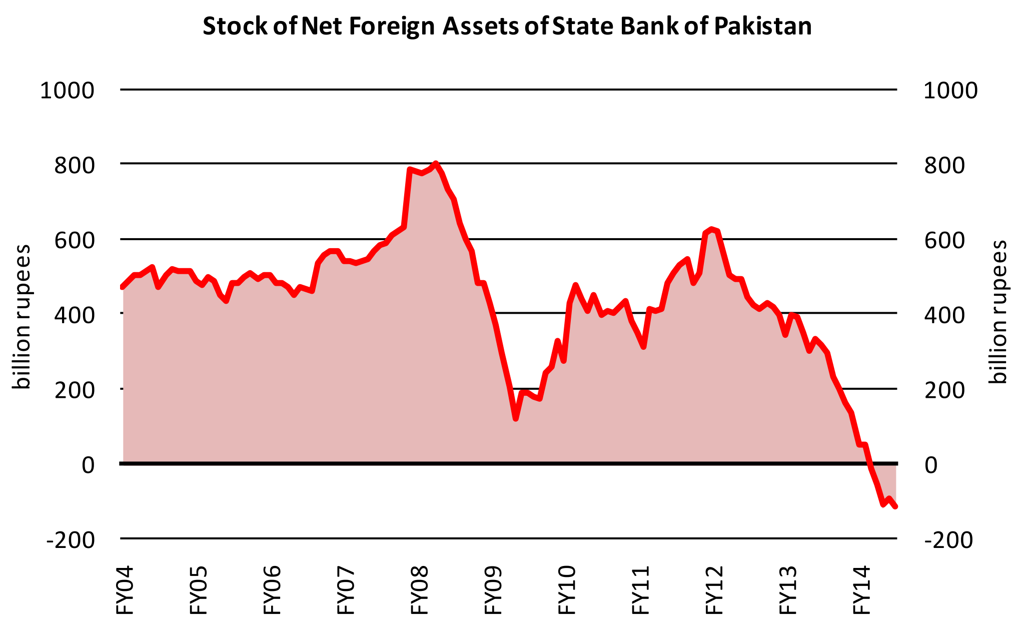
MONETARY POLICY STATEMENT

January 2014



STATE BANK OF PAKISTAN

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Executive Summary

1. The SBP increased the policy rate by 50 basis points (bps) each in September and November 2013 mainly on account of two concerns. One was the continued deterioration in the balance of payments position while the other was worsening of inflation outlook. Nevertheless, due to earlier reductions in the policy rate and settlement of energy sector circular debt, credit to private businesses and economic activity has shown early signs of recovery. Similarly, fiscal consolidation efforts have been initiated, which are expected to gradually alleviate pressure on monetary aggregates.

2. The fundamental weakness in the balance of payments position is persistent contraction in net financial flows since FY08. Substantial repayments of IMF loans during the last two and a half years have only increased the pressure. For some time, SBP did manage to contain the repercussions of these developments. Nonetheless, due to continued net outflow of foreign currency from the system together with the need to build foreign exchange reserves, the exchange rate did experience substantial volatility during H1-FY14.

3. However, stress in the balance of payments could recede gradually. There is a marginal pick-up in net capital and financial flows of $800 million during July – November, FY14 compared to a decline of $263 million in the corresponding period of last fiscal year. At the same time, considerable financial inflows are expected during H2-FY14. These include overdue proceeds from the privatization of PTCL, floatation of euro bonds in the international market, and additional flows from bilateral and multilateral sources under the new IMF program.

4. Similarly, the payment of $1151.2 million to the IMF during Q2-FY14 was the peak of the loan repayment schedule. In fact, the net financing received from the IMF during H1-FY14 was negative $925.2 million despite receiving $1101 million under the new IMF program. As payments decline during the coming quarters, net financing from the IMF will start to increase. The cumulative effect of these expected developments is going to be a gradual increase in SBP's foreign exchange reserves, which have declined to $3.5 billion by 10th January 2014.

5. There is no room for complacency and considerable effort is required to bring a sustainable improvement in the outlook of external accounts. Specifically, two aspects of balance of payments require focus and reforms. First, the net private

direct and portfolio investments are far too low; 0.5 percent of GDP by end FY13. These will have to increase to reduce reliance on foreign loans and IMF programs and finance the external current account deficit. Second, the export to GDP ratio, 10.5 percent by end-FY13, has been on a slight declining trend for over a decade now. Significant improvement in product and market diversification is required to reverse this trend and reduce the trade deficit.

6. The trade deficit has been hovering around 6.5 percent of GDP on average for the past five years. It is expected to increase to 7 percent of GDP or $17.1 billion in FY14 despite a projected increase of 6 percent in export receipts that includes the impact of recently approved GSP plus status accorded to Pakistani exports by European Union. This is because import payments are also expected to grow around 8 percent due to pick up in domestic industrial activity. Assuming a steady increase in workers' remittances together with timely receipt of remaining Coalition Support Funds and proceeds from the auction of 3G licenses, the external current account deficit for FY14 is projected to remain in the range of 1.0 to 1.8 percent of GDP.

7. International commodity prices, especially those imported by Pakistan, have either remained stable or declined since the beginning of FY14. This has neutralized to some extent the direct impact of exchange rate volatility on CPI inflation. Thus, the sharp increase in year-on-year CPI inflation during H1-FY14, from 5.9 percent in June 2013 to 9.2 percent in December 2013, is primarily due to domestic factors.

8. Specifically, to ease the stress on fiscal account due to substantial electricity tariff differential subsidy the government has increased the electricity tariffs in two stages during H1-FY14. This has pushed up wholesale as well as consumer prices. Similarly, to check the declining tax revenues the government has increased the General Sales Tax (GST), withdrawn tax exemptions on some products, and increased income tax rates. At the same time prices of perishable food items have increased considerably, except in December 2013 when they declined sharply, together with a rise in wheat prices.

9. Although the fiscal measures have adversely affected inflation outlook for FY14, they will help reduce budgetary borrowings from the banking system and thus inflationary pressures in the medium term. Thus, the recent uptick in inflation is a cost of delayed fiscal adjustment. The important point is that the risk of demand-driven inflation is still rather moderate. For instance, the year-on-year Non Food Non

Energy (NFNE) inflation is 8.2 percent in December 2013; marginally up from 7.8 percent in June 2013.

10. This is because economic activity has remained quite sluggish over the past few years. It will take some time before expected pick-up in economic growth pushes up aggregate demand. Nevertheless, SBP expects average CPI inflation for FY14 to fall between 10 to 11 percent, which would be higher than the target of 8 percent announced by the government. Other than attending to external sector risks, the reason for recent increases in the policy rate was also to manage expectations in the wake of expected inflation remaining higher than the target and restrict decline in real interest rates.

11. In September 2013, the SBP also linked the minimum rate of return on average balances held in saving deposits with the floor of the interest rate corridor. Specifically, the return on saving deposits cannot be more than 50 bps lower than the floor of the interest rate corridor, which is currently 7.5 percent. This policy intervention ensures that deposit rates respond more strongly to policy rate changes. This would help in deposit mobilization and maintaining a reasonable growth in deposits necessary to meet the credit requirements of the economy.

12. The credit availed by private sector businesses have responded to reductions in policy rate during the last two years and relative improvement in availability of electricity to productive sectors. During the first five months of current fiscal year private businesses have borrowed Rs161 billion, of which Rs38 billion is for fixed investment, compared to Rs16 billion in the corresponding period of last year. Substantial credit uptake by sectors such as textiles, electricity, gas, and water and commerce and trade has been observed. Improving financial position of major corporate sectors along with higher expected demand for their products and improvement in net NPLs to net loans ratio may help in sustaining this initial uptake going forward.

13. Due to its accelerated growth, the contribution of private sector credit in expansion of Net Domestic Assets (NDA) of the banking system has increased to 37.0 percent during 1st July – 27th December, FY14, which is considerably higher than 14.2 percent during the corresponding period of FY13. However, fiscal borrowings for budgetary support continue to dominate overall monetary expansion for the same period. Moreover, unlike last year, all of these borrowings are from the SBP.

Specifically, in net terms, the fiscal authority borrowed Rs612.4 billion from the SBP and retired Rs18.5 billion to the scheduled banks.

14. This is because banks were not offering sufficient funds at market interest rates prevailing at the beginning of FY14. Increases in policy rate in September and November 2013 have helped the fiscal authority in raising sufficient funds from the scheduled banks, albeit mostly in 3-month T-bills, and retiring some of their borrowings from the SBP in Q2-FY14. This, together with declining foreign exchange reserves, has kept the market liquidity conditions tight and at times volatile. The result is that short term market interest rates remain on the higher side compared to increases in the policy rate.

15. Nevertheless, the quarterly flow of fiscal borrowings from the SBP has remained positive in both quarters of H1-FY14. This does not bode well for the effectiveness of monetary policy. The SBP expects that government will keep these borrowings in check in H2-FY14 and lower outstanding stock gradually as stipulated in the new IMF program. The growth in broad money (M2) based on the expected developments in various sectors of the economy is projected to remain between 13 and 14 percent.

16. Containment of fiscal borrowings from the SBP would increase borrowing requirements from the scheduled banks. Timely receipt of budgeted foreign inflows could provide some respite; however, consistent reduction in the size of the fiscal deficit is critical for medium term macroeconomic stability. This would require significant tax, expenditure and debt management reforms. A persistently high fiscal deficit has already resulted in accumulation of short term domestic debt at a very rapid pace; 27 percent on average during the last three fiscal years.

17. For FY14, the government has announced a fiscal deficit target of 6.3 percent of GDP and managed to contain it at 1.1 percent of GDP during Q1-FY14. This is a positive start that needs to continue not only during remaining months of this fiscal year but also in the medium term. A key risk to the fiscal position is a possible shortfall in tax revenues, recurrence of energy sector circular debt, and delays in budgeted foreign inflows. Such deviations could lead to increase in borrowings from the banking system, further accumulation of domestic debt and higher inflation.

18. Although there are some risks to the balance of payments position due to uncertainty surrounding expected foreign inflows, expected increase in inflation is

slightly lower than anticipated earlier. In view of the above, the Board of Directors of SBP has decided to keep the policy rate unchanged at 10.0 percent.

I. Economic Environment during H1-FY14

A. Global Developments

1. Global economic recovery remains weak and continues to face uncertainty due to slowing growth in emerging economies, persistent fiscal issues in the US and financial imbalances in the euro area. Even the Japanese economy, where growth was expected to accelerate after the economic reforms introduced in April 2013, is slowing down. This has diminished the prospects of any positive impact on global economic growth. This is reflected in downward revision of global economic growth estimates by the IMF in October 2013 reinforced further by a similar revision by the OECD in November 2013.[1]

2. Notwithstanding the Federal Reserve's commitment to maintain its accommodative monetary policy along with marginally reducing its asset purchase program in January 2014, market sentiments remain wary of a policy reversal in the near term. These sentiments not only limit the effectiveness of Federal Reserve's impetus to the US economic recovery but also reflect global financial markets uneasiness regarding implications of continuous injection of liquidity. Moreover, uncertainty surrounding the future of legislative ceiling on the US federal government budget is further exacerbating an already fragile investor confidence in the US economy supporting global economic growth.

3. On the other hand, while fears of a deeper recession in the euro zone have dissipated the prospects of a decent growth remain minimal. Fiscal and financial conditions continue to remain weak. High labor costs and a strong euro are eroding competitiveness of peripheral economies. Despite easy monetary policy, tight credit conditions continue as high public debt levels and financial imbalances fail to attract investors. Taken together, these conditions are limiting economic recovery in the euro zone. As progress on banking union remains limited so far and development on fiscal and political union nonexistent, economic outlook for the euro zone remains uncertain.

4. Meanwhile, the economic revival strategy of Japan, centered on cheap credit, a weak yen and long term reforms to boost competitiveness, has not yet resulted in

[1] IMF revised its 2013 global growth forecast in October to 2.9 percent from 3.1 percent announced in July 2013. Similarly, in November 2013 the OECD also lowered its estimates for economic growth for 2013 to 2.7 percent compared to its May forecast of 3.1 percent.

the anticipated rebound in corporate investment and personal incomes. Exports have also grown less than expected despite a weaker yen, partly due to slowing growth in many emerging economies. Bank of Japan's reaffirmed commitment to continue injecting money in the economy to achieve its inflation target of 2 percent by 2015 has not mitigated risks of deflation. Much of the increase in prices is being attributed to rising costs for fuel and other imports. Resultantly, estimates of growth have been slashed for the last quarter of 2013 on the back of reduced investment.

5. Despite weak global economic growth prospects, capital markets, particularly of the advanced economies, have been soaring. As monetary stimulus from the US and Japan has injected substantial liquidity into the global financial system stock prices have increased manifold. Since the market low of March 2009 the Dow is up 148 percent, S&P 500 has jumped 169 percent and Nikkei is up by 125 percent. These trends in capital markets in the backdrop of weak economic fundamentals appear unsustainable and any abrupt correction can have negative repercussions for the global economy.

6. The capital markets in the emerging economies are already experiencing the brunt of uncertainties prevailing in the global financial markets due to anticipated increase in returns on financial assets of advanced economies. After witnessing sharp depreciation, currencies of the most affected five economies, namely, South Africa, India, Indonesia, Turkey and Brazil continue to experience volatility. Investors' confidence on these economies is still low due to large current account deficits, relatively high rates of inflation and weak economic growth.

7. Pressures on international commodity prices increased marginally in December 2013 after remaining subdued till November 2013. This increase is due to both seasonal pick up in food prices and accelerated growth in energy prices. Favorable supply of stocks permitted food prices to fall till November 2013. Pressures on energy prices reemerged in the wake of falling OPEC supplies due to disruptions in the Middle East and Africa; however, the increase in prices remained moderate till November 2013. Nevertheless, global inflation was likely to remain subdued in the near future on the back of weak global demand both in advance as well as in emerging economies.

B. Domestic Developments

8. An almost continuous and significant deterioration in the balance of payments position and surge in inflation led to a reversal of monetary policy stance during H1-FY14. In fact, the balance of payments position became so vulnerable that Pakistan had to sign yet another program with the IMF in September 2013. After reducing the policy rate to 9.0 percent in June 2013, the SBP increased it by 50 bps each in the monetary policy decisions of September and November 2013.

9. Inflation increased sharply and considerably during H1-FY14. It was largely anticipated in the wake of some necessary fiscal measures that had been announced in the federal budget for FY14. These included increase in the rate of General Sales Tax (GST) and removal of some exemptions together with an upward revision in electricity tariffs for commercial and household consumers. Disruptions in supply chain of perishable food items also contributed towards rising inflation. Consequently, inflation was expected to accelerate well beyond the FY14 target of 8.0 percent set by the government, necessitating an increase in the policy rate.

10. The outlook for balance of payments appeared weak on account of expected deterioration in the external current account and less than expected flows in the capital and financial account. Consequently, deficit in the overall balance of payments widened. With large net repayments to the IMF, the foreign exchange reserves declined further and depreciation of exchange rate accelerated before steadying in December 2013. Increases in policy rate helped in managing market sentiments.

11. Besides fundamental factors, the speculative sentiments on account of IMF's end quarter targets for Net International Reserves (NIR) and uncertainty over foreign financial inflows resulted in excessive exchange rate volatility. To calm sentiments, SBP intervened in the foreign exchange market in a calibrated manner and succeeded in limiting the exchange rate volatility. While the end-September 2013 NIR target was missed, the SBP met the end-December 2013 NIR target despite shortfalls in projected financial inflows.

12. Carrying out reforms, particularly those related to the fiscal sector, were also critical to reduce the fiscal deficit to a sustainable level. In the FY14 budget, the target for fiscal deficit was set at 6.3 percent of GDP, significantly lower than the 8.0 percent realized in FY13. This lower target assumed a substantial growth in tax

revenues and reduction in subsidy related expenditures. In Q1-FY14, the fiscal authority managed to keep the fiscal deficit under control. Maintaining this performance in remaining quarters of FY14, however, appeared challenging as the total revenues improved only due to one-off increases in non-tax revenues.

13. At the same time, budgeted external financing of the fiscal deficit did not materialize during H1-FY14. As a result, it was mostly financed through borrowings from the SBP. The government was unable to meet its requirements from the scheduled banks due to their lack of interest in government securities, especially prior to increases in policy rate in September and November 2013. Nevertheless, the fiscal authority managed to reduce the end September 2013 stock of borrowings from SBP (cash basis) to Rs2521 billion; below the ceiling of Rs2690 billion set by the IMF as a performance criterion. The stock of these borrowings as on 27th December 2013 was Rs2759 billion compared to end-December target of Rs2560 billion.

14. In addition to investment in government securities, banks also accelerated lending to the private sector in Q2-FY14. Private sector credit (PSC) grew significantly due to improved market sentiments and electricity supply after the settlement of energy sector circular debt. Earlier in Q1-FY14, despite lack of interest in government securities, banks did not lend to the private sector due to low demand for credit which is typical in the first quarter.

II. Recent Economic Developments and Outlook

A. Market Interest Rates: Responding to Policy Rate Changes amid Tight Liquidity Conditions

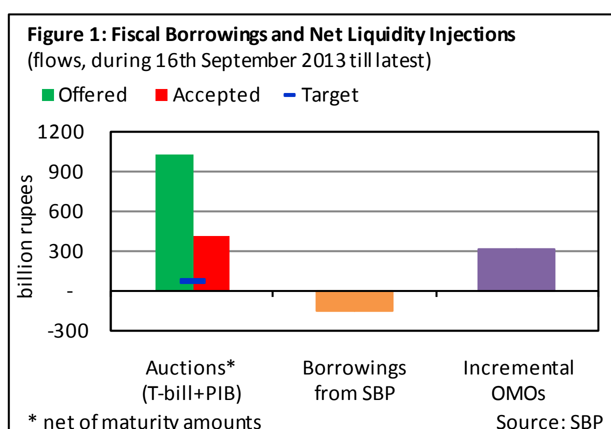
15. Since the beginning of FY14, financial markets can be characterized by volatile liquidity conditions, rising market interest rates and pressure on exchange rate. The underlying reasons for these conditions are prevailing uncertainty over foreign financial flows and rising inflation. The market has also been anticipating build-up of foreign exchange reserves through purchases of dollars and increase in borrowings from the scheduled banks to meet the end quarter IMF targets pertaining to government borrowing from SBP and NIR. As a result, speculative sentiments developed and the pressure on short term interest rates increased.

16. Volatility in market liquidity conditions was largely driven by the pattern of government borrowing from the banking system, which has changed significantly

since the September 2013 monetary policy decision. With an increase in the policy rate in September and November 2013, banks' interest in government securities has revived, enabling the fiscal authority to meet its borrowing needs from scheduled banks.

17. The sharp increase in average offer-to-target ratio, for both T-bill and PIB auctions, from 0.6 during 1st July to 13th September, FY14 to 1.4 since then indicates strong market participation. Specifically, since the September 2013 monetary policy decision, fiscal authority has raised Rs408 billion net of maturities through auction of T-bills and PIBs in the primary market (**Figure 1**). This has contributed in retirement of fiscal borrowings from SBP subsequently increasing pressure on market liquidity conditions.

Figure 1: Fiscal Borrowings and Net Liquidity Injections
(flows, during 16th September 2013 till latest)



* net of maturity amounts
Source: SBP

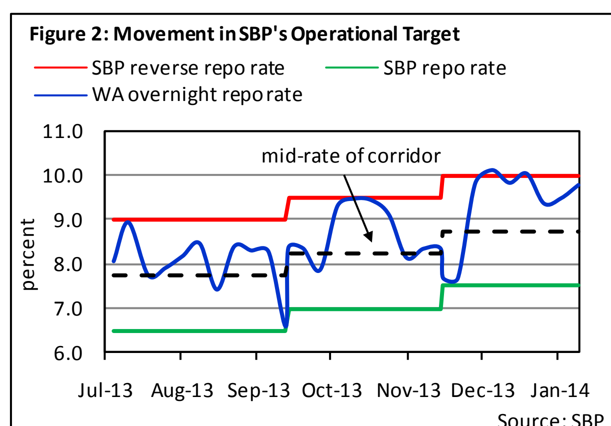
18. While the government did meet the IMF target pertaining to fiscal borrowings from SBP for Q1-FY14, as on 27th December 2013 the stock of these borrowings was Rs2759 billion compared to end-December target of Rs2560 billion. The SBP has helped the fiscal authority in raising Rs91 billion through the outright sale of government securities on 30th December 2013, which effectively shifted government borrowing from SBP to scheduled banks. Apart from incurring some additional cost to the government, these outright transactions have further increased the interbank liquidity pressures resulting in increased access to SBP's reverse repo window and liquidity injections.[2]

19. At the same time, net outflow of rupee liquidity from the market continued on account of widening of overall balance of payments deficit. Low financial inflows largely explain the contraction in net foreign assets of the banking system, which reduced the availability of rupee liquidity in the system. In addition, increase in current account deficit also contributed in decline of rupee liquidity.

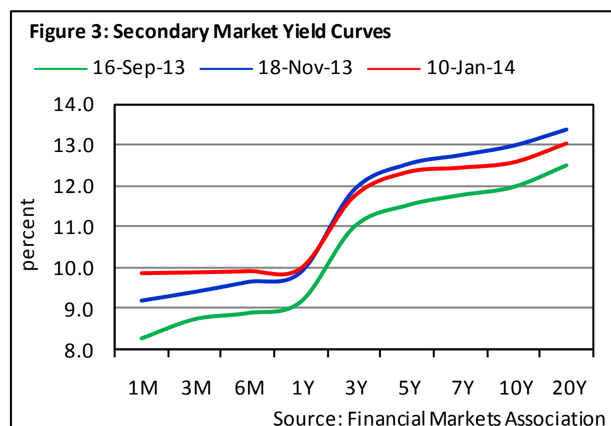
[2] After 26th December, 2013, the average volume per visit to SBP's ceiling facility and average daily net OMO injections stand at Rs18 billion and Rs43 billion, respectively. Further, the average yield for government papers maturing in less than 30 days has been hovering around 9.90 percent since the last T-bill auction held in Q2-FY14, while the average yield on outright sale transactions for 25 days was 10.49 percent.

20. In addition, the cumulative growth of banking system deposits of just 5.4 percent during the post September 2013 monetary policy period also kept the rupee liquidity short in the interbank market. Consequently, SBP has injected significant amount of liquidity, cumulative Rs319 billion, through its Open Market Operations (OMOs). As on 10th January 2014, the level of outstanding liquidity injections stands at Rs23 billion. Banks also met their liquidity requirements through access to SBP's overnight reverse repo facility with large volumes, net Rs27 billion per visit, during the same period.

21. These tight and at times volatile interbank liquidity conditions are reflected in movements of overnight money market repo rate, which is hovering quite close to the ceiling of the interest rate corridor. In fact, to meet fortnightly reserve requirements and to avoid penalty on excessive use of reverse repo facility, banks had to borrow at rates higher than the policy rate (**Figure 2**). On average, the overnight repo rate has remained 51 bps above the middle of SBP's 250 bps interest rate corridor since the September 2013 monetary policy announcement.



22. Following the overnight rate, other market interest rates are also showing a rising trend. Against the 100 bps increase in the policy rate in FY14 so far, an average of 100 and 94 bps increases in T-bill and PIB rates can be observed in the primary market, respectively. Similarly, a 105 and 74 bps average increase in secondary market yields for both short and long tenor securities can be witnessed till 10th January 2014 (**Figure 3**). This indicates the strong transmission of SBP's policy rate changes to market interest rates.

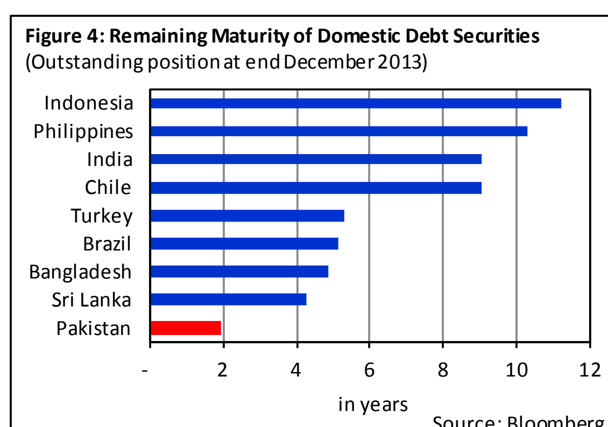


23. A relatively higher increase in short-term rates compared to long term rates indicates market's expectation of a further increase in the policy rate by SBP during FY14. This is also reflected in their bidding pattern during auctions of government

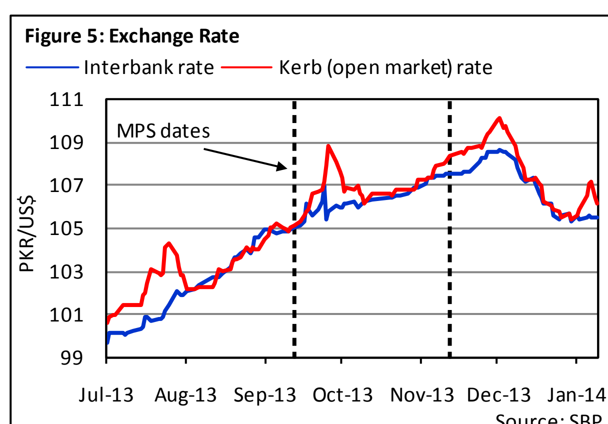
securities. For instance, in the T-bill auctions held since the September 2013 monetary policy decision, 96 percent of total bids were on average for 3-month tenor only. Apart from increasing the roll-over risk, this investment pattern is keeping an upward pressure on short-term market interest rates.[3]

24. In addition, due to improved returns market's interest for investment in longer tenor government securities has also increased after the September 2013 monetary policy decision. In fact, in the last two PIB auctions, market offered substantially higher amounts with an offer-to-target ratio of 1.7, on average. The fiscal authority, however, did not use the opportunity to improve its debt maturity profile by accepting such offers due to cost considerations.

25. Borrowing more through T-bills than PIBs, during the past few years, however, has drastically deteriorated the maturity profile of tradable domestic debt securities. Among the peer countries, the weighted average of remaining maturity of domestic debt securities in Pakistan is the lowest at less than 2 years (**Figure 4**).



26. The increase in market interest rates has also helped in checking the depreciation of Pak rupee. During FY14, three distinct trends can be identified in the movement of Pak rupee against the US dollar. In the first phase the rupee depreciated by 5.1 percent till the announcement of monetary policy on 13th September 2013. In the second phase, after the policy rate increases, the depreciation of rupee decelerated. In the third phase, the rupee has appreciated after a brief period of sharp depreciation (**Figure 5**). Since 13th September, the rupee has depreciated by 0.5 percent only, implying an overall depreciation of 5.5 percent against the US dollar in FY14 up till 10th January 2014.



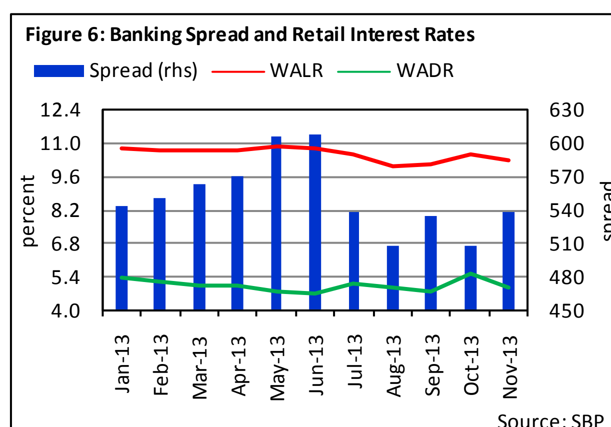
[3] Specifically, on the basis of last auction on 8th January 2014, out of total Market Treasury Bills (MTBs) stock of Rs3009 billion, the government has to roll-over Rs2275 billion (76 percent) in just 84 days.

27. Depreciation in the consequence of economic fundamentals as well as speculative sentiments. The pickup in economic activities can be witnessed from the accelerated growth in LSM sector and imports, which increased the demand for foreign exchange. At the same time, financial flows remained below expectations, which did not allow accumulation of foreign exchange reserves and thus strengthened expectations of exchange rate depreciation. This, in turn, encouraged speculative activities in the foreign exchange market. Despite unchanged economic fundamentals on the external front, the recent appreciation of the rupee against the US dollar and the occasional increase in kerb market premium validates the presence of such sentiments.

28. As emphasized many times by the SBP, a long term solution to exchange rate stability lies in a sustainable balance of payments position. Sustainability of balance of payments position in turn depends on structural reforms that ensure a consistent increase in exports and private financial inflows. In the absence of such reforms, the burden of adjustment will continue to fall disproportionately on exchange rate and interest rate. An abrupt adjustment in exchange rate not only increases the fiscal burden but negatively influences inflation expectations as well. Similarly, an increase in interest rate has a cost in terms of discouraging a much needed revival in domestic private investment.

29. After a 100 bps increase in the policy rate by SBP during H1-FY14, KIBOR, which is used as a benchmark for loans to the corporate sector, has increased by 95 bps on average up till 10th January 2014. Similar to KIBOR, banks' weighted average incremental lending rate (WALR) has also increased, by 23 bps, during August-November 2013, albeit at a slower pace. Deposit rate (WADR), on the other hand, has declined by 7 bps in the same period (**Figure 6**). The impact of policy rate change typically transfers with a lag to retail interest rates. Thus both WALR and WADR are expected to increase in the coming months.

Figure 6: Banking Spread and Retail Interest Rates



Source: SBP

B. Monetary Expansion: Private Sector Credit Increases Together with Fiscal Borrowings from SBP

30. The monetary expansion, on year-on-year basis, has decelerated somewhat to 14.2 percent as on 27th December 2013 from 15.3 percent a year earlier despite substantial government borrowings from the banking system and pick up in private sector credit. This moderation is largely due to a sharp contraction in the Net Foreign Assets (NFA) of the banking system on the back of a continuous stress on external sector. (**Table 1**). Specifically, NFA of SBP has contracted by Rs226 billion during FY14 till 27th December 2013. Due to a continuous decline over the last two and a half years, the stock of SBP's NFA has now turned negative (**Figure 7**).

Table 1: Monetary Aggregates

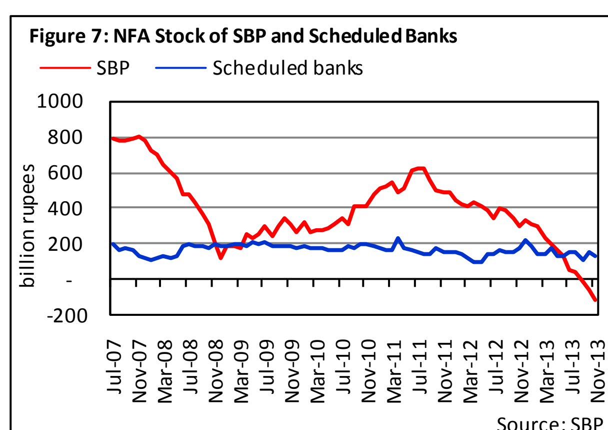
stock and flow in billion rupees, growth in percent

	June 2013 Stocks	Flow during		
		Jul 1-Dec 28, FY13	Jul 1-Dec 27, FY14	FY14[1]
NDA: *of which*	8589	515	701	1126
Net budgetary support (i+ii)	5246	584	594	
(i) SBP	2213	-143	612	
(ii) Scheduled banks	3033	727	-19	
Commodity operations	468	-38	-95	
Private sector credit	3357	73	259	
Credit to PSEs	288	34	40	
NFA (i+ii)	269	20	-216	66
(i) SBP	133	-54	-226	
(ii) Scheduled banks	136	74	10	
Money supply (M2)	**8858**	**535**	**484**	**1192**
Reserve money	2535	265	271	
Currency in circulation	1938	219	230	
Total deposits	6909	316	254	
Growth (year-on-year)				
Net budgetary support	38.1	29.5	33.2	
Scheduled banks	44.9	38.3	6.9	
Private sector credit	-0.6	3.4	4.8	
Money supply (M2)	15.9	15.3	14.2	13.0-14.0
Reserve money	15.8	15.9	14.4	
Currency in circulation	15.8	17.4	14.6	
Total deposits	15.9	14.6	14.2	

1: Projections

Source: SBP

Figure 7: NFA Stock of SBP and Scheduled Banks



Source: SBP

31. The contraction in NFA was offset by expansion in the Net Domestic Assets (NDA) of the banking system, particularly due to substantial fiscal borrowings for budgetary support. On cumulative basis, these borrowings have been entirely from the SBP during FY14 so far. However, the fiscal authority did manage to retire some of these borrowings during Q2-FY14 through borrowings from scheduled banks. The changing composition of government borrowing is largely due to an increase in banks' interest in government securities after increases in the policy rate. Specifically, since the increase in policy rate on 13th September 2013, fiscal authority has borrowed Rs448

billion from the scheduled banks and retired Rs191.5 billion to SBP up till 27th December 2013.

32. Notwithstanding this effort, the fiscal authority could not keep its borrowings from the SBP at zero in flow terms during the first quarter of FY14. The government, however, did meet the end September 2013 target on such borrowings agreed with the IMF (**Table 2)**. As on 27th December 2013 the stock of government borrowing from SBP (cash basis) stands at Rs2759 billion against the IMF target of Rs2560 billion.

Table 2: Monetary Targets of IMF Program for FY14

stocks in billion rupees

	End-September		End-December	
	Target	**Actual**	**Target**	**Actual***
SBP NDA	2877	2595	2901	2900
Government borrowing from SBP (cash basis)	2690	2521	2560	2759

* Provisional, up to 27th December 2013

Source: IMF and SBP

33. As a result of excessive fiscal borrowings from the banking system and a weak external position, NDA to NFA ratio of banking system has increased sharply to 177 as on 27th December 2013 from 32 at end June 2013. This deterioration clearly highlights the risk of substitution of domestic assets with foreign assets, which may have adverse implications for exchange rate as well as inflation outlook. Higher expected foreign inflows during H2-FY14 are likely to relieve some of the pressure of government borrowings from banking system along with improving the NDA to NFA ratio. Nonetheless, government borrowing is still expected to be the dominant contributors to the projected M2 growth of 13 to 14 percent during FY14.

Table 3: Private Sector Credit

flows; billion rupees

	FY13 Jul-Nov	**FY14 Jul-Nov**
Total credit to private sector	68.9	170.4
1. Loans to private sector businesses	16.1	160.7
By Type		
Working capital	12.6	123.0
Fixed Investment	3.5	37.8
By Sectors: *of which*		
Agriculture	9.6	8.4
Manufacturing: *of which*	-12.0	86.0
Textiles	16.2	78.0
Chemicals	3.8	-8.6
Food products & beverages	-36.4	-20.9
Electricity, gas and water	4.7	33.0
Construction	-1.3	-0.3
Commerce and trade	2.4	25.1
Services	1.5	8.0
2. Personal: *of which*	7.6	17.0
Consumer financing	3.6	14.0
3. Investment in securities*	9.0	4.5
4. NBFC*	34.1	-17.7
5. Others	2.1	5.8

Source: SBP

34. A positive development, however, is that there has been an accelerated growth in private sector credit (**Table 3**). As a result, its contribution in NDA of the banking system and thus in the overall monetary expansion has increased considerably during FY14 so far. Specifically, private sector has borrowed Rs170

billion during July-November FY14, out of which Private Sector Businesses (PSBs) availed Rs161 billion.[4] This was the result of reasonable credit up take by businesses (textiles, energy, commerce and trade) as well as consumers. Encouragingly, a sizeable credit was availed for fixed investments, especially by energy (Rs9 billion), textile (Rs6 billion), cement (Rs5 billion), and sugar (Rs4 billion) sectors.

35. This broad based increase in credit, both in terms of volume and type, can be attributed to several factors. These include: (a) improved financial conditions of the corporate sector partly due to decrease in interest rates during FY12 and FY13 (**Table 4**); (b) improved supply of electricity after settlement of energy sector circular debt by the government; and (c) better business sentiments after the May 2013 elections. Apart from these broad factors, specific industry-level effects are also at play. While cement and textiles are modernizing and expanding their production capacity due to higher expected demand (both domestically and internationally-GSP Plus), sugar sector is investing heavily in bagasse based power generation projects.

Table 4: Financial Indicators of Selected Industries*
in percent

	Textile		Cement		Energy	
	2013	**2012**	**2013**	**2012**	**2013**	**2012**
Financial Expenses to Sales	5.6	8.6	6.8	10.1	6.2	4.8
Cash Flow to Sales	2.9	0.2	24.8	15.8	13.8	6.3
Coverage Ratio	27.5	18.6	21.2	20.5	98.8	-16.9
Gross Profit Margin	5.0	-0.1	35.9	27.1	18.2	18.7
Operating Margin	4.3	-3.8	31.4	22.4	23.2	14.0
Net Profit Margin	5.4	0.7	20.1	10.1	11.7	4.7

*up to June
Source: Financial statements of listed companies

36. The upward trend in credit utilization along with growth in LSM of 5.7 percent during July-October 2013 signal revival in domestic economic activity. Going forward, however, challenges remain. Besides fiscal dominance, law and order conditions have yet to improve and energy shortages still persist. The current rise in interest rate could also have a dampening impact on utilization of credit and economic activity.

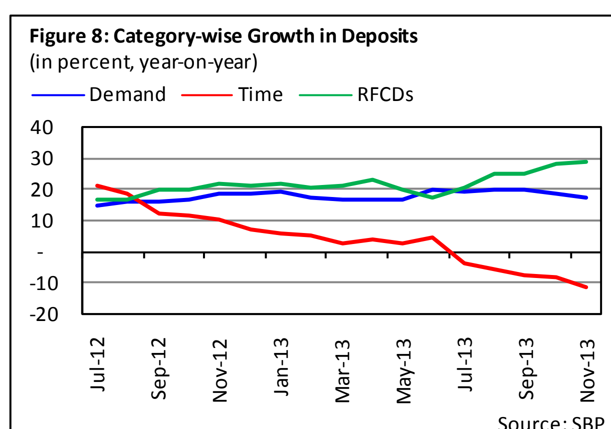
37. Furthermore, better financial position of corporate sector may not necessarily translate into higher utilization of credit. For example, with improved financial conditions, the cement sector has deleveraged and reduced its demand for working capital. Whereas, many of the loss making textile companies, whose profit margins, cash flows and net worth improved, increased their borrowings. This is because other factors such as initial circumstances of the industry and demand conditions in the respective markets also influence credit utilization by the corporates.

[4] The disaggregated level of private sector credit is available till November 2013 while the aggregated figure as shown in weekly Monetary Survey is available up to 27th December 2013 (Table 1).

38. The increased demand for credit, however, was not met with a concomitant growth in banks' deposits. In fact, year on year growth in private sector deposits has moderated to 14.2 percent as on 27th December 2013 from 14.6 percent a year earlier. This marginal deceleration in deposit growth may be attributed to (a) lower real interest rates due to higher expected inflation; (b) relatively better returns on other assets such as equity and real estate; (c) increase in withholding tax on cash withdrawals and fear of FBR access to bank accounts; and (d) imposition of income support levy.

39. Besides moderation in growth of overall deposits, variation in growth of its components is also a matter of concern (**Figure 8**). Specifically, time deposits have been continuously declining since the beginning of FY14. Furthermore, growth in demand deposits is decelerating largely due to saving deposits. This is despite an increase in minimum return on saving deposits and its linkage with the SBP repo rate. This reflects banks' efforts to match short-term assets with short term liabilities as well as banks' and savers' aversion for long term instruments.[5] The downtrend in time deposits does not bode well for the economy as it reduces banks' capacity to lend for long term investment projects.

Figure 8: Category-wise Growth in Deposits
(in percent, year-on-year)



Source: SBP

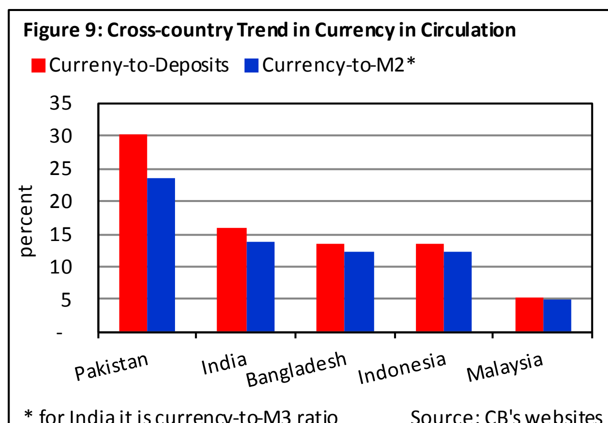
40. The growth in resident foreign currency deposits has also been accelerating; 17.4 percent or Rs89.6 billion during 1st July to 27th December, FY14 as compared with 10.3 percent or Rs45.3 billion during the similar period of FY13. Their share in total deposits has increased from 7.7 percent to 8.4 percent. The increase in these deposits is largely explained by the depreciation of Pak rupee against the US dollar. Availability of dollar deposits is important as it allows the depositors to switch from local currency deposits to foreign currency when faced with changes in exchange rate expectations. This flexibility checks the outflow of deposits and consequent liquidity risk of the banking system amid changing exchange rate expectations.

41. Growth in currency in circulation (CiC) has also decelerated to year-on-year 14.6 percent as on 27th December FY14 compared to 17.4 percent last year. Increase

[5] For instance, inflows in National Saving Schemes were only Rs63.7 billion during July-October FY14 as compared to Rs184.3 billion in the corresponding period last year.

in interest rates and the depreciation of Pak rupee has increased the opportunity cost of holding cash, which explains this slowdown in CiC. Despite this deceleration, the currency to deposit ratio of 30.3 percent as on 27th December, FY14 is almost at the same level as last year. This suggests that close to one third of the total transactions in the economy are still cash based, which is quite high compared to peer countries (**Figure 9**).

Figure 9: Cross-country Trend in Currency in Circulation



* for India it is currency-to-M3 ratio Source: CB's websites

42. In this backdrop, SBP has taken regulatory as well as policy decisions to reduce quantum of currency in the system. For instance, banks have been instructed to pay a minimum rate of return on saving and term deposits on monthly average balances instead of minimum balances. SBP has also linked the minimum rate of return on saving deposits with the floor of interest rate corridor to ensure better real returns to depositors. Likewise, a number of initiatives have been taken under the umbrella of Financial Inclusion Program (FIP) to increase outreach of the financial sector.

C. Fiscal Deficit: Consistent Reduction Required to Stem Sharp Domestic Debt Accumulation

43. The Q1-FY14 fiscal data shows that the government has managed to contain the fiscal deficit to 1.1 percent of GDP or Rs287 billion. This is lower than the average deficit of 1.4 percent during the first quarter of the last four years. The Q1-FY14 fiscal deficit was also considerably lower than its ceiling of Rs419 billion set under the IMF program. Both the increase in total revenues and cut in expenditures have helped in keeping the deficit low.

44. Maintaining this performance during the remaining quarters of FY14, however, would be quite challenging. This is because total revenues have mostly increased due to one-off non-tax revenues of Rs125 billion. These include proceeds of Rs68 billion from Universal Service Fund (USF) accumulated over many years and mark up income of Rs57 billion received from PSEs and provinces.[6] Moreover, foreign

[6] USF was created to increase Tele-density and wireless loop coverage in the country. Telecom service providers contribute 1.5 percent of their revenues to this fund every year.

grants of Rs10 billion have also contributed to non-tax revenues.[7] Reliance on temporary non-tax revenues to contain fiscal deficit in essence highlights that further effort is required to address the structural fiscal weaknesses.

45. A positive development, however, is that tax revenues grew sharply by 19.0 percent in Q1-FY14 compared to 10.3 percent in the corresponding period of last year. This growth is still lower than what is required to achieve the annual budget target. For instance, the tax collected by the FBR grew by 17.2 percent during Q1-FY14 against 27.8 percent required to achieve the FY14 target of Rs2475 billion (**Table 5**). This is despite additional measures announced by the government to strengthen tax administration and revenue collection, including increase in GST from 16 to 17 percent, removal of exemptions, and introduction of some new taxes. The total tax revenues also include Rs20.8 billion collected as development surcharges on gas, which is the highest level for a quarter.[8]

Table 5: Summary of Consolidated Fiscal Operations

billion rupees, unless stated otherwise

	FY13[P]	FY14[BE]	Q1-FY14[P]
Total revenue: *of which*	**2982**	**3640**	**830**
FBR tax revenue	1936	2475	469
SBP profit	220	200	80
CSF money	172	na	0
3G license fee	-	120	0
Total expenditures	**4816**	**5291**	**1117**
Current: *of which*	3676	3964	946
Subsidies[1]	367	240	60
Interest	991	1154	301
Development & Net Lending	1140	1327	170
of which; Net lending	363	-	83
Budget balance	**-1834**	**-1651**	**-287**
Financing	**1834**	**1651**	**287**
External	-2	169	-27
Domestic	1835	1482	314
Non- Bank	378	507	116
Bank	1457	975	198
Memorandum items (as percent of GDP):			
Overall budget balance	-8.0	-6.3	-1.1
Primary balance[2]	-3.7	-1.9	-0.1
Revenue balance[3]	-3.0	-1.2	-0.4

P: Provisional; BE: Budget Estimates

na: not available or separately identified in the Federal Budget 2013-14.

[1] shows subsidies by federal government only

[2] total revenues minus total expenditures (excluding interest payments)

[3] total revenues minus current expenditures

Source: Ministry of Finance and SBP

46. With tax revenues at Rs806 billion during July-November FY14, the FBR would have to deliver a 32.9 percent growth during the remaining months of FY14 to meet the budget target. Achieving this growth seems difficult as it is more than twice the average growth of 16.0 percent in past 10 years for the same period. Moreover, tax measures announced in FY14 budget have only added to the burden of existing tax payers instead of bringing untaxed segments of the economy under tax net and expanding the tax base necessary to ensure a sustained increase in tax collection.

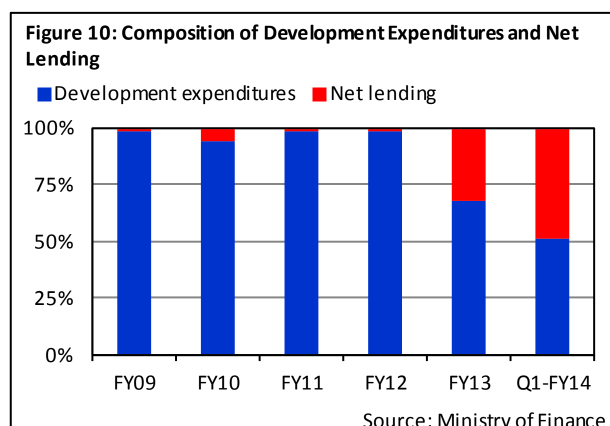
[7] Foreign grants are now treated as part of non-tax revenues instead of a financing item in fiscal data.

[8] The likely imposition of a new Gas Infrastructure Development Cess on commercial and industrial use of gas from Jan-2014 could increase this revenue further.

Without expanding tax base and gradually bringing all income generating sectors of the economy into the tax net, tax woes of Pakistan's economy are likely to continue.

47. On the expenditure side, current expenditures were largely contained in Q1-FY14. They grew by only 5 percent compared to 28.1 percent growth in the corresponding period of last year. Reduction in interest payments partly explains this deceleration in growth of current expenditures. While power subsidies in Q1-FY14 were almost the same as in the corresponding period of last year, expenditures linked to transmission and distribution losses of power sector and loss-making Public Sector Enterprises (PSEs) continue to keep fiscal resources under stress. Treatment of these expenditures as part of *Development and Net Lending* in Q1-FY14 as opposed to accounting them as current expenditure explains most of the deceleration in growth of current expenditures. Moreover, this adjustment ends up showing higher development expenditures (**Figure 10**).

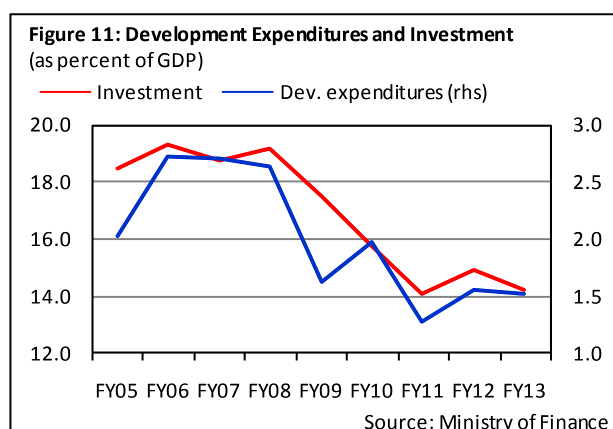
Figure 10: Composition of Development Expenditures and Net Lending



Source: Ministry of Finance

48. As has been the case for the past few years brunt of reducing the deficit could again fall on development expenditures. This, in turn, would have negative implications for investment and growth in the economy (**Figure 11**). On the other hand, if development expenditures, excluding net lending, are kept at the budget estimates, the fiscal deficit could increase significantly higher than the budget target.

Figure 11: Development Expenditures and Investment
(as percent of GDP)

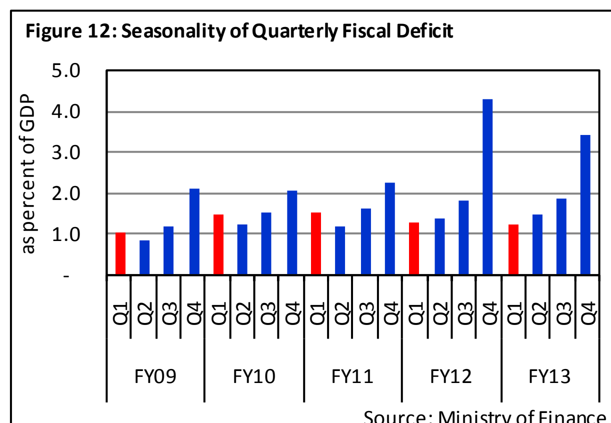


Source: Ministry of Finance

49. As highlighted in the last Monetary Policy Statement, higher interest payments have become a major source of stress on fiscal accounts. The volume of interest payments stood at Rs301 billion in Q1-FY14. With most of the deficit being financed through short term borrowings during FY14 so far, there is a risk that interest payments could turn out to be higher than budget estimates. Consequently, the burden of interest payments, as a percentage of total expenditures and revenues, may increase further.

50. Thus, it would be difficult to keep total expenditures within budget estimates unless development expenditures are reduced substantially. This, combined with expected shortfall in tax revenues, represent the main challenge to contain the fiscal deficit during remaining quarters of FY14. Any delay or shortfall in projected foreign inflows, 3G license fees and euro bond issuance, could make the task even more difficult. It is worth highlighting that there is a strong seasonality of fiscal deficit remaining high in the second half of a fiscal year (**Figure 12**). Therefore, while fiscal deficit in FY14 is likely to be lower than last year's deficit of 8.0 percent, it could still deviate from the announced target of 6.3 percent of GDP.

Figure 12: Seasonality of Quarterly Fiscal Deficit



Source: Ministry of Finance

51. Over the past few years, a persistently high fiscal deficit together with decline in external financing has resulted in accumulation of domestic debt at a rapid pace. For instance, the domestic debt has grown by 27 percent on average during the last three years. By end-November 2013, the outstanding stock of government domestic debt and liabilities has reached to an historic level of Rs10.4 trillion. More than half of this debt, around 57 percent, has a maturity of one year or less.

52. This rapid accumulation of domestic debt poses serious roll over risk and a high likelihood of continued fiscal borrowings from the SBP. This trend could further deteriorate unless concerted efforts are made to change the maturity profile in favor of long term bonds. In addition, it would keep an upward pressure on market interest rates as banks would demand high returns to finance increasing fiscal deficit and rising debt.

D. External Sector: Outlook Contingent upon Realization of Budgeted Financial Inflows

53. Notwithstanding receipt of two tranches under the new arrangement with the IMF, the external sector remains vulnerable and has deteriorated further during H1-FY14. Weak financial inflows together with high debt repayments are the major source of stress on external accounts. Although higher than last year, the total net capital and financial account flows fell short of expectations and remain lower than what is required to finance the external current account deficit without drain on

reserves. In addition, large repayments to the IMF has resulted in depletion of SBP's foreign exchange reserves to $3.5 billion as of 10th January 2014 from end-June 2013 level of $6.0 billion (**Table 6**).

54. The new IMF program has so far not helped in attracting financial inflows and providing the much needed stability in the foreign exchange market.[9] Instead, effort to meet the stringent end-September 2013 target of NIR aggravated speculative sentiments, leading to increased volatility in the foreign exchange market.[10] This situation made it difficult for SBP to build reserves and meet the target. The pressures on exchange rate, nevertheless, continued till early December 2013 when government and SBP stepped up their efforts to quell speculative sentiments in the market, leading to strengthening of Pak rupee against the US dollar.

Table 6: Balance of Payments Summary

billion US$, unless otherwise indicated

		Jul-Nov		
	FY13	FY13	FY14	FY14[1]
I. Current account balance	**-2.5**	**-0.7**	**-1.9**	
Trade balance	-15.4	-6.7	-7.3	
Exports	24.8	10.3	10.2	
Imports	40.2	17	17.5	
Services balance	-1.5	-0.5	-1.1	
of which: CSF	1.8	1.1	0.3	
Income balance	-3.7	-1.5	-1.7	
Current transfers balance	18.1	8.0	8.2	
of which: Remittances	13.9	6.0	6.4	
II. Capital and Financial Account	**0.6**	**-0.3**	**0.8**	
Capital Account	**0.3**	**0.1**	**0.1**	
Financial Account: *of which*	**0.3**	**-0.3**	**0.7**	
Direct investment (net)	1.3	0.3	0.3	
Portfolio investment (net)	0.0	0.1	0.0	
Other Investment (net)	-0.9	-0.7	0.4	
Official Disbursements	2.5	0.9	1.1	
Amortization	2.3	0.9	1.3	
III. Errors and omissions	**-0.1**	**0.0**	**-1.0**	
Overall balance (I + II + III)	**-2.0**	**-1.0**	**-2.1**	
Memorandum items:				
Current account as % of GDP	-1.0	-0.3	-0.8	-1.0 to -1.8
Financial account as % of GDP	0.1	-0.1	0.3	
Change in IMF credit and loans	-2.9	-1.1	--1.1	
Net SBP forex reserves[2]	6.0	8.7	3.0	
Exports growth (%)	0.4	2.7	-0.9	6.0
Imports growth (%)	-0.6	1.1	3.0	8.0
Remittances growth (%)	5.6	14.2	7.1	

[1] SBP Projections

[2] Excluding CRR and foreign currency cash holdings

Source: SBP

55. The current account deficit was $1.9 billion during July-November FY14, which is in line with SBP projections but considerably higher than last year's level even after adjusting for Coalition Support Funds (CSF). Higher trade deficit remained the main contributor to this widening of current account deficit as imports increased by 3.0 percent while exports recorded a marginal decline of 0.9 percent during this period.

[9] Pakistan signed an Extended Fund Facility (EFF) amounting to $6.64 billion in September 2013. Unlike the last IMF program when the initial disbursement of $3.0 billion was substantial enough to immediately reduce stress on BOP, the EFF is designed to address medium and long-term balance of payments problems and entails gradual disbursements in small tranches.

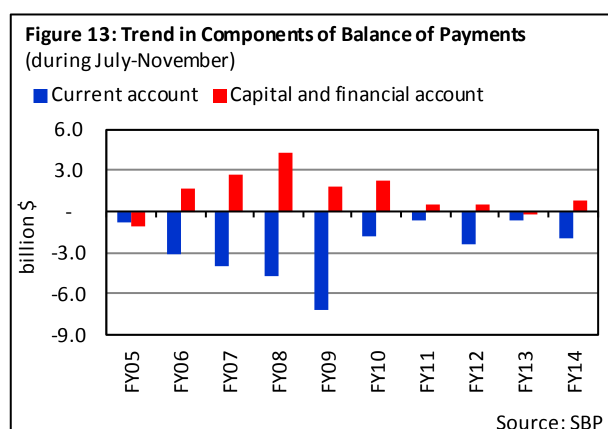
[10] The net international reserves (NIR) are defined as the dollar value of the difference between usable gross international reserve assets and reserve-related liabilities, evaluated at the program exchange rates.

56. Acceleration in import growth, despite stability in international commodity prices, was mainly driven by higher import of machinery and metals, witnessing growth of 27.2 percent, and 14.3 percent respectively. This reflects improved domestic economic activity as indicated by acceleration in LSM growth during July-October FY14. Incorporating this pickup in economic activity and expected increase in demand for machinery and oil imports for power generation, the overall import growth is forecasted at 8.0 percent for FY14.

57. On the other hand, exports recorded a decline of 0.9 percent during July-November FY14 despite a strong 5.6 percent and 25.0 percent increase in exports of textiles and petroleum products respectively. Given the approval of GSP plus status for Pakistani exports to European Union and government's recent decision to divert gas to industrial sector, growth in exports is forecasted to improve to 6 percent in FY14.[11] On the downside, increase in cost of production on account of higher energy prices could negatively affect competitiveness of the export sector.

58. The overall current account deficit for FY14 is projected to remain in the range of 1.0 to 1.8 percent of GDP, which is not very high by historical standards and does not seem to pose risk to the external sector (**Figure 13**). This outlook, however, is dependent on the realization of remaining $878 million under the Coalition Support Fund (CSF) and $1.2 billion as proceeds from the auction of 3G license fee.[12] In case of delay or shortfall, the external current account deficit could increase substantially.

Figure 13: Trend in Components of Balance of Payments
(during July-November)



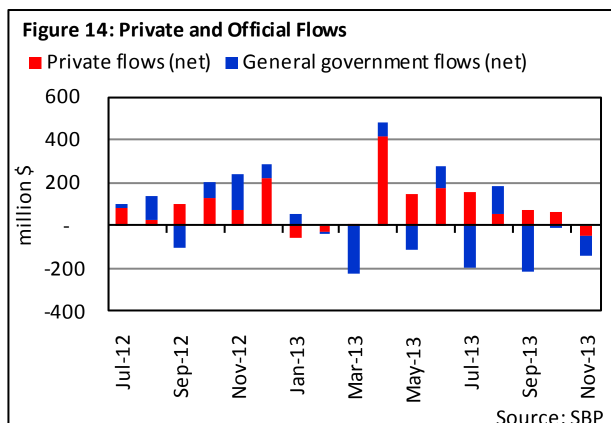
Source: SBP

59. Unlike FY13, the financial account has shown a surplus during July-November FY14. The magnitude of this surplus, however, has not been enough to finance the current account deficit. Specifically, the net capital and financial flows stood at $800 million during July-November FY14 against an outflow of $263 million in the corresponding period of last year. This improvement in financial account is mainly due to drawing of another $245 million from the bilateral SWAP agreement with

[11] Government's Economic Coordination Committee (ECC) has decided to divert the gas allocation to industrial units from power sector.

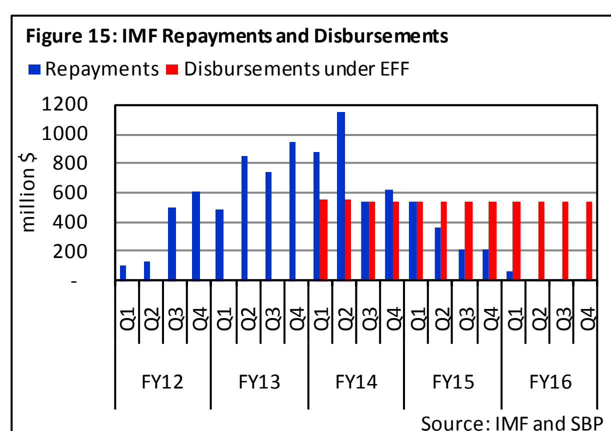
[12] Pakistan has already received $322 million under coalition support fund against the due amount of $1.2 billion assumed for FY14.

China together with banks and other sectors bringing in their assets held overseas.[13] Both the private and official inflows, however, have remained weak (**Figure 14**). In particular, the private financial inflows have been significantly lower at $293 million during July-November FY14 against $408 million in the corresponding period of FY13.



60. Given higher debt servicing requirements, more than disbursements from multilateral donors, the net general government account continued to remain a drain on financial account and foreign exchange reserves. Moreover, IMF repayments of approximately $1.9 billion in H1-FY14 against receipt of $1.1 billion under the new program added to the stress. Resultantly, SBP reserves fell to the lowest level of $2.9 billion as of 3rd December 2013, which fuelled speculative sentiments and increased pressure on rupee to depreciate.

61. However, stress in the balance of payments could recede gradually, provided the estimated foreign inflows are received during H2-FY14. These inflows include overdue proceeds of $800 million from the privatization of PTCL, $500 million from the international market through floatation of euro bonds, and additional flows from bilateral and multilateral sources under the new IMF program. Similarly, the payment of $1151.2 million to the IMF during Q2-FY14 was the peak of the loan repayment schedule. As payments decline during the coming quarters, net financing from the IMF will start to increase (**Figure 15)**. The cumulative effect of these expected developments is going to be a gradual increase in SBP's foreign exchange reserves, which stands at $3.5 billion as on 10th January 2014.

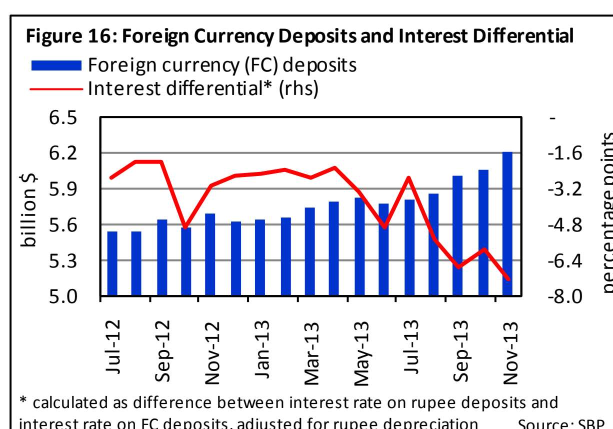


62. The exchange rate has depreciated by 5.5 percent since end-June 2013 to 10th January 2014. Most of this depreciation took place till 3rd December, when

[13] Currency swap agreement between China and Pakistan signed on 9th December, 2011, allows both countries to purchase and repurchase currency from each other.

exchange rate had depreciated by approximately 8.2 percent. Amid falling reserves and efforts to meet the end-quarter NIR target of the IMF, it became quite challenging for the SBP to discern between market's genuine liquidity requirements and speculative tendencies. Besides SBP interventions in the foreign exchange market, strong communication by both SBP and the government to contain speculative sentiments in the market helped in stemming the fall of rupee.

63. Moreover, increases in the policy rate and resultant increase in return on rupee deposits also helped in discouraging the speculative sentiments. However, return on rupee deposits vis-à-vis foreign currency deposits, adjusted for exchange rate depreciation, is still quite low (**Figure 16**).



64. Considerable effort is required to bring a sustainable improvement in the external accounts. In particular, significant increase in private inflows is needed to keep the external sector on a sustainable path without recourse to debt creating inflows. In this context, implementation of reforms to improve the overall business environment is needed to revive the interest of foreign investors in Pakistan economy. Moreover, improvement in security conditions could also provide a positive signal to foreign private investors.

E. Inflation: Increases after Some Fiscal Consolidation

65. The CPI Inflation has increased significantly during H1-FY14, with year-on-year inflation increasing from a low of 5.1 percent in May 2013 to 10.9 percent in November 2013 before receding slightly to 9.2 percent in December 2013 (**Table 7**). Both food and non-food groups of the CPI basket contributed in the increase of

Table 7: Inflation

in percent

	year-on-year		period average	
	Jun-13	**Dec-13**	**H1- FY14**	**FY14[1]**
CPI headline	**5.9**	**9.2**	**8.9**	**10.0-11.0**
Food group	7.9	9.3	9.9	
Non-food group	4.4	9.1	8.2	
Core measures				
NFNE*	7.8	8.2	8.5	
20% trimmed	6.8	8.7	8.2	

* non-food non-energy; [1] Projections

Source: PBS and SBP

headline inflation. The food inflation was largely contributed by volatile price movements in perishable food items mainly due to disruptions in supply chain, while non-food inflation picked up on account of fiscal measures.

66. To reduce the fiscal deficit, the government undertook some overdue fiscal consolidation measures in the budget for FY14. These measures include rationalization of energy sector subsidies and an upward revision of General Sale Tax (GST) rate in addition to withdrawal of some exemptions. This has pushed up wholesale as well as consumer prices.

67. Specifically, in July 2013, the government increased the GST by 1 percentage point to 17 percent on most retail goods and services to check the declining tax revenues. Subsequently, an additional 2 percent value added tax (VAT) was introduced on few manufactured items in October 2013. The government also withdrew some of the earlier GST related exemptions, the most notable being the GST concession on readymade garments.

68. Similarly, the electricity tariffs were adjusted in two steps. Effective from August 2013, electricity tariffs for commercial, bulk residential and industrial users were increased by about 24 percent, which affected the Wholesale Price Index (WPI). Also, a tariff increase of around 16 percent for domestic consumers in October 2013 directly affected the CPI. These increases in GST and upward adjustment in electricity prices have resulted in a significant increase in prices of retail goods as well as those administered by the government (**Figure 17**).[14]

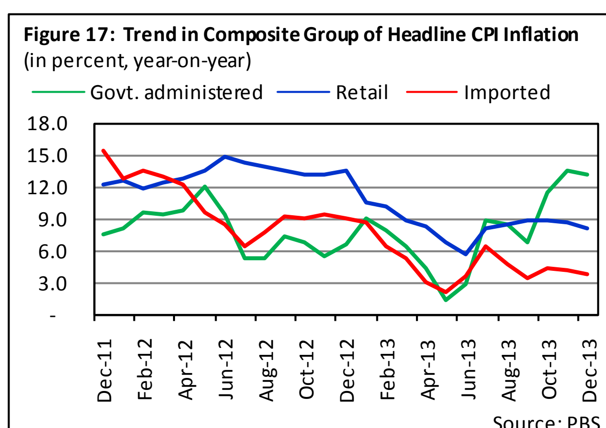


Figure 17: Trend in Composite Group of Headline CPI Inflation
(in percent, year-on-year)

69. Contrary to increase in prices of administered and retail goods, inflation on account of imported goods have remained subdued despite considerable volatility in exchange rate during H1-FY14. This is because of deceleration in international commodity prices, which helped in neutralizing to some extent the direct impact of exchange rate volatility on CPI inflation. Going forward, weak global economic

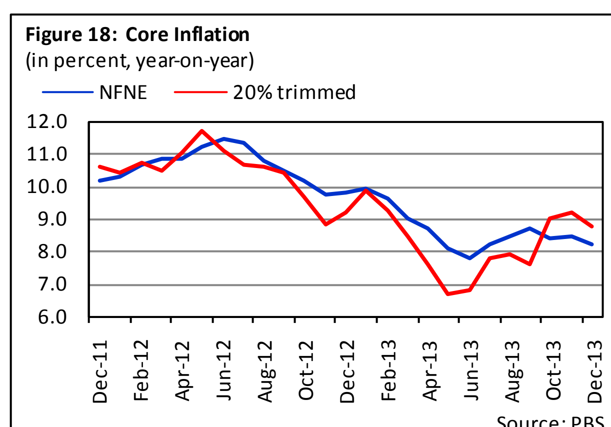
[14] A good manufactured under the registered manufacturing setup or appearing with a certain brand in CPI basket is categorized as retail good. Retail goods include Biscuits, Cereals, Milk (powder & pack), Cooking oil, Ghee, Beverages, Candies, Jam, Juices, Masala packs, Tea, Pickle, Cigarettes, Cloths, Shoes, Electrical appliances, Matress & sheets, Soap, Detergents, Medicines, Vehicles, Books, Magazines, Private. Schools, Cosmetics and watches.

conditions may contain the price elastic demand for imported products, hence keeping the imported CPI inflation low in FY14.

70. However, the market price of wheat has remained higher on average during H1-FY14 compared to the government's current procurement price of Rs1200 per maund. It is expected that wheat prices would hover around the current level of Rs1575 per maund until the new wheat crop is harvested or the government releases some of its strategic wheat reserves to bring the market price down.

71. Although the fiscal measures have adversely affected the inflation outlook for FY14, they will help reduce budgetary borrowings from the banking system and thus inflationary pressures in the medium term. Thus, the increase in inflation during H1-FY14 is a cost of delayed fiscal adjustment. The important point is that the risk of demand-driven inflation is still rather moderate. For instance, the year-on-year Non Food Non Energy (NFNE) inflation is 8.2 percent in December 2013; marginally up from 7.8 percent in June 2013 (**Figure 18**).

Figure 18: Core Inflation
(in percent, year-on-year)



Source: PBS

72. This is because economic activity has remained quite sluggish over the last five years. It will take some time before the pick-up in economic growth pushes up aggregate demand. Moreover, explicit limits on government borrowing from the SBP, as stipulated in the new IMF program, could also have a beneficial effect on inflation expectations. Nevertheless, SBP expects average CPI inflation for FY14 to fall between 10 to 11 percent, which would be higher than the target of 8 percent announced by the government. Other than attending to external sector risks, the reason for recent increases in the policy rate is also to manage expectations in the wake of expected inflation remaining higher than the target and restrict decline in real interest rates.

III. Concluding Remarks

73. Financial market liquidity conditions remained volatile due to prevailing uncertainties over financial flows and rising inflation. The quarterly IMF program performance criteria targets also had its impact over market behavior. Together,

these gave rise to speculative sentiments resulting in rise in market interest rates and exchange rate volatility. A relatively higher increase in short-term rates compared to long term rates indicates market's expectation of a further increase in the policy rate by SBP during FY14. In addition, due to improved returns, market's interest for longer tenor government securities has also increased. The fiscal authority must use the opportunity to improve its debt maturity profile.

74. The increase in market interest rates also had a positive influence in slowing down the depreciation of Pak rupee. A durable solution for exchange rate stability, however, is in a sustainable balance of payments position, which in turn depends upon sustained increase in exports and structural reforms. In the absence of such reforms, the burden of adjustment falls disproportionately higher on exchange rate and interest rate adjustments. The former not only increases the fiscal burden, but also fuels inflation expectations. Moreover, it discourages private investment, which is much needed for economic growth in the country.

75. Despite substantial government borrowing from the banking system and a decent pick up in private sector credit, the overall monetary expansion has decelerated somewhat. This moderation largely owes to sharp contraction in net foreign assets of the banking system. Although, government borrowing from SBP remains substantial, the increase in government borrowing from the scheduled banks, more recently, due to increase in interest rates is encouraging.

76. Nevertheless, the quarterly flow of fiscal borrowings from the SBP has remained positive in both quarters of H1-FY14. This does not bode well for the effectiveness of monetary policy. The SBP expects that government will keep these borrowings in check in H2-FY14 and lower outstanding stock gradually as stipulated in the new IMF program.

77. A positive development has been the accelerated growth in private sector credit. Going forward, however, challenges remain. Besides fiscal dominance, law and order conditions have yet to improve and energy shortages still persist. The current rise in interest rate could also have a dampening impact on utilization of credit and economic activity.

78. The Q1-FY14 fiscal data shows that government has managed to contain fiscal deficit. Increase in total revenues and cut in expenditures helped in keeping the deficit low. Maintaining this performance in remaining quarters of FY14, however,

would be challenging since the revenues were boosted by one-off non-tax revenues. A positive development is that tax revenues grew sharply. Nevertheless, this growth in tax revenues is significantly lower than what is required to achieve the annual budget target. Thus, the reliance on temporary non-tax revenues to contain fiscal deficit in essence highlights that further efforts would be required to address the structural fiscal weaknesses.

79. The tax measures announced in FY14 budget have only added to the burden of existing tax payers instead of bringing untaxed segments of the economy under the tax net and expand the tax base for sustained increase in tax collection in coming years. Without expanding tax base and gradually bringing all income generating sectors of the economy into tax net, the tax woes of Pakistan's economy are likely to continue.

80. Notwithstanding the receipt of two tranches under the new IMF program, the external sector remains vulnerable and is deteriorating. Weak financial inflows, together with high debt repayments, remain the source of stress. The new IMF program has so far not helped in attracting financial inflows and providing the much needed stability in the foreign exchange market. The overall balance of payments deficit has widened and, along with large repayments to IMF, resulted in depletion of SBP's foreign exchange reserves.

81. The overall current account deficit for FY14 is projected to increase. However, it is not deemed very high by historical standards and does not seem to pose risk to the external sector. The external current account deficit and its financing rests with inflows like CSF, 3G license fee, privatization of PTCL related inflows, and issuance of euro bond. Absence of these flows could potentially result in a balance of payments deficit as against an anticipated surplus for FY14. Together with net repayments to the IMF for FY14, this suggests that there are some risks to the balance of payments position.

82. Inflation has increased sharply during H1-FY14. Both food and non-food groups of the CPI basket contributed in the increase of headline inflation. Food inflation was largely contributed by volatile price movements in perishable food items due to disruptions in their supply-chain, while non-food inflation picked up on account of fiscal consolidation measures of the government. Contrary to the increase in prices of administered and retail goods, inflation on account of imported goods remained subdued despite depreciation of the Pak rupee.

83. Although there are some risks to the balance of payments position due to uncertainty surrounding expected foreign inflows, expected increase in inflation is slightly lower than anticipated earlier. In view of the above, the Board of Directors of SBP has decided to keep the policy rate unchanged at 10.0 percent.