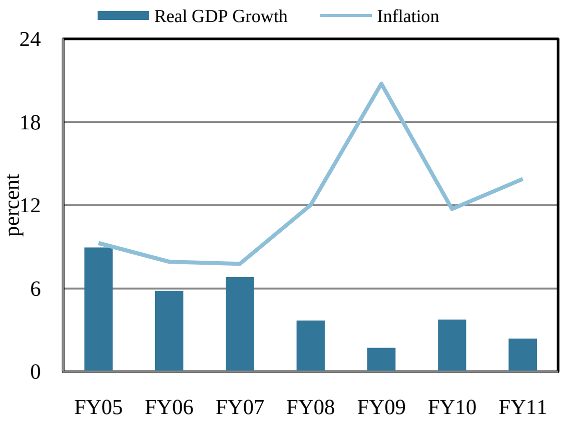
5 Inflation and Monetary Policy

5.1 Overview

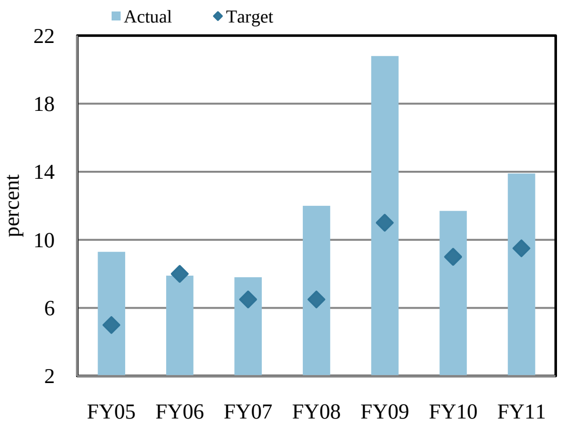
In spite of active monetary management, FY11 turned out to be yet another year of double digit inflation, fueled by supply side factors including devastating floods at the beginning of the year, and strong global prices of oil and agriculture commodities. On the demand side, massive government borrowing from SBP especially during first quarter of the year added to inflationary expectations. After November 2010, the government switched its borrowing away from SBP towards commercial banks. While this is a welcome development for managing inflationary expectations, it does crowd out the private sector.

Figure 5.1: Inflation-Growth Nexus



Source: State Bank of Pakistan

Figure 5.2: Inflation Targets Vs Actual



Source:: State Bank of Pakistan

The supply constraints not only kept inflation high, but also hurt growth (**Figure 5.1**). Economic activities were increasingly disrupted by persisting electricity and gas shortages, heightened security concerns, and increased cost of capital. Both inflation and real GDP growth targets were not met as shown in **Figure 5.2**. Actual annual inflation turned out to be well above the targeted level in FY11 as has been the case since FY06, and real GDP growth remained below the target for five out of the last seven years.

Formulating monetary policy in this environment (i.e., low growth and high inflation) is especially demanding since policy measures to contain inflationary pressures entail the risk of further restricting economic activities.[1] Being mindful of these challenges, SBP has vigilantly made use of any possible room available to contain inflation and support economic activities in recent years. In addition to adjusting the policy rate, SBP has also been implementing measures to improve its monetary policy framework and to support business activities.

[1] Trade-off between growth and inflation is well documented in economic literature.

Economic environment ahead of FY11[2]

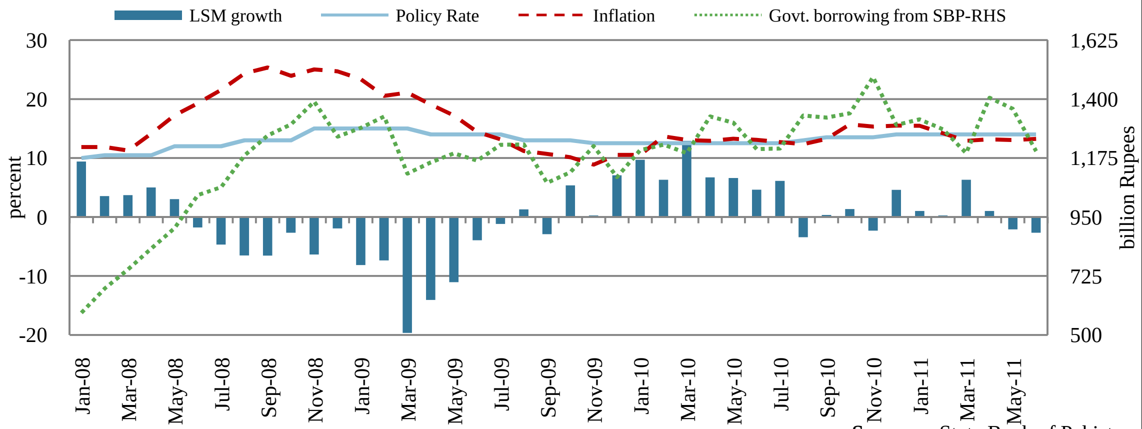
Before the beginning of FY11, headline inflation was gradually receding during the second half of FY10, while core inflation (non-food non-energy) was hovering at around 10.3 percent. Large scale manufacturing was growing at a modest pace. The current account balance was showing some improvement, supported by healthy exports and robust growth in workers' remittances. A sharp increase in cotton prices – an export commodity for Pakistan – was also observed in the fourth quarter of FY10. In contrast to these positives, fiscal developments proved to be inconsistent with earlier projections since the deficit for FY10 reached 6.3 percent of GDP against a target of 4.9 percent.

Inflation for FY10 turned out to be 11.7 percent against the target of 9.0 percent. Furthermore, the government was unable to meet its quarterly borrowing limits from SBP under IMF's Stand-By Arrangement (SBA) program for the third and fourth quarter of FY10. In view of these mixed developments, SBP kept its policy rate unchanged at 12.5 percent in all three monetary policy announcements during the second half of FY10 (**Figure 5.3**).

Monetary policy stance in H1-FY11

SBP's inflation projection at the beginning of FY11 was in the range of 11 to 12 percent for the year, compared to the government target of 9.5 percent. Inflationary pressures were on the higher side since there was no easing in government borrowing from SBP. The government net budgetary borrowing from SBP reached Rs 65.0 billion in first three week of July 2010, in addition to an increase of over Rs 100 billion during the second half of the previous year.

Figure 5.3: SBP Monetary Policy - Key Indicators for Consideration



Source: : State Bank of Pakistan

Containing the fiscal deficit for FY11 at the targeted level of 4 percent was clearly going to be very difficult. The possible impact of implementing a reformed GST, as agreed with the IMF, and upward revision in electricity tariffs worsened the inflationary outlook. Meanwhile, improvement in the external accounts was projected to remain modest. These developments necessitated adjustment in monetary policy to contain inflationary pressures; consequently, SBP increased its policy rate by 50 bps to 13.0 percent in its monetary policy announcement of July 2010. The minutes of the Monetary Policy Committee (MPC) reveal that an increase in the benchmark interest rate was unanimously recommended by all members of the committee.

[2] In this section, inflation numbers are based old base as the monetary policy decisions and inflation projections during FY11 were based on these numbers.

However, soon after the policy rate was increased, the country experienced devastating floods. A significant portion of agriculture land was impacted. Infrastructure (e.g., road network, railway tracks, canal system, communication, government buildings etc.) was seriously damaged, and over twenty million people were displaced. Consequently, food inflation increased sharply, surging to 21.2 percent in September 2010 compared to 12.8 percent in July. Headline inflation also saw a rise of 337 bps to 15.7 percent over the same period.

The floods also undermined government efforts to contain fiscal deficit. Expenditures of federal and provincial governments significantly increased, priorities were shifted from development expenditures towards rehabilitation of flood affectees, and the efforts to collect revenues suffered a major setback. The widening fiscal deficit was largely financed through short-term borrowing from the banking system. Specifically, government borrowing from SBP spiked to Rs 220.3 billion by 24^{th} September 2010 from the beginning of the year. Reserve money also registered an expansion of 9.4 percent over the same period compared to 11.4 percent for the full year of FY10.

In these circumstances, SBP's inflation projections for the year were revised upward in the range of 13.5 to 14.5 percent. Moreover, the current account balance was also projected to deteriorate due to possible increase in imports of food items and slowdown in exports. Keeping the inflationary impact of these issues in mind, SBP revised its policy rate upward by 50 bps to 13.5 percent in its monetary policy statement of end September 2010.

Despite gradual monetary tightening, the inflationary outlook continued to worsen. Food inflation peaked at over 20 percent in Q2-FY11. Government borrowing from SBP followed a rising trend, reaching Rs 251.3 billion by 27^{th} November 2010, just before the announcement of SBP's monetary policy statement on 29^{th} November. The sharp increase in international commodity prices emerged as an added risk to the inflationary outlook. Specifically, the price of oil increased significantly during Sep-Nov FY11.[3] There was, however, a silver lining to these negatives, as the impact of rising international prices of cotton and textile related exports was markedly positive on the current account. However, the overall impact on the external sector was fairly uncertain at that point in time. Although the current account balance registered significant improvements in the months of September and October, it deteriorated once again in November 2010. Against this backdrop, the SBP increased its policy rate by another 50 bps to 14.0 percent in November 2010. Minutes of the MPC meetings reveal that six out of eight members voted for a 50 bps increase in the policy rate and one member voted for a 100 bps rise, whereas another member voted to maintain the policy rate at 13.5 percent. With this announcement, the cumulative rise in the policy rate reached 150 bps during the first half of the year.

Monetary policy stance from gradual tightening to Hold: H2-FY11

Although implementation of fiscal reforms to enhance tax collection was held in abeyance, the government made concerted efforts to shift its borrowing away from SBP towards commercial banks. The government started to gradually retire its debt to the central bank from mid-December 2010, the government actually retired Rs 214.1 billion to the central bank during one and half month (from 11^{th} Dec-10 to 29^{th} Jan-11). Moreover, risks to the external account position were subsiding, and inflationary pressures were also expected to ease off once the effect of supply side disturbances was dissipated. In addition to the lagged impact of monetary tightening in H1-FY11, these developments allowed the SBP to change its monetary policy

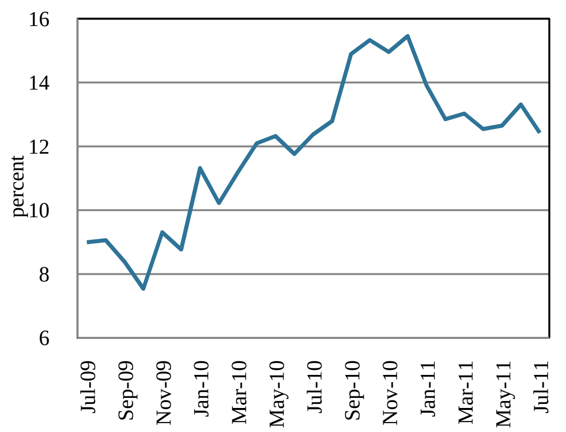
[3] Given the Pakistan's dependence on imported oil, changes in oil price have strong implication for inflationary outlook through both direct and indirect channels.

stance from gradual tightening to hold. Specifically, SBP kept its policy rate unchanged at 14.0 percent in its monetary policy announcement in January 2011.

It is pertinent to note here, that the MPC was fairly divided on the recommendation to hold the policy rate unchanged. In fact, three out of eight voting members were of the view that the policy rate should be increased since upside risks to inflation were high.[4] Specifically, reserve money supply saw an expansion of 16.5 percent during 1st July 2010 to 15th January 2011, compared to 11.4 percent over the same period last year.

With hindsight, the decision to hold the policy rate unchanged in January 2011 proved to be correct. The government adhered to its commitment to shift its borrowing from SBP towards commercial banks. However, implementation of much needed fiscal reforms (particularly for revenue generation) was delayed.[5] The real comfort came from improvement in the external sector. The current account balance improved significantly due to strong growth in exports and robust growth in workers' remittances. These positives allowed SBP to keep its policy rate unchanged in the next two monetary policy announcements (26th March and 21st May 2011).

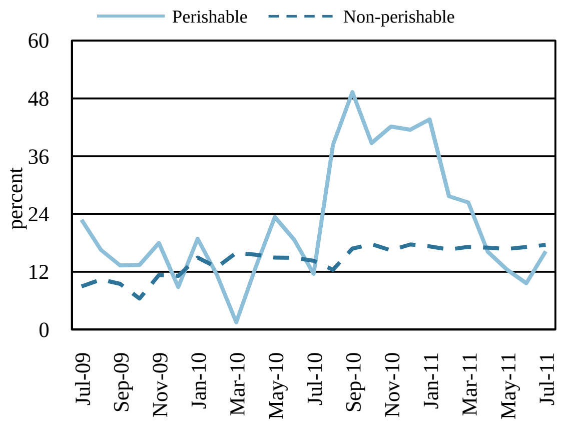
Figure 5.4: Trend in CPI inflation



Source: : State Bank of Pakistan

Headline inflation for FY11 turned out to 13.9 percent compared to 11.7 percent in the previous year (with CPI base year 2000-01). While it was largely in line with revised SBP projections of 14.0 to14.5 percent, stubborn inflation despite SBP's active monetary management, attracted some criticism from the print media and business communities.[6] Increasingly within SBP, there was a realization that activities are largely constrained by supply side factors like the energy shortage, security concerns, and socio-political uncertainty. There was a need to balance our policy formulation.

Figure 5.5: Food Inflation (YoY)



Source: : State Bank of Pakistan

[4] Five members voted for status quo, i.e., to keep interest rates unchanged.

[5] Specifically, the government was largely unmoved on key fiscal reforms including expanding tax net to agriculture sector, restructuring of loss making public sector enterprises (PSEs) and implementation of reformed general sales tax (GST). For details, please see Chapter on Public Finance.

[6] The response to this criticism can be found by turning attention towards the massive government borrowing from the SBP which took place during H1-FY11 and supply disruptions on account of devastating floods at the beginning of the year. If the SBP had not continued with monetary tightening during the first half of the year, annual inflation would have been significantly higher than the level observed in FY11.

Inflation target for FY12 and monetary easing at the beginning of the year

Based on the lagged impact of monetary tightening during H1-FY11, the gradual retirement of inflationary borrowing from the SBP (during H2-FY11) and a targeted fiscal deficit of 4 percent of GDP, SBP projected FY12 inflation to lie in the range of 11.5 to 12.5 percent. In addition to the continued improvement in the external front, this created some room for the SBP to change its monetary policy stance. Accordingly, the SBP reduced its policy rate by a cumulative 200 bps to 12.0 percent in its two successive monetary policy announcements.

Having said this, we are aware that weakness in the fiscal accounts poses a major risk to the inflationary outlook for this year. There is a dire need to implement key fiscal reforms, especially related to revenue generation measures and restructuring loss making PSEs. However, we remain confident that the government will continue to honor its commitment to stay below its borrowing limit from SBP and to aggressively seek non-traditional sources of external finance.

5.2 Inflation[7]

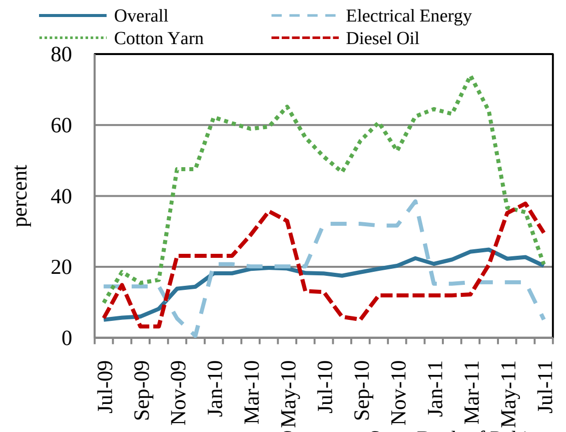
Average annual inflation for FY11 was 13.7 percent, compared to 10.1 percent in the preceding year. While the floods in the early part of FY11 are largely held responsible for the increase in inflation, we believe that a double-digit increase in prices was more or less inevitable.

The prices of perishable commodities were affected most by the floods, since their supply was severely restricted. Average inflation in perishable commodities stood at 29.8 percent in FY11 as compared to 15.0 percent in FY10. However, prices of other non-perishable food items, for which production and supply remained largely unaffected by the floods, also rose appreciably during the year.

To an extent, the rise in prices of non-perishable food items – and non-food commodities in general – was a consequence of rising international commodity prices. The higher global prices of edible oils, sugar, cotton, crude oil and petroleum products, and metals contributed significantly – directly and indirectly – towards maintaining upward pressures on domestic prices across the board.

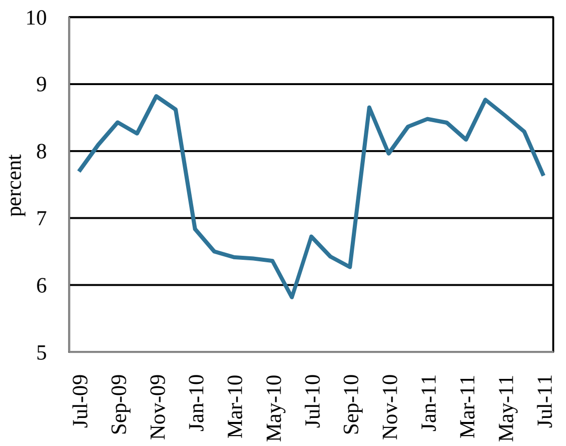
The trend in WPI, which averaged 21.1 percent in FY11, is a reflection of increases in international commodity prices. The

Figure 5.6:WPI Inflation and selected Components



Source: : State Bank of Pakistan

Figure 5.7: House Rent (YoY Growth)



Source: : State Bank of Pakistan

[7] This section is based on new CPI with base year 2007-08. For details on trends of different price indices, see monthly Inflation Monitor of SBP. http://www.sbp.org.pk/publications/Inflation_Monitor/index.htm

dramatic rise in cotton prices in the middle of FY11 and the steady increase in oil and petroleum product prices for most of FY11 were the major drivers of WPI inflation. However, as global commodity prices crashed at the end of FY11, domestic wholesale prices too have either stagnated or declined on a monthly basis.

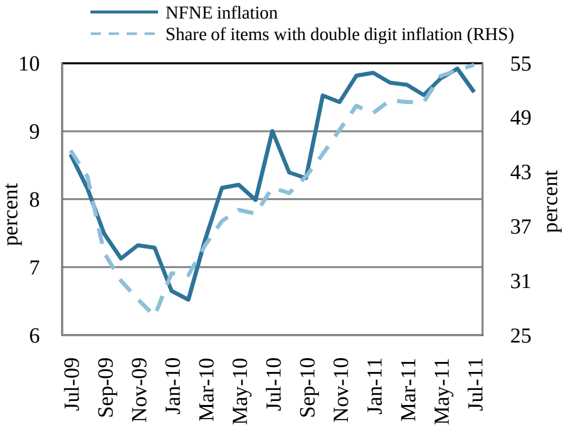
While the contribution of global commodity prices in FY11 was significant, domestic policy decisions, such as the gradual phasing out of power subsidies and the encapsulation of more goods and services into the sales tax net, also played their part in maintaining price pressures. Simultaneously, house rents also rose due to the increase in construction costs. This trend contributed significantly to headline inflation due to its weight in CPI.[8]

Most importantly, we believe that the perception that the government uses inflationary finance – such as borrowing from the central bank – reinforces self-fulfilling inflation expectations. So far, however, the government has managed to contain its level of borrowing from SBP at the end of the last two quarters of FY11, which will be important in anchoring expectations moving forward.

Such inflationary expectations are visible in the broad-based nature of inflation across commodities in the economy. The percentage of commodities exhibiting double-digit inflation has increased steadily from 29 percent in November 2009 to 55 percent in July 2011.[9] Non-food non-energy (NFNE) inflation, a measure of core inflation, increased steadily in FY11 and averaged 9.4 percent, reflecting persistence of inflationary pressures in the economy.

Inflation persistence has been corroborated by an internal survey that seems to indicate the backward-looking nature of inflation expectations.[10] Thus, the government's inflation target for FY12 of 12 percent appears to incorporate this persistence.

Figure 5.8: Core Inflation and Diffusion



Source: : State Bank of Pakistan

In fact, we believe that FY12 might bring about a slowdown in inflation as global commodity prices have and are expected to ease in the year. These prices are notoriously hard to predict, but with the euro-zone debt crisis; weak economic recoveries in the developed world; rising benchmark rates in developing countries seeking to rein in inflation; and rising agricultural output in response to high FY11 agriculture prices, we have reason to believe that commodity prices will recede in FY12. However, with the removal of subsidies in the domestic economy, the country will remain exposed to volatility in the commodities market and domestic price levels are expected to trend accordingly.

One of the key risks faced by the economy will be fluctuations in the price of crude oil and petroleum products. Even though the price of crude oil receded in May-July 2011, it may stage a

[8] House rent has a weight of 21.81 percent in the CPI.

[9] This means that since Nov-09, the number of commodities registering double-digit inflation has risen by an average of 6 each month.

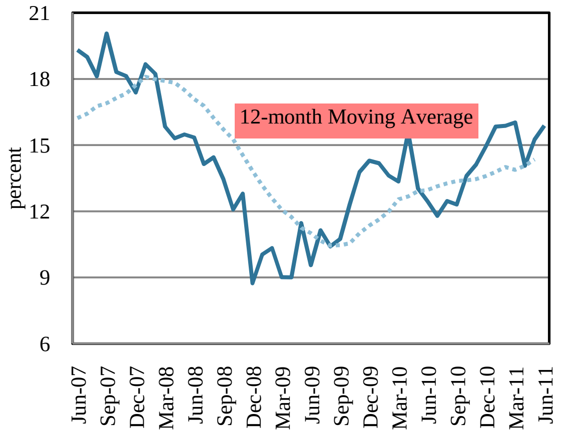
[10] Backward-looking expectations mean that consumers and producers forecast inflation using its past levels

comeback due to the expected increase in demand from non-OECD countries, which will likely be higher than the increase in output from OPEC countries. Implied volatility in oil prices remains fairly high and price forecasts are uncertain. In the absence of subsidies, the economy stands vulnerable to this volatility in oil markets. However, on the other hand, the removal of subsidies is necessary to control the country's fiscal gap and, in turn, inflationary expectations.

It is pertinent to note that inflation expectations may still persist even if greater fiscal discipline prevails. Supply constraints across the economy in the shape of power and natural gas shortages; inconsistency in changes in administered prices; and security concerns will not only contribute to inflation but also bolster perceptions of future price increases. An expansion in aggregate supply remains highly unlikely given the curtailment of development expenditures – due to the government's weak fiscal position – and the low level of fixed investment in the economy. The aggregate demand-supply gap is, therefore, expected to remain and contribute to inflationary pressures.

Despite the persistence in inflation and its expectations, we expect headline inflation to recede gradually over the next few months, as the high level of prices witnessed during last year's floods becomes the base for calculations. The decline in inflation may be also accelerated by falling global commodity prices and concrete steps towards fiscal consolidation to anchor inflation expectations and free up credit for the private sector to pursue capacity expansions.

Figure 5.9: YoY Growth in M2

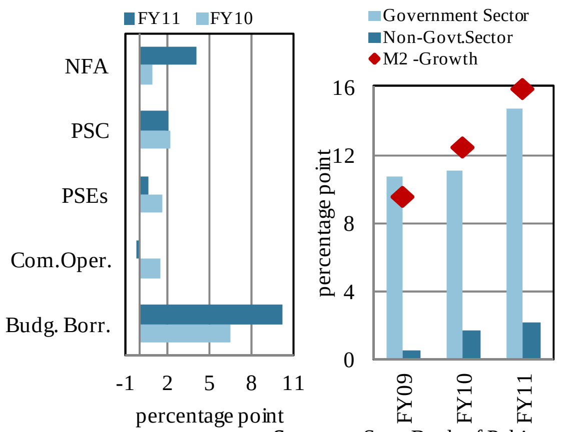


Source: : State Bank of Pakistan

5.3 Development in Monetary Aggregates

Growth in broad money supply (M2) gained traction for yet another year. Broad money increased by 15.9 percent in FY11 compared to 12.5 percent in the preceding year (**Table 5.1**). Monthly YoY growth in M2 depicts a rising trend since Dec 2008 after having a span of sharp deceleration during in H1-FY08 (**Figure 5.9**). A larger part of M2 growth in recent years was attributable to the government sector, which marginalized scope for private sector activities. Nearly 80.0 percent of banking resources in FY11 were used to finance budgetary requirements in the wake of growing fiscal slippages. Moreover, quasi -fiscal activities such as commodity operations and provision of credit to PSEs also took their toll on domestic banking resources (**Figure 5.10**).

Figure 5.10: Contribution in M2



Source: : State Bank of Pakistan

In FY11, the most striking feature of M2 growth was the sharp increase in Net Foreign Assets (NFA) of the banking system. This trend represents a stark contrast to the growth pattern observed in the previous three years, when NFA experienced a cumulative decline of Rs 439.6 billion. Another positive development was the containment of deficit monetization via central bank borrowing. The government adhered to its borrowing limits agreed with SBP and retired Rs 100.4 billion to the central bank during Jan-Jun FY11. However, the limits were observed only at the quarter ends, whereas the government continued to borrow from central bank during the course of each quarter.

Table 5.1: Monetary Aggregates
flows in billion Rupees, growth in percent

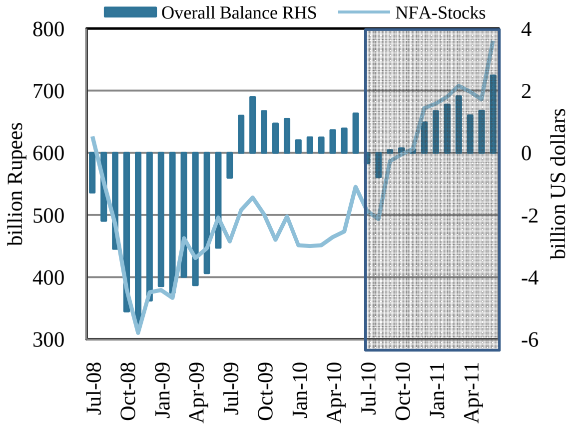
					% Growth	
	FY10	**FY11**	**H1-FY10**	**H1-FY11**	**FY10**	**FY11**
Broad money (M2)	640.0	918.0	300.4	399.5	12.5	15.9
NFA	49.4	235.0	47.5	108.2	10.0	43.1
SBP	75.9	235.3	57.8	131.1	25.0	62.1
Scheduled banks	-26.4	-0.3	-10.2	-22.8	-13.7	-0.2
NDA	590.6	682.9	252.8	291.3	12.7	13.1
SBP	86.4	48.7	-24.6	-81.7	9.6	4.9
Scheduled banks	504.2	634.2	277.4	373.0	13.5	14.9
of which						
Government borrowing	406.6	579.6	285.2	318.4	20.0	23.7
For budgetary support	330.4	590.2	199.6	281.7	19.7	29.3
SBP	44.0	-8.0	106.6	-100.4	3.8	-0.7
Scheduled banks	286.4	598.2	93.0	382.1	55.5	74.5
Commodity operations	77.0	-15.7	85.0	34.2	22.9	-3.8
Non government sector	198.8	158.5	-18.0	-21.3	6.2	4.7
Credit to private sector	112.9	121.3	-11.7	-42.0	3.9	4.0
Credit to PSEs	85.0	36.3	-8.0	20.6	31.9	10.3
Other items net	-14.9	-55.1	-14.5	-5.7	2.5	9.2

Source: State Bank of Pakistan

5.3.1 Net Foreign Assets (NFA)

Following improvement in the country's external accounts, pressure on NFA of the banking system gradually eased off. The NFA of the banking system witnessed an expansion of Rs 235.0 billion during FY11, considerably higher when compared with Rs 49.4 billion in FY10 (**Figure 5.11**).

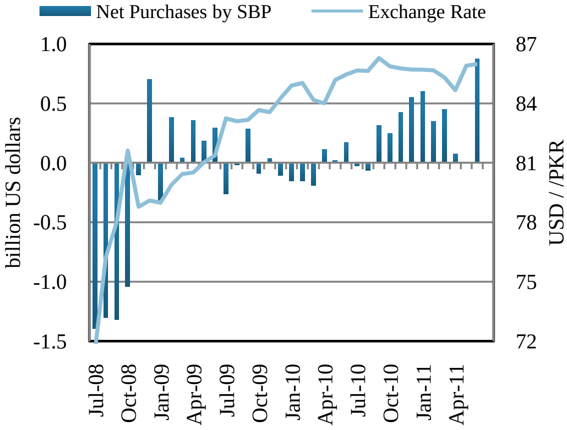
Figure 5.11: Stock of the NFA and Overall External Balance



Source: State Bank of Pakistan

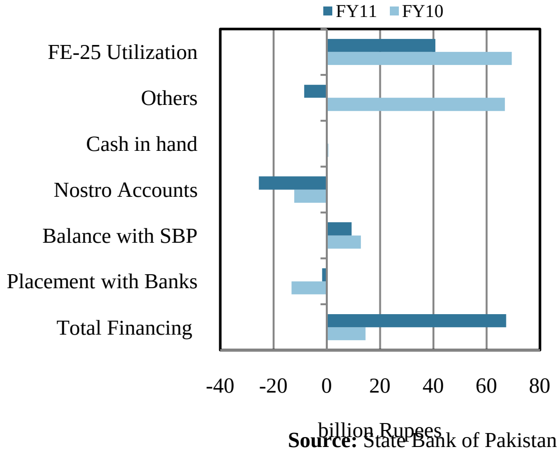
Within the banking system, expansion in NFA was primarily driven by accumulation of the SBP's foreign exchange reserves. Institutional flows from multilateral agencies, logistic support funds and other foreign grants supported this trend. The SBP NFA also gained impetus from net purchases in the foreign exchange market. Specifically, the SBP's active participation in the foreign exchange market helped to reduce excessive volatility in the exchange rate during the year (**Figure 5.12**).

Figure 5.12: Central Bank Intervention in the Forex Market



Source: State Bank of Pakistan

Figure 5.13: FE-25 Utilization



Source: State Bank of Pakistan

In contrast to the central bank's reserve assets, NFA of scheduled banks witnessed a contraction of Rs 0.3 billion during the year. Aside from the sale of foreign exchange to SBP, lower inflows from FE-25 deposits and a rise in foreign currency loans kept the NFA position of scheduled banks in check. In fact, the steady increase in the EFS rate over the last two years in addition to an all time low interest rate environment at the international level pushed up the interest rate differential between foreign currency loans and EFS financing. Together with a stable exchange rate, this development allowed traders (exporters and importers) to substitute EFS financing with low cost foreign currency loans. As a result, banks' placements of foreign currency assets in nostro accounts declined during FY11. This substitution in the utilization of FE-25 deposits further depleted scheduled banks' NFA (**Figure 5.13**).

5.3.2 Net Domestic Assets (NDA)

NDA of the banking system registered a growth of 13.1 percent during FY11, slightly higher than 12.7 percent in FY10. Among the causative factors, major contribution in NDA expansion came from budgetary financing, whereas share of commodity operations and credit to public sector enterprises declined during FY11 (**Table 5.2**).

Table 5.2: Contribution in NDA Growth

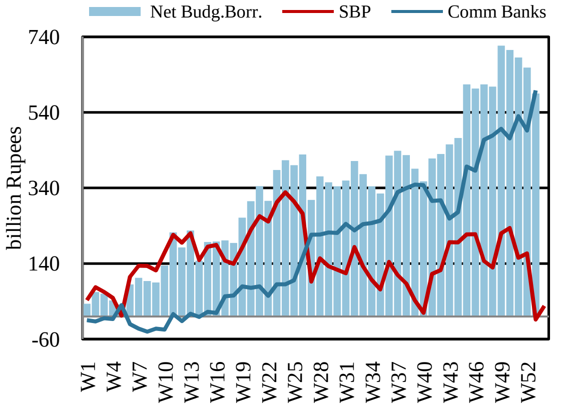
	FY09	FY10	FY11
NDA growth	15.4	12.7	13.1
Budgetary borrowing	7.9	7.1	11.3
Commodity operations	5.2	1.7	-0.3
PSC	0.4	2.4	2.3
PSEs	3.8	1.8	0.7
OIN	-1.9	-0.3	-1.0

Source: State Bank of Pakistan

Government borrowings for budgetary support

Budgetary borrowings from the banking system reached a record high of Rs 590.2 billion during FY11 compared to Rs 330.4 billion in the previous year. In addition to this, the government also borrowed Rs 424.0 billion from other domestic sources of funding. Fiscal slippages and shortfall in external financing left the government with no option but to rely on domestic resources.

Figure 5.14: Budgetary Borrowing from the Banking System (Cumulative Flows)

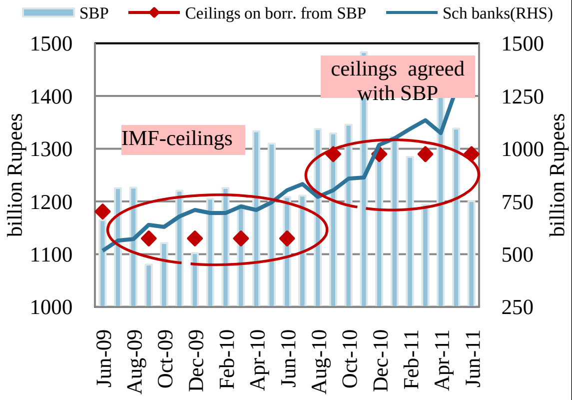


Source: State Bank of Pakistan

However, an important development during

FY11was the welcome shift in the composition of budgetary borrowing from the SBP to scheduled banks. Specifically, the government retired Rs 8.0 billion to the central bank during FY11. It may be pertinent to note here that during Jul-Nov FY11, the burden of deficit financing remained concentrated on the SBP; it was only after November 2010 that the government altered its financing mix and eased its reliance on central bank borrowing because of an understating with the SBP (**Figure 5.14**). Retrospectively, the large fiscal deficit could not allow the government to remain within ceilings agreed under the IMF SBA program, and the limit on central bank borrowing was breached in the last two quarters of FY10 to this effect. The same trend continued in the Jul-Nov FY11, and SBP financing reached a level of Rs 274.7 billion, posing a considerable inflationary threat.

Figure 5.15: Stock of Net Budgetary Borrowing from Banking System



Source: State Bank of Pakistan

In view of the adverse implications of heavy central bank borrowing for the overall macro-economy and effective monetary management, the government and the SBP mutually agreed upon a ceiling on government borrowing.[11] The restraint on central bank borrowing after November 2010 continued to remain in line with ceilings agreed with the SBP. The government's compliance with ceilings at quarter-ends seems quite encouraging. However, these restrictions were not observed during the course of each quarter and, on average, the government borrowed Rs 133.5 billion in each month of the last two quarters in FY11(**Figure 5.15**). Over the same period, government borrowing from scheduled banks increased since there was no recipe for curtailing the overall size of the fiscal deficit.

Scheduled banks were able to finance budgetary requirements of Rs 598.2 billion during FY11. Retirement under commodity operation loans and low credit off-take to the PSEs allowed banks to fulfill government appetite for borrowing.

Advances to the public sector enterprises (PSEs) decelerated during FY11 and banks financed credit demand of Rs 36.3 billion during FY11, as compared to 85.0 billion in the previous fiscal year. Majority of the increase in credit to PSEs came from cash-strapped, publicly-owned oil and electricity distribution companies, whereas demand from Pakistan Steel Mills (PSM) and Pakistan International Airlines (PIA) also remained high. This again point to the urgent need to restructure loss making PSEs.

Commodity operations

Net retirement in commodity finance loans was one of the few positives during the year.[12] Specifically, commodity finance loans registered a net retirement of Rs 15.7 billion in FY11 compared to net disbursements of Rs 77.0 billion in the preceding year (**Figure 5.16**).

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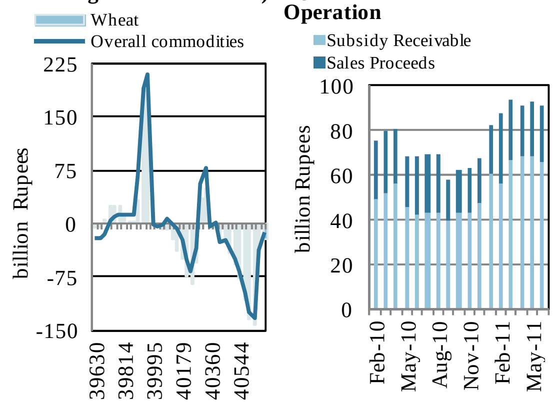
[11] The government agreed to keep its outstanding stock of borrowing from the central bank at the September 2010 level of Rs. 1,155 billion (on cash basis).

[12] In spite of self liquidating nature of commodity finance loans, the outstanding stock continued to pile up in recent years as the receivables on account of sale proceeds and subsidies of TCP, PASSCO and Provincial Foods departments jumped up.

Under commodity operations, a significant improvement was registered in the outstanding stock of wheat financing. The timely decision to export surplus wheat strengthened repayment capacity of procurement agencies, and created room for wheat procurement for FY11. Moreover, actual wheat procurement also remained lower than the targeted quantity. Consequently, demand of commodity loans remained subdued. The federal and provincial procurement agencies retired Rs 23.1 billion of wheat advances during FY11, which stands in contrast to an increase of Rs 48.4 billion in the previous year. A number of factors were responsible for hampering the wheat procurement drive during FY11 including: (1) lack of proper storage facilities since the agencies were already carrying wheat stock from the preceding year; (2) efforts to manage financial burden; and (3) non-materialization of subsidy receivables from the government (**Figure 5.16**).

Figure 5.16: Commodity Financing -cumulative flows) **Receivable of Procurement Agencies under Wheat Operation**

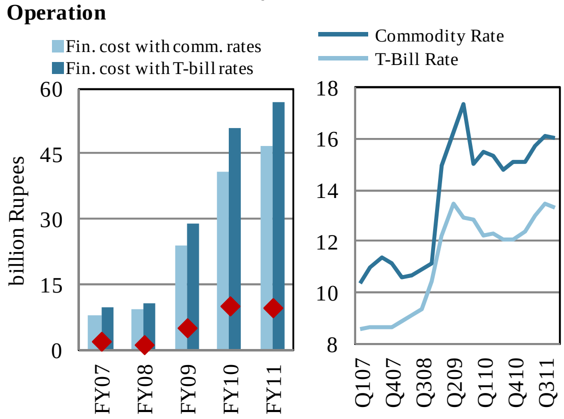


Source: State Bank of Pakistan

Aside from wheat, rice advances also experienced retirement during FY11. Procurement agencies made repayments by offloading rice stocks in the market. In addition to domestic procurement, banks also financed imports of sugar and fertilizer during FY11.

It may be important to note here that commodity loans are expensive for the government. Specifically, while the federal government borrows at t-bill yields, commodity loans are priced above KIBOR by a set margin. Any attempt to substitute expansive commodity financing with market-based borrowing would therefore reduce the government's financial burden on account of lower interest payments (**Figure 5.17**).

Figure 5.17: Financial Cost Associated with Commodity Operation **Comparison of Average Quarterly Rates** (percent)

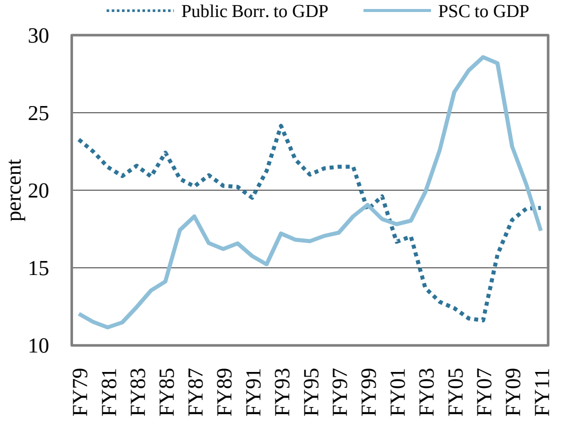


5.4 Private Sector Credit

Private sector credit registered a moderate growth of 4 percent during FY11, slightly higher than the growth rate experienced in FY10. This is a third consecutive year of low credit growth. To this effect, the credit to GDP ratio fell considerably in FY11 to 17.4 percent from 28.6 percent in FY08.

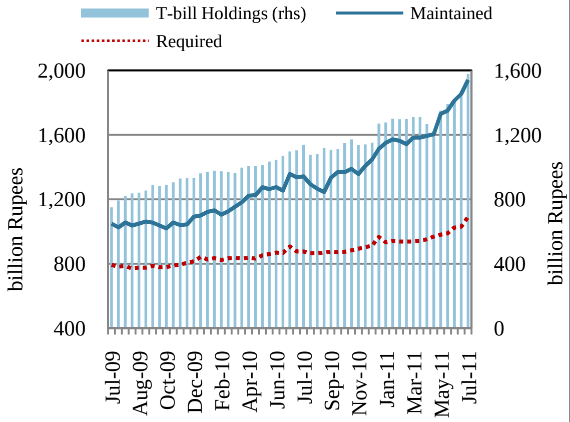
The composition of credit shows that credit expansion in FY11 was largely to meet working capital requirements as raw material prices continued to increase especially for textiles, sugar, edible oil and iron & steel industries. Specifically, 93.7 percent of the credit extended to corporate and SMEs was utilized for day-to-day business activity only.

Figure 5.18: Crowding Out of Private Sector Credit



Source: State Bank of Pakistan

Figure 5.19: Banking System Liquidity



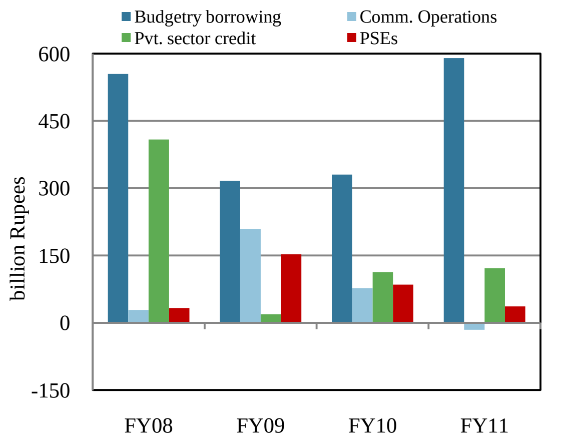
Source: State Bank of Pakistan

Credit expansion to SME sector as well as the number of SME borrowers experienced a decline during FY11. Both demand and supply side factors were at play. Credit demand from SMEs remained subdued due to high interest rates, continuous electricity and gas shortages, high collateral requirements for bank loans, and excessive documentation. On the supply side, scheduled banks were also reluctant to take exposure in this relatively riskier sector. However, compared to SME, corporate sector demand for credit increased significantly during FY11. Sharp increase in cotton and sugarcane prices and revival of business activities on account of strong demand for textile products from abroad (exports) created demand for loans from the corporate sector. Both the number of borrowers and credit to this sector increased during the year.

Compared to working capital loans, long-term borrowing for capacity enhancements remained passive. Specifically, fixed investment loans decelerated sharply during FY11 – a reflection of the weak socio-economic environment prevailing due to energy shortages, security concerns and escalating costs of doing business.

With regard to supply of loans, scheduled banks preferred to invest in liquid assets rather than extending credit to the private sector (**Figure 5.18 & 5.19**). Opportunity to invest in risk free government securities at high returns and increasing non-performing loans (NPLs) played a key role in encouraging banks to shift assets from advances towards investments.[13] This trend implies that massive government borrowing for budgetary finance is restricting flow of funds to the private sector (**Figure 5.20**).

Figure 5.20: Constraint to Private Sector Credit



Source: State Bank of Pakistan

[13] NPLs to loan ratio reached at a level of 15.4 percent in Jun FY11, considerably higher than 12.9 percent in corresponding period last year.

Table 5.3: Private Sector Advances (billion Rupees)

	Trade Finance		*Working Capital*		*Fixed Investment*	
	FY10	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Private Sector (Advances)	23.1	56.7	20.8	105.3	62.1	11.0
A. Agriculture, hunting and forestry	-0.6	0.6	-1.0	9.8	8.7	0.6
B. Manufacturing	14.2	42.2	3.7	82.6	13.9	-3.0
Food Manufacturers	3.6	0.9	9.3	51.0	-2.1	9.1
Textile Manufacturers	1.7	29.9	-23.3	20.5	8.7	-5.9
Manufacturing Less Food and Textile	8.9	11.4	17.7	11.2	7.3	-6.2
C. Electricity, gas and water supply	1.1	1.8	8.5	37.6	51.5	14.5
D. Construction	-0.2	-0.5	-5.5	-1.7	1.8	2.8
E. Commerce and Trade	2.9	4.6	-1.6	-15.1	-5.1	-5.6
F. Transport, storage and communications	0.1	0.2	4.7	-3.8	3.0	4.6

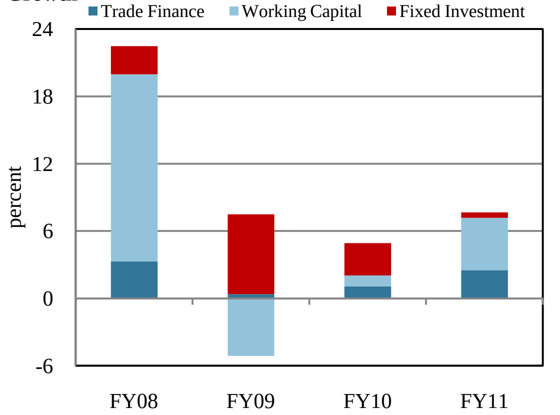
Source: State Bank of Pakistan

Private sector loans

Within credit, advances to the private sector during FY11 increased from 4.9 percent in FY10 to 7.7 percent in FY11 (**Table 5.3**).

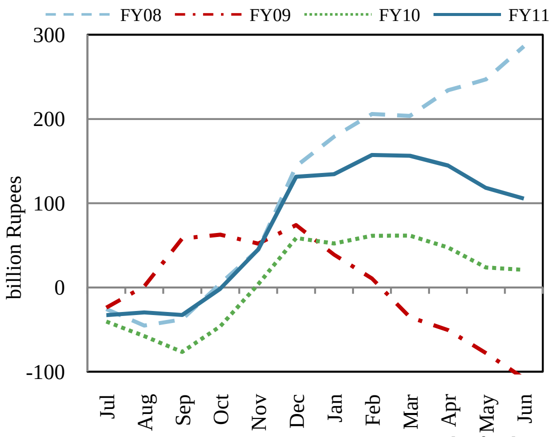
Working Capital Loans: Increase in the operating costs of businesses due to higher commodity prices and the energy deficit supported demand for working capital loans during FY11. Furthermore, healthy export growth particularly during the second half of the year also contributed to higher demand for working capital loans. As a consequence, these loans recorded YoY growth of 9.5 percent in FY11 compared with 1.9 percent in the last year (**Figure 5.21**). In absolute terms, working capital loans rose by Rs 105.3 billion during FY11 as compared to an increase of Rs 20.8 billion.

Figure 5.21: Private Sector Advances - Contribution in Growth



Source: State Bank of Pakistan

Figure 5.22: Working Capital Loans - Cumulative Flows

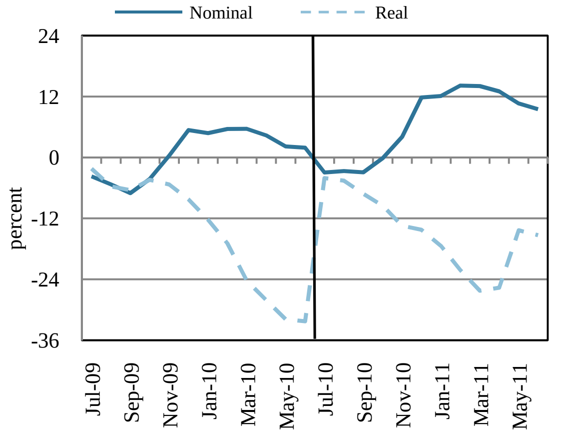


Source: State Bank of Pakistan

Another contributing factor towards growth in working capital loans was lower net retirement after the credit off-take cycle. Usually, loans taken under seasonal financing are mostly retired in the second half of the same year. This phenomena did not figure as prominently during FY11 as in previous years, with the exception of FY08 (**Figure 5.22**). The sector-wise break-up reveals that net credit expansion in working capital loans during H2-FY11 was concentrated in the sugar industry. In fact, huge disbursements were made to sugar manufacturers during Jan-Mar FY11 which were significantly higher than the monthly average disbursements during the last three years. As a result, the industry witnessed net credit expansion even during the retirement season. This unusual pattern was primarily attributed to higher sugarcane prices as well as repayments of outstanding dues to the growers by sugar manufacturers.

The overall increase in working capital loans was concentrated in the manufacturing and power sectors. These two sectors jointly accounted for 114 percent of aggregate working capital loans. Most of the demand for running finance came from the sugar, textile and edible oil sectors. These sectors faced rising input prices such as those of cotton, sugarcane, edible oil, iron and steel. Working capital loans adjusted for higher prices of raw materials witnessed negative growth in FY11 (**Figure 5.23**).More importantly, excluding the food and textile sectors, demand for working capital loans remained largely unchanged as compared to the levels observed in FY10.

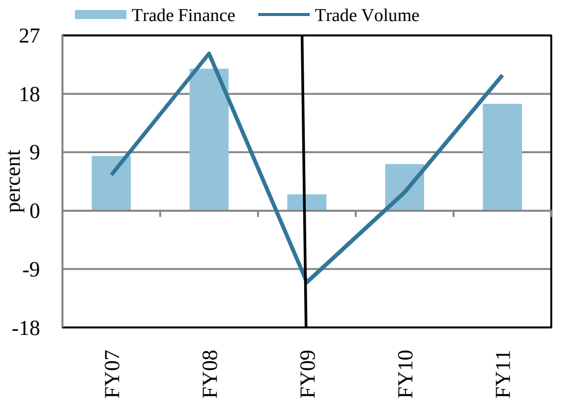
Figure 5.23: Working Capital Loans to Private Sector



Source: State Bank of Pakistan

Trade Finance: In line with increase in trade volume, trade financing accelerated during FY11 and posted strong growth of 16.5 percent compared with 7.2 percent in the preceding year (**Figure 5.24**). Both export and import finance contributed toward this acceleration during the period under discussion.

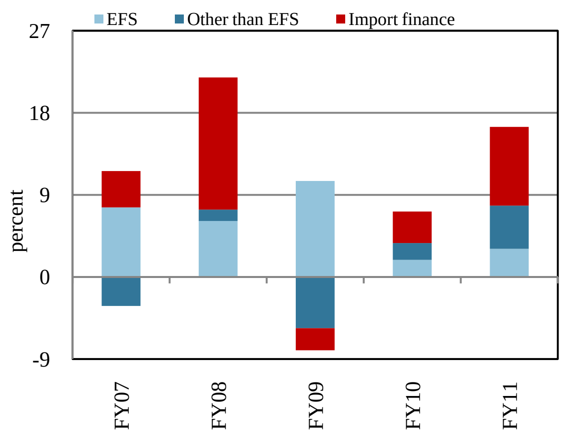
Figure 5.24: Co-Movement in Trade Finance and Trade Volume



Source: State Bank of Pakistan

Within overall export finance, concessional financing (EFS category) registered an increase of 5.4 percent in FY11, whereas loans other than EFS (FE-25 loans for exporters) witnessed remarkable growth of 40 percent during FY11 compared with 17 percent in FY10 (**Figure 5.25**). The increase in foreign currency loans availed by exporters was mainly due to the combined effect of a relatively stable exchange rate and the interest rate differential between domestic and foreign currency lending rates. Specifically, while domestic interest rate inched up, the weighted average foreign currency lending rate was declining continuously till Feb 2011. Exporters were naturally hedged against exchange rate risk in this regard, and availed this opportunity readily. However, as the foreign currency lending rate began to increase, exporters started to retire outstanding loans (**Figure 5.26**).

Figure 5.25: Composition of Trade Financing



Source: State Bank of Pakistan

Sector-wise distribution of trade loans reveals that textile sector remained the major beneficiary and availed nearly two-thirds of concessional lending (EFS) during the period under consideration. Moreover 58.6 percent of export loans other than concessional financing were also availed by the textile sector, which is in line with the sector's export performance during FY11.

Within the trade loans category, manufacturing and commerce & trade sectors also utilized foreign currency loans for imports. While growth in credit to the commerce & trade sector was mainly caused by increase in imports of finished products, increase in import finance availed by the textile sector was concentrated towards cotton procurement, primarily due to soaring international prices of raw cotton. The impact of higher international commodity prices were also visible in basic iron & steel, edible oil and cement industries.

Fixed Investment: Unlike running finance and trade loans, fixed investment loans witnessed a sharp fall in FY11. Specifically, these capacity enhancement loans increased by only 1.4 percent – the lowest growth witnessed during the last five years.

Monthly trends in fixed investment loans indicate a marginal decline up to Jul-May (**Figure 5.27**). Large disbursements were made during the month of June to the power, fertilizer, basic metals, and electrical machinery, construction and telecom sectors due to which overall fixed investment loans depicted an end-year increase. Net credit expansion to this effect stood at Rs 15 billion in June 2011 against net retirement of Rs 4 billion in the first eleven months of FY11.

Despite a substantial increase in disbursements of fixed investment loans in Jun-11, overall disbursements in FY11 were well short of the average increase (Rs 45 billion) registered in the previous three years. As mentioned earlier, these disbursements were concentrated in a few sectors only.

Figure 5.26: FE-25 Loans vis-a-vis Foreign Currency Lending Rate

Export Financing

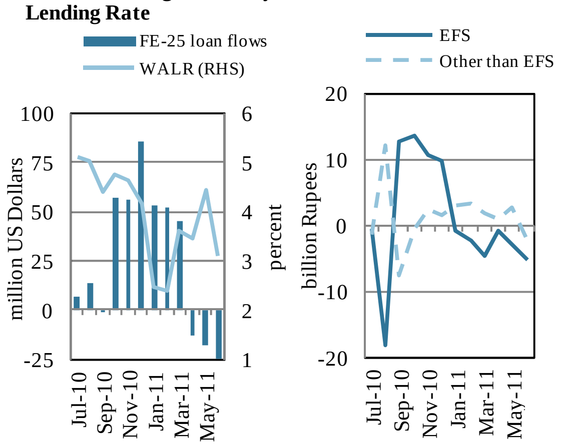
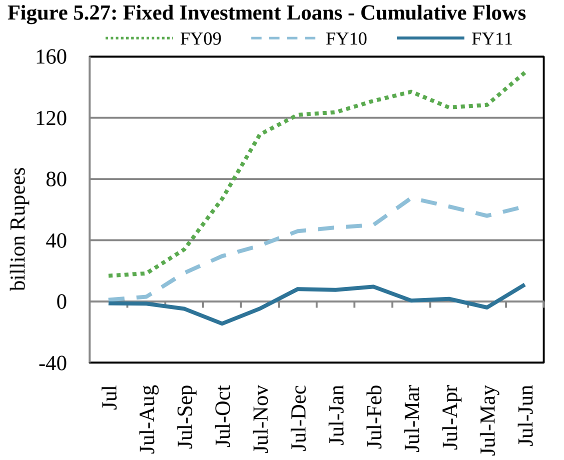
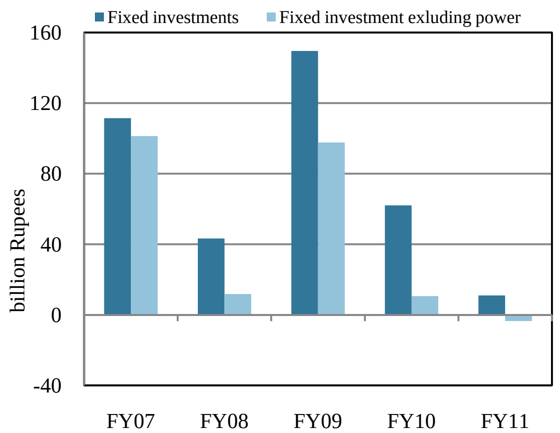


Figure 5.27: Fixed Investment Loans - Cumulative Flows



Source: State Bank of Pakistan

Figure 5.28: Fixed Investment Loans



Source: State Bank of Pakistan

Excluding the power sector, overall fixed investment loans witnessed net retirements of Rs 3.5 billion during FY11 (**Figure 5.28**).

Table 5.4: Investment Flows - Major Sectors
million Rupees

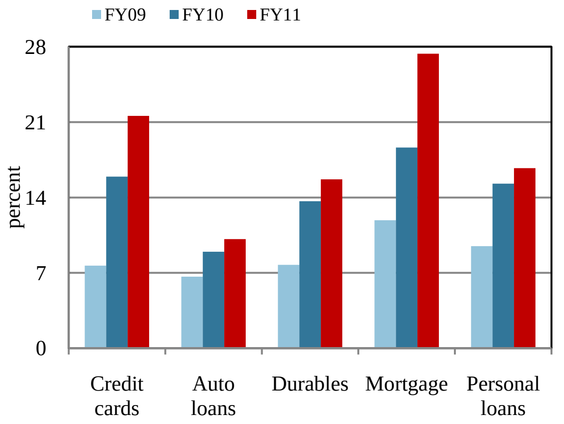
	Fixed Investment	Foreign Inflows	Total
Power	14,459.0	23,681.9	38,141.0
Cement & ceramics	-4,866.4	6,572.5	1,706.2
Sugar	8,526.8	401.2	8,928.0
Beverages	-394.0	662.0	268.0

Source: State Bank of Pakistan

Nonetheless, aggregate long term loans availed by the power sector were considerably lower in FY11 compared to FY10 since the sector also received inflows through foreign private investment. Similarly, the cement and beverages industries also relied on foreign inflows for capacity enhancements instead of borrowing from domestic resources (**Table 5.4**).

Other sectors which witnessed an increase in fixed investment loans – such as textile, electrical machinery apparatus and telecom - also witnessed an increase in the imports of their respective machinery and apparatus. However, significant declines in fixed investments for the spinning and textile finishing sub-sectors overshadowed investment activities within weaving, made-ups, knitwear and other textile manufacturing sub-sectors. The sugar sector also witnessed an increase of Rs 8.5 billion under fixed investment loans during FY11.

Figure 5.29: Consumer Loans - NPLs to Loan Ratio



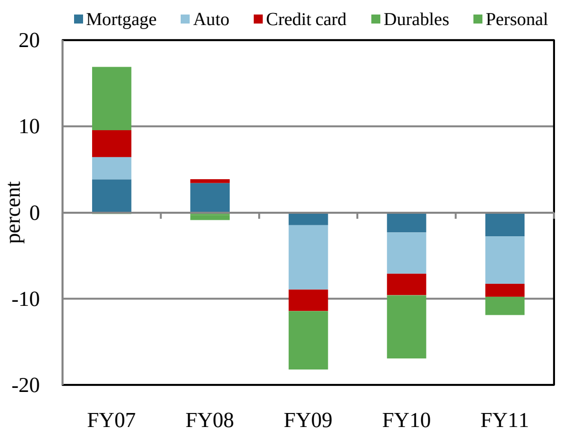
Source: State Bank of Pakistan

Consumer loans

Consumer financing continued to decline for the third successive year, by 11.9 percent in FY11 compared with 16.9 percent in the previous year. Whereas higher interest rates kept demand for consumer loans in check, banks were conservative in lending to this risky business segment in light of mounting NPLs on the consumer loan portfolio (**Figure 5.29**) – particularly in the presence of opportunities to invest in risk free government paper.

Each category within the consumer finance segment has registered a persistent increase in the loan infection ratio for the last three years. This increase has been a combination of rising NPLs and declining credit to each category with the exception of consumer durables. Consumer durables were the only category under consumer financing which recorded positive growth rate during FY11. However, its share is very nominal in terms of the overall portfolio, and impact on overall consumer loans remained muted.

Figure 5.30: Consumer Loans - Contribution



Source: State Bank of Pakistan

Major contribution towards net retirement of consumer financing came from the auto sector (**Figure 5.30**). Despite an increase in auto sales, significant retirements indicate increasing prominence of cash-based sales. However, data on disbursements suggests some improvement took place in consumer financing during FY11. Amongst the large privatized banks, one bank in particular is aggressively involved in auto financing, encouraged by the decline in non-performing loans within this category during the last two years. Nonetheless, the overall impact of retirements in outstanding stock of loans exceeded total disbursements during the period under consideration.

Box 5.1: Rebasing of Price Indices

In September 2011, the Federal Bureau of Statistics (FBS) developed a new set of price indices with FY08 as the base year. The weights of consumer items in the new basket have been derived from a Family Budget Survey conducted by the FBS in FY08 that covered above 50 thousand households in 65 cities. The salient features of new base data are given below:

Consumer Price Index

- The number of commodities included in new CPI basket is 487; earlier it was 374. These commodities have been classified into 12 groups according to a scheme developed by United Nations, i.e. "Classification of Individual Consumption According to Purpose (COICOP) (**Table 5.5**).
- In the new basket of consumer goods, the weight of the foods group is lower. This implies that headline inflation will be more resilient to food price shocks in the future. On the other hand, the share of transport and communication has increased, which means that increases in the price of petrol and diesel will have a larger effect in the new measure of CPI inflation.
- The new index covers 40 cities compared with 35 cities in old index. The number of income groups has also been increased from 4 to 5: the first group contains consumers with incomes upto Rs 8000 per month; the second income group is Rs 8001-12000; the third group is Rs 12001-18000; the fourth group is Rs 18001-35000 and the last group of consumers has incomes above Rs 35000 per month.
- In the old CPI, the rent index was estimated indirectly using the price of building materials and the wages of the labor; however, in the new series, it is based on an actual rent survey conducted on a quarterly basis.

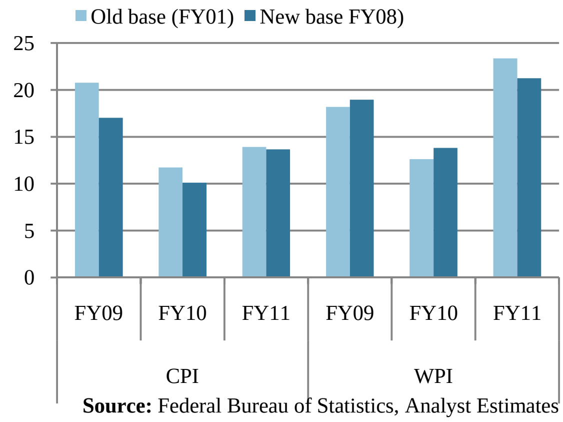
Table 5.5: Changes in the CPI Basket

Commodity Groups in FY01 Basket	Weight	Commodity Groups in FY08 Basket	Weight
Food Beverages & Tobacco	40.3411	Food & Non-Alcoholic Beverages	34.8343
		Alcoholic Beverages & Tobacco	1.4135
		Restaurant & Hotels	1.2286
	40.3411		**37.4764**
Apparel, Textile & Footwear	**6.0977**	Clothing & Footwear	**7.5708**
House Rent	23.4298	Housing	21.81
Fuel & Lighting	7.2912	Water, Electricity, Gas & Other Fuels	7.60
	30.721	Housing &Water, Electricity, Gas & Other Fuels	**29.41**
Household Furniture & Equipment	**3.2862**	Furnishing & Household Maintenance Equipment	**4.2082**
Transport & Communication	7.3222	Transport	7.2023
		Communication	3.2198
	7.3222		**10.4221**
Recreation & Entertainment	**0.8259**	Recreation & Culture	**2.0227**
Education	**3.4548**	Education	**3.9431**
Cleaning, Laundry & Personal Appearance	**5.8788**	Miscellaneous Goods & Services	**2.755**
Medicare	**2.0728**	Health	**2.1868**

Source: Federal Bureau of Statistics

Since inflation in the recent past has been driven to a large extent by food prices, the new measure of CPI demonstrated lower year-on-year inflation compared with old series (**Figure 5.31**).

Figure 5.31 Comparison of YoY Inflation in Old and New Base Data



Source: Federal Bureau of Statistics, Analyst Estimates

Wholesale Price Index (WPI)

For the WPI, the number of items has been increased to 463 from 425; the number of cities covered has been increased to 21 from 18; and the commodity groups have also been reclassified according to the scheme developed by United Nations (**Table 5.6**). As the weights allocated to different groups have also been changed, the overall inflation calculated according to the groups of commodities is different.

Table 5.6: Changes in the WPI Basket

Commodity Groups in FY01 Basket	Weight	Commodity Groups in FY08 Basket	Weight
Food	42.12	Agriculture, Forestry and Fishery Products	25.77
Raw Material	7.99	Food Products, Beverages & Tobacco, Textiles, Apparel & Leather Products	31.11
Fuel, Lighting & Lubricants	19.29	Ores & Minerals, Electricity, Gas & Power	12.04
Manufactures	25.87	Other Transportable Goods except Metal Products, Machinery & Equipment	22.37
Building Material	4.73	Metal Products, Machinery & Equipment	8.71

Source: Federal Bureau of Statistics