Government of the Punjab
Punjab Pension Fund

Dated: 10 June 2011

MONTHLY REVIEW OF INVESTMENTS

May 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-May 2011
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	1,486
Less: expenses during the period	(16)
Ending fund size	**13,567**

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 Jun 2010		31 Dec 2010		31 May 2011	
	Amount	%	Amount	%	Amount	%
PIBs	5,737	47.4	5,789	45.0	7,094	52.3
T-Bills	3,145	26.0	595	4.7	3,557	26.2
Short term bank deposits	3,015	24.9	6,000	46.6	2,560	18.9
Corporate bonds/TFCs	176	1.5	349	2.7	349	2.6
Cash at bank	21	0.2	130	1.0	3	0.0
Other assets*	3	0.0	1	0.0	4	0.0
Total Fund Size	**12,097**	**100.0**	**12,864**	**100.0**	**13,567**	**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.
  - During the month of May 2011, PPF added a significant amount of long-term (10-yr, 15-yr & 20-yr) PIBs to its portfolio. PIBs having total face value of Rs.

1,425 m (10yr PIB - Rs. 1,075 m, 15-yr PIB - Rs. 225 m & 20-yr PIB - 125 m) having a average yield of 14.09% p.a. (the actual yield is even higher if reinvestment of 6-monthly coupons is taken into account) were purchased during the month. Most of the PIBs (face value Rs. 1,275 m) were purchased in the PIB auction held on 25 May 2011 while some PIBs (face value Rs. 150 m) were purchased from the secondary market.

- 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-May 2011	13.46%	13.31%		
May 2011	13.75%	13.62%		

*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 - May 2011	9.72%	-3.59%	13.2	599.4	2.21%
Jul 2008 - May 2011 (CAGR)*	13.00%	10.84%			

*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 present value of liabilities has a negative correlation with interest rates - it increases sharply when interest rates decrease and vice versa.
- During FY 2008-09, interest rates for all maturities 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 for shorter maturities but declined for longer maturities. Liability index grew by a modest 9.41% during that period.
- During the current year i.e. FY 2010-11, interest rates for all maturities have increased. Liability index declined by 3.59% 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

- Ministry of Finance has released Pakistan Economic Survey 2010-11 which contains the figures of GDP growth for FY11 and the revised figures for FY10.
- Three major segments of the GDP are agriculture, industry and services. Their shares in GDP, growth rates and contributions to the GDP during the last two financial years are summarized in the following table:

	Growth rate (%)		Contribution to GDP growth (%)		Share in GDP (%)	
	FY10	FY11	FY10	FY11	FY10	FY11
Commodity producing sectors	4.7	0.5	2.22	0.24	47.6	46.7
Agriculture	0.6	1.2	0.13	0.26	21.2	20.9
Industry	8.3	(0.1)	2.09	(0.02)	26.4	25.8
Services sector	2.9	4.1	1.54	2.15	52.4	53.3
Overall GDP	**3.8**	**2.4**	**3.76**	**2.39**	**100.0**	**100.0**

Source: Pakistan Economic Survey 2010-11 (published by Ministry of Finance)

- Growth rate of Agriculture sector has remained subdued over both the years. In fact the sector is facing a serious long-term slow down in its growth potential. Over the last decade, this sector has grown at an average rate of 2.7% p.a. and its share in GDP has declined from 26% to 21%.
- Growth rate of Industry sector was very impressive (8.3% as per revised figures) during FY10 but the momentum did not sustain and the growth of the sector during FY11 has been close to zero. The slowdown can be attributed to various factors including law & order situation, power shortages and rising costs of production.
- Growth rate of Services sector has been impressive (4.1%) during FY11 and accounts for 90% of the growth in overall GDP during the year. This sector has outperformed the commodity producing sectors over the last decade which explains its rising share (53.3% at the end of FY11) in overall GDP.

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 - Mar						
	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	**1,402**	**1,495**	**69.1**	**65.6**	**9.6**	**8.6**	**6.7**
(1a) Tax	1,015	1,118	50.0	49.0	6.9	6.5	10.1
Direct Tax	342	374	16.9	16.4	2.3	2.2	9.3
Indirect Tax	672	743	33.2	32.6	4.6	4.3	10.6
(1b) Non-tax	387	378	19.1	16.6	2.6	2.2	(2.5)
Dividend	43	30	2.1	1.3	0.3	0.2	(31.4)
SBP Profit	183	125	9.0	5.5	1.2	0.7	(31.7)
(2) Total expenditure	**2,028**	**2,279**	**100.0**	**100.0**	**13.8**	**13.2**	**12.4**
(2a) Current	1,660	1,910	81.9	83.8	11.3	11.0	15.1
Domestic Debt Service	429	460	21.1	20.2	2.9	2.7	7.3
Foreign Debt Service	45	48	2.2	2.1	0.3	0.3	5.6
Defence	270	335	13.3	14.7	1.8	1.9	24.2
(2b) Development	347	282	17.1	12.4	2.4	1.6	(18.8)
Budget surplus / (deficit)	**626**	**783**	**30.9**	**34.4**	**4.3**	**4.5**	**25.1**
Financing							
External	93	83	4.6	3.6	0.6	0.5	(10.3)
Domestic	533	700	26.3	30.7	3.6	4.0	31.3
Non-bank	322	384	15.9	16.8	2.2	2.2	19.0
Bank	211	316	10.4	13.9	1.4	1.8	50.1
Privatization	-	-	-	-	-	-	-
GDP	**14,668**	**17,304**					
Revenue surplus/(deficit)[1]	**(258)**	**(415)**			**(1.8)**	**(2.4)**	**(60.6)**

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

Source: Ministry of Finance

- Most of the components of the budget worsened during the first nine months of the current fiscal year.
  - Expenses grew faster than revenues. As a result, budget deficit grew sharply by 25.1% & stood at Rs. 783 bn (Rs. 626 bn in the same period last year);
  - Both revenues & expenses fell as a percentage of GDP. However, revenues showed a bigger decline. Budget deficit grew to 4.5% of GDP;

- Only 66% of the expenses were financed through revenues (49% through tax revenues & 17% through non-tax revenues). 31% of the expenses (amounting to Rs. 700 bn) were financed through domestic borrowing.
- Growth in expenses was attributable entirely to current expenditure. Development expenditure declined by 19% compared with the same period of last year. As a percentage of GDP, it fell from 2.4% of GDP last year to just 1.6% of GDP this year. Share of development expenditure in total expenditure declined from 17% last year to 12% this year. This has adverse consequences for long-term growth potential of the economy;
- Revenue deficit increased to Rs. 415 bn or 2.4% of GDP. Thus the Government had to finance its current expenditures to the extent of Rs. 415 bn from borrowing. It is evident that the fiscal imbalances are leading the Government into a debt trap.

- High fiscal deficit combined with heavy borrowing is contributing to high inflation, high interest rates and crowding out of the private sector.
- Federal Government has announced the budget for FY12. The provinces however, are yet to announce their budgets. Analysis of the consolidated budgetary figures will be made once the provincial budgets are announced. The key targets set by Federal Government for FY12 are summarized as under:

DEBT

Total Debt:

- Total debt is summarized in the following table:

	Amount (USD bn)		Amount (Rs. bn)		As % of GDP		Growth[1] (%)
	June-10	Mar-11	June-10	Mar-11	June-10	Mar-11	Jul-Mar 11
Domestic Debt & Liab.			4,895	5,594	33.4	32.3	14.3
External Debt	55.9	59.5	4,783	5,114	32.6	29.6	6.9
Total Debt			**9,677**	**10,709**	**66.0**	**61.9**	**10.7**
Exchange Rate (Rs./USD)			85.56	85.90			
GDP			14,668	17,304			

Source: SBP

Domestic Debt:

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

Domestic Debt & Liab.	Amount (Rs. bn)		As % of Total Dom. Debt		As % of GDP		Growth (%)
	Jun-10	Mar-11	Jun-10	Mar-11	Jun-10	Mar-11	Jul-Mar FY 11
I) Permanent	794	1,008	16.2	18.0	5.4	5.8	26.9
Ijara Sukuk	42	179	0.9	3.2	0.3	1.0	323.7
PIBs	505	561	10.3	10.0	3.4	3.2	11.1
Prize Bonds	236	263	4.8	4.7	1.6	1.5	11.5
II) Floating	2,399	2854	49.0	51.0	16.4	16.5	19.0
III) Unfunded	1,456	1,600	29.8	28.6	9.9	9.2	9.7
Saving Schemes	1350	1,492	27.6	26.7	9.2	8.6	10.5
IV) FC loans	3	2	0.1	0.0	0.0	0.0	(51.6)
Domestic Debt	**4,653**	**5,463**	**95.1**	**97.6**	**31.7**	**31.6**	**17.4**
Domestic Liab.*	**241**	**132**	**4.9**	**2.4**	**1.6**	**0.8**	**(45.2)**
Total	**4,895**	**5,594**	**100.0**	**100.0**	**33.4**	**32.3**	**14.3**
GDP	**14,668**	**17,304**					

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 51% 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.
- Ijara Sukuk is a Shariah compliant floating-rate debt instrument with a maturity of 3 years. It is a relatively new instrument and Government borrowing through this instrument has grown quite rapidly over the current year. Total borrowing through Ijara Sukuk stood at Rs. 179 bn or 3.2% of total Domestic Debt & Liabilities of the Government as at end-March 2011.

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] (%)
	Jun-10	Mar-11	Jun-10	Mar-11	Jun-10	Mar-11	Jul-Mar FY11
1) Public Debt	52.1	55.6	4,458	4,777	30.4	27.6	7.1
a) Govt Debt	42.9	45.6	3,671	3,914	25.0	22.6	6.6
i) Medium & long term	42.1	44.6	3,603	3,835	24.6	22.2	6.4
ii) Short term	0.8	0.9	68	79	0.5	0.5	16.0
b) From IMF	8.1	8.9	691	768	4.7	4.4	11.1
c) Foreign Ex Liabilities	1.1	1.1	96	94	0.7	0.5	(1.6)
2) PSE Guaranteed Debt	0.2	0.1	14	9	0.1	0.1	(33.1)
3) PSE Non-Guaranteed Debt	1.1	1.0	93	88	0.6	0.5	(5.7)
4) Schedule Bank Borrowings	0.2	0.4	16	30	0.1	0.2	82.3
5) Pvt. Guaranteed Debt	0.0	0.0	0	0	0	-	-
6) Pvt. Non-Guaranteed Debt	2.2	2.3	191	200	1.3	1.2	5.0
7) Pvt. Non-Guaranteed Bonds	0.1	0.1	11	11	0.1	0.1	0.2
Total External Debt	**55.9**	**59.5**	**4,783**	**5,114**	**32.6**	**29.6**	**6.9**
Exchange Rate (Rs./USD)			**85.56**	**85.90**			
GDP			**14,668**	**17,304**			

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

- Helped by a stable exchange rate, the rupee value of the external debt has grown by a modest 6.9% during the first nine months of the financial year.
- The feedback loop between external debt and exchange rate explains the major risk underlying foreign currency loans.
    - 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 - Apr		
	FY 10	FY 11	Growth* %
Current Account	(3.5)	0.7	122
Capital Account	0.2	0.1	(44)
Financial Account	3.5	0.4	(88)
Errors and Omissions	0.5	(0.0)	(107)
Overall Balance of Payments	**0.7**	**1.2**	**66**

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 - Apr		
	FY 10	FY 11	Growth %
Current Account (1+2+3)	**(3.5)**	**0.7**	**122**
(1) Balance of trade in Goods & Services	**(11.2)**	**(9.7)**	**14**
Goods: Exports f.o.b	16.2	20.5	27
Goods: Imports f.o.b	25.5	28.8	13
Balance of trade in goods	(9.3)	(8.3)	11
Services: Credit (exports)	3.7	4.7	25
Services: Debit (imports)	5.7	6.1	7
Balance of trade in services	(1.9)	(1.4)	28
(2) Balance of Income Transfers	**(2.6)**	**(2.4)**	**7**
Income: Credit (inflows)	0.5	0.6	20
Income: Debit (outflows)	3.1	3.0	(3)
Interest Payments	1.1	1.1	(1)
Profit & Dividend	0.5	0.5	4
(3) Balance of Current Transfers	**10.4**	**12.8**	**24**
Current Transfers: Credit (inflows)	10.5	12.9	23
Workers' Remittances	7.3	9.0	24
FCA Residents	0.6	0.4	(39)
Current Transfers :Debit (outflows)	0.1	0.1	(33)

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 decent surplus during Jul-Apr FY11, the underlying fundamentals suggest that there is little room for complacency.
    - The increase in exports is attributable more to higher prices and less to higher volumes. Higher cotton prices have immensely helped the export performance. A moderation of cotton prices, which has already started to happen in the international markets, will adversely affect the export figures.
    - Imports are expected to grow faster in the near future because of high international commodity prices, especially oil.

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-Apr		
	FY 10	FY 11	Growth %
Financial Account (1+2+3)	**3.5**	**0.4**	**(88)**
(1) Direct Investment	1.7	1.2	(28)
(2) Portfolio Investment	(0.0)	0.3	721
(2a) Equity	0.6	0.4	(38)
(2b) Debt	(0.6)	(0.1)	91
(3) Other Investment	1.9	(1.1)	(156)
Equity based flows (1+2a)	2.2	1.5	(30)
Debt based flows (2b+3)	1.3	(1.1)	(186)

Source: SBP

- Financial Account shows a significantly weak position compared with the same period of last year. Equity flows have been weaker than the same period of last year. Debt flows have been negative i.e. a net repayment of USD 1.1 bn has been made during the Jul-Apr of current financial year. This indicates a weak financing capacity in case the Current Account runs into 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
Mar-2011	13.2	1.5	13.9	18.0	2.0	17.5	9.9	1.1	11.4
Apr-2011	13.0	1.6	13.9	17.2	1.4	17.8	10.2	1.8	11.3
May-2011	13.2	0.2	13.9	15.9	-1.1	17.9	11.4	1.1	11.2
12 month high	15.7	2.7	13.9	21.2	5.3	17.9	12.1	1.8	12.0
12 month low	12.3	-0.7	11.7	12.8	-2.1	12.5	9.7	0.2	11.2

[1]12 month moving average

Source: FBS, SBP.

- The breakdown of CPI inflation into its various components is shown in the following table:

Index	Weightage % in CPI	May 2011 - CPI Inflation (%)		
		YOY	MOM	12mma
CPI	100	13.2	0.2	13.9
CPI food	40.34	15.9	-1.1	17.9
Non-perishable food items	35.20	16.4	-0.2	15.8
Perishable food items	5.14	12.3	-7.0	31.8
CPI non-food	59.66	11.4	1.1	11.2
Apparel, textile & footwear	6.10	13.7	1.8	11.6
House rent	23.43	7.5	1.0	7.4
Fuel & lighting	7.29	12.1	0.8	16.2
Household, furniture & equipment etc.	3.29	11.9	1.0	9.8
Transport & communication	7.32	15.9	3.3	14.6
Recreation & entertainment	0.83	0.8	0.1	11.4
Education	3.45	5.7	1.2	6.2
Cleaning, laundry & personal appearance	5.88	17.2	1.6	11.8
Medicare	2.07	18.1	2.3	14.4

Source: SBP

- YOY CPI inflation remained close to 13% during Mar, Apr & May 2011.
- Although food segment is contributing more than the non-food segment to overall inflation, YOY inflation in the food segment declined from 18% in Mar to 15.9% in May and MOM inflation in the food segment was negative (-1.1%) in May. This is an encouraging development.

- SBP has developed an Inflation Diffusion Index (IDI) which is based on the MOM changes in the prices of the commodities in CPI basket. It is calculated as the difference between the proportion of items with increasing prices and the proportion of items with decreasing prices. IDI has been found to be a leading indicator of Pakistan's YOY inflation. The overall IDI declined from 54.7% in Mar to 52.7% in Apr 2011.

CORE INFLATION

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

	Core Inflation					
Period	NFNE[1] (%)			Trimmed[2] (%)		
	YOY	MOM	12mma	YOY	MOM	12mma
Mar-2011	9.5	1.0	9.8	11.9	1.1	12.7
Apr-2011	9.4	1.6	9.7	11.6	1.2	12.4
May-2011	10.2	0.2	9.7	12.1	0.9	12.4
12 month high	10.4	1.6	11.0	13.6	1.2	12.9
12 month low	9.2	0.4	9.7	11.6	0.4	11.2

[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

- YOY NFNE inflation picked up in May and recorded double digit increase after remaining in single digits over the last few months. The diffusion of NFNE inflation increased from 52.1% in Mar to 62.3% in April thus indicating that inflationary pressures are spreading within non-food & non-energy items.
- High MOM inflation has been recorded by both NFNE and Trimmed measures of core inflation during Mar and Apr 2011, however; it eased off in May 11.

- 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
Mar 2011	25.4	3.3	22.2	19.4	1.8	18.5	29.8	4.5	25.1
Apr 2011	25.9	2.3	22.6	19.4	0.8	18.8	30.7	3.4	25.4
May 2011	22.9	-1.6	22.7	19.0	-0.2	19.2	25.7	-2.4	25.3
12 month high	25.9	3.5	22.7	22.7	4.5	19.2	30.7	4.5	25.4
12 month low	17.6	-1.6	12.9	14.3	-1.5	11.9	20.2	-2.4	13.9

Source: SBP

- A breakdown of WPI inflation into its various components is shown in the following table:

Index	Weightage (%) in WPI	May 2011 - WPI Inflation (%)		
		YOY	MOM	12mma
WPI	100	22.9	-1.6	22.7
WPI food	42.1	19.0	-0.2	19.2
WPI non-food	57.9	25.7	-2.4	25.3
Raw materials	8.0	29.6	-15.0	60.2
Fuel, lighting & lubricants	19.3	26.1	2.3	15.7
Manufactures	25.9	27.3	-1.7	26.8
Building materials	4.7	9.6	1.6	12.8

Source: SBP

- Negative MOM inflation was recorded for the month of May by WPI and both of its Food & Non-Food segments. In fact the MOM inflation numbers for the overall WPI and the Non-Food segment of WPI were the lowest over the last 12 months. This is a positive development.
- Detailed analysis of the sub-groups of the Non-Food WPI shows that negative MOM inflation was recorded in all but one subgroup.
- However, the YOY inflation and its 12-month moving average are still quite high in case of overall WPI and most of its subgroups.

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
Apr 2011	31.9	4.6	24.5	35.8	6.1	20.7	25.7	2.0	31.2
12 month high	37.6	6.1	30.0	36.0	9.4	32.4	46.2	6.1	32.6
12 month low	13.2	-7.3	10.1	8.7	-8.7	12.0	19.2	-4.8	9.6

Source: IMF

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

Index	Weightage (%) in Commodity Index	Apr 2011 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**31.9%**	**4.6%**	**24.5%**
Fuel Commodities (Energy)	**63.1**	**35.8%**	**6.1%**	**20.7%**
Petroleum	53.6	38.4%	7.0%	20.1%
Natural Gas	6.9	27.3%	0.0%	19.6%
Coal	2.6	22.8%	-2.5%	36.0%
Non-Fuel Commodities	**36.9**	**25.7%**	**2.0%**	**31.2%**
Industrial inputs	18.4	20.0%	1.3%	46.3%
Agricultural Raw Mat.	7.7	36.8%	-1.0%	32.5%
Metals	10.7	13.3%	2.4%	54.1%
Edibles	18.5	32.7%	2.8%	18.9%
Food	16.7	33.3%	3.4%	19.2%
Beverages	1.8	27.7%	-2.4%	17.6%

Source: IMF

- International commodity prices exhibited high YOY as well as MOM inflation during Apr 2011. Subgroups experiencing highest YOY inflation include petroleum, agriculture raw materials and food.
- The major reasons behind recent increases in international commodity prices include:
  - Better than expected economic performance of emerging markets;
  - Natural calamities in Japan and political unrest in oil producing Gulf & North African region;
  - Depreciation of US dollar against major currencies.

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 - 21 May FY11)	
		End Jun 2010	Absolute	%
	Broad Money (M 2)	5,777	677	11.7
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	247	19.1
B	Demand, Time & other deposits	4,482	430	9.6
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA) of banking system	545	184	33.8
D	Net Domestic Assets (NDA) of banking system (a+b+c)	5,232	493	9.4
a	Net Govt. Sector borrowings	2,441	545	22.3
b	Credit to Non Govt. Sectors	3,389	127	3.7
c	Other items (net)	(598)	(179)	

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 - 21 May FY11)	
		End Jun 2010	Absolute	%
	Reserve Money (RM)	1,679	286	17.1
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	247	19.1
B	Others (Cash in tills & Deposits)	384	40	10.4
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA)	379	135	35.6
D	Net Domestic Assets (NDA) (a+b+c)	1,301	151	11.6
a	Govt. Sector	1,225	151	12.3
b	Non Govt. Sector	330	13	3.9
c	Others	(254)	(13)	

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 Aggregates through the multiplier effect (repeated cycles of deposits and loans), the risk of high growth in M2 in future has increased which, accompanied by slow growth in Real GDP, may prove inflationary.
- 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
Mar 2011	13.76	13.05	14.08	13.53	13.73	13.11
Apr 2011	13.80	13.18	14.10	13.66	13.67	13.22
May 2011	13.82	13.31	14.09	13,78	13.74	13.34
12m high	13.84	13.31	14.25	13.78	13.83	13.34
12m low	12.38	12.23	12.84	12.52	12.37	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 despite slower economic growth.
- 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 has maintained the discount rate at 14% in its monetary policy decision dated 21 May 2011. The key points of SBP's decision are summarized as under:
    - Pakistan's current economic situation displays a mixed situation.
        - Positive elements include better-than-expected external account position (driven by strong export earnings & robust growth in remittances), higher foreign exchange reserves and higher proportion of Net Foreign Assets (NFA) in money supply.

    - Major challenges include high inflation, weak economic growth, weak private investment and large budget deficit.
- While setting Monetary Policy, SBP is trying to strike a balance among multiple objectives including
    - Containment of inflation;
    - Promotion of productive economic activity driven by private sector; and
    - Stability of financial markets.
- The impressive performance of the External Account and the increasing trend in Foreign Exchange Reserves may be difficult to sustain due to various factors including:
    - Decline in international cotton prices;
    - Higher international oil prices;
    - Debt obligations becoming due in FY12.The external account is performing better than expectations.
- Government has demonstrated a commitment to retire its borrowings from SBP.
- By 7 May 2011, YOY growth in Private Sector Credit was only 3.2% which was much lower than the YOY growth of 15.3% in Bank Deposits. The basic intermediation function (allocation of savings to productive private-sector investments) of banks is being constrained because of high Government borrowing.
- Provisional National Income Accounts show that real private investment declined by 3.1% while real private consumption grew by 7%. Declining real private investment & rising real private consumption combined with energy shortages explain the widening output gap (difference between aggregate domestic demand & supply) which is responsible for the low-growth high-inflation experienced by the economy over the last few years.
- The solution lies in wide-ranging fiscal reforms aiming at:
    - Stemming leakages in tax system;
    - Broadening of tax net;
    - Expenditure control (especially removal of untargeted subsidies).
- Economic revival depends on various factors including:
    - A manageable debt burden;
    - Single digit inflation;
    - Higher private sector investment.
- Budget for FY12 is expected to reflect Government's commitment to address the fiscal issues.

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 the 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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