

MONETARY AND EXCHANGE RATE POLICIES

MONETARY AND CREDIT POLICY

The State Bank of Pakistan continued to strive during FY 2002-03 to keep a balance between uninterrupted foreign exchange inflows, stable exchange rate and lower real interest rates, besides regulating monetary and credit flows and to effectively fine-tune the monetary policy. In continuation of the previous year, the stance of monetary policy during FY 2002-03 remained accommodative. The discount rate was lowered from 9.00 per cent to 7.50 per cent w.e.f. November 18, 2002. As a result, the State Bank was also able to reduce yields on Treasury Bills of different maturities. This rationalization of the discount rate was aimed at easing the money market which became tight after depreciation in the value of dollar in the wake of September 11 event and also for inducing financial institutions to reduce their lending rates to kick start the economy. Lower lending rates caused by easy monetary policy and improvements in the macroeconomic fundamentals led to increased economic activity together with escalation in the demand for private sector credit. The banks have also passed on some benefits of reduction in their intermediation costs in the form of lower lending rates, but not in the same proportion.

The Bank also took a number of policy measures to boost exports, which came under pressure after the September 11 event. These included simplification of procedures to eliminate excessive documentation, reduction in the refinance mark-up rate, inclusion of more items on the eligible list, setting up a pre-shipment Export Finance Guarantee (PEFG) agency and introduction of Foreign Currency Export Finance (FCEF) facility.

Monetary Policy Statement: One of the core functions of State Bank of Pakistan is to prepare and conduct monetary policy. The State Bank of Pakistan has been performing this function since its inception, but for the first time, State Bank issued monetary policy statement in which monetary and other development affecting the conduct of monetary policy were discussed and disseminated. The first statement was issued in January 2003 explaining the developments of the past year, their impact on monetary policy, and State Bank of Pakistan's response and justification. The second statement was issued in July 2003 giving a rationale of monetary policy stance while reviewing the important events and actual outcome of last 6-months' monetary policy related issues. The relatively easy monetary policy stance of the State Bank of Pakistan was justified by evaluating the positive and negative factors, which have their impact on containment of inflation, a primary goal of monetary policy. It was argued that there is no immediate threat to prices to increase beyond a tolerable level and hence the easy monetary policy stance will continue for the next 6-months unless some extra ordinary and unexpected events occur for which State Bank of Pakistan shall take corrective measures as it is monitoring the situation vigilantly.

Interest Rates Environment: The focus of monetary policy in the financial year 2002-03 was on the stability of exchange rate to maintain trade competitiveness, contain inflation and provide an interest rates environment to stimulate economic growth mainly through private sector. This was partly achieved by lowering discount rate, which was 14% in June 2001 and reduced to 7.5% by November 2002. In addition, easy monetary policy by which State Bank was able to maintain export competitiveness by maintaining stable exchange rate, it was able to lower yield on T.bills of different tenors. The yield on 6-month T-bills decreased from 6.44% in July 2002 to 1.67% by end-June 2003. Like-wise, yields on 3 and 6 months T-bills and PIBs decreased significantly. This raised pressure on the government to reduce its borrowing cost through rationalization of interest rates on national savings schemes.

The discount rate cuts and relatively easy monetary policy were aimed at inducing banks to reduce their lending rates in order to provide low cost credit to the private sector to kick start economy. Banks responded positively and lending rates have come down significantly since July 2001. The weighted average lending rates, which were 14.49% in July, 2001 came-down to 12.17% in July 2002 and to 7.58% in June 2003. As export refinance rates are linked to yield on 6-months T-Bills, they have declined from 11.5% in July 2001 to 2% at end-June 2003. The weighted average deposit rate of banks also decreased to 1.9% in June 2003 from 4.99% in July 2001.

The process of lowering the discount rate, declining NPLs and pressure on banks to lend to the private sector instead of investing of low yield government papers resulted in narrowing the banking spread. The gap between lending and deposit rates narrowed from 950 basis points in July 2001 to 568 basis points in June 2003. Though, there is further scope in the spread between lending and deposit rates it is still encouraging because relatively more reduction was in average lending rates than in average deposit rates.

Private Sector Credit: In a low inflation scenario it was possible for the State Bank of Pakistan to adopt an easy monetary policy and force the interest rates, mainly the lending rates to go down. As a result, bank credit to private sector recorded an unprecedented increase of almost 300% during the year 2002-03 compared with the credit disbursement last year. The total credit by the banking sector was Rs.154 billion (which does not include self-financing and credit expansion from non-bank financial institutions like leasing, modarbas, etc). This development is reflected in the strengthening of macro-economic fundamentals of the economy supported by the continuity of structural adjustment policies and restoration of private sector confidence of economy. The confidence building process was facilitated by liquidity conditions in the market due to continued foreign inflows and less than full sterilization by the State Bank.

Besides, an overall credit expansion, which was exemplary, almost 55% of the credit was used by the manufacturing sector, i.e., Rs.83.5 billion during 2002-03 compared to Rs.7.6 billion a year earlier. In addition, it is encouraging that enhanced utilization of credit was mainly by the higher value addition sectors within the manufacturing sector. Moreover, the credit expansion was shared among all other sectors in the economy. State Bank of Pakistan's initiatives also helped agriculture sector to avail sufficient credit. As the overall interest rates and the export refinance rates, which are linked to 6-months' T.bills, have gone down significantly the net credit to export refinance was also higher in 2002-03 than in 2001-02.

RESEARCH AND ANALYTICAL OUTPUT

As central bank, State Bank of Pakistan has a major role to play in shaping the agenda of economic research & development, not only in the field of monetary & financial policies, but also for broader national economic issues. This role has been considerably enhanced with the attainment of autonomy by SBP in management of banking system and in the conduct of monetary policy. Clearly, economic analysis of high quality would be reflected in sound macroeconomic management and the evolving structure of monetary & financial system expected to be resilient against internal & external shocks. In this context, Research Department has begun to play an important role by providing key inputs for economic policy formulation through analytical reviews and research work.

Research priorities were defined clearly during FY03. Accordingly, the department was required to make a comprehensive assessment of financial sector, beside completion of SBP flagship publications, i.e. Quarterly Reports on the state of economy and Annual Report. In addition, the

department is also committed to undertake a number of development tasks, which include formulation of framework for macroeconomic projections, improved coverage of SBP Annual Report, study on core inflation, development of infrastructure index and coordinating study on competitiveness of textile exports.

SBP's Annual and Quarterly Reports: The contribution of Research Department is largely concentrated in SBP main publications. These reports highlight important issues faced by different sectors of the economy. Efforts have been made to not only improve quality of analysis but also to expand coverage of issues.

In this context, new chapter titled 'Socioeconomic Update' was included in the last Annual Report for FY02. This chapter provided a review on the status of socioeconomic sector in Pakistan and set a baseline for future discussion on the social sector in SBP reports.

In addition, another new chapter on 'Islamization of Financial System in Pakistan' was also included in the Report. This chapter not only provided a brief history of initiatives to Islamize the financial system, but also described the working of Commission for Transformation of Financial System, constituted following judgment of Supreme Court of Pakistan. In addition, the chapter also outlined framework for regulating and supervising Islamic banking system.

Furthermore, Annual Report also carried a section on energy sector in Pakistan. This section outlined the structure of energy sector with a view to highlight the core issues of the sector.

Financial Sector Assessment (FSA): Research Department also undertook a comprehensive assessment of the financial sector for period 1990-2000. The study, published in October 2002, presented first concrete and broad-based assessment of developments and performance of financial sector during 1990s. The report not only incorporated an analytical review of reforms undertaken during the decade, but also supplemented it with lessons drawn from the earlier liberalization process and identified areas that were ignored in the past.

The publication of FSA was preceded by a conference on financial System in Pakistan (held in June 2002) in which draft assessment report was deliberated upon and views were sought from participants to strengthen the financial system. In fact, it was the first time SBP had invited various stakeholders on financial system to offer their perspectives on financial sector reforms during the period and sought input toward formulation of future policies. To institutionalize the participation of stakeholders in policy formulation, an Advisory Group, consisting of nine financial sector experts has been formed for providing an objective and fresh perspective to the central bank policies impacting the financial sector.

SBP Working Paper Series: This series was conceptualized by the Research Department as a quick win project. These are short papers initiated by individual officers, containing in-depth analyses of issues that otherwise do not fall completely within the ambit of the SBP's main publications. These papers are released on the SBP website (www.sbp.org.pk) following an internal review process. Six papers were released during FY02-03 on the topics related to growth cycle in Pakistan and identification of seasonal factors in Islamic Calendar.

Economic Data on SBP Website: For timely and meaningful disclosure of economic and financial data through SBP Website, the Research Department standardized formats of data tables in coordination with other departments of SBP. This was conceptualized as a quick win project and its successful implementation has improved the content and coverage of economic and

financial information being released to the public at large and led to timely disclosure of key information to the businesses and policy makers. Moreover, data sites are being monitored regularly to minimize time lags in making data available.

Quarterly Macroeconomic Projections: Research Department also facilitated economic decision-making process through its independent projections on key macroeconomic variables. The forecasts help policy makers develop a view of future economic growth; enables them to assess performance of the economy on quarterly basis; provides an opportunity for quarterly reviewing of Bank's operational targets; and help the Bank form an independent judgment on economic growth prospects. The first macroeconomic projections for FY03 were prepared in September 2002. These forecast are updated quarterly on the basis of recent available data and submitted to management before start of each quarter.

An Assessment Of Competitiveness Of Pakistan's Textile Exports: The department is also supervising study on export competitiveness of Pakistan's textile sector. M/s Associated Productivity Consultant (APC) has been appointed as outside consultant to conduct this study on Pakistan's textile sector.

In this context, the department has arranged first meeting of the steering committee (comprising representatives of APTMA, TCO, EPB, FCCP&I and prominent entrepreneurs) and nominees from various associations in textile sector to seek input for the study. So far, pre-testing of questionnaire has been completed and domestic survey is being conducted.

A Study On Core Inflation: This study would allow policy makers to recognize temporary (non-structural) fluctuations in inflation, enabling a more accurate analysis of the effectiveness of monetary policy. The study is under review by designated peers, and other officers at SBP. After incorporating comments from peer reviewers, the draft would be finalized, disseminated widely and used in policy formulation.

Development Of Infrastructure Index: A composite index of infrastructure industries was developed as a leading indicator for economic activities in the infrastructure sector. Since the infrastructure sector provides key inputs for the commodity-producing sector of the economy, this index provides an early signal for the performance of the broader economy.

EXCHANGE RATE STABILIZATION & LIBERALIZATION OF THE REGIME

As a matter of policy and with a view to improve the confidence of the market and reduce the risk of the system to speculation, State Bank has been vigorously implementing the strategy to both liberalize the entire foreign exchange rate regime and to provide stability to the exchange rate itself. The post September 11 events, the ensuing global recession and other exogenous shocks although initially lowered export earnings, the impact of these events on the exchange rate remained limited. The Rupee has remained stable, thus enabling the exporters to correctly price their products and benefit from the increased opportunities created in the European Union, where benefits of increased quotas were negotiated with reduced or eliminated tariffs. Some of the steps taken and policy measures introduced by the State Bank of Pakistan towards this end include:

- The Foreign Exchange Manual has been updated, revised, and brought in line with the market needs and realities. This has removed the long-standing anomalies that existed between the move towards liberalization and the rules that were conceived for the control regime.
- Formation of Exchange Companies was a vital part of SBP's strategy for developing a sound and documented foreign exchange market in the country on sound governance principles. The work on formulation of proper regulatory and legislative framework has been completed and nine licenses already issued for formation of exchange companies. As a result, five companies are already in operation and progressive facilitation of retail foreign exchange business through these companies would phase out the moneychangers within the next year. This would not only lead to better regulation and supervision of the activities of this market, but also allow for better service provision to the end user.
- Home remittances have started to be channeled through the banking system for a variety of reasons including the curb on hawala and hundi and the elimination of differential between the open and interbank market. Also, the five big Pakistani banks have also streamlined their remittance mobilization and processing, making it possible for the families in Pakistan to receive remittances within 24-48 hours in the larger cities of Pakistan.
- Authorized Dealers have been delegated the powers to allow remittances of surplus passage/freight collection of Foreign Airlines /GSA of Foreign Airlines subject to certain limitations on their amount.
- NOSTRO Limits, imposed on the Authorized Dealers for balances held abroad on account of their trading activities, have been withdrawn.
- Subject to certain conditions and State Bank's prior approval, residents of Pakistan including firms and companies are allowed to make equity-based investments, other than portfolio investment, in incorporated or unincorporated companies and Joint Ventures abroad.
- Authorized Dealers were allowed to freely buy and sell foreign currencies from and to other Authorized Dealers in Pakistan within the individually permissible exposure limits.

- To introduce the needed flexibility and widen the scope of the FE-25 Scheme, it was decided that while computing the 20% cap on FE-25 deposits against local currency deposits, the foreign currency deposits mobilized under FE-25 and utilized for financing of trade related activities will be netted off.
- Authorized Dealers were allowed to issue foreign currency travelers' cheques, for restricted amounts, to foreign and Pakistani nationals (resident and non-resident) against surrender of foreign exchange in cash.
- Shipping Companies were allowed to open and operate foreign currency accounts in Pakistan for both receipt and payment of foreign exchange.
- Relevant rules were revised to allow Authorized Dealers to hold on to the incremental foreign exchange deposits mobilized by them as against the earlier requirement of surrendering the same to State Bank under FE-31 Scheme.
- Establishment of Swap Desk to ensure two-way liquidity in the foreign exchange forward market not only gave support to the inter-bank market but also to the importers and exporters by rationalizing forward premiums. On the other hand, the desk also provided ample support to the money market through this mechanism.

Introduction of Karachi Interbank Offer Rate (KIBOR) which has grown in stature as the benchmark for borrowing and lending in the interbank market for maturities up to six months. The benchmark is becoming increasingly popular for pricing customer loans