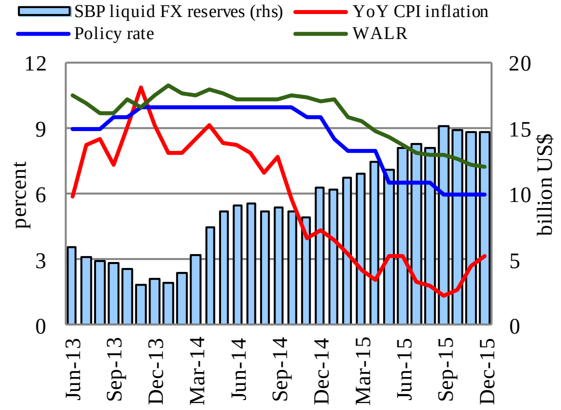
3 Inflation and Monetary Policy

3.1 Overview

Declining inflation, stability in exchange rate, significant rise in foreign exchange reserves, and contained budgetary borrowings from SBP, has created room to decrease the policy rate to a historically low level of 6 percent in September 2015 (**Figure 3.1**).[1] In the subsequent monetary policy reviews of November 2015 and January 2016, SBP decided to keep the policy rate unchanged because the trends of key macroeconomic indicators and their future path suggested that the benefits and risks were held in balance. Furthermore, the realization of the lagged impact of aggressive monetary easing from November 2014 to September 2015, indicated by a pickup in real economic activity and higher bank credit to the private sector, also supported SBP's decision to keep the policy rate unchanged.

Figure 3.1: Policy Environment - Key Indicators



Source: State Bank of Pakistan

Notwithstanding positive developments, a few indicators witnessed adverse movements in H1-FY16. For instance, there was a sharp increase in currency in circulation, which surged by 2.6 times the rise observed during H1-FY15. At the same time, deposit mobilization was subdued in H1-FY16, and was only 50 percent of the rise in bank deposits seen in the same period last year. Inflation appeared to have bottomed out, as it inched up for four consecutive months since September 2015. Pressures in the foreign exchange market resulted in a 2.8 percent depreciation of the PKR (upto 10th March 2016) against the USD, mainly due to a rise in the current account deficit in Q2-FY16. This, together with

[1] At 6 percent, the policy rate is the lowest since August 1973. Cumulatively, the policy rate has been reduced by 400 bps since November 2014.

continued government borrowings from commercial banks, kept the overnight repo rate slightly above the policy rate in recent months.[2]

In the money market, SBP injected liquidity through open market operations (OMOs) and maintained the cut-off rate very close to the policy rate. Moreover, since September 2015, notable rise in bank deposits and decline in currency in circulation has also played an important role in supporting the interbank liquidity.[3]

The credit demand from both fiscal authorities (for budgetary support) and private sector resulted in a monetary expansion of Rs 479.7 billion in H1-FY16, as compared to Rs 442.9 billion in the equivalent period of the previous fiscal year. Component-wise, net foreign assets (NFA) of the banking system demonstrated noteworthy expansion of Rs 150.6 billion in H1-FY16, largely due to higher official inflows in the NFA of SBP during Q1-FY16. On the other hand, increase in net domestic assets (NDA) of the banking system was modest in H1-FY16 as compared to H1-FY15.

In absolute terms, government budgetary borrowing from the banking system (on cash basis) was Rs 183.3 in H1-FY16. The fiscal authorities resorted to financing their deficit through borrowings from external resources and commercial banks. As a result, they were able to retire SBP debt of Rs 429.2 billion during the period. This shift in borrowing from SBP to commercial banks has enabled the government to meet the IMF targets for end-September and end-December 2015 set under the Extended Fund Facility.

In this situation, developments in the credit market were encouraging. Private sector credit (PSC) expanded by Rs 352.9 billion in H1-FY16 against Rs 222.3 billion in the same period last year. The expansion in PSC was broad based as a large number of sectors (including textiles, fertilizer, retail trade, construction, and electricity) availed higher credit in FY16. Furthermore, significant developments in the credit market also included: (i) higher advances for fixed investment purposes to construction-related sectors, telecommunications, land transport, and electricity and gas production, and (ii) continuation of higher consumer credit for housing and automobiles.[4] Higher expansion in PSC is attributable to the

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[2] This document uses the name commercial banks and scheduled banks interchangeably.

[3] During H1-FY16, currency in circulation has been higher while deposit generation has been lower as compared to the same period last year. This was particularly true during eid festival at the end of Q1-FY16.

[4] However, there were few sectors that availed lesser volumes of fixed investment loans in H1-FY16 compared to the same period last year. These included spinning, refined petroleum, beverages, weaving of other textiles, cattle/dairy farming, and sugar.

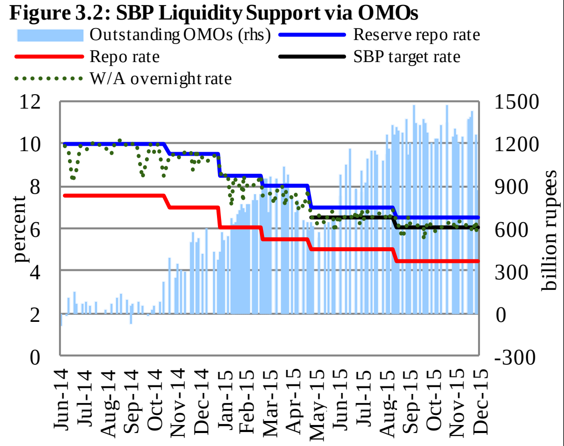
improved business environment (better security situation and improved energy management); lower cost of borrowing;[5] and modest risk premium for banks.

Low prices of international commodities (particularly oil) and subdued monetary expansion along with contained budgetary borrowings from SBP, resulted in a decline of average CPI inflation to only 2.1 percent in H1-FY16 as compared to 6.1 percent during H1-FY15. The trend of CPI suggested that inflation might have bottomed out by end of Q1-FY16. The reversal in Q2-FY16 was mainly due to both direct and indirect impact of food and energy groups. In particular, the following factors played a major role: upward adjustment in petroleum prices in November 2015; lagged impact of PKR depreciation against the USD during Q1-FY16; and imposition of regulatory duties on imports of various items, along with a percentage point across-the-board increase in customs duties (see **Section 3.4** for details).

3.2 Money market developments

SBP injected liquidity through OMOs during Q1-FY16 for broadly two main reasons: (i) to keep the overnight money market rate close to SBP target rate of 6 percent and; (ii) to partially neutralize the impact of high government borrowing from commercial banks on interbank liquidity. This has led to increase in the level of OMO injections during Q1-FY16 (**Figure 3.2**). However, post-monetary policy announcement of September 2015, OMO injections have comparatively remained unchanged.

Figure 3.2: SBP Liquidity Support via OMOs



Source: State Bank of Pakistan

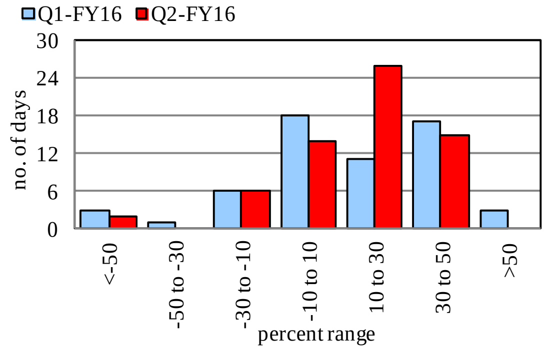
[5] Weighted average lending rates during H1-FY16 were 276 bps lower than in the same period last year.

Despite the high level of OMO injections, overnight interbank rates stayed, on average, 13 basis points above the SBP target rate of 6 percent in Q2-FY16 (**Figure 3.3**).[6] This was partially a result of SBP's efforts to keep the build-up of pressures in foreign exchange market at bay.[7]

The relatively comfortable interbank liquidity situation in Q2-FY16 is attributed to better fiscal position and higher bank deposits. Healthy growth in tax revenues and timely receipt of foreign flows in the quarter also allowed the government to contain its borrowings from the banking system.

Fiscal authorities mobilized Rs 44.7 billion through PIBs and T-bills from commercial banks in Q2-FY16, as compared to Rs 273.2 billion in Q1-FY16. As indicated in **Table 3.1**, the government accepted lower amounts than both targets and maturity in primary auctions. The main reason behind government's lower borrowing from commercial banks was the successful Ijara Sukuk auction in December 2015, which reduced

Figure 3.3: Deviation of Overnight Market Rate from the SBP Target Rate*



*+ve difference in basis points means overnight rate higher than SBP target rate and vice versa
Source: State Bank of Pakistan

Table 3.1: Auction of Government Securities in FY16
billion rupees

	Target	Maturity	Accepted	Accepted: Net of target	Accepted: Net of maturity
PIB					
Q1	200.0	403.7	218.3	18.3	-185.4
Q2	150.0	5.7	182.9	32.9	177.2
T-bills					
Q1	1,200.0	862.6	1,321.2	121.2	458.6
Q2	1,225.0	1,146.4	1,014.0	-211.0	-132.4
Ijara					
Q1	-	-	-	-	-
Q2	100.0	233.8	117.7	17.7	-116.1
All					
Q1	1,400.0	1,266.3	1,539.5	139.5	273.2
Q2	1,475.0	1,385.9	1,314.5	-160.5	-71.4

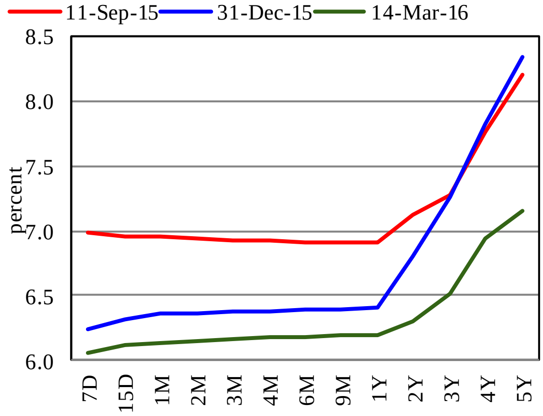
Source: State Bank of Pakistan

[6] Daily overnight interbank rate remained higher than the target rate in 79 percent of days in Q2-FY16 as compared to 71 percent in Q1-FY16.
[7] Kerb market premium against USD rose from Rs 0.1 at end-September 2015 to as high as Rs 2.0 during December 2015.

pressures from the conventional banks to finance government budgetary requirements.[8]

Given the market liquidity situation and 50 bps cut in the policy rate announced on 11th September 2015, the secondary market yield curve displayed a downward shift in case of all tenors of less-than-3 year maturities up to end-December 2015 (**Figure 3.4**). However, as per the latest data (up to 14th March 2016), the long end of the yield curve has also declined, indicating a successful transmission from short-term to long-term rates. The transmission mechanism also affected the lending rates offered by commercial banks.

Figure 3.4: Secondary Market Yield Curve



Source: State Bank of Pakistan

In line with the declining policy rate trend, the weighted average lending rate (WALR) continued to slide, reaching its lowest level in over a decade to 7.3 percent during December 2015, from 10.3 percent in January 2015.[9] The average WALR during H1 indicates that the cost of borrowing in FY16 was 7.6 percent as compared to 10.4 percent in FY15. Due to this lower cost of borrowing and relatively stable liquidity conditions, credit to private businesses increased; this, in turn, was one of the key contributors to the expansion in money supply in Q2-FY16.

3.3 Developments in monetary aggregates

Broad money supply expanded by Rs 479.7 billion in H1-FY16 – slightly higher than the increase of Rs 442.9 billion seen in the same period last year (**Table 3.2**). However, unlike last year, when the entire expansion was concentrated in Q2, this year's increase was observed in both quarters. Budgetary borrowings from commercial banks and credit to private sector contributed to the overall expansion.

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[8] Islamic banks with surplus liquidity were looking for investment avenues because the last Ijara auction was held 18 months ago in June 2014, and a number of auctions worth Rs 233.8 billion matured in Q2-FY16.

[9] The last time the WALR was lower than 7.3 percent was in April 2005.

Table 3.2: Absolute Changes in Monetary Aggregates
billion rupees

	FY15			FY16		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Money supply (M2)	-6.0	448.9	442.9	119.8	360.0	479.7
NDA	25.2	368.9	394.1	8.2	321.0	329.2
SBP	-66.9	-140.3	-207.2	205.2	-71.6	133.6
Commercial banks	92.1	509.2	601.3	-197.0	392.6	195.5
NFA	-31.2	80.0	48.8	111.6	39.0	150.6
SBP	-8.2	74.7	66.5	150.9	28.8	179.7
Commercial banks	-23.0	5.3	-17.7	-39.3	10.2	-29.1

Source: State Bank of Pakistan

On the liability side, the currency in circulation (CIC) saw a marked increase of Rs 325.4 billion during H1-FY16, which was about 2.6 times the rise seen during the same period last year. This increase was largely because of Eid holidays during the first quarter of the year and the imposition of withholding tax (for non-filers) on all banking transactions exceeding Rs 50,000. Specifically, the CIC increased by Rs 415.7 billion during Q1-FY16, which was followed by a decrease of Rs 90.2 billion during the second quarter of the year.

Private sector deposits, which are a prime source of funding for commercial banks, increased by Rs 144.4 billion (1.8 percent growth) during H1-FY16, compared with Rs 292.2 billion (4.0 percent growth) in the same period last year. The entire increase (Rs 457.0 billion) came during second quarter of the year, as the funds started flowing back into the banking system after a hefty rise in CIC during Q1-FY16.

Net Foreign Assets (NFA)

NFA of the banking system expanded by Rs 150.6 billion in H1-FY16, more than three times the increase witnessed in the same period last year. The bulk of this flow (Rs 111.6 billion) was concentrated in Q1-FY16, as NFA of SBP expanded due to official inflows from issuance of Eurobond, commercial borrowing by the government, and CSF receipts.

On the other hand, NFA of scheduled banks contracted by Rs 29.1 billion during H1-FY16.[10] Detailed analysis shows that trade financing against FE-25 deposits increased by US$ 304 million to US$1.5 billion during H1-FY16. Only a small part of this financing was catered through increase in FE-25 deposits (US$ 59.0

[10] In Q2-FY16, the trend in NFA of scheduled banks reversed and expanded by Rs 10.2 billion, partially offsetting the contraction in the previous quarter.

million), with the major funding coming via liquidation of commercial bank's FX claims on non residents.

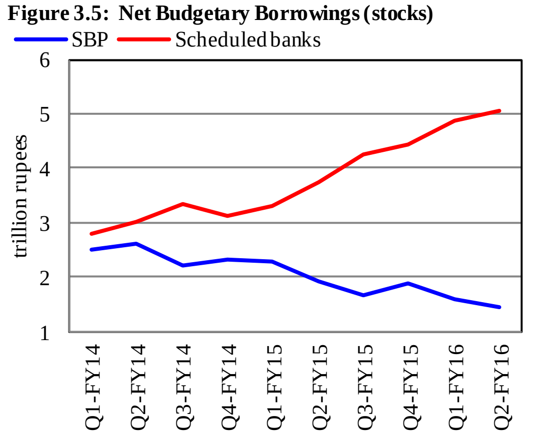
Net Domestic Assets (NDA)

NDA of the banking system increased by Rs 329.2 billion (3.1 percent) in H1-FY16 as compared to Rs 394.1 billion (4.2 percent) in the same period last year. This lower expansion in NDA was largely attributed to relatively healthy retirement of loans for commodity operations and contained government borrowing for budgetary finance. These two factors partially offset the expansionary impact of a pickup in credit to private sector.

Government borrowing for budgetary support[11]

The government borrowed Rs 183.3 billion from the banking system in H1-FY16 as compared to Rs 199.0 billion in the same period last year. Most of the budgetary borrowing in H1-FY16 was in the first quarter, with only Rs 43.9 billion borrowed in Q2-FY16.

Figure 3.5: Net Budgetary Borrowings (stocks)



Source: State Bank of Pakistan

Within the banking system, the government continued to retire SBP debt, which declined by Rs 429.2 billion in H1-FY16.[12] This net retirement to SBP allowed the government to meet the quarterly limit of zero budgetary borrowing set under the SBP Act 1956 and the target set by the IMF for both quarters of FY16. Furthermore, **Figure 3.5** depicts that budgetary requirement of the government has gradually shifted away from SBP to scheduled banks over the past few quarters.[13]

Since the government was in deficit (albeit at lower level) for H1-FY16, it implies that net retirements to SBP had to be financed from other sources of funding. Specifically, the government borrowed Rs 944.4 billion from commercial banks,

[11] Numbers of budgetary borrowings are on cash basis.
[12] Government retired SBP debt in the first and second quarters of both FY15 and FY16.
[13] Stock of government borrowing from SBP declined from its recent peak of Rs 2,248.0 billion at 15th June 2015 to Rs 1,457.5 billion at end-December 2015.

non-bank, and external resources during H1-FY16, which was considerably higher than the deficit of Rs 515.2 billion for the same period.

Commodity operations

Loans for commodity operations recorded a net contraction of Rs 41.8 billion during H1-FY16, which was higher than the retirement in the same period last year (**Table 3.3**). This contraction entirely stemmed from wheat loans, as financing for all other commodities saw a modest rise during the review period.

Table 3.3: Loans for Commodity Operations
billion rupees

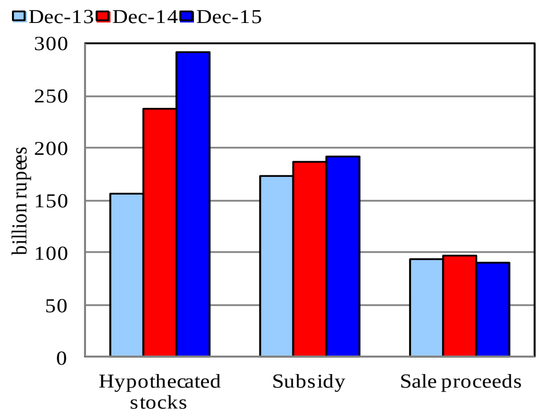
	H1-FY15	H1-FY16
Wheat	-23.1	-47.9
Sugar	-2.0	1.6
Fertilizer	-0.5	4.1
Cotton	0.0	0.4
Rice	0.1	0.0
Total	-25.6	-41.8

Source: State Bank of Pakistan

Wheat stocks with procurement agencies were recorded at 7.4 million tons at the end of H1-FY16 – 1.6 million tons lower than stocks at end-June 2015.[14] This offloading of stock enabled the procurement agencies to make loan retirements.[15]

Unlike last year, there was a net expansion in loans for fertilizer imports. To avoid shortage of fertilizer due to an expected fall in domestic production in the winter season, the government imported 1.6 million tons of fertilizer during Jul-Dec FY16.

Figure 3.6: Total Receivables of Procurement Agencies



Source: State Bank of Pakistan

Despite healthy retirement during the first half of the year, the outstanding stock of loans for commodity operations reached Rs 522.6 billion by end- December 2015. As shown in **Figure 3.6**, a large portion of these loans was backed by hypothecated stocks. However, receivables on account of

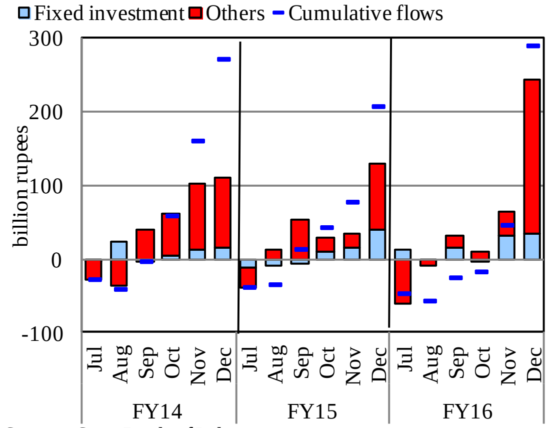
[14] The decline in stock during Jul-Dec FY15 was 0.9 million tons.
[15] It must be recalled that in FY15, private sector imported 0.7 metric tons of wheat to benefit from price differential between international and domestic prices. As a result, procurement agencies were unable to offload their stock due to this additional wheat in the market.

sale proceeds and subsidies stood at Rs 89.6 billion and Rs 192.0 billion by end-December 2015. Timely realization of these receivables would help reduce outstanding volume of loans for commodity operations.

3.4 Credit to private sector

Credit to private sector expanded by Rs 352.9 billion in H1-FY16 as compared to Rs 222.3 billion in the same period last year.[16] A significant part of this credit was availed by private sector businesses (**Table 3.4**). There was high credit off-take in December 2015, which was enough to compensate for the lower cumulative flow during earlier months of the year (**Figure 3.7**).[17] This should not be surprising, as private sector credit generally takes off from November onwards due to the beginning of the credit cycle. It is worth noting that the monthly flow in December 2015 – being twice as high as the average monthly flow in December of FY14 and FY15 may not just be a seasonal phenomenon.

Figure 3.7: Credit to Private Sector Businesses



Source: State Bank of Pakistan

The demand for private sector credit was high due to lower cost of credit and better market conditions. Similarly, the inclination and ability of banks to lend to the private sector also improved, as suggested by: (i) frequency and volume of SBP OMO injections; (ii) high deposit growth in Q2-FY16; (iii) comparatively lower government budgetary borrowings; and (iv) relatively high return on private sector lending.[18]

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[16] A portion of this increase can be attributed to reclassification of selected assets of Islamic banks to advances in Q2-FY16. Even with the exclusion of this rise, the expansion in credit to private sector in H1-FY16 is visible.

[17] During FY11-15, average credit to private sector businesses during the month of December was only Rs 117 billion, against Rs 244 billion in December 2015. Given the depressed commodity prices in December 2015, such a massive increase in nominal credit off-take looks intriguing. The higher credit during the month was mainly extended to manufacturing (of food products, beverages, textiles, chemicals and petroleum products), commerce (wholesale and retail trade), and agriculture (major crops).

[18] Cut-off rates for 3-year PIBs have stayed lower than the weighted average lending rate in almost all months since January 2015.

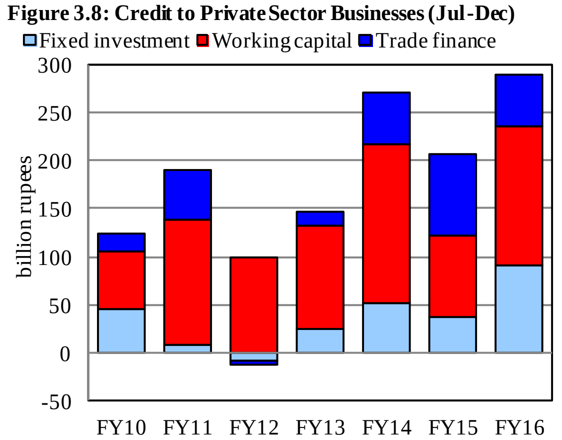
Table 3.4: Loans to Private Sector Businesses (Jul-Dec)
billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	FY16	FY15	FY16	FY15	FY16	FY15	FY16
Total	207.6	290.1	84.5	144.5	36.9	90.9	86.1	54.7
1) Agriculture	18.3	17.7	11.1	14.1	7.5	3.0	-0.3	0.6
2) Manufacturing	114.6	164.4	27.1	92.6	19.8	20.5	67.7	51.3
Food & beverages	15.0	4.9	-17.1	-19.3	9.5	8.4	22.6	15.8
Textiles	57.7	82.6	34.8	72.5	-1.4	1.4	24.4	8.7
Coke & petroleum	14.4	19.3	7.3	1.2	5.7	-2.1	1.3	20.2
Chemicals	2.2	40.9	-5.4	28.6	7.5	6.8	0.0	5.6
3) Electricity, gas & water	-4.4	20.4	6.5	3.2	-9.5	18.7	-1.4	-1.5
4) Construction	11.8	20.9	1.2	5.9	10.6	12.5	0.0	2.4
5) Commerce and trade	18.3	22.4	6.0	20.8	1.5	0.7	10.8	1.0
6) Transport & comm.	10.3	13.2	11.5	-7.1	-0.9	21.0	-0.3	-0.6
7) Real estate	14.0	15.7	9.8	8.9	5.6	5.0	-1.4	1.8
8) Others*	24.6	15.4	11.4	6.0	2.2	9.6	11.0	-0.2

*Others include Fishing, Mining and Quarrying, Ship breaking, Hotels, Education, Health, Community service and other private business. Fall in trade financing in *Others* during Jul-Dec FY16 came primarily from Ship breaking.
Source: State Bank of Pakistan

Improvement in credit to private sector in FY16 over the previous year primarily came from the manufacturing sector, followed by commerce and trade, construction, and electricity. With the exception of ship breaking (which received Rs 13.4 billion lower cumulative flows in FY16 over FY15), the improvement can be considered broad-based.

Figure 3.8: Credit to Private Sector Businesses (Jul-Dec)



Source: State Bank of Pakistan

While credit for working capital and fixed investment categories showed higher growth, credit for trade financing was lower in H1-FY16 as compared to FY15. This lower trade financing was primarily a function of net retirement of non-EFS loans, which dragged down the overall number.

A welcome development was the gradual rise in net credit disbursement for fixed investment to Rs 90.9 billion in H1-FY16 (**Figure 3.8**). It appeared that many firms were expanding their operations by availing fixed investment loans. The expansion was particularly notable in: production, transmission and distribution of electricity; road transport; construction of roads; telecommunications; sugar; manufacturers of electricity distribution machinery; cement; fertilizer; and pharmaceutical sectors. Given the medium-term nature of these loans, this indicated that private sector was taking the benefit of lower cost of funding. A sustained growth in credit for fixed investment bodes well for overall investment rate in the country, which currently hovers around 15 percent of GDP – much lower than the regional economies (**Box 3.1**).

A continuation of credit demand requires favorable monetary conditions and improvement in performance of manufacturing and services sectors. Realization of this could bode well for growth in private sector going forward.

Agriculture sector

Net disbursement to agriculture sector expanded Rs 17.7 billion in H1-FY16 as compared to Rs 18.3 billion in the same period FY15. However, credit extension in Q2-FY16 was much higher as compared to Q2-FY15. The biggest beneficiary was livestock, which availed half (Rs 8.7 billion) of the total credit to the sector during the second quarter. Commercial banks made gross disbursement (excluding retirement) of Rs 220.1 billion to the agriculture sector during H1-FY16 as compared to Rs 204.8 billion in the same period last year. The higher cumulative flow is entirely attributed to *production* rather than *development*; credit to the latter declined by Rs 4.5 billion in the period.

Manufacturing sector

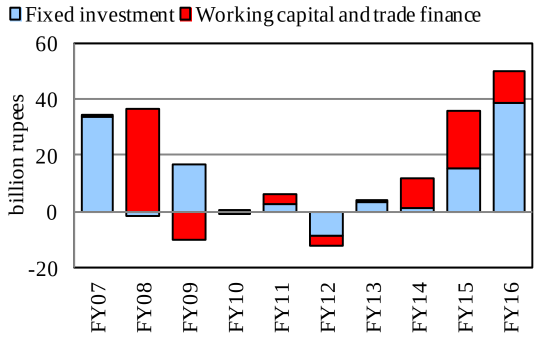
Credit to manufacturing sector showed a higher growth of 9.6 percent during H1-FY16, as compared to 7.0 percent in the same period last year. The main beneficiaries were textile and chemicals sectors.

Loans to textile sector witnessed a net increase of Rs 82.6 billion in H1-FY16 as compared to Rs 57.7 billion in H1-FY15. As usual, most of this increase was concentrated in Q2, when cotton procurement by textile firms peaked.[19] The majority of the credit was for working capital requirement, followed by trade finance. It seems that due to subdued textile exports (down 9 percent YoY during H1-FY16) following low commodity prices and subdued international demand, the textile industry was not upbeat about expanding as a small increase in fixed investment loans was largely for balancing, modernization and replacement.

[19] There was a net contraction of Rs 8.7 billion in Q1-FY16 as compared to Rs14.8 billion in the same period last year.

The chemicals sector showed the biggest improvement within manufacturing by availing Rs 40.9 billion credit in H1-FY16, as compared to a negligible Rs 2.2 billion in the same period of FY15. It availed credit during both quarters; most of this was for working capital. About 75 percent of the credit within chemicals was availed by the fertilizer sector; the reason being a rise in capacity utilization of local urea manufacturers to cater to local demand.[20]

Figure 3.9: Credit to Construction-related Sectors* (Jul-Dec)



* Includes construction, transport, storage, communications and real estate.
Source: State Bank of Pakistan

<u>Other private sector businesses</u>

Developments in construction-related sectors hinted at a pickup in economic activity, probably due to the initiation of CPEC-related projects.[21] For instance, the total credit availed by this group was Rs 49.8 billion — the highest since FY07 (**Figure 3.9**). Even better, category-wise data shows that a majority of the financing was for fixed investment purposes.

Similarly, production, transmission and distribution of electricity availed Rs 20.3 billion credit during H1-FY16, against a negligible Rs 1.7 billion in the same period last year. Majority of the credit (Rs 16.0 billion) was availed for fixed investment purposes, which is the highest since FY10 (**Figure 3.10**). It is a good sign for the sector, which has lagged behind in growth over the past few years.

[20] Given the government's willingness to grant concessions in gas prices, urea manufacturers have agreed to reduce the commodity price by Rs100 from every 50kg bag in addition to the relief of Rs 500 given on each bag of di-ammonium phosphate (DAP) fertilizer. The lower price would have increased the demand.

[21] Includes construction, transport, storage, communications and real estate.

Cumulative credit flow to retail trade was a healthy Rs 18.2 billion during H1-FY16 – nine times the amount availed in the same period last year.

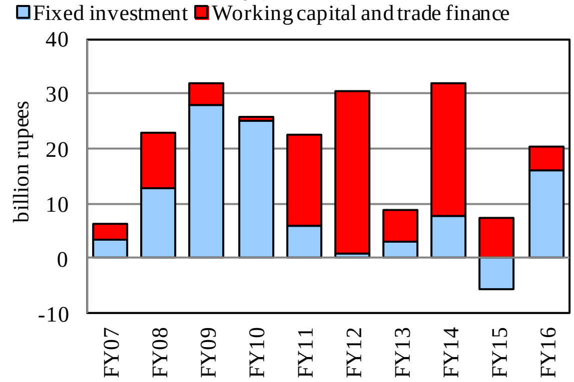


Figure 3.10: Credit to Production, Transmission and Distribution of Electricity (Jul-Dec)
Source: State Bank of Pakistan

<u>Consumer financing</u>

Consumer financing reported a cumulative flow of Rs 11.4 billion in H1-FY16 as compared to Rs 12.3 billion in the same period last year. Yet, there was a noticeable improvement in the second quarter of the year, when credit to consumers grew by Rs 16.3 billion as compared to just Rs 6.8 billion in Q2-FY15. The rise in the credit is attributed to auto and house building loans.

Auto financing rose by Rs 13.3 billion throughout H1-FY16 (particularly in December 2015) as compared to Rs 7.4 billion in H1-FY15. Similarly, house building loans showed a considerable improvement, rising Rs 2.7 billion in H1-FY16 against Rs 0.2 billion in the same period last year.[22] Since FY10, loans for auto and house building showed a rising trend (**Figure 3.11**), as interest rates fell and SBP allowed financing of cars up to 9 years old. Preliminary data suggests that auto financing has started to benefit the sales of local car assemblers, which are expected to post a healthy rise in FY16 (**Chapter 2**).

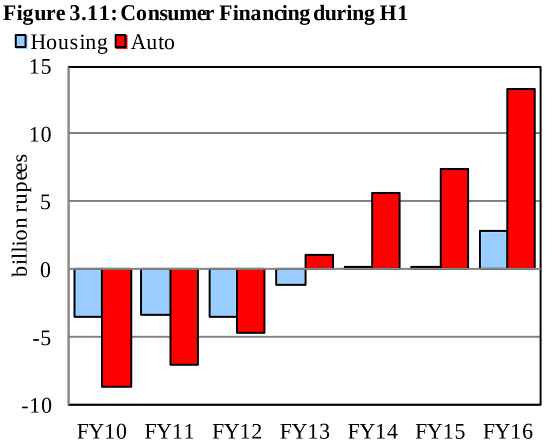


Figure 3.11: Consumer Financing during H1
Source: State Bank of Pakistan

Despite the impressive performance of these sectors, Rs 6.0 billion in net retirement of personal loans in H1-FY16 was enough to dampen the overall flow in consumer financing during the period. The Rs 13 billion

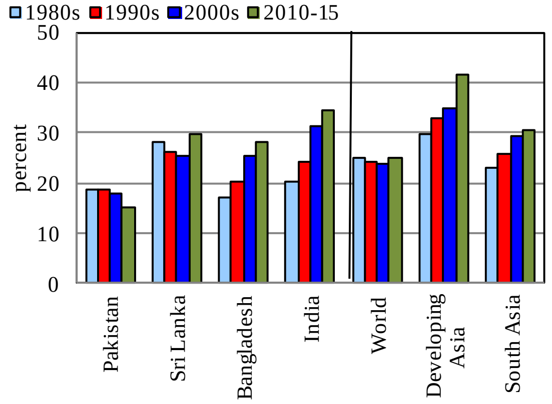
[22] Majority of the increase in house building loans (Rs 1.5 billion) was realized in Q1-FY16.

contraction in the first quarter was mainly due to high retirements of personal loan disbursed in the past few years. Yet, encouragingly, there was a Rs 7.0 billion rise in personal loans during Q2-FY16.

Box 3.1: Why Saving and Investment are Low in Pakistan?
Most of Pakistan's economic issues center around low saving and investment rates. Pakistan's investment to GDP ratio is around 15 percent, which is much lower than other South Asian economies, where rates are on a growing path (**Figure 3.1.1**).[23] Similar is the situation with saving rate, Pakistan's saving to GDP ratio averaged at 14.5 percent as compared to 22.7 percent for other South Asian economies in the last 36 years.[24]

The main factors behind low saving and investment rates, as highlighted in a recent SBP Staff Note,[25] are given below:

Figure 3.1.1: Investment to GDP Ratio



Source: Haver Analytics

- **Role of financial sector**: Financial sector plays a key role in financing of development in an economy. Within the financial sector the role of specialized financial institutions is critical for promoting investment and long term projects. Historically, Pakistan had adopted long-term financing from specialized financial institutions, like PICIC, IDBP, NDFC, etc. However, these institutions are now a history due to their inefficiencies, mismanagement, increasing non performing loans and their burden on public finances. This situation has also negatively affected the development process/investment in the economy. On the other hand, Pakistan's financial sector is presently dominated by commercial banks, which are not specialized for long-term financing due to their short term nature of funding sources i.e. deposits. Mortgage financing is one such area where the domestic banking system has struggled to penetrate.
- **Declining foreign investment**: While Pakistan has been attracting foreign companies since independence in different sectors, it attracted substantial amount of foreign investment in mid 2000s in banking and telecommunication sectors. However, due to deteriorating security situation after 2007 coupled with global financial crisis of 2008-09, foreign investors avoided Pakistan as an investment destination.

[23] Here it is important to qualify that being an important ally in the global war against terrorism, Pakistan has paid a heavy price over the past decade in the form of security concerns and low investment rate.
[24] These South Asian economies are Bangladesh, India, Nepal and Sri Lanka
[25] Ali, Amjad (2016), Saving and Investment in Pakistan; *SBP Staff Note*, 01/16; January 2016. The paper is available at: http://www.sbp.org.pk/publications/staff-notes/SavingInvestmentStaffNote-Jan-16.pdf

- **Low saving rate**: While foreign savings are important in financing the saving-investment gap, the most reliable source of funds for investment in a country is its own saving – Pakistan's record in this aspect is also not encouraging. A number of factors are responsible for low savings rate in Pakistan, as mentioned below:
    - **Income level**: As saving is positively associated with income, an important reason for decline in saving is persistently low real GDP growth in Pakistan during the last many years.
    - **Inflation**: High inflation reduces the value of saving; and with given nominal interest rates, it is a disincentive to save in financial instruments. In Pakistan, a continuous five years of double digit inflation between FY08-FY12 has also contributed to decline in saving rates during this period.
    - **Rate of return**: Rate of return on saving is the most important factor affecting saving rate. Data for Pakistan suggests that national saving rates have followed the trend on real interest rate in general. Particularly, private sector saving has strong association with the real interest rate – having a correlation coefficient of 0.62.[26]
    - **Other factors**: Empirical literature[27] on determinants of saving behavior also finds education, financial deepening, culture, religion, and demographic factors (like labor force participation rate, dependency ratio, etc.) as important factors affecting saving rate.
    - **Lack of savings products**: Presently, the formal financial sector offers very limited range of savings products to its customers (e.g., deposits, mutual funds). Products are particularly limited for those individuals who do not prefer interest-based returns due to religious orientation. Therefore, people are drawn towards holding cash, gold, and FX either at their homes, or in bank lockers. These savings are not documented anywhere.
    - **Lack of efforts to mobilize savings**: Institutions involved in savings mobilization like CDNS, asset management companies and commercial banks, do not seem to make strenuous efforts to penetrate in the market to attract customers. It appears that many households are not even aware of savings instruments offered by these institutions, which leads them to use bank lockers to hold savings.
    - **Large undocumented economy**: Due to complex taxation system in the country, households deliberately avoid the modes of savings that necessitate documentation.
- **Difficult business conditions**: Terrorism across the country during the last many years, deterioration of general law and order in big cities and energy shortages made the business environment difficult in Pakistan, which not only kept foreign investors away from the country, but also dissuaded local businesses from expanding their investments in recent years. Pakistan's ranking on the ease of doing business index of World Bank has persistently deteriorated. This index had worsened by 51.5 percent between 2005 and 2015.
- **Policy weaknesses:** Although Pakistan has now achieved reasonable political stability, it has a history of frequent changes in political regimes, which had compromised the quality and

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[26] Weighted average deposits rates have been used for this analysis. SBP policy rate and NSS rates (on Special Savings Certificates) have almost perfect correlation with weighted average deposits rates.

[27] See for example: (a) Edwards, Sebastian 1995; Why are Savings Rates so Different Across Countries? An International Comparative Analysis; NBER Working Paper No. 5097; and (b) Kazmi, Aqdas Ali 2001; A Study on Saving Functions for Pakistan: The Use and Limitations of Econometric Methods; Lahore Journal of Economics; 6:2; Jul-Dec.

consistency of economic decision making.[28] Such weaknesses in policy making not only impacted existing businesses but also kept away new investment.

- **Decline in public sector investment**: Public sector investment, particularly in infrastructure, crowds in private investment, and helps growth. However, in Pakistan the share of public investment has declined from an average of 9.5 percent in 1990s to only 5.5 percent in FY15. One obvious reason is increasing fiscal constraints due to low tax to GDP ratio and meager external financing, which hardly allows the government to spend much on development programs.

The recent low inflation, better balance of payments situation and improved security conditions have provided an opportunity to the policy makers to fix structural issues such as energy constraints, improving governance and increasing public investment. The low inflation would also give cushion to urban households to mobilize savings. However, uplifting the rural saving rate could be a challenge due to the prevailing soft commodity prices. Similarly, a business friendly environment with coherent economic policies can provide adequate incentives for manufacturers to move up in the value chain, and invest in technology that will allow shift from producing low value added goods to high value products.

3.5 Inflation

Benefiting from the persistent slump in international commodity (especially oil) prices and subdued monetary expansion, headline CPI inflation declined to an average of 2.1 percent in H1-FY16, compared to 6.1 percent during the same period last year. This visible decline, however, conceals a key development during the period: inflation has bottomed out. Year-on-year inflation inched up for all three months of the second quarter and reached 3.2 percent by December 2015, against the gradual decline observed in Q1-FY16. As a result, average inflation for Q2-FY16 reached 2.5 percent, compared with 1.7 percent in Q1-FY16 (**Table 3.5**).[29]

This reversal was largely attributed to; (i) lagged impact of depreciation of the PKR during Q1-FY16; (ii) pick up in prices of a number of food items, especially pulses, tea and a few perishables;[30,31] (iii) imposition of regulatory duties on a

[28] For example, a number of incentives were given for investment in fertilizer, power and CNG sectors with a commitment of uninterrupted gas supplies. But such commitments were made without having a fair assessment of available gas resources.

[29] The marginal increase in YoY inflation was not a surprise. With a continuous fall in CPI inflation to only 1.3 percent YoY in September 2015, and fall in WPI for the consecutive eleven months from November 2014 to September 2015, few segments of the society raised concerns of deflation. However, a detailed analysis showed that the headline CPI inflation is likely to bottom out in near future (**Special Section 2** on **Analysis of Deflation** in SBP Annual Report for FY15).

[30] In addition, electricity and gas prices also rose by 3.4 and 9.9 percent on YoY basis respectively in Q2-FY16, compared with only 1.2 percent for electricity charges and no change in gas price in Q2-FY15.

wide range of luxury and non-seasonal items, and a one percentage point increase in customs duties; and (iv) an upward adjustment in petroleum prices (w.e.f. 1st November 2015) (**Figure 3.12**).

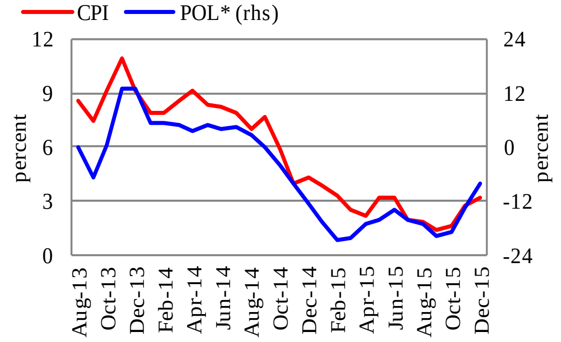
Table 3.5: CPI Inflation (percent)

		Overall	Food	Non-food	Energy	Core		
						NFNE	Trimmed	RSC-CPI*
FY15								
	Q1	7.5	6.6	8.2	9.1	8.0	7.3	8.2
	Q2	4.7	3.6	5.5	-2.5	7.1	5.5	7.4
H1		6.1	5.1	6.9	3.0	7.6	6.4	7.8
	Q3	3.2	1.9	4.2	-6.1	6.2	4.2	6.5
	Q4	2.8	2.0	3.4	-5.0	4.9	3.6	5.2
FY16								
	Q1	1.7	0.3	2.6	-3.5	3.9	2.8	4.3
	Q2	2.5	1.8	3.0	-1.2	3.8	2.8	4.4
H1		2.1	1.0	2.8	-2.4	3.8	2.8	4.3

*Relatively Stable Component of CPI, its detailed methodology and group-wise items along with their weights can be viewed at: http://www.sbp.org.pk/publications/wpapers/2013/wp66.pdf
Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Excluding two most volatile commodity groups from the CPI basket, non-food-non-energy (NFNE) inflation averaged 3.8 percent for Q2-FY16. This was not only well below the level of NFNE inflation (7.1 percent) that prevailed during the same quarter last year, but was also slightly lower than the level in Q1-FY16. Similarly, RSC-CPI recorded 4.4 percent increase in Q2-FY16, compared to 7.4 percent in Q2-FY15. All these core indicators imply that the recent increase in headline inflation was largely driven by both direct and indirect impact of food and energy groups.

Figure 3.12: Headline Inflation in CPI and POL Prices (YOY)



*POL: Average of YoY changes in prices of super petrol and high-speed diesel
Source: Pakistan Bureau of Statistics and State Bank of Pakistan calculations

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[31] The government, faced with revenue shortfall in Q1-FY16, took a number of additional revenue measures in Q2-FY16. These included imposition of regulatory duties and increase in customs duty. Moreover, the government also increased sales tax rates on petrol and high speed diesel in Q2-FY16.

The food group, which accounts for more than one-third of the CPI basket, saw an average inflation of 1.8 percent during Q2-FY16, compared with only 0.3 percent in Q1-FY16. This rise largely stemmed from a sharp increase in prices of a few commodities (including onions, tomatoes, tea, cigarettes, gram and related products); the number of composite food items showing inflation remained almost unchanged during both the quarters.[32] The increase was attributed to different factors, including a pick-up in international tea prices, damages to gram crop, and an upward revision in federal excise duty on cigarettes.[33,34,35]

Among the sub-indices of the CPI basket, the highest increase was recorded in the alcoholic beverages and tobacco group.[36] Average inflation for this group was 18 percent in H1-FY16, compared with 22 percent in H1-FY15, as some products (like cigarettes) are being sold for higher-than-retail prices in different parts of the country.[37]

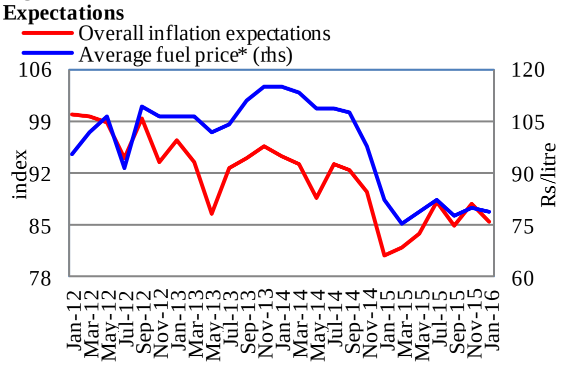
Another important development during Q2-FY16 was a deflation of 8.6 percent YoY in the transport group, down from 11.6 percent in Q1-FY16. In fact, following two downward adjustments in retail prices of petroleum products in Q1-FY16, there was an upward adjustment in November 2015.[38] Moreover, petroleum prices were kept unchanged in December 2015 despite a sharp reduction in international oil prices. As a result, the pass-through of international oil prices to domestic prices slightly slowed during the second quarter. However, it is important to mention here that the pass-through in Pakistan is still stronger as compared with regional and advanced countries (**Box 3.2**).[39]

Among other indices, housing services (house rent, water, gas and electricity) posted an average inflation of 5.1 percent YoY in H1-FY16, compared with 7.3

[32] Prices of perishable food items recorded an increase of 0.7 percent YoY in Q2-FY16, compared to a reduction of 9.8 percent in Q1-FY16.
[33] Domestic tea prices increased following an uptick in international prices. A seasonal increase in local demand also contributed to the rise in tea prices.
[34] Cognizant of damages to gram crop, the government allowed the import of 50,000 tons of gram in September 2015.
[35] Federal excise duty on sales of cigarettes was increased from Rs 3,030 to Rs 3,155 per thousand cigarettes (source: Federal Board of Revenue vide SRO 1181(I)/2015).
[36] This group includes cigarettes, betel leaves, and betel nuts only.
[37] In addition to cigarette, soft drink and kerosene oil are selling at higher prices than fixed by manufacturers/government. This behavior is evident from detailed CPI data. Furthermore, this issue has been highlighted several times in the SBP's State of the Economy reports. However, the benefits of checks on prices from relevant authorities have yet to materialize.
[38] Petrol and diesel prices were increased by Rs 2.5 and Rs 1.75 per liter respectively in November 2015.
[39] The benefit of the fall in international oil prices was passed on to consumers in February 2016.

percent during the same period last year.[40] Moreover, inflation in this group was remarkably stable for both quarters. A relatively lower inflation in house rent during Q2-FY16 was enough to offset the upward revision in gas tariffs for households during September 2015.

Figure 3.13: Fuel Prices and Consumers' Inflation Expectations



*Average of price of super petrol, and high-speed diesel
Source: Pakistan Bureau of Statistics and State Bank of Pakistan calculations

Outlook

The recent iteration of the consumer expectation survey in January 2016 shows a significant decline in inflation expectations compared to the previous survey. Low inflationary expectations were visible in all the commodity groups for the coming six months. It seems that consumers have factored in the potential impact of a sharp fall in international oil prices and stability in the PKR against the USD (**Figure 3.13**).[41,42]

The government reduced domestic petrol prices by 6.6 percent and 11.9 percent in February and March 2016, respectively, following the free fall in international crude prices to 12-year lows.[43] Both direct and indirect impact of lower fuel prices is likely to offset some of the inflationary pressures stemming from additional taxation measures introduced in the second quarter of the year.

Like the consumer expectations survey, a market-based indicator of inflation expectations (yield spread between long-term and short-terms government securities) also points towards lower inflation going forward. Specifically, the secondary market yield spread between 10-year PIBs and 3-month T-bills is gradually edging down from the first week of December 2015 onwards, after

[40] House Rent Index carries a weight of 29.41 percent in the CPI basket. This group includes house rent, electricity, gas, water, kerosene oil, firewood, construction items and construction related wage rate.

[41] After depreciating during Q1-FY16, the exchange rate has moved in a narrow range of Rs 104 to 105 per US$ in the last few months.

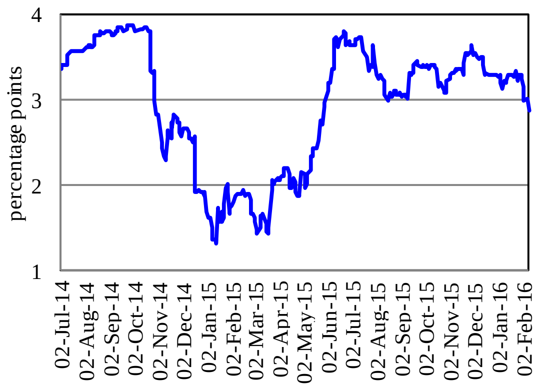
[42] Government has in fact revised petrol and high-speed diesel prices downward by Rs 8.84 per litre and Rs 4.67 per litre respectively.

[43] Global oil prices plunged to 12-year lows of around US$ 35 per barrel in 2015, and are expected to remain considerably low in 2016. In Pakistan, the price of petrol and high speed diesel oil fell by an average of 26.4 and 22 percent, respectively, between October 2014 and December 2015.

inching up in October and November 2015 (**Figure 3.14**).[44] This implies that the market expects inflationary pressures to remain subdued going forward.

Finally, there is a need to account for the potential impact of the low level of prevailing interest rates (through aggregate demand), taxation measures, and movements in the exchange rate on inflation. Taking all these issues into account, SBP expects average CPI inflation for FY16 to fall in the range of 3 to 4 percent, which is well below the target of 6.0 percent for the year.

Figure 3.14: Secondary Market Yield Spread: 10-year PIB and 3-month Treasury Bills



Source: State Bank of Pakistan

Box 3.2: The Economics of Oil Prices Pass-through in Pakistan

Following the persistent reduction in crude oil prices from July 2014 onwards, many countries lowered their fuel prices, which also helped reduce inflation worldwide.[45] The magnitude of this price pass-through has led to perceptions that there exists a one-to-one relationship between international and domestic prices of petroleum products. Similarly, some analysts in Pakistan attribute the fall in oil prices alone for lowering inflation in the country. We briefly review these two points.

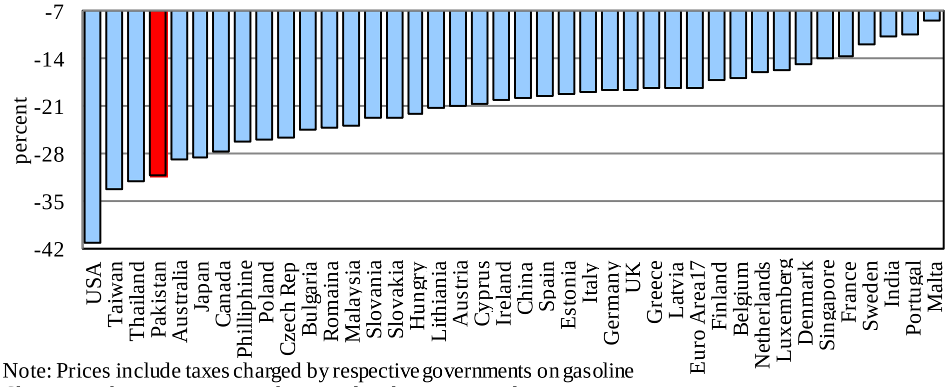
A. Pass-through and one-to-one relationship

Pakistan has followed a prudent policy for the pass-through of the decline in international oil prices to domestic consumers. On the one hand, it has made larger reduction in domestic oil prices compared with a number of other regional countries (**Figure 3.2.1**); on the other hand, it has held up some of the potential consumer surplus with itself. It is not just that the government was able to realize some revenues from this policy; it also helped domestic demand management.

[44] The secondary market yield of 10-year PIBs saw a reduction of 21 bps in January 2016 as compared to a marginal increase of 7 bps during the months of November and December 2015.

[45] International oil prices persistently fell from US$ 105.2 per barrel in July 2014 to US$ 36.5 per barrel in December 2015.

Figure 3.2.1: Change in Retail Gasoline Price in Selected Economies between Oct 2014 and Feb 2016



Note: Prices include taxes charged by respective governments on gasoline
Change is taken as percentage change in local currency per litre
Source: Bloomberg and State Bank of Pakistan calculations

Reducing oil prices means an increase, not only in demand for oil, but also of other consumer goods (as consumers may shift some surplus to other commodities). This could have led to a rise in excess demand and, in turn, led to undesirable fluctuations in the general price level and relative prices.

This policy of cautious pass-through also helped the government prevent a situation of deflation (in consumer prices) in the country, which is even more harmful for economic activity.[46] Inflation in Pakistan remained more stable during the last one and a half years compared to other regional countries.[47] It is important to note that a few countries, like Taiwan and Thailand, faced a deflationary situation mainly because they aggressively passed on the benefit of continuously falling oil prices to their domestic consumers.[48]

Further, higher volatility in prices is harmful for overall economy, as it causes uncertainty in business decision making. Therefore, from economic point of view, it is prudent for the government to create a buffer between global and domestic prices, in order to ensure stability in domestic prices.

In Pakistan, domestic fuel prices are notified by the Oil and Gas Regulatory Authority (OGRA) according to a defined mechanism for linking domestic and international oil prices. Usually, the government adjusts prices on monthly basis to account for changes in international prices and/or exchange rate. However, it must be kept in mind that the pass-

[46] For details see **Special Section 2** on **Analysis of Deflation** in SBP Annual Report for FY15.
[47] The coefficient of variation of YoY CPI inflation during July 2014 to December 2015 is lower in case of Pakistan, compared to Philippines, Singapore, Sri Lanka, Taiwan, Thailand, and Vietnam.
[48] Taiwan was in deflation from January 2015 to August 2015, while Thailand has been facing deflation from January 2015 to January 2016 on YoY basis (source: Haver Analytics).

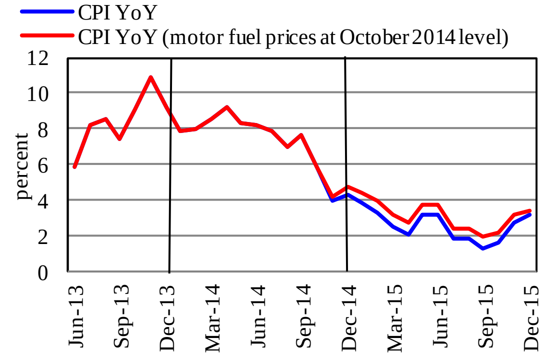
through of changes cannot be one-to-one due to a number of factors, such as taxes, inland freight, and margins of distributors and/or dealers etc.[49]

B. Are falling oil prices the sole cause of lower inflation?

Oil prices have both direct and indirect impact on the prices of goods and services in the CPI basket.[50] It is relatively difficult to measure the indirect impact of oil prices; however, the direct effect of the same can be easily calculated.

For this purpose, we re-calculated the headline inflation from October 2014 onwards by assuming oil prices at the level of October 2014 and compared it with the actual CPI inflation rate (**Figure 3.2.2**). It is evident that inflation shows a declining trend in Pakistan even after excluding the direct impact of fall in oil prices.[51] In fact, inflation in Pakistan started declining in December 2013 – well before the global oil prices began to slide in July 2014.

Figure 3.2.2: Direct Impact of Lower Motor Fuel Prices on Headline Inflation



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

In sum, though the fall in oil prices was one of the major factors behind the recent decline in inflation, others factors such as lower commodity prices (wheat, rice and edible oil) also contributed in softening of CPI inflation. Moreover, a stable exchange rate and a lagged impact of tight monetary policy during FY13 and initial months of FY14 have also played a role to keep inflation on a low trajectory.

[49] Effective April 16, 2006 OGRA is notifying different fuel prices. Also, effective June 1, 2011, refineries and Oil Marketing Companies (OMCs) notify ex-refinery and ex-depot prices of motor spirit (MS), high octane blended component (HOBC), light diesel oil (LDO) and some airline fuels such as JP1, JP4 & JP8. The components for determining prices of different fuel products are ex-refinery price based on concept of "Import Parity", government levies (excise duty and Petroleum Development Levy), inland freight, distributor and dealer margins, and sales tax. For details, see: http://ocac.org.pk/pricingFormula and http://www.ogra.org.pk/cats_disp.php?cat=86

[50] It should be noted that lower international prices of both oil and other commodities such as wheat and rice are among other factors that have contributed to the recent fall in inflation.

[51] As regards the indirect impact, the first round impact of oil prices is on the transport sector. If we adjust this, the overall CPI inflation still shows a declining trend.