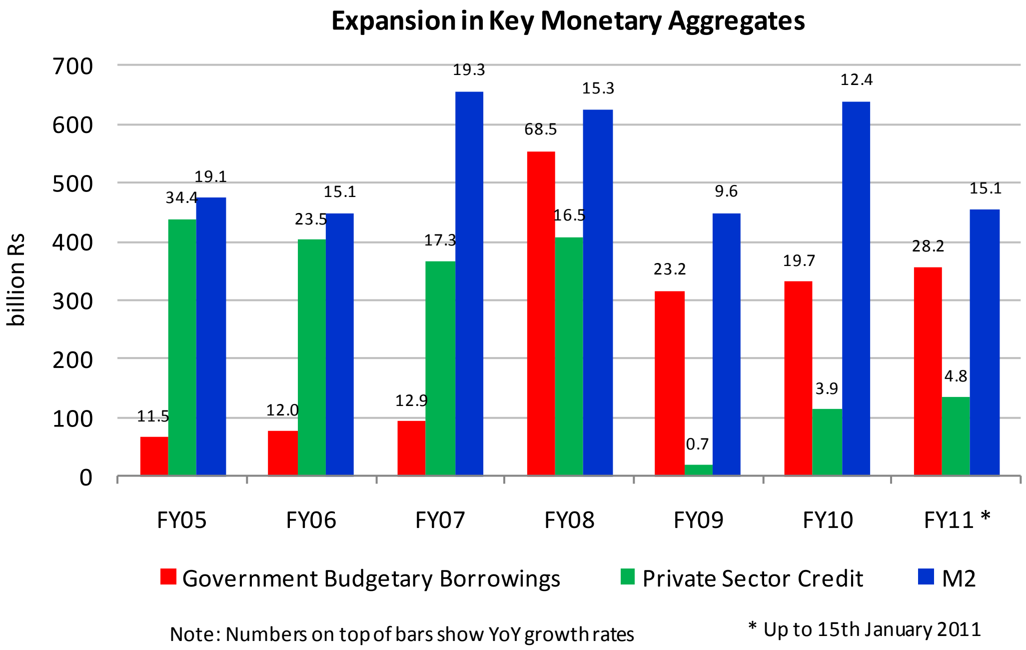
# MONETARY POLICY STATEMENT

## January 2011




# STATE BANK OF PAKISTAN

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## Executive Summary

Delays in crucial economic reforms have increased challenges for the management of the economy. Despite high interest rates, the fiscal deficit and borrowings from the banking system is continuing to stoke inflationary pressures. This is impeding economic recovery and increasing the debt burden of the country. However, an improved external current account and stable financial markets allow for some optimism. Under these challenging circumstances, a proactive monetary policy is necessary but not sufficient to tackle high and persistent inflation.

Inflationary pressures that were already high at the beginning of FY11, and have remained at elevated levels during H1-FY11. In December 2010, year-on-year CPI inflation was 15.5 percent while its average for H1-FY11 stands at 14.6 percent. Not only did the contributing factors of inflation continued to prevail in H1-FY11, the economy also experienced an additional shock in the form of unprecedented devastating floods.

Despite some adjustments in the prices of electricity and gas, the larger issue of energy shortages remains unresolved. This is contributing to the underutilization of existing productive capacity and discouraging new investment in the economy. Consequently, the aggregate demand and supply gap is still large enough to push inflation further. Surging international food and commodity prices are also playing a role in intensifying expectations of rising domestic inflation.

Thus, the revised projection of average CPI inflation for FY11 falls in the range of 15 to 16 percent, along with high probability of double digit inflation in FY12. To bring inflation under control, the critical measures would be fiscal consolidation and reduction in fiscal deficit and government borrowings from SBP. These measures would support SBP's efforts to contain monetary expansion and thus ease aggregate demand pressures.

After a continuous rise in government borrowing from SBP since the beginning of FY11, there seems to be some respite on this front. The outstanding stock (on cash basis) of these borrowings, which had increased to Rs1500 billion by mid-December 2010 from Rs1171 billion at end-June 2010, has reached close to Rs1277 billion by 25th January, 2011. This is an encouraging development and, if sustained, could help in restricting excess money growth and moderating expectations of high inflation.

At the same time, due to an improvement in the external current account, the increase in Net Foreign Asset (NFA) has contributed to maintaining year-on-year reserve money growth at 16.6 percent. Thus, while there is a favorable compositional change in reserve money, the growth of its Net Domestic Asset (NDA) component still needs to be curtailed to reduce inflation.

The external current account shows a surplus of $26 million during H1-FY11, which is a marked improvement over earlier projections. Robust export earnings of $11.1 billion are the main reason underlying this encouraging development. Higher international prices of Pakistan's exports like textiles and rice were helpful in this regard. Specifically, of the $1.8 billion incremental increase in exports in H1-FY11 (over H1-FY10), about $1.4 billion is due only to the increase in prices. Assuming that this trend continues in H2-FY11, export growth in FY11 is projected to be 15 percent. Imports, which grew by 10.1 percent in H1-FY11, are projected to grow by 12 percent in FY11, primarily on account of rising international commodity prices, especially oil.

Further support to the external current account in H1-FY11 was provided by strong inflows of remittances, $5.3 billion, and the disbursement of Coalition Support Funds (CSF), $743 million. Consequently, even with modest direct and portfolio investments, and despite delays in disbursement of official loans, SBP's foreign exchange reserves have increased from $13 billion at end-June 2010 to 13.5 billion at end-December 2010.

This build-up in reserves and thus NFA is one of the factors responsible for stability in the financial markets, despite increased borrowings from the scheduled banks by both the government and the private sector, especially in Q2-FY11. However, given a decline in financial inflows, the financing of even a smaller external current account deficit for FY11 (projected at 1.5 percent of GDP) could pose challenges for an adequate build-up of foreign exchange reserves.

The credit availed by the private sector during Q2-FY11 was Rs211 billion compared to Rs199 billion in the corresponding period last year. This trend was despite a declining growth in Large-scale Manufacturing (LSM) and is largely attributable to the rising cost of inputs. This pickup in private sector credit may slow down in the coming months as it was mostly due to seasonal working capital requirements. The recourse of the government to the banking system, on the other hand, is likely to increase in H2-FY11. This is both because of the widening gap between revenues and expenditures in the fiscal accounts and subdued financing available from external sources; with only Rs47 billion having been realized in H1-FY11.

Tax collection of Rs661 billion by the Federal Board of Revenue (FBR) during H1-FY11 shows a growth of 13 percent only. At the beginning of the fiscal year, a growth rate of 26 percent was envisaged to achieve the full year target of Rs1667 billion. Thus, a shortfall in revenue appears quite likely, especially with the postponement of revenue enhancement measures. At the same time, rising expenditures, primarily owing to subsidies for energy, food items (like wheat and sugar), cash transfers, and security related activities, further indicate difficulties that lie ahead.

At the beginning of the fiscal year, the announced fiscal deficit target was Rs685 billion (4 percent of GDP) that was revised to Rs812 billion (4.7 percent of GDP) in the aftermath of the floods. The provisional data from the financing side of the budget, however, suggests that the deficit has probably already beginning to touch Rs500 billion by the close of H1-FY11. Thus, even meeting the revised target would be a challenge in the absence of fiscal reforms.

These fiscal developments have two implications. First, the overall demand for money is unlikely to subside, which indicates high aggregate demand relative to current productive activity. A concurrent increase in banking system deposits through a decline in currency in circulation would be helpful in meeting this demand without additional pressure on market interest rates. Second, the private sector is likely to be squeezed out, which is contrary to what the economy needs for the revival of investment and growth.

It is important that the government spells out a clear and coherent strategy to limit fiscal slippages. This is all the more important given that the proposed reforms in the GST along with other tax measures have been postponed. Moreover, in January 2011, the government reversed the decision of increasing retail prices of petroleum products. Apart from adversely affecting revenue collections and increasing expenditures on subsidies, these actions have made it difficult to raise external resources for budget financing.

To understand SBP's policy stance for H2-FY11, it would be useful to assess these developments in the backdrop of three successive 50 bps hikes in the policy rates that have already been announced in this fiscal year. In providing its rationale, SBP had primarily focused on high and persistent inflation that was being exacerbated by a structural fiscal deficit frequently financed by government borrowings from SBP. It was highlighted that fiscal problems were not only undermining the monetary policy stance but also carrying the risk of adversely affecting external accounts. The direct link between the pace of government borrowings from SBP and the expectations that individuals and businesses formulate about future inflation was also emphasized. In SBP's view, these expectations have been a major contributing factor in pushing core inflation up, which often gets less attention than supply side factors like fuel and food prices.

While the underlying structural reasons for this policy stance have not changed significantly, there are three sources of comfort. First, SBP anticipates that the current shift away from SBP financing will be consolidated since an understanding has been reached with the government that it will restrict its borrowings from the SBP to below the end September stock of Rs1290 billion. Second, an external current account surplus in H1-FY11 is somewhat rare in Pakistan and is a marked improvement over earlier projections. This indicates that the risk of fiscal problems slipping into external account has not materialized so far, thereby providing an opportunity to address the persistent fiscal issues. Third, SBP is optimistic that the recent multi-partisan efforts will improve fiscal revenues and curb current spending (one-off and continuous).

Further, candid disclosure by the government of the impending crisis in case of failure to reinvigorate fiscal reforms cannot be brushed off lightly. Under these exceptional circumstances, it is expected that tangible steps will be taken to steer the economy back on track. The likely positive outcome of these developments has been incorporated in monetary policy considerations, while not ignoring the existence of a monetary overhang. SBP believes that, on balance, this provides a window of opportunity and the focus should be on subsequent developments.

SBP is also aware of the delicate balance that needs to be struck between risks to inflation and economic growth and therefore has decided to keep the policy rate unchanged at 14 percent for the time being. The future course of policy action will be contingent upon expected progress of key areas of concern to SBP.

## A. Economic Environment and SBP's Policy Response: H1-FY11

***High and persistent inflation led to gradual increase in the policy rate…***

1. After keeping the policy rate unchanged at 12.5 percent since January 2010 the SBP increased it gradually to 14 percent, starting with the first monetary policy statement of FY11 in July 2010. The main reason has been persistence of inflation that was expected to continue in FY11 and well into FY12. Risks of fiscal slippages, both in the shape of high deficit and increased borrowings from the SBP, also had a bearing on the decision. Further, both the inflation and fiscal deficit targets had already been missed in FY10. Therefore, renewed efforts were required to contain their negative repercussions for macroeconomic stability in general and inflation expectations in particular.

2. Prospects of economic recovery, on the other hand, seemed relatively better at the beginning of FY11. Similarly, although an increase in the external current account deficit was expected, it was deemed manageable given the anticipated disbursement of loans from bilateral sources and international financial institutions. Nevertheless, crippling electricity and gas shortages along with dismal law and order conditions remained a major concern for the private sector's productive activities.

***Fiscal slippages have resulted in substantial monetary expansion…***

3. The persistence of inflation at double digit levels and its worsening outlook, however, remained the most serious economic issue. While SBP has tightened monetary policy, fiscal authorities have struggled to implement the reforms required to contain the fiscal deficit and reduce inflationary pressures. The announced reforms of GST have been postponed, the subsidies to the energy sector have continued unabated despite adjustments in energy prices, and amendments in the SBP Act to restrict government borrowings from SBP have yet to be promulgated.

4. The result is substantial money growth in H1-FY11 led by government borrowings from the banking system, in particular from the SBP. This reflects dilution of the tight monetary policy stance and presence of considerable aggregate demand in the economy relative to its productive capacity, especially with buoyant demand in the rural economy because of higher crop prices and the consumption impact of growing remittances. Some of the borrowing from SBP could have been avoided to remain consistent with the spirit of macroeconomic stabilization and commitment of

the government. However, rejection and/or picking up of less than targeted amounts in the PIB and T-bill auctions, as seen in H1-FY11, were in conflict with stated intentions.

***Marked improvement in the external current account was masked by a decline in financial inflows…***

5. Moreover, the fifth review of IMF's Stand-by Arrangement (SBA), due to be completed by the end of September 2010, could not be concluded and the Government of Pakistan had to seek for a nine month extension. As a consequence there was a substantial shortfall in the disbursement of official loans, which has implications for external budget financing and the balance of payments. However, a marked improvement in the external current account, led by a robust export growth, has provided a cushion to the balance of payments position so far.

6. The challenges of macroeconomic management have increased further after the catastrophic floods of August 2010 which seriously damaged the economy. To restore confidence and mitigate uncertainty in the wake of changing economic conditions, the need for implementing the much awaited and much needed economic reforms has become all the more important. These include: implementation of comprehensive tax and expenditure reforms, effective resolution of energy sector issues, and restriction of government borrowings from SBP. Committed and credible progress in these areas will go a long way in increasing the resource envelope of the country, reviving economic growth on sustainable basis, and pegging expectations of high and persistent inflation.

***Global economic recovery remains fragile and uncertain despite extraordinary policy measures…***

7. The deliberations over the need for economic and regulatory reforms are not limited to Pakistan. The global economy is debating how to reform the international monetary system, devise appropriate regulation of the financial sector, and handle the implications of the burgeoning debt burden of advanced economies. After a year of fragile and uneven recovery, the global economy is expected to show similar trends during 2011. Despite exceptional performance from emerging market economies during 2010, the weaknesses in major developed economies continue to drag the global recovery and pose risks for world economic stability in the coming years.

8. The unprecedented set of policy measures taken by advanced economies, including exceptionally low interest rates, have helped in stabilizing global financial markets and initiating global recovery. However, overcoming the structural problems that led to the crisis and those that were created by it are proving quite challenging. The advanced economies are now facing prospects of protracted unemployment, widening fiscal deficits, and increasing public debt burdens. Moreover, sovereign debt markets in the euro zone are in serious distress and strong fiscal austerity measures are being introduced to mitigate the uncertainty in financial markets.

9. In contrast, emerging economies have been showing strong recovery since the third quarter of 2009. As a result, they are experiencing substantial capital inflows, leading to debates on appropriate exchange rate policies. Moreover, better performance by these economies has contributed to the rise in international commodity prices, though the role of supply concerns cannot be ruled out. Many central banks around the globe are increasing policy rates in the wake of growing inflationary pressures. Also, many emerging economies are intervening in currency markets and imposing controls and/or taxes to discourage short term capital inflows.

10. The situation in Pakistan is rather different. While it is also facing fiscal distress and rising inflationary pressures, the extent of financial inflows is not comparable with other emerging markets. The risk premium to invest in Pakistan is perceived to be quite high in global financial markets due to both economic and non economic factors. In this context, the implementation of an economic reform agenda that addresses the structural fiscal and energy sector problems has become increasingly urgent.

## B. Recent Economic Developments and Outlook

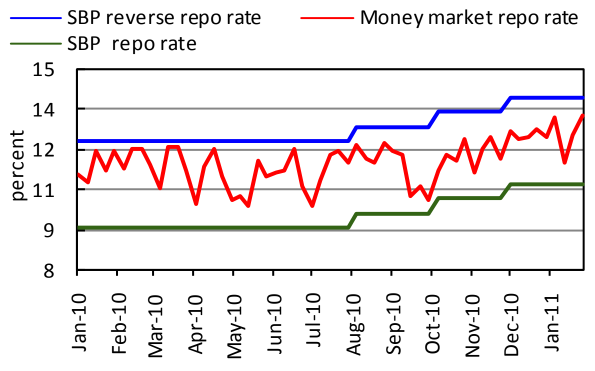
***Increases in policy rate were implemented through calibrated liquidity management…***

11. The policy rate has been increased by 150 basis points (bps), staggered in three stages of 50 bps each, since July 2010. Implementation of this policy stance entailed mopping up of liquidity while remaining cognizant of macroeconomic conditions affecting day to day availability of liquidity. As a result of these calibrated interventions in the money market, the weighted average overnight money market repo rate has also increased by 124 bps on average, up till 27th January 2011, compared to the period when policy rate was kept unchanged. Most of this increase

has been since the 29th September 2010 policy decision (99 bps) as compared to the increase after the 29th July 2010 policy announcement (25 bps) (see **Figure 1**).

12. The earlier smaller increase in the overnight money market rate was due to a relatively liquid money market. By the week ending on 9th September 2010, the overnight money market repo rate had increased significantly (61 bps); however in the following weeks it decreased by 148 bps, dragging the overall average down. This was mainly because during the last three weeks of September, SBP intentionally kept the market liquid. This was required in anticipation of higher Eid and flood related cash requirements of the public and tax related outflows from the system.

**Figure 1: Movement in Overnight Repo Rate**




13. At the same time, during Q1-FY11, the money market witnessed large inflows due to heavy government borrowings from SBP, expansion in net foreign assets and retirement of private sector and commodity operations related credit (see **Table 1**). A significant portion of these inflows, however, did not affect interbank market liquidity. This can be seen in a relatively higher increase in currency in circulation and decline in bank deposits, suggesting a rise in transaction demand for money. Other than the seasonal pattern, these can be attributed to relief activities and temporary disruptions of banking services in the flood affected areas. This explains the average net injections of Rs21 billion by SBP in Q1-FY11.

**Table 1: Inter-bank Market Liquidity Conditions**

billion rupees, unless stated otherwise

| | Q1-FY11 | Q2-FY11 |
|---|---|---|
| Total deposits[1] | -59.5 | 357.1 |
| Currency in circulation | 93.4 | 126.1 |
| NFA of the banking system | 41.9 | 84.9 |
| Net budgetary borrowing from SBP | 120.5 | -28.1 |
| Private sector credit | -47.7 | 211.0 |
| Commodity finance | -26.0 | -23.9 |
| T-bill auctions (net of maturities) | 54.9 | 72.1 |
| Average outstanding OMO, repo, reverse repo | 21.0 | -8.3 |
| Average overnight money market repo rate (%) | 11.7 | 12.1 |

[1] Excluding government deposits

Source: SBP

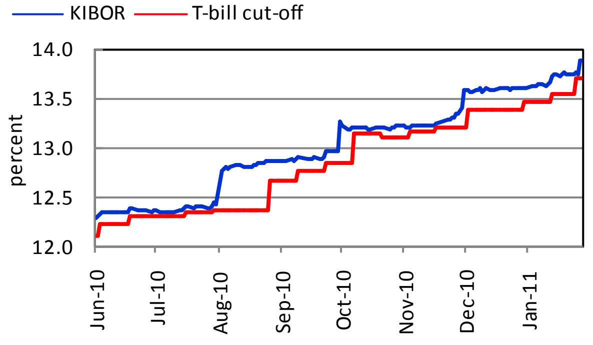
14. In Q2-FY11, the behavior of macroeconomic factors influencing market liquidity changed considerably. The demand for credit by the private sector picked up significantly and the government raised relatively higher amounts in the T-bill auctions. However, the increase in SBP's net foreign assets together with a substantial growth in bank deposits helped in easing liquidity pressures. At the same

time, to implement the increase in policy rate the SBP drained surplus liquidity from the market.

***Despite increases in market interest rates, demand for money remains substantial…***

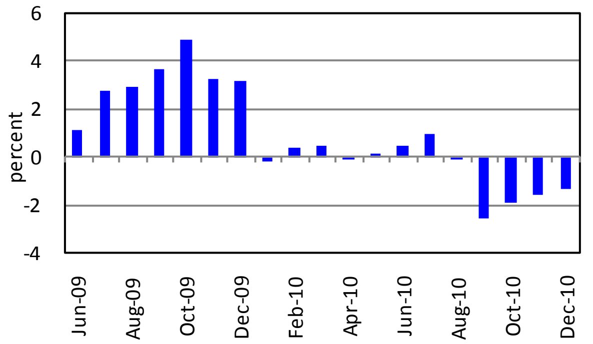
15. Other market interest rates have also been steadily following the rise in the policy rate and its implementation through Open Market Operations (OMOs). For instance, the 6-month KIBOR has increased by 146 bps to 13.9 percent up till 28th January 2010 since the monetary policy announcement of 29th July 2010 (see **Figure 2**).

**Figure 2: Daily Movement in 6-Month KIBOR and T-bill Cut-off Rate**




16. Following the increase in KIBOR, which is used as a benchmark for most of the corporate lending, the incremental weighted average lending rate (WALR) increased to 14.2 percent in December 2010 from 13.2 percent in June 2010. In real terms, the lending rates are also increasing; however, these are still in the negative zone showing that the desired impact of rise in interest rates has not yet materialized (see **Figure 3**).

**Figure 3: Real Lending Rate***




* Weighted average lending rate minus YoY inflation

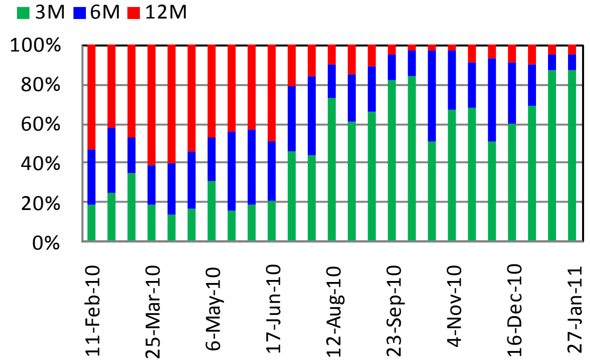
17. Despite an increase in the policy rate and its transmission to market interest rates, the growth in key monetary aggregates remains substantial. For instance, the reserve money has grown by 16.6 percent (YoY) up till 15th January 2011. However, this represents a favorable compositional change in reserve money in the form of a decline in government borrowings from SBP since mid December 2010 and an increase in SBP's NFA on the back of improved external current account position. Similarly, the broad money grew by 15.1 percent during the same period despite a modest growth of 4.8 percent in the credit to the private sector. This is due to the sharp growth in credit to government 25.8 percent from the banking system. The continuation of these trends can undermine efforts to bring inflation down and mitigate inflationary expectations.

18. Even if government borrowing from SBP is contained, the overall demand for money may not subside during H2-FY11 given incremental government borrowings from scheduled banks. The required reduction in the demand for money would require a reduction in the fiscal deficit – the source of continued government borrowings from scheduled banks. Further, to ensure that government borrowing from SBP remains under control, it is pertinent that the government's borrowing targets from the market are realistic, well-assessed, and adhered by the Ministry of Finance.

***Stronger market expectations of high inflation are ingrained in banks' bidding pattern in T-bill auctions…***

19. Market expectations of higher inflation and interest rates are now more obvious in the bidding pattern of T-bill auctions. As these expectations become entrenched, the banks increase their interest in investing in relatively shorter tenor government securities. Not surprisingly, the offers for 12-month T-bills are declining and are being replaced mostly by offers of 3-month T-bills. On average, more than 60 percent of the bids in the recent auctions are for 3-month T-bills. Whereas, bids for 12-month T-bill have fallen below 10 percent (see **Figure 4**).

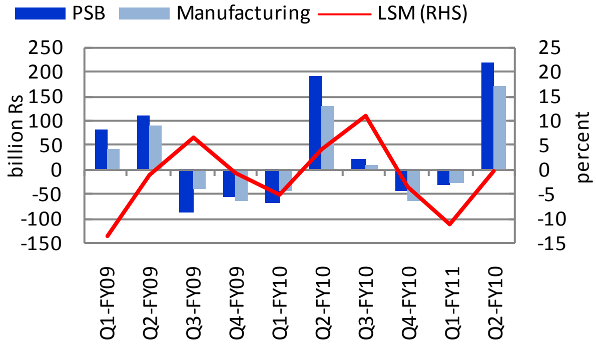
**Figure 4: Distribution of Tenor-wise Offers in T-bill Auctions**




***Significant pick up in credit to private sector is seasonal and driven by higher raw material prices…***

20. The higher market interest rates had some dampening impact on credit demand of private sector, yet, due to seasonal requirements of the manufacturing sector, it increased by Rs211 billion in Q2-FY11 (see **Figure 5**). This has pushed up the year-on-year growth in private sector credit to 4.8 percent by 15th January 2011 as

**Figure 5: Credit to PSB, Manufacturing Sector and LSM Growth**




PSB: Private Sector Businesses

compared with a contraction of 1.8 percent a year earlier. This credit expansion can largely be attributed to the rising cost of inputs because economic activity shows a considerable slowdown as reflected in declining growth in the LSM sector.

21. The impact of a rise in the cost of imports is visible in the substantial growth in credit for working capital purposes. The total credit extended for working capital during H1-FY11 was Rs183.5 billion, which is 97 percent of the total loans to the private sector businesses (see **Table 2**). For instance, the textile sector, which is the major borrower, availed substantial amount of credit (Rs106.3 billion) on account of doubling of cotton prices in FY11 (see **Table 3**). On the other hand, credit for fixed investment continues to show a declining trend. The fundamental reason for this discouraging behavior remains severe electricity and gas shortages and deteriorating law and order conditions. Without addressing these issues it would be difficult to revive domestic investment and sustainable economic growth.

**Table 2: Private Sector Credit**
flows in billion rupees

| | H1-FY11 | H1-FY10 | FY10 |
|---|---|---|---|
| **Total credit to private sector** | **163.0** | **109.3** | **112.9** |
| **1. Loans to private sector businesses** | **190.2** | **124.7** | **105.5** |
| ***By type*** | | | |
| Working capital: *of which* | 183.5 | 81.3 | 40.6 |
| *Trade finance* | *50.8* | *19.6* | *23.1* |
| Fixed investment | 6.7 | 43.4 | 65.3 |
| ***By sectors:*** *of which* | | | |
| Agriculture | 9.1 | 6.1 | 7.0 |
| Manufacturing: *of which* | 143.6 | 85.3 | 31.8 |
| *Textiles* | *106.3* | *52.2* | *-12.8* |
| Electricity, gas and water | 23.3 | 27.3 | 61.1 |
| Construction | 3.0 | -1.6 | -3.9 |
| Commerce and trade | 4.1 | 5.9 | -4.0 |
| **2. Personal:** *of which* | **-15.5** | **-24.3** | **-42.7** |
| *Consumer financing* | *-17.4* | *-28.6* | *-49.3* |
| **3. Investment in securities and shares** | **8.9** | **2.4** | **31.9** |
| **4. Others** | **-20.7** | **6.5** | **18.2** |

Source: SBP

22. Furthermore, the expansion in private sector credit is not in proportion to the growth in deposits of the banking system, which grew by 14.2 percent by 15th January 2011 (YoY). As a result, the private sector's credit to deposit ratio has declined to 67.8 percent from 73.8 percent in the corresponding period of last year. This suggests that banks were not constrained to lend to the private sector due to availability of funds, but were reluctant to extend loans to the private sector. Banks' reluctance is being accentuated by an acceleration in the banking system's Non-Performing Loans (NPLs), which have reached close to Rs500 billion by the end of Q1-FY11. At the same time, government's growing financing needs provided banks the opportunity to invest in risk free, albeit relatively low yielding, government securities.

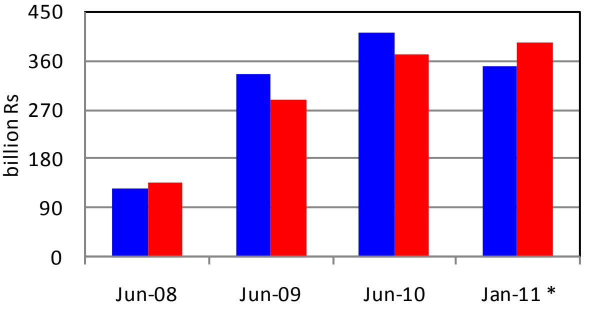
**Table 3: Trends in Cotton Prices**
rupees per maund; daily averages

| Month | FY11 | FY10 | % change |
|---|---|---|---|
| July | 6522 | 3470 | 88.0 |
| August | 6556 | 3446 | 90.2 |
| September | 6796 | 3464 | 96.2 |
| October | 7521 | 3597 | 109.1 |
| November | 8776 | 3974 | 120.8 |
| December | 9117 | 4364 | 108.9 |
| Average | 7548 | 3719 | 102.9 |

Source: All Pakistan Textile Mills Association

23. In addition, the outstanding stock of credit extended to the public sector for procurement of commodities and Public Sector Enterprises (PSEs) remains at an elevated level of Rs748.3 billion up to 15th January 2011 (see **Figure 6**). This has squeezed the capacity of banks to lend to the private sector as well as to the government for its budgetary requirements. To create space for lending in future it is necessary that the credit availed for commodity operations and by the PSEs is retired by a significant amount.

**Figure 6: Commodity Financing and Credit to PSEs (Stocks)**

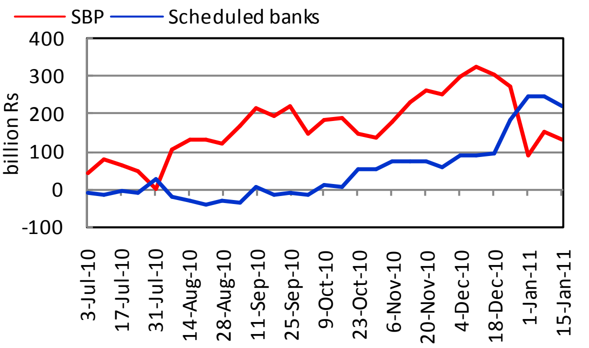



* Up to 15th January 2011

***Monetary expansion is led by government borrowings together with desirable increase in net foreign assets…***

24. The government had borrowed Rs222.2 billion from the scheduled banks for budgetary support up till 15th January 2011, with most of it coming after Q1-FY11. During Q1-FY11 almost all of the government borrowing for budgetary support was from SBP (Rs120 billion). The government continued to borrow from SBP during Q2-FY11 except during the last two weeks of December 2010 (see **Figure 7**). Other than the realization of coalition support funds (approximately Rs54 billion) and transfer of SBP profits (Rs40 billion), this reduced recourse to SBP was possible due to a realization of Rs51 billion above maturity in the last two T-bills auctions of December 2010, Rs21 billion in the PIB auction, and successful issuance of Ijara Sukuk of Rs37 billion.

**Figure 7: Government Borrowings for Budgetary Support - Cumulative Flows since End-June 2010**




25. Thus, after a continuous rise in government borrowing from SBP since the beginning of FY11, there seems to be some respite on this front. The outstanding stock (on cash basis) of these borrowings, which had increased to Rs1500 billion by mid-December 2010 from Rs1171 billion at end-June 2010, has reached close to Rs1277 billion by 25th January 2011. This is an encouraging development and, if

sustained, could help in restricting excess money growth and moderating expectations of high inflation.

26. Nevertheless, the overall government borrowings from the banking system for budgetary support of Rs355.2 billion during 1st Jul - 15th January FY11 remains substantially high (see **Table 4**). It constitutes 109 percent of the expansion in net domestic credit and 78 percent of the overall monetary expansion, suggesting that government has been the major user of banking system resources.

**Table 4: Monetary Aggregates**
billion rupees; percent

| | June 2010 Stocks | Flows during Jul 1-Jan 15, FY11 | Jul 1-Jan 16, FY10 | FY11 Proj. |
|---|---|---|---|---|
| NDA: *of which* | 5,232.0 | 327.0 | 256.6 | 798.0 |
| Net budgetary support | 2,011.5 | 355.2 | 164.3 | - |
| Commodity operations | 413.2 | -59.6 | -20.5 | - |
| Private sector credit | 3,019.8 | 134.0 | 101.4 | - |
| Credit to PSEs | 351.4 | 19.7 | 83.8 | - |
| NFA | 545.3 | 126.9 | 20.1 | 79.0 |
| Money supply (M2) | 5,777.2 | 453.9 | 276.8 | 877.0 |
| *YoY growth(%)* | | *15.1* | *14.1* | *15.2* |
| ***Memorandum items*** | | | | |
| Net budgetary support | | | | |
| *from SBP* | *1,208.7* | 133.0 | -16.6 | - |
| *from Scheduled banks* | *802.8* | 222.2 | 180.9 | - |
| Currency in circulation | 1,295.4 | 273.6 | 181.0 | - |
| Total deposits | 4,475.2 | 179.0 | 94.1 | - |
| Reserve money | 1,679.3 | 277.5 | 171.1 | - |
| *YoY growth (%)* | | *16.6* | *14.2* | *18.1* |

Source: SBP

27. Government borrowing from the banking system is likely to increase during the next two quarters of FY11. For Q3-FY11, the Ministry of Finance (MoF) has already announced sizeable borrowing targets through various instruments such as Treasury Bills, Pakistan Investment Bonds, and Ijara Sukuk (see **Table 5**). The rejection and/or picking up less than targeted amounts in the PIB and T-bill auctions, as seen in H1-FY11, must be avoided. In the first two T-bill auctions of Q3-FY11, the government has raised close to the target of Rs360 billion albeit at higher rates.

**Table 5: Auction Summary of Government Securities**
billion rupees; percent

| | H1-FY11 Target | Realized amount | Cut-off rate[2] | Q3-FY11[1] Target | Realized amount | Cut-off rate[2] |
|---|---|---|---|---|---|---|
| **T-bills** | **1220** | **1364** | - | **980** | **363** | - |
| 3-Month | - | 875 | 13.3 | - | 331 | 13.7 |
| 6-month | - | 411 | 13.5 | - | 25 | 13.7 |
| 12-month | - | 78 | 13.8 | - | 7 | 13.9 |
| **PIBs:** *of which* | **85** | **27** | - | **35** | - | - |
| 3-years | 12 | 6 | 14.2 | 7 | - | - |
| 10-years | 25 | 18 | 14.4 | 9 | - | - |
| 30-years | 8 | Rejcted | - | 2 | - | - |
| **Ijara Sukuk** | **80** | **89** | - | **45** | - | - |
| **Total** | **1385** | **1480** | - | **1060** | **363** | - |

[1] Up to 27th January 2011
[2] These corressponds to the last auction held during the period
Source: SBP

28. It is worth mentioning that the incremental borrowings through short term instruments (3-month T-bill in particular) are consistently increasing the future roll over requirements as well as the interest expense of the government. Thus, a debt management strategy geared towards long term borrowings would be more desirable. The strategy should also be flexible enough to absorb unanticipated

shocks, such as shortfalls in external financing, without resorting to borrowings from SBP.

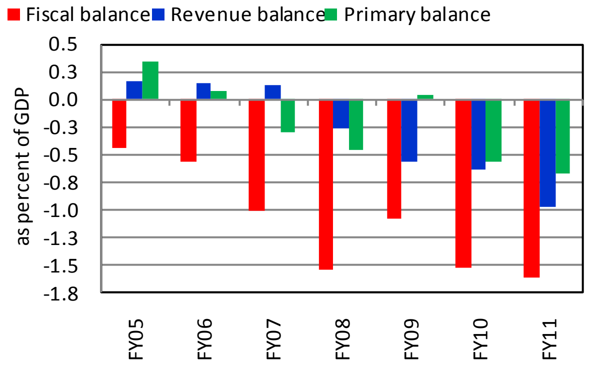
29. A significant growth in currency in circulation is one of the consequences of higher government borrowings from the SBP. Though these borrowings have come down since mid-December 2010, the year-on-year growth of 17.7 percent in currency in circulation up till 15th January 2011 remains quite high. This has raised the currency to deposit ratio to 33.7 percent from 28.9 percent at end June 2010. A reduction in currency in circulation through better financial intermediation would be beneficial for improving the funding base of the banking system to meet credit requirements of both the government and the private sector.

30. The desirable increase in NFA of the banking system, Rs127 billion, is a welcome development and has helped in improving the NDA to NFA ratio. However, given a sizeable increase in NDA, the overall monetary expansion of Rs454 billion during 1st July 2010 – 15th January 2011 is substantially higher as compared with Rs.276.8 billion in the corresponding period of last year. This expansion is also more than earlier expectations and indicates higher probability of an increase in inflation in coming years. The revised projection of M2 growth is around 15 percent for FY11.

***Deferment of key reforms weakens an already stressed fiscal position…***

31. The higher demand for money, largely emanating from the public sector borrowings, is a reflection of expenditure revenue gap of fiscal accounts. The Q1-FY11 data of fiscal accounts show considerable deterioration in key indicators of fiscal balance compared to their levels in past years (see **Figure 8**). The prime reason for this high deficit is shortfall in both tax and non-tax revenues. During Q1-FY11, the FBR tax revenue grew by 11.2 percent, which is well below the required average annual growth of 26 percent to meet the target of Rs1667 billion for FY11 (see **Table 6**). Even in Q2-FY11, the growth of 15 percent in FBR' tax revenues raised the overall collection to only Rs661 billion in H1-FY11.

**Figure 8: Fiscal Performance Indicators in Q1**



32. Total expenditures, on the other hand, were largely contained in Q1-FY11. This was possible due to a substantial cut in development spending despite rising current expenditures owing primarily to continuation of subsidies for energy, food items (like wheat and sugar) and cash transfers. While it may have been a necessary adjustment it can only provide a short-term respite and has downside implications for the much needed investment in the economy's infrastructure.

**Table 6: Summary of Consolidated Fiscal Operations in FY11**

billion rupees; unless stated otherwise

| | Budget Estimates[1] | Q1 | Q2[P] |
|---|---|---|---|
| **Total revenue** | **2574.0** | **406.5** | - |
| Tax: *of which* | - | 323.7 | - |
| FBR tax revenue | 1667.0 | 293.5 | 367.1 |
| Non-tax: *of which* | - | 82.9 | - |
| SBP profit | - | 40.0 | 40.0 |
| CSF money | - | 0.0 | 63.7 |
| **Total expenditure** | **3258.0** | **682.7** | - |
| Current | - | 566.8 | - |
| Development | - | 62.8 | - |
| Unidentified | - | 53.2 | - |
| **Budget Deficit** | **-685.0** | **-276.2** | **-214.2** |
| **Financing** | **685.0** | **276.2** | **214.2** |
| External | 186.0 | 56.9 | -10.3 |
| Domestic | 499.0 | 219.3 | 224.5 |
| Non-bank | 333.0 | 98.4 | 59.5 |
| Banking system: *of which* | 166.0 | 121.0 | 165.0 |
| SBP | - | 118.3 | -38.3 |
| **Fiscal deficit as % of GDP** | **4.0** | **1.6** | **1.2** |

[1] As announced in the federal budget for FY11.
[P] Provisional
Source: SBP

33. The provisional estimates of the budget financing in Q2-FY11 indicate that the fiscal deficit has already increased to around Rs500 billion during H1-FY11. At the beginning of the fiscal year the FY11 fiscal deficit target was Rs685 billion (4 percent of GDP) that was revised to Rs812 billion (4.7 percent of GDP) in the aftermath of floods. Containing the deficit within this revised target would require an annual growth of around 35 percent in FBR tax revenues during H2-FY11. This seems quite difficult since the government has already postponed the proposal to reform the GST and the implementation of other fiscal measures is also unclear.

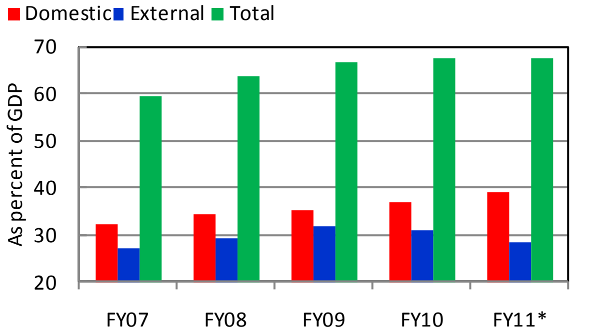
34. The government's decision of not passing on the impact of rising international oil prices to domestic consumers is also reducing the resource envelope. It is estimated that the government has borne a cost of Rs7 billion in December 2010 and January 2011. If the government keeps domestic prices unchanged and international prices remain at current levels, then it could incur an estimated additional loss in the range of Rs25 to 35 billion by the end of this fiscal year. Moreover, the government had planned to raise Rs55 billion in FY11 as non-tax revenue through issuance of license to mobile companies for adopting new technology. However, no progress has been made so far in this regard and, therefore, revenue shortfalls are likely to increase further. The issue of circular debt is also likely to make it difficult to realize other non-tax revenues in the shape of dividends, royalties, etc.

35. Notwithstanding these expected shortfalls in revenues, the likely increase in expenditures could also add to the fiscal problems with negative repercussions for the rest of the economy. While increase in security and flood related expenditures are unavoidable, the continuation of subsidies to the energy sector, over and above the budgeted amount, poses a serious risk to the fiscal outlook. This suggests that even the revised fiscal deficit target for FY11 is likely to be missed for yet another year.

36. Moreover, a substantial shortfall in external financing for the budget is expected. The planned external financing for FY11 was contingent upon the implementation of economic reforms. In view of the slippages in reforms, there is a likelihood that these flows may not materialize in H2-FY11. The total external financing received by the government during H1-FY11 was Rs47 billion, which is much lower than the target set in the budget. Consequently, a disproportionally large financing of the fiscal deficit is likely to continue from domestic sources.

37. The issue of a widening fiscal deficit, if not addressed, may have implications for debt sustainability. Public sector debt to GDP ratio, a widely used indicator of fiscal sustainability, has already shown deterioration during the past few years (see **Figure 9**). In FY11, not only has government's overall debt grown substantially by Rs812 billion to Rs9.1 trillion, the proportion of short-term debt (i.e., less than one year duration) also increased. These trends hint at the difficult fiscal position that the country will face in the coming years.

**Figure 9: Public Sector Debt and Liabilities**



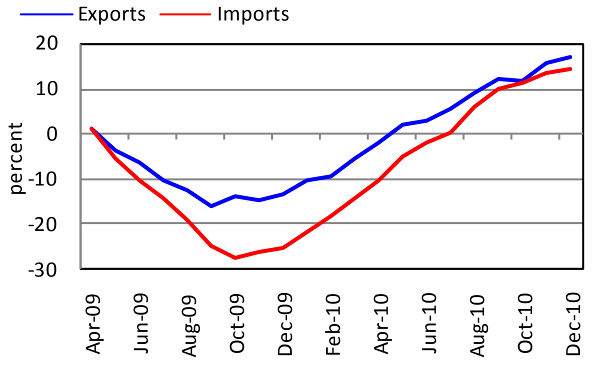

Note: Debt includes debt and liabilities of government, PSEs, and SBP. *: Showing projected levels at the end of FY11

38. Thus, the government must embark upon economic reforms and implement a clear and coherent strategy to limit further increases in the fiscal deficit, which is pivotal for resurrecting macroeconomic stability. To this end, comprehensive reforms of the existing tax system and rationalization of unnecessary expenditures should be the immediate first step. This must be followed by broadening of the tax base and optimizing developmental expenditures in critical areas to enhance the productive capacity of the economy.

***Improvement in external current account has been overshadowed by weak capital and financial inflows…***

39. While the fiscal position awaits progress, the external current account has shown substantial and unexpected improvement in H1-FY11. A robust growth of 19.4 percent in exports is the main reason behind this encouraging development (see **Figure 10**). High international prices of Pakistan's exports like textiles and rice proved quite helpful in this regard. Specifically, of the $1.8 billion incremental increase in H1-FY11 over H1-FY10 close to $1.4 billion is due to the price increase only. Imports, which grew by 10.1 percent in H1-FY11, are projected to grow by 12 percent in FY11, primarily on account of rising international commodity prices, especially oil.

**Figure 10: Growth in Imports and Exports (12-M Moving Avg.)**




40. Further support to the external current account was provided by strong inflows of remittances, $5.3 billion, and scheduled disbursement of Coalition Support Funds (CSF), $743 million. As a result, the external current account turned into a surplus in Q2-FY11 (US$613 million) leading to overall surplus of $26 million in H1-FY11 (see **Table 7**). It was the first time since Q1-FY05 that quarterly current account has turned into surplus.

**Table 7: Summary of Balance of Payments**

billion US$, unless stated otherwise

| | | H1 | | |
|---|---|---|---|---|
| | FY10 | FY10 | FY11 | FY11[1] |
| **I. Current account balance** | **-3.9** | **-2.6** | **0.03** | **-3.0** |
| Trade balance | -11.5 | -5.9 | -5.6 | - |
| Exports | 19.7 | 9.3 | 11.1 | - |
| Imports | 31.2 | 15.2 | 16.7 | - |
| Services balance | -1.7 | -1.5 | -0.5 | - |
| Income balance | -3.3 | -1.6 | -1.5 | - |
| Current transfers balance | 12.6 | 6.4 | 7.6 | - |
| Remittances | 8.9 | 4.5 | 5.3 | - |
| **II. Capital and Financial A/C** | **5.3** | **3.0** | **0.9** | **2.8** |
| of which: | | | | |
| Direct investment | 2.1 | 0.9 | 0.8 | - |
| Portfolio investment | -0.1 | 0.3 | 0.2 | - |
| Other official inv. Lib. | 2.0 | 0.9 | -0.1 | - |
| **III. Errors and omissions** | **-0.1** | **0.6** | **0.1** | - |
| **Overall balance (I+II+III)** | **1.3** | **1.1** | **1.0** | **-0.1** |
| **Memorandum items:** | | | | |
| CAB as % of GDP | -2.3 | -1.5 | 0.0 | -1.5 |
| Exports growth (%) | 2.9 | -7.7 | 19.4 | 15.0 |
| Imports growth (%) | -1.7 | -17.1 | 10.1 | 12.0 |

[1] Projections as on 25th January 2011

Source: SBP

41. The assessment of the likely path of exports and imports in H2-FY11 suggests that even with continuation of current strong export performance, the momentum in imports may reduce the likelihood of a surplus in external current account in H2-FY11. Assuming that export price trends continue in H2-FY11,

the export growth in FY11 is projected to be 15 percent. Imports, which grew by 10.1 percent in H1-FY11, are projected to grow by 12 percent in FY11 primarily due to rising international oil prices.

42. Similarly, assuming continued inflow of worker's remittances and disbursement of remaining CSF as projected earlier, the external current account deficit for FY11 is expected to be around $3.0 billion or 1.5 percent of GDP. However, the impact of this improved outlook of the external current account on the overall balance of payment may be neutralized by a worsening outlook for capital and financial inflows. Thus, the financing of even a smaller projected external current account deficit for FY11 could pose challenges for an adequate build up of foreign exchange reserves.

43. The capital and financial inflows of US$884 million during H1-FY11 have already shown a significant shortfall from earlier projections. This is also the lowest half yearly level observed since H2-FY05 (see **Figure 11**). The deceleration in these flows was both due to declining foreign direct and portfolio investments and delays in disbursement of official loans. The perceived high country risk, relative to other emerging market economies, as reflected in the high credit default swap (CDS) rates on Pakistan's foreign currency bonds, is the main factor underlying the reluctance of foreign investor to invest in the country. Whereas most of the projected foreign loans did not materialize due to the delays in implementation of economic reforms. In fact, disbursement of new loans was not sufficient to meet the repayments of outstanding loans due in Q2-FY11.

**Figure 11: Capital and Financial Accounts**

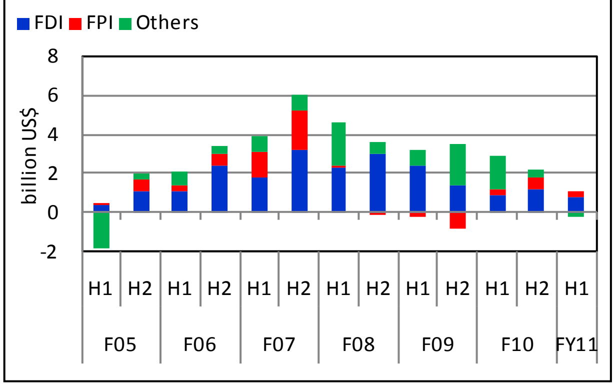



**Table 8: Principal Repayments of Outstanding IMF Loans**
million US$

| | ECF | SBA[1] | Total |
|---|---|---|---|
| FY11 | 270 | 0 | 270 |
| FY12 | 256 | 920 | 1,176 |
| FY13 | 189 | 2,700 | 2,889 |
| FY14 | 81 | 3,226 | 3,307 |
| FY15 | 27 | 1,282 | 1,309 |
| FY16 | 0 | 58 | 58 |
| **Total** | **822** | **8,186** | **9,008** |

[1] Includes repayment of ENDA starting in FY14.
Note: Amounts converted from SDR @ US$ 1.56/SDR as on 28th January 2011
ECF: Extended Credit Facility; SBA: Stand-By Arrangement
Source: IMF

44. The overall balance of payments witnessed a surplus of $1 billion in H1-FY11 and the SBP's foreign exchange reserves increased to $13.5 billion from $13 billion at end-June 2010. Consequently, the foreign exchange

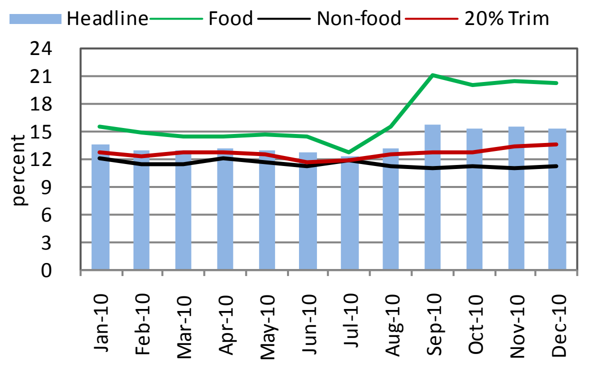
market remained stable during H1-FY11. A larger accumulation of foreign exchange reserves, however, may be required given the future repayment requirement of official loans, such as repayments of IMF loan starting in February 2012 (see **Table 8**).

***Inflation continues to persist at high levels…***

45. Inflationary pressures that were already considerably high at the beginning of FY11 have remained at an elevated level during H1-FY11. Not only did some of the contributing factors of inflation continued to prevail, the economy also experienced an additional shock in the form of devastating floods. Similarly, despite adjustments in the prices of electricity and gas, the larger issue of energy shortages has yet to be resolved. This is contributing to the underutilization of existing capacity and discouraging new investment in the economy.

46. Consequently, the aggregate demand and supply gap is still high and causing inflation to persist (see **Figure 12**). Rising international commodity prices are also playing a role in intensifying domestic inflationary pressures. These developments together with uncertainty over economic reforms have further entrenched expectations of high inflation.

**Figure 12: Consumer Price Inflation (YoY)**




47. The floods at the beginning of FY11 damaged the crops and disrupted the production and supply chain, worsening inflationary pressures. As a result, the headline CPI inflation jumped to 15.7 percent (YoY) in September 2010 and is still at 15.5 percent in December 2010. The average inflation, having fallen to 11.7 percent in FY10, has risen to 14.6 percent during H1-FY11 (see **Table 9**).

**Table 9: Inflation Indicators**

percent

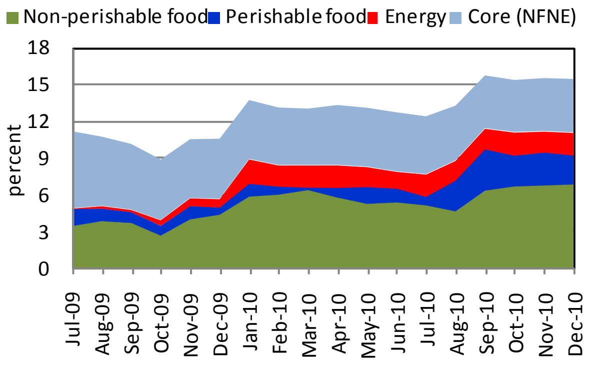
| | YoY | | Average | |
|---|---|---|---|---|
| | Jun-10 | Dec-10 | H1-FY11 | FY11[1] |
| **CPI Headline** | **12.7** | **15.5** | **14.6** | **15-16** |
| Food group | 14.5 | 20.4 | 18.5 | |
| Non-food group | 11.2 | 11.4 | 11.3 | |
| **Core Measures** | | | | |
| Non-food non-energy | 10.4 | 9.5 | 9.6 | |
| 20% Trimmed | 11.7 | 13.6 | 12.5 | |

[1] Projections

Source: FBS and SBP

48. This surge in inflation during recent months is broad based and is visible in both food and non-food inflation. Within the food group, post-flood inflation in perishable items has declined, as expected, and is visible in the month on month changes. However, the overall food inflation is still at a higher level relative to its pre-flood path. This is because, contrary to general perception, the contribution of non-perishable food items is higher and has increased during the last couple of months (see **Figure 13**).

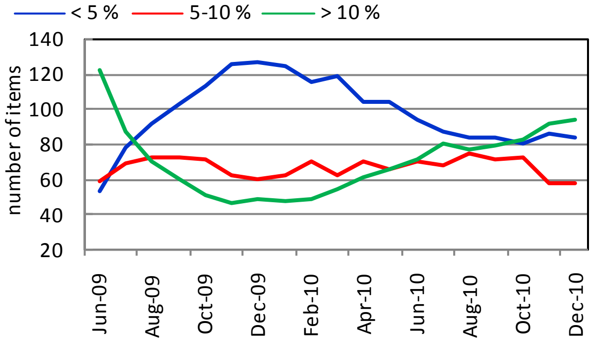
**Figure 13: Contributions to YoY Inflation**




49. The CPI items other than the food group are also contributing significantly to inflation and are a source of concern for its persistence over a longer period of time. The 20-percent trimmed mean measure of core inflation—that excludes the most volatile items in the CPI basket—rose to 13.6 percent in December 2010. It has increased by an average of 12.6 percent in the last 12 months and has been increasing since June 2010.

50. Similarly, the non-food non-energy (NFNE) measure of core inflation has also been close to 10 percent since November 2009. The number of items in the NFNE measure of inflation exhibiting an annual inflation of more than 10 percent has also increased to 94 in December 2010 compared to 49 in December 2009 (see **Figure 14**). This clearly shows that the inflationary pressures are not limited to food and energy prices and are fast becoming widespread.

**Figure 14: Distribution of Core (NFNE) CPI Items (Based on YoY Inflation)**




51. A look at the last three years trends in inflation shed some further light on the main source of persistence in inflation. With the exception of one month (October 2009), year-on-year (YoY) CPI inflation has remained in double digits since January 2008. In these three years, only an expansionary fiscal stance, frequently financed by

borrowings from the SBP, matches the persistence of inflation. On the other hand, both the international commodity prices and domestic wholesale prices have increased, come down, and increased again. The adjustments in electricity prices have been sporadic. The disruption in the supply chain of food items has only taken place once in Q1-FY11 due to the devastating floods.

52. The revised projections of average CPI inflation for FY11 fall in the range of 15 to 16 percent, along with high probability of double digit inflation in FY12. To bring inflation under better control an important measure would be fiscal consolidation and reduction in the fiscal deficit and the government borrowings from SBP. These measures would support SBP's efforts to contain monetary expansion within desirable limits and thereby ease aggregate demand pressures.

## C. Risks and Challenges

53. The current level of high inflation remains the primary concern for sustainable economic growth. Its persistence carries risks for macroeconomic stability and increase in uncertainty, discouraging savings and investment in the economy. The latter, in particular, restricts the development of productive capacity of the economy and thus contributes in increasing the aggregate demand supply gap.

54. Persistence of high inflation is also eroding competitiveness of exports through a real appreciation of the domestic currency. If the difference between domestic inflation and that of the trading partners is not brought down, the pressure on exchange rate to depreciate could increase. In turn, this could make imports more expensive, causing domestic inflation to rise further.

55. Moreover, persistence of inflation at elevated levels strengthens expectations of it remaining high, making it all the more difficult to have desirable effects of anti-inflation policies. Under these circumstances, to bring inflation down, even larger adjustments in the interest rate and exchange rate would be required. As a result, the contraction in economic activities could be relatively higher and may prolong.

56. SBP's current monetary policy stance is cognizant of these inflationary trends and their implications for the economy. This stance has also incorporated the short term effects of high interest rates on economic activity. However, it must be remembered that only low and stable inflation can ensure sustainable economic

growth. Thus, in effect, SBP's focus on controlling inflation is geared towards supporting long term economic growth.

57. As highlighted in previous monetary policy statements, a major obstacle for SBP in having desirable effects on inflation has been an expansionary fiscal stance, frequently financed by government borrowings from the SBP. Further delays in crucial economic reforms have the risk of making fiscal stance inconsistent with the efforts to bring inflation down. However, since mid December 2010, government has reduced its borrowings from the SBP. This is an encouraging development and would help in restricting expectations of high inflation. The challenge is to consolidate this current shift away from SBP financing.

58. The risk of a higher fiscal deficit, if not addressed, has implications for debt sustainability. A large portion of maturing debt has to be rolled over to the next period. In the presence of continuing expenditure revenue gap, this will be financed by further domestic borrowings. This could add pressure on market interest rates, making debt servicing even more expensive in the coming years. The rising debt servicing together with increased requirement for security and flood related spending, would leave little space for government spending on critical areas like infrastructure, education and health.

59. The failure in implementation of reforms could complicate the resolution of structural issues currently hindering economic activities. Specifically, it might reduce the availability of resources for development expenditures commensurate with the needs of a growing economy. Further, power shortages are a critical factor explaining the downturn in economic activities marginalizing the prospects of a sustainable recovery. Addressing this issue must be a top priority to ensure optimal utilization of existing productive capacity.

60. The considerable improvement in the external current account balance in H1-FY11 is still prone to some risks. The growth in exports is impressive but is largely the outcome of current rising trends in international prices of commodities, particularly of cotton. The relatively lower contribution through an increase in volume of exports is explained by the inadequate supply of electricity and gas and other bottlenecks. The prospects of a weak global economic recovery have also a bearing on increase in demand for country's exports. In this situation, any dip in the international prices may adversely affect exports.

61. On the other hand, imports are also likely to bear the brunt of rising international commodity prices in the form of higher import payments. Moreover, from a long term perspective, improvement in external current account deficit due to flows like CSF must also be discounted since these are not permanent in nature and are not reflective of any productive activity. The challenge to make the current account balance sustainable, therefore, remains there and requires capacity building in the economy for a broad based robust growth in exports of goods and services.

62. The decline in financial flows during H1-FY11 has raised concerns for even financing a smaller current account deficit. The revival of these flows hinges on creating a business environment conducive for attracting foreign investment and restoring confidence of foreign lenders through economic reforms. Both of these can be established gradually over time and require consistency in policy directions. Sustained financial inflows, particularly based on foreign investment, would be essential to allow the current account deficit to widen to meet the needs of a growing economy.