

1 Formulation and Effectiveness of Monetary Policy

Macroeconomic indicators further improved in FY15 on account of declining inflation and positive outlook for external, real, and fiscal sectors. Given benign inflation environment and outlook, SBP reduced its policy rate by a cumulative 300 bps during FY15 to 7.0 percent. The efforts to rein-in inflation proved to be effective as average headline inflation declined to 4.5 percent in FY15 from 8.6 percent in FY14. With improved macroeconomic indicators and market sentiments, SBP apart from slashing the policy rate in FY15, revised the interest rate corridor framework to strengthen the monetary policy transmission mechanism. While the decline in lending rates is expected to revive private investment going forward, lower deposit rates may discourage deposit growth. To address this issue, SBP responded with a reduction in corridor width by increasing the SBP repo (floor) rate to protect the interest of depositors.

Moreover, uptick in credit for long term investment purposes and stable exchange rate during the period boded well for the effectiveness of monetary policy. The balance of payments position continued to improve in FY15. It is particularly reflected in sustained increase in Pakistan's foreign exchange reserves by US\$ 4.6 billion to US\$ 18.7 billion by June 30, 2015.

1.1 Monetary Policy Statement

Though key macroeconomic indicators were positive even at the start of the FY15, however, adopting a cautious approach, SBP kept the policy rate unchanged in July and September 2014. In November 2014, the policy rate was cut by 50 bps to 9.5 percent due to further improvement in the external sector amid continuing increase in foreign exchange inflows, falling inflation on the back of plummeting global oil prices and fiscal consolidation.

Positive sentiments further strengthened during H2-FY15. Particularly, downward trajectory of inflation and inflation expectations, average annual inflation being significantly below the target, continued soft global commodity prices, upward trajectory of foreign exchange reserves, and containment of fiscal deficit provided grounds for further reduction in the policy rate. In response, a cumulative cut of 250 bps in the policy rate was announced in H2-FY15.

1.2 Implementation of Revised Interest Rate Corridor Framework

SBP had established an 'Interest Rate Corridor (IRC)' in August 2009 with SBP reverse repo rate, the policy rate, as ceiling and SBP repo rate as floor. The main objective of introducing the corridor was to minimize volatility in the money market by ensuring the movement of short term interest rates within a reasonable range.

To bring monetary policy framework further closer to best international practices, strengthen the transmission of monetary policy, and better manage liquidity in the interbank market, SBP revised the IRC framework in May 2015. In the improved IRC framework, a new SBP Target Rate has been introduced between the ceiling and floor of IRC to signal SBP's stance of monetary policy. Purpose of introducing this rate is to target the overnight money market repo rate close to a particular level. This target rate will be the main Policy Rate of SBP. Currently, IRC ceiling and floor has been set at 50 bps above and 150 bps below the policy (target rate). The width of IRC has also been reduced by 50 bps from 250 bps to 200 bps.

1.3 Research

During FY15, the SBP continued to conduct rigorous quantitative and qualitative research on challenging macroeconomic issues on the basis of micro-foundations with applied and theoretical tools. While considering the areas of interest for SBP, some research studies were completed in collaboration with national/foreign universities/organizations both in private and public sector including IBA, Karachi; Bureaus of Punjab and Sindh; Pakistan Bureau of Statistics; Yale University, USA; MIT, USA; London School of Economics, UK. Major research related activities performed during FY15 included the following:

- For clear articulation and implementation of a forward looking, transparent and effective monetary policy framework in SBP, consumer confidence, inflation expectation indices and model based forecast on some of the macroeconomic indicators were prepared and provided to the Advisory Committee on Monetary Policy (ACMP) and the Central Board.
- A study to compare the forecasting performance of a large set of models of inflation has been completed. The performance has been measured at different forecast horizons and for different time periods: when inflation is low, high and moderate. Different forecasting models perform differently during low, high and moderate inflation regimes. Similarly, for monetary policy analysis purpose at monthly frequency, a Vector Autoregression (VAR) model has also been developed.
- The first generation of reduced-form dynamic-stochastic general equilibrium models known as the Forecasting and Policy Analysis System (FPAS) was developed and launched. It is useful for forecasting and scenario analysis for macroeconomic indicators like inflation, exchange rate, and large scale manufacturing production gap on quarterly basis.
- To explore the dynamics of agriculture credit markets in the country, the experimental study initiated last year, moved into its third phase. This phase will help understand the mechanisms that encourage growers to fully settle their loans. The first two phases of the experiment known as the Matiari project showed that how a bank was able to lend to small and medium sized growers using an intermediary. Preliminary results of the previous two phases reveal some interesting facts about agricultural credit dynamics in the country. Detailed report will be shared with all the stakeholders after completion of the third phase.
- To further intensify the debate and exposure on the best practices for extending financing facilities to small farmers the focus and theme of the 20th Zahid Husain Memorial Lecture organized in Islamabad was “Trader Agent Intermediated Lending (TRAIL): A New Approach to Financing Smallholder Agriculture in LDCs”. Mr. Dilip Mookherjee, professor of Boston University, USA, was the guest speaker. The lecture while supporting the findings of Matiari project study opened new vistas for agri-credit market research.
- A Management and Organizational Practices (MOP) Survey was conducted in collaboration with Pakistan Bureau of Statistics (PBS) and the London School of Economics (LSE). It will help understand the inner working of manufacturing sector firms and their management and organizational practices (MOP) in Pakistan and will allow international comparison of MOP and other indicators, which will help improve management practices and production performance. This would also enable banks to have deeper insights of the corporate sector management practices and culture and thus will help them in better appraising the capacity of corporate to utilize credit.
- SBP got the chair of SAARCFINANCE Network during 29th meeting of the Network, held on October 9, 2014 in Washington D.C, U.S.A. and Governor SBP became Chairperson of the Network. As the Secretariat for SAARCFINANCE related activities, SBP organized following seminars and meetings:

- (1) *Consumer Protection in Banks: The SAARC Perspective* was organized on March 19-21, 2015 at Islamabad wherein delegates from member countries participated in the seminar and presented country papers on the subject issue.
- (2) The 21st SAARCFINANCE Coordinators' meeting was held on March 19-21, 2015 at Islamabad. The Governor SBP inaugurated the meeting and appreciated the initiatives taken by regional central banks for the creation of regional database and conducting research studies under the collaborative arrangements which will help in harmonization of banking rules and strengthening economic and financial integration in the region.
- (3) Facilitated Bangladesh Bank in organizing the 30th SAARCFINANCE Group Meeting at Dhaka, Bangladesh on June 12, 2015. The major issues deliberated upon during the meeting included; SAARCFINANCE database-way forward, modalities for collaborative research studies by SAARCFINANCE member countries; proposal for identifying areas of regional cooperation and integration, which would eventually act as the roadmap for SAARCFINANCE; SAARCFINANCE database.

1.4 Economic Analysis / Publications

During FY15, SBP continued its efforts to improve the quality and depth of analysis presented in its flagship publications, i.e., annual and quarterly reports. These reports are submitted to both Houses of the Parliament. The reports published during FY15 highlighted a number of economic issues. For example, while mentioning weaknesses in the compilation of data on the large-scale manufacturing and livestock, SBP argued that most of the vibrancy witnessed in the economy is not adequately reflected in national income accounts data. Similarly, against the commonly held view, SBP pointed out that it is the distribution, not generation, which is more binding constraint in the power sector. In effect, even if generating units are geared up to increase capacity utilization, the country simply does not have the capacity to distribute this power to where it is needed (i.e., from the main-grid to actual users).

In FY15, SBP initiated a new Staff Notes series, which contain articles on current economic and relevant banking issues in Pakistan to initiate debate on these issues among informed general public. The first note evaluated different measures on PKR misalignment and concluded that these measures can be helpful, but cannot be a strict guide to policymakers. While the note acknowledges that an unusually strong US Dollar against Euro and other trading partner currencies in recent months has led to PKR appreciation, the assessment of its impact on Pakistan's exports is vague, as structural bottlenecks appear more important in explaining the slowdown in exports.

1.5 Data Management System

With the objective of strengthening the capacity of DWH and data management system to serve as a strong input for robust and effective policy formulation and supervision, all business processes of data compilation processes at SBP are mostly automated. SBP always endeavors to provide quality and timely statistics to users on regular basis. The statistics compiled and disseminated with different periodicities mainly relate to monetary, financial and external sectors. In the recent past, SBP has brought numerous improvements in data compilation and dissemination by adopting international standards. Some of the achievements include:

- Implementation of the IMF's Manual on Balance of Payments and International Investment Position, 6th Edition (BPM6)
- Compilation of trade in services data as per standard classification as prescribed in Manual of Statistics of International Trade in Services-2010 (MSITS 2010) published by United Nations consistent with the BPM6 services classification recognized as EBOPS-2010 classification

- Adoption of latest classification systems such as Harmonized Coding System (HS) for classification of trade data and International Standard Industrial Classification (ISIC 3.1) for private sector business and now in the process of implementing ISIC 4
- Compilation of International Investment Position (IIP) of Pakistan on quarterly basis to meet international standards
- Compilation of Foreign Direct Investment Statistics according to the concepts of Ultimate Controlling Parent (UCP)
- Compilation of Coordinated Portfolio Investment Survey (CPIS) on semi-annual basis initiated for adoption of international standards
- Compilation of quarterly Gross External Debt Statistics initiated as per External Debt Guide 2013 aligned with BMP6 and Special Data Dissemination Standards (SDDS) requirement of IMF
- Implementation of System of National Accounts 2008 (SNA 2008) for the compilation of Flow of Funds Accounts of Pakistan
- Adoption of the methodology of Manual of Financial & Monetary Statistics 2000 (MFSM 2000) for compilation of monetary statistics
- Improvement in scope, coverage, and timeliness of all important statistics compiled in SBP
- Compilation of Prudential and Structural Islamic Financial Indicators (PSIFIs)
- Compilation of Regional Statistics on advances by place of disbursement and utilization