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**Pakistan Market****1QFY10 MPS: SBP opted for a cautious stance****MORNING BRIEFING**

KSE100 Index: Closing 8011.31 ↓ (-47.15)

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- SBP has opted to reduce policy rate by 100bps to 13%, as against our expectation of 150bps.
- No change in CRR and SLR composition.
- SBP has introduced a corridor for money market operation by introducing overnight repo rate, 300bps below reverse repo rate of 13%.
- To combat the fast moving challenges, SBP has decided to issue six Monetary Policy Statements from existing four statements in a year.
- Our view, SBP has provided a comprehensive policy package but reacted with lower than expected policy stimulus.

Additionally, SBP expects inflation at 10% and M2 at 13% in FY10. Given the threat of economic slowdown and expected lower credit off take, we expect SBP to continue to ease its stance to 10% by June FY10. We recommend investors to continue to look for fixed income options due to sufficient liquidity available in the system owing to retirement of private credit offtake, PSE retirement upon settlement of inter-corporate debt and commodity financing retirement. Improved liquidity is also likely to bode well for equity market.

**Interest rate corridor Implication**

SBP has introduced a corridor for money market operation by introducing overnight repo rate, 300bps below reverse repo rate. The new framework will reduce volatility in short term market interest rates thus improving the transmission of monetary policy signals and strengthening its role in fostering the price stability.

**Table: Historical discount rate**

Date	Rate	Date	Rate
1-Feb-92	14.0	19-Sep-00	12.0
14-Apr-92	14.0	5-Oct-00	13.0
6-Dec-92	15.0	7-Jun-01	14.0
16-Aug-93	17.0	19-Jul-01	13.0
1-Mar-94	15.0	17-Aug-01	12.0
6-Feb-95	15.5	20-Oct-01	10.0
29-Oct-95	16.5	23-Jan-02	9.0
12-Nov-95	17.0	18-Nov-02	7.5
22-Oct-96	20.0	11-Apr-05	9.0
18-Jun-97	19.0	29-Jul-06	9.5
28-Jul-97	18.5	1-Aug-07	10.0
29-Oct-97	18.0	31-Jan-08	10.5
1-Jul-98	16.5	23-May-08	12.0
4-Mar-99	15.5	30-Jul-08	13.0
3-Apr-99	14.0	12-Nov-08	15.0
19-May-99	13.0	21-Apr-09	14.0
5-Jan-00	11.0	15-Aug-09	13.0

Source: SBP

**Also in focus****NPLs growth slows in 2Q2009**

State Bank of Pakistan (SBP) has released banking sector non-performing loans data as of Jun 30, 2009. According to the data, Non Performing Loans (NPLs) of all scheduled banks has reached Rs398bn as of Jun 30, 2009 versus Rs379bn at the end of Mar 2009, an increase of Rs18.7bn QoQ. This increase is significantly lower than incremental NPLs of Rs67bn and Rs34bn, respectively, recorded in the previous two quarters.

Resultantly, Net NPLs growth has also slowed considerably with Net NPL rising by Rs2bn to Rs119bn as against Rs117bn as at Mar 31, 2009. Non Performing Loans have remained a key risk factor for the sector and was the major reason for 24% decline in sector profitability in 1Q2009. The slowdown in NPLs growth bodes well for the future banking sector outlook and is likely to reduce the quantum of provisioning in the future quarter. That said, 2009 would still remain a difficult year for the banking sector with sector earnings likely to decline by 5%.

**What has stopped SBP from being aggressive?**

Lack of fiscal accounts reconciliation between SBP and Ministry of Finance has caused SBP to follow a neutral approach. SBP is unaware of the total fiscal slippages in FY09 and remains clueless on the status of new IMF loan. This, along with aggressive FY10 revenue targets and massive development outlays has compelled SBP to remain on the back foot. Though, inflation and the twin deficits have depicted a substantial improvement from past quarters.

**What's next from here?**

Obviously, severity of the risk and challenges will derive the future policy stance and SBP has termed the following risks in its review:

- Power shortages linked to private sector viability and banking sector asset quality.
- Power and fuel price adjustment likely to reduce the pace of economic growth and stimulate inflation.
- This should cast a shadow on the government's ability to collect tax revenues and meeting fiscal targets.
- Slower than expected global recovery, lower foreign investments and increased imbalance between debt and non-debt external flows.

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