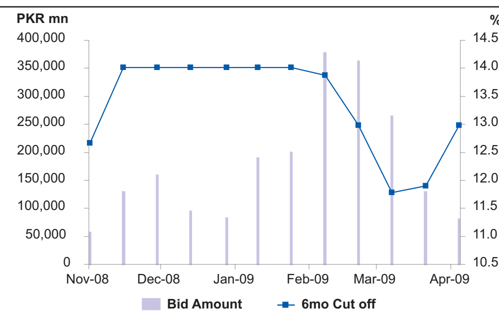
Given the weak economic expectations and Balance of Payments gap of USD 4.4bn in 9mo FY09, fundamentals remain poised against the PKR. Therefore investment in PKR based interest yielding instruments would be structurally vulnerable to further currency depreciation. This firmly necessitates a wider interest rate differential against the PKR's major counterpart the USD, against which the PKR is a managed float. In order to secure investor confidence in Pakistan's capital markets, interest rates would have to price in the currency weakness which indicates the policy rates should theoretically tighten rather than ease in line with US interest rates. The 5yr PIB is currently trading in the range of 13% against the relevant UST reflecting a spread of approximately 1,100bps compared to roughly 900bps in Jun08.

Pity party

In recent weeks the government has announced cuts of between 100-150bps on National Savings Schemes while cut off yields in the Apr 16'09 PIB auction contracted by 100-150bps. We believe this is largely connected to an accelerated level of interest in National Savings Schemes and short supply of longer tenor government securities. Investment in National Savings Schemes increased by almost 50% by Jan09 and has catapulted to an estimated PKR 130bn on an annualized basis in FY09. This is phenomenal compared to FY08 levels of PKR 87bn and disinvestment of nearly PKR 50bn in FY05.

Although high demand for these government securities justifies the downward adjustment in yields by the Ministry of Finance, it also reflects the government's sympathetic approach to the banking sector's resource mobilization endeavors. Resource mobilization is the current environment is likely to be extremely competitive with the Demand and Time Deposits (DTL) base still reflecting a drawdown of PKR 81bn in FY09 as of Apr 5'09 over stock of PKR 3,703bn in Jun08. Although there has been a significant recovery of the DTL base from the sharp drawdown of PKR 250bn in Oct08, due to the SBP's intervention, the banking system's savings base remains on thin ice and must be protected. This is not only necessary in the face of the government's money demand but also to sustain economic growth via private sector credit off-take.

Chart 5: T-bill auction trends



Source: SBP & IGI Money Market Desk

Fiscal factor

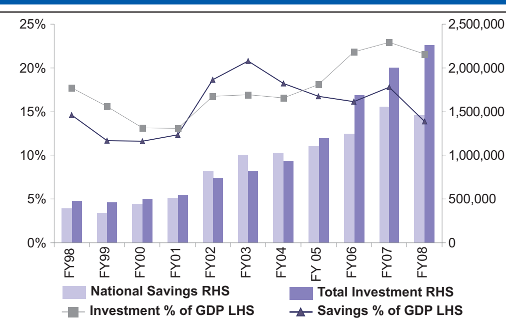
With Stagflation on the horizon, the Tax revenue target of PKR 1.36tn is unlikely to be met increasing pressure on the Non-Tax Revenue segment. Meanwhile the government continues to fund its budgetary gap via increasing dependence on the risk-averse Commercial Banking sector and direct borrowing from the State Bank. Net Government Budgetary borrowing currently amounts to PKR 227bn as of Apr 5'09 over Jun08 stock of PKR 1,519bn. The recent surge in T-bill auction bid volumes past the PKR 370bn level, suppressed the short end of the yield curve by 200-250bps in Feb09 over the previous month, but saw a correction of 100-150bps in Apr09. Liquidity dried up and bid volumes contracted to the PKR 80bn range pushing 3mo, 6mo and 1yr cut off yields up again.

Consequently fiscal liquidity requirements remain a key vulnerability which in our view limits the potential for a rate cut at present. While the State Bank books are saturated with government borrowing, the Commercial Banking sector must remain liquid via effective resource mobilization and an attractive Savings rate would be crucial to secure that. The banking sector will provide a key cushion to the government's rising financing needs especially if external financing is delayed. Although to a large extent this has been resolved by the mandatory 5% floor on PLS rates introduced by the SBP in CY08, future banking sector liquidity will be heavily reliant on a strong and stable policy rate signal.

Confidence deficit could decouple Policy rate link with Savings

The delicate political situation in Pakistan serves as the wildcard or key risk to our view on interest rates. Investor confidence in Pakistan could crumble on a weakening law and order situation or cracks in the federal government. This will have a direct impact on the deposit base and capital markets and ultimately market liquidity effectively nullifying the impact of a strong policy stance on the savings rate. In FY08 the Savings rate as a % of GDP plummeted to 14% from 18% of GDP the previous year. In FY09 the trend appears to have continued with over PKR 300bn in NFA outflows and a PKR 250bn drawdown on the deposit base which has since rebounded to a net outflow of PKR 80bn.

Chart 6: Saving and Investment Gap **(PKR mn)**



Source: SBP

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