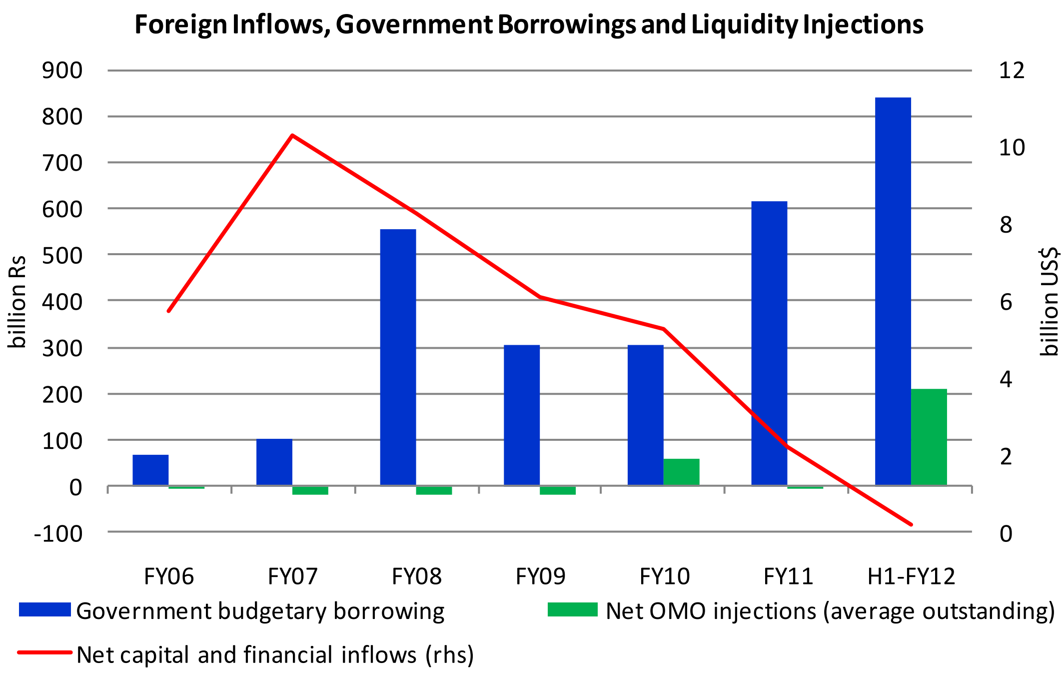
Monetary Policy Statement

February 2012



STATE BANK OF PAKISTAN

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Contents

List of Tables

List of Figures

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Executive Summary

1. The basic challenge faced by Pakistan's economy is financing its fiscal and external current account deficits. The size of these deficits may not be considered large given the current state of falling private sector investment demand in the economy. A reflection of overall low aggregate demand can be seen in the declining inflation trend, contraction in the real private sector credit, and falling volume of imports. The SBP's monetary policy stance in FY12 so far, a cumulative reduction of 200 basis points, has been largely framed in this context.

2. The lack of diversified and sustainable financing sources has resulted in substantial borrowings from the banking system by the government and declining foreign exchange reserves. This has squeezed the availability of credit for the private sector and increased the pressure on liquidity. The SBP has been providing substantial liquidity on almost permanent basis, on average Rs230 billion during 1st July – 9th February 2012, to ensure smooth functioning of the payment system and avoid financial instability. The continuation of this trend, however, carries risks for effectively anchoring inflation expectations in the medium term.

3. The uncertain market liquidity flows have lead to excess volatility in short term interest rates and increased the challenges of monetary management. The main reasons for this uncertainty include: a sharper deterioration in the external current account deficit, a declining trend of foreign inflows, and a higher currency to deposit ratio. However, other market interest rates, such as KIBOR and Weighted Average Lending Rate (WALR), have largely followed the policy rate reductions.

4. A declining interest rate environment together with a relatively better growth in Large-scale Manufacturing (LSM) is expected to help the pickup in private sector credit. The LSM sector grew by 1.5 percent during July-November, FY12, which is in contrast to an average contraction of 3.1 percent during the same period of last three years. Moreover, credit to the private sector has expanded by Rs238 billion during 1st July – 3rd February, FY12. However, to assess its likely path few points need to be kept in mind.

5. First, given the continuing energy shortages, unfavorable law and order conditions, and an uncertain political environment, the desired boost in business confidence and thus private sector credit may not take place. Second, profitability of the textile sector, a major user of private sector credit, was better in FY11 due to

higher cotton prices. This would facilitate repayments or keep the demand for fresh credit to a minimum in FY12. Third, the utilization of installed industrial capacity is considerably low and continues to decline, which is inhibiting credit demand for fixed investment. Fourth, all of the fresh credit disbursement in H1-FY12 was utilized to meet the working capital requirements, which implies that a significant part of this credit will be retired in H2-FY12.

6. Thus, the full year expansion in credit to the private sector is expected to remain weak for yet another year in FY12 despite interest rate reductions. Its year-on-year growth is already negative in real terms and indicates depressed private investment demand in the economy. In addition, given substantial government borrowings from the scheduled banks together with rising NPLs, banks are likely to continue to avoid lending to the relatively riskier private sector.

7. According to provisional data, the government has borrowed Rs444 billion from the banking system, during 1st July – 3rd February, FY12 to finance its current year's fiscal deficit. This includes Rs197 billion borrowed from the SBP and shows a year-on-year growth of 25.8 percent. Moreover, these borrowings are significantly higher than the yearly financing requirements of Rs293 billion envisaged in the FY12 budget.

8. The provisional estimate of fiscal deficit for H1-FY12, from the financing side, shows a deficit of Rs532 billion or 2.5 percent of GDP. Given that the fiscal deficit is always higher in the second half of a fiscal year, by at least 0.5 percent of GDP during the last ten years, containing the FY12 fiscal deficit close to the government's revised target of 4.7 percent of GDP would be difficult. Encouragingly, the tax collection by the Federal Board of Revenue during H1-FY12, at Rs840 billion, has shown a strong growth of 27.1 percent. Similarly, the announcement of auction of 3G licenses in the telecommunication sector is a positive development and could help in containing the potential fiscal slippage.

9. However, based on the seasonal pattern of tax collections, the full year target of Rs1952 billion still seems ambitious. At the same time, there are indications that the issue of circular debt in the energy sector remains and losses of major Public Sector Enterprises (PSEs) continue to increase. Thus, the likelihood of slippages on the expenditure side on account of subsidies, over and above the budgeted amount, cannot be ruled out. The delay in these subsidy payments may have implications for resolving the circular debt issue.

10. The risks to external position have also increased due to worsening terms of trade, fragile global economic conditions, and continued paucity of financial inflows. In addition, $1.1 billion are scheduled to be repaid to the IMF in H2-FY12. The SBP's foreign exchange reserves have already declined to $12.2 billion as on 9th February 2012 from $14.8 billion at end-June 2011. Similarly, the rupee-dollar exchange rate has depreciated by 5.2 percent in FY12 so far.

11. Led by 33.7 percent growth in imports of petroleum products on the back of elevated international oil prices, total imports have increased to $19.7 billion in H1-FY12. The volume of imports remained muted, which indicates moderation in domestic demand pressures. Given the rising tensions in the US-Iran relations and political uncertainty in the Middle East region, the oil prices are unlikely to fall significantly in the near future and may even increase. Therefore, despite low volumes, imports are projected to grow in the range of 12.5 to 14.5 percent for FY12.

12. Similarly, while the falling cotton prices played their part in sharper than expected slowdown in export receipts, $12 billion in H1-FY12, the volume of exports have also declined considerably. Assuming that these trends would continue in H2-FY12 export receipts are projected to show a decline of 3 to 5 percent in FY12. Incorporating a steady flow of workers' remittances, the external current account deficit is expected to remain in the range of $3.5 billion to $5.5 billion or 1.5 to 2.4 percent of GDP. The possibility of limiting the deficit to the lower bound of the range is mainly contingent upon the realization of Coalition Support Fund, $800 million, and the proceeds from the auction of 3G licenses, estimated to be around $850 million.

13. The real challenge is to finance this projected external current account deficit. The actual net capital and financial inflows during H1-FY12 was only $167 million due to decline in both the direct and portfolio investments and shortfalls in official flows. Assuming that all the official flows contemplated by the government are realized – $500 million from the issuance of euro bonds, $800 million from the privatization proceeds of PTCL, and budgeted loans from international financial institutions – the net capital and financial inflows could increase to $3.8 billion by June 2012.

14. These fiscal and external developments have resulted in a skewed composition of monetary aggregates. In particular, the increase in the Net Domestic Asset (NDA) component of M2 is disproportionally large while the Net Foreign Assets (NFA) has contracted. Given its strong correlation with inflation, the resulting

increase in the NDA to NFA ratio is not a welcome development. The year-on-year growth in M2 for FY12 is projected to be in the range of 12 to 13 percent.

15. The changing composition of M2 requires a careful interpretation. For instance, the deterioration in the external sector is mostly due to adverse terms of trade developments and uncertain official inflows and may not be a sign of rising aggregate demand. Similarly, the pressure on aggregate demand due to the government borrowings from the banking system is being partly offset by the weak private investment demand.

16. These conjectures are supported by the decline in year-on-year CPI inflation to 10.1 percent in January 2012. In addition to moderation in aggregate demand, this also reflects improvement in domestic supplies of food items. However, there are indications of underlying inflationary pressures. For instance, the number of CPI items showing year-on-year inflation of more than 10 percent is significant and mostly belong to the non-food category.

17. The SBP expects the average inflation in FY12 to remain in the range of 11 to 12 percent, which implies an uptick in inflation in H2-FY12. The main reasons for this assessment include: increases in electricity and gas prices, high international oil prices, impact of exchange rate pass-through, increase in support price for the upcoming wheat procurement season, and substantial government borrowings from the banking system.

18. For inflation to come down further, the implementation of the Medium Term Budgetary Framework (MTBF) is imperative. The MTBF envisages a systematic reduction in the fiscal deficit to 3.0 percent of GDP in FY14 by increasing the tax to GDP ratio and stipulates inflation targets of 9.5 percent for FY13 and 8 percent for FY14. Decisive reforms in the energy sector can also go a long way in achieving the MTBF targets. These reforms not only will reduce the government's reliance on banking system borrowings but also minimize the need to adjust the energy prices in a sporadic and unpredictable manner. Both these factors would help in improving the effectiveness of monetary policy and its contribution in keeping inflation low and stable.

19. In conclusion, despite moderate aggregate demand, pressure on rupee liquidity is likely to continue due to uncertain foreign inflows and substantial government borrowings to finance the fiscal deficit. Moreover, inflationary pressures

have not eased significantly. It must be emphasized that sustainable economic recovery over the medium term would call for a sizeable increase in both the domestic and foreign private investment in the economy. For this to happen, the business confidence needs to be revived by reducing uncertainties due to energy shortages. Against this backdrop, the Central Board of Directors of SBP considers the 200 bps reduction in the policy rate, already introduced in FY12, to be appropriate and has decided to keep the policy rate unchanged at 12 percent.

I. Economic Environment during H1-FY12

1. The SBP lowered its policy rate by a cumulative 200 basis points (bps) in H1-FY12; 50 bps in July 2011 and 150 bps in October 2011. The decision was primarily motivated by a high probability of meeting the 12 percent CPI inflation target for FY12 and the need to revive the private investment demand in the economy. The initial projections of a moderate external current account deficit and controlled government borrowings from SBP in Q1-FY12 also helped in introducing aggressive reductions in the policy rate.

2. However, faster than anticipated widening of the external current account deficit and persistence of inflationary pressures were the main factors in keeping the policy rate unchanged at 12 percent in the November 2011 monetary policy review. In pursuing this stance, SBP expressed its concerns regarding substantial injections of liquidity in the system due to heavy borrowings of the government from the scheduled banks and declining foreign exchange reserves. The permanent nature of these injections has posed a dilemma for SBP in terms of striking an appropriate balance between prudent liquidity operations to anchor inflation expectations and payment system stability.

3. The SBP has consistently highlighted risks to macroeconomic stability emanating from fiscal weaknesses and falling foreign financial inflows. These include resurgence of medium term inflationary pressures and difficulty in preserving foreign exchange reserves. In this context, it has repeatedly pointed out the need to initiate comprehensive fiscal reforms, in particular those related to increasing the tax base of the economy, and curtail its borrowings from the SBP. A permanent solution to the energy sector problems is also critical in reducing the subsidy burden and in improving the effective utilization of installed productive capacity.

4. At the beginning of FY12, the government had expressed its commitment to keep the yearly flow of its borrowings from SBP to zero. The government did adhere to its commitment in Q1-FY12 and in fact retired borrowings from SBP. This was not the case in Q2-FY12 and government borrowed substantial amounts from SBP.

5. The SBP was also aware of the increasing vulnerabilities of the external sector. The deterioration in the external current account balance from September 2011 onwards, emanating from an enlarged trade deficit, was beyond expectations. With unmatched financial inflows, the foreign exchange reserves of the SBP had a dip and

pressure on the exchange rate increased. These developments put a caution for the SBP policy decision due to their unfavorable consequences for inflation outlook.

6. In the absence of external sources of financing, government's efforts to contain its borrowings from SBP resulted in an increase in borrowings from the scheduled banks. In H1-FY12, these borrowings grew significantly and indicated continued fiscal pressures despite good growth in tax revenues. Moreover, substantial current and expected borrowing requirement of the government from scheduled banks was one reason why banks continued to avoid their exposure to the relatively risky private sector despite decent growth in deposits.

7. The SBP was aware that reducing the policy rate might not have the desired impact on private sector credit unless issues with energy sector are resolved. As part of the solution to the energy sector problems, the government has partially retired the outstanding inter-agency circular debt of the energy sector by issuing government securities in Q2-FY12. It was expected that this measure would contribute significantly in not only addressing the energy shortages in the country but also enable allocation of bank's stuck up resources to more productive activities.

8. Similarly, to promote competition in the banking system, incentivize savings in the economy, and lower the currency in circulation, SBP has encouraged depositors to invest in government securities through Investor's Portfolio Securities (IPS) accounts. Over time, this strategy would help in diversifying government's funding source, deepen the secondary market of government securities, and facilitate the issuance of corporate debt.

9. The domestic economy was also affected by fragile global economic conditions. The global economy slowed down further due to deep-seated euro zone sovereign debt crisis, fragile financial conditions, and intractable fiscal issues running through other developed economies such as the USA and England. While the frantic efforts by policy makers – extraordinary fiscal stimuli, record low interest rates, and buying government securities through money creation – might have averted a depression, they have complicated the exit strategy. This is especially true for central banks. The monetary policy now seems subservient to sovereign debt and financial stability considerations.

10. The downgrade in credit ratings of many advanced economies, including the USA, has complicated matters further by making it more challenging to raise debt to

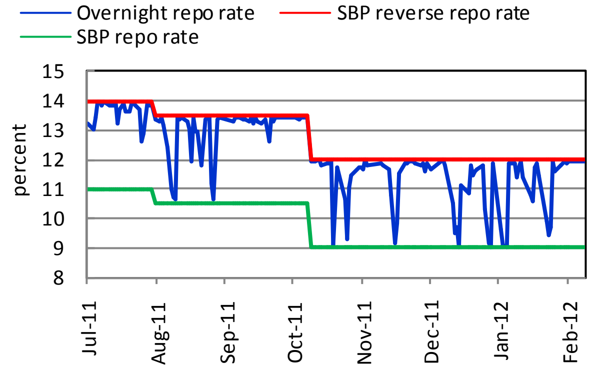
finance large fiscal deficits. The financial markets remain nervous, especially in the euro zone, and await progress on a medium term and credible fiscal consolidation strategy. Emerging markets are also experiencing slowdown in their economies. These developments have increased uncertainty and blurred the prospects of global economy recovery.

11. The basic message of these global developments should not be missed by economies like Pakistan that are experiencing fiscal difficulties and rising public debts. If fiscal issues are 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. Implementing Policy Stance: Managing Liquidity Flows

Figure 1: Movements in SBP's Operational Target in FY12



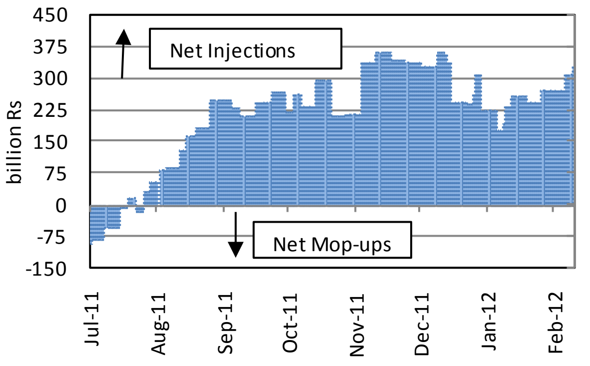
12. Given SBP's operational monetary policy framework, the overnight money market repo rate should have come down by an average of 200 bps after a cumulative reduction in the policy rate of the same magnitude in H1-FY12. SBP's liquidity operations were expected to provide the residual liquidity demanded by the system to maintain the overnight repo rate in the middle of interest rate corridor. However, the overnight rate declined by only 94 bps on average up till 9th February 2012 and remained higher than the middle of the corridor, 10.5 percent, despite substantial liquidity injections by the SBP. Moreover, reflecting uncertainty in market liquidity conditions it exhibited excessive volatility (see **Figure 1**).[1]

13. The higher requirement for liquidity is evident from the rising amount of outstanding injections through Open Market Operations (OMOs). Since end-August

[1] This refers to the average decline in the overnight money market repo rate between 1st August 2011 to 9th February 2012, compared to the average rate observed during 1st December 2010 to 30th July 2011 — the period during which the policy rate was kept unchanged. During the same period, the coefficient of variation has increased from 7.0 percent to 11.0 percent.

2011, a substantial amount is being continuously rolled over with occasional fluctuations due to changing market conditions (see **Figure 2**). The outstanding amount of liquidity injections peaked at Rs360 billion in mid-December 2011, whereas the average for H1-FY12 was Rs205 billion. As on 10th February 2012, the outstanding amount of liquidity injections is Rs326 billion. This is significantly higher than normal SBP operations and has developed characteristics of a permanent nature, which poses risks to inflation outlook. Despite these risks, SBP continues to inject liquidity to ensure smooth functioning of the payment system and avoid financial instability.

Figure 2: Outstanding Open Market Operations



14. At the same time, scheduled banks have been resorting more frequently to both the SBP's reverse repo (discount window) and repo facility to avail large amounts of liquidity or place excess funds. For instance, the average amount discounted per visit, during 1st July – 9th February, FY12 was Rs20 billion, which is much higher than the average amount of Rs13 billion during the last two fiscal years. This high volume and frequency of access to the discount window or the repo facility by the financial institutions reflects uncertainty of market flows.

15. These developments in the overnight money market repo rate and market liquidity conditions can be explained by considering deviations in macroeconomic conditions compared to their earlier projected path. These include a sharper deterioration in the external current account deficit, unpredictable pattern of government borrowing from the banking system, and a higher currency to deposit ratio (see **Table 1**). SBP did neutralize their liquidity implications to ensure consistency with the monetary policy stance through substantial liquidity interventions.

Table 1: Inter-bank Market Liquidity Conditions
billion rupees, unless stated otherwise

	Q1-FY12	Q2-FY12
Total deposits[1]	-62.3	352.8
Currency in circulation	42.5	47.2
NFA of the banking system	-82.9	-57.2
Net budgetary borrowing from SBP	-101.9	219.2
Private sector credit	-88.7	282.2
Commodity finance	-2.8	-60.8
T-bill auctions (net of maturities)	255.8	-96.5
Average outstanding OMOs, repo, reverse repo	154.7	296.6
Average overnight money market repo rate (%)	13.2	11.5

[1] Excluding government deposits.
Source: SBP

16. The actual external current account deficit of $2.2 billion during H1-FY12 is already higher than the earlier projected deficit for the year. This together with lower foreign financial inflows increased pressure on the exchange rate. Although SBP's monetary policy framework entails an exchange rate regime that is responsive to market conditions, but to quell speculative pressures SBP did support the market through foreign exchange interventions. Consequently, rupee liquidity from the system contracted as reflected in decline in the net foreign assets of SBP. Thus, unlike FY11 when SBP was building foreign exchange reserves and generating rupee liquidity, a weak balance of payment position in FY12 has become a source of liquidity drain.

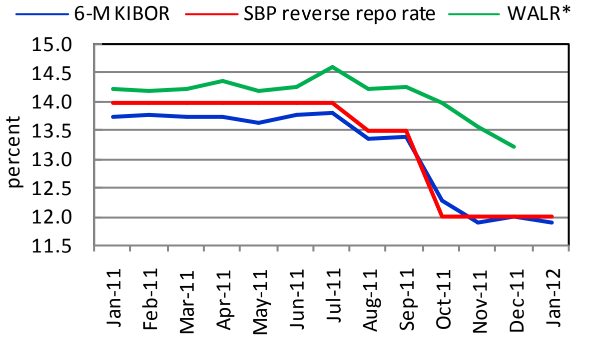
17. Similarly, the pattern of government borrowing from the banking system added to the challenges of liquidity management. For instance, during Q1-FY12, government raised Rs100 billion over and above the announced T-bill auction target for the quarter. This increased pressure on market liquidity and kept the overnight repo rate closer to the corridor ceiling despite substantial liquidity injections by the SBP. However, during Q2-FY12, the government was unable to even rollover the maturing T-bills, mainly because of low participation in the last two auctions of Q2-FY12. The government accepted Rs840 billion against a target of Rs1025 billion for Q2-FY12, which increased availability of liquidity in the market.

18. A more noticeable development is that the scheduled banks placed lower bids in some of these auctions, which is a realization of the rollover risk on government's outstanding obligations highlighted earlier by SBP. Given the institutional arrangement, government borrowed from SBP to settle its maturing debt with scheduled banks. The outstanding stock of government's borrowings from SBP had already been rising since the beginning of Q2-FY12 after a net retirement of Rs104 billion in Q1-FY12.

19. Thus, government's debt management has contributed in making market liquidity flows unpredictable, leading to excess volatility in short term interest rates. This has distorted the price discovery mechanism in the interbank market and weakened the effectiveness of monetary policy signals. More importantly, it created uncertainty in the market regarding government's borrowing needs from the scheduled banks. From the monetary management point of view, it has created additional challenges in striking an appropriate balance between prudent liquidity operations to anchor inflation expectations and payment system stability.

20. Despite excessive volatility in the money market overnight repo rate, other market interest rates have remained steady and broadly followed the policy rate reduction (see **Figure 3**). However, the average spread between policy rate and 6-month Karachi Interbank Offered Rate (KIBOR) has narrowed to only 12 bps after the cumulative 200 bps reduction in the policy rate. This spread was 27 bps on average during 1st December 2010 to 30th July 2011 when the policy rate was kept unchanged. In SBP's assessment, the market interest rates could have declined more, by at least 15 bps, had there been relative stability in the overnight repo rate around the middle of the corridor.

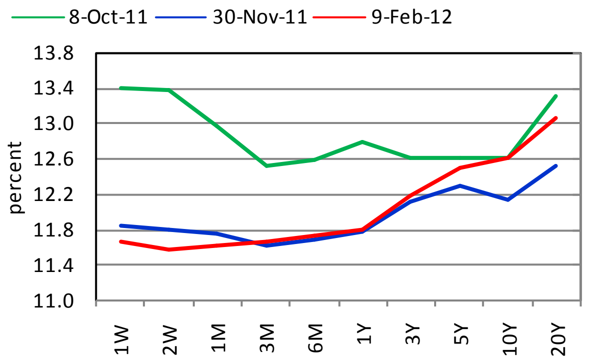
Figure 3: Movement in Policy and Market Interest Rates



* Weighted average lending rate (incremental)

21. Moreover, after the November 2011 review, when the SBP kept the policy rate unchanged, some market interest rates have been increasing gradually (see **Figure 4**). For instance, the rates for government securities for all tenors in the secondary market have increased on average by 26 bps, with most of the changes observed in longer tenors. As on 9th February 2012 the spread between 10 year PIB and the 6 month T-bill stood at 88 bps, which was 30 bps only before the November 2011 monetary policy review.

Figure 4: PKRV Yield Curves



22. One probable reason is the replacement of high priced Term Finance Certificates (TFCs) issued earlier with government securities of Rs391 billion to consolidate the outstanding inter-agency circular debt of the energy sector and the unpaid subsidy claims on account of government's commodity operations. This increased the supply of government securities and the bank's demand for additional securities declined on the margin. As a result, the secondary market yields on these securities have inched up.

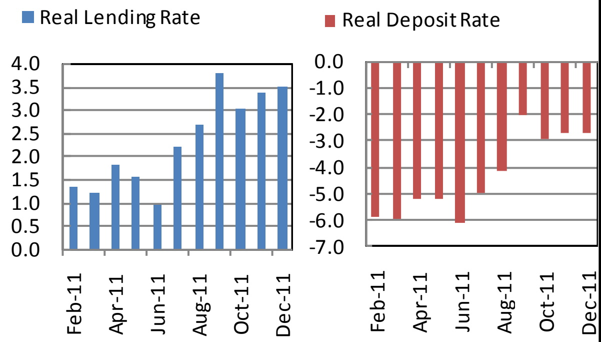
23. The decline in incremental lending rates to the private sector – the Weighted Average Lending Rate (WALR) – is less than the reduction in the policy rate and

KIBOR during H1-FY12. Specifically, WALR has declined by 139 bps up till December 2011, increasing its spread with the 6 month KIBOR to 125 bps from 47 bps in June 2011. This is partly because of the lag involved in contracting fresh loans in the new declining interest rate environment. As more and more fresh loans are availed at a relatively lower rate, the WALR may decline further.

24. The other reason for a gradual decline in WALR is a decline in banks' return on government securities. It is probable that to avoid this squeeze, they have been reluctant to lower the lending rates for the private sector more quickly. This is possible because their cost of raising funds as depicted by the Weighted Average Deposit Rate (WADR) has not changed yet in response to the policy rate reduction. To maintain their profitability, banks may lower the WADR in the coming months.

25. The real WALR, however, has increased due to declining inflation (see **Figure 5**). This trend is likely to change as inflation is expected to increase in H2-FY12 and the transmission of policy rate reductions further lowers the nominal WALR. A slightly positive real interest rate is expected to contain growth in aggregate demand at a moderate level and at the same time would help in maintaining the inflation on the targeted trajectory.

Figure 5: Real Interest Rates



* Nominal weighted average rate minus YoY CPI inflation

B. Monetary Aggregates: Skewed Composition

26. A declining interest rate environment has put pressure on banks to increase their exposure to the private sector as opposed to just placing their funds in the risk-free high-yielding government securities. This is because as their return from government securities declines on the margin, they will have to compensate it from other sources to avoid reduction in their profits. Thus, there may be an incremental improvement in the supply of credit to the private sector.

27. Similarly, a relatively better growth in Large-scale Manufacturing (LSM) sector is also expected to help the pickup in demand for private sector credit (PSC). The LSM sector grew by 1.5 percent during July – November, FY12, which is in contrast to average contraction of 3.1 percent in the LSM during the same period of last three

years. However, two points need to be kept in mind before assessing the full impact of policy rate reductions on the behavior of private sector.

28. First, given the infrastructural bottlenecks such as energy shortages, unfavourable law and order conditions, and an uncertain political environment, the desired boost in business confidence and thus private investment demand may not take place. As a result, the demand for credit by the private sector could remain weak despite interest rate reductions. Second, government borrowings from the banking system remain substantial and have remained largely unresponsive to interest rate changes. Banks are, therefore, likely to continue to avoid lending to the relatively risky private sector. Rising Non-performing Loans (NPLs) are already dettering banks to increase their exposure to the private sector.

29. In addition, exogenous variables like changes in key export and import prices in international markets and fragile global economic recovery are also affecting domestic economic conditions. A detailed, dis-aggregated, and careful assessment of the monetary data helps in evaluating the impact of these exogenous factors together with the reduction in interest rates on private, government, and net external demand.

30. The reserve money expanded by only 147.5 billion during 1st July – 3rd February, FY12. The Net Domestic Assets (NDA), which largely constitute SBP's liquidity operations and government borrowings from SBP, expanded by Rs333 billion. The Net foreign Assets (NFA), depicting the external sector pressures, contracted by Rs185.5 billion. Given its strong correlation with inflation, the resulting increase in the NDA to NFA ratio, to 3.9 from 2.2 on 30th June, 2011, is not a welcome development.

31. However, the changing composition of SBP's balance sheet requires a careful interpretation. For instance, the deterioration in the external sector is mostly due to adverse terms of trade developments and uncertain official inflows and may not be a sign of rising aggregate demand. Similarly, the pressure on aggregate demand due to the government borrowing from SBP is being partly offset by the weak private investment demand. The declining inflation trend and projections of meeting the 12 percent average inflation target for FY12 tend to support these conjectures.

32. A look at the behavior of broad money (M2) aggregates also confirms that most of the demand in the economy is from the government sector (see **Table 2**). For

instance, as on 3rd February, 2012, the year-on-year growth in government borrowing from scheduled banks to finance its current year's fiscal deficit is 60.3 percent. The year-on-year growth in private sector credit, on the other hand, is only 6.3 percent and given an average inflation of 10.8 percent during July – January, FY12, is negative in real terms. 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.

Table 2: Monetary Aggregates
billion rupees

	June 2011 Stocks	Flow during Jul 1-Feb 3 FY12[P]	Flow during Jul 1-Feb 4 FY11	FY12[1]
NDA: *of which*	5,914.9	500.0	370.0	1029.0
Net budgetary support	2,601.6	835.1	409.1	-
excluding PSEs debt		*444.1*	*409.1*	-
Commodity operations	397.5	-77.7	-72.8	-
excluding PSEs debt		*0*	*-72.8*	-
Private sector credit	3,141.2	237.8	158.2	-
Credit to PSEs	387.6	-270.9	20.2	-
excluding PSEs debt		*42.1*	*20.2*	-
NFA	780.3	-188.1	124.3	-213.0
Money supply (M2)	6,695.2	311.9	494.3	816.0
YoY growth		11.7	15.9	12.2
Memorandum items				
Net budgetary support				
from SBP	1,200.7	197.0	183.7	-
from scheduled banks	1,401.0	638.1	225.4	-
Currency in circulation	1,501.4	172.8	257.8	-
Total deposits	5,183.6	140.0	232.0	-
Reserve money	1,965.8	147.5	274.3	-
YoY growth		*8.2*	*16.5*	*11.9*

Source: SBP
[P] Provisional
[1] Projections

33. In flow terms, the PSC expanded by Rs283 billion in Q2-FY12, which is historically the highest flow of credit extended to the private sector in a quarter. This extraordinary expansion in PSC can partially be explained by a delay in cotton arrivals to the textile sector. The cotton arrivals to the ginners usually begin in the month of August or September, but this year the season began in October. Despite substantial credit flow in Q2-FY12, cumulatively the PSC expansion in H1-FY12 was limited to Rs193 billion as there had been more than usual seasonal retirements in Q1-FY12. One possible explanation for limited expansion in PSC in H1-FY12 is better corporate profitability in FY11, which facilitated repayments or kept the demand for fresh credit low.

34. An analysis of the detailed private sector credit data reveals that loans to private sector businesses have not followed the overall trend and in fact was less than half of the total extension of credit to the private sector. A major part of credit belongs in the 'others' category that includes credit to Non-bank Finance Companies (NBFCs) and some Public Sector Enterprises (PSEs).[2] Moreover, all of the fresh credit disbursement was utilized to meet the working capital requirements (see **Table 3**).

[2] There are some PSEs which are not covered in Weekly Monetary Survey and hence, credit to those PSEs becomes part of private sector credit. However, this difference is taken care of in monthly data on credit to Private Sector Businesses.

35. The credit for fixed investment, on the other hand, has contracted by Rs12.4 billion during H1-FY12. This reinforces the view that the primary factors for low credit demand for fixed investment remain the infrastructural bottlenecks such as energy shortages, unfavorable law and order conditions, and uncertain political environment. In addition, the utilization of installed capacity in major industries is considerably low and continues to decline, which explains low investment in the economy. The declining investment was one of the key considerations for SBP to ease its monetary policy stance in H1-FY12, given that inflation was expected to fall within its target for the year.

Table 3: Private Sector Credit
flows; billion rupees

	H1-FY11	H1-FY12	Q2-FY12
Total credit to private sector	**163.4**	**193.5**	**282.2**
1. Loans to private sector businesses	**190.2**	**85.2**	**180.4**
By type			
Working capital: *of which*	183.5	97.6	163.3
Trade Finance	50.8	-5.1	21.7
Fixed investment	6.7	-12.4	17.1
By Sectors: *of which*			
Agriculture	9.1	8.9	2.6
Manufacturing: *of which*	143.6	52.3	133.3
Textiles	106.3	30.8	75.2
Chemicals	14.4	-19.1	35.9
Food products & beverages	-0.6	7.3	11.7
Electricity, gas and water	23.3	29.8	25.4
Construction	3.0	-3.0	0.2
Commerce and trade	4.1	1.6	6.7
Transport, storage and comm.	3.0	-6.9	-0.2
Services	-0.5	-1.8	7.3
2. Personal: *of which*	-15.5	-8.1	-3.3
Consumer financing	-16.3	-7.3	-2.8
3. Investment in securities and shares	8.9	11.9	9.0
4. Credit to NBFI	5.6	24.2	18.0
5. Others	-25.9	80.4	78.2

Source: SBP

36. In terms of sector wise classification, all the major sectors have witnessed deceleration in credit compared to last year. In particular, the loan to the textiles sector, which typically avails a large share of credit to the manufacturing sector, is significantly lower than last year. In FY11, the profitability of the textile sector was substantial due to windfall gains on account of high cotton prices. High profitability along with subsequent decline in cotton prices in FY12 explains the relatively lower requirement for credit in H1-FY12, despite higher cotton procurement (see **Table 4**).

Table 4: YoY % Changes in Cotton Arrival and Average Prices

	Arrival with ginners	Price
October 2011	13.0	-18.9
November 2011	6.9	-37.6
December 2011	17.7	-40.8
January 2012	11.8	-44.6

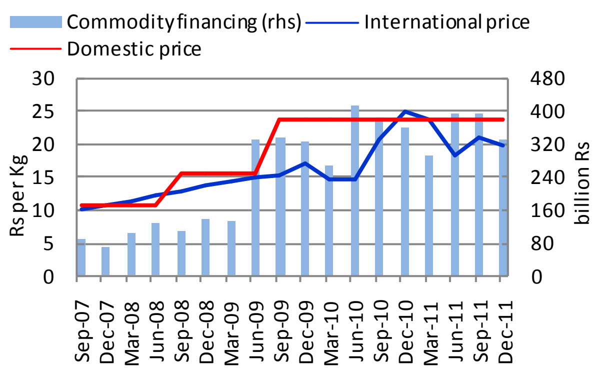
Source: Pakistan Cotton Ginners Association

37. Since the credit expansion in H1-FY12 was entirely for meeting working capital requirements, most of this credit, following its usual behavior, is likely to be retired in H2-FY12. This implies that full year expansion in credit to the private sector is expected to remain weak for yet another year in FY12. The pressure of borrowings from government and PSEs, on the other hand, is likely to continue until outlook of foreign inflows improves or fiscal reforms are undertaken.

38. In November 2011, the government converted TFCs of PSEs worth Rs391 billion that were on the books of banks into PIBs and T-bills. The purpose of this settlement was to restore the borrowing capacity of the PSEs and reduce the cost of borrowing as banks were paid a return higher than the rates on government securities. The PSEs involved in this settlement were from the energy sector and commodity procurement; while an amount of Rs313 billion was settled for the former, Rs78 billion were adjusted against the latter.

39. The credit to PSEs, excluding the settlement of circular debt, has expanded by Rs42 billion during 1st July – 3rd February, FY12. Due to the increased borrowing capacity, the PSEs are likely to continue their borrowings to make payments, which may temporarily decelerate the future growth in circular debt. This settlement, though partial, is expected to contribute in resolving the energy crisis to some extent. For a permanent solution of the circular debt, however, there is need to address the structural issues causing inefficiencies and deterioration in the financial condition of these PSEs.

Figure 6: Wheat Prices and Stock of Commodity Finance



40. The bank's credit for commodity financing is also expected to increase substantially in FY12 as the government has raised the procurement price to Rs1050 per 40 kg for the forthcoming wheat crop. As on 3rd February, 2012, after adjusting Rs78 billion, the stock of government borrowings for commodity operations stands at Rs320 billion (see **Figure 6**). While the international wheat prices are on a declining trend, the increase in domestic prices of wheat has reduced the incentive for its export by the private sector.[3] Consequently, the credit requirement for wheat procurement in Q4-FY12 could increase substantially due to both higher prices and volume of procurement.

41. The major driver of monetary expansion, however, has been the government borrowing for budgetary support from the banking system. During 1st July – 3rd February, FY12, government borrowed Rs835 billion. Adjusting for Rs391 billion that was used to retire the outstanding inter-agency circular debt of the energy sector

[3] A similar phenomenon was observed in FY09, when the government raised the wheat procurement price to Rs950 per 40 kg and international prices declined to significantly lower levels.

and the unpaid subsidy claims on account of government's commodity operations, government's current year budgetary borrowings come to Rs444 billion. This is significantly higher than the yearly financing requirements of Rs293 billion from the banking system envisaged in the FY12 budget.

42. Of the total budgetary borrowings, Rs197 billion were from the SBP. This has pushed the stock of net budgetary borrowing from the SBP to Rs1352 billion (on cash basis), which is higher than the mutually agreed limit of Rs1155 billion. Most of the incremental increase in these borrowings was in Q2-FY12 and largely due to the difficulties for the government to rollover the maturing T-bills. In particular, it had to accept less than the offered amounts particularly in the last two auctions of Q2-FY12. This has created uncertainty in the market regarding government's financing needs from the scheduled banks.

43. In addition to raising less than targeted amounts through auction of T-bills, the detailed auction results reveal that the government has also deviated significantly from its total announced target of Rs1775 billion for H1-FY12. While in Q1-FY12 the government exceeded the targeted amounts, it was unsuccessful in raising the desired amount in Q2-FY12. In total, it fell short by Rs85 billion. At the same time, it raised more than the targeted amounts in the PIB and Ijara Sukuk auctions (see **Table 5**). The results of the first three T-bill auctions of Q3-FY12 show that the government continues to deviate from the announced targets. Against the total target of Rs575 billion for Q3-FY12, it has already raised Rs386 billion in the first three auctions of the quarter.

Table 5: Auction Summary of Government Securities[1]

billion rupees; percent

	H1-FY12			Q3-FY12		
	Target	Realized amount	Cut-off rate[2]	Target	Realized amount	Cut-off rate[2]
T-bills	**1775**	**1690**	-	**575**	**386**	-
3-Month	-	124	11.83	-	101	11.74
6-month	-	579	11.67[4]	-	182	11.81
12-month	-	987	11.90	-	103	11.89
PIBs: *of which*	**95**	**103**	-	**50**	-	-
3-years	19	32	12.45	10	-	-
5-years	21	21	12.70	10	-	-
10-years	31	48	12.70	20	-	-
20-years	6	NBR[3]	-	10	-	-
Ijara Sukuk	**50**	**70**	-	**50**	-	-
Total	**1920**	**1863**		**675**	**386**	

Source: SBP

[1] Up to 9th February 2012

[2] These correspond to the last auction held during the period

[3] No bids received

[4] Rate corresponds to auction held on 30th November 2011 due to rejections of 6M bids in last two MTB auctions

C. Structural Fiscal Weaknesses: Decisive Reforms Needed

44. The heavy reliance on borrowing from the banking system is mainly a consequence of shortfalls in financing from the external sources. Compared to an estimated amount of Rs 135 billion in the FY12 budget, the government has received

Rs34 billion only in H1-FY12. For instance, the government has yet to receive approximately Rs115 billion expected from the remaining amount of PTCL privatization proceeds and issuance of euro bonds. In case these, along with other financing flows, do not materialize in H2-FY12 the borrowings from the banking system may continue.

45. Higher borrowings from the banking system also indicate a probable widening of the fiscal deficit. The provisional estimate of fiscal deficit for H1-FY12, from financing side, comes at Rs532 billion or 2.5 percent of GDP (see **Table 6**). This excludes the borrowings related to the settlement of circular debt. Given that the fiscal deficit is usually higher in second half of a fiscal year, containing the FY12 fiscal deficit close to the government's revised target of 4.7 percent of GDP seems difficult.

Table 6: Summary of Consolidated Fiscal Operations

billion rupees; unless indicated otherwise

	FY12[BE]	Q1-FY12	Q2-FY12[P]	H1-FY12[P]
Total revenue: ***of which***	**2870**	**534**		
FBR tax revenue	1952	374	466	840
SBP profit	200	54	50	104
CSF money	110	0	0	0
Total expenditures	**3721**	**791**		
Current: *of which*	3054	657		
Subsidies[1]	180	32		
Interest	791	177	205	382
Development	658	88		
Unidentified	0	45		
Budget Deficit	**-852**	**-257**		
Financing	**852**	**257**	**275**	**532**
External	135	-4	38	34
Domestic	717	262	237	499
Memorandum items (as percent of GDP)				
Overall fiscal balance	4.0	1.2	1.3	2.5
Inc. PSEs debt settlement	-	1.2	3.2	4.4
Primary balance[2]	0.3	0.4		
Revenue balance[3]	0.9	0.8		

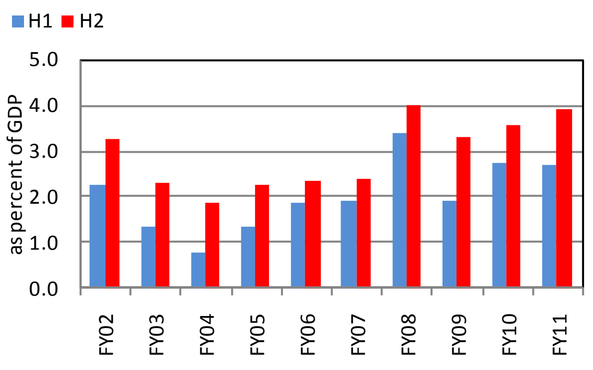
Source: Ministry of Finance and SBP

[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

46. During the last ten years the fiscal deficit in the second half of the fiscal year has been higher by at least 0.5 percent of GDP compared to the deficit in first half (see **Figure 7**). In some instances, the second half deficit has even exceeded the first half deficit by more than one percent of GDP. This suggests that it would be difficult to maintain the fiscal deficit for FY12 below 5.5 percent of GDP.

Figure 7: Seasonality in Fiscal Deficit



47. To manage the expected fiscal deficit, it is important that the government steps up its efforts to increase revenues and reduce expenditures. Encouragingly, the FBR tax collection during H1-FY12, at Rs840 billion, showed a strong growth of 27.1 percent as compared with a 13.7

percent growth registered during H1-FY11. This is primarily due to high growth in import related taxes, but was also contributed significantly by income tax and domestic component of sales tax. The collection of FBR taxes is in accordance with the target set by FBR for this period, however, based on the seasonal pattern of tax collections, the full year target of Rs1952 billion still seems ambitious. Even if the tax collection target is achieved, the tax to GDP ratio would reach 9.3 percent which is better than last year but may still not be sufficient in easing the fiscal stress.

48. Similarly, the announcement of auction of the 3G licenses in telecommunication sector is a positive development and will help in containing the fiscal deficit. However, compared to the budgeted amounts, a likely shortfall is expected in the realization of coalition support fund (CSF) and petroleum development levy (PDL). While the former is linked with geopolitical developments, the latter is due to the fact that in Q1-FY12 the government did not completely transfer the increase in international oil prices to the domestic market.

49. The likelihood of slippages on the expenditure side on account of subsidies, over and above the budgeted amount, cannot be ruled out either. There are indications that the issue of circular debt due to the continuing losses in the energy sector has not been completely resolved. The settlement of this debt would translate into an increase in subsidies beyond the budgeted amount. The delay in these subsidy payments may have implications for resolving circular debt issue. The permanent solution of the circular debt issue requires rationalization of electricity tariff in accordance with the cost of producing electricity and improving the overall efficiency of the energy sector.

50. As a result of low tax to GDP ratio and pressures on expenditures due to untargeted subsidies, the underlying fiscal imbalances are likely to breach their full year targets. For instance, the primary deficit during Q1-FY12 at 0.4 percent is already higher than its 0.3 percent target set in the FY12 budget. Similarly, the revenue deficit was 0.8 percent, which is also close to the full year target of 0.9 percent of GDP. Such high levels of primary and revenue deficits indicate that it would be difficult to manage the rising debt over the medium-term. During H1-FY12 public sector debt has already increased to Rs12 trillion. It has reached 61.1 percent of GDP and would be difficult to bring it in line with the target of 46 percent by FY14 as envisaged in the Medium Term Budgetary Framework (MTBF).

51. In SBP's assessment, the fiscal stress cannot be lowered significantly without comprehensive reforms that tackles: (1) existing tax distortions by bringing all sources of income into tax net; (2) documentation of the economy to reduce tax evasion; (3) improve provincial government's fiscal management, particualrly, revenue collection; and (4) loss-making PSEs to make them financially viable.

D. External Position: Uncertain Financial Inflows

52. The risks to external position have increased due to a larger than expected external current account deficit and continued paucity of financial inflows. As a result the foreign exchange reserves have declined and there is pressure on the exchange rate.

53. The external current account deficit has reached to $2.2 billion in H1-FY12, which is already higher than SBP's full year projection made at the beginning of FY12 (see **Table 7**). This deterioration is primarily due to a sharper widening of the trade deficit. In particular, the windfall gains to export receipts due to abnormally higher cotton prices in FY11 have dissipated faster than anticipated. The dominant impact of prices in the export performance of FY11 was always a source of concern, as it reflected an increased exposure of the economy to the movements in international commodity prices. Moreover, due to weaker than projected global economic recovery, the demand for exports also remained depressed. At the same time, continued energy shortages and delays in the cotton arrivals due to heavy rains in Sindh, which washed away around 2.0-2.5 million bales, also affected the export performance.

Table 7: Summary of Balance of Payments
billion US$

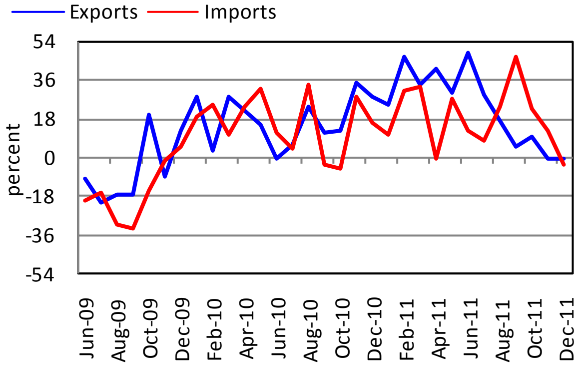
	H1-FY11	H1-FY12	FY12[1]
I. Current account balance	**0.0**	**-2.2**	**-3.5 to -5.5**
as % of GDP	*0.0*	*-2.1*	*-1.5 to -2.4*
Trade balance	-5.8	-7.6	-
Exports	11.1	12.1	-
Imports	16.9	19.7	-
Services balance	-0.3	-1.3	-
Income balance	-1.5	-1.6	-
Current transfers balance	7.6	8.4	-
Remittances	5.3	6.3	-
II. Capital and Financial	**1.0**	**0.2**	-
of which:			-
Direct investment	0.8	0.5	-
Portfolio investment	0.2	-0.1	-
Other official inv. Lib.	-0.1	0.1	-
III. Errors and omissions	**-0.1**	**0.2**	-
Overall balance (I + II + III)	**1.0**	**-1.8**	-
Memorandum items:			-
Net SBP forex reserves[2]	13.5	12.9	-
Exports growth	19.3	9.1	-3.0 to -5.0
Imports growth	11.2	16.9	12.5 to 14.5

Source: SBP
[1] Projections
[2] Excluding CRR and foreign currency cash holdings

54. As a result, total export receipts during H1-FY12 were $12.0 billion and their growth has turned negative. The year-on-year decline in exports is 0.8 percent in December 2011 compared to a high growth of 48.6 percent in June 2011 (see **Figure**

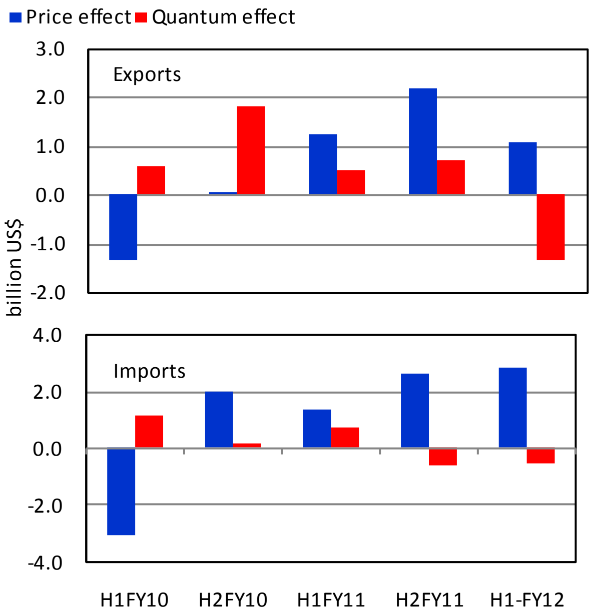
8). Separation of the impact of prices and quantum on the value of exports reveals that both the fall in international cotton prices and decline in export volume have contributed in this slowdown in export performance (see **Figure 9**). In H2-FY12, the impact of lower cotton prices is expected to be more pronounced. The international cotton prices have come down by 58 percent since its peak in March 2011. Assuming that these trends continue in H2-FY12, exports are projected to show a decline of 3 to 5 percent in FY12.

Figure 8: YoY Growth in Imports and Exports



55. Total imports in H1-FY12 were $19.7 billion, which show a growth of 17.0 percent over H1-FY11. This growth is largely being contributed by the imports of petroleum group which have grown sharply by 33.7 percent on the back of elevated international oil prices. Contrary to expectations of international oil prices coming down to around $100 per barrel, they are still hovering around $115 per barrel. The overall import growth is not being contributed by the volume of imports and therefore cannot be attributed to domestic demand pressures. Given the rising tensions in the US-Iran relations and political uncertainty in the Middle East region, the oil prices are unlikely to fall significantly in the near future and may even increase. Therefore, despite low volumes, imports are projected to grow in the range of 12.5 to 14.5 percent for FY12.

Figure 9: Composition of Changes in Exports and Imports*



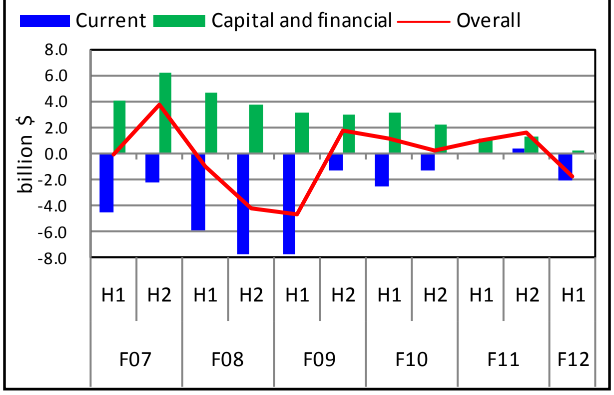
* Based on FBS data

56. The combined impact of a decline in exports and significant import growth, together with steady flow of workers' remittances, is expected to result in an external current account deficit of $3.5 billion to $5.5 billion or 1.5 to 2.4 percent of GDP. The possibility of limiting the deficit to the lower bound of the range is mainly contingent upon the realization of CSF ($800 million) and the 3G license fee ($852

million). From an historical perspective, the projected external current account deficit does not appear to be a cause of concern, as the country has experienced much higher deficits in the past.

57. Nevertheless, the economy would need a surplus of at least $3.5 billion in the capital and financial account in FY12 to finance the external current account deficit without using the foreign exchange reserves. The actual net capital and financial inflows during H1-FY12 were only $167 million (see **Figure 10**). Given the current trend in foreign investment inflows, the maximum projected amount of net capital and financial inflows in FY12 would be around $3.8 billion. This assumes that all the official flows contemplated by the government are fully realized. For instance, the government is planning to raise $500 million though issuing euro bonds, and $800 million from the privatization proceeds of PTCL.

Figure 10: Balance of Payments

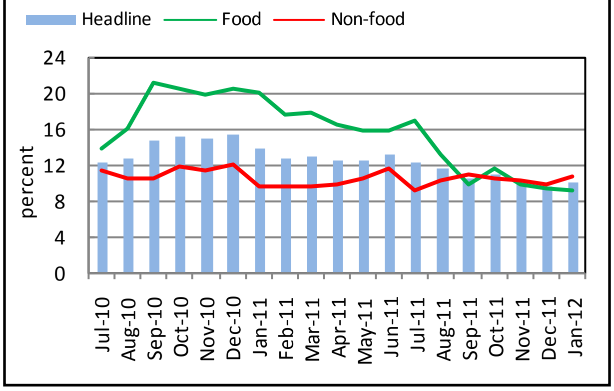


58. In addition, $1.1 billion are scheduled to be repaid to the IMF in H2-FY12. This will make the task of managing foreign exchange reserves even more challenging. SBP's liquid foreign exchange reserves have already come down to $12.2 billion by 8th February, 2012 from $14.8 billion at end-June 2011. Similarly, the rupee-dollar exchange rate is under pressure and has depreciated by 5.2 percent in FY12 so far.

E. Declining Inflation: A Positive Development

59. The decline in year-on-year CPI inflation to 10.1 percent in January 2012 is a positive development. This is contributed by both food and non-food groups though the share of falling food inflation is higher than the decline in non-food inflation (see **Figure 11**). Food inflation has come down from 15.9 percent in June 2011 to 9.2 percent in January 2012 (see **Table 8**). Similarly,

Figure 11: Consumer Price Inflation (YoY)



month-on-month inflation has declined to 0.9 percent on average during July – January, FY12 compared to 1.3 percent in the corresponding period of the last year.

60. This declining trend in inflation is due to moderation in aggregate demand as well as improvement in domestic supplies of food items. Indicators of moderation in demand include a contraction in real private sector credit and deceleration in volume of imports. Favorable weather conditions and positive impact of floods last year improved productivity resulting in increased production of minor crops in particular. Moreover, international food prices have also been declining and many of the domestic food items are following these trends.

Table 8: Inflation Indicators

	YoY		Average	
	Jan-11	Jan-12	Jul-Jan FY12	FY12[1]
CPI Headline	***13.9***	***10.1***	***10.8***	***11-12***
Food group	20.2	9.2	11.4	-
Non-food group	9.7	10.7	10.3	-
Core Measures				-
Non-food non-energy	9.9	10.3	10.2	-
20% Trimmed	12.1	10.4	11.6	-

Source: FBS and SBP

[1] SBP's projections

61. To some extent low private sector demand has been offset by the elevated government spending as indicated by their substantial borrowings from the banking system. Similarly, the effective utilization of installed productive capacity of the economy remains depressed due to continued electricity and gas shortages. This explains the relatively slower decline in underlying inflationary pressures (see **Figure 12**). For instance, the 20 percent trimmed core inflation, has come down to 10.4 percent in January 2011 from 12.4 percent in June 2011, but the number of CPI items showing inflation of more than 10 percent is still significant and mostly belong to the non-food category (see **Figure 13**).

Figure 12: Core Inflation (YoY)

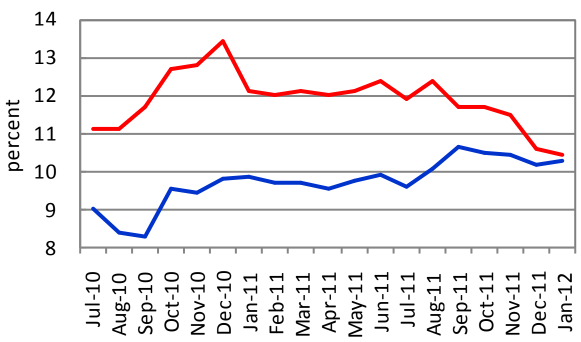
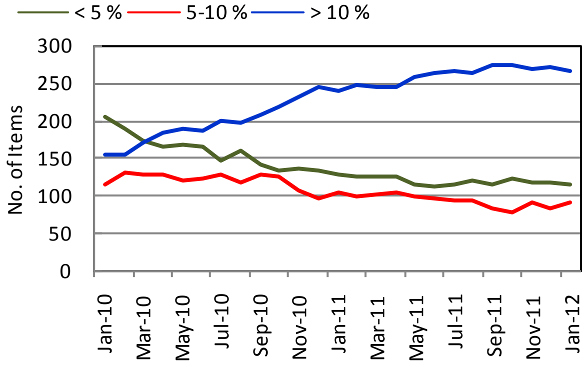


Figure 13: Distribution of CPI Basket (YoY Inflation)



62. Thus, for inflation to come down further it is important that the government curtails its borrowing from the banking system by systematically reducing its fiscal

deficit. At the same time, the government needs to implement decisive reforms to increase the availability of energy, which should help in improving the industrial capacity utilization and thus domestic supply, easing the inflationary pressures.

63. The resolution of energy sector issues would, however, have implications for inflation. For instance, an element of the solution entails rationalization of electricity and gas prices. An upward adjustment in these prices not only contributes directly but has their second round impacts also as other prices incorporate these changes. If the government avoids these adjustments, it would result in an increase in subsidy payments to the energy sector putting pressure on government borrowings and therefore inflation.

64. The government has already been increasing electricity and gas prices, therefore, SBP expects an uptick in inflation in H2-FY12. Similarly, international oil prices are expected to remain at a high level, which will translate into higher domestic inflation. The impact of 5.2 percent depreciation of exchange rate during 1st July to 9th February, FY12 on inflation in H2-FY12 cannot be ruled out either. Moreover, the announcement of increase in wheat support price from Rs950 to Rs1050 per 40 kg for the upcoming wheat procurement season will have an impact on food inflation.

65. These factors are likely to inhibit expectations of inflation to come down further. Therefore, SBP expects the average inflation to remain in the range of 11 to 12 percent in FY12. The actual outcome may remain within the target of 12 percent for FY12, however, to ensure sustainable growth of the economy there is need to bring inflation further down. In this regard, therefore, it is imperative that the monetary and fiscal authorities work in tandem to ensure that the inflation targets of 9.5 percent for FY13 and 8 percent for FY14, as envisaged in the MTBF, are achieved.

III. Concluding Remarks

66. Faced with a constraining domestic and global economic environment, SBP's monetary policy is trying to strike an appropriate balance among multiple and often competing considerations. These include: bringing inflation further down, ensuring financial stability, preserving foreign exchange reserves, and supporting private investment in the economy.

67. While pursuing these objectives, SBP cannot ignore related developments in the economy, especially the deviations in key variables from their projected path. For instance, pattern of government borrowings from the banking system, delays/shortfalls in projected foreign inflows, and changes in administered prices of energy do affect SBP's assessment of the economy.

68. SBP's inflation forecasts indicate a high probability of meeting the 12 percent average CPI inflation target for FY12. This is due to moderation in private sector demand as well as improvement in domestic supplies of food items. However, underlying inflationary pressures remain and there are upside risks in meeting the medium term inflation targets. The main reasons for this assessment include: increases in electricity, gas, and domestic petroleum product prices, exchange rate depreciation, and substantial government borrowings from the banking system.

69. Increase in government borrowings from the banking system is largely due to shortfalls in projected external financing. In any case, this has squeezed the availability of credit for the private sector and increased the pressure on rupee liquidity. The unpredictable pattern of these borrowings has created additional challenges in terms of striking an appropriate balance between prudent liquidity operations to anchor inflation expectations and payment system stability. The government borrowings from the banking system are likely to remain substantial in H2-FY12.

70. The need for effective fiscal reforms is evident and highlighted repeatedly. The MTBF of the government already outlines the broad contours of this strategy and needs effective implementation. Similarly, the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) also provides important benchmarks to reduce the fiscal deficit and the debt burden and thus the need for excessive borrowings from the banking system.

71. Government borrowing is not the only source of liquidity drain from the system. Due to worsening terms of trade and declining volume of exports, the trade deficit has widened considerably. At the same time, foreign financial inflows continue to decline, increasing pressure on foreign exchange reserves and exchange rate. Although SBP's monetary policy framework entails an exchange rate regime that is responsive to market conditions, but to quell speculative pressures SBP did support the market through foreign exchange interventions. Consequently, rupee liquidity from the system contracted.

72. The pressure on the external sector is likely to remain in H2-FY12. Given the scheduled increase in repayments of outstanding loans in H2-FY12, realization of budgeted flows, such as proceeds of privatization receipts, euro bond, Coalition Support Funds, and 3G license fees, has become critical for strengthening the external position. In the medium term, vulnerability of the external position to international commodity price movements can be mitigated through a gradual diversification of export products and markets.

73. Apart from liquidity implications, the fiscal and external sector developments have resulted in a skewed composition of monetary aggregates. In particular, the increase in the NDA component of M2 is disproportionally large while the NFA has contracted. Within the NDA, most of the increase is due to government borrowings from the banking system for budgetary support; credit to the private sector remains muted.

74. Weak growth in private sector credit and thus private investment in the economy is a source of concern for SBP. This is because sustainable economic recovery over the medium term would call for a substantial increase in both the domestic and foreign investment in the economy. For this to happen, the business confidence needs to be revived by reducing uncertainties due to energy shortages. Monetary policy can only play a marginal role in economic growth by contributing towards keeping inflation low and financial markets stable.

75. In conclusion, despite moderate aggregate demand, pressure on liquidity is likely to continue due to uncertain foreign inflows and substantial government borrowings to finance the fiscal deficit. Moreover, inflationary pressures have not eased significantly. Against this backdrop, the Central Board of Directors of SBP considers the 200 bps reduction in the policy rate, already introduced in FY12, to be appropriate and has decided to keep the policy rate unchanged at 12 percent.