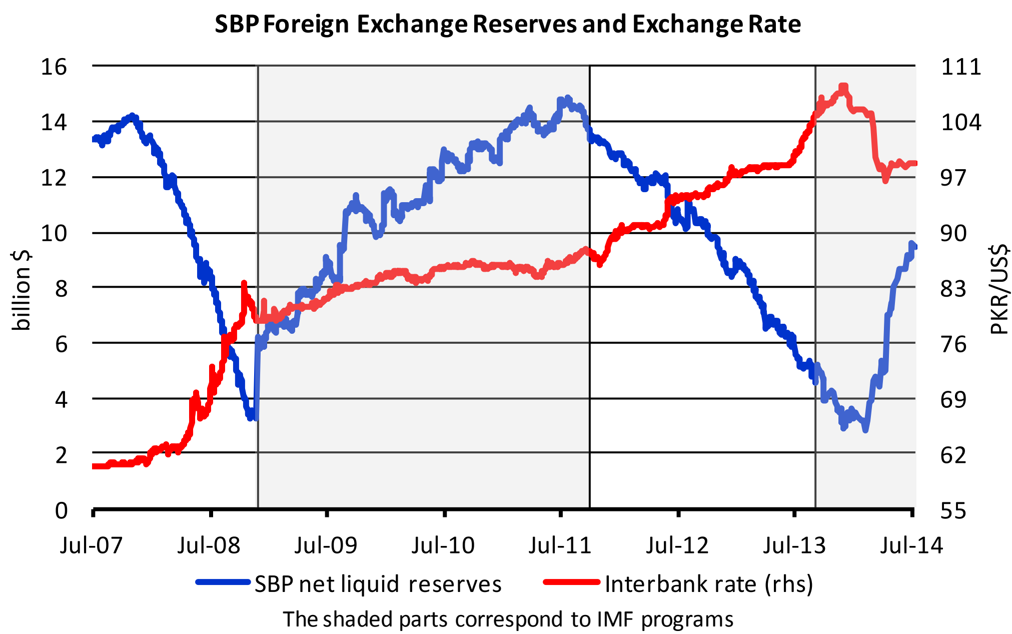
# MONETARY POLICY STATEMENT

## July 2014



# STATE BANK OF PAKISTAN

## Contents

Executive Summary 1

I. Economic Environment during H2-FY14 5

A. Global Developments 5

B. Domestic Developments 7

II. Recent Economic Developments and Outlook 8

A. Short Term Interest Rates: Reinforcing Improved Market Sentiments 8

B. Monetary Expansion: Receding Due to Lower Government Borrowings Amid Rising Private Sector Credit 13

C. Fiscal Deficit: Curtailed and Supported by Increased External Finance 19

D. External Sector: Increasing Financial Inflows and Rising Reserves 22

E. Economic Growth: Sustainability of Recovery Requires Additional Reforms 26

F. Inflation: Moderate at a Single Digit Level 29

III. Concluding Remarks 31

List of Acronyms 34

## List of Tables


| | | |
|---|---|---|
| Table 1: | Treasury Investments by Banks | 12 |
| Table 2: | Monetary Aggregates | 14 |
| Table 3: | Private Sector Credit | 15 |
| Table 4: | Financial Indicators of Selected Industries | 16 |
| Table 5: | Summary of Consolidated Fiscal Operations | 20 |
| Table 6: | Balance of Payments Summary | 23 |
| Table 7: | Average Inflation | 29 |


## List of Figures


| | | |
|---|---|---|
| Figure 1: | Interest Rate Corridor and SBP's Liquidity Provisions | 9 |
| Figure 2: | Exchange Rate, Market Nostros and Trade Financing | 10 |
| Figure 3: | Market and Retail Interest Rates | 11 |
| Figure 4: | Yield Curves and Average Term Spreads | 12 |
| Figure 5: | Contribution in Broad Money Growth | 13 |
| Figure 6: | Government Borrowings and Composition of Fiscal Deficit Financing from the Banking System | 13 |
| Figure 7: | Average Annual Growth in Monetary Aggregates | 14 |
| Figure 8: | Stock of Net Foreign Assets of SBP | 17 |
| Figure 9: | Real Deposit Growth and Real Returns | 18 |
| Figure 10: | Trend in Energy Subsidies | 21 |
| Figure 11: | SBP Reserves and Exchange Rate | 23 |
| Figure 12: | Growth in Effective Exchange Rate | 24 |
| Figure 13: | Oil Imports | 24 |
| Figure 14: | Real GDP Growth | 26 |
| Figure 15: | Average Electricity Load Management | 26 |
| Figure 16: | Investment Expenditure | 27 |
| Figure 17: | Target vs. Actual CPI Inflation | 29 |

## Executive Summary

1. Economic conditions are certainly better at the beginning of FY15 than a year ago. The foreign exchange reserves held by SBP are considerably higher accompanied by stability in the foreign exchange market. Growth in broad money is contained due to deceleration in government's budgetary borrowings from the banking system. Inflation remains in single digits and private sector credit is picking up along with moderate economic recovery. Accordingly, SBP maintained the policy rate at 10 percent during H2-FY14; it was last increased in November 2013.

2. A detailed assessment of the economy, however, indicates that challenges and vulnerabilities remain. Continuation of prudent policies and reforms are needed to build-on positive developments and to achieve protracted stability. For instance, only comprehensive tax reforms can reduce the fiscal deficit and keep broad money (M2) expansion within safe limits on enduring basis. Similarly, energy sector reforms can not only provide critical impetus to economic growth but also help reduce import bill and thus ease pressure on the balance of payments position.

3. On its part, SBP is effectively managing market sentiments by supplementing the monetary policy stance with calibrated liquidity operations in the interbank market. Apart from anchoring inflation expectations, this has contributed in achieving stability in the foreign exchange market and in building foreign exchange reserves. This has also facilitated the shift in banks' investment from T-bills to PIBs, which has improved domestic debt maturity profile and reduced the roll-over risk for the government.

4. Specifically, despite significant injections by SBP, appetite for liquidity remained sufficiently high in the market. As a result, short-term interest rates remained on the higher side, making rupee liquidity more expensive. This reduced pressure on exchange rate as it discouraged speculative holdings of foreign exchange and made trade financing through foreign currency deposits held by banks more attractive. To contain growth in SBP's Net Domestic Assets (NDA) and reserve money, SBP will continue to monitor liquidity conditions in the market.

5. Nevertheless, year-on-year growth in M2 has decelerated to 12.5 percent by end-June 2014 – the lowest rate of monetary expansion during last three years. This was mainly due to a significant reduction in government borrowings for budgetary support from the banking system. Specifically, the government borrowed Rs303

billion from the banking system during FY14; around 21 percent of Rs1446 billion borrowed in FY13. Lower borrowing and subsequent deceleration in broad money, projected to be around 12.9 percent in FY15, are contributing towards low inflationary expectations.

6. The lower demand for credit by the government also provided necessary space to the private sector to borrow from the banking system. Given a stable monetary policy stance along with improving macroeconomic conditions, private sector credit has increased by Rs328.9 billion during July-May, FY14 – highest in last six years. A majority of this increase was availed for working capital though an amount of Rs83.2 billion was also utilized for fixed capital formation.

7. Going forward, an analysis of financial indicators of major industries along with persistent energy shortages and deteriorating security conditions hint towards some risks to credit demand. However, given robust profitability, asset quality, and capital adequacy of the banking sector a reasonable supply of credit by banks can be expected. Envisaged lower government borrowings from banks also support this assessment. Nevertheless, deposit growth of 12.6 percent in FY14 needs to be improved.

8. Sustainability of lower government borrowings from the banking system, including SBP, is contingent upon further reduction in the fiscal deficit and continuation of external financing. In this context, the government has set a target of 4.9 percent of GDP for the fiscal deficit of FY15; about 0.9 percent below the revised FY14 estimate of 5.8 percent of GDP. Also, a little over 80 percent of the projected deficit is envisaged to be financed from external and non banking sources.

9. From the point of view of monetary policy, evaluation of fiscal position is important to gauge risks to projected money growth, private sector credit estimates, and inflation outlook. A major risk to the fiscal position of FY15 is from the revenue side. In particular, the FBR revenue target of Rs2810 billion looks challenging given the current narrow tax base. The target for FY14 has been missed despite a significant growth of 17.5 percent. Moreover, growth in total revenues was due to a significant increase in non-tax receipts during FY14, which may not be the case in FY15.

10. Nonetheless, lower fiscal deficit and increase in external financing in FY14 has already resulted in slower accumulation of domestic debt. The growth in domestic

debt during FY14 has decelerated to 14.5 percent, which is significantly lower than the average growth of around 27 percent during the last three years. This bodes well from the point of view of country's risk perception and could help in attracting investment in the economy.

11. The substantial increase in external borrowings since February 2014 have provided a much needed respite and short term stability to the balance of payments position. These foreign inflows have resulted in a capital and financial account surplus of $6.1 billion during Jul-May FY14, which is a marked improvement compared to a surplus of only $465 million in the corresponding period of last year. Not only did this surplus comfortably finance the current account deficit of $2.6 billion but has also led to a significant increase in SBP's foreign exchange reserves.

12. From a low level of $2.8 billion on 7th February 2014, SBP's foreign exchange reserves have increased to $9.6 billion by 4th July 2014. Similarly, the Net International Reserves (NIR) also gradually increased, reaching positive 2.7 billion by end-June 2014 compared to negative 2.4 billion a year earlier – a net increase of $5.1 billion. These developments brought about a fundamental shift in sentiments in the foreign exchange market from March 2014 onwards. The exchange rate has stabilized slightly below Rs99 to USD after experiencing significant appreciation. More recently, on 14th July 2014, Moody's Investors Service has revised the outlook on Pakistan's foreign currency government bond rating to stable from negative.

13. The impetus of positive sentiments together with continuation of IMF program and government's privatization plan is expected to result in further strengthening of the external position in FY15. Specifically, with current account deficit projected to remain around 1 percent of GDP in FY15, SBP expects its foreign exchange reserves to exceed $13 billion by end-June 2015 on the back of continued financial inflows. The main risks to this assessment are uncertainty over international oil prices and possible delays in planned foreign inflows.

14. Sustaining this trend in the medium term, especially in the post IMF program years, would require additional efforts and reforms. For instance, a trade deficit of over 6 percent of GDP would need to be curtailed. Improving efficiency and competitiveness of exports and reducing the share of imported oil in meeting domestic energy needs are examples of required reforms. A significant recent appreciation of the Real Effective Exchange Rate (REER) would also need to be

monitored carefully in this context. Similarly, improvement in country's security conditions is also critical in attracting non debt creating financial inflows.

15. Despite challenging security conditions and energy shortages, the real GDP grew by 4.1 percent in FY14. Encouragingly, this relatively higher growth was led by recovery in the industrial sector, thanks to better performance of Large Scale Manufacturing (LSM). However, investment expenditures as a percent of GDP have declined to 14 percent in FY14, which indicates erosion in economy's future productive capacity.

16. The average CPI inflation in FY14, 8.6 percent, is in single digits for the second consecutive year. For FY15, the SBP expects average CPI inflation to remain in the range of 7.5 percent to 8.5 percent. Other than assuming continuation of current monetary policy stance, this outlook is supported by (i) continuation of moderate aggregate demand; (ii) further containment in government budgetary borrowing from the banking system; and (iii) overall stable outlook of international commodity prices. However, international oil price uncertainty and unanticipated price shocks pose risks to the inflation outlook.

17. In conclusion, the Board of Directors of SBP has decided to keep the policy rate unchanged at 10.0 percent. Henceforth, the Board has also decided to publish the summary of minutes of monetary policy proceedings of the Board meeting in four weeks.

# I. Economic Environment during H2-FY14

## A. Global Developments

1. Global economic growth prospects remain weak as advance economies, particularly US and Euro zone, continue to experience slow growth despite corrective measures. While Japan has exhibited better economic activity, its ability to drive advance economies' growth is contingent upon the success of its structural reforms. At the same time, emerging economies, after recovering from the recent financial crisis, are already operating close to their potential. Resultantly, the global economy is expected to grow slower during 2014. In its latest assessment, the World Bank has revised its projection for growth in global ouput downwards by 40 bps to 2.8 percent for 2014.

2. The US economy experienced slower GDP growth during first quarter of 2014. This was largely a result of extreme weather conditions that curtailed investment and exports[1]. However, market sentiments improved following the suspension of federal government budget ceiling up until March 2015. Moreover, continued forward guidance by the Federal Reserve on reducing its asset purchase program kept financial market volatility at bay.[2] This progress in balance sheet adjustment coupled with consistently improving job markets data is expected to yield an upturn in US economic growth in the second half of 2014.

3. On the other hand, amidst low inflation, Euro zone growth continues to remain subdued. Economic fragilities in peripheral economies remain despite a pickup in their exports. With a strong euro, these peripheral economies have made their exports competitive through negligible increases in wages. Financial conditions, however, have improved in the Euro zone on account of three important developments. These are: progress in restoration of fiscal discipline in most economies within the Euro area, establishment of a pan-European banking supervision regime and substantial monetary easing in June 2014 by the ECB.[3] Nevertheless, banking stress would continue to drag economic recovery in the Euro zone in the medium term.

[1] World Bank (2014), Global Economic Prospects.

[2] Asset purchase program stands at at $35 billion per month from July 2014, down from $75 billion in January 2014.

[3] The ECB introduced several monetary easing measure in June including a cut in its benchmark rate to rate from 0.25 to 0.15 percent; a cut in deposit rates for banks from zero to -0.1 percent (to push banks to lend) and a substantial injection of liquidity and credit easing measures including a Targeted Long Term Refinancing operation (TLTRO).

4. In contrast, Japan's economy has shown significant improvement with both fiscal and monetary stimulus impacting output. A sharp acceleration in consumer and business spending prior to the implementation of a sales tax hike from April 2014 have helped maintain a broadly stable momentum in economic activity. However, the prospects of Japan's economy following an upward trajectory remain dependent upon the success of its structural reforms aimed at increasing the potential output.

5. Broadly, these developments in advanced economies have had a muted effect on international financial and capital markets. Most emerging market economies have experienced limited currency and stock market reactions since actual tapering in the US. A few cases of large depreciations in countries, for example Thailand and Argentina, however, are mainly a consequence of domestic political developments and weak macroeconomic fundamentals. Moreover, the regional outlook for these economies remains dependent upon growth supporting measures by China and a recovery in global demand for exports.

6. Nevertheless, capital inflows have in fact rebounded for emerging economies. Resultantly, currencies like the Brazilian Real and the Indian Rupee are regaining strength, thereby, reducing pressure on central banks in these emerging economies to tighten their policy. In addition, recent monetary easing measures taken by the ECB are expected to further boost these capital inflows as Euro Zone banks have larger cross-border dealings than those of US and Japanese counterparts. Thus, emerging market economies remain vulnerable to large spillover effects from advanced economies, thereby requiring strong macroeconomic fundamentals to cope with the resulting challenges.

7. Largely reflecting global growth trends, international commodity prices are expected to remain subdued in the medium term. World food prices have also stabilized since March 2014 as global production recovers from adverse weather conditions. Similarly, international oil price movements are expected to stay within a narrow band. This is because OPEC production remains comfortable despite geo-political concerns in Iraq and Syria.[4] Resultantly, global inflation outlook remains benign, which bodes well for Pakistan's economy in the shape of stable international prices.

8. Moreover, global appetite for higher yields in the face of ample liquidity improves Pakistan's prospects of attracting further capital from international

[4] Crude oil prices (SA light) averaged around $107/pbl during H2-FY14.

markets. However, a slower global economic recovery may represent negative implications for Pakistan's trade prospects.

## B. Domestic Developments

9. During H2-FY14, macroeconomic indicators of Pakistan's economy like reserve level, private sector credit, large scale manufacturing (LSM) and inflation moved in the right direction. This, along with gains in confidence in the economy which is reflected in the most recent consumer confidence surveys of SBP,[5] allowed SBP to keep the policy rate unchanged at 10.0 percent.

10. External account witnessed substantial improvement in H2-FY14. Receipt of foreign inflows under Pakistan Development Fund (PDF), successful issuance of Eurobonds after a gap of seven years, inflows from auction of 3G/4G spectrum and loans from multilateral agencies all added to a surplus in the capital and financial accounts. Robust growth in workers' remittances and Coalition Support Fund (CSF) inflows helped manage current account deficit as well. Further, relatively low IMF repayments also eased some of the pressures on SBP reserves in H2-FY14.

11. Resultantly, the pressure on the balance of payments position eased and SBP was able to meet the IMF's adjusted Net International Reserves (NIR) target for end March 2014 through buildup of foreign exchange reserves.[6] The stability in foreign exchange market along with improvement in net foreign assets (NFA) was a natural consequence of these developments.

12. On the fiscal front, the government successfully brought down the fiscal deficit during FY14. The contraction in fiscal deficit primarily came on the back of: i) substantial increase in non-tax revenues; ii) reduction in energy sector subsidy and iii) decrease in development outlay of federal and provincial governments. Furthermore, efforts of fiscal consolidation were also reflected in a slower growth in total expenditures. The estimated fiscal deficit for FY14 has also been revised downwards to 5.8 percent of GDP from the budgeted 6.3 percent.

13. Higher than expected external financing helped in substantially reducing government's reliance on domestic sources to finance the deficit. Consequently,

[5] The Consumer Confidence Index (CCI) for July 2014 is 142.26. Although it is slightly lower than 143.99 observed in May 2014, it is still higher than 141.82 and 133.59 recorded in March and January 2014, respectively.
[6] As per provisional estimates, NIR target for June 2014 has also been met.

government borrowing for budgetary support from the banking system witnessed a sharp decline in H2-FY14. Importantly, the fiscal authority managed to bring down the stock of borrowings from SBP below the IMF performance criterion ceiling for end-March 2014. However, the NDA target was missed by a small margin.

14. Credit to the private sector improved on the back of receding government borrowings from the banking system. Also, it grew significantly due to pickup in economic activities, improved market sentiments and better energy availability. Increase in credit to the private sector was dominated by private sector businesses and resurgence in consumer financing. Importantly, private sector businesses not only availed credit for ongoing activities i.e. working capital requirements but also for expansion purposes i.e. fixed capital.

15. Led by revival in LSM, real GDP grew by 4.1 percent in FY14, which is the highest since FY08. Inflation remained in single digit during FY14 despite some volatility in prices of perishable food items. Worringly though, decline in real investment expenditure continued in FY14 as well, as it slipped to 14.0 percent of the GDP from 19.2 percent in FY08; the same was 14.6 percent last year.

16. On the debt management front, roll-over risk has been reduced as the government has switched its borrowing to longer term PIBs from shorter term T-Bills. However, in addition to interest rate risk, it may create potential liquidity pressures for banks as their resources are invested for longer term compared to their shorter tenor liabilities.

## II. Recent Economic Developments and Outlook

### A. Short Term Interest Rates: Reinforcing Improved Market Sentiments

17. To consolidate the improvement in major economic indicators and market sentiments, SBP kept its reverse repo (policy) rate unchanged at 10.0 percent during H2-FY14; it was last increased in November 2013. Besides favorable outlook for inflation, the most significant factor contributing towards this stability in interest rates is the recent improvements in the external sector.

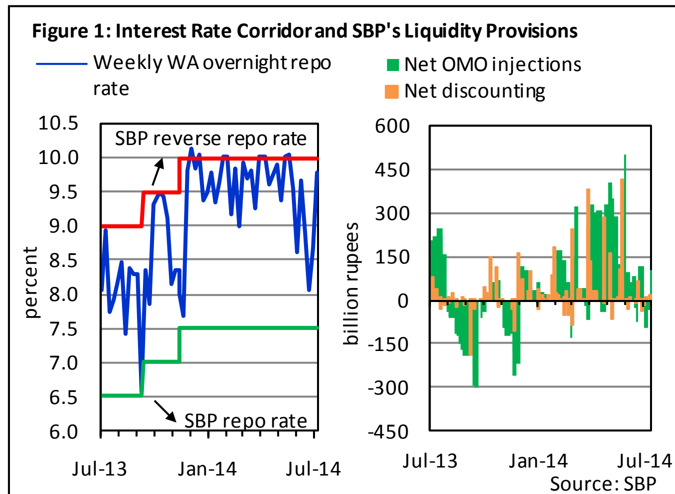
18. SBP, cognizant of these developments, is also playing its role in effectively anchoring market sentiments by supplementing the monetary policy stance with calibrated liquidity management in the interbank money market. This, in turn, has

also contributed towards achieving stability in the foreign exchange market and in building up of foreign exchange reserves.

19. Stability in the foreign exchange market is an important component of effective anchoring of market sentiments. To achieve this, SBP conducted calibrated liquidity operations in the interbank market post January 2014 monetary policy decision. Despite significant injections by SBP, appetite for rupee liquidity remained sufficiently high in the market. Specifically, the average net liquidity injections by SBP stood at Rs133 billion with an average cover-to-bid ratio of 0.80. [7]

20. Under these tight liquidity conditions banks frequently visited the SBP's overnight reverse repo facility with demand for hefty volumes to meet reserve requirements and their liquidity needs.[8] Further, to avoid the penalty cost of 50 bps over and above the policy rate[9], banks' bids in the auctions of open market operation (OMO) were near or above the policy rate of 10.0 percent on many occasions. This pattern of bidding was further reinforced, as SBP at times, set the OMO cut-off rates above the policy rate.[10] As a result, the weekly weighted average money market overnight repo rate has been hovering around 9.5 percent since the January 2014 monetary policy decision. In fact, about 25 percent of the time, it remained higher than the ceiling of SBP's 250 bps interest rate corridor (**Figure 1**).

**Figure 1: Interest Rate Corridor and SBP's Liquidity Provisions**

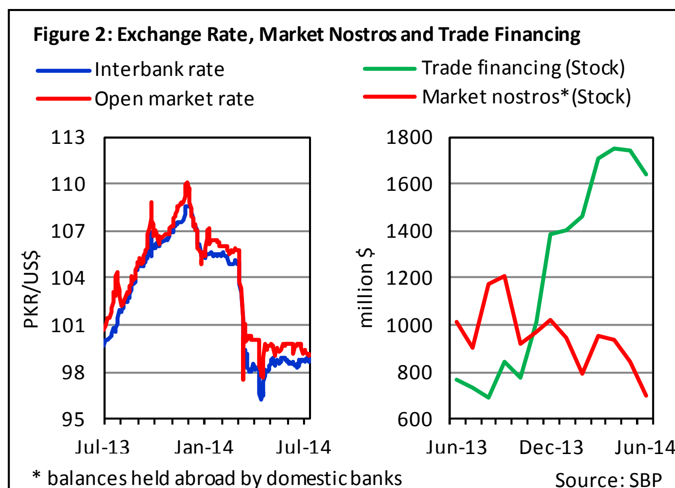


Source: SBP

21. The elevated interbank overnight repo rate in turn kept other short-term money market rates on the higher side and made rupee liquidity more expensive. This, in turn, reduced pressure on exchange rate as it discouraged speculative outflow of foreign exchange and made trade financing through foreign currency

[7] As of 11th July 2014, the outstanding net liquidity injections by SBP are Rs106 billion.
[8] On average, market acquired Rs14 and Rs8 billion per visit in the post and pre January 2014 monetary policy decision, respectively.
[9] In case an eligible institution accesses the SBP repo/reverse-repo facilities more than 7 times during a given quarter, a spread of plus/minus 50bps is applied over and above the applicable SBP Overnight Reverse Repo and Repo Rates, respectively, for the remainder of the same quarter.
[10] For example, out of 24 OMO injections conducted after the January 2014 policy decision, 9 times the OMO cut-off rate was higher than the prevailing policy rate of 10.0 percent.

deposits held by banks more attractive.[11] The later trend is reflected in drawdown of scheduled banks' market nostros against foreign currency deposits, and subsequent increase in trade financing, during the past few months (**Figure 2**).




22. By 11th July 2014, PKR has appreciated by 6.7 percent against the USD in the interbank market since January 2014 monetary policy decision.[12] This appreciation is due to a combination of positive sentiments and improvements in the external sector. For instance, during 17th January to 11th July, 2014, SBP reserves increased by $6.2 billion on account of various inflows such as issuance of Eurobonds, CSF proceeds, PDF inflows, sale of licenses of 3G/4G spectrum and net foreign exchange purchases. These inflows strengthened the balance of payments position and contributed in improving market sentiments. SBP's monetary policy stance and associated liquidity management ensured that this virtuous cycle continues to deliver stability in the foreign exchange market.

23. Further, improved inflow of foreign exchange in the interbank market and appreciation of PKR against the USD reinforced each other. The sharp appreciation in PKR-USD parity encouraged exporters to sell their foreign exchange receipts earlier in the spot and forward market, which accelerated PKR appreciation. At the same time, the SBP also reduced its outstanding forward position by $1125 million during January-May FY14, which also augmented foreign exchange liquidity in the interbank market.[13]

24. Nonetheless, it is important to highlight that most of the recent improvement in financial account and appreciation of PKR against USD is due to debt creating flows, and not because of private financial inflows or improvement in the trade

[11] When banks lend, for example to exporters, the foreign currency is sold in the interbank market and the rupee counterpart is provided to the borrower. The return on such loans is typically the LIBOR plus premium reflected by the swap curve. Loans against foreign currency deposits become attractive if the borrowing cost of rupee loans is higher and the PKR value remains stable (or it appreciates).

[12] Overall, PKR has appreciated by 0.9 percent in FY14.

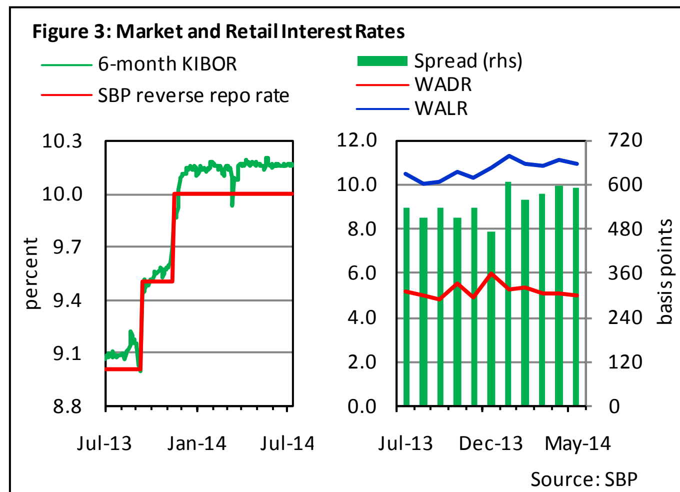
[13] At the end of May 2014, the outstanding forward position stands at $1525 million. The end June 2014 target for the same is $2150 million under the IMF program. Provisional estimates indicate that this target has also been met.

account. A more sustainable solution for stability in the foreign exchange market lies in the revival of private inflows and reduction in the trade deficit.

25. Other than contributing towards foreign exchange market stability, higher short-term rates in the domestic money market, such as the OMO cut-off rates, kept yields on T-bills of all maturities very close to the policy rate. Historically, as the government has rarely accepted bids on T-bills above the policy rate so banks participation in T-bill auctions has declined significantly. As a consequence, fiscal authority has retired Rs1224 billion worth of T-bills since the January 2014 monetary policy decision.

26. Similarly, the elevated yields on short-term government papers have also kept the corporate benchmark rate, i.e. KIBOR, on the higher side. Usually, the 6-month KIBOR strictly follows the trend in the policy rate.[14] However, it has been showing a positive spread over the policy rate and consistently hovering around 10.2 percent since December 2013. Effect of higher KIBOR can also been seen in higher weighted average lending rate (WALR) and somewhat increased banking spread (**Figure 3**). This emerging trend may negatively influence private investment in future as it will keep real lending rates on the higher side.

**Figure 3: Market and Retail Interest Rates**

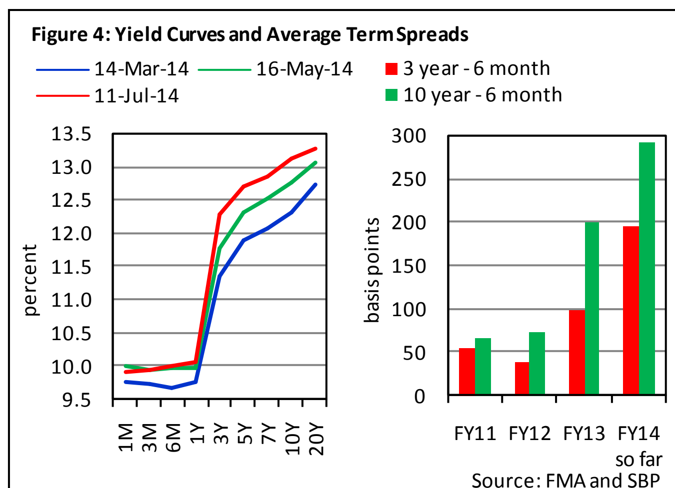


Source: SBP

27. The stable inflation and exchange rate outlook, partly due to slightly higher interest rates, made longer term investment more attractive for banks for most of the H2-FY14. Against the target of Rs480 billion in PIB auctions, market offered Rs1930 billion, out of which fiscal authority accepted Rs1874 billion. The decline in effective maturity due to reopening of previous issues and lucrative term premium of around 240 bps (compared to an average 100 bps in the last two fiscal years) provided enough incentive to attract unprecedented bids in the PIB auctions (**Figure**

[14] During the last three years (July 2010 to December 2013), the average spread has been around negative 11 bps.

**4**). This shift in banks' investment in PIBs has improved domestic debt maturity profile and reduced the roll-over risk for the government.[15]




28. The analysis also reveals that around half of the investment in PIBs made during Q3-FY14 is in the 3-year paper, which roughly indicates the horizon of banks' view about monetary policy (**Table 1**). It is interesting to note that the bulk of the fresh investments in PIBs (66 percent) have been categorized under `Available for Sale' bucket which insulates banks profit and loss account from adverse interest rate movements. However, the interest rate risk still remains as banks have to revalue these investments and the interest rate insensitive portion (under 'Held to Maturity' category) is only 33 percent.[16]

29. Moreover, significant funding from PIB auctions helped fiscal authority to retire borrowings from the SBP and meet the IMF program target of Rs2390 billion for end March 2014. However, despite successful conduct of recent Sukuk auction[17], the provisional estimates indicate that the end June 2014 target of government borrowings from SBP has been missed.

**Table 1: Treasury Investments by Banks**

billion rupees, flows during Q3-FY14

| | Held for Trading | Available for Sale | Held-to-Maturity |
|---|---|---|---|
| **MTB** | 60.4 | -382.9 | -61.4 |
| **PIB** | 7.3 | 497.7 | 245.3 |
| ***3-year*** | *6.3* | *250.9* | *131.8* |
| ***5-year*** | *3.8* | *140.1* | *73.7* |
| ***10-year*** | *-2.8* | *106.7* | *39.8* |
| **Other** | 3.8 | -41.5 | 2.3 |
| **Total** | **71.5** | **73.4** | **186.3** |

Source: Unaudited Quarterly Accounts of Banks

30. Nevertheless, shifting from shorter to longer tenor securities could potentially enhance banking industry's risk exposure towards future interest rate changes. Thus, from the perspective of financial stability, SBP is carefully monitoring and analyzing these important emerging trends.

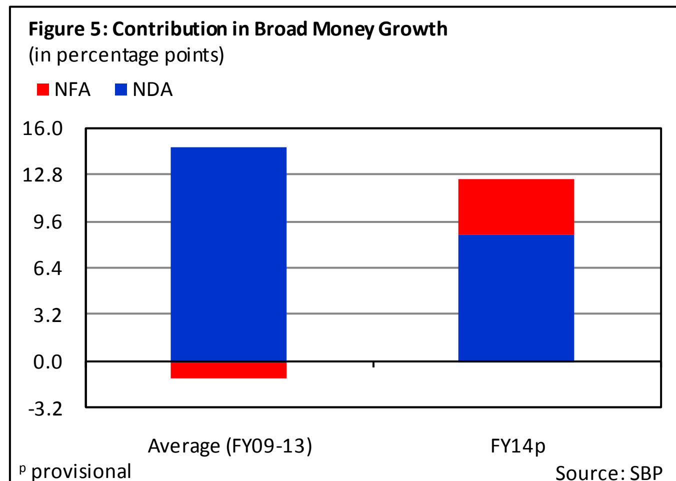
[15] According to latest data up to May 2014, 56 percent of the total outstanding government securities held by banks and non-banks were in the form of PIBs. The same ratio was 26 percent at the beginning of FY14.

[16] In terms of BSD Circulars No. 10 and 14 of 2004 , banks/DFIs are required to classify their investment portfolio as (i) Held to Maturity (ii) Held for Trading and (iii) Available for Sale. Any surplus/deficit on category (ii) will be charged to profit and loss account, while any such surplus/deficit on (iii) will be taken to `surplus/deficit on Revaluation of Securities' account in the balance sheet. Securities held under (i) are not required to be revalued.

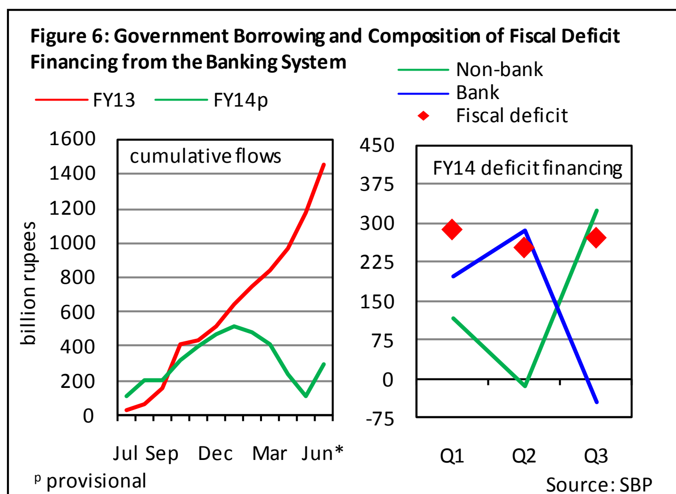
[17] Against the target of Rs49.5 billion, islamic banks offered Rs113.7 billion in the recent Sukuk auction held on 20th June 2014. Despite lucrative offers, government adhered to the target and raised the amount at a cut-off margin of 200 bps below the latest avaiable weighted average yield on 6-month T-bills.

## B. Monetary Expansion: Receding Due to Lower Government Borrowings Amid Rising Private Sector Credit

31. The year-on-year growth in broad money (M2) has decelerated to 12.5 percent in FY14 from 15.9 percent a year earlier. This is the lowest monetary expansion during the last three years, which is mainly due to a significant deceleration in growth of Net Domestic Assets (NDA) of the banking system (**Figure 5**). However, part of the impact of this slowdown in NDA was offset by a considerable expansion in NFA of the banking system during the same period.




32. Some deceleration in NDA of the banking system was expected in the second half of FY14 as higher external inflows starting in February 2014 substituted part of government borrowings from the banking system. This impact was further compounded by a relatively lower fiscal deficit and increase in non-bank borrowings that reduced the government's financing needs from the banking system (**Figure 6**). Specifically, government borrowed Rs303 billion for budgetary support from the banking system during FY14, which is around 21 percent of Rs1446 billion borrowed in FY13 (**Table 2**).




33. Other factors that have contributed in the slowdown of government borrowings from the banking system and thus money creation are the quantitative limits set under the IMF program. These include the direct impact of ceiling set on government borrowings from SBP and indirect impact of restrictions on the fiscal deficit. Historically, because of these limits both reserve money and broad money have on average grown at a slower pace during the years of IMF programs than years

without IMF programs (**Figure 7**). This lower borrowing and resultant deceleration in reserve and broad money is contributing towards low inflationary expectations.

**Table 2: Monetary Aggregates**

stock and flow in billion rupees, growth in percent

| | June 2013 Stocks | Flows during | | |
|---|---|---|---|---|
| | | FY13 | FY14[P] | FY15[1] |
| NDA: *of which* | 8589 | 1479 | 778 | 830 |
| Net budgetary support | 5246 | 1446 | 303 | |
| SBP | 2213 | 507 | 197 | |
| Scheduled banks | 3033 | 940 | 106 | |
| Commodity operations | 468 | 32 | 25 | |
| Private sector credit | 3357 | -19 | 384 | |
| Credit to PSEs | 288 | 31 | 54 | |
| NFA | 269 | -263 | 332 | 461 |
| SBP | 133 | -261 | 357 | |
| Scheduled banks | 136 | -2 | -25 | |
| **Money supply (M2)** | **8858** | **1216** | **1110** | **1291** |
| Reserve money | 2535 | 346 | 326 | 369 |
| Currency in circulation | 1938 | 264 | 240 | |
| Total deposits | 6909 | 950 | 868 | |
| **Growth (year-on-year)** | | | | |
| Net budgetary support | | 38.1 | 5.8 | |
| Scheduled banks | | 44.9 | 3.5 | |
| Private sector credit | | -0.6 | 11.4 | |
| Money supply (M2) | | 15.9 | 12.5 | 12.9 |
| Reserve money | | 15.8 | 12.9 | 12.9 |
| Currency in circulation | | 15.8 | 12.4 | |
| Total deposits | | 15.9 | 12.6 | |

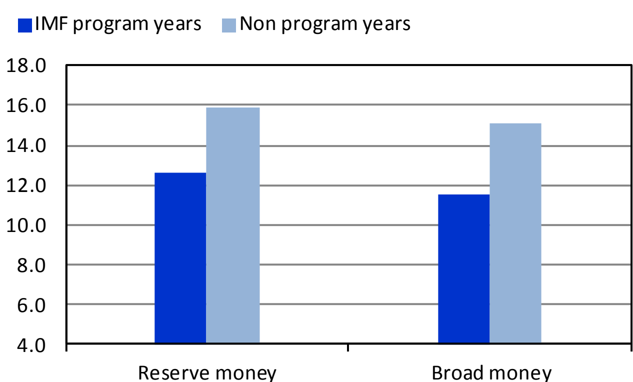
P:Provisional; [1] Projections

Source: SBP

34. With lower financing needs, government was able to meet the end-March 2014 net borrowing target of Rs2390 billion from SBP as agreed in the IMF's Extended Fund Facility (EFF). Thereafter, according to provisional estimates, stock of government borrowings from SBP (on cash basis) has increased to Rs2328 billion as on end June, 2014 compared to IMF's target of Rs2240 billion. This shows that the end June 2014 target of government borrowings from SBP, agreed with the IMF, has been missed.

35. The lower demand for credit by the government provided necessary space to the private sector to borrow from the banking system. Given a stable monetary policy stance along with improving macroeconomic conditions, private sector credit has increased by Rs328.9 billion during July-May, FY14, while loans to private sector businesses (PSBs) have increased by Rs275.4 billion – highest in last six years (**Table 3**).[18] This welcome rise in credit is attributable to uptake by traditional sectors, such as textiles, energy and agriculture; and non-traditional sectors, such as, telecom, beverages, metals, retail trade and

**Figure 7: Average Annual Growth in Monetary Aggregates**
(during FY78 to FY13)




Source: SBP

[18] As per provisional monetary survey of end June 2014, flow of credit to the private sector is Rs384 billion (Table 2).

petroleum products. This upward trend in credit uptake along with growth in LSM of 4.3 percent (year-on-year) during July-April 2014 suggests continuity in revival of economic activity.

36. Analysis of loans by type shows that while a bulk of credit was availed for working capital, a sizeable amount was also utilized for capital formation (**Table 3**). Credit for long-term purposes was taken by energy (Rs22.3 billion), telecom (Rs18.6 billion), sugar (Rs11.2 billion), agriculture (Rs9 billion) and textiles (Rs7.6 billion). While telecom sector is investing in expanding their infrastructure after obtaining 3G/4G spectrum; energy and textiles are possibly modernizing and expanding their production due to expected higher demand. In addition, sugar sector is investing in bagasse based Co-Generation Power Projects. This suggests some pickup in investment in the coming year.

**Table 3: Private Sector Credit**
flows; billion rupees

| | FY13 | FY14 |
|---|---|---|
| | Jul-May | |
| **Total credit to private sector** | **33.0** | **328.9** |
| **1.Loans to private sector businesses** | **83.4** | **275.4** |
| ***By Type*** | | |
| Working capital | 95.9 | 192.2 |
| Fixed Investment | -12.5 | 83.2 |
| **By Sectors:** *of which* | | |
| Agriculture | 18.5 | 31.8 |
| Manufacturing | 80.0 | 168.6 |
| Textiles | 43.7 | 40.5 |
| Chemicals | -5.8 | 3.7 |
| Food & beverages | 30.9 | 96.4 |
| Sugar | 28.1 | 45.0 |
| Non-metallic mineral products | -12.6 | -12.9 |
| Cement | -12.0 | -13.2 |
| Energy | 6.3 | 50.3 |
| Construction | -1.2 | -3.8 |
| Commerce and trade | -5.1 | 10.0 |
| Transport | -17.2 | 25.6 |
| Services | -9.8 | -2.2 |
| **2. Personal** | **20.5** | **28.0** |
| Consumer financing | 15.4 | 26.7 |
| **3. Investments** | **25.0** | **17.7** |
| **4. NBFC** | **-84.4** | **-2.3** |
| **5. Others** | **-11.6** | **10.2** |

Source: SBP

37. Along with higher demand by the private sector there has been some decline in real lending rates in FY14. Real WALR has declined from 3.4 percent in June 2013 to 2.4 percent in May 2014, explaining some of the increase in private sector credit. Moreover, decline in the risk premium[19] by 80bps over the same period indicates banks' increased preference for lending to the private sector during FY14. Further, the imposition of floor on return on savings deposits may have incentivized banks to lend to the private sector to maintain their profitability.

38. The major indicators of industrial sector performance by March 2014, however, have declined marginally (**Table 4**). Volatility in exchange rate during FY14

[19] Risk Premium equals WALR minus 6-month T-Bill rate.

affected the profitability of sectors more open to trade activities. For example, the textile sector earned good profits due to sharp depreciation and stable cotton prices in the first half of FY14, while PKR appreciation in the second half along with falling yarn prices in international market reduced their operating profit margins. On the other hand, energy sector gained on account of lower fuel costs payable in US dollars in the second half of FY14. Moreover, increase in tax expenses also affected corporate profitability. These recent performance indicators of the industry hint that some risks to credit uptake exist from the demand side.

**Table 4: Financial Indicators of Selected Industries***

in percent

| | Textiles | | Cement | | Energy | |
|---|---|---|---|---|---|---|
| | **FY13** | **FY14** | **FY13** | **FY14** | **FY13** | **FY14** |
| Gross Profit Margin | 14.8 | 13.2 | 36.0 | 35.1 | 8.1 | 8.0 |
| Operating Margin | 12.4 | 11.4 | 32.0 | 28.3 | 7.8 | 8.4 |
| Net Profit Margin | 8.1 | 7.3 | 20.6 | 21.7 | 4.6 | 5.1 |
| Cash Flow to Sales | 10.9 | 10.1 | 26.2 | 27.2 | 5.3 | 5.7 |
| Cost of Goods Sold to Sales | 85.2 | 86.8 | 64.0 | 64.9 | 91.9 | 92.0 |
| Financial Expenses to Sales | 3.3 | 3.2 | 5.8 | 3.8 | 1.2 | 1.0 |
| Interest Coverage Ratio | 17.8 | 20.5 | 13.3 | 9.3 | 19.3 | 18.6 |
| Inventory Turnover Ratio | 43.6 | 47.1 | 7.5 | 6.4 | 10.1 | 11.0 |

* Up to March 2014; ratios are calculated according to weighted average of companies

Source: Financial statements of 47 listed Companies

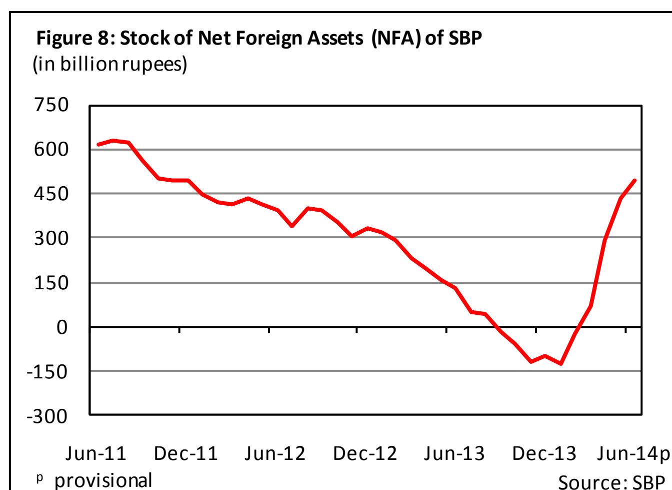
39. On the other hand, profitability of the banking sector from core business activities has remained stable as indicated by net interest margin (NIM) of around one percent in Q3-FY13 and Q3-FY14. Return on Assets (ROA) and return on equity (ROE, before taxes) have, however, improved over the same period. This is due to higher fee based income, gains from foreign currency dealings and lower provisioning expenses. Further, the non-performing loans (NPLs), both gross as well as net, show a year-on-year decline in Q3-FY14. Given robust profitability, muted credit risk and expected lower government borrowings from banks, it is anticipated that banks would shift from relatively low return investments in government securities to high return private sector loans.

40. This potential shift poses some challenges for financial stability of the banking sector, which indirectly has implications for monetary policy considerations. Specifically, any switch from zero risk weighted investments in government securities to higher risk weighted advances would entail additional capital charge and hence some reduction in the capital adequacy of the banking sector. Particularly, for small banks with proportionately higher investments to deposit ratio (IDRs), such a portfolio shift may bring their capital adequacy ratio (CAR) under pressure. Among other factors, banks' temptation to maintain CAR around the current level of 15 percent, may lead to less risk taking and somewhat lower growth in advances.

41. For FY15, SBP expects that the improvements in main macroeconomic indicators will continue though risk of loss of investor confidence remains.[20] Nevertheless, we expect investment and production to continue their upward trajectory in the coming year. Banks, with satisfactory asset quality and capital adequacy, are willing to lend. Therefore, considering the recent momentum in credit uptake in FY14 and expected growth in GDP and LSM, the private sector credit is expected to grow by 7.6 percent in FY15.

42. The reversal in Net Foreign Assets of the banking system, specifically of SBP, is another major development in monetary aggregates. After continuously contracting for the past two and a half years, NFA of SBP has started to increase since February 2014 (**Figure 8**). Specifically, the stock of SBP NFA, which had declined to negative Rs123.4 billion by end January 2014, has increased to positive Rs489.5 billion by end June 2014. This increase is primarily a reflection of a buildup in SBP's foreign exchange reserves on the back of considerable improvement in financial inflows.

**Figure 8: Stock of Net Foreign Assets (NFA) of SBP**
(in billion rupees)




p provisional Source: SBP

43. The increase in external inflows and lower government borrowings from the banking system improved the overall NDA-to-NFA ratio as well. As on 30th June 2014 this ratio has declined to 15.6 from 31.9 a year earlier. This decline in NDA to NFA ratio is reflective of the fact that the risk of substituting domestic assets with the foreign assets is now relatively lower, which is a good sign for exchange rate and inflation outlook.

44. On the liability side, the growth in currency in circulation (CiC) during the current year has decelerated to 12.4 percent, which was 15.8 percent last year (**Table 2**). The current year's lower growth in CiC is in line with lower government borrowings from SBP. Additionally, lower transactional demand for currency owing to slowdown in agriculture sector may have also contributed to this deceleration.

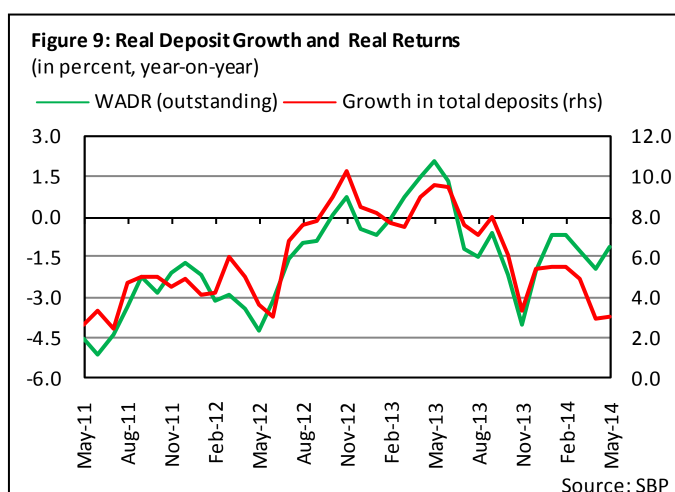
[20] According to Overseas Investors Chambers of Commerce (OICCI) bi-annual survey of March 2014, business confidence has gone down slightly due to rising cost of doing business, energy crises and deteriorating security environment. However, recent announcement of decline in corporate tax rate from 35 percent to 33 percent for large tax payers in the budget for FY15, may have slightly improved business sentiments.

Despite this deceleration in CiC, the currency to deposit ratio has remained unchanged at previous year's level of 28, due to lower growth in deposits.

45. Nevertheless, since most of the improvement in NFA and thereby lower pressure of government borrowings from SBP is due to non-recurring external inflows, sustainability of this trend could become challenging. For instance, despite lower net government borrowings[21] of Rs196.9 billion from SBP during FY14 as compared to last year (Rs506.9 billion), the current year's increase in SBP's holding of MRTBs of Rs577.1 billion is higher than last year (Rs515.5 billion). The difference between the two is mostly explained by an inflow of Rs157 billion in government deposits received as grant under PDF. Thus, rather than relying on transitory inflows, a meaningful increase in government resources such as tax revenues will be required to consistently contain and reduce the stock of government borrowings from SBP as stipulated in the SBP Act.

46. Another challenge in the monetary sector is less than desirable deposit mobilization by banks to meet the total credit demand of the economy. Thus, the growth in total private sector deposits was of 12.6 percent during FY14, could be due to (i) continued negative real return on deposits which may be encouraging households to save outside the formal economy (**Figure 9**);[22] (ii) government's decision to allow access to FBR over information on depositor's accounts with banks; (iii) tax on cash withdrawals; and (iv) lower government borrowings.

**Figure 9: Real Deposit Growth and Real Returns**
(in percent, year-on-year)




Source: SBP

47. With moderate growth in deposits, it became difficult to simultaneously meet the end March 2014 IMF targets for government borrowings from SBP and SBP's NDA. For instance, towards the end of March 2014 strong participation of scheduled banks in the PIB auction necessitated liquidity injections by SBP. As a result, though government borrowings from SBP remained lower than IMF target for end March

[21] Net government borrowings equal total liabilities of the government (including MRTBS - the instruments through which government borrows from SBP) minus their total deposits.
[22] Real weighted average rates on outstanding deposits have been on average negative 1.54 percent during the period Jul-May FY14 compared to on average positive 0.05 percent in the corresponding period of last year.

2014, these liquidity injections led to a breach of SBP's NDA target by a small margin[23].

48. Going forward, given SBP's policy of linking minimum saving deposit rate with the repo rate, an improvement in real return on deposits can be expected. The inflation is also expected to remain stable in FY15. These factors may help in attracting higher volume of deposits in the banking system. Moreover, the exclusion of time deposits under the revised regulation will have limited impact on growth in deposits because it will be difficult for banks to reduce return on term deposits below the savings category.[24]

## C. Fiscal Deficit: Curtailed and Supported by Increased External Finance

49. Ministry of Finance's provisional estimates for FY14 show the fiscal deficit at 5.8 percent of GDP (**Table 5**). This is considerably lower than 8.2 percent recorded in FY13 and 6.3 percent target for the year. A combination of tax measures, non-tax revenues and restraint over expenditures, particularly development spending, has contributed in reducing the fiscal deficit for FY14.

50. Total revenues have been estimated to grow by 28.8 percent in FY14; the highest growth recorded in the last decade and higher than the budget estimates. This acceleration in revenue growth is primarily due to substantial increase in non-tax revenues, which exceeded the budget estimates and compensated for the lower tax collection by the FBR. Specifically, the non-tax revenues grew by 45.9 percent, bolstered by one-off revenue receipts of Rs157 billion under Pakistan Development Fund (PDF), CSF of Rs105 billion, proceeds of Rs89 billion from the auction of 3G/4G spectrum, and Rs67 billion from Universal Service Fund. Moreover, the transfer of SBP profits has been considerably higher than the budget estimates.

51. Reflecting the impact of increase in GST and removal of some tax exemptions and concessions, the tax revenues have been estimated to grow by 22.5 percent in FY14 against 7.1 percent increase in last year. Similarly, the FBR tax collection has been estimated to grow by 17.5 percent compared to a meager 2.9 percent growth witnessed last year. Despite this relative improvement, the growth is below the 27.8 percent increase envisaged in budget estimates, resulting in breach of the target.

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[23] As per end June 2014 provisional estimates, SBP NDA target may have also been missed by a negligible margin.
[24] BPRD Circular No. 2 dated May 27, 2014, "Minimum Rate of Return on Saving Deposits and SBP Repo Rate."

52. Deceleration in growth of development expenditures (including net lending) to 5.3 percent in FY14 (or 4.7 percent of GDP) from 53.2 percent in FY13 (or 5.1 percent of GDP) is the other main factor that has helped in reducing the fiscal deficit in FY14. The current expenditures, on the other hand, are still higher than the budget estimates and recorded a growth of 11.9 percent compared to 2.6 percent a year earlier[25]. As highlighted in previous monetary policy statements, reduction in the fiscal deficit was always going to be difficult with the budgeted amount of development expenditures. Moreover, the development spending was linked to additional revenue generation through Gas Infrastructure Development Cess (GIDC) and other administrative measures, which could not generate the desired amount of revenues.[26]

**Table 5: Summary of Consolidated Fiscal Operations**

billion rupees, unless stated otherwise

| | FY13[P] | FY14[BE] | FY14[RE] | FY15[BE] |
|---|---|---|---|---|
| **Total revenue:** *of which* | **2982** | **3640** | **3843** | **4216** |
| FBR tax revenue | 1936 | 2475 | 2275 | 2810 |
| SBP profit | 220 | 200 | 260 | 270 |
| CSF money | 172 | - | 105 | - |
| 3G license fee | - | 120 | 89 | 56 |
| **Total expenditures** | **4816** | **5291** | **5314** | **5638** |
| Current: *of which* | 3676 | 3964 | 4114 | 4421 |
| Subsidies[1] | 367 | 240 | 323 | 203 |
| Interest | 991 | 1154 | 1187 | 1325 |
| Development; *of which* | 1140 | 1327 | 1200 | 1217 |
| Net lending | 363 | - | 86 | 120 |
| **Budget balance** | **-1834** | **-1651** | **-1471** | **-1422** |
| **Financing** | **1834** | **1651** | **1471** | **1422** |
| External | -2 | 169 | 714 | 508 |
| Domestic | 1835 | 1482 | 757 | 914 |
| Non- Bank | 378 | 507 | 382 | 686 |
| Bank | 1457 | 975 | 375 | 228 |
| **Memorandum items (as percent of GDP)** | | | | |
| Overall budget balance | -8.2 | -6.3 | -5.8 | -4.9 |
| Primary balance[2] | -3.7 | -1.9 | -1.1 | -0.3 |
| Revenue balance[3] | -3.1 | -1.2 | -1.1 | -0.7 |

P: Provisional; BE: Budget Estimates; RE: Revised Estimates

[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

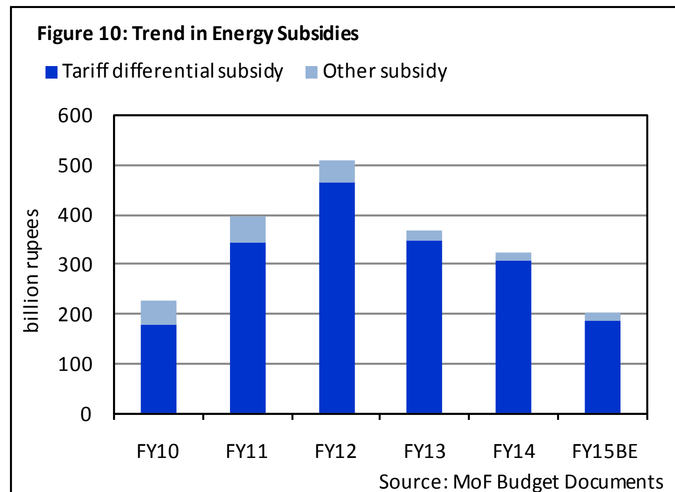
53. Along with more than budgeted subsidies, interest payments continue to remain the major contributor to higher current expenditures. Interest payments are estimated at Rs1187 billion – about 30 percent of the current expenditures and 40 percent of the tax revenues. Though the upward adjustment in electricity tariffs has resulted in marginal reduction in subsidies, the issues related to governance and distribution losses of power companies remain a major risk to fiscal accounts (**Figure 10**). While substantial reduction in subsidies seems difficult going forward, interest payments are likely to fall in FY15 with slowdown in domestic debt accumulation and relative increase in low cost external funding.

[25] Current expenditures include unidentified or statistical discrepency.

[26] The GIDC was expected to generate revenues around 0.4 percent of GDP. However, this could only yield revenues equivalent to 0.15 percent of GDP.

54. Lower fiscal deficit in FY14, especially the primary deficit declining to 1.1 percent from 3.7 percent of GDP in FY13, and increase in external borrowings, have resulted in slower accumulation of domestic debt. The growth in domestic debt during FY14 has decelerated to 14.5 percent, which is significantly lower than the average growth of 27 percent during the last three years. This bodes well from the point of view of country's risk perception and could help in attracting investment in the economy.

**Figure 10: Trend in Energy Subsidies**




Source: MoF Budget Documents

55. The growth in total interest payments are also expected to slowdown in FY15 as the share of relatively low cost external debt has increased. For instance, the interest cost on recently issued Eurobonds for 5 and 10 year tenors is 7.25 and 8.25 percent compared to an interest cost of 12.66 and 13.08 percent for PIBs of similar tenor[27]. However, the cost attached with external debt is susceptible to exchange rate risk among other factors.

56. The target for consolidated fiscal deficit in FY15 is set at 4.9 percent of GDP, about 0.9 percent below the revised FY14 estimate of 5.8 percent of GDP. Underlying this fiscal deficit target is the provincial surplus of Rs289 billion, FBR tax revenue of Rs2810 billion, cut in current expenditure by 1 percent of GDP with a substantial decrease in subsidies to Rs203 billion, and reduction in development expenditures by 0.5 percent of GDP.

57. Though cutting development spending has proved to be the easiest option, reducing subsidies as envisaged in the budget does not seem plausible under the current circumstances. Given that increase in electricity tariffs last year – 16 percent for household and 24 percent for commercial and industrial use – helped to reduce subsidies by only Rs50 billion, reducing subsidies by more than Rs100 billion would require a substantial increase in the tariffs. It indicates that there is a risk that circular debt could reemerge unless substantial reforms are undertaken.

[27] The total interest cost of Eurobonds comes to around $1.2 billion (or Rs 117 billion at the prevailing exchange rate). In comparison the interest cost on raising equivalent amount of local currency bonds (PIBs) is about Rs 191 billion.

58. Nevertheless, major risk to the fiscal deficit target of 4.9 percent in FY15 is from the revenue side. In particular, the FBR revenue target of Rs2810 billions looks challenging given that no major tax reform has been introduced in the FY15 budget. Moreover, growth in total revenues was due to a significant increase in non-tax receipts, which may not be the case in FY15. This underscores the need for reforms to broaden the tax base and improve the tax collection system. Without enhancing tax revenues, it seems difficult to keep the fiscal deficit low while maintaining a minimum level of development spending, which is critical for infrastructure needs of the economy.

## D. External Sector: Increasing Financial Inflows and Rising Reserves

59. Notwithstanding higher current account deficit in comparison to FY13, the overall external sector position improved considerably during H2-FY14. This has been mainly due to a substantial increase in the capital and financial account, which witnessed a surplus of $6.1 billion during Jul-May FY14 against $465 million in the corresponding period of last year (**Table 6**). Besides the advantage of an IMF program, the receipt of $1.5 billion under Pakistan Development Fund (PDF) and more than estimated issuance of Eurobonds[28], on account of investors' overwhelming response, considerably reduced external sector concerns.

60. Further, loans from multilateral donors under the IMF program[29] ($1.8 billion), auction of 3G/4G spectrum (foreign exchange component of $547 million), UBL privatization proceeds ($311 million), continued CSF inflows ($1.0 billion), and government loans from commercial banks ($348 million) supported an upward trajectory of foreign exchange reserves. These developments in external sector brought about a fundamental shift in sentiments in foreign exchange market.

61. Fresh disbursements ($1.7 billion) under the new IMF program also helped offset some of the impact of substantial repayments related to the previous IMF program ($3.1 billion) during the year and averted drawdown of SBP reserves. The net SBP reserves have increased to $9.6 billion as of 4th July 2014, equivalent to 2.8 months of imports, from the lowest level of $2.8 billion on 7th February, 2014 that was less than a month of import cover.

[28] The realisation was four times the budgeted amount of $500 million. Out of this $1 billion is raised for 5-years at a fixed rate of 7.25 percent and $1 billion for 10-years at a fixed rate of 8.25 percent. These rates were 5.58 percent and 5.56 percent higher than the benchmark US treasury rates for bonds of corresponsing tenor.

[29] These include WorldBank ($1 billion), ADB ($400 million) and IDB ($400 million).

62. Better inflows and build-up of foreign exchange reserves position also helped in comfortably meeting the IMF's end March FY14 target of Net International Reserves (NIR) without putting pressure in the foreign exchange market.[30] As per provisional estimates, the end June 2014 NIR target has also been met. Importantly, the NIR by end-June 2014 is positive 2.7 billion compared to negative 2.4 billion a year earlier – a net increase of $5.1 billion. Based on these developments, Moody's Investors Service has revised the outlook on Pakistan's foreign currency government bond rating to stable from negative on 14th July 2014.

63. These developments resulted in a complete reversal of exchange rate depreciation witnessed in H1-FY14.[31] In fact the sentiments in the foreign exchange market started improving well before the pickup in foreign exchange reserves in March 2014 (**Figure 11**). SBP actions in the form of increase in the policy rate in H1-FY14 followed by tight rupee liquidity conditions in the interbank market resulted in curbing the speculative demand for foreign exchange. On the back of continued

**Table 6: Balance of Payments Summary**

billion $, unless stated otherwise

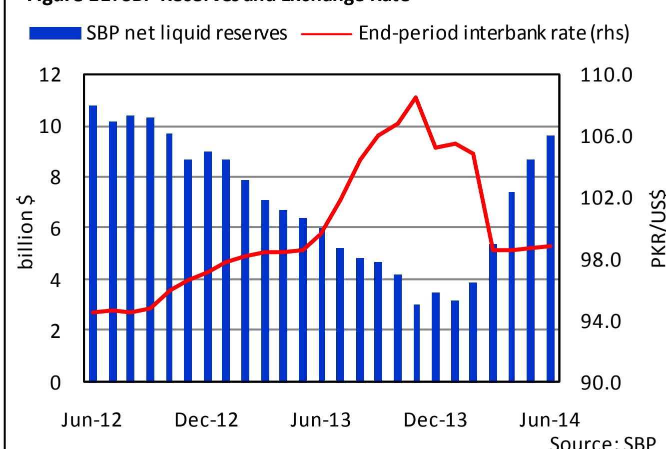
| | FY13 | FY13 (Jul-May) | FY14 (Jul-May) | FY15[1] |
|---|---|---|---|---|
| **I. Current account balance** | **-2.5** | **-2.2** | **-2.6** | -2.5 |
| Trade balance | -15.4 | -14.1 | -15.0 | |
| Services balance | -1.5 | -1.3 | -2.1 | |
| *of which* :CSF | 1.8 | 1.8 | 1.1 | |
| Income balance | -3.7 | -3.4 | -3.6 | |
| Current transfers balance | 18.1 | 16.7 | 18.2 | |
| *of which* : Remittances | 13.9 | 12.8 | 14.3 | |
| **II. Capital account:** *of which* | **0.26** | **0.25** | **1.8** | |
| Pakistan Development Fund | 0.0 | 0.0 | 1.5 | |
| **III. Financial account :** *of which* | **0.55** | **0.21** | **4.36** | |
| Direct investment (net) | 1.3 | 1.1 | 1.3 | |
| Portfolio investment (net) | 0.03 | -0.02 | 2.4 | |
| *of which* :Eurobond | 0.0 | 0.0 | 2.0 | |
| General government (net) | 0.25 | 0.11 | 0.98 | |
| **IV. Errors and omissions** | **-0.3** | **-0.2** | **-0.2** | |
| **Overall balance (I + II + III +IV)** | **-2.0** | **-1.9** | **3.3** | |
| **Memorandum items:** | | | | |
| Current account as % of GDP | -1.1 | -1.0 | -1.1 | -0.9 |
| Capital and financial a/c as % of GDP | 0.3 | 0.2 | 2.7 | |
| Change in IMF credit and loans | -2.5 | -2.3 | -0.47 | |
| End period net SBP forex reserves[2] | 6.0 | 6.4 | 8.7 | |
| Exports growth (%) | 0.4 | 0.7 | 1.3 | 5.0 |
| Imports growth (%) | -0.6 | 0.3 | 3.3 | 7.0 |
| Remittances growth (%) | 5.6 | 5.7 | 12.4 | |

[1] SBP projections

[2] Excluding CRR and foreign currency cash holdings

Source: SBP

**Figure 11: SBP Reserves and Exchange Rate**



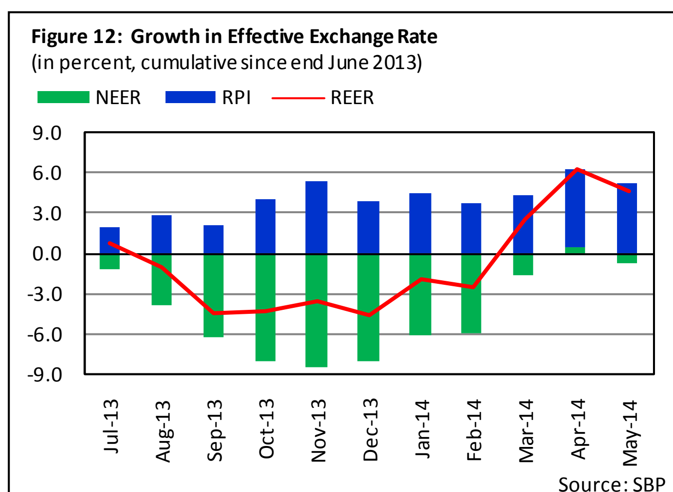
Source: SBP

[30] The target for end March FY14 was exceeded by a considerable margin of $732 million.

[31] Although depreciation in exchange rate was arrested following SBP and government efforts in early December 2013, pressure in the market continued and exchange rate hovered around Rs105-106 per USD in Jan-Feb FY14.

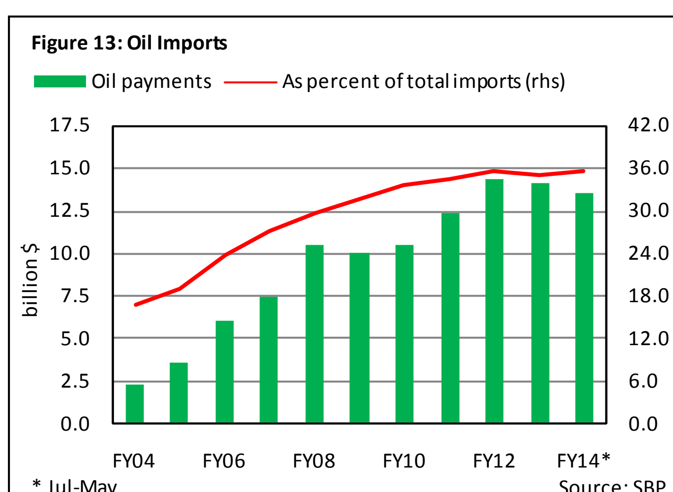
improvement in market sentiments and supplemented by larger foreign exchange inflows exchange rate has appreciated by 10.0 percent to Rs98.8 per USD on 4th July 2014 after reaching a high of Rs108.6 per USD on 3rd December 2013.[32]

64. PKR has also strengthened against other trading partners' currencies.[33] The nominal effective exchange rate (NEER) has appreciated by 8.5 percent during December 2013 to May 2014. Despite relative price index (RPI) decreasing by 0.07 percent, real effective exchange rate (REER) has appreciated by 8.4 percent during this period (**Figure 12**). This appreciation in real exchange rate suggests deterioration in export competitiveness of the country. This could further add to trade deficit, which continues to remain high and is the major contributor to the current account deficit.




65. Despite continually rising workers' remittances, the external current account witnessed a higher deficit of $2.6 billion during Jul-May FY14 as compared to $2.2 billion in the corresponding period of last year. This was mainly contributed by a higher trade deficit as growth in imports (3.3 percent) outpaced growth in exports (1.3 percent).

66. Trade deficit has remained around 6.5 percent of GDP during the past five years largely due to higher oil imports and stagnant exports. The oil imports have remained the major contributor to rising import bill with its share in imports doubling since FY04. This suggests that reducing oil imports could go a long way in keeping




[32] In FY14 PKR has appreciated by 0.9 percent.
[33] Although PKR has appreciated againt other currencies, appreciation against USD contributed mostly to the appreciation in NEER.

trade deficit at a manageable level,[34] which could be achieved by shifting electricity generation to low cost alternatives such as coal, hydel, etc (**Figure 13**).[35]

67. Similarly, expansion in exports could be achieved through diversification, both across products and markets. Growth in exports during Jul-May FY14 was largely due to textiles as non-textile exports witnessed a decline. Given the high concentration of textiles in Pakistan's exports to European region (75 percent of total exports to EU), Pakistan is likely to partially benefit from GSP plus status because textiles have the least tariff relief under this scheme.[36] In this context, new product lines need to be developed within the textile sector in addition to focusing on new areas to increase their share in overall exports.[37] Also, new export destinations should be explored.

68. Incorporating the latest developments and accounting for expected increase in energy supply, SBP projects exports to grow in the range of 4.0 to 6.0 percent in FY15. Similarly, given the stable outlook of international commodity prices and expected better economic activity, imports are expected to witness a higher growth in the range of 6.0 to 8.0 percent in FY15. These projections of exports and imports growth translate into a trade deficit of $17.1 to $18.4 billion (or 5.5 to 7.0 percent of GDP) for FY15. Assuming $1.2 billion CSF, proceeds of $300 million from auction of remaining 4G license and workers' remittances at $16.5 billion, the external current account deficit is projected to remain in the vicinity of 1.0 percent of GDP.

69. In addition to a benign external current account outlook, realization of inflows on account of planned privatization of OGDCL and other public sector entities, planned issuance of Eurobond ($500 million) and Sukuk ($500 million) in international markets and program financing from multilateral donors under the IMF program would also help in maintaining the upward trajectory in foreign exchange reserves in FY15. The consistent foreign exchange reserve build-up together with a prudent monetary policy stance would facilitate in keeping the foreign exchange market stable.

70. Nonetheless, sustainability of external sector over the medium term could become challenging, specifically in the post IMF program years. Sustaining the recent

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[34] Level of trade deficit that could be financed through private inflows, and hence does not translate into stress in the foreign exchange market.

[35] Economic Survey 2013-14 outlines road map of increasing the power generation capacity as well as improving the energy mix in the medium trem.

[36] Scheik, Zeevar(2013), "Enhancing Pakistan's Trading Benefits from the proposed EU GSP plus Scheme", Trade Related Technical Assistance Program funded by European Commission.

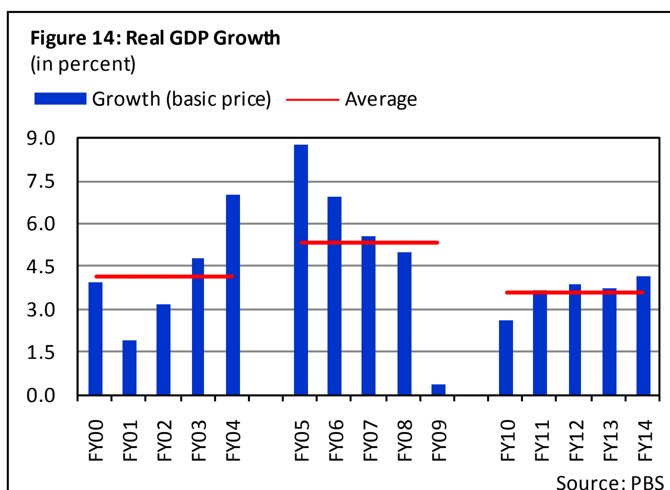
[37] Leather, sports and footwear etc.

improving trends over medium term needs additional efforts to ensure better law and order, address energy sector issues, carry out fiscal reforms, and improve economic governance. The improved domestic outlook on account of these measures would result in restoring investors' confidence and thus revival of non-debt creating private inflows which remains at the heart of external sector sustainability.

## E. Economic Growth: Sustainability of Recovery Requires Additional Reforms

71. The National Income Accounts estimates show that real GDP grew by 4.1 percent in FY14 compared to 3.7 percent last year. Though real GDP growth target of 4.4 percent for FY14 was missed, it is first time in 6 years that growth has surpassed the 4 percent mark (**Figure 14**). Encouragingly, this higher growth in FY14 was led by recovery in the industrial sector, thanks to better performance of LSM and a turnaround in construction activity besides improvement in electricity generation. This improvement lends some credence to SBP's consistent stance that the major constraint to growth is not high nominal interest rates set by SBP's monetary policy; rather it is issues like energy shortages and law and order conditions.

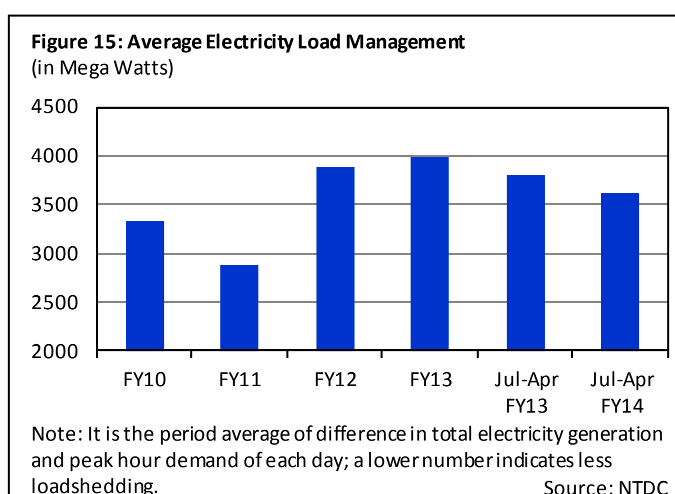
**Figure 14: Real GDP Growth**
(in percent)




Source: PBS

72. As anticipated at the beginning of FY14, electricity generation did improve during the year. Following the resolution of circular debt in June 2013 capacity utilization by power companies has somewhat increased (**Figure 15**). Not only did it increase value addition by electricity and gas distribution, but also helped the manufacturing sector. The manufacturing sector also benefitted from some recovery in exports, especially of textiles.

**Figure 15: Average Electricity Load Management**
(in Mega Watts)



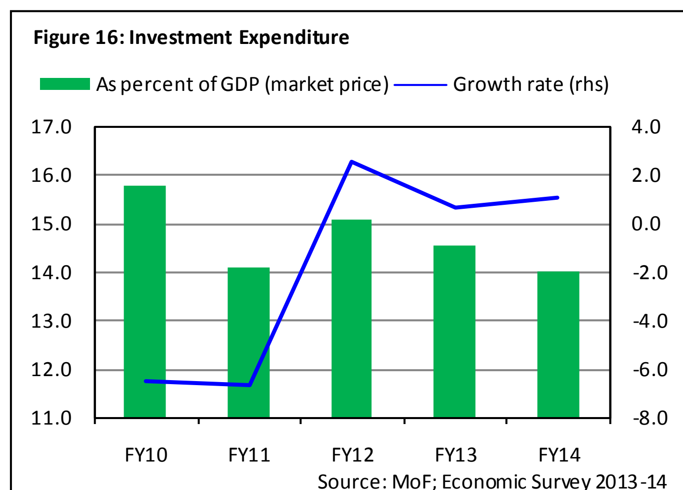

Note: It is the period average of difference in total electricity generation and peak hour demand of each day; a lower number indicates less loadshedding.
Source: NTDC

73. On the other hand, agriculture sector growth decelerated mainly due to decline in the production of cotton and other minor crops. Though growth in services sector was also lower than last year, its contribution to growth remains significant given its high share in GDP. A sustainable increase in GDP growth, nonetheless, would require consistent improvement in productivity across sectors, which is not directly related to SBP's monetary policy stance. The role of monetary policy is limited in increasing the economy's growth potential. Its fundamental role in economic growth is to ensure monetary and financial stability on consistent basis.

74. On the demand side, the real GDP growth continued to be driven by higher consumption. Both the private and public sectors contributed to 6.9 percent increase in total consumption compared to 3.4 percent growth last year. As a result, the share of consumption in domestic demand has slowly and steadily risen from 82 percent in FY08 to 87 percent in FY14.[38] Although aggregate demand is still moderate in SBP's assessment a falling share of investment in GDP is worrisome as it indicates erosion in the economy's future productive capacity.

75. Decline in growth in investment expenditures in FY14 validates this concern. The total investment grew by only 1 percent in FY14, down from 2.5 percent growth last year, largely due to decline in private sector investment by 1.6 percent. It also maintained its declining trend in terms of percent of GDP, falling to 14.0 percent in FY14 from 14.6 percent last year (**Figure 16**). It seems that the increase in credit for fixed investment in FY14 is meant for replacement of depreciating capital assets and investment. Moreover, growth in private sector credit usually affect investment with a lag of one year. Increase in investment as a share of GDP is critical for a sustainable path to economic recovery in the medium term.

**Figure 16: Investment Expenditure**



Source: MoF; Economic Survey 2013-14

76. While the importance of political stability, better law and order conditions and a conducive business environment can hardly be overemphasized in promoting investment, addressing energy shortages can go a long way in reviving investment

[38] Domestic demand is the sum of total consumption and investment expenditures of both private and public sectors.

and sustaining higher growth. These constraints have been affecting productivity, thereby constraining economy's ability to produce at its potential, which itself has declined over the past few years due to falling investment and other constraints.

77. Although the resolution of circular debt and consequent increase in utilization of existing generation capacity has provided temporary relief, there is a need to expand the existing capacity through low cost alternatives, stem line losses and improve recoveries to permanently contain the reemergence of circular debt. A combination of increased utilization of existing power generation capacity and addition of new capacity is necessary to further narrow the supply-demand energy gap going forward.

78. Further increase in electricity supply, combined with expected higher growth in exports, could help the manufacturing sector maintain the current momentum. In addition, completion of government's planned infrastructure projects is likely to provide boost to construction activity and related industries. The current trends in private sector credit also point to better real economic activity in FY15. These developments in industrial sector are also likely to positively impact the performance of services sector, which could also marginally benefit from improved telecommunication services with the start of 3G/4G mobile technology. Incorporating these improvements, the real GDP growth is projected to be between 4 to 5 percent in FY15.[39]

79. To achieve and sustain higher growth rate in excess of 6 percent—which is the minimum level required to absorb the expected new entrants in the labor market—it is imperative for the government to complete the planned addition to power generation over the coming years. At the same time, there is also need to gradually shift oil-based power generation to low-cost alternatives. Similarly, improving law and order conditions has become vital to arrest the declining trend in investment. Fiscal reforms that could provide room for banks to lend to the private sector and for government to spend more on infrastructure can also revive private investment and growth.

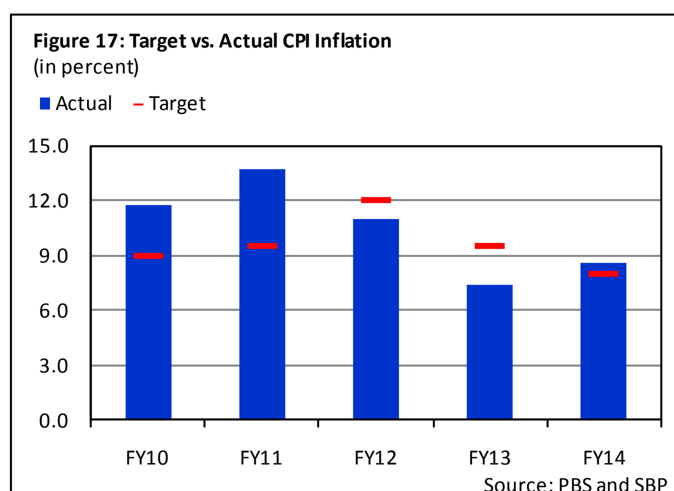
[39] This growth outlook assumes about 3 percent growth in agriculture, which is dependent on weather conditions and is highly uncertain.

## F. Inflation: Moderate at a Single Digit Level

80. The year-on-year inflation witnessed high volatility during FY14. It rose from 5.9 percent in June 2013 to 10.9 percent in November 2013, declined in subsequent months before rising again to 9.2 percent in April 2014. Thereafter, it has again receded to 8.2 percent in June 2014. Though the upward adjustment in administered prices in the first few months of FY14 caused higher inflation initially, volatility in the prices of perishable food items owing to supply chain disruptions resulted in higher than usual variation in year-on-year inflation.[40]

81. Nevertheless, for the second consecutive year, the average CPI inflation in FY14 has remained within the single digit level of 8.6 percent though it is still higher than the year's inflation target of 8.0 percent set by the government (**Figure 17**). Anticipating this outcome, the policy rate has been maintained at 10 percent since November 2013 to further anchor inflation expectations by keeping the real interest rate in the positive territory.

**Figure 17: Target vs. Actual CPI Inflation**
(in percent)



Source: PBS and SBP

82. Despite relatively high average CPI inflation than FY13, both measures of core inflation, i.e. non-food non-energy (NFNE) and 20% trimmed, exhibited gradual softening during FY14 (**Table 7**). This indicates moderate aggregate demand in the economy relative to the available productive capacity. The marginal increase in GDP growth to 4.1 percent in FY14 is mostly a reflection of better utilization of spare capacity.

**Table 7: Average Inflation**

in percent

| | FY13 | FY14 | FY15[1] |
|---|---|---|---|
| **CPI headline** | **7.4** | **8.6** | **7.5 - 8.5** |
| Food group | 7.1 | 9.0 | |
| Non-food group | 7.5 | 8.3 | |
| **Core measures** | | | |
| NFNE* | 9.6 | 8.3 | |
| 20% trimmed | 9.0 | 8.5 | |

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

Source: PBS and SBP

[40] Perishable food items exhibited inflation of 15.4 percent during FY14 as compared to 1.5 percent inflation in FY13.

83. In general, the supply conditions have improved in FY14. This is reflected in better growth of large scale manufacturing (LSM) supported by a gradual enhancement in power generation. Also, better production of non-perishable food items, such as sugar and rice during H1-FY14 and wheat by the end of FY14 contributed to this trend.[41] This improvement in supply conditions along with moderate aggregate demand helped in containing inflationary pressure buildup in FY14. In addition, general deceleration in international commodity prices along with stability in international oil price has also favorably affected domestic inflation in FY14.

84. Moreover, to reduce the budget deficit, the government undertook some fiscal consolidation measures in line with the requirements of the ongoing IMF program. For instance, to reduce subsidies, the government introduced upward adjustment in power tariffs earlier in the year and also enhanced GST rate while withdrawing certain tax related exemptions. This kept CPI inflation elevated in H1-FY14. On the other hand, improvements in external financing in H2-FY14 not only contained the inflationary impact of government budgetary borrowing from the banking system but also resulted in appreciation of PKR in March 2014. Thereafter, exchange rate has remained stable, thereby easing pressure on domestic prices of imported goods.

85. The containment of government budgetary borrowings and exchange rate stability amid improved foreign inflows have helped in anchoring inflation expectations. This is also evident from the SBP-IBA Consumer Confidence Survey (CCI) of July 2014 that predicts more or less stable inflation expectations till H1-FY15. As sentiments in the economy have improved, there is uptake in private sector credit and banks have started investing in long term government securities (PIBs). This trend is expected to continue in FY15 as well.

86. The SBP expects average CPI inflation to remain in the range of 7.5 percent to 8.5 percent in FY15. Other than assuming continuation of current monetary policy stance, this outlook is supported by (i) continuation of moderate aggregate demand along with ongoing improvement in capacity utilization; (ii) further containment in government budgetary borrowing from the banking system; (iii) overall stable outlook of international commodity prices; and (iv) marginal impact of new tax measures for FY15. However, international oil price uncertainty and unanticipated price shocks pose risks to the inflation outlook.

[41] Non-perishable food group witnessed inflation of 7.6 percent both during FY14 and FY13.

## III. Concluding Remarks

87. There has been noticeable improvement in most macroeconomic indicators of the economy in FY14. Led by external sector, both monetary and fiscal sectors showed visible progress. Economic activity continued an upward trajectory as indicated by increase in production (GDP), growth in LSM and rise in private sector credit. Inflation, despite some volatility, remained in single digit. These are all welcome signs requiring continuity in policy stance and vigilance regarding potential risks.

88. Notwithstanding higher current account deficit in comparison to FY13, the overall external sector position has improved due to considerable increase in net flows in financial accounts and robust growth in remittances. Most of these inflows are, however, non-recurring in nature and debt creating. Private inflows in FDI and FPI have improved but not to the extent that they could support current account deficit. Unless the fundamental weakness in the balance of payments i.e. the trade deficit is addressed, external account would remain vulnerable in the absence of matching private inflows.

89. The outlook for external account in FY15, however, is stable. Barring any exogenous shock, the current account deficit is expected to remain in a manageable range. Official inflows are again expected to lead financial and capital account surplus which would add to the foreign exchange reserves. Sustainability of these trends in the medium term, specifically in the post IMF program years, requires additional efforts to ensure better law and order, address energy sector issues, carry out fiscal reforms, and improve economic governance.

90. Improvement in the external sector is also visible in the foreign exchange market as PKR appreciated considerably against USD in H2-FY14. A combination of positive sentiments, private inflows (from exporters) and reduction in SBP outstanding forward position led to the recent rally in the value of rupee. As the liquidity in the foreign exchange market improved, SBP calibrated its interventions to anchor market sentiments, stabilize foreign exchange market and build up reserves. This, in turn, helped achieve the NIR targets of March and June 2014 set by the IMF.

91. Despite significant injections in the market rupee liquidity remained tight, which facilitated stability in the foreign exchange market. Nevertheless, the average money market repo rate hovered slightly above the ceiling of SBP corridor that

nudged other market interest rates towards the higher side. Continuation of this trend may have negative implications for real interest rates and private investment in the economy.

92. The one-off external inflows enabled the government to borrow lower amounts from the banking system for budgetary support. As government's demand for credit eased, private sector borrowed substantial amount of credit for working capital and fixed investments. Given the current momentum in credit uptake and expected growth in LSM and GDP, we expect private sector credit to grow reasonably well in FY15. This assessment also takes into account the satisfactory asset quality and capital adequacy of the banking sector.

93. The concern in this regard is the less than desirable growth in banking system deposit. To provide incentive to savers through real returns and encourage them to save inside the formal economy, SBP has already linked the minimum rate on savings deposits to 50bps below the floor of the interest rate corridor. Government too needs to reconsider measures, such as tax on cash withdrawals and access to FBR over customer accounts, which deter depositors.

94. On the fiscal front, government successfully brought down the fiscal deficit to 5.8 percent of GDP from the budgeted 6.3 percent, primarily through increase in non-tax revenues and decrease in development outlay of federal and provincial governments. However, running expenses of the government remained high and the FBR tax collection target in FY14 is estimated to fall short of the target. This implies that the improvements in the fundamental factors, on the fiscal front, are still awaited.

95. Another important highlight, in the fiscal sector, is the slower accumulation of domestic debt. Lower fiscal deficit and increase in external borrowings resulted in slower growth in domestic debt during FY14. This bodes well from the point of view of country's risk perception and could help in attracting investment in the economy. Moreover, the recent shift in borrowing pattern of government from short term to long term is also expected to lower the rollover risk and lengthen average term to maturity of public debt going forward.

96. The growth in investments has once again declined despite real GDP growing at 4.1 percent in FY14. The continuous decline in the investment to GDP ratio has increased the likelihood of a decline in the productive capacity in the economy as

well. In this backdrop, the decline in both measures of core inflation, non-food non-energy (NFNE) and 20% trimmed, indicate moderate aggregate demand in the economy, at the moment. However, as demand picks up, the production constraints existing in the economy might become binding which could lead to inflationary pressures in the medium term.

97. However, currently due to the containment of government budgetary borrowings and exchange rate stability amid improved foreign inflows, inflation expectations are benign. This is evident from the SBP-IBA Consumer Confidence Survey (CCI) of July 2014 that predicts more or less stable inflation expectations till H1-FY15. SBP also expects inflation to remain in single digit in FY15. However, international oil price uncertainty and unanticipated price shocks pose risks to the inflation outlook.

98. While the importance of bringing political stability, improving law and order conditions and creating conducive business environment can hardly be overemphasized, addressing energy shortages can go a long way in reviving investment and sustaining higher growth. It is these constraints which have been affecting productivity and constraining economy’s ability to produce at its potential. Interest rate, at the moment, do not appear to be the prime factor affecting investment in the economy.

99. In conclusion, the Board of Directors of SBP has decided to keep the policy rate unchanged at 10.0 percent. Henceforth, the Board has also decided to publish the summary of minutes of monetary policy proceedings of the Board meeting in four weeks.

## List of Acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| BE | Budget Estimates |
| BPRD | Banking Policy & Regulation Department |
| bps | Basis Points |
| BSD | Banking Surveillance Department |
| CAR | Capital Adequacy Ratio |
| CCI | Consumer Confidence Survey |
| CiC | Currency in Circulation |
| CPI | Consumer Price Index |
| CRR | Cash Reserves Requirement |
| CSF | Coalition Support Fund |
| ECB | European Central Bank |
| EFF | Extended Fund Facility |
| EU | European Union |
| FBR | Federal Board of Revenue |
| FDI | Foreign Direct Investment |
| Forex | Foreign Exchange |
| FPI | Foreign Portfolio Investment |
| FY | Fiscal Year |
| GDP | Gross Domestic Product |
| GIDC | Gas Infrastructure Development Cess |
| GSP | Generalized System of Preferences |
| GST | General Sales Tax |
| H1 | First half |
| H2 | Second Half |
| IBA | Institute of Business Administration |
| IDB | Islamic Development Bank |
| IDR | Investments to Deposit Ratio |
| IMF | International Monetary Fund |
| KIBOR | Karachi Interbank Offer Rate |
| LIBOR | London Interbank Offer Rate |
| LSM | Large-scale Manufacturing |
| M2 | Broad Money |
| MoF | Ministry of Finance |
| MRTBs | Market Related Treasury Bills |
| MTB | Market Treasury Bills |
| NBFCs | Non Bank Finance Companies |
| NDA | Net Domestic Assets |
| NEER | Nominal Effective Exchange Rate |
| NFA | Net Foreign Assets |
| NFNE | Non-Food Non-Energy |

| | |
|---|---|
| NIM | Net Interest Margin |
| NIR | Net International Reserves |
| NPLs | Non-Performing Loans |
| NTDC | National Transmission and Dispatch Company |
| OGDCL | Oil and Gas Development Company Limited |
| OICCI | Overseas Investors Chambers of Commerce and Industry |
| OMO | Open Market Operations |
| OPEC | Organization of the Petroleum Exporting Countries |
| PBS | Pakistan Bureau of Statistics |
| PDF | Pakistan Development Fund |
| PIBs | Pakistan Investment Bonds |
| PKR | Pakistan Rupee |
| PPL | Pakistan Petroleum Limited |
| PSC | Private Sector Credit |
| PSEs | Public Sector Enterprises |
| PTCL | Pakistan Telecommunication Limited |
| Q1 | First Quarter |
| Q2 | Second Quarter |
| Q3 | Third Quarter |
| Q4 | Fourth Quarter |
| RE | Revised Estimates |
| REER | Real Effective Exchange Rate |
| RHS | Right Hand Side |
| ROA | Return on Assets |
| ROE | Return on Equity |
| RPI | Relative Price Index |
| Rs | Pakistani Rupees |
| SA light | Saudi Arabian Light |
| SBA | Standby Agreement |
| SBP | State Bank of Pakistan |
| T-Bills | Treasury Bills |
| TDS | Tariff Difference Subsidy |
| TLTRO | Targeted Long-term Refinancing Operation |
| UBL | United Bank Limited |
| US | United States |
| USD | United States Dollar |
| WADR | Weighted Average Deposit Rate |
| WALR | Weighted Average Lending Rate |
| YoY | Year on year |
| $ | United States Dollar |
| 3G | 3rd Generation |
| 4G | 4th Generation |