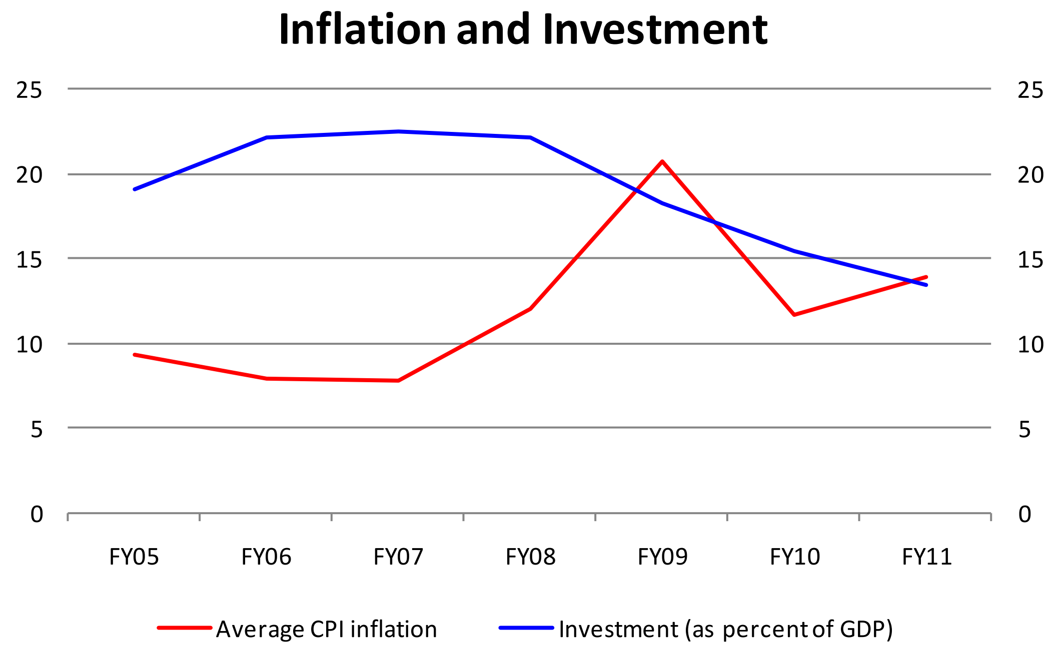
MONETARY POLICY STATEMENT

July 2011



STATE BANK OF PAKISTAN

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Executive Summary

1. A relative decline in average CPI inflation compared to earlier projections and a gradual buildup of foreign exchange reserves provide a modicum of macroeconomic stability as the economy begins a new fiscal year. These developments appear more pronounced in the backdrop of devastating floods of early FY11 and a significant shortfall in external financial inflows. While the containment of government borrowings from SBP in H2-FY11 played its part in relatively improving the inflation outlook, a substantial increase in export prices and steadily rising remittances facilitated the reserve accumulation. A cumulative increase of 150 basis points in SBP's policy rate during H1-FY11 and a proactive management of financial markets also helped in realizing these incremental gains.

2. A lower than projected inflation does not provide an enduring source of comfort for SBP as it continues to show a high degree of persistence at an elevated level. The 12-month moving average of CPI inflation was 13.9 percent in June 2011, exactly the same level observed in every subsequent month since December 2010, and 4.4 percentage points higher than the target for FY11. This level of inflation is not limited to the prices of few items and is in fact quite broad based, indicating that expectations of inflation are fairly entrenched in the economy. Thus, a meaningful reduction in inflation would require consistent and credible implementation of monetary and fiscal policies.

3. Acknowledging the persistence of inflation, the government has announced an inflation target of 12 percent for FY12. The government has also provided in the Medium Term Budgetary Framework (MTBF) a desired path of inflation of 9.5 percent and 8 percent for the subsequent two years. Conditional upon factors such as adjustments in the administered prices of electricity and oil and a projected broad money (M2) growth of 15 to 16 percent SBP's forecast of average inflation ranges between 11 and 12 percent during FY12.

4. A close inspection of the overall expansion in monetary aggregates and their changing composition is important to understand both the moderate decline and persistence of inflation. For instance, reserve money grew by 17.1 percent in FY11 with 82 percent of the expansion coming from an increase in the Net foreign Assets (NFA) of SBP. Accumulation in NFA is a reflection of the external current account surplus and build-up of reserves by the SBP. A surplus in the external current account, in turn, is an indication of somewhat restrained aggregate demand in the

economy and therefore relative stability in inflation, albeit at a high level. Retirement of government borrowings from SBP towards the end of both the third and fourth quarter of FY11 has also been helpful in improving the inflation outlook.

5. The government borrowing from scheduled banks, however, has increased substantially. It grew by 74.5 percent in FY11 and contributed 65 percent to the 15.9 percent growth in broad money (M2). The growth in private sector credit, on the other hand, was only 4 percent with negligible demand for fixed investment. These monetary trends show that the decline in aggregate demand is less than desirable and expansion in productive capacity of the economy remains weak. Both these factors help understand the persistence of inflation. The falling productivity due to severe energy shortages and deteriorating law and order conditions together with unanticipated and sporadic adjustments in the administered prices are also adding inertia to inflation.

6. The borrowing needs of the government from the scheduled banks were mostly met through short term instruments. This has increased the rollover requirements substantially and has complicated liquidity management. Apart from mitigating the resulting volatility in the money market overnight repo rate and keeping it consistent with the monetary policy stance, SBP's liquidity operations had to strike a difficult balance among multiple and competing considerations. These include stability of the payments system, adequate availability of liquidity in the market, and build up of foreign exchange reserves.

7. The underlying reasons of growing government borrowings are structural and not specific to FY11 though it must be acknowledged that FY11 was a difficult year given floods and other pressing spending needs. The consolidated fiscal data has not been released, however, provisional estimates from the financing side indicate that the fiscal deficit in FY11 may have reached close to Rs1127 billion or 6.2 percent of GDP. Excluding the one-off payment of Rs120 billion to partially settle the circular debt in the energy sector, the fiscal deficit in FY11 comes down to 5.6 percent of GDP.

8. The main structural weaknesses causing this high level of fiscal deficit and a rise in total debt are low tax to GDP ratio and rigid current expenditures. While exemptions and ineffective taxation of major parts of income generating sectors of the economy are limiting the revenue generation capacity, continued provision of financial support to the loss making Public Sector Enterprises (PSEs) and untargeted

subsidies are keeping the current expenditures under pressure. Consequently, the tax to GDP ratio remains low, 8.6 percent in FY11, and any fiscal adjustment inevitably results in cuts in the development expenditures, which is not desirable given the infrastructure needs of the economy.

9. These considerations underscore the need to accelerate the implementation of fiscal reforms currently being considered by the government. A path of fiscal deficit in the next three fiscal years has been provided in the Medium Term Budgetary Framework (MTBF), which shows a budget deficit target of 4 percent for FY12. Moreover, the government is planning to reduce the revenue deficit to zero in FY12 with a projected surplus in the following two years. This assumes an ambitious increase in tax collection by the Federal Board of Revenue (FBR). An effective implementation of fiscal reforms, especially those related to broadening of the tax base, and better coordination with the provinces are urgently required to implement this plan.

10. Unlike fiscal accounts the position of the external current account improved considerably in FY11 and contrary to earlier projections a surplus of $542 million has been realized. A significant and unexpected growth of 29.4 percent in exports and a robust growth in workers' remittances, which now stand at $11.2 billion, are the primary factors responsible for this improvement. Fragile global economic conditions and dominance of price effect in both exports and imports, which was more pronounced in H2-FY11, has increased exposure of the economy to movements in international commodity prices.

11. Incorporating the recent declining trend in international cotton prices and likely continuation of international oil prices around $100 per barrel, projected growth rate of exports is 6 to 7 percent and that of imports is 10.5 to 11.5 percent. The external current account is expected to show a modest deficit of 0.8 percent of GDP in FY12. Given an increase in debt obligations and continued suspension of IMF's Stand-By Arrangement (SBA) financing even a small external current account deficit could pose challenges in terms of maintaining an upward trajectory of SBP's foreign exchange reserves.

12. The main risk in external accounts emanates from the declining capital and financial flows, which have dropped to $1.8 billion in FY11 from $5.3 billion in FY10. The perceived high country risk, relative to other emerging market economies, is the main factor underlying the reluctance of private foreign investors to invest in the

country. The delays in implementation of economic reforms, on the other hand, resulted in shortfalls in estimated foreign loans. Nonetheless, by end-June 2011, SBP's liquid foreign exchange reserves have increased to $14.8 billion from $13.0 billion at end-June 2010. A reflection of an improved overall external position can also be seen in a relatively stable exchange rate; Pak rupee marginally depreciated by 0.5 percent against the US dollar in FY11.

13. The provisional National Income Accounts, however, do not share the positive aspects of external accounts. The devastating floods at the start of FY11 were a serious setback for economic growth in the economy already beset by continuing energy shortages and deteriorating law and order conditions. As a result, real GDP growth of 2.4 percent fell short of the target by more than 2 percentage points. The main casualty was the real private investment expenditures. The gross fixed capital formation by the private sector contracted by 3.1 percent, leading to a decline in total gross investment to 13.4 percent of GDP; the lowest level since FY74. However, due to strong growth in real consumption expenditures, aggregate domestic demand grew by 5.9 percent.

14. At the same time, national savings have increased to 13.8 percent of GDP, mainly due to net factor income from abroad. Consequently, the gap between national savings and investment as a percent of GDP has turned marginally positive. Since this positive gap is mostly due to falling investment, it cannot be considered as an encouraging development from the perspective of reviving economic activities and sustaining high growth over the medium term.

15. Against this backdrop, SBP has decided to reduce the policy rate by 50 basis points to 13.5 percent effective 1st August 2011. The key parameter in this assessment is the outlook of inflation that indicates that average inflation in FY12 is expected to remain in line with the announced target. No adjustment in the interest rate would have entailed further tightening of monetary policy in real terms, which is not warranted given the decline in private investment. Moreover, despite fiscal slippages, the government has adhered to restricting the stock of its borrowings from SBP to Rs1155 billion (on cash basis). In fact, the government retired these borrowings compared to both the end-June 2010 level as well as the mutually agreed limit of end-September 2010 level. The government has also expressed its commitment to continue with a stance of zero borrowings from SBP in yearly flow terms in FY12, which bodes well for anchoring inflation expectations. However, the developments related to expected financial inflows and pattern of government

borrowings from scheduled banks will need to be monitored closely to assess potential risks for macroeconomic stability.

I. Economic Environment during H2-FY11

1. The SBP kept the policy rate unchanged at 14 percent in H2-FY11. The key factors influencing this decision included an extraordinary improvement in the external current account balance and restrained borrowings of the government from SBP on quarterly basis. These developments reflected an improvement in outlook of external account and inflation expectations compared to their assessment in H1-FY11. A relative decline in average CPI inflation compared to earlier projections, particularly since February 2011, also favored the stance of no change in the policy rate.

2. At the same time, SBP did not ignore the persistence of inflation at a high level and acceleration in monetary expansion due to government borrowings from the scheduled banks. SBP also expressed its concerns about the extent of financial disintermediation as the growth in private sector credit was not commensurate with the growth in total deposits of the banking system. The substantial pick up in private sector credit in H1-FY11 was primarily due to working capital requirements and was expected to come down in H2-FY11.

3. It was anticipated that the decline in fixed investment by the private sector would continue to constrain expansion of the productive capacity of the economy, utilization of which was already beset by severe energy shortages and deteriorating law and order conditions. Thus, despite a moderation in aggregate demand, as evident by the external current account surplus, inflation was expected to persist in double digits as the aggregate supply remained weak.

4. Moreover, the growing borrowing requirements of the government were mostly met through short term instruments. This increased the rollover requirements substantially and complicated liquidity management. One reason for government’s increased reliance on borrowings from scheduled banks is the mutually agreed limit of their borrowings from SBP. Demonstrating its commitment government did adhere to this limit in both quarters of H2-FY11. The increase in government borrowings from SBP during Q4-FY11 was temporary and a reflection of government’s efforts to internalize the growing quasi-fiscal expense related to the circular debt of the energy sector.

5. However, low tax base and rigid current expenditures are the main reasons for the stressed fiscal position. Incorporating the expected decline in tax revenues due to the floods in Q1-FY11, the FBR's target was revised downwards. Additionally, one-off tax measures together with administrative steps to improve tax compliance were introduced to achieve the revised target. Notwithstanding the substantial increase in tax collection in the last quarter of FY11, the tax to GDP ratio for the year has declined. Adding to the pressures on the fiscal position, the subsidies to the energy sector continued despite adjustments in energy prices and there were shortfalls in realizing external official inflows.

6. In addition to shortfalls in official inflows, there was a further decline in private inflows in H2-FY11 despite high interest rates in Pakistan's economy. Given a rising trend in total debt and re-payment requirements of foreign loans, the overall strength of the balance of payments was also an important consideration while formulating the monetary policy stance. Taking advantage of an improved external current account position, SBP continued with its efforts to build foreign exchange reserves.

7. The global economic environment has largely remained fragile. The advanced economies are still struggling to gain traction after making initial gains in stabilizing financial markets and avoiding the 2008 recession from becoming a 2011 depression. The emerging economies, on the other hand, are unwinding the expansionary policies and debating the trade-off between controlling inflation and handling substantial capital inflows. This 'multi-speed' recovery in different parts of the world together with rise in global inflation has opened up a Pandora's box of policy issues. The turmoil in the oil-rich Middle East and North Africa (MENA) region and damage to the Japanese economy in the wake of an historic earthquake and tsunami have complicated matters further.

8. The larger policy debates continue to revolve around reforming the international monetary system and institutions, devising appropriate regulation of the financial sector, and adoption of macro-prudential frameworks by the central banks. However, more recently, the issues of sovereign debt crisis in the euro zone economies and the political debate in the US over raising the debt ceiling have taken the center stage. Irrespective of the outcome of these debates, the balance of economic power and influence over global policy issues is tilting in favor of emerging economies, in particular China, India, and Brazil. Smaller economies like Pakistan need to understand the implications of these subtle yet important changes.

9. Starting with Greece in 2010, the concerns over unsustainable fiscal deficit and sovereign debt positions have now spread to Ireland, Portugal, Spain, and even Italy. The differences over solutions, in terms of stringent fiscal austerity versus debt re-structuring, have kept the euro zone economies distracted from a unified approach towards avoiding a relapse in economic recovery. Similarly, given the size of the US economy and the use of US dollar as an international reserve currency, the implications of a US debt default, if it actually transpires, can have far reaching consequences for the global economy. It not only could influence prospects of global recovery but the negative impact on global financial markets and commodity prices would be difficult to ignore.

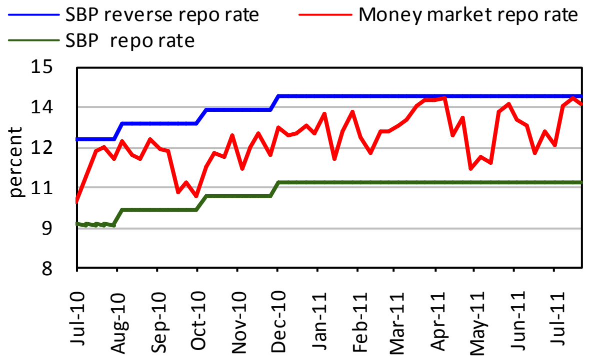
10. Unfavorable movements in international commodity prices and trade flows and difficulty in accessing global financial markets are examples of potential challenges for Pakistan's economy. Even if the global economy stabilizes, these global developments reveal useful lessons for Pakistan given its own fiscal difficulties and rising debt burden. While the specific source and nature of fiscal issues in Pakistan is different, the broad message is the same. If not addressed in time, the strong inter-linkages between fiscal vulnerabilities and financial stability tend to spill over to other sectors, disrupting productive economic activities.

II. Recent Economic Developments and Outlook

A. Liquidity Management: Policy Rate to Market Interest Rates

11. SBP's reverse repo rate (the policy rate) and SBP's repo rate, which define the corridor for the money market overnight repo rate, have been kept unchanged at 14 and 11 percent respectively since their last increase in November 2010. SBP conducted its liquidity operations in line with this stance while remaining cognizant of changing macroeconomic conditions affecting day to day availability of liquidity. As a result the money market overnight repo rate – SBP's operational target – remained on average around 12.8 percent; slightly higher but close to the middle of the corridor (see **Figure 1**).

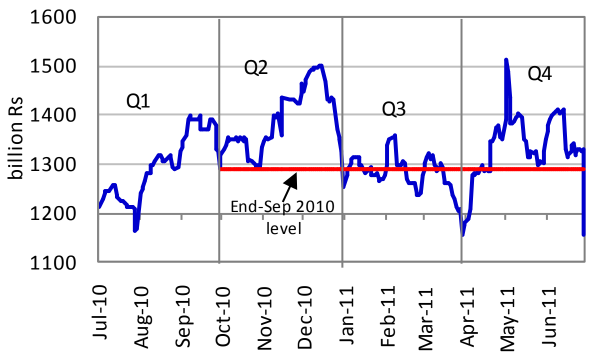
Figure 1: Movement in Overnight Repo Rate



12. However, it did experience relatively higher volatility, especially in Q4-FY11, as indicated by an increase in the coefficient of variation to 6.0 in Q4-FY11 compared to 5.0 in Q3-FY11. Apart from keeping the money market overnight rate consistent with the operational target, SBP's liquidity management had to strike a difficult balance among multiple and competing considerations. These include build up of foreign exchange reserves, stability of the payments system, and adequate availability of liquidity in the market.

13. The government borrowing pattern from the banking system was the main driver of fluctuations in the money market liquidity in Q4-FY11. Although the government did contain its borrowings from SBP towards the end of the quarter within the mutually agreed limit, it borrowed substantial amounts during the quarter that led to unpredictable injection of liquidity in the system (see **Figure 2**). For instance, to internalize the growing quasi-fiscal expense related to the circular debt of the energy sector, the government provided a grant of Rs120 billion to PEPCO in May 2011, which created excess liquidity in the market and temporarily lowered the money market overnight rate.

Figure 2: Stock of Government Borrowing from SBP (Cash Basis)



14. To ensure consistency with the monetary policy stance and to neutralize the expansionary effect of government borrowings on reserve money, SBP shifted a portion of this borrowing, Rs61 billion, to the market through an outright Open Market Operation in May 2011. A similar outright sale of Rs46 billion of government securities was again conducted towards the end of Q4-FY11. Thus, at times, SBP's liquidity operations were adversely affected by government's debt management considerations.

15. The government also raised substantial amounts, over and above the announced targets, from the scheduled banks in the regular fortnightly auctions of T-bills. For instance, it borrowed Rs128.8 billion over and above the announced target of Rs1150 billion for Q4-FY11. This caused unanticipated outflow of liquidity from the system and created challenges for liquidity management. SBP had to inject the required liquidity to ensure stability of the payments system.

16. The movements in other macroeconomic factors influencing the market liquidity largely followed the seasonal pattern or were broadly anticipated (see **Table 1**). The credit retirement by private sector and rise in deposits in Q4-FY11 contributed towards easing liquidity conditions. Similarly, substantial inflows due to improvement in the external accounts allowed SBP to build reserves, increasing the availability of rupee liquidity in the system. However, credit availed by the government for commodity operations offset these inflows to some extent. On the whole, excess liquidity conditions in Q4-FY11 entailed net mop up of Rs38.6 billion contrary to a net injections of Rs20.5 billion in Q3-FY11.

Table 1: Inter-bank Market Liquidity Conditions

billion rupees, unless stated otherwise

	Q3-FY11	Q4-FY11
Total deposits[1]	26.4	384.5
Currency in circulation	-4.9	-8.6
NFA of the banking system	35.7	72.6
Net budgetary borrowing from SBP	-107.2	6.9
Private sector credit	66.5	-108.5
Commodity finance	-71.7	105.9
T-bill auctions (net of maturities)	158.6	113.0
Average outstanding OMO, repo, reverse repo	20.5	-38.6
Average overnight money market repo rate (%)	13.0	12.7

[1] Excluding government deposits

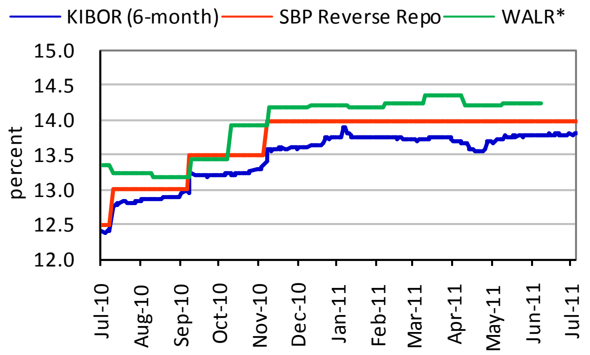
Source: SBP

17. The SBP does not foresee any major difficulty in managing the market liquidity in Q1-FY12 largely on account of two factors. First, both private and public sectors would be retiring their respective borrowings availed for seasonal needs and for wheat procurement. Thus, the incremental requirement of liquidity would be lower to this extent. Second, SBP will continue its efforts to build foreign exchange reserves that would further augment the availability of domestic rupee liquidity.

18. The SBP expects that the government would be able to meet its borrowing requirements as per the pre-announced T-bill auction target of Rs750 billion during Q1-FY12. The SBP also assumes that the government will adhere to its commitment of zero net borrowings from SBP and that the projected foreign inflows would be realized. Deviations from these assumptions could affect the market liquidity conditions which would need to be monitored very closely to avoid any undue pressure on interest rates.

19. Both the Karachi Interbank Offer Rate (KIBOR) of different tenors and Weighted Average Lending Rate (WALR) have broadly followed the changes in the policy rate (see **Figure 3**). Against 150 bps increase in the

Figure 3: Movement in Policy and Market Rates

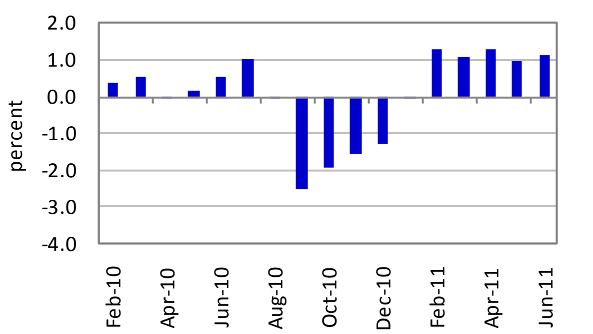


*Weighted Average Lending Rate

policy rate during FY11, 6-month KIBOR and WALR have increased by 143 and 103 bps respectively. While the movement in KIBOR is a reflection of monetary policy stance and prevailing liquidity conditions, changes in WALR are also influenced by credit demand of the private sector. Muted incremental credit demand of the private sector during FY11 partially explains this relatively lower increase in WALR.

20. In real terms, however, WALR has been increasing gradually and turned positive in H2-FY11. Given a relatively better inflation outlook, this trend could continue even if the nominal rates do not increase. The positive real lending rates would help discourage speculative credit demand in the economy (see **Figure 4**). Unlike lending rates, the Weighted Average Deposit Rate (WADR) has not changed much during FY11. It increased from 6.8 percent in June 2010 to 7.2 percent in June 2011. This represents a weakness of the monetary policy transmission mechanism as evident from a stagnant and high currency to deposit ratio of 29 percent on 30th June 2011.

Figure 4: Real Lending Rate*



* Nominal weighted average lending rate minus YoY inflation

21. An increase in the policy rate implicitly assumes that the banking system will offer higher returns to attract additional deposits and thus reduce the currency in circulation. However due to lack of financial deepening and absence of competition in the banking system this has not been the case. The structure of deposits with 30.6 percent of total deposits held at zero rate of return as on 30th June 2011 also explain the overall low WADR. Excluding these deposits that largely represent transactional demand for money and not the savings considerations, the WADR increases to 9.9 percent for 30th June 2011.

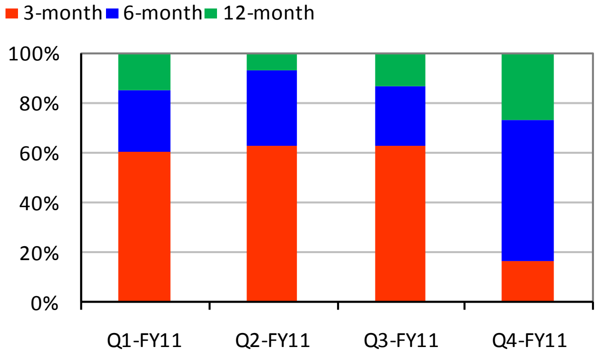
22. Nonetheless, to promote competition in the banking system and to offer alternative sources of savings to the population, SBP has been encouraging the Investor's Portfolio Securities (IPS) accounts. By opening these accounts with the banks, an individual can directly invest in high yielding government securities in both the primary and secondary market. Over time this strategy would diversify the government's funding source, deepen the secondary market of government securities, and facilitate the issuance of corporate debt. Importantly, the option of placing savings in deposits with the banks or investing them in government paper

could provide a stiff competition to banks in attracting fresh deposits from the system. This would help lower the currency in circulation and improve the transmission of monetary policy changes to market interest rates.

23. Following a direction similar to KIBOR and lending rates, interest rates on Treasury bills (T-bills) in the primary market also increased during the year. This increase not only reflects the impact of increase in the policy rate but also the relatively higher demand of funds by the government. For example, during FY11, the cut off rates for the 3-month, 6-month and 12-month paper in the T-bill auctions have increased by 138, 143 and 149 basis points. It is important to note that while the overall direction of interest rates in the economy is provided by the SBP, the auction to auction movement in T-bill cut-off rates is not a reflection of change in the monetary policy stance. These rates are set by the Ministry of Finance after assessing their borrowing needs and are a reflection of market's expectations of fiscal needs and inflation.

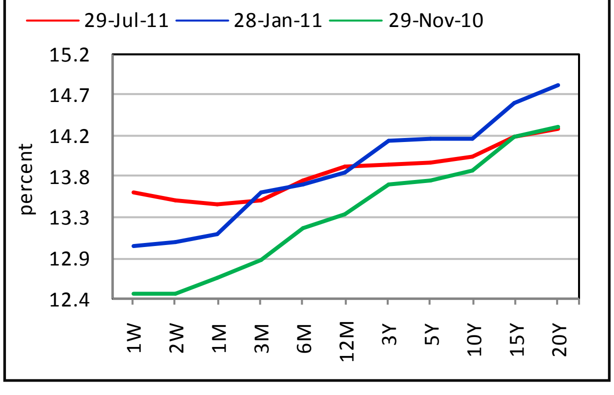
24. While the increase in interest rates across different tenors was almost the same, banks' bidding pattern in T-bill auctions changed considerably during Q4-FY11 in favor of 6 and 12-months T-bills (see **Figure 5**). The proportion of amount offered by banks in these tenors in Q4-FY11 increased to 84 percent compared to an average of 39 percent in the first three quarters of FY11. Similar change in banks' behavior can be observed in the PIB auctions. This probably reflects market's expectations that inflation will remain at the same level that has been observed in recent months.

Figure 5: Tenor-wise Offers in T-bill Auctions



25. The relative stability of expectations of inflation can also be inferred by observing the change in the yield curve of 29th July and 28th January 2011; the period during which SBP has kept the policy rate unchanged (see **Figure 6**). The long term interest rates have declined slightly compared

Figure 6: Yield Curves



to the short term rates in the secondary market. As a result, the spread between 6-month T-bill and 10-year PIB has declined from 53 bps to 26 bps.

B. The Behavior of Monetary Aggregates: The Composition Matters

26. The increase in interest rate helps control inflation by keeping aggregate demand closer to the aggregate supply. In the absence of high frequency data on aggregate demand, monetary aggregates become useful indicators to gauge aggregate demand pressures. However, evaluating the impact of increase in interest rates on monetary aggregates and thus inflation is not straight forward. Different components of monetary aggregates respond differently to interest rate changes. Similarly, the relationship between money and inflation is not one-to-one. A closer inspection of changing composition of monetary aggregates is required to assess the inflation behavior.

27. For instance, reserve money grew by 17.1 percent in FY11 with 82 percent of the expansion coming from an increase in the Net foreign Assets (NFA) of SBP. Accumulation in NFA is a reflection of improvement in the external current account and build-up of reserves by the SBP. Thus, growth of reserve money, which seems to be on the higher side, is not a point of concern at the moment as it has improved markedly in favour of NFA. Retirement of government borrowings from SBP towards the end of FY11 also helped as it mitigated the growth in the Net Domestic Asset (NDA) component of SBP's balance sheet. The resulting decline in NDA to NFA ratio is an indicator of relatively stable inflation outlook.

Table 2: Monetary Aggregates
flows in billion rupees, percent

	FY10	FY11[P]	FY12[1]
NDA: *of which*	590.6	682.9	998.0
Net budgetary support	330.4	590.2	-
Commodity operations	77.0	-15.7	-
Private sector credit	112.9	121.3	-
Credit to PSEs	85.0	36.3	-
NFA	49.4	235.1	41.0
Money supply (M2)	640.0	918.0	1,039.0
YoY growth	*12.5*	*15.9*	*15.5*
Memorandum items:			
Net budgetary support			
from SBP	44.0	-8.0	-
from Sch. banks	286.4	598.2	-
Currency in circulation	143.2	206.0	-
Total deposits	494.8	708.5	-
Reserve money	171.7	286.6	-
YoY growth	*11.4*	*17.1*	*15.0*

[1] Projections; P: Provisional
Source: SBP

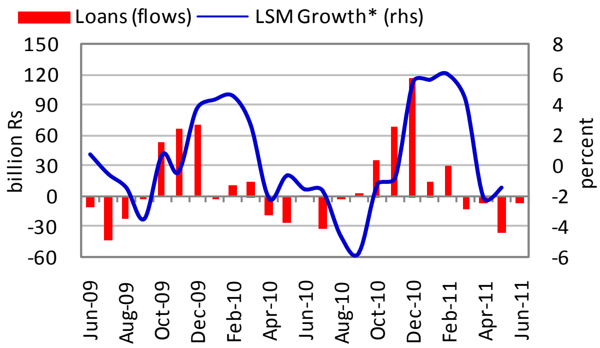
28. The broad money grew by 15.9 percent during FY11. However, unlike reserve money growth, 65 percent of this growth came from government borrowings from scheduled banks, which grew by 74.5 percent in FY11. This confirms SBP's earlier assessment that even if government borrowing from SBP is contained, the overall demand for money may not subside given incremental government borrowing from

the banking system. The required reduction in the demand for money and thus aggregate demand would require a reduction in the fiscal deficit – the source of continued government borrowings from scheduled banks.

29. The high nominal lending rates did have their impact on the demand for credit by the private sector. However, non-economic factors such as deteriorating law and order conditions and severe energy crisis remain the dominant factors affecting the real productive economic activity and thus expansion in the Private Sector Credit (PSC). In addition, the devastating floods in early FY11 seriously damaged the economic infrastructure, further disrupting the economic activity. Not surprisingly, the year-on-year growth in PSC was only 4.0 percent in FY11. Given the average CPI inflation of 13.9 percent in FY11, the growth in PSC in real terms was in fact negative.

30. Moreover, this growth in PSC is not commensurate with the growth in deposits of the banking system, which grew by 15.8 percent in FY11. 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 increase in the banking system's Non-Performing Loans (NPLs), which have reached to Rs573.5 billion by the end of Q3-FY11. At the same time, government's growing financing needs provided banks the opportunity to invest in risk free government securities. Keeping in view the positive link between the PSC and economic growth, government's dependence on bank borrowings is distorting credit allocation process to its optimal ends.

Figure 7: Loans to Private Sector Businesses and LSM Growth



* 3-month moving average

31. In flow terms the credit availed by the private sector was Rs121.3 billion in FY11, which followed a typical seasonal pattern. **Figure 7** shows that it picks up in September, reaches its peak in December, and from January onwards starts declining. The retirement cycle continues till August. The seasonality aspect was further reinforced in FY11 as most of this credit was availed to finance working capital. Essentially, the private sector availed credit for the purpose of bridging the gap between production and sale of their output. At the completion of their output and selling cycle they retired this credit.

32. Assessment of classification of loans to private sector business into working capital and fixed investment finance reveals that 94.5 percent of the total credit expansion was indeed in the former category during FY11. Given the short term nature of working capital finance, which was driving growth in PSC in H1-FY11, its retirement during H2-FY11 is not surprising (see **Table 3**). For instance, 'Textiles' and 'Sugar', within the manufacturing sector availed 68 percent of the total PSC from the banking system during H1-FY11. However, during H2-FY11 overall retirements of around Rs41.7 billion led to a substantial decline in PSC.

Table 3: Private Sector Credit
flows in billion rupees

	H2-FY11	H1-FY11	FY11
Total credit to private sector	**-41.7**	**163.0**	**121.3**
1. Loans to private sector businesses	**-17**	**190.2**	**173.2**
By type:			
Working capital: *of which*	-20.0	183.5	163.5
Fixed investment	3.0	6.7	9.7
By sectors: *of which*			
Agriculture	1.9	9.1	11.0
Manufacturing: *of which*	-21.7	143.6	121.9
Textiles	*-61.9*	*106.3*	*44.5*
Electricity, gas and water	30.6	23.3	53.9
Construction	-2.4	3	0.6
Commerce and trade	-20.1	4.1	-16.0
2. Personal : *of which*	**-12.0**	**-15.5**	**-27.5**
Consumer financing	*-10.9*	*-16.3*	*-27.2*
3. Investment in securities & shares	**1.7**	**8.9**	**10.5**
4. Others	**-14.3**	**-20.6**	**-35.0**

Source: SBP

33. A rapid surge in cost of production as indicated by an increase of 23.4 percent in Wholesale Price Index (WPI) during FY11, explain the major part of credit availed to finance working capital (see **Table 4**). The impact of higher input cost was particularly strong in spinning and weaving sub-sectors as average cotton prices rose by 90 percent during FY11. In addition, increase in energy prices and gradual reduction in domestic subsidies together with increase in wages contributed to the increase in cost of production.

Table 4: Trends in Raw Material Prices
annual percent change

	FY10	FY11
WPI	**12.6**	**23.4**
Raw materials	**29.1**	**57.3**
Cotton	32.7	90.0
Sugarcane	64.0	44.9
Fuel, lighting & lubricants	**14.5**	**17.4**
Diesel Oil	16.8	17.7
Furnace Oil	26.9	22.9
Manufactures	**10.1**	**27.4**
Chemicals	-0.6	22.9
Fertilizers	-4.6	20.7
Pesticides and insecticides	7.6	12.5
Building materials	**-5.4**	**13.2**

Source: Federal Bureau of Statistics

34. The impact of higher cotton prices, however, has been partially compensated by an increase in export price of textiles in international markets, resulting in healthy profits of the textile sector. This facilitated retirement of working capital finance in H2-FY11. Moreover, given the prevailing dismal law and order conditions and prolonged energy shortages, the economic environment is not conducive for fixed business investment. The yearly flow in fixed investment finance was only Rs9.7 billion, which was much less than Rs65 billion availed last year. There is a risk that

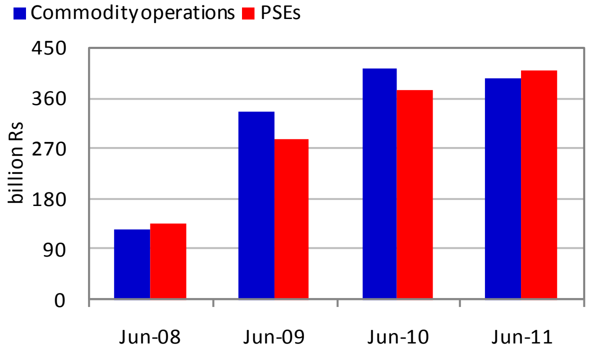
complete absence of investment activities would constrain additions to future productive capacity of the economy.

35. Banks' capacity to lend to private sector was further constrained by government borrowings for its commodity operations. The high outstanding stock of credit for commodity finance at Rs397.5 billion is paradoxical since it is a self-liquidating financing arrangement. It reflects inefficiencies in the commodities operations and is constraining banks' lending capacity to other sectors. However, net retirement of Rs15.7 billion during FY11 is a welcome development when compared with net expansion of Rs77 billion in FY10. Low wheat procurement in the latest season, its export and increased depletion of outstanding stock helped achieve this retirement.

36. The continuation of retirement in commodity financing, however, is exposed to a major risk. If federal or provincial governments continue to provide subsidy on wheat then the retirement of existing stock of commodity finance will slow down and may exacerbate the commodity related circular debt. The financing of commodity operations at a rate of KIBOR plus 2.75 percent is keeping pressure on interest rates to remain on the higher side and distorting the credit pricing mechanism in the markets. These issues can be resolved by gradually increasing the role of private sector in commodity operations. The government should restrict its role in maintaining strategic reserves of essential commodities only. This will ensure credit utilization in accordance with the commodity procurement cycle and determination of its price according to the market forces.

37. Contrary to retirement in commodity finance, credit to PSEs increased by Rs36.3 billion in FY11, which is less than the half of the amount availed in FY10 (Rs85 billion). However, the substantial outstanding stock of credit to PSEs at Rs387.6 billion and their ever deteriorating financial health is a point of concern for all the stakeholders (see **Figure 8**). Thus, to create space for further lending and to encourage the private sector, there is an urgent need on the part of the government to effectively address the circular debt in the energy sector. This would help in easing pressure on interest rates, revive

Figure 8: Commodity Financing and Credit to PSEs (Stocks)



investment by the private sector, and alleviate constraints impeding the production of electricity. The cost of neglecting these issues would be a lower aggregate supply and persistence of inflation.

38. Government borrowings for budgetary support, however, remained the dominant factor in the overall credit expansion. A positive development is that government retired its borrowing from SBP on end-quarter basis in H2-FY11 though it did borrow during the quarters especially in Q4-FY11. The stock of government borrowing from SBP (on cash basis) at end-June stands at Rs1155 billion, which is significantly lower than the mutually agreed limit of Rs1290 billion. However, to meet this target government's reliance on scheduled banks has increased, with most of this increase coming in H2-FY11. The retirement of borrowings from SBP bodes well for inflation expectations but continued dependence on scheduled banks risks limiting the availability of resources for the private sector.

39. Although government used various debt instruments, such as T-bills, Pakistan Investment Bonds (PIBs), Government Ijara Sukuk (GIS), to raise funds for budgetary support yet the dominant instrument remained short term T-bills. For instance, against the pre-announced target of Rs2130 billion, government raised Rs2321 billion, including maturities of Rs2050 billion in H2-FY11. For Q1-FY12, the incremental borrowing requirement, over and above target of Rs750 billion, is Rs48.3 billion. This excludes the maturing debt issued in previous T-bill auctions and accounts for reversal of outright sales of Rs107 billion conducted in May and June 2011. In first two auctions of FY12 government has raised Rs242 billion (see **Table 5**).

Table 5: Auction Summary of Government Securities

billion rupees; percent

	H2-FY11			Q1-FY12[1]		
	Target	**Realized amount**	**Cut-off rate[2]**	**Target**	**Realized amount**	**Cut-off rate[2]**
T-bills	**2130**	**2321**	**-**	**750**	**242**	-
3-Month	-	745	13.5	-	37	13.5
6-month	-	1128	13.7	-	112	13.8
12-month	-	449	13.9	-	92	13.9
PIBs: *of which*	**95**	**130**	**-**	**50**	**-**	**-**
3-years	19	42	14.0	10	-	-
5-years	19	13	14.1	12	-	-
10-years	33	75	14.1	16	-	-
30-years	5	0	14.2	3	-	-
Ijara Sukuk	**90**	**93**	**-**	**n.a**	-	-
Total	**2315**	**2545**	**-**	**800**	**242**	-

[1] Up to 29th July 2011; [2] These correspond to the last auction held during the period; n.a: not available

Source: SBP

40. Further, given that T-bills have a maturity of maximum one year, the rollover requirements have increased substantially. To put in perspective, the rollover requirements at the beginning of FY11 were Rs1348 billion. After including the fresh borrowings during the year, the minimum amount of T-bills that the government will be required to rollover at least once during FY12 would be Rs1971 billion. This amount will increase further as the government issues new 3- and 6-month T-bills for

fresh borrowings in FY12. Thus, the amount and frequency of rollovers is increasing exposure to the interest rate risk for the government as well as the scheduled banks. While the risk for the government is obvious in terms of high fiscal cost, the risk faced by the banks is more subtle in terms of re-pricing of securities and re-investment considerations.

41. Thus, a forward-looking debt strategy that reduces the share of short term securities and is geared towards long term borrowings would be highly desirable. Apart from mitigating the interest rate risk, such a strategy could also prove flexible in terms of absorbing uncertainty related to external borrowings. Further, it would also help in reducing the reliance of government borrowing from the SBP on consistent basis.

C. Fiscal Stress and Public Debt: Structural Weakness is the Root Cause

42. In addition to bank financing, government also borrowed Rs424 billion from the domestic non-bank sources. The total domestic financing for budget in FY11 thus stands at Rs1013 billion, which exceeds the budget estimate by Rs514 billion (see **Table 6**). This excessive reliance on domestic sources is mainly a reflection of a stressed fiscal position. However, shortfall in external financing and one off factors such as less than planned receipts under Coalition Support Fund (CSF) and partial settlement of the energy sector circular debt also played their part.

Table 6: Summary of Consolidated Fiscal Operations

billion rupees, unless indicated otherwise

	FY11^{BE}	Jul-Mar FY11^{P}	FY11^{P}	FY12^{BE}
Total revenue: *of which*	**2574**	**1495**	**-**	**2871**
FBR tax revenue	1667	1017	1550	1952
CSF money	129	64	64	-
Total expenditures	**3258**	**2279**	**-**	**3721**
Current: *of which*	2519	1910	-	-
Subsidies[1]	127	205	380	166
Interest	699	507	-	791
Development	740	353	-	-
Unidentified	0	16.0	-	-
Budget Deficit	**-685**	**-783**	**-**	**-850**
Financing	**685**	**783**	**1127**	**850**
External	186	83	114	135
Domestic	499	700	1013	716
Memorandum items (as percent of GDP)				
Overall fiscal balance	-4.0	-4.3	-6.2	-4.0
Primary balance[2]	0.1	-1.7	-	-
Revenue balance[3]	0.3	-2.3	-	0.0

P: Provisional; BE: Budget estimates
[1] Shows subsidies by federal government only; [2] Total revenues minus total expenditures (excluding interest payments); [3] Total revenues minus current expenditures
Note: The budget estimates of FY12 total revenues and expenditures are computed by using their GDP ratios published in Medium Term Budgetary Statement.

43. The tax collection in FY11 remained weak during most of the year except the last quarter. During the first three quarters, FBR's tax collection grew by 12.2 percent against the required 25.6 percent growth given the budget target of Rs1667 billion. Incorporating the expected decline in tax revenues due to the floods in Q1-FY11, the FBR's target was revised downwards. Additionally, one-off tax measures together with administrative steps to

improve tax compliance were introduced to achieve the revised target. Consequently, the FBR tax revenues grew by 26.8 percent in Q4-FY11. This resulted in a total collection of around Rs1550 billion in FY11. Notwithstanding the substantial increase in tax collection in the last quarter of FY11, the tax to GDP ratio for the year declined to 8.6 percent.

44. On the expenditure, side provision of subsidies, over and above the budgeted amount, also contributed in the fiscal slippage. For instance, against a budgeted amount of Rs127 billion, the total spending on subsidies is estimated at Rs380 billion. This includes the payment of Rs120 billion to internalize the growing quasi fiscal deficit related to the circular debt of the energy sector. To some extent, this increase in spending on subsidies was compensated by a cut in development spending.

45. The consolidated fiscal data has not been released, however, provisional estimates from the financing side indicate that the fiscal deficit in FY11 may have reached close to Rs1127 billion or 6.2 percent of GDP. Excluding the one-off payment of Rs120 billion related to the circular debt, the fiscal deficit in FY11 comes down to 5.6 percent of GDP. This is significantly higher than the target of 4.0 percent set at the start of the year. This high level of fiscal deficit is mainly due to structural weaknesses though it must be acknowledged that FY11 was a difficult year given floods and other pressing spending needs.

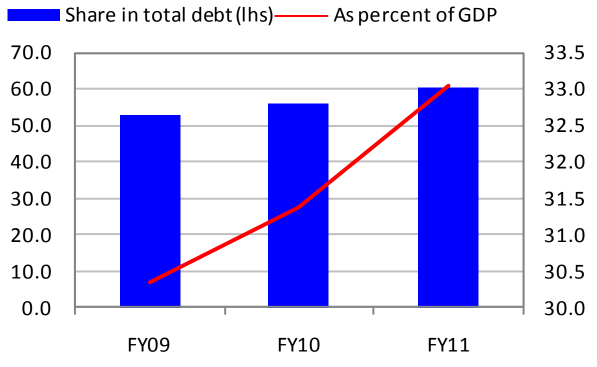
46. An indication of entrenchment of these structural weaknesses can be seen in a rise in both the primary deficit and revenue deficit in the first three quarters of FY11 to their highest level in last ten years. The main underlying reasons, which are not specific to FY11, are low tax to GDP ratio and rigid current expenditures. While exemptions and ineffective taxation of major parts of income generating sectors of the economy are limiting the revenue generation capacity, continued provision of financial support to the loss making public sector enterprises and untargeted subsidies are keeping the current expenditures under pressure. Consequently, any fiscal adjustment inevitably results in cuts in the development expenditures, which is not desirable given the infrastructure needs of the economy.

47. Moreover, as a consequence of high fiscal deficit and low external financing, domestic debt of the government is growing quite rapidly. It grew by 28.0 percent in FY11, which translates into an increase of 1.6 percentage point of GDP. Moreover, the share of domestic component of government’s total debt has increased to over 60 percent in FY11 (see **Figure 9**). This changing composition of debt could increase

government's interest cost significantly in the coming years since the cost of raising domestic debt is relatively high.

48. These considerations underscore the need to accelerate the implementation of fiscal reforms currently being considered by the government. Delay in these reforms not only are contributing to fiscal imbalances but also holding up the realization of external official inflows and completion of the Stand-By Arrangement with the IMF.

Figure 9: Government Domestic Debt



49. A path of fiscal deficit in the next three fiscal years has been provided in the MTBF, which show a budget deficit target of 4 percent for FY12. Moreover, the government is planning to reduce the revenue deficit to zero in FY12 with a projected surplus in the following two years. This assumes an ambitious increase in tax collection by the Federal Board of Revenue (FBR). A consistent and credible implementation of fiscal reforms, especially those related to broadening of the tax base, and better coordination with the provinces is urgently required to implement this plan.

D. Does an External Current Account Surplus Mean a Strong Balance of Payment Position?

50. At the beginning of FY11 SBP projected that fiscal slippages and likely worsening of external terms of trade could translate into a significant external current account deficit. While the fiscal slippages did happen, the terms of trade improved unexpectedly during FY11 that reduced the trade balance compared to earlier projections. In addition, a robust growth in workers' remittances and improvement in income balance contributed to a sharp acceleration in net factor income from abroad. Taken together, these factors strengthened the external current account balance (CAB), which shows a surplus of $542 million in FY11 (see **Table 7**).

51. The improvement in trade balance is primarily due to a substantial growth of 29.4 percent in exports during FY11, resulting in an export earnings of $25.5 billion.

Although the impact of prices on value of exports was dominant throughout the year, it was more pronounced in H2-FY11. Thus, exports grew by 38.6 percent in H2-FY11 compared to 19.2 percent in H1-FY11. A similar growth pattern can be seen in imports that grew by 14.2 percent in FY11, leading to import payments of $35.6 billion. The only difference is that quantum of imports actually declined in H2-FY11 (see **Table 8**). The dominance of price effect in both exports and imports has increased exposure of the economy to movements in international commodity prices.

Table 7: Summary of Balance of Payments
billion US$

	H1-FY11	H2-FY11	FY11	FY12[1]
I. Current account balance	**-0.1**	**0.7**	**0.5**	**-2.0**
Trade balance	-5.7	-4.4	-10.2	
Exports	11.1	14.4	25.5	
Imports	16.8	18.8	35.6	
Services balance	-0.5	-1.6	-2.1	
Income balance	-1.5	-1.5	-3.0	
Current transfers balance	7.6	8.2	15.8	
Remittances	5.3	5.9	11.2	
II. Capital & Financial balance	**0.9**	**0.9**	**1.8**	**1.7**
Direct investment	0.8	0.7	1.5	
Portfolio investment	0.2	0.1	0.3	
Other official inv. Lib.	-0.1	0.2	0.2	
III. Errors and omissions	**0.1**	**0.0**	**0.1**	
Overall balance (I + II + III)	**1.0**	**1.5**	**2.5**	**-0.4**
Memorandum items:				
CAB as percent of GDP	*-0.1*	*0.3*	*0.3*	*-0.8*
Net SBP forex reserves	13.5	14.8	14.8	-
Exports growth	19.2	38.6	29.4	6.5
Imports growth	11.0	17.2	14.2	11.0

[1] Projections
Source: SBP

52. The export growth in FY12 is forecasted to fall between 6 to 7 percent. In forming this projection, due consideration has been given to the recent declining trend in international cotton prices, which has been a main driver of export growth in FY11. Additionally, effects of factors like fragile global economic recovery and continued energy shortages have also been incorporated. The growth in imports is projected to be in the range of 10.5 to 11.5 percent. This accounts for the recent trends in international commodity prices, including oil, and expected import demand in the domestic economy. This trade outlook, even after assuming strong growth in workers' remittance, is expected to turn the external current account balance into a modest deficit of around 0.8 percent of GDP.

Table 8: Price and Quantum Effects of Imports and Exports in FY11
share in absolute changes over last year

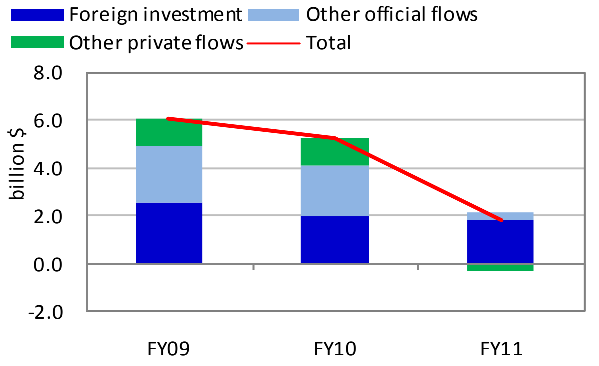
		Export	Import
H1	**Quantum effect**	30.7	37.4
	Price effect	69.3	62.6
H2	**Quantum effect**	6.3	-23.4
	Price effect	93.7	123.4
Year	**Quantum effect**	15.7	7.5
	Price effect	84.3	92.5

Source: SBP

53. In sharp contrast to improvement in the external current account balance, financial account continued its worsening trend (see **Figure 10**). Net capital and financial inflows dropped to US$1.8 billion in FY11 from $5.3billion in FY10. Both the decline in foreign investment and shortfall in expected official loans have contributed towards lowering the surplus in the capital and financial accounts. The perceived high country risk, relative to other emerging market economies, is the main factor

underlying the reluctance of foreign investors to invest in the country. Most of the estimated foreign loans did not materialize due to delays in implementation of economic reforms. Against the estimated capital grants and official loans of $4.8 billion, only $2.4 billion were realized in FY11.

Figure 10: Net Capital and Financial Flows



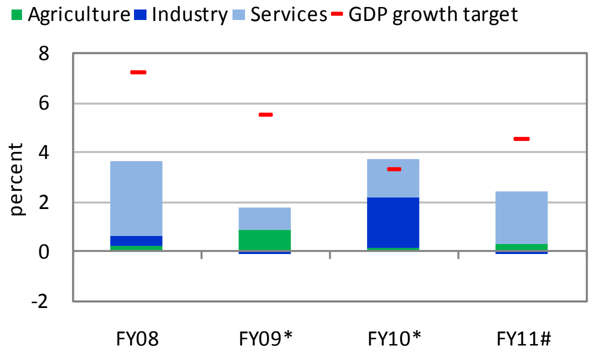
54. The main risk in external accounts emanates from the declining financial inflows. Given an increase in debt obligations and continued suspension of IMF's Stand-By Arrangement (SBA), financing even a small external current account deficit could pose challenges in terms of maintaining an upward trajectory of SBP's foreign exchange reserves. Nonetheless, in FY11 improvement in the external current account overshadowed this substantial decline in capital and financial inflows and there was an almost 100 percent increase, to $2.5 billion, in the overall balance of payments surplus. In turn, this has helped SBP in building its liquid foreign exchange reserves, which have increased to $14.8 billion by the end of FY11 from $13.0 billion at end-June 2010.

55. A reflection of an improved overall external position can also be seen in a relatively stable exchange rate; Pak rupee only marginally depreciated by 0.5 percent against the US dollar in FY11. However, due to a significant depreciation of the US dollar against major international currencies, Pakistan's Nominal Effective Exchange Rate (NEER) depreciated by 8.4 percent in July-May FY11. Thus, despite a higher domestic inflation compared to its trading partners, Pakistan's Real Effective Exchange Rate (REER) depreciated by 0.4 percent.

E. Growth Accounting: Investment Needs Revival

56. The provisional National Income Accounts estimates show that real GDP grew by 2.4 percent in FY11 against the target of 4.5 percent for the year (see **Figure 11**). This underperformance is largely explained by continuing energy shortages and deteriorating law and order situation, however, the

Figure 11: Contributions to Real GDP Growth



* Revised; # Provisional

devastating floods at the start of FY11 was yet another setback to an already slowing economy. Besides damaging agriculture crops, the floods destroyed the infrastructure causing disruption in supply chain and productive activities. The industrial production, in particular, suffered heavily while losses in agriculture were, to some extent, offset by improved performance in the post-flood period.

57. On the expenditure side, the slowdown in real GDP growth is explained by decline in real investment demand, primarily driven by low private investment (see **Table 9**). The real gross fixed capital formation by the private sector has contracted by 3.1 percent while its share in real GDP fell to 9.7 percent in FY11. Nonetheless, the growth in aggregate domestic demand accelerated to 5.9 percent due to a strong growth in real consumption expenditures. The broad factors that boosted consumption include higher rural incomes on account of rise in prices of cash crops, record increase in workers' remittances, and an expansionary fiscal stance.

Table 9: Growth in Expenditures on Real GDP

percent

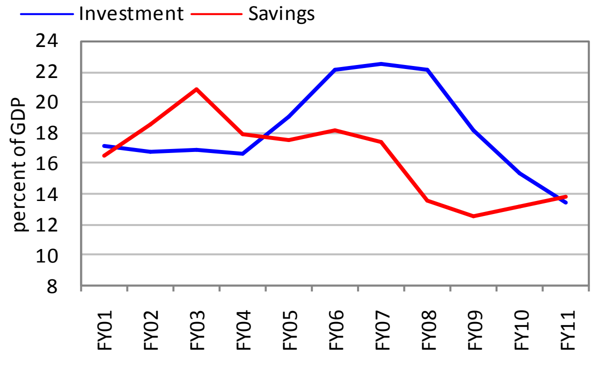
Sectors	FY09[R]	FY10[R]	FY11[P]
Total consumption expenditures	5.0	3.9	7.0
Private	12.2	4.0	7.0
General government	-31.5	2.2	7.5
Investment expenditures	-13.3	-5.1	-0.1
Gross fixed capital formation	-14.8	-6.1	-0.4
Private	-9.2	-5.7	-3.1
Public and general government	-19.1	-7.3	7.7
Changes in stocks	3.6	4.1	2.4
Total domestic demand	**1.4**	**2.3**	**5.9**
Export of goods and non-factor services	-3.3	15.8	-14.2
Import of goods and non-factor services	-15.1	4.4	6.1
Gross domestic product (mp)	**3.6**	**4.1**	**2.4**
Gross domestic product (fc)	**1.7**	**3.8**	**2.4**

R: Revised; P: Provisional

Source: Economic Survey 2010-11

58. The gross total investment has come down to 13.4 percent of the GDP in FY11; the lowest level recorded since FY74. At the same time, national saving has increased to 13.8 percent of the GDP, mainly due to increase in net factor income from abroad. Consequently, the gap between national saving and investment as a percent of GDP has turned marginally positive (see **Figure 12**). Since this positive gap is mostly due to falling investment, it cannot be considered as an encouraging development from the perspective of reviving economic activities and sustaining high growth over the medium term.

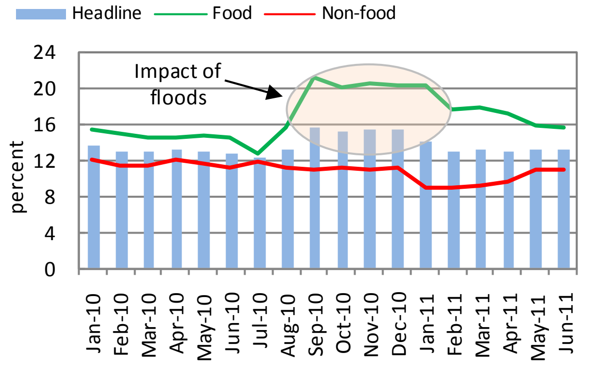
Figure 12: Saving Investment Gap



F. Inflation: High and Persistent

59. The impact of flood was not limited to disruption in economic activity but it also caused a spike in inflation, particularly during September 2010 to December 2010. In this period, the year-on-year CPI inflation averaged at 15.5 percent. There has been a modest decline in inflation since then as the impact of flood is dissipating (see **Figure 13**). For instance, the average of the year-on-year CPI inflation in the six-month post-flood period is 13.3 percent. However, a comparable six-month pre-flood average indicates that persistence of inflation is not due to floods alone.

Figure 13: Consumer Price Inflation (YoY)



60. Overall, the average CPI inflation in FY11 was 13.9 percent, which is slightly lower than SBP's earlier projections but higher than the target of 9.5 percent for the year (see **Table 10**). Importantly, this inflation is not limited to food items only as feared earlier due to floods. Prices of perishable food items, which were more severly affected after the floods, have declined considerably. On the other hand, prices of non-perishable items have increased, leaving the overall food inflation largely at the same level observed before the floods. Thus, it is the behaviour of non-food inflation that needs to be assessed more closely to understand the persistence of inflation. The non-food inflation has been more than 10 percent on year-on-year basis during the last two months after remaining in single digits during the previous four months (see **Figure 13**).

Table 10: Inflation Indicators
percent

	YoY		Average	
	Jun-10	Jun-11	FY11	FY12[1]
CPI Headline	**12.7**	**13.1**	**13.9**	**11-12**
Food group	14.5	15.7	18.0	-
Non-food group	11.2	11.0	10.5	-
Core Measures				-
NFNE	10.4	10.4	9.7	-
20% Trimmed	11.7	12.0	13.0	-

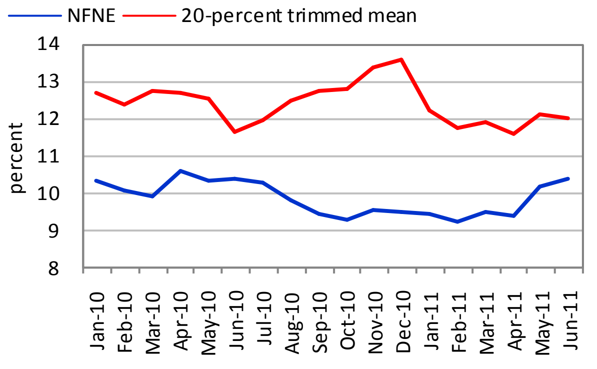
[1] Projections
Source: FBS and SBP

61. Furthermore, increase in electricity tariffs and adjustments in domestic oil prices did contribute to inflation both directly and indirectly.[1] The indirect effect is

[1] Passing the increase in international oil prices and cost of electricity generation to consumers is required under current economic environment though it results in a temporary increase in inflation. If the government continues to subsidize domestic oil and electricity bills, it will have adverse implications for its fiscal position as well as for inflation.

evident in both the measures of core inflation. While 20-percent trimmed mean has been fluctuating around 12 percent for the last six months, the non-food non-energy (NFNE) measure has risen to double-digits after remaining in a narrow range between 9.2 and 9.8 percent in the previous 9 months (see **Figure 14**). This shows that inflationary pressures are fairly broad based. For instance, the number of CPI items showing year-on-year rise of more than 10 percent has increased to 195 in June 2011 compared to 153 in June 2010.

Figure 14: Core Inflation (YoY)



62. This assessment suggests that CPI inflation is likely to persist in double digits in FY12, though it is expected that it will be lower than the outcome of FY11. It is important to remember that a cumulative increase of 150 basis points in SBP's policy rate during H1-FY11 greatly helped in making this incremental gain. The persistence of inflation essentially indicates that the gap between aggregate demand and supply is still significant and that high inflation expectations are prevalent. Efforts to contain demand through monetary policy have been diluted by an expansionary fiscal policy, while aggregate supply has been affected by falling productivity due to severe energy shortages and deteriorating law and order conditions. Consistent with real GDP growth target of 4.2 percent, outlook of the fiscal and external accounts, and expected money growth of 15 to 16 percent, inflation is projected to fall in the range of 11 to 12 percent.

63. The announced target of average CPI inflation for FY12 is 12 percent. The government has also announced in the MTBF a desired path of inflation of 9.5 and 8 percent for the subsequent two years. Adherence to the broad fiscal parameters of MTBF would facilitate a reduction in aggregate demand and help achieve the inflation target. An improvement in the fiscal position is also expected to reduce government borrowings from the banking system and create space for the private sector. The resulting expected increase in investment would enhance the productive capacity of the economy and help further narrow down the output gap. Government's commitment to continue to limit its borrowings from the SBP would also be beneficial for lowering the expectations of inflation.

III. Concluding Remarks

64. Pakistan's economy is currently facing three broad challenges in the shape of persistence of inflation at a high level, falling private investment and low growth, and rising total debt due to a low tax to GDP ratio. At the same time, severe energy shortages and dismal law and order conditions have rendered the domestic economic environment least conducive for productive activities. Developments in the global economy are not that encouraging either from the perspective of international commodity prices and trade flows. In these circumstances, SBP's monetary policy has been striving to bring inflation down, keep financial markets stable, and build foreign exchange reserves. The over arching objective is to promote macroeconomic stability and provide a foundation for sustainable economic growth.

65. After increasing the policy rate by a cumulative 150 basis points during H1-FY11, SBP has kept it unchanged since January 2011. SBP conducted its liquidity operations in line with this stance while remaining cognizant of changing macroeconomic conditions affecting day to day availability of liquidity. At the same time SBP delivered stability in the payments system and also managed to build foreign exchange reserves. The uncertainty surrounding government borrowing pattern from the banking system did result in relatively higher volatility in the money market overnight repo rate, but the overall change in market interest rates followed the monetary policy stance.

66. Different components of monetary aggregates responded differently to these interest rate changes. For instance, the demand for credit by the private sector, especially for fixed investment, remained subdued while that of the government increased substantially. Similarly, accumulation in the NFA, on the back of an improved external current account, changed the composition of monetary aggregates, especially the reserve money. While increase in the share of NFA in monetary expansion is an indicator of somewhat restrained aggregate demand, and therefore relative stability in inflation, the increase in government borrowings indicate that the decline in aggregate demand has been less than desirable.

67. At the same time, factors such as deteriorating law and order conditions and severe energy conditions are seriously affecting the real productive economic activity. This is constraining the current utilization and future expansion of the economy' productive capacity. A key indication is the falling investment to GDP ratio.

Thus, while the overall aggregate demand may have moderated, the gap between aggregated demand and supply has not, which explains the persistence of inflation.

68. The continuation of these trends can undermine efforts to bring inflation down and mitigate inflationary expectations. Both the core inflation measures indicate that inflation is not limited to the prices of few items, even after accounting for the impact of floods on prices of food items, and is in fact quite broad based. A positive development from the perspective of inflation expectations is that government has shown its commitment to limit its borrowings from the SBP. While remaining cognizant of unanticipated and sporadic adjustments in administered prices of electricity and oil together with movements in international commodity prices, a meaningful reduction in inflation would require consistent and credible implementation of monetary and fiscal policies.

69. The structural weaknesses in the fiscal accounts, such as low tax to GDP ratio and rigid current exp`enditures, are causing fiscal slippages and is increasing government borrowings from the banking system as well as the share of relatively expensive domestic debt in the total debt. Given an increase in the banking system's NPLs, banks' incentives to lend for long term private sector projects are not very strong either; government's growing financing needs are providing them with ample opportunity to invest in risk free government securities. This is curtailing the pool of funds for the private sector at a time when the economy needs it most. Moreover, the reliance on short term bank borrowings has increased the amount and frequency of rollovers of T-bills along with the exposure to the interest rate risk for both the government and scheduled banks.

70. These considerations underscore the need to accelerate the implementation of fiscal reforms currently being considered by the government. These include, but are not limited to, broadening the tax base by bringing all the sources of income into the tax net, restructuring and privatization of loss making PSEs, and developing a forward-looking debt strategy. The government has announced a MTBF, which provides a path of fiscal deficit in the next three fiscal years. An effective implementation of fiscal reforms and better coordination with the provinces would be required to implement this plan.

71. On the external front, improvement in the current account due to a phenomenal growth in exports and strong growth in workers' remittances helped SBP in building foreign exchange reserves. However, fragile global economic

conditions, declining financial inflows, and dominance of price effect in both exports and imports suggest caution in assessing the outlook of the overall balance of payments position.

72. Against this backdrop, SBP has decided to reduce the policy rate by 50 basis points to 13.5 percent effective 1st August 2011. The key parameter in this assessment is the outlook of inflation that indicates that average inflation in FY12 is expected to remain in line with the announced target. No adjustment in the interest rate would have entailed further tightening of monetary policy in real terms, which is not warranted given the decline in private investment. Moreover, despite fiscal slippages, the government has adhered to restricting the stock of its borrowings from SBP to Rs1155 billion (on cash basis). In fact, the government retired these borrowings compared to both the end-June 2010 level as well as the mutually agreed limit of end-September 2010 level. The government has also expressed its commitment to continue with a stance of zero borrowings from SBP in yearly flow terms in FY12, which bodes well for anchoring inflation expectations. However, the developments related to expected financial inflows and pattern of government borrowings from scheduled banks will need to be monitored closely to assess potential risks for macroeconomic stability.