Government of the Punjab

Punjab Pension Fund

Dated: 11 April 2011

MONTHLY REVIEW OF INVESTMENTS

March 2011

FUND SIZE

- A summary of changes in fund size during the current financial year is given in the following table:

Rs. millions (rounded to the nearest million)

	Jul-Mar 2011
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	1,196
Less: expenses during the period	(13)
Ending fund size	**13,280**

The numbers exclude unrealized capital gains/losses

FUND'S PORTFOLIO

- The Fund's exposures to different investment types are summarized as under:

Amounts: Rs. millions (rounded to the nearest million)

%: as percentage of Total Fund Size

	30 June 2010		31 Dec 2010		31 March 2011	
	Amount	%	Amount	%	Amount	%
PIBs	5,737	47.4	5,789	45.0	5,643	42.5
T-Bills	3,145	26.0	595	4.7	4,611	34.7
Short term bank deposits	3,015	24.9	6,000	46.6	2,503	18.8
Corporate bonds/TFCs	176	1.5	349	2.7	340	2.6
Cash at bank	21	0.2	130	1.0	176	1.3
Other assets*	3	0.0	1	0.0	7	0.1
Total Fund Size	**12,097**	**100.0**	**12,864**	**100.0**	**13,280**	**100.0**

*Other assets include prepaid expenses for management of PPF and book value of fixed assets (vehicles, computers etc.) of PPF

- Long-term investments consist of PIBs and TFCs whereas short-term investments consist of T-bills and bank deposits.
- PPF has been switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.

FUND'S PERFORMANCE

- Time Weighted Return (TWR) earned by PPF is summarized as under:

Period	Annualized Return for the period			Long-term Benchmark
	Gross Return	Net Return*	CPI Inflation	CPI Inflation + 3%
FY 2008-09	15.21%	15.00%	13.14%	16.14%
FY 2009-10	13.79%	13.61%	12.69%	15.69%
Jul-Mar 2011	13.38%	13.23%		
March 2011	13.78%	13.64%		

*Net Return means the return after deducting expenses incurred on management of PPF

- Inflation rates over the last 2-3 years have been much higher than our long-term inflation expectations of 9%-10% p.a. Current interest rates are also higher than our long-term expectations. We consider this an opportunity to invest in long-term fixed rate instruments. As inflation and interest rates decline and revert to their long-term averages, the strategy to invest at fixed rates will pay off and the Fund will be able to earn an attractive real rate of return in accordance with its long-term objective.

GROWTH IN ASSETS vs. LIABILITIES AND FUNDING RATIO

- We have constructed a liability index on the basis of next 30-year pension-related cash outflows as projected by the Actuary of the Fund. The index captures the growth in market value of the liabilities i.e. the present value of next 30-year liabilities computed at market rates of interest.
- The following table summarizes the amount & growth of Fund's assets vis-à-vis the amount & growth in 30-year Pension liabilities of GoPb:

	During the period		End of period		
Period	Growth		Market Value (Rs. billions)		Funding Ratio
	Fund's Assets	Liability Index	Fund's Assets (a)	30-yr Pension Liabilities (b)	(a)/(b)
FY 2008-09	15.00%	28.01%	3.5	575.9	0.60%
FY 2009-10	13.21%	9.41%	12.1	621.7	1.94%
Jul 2010 - Mar 2011	6.68%	-7.65%	12.9	574.1	2.24%
Jul 2008 - Mar 2011 (CAGR)*	12.68%	9.81%			

*CAGR means Compound Annualized Growth Rate

- Since the pension liabilities have very long maturities, their present value is highly sensitive to changes in interest rates. The following table illustrates this:

	Yield on 10-yr PIB (% p.a.)			Growth in liability index
	Beg of period	End of period	Change during the period	
FY 2008-09	13.29%	11.98%	-1.31%	28.01%
FY 2009-10	11.98%	12.84%	0.86%	9.41%
Jul 2010 - Mar 2011	12.84%	14.08%	1.24%	-7.65%

- During FY 2008-09, interest rates declined. Liability index grew by 28% during that period. The present value of liabilities increased sharply as the future liabilities were discounted at a lower rate.
- During FY 2009-10, interest rates increased. Liability index grew by a modest 9.41% during that period.
- During the current year i.e. FY 2010-11, interest rates have increased. Liability index declined by 7.65% during this period. The present value of liabilities declined sharply as the future liabilities were discounted at a higher rate.
- **The above analysis highlights that the biggest risk exposure of the pension liabilities is a decline in interest rates. It can sharply increase the requirement of funds to meet the same liabilities and thus lower the Funding Ratio of the pension plan.**
- **The focus of the investment strategy of PPF should therefore be on managing the interest rate risk.**

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

- SBP expects real GDP growth for FY 11 to be in the range of 2-3%.
- As per the Quantum Index of Large-scale Manufacturing (QIM) released by Federal Bureau of Statistics (FBS), Large Scale Manufacturing sector showed a positive growth of 1.03% during Jul-Jan FY11 over the same period of last year.
    - Major sub-sectors showing increase in production include textiles, pharmaceuticals, chemicals, leather products, automobiles & electronics.
    - Major sub-sectors showing a decline in production include food-beverage-tobacco, petroleum products, non-metallic minerals, metal industries and fertilizers.
- Of the three major sectors i.e. industry, agriculture and services, the services sector is expected to perform well during FY11 and exceed its growth target of 4.7% driven by healthy growth in
    - social, community and personal services (led by massive relief and rehabilitation efforts undertaken in flood-affected areas),
    - finance & insurance and
    - transport, storage & communication subsectors.
- Agriculture sector which includes crops and livestock suffered the most due to the floods. Kharif crops especially cotton suffered a loss of output. Livestock which has performed very well in recent years also suffered a setback. However, excessive monsoon rains increased the availability of water for the Rabi crops which are expected to perform well. Overall performance of agriculture sector itself will remain subdued this year. However, significant growth in nominal income of farmers due to rise in prices of agricultural commodities, will support the demand for other goods and services being produced in the economy.

FISCAL MANAGEMENT

- A summary of revenues and expenditures during the current financial year and their comparison with the same period of the previous financial year is shown in the following table:

	Jul - Dec 10						
	Amount (Rs. bn)		As % of total exp.		As % of GDP		Growth (%)
	FY 10	FY 11	FY 10	FY 11	FY 10	FY 11	FY 11
(1)Total revenue	**909.9**	**989.6**	**69.3**	**66.9**	**6.2**	**5.8**	**8.8**
(1a) Tax	659.2	721.6	50.2	48.8	4.5	4.2	9.5
Direct Tax	211.4	239.1	16.1	16.2	1.4	1.4	13.1
Indirect Tax	447.8	482.5	34.1	32.6	3.1	2.8	7.8
(1b) Non-tax	250.7	268.0	19.1	18.1	1.7	1.6	6.9
Dividend	26.5	17.5	2	1.2	0.2	0.1	(34.2)
SBP Profit	135.0	80.0	10.3	5.4	0.9	0.5	(40.7)
(2) Total expenditure	**1313.2**	**1480.0**	**100**	**100**	**9.0**	**8.6**	**12.7**
(2a) Current	1058.6	1226.8	80.6	82.9	7.2	7.1	15.9
Domestic Debt Service	262.0	276.5	19.9	18.7	1.8	1.6	5.5
Foreign Debt Service	32.2	33.9	2.5	2.3	0.2	0.2	5.4
Defence	166.0	215.0	12.6	14.5	1.1	1.3	29.5
(2b) Development	224.7	144.5	17.1	9.8	1.5	0.8	(35.7)
Budget surplus / (deficit)	**(403.3)**	**(490.4)**	**(30.7)**	**(33.1)**	**(2.7)**	**(2.9)**	**21.6**
Financing							
External	110.3	47.0	8.4	3.2	0.8	0.3	(57.4)
Domestic	293.0	443.4	22.3	30.0	2.0	2.6	51.3
Non-bank	185.8	157.4	14.2	10.6	1.3	0.9	(15.3)
Bank	107.2	286.0	8.2	19.3	0.7	1.7	167.0
Privatization	0	0	0	0	0	0	-
GDP	**14,668**	**17,182**					
Revenue balance (1-2a)	**(148.7)**	**(237.2)**			**(1.0)**	**(1.4)**	**59.5**

[1]Revenue surplus/(deficit) = Total revenue - Current expenditure

Source: Ministry of Finance

- Most of the components of the budget worsened during the first half of the current fiscal year.
  - Tax as well as non-tax revenues fell as a percentage of GDP;
  - Development expenditure faced a major decline. It fell by 35.7% compared with the same period of last year. As a percentage of GDP, it fell from 1.5% of GDP last year to just 0.8% of GDP this year. This has adverse consequences for long-term growth potential of the economy;

- Overall budget deficit increased to 2.9% of GDP;
- Revenue deficit increased to Rs. 237.2 bn or 1.4% of GDP showing a deteriorating capacity to meet even the current expenditures.

- Due to a weak economy and an inefficient tax collection system, the fiscal situation is expected to remain quite challenging in the near future.
- Fiscal deficit has reached Rs. 490 bn in first half out of which Rs. 286 bn has been financed from domestic bank borrowing which has increased by 167% over this period.
- High fiscal deficit combined with heavy borrowing is contributing to high inflation, high interest rates and crowding out of the private sector.

DEBT

Total Debt:

- Total debt of Pakistan is summarized in the following table:

	Amount (USD bn)		Amount (Rs. bn)		As % of GDP		Growth[1] (%)
	June-10	Dec-10	June-10	Dec-10	June-10	Dec-10	Jul-Dec 10
Domestic Debt	54.4	61.8	4,653	5,295	31.7	30.8	13.8
External Debt	55.9	58.4	4,783	5,001	32.6	29.1	4.6
Total Debt			**9,435**	**10,295**	**64.3**	**59.9**	**9.1**
Exchange Rate (Rs./USD)			85.56	85.64			
GDP			14,668	17,182			

Domestic Debt:

- The domestic debt profile of Pakistan is summarized in the following table:

Domestic Debt	Amount (Rs. bn)		As % of Total Dom. Debt		As % of GDP		Growth (%)
	Jun-10	Dec-10	Jun-10	Dec-10	Jun-10	Dec-10	FY 11
I) Permanent	794	910	17.1	17.2	5.4	5.3	14.5
PIBs	505	522	10.9	9.9	3.4	3.0	3.3
Prize Bonds	236	252	5.1	4.8	1.6	1.5	6.8
II) Floating	2,399	2,859	51.6	54.0	16.4	16.6	19.2
III) Unfunded	1,456	1,524	31.3	28.8	9.9	8.9	4.7
Saving Schemes	1350	1416	29.0	26.7	9.2	8.2	4.9
IV) FC Instruments	3	2	0.1	0.0	0.0	0.0	(48.4)
Total Domestic Debt	**4,653**	**5,295**	**100.0**	**100.0**	**31.7**	**30.8**	**13.8**
GDP	**14,668**	**17,182**					

Source: SBP

- The government's dependence on short-term borrowing is quite high and has increased further during the current financial year. Floating debt, which consists of T-bills having maturities of 3, 6 and 12 months, constituted 54% of the total domestic debt at the end of Dec 2010.
- The result is that the Government has to roll over its debt after very short intervals. This, combined with the fresh borrowing needs of the Government, is putting further upward pressure on interest rates.

External Debt:

- The external debt profile of Pakistan is summarized in the following table:

External Debt	Amount (USD billion)		Amount (Rs. billion)		As % of GDP		Growth[1] (%)
	June-10	Dec-10	June-10	Dec-10	June-10	Dec-10	Jul-Dec10
1) Public Debt	52.1	54.6	4,458	4,679	30.4	27.2	5.0
a) Govt Debt	42.9	44.8	3,671	3,837	25.0	22.3	4.5
i) Medium & long term	42.1	43.9	3,603	3,763	24.6	21.9	4.4
ii) Short term	0.8	0.9	68	74	0.5	0.4	8.9
b) From IMF	8.1	8.7	691	748	4.7	4.4	8.3
c) Foreign Ex Liabilities	1.1	1.1	96	94	0.7	0.5	(1.9)
2) PSE Guaranteed Debt	0.2	0.1	14	6	0.1	0.0	(58.5)
3) PSE Non-Guaranteed Debt	1.1	1.0	93	89	0.6	0.5	(3.8)
4) Schedule Bank Borrowings	0.2	0.2	16	20	0.1	0.1	18.4
5) Pvt. Guaranteed Debt	0.0	0.0	0	0	0	0	-
6) Pvt. Non-Guaranteed Debt	2.2	2.3	191	196	1.3	1.1	2.9
7) Pvt. Non-Guaranteed Bonds	0.1	0.1	11	11	0.1	0.1	(0.1)
Total External Debt	**55.9**	**58.4**	**4,783**	**5,001**	**32.6**	**29.1**	**4.6**
Exchange Rate (Rs./USD)			**85.56**	**85.64**			
GDP			**14,668**	**17,182**			

[1]Growth in rupee value
Source: SBP, MOF, Reuters

- Relationship between external debt and exchange rate is a tricky one.
  - Depreciation of exchange rate leads to higher debt servicing cost (in terms of domestic currency) on external debt.
  - Repayment of external debt, especially in the backdrop of a weak external account position, can cause depreciation of the exchange rate.

EXTERNAL ACCOUNT

- Balance of payments is summarized in the following table:

Billion US $

	Jul-Feb 2011		
	FY 10	**FY 11**	**Growth* %**
Current Account	(3.0)	(0.1)	97
Capital Account	0.1	0.1	(38)
Financial Account	2.9	1.3	(54)
Errors and Omissions	0.5	0.2	(50)
Overall Balance of Payments	**0.5**	**1.6**	**213**

Source: SBP

*Growth is positive where an account has shown improvement e.g. deficit has decreased or surplus has increased. Growth is negative where an account has worsened e.g. deficit has increased or surplus has decreased.

CURRENT ACCOUNT

- Detailed position of Current Account is given in the following table:

Billion US $

	Jul-Feb 11		
	FY 10	**FY 11**	**Growth %**
Current Account (1+2+3)	(3.0)	(0.1)	97
(1) Balance of trade in Goods & Services	**(9.2)**	**(8.1)**	**12**
Goods: Exports f.o.b	12.5	15.5	24
Goods: Imports f.o.b	20.1	22.6	13
Balance of trade in goods	(7.6)	(7.2)	5
Services: Credit (exports)	2.8	3.8	34
Services: Debit (imports)	4.5	4.7	6
Balance of trade in services	(1.6)	(0.9)	44
(2) Balance of Income Transfers	**(2.0)**	**(1.9)**	**6**
Income: Credit (inflows)	0.4	0.4	24
Income: Debit (outflows)	2.3	2.3	(1)
Interest Payments	0.9	0.9	1
Profit & Dividend	0.3	0.3	(8)
(3) Balance of Current Transfers	**8.2**	**9.9**	**21**
Current Transfers: Credit (inflows)	8.2	9.9	20
Workers' Remittances	5.8	7.0	20
FCA Residents	0.5	0.3	(31)
Current Transfers :Debit (outflows)	0.1	0.0	(32)

Source: SBP

- The Current Account has shown remarkable improvement compared with the same period of last year.
    - Deficit on trade in goods & services is lower than the same period of last year. Exports of goods as well as services have grown faster than imports.
    - Workers' remittances have also shown a healthy growth over the same period of last year.
- Although Current Account has recorded a small deficit of $(0.1) bn during Jul-Feb FY11, SBP expects the Current Account balance to deteriorate during the rest of FY11 and to record a deficit of 1.5% of GDP for the entire FY11. This translates into a Current Account deficit in the range of $3 bn for FY11.
    - The increase in exports during first eight months FY11 is attributable more to higher prices and less to higher volumes. Export growth for the entire FY11 is projected by SBP at 15%.
    - Imports are expected to grow faster during H2-FY11 compared with H1 because of rising international commodity prices, especially oil. Import growth for the entire FY11 is projected by SBP at 12%.

FINANCIAL ACCOUNT

- Composition of the Financial Account during the current financial year and its comparison with the same period of last financial year is shown in the following table:

Billion US $

	Jul-Feb 11		
	FY 10	**FY 11**	**Growth %**
Financial Account (1+2+3)	**2.9**	**1.3**	**(54)**
(1) Direct Investment	1.2	1.0	(19)
(2) Portfolio Investment	(0.3)	0.2	176
(2a) Equity	0.3	0.3	(10)
(2b) Debt	(0.6)	(0.1)	89
(3) Other Investment	2.0	0.1	(94)
Equity based flows (1+2a)	1.5	1.3	(17)
Debt based flows (2b+3)	1.4	0.1	(96)

Source: SBP

- Financial Account shows a significantly weak position compared with the same period of last year. Equity as well as Debt flows have been weaker than the same period of last year. This clearly indicates a weak capacity to finance the Current Account Deficit.

INFLATION

CONSUMER PRICES

- A summary of consumer price inflation rates is given in the following table:

Period	CPI Inflation								
	CPI Overall (%)			CPI Food (%)			CPI Non-food (%)		
	YOY	MOM	12mma[1]	YOY	MOM	12mma	YOY	MOM	12mma
Jan-2011	14.2	1.3	13.9	20.4	2.1	17.1	9.0	0.6	11.3
Feb-2011	12.9	-0.7	13.9	17.7	-2.1	17.4	8.9	0.5	11.0
Mar-2011	13.2	1.5	13.9	18.0	2.0	17.6	9.1	1.0	10.8
12 month min.	12.3	-0.7	11.7	12.8	-2.1	11.9	8.9	0.1	10.8
12 month max.	15.7	2.7	13.9	21.2	5.3	17.6	12.2	1.5	11.8

[1]12 month moving average

Source: SBP

- On a year-on-year (YOY) basis, CPI inflation is quite high and is attributable mainly to food inflation. Non-food items which constitute 59.66% of CPI recorded single digit YOY inflation of 9.1% whereas food items which constitute 40.34% of CPI recorded YOY inflation of 18.0%. Both components combined to record overall YOY CPI inflation of 13.2%.
- The breakdown of CPI inflation into its various components is shown in the following table:

Index	Weightage % in CPI	Mar 2011 - CPI Inflation (%)		
		YOY	MOM	12mma
CPI	100	13.2	1.5	13.9
CPI food	40.34	18.0	2.0	17.6
Non-perishable food items	35.20	16.8	1.5	15.3
Perishable food items	5.14	26.9	5.6	32.5
CPI non-food	59.66	9.1	1.0	10.8
Apparel, textile & footwear	6.10	13.5	1.6	10.7
House rent	23.43	6.6	0.7	8.0
Fuel & lighting	7.29	9.1	-0.02	17.0
Household, furniture & equipment etc.	3.29	11.6	1.2	8.8
Transport & communication	7.32	10.5	1.7	15.7
Recreation & entertainment	0.83	10.5	0.1	13.7
Education	3.45	5.1	0.1	6.7
Cleaning, laundry & personal appearance	5.88	13.6	3.1	10.6
Medicare	2.07	16.4	0.2	13.1

Source: SBP

CORE INFLATION

- A summary of measures of core inflation is given in the following table:

Period	Core Inflation					
	NFNE[1] (%)			Trimmed[2] (%)		
	YOY	MOM	12mma	YOY	MOM	12mma
Jan-2011	9.4	0.7	9.9	12.2	0.9	12.6
Feb-2011	9.2	0.6	9.8	11.7	0.4	12.6
Mar-2011	9.5	1.0	9.8	11.9	1.1	12.7
12 month min.	9.2	0.4	9.8	11.7	0.4	11.2
12 month max.	10.6	1.7	11.9	13.6	1.2	12.7

[1]NFNE stands for non-food non-energy measure of core inflation

[2]Trimmed Mean measure of core inflation excludes 20% of the items in the CPI basket showing extreme changes in price

Source: SBP

- Year-on-year NFNE inflation has remained in single digits over the last few months indicating that inflationary pressures are concentrated in food & energy items.
- Since the trimmed mean excludes the more volatile items, it is a relatively more stable measure of inflation. 12-month moving average of trimmed mean inflation stands at 12.7% which suggests that inflationary pressures are quite persistent and it will take some time to control them.

WHOLESALE PRICES

- A summary of inflation rates based on WPI (Wholesale Price Index) is given below:

	WPI Inflation								
Period	WPI Overall (%)			WPI Food (%)			WPI Non-food (%)		
	YOY	MOM	12mma	YOY	MOM	12mma	YOY	MOM	12mma
Jan 2011	22.6	1.6	21.6	20.6	1.7	18.0	24.2	1.6	24.5
Feb 2011	24.4	1.9	22.0	19.2	-0.6	18.3	28.6	3.8	25.0
Mar 2011	25.4	3.3	22.3	19.4	1.8	18.6	30.1	4.5	25.4
12 month min.	17.6	-0.6	10.1	14.4	-1.5	11.4	20.1	-2.0	9.2
12 month max.	25.7	3.5	22.3	22.7	4.5	18.6	30.1	4.5	25.4

Source: SBP

- The WPI portrays an even worse picture of inflation than the CPI. Overall WPI and both of its major components i.e. food and non-food are showing YOY inflation of more than 20%. Since wholesale prices eventually feed into consumer prices, WPI inflation is a leading indicator of CPI inflation and indicates that the near-term outlook for CPI inflation is not promising.
- A breakdown of WPI inflation into its various components is shown in the following table:

Index	Weightage (%) in WPI	Mar 2011 - WPI Inflation (%)		
		YOY	MOM	12mma
WPI	100	25.4	3.3	22.3
WPI food	42.1	19.4	1.8	18.6
WPI non-food	57.9	30.1	4.5	25.4
Raw materials	8.0	66.9	5.4	61.1
Fuel, lighting & lubricants	19.3	17.4	4.8	16.6
Manufactures	25.9	33.0	4.0	24.9
Building materials	4.7	13.0	1.4	13.0

Source: SBP

- As per the wholesale price index, non-food inflation is actually higher than food inflation. Since the WPI tracks international price trends more closely, this reflects the rising trend in prices of non-food items.

INTERNATIONAL COMMODITY PRICES

- The following table summarizes international commodity price inflation rates:

Period	Inflation Rates as per the indices maintained by IMF								
	(Overall) Index of Fuel & Non-fuel Commodities (%)			Commodity Fuel (Energy) Index (%)			Index of Non-fuel Primary Commodities (%)		
	YOY	MOM	12mma	YOY	MOM	12mma	YOY	MOM	12mma
Jan 2011	27.3	6.6	25.4	20.6	3.9	26.3	38.9	11.0	24.6
Feb 2011	36.1	4.4	24.7	29.8	4.5	24.1	46.9	4.4	26.2
Mar 2011	37.3	4.9	24.0	35.5	9.5	22.4	40.5	-2.1	26.9
12 month high	48.3	6.6	28.2	60.0	9.5	32.3	46.9	11.0	26.9
12 month low	9.9	-7.5	3.6	8.7	-8.8	5.2	10.3	-5.1	4.1

Source: IMF

- A breakdown of the Commodity index into its various components is given below:

Index	Weightage (%) in Commodity Index	Mar 2011 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**37.3**	**4.9**	**24.0**
Fuel Commodities (Energy)	**63.1**	**35.5**	**9.5**	**22.4**
Petroleum	53.6	37.5	11.0	22.4
Natural Gas	6.9	6.5	0.0	15.0
Coal	2.6	35.6	-0.3	38.2
Non-Fuel Commodities	**36.9**	**40.5**	**-2.1**	**26.9**
Industrial inputs	18.4	48.9	-0.6	39.1
Agricultural Raw Mat.	7.7	36.2	6.9	33.4
Metals	10.7	56.2	-4.0	42.4
Edibles	18.5	32.2	-3.6	17.1
Food	16.7	31.7	-4.1	17.3
Beverages	1.8	36.0	0.4	16.9

Source: IMF

- International commodity prices exhibited high YOY as well as MOM inflation during Mar 2010. MOM inflation was driven primarily by petroleum (which is a heavy weight in the index) and agriculture raw materials.
- The major reasons behind high inflation in international commodity prices include:
  - high demand from emerging markets whose economic performance has been better than expectations;
  - sluggish supply response combined with high weather-related damages for many commodities.
  - political unrest in oil producing Gulf & North African region.

MONEY SUPPLY & INTEREST RATES

- A summary of the total stock of money supply (M2) and the changes in it during the current financial year is given in the following table:

Rs. billions

			Change (1 Jul - 26 Mar FY11)	
		End Jun 2010	Absolute	%
	Broad Money (M 2)	5,777	523	9.1
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	231	17.8
B	Demand & Time deposits	4,475	288	6.4
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA) of banking system	545	188	34.5
D	Net Domestic Assets (NDA) of banking system (a+b+c)	5,232	335	6.4
a	Net Govt. Sector borrowings	2,441	275	11.3
b	Credit to Non Govt. Sectors	3,389	232	6.8
c	Other items (net)	(598)	(172)	

Source: SBP

- A summary of the total stock of Reserve Money (RM) and the changes in it during the current financial year is given in the following table:

Rs. billions

			Change (1 Jul - 26 Mar FY11)	
		End Jun 2010	Absolute	%
	Reserve Money (RM)	1,679	253	15.1
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	231	17.8
B	Others (Cash in tills & Deposits)	384	22	5.7
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA)	379	189	49.9
D	Net Domestic Assets (NDA) (a+b+c)	1,301	64	4.9
a	Govt. Sector	1,225	46	3.8
b	Non Govt. Sector	330	12	3.6
c	Others items (net)	(231)	6	

Source: SBP

- It is evident that, during the current financial year, the Monetary Base (Reserve Money RM) has grown much faster than the Monetary Aggregate (Broad Money M2). The major causes of high growth in Reserve Money include
  - growth in NFA; and
  - government borrowing from SBP
- Since the Monetary Base is ultimately converted to Monetary Aggregate through the multiplier effect (repeated cycles of deposits and loans), the risk of high growth in M2 in future has increased. And high growth in M2 accompanied by slow growth in Real GDP will lead to higher inflation. This scenario clearly points towards persistence of inflationary pressures in the near future.
- A summary of interest rates for the last few months is given below:

Period	Yield on 1-yr T-bill (% p.a.)		Yield on 10-yr PIB (% p.a.)		6-month KIBOR (% p.a.)	
	Month end	12mma	Month end	12mma	Month end	12mma
Jan 2011	13.84	12.81	14.22	13.29	13.83	12.89
Feb 2011	13.78	12.93	14.20	13.41	13.76	13.00
Mar 2011	13.76	13.05	14.08	13.53	13.73	13.11
12m high	13.84	13.05	14.25	13.53	13.83	13.11
12m low	12.23	12.21	12.56	12.43	12.27	12.41

Source: SBP, Reuters

- Two major reasons behind the persistence in high interest rates include high inflation and high budget deficit & borrowing by the government.
- Continued spending by the government in excess of its resources is pushing up aggregate demand despite a tight monetary policy and slowdown in private sector spending. Supply constraints due to energy shortages and scarcity of credit are preventing a similar growth in aggregate supply. The demand-supply gap is leading to intensification of inflationary pressures.
- The most crucial adjustment that the economy needs is a lowering of budget deficit and borrowing by the government. This will narrow the demand-supply gap, lower the inflationary pressures and pave the way for lower interest rates and revival of credit flow to the private sector.
- SBP maintained the discount rate at 14% in its latest monetary policy announcement. The key points of the monetary policy statement are summarized as under:
  - The government must give top priority to addressing the structural fiscal weaknesses. The government has a compelling need to introduce comprehensive tax reforms, rationalization of subsidies and a forward-looking debt management strategy.

These measures will help in lowering of government borrowings from the banking system thus creating space for private sector and lowering their borrowing costs which will support the utilization and expansion of the economy's productive capacity.

In the absence of such reforms, private and public sector investments are falling while total debt is rising and expectations of high inflation are becoming entrenched;

- YOY inflation has declined from 15.5% in December 2010 to 12.9% in February 2011 due to
  - Lowering of food prices after the sharp rise in the aftermath of floods;
  - Incomplete pass-through of international oil prices to domestic market;
  - Smaller than required adjustment in electricity prices to phase out power sector subsidy; and
  - A reduction in stock of government borrowing from SBP.
- Future path of inflation will be influenced by fuel and electricity prices, trends in government borrowing from SBP and the impact of GST reforms;
- Against the budget estimate of Rs. 230 bn for the year, only Rs. 48 bn have so far been received from external sources to finance the budget. This is creating a risk of further substantial borrowings by the government from the banking system;
- Government's reliance on short-term borrowing instruments e.g. 3-month T-bills has been increasing which is creating liquidity management problems for SBP apart from pushing up the interest rates. There is an urgent need for a debt plan that focuses on long-term borrowings;
- Export growth has been very impressive during the current year. However, more than 90% of the increased earnings during Jul-Feb FY 11 over the same period of last year are attributable to higher prices rather than higher volumes.
- The external account is performing better than expectations. There seem to be no immediate risks to the Current Account Balance. The overall Balance of Payments position is healthy with a gradual build-up of foreign exchange reserves and a stable foreign exchange market.
- Although SBP has kept the policy rate unchanged at 14%, there is little room for complacency and the risks to the economy may increase if meaningful economic reforms are not carried out to address the structural weaknesses.

INVESTMENT STRATEGY

- Our long-term inflation expectation for the future is in the range of 9-10% p.a. a fixed rate of return of 12.5% p.a. or above on the investments is consistent with PPF's long-term return objective of 'inflation + 3%'.
- The current inflation rate is too high and will gradually revert to its long-term average. Since above-average inflation has led to above-average interest rates also, this is an opportunity to invest at fixed rates of return for longer periods.
- Considering the attractive yields on a few highly rated TFCs, the ISC may consider increasing the allocation to corporate bonds/TFCs which currently stands a maximum of 5% of Fund size.
- A major limitation of investments in floating-rate TFCs is that their yields are vulnerable to a decline in interest rates. In order to manage the interest rate risk underlying the floating-rate investments, the ISC will consider entering into fixed-for-floating Interest Rate Swaps so that PPF can convert its floating-rate investments into fixed-rate investments.
- The ISC is yet to make a decision on our recommendation to allocate 10% of Fund size to equity investments. This will also be discussed in the next ISC meeting.
- There has been no breakthrough in negotiations with commercial banks for long term placement of funds. The banks are generally reluctant to offer term deposits for periods longer than one year. The ISC may consider revising the asset allocation and reallocating this portion to other avenues such as corporate bonds/TFCs, T-bills, Short-term TDRs, PIBs, Saving Schemes or Stocks etc.

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