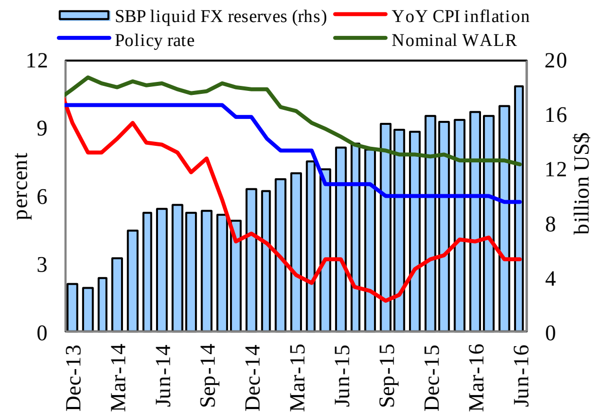
3 Monetary Policy and Inflation

3.1 Overview

The comfort on macroeconomic front – low inflation and overall external surplus – that Pakistan enjoyed in FY15, persisted in FY16. This allowed SBP to continue the staggered monetary easing which it rolled out last year (**Figure 3.1**). Carrying out two separate cuts of 50 and 25 basis points, SBP brought the policy rate down to 5.75 percent, which is the lowest level since early 1970s. The objective behind this easy posture was to reinforce the on-going economic recovery, which is well-poised to move towards a higher growth trajectory. Modest gains have been achieved so far: businesses have reverted to bank borrowing; the import of capital goods has firmed up; and large-scale manufacturers have resumed BMR development.

Figure 3.1: Key Policy Indicators



Source: State Bank of Pakistan

At its core, this much-needed policy space to SBP owed primarily to a downbeat global commodity market. Low oil prices in particular seeped deeply into inflation and inflation expectations in the economy, bringing down the average headline CPI numbers to only 2.9 percent for FY16.[1] This was not even half of the annual target set for the year, and was significantly lower than 4.5 percent inflation recorded in FY15. Importantly, though the deflation in transport group was quite sharp, the disinflation in CPI was diffused across a large number of goods and services (**Section 3.4**). This suggests that there is more to falling inflation in Pakistan than just the commodity prices: better supply of perishables; contained monetary expansion over the past few years; and a stable exchange rate have certainly played their part.

On a similar note, oil prices have been the most important driver of the improvement in Pakistan's balance of payments. The cut in the oil import bill steepened in FY16, as payments fell to only US$ 7.7 billion – just half of what we paid a couple of years ago.[2] The overall external position firmed up also on the back of a modest increase in worker remittances and higher FX borrowings by the government during the year. For the full year, SBP's gross reserves increased by US$ 4.6 billion to reach US$ 18.1 billion at end-June 2016. Not only did this improvement help maintaining calm in the FX market and ensuring PKR stability, this was also pivotal in lowering the risk profile of the economy.

However, the monetary management and policy choices for SBP have not been straightforward. All through the year, variations in the global economy, periodic fiscal measures, and changing business sentiments kept influencing policy anchors. SBP had to fine-tune the policy course accordingly: after the first rate cut in September 2015, the second one came much later in May 2016. For eight months in the middle, during which the Monetary Policy Committee sat thrice, SBP kept the policy rate

[1] As per the inflation expectations survey conducted by IBA and SBP, number of respondents expecting a rise in prices over the next 6 months reduced to 42.28 percent in July 2015, compared with 49.04 percent in the survey conducted in July 2014.
[2] The oil import bill posted a decline of US$ 4.5 billion in FY16, compared to US$ 2.6 billion in FY15. In absolute terms, the oil payments have fallen from US$ 14.8 billion in FY14, to US$ 12.2 billion in FY15 and only US$ 7.7 billion in FY16.

unchanged. This interim policy hiatus basically represented a temporary reversal in crude oil prices and its spill-over on domestic inflation and FX position. The cautious stance was further grounded on an early pick up of private credit; increase in domestic petroleum prices in November 2015; imposition of regulatory duties on many imported items in December 2015; across-the-board increase in customs duties; and sporadic pressures in the FX market. However, after inching up till February 2016, inflation softened again as global oil prices fell sharply in early January, and the government passed on its impact to domestic fuel prices.[3] Though oil prices reversed and kept increasing steadily from mid-January onwards, its impact was not passed on to domestic consumers. The medium-term outlook for inflation and FX also remained benign.[4] This urged SBP to cut the policy rate in May 2016. So effectively, the uncertain outlook of oil prices and pressure on domestic inflation due to administrative measures presented a major challenge – and it still does, as discussed later – that SBP had to deal with in formulating its policy.[5]

Another challenge for monetary management has been the heavy borrowing of the government from commercial banks (**Table 3.1**). Though the overall borrowing volume was less than last year, its impact on banking liquidity was more pronounced in FY16, as the pace of deposit mobilization faltered to a 7-year low. The interbank market would have faced severe liquidity constraints if left on its own; this would have disrupted the impact of the cut in policy rate on the retail cost of private lending. To avoid this, SBP supplemented its monetary policy decisions with timely liquidity interventions in the interbank market. The average outstanding level of OMO (injections) was increased from Rs 413.1 billion in FY15 to an unprecedented Rs 1.3 trillion.[6] The objective was to keep the overnight rate (operating target) close to the policy rate, in order to enhance policy effectiveness and ensure smooth functioning of the money market.[7]

Table 3.1: Details of Monetary Aggregates
Billion rupees

	Abs. change in stocks		Percent growth in stock	
	FY15	**FY16**	**FY15**	**FY16**
M2 (A+B)	1,315.6	1,542.6	13.2	13.7
A. NFA	219.7	193.4	37.0	23.8
B. NDA	1,095.9	1,349.2	11.7	12.9
Government borrowing	933.0	847.1	15.5	12.2
Budgetary borrowing	888.3	787.0	16.3	12.4
SBP	-434.2	-475.0	-18.7	-25.2
Scheduled banks	1,322.6	1,262.0	42.4	28.4
Commodity operations	72.0	58.0	14.6	10.3
Others	-0.1	-2.0	0.6	20.8
Non-government borrowing	303.5	570.7	7.3	12.8
Private sector	223.8	460.6	5.9	11.5
Private businesses	187.7	332.4	6.6	11.0
PSEs and other FIs	79.6	110.1	21.3	24.3
Other items net	-140.6	-68.7	17.5	7.3
OMO impact	679.8	870.7	NA	NA

NA: not applicable
Source: State Bank of Pakistan

The liquidity management has been successful in smoothing the transmission of policy rate to retail rates. Some downward pressure on retail rates also came from cut-throat competition among banks to win over quality projects in more vibrant sectors.[8] Islamic banks, with excess liquidity and limited

[3] Price of Saudi Arabian Light plunged to only US$ 21.3 per barrel by the third week of January 2016, from US$ 33.6 per barrel average price in December 2015.
[4] Although global oil prices (Saudi Arabian Light) increased by 12.0 and 18.1 percent in February and March 2016, the government cut price of petrol in the domestic market by 6.6 and 11.9 percent, respectively.
[5] Administrative measures include tax measures such as change in FEDs, regulatory duty and tax structure on POL products.
[6] In effect, though the government's borrowings from SBP continued to decline for the second consecutive year, its borrowings from scheduled banks remained strong. Carefully timed OMOs were instrumental in meeting various targets set by the IMF during the year, including ceilings on SBP NDA, and net budgetary borrowings from SBP.
[7] Smooth functioning of the money market is gauged from the frequency of commercial banks resorting to SBP's reverse repo facility; this frequency declined in FY16 compared to last year. Though volumes were higher, this was mainly due to end-of-the-quarter unwinding of OMO transactions (to meet the IMF ceiling for SBP NDA).
[8] A major irritant that banks faced was the preference of conglomerates to opt for internal financing – rather than bank borrowing – given their cash rich positions. In fact, large corporations had been deleveraging over the past few years, especially in the cement, FMCG, chemicals, and automobile sectors, to name a few. While the motives to pursue deleveraging may vary at firm level, some common factors which brought this strategy into play were: excess capacities; weak external demand; high interest rates over the past few years; energy constraints; and a low growth macro-environment,

avenues for funds' placement, were particularly eager to take blue-chip assets on their books.[9] Even those conventional banks who were looking to restructure their asset portfolios (by partially switching from investment in government securities to private lending) also contributed to giving more negotiating power to the borrowers. This, along with the cut in policy rate, led to a reduction of weighted average lending rates (WALR) from an average of 10.2 percent in FY15, to only 7.8 percent – the level last seen a decade ago.

The availability of low cost funding has been supportive for businesses. The timing of monetary easing has been the catalyst, with a large number of mega public ventures entering their initiation phase, and the early harvest projects under the CPEC approaching financial closure. Energy projects particularly got quick nods on affordability and viability, because in addition to low interest rates, these also benefited from PKR stability and a benign outlook for commodity prices (including oil, coal, gas, etc.). Mass transit projects were the next; managed under a close public scrutiny, these projects and related private borrowings carry a minimal credit risk. In the meantime, smoother energy supplies resulted in an increase in the capacity utilization of manufacturing firms (e.g., fertilizer); this increased their working capital requirements. In some sectors, firms had to resort to bank borrowing to deal with their cash flow problems (**Section 3.3**).

In effect, the decline in government borrowing from the banking system was more than offset by a higher growth in credit to private sector. This pushed the growth in net domestic assets of banking industry to 12.9 percent during FY16, compared to 11.7 percent in FY15. Meanwhile, the growth in net foreign assets (NFA) of the banking system went through some moderation, as a sharp rise in SBP reserves was partially offset by FX borrowings by commercial banks that turned their NFA to a *negative* Rs 25.4 billion (**Section 3.2**). On aggregate, the broad money supply (M2) showed a slightly higher growth in FY16 compared to the preceding year.

Looking ahead, the mega infrastructure projects and an upbeat energy outlook will continue to remain instrumental in holding the momentum of private lending. SBP will remain watchful in maintaining a fine balance between supporting investment activity and avoiding the build-up of macroeconomic imbalances. As things stand, SBP foresees domestic inflation at a higher level in FY17, but within a moderate range of 4.5 – 5.5 percent. This assessment is based on an expected normalization of fuel inflation; pass-through of additional taxes announced in Budget 2016-17; and the build-up of inflation expectations as hinted in the recent IBA-SBP Consumer Confidence Survey (**Section 3.4**). As for the external sector, short-term risks seem manageable, given the ongoing commodity slump, expected financial flows and an adequate FX cover. That said, the assessment on macro economy, and therefore policy decisions, will be challenged by increased uncertainty in the global economy. A detailed analysis of these challenges is discussed below.

Uncertainty in global oil prices adding risks to the inflation outlook

The continued uncertainty in global oil prices still remains a concern. Ever since the free fall in oil prices that began in July 2014, the stability in the global oil market remains elusive. Throughout FY16, oil prices went up one quarter, down the other, to inch up again in the next. Not only is this roller-coaster trend in oil prices taking a toll on the robustness of inflation forecasts, it has also blurred the external sector outlook. Global oil prices that recovered steadily post mid-February 2016 on the back of market balancing, declined again after the Brexit vote in end June 2016. A cursory look at **Table 3.2** reveals the volatility in oil price forecast. For instance, in its October 2015 forecast, the World Bank had projected oil prices to stay at US$ 51.4 bbl on average for 2016; however, in just

which made firms pessimistic about generating sufficient revenues to cover costs. For details, see Special Section titled "Comparative assessment of corporations in light of credit to private sector" in SBP's Third Quarterly Report for FY16.

[9] Anecdotal evidence suggests that these banks have been competing, particularly in terms of rates, with the conventional banks in gaining the latter's market share and existing portfolio; the WALR of Islamic banks remained roughly 100 bps lower than conventional banks during FY16.

three-month period, it lowered its projections by around US$ 14/bbl, before revising them upward again in April and July 2016.

Deposit mobilization remained weak

Another complication that has emerged for SBP's monetary management is a sharp slowdown in deposit mobilization, in spite of acceleration in the pace of money creation in the economy.[10] Instead of deposits, it seems that public preference has shifted in favor of currency. The year closed with the highest ever annual growth in currency in circulation, with a currency to deposit ratio that is unprecedented since FY03 (**Figure 3.2**).[11]

Effectively what this implies is that, though the pace of money supply growth has increased in the economy, less money is now coming *back* to the banking system. This in turn suggests that more economic transactions now involve out-of-bank settlements. While the continued vibrancy in the informal economy partly explains this trend, we believe that even for the settlement of formal transactions, the general public has now become more inclined towards using hard cash (see **Chapter 4**).

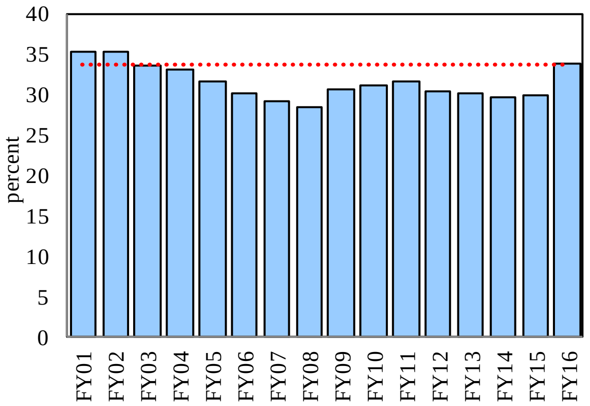
One reason for lower preference for bank deposits is the imposition of withholding tax of 0.4 percent on non-cash banking transactions (cross-cheques, demand drafts, pay orders, etc.) undertaken by the non-filers.[12] The business community has serious apprehensions over this measure and has repeatedly requested for its withdrawal. It is important to recall here that the business sector deposits, which constitute nearly a third of total (non-government) bank deposits, are used primarily to facilitate their voluminous transactions. Therefore, a tax on these transactions over and above usual business levies (like income tax, sales tax, FED, etc.) is surely an added burden. Hence, it is not surprising to see the growth in business sector deposits dropping quite sharply in FY16

Table 3.2: Changes in Oil Price Forecasts
US$/bbl

	World Bank's Forecast*		EIA's Forecast**	
Forecast date	**2016**	**2017**	**2016**	**2017**
Jan-15	56.9	60.8	75.0	NA
Apr-15	57.2	61.1	75.0	NA
Jul-15	61.2	63.7	67.0	NA
Oct-15	51.4	54.6	58.6	NA
Jan-16	37.0	48.0	40.2	50.0
Apr-16	41.0	50.0	34.7	40.6
Jul-16	43.0	53.2	43.7	52.2

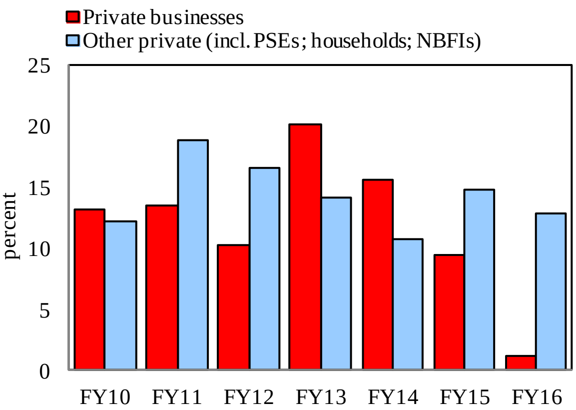
* Forecast of average of Brent Crude, West Texas Intermediate and Dubai Fateh (Source: The World Bank)
** Forecast of Brent Crude (Source: Energy Information Administration, US)

Figure 3.2 Currency to Deposit Ratio (yearly average)



Source: State Bank of Pakistan

Figure 3.3: Annual Deposit Growth (Sector-wise)



Source: State Bank of Pakistan

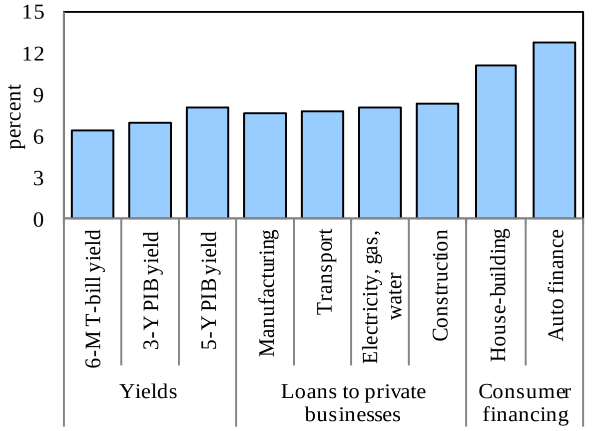
[10] While the growth in demand deposits declined from 13.7 percent in FY15 to 10.8 percent in FY16, time deposits posted *net withdrawals* (4.3 percent) during FY16 compared to 7.0 percent growth last year.
[11] Currency growth in FY16 stood at 30.5 percent. An equivalent or higher growth to this was last seen in FY73 – in the aftermath of Dhaka fall.
[12] In FY16, the government initially imposed a withholding tax of 0.6 percent on all non-cash banking transactions undertaken by non-filers. The rate was later lowered to 0.4 percent, through SRO 169(I) 2016, dated 29th February 2016.

compared to other deposit holders (like households, PSE, and NBFIs) (**Figure 3.3**).[13] This decline in deposit growth does not bode well, especially at a time when the demand for bank loans is quite high from both the public and private sectors. In a larger scheme of things, this could further offset SBP's measures to deepen the penetration of financial industry.

Monetary conditions, post IMF

It appears that banks' appetite for government papers has plateaued, especially if the prevailing (low) yields persist. Banks would instead be tempted to spare funds for private lending, especially high-return assets, in order to protect their bottom lines from falling (**Figure 3.4**). Anecdotes point at their aggressive marketing campaigns for consumer financing products, especially automobile finance and mortgages. Furthermore, most projects in transport, construction, and energy are in tandem with public infrastructure; in terms of credit worthiness, these are as safe as government papers. Meanwhile, the credit risk has been contained as reflected in falling infection ratio – measured as gross NPLs as percent of gross advances (**Figure 3.5**).

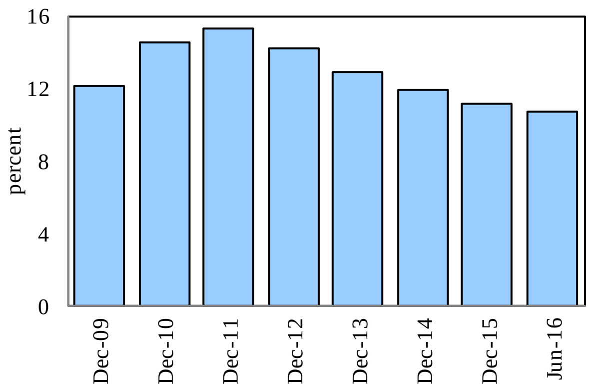
Figure 3.4: Returns on Competing Assets (June 2016)



Source: State Bank of Pakistan

In these circumstances, the government will likely be resorting to SBP funding. This represents a convenient arrangement for the government to avoid increase in borrowing cost, especially after the completion of IMF program that had placed ceilings/limits on these borrowings. Already, up till the 3rd week of October FY17, the government borrowing from SBP has increased to Rs 683.1 billion (cash basis), compared to net retirements during the same period last year. At the same time, however, the level of SBP OMO injections has gone down, leading to a contained reserve money growth.

Figure 3.5: Non-performing Loans of Commercial Banks as Percent of Advances



Source: State Bank of Pakistan

While commercial banks have significant volume of funds placed in long-term papers, the weak growth in deposit mobilization might hold their lending activity back. The role of SBP will remain crucial in ensuring an uninterrupted transmission process of monetary policy.

3.2 Developments in monetary aggregates

In overall terms, the broad money supply (M2) showed a slightly higher growth of 13.7 percent during FY16 as compared to 13.2 percent in FY15. Both components of M2, i.e. NDA and NFA,

[13] It is important to mention here that the growth in businesses' deposits has been on declining trend from FY13 onwards. However, this must be seen in the context of overall growth in money supply in the system. During FY13 and FY14, SBP had pursued a tight monetary stance due to pressures emanating from external sector as well as inflation expectations. In FY15, M2 growth had inched up slightly to reach 13.2 percent, and corporate deposits grew by 9.4 percent. In FY16, the situation aggravated further as against a 13.7 percent growth in the overall M2, corporate deposits grew by only 1.2 percent.

expanded during the period **(Table 3.1**).

3.2.1 Net foreign assets (NFA)

Surpluses recorded in the external account continued the build-up of net foreign assets of the banking system (**Table 3.3**). However, the pace of increase in NFA slowed down in FY16. As a result of this, the outstanding stock of NFA of scheduled banks has declined to negative (Rs 25.4 billion) – for the first time since May 2000 (**Figure 3.6**). However, unlike 2000, this situation does not represent FX strain in the banking industry.

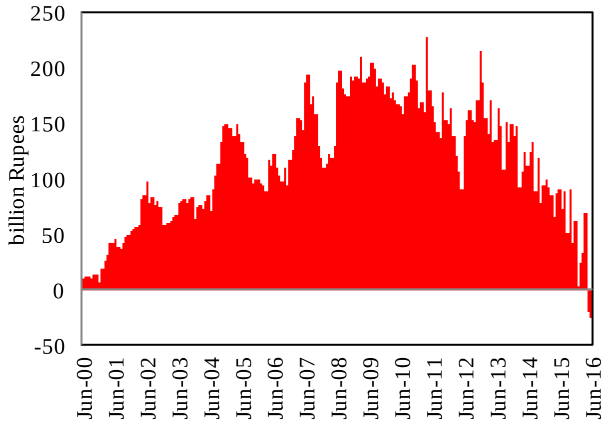
In contrast, the expansion in the NFA of SBP continued in FY16 and at much higher pace than last year. This expansion represents higher official inflows during the year, including tranches from the World Bank and ADB, and also mobilization of FX funding via bond issuances (**Chapter 6**).

Table 3.3: Net Foreign Assets
Billion rupees

	Stocks			Flows	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
Banking system	593.0	812.7	1006.2	219.7	193.4
SBP	481.7	722.4	1031.6	240.7	309.2
Scheduled banks	111.4	90.3	-25.4	-21.0	-115.8

Source: State Bank of Pakistan

Figure 3.6: Stock of Net Foreign Assets of Scheduled Banks



Source: State Bank of Pakistan

3.2.2 Net domestic assets (NDA)

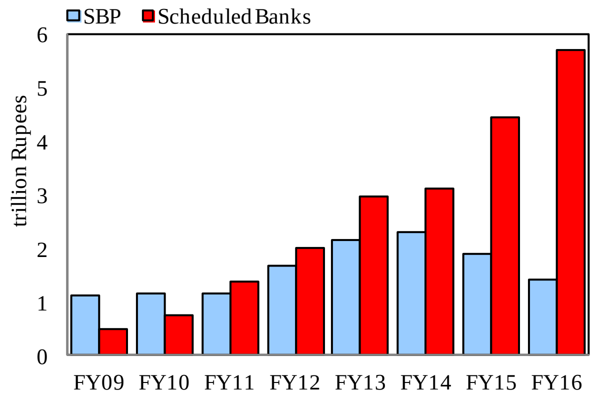
Net domestic assets of the banking system showed a higher growth in FY16 compared to the preceding year (**Table 3.1**). The higher expansion in NDA is entirely due to an increase in private credit off take, which more than offset the impact of lower budgetary borrowings from the banking system.

Government borrowings for budgetary support

Budgetary borrowings from the banking system rose by Rs 787.0 billion in FY16, against Rs 888.3 billion in FY15. The lower flow in FY16 mainly reflects a shift in composition of budgetary finance: the government borrowed *more* from external resources during the year, which included project loans from IFIs, bond issuances, as well as borrowings from foreign commercial banks.

Within the domestic banking system, the government continued its previous year's practice of retiring central bank debt via borrowings from scheduled banks (**Figure 3.7**). The government retired SBP debt in all the four quarters of the year, meeting the quarterly target as prescribed under the SBP Act. Having said that, the borrowing of the government from scheduled banks remained strong: huge volume of liquidity was supplied to the interbank market, which commercial banks used for onward lending to government and private sectors.

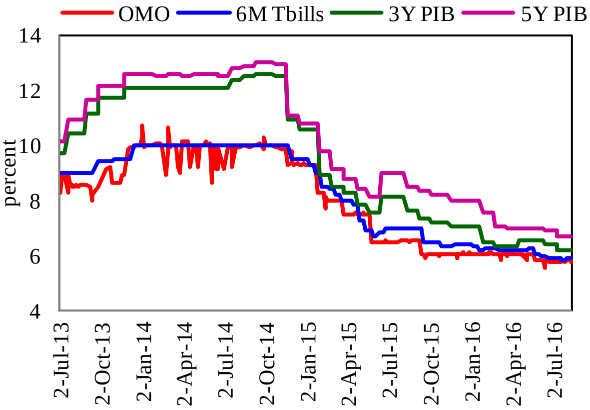
Figure 3.7: Outstanding Budgetary Borrowing from the Banking System



Source: State Bank of Pakistan

On aggregate, commercial banks lent Rs 1.3 trillion to the government during FY16. Similar to previous year, the bulk of this lending was against long-term securities, especially the PIBs. However, given the stark difference in money market conditions in the two years, the persistence of this trend was surprising. Firstly, the spread between the cut-off rate of OMOs and PIBs narrowed considerably in FY16, which should have lowered the incentive for banks to channelize SBP liquidity into PIB investments (**Figure 3.8**). Secondly, the term premium between 6-month T-bill rate and the PIB rate for 3 and 5 years in FY16 was significantly lower than FY15. And finally, businesses' demand for bank loans was much stronger; in fact, the net increase in private credit off take was more than double in FY16 compared to last year. It appears that despite these factors, banks' appetite for PIBs remained strong because they wanted to lock in funds in longer tenors (to materialize capital gains) anticipating further cut in interest rates. Easy funding available from SBP also probably played its part in keeping the yields low.[14]

Figure 3.8: Spread Between Cut-off Rates of OMOs, T-bills and PIBs



Source: State Bank of Pakistan

Table 3.4: Government Papers' Auction Profile
Billion rupees

	Target	Maturity*	Total		Net of maturity			Offered/ Target	Accepted/ Offered
			Offered	Accepted**	Target	Offered	Accepted		
Market treasury bills									
FY15	3,745	3,305	6,623	3,710	440	3,318	405	1.77	0.56
FY16	5,100	4,470	8,975	4,909	630	4,505	439	1.76	0.55
Pakistan investment bonds									
FY15	750	80	2,166	1,006	670	2086	926	2.89	0.46
FY16	775	197	2,560	964	578	2363	767	3.30	0.38
Ijara sukuk									
FY15	-	-	-	-	-	-	-	-	-
FY16	280	277	717	314	3	441	38	2.56	0.44

* Maturity excludes PIB coupon payments and includes the series of Ijara sukuk matured in November 2015.
** Acceptance includes non-competitive bids as well.
Source: State Bank of Pakistan

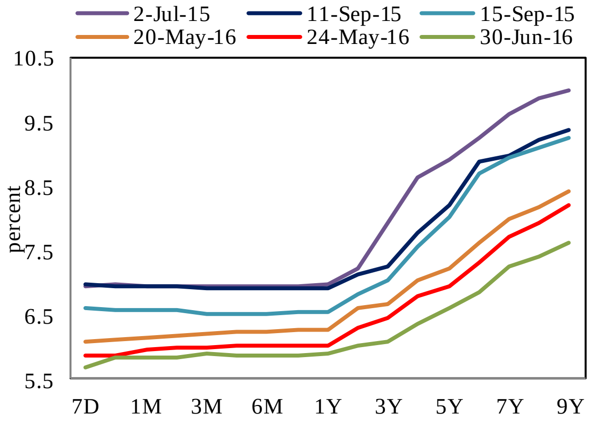
Within PIBs, banks placed most funds in 3 and 5 year tenors.[15] The high demand for PIBs led to a sharp reduction of up to 200 basis points in their weighted average cut off yields – much higher than the 75 basis points reduction in the policy rate.[16] Banks were quite aggressive in placing offers for these instruments – as seen by a higher offered-to-target ratio in PIB auctions – which induced the government to mobilize funds in excess of targets (**Table 3.4**).

As for the T-bills, commercial banks' appetite remained lower than the long-term instruments.[17] Though in absolute terms, commercial banks offered more funds than the targets set by the government in T-bill auctions, the offered-to-target ratios for these instruments was much less than

[14] The impact of low yields on banks' profitability has been discussed in SBP's Quarterly Performance Review of the banking industry Apr-Jun 2016.
[15] The share of 3 and 5 year PIBs in total PIB investment during FY16 was 92.6 percent.
[16] For 3 and 5 year PIBs, the WA cut off was reduced by 160 bps and 200 bps during FY16, respectively.
[17] The outstanding stock of T-bill holding of commercial banks increased by Rs 501.7 billion in FY16, compared to Rs 613.6 billion in the previous year.

what was observed in the auctions of PIBs and Ijara.[18] The supply side was not forthcoming either. The government had sufficient low-cost funding available in the longer tenor, which corresponded well with its objective of lengthening the maturity profile of public debt and reducing its average cost; therefore, it borrowed much less via T-bills than the amounts targeted and offered. Within T-bills, the pattern of government borrowing in different tenors (3-month, 6-month and 12-month) was quite balanced.

Figure 3.9: Secondary Market Yields



Source: State Bank of Pakistan

The decline in policy rate together with auction rates led to a downward movement of the yield curve (**Figure 3.9**). Despite its downward shift, the nature of the yield curve remained the same: flat over the short-term horizon, and upward sloping over the medium and long-term horizon (indicating that the market was expecting a higher term-premium on tenors only above one year). Moreover, the slope of the yield curve declined during the year: the fall in yields on instruments maturing after one year was steeper than for those maturing within one year. This was due to both a sharper fall in auction rates of PIBs than T-bills, as well as a disproportionate rise in PIB demand from commercial banks.

Table 3.5: Changes in Stock of Commodity Loans

Billion rupees

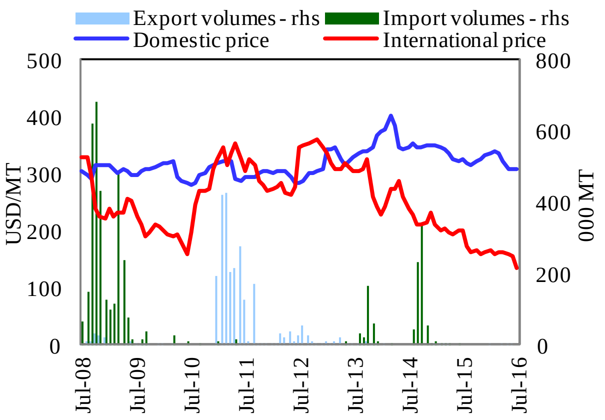
	FY15	FY16
Wheat	94.4	49.6
Sugar	1.0	0.6
Urea	-26.1	21.6
Rice	0.1	0.0
Cotton	2.6	0.3
Total	72.0	72.1

Source: State Bank of Pakistan

3.2.3 Commodity operations

The outstanding stock of loans for commodity operations increased in FY16 by roughly the same amount as last year (**Table 3.5**). However, within the commodity loan profile, a shift emerged in composition: while the increase in these loans was explained entirely by wheat in FY15, the activity in fertilizer sector (urea) also contributed to commodity borrowings in FY16.

Figure 3.10: Wheat Price Differential and Pakistan's Trade



Source: Pakistan Bureau of Statistics and Haver

Despite a higher production this year, procurement agencies borrowed only about half the amount for the purchase of wheat compared to last year.[19] This was because procurement agencies were not able to offload the stocks they had piled from the previous season. It is important to recall here that these agencies were not able to sell their stocks last year either, as private imports had created a glut-like situation in the domestic market.[20] Similar situation persisted in FY16 (**Figure 3.10**).

[18] The offer to target ratio remained at 1.8, much less than 3.3 and 2.6 for PIBs and Ijara respectively.

[19] Procurement agencies procured 6.23 million MT of wheat during the current season, compared to the target of 7.05 million MT.

[20] High price differential between the domestic and international wheat had led the private sector to import the commodity in FY15. Only in October 2014, there was an import of 354.4 thousand MT of wheat in the country. The government first

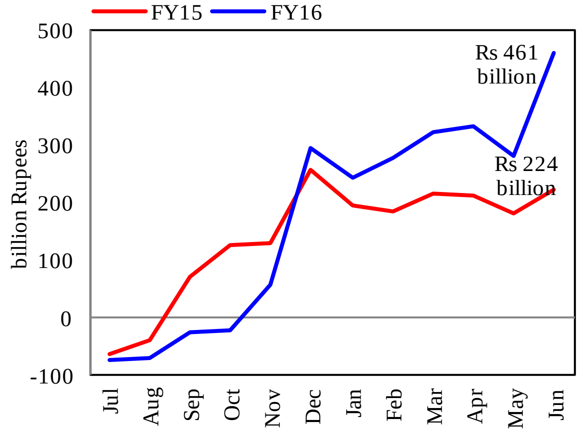
In order to facilitate procurement agencies in offloading their stocks, Economic Coordination Committee along with the governments of Punjab and Sindh, had announced a program from January 2015 onwards to provide a rebate of US$ 90/MT for wheat export.[21] However, the difference between domestic and international prices of about US$ 140/MT during that period was too large to make the policy effective.[22] In July 2016, the government further increased the subsidy amount by US$ 30/MT (reaching US$ 120/MT);[23] however, by this time, the price differential had already risen to US$ 175/MT between domestic and international markets. Therefore, it will not be surprising if the stocks placed with procurement agencies remain unsold in coming months.

A more wholesome alternative arrangement is to sell subsidized wheat in *domestic* market, i.e., to local flour mills, confectionaries, and manufacturers of value-added products (pastas, cereals, infant food, etc.). This will serve a major objective of promoting value-addition in the country. The FMCG sector can benefit heavily from low-cost wheat supplies, as in addition to meeting domestic demand, this sector can also penetrate in the value-added export market.

3.3 Credit to private sector

Government initiatives, including public development spending and CPEC-related projects, provided a boost to activity in the private sector during FY16 (**Figure 3.11**). For instance, for a public mass transit project (like Orange Line Metro Train and the Green Line Bus Rapid Transit system), the task of building terminals and other related infrastructure is delegated to private contractors. This also boosts sale of cement, steel and other building material in the country. In some cases, import of buses (and other vehicles) is carried out by private traders.[24]

Figure 3.11: Credit to Private Sector (cumulative flows)



Source: State Bank of Pakistan

In addition, better energy supplies (LNG imports; increase in power generation) led to a higher capacity utilization in the domestic manufacturing sector. Furthermore, mortgage and automobile financing also picked up as banks sought alternative avenues to strengthen their earnings. Hence, private credit off-take was twice as high as the previous year by end-June.[25] Furthermore, most of the lending was long-term (fixed investment), for the financing of mega projects in energy, construction and transport sectors – which typically have a longer gestation period (**Table 3.6**).

imposed 20 percent RD in November 2014 to curb these imports, and later in January 2015, it banned the wheat imports altogether.

[21] Federal government had announced subsidy of US$ 55/MT for Punjab and US$ 45/MT for Sindh. In addition to this subsidy, provincial governments offered additional support to exporters (US$ 35/MT in Punjab, and US$ 45/MT in Sindh).

[22] As a result, the stock of wheat with procurement agencies increased further by 0.8 million MT to 9.8 million MT in FY16.

[23] To be shared equally by federal and provincial governments.

[24] At this point, it is worth nothing that high net credit off-take during FY16 was largely concentrated in sectors where the activity was propped up, either directly or indirectly, by the government's activities, such as the power generation, road construction, and transport sectors (direct support emanated in the form of government securities, for example, against road financing, or guaranteed payments, such as those offered to IPPs). Thus, a case could be made that lower interest rates alone may not have had as emphatic an impact on credit growth, had the fiscal thrust been missing.

[25] Improvement in asset quality, reflected in the decline in infection ratio (for all banks collectively) from 13 percent in CY13 to 11.4 percent in CY15, also represented a decline in credit risk, which tends to whet the lending appetite of banks

Table 3.6: Loans to Private Sector Businesses
Billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Total loans to private businesses	187.7	332.4	24.7	121.4	128.1	171.7	34.9	39.3
Of which								
1) Manufacturing	68.4	210.9	-29.7	132.4	85.0	31.0	13.1	47.5
i) Textiles	-8.4	62.7	-19.6	33.7	16.6	13.1	-5.5	15.9
Spinning, weaving, and finishing	-8.1	44.1	-15.1	29.7	10.5	7.5	-3.6	6.9
ii) Chemicals	17.9	60.7	-1.3	47.3	19	7.5	0.2	5.8
Fertilizer	12.2	51.7	-2.4	42.2	12.4	9.0	2.2	0.5
iii) Food products & beverages	15.3	46.7	-5.5	26.6	9.2	10.9	11.6	9.2
Rice processing	-0.4	13.7	-2.0	11.0	0.0	-0.5	1.6	3.2
Edible oil and ghee	2.5	13.1	1.6	7.3	-3.0	0.6	3.9	5.1
Sugar	5.2	8.6	-10.1	6.1	11.5	5.7	3.8	-3.2
iv) Basic and fabricated metal	4.5	12.5	-3.0	10.3	3.1	-0.4	4.4	2.6
v) Rubber, plastics and paper	3.0	8.1	-1.5	4.3	1.6	4.6	2.9	-0.8
vi) Electrical equipment	-3.5	5.1	-3.1	-5.1	-1.1	5.0	0.7	5.1
2) Electricity, gas & water supply	-11.4	45.6	-1.0	13.5	-10.7	38.7	0.3	-6.7
3) Transport, storage & communications	29.5	35.6	12.5	1.2	16.7	34.9	0.3	-0.5
Road transport	12.7	18.5	-0.1	0.4	12.9	18.2	0.0	-0.1
4) Construction	13.6	31.6	0.0	1.2	12.0	31.2	1.6	-0.8
Road infrastructure	9.3	25.0	-0.3	2.3	9.6	21.8	0.0	0.9
5) Agriculture	32.7	7.7	22.3	-0.8	10.9	8.4	-0.5	0.2

Source: State Bank of Pakistan

Monetary policy complemented public projects

While public spending boosted aggregate demand, SBP's accommodative monetary policy brought about a further reduction in retail lending rates and laid the foundation for availability of cheap credit for the private sector. This occurred in the backdrop of strategic regional partnerships (with China), long-term deals for procurement of energy resources (Qatar), and setup of new facilities (for LNG, solar, hydel and coal-based thermal power generation). Collectively, these factors fuelled credit demand for infrastructure development of related supply chains, such as specialized terminals, transport infrastructure and resource handling facilities. A complementary stimulus was provided by CPEC-related activities to enhance the road network along the intended corridor. Interestingly, even conservative banks could not resist the lure of extending loans for road development; the expected volume of traffic handled by the proposed highways and arteries, and projected revenues from toll collections, made financing decisions fairly straightforward.

Improved energy management led to greater capacity utilization and expansion

Energy shortfalls (and associated losses) have been a major reason behind under-utilization of capacities in energy intensive sectors like fertilizers, steel and paper over the past few years. Therefore, as energy supplies improved, firms in these sectors were able to scale up their capacity utilization. For instance, fertilizer and paper manufacturers benefited heavily from LNG imports, whereas metal manufacturers were able to increase production due to smoother power supplies.[26] Naturally, working capital requirements of these firms remained strong. Anecdotal evidence suggests that not only are some firms undertaking BMR activity, but a few sick units – which had temporarily ceased operations – came back online during FY16; some prior defaulters also registered comebacks, clearing away their outstanding dues and applying for fresh loans from commercial banks.

Spinning sector facing liquidity shortages

The bulk of working capital loans was diverted to textiles. Within textiles, though spinning sector is usually the largest recipient of bank credit, this time its heavy off-take looks a little surprising: yarn

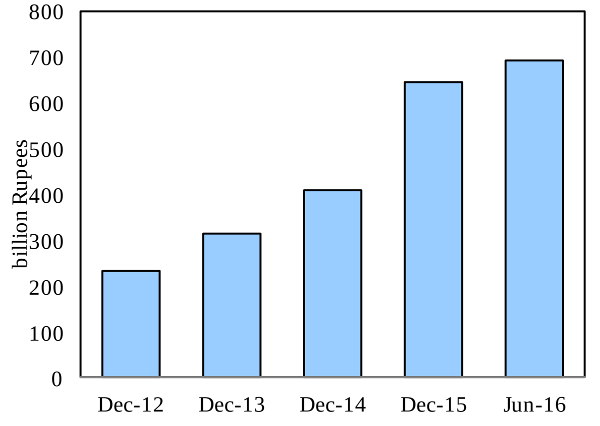
[26] Production of fertilizer remained 14.7 percent higher than last year; and billets production by 18.3 percent. As for paper, production rebounded quite strongly in the second half of FY16, growing by 21.8 percent YoY.

production has inched up only slightly during the year, whereas its export quantum has fallen by 30.2 percent. It appears that higher funding requirements represent more of the sector's liquidity constraints than the real activity.

Islamic financing made further inroads

Growth in financing by Islamic Banking Institutions (IBIs) outpaced the growth in financing by conventional banks during FY16, with the greater portion composed of fixed investment loans (**Figure 3.12**).[27] In terms of the preferred mode of financing, Diminishing Musharaka and Murabaha collectively accounted for about 56 percent of overall IBI financing as of June 2016.[28]

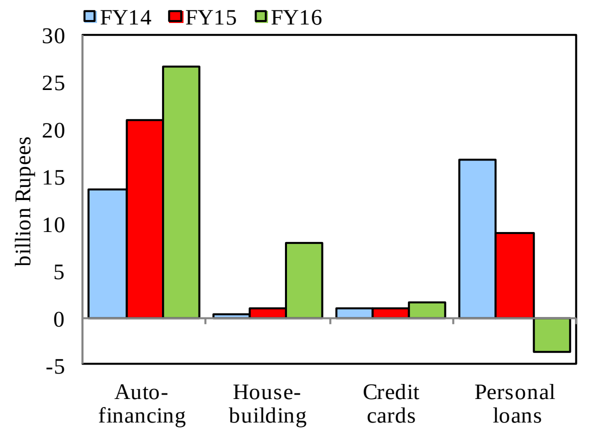
Figure 3.12: Outstanding Loans of Islamic Banking Institutions



Source: State Bank of Pakistan

SBP has taken several measures during the last couple of years to expand the debt and money market for IBIs. For instance, SBP introduced the open market operations for IBIs (Bai-muajjal of sukuk); reduced minimum capital requirement for Islamic windows of conventional banks;[29] and launched more instruments to create depth in the Islamic debt market.[30] Moreover, SBP's guidelines for Islamic financing with regard to agriculture, microfinance and SME sectors provide a framework for innovation by IBIs in tapping underserved segments.[31]

Figure 3.13: Changes in the Stock of Consumer Financing



Source: State Bank of Pakistan

Consumer financing is picking up

Auto-financing and house-building loans were the mainstay of the consumer financing segment during FY16 (**Figure 3.13**). It appears that commercial banks are particularly marketing these collateralized products instead of clean lending products like credit cards and personal loans (**Figure 3.14).**

Meanwhile, IBIs consolidated their presence in housing finance, accounting for a greater share of the niche segment compared to conventional banks. IBIs accounted for nearly 54.2 percent of the

[27] By contrast, net lending by conventional banks grew by only 3 percent in the comparable period – albeit from a much larger base; the outstanding balance for conventional banks was Rs 4.2 trillion as of December 2015. Meanwhile, fixed investment lending by top-3 Islamic Banks posted an increase of Rs 34.1 billion (out of total increase of Rs 64.8 billion) during FY16.

[28] The share of Diminishing Musharaka is 35.8 percent while that of Murabaha is 20.1 percent.

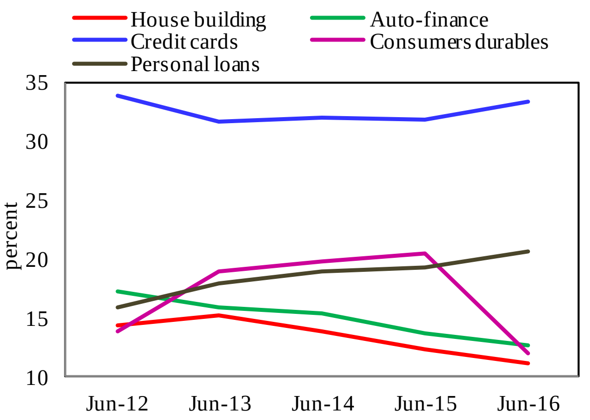
[29] Through BPRD Circular No. 10 dated 17th October 2014, SBP revised the MCR for Islamic banking subsidiary from Rs 10 billion to Rs 6 billion. However, the intending Islamic banking subsidiary shall be required to raise its paid-up capital (net of losses) up to Rs 10 billion within a period of 5 years from the date of commencement of its operations.

[30] During FY16, the government was able to successfully raise liquidity through Ijara Sukuk in three different auctions. Of the total target of Rs 280 billion in FY16, scheduled banks showed high interest by offering Rs 717.4 billion.

[31] Having said that, there is still room to explore untapped segments further, given that the bias for corporate lending prevalent among conventional banks is mirrored among IBIs as well. In fact the top three sectors to receive loans from IBIs and conventional banks are virtually the same – namely textiles, consumers, and firms involved in production and transmission of energy.

outstanding stock of housing finance extended by commercial banks, with conventional banks accounting for the remaining 45.8 percent, as of March 2016.

Figure 3.14: WALRs for Consumer Financing

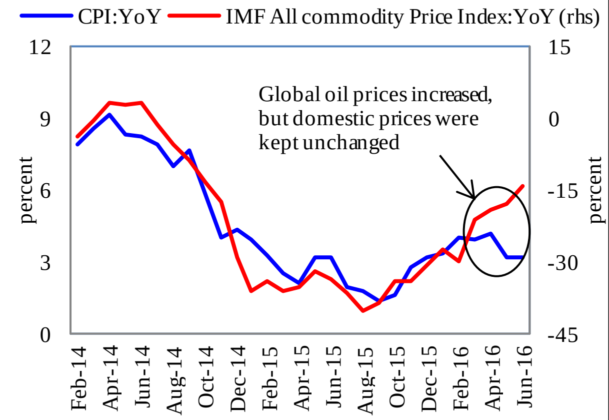


Source: State Bank of Pakistan

3.4 Inflation

CPI inflation hit a 47-year low in FY16 to reach only 2.9 percent, significantly lower than the target of 6.0 percent set at the beginning of FY16.[32] This decline in inflation is attributed to a smooth and timely pass-through of global commodity deflation on domestic prices (**Figure 3.15**);[33] better supply of perishable items;[34] a stable exchange rate;[35] and contained monetary expansion by SBP. That said, global prices, especially of oil, had a dominant contribution in lowering inflation: not only did this help reduce inflation expectations in the economy, it also induced cost-driven disinflation across non-oil items.

Figure 3.15: Commodity Prices and Inflation in Pakistan



Source: Pakistan Bureau of Statistics and IMF

The impact of decline in global commodity prices was more pronounced in wholesale price index (WPI), which has shown on average a deflation of 1.1 percent during FY16. However, the negative inflation in WPI was visible only in the first half of the year; the second half actually showed positive YoY *inflation*.

Stepping back, the decline in CPI inflation was fairly broad-based and was visible across various sub-heads, including food, non-food, core inflation and major sub-indices (**Table 3.7**).

Within food, prices of certain items posted a significant increase over last year: a pickup in international prices pushed domestic tea prices up; short supplies led to a higher inflation in onion and key pulses; and an increase in FED during the year was passed on to cigarette prices. However, their

[32] It was back in FY69, that the headline inflation came down to only 1.6 percent.
[33] IMF commodity price index fell 30 percent during July 2015 to June 2016, compared to 23.6 percent during July 2014 to June 2015. Within commodities, food price index declined 9.2 percent, metal price index 23.1 percent and crude oil price index 41.4 percent during July 2015 to June 2016.
[34] In overall terms, perishable items recorded deflation of 3.3 percent in FY16, compared to 2.4 percent increase last year (carrying a weight of 4.99 percent in CPI, this group includes fresh fruits, fresh vegetables, potatoes, onions and tomatoes). Price of potatoes normalized during FY16, after an extraordinary increase in FY14 on account of low domestic production and availability of costly Chinese and Indian potatoes in the market. On the contrary, tomato prices remained lower than last year due to improved supplies on the back of high domestic production as well as increased imports from India and Afghanistan (source: Pakistan Bureau of Statistics). Besides supplies, low oil prices have also contributed in deflation in perishable items via reduction in transportation cost.
[35] On average, nominal exchange rate was Rs 101.5 per US dollar in FY15 and Rs 104.4 per US dollar in FY16.

impact was offset by a sharp fall in prices of heavyweight items like wheat, rice and edible oil to a large extent (**Figure 3.16**).[36]

Energy prices continued to slide in FY16 as well, registering a decline of 0.8 percent after 1.4 percent decline in FY15.[37] Although the government increased electricity and gas tariffs by 3.3 percent and 8.3 percent respectively in FY16, the fall in price of petrol and high speed diesel more than offset the impact of this increase.[38]

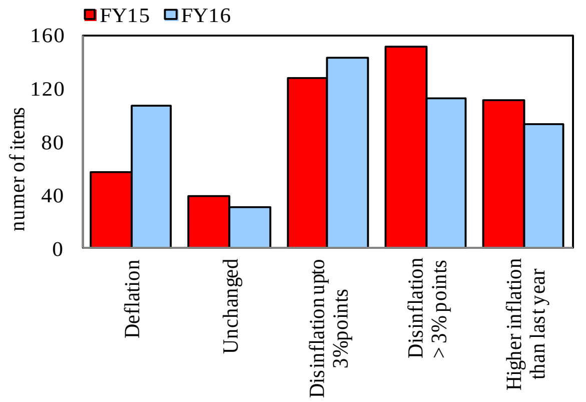
The inflation in non-food-non energy group clocked in at 4.2 percent in FY16, contributing over 72 percent of the headline inflation during the year. The disinflation in this category represents both the second-round impact of low oil prices, as well as contained monetary expansion over the past few years. It is important to recall here that the NFNE group is a relatively stable component of the headline CPI, and typically contributes less in determining the short-term inflation *path* (**Figure 3.17**). This phenomenon is primarily explained by the composition of NFNE: the bulk of this group (69 percent) is comprised of services items like house rent, education, transport services (fares), health, tailoring, etc. Since inflation in services items usually exhibits downward rigidity – due to a larger in-built wage component – this group posts a higher inflation compared to food and the headline CPI, especially when the inflation is on a downward trajectory (**Figure 3.18**).

Table 3.7: Group-wise CPI Inflation
percent

	Average inflation		Contribution in inflation	
	FY15	**FY16**	**FY15**	**FY16**
Overall CPI	**4.5**	**2.9**	**4.5**	**2.9**
i. Food & non-alcoholic beverages	2.6	1.0	1.0	0.4
ii. Alcoholic beverages & tobacco	20.8	22.0	0.3	0.4
iii. Clothing & footwear	8.0	4.8	0.6	0.4
iv. Housing group	6.3	5.1	1.6	1.3
v. Furnishing	6.5	4.2	0.3	0.2
vi. Health	5.4	3.7	0.1	0.1
vii. Transport	-4.1	-6.9	-0.3	-0.5
viii. Communication	0.3	0.4	0.0	0.0
ix. Recreation & culture	3.5	2.1	0.1	0.0
x. Education	13.8	8.5	0.5	0.3
xi. Restaurant & hotels	7.0	5.0	0.1	0.1
xii. Miscellaneous	5.2	3.2	0.2	0.1
Food (wt: 37.48) (i+ii+xi)	3.5	2.1	1.5	0.9
Energy* (wt: 9.01)	-1.4	-0.8	-0.1	-0.1
NFNE (wt: 53.51)	6.5	4.2	3.2	2.1

Source: Pakistan Bureau of Statistics; * SBP calculations

Figure 3.16: Distribution of 487 items of CPI by Size of Change



Source: Pakistan Bureau of Statistics and State Bank of Pakistan's calculations

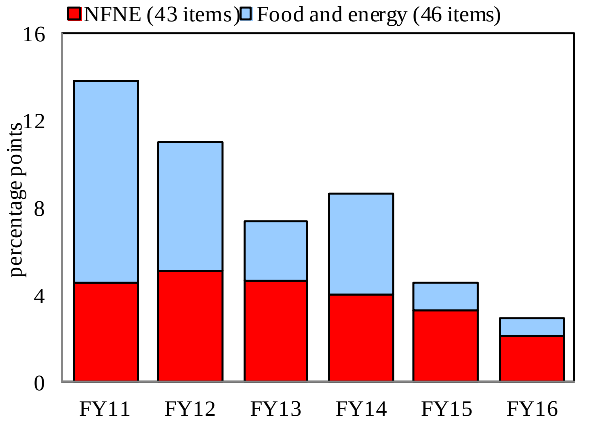
Similar to FY15, NFNE inflation remained higher than the headline CPI in FY16 as well. Price indices of education and tailoring recorded prominent increases of over 8 percent during the year. Moreover, house rent, which constitutes 40.7 percent of this group, recorded inflation of 5.6 percent. Some of its impact was offset by deflation recorded in transport services. Nonetheless, if transport services had declined more in line with fuel prices, the overall NFNE inflation could have been less. But these prices showed some stickiness, due to reasons mentioned above; specifically, the overall motor fuel index posted a deflation of 13.2 percent during FY16, but the transport services index declined by only 5.4 percent. While train fares remained unchanged during FY16, air fares posted an

[36] Wheat, rice, cooking oil and vegetable ghee have a combined weight of 5.76 percent in CPI basket. Specifically, the price of wheat and flour decreased due to sufficient stocks and depressed global commodity prices. Wheat and wheat flour recorded deflation of 2.6 and 2.2 percent respectively in FY16, compared to fall of 5.5 and 2.5 percent in last fiscal year.
[37] Energy-CPI is calculated by State Bank of Pakistan, and includes electricity, gas, kerosene oil and motor fuel.
[38] The price of petrol fell gradually to Rs 64.2/liter in June 2016, from Rs 77.8/liter in June 2015. Likewise, the price of high speed diesel fell from Rs 87.1/liter in June 2015 to Rs 72.5/liter in June 2016. On the other hand, the average price of CNG marginally fell to Rs 70.2/kg in FY16, from a much stable price of 73.0/kg in FY15. Moreover, between October 2014 and June 2016, the prices of petrol and high speed diesel have fallen by 38 and 32.5 percent, respectively in Pakistan.

increase of 2.3 percent YoY. Together, these partially offset the impact of the relief that the bus owners provided to their customers during the year.[39]

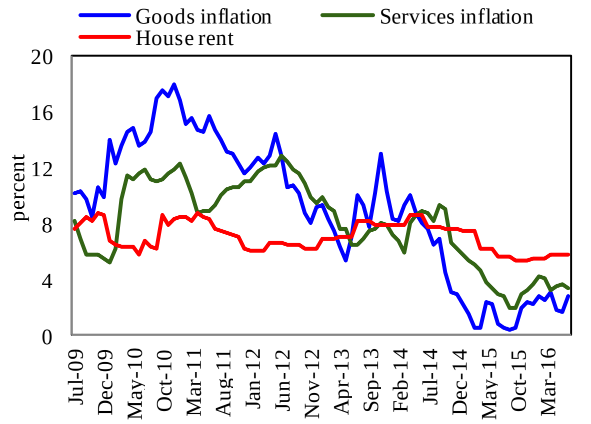
Besides services, price trends in a couple of other items within NFNE have been noteworthy: pharmaceuticals and cars. After staying flat over the past many years, prices of a few commonly-used medicines (like Panadol, Disprin and Ventolin) recorded an abrupt increase during FY16. It turned out that some key pharmaceutical firms revised the prices of their products upward, without a formal approval from the Drug Regulatory Authority of Pakistan (DRAP).[40] This increase primarily represented a lagged pass through of a rise in input cost (including PKR depreciation), as well as an attempt to bring domestic prices in line with the regional peers. Later, in July 2016, DRAP formalized this price increase along with many other medicines, using FY16 inflation as a benchmark.[41]

Figure 3.17: Composition of CPI Inflation



Source: Pakistan Bureau of Statistics

Figure 3.18: Services, Goods and House Rent Inflation



Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Similarly, car assemblers increased the prices of various models in January 2016 by up to Rs 117,880. This increase was mainly due to imposition of regulatory duty and increase in customs duty on CKD and parts of cars (among other imported items) by one percentage point in November 2015. In addition to this, one assembler increased the price of its brand, as it added new features to the existing model.[42]

Inflation outlook

Based on macroeconomic fundamentals and global commodity outlook, SBP expects inflation to be in the range of 4.5-5.5 percent in FY17, against the target of 6.0 percent set by the government. Assuming higher international oil prices for FY17 (i.e., US$ 48/bbl, compared to US$ 42/bbl in FY16), the expected increase in inflation during the year would stem primarily from the normalization of fuel inflation in the country. Nonetheless, uncertainties emanating from the global economic outlook are high. Specifically, global oil prices, which recovered steadily between mid-February and June 23, 2016 on the back of market balancing declined again after the Brexit vote in end June 2016.[43] Presently, oil price outlook is blurred with significant downside and upside risks.[44] Downside risks

[39] In FY16, reduction of 7.2, 6.3 and 9 percent were observed in intra-city bus fares (max. fare), A/C bus (inter-city fare), and minibus (intra-city max. fare), respectively, compared to fall of 4.6, 8.4 and 0.7 percent in FY15.
[40] Thirty one medicines are reported in CPI basket, out of which rise in the prices of 17 medicines was observed, while prices of remaining 14 items declined or remained stable in FY16, on YoY basis.
[41] Source: S.R. O. 628 (I)/2016 dated July 22, 2016, DRAP, Ministry of National Health Services, Regulations and Coordination.
[42] CPI takes into account the prices of Suzuki Mehran, Cultus, Toyota Corolla and Honda Civic.
[43] By end-June 2016, oil prices had recovered to US$ 48.1/bbl. However, it came down again to US$ 43.8/bbl by end-July and continued to stay around this level by the first week of August (Source: US Energy Information Administration).
[44] The International Energy Agency has put this complexity in oil price forecast in its Medium-term Oil Market Report for July 2016 as: "For some time now analysts have tried to understand when the oil market will return to balance. A year ago it

stem from available crude stocks, global efforts to enhance energy efficiency, carbon emission cuts and a possible re-evaluation of on-hold oil investment projects; meanwhile, upside risks include a fall in non-OPEC oil production, more than expected growth in emerging markets (EMs) (especially China, India and Brazil) and oil supply disruption due to geopolitical factors. Therefore, the international oil prices are expected to fluctuate between US$ 43 and $55/bbl in FY17.[45] Due to its critical role in Pakistan's economy, the eventual path of global oil price will significantly influence the inflation outcome.

Domestic factors also play into the expectation of higher inflation next year. The most obvious factor is the tax measures introduced by the government in Budget 2016-17: the government increased FED on beverages from 10.5 to 11.5 percent; replaced 5 percent FED on cement by fixed rate of Rs 1 per kg; imposed regulatory duty on powdered milk; and increased the rate of sales tax on certain ingredients of poultry feed from 5 to 10 percent. These measures have already resulted in an increase in prices of certain items like cigarettes and cement in Q1-FY17.[46] In addition to taxation measures, some upward pressure on CPI is also expected to come from inflation expectations in the economy. The recent IBA-SBP consumer confidence survey (for September 2016) reveals that more participants of the survey expect an increase in overall, food, energy, and NFNE prices in coming six months, compared to same period last year.[47] On the flip side, if downside risks on global commodity prices materialize, then it will help mitigate domestic inflationary pressures; actual inflation may end up below the forecast for yet another year.[48]

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was widely believed that this would happen by the end of 2015 but that view has proved to be very wide of the mark. In 2014 and again in 2015 supply exceeded demand by massive margins, 0.9 mb/d and 2 mb/d respectively, and for 2016 we expect a further build of 1.1 mb/d. Only in 2017 will we finally see oil supply and demand aligned but the enormous stocks being accumulated will act as a dampener on the pace of recovery in oil prices when the market, having balanced, then starts to draw down those stocks. Unless we see an even larger than expected fall in non-OPEC oil production in 2016 and/or a major demand growth spurt it is hard to see oil prices recovering significantly in the short term".

[45] Source: IMF and World Bank commodity price forecast as of August 18, 2016 and October 19, 2016 respectively. At the time of write up the average crude oil prices were US$ 49.2/bbl (average of WTI and Brent as of October 28, 2016).

[46] For example, cement prices rose by roughly Rs 30-45 per bag after announcement of federal budget for FY17.

[47] IBA-SBP's Consumer Confidence Survey (CCS) for September 2016 suggests that the share of respondents expecting a rise in overall prices during next six months rose to 43.70 percent, compared to 39.35 percent in September 2015. This rise in expectations was on the cards due to seasonal impact of Ramzan, Eid and budget related tax measures.

[48] At the start of FY16, CPI inflation was expected to remain in the range of 3.5 to 4.5 percent for the year.