

1 Enhancing Effectiveness of Monetary Policy

1.1 Monetary Policy Formulation

Macroeconomic conditions continued to improve during FY16 with average annual headline CPI inflation declining to historic low of 2.9 percent, well below its annual average target of 6 percent. Real GDP grew by 4.7 percent, the highest in the last eight years. Foreign exchange reserves maintained their upward trajectory reaching to an all time high of USD 23.1 billion. The exchange rate also remained stable particularly during the second half of FY16 after showing some fluctuation in the first half. Credit to private sector almost doubled from last year and gross domestic fixed capital investment increased by 5.7 percent during FY16. Net foreign direct investment also increased by over 100 percent in FY16 largely due to the ongoing CPEC related projects.

Given the benign inflationary outlook, SBP continued with the gradual reduction in the policy rate during the year to augment investment and growth. The policy rate was reduced by 75bps to 5.75 percent in FY16 compared to over 300bps reduction in FY15. Further, the process for developing a roadmap for implementing the flexible inflation targeting framework, which is an important component of the SBP Vision 2020, started during the year. This would include extensive research to ensure smooth transition to inflation targeting in the coming years and would make the SBP monetary policy function more effective and transparent.

1.1.1 Constitution of Monetary Policy Committee

The constitution of the Monetary Policy Committee (MPC) was a major milestone achieved during the year after enactment of necessary amendments in SBP Act, 1956 in November 2015. It will strengthen the monetary policy formulation process and ensure its independence in line with international best practices. The MPC comprises three external economic experts, three SBP executives and three SBP Board members with the Governor SBP as its Chairperson. The Committee has been mandated to independently formulate monetary policy based on assessment of macroeconomic conditions, including inflation outlook, economic growth indicators, balance of payment, exchange rate and foreign exchange reserves position. It also has powers to make regulations for implementation of its monetary policy stance. After constitution, the MPC held three meetings during FY16 and approved bimonthly monetary policy statements issued by SBP. In order to bring greater transparency in monetary policy decision making, SBP has also started publishing minutes of MPC meetings, as this would facilitate the market and general public in better appreciating and understanding the central bank's monetary policy stance.

1.1.2 Improvements in Transmission of Monetary Policy

To further improve the implementation of monetary policy, the Interest Rate Corridor (IRC) framework was revised in May 2015 in line with international best practices. The revised framework introduced SBPs Policy Rate as an explicit Target Rate to unambiguously signal the central bank's monetary policy stance and to align the operational target of overnight money market repo rate with it. Due to implementation of the explicit target rate in FY16, volatility in the money market overnight repo rate reduced significantly. The standard deviation of the overnight repo rate has come down to 0.45 in FY16 from 1.28 in FY15. As a result, the transmission of policy rate improved across the other market interest rates as well. For instance, 6-month KIBOR (corporate benchmark for lending) started to follow closely the trends in target rate rather than the ceiling of IRC (penal rate) that it broadly used to follow earlier. On average the 6-month KIBOR during the year remained 03bps below the ceiling of IRC as compared to 16bps above the ceiling in FY15. In order to keep the interest rate

closer to the target rate, Open Market Operations (OMOs) were conducted more frequently in FY16 with significantly higher volumes than the last year.

1.2 Exchange Markets and Reserve Management

The ongoing monitoring of financial markets, routine liquidity operations in the money market and calibrated interventions in the FX market continued during the year to implement the monetary policy stance, to ensure stability and smooth functioning of both money and FX market and to build up foreign exchange reserves. In line with SBP Strategic Plan 2016-2020 (Vision 2020), a number of measures were taken to improve the efficiency and effectiveness of FX regime in the country (see **Box 1.1**).

Box 1.1: Initiatives taken to improve effectiveness of foreign exchange regime during FY16:

- To enhance efficiency in trade transactions, SBP in collaboration with Pakistan Customs, automated issuance of Form E for declaration of Exports to Pakistan Customs with effect from November 2, 2015. However, declaration on physical Form E shall continue in areas where Web-based software for custom clearance i.e. WeBOC is not available.
- With a view to further streamline regulatory instructions, Authorized Dealers were advised to convert export proceeds in PKR, where the concerned exporter had failed to do so within prescribed time period of three working days, at the 'buying' rate of weighted average exchange rate that prevailed on the third day of receipt of such funds, as available on SBP website under advice to the concerned exporter.
- With a view to facilitate Hajj Group Organizers (HGO) during Hajj operations the year 2015, Authorized Dealers (ADs) were allowed to remit foreign exchange (Saudi Riyals) on behalf of the HGOs that have been allocated quota by the Ministry of Religious Affairs (MORA) under the Private Hajj Scheme.
- In order to ensure meticulous compliance of foreign exchange rules & regulations and to further improve efficiency in enforcement process, a dedicated 'Compliance and Enforcement Division' was established in Exchange Policy Department.
- To facilitate exchange companies, an SBP-Customs Joint Booth was established at International Departure Lounge of Bacha Khan International Airport, Peshawar, to export permissible foreign currencies from Peshawar and adjoining areas. Such booths are already working at Karachi, Lahore and Islamabad airports.
- In order to improve liquidity of US Dollar in the market, Exchange Companies have been allowed to import cash US Dollars from Jinnah International Airport, Karachi and Allama Iqbal International Airport, Lahore against export of permissible foreign currencies.
- In order to facilitate stakeholders, the Foreign Exchange Manual was updated and placed on SBP website.

1.2.1 Introduction of New GoP Debt Instruments

In Pakistan, both the primary and secondary markets for conventional government securities are liquid and efficient. However, the market for Islamic instruments is relatively less mature owing primarily to lack of regular issuances of government debt instruments over the years. In order to give the Government of Pakistan (GOP) an additional avenue to raise funds from the domestic markets and to facilitate Islamic Banking Institutions (IBIs) in their liquidity management, SBP in consultation with GOP introduced the *Bai-Muajjal* of GOP *Ijara Sukuk* (GIS) and Fixed Rental Rate GIS by GoP. During the years, the GOP raised amounts of Rs 208.6 billion and Rs 197 billion respectively through these instruments.

1.2.2 Management of Foreign Exchange (FX) Markets

The Foreign Exchange market remained stable during the year after witnessing some downward adjustment in the first quarter of FY16. With no major spikes, the USD/PKR exchange rate witnessed only a moderate depreciation of 3 percent in FY16. The stability and ample liquidity in the FX market also significantly contributed in continued buildup of FX reserves, which increased by USD 4.4 billion during FY16 to reach to a record high level of USD 23.1 billion as at the close of the fiscal year.

1.2.3 Foreign Exchange Reserve Management

Global financial markets were marked by three major themes in FY16: low-to-negative interest rates, high market volatility and heightened risk perceptions. In line with the overall guiding investment principles of safety, liquidity and return and taking cognizance of the prevalent ‘three main themes’ in the global markets, the returns were optimized through diversification into new markets. In this vein, funds were deployed into international Islamic Sukuk adding to diversification gains from investment in Chinese government bonds, already in place. Efforts to optimize returns through portfolio diversification, effective FX Management, effective market strategies and favorable market developments have resulted in higher returns on SBP’s foreign currency investment portfolio in FY16, compared to FY15. Further, to support diversification in FX reserves management, two new Nostro accounts in CNY and JPY are being opened. A Code of Conduct for Back Office operations has also been developed and implemented.

1.3 Home Remittances

Pakistan Remittance Initiative (PRI) (a joint initiative of SBP, Ministry of Finance, & Ministry of Overseas Pakistanis) has contributed significantly in enhancing the flow of remittances into the country through formal channels. The Home remittances continued to grow though at a reduced rate of 6.4 percent and increased to USD 19.9 billion during FY16 compared with USD 18.7 billion in FY15. The reduction in growth rate of remittances could be attributed to economic difficulties being faced by Saudi Arabia and Gulf countries due to the steep reduction in oil prices. The remittances have been a very important component of our external sector as the trade deficit is largely funded by the remittances; in FY16 they funded nearly 50 percent of the country’s imports and were equivalent to 7.0 percent of GDP. During the year following major steps were taken, under the auspices of PRI, to facilitate the flow of remittances:

- A financial training and awareness program for intended emigrant workers was launched at all seven Protectorate of Emigration Offices and departure lounges of international airports in coordination with Bureau of Emigration & Overseas Employment, commercial banks and Civil Aviation Authority.
- To further enhance domestic outreach of remittance distribution network, ZTBL and Pakistan Post were added in the network through an arrangement with a commercial bank. Similarly, AJK Bank also entered into remittance distribution arrangement with a commercial bank.
- To increase the overseas outreach, 36 new overseas tie ups were added during the year in different overseas corridors including South Africa.
- In order to further streamline the process, comprehensive instructions were issued on ‘Reimbursement of TT Charges scheme on Home Remittance in May 2016.

1.4 Research

The SBP has an elaborate research function to conduct research on key macroeconomic issues and challenges faced by the country and in key areas of focus of the central bank, which forms the basis for its policy and regulatory interventions. The following major research activities were completed during FY16.

- Inputs and forecasts from the customized Forecasting and Policy Analysis System (FPAS) model for Pakistan were prepared and provided to the Monetary Policy Committee (MPC). The studies on open economy DSGE model including external balance assessment approach of exchange rate misalignment, dominant borrower syndrome, comparison of various RBC models and estimation of financial conditions index were also completed.

- A study on “Monetary Policy Effectiveness in Pakistan: Evidence from “Factor Augmented Bayesian Structural Vector Autoregression (FABSVAR) model” was also conducted. This study used Pakistan’s monthly time series data covering July 1992 to June 2015 period to assess impact of monetary policy and exchange rate dynamics on inflation in the country. Combining a set of relevant variables (including different interest rates, monetary aggregates, exchange rates) in one factor, this study found significant impact of monetary policy and exchange rate dynamics on inflation; however the impact of global commodity prices was even higher.
- The role of money *vis-à-vis* interest rate as policy instruments on their relative effectiveness in terms of taming inflation was conducted. Results suggest not to completely deemphasize the role of monetary aggregates, and to vitalize the interest rate instrument. In another analysis to see if SBP’s response to inflation across high and low inflation regimes is asymmetric; it was found that it is more aggressive during the high inflation regime than in the low inflation regime.
- To understand the dynamics of agriculture credit in Pakistan, field experiments in Matiari (Sindh) were carried out during the last couple of years. The study helped in identifying the constraints holding back credit supply to small and medium sized growers. This study has been extended in order to understand the mechanisms that encourage growers to fully settle their loans.
- The first phase of Management and Organizational Practices Survey (MOPS) was completed in collaboration with Pakistan Bureau of Statistics and the London School of Economics (LSE) for the manufacturing sector firms located in Punjab. After US, Pakistan is the first country to organize a MOPS. This will help in understanding the management practices of manufacturing sector firms in Pakistan and the role of such practices in firms’ productivity growth. On completion of the first phase, this survey has been extended to rest of the provinces in Pakistan.

Box 1.2: Initiatives under SAARCFINANCE

- A joint study on “Managing Capital and Remittance Flows in SAARC Region for Safeguarding Financial Stability” by Reserve Bank of India and State Bank of Pakistan was completed. This study of SAARC countries assessed causes of capital flight and gave policy recommendations to member countries.
- The 22nd SAARCFINANCE Coordinators’ meeting was held on August 17, 2015 at Islamabad. As a chairman of SAARCFINANCE Network, Governor SBP attended the 7th SAARC Finance Ministers’ Meeting held in Kathmandu, Nepal on 20th August 2015. A progress report of the SAARCFINANCE (the Network of SAARC Central Bank Governors and Finance Secretaries of the region) was presented by the Governor. He highlighted some recent initiatives undertaken by the SAARCFINANCE Network for fostering closer relationships and building human capability (in the field of central banking) amongst SAARC partners.
- SBP also organized 31st SAARCFINANCE Group meeting on October 8, 2015 at Lima, Peru, alongside the IMF/World Bank annual meetings. Governor SBP chaired the meeting. During the meeting, the SAARCFINANCE Chair was transferred from the SBP to Central Bank of Sri Lanka.
- Two SAARCFINANCE seminars were organized on: i) Internal Audit in Central Banks: Methodologies & Practices (in November 2015); and ii) Payment Systems and Correspondent Banking in the SAARC Region (in May 2016). The first seminar focused on sharing knowledge on internal audit practices, standards, systems, and latest developments/issues facing internal audit functions in the central banks across the SAARC region. Whereas the second seminar focused on exploring ways to develop a robust payment systems and correspondent banking in the SAARC region which could play an important role in achieving secure, safe, and reliable mechanisms for financial transactions. The delegates from participating member central banks also shared their respective country experiences on the aforesaid areas.

1.5 Economic Analysis / Publications

The annual and quarterly reports on the State of Pakistan's economy are the flagship publications of SBP that provided in-depth analysis of economic issues, trends and challenges. Economic analysis presented in these reports and assessments on a number of topical issues are well recognized by the stakeholders. Some of the important issues covered in the reports included; why credit-to-GDP ratio is falling? ; An analysis of deflation; why Pakistan's exports are stagnant? ; and Impact of decline in global oil prices.

In addition to the regular reports, a Staff Note was released on an important issue of low savings and investment in the country. This note attempted to explore underlying factors behind low investment rates and resource mobilization in Pakistan. Further, the feedback was provided to external stakeholders on different policy issues, like; Investment Policy and the Strategic Trade Policy Framework, CPEC Long Term Plan on Financial Cooperation 2016-2030, and budgetary proposals.

1.6 Data Management System

In light of SBP Vision 2020, almost all data compilation processes at SBP have been automated. In addition to the internal use in research based policy formulation, the SBP statistics are widely used by cross section of stakeholders for research etc. The statistics compiled and disseminated over different periods mostly relate to monetary, financial and external sectors. Of late, SBP has brought about numerous improvements in data compilation and dissemination including:

- Improvement in the data coverage of Pakistan's balance of payments statistics as per IMF guidelines.
- Adoption of the latest international data compilation standards in the compilation and dissemination of International Investment Position (IIP) of Pakistan.
- Improvement in the scope of monetary statistics compiled under IMF's MFS Manual (2000) & Guide (2008) with inclusion of money market mutual funds data.
- Enhancement in the scope of monetary statistics by compilation of demand side information on number of loan applications and amount of loan demanded under International Standard Industrial Classification (ISIC 3.1) sectoral classification.
- Publication of new set of information on advances for private sector business and SME sector by type of finance in monthly statistical bulletin from December, 2015 onwards.
- Revamp of the annual publication 'Financial Statements Analysis of companies (Non-financial) listed at Karachi Stock Exchange.
- Initiation of the process of Compilation of Rent and Price Index of commercial properties.