1 Enhancing Effectiveness of Monetary Policy

1.1 Monetary Policy Stance in FY17

The SBP followed an accommodative policy stance in FY17 and kept the policy rate unchanged at 5.75 percent. This policy stance was largely assisted by favorable macroeconomic conditions albeit some external sector pressures due to decline in both exports and workers' remittances. Hence, with the overarching objective of price stability, the policy stance assisted and strengthened economic recovery process along with stability in financial and foreign exchange markets.

The accommodative monetary policy stance along with improvement in law and order and energy situation led to healthy growth of over 67 percent in credit off take by the private sector enabling the economy to grow by 5.3 percent, the highest in last 10 years. From demand side, private sector credit benefited from historic low interest rates, strengthening aggregate demand, growing momentum of CPEC-related projects, improved energy supplies, and relatively higher public sector developmental expenditures. From supply side, improvement in the growth of banks' deposit and less government borrowing from banks enhanced banks' lending capacity.

The stable policy rate coupled with SBP's money market operations helped to contain volatility in the money market overnight repo rate. This stability also translated into market interest rates as well. The daily average yields on 3-month, 12-month MTBs and 3-year PIBs remained around 5.92 percent, 5.97 percent and 6.40 percent respectively in FY17. This trend also transmitted somewhat to 6-month Karachi Interbank Offer Rate (KIBOR) which stayed around 6.10 percent on average during the same period.

1.1.1 Monetary Policy Committee

The Monetary Policy Committee (MPC) regularly met during the year to review and deliberate on SBP's monetary policy stance within the overall macroeconomic conditions and their projections. Trade-offs between conflicting objectives were thoroughly reviewed through empirical as well as technical analyses and forward looking decision making approach gained further importance. The Bank during the year started posting proceedings of the MPC meetings along-with the voting pattern on its website. The publications of the proceedings improved transparency and credibility of monetary policy formulation process, enabled the market to better appreciate the SBP monetary policy stance and facilitated aligning market expectations besides improving monetary policy transmission mechanism.

1.1.2 Roadmap for Adoption of Flexible Inflation Targeting

The *SBP Strategic Plan 2016-2020* envisages implementation of flexible inflation targeting regime. For this purpose, a road map is being prepared which would delineate the requisites steps involved in moving towards a flexible inflation targeting regime. The roadmap would also highlight the main questions to be addressed in adopting inflation targeting. Finally, a detailed report would be prepared with recommendations on different aspects of the flexible inflation targeting regime. The Key aspects of FIT being researched include:

- Choice of suitable nominal anchor for flexible inflation targeting (FIT) regime
- Optimal range of inflation to target in the FIT regime
- Monetary policy communication in FIT regime

1.2 Money and Debt Market

The SBP conducts regular Open Market Operations (OMOs) to implement its monetary policy stance and keep the money market overnight repo rate close to the SBP target rate i.e. "Policy Rate". As a result of timely interventions by the Bank, the volatility in the money market overnight repo rate reduced significantly; the standard deviation of the overnight repo rate reduced to 0.19 in FY17 from 0.42 in FY16. Further, significant reduction in maintenance of excess cash reserves by banks was also witnessed during the year, which is indicative of better utilization of available liquidity. The banks' recourse to SBP's Corridor facilities also reduced significantly during the year to 44 times from 73 times last year, reflecting improved liquidity management by banks and SBP.

1.2.1 SLR Reduction for Islamic Banks

The infrequent issuance of Sukuk by the Government during last 3 years has resulted into a significant decline in the supply of Sukuk making it difficult for Islamic Banks (IBs) to comply with the Statutory Liquidity Requirements (SLR). The maturity of GOP *Bai-Muajjal* of Rs 225 billion in November 2016 further reduced the pool of SLR eligible securities for IBs. In the absence of SLR eligible securities, IBs would have to keep cash for maintaining their SLR which could have adversely impacted their competitiveness. Accordingly, the SLR for IBs was reduced from 19 percent to 14 percent with effect from November 17, 2016.

1.2.2 Successful completion of IMF EFF Program

The IMF's Extended Fund Facility (EFF) program was successfully completed during the year with SBP playing a vital role both in negotiations and achieving quantitative targets of NIR, NDA, forward/SWAP transactions and other structural benchmarks set under the EFF.

1.3 Foreign Exchange Reserve Management

Global financial markets were marked by a great deal of uncertainty in FY17 due to a number of unexpected political developments especially US electing Trump, UK voting to leave EU, a closely fought election in France and a constitutional referendum in Italy. All these political events were a challenge to the prevailing global economic policy environment of fiscal austerity combined with un-conventional monetary policies and led to a high degree of uncertainty to the future path of economic growth and policies. The shift in sentiments – especially in the U.S. after the presidential election – along with the improved global data and the prospect for a move away from unconventional monetary policy and fiscal austerity to monetary policy normalization and fiscal stimulus led many market observers to believe that the U.S. economy is about to pivot to a new paradigm. The US Federal Reserve in particular was prompted to increase the pace of rate hikes implementing three rate hikes since Trump's election.

In line with the overall principles of safety, liquidity and return and keeping in mind the current market conditions, SBP gradually increased its allocation to short term US treasuries, which proved beneficial as yields on US treasuries improved. SBP also continued with its policy of investment diversification to include higher yielding instruments without increasing the investment risk as well as enhancing the investment in Islamic Sukuk.

Box 1.1: Initiatives Taken to Improve Effectiveness of Foreign Exchange Regime During FY17

- The Parliament passed the amendments in *Foreign Exchange Regulation Act (FERA), 1947* proposed by SBP empowering SBP to impose monetary penalties on its regulatees for violation of foreign exchange rules/regulations. It will enable SBP to more effectively administer the foreign exchange business of authorized dealers and exchange companies in Pakistan.

- Capacity building of authorized dealers, exchange companies and law enforcement agencies in collaboration with Institute of Bankers Pakistan and National Institute of Banking and Finance is being done on continuous basis. So far around 1500 officials have been given training in foreign exchange rules and regulations at different locations across the country.

- In order to facilitate stakeholders and to strengthen monitoring of import payments from Pakistan, SBP and Pakistan Customs have developed Electronic Import Form (EIF) module in Pakistan Customs' Web Based system WeBOC. The project has successfully been implemented and is operational since September, 2016.

- The permissible offshore accounts of resident entities were brought under SBP regulatory ambit. The registration/acknowledgment procedures of capital account transactions of private sector were simplified along with segregation of China Pakistan Economic Corridor (CPEC) projects in order to establish a database of foreign exchange obligations. These instructions will also enable SBP in effective assessment of foreign exchange implications of CPEC.

- In order to promote the culture of documentation, the regulatory due diligence of export of securities (Issue/Transfer) to non-resident investors against their investment into Pakistan (FDI-Inward) was enhanced. The instructions will also facilitate real investors and discourage money launderers to channelize their funds as foreign investment in Pakistan.

- In view of peculiar nature of trade with Afghanistan through land routes, especially through *Torkham* and *Chaman* borders, banks have been allowed to register contracts of the Pakistani importers and make payments there against, as and when required, through a more liberalized mechanism in terms of which routing of transport documents has been allowed directly from exporter to importer, without involving exporter's or importer's bank.

- The foreign portfolio investment through banking channel was further streamlined during the year whereby non-resident portfolio investors were allowed to use their funds in Special Convertible Rupee Account to meet margin requirements of ready/cash market transactions in Pakistan Stock Exchange. The foreign investors have also been permitted to pledge their unencumbered securities in favor of National Clearing Company of Pakistan to meet such margins till settlement of respective transactions.

- Exchange Companies are required to submit various reports/returns to SBP according to their scope of business. In order to facilitate Exchange Companies and enhance integrity of reporting of data, an integrated reporting system has been implemented to enable Exchange Companies to submit comprehensive data to SBP through web based online system.

1.4 Home Remittances

During FY17, Home remittances declined by 3.1 percent to USD 19.3 billion as compared to USD 19.9 billion in the preceding year. The fall in home remittances was recorded for the first time since FY04. This decline is mainly attributed to the following factors:

- A sharp decline in oil prices appears to be the most significant factor as home remittances from Middle East fell by 5.1 percent to US Dollar 12.1 billion in FY17 compared with US Dollar 12.8 billion in the preceding year. Consequently, the share of home remittances from Middle East declined to 62.7 percent in FY17 from 64.0 percent in FY16. Qatar is the only Middle Eastern country which posted positive growth of 6.2 percent in remittances to Pakistan during the year.

- Increased disclosure requirements and subsequent increase in compliance costs in USA led to a fall in home remittances by 3.2 percent in FY17. Specifically, home remittances declined from US Dollar 2.5 billion in FY16 to US Dollar 2.4 billion in FY17.

- Home remittances from UK to Pakistan declined by 9.4 percent during FY17 mainly due to a sharp depreciation in British Pound against US Dollar (i.e. 12.3 percent) after the announcement of Brexit to end-June 2017. This suggests that if adjusted for depreciation, remittances from UK have actually increased in British Pound terms.

- Money Service Businesses (MSBs) in UK and Australia are facing problems in transferring funds due to closure of bank accounts as banks adopted wholesale de-risking policy. MSBs without a bank account have to share their income with other entities for transferring their funds.

Box 1.2: Initiatives Taken for Growth of Home Remittances

- **Pre Departure Briefings:** PRI in coordination with Bureau of Emigration & Overseas Employment (BE&OE), 3 commercial banks and one microfinance bank is conducting a financial training program at Protectorate of Emigrant Offices. All seven Protectorate Offices throughout the country are participating in the project. The main objective of this program is to create awareness amongst intended emigrant workers regarding sending remittances through formal channels and to accelerate the process of financial inclusion.

- **IBAN Account Number:** PRI in collaboration with SBP and commercial banks is promoting use of International Bank Account Number (IBAN) format by the remitters and beneficiaries to enhance efficiency and reduce instances of remittance not reaching beneficiaries due to incomplete/incorrect account numbers.

- **PRI Call Center Infrastructure Enhancement:** In order to further expedite the home remittance complaint resolution process, PRI call center automation enhancement and integration was initiated during the year; it would be completed and made operational by December 2017.

- **Increase in Outreach:** New domestic financial institutions have been included for payment of remittances. The network of ZTBL branches has started payments of home remittances under an agreement with a bank. Similarly, the network of FINCA Microfinance Bank and NRSP Microfinance Bank entered in home remittance business. As far as overseas outreach is concerned, domestic financial institutions have made over 36 new agency arrangements with overseas tie ups in FY17 including New Zealand.

1.5 Research

The SBP continued conducting research on key macroeconomic issues and challenges faced by the country. Forecasts from the SBP's Forecasting and Policy Analysis System (FPAS) for Pakistan were prepared, which are used by the Monetary Policy Committee of the Bank while approving the monetary policy statement every 2 months. The FPAS model provided scenario analysis for real interest rate, real exchange rate, manufacturing production and inflation.

Research relating to the extension of Dynamic stochastic general equilibrium (DSGE) and Forecasting and Policy Analysis System (FPAS) models continued during the year by considering government and external sectors, in collaboration with Professor Dr. Ehsan Choudhri (of Carleton University, Canada) under the aegis of International Growth Center (IGC) Pakistan. Further, a valuable theoretical contribution was made by developing a Fully Modified HP Filter, which is an important tool for business cycle estimation with reduced end point bias (SBP Working Paper 88).

After successfully completing the first phase of the Management and Organizational Practices Survey (MOPS) in Punjab, the second phase was launched, during the year, to extend the survey across the country in collaboration with Pakistan Bureau of Statistics and the London School of Economics. This study will help to assess important aspects of management practices, like data-driven and decentralized decision making, by manufacturing firms in the country. Such awareness is necessary to take decision about required policy intervention(s) to improve firm's level productivity in Pakistan.

As per practice the 21st Zahid Husain Memorial Lecture was organized in December 2016. Professor Timothy John Besley, the *W. Arthur Lewis* Professor of Development Economics and Political Science at London School of Economics, UK, delivered the lecture. He highlighted the role of state capacities as drivers of economic growth. A video documentary on the history of SBP was also played before the lecture to highlight the role of Mr. Zahid Husain, the first governor and founder of SBP, in formation of SBP and others services rendered by him for the nation. Government officials, federal secretaries, faculty members of various universities and bankers attended the lecture.

SBP also organized two seminars under Pakistan and World Economy Series: one by Professor Dr. Ehsan Choudhri (of Carleton University, Canada) and other by Dr. Andrei Zlate of Federal Reserve Bank of Boston, USA. SBP also published 13 working papers during the year contributed by officers in monetary policy and research cluster of the Bank. The 12th Volume of the SBP Research Bulletin was also released during this year.

1.6 Economic Analysis / Publications

The SBP publishes its flagship quarterly and annual reports on the state of Pakistan economy that provide in-depth analysis of economic trends, issues and challenges. During FY17, these reports covered a wide array of subjects. For instance, the increasingly dominant role of consumption in GDP growth was analyzed and its implications on private investment evaluated. Similarly, the main challenges faced by the food industry were discussed, which included the presence of informal players, inefficiency of supply chains, and the small land holding by majority of farmers. With regards to the external sector, the widening discrepancy between the import data provided by Pakistan Bureau of Statistics (PBS) and SBP, and the steps SBP was undertaking to improve the reporting of import and external financing data (to minimize the discrepancy and increase the accuracy of Balance of Payment data), were highlighted in one of our quarterly reports. Moreover, SBP provided analytical and data support for relevant sections of the Economic Survey of Pakistan 2016-17, published by the Ministry of Finance.

In the Annual Report for FY16, a thematic chapter on social sector developments was included. The chapter provided a detailed analysis of developments and progress in Pakistan's social sector indicators – comprising population and demographics, health, education, poverty, income inequality, and government spending on social sectors – from the year 2000 onwards. The country's relative progress in social indicators under the Millennium Development Goals (MDG) framework was also discussed. The chapter was widely covered in the print media, with academics and social scientists largely appreciating the quality and depth of the analysis. On the fiscal side, the gaps in taxation system and the need for structural reforms were highlighted. Moreover, post-18th Amendment fiscal federalism issues including the increasing responsibility of provinces for greater revenue mobilization, especially from agriculture and services sectors, were highlighted. Similarly, the importance and ways of increasing savings through National Savings Schemes (NSS) and the need to manage contingent liabilities were discussed in detail.

1.7 Data Management System

As envisaged in *SBP Vision 2020*, all major statistics are compiled according to the international standards and most of the data compilation processes at SBP are automated. The balance of payments statistics, monetary statistics, flow of funds accounts and debt statistics are compiled according to the guidelines of the relevant manuals prepared by the international agencies such as IMF, UN, World Bank. The statistics being produced by SBP are used for analysis, research and policy formation within and outside SBP by various stakeholders.

Further a number of improvements in data compilation and dissemination were made during the year including the following:

- Augmentation of availability of BOP data series as per guidelines of Balance of Payments and International Investment Position Manual of the IMF, sixth edition (BPM6). To fulfill the requirements of researches, a comparable time series data for undertaking meaningful analysis has been made available.
- Started Compiling Government Domestic Debt data as per Public Sector Debt Guide 2013 of IMF. This has brought our debt statistics in line with the international standards.
- Work on compilation of rent and price index of commercial properties was initiated for the first time in Pakistan. Field surveys for collection of the required data are in progress; the indices will be compiled on half-yearly basis. The indices will help to investigate the behavior of commercial properties market and will be used to monitor the evolution of property prices over time. The indices will allow buyers and sellers to estimate values of commercial properties at a particular point of time.
- Enhanced the coverage of monetary statistics under the guidelines of MFSM 2008 to fulfill the requirements of Special Data Dissemination Standard (SDDS) and General Data Dissemination Standard (GDDS) and to adopt international standards.
- Compilation of Flow of Funds Accounts according to SNA 2008 was started to adopt the latest international guidelines for compilation of Flow of funds accounts.