

1 Formulation and Effectiveness of Monetary Policy

1.1 Monetary Policy Formulation

After monetary easing in the last two fiscal years that witnessed policy rate going down from 14.0 percent to 9.0 percent, SBP changed its policy stance in September 2013. The change was primarily based on growing inflation concerns and external sector vulnerabilities; although a healthy growth in credit to private sector was recorded after nearly four years of sagging rates. During H1-FY14, SBP increased its policy rate by a cumulative 100 basis points (bps) to 10.0 percent; 50 bps each in September and November 2013.

During H2-FY14, sentiments of the economy improved due to positive developments in headline variables. More specifically, receipt of foreign inflows under Pakistan Development Fund, successful issuance of Eurobonds, inflows from auction of 3G/4G spectrum and loans from multilateral agencies all added to a surplus in the capital and financial accounts. Further, relatively low IMF repayments also eased some of the pressures on SBP reserves in H2-FY14. Since then, SBP has kept the policy rate unchanged as vigilance was required to ensure sustainability and improvement in key economic indicators. Indeed, this policy stance has yielded positive results as in addition to broadly accomplishing the inflation target for FY14, foreign exchange market remained stable.

With the objective of stimulating discussions on contemporary macroeconomic issues, SBP released nine working papers during FY14. Applying various methodologies and econometric techniques, the papers focused on different aspects of Pakistan economy. These include, among others, stability of money demand function, external debt, economic growth, measures of core inflation, interbank liquidity, and transmission mechanism of monetary policy.

1.2 Research

Micro level research continued during the year with the objective to facilitate the management in forward-looking policy decision making. Consumer confidence and inflation expectations surveys were conducted regularly. And its results were used for analysis of economic conditions in the country and monetary policy deliberations. Work on a customized small open economy Dynamic Stochastic General Equilibrium (DSGE) model for Pakistan was initiated and a report on “changing trends in labor markets of Pakistan” completed during the year.

To assess behavior of demand and supply of corporate and SME business loans in Pakistan, a credit assessment survey was launched through selected senior officers of all domestic and foreign banks across the country. This survey is still in progress. And to understand supply and demand dynamics of agriculture credit in Pakistan, SBP initiated an agriculture credit experiment to study agriculture credit trends. During the year, the scope of the survey was expanded in terms of number of farmers and credit size. Preliminary results from the survey were shared with the senior management of the Bank. Detailed report will be shared with all the stakeholders in due course.

In April 2014, the State Bank of Pakistan published a study on Monetary Policy Framework in SAARC region. The study provides a comprehensive analysis of existing monetary policy framework in the SAARC countries. The diversity in the implementation and formulation of monetary policy practices in SAARC countries provides an opportunity to learn from each other's experiences and for increased cooperation in mutually beneficial areas. The study also provides a good starting point in

having an assessment of where SARRC, as a group, stands today and what are the gaps from global best practices that needs to be filled.

During the year under review, SBP organized a seminar on "Risk Management Framework in Banks under the aegis of SAARCFINANCE - the Network of SAARC central bank governors and finance secretaries. The Seminar was aimed at sharing knowledge and experience of SAARC member central banks in the areas of risk management and resolution of specific issues in their respective jurisdictions. The delegates from member countries presented their Country Papers on the subject issue.

1.3 Economic Analysis and Publications

SBP evaluates performance of different sectors of the economy, as well as prevailing economic policies under a broader framework. Economic analysis is disseminated through SBP's flagship publications, i.e., the Annual and Quarterly Reports. During the year, the bank produced and published an Annual Report, and three quarterly reports on state of the economy. These reports were submitted to both Houses of the Parliament as required by SBP Act.

As usual, the reports generated informed debate on economic performance of Pakistan among academia and in the press/media. The Annual Report for FY13, presented in-depth assessment of various sectors of the economy including, real sector, energy, inflation, monetary policy, fiscal operations, public debt, and external sector. Moreover, it also included a number of boxes and special sections focusing on topical issues. SBP's quarterly reports captured the changing trend of macroeconomic indicators and sentiments about the economy during FY14.

SBP produces various other publications that provide macroeconomics and financial stability analysis, in addition to disseminating detailed statistical information on various sectors of the economy. Notable among these publications are "Financial Stability Review" (bi-annual), "Monetary Policy Statement" (every other month), "Inflation Monitor" (monthly), "Islamic Banking Bulletin" (yearly), "Branchless Banking Newsletter" (quarterly) and "Development Finance Review" (annual).

Financial Stability Review (FSR) serves as an important tool for assessment of financial stability and is considered an effective device for a macroprudential policy toolkit. The FSR provides comprehensive coverage of financial sector encompassing analysis of banks, DFIs, insurance sector, Non Banks Financial Institutions, financial markets, payment and settlement systems. It aims at highlighting key risks and vulnerabilities to policy makers, market participants, and the public at large. The recent FSRs for the year 2013 highlighted impact of various issues like energy crises and circular debt on banking balance sheet, increasing exposures of the Government on financial sector and limited credit flow to private sector, high stock of NPLs, frictions in financial markets, solvency issues, developments in Islamic banking and payment system. The stability analysis also indicated the reasons behind improvement in operating performance and solvency of the financial system, while highlighting impediments in effectiveness of intermediation and risks facing the financial system.

Two of SBP's activities are noteworthy from academic research point of view. First is the SBP working paper series, which release quality research articles on SBP website that are internal peer reviewed. Second is the SBP Research Bulletin (annual) which is an academic journal listed in American Journal of Economic Literature. SBP also regularly publishes several statistical publications that include "Statistical Bulletin" (monthly) "Statistics on Scheduled banks in Pakistan" (half yearly), "Banking Statistics of Pakistan" (Annual), "International Investment Position of Pakistan" (annual) and "Financial Statement Analysis of Financial Sector" among others.

1.4 Data Management

At SBP, the business processes of data compilation are mainly automated. The International Transactions Reporting System for online data acquisition of monthly foreign exchange returns from banks through data warehouse underpins the compilation of BOP and other statistics relating to external sector.

The statistics are compiled in line with the international compilation and dissemination standards. IMF's Manual on Balance of Payments and International Investment Position, 6th edition (BPM6), External Debt Statistics Guide of Compilers and Users, Monetary and Financial Statistics Manual 2000 (MFSM) and United Nations Manual of Statistics of International Trade in Services-2010 (MSITS 2010) are broadly followed as guidelines for the compilation of Statistics. State Bank of Pakistan is committed to produce quality statistics with high degree of reliability, timeliness, and follows General Data Dissemination System (GDDS) of the IMF. The Bank also fulfils the requirements of Special Data Dissemination Standard (SDDS) of the IMF.

Box 1.1: Major Steps taken for Improvements in Data Management System

SBP's notable achievements in data compilation, dissemination procedures and adopting international standards include:

- Implementation of IMF's Manual on Balance of Payments and International Investment Position (BPM6) for compilation of Balance of Payments and International Investment Position
- Compilation of quarterly External Debt Statistics broadly in lines with External Debt Statistics Guide for Compilers and Users -2013
- Compilation of international trade in services in line with the Manual of Statistics of International Trade in Services-2010 (MSITS 2010) classification consistent with Extended Balance of Payments Services - EBOPS (classification)
- Compilation of Coordinated Portfolio Investment Survey (CPIS) on semi-annual basis
- Development and dissemination of data archive on SBP web to facilitate users in undertaking statistical and